



Buy Pitch

Financial Institutions Group (FIG)

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Wednesday, October 30th, 2013



WESTERN INVESTMENT CLUB

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WESTERN INVESTMENT CLUB

Agenda

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Investment History

Investment Thesis

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External Analysis

Valuation

Trading Multiples and Operating Metrics

Dividend Discount Model

Valuation Summary

Risks and Catalysts

Investment Recommendation



WESTERN INVESTMENT CLUB

Banco Santander

Company Overview

Largest bank in the Eurozone with a strong global presence and sound capital

- Founded in Santander, Spain in 1857
- Banco Santander is the largest bank in the Eurozone by market value
 - Current market capitalization of \$97.9bn
 - 13th largest bank in the world by market cap
- Global network of 14,400 branches and 187,000 employees



Banco Santander branch in London, UK - 35% of gross loans in UK

Banco Santander

Investment History



Source: Google Finance (5-year stock performance)

- Original investment thesis: stock fundamentally undervalued during financial crisis
- Sell thesis: 100% gain, did not sell entire position because still strong value play with high dividend yield
 - Historical dividend yield of 9.0% - 10.5%

Banco Santander

Performance Since November 2011 Buy

27.4% return on Banco Santander to date

Western Investment Club - Financial Institutions (FIG) Portfolio

Company name	Share price (at buy)	Book value	Current share price	Market value	Capital gain	Dividends	Total return
Banco Santander	\$7.95	\$5,567.68	\$8.83	\$6,181.00	11.02%	\$910.00	27.36%
Metlife	39.67	5,950.52	48.96	7,344.00	23.42%	41.42	24.11%
Unico American Corp.	11.98	1,198.23	12.32	1,232.00	2.82%	-	2.82%
Genworth MI Canada	21.44	3,216.50	32.90	4,935.00	53.43%	144.00	57.90%
Power Financial Corp.	32.99	3,299.00	34.05	3,405.00	3.21%	70.00	5.33%
Total		\$19,231.93		\$23,097.00	20.10%	\$1,165.42	26.16%

Note: Market data as of 10/30/2013

- Strong return since November 2011 buy of 27.36%
 - Undervalued at current price – capital ratios and asset quality much stronger than peers under ECB assessment review
- Strong dividend return much higher than other banks stocks
 - Provides significant investment downside risk
 - Management has guaranteed €0.60 annual dividends per share in future

Banco Santander

Investment Thesis

Stable bank, strong capital ratios, attractively valued, low downside



Banco Santander is Spain's largest bank by assets

Company Overview

(\$ in millions of USD)

Ticker	NYSE:SAN
Stock Price	\$8.83
Market Capitalization	97,942
52-Week Trading Range	6.31 - 9.32
Earnings per Share	\$0.55
Price-to-Earnings (P/E)	16.0x
Price-to-Tangible Book Value	1.06x
Dividend Yield	8.98%

1. Strong gross loans and deposits profile
 - Largest bank in Spain – diversified globally with 74% of profits coming outside Europe
2. Potential for net interest margin expansion in international markets boosting profitability
 - Upward sloping yield curve
 - 74% of profits from retail banking (low-risk)
3. Attractive valuation
 - Trading below peers on P/TBV – 1.06x very cheap for a stable bank like Santander
 - Valuation has been suppressed due to investment risks in Spanish
 - Upside potential of 17% intrinsic value
4. Very high dividend yield (~9%) provides significant downside risk protection

Banco Santander

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5. Attractive strategic initiatives

- Santander sell off units that are expensive on P/TBV (SAN Mexico potential M&A target)
- Recent acquisition of El Corte Inglés

6. Resurgent Spanish Economy

- Signs of Spanish banking sector strengthening
- Spanish unemployment decreasing
- GDP rose in 3Q2013

7. ECB stress tests

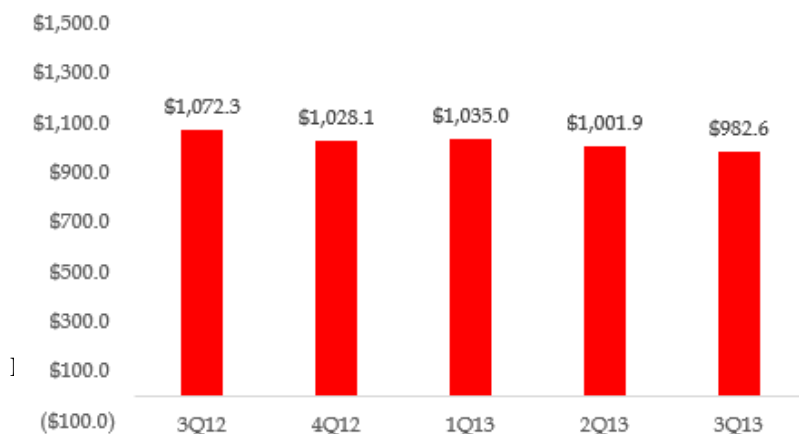
- Stronger capital ratios and asset quality than peers - driven by reduction in non-performing loans (NPLs)
- Greater transparency and confidence in European banking sector helps valuation

Banco Santander

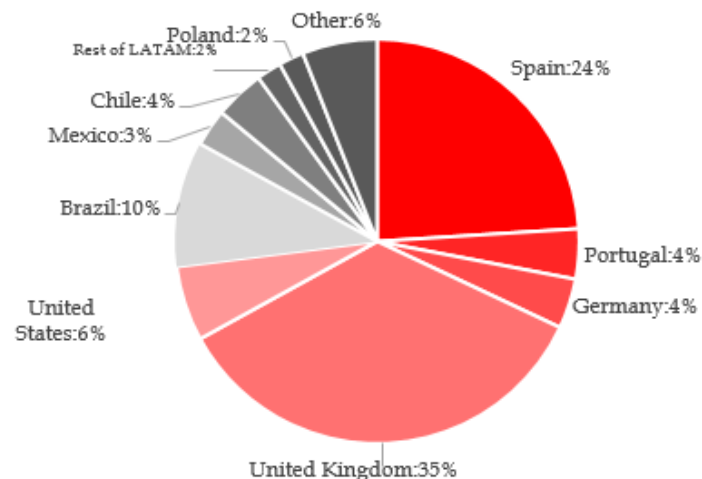
Loan and Deposit Profile

Forecasted increase in net loans will drive future profitability

Change in Gross Loans (Quarter-over-Quarter)



Geographic Breakdown of Gross Loans



* Adjusted for exchange rate impact

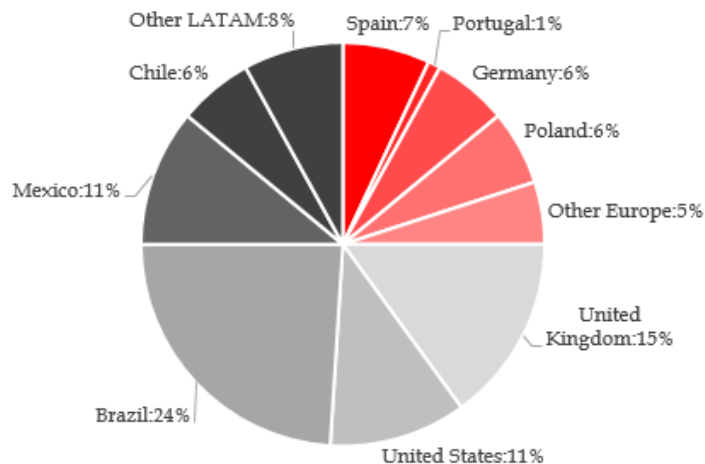
- Gross loans steadily decreasing as economies Santander operates in have experienced difficulty
 - Expected loan growth in future in higher credit growth regions
- Strong net interest margin of 2.54% on gross loans
 - Increase in net loans will drive profitability (upward sloping yield curve)
- Very well diversified internationally

Banco Santander

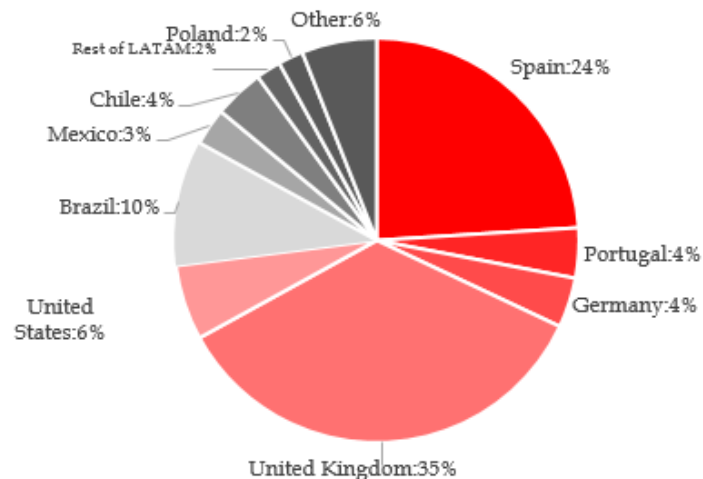
Distribution of Profits by Geographic Segment

Santander strong loan profile well-diversified internationally

Breakdown of Profit by Geographic Segment



Geographic Breakdown of Gross Loans



Source: Company Reports

- 49% of total profit from Latin America and 25% of profit from Europe
 - Exposed to FX risk from LATAM but higher credit growth region
- High diversification in profit generation across ten core countries

Geographic Breakdown

Macroeconomic outlook improving in Santander core geographies

Real GDP Growth in Santander Core Geographies (%)			
	2012	1H13	2014 IMF
Spain	-1.6%	-1.8%	0.2%
Portugal	-3.2%	-3.1%	0.8%
Germany	0.9%	0.5%	1.4%
United Kingdom	0.2%	0.8%	1.9%
United States	2.8%	1.4%	2.6%
Brazil	0.9%	2.6%	2.5%
Mexico	3.6%	1.2%	3.0%
Chile	5.6%	4.5%	4.5%
Argentina	1.9%	3.5%	2.8%
Poland	1.9%	0.8%	2.4%
Banco Santander¹	1.4%	1.4%	2.3%

Source: IMF; Company Reports

Note: Financial data as of 09/30/2013

¹ Based on weighted-average YoY of 10 core countries

- Better macroeconomic outlook will drive future profitability in high-growth credit regions
- Weighted average GDP growth in Santander's core geographies expected to improve
- Improving economic growth in Brazil and LATAM helps mitigate foreign exchange risk
 - Santander heavily exposed to FX risk due to 75% of profits earned outside continental Europe

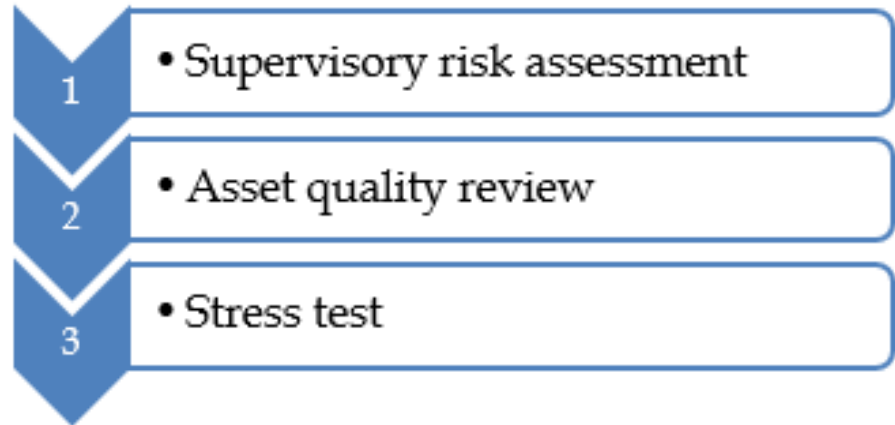
Banco Santander

External Analysis: ECB Banks Stress Tests

ECB announces start of comprehensive assessment of EU banks



European banks receive blunt warning from ECB



- ECB implements comprehensive bank assessment starting in early Nov 2013 and ending Oct 2014
- Designed to dispel doubts about European banks' financial health
- Provide increased balance sheet transparency across the sector
- Santander to be one of many European banks to be tested
 - Performed above peers on similar test by Oliver Wyman in 2012

Banco Santander

External Analysis: Recent News

Santander increasing exposure to domestic Spanish market



Banco Santander is Spain's largest bank by assets

Banco Santander (NYSE:SAN)

- 40% of book value was in Deferred Tax Assets
- Under Basel III, DTA's can no longer be counted as part of a bank's core capital buffer
- Proposed changes to convert DTA's to tax credits, increasing capital ratios

Santander bets on resurgent Spanish economy – *Financial Times, Madrid*

- First significant investment in Spain since start of Financial Crisis by purchasing 51% of consumer finance division of department store El Corte Inglés
 - Deal values finance arm of El Corte Inglés at 415mn euros
 - Santander's consumer unit had gross outstanding loans worth 59.2bn euros in 2012
- Increases exposure to struggling Spanish consumers in market where unemployment rate is 26%

External Analysis: Spain Economy

Spain emerges from a two year recession

- Signs that country's economy is on the mend:
 - GDP rose in Q3 after nine consecutive quarters of decline
 - Strong exports, increase in Q3 household consumption
 - Slight decline in unemployment in Q3, down from 26.3% to 25.98%
 - Due in part to seasonal hiring in tourism
 - Foreign investors interested in buying Spanish banks' bad loans
- However, still unfavourable labour market outlook and high household debt

More foreign investors are making deals in Spain

- Bill Gates paid \$148.4mn for 6% of Spanish construction company FCC
 - Buffet and Slim have recently invested in Spain as well
- If Spanish economic conditions meet expectations to recover back to normal, much upside can be realized in this industry

Banco Santander

Comparable Companies Analysis – Trading Multiples

Santander very undervalued on P/TBV

Trading Multiples

Company name	(City, State)	Share price	Market cap (mn)	Price /			Div. yield	ROATCE
				2013E EPS	2014E EPS	TBV		
BBVA	Madrid, ESP	\$12.01	\$68,749.2	10.6x	11.7x	1.43x	4.61%	5.41%
HSBC	Hong Kong, CHN	\$55.30	207,341.3	11.6x	11.2x	1.35x	5.15%	10.31%
Caixabank	Barcelona, ESP	\$3.75	18,067.5	27.5x	10.6x	0.66x	5.47%	1.17%
Banco Bradesco	Osasco, BRA	\$14.77	61,893.7	11.1x	9.8x	2.12x	4.03%	19.59%
Mean				16.6x	11.2x	1.15x	5.08%	5.63%
Median				11.3x	10.9x	1.4x	4.88%	7.86%
Banco Santander	Santander, ESP	\$8.83	\$97,943.3	15.1x	10.9x	1.06x	8.98%	4.65%

Note: Market data as of 10/30/2013; Financial data as of 9/30/2013

- Santander is trading very cheap on price-to-tangible book value (P/TBV)
 - Expect to trade along with peers in long-term
- Santander may be looking to sell-off units that are expensive on P/TBV such as Santander Mexico – book value of \$5.6bn
 - Can allocate capital to areas of faster growth

Banco Santander

Comparable Companies Analysis – Operating Metrics

Santander TCE/TA suppressed in past, expected to increase in future quarters

Operating Metrics

Company name	(City, State)	Market cap (mn)	Balance sheet			TCE/TA
			Total Assets	Gross loans	Deposits	
BBVA	Madrid, ESP	\$68,749.2	\$880,143.3	\$507,032.7	\$403,948.1	5.17%
HSBC	Hong Kong, CHN	207,341.3	2,692,538.0	1,166,300.0	1,311,396.0	5.36%
Caixabank	Barcelona, ESP	18,067.5	480,645.7	308,359.6	221,657.0	5.77%
Banco Bradesco	Osasco, BRA	61,893.7	368,545.9	133,257.4	96,954.8	7.99%
Mean			1,351,109.0	660,564.1	645,667.0	5.43%
Median			880,143.3	507,032.7	403,948.1	5.36%
Banco Santander	Santander, ESP	\$97,943.3	\$1,752,086.6	\$1,029,460.7	\$864,761.8	3.72%

- Santander tangible common equity / tangible assets has been suppressed in the past due to NPLs and increased loan loss provisions
 - This has suppressed valuation in the past
- Improving NPLs along with strong loan and deposit portfolio should drive value in the future

Banco Santander

Comparable Companies Analysis – Operating Metrics

Strong asset quality and capital ratios should drive future profitability

Operating Metrics

Company name	(City, State)	Market cap (mn)	Asset Quality and Capital			Profitability		
			NPLs	Tier 1	Leverage	NIM	Core ROAA	ROATCE
BBVA	Madrid, ESP	\$68,749.2	5.52%	10.80%	5.65%	2.66%	0.58%	5.41%
HSBC	Hong Kong, CHN	207,341.3	3.30%	13.40%	5.67%	2.32%	1.11%	10.31%
Caixabank	Barcelona, ESP	18,067.5	8.62%	11.10%	5.18%	1.48%	0.16%	1.17%
Banco Bradesco	Osasco, BRA	61,893.7	4.99%	11.02%	8.34%	6.70%	5.29%	19.59%
Mean			5.81%	11.77%	5.50%	2.15%	0.62%	5.63%
Median			5.52%	11.10%	5.65%	2.32%	0.58%	5.41%
Banco Santander	Santander, ESP	\$97,943.3	4.45%	11.17%	4.97%	2.54%	0.35%	4.65%

- Santander has strong asset quality and capital ratios
 - Santander should be less affected by European Central Bank stress tests than other banks in Spain and Europe
- Santander has strong net interest margin of 2.54% by having a presence in fast growth credit regions – opportunity for margin expansion

Banco Santander

Dividend Discount Model (DDM) Valuation

Implied share price of \$10.46 from DDM (17.3% upside potential)

Dividend Discount Model Sensitivity Analysis - Implied Share Price

		Cost of Equity						
		14.3%	13.3%	12.3%	11.3%	10.3%	9.3%	8.3%
Dividends per Share (Euros)	€ 0.45	\$8.44	\$8.76	\$9.10	\$9.46	\$9.83	\$10.23	\$10.66
	€ 0.50	\$8.76	\$9.09	\$9.43	\$9.79	\$10.18	\$10.58	\$11.01
	€ 0.55	\$9.08	\$9.41	\$9.76	\$10.13	\$10.52	\$10.93	\$11.36
	€ 0.60	\$9.40	\$9.74	\$10.09	\$10.46	\$10.86	\$11.28	\$11.72
	€ 0.65	\$9.72	\$10.06	\$10.42	\$10.80	\$11.20	\$11.62	\$12.07
	€ 0.70	\$10.04	\$10.39	\$10.75	\$11.14	\$11.54	\$11.97	\$12.42
	€ 0.75	\$10.36	\$10.71	\$11.08	\$11.47	\$11.88	\$12.32	\$12.78
	€ 0.80	\$10.68	\$11.04	\$11.41	\$11.81	\$12.22	\$12.66	\$13.13

- Strong upside potential of 17.3% from DDM implies Santander is trading below its intrinsic valuation
 - Sensitivity range of \$8.44-\$13.13 shows little downside risk to investment
- DDM valuation performed under extremely conservative modelling assumptions (change in key driver will further increase valuation)

Dividend Discount Model (DDM) Valuation

Key Assumptions	
Metric	Assumption
Fully diluted shares outstanding (mn)	11,092.0
Dividends per share assumption ¹	€ 0.60
Cost of equity (discount rate) ²	11.33%
Exit multiple of 2019E GAAP net income ³	11.30x
Capital and Assets:	
Tangible equity / tangible assets ⁴	4.50%
Long-term gross loans growth ⁵	3.00%
Net interest margin ⁶	2.54%
Non-performing loans (NPLs) as % of gross loans ⁷	4.45%

¹ Based off management forecast

² Bloomberg consensus (assuming risk-free rate 2.53%, beta 1.8x and MRP of 5.0%)

³ Based on 2013E median P/E for comparable companies

⁴ Long-term target projection based on ECB stress tests

⁵ Based on management forecast

⁶ Assuming no change in forward yield curve

⁷ Maintain current level

- Very conservative assumptions used to arrive at intrinsic valuation
 - Key value drivers for profitability will be expansion in net interest margin (upward sloping yield curve) and higher growth in gross loans

Banco Santander

Valuation Summary

Banco Santander undervalued by 17.5% at current stock price

Valuation Summary		Implied share price			
Metric		Low	Median	High	Range
Market	52-Week Trading Range	\$6.31	\$8.83	\$9.32	\$3.01
Price /	2013E P/E	\$6.21	\$6.62	\$16.11	\$9.90
Earnings (x)	2014E P/E	\$7.99	\$8.87	\$9.47	\$1.49
P / TBV	2013E P/TBV	\$5.51	\$11.61	\$17.67	\$12.16
DDM	Dividend Discount Model	\$8.44	\$10.46	\$13.13	\$4.69
Final implied share price (median)					\$10.38
Current share price				\$	8.83
<i>Implied upside potential (margin of safety)</i>					17.5%

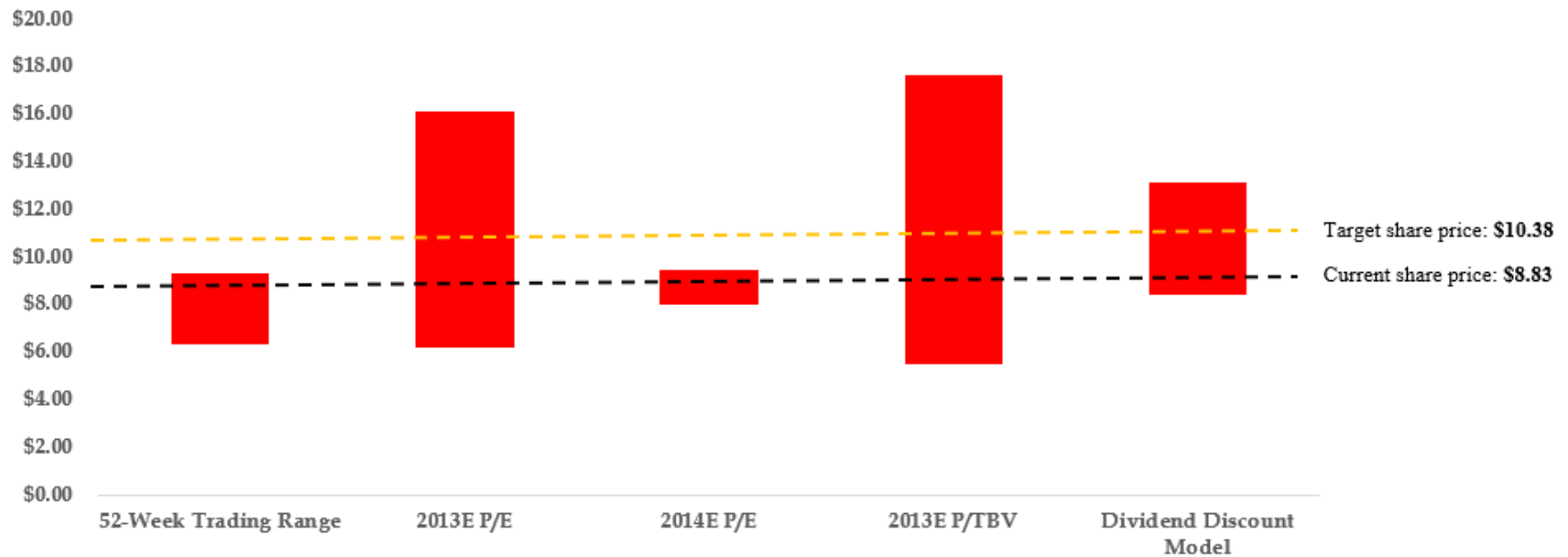
- The final implied share price for Santander is \$10.38 (17.5% upside)
- More weighting placed on DDM valuation and P/TBV as more pertinent in current banks environment
 - P/E not strong valuation metric due to increase in NPLs and provisions

Banco Santander

Valuation Summary

Banco Santander undervalued by 17.5% at current stock price

Valuation Summary - Football Field Analysis



- Target share price for Banco Santander calculated to be \$10.38
 - Santander trading in lower range of key valuation metrics

Banco Santander

Risks and Catalysts

Key risks

- Foreign exchange rate risk
- Slower than forecasted economic recovery in Spain and ten core operating countries
- Potential dividend reform for Spanish banks
- Forced equity raise for higher capital may lead to dilution

Catalysts

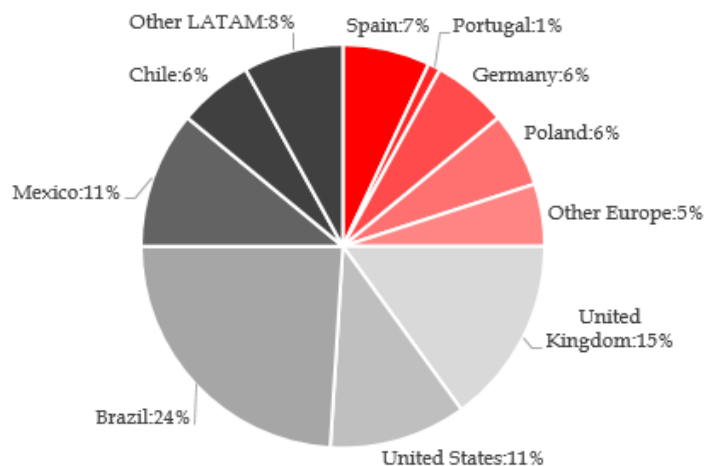
- Positive performance from ECB banks stress tests
 - Increase Santander valuation
 - More transparency and investor confidence in European banks
- M&A activity – potential to sell off assets expensive on P/TBV and reallocate capital to areas of higher credit growth (SAN Mexico potential target)
- Increase in forward yield curve driving net interest margin expansion

Banco Santander

Risks – Foreign Exchange

FX rate exposure as 75% of profit is earned outside of Europe

Breakdown of Profit by Geographic Segment



- Profits primarily from LATAM
 - Well diversified offering protected profitability
 - Heavily exposed to FX rate risk
 - Emerging markets prone to more volatile exchange rates
 - Brazilian real -9 percentage points against the euro in past year, Mexican peso +5 p.p., Chilean peso +2 p.p.
-
- Actively manages exposure through exchange rate derivatives including FX forwards and options
 - Currently hedges \$22.165 B of investments of permanent nature in Brazil, UK, Mexico, Chile, USA, and Poland

Banco Santander

Final Recommendation

**Buy 700 shares
at \$8.83**

Total Investment: \$6,200



Buy Pitch

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