

Private Client Research

30 October 2019

Macquarie Group

Restructure of equities business

Macquarie Group (MQG) plans to restructure its equities business to focus on the Asia Pacific (APAC) region, where it has the most scale, according to a media report. This will see it reduce its domestic cash equities presence in Europe, the Middle East and Africa (EMEA) and the Americas. The changes are said to be in response to structural changes in the market, of which MiFID II* is likely to be the most material.

Macquarie has signed a preliminary cooperation agreement with French broker Kepler Cheuvreux in Europe and APAC, which will provide clients with reciprocal access to equity trading and research capabilities across the two firms.

Ord Minnett is not surprised by the move given scale has become increasingly important for equities, and Macquarie's EMEA and Americas equities businesses have been likely loss-making. The move would be a minor positive for its medium-term return on equity (ROE), although the main downside risk is the extent to which the equity capital markets (ECM) is affected given the reduced research coverage.

We maintain our Accumulate rating on Macquarie Group with a \$1.33 target price.

- **Cash equities profitability** – Macquarie merged its securities business with its fixed income, currencies and commodities (FICC) arm in 2H17 to form the commodities and global markets (CGM) division. As such, the profitability of the equities franchise is no longer visible. In the years just prior to the creation of CGM, however, the securities division had a patchy track record of profitability on a pre-tax, pre-bonus basis, and equities trading income has been relatively weak since then. Equities trading income has shrunk to less than 2% of group revenue.
- **Scale** – In equities, scale matters. Clients are increasingly looking for partners that either have global footprint with scale across multiple regions, or niche offerings in select regions or segments. Macquarie clearly has scale in its Australian and broader APAC equities business, although it is a reasonably small player in the US and European markets. For example, according to the 2019 operational briefing, Macquarie had 550-plus stocks under coverage in the Americas; this compares to 1,400–1,500 for the leading players in that market. Macquarie will retain a niche presence in US equity research. MiFID II has placed additional pressure on these businesses, driving clients to consolidate brokerage and reduce the list of brokers they are willing to deal with. We see this move by Macquarie as a sensible reaction to this problem and it shows its strong focus on returns. We note Deutsche Bank recently exited a number of its global equities businesses.
- **Restructuring charges** – Press reports suggest there will be a 100–120 headcount reduction. This will lead to restructuring charges, which have not been quantified by the company, to be taken from 2H20 onwards.
- **ECM** – The main argument in favour of retaining an equities presence is that it is necessary to support the equity capital markets (ECM) franchise. To this point, Macquarie had structured its equities business in EMEA and the Americas around niche segments where it saw competitive advantage and provided linkages to other parts of the franchise (such as commodities, infrastructure, etc). Time will tell whether the restructuring of the equities business has negative revenue implications for the ECM platform. We note Macquarie's European ECM business is relatively small and has become increasingly driven by principal investments.
- **Kepler Cheuvreux** – Macquarie has signed a preliminary cooperation agreement with Kepler Cheuvreux which will give clients reciprocal access to equity capabilities across Europe and Asia. Cross-distribution of European and APAC equity research will commence in early 2020. Macquarie is looking for a similar partner in the Americas region.

Recommendation

Accumulate

Risk

Higher

Target price

\$133.00

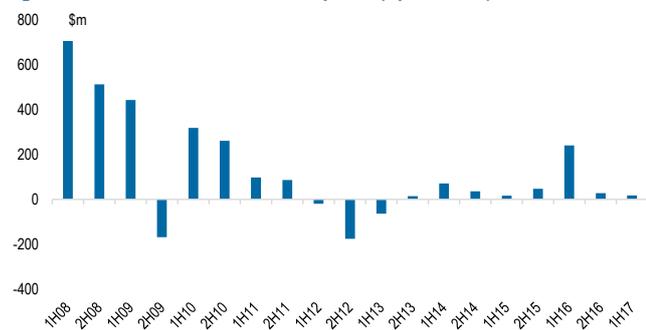
Last price

\$134.45



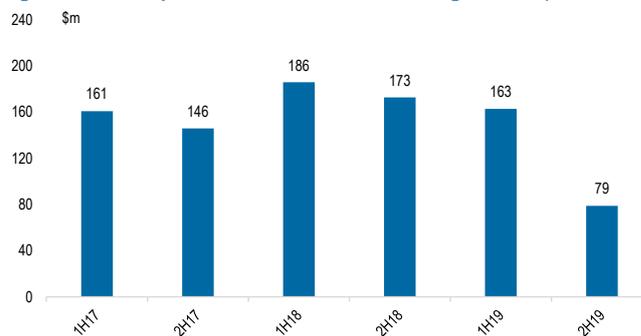
* MiFID II is a legislative framework instituted by the European Union (EU) to regulate financial markets in the bloc and improve protections for investors. Its aim is to standardise practices across the EU and restore confidence in the industry, especially after the 2008 global financial crisis.

Figure 1: MQG securities division profit (up to 1H17)



Source: Company reports.

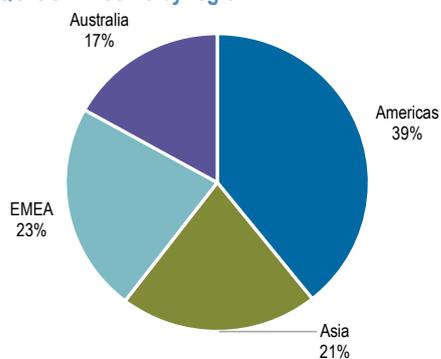
Figure 2: MQG equities – Net interest and trading income (since 1H17)



Source: Company reports.

Note: Excludes equities brokerage and commissions which are not separately disclosed.

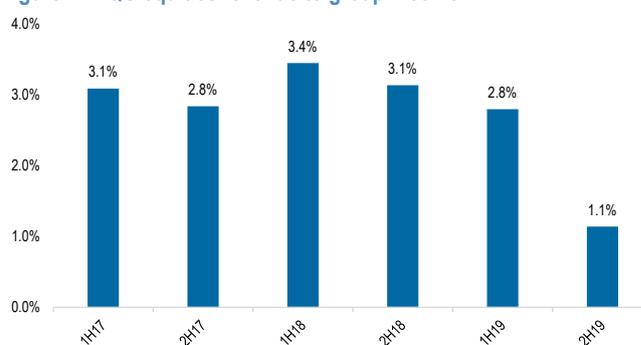
Figure 3: MQG CGM income by region



Source: Company reports.

Note: Income ex earnings on capital and other corporate items.

Figure 4: MQG equities revenue to group income



Source: Company reports.

Investment View, Valuation and Risks

Investment Thesis

We believe Macquarie is well positioned within the global investment banking and diversified financials space, supported by its market positioning in key niches (commodities, infrastructure, and Green Energy) and strong attention to risk management. While we expect the contribution to revenue from volatile income streams (performance fees and gains on sale) will normalize over FY20, on a medium-term view we expect its ongoing investment (including in renewables, technology and infrastructure sectors) will be a positive earnings driver, with current asset values likely having benefited from the lower bond yield environment. Given these factors, we rate Macquarie at Accumulate.

Valuation

Our Jun-20 PT of \$133 is premised on our sum-of-the-parts valuation methodology, which separately values Macquarie's business units. The P/E applied to each unit has been adjusted to match Macquarie's March year-end.

(A\$m)	Divisional profit		Fully allocated NPAT	PE	Valuation
	FY19	FY20E	FY20E	FY20E	
Macquarie Asset Management	1,874	1,967	914	18.9	17,265
Banking and Financial Services	756	842	589	14.9	8,781
Macquarie Capital	1,761	1,346	685	12.0	8,225
Commodities and Global Markets	1,745	1,458	848	10.0	8,460
Corporate & Other	-3,154	-2,576	0	-	0
Divisional Valuation	2,982	3,037	3,037	14.1	42,731
Surplus Capital					0
MQG (\$m)					42,731
Shares outstanding (m)					332
MQG (\$ per share)					129
MGG TP (Jun 20)					133

Source: Company data, Ord Minnett estimates

Risks to Rating and Price Target

Downside risks to our share price target include market dislocation, which could impact client activity, drive impairment losses and reduce the ability for the group to realise gains on sale of its investments.

Please contact your Ord Minnett Adviser for further information on our document.

Guide to Ord Minnett Recommendations

Our recommendations are based on the total return of a stock – nominal dividend yield plus capital appreciation – and have a 12-month time horizon.

SPECULATIVE BUY	We expect the stock's total return (nominal yield plus capital appreciation) to exceed 20% over 12 months. The investment may have a strong capital appreciation but also has high degree of risk and there is a significant risk of capital loss.
BUY	The stock's total return (nominal dividend yield plus capital appreciation) is expected to exceed 15% over the next 12 months.
ACCUMULATE	We expect a total return of between 5% and 15%. Investors should consider adding to holdings or taking a position in the stock on share price weakness.
HOLD	We expect the stock to return between 0% and 5%, and believe the stock is fairly priced.
LIGHTEN	We expect the stock's return to be between 0% and negative 15%. Investors should consider decreasing their holdings.
SELL	We expect the total return to lose 15% or more.
RISK ASSESSMENT	Classified as Lower, Medium or Higher, the risk assessment denotes the relative assessment of an individual stock's risk based on an appraisal of its disclosed financial information, historical volatility of its share price, nature of its operations and other relevant quantitative and qualitative criteria. Risk is assessed by comparison with other Australian stocks, not across other asset classes such as Cash or Fixed Interest.

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