

## The Case for European Financials

March 24, 2020 - Updated from original posting.

The outlook for the European banks owned across equity strategies managed by Harris Associates has moderated given the impact of the coronavirus to the global economy. While we are not experts on the coronavirus, we have a deep investment team that is experienced and practiced at valuing businesses. This disciplined approach helps us identify opportunities during times of crisis and increased volatility. We continue to believe we are positioned in the strongest banks in the sector, including BNP Paribas, Credit Suisse Group, Intesa Sanpaolo, Lloyds Banking Group and Royal Bank of Scotland (RBS), given they are well capitalized and possess high profitability buffers.

### Impact to intrinsic value

We are constantly stress testing our assumptions to determine the interest rate and economic sensitivity of our banks. To incorporate slower economic growth and reduced central bank interest rates, we are making three primary adjustments:

1. Reducing base interest rates
2. Lowering loan growth
3. Increasing credit costs

### Interest rates

We believe the coronavirus will impact interim cash flows as governments take austerity measures and expect these even lower base rates to persist for the short term. Our base case scenario is that rates remain lower for the next two years with an eventual return to pre-coronavirus levels in 2022. As a result of lower interest rates for potentially the next two years, we have brought down fair values by a few percentage points. In a lower for longer scenario, where these recently lowered rates persist for the next four to five years, our intrinsic value estimates could be reduced by an additional mid-single percent. Keep in mind that assumes no offsetting measures taken by management, including cost reduction measures, growing fee-based businesses and a rationalization of marginal competitors, a scenario we see as unlikely.

European banks have been operating in an environment with negative interest rates for some time now. Actions taken by our banks have produced positive returns as a result of adeptly reducing costs, investing in digital and repositioning their asset mix toward superior quality. For example, we've invested with CEO Antonio Horta-Osorio since his days at Banco Santander. We initiated a position in Lloyds, the U.K. leader in consumer banking, in December 2011 after his arrival because of Horta-Osorio's strong operational and capital allocation track record. Under his leadership, Lloyds has improved its ROTE over the last eight years by reducing operating and credit costs that more than offset the headwinds from lower interest rates.

## HARRIS ASSOCIATES

Harris Associates manages US, global, and international strategies. The firm employs an intensive, fundamental in-house research process to identify companies trading at a significant discount to managers' estimates of intrinsic business value. Harris Associates uses its experienced team, consistent and pervasive philosophy, repeatable and fundamental process, and long-term investment horizons as the foundation of steadfast conviction.

### HARRIS ASSOCIATES L.P.

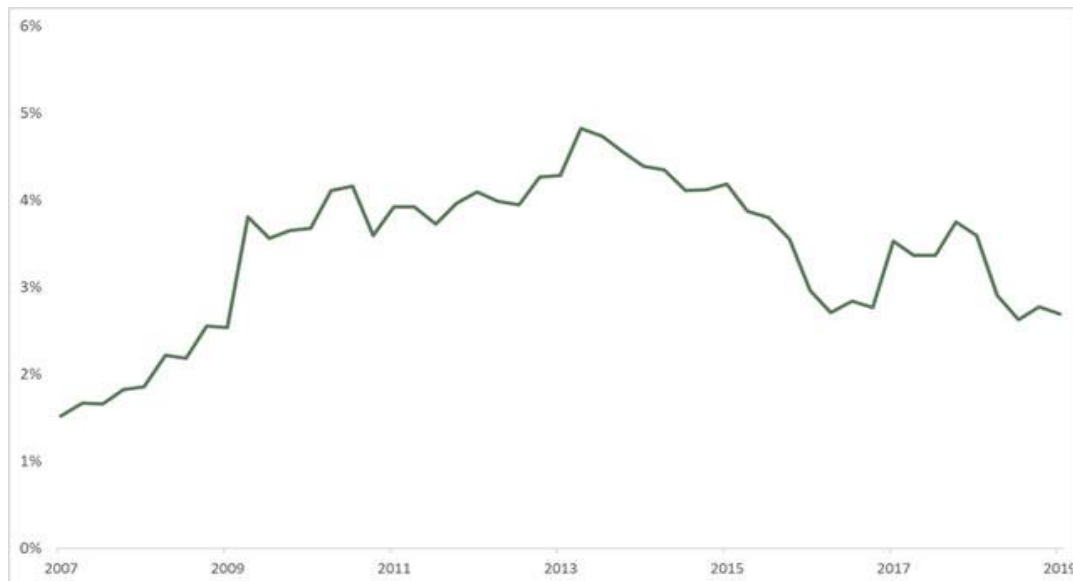
An affiliate of Natixis Investment Managers. Investment adviser registered with the U.S. Securities and Exchange Commission (IARD No. 106960), which is licensed to provide investment management services in the United States. 111 S. Wacker Drive #4600 Chicago, IL 60606, USA. [www.harrisassoc.com](http://www.harrisassoc.com)

**Asset quality**

We believe the European banks are in a much stronger position to weather a potential credit downturn today than they have been during previous cycles. Tighter underwriting standards, higher capital levels, slower credit growth, and the absence of any obvious residential or commercial real estate bubbles all contribute to this relatively strong positioning. Governments across Europe are being very proactive in supporting small- and medium-sized enterprises and industries that are more exposed to the coronavirus, such as airlines and hotels.

Going forward, we do assume increases in non-performing loans (NPLs) and bankruptcies of corporate clients of the European banks. Overall, we are now modeling in a double digit percent increase in both NPLs and credit costs for both FY2020 and FY2021. Because we believe our bank holdings have strong loan books with high levels of underlying profitability, we do not expect these short-term adjustments will be material to our valuations.

Figure 1: European Banks NPL Ratio

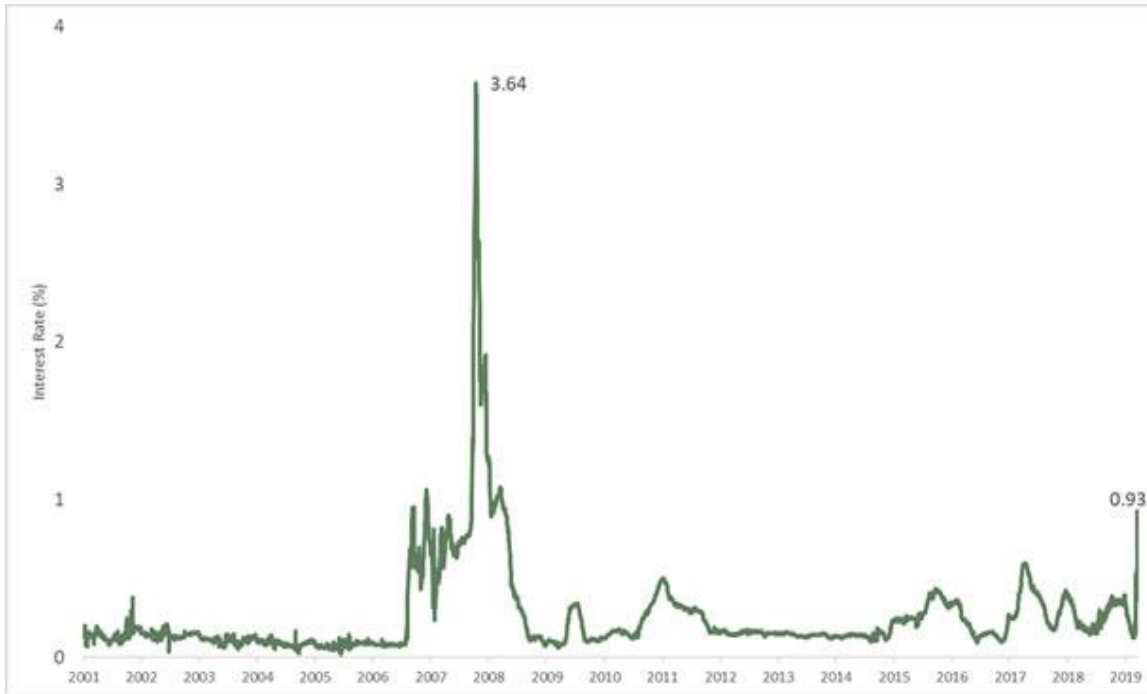


As of 12/31/2019  
 Source: European Central Bank

**Liquidity**

The European Central Bank (ECB) is taking steps to ensure liquidity. The ECB reintroduced LTRO, a cheap loan scheme that was first used in 2011, with the aim to eliminate potential Euro liquidity strains. In the first LTRO auction this week, €109 billion was taken up by 110 banks. We believe this will be an effective backstop for banks as funding conditions worsen. We are monitoring three month Libor–OIS spreads. While they have widened in the past week, they remain well off the global financial crisis highs.

Figure 2: 3 Month USD LIBOR–OIS Spread



As of March 18, 2020

Source: Bloomberg

While we believe government actions to provide liquidity are the correct course of action, we are also comforted by the significant improvement in bank liquidity coupled with a reduced reliance on higher risk wholesale funding sources. Autonomous,<sup>1</sup> an independent research firm focused on financial institutions, estimates European banks aggregated loan-to-deposit ratios fell from 125% in 2008 to less than 100% currently. In addition, we believe that our bank holdings possess lower liquidity risk than the average given superior franchises coupled with better business models.

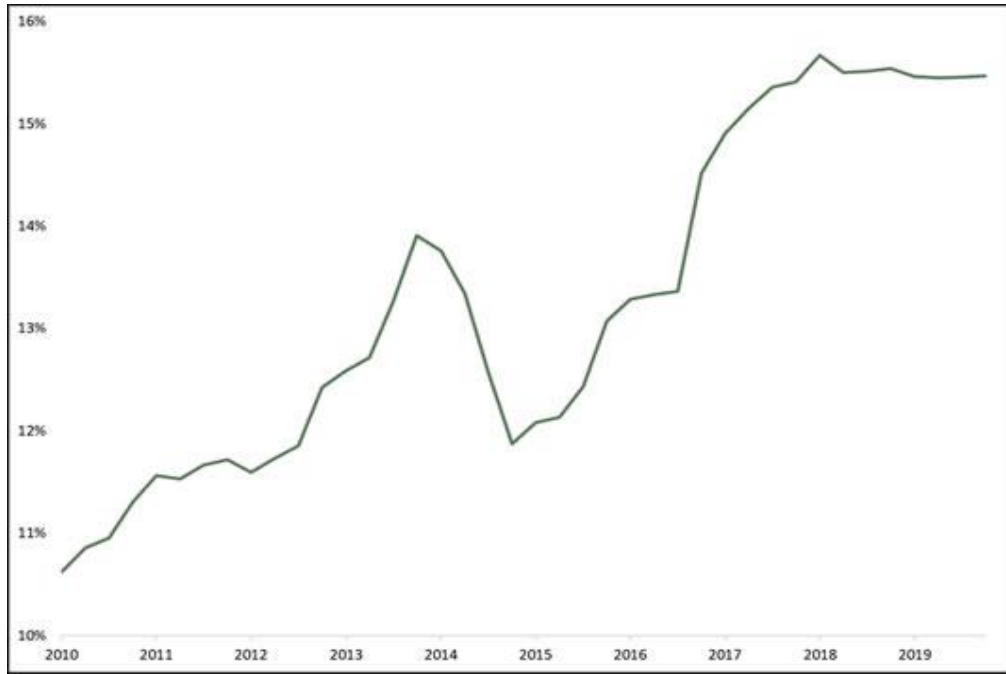
### Capital

When the large global banks entered the global financial crisis they were unprepared for the situation with a comparable CET1 capital position of only 3.8% in 2007 versus 13.4% at the end of 2019.<sup>1</sup> Today, capital levels are effectively 3.5x higher than before the start of the 2008 financial crisis and many of our banks possess either higher capital levels or more diversified/lower risk business models than the average.

While regulations and rules stiffened over the last decade, central banks in Europe and the United Kingdom are now reducing these counter cyclical buffers to help support the economy.

The Bank of England (BOE) recently announced reduced capital requirements for both RBS and Lloyds, leaving them both way over-capitalized.

Figure 3: European Banks Core Tier 1 Capital Ratio



As of 12/31/2019

Source: European Central Bank

Given the spread of the virus within Italy, it appears Intesa will be the most impacted by this as it stands now. However, Intesa has a ~460bps capital buffer over required capital, positioning the company to handle potential spikes in credit costs.

Figure 4: European Bank Capital Levels

As of March 17, 2020	2007 Core Tier 1 Ratio	2019 Core Tier 1 Ratio
BNP Paribas	7.3%	12.4%
RBS	7.3%	16.2%
Lloyds	8.1%	13.8%
Intesa Sanpaolo	5.9%	14.1%
Credit Suisse	11.1%	12.7%

Source: Harris Associates

**Widening value gap**

As is often the case, share prices of our banks have fallen by approximately 45% over the last month. We believe a value gap is widening. When this occurs, you can expect us to purchase the names with the most upside to intrinsic value, essentially de-risking our portfolio.

Figure 5: Financial holdings valuation update

As of March 17, 2020	Stock Price Total Return QTD	Price to Tangible Book Value FY1	Price to Earnings Ratio FY1	Dividend Yield 2020E
BNP Paribas (€)	-45%	0.4x	5.5x	10.6%
RBS (£)	-45%	0.5x	9.2x*	9.1%
Lloyds (£)	-43%	0.7x	5.5x	10.0%
Credit Suisse (CHF)	-48%	0.4x	4.0x	4.6%
Intesa Sanpaolo (€)	-38%	0.5x	5.6x	12.6%

Source: Harris Associates estimates. \*RBS P/E adjusted for one-time items.

When the uncertainty starts to wane in time, we believe the European financials can provide strong total returns for our shareholders. Thank you for your continued confidence and patience.

David G. Herro, CFA  
Partner and CIO-International Equity

Jason E. Long, CFA  
Partner and Portfolio Manager

Justin D. Hance, CFA  
Partner and Portfolio Manager

1Autonomous Research. (2020). European Banks – What’s Priced In.

Investing in foreign securities presents risks that in some ways may be greater than U.S. investments. Those risks include: currency fluctuation; different regulation, accounting standards, trading practices and levels of available information; generally higher transaction costs; and political risks.

Investing in value stocks presents the risk that value stocks may fall out of favor with investors and underperform growth stocks during given periods.

The information, data, analyses, and opinions presented herein (including current investment themes, the portfolio managers’ research and investment process, and portfolio characteristics) are for informational purposes only and represent the investments and views of the portfolio managers and Harris Associates L.P. as of the date written and are subject to change and may change based on market and other conditions and without notice. This content is not a recommendation of or an offer to buy or sell a security and is not warranted to be correct, complete or accurate.

Certain comments herein are based on current expectations and are considered “forward-looking statements”. These forward looking statements reflect assumptions and analyses made by the portfolio managers and Harris Associates L.P. based on their experience and perception of historical trends, current conditions, expected future developments, and other factors they believe are relevant. Actual future results are subject to a number of investment and other risks and may prove to be different from expectations. Readers are cautioned not to place undue reliance on the forward-looking statements.

## Additional Information

This material has been provided for information purposes only to investment service providers or other Professional Clients or Qualified Investors and, when required by local regulation, only at their written request. This material must not be used with Retail Investors. In the E.U. (outside of the UK and France): Provided by Natixis Investment Managers S.A. or one of its branch offices listed below. Natixis Investment Managers S.A. is a Luxembourg management company that is authorized by the Commission de Surveillance du Secteur Financier and is incorporated under Luxembourg laws and registered under n. B 115843. Registered office of Natixis Investment Managers S.A.: 2, rue Jean Monnet, L-2180 Luxembourg, Grand Duchy of Luxembourg. Italy: Natixis Investment Managers S.A., Succursale Italiana (Bank of Italy Register of Italian Asset Management Companies no 23458.3). Registered office: Via San Clemente 1, 20122 Milan, Italy. Germany: Natixis Investment Managers S.A., Zweigniederlassung Deutschland (Registration number: HRB 88541). Registered office: Im Trutz Frankfurt 55, Westend Carrée, 7. Floor, Frankfurt am Main 60322, Germany. Netherlands: Natixis Investment Managers, Nederlands (Registration number 50774670). Registered office: Stadsplateau 7, 3521AZ Utrecht, the Netherlands. Sweden: Natixis Investment Managers, Nordics Filial (Registration number 516405-9601 - Swedish Companies Registration Office). Registered office: Kungsgatan 48 5tr, Stockholm 111 35, Sweden. Spain: Natixis Investment Managers, Sucursal en España. Registered office: Serrano n°90, 6th Floor, 28006 Madrid, Spain. Belgium: Natixis Investment Managers S.A., Belgian Branch, Louizalaan 120 Avenue Louise, 1000 Brussel/Bruxelles, Belgium. • In France: Provided by Natixis Investment Managers International – a portfolio management company authorized by the Autorité des Marchés Financiers (French Financial Markets Authority - AMF) under no. GP 90-009, and a public limited company registered in the Paris Trade and Companies Register under no. 329 450 738. Registered office: 43 avenue Pierre Mendès France, 75013 Paris. • In Switzerland: Provided by Natixis Investment Managers, Switzerland Sàrl, Rue du Vieux Collège 10, 1204 Geneva, Switzerland or its representative office in Zurich, Schweizergasse 6, 8001 Zürich. • In the British Isles: Provided by Natixis Investment Managers UK Limited which is authorised and regulated by the UK Financial Conduct Authority (register no. 190258) - registered office: Natixis Investment Managers UK Limited, One Carter Lane, London, EC4V 5ER. When permitted, the distribution of this material is intended to be made to persons as described as follows: in the United Kingdom: this material is intended to be communicated to and/or directed at investment professionals and professional investors only; in Ireland: this material is intended to be communicated to and/or directed at professional investors only; in Guernsey: this material is intended to be communicated to and/or directed at only financial services providers which hold a license from the Guernsey Financial Services Commission; in Jersey: this material is intended to be communicated to and/or directed at professional investors only; in the Isle of Man: this material is intended to be communicated to and/or directed at only financial services providers which hold a license from the Isle of Man Financial Services Authority or insurers authorised under section 8 of the Insurance Act 2008. • In the DIFC: Provided in and from the DIFC financial district by Natixis Investment Managers Middle East (DIFC Branch) which is regulated by the DFSA. Related financial products or services are only available to persons who have sufficient financial experience and understanding to participate in financial markets within the DIFC, and qualify as Professional Clients or Market Counterparties as defined by the DFSA. No other Person should act upon this material. Registered office: Office 23, Level 15, The Gate Building, East Wing, DIFC, PO Box 506752, Dubai, United Arab Emirates. • In Taiwan: Provided by Natixis Investment Managers Securities Investment Consulting (Taipei) Co., Ltd., a Securities Investment Consulting Enterprise regulated by the Financial Supervisory Commission of the R.O.C. Registered address: 34F., No. 68, Sec. 5, Zhongxiao East Road, Xinyi Dist., Taipei City 11065, Taiwan (R.O.C.), license number 2018 FSC SICE No. 024, Tel. +886 2 8789 2788. • In Singapore: Provided by Natixis Investment Managers Singapore (name registration no. 53102724D) to distributors and institutional investors only. Natixis Investment Managers Singapore is a division of Ostrum Asset Management Asia Limited (company registration no. 199801044D). • In Hong Kong: Provided by Natixis Investment Managers Hong Kong Limited to institutional/ corporate professional investors only. • In Australia: Provided by Natixis Investment Managers Australia Pty Limited (ABN 60 088 786 289) (AFSL No. 246830) and is intended for the general information of financial advisers and wholesale clients only. • In New Zealand: This document is intended for the general information of New Zealand wholesale investors only. This is not a regulated offer for the purposes of the Financial Markets Conduct Act 2013 (FMCA) and is only available to New Zealand investors who have certified that they meet the requirements in the FMCA for wholesale investors. Natixis Investment Managers Australia Pty Limited is not a registered financial service provider in New Zealand

## Additional Information (Ctd.)

. • In Latin America: Provided by Natixis Investment Managers S.A. • In Chile: Esta oferta privada se inicia el día de la fecha de la presente comunicación. La presente oferta se acoge a la Norma de Carácter General N° 336 de la Superintendencia de Valores y Seguros de Chile. La presente oferta versa sobre valores no inscritos en el Registro de Valores o en el Registro de Valores Extranjeros que lleva la Superintendencia de Valores y Seguros, por lo que los valores sobre los cuales ésta versa, no están sujetos a su fiscalización. Que por tratarse de valores no inscritos, no existe la obligación por parte del emisor de entregar en Chile información pública respecto de estos valores. Estos valores no podrán ser objeto de oferta pública mientras no sean inscritos en el Registro de Valores correspondiente. • In Colombia: Provided by Natixis Investment Managers S.A. Oficina de Representación (Colombia) to professional clients for informational purposes only as permitted under Decree 2555 of 2010. Any products, services or investments referred to herein are rendered exclusively outside of Colombia. This material does not constitute a public offering in Colombia and is addressed to less than 100 specifically identified investors. • In Mexico: Provided by Natixis IM Mexico, S. de R.L. de C.V., which is not a regulated financial entity, securities intermediary, or an investment manager in terms of the Mexican Securities Market Law (Ley del Mercado de Valores) and is not registered with the Comisión Nacional Bancaria y de Valores (CNBV) or any other Mexican authority. Any products, services or investments referred to herein that require authorization or license are rendered exclusively outside of Mexico. While shares of certain ETFs may be listed in the Sistema Internacional de Cotizaciones (SIC), such listing does not represent a public offering of securities in Mexico, and therefore the accuracy of this information has not been confirmed by the CNBV. Natixis Investment Managers is an entity organized under the laws of France and is not authorized by or registered with the CNBV or any other Mexican authority. Any reference contained herein to "Investment Managers" is made to Natixis Investment Managers and/or any of its investment management subsidiaries, which are also not authorized by or registered with the CNBV or any other Mexican authority. • In Uruguay: Provided by Natixis Investment Managers Uruguay S.A., a duly registered investment advisor, authorised and supervised by the Central Bank of Uruguay. Office: San Lucar 1491, Montevideo, Uruguay, CP 11500. The sale or offer of any units of a fund qualifies as a private placement pursuant to section 2 of Uruguayan law 18,627. • The above referenced entities are business development units of Natixis Investment Managers, the holding company of a diverse line-up of specialised investment management and distribution entities worldwide. The investment management subsidiaries of Natixis Investment Managers conduct any regulated activities only in and from the jurisdictions in which they are licensed or authorised. Their services and the products they manage are not available to all investors in all jurisdictions. It is the responsibility of each investment service provider to ensure that the offering or sale of fund shares or third party investment services to its clients complies with the relevant national law.

In the United States: Provided by Natixis Distribution, L.P., 888 Boylston St., Boston, MA 02199 for U.S. financial advisors who do business with investors who are not U.S. Persons (as that term is used in Regulation S under the Securities Act of 1933) or persons otherwise present in the U.S. It may not be redistributed to U.S. Persons or persons present in the U.S. Natixis Investment Managers includes all of the investment management and distribution entities affiliated with Natixis Distribution, L.P. and Natixis Investment Managers S.A.

This document may contain references to copyrights, indexes and trademarks that may not be registered in all jurisdictions. Third party registrations are the property of their respective owners and are not affiliated with Natixis Investment Managers or any of its related or affiliated companies (collectively "Natixis"). Such third party owners do not sponsor, endorse or participate in the provision of any Natixis services, funds or other financial products.

The index information contained herein is derived from third parties and is provided on an "as is" basis. The user of this information assumes the entire risk of use of this information. Each of the third party entities involved in compiling, computing or creating index information, disclaims all warranties (including, without limitation, any warranties of originality, accuracy, completeness, timeliness, non-infringement, merchantability and fitness for a particular purpose) with respect to such information.

The provision of this material and/or reference to specific securities, sectors, or markets within this material does not constitute investment advice, or a recommendation or an offer to buy or to sell any security, or an offer of any regulated financial activity. Investors should consider the investment objectives, risks and expenses of any investment carefully before investing. The analyses, opinions, and certain of the investment themes and processes referenced herein represent the views of the portfolio manager(s) as of the date indicated. These, as well as the portfolio holdings and characteristics shown, are subject to change. There can be no assurance that developments will transpire as may be forecasted in this material. Although Natixis Investment Managers believes the information provided in this material to be reliable, including that from third party sources, it does not guarantee the accuracy, adequacy, or completeness of such information. May not be redistributed, published, or reproduced, in whole or in part. Amounts shown are expressed in USD unless otherwise indicated.