C|A

CAMBRIDGE ASSOCIATES LLC

EUROPEAN MARKET COMMENTARY

THE TROUBLE WITH EUROPEAN FINANCIALS

September 2007

Eric Winig
Andrew Kim

The Trouble with European Financials

Should investors be worried about the European financial sector? This may seem an odd question to ask given that most problems in credit markets have thus far been centered in the United States, and that both the European Central Bank and Bank of England (BOE) have moved aggressively to head off trouble.[1] Still, there are legitimate reasons for concern. While the locus of the crisis may have been the United States, European institutions not only have significant exposure to bad debt (now commonly referred to as "toxic waste"), but have also set up opaque, off-balance sheet structures that defy analysis and could expose the parent institutions to significant losses in the event the credit crisis worsens. Even if one assumes there is no systemic crisis looming, U.K. and continental institutions have a lot of bad debt on their books that will almost certainly deal a sharp blow to future earnings. As financials are by far the largest-weighted sector in both the United Kingdom and continental Europe (Table A), any hit to profits would likely cause share prices to sink a good deal lower unless earnings multiples were to move sharply higher, which seems unlikely to be sustainable in the current environment.

Earnings—Less than Meets the Eye?

The main rallying cry for those of a bullish persuasion over the past few years has been that price-earnings (P/E) multiples are "reasonable" based on trailing 12-month earnings.[2] However, as we and others have pointed out, these multiples tend to flatter equities during periods such as the present in which profits and profit margins are cyclically high, and (more germane to this paper) have recently relied heavily on rapid growth in financial and energy sector earnings. For the 12 months ended in August, for example, the U.K. and continental financial sectors, which make up 25.6% and 29.4% of their respective indices, contributed 31.4% and 40.6% of total earnings, and 36.0% and 64.4% of earnings *growth* (Table B). Since third quarter 2003, the U.K. and continental financial sectors have contributed 32.8% and 47.9% of total earnings growth for their respective indices.

The problem seems most acute on the Continent, where financials have dominated earnings growth over the past few years due to a number of one-off factors such as a boom in mergers and acquisitions (M&As), heavy debt issuance by European companies, and rampant securitization of that debt.[3] Thus, any hit to financial sector earnings will likely fall most heavily on the Continent. With regard to the United Kingdom, we have previously pointed out that it is heavily reliant on financial and energy sector earnings,[4] and this continues to be the case; however, the Continent's larger reliance on financials makes it more vulnerable to a worsening of the credit crunch.

---

[1] Indeed, while the BOE was initially critical of other central banks for what it labeled irresponsible liquidity injections, the bank subsequently attempted to bail out Northern Rock in mid-September, after which the U.K. government stepped in to effectively guarantee depositor savings at *all* institutions when Northern Rock investors ignored the BOE's actions and queued to withdraw their savings.

[2] This applies not only to European equities, but to global markets in general.

[3] For a detailed discussion of European credit, please see our October 2006 Market Commentary *European Credit: An Accident Waiting to Happen?*

[4] Please see our May 2006 Market Commentary *U.K. Equity Valuations: A Cross-Sectional Peek.*

It is also worth noting that sustained trouble in the financial sector is unlikely to stay "contained" for long. To give just one example, continental equity multiples have been boosted in recent years by the buoyant M&A market, with investors buying shares in hopes the company will subsequently be bought out. Assuming this is coming to an end (and signs are that it is, central bank activity notwithstanding), multiples are, on balance, likely to adjust lower. In short, the financial sector is unique in that its actions affect every other sector through funding activities, etc., and troubles in financials are therefore likely to have a large and broad effect on economic activity.

Where Are the Bodies Buried?

With reports of troubled financial institutions coming fast and furious (one of the more eye-catching was that of the aforementioned Northern Rock, which faced queues of depositors seeking to withdraw funds in a real, honest-to-goodness bank run), investors are rightly asking who has exposure to debt now referred to as "toxic waste"—specifically (but not exclusively) U.S. subprime mortgage paper. However, the question is more complicated than it appears. To begin with, even the most plugged-in investment banks readily admit they have little insight on the scope of the problem. Goldman Sachs, for example, recently observed, "Getting a good sense of the size of potential losses in European institutions is challenging given the complex nature of the underlying instruments and the opaque nature [of] the funds holding the exposure." Merrill Lynch echoed these sentiments, commenting that "in the absence of disclosure, *we can not size the potential risks* from subprime and CDOs at most banks." (Emphasis added.) Indeed, this theme recurs in virtually every report penned on the crisis—put bluntly, while investors can try to guess where problems will surface next, there is simply *no way to know* the total exposure of European institutions, let alone which firms are (or soon will be) in trouble.

Further, even if total direct exposures were known, they would likely understate the true scope of the problem. J.P. Morgan, for example, recently observed that "evidence is gathering of deteriorating asset quality in prime lending and this is likely to intensify," and also noted subprime markets outside the United States (e.g., the United Kingdom and Spain) are vulnerable. Indeed, J.P. Morgan believes the *primary* risk to global financials is "complacency by management and equity markets that the U.S. asset quality problem is merely a sub-prime problem and insufficient attention to indirect affects [sic]."

Given all that, many analysts have taken their best shot at quantifying exposures, as well as the potential impact on earnings. However, all such analyses are prefaced with two significant caveats: first, that the black-box nature of the problem makes any analysis little more than an educated guess, and second, that changing market conditions could quickly invalidate any conclusions drawn.

J.P. Morgan, for example, says 2007 earnings for European financials (including the United Kingdom) could take a 2.7% hit, although analysts excluded any impact from mortgage originations gone bad or banks that financed ailing mortgage originators, the latter of which "is expected to be the greatest risk area." Goldman Sachs, meanwhile, pegs initial losses for continental institutions at US$20 billion (split equally between banks and investment funds), or about 16% of trailing 12-month earnings, and says there are "further significant exposures in the UK." Finally, Merrill Lynch says 2008 earnings for European *banks* (including the United Kingdom) could show a 10% decline, although this excludes several major players (ABN AMRO, Barclays, RBS, Santander, and Fortis) on whom Merrill is "research restricted." As noted above, all three firms also stressed that their estimates were highly dependent on a number of unknown variables, and thus susceptible to major revisions as conditions change.

What's an SIV?

Part of the reason for analysts' confusion has to do with the proliferation in recent years of opaque, off-balance-sheet vehicles designed to boost profits by essentially borrowing short and lending long. The two most common conduits are asset-backed commercial paper (ABCP) conduits and structured investment vehicles (SIVs). While a detailed discussion is beyond the scope of this paper, it is useful to understand the general mechanics of such structures.

ABCP conduits and SIVs differ in terms of specifics (e.g., asset composition), but are similar from a broad perspective. Both generally issue commercial paper (CP) with maturities of less than 90 days, using the proceeds to fund a portfolio of longer-term debt (e.g., loans, asset-backed securities, collateralized debt obligations, etc.). Such conduits are typically rated quite highly by ratings agencies. In the case of ABCP conduits, high ratings are due in large part to the fact that their CP is *fully covered* by back-up funding lines from highly rated banks—in other words, the banks are committed to funding these vehicles even if they are unable to sell their CP to investors. In the case of SIVs, back-up funding tends to be limited; their primary method for maintaining high ratings has to do with carefully monitoring holdings. As Merrill Lynch put it in a recent report, "While SIVs are structured as evergreen vehicles and can operate with ratings below AAA, they use different modes of operation to restore themselves to triple-A health." Both ABCP conduits and SIVs are generally off–balance sheet, but any earnings are consolidated into profit and loss statements.

The main problem for analysts is the opaque nature of these vehicles, coupled with the potential for significant losses if credit markets remain frozen for any long stretch of time. Put simply, these vehicles are designed for "normal" market conditions, when capital flows freely and is generally available. In the case of a widespread credit crunch, vehicle managers unable to sell CP would either be forced to draw down funding lines or sell assets. In such an environment, institutions could realize substantial losses from these types of vehicles, with forced sales exacerbating downward pressure on asset prices, which may go a long way toward explaining why central banks have acted in such a hurried manner in recent months, even as equity markets remain near all-time highs.

Conclusion

The European financial sector has been of enormous importance to overall earnings over the past several years, and has thus factored heavily in bullish analysis based on P/E multiples that use trailing 12-month earnings. However, the sector is quite exposed to the current troubles with U.S. subprime debt, and indeed the credit crisis appears to be spreading quickly to other forms of debt. While analysis of European financials' exposure to bad debt is near impossible due to the opaque and off-balance-sheet nature of many investment structures, it is readily apparent that exposures are significant, and that losses will increase rapidly if the crisis worsens. Given that we also believe continental equities are now pricing in a best-case scenario for structural reform,[5] the region is likely to suffer disproportionately from a worsening credit crunch that spills over into economic activity.

[5] Please see our June 2007 Market Commentary *European Equities: Priced for Perfection?*

Table A

MSCI U.K. AND MSCI EUROPE EX U.K.
SECTOR WEIGHT AND EARNINGS BREAKDOWN

As of 31 August 2007

	MSCI U.K.		MSCI Europe ex U.K.	
	Sector Weight (%)	Contribution to Earnings (%) Last 12 Months	Sector Weight (%)	Contribution to Earnings (%) Last 12 Months
Consumer Discretionary	9.30	8.46	10.25	7.79
Consumer Staples	11.87	7.75	8.29	5.75
Energy	17.02	20.85	6.23	7.31
Financials	25.57	31.40	29.38	40.61
Health Care	7.76	7.27	7.12	5.41
Industrials	6.36	3.86	11.82	9.19
Information Technology	0.74	0.42	5.49	3.55
Materials	9.32	8.69	8.03	8.25
Telecommunication Services	7.53	6.67	6.36	5.82
Utilities	4.52	4.65	7.03	6.33

Sources: Factset Research Systems and MSCI Inc. MSCI data provided "as is" without any expressed or implied warranties.

Notes: Earnings are calculated by taking the earnings per share for the latest 12 months multiplied by total common shares outstanding. Earnings for the MSCI U.K. Index were calculated in pounds and the MSCI Europe ex U.K. Index were calculated in euros. This calculation was done by using Factset's portfolio analysis.

Table B

MSCI U.K. 12-MONTH CHANGE IN EARNINGS: FINANCIALS VERSUS OVERALL INDEX

31 December 2000 - 31 August 2007

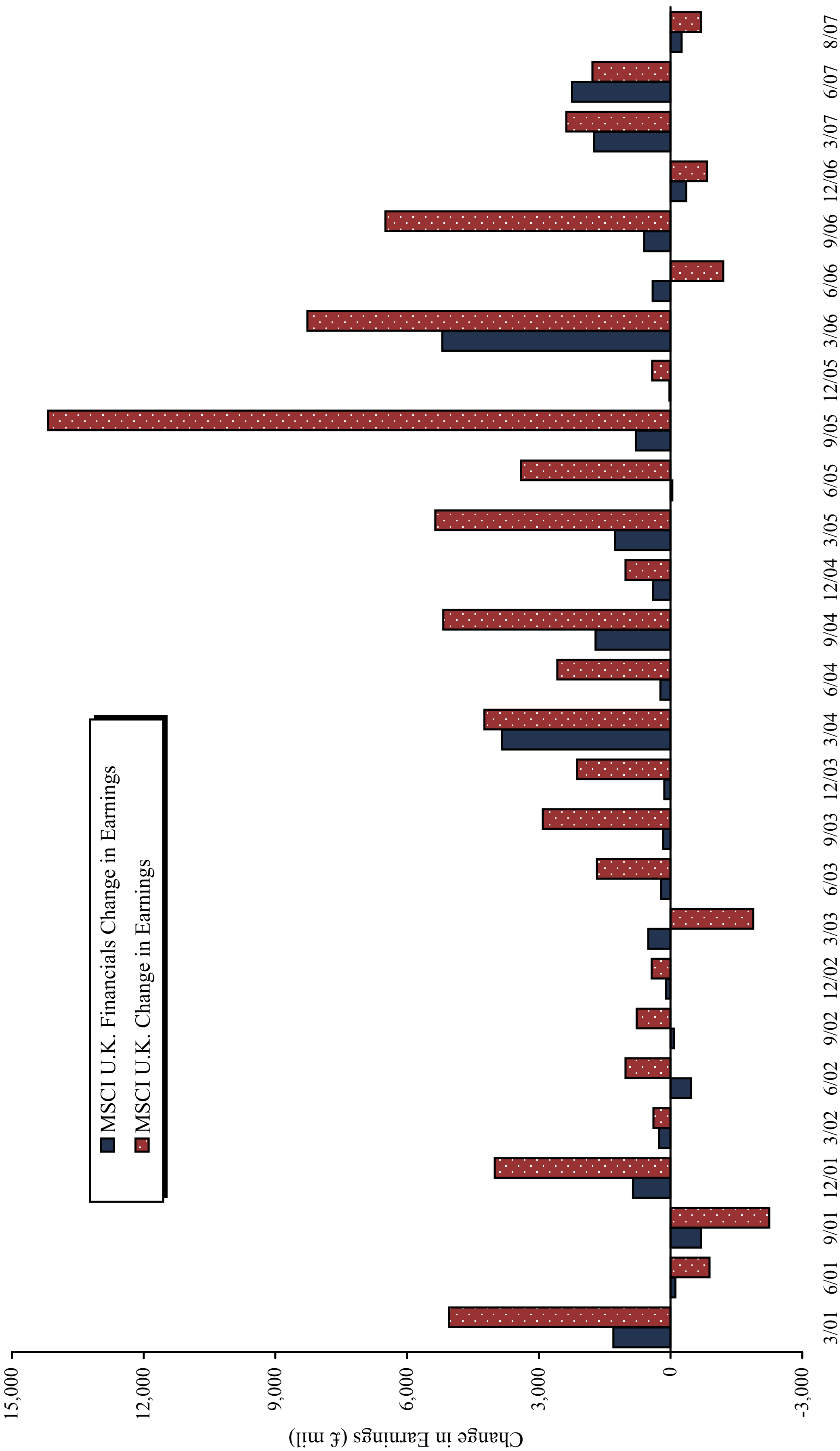
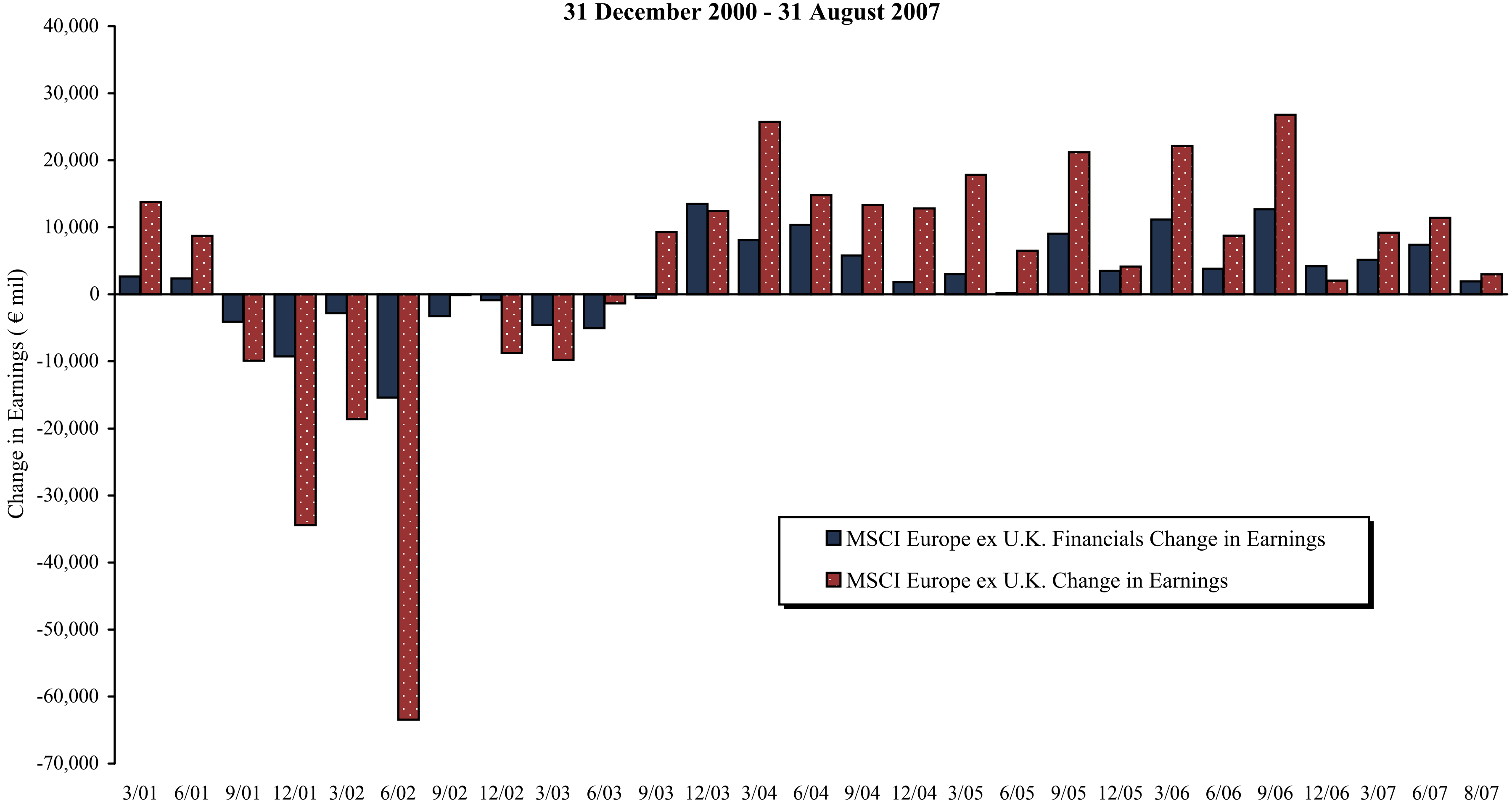


Table B (continued)

MSCI EUROPE EX U.K. 12-MONTH CHANGE IN EARNINGS: FINANCIALS VERSUS OVERALL INDEX

31 December 2000 - 31 August 2007



Sources: Factset Research Systems and MSCI Inc. MSCI data provided "as is" without any expressed or implied warranties.

Notes: Graphs show 12-month change in earnings for the MSCI U.K. (MSCI Europe ex U.K.) financial sectors and the overall MSCI U.K. Index (MSCI Europe ex U.K. Index) including financials. Earnings are calculated by taking the earnings per share for the latest 12 months multiplied by total common shares outstanding. This calculation was done by using Factset's portfolio analysis.