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EU banks with solid start into 2017 after rally in Q4 2016—new hope for the European banking industry?

zeb.market.flash Q1 2017

Key topics

I. State of the banking industry

- The banking sector's market capitalization increased further in Q1 of 2017: on average, the global top 100 banks increased their market cap by 3.8% reaching EUR 5.4 tr—the highest level in recent years.
- After a very strong Q4 2016 with 17.2% TSR, global top 100 banks reached 4.8% in Q1 2017.

II. Economic environment and key banking drivers

- The world economic climate and economic sentiment of the euro area continued their improvement in the first quarter of 2017.
- The EURIBOR yield curve steepened slightly, while a second Fed interest rate increase lifted the USD LIBOR curve, most notably at the short end, thereby flattening the curve.

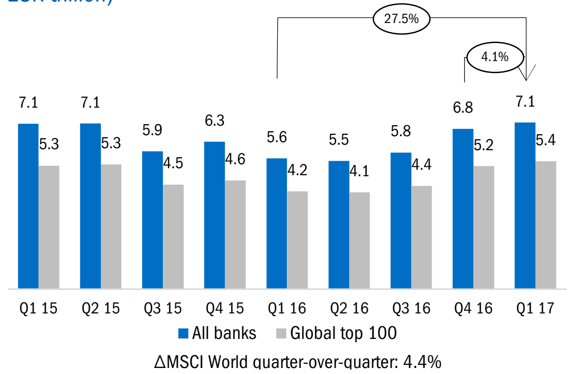
III. Capital increases in the European Banking sector—a question of confidence or price?

- 2017 started with significant capital increases by UniCredit and Deutsche Bank—together totaling nearly EUR 21 bn, almost twice the total volume raised by all European banks during the past 3.5 years.
- In chapter III, we analyze the environment of capital increases and the influence of confidence and price on the success of issuing new shares.

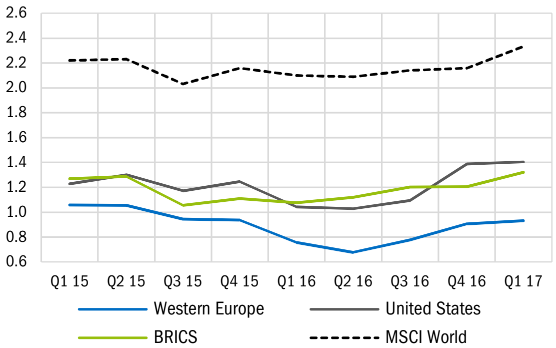
I. State of the banking industry

After a rally in the last quarter of 2016, the global banking sector showed a solid capital market performance in the first quarter of 2017. On average, the global top 100 increased their market cap by 3.8% (all banks: +4.1%) and total shareholder return reached +4.8%.

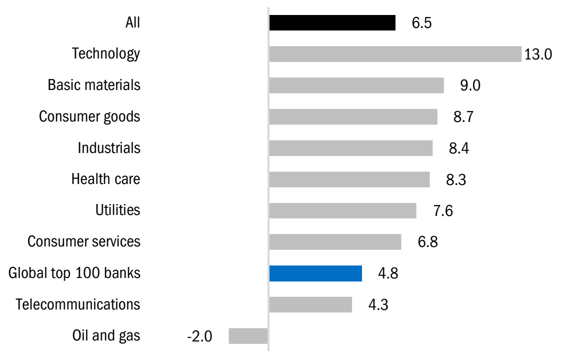
Market capitalization of the banking sector (end of quarter, in EUR trillion)[1)]



Price-to-book ratio of global top 100 banks and MSCI World[2)]



TSR of industry sectors worldwide (1/2017–3/2017, in %)[3)]



Top/lowest TSR performance among global top 100 banks (1/2017–3/2017, in %)

Top performers	Country	TSR
CAIXABANK S.A	Spain	28.3
KOTAK MAHINDRA	India	21.2
BANCO DO BRASIL	Brazil	20.6
HDFC BANK LTD	India	19.6
STATE BANK INDIA	India	17.3
Low performers	**Country**	**TSR**
FIRSTRAND LTD	South Africa	-10.7
NATIONAL COMMERCIAL BANK	Saudi Arabia	-8.5
SBERBANK	Russia	-7.8
SMFG	Japan	-7.7
HAITONG SECURITIES	China	-7.3

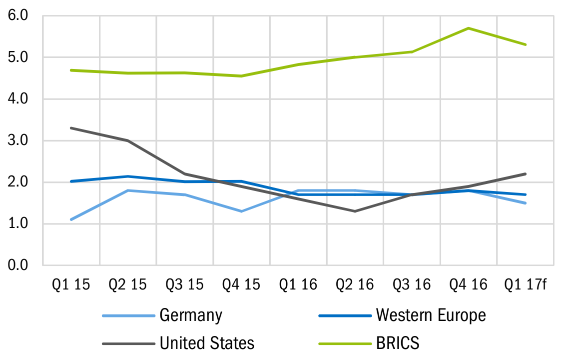
1) All banks worldwide according to Bloomberg classification. Global top 100 banks contain largest banks by market capitalization on December 31, 2016. Figures are aggregated in EUR, without adjustments for foreign currency effects; 2) Western Europe: euro area, Denmark, Norway, Sweden, Switzerland, UK. BRICS: Brazil, Russia, India, China, South Africa; 3) Total shareholder return (TSR) of industry sectors other than banking based on global sector total return indices, aggregated and provided by Thomson Reuters Datastream. Average total shareholder returns of global top 100 banks are weighted by the market capitalization of each bank; Source: Bloomberg, Thomson Reuters Datastream, zeb.research

- In Q1 2017 the market capitalization of global top 100 reached EUR 5.4 tr, the highest level in recent years, while the market cap of all banks grew year over year by 27.5%, reaching early 2015 levels.
- European banks' P/B ratios continued their recovery in Q1 from a low point in mid-2016, growing for the fourth consecutive quarter and nearing an average of 1.0x, even as US peers' ratios leveled out at 1.4x.
- The only European top TSR performer in Q1 was Caixabank, which experienced a strong rise in post-tax profits of more than 28% in 2016 and whose stock was buoyed in Q1 by news of an insurance deal with Barclays.
- Indian banks are among top TSR performers due to a strong Indian stock market rally since the beginning of 2017.

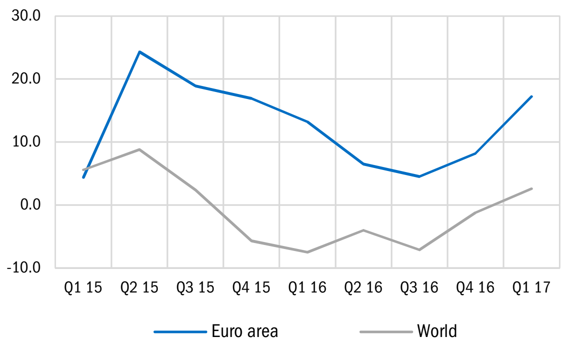
II. Economic environment and key banking drivers

The world economic climate as well as economic sentiment of the euro area continued to improve in the first quarter of 2017. A second Fed interest rate increase substantiated the robust development of the (US) economy and lifted the USD LIBOR curve mainly at the short end.

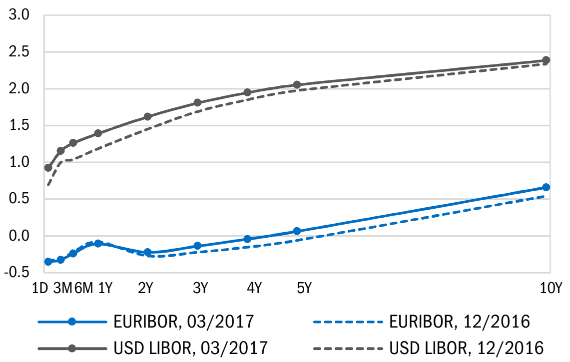
GDP growth and forecasts (real GDP, year-over-year growth rates, in %)[1)]



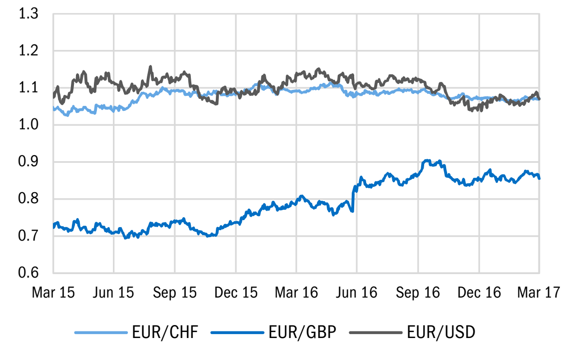
Economic sentiments (Ifo Economic Climate Balance)[2)]



Money and capital market rates



FX rates (EUR/CHF, EUR/GBP, EUR/USD)

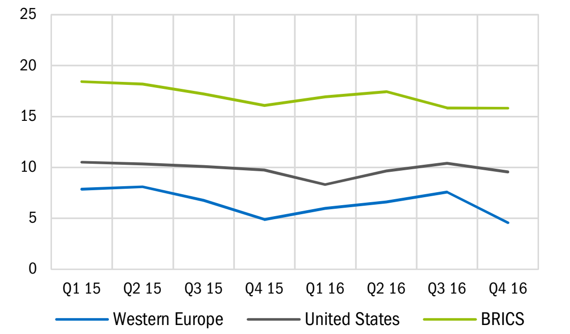


1) Western Europe: euro area, Denmark, Norway, Sweden, Switzerland, UK. BRICS: Brazil, Russia, India, China, South Africa; Q1 17 based on forecasts; 2) The Ifo Business Climate Balances is an assessment of a region's general economic situation and expectations regarding key economic indicators. In Q1 2017, the Ifo Institute eliminated index values from their survey and only provided balances. For the time t, the balance is the difference between shares of assessments with "good/better/higher" (+) and "bad/worse/lower" (-). The balance ranges from -100 points to +100 points. Data is only available for the euro area and world region; Source: Bloomberg, Ifo Institute for Economic Research, Thomson Reuters Datastream, zeb.research

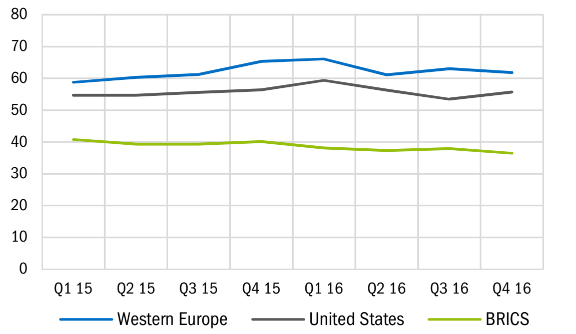
- According to forecasts, the US economy is expected to accelerate growth in Q1 2017 (+0.3pp), while for Germany, Western Europe and BRICS the forecast shows slightly decreasing expectations with regard to growth figures.
- However, in Q1, the economic climate for the euro area increased strongly due to far more positive expectations about the upcoming economic situation (notably, inter alia, in Austria, Spain or France). The world economic sentiment also emerged to a positive value, indicating a moderate recovery in the world economy.
- The decision by the Fed to increase interest rates for the second time by 25bp substantiates the positive expectations regarding the economy. However, the USD LIBOR curve flattened due to a significant rise at the short end of the curve. Lacking a comparable change in monetary policy from the ECB, the EURIBOR curve steepened slightly as negative rates at the short end (>3 months maturity) are maintained for the seventh consecutive quarter.
- After hitting a 10-year low against the US dollar following US election results, the euro recovered 1.4% in Q1 2017 as the latest Fed decision failed to meet the expectations of the market participants (stronger increase in interest rates). EUR/GBP remained mostly steady throughout Q1, with GBP unable to recover ground on the 8% yoy loss.

US and BRICS remain ahead of Europe regarding banking profitability. After improving profitability over the last three quarters, European banks' profitability decreased slightly, falling back to an average RoE of 4.6% in Q4 2016.

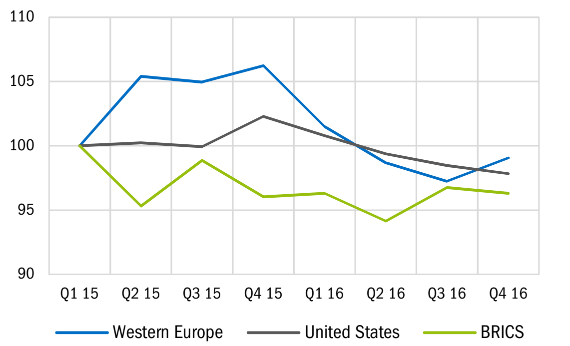
RoE after tax of global top 100 banks (in %)[1]



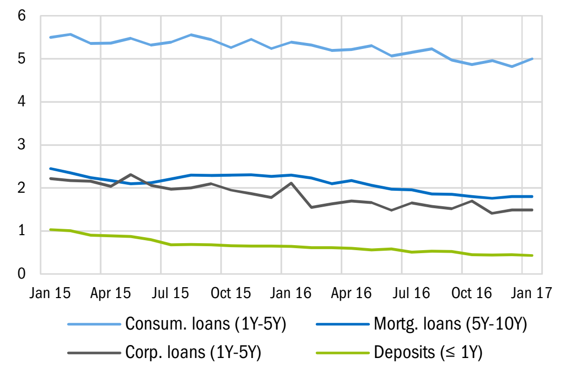
Cost-income ratio of global top 100 banks (in %)[2]



RWA density development of global top 100 banks (in %)[3]



Customer interest rates in the euro area (new business, in %)



Q1 17 data not yet available; 1) Post-tax RoE (return on equity): post-tax profit to average total equity; 2) Cost-income ratio: operating expenses to total income; 3) RWA density: risk-weighted assets (RWA) to total assets; RWA density indexed to 100 on March 31, 2015; Source: Orbis Bank Focus, ECB, zeb.research

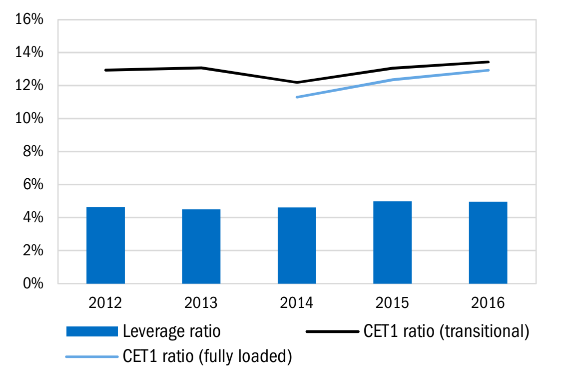
- RoE of European banks strongly driven by large EU banks ending 2016 with very low or even negative average RoEs (HSBC: 1.8%, Deutsche Bank: -2.0%, Credit Suisse:-5.6%, Royal Bank of Scotland:-10.1%), pulling down the EU average. Litigation costs continued to burden both Credit Suisse and the Royal Bank of Scotland, while the Royal Bank of Scotland faced restructuring and state aid obligation costs.
- Whereas the CIR of European and BRICS banks decreased slightly in the final quarter of 2016, US banks' CIR increased by 2.2pp.
- Following a strong reduction of European banks' RWA density over the first three quarters of 2016 (-9.0pp), European banks ended the year with a slight increase of 1.8pp. The RWA density of US banks continued to fall.

III. Special topic

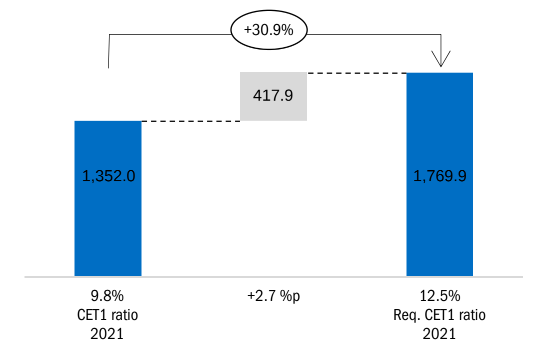
Capital increases in the European Banking sector—a question of confidence or price?

2017 started with significant capital increases by two large European players, UniCredit and Deutsche Bank, together totaling nearly EUR 21 bn. Although the European banking sector is characterized by low profitability and capital market valuation, could this development be a signal of an overall improvement in the capital-raising environment for European banks perhaps due to increasing confidence in the banking sector? Or is it more a question of price?

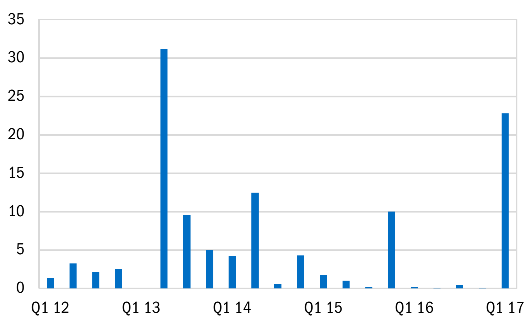
CET1 ratio / leverage ratio of European top 50 banks[1)]



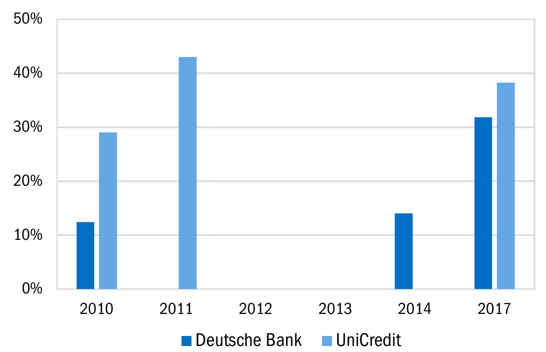
Capitalization gap in 2021 of European top 50 banks, in EUR bn[2)]



Deal volume rights offering of all European banks since 2010, in EUR bn



Discount per share for Deutsche Bank and UniCredit capital increases since 2010[3)]



1) CET1: common equity Tier 1 capital to risk-weighted assets; 2012/13: Tier 1 ratio; leverage ratio based on reported figures, est. if not available; Sample contains 50 largest European banks by latest stated total assets for 2016; Europe includes the 28 EU countries, Norway, Russian Federation, Switzerland, Turkey; 2) Results based on the zeb.European Banking Study: includes effects from regulation / other rules and changing yields and based on scenarios without management actions, see zeb.European Banking Study for further details; 3) Percent discount to the last closing price before announcement of capital increase; Source: Bloomberg, zeb.research

In recent years banks have focused on improving their capital basis, resulting in significantly higher capital ratios. This trend continued in 2016, as banks' capitalization continued rising, with transitional CET1 and leverage ratios well above regulatory requirements. The average transitional CET1 ratio of Europe's 50 largest banks rose to 13.4% and the average leverage ratio to 5.0%. Nonetheless, nearly 25% of the European top 50 banks still exhibit current transitional CET 1 ratios below the expected future regulatory burden of 12.5%. Furthermore, zeb's European Banking Study 2017 shows that the upcoming regulatory initiatives, together with expected persistently low profitability, will massively affect capital ratios over the next five years. In a simulated baseline scenario without management action, the capitalization of the top 50 European banks falls below 10% to 9.8% on average by 2021. Fixing a realistic target for the CET1 ratio at

12.5%, zeb's European Banking Study 2017 anticipates a capital gap of approximately EUR 420 bn in 2021.[1] Although the current average capital ratios indicate a different picture, the European banking sector will continue to have a massive need of further capital. However, closing such capital gaps is not straightforward in an environment where insufficient profitability is a key issue. In particular, the ongoing low yield environment and higher regulation will put further pressure on the profitability of European banks. Based on the results of zeb's European Banking Study 2017, the top 50 European banks will on average suffer a significant decline in profitability as their post-tax return on equity decreases to 1.7% in 2021. Under these circumstances, it is hard to imagine that investors are willing to provide the banking sector with new capital.

It was therefore surprising as 2017 began with the highest volume of equity capital increases in the European banking sector in the past three years. The volume of approximately EUR 22.8 bn—more than twice the total volume European banks raised during the past 3.5 years—can be accounted for by the large capital increases of UniCredit and Deutsche Bank. On February 6, Italy's largest bank started a substantial capital increase of nearly EUR 13 bn, the largest capital increase in Italian economic history and the third significant increase by UniCredit since 2008. After a reported loss of EUR 13.6 bn in the fourth quarter, primarily driven by increased loan loss provisions, UniCredit's CET 1 ratio had been pushed down by 2%p to 8.2% and therefore far below its current capital requirement of 10%. Raising fresh capital thus re-strengthened the capital base sufficiently and is also expected to strengthen the bank's position for its plan to get back on track.

Following UniCredit's successful capital increase, Deutsche Bank announced on March 5 that it would be the second large European player to raise capital. With its fifth capital increase in a decade—and part of a larger change in strategy—the bank aimed to raise a further EUR 8 bn new cash from capital markets and to issue 687.5 m new shares—about 50% of its existing share count. The major reason for this increase came from the almost continuous capital adequacy challenges facing the bank in recent years exacerbated by recurrent high litigation costs. With this measure, Deutsche Bank expects to raise its pro forma CET 1 ratio above 14% (currently 11.8% fully loaded) in order to reassure shareholders and to bring the focus to its new restructuring plans.

These two examples may indicate that confidence in the European banking sector has returned slightly and that raising capital through capital markets is and will continue to be possible. Of course, both of these capital increases were also accompanied by new strategic measures for the issuing banks. Deutsche Bank managed to conclude many of its litigation battles, announced a repositioning plan of its business and held out on the prospect of paying dividends, while UniCredit presented its recovery plans to further strengthen its capital base and to hasten its reduction of bad loans. However, this confidence seems to have been bought at a very high price. The rights offered by UniCredit had been priced at EUR 8.09 per share—shareholders received 13 new shares for every five owned—implying a discount of 38%. Deutsche Bank sold its stocks at EUR 11.65 apiece implying a discount of nearly 32%. This deep discount is even more pronounced when compared to previous capital increases where, for instance, Deutsche Bank discounted new shares between only 12% and 14% to raise a comparable volume of capital (2010: EUR 10.2 bn, 2014: EUR 8.5). Although UniCredit has sold its shares at a deep discount in the past already, the latest measures of both banks indicate a general requirement to offer investors incentives via steep discounts on new equity.

Nevertheless, the economic conditions for banks to issue new shares is much better than in previous years, boosted by expectations of higher interest rates, buoyant equity markets and expectations of a reduced regulatory burden. A credible strategy to achieve sustainable profitability in future remains necessary if banks wish to avoid relying on deep discounts to incentivize shareholders. All in all, the possibility for the European banking sector to raise fresh capital from the market is obviously a question of confidence and price.

[1] For further details see the zeb.European Banking Study 2017. The simulation is an impact analysis of effects from regulation / other rules and persistently low yields and based on scenarios without management actions (e.g. excludes cost increases / decreases, changes of non-interest earnings or B/S structure/volume not related to implemented initiatives and rules).

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. All data and calculations of this issue are based on the date of April 3, 2017. The global top 100 banks cluster contains the largest banks by market capitalization on December 31, 2016 and is updated on an annual 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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For more information: www.zeb.de

Contact

Dr. Dirk Holländer
Director

Taunusanlage 19
60325 Frankfurt am Main | Germany

Phone +49.69.719153.597
E-mail dhollaender@zeb.de

Volker Abel
Senior Manager

Taunusanlage 19
60325 Frankfurt am Main | Germany

Phone +49.69.719153.453
E-mail vabel@zeb.de

Dr. Ekkehardt Bauer
Senior Manager zeb.research

Hammer Straße 165
48153 Münster | Germany

Phone +49.251.97128.225
E-mail ebauer@zeb.de

Maximilian-Josef Kaulvers
Senior Consultant

Hammer Straße 165
48153 Münster | Germany

Phone +49.251.97128.399
E-mail mkaulvers@zeb.de

Dr. Benedikt Rotermann
Consultant zeb.research

Hammer Straße 165
48153 Münster | Germany

Phone +49.251.97128.390
E-mail benedikt.rotermann@zeb.de