# Brazilian Banks

## What does a lower Selic mean for Brazilian banks?

Equities

Americas
Banks

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**Interest rate expectations are coming down sharply**

Rate expectations in Brazil are coming down and with them a new source of potential earnings risk is emerging. Our Economics team now forecasts a 200bp fall in the Selic, from the current level of 14.25%, by the end of 2016, and another 175bp reduction in 2017 (click here). In the same manner that a rising Selic was positive for bank margins over the past three years with the re-pricing (up) of loan books, a falling Selic is expected to put pressure on net interest margins (NIM) and weigh on bank profits.

**NIM sensitivity: A 100bp Selic reduction would lower NIM by 11bp, on average**

An analysis of the last tightening cycle showed that for every 100bp rise in the Selic, NIM expanded by 11bp for banks under our coverage, with a time lag of three quarters. Given our new Selic forecasts, this implies a NIM contraction of ~42bp for banks under our coverage by the end of 2018. By bank, the NIM sensitivity for every 100bps Selic change varied from 6bp at Itau to 13bp at Bradesco.

**Risks to our NIM forecasts of a 9bp reduction in 2017 and 1bp in 2018**

Given the time lag of rate cuts on NIM, we see low risk to our NIM expectations in 2016 but there could be downside risk to our current NIM forecasts in 2017 and 2018 if the reduction in policy rates be in line or ahead of our latest macro forecasts. A sensitivity analysis suggests for every 10bp reduction in NIM (below our current estimates) could lower our 2017E EPS by 8.0%.

**Underweight Brazilian banks within a LatAm/EM context**

We have become cautious on Brazilian banks, as illustrated by the Sell rating downgrades of Banco do Brasil (click here) and Santander Brasil (click here) in the past two weeks, largely on valuation grounds as we believe the risk/reward profiles have become unattractive. Brazilian banks have rallied strongly (up 46% in US$ on average over the past three months) yet fundamentals remain under pressure: over the same period, we have cut our 2016 EPS estimates by 13.4%. Itau remains our only Buy rated bank in Brazil.

**Figure 1: Brazilian banks – summary valuation**

| | Rating | Price LC | Price Target LC | Upside (%) | Mkt Cap (USD millions) | P/E 2016E | P/E 2017E | P/BV 2016E | P/BV 2017E | Adj. ROE (%) 2016E | Adj. ROE (%) 2017E | Dividend Yield 12-month Fwd (%) |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Banco do Brasil | Sell (CBE) | 17.73 | 16.00 | -9.8 | 14,877 | 5.8x | 4.7x | 0.6x | 0.5x | 10.8 | 12.1 | 4.5 |
| Bradesco | Neutral | 24.65 | 27.50 | 11.6 | 39,833 | 8.5x | 7.9x | 1.4x | 1.2x | 17.3 | 16.5 | 4.2 |
| Itau Unibanco | Buy | 30.47 | 36.00 | 18.1 | 52,692 | 9.1x | 8.2x | 1.6x | 1.4x | 18.4 | 18.6 | 4.4 |
| Santander Brasil | Sell | 17.85 | 16.00 | -10.4 | 19,330 | 12.6x | 10.9x | 1.2x | 1.2x | 9.6 | 10.7 | 5.7 |

Source: UBS estimates. Prices as of 19 May 2016. All PTs derived from Gordon Growth Models

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# Brazilian Banks

UBS Research THESIS MAP | MOST FAVORED | LEAST FAVORED

**Itau** | **Banco do Brasil, Santander Brasil**

PIVOTAL QUESTIONS

**Q: What does a lower Selic mean for NIMs?**

In the manner that a rising Selic over the past three years was positive for bank margins with the re-pricing (up) of loan books, a falling Selic would put pressure on net interest margins. More positively, lower policy rates may help a recovery in loan growth and lessen asset quality pressure, although we consider this to be more closely linked to economic growth, while potentially bringing down cost of equity further. more →

**Q. Will competition remain rational?**

We believe competition and pricing behaviour will remain rational in the short to medium-term (i) as the re-pricing (up) of the back book of the lending portfolio is ongoing, led by public banks; (ii) given a lack of appetite to lend with prevailing macro uncertainties; while (iii) capital limitations among public banks, as illustrated by low core tier I ratios when compared to its peers will likely constrain the ability to expand their balance sheet, when economic activity eventually picks-up. more →

WHAT'S PRICED IN?

**Current valuations suggest the market is expecting a c1% increase in earnings.**

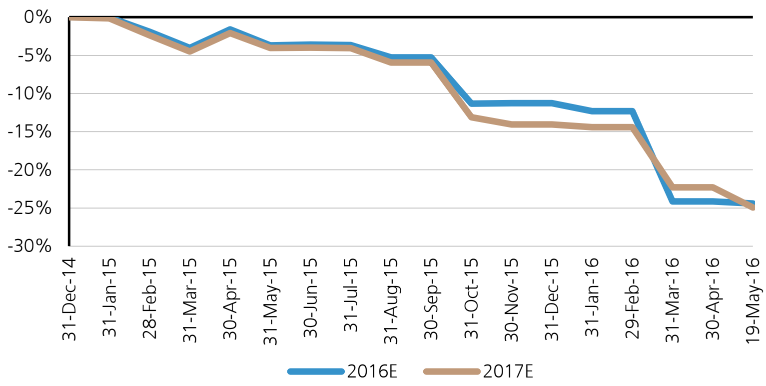
Using 1-year forward consensus estimates, Brazilian banks have re-rated to 8.3x PE and 1.3x P/BV from 5.9x PE and 1.0x P/BV over the past 3 months. In PE terms, the sector is now in line with the five years historical mean (at 8.3x PE) while in P/BV terms, it is at a 7% discount to its historical mean (at 1.4x).

UBS VIEW

**The outlook for Brazilian banks remains challenging,** with growth uncertainties and rising unemployment. Asset quality remains the key concern with a rising provisioning burden as evident in 1Q16 results weighing on profits and return. Prospects of a sharply lower Selic will become another source of earnings risk. We are underweight Brazilian banks within a LatAm/EM banking as the risk/reward profile of the sector is unattractive: over the past three months, the sector is up 30.2% in local currency (46.3% in US$) yet we have cut our 2016E EPS by -13.8% and 2017E by -12.3%.

EVIDENCE

**Brazilian banks – cumulative EPS changes**




Source: UBS estimates

## OUR THESIS IN PICTURES

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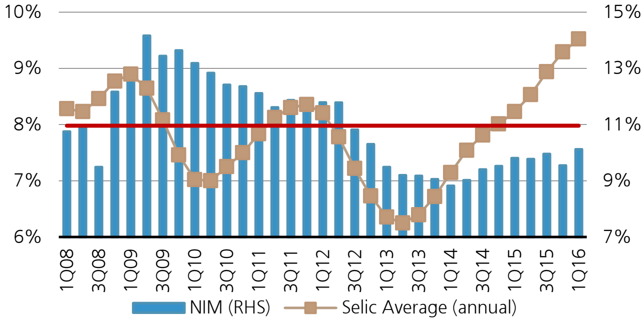
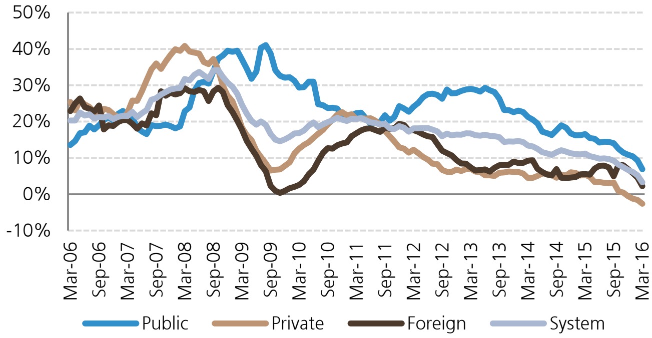
**Brazil banks NIMs vs Selic rate**



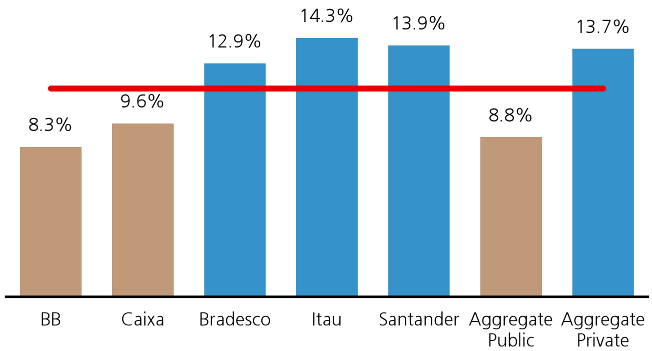

**The changes in the average Selic rate have a high positive correlation with NIM changes suggesting a lower Selic in the future could weigh on NIM**

**Brazilian banks loan growth (% yoy)**



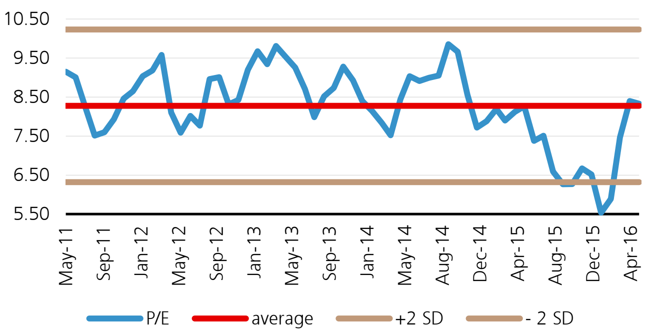

**The competitive outlook looks stable in part because banks' appetite to lend, especially public banks, has decreased sharply, as reflected by the slowdown in system loan growth.**

**Core tier I (as of 1Q16)**




**Capital limitations among public banks, as illustrated by low core tier I ratios when compared to their peers, will likely constrain the banks' ability to expand their balance sheets when economic activity eventually picks-up**

**Bz banks P/E 1 year forward evolution**




**Using 1-year forward consensus estimates, Brazilian banks are trading on 8.4x PE. This is just above its 5-year historical average of 8.3x PE.**

Sources for exhibits above: Banks, Brazil Central Bank, I/B/E/S MSCI Consensus Aggregates, Thomsons Financials DataStream and UBS

return ↑

## Q: What does a lower Selic mean for NIMs?

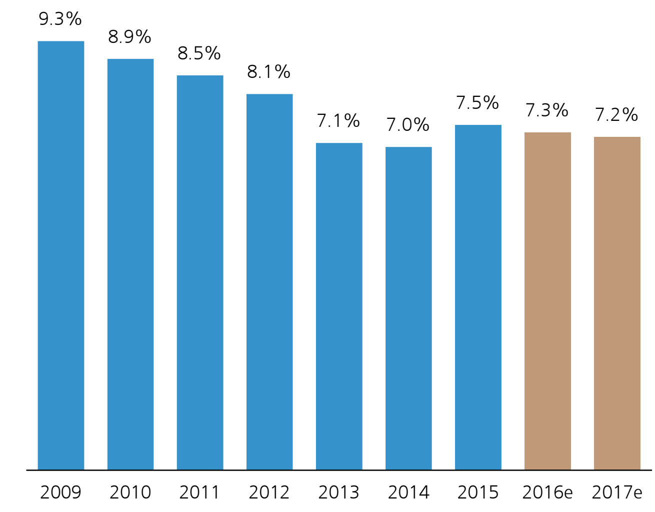
### UBS VIEW

In the same manner that a rising Selic over the past three years was positive for bank margins with the re-pricing (up) of loan books, a falling Selic would put pressure on net interest margins. More positively, lower policy rates may help a recovery in loan growth and lessen asset quality pressure, although we consider this to be more closely linked to economic growth, while potentially bringing down cost of equity further (see Figure 27).

### EVIDENCE

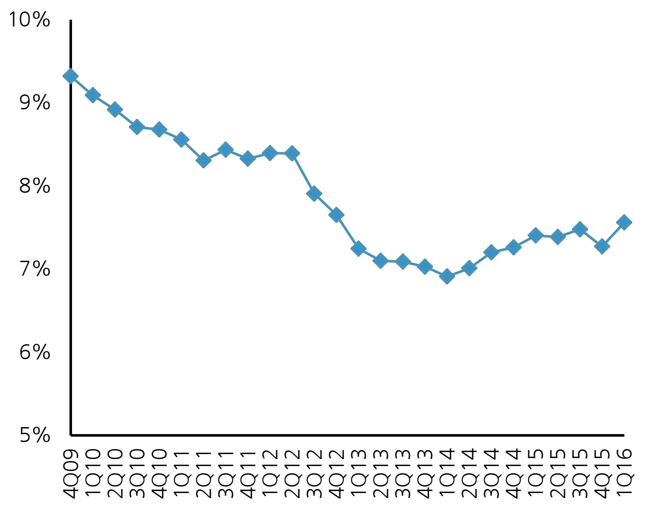
After years of margin pressure, Brazilian bank's NIMs inflected in 1Q14, with margins expanding from 6.9% in 1Q14 to 7.6% in 1Q16. In 2015, NIMs went up 48bps on average for the banks under our coverage on the back of (i) higher Selic rate; (ii) higher trading gains; and (iii) the re-pricing of front/back books.

**Figure 2: Brazilian banks' NIMs – annual evolution**




Source: Banks and UBS estimates. Note: considers BB, Bradesco, Itau and Santander Brasil

**Figure 3: Brazilian banks' NIMs – quarterly evolution**




Source: Banks and UBS estimates. Note: considers BB, Bradesco, Itau and Santander Brasil

Looking ahead, our Economics team expects the easing cycle to start in August 2016 and that it should last until mid-2017. They have recently published new macro forecasts that included the Selic falling from the current level of 14.25% to 12.75% by the end of 2016 and to 10.50% by the end of 2017. As a rule of thumb, we assume every 100bp cut in policy rates leads to a margin contraction around 10bp with an average time lag of three quarters to one year.

In the current tightening cycle that started in April 2013, the Selic rate went up by 700bps, peaking at 14.25% in April 2015. In the same period, system spreads were up from 22.5% to 29.3% in April 2015, reaching the historical high in March 2016 at 37.3%. At the same time, NIMs went up from 6.8% in 1Q13 to 7.3% in 2Q15, peaking at 7.5% in 1Q16 (+78bps).

This implied an 11bp NIM expansion for each 100bps increase in the policy rate, with a time lag of three quarters. As banks' liabilities usually re-adjust faster than assets, we observed NIM initially declining to 6.6% in 1Q14 before expanding in subsequent quarters. The NIM expansion took place against a backdrop of a changing loan mix towards lower-yield and less risky types of loans that understated the NIM expansion. At the same time, during this period, banks posted higher than normal trading income that helped elevate margins. In this analysis, we have assumed the two trends offset each other in terms of the impact on NIM. By bank, the NIM sensitivity for every 100bps Selic rise varied from 6bp at Itau to 13bp at Bradesco (see Figure 4).

Assuming the relationship between changes in the Selic and changes in NIM remain positively correlated, both with a rising Selic as well as with a falling Selic, our new Selic forecasts suggest a NIM contraction of ~42bp for banks under our coverage by the end of 2018 (assuming a 375bp reduction in the Selic by the end of 2017 and a one-year time lag for this to fully impact margins).

**Figure 4: Potential implications of Selic changes on NIM**

| | BB | Bradesco | Itau | Aggregate |
|---|---|---|---|---|
| 1Q13 (start of tightening cycle) | 5.8% | 7.3% | 7.2% | 6.8% |
| 2Q15 (final Selic hike) | 5.9% | 7.9% | 8.2% | 7.3% |
| 1Q16 (aggregate NIM peak) | 6.4% | 8.2% | 7.6% | 7.5% |
| | | | | |
| NIM change | 61 bps | 88 bps | 43 bps | 78 bps |
| Selic change | 700 bps | 700 bps | 700 bps | 701 bps |
| | | | | |
| **NIM change to every 100bps change in Selic** | **9 bps** | **13 bps** | **6 bps** | **11 bps** |
| | | | | |
| **Implication of 375bps lower Selic on NIMs** | **-33 bps** | **-47 bps** | **-23 bps** | **-42 bps** |

Source: Banks, Central Bank and UBS estimates. Note: We exclude Santander Brasil from this analysis as NIM change during tightening cycle (-43bps) was driven by loan mix change and hedge effects

In our models, we assume NIM for the banks under our coverage falls by 17bp in 2016, on average – despite the effect of loan book re-pricing, lower trading gains should pressure margins. We also forecast NIMs to contract by 9bps in 2017 and 1bp in 2018, indicating potential downside risk to current estimates should the reduction in policy rates be in line with or ahead of our latest macro forecasts.

**Figure 5: NIM evolution by bank**

| | | | | | Change | | |
|---|---|---|---|---|---|---|---|
| | **2015** | **2016E** | **2017E** | **2018E** | **16E/15** | **17E/16E** | **18E/17E** |
| Banco do Brasil | 6.2% | 6.3% | 6.1% | 6.2% | 13 bps | -20 bps | 5 bps |
| Bradesco | 7.7% | 7.8% | 7.7% | 7.7% | 13 bps | -12 bps | 5 bps |
| Itau | 8.1% | 7.6% | 7.5% | 7.4% | -44 bps | -9 bps | -13 bps |
| Santander Brasil | 8.4% | 7.7% | 8.0% | 8.1% | -65 bps | 30 bps | 4 bps |
| **Aggregate** | **7.46%** | **7.29%** | **7.20%** | **7.19%** | **-17 bps** | **-9 bps** | **-1 bps** |

Source: Banks and UBS estimates

## WHAT'S PRICED IN?

According to the Central Bank, market consensus (as of 16 May) for the Selic rate by the end of 2016 is at 13.00% and by the end of 2017 at 11.50%.

With the easing cycle expected by consensus to start towards the year end and given the time-lag for rate cuts to fully impact NIM, we see low risk to our 2016 estimates from lower rates. However, there is a potential downside risk to consensus 2017 estimates in case our economists' scenario materializes

(Selic at 12.75% in 2016 and 10.50% in 2017): a sensitivity analysis suggests every 10bp reduction in NIM (below our current estimates) could lower our 2017E EPS by 8.0% (see Figure 6).

**Figure 6: Brazilian banks NIM sensitivity analysis of 10bp lower NIM**

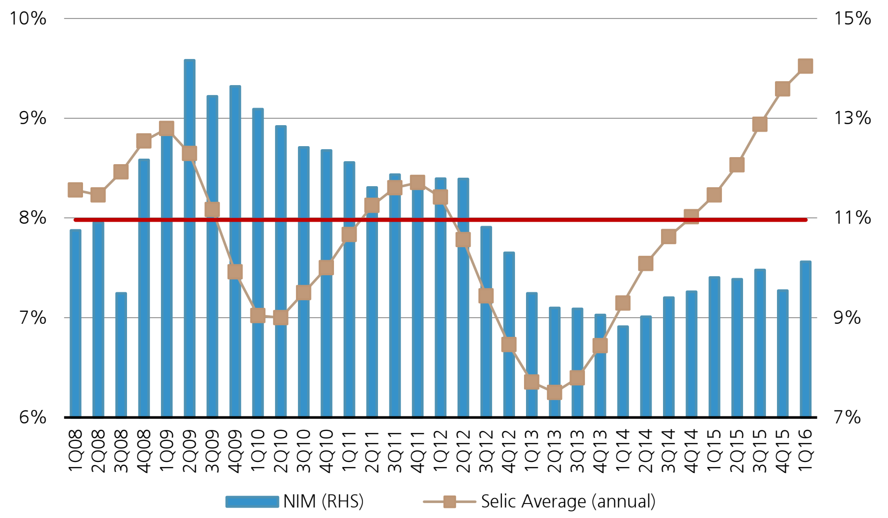
| | Banco do Brasil | Bradesco | Itau | Santander Brasil | Aggregate |
|---|---|---|---|---|---|
| **Base Scenario (2017e)** | | | | | |
| NII | 60,136 | 57,914 | 73,562 | 34,276 | 225,886 |
| NIM | 6.1% | 7.7% | 7.5% | 8.0% | 7.20% |
| Net Income | 10,972 | 17,670 | 22,883 | 6,200 | 57,726 |
| | | | | | |
| **-10bps higher NIM** | | | | | |
| NII | 59,152 | 57,161 | 72,587 | 33,849 | 222,749 |
| NIM | 6.0% | 7.6% | 7.4% | 7.9% | 7.10% |
| Net Income | 10,092 | 17,184 | 22,231 | 5,869 | 55,376 |
| **% Net Income change** | **-8.0%** | **-2.7%** | **-2.9%** | **-5.3%** | **-4.1%** |

Source: UBS estimates

## Regression analysis suggests NIM at 7.1% in 2018

The changes in the average Selic rate have a high correlation with NIM changes in the following four quarters for the period after 4Q11 at 0.92.

**Figure 7: Selic rate vs. NIM (1Q08-1Q16)**




Source: Brazil Central Bank, banks and UBS. Note: NIMs are the aggregated NIMs of Banco do Brasil, Bradesco, Itaú and Santander Brasil

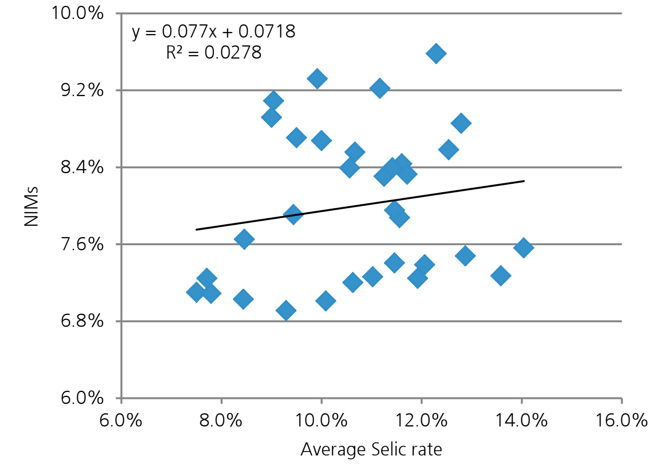
Our economists expect an average Selic rate of c11% in 2017. The last time the average Selic rate was at this level was during 4Q14, during the last tightening cycle. At that time, average NIM (for BB, Bradesco, Itaú and Santander Brasil) was at 7.3%, 30 bps below 1Q16 (at 7.6%).

We run a regression analysis of the average Selic rate vs. NIM from 1Q08 to 1Q16, however, the R-squared of this regression is low, at 0.04. In our view, the low coefficient of determination is partly due to the shift in the loan mix effect and the time needed to re-price the whole book.

We re-run our analysis comparing average Selic rate vs. average NIM in the following four quarters for the period after 2Q14, when the last tightening

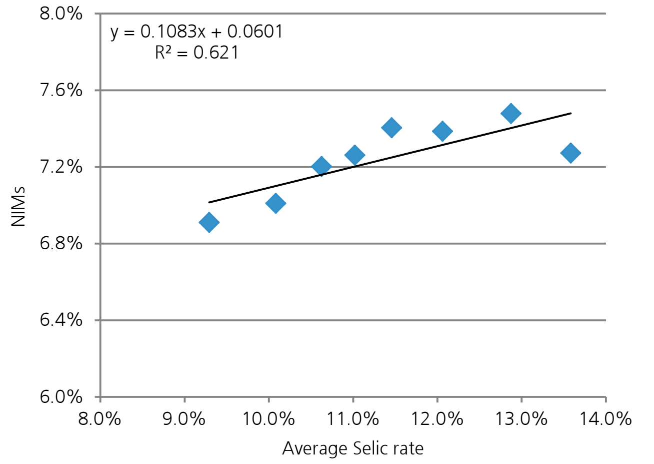
cycle started. In this period we were able to capture a good portion of loan book re-price with lower impact of loan mix changes. The R-squared of this new regression was high, at 0.62. For an average Selic rate of 11.0% in 2017 we would have average NIM at 7.2%, in line with our expectations. However, with average Selic at 10.5% in 2018, we would have average NIM at 7.1%, slightly below our current our forecast.

**Figure 8: LTM average Selic rate vs NIM (1Q08-1Q16)**




Source: Brazil Central Bank, banks and UBS. Note: NIMs are the aggregated NIMs of Banco do Brasil, Bradesco, Itaú and Santander Brasil.

**Figure 9: LTM average Selic rate vs NIM (1Q14-1Q16)**




Source: Brazil Central Bank, banks and UBS. Note: NIMs are the aggregated NIMs of Banco do Brasil, Bradesco, Itaú and Santander Brasil.

**Bradesco was the least affected bank in previous easing cycle,**

The previous easing cycle started in August 2011, with Selic decreasing from 12.5% to 12.0%. The Selic rate bottomed in October 2012 at 7.25% and remained at this level until March 2013. At the same time, the average Selic rate (LTM) reached the lowest level one year later in March 2014.

The aggregate bank's NIM declined from the peak of 8.4% in 1Q12 to 6.9% 1Q14 given the lower Selic rate, but also the change in loan mix to low-risk/low-yield portfolios.

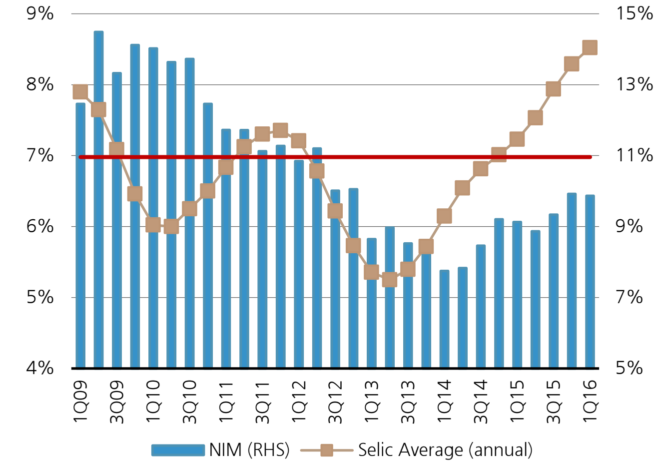
At bank level, Bradesco's NIM was the least impact, down -86bps while Santander Brasil's declined by -259bps.

**Figure 10: Changes in banks' NIM (1Q12-1Q14)**

| | 1Q12 | 1Q14 | change |
|---|---|---|---|
| LTM Avg Selic | 11.8% | 9.3% | -247 bps |
| **NIM** | | | |
| BB | 6.9% | 5.4% | -155 bps |
| Bradesco | 7.9% | 7.0% | -86 bps |
| Itau | 8.9% | 7.1% | -178 bps |
| Santander Brasil | 11.8% | 9.2% | -259 bps |
| **Aggregate** | **8.4%** | **6.9%** | **-148 bps** |

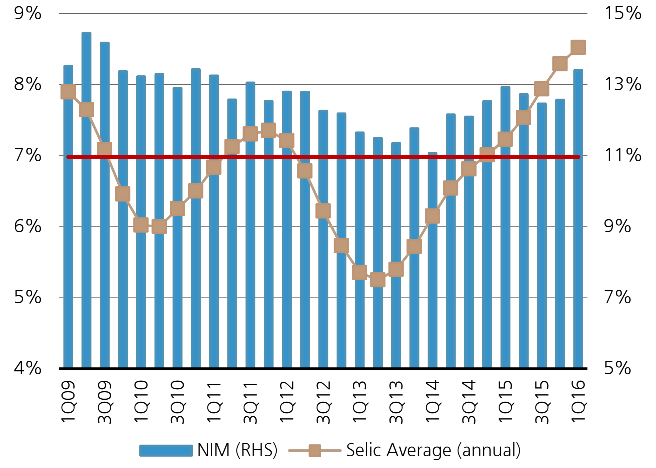
Source: Banks, Brazil Central Bank and UBS

**Figure 11: BB NIM vs Selic rate (LTM average)**



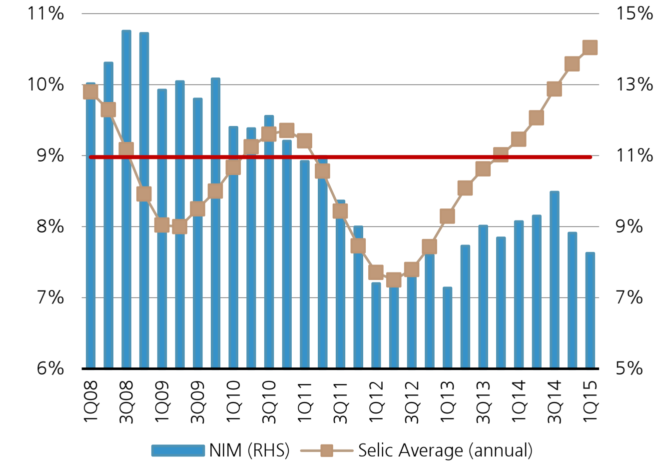

Source: Company, Brazil Central Bank and UBS

**Figure 12: Bradesco NIM vs Selic rate (LTM average)**



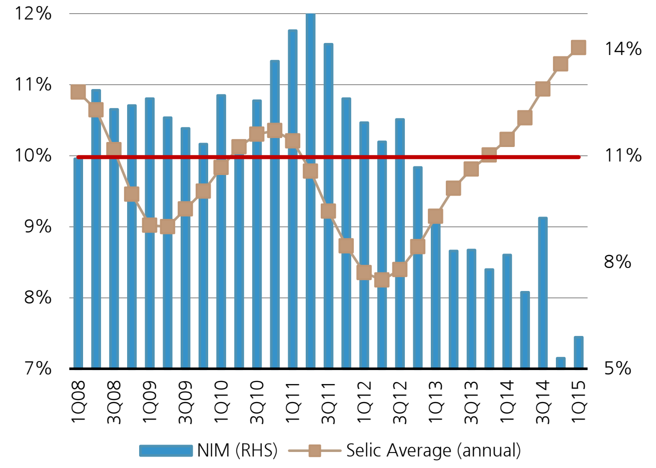

Source: Company, Brazil Central Bank and UBS

**Figure 13: Itau NIM vs Selic rate (LTM average)**




Source: Company, Brazil Central Bank and UBS

**Figure 14: Santander NIM vs Selic rate (LTM average)**




Source: Company, Brazil Central Bank and UBS

In terms of earnings, Bradesco's earnings CAGR (12-13) was the highest at 4.4%, followed by Itau at 4.0%. Santander Brasil's was the lowest at -10.3%.

**Figure 15: Impact of lower Selic rate (2012-2013)**

| | NIM | | | NIM change | NII growth (% yoy) | | | Earnings growth (% yoy) | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | 2011 | 2012 | 2013 | 2013/2011 | 2012 | 2013 | CAGR (12-13) | 2012 | 2013 | CAGR (12-13) |
| BB | 7.1% | 6.7% | 5.7% | -142 bps | 12.4% | 0.0% | 6.1% | -1.9% | -10.2% | -6.1% |
| Bradesco | 8.0% | 7.8% | 7.2% | -83 bps | 11.4% | -1.2% | 4.9% | 2.9% | 5.9% | 4.4% |
| Itau | 9.2% | 8.4% | 7.2% | -203 bps | 3.3% | -7.4% | -2.2% | -4.1% | 12.8% | 4.0% |
| Santander Brasil | 10.9% | 11.5% | 10.0% | 0 bps | 12.8% | -4.9% | 3.6% | -9.1% | -11.5% | -10.3% |
| **Aggregate** | **8.5%** | **8.1%** | **7.1%** | **0 bps** | **9.2%** | **-3.5%** | **2.7%** | **-2.3%** | **1.7%** | **-0.3%** |

Source: Company data, UBS estimates

# Q: Will competition remain rational?

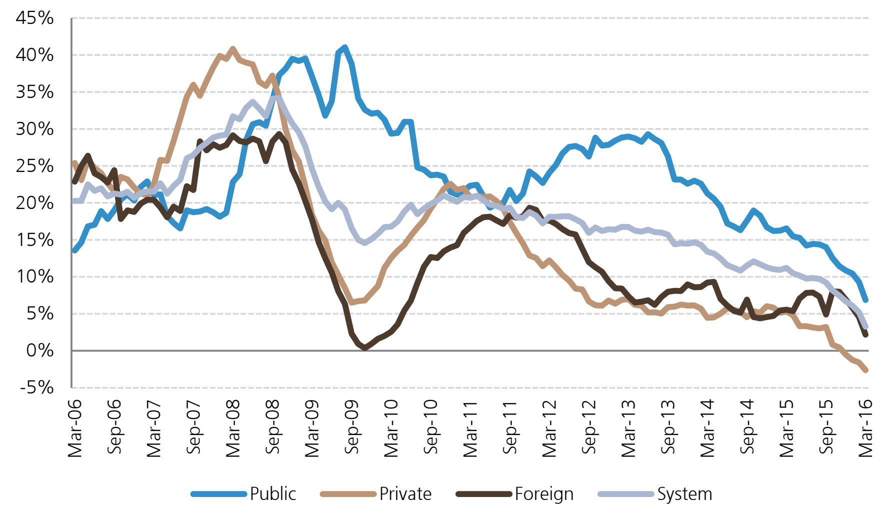
### UBS VIEW

We believe competition and pricing behaviour will remain rational in the short to medium-term (i) as the re-pricing (up) of the back book of the lending portfolio is ongoing, led by public banks; (ii) given a lack of appetite to lend with prevailing macro uncertainties; while (iii) capital limitations among public banks, as illustrated by low core tier I ratios when compared to its peers will likely constrain the ability to expand their balance sheet, when economic activity eventually picks up.

### EVIDENCE

From our observation, the re-pricing (up) of the back book (i.e. outstanding loans) is still going on albeit coming closer to an end given the last Selic hike occurred in July 2015. We have also seen appetite to lend, especially among public banks decreasing sharply with the economy in recession: over the past year, loan growth for the system has declined to 3.3% yoy in March 2016 from 11.2% yoy in March 2015 with that for public banks falling to 6.9% from 16.6% over the same period.

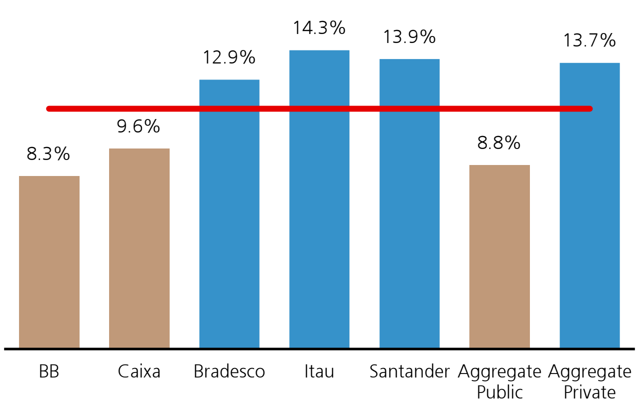
**Figure 16: Brazilian banks loan growth (% yoy)**




Source: Brazil Central Bank

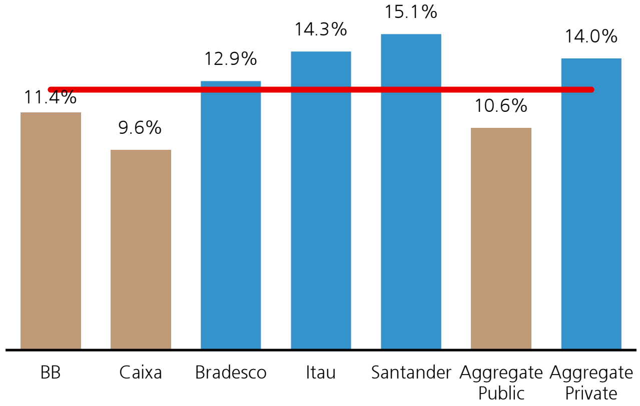
In terms of capital position, Banco do Brasil's core Tier 1 ratio of 8.3% is the lowest among the banks we cover. Although it currently meets the minimum local regulatory capital requirement of 5.125%, it is low by international standards. The low capital level was illustrated by the reduction in its dividend payout ratio from 40% to 25% in February 2016. Besides, looking ahead, minimum local core capital requirements rise sharply to 7.25% by the end of 2017, 8.75% by year-end 2018 and 10.5% at the end of 2019.

**Figure 17: Core tier I – Public vs Private banks (as of 1Q16)**




Source: Banks and UBS

**Figure 18: Tier I – Public vs Private banks (as of 1Q16)**

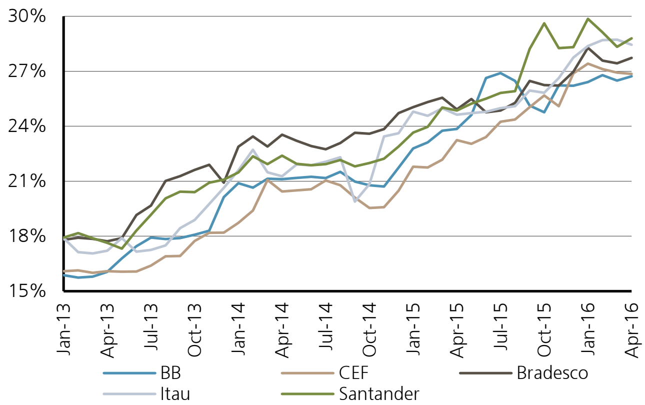



Source: Banks and UBS

## Evidence of loan re-pricing

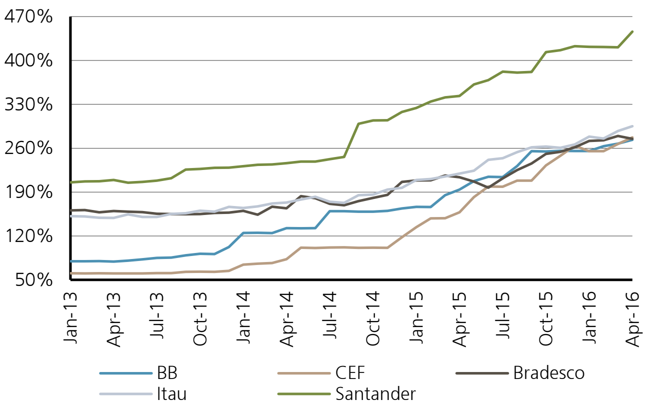
Over the last two years, we have seen banks re-price their lending rates across the board. The re-pricing process has been led by public banks (given their dominant market positioning), with private banks following.

**Figure 19: Individuals – Auto loan lending rates (% p.a.)**



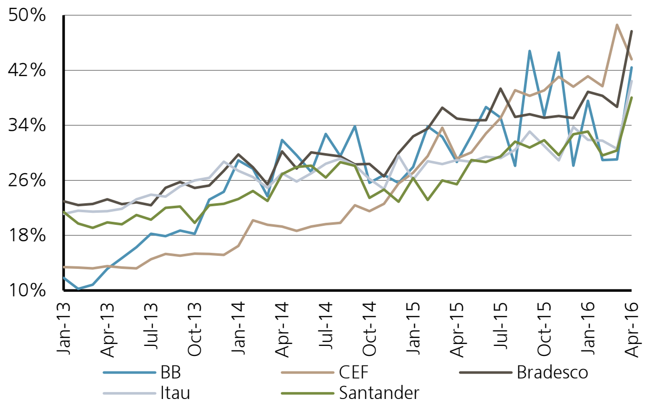

Source: Brazil Central Bank

**Figure 20: Individuals – Overdraft lending rates (% p.a.)**



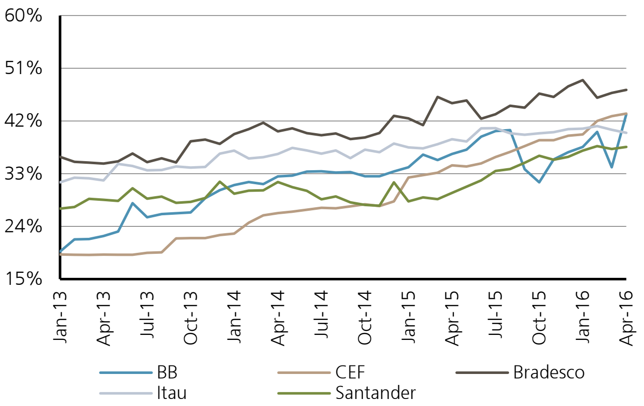

Source: Brazil Central Bank

**Figure 21: Corporate – Working Capital rates (% p.a.)**




Source: Brazil Central Bank

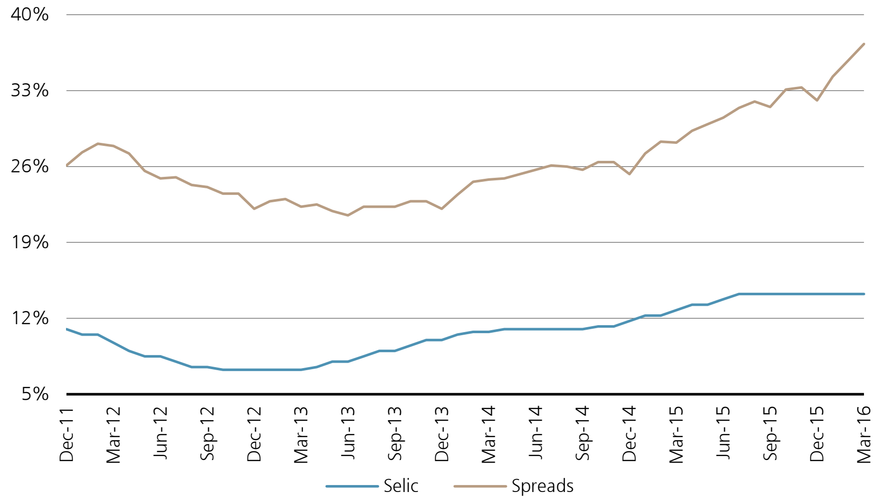
**Figure 22: Corporate – Discounting of bill rates (% p.a.)**




Source: Brazil Central Bank

The combination of a higher Selic and more rational pricing behaviour has resulted in system-wide spreads rising from 25.7% in June 2013 to 37.3% in March 2016 (590bps higher than July 2015 when Selic peaked), the historical high.

**Figure 23: System spreads**




Source: Brazil Central Bank. Note: Comprises new non-directed credit. Excludes operations with regulated rates, operations with funds from BNDES or any operations with government funds or funds with mandatory destination

These higher spreads paved the way for NIM expansion since 2Q14. Even with the beginning of the easing cycle, we should continue to see spreads to go up by 2-3 months given the positive impact in cost of funding.

# Valuation

Our valuation methodology for banks is based on a Gordon growth model, which assumes for Brazilian banks an average sustainable ROE of 16.9%, average COE of 16.0% and a growth factor of 9.5%.

Currently, Brazilian banks trade on 9.0x PE and 1.2x PBV with 14.0% ROE on 2016 estimates. On 2017 estimates, they are on 7.9x PE and 1.1x PBV with 14.5% ROE.

**Figure 24: Valuation summary**

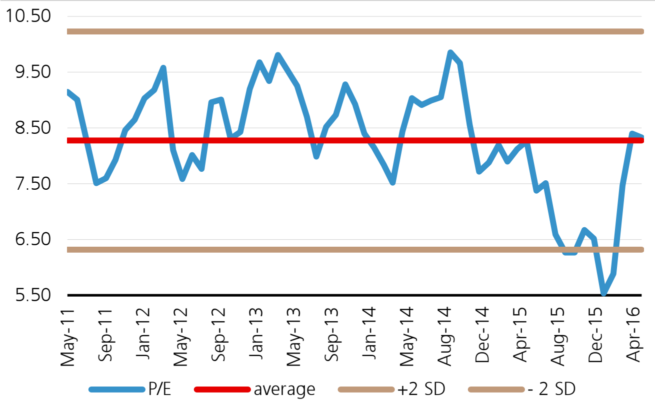
| | Ticker | Rating | Price LC | Price Target LC | Upside (%) | Mkt Cap (USD millions) | P/E 2016E | P/E 2017E | P/BV 2016E | P/BV 2017E | Adj. ROE (%) 2016E | Adj. ROE (%) 2017E | Dividend Yield 12-month Fwd (%) |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **Brazilian Banks** | | | | | | | | | | | | | |
| Banco do Brasil | BBAS3.SA | Sell (CBE) | 17.73 | 16.00 | -9.8 | 14,877 | 5.8x | 4.7x | 0.6x | 0.5x | 10.8 | 12.1 | 4.5 |
| Bradesco | BBDC4.SA | Neutral | 24.65 | 27.50 | 11.6 | 39,833 | 8.5x | 7.9x | 1.4x | 1.2x | 17.3 | 16.5 | 4.2 |
| Itau Unibanco | ITUB4.SA | Buy | 30.47 | 36.00 | 18.1 | 52,692 | 9.1x | 8.2x | 1.6x | 1.4x | 18.4 | 18.6 | 4.4 |
| Santander Brasil | SANB11.SA | Sell | 17.85 | 16.00 | -10.4 | 19,330 | 12.6x | 10.9x | 1.2x | 1.2x | 9.6 | 10.7 | 5.7 |
| **Mexican Banks** | | | | | | | | | | | | | |
| Banorte | GFNORTEO.MX | Buy | 95.97 | 109.80 | 14.4 | 15,043 | 13.8x | 11.8x | 1.8x | 1.6x | 13.8 | 14.4 | 1.6 |
| Banregio | GFREGIOO.MX | Buy | 103.91 | 115.00 | 10.7 | 1,860 | 16.2x | 14.3x | 2.7x | 2.4x | 17.8 | 17.8 | 1.9 |
| Gentera | GENTERA.MX | Neutral | 32.69 | 38.00 | 16.2 | 2,970 | 14.8x | 13.1x | 3.3x | 2.9x | 22.4 | 22.0 | 1.1 |
| Inbursa | GFINBURO.MX | Buy | 31.74 | 47.00 | 48.1 | 11,920 | 15.2x | 13.0x | 1.9x | 1.7x | 12.9 | 13.5 | 2.2 |
| Santander Mexico | SANMEXB.MX | Buy | 32.15 | 35.60 | 10.7 | 12,565 | 14.5x | 13.3x | 1.8x | 1.7x | 12.8 | 13.0 | 3.2 |
| Unifin | UNIFINA.MX | Buy | 49.84 | 62.00 | 24.4 | 962 | 16.1x | 13.2x | 3.6x | 3.2x | 23.8 | 25.7 | 1.6 |
| **Andean Banks** | | | | | | | | | | | | | |
| Bancolombia | CIB.N | Sell | 35.13 | 30.80 | -12.3 | 8,659 | 11.3x | 10.7x | 1.3x | 1.3x | 12.8 | 12.9 | 2.9 |
| Davivienda | DVI | Buy | 25,900 | 32,800 | 26.6 | 3,863 | 7.8x | 7.1x | 1.2x | 1.1x | 16.2 | 16.0 | 0.0 |
| Credicorp | BAP.N | Buy | 139.68 | 155.30 | 11.2 | 11,694 | 12.1x | 11.1x | 2.2x | 1.9x | 19.7 | 20.0 | 2.5 |
| Santander Chile | BSAC.K | Neutral | 18.49 | 19.90 | 7.6 | 8,725 | 11.9x | 10.3x | 2.0x | 1.8x | 18.2 | 19.5 | 5.0 |
| **Argentine Banks** | | | | | | | | | | | | | |
| Galicia | GGAL.O | Neutral | 26.20 | 36.00 | 37.4 | 2,606 | 9.3x | 9.8x | 2.5x | 2.0x | 33.3 | 27.9 | 4.1 |
| Frances | BFR.N | Sell | 18.42 | 21.00 | 14.0 | 3,418 | 11.6x | 13.6x | 2.8x | 2.3x | 29.1 | 23.2 | 1.7 |

Source: Company data, UBS estimates. Note prices as of 19 May 2016

Using 1-year forward consensus estimates, Brazilian banks have re-rated to 8.3x PE and 1.3x P/BV from 5.9x PE and 1.0x P/BV over the past 3 months.

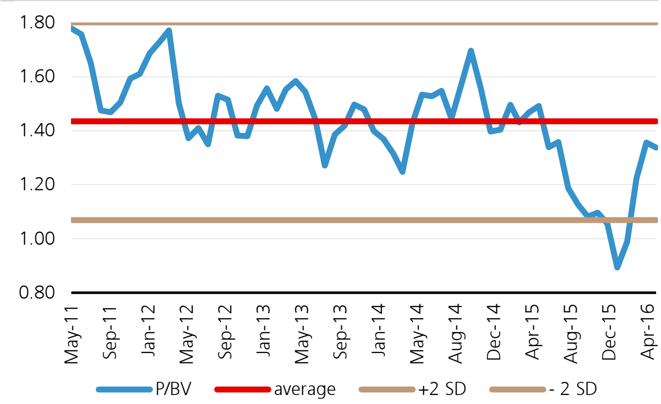
In PE terms, the sector is now in line with the five-year historical mean (at 8.3x PE) while in P/BV terms, it is at a 7% discount to its historical mean (at 1.4x).

**Figure 25: Brazil banks: consensus 1-yr forward PE**




Source: I/B/E/S MSCI Aggregates, Thomson Financials DataStream, UBS

**Figure 26: Brazil banks: consensus 1-yr forward P/BV**




Source: I/B/E/S MSCI Aggregates, Thomson Financials DataStream, UBS

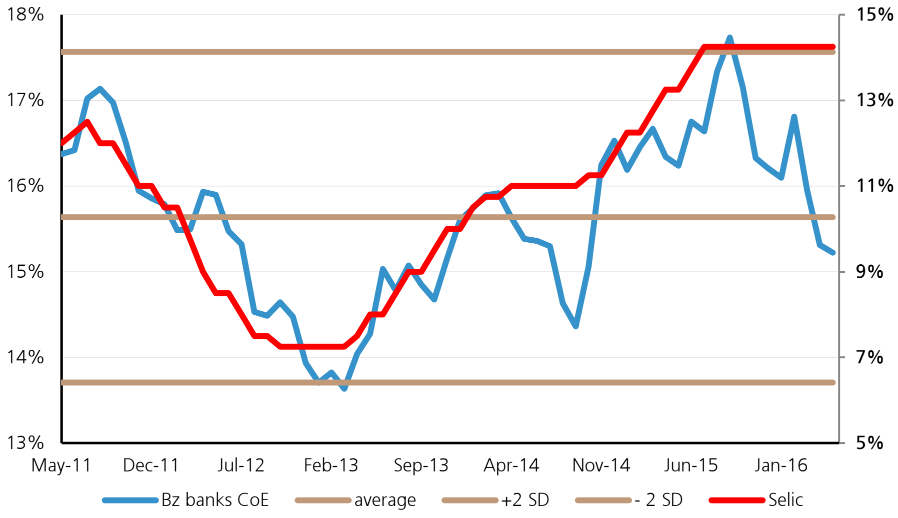
## Implied COE for Brazilian banks

Brazilian banks' implied COE has also come down considerably over the past three months given improved risk appetite and expectations of political reforms. Today, it stands at 15.2%, down from 17.3% at the end of January 2016. This compares to a 5-year historical average of 15.7%.

Going forward, COE could come down further with a lower Selic, although the impact on share price performance would likely be constrained by negative earnings momentum such as that arising from potential margin pressure.

Over the past five years, Brazilian banks' implied COE troughed at 13.7% in February 2013, at a time when the Selic was at 7.25%. Given expectations for a sharp fall in the Selic, this suggests there is scope for COE to come down further although we note that the last time the Selic was at 10.5% (the level to which our Economics team forecasts the policy rate will fall by 2017), the implied COE for Brazilian banks was 15.7%, in line with the historical 5-year average.

**Figure 27: Brazilian banks implied CoE vs Selic rate**




Source: Brazil Central Bank, I/B/E/S MSCI aggregates, MSCI indices, Thomson Financials DataStream, UBS

**Valuation Method and Risk Statement**

Itau Unibanco PT is Gordon Growth Model derived, with a CoE of 15.5%, sustainable ROE of 20.0% and growth of 9.5%
Bradesco PT is Gordon Growth Model derived, with a CoE of 15.5%, sustainable ROE of 18.00% and growth of 9.5%
Santander PT is Gordon Growth Model derived, with a CoE of 16.2%, sustainable ROE of 16.4% and growth of 9.5%
Banco do Brasil PT is Gordon Growth Model derived, with a CoE of 16.9%, sustainable ROE of 13.25% and growth of 9.5%
Brazilian financials' performance is closely linked to local economic conditions and changes in interest rates and foreign exchange. Also, Brazilian financials may be affected by changes in regulatory framework and overall local and foreign competition..

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Source: UBS. Rating allocations are as of 31 March 2016.
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|---|---|---|---|---|---|
| **Banco do Brasil**[5, 7, 20, 22] | BBAS3.SA | Sell (CBE) | N/A | R$17.31 | 20 May 2016 |
| **Bradesco**[7, 16] | BBDC4.SA | Neutral | N/A | R$24.38 | 20 May 2016 |
| **Itau Unibanco**[7, 16] | ITUB4.SA | Buy | N/A | R$30.08 | 20 May 2016 |
| **Santander Brasil**[7, 16] | SANB11.SA | Sell | N/A | R$17.67 | 20 May 2016 |

Source: UBS. All prices as of local market close.
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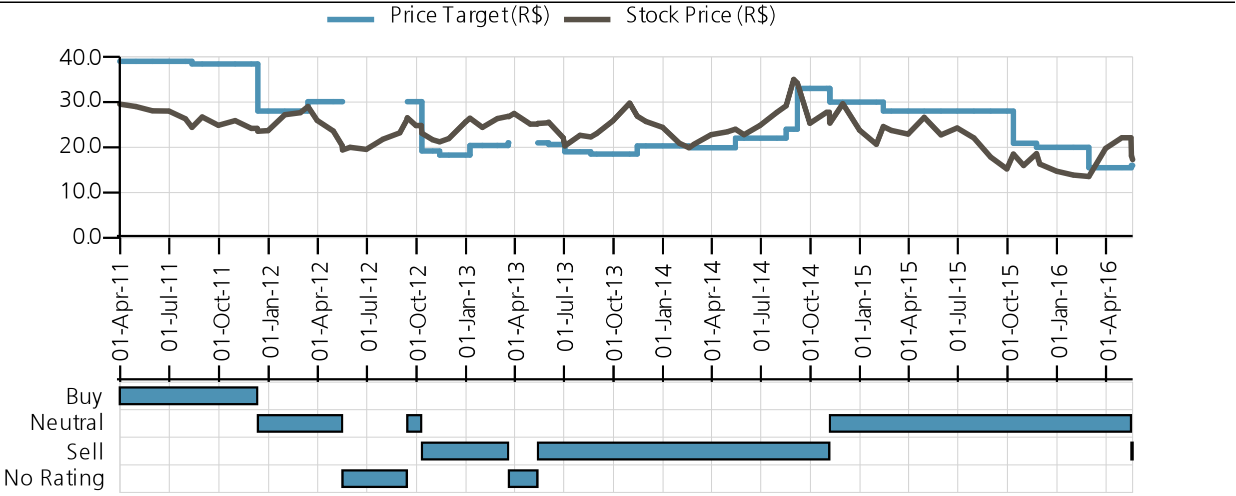


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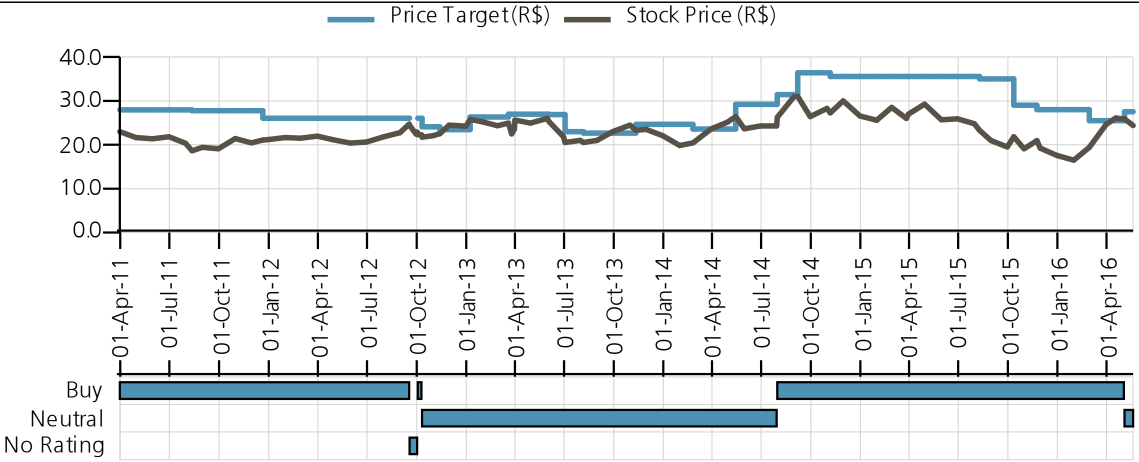
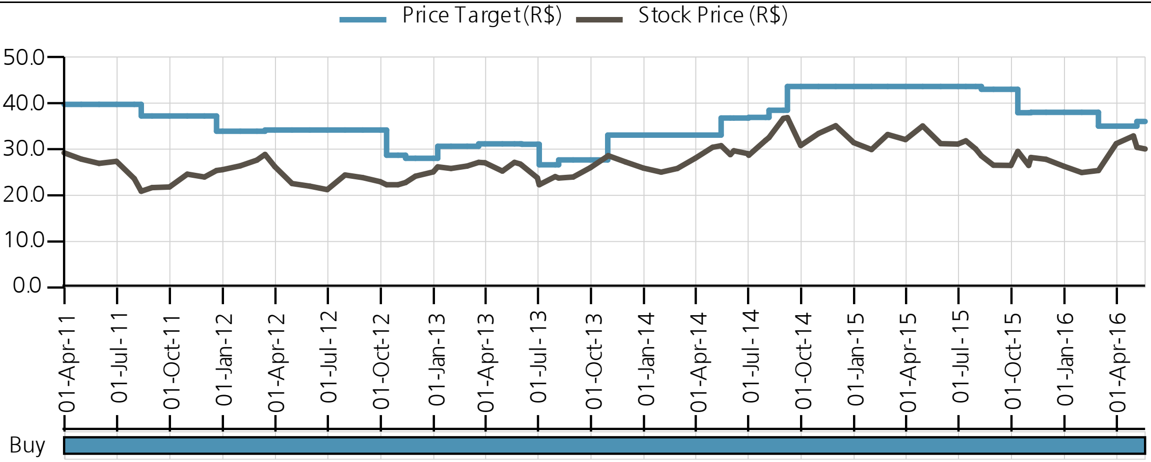
**Bradesco (R$)**



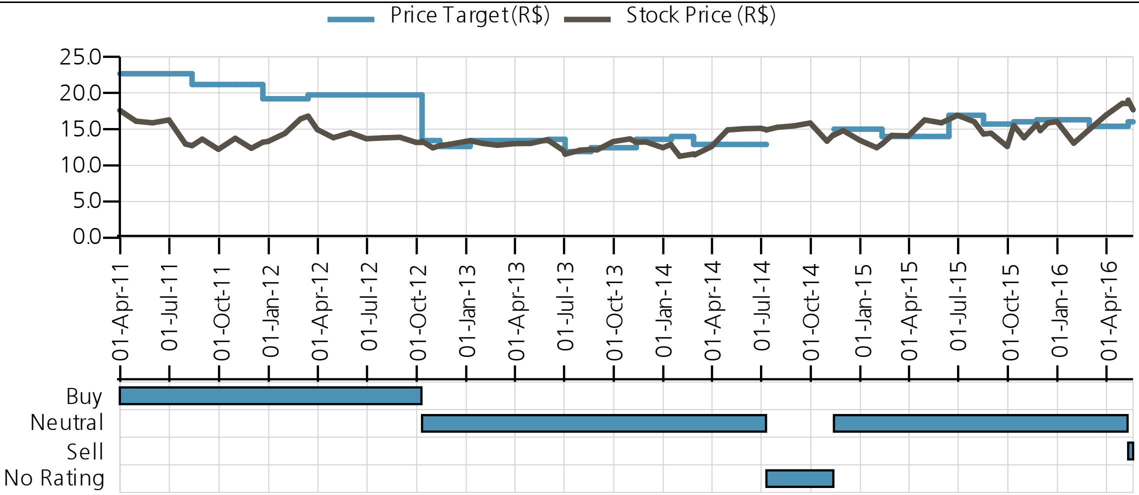

Source: UBS; as of 20 May 2016

**Itau Unibanco (R$)**




Source: UBS; as of 20 May 2016

**Santander Brasil (R$)**

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