VM Wealth Management Limited

Bond Analysis: HSBC 8.00% Perpetual (Callable 2028)

VMWM Research | November 15, 2023

876-960-5000 vmwmclientservices@myvmgroup.com vmwealth.myvmgroup.com 53 Knutsford Boulevard, Kingston 5

- **Bond Recommendations:**

Conservative Risk Appetite: **UNDERWEIGHT**

Moderate Risk Appetite: **OVERWEIGHT**

Aggressive Risk Appetite: **MARKETWEIGHT**

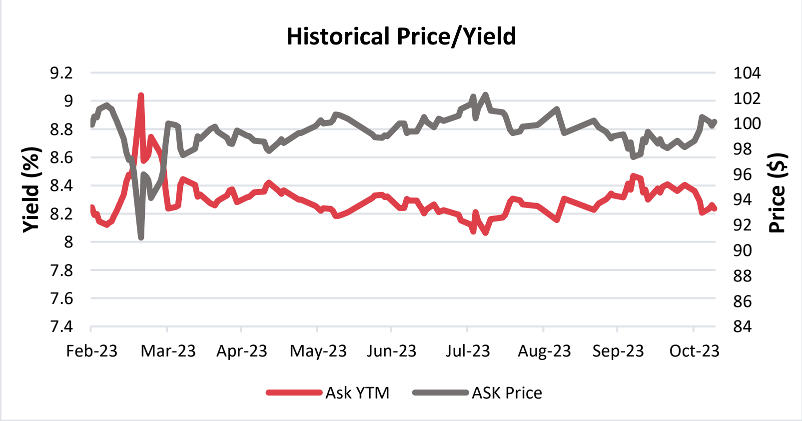
ABOUT THE COMPANY

HSBC Group or HSBC Holdings plc (HSBC) is a multinational financial services organization headquartered in London, UK. It is one of the largest and most prominent banking and financial services institutions in the world. HSBC provides a wide range of financial services, including retail and commercial banking, wealth management, asset management, insurance, and investment banking. HSBC caters to a diverse and multinational clientele, serving millions of customers, including individuals, businesses, institutions, and governments.

Despite the company's exposure to foreign currency risks, via its global operations, HSBC has consistently grown its profit year-over-year through, strongly driven by interest income. While aligning efforts to strategic developments to boost the company's financial performance, HSBC has made commitments to environmental and sustainability goals, including efforts to reduce its carbon footprint and promote sustainable finance.

While HSBC continues its global expansion, with a recent announcement of to widen product offerings in India, the company is also on its quest to digital asset adoption. HSBC plans to introduce a digital assets custody service for institutional clients investing in tokenized securities in 2024. This service, along with HSBC Orion, the platform for issuing digital assets, and the recently launched tokenized physical gold offering, will provide a comprehensive digital asset solution for HSBC's institutional clients.

Barclay's PLC: Bond Term Summary	
Parent Company	HSBC Holdings PLC
Issuer	HSBC Holdings PLC
Currency	USD
Issued Amount	2,000,000 (M)
Issue Date	03/07/2023
Tenor	Perpetual/Call
Industry	Finance (Banking)
Ask Yield to Worst (As of November 8, 2023)	8.02%
Call Price (Ask Price to Worst)	$100
Coupon	8.00%
Issuer Credit Rating (S&P)	A-
Outlook (S&P)	Stable
Maturity Type	Perpetual/Call Next Call date: 03/07/2028
Maturity	Perpetual/Call
Day Count Basis	30/360
Use of proceeds	Refinancing, General Corporate Purposes and Maintaining Capital Base



Recommendation: HSBC witnessed a significant surge in net profit, coupled with improvements in the cost-to-income ratio and net interest margin. Despite the inherent risk in the 8% perpetual bond, its appeal is bolstered by an ample liquidity coverage ratio (134%), reliable funding options, and the issuer's investment-grade credit rating. While an attractive yield option for moderate investors, the comparatively low ask yield diminishes its allure for more aggressive investors when compared to peers.

ECONOMIC OVERVIEW (UNITED KINGDOM & Hong Kong SAR)

With its headquarters in the UK, the performance of the UK economy significantly impacts the operations of HSBC. The UK economy grew by 0.20% in August 2023, which was driven primarily by the services sectors, while the manufacturing and construction sectors contracted. The IMF projects that the UK economy is expected to contract from a growth rate of 4.10% in 2022 to a growth rate of 0.50% in 2023. This projection is influenced by the implementation of tighter monetary policies aimed at controlling persistently high inflation and the continued effects of a terms-of-trade shock resulting from elevated energy prices. The Bank of England (BOE) has lifted the policy rate to a 15-year high of 5.25% over 14 consecutive rate hikes. Despite a recent pause by the BOE, the policy rate is expected to remain elevated for an extended period of time, which will negatively impact growth. On October 20, 2023, S&P Global Ratings (S&P) affirmed its 'AA/A-1+' unsolicited long- and short-term foreign and local currency sovereign credit ratings on the UK. The outlook for these ratings continues to be stable. This decision is based on the UK's strong economic performance, which has remained resilient despite facing various challenges. Additionally, there is an expectation that government deficits will gradually decrease over the next two to three years.

The company also has a strong presence the Hong Kong SAR, which is impacted by activities in Mainland China. The IMF anticipates a 4.40% GDP growth for Hong Kong SAR in 2023, an improvement from the 3.50% contraction in 2022. As of September 2023, Hong Kong's 12-month inflation rate increased to 2%, compared to the previous two months where it stood at 1.80%. The IMF anticipates that the price index will reach 2.60% by the end of the year. In November 2023, the Hong Kong Monetary Authority (HKMA) decided to maintain its base rate at 5.75%. This decision followed the US Federal Reserve's choice to pause its monetary tightening cycle. Hong Kong has traditionally aligned its monetary policy with that of the Fed since 1983 to uphold the peg of the local currency to the US dollar. On March 30, 2023, Fitch Ratings reaffirmed Hong Kong's Long-Term Foreign-Currency Issuer Default Rating (IDR) at 'AA-' with a Stable Outlook. The ratings are underpinned by substantial fiscal reserves, strong external finances, and high per capita income. Additionally, the ratings acknowledge the increasing alignment of governance and institutional management practices with mainland China (A+/Stable), a trend that has been progressing steadily since 2019.

NINE MONTHS ENDED SEPTEMBER 30, 2023 (9M 2023)

$ (millions)	FY 2021	FY 2022	9M 2022	9M 2023
Net Operating Income	50,480	48,135	33,898	50,621
Operating Costs	34,620	33,330	23,837	23,720
Net profit	14,693	16,670	11,588	24,337
Return on Shareholders' Equity	7.10%	8.70%	8.40%	18.30%
Net interest margin	1.20%	1.48%	1.33%	1.70%
Cost Efficiency ratio	69.90%	64.40%	66.30%	44.20%
Total assets	2,957,939	2,966,530	2,991,965	3,020,611
Total Shareholders' Equity	198,250	187,484	177,659	182,720
Liquidity coverage ratio	139%	132%	127%	134%
Leverage Ratio	5.20%	5.80%	5.40%	5.70%
Common Equity Tier 1 ratio	15.80%	14.20%	13.40%	14.90%

For the nine months ending September 30, 2023, HSBC reported a net operating income of $50.62 billion, representing a 49.33% YoY increase compared to the $33.90 billion recorded during the same period in the previous year. The revenue growth during the reporting period can be attributed to several factors including an impairment recorded in 9M 2022 and a subsequent reversal in 9M 2023 related to the planned sale of the company's retail banking operations in France. Additionally, a provisional gain on the acquisition of Silicon Valley Bank (SVB) UK contributed to this increase. Also, wider interest rate spreads resulting from the Bank of England's tighter monetary policy generated revenue for the insurance, wealth and advisory segments.

Operating costs saw a slight decrease of 0.49% ($117.00 million), amounting to $23.72 billion. This decline was primarily attributed to favorable foreign currency translation differences between the periods. Lower restructuring and related costs, a reversal of historical asset impairments and a continued focus on cost discipline contributed to the reduction in operating costs. However, these positive factors were offset by increases in technology costs, the impacts of rising inflation, and higher performance-related pay accrual. Additionally, severance payments recorded in the first half of 2023 related to employee restructuring contributed to the overall operating costs.

As the growth in income outpaced that of expenses, the company's cost efficiency ratio improved from 66.30% to 44.20%, indicating better efficiency which is essential to improving profitability. The company's net profit more than doubled at the end of the 9-month period, jumping from $11.59 billion to $24.34 billion. This boost in net profit significantly improved the return on average shareholders' equity (ROE), which increased by 990 basis points (bps) from 8.40% at the end of Q3 2022 to 18.30% at the end of the reporting period, indicating enhanced efficiency in generating profits from the equity base.

As of the end of Q3 2023, HSBC reported a slight year-on-year growth of 0.96% in its asset base, reaching $3.02 trillion, stemming from growth in financial investments and an increase in settlement accounts. These positive factors were partly offset by a decrease in assets held for sale, lower loans and advances to customers, and a reduction in reverse repurchase agreements. Notably, the bank's liquid assets improved its liquidity coverage ratio (LCR) of from 127% to 134%, exceeding regulatory requirements. These assets are effectively hedged against interest rate risk.

The Common Equity Tier 1 (CET1) ratio for the bank stood at 14.90% at the end of Q3 2023, compared to 13.40% in the comparative period. CET1 is a crucial measure of capital adequacy in the banking industry, with a Basel III benchmark of 4.50%. It represents the highest quality capital that a bank holds, and serves as a financial buffer to absorb losses, ensuring the stability and solvency of the bank. CET1 capital is used to assess a bank's ability to withstand financial stress, even during challenging economic conditions.

The leverage ratio for the period was 5.70%, a slight decrease from 5.90% in Q3 2022. This change was attributed to an increase in tier 1 capital. It's important to note that the UK minimum leverage ratio requirement of 3.25% was augmented by a leverage ratio buffer of 0.90%, comprising an additional leverage ratio buffer of 0.70% and a countercyclical leverage ratio buffer of 0.20%. The leverage ratio is a measure of a bank's capital adequacy and its ability to cover its total exposure with its capital.

ISSUER RATINGS ANALYSIS

Standard & Poor's: A-/Stable

On May 13, 2020, S&P lowered its issuer credit ratings on HSBC 'A-/A-2' from 'A/A-1' with a stable outlook. The downgrade by S&P reflects their anticipation of HSBC's earnings prospects staying subdued for an extended period, coupled with a significant restructuring. However, the stable outlook suggests confidence that HSBC's robust balance sheet profile and diversified exposures are expected to provide resilience even in the face of potential economic risks across key geographies. The rating and outlook were last reviewed by S&P in May 2023.

Fitch Ratings': A+/Stable

On September 8, 2023, Fitch Ratings affirmed HSBC's Long-Term Issuer Default Rating (IDR) at 'A+' with a stable outlook. The ratings also include a 'a+' Viability Rating (VR). HSBC's ratings are based on its strong franchise, conservative risk profile, substantial capital and liquidity buffers, solid asset quality, and profitability. The group's global network and diversified business model, balancing retail and commercial banking with moderate market activities, contribute to its robust business profile. The impact of high interest rates has been significant in boosting HSBC's income, mitigating risks associated with strategic initiatives and restructuring in certain parts of the group.

BOND RATINGS ANALYSIS

Fitch Ratings': BBB

Fitch assigned a credit rating of 'BBB' to the 8% perpetual bond, which is lower than the issuer's 'A+' rating. This rating discrepancy is due to perpetual subordinated bonds being classified as junior debt, making them relatively riskier for creditors. In the event of a borrower default, holders of perpetual subordinated loans have a lower repayment priority than holders of unsubordinated loans. The heightened risk associated with subordinated loans leads to higher interest rates compared to unsubordinated bonds. Perpetual bonds allow issuers to raise capital without the obligation of repayment, providing investors with a continuous stream of interest payments indefinitely.

OUTLOOK

The Diversified Business Model

HSBC's strength lies in its robust global network and well-established franchises in key markets, forming a solid foundation for its business. The bank maintains a diversified business model, strategically balancing its focus on retail and commercial banking with moderate involvement in markets activities. The current environment of high interest rates has significantly boosted HSBC's net interest income, serving as a substantial mitigating factor against risks associated with the ongoing restructuring efforts, particularly in addressing underperforming segments within the group.

Resilient Funding and Liquidity Position and Strong Capitalization Strategy

HSBC is anticipated to maintain a secure funding and liquidity position, backed by robust retail funding franchises in its core markets and access to well-established global capital markets with strong investor demand. Furthermore, the group's capitalization is expected to stay strong, aligning with risk levels, with a targeted CET1 range of 14%-14.5%, reflecting flexibility in capital management and reliable access to capital.

COMPARABLES ANALYSIS

When compared to a few peers of a similar S&P credit rating in the table below, the coupon on HSBC 8% Perp is equivalent to BACR 8% Perp and HSBC 8% Perp. However, the ask yield, which is the lowest possible yield an investor can expect to receive from a bond, is below the comparable average, with the shortest period until the first call date in July 2028.

Issue	Ask Price ($)	Bond Rating (S&P)	Tenor	Ask Yield (%)	Spread (bps)
Llyods 8% Perp	91.727	BB-	2029*	9.996	557.40
Barclays 8% Perp	92.1216	BB-	2029*	10.043	562.07
HSBC 8% Perp	101.3485	BBB**	2028*	7.655	324.19
US 5Y***	101.9609	AA+	2028	4.428	-

(***) Benchmark

(**) Fitch Ratings

(*) Call Date

Source: Bloomberg (November 14, 2023)

INVESTMENT POSITIVES

1. **The Company Remains Liquid**: The LCR is above the 100% benchmark, which signals HSBC's ability to meet short term debt obligations, including coupon payments and the financing the company's recent share buyback programme and dividend payment.
2. **Geographic diversity**: With operations across various regions in Europe, Asia and North America, the company mitigates the risk associated with economic, political and social instability in a particular region.
3. **Continued Cost Efficiency:** The company has implemented strategic cost containment measures, which have reaped the reward of improved efficiency and is anticipated to continue bettering HSBC's operations.
4. **Strong Income Potential:** HSBC is anticipated to benefit from wider interest spreads in the next 12-18 months, as monetary conditions remain tight to combat elevated inflation.
5. **Stable Issuer Ratings:** Standard & Poor's, Fitch and Moody's affirmed HSBC' issuer ratings in the last 12 months, indicating stable creditworthiness and financial stability.
6. **Consistently Robust Financial Performance:** The company has been able to grow profit annually, while improving key financial metrics such as ROE and LCR, which highlights its ability to maintain interest payments to bondholders.
7. **Strong Capital Base:** A stable CET1 ratio indicates HSBC's strong capital base, which enhances its financial stability by providing a buffer against unexpected losses and economic downturns, reducing the likelihood of financial distress or defaults.

INVESTMENT NEGATIVES

1. **Mainland China Commercial Real Estate Decline**: With a strong presence in Hong Kong SAR, which has strong economic ties with China, HSBC faces increases expenses relating to expected credit losses (ECL) due to the decline in the commercial real estate market in China.
2. **Bond Rating Lower Than Issuer:** The bond rating of the 8.0% Perpetual Bonds is lower than the issuer's rating because they are classified as Junior Subordinated debt, implying a lower claim in case of financial distress or default. This lower bond rating suggests higher credit risk for bondholders.
3. **Slow UK Economic recovery:** Elevated interest rates, persistent uncertainties, and sluggish productivity may pose challenges for the UK in maintaining economic stability, which could negatively impact the demand for HSBC's products and services, while deteriorating its existing portfolios.
4. **Elevated Inflation May Lead to an Increase in Non-Performing Loans:** Increasing inflation and higher interest rates are expected to have a negative impact on households' disposable income and their ability to manage debt payments.

VM Wealth Management Limited

Bond Analysis: HSBC 8.00% Perpetual (Callable 2028)

VMWM Research | November 15, 2023

CONCLUSION

During the initial nine months of the ongoing fiscal year, HSBC experienced a substantial increase in net profit, accompanied by enhancements in both the cost-to-income ratio and net interest margin. This was supported by the company's geographic diversification, cost containment measures and the gains from higher interest rates. Notably, the 8% perpetual bond, despite carrying inherent risks, remains appealing due to a robust liquidity coverage ratio of 134%, dependable funding alternatives, and the issuer's investment-grade credit rating. While positioned as an enticing high-yield choice for moderate investors, it should be noted that the bond's appeal may be less pronounced for more aggressive investors, especially when compared to offerings from peer institutions.

Therefore, we recommend that investors consider buying HSBC 8.0% Perpetual Bonds for their strong appeal as follows:

Conservative Risk Appetite: UNDERWEIGHT (Due to the Maturity risks and the Perpetual bonds being consider Junior Subordinated Debt)

Moderate Risk Appetite: OVERWEIGHT

Aggressive Risk Appetite: MARKETWEIGHT (Due to lower ask yields to its counterparts)

DEFINITIONS

- **OVERWEIGHT** - Security is deemed to be undervalued and is expected to outperform compared to the average market return and/or return of comparable securities in the same sector or industry.
- **MARKETWEIGHT** – Security is expected to provide similar returns compared to the market in general or at the same pace as comparable companies; neither strongly positive nor negative.
- **UNDERWEIGHT** – Security is deemed to be overvalued and is expected to underperform compared to the average market return and/or return of comparable securities in the same sector or industry.
- **ZEROWEIGHT** – This security is substantially distressed or at risk of a shock which may significantly impair its value.