Daiwa SB Investments

PM'S PERSPECTIVES

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Regional Bank Stocks are Wonderful

When I think about unpopular stocks, regional banks do tend to pop into my mind at this moment in time. The Financial Services Agency (FSA) indicated that more than half of regional banks are losing money[*1] in their core business. The media describes the business model of regional banks as unsustainable in a negative-interest-rate environment with a falling population in Japan. Now there are only few analysts who focus on regional bank stocks. As a result, many regional bank stocks are trading at a discount, more specifically at only 0.2-0.4 times the book value per share or at 4-9 times the earnings per share. How should we invest in these stocks going forward?

Personally, I am bullish on regional bank stocks, however, only if you choose sound but undervalued names.

I am bullish on regional bank stocks because they are cyclicals whose performances are linked to interest rates, and the interest rates have turned upward. Their business model is simple. They raise money by gathering deposits, and make profits by lending or investing it. With wages and rents at branch offices accounting for a majority of their fixed costs (excluding funding costs), yields on investments and loans determine the performance of regional banks.

Interest rates have been kept low up until now by a couple of factors such as the Bank of Japan (BoJ)'s negative-interest-rate policy, which has pushed down their earnings by cutting loan margins. However, interest rates began to rise in response to the rising interest rates in the US and the BoJ's policy adjustments, which is likely to give a boost to the earnings of regional banks.

References
*1 'Summary Points from for Providing Better Financial Services in the Era of Transition - Financial Services Policy; Assessments and Strategic Priorities 2018'
https://www.fsa.go.jp/en/news/2018/20180926/Financial_Services_Policy2018.pdf
https://www.fsa.go.jp/en/news/2018/20180926/Summary_Financial_Services_Policy2018.pdf

Main criticisms of regional bank stocks and the author's view against them

Main criticisms of regional bank stocks	The author's view
Loans will not grow in a falling population.	The outstanding balance of lendings at regional banks has been expanding over the past 10 years.
The negative-interest-rate environment is pushing down their profit margins.	1) The Bank of Japan reduced an outstanding balance where negative interest rates are applied in July 2018. 2) Loan margins are likely to turn positive at some regional banks.
Competition is intensifying as they increase loans outside the region.	There are movements which mitigate competition. For example, the Shinwa Bank and the Eighteenth Bank both located in Nagasaki Prefecture merged, while megabanks are closing local branch offices.
Their business will be replaced by fintech start-ups.	1) It is difficult for fintech companies to replace banks because they need capital to offer loans. 2) Regional banks may be able to cut costs by using fintechs.
They take on excessive risks in real-estate investments.	You can invest in sober and sound stocks.
They take on excessive risks in securities investments.	You can invest in sober and sound stocks.
It sounds obvious that they are undervalued, because they are always increasing capital.	You can invest in those with fewer risks of capital increases.

Source: Daiwa SB Investments

The industry reorganisation is also a positive factor for the stocks. Regional banks have lagged behind megabanks in restructuring. One of the culprits is the Japan Fair Trade Commission (JFTC). The JFTC was careful about reorganisations in the sector, showing concerns about a rise of their market share in the loan market. Nevertheless, the JFTC approved the merger between the **Fukuoka Financial Group**, which had the Nagasaki prefecture based **Shinwa Bank** under its umbrella, and the Nagasaki prefecture based **Eighteenth Bank** on 24 August 2018. So I expect mergers by regional banks to increase in the future with lower barriers against sector restructurings than before.

I pay attention to the following points in investments in regional bank shares. If you interview regional banks, you can find a number of banks whose fundamentals are solid without any excessive risks and with a clear vision on a path to earnings growth in contrast to their bad public image. At recent earnings announcements, we often see conservative earnings forecasts in sectors related to the three biggest consumer durables, namely houses, automobiles and smartphones, due to their sluggish sales. However, regional banks are immune from this trend as the interest rates are rising. So we expect to see an upturn in their earnings especially in the latter half of the economic expansion.

What the author focuses on in investments in regional bank stocks

Item	Comment
Valuation	1) Are their stock prices cheap in terms of PER and PBR? 2) Are their dividend yields attractive?
Growth potential in the loan balance	1) Do they have ways to increase the loan balance independently outside the region? 2) Can they raise their market share and reap benefits as survivors through industry consolidations etc. within their regions? 3) Are mid- to long-term fundamentals such as demographics in their area and location conditions of their offices favorable?
Risks and profitability in loans	1) Are their lending methods and status of borrowers sound? 2) Are their loan margins likely to turn up?
Securities	1) How much unrealized gains do they have? 2) Aren't they involved in risky investments?
Loan loss reserves	1) Do they have conservative allowance criteria? 2) Is there any possibility that they increase their allowances in the future?
Risk of capital increase	1) Do they have sufficient capital? 2) Do they have a history of capital increases?
Others	1) Is their expense ratio likely to fall? 2) Are their revenue sources including commission income likely to increase? 3) Are managers and staff enthusiastic about their work?

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