May 2014

Financial Institutions

Sector Review – May

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Financial Institutions Universe:

- Citigroup
- BCP
- BNP Paribas
- AIG
- HSBC

This month's detailed company review:

- Citigroup

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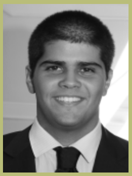

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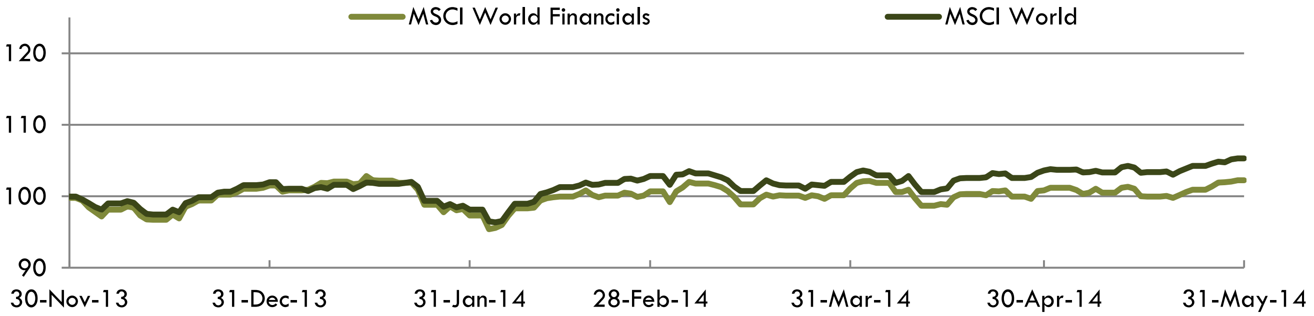
1. Sector Overview

- Data related with the availability of credit given by banks in Europe has shown that bank lending in the euro-zone is continuing to fall, making nearly two years of declines and indicating that scarcity of credit is still a drag on the area's weak economic recovery. The fact that the economic recovery of the euro-zone is being greatly undermined by the lack of credit allied to the fears of deflation, which is becoming a real threat in nearly half of the currency's countries, is probably going to lead the ECB to continue cutting interest rates. There is even the chance that the ECB pushes the rate that it pays on deposits to a value below zero so that it can encourage banks to lend. The reaction of European financial institutions and the effects of this potential cut on these institutions are still uncertain.

- According to a report published by the Chinese Academy of Social Sciences, China's vast "shadow banking" sector is now valued at 4.4 trillion USD. Although this number is moderately lower than the 4.8 trillion USD estimated by the rating agency Moody's, it is still uncomfortably high. This "unofficial" banking system encompasses a huge network of lending outside formal channels and beyond the reach of regulators. The size of the system is equivalent to approximately one fifth of the domestic banking sector's total assets, which is enough to pose a very significant systemic risk.

Financial Institutions Sector vs. Overall market



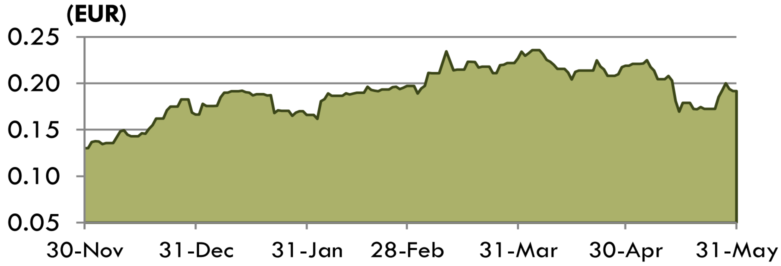
- The observed trend in April, and in 2014 in a more general sense, has continued in May with the MSCI World Financials underperforming the general market index, by almost 3 points. This may not seem like much but if we take into account the relative performance in 2013 we definitely see a widening gap. This has surprised us given our expectations in the beginning of the year that an increasing interest environment would benefit the sector. However, the trend can be easily explained if we consider the fact that the largest firms in the sector have been exposed to intense regulatory pressure, hurting their performance due to a high media exposure.

Source: Bloomberg (as of 01.06.2014)

2. Followed Companies

BCP
(Ticker: BCP PL)

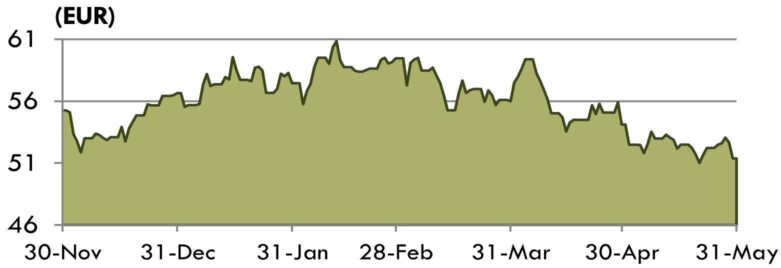
- During the month of May, Millennium BCP repaid the Portuguese state 400 million euros in loans held in so-called contingent convertible bonds (CoCos). The bank originally received 3 billion euros in the beginning of the sovereign debt crisis as one part of Lisbon's 78 billion euro bailout that ended this month. This is the first repayment that the bank has made.



Price (EUR):	0.19
Target Price (EUR):	0.22
Up/downside:	17.4%
Performance 3M:	1.4%
P/E Ratio:	n/a
ROC/WACC:	0.2x

BNP Paribas
(Ticker: BNP FP)

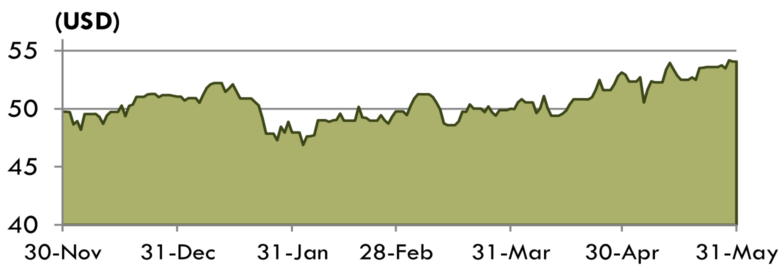
- The value of the fine that BNP Paribas may have to pay for moving funds of clients in violation of U.S. sanctions on Sudan, Iran, Cuba may be well above 5 billion USD. The bank may also face a temporary ban on transferring money into and out of the U.S.. The effect that this fine may have on the dividend paid by the bank is putting a negative pressure on its stock price.



Price (EUR):	51.37
Target Price (EUR):	63.26
Up/downside:	23.1%
Performance 3M:	-10.3%
P/E Ratio:	13.5x
ROC/WACC:	0.4x

AIG
(Ticker: AIG US)

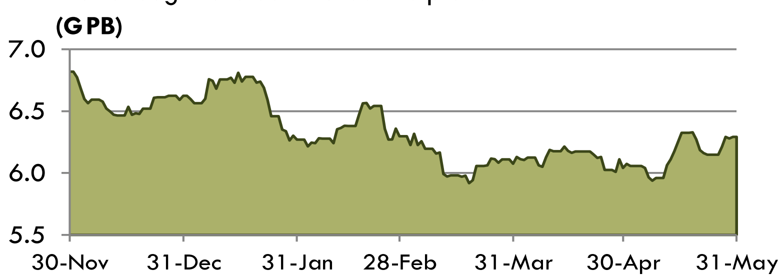
- At the end of the month Standard & Poor's Rating Services said that it revised its outlook on AIG from negative to stable. According to this rating agency, "The outlook revision reflects improved fixed-charge coverage driven by stronger operating earnings and declining financial leverage, which has reduced interest expense".



Price (USD):	54.07
Target Price (USD):	58.00
Up/downside:	7.3%
Performance 3M:	9.3%
P/E Ratio:	12.2x
ROC/WACC:	0.3x

HSBC
(Ticker: HSBA LN)

- During the month of May, HSBC's pay policy as come under fire from investors. At an annual meeting held during this month, more than a fifth of HSBC's shareholders opposed to the bank's pay policy for the next three years. Although the opposition was slightly more than 20%, this was not enough to block the bank's plans.



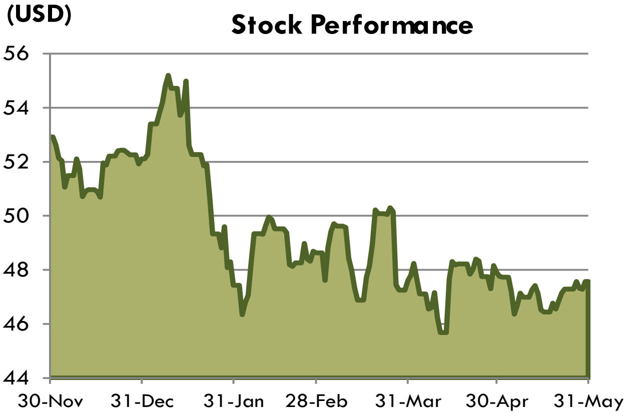
Price (GBP):	6.29
Target Price (GBP):	6.82
Up/downside:	8.4%
Performance 3M:	1.1%
P/E Ratio:	13.7x
ROC/WACC:	0.7x

Source: Bloomberg (as of 01.06.2014)

3. Stock Analysis: Citigroup

Corporate News

- At the end of the month, Chief Financial Officer John Gerspach stated that Citigroup's revenues coming from the Markets divisions of the bank were expected to decline between 20 and 25 percent in the second quarter when compared to a year earlier. According to Gerspach, the main reasons behind this negative decline are geopolitical events, uncertainty in the global economic environment and low price volatility. The low volatility which is a result of lower rates of movement in the markets has been especially harmful to bank. The trading volumes were particularly low in May, a trend that has been felt industry-wide.



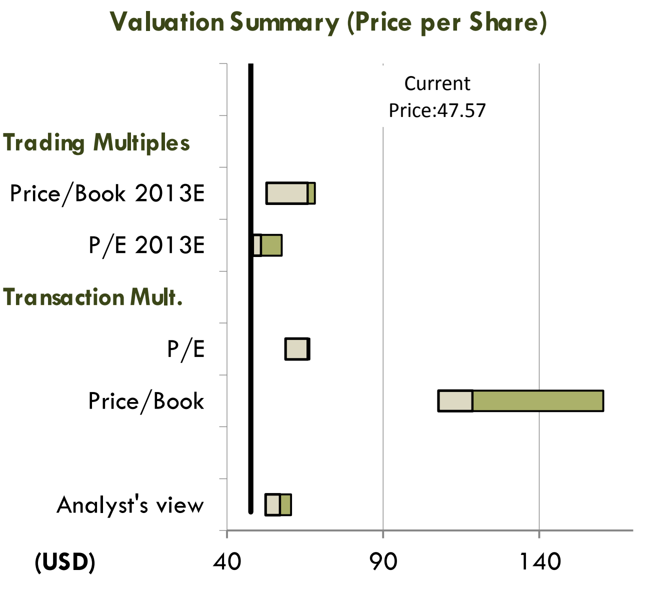
Market Performance

- Following the big price drop by the beginning of the year, from around $55 per share to near $46, a drop of about 16% in less than a month, due to weak Q1 results, low trading volumes, among other reasons, Citigroup appears to be stabilizing at $47/48, after a few months of volatility. This leads us to think that the stock has probably reached its support level, which may indicate that this would be a good time to buy.
- Despite being somewhat underwhelming, first quarter results were actually solid when compared with Q1 2013 and if we consider that Citigroup, which has very low dividend yields (0.1%), will eventually have to return capital to investors in the next few years, through buybacks or increased dividends, we expect that the stock will at some point yield a good return.

Citigroup (USD)	
Current Price (31/05/2014)	47.57
52-week high % change	-13.9%
Median Target Price	56.96
Market Capitalisation (mn)	144,508
Return on Common Equity	6.9%
Dividend Yield	0.1%
Beta (vs. S&P500)	1.7x
Total Debt/Equity	290.5%

Valuation Summary

- At $47.57 per share, Citigroup appears to be undervalued under any measure we use. The aforementioned drop in price seems to have found some resistance, which is supported by the fact that only one analyst recommends to sell (out of 34 under analysis). The median estimate for the target price is $57, similar to the maximum trading prices in the past six months, which implies a potential upside of 20% on the bank. As for the remaining metrics, only the median trading P/E multiples points to full valuation, with the P/B multiples indicating towards a significant discount, which is expected to dissipate, or at least reduce, in the next few years.



Source: Bloomberg (as of 01.06.2014)

Comparable Analysis

Company Name	Currency	MCap (mn)	Value (mn)	Price/Book LTM	Price/Book 2013E	Price/Book 2014E	ROE LTM	ROE 2013E	ROE 2014E	P/E LTM	P/E 2013E	P/E 2014E
Citigroup	USD	144,508	775,259	0.7x	0.7x	0.6x	6.9%	7.1%	7.5%	9.6x	10.1x	8.8x
HSBC	GBp	120,314	n/a	n/a	1.1x	1.0x	8.1%	9.7%	10.3%	n/a	11.3x	10.2x
J.P. Morgan	USD	210,316	n/a	1.0x	1.0x	0.9x	7.6%	10.0%	10.3%	8.8x	10.2x	9.2x
Bank of America	USD	159,207	n/a	0.7x	0.7x	0.7x	3.9%	4.8%	7.2%	10.2x	15.2x	9.8x
Goldman Sachs	USD	74,171	561,648	1.0x	1.0x	0.9x	10.5%	10.3%	10.3%	9.6x	10.2x	9.5x
Morgan Stanley	USD	60,834	466,176	1.0x	0.9x	0.9x	5.2%	7.6%	8.6%	14.4x	12.4x	10.5x
75th Percentile				1.0x	1.0x	0.9x	8.0%	10.0%	10.3%	10.2x	12.1x	10.1x
Median				**1.0x**	**0.9x**	**0.9x**	**7.3%**	**8.6%**	**9.4%**	**9.6x**	**10.7x**	**9.7x**
25th Percentile				0.7x	0.8x	0.7x	5.6%	7.2%	7.8%	9.6x	10.2x	9.3x

- Above we can see the comparable companies we considered for Citigroup, being that we chose mainly American banks and tried to focus on commercial banks with Morgan Stanley and Goldman Sachs being the exceptions. The above mentioned price drop in the beginning of the year has been very detrimental for Citigroup's relative valuation metrics. As we can see this has led Citigroup to underperform both in terms of Price/Book and P/E multiples, being that the discount in the former (25^{th} percentile) is more noticeable. Moreover, looking to ROE, another useful metric, we can see that Citigroup has a poor performance as well. Taking the more relevant peers, J.P. Morgan and Bank of America given that these are the three largest American banks with commercial and investment operations, we can see that Citigroup's resembles much more BoA than J.P. Morgan, possibly due to the recent regulatory pressures and poor financial results.

Precedent Transactions

Announced Date	Target Company	Target Country	Buyer Company	Buyer Country	EV (EUR mn)	P/E	Price/Book
05-Dec-13	Bank Gospodarki Zywnosciowej SA	PL	BNP Paribas SA	FR	1.002	22,5x	1,1x
02-Jul-13	Bank of Ayudhya	TH	Mitsubishi UFJ Financial Group	JP	4.229	14,0x	1,5x
28-Sep-12	Denizbank AS	TR	Sberbank of Russia	RU	2.836	12,4x	1,5x
02-Nov-10	Turkiye Garanti Bankasi AS	TR	BBVA SA	SP	2.690	11,0x	1,7x
09-Oct-10	Bank Zachodni WBK SA	PL	Banco Santander SA	SP	4.207	13,9x	2,3x
09-Jun-10	Grupo Financiero Santander Mexic	MX	Banco Santander SA	SP	2.078	15,3x	2,8x
75th Percentile						14,0x	2,3x
Median						**13,9x**	**1,7x**
25th Percentile						12,4x	1,5x

- The aforementioned Price/Book discount becomes fairly obvious when we look at the precedent transaction multiples. In previous reports we have talked about this same tendency of lower multiples, and we have tried to explain them using the perceived lack of trust from the markets in the sector of financial institutions, being that this stems from the several financial scandals that have afflicted these companies, and also poor results when contrasted with analyst expectations. The median P/B multiple is significantly higher than the one Citigroup currently trades for – 1.7x vs 0.7x – as well as historical multiples for the firm, while the P/E multiples seem much more sensible – 13.9x vs 10x – nevertheless still reflecting the control premium implicit in transactions.
- If we consider, or expect, that the financial sector will eventually correct despite the disappointing recent performance, then this can be a great source of value for investors. As firms, such as Citigroup, that are at the bottom range of their valuations according to fundamentals, return to expected levels of profitability and improve their transparency this discount to their book value should disappear and yield good returns.

Source: Bloomberg (as of 01.06.2014)