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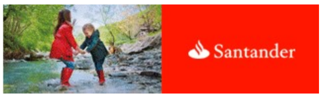

Spanish Financial Sector: Digitalisation Helps Profits

TOPICS: Banking Industry Banking Profits Banks Digitalisation Spain Banking Sector

Both Santander and BBVA generate most of their profits abroad enabling them to weather downturns in their home market

POSTED BY: OFELIA MARÍN LOZANO 13TH JUNE 2018

The Spanish financial sector has made an **unprecedented effort to sanitise its books:** since the beginning of the crisis in 2008, sanitising and provisions (amounting to some 260 billion

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euros) have reduced profit margins by two thirds, according to figures from the latest annual meeting of the financial sector organised by the Ratings Organisation, Deloitte and ABC. In the last four years the network of branches has reduced by 40% and the number of employees by 32%. Bad debt has also reduced by half, and is now below the average for the EU. Return on equity has improved (7% in December 2017 compared to the average 6% in the EU), but nowehere in Europe apart from Sweden has it reached the double digit levels of before the crisis.

The role of digitilisation replacing branches was one of the recurrent themes of the meeting. On one side, it makes clear the exponential growth of services linked to technology. For example, **BBVA expects that more than half of the bank´s sales will be through digital channels by the end of 2019** (currently 37%). It highlighted the growth in consumer credit (up 64% in Q1 2018, after an increase of 129% in Q1 2017), where 55 % of loans are managed by mobile device. It focused on technology as one of the reasons for its profits being higher than the competition (Return on Equity (ROE) 11.9% and Return on Tangible Equity (ROTE) 14.6% in Q1 2018).

Nevertheless, it was repeatedly affirmed that all ways must be used. Thus CaixaBank pointed out that, even though 56% of their clients are digital, three quarters of them also visit branches. Maria Dolores Dancausa (Bankinter) stated that more than two thirds of their clients use both digital channels and branches. Jaime Guardiola (Sabadell) recalled that the clients who centre their activity around the branch usually have a high income. The human touch makes a difference. But that doesn´tmean that you don´t need a good digital platform. And Jose Sevilla (Bankia) pointed out that 40% of his clients still only used the Branch.

THE CORNER TEAM

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The sector in 2017

A decade after the beginning of the financial crisis, n**et profits continue the upward trend begun in 2012.** Net profits in three banks (Caixabank, Bankinter and Sabadell exceed pre-crisis levels, registering new historic highs. In Spain the profit margin before provisions shows a slight improvement, despite the interest rate environment, apart for thos ebanks who have had to deal with exceptional outlays linked to corporate operations (the purchase of Mare Nostrum by Bankia and BPI by CaixaBank).

However, the view in terms of income per share is much less favourable: less than half pre-crisis levels (in the two biggest banks it is a third of what it was, in Bankinter 62% and in Sabadell 26%).

In terms of the profit margin per share resulting from activity in Spain, Sabadell and Bankinter are in the best position, with almost two thirds of pre-crisis levels; between the two biggest Banks, BBVA is in a better position than Santander (the profit margin for activity in Spain is 24% and 38% respectively of the levels in 2007).

What to expect for future profits

On the income side, they foresee an increase thanks to the reduction in the average cost of resources – fixed term deposits have moved towards sight deposits and non-interest bearing accounts, the stabilisation of spreads with clients after various years of of falls, the continued capture of resources outside the balance sheet (principally investment and insurance funds) and, above all, the significant increase in profitability from the normalisation of interest rates.

On the costs side, some adjustments of operational costs are posible (above all in entities that have

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completed takeovers where there exist synergy savings), as well a reduction in funding for provisions, although in both cases to a lesser degree than seen in the past.

The assessments of the entitities point to a significant improval in results over the next few years:

- **Santander (José Antonio Alvarez)** expects a double digit increase in BPA in 2018, maintaining a return on tangible equity (ROTE) above 11.5% (11.8% in 2017) and a capital ratio CET1 fully loaded superior to 11% (10.8% in 2017).

- **BBVA (Carlos Torres)** recalls that in Q1 2018 its profits were already experiencing increases of 12%, and anticipates an increase in income over the next two years of 9-10%, with an increase in costs of 1-3% and a consequent improvement in efficiency.

- **CaixaBank (Gonzalo Gortazar), after a decade of successful organic and inorganic growth** (from 5,480 branches and 10.4 million customers ten years ago to 5,343 branches and 15.7 million customers now) anticipates a Strategic Plan for 2019-2020 which focuses on organic growth.

- **Bankia (José Sevilla) hopes to reach net profits of 1.3 billion euros** (an increase of 63% in 3 years) and a dividend distribution ratio of 45-50%, with return on equity (ROE)

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of 10.8%, with an efficiency increase of 47%, bad debt levels increasing 4% and solvency (CET 1 fully loaded) of 12% (commiting itself to return the excess of capital over 12%)

- **Bankinter (María Dolores Dancausa)** insisted that her bank is the only one that has not participated in any merger since its creation in 1964, and on its relative immunity to the profound crisis which has hit the sector (it was barely touched by the real estate crisis).**This makes it the best placed bank from a historical perspective:** both net profits and profit margins are at historical highs. Bankinter is quoted at the best multiple over its book value (1.6%, about double the average).

- **Sabadell (Jaime Guardiola)** sets as objectives for 2020 (compared with 2017) a ROTE of 13%, with strong growth in profits outside Spain (in the UK and Mexico), basic margin up by 17%, volumen of business up by 11%, efficiency rate about 47% and a reduction of problematic loans of 2% (problematic loans/total loans).

Profitability and stock market valuation

The return on equity will condition the relation between price and book value and the stock market valuations of the banks, as it has in the past. To the extent that the sector is capable of recovering double digit ROE as anticipated, it should be able to regain stock market valuations

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clearly above book value; even further in a background of long term interests rates at least two percentage points lower than in the past and of a return on equity estimated at 8% by the Bank of Spain.

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