



Banks' equity vs AT1: deal or no deal?

The kingdom of Creditonia

In the kingdom of Creditonia you are the Chief Investment Officer tasked with ensuring that the asset allocation decisions maximise the return of the king's portfolio. The king is not really worried about risk and having seen two would-be investment managers, Mickey and Donald, on "XFactor Investing" he points you to them. They both invest in the only two meaningful assets available in the kingdom: banks' equity and banks' debt.

You decide to hold a competition to tell who is going to win your trust and help you invest the king's money: for a year they have to pick ten between bank stocks and bonds; at the end of the year the results will be made public and the decision on who is the best performer will be taken.

When the year ends the results show that Mickey is better than Donald at investing. Indeed, in banks' equity 100% of Mickey picks went up 10% each, while only 87.5% of the stocks picked by Donald went up (again by 10%). Additionally, Mickey is also better than Donald at investing in banks' debt: here 62.5% of the bonds he picked went up, while Donald achieved a 50% hit ratio. Suppose that all the stocks that go up give a 10% total return and those that go down give a -10%, while the bonds that go up return 5% and those that fall yield a -5% total return.

Which manager is the real deal here? Which one would you choose to invest the kings' money with in this fantastic world of banks' risk?

It seems obvious, doesn't it?

Or does it?

2018 market recap and 2019 outlook

After a very bullish run since 2014, which peaked in 2017, European banks' AT1 bonds last year experienced a negative total return rate in the area of -6% for EUR-denominated bonds and -4% for USD-denominated ones. Admittedly, they were not alone as 80% to 90% of the asset classes decreased in value in 2018 in dollar terms. European banks' stocks also suffered a bruising year, with the sector declining 25% to 30% in total return on average.

At this point, the question that all the investors in the banking space are trying to figure out is if 2019 will be another difficult year or not.

Last year we saw both a widespread risk-off environment and a series of idiosyncratic risk spikes, for instance in the case of Deutsche Bank, Italian banks and Danske Bank. The news flow on Deutsche Bank continued to be negative with regards to its restructuring and profitability; the Italian banks were hit by their unavoidable linkage with Italy sovereign risk and negative macroeconomic figures for the country and finally Danske Bank experienced a fallout from the money laundering scandal that hit them. To be honest, one could argue that the banking sector had many other themes and (mostly) negative news in the year, for example linked to the emerging market sell-off experienced during the summer or the technicalities with HSBC Discos, but those mentioned were certainly amongst the highest profile headlines I saw.

That was 2018, but what does 2019 have on the menu for the sector? What we have seen so far is this:



- Firstly, Italy is flirting with recession: Figure 1 shows the trend of the PMIs (manufacturing, services and composite). All these leading indicators consistently weakened close to a recessionary level.



Figure 1 Italy PMIs. Source Bloomberg.

- Secondly, even Germany and France’s economies are slowing down: Figure 2 shows both the trend in the composite PMIs and in the GDPs. Germany Q3 GDP went into negative territory.

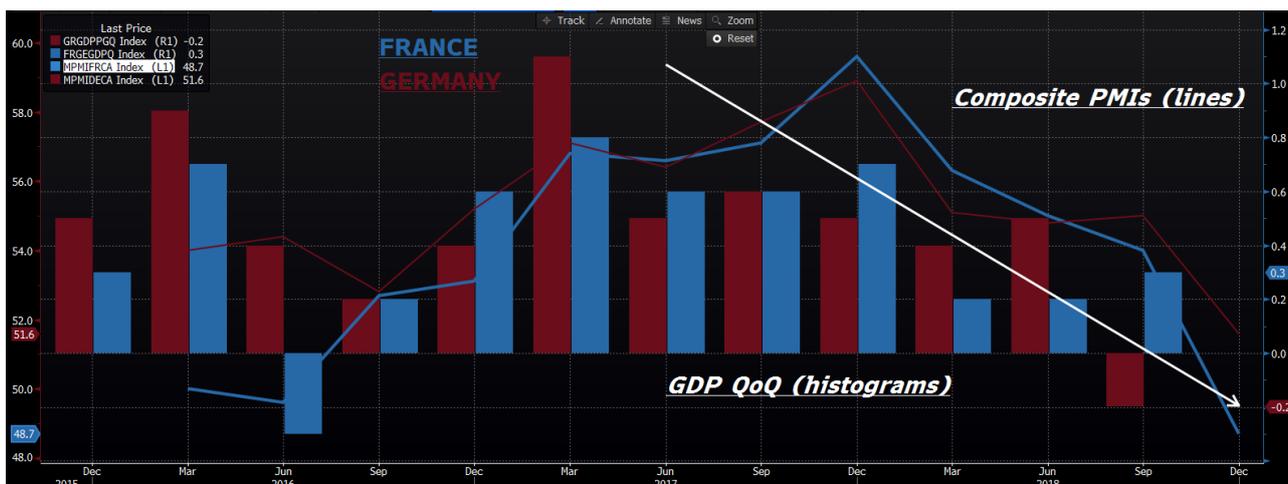


Figure 2 France and Germany GDP QoQ and PMIs. Source Bloomberg.

- Finally, fundamentals at European banks are no longer improving (Table 1), and the incoming economic slowdown will put some pressure on assets’ quality and NPLs. On profitability, I shall only note that short term interest rates are still negative while curves are generally flatter, which is negative for the carry trade. Moreover, the traditional banking business model is ever more challenged by new technologies and the start-ups that exploit them, forcing banks to focus on difficult cost cuttings.

CET1 ratio	Q2 2017	Q3 2017	Q4 2017	Q1 2018	Q2 2018
European Banks (ECB)	13.88%	14.32%	14.64%	14.16%	14.10%
UK Banks (BoE)	14.90%	14.90%	14.90%	14.80%	15.00%

Table 1 CET1 ratio comparison. Source ECB and BOE.



With this background in mind, the general feeling is that 2019 is not shaping up to be the greatest of years for banks' capital, but a) things may change in due course and b) probably at least some of the bad news are already priced in current valuations. The next question is then which part of the capital structure is going to be the best relative value choice. Before answering this question, it is important to understand what AT1 bonds actually are.

AT what!?

AT1 (Additional Tier-1) bonds, aka CoCo (Contingent Convertible) bonds, are part of the broader family of Hybrid bonds. Hybrid bonds fulfil several markets' demands. Let's think about them.

As an investor, would you like to earn a considerable spread over government bonds, say comparable to the dividend yield of stocks, without having to buy the equity of a company, but simply investing in its debt?

As an issuer, would you like to increase the size of your equity cushion (and your rating) without diluting the current shareholders and at the same time getting the benefit of the tax shield on the periodic payments like in bonds or loans, but without the increased leverage?

As a regulator, would you like to be able to have the possibility to recapitalise a distressed subject under your responsibility without having to access the markets (or the taxpayers' funds) in difficult times?

The rational answers to all those questions are, of course, yes, and that is why the market for Hybrids and CoCos has not only established itself, but has also blossomed over the last several years.

What exactly is a hybrid bond after all? There are several structures and digging too deeply would take too much space and time, but generally speaking hybrid bonds are subordinated to all capital but equity, are long dated or perpetual in maturity, are callable, have deferrable coupons and can take the form of subordinated debt or preferred shares. Hybrids can be unrated or rated, if rated they can be either Investment Grade or High Yield.

By their nature they are much less sensitive to interest rates and much more to credit risk; their valuation is closely related to, among other things, the subordination status, the extension risk (i.e. the implications if they are not called at the first call date), the coupon deferral (cumulative or non-cumulative) and the replacement capital covenant (i.e. whether the issuer, upon calling the bonds, needs to replace those bonds with similar capital or not: it is basically a protection for the senior creditors of the issuer).

While Hybrid bonds are subordinated, CoCos can potentially also be senior (see for example Rabobank CoCos), although this seniority does not count for much. They are usually issued by financial institutions to build up the "stronger" segment of the capital structure (i.e. the equity and the more equity-like part). A contingent convertible is a debt instrument that automatically converts into equity (or is subject to a permanent or temporary write off) when the financial institution is close to non-viability. This means that in extreme cases of equity capital injection, the company does not need to issue new shares, but simply converts (or is forced to convert) part of its debt into equity. Hence this family of instruments shows a risk profile that can be described as one of a low probability of a big loss (when a bank is close to default) and a high probability of small gain (when the bank is a going concern). They now form an integral part of the regulators' toolbox, together with of course equity, to try and make banking systems more resilient.

The additional risks of Hybrids and CoCos obviously amplify the losses when spreads widen or there is a general risk-off environment.



Relative Value

It is certainly difficult to treat all the AT1 bonds in the same way given that, as seen above, they have features that can be different from each other, hence making them more or less appealing. For example, reset spreads, coupon deferral, extension risk and replacement capital covenants are all features to keep in mind when evaluating a bond. Nonetheless a possible way to assess their relative cheapness, or lack thereof, is to compare them with returns expected on other layers of capital with different seniority.

In this instance, I have decided to compare them with equity capital given the driving rationale behind their issuance, i.e. the regulators' willingness to protect senior creditors, depositors and public money.

In terms of procedure, I have calculated the expected returns for the equities of several banks by applying the CAPM theory and intuition. Then, I estimated a rolling 30-day beta and used it in conjunction with (a rather arbitrary choice I must admit) 7% market risk premium, to estimate the expected returns of the equity capital over time. Finally, I have compared these returns with the yield of the AT1 bonds by building a ratio. When this ratio is above 1.5, meaning that the expected return on the equity is 1.5 times higher than the one the AT1, I consider the equity cheap. When the ratio is less than 0.5, I consider the equity dear and the AT1 cheap. A ratio in between those two levels does not yield a strong view in any direction.

What do the numbers tell us? The investable universe of AT1s comprises around one hundred bonds among EUR, USD, GBP and JPY, however here I will show the results only for Unicredit, Deutsche Bank, Danske Bank, Santander, Barclays, Société Générale and HSBC. I chose this sample because it is representative of some of the main themes that played out last year.

The general comment is that at the moment there aren't any strong signals either for AT1s or for equities, although the valuations seem to be tilted more towards equity cheapness than otherwise. The two bonds from Unicredit, the 8% in USD and the 5.375% in EUR both look a bit expensive, since the ratios are around the 1.5 threshold.

Barclays, SocGen, HSBC and Santander charts tell a very similar story; it is also worth noting that the Santander equity has always been on the cheap side since the issuance of the AT1 bond in September 2017. I don't have a final answer on the reason why, but my guess is that maybe Santander was perceived to be a better credit risk than other banks.

Danske Bank's ratio is the less uninspiring one, sitting around 1, while DB seems to be a bit more decisively on the equity cheapness, probably due to the big selloff in the stock seen last year: it seems that the credit market is anticipating a successful turnaround much more than the equity market is doing.

I have also done a rough "*back testing*" exercise, whose results are in a table after the charts.

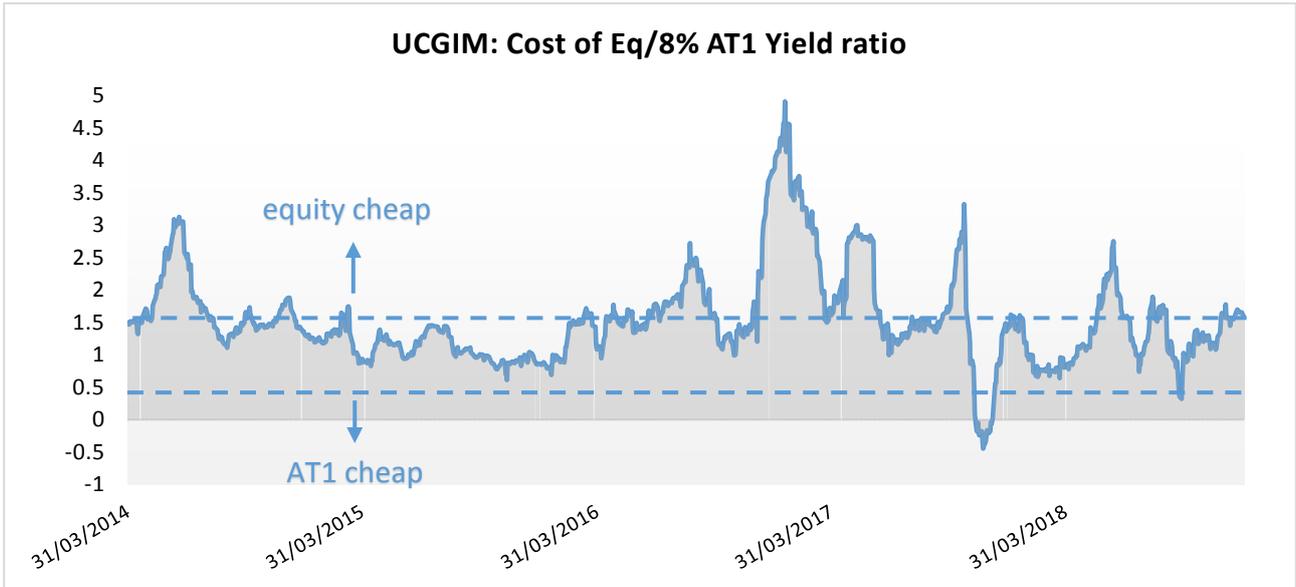


Figure 3 Source Bloomberg. Own calculations.

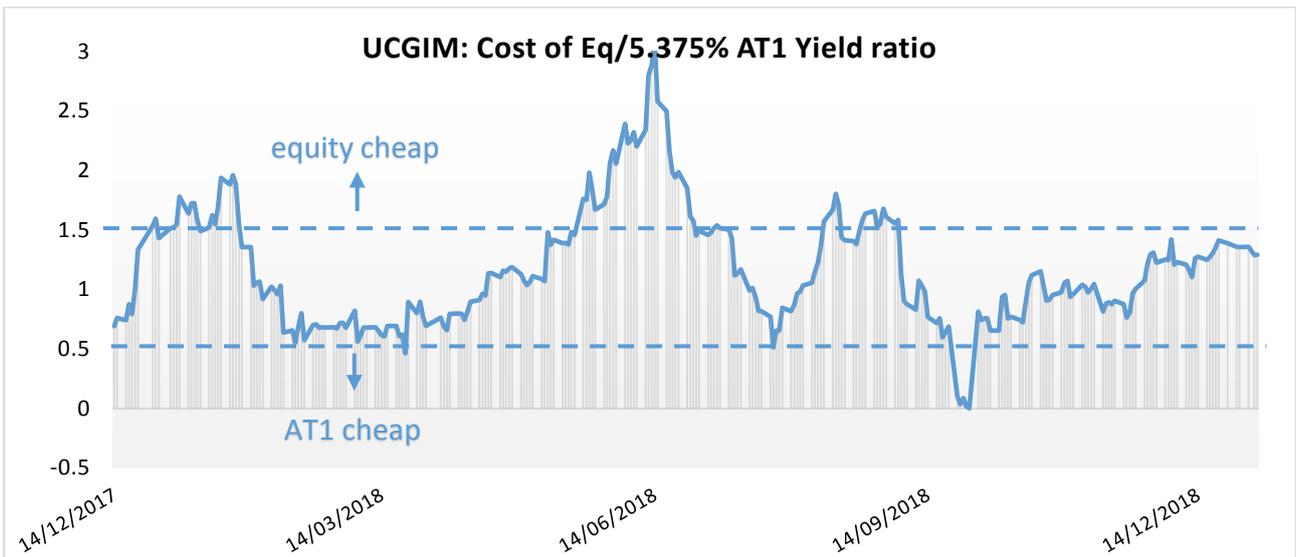


Figure 4 Source Bloomberg. Own calculations.

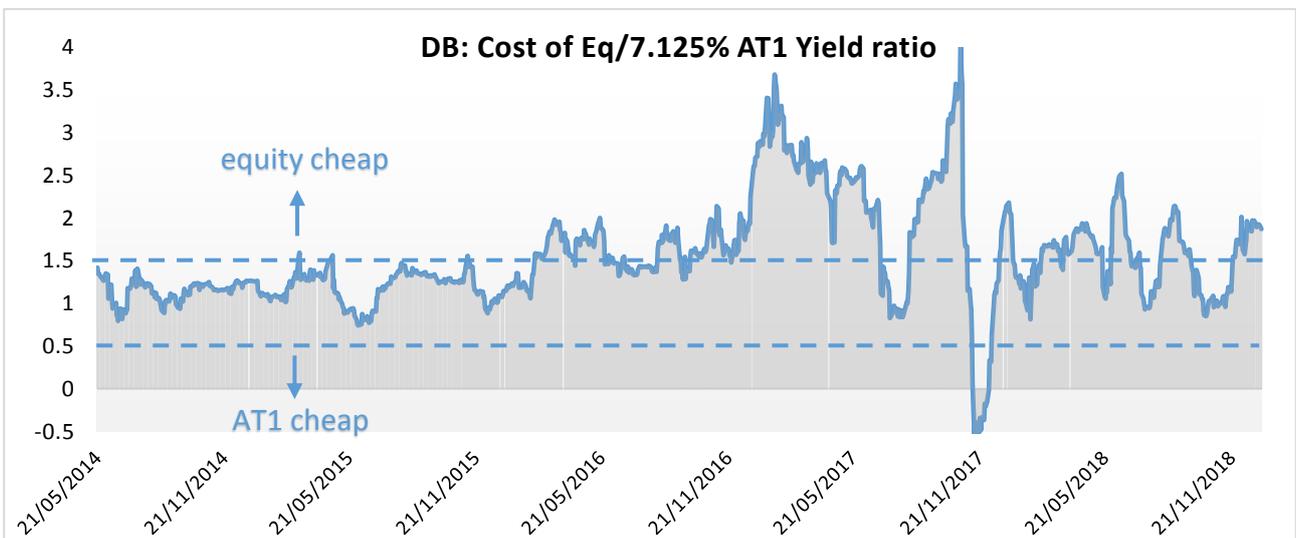


Figure 5 Source Bloomberg. Own calculations.

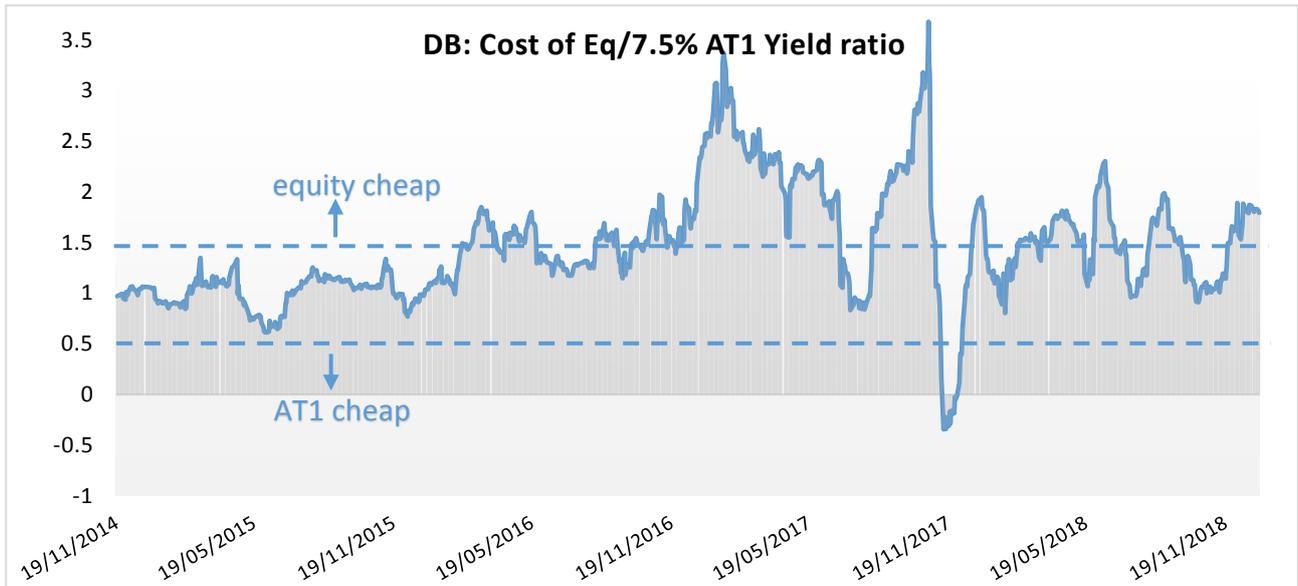


Figure 6 Source Bloomberg. Own calculations.

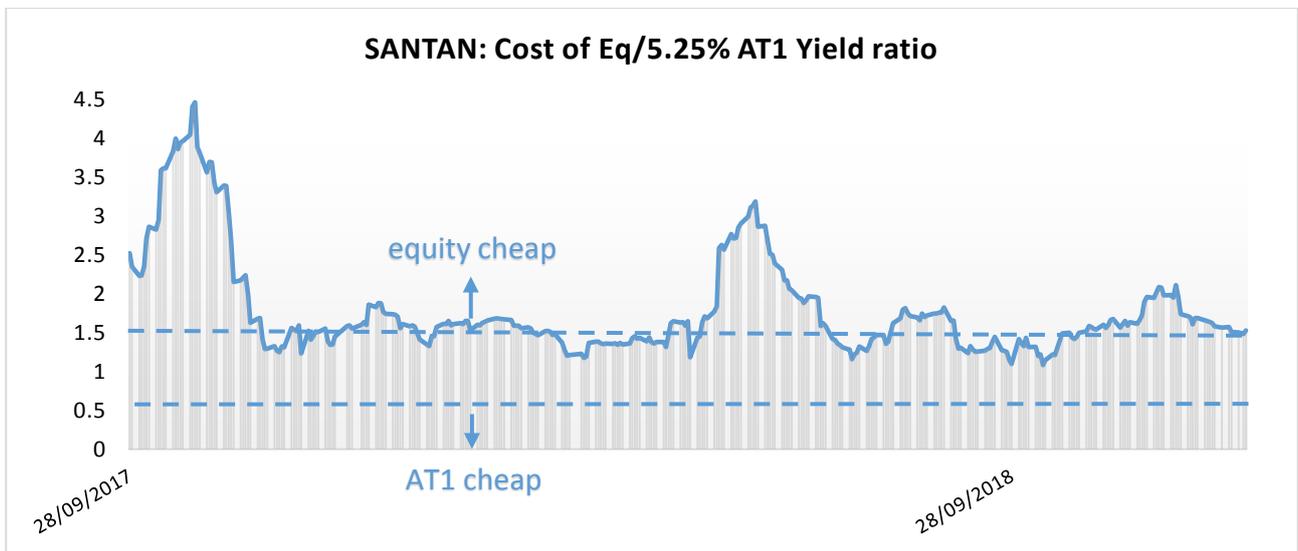


Figure 7 Source Bloomberg. Own calculations.

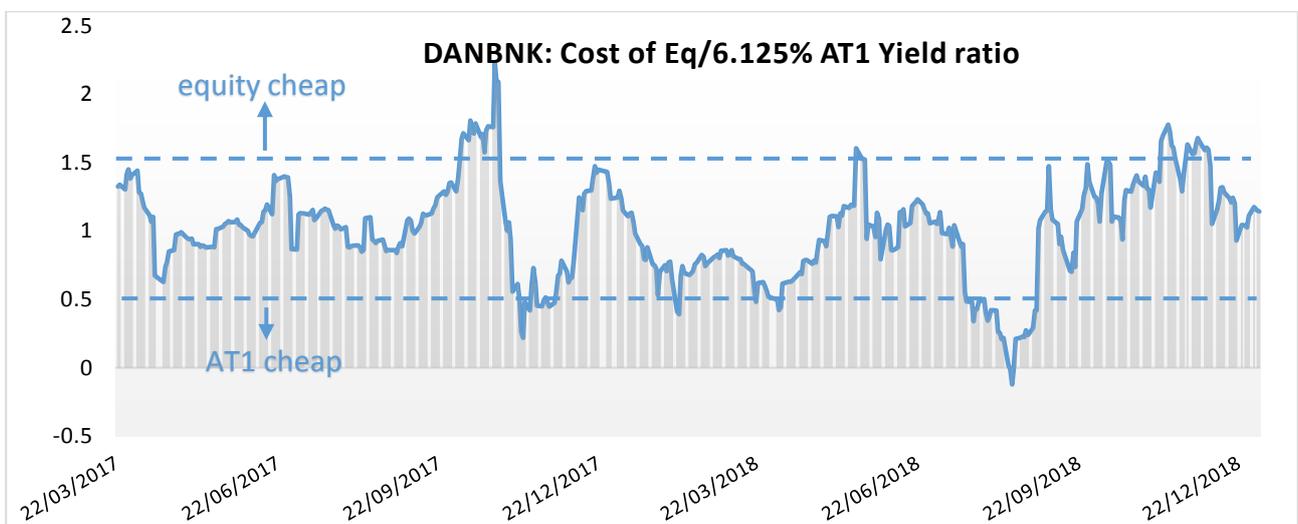


Figure 8 Source Bloomberg. Own calculations.

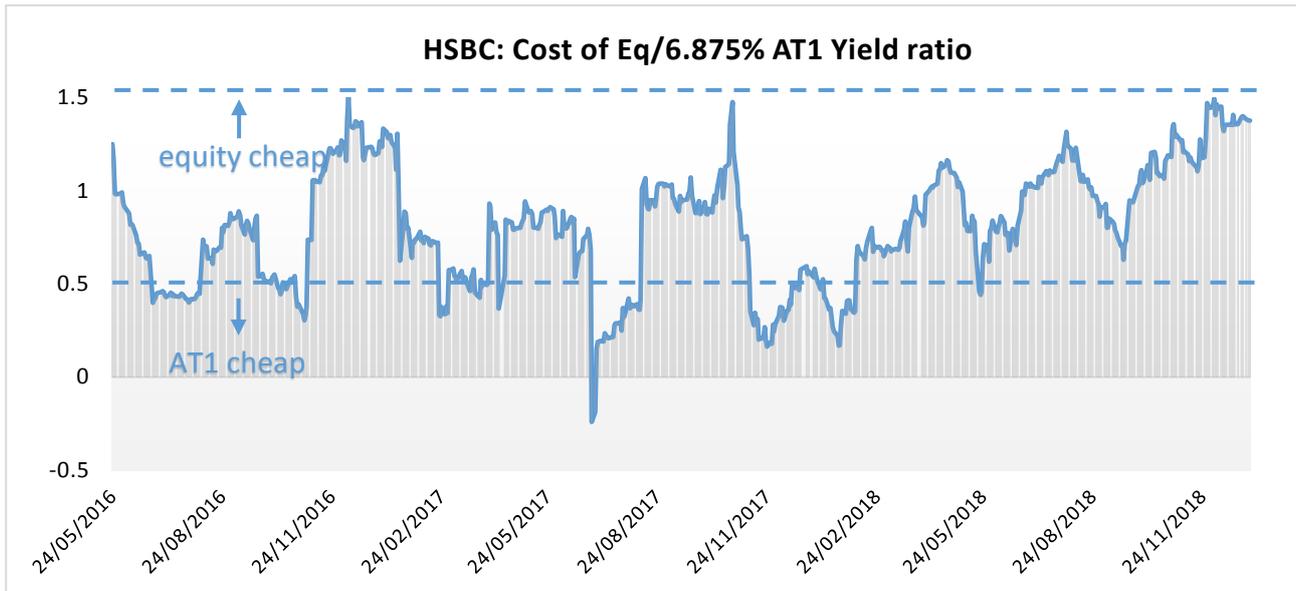


Figure 9 Source Bloomberg. Own calculations.

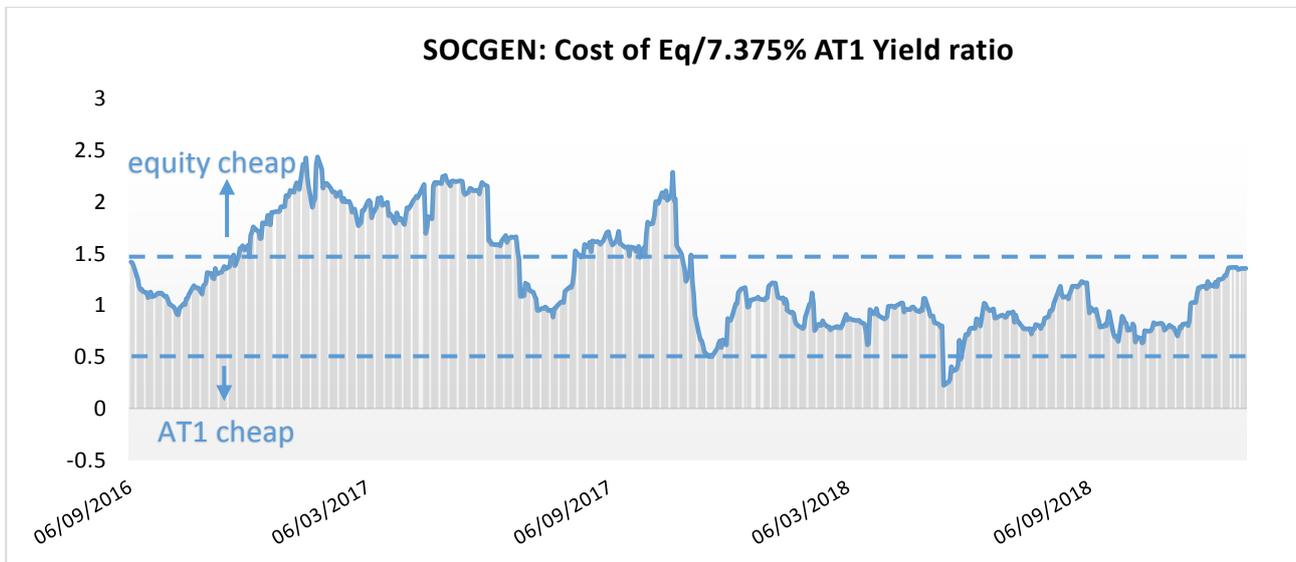


Figure 10 Source Bloomberg. Own calculations.

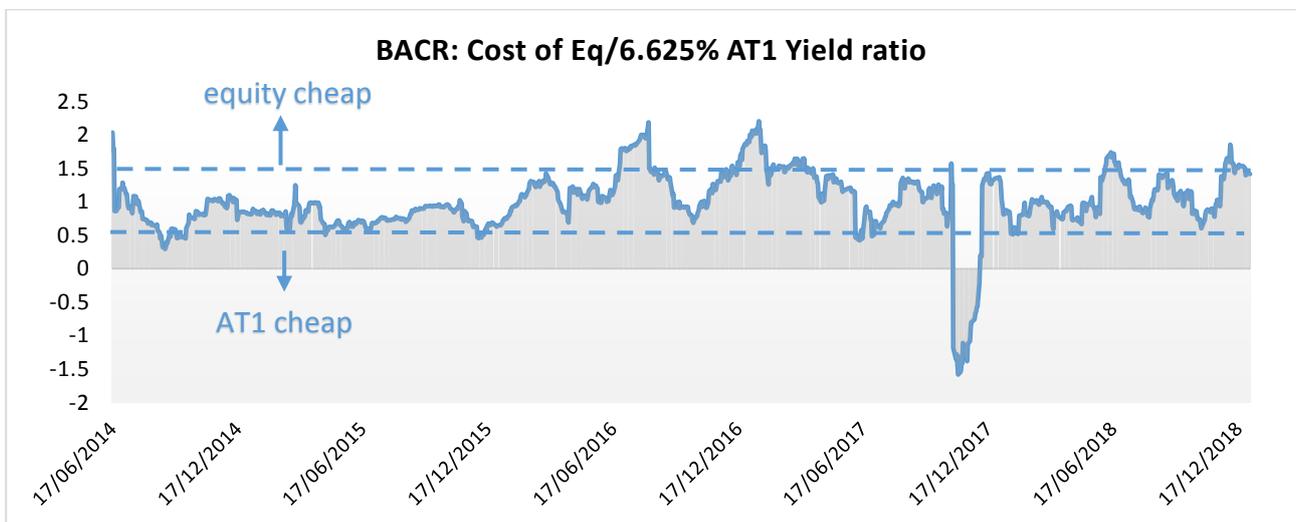


Figure 11 Source Bloomberg. Own calculations.



This “back test” in reality is only a quick check to see if the signals generated by the ratio are consistent with the description of the ratio itself, i.e. if the equity actually performs better than the AT1 bond from points in time when it is cheap and vice versa. I am not claiming to generate an algorithm that gives buy and sell signals, but I just want to assess if, by taking some of the more extremes level reached by the ratio as entry/exit points, the strategy would have given a positive return (trading and borrowing costs aside). The calculations are based on an adjusted beta-weighted positions.

The following table sums up the results of the study.

TOTAL RETURNS

DANSKE BANK 6.125 USD DANSKE STOCK (USD)	23/10/2017-30/11/2017		30/11/2017-02/01/2019			
	SHORT	+1.02%	LONG	-12.57%		
	LONG	-2.314%	SHORT	+19.35%		
	NET	-1.29%	NET	+6.78%		
SOCGEN 7.375% USD SOCGEN STOCK (USD)	06/01/2017-30/05/2018		30/05/2018-02/01/2019			
	SHORT	-12.73%	LONG	-0.54%		
	LONG	-1.28%	SHORT	+11.93%		
	NET	-14.01%	NET	+11.39%		
HSBC 6.875% USD HSBC STOCK(USD)	30/06/2017-02/01/2019					
	LONG	+4.53%				
	SHORT	+1.94%				
	NET	+6.47%				
DB 7.5% USD DB STOCK (USD)	20/01/2017-21/07/2017		20/10/2017-20/11/2017		20/11/2017-02/01/2019	
	SHORT	-19.86%	SHORT	+0.60%	LONG	-16.07%
	LONG	+3.26%	LONG	+5.99%	SHORT	+25.87%
	NET	-16.60%	NET	+6.59%	NET	+9.80%
DB 7.125% USD DB STOCK (GBP)	20/01/2017-21/07/2017		20/10/2017-20/11/2017		20/11/2017-02/01/2019	
	SHORT	-22.66%	SHORT	-1.60%	LONG	-17.57%
	LONG	+0.83%	LONG	+5.81%	SHORT	+24.88%
	NET	-21.82%	NET	+4.21%	NET	+7.31%
BARC 6.625% USD DB STOCK (GBP)	20/11/2017-02/01/2019					
	LONG	+1.69%				
	SHORT	+9.97%				
	NET	+11.66%				
UNICREDIT 8% USD UNICREDIT STOCK (USD)	03/01/2017-20/11/2017		20/11/2017-20/06/2018			
	SHORT	-26.65%	LONG	-5.30%		
	LONG	+16.17%	SHORT	+4.92%		
	NET	-10.48%	NET	-0.38%		
UNICREDIT 5.375% EUR UNICREDIT STOCK (EUR)	14/06/2018-28/09/2018		28/09/2018-02/01/2019			
	SHORT	+2.86%	LONG	-6.28%		
	LONG	-5.24%	SHORT	+7.09%		
	NET	-2.38%	NET	+0.81%		

Table 2 Source Bloomberg. Own calculations.

So overall, the results seem to roughly confirm the goodness of the ratio, with most trades in positive territory. Nonetheless we must be aware that using it as a trading strategy is not as straightforward as it may seem. In this respect, the result of the competition between Mickey and Donald can be revealing too.



Competition Results

Let's go back to the original question about who is the portfolio manager that we should choose in the end, Mickey or Donald? The outcome of the competition seemed to point towards Mickey. On the face of it, he is the obvious choice: after all he gets better results both in stocks and bonds.

However, life is never easy and investment decisions are not straight lines between two points.

In fact, if I told you that out of the 10 picks, Mickey chose 2 equities that both went up (hence 100% hit ratio) and 8 bonds of which 5 went up (62.5% hit ratio); while Donald chose 8 stocks of which 7 went up (87.5% hit ratio) and 1 of the 2 bonds that he chose went up (50% hit ratio), would you change your mind?

Now you can clearly see that, despite being more effective in the two choices separately, Mickey only has a 70% overall hit ratio (7 good picks out of 10). While the much-ill-treated Donald has an overall hit ratio of 80% (8 good picks out of 10). Hence Donald wins!

The first moral of the story is that back tests have to be taken with a pinch of salt (that includes mine as well).

The second moral of the story is that, despite all the marketing spin, sometimes the performing managers are the least expected and most surprising ones.

Nicola Marinelli Senior Portfolio Manager

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