cadiz
ASSET MANAGEMENT

# FirstRand
## Ready to conquer an avalanche of bad debts


### ACTING AS A FINANCIAL INTERMEDIARY

FirstRand (FSR) is a significant provider of credit to the economy, offering a universal set of transactional, lending, investment and insurance products and services. Banks act as financial intermediaries, standing between savers and borrowers, earning a portion of their revenue through paying lower interest rates to depositors, and lending out those deposits at higher interest rates. Banks also generate revenue through non-interest income which encompasses all other business activities they engage in.

### STRONG COMPETITIVE ADVANTAGE TO FIGHT OFF NEW COMPETITION

Most of the South African market is still concentrated in five major banks; FirstRand, Capitec, Standard Bank, Absa and Nedbank. FirstRand has a number of leading brands within the group, including First National Bank (FNB), Rand Merchant Bank (RMB), WesBank, and Aldermore. FNB is the main generator of earnings for FirstRand and represents the group's banking activities in the retail and commercial segments in South Africa and the broader African continent.

With the cost of launching a new bank declining over the last few years, South African banks have recently been faced with new competition from entrants that have launched digital banking services. In South Africa, branchless digital banks have started to gain traction with consumers, partially due to banks' encouragement. Although new competition offers banking services and products at lower fees, the cheapest South African banks are not necessarily the most successful at attracting customers. Higher levels of customer satisfaction allow banks to attract customers, giving them pricing power. FNB's customer service levels are one of the highest in the industry. In addition, FirstRand's defensive brands, strong credit products and large customer base strengthen their competitive advantage.

### THE IMPACT OF COVID-19 ON FIRSTRAND

FirstRand operates mainly in South Africa, the rest of Africa as well as in the United Kingdom. Prior to Covid-19, the operating environment in South Africa was already tough as the group faced a weak local economy, largely owing to high government indebtedness, ongoing inefficiencies in the state-owned enterprises, combined with low private sector investment and high unemployment rates. These conditions in turn placed significant and sustained pressure on both household and corporate income.

The South African bank industry as a whole has been significantly affected by the current pandemic as banks are generally geared to economic activity. Due to Covid-19, both consumers and businesses have experienced a loss of income, therefore some borrowers will be unable to meet their debt obligations. As a result, banks will have to write off an increasing amount of bad debts, causing bank's earnings to decline.

While it is likely that the economic impact of Covid-19 will be greater than the 2007-2008 financial crisis, South African banks are also in a better position to weather the storm. Bank capital levels have increased over the past decade and banks have created bigger provisions for future credit losses. South African banks are also unlikely to pay dividends this year, as requested by the regulator.

### HIGH-QUALITY NAME IN THE SECTOR

FirstRand is an above average business which has historically been able to generate positive net income after cost of capital as well as return on equity greater than its cost of equity, creating value for its shareholders. The group is recognised as one of the higher quality banks due to its higher capital position, higher profitability and lower pre-crisis non-performing loans when compared to peers. »

Over the past few years, the company has shown good cost efficiency, which has become critical in the current environment of weaker revenue. FirstRand has been able to efficiently pivot its operating models and exercise stricter cost controls, allowing the business to not only defend its profitability, but also gain a competitive advantage. The group's strong operating margins, driven by a lower cost-to-income ratio than its peers, has allowed FirstRand to consistently achieve stronger returns on equity. Historically, FirstRand is a defensively strong value creator, offering attractive dividend yields to investors.

As a high-quality bank that generates value for its shareholders, we believe that FirstRand is in a good position to protect its balance sheet and return on equity. Capital levels are sufficient to absorb potential losses from a severe economic slowdown. We believe FirstRand is an attractive investment which will provide a superior return over the long term. •

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