

## Brazilian banks

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### COMMENT

## LAIC it or not, we like Brazilian banks

*In this note we highlight the key takeaways of our meetings with Latam Banks corporates and of the panels we hosted at our LAIC (Latin America Investment Conference), attended by over 1,000 local and foreign investors, and more than 300 speakers from 120+ listed and private corporations, government officials, consultants and law firms during February 3-5.*

**Supreme Court ruling on economic plans:** The panel we hosted with lawyers from MHM Law Firm left us far more comfortable with the potential outcome of the Supreme Court ruling on economic plans. The potential impact should be far below the R\$150bn speculated in the press. Our base-case scenario is within the range of R\$8-R\$26bn, which would imply only 1-3% of the aggregate market cap of the top four banks. This matter has been an overhang for the sector and we think there's room for positive stock performance on the back of this. However, we acknowledge that the trial can be extended until Sep/Oct, so expect some headline risk.

**Sentiment generally more positive towards Brazilian banks (with a "little hand" from Itau):** Sentiment towards Brazilian banks was generally more favorable among investors, despite overall concerns with the evolution of key macroeconomic indicators and the outcome of Supreme Court ruling. Itau's strong 4Q13 results certainly brought significant attention to the sector, including foreign investors, which had been more risk averse. Brazilian banks are trading at low multiples when compared to historical averages and are seen as an interesting investment opportunity for LatAm / EM focused funds and seen by a number of local investors as cheap enough to outperform the local benchmark, especially compared to other consumer names. But concerns on the Supreme Court ruling on Economic Plans is what is holding investors back from buying banks more aggressively, particularly foreigners, where such concerns seem more exacerbated. Despite a challenge year ahead on the macro front, we believe Brazilian banks have the stage set for double-digit earnings growth in 2014. Asset quality improvement, cost control, the pull back of public banks and higher credit spreads were a common ground between the management teams of Itau, Santander and Bradesco (to different degrees, of course).

**Stock calls:** Concerns regarding the Supreme Court ruling and the economic plans are exaggerated and create in our view a buying opportunity. Itau Unibanco remains our top pick in Brazil. A lot has been asked about whether it was time to change our long-held relative call against Bradesco (17% outperformance since our Sep-13 sector report), but while we do not see much room for further outperformance, we see no reason to believe it would give it back, as the ROE differential is likely to continue. We continue to like Santander Brasil and Banco do Brasil, but a more favorable risk perception towards the Supreme Court ruling should likely benefit Banco do Brasil the most, which seems more undervalued at current levels.

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## Economic plans: In reality more smoke than fire

MHM Law firm confirmed the views expressed in the breakfast we hosted in November last year and gave investors additional details on what we should expect from the trial, expected to start this month. Without getting in boring legal discussions, it was very clear to us any impact would be far lower versus what the market seems to be pricing in on banking stocks representing in our view a good buying opportunity in the sector.

### Five reasons why R\$150bn does not make sense

They supported the view that the R\$150bn impact for the system, as stated by the Ministry of Finance, is just not accurate and in the worst-case scenario we would be talking about R\$53bnm. There are five key reasons:

1. The government considered the balance of *all* savings accounts in those periods (instead of only the accounts that were affected by the change in the remuneration formula);
2. It assumed all the accountholders would ask for reimbursement;
3. It also assumed all account holders have all the necessary documentation to require the restitution of the amounts and/or that all the banks keep records of the savings accounts of that period available for public consultation.
4. Last but not least, the government assumes that all the accountholders would receive their payment immediately after the potential favorable ruling.
5. It considers banks lose in all four economic plans (Bresser, Summer, Collor 1 and Collor plans)

### And why R\$53bn might still be heavily an overstatement

The potential liability is significantly lower at R\$53bn as per the calculation performed by the Public Attorney's office. This calculation appropriately excludes Plan Collor II, in which the banks had the vast majority of favorable decisions in inferior courts 88% of decisions were in favor of the banks including Color II, the values already paid and/or provisioned, those small amounts that do not justify a legal action and most and foremost only the saving deposits that were "theoretically" harmed by the date of inception of the new monetary adjustment factor.

The calculation is far more accurate but from our conversation with MHM Law it could still be significantly overstated for the following reasons:

- The amount still consider banks lose on Plan Color I, which account for 50% of the R\$53bn. Banks have won the majority of cases with Color I with regards to the deposits that were held at the Central Bank, so the outcome regarding the deposits that remained with the banks during this plan is still uncertain.
- This amount still assumes that all accountholders with amounts that would justify a legal action would ask for reimbursement. However, some accountholders from that period already passed away. We also find it unlikely that a significant amount of people still keep the records to prove the balance they had in their accounts or that the financial institutions still have that database. By law, banks are not required to keep client records for more than 10 years. The last plan (Collor 2) was 23 years ago.
- An interesting data point provided by the banks and highlighted by MHM lawyers is the fact only 10% of accountholders actually filed a lawsuit, which account for 50% of the deposits at the time. So in theory that would reduce the impact to R\$26bn plus new lawsuits that could arise (only possible to collective lawsuits, probably only a small fraction).
- Finally, according to the lawyers, payment due would be made only after 6 months of the trial, considering the unlikely best-case scenario on which the bank agrees with the

compensation. However, if the bank disputes the amount, it can take up to 5 years for the payment to be made.

According to IDEC (Consumer Protection Institute), the expected loss for the banks would be even lower at only R\$8bn.

As per our estimates based on this value and the market share of savings accounts in 1988 (already *pro-forma* for the mergers and acquisitions made since then), we believe the impact is rather limited for the top four listed banks, representing, in this "worst-case scenario", a combined 6.6% of their market cap. However, for the reasons mentioned above, we believe the range should be between R\$8-27bn, which leads to only 1-3% impact of the aggregate market cap of top Brazilian banks. Banco do Brasil would be the most affected one among listed banks (but far from meaningful), with the impact reaching ~R\$1.3-4.4bn (2-7% of market cap). Caixa Economica Federal would be the most impacted bank, as it held 1/3 of the savings accounts at the time.

**Exhibit 1: Potential impact per bank**  
R\$ billion, market cap prices as of 02/07/2014

	Mkt share of saving deposits as of 1988	R\$ 53bn litigation		R\$ 26.5 billion litigation		R\$ 8 billion litigation	
		Impact per bank (R\$bn)	as % of mkt cap	Impact per bank (R\$bn)	as % of mkt cap	Impact per bank (R\$bn)	as % of mkt cap
BB	16.7%	8.9	14.4%	4.4	7.2%	1.3	2.2%
ITAU	10.4%	5.5	3.7%	2.8	1.9%	0.8	0.6%
CAIXA	34.4%	18.3	n.a.	9.1	n.a.	2.8	n.a.
BRASESCO	16.5%	8.8	7.9%	4.4	4.0%	1.3	1.2%
SANTANDER	1.8%	0.9	2.2%	0.5	1.1%	0.1	0.3%
HSBC	3.9%	2.1	n.a.	1.0	n.a.	0.3	n.a.
<b>Top 4 Listed Banks</b>	<b>45.4%</b>	<b>24.1</b>	<b>6.6%</b>	<b>12.0</b>	<b>3.3%</b>	<b>3.6</b>	<b>1.0%</b>

Source: MHM Law, Credit Suisse

**A look at some of the judges' track records in the matter**

Out of the 11 judges from the Supreme Court, two decided not to vote as they have conflicts of interest. Out of the remaining 9, 6 have already voted on the matter in other opportunities. While it is hard to say whether they will keep their previous votes or not as some of them took place several years ago and they could have a different understanding on the subjects in light of the deeper discussion that is being carried out (for good or for worse), it is interesting to look at their track records on the matter.

**Exhibit 2: Previous ruling on economic plans**  
R\$ billion, unless otherwise stated

Minister	Total final decisions					
	Bresser Plan		"Verão" Plan		Collor Plan	
	Favorable	Unfavorable	Favorable	Unfavorable	Favorable	Unfavorable
Carmen Lúcia	0	0	5	0	0	1
Celso de Mello	4	0	78	0	0	51
Gilmar Mendes	0	0	2	0	0	12
Joaquim Barbosa	1	0	6	0	1	16
Marco Aurélio	6	0	33	0	5	11
Ricardo Lewandowski	0	0	3	0	1	3
<b>Total</b>	<b>11</b>	<b>0</b>	<b>127</b>	<b>0</b>	<b>7</b>	<b>94</b>

Source: MHM Law, Credit Suisse

**Companies Mentioned** (Price as of 06-Feb-2014)

**Banco do Brasil** (BBAS3.SA, R\$21.6)  
**Banrisul** (BRSR6.SA, R\$10.64)  
**Bradesco** (BBDC4.SA, R\$26.23)  
**CaixaBank** (CABK.MC, €4.8)  
**Itau Unibanco** (ITUB4.SA, R\$31.85)  
**Santander Brasil** (SANB11.SA, R\$11.17)

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