

Argentine Banks

Are we close to a turning point? Banks' sensitivity to rates and loan growth

Equities

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Macroeconomic data confirms challenging 2016 for banks

In our takeaway note on 1Q16 [Argentine banks](#) results, we flagged two triggers to become more positive on the Argentine banks: tamed inflation, and a pickup in loan demand. Over the past few days, the Argentine authorities published revised statistics. Inflation remains high, as per the reformulated Argentine CPI calculated by INDEC at 4.2% in May (L12M: 44%). Loan growth for April (latest data from Central Bank) was 32.6%, i.e. negative in real terms. INDEC also published today 1Q16 GDP growth at +0.5%yoy (-0.7%qoq). We have a cautious view on the sector ([Initiation on Arg Banks](#)), and prefer Galicia (Neutral), over Macro (Neutral), and Frances (Sell).

Deep dive into margins: sensitivity of earnings to rates and loan growth

The BCRA has lowered the Lebac rate by 725bps YTD to 30.75%. This will lead to lower margins at the banks, as securities income decreases. Securities income represented 1/3 of net interest income for the three banks in 2015. We estimate that **every 5% cut in Lebac rate translates into ~5% in lower EPS for banks**. Currently the sector has one of the highest NIMs in the world at 10.7% on average in 1Q16, and we expect a compression of 109bps over the next three years. At the same time, it is too early for the lower inflation to translate into higher loan growth. **Every 5% loan growth translates into ~11% change in EPS**. The Ministry of Finance and local banks expect inflation to go down to 20% by December 2016.

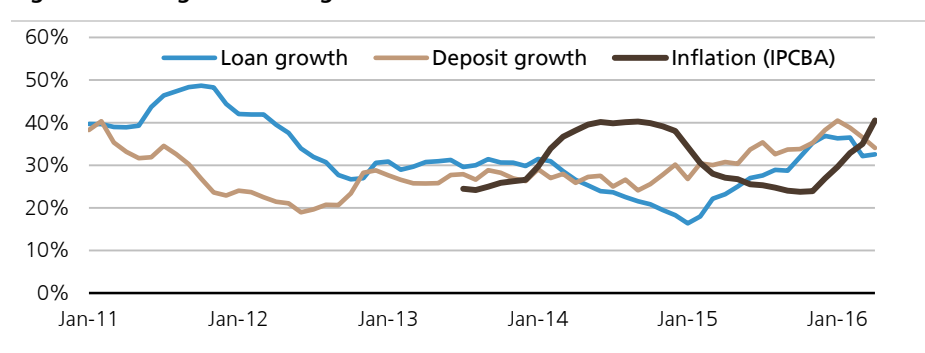
We remain cautious on the banks, until loan demand picks up

We forecast loan growth of 27% at the 3 banks under our coverage in 2016 (vs inflation of 33%), and 23% in 2017 (inflation of ~20%). We expect margin compression of 49bps in 2016 and 90bps in 2017, on average. Until loan growth picks up in real terms, we expect earnings growth to be below inflation levels. We expect operating expenses to remain high, as banks need to invest in their branch network. Asset quality should remain healthy in the system (NPL 1.9% in April). We forecast EPS growth of 23% in 2016 and 7% in 2017.

Valuation: cautious on Argentine banks; residual income-based

Argentine banks trade at 11x earnings and 3x 2016E book. **Key risks:** weaker growth, NIM contraction, [re-inclusion in the MSCI](#).

Figure 1: Loan growth is negative in real terms



Source: UBS, BCRA latest data as of April 2016

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Argentine Banks

UBS Research THESIS MAP MOST FAVORED

LEAST FAVORED

Grupo Galicia

Banco Macro, BBVA Frances

PIVOTAL QUESTIONS

Q: What external events could impact banks' stocks?

Flow events could impact banks' stocks, such as the MSCI re-inclusion of Argentina into the EM index, and the potential sale of ANSES shareholding. We expect limited new news on the banking regulatory front, as regulations have already been meaningfully relaxed in the past months.

["Strong play on the Argentine recovery and SME Finance, but margins at risk" 6/01/2016](#)

Q: What are the mechanics of economic normalization for the banks?

Decreasing inflation will go hand in hand with margin compression. Lower inflation will erode revenues from float (investing cheap deposits into high yielding securities), while funding will be less favorable. Banks will have to increase lending to offset the lower margins. Potential winners include banks with larger share of retail deposits and lower reliance on securities income. Lower margins will lead to consolidation as less efficient banks are forced out of business. A recent press article in La Nacion mentioned Citibank Argentina retail operations could be sold for US\$ 180mn – US\$ 250mn.

["Back in business, but challenges remain" 2/16/2016](#)

Q: Is the economy helping the banks?

The macro scenario remains challenging. With policy rates (Lebac) at 30.75%, inflation at close to 44%, the transition to a normalized economy bears challenges despite meaningful successes (FX liberalization, holdouts, normalization of banking regulations). Meetings with local players suggest that the consumer should be weak in the medium term, and corporate investing could take some time to pick up. Despite a low banking intermediation (loans/GDP at 13%), it could be 18 months before the banking sector grows in real terms. In the meantime, margins should compress from abnormally high levels.

["How are the Argentine banks coping with the Macro-economic normalization" 5/11/2016](#)

WHAT'S PRICED IN?

Current valuations price in a strong rebound in lending and lower cost of equity. During 2015, Argentine ADRs outperformed (+47% vs. -24% for MSCI EM Banks) on the biggest decrease in cost of equity assumptions among EM banks. Markets currently price in a COE for Argentine banks of 11% (second-best in LatAm after Mexico), down from 20% at the beginning of 2015, and ROE of 28%. Year-to-date, Argentine banks have underperformed, gaining 14% (MSCI LatAm Banks +46%). Arg banks trade on 11x 2016 EPADR and 3x book.

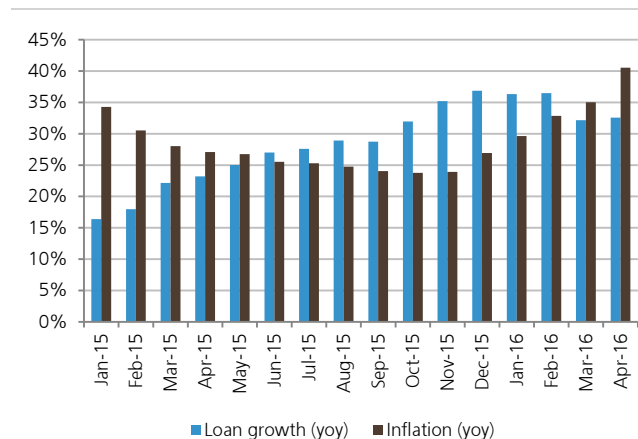
UBS VIEW

2016-17 will be transition years. Macro normalization is good in the long term but means banks need to adapt their business models. Banking intermediation will rise but we caution that it will come at the cost of lower margins. In 2016-17, real gains (above inflation) will probably be limited.

EVIDENCE

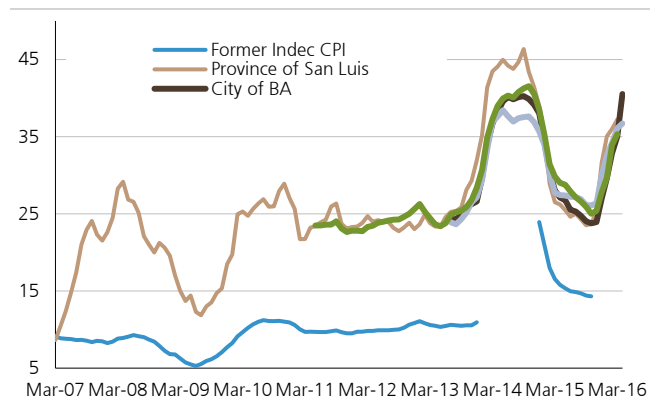
Margins are among the highest in the world due to inflationary distortions. Galicia is better positioned due to its network in the provinces and reliance on fees. Macro has a large network and focus on the underserved SME finance segment but depends heavily on securities income. Frances has lost lending market share and has a larger reliance on securities income.

Figure 2: Argentine system Loan growth (yoy)



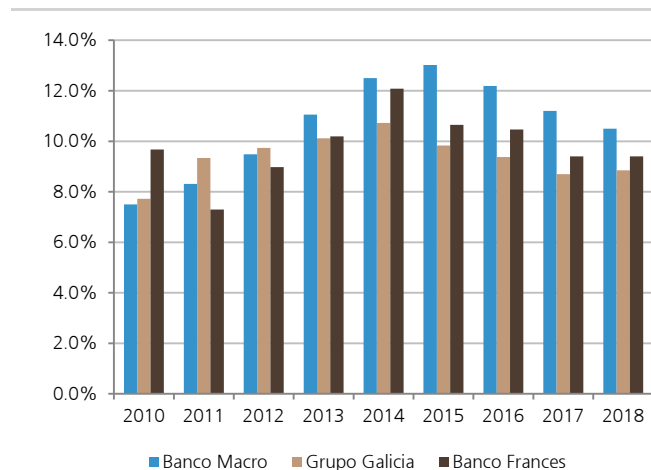
Source: BCRA and Ciudad

Figure 3: Argentine inflation remains high



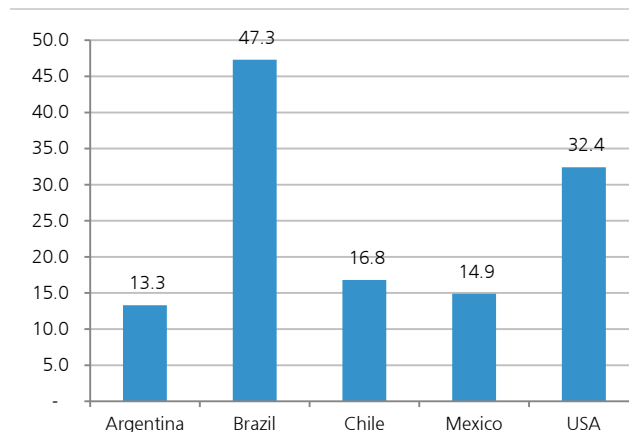
Source: Haver, Ciudad, UBS

Figure 4: Margins remain at risk: NIM compression of 109bps in the coming 3 years



Source: Company data, UBS estimates

Figure 5: Limited operating leverage (commercial bank branches per 100,000 adults in 2015)



Source: World Bank

Figure 6: LatAm valuations table

BANKS	Ticker	Rating	Price (local)	Target price	Target	Mkt Cap (US\$ mn)	EPS		P/E		P/BV		Adj. ROE (%)		Dividend Yield
				(local)	upside (%)		2016E	2017E	2016E	2017E	2016E	2017E	2016E	2017E	
Banco do Brasil	BBAS3.SA	Sell (CBE)	16.0	16.0	-0.2	13,890	3.1	3.8	5.1	4.2	0.5	0.5	10.8	12.1	5.2
Bradesco	BBDC4.SA	Neutral	24.5	27.5	12.5	41,060	3.0	3.2	8.3	7.7	1.3	1.2	17.3	16.5	4.4
Itaú Unibanco	ITUB4.SA	Buy	29.0	36.0	24.3	53,278	3.4	3.8	8.6	7.7	1.5	1.3	18.4	18.6	4.7
Santander Brasil	SANB11.SA	Sell	17.4	16.0	-7.8	19,851	1.4	1.6	12.2	10.6	1.1	1.1	9.6	10.7	5.9
BTG Pactual ⁽¹⁾	BBTG11.SA	Not Rated	17.5	n.a.	n.a.	4,672	4.6	4.3	4.0	4.2	0.8	n.a.	n.a.	n.a.	-
Banrisul ⁽¹⁾	BRSR6.SA	Not Rated	8.1	n.a.	n.a.	1,005	1.6	1.8	4.9	4.4	0.5	0.5	12.0	11.3	-
Brazilian Banks						133,756	3.0	3.3	8.5	7.6	1.3	1.1	15.3	15.4	4.6
Gentera	GENTERA.MX	Neutral	32.0	38.0	18.8	2,800	2.3	2.5	14.2	12.6	3.2	2.8	22.4	22.0	1.2
Banorte	GFNORTEO.MX	Buy	97.1	109.8	13.1	14,292	7.0	8.2	13.9	11.9	1.8	1.6	13.8	14.4	1.6
Inbursa	GFINBURO.MX	Buy	30.0	47.0	56.8	10,614	2.2	2.5	13.9	12.0	1.7	1.6	12.9	13.5	2.4
Santander Mexico	SANMEXB.MX	Buy	31.8	35.6	11.8	11,455	2.3	2.5	14.1	12.9	1.7	1.6	12.8	13.0	3.3
Banregio	GFREGIOO.MX	Buy	99.1	115.0	16.1	1,725	6.4	7.2	15.5	13.8	2.6	2.3	17.8	17.8	1.9
Unifin	UNIFINA.MX	Buy	45.9	62.0	35.1	859.5	3.3	3.9	14.1	11.7	3.3	2.9	24.7	26.0	1.8
Mexican Banks						41,745	4.0	4.7	14.0	12.3	1.9	1.7	14.3	14.7	2.2
Frances	BFR.N	Sell	20.5	21.0	2.6	3,662	1.6	1.4	12.5	14.6	3.0	2.5	29.1	23.2	1.6
Galicia	GGAL.O	Neutral	29.9	36.0	20.5	2,869	2.9	2.7	10.3	10.9	2.7	2.2	33.3	27.9	3.7
Macro	BMA.N	Neutral	71.8	77.0	7.2	4,197	6.8	6.5	10.5	11.0	2.7	2.2	31.2	27.7	0.3
Bancolombia	CIB.N	Sell	34.4	30.0	-12.8	8,272	3.3	3.3	10.5	10.5	1.3	1.2	12.9	13.0	3.0
Davivienda	DVL.p.CN	Buy	27,180	34,000	25.1	4,039	3,640	4,031	7.5	6.7	1.2	1.1	17.4	17.0	0.0
Credicorp	BAP.N	Buy	149.3	155.3	4.0	11,905	11.9	13.0	12.5	11.5	2.2	1.9	19.7	20.0	2.4
Banco de Chile ⁽¹⁾	CHL.SN	Not Rated	69.8	n.a.	n.a.	9,909	5.6	6.1	12.6	11.6	2.5	2.3	22.2	19.7	5.0
Santander Chile	BSAC.K	Neutral	18.6	19.9	6.9	8,768	1.6	1.8	12.0	10.4	2.0	1.9	18.2	19.5	4.9
Andean Banks						53,620			11.5	11.0	2.1	1.9	21.0	19.8	3.1
Europe					24.2	900,388			8.2	7.3	0.6	0.6	8.6		
EMEA					13.2	261,715			7.1	6.0	0.9	0.8	14.3		
Asia (ex-Japan)					5.4	1,432,083			6.4	5.9	0.8	0.7	13.0		
Latin America					15.6	207,247			8.4	7.5	1.5	1.3	17.2		
Developed					21.1	2,267,006			8.9	8.0	0.7	0.7	9.3		
GEM					7.8	1,901,045			6.7	6.1	0.9	0.8	13.7		
Global Average						1,825,286			6.6	6.0	0.9	0.8	14.0		

Source: UBS and Bloomberg. (1) Bloomberg estimates. Price as of June 28th

Valuation Method and Risk Statement

LatAm financials' performance is closely linked to the local economic conditions and changes in interest rate and foreign exchange. Also, Latin American financials may be affected by changes in regulatory framework and the overall local competition and foreign competition.

We value Argentine banks based on a residual income model, using forecasted earnings to which we deduct a cost of equity. We define a sustainable return on equity and sustainable earnings growth. Our cost of equity is based on the long term risk free rate, to which we add a market risk premium multiplied by the stock's beta.

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Buy	FSR is > 6% above the MRA.	49%	32%
Neutral	FSR is between -6% and 6% of the MRA.	38%	26%
Sell	FSR is > 6% below the MRA.	14%	19%
Short-Term Rating	Definition	Coverage ³	IB Services ⁴
Buy	Stock price expected to rise within three months from the time the rating was assigned because of a specific catalyst or event.	<1%	<1%
Sell	Stock price expected to fall within three months from the time the rating was assigned because of a specific catalyst or event.	<1%	<1%

Source: UBS. Rating allocations are as of 31 March 2016.

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Banco Macro SA ¹⁶	BMA.N	Neutral	N/A	US\$71.80	28 Jun 2016
BBVA Banco Frances SA ^{5, 16}	BFR.N	Sell	N/A	US\$20.46	28 Jun 2016
Grupo Financiero Galicia SA ^{5, 16}	GGAL.O	Neutral	N/A	US\$29.88	28 Jun 2016

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

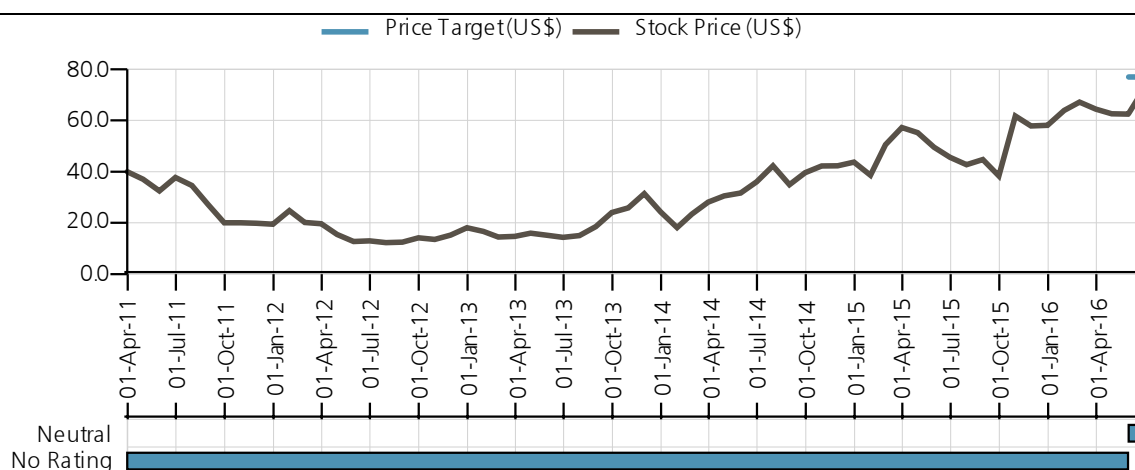
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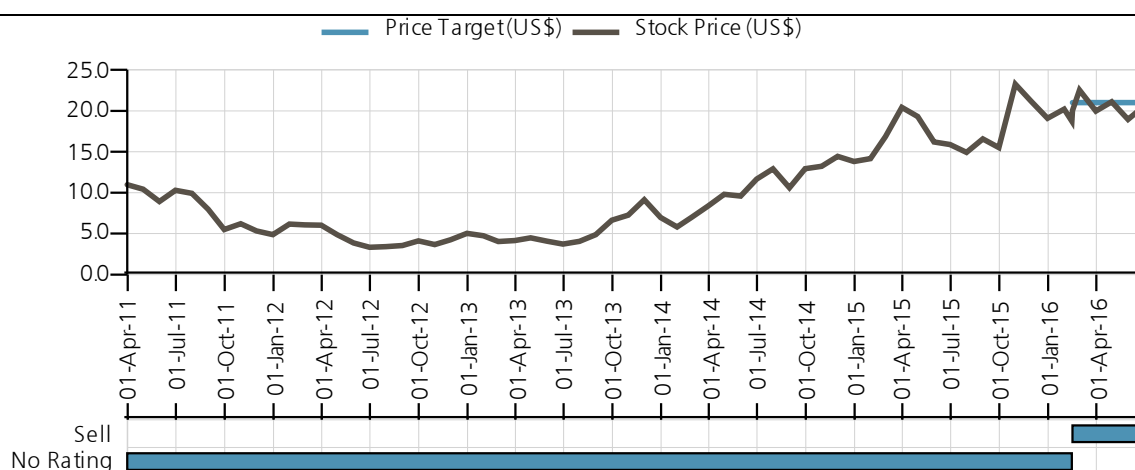
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Banco Macro SA (US\$)



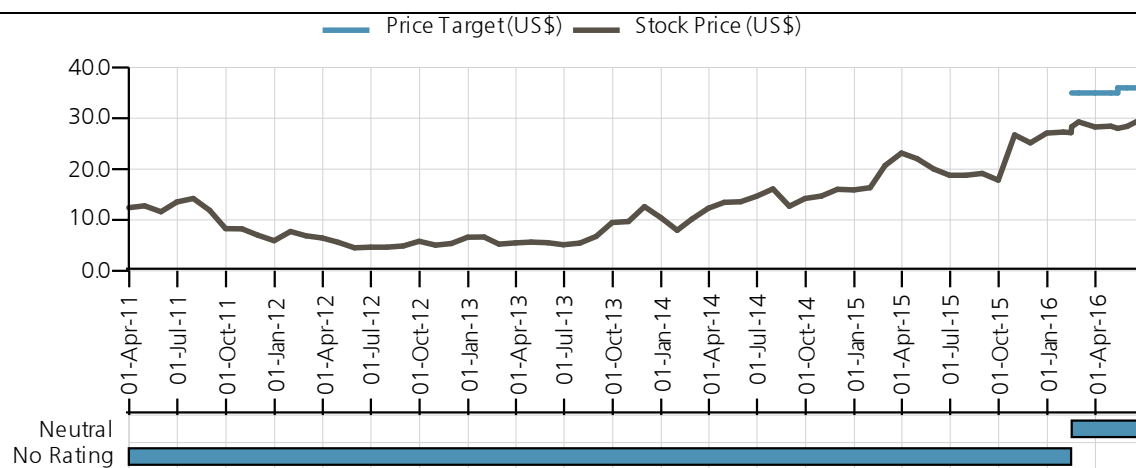
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