Axiom Alternative Investments

Investing with a financial sector specialist

Webinar – European Banks, Q2 2024 results

09/05/2024

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This document was prepared by Axiom Alternative Investments Ltd.

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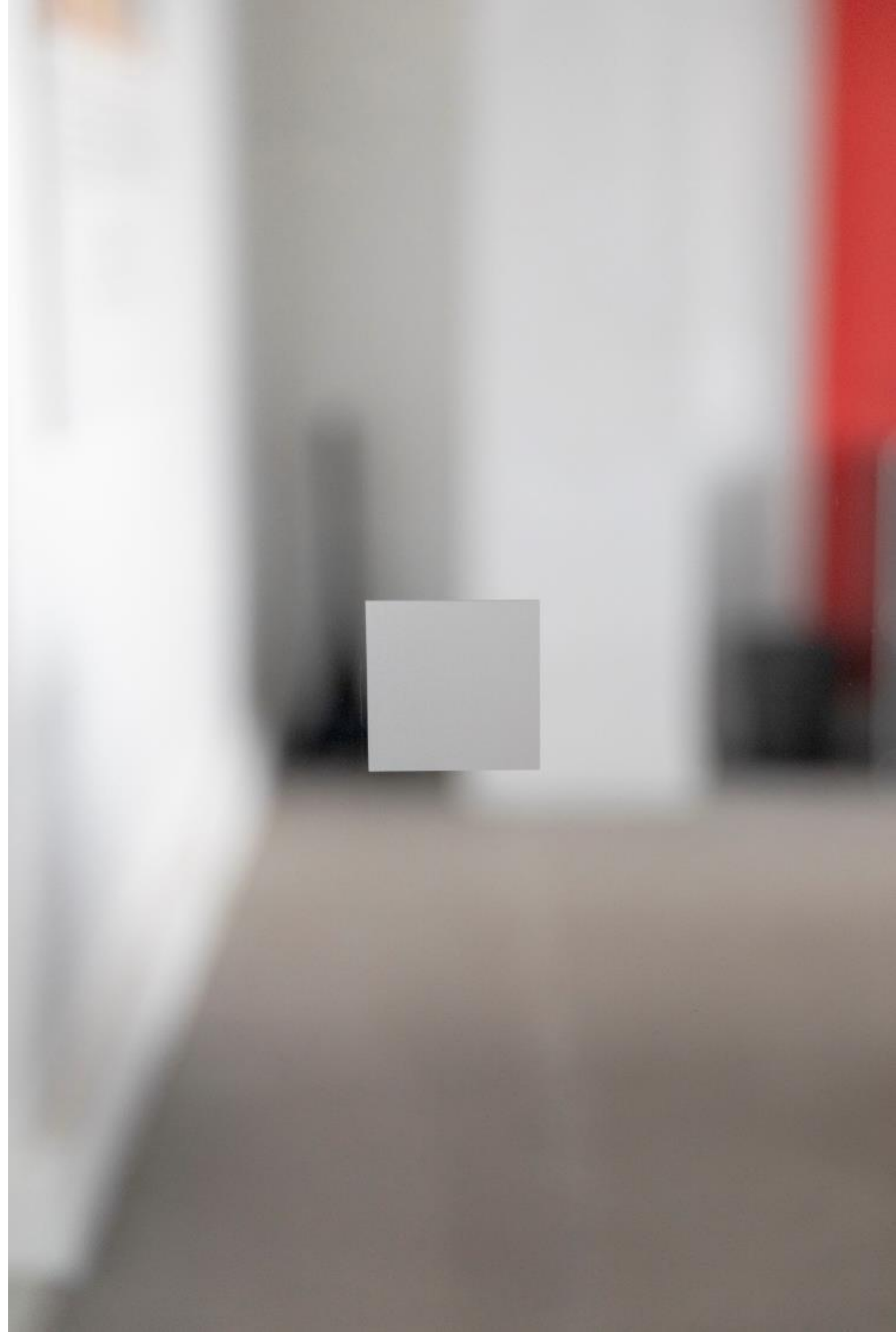
ANTONIO ROMAN

I. Q2 earnings review

II. European bank equities update

III. European financial credit update



Key takeaways

European Banks earnings expectations are being revised higher for the 17th quarter in a row

- **Net interest margin** and **costs** expectations **have stabilized. Volumes** and **fees** are driving **upgrades**
- **The UK and Eastern and Southern Europe** have had the most positive revisions
- **Société Générale** has suffered from weak retail revenues, while **Commerzbank** was penalized by wage negotiations

Multiples remain stuck at c. 7x earnings

- H1 rerating was partly reversed during the summer. The sector is trading just below 7x vs. 7.5x in May
- **The discount to the broader market remains very high at 45%,** vs. pre-Covid levels of 25%-30%
- The sector is trading at a ~70% gap to its fair value (Gordon-Shapiro DDM)
- This **persistent gap** could be explained by “peak earnings” sentiment and fears of external interventions (special taxes, restrictions on distributions, etc.)

The carry is there, but the bull case needs a catalyst

- Banks are still the leading sector in terms of distribution with a **total cash yield of c. 11%**
- **Economic growth rebound following rate cuts** could be a strong **catalyst** for European Banks stock rerating : steeper curves driving further NII growth, higher volume and fee growth expectations, lower political risk
- In the meantime, we are **paid to wait with a c. 15% carry** (of which 11% in cash and 4% in book value accretion)

Financial credit highlights

- Financial credit has benefited from upgrades and spreads tightening
- Though current spreads are towards the lower end of their historic range, the average credit quality is at its highest
- The CMDI package could impact senior spreads

Source: Axiom Alternative Investments

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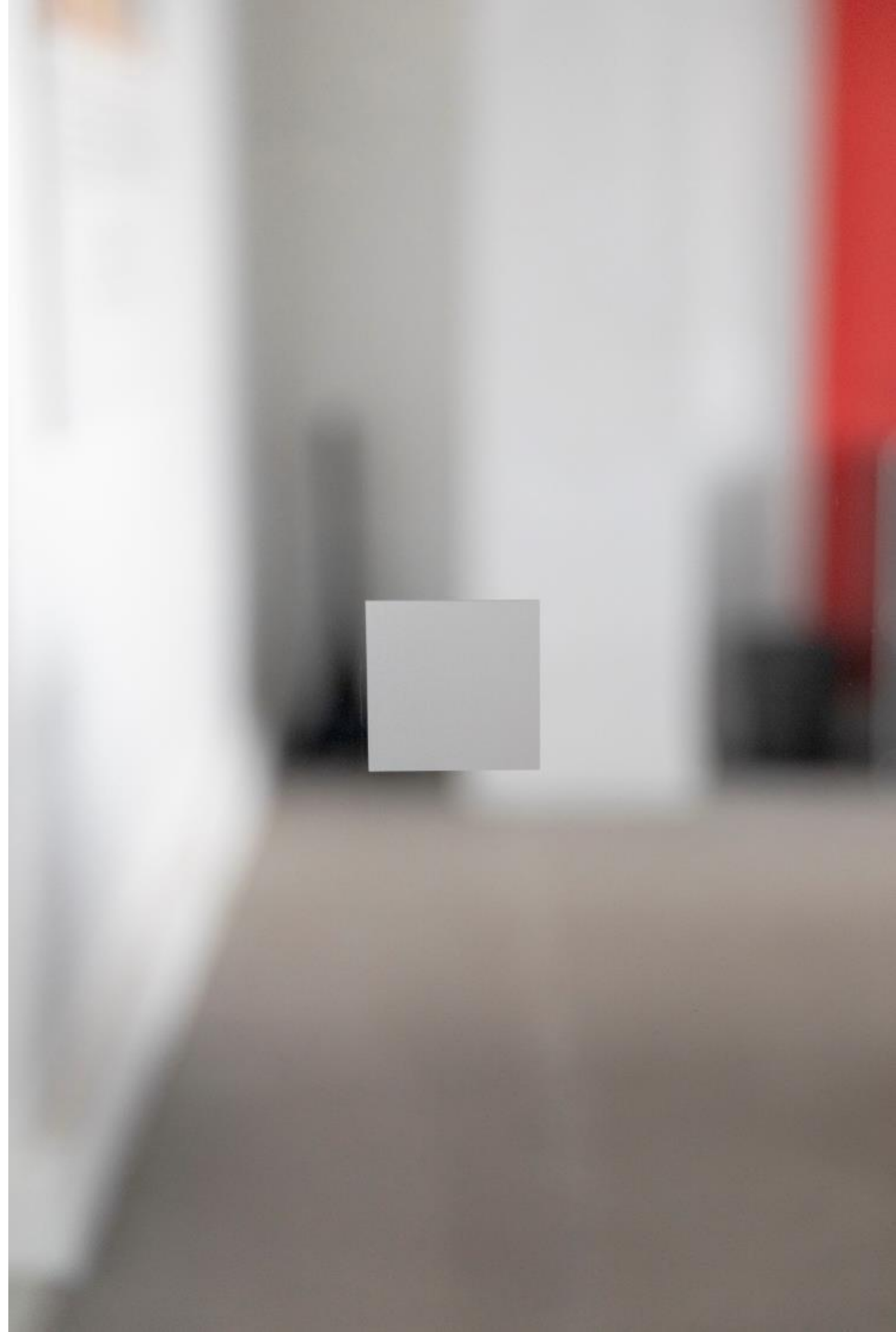
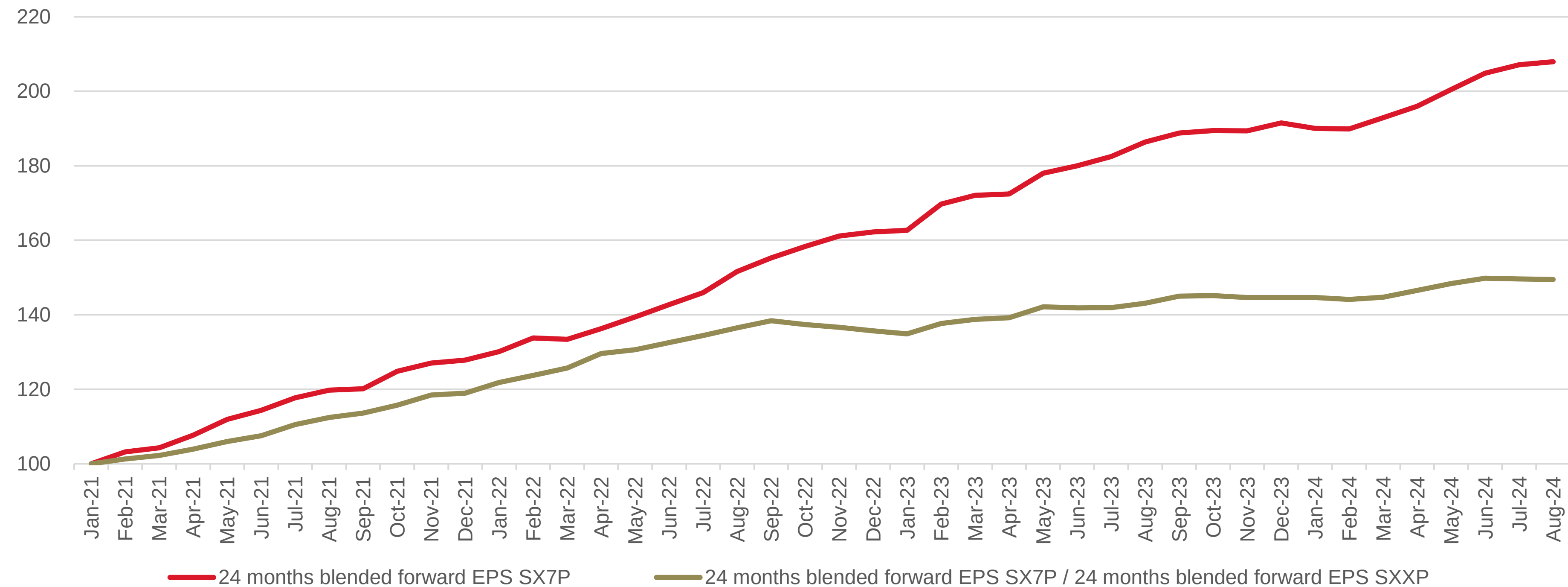


I.1 Bank earnings expectations are still being revised higher

Stoxx 600 Banks: absolute and relative earnings expectations, 24 months forward

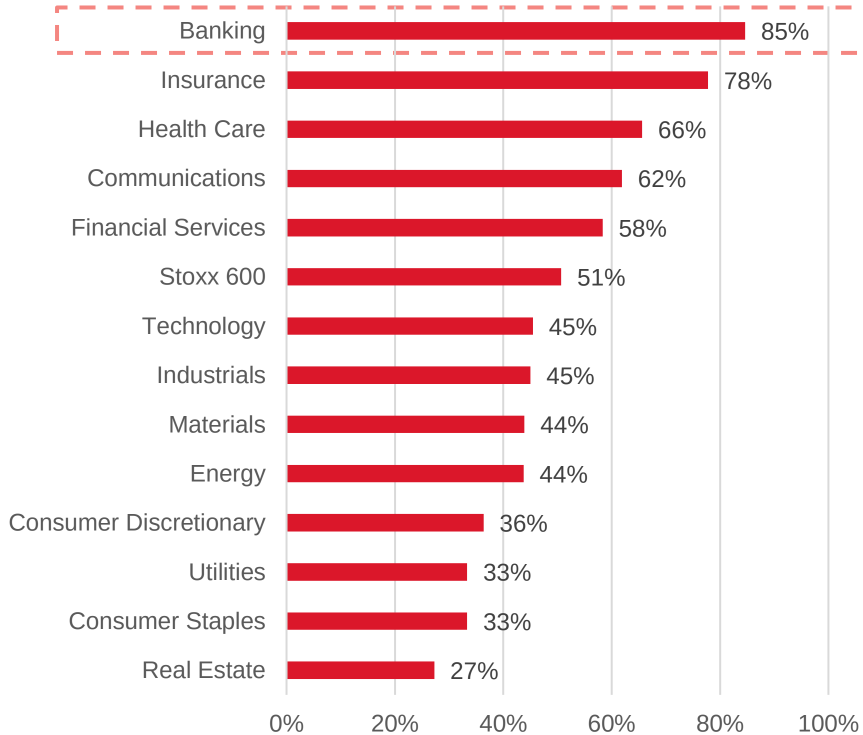


The strength and longevity of the bank earnings upgrade cycle continues to surprise

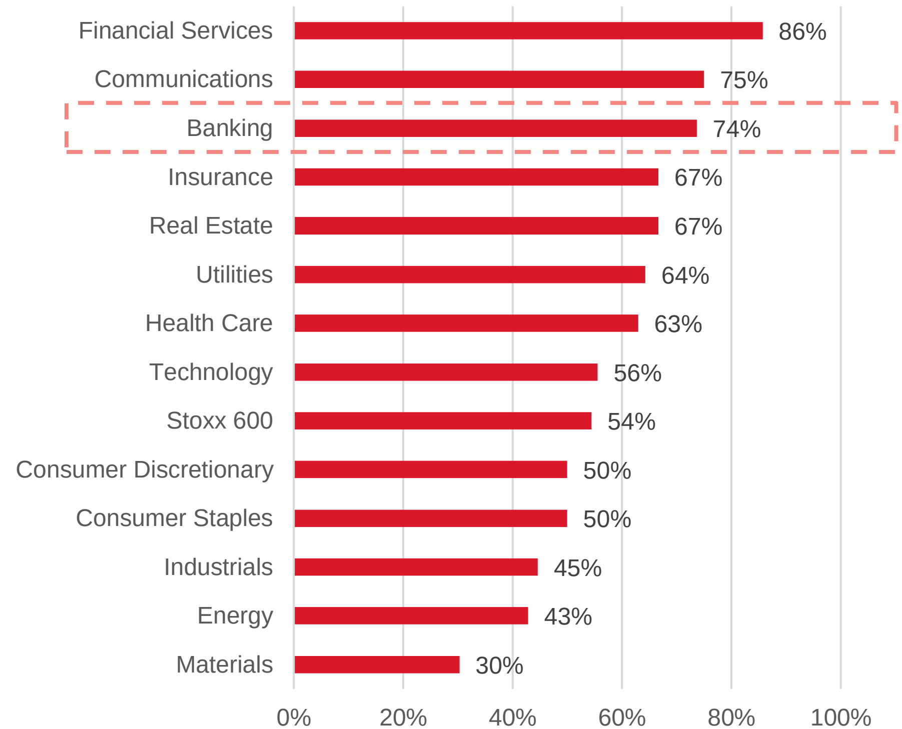
Data as of 20/08/2024 | Source: Axiom Alternative Investments

I.2 Banks had the best rate of positive sales surprises

Positive sales surprise



Positive earnings surprise

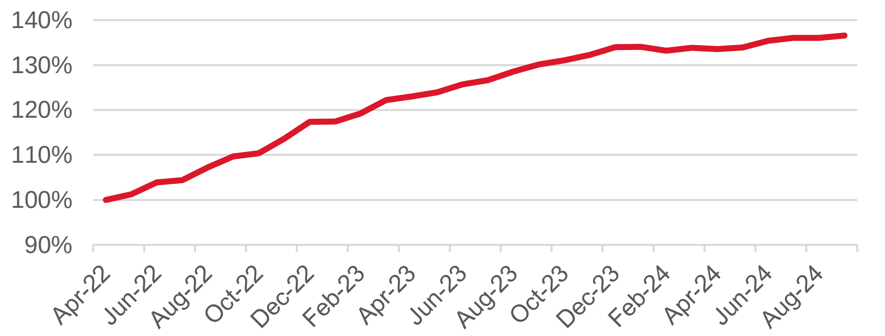


In a mediocre European Q2 earnings season overall, financials and banks in particular displayed excellent revenue dynamics

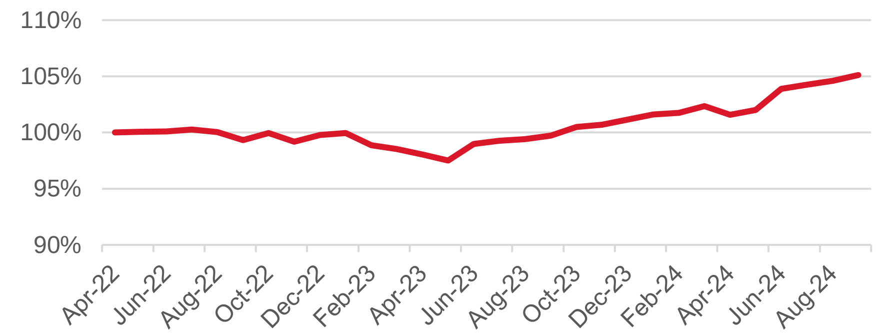
Data as of 20/08/2024 | Source: Axiom Alternative Investments

I.3 Commissions are gaining momentum

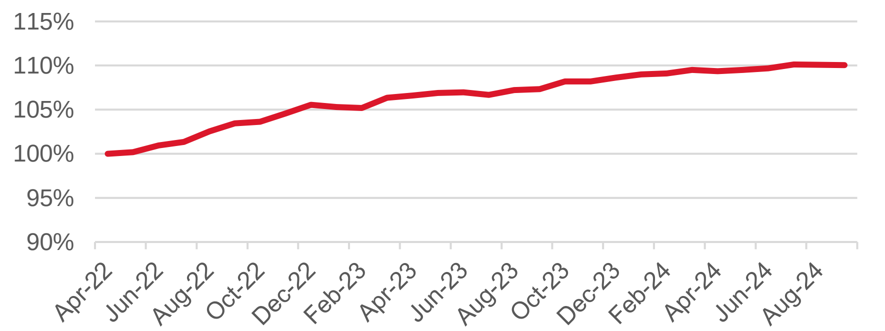
FY24e Net Interest Income (rebased)



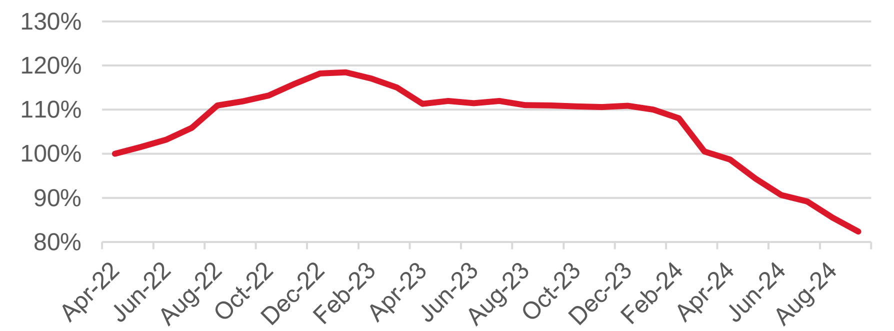
FY24e Fees (rebased)



FY24e Costs (rebased)



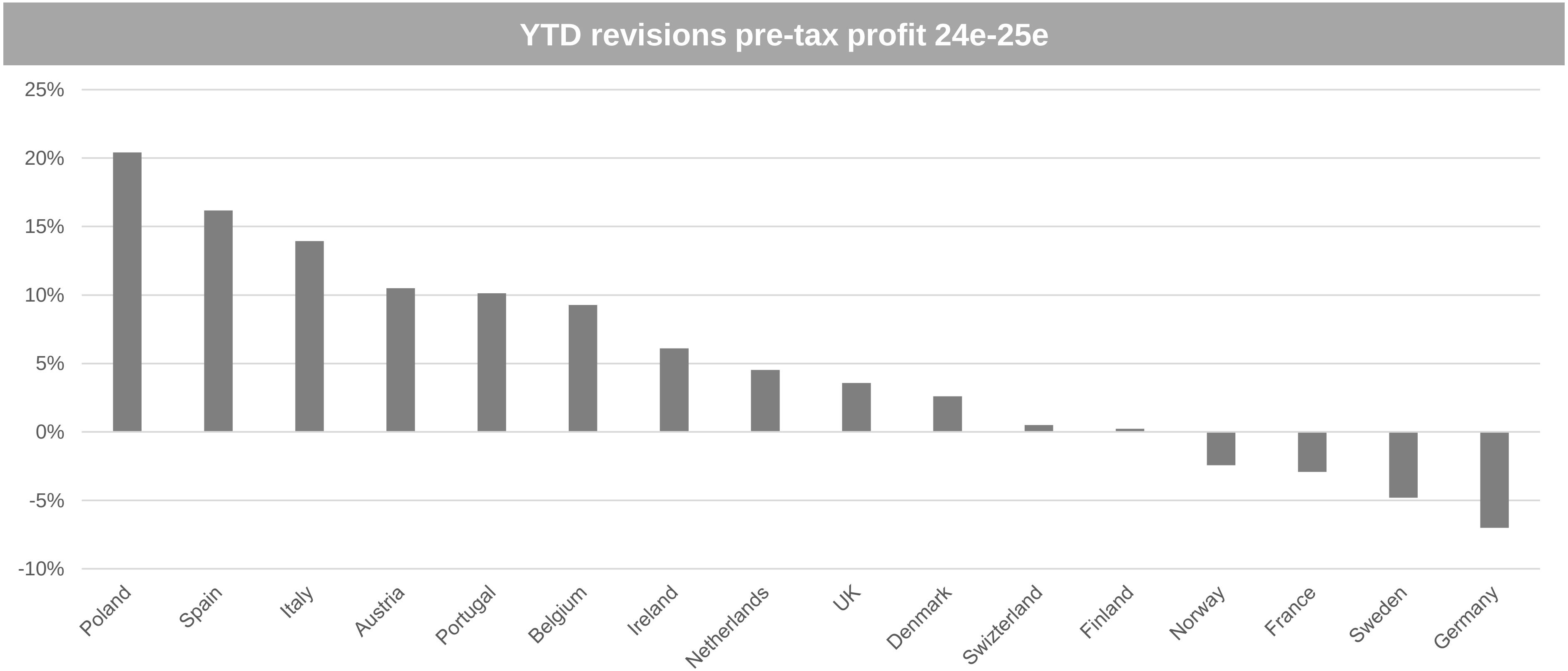
FY24e Provisions (rebased)



The quarter was characterized by in-line costs, slightly better net interest income thanks to volume effects, strong commissions across the board, and a low cost of risk

Data as of 20/08/2024 | Source: Axiom Alternative Investments

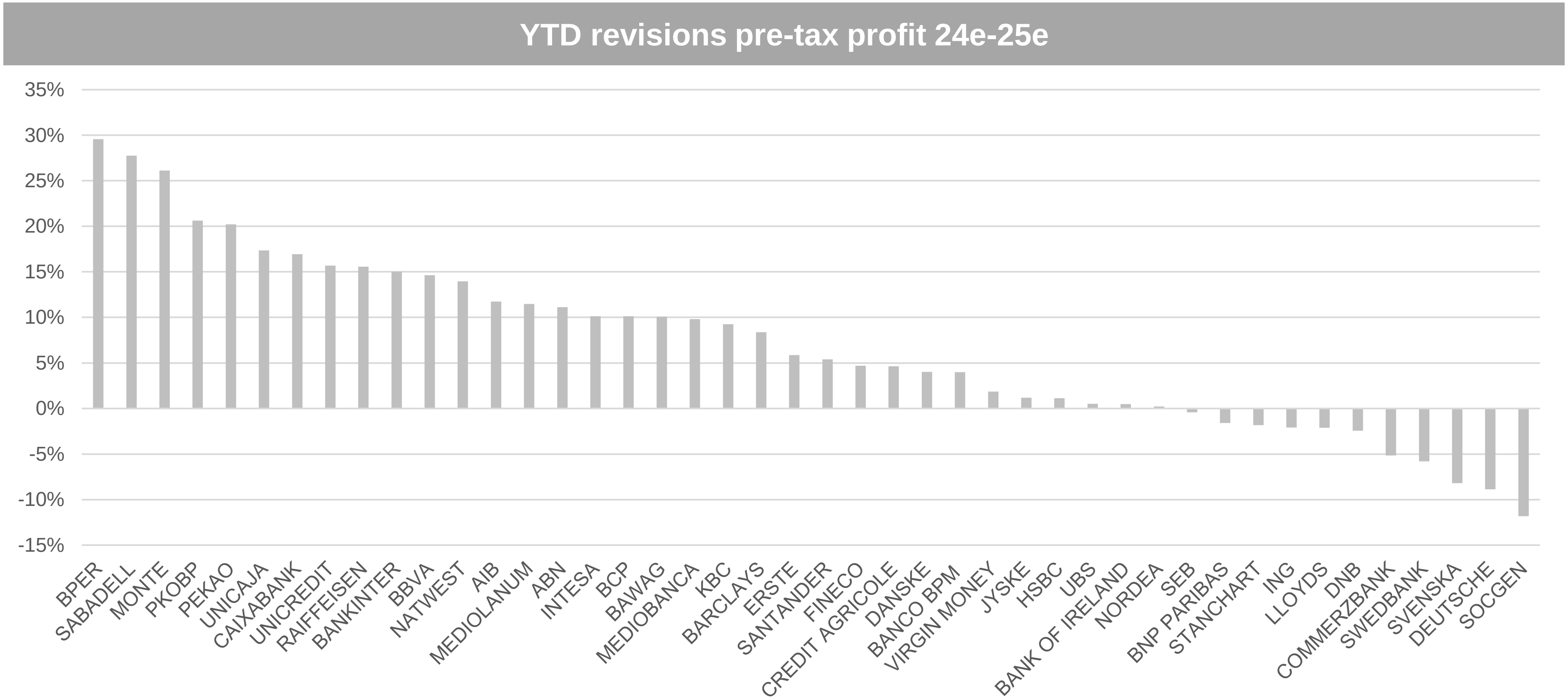
I.4 YTD revisions by country



Nordics (volumes, retail margins), France (retail) and Germany (non-recurring legal provisions) have underperformed. Eastern and Southern Europe have benefitted from resilient net interest margin and better volumes.

Data as of 20/08/2024 | Source: Axiom Alternative Investments

I.5 YTD revisions by bank

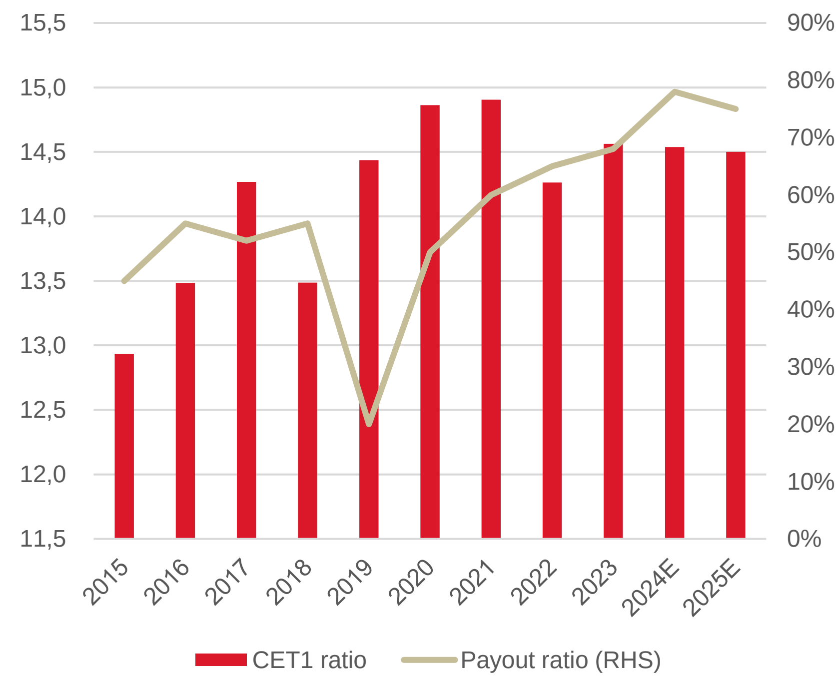


The “low quality” periphery banks (BPER, Monte, Sabadell, Unicaja) top the YTD ranking. Société Générale is dragged down by weak French retail revenues. Lloyds, Deutsche, are penalized by non-recurring legal provisions.

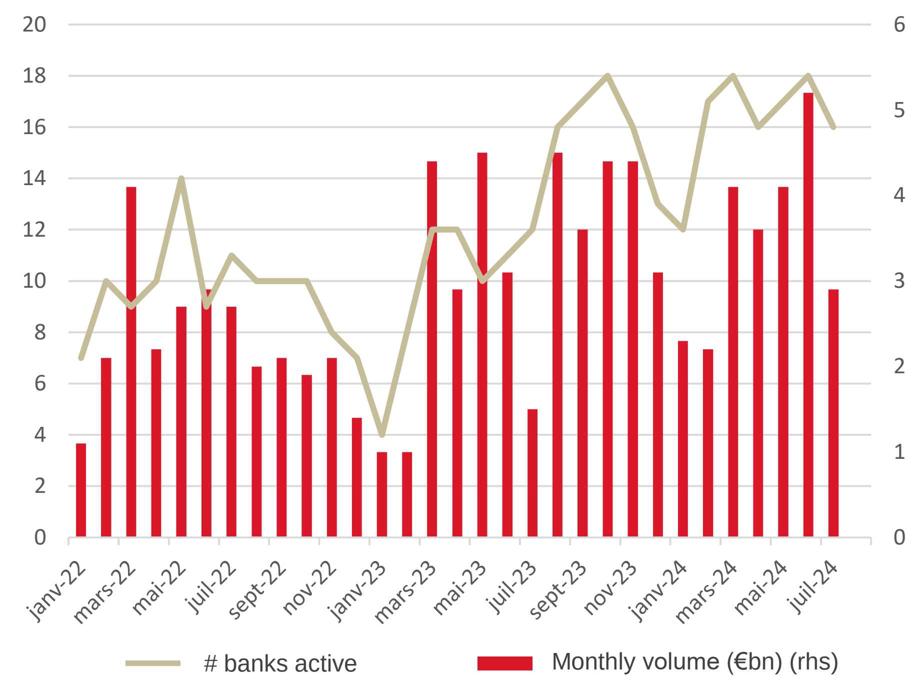
Data as of 20/08/2024 | Source: Axiom Alternative Investments

I.6 Capital generation remained strong, supporting record distributions

High payouts are not eroding excess capital



Buyback volumes have reached new highs



Despite a ~75% payout ratio, banks have been able to preserve excess capital levels. Buybacks now represent c. 25% of profits and c. 10% of daily exchange trading volumes.

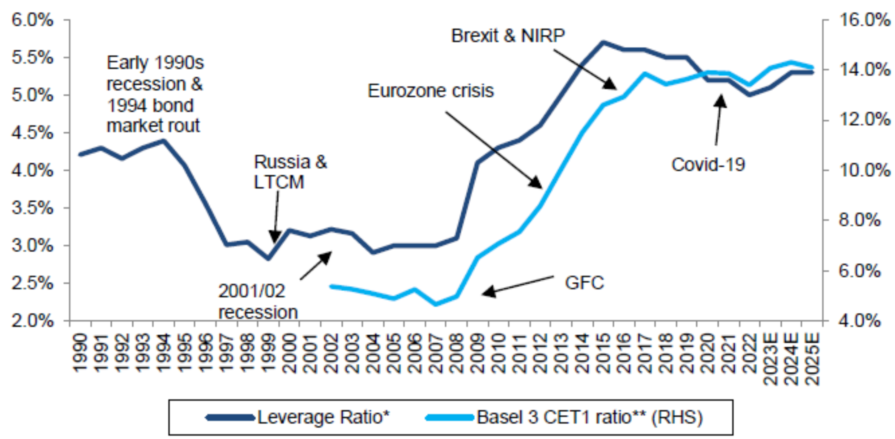
Data as of 20/08/2024 | Source: Axiom Alternative Investments, Bloomberg, Mediobanca Research

I.7 25th April 2024, key date for EU banks

The EU Parliament in plenary session approved the Banking Package

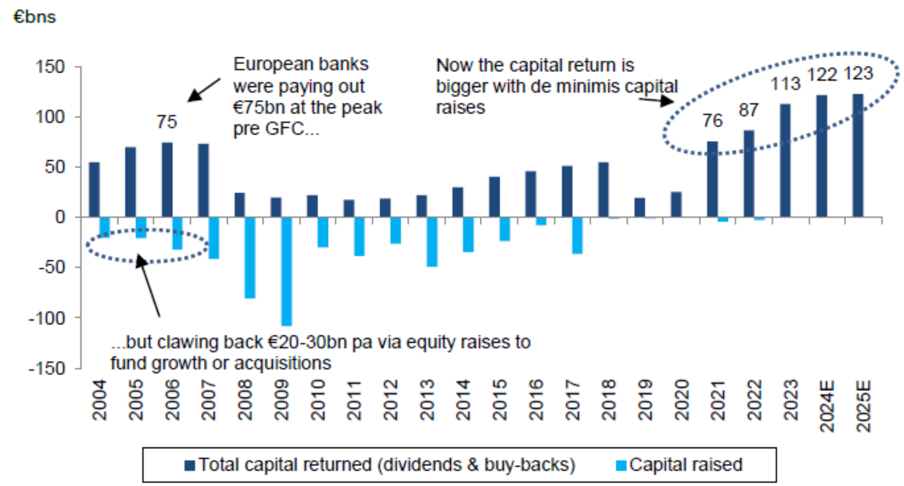
- **We entered a new cycle of capital return to shareholders**
- **Perpetuation and further improvement of the Danish Compromise (250% risk weighting from 1 January) is a major benefit for bancassurance models (cf. BNP/AXA IM)**

Leverage & Solvency have reached their landing zone



*Fonds propres tangibles/actifs ajustés ** Estimation avant 2011 sur la base des ratios de Bâle 1 et Bâle 2

Cautious regulatory approach led to excess capital



Data as of 20/08/2024 | Source : Axiom Alternative Investments, Autonomous

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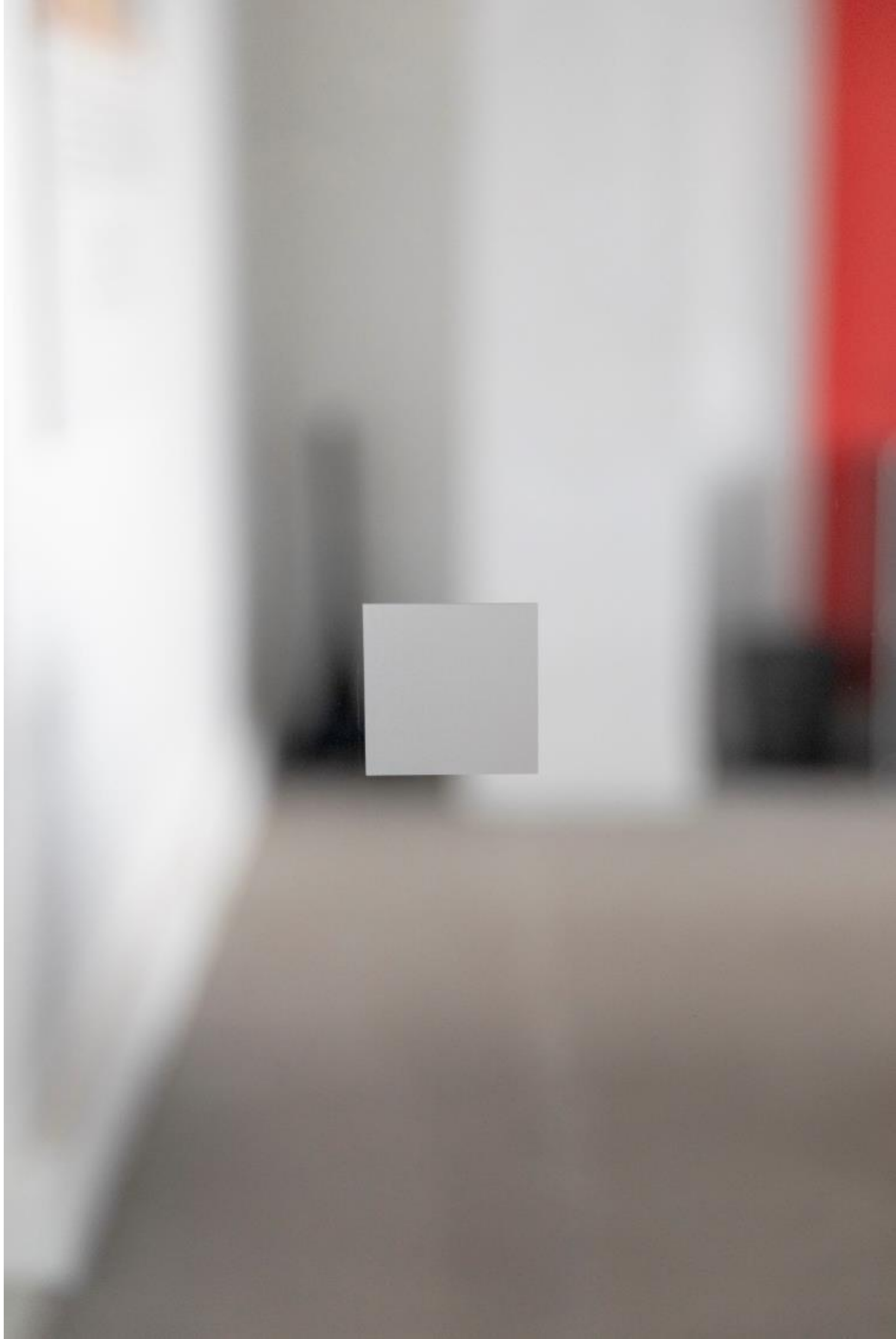
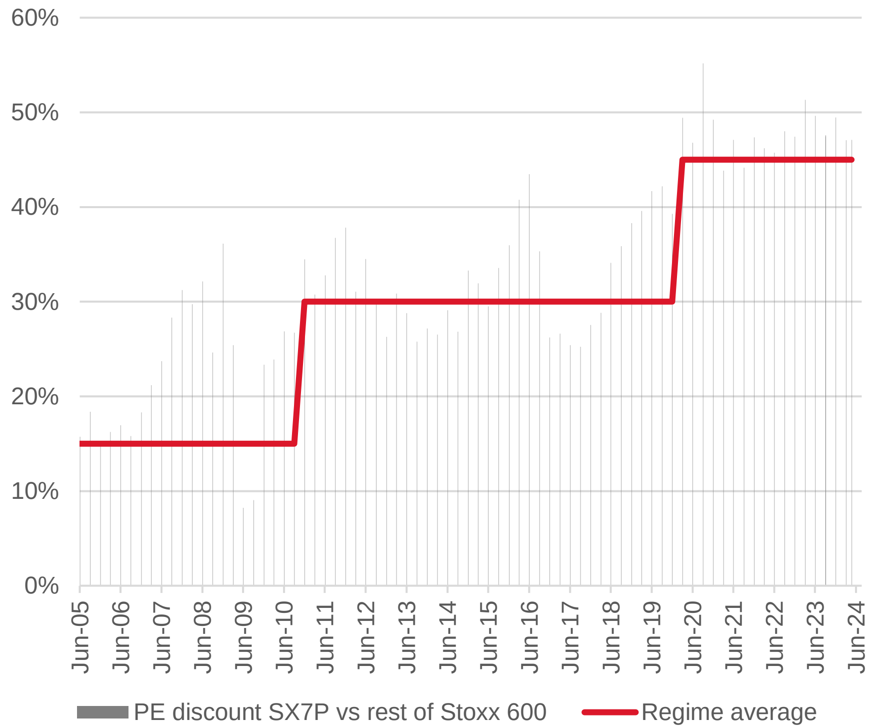
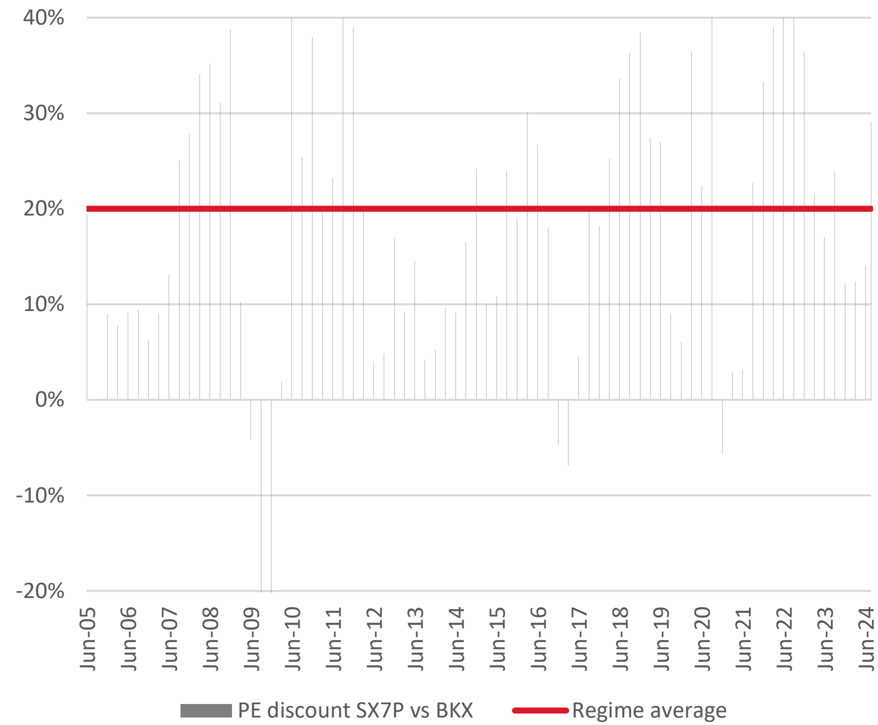


II.1 The post-Covid valuation discount anomaly is persisting

European banks have been trading at a record discount to the Stoxx 600 since Covid



The discount to American banks is also higher than usual

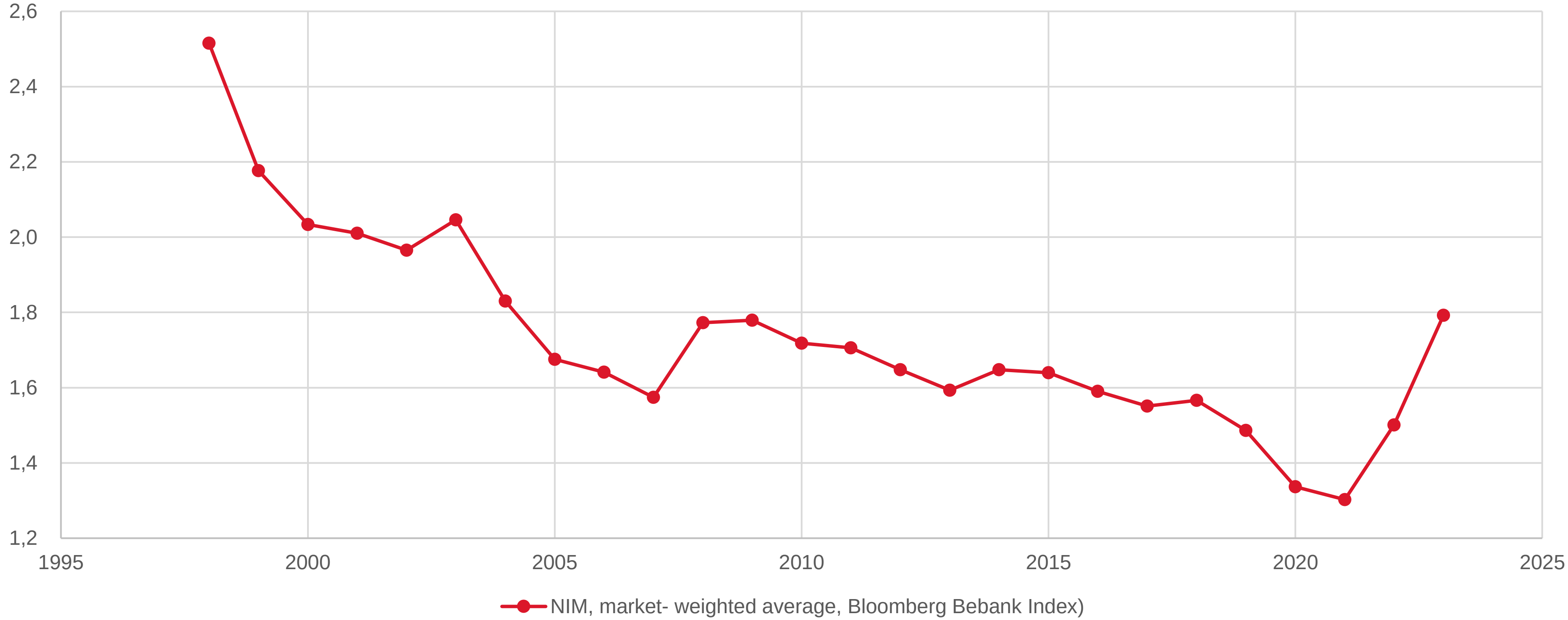


Despite better fundamentals (higher payout ratios, lower credit and legal risk, less regulatory uncertainty, less new capital for Fintech), banks are trading at a record discount to other parts of the market. Potential “reasons” include “peak earnings” sentiment and fears of external interventions (special taxes, long-term effects of previous ECB dividend ban)

Data as of 20/08/2024 | Source: Axiom Alternative Investments

II.2 Current net interest margins are not particularly elevated

Net interest margin has rebounded from its negative interest rate policy lows but is far from its historical highs

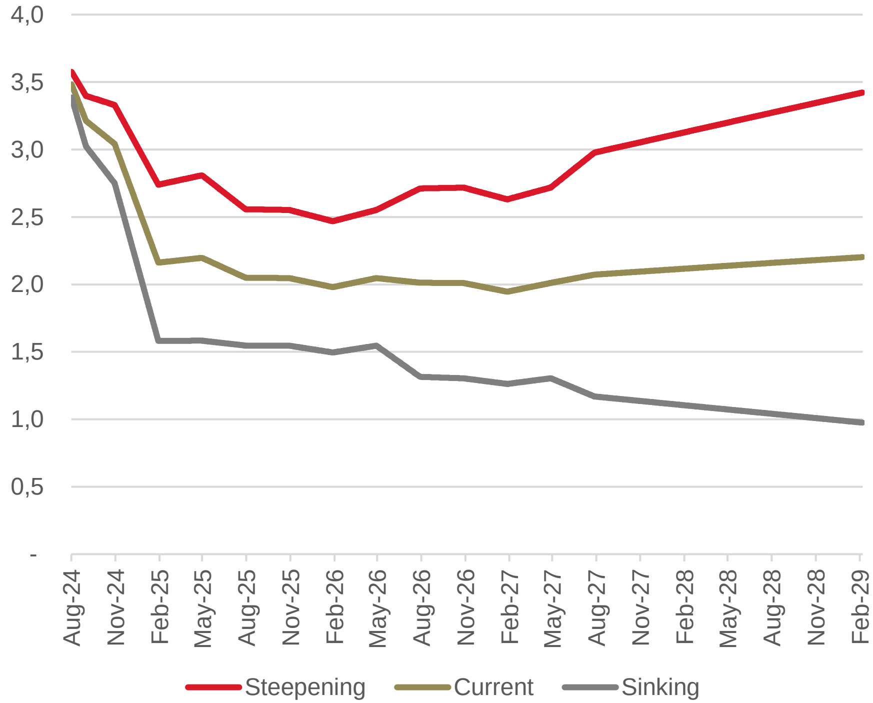


Over the past 3 years, net interest margin has risen from its historical low to its long-term average level. It could keep climbing should the curve bull steepen, or lending spreads improve.

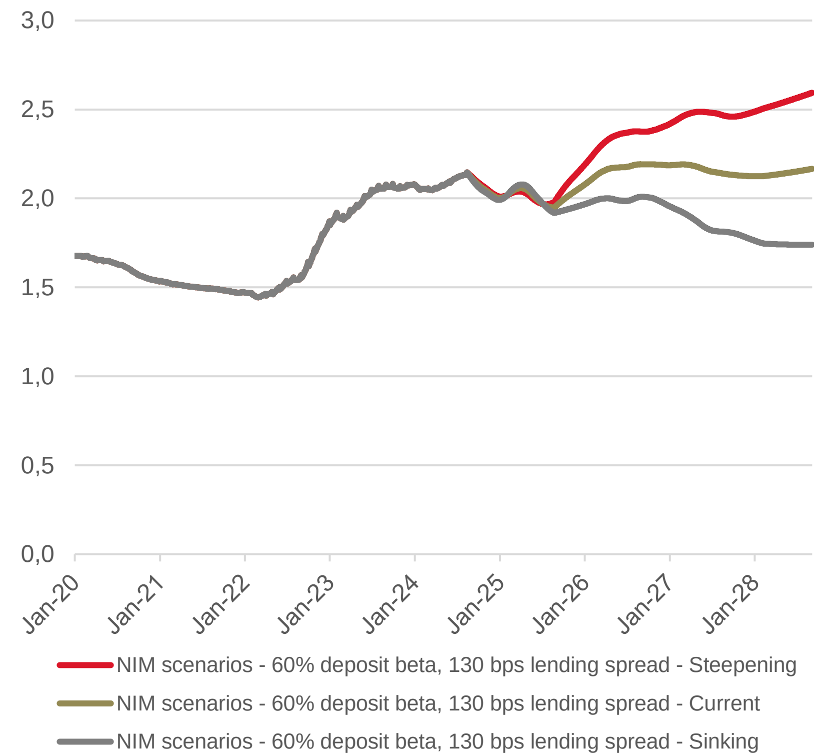
Data as of 20/08/2024 | Source: Axiom Alternative Investments

II.3 Net interest margins would benefit from a steeper curve

Euribor scenarios



Net interest margin scenarios (commercial book)

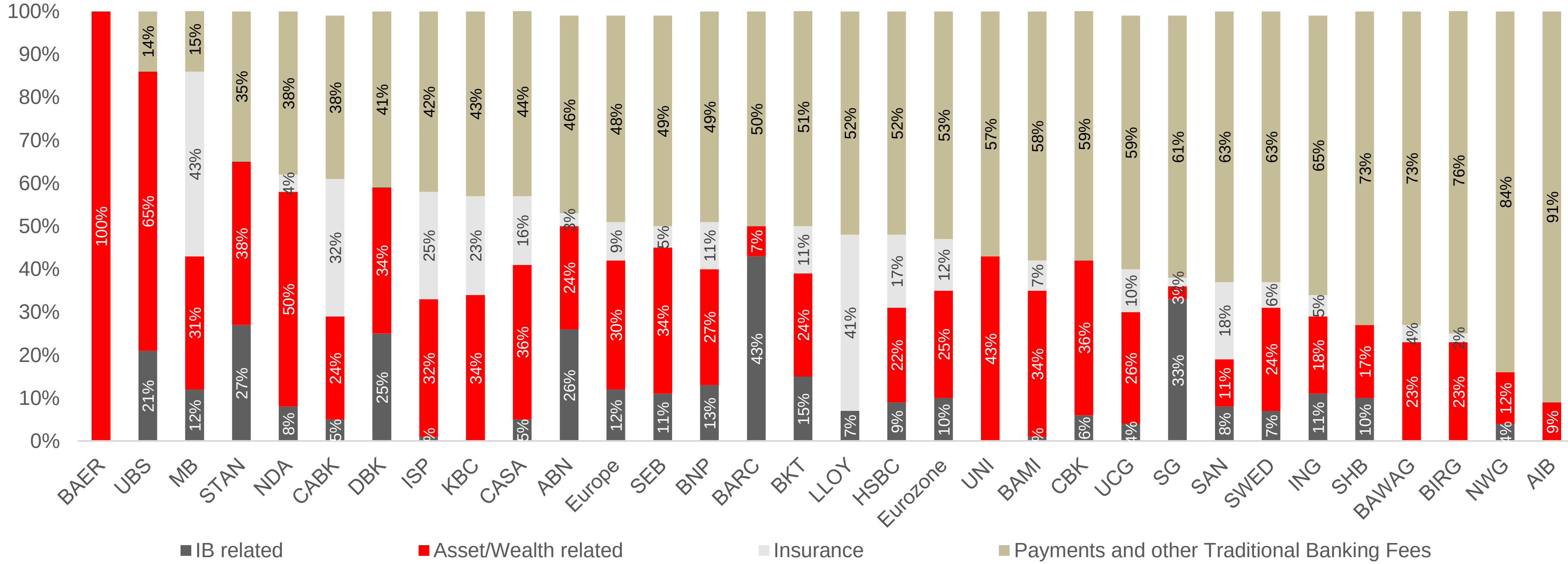


Net interest margin should stay around current levels if the forward curve is correct. The steepening scenario could lead to very significant net interest margin growth over time. A return to negative interest rate policy would be symmetrically negative.

Data as of 20/08/2024 | Source: Axiom Alternative Investments

II.4 Commissions could benefit from an increase in risk appetite following rate cuts

Cyclical fees (Asset Management/Wealth Management, Investment Banking and Insurance) are ~52% of European banks' fee revenues

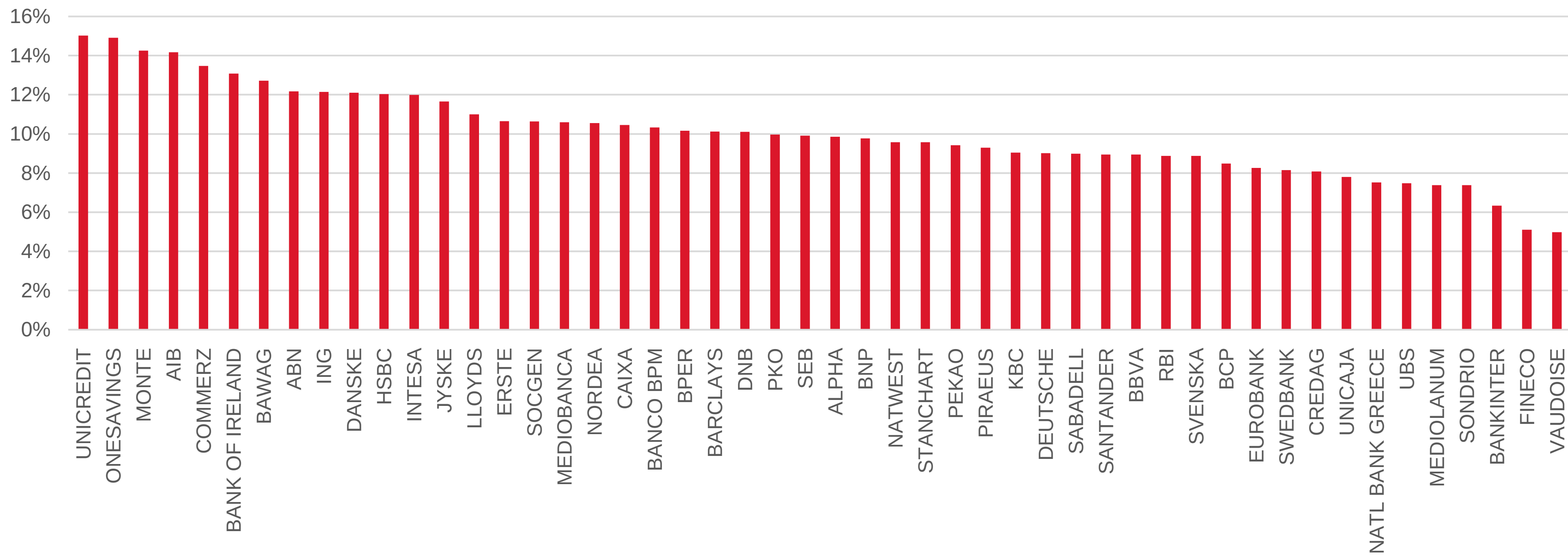


Rate cuts are generally followed by above-trend fee growth thanks to higher loan production, investment banking activity and financial savings flows

Data as of 20/08/2024 | Source: Axiom Alternative Investments, Morgan Stanley Research, Morgan Stanley Research Equity estimates, ECB, Haver

II.5 Valuations offer an asymmetric payoff

Annual cash yield (24e-26e average)



Combined with the ability to conduct extraordinary buybacks, high payout ratios protect multiples to the downside. European banks currently offer a distribution yield of c. 11% vs. a LT average of 4%-5%.

Data as of 20/08/2024 | Source: Axiom Alternative Investments

II.6 Valuations offer an asymmetric payoff – cont.

Distance to fair value based on a Gordon-Shapiro Dividend Discount Model (constant ROE and payout)

AVERAGE PAYOUT RATIO	AVERAGE ROE: 6%	8%	10%	12%	14%
40%	**-50%**	**-18%**	**33%**	**129%**	**367%**
50%	**-43%**	**-11%**	**33%**	**100%**	**211%**
60%	**-37%**	**-6%**	**33%**	**85%**	**155%**
70%	**-32%**	**-2%**	**33%**	**75%**	**125%**
80%	**-27%**	**2%**	**33%**	**68%**	**107%**
90%	**-23%**	**4%**	**33%**	**64%**	**95%**
100%	**-20%**	**7%**	**33%**	**60%**	**87%**

With a long-term cost of equity of 10%, and assuming current ROEs and payouts are sustainable, the sector offers a ~70% upside.

Data as of 20/08/2024 | Source: Axiom Alternative Investments, assuming a 10% Cost of Equity

II.7 Scenarios for the next 12 months

BEAR CASE	BORING CASE	BULL CASE
Adverse macro scenario materialize forcing central banks to do **emergency cuts**. Short and long-term rates sink to **below 1%**	**The economy remains weak** as policy rates come down; **curves stay inverted.**	**Growth reaccelerates** as policy rates are cut, leading to **steepening** curves
Net interest margins erode and uncertain macro restrains capital returns	Uncertainty around **growth** and **asset quality** remains.	Net interest income is supported by lower deposit costs, **positively-sloped curves** and volume growth. **Risk appetite** boosts fees.
Defaults pick-up as job markets weaken and the credit supply dries	Credit demand stays weak, and **defaults converge slightly above** their long-term levels.	PMIs rebound quicker, leading the market to price **credit and fee growth** and less asset quality stress
The **P/B** of the sector **plunges** to the lows of the 2010s (0.5x-0.6x) **Total return: - 20%**	Earnings and payouts stay elevated, but the sector **does not rerate**. The carry is the main source of total return. **Total return: +15%**	The sector benefits from both the **carry** and a **rerating** (> 1.0x P/B) **Total return: +50%**

Data as of 20/08/2024 | Source: Axiom Alternative Investments

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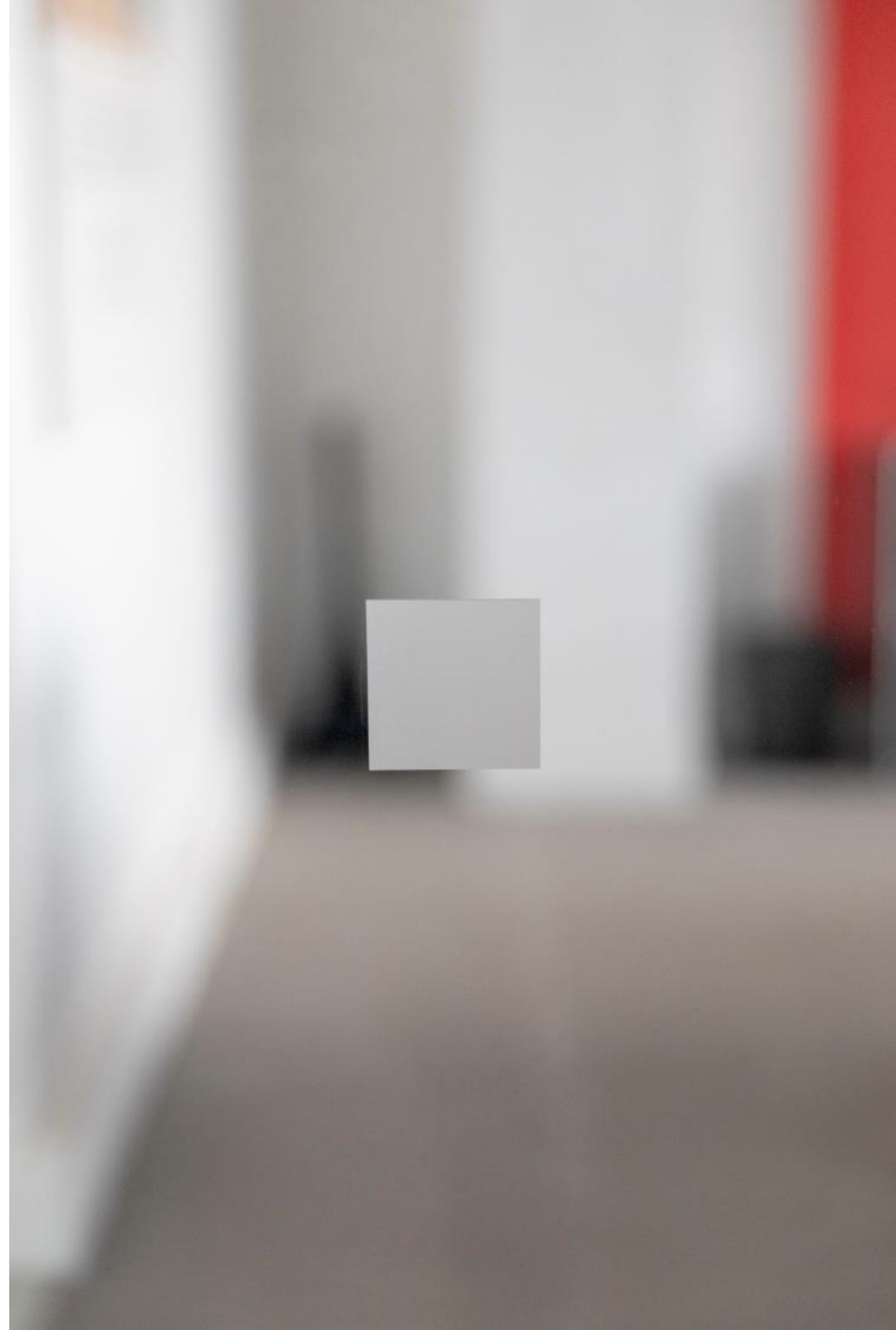


III.1 Financial credit: YTD performance

YTD performance drivers

Type	Yield to worst	Rates duration	Spread duration	*Total performance YTD*	*Market effect YTD*
EUR Sovereign 3-5Y	2.76%	3.71	3.71	***1.50%***	***0.00%***
EUR Covered 1-5Y	2.85%	2.84	2.89	***1.78%***	***0.35%***
EUR Senior	3.40%	3.74	3.84	***2.77%***	***1.00%***
EUR Tier 2	3.99%	3.36	3.91	***3.63%***	***1.09%***
EUR AT1	6.50%	3.54	4.91	***8.38%***	***4.66%***

Spreads: levels and quantiles

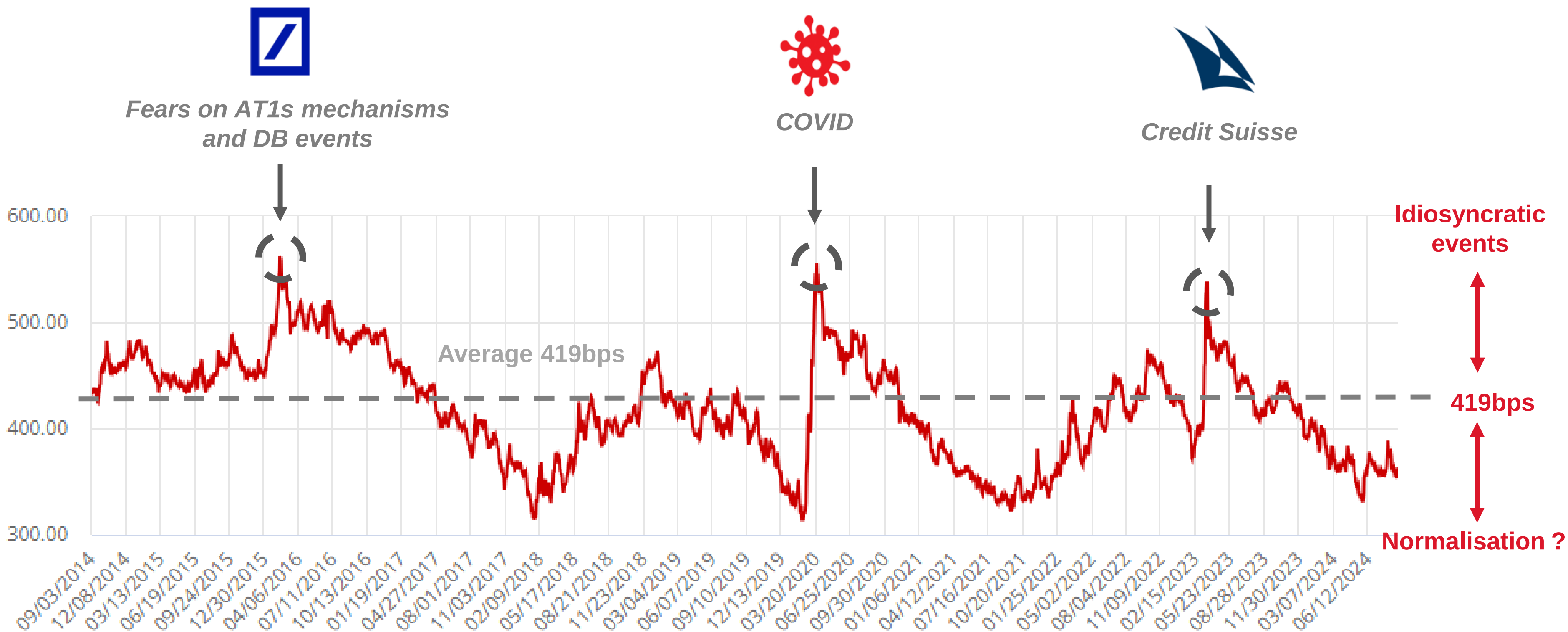
Index	Spread (bps)	Quantile[1]
BBG Euro AT1 (BB+/BB)	398	16%
BBG Euro HY Non-Fin Corp (BB-/B+)	335	30%
BBG Euro Banking T2 (BBB+/BBB)	164	35%
SubFin	109	11%
SeniorFin	62	25%

Credit has benefitted from carry and a compression in spreads. Rates were relatively neutral. From a historical perspective, current spread levels may be deemed “tight”.

Data as of 20/08/2024 | Source: Axiom Alternative Investments, Autonomous | [1] Quantiles over a 10-year period. For example, a 16% quantile means that spreads were lower only 16% of time over the last 10 years. Lower the figure, tighter the spreads.

III.2 AT1 valuations

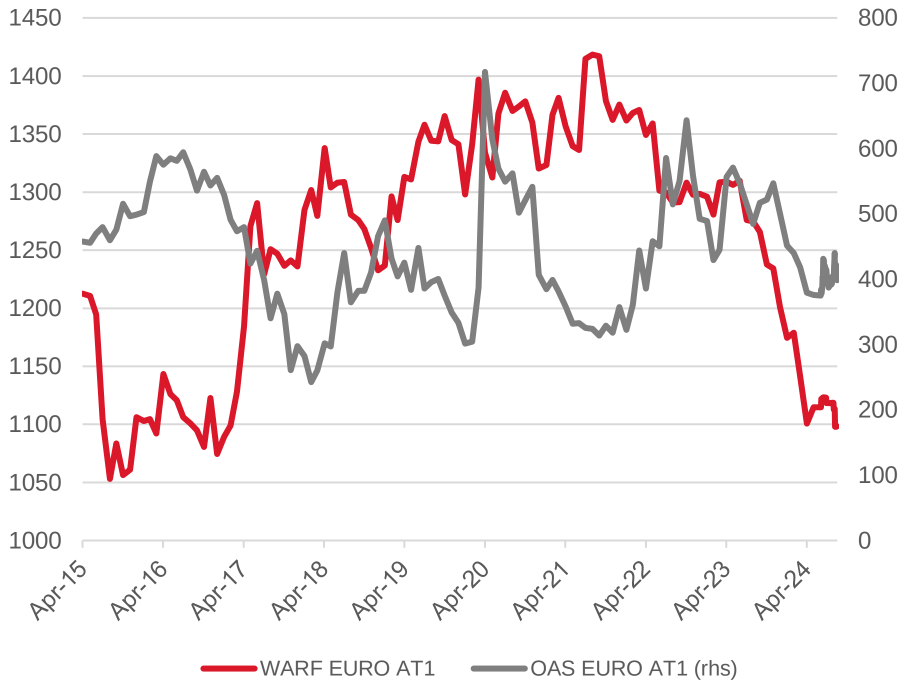
BofA CoCo index' spread history over 10 years

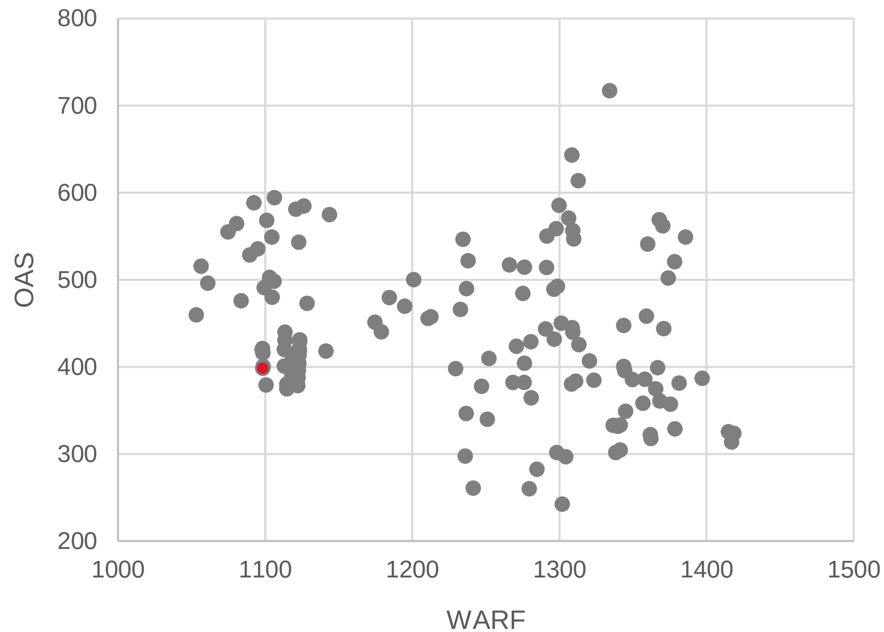


Data as of 03/09/2024 | Source: Axiom Alternative Investments, BofA CoCo index

III.3 Are AT1 spreads tight ?

Tighter spreads but improved fundamentals





Banks, and especially the smaller ones, have benefitted from significant upgrades in the past 3 years. Adjusted for credit quality, AT1 spreads look reasonable.

Data as of 20/08/2024 | Source: Axiom Alternative Investments, Autonomous

III.3 The CMDI* package

Bank liabilities hierarchy discussions

senior

European Commission proposal	European Parliament proposal	Counicl of the European Union proposal
Preferred liabilities	Preferred liabilities	Preferred liabilities
Covered deposits DGS Eligible deposits of natural persons and SMES Other, non-covered deposits	Covered deposits DGS Eligible deposits of natural persons and SMES Other, non-covered deposits	Covered deposits/ DGS Eligible deposits of natural persons and SMEs Other non- covered deposits < 1 year maturity Other non- covered deposits > 1 year maturity
Ordinary unsecured liabilities (senior debt, derivatives, etc.)	Ordinary unsecured liabilities (senior debt, derivatives, etc.)	Ordinary unsecured liabilities (senior debt, derivatives, etc.)
Senior non-preferred liabilities	Senior non-preferred liabilities	Senior non-preferred liabilities
Other subordinated debt	Other subordinated debt	Other subordinated debt
Tier 2 instruments	Tier 2 instruments	Tier 2 instruments
AT1 instruments	AT1 instruments	AT1 instruments
CETI instruments	CETI instruments	CETI instruments

junior

Seniorizing deposits is seen as a necessary step towards the completion of a European deposit guarantee scheme. Though Moody's has said it would be a credit negative for senior bonds, S&P and Fitch expect little impact on ratings.

Data as of 20/08/2024 | *Crisis Management and Deposit Insurance | Source : Axiom Alternative Investments, Autonomous

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Source: Axiom Alternative Investments

Q&A

Thank you for attending the Axiom Alternative Investments webinar.

See you next quarter.