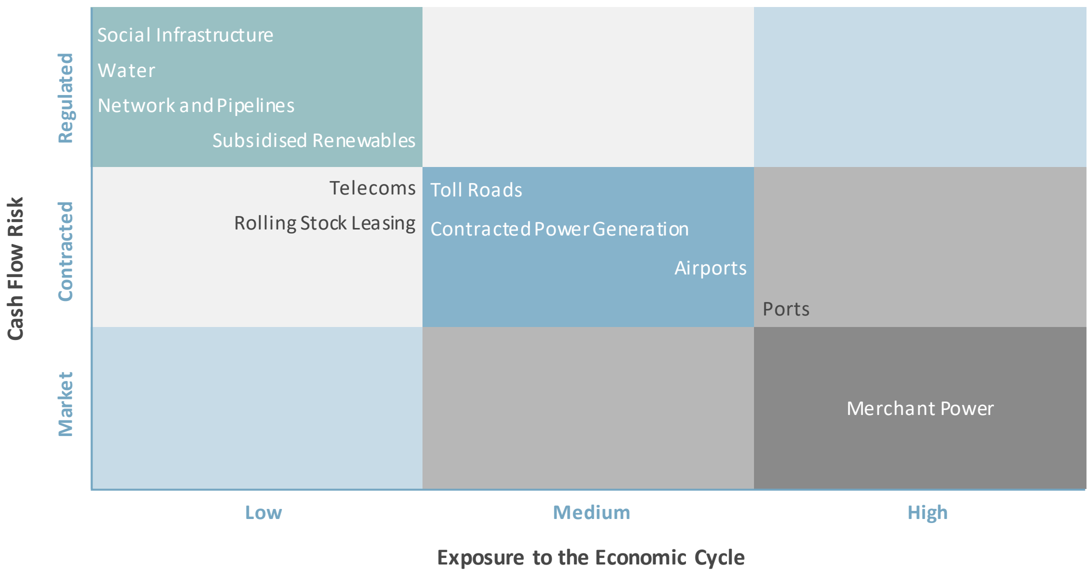
OPTIMISING RISK-ADJUSTED RETURNS FROM INVESTING IN EUROPEAN BANKS

European pension funds and insurance investors are increasingly challenged by negative rates with scarcity of low-risk investment opportunities offering long-term stable return. We think a clear investment opportunity exists at each European member country level as part of an industry-wide upgrade of the IT infrastructure and branches of European banks. Such an upgrade can even be kick-started initially and customised at individual bank level.

A split of European banks into “banking services” and separate standardised “utility banks” holding IT infrastructure and/or branches gives rise to a large investable opportunity matched to risk appetite of infrastructure and securitisation investors. This investor base is best positioned to monetise long-term annuity of low-risk cash flow with low sensitivity to the economic cycle. It would necessitate establishing relevant laws and regulations to ensure captive demand to underpin the cash flows, thus placing this opportunity set in the top left of the below matrix (i.e. least at risk). There is a clear economic case for banks to participate in such a scheme of their own volition, but national-level support ensures a quicker rollout while limiting risks to invested capital.

Figure 1: Sensitivity of Infrastructure Asset to the Economic Cycle and Cash Flow Risk



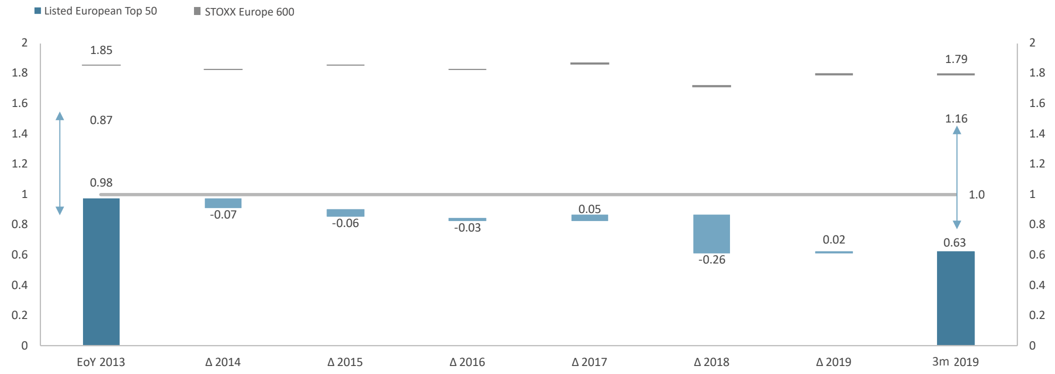
Source: Deutsche Asset Management, January 2017. For illustrative purposes only.

The accessible cost of capital for IT infrastructure and branch network reorientation could be 3%–4% or lower on capital raised, given potential annuity like characteristic of the cash flow return. In contrast, current average cost of equity capital for banks is around 9% or higher, assuming a bank is even able to tap primary capital in the current market. The significant gap in pricing and investor demand suggests that a bank might consider exploring this framework as an alternative to current IT upgrade plans. Each individual bank would need to map out and be mindful of future coordination and standardisation at industry level. The cost might be less than current envisaged IT spend plans of most banks, preserving capital for future revenue generation.

CURRENT STATE OF PLAY FOR EUROPEAN BANKS

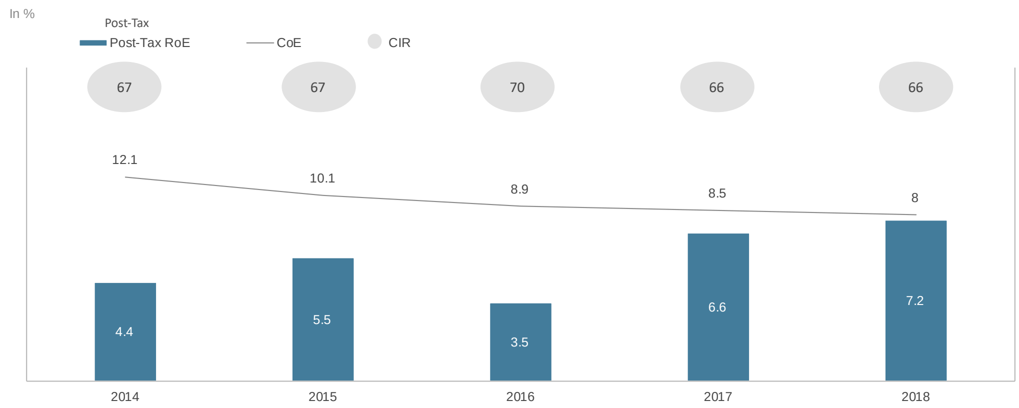
Disruption from emergent technologies is accelerating profit erosion at European incumbent banks, squeezed already by negative rates, outdated legacy IT infrastructure, and tougher regulatory requirements. Lack of confidence in future profitability is further reinforced by public markets valuation of the sector, which is trading at a significant discount to book value.

Figure 2: Price-to-Book Ratio (P/B Ratio) Development of Listed European Top 50



Source: Thomson Reuters Datastream, Zeb

Figure 3: Post-Tax Return on Equity/Cost of Equity/Cost-Income Ratio 1)



Source: Zeb and Credit Suisse

The banking sector remains a critical artery to the economic well-being of Europe, given that a large majority of companies rely on European banks for financing, thus representing a much lower proportion of credit disintermediation than in the US. Yet, European banks are caught in the vortex of rapidly shrinking profits, stubborn cost base, and a less viable business model. Cosmetic changes to improve operational efficiency will only go so far when a revolutionary "big bang" approach is desperately needed.

SOLVING THE PROFITABILITY PUZZLE

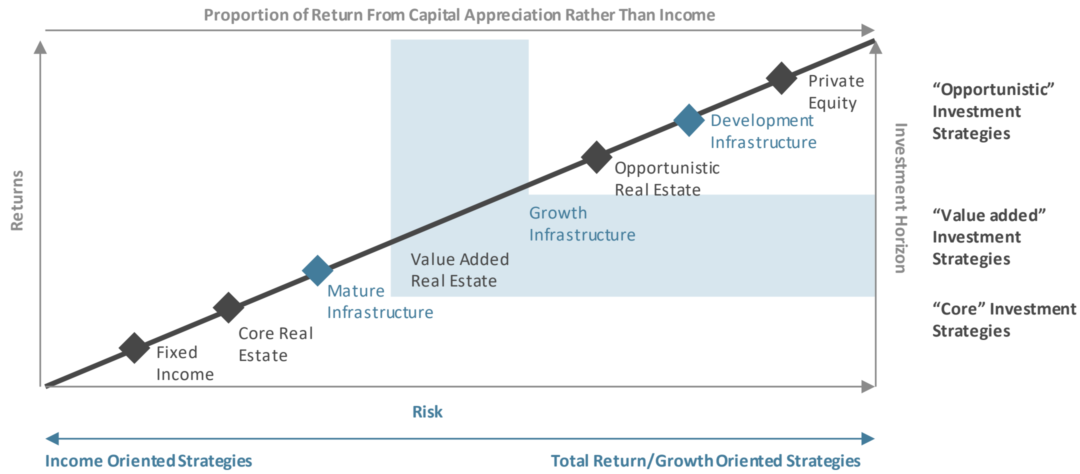
Incumbent European banks have unrecognised valuable infrastructure—namely their branch network and IT infrastructure—that has largely (not always) ensured secure processes and safe handling of confidential personal information. At present, the outdated IT systems and branches have become a millstone around their necks and an expensive cost burden, even though it provides a vital social service for a significant proportion of the European population. A recent announcement from Commerzbank in Germany to close an additional 200 of its branches continues a trend seen across Europe, with smaller towns and rural areas at greater risk of losing banking access.

"To quote the Bank of England, "Finance enables people and businesses to save, borrow, invest, transfer risks and make payments. It also helps safeguarding finances and financial identities.""

However, this very burden holds the potential to unlock intrinsic value in banks' balance sheets. To quote the Bank of England, "Finance enables people and businesses to save, borrow, invest, transfer risks and make payments. It also helps safeguarding finances and financial identities." To date, this function has been largely facilitated by incumbent banks. Thus, hiving off the banks' infrastructure could solve two congruent goals: i) It provides low-cost funds on a large scale to upgrade and safeguard a strategic industry, and ii) it addresses a topical public issue around digital sovereignty as espoused to by the incoming European Commission Head.

Firstly, on availability of low-cost funds, using the banks expertise to upgrade the infrastructure would help position such an investment opportunity close to that of a mature infrastructure category, as shown in the chart below. This could therefore be an income-oriented investment opportunity with concomitant lower cost of capital. Infrastructure funds have historically favoured investment in regulated energy and water utilities, toll roads, and other assets that deliver steady, low-risk returns over a long period of time. These funds continue to broaden their remit driven by excess liquidity and a dearth of traditional projects. The proposed investment here would be a proxy for investing in "regulated networks."

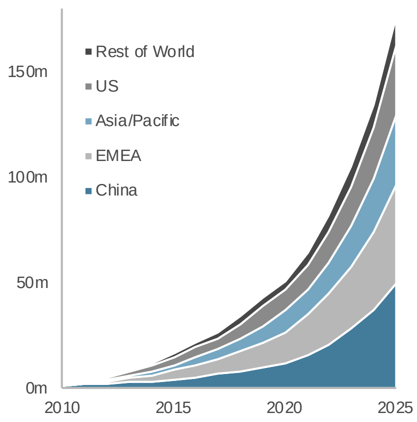
Figure 4: Risk/Return Profile of Infrastructure Investment



Source: Deutsche Asset Management, January 2017. For illustrative purposes only.

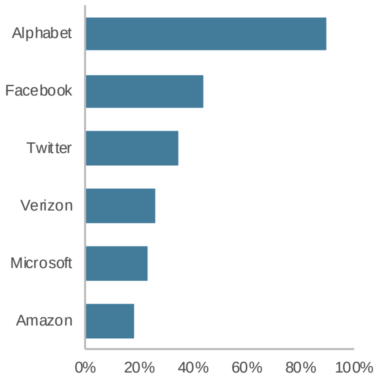
Secondly, it aids the goal of digital sovereignty. Wider sharing and use of data needs to be accompanied by improvements in security and a clearer sense of data privacy, legitimate use, and liability. Bank of England Research suggests that the unbundling of business models could result in more than 40% of financial services to be cloud hosted in a decade as data standards and protocols enable households and businesses to access better, more customised financial services and enable competition. This makes it all the more important to ensure appropriate security and operational resilience.

Figure 5: The Growth of Data Around the World



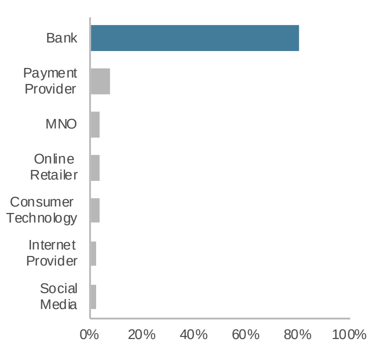
Source: IDC White Paper, November 2018

Figure 6: Data Sharing With Third Parties



Source: Reuben Binns

Figure 7: Data and Trust



Source: BCG, Capgemini

In this context, the new Franco-German initiative to strengthen Europe's data infrastructure, specifically around cloud hosting, recognises the value of data as a national and strategic asset, requiring secure data infrastructure and pipes. A centralised cloud security infrastructure involving national governments has many merits—not least the ability to manage data requests and requirements of the private sector on an anonymised basis—thus creating effective governance and safeguards on data usage by the big-tech companies and other private operators.

Systemic national banks in each country (e.g. Germany, France, Austria, and Greece to name a few) would seem most suitable entities to forge public-private partnerships. Given the strategic and security dimension, this initiative could even involve UK banks and government, regardless of the Brexit outcome. The framework would be implemented at national level with each country investing in bank IT infrastructure or buying branches at a reasonably determined long-term fair value.

Each national government could use its own resources to invest in IT infrastructure of national banks and buy bank branches as a "bridge investment," i.e. Commerzbank and Credit Agricole. Consolidation of nondifferentiated parts of a bank would also aid investment in a more aspirational technology platform not constrained by legacy technology standards. This is no different than utility power grids or telecommunications infrastructure being separate from service providers.

Public-private collaboration in this manner would target building a fresh state-of-the-art common IT infrastructure that handles both banking data (retail and wholesale) along with other nonbanking data, such as healthcare, census, and local authority related needs. It would need to be approached in a genuine partnership and consultation with banks, such that there would be a clear divide between the common utility infrastructure and the rightful proprietary data of each bank. A variant of this is already being pursued in Germany between the cooperative bank Frankfurter Volksbank and the savings bank Taunus Sparkasse, where the two rival organisations take turns using the same branch on different days of the week.

There are a number of precedents (e.g. health education and safety education campaigns) in which the public sector took a lead role in shaping the direction of society in a manner that benefits all. This concept potentially unlocks an opportunity for the European banking sector to play a leading role while safeguarding the security of its customers.

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ABOUT HOULIHAN LOKEY

Houlihan Lokey (NYSE:HLI) is a global investment bank with expertise in mergers and acquisitions, capital markets, financial restructuring, and valuation. The firm serves corporations, institutions, and governments worldwide with offices in the United States, Europe, the Middle East, and the Asia-Pacific region. Independent advice and intellectual rigor are hallmarks of the firm's commitment to client success across its advisory services. Houlihan Lokey is ranked as the No. 1 M&A advisor for all U.S. transactions, the No. 1 global restructuring advisor, and the No. 1 global M&A fairness opinion advisor over the past 20 years, according to Thomson Reuters. For more information, please visit www.HL.com.

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