GLOBAL IDEAS

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Morgan Stanley 11th Annual European Financials Conference feedback

Anchor Capital CIO Sean Ashton and Head of Alternative Investments, Glen Baker last week attended the *2015 Morgan Stanley (MS) 11th Annual European Financials Conference* which took place in London. Below we include feedback and summaries on some of the more interesting presentations and meetings we had with companies at the event.

To summarise, we would say that most banks presenting at the conference had the same message: the global economic environment is generally supportive or moving in the right direction, while legislative challenges continue to exist these are not worsening and most companies seem to want to, as these companies termed it, "shrink" their way to greater profitability/returns. Branch closures are a clear trend, while many companies also spoke about online banking capability as being a big competitive point of differentiation.

In the European banking space, we currently own Lloyds Banking Group in our portfolio. While the share has not been a good performer for us we do believe it warrants hanging onto (*see our detailed comments on the company below*). We highlight that from the presentations we attended UBS could be an interesting bank to potentially add given its heavy weighting to wealth management. As the group has the highest proportion of capital-light commission income (60% of total income) of its peer group, it should generate capital faster than its peers and is already well capitalised. This should enable the group to be generous with dividend payments. MS forecasts are way ahead of consensus expectations regarding UBS' dividends – it expects UBS to trade at an 8% dividend yield to FY16 which, if this is indeed the case, will likely result in strong share price gains for the Swiss banking Group.

Below we highlight the main points from those presentations/meetings which stood out for us:

Graham Secker – MS economist:
<u>Secker indicated that we are starting to see an increase in inflation expectations in Europe, which he believed should be positive for banks</u>. He noted however that MS was less optimistic on the insurance sector than on banks and diversified financials. The great performance by insurance counters has been driven by dividends and, as bond yields tick higher, the attraction of insurers should begin to fade. We would not entirely agree with this viewpoint, highlighting that dividend yields should remain forefront in investors' minds in an environment of low nominal returns

James Gorman – MS CEO:

- Gorman was of the view that in terms of the regulatory environment for banks globally it "feels like we are close to the end of all the changes." He commented that regulatory headwinds (legislative issues, currency/libor etc.) were "70%-80% out the way".
- On the macro front he highlighted that the <u>US economy was "on a path of inexorable improvement."</u> Personally, <u>he thinks that the first interest rate hike in the US will be in June, and if not then likely in September.</u>
- Gorman made the point that European growth has been generally positive, despite all the noise around Greece. However, he did indicate his concern around the long-term growth outlook for China.
- His outlook on MS was summarised as them having "significantly de-risked the organisation; the balance sheet has been reduced by one-third and half the business is Wealth & Asset Management – the ballast."

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Global Ideas is a newsletter published three times a week (Monday, Wednesday and Friday) and available only to clients of Investor Campus and Anchor Capital. The key objective of this newsletter is to provide ideas for investment in the global investment universe.

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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Barclays – Antony Jenkins (CEO):

- Jenkins indicated that costs would remain the strategic battleground for the sector in the coming years and that growth was hard to come by. Barclays' big focus was on technological innovation. He noted that Barclays has taken a GBP1.8bn reduction in costs in one year and it will take out a further GBP600mn of costs this year.

Lloyds Banking Group – Antonio Horta-Osorio (CEO):

- Lloyds is targeting a cost to income ratio of 45% by 2017 - it currently stands at 50%.
- The Group is of the view that it is underrepresented in car finance and in the credit card business.
- Lloyds has targeted GBP30bn of net new lending over the next 3 years and, while this sounds impressive, it amounts to only 2%-3% growth p.a. on the current base.
- The bank is the leading provider of mortgages in the UK and also the largest retail and commercial bank in the country. While the UK economy is growing and unemployment is falling – house prices have recovered nicely and **household debt to net wealth has also improved to pre-crisis levels**.
- Osorio was of the view that interest rates in the UK would likely stay lower for longer (we found it difficult to reconcile ourselves with the above statement probably due to a lack of inflation evidenced in the system).
- Lloyds currently has no exposure to investment banking.
- The bank is targeting an additional GBP1bn of run-rate savings from 2015-2017, which will cost an estimated GBP1.6bn in restructuring expenses to achieve (GBP400mn below the line).
- Osorio noted that it "should achieve a 13.5%-15% ROE over the strategic period". The Group is targeting a >50% dividend payout ratio, however no guidance was given on when exactly Lloyds will get there.

We also attended a Group meeting with Lloyds investor relations (IR) following the initial presentation and below we highlight the main points from this meeting:

- Lloyds indicated that it was key to invest in digital channels and that a winning strategy would be a multi-channel approach as the most profitable customers use all channels.
- Lloyds Group currently has 2,200 branches across all brands and indicated it would close a net 150 branches over the next 3 years.
- The bank believes its steady state Common Equity Tier 1 (CET1) capital ratio requirement is 12%.
- We note that, in our view, there was some politics at play in their guidance on ROE – while a 15% ROE is seen as acceptable to politicians, if one told the market a 20% ROE was achievable, it would attract a lot of unwanted attention from politicians. Our sense here is that Lloyds is under guiding relative to its potential.
- In terms of dividends, Lloyds said it has started off at a modest level, and the Group would adopt a progressive dividend policy to get up to >50% payout "over the medium term."
- The bank has a market-leading cost to income ratio of 50% but said it was targeting 45% by 2017. However, it highlighted that investors need to move away from the idea that Lloyds will be an "absolute cost reduction story" – costs will rise by a nominal amount and thus, by implication, Lloyds needs to drive income growth in order to achieve cost to income reductions. Management appear confident in this regard.
- UK base interest rate assumptions: Lloyds thinks that the new norm will be 3% for base rates, but it was unlikely to get there anytime soon (2.5% by 2018, was the CEO's view).
- Net interest margins (NIM): Lloyds is guiding to 255bps in FY15 (+10bps), which positively surprised most analysts. There are some Lloyds-specific factors driving this: A lot of "crisis money" came into their deposit funding mix in the bad times (2008), and there is GBP38bn worth of deposits which will roll off the books this year. Average rates of 2.5%-3.0% are being paid on this money and this could go to 50bps on instant access or 1% on fixed deposit (if it gets rolled). So, in a worst case scenario, Lloyds will see **a net benefit of at least 1.5%-2.0% on GBP38bn = ~GBP600-GBP700mn, or +-9% of FY14 "underlying" PBT**. This will clearly be a big driver of earnings growth for the year ahead.
- Customers in the UK are also very unlikely to be offered interest-only mortgages now. "We don't want to grow our market share in mortgages, now 23%. Will grow in line with the market."
- Other income: Lloyds is guiding to flat this year and believes it will see growth in the insurance and commercial sector, while Retail will remain challenging – "it is not as easy to charge fees in the UK as it used to be."
- Bad debts: Clearly, bank balance sheets in Europe are in better shape than in many years with respect to asset quality. Lloyds said it was "struggling to find bad debts right now." While it had some write backs last year, Osorio reckons that the Group's through-the-cycle figure will be 40bps, but has guided to 30bps this year.
- **Underlying vs statutory reported net income**: There were a number of material differences between these two reported profit metrics in FY14, largely relating to restructuring charges and payments that Lloyds has had to make for payment protection insurance (PPI) reimbursements. These totalled the following in FY14:
    - Asset sales & volatile items – GBP1.7bn;
    - simplification costs – GBP966mn;
    - TSB costs – GBP558mn; PPI – GBP2.2bn;
    - Other legacy – GBP925mn; other statutory items - +GBP374mn.
    - The net difference amounted to GBP6bn in FY14 btw statutory and underlying. Guidance for FY15: asset sales – "won't see such a big number, maybe GBP700mn; TSB costs go to zero after FY15, so a small number this year; PPI – likely GBP700mn based on recent experience; other legacy should also reduce. All in all, we reckon the gap between the two earnings numbers should decline to no more than GBP2.5bn. This implies reported statutory profit should rise by at least GBP3.5bn vs FY14, before any operational improvements.

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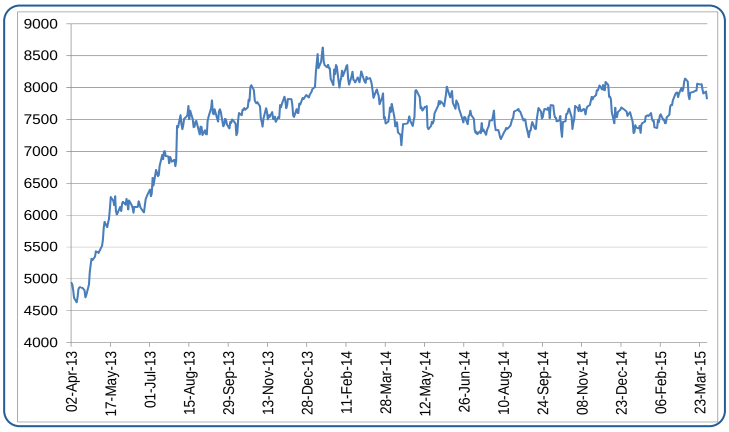
- **Consensus expectations for FY15 imply net income of GBP5.7bn**, or GBp8 when assessed on underlying earnings. We suspect there is some scope to beat these numbers. This places the stock at a forward 10x P/E multiple. The market is forecasting a GBp2.8 dividend for FY15 (a 35% pay-out ratio). This is probably sufficiently conservative given management's indication that they will move to a >50% pay-out ratio in the medium term. However, consensus is looking for a GBp5 dividend by FY17 (within the group's strategic planning horizon), implying 1.8x dividend cover, but we think the market's earnings expectations for that year are probably on the light side.

Conclusion:
Lloyds does not fit into what we would typically look for in a business – it is not a fantastic business as judged by ROE, prospects for deployment of capital do not appear amazing and, generally speaking, the environment is slow (albeit probably improving). However, the share price has gone nowhere for the past year and the business and operating environment is undoubtedly improving. If anything, their returns could surprise on the upside from very low levels of expectation. The share is cheap (as is most of the European sector) – a 10x forward P/E multiple, 1.44x tangible book. If they can achieve at least a 15% ROE in coming years, this would (in our minds) justify at least a 1.7x-2.0x book (+20%). The reason these shares have been held back is due to regulatory uncertainty around capital rules (Lloyds strongly believes it is sufficiently well capitalised), legacy issues holding back growth and a lack of lending growth – all of these seem to be moving in the right direction. While the share has done nothing for a year, it is no doubt worth more than it was a year ago and we think it does potentially represent a re-rating opportunity. However, once that re-rating is done, this is unlikely to represent a core long-term holding in our portfolios.

Lloyds Banking Group share price, GBP:



Source: TBO, Anchor Capital

Banco Santander:

- Structural impacts have taken the bank's pre-crisis return on tangible equity from 20% to the current 12%-14%. This is largely due to greater capital requirements.
- The bank's dividend policy is 30%-40% of earnings.
- The Group noted that "We are well positioned to deliver growth in profitability ahead of peers" adding that "Greater capacity for loan generation – mature markets will benefit from interest rate cycle generating credit, helped by low cost of funding, while a presence in emerging markets (EMs) with low banking penetration and growing demand for credit."
- "We are seeing positive growth trends across all our markets." We found this comment rather surprising given their Brazilian exposure, an economy under significant pressure due to (among other issues) a low oil price environment

UBS

- UBS indicated that its capital ratios are the highest out of all its global competitors.
- The bank highlighted "Our ability to build capital organically is second to none."
- UBS has 10%-15% profit growth over the cycle.

According to MS estimates, UBS trades at a forward 13.5x P/E multiple to FY15 (and 10.0x to FY16) and a ~15.5% ROE to 2017. Looking at its comparative grouping would imply that if MS are correct in terms of their estimates then the stock should be due for some relative re-rating. This is especially true if MS' predictions on dividends are correct (they have UBS trading at an 8% dividend yield to FY16, implying a 90% pay-out ratio by then). We need to assess the reasonableness of this number, but we note that according to MS research it has the least capital intensive earnings stream as judged by commission income as a percentage of total income.

Nordic Banks:
These banks are probably worthwhile paying a bit more attention to as they appear to be very well run from the perspective of having good capital ratios and decent cost to income ratios. However, ROEs are largely all still quite low. Nordea has a 49% cost to income ratio, while its CET1 capital ratio stands at 15.7% (which is very good). The DNB Group are targeting a 12% ROE in 2016/2017, but a less than 50% dividend payout. 86% of its savings products are sold online with its branches down from 244 in 2007 to the current 137 branches. Its cost to income ratio is now in the low-40s (its target is 40%). We note though that the Group is very exposed to Norway's oil dependence, which poses some risks to lending growth and asset quality given the sharp fall in the oil price.

Swedbank
Domestic consumption is strong in Sweden while the country also has a strong property sector. Increased regulation in the country could result in higher levels of securitisation. Swedbank has a CET1 ratio of 21% (very well capitalised by European standards). There is also a large housing stock shortage in Stockholm, with the real estate market pretty overheated. This obviously presents some risks, but we think bad debts are unlikely to be elevated in the near-medium term. Through digitalisation, Swedbank is enabling customers to do their own stress tests online and, while the bank believes it needs more educated customers, it currently has c. 80% of its customers connected to digital services.

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Asset manager (Schroders, Aberdeen & Henderson) panel discussion:

Henderson highlighted that the theme of demand for income was a very enduring one and currently (in the US) not only the low interest rate environment but also the retirement of baby boomers will underpin this trend. The US still accounts for half the world's wealth and is therefore a very attractive market to have exposure to from a Wealth Management perspective.

There is a general shift taking place where clients want to access their savings via mobile channels. Brand is very important here and European asset managers are becoming distinctly competitively disadvantaged vs global peers due to regulation e.g. bonus capping. Aberdeen said it would rather buy back shares than do a special dividend, while Henderson has come through a period of heavy investment and will now move into a phase of capital returns to shareholders (through share buybacks and special dividends). Aberdeen also indicated that it would love to have more of a presence in the US but it said it hadn't found anything that fits in with their business from an acquisition perspective. It was also highlighted that European Asset Managers would benefit directly from quantitative easing (QE) and long-term low interest rates

Conclusion:

The European banking environment continues to face regulatory headwinds, but we get the sense that the worst of this has passed. In addition, asset quality is improving due to falling bad debts and NIMs in many instances could improve. Some signs of growth in lending are also emerging. This should enable many banks to deliver reasonable earnings growth, although returns on equity are unlikely to return to pre-crisis levels (13%-15% is a reasonable expectation in the current capital rules environment). Nevertheless, valuations across the sector are not necessarily pricing in this improvement and we think there is the opportunity for decent returns from current price levels.

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