Global Banks

Value stocks in US and Europe

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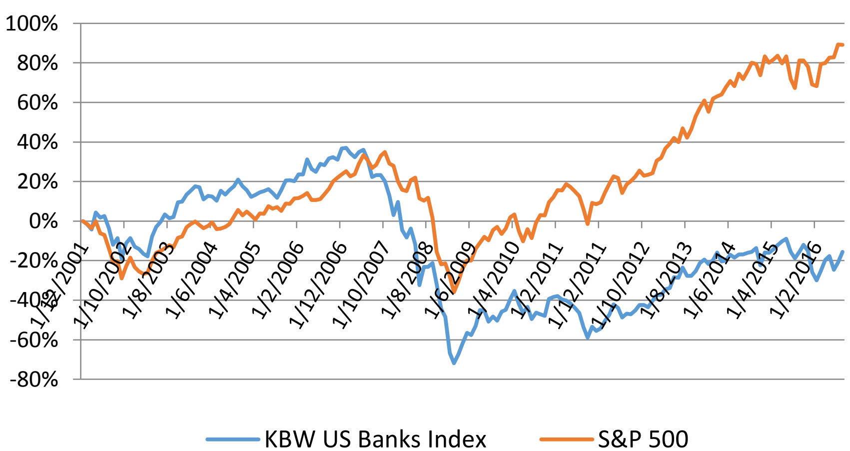
Active Banking Fund

Banking sector remains cheap post 2008-9 financial crisis

- Higher capital requirements and record low interest rates lead to lower return on equity (RoE) for banking stocks
- Reduced investor appetite for certain “higher risk” banking stocks (particularly in the Eurozone)
- Even in the US, where banks are now highly profitable and very well capitalised, the banking sector is the cheapest amongst all 10 sectors in the S&P 500
- Many healthy and highly profitable banks still command low valuation multiples due to misinformed and distorted market perceptions (US) or a problematic environment in which they operate (Eurozone)

Indices % performance since end 2001



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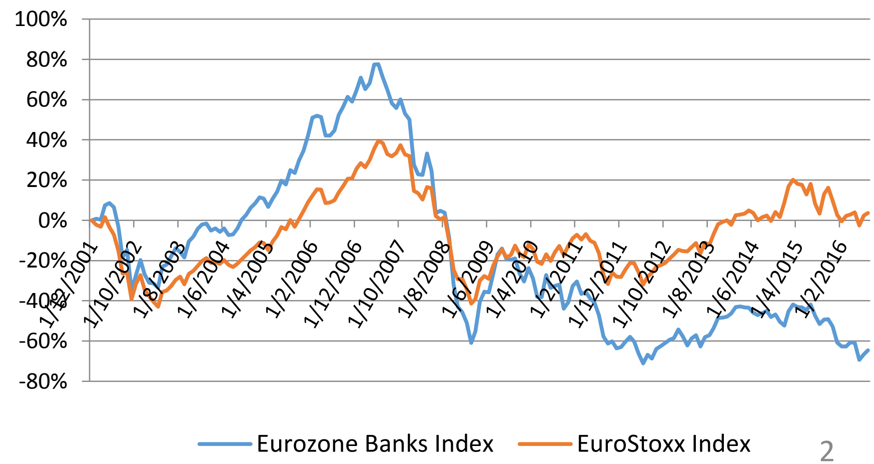
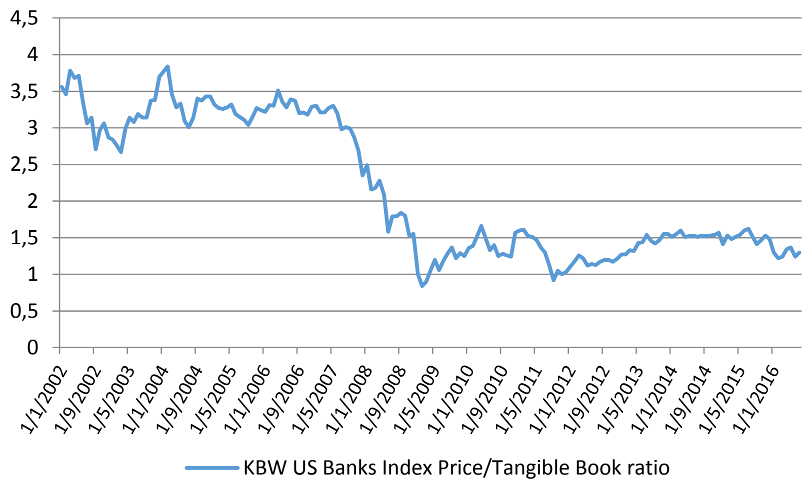
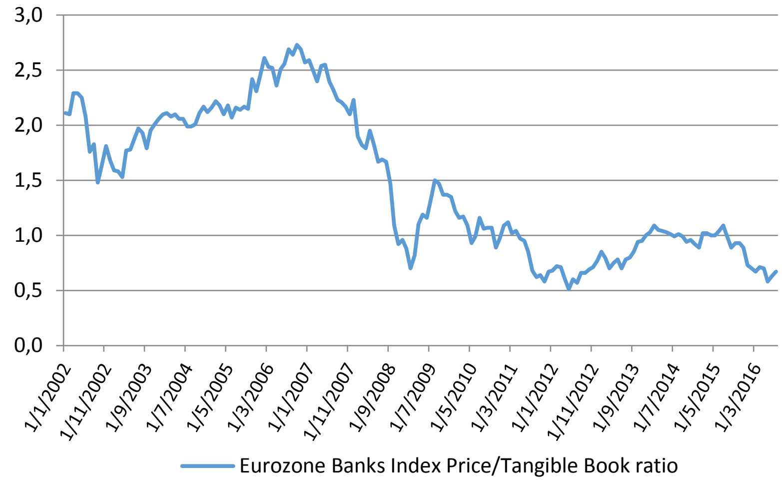


US and European banks trading at very low valuation multiples





Ratio (for KBW US Banks Index)	Ratio as at end August 2016	Ratio monthly average pre financial crisis (2002-2008)
Price/Book	1.02	1.95
Price/Tangible Book	1.37	3.09
Price/Earnings (P/E)	12.8	14.6

Ratio (for Eurozone Banks Index)	Ratio as at end August 2016	Ratio monthly average pre financial crisis (2002-2008)
Price/Book	0.56	1.66
Price/Tangible Book	0.67	2.11
Price/Earnings (P/E)	11.4	13.5

In this environment, some banks look very cheap

Active Banking Fund

- When a sector is beaten down and news are generally negative, there are always good investment opportunities for shrewd fund managers
- US banks in particular stand to benefit from expected interest rate hikes from the Federal Reserve; first rate hike in December 2015, next rate hike expected in December 2016, with 3-4 additional rate hikes expected by 2018
- This is the main theme of the Active Banking Fund, investing in highly profitable, adequately capitalised and well managed banks with low valuation multiples; the focus is on banks with a market cap of at least $10bn
- The Fund is currently almost exclusively invested in US banks:
  - Much stronger balance sheets and higher RoE and profitability than their European counterparts
  - US interest rate outlook much more supportive; US base rate expected to hit 2% in 2018 from 0.5% today while Euribor interest rate expected to remain negative or zero until at least 2018
- Even so, there are a few highly profitable Eurozone banks which are now extremely attractive from a valuation perspective; Eurozone banks index Price/Book ratio (relative to other Eurozone sectors and US banks) is currently at its lowest ever
- Big divergence in US sector valuations:
  - Other US sectors/industries have: High valuations coupled with low growth
  - US banks have: Low valuations coupled with high growth potential (in a higher interest rates environment)
  - S&P 500 current Price/Tangible Book ratio of 7.63 (vs 1.37 for US banks)
  - S&P 500 current P/E ratio of 20.4 (vs 12.8 for US banks)

US banks value stock – Bank of America

- Bank of America has gone a long way since the 2008-9 crisis
- Forced to write off tens of billions of dollars in bad investments and loans following its 2008 acquisitions of Countrywide Financial and Merrill Lynch
- From 2011 to 2014, BoA paid almost $60bn in fines to investors and the US government (in relation to fraudulent transactions during the financial crisis)
- Since 2014, the Bank has finally put all its past sins behind it; 2015 reported annual profit was its highest since 2006 and close to pre-crisis record profit levels; bank benefited substantially from deposit and loans growth and low credit losses in a very benign US economic environment
- Share price is currently 72% below its pre-crisis peak
- Current Price/Book ratio is 0.65 and Price/Tangible Book ratio is 0.92; no other US megabank (apart from Citigroup) trades below tangible book value
- Current P/E based on latest quarterly earnings (annualised) is 10.6, well below the current average P/E for the US banking sector of 12.8
- Most importantly, BoA has the most interest rate sensitive balance sheet of any major US bank due to its sizeable retail banking network across the US; with US interest rates expected to go up gradually, BoA's net interest income and profits will get a major boost

How BoA will benefit from higher interest rates

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- From BoA's Q2 2016 earnings presentation: "We remain well positioned for net interest income to benefit as rates move higher. A +100 bps parallel shift in interest rate yield curve is estimated to benefit net interest income by $7.5bn over the next 12 months"
- Current expectations are that the US base rate (that determines US banks deposit and loan rates) will be increased by at least 1.00% by end 2018. If this happens, we estimate a 25% upside on BoA's net income and share price by 2018

	Current (last 4 quarters)	Expected in 2018 (post rate hikes)	% increase
Net interest income	$37.7bn	$45.2bn	20%
Provision for credit losses (estimate)	$3.6bn	$5.4bn	50%
Increase in pre-tax profit		**$5.7bn**	
2015 pre-tax profit	$22.2bn		
Increase in pre-tax profit (2018 vs 2015)			**26%**

Bank of America

- An increase in interest rates and associated BoA profitability should enable share price to revert to a more normalised Price/Tangible Book ratio of 1.2 by 2018, more in line with other US megabanks. This represents a share price upside of 30% (assuming no valuation multiple expansion)
- Since 2014, when BoA stopped paying fines for its past misdeeds, many analysts have been repeatedly saying that BoA is a "$20 stock" on the assumption of higher interest rates and profitability. With a current share price of $15.3 and at least 25% potential upside by 2018 (to $19), these analysts are likely to be proved right

Bank of America – More scope for dividend hikes and buybacks

- After struggling to pass Federal Reserve stress tests in previous years, Bank of America is once more in the clear to increase its dividend and share buybacks, as its higher profits are generating bigger capital surpluses
- Bank of America is one of two US megabanks (the other is Citigroup) that has the potential to further raise its dividend. This is good news for the share price as the stock becomes more attractive for income oriented investors
- Bank of America recently increased its quarterly dividend by 50% (only the second dividend hike since the financial crisis) and additional dividend hikes are likely in due course. Quarterly dividend over time:
  - 2009 – June 2014: $0.01 per share
  - Sep 2014 – June 2016: $0.05 per share (average dividend yield of 1.2%)
  - As from August 2016: $0.075 per share (current dividend yield of 2.0%)
- Bank of America also got Federal Reserve clearance in June 2016 to increase its authorised annual share buybacks from $4bn to $5bn. Higher buybacks have contributed towards reducing the bank's share price volatility in recent months
- Analysts expect additional dividend hikes and higher annual share buybacks by the bank in the next 2 years (to catch up with other US banks) which further strengthens the case for buying the stock. Currently the average dividend yield for the big US banks is 2.5%

European banks value stock – BNP Paribas

- European banks have been completely out of favour in the last 12 months; major concerns about hidden non-performing loans and additional capital requirements, exacerbated by almost zero growth in the Eurozone and Brexit implications
- Eurozone banks index down 42% since July 2015 peak with current relative Price/Book ratio of the index at its lowest ever; most Eurozone banks are plagued by low profitability due to negative interest rates and high non-performing loans
- BNP Paribas stands out amongst the crowd:
  - Most profitable bank in the Eurozone; annual profit of €6.7bn in 2015 and €3.8bn in H12016 (€7.6bn annualised)
  - Largest bank in the Eurozone by market cap (jointly with Spain's Santander) due to share price outperformance vs its weaker peers
  - A well managed and relatively conservative bank with very diversified businesses
  - Very low non-performing loans (<2%) compared to Eurozone banks average (>5%, with peripheral Eurozone banks NPLs at >10%)
  - Voted by Euromoney as the "World's best bank for 2016"
  - Very attractive valuation; current P/E of 8.5, Price/ Book ratio of 0.64 and Price/Tangible Book ratio of 0.75; much cheaper than comparable US banks
  - Pays consistently high dividends; current dividend yield of 5.1%
- Share price upside based on following assumptions:
  - Assuming P/E reverts to that of comparable US megabanks (currently at 11): **+30%**
  - Assuming Price/Tangible Book ratio reverts to 1.0 (still below historic average): **+33%**
  - Assuming price reverts to average analysts' price target of €55: **+21%**

Why BNP is a very profitable franchise

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- A diversified business model, both in terms of businesses and geographies, insulates the bank from relative weakness in core Eurozone markets; it has presence (via banking licenses) in 75 countries
- Very solid and profitable businesses in retail banking, consumer finance, corporate & institutional banking, private banking, wealth management and insurance
- Highly profitable retail banking franchises in France, Belgium, Italy (BNL), Turkey (via a joint venture with TEB Group) and the US (BankWest)
- Corporate & Institutional Banking unit has a global presence, including Asia, and is particularly strong in fixed income products and securities services (multiple awards received every year)
- Unlike the two big Spanish banks (Santander and BBVA), BNP Paribas has no major presence in struggling Latin American economies and since 2011 has exited from weak Eurozone countries such as Greece
- Even its Italian banking subsidiary, BNL, is highly profitable with reported NPLs well below the average for Italian banks
- Despite very strong performance and financial metrics, BNP Paribas remains undervalued due to the general negative sentiment towards European banks and the Eurozone

BNP PARIBAS

Why Euromoney named BNP Paribas as "World's best bank for 2016"

- From Euromoney: "At a time when most European banks seem incapable of satisfying any of the three external groups to which they are answerable – customers, shareholders and regulators – BNP Paribas stands out for doing a good job for each of them"
- 10.1% return on tangible common equity in 2015, far better than its European peer group and better than some of the large and highly profitable US banks
- It has consistently maintained a 45% dividend payout ratio
- Core tier 1 ratio up to 11% in 2015 (from 10% in 2014) and leverage ratio up to 4.0% (from 3.4%)
- Very strong presence in the fast growing international cash management business; when RBS decided to withdraw from this business in 2015 it proposed to its customers to switch to BNP Paribas
- Winning new customers in retail banking in Europe with an impressive digital offering called "Hello bank!". Already derives 9% of all individual client revenues from Hello Bank! at a time when all banks are grappling with their digital strategies
- Its highly profitable US subsidiary, BankWest, is one of the top 30 US banks and shares the BNP Paribas culture of digital innovation; it launched the first snap-to-pay feature in the US last year, enabling payment of bills via a mobile banking app and the capture of essential bill information using customers smartphone cameras

BNP PARIBAS