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INVESTMENT NOTE **24 FEBRUARY 2014**

The 'new' HSBC

Filippo Alloatti, Senior Analyst at Hermes Credit, reacts to today's HSBC results

Pre-tax profit came in at the lower end of estimates and the market is concerned about bottom-line growth. That said, the management is probably right in evocating choppy waters ahead.

A lot has already been achieved. The group has started a massive simplification of the business model which could eventually mean that the management will have a better control of the various parts of the "empire". Since 2011, more than 50 transactions have been announced or closed, reducing existing business and selling business, for a total of $95bn RWAs or 8% of the FY12 group total. HSBC now operates in 35 countries down from 50 which is positive for the investment case as it has helped increase capital. HSBC CRD IV common equity tier 1 ratio (CET1) has reached 10.9% as of FY13. Given the size and complexity of the group, we feel more can be done here. The previous guidance of CET1 of more than 10% needs an update. Issuance of contingent convertible (CoCo) in additional tier 1 (AT1) could help to that end.

Other than EM's exposure (~15% of Group profit and 50% of revenues), the market will also *most likely* focus on outlook for top line growth and potential for further cost cutting. Since 2011 $4.5bn has been taken out of the cost base and headcount has been reduced by 28,000. Additional cost cutting in growth regions, such as Asia Pacific (15% of total loans), are open for debate as well. Especially considering peers are still investing. In the 10th anniversary of the ill-fated takeover of Household, management's attention will turn to the US. HSBC USA Inc, the entity that contains the Group's US bank is badly in need of restructuring as its low single digit RoE is well below the management's target. There is further room for optimisation in the UK, continental Europe, where progresses have been made.

Given the recent scandals that have plagued the industry, including PPI, money laundering, and LIBOR, compliance and regulatory costs will only continue to increase. In fact, at Q3 they were up by a marginal $500m. The question is, whether this will *meaningfully* reduce the volatility of future earnings. In terms of reserving for claims, HSBC has cumulatively put aside more than $4bn in provisions for its UK customer redress since 2011; some $2bn should still be on its book.

Regarding the UK "ring-fence", this will surely cause HSBC much less of a headache than peers such as Barclays or The Royal Bank of Scotland, as almost 80% of the revenues are generated outside of the UK. Lastly, I do not expect an impact on HSBC cap securities as these are issued out of HSBC Holdings PLC.

-ENDS-

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