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zeb/

Banks from emerging markets lose their edge – European banks in search of sustainable strategies

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Key topics

I. State of the banking industry (p. 2)

- In Q2 2013, US and Western European banks exhibited solid TSR performances fueled by promising P&L results in Q1 2013
- Investors, however, became cautious about BRICS and especially Chinese banks, leading to lower valuations and higher CDS spreads

II. Key banking drivers (p. 6)

- The recession in Western Europe continued with negative growth rates for the fourth quarter in a row
- Sovereign interest rates remained low but increased in Q2 2013 as the US Federal Reserve considered adopting an expansive monetary policy

III. Special topic: Generating value in banks while acting as a responsible citizen (p. 10)

- Double sustainability as a strategic chance for banks
- Social/ecological sustainability tends to push TSR performance of banks but financial sustainability is a clear pre-condition

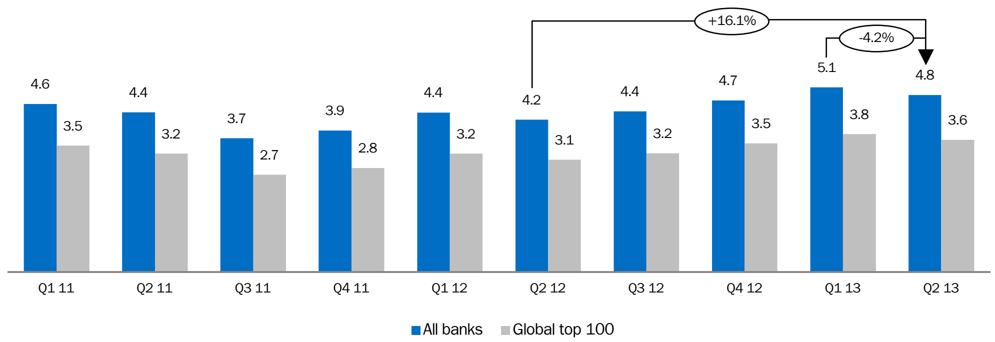
I. State of the banking industry

Market valuation

In Q2 2013, the global banking rally of the last quarters came to a halt as the sector's total market capitalization fell back to EUR 4.8 tr. Large institutions from China and Latin America suffered significant losses in their market valuation driven by fears of a liquidity squeeze in the Chinese banking system and uncertain consequences of the turmoil in Brazil.

Upward trend in global market cap stopped

Fig. 1: Market capitalization of the banking sector (end of quarter, in EUR tr)



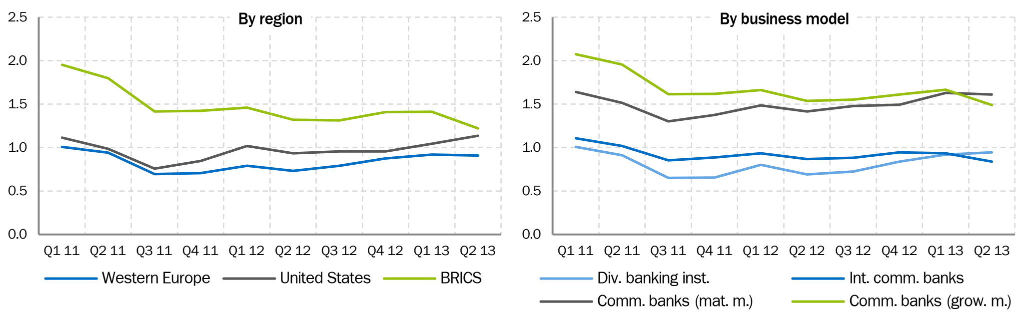
All banks worldwide according to Bloomberg classification. Global top 100 banks contain largest banks by market capitalization on Dec 31, 2012.
Source: Thomson Reuters Datastream, zeb/research

/ The market capitalization of all banks decreased by 4.2% to EUR 4.8 tr; however, this is still 16.1% or EUR 0.6 tr above the value one year ago

/ Especially large Chinese institutions were affected by investors' growing fear of a liquidity squeeze in the Chinese banking system

Emerging markets seem to lose their edge

Fig. 2: Price-to-book ratio of global top 100 banks



International commercial banks generate more than 70% of their earnings from classic banking activities in different international markets, commercial banks from mature/growing markets more than 70% in their respective market types, diversified banking institutions more than 30% from investment/ non-classic banking. Western Europe: Euro area, Denmark, Norway, Sweden, Switzerland, UK. BRICS: Brazil, Russia, India, China, South Africa.
Source: Thomson Reuters Datastream, zeb/research

/ Looking at P/B ratios, BRICS banks have lost their edge: with an average price-to-book ratio of 1.2 (-13.6%), BRICS institutions are only valued at slightly more than US banks, whose ratio increased by 8.7% to the highest valuation since Q1 2011

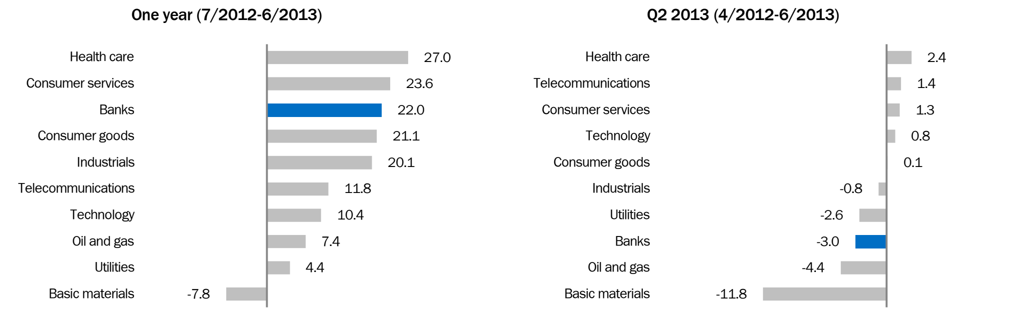
/ In terms of business models, it is remarkable that the average P/B ratio of commercial banks with a focus on mature markets is now higher than that of banks with a focus on growing markets

Equity performance

In Q2 2013, the global banking industry's performance was negative in terms of total shareholder return (TSR), but due to the strong recovery in 2012, the global banking sector still ranks well on a year-over-year perspective. Among the largest 100 institutions, banks with activities in growth markets have negative total shareholder returns while especially US and some European banks perform well.

Poor overall banking sector performance in Q2 2013

Fig. 3: Total shareholder return of industry sectors worldwide (in %)

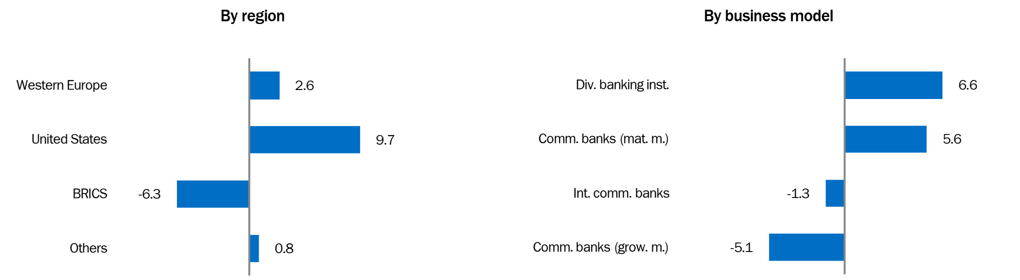


Total shareholder return of industry sectors based on global sector total return indices, aggregated and provided by Thomson Reuters Datastream.
Source: Thomson Reuters Datastream, zeb/research

- With total shareholder returns of -3.0% in Q2 2013 and +22.0% year-over-year, the banking sector exhibited poor performance last quarter but solid growth during the last year
- On a year-over-year basis especially health care and consumer services outperformed the banking sector; in Q2 2013, only the sectors oil & gas and basic materials performed worse

Significant TSR differences across regions and business models

Fig. 4: Total shareholder return of global top 100 banks (4/2013–6/2013, in %)



Average total shareholder returns are weighted by the market capitalization of each bank.
Source: Thomson Reuters Datastream, zeb/research

- In Q2 2013, large US institutions in the global top 100 sample created +9.7% of shareholder value on average, contrary to the sector's recent development
- BRICS banks actually destroyed value (-6.3%), which is in line with the other findings described above
- In line with increasing price-to-book ratios (Fig. 2), diversified banking institutions showed the best TSR performance in Q2 2013 with +6.6%; in contrast, international commercial banks (-1.3%) and commercial banks with a regional focus on growing markets (-5.1%) even destroyed shareholder value on average

Clear regional pattern for top and low TSR performers

Fig. 5: Top/low TSR performers among global top 100 banks (4/2013–6/2013, in %)

Global

Top performers	Country	TSR	Low performers	Country	TSR
Lloyds Banking Group PLC	Britain	29.7	Ping An Bank Co Ltd	China	-49.7
Charles Schwab Corp/The	United States	20.4	Industrial Bank Co Ltd	China	-44.9
Sumitomo Mitsui Financial Group Inc	Japan	19.1	Grupo Financiero Banorte SAB de CV	Mexico	-22.1
Qatar National Bank SAQ	Qatar	18.7	Yapi ve Kredi Bankasi AS	Turkey	-20.6
Capital One Financial Corp	United States	14.9	Itau Unibanco Holding SA	Brazil	-20.0

Western Europe

Top performers	Country	TSR	Low performers	Country	TSR
Lloyds Banking Group PLC	Britain	29.7	Standard Chartered PLC	Britain	-16.2
UBS AG	Switzerland	11.5	CaixaBank	Spain	-10.6
Intesa Sanpaolo SpA	Italy	11.5	Danske Bank A/S	Denmark	-5.8
UniCredit SpA	Italy	10.3	Erste Group Bank AG	Austria	-4.7
KBC Groep NV	Belgium	10.0	Barclays PLC	Britain	-4.0

Source: Thomson Reuters Datastream, zeb/research

/ Q2 2013 top and low performer rankings show a clear regional pattern: the five best-performing institutions are mostly from mature markets with a quarterly TSR of 15% and above, low performers are solely from growth markets with a loss of shareholder value of up to 50%

/ In Western Europe, publication of strong P&L results led to a good TSR performance of some British banks; in the case of Lloyds Banking, the TSR performance would have been even better if rumors about a possible re-privatization had not affected the stock negatively in June 2013

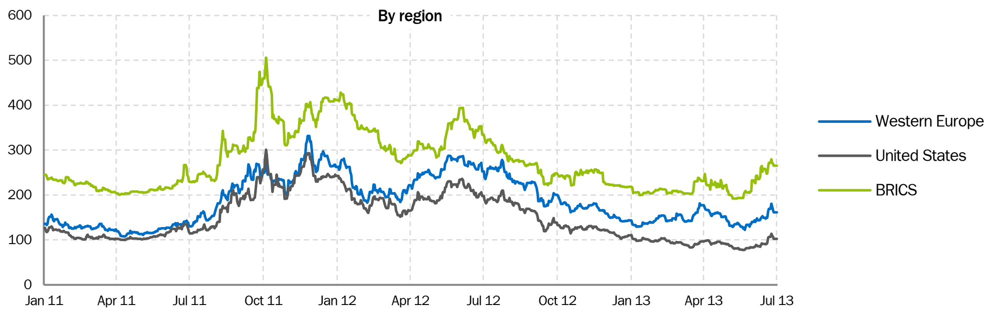
/ Italian banks as Intesa Sanpaolo and UniCredit published promising Q1 2013 results, too, which led to respective TSRs of +11.5 and +10.3% during Q2 2013

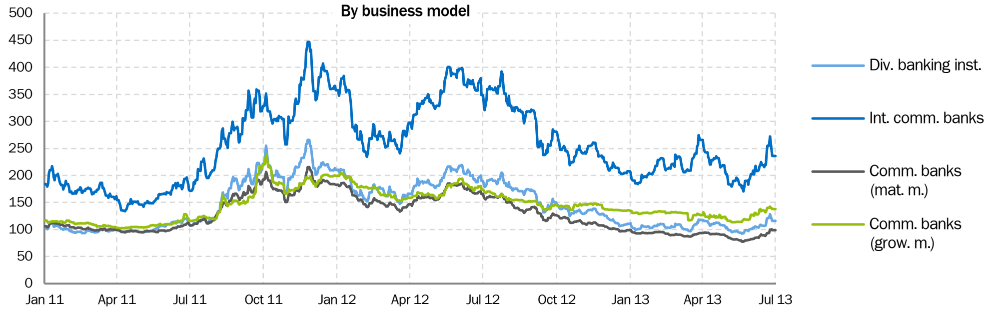
Debt perspective

From a debt perspective, Q2 2013 showed a mixed picture for global banks. CDS spreads decreased in the course of April and May but jumped up again in June. Nevertheless, the rating situation improved slightly with four rating upgrades and no further downgrades in the last quarter. Note, however, that the three S&P downgrades from July 4, 2013 for Barclays, Credit Suisse and Deutsche Bank have not been considered in the analysis yet.

Higher volatility in CDS spreads during last quarter

Fig. 6: CDS spreads of global top 100 banks (avg. 5-year CDS spreads, in bp)



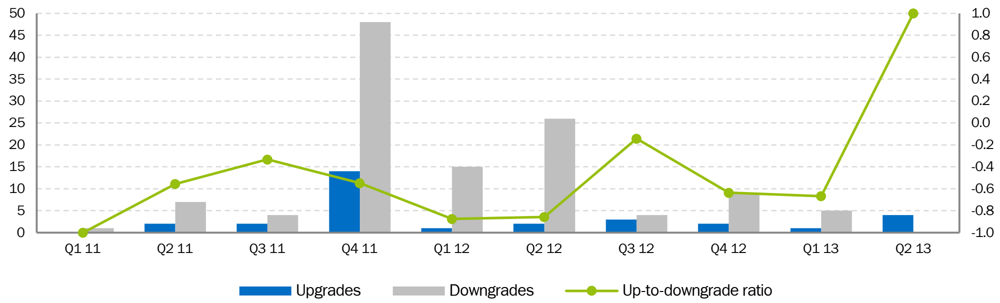


5-year CDS spreads are calculated as unweighted average of CDS spreads of each bank.
Source: Thomson Reuters Datastream, zeb/research

- Banks' CDS spreads became more volatile in Q2 2013: after strong decreases in April and partly May, CDS spreads jumped up again in June due to increasing uncertainties regarding the Chinese banking sector, some larger Western European banks and the political situation in Portugal
- Among regions, CDS spreads of BRICS banks were driven by the problems in China but also Russian banks who had to pay significantly higher spreads throughout the quarter
- CDS spreads of international commercial banks displayed the highest volatility among all business models

Fig. 7: Rating changes of global top 100 banks

Only upgrades in banks' ratings last quarter



Rating changes consider the number of upward and downward revisions of the long-term rating of global top 100 banks as provided by Standard & Poor's, Moody's, Fitch Ratings. Outlook revisions are excluded. Up-to-downgrade ratio (right-hand axis) is a harmonized index calculated as (number of upgrades – number of downgrades)/sum of upgrades and downgrades.
Source: Standard & Poor's, Moody's, Fitch Ratings, zeb/research

- After a high number of downgrades of banks in the past, Q2 2013 brought only positive rating changes and no further negative revisions – for the first time since Q3 2010
- The three S&P downgrades for Barclays, Credit Suisse and Deutsche Bank from July 4, 2013 however, have not been included in the figure yet

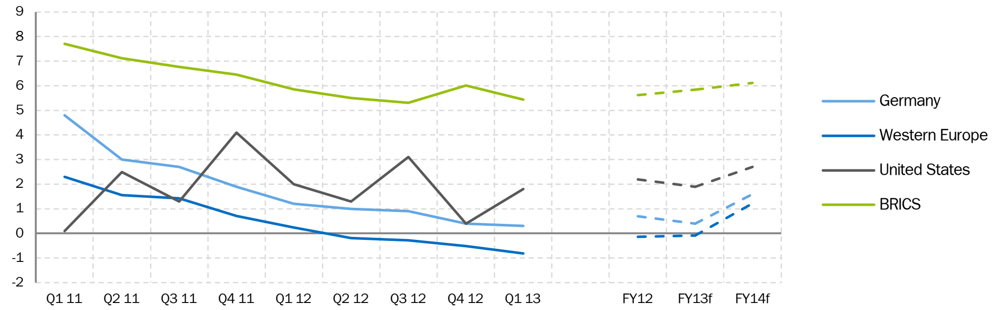
II. Key banking drivers

Economic perspectives

The economic environment remains challenging for banks. Especially in Western Europe, the economic downturn continues and forecasts see no fundamental change in the near future.

Economic condition of Western Europe further worsens

Fig. 8: GDP growth and forecasts (real GDP, year-over-year growth rates, in %)

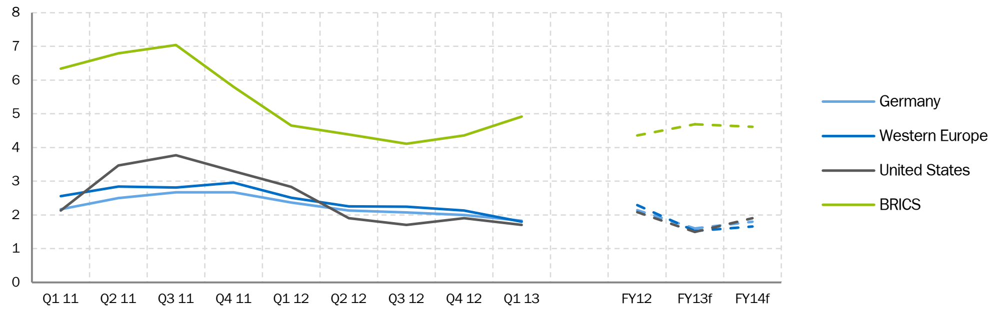


Q2 2013 data not yet available at the time of writing.
Source: Thomson Reuters Datastream, zeb/research

- The difficult economic conditions in Western Europe further worsened in Q1 2013: the growth rate was negative for the fourth quarter in a row and forecasts predict overall negative growth, even for the full year 2013; however, forecasts predict a recovery for 2014
- The US economy continued its “bumpy” growth path: in Q1 2013 its growth rate increased again to nearly 2%
- Growth in BRICS decreased but is still between 5% and 6% which corresponds to the expectations for the next quarters and years

BRICS inflation speeds up

Fig. 9: Inflation rates and forecasts (annual change of average consumer prices, in %)



Q2 2013 data not yet available at the time of writing.
Source: Thomson Reuters Datastream, zeb/research

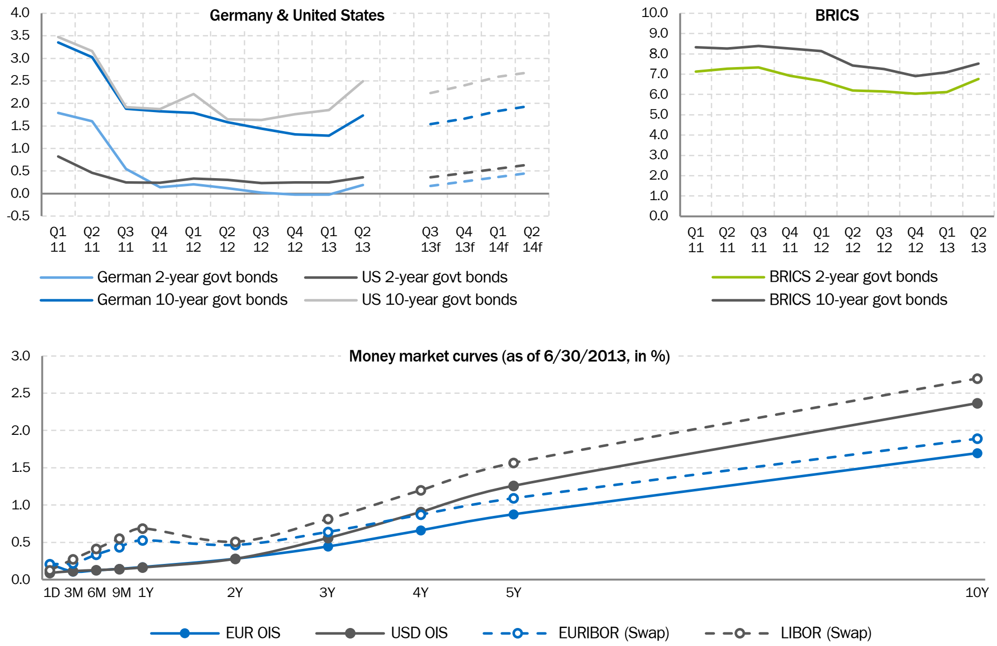
- In Q1 2013, inflation rates in Western Europe and Germany decreased slightly below 2% despite the ECB’s current low-interest policy that saw another reduction of the central rate to 0.5% in May 2013
- At the same time, inflation in BRICS countries rose to nearly 5% in Q1 2013

Interest rates

Especially in the US and BRICS, interest rates increased in the last quarter. In Germany and the US, the yield curve became steeper as short-term government bond yields rose less than long-term yields, making maturity transformation for banks a bit easier.

Sovereign interest rates rise in Q2 2013

Fig. 10: Government bond yields (in %) and interbank market rates



BRICS bond yields calculated as unweighted average, no forecast data available for BRICS countries. OIS denotes overnight indexed swap.
Source: Bloomberg, zeb/research

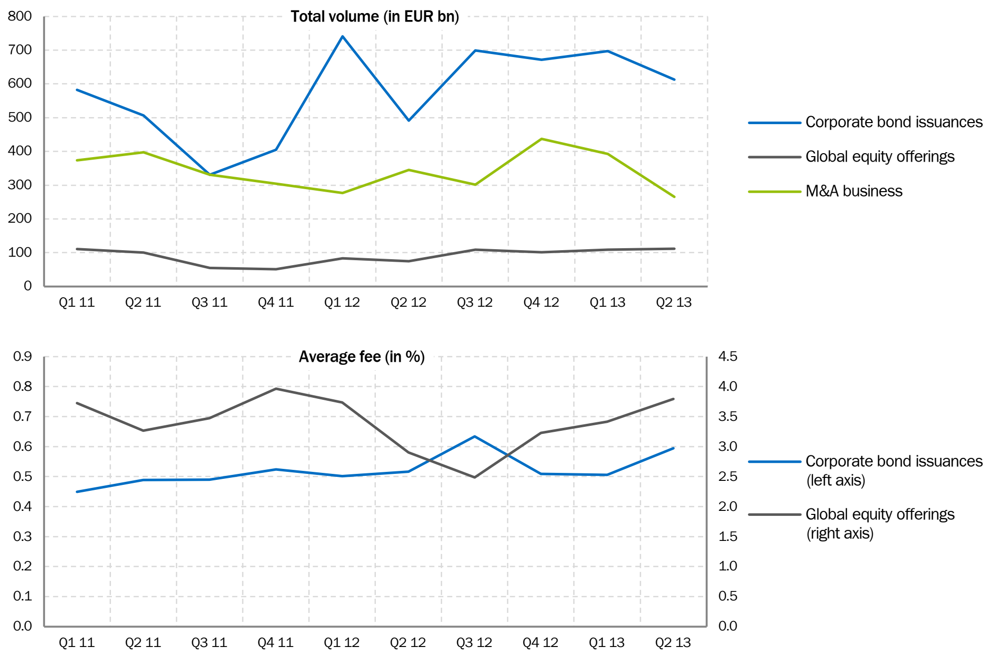
- Q2 2013 saw an increase of interest rates and government yields on a global basis mainly due to the recent announcement of the US Federal Reserve to consider an end of its expansive monetary policy
- In Germany, the average 2-year bond yield was slightly positive after being negative for two quarters in a row

Investment banking activities

The global investment banking business showed mixed results in Q2 2013. On the one hand, volumes of corporate bond issuances and M&A transactions decreased, but on the other hand, fee rates improved strongly.

Bond and M&A deal volumes decline but margins improve further

Fig. 11: Global issuance business and deal volume of global M&A business



All M&A transactions classified by announcement date. No fee rates available for M&A transactions.
Source: Bloomberg, zeb/research

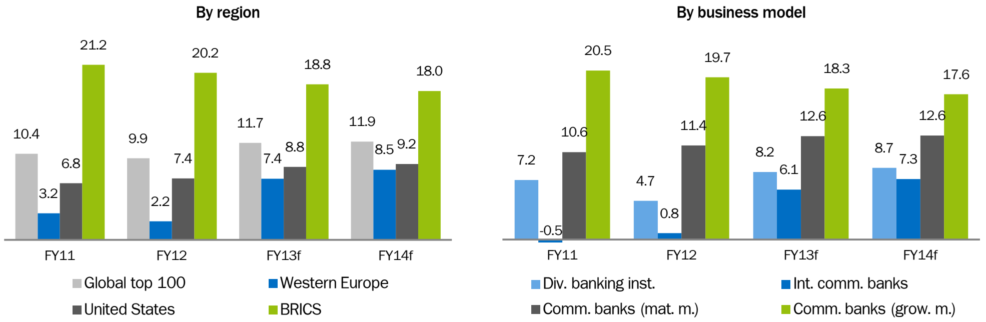
- In Q2 2013, global bond issuances did not reach last quarters' levels (-12% compared to the previous quarter) but the overall deal volume remained relatively high
- M&A transactions decreased strongly (-33%), breaking the previous seasonal pattern from 2011 and 2012, where the second quarter achieved better results than the first quarter
- With regard to margins, Q2 2013 was quite successful as the average fee increased strongly, reaching almost the highest level of the last two years: the average fee of corporate bonds issuances rose by 8bp to nearly 0.60% whereas the average equity offerings fee reached 3.80%, up nearly 40bp compared to Q1 2013

Banking profitability

From a profitability perspective, the banking world is still divided into two clusters. US and Western European banks achieved low RoEs in 2011 and 2012 and are expected to remain significantly below 10% even in 2014. Instead, institutions from BRICS countries achieved an average RoE of more than 20%, but it is expected that this profitability will fall well below 20% in the upcoming years. Commercial banks are still clearly ahead of diversified or international commercial banks but commercial banks from growth markets actually face falling RoE forecasts over the next years, narrowing the gap between them and the other business models.

Heterogeneous RoE forecasts

Fig. 12: RoE after taxes and yearly RoE forecasts of global top 100 banks (in %)



Forecasts are calculated as equity-weighted averages of analysts' consensus forecasts as available in Bloomberg.
Source: Bloomberg, zeb/research

- After achieving low RoE figures in 2011 and 2012, analysts expect a rise in profitability for US and Western European banks in 2013 and 2014 which is in line with the recently published promising P&L results for Q1 2013
- Nevertheless, the expected RoE increases for US and Western European banks have been significantly reduced in the last quarters: in the case of Western Europe, RoE forecasts for 2013 initially started at 11.2% two years ago in Q2 2011, slipped to 7.8% in Q2 2012 and were recently reduced again to 7.4%
- The profitability of BRICS banks may also decline in 2013 and 2014 as forecasts expect RoEs to be well below 20% for these years; this is in line with our previous results showing that banks in growth markets seem to lose (part of) their performance advantages

III. Special topic

Generating value in banks while acting as a responsible citizen – A contradiction?

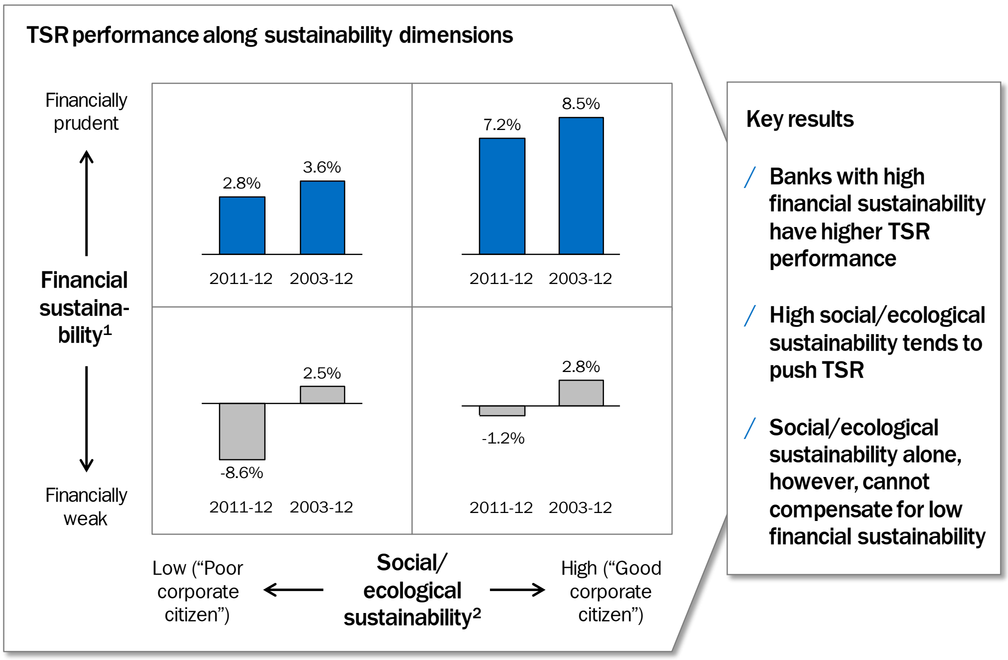
Hypothesis: Sustainability as value driver in banking

In this edition's special topic, we investigate the role of sustainability as a value driver in banking. For our brief analysis, we consider the hypothesis that the (perceived) sustainability of banks acts as a driver for value generation in banks. Two dimensions of sustainability need to be clearly distinguished. Financial sustainability shall be interpreted as a solid financial performance with volatility and risks well under control. Social/ecological sustainability on the other hand concerns the fair treatment of the environment, all members of society and all (current and future) generations.

We proxy financial sustainability by identifying outlier positions in bank's financial constraints. Banks with a high financial sustainability show no or only one outlier with respect to these constraints: leverage, liquidity, tier1 ratio and share of classic banking. Banks with several outlier positions are classified as banks with a low financial sustainability. Social/ecological sustainability is a bit more difficult to grasp and measure. For this we use sustainability ratings as a proxy. Here, we rely on the comprehensive CSRHub database, as it contains individual ratings for the relevant dimensions community, employees, environment and governance. In addition, CSRHub is the most comprehensive social/ecological sustainability rating with the widest coverage for our purposes.

Sustainability no contradiction to TSR performance

Fig. 13: Financial vs. social/ecological sustainability

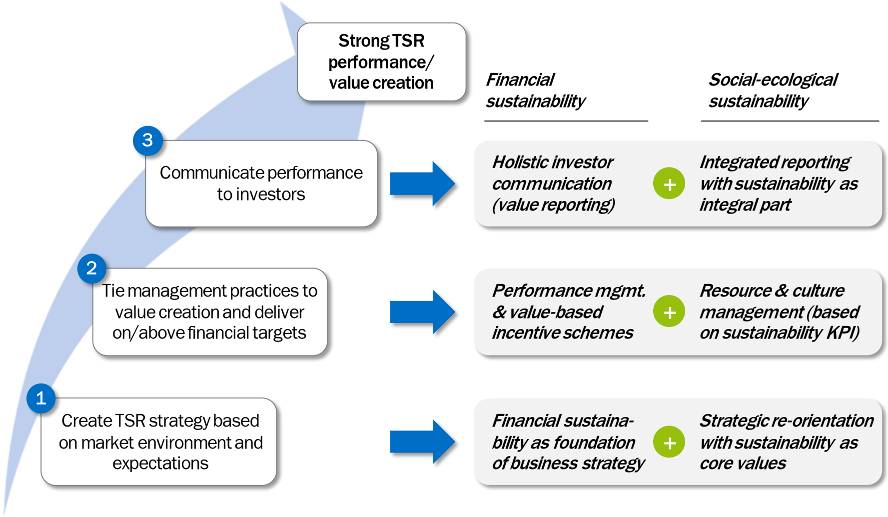


1) Financial sustainability proxied by number of outliers in dimensions liquidity, leverage, tier1 ratio and share of classical banking
2) Data on sustainability ratings 2012 from CSRHub database, analysis focused on developed markets due to data issues
Source: Thomson Reuters Datastream, zeb/research

Based on the covered banks in our global top 100 sample, we find that financially prudent banks (i.e. with a high financial sustainability) have a superior total shareholder return (TSR) performance compared to banks with a low financial sustainability (see Fig. 13). Looking at social/ecological sustainability, the pattern also holds but is somewhat less pronounced, especially over the longer term period 2003-2012. This is not surprising as the attention for a more social/ecological orientation in banks has only recently grown in the wider public.

Putting both observations together, one can conclude that social/ecological sustainability tends to push a bank's TSR performance but with financial sustainability being a clear pre-condition. Banks with a high social/ecological but low financial sustainability have lower TSR performances on average than banks with low social/ecological but high financial sustainability in both considered time periods. The full TSR potential can only be realized when you combine both sustainability dimensions. Banks with low financial and social/ecological sustainability scores have the poorest TSR performances, especially in the shorter time period 2011-2012 in which the sustainability orientation of banks has gained more attention in light of various banking scandals.

Fig. 14: TSR journey – management implications



Source: zeb/

Double sustainability as a strategic chance

What are the management implications associated with sustainability? In these uncertain times where many banks re-evaluate their strategic focus, double sustainability (i.e. both financial sustainability and social/ecological sustainability) offers a promising orientation for a bank's overall TSR journey. In total, six actions have to be taken on the three steps of the TSR journey. First, the TSR strategy needs to be re-evaluated with financial sustainability as its foundation. In addition, social/ecological sustainability has to be included in the institution's core values. Once a sustainable business/TSR strategy has been developed, management practices need to be tied to the new strategy. This is done via value-based incentive schemes and performance management on the financial side, as well as a dedicated resource and culture management with specific sustainability KPIs on the social/ecological side. During the third step, the strategic re-orientation needs to be properly communicated to investors and the public. A comprehensive value reporting, in which sustainability forms an integral part of the reporting, is suitable for holistically informing investors about all relevant value dimensions. This integrated reporting can be a crucial step on the TSR journey because the new strategic orientation towards more financial and social/ecological sustainability has to be credibly communicated. However, if not done properly, it will be perceived as another smokescreen from the financial industry.

About zeb/market flash

zeb/market flash is a quarterly compilation of market data, putting the total shareholder return (TSR) performance of the global banking industry, economic fundamentals and key value drivers into perspective. It is published by zeb/rolfes.schierenbeck.associates. All data and calculations of this issue are based on the due date July 1, 2013. The global top 100 banks cluster contains the largest banks by market capitalization on Dec 31, 2012 and is updated on a yearly basis. Data is subject to ongoing quality assessment. As a consequence, minor adjustments could be applied to historical data as well as forecasts shown in previous issues of zeb/market flash.

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