Sector focus: Prospects are bright for European financials

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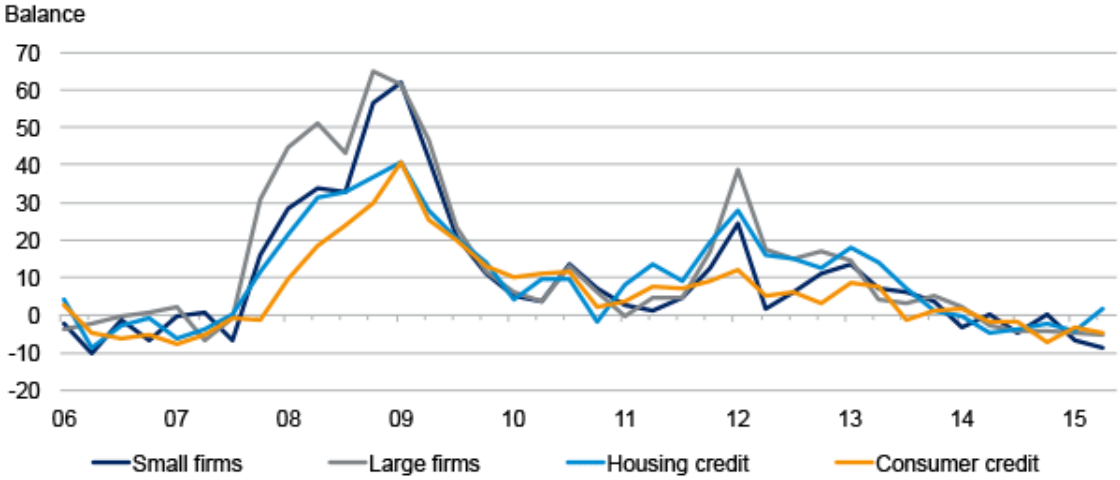
We put the spotlight on European financials and find that the current market environment remains very favourable, particularly for banks.

Monetary stimulus, improved fiscal conditions, rising bank credit growth and consumer resilience across the eurozone is driving an acceleration in earnings momentum alongside greater bank capital generation. Low equity valuations and attractive yields are highly supportive for returns. We are consequently taking a constructive view on the wider European financials sector with a preference for banks and real estate and selective exposure to insurance.

Bank lending to corporates is picking up

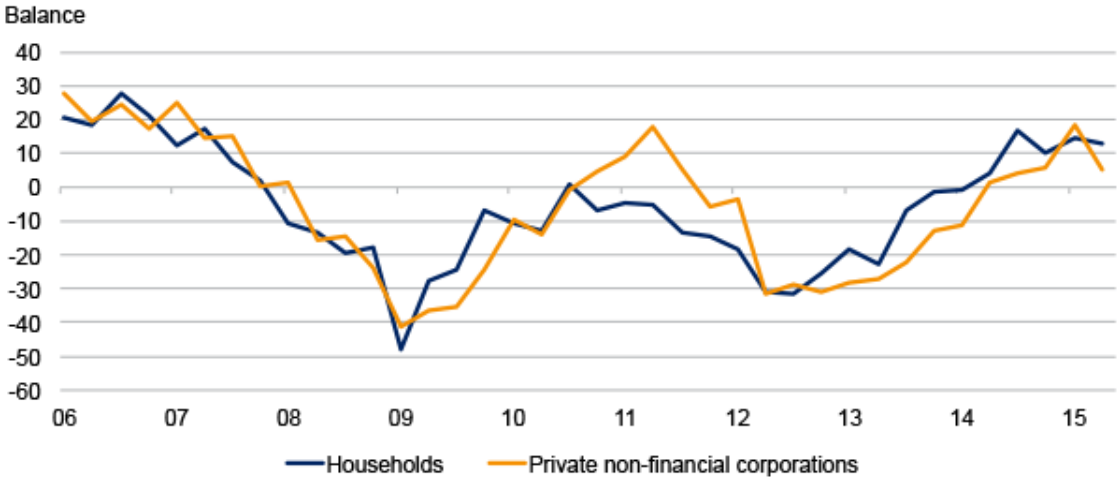
The low interest rate environment and a recovery in eurozone GDP is producing much improved corporate earnings momentum, driven by the falling oil price, associated currency tailwinds and a significant boost to consumer disposable income. Interestingly, we note a rise in banking lending to corporates which we would expect to accelerate further in the coming quarters as indicated by several credit surveys. This momentum is also driving a clear acceleration in mortgage demand, mainly thanks to refinancing with customers drawing the full benefit of lower rates. In addition to refinancing, it also seems that underlying household credit demand is picking up as lending restrictions ease.

Lending restrictions (degree of difficulty)



Source: Thomson Datastream, ECB, Schroders, as at 15 May 2015

Demand for new loans



Source: Thomson Datastream, ECB, Schroders, as at 15 May 2015

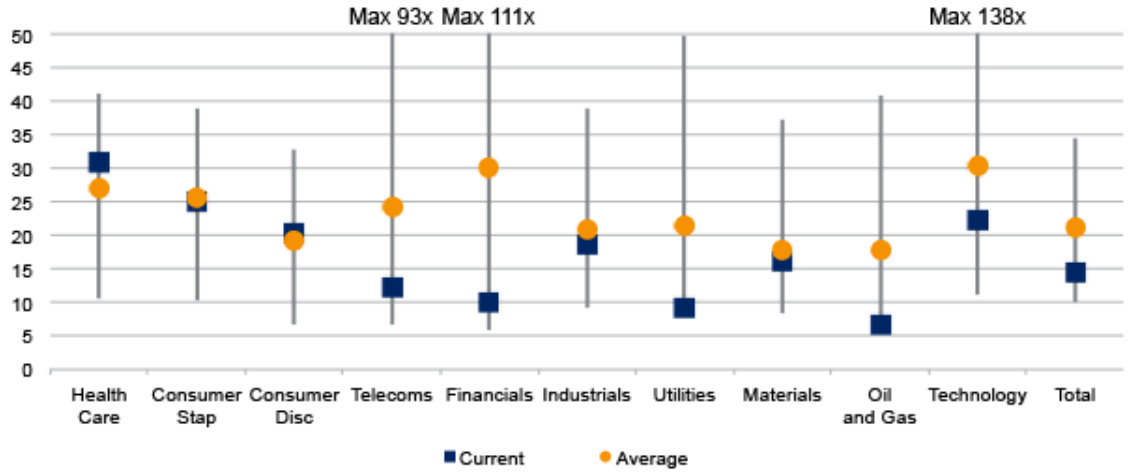
With economic output rising across the eurozone we are now witnessing healthy domestic consumer growth (the improvement is especially evident in southern Europe). Buoyant export markets, in part boosted by the weak euro/dollar, are allowing the former deficit countries in the eurozone to report clear current account surpluses, which has mitigated external funding shocks to the banking system. With regards to Greece, the sovereign exposure now resides with the International Monetary Fund and European Central Bank (ECB) which removes any direct private sector contagion, albeit the implications of any default would be severe for Greece and its banking system on its own, but largely irrelevant to the rest of the European economy. The ECB's €1.1 trillion quantitative easing (QE) programme is a very effective insurance backstop in this regard.

As bank funding costs decline, rising capital market revenues (including robust asset management flows and corporate investment banking) coupled with a peak in non-performing loan formation means bank net income is set to enjoy strong momentum. Our forecasts would indicate a return to record profits by 2017.

Valuations remain attractive

Turning our attention to valuations, it is noteworthy that European equities (and eurozone assets in particular) continue to be very attractively valued on CAPE (cyclical adjusted price to earnings) and yield metrics. In this context it is also worth highlighting that financials (banks + insurance + real estate) are currently trading at a material discount to the wider Europe ex UK market.

Europe ex UK – cyclically adjusted price to earnings (CAPE) by sector



Source: Thomson Datastream. Based on data from 31 December 1982 to 30 April 2015

Banks' dividend yields are poised to rise

We have an overweight allocation to banks within our core European portfolios. This reflects a view that whilst there are some regulatory uncertainties (for example arising as result of the ECB's drive for harmonisation of capital treatments across the eurozone, coupled with global regulatory drives to firm up on the consistency and prudence of risk weighted asset calculations) we consider that much of the sector is now more than adequately capitalised and, importantly, also strongly capital generative.

This should allow many banks to pay meaningful dividends in future. By way of example, the pan European banking sector trades on an estimated dividend yield of just over 3% for 2015, but by 2018 we expect this to rise to close to 6% (versus the market at 3%) as profitability improves and as pay-out ratios rise. Given the strong probability of a sustained low interest rate backdrop, such yields are expected to be highly supportive to share price performance. In addition, we see the macro backdrop as supportive with lending now beginning to recover and provisioning burdens falling. First quarter results have highlighted these trends and our discussions with management teams indicate that these have accelerated into the second quarter.

Whilst sustained low interest rates do present a challenge to the generation of net interest income, it is important to note that banks in Europe typically have quite well-diversified revenue streams. Indeed, on average, non-interest income accounts for over 40% of sector revenue with fee income (positively correlated with macro recovery) forming the vast majority (over two-thirds) of this.

Limiting our exposure to regulatory or revenue risk

Our bank holdings are concentrated in businesses that we see as attractively valued and not overly exposed to either further potential regulatory changes or the revenue threat posed by sustained near zero interest rates.

As an example, Intesa SanPaolo is without doubt the strongest bank in Italy with a capital position well ahead of peers (pan European as well as Italian) with strong gearing to improving credit quality, recovering credit demand and a surge in fee income (which comprises over 40% of revenues; growing at 15%). We expect continued positive consensus EPS revisions and a highly attractive dividend pay-out (by 2018 the dividend yield should exceed 7%).

Insurers face regulatory uncertainty

Regarding insurers, we maintain an underweight allocation as regulation remains significantly uncertain. The new EU capital rules for insurers, Solvency II, will be introduced from January 2016, but the final calibration of the rules remains unclear and may not be settled until late this year. Meanwhile, the shift down to very low government bond yields in the first quarter of this year appears to have made regulators cautious, particularly around capital requirements for long-term guarantees. There is much uncertainty,

therefore, and this has driven the underperformance of insurance over the last three months. We remain convinced that the major European insurers will be adequately capitalised under Solvency II, though we no longer expect a step up in dividend pay-outs across the sector once Solvency II is introduced. Nevertheless, insurance remains one of the highest dividend paying sectors, and we do expect certain stocks – such as Aegon and Sampo – to increase pay-outs over the coming years.

Low long-term government bond yields present challenges for insurers that have historically offered policyholders long-term guaranteed returns. These guarantees are common in Germany, Holland, Belgium and Norway, but are not found in France and the UK. The issue is exacerbated by Solvency II, which penalises duration mismatches between assets and liabilities. In practice an insurer that has written long-term guarantees can do very little about prolonged low long-term bond yields. Their strategy needs to be to write sufficient non-guaranteed business to generate the profits that will be needed to meet the future guaranteed payments. We are confident that major European insurers including Aegon have sufficiently profitable non-guaranteed business to be able to deal with prolonged low yields – our concerns are with more concentrated insurers, which for the most part are in the non-quoted sector.

Insurance valuations are undemanding

The European insurance sector trades at 11x estimated 2016 operating earnings, and 1.1x estimated 2015 enterprise value for a 12% prospective return on enterprise value. The estimated 2015 dividend yield for the sector is 4.6%. None of these multiples is particularly challenging, though the earnings growth trajectory is slow – we estimate just 4% annual EPS growth for the large European (ex-UK) insurers over the next four years (UK large cap insurers have higher growth).

Dutch group Aegon is one of the lowest valued European insurers on a 9x multiple of estimated 2016 earnings. Over the last several years management has been taking steps to clean up its balance sheet, which had been over-leveraged and over-exposed to interest rate risk. We believe this process is largely complete, but market confidence remains low, particularly in the wake of charges for mortality risk provisioning in 2014. Under its Transamerica brand in the US, Aegon has built a market-leading employee retirement benefits product and administration platform that is seeing strong asset inflows. We expect the market to focus more on this as confidence grows that the balance sheet issues have been addressed, allowing a re-rating.

Stocks mentioned are for illustrative purposes only and not a recommendation to buy or sell.

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