Axiom Alternative Investments

Investing with a financial sector specialist

Webinar – European Banks, 2023 results

13/03/2024

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Axiom Alternative Investments

MANAGING PARTNER
CIO

DAVID BENAMOU

PORTFOLIO MANAGER

ANTONIO ROMAN

Key takeaways

2023: a record year for the European banking sector

- **ROE > 12%,** highest since the GFC
- **€120bn distributed** in dividends and buybacks, highest since the GFC
- **EPS 75% higher vs. 2019**
- Driven by net interest income **25%-30% higher vs. 2019** despite the credit slowdown, the inverted rate slope and an undemanding context for Investment Banking activities

Not a blip but a profitability reset

- Q4 earnings have been mixed but in aggregate resulted in **small expectation improvements for 2024/2025**
- Analysts are expecting stable NII and net income in 2024/2025 vs. 2023, with buybacks fueling ~3%/year EPS growth
- Uncertainties remain around the evolution of deposit costs as rates come down, as well as asset quality, particularly in CRE, but not in a magnitude that should derail earnings trajectory

NII: tailwinds ultimately stronger than headwinds

- **NII wont' evolve in tandem with short-term rates**
- There are **headwinds**: the shift from current accounts to savings products or term accounts is still ongoing, and banks will earn less on cash and short duration assets as the ECB lowers policy rates
- But also, **tailwinds**: the longer parts of the balance sheet (fixed loans, mortgages, deposit hedges) still are **to reprice** at current interest rate levels
- Net, headwinds and tailwinds should offset each other in 2024/2025 and **tailwinds should start to dominate in 2026**

CRE risks

- The **US office crisis** and the pressure on broader real estate valuations have raised concerns regarding bank exposures
- We see overall **a healthy picture for European CRE** bank debt sustainability but with areas of weakness

Source: Axiom Alternative Investments

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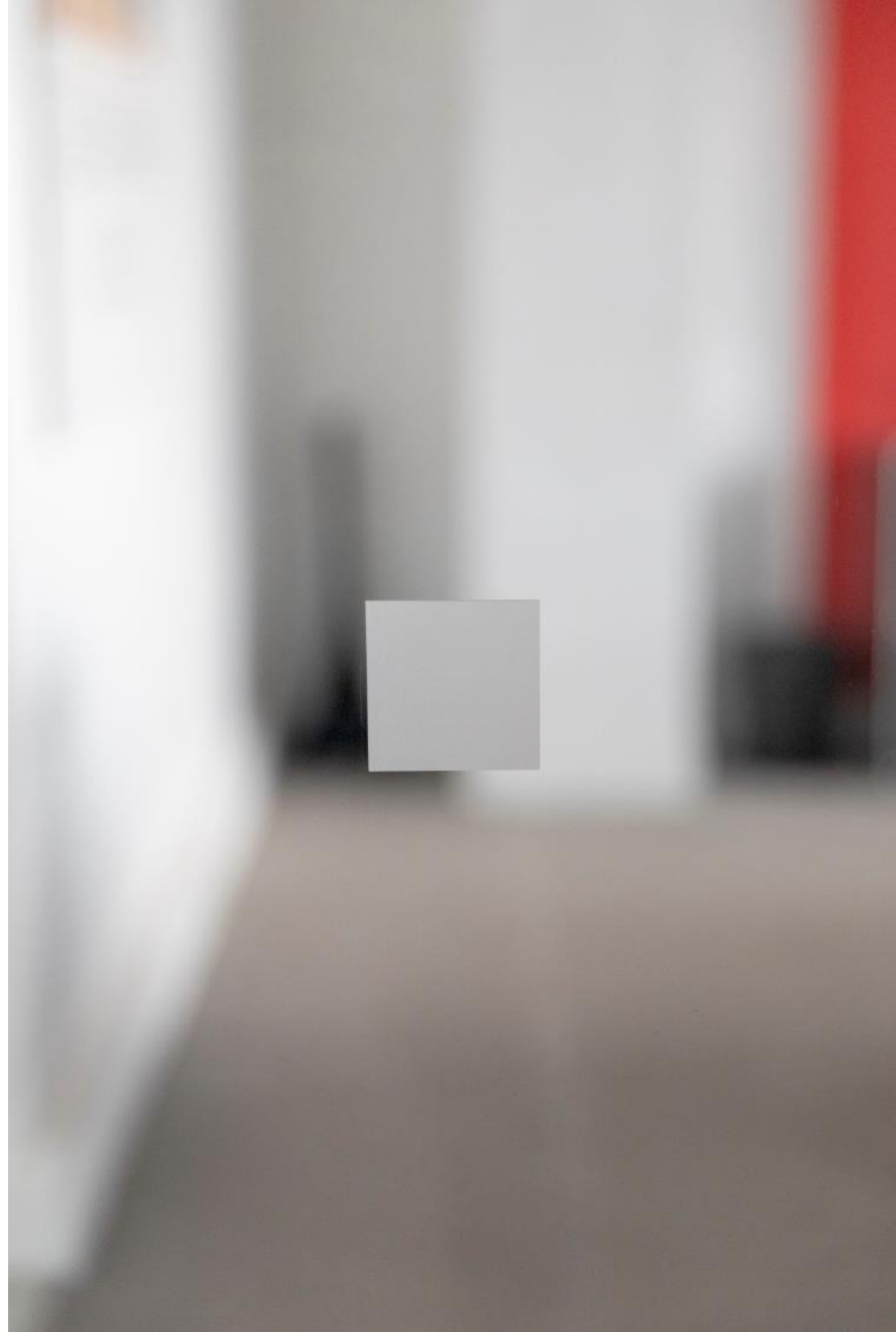
I. **A lookback on a record year**

II. What level of profitability should we expect going forward?

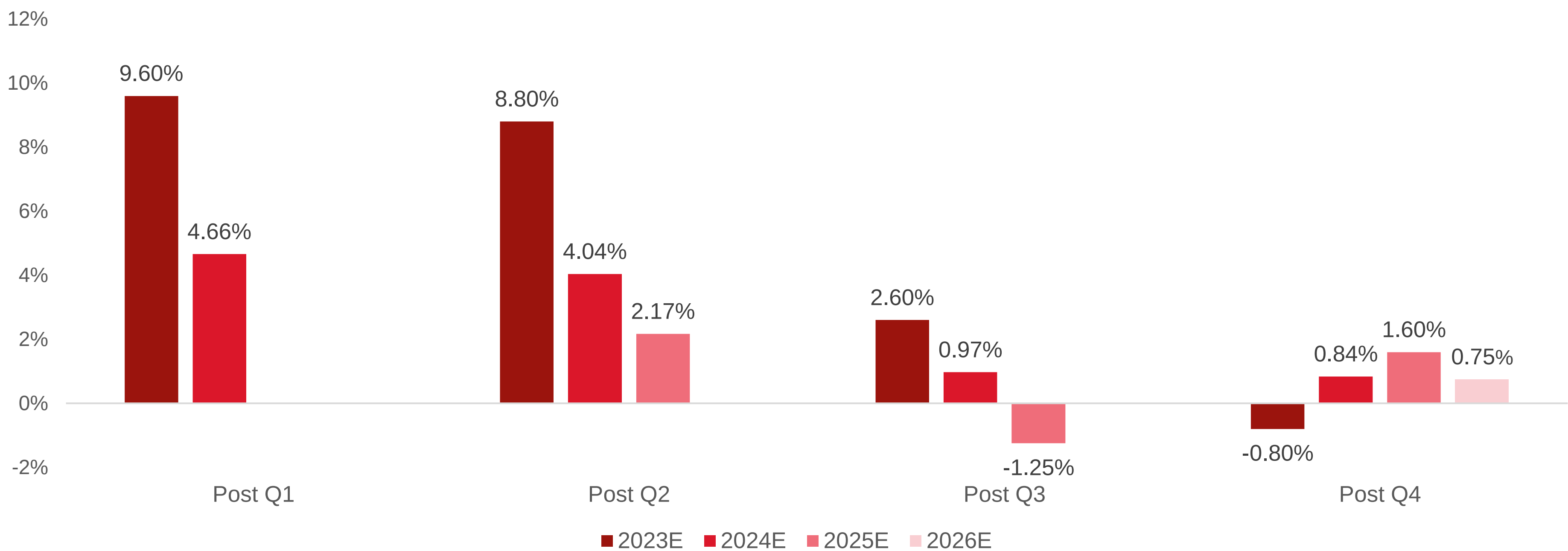
III. Can CRE change the picture?

IV. The investment case



I.1 A year of positive earnings revisions (1/2)

EPS revisions post Q1-Q4 2023

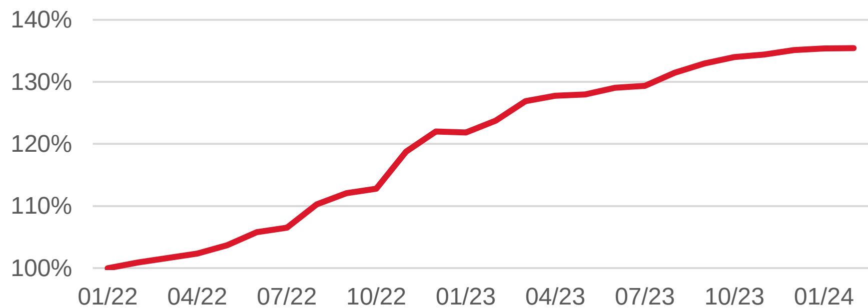


The bulk of positive revisions occurred in the first half of a year but **Q4 was still supportive** for 2024/2025 EPS

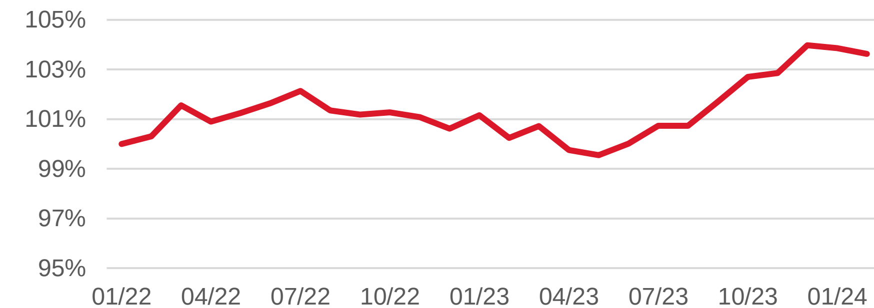
Data as of 05/03/2024 | Source: Axiom Alternative Investments

I.2 A year of positive earnings revisions (2/2)

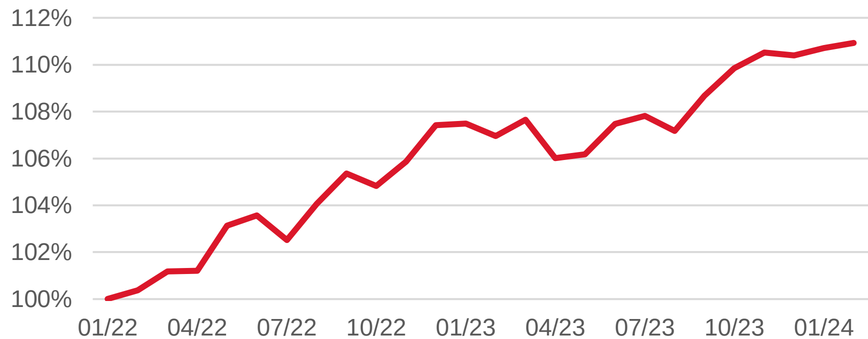
FY23e NII (rebased)



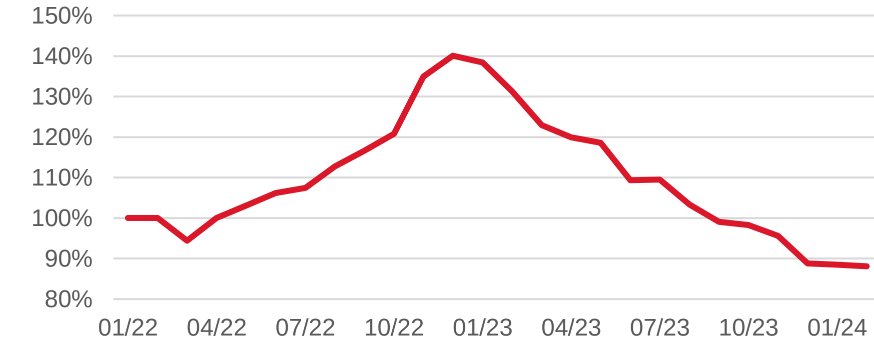
FY23e Fees (rebased)



FY23e Costs (rebased)



FY23e Provisions (rebased)

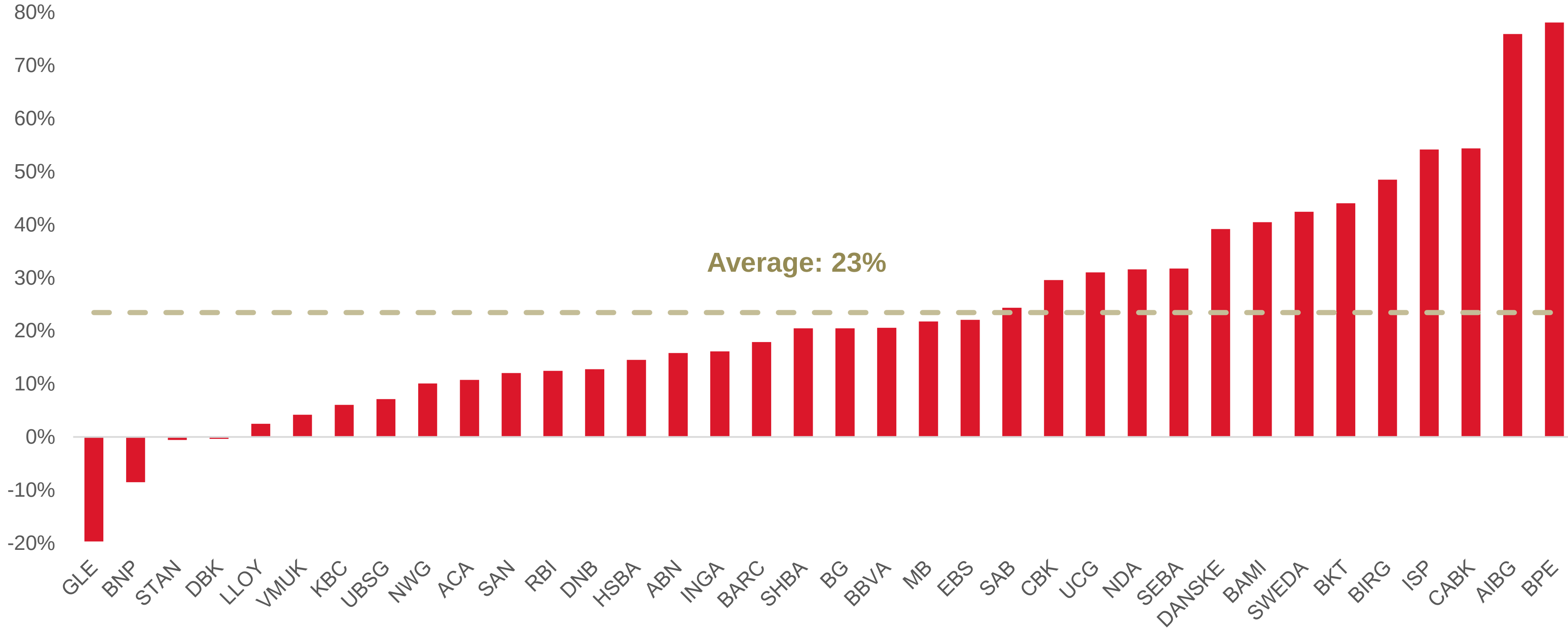


NII was the main driver as rates climbed in 2022 and deposit betas stayed lower for longer in 2023. **Inflation** led to much higher costs than initially expected. **Fees** went up in nominal terms but down in real terms. **Asset quality** was resilient.

Data as of 05/03/2024 | Source: Axiom Alternative Investments

I.3 Spain, Italy, Ireland and the Nordics won the NII sprint

NII 2023 YoY growth

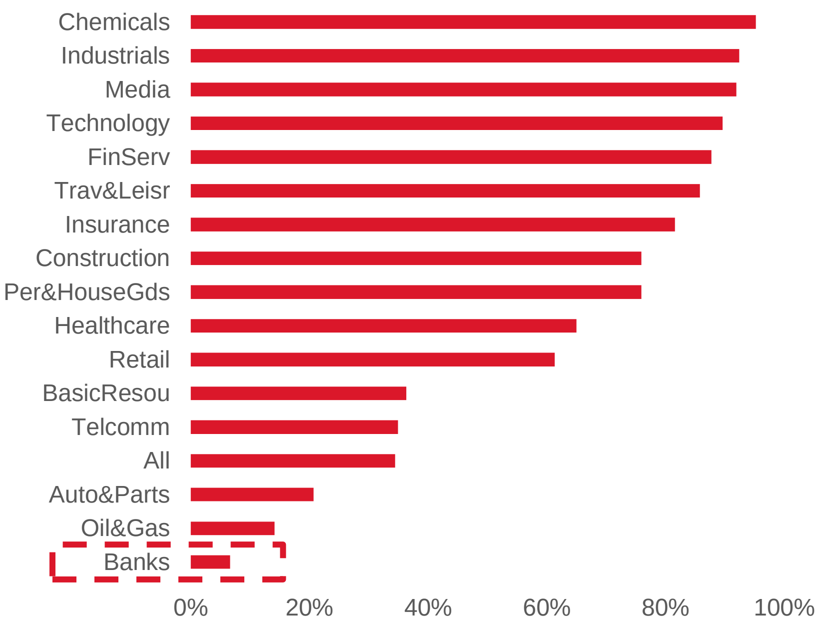


Only French banks and Stan Chart had lower NII in 2023 vs. 2022. UK banks did not take advantage of higher rates due to replicating portfolios and higher deposit costs. Short-duration banks with a lot of current accounts won the race in 2023.

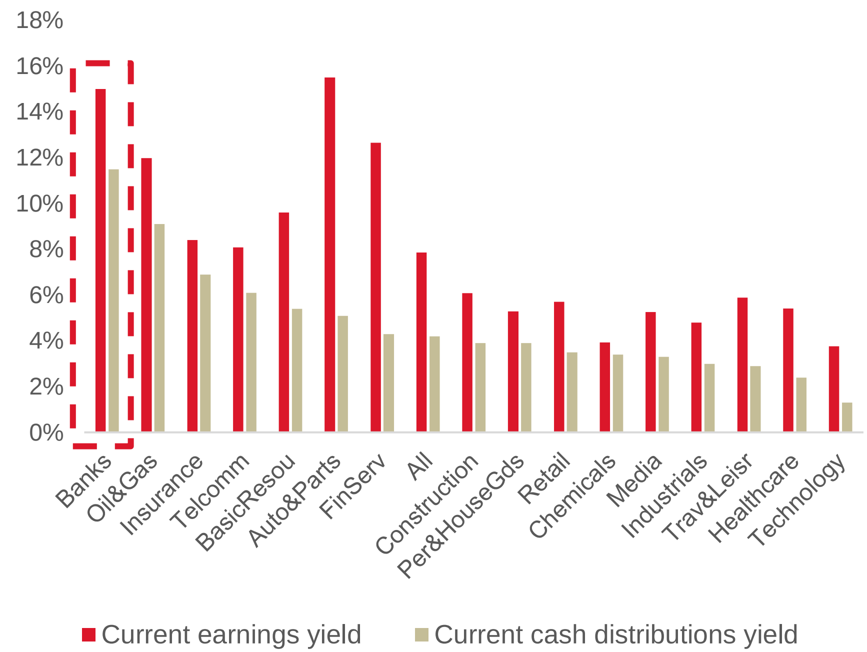
Data as of 05/03/2024 | Source: Axiom Alternative Investments

I.4 Banks have climbed to the top of the value podium

Valuation quantile (last 15 years)



Cash distributions yield

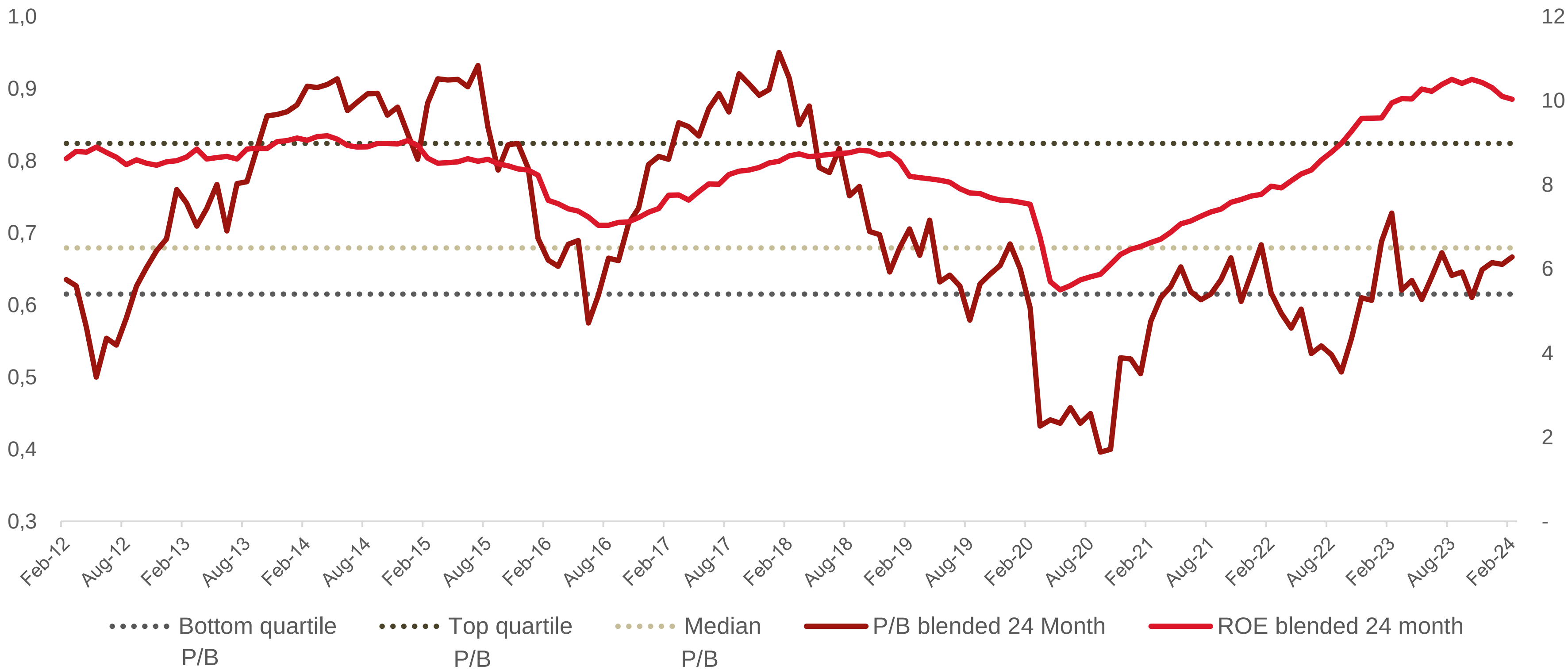


Banks offer **unparalleled value** in the European stock market

Data as of 05/03/2024 | Source: Axiom Alternative Investments

I.5 Market performance was good but not as good as we expected

Evolution of Price / Book *(left-hand scale)* vs Return On Equity *(right-hand scale)*



P/B back to median post-GFC levels only despite record profitability, payouts and excess capital

Data as of 05/03/2024 | Source: Axiom Alternative Investments

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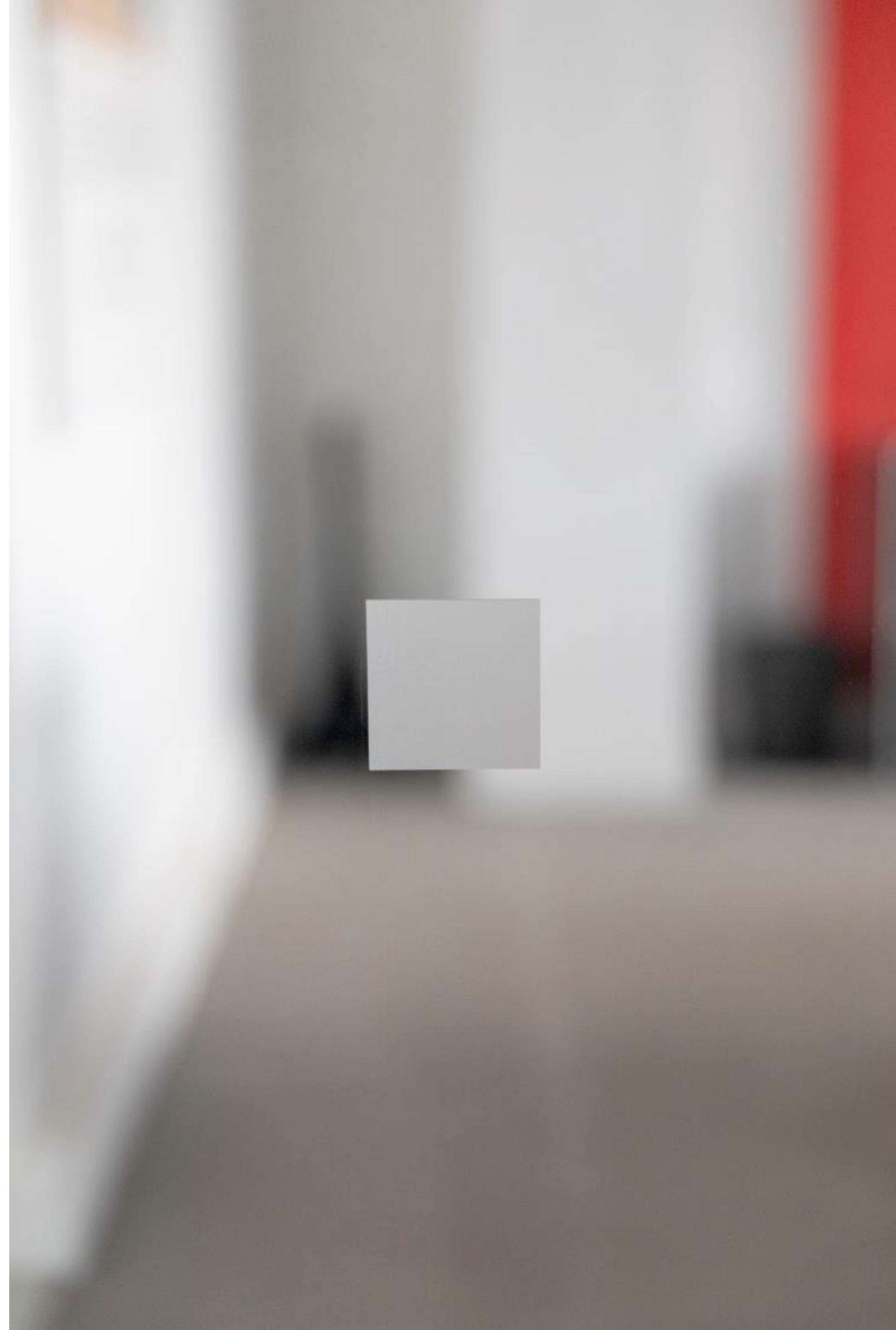
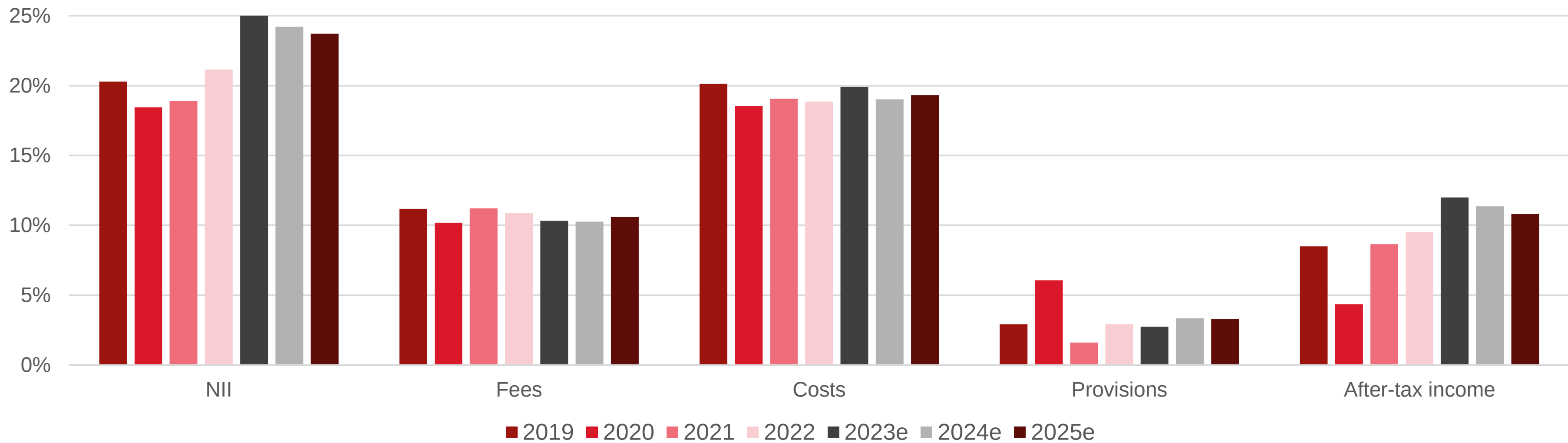


II.1 Current consensus: ROE to stabilize slightly above 10%

Return On Equity[1] analysis



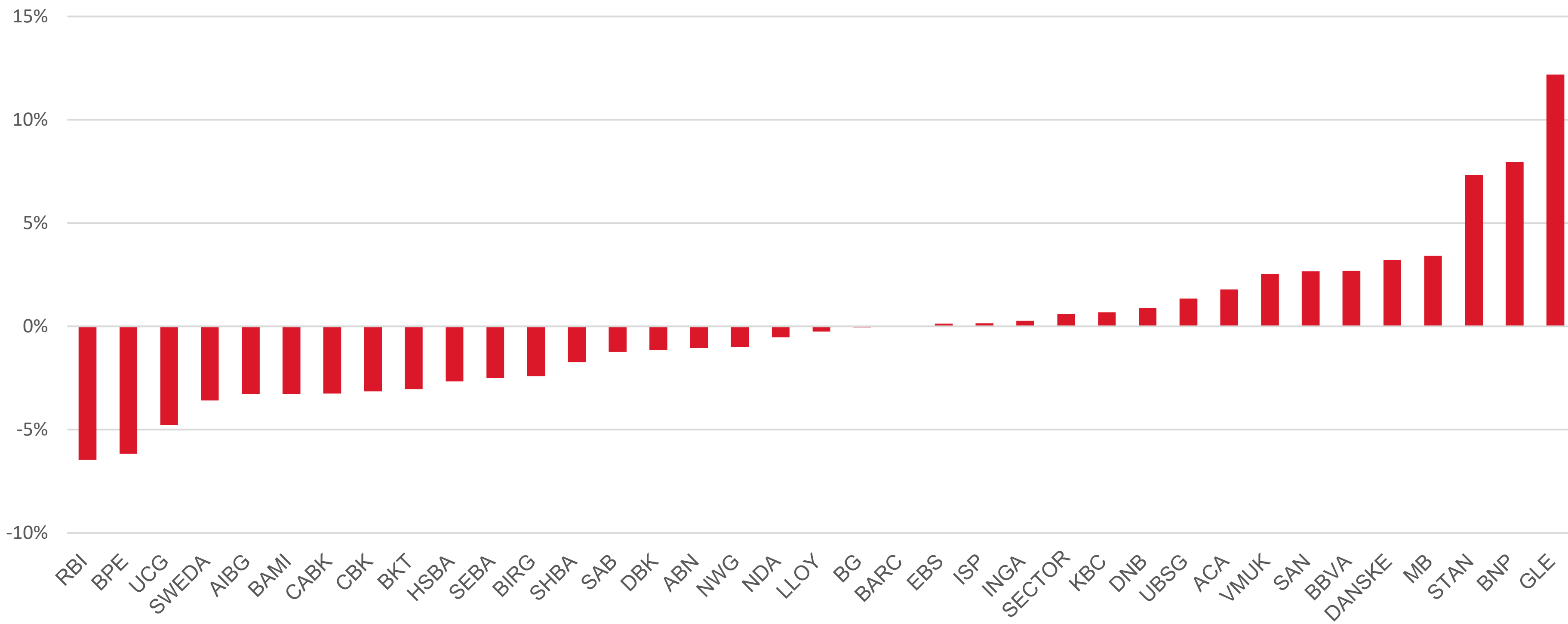
Theme	Shock	Comment	After-tax ROE
Commercial spreads	+/- 50 bps	150 - 175 bps in NIRP ; 225+ bps in normal environment	+/- 3 pts
Volumes	+/- 5%	Deleveraging expected in 2023 after strong growth in 2022	+/- 1 pt
Fees	+/- 5%	Total fees tend to be stable ; deep recession -10%	+/- 0.5 pts
Costs	+/- 5%	Driven by salary inflation, cost reductions and levies	-/+ 1 pt
Provisions	+/- 40 bps	TTC: 40 bps ; Recession: 80 bps ; Depression: 120 bps	-/+ 2.5 pts

ROE is expected to decline **from 12% to 10%-11%** on the back of i. book value growth ii. higher provisions iii. nominal NII unchanged

Data as of 05/03/2024 | Source: Axiom Alternative Investments | [1]Trimmed mean SX7P members.

II.2 Current consensus: NII to stay around 2023 levels

NII CAGR 25/23 (consensus)

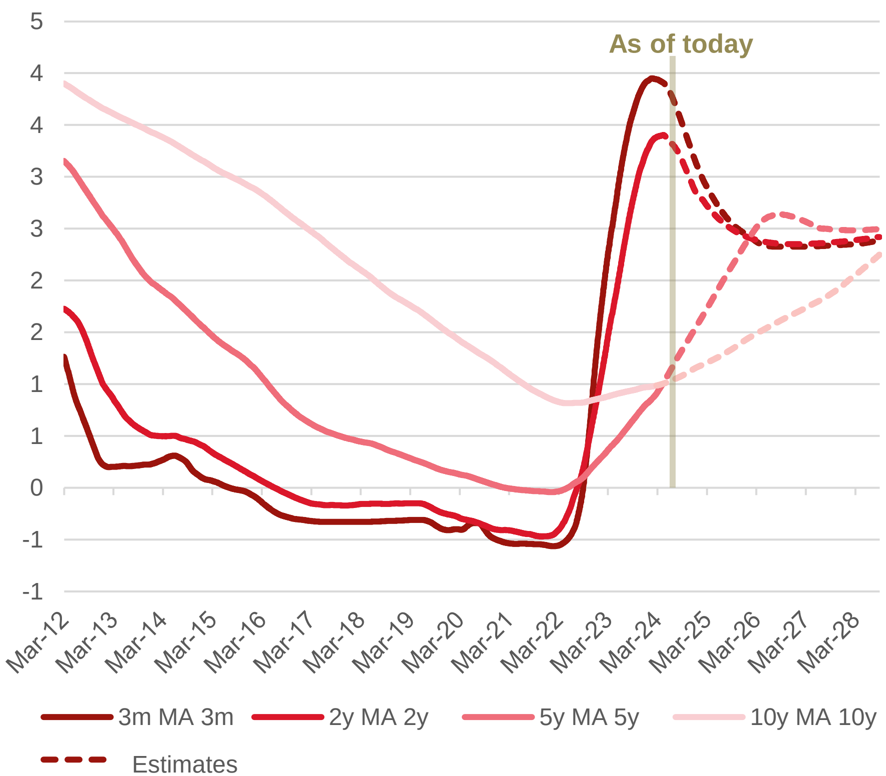


2023 NII winners should be more penalized by the incoming decrease in short-term rates.
French banks are expected to see a recovery in NII.

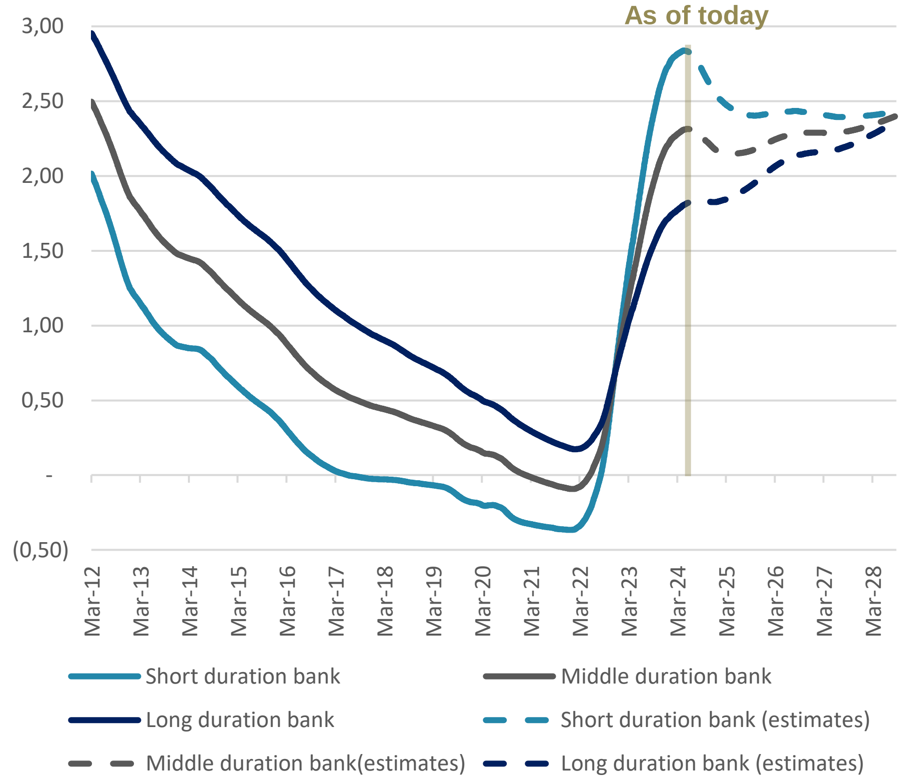
Data as of 05/03/2024 | Source: Axiom Alternative Investments

II.3 NII will benefit from the lagged repricing of longer-dated books

Moving averages of Euribor tenors illustrate the tailwinds from longer dated books



Different duration profiles lead to different repricing dynamics

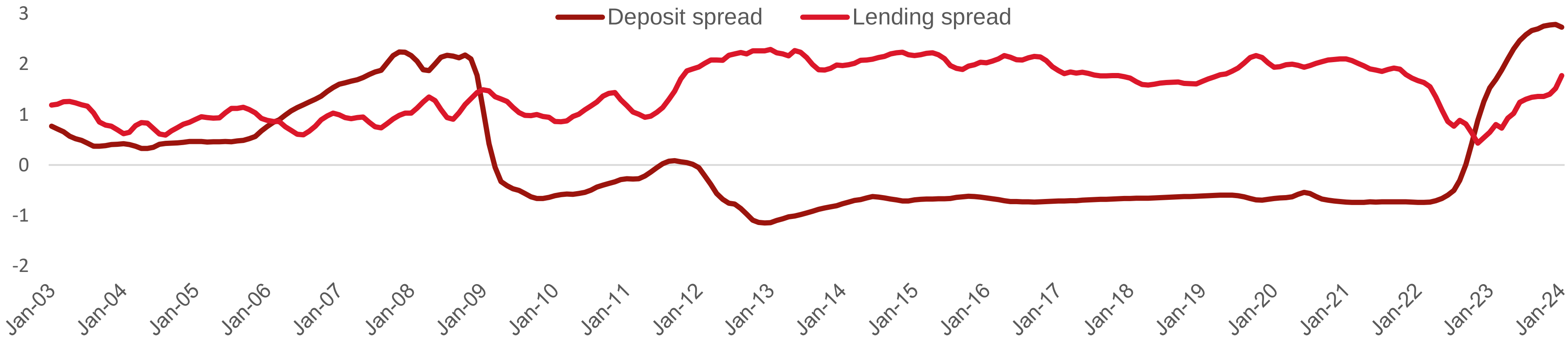


The initial duration at origination of assets and hedges (we estimate it around 3,5-4 years for the sector) and barbell profile (mix of cash/floating and longer-dated fixed loans/swap hedges) introduce **non-linear lag effects on NII**

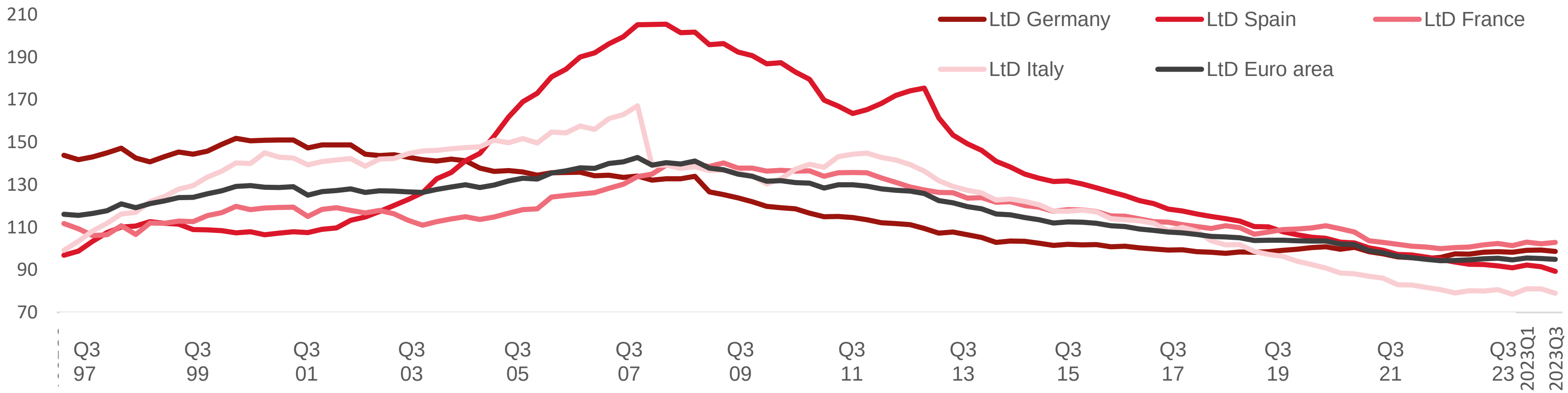
Data as of 05/03/2024 | Source: Axiom Alternative Investments | Based on Euribor historical and forward curves. Illustrative examples only.

II.4 Lending and deposit spreads should remain healthy (1/3)

Lending spreads have recovered from 2023 lows



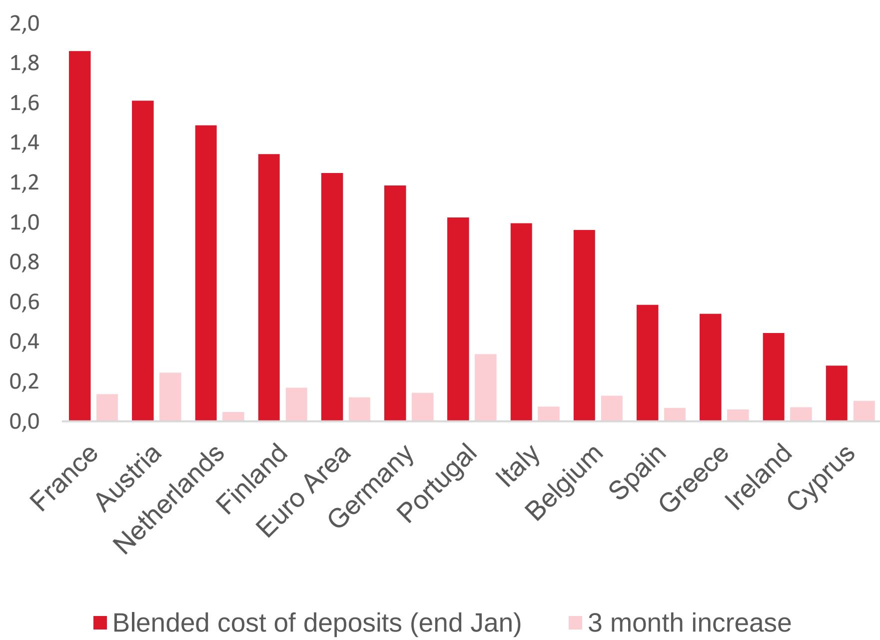
Lower loan-to-deposit ratios support higher deposit margins



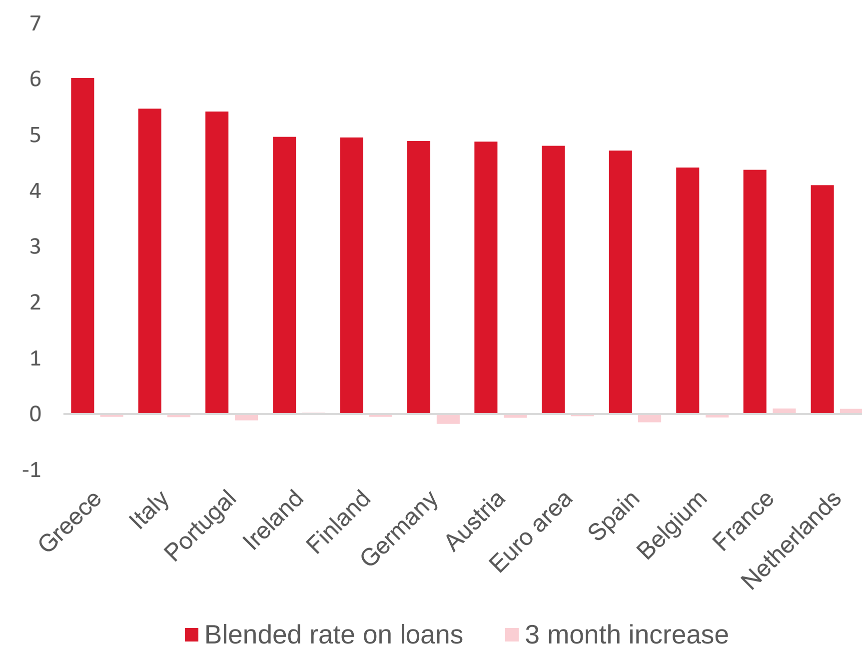
Data as of 05/03/2024 | Source: Axiom Alternative Investments

II.5 Lending and deposit spreads should remain healthy (2/3)

Blended cost of deposits (end of January)



Blended rate on loans (end of January)

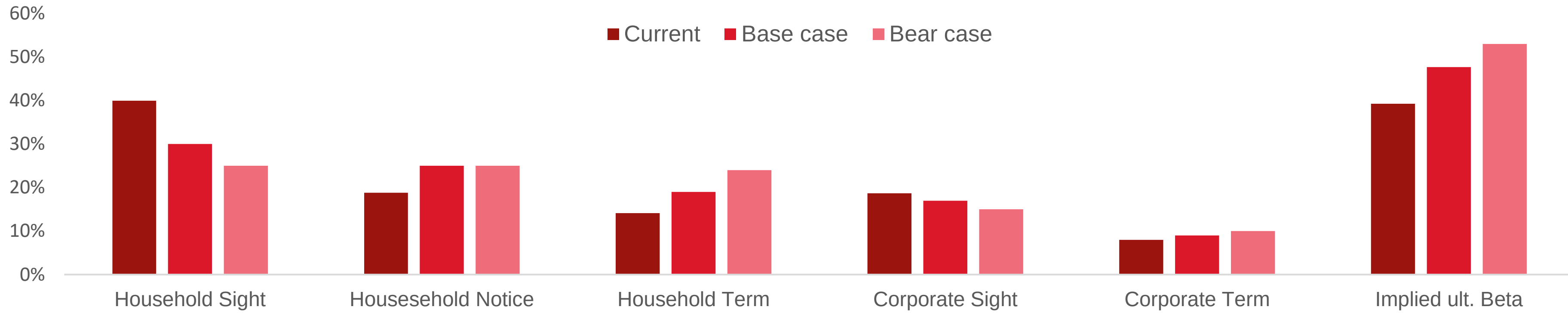


The shift from current accounts to term deposits continues at a moderate pace, but interest rate on term accounts are coming down slightly (-6 bps in January). Overall deposit margins continue to be better than expected.

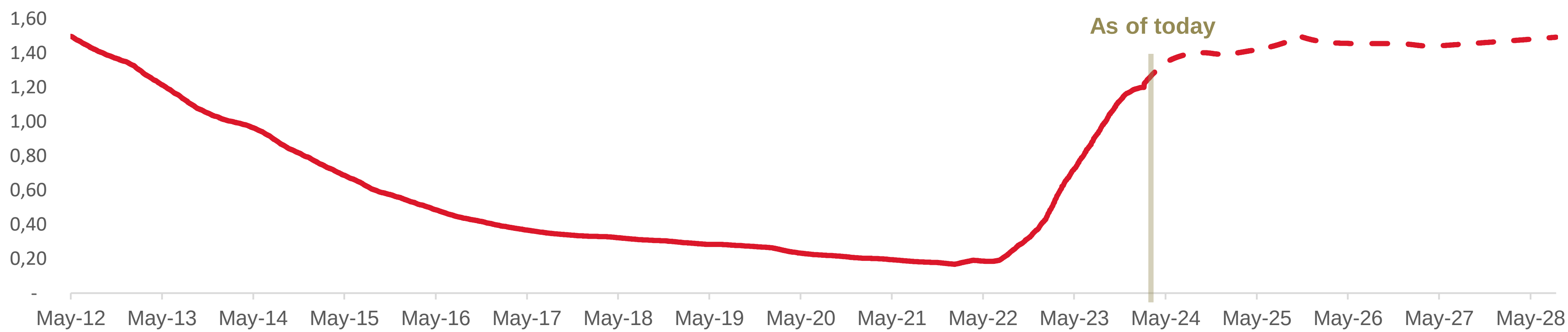
Data as of 05/03/2024 | Source: Axiom Alternative Investments

II.6 Lending and deposit spreads should remain healthy (3/3)

We expect the share of current accounts to fall further but to remain above 40%



Cost of deposits (assuming a conservative 60% ultimate deposit beta)

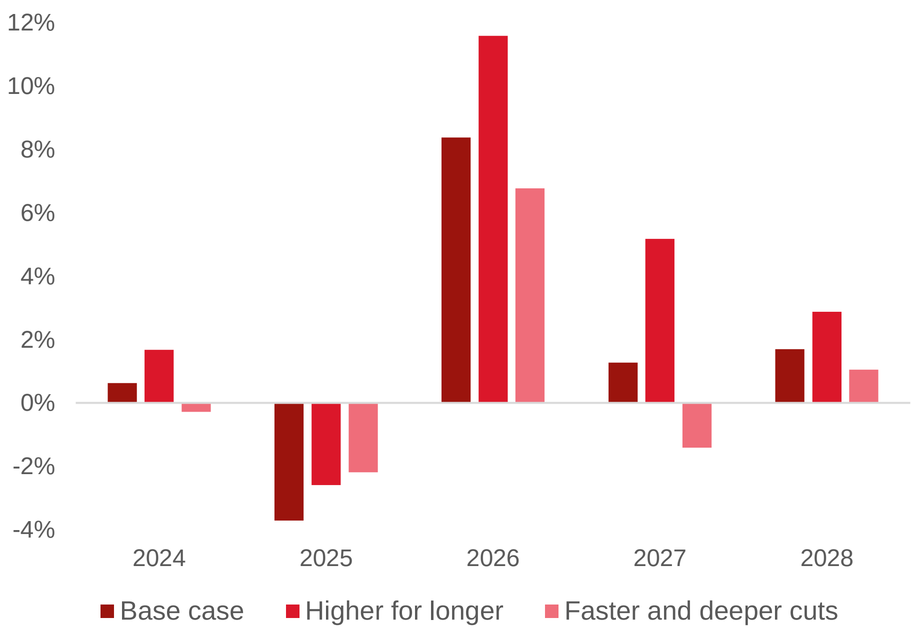


Assuming a 60% ultimate beta (conservative), at current forward rates, deposit margins would revert to 100 bps, their pre-GFC average

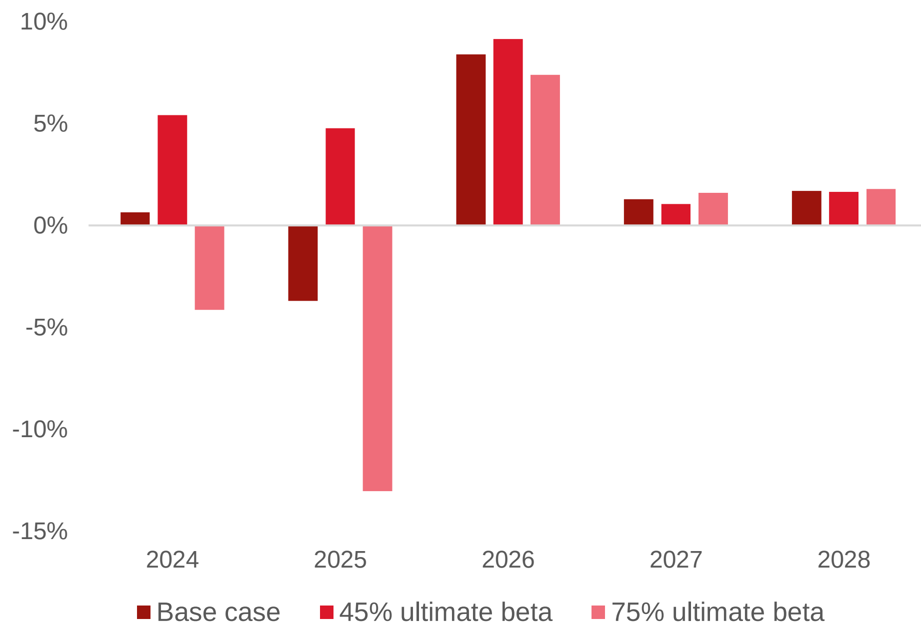
Data as of 05/03/2024 | Source: Axiom Alternative Investments

II.7 All in all, at sector level, NII should be stable in 2024 and 2025, and resume its growth once the cutting cycle ends

NII sensitivity to interest rates



NII sensitivity to deposit betas



- The **base case** assumes the current forward curve, 60% ultimate deposit beta (conservative) and 150 bps lending margins
- Deposit betas matter more in the short-term than the timing and the speed of rate cuts. The higher the deposit beta, the less sensitive the sector is to short-term rates.
- **Higher for longer**: 07 Oct 23 forward curve (neutral rate = 3%)
- **Faster and deeper cuts**: 27 Dec 23 forward curve (neutral rate = 1.8%)

Data as of 05/03/2024 | Source: Axiom Alternative Investments

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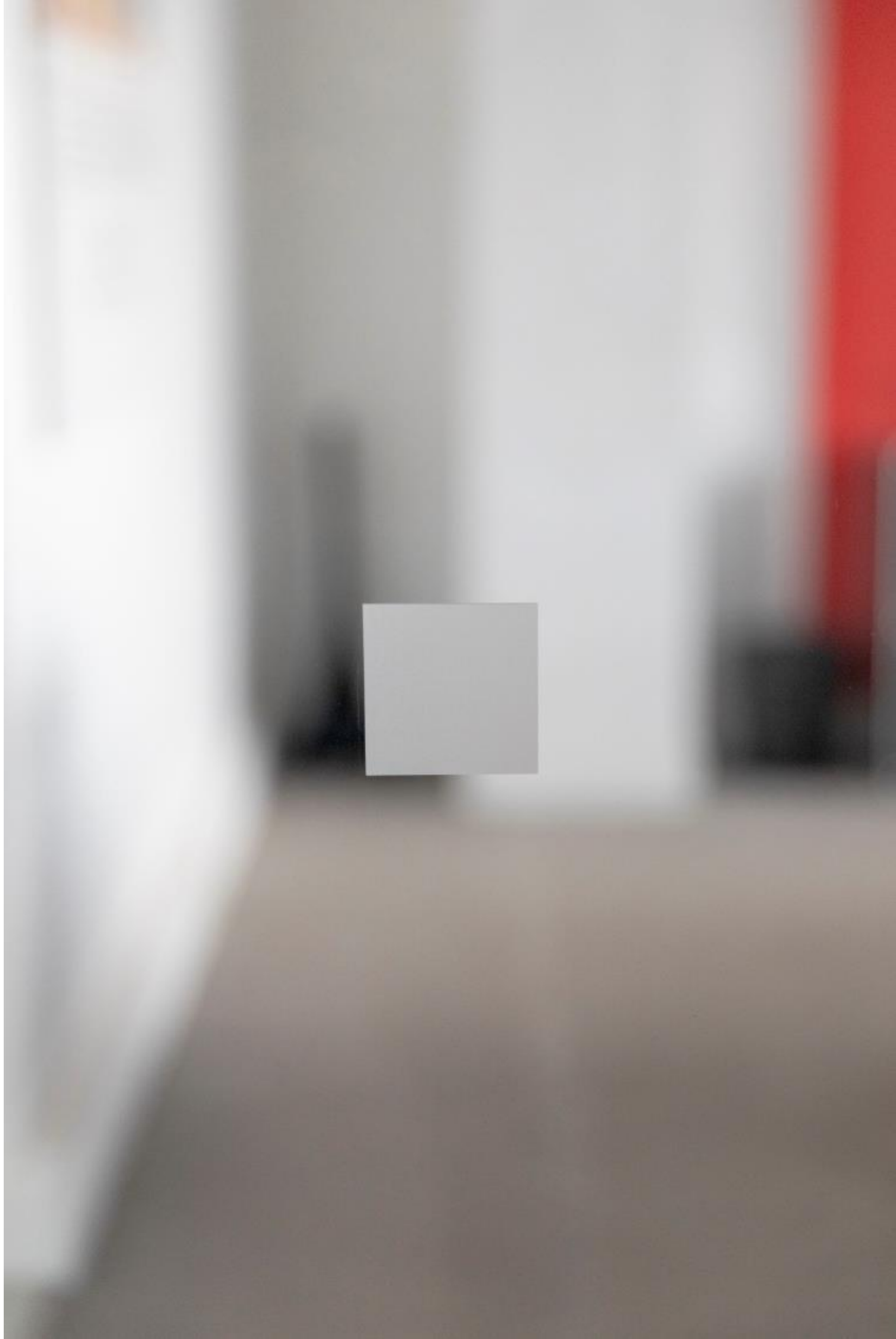
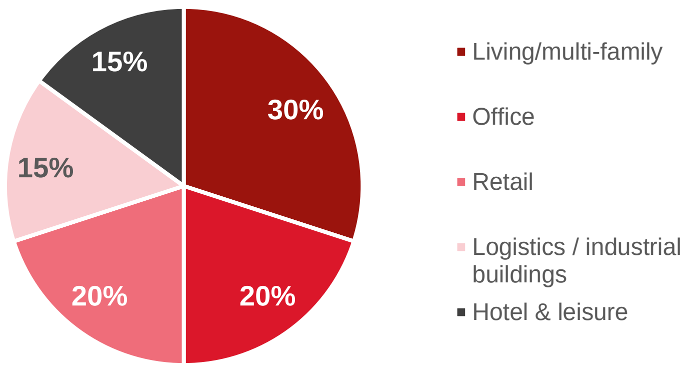
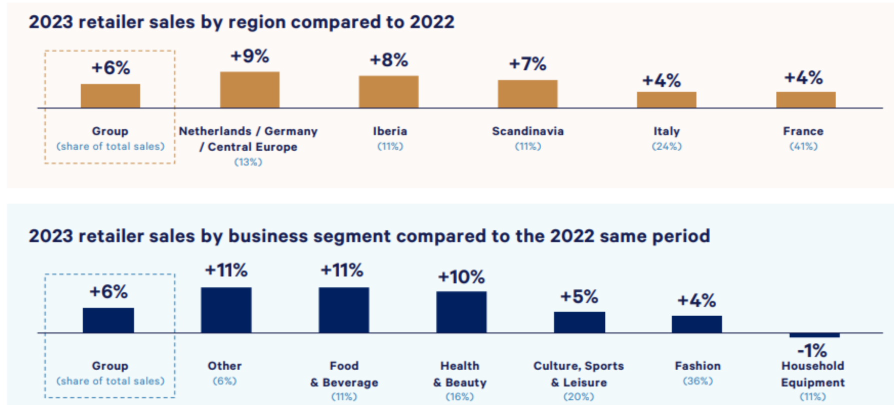


III.1 CRE: a catchword that covers contrasting realities

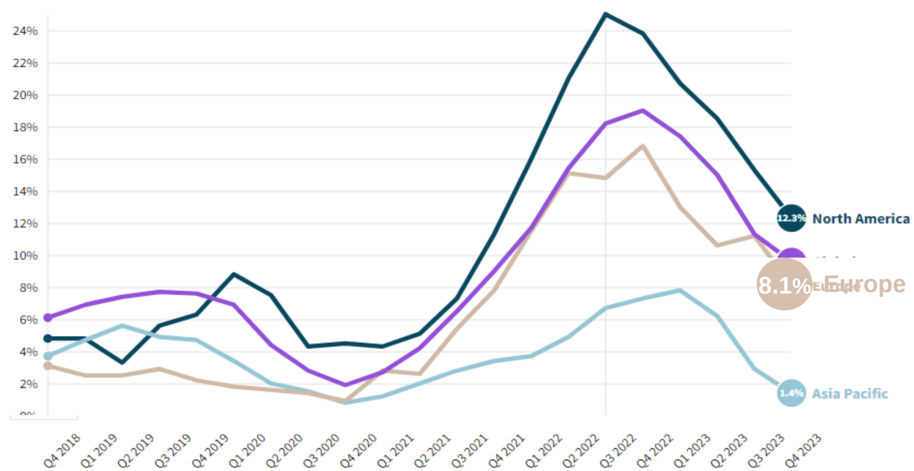
European bank exposures to CRE by sub-sectors



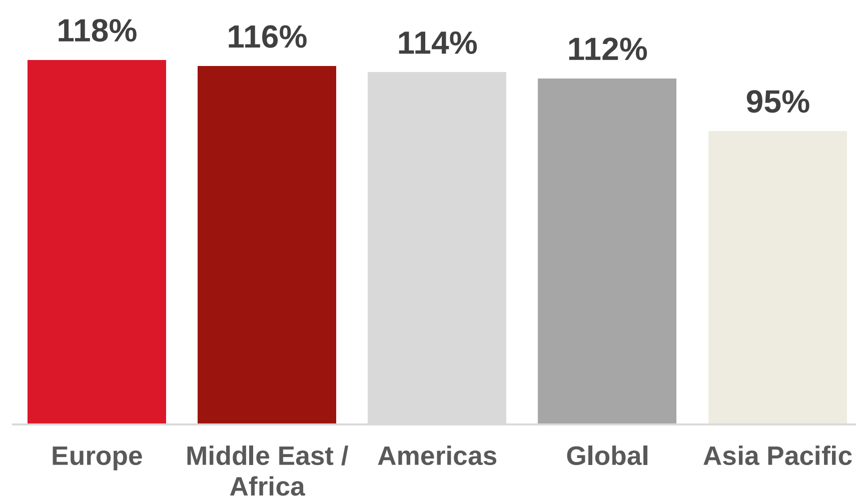
Retail has recovered faster than most expected



Logistics/industrials: rental growth slowing from peak levels across regions



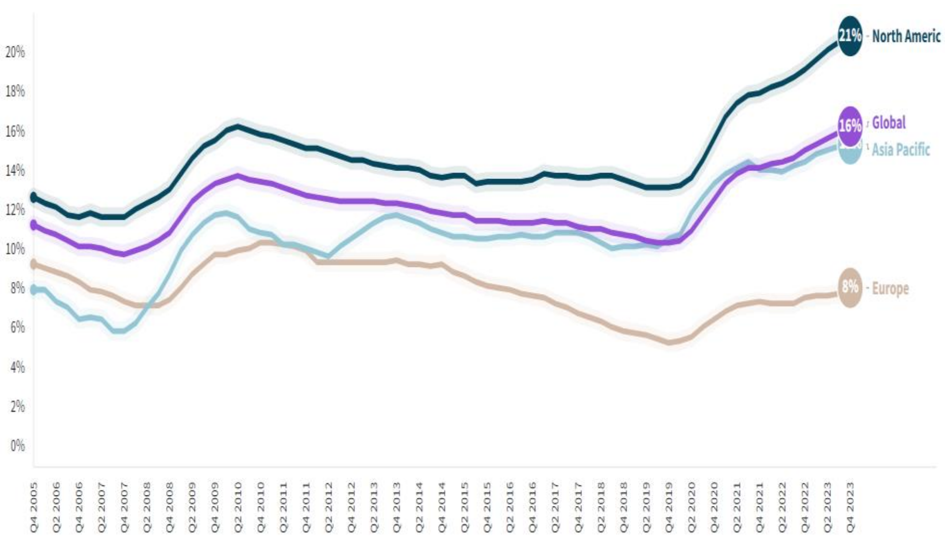
Hotels are in excellent health: ReVPAR Recovery to 2019



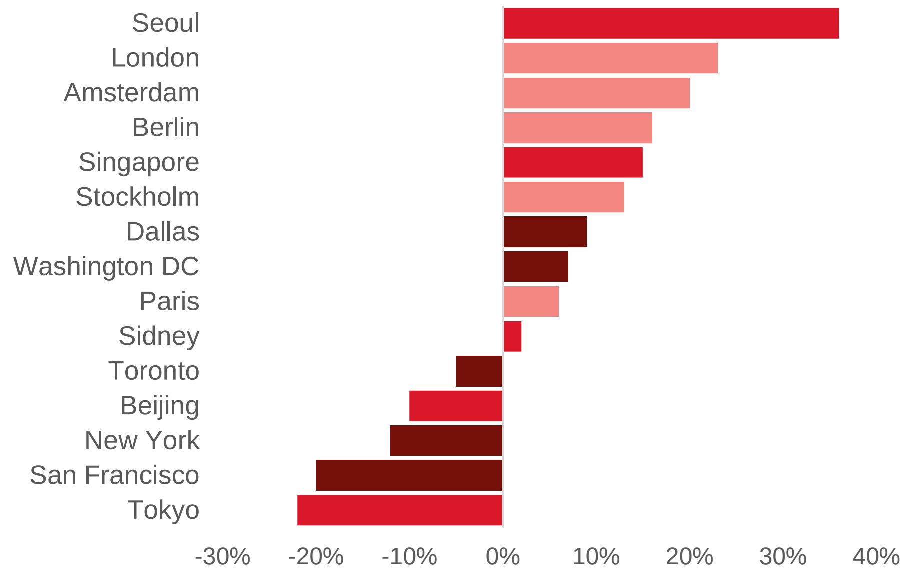
Data as of 05/03/2024 | Source: Axiom Alternative Investments, Klepierre, JLL

III.2 Troubled office exposures are mostly located in the US

Office Vacancy Rate (%), Q2 2005 – Q4 2023



Office rents have been growing in most European cities



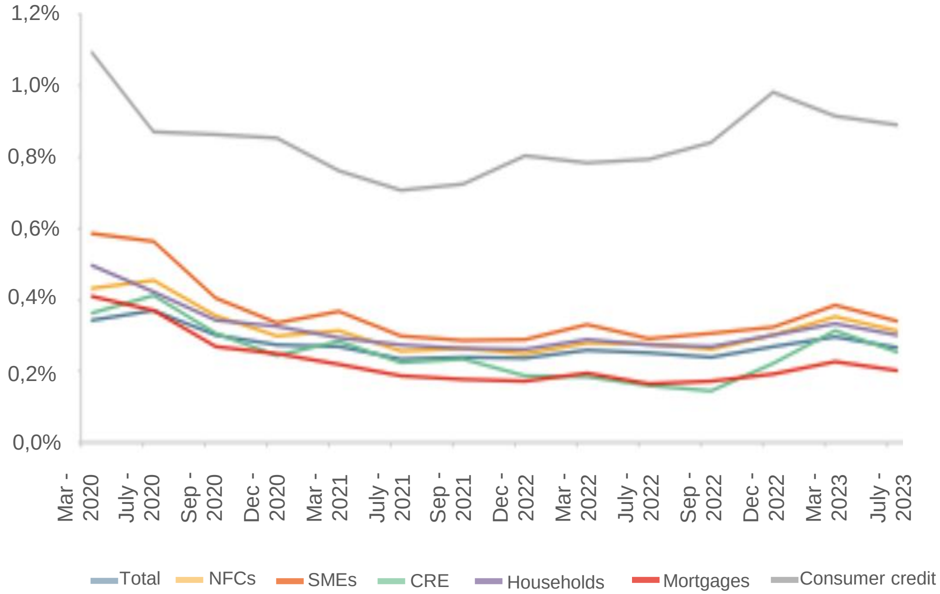
What could explain the differences?

- **Work from home/hot desking** existed pre-pandemic in Europe: 1.0x desk per employee in the US vs. 0.7x in Europe
- Shorter commute times and more shared living/office areas favor higher rate of return to office. Intra-muros areas are performing much better than CBDs.
- A **lower leverage** with much less use of junior and mezzanine debt
- Owners tend to have a long-term approach and **are keener to refill equity**
- **Tighter interest-rate hedges**

Data as of 05/03/2024 | Source: JLL Research, January 2024 EBA supervisory reporting data

III.3 Large European banks are not witnessing abnormal losses on CRE

CRE NPLs are stable in Europe



European Banks: 2023 CET1 ratio sensitivity to 10% loss rate on US Office CRE – Manageable impact (€bn, bps)

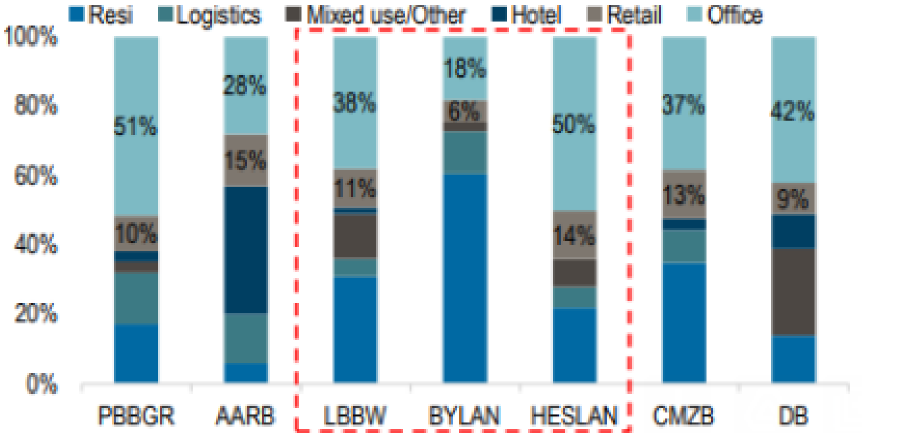
	US office CRE	Total US office CRE LLPs on 10% Loss rate	Assumed existing allowance	Additional LLPs needed	CET1 hit (bps)
DBK	7	0.7	0.2	0.5	10
Santander	2	0.2		0.2	2
BAWAG	0.5	0.05		0.05	18
Barclays	0.5	0.1		0.1	1
ING	1.3	0.1		0.1	3
Societe Generale	1.2	0.1		0.1	2

Hotels/logistics/retail are **doing better than in the past**. US office CRE per se cannot have any material impact on the European listed banks. European office offers a contrasted picture but has been resilient so far. Most of the stress in Europe is around new developments due to **valuation problems** and **high construction costs**.

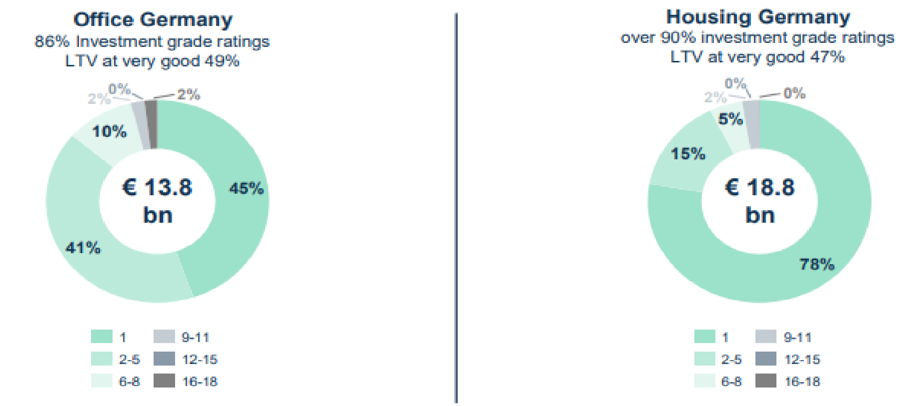
Data as of 05/03/2024 | Source: Axiom Alternative Investments | Source: JP. Morgan estimates

III.4 The case of specialist German lenders

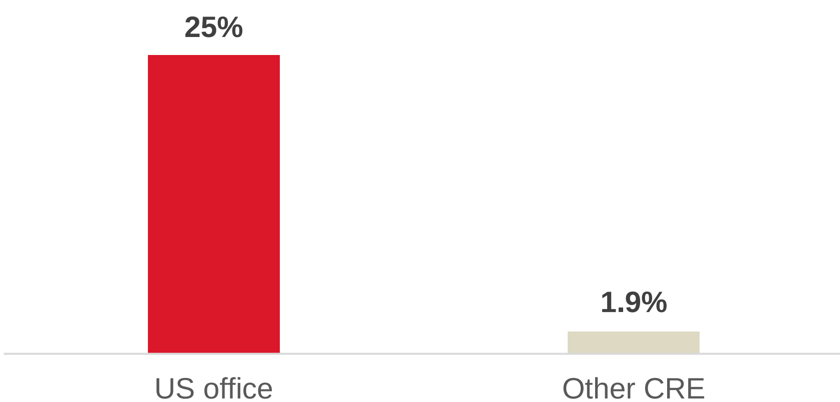
Helaba and PBB are the most exposed to the office market



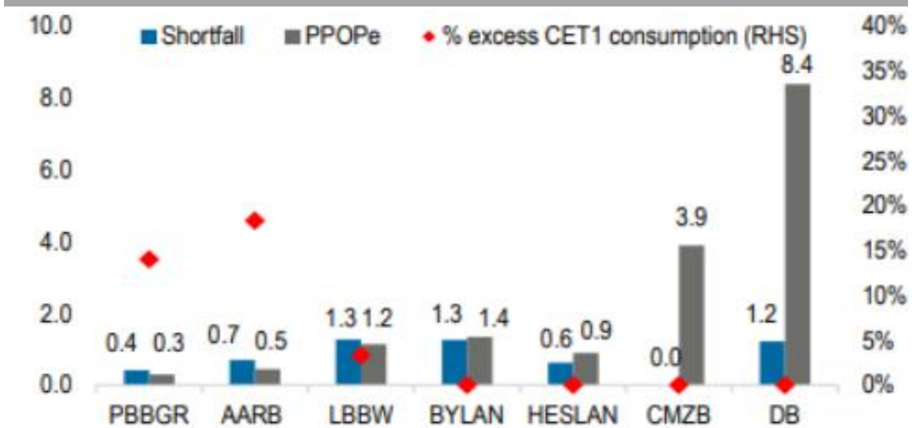
LBBW German CRE portfolio does not seem under any stress so far



NPL ratio for Aareal



Shortfall to reach best-in-class US CRE coverage (€bn)



Data as of 05/03/2024 | Source: JP Morgan estimates, Axiom analysis, LBBW company slides as of end of FY23

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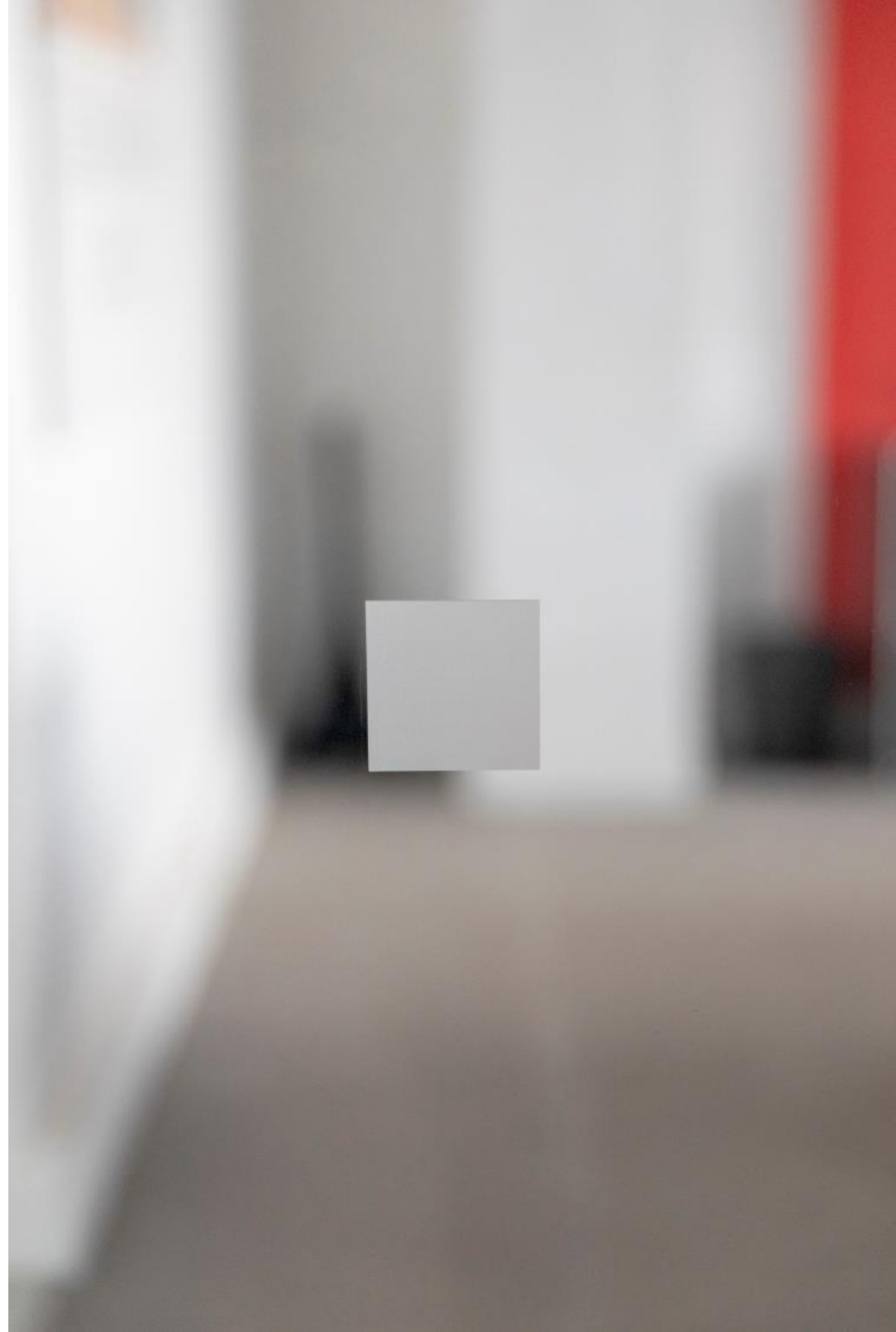

IV. The bull case, the boring case and the bear case

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%**	**Rate cuts** are **delayed** due to sticky inflation, with inverted curves persisting	Policy rates start to come down thanks to **good inflation data** while curves slowly disinvert
NIMs erode and uncertain macro restrains earnings and capital returns	Uncertainty around **deposit betas** and **asset quality** remains.	Deposit betas remain low & hedge portfolio tailwinds are **higher than expected**
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 **more NII and fees** growth and less asset quality stress
The **P/B** of the sector **plunges** to the lows of the 2010s (0.5x-0.6x)	Earnings and payouts stay elevated, but the sector **does not rerate**. The carry is the main source of total return.	The sector benefits from both the **carry** and a **rerating** (~1.0x P/B)

Data as of 05/03/2024 | Source: Axiom Alternative Investments

Q&A

Thank you for attending the Axiom Alternative Investments webinar.

See you next quarter.