

Investment Competition

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FinBr Team

Adalberto Porfirio Silvestre

Ana Regina Muzzi Kalil

Diego Bastos

Dimitar Stoyanov

Mauricio Noda

Nathalia Caserio Brborich



Banco ABC Brasil (ABCB4:BZ)

I. Description

Banco ABC Brasil S.A. attracts deposits and offers commercial banking services. The Bank advises on underwriting activities and mergers and acquisitions, offers commercial loans, treasury services, and international lines of credit.



| Market Data | |
|--------------------|--------------|
| Px/Chg 1D (BRL) | 16.22/+0.31% |
| 52 Wk H (03/19/18) | 19.86 |
| 52 Wk L (08/13/18) | 13.50 |
| YTD Change/% | -.674/-4% |
| Mkt Cap BR | 3,424.6M |
| Shrs Out/Float | 104.5M/77.0M |

II. Investment summary

Banco ABC Brasil is a commercial bank specialized in mid and large sized companies. The bank has a stable BB credit rating and management with a very strong track record. Executives own 5.2% of the shares of the bank, which provides them with an important incentive to perform at their best. The bank is currently developing a digital investment platform aimed at individuals, which will help it expand its customer base. It has hired the Director of Digital Business from Banco do Brasil to lead the digital transformation. The bank valuation is significantly lower compared to IBOVESPA with a P/E ratio of 7.43 vs 20.37, P/B ratio of 0.95 vs 1.92, despite the fact that it is very profitable institution with a ROE of 14.3%, steady growth of assets and sales over the past 5 years. Recently, Banco ABC has successfully strengthen its capital position through a rights issue. Moreover, ABC has a Beta above 1, which provides a greater exposure to the market. This could be beneficial in case of

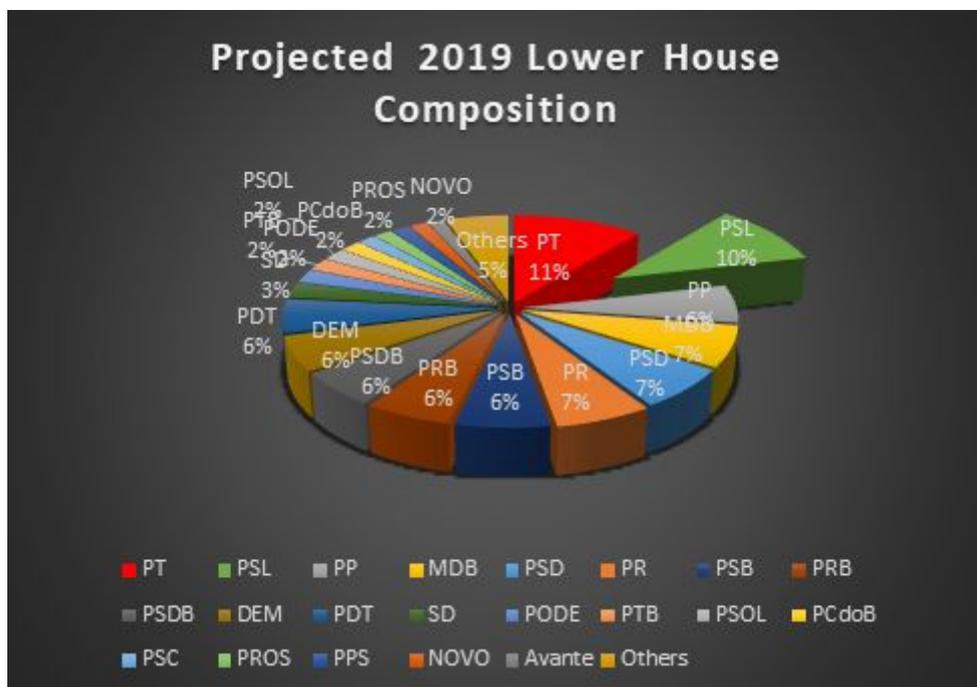
continuation of the market rally. Finally, the rising interest rates around the globe combined with a improved economic activity in Brazil could force Central Bank of Brazil to increase interest rates in the future. Traditionally, banks outperform in periods of rising interest rates.

III. Macroeconomics

The last presidential elections in Brazil ended in October 2018 with the victory of Jair Bolsonaro, bringing expectations for structural changes, which are awaited for the economic recovery of Brazil.

A great optimism was caused by a candidate who despite being elected with far-right proposals, has a liberal platform in the economic sphere. In contrast to the last 12 years of governance, in which the Brazilian economy was marked by great interference of the State, significant increase of credit and public spending, generating serious challenges for the future government: economy with weak growth, high unemployment, social security and tax burdens with a high cost for the public budget.

Bolsonaro will have strong popular support in his future policy making and should quickly find political support to move forward in areas such as fiscal and social security in to maintain investor confidence.

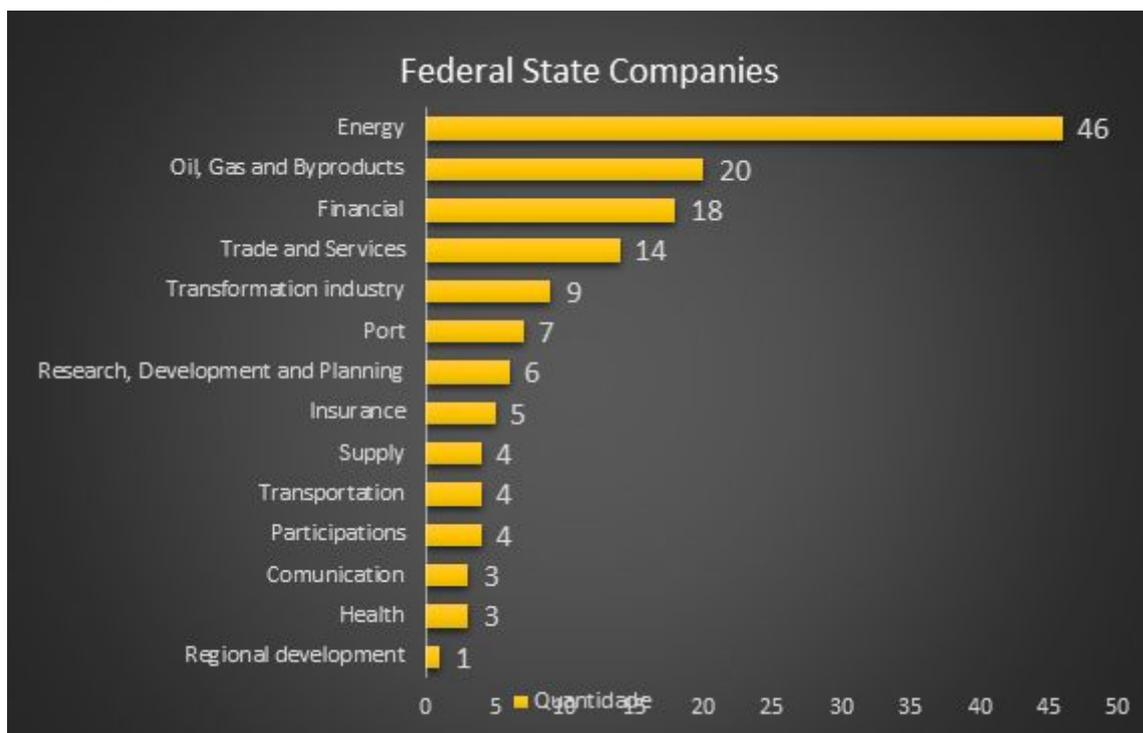


In order to give a boost to the economy, he has appointed economist Paulo Guedes - master and PhD from the University of Chicago, founder of BTG Pactual investment bank and the asset management company BR Investments. The future minister of

the economy defends unrestricted reduction of the State and thus its expenses and proposes privatizations of almost all Brazilian state-owned not considered strategic in order to remove part of the Brazilian public debt accumulated until now.

Another ambitious proposal is the creation of a great federative pact contemplating the federative units and the Brazilian municipalities with the resources currently directed to the payment of interest. This would reduce the indebtedness and expenses, allowing investments in infrastructure and essential services.

Guedes's objective is to sell all Brazilian state-owned companies are to private investors. As a result, the sale of Brazilian State stakes in state-owned companies would generate approximately R\$ 800 billion, thus reducing almost 20% of the federal public debt, of almost R\$ 3.6 trillion.



Source: SEST/MP/ Gov.

The future minister is also in favor of maintaining the macroeconomic tripod (tax and inflation target regime and floating exchange rate), and also supports a program of simplification and unification of federal taxes, decentralization and municipalization to increase the tax resources at the base of society.

Among all the great challenges, perhaps the biggest one for the future government of Bolsonaro is the need for an effective Social Security reform, which would reduce rights and public spending, thus unblocking the federal budget.

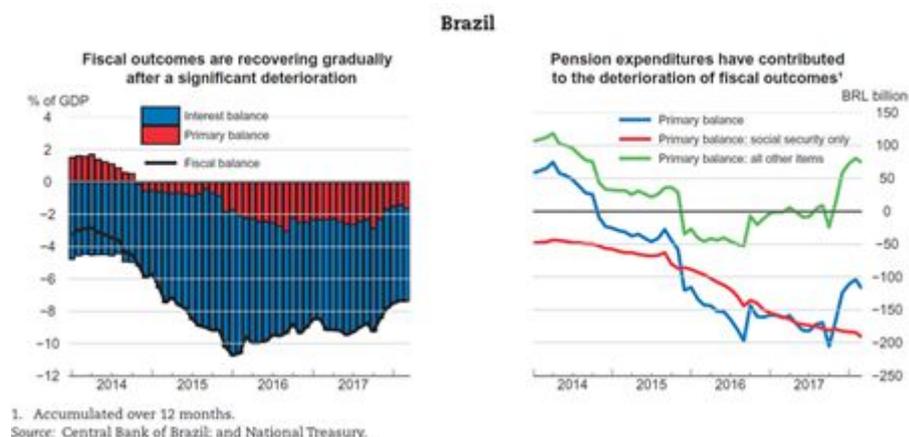
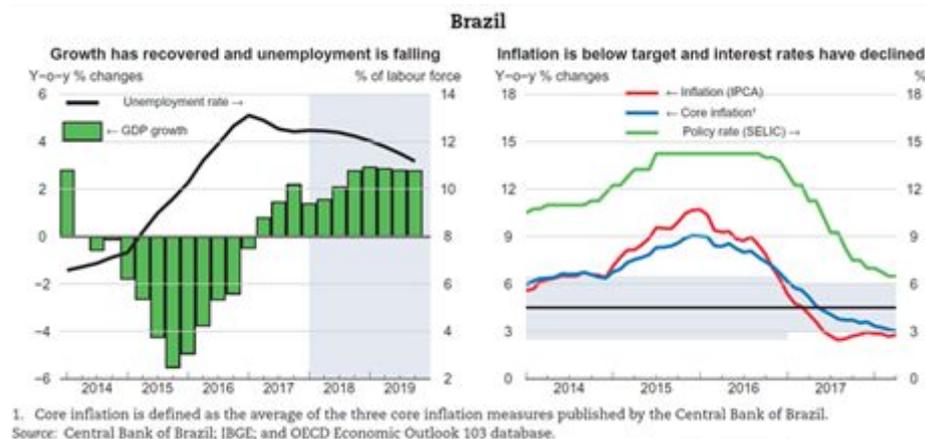
In addition to reducing welfare spending, Mr. Guedes advocates for moving to a funded scheme where the worker's retirement is the result of what he/she has saved throughout his/her life. With capitalization, companies would not have to pay for the charges and workers would have assets and capitalization in their names, reducing costs.

The Brazilian Congress has already proposed a Social Security reform, which is less radical than that of Bolsonaro, but should be reviewed for approval in 2019. The goal of the government of Bolsonaro is to maintain the optimism of the financial market and not lose time, a potential approval would be followed by discussion on the subject for more structural changes in the social security model.

In addition to that, an approval of a proposal for political and administrative independence of the Central Bank with a 4-year term for the head is still awaited. Regardless of the action of the current President, Michel Temer, Bolsonaro has already signaled that the Brazilian Central Bank will not have any kind of political interference.

In the context of all these policies and events in 2019, there should be a rapid recovery of the credit market, following a reduction of unemployment rate, entry of people into the formal market, mergers and acquisitions of companies, development of medium and large companies, this time in a more solid, structural manner with less risk.

Bolsonaro was elected by making unpopular but necessary proposals, the Brazilian electorate understood and supported him. The doubts about the electoral result are gradually fading away, so it is clear that the goal of most Brazilians is to approve the reforms aimed at promoting balance in public accounts, generating a favorable environment for growth, reducing unemployment and increasing income.



IV. **Industry outlook and Competitor analysis**

Based on the recent results of Brazilian elections we expect a wave of positive earnings for most of the Brazilian banks in 2019. Due to higher growth of the economy, the increase in credit activity and an expectation of the SELIC rate remaining in one digit range, the forecast is that the balance of credit operations will grow between 6% and 8% with an IPCA (official inflation index) estimated at 4%. Overall loan growth is likely to continue to expand with good asset quality trends and no material pressure on margins. The negative effect of the mark-to-market will probably be smaller than it was in 2018.

The positive trends from previous quarters related to Asset Quality will probably continue during the next months. According to the Central Bank's information (as of August), the overall delinquency rate was flat in the first two months of the quarter for household and corporate loans. The ratio was also flat for state-owned banks and local private banks, while it went up 10 bps for foreign banks.

Operating trends are likely to continue healthy in the next months. The top-down scenario is the main driver for share performance of banks, but our view is that their bottom-up dynamics have been very good, in fact among the best in the last few years, with big improvement in asset quality and the extensive deleveraging of Brazilian households.

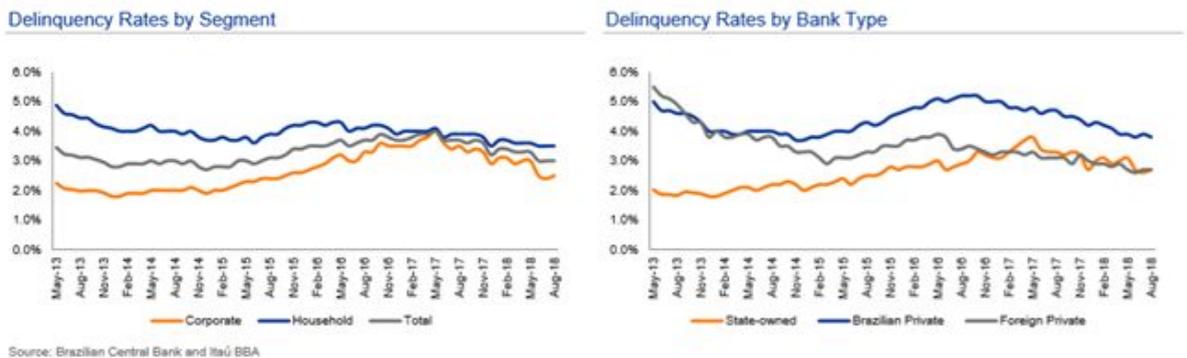
We expect loan growth to accelerate slightly on a yearly basis. Loan growth for most Brazilian banks was not good in 1Q18 (0.1% YoY for the Brazilian financial system) but improved a bit in 2Q18 (1.7% YoY), and is expected to accelerate further. Household loans will continue to lead this expansion, as happened in the last few quarters.

According to the credit data from the Central Bank of Brazil, the first two months of the quarter showed that foreign banks continued leading the expansion (up 13% YoY, or 2.9%, vs. June's figures) followed by local private banks (up 9% YoY and 1.1% vs. June's figures). State-owned banks were the biggest laggard (-2% YoY and no growth in these two months).

In April of 2018 the National Monetary Council (CMN) determined that banks could not apply different interest rates to overdue and non-overdue revolving credit card loans. According to the regulation, banks had until June to apply the same interest rate to overdue and non-overdue loans. Some state-owned banks, such as Banco do Brasil and Caixa, were already applying similar interest rates to both loan categories,

while other private banks, such as Bradesco and Santander Brasil applied different rates.

Overdue revolving loans represent about 57% of the total revolving credit-card portfolio for the Brazilian financial system, while credit card loans represent 12% of banks' total households portfolio. It is difficult to calculate the impact of this measure, but as a proxy of the share of overdue revolving loans over total credit card loans of the Brazilian financial system, we estimate a quarterly impact of around R\$ 135 million.



Analysis of other important credit lines, such as mortgage, auto, credit card or payroll loans, also showed no sign of deterioration. For payroll and credit card loans, the ratio was flat in July and August, while it went down 10 bps for mortgage and auto loans.

Loan disbursement continued to increase, reaching R\$ 327 billion in August – the highest monthly volume since December 2015. Corporate loan disbursements reached R\$ 143 billion (+16% YoY), while household loan disbursements amounted to R\$ 184 billion (+14% YoY).

The NPL ratio (overdue by 90 days) came in at 3.0% for the third consecutive month. Delinquency in the household portfolio was flattish MoM, at 3.5% (and down 40 bps YoY), while the corporate segment slipped by 10 bps MoM, reaching 2.5% (a 100-bp decline YoY).

In August, private local banks had the largest delinquency contraction, down by 10 bps MoM, offsetting the 10-bp increase by the state-owned banks. In the YTD comparison, Brazilian private and foreign banks led the decline, both down by 40 bps YoY, while state-owned banks were flat.

Delinquency Rate and Loan-Loss Provisions

| | (%) | Growth Analysis | | | |
|-----------------------------------|--------|-----------------|------------|------------|------------|
| | | Month | 3 Mo | YTD | 12 Mo |
| Delinquency Rate (90 days) | 3.0% | 0 b.p. | (30) b.p. | (20) b.p. | (70) b.p. |
| Private Banks | 3.8% | (10) b.p. | (10) b.p. | (40) b.p. | (90) b.p. |
| Foreign Banks | 2.7% | 0 b.p. | 0 b.p. | (30) b.p. | (40) b.p. |
| State Ow ned Banks | 2.7% | 10 b.p. | (40) b.p. | 0 b.p. | (60) b.p. |
| Allowance for Loan Losses | | | | | |
| Private Banks | 8.0% | (10) b.p. | (20) b.p. | (60) b.p. | (100) b.p. |
| Foreign Banks | 5.7% | (10) b.p. | (10) b.p. | (30) b.p. | (80) b.p. |
| State Ow ned Banks | 5.7% | 10 b.p. | 30 b.p. | 20 b.p. | 30 b.p. |
| Coverage Ratio | | | | | |
| Private Banks | 210.5% | 283 b.p. | 27 b.p. | 576 b.p. | 1,904 b.p. |
| Foreign Banks | 211.1% | (370) b.p. | (370) b.p. | 1,111 b.p. | 143 b.p. |
| State Ow ned Banks | 211.1% | (427) b.p. | 3,692 b.p. | 741 b.p. | 4,747 b.p. |

Note: ▲ indicates above total credit growth and ▼ indicates below total credit growth

Source: Brazilian Central Bank

The corporate portfolio had the best MoM growth. Household loans were also up by 1.3%. The highlights were auto loans (+1.4%), personal loans (+1.3%) and others (+2.4%). Earmarked loans were up 0.5% MoM – the first monthly increase since June 2017.

For 2019, we expected economic growth to pressure inflation and interest rates to go higher. Economic growth will increase the capital need from medium and small corporation and medium size banks like ABC can experience growth in loan volumes without changes on delinquency rates or losses.

ABC Brasil main competitors include Banco Panamericano, Daycoval and Alfa. The middle and small corporate loans segment turns even more competitive with the entrance of large Universal banks, like Itau and Bradesco. ABC has strong capital structure and we believe that ABC can get competitive funding rates.

V. Valuation

Our target price is 21 BRL or 9x 2019E Earnings and implies a 30% upside potential. We derive this target from an equally weighted average of a relative and dividend discount model valuations.

a) Relative valuation

| Ticker | Name | P/E | P/B | ROE | ROA | Texas ratio | Tier 1 ratio | Div Yield | YTD Total Return | Total Loan/D eposits | Rev Growth % | EPS growth % | EPS Growth (FY1) |
|----------------|------------------------|--------------|-------------|-------------|------------|--------------|--------------|------------|------------------|----------------------|--------------|--------------|------------------|
| ABCB4 | BANCO ABC BRASIL | 7,43 | 0,95 | 14,3 | 1,705 | 12,48 | 14,04 | 6,53 | 2,63 | 178,2 | 7,56 | 0,29 | 6,78 |
| BBAS3 | BANCO DO BRASIL | 10,21 | 1,22 | 12,5 | 0,9 | 79,83 | 13,80 | 2,95 | 40,37 | 145,9 | -13,13 | 49,73 | 15,44 |
| SANB11 | BANCO SANTANDER BRASIL | 13,86 | 1,72 | 13,0 | 1,626 | | 14,70 | 4,22 | 38,14 | 104,3 | -9,80 | 28,68 | |
| BBDC4 | BANCO BRADESCO | 13,60 | 2,10 | 16,5 | 1,443 | | 13,10 | 3,21 | 19,37 | 68,2 | -11,01 | -3,07 | 8,05 |
| ITUB4 | ITAU UNIBANCO | 13,64 | 2,47 | 18,5 | 1,70 | 20,94 | 16,20 | 6,61 | 25,06 | 122,4 | -11,36 | 3,94 | 5,45 |
| <i>Average</i> | | <i>11,75</i> | <i>1,69</i> | <i>15,0</i> | <i>1,5</i> | <i>37,75</i> | <i>14,4</i> | <i>4,7</i> | <i>25,1</i> | <i>123,8</i> | <i>-7,5</i> | <i>15,9</i> | <i>8,9</i> |

We believe that a fair valuation of Banco ABC can be obtained based on the average P/B and P/E ratios of Brazilian banks focused on corporate banking and incorporating a 20% discount to account for the smaller size of the bank, lower liquidity and EPS growth. This results in a price to book ratio of 1.35 and a price to earnings ratio of 9.4. The implied target price is 20.5 BRL (9.4×2.18) and 23.1 BRL (1.35×17.11) respectively, resulting in an average price of 21.8 BRL.



b) Dividend discount model valuation

| | |
|---------------------------|-------|
| Current price | 16,22 |
| EPS | 2,18 |
| Adjusted B | 1,1 |
| Current risk-free rate | 8,2% |
| Historical risk-free rate | 10% |
| Market rate | 13,4% |
| Risk premium | 3,4% |
| EPS 5Y growth rate % | 6,6% |
| Dividend | 1,08 |
| Cost of equity | 12% |
| Target price | 20,3 |

Banco ABC had negative cash flows in the recent years and quarters which makes the usage of the FCFE model for valuing the firm difficult and unreliable. We believe that

dividends are a good indicator of the cash flows of banks and thus we applied the Dividend Discount or Gordon Growth model. DDM is very suitable for mature companies with stable dividends and growth rate, attributes applicable to ABC.

Firstly, we estimate the cost of equity based on the current risk free rate, the beta and the market risk premium ($0.082 + 1.1*(0.134-0.10) = 12\%$). Secondly, we divide the forward dividend by the difference between the cost of equity and the growth rate ($1.08/(0.12 - 0.066)$) and obtaining a target price of BRL 20.3.

Assumptions:

1. Banco ABC is comparable to Banco do Brasil, Santander, Bradesco and Itaú
2. The fair discount rate to be applied for the smaller size of Banco ABC is 20%
3. The historical risk-free rate is equal to the historical 10Y average interest rate
4. The current risk-free rate is equal to the 2Y government-issued bond yield
5. The market rate of return is equal to the historical 20Y average rate
6. The dividend will grow in the future constantly at the 5Y average EPS growth rate
7. Payout ratio will remain unchanged in the future
8. The income that is not paid out as a dividend is reinvested
9. 1Y EPS growth of 6,78%
10. Stable credit quality

VI. Risks

Negative

1. Credit quality deterioration
2. Competition
3. EM currency crisis
4. Economic environment
5. Pressure on NII from lower interest rates

Positive

1. Favourable reforms by new government
2. Recovery of Brazilian economy
3. Improvement on external trade volumes
4. Digital investment platform success

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