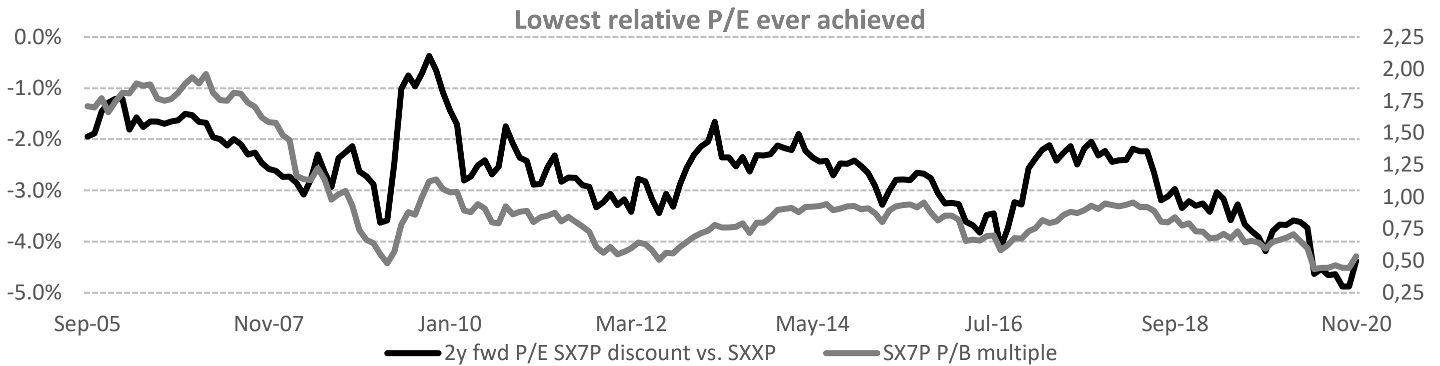
AXIOM
ALTERNATIVE INVESTMENTS

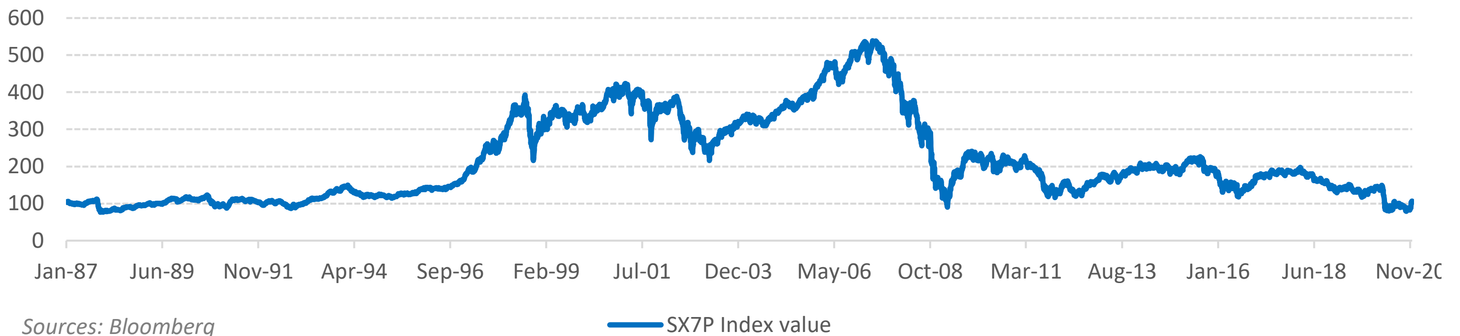
AXIOM AI - Should we return to Bank stocks?

Solid fundamentals despite low valuations

The banks' excellent results in the third quarter surprised the market and analysts’ consensus. Profits exceeded expectations by more than 30% on average, and capital ratios reached record highs. However, it was not until the figures on vaccine efficacy were released that the market began to show renewed confidence in the sector**. Despite the strength of the recent rally, current valuations remain excessively low.** Banks are trading at a price-to-earnings ratio of 8.2x as at 2022, which represents a 43% decrease compared to 14.6x for the STOXX 600 (graph 1).
Banks remain, together with insurers, the cheapest sector relative to consensus.

1 : The cheapest sector to date





Sources: Bloomberg

We believe that **the dichotomy between valuations and fundamentals sets the sector for strong outperformance potential over the coming year.**
The current discount can be explained mainly by three factors:

- The effects of monetary policy, which have so far been detrimental to profitability for banks
- The regulators' decision to ban dividend distributions
- Fears related to the Covid provisions

and lastly, the financial sector is benefiting from a positive consolidation dynamic.
We detail below the expected catalysts on these four subjects which should, in our opinion, contribute to a strong recovery of the sector in the short to medium term.

1 The new measures expected from the ECB in December 2020 should improve banks' profitability.

The ECB stated that new stimulus measures would be announced on the 10th of December and that any new package should help European banks given their central role in financing the real economy.

Acknowledging that further rate cuts would be ineffective, the ECB expressed its preference for measures, such as TLTRO, boosting credit transmission without weakening the financial system. The current TLTRO III programme, which under certain conditions allows banks to borrow from the central bank at -1%, expires in June 2021. We expect that it

will be extended, on more favourable terms allowing more banks to participate by soliciting larger volumes or even paying a lower rate.

The tiering allows banks to place their deposits with the central bank at 0% up to a certain threshold (6 times the required reserves) and thus mitigate the impact of negative rates. Above this threshold, the rate of -0.5% applies. In view of the strong growth in savings this year, we expect the ECB to raise this threshold, potentially above 8 times the required reserves.

A favourable new stimulus plan could give a new boost to the current rally and generate a 3% to 8% revision of Eurozone banks' earnings expectations for 2022.

2 The lifting of the ban on dividends and share buybacks (expected in Q1 2021) offers prospects for returns that we consider very attractive.

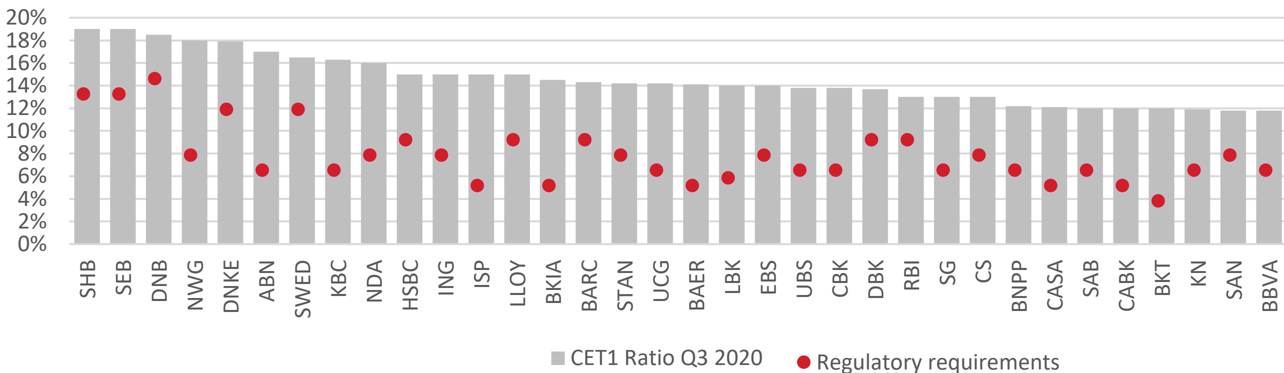
Bank stocks suffered badly from the general ban on dividend payments in March this year. The main reason for this measure taken by the ECB was to strengthen the capacity of banks to finance the real economy during the crisis. The ban on paying dividends for the 2019 financial year has resulted in a sharp increase in capital ratios (40bps). Total capital in excess of regulatory requirements now represents around 40% of banks' capitalisation (Graph 2).

The ECB is expected to decide in December on the lifting of this ban. We believe that the positive news on the roll-out of COVID vaccines will continue to argue for a cautious return to dividend distributions in 2021.

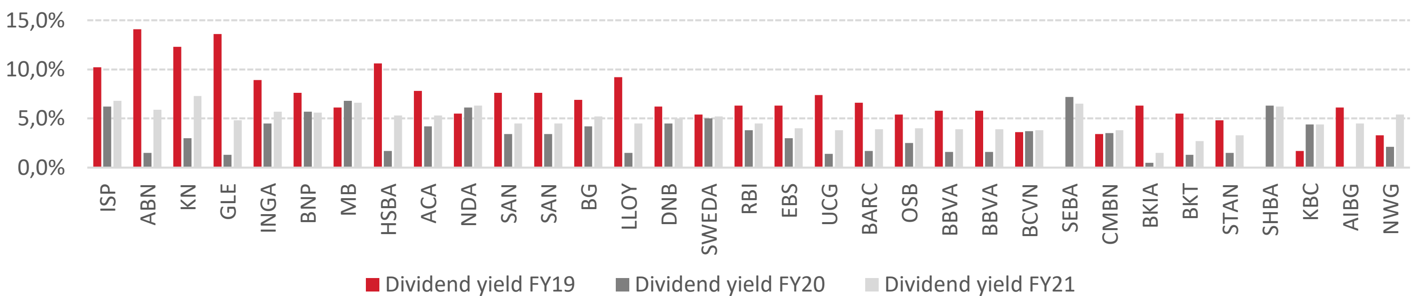
We expect the ECB to follow the Bank of England in announcing a possible return on a case-by-case basis, depending on the strength of each bank.

This announcement should be crucial for the recovery of the sector. Assuming banks catch up with the dividends related to the 2019 financial year, returns for many banks could be in double digits (Graph 3), without taking into account likely share buybacks.

2 : European banks have capital surpluses



3 : Very attractive yield forecasts



Source : Bloomberg November 2020

3 The downward revision of losses on bank loans in 2021 should reassure investors

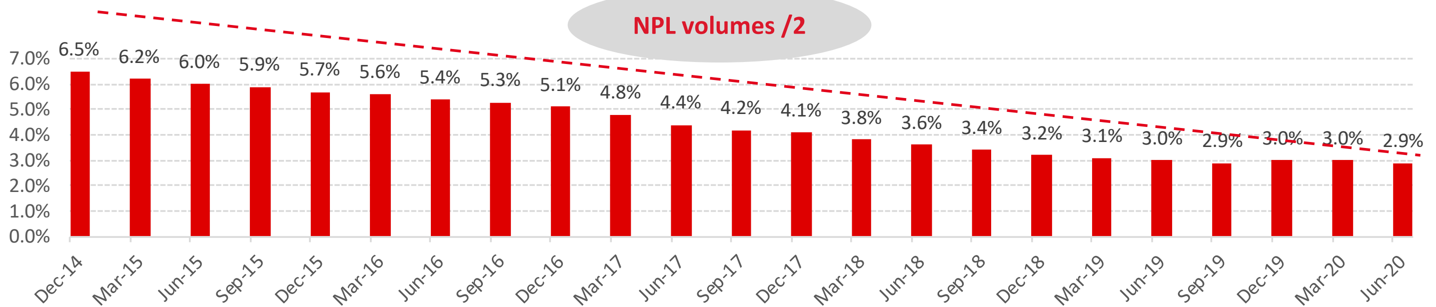
This crisis displays surprising features: only a few well-identified sectors are severely affected, employment and businesses are being preserved by exceptional fiscal policies on a massive scale, property prices are rising in most European countries, and household and business savings are reaching record levels. For the banking sector, this has resulted in stable default rates and non-performing loans' ratios (Chart 4).

The doubling of provisions taken by banks this year is therefore more a reflection of the prudence imposed by the new IFRS 9 accounting framework, namely the requirement for banks to immediately recognise losses on future defaults predicted by their model.

While the existence of payment moratoria continues to hide some of the problems encountered by companies, the extremely granular data published by the banks provides some visibility on the year 2021. It seems to us that the analysts' consensus is excessively cautious on credit losses since it forecasts 2021 provisions equal to 70% of the provisions made in 2020, when the economic situation will undoubtedly improve. Moreover, the default rates observed on loans coming out of moratorium are extremely low so far. Finally, 85% of the moratoria are expected to expire by the end of 2021 (Graph 5), so analysts should quickly revise down-their expectations of losses related to defaults on bad loans.

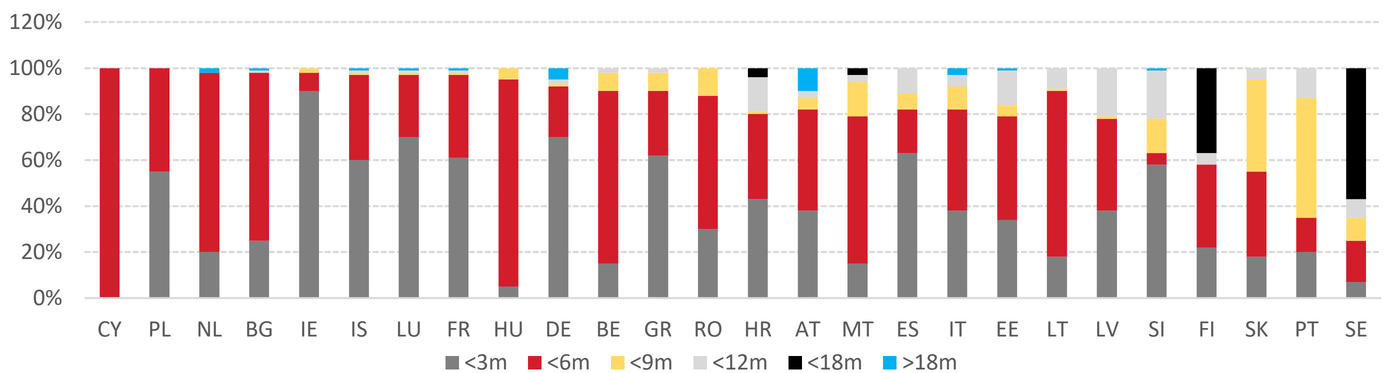
4 : NPL ratios have remained stable on average since 2018

Evolution of non-performing loans ratio (NPLs)



Sources: BCE June 2020

5 : Most moratoriums are expected to expire by the end of 2021 providing better visibility to analysts



Sources: BCE

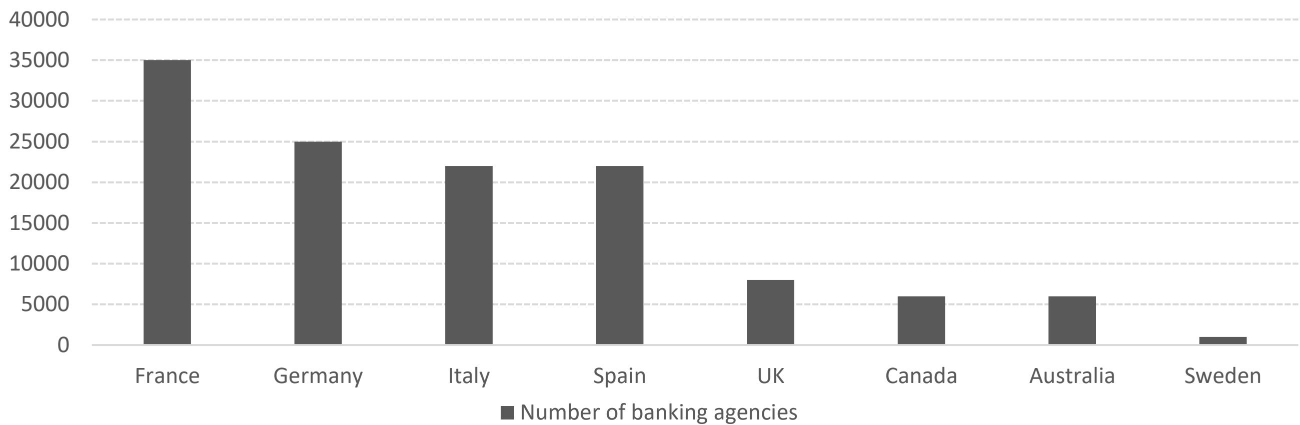
4 Continued consolidation and cost reductions in 2021 should boost the sector and provide further upside potential.

During lockdown, bank customers, and banks themselves, were able to see the advantages of online banking. We believe the crisis will favour the digital strategy and cost reduction. Some banks have even announced that they won't reopen branches that were closed during lockdown. This should help improve the sector's cost/income ratio, which remains high in some countries. For example, there are 60 branches per 100,000 inhabitants in France, 50 in Spain and 40 in Italy, compared with 15 in the United Kingdom, Sweden and Norway (graph 6).

2020 has also been a rich year for M&A in the banking sector. Targets are cheaper, capital is abundant and difficult to distribute: all reasons to engage in synergy-generating operations. Bankia-Caixa Bank, Intesa-UBI, Credit Agricole - Credito Valtellinese, but also Unicaja-Liberbank... The list of potential future candidates is long. The optimism of managers regarding the value in the sector contrasts with that of investors who still perceive the sector as "non-investable". This consolidation trend reflects the regulator's determination to see cross-border mergers (the ECB allows the use of "badwill" to cancel the impact on the consolidated CET1 of an acquisition at a price below book value), as well as the massive potential for synergies in the least efficient markets.

We believe that further cost reductions, whether organic or through M&A, will strengthen banks' operating profitability, particularly in the most segmented markets.

6 : Digitalisation should intensify in the most fragmented markets



Sources: BCE, Eurostat, different central banks

Presentation of the Axiom Equity fund: A concentrated portfolio reflecting strong convictions

Axiom Equity* is a thematic fund invested in European financial stocks. Its objective is to outperform the Stoxx Europe 600 Banks Net Return index over a 5 years minimum investment horizon.

The investment universe of the fund covers approximately 105 stocks included in the three main European financial indices: the banking index (SX7P), the insurance index (SXIR) and the financial services index (SXFR). Opportunistically, the fund can also be positioned in smaller European financial institutions offering an attractive risk/return profile.

Instrument selection is based on fundamental analysis covering the main risks of the sector: Solvency, liquidity, management quality, credit risk, sovereign risk, etc.
This analysis is based on:

- internal tools for stress testing and analysing the credit quality of issuers
- an in-depth analysis of banking regulations
- stock market valuation of companies: Stock market ratios, peers' analysis, consensus analysis

The fund's investment case:

- A concentrated portfolio (between 20 and 30 securities) with a significant bias on banks' stocks (allocation between 70% and 100%), core expertise of Axiom.
- A research and management team dedicated to financial securities with a unique knowledge of banking regulations
- Strong opinions from the management team that can lead to significant weighting deviations from the benchmark
- Off-index opportunities under researched by analysts

Axiom Equity is now positioned to take advantage of the catalysts described above:

- on the banks that will benefit the most from the lifting of the dividend ban (e.g.: ABN, Banca IFIS, Bawag)
- on banks that have a conservative internal models and whose consensus poorly reflects the outlook on credit losses (e.g.: AIB, KBC, Spanish banks)
- on banks that are potential candidates for consolidation (Ex: Sabadell, Société Générale)

** Regarding the Axiom Equity fund, we have decided to change its name so that it is more in line with its investment policy and strategy. Axiom Equity becomes Axiom European Banks Equity, change which will be effective during the month of December.*

7 : Few examples

Allied Irish Banks

- **Capital frontloading:** management is choosing to book TRIM impact in 2020. Irish Banks have much more punitive capital models due to GFC shock still included in calibration
- **Provisions frontloading:** 1H20 losses were >40% of the 3Y cumulative EBA 2018 stress loss for AIB (vs. 15%-20% for other European large banks)
- Revenues not as bad as feared, with management guidance seen as conservative. Did not include TLTRO impact.
- **In short:** we bet better asset quality than expected will lead to strong EPS recovery in 2021 & 2022 and want to take advantage of depressed valuations

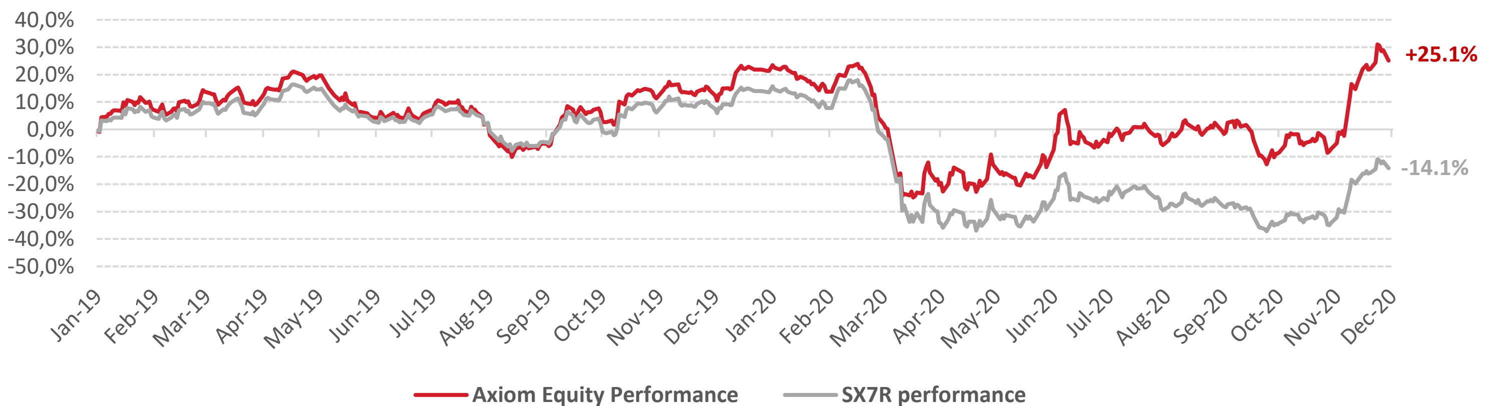
ASR

- **News flow on the S-II review** (which was overly negative for life insurers with long liabilities due to Ultimate Forward Rate reform) turning as political considerations trump regulatory pressures
- **Capital generation** – the key "cash flow like" metric investors are focused on – should start to drift upward once UFR effect is fading
- Valuations are not demanding at 0,9 P/B vs. historical RoE in the 10%-15% range
- **Advice by Dutch Central Bank not to pay dividends withdrawn**
- Further possible involvements in the **Dutch life insurance consolidation movement** (with Athora looking to complete in-force transactions)

Source: Bloomberg November 2020

Axiom Equity: outperformance of 39% compared to its benchmark

Performance versus benchmark since January 2019**



*** Please note that since January 2019, the fund's investment process is based solely on a fundamental approach as opposed to a management including an algorithmic approach as previously.*

Source: Bloomberg

[1] Data to the 30th of November 2020

Main risks

Equity risk
Due to its investment objective, this Fund is exposed to equity risk. Therefore, its value may decrease when the equity market declines, especially when prices of financial stocks decrease.

Liquidity risk
Liquidity risk exists when particular investments are difficult to purchase or sell. This can reduce the Fund's returns because the Fund may be unable to transact at advantageous times or prices. This can be the result of shocks of unprecedented intensity and severity such as but not limited to pandemics and natural disasters.

Risk related to the use of financial futures instruments (IFT) - As the Fund, may invest in derivatives, the net asset value may fall more significantly than the markets and financial instruments underlying these products. The occurrence of this risk may lead to a reduction in the net asset value of the Fund.

Glossary

1. **CET1** - (Common Equity Tier 1) **-**Under Basel 3, Common Equity Tier 1 is the strongest form of regulatory capital, comprising mainly share capital and retained earnings with some deductions as compared to accounting capital (such as deferred tax assets). The CET1 ratio is the ratio of CET1 capital to risk weighted assets.

2. **TLTRO3** - Targeted longer-term refinancing operations » : TLTROs are targeted long-term refinancing operations granted to banks by the European Central Bank.

3. **NPLs** - (Non-performing loan) A NPL is an exposure of which it is likely that the counterparty will not reimburse all or part of the outstanding that has been made available to it. However, for reporting purposes, the EBA defined the concept of Non-Performing Exposures (NPE), which was subsequently adopted by the ECB. NPEs are exposures that meet at least one of the following two criteria: (i) Past due: an exposure is past due when the payment delay is greater than 90 days from the first payment incident (principal, interest or unpaid fees) (ii) Unlikely to pay" (UTP): this criterion implies that the debtor is considered to be very reluctant to pay all of his credit obligations, regardless of the collateral and regardless of the existence of any amount in ate payment or the number of days late.

4. **Bâle 1, 2, 3** - Under Basel 3, Common Equity Tier 1 is the strongest form of regulatory capital, comprising mainly share capital and retained earnings with some deductions as compared to accounting capital (such as deferred tax assets). The CET1 ratio is the ratio of CET1 capital to risk weighted assets.

5. **Tiering** – Tiering is a tiered rate system. The Governing Council of the European Central Bank (ECB) decided on 12/09/2019 to establish a two-tier reserve remuneration system, in which part of the liquidity surplus of credit institutions (that is, the excess of reserve assets over minimum reserves) is not subject to a negative remuneration corresponding to the rate applicable to the deposit facility. This decision aims to support the banking transmission of monetary policy, while preserving the positive contribution of negative interest rates to the accommodative orientation of monetary policy and the pursuit of sustainable inflation convergence towards the ECB's target

6. **Badwill** - Badwill is a negative difference between the acquisition value of an asset and its fair carrying value. Goodwill is more commonly used as an expression for positive deviation and goodwill, the reverse of Badwill. More concretely, this means that in the event of acquisition such as that of UCG/BAMI, the acquirer values the equity of the target in its balance sheet at book value and not at the acquisition price. This allows for lower acquisition prices to make acquisitions without damaging CET1.

Disclaimer

This document is provided for informational purposes only and reserved for professional investors and not professionals within the meaning of MiFID2.
Due to the simplified aspect of this presentation, the information contained in this document is non exhaustive and/or incomplete and therefore cannot bear any contractual value.
This document is realized for institutional investors and distribution partners. It does not constitute an offer or an advice to buy or sell any investment or specific product.
Although this document has been prepared with the greatest care from sources which Axiom AI considers trustworthy, it does not guarantee the accuracy and completeness of the information and assessments it contains, which are only indicative. Axiom AI's information and opinions are subject to change without notice.
Axiom Alternative Investments' sales teams are at your disposal to help you obtain personalized advice.