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UBS: 2Q15 results feedback

UBS reported strong 2Q15 earnings of CHF1.2bn, 53% up on the comparable 2014 quarter. This equates to diluted EPS of CHF0.32 for the quarter and CHF1.28 over the past 12 months, putting the company on a trailing 16.8x P/E multiple. While this appears quite rich when compared to its peers we note the enormous step change in the company's targeted ROE in 2016, which increases from the 2015 target of around 10% to over 15%. If this is indeed achieved, and we think it will be, earnings should rise dramatically. We continue to see UBS as a high quality business that is reasonably priced and well positioned in the new global financial landscape.

We begin this further discussion of UBS' 2Q15 results by looking at ROE. The average adjusted return on tangible equity over the past four quarters was 10.15%, in line with the Group's 2015 return target of "around 10%" It is very significant that UBS targets a return on tangible equity of over 15% from 2016. This, combined with the estimated 50% pay-out ratio makes a strong valuation case for owning the stock. We estimate that tangible BVPS could be around CHF12.30 by December 2015; a 15% return on this base would equate to EPS of CHF1.845 and an 11.7x forward P/E. This multiple is slightly higher than our valuation estimates for a stock like JP Morgan but the differential is justified, we think, because of UBS' significant dividend paying potential. We estimate that the forward dividend yield from 2016 is at least 4.3% p.a. but potentially significantly higher (we have seen credible estimates as high as 8% p.a. by 2017).

UBS does provide quite detailed performance targets and qualifies these as being "over the cycle" (the over 16% ROE target from 2016 is amongst these). Presumably this suggests higher returns should be expected in more favourable market conditions and if the next few years see rising rates then we may indeed see higher performance than these through the cycle estimates. This is probably what underlies the divergence in dividend yield estimates and why the 4.3% we estimated above seems relatively conservative.

As far as interest-rate sensitivity goes, management disclosed that a 100-bpt parallel and instantaneous rise in global interest rates would generate about CHF900mn in additional net interest income across the Group (CHF 600m in wealth management, CHF 200m in wealth management Americas and CHF 100m in retail & corporate). This equates to about 15% of additional PBT. If one restricts this rate increase to the US only, then it would generate about CHF600mn – CHF700mn additional net interest income (NII), or 11% additional PBT. Rising rates would also benefit non-interest income in UBS' case because the bank has temporarily waived fees on certain accounts due to the low rate environment. Management have indicated that they would reverse this fee-waiver were rates to rise.

We note that the above-mentioned expectation of gradually rising US rates is one of the reasons we like global banks (and, associated with this, the fact that they would benefit from higher market volatility and trade volumes that should attend this return to interest rate normality in the US). Global banks seem to be turning a major corner after the traumatic dislocations following the credit crisis; if the torrent of new legislation slows, and legacy issues and litigation get resolved, the 'learning effect' could allow banks to operate much more efficiently within increasingly familiar legal and financial structures.

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We scan the globe looking for good opportunities. We provide our model portfolios, as well as news and views on our watch-list, which is continually reviewed and updated.

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UBS key performance indicators (KPI)s and valuation metrics:

UBS		2Q15	2Q14	Q/Q
Adjusted profit before tax	CHF million	1,635	1,191	37%
Attributable Net Profit	CHF million	1,209	792	53%
Diluted EPS	CHF	0.32	0.21	52%
Return on tangible equity	%	9.6%	7.2%	33%
Total BV/share	CHF	13.71	13.20	4%
Tangible BV/share	CHF	12.04	11.54	4%
Spot share price	CHF	21.52		
PE (on trailing 12m EPS)	x	16.81		
Price/book	x	1.6		
Price / tangible book	x	1.8		

Source: Company data, Anchor Capital

Composition of operating profit:

UBS		2Q15	
Operating profit before tax	CHF million	**1,759**	**100%**
- Wealth management	CHF million	756	43%
- Wealth management Americas	CHF million	191	11%
- Retail & Corporate	CHF million	397	23%
- Global Asset management	CHF million	130	7%
- Investment Bank	CHF million	551	31%
- Corporate center	CHF million	-267	-15%

Source: Company data, Anchor Capital

In addition to return estimates a consideration of the cost of capital is also important. This raises interesting questions: what is the risk free rate for Swiss assets when the 10-year Swiss government bond still trades at a negative yield (-0.1%)? If the equity risk premium is 4% and the beta is below 1 this could suggest a very low, and apparently unrealistic, cost of capital. A lower cost of capital does indeed seem appropriate for the large global banks because of the enormous derisking of their business models that has followed in the wake of the credit crisis. The lingering issue though, is that litigation risk remains high. Thus you could formulate their risk exposures, very generally, in terms of: (1) a significantly derisked core business; and (2) heightened litigation risk. If the second risk dissipates in time, partly as a result of the legacies of the credit crisis being resolved and partly as a result of improved compliance then the overall risk that the banks pose as investments could be quite low and therein lies the potential value uplift. It is indeed true that potential returns on global banks are structurally lower – this is the case for many asset classes in the 'new normal' world of low yields; what is less frequently noticed is that they are also potentially much less risky businesses.

On the topic of derisking, we note the robustness of UBS' balance sheet: their fully applied Basel III CET1 capital ratio was 14.4% in 2Q15, well above their target of at least 13% and ahead of all other large global banks.

Generally, UBS appears well ahead of the curve in terms of managing regulatory change. The bank also continues to receive top awards, amongst these the *Euromoney* award "for Excellence for Best Global Wealth Manager" which, we think, can only amplify fund flows. We further note its strong position in Asia, particularly in China, which should see UBS continue to benefit from growth in GDP and wealth in emerging markets. UBS' management appeared surprisingly unconcerned about the recent equity market rout in China and seemed to regard it as part of the normal turbulence associated with a growing economy (note that Jamie Dimon expressed similar sentiments at JP Morgan's recent quarterly results presentation).

Perhaps it is worth recapping a few general features of UBS business model. The company places an emphasis on building multi-generational client relationships and this long-term approach, we think, significantly adds to the quality of their earnings stream. We also note that the investment bank has been restructured and refocused to become more predictable – it has intentionally moved out of the non-linear parts of the business. UBS is principally a wealth manager and perhaps the "only truly global wealth manager," as the bank likes to characterise itself. Other important KPIs, apart from the ROE targets discussed above, are: for 10% - 15% p.a. growth in profits in its Wealth Management and Wealth Management Americas businesses (i.e. the core of UBS); 3% - 5% net new money growth rate in Wealth Management; a 2% - 4% net new money growth rate in Wealth Management Americas.

A risk that sometimes attends wealth managers is that the true capital that is generating business returns is potentially footloose intellectual capital. So buying the share doesn't necessarily equate to owning the capital that has, in the past, generated excellent returns. UBS is however quite a different kind of entity and although, like all companies, it depends on talented individuals it is so large and systematic that this sort of key person risk would not, we think, apply in its case.

Lastly, note that the next quarter to be reported will be 3Q15 which tends to be quite weak for seasonal reasons. This should be borne in mind when interpreting the business' underlying earnings momentum.

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* note Blake Allen owns UBS shares

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