

GOOD RESULTS, BUT A FEW CREDIT CONCERNS TO LOOK OUT FOR

We conclude that Santander's Q4 2009 earnings are more favourable than expected, against both our and consensus estimates. However, there are some issues to be concerned about; most notably we see (as for BBVA in Q3 2009) that the €2.6bn capital gains from the IPO of the Brazilian operations and issues exchange have been wholly used by booking them to generic provisions, Metrovacesa provisions and the purchase of underperforming real estate. These are obviously extraordinary measures to help alleviate the deterioration in asset quality, but we note that the underlying metrics are not as bad as at BBVA: particularly that the coverage ratio has increased q-o-q (rather than decreased, as was the case at BBVA) and that the q-o-q increase in NPLs is more modest.

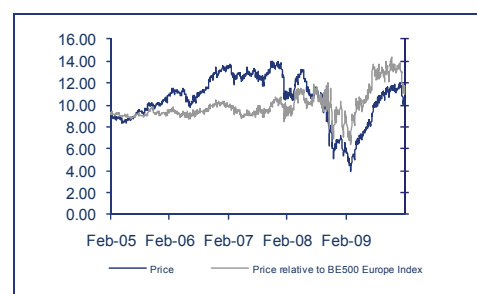
- Net income for Santander in Q4 2009 was €2.2bn against our and consensus expectations of €2.0bn. Pre-tax profit was €3.0bn against our €2.6bn estimate and consensus of €2.8bn. The beat against our estimate comes mainly from net loan loss provisions being lower than we forecast by €250m and net interest income being ahead by €365m.
- The key focus, in the light of BBVA's results, is asset quality deterioration. Santander's deterioration in asset quality proved more modest than at BBVA, but we still harbour concerns that in the absence of capital gains in 2010, earnings might suffer considerably from elevated loan losses.
- We have a HOLD rating on Santander. We see much greater upside potential to fair value at BBVA (also a HOLD), but for the near term we favour Santander's ability to demonstrate better earnings resilience in an environment of deteriorating Spanish loan losses. We would look to upgrade BBVA and Santander to BUY when there is clarity that the loan loss cycle in Spain has reached a nadir. However, ahead of fiscal tightening in that country, expanding sovereign CDS spreads potentially translating into wider corporate CDS spreads (leading to inherently more expensive funding costs), and the prospect of perhaps worse-than-expected loan losses in coming quarters, we feel it is far too early to turn positive. We prefer to be Buyers of safe-haven Nordic banks like DNB NOR and Svenska Handelsbanken.

Research

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Rating	HOLD
Target price (€)	13.00
Yesterday's closing price (€)	10.21
Upside/downside	27%
Sector	Pan-European Banks
Market Cap (€bn)	38.5

(€/€m)	2009A	2010E	2011E
Net interest income	26,298	26,891	28,116
Net fees & commissions	9,080	9,534	10,011
Trading profits/losses	3,423	3,491	3,561
Other revenue	579	629	653
Total operating revenues	39,380	40,546	42,341
Operating costs	-16,421	-17,232	-17,995
Operating profit	22,959	23,315	24,347
Total provisions	-9,484	-10,249	-7,944
Pre-tax profit	11,763	11,353	14,690
ROA	0.83%	0.75%	0.90%
ROE	14.12%	12.02%	14.37%
ROTNV	19.46%	16.81%	19.24%
Cost/income ratio	-41.70%	-42.50%	-42.50%
Payout ratio	38.02%	40.00%	40.00%
Net interest margin	2.73%	2.66%	2.59%
LLC % gross loans	-1.42%	-1.43%	-1.05%
NPL ratio	3.51%	4.25%	3.20%
NPL coverage ratio	75.33%	75.00%	85.00%
Loans % deposits	136%	136%	137%
Core tier 1 ratio	8.61%	9.39%	9.81%
EPS	1.09	1.04	1.35
DPS	0.41	0.42	0.54
P/TNAV	1.91	1.72	1.52
Div yield	4.03%	4.08%	5.28%



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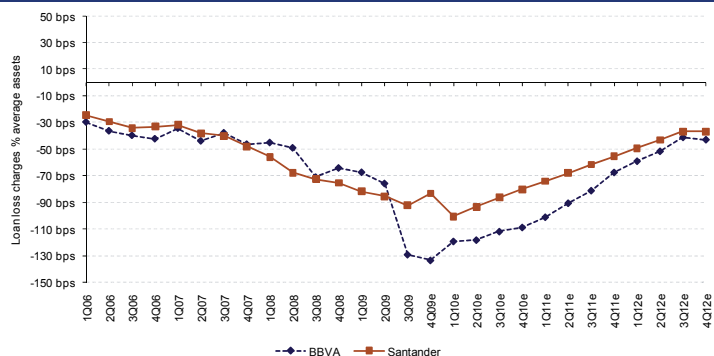
RESULTS ANALYSIS

Asset Quality – More Modest Deterioration than at BBVA, but Watch the Warning Signs

Within earnings, loan loss provisions were lower than we expected. The loan loss rate was 1.32% in Q4 2009, an improvement on the 1.45% seen in Q3 and better than our 1.50% expectation. Remember that for BBVA there was a marked increase in the loan loss ratio in Q3 2009 to 2.10%, from 1.22% in Q2 2009, on the premise that the capital gains of €830m were being booked as a 'one-off' contribution to generic provisions. However, BBVA then went on to shock the market with a loan loss rate of 2.16% in Q4 2009, with significantly higher provisioning for real estate in Spain and consumer and corporate exposures in the US.

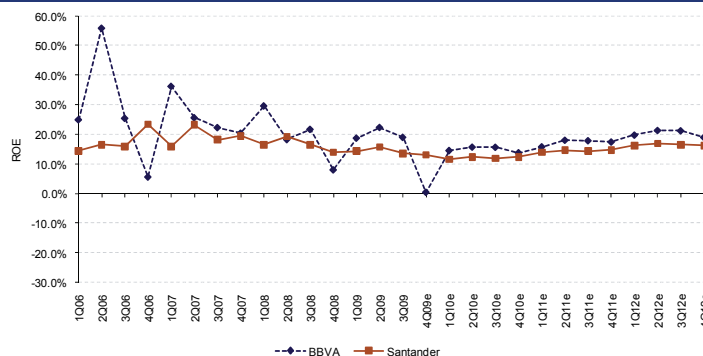
Santander's q-o-q increase in loan loss reserves (LLR) was €1.9bn (+11%) to €18.5bn, evenly split between an increase in specific and generic loan loss reserves. This compares with the more modest increase in LLR of 6% q-o-q seen at BBVA, with generic provisions within that falling by 26%. Whether this is due to BBVA potentially having worse underlying credit quality or whether it is due to BBVA's management being more aggressive in writing off losses versus Santander is open to debate. It is nevertheless our conclusion, as has often been proved the case historically, that Santander shows much less volatile results through the cycle than BBVA.

Figure 1: BBVA's Loan Loss Provisioning Now Much Worse Than Santander's



Source: Matrix Corporate Capital Research

Figure 2: Santander Has Shown Much Less ROE Volatility Than BBVA Through the Cycle



Source: Matrix Corporate Capital Research

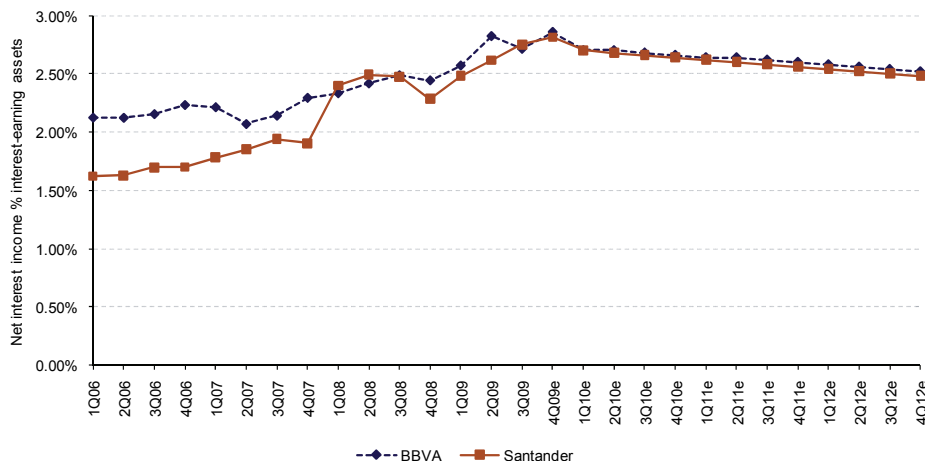
Santander's coverage ratio improved only slightly q-o-q to 75%, from 73% in Q3. This compares with the coverage ratio falling to 57% from 67% at BBVA over the same period. On an absolute basis, Santander's generic provisions increased by ~€700m net. Within this, there was a contribution from capital gains of €1.5bn, with offsetting specific losses. This is better than what we saw at BBVA in Q3 2009, which booked €830m in capital gains to generic provisions, but where the level of generic provisions stayed nearly flat q-o-q, with the bulk of the contribution used up by specific losses. The impression we have is that, although Santander is playing the same game as BBVA of using exceptional gains to offset loan losses, the underlying deterioration in asset quality is not quite as bad as at BBVA. **We still have concerns, however, particularly as to what will happen to Santander's reported loan loss provisions in Q1 2010 in the absence of substantial capital gains.**

Non-performing loans increased by 8.3% q-o-q in Q4 (an absolute increase of €1.9bn) versus the 29% increase seen at BBVA. **We judge the overall credit quality deterioration at Santander to be less severe than at BBVA – lower provisioning rates; an improvement in coverage ratios (not deterioration, as at BBVA); and a more modest increase in underlying NPLs as well.**

Net Interest Income – Impressive Expansion in Margins

Santander showed an impressive expansion in its NIM to 2.81% in Q4 from 2.72% in Q3 2009, against our expectation of no change. This underpinned the beat in net interest income against our expectations. Note that the NII beat was also due to the more modest q-o-q contraction in the customer loan book – by -1% against our expectation of -3%.

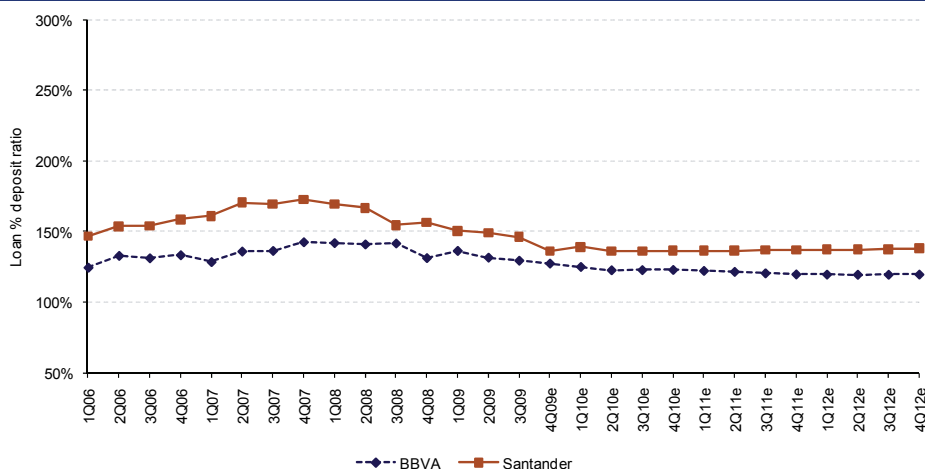
Figure 3: NIM Development has Been Impressive for Both Large-Cap Spanish Banks



Source: Matrix Corporate Capital Research

Like BBVA, the large cap Spanish banks are demonstrating that they can improve margins better than their domestic mid-cap peers. We put this down to several factors: the large cap banks are less focused on the competitive Spanish market than pure-play domestic peers; the competitive edge gained by the large cap banks has given them the advantage of greater asset pricing power; and the improvement of the franchises for the large cap Spanish banks relative to the caja banks throughout the crisis has resulted in a flight-to-quality of cheap customer deposits to the former, as demonstrated by the fall in their loan-to-deposit ratios. Indeed, we see for Santander that its LTD ratio has improved yet again, to 136% from 146% in Q3 2009.

Figure 4: BBVA and Santander Continue to Improve Their LTD Ratios



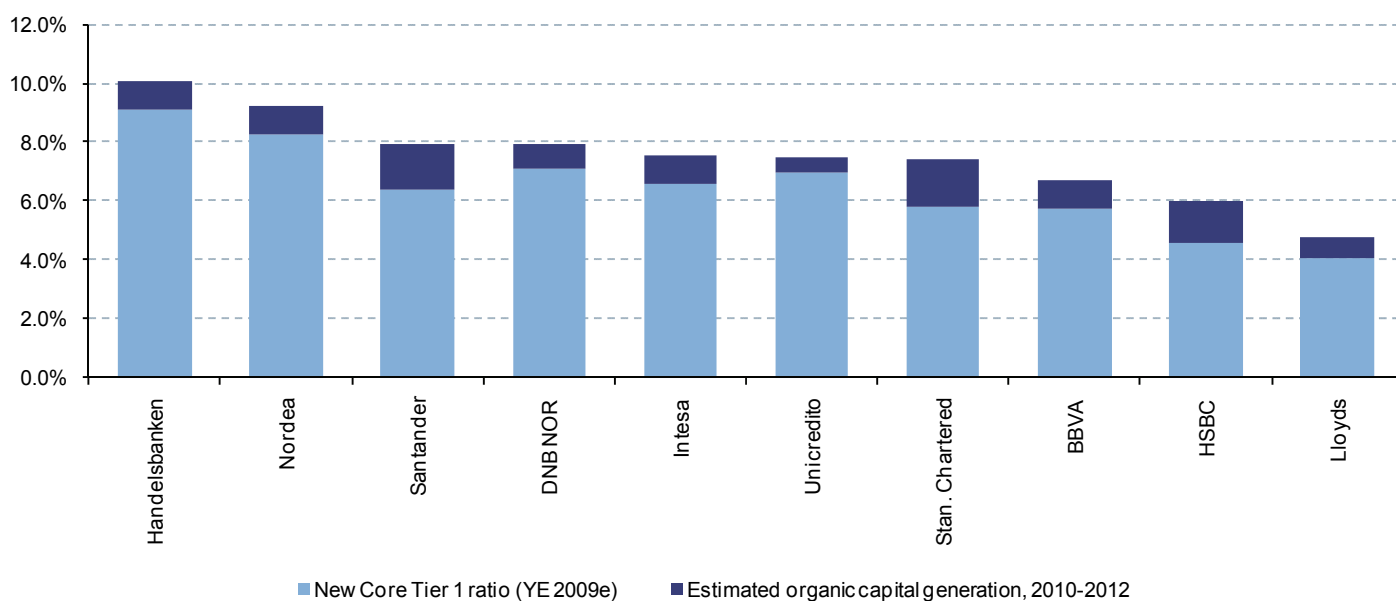
Source: Matrix Corporate Capital Research

Going forward, we model a modest contraction in NIM for both Santander and BBVA, as the lagged effect of assets being repriced downwards has an impact on overall margins. An increase in base rates would also be negative for liability spreads given that the Spanish banks are more dependent on wholesale funding than their large cap lending bank peers (as denoted by their loan-to-deposit ratios being comfortably above 100%). However, our expectation is that base rates will not rise until at least after the end of 2010; and even then only modestly given that significant deflationary pressures still exist in the economy.

Capital – Solid Under Basel II and Basel III, and Importantly, Much Better than at BBVA

The Tier 1 ratio improved to 10.1% in Q4 and the Core Tier 1 ratio to 8.6%, ~90bps better than at the Q3 2009 stage. We have run through our Basel III capital analysis again for the new numbers released and see a Core tier 1 ratio at the end of 2012 of 7.9% (including organic capital generation), which is comfortably above our expectation of a regulatory minimum of 6.0%; and, more importantly, compares well with BBVA, whose Core Tier 1 ratio we calculate as only 6.7% at the end of 2012. We include the revised table below, showing new Basel III Core Tier 1 ratios for Santander and BBVA compared with the other large cap European lending banks.

Figure 5: Basel III Core Tier 1 Ratios as at the End of 2012, Including Organic Capital Generation



Source: Matrix Corporate Capital Research

Figure 6: Banco Santander Earnings Table

	FY 2008	Q4 2009E	Q4 2009	FY 2009	FY 2010E	FY 2011E	FY 2012E
Income statement (€m)							
Net interest income	20,945	6,455	6,820	26,298	26,891	28,116	29,602
Net fees & commissions	9,020	2,135	2,252	9,080	9,534	10,011	10,512
Trading profits/losses	2,597	444	806	3,423	3,491	3,561	3,632
Other revenue	927	238	131	579	629	653	679
Total operating revenues	33,489	9,271	10,009	39,380	40,546	42,341	44,425
Operating costs	-14,949	-3,953	-4,282	-16,421	-17,232	-17,995	-18,787
Operating profit	18,540	5,319	5,727	22,959	23,315	24,347	25,638
Total provisions	-6,601	-2,535	-2,284	-9,484	-10,249	-7,944	-5,527
Impairments on other assets	-91	-50	-94	-401	-401	-401	-401
Goodwill impairment	0	0	0	0	0	0	0
Other income / expense	-426	-112	-382	-1,311	-1,311	-1,311	-1,311
Pre-tax profit	11,421	2,621	2,967	11,763	11,353	14,690	18,399
Taxes	-2,391	-550	-535	-2,336	-2,384	-3,085	-3,864
Minorities	-473	-93	-207	-516	-404	-522	-654
Other non-operating items	319	0	-23	0	0	0	0
Net profit	8,877	1,978	2,202	8,912	8,566	11,083	13,881
Assets (€m)							
Loans to customers	634,884	646,199	664,146	664,146	705,493	767,336	836,395
Interbank loans	64,731	46,658	57,641	57,641	59,970	64,913	70,264
Total securities	227,878	259,986	259,653	259,653	281,057	304,225	329,303
Intangible assets	18,836	23,474	22,865	22,865	22,865	22,865	22,865
Total assets	1,049,632	1,081,423	1,110,529	1,110,529	1,180,967	1,278,883	1,386,001
Net interest-earning assets	947,457	937,376	978,515	978,515	1,041,887	1,131,460	1,230,534
Liabilities (€m)							
Interbank borrowings	79,795	76,091	73,126	73,126	77,602	83,999	90,923
Customer deposits	672,531	700,358	694,171	694,171	732,363	792,733	858,080
Total shareholders' equity	57,587	67,848	68,666	68,666	73,805	80,455	88,784
Tangible net asset value	38,751	44,374	45,801	45,801	50,940	57,590	65,919
Important financial ratios							
ROA	0.90%	0.73%	0.80%	0.83%	0.75%	0.90%	1.04%
ROE	15.67%	11.74%	12.99%	14.12%	12.02%	14.37%	16.40%
ROTNV	22.91%	17.83%	19.23%	19.46%	16.81%	19.24%	21.06%
Cost/income	-44.64%	-42.63%	-42.78%	-41.70%	-42.50%	-42.50%	-42.29%
Tax rate	-20.94%	-21.00%	-18.03%	-19.86%	-21.00%	-21.00%	-21.00%
Payout	54.22%	55.00%	58.36%	38.02%	40.00%	40.00%	40.00%
Net interest margin	2.36%	2.72%	2.81%	2.73%	2.66%	2.59%	2.51%
LLC % gross loans	-1.09%	-1.50%	-1.32%	-1.42%	-1.43%	-1.05%	-0.67%
Non-performing loans % gross loans	2.22%	4.00%	3.51%	3.51%	4.25%	3.20%	1.70%
NPL coverage ratio	90.64%	73.00%	75.33%	75.33%	75.00%	85.00%	120.00%
Loans % deposits	156.37%	140.90%	136.18%	136.18%	136.32%	136.98%	137.93%
Tier 1 ratio	9.12%	9.45%	10.08%	10.08%	10.83%	11.14%	11.60%
Core tier 1 ratio	7.58%	7.95%	8.61%	8.61%	9.39%	9.81%	10.37%
Equity % total assets	5.49%	6.27%	6.18%	6.18%	6.25%	6.29%	6.41%
RWA % total assets	48.97%	50.32%	50.58%	50.58%	48.51%	48.49%	48.43%

Source: Matrix Corporate Capital Research

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