Asia Credit Research

Earnings Review: HSBC Holdings PLC ("HSBC")

Issuer Profile: Positive (2)

Ticker: **HSBC**

Background

HSBC Holdings PLC ('HSBC') is one of the world's largest banks by asset size and a global systemically important bank ('GSIB'). Based in London, it is the holding company for the HSBC Group which includes global banking operations across 67 countries and territories through major subsidiaries HSBC Bank PLC (in Europe and the UK) and The Hongkong and Shanghai Banking Corporation, Limited (in Asia) amongst others. As at 31 March 2018, it had total assets of USD2,652.1bn.

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Recommendation

- Rising costs dented HSBC's earnings despite underlying business growth in its key segments. This adds to an already clouded earnings outlook from risks in its major economies (UK and Hong Kong).
- That said, HSBC's size and operating diversity is a key credit strength in our view and supports the continuation of our Positive (2) Issuer Profile.
- With a constructive outlook for banks, we tend to look lower in the capital structure for higher yield. While the HSBC 4.70 PERPc22 is decent value within the AT1 space compared to the Singapore banks which have the same Issuer Profile, we think the BAERVX 5.75 PERPc22 could be a better pick. The spread pick up more than compensates for the smaller but more focused business profile (we presently rate Julius Baer Group Ltd at Neutral (3)). In addition, the reset step-up is higher for the BAERVX 5.75 PERPc22.

Relative Value:

Bond	Maturity / Call date	CET1 Ratio	Ask Yield	Spread
HSBC 4.70 PERPc22 (AT1)	08/06/2022	14.5%	4.16%	183
BAERVX 5.75 PERPc22 (AT1)	20/04/2022	16.7%	4.57%	225
UOBSP 4.0 PERPc21 (AT1)	18/05/2021	14.9%	3.30%	108
ANZ 3.75 '27c22 (T2)	23/03/2022	16.3%	3.24%	94

Indicative prices as at 11 May 2018 Source: Bloomberg
Common Equity Tier 1 (CET1) Ratio based on latest available quarter

Key Considerations

- **Rising expenses dent profits:** HSBC's 1Q2018 reported profit before tax fell 4% y/y to USD4.8bn as 6% y/y growth in reported revenue and lower reported impairment costs were offset by a 13% rise in operating expenses due to business investment and enhancing digital capabilities. Business investment was concentrated on Retail Banking & Wealth Management ('RBWM') in the UK and Mainland China, while technology investment was broad based. Elevated expenses are likely to continue as the bank continues to push into technology and the operating environment remains supportive for on-going business growth. Future expenses may also include further costs associated with Brexit as well as corporate re-organization costs (UK ring-fencing, Hong Kong intermediate hold co). Results also reflected USD897mn in provisions in relation to active discussions with the Department of Justice investigations into prior year residential mortgage-backed securities activities. Adjusting for the provisions and other significant items, adjusted profit before tax of USD6.0bn was still down 3% y/y, primarily due to a significant fall in Corporate Centre performance (balance sheet management, adverse swap mark-to-market movements).

- **Business growth supporting top line:** Revenue growth was driven by deposits and UK mortgage lending volume growth in RBWM as well as higher deposit margins. Within Commercial Banking, lending growth in Hong Kong and the UK, along with better deposit margins and volumes also supported Global Liquidity & Wealth Management performance. Global Banking and Markets ('GBM') performance was flat y/y as lower client activity in fixed income was mitigated by growth in transaction banking and equities revenues. Overall, net interest margins improved q/q and y/y, up by 3bps and 4bps respectively to 1.67% due to a larger rise in gross yields (especially in Hong Kong) compared to the increase in the cost of funds. By segment, Commercial Banking continues to be the highest contributor to total adjusted profit before tax at 35% for 1Q2018. This is followed by somewhat even contributions from RBWM and GBM at 32% and 28% respectively. This broadly balanced mix of businesses supports some level of underlying stability in HSBC's results in our view.

- **European and Asian businesses driving growth**: Supporting the higher business investment, HSBC's balance sheet grew in 1Q2018 with net loans and advances to customers up 2% q/q. As mentioned previously, growth came from UK mortgage lending as well as commercial lending in Hong Kong and the UK. This likely helped segment performance by geography with reported profit before tax in Europe and Asia improving noticeably y/y. Middle East and North Africa and Latin America also improved y/y but their contribution to overall reported profit before tax is relatively small. North America generated a loss before tax of USD596mn, which was due to the higher provisions for investigations into RMBS. As a result of the above, Asia contributed the bulk of reported profit before tax for HSBC (100% for 1Q2018 due to losses in Europe and North America). Excluding provisions and other significant items, Asia's contribution still remains dominant with 79% of adjusted profit before tax.

- **Active capital management with an eye on the future position**: Given earnings and balance sheet growth as well as a transitional impact from implementation of IFRS9 and dividends paid, HSBC's CET1 capital ratio and leverage ratio remained stable q/q at 14.5% and 5.6% respectively as at 31 March 2018. Risk weighted assets growth of 2.6% was marginally ahead of loans growth due to foreign currency translation differences, asset growth and changes in asset quality. Notwithstanding the stable q/q CET1 ratios, HSBC announced an up-to-USD 2bn share buyback as well as its intention to call USD6bn in AT1 capital instruments. Management has guided that given potential growth opportunities, there will be no more share buy-backs expected in 2018.

OCBC Global Treasury

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Explanation of Issuer Profile Rating / Issuer Profile Score

Positive ("Pos") – The issuer's credit profile is either strong on an absolute basis, or expected to improve to a strong position over the next six months.

Neutral ("N") – The issuer's credit profile is fair on an absolute basis, or expected to improve / deteriorate to a fair level over the next six months.

Negative ("Neg") – The issuer's credit profile is either weaker or highly geared on an absolute basis, or expected to deteriorate to a weak or highly geared position over the next six months.

To better differentiate relative credit quality of the issuers under our coverage, we have further sub-divided our Issuer Profile Ratings into a 7 point Issuer Profile Score scale.

IPR	Positive		Neutral			Negative	
IPS	1	2	3	4	5	6	7

Explanation of Bond Recommendation

Overweight ("OW") – The performance of the issuer's specific bond is expected to outperform the issuer's other bonds, or the bonds of other issuers either operating in the same sector or in a different sector but with similar tenor over the next six months.

Neutral ("N") – The performance of the issuer's specific bond is expected to perform in line with the issuer's other bonds, or the bonds of other issuers either operating in the same sector or in a different sector but with similar tenor over the next six months.

Underweight ("UW") – The performance of the issuer's specific bond is expected to underperform the issuer's other bonds, or the bonds of other issuers either operating in the same sector or in a different sector but with similar tenor over the next six months.

Other

Suspension – We may suspend our issuer rating and bond level recommendation on specific issuers from time to time when OCBC is engaged in other business activities with the issuer. Examples of such activities include acting as a joint lead manager or book runner in a new issue or as an agent in a consent solicitation exercise. We will resume our coverage once these activities are completed.

Withdrawal ("WD") – We may withdraw our issuer rating and bond level recommendation on specific issuers from time to time when corporate actions are announced but the outcome of these actions are highly uncertain. We will resume our coverage once there is sufficient clarity in our view on the impact of the proposed action.

Analyst Declaration

The analyst(s) who wrote this report and/or her or his respective connected persons did not hold securities in the above-mentioned issuer or company as at the time of the publication of this report.

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