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Financial Services: The Road Ahead

KKR

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Financial Services: The Road Ahead

The financial services industry is undergoing a sea change, we believe. Heightened regulation, de-leveraging, and low rates are all challenging traditional financial intermediaries to ponder what will be the key drivers of growth and returns in this new and unfamiliar environment. Our base view is that these changes are secular, not cyclical, ones, and as such, we think now is the time for all investors associated with the industry to consider the role financial intermediaries will play in the capital formation and distribution process in the years ahead. So, in an effort to better crystalize our own views amid this significant period of change, we offer commentary into what we believe is the road ahead for financial services.

"It is during our darkest moments that we must focus to see the light."

ARISTOTLE ONASSIS
PROMINENT GREEK SHIPPING MAGNATE (1906–1975)

Given all that has transpired since the Great Recession in the U.S. to the financial services industry, we thought it might make sense to spend time outlining some of the opportunities and challenges we think the sector now faces. We certainly don't profess to have all the answers, but we do have some strong viewpoints on what smaller balance sheets, less liquidity, and heightened regulation mean for those who either invest in financial services stocks and/or use products that the industry has traditionally supplied to the market. Our conclusions are as follows:

1. In terms of public equities, we believe investors should now think about their capital allocation to the financial services sector as morphing from good beta into 'boring beta.' Today the beta in the financial services industry in the United States is 1.4, down from a peak of 1.7 in October 2010, but we think it is headed materially lower[1]. Specifically, our research leads us to think it could drop to 1.0 or so over the next 2-3 years. This decline has significant implications for portfolio construction because it would mean that an investment manager's portfolio beta could be overstated in up markets and understated in down markets. Big-cap technology stocks endured a similar fate after their fall from grace at the turn of the decade, and we now expect a similar outcome in the financial sector.

2. Our changing-beta thesis is driven by our view that the current reshaping of the competitive landscape in financial services is a secular, not a cyclical phenomenon. Margins, asset turns, and leverage—the three ingredients of ROE—are likely to remain subpar for some time as the velocity of money stagnates, regulation increases, and leverage falls. Consistent with this view, our research shows the sector's market cap contracting by another 250 to 300bp from the current 15% of the overall U.S. public equity market over the next 3-5 years.

3. Government-mandated balance sheet contraction throughout the financial services industry is expected to continue to make credit availability more difficult for everyone, including financial counterparties. Exacerbating the issue is that individual and institutional investors, many of whom are currently helping to "plug" the shortfall in lending created by Wall Street's downsizing, do not lever their capital by the multiples that banks and brokers do. If there is good news, it is for patient allocators of capital, pension funds in particular, in the global fixed income markets. Why? Because the 300-400 basis point illiquidity premium that is currently available because of slower volumes and tighter liquidity is likely to persist for some time and could even widen in the future[2].

4. The euro crisis and its effect on all global financial services firms, including those in the U.S., are not to be under-estimated. Our recent visits to the Continent confirm that banks are taking a more nationalist bent, particularly in countries like France. We believe this 'new' approach will dampen cross-border lending in Europe and that lending to Asia will also be curtailed in certain instances. Supporting this latter view is a recent analysis done by the global investment bank Morgan Stanley, which shows that a full 43% of all large-ticket trade financing to Asia came from European banks in 2010. Today, that percentage is just 3%.[3]

5. Regardless of the macro headwinds the sector faces, a handful of companies, particularly those lenders directly levered to an improving housing market, are likely to significantly outperform the sector and the overall market. See below for details, but our prerequisites for success include great leadership, rising return on equity, book value growth, and a scale, technology, and content advantage.

There will be both clear winners and losers amid the changing competitive landscape we see unfolding in the coming years. For the nimble and the capable, the environment could lead to significant market share gains and/or new businesses and profit centers. Ironically, at a time when the financial services industry is retreating, the need for capital, advice, and solutions by many parts of the corporate sector, small and medium-size businesses in particular, has actually being going up, not down. On the other hand, many traditional financial intermediaries, particularly those that are slow to react, are likely to see their business models come under additional pressure as volumes decline and regulatory oversight increases against a backdrop of low interest rates.

Looking at the big picture, we continue to view a world where decent growth in the private sector is largely offset by government downsizing and bank deleveraging in many parts of the developed market. In the U.S., for example, private sector cumulative GDP grew by 3.6% year-over-year in the first half of this year, while the government sector actually fell by 2.2%[4] over the same period. However, because governments in key markets like the U.S. and Europe can't seem to agree on important fiscal reform, their central banks have been forced to take steps that try to fill the gap by monetary policy. Specifically, the ECB is now making economic reforms a pre-condition for monetary support via its OMT (Outright Monetary Transaction) policy, while the Federal Reserve is now explicitly targeting jobs via QE (Quantitative Easing), with purchases of housing-related securities a major part of this strategy.

Within the emerging markets (EM), we still expect outsized growth, but we also want to underscore that many of today's big EM growth stories, including China (too much fixed investment), India (too much inflation), and Brazil (too little infrastructure), all face macroeconomic headwinds that were not as prevalent in the past.

Against this backdrop, we still prefer retaining oversized exposure to 'spicy' credit in the low-rate, slower-growth environment that we are forecasting. We also continue to overweight real assets to protect against what we view as long-term inflationary policies by many developed market central banks. In particular, the current policy of holding nominal rates below nominal GDP, which is being pursued in the U.S., U.K., and Europe, may ultimately prove inflationary, we believe. One can see the importance of this relationship for financial services in *Exhibits 1 and 2*. Finally, as we discuss below in detail, we see a large and growing opportunity to help fill the

1 See *Exhibit 7*

2 See *Exhibit 15*

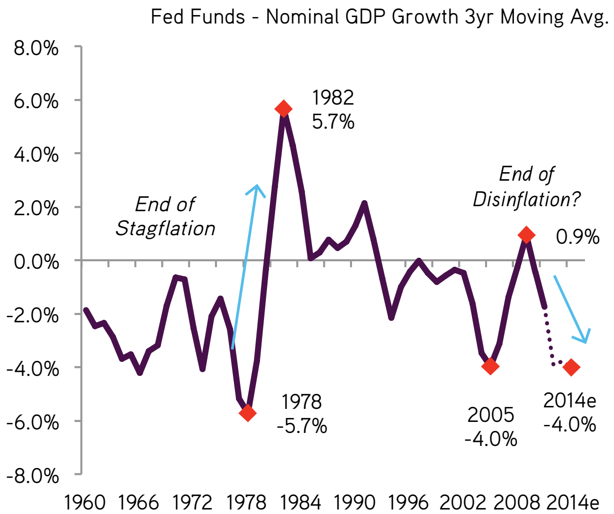
3 Morgan Stanley Research Report "*EU Bank Deleveraging & Asian Trade Finance*" dated May 1, 2012 by Huw Van Steenis.

4 As of September 27, 2012. Source: Bureau of Economic Analysis.

financing 'hole' left by traditional financial intermediaries in areas such as middle-market lending and real estate.

EXHIBIT 1

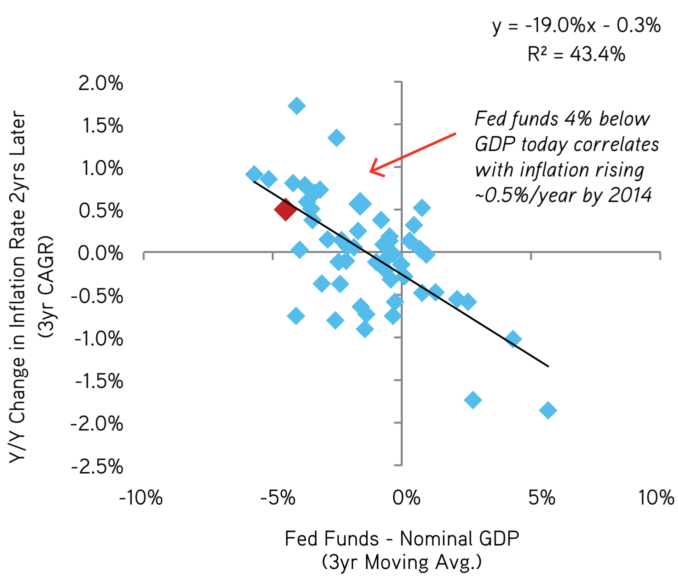
Many Central Banks are Holding Interest Rates Below GDP Growth, Which Could Ignite Inflation Over Time



e = KKR Global Macro & Asset Allocation estimates as of September 30, 2012. 1960 to current. Source: KKR Global Macro & Asset Allocation analysis of Federal Reserve and Bureau of Economic Analysis data.

EXHIBIT 2

Historically, a Strong Relationship Between Fed Policy and the Direction of Inflation Two Years Later



e = KKR Global Macro & Asset Allocation estimates as of September 30, 2012. 1960 to current. Source: KKR Global Macro & Asset Allocation analysis of Federal Reserve and Bureau of Economic Analysis data.

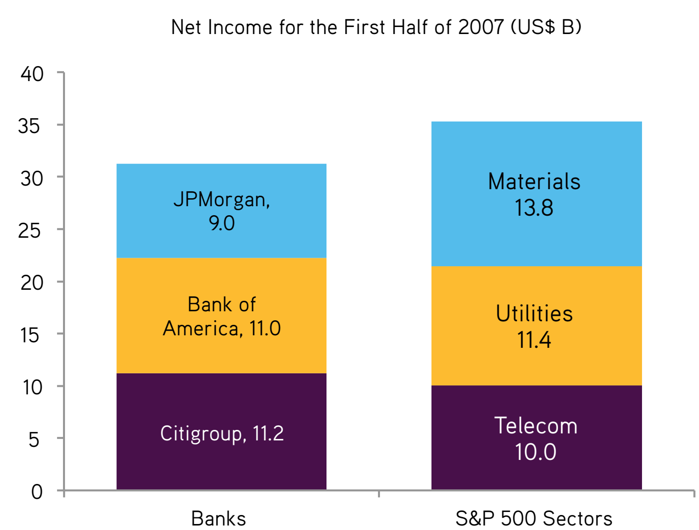
Details:

During my introductory phase on Wall Street covering financial services stocks in the early 1990s as a research analyst, it became increasingly clear to me that several sizeable positive tailwinds were beginning to swirl around the industry. In particular, globalization, deregulation, consolidation, and retirement savings all emerged as powerful secular drivers of growth and returns across the spectrum of the global wholesale business. These four mega-trends were ultimately turbo-charged by the historic dismantling of the Glass-Steagall Act, which was passed in 1999[5]. Whether it was explicit or not, our impression was that many executives took this repeal as a clear signal that more and bigger were better when it came to a firm's footprint in the financial services industry.

However, by 2007, on the heels of lax regulation, a housing boom, and outsized leverage, the large and mega-cap segment of the financial services industry had gone too far – and on too many fronts. All told, the U.S. financial sector accounted for 41% of incremental earnings growth in 2006, 28% of total earnings, and 22% of the public equity market capitalization of the S&P 500. And that did not include quasi-financials like GE Capital and GM Financial, which boosted the contribution from financials to over 45% of total earnings[6]. As a proxy of how extreme things had gotten, Citigroup, Bank of America, and JPMorgan in the first six months of 2007 earned \$31.3 billion, which was just slightly smaller than the Materials (and remember, China was booming at this time), Utilities and Telecom sectors combined *(Exhibit 3)*. At the same time, the composite (i.e., the average) of brokerage stocks we tracked earned a return on equity of 18.0% on a leverage ratio of 16.2 *(Exhibit 4)*. That was then.

EXHIBIT 3

Earnings at the Big Three Banks Were Almost as Large as the Materials, Utilities and Telecom Sectors Combined



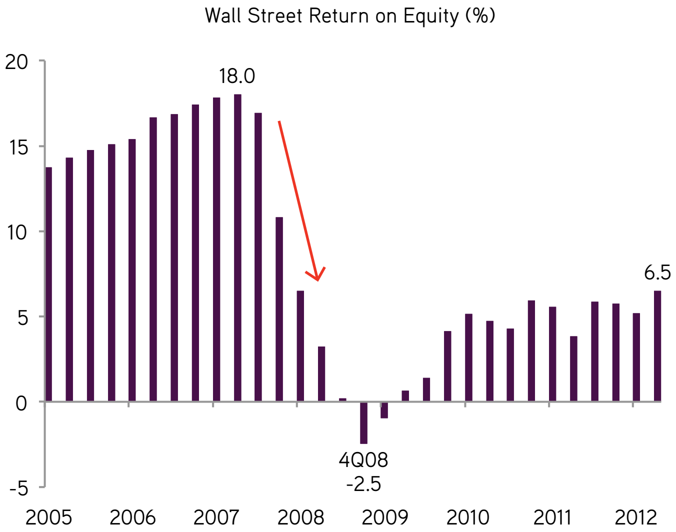
Data as at July 31, 2012. Source: Factset.

5 The Glass-Steagall Act became law in 1933. In 1986/1987 the Act saw easing of restrictions allowing bank holding companies to own investment bank affiliates with up to 25% of their business in securities underwriting (up from 10%). In 1996, sections of the Act were eliminated and banks were allowed to acquire securities firms. Finally, in 1999, the Glass-Steagall Act was repealed in entirety. Source: http://www.pbs.org/wgbh/pages/frontline/shows/wallstreet/weill/demise.html

6 Data for fiscal year 2006 for companies within the S&P 500 on December 31, 2006.

EXHIBIT 4

Financials Now Deliver Much Lower Returns



Aggregate of GS, MS, BAC, C, and JPM net income divided by average common equity. Data as at 2Q2012. Source: Factset.

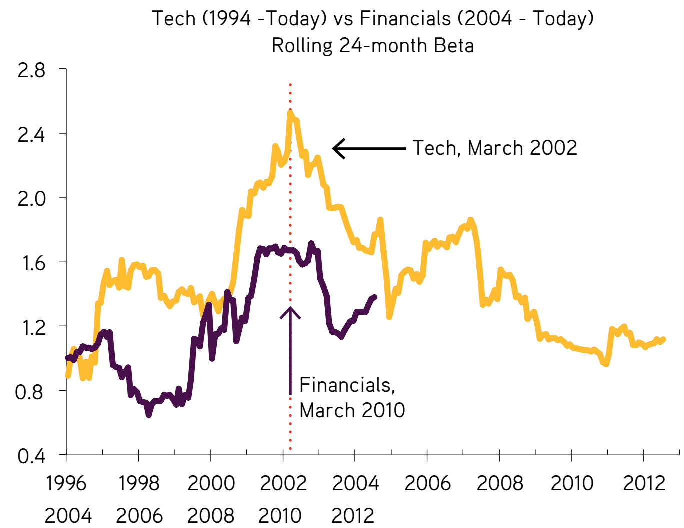
Today what we see is an unsettled environment where many of the underpinnings of the sector's advance are being called into question, including the four major tailwinds we identified two decades ago. Indeed, the trend towards further consolidation is unlikely to persist when "Too Big to Fail" is considered a major cause of the financial crisis, while deregulation has been replaced by re-regulation. Nowhere has this reversal been more apparent than the securitization market, which has slowed to a near standstill after multiple years of uninterrupted growth. In terms of retirement savings, baby-boomers are actually now transferring a large portion of their retirement allocations back towards fixed income, often at the expense of higher-margin equity mutual fund products. Finally, though globalization continues, Europe's deleveraging and China's rebalancing will certainly affect the trajectory and smoothness of this process, in our view.

So, with this as a backdrop, we would make the following five observations about the financial services industry as we view it from our macro perch at KKR:

Financial stocks are headed towards becoming 'boring beta.' American Pulitzer Prize winner Russell Baker once snipped that "An educated person is one who has learned that information almost always turns out to be at best incomplete and very often false, misleading, fictitious, mendacious – just dead wrong." When I was getting 'educated' about finance at the Wharton School of Business in the mid-1990s, I was fortunate to learn a thing or two about the beta of a stock from some very gifted professors. However, as I apply some of those academic theories in today's mixed-up, macro-heavy world, I feel a little cynical – almost like Russell Baker. In particular, I have become quite skeptical of the stated beta of the financial services industry. In fact, I think it is "just dead wrong." Key to my thinking is that the sector's beta is being de-rated, and as a result, its current beta may end up being viewed as 'bad', not good beta, when a portfolio manager looks to add "juice" to his or her portfolio. Consequently, financial stocks may be more sensitive to market moves on down days but less sensitive on up days.

EXHIBIT 5

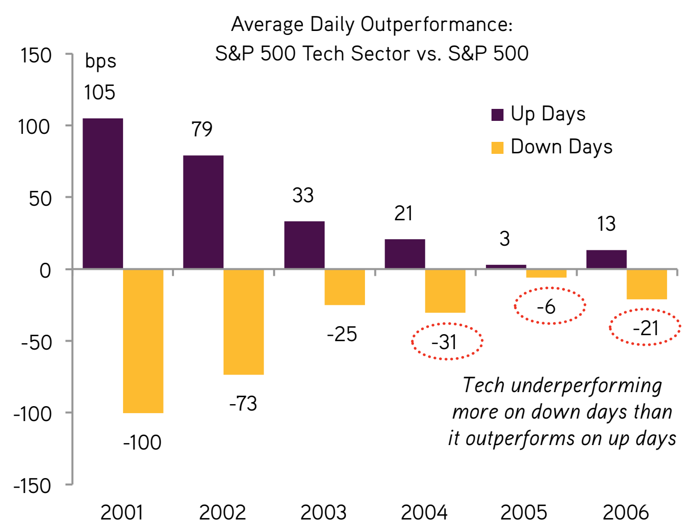
Financials, Like Tech, are Becoming "Boring" Beta



Data as at July 25, 2012. Source: S&P, Factset.

EXHIBIT 6

Déjà Vu: We Believe Financials are Likely to Repeat Tech's Performance

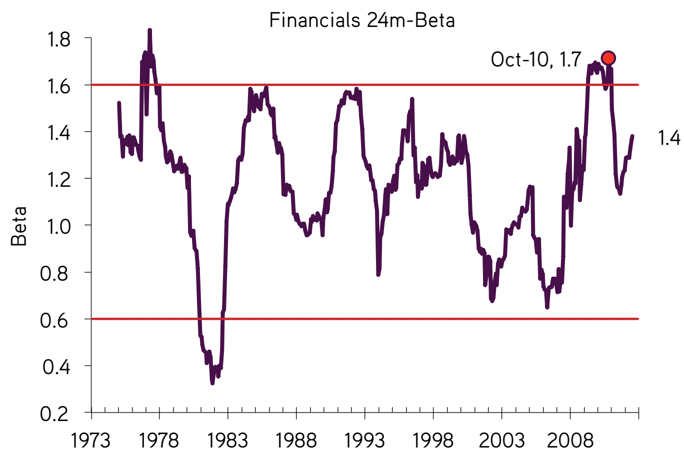


Data as at August 2, 2012. Source: Bloomberg, KKR Global Macro and Asset Allocation analysis. Up days are days the S&P 500 market ends higher than the prior day, and vice versa.

We have seen this movie before. As the exhibits above show, technology had a big beta and large representation in the S&P 500 at the turn of the century. Importantly, when the market began to rebound in 2003, investors piled back into names like Cisco, Nortel, Advanced Micro Devices and LSI Logic in hopes of recapturing the high-beta performance of the sector. Unfortunately, the sector's beta was beginning to crumble *(Exhibit 5)*. As a result, portfolio managers seeking higher-beta representation from the tech sector were getting almost the exact opposite. Specifically in 2004, for example, on up days, tech stocks outperformed by 21bp, while on down days, tech stocks underperformed the market by 31bp *(Exhibit 6)*. This trend continued for years until technology's aggregate beta bottomed around 2010.

EXHIBIT 7

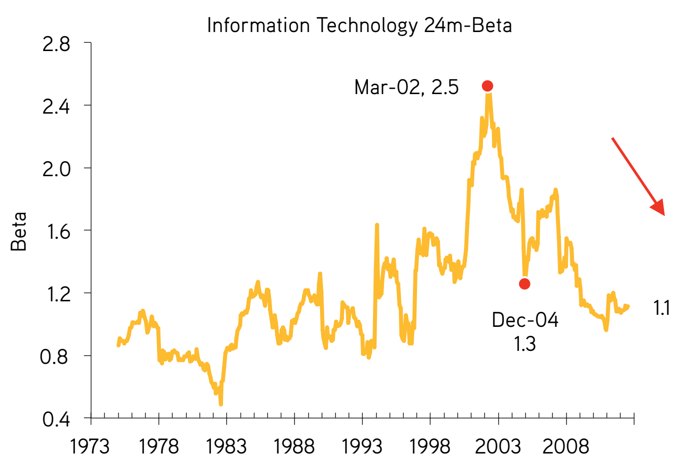
Financials' Beta Appears Poised to Plummet Soon...



Data as at July 26, 2012. Source: S&P, Factset, Morgan Stanley.

EXHIBIT 8

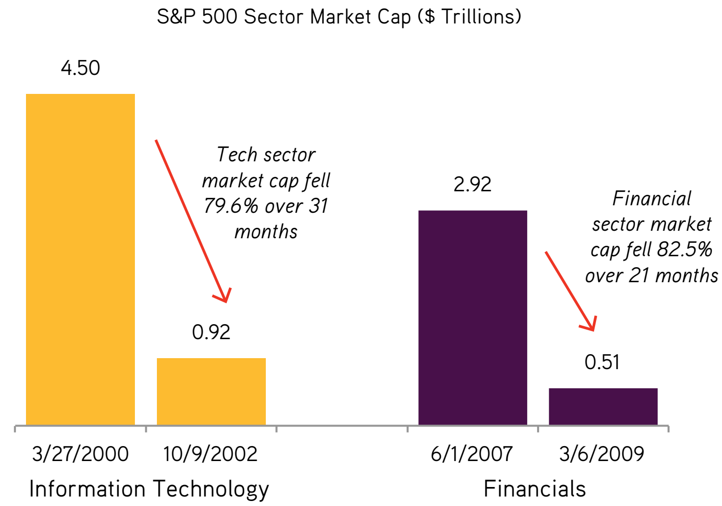
...Similar to What Happened to the Tech Sector After 2003



Data as at July 26, 2012. Source: S&P, Factset, Morgan Stanley.

EXHIBIT 9

We Have Seen this Movie Before: The Financial Sector Beta is Next



Data as at July 25, 2012. Source: S&P, Factset.

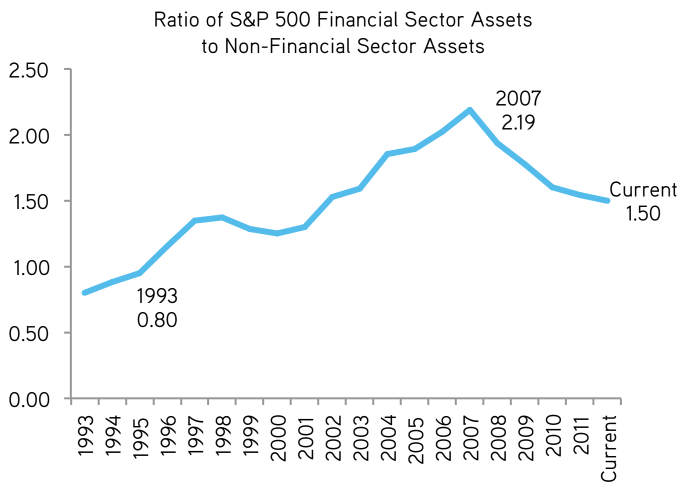
So, what does this mean for investors? It means that the beta of their portfolios may be overstated in up markets and understated in down markets if one owns some of the higher-beta stocks in financial services. If we are right, this insight may have significant implications for portfolio construction, as many growth managers suffered mightily in the early to mid-2000s when they kept buying what they thought were high-beta technology stocks like Microsoft and Cisco that ultimately proved disappointing. Our strong view is that analysts and portfolio managers who traffic in the financial services sector should spend time researching and owning companies that are not downsizing or being de-rated for the foreseeable future, or at least until this beta "hangover" wears off for the overall sector. We certainly acknowledge that our analysis applies to the sector in aggregate (and higher-beta large-capitalization names in particular), and there will always be growth stories and turnaround stories that are worth pursuing, but we want our view to be clear: now is the time to try to focus on the divergences within the sector, not the aggregate. Among the current divergences we think are worth pursuing, a potential sustained U.S. housing recovery definitely ranks near the top of our list.

Returns and performance in the sector will likely continue to lag. As the 2Q12 results showed across many traditional global wholesale firms, many financial intermediaries are currently unable to produce returns that exceed their costs of capital. Some of the fall-off in returns is related to low interest rates, which penalize companies that have traditionally held other people's money for a profit. One could argue that this headwind is cyclical, but we do not think so, given Europe's restructuring and China's rebalancing. Probably more important, though, is that we think regulation will continue to intensify, which likely means lower leverage ratios, returns, and growth across the sector. Some investors with whom we speak argue that regulatory scrutiny should begin to abate in the global wholesale business. We do not see it this way, as history suggests regulation is usually a lagging, not a leading or coincident indicator. In 1929, for example, the U.S. stock market crashed, but it was not until 1933 that heavy regulation was even introduced, ultimately separating investment banking from traditional banking services. So, if some form of the Volker rule is adopted before long, it would actually be pretty much right on schedule with past such happenings.

Also, despite recent announcements about downsizing of staff and withdrawing from business lines, we believe that further capacity needs to come out of the financial services system. There are a lot of ways to measure capacity, but one easy proxy that we track is financial sector assets relative to non-financial sector assets. As *Exhibit 10* shows, this ratio was 0.80 in 1993, surged to 2.19 in 2007, and is now just back to 1.50. We are not sure if we get back to 0.80, but our research leads us to believe that a target of 0.90-1.00 is realistic. If we are right, then that would suggest another 35-40% of downside.

EXHIBIT 10

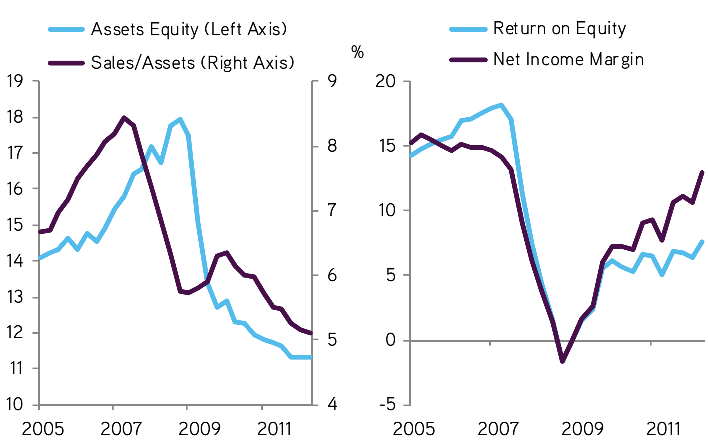
At the Peak of the Housing Bubble, There Were $2.19 of Financial Sector Assets for Every $1.00 of Non-Financial Sector Assets on S&P 500 Balance Sheets



Current = July 30, 2012. Source: S&P, Bloomberg, KKR Global Macro and Asset Allocation analysis.

EXHIBIT 11

ROE has Gone from Double to Mid-Single Digits in Four Years, Even With Margins Improving

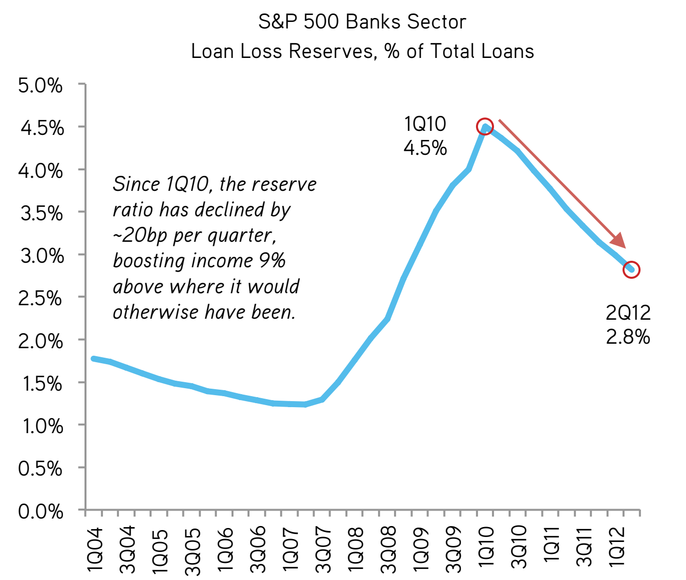


Aggregate of GS, MS, BAC, C, and JPM balance sheets. Data as at 2Q2012. Source: Factset.

Some investors tell us that our view is too negative, returns are poised to rebound, and the sector will regain its leadership role. Maybe, but consistent with our view on the sector's beta, we think there is something larger and more structural going on that warrants investor attention. Key to our thinking is that many financial services firms face challenges on all three inputs that drive return on equity: leverage, asset turns, and margins (though to a lesser degree). One can see the broad-based degradation of the return profile versus the mid-2000s in *Exhibit 11*. Indeed, were it not for some improvement in margins (largely cost cutting and, more importantly, reserve releases; see *Exhibit 12* below), return on equity would actually not have rebounded much at all. All told, we estimate reserve releases totaled $77 billion between 2Q10 and 2Q12, pushing provisioning 34% *lower* and income 9% *higher* than what they would have been if reserves held constant.

EXHIBIT 12

Reserve Releases, Not Top Line Growth, Have Been a Huge Driver of Earnings Growth and Returns Over the Past Several Quarters



Data as at June 30, 2012. Source Deutsche Bank.

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This decline in beta has significant implications for portfolio construction as portfolio beta could be overstated in up markets and understated in down markets.

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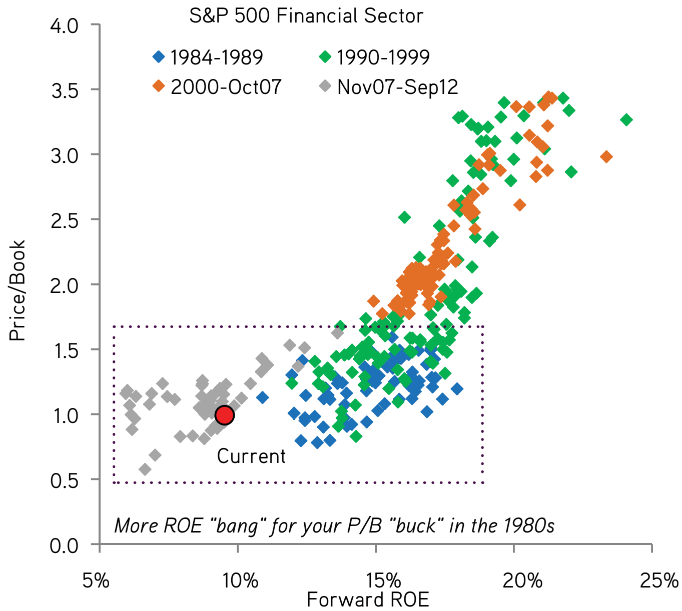
EXHIBIT 13

In Our View, Valuations Do Not Look Particularly Compelling Relative to the Returns on Offer



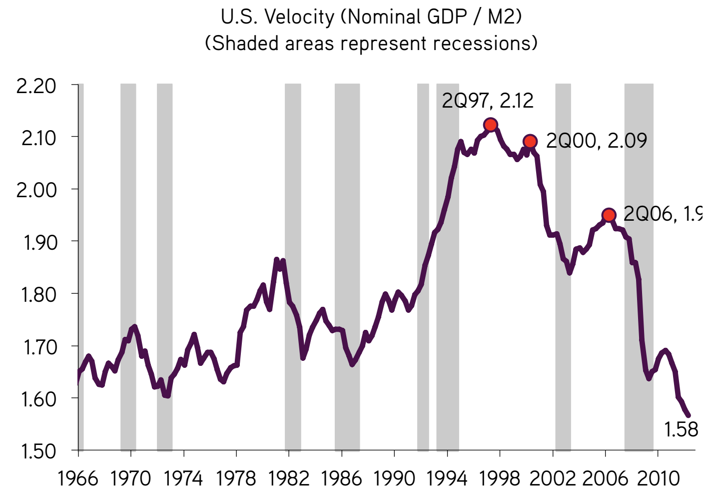
Observation period = January 1984 to September 2012. Source: KKR Global Macro and Asset Allocation, IBES /First Call.

Our ROE insights are critical not only for returns but also for valuation. As one can see in *Exhibit 13*, there has historically been a tight relationship between returns and price/book valuations, which suggests valuations are not poised to meaningfully improve. In fact, the sector now trades at the same price-to-book level that it did in the 1980s, despite returns being much higher in that decade than today. By comparison, we believe when the sector was growing quite fast in the 1990s and early 2000s, investors were willing to pay a higher multiple for the accelerated structural growth, as deregulation allowed many firms to expand their business mix into more lucrative products. Moreover, our research suggests that there was a secular decline in rates, which increased both activity and the benefit of holding sizeable security portfolios on balance sheets. Today, as we describe in more detail below, we think lower leverage, a bottoming in rates, and higher regulatory hurdles are likely to keep growth rates far below what was achieved during the 1990-2000 period.

Balance Sheet Downsizing Means an Illiquidity Premium. As Wall Street and its peers in Europe continue to de-lever their business models, we believe one thing is clear: the velocity of money—and the liquidity associated with it—is falling, a trend we expect to continue. As *Exhibits 14 and 15* show, nominal GDP/M2 as well as traditional trading volumes have fallen by substantial amounts in recent years.

EXHIBIT 14

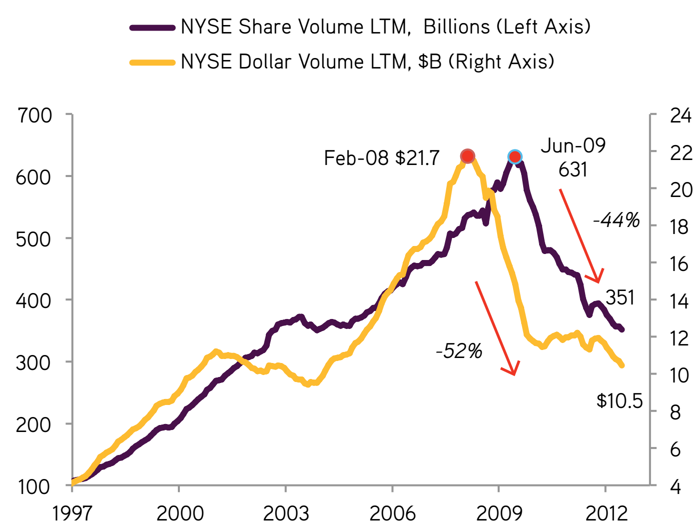
Velocity of Money Has Collapsed



Velocity = nominal gross domestic product / M2 money supply aggregate. Data as at 1Q2012. Source: BEA, Federal Reserve, Bloomberg.

EXHIBIT 15

Trading Volumes Have Halved



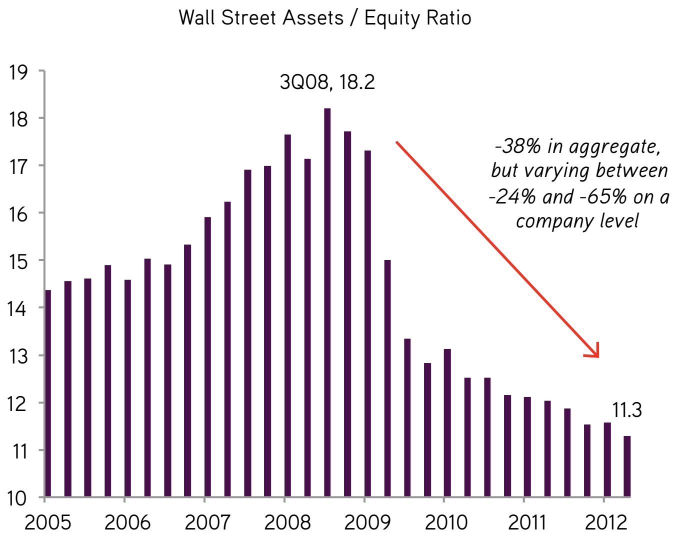
Data as at June 27, 2012. Source: Bloomberg.

Not surprisingly, this slowdown is occurring as Wall Street's dealer inventories are shrinking. As *Exhibit 17* illustrates, inventory of corporate securities held by global wholesale firms have shrunk by a startling 79% since 2007, with primary dealer inventories today back to 2001 levels, although the U.S. economy is 47% bigger today than it was back then[7]. This is extremely important, in our view, because it means there are fewer people facilitating the buying and selling of credit securities, which makes transacting not only more expensive but also more difficult.

7 According to the Bureau of Economic Analysis, U.S. Gross Domestic Product was $15,076 billion in 2011 versus $10,286 billion in 2001, as of July 27, 2012.

EXHIBIT 16

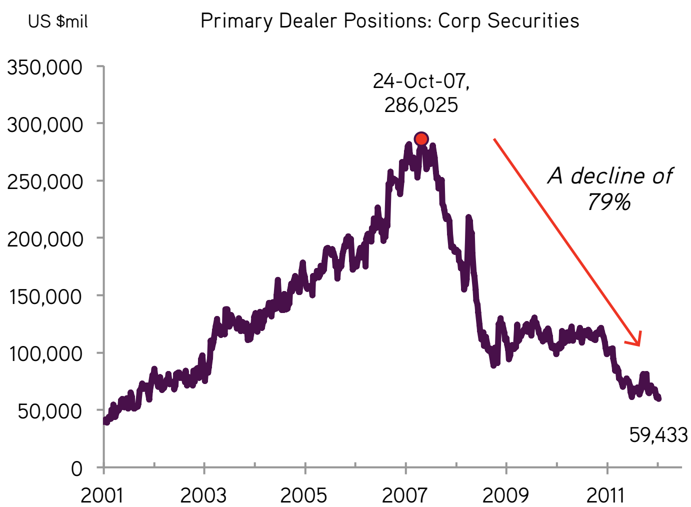
Wall Street Balance Sheets Have Shrunk...



Aggregate of GS, MS, BAC, C, and JPM balance sheets. Data as at 2Q2012. Source: Factset.

EXHIBIT 17

...and Inventory of Corporate Securities has Collapsed

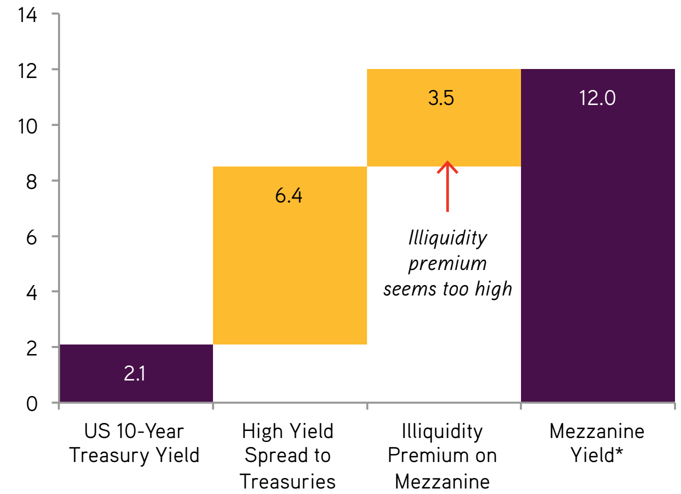


Data as at July 11, 2012. Source: Bloomberg.

Consistent with this shrinkage, there has been a significant widening in the market's "illiquidity premium" as the spreads between buyers and sellers have widened *(Exhibits 18 and 19)*. All told, we think that this premium is now close to 300-400 basis points, and probably more importantly, it is likely to persist, even though real rates are negative and nominal rates are quite low *(Exhibit 17)*. Though not exact, we can measure this "premium" in a variety of ways. One way is to look at the yield difference between what a junk bond and a mezzanine security might offer. As one can see in *Exhibit 18*, it currently is about 300-400 basis points. Importantly, we feel that we are being generous in this analysis as an implied loss rate of 640 basis points appears too high, given strong balance sheets amid reasonable business conditions for corporates.

EXHIBIT 18

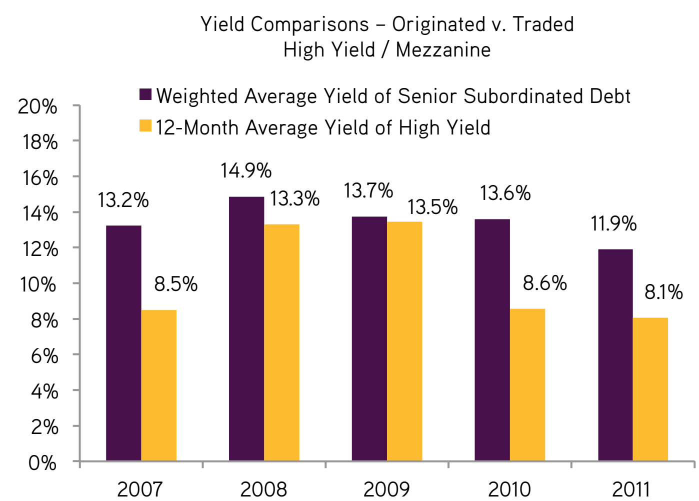
...Which Has Created a Substantial Illiquidity Premium



* KKR Global Macro and Asset Allocation team estimated. Data as at November 30, 2011. Source: Bloomberg, KKR.

EXHIBIT 19

Evolution of Illiquidity Premium



Source: S&P LSTA, Public Company Filings of Ares Capital Corporation. Weighted average yields of senior term debt and senior subordinated debt. Data as at December 31, 2011.

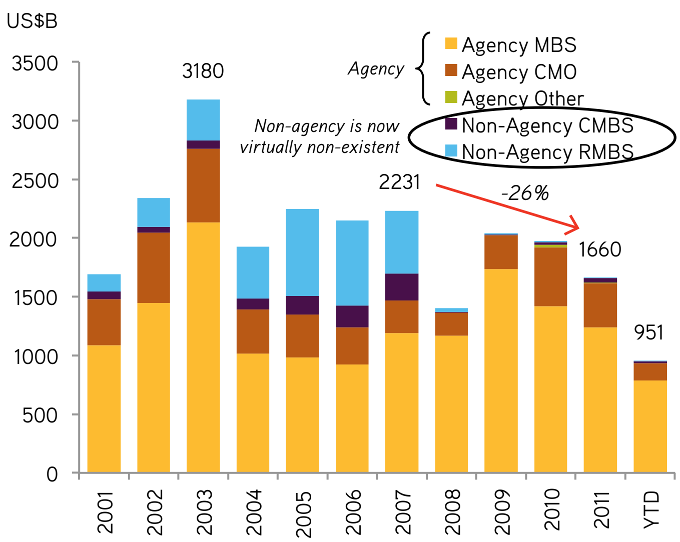
Another way to look at the same issue is to track the spread between traded high yield and originated senior subordinated debt over time. As *Exhibit 19* shows, the spread was quite wide during the downturn in 2007 before narrowing to almost parity in 2009. However, as the financial landscape has shifted and liquidity has become more of an issue, the spread has widened again. What makes the current situation even more intriguing for investors is that this spread is being offered despite robust corporate profit growth, which was not the case in 2007.

When it comes to access to capital these days, small and medium-size businesses are clearly being hit the hardest. One reason: With Wall Street striving for a smaller footprint, fewer and fewer bankers are now calling on these companies. Further exacerbating this issue is the shrinkage in the unconventional banking market. Nowhere is this more evident than in the mortgage market: Issuance of non-agency residential mortgage-backed securities (RMBS) and commercial mortgage-backed securities (CMBS) has shrunk 95% to $37 billion in 2011, down from $766 billion in 2007 (*Exhibit 20*). As a result, the cost of capital for financing has skyrocketed; mortgage REIT yields, which are a good proxy for cost of equity for non-traditional borrowers, are now at 10.8%, up from 4.3% in January 2007 *(Exhibit 21)*.

EXHIBIT 20

The Unconventional Banking Market Has Collapsed

U.S. Mortgage Related Issuance



Year-to-date through June 30, 2012. Sources: SIFMA, Dealogic, FDIC, GSEs, NCUA, Thomson Reuters, Bloomberg.

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Margins, turns, and leverage – the three ingredients of ROE – are likely to remain subpar for some time as the velocity of money slows, regulation increases, and leverage falls.

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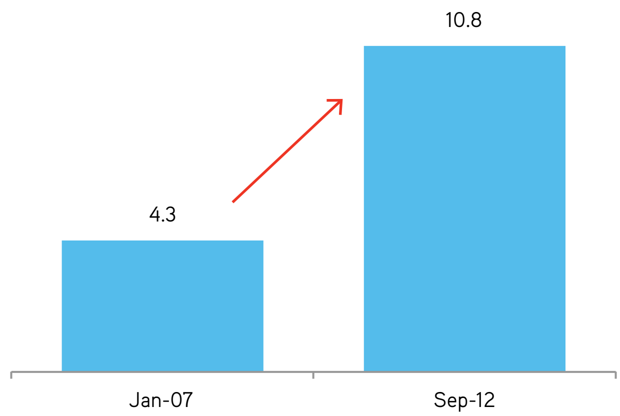
EXHIBIT 21

Costs For Non-Traditional Borrowers are Increased

Mortgage REIT Equity Dividend Yield (%)



Data as at September 18, 2012. Average equity dividend yield of NLY, MFA, CMO, RWT, NCT, ANH. Sources: Bloomberg.

Reshaping of European Banking Landscape Has Far-Reaching Implications. While there is certainly a lot going on in the United States financial services industry, it actually pales in comparison to what I see on the ground in Europe and what we think it means for all financial services firms. The key to our thinking is two-fold. First, using one of our original frameworks, Europe is going through both Phase II (bank deleveraging) and Phase III (government deleveraging) at the same time *(Exhibit 22 and 23)*. Second, unlike the United States, Europe is much more dependent on bank loans and much less dependent on capital markets, bonds in particular, to finance its companies *(Exhibit 24)*.

As we think about where we are headed, we are constantly struck by the fact that investors keep waiting for a Lehman-type moment in Europe. Our take: maybe it has actually already occurred. Here is our thinking. When the Troika 'haircut' private investors in Greek government debt, it forever altered the rules of engagement in Europe — most of us just weren't paying close enough attention to the nuances to fully appreciate it. True, it has not been the same type of violent repatriation of capital we saw with Lehman, and Draghi has now pledged the full faith and credit of the ECB to stem the capital flight, but the behavior pattern of banks, corporations, and individuals is now playing out the same way, albeit much more slowly. In particular, it appears lending patterns have seized up, while capital is still fleeing weaker players like Spain at an unsustainable pace. Indeed, as *Exhibits 25 and 26* show, net outflows excluding the Bank of Spain are now over 50% of GDP.

EXHIBIT 22

Europe Deleveraging is Behind the US

YEAR	EUROPEAN BANKS & DIVERSIFIED FINANCIALS: ASSETS /EQUITY	EUROPEAN BANKS & DIVERSIFIED FINANCIALS: ASSETS €TRILLION	EUROPEAN BANKS & DIVERSIFIED FINANCIALS: EQUITY €TRILLION	US BANKS & DIVERSIFIED FINANCIALS: ASSETS /EQUITY	US BANKS & DIVERSIFIED FINANCIALS: ASSETS $TRILLION	US BANKS & DIVERSIFIED FINANCIALS: EQUITY $TRILLION
2000	22.6	10.9	0.5	14.1	4.4	0.3
2001	22.9	11.8	0.5	13.6	4.8	0.4
2002	23.5	11.5	0.5	13.6	5.1	0.4
2003	23.2	12.1	0.5	13.6	5.8	0.4
2004	23.8	13.8	0.6	12.5	7.3	0.6
2005	25.2	18.3	0.7	13.1	8.0	0.6
2006	24.4	20.9	0.9	12.8	9.3	0.7
2007	25.1	25.5	1.0	13.5	10.8	0.8
2008	29.5	27.5	0.9	15.0	11.7	0.8
2009	21.5	25.3	1.2	11.4	12.1	1.1
2010	20.7	27.3	1.3	10.8	12.6	1.2
2011	21.8	28.5	1.3	10.4	12.8	1.2
2Q2012	21.8	29.6	1.4	10.2	13.1	1.3

Data as at 2Q2012. Bottom up aggregates for Banks and Diversified Financials within the MSCI Europe and S&P 500 respectively. Source: MSCI, S&P, Factset, Bloomberg.

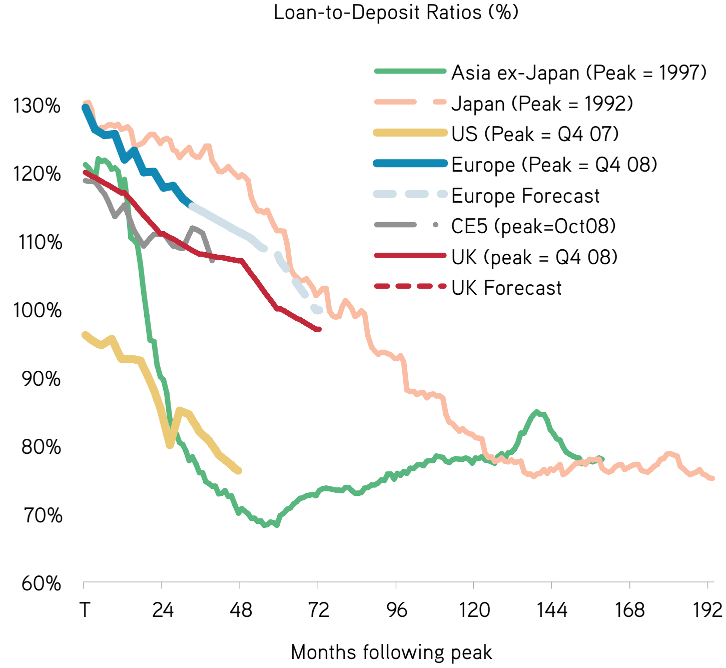
"

There will be both clear winners and losers amid the changing competitive landscape we see unfolding in the coming years.

"

EXHIBIT 23

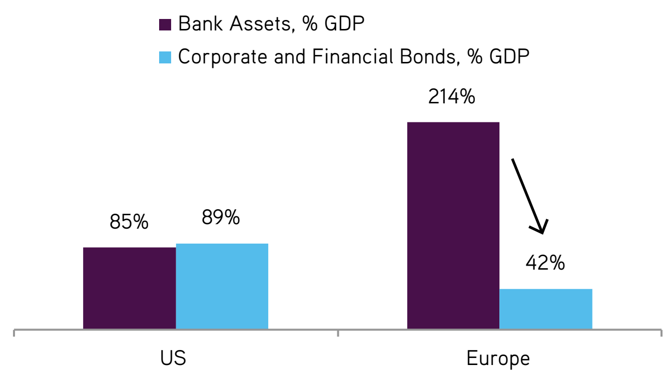
History Suggests That There is Likely to be Multi-Year Deleveraging



Source: Morgan Stanley report dated June 26, 2012 by Huw Van Steenis, National Central Banks, SNL. Note: ECB has a version of this chart but starting Japan in 1997 rather than 1991, missing the bigger deleveraging story.

EXHIBIT 24

Compared to the U.S., Europe Is More Dependent on Bank Loans and Less Dependent on Capital Markets

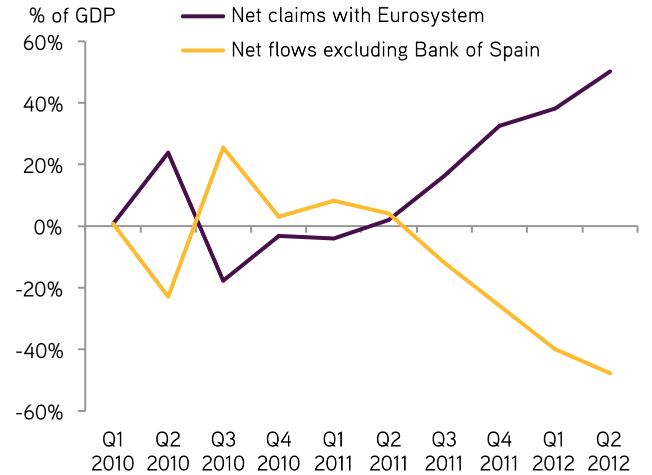


Data as at December 31, 2011. Bank assets are bottom-up aggregates for Banks and Diversified Financials within the MSCI Europe and S&P 500 respectively. Source: Bank for International Settlements, World Bank, MSCI, S&P, Factset, Bloomberg.

Looking ahead, if the overall situation in Europe is to improve meaningfully, we think at least four things should occur. First, the banks have to feel that their cross-border peers are as good credits as their domestic peers. The ECB clearly understands the severity of this issue, and it was why Draghi was so forceful in his commentary of late. To date, though, his comments have not fully assuaged investors, as the capital flows as a percent of GDP in Spain attest *(Exhibit 25)*.

EXHIBIT 25

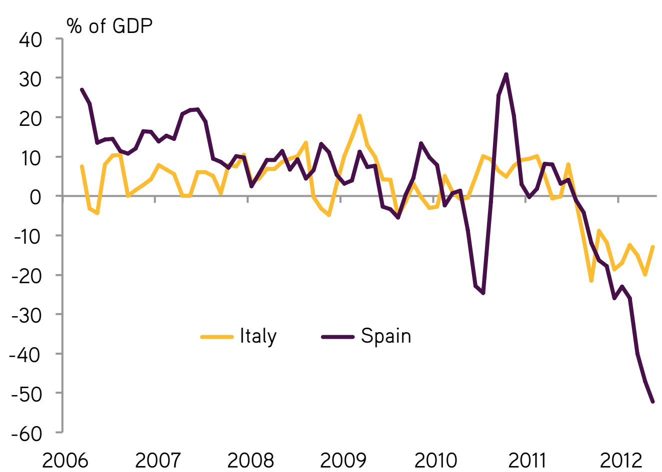
Spanish Net Private Sector Capital Flows



Data as at 2Q2012. Source: Nomura, Bank of Spain. Note: Private flows include both portfolio flows and banking flows.

EXHIBIT 26

Portfolio and Other Flows Adjusted For Central Bank Flows (3m Sum)



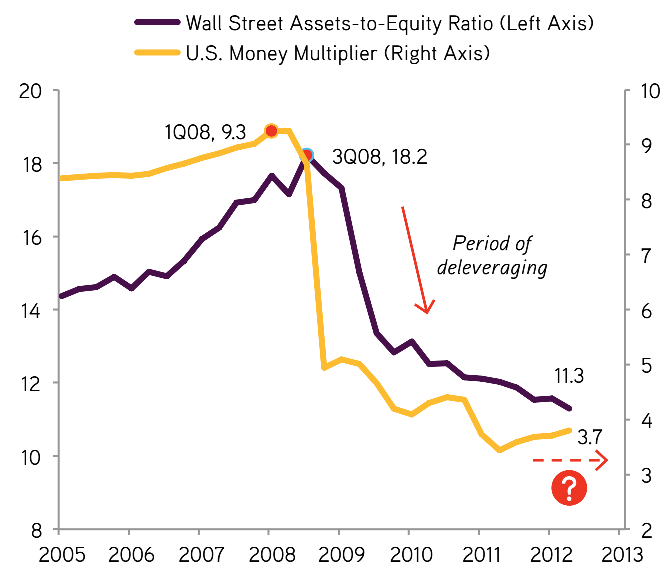
Data as at 2Q2012. Source: Nomura, ECB.

Second, investors have to gain confidence that sovereign risks throughout the region are all above a certain threshold of credit quality. Germany and Spain are not likely to have the same cost of capital anytime soon, as the spread is still too wide, Spain's yields in absolute terms are just too high, and we expect that Spain will continue to miss its fiscal targets over the medium term. However, we feel that this headwind is now being ameliorated through the recent introduction of the Outright Monetary Transaction (OMT) program and the precautionary credit line facility, which were both introduced on September 6th, 2012.

Third, we believe some form of a growth plan in Europe is ultimately needed so that the weaker countries can gradually heal their wounds and the current governments throughout the region do not face the threat of significant social unrest. At just 1.0% of GDP, the €120bn 'Growth Compact' the EU announced last June seems like little more than a down payment on the sort of stimulus that is actually required. By comparison, we estimate that growth initiatives announced by the Chinese government this year amount to roughly 4% of GDP over an implementation period of the next 3 to 5 years, while QEIII announced by the Federal Reserve last month could reach a sizable 3% of GDP for each year the program is in place[8]. Finally, political tensions across the Eurozone are running high, and some détente is soon needed if this union is to work together in a functional manner in the months and years ahead.

EXHIBIT 27

The Money Multiplier Doesn't Work While Financials are Deleveraging

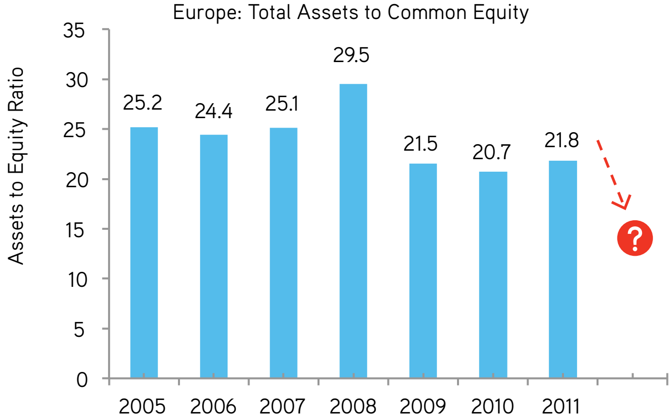


Money multiplier = M2/Monetary Base. Wall Street Assets to Equity Ratio is an aggreaget of GS, MS, BAC, C, and JPM balance sheets. Data as at 2Q2012. Source: Factset.

8 While there is no official total for stimulus in China, the estimates of total local and central government investment plans to promote growth vary between RMB 7 to 12 trillion, of which central government projects total RMB 3.6 trillion. Growth initiatives sources: BofA Merrill Lynch, ISI Group, JPMorgan, Citigroup, Nomura, KKR Global Macro & Asset Allocation analysis. QEIII GDP information from FOMC statement released September 13, 2012.

EXHIBIT 28

Will Deleveraging Also Be Disinflationary in Europe? We Think So

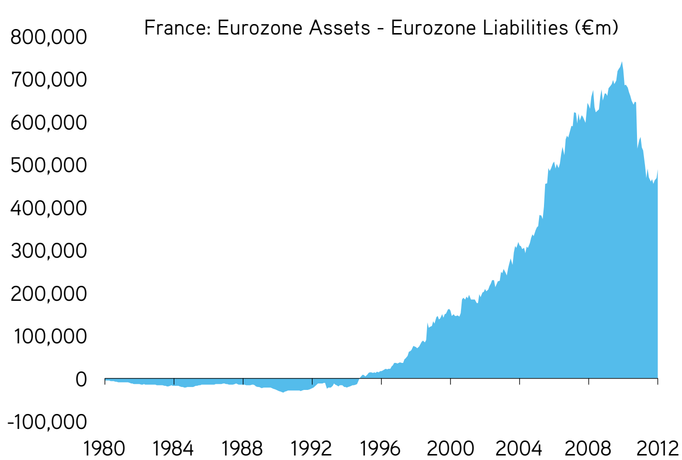


Bottom up aggregates for Banks and Diversified Financials within the MSCI Europe. Source: MSCI, Factset, Bloomberg.

We believe that there is one other important fall-out from the European banking situation that may be under-estimated by investors. Specifically, as one of my former colleagues from Morgan Stanley, Huw Van Steenis, highlighted to me on a recent trip to Europe, the trade linkage between Europe and Asia is larger than many realize. All told, Huw estimates that only 3% of large-scale Asian trade receivables are now being underwritten by European banks, versus 43% in 2010 (*Exhibit 30*). Given relatively tight trade credit conditions, weak growth in the advanced economies, and lackluster demand, we were not surprised that export growth from China to the rest of the world declined to only one percent year-over-year in July, compared to 20% in 2011, while exports to Europe declined 16% year-over-year versus a 14% gain in 2011[9].

EXHIBIT 29

French Banks Have a €450B Funding Gap in the Eurozone (Outside France), Already Down from Over €700B at its Peak, But Only 15 Years Ago It Was Zero

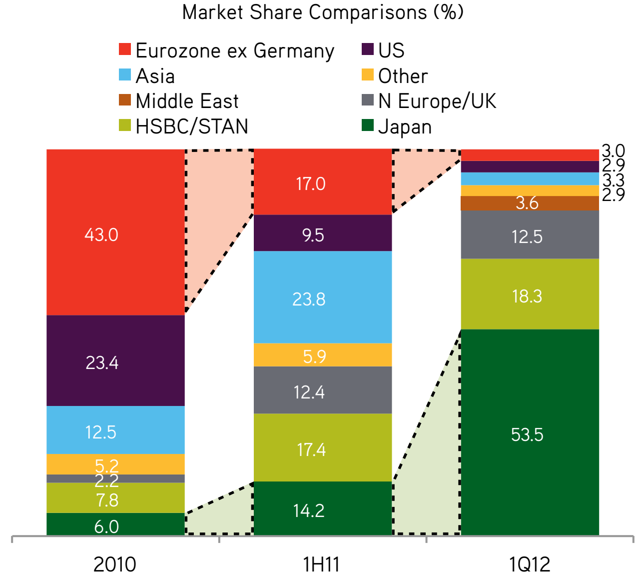


Source: Morgan Stanley report dated June 26, 2012 by Huw Van Steenis, Banque de France.

9 Source: China Customs data as at September 9, 2012.

EXHIBIT 30

Euro Area Market Share of Large-Ticket Asian Trade Finance has Fallen to 3% From 43% in 2010



Morgan Stanley research report dated May 1, 2012 "Cross Asset Research: EU bank deleveraging & Asian trade finance," Dealogic

What has not changed in my mind is what I think will lead to significant outperformance of individual financial services companies, irrespective of market conditions. If we are right about the competitive landscape that now exists, then many of these companies may need to change their business models to get their returns significantly above their costs of capital. They may need to enter new business and exit old ones, ultimately right-sizing their staff, capital, and infrastructure to appropriately take advantage of the true opportunity set being presented to them.

Undoubtedly, this transition will not be easy, which is why, as I have said and written before, we think that the most important characteristic of tomorrow's successful financial services companies will be the quality of leadership, the men and woman who set not only the direction but also the tone that underscores that direction. Great leaders in financial services—and for that matter, in almost any industry—build and maintain great brands as part of great organizations. So watch out for an executive who says his or her company stands for one thing, but acts in a way that is contrary to the company's values and brand promise. In fact, I would go as far as to say that, after having studied financial services companies for nearly two decades, in my view quarterly financial metrics rarely give outside investors the real picture of what is going on inside the engine room of a financial services organization. Find out what the young people think about their day-to-day managers. Are the rising stars staying or going? Is the firm bringing in outside hires that add to, not detract from its culture? Leadership, direction and upward mobility matter. Great leaders inspire their employees to "wear the brand," using their actions and words to continually reinforce the culture and vision of the organization. Without a vision, companies are often destined for bureaucracy. When employees must constantly resort to rule-making to establish and defend positions, they usually fail to take appropriate risk or innovate faster than the market is moving.

Beyond the intangibles, one financial metric I follow closely is the long-term growth of tangible equity. I am not arguing for upward revaluation in today's environment — the regulatory overhang and the economic uncertainty are just too thick right now. Rather, I am looking to champion companies whose managements understand that compounding tangible book value at a decent clip each year with no major surprises can create enormous wealth. Those managers that "get it" understand that high-priced repurchases of their own shares and/or poor risk management are anathema to growing their businesses and shareholder value over time. In particular, expect the stocks of companies that take big charges in the course of restructuring, write-downs, or restatements to lag. Bottom line: If the tangible book value is not growing, the stock probably is not going up (or at least is not rising as fast as it could).

Another financial metric I still look for is improving return on equity (ROE). We use this metric a lot when finding stocks in any sector that dovetail with our demographic work (see *Brave New World: The Yearning for Yield Across Asset Classes* from December 2011), but financial services companies in particular trade better when their ROEs are headed "up and to the right." My favorite strategy is to find firms that are increasing returns by improving asset turns through greater balance sheet efficiency. Margin expansion is nice too, but it has to be more than companies just releasing reserves or restricting discretionary spending to achieve short-term results.

I also believe that financial firms can distinguish themselves through scale, technology and cost advantages. This is particularly true if it includes an overlay of value-added "content," such as strong risk management services, proprietary insights, and improved execution. Look for companies that can consistently build moats around their businesses. Many of the exchanges have done this through "proprietary" liquidity and massive back-office efficiencies. The same approach is true for leading trading firms, processors and insurance companies. Finally, I believe that a global footprint and the requisite technological prowess to support it are increasingly becoming a prerequisite for success in many financial services, including asset management, processing, capital markets and trading, and advisory services. Based on our latest estimates, we expect north of 70% of global growth over the next 3-5 years to come from outside of the developed markets[10].

Summary

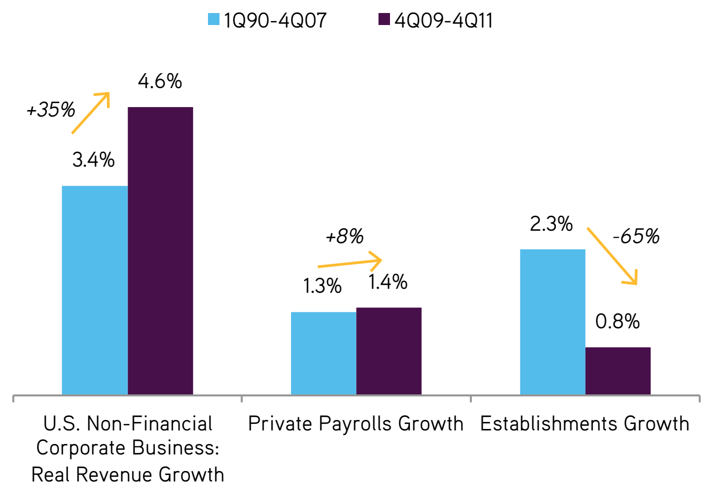
It is fairly clear that the environment for many financial services companies and their investors is tough right now. In particular, heightened regulation amid global macro uncertainty has made it difficult for companies with capital market sensitivities to earn excess returns. At the same time, our research shows that low rates are hurting net interest income across a variety of products, including deposits, margin loans, and treasury services.

However, amid all macro crosscurrents, there is a still lot of opportunity for select firms. Our research shows that U.S. housing is bottoming, autos sales are increasing, and U.S. manufacturers are now more competitive. As these industries—as well as new ones that spring up—look for solutions to their financing needs, there will be tremendous opportunity for financial services companies that can partner with these companies to grow their businesses within the United States. Moreover, there will be opportunity amid the challenges in Europe, and with emerging market consumerism blossoming over the next 3-5 years, there will be plenty for financial services companies with a strong international footprint to pursue[11]. Unlike in the past, though, we believe tomorrow's leading companies will need to be better managed, more innovative, and more disciplined than many of the players that took the sector to such extremes during the period leading up to the financial crisis.

For users of financial services, the likely outcome is wider spreads, more restrictions, and—particularly outside the U.S.—greater dependence on the capital markets. Our world view also likely means that small and medium-sized businesses face greater headwinds growing their businesses. Not surprisingly, new business formation since the great recession is running 35% below trend, at least partly due to diminished credit availability (*Exhibit 31*).

EXHIBIT 31

New Business Formation Has Been Extremely Lackluster, Particularly Relative to Revenue Trends



Data as at July 31, 2012. Source: U.S. Bureau of Economic Analysis, U.S. Bureau of Labor Statistics, Haver.

Finally, for investors in financial services stocks, our belief is that now is the time to do a portfolio review from top to bottom. Study high-beta names in the portfolio to make sure they are not becoming bad or boring beta. Try to find companies that are taking advantage of the aforementioned growth opportunities, including the recovery we have been predicting in housing, and equally important, identify companies which lack our prerequisites for success. Most important, get to know the management of a company. Our experience leads us to believe that it will be a full understanding of a company's intangibles—leadership, brand promise, and culture—that will make tangible financial metrics both easier to understand and much more valuable in assessing the overall value creation/destruction trends at the company and in the overall sector.

10 Developed markets are namely Advanced Economies as defined by the International Monetary Fund (IMF). Data as at April 17, 2012. Source: IMF, Haver.

11 See *The World in Rebalancing Mode: A Marathon, Not Sprint* published in June 2012 and available at www.kkrinsights.com.

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