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CODE NAME: PROJECT BELEM

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Abstract

The present case-study concerns about the analysis of the sale of Banif Mais, the sub-holding of Banif Group for specialized credit activity, taking into account the bank's financial situation in 2014. In 2011, Portugal was submitted to an external finance programme carried out by troika which imposed very restricted measures to the financial sector. Subsequently, Banif was not able to accomplish the required results having to appeal to Government financing, being under a recapitalization plan since 2012.

Code Name: Project Belem¹

“Whenever someone thought he could change the world, the world has changed. We believe.”

Horácio da Silva Roque, Founder of Banif- Financial Group²

In early 2014, Jorge Tomé, CEO of the Banif group, without never losing hope, found himself seriously concerned about the bank's situation. The repayment of the second tranche of the Contingent Convertible Bonds (Cocos) to the Government was being prepared, due to be paid in few days, nonetheless already with a delay of four months in face of the deadline stipulated in the recapitalization plan approved in January 2013. With such delay, the repayment of the last tranche was under risk and Jorge Tomé knew that by December, he would have to find a solution for the payment of the remaining €125 million in Hybrid instruments whose costs were increasing every year.

¹ Project Belem was the code name given to the Banif Mais sale process.

² Internal company presentation-recruitment process 2015.

To make things worse the group's shares had been falling sharply (Exhibit 1), the restructuring plan had not yet been approved by the ECB³ and the possibility of recurring to another increase of capital from its investors was out of question at least in the near future. It was in that context, that in July, Nicolas Wallaert, general director of Cofidis, a European leader in personal credit granting, decided to make an unsolicited and indicative proposal for the purchase of Banif Mais, the sub-holding of Banif Group for specialized credit activity.

History of the Company ⁴

Banif – Banco Internacional do Funchal – was founded in 1988 when Horácio Roque⁵ and a group of investors decided to purchase the extinct Caixa Económica do Funchal which at the time was accounted with a financial loss of 10M contos de réis⁶.

In an initial phase the group began by focusing on the consolidation of its presence in Madeira and on the improvement of its financial situation, and simultaneously by rapidly adopting a strategy of expansion of its business portfolio by means of establishing a pension fund management company, a leasing company and two asset management subsidiaries. Hence, from its inception, Banif had grown organically as well as by acquiring several other banks.

In 1992, the shares of Banif became listed for trading in Lisboa and Oporto Stock Exchanges, a milestone that highlighted the financial growth of the group. The following year, the Group launched its internationalization phase and the diversification of business areas by means of

³ In the absence of a restructuring plan approved by the European Commission, and faced with the possibility of the Government investment being declared illegal with the unfolding requirement for its restitution, shareholders and the Banif Board of Directors initiated the sale process of the institution.

⁴ Recapitalization Plan 2012 and Group History from Banif's website:
<http://www.banif.pt/xsite/Particulares/Institucional/Historia.jsp?CH=3741>, accessed on 20-10-2015

⁵ Horácio Roque was the founder and president of Banif group till date of his death (2010)

⁶ 1 conto de réis equal to 1,000 escudos. The escudo was the currency used in Portugal before the euro adoption in 2002. 1 euro is equivalent to 200.48 escudos.

establishing a branch in the Grand Cayman Island and by acquiring a brokerage company, operations which marked the beginning of the group's investment activity.

In 1996, Banif became the largest financial group in Azores by acquiring a control position in Banco Comercial dos Açores (BCA), the Azores' largest commercial bank, which would be totally acquired later in 2003. With this purchase Banif turned out to be one of the banks with greater influence on the islands.

In the following two decades, the group constituted companies, acquired other commercial and investment banks and also built significant presence in different business areas such as pension funds and asset management, leasing, consumer credit, investment banking, insurance and brokerage. In terms of geography, the group expanded its presence to the continent and to other countries such as Brazil, USA, South Africa, Venezuela, Spain, Malta and Cape Verde by opening representative offices, acquiring existing entities and establishing partnerships (Exhibit 2).

The idea that more diversified deals would provide more strength and flexibility to the business, to the extent that it would create more future growth opportunities, characterizes the expansion strategy of the group. In fact, this was the strategy adopted by several other entities in the 90s. Due to the globalization, many companies regarded M&A transactions as the quickest and least expensive means of gaining a presence in a foreign country, preserving their place in the global economy, and also as an opportunity to consolidate industries.⁷

Thus, in the span of twenty years, the group evolved from 19 Branches in Madeira to a total of 373 branches in Portugal, Madeira, Azores (360) and Brazil (13) with 708 global points-of-sale

⁷ Pettitt, Barbara S.; Ferris, Kenneth R. (2013) *Valuation for Mergers and Acquisitions*, Pearson Education

located.⁸ In 2011 the group joined the PSI-20 reference indicator of the Portuguese stock market, and it was ranked by Brand Finance as one of the 500 most valuable finance brands in the world (487th position), thus being listed in the "Global 500 Banking Brands Index". Despite this strong and rapid growth, since 2012 the bank has been witnessing a reduction in their global presence as a result of poor management decisions.

But what went wrong for the group?

Throughout the expansion period, Banif acquired minority positions in different businesses, positions which do not allow a control position in management decision making, e.g. the Banca Puyeo, where Banif holds 33% of its capital, an institution found to be too expensive and not fitting the group's policy. Indeed, over the years, the bank did not present a strategical orientation aimed at centralized all its acquisitions, and this made evident the difference between acquisition policies in its branches.

Moreover, the fact of having a strong presence in the Portuguese islands did not justify the expansion to other islands like for example Cape Verde (BCN- Banco de Cabo Verde). The only similarity they shared was their geographical definition, but being was a block of land surrounded by water was not a sufficient reason to take the structure and the type of business as being identical, as some as some of the group leaders liked to believe⁹.

Furthermore, the bank was not able to hold a leading position in the corporate segment, since it had established itself in the continent too late, once compared with existing banks, thus facing high competition in the product diversity offered by its competitors. Hence, Banif focused on the real

⁸ Data from 2010 Banif Annual report

⁹ Some people entitled Banif as a bank of islands and believed that the group's strategy should be oriented towards a greater presence on them.

estate segment, having nowadays a portfolio of €1,521 million¹⁰. Additionally, the fact of being a small bank, made it unable for Banif to benefit from economies of scale leading to high results in its cost-to-income ratio¹¹ (Exhibit 3).

To top it all, since the death of Banif's founder, the family could not reach consensus on the heritage making it a media scandal in Portugal by involving renowned socialites in their dispute. This undermined the stability and credibility of the bank which already had its image severely weakened in the face of the country's adverse economic environment.

Portuguese Economic and Financial Climate

The bursting of the speculative bubble in the US real estate market, in 2008 led to the bankruptcy of one of the largest financial institution of the United States, Lehman Brothers, and had repercussions all over the world. The failure of the American model based on the shortage of liquidity, the relaxation of credit standards, the abuse of securitization and the absence of regulation, highlighted the need to increase the robustness of the financial system in order to prevent the recurrence of similar scenarios in the future, not only in the United States but also globally.

In fact, after this international crisis, many EU members, in particular the peripheral ones, failed to maintain their debt levels within the limits agreed in the European Union. The year of 2010 was characterized by the European Sovereign debt crisis mainly in Greece and Portugal due to the poor

¹⁰ It is the net book value (the discounted operating units are not included) of the real assets portfolio in 2013. Data from Banif's annual report 2014.

¹¹ The cost to income ratio measures the efficiency of a bank in its cost allocation and results from the ratio between operating costs and operating income.

management of government expenditure, and in Ireland due to its difficulties in the financial system, while in Spain it was due to the real state bubble (Exhibit 4).

In Portugal, the poor management of government expenditure led to a downgrade of the national sovereign debt which hindered the access to the international debt and capital markets (interbank and securities), thus causing a serious liquidity problem in the banking sector. The lack of liquidity had a negative impact on the credit supply activity, the main source of revenue of the Portuguese banks which was already characterized by a strong contraction brought about by the subprime crisis in 2008 that had imposed the introduction of more restrictive risk policies and higher selection standards in the credit granting. In addition, due to the unfavorable economic situation, seen in the increase of the unemployment rate and in the number of companies' bankruptcies, the demand for credit from individuals and companies also decreased, and this led to the stagnation of the credit growth.

In this context, banks invested heavily in Portuguese Government Bonds (Exhibit 5) in 2010 in order to have more liquidity. On the one hand it served as collateral for funding operations from the European Central Bank and on the other hand it served as an instrument to finance the State, taking into account the lack of demand for Sovereign bonds in the international markets. Bankers used the money lent by the ECB with low interest rate to buy Portuguese debt with high yields and this allowed them to offset the cost of recapitalization operations¹². In 2011, the downgrade of the Portuguese bonds soared the treasury yields and the ECB stopped financing the Portuguese banks under acceptable terms.

¹² APB's report 2014: http://www.apb.pt/estudos_e_publicacoes/boletim_informativo, accessed in 12-20-2015

The decrease in liquidity and the heavy dependence from the Central Bank, forced banks to adopt a strategy of deleverage and to attract new deposits by means of increasing interest rates and by offering a larger variety of products. In fact, the clients' resources had been increasing since 2010, in particular term deposits, since these are applications with a low level of risk for the investor and also more stable for the banks in terms of long term financing.

Furthermore, national banks also lost value on their asset portfolios, with the restructuring of Greek debt¹³ and the fear of the contagion effect to the peripheral banks, as well as the euro's depreciation against the dollar, the devaluation of the stock market (Psi-20) and the increasing lack of confidence in Portuguese banks unfolding the scandals in two Portuguese banks: BPN (Banco Português de Negócios) and BPP (Banco Privado Português)¹⁴.

In April 2011, the financing conditions were already unaffordable, forcing the country to pursue international financial assistance. The Economic and Financial Assistance Programme of the European Union (EFAP) carried out by the Troika, resulting from the union of the European Central Bank (ECB), the International Monetary Fund (IMF) and the European Commission),¹⁵ was characterized by a set of requirements designed to improve the economic growth and to ensure the recovery of the Portugal access to the international debt markets in 2013. At the financial level,

¹³ The first bailout program provided to Greece dates from May 2nd, 2010, and the second from March 14th, 2012. A bailout program results from the injection of money by outside investors. In that case, in the second bailout program, the EU countries contributed with the major portion of the bailout.
<http://www.economist.com/blogs/economist-explains/2013/04/economist-explains-2>. Accessed in 12-20-2015

¹⁴ BPN was nationalized and BPP declared insolvency.

¹⁵ The Portuguese Government and Troika signed a memorandum of understanding, guaranteeing the grant of a loan of 78,000 million euros until 2014.

it was required the reinforcement of the minimum capital core Tier 1 ratio¹⁶ to 9% in 2011, and to 10% in 2012, and to reduce the transformation ratio¹⁷ to 120% until December 2014 .

Furthermore, beginning in 2011, a set of cross-sectional inspections to the eight largest Portuguese financial groups was carried out in order to reassess the quality of the bank's assets. The first one was the SIP - Special Inspection Programme-2011- comprehending the evaluation of the credit impairments and also the validation of the parameters used in stress tests. It was performed to evaluate the banks' capacity to absorb shocks in adverse situation. Curiously enough, one of the major Portuguese bank, BES (Espírito Santo Bank)¹⁸ was classified with an outstanding assessment regarding the results from the tests, and scarcely two years later it was the center of one of the biggest Portuguese financial scandals, culminating several ongoing investigations to family members who are now under suspicion of being involved in fraudulent actions of various kinds.

Yet, as a result of this inspection, Banif failed the tests and two other banks¹⁹ showed the need for improvements in specific areas, forcing these institutions to resort to Government financial aid in order to be able to meet the capital requirements by means of direct capital injection and/or contingent convertible bonds.

¹⁶ The Core Tier 1 ratio establishes a minimum level of capital that institutions must have in the light of the capital requirements rising from the risks associated with their activity. As such, it is determined by the ratio between core capital and positions weighted according to their risk. The capital considered core comprises the capital of better quality service in terms of permanence and ability to absorb losses, net of any losses and certain elements without autonomous realizable value, within a perspective of continuity of the activity of an institution. The positions weighted according to their risk represent a measure of risks arising from financial activities, including credit, market and operational risk. Source: <https://www.bportugal.pt/pt/PT/OBancoeoEurosistema/ComunicadoseNotasdeInformacao/Paginas/combp20110407.aspx> accessed in 12-20-2015

¹⁷ The transformation ratio is a liquidity ratio that results from the quotient between the loans and the deposits from clients.

¹⁸ BES was one of the major banks in Portugal that belonged to the Espírito Santo family

¹⁹ BPI and BCP

Contingent Convertible bonds (CoCos) were commonly used in Europe in order to support the banks to strengthen its robustness. CoCos were hybrid securities which could be converted into capital qualify as regulatory capital eligible under Basel III standards²⁰ when the capital of the issuing bank fell below a certain portion of its risk weighted assets.

The second inspection was the OIP – the On-site Inspection Programme-2012 - which assessed the great exposure held by financial institutions versus construction companies and the real estate. In 2013 it was followed by the ETRICC²¹, which evaluated the credit impairment regarding all segments except for the credits of collective impairment (housing and consumer) and the loans to public sector entities, and finally by the ETRICC2 (2013-2014), which analyzed the clients' business plans relevant to the banking system.

The EBA (The European banking Authority) also executed an Asset Quality Review (AQR-2013) and a stress test to the largest banks of each European country²². The AQR assessed the adequacy of the valuation of the assets, the collaterals and the related provisions, while the stress test evaluated the banks' resilience in two different macroeconomic scenarios, a base scenario and an adverse one, the latter with a low probability of occurrence²³.

All these measures were part of the comprehensive assessment that the ECB initiated in November 2013 with the aim of creating a banking union based on a single supervisory mechanism, a single

²⁰ Basel III is a set of banking reforms promoted by the Financial Stability Board and the G20 to strengthen the financial system after the subprime crisis.

²¹ ETRICC stands for Cross Exercise of impairments Review of loan portfolios.

²² It covered 130 European banks, including three national banks. Initially, the Portuguese banks in the program were Caixa Geral de Depósitos, BPI, BCP and Espirito Santo Financial Group (the holding of Bes). The last one was eventually excluded since it was facing a resolution program in response to the above mentioned BES scandal.

²³ In the adverse scenarios the GDP annual growth rate, the unemployment rate, the long term interest rate of the treasury bonds and the real estate prices were more stringent.

mechanism of resolution and a single mechanism of deposit-guarantee in order to solve the problem of interconnection between bank risk and sovereign risk.

Three years later and after twelve review missions, Portugal officially left the international rescue plan, thus avoiding the payment of the last settled tranche. Portugal is currently under post-programme observation, in line with the appropriate IMF and European rules.

The situation of Banif

The financing situation of Banif was weakened by the rating downgrades occurred in 2011 which led to an early repayment of €420 million due to the interbank lending in that year. The institution failed to comply with the legal capital requirements, thus demanding private²⁴ and government investment, in a total of € 1,400 million.

In order to be able to meet the capital requirements, the government investment, which included the access to the recapitalization fund, summed €1,100 million, €400 million in CoCos (Exhibit 6) and €700 million in a capital increase subscribed by the Treasury which corresponded to 60.53% of the bank's control, the equivalent to 49.91% in terms of voting rights (Exhibit 7). Furthermore, with the purpose of getting an additional margin to meet the extremely severe operating environment, the rights issue summed €300 million.

This capital increase was divided in two main phases. The first comprised the Government investment, that is, the €1,100 million invested in January 2013, equivalent to 99.2% of the bank's control. The second included a new increase in the share capital of Banif, a right issue up to the amount of €450 million until the end of May 2014, of which € 150 million euros were used to pay

²⁴ It was given preference to existing shareholder and then to the employees and public in general

directly €150 million in CoCos in order to reduce the state control to a 60.53% return of the bank to private hands.

As a result of the government financial investment, Banif had committed to submit and comply with a recapitalization plan that comprehended a set of management measures to be implemented. These measures included a corporate reorganization²⁵ which would simplify the group's structure, reduce the intragroup financing cost and improve the transparency, an operational turnaround which would optimize the cost structure and improve the generation of operating income; a deleveraging program which would involve the disposal of non-core asset classes or assets with a reduced return and finally; a capital optimization program which would comprise specific programs of RWA optimization by reassessing the level of collateralization of credit operations.

Yet, by the end of 2014, the bank still could not find an investor interested to buy the share capital owned by the State and still had also not paid the last CoCos tranche. The need to sell Banif Mais came precisely from the urgency to meet the payment agreed with the Government and also from the need to comply with the deleveraging program, since on the one hand it was not part of the core business of the group, and on the other hand it represented a significant weight in the group's operating income, c. 22.7%,²⁶, thus causing a quick and significant positive impact on the capital ratios.

Banif Mais

²⁵ Banif's recapitalization plan 2012.

²⁶ The figure shows the results obtained by dividing the consolidated net operating income of Banif Mais and the consolidated operating income of Banif Group. Data: Banif Mais Annual Report 2014 and Banif Group Annual Report 2014. Despite the fact that Banif Mais SGPS, SA is not fully owned by the Banif Group, the difference that may exist in this calculation is negligible. Source: www.banif.pt, accessed in 12-21-2015.

In 2009, within its diversification strategy, the Banif Financial Group acquired 100% of the share capital of Tecnicrédito SGPS, a Portuguese group specialized in automobile loans and consumer credit that it was later rebranded as Banif Mais SGPS, SA.

The Banif Mais SGPS, SA is currently the sub-holding of Banif group for the specialized credit activity with a leading position in the auto finance market (Exhibit 8). It has a significant international presence in Slovakia and Poland through Portuguese bank branches and also in Hungary through the Hungarian bank, Banif plus Bank Zrt. The company is currently exiting Spanish market by means of the sale of its credit portfolio (Exhibit 9).

The core business of Banif Mais is “consumer credit,” with auto financing as a driver for all activity. It develops a Push Strategy where auto dealers are the main channel for product placement. Banif Mais has approximately 6,000 live dealers in its database, working on a regular basis with c. 1,500. It offers global and flexible solutions such as auto loans, stock finance, personal loans, credit for agriculture and machinery and insurance.

Its marketing strategy is based on close proximity with its commercial partners, the auto-dealers, on competitive products which address clients’ and auto-dealers’ specific needs, as well as on strong systems and IT tools.²⁷ Nearly 70% of proposals for credit granting are received by phone and the remaining through the internet- netcrédito. Banif Mais shows clearing accounts with the major Portuguese retail banks but concentrates its collections in Banif which is the institution responsible for providing the wholesale funding.

Banif has 27 years of experience in the Portuguese market, being one of the leaders in consumer credit with a market share of approximately 20% in used auto financing and 44% in motorcycles.

²⁷ Web banking, online simulation and call center- 7 days week

In Hungary, the bank has been operating for 15 years being the second player in the used cars financing market (16% in Used and 27% in New). The car financing accounts for approximately 80% of the production and the Portuguese activity is the most representative with 89% of the gross credit portfolio.

The sale process

The sale process of Banif Mais SGPS started with an unsolicited and indicative proposal from Cofidis Participations in July 2014, which led the Banif Investment Bank, the financial advisory, to invite another eight entities with potential strategic fit. The nine entities have gone through all the process steps but only three of them submitted binding offers. Cofidis won the race and ended up buying Banif Mais for €400M (Exhibits 10 and 11). The sale was announced on December 12th 2014 reaching €410 million euros (€344 M was the estimated equity book value plus a fixed premium of €66 M), having been completed on June 4th 2015 by €400 M euros, with the €10 M difference related to an impairment adjustment.²⁸

Cofidis Participations²⁹ was created in France in 1982 by developing an innovative concept of distribution of consumer credit products and services using distant marketing techniques, without recurring to a branch network. The development of the Group has relied on numerous distribution partnerships, as well as on tailored IT tools to strengthen the customer relationship. Nowadays, it operates in eight European countries: France, Belgium, Portugal, Spain, Italy, Czech Republic, Slovakia and Hungary. The group is leader in the consumer credit segment, with outstanding loans

²⁸ Data retrieved in <http://eur-lex.europa.eu/legal-content/PT/TXT/PDF/?uri=OJ:C:2015:426:FULL&from=PT> accessed in 12-22-2015

²⁹ Data contained in the internal Information- Cofidis binding offer, and also available in its website: <http://www.cofidis.com/>.

exceeding EUR 10.5 billion in 2013. In the same year, the credit granted amounted to €3.3 billion and net banking income exceeded €1.1 billion.

In 2009 it was acquired by Crédit Mutuel, CM11-CIC Group, which comprises 18 regional banks and is the second largest retail banking group in France with leading positions in non-life insurance products, electronic banking, home loans, SME (small and medium size enterprises) loans and farming loans. The banks are deeply embedded in local fabric and are responsible for managing their clients' relationship in a fully decentralized way.

In 2013, CM11-CIC reached 510 million of total assets, employing more than 65,000 people in France and Europe and had the best ratings among French banks. It distributes its banking products through its franchises Crédit Mutuel, CIC, Cofidis, and Targobank reaching its 24.2 million clients. 20% of its net operating income is made outside France.

Cofidis is present in Portugal since 1986 and holds a very strong position in the Portuguese consumer finance market, especially in the direct revolving credit, where it is the leader. In 2013, Cofidis was the 4th player in Outstanding loans (€ 835M), and the 2nd player in the Net operating income with more than €120M.

The purchase of Banif Mais allowed Cofidis to benefit from the bank existing presence in other countries, where it aimed to strengthened and gain scale. It also took advantage from Banif Mais expertise in automotive financing which was a key area of interest for the company and fully in line with its development strategy. Moreover, together, both companies could increase their integrated position in the Portuguese automotive finance market since the funding would be facilitated thanks to the CM11- CIC resources. By performing the deal, both companies could also share their respective know-how in terms of partnerships, credit insurance, customer risk

management and IT tools. Together, they would be better equipped to face an increasingly aggressive competition and a more restrictive regulatory environment.

Conclusion

Jorge Tomé knew that the sale of Banif Mais was unavoidable within the deleveraging program imposed by the ECB, but the following questions remained to be answered: Was it the right time to carry it out? Would Jorge Tomé be bound to accept a less attractive offer in the rush to meet the CoCos payment deadlines or simply to meet the capital ratio requirements? Was it a fair valuation of Banif Mais?

Teaching Notes

Case Synopsis

The sovereign debt crisis marked the year 2010. The financial imbalances of Greece and Ireland spread the feeling of contagion to Portugal and Spain. The two countries saw their public debt triggered as a consequence of the downgrade of their country ratings. Investors lost confidence in these markets and a reflection of this effect could be seen in the increase of their treasury yields in the freezing of the interbank market, in the depreciation of the euro against the dollar and in the devaluation of the main European stock markets.

In that context, Portugal was forced to resort to external financial assistance in 2011. The bailout program of 78,000 million euros included a series of restrictive measures to be adopted, particularly in the banking sector. The banks were required to comply with stricter capital and transformation ratios, while, at the same time they were subjected to a series of inspections to assess the credit quality offered.

Banif, the seventh largest Portuguese bank, was one of the three national banks that failed to comply with the requirements settled by the ECB, leading to a Government investment of 1,100 M euros. Of the total of the investment, €400M were in the form of contingent convertible bonds (CoCos) which are hybrid instruments widely used in Europe to boost bank's core tier I ratio. In return, Banif had to commit itself to a recapitalization plan which comprised, among other measures, a deleveraging program involving the sale of non-core assets as well as assets with lower returns.

The need to sell Banif Mais came precisely from that program since it was not a core asset and it represented simultaneously a significant weight in the group's operating income which could lead to a rapid increase in the capital ratios of the bank.

At the time of the unsolicited proposal of Cofidis to buy Banif Mais, the bank was in a difficult situation. It failed to meet the deadlines of the first two tranches of CoCos, and in the course of the events it would hardly get money to pay the last one, which was due by the end of the year. Moreover, Brussels did not approve its restructuring plan that required the bank to find an investor interested in the percentage of capital owned by the State.

Learning Objectives

After reading and analyzing the case, students should be able to:

- Better understand the European Sovereign Debt crisis and its implications for the peripheral countries.
- Relate the behavior of a country's treasury yields with the investor confidence.
- Realize the challenge of evaluating a bank, taking into account the minimum capital ratios that it must comply and the risk of the country given its current situation.

- Have a broad view of Contingent Convertible Bond concept.

Assignment Questions

The following questions may facilitate the understanding of the case:

1. What are the main challenges faced by Banif? Comment briefly in the light of its growth strategy and government impositions.
2. What are CoCos? Why were they used during the financial crisis?
3. What could be the potential interest of Cofidis in acquiring Banif Mais?
4. Perform a valuation of Banif Mais taking into account the minimum core tier 1 ratio legally required. Assume that any excess of equity will be distributed to the existing shareholders at a 3% cost.
5. Taking into account the available information on the industry where Banif Mais operates, comment the result of the valuation.
6. Regarding the fact that Banif Mais has been acquired by Cofidis which makes part of the Credit Mutuel Group (one of the French credit giants) comment the value offered.

Case Analysis- Proposed Solution

Q1. What are the main challenges faced by Banif? Comment briefly in the light of its growth strategy and government impositions.

Since its inception, Banif has adopted an aggressive growth without a centralized and structured strategy. It acquired expensive minority positions, it expanded to several business areas and locations and it constituted an expensive real estate credit portfolio with value losses over the years.

The bank is currently in an unstable situation. Since the death of its founder in 2010, the name of the group is involved in a family dispute. Moreover, it is having difficulties in complying with the measures and deadlines established in its recapitalization plan, and after several unsuccessful attempts trying to have its restructuring plan approved by the ECB, it was not yet well succeeded, which means that the bank needs to find an investor to buy the share capital owned by the State.

Q2.What are CoCos? Why they were used during the financial crisis?

Contingent Convertible Bonds are hybrid subordinated bonds that have characteristics of both equity and debt. They were widely used during the European sovereign crisis, since they have the main advantage of being considered eligible to core capital requirements of Basel III.

CoCos have two main pre-contractual characteristics, the trigger level and the loss absorption scheme. The first can be automatic (when the capital ratio of the bank falls below a certain level) or discretionary (when it is activated by the regulatory authority if it considers the bank's existence in risk). The absorption capacity is activated by the trigger and the CoCo can be converted into equity (depending on the pre-established terms can be dilutive or not for the existing shareholders), or suffer a principal write-down depending on the established characteristics. When the trigger is activated the debt is reduced and the capital of the bank gets a boost.³⁰

Q3. What could be the potential interest of Cofidis in acquiring Banif Mais?

Cofidis has its business focus on consumer credit activity while Banif Mais has its focus on auto finance. This means that by purchasing Banif, the presence of Cofidis in auto finance market, which is very limited, will be strengthened. Moreover, after the acquisition, Cofidis will enjoy a stronger

³⁰ Avdjiev Astefan, Bogdanova Bilyaana, Kartasheva Anastasia, 2013, CoCos: A primer, BIS quarterly Review.

performance in the auto finance credit when compared with the one already developed by Banif Mais, since its cost of funding will be lower (it is part of the Credit Mutuel Group). This will accelerate the auto business growth.

As Cofidis is part of the Mutuel group where local responsibilities are preserved, as stated in the case, the company will preserve the continuation of the current strategy based on confidence in the current management team. This reveals that the strategic interest and financial evaluation did not rely on cost synergies.

On the other hand, this acquisition cannot be resumed just to a purchase of a new business activity, considered the very limited presence of Cofidis on the auto finance market, without major synergies. In fact, Cofidis will benefit from a cross-selling potential since its customer base will increase. Cofidis can offer a more attractive automobile credit to all its existing customers and also offer new types of credit to all new customers who will gain from this acquisition. Furthermore, it will benefit from the existing presence and the familiarization of Banif Mais in foreign countries such as Hungary, Poland and Slovakia.

Q4. Perform a valuation of Banif Mais taking into account the minimum core tier 1 ratio legally required. Assume that any excess of equity will be distributed to the existing shareholders at a 3% cost.

In order to perform a valuation of a bank using a DCF approach, the appropriate methodology is the FTE method, where the Free Cash Flows are discounted at the cost of equity, since it makes no sense to separate between financial and operating Cash flow when evaluating a financial institution. The reference date of the valuation was the date of the sale announcement (12 December 2014) and the explicit end of the period was 2018. The projections used were provided by Banif Mais.

Cost of equity and input variables

To compute the Banif Mais's cost of equity the capital asset pricing model (CAPM)³¹ was used in which the risk free rate was the Germany Bund 10-years (0.624%)³² at the sale announcement date, and the beta was the Banif's beta of equity,³³ since Banif Mais is not listed and is integrated in Banif group whose levered beta was 1.10.³⁴

To compute the equity risk premium (ERP), the historical market risk premium for mature markets (6%),³⁵ plus the country risk premium,³⁶ was used, as seen in Professor Damodaran's ERP analysis (January 1, 2014). At the time of the professor's analysis, the rating of Portugal was Baa3, but it was subsequently amended to Ba1³⁷, on July 25th of that year, and this would decrease the ERP used in the valuation. The equity risk premium achieved was 11.40%³⁸ and the cost of equity, taking into account all the mentioned variables, was 13%.

In what concerns the other input variables, the inflation rate given by the ECB for the last quarter of 2014, longer term (5 years ahead)³⁹ was used as the growth rate for the model. The cost of debt

³¹ CAPM says that the cost of capital (r_e) results from the risk free rate plus the risk premium which results from the investment's beta (β) times the market risk premium (mrp).

$$r_e = r_f + \beta \times mrp$$

³² Data from Bloomberg accessed on 01-06-2016

³³ It was computed using the historical information of the Banif's stock price provided by Bloomberg using the covariance between its returns and the returns on the Psi-20 Index divided by the variance of the Psi-20 Index returns.

³⁴ A possible solution was to resort to the beta of the industry given by Damodaran. However, its database does not contain a specific analysis for credit consumer companies being the banks' sector the best approach. The vast majority of consumer credit institutions are incorporated in banks which are their source of funding (Banif Mais with Banif, Cofidis with Credit Mutuel or Cetelem with the BNP Paribas).

³⁵ Santa-Clara, Pedro and Shu Yan, 2010, Crashes, Volatility and the Equity Premium: Lessons From S&P 500 Options, The Review of Economics and Statistics.

³⁶ Damodaran, Aswath, 2014, Equity Risk Premiums (ERP): Determinants, Estimation and Implications. The 2014 Edition.

³⁷ Moody's site accessed on 12-20-2015: https://www.moody.com/research/Moodys-upgrades-Portugals-government-bond-rating-to-Ba1-and-assigns--PR_304267.

³⁸ Damodaran Online, Risk Premiums for other markets (1/14), <http://pages.stern.nyu.edu/~adamodar/> accessed on 12-20-2015.

³⁹ https://www.ecb.europa.eu/stats/prices/indic/forecast/html/table_hist_hicp.en.html, accessed on 12-20-2015.

was fixed in 3% (data given by the bank- internal cost funding) and the tax rate was fixed in the amount resulting from the average of the income taxes between 2013 and 2018 (Exhibit 12).

Free Cash flow to Equity

Given the Banif Mais projections, it was firstly assumed that the risk profile of Banif Mais would not undergo major changes, and consequently the proportion of the risk weighted assets (RWAs) in relation to total assets remained constant at the value of 2013 (89.54%). Then, for the calculation of the core tier 1 capital the net profit of the current year (t) was added to the core tier 1 capital of the previous year (t-1).

$$\text{Core Tier I Capital}_t = \text{Core Tier I Capital}_{t-1} + \text{Net income}_t$$

When performing this valuation it was assumed that the excess of equity would be distributed among the shareholders. It resulted from the difference between the shareholder's equity and the required equity imposed by the ECB (10% of the RWAs).

The Free Cash flow to Equity (FCFE) resulted from the difference between the net income and the required equity variation. It was computed by the difference between the required equity of the year (t) and the one of the previous year (t-1). Having reached the FCFE, it was then discounted at the cost of equity (discounted cash flow to equity –DCFE) and added to the terminal value⁴⁰ (the inflation rate used: 1.9%) (Exhibit 13).

$$DCFE_t = \frac{\text{Net income}_t - 0.1 \times (RWA_t - RWA_{t-1})}{(1 + r_e)^t}$$

⁴⁰ Terminal Value = $\frac{DFCFE_t(1+g)}{r_e-g}$, where g is the growth rate and r_e is the cost of equity.

After that, the equity was adjusted by the amount of the excess of equity of the year 2013 that would be distributed to the shareholders and replaced by internal financing at an interest rate of 3%. This internal financing would lead to a constant negative impact equal to the interest cost net of income taxes. The value of the impact on equity cash flow was also discounted at the cost of equity and added to the terminal value which summed approximately to € 374 M (Exhibit 14).

$$Discounted\ Impact_t = \frac{((Equity_{2013} - 0.1 \times RWA_{2013}) \times r_d \times (1 - t))}{(1 + r_e)^t}$$

Q5. Regarding the fact of Banif Mais has been acquired by Cofidis, which is part of the Credit Mutuel Group (one of the French credit giants), comment the value offered.

Banif Mais was acquired by Cofidis having as source of funding the Credit Mutuel, a much larger entity than Banif. This led us to believe that the financing cost will be smaller. Moreover, since the sovereign financial crisis in Europe, the European Central Bank has sought to maintain very low levels of interest rates.

Regarding the equity value computed in the previous question it was above the offered price (considering only the value of equity and not the fixed premium of €66M) even considering that the computed cost of equity should be smaller due to the fact that it was used the beta of Banif, which taking into account the bank's situation it represented higher systematic risk and also, it was not considered the increase on the Portugal's rating.

Moreover, if we considered that from 2014 onwards Banif Mais will have access to a lower financing cost, the final price will increase leaving us to conclude that the value of the company was undervalued (Exhibit 15).

Q6. Taking into account the available information on the industry where Banif Mais operates, comment the result of the valuation.

The multiples that should be used to compare financial institutions⁴¹ are equity multiples, such as the price to book value⁴² and the price to earnings,⁴³ since the multiples that are used to value firms required the EBITDA or EBIT values which cannot be easily adapted to financial services firms. In this type of institutions, the problems of valuation are related to the difficulty in estimating the Cash flow to the firm, since capital expenditures, working capital and debt are not clearly defined and, also, because they are highly dependent on regulatory requirements.

For the multiples comparison the companies that belongs to the auto financing sector were used. These are consumer credit companies that belong to the Specialty Finance Industry. This industry comprises auto finance, credit card, mortgage, and alternative financial services. The auto financing sector was chosen, and not the broader sector of consumer credit, since 80% of the net income of Banif Mais comes from car financing.

In the performed valuation, the achieved P/E ratio for Banif Mais was 20.26X and the P/B ratio was 1.18X (Exhibit 16). Both values are slightly above the industry average multiple (19.63X and 1.02X respectively). However, it is important to notice that the sample dimension is reduced, thus, it can be considered not representative of the population. Furthermore, auto finance does not represent 100% of the Banif Mais activity, and this may lead to minor differences in the value of its multiple. Additionally, the considered companies are not restricted to the offer of auto finance, providing other types of credit.

⁴¹ Damodaran, Aswath, 2009, Valuing Financial Service Firms.

⁴² $P/B = \frac{Price}{Book\ value\ of\ equity}$

⁴³ $P/E = Price/Earnings$

In order to overcome the questions set, the conclusion was also based on the report “Specialty Financing Industry Insights” of the William Blair company for 2014 (Exhibit 17), where the price earnings ratio was on average 21.7X (21.4X median), once again, a value closed to the one achieved on the valuation and in line with the information presented on Mercer’s article “*Specialty Finance Sector shows signs of M&A life,*” where the price to earnings ratio was 23.2X for 2013, wherein the trend has been the reduction of the ratio since the previous year (2012).⁴⁴ Moreover, regarding the book to price ratio in the William Blair’s analysis, this multiple was less than 1.50X for 53.3% for the companies analyzed in the specialty financing sector, and this confirms the result for Banif Mais’s multiple (Exhibit 18).

⁴⁴ <http://mercercapital.com/article/specialty-finance-sector-shows-signs-of-ma-life/> accessed on 12-30-2015