Europe's most exciting IPO in years is ABN AMRO

By Peter Garnry, Head of Equity Strategy at Saxo Bank

- **ABN AMRO returns to public markets after seven years of state ownership**
- **The stock looks very attractive based on IPO mid-price of €18/share**
- **Offering, with initial range of of €16-20, is expected to be priced on November 19**
- **Netherlands macroeconomic environment supportive to ABN AMRO's business**
- **ABN AMRO's financial performance is better than its European peers'**
- **At mid-price, the price-to-book ratio of 1.05x is only slightly above peers**

Headquarters of the Dutch financial group whose stock offering is the most captivating European IPO in years. Image: www.abnamro.com

ABN AMRO, the Dutch banking group founded in 1991 through a merger, is returning to public markets on November 20 after seven years of government ownership that resulted from a rescue at the height of the financial crisis.

Much water has flown under the bridge since the mayhem of 2008-2009, and it is a strong financial institution returning to public markets. We see a lot of value in ABN AMRO based on the current IPO price range of €16-20 per share.

A phoenix rises

ABN AMRO was an aggressive European financial institution leading up to the financial crisis, expanding its commercial and investment banking operations in various European markets.

In 2007 a bidding war emerged for the Dutch bank, with Barclays fighting against a consortium of RBS, Fortis and Banco Santander.

The consortium won the battle, but the acquisition and financial crisis proved too much for Fortis which went to its knees. The Dutch government had to launch a rescue operation to take over Fortis' assets in the Netherlands.

After many years of state ownership, cost restructuring, asset divestment, boosting tier-1 capital as well as navigating the European debt crisis, ABN AMRO is ready to re-enter public markets. Investors will be pleased to see the strength of the bank compared with its peers.

Amsterdam stock exchange. The Dutch government is likely to sell a 23% stake and retain control of ABN AMRO. Photo: iStock

The offering

The Dutch government is offering 188 million shares to the public in addition to an over-allotment option to the underwriters of 28.2 million shares.

The joint global coordinators and joint bookrunners are ABN AMRO, Deutsche Bank and Morgan Stanley. If the option is exercised, which we expect, the government will be selling a 23% stake in ABN AMRO and keeping a controlling majority after the sale.

The initial IPO price range is €16-20, and the offering is expected to be priced on November 19 and the stock to begin trading on November 20. Based on the mid-price, the offering is valued at €3.89 billion and the market value of the bank is €16.92 billion.

Our research into AEX shares (the leading Dutch equity index with 25 members), shows that the median daily trading volume as a percentage of free floating shares is 0.48%

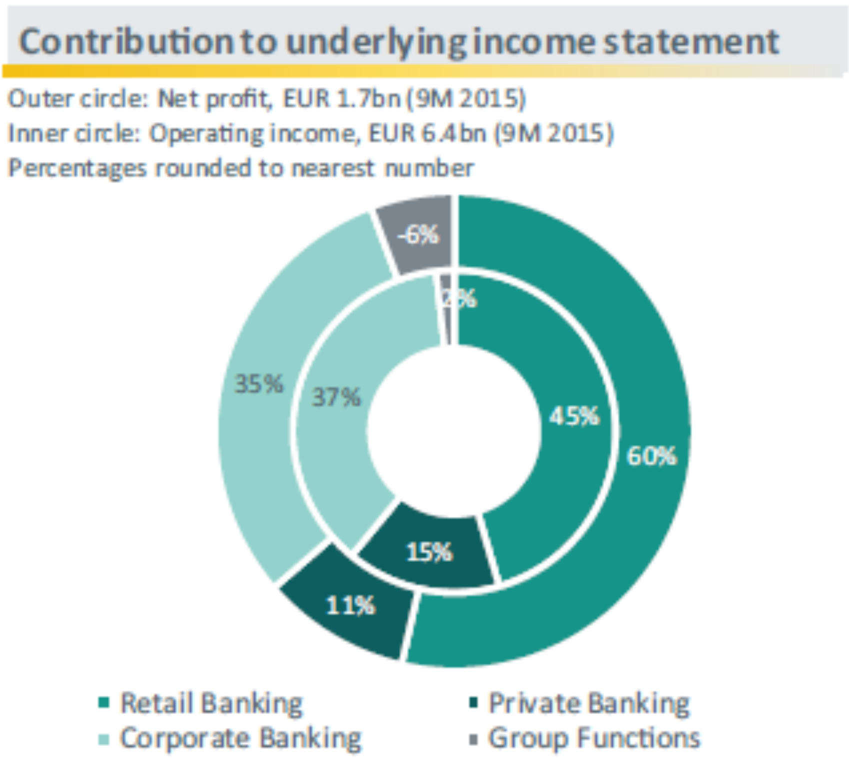
We expect the free float in ABN AMRO to be 216.2 million shares. Based on the average trading volume in AEX shares and the mid-price of €18, we project the average daily traded value in ABN AMRO shares to be around €18.7 million.

Business and strategic goals
According to the IPO prospectus, under the business section, the bank describes itself as follows:

> *The Group is a leading Dutch full service bank with a transparent and client-driven business model, a moderate risk profile, a clean balance sheet with predominantly traditional banking products, and a strong capital position and funding profile. The Group services retail, private and corporate banking clients with a primary focus on the Netherlands and with selective operations internationally. The Group holds a strong position in the Netherlands across all three market segments: Retail Banking, Private Banking and Corporate Banking. The Group believes it has a stable client base that generates recurring and resilient operating income.*

ABN AMRO has around 21% market share in the Netherlands retail banking industry and 22% among small businesses.

The chart below shows the operating income distribution (inner circle). Retail banking contributes 45% of operating income (and 60% of net profits, highlighting its high profitability), with corporate banking contributing 37%, private banking 15% and the remaining 2% from group functions.

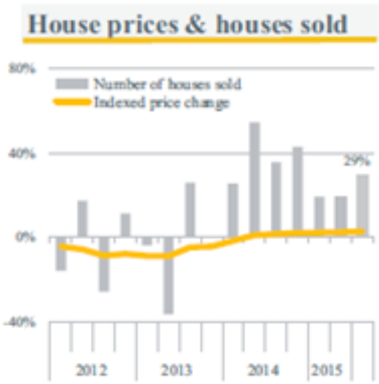


Source: ABN AMRO (IPO prospectus p. 235)

The Netherlands has performed better than most other European economies since the financial crisis, and the indicators below also show that the macroeconomic picture looks favourable going into 2016.

With a weak trade-weighted euro, fiscal policies becoming accommodative in 2016 across the continent and aggressive monetary policy from the European Central Bank, the European economy will continue to heal in 2016 providing a tailwind for the Dutch economy and for ABN AMRO's banking operations.

Quarterly on quarterly data
Source: Thomson Reuters Datastream, Statistics Netherlands



Year on year change in average price houses sold and number of houses sold
Source: Statistics Netherlands StatLine, House Price Index existing own homes

The Netherlands, seasonally adjusted confidence (end of period) Source: Statistics Netherlands StatLine, Consumer confidence economic climate and willingness to buy

Source: ABN AMRO (IPO prospectus, p. 238)

In terms of financial performance, ABN AMRO is doing better than its European peers. Operating income for the first nine months of 2015 is €6.4 billion, up 8.3% year-on-year, while operating expenses are down 6.1% y/y in addition to a 62% y/y decline in impairments. The combined effect on the bottom line has been sizable, with profit to shareholders up 125% y/y for the first nine months.

Total equity to owners is €16.1 billion as of September 30, up from €14.9 billion at the end of 2014. The improved financial results have increased the common equity tier-1 capital ratio to 14.8% in the third quarter of 2015 from 12.2% in 2013 and 10% in 2012.

Management lays out four very tangible strategic goals in the IPO prospectus:

1. Deliver a return on common equity between 10-13%
2. Cost income ratio between 56-60% by 2017
3. Common equity tier-1 capital ratio between 11.5-13.5% (fully-loaded*)
4. Annual dividend payout ratio of 50% in 2017

IPO price too good to be true?

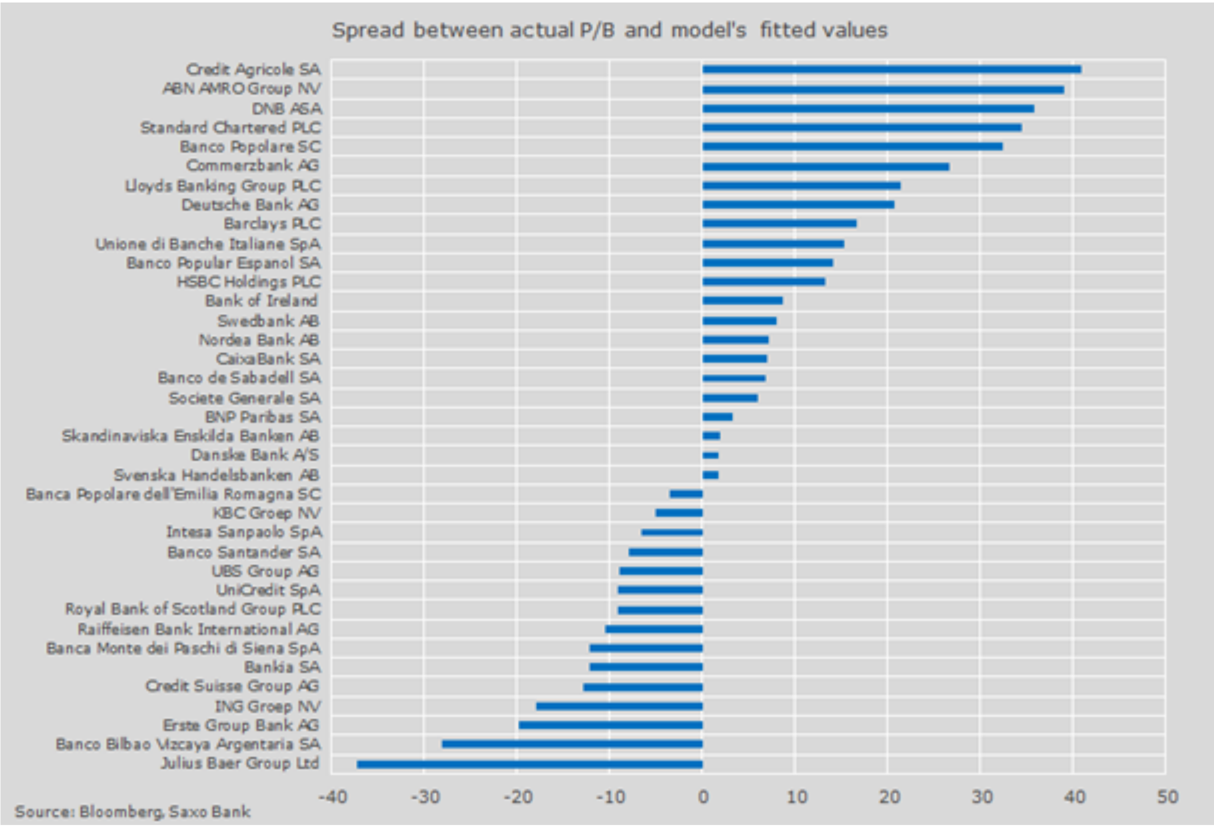
Based on the numbers in the IPO prospectus, we expect 2015 profit to shareholders to be €2.16 billion, translating into around a 13.7% return on equity (based on average equity to shareholders for 2015).

With a total of 940 million shares outstanding and total equity to shareholders of €16.1 billion, the book value per share is €17.1 as of September 30. At the IPO mid-price of €18, this translates into a current price-to-book ratio of 1.05x. In comparison, European banks trade on average at a price-to-book of around 0.96x, so ABN AMRO is listed with a valuation slightly above peers.

However, given the group's financial performance and strength of the balance sheet, the stock price should be much higher than the €18 mid-price.

There are 36 European banks in the STOXX 600 Banks Index, with more than 10 analysts covering the stock and providing CE tier-1 ratios (fully-loaded) to the market. With the two variables (2015E ROE and CE tier-1 ratio (fully-loaded) in a simple multiple linear regression, we are able to explain 78% of the observed variance in the price-to-book ratios.

If we insert ABN AMRO's numbers (13.7% expected ROE and 14.8% CE tier-1 ratio) into the regression model, the fitted price-to-book ratio is 1.46x instead of the 1.05x based on the mid-price of €18 per share. In other words, if ABN AMRO were priced correctly based on only these two variables, then the share price should be 39% higher than the current indicated mid-price (see chart below).



Only Credit Agricole is more mispriced on the upside. In fact, out of the 36 European banks in the index, only two banks, Lloyds Banking Group and KBC Groep, are expected to deliver higher ROE in 2015.

In terms of CE tier-1 capital ratio, only the Swedish banks (SEB, Nordea Bank, Swedbank and Svenska Handelsbanken) and Julius Baer have higher capitalisations than ABN AMRO, which highlights the strong quality of the bank's balance sheet.

Based on expected profit to shareholders of €2.16 billion in 2015 and a payout ratio of 50% (in 2017), then the expected dividend per share is €1.15 assuming unchanged profits. Based on the mid-price this translates into an expected dividend yield of 6.4% significantly higher than its peers in Europe.

Unless the Dutch government changes the IPO price range, it is our view that ABN AMRO is a very attractive stock, and we see good value in the stock at prices up to €25. Prices above €25 can be justified but then the expected future returns for investors are a lot less.

* *In compliance with all Basel III regulatory rules for capital*

Holland has performed better than most other European economies since the financial crisis. Photo: iStock

— Edited by John Acher

Peter Garnry is head of equity strategy at Saxo Bank