ClearBridge Investments

# Peripheral European Banks Worth a Closer Look

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The crisis in European banking has forked, with significant differences opening up between core and periphery institutions.

On one part of the fork are banks with favorable credit trends which has made fixing their balance sheets easier. Without the burden of credit losses, these institutions have responded to regulatory pressures with cost cutting plans, business restructurings and divestiture of assets. Some of these banks, such as **Barclays** and **BNP Paribas**, are at the end of this journey and have announced "post crisis" or "business as usual" strategies. Others on this same fork, such as Deutsche Bank, are still working through regulatory issues but the market is willing to give them ample amounts of capital to resolve them.

Stocks on this part of the fork, largely populated by banks in the core of Europe, have enjoyed significant stock price appreciation and most are priced for more normal stock returns. Capital levels have been rebuilt and margins improved. These post-restructuring institutions are emerging as financial utilities where the focus is on healthy and sustainable dividend payouts with low growth rates.

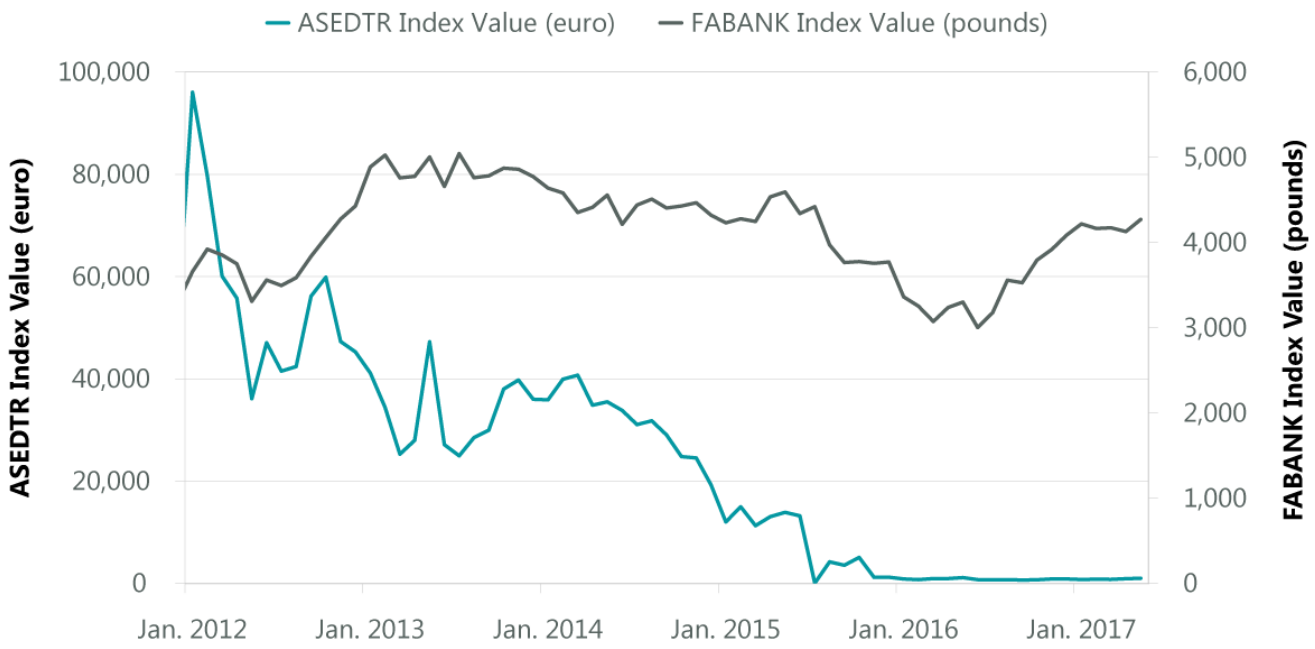
The other fork consists of peripheral institutions dealing with a very different environment due to the current credit crisis in southern Europe. The size of losses in these institutions is still a worry and stock prices are much deeper below fair value. Their plans are identical to those on the "post restructuring fork" and include cost cutting and business rationalization along with asset sales. However, piling credit losses have led to widening holes in their balance sheets. Burdened by losses, these banks have failed to show the marked improvement of their peers in core markets (Exhibit 1). Based primarily in Greece, Italy, Portugal and parts of Spain, such institutions keep filling still deepening holes. The holes will inevitably be plugged, but current risk is high and the market is not willing to embrace the upside yet.

Many of these institutions have launched two to three capital raisings over the last few years, shaking investor confidence. Lenders like Italy's Banca Monte dei Paschi are "technically bankrupt" and struggling to get coverage ratios higher without impacting solvency. They are also depleting the vast majority of their pre-provisioning profits to shore up loss provisions. With all this attendant bad news, the stock prices of peripheral banks are pricing in distress and the chance of bankruptcy. Hence, we believe the stock returns for any institution that successfully survives the crisis will be substantial. The appealing risk-reward among peripheral banks has led us to recently take a position in Italy's **UniCredit** in our international value strategies and we are looking closely at other companies expected to be survivors.

In some cases, we believe current prices do not accurately reflect an improving economic environment in peripheral Europe, which is catching up to the recovery in the core of the Continent. Loan demand, GDP growth, consumer and business sentiment, retail sales and construction spending are all recovering strongly in Spain, Italy, Portugal, Cyprus and Greece. This should allow the banks to reduce exposure to non-performing loans and replace these with solid credit assets.

Historically, alpha generation from European banks has been driven by the core. While the margin of safety is still much higher in the core, there is a strong case to incrementally increase exposure to the periphery as the survivors come into clearer focus.

Exhibit 1: Performance of Core and Peripheral Banks Has Diverged Since Financial Crisis




As of May 31, 2017. Core banks represented by UK banks in the FTSE All-Share Banks Index (FABANK), peripheral banks by FTSE Athex Banks Index (ASEDTR). Source: Bloomberg.

## About the Author

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- 23 years of investment industry experience
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