Axiom Alternative Investments

Investing with a financial sector specialist

Webinar

15th of November 2023

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I.1 Key takeaways

Highlights

11th consecutive quarterly result

with European banks beating analysts' consensus.
80% of banks delivered net results in line with or above consensus.

Earnings momentum still positive

- FY24e pre-provision profits upgraded by 2%-3% on an aggregate level post results
- 2023e net income growth of c. 40% vs. 2022
- Index aggregate ROE close to 12% for 2023e (vs. last decade peak of 8%)

Contrasts are starting to emerge

- NII in the Euro area was up c. 5% Q/Q driven by peripheral banks. However, UK banks missed due to intensifying deposit migration and mortgage competition.
- Capital generation remains strong (+5-10bp), with Commerzbank and Deutsche Bank increasing capital returns as soon as Q3 (normally an interim/full year event)
- Costs in line and provisions slightly below expectations

Valuation

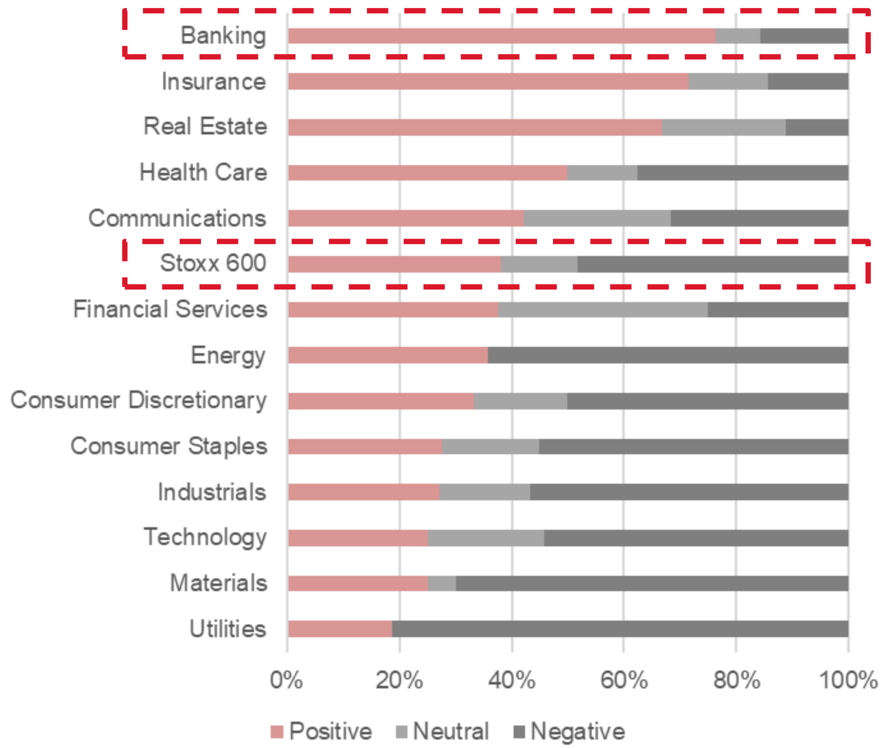
European banks have derated further as investors remain concerned with the credit cycle, competition for deposits, interest rates volatility and political interference

Data as of 03/11/2023 | Source: Axiom Alternative Investments

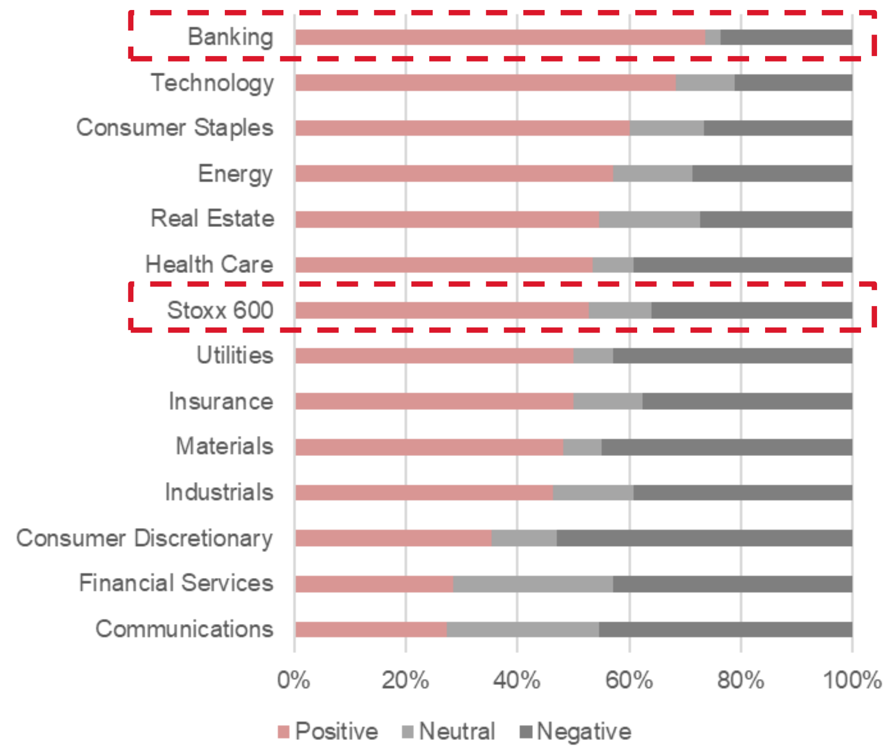
I.2 Earnings surprises

Positive again in a difficult quarter for European stocks

Sales beat rate[1] by sector (BICS)



Earnings beat rate[1] by sector (BICS)



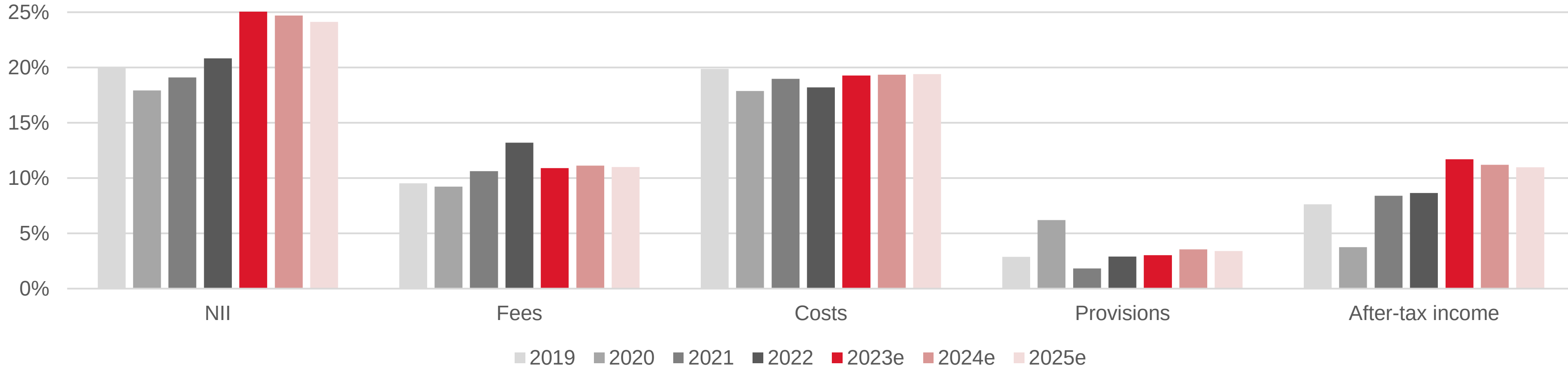
Banks are one the few sectors in Europe still displaying positive revenue momentum

Data as of 03/11/2023 | Source: Axiom Alternative Investments, Bloomberg | [1] Beat rate: % of stocks reporting sales or earnings above / in line / below consensus.

I.3 Post Q3 consensus summary

A new reference point for the profitability of the banking sector

Return on equity: 12% is the new 8%



Sensitivities to macroeconomic scenarios

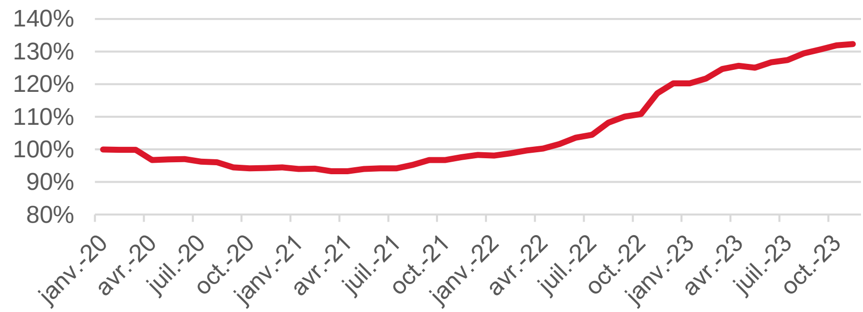
Item	Shock	Comment	After-tax ROE
Commercial spreads	+/- 50 bps	150 - 175 bps in NIRP ; 225+ bps in normal environment	+/- 3 pts
Volumes	+/- 5%	Deleveraging expected in 2023 after strong growth in 2022	+/- 1 pt
Fees	+/- 5%	Total fees tend to be stable ; deep recession -10%	+/- 0.5 pts
Costs	+/- 5%	Driven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

Data as of 03/11/2023 | Source: Axiom Alternative Investments, Bloomberg

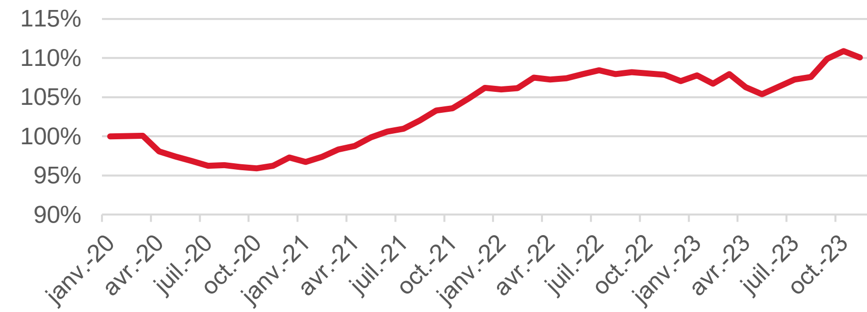
I.4 Earnings revisions

Positive but decelerating

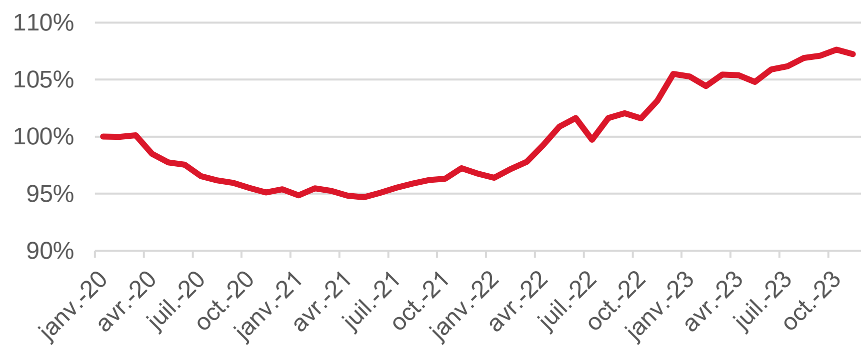
FY23e NII (rebased)



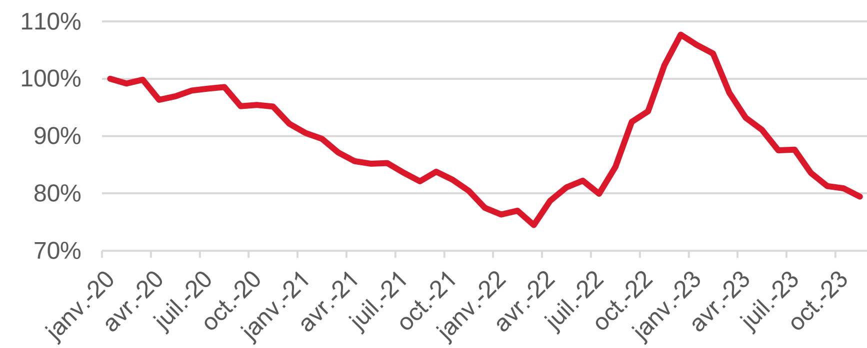
FY23e Fees (rebased)



FY23e Costs (rebased)



FY23e Provisions (rebased)



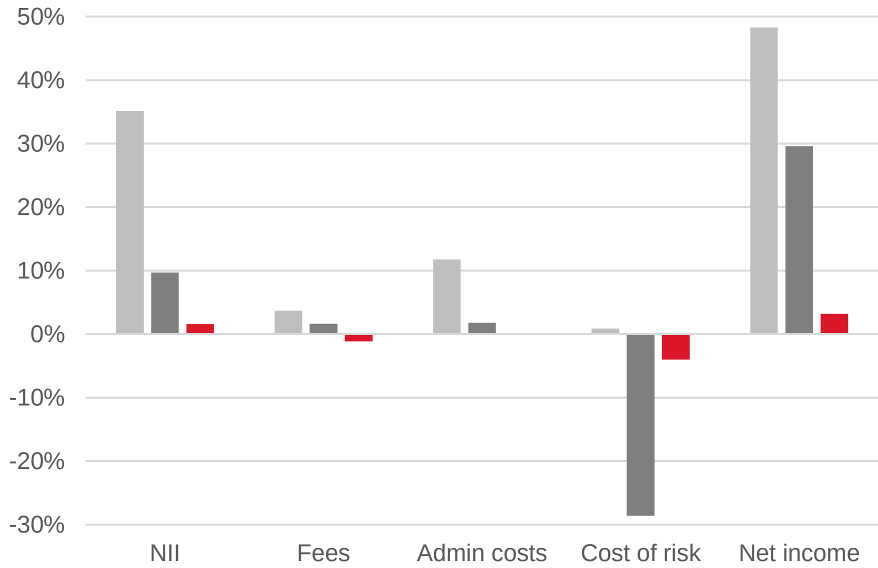
After a stellar expansion, earnings expectations are likely to stabilize as NII starts to plateau. Interest rates and deposit costs will remain the principal source of volatility.

Data as of 03/11/2023 | Source: Axiom Alternative Investments

I.5 Revisions to consensus estimates

By P&L item

2023 consensus earnings revisions



2024 consensus earnings revisions

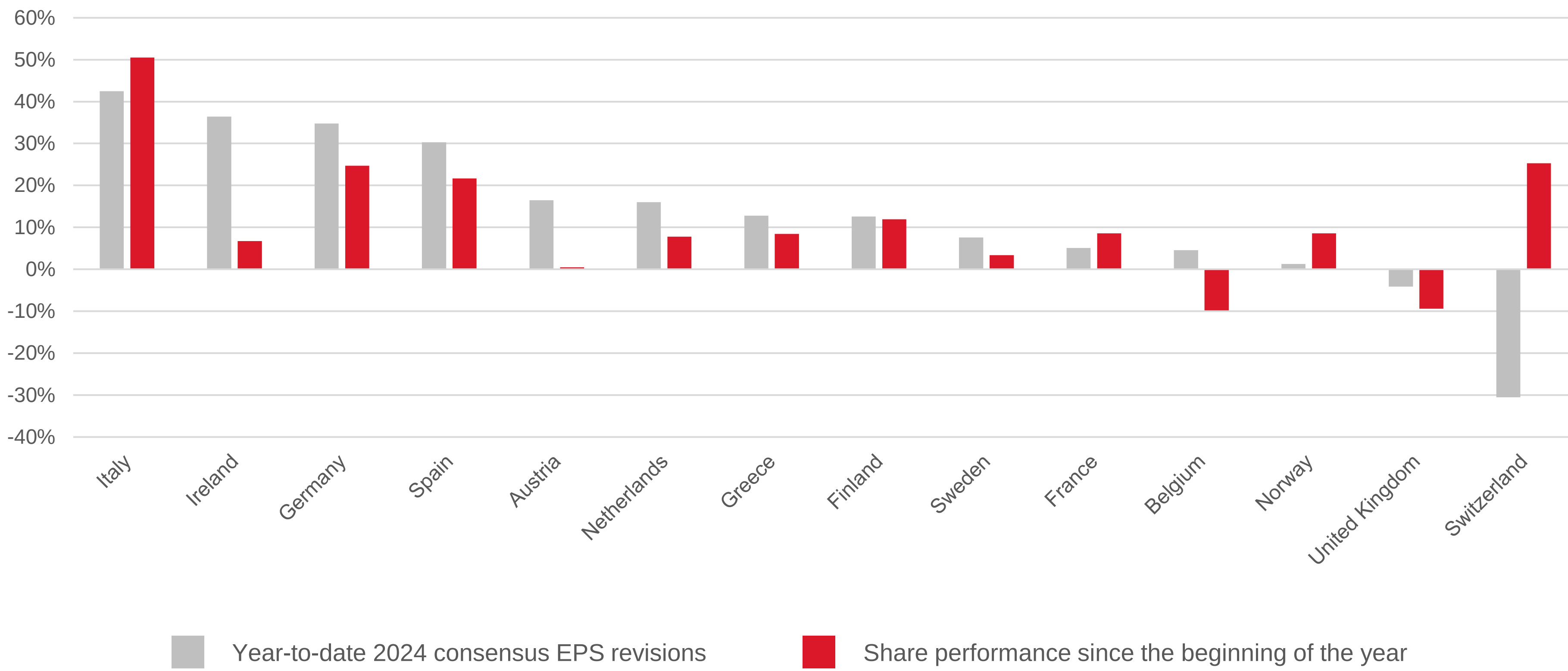
Since January 2022 | YTD | Q3 2023 results

NII and provisions are still the largest drivers of earnings volatility.

Data as of 03/11/2023 | Source: Axiom Alternative Investments, Bloomberg

I.6 Revisions to consensus estimates

By country

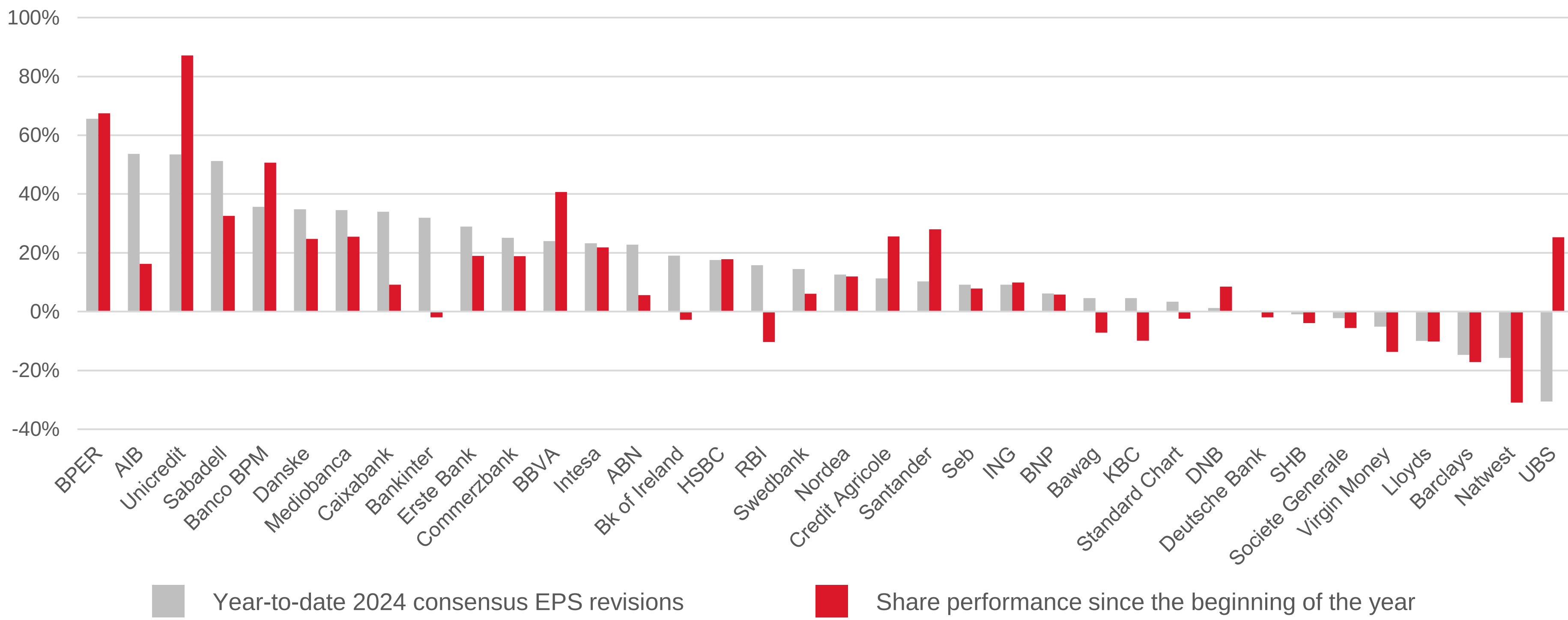


Short duration banks in geographies with weak deposit competition (Ireland, Spain, Italy, Greece) are winning this year.

Data as of 03/11/2023 | Source: Axiom Alternative Investments, Bloomberg

I.7 Revisions to consensus estimates

By bank



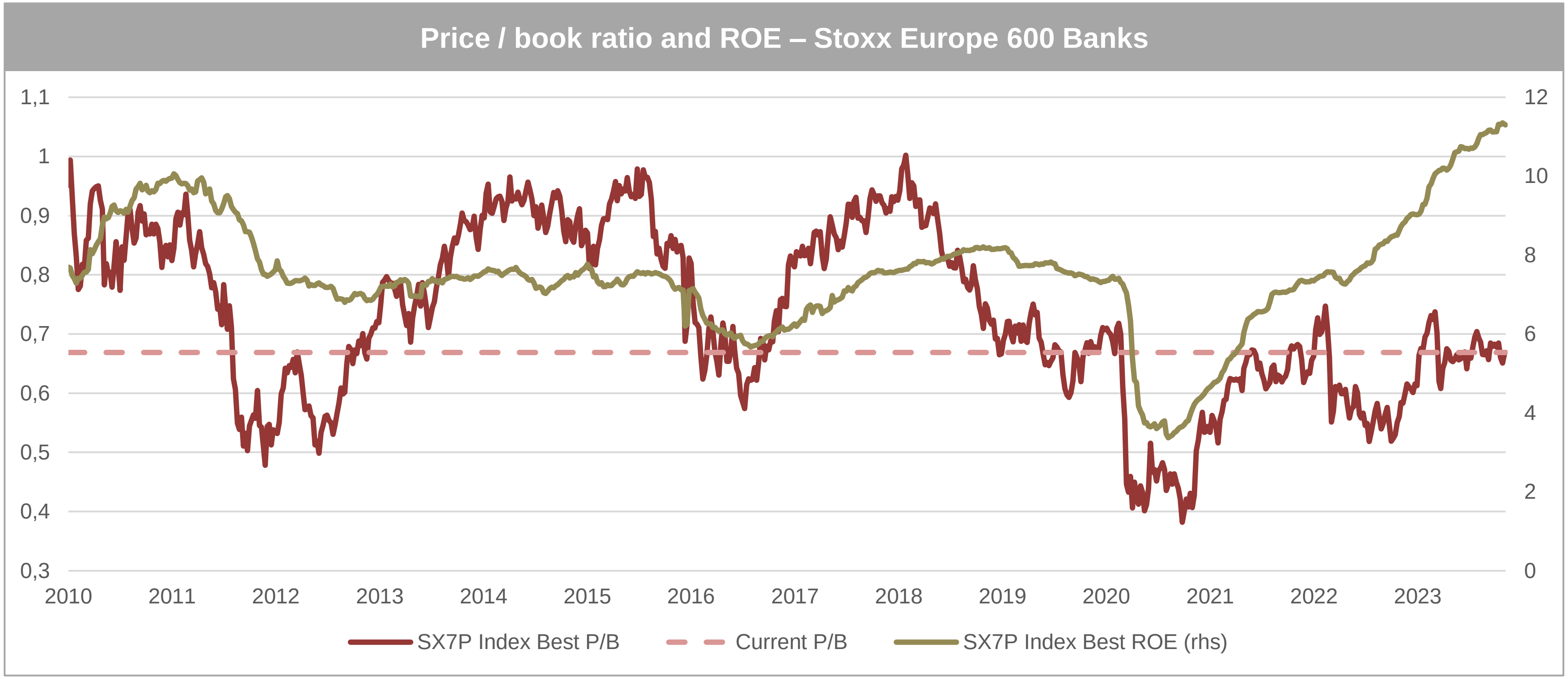
Core eurozone banks (France, Netherlands), UK and Nordics have underperformed mostly due to more competitive retail markets, different hiking cycle dynamics and longer duration assets.

Past performance is not a reliable indicator of future performance. It does not constitute an investment recommendation

Data as of 03/11/2023 | Source: Axiom Alternative Investments, Bloomberg

I.8 Price-to-book ratio vs. 1y forward ROE

Post-GFC evolution



Banks are stuck at the bottom end of their pre-COVID range despite a massive shift in profitability and distributions. Current market pricing seems to reflect an implausible drop in earnings of over 40%.

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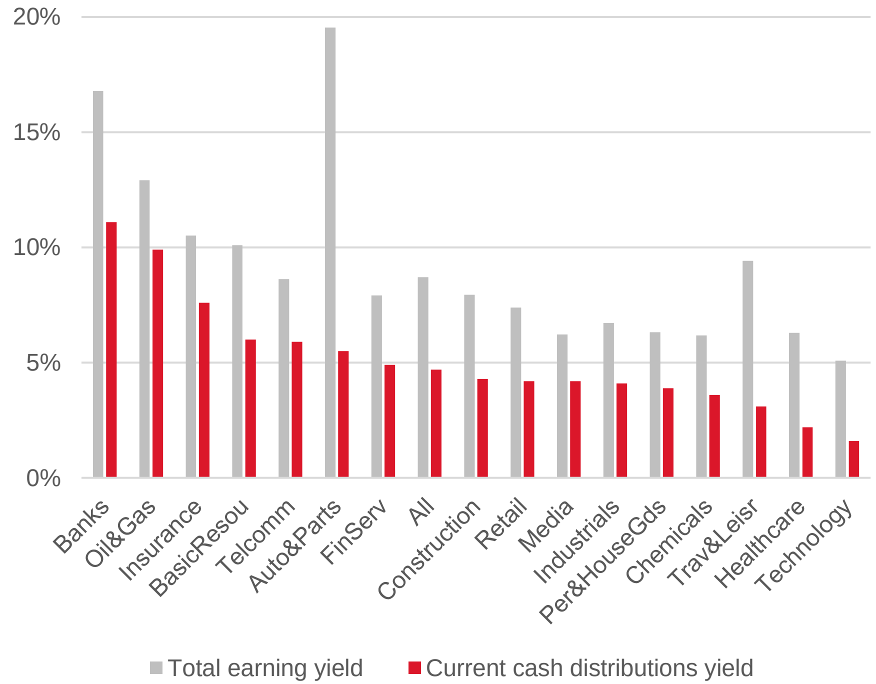
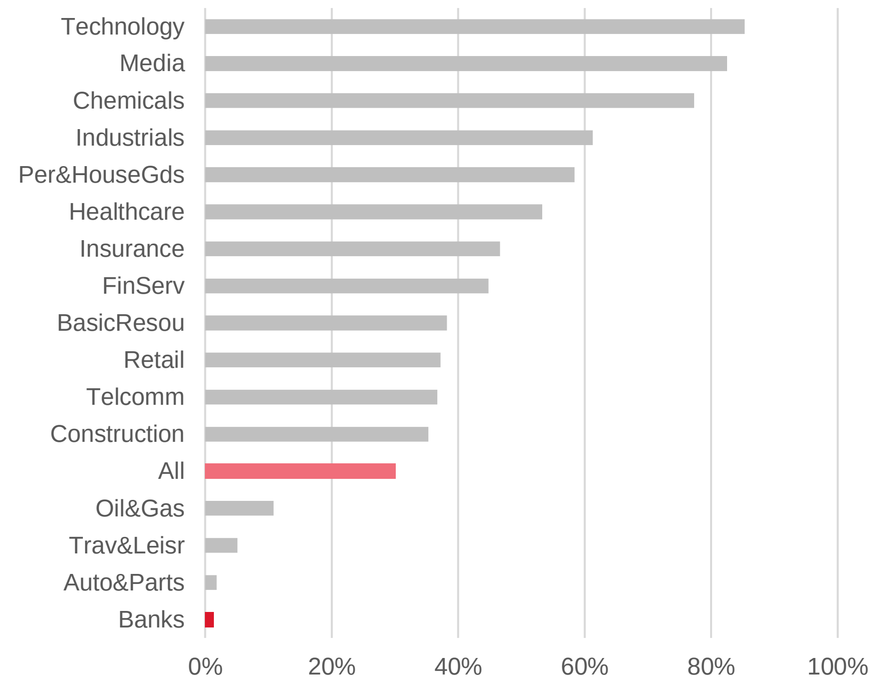
Data as of 03/11/2023 | Source: Axiom Alternative Investments, Bloomberg

I.9 Sectoral analysis
Yields and valuations

Cash distribution yields ("cash" dividends + share buybacks)



Valuation quantiles (last 15 years)



Banks offer the highest distribution yield and the widest discount to long-term multiples

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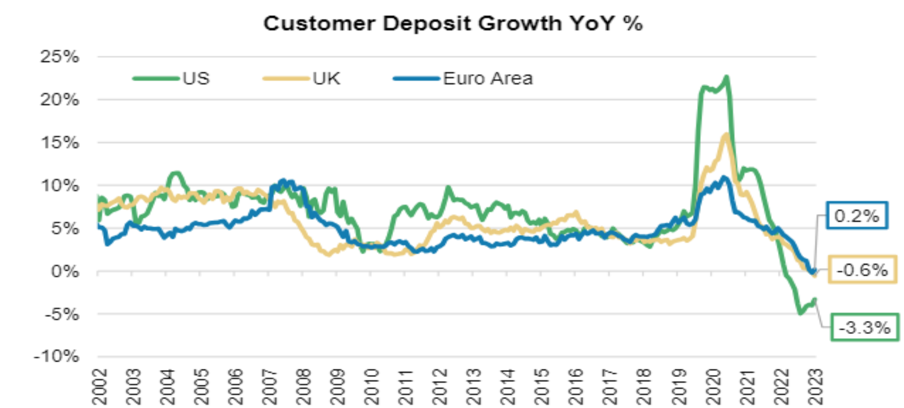
Data as of 03/11/2023 | Source: Axiom Alternative Investments, Bloomberg

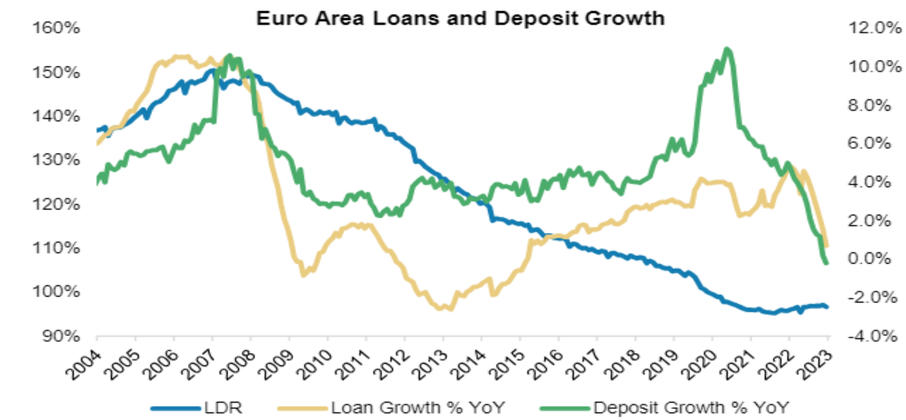
II.1 Loan and deposit trends

Volumes

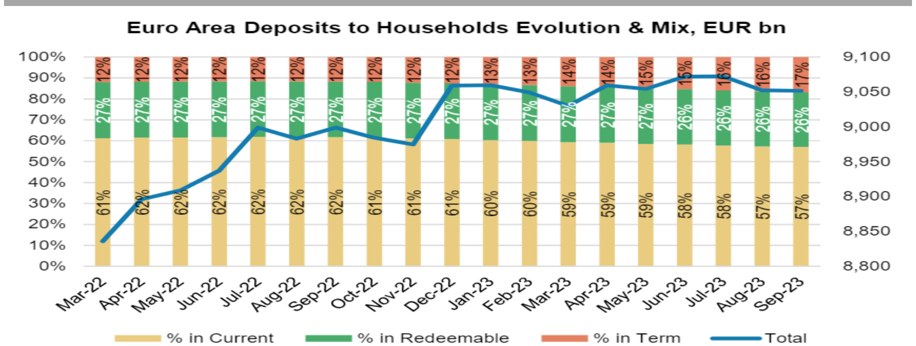
Deposits are stagnating



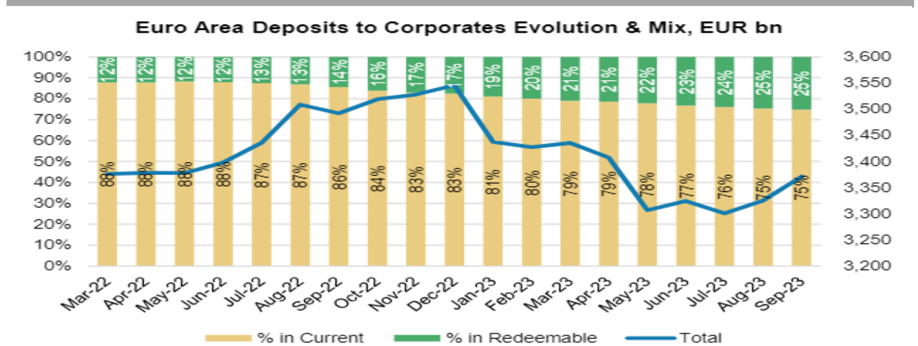
The loan-to-deposit ratio remains stable just below 100%



Shift from overnight into time deposit: households



Shift from overnight into time deposit: corporates

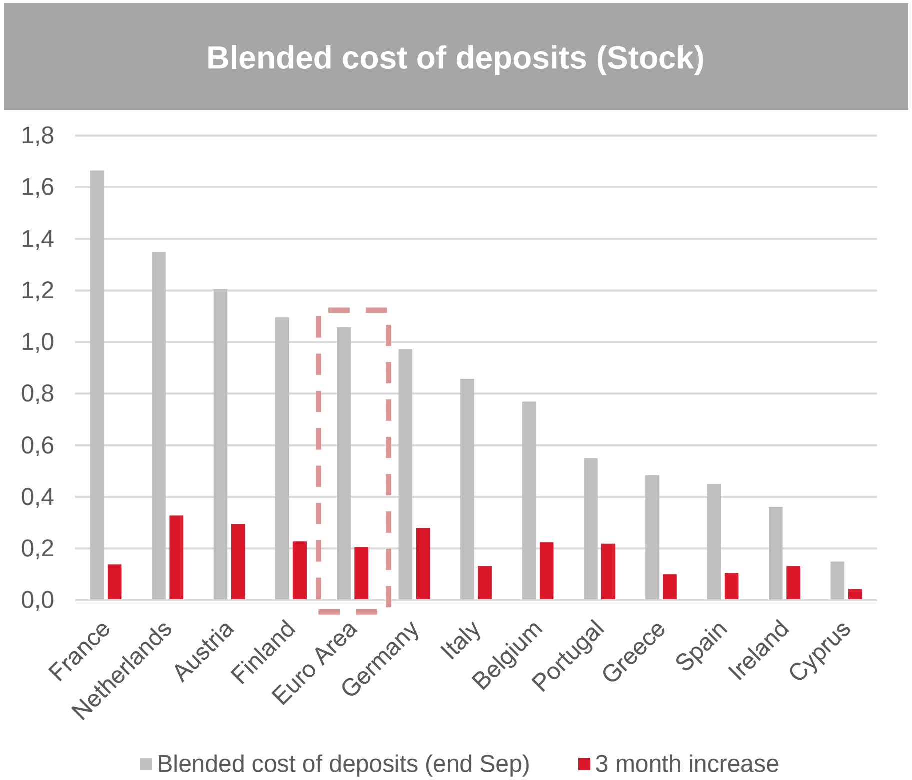


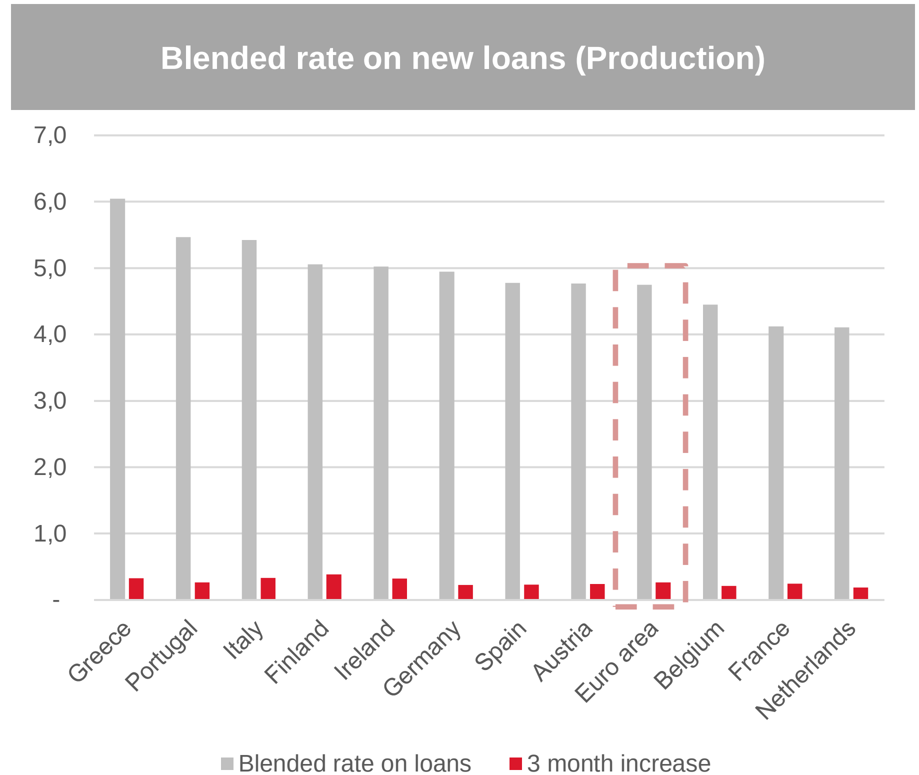
The private sector is deleveraging, which manifests itself in stagnating loan and deposit volumes. The shift away from current accounts in savings/term accounts is slow and not accelerating.

Data as of 03/11/2023 | Source: Axiom Alternative Investments, ECB, Morgan Stanley

II.2 Loan and deposit trends

Rates levels on loan and deposits





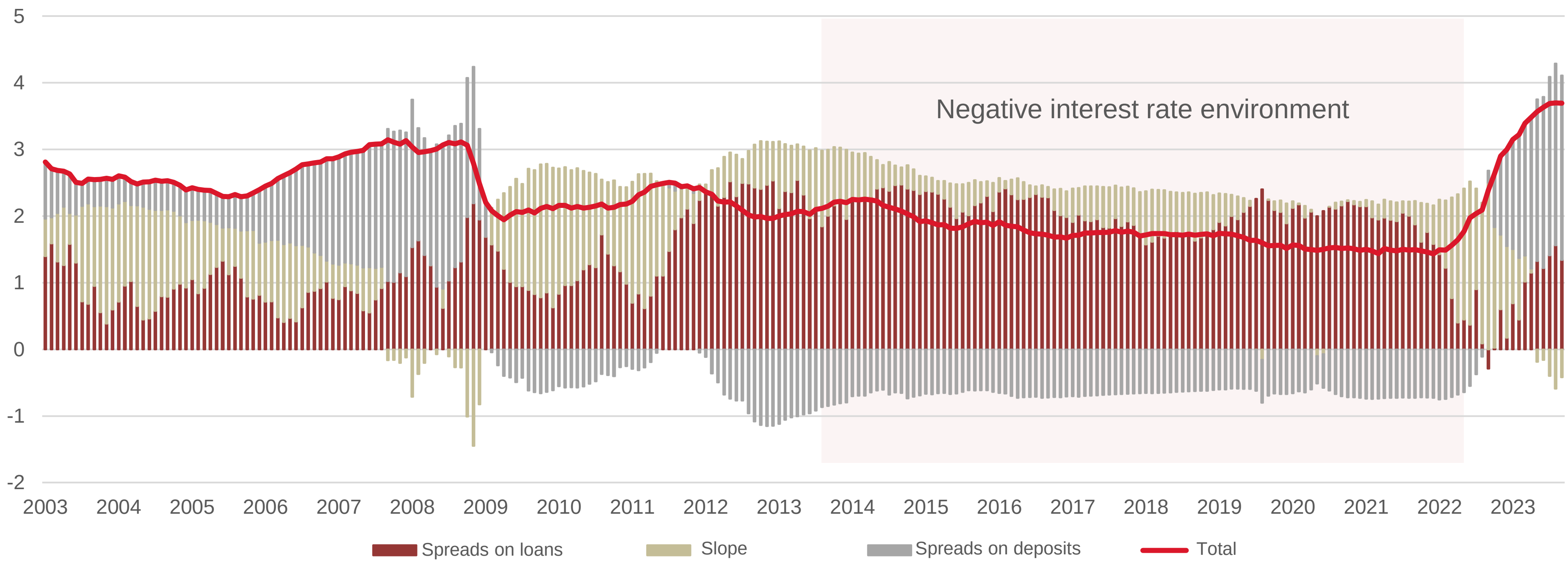
The gradual repricing of deposits gives breathing space to banks with longer duration assets and hedges. No acceleration of competition in September. Southern European markets remain the least competitive. Stabilization in France.

Data as of 03/11/2023 | Source: ECB, Axiom Alternative Investments

II.3 Loan and deposit trends

Long-term customer spreads

Breakdown of the interest margin spread on new loans (in percentage)



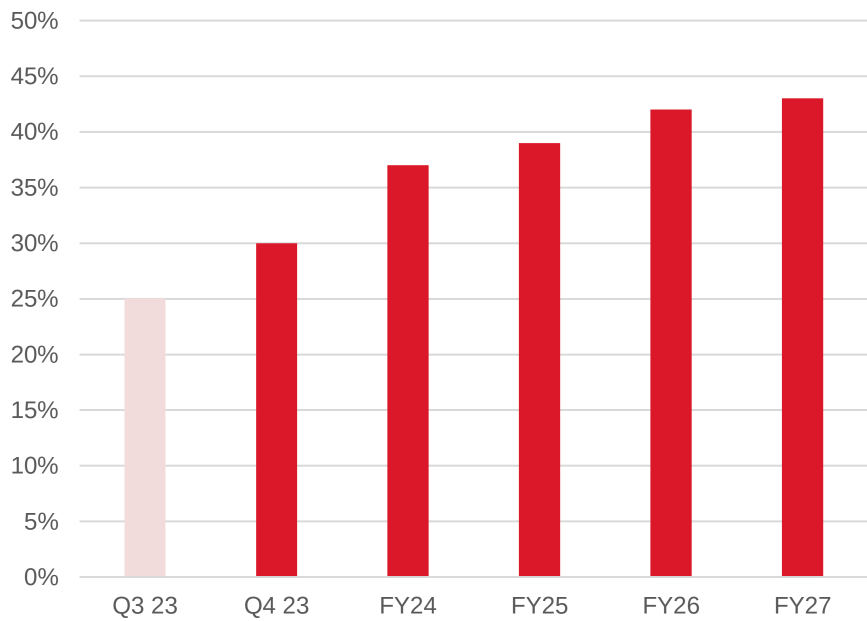
The current hiking cycle has expanded customer spreads to record highs, but these haven't flown to the P&L due to embedded duration. In a rate cut scenario with re-steepening (not unlikely given the new deglobalisation/fiscal paradigm), asset and hedge roll yields could stay elevated, protecting margins.

Data as of 03/11/2023 | Source: ECB, Axiom Alternative Investments

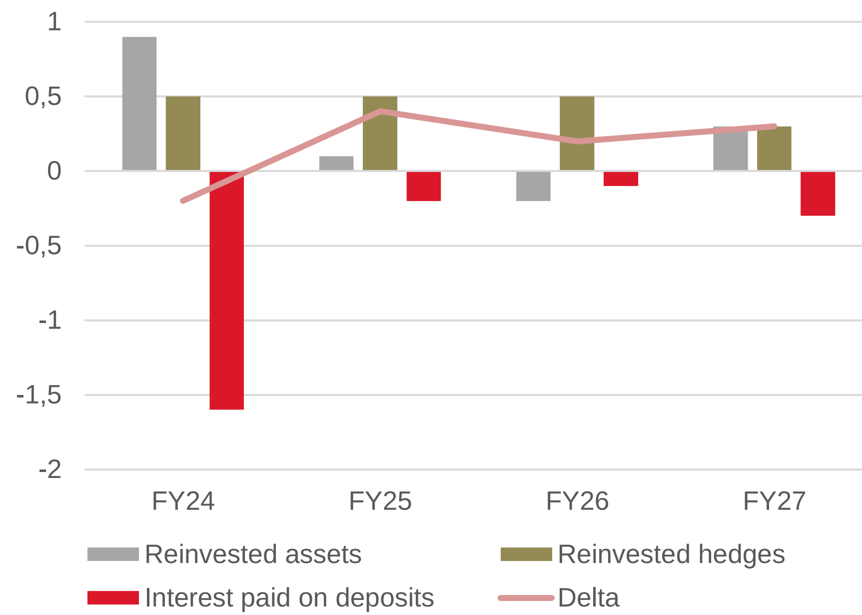
II.4 NII projections into 2024 and beyond

Commerzbank 2027 NII guidance

Assumed deposit beta (cost of deposits as % of ECB deposit rate)



NII walk into from 2023 to 2027 (assuming rates follow forward curve) – in € bn



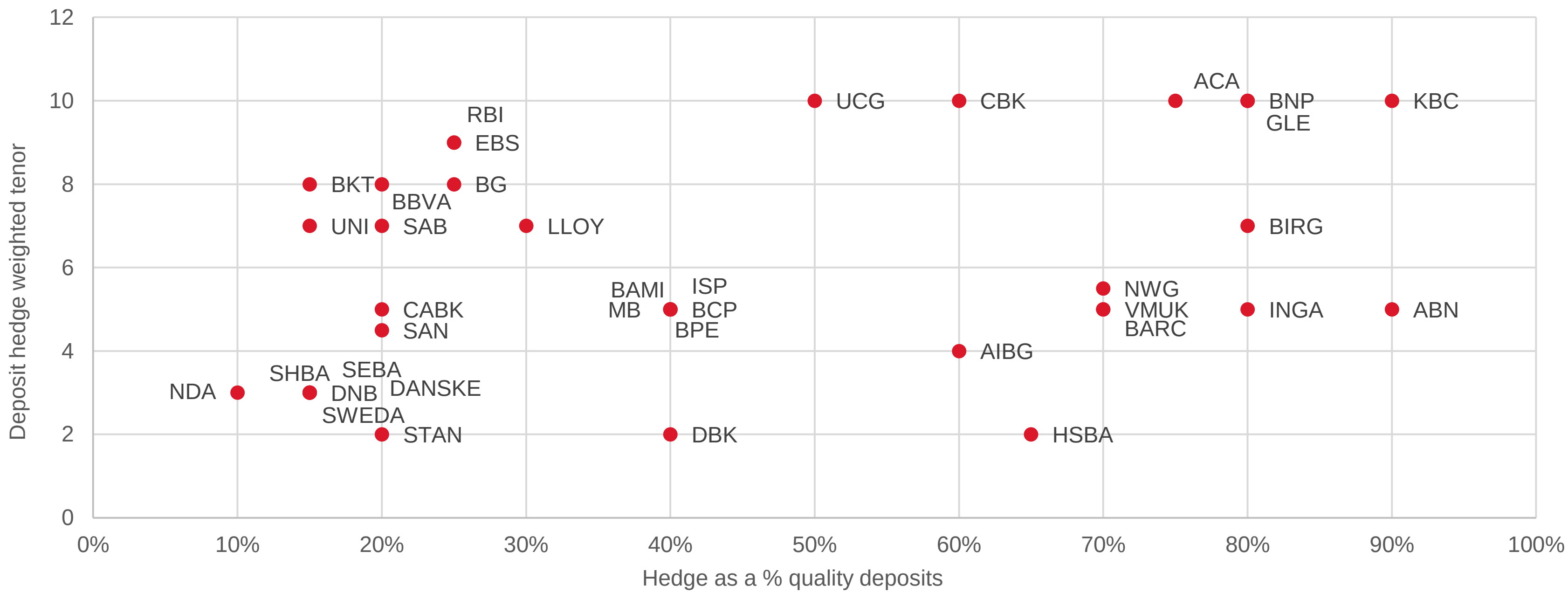
Commerzbank would be able to grow its NII over the next few years even with increasing deposit betas and interest rate cuts thanks to the reinvestment of assets and hedges

Data as of 03/11/2023 | Source: Commerzbank, Axiom Alternative Investments

II.5 NII projections into 2024 and beyond

Deposit hedges

European banks employ a variety of ALM strategies



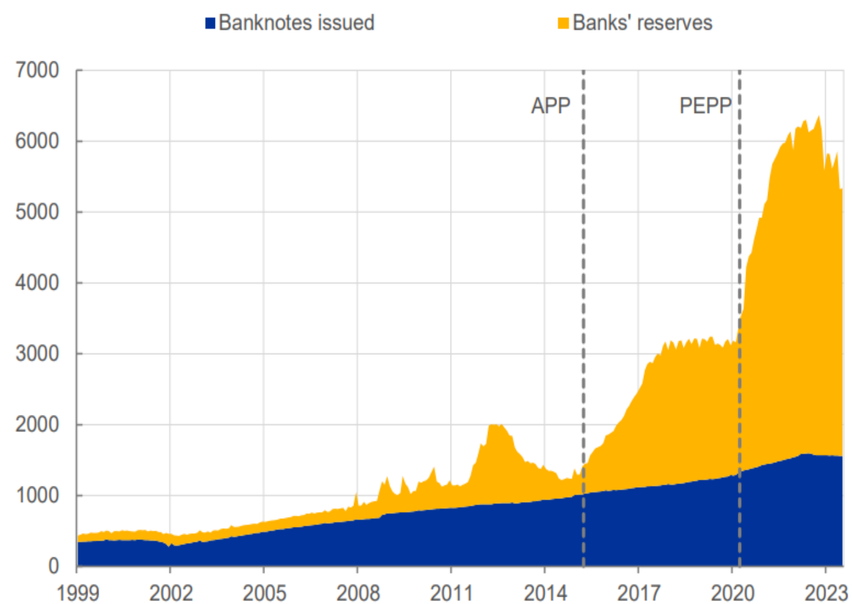
Nordic and Spanish banks are more sensitive to short-term rates. Banks in France, Belgium, the Netherlands and Germany react more slowly and are more sensitive to the steepness of the slope.

Data as of 03/11/2023 | Source: Axiom Alternative Investments, Autonomous

II.6 The ECB operational framework review

The Minimum Required Reserves debate

The Base Money problem



Potential solutions and trade-offs

- The ECB is making huge losses on excess reserves
- Recently the ECB decided to pay 0% instead of the deposit rate on MRR, citing “monetary policy efficiency”
- MRR are currently set at c. 1% of deposits + ST liabilities
- Some non-executive voting members (Bundesbank) have suggested that the MRR should be increased “substantially”
- Executive board members (Largarde, Schnabel, de Guindos) are against
- QT vs. anti-fragmentation tool is another important debate

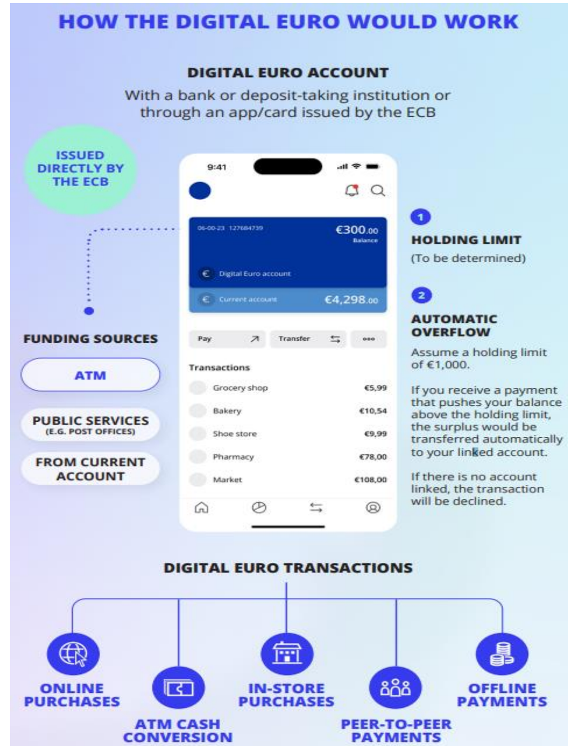
If MRR is raised to 2% at 0% remuneration the impact on the banking sector profit would be c. -2%. The LCR ratio would drop by c. 5pts. PEPP/APP run-off framework will have financial stability impacts and therefore on banks’ cost of equity.

Data as of 03/11/2023 | Source: ECB, Axiom Alternative Investments, Autonomous

II.7 The digital Euro

Real threat or doomed to fail?

- Cash-like: issued and guaranteed by the ECB. Storable by households only
- Pay everywhere. Works offline “where cards can’t go”
- Privacy: no personal or transaction data stored by the ECB
- EUR 3,000 account maximum limit to cap reduction in bank current accounts.
- -6% impact on bank profits if 50% adoption rate



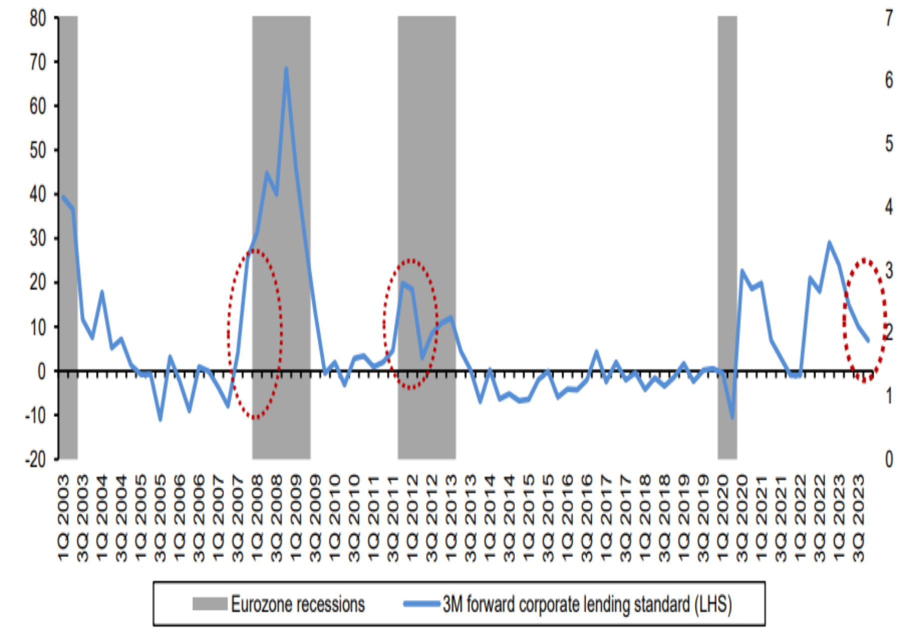
Final-user value of the digital euro not clear yet (bank accounts are already guaranteed and payments work well). Revolutionizing the EU payment landscape will prove complex. Privacy claims not reconcilable with KYC/ALM constraints. Technology not yet available for off-line. E-CNY only 0,15% of M0[1].

Data as of 03/11/2023 | Source: ECB, Axiom Alternative Investments, Autonomous | [1] MO: the monetary base is made up of banknotes and coins, plus the required and excess reserves that commercial banks deposit with the central bank, plus deposit facilities.

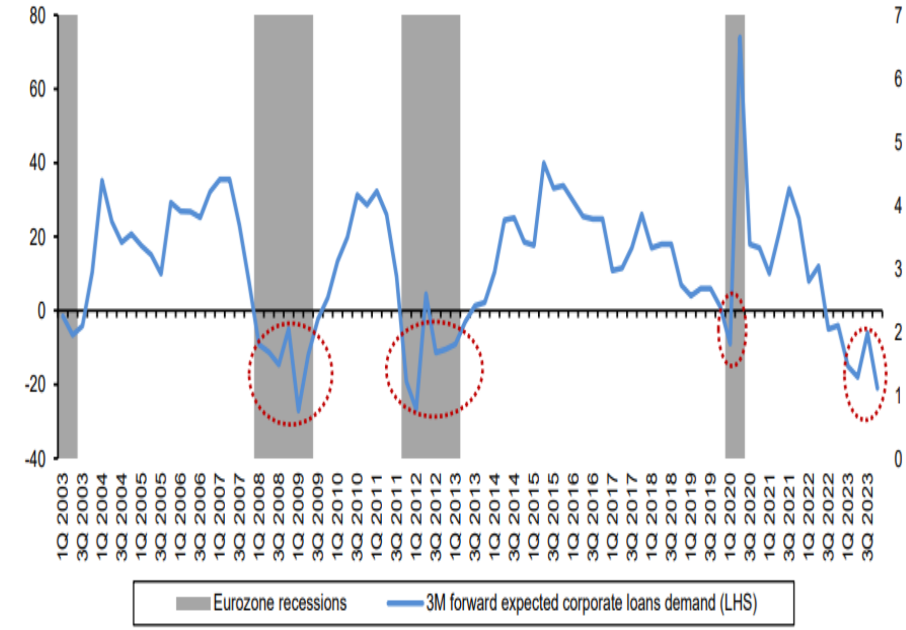
II.8 Credit conditions

Credit demand and standards

Net % expecting tighter corporate lending standards



Net % expecting higher corporate loan demand



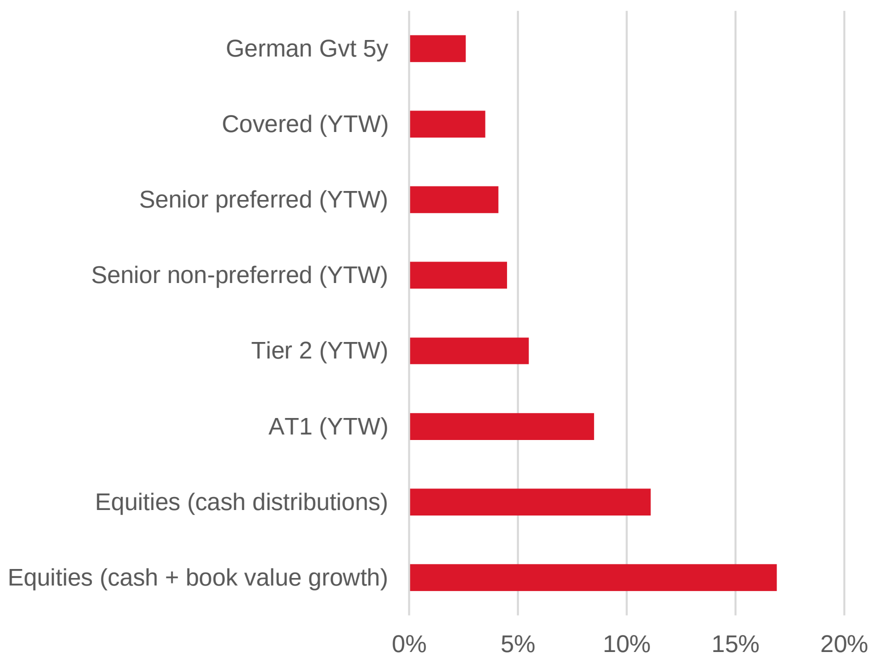
Corporate loan demand is in recessionary level. According to this indicator, a recession should have started last year. Excess cash, expectation of better rates in the future and public sector crowding out may be part of the explanation.

Data as of 03/11/2023 | Source: ECB, Axiom Alternative Investments

III.1 Yields across the capital structure

Attractive premium for subordination and earnings risk

Yields across the capital structure



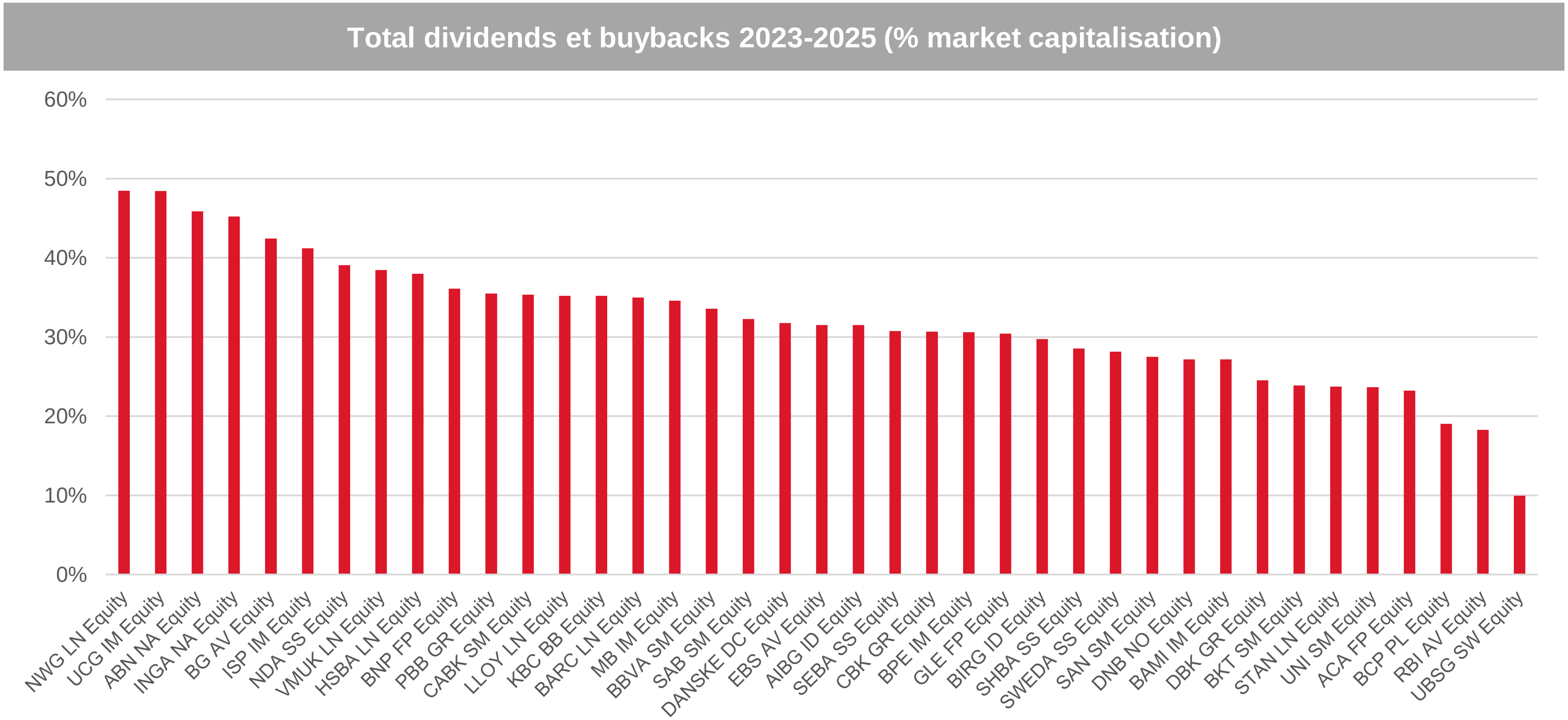
YTD performance decomposition

Significant premium for subordinated parts of the capital structure. AT1/T2 spread ratio at historical highs. Bank equities have barely rerated YTD in terms of P/B (4%) despite a 20% jump in profit expectations. Carry is a powerful volatility absorber.

Data as of 03/11/2023 | Source: Axiom Alternative Investments

III.2 Dividends and buybacks

Total distribution yield over 3 years



European banks pay out on average 60% of their profits, in dividends (80% of total distributions) and share buybacks (20% of total distributions). The build-up in excess capital could lead to higher payout ratios.

Past performance is not a reliable indicator of future performance. It does not constitute an investment recommendation

Data as of 03/11/2023 | Source: Axiom Alternative Investments, Bloomberg

III.3 Positioning

Examples of portfolio holdings

Examples of portfolio holdings	
BNP	- Marathon runner given the ALM structure in France and fixed loans in Italy - Screens well in terms of total distributions over next 3 years - Delivery on jaws objectives likely - 12% CET1 target in 2025e reiterated. More buybacks if growth objectives not met.
ING	- Resilient NII + other income line into 2024 - Higher retail deposit competition in Netherlands but signs of cool down - Leading capital generation - Total market cap distribution at 15%+ per year
Natwest	- NIM pressure story overblown - Commitment to capital return - Proven track-record on costs - One of the highest yields at 4x earnings
Sabadell	- Under-appreciated NII story due to longer duration than Spanish peers - Potential for capital surprise - Strong leadership - Valuation margin of safety at 0.4x p/b
Société Générale	- Turnaround in profitability to materialize next year ; distributions in 2025 - CIB has proven its quality and resilience - Issues in French retail mostly behind us - ALD/Leaseplan success key uncertainty but share price already took the drawdown

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Data as of 03/11/2023 | Source: Axiom Alternative Investments, Bloomberg

III.4 Main risks and mitigating factors

10%+ ROE can persist in a broad set of macro-economic scenarios

Risk	Payout ratio	P&L	Balance sheet	Mitigating factors
Interest rate cuts		●	●	- Potential 3m-5y re-steepening - Real estate exposures - Unrealized losses and lapse risk - Fee businesses (asset management, M&A and capital markets)
Credit defaults	●	●	●	- 25-30 bps of precautionary provisions - state-guaranteed loans - No aggregate private debt bubble (private debt / GDP ratio now at 155% vs. 165% in 2010) - conservative underwriting
Liquidity tightening		●	●	- MRO/LTRO spreads - Share of operational deposits and guaranteed deposits - UBS situation still unresolved: discussions in Switzerland
Taxes & bank bashing		●		- Special taxes already implemented in most jurisdictions - Counter-cyclical effect of government interventions
MRR		●	●	- Undesired side effect on LCR ratios - Opposition of ECB executive board - 2% MRR possible, above extremely unlikely
Change in regulations	●	●		- Limited residual effect from Basel IV implementation - Move from more regulation to more supervision
Buyback approval	●			- ECB track-record speaks for itself - Buyback approvals at risk only if sudden deterioration in economic outlook (i.e. deep recession) or serious external shock
Non-bank competition		●		- Neobanks struggling as funding dried - Increased scrutiny on private credit, also opportunity for banks to offload risk - Big Tech moving in small steps (GS/Apple partnership), “Alibaba” risk

The combination of cheap valuations and earnings resilience provide a strong support for returns

Data as of 03/11/2023 | Source: Société Générale, Axiom Alternative Invesmtents

I. European banks Q3 2023 results overview

II. Trending topics

III. Outlook and positioning

IV. Q&A

IV. Q&A
Key Takeaways

Positive earnings revisions continue despite the economic slowdown in Europe

- **11th quarter in a row** where results exceeds consensus.
- Earnings revisions slowing but still significant at c. +2%/+3% on aggregate, well above the Stoxx Europe average
- A new reference point of 11-12% for cycle peak ROE (vs. 8% in the previous decade)

Investors are paid a lot to ride this cycle

- A 16%-17% carry (i.e. at constant price-to-book and current earnings outlook, investors will make 16%-17% / year)
- Cash distribution yield at 11%+ (with several banks offering 15%+)

Earnings power to be maintained in a broad range of economic scenarios

- 25-30 bps of precautionary provisions (i.e. no impact of first 2 pts in increase in unemployment on earnings)
- Countercyclical impact of lower rates on real estate exposures, asset management and capital markets
- NII would be preserved and could grow in case of rate cuts with re-steepening
- Lower credit creation releases capital for distributions

Key themes to watch

- Net interest income dynamics, between asset and hedge rollovers, competition for deposits, and lending margins
- Payout ratios (dividends, buybacks) potentially above 100% for some banks
- Level of demand for mortgage loans and corporate loans
- Cost of risk dynamics and possible use of prudential provisions (equal to 2/3 of a normal provisioning year)
- A particular focus on commercial real estate (it represents 10% of total bank balance sheets in Europe (office CRE is 2%) compared to over 30% for US regional banks).
- ECB operational framework review

Thank you for attending the Axiom Alternative Investments webinar.

See you next quarter.