LatAm Financials Outlook 2016
Headwinds persist

Equities

Latin America
Financial

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GEM bank strategy: Underweight Asia; Neutral LatAm; Overweight EMEA

Given rising external risks (China growth worries, commodity price volatility and prospects of higher Fed fund rates), disappointing macro growth trends and negative earnings momentum (we have cut our 2016 EPS estimates 10.7% over the past year), we believe the near-term outlook for LatAm banks remains challenging. Instead, we prefer LatAm non-bank financials, given their defensive characteristics (earnings resilience, revenue diversification) and supportive valuations.

Overweight Mexico; neutral Brazil; prefer Colombia in Andeans

We are positive on banks in Mexico (early-cycle characteristics such as robust loan growth and improving asset quality). We remain neutral in Brazil, with a preference for private banks (NPL buffers) over public (asset quality risk) and prefer Colombia (valuation support) over Peru (MSCI overhang) and Chile (regulatory risk). Key themes for 2015 are: 1) external risks; 2) credit demand disappointments; 3) asset quality; and 4) sector consolidation.

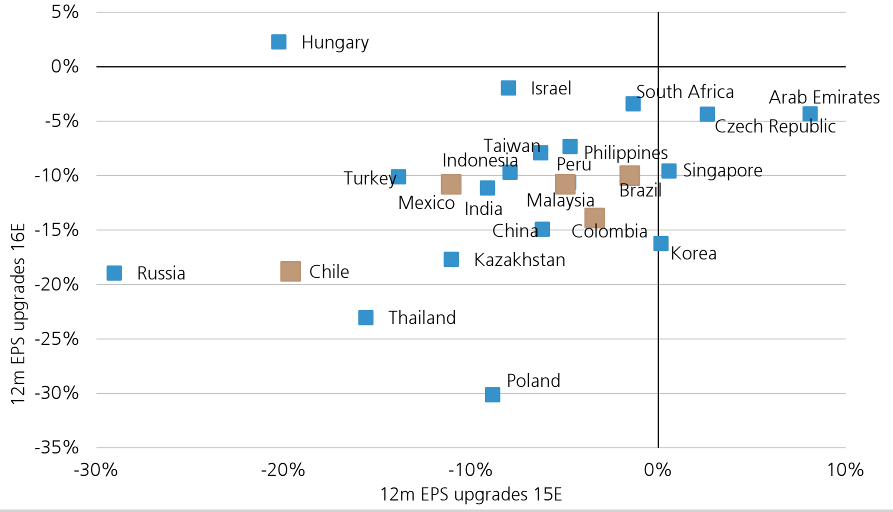
We remain positive on non-bank financials: focus on cost controls

For the third straight year, we prefer non-banks over banks in Brazil. In Mexico, we prefer banks over Bolsa. In 2015, Brazilian non-banks held up relatively well. Volume growth could be stable to slightly down YoY, but still positive. We do not expect meaningful margin pressure for the dominant players. The main themes for 2016 are: 1) earnings resilience; 2) margins; 3) competition; and 4) regulatory risk.

LatAm financials: Top picks and least preferred names

For **banks**, Banco do Brasil remains our least preferred bank in Brazil (asset quality). In contrast, our top banking Buys are Inbursa (retail growth expansion), Banorte (cyclical upside) and Itaú (balance sheet strength). For **non-banks**, our top picks are Cielo (resilient earnings; risks on costs) and BBSE (strong earnings growth, high ROE), with Cetip (risk/reward not attractive) and SulAmerica (expensive) our least preferred stocks.

Figure 1: EM banks: Changes to EPS estimates in past 12 months



Source: UBS estimates

UBS Research THESIS MAP

MOST FAVORED

Inbursa, Banorte, Itau, Cielo and BB Seguridade

LEAST FAVORED

Banco do Brasil, SulAmerica and Cetip

PIVOTAL QUESTIONS

Q: How bad will the asset quality problem be for Brazilian banks?

Given worsening macro conditions, NPL risk is still rising. We estimate the NPL ratio for banks under our coverage to rise from an estimated 3.1% at YE15 to 3.5% by YE16. Banks have prudently set aside more provisions with coverage ratio at 207% and a NPL buffer at 1.23% at 3Q15. For banks to post zero profits in 2016, we estimate NPLs would have to go up to by 516bp from the 2015 level, or to 8.3%.

Q: Can Andean banks perform with weaker commodity prices?

Further weakness in commodity prices could adversely impact credit demand and asset quality for Andean banks. Given the economic importance of commodities, a regression analysis shows a positive relationship between changes in oil price and Colombian banks (correlation score of 0.62) as well as between copper prices and banks in Chile (0.83) and to a lesser extent in Peru (0.38).

Q: What could be the implications from the sale of HSBC Mexico

In a recent report (click to see report), we valued HSBC Mexico, the 5th largest bank in Mexico with a 7.7% market share of assets, at US$4.5bn-5.9bn. The acquisition of HSBC Mexico by a local bank would further consolidate the sector potentially enhancing pricing power but could also lead to a meaningful capital raising by the successful bidder.

Q. What should happen for non-banks margins in 2016?

As volume growth remains below trend, sustaining margins remains a key focus for all companies. Controlling margins – through both pricing and cost control – will be more necessary than ever. We do not expect meaningful margin pressure for those dominant players.

WHAT'S PRICED IN?

Current valuations suggest the market is expecting a c24% fall in earnings.

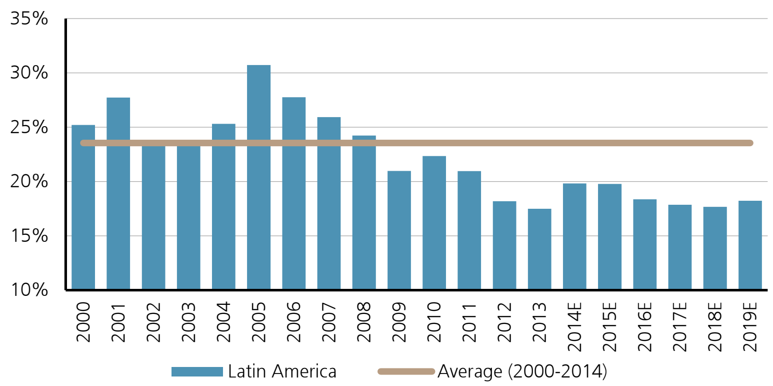
The market remains skeptical about the banks sector's earnings outlook for 2016: based on 1-year forward PE multiples, consensus is expecting a 23.8% fall in earnings to get back to long-run average valuations.

UBS VIEW

The outlook for banks remains challenging given the sector’s late-cycle characteristics in most LatAm banking sectors (i.e. falling loan growth and higher provisions) that are weighing on profitability and returns. Until we see evidence of positive earnings momentum, we maintain our neutral stance on the sector (we have cut our 2016 EPS estimates for LatAm banks by 10.7% over the past year).

EVIDENCE

LatAm banks' falling RoE expectations



Source: UBS estimates

Outlook 2016 – Summary

2015 sector performance

Weak performance for LatAm banks in 2015

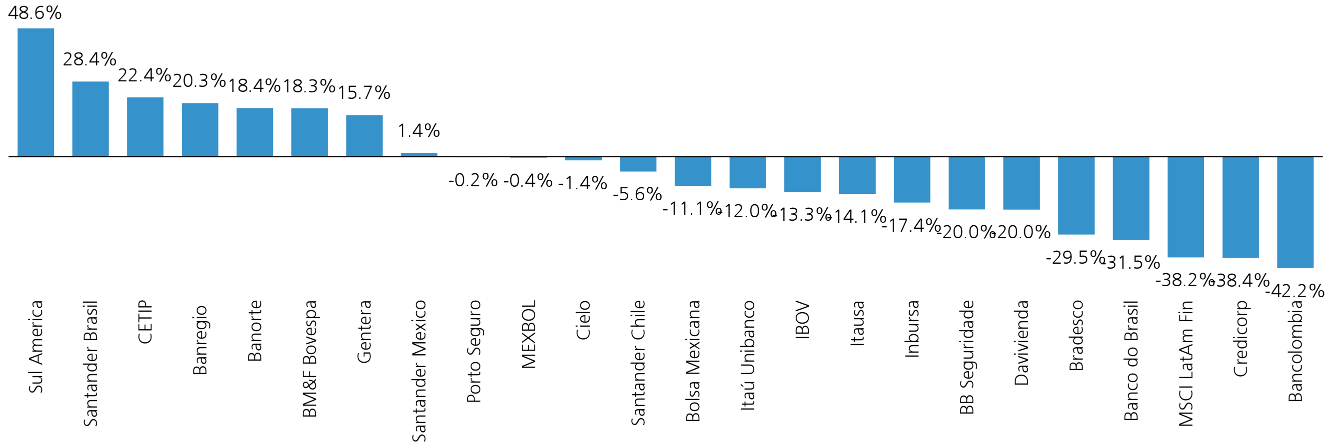
LatAm banks had a poor 2015: the sector was down 23.4% in US dollar terms and down 8.7% in local currency. The sector underperformed emerging market (EM) banks by 2.3%in US dollar terms, although it did outperform EM banks by 3.8% in local-currency terms. Relative to LatAm equities, LatAm banks underperformed by 9.5%. A country breakdown shows negative performance in all countries. Chilean banks delivered the least negative performance (-5.6% in US dollars), while bank performance in Colombia was the weakest (-41.0% in US dollars). Banks in Mexico (-7.8%), Peru (-38.4%) and Brazil (-40.5%) all posted negative performances.

At the stock level, Santander Brasil (28.4% in local currency), Banregio (20.3%) and Banorte (18.4%) were the best-performing LatAm banks, while Bancolombia (-42.2%) was the weakest performer due to a slower macro outlook, asset quality risk and negative earnings momentum.

LatAm non-bank performance was generally positive

For LatAm non-bank financials, 2015 was generally positive, as they outperformed banks, supporting our overweight stance on the segment based on earnings resilience, a lower impact of higher CSLL in Brazil, good dividend payouts and limited credit risks. The three best-performing stocks among LatAm non-bank financials were SulAmerica (+48.6% in local currency), Cetip (+22.4%) and BM&F Bovespa (+18.3%).

Figure 2: Stock performance (2015 – local currency)



Source: Bloomberg, UBS

Investment strategy for 2016

Neutral on LatAm banks

We are neutral on LatAm banks (within GEM) but continue to prefer non-banks over banks in 2016

We are underweight banks in global emerging markets, given rising external risks and deteriorating fundamentals (see our GEM Banks Outlook 2016 publication). Within a GEM banking context, we have a neutral stance on LatAm banks, as we are underweight banks in Asia/China and overweight those in EMEA.

Reflecting ongoing external uncertainties, disappointing macro growth trends and negative earnings momentum, we believe the near-term outlook for LatAm banks remains challenging. Instead, we prefer LatAm non-bank financials (overweight), given their more defensive characteristics and still supportive valuations. Challenges facing LatAm banks in the year ahead include:

- **External risks – continued worries:** We expect risk-aversion towards the sector to persist, given increasing uncertainties over Chinese growth and with further rate hikes by the Federal Reserve. On 16 Dec 2015, the Fed increased rates by 25bps. Our US economics team forecasts a cumulative 100bp rise in each of the next two years, leaving the funds rate at 2.38% by year-end 2017. Prospects of a new tightening cycle in the US could raise market concerns about liquidity outflow and FX volatility in emerging markets.

Another year of subdued GDP growth prospects

- **Domestic growth still under pressure:** Although our macro colleagues expect the global economy to grow 3.4% during 2016-17 versus an estimated 3.1% in 2015 (click for report), they expect economic growth in LatAm to remain at a below-trend growth level over the next two years. In Brazil, we forecast another year of economic recession, while in the Andeans, persistent weakness in commodity prices could further weigh on growth expectations. The key exception is Mexico, where stronger US growth and the impact of structural reforms domestically should further underpin GDP growth.

Figure 3: LatAm GDP growth outlook

	2014	2015E	2016E	2017E
Brazil	0.1%	-3.6%	-2.8%	0.7%
Chile	1.9%	2.0%	2.5%	3.0%
Colombia	4.6%	2.6%	2.8%	3.2%
Mexico	2.1%	2.3%	2.7%	3.2%
Peru	2.4%	2.8%	3.4%	4.0%

Source: UBS estimates

- **Asset quality:** Given Brazil's precarious macro outlook, we forecast NPLs rising to 40bps in 2016, having gone up by an estimated 40bps in 2015. We see the highest credit risk for public banks that rapidly grew loans in recent years, while private banks' elevated NPL buffers may help offset the provisioning burden. Elsewhere, the asset quality outlook is mixed. In Mexico, we are likely to see further improvements as the economy picks up and given the sector's early stage of the credit cycle. In the Andeans, persistent weakness in commodity prices and the impact of El Niño could weigh on asset quality.

Over the past year, we have lowered our 2016 LatAm bank EPS estimates 10.7%

- **Negative earnings momentum:** LatAm banks' earnings have moved into negative territory. Over the past year, we have lowered our 2016 LatAm bank EPS estimates 10.7%. That is compared to LatAm non-bank financials, where we cut our 2016 EPS estimates just 1.0%. The 2016 EPS cuts largely come from

the Chilean banking sector (-18.8%), followed by Colombia (-13.7%) and Mexico (-10.8%).

Figure 4: EPS 2016E revisions since start of 2015

EPS revision since 1-jan-15	2016E EPS
LatAm banks	-10.7%
Non-bank financials	-1.0%
LatAm Financials	-8.8%

Source: UBS estimates

Despite earnings downgrades, valuations appear to be fair rather than expensive

- **Valuations appear to be pricing in these risks:** Despite negative earnings revisions and lower sector ROE expectations, we believe LatAm banks' valuations are fair rather than expensive. The sector currently trades on 6.9x PE and 1.3x P/BV, with ROE at 18.4% on our 2016 estimates. We are unlikely to turn constructive on LatAm banks until we see evidence of positive earnings momentum.

Overweight on non-bank financials

For non-bank financials, we prefer insurance and cards over exchanges

We reiterate our positive stance on non-bank financials. We continue to prefer defensive segments (insurance, cards) but are becoming incrementally more positive on exchanges due to more attractive valuation and revenue diversification.

- **Resilient earnings make non-banks a defensive investment:** We continue to prefer companies with specific earnings drivers and limited exposure to the macro situation. For Cielo, revenue diversification should benefit from still-good growth in POS rental and prepayment. However, the secular theme of substitution of cash by other payment methods could decelerate with mounting fiscal pressure and informality. Therefore, we expect weak card growth but strong ancillary revenue at Cielo. For BBSE, earnings growth may come from an increase in the penetration of insurance products in BB's client base.

LatAm non-bank financials offer attractive growth-adjusted valuations

- **Valuation still supportive:** Most non-bank financials trade at a discount to global peers on a pure PE basis and are more attractive on a PEG basis (ie, when we adjust valuations for growth). LatAm insurance companies trade on 9.1x P/E 16e vs. 10-16x for EM peers. Cielo trades on 16.8x P/E 16e vs. 17-20x for US acquirers. In the case of exchanges, Bovespa trades on 10.1x P/E 16e vs. 20-36x for global exchanges.

- **Incrementally more constructive on exchanges but remain neutral.** We have an incrementally more positive view on **BVMF**, due to more attractive valuation and revenue diversification. In particular, ancillary revenue and derivatives have become the main drivers of revenue growth, ahead of equities. We view the current environment in Brazil as favourable for fixed income and private equity and challenging for public equities, with stable turnover and subdued volumes. Cost controls could disappoint in 2016 at BVMF, in our view. We remain cautious on **Bolsa de Mexico**, with impairment risk in the derivatives business and limited room to cut expenses. Two points where markets look overly negative: Bolsa's low guidance (we think the company is being too conservative) and competition risk (we think a potential new player is underestimating the difficulty of setting up a new exchange). For **Cetip**, the stock could trade sideways until we get more clarity on potential M&A – while we continue to see current valuation as rich and think the risk/reward is not attractive.

Figure 5: LatAm financials' investment strategy summary

Sector	Stance	Comments
Banks	Neutral	
Brazil	Neutral	Despite an uncertain GDP growth outlook and weak domestic credit demand, the sector's earnings have been relatively resilient. The sector is seeing higher NIM from loan book re-pricing but concerns over asset quality remain despite high NPL buffers. We prefer private banks in Brazil (Buy ratings on **Itaú** – top pick in Brazil – and **Bradesco**). **BB** (Neutral) is our least preferred stock. We also have a Neutral rating on **Santander Brasil.**
Mexico	Overweight	After three years of downturn, Mexican banks are undergoing an inflection point in credit demand that we expect to last for 2-3 years. Mexico's counter-cyclical characteristics may help sustain the recovery in asset quality; together with a margin tailwind from higher policy rates, they could underpin earnings momentum in the next few years. Top pick: **Inbursa** (Buy; high ROA). For large banks, we also have Buy ratings on **Banorte** (earnings growth) and **SanMex** (credit growth). For SME Finance, we have Buy ratings on **Banregio** (NIM rebound), **Gentera** (pricing power and growth potential) and **Unifin** (strong growth and improving NPLs).
Andeans	Neutral	External risks are likely to impact sector performance; persistent commodity price weakness could weigh on sector growth and sentiment but valuations are more supportive. Preference for Colombia (valuation support) over Peru (MSCI overhang) and Chile (regulatory risk). We have a Buy on **Bancolombia** (recently upgraded on valuation); **Davidienda** (favourable earnings growth outlook); and **Credicorp** (current valuations pricing in MSCI overhang). Neutral: **SanChile** (regulatory risk).
Non-banks	Overweight	
Exchanges	Neutral	Stable competitive pressure, top-line growth in the medium term and operating leverage. **Bovespa** (Neutral): Another challenging year for equities; derivatives and ancillary should do well. Equities will benefit from clearing integration only in 2017. Cost controls could disappoint in the medium term and improve in 2017. **Cetip** (Sell): No trigger in the short term; limited room to further increase pricing in auto segment; and exposed to weaker macro through its auto financing unit. M&A would be the main driver for the stock price. **Bolsa de Mexico** (Neutral): Risk of another annual impairment in derivatives and still weak volume in derivatives. Overdone risks: Low guidance (we think the company is under-promising) and competition.
Acquirers	Overweight	Buy on **Cielo** (Strong volume growth, resilient earnings in the current challenging macro outlook and controlled risks), potential risks revolve around cost controls and integration of Cateno (growth is below expectations).
Insurance	Overweight	Positive trends (high EPS growth, earnings resilience and rising ROE); beneficiaries of higher interest rates. Top pick: **BB Seguridade** (strong earnings growth; higher ROE); Neutral on **Porto Seguro** (auto insurance resilience but expensive) and Sell on **SulAmerica** (challenging outlook).

Source: UBS estimates

Valuation methodology

Our valuation methodology for banks is based on a Gordon growth model, which assumes for Brazilian banks average sustainable ROE of 17.6%, average COE of 16.0% and a growth factor of 9.5%. For Mexican banks, our valuation methodology assumes average sustainable ROE of 19.1%, COE of 10.4% and a growth factor of 5.9%, while for Andean banks, ROE is 16.0%, COE is 12.0% and the growth factor is 5.4%. Since our price targets look one year forward, we use our 4Q16 BVPS estimate as the basis for deriving our price targets. Based on consensus estimates, LatAm banks are trading 23.8% below the historical 1-year forward PE of 10.1x (Figure 7).

Implied COE for Brazilian (16.2%) banks is the second highest after that for China (18.5%) and well above the EM banking average of 13.5%

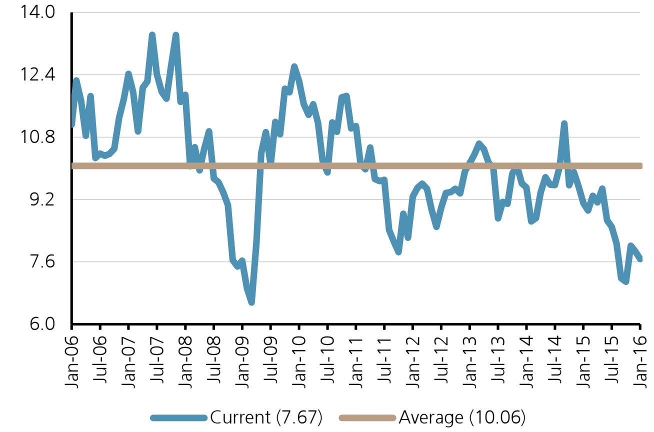
The non-bank financials we cover trade at 8-17x 2016E earnings. We value the exchanges and Cielo with a discounted cash flow analysis, assuming WACC of 11.3-16.7%. We value the insurers with a residual income model, assuming average COE of 14.6%. We think businesses that are less capital intensive, such as some non-bank financials, may have a lower COE.

Figure 6: Valuation summary

	Ticker	Rating	Price (LC)	Price Target (LC)	Mkt Cap (USD millions)	P/E 2016E	P/E 2017E	P/BV 2016E	P/BV 2017E	ROE (%) 2016E	ROE (%) 2017E	EPS 2016E	EPS 2017E	Dividend Yield 12-month Fwd (%)
Brazilian Banks														
Banco do Brasil	BBAS3.SA	Neutral (CBE)	13.95	20.00	9,932	3.3x	3.0x	0.4x	0.4x	14.2	14.3	3.96	4.11	12.1
Bradesco	BBDC4.SA	Buy	18.04	30.80	22,631	5.0x	4.6x	0.9x	0.8x	19.1	18.4	3.04	3.51	7.0
Itau Unibanco	ITUB4.SA	Buy	24.77	38.00	37,445	6.1x	5.6x	1.2x	1.1x	21.6	20.2	3.39	3.96	5.8
Santander Brasil	SANB11.SA	Neutral	13.71	16.30	12,947	8.5x	7.8x	0.9x	0.8x	10.2	11.0	1.21	1.43	7.0
Mexican Banks														
Banorte	GFNORTEO.MX	Buy	88.85	105.60	13,739	12.1x	10.1x	1.6x	1.4x	14.0	14.9	5.49	6.20	1.4
Banregio	GFREGIOO.MX	Buy	85.42	102.00	1,562	14.4x	12.3x	2.4x	2.1x	17.4	18.0	5.01	5.31	0.0
Gentera	GENTERA.MX	Buy	30.52	34.00	2,805	13.4x	12.2x	3.0x	2.6x	24.6	22.9	1.90	1.96	1.2
Inbursa	GFINBURO.MX	Buy	28.70	47.00	10,669	12.4x	11.2x	1.6x	1.5x	13.7	13.8	2.06	1.77	2.1
Santander Mexico	SANMEXB.MX	Buy	28.25	33.50	10,675	12.0x	10.5x	1.6x	1.4x	13.6	14.3	2.07	2.03	3.6
Unifin	UNIFINA.MX	Buy	53.38	62.00	1,050	17.1x	14.0x	3.8x	3.3x	24.1	25.3	4.31	2.34	1.5
Andean Banks														
Bancolombia	CIB.N	Buy	25.50	30.80	6,132	6.4x	6.1x	0.9x	0.8x	12.6	12.7	5.53	3.83	4.9
Credicorp	BAP.N	Buy	89.48	149.50	7,137	6.6x	6.0x	1.3x	1.1x	19.7	19.1	10.55	12.25	4.1
Davivienda	DVI_p.CN	Buy	21,420	30,000	2,913	6.9x	6.2x	1.0x	0.9x	15.2	15.2	2,391	3,064	0.0
Santander Chile	BSAC.K	Neutral	16.74	19.80	7,887	9.8x	8.1x	1.9x	1.7x	17.9	19.9	2.05	1.49	0.0
Holdings														
Itausa	ITSA4.SA	Buy	6.67	10.50	11,202									
	Ticker	**Rating**	**Price (LC)**	**Price Target (LC)**	**Mkt Cap (USD millions)**	**P/E 2016E**	**P/E 2017E**	**EV/EBITDA 2016E**	**EV/EBITDA 2017E**	**ROE (%) 2016E**	**ROE (%) 2017E**	**EPS 2016E**	**EPS 2017E**	**Dividend Yield 12-month Fwd (%)**
Exchanges														
BM&F Bovespa	BVMF3.SA	Neutral	10.52	13.00	4,967	10.1x	8.9x	6.3x	5.2x	9.6	10.8	0.73	0.98	6.3
Bolsaa	BOLSAA.MX	Neutral	21.56	29.00	713	14.0x	12.6x	7.6x	6.8x	16.0	17.1	0.84	1.38	5.4
Cetip	CTIP3.SA	Sell	36.59	34.00	2,334	16.3x	13.6x	10.6x	9.5x	33.2	36.5	2.08	2.33	3.9
Acquirers														
Cielo	CIEL3.SA	Buy	35.00	50.00	16,393	16.8x	14.6x	9.2x	8.1x	48.8	44.8	1.71	1.86	1.8
Brazilian Insurers								**P/BV**						
BB Seguridade	BBSE3.SA	Buy	23.59	37.00	11,723	11.0x	9.5x	4.5x	4.0x	43.7	45.1	1.61	2.00	7.3
Porto Seguro	PSSA3.SA	Neutral	27.23	36.00	2,188	8.2x	7.4x	1.3x	1.3x	18.9	19.3	2.73	3.16	6.9
Sul America	SULA11.SA	Sell	17.78	18.80	1,505	8.1x	7.2x	1.3x	1.1x	16.2	16.5	1.61	2.15	4.9

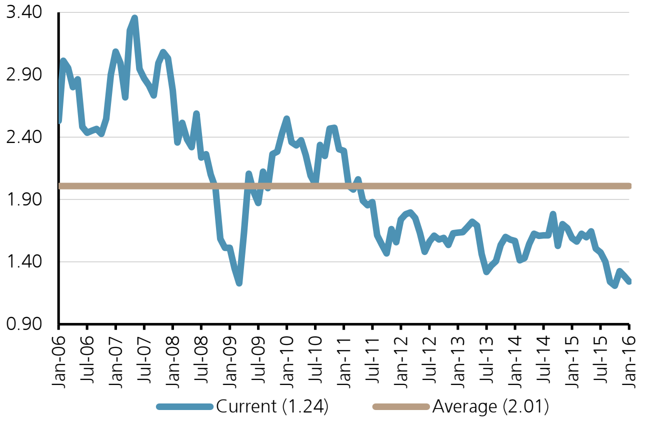
Note: Current prices as of 08 Jan 2016.
Source: UBS estimates

Figure 7: LatAm banks – consensus 1-year forward PE



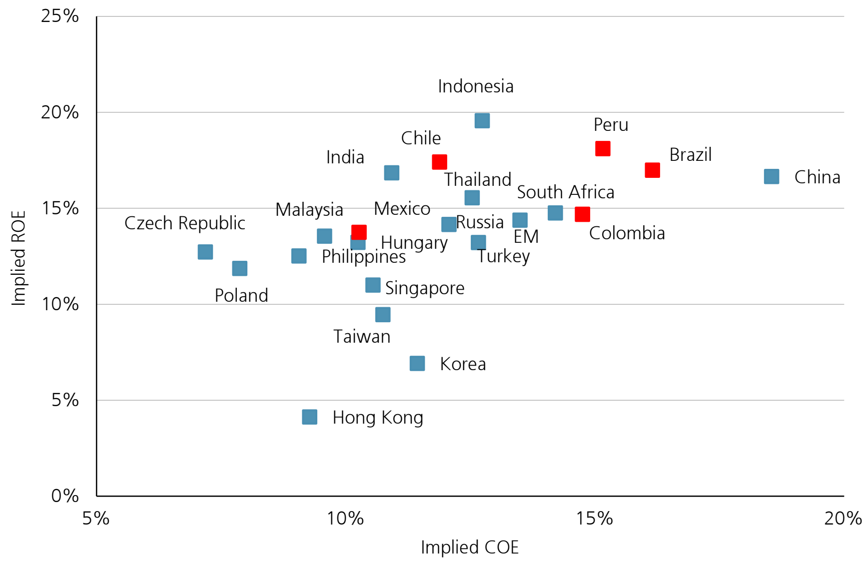
Source: I/B/E/S; Thomson Reuters DataStream; UBS

Figure 8: LatAm banks – consensus 1-year forward PBV



Source: I/B/E/S; Thomson Reuters DataStream; UBS

Figure 9: EM banks' implied COE vs. implied ROE



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

UBS vs. consensus

Our earnings forecasts for Brazilian banks are now 7.8% above consensus estimates for 2016 and 4.3% above for 2017. For Mexican banks, we are 0.7% below consensus estimates for 2016 and 1.8% below for 2017, while for Andean banks, we are 2.6% below consensus estimates for 2016 but 0.5% above for 2017. For non-banks, our estimates are 1.7% below consensus for Brazilian companies in 2016 and 0.3% below in 2017. For Bolsa, we are 1.5% above consensus in 2016 and 1.2% in 2017.

Figure 10: UBS vs. consensus

	UBSe		Consensus		UBSe vs. Cons.	
	2016	2017	2016	2017	2016	2017
Brazilian Banks	**13.52**	**14.70**	**12.54**	**14.10**	**7.8%**	**4.3%**
Banco do Brasil	4.23	4.65	3.94	4.45	7.4%	4.6%
Bradesco	3.59	3.90	3.34	3.63	7.6%	7.4%
Itau Unibanco	4.09	4.39	3.80	4.19	7.7%	4.7%
Santander	1.60	1.77	1.46	1.83	9.5%	-3.5%
Mexican Banks	**23.38**	**27.28**	**23.55**	**27.78**	**-0.7%**	**-1.8%**
Banorte	7.34	8.78	7.21	8.43	1.8%	4.1%
Banregio	5.95	6.92	6.28	7.44	-5.3%	-7.0%
Gentera	2.28	2.51	2.21	2.50	3.2%	0.3%
Inbursa	2.32	2.57	2.19	2.47	5.8%	4.1%
Santander Mexico	2.36	2.68	2.41	2.86	-2.1%	-6.0%
Unifin	3.13	3.82	3.25	4.08	-3.7%	-6.4%
Andean Banks						
Bancolombia	3.95	4.16	4.21	4.58	-6.0%	-9.2%
Davivienda	3,102	3,461	3,045	3,327	1.9%	4.1%
Credicorp	13.47	14.93	13.56	15.28	-0.7%	-2.3%
Santander Chile	1.71	2.06	1.82	1.88	-5.8%	9.5%
Non-banks						
BB Seguridade	2.15	2.49	2.18	2.47	-1.4%	0.7%
Porto Seguro	3.33	3.66	3.38	3.72	-1.5%	-1.6%
Sul America	2.20	2.46	2.30	2.56	-4.5%	-3.6%
BM&F Bovespa	1.04	1.18	1.03	1.14	1.5%	3.7%
Bolsaa	1.54	1.71	1.52	1.69	1.5%	1.2%
Cetip	2.25	2.69	2.22	2.55	1.1%	5.7%
Cielo	2.08	2.39	2.16	2.49	-3.7%	-4.0%

Source: UBS estimates, Bloomberg

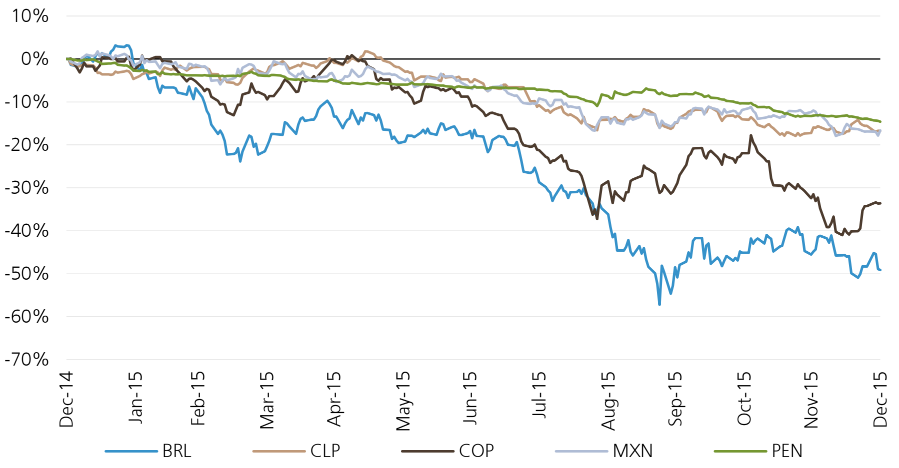
Key themes for 2016 – Banks

1. External risks

We expect risk-aversion towards the sector to persist, given ongoing uncertainties about Chinese growth and with further rate hikes by the Federal Reserve. On 16 Dec 2015, the Fed increased rates by 25bps. Our US economics team forecasts a cumulative 100bp rise in each of the next two years, leaving the funds rate at 2.38% by year-end 2017. In China, our economist is looking for GDP growth to weaken to 6.2% in 2016 and 5.8% in 2017, the lowest period of growth since 1990 (when GDP growth was 3.8%). Prospects of a new tightening cycle in the US and growth uncertainties in China could raise market concerns about liquidity outflows and FX volatility in emerging markets.

LatAm banks could be affected by another round of risk-aversion, given Chinese growth worries and Fed tightening

Figure 11: FX evolution by country



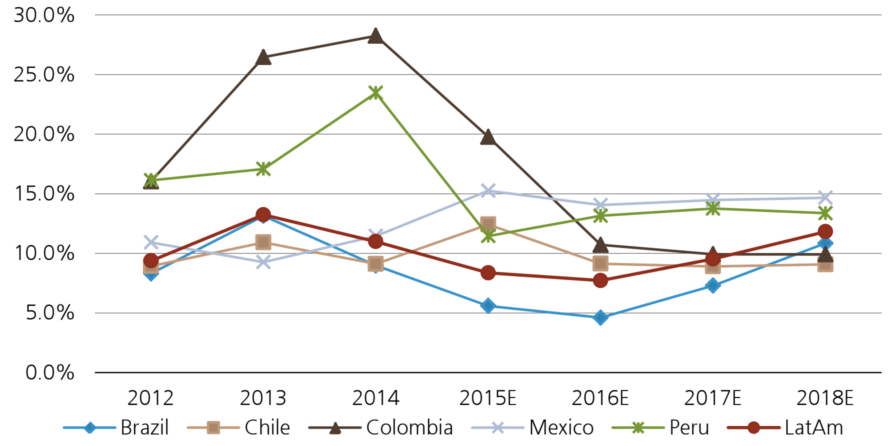
Source: Bloomberg

2. Credit demand – further disappointments?

Reflecting macro growth uncertainties, credit demand across LatAm could come under further pressure. Currently, we forecast loan growth for LatAm banks at 7.7% in 2016 versus 8.8% in 2015, with credit growth expected to be most subdued in Brazil at 4.6% in 2016 and most resilient in Mexico at 14.1%. In our 1Q16 banking survey (click for report), downside risk to loan growth over the next 12 months was expected in Brazil, Chile, Colombia and Peru. Only in Mexico was loan growth expected to surprise on the upside.

Our forecast for 7.7% loan growth for LatAm banks in 2016 is the lowest since 2009

Figure 12: LatAm bank loan growth trends (based on UBS coverage)



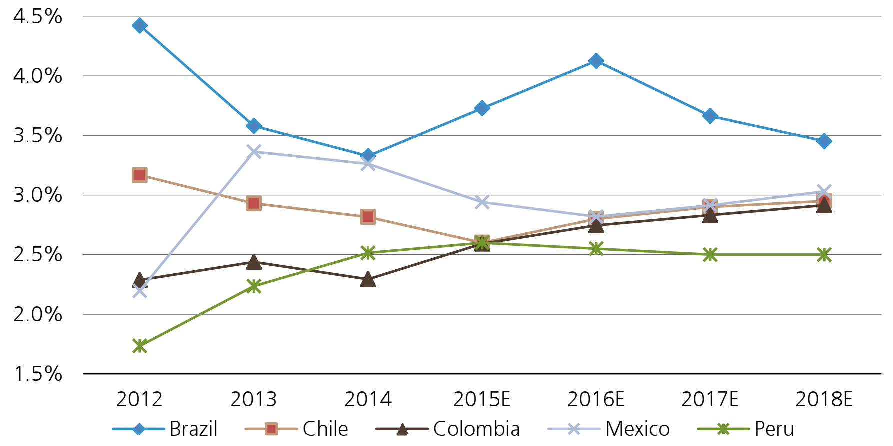
Source: UBS estimates

3. Asset quality – mixed trends

Asset quality risk is rising despite banks' elevated NPL buffers and coverage ratios

In Brazil, asset quality remains the main concern for the banking sector, given rising macro growth uncertainties. In recent quarters, banks have built up their coverage ratios (above 200%) and NPL buffers (at 123bps of loans at 3Q15). In our view, elevated coverage ratios/NPL buffers will enable banks to endure higher delinquencies without necessarily being hit by a sharp rise in loan-loss provisioning requirements. For banks under our coverage to post zero profits in 2016, we estimate NPLs would have to go up to by 516bp from the 2015 level, or to 8.3%.In contrast, the NPL ratio in Mexico has come down by 55bps over the past year and we expect it to improve further in 2016. Among Andean banks, further weakness in commodity prices alongside an adverse impact from El Niño could raise NPL risk.

Figure 13: NPL ratio evolution by country (2012-18E – based on UBS coverage)



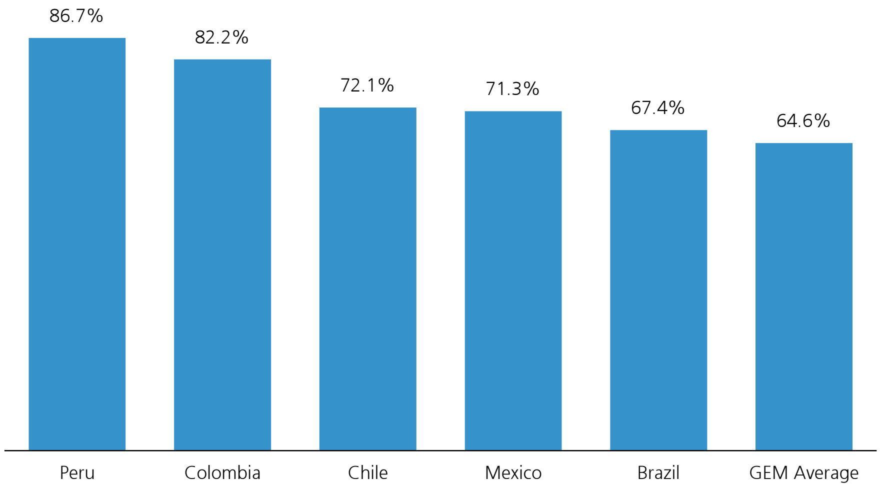
Note: Considers only the banks under our coverage.
Source: Banks and UBS estimates

4. Sector consolidation

We view a tighter industry structure as positive for incumbent players due to higher market shares and greater pricing power. In Brazil, we expect Bradesco to get full regulatory approval to acquire HSBC's local operations in Brazil, while BTG has also recently been selling non-core banking assets. In Chile, the industry structure should also tighten with the merger of Corpbanca and Itaú that is expected to be completed in March 2016 (all regulatory approvals have been received). In Mexico, the anticipated sale of HSBC Mexico to a local bank would consolidate the sector further this year.

We expect consolidation in Brazil, Chile and Mexico in 2016

Figure 14: Industry structure: Top 5 banks' market share of assets



Source: UBS estimates

Key themes for 2016 – Non-Bank Financials

Resilience of earnings remains key investment positive. Non-banks' earnings continue to be less impacted by the weak macro scenario, especially in the case of BB Seguridade and Cielo. Bovespa is the most exposed to macro weakness, although it is showing positive earnings momentum due to derivatives. SulAmerica also has exposure to weak macro that, combined with rising unemployment, could negatively impact the number of beneficiaries and premium growth.

As volume growth remains below trend, cost efficiency remains a key focus for all companies. We expect competitive trends and the regulatory environment to be stable in upcoming quarters.

1. Earnings resilience through diversification

Non-banks' earnings are less dependent on macro trends and have diversified their revenue

Non-bank financial companies we cover have **company-specific earnings drivers and have diversified their revenue (new products/markets)**. This limits their dependence on the weak macro environment in Brazil, although we recognize that they are not insulated from it.

For **insurers, BB Seguridade's** earnings growth is derived mostly from an increase in the penetration of insurance products in BB's client base. Looking at 2012-14, even with weak GDP growth, BBSE delivered growth of 31% per year, on average. At the same time, BBSE is less exposed to unemployment, as BB's client base has relative job stability (public employees). In terms of product diversification, BBSE may extend in 2016 the offer of a credit life product to other SME credit lines, as well as launching new products to the rural segment with higher margins. For **Porto Seguro**, historical data shows that despite weak GDP growth, auto insurance growth has been consistently strong, benefiting from low penetration levels. In terms of revenue diversification, the company has its virtual mobile operator and an independent service company, with revenue are still very concentrated in auto premiums.

In the case of **Cielo**, the company may continue to benefit from strong growth in POS rental and prepayments, while we expect another year of weak card growth in acquiring. We note that acquiring is just one-third of total revenue, which is often overlooked by markets. For acquirers, our proprietary analysis suggests new payment systems and new purchasing habits (e-commerce, e-wallet in particular) represent a tailwind for captured volume. Cateno (JV with BBAS active on the issuing side) is showing slower-than-expected growth but we expect some initial disclosure around synergies in 2016.

For **exchanges**, new products can help offset some of the weakness seen in equity volume. **Cetip** is developing new products, although guidance is still limited, including COE (structured operations certification) and the launch of CCP. In the financing unit, new initiatives include electronic formalization for auto loans; and a real estate platform for collateral management. We acknowledge those efforts but continue to believe markets are overpaying for the potential earnings uplift. For **Bovespa**, we highlight the initiative to develop capital markets by offering incentives for SMEs to list and increase ancillary revenue (especially sec lending, market data and treasuries trading).

2. Stable margins

Controlling margins – through pricing and cost control – will be more necessary than ever

We recognize the diversification of revenue; however, we flag that controlling margins – through pricing and cost control – will be more necessary than ever.

The main challenge for **Cielo** will revolve around cost controls. We do not expect irrational competition from either Itaú-Rede or Santander in the acquiring space. We also do not expect disruptive regulations that would pressure pricing in the acquiring space. Notably, Cielo has been focused on defending margins as opposed to focusing on market share, and we believe that is the right strategy. Therefore, the main challenge for Cielo will be to control costs. A series of new products and acquisitions have put pressure on efficiencies and we expect management to: 1) provide better guidance on costs (we find the current guidance on cost per transaction at the Cielo Brasil subsidiary of little help); and 2) better integrate the rich and diverse product offering. The payment industry requires high investments and Cielo is no exception to the rule, and we would welcome a path to improve the return of past investments.

For **exchanges**, pricing is usually a non-issue for the market, as dominant positions translate into limited pricing pressure in trading and registration. We also do not see regulatory oversight on pricing. On the cost side, we believe most of the low-hanging fruit in terms of efficiency gains at BVMF has been captured; therefore, we expect some cost growth acceleration in 2016, closer to inflation. Moreover, the end of some multi-annual projects (such as the clearing upgrade) suggests that some resources allocated under capex will be accounted again under operating expenses (opex) in 2016. We think cost controls will be a challenge at BVMF in 2016 and expect some slight margin pressure.

For **insurers**, we expect loss ratios in auto and health segments to deteriorate during the year on the back of the macro scenario, pressuring **Porto Seguro** and **SulAmerica's** margins. Insurers will need to focus on cost controls to reduce G&A ratios to offset the higher loss ratios. For **BB Seguridade**, with potential deceleration in premiums and contribution growth, management could focus on improving margins through: 1) focus on the bancassurance channel for life product; 2) launch of new products to the rural segment with higher margins to reduce the participation of crop insurance (low margin) in the mix; 3) upselling insurance products – BBSE may use propensity models to increase the average ticket; and 4) strong cost controls to reduce G&A expenses.

3. Regulatory risk

Key risks from regulatory changes and tax uncertainties

For **acquirers**, we expect a stable regulatory environment. The end of exclusivity for smaller brand networks in Brazil should be effective around 3Q16 (we believe the market expects it for 1Q16). Importantly, the 2015 annual Central Bank on the card sector did not bring any news on the regulatory front. While we believe the CB continues to analyse pricing trends in the sector, we do not expect action on the settlement period for credit (T+28) or on potential caps on debit MDR.

For **Bovespa**, our main focus is on taxes. The pending tax dispute relating to the tax benefit created by the merger of BM&F and Bovespa is ongoing at the administrative level and we expect no quick resolution. Notably, Bovespa has not provided for this risk, which is considered remote. Markets may watch potential provisions: when the case goes from the administrative court to a judicial court, Bovespa could be required to make a judicial deposit (potentially remunerated), which would impact its cash flow. As the fiscal situation in Brazil remains

challenging, we do not rule out further discussions about new taxes, potentially on the financial side (IOC, CPMF).

For **insurers**, in terms of capital requirements, a requirement for market risk was announced in December 2014 by the regulator. It is likely to be implemented in two phases: 50% of the requirement from 31 Dec 2016 to 30 Dec 2017 and 100% from 31 Dec 2017 on. Higher capital requirements could limit growth and reduce dividend payouts. However, we think the insurers we cover have relatively comfortable levels of capital adequacy.

4. Competition

Competitive pressures could weigh on margins but shift focus to costs

Market shares are becoming less relevant. Most companies we cover have a *de facto* monopoly or well established dominant position. As we mentioned, margins matter more than volume at this stage.

For **acquirers**, we have written repeatedly that markets needed to focus less on volume and more on pricing. Past regulatory changes have created a more level playing field for acquirers. This may facilitate market share gains for smaller players, notably Santander (~7% market share today). However, we still expect a benign environment, with Rede, the second largest player, maintaining a rational competitive stance. As Rede will be better integrated in the Itaú group, it could capture some market share away from Cielo, but we expect overall rational pricing behaviour.

For **exchanges**, competitive pressure is stable, with **Bovespa** remaining the de facto monopoly in Brazil for the foreseeable future, while **Bolsa in Mexico** is also a de facto monopoly. In Mexico, pressure from ADRs (NYSE volume) is stronger than in Brazil, where markets are deeper. We do not see the potential creation of a new exchange in Mexico as a credible threat. Conversely, Mexican markets have taken share away from banking intermediation, as rates remain at historical lows and companies have good access to capital markets. For **Cetip**, competition or integration (with Bovespa) will depend on ongoing M&A discussions. Therefore, we expect a stable competitive environment in the sub-sector.

In the current scenario of loan growth slowdown and asset quality risk, banks have been focusing on increasing service revenue, especially in the **card** and **insurance** segment. However, we think competitive pressure is still low in the main bancassurance segments (life, pension and premium bonds), as large portions of the population do not have multiple bank accounts. For the **auto segment**, some players are growing at much higher rates than the market average. In our view, higher rates and the recent improvement in loss ratios could allow players to be more aggressive in terms of pricing in 2016. However, we do not expect competition to be as aggressive as in the past, given the weak macro backdrop.

LatAm financials strategy

We prefer LatAm non-bank financials over LatAm banks

Given rising external risks and macro growth uncertainties, we recommend LatAm non-bank financials over LatAm banks. LatAm non-bank financials have more earnings resilience (Cielo and BBSE) and defensive qualities – we have a preference for insurance and cards but remain cautious on exchanges. In contrast, for LatAm banks, we maintain a neutral stance (within a GEM banking context), given the subdued macro growth outlook, weaker credit demand, NPL worries and negative earnings revisions, although valuations remain fair rather than demanding.

Below, we outline our investment strategy for 2016 for banks (by country) and non-bank financials.

Brazilian banks

We have a neutral stance on Brazil, with Itaú our top pick

We maintain our neutral stance on Brazilian banks at least until macro uncertainties start receding and there is evidence of NPLs/provisions peaking. With higher interest rates and lower competition from public banks, we continue to see the restoration of pricing power, with further upside risk to our NIM/earnings estimates. Brazilian banks have also set aside additional provisions, resulting in elevated NPL buffers and coverage ratios that may help absorb a higher provisioning burden. For banks under our coverage to post zero profits in 2016, we estimate NPLs would have to go up to by 516bp from the 2015 level, or to 8.3%. We have a clear preference for private banks, with Itaú our top pick, while Banco do Brasil (Neutral) is our least preferred name.

Itaú Unibanco (Buy) is our anti-consensus buy idea for 2016. Itaú has been prudently building up its NPL coverage ratio, with its NPL (90d) buffer at 2.3% (ie, NPLs could rise from 3.3% currently to 5.6% without Itaú necessarily having to make additional provisions). Fundamentally, the outlook remains supportive in terms of higher NIM from loan book re-pricing and cost discipline, while strategically, there's greater focus on geographical diversification to reduce dependency on Brazil. As such, we forecast ROE at 21.6% in 2016, one of the highest among EM banks. Itaú is our top pick bank in Brazil.

Bradesco (Buy) underperformed Itaú by 17.5% in 2015, widening the discount to ~17% vs. the historical average of 7%. There are concerns related to the HSBC acquisition in terms of ROE dilution (we estimate ~90bps), as well as lower tier I. It will be challenging for Bradesco to reduce the number of branches as well as headcount and to alleviate elevated cost pressure arising from the HSBC acquisition. On the other hand, Bradesco could continue to generate strong NII growth from further loan re-pricing and has built up a meaningful NPL buffer (175bps) in case asset quality deteriorates sharply.

Santander Brasil (Neutral): was the second best performing stock in our LatAm financial universe, with a performance of 28.4% (local currency) in 2015. As such, its valuation has become relatively less attractive, with the stock now trading on 8.5x PE and 0.9x PBV, with ROE at 10.2% on 2016 estimates. We expect credit growth to come down with ongoing macro uncertainties, while delinquency risk has been rising but remained under control, with the SME segment considered to be potentially the most vulnerable. We expect the bank to continue focusing on cost control, with opex expected to grow below inflation in 2016. Santander Brasil's ROE and ROA forecasts for the next couple of years are the lowest among the Brazilian banks we cover.

Banco do Brasil (Neutral) remains our least preferred bank in Brazil. Despite some margin recovery from higher spreads, rising asset quality risk could depress profitability and returns. We forecast BB's ROE to weaken from 14.8% in 2015 to 14.2% in 2016. Despite a slightly higher coverage ratio at 213%, BB's NPL buffer of 54bps (up from 22bps) still ranks the lowest among the banks we cover. Also, the core tier 1 ratio, at 8.1%, is low by GEM standards. Valuations appear to be depressed but also undermined by negative earnings momentum (in the past 12 months we've lowered 2016 EPS estimates 15.3%) and rising cost of equity.

Mexican banks

We stay positive in Mexico, with Inbursa our top pick

At a time when banks in emerging markets are seeing falling loan growth and rising NPL risks, banks in Mexico are among the few that have seen an inflection point in credit demand (with loan growth up from a trough of 8.2% in October 2014 to 13.3% in November 2015), as well as asset quality improvements (with the NPL ratio down 55bps over the past year). Alongside the sector's early cycle characteristics, rising policy rates domestically could provide a tailwind for margins, combining to boost earnings and ROE. We forecast sector EPS growth of 19.8% in 2016 (almost four times the EM banking average of 5.2%), with sector ROE rising to 14.0% from 12.9% in 2015. With that in mind, we reiterate our overweight stance on Mexican banks within a GEM and LatAm context.

Inbursa (Buy, UBS Key Call) is our top pick in Mexico (and a UBS Key Call). Following the acquisition of Banco Walmart, Inbursa's aggressive branch expansion will result in the number of branches rising to 900 by year-end from 384 in 2Q15, paving the way for rapid retail revenue growth from 2016 onwards. The bank is also well placed to benefit from lending growth related to major infrastructure projects (such as Mexico City's new airport). We forecast 2016 EPS growth at 30.6%, one of the highest among EM banks. With a recurring ROA of over 3.0%, Inbursa stands out as having some of the strongest earnings power among banks in emerging markets.

Banorte (Buy) is another Mexican bank that we like, as it is well positioned to benefit from acceleration in credit demand, rising rates, as well as improved cross-selling and efficiency upside (IBM alliance), with credit costs lower, culminating in 19.3% EPS growth in 2016E. Disposal of underperforming non-core assets such as its Texan bank could also boost earnings, with potential for further capital deployment. We have also been impressed by senior management (chairman and CEO) over the past year, as illustrated by the quality and performance of earnings results in recent quarters, and we believe there are sufficient corporate governance safeguards in place to maximise shareholder value.

Santander Mexico (Buy): Among the three large-cap Mexican banks, Santander Mexico is last in the pecking order of our Buy rated names. The fundamental upside is less clear-cut: fee growth has been more challenging than expected while the bank continues to be burdened by elevated levels of loan-loss provisions, with additional provisions expected to be set aside in upcoming quarters for two Mexican corporates: ICA and Avingola. However, credit growth has been impressive while costs are relatively under control and valuation remains supportive.

Gentera (Buy): 1H is seasonally weaker, with a slow start in lending origination and higher expenses (especially the newly implemented rebates to good clients).

Pricing power, loan growth potential and new products/new geographies offer upside. We do not expect a meaningful improvement in expenses, with a stable efficiency ratio in the mid-60% range. We remain positive on the ability of management to control asset quality. Finally, we see fee-related products (remittances, mobile payments, micro insurance) as the right strategy, but an earnings contributor only in the upcoming 3-5 years. We continue to like the bank's strong capital and funding base, along with its high and recurrent ROA, and we expect low- to mid-teen EPS growth in the upcoming 5 years.

Banregio (Buy) is a leader in SME lending markets in Mexico. Banregio is the most positively impacted by rising rates due to its fixed funding/variable rate asset base. We like the company's expertise in SME lending (85% of its loan book in SME) and outstanding trends in finding. We also acknowledge its strong management and asset quality (despite growth in new products, such as leasing). Opex controls could be a challenge as the company continues to grow in other regions.

Unifin (Buy) is the leading independent leasing company in Mexico. Unifin is a strong play on the SME finance opportunity (average ticket is $100k). It grew assets at 47% p.a. in 2010-14 and we see similar growth in 2016. The company's track record is impressive, with an average ROA of 3.7% in 2010-14, making it one the most profitable financials globally. Unifin is a non-bank financial institution (NBFI); its funding is wholesale-dependent and solid. Cost of funding could increase with rising rates but we see mitigating factors (change in mix). Finally asset quality is impeccable and supported by favourable regulations (Unifin keeps ownership title of leased assets). Strong outperformance in 2015 begs the question of valuation but we continue to like the name due to its growth potential. As a recently-listed company, Unifin will have to deliver on its guidance (especially on margins), while stock liquidity ($2m) remains a concern.

Andean banks

We are neutral on Andean banks, with a preference for Colombia over Peru and Chile

The performance of Andean banks in 2016 is likely to be impacted by external risks (China growth worries, volatility in commodity prices, as well as further US rate hikes). Further weakness in commodity prices could adversely impact credit demand and asset quality, while higher taxes are expected in Chile and Colombia. Given the economic importance of commodities, a regression analysis shows a positive relationship between changes in oil price and Colombian banks (correlation score of 0.62) as well as between copper prices and banks in Chile (0.83) and to a lesser extent in Peru (0.38). However, sector valuations in Colombia and Peru appear to be pricing in a lot of these risks. Within a LatAm context, we have a neutral stance among Andean banks, with a preference for Colombia (depressed valuations) over Peru (MSCI overhang) and Chile (regulatory risk).

Bancolombia (Buy): We recently upgraded Bancolombia to a Buy from a Sell (see report), as we believe that at current valuations, a weaker fundamental outlook is already priced in, with the stock trading on 6.4x PE, 0.9x PBV, with ROE at 12.6% on 2016 estimates. With higher Fed funds rates, we think there could be upside risk to NIM and earnings if domestic rates rise further. We also think the bank's capital position is understated, as retained earnings have yet to be incorporated and given the bank's higher risk weighted asset (RWA) density. Stock performance has been highly correlated to changes in oil prices (a correlation score of 0.68). While there could be further oil price volatility in the short term, our oil team forecasts the WTI price rising to an average of US$52.5 in 2016 (from US$33.97

currently), arising from an anticipated 40% capex reduction in 2015 and another 28% reduction in 2016 (see report). If oil prices reach UBS's forecast of US$52.5 (up 54.5%), CIB's share price could go up 47.8%.

Davivienda (Buy) is our most preferred pick in Colombia. Davivienda could continue to gain market share in Colombia, growing loans in the mid-teens, due to its expertise in the mortgage and SME segments. We also think markets are overdoing the capital shortfall at the bank, as capital ratios are understated in Colombia (we expect no capital raise in 2016). A potential increase in the VAT tax as early as 1Q16 could hurt the consumer segment; therefore, we expect more growth in the corporate segment. Notably, the bank has low exposure to the oil and gas industry. As the stock was excluded from the MSCI index in 2015, we expect no more technical adjustments. Key risks relate to the macro outlook, with potentially slower investment after 2016.

Credicorp (Buy): While de-dollarisation remains a key priority for policy makers, banks are likely to receive further central bank funding support in the form of repos. As such, we expect local currency loan-to-deposit ratios to remain elevated this year, although the unhedged FX credit exposure could come down. While funding costs are likely to rise, NIM will not necessarily come under pressure, given the loan mix shift from dollar into soles currencies. Mi Banco has also switched from the clean-up stage into a growth phase, with ROE of mid-20s expected by the end of 2016. Uncertainties over MSCI's decision on Peru's investment status could weigh on share price performance in 1H16.

Santander Chile (Neutral): Despite macro uncertainties (falling copper prices), cyclical headwinds and a rising tax burden, we expect the bank's underlying fundamentals to remain solid in the year ahead. We expect loan growth to moderate at high single-digits, while NIM could ease a little with lower inflation and the introduction of Basel III liquidity requirements. Asset quality appears to be holding up well, especially in the corporate sector, although banks will be hit by a one-time provisioning charge in the coming quarter for high loan-to-value mortgages. A new banking law on capital requirements is likely to align Chilean banks to global bank standards and could raise tier 1 capital ratios with lower risk weightings. With the stock trading on 9.8x PE, 1.9x PBV and ROE of 19.1% on 2016 estimates, we think Santander Chile is fairly valued.

Non-bank financials

We reiterate our overweight stance on non-bank financials, with BBSE and Cielo our top picks

For the third year in a row, we keep our overweight on non-banks in Brazil, especially given earnings resilience, with a preference for insurance and cards, while we remain cautious on exchanges. We maintain our Buy ratings on BB Seguridade and Cielo.

Cielo (Buy) presents a resilient earnings profile, driven by stable margin trends in card acquiring and revenue diversification (healthy growth in POS and prepayment). We expect weak card volume growth (0% credit cards, 10.8% in debit), although we think pricing will offset weak volume. The main challenges for the company in 2016 will be to integrate the many acquisitions and new products it has launched recently and to deliver revenue on them. Competition and the regulatory environment could be relatively stable in 2016. Risks in the short term include opex/capex pressure.

BB Seguridade (Buy, UBS Key Call). Despite positive earnings momentum and resilience, the stock underperformed other Brazilian insurers in 2015. We think the

stock is still a Buy, given: 1) the business is resilient to deteriorating macro (internal growth driver); 2) the client base, mainly formed by public employees, is less exposed to unemployment risk; and 3) rising rates could continue to have a positive impact on financial income, supporting earnings growth. Despite the challenging macro scenario and increased social contribution (CSLL), we believe BBSE can deliver ~8% earnings growth in 2016.

BM&F Bovespa (Neutral) may experience a disconnect between healthy revenue growth and weak valuation due to sentiment, as equities remain weak and the outlook is uncertain. Valuation has become more attractive; therefore, we are incrementally more constructive on the stock, although we maintain our Neutral rating. Bovespa will continue to trade based on IBOV/macro risks. While equity volume remains weak, derivatives have been strong and margins on derivatives have gone up. Ancillary revenue (sec lending, custody, treasuries) may continue to grow as a healthy pace (~20%). Efficiency could be a risk, as we see limited remaining low-hanging fruit and cost growth is accelerating.

Bolsa Mexicana (Neutral): EM equity volume could be supportive but derivatives still look like a missed opportunity. We remain concerned about a potential impairment test on the derivatives business. We also expect limited further cost-cutting, as most of the adjustment has been made. On the flip side, we think the market have over-reacted to the weak guidance (we think the company is under-promising) and competition risk (unlikely at this stage). While we recognize BMV's good dividend, we prefer to have exposure to Mexico via banks.

Porto Seguro (Neutral) had a good performance during 2015, with strong earnings growth underpinned by higher financial income, auto insurance premium resilience and an improving loss ratio. In our view, higher rates and the recent improvement in the loss ratio may allow players to be more aggressive in terms of pricing in 2016. However, we do not expect competition to be as aggressive as in the past, given: 1) the weak macro backdrop; and 2) FX weakness. Financial income could continue to benefit from a higher Selic rate. The stock seems fairly priced.

Cetip (Sell) may be impacted more than other financials from decelerating macro for two reasons: 1) one-third of its revenue is exposed to the auto financing sector; 2) we see limited room to increase pricing. We expect more guidance on the potential positive impact from mortgages, while we continue to believe markets are overpaying upfront for it. More positively, we recognize the resilient securities business. In the short term, the stock could trade based on M&A discussions and we see the current risk/reward as unattractive. We prefer to be positioned in the other financials.

SulAmerica (Sell) was the best performing stock under coverage in 2015 (up 48.6%). The outlook for SulAmerica is challenging. The weak macro scenario and rising unemployment could negatively impact premium growth. At the same time, FX depreciation, still-high medical inflation and unemployment could pressure claims.

Regional overview

Brazil

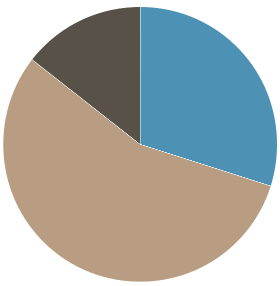
Macro outlook

We expect the Brazilian economy to contract by another 2.8% in 2016 (after a 3.6% contraction in 2015E). The lack of a fiscal anchor and political uncertainty will likely put pressure on the yield curve and FX, undermining consumption and investment, while fiscal adjustment could result in further taxes rises. We forecast inflation falling to 6.4% in 2016e from 10.6% in 2015e but unemployment rising to 11.1% in 2016YE from 7.5% in Nov-15, and assume the Copom will continue the tightening cycle, increase the Selic rate by 150bps in 2016 to 15.75%. We expect the BRL/US$ to end 2016 at R$4.30.

Bank fundamentals

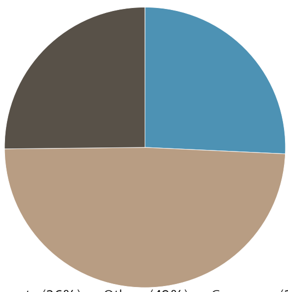
Given the worsening macro outlook, we expect loan growth to decelerate to 6.8% in 2016 from 7.2% in 2015. At the same time, NPL risk is rising notably among SME loans (supply chain to the oil & gas sector) and payroll loans. We expect 40bps higher NPL in 2016, while provision expenses should increase by c15% yoy. Rational pricing behaviour should allow the loan book (back/front) to be further re-priced, underpinning NIM expansion in 2016 (+20bps) rate. Banks will also continue to focus on cost control - we estimate opex growth at 6.9%. With a higher effective tax rate (300bps on average), we expect aggregate 2016 EPS growth of 4.4% and 16.9% ROAE.

Figure 15: Mkt share (Loans) as of Sep 2015



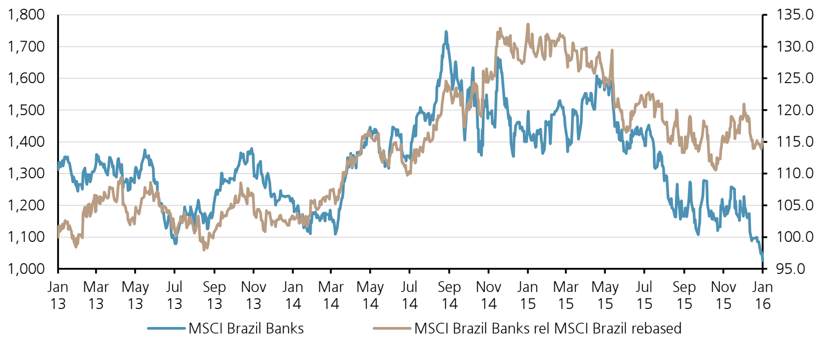
Source: UBS, Brazil Central Bank.

Figure 16: Loan mix as at Sep 2015



Source: Central Bank and UBS.

Figure 17: Banks Index & rel market



Source: Thomson Financials DataStream, MSCI, UBS

Figure 18: Macro forecasts

Brazil	2015E	2016E	2017E
GDP	-3.6	-2.8	0.7
Interest rates			
Policy rate (selic) y/e	14.25	15.75	12.25
Exchange rates			
USD/BRL avg	3.28	4.20	4.20
USD/BRL y/e	4.10	4.30	4.10

Source: UBS estimates

Figure 19: RoE decomposition

Brazil	15E	16E	17E
Net Int Margin (%)	5.38	5.49	5.33
Non Int Income (%)	2.68	2.65	2.68
Non Int Expense (%)	-3.82	-3.77	-3.76
Pre-provision Op Profit (%)	4.24	4.37	4.25
Provisions (%)	-1.63	-1.70	-1.55
Pre-exc. PTP (%)	2.61	2.67	2.70
Tax (%)	-0.86	-1.00	-1.01
UBS Adj. RoA (%)	1.73	1.64	1.65
Equity Multiplier (x)	12.7	12.2	11.5
UBS Adj. RoE (%)	22.0	20.1	19.1

Source: UBS estimates

Figure 20: Growth and valuation

Brazil	15E	16E	17E
Growth (%)			
UBS Adj. EPS	15.8	3.1	7.9
Op. Profit Per Share	19.0	12.0	4.0
Net Dividend	3.0	22.0	8.2
BVPS	10.5	13.9	13.1
Valuation			
UBS Adj. P/E (x)	5.7	5.5	5.1
P/OPS (x)	2.3	2.0	1.9
P/Book (x)	1.1	1.0	0.9
Net Yield (%)	5.6	6.5	7.0

Source: UBS estimates

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Figure 21: Top 10 banks Brazil as of 2Q15

Bank	Status	Listed/un-listed	Major shareholder	Assets (US$ bn)	Market share	Branches
Banco do Brasil	State Owned	Yes	Federal Government (59%), Previ (10.4%)	452.6	18.35%	5,424
Itau	Local	Yes	IUPAR (25.5%), Itausa (19.36%)	369.5	14.98%	3,809
Caixa Economica Federal	State owned	No	Federal Government	361.3	14.65%	3,401
Bradesco	Local	Yes	Cidade de Deus (24%), Fundacao Bradesco (9%)	280.0	11.35%	4,543
Santander	Foreign	Yes	Santander Group (88.3%)	198.0	8.03%	2,646
HSBC	Foreign	No	HSBC	57.5	2.33%	851
BTG Pactual	Local	Yes	BTG Pactual Holding S.A.	51.5	2.09%	9
Safra	Local	No	Safra Family	46.1	1.87%	106
Votorantim	Local	No	Local investors (50%) & Banco do Brasil (50%)	33.4	1.35%	14
Citibank	Foreign	No	Citibank group	22.8	0.93%	126

Source: UBS, Brazil Central Bank, CVM. Rank excludes development bank BNDES

Themes for 2016

- **Asset quality:** This remains the main concern for the banking sector given rising macro growth uncertainties. In recent quarters, banks have built up their coverage ratio (above 200%) and NPL buffers (at 123bp of loans at 3Q15). In our view, the elevated coverage ratio/NPL buffer will enable banks to endure higher delinquencies without necessarily being hit by a sharp rise in loan-loss provisioning requirements.

- **Further margin expansion:** With banks now re-pricing loans for higher funding costs as well as rising credit risk and taxes, we believe NIM improvements could be faster and higher than expected. We think there is upside risk to our current NIM forecast in 2016 (+20bps). For every 10bp rise in NIM above our estimate, our sector 2016 EPS would rise by 3.6%.

- **Negative loan growth?** A combination of weaker credit demand and lower appetite to lend will likely see credit demand decline further in 2016. Among private banks, we think a larger-than-expected contraction in GDP growth could push domestic loan growth into negative territory for private banks.

Key recommendations

Within a GEM banking context, we are neutral Brazilian banks, with a preference for private banks (stronger balance sheets) over public banks (asset quality risk).

- **Itau Unibanco** (Buy) is our top banking pick in Brazil as well as our GEM anti-consensus buy idea for 2016. Itau has been prudently building up its NPL coverage ratio, with its NPL (90d) buffer now at 2.3% (i.e., NPL could rise from 3.3% currently to 5.6% without Itau necessarily having to make additional provisions). Fundamentally, the outlook remains supportive in terms of higher NIM from loan book re-pricing and cost discipline, while strategically there's greater focus on geographical diversification to reduce dependency on Brazil. As such, we forecast ROE at 21.6% in 2016, one of the highest among EM banks.

- **Banco do Brasil** (Neutral) remains our least preferred bank in Brazil. Despite some margin recovery from higher spreads, rising asset quality risk could depress profitability and returns. In spite of a slightly higher coverage ratio at 213%, BB's NPL buffer of 54bp still ranks lowest among Brazilian banks under coverage. Also, the core tier 1 ratio, at 8.1%, is low by GEM standards.

Figure 22: Other data as at Sep 2015

Total banking assets (US$ bn)	2,466
No of banks	118
Loans/GDP	55.0%
Mortgages/GDP	9.7%
Loans/Deposits	164.2%
Population (m)	204.5
Working Population (m)	100.9
No. of credit cards (m)	162.0

Source: UBS, Central Bank, Febraban IBGE and ABECS. Total Assets as at Jun 2015, Credit cards as at Dec 2014, Population as at July 2015

Chile

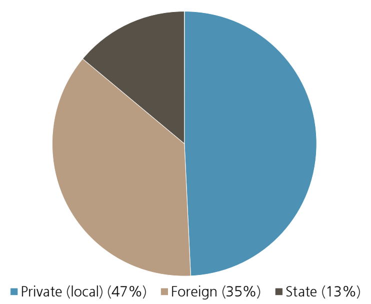
Macro outlook

We expect a rebound in GDP growth to 2.5% in 2016 from 2.0% in 2015, still weak by Chilean standards and recovering somewhat from a disappointing year. In 2016, we should see a natural rebound in economic activity, led by stable consumer and non-mining exports. Beyond the risk posed by a Chinese deceleration on copper prices, we expect some normalisation in business confidence. We expect inflation to trend back to the centre of the target range around 3%, after accelerating in both 2014 and 2015. We expect rates to rebound to 4.0% by year-end 2016, while CLP should appreciate to 670 by year-end 2016.

Bank fundamentals

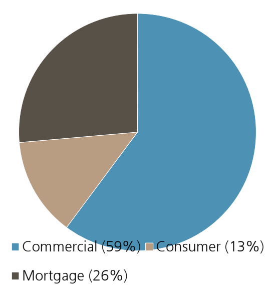
Chile is experiencing decelerating growth, visible in both investment and consumption, while a less accommodating monetary policy could impact economic activity. For 2016, banks expect average levels of loan growth (c10%) but normalised inflation could lead to lower NIMs. Regulatory pressures on fees, taxes and rate caps have abated, while a new Banking Law should be mostly benign for banks. There is renewed focus on cost controls while asset quality is expected to remain relatively stable. However, higher statutory taxes will likely weigh on industry earnings and ROE.

Figure 23: Mkt share (Loans) as of 3Q155



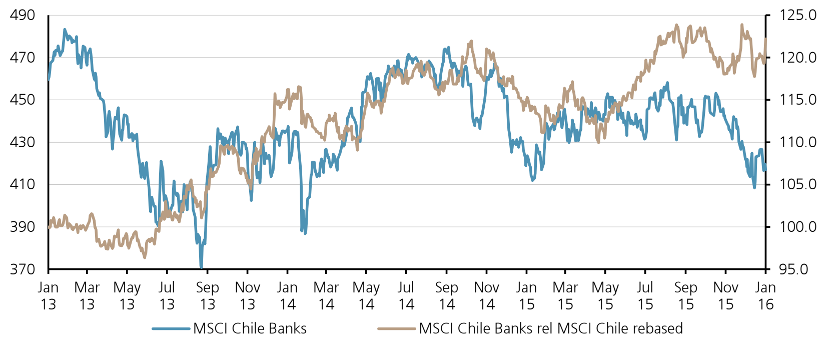
Source: UBS, Superintendencia Bancos & Instituciones Financieras, UBS

Figure 24: Loan mix as at 3Q155



Source: UBS, Superintendencia Bancos & Instituciones Financieras, UBS

Figure 25: Banks Index & rel market



Source: Thomson Financials DataStream, MSCI, UBS

Figure 26: Macro forecasts

Chile	2015E	2016E	2017E
GDP	2.0	2.5	3.0
Interest rates			
Interbank interest rate (December av	3.50	4.00	4.50
Exchange rates			
USD/CLP avg	621.50	667.50	660.00
USD/CLP y/e	665.00	670.00	650.00

Source: UBS estimates

Figure 27: RoE decomposition

Chile	15E	16E	17E
Net Int Margin (%)	3.80	3.84	3.93
Non Int Income (%)	1.23	1.17	1.15
Non Int Expense (%)	-2.19	-2.14	-2.10
Pre-provision Op Profit (%)	2.84	2.87	2.98
Provisions (%)	-1.20	-1.14	-1.01
Pre-exc. PTP (%)	1.65	1.73	1.98
Tax (%)	-0.25	-0.32	-0.39
UBS Adj. RoA (%)	1.37	1.39	1.57
Equity Multiplier (x)	12.3	12.8	12.7
UBS Adj. RoE (%)	16.9	17.9	19.9

Source: UBS estimates

Figure 28: Growth and valuation

Chile	15E	16E	17E
Growth (%)			
UBS Adj. EPS	-27.4	15.0	20.2
Op. Profit Per Share	-14.9	14.1	11.0
Net Dividend	10.5	-17.0	20.2
BVPS	-9.0	8.8	9.8
Valuation			
UBS Adj. P/E (x)	11.4	10.0	8.3
P/OPS (x)	5.5	4.8	4.4
P/Book (x)	2.1	1.9	1.7
Net Yield (%)	6.4	5.3	6.4

Source: UBS estimates

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Figure 29: Top 10 banks Chile as of 3Q15

Bank	Status	Listed/un-listed	Major shareholder	Assets (US$ bn)	Market share	Branches
Banco Santander, Chile	Foreign	Yes	Santander group	49.69	17.6%	465
Banco de Chile	Local	Yes	Largest: Sociedad Administradora de la Obligación Subordinada SAOS S.A.	44.11	15.7%	419
Banco del Estado de Chile	State-owned	No	Government Owned	43.37	15.4%	366
Banco de Crédito e Inversiones	Local	Yes	Juan Yarur and local investors	35.95	12.8%	301
Corpbanca	Local	Yes	Corp Group Banking	29.96	10.6%	110
Banco Bilbao Vizcaya Argentaria, Chile	Foreign	No	BBVA International	18.67	6.6%	138
Scotiabank Chile	Foreign	No	Scotiabank group	14.47	5.1%	98
Banco Itaú Chile	Foreign	No	Itaú Unibanco Group	11.92	4.2%	97
Grupo Security	Local	Yes	Inversiones Centinela	7.73	2.7%	29
Banco Bice	Local	No	Matte family & other local investors	7.47	2.7%	27

Source: Bloomberg, Superintendencia Bancos & Instituciones Financieras Chile, UBS

Themes for 2016

- **New mortgage rules:** Effective from 1 January 2016, the banking sector faces additional provisions for high loan-to-value mortgages, estimated at Ch$200-250bn that will be booked in Q4 15 or Q1 16. It is unclear whether the regulator will also look to introduce new models for SME/consumer loans that could result in further provisions.
- **New banking regulation:** New regulation on (Basel III) capital requirements is expected to be published before the end of 2016. Capital rules are currently based on Basel I risk-weighted assets (RWA). Given the sector's high RWA density, we think additional capital needs will be limited.
- **Higher taxes:** Given the 2014 tax reforms, the statutory income tax rate is set to rise to 23% in 2016, from 22% in 2015, and steadily rising to 27% by 2019, weighing on sector profits and returns.

Key recommendations

We have a Neutral rating on **Santander Chile**. The macro outlook should improve a little although challenges persist with credit demand expected to remain weak while normalised inflation could lead to lower bank margins. We view Santander Chile as a well-run bank, but a higher tax burden will likely constrain ROE to 17-18% over the next two years.

Figure 30: Other data as at 3Q15 (unless otherwise stated)

Total banking assets (US$ bn)	282
No of banks	24
Loans/GDP	89%
Mortgages/GDP	23%
Loans/Deposits	124%
Population (m)	18
Working Population (m)	9
No. of credit cards (m)	10

Source: UBS, INE, Superintendencia Bancos & Instituciones Financieras de Chile. Data for Population as of December 2014, data for credit card as of April 2015.

Colombia

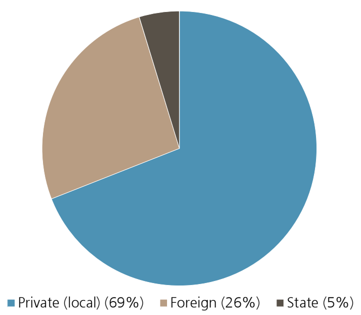
Macro outlook

We forecast GDP growth at 2.8% in 2016 versus 2.6% in 2015. The country's sizeable current account deficit is posing risks for the currency and for growth. Lower oil prices and reduced fiscal revenues have raised downside risks to housing and infrastructure spending, two key engines of growth. Unemployment at historical lows suggests consumption could support growth in 2016. If and when inflation normalises (we expect in 2016), Colombia could be one of the few countries that has room to cut rates. We expect rates of 5.25% in 2015 and 4.75% in 2016, and a COP at 3,150 in 2016.

Bank fundamentals

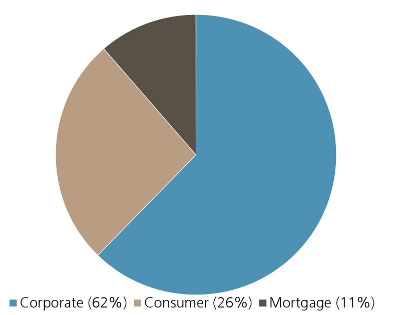
Given the macro outlook, we expect loan growth to decelerate in 2016 to high single-digits. Despite the weakening growth, asset quality should be stable or deteriorate only slightly. In particular, banks have limited exposure to the oil corporate sector and low unemployment suggests limited pressure on consumer NPLs. We expect the cost of risk to increase slightly in 2016, from a low level. There could be upside risk to banks' margins should policy rates rise post US Fed tightening. We also highlight increased taxes in 2016 due to the voted rise in the social contribution and equity tax.

Figure 31: Mkt share (Loans) as of September 2015



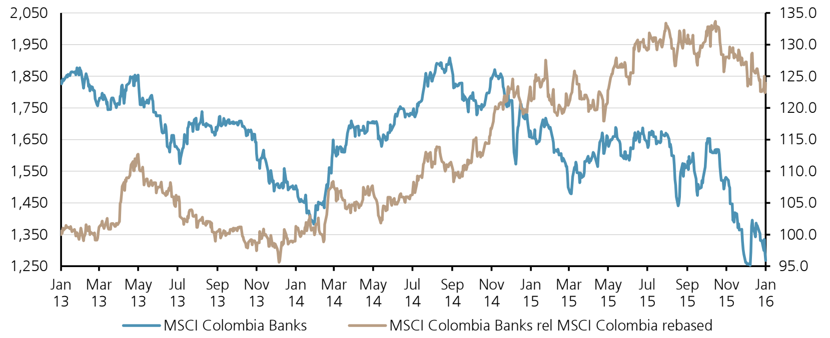
Source: UBS, Superintendencia Financiera de Colombia

Figure 32: Loan mix as of September 2015



Source: UBS, Superintendencia Financiera de Colombia

Figure 33: Banks Index & rel market



Source: Thomson Financials DataStream, MSCI, UBS

Figure 34: Macro forecasts

Colombia	2015E	2016E	2017E
GDP	2.6	2.8	3.2
Interest rates			
3 month interest rate (% average)	5.25	4.75	4.50
Exchange rates			
USD/COP avg	2397.00	3012.50	3025.00
USD/COP y/e	2875.00	3150.00	2900.00

Source: UBS estimates

Figure 35: RoE decomposition

Colombia	15E	16E	17E
Net Int Margin (%)	4.66	4.89	4.88
Non Int Income (%)	1.91	1.75	1.69
Non Int Expense (%)	-3.35	-3.22	-3.20
Pre-provision Op Profit (%)	3.22	3.42	3.37
Provisions (%)	-1.13	-1.40	-1.29
Pre-exc. PTP (%)	2.09	2.02	2.07
Tax (%)	-0.52	-0.57	-0.64
UBS Adj. RoA (%)	1.56	1.43	1.41
Equity Multiplier (x)	9.0	9.2	9.3
UBS Adj. RoE (%)	14.0	13.1	13.1

Source: UBS estimates

Figure 1: Growth and valuation

Colombia	15E	16E	17E
Growth (%)			
UBS Adj. EPS	-20.9	2.9	6.3
Op. Profit Per Share	-9.1	19.7	5.4
Net Dividend	-37.7	27.7	5.4
BVPS	-5.3	5.7	8.6
Valuation			
UBS Adj. P/E (x)	6.6	6.5	6.1
P/OPS (x)	3.2	2.7	2.6
P/Book (x)	1.0	0.9	0.8
Net Yield (%)	3.8	4.8	5.1

Source: UBS estimates

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Figure 36: Table 1: Top 10 banks Colombia as of September 2015

Bank	Status	Listed/un-listed	Major shareholder	Assets (US$ bn)	Market share	Branches
Grupo Aval	Local	Yes	Local investors	44.45	28.0%	1513
Bancolombia	Local	Yes	Largest: Grupo Suramericana and Inversiones Argos	41.93	26.4%	801
Davivienda	Local	Yes	Local investors	19.33	12.2%	585
BBVA Colombia	Foreign	No	BBVA group	14.98	9.4%	472
Corpbanca	Foreign	No	Chilean "Saieh Group" and other investors	9.81	6.2%	747
Banco Agrario de Colombia	State-owned	No	Government	7.51	4.7%	191
Red Multibanca Colpatria	Foreign	No	Scotiabank and local investors	7.24	4.6%	137
Banco GNB Sudameris	Foreign	No	Gilex Holding B.V.	6.09	3.8%	169
BCSC - Banco Caja Social	Local	No	Local investors	3.86	2.4%	263
Citibank	Foreign	No	Citibank group	3.54	2.2%	82

Source: UBS, Superintendencia Financiera de Colombia, press releases. Notes: (1) Grupo Aval: Banco de Bogotá, Banco de Occidente, Banco Popular, Banco AV Villas, Corfin Colombiana (2) Corpbanca: includes Helm Bank.

Themes for 2016

- **Decelerating loan growth:** With a second year of weaker growth (still healthy by LatAm standards, however), we expect banks to restrict the loan supply and system loan growth at high single-digits for 2016.
- **Provisioning expenses normalising:** We expect asset quality to deteriorate only slightly at the system level. Exposure of banks to oil companies seems limited (which raise bonds on international markets directly), while low unemployment is also supportive of healthy consumer NPLs. That said, we believe banks will raise (albeit slightly) their coverage ratios. Cost of risk should rise slightly in 2016.
- **Issuance overhang limited:** Several Colombian financials have already tapped the equity markets (CIB, Aval), and we do not see any urgency for Davivienda to raise equity, especially as sector growth slows.

Key recommendations

We recently upgraded **Bancolombia** to a Buy from Sell, as we believe that at current valuations, a weaker fundamental outlook is already priced in with the stock. With higher Fed funds rates, we think there could be upside risk to NIM and earnings should we see domestic rates rise further. **Davivienda**, also Buy rated, is our preferred peak in Colombia. We like its more aggressive growth profile and exposure to consumer/mortgages, though the weaker macro represents a headwind.

Figure 37: Other data as of September 2015

Total banking assets (US$ bn)	159
No of banks	53
Loans/GDP	46%
Mortgages/GDP	5.2%
Loans/Deposits	93%
Population (m)	46
Working Population (m)	25
No. of credit cards (m)	15

Source: UBS, Superintendencia Financiera de Colombia, Departamento Administrativo Nacional de Estadística. Working populations as at FY2014.

Mexico

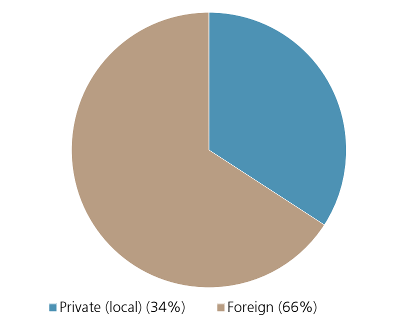
Macro outlook

We expect Mexican growth to pick up to 2.7% in 2016 and 3.2% in 2017, given a sturdier US economy, stabilisation of oil production and a strong consumer. We expect a modest pick-up in inflation to 3.2% on the back of base effects. As we foresee Banxico shadowing the Fed, we assume a 100bp hike in 2016 and 75bp in 2017. We think the peso could weaken further before strengthening, and forecast the MXN at 17.0 by end-2016 and 16.5 by end-2017.

Bank fundamentals

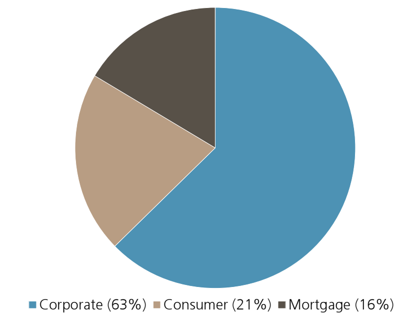
As growth in other emerging markets slows, Mexico's loan growth has doubled from a trough of 8.1% in October 2014 to 16.0% in September 2015. Asset quality is also improving with NPL down to 2.8% in September 2015 from 3.4% a year earlier. Looking ahead, we conservatively forecast loans to grow at ~14% in 2016, driven by both corporate and consumer loans. A loan mix shift should lift margins slightly next year (our NIM forecast does not factor in a hike in policy rates), while good cost control should lower the cost/income ratio to 40.7%. Improving asset quality should pave the way for lower credit costs, resulting in a sector ROE of 14.1%.

Figure 38: Commercial Banks Mkt share (Loans) as of September 2015



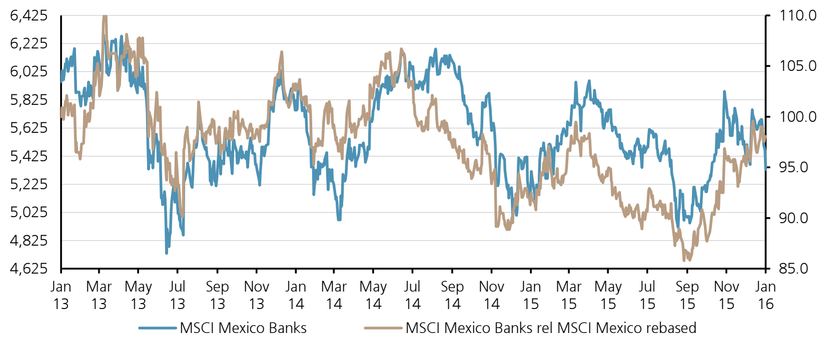
Source: UBS, CNBV, Banxico

Figure 39: Loan mix as at September 2015



Source: UBS and CNBV

Figure 40: Banks Index & rel market



Source: Thomson Financials DataStream, MSCI, UBS

Figure 41: Macro forecasts

Mexico	2015E	2016E	2017E
GDP	2.3	2.7	3.2
Interest rates			
cetes (Dec. average)	3.28	4.12	5.24
Exchange rates			
USD/MXN avg	14.65	16.63	16.75
USD/MXN y/e	16.25	17.00	16.50

Source: UBS estimates

Figure 42: RoE decomposition

Mexico	15E	16E	17E
Net Int Margin (%)	4.04	4.21	4.43
Non Int Income (%)	1.65	1.66	1.69
Non Int Expense (%)	-2.48	-2.42	-2.36
Pre-provision Op Profit (%)	3.21	3.45	3.75
Provisions (%)	-1.06	-1.04	-1.14
Pre-exc. PTP (%)	2.26	2.53	2.73
Tax (%)	-0.55	-0.66	-0.72
UBS Adj. RoA (%)	1.70	1.86	2.00
Equity Multiplier (x)	7.6	7.5	7.3
UBS Adj. RoE (%)	12.9	13.9	14.6

Source: UBS estimates

Figure 43: Growth and valuation

Mexico	15E	16E	17E
Growth (%)			
UBS Adj. EPS	4.4	19.8	16.5
Op. Profit Per Share	6.1	17.9	17.8
Net Dividend	129.3	2.6	28.0
BVPS	9.8	11.0	11.3
Valuation			
UBS Adj. P/E (x)	14.6	12.2	10.5
P/OPS (x)	7.4	6.3	5.4
P/Book (x)	1.8	1.6	1.5
Net Yield (%)	2.3	2.1	2.6

Source: UBS estimates

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Figure 44: Table 1: Top 10 banks Mexico as of September 2015

Bank	Status	Listed/un-listed	Major shareholder	Assets (US$ bn)	Market share	Branches
BBVA Bancomer	Foreign	No	BBVA	103	22.5%	1,821
Santander	Foreign	Yes	Santander group	69	15.0%	1,214
Banamex	Foreign	No	Citigroup	67	14.5%	1,494
Banorte-Ixe	Local	Yes	Group of local investors headed by Roberto Gonzalez Barrera	53	11.6%	1,187
HSBC	Foreign	No	HSBC Group	36	7.8%	989
Scotiabank	Foreign	No	Scotiabank group	20	4.4%	579
Inbursa	Local	Yes	Local investors (95% - Carlos Slim and Criteria Caixacorp)	17	3.7%	379
Interacciones	Local	Yes	Grupo Financiero Interacciones headed by Carlos Hank	10	2.1%	1
Banco del Bajío	Local	No	Grupo Hermes headed by Carlos Hank	9	1.9%	292

Source: UBS, Banxico and CNBV. Note branch numbers as at 3Q15.

Themes for 2016

- **Higher policy rates:** Following the 25bp hike in policy rate in December 2015, our economists forecast the central bank's overnight rate to rise by 100bp in 2016 and 75bp in 2017. As Mexican banks are highly asset-sensitive, the sector is well positioned for margin expansion in the coming two years.

- **Loan growth – upside risk?** As an economy that is linked to US economic recovery and less dependent on China growth, Mexico is well placed to see credit demand rising further in 2016. We think there could be upside risk to our current 14.1% loan growth estimate next year, especially if we see a stronger recovery in consumer loans, notably in credit cards.

- **The exit of global banks?** We believe foreign banks are coming under pressure from shareholders to dispose of underperforming businesses (characterised by the ROE being well below the COE over several years). Earlier in 2015, HSBC indicated that it would look to sell its Mexican operations, a business that we valued in April 2015 at between US$4.9-6.5bn (click to see report), although given FX weakness, this could now be US$4.5-5.9bn.

Figure 45: Other data as at September 2015

Total banking assets (US$ bn)	459
No of banks	51
Loans/GDP	21%
Mortgages/GDP	3%
Loans/Deposits	104%
Population (m)	121
Working Population (m)	50
No. of credit cards (m)	25

Source: UBS, CNBV, INEGI and World Bank

Key recommendations

We have an overweight stance on Mexican banks within a GEM context, given the country's improving macro outlook and the banking sector's structural/cyclical upside.

Inbursa is our top pick (Key Call, Buy). Following the acquisition of Banco Walmart, Inbursa's aggressive branch expansion has resulted in the number of branches rising to 900 by the end of last year from 384 in 2Q15, paving the way for rapid revenue growth from 2016 onwards and underpinning profitability. We forecast 2016 ROA at 3.1%, one of the highest among EM banks.

We also like **Banorte** (Buy). The bank is well positioned to benefit from acceleration in credit demand, rising rates as well as improved cross-selling and efficiency upside (IBM alliance) with credit costs lower, culminating in 19.3% EPS growth in 2016E.

In the non-banks space we have a Buy rating on **Unifin**, given its focus on leasing, strong asset quality and high collateral, while margins look sustainable.

Peru

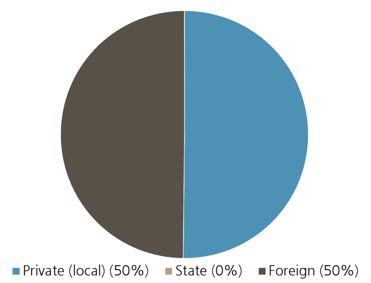
Macro outlook

We forecast a moderate recovery in GDP growth to 3.4% in 2016 and 4.0% in 2017 from a mediocre 2.8% in 2015. In 2016, consumption is expected to remain weak, with El Niño another source of downside risk, but mining and investments should be stronger. We expect inflation to be reined at 3.2% in 2016 and 2.6% in 2017. Following in the Fed's footsteps, the central bank is expected to tighten policy rates in both 2016 and 2017. Despite continued FX intervention by the central bank, we see the PEN weakening to 3.55 by year-end 2016 and 3.65 by year-end 2017.

Bank fundamentals

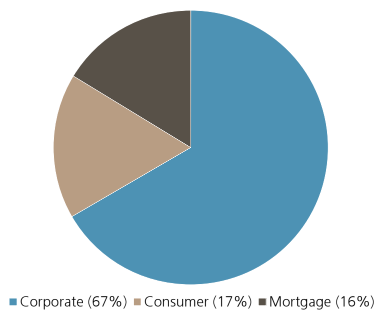
With an improving macro outlook, we expect loan growth to pick up to 13.2% in 2016, driven by corporate lending (mining/infrastructure) while the consumer should rebound, and microfinance remains resilient. Asset quality should remain under control although the focus will be on FX loans with further currency weakness. Net interest margins should remain relatively stable with higher funding costs offset by a loan mix shift and more PEN-denominated loans. In our coverage universe, ROE should remain around 19% in 2016.

Figure 46: Mkt share (loans) as of September 2015



Source: Superintendecia de Banca, Seguros y AFP, Asbanc, UBS

Figure 47: Loan mix as at September 2015



Source: Superintendecia de Banca, Seguros y AFP, asbanc, UBS

Figure 48: Banks Index & rel market

Source: Thomson Financials DataStream, MSCI, UBS

Figure 49: Macro forecasts

Peru	2015E	2016E	2017E
GDP	2.8	3.4	4.0
Interest rates			
Central Bank Discount rate (Dec. avg	3.75	4.25	4.50
Exchange rates			
USD/PEN avg	3.00	3.38	3.60
USD/PEN y/e	3.20	3.55	3.65

Source: UBS estimates

Figure 50: RoE decomposition

Peru	15E	16E	17E
Net Int Margin (%)	5.08	5.23	5.30
Non Int Income (%)	2.72	2.65	2.66
Non Int Expense (%)	-3.54	-3.59	-3.58
Pre-provision Op Profit (%)	4.27	4.29	4.39
Provisions (%)	-1.28	-1.37	-1.40
Pre-exc. PTP (%)	2.98	2.92	2.99
Tax (%)	-0.80	-0.79	-0.81
UBS Adj. RoA (%)	2.12	2.08	2.14
Equity Multiplier (x)	9.7	9.5	8.9
UBS Adj. RoE (%)	20.6	19.7	19.1

Source: UBS estimates

Figure 51: Growth and valuation

Peru	15E	16E	17E
Growth (%)			
UBS Adj. EPS	16.2	10.0	10.8
Op. Profit Per Share	9.4	12.6	10.5
Net Dividend	-100.0	NA	2.1
BVPS	2.8	15.5	15.4
Valuation			
UBS Adj. P/E (x)	7.3	6.7	6.0
P/OPS (x)	3.6	3.2	2.9
P/Book (x)	1.5	1.3	1.1
Net Yield (%)	0.0	4.1	4.2

Source: UBS estimates

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Figure 52:Table 1: Top 10 banks Peru as of September 2015

Bank	Status	Listed/un-listed	Major shareholder	Assets (US$ bn)	Market share	Branches
B. de Crédito del Perú	Private	Yes	Grupo Credito (85%), Credicorp (13%, Atlantic Security Holding and Romero Family)	119.12	34.4%	446
B. Continental	Foreign	Yes	Holding Continental (92%, BBVA + Grupo Brescia)	76.63	22.1%	331
Scotiabank Perú	Foreign	Yes	Bank of Nova Scotia (97.7% direct and indirect)	54.25	15.7%	211
Intercorp Financial Services	Private	Yes (listed via IFS)	Intercorp (Rodriguez Pastor Family) (68.9%)	39.23	11.3%	287
B. Interamericano de Finanzas	Foreign	No	Group Fierro (through its subsidiaries Britton S.A. and Landy S.A.)	10.91	3.2%	88
B. Financiero	Private	Yes	Grupo ACP (60%, social mission group, owner of other LatAm microcredit institutions)	8.20	2.4%	1
Citibank	Foreign	No	Citibank group	6.95	2.0%	79
Banco Santander Peru	Foreign	No	HSBC group	4.81	1.4%	1
Banco Falabella	Private	No	Falabella Peru	4.56	1.3%	94
HSBC Bank Perú	Foreign	Yes	Banco del Pichincha	0.00	0.0%	0

Source: SBS, company data, UBS estimates

Themes for 2016

- **Loan-deposit ratio (LDR) to remain elevated:** Given the ongoing de-dollarisaton process and potential currency weakness, we believe the LDR (PEN) ratio will likely remain elevated (in September 2015, it was at 157%). We do not think this would constrain local currency lending, given central bank funding support, although funding costs could rise.

- **FX credit risk?** Although the NPL ratio for loans in US dollars has been stable at 2.6%, further currency weakness raises market concerns over FX credit risk. Based on the latest central bank data, 34% of system-wide loans are in US dollars (down from 43% at year-end 2014). Although the majority of these loans are to borrowers with US dollar revenues, we estimate up to 10% of total loans do not have a natural hedge so could be susceptible to FX volatility.

- **MSCI reclassification overhang:** The postponement of a decision by MSCI to downgrade Peru's classification from emerging market to frontier market until June 2016 could serve as an overhang on the performance of the banking sector, given concerns over an outflow of liquidity. To avoid a reclassification downgrade, the Peruvian authorities are pushing through a number of initiatives to enhance market liquidity, such as the elimination of capital gains tax and reduced transaction fees.

Key recommendations

We have a Buy rating on **Credicorp**. While de-dollarisation remains a key priority for policy makers, banks are likely to receive further central bank funding support in the form of repos and state deposit auctions. As the largest bank in Peru, Credicorp is well placed to benefit when credit growth recovers. While funding costs will likely rise, NIM will not necessarily come under pressure, given the loan mix shift from dollar into soles currencies. Mi Banco is also switching from the clean-up stage into a growth phase, with ROE of mid-20s expected by the end of this year.

Figure 53: Other data as at September 2015 (unless otherwise stated)

Total banking assets (US$ bn)	107
No of banks	17
Loans/GDP	36%
Mortgages/GDP	5.9%
Loans/Deposits	109%
Population (m)	31
Working Population (m)	16
No. of credit cards (m)	8

Source: UBS, Superintendecia de Banca, Seguros y AFP, INEI, BCRP, Asbanc, CIA Factbook. Note: Working Population as at Dec 2014.

Valuation Method and Risk Statement

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

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Buy	FSR is > 6% above the MRA.	48%	36%
Neutral	FSR is between -6% and 6% of the MRA.	39%	28%
Sell	FSR is > 6% below the MRA.	12%	22%
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 December 2015.
1:Percentage of companies under coverage globally within the 12-month rating category.
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Company Disclosures

Company Name	Reuters	12-month rating	Short-term rating	Price	Price date
Banco Davivienda[5, 7]	DVI_p.CN	Buy	N/A	P21,420.00	08 Jan 2016
Banco do Brasil[5, 7, 20, 22]	BBAS3.SA	Neutral (CBE)	N/A	R$13.95	08 Jan 2016
Bancolombia[4, 5, 6, 7, 16b]	CIB.N	Buy	N/A	US$25.50	08 Jan 2016
Banorte[5, 7]	GFNORTEO.MX	Buy	N/A	P88.85	08 Jan 2016
Banregio[16a]	GFREGIOO.MX	Buy	N/A	P85.42	08 Jan 2016
BB Seguridade	BBSE3.SA	Buy	N/A	R$23.59	08 Jan 2016
BM&F Bovespa	BVMF3.SA	Neutral	N/A	R$10.52	08 Jan 2016
Bolsa Mexicana[16a]	BOLSAA.MX	Neutral	N/A	P21.56	08 Jan 2016
Bradesco[5, 7, 16b]	BBDC4.SA	Buy	N/A	R$18.04	08 Jan 2016
Cetip[5]	CTIP3.SA	Sell	N/A	R$36.59	08 Jan 2016
Cielo	CIEL3.SA	Buy	N/A	R$35.00	08 Jan 2016
Credicorp[7, 16b]	BAP.N	Buy	N/A	US$89.48	08 Jan 2016
Gentera[5]	GENTERA.MX	Buy	N/A	P30.52	08 Jan 2016
Inbursa[3, 5, 7]	GFINBURO.MX	Buy	N/A	P28.70	08 Jan 2016
Itau Unibanco[5, 7, 16b]	ITUB4.SA	Buy	N/A	R$24.77	08 Jan 2016
Itausa[7]	ITSA4.SA	Buy	N/A	R$6.67	08 Jan 2016
Porto Seguro[2]	PSSA3.SA	Neutral	N/A	R$27.23	08 Jan 2016
Santander Brasil[5, 7, 16b]	SANB11.SA	Neutral	N/A	R$13.71	08 Jan 2016
Santander Chile[2, 4, 5, 7, 16b]	BSAC.K	Neutral	N/A	US$16.74	08 Jan 2016
Santander Mexico[5, 16b]	SANMEXB.MX	Buy	N/A	P28.25	08 Jan 2016
SulAmerica	SULA11.SA	Sell	N/A	R$17.78	08 Jan 2016
Unifin[2, 4, 6]	UNIFINA.MX	Buy	N/A	P53.38	08 Jan 2016

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