ALPHAVALUE
independent equity research

DEMOLITION...
THEN REGULATED REBUILDING

A STRATEGIC REVIEW
OF LANDSCAPE OF EUROPEAN BANKS

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Economic globalisation induced financial globalisation…

The Economist, 11/10/2008

Foreign assets & liabilities of advanced economies quadrupled to 450% of GDP in the last 20 years (it doubled to 200% of emerging countries GDP)

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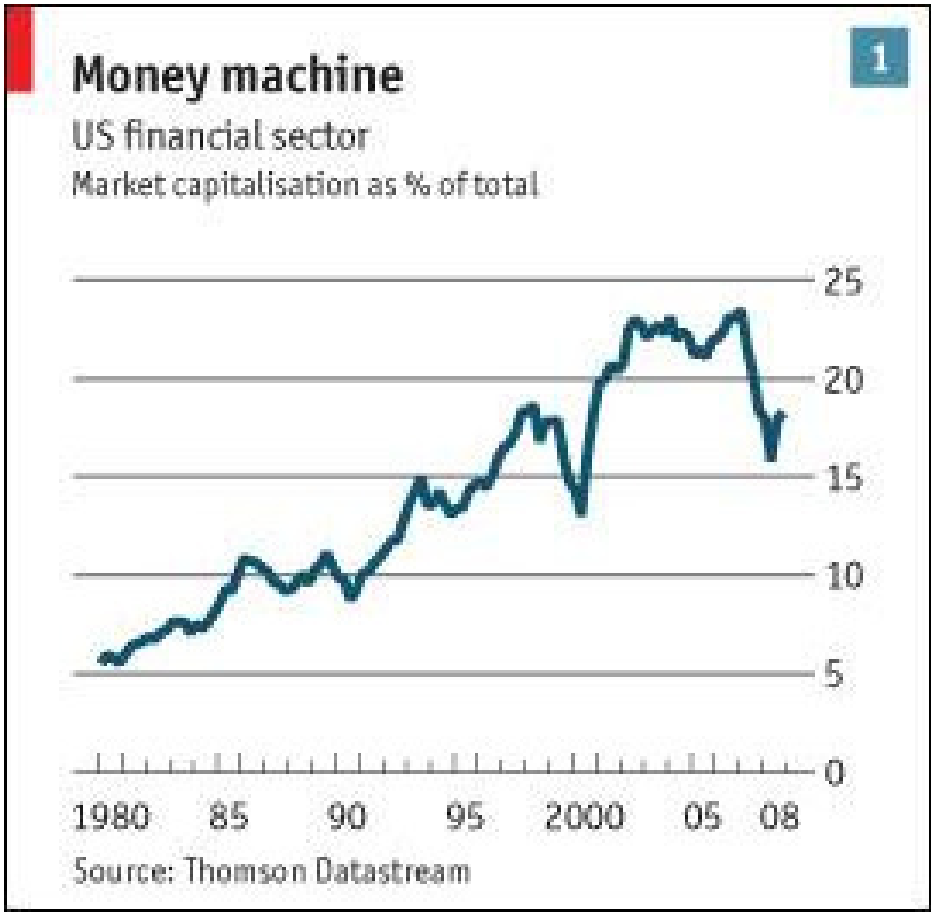
… but the financial sector became the definite « freeloader » of the market economy



The Economist, 18/10/2008

The market cap of the financial sector was bloated fivefold in a quarter of a century

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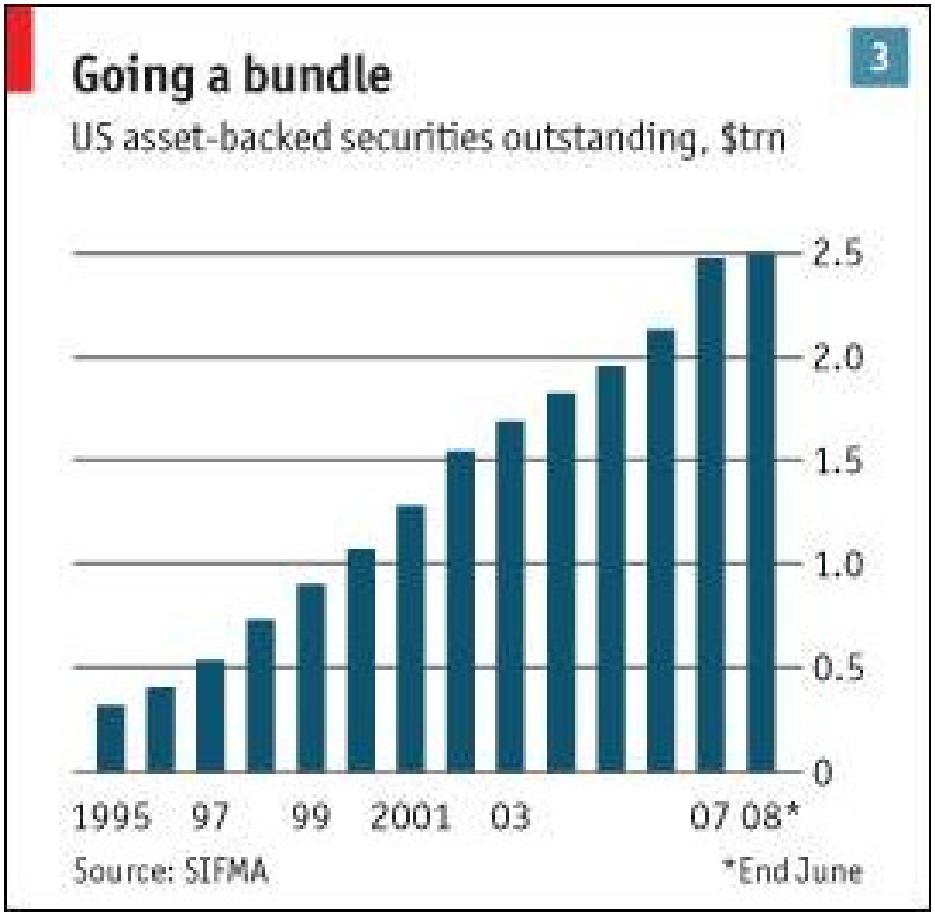
Securitization looked like a « free lunch » bonanza: the banks kept most of the « Return » (greed) and offloaded the « Risk » (fear)… Or so they thought…



The Economist, 18/10/2008

Securitization inflated over 6 times in less than 12 years (1995-2007)

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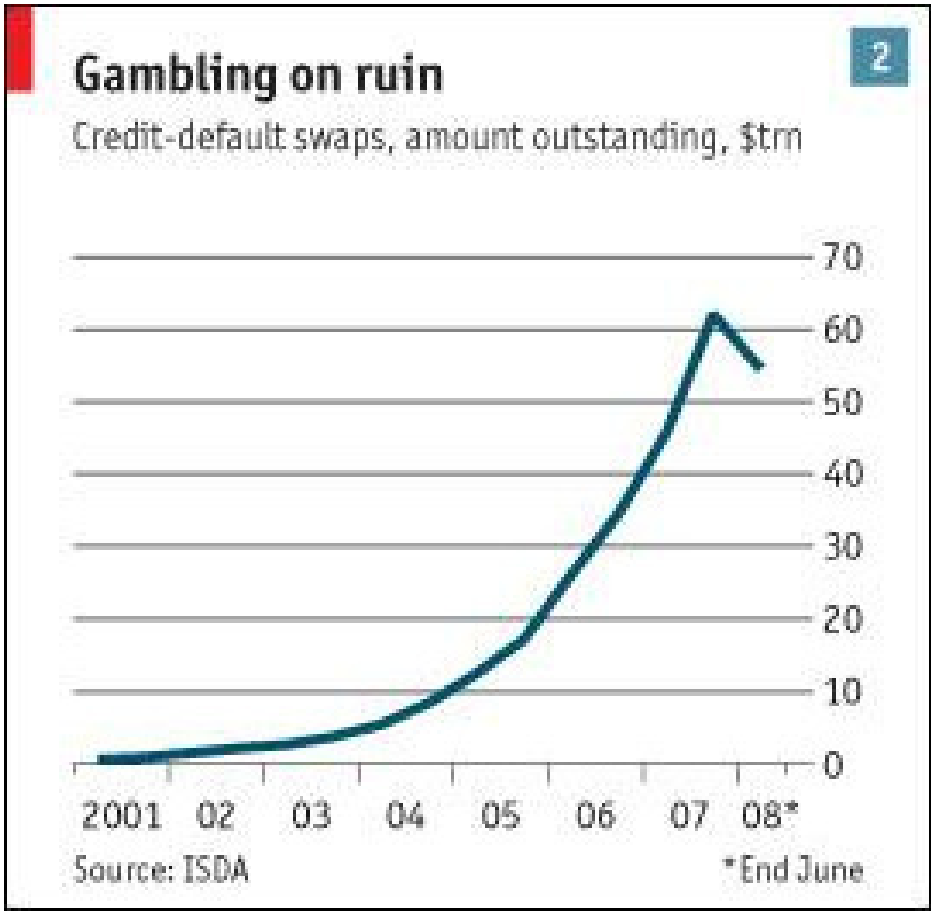
CDS: how to spell « massive destruction weapons »



The Economist, 18/10/2008

CDS exploded by 6 times in 2 ½ years (2005-mid 2007), exceeding in notional amount one time worldwide GDP (circa $60trn)

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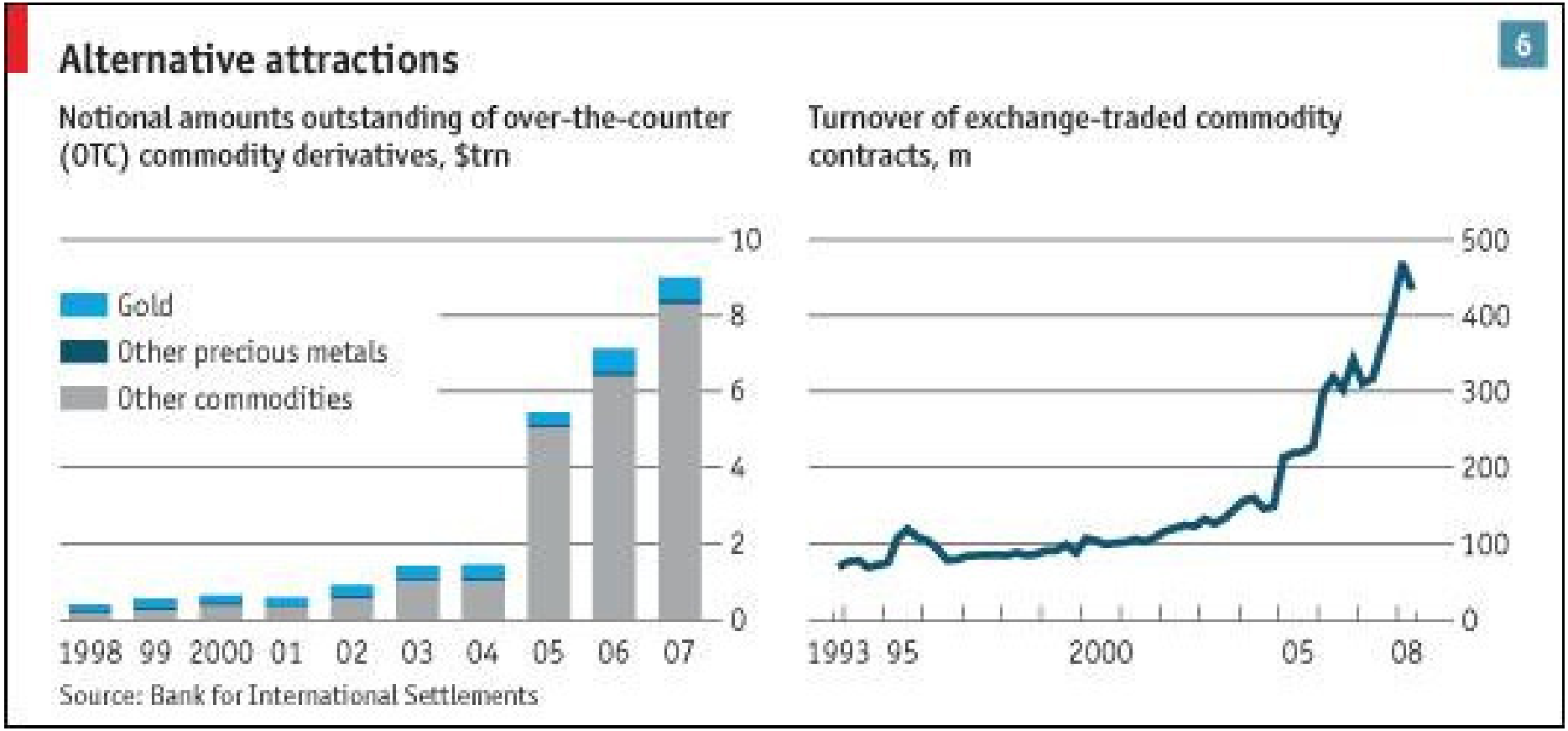
Speculation is best illustrated by the boom in OTC commodity derivatives: x 7 in 3 years (2004-2007)



The Economist, 11/10/2008

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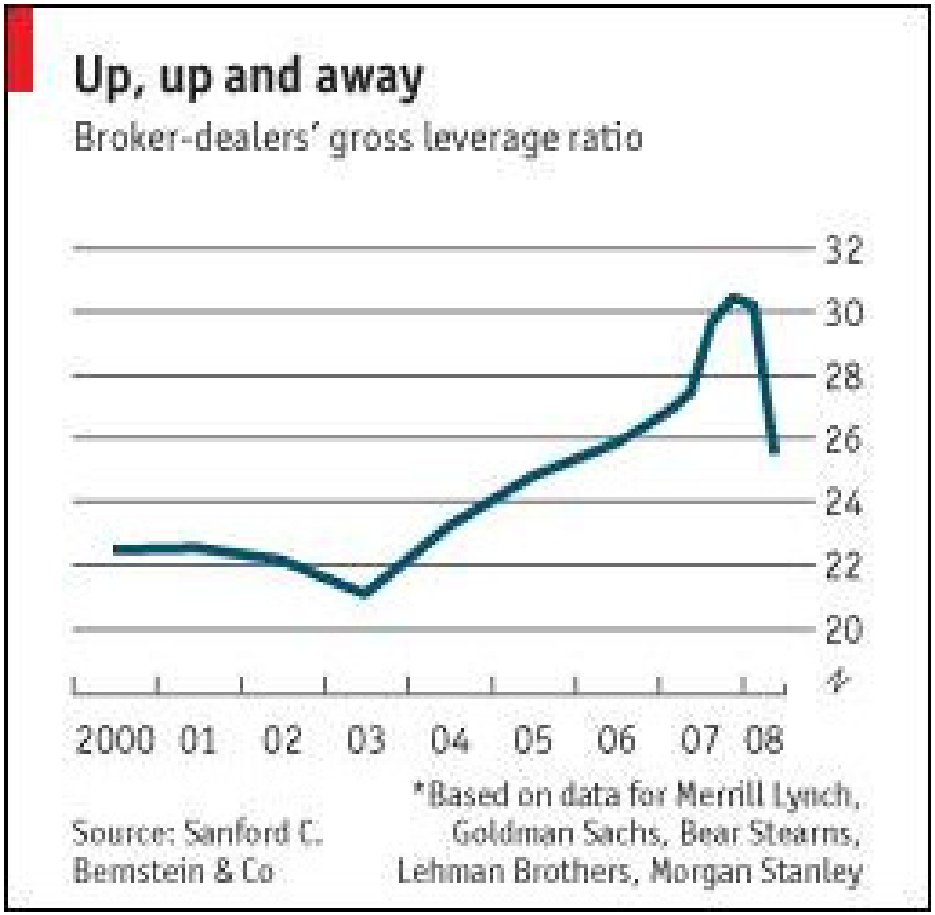
Investment banks: how to spell « confusion » between intelligence and sheer leverage…



The Economist, 25/10/2008

US investment banks' leverage ballooned by 40% between mid-2003 and mid-2007

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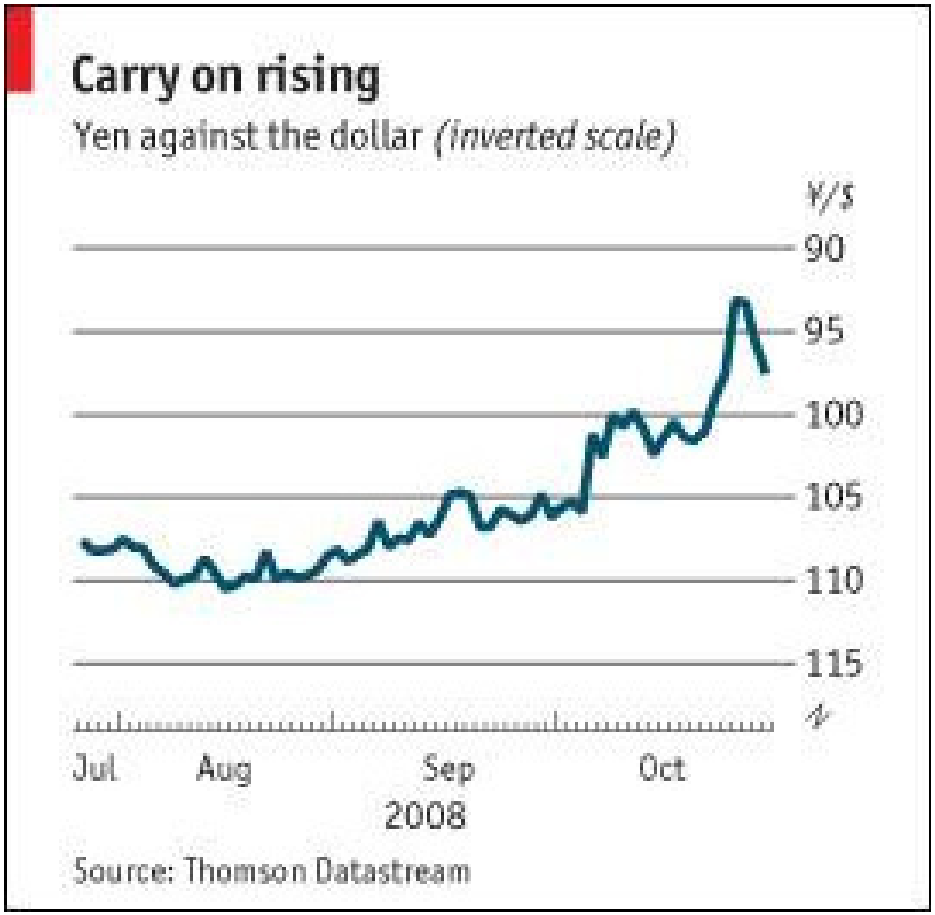
One rediscovers the true nature of the Yen Carry Trade



The Economist, 01/11/2008

The deleveraging of speculative positions induced a violent 16% Yen appreciation in eight weeks

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Eighteen months ago, economists boasted about bloated world liquidities… today, we put up with busted world liquidations

The Economist, 01/11/2008

A big confusion between excess liquidities and excessive debt: the latter must be repaid and fired up a massive and forced liquidation process. Commodities fell 40% in 4 months and stockmarkets melted by 50% in 5 months.

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The Bank bail-out programs: amounts unheard of…

	COUNTRY	GDP €bn	GDP year	Bank capital €bn	GDP %	Bank funding guaranties €bn	GDP %	Total Bank rescue plan €bn	GDP Total %
1	Germany	2 307	2006	80	3%	400	17%	480	21%
2	United Kingdom	2 025	2007	50	2%	313	15%	363	18%
3	**France**	1 780	2006	40	2%	320	18%	360	20%
4	Spain	972	2006	30	3%	100	10%	130	13%
5	Netherlands	529	2006	20	4%	200	38%	220	42%
6	Austria	258	2006	15	6%	85	33%	100	39%
7	Portugal	155	2006	4	3%	20	13%	24	16%
	Sub-total	**8 026**		**239**	3%	**1 438**	18%	**1 677**	21%
8	Italy	1 543	2007	30	2%	unknown		30	2%
9	Belgium	332	2007						
10	Poland	306	2007						
11	Sweden	302	2006	unknown		unknown		156	52%
12	Denmark	215	2006						
13	Greece	195	2006						
14	Ireland	178	2006			400	225%	400	225%
15	Finland	168	2006						
16	Czech Republic	114	2006						
17	Romania	98	2006						
18	Hungary	94	2006						
19	Slovakia	38	2006						
20	Luxembourg	33	2007						
21	Slovenia	31	2006						
22	Lithuania	24	2006						
23	Bulgaria	21	2006						
24	Latvia	16	2006						
25	Cyprus	15	2006						
26	Estonia	13	2006						
27	Malta	4	2005						
	Sub-total	**3 740**		**30**	0%	**400**	11%	**586**	16%
Total Europe 27 countries		**11 766**		**269**	2%	**1 838**	16%	**2107**	18%
	Norway	275	2007	41	15%	-	0%	41	15%

Sources : Bank rescue plans (La Tribune, 13/10/2008) ; National GDP (Minéfi, French Ministry of Finance)

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Countries with high bank credit growth and high loan-to-deposit ratio are of concern…

	COUNTRY	Bank credit to private sector 2002 (%GDP)	Bank credit to private sector 2007 (%GDP)	Cagr 02-07	Loan/deposit 2007-2008	Non Performing loans 2007-2008	Risk weighted capital 2007-2008	Foreign ownership (% assets) 2007-2008
	Europe 27							
1	Austria	105%	114%	2%	121%	2%	13%	3%
2	Belgium	74%	92%	4%	88%	1%	12%	25%
3	Bulgaria	20%	67%	**28%**	105%	2%	14%	82%
4	Cyprus	165%	206%	5%	**169%**	**12%**	13%	13%
5	Czech Republic	31%	48%	**9%**	75%	**4%**	12%	97%
6	Denmark	146%	202%	7%	**367%**	1%	14%	na
7	Estonia	64%	94%	**8%**	**205%**	1%	15%	97%
8	Finland	58%	82%	7%	**152%**	0%	15%	57%
9	**France**	**86%**	**105%**	**4%**	**143%**	**3%**	**10%**	**10%**
10	Germany	117%	105%	-2%	96%	3%	13%	4%
11	Greece	60%	92%	**9%**	100%	**5%**	10%	41%
12	Hungary	35%	62%	**12%**	133%	2%	11%	82%
13	Ireland	109%	198%	**13%**	**199%**	1%	11%	32%
14	Italy	80%	102%	5%	**146%**	**5%**	10%	na
15	Latvia	37%	102%	**22%**	**233%**	0%	13%	67%
16	Lithuania	16%	61%	**30%**	**162%**	3%	11%	66%
17	Luxembourg	104%	192%	**13%**	44%	0%	14%	95%
18	Malta	91%	119%	5%	75%	2%	23%	75%
19	Netherlands	141%	193%	6%	**151%**	1%	13%	8%
20	Poland	27%	40%	**8%**	97%	**5%**	12%	71%
21	Portugal	141%	169%	4%	**163%**	1%	10%	21%
22	Romania	10%	35%	**29%**	115%	**4%**	13%	88%
23	Slovakia	39%	42%	2%	84%	**4%**	22%	92%
24	Slovenia	40%	81%	**15%**	**146%**	3%	11%	38%
25	Spain	106%	183%	**12%**	134%	1%	11%	12%
26	Sweden	100%	124%	4%	**234%**	1%	10%	na
27	United Kingdom	141%	191%	6%	125%	1%	13%	55%
Average E27(unweighted)		**79%**	**115%**	**8%**	**143%**	**3%**	**13%**	**51%**

Source : AlphaValue Data

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Countries with high bank credit growth and high loan-to-deposit ratio are of concern...

	COUNTRY	Bank credit to private sector 2002 (%GDP)	Bank credit to private sector 2007 (%GDP)	Cagr 02-07	Loan/deposit 2007-2008	Non Performing Loans 2007-2008	Risk weighted Capital 2007-2008	Foreign ownership (% assets) 2007-2008
"Fat 3"								
28	USA	169%	209%	4%	**269%**	1%	13%	na
29	Japan	180%	150%	-4%	80%	2%	12%	na
30	Switzerland	153%	178%	3%	128%	0%	13%	na
B.R.I.C.S.								
31	Brazil	32%	52%	10%	84%	5%	18%	23%
32	Russia	18%	38%	**17%**	120%	2%	15%	18%
33	India	33%	47%	8%	82%	5%	13%	7%
34	China	132%	119%	-2%	83%	7%	11%	8%
Excess "proxies"								
35	Iceland	106%	372%	**29%**	**392%**	1%	12%	0%
36	Ukraine	18%	59%	**27%**	**151%**	2%	14%	35%
At Europe's border								
37	Norway	75%	99%	6%	**182%**	1%	12%	na
38	Turkey	16%	30%	**13%**	74%	4%	21%	15%

Sources : IMF, Fitch estimates October 21, 2008

The problem is not really "how many problem loans a country has to deal with", it's more "how much that country is relying on international funding" (through the interbank market) in the current Credit Crisis that encompasses "forced" liquidation of the shadow banking system ("non bank banks" such as SIVs and hedge funds)

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Country risk: Central & Eastern Europe is in terrible shape

The Economist, 25/10/2008

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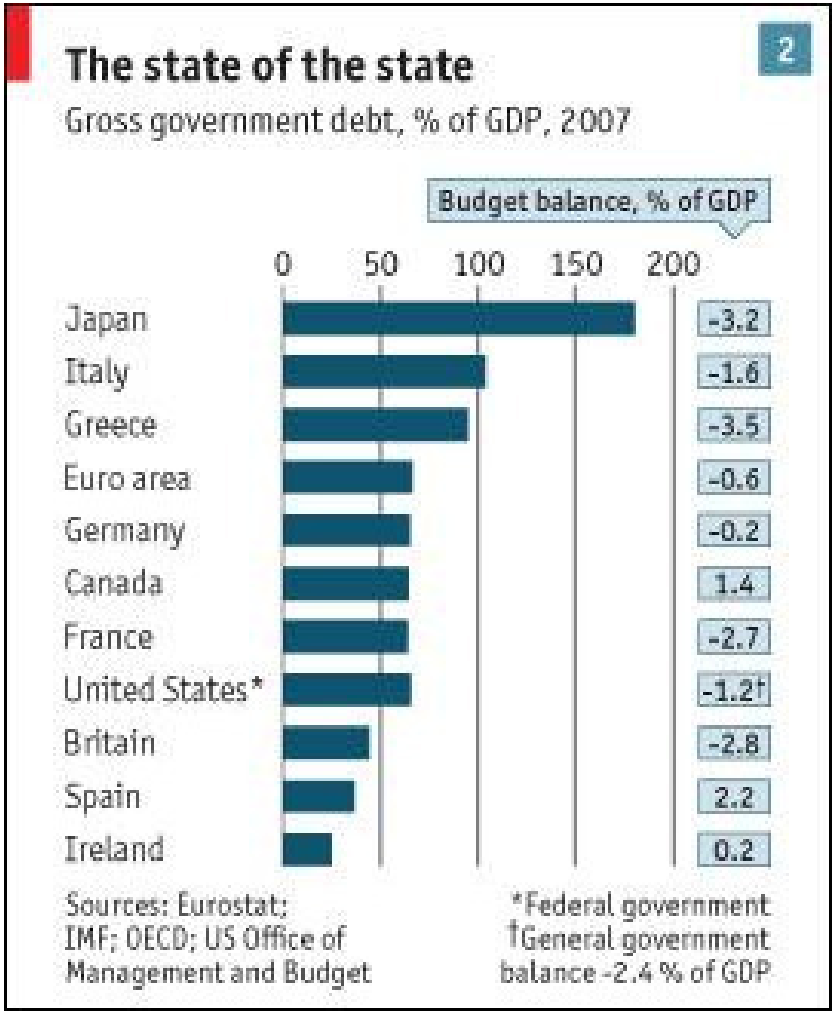
What's next? Jeffrey Immelt (CEO of General Electric) reads Keynes again…



The Economist, 01/11/2008

Huge government budget spendings will be required to counter the deflationary private debt collapse. Public debt will balloon. Maastricht ratios need to be put aside for a while.

As an illustration in Europe, French government debt could easily increase from 65% to 90% of GDP within 5 years.

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The crisis aftermath: the « ins » and « outs » of banking

- The 4 F rule
  - ✓ Flight to **safety** (a chain is no stronger than its weakest link)
  - ✓ Flight to **quality** (OPM: one doesn't gamble with other people's money)
  - ✓ Flight to **liquidity** (cash is king)
  - ✓ Flight to **simplicity** (KISS: « Keep it simple, stupid! »)

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The crisis aftermath: the « ins » and « outs » of banking

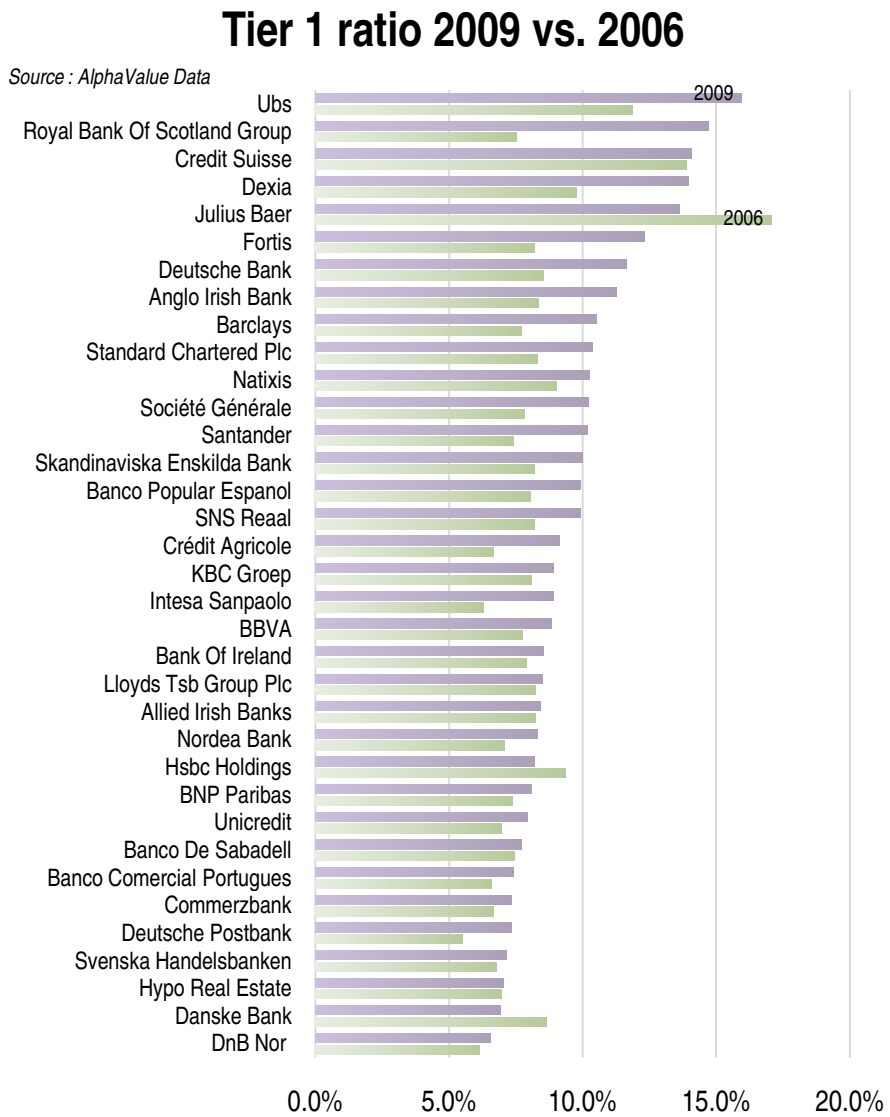
- The « ins » of banking: Regulation

  - ✓ Retail banking (financing the real economy) is « dumb, but smart »
  - ✓ Old fashioned Corporate banking (loans, payment services, real economy hedging services through organized markets: f/x, interest rate, commodity,…)
  - ✓ Universal banking
  - ✓ Back to historic cost accounting (marking-to-market long term banking assets that are financed with short term funding is self-defeating)
  - ✓ Regulation buzzwords: liquidity (≠ mark to market), solvability, simple leverage ratios (this crisis showed the failure of Risk Weighted Assets and Tier 1 ratios)
  - ✓ (…)

The crisis aftermath: the « ins » and « outs » of banking

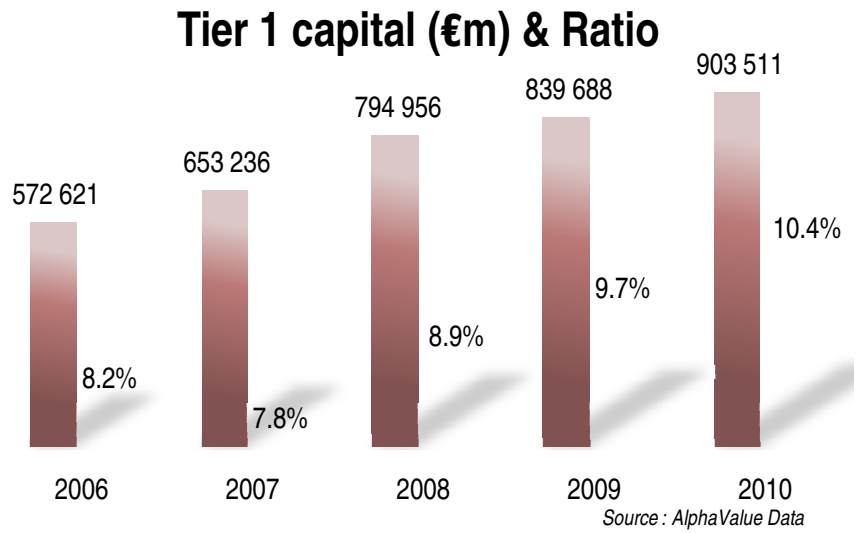
- The « outs » of banking: Speculation
  - ✓ Investment banking (engineering one's next year's bonus) is « smart, but dumb »
  - ✓ Special purpose banks
  - ✓ Structured finance/products and Quantitative engineers
  - ✓ Proprietary trading (≈ inhouse Hedge Fund), Financing & servicing hedge funds (prime brokerage,…)
  - ✓ Derivative products not covering a real economy/customer need
  - ✓ Off balance sheet (SIVs, back-up credit lines, monoline insurers,… in other words, the « non bank banks », also called the « shadow banking system »)
  - ✓ Regulation buzzwords: ban on asymetric variable compensation packages, ban on offshore centers,…
  - ✓ (…)

35 European banks: higher Tier 1 doesn't necessarily mean « safer »…



In essence, the banking system failed because of its unconditional faith in « market wisdom » and regulatory ratios. Two things had been left out in the process:

1. some bankers lose ethics and good sense when « stress-tested » with asymetric enrichment incentive system;
2. banking is a « public purpose » service (i.e. financing the real economy) that can no longer be entrusted to the private sector without public regulation: bankers gambling to their personal benefits (bonuses, stock options) retail customer deposits with an (implicit) government guarantee (to avoid the real economy systemic collapse) is no longer politically, nor socially, acceptable.



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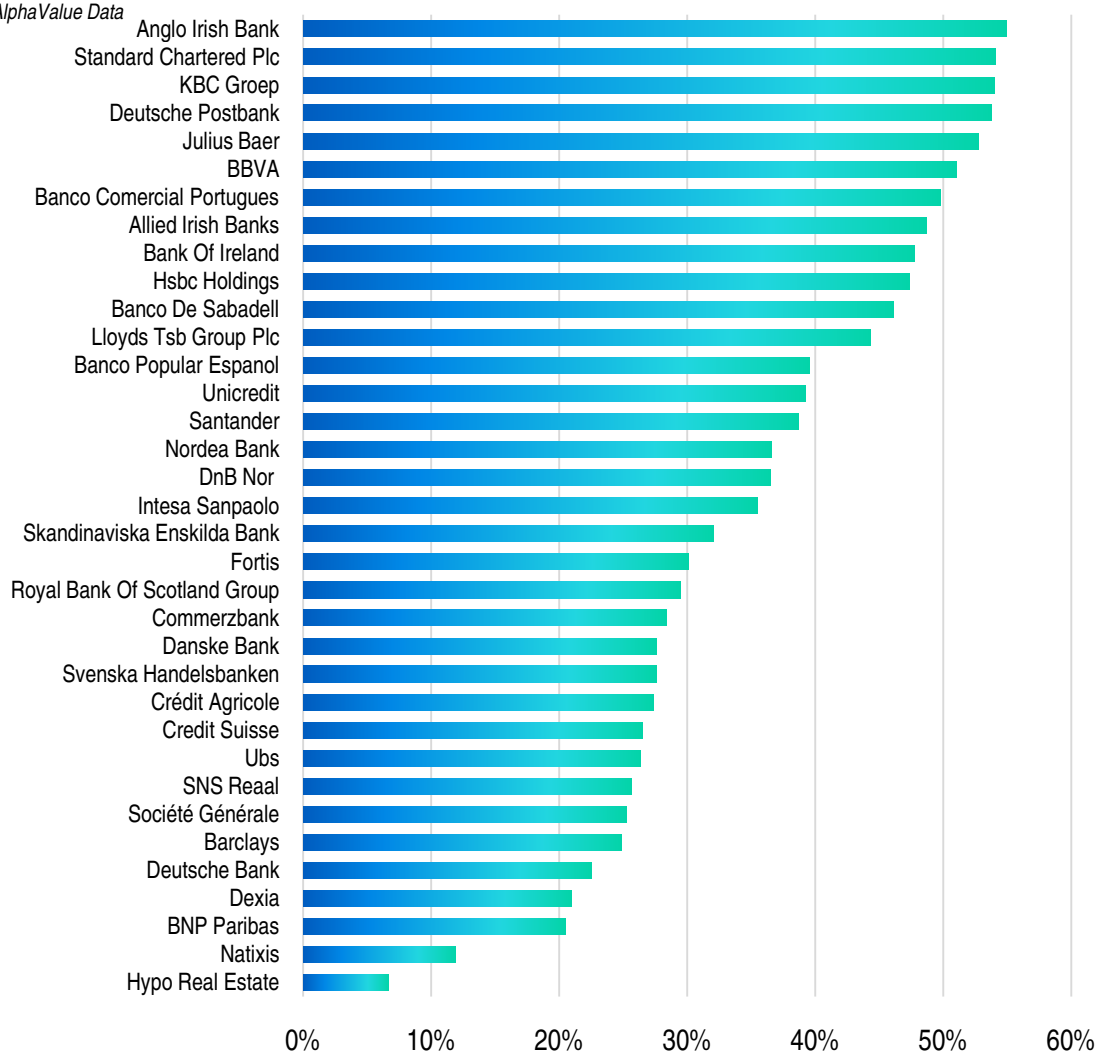
35 European banks: the retail deposit competitive advantage? Yes and No!

Customer Deposits /Total Assets (2008e)

Source : AlphaValue Data



In German, one would say « Ja…ein », as a contraction between « Ja und Nein »

While not having access to retail deposits is a definite funding risk (Hypo RE, Natixis, Dexia,...), a high retail deposit base is NOT a bullet-proof vest against a liquidity squeeze (Irish banks, KBC,…)

The Universal banking model is a « plus », but it becomes a hefty « minus » if the investment banking side means tanking the retail banking side… (Fortis, RBS, Dexia, UBS, Natixis, Société Générale, Crédit Agricole,…)

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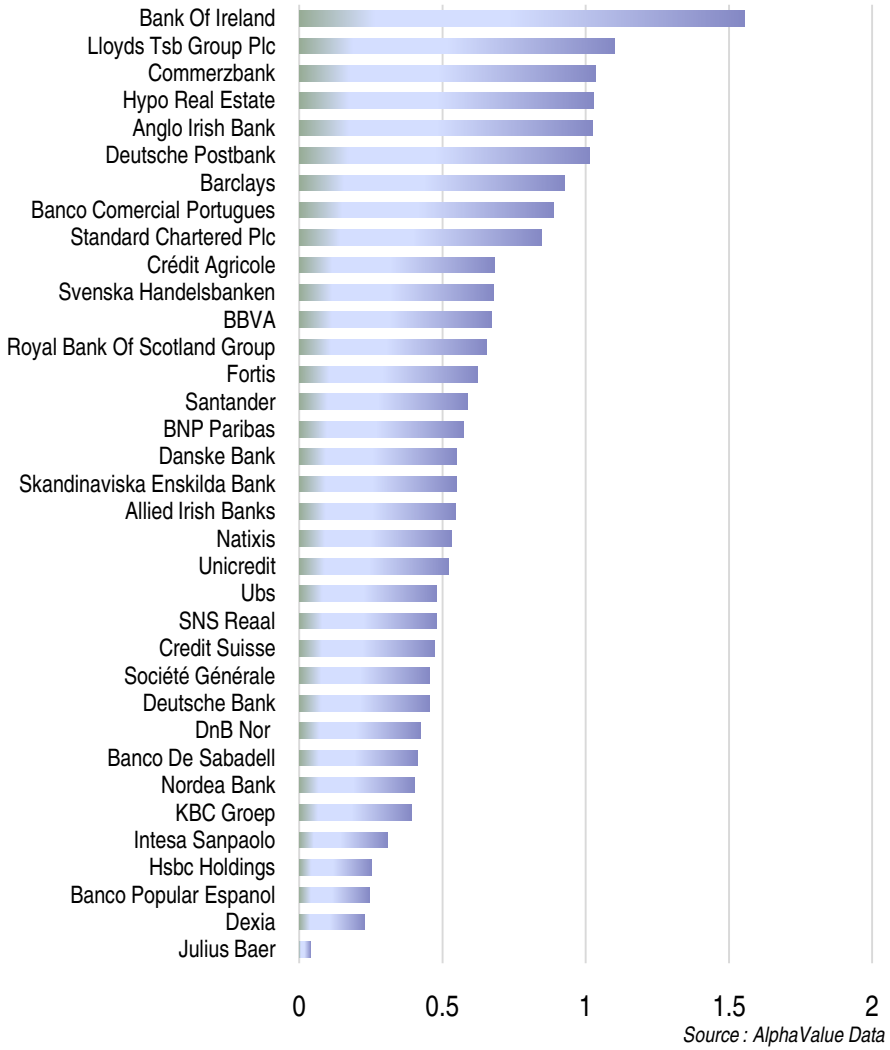
35 European banks: in fact, markets are concerned by high level of debt in bank capital base

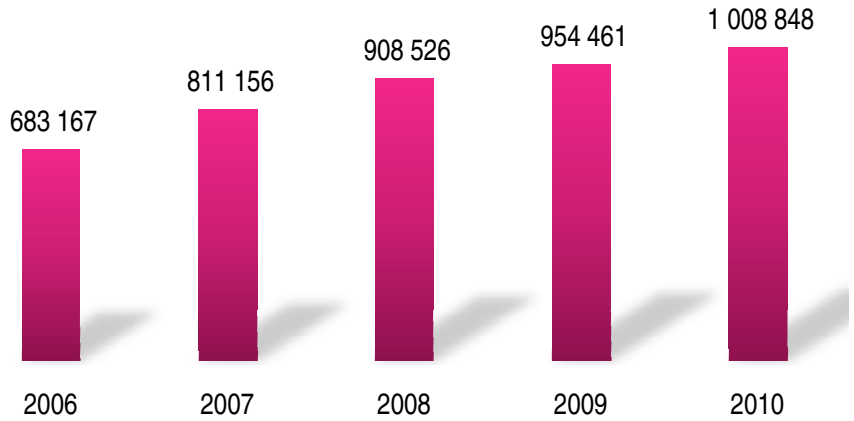
GrossDebt/Equity (gp share) 2008



Source : AlphaValue Data

High level of gross debt versus equity is a relatively better discriminant in the current liquidity scare (Irish banks, Lloyds, Commerzbank, Hypo RE,…), but even a low debt/equity ratio is no guarantee against bank frailty (Dexia, KBC,…)

Total Equity (€m)



Source : AlphaValue Data

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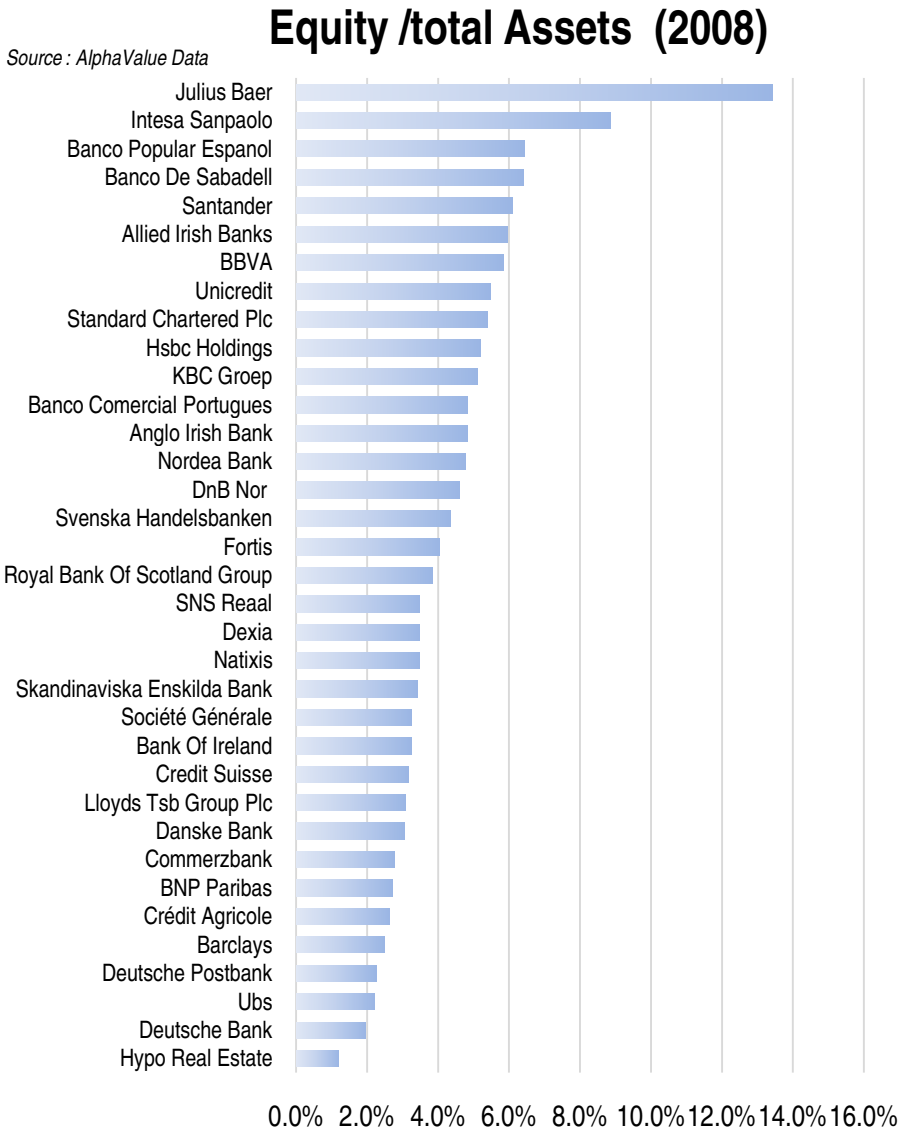
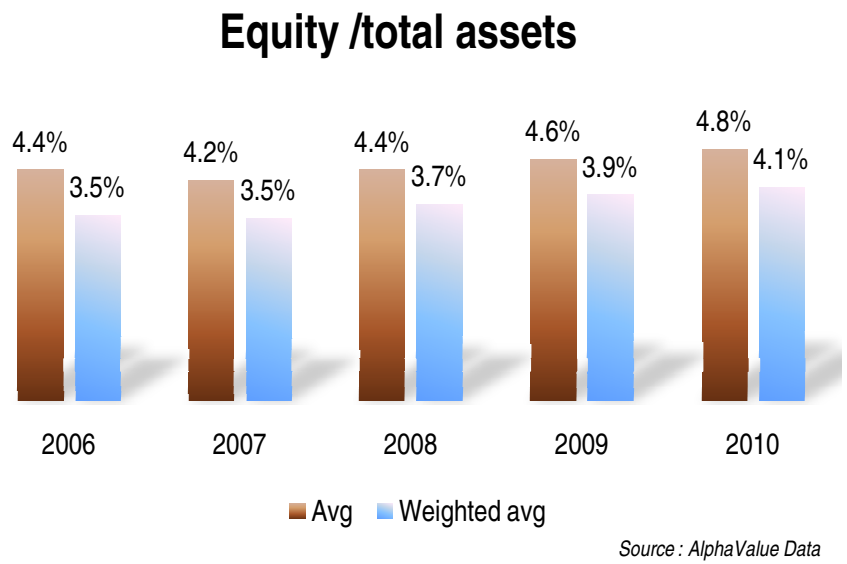
35 European banks: leverage as a better proxy for « deleveraging risk » than Tier 1



The higher the absolute leverage (= lower equity/total assets ratio), the greater risk a bank could encounter in a necessary deleveraging : illiquid securities markets, cash-strapped borrowers, over-indebted consumers,…



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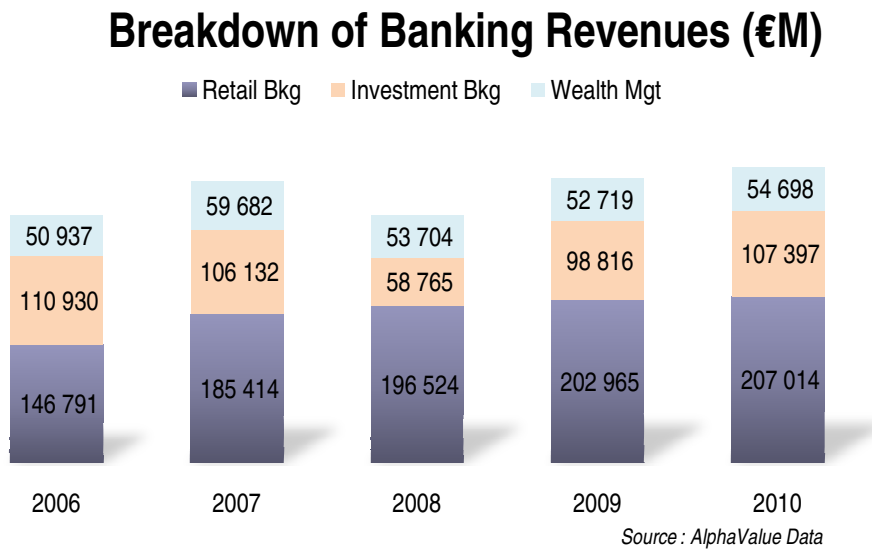
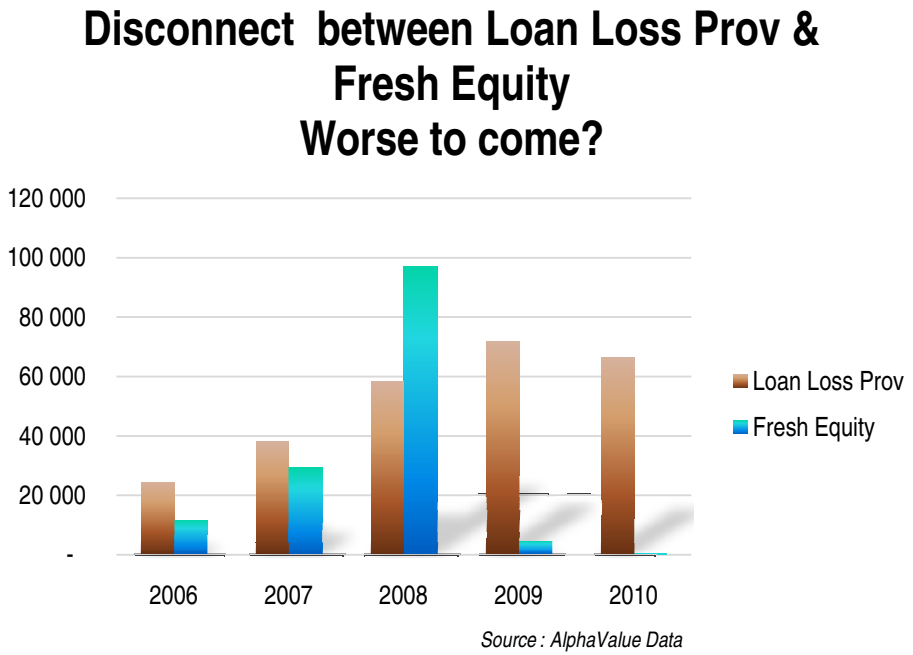
35 European banks: retail banking as a buffer in the forthcoming economic slowdown





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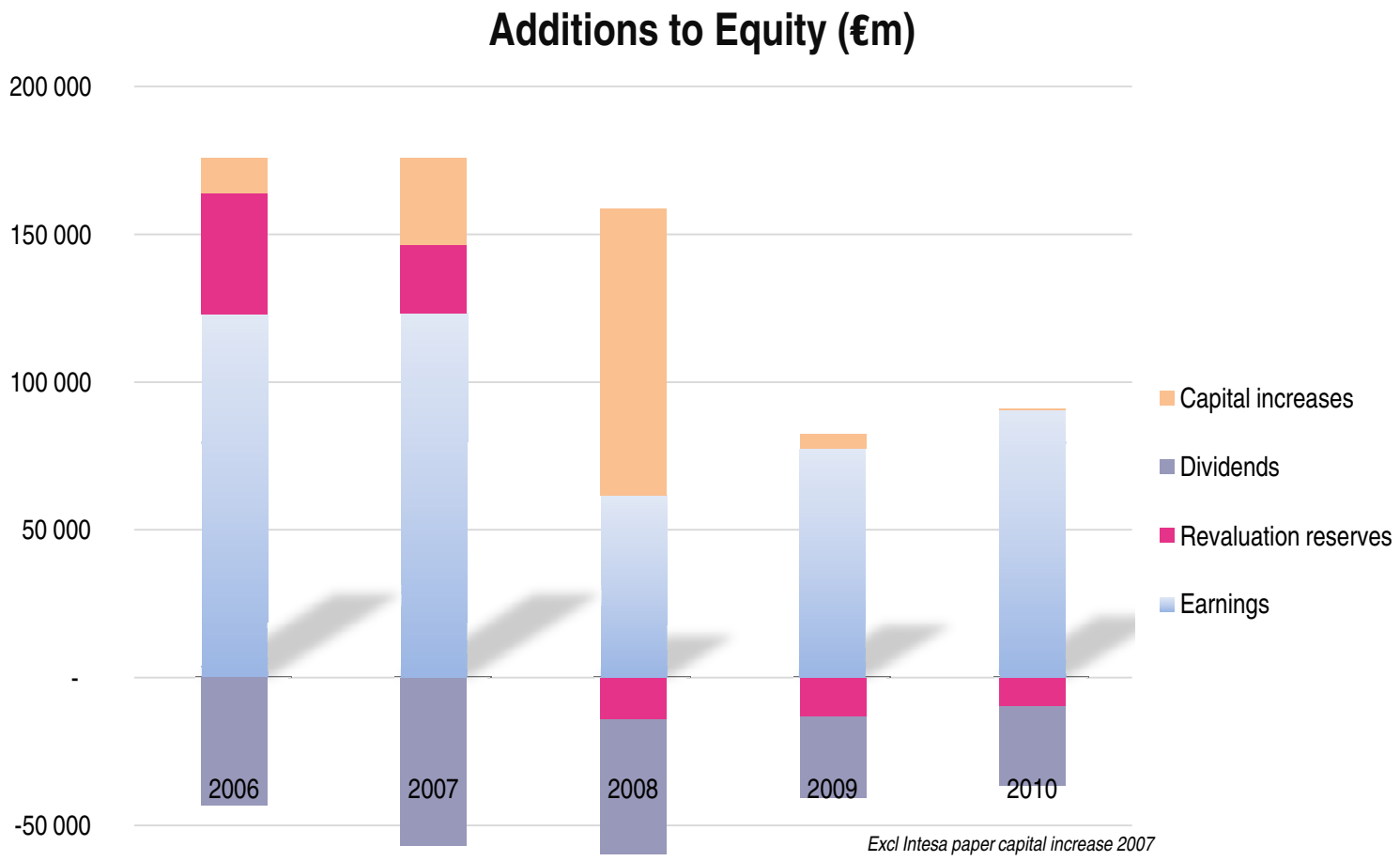
35 European Banks: revaluation reserves to enter into reverse shift, plus dividend cuts for 2008-2010



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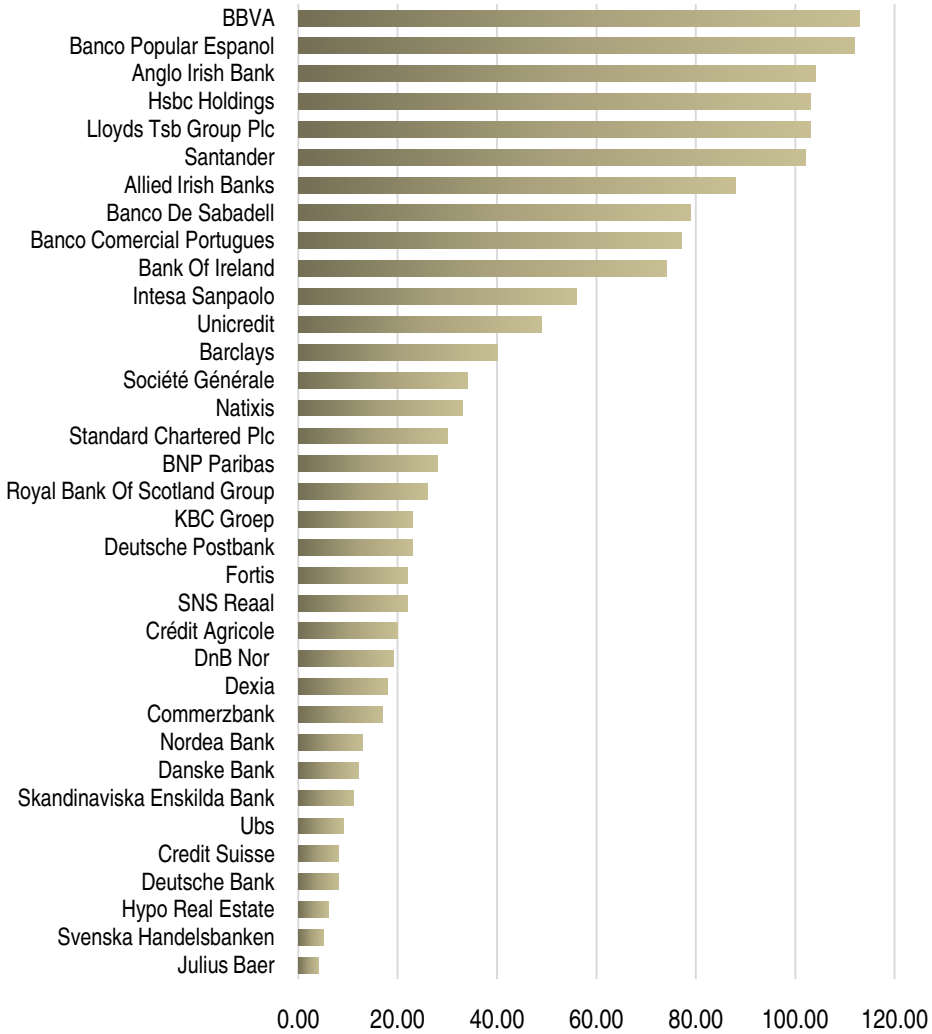
35 European banks: traditional loan losses to follow in 2009 the 2008 mark-to-market losses

Loan Loss 2009 (bp)



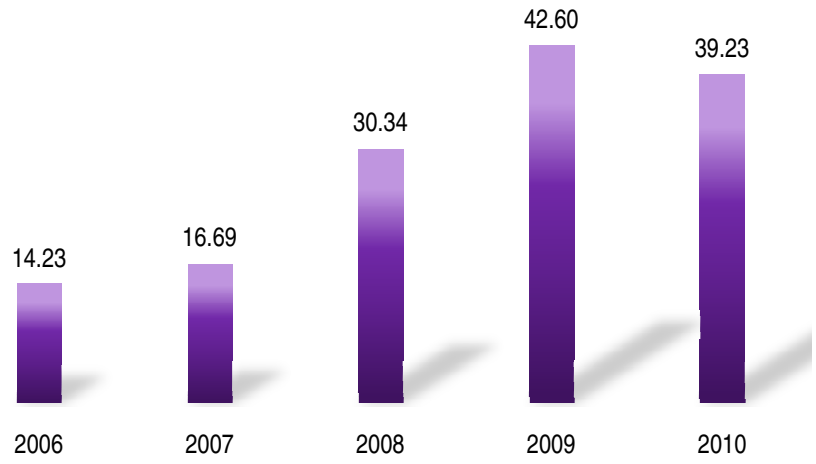
Source : AlphaValue Data

2008 is the « Year of financial innovation mark-to-market losses »: it's the financial crisis « first round ».

2009 will prove to be the « Year of old-fashioned banking loan losses »: it's the real economy crisis « second round ».

Who's the chicken, who's the egg? Two things are sure: Somebody did kill the Golden egg-laying goose! And now, everybody is playing chicken…

Avg non weighted Loan Loss (bp)



Source : AlphaValue Data

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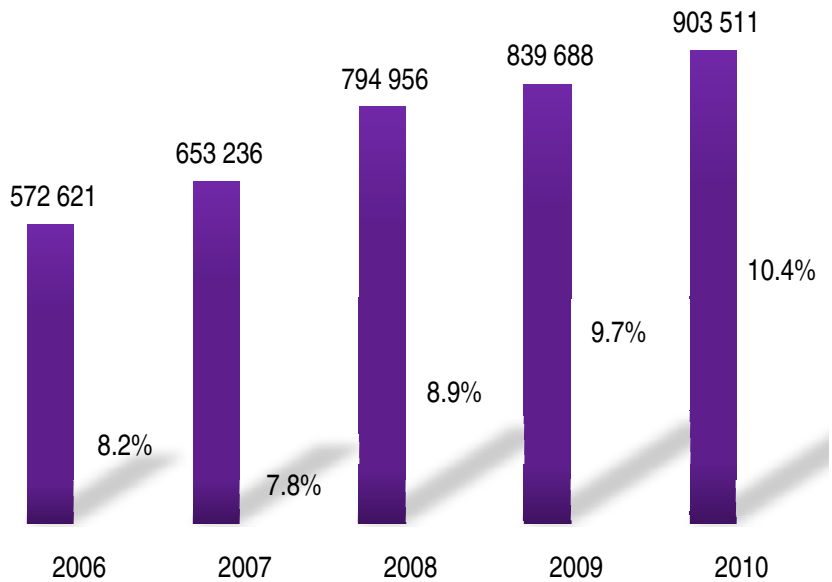
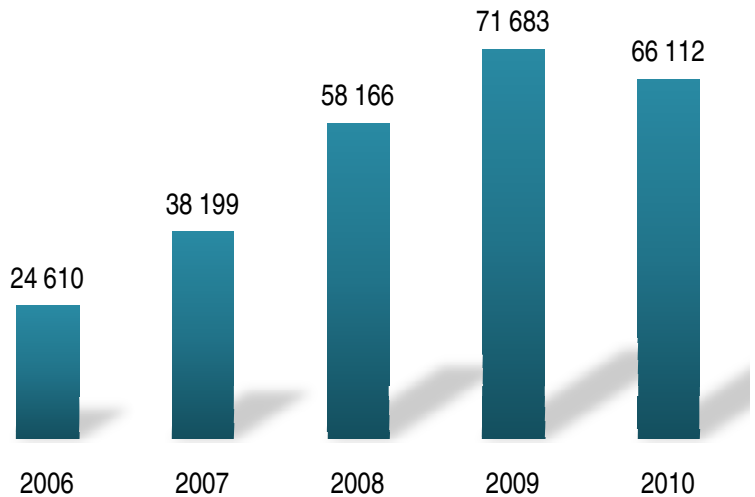
35 European banks: higher Tier 1 to face higher Loan losses that will peak in 2009

Tier 1 capital (€m) & Ratio



Source : AlphaValue Data

Loan Loss Provisions (€m)



Source : AlphaValue Data

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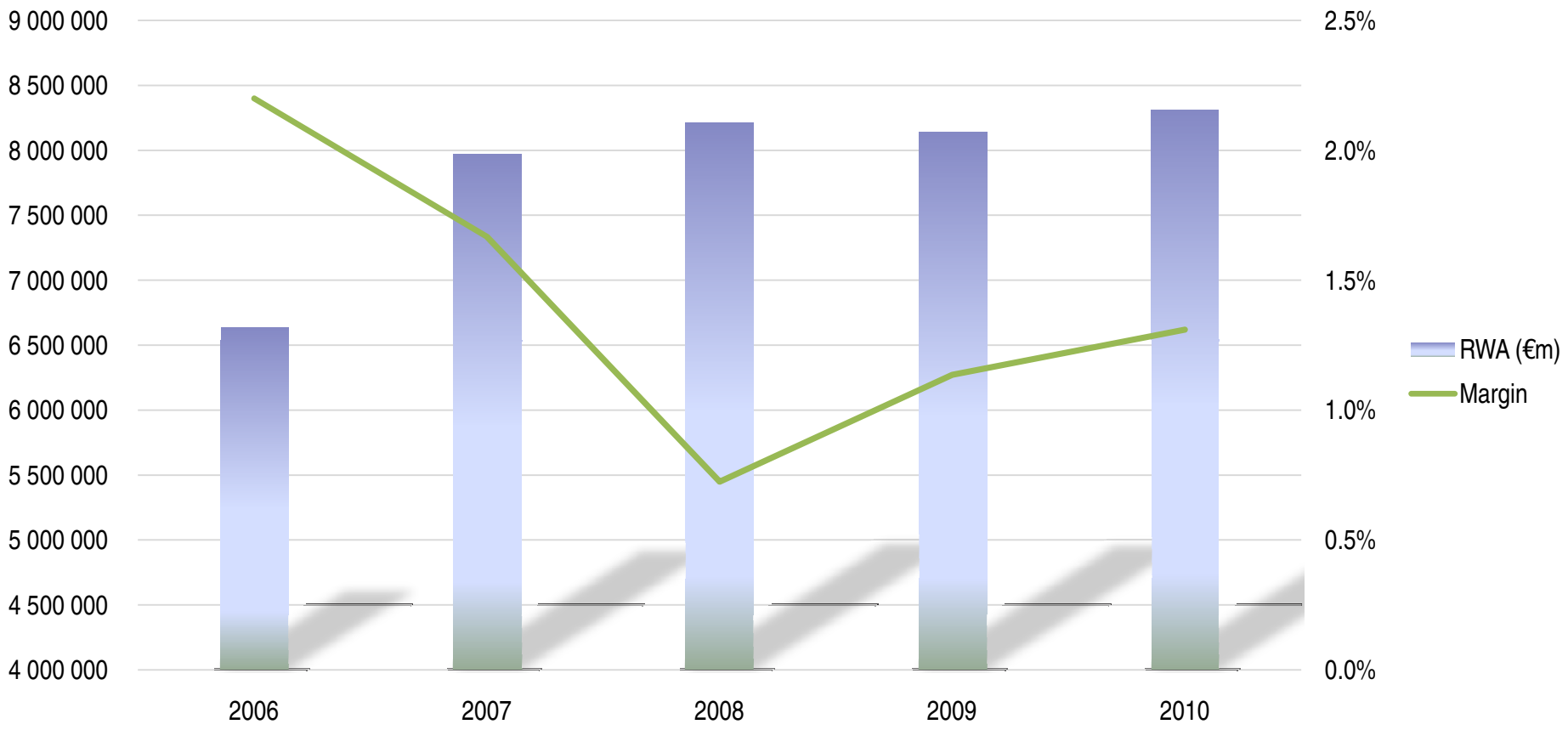
35 European banks: partial rebounds of operating margins on resilient RWA, paralleling the declining ROE



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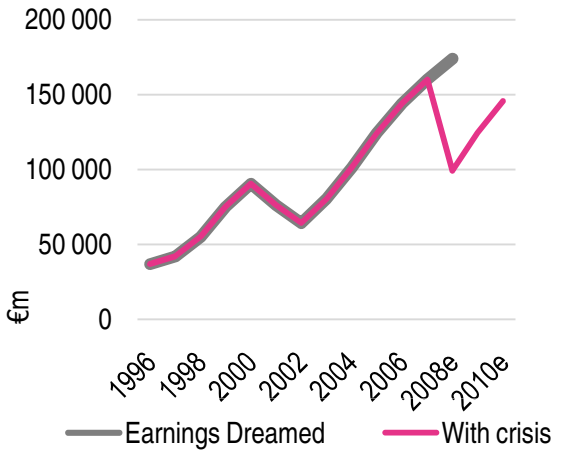
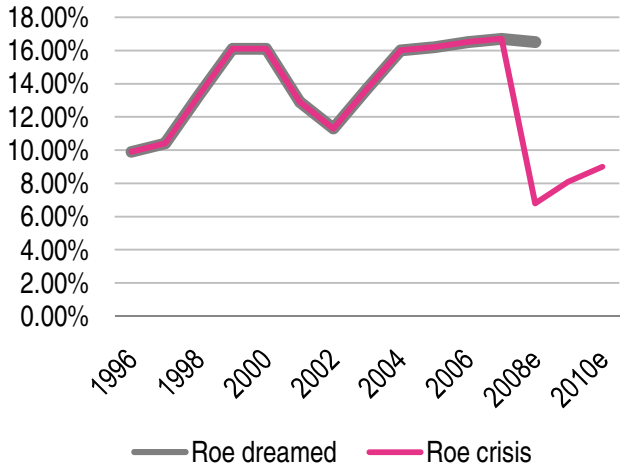
35 European banks: after the « wishful thinking », the back-to-earth « headache »

European Banks Earnings



Source : AlphaValue Data

Roe

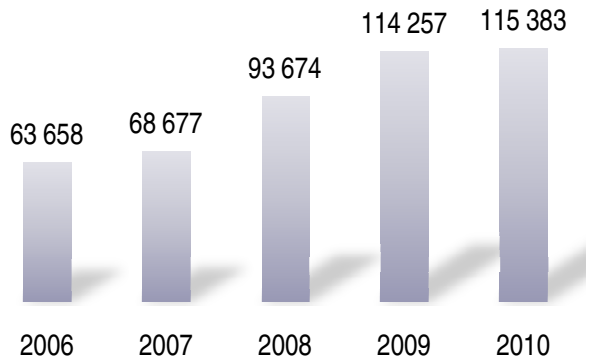


Source : AlphaValue Data

The consensus for banks remains too high for 2009

Expected drop in ROE, mainly due to massive dilution of existing shareholders

Number of shares (million)



Source : AlphaValue Data

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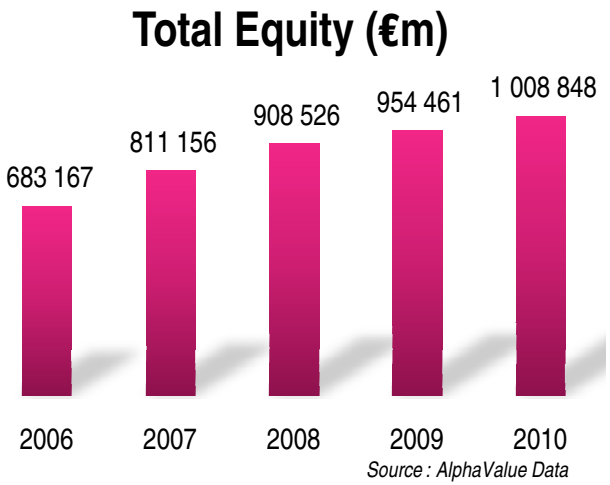
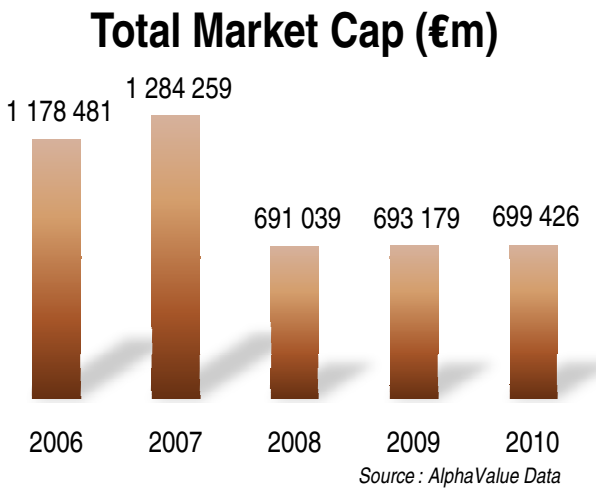
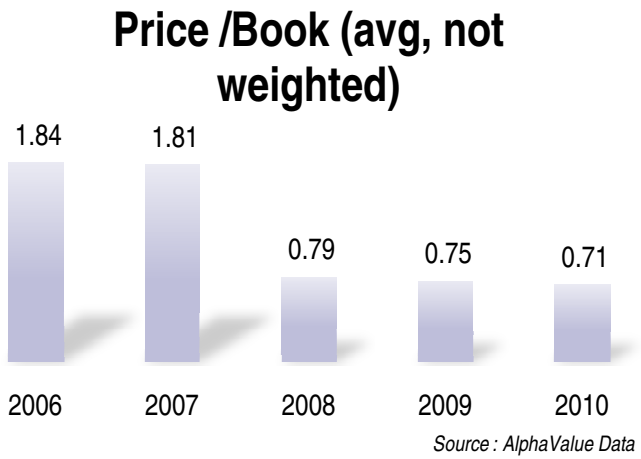
35 European banks: ROE down from a record 18% in 2006 to 7% in 2008, reflected in a downbeat PBR from 1,8x in 2006 to 0,8x in 2008







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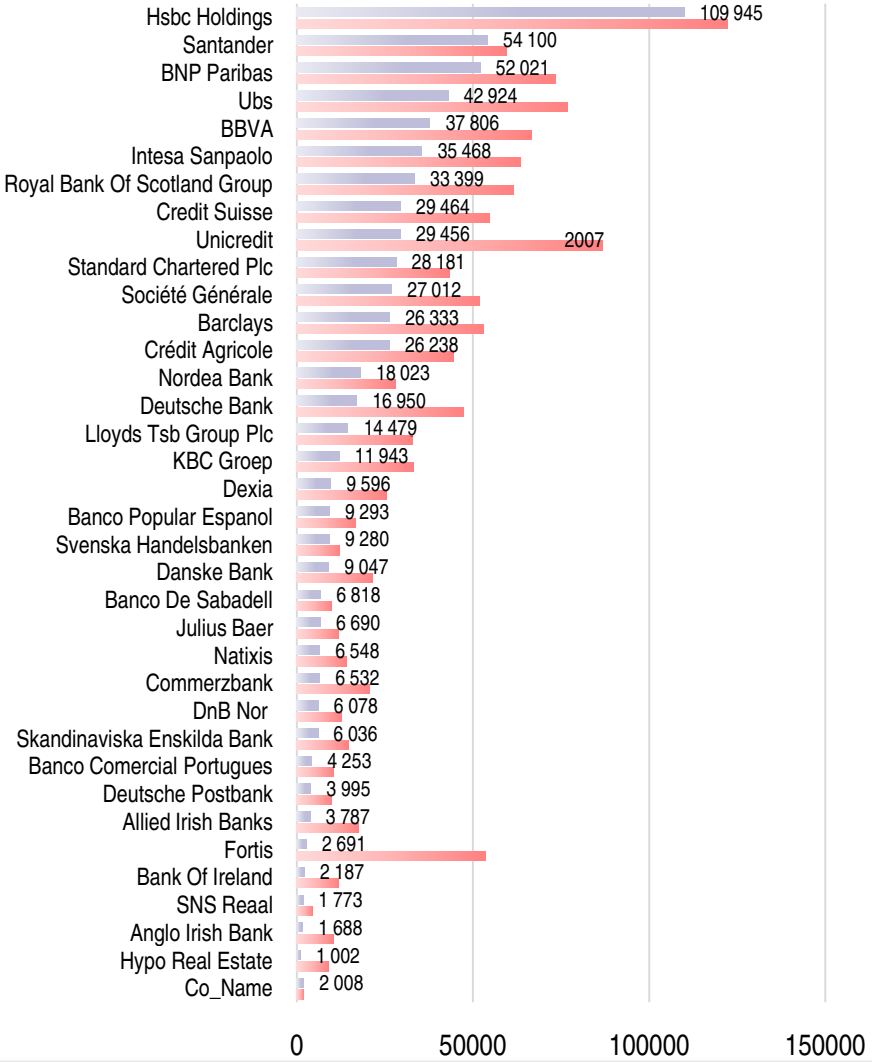
35 European banks: what a difference a single year makes!

Market Cap (ranked on 2008)

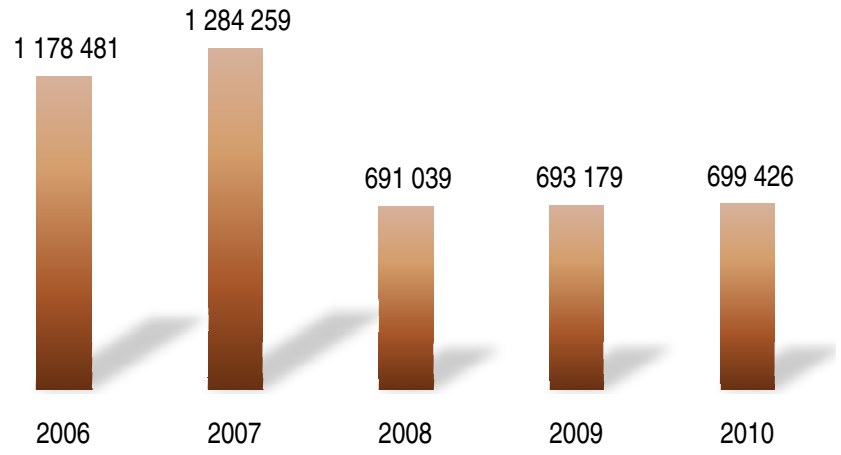
Source : AlphaValue Data



When « high flying » takes its toll:

« For sale, parachute. Brand new. Used once. Never opened. Only a few blood stains… »

Total Market Cap (€m)



Source : AlphaValue Data

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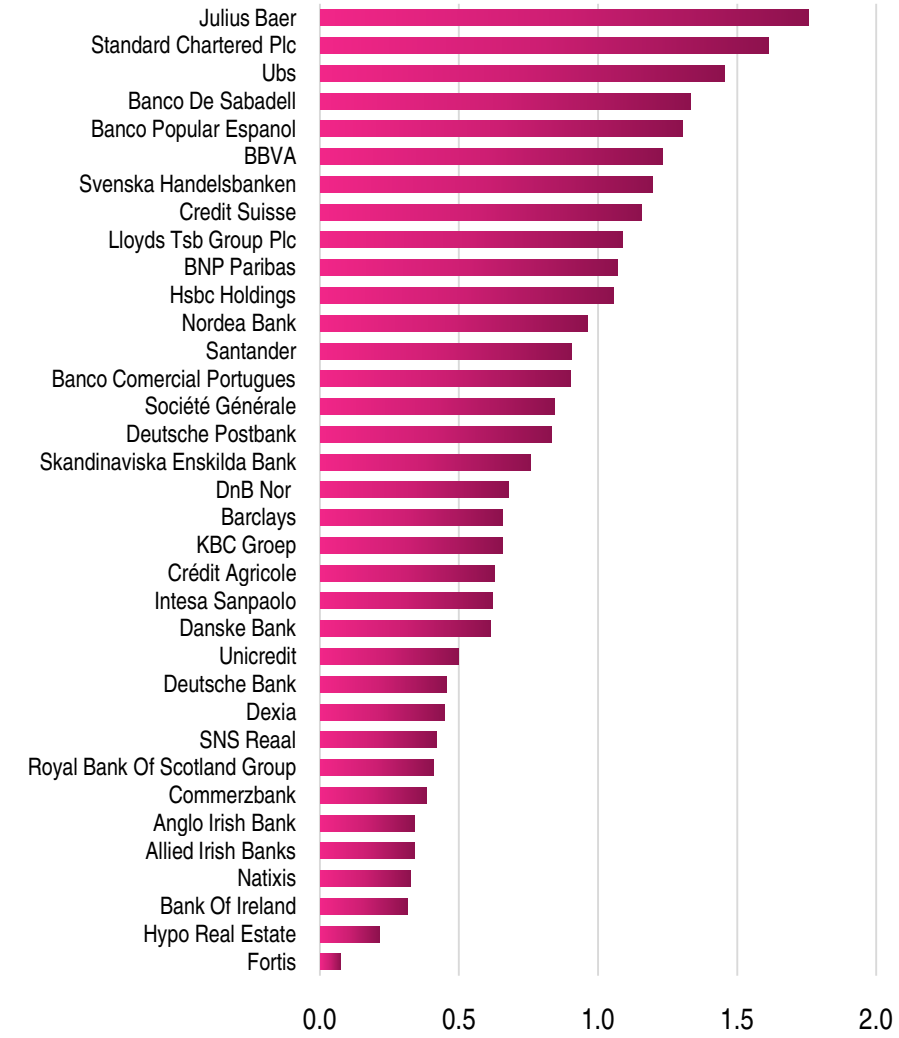
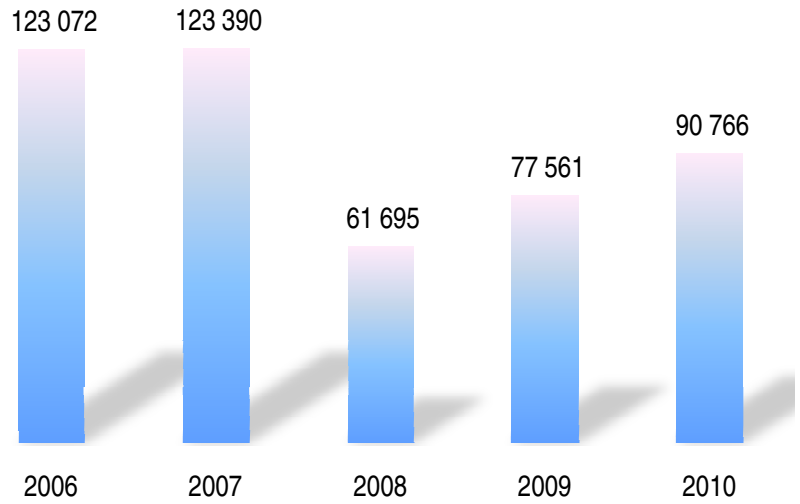
35 European banks: it's sale time! But there is no rush to buy…

P/Book 2008

Source : AlphaValue Data



Earnings (€m)



Source : AlphaValue Data

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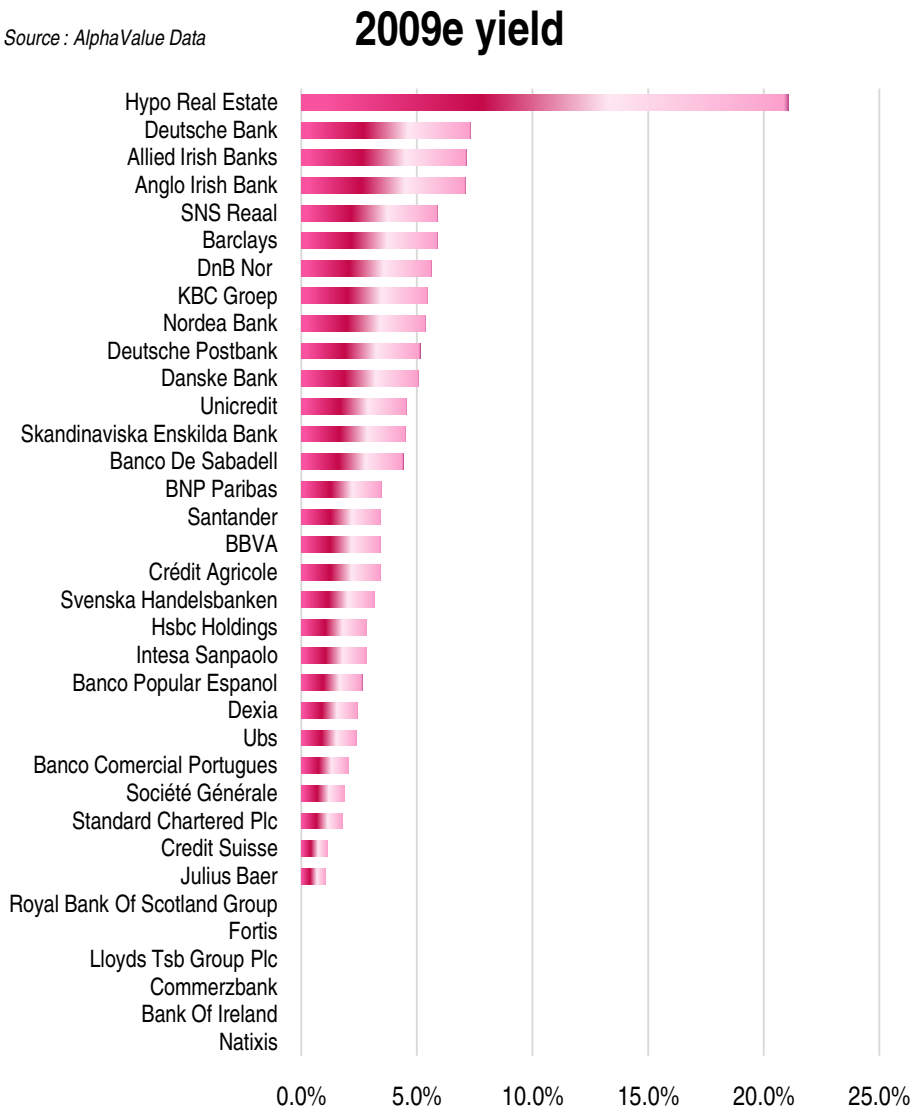
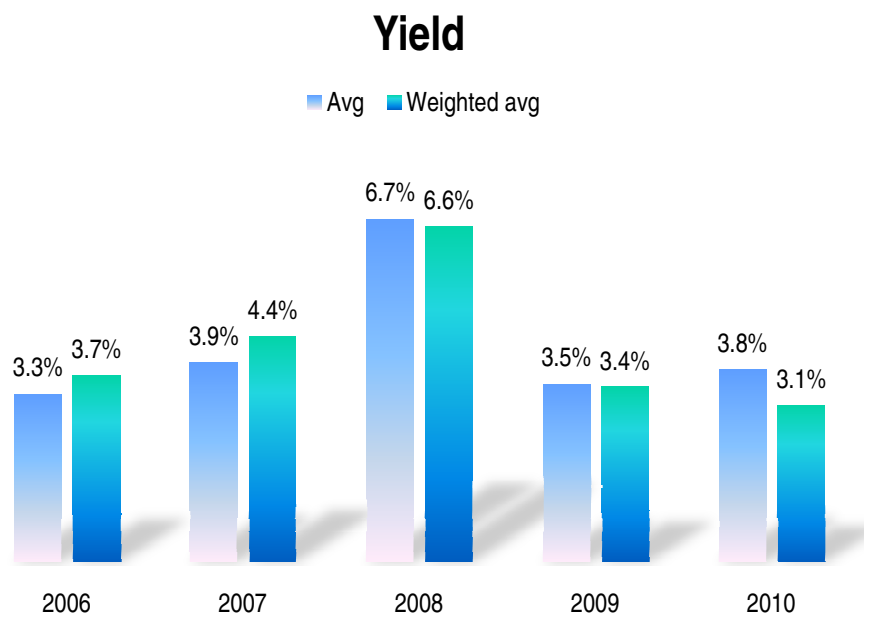
35 European banks: dividend yield will revert to the mean, i.e. dividends will be cut by 40% on average in 2009...

Source : AlphaValue Data





Source : AlphaValue Data

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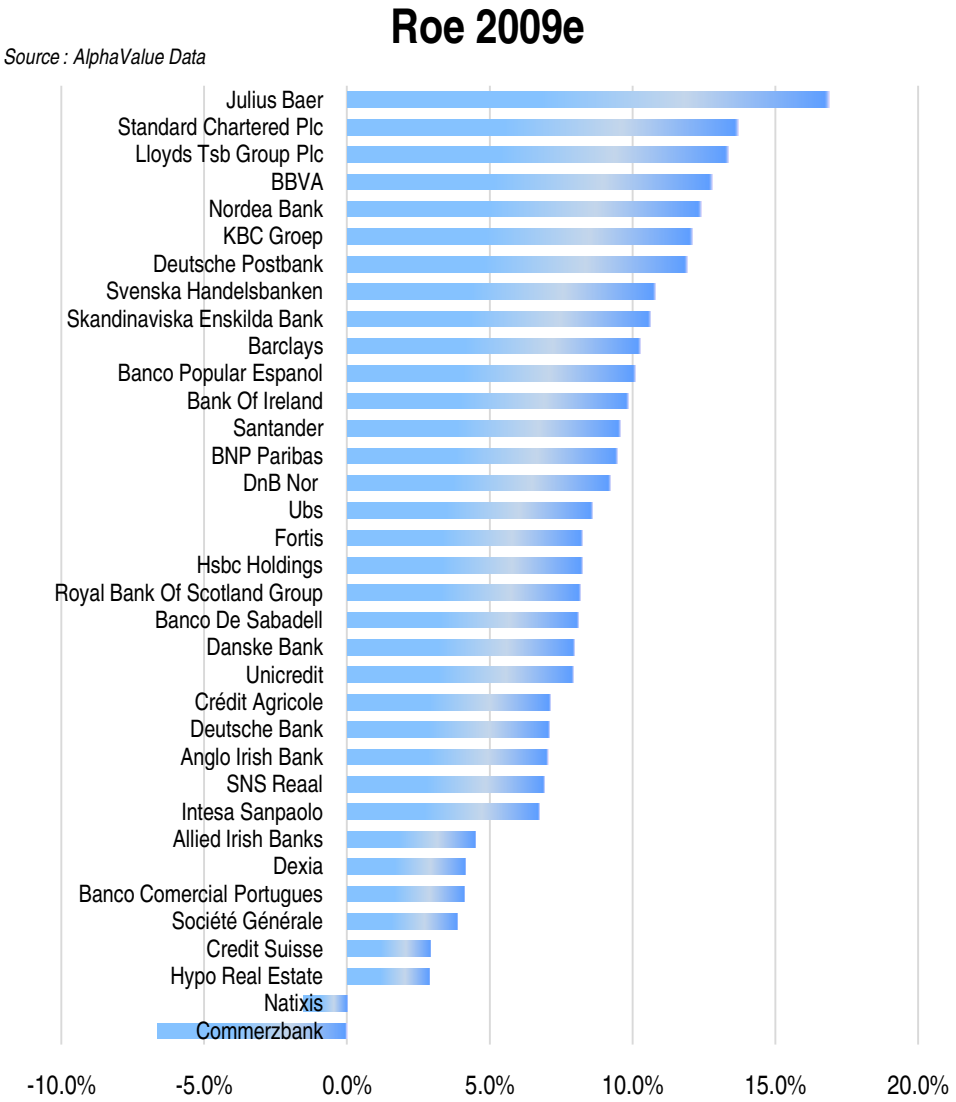
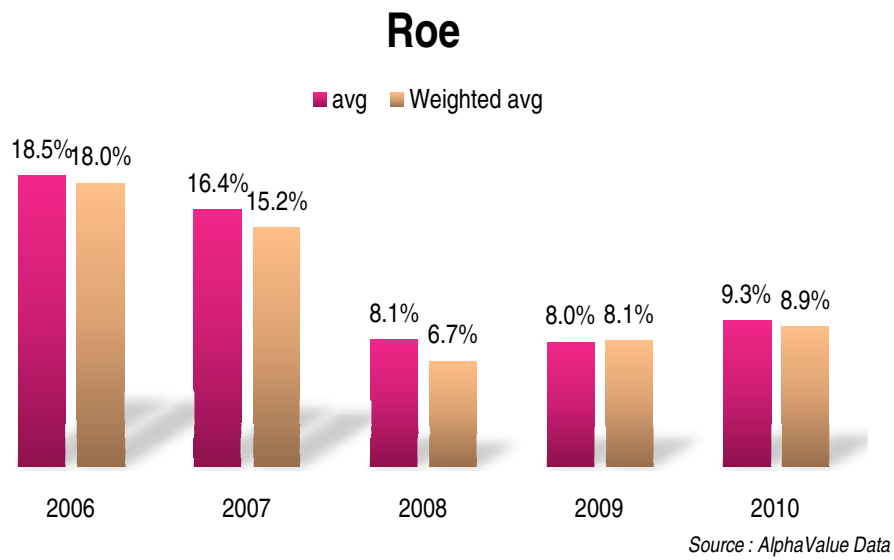
35 European banks: ROE to be halved in 2008-2010 versus the record 2006-2007



ROE will fall, for sure. But, let's think of it: if the outcome of the crisis is « less speculative banks », it means – then – « less risky banks ». Back to normal: lower return for lower risk does not NECESSARILY mean lower REAL value creation. On the other hand, it means « back to REAL work for bankers ».

Before: ROE (18%) / COE (10%) → PBR = 1,8x

After: ROE (12%) / COE (10%) → PBR = 1,2x



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