A&M Valuation Insights – German vs. European Banks

November 2022

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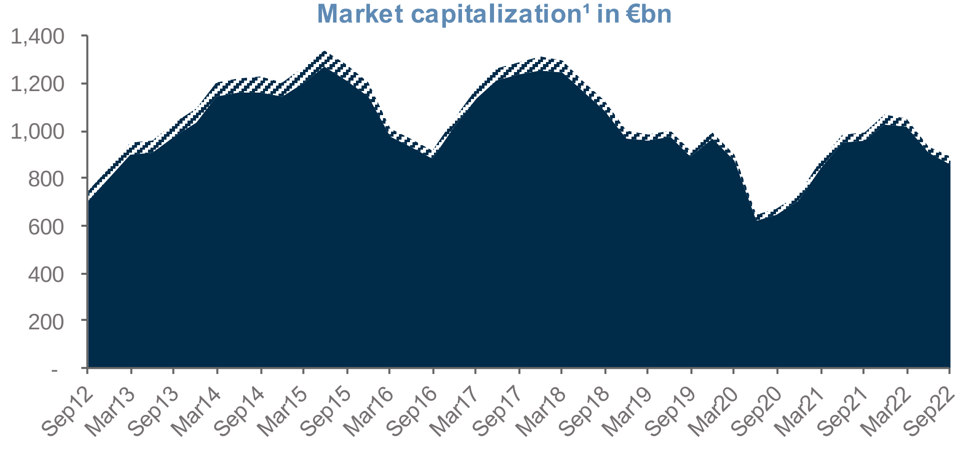
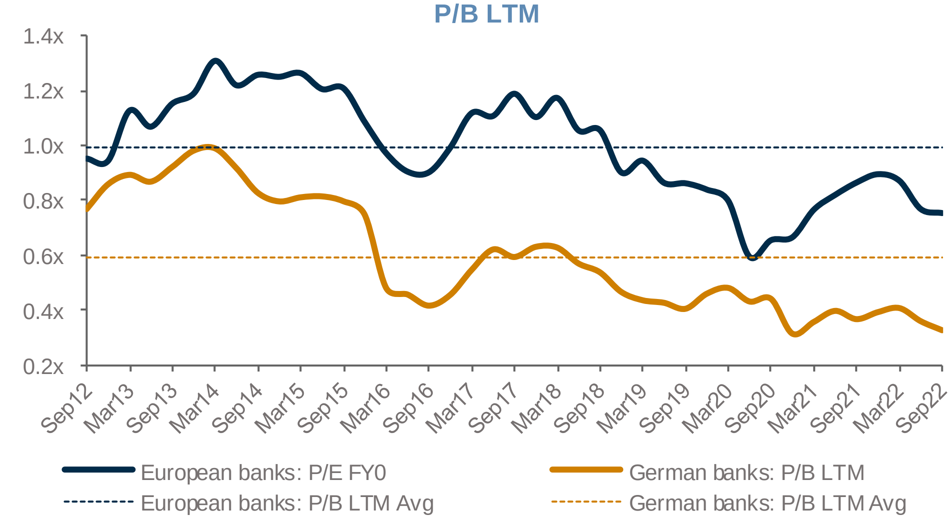
With the drop in equity prices, the expected return from investing in European banks hits a 10Y high and P/B ratios remain suppressed…

The implied cost of equity of European [German] banks reaches 14.8% [17.4%] p.a., and the P/B is at 0.76x [0.32x].



Source: S&P Capital IQ; A&M Analysis.
Note: (1) 60TD Avg.



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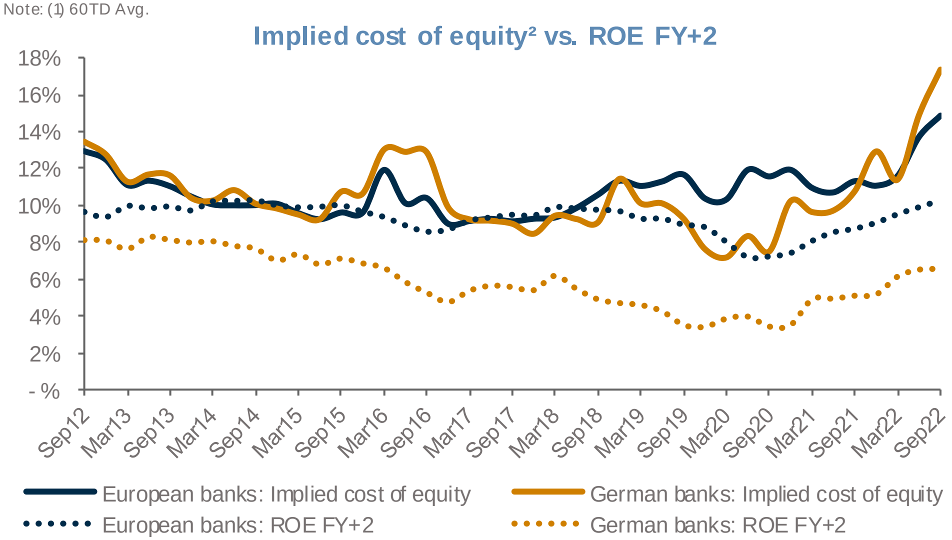


Source: S&P Capital IQ; A&M Analysis.
Note: (2) Determined by equating market cap (60TD Avg) to consensus earnings forecasts and solving for the IRR.

Takeaways

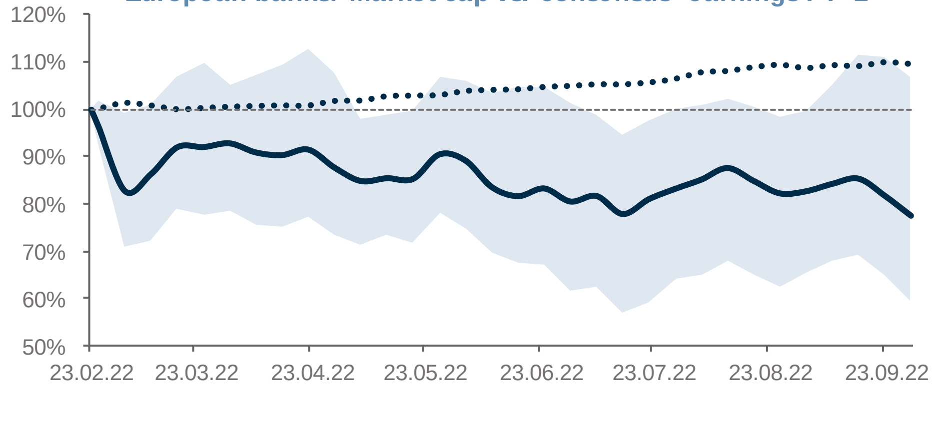
- Total market capitalization (60TD average) of European [German] banking sector fell to €890bn [€29bn] in Sep22. Overall, European [German] banks outperformed the European [German] equity market with a total shareholder return (TSR)[3] of -2.7% [-1.7%] QoQ vs. -4.3%[4] [-7.3%[5]] QoQ. German bank TSR performance was primarily driven by Commerzbank (+9.8% QoQ).
- The decline in banks' market capitalizations, coupled with a positive earnings outlook (see next page), led to record levels of the implied cost of equity of 14.8% [17.8%] p.a. for European [German] banks, widening the gap to the ROE forecast for the next fiscal year (FY+2) of 10.3% [6.5%] p.a.
- This gap is also reflected in the market cap-weighted P/B ratio for European [German] banks, which continues its downward trend and currently stands at 0.76x [0.32x], coming close to the 10Y low during the peak of the COVID-19 pandemic in 2020-21.

Notes: (3) Based on end-of-quarter spot prices and dividends;
(4) STOXX Europe 600; (5) CDAX.

…while P/E ratios fall to their 10Y low, as the earnings outlook for European banks remains positive amid economic turmoil.

P/E ratios based on next year's earnings (FY+2) of European [German] banks stand currently at 6.2x [4.8x].

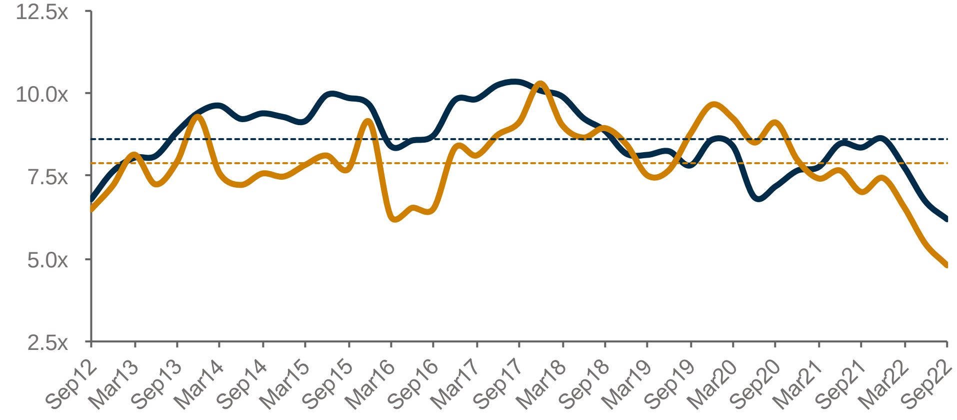
European banks: Market cap vs. consensus earnings FY+2



European banks: Market Cap Range
European banks: Market Cap
European banks: Net Income FY+2 Est.

Source: S&P Capital IQ; A&M Analysis.

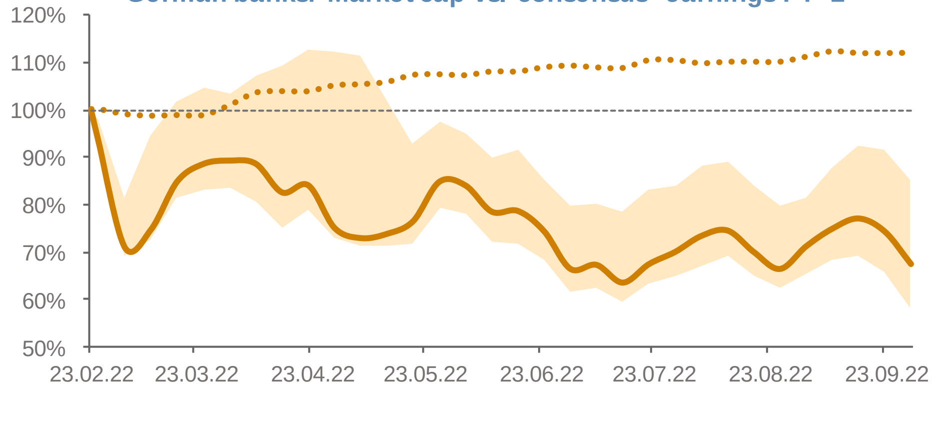
P/E FY+2



European banks: P/E FY+2
German banks: P/E FY+2
European banks: P/E FY+2 Avg
German banks: P/E FY+2 Avg

Source: S&P Capital IQ; A&M Analysis.

German banks: Market cap vs. consensus earnings FY+2



German banks: Market Cap Range
German banks: Market Cap
German banks: Net Income FY+2 Est.

Source: S&P Capital IQ; A&M Analysis.

Takeaways

- While the market capitalization of European [German] banks fell to 77.3% [67.4%] of the its pre-war level (as of 23 February 2022), consensus earnings estimates for European [German] banks have been steadily rising to 109.4% [112.2%] since the outbreak of the Russia-Ukraine war.
- As a result, the market cap-weighted P/E ratio based on next year's earnings (FY+2) of European [German] banks fell to its 10Y low of 6.2x [4.8x] in Sep22.
- Investor concerns over an economic downturn, deteriorating asset quality and a potential surge in loan losses outweigh the earnings potential from rate hikes recognized in consensus estimates.
- The heightened risk perception of investors is also shown in record levels of the implied cost of capital (see previous page).

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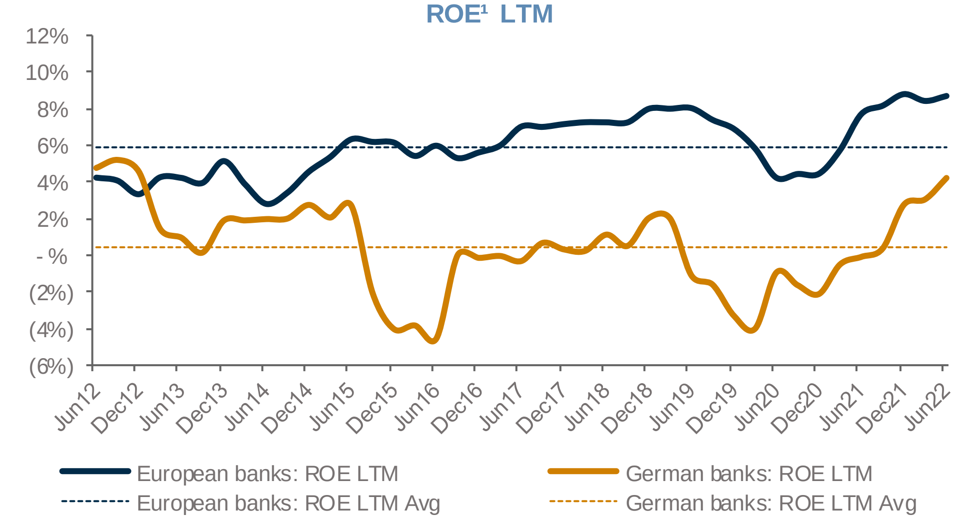
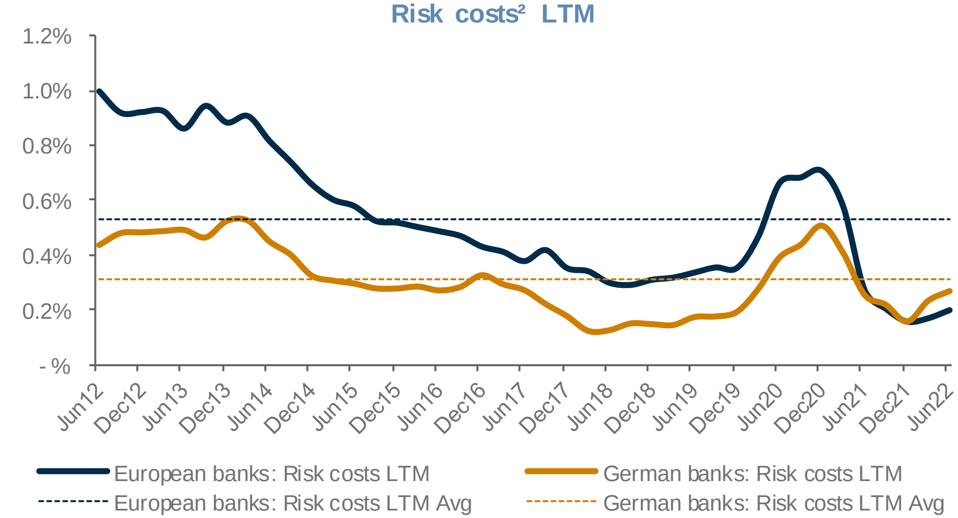
European and German banks reported near-record levels of ROE in Jun22, driven by cost savings and moderate loan losses…

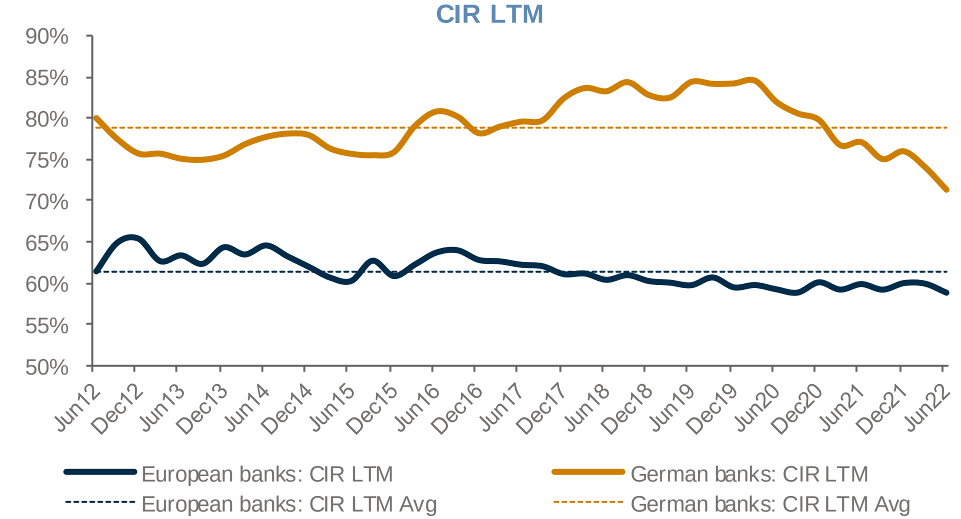
ROE for the last twelve months (LTM) increased to 8.6% [4.2%] for European [German] banks.



Source: S&P Capital IQ; A&M Analysis.
Note (1): Net income to common divided by average common shareholders' equity.



Source: S&P Capital IQ; A&M Analysis.
Note (2): Provision for credit losses in % of average loans.



Source: S&P Capital IQ; A&M Analysis.

Takeaways

- European [German] banks reported a market cap-weighted ROE for the last twelve months (LTM) of 8.6% [4.2%] in Jun22, withstanding the challenging economic environment. German banks' ROE was up 1.2%-points vs. Mar22 and 4.3%-points vs. Jun21.
- The higher ROE figure of German banks is largely due to successful cost reductions at Deutsche Bank and Commerzbank, which translates into an improved CIR of 71.2%, still way above their European peers (58.8%).
- Provisions for credit losses increased slightly to 0.20% [0.27%] for the European [German] banking sector. German banks' LTM risk costs as of Jun22 are primarily attributable to the Russian exposure of Commerzbank.
- The effects of higher interest rates are not yet fully reflected in the banks' reported ROE figures and should manifest themselves in the medium to long term.

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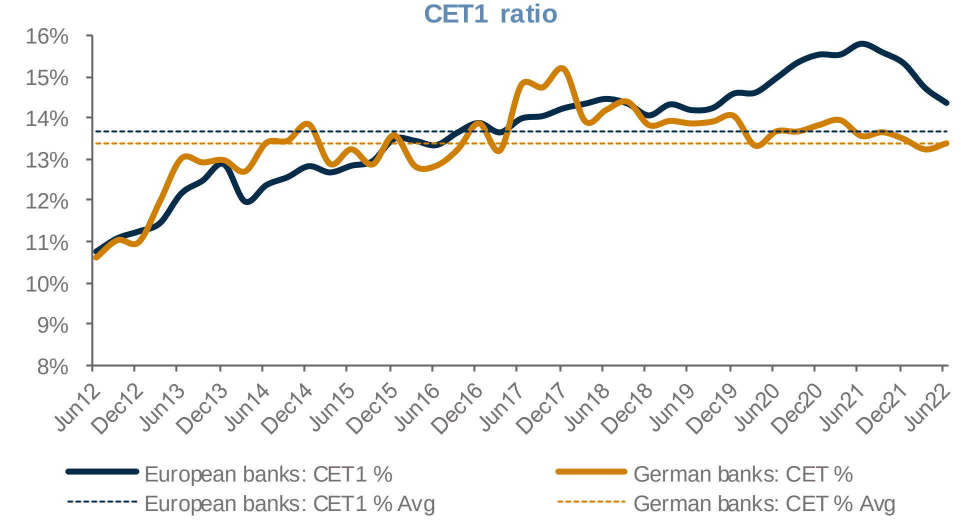
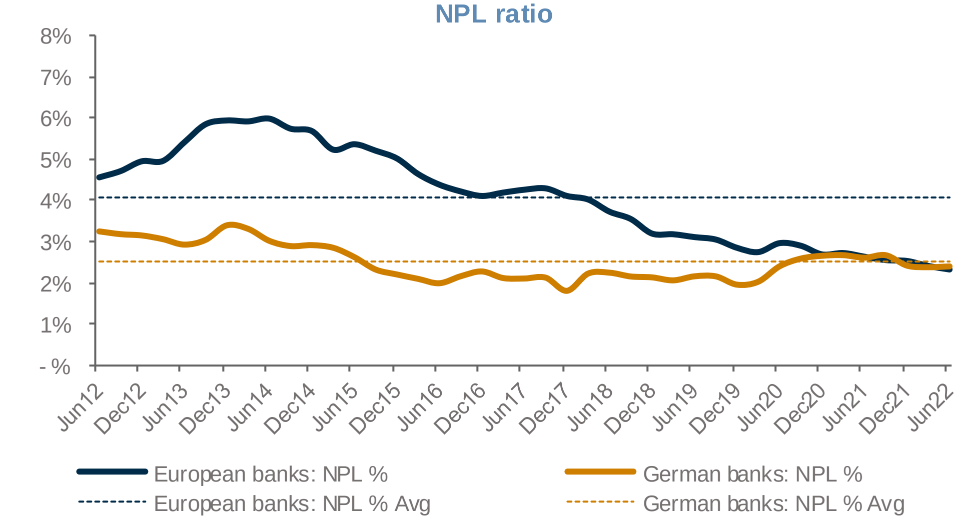
…while CET1 ratios of European banks fell significantly since Jun21, primarily driven by valuation losses in OCI¹ due to steeper yield curves.

The CET1 ratio of European [German] banks stands at 14.4% [13.4%] in Jun22, down from 15.8% [13.6%] in Jun21.



Source: S&P Capital IQ; A&M Analysis.



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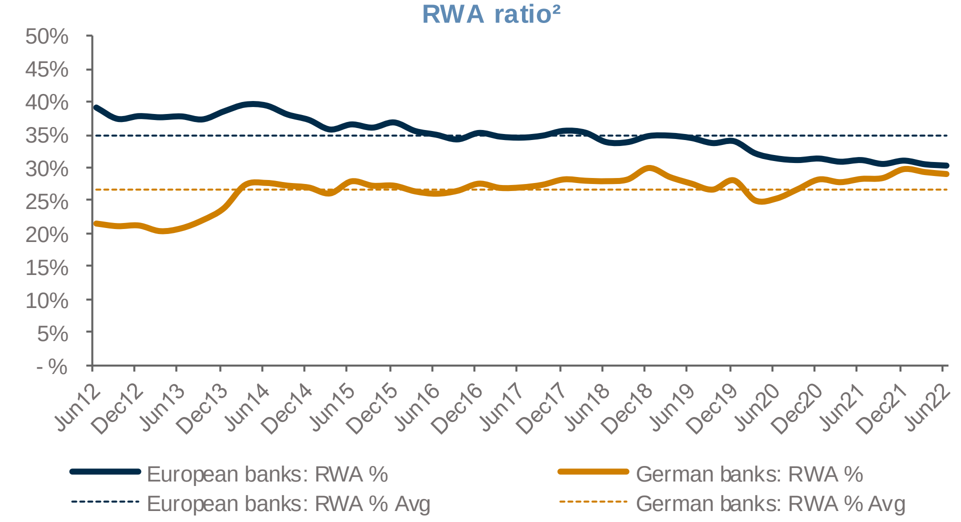

Source: S&P Capital IQ; A&M Analysis.

Note: (2) Risk-weighted asses in %of balance sheet total.

Takeaways

- The market cap-weighted CET1 ratio of European banks declined from its high of 15.8% in Jun21 to 14.4% in Jun22. This is mainly due to valuation losses in European banks' bond portfolios (recorded in other comprehensive income¹) as a result of steeper yield curves, regulatory changes (deduction of intangible software assets) and share buyback programs, primarily related to UK banks. Overall, banks' capitalization stays above regulatory and market requirements.
- The RWA ratio (risk-weighted assets in % of the balance sheet total) remained stable, as regulatory changes (IRB modelling requirements and implementation of CRR II rules) and favorable exchange rate movements had an offsetting effect.

Notes: (1) And thus not reflected in the reported ROE (see previous page).

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Study design

The study is based on all listed banks in European developed markets (as defined by S&P) with a market capitalization of ≥€100m at the end of each quarter in the Sep12-Sep22 period. To counter short-term fluctuations in market value, we use the average price from a 60-trading day (TD) period throughout the study. Further criteria have been the availability of industry-specific data and analyst forecasts for the institutions considered. All financial metrics are based on IFRS. Market constituents change over time and an institution is only considered for any given quarter if it meets the selection criteria at that point in time. All data has been sourced from the S&P Capital IQ database. As of Sep22, the dataset includes 98 banks. We performed our calculations on 10 November 2022.

Financial metrics, such as ROE, are market cap-weighted and the top/bottom 5% have been trimmed. If LTM data was not available, we referred to the last FY.

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 A&M Valuation Insights.