Asia Credit Research

Earnings Review: Landesbank Baden-Württemberg ("LBBW")

Issuer Profile: Neutral (4)

Ticker: **LBBW**

Background

Based in Stuttgart Germany, Landesbank Baden-Württemberg ('LBBW') is a public law institution providing universal services covering large corporates, capital markets businesses and real estate financing. As at 31 December 2018, it had total assets of EUR241.2bn. As per its 2017 annual report, the bank is 40.5% owned by the Savings Bank Association of Baden-Württemberg, the state capital of Stuttgart (18.9%) and the State of Baden-Württemberg (40.5%).

Andrew Wong
+65 6530 4736
WongVKAM@ocbc.com

Recommendation

- LBBW announced FY2018 results which were overall constructive with consolidated profit before tax up 8.4% y/y to EUR558mn. Contributing to the performance was improved expense performance which offset continued weakness in the top line.
- Balance sheet growth weakened the CET1 capital ratio y/y to 15.1% (2017: 15.7%) but it nevertheless remains sound and above 2018 (8.80%) and 2019 (9.75%) regulatory minimum capital requirements. As such we retain our Neutral (4) Issuer Profile on LBBW.
- Compared to other issuers we rate at Neutral (4), we see decent value in LBBW 3.75% '27c22s. We also see SOCGEN 4.3% '26c21s as fair while the STANLN 4.4 '26c21 looks tight in our view. We see some volatility in prices for CMZB papers given potential event risk.

Relative Value:

Bond	Maturity / Call date	CET1 Ratio	Ask Yield	Spread (bps)
STANLN 4.4 '26c21 (T2)	23/01/2021	14.2%	3.53%	150
SOCGEN 4.3 '26c21 (T2)	19/05/2021	11.2%	3.63%	161
CMZB 4.875 '27c22 (T2)	01/03/2022	12.9%	4.47%	244
LBBW 3.75 '27c22 (T2)	18/05/2022	15.1%	4.26%	221
CMZB 4.2 '28c23 (T2)	18/09/2023	12.9%	4.55%	244
BACR 3.75 '30c25 (T2)	23/05/2025	13.2%	5.25%	305

Indicative prices as at 1 March 2019 Source: Bloomberg
Common Equity Tier 1 (CET1) Ratio based on latest half-year financial report

Key Considerations

- **Top-line performance remains weak:** Net interest income was marginally down 1.8% y/y to EUR1.56bn as an increase in loans to corporate customers and real estate was offset by the low interest rate environment and intense competition within the banking sector. Net fee and commission income was also 3.9% lower y/y to EUR513mn (FY2017: EUR534mn) due to lower brokerage fees and financing commissions while gains from re-measurements and disposals was down 23.4% y/y as a result of lower proceeds from the sale of securities and shares (FY2017 included an exceptional gain due to the more favourable environment). Within the net gains, allowances for losses on loans and securities rose 53.5% y/y to EUR142mn due to the weaker operating outlook. That said, allowances remain below the long-term average according to management, and there appears no concerns with loan quality. The non-performing loan ratio fell to 0.6% in FY2018 against 0.7% in FY2017. Other operating income was up 38.1% y/y and this all contributed to total operating income down 3.1% y/y to EUR2.4bn.

- **Expense performance continues to mitigate:** Administrative expenses were down 2.8% y/y despite higher investment in IT infrastructure from lower staff costs with the cost to income ratio improving to 72.8% in FY2018 against 76.4% in FY2017. This together with the absence of the state guarantee commission following the sale of the Sealink portfolio as well as a 70% y/y fall in restructuring expenses more than offset the 28.8% y/y rise in bank levy and deposit guarantee fees, which are system wide expenses that relate to full year Single Resolution Fund payments (European bank levy) and LBBW's membership in the Landesbanks' bank-related guarantee fund under the German Deposit Guarantee Act. This drove the y/y improvement in consolidated profit before tax.

- **Segment contributions are positive but in varying degrees:** In terms of PBT by segment, Corporate Customers was stable y/y at EUR296mn as margin pressure due to competition and low interest rates was offset by higher lending volumes to medium-sized and large enterprises (+10% y/y to EUR49bn). Commercial real estate finance and infrastructure and project finance performance was weaker however with PBT down 12.6% y/y due to presence of non-recurring pre-payment penalties recorded in 2017. This masked solid business volumes in commercial real estate with volumes up 40% y/y. Similar to other bank results, Capital Markets was significantly weaker y/y by 79.0% to EUR46mn (FY2017: EUR219mn) on the back of cautious customer sentiments and volatile markets which impacted business volumes and credit spreads as well as higher prior year income from sale of securities given the more constructive market sentiments. The Private Customers/Savings Banks segment also benefited from higher volumes in mortgage transactions, customer deposits and asset management and this along with lower IT expenses translated into EUR25mn in PBT against a loss of EUR38mn in FY2017. Overall improvement in PBT however was due to a EUR187mn y/y improvement in reconciliation items.

- **Current strategy continues:** With underlying results sound and somewhat mitigating the challenging operating environment, LBBW has somewhat affirmed their current strategic path. This is focused on four key priorities including business focus, digitalization, sustainability and agility. Business focus in particular has seen tangible results with volume growth in SMEs and large corporate clients to offset margin pressure. Its financial targets include return on equity of ~6% (4.3% in FY2018), a cost to income ratio below 60% and a CET1 capital ratio of ~13%. While the trends in return on equity and cost to income were positive over FY2017-2018, the gap remains large and LBBW's ability to achieve these targets could prove challenging should Germany's economic growth slow. That said, Germany's GDP growth remains above the EU average.

- **Capital ratios remain comfortable despite the growth in loans:** As mentioned above, loans to corporate customers offset the lower interest rates with total assets up 1.5% y/y and risk weighted assets up 6.1% y/y. Loans to corporate customers comprise 39% of LBBW's total loans followed by loans to financial institutions (34%) and Real Estate (13%). By geography, loans to German borrowers comprised 69% of total loans. Loan growth drove a y/y fall in fully loaded CET1/CAR ratios to 15.1%/21.9% from 15.7%/22.2% in FY2017. This remains above regulatory minimum capital requirements, which have increased in line with the EU's Capital Requirements Regulations, and are set annually by the ECB on the basis of the Supervisory Review and Evaluation Process (SREP) with LBBW's phased in CET1/CAR 2018 capital requirement of 8.80%/12.30%. Its current CET1 ratio also is above the 2019 CET1 capital requirement of 9.75%.

OCBC Global Treasury	
Treasury Advisory **Corporate FX & Structured Products** Tel: 6349-1888 / 1881 **Interest Rate Derivatives** Tel: 6349-1899 **Investments & Structured Products** Tel: 6349-1886 **GT Institutional Sales** Tel: 6349-1810	**Credit Research** **Andrew Wong** +65 6530 4736 WongVKAM@ocbc.com **Ezien Hoo, CFA** +65 6722 2215 EzienHoo@ocbc.com **Wong Hong Wei** +65 6722 2533 wonghongwei@ocbc.com **Seow Zhi Qi** +65 6530 7348 ZhiQiSeow@ocbc.com

Explanation of Issuer Profile Rating / Issuer Profile Score

Positive ("Pos") – The issuer's credit profile is either strong on an absolute basis, or expected to improve to a strong position over the next six months.

Neutral ("N") – The issuer's credit profile is fair on an absolute basis, or expected to improve / deteriorate to a fair level over the next six months.

Negative ("Neg") – The issuer's credit profile is either weaker or highly geared on an absolute basis, or expected to deteriorate to a weak or highly geared position over the next six months.

To better differentiate relative credit quality of the issuers under our coverage, we have further sub-divided our Issuer Profile Ratings into a 7 point Issuer Profile Score scale.

IPR	Positive		Neutral			Negative	
IPS	1	2	3	4	5	6	7

Explanation of Bond Recommendation

Overweight ("OW") – The performance of the issuer's specific bond is expected to outperform the issuer's other bonds, or the bonds of other issuers either operating in the same sector or in a different sector but with similar tenor over the next six months.

Neutral ("N") – The performance of the issuer's specific bond is expected to perform in line with the issuer's other bonds, or the bonds of other issuers either operating in the same sector or in a different sector but with similar tenor over the next six months.

Underweight ("UW") – The performance of the issuer's specific bond is expected to underperform the issuer's other bonds, or the bonds of other issuers either operating in the same sector or in a different sector but with similar tenor over the next six months.

Other

Suspension – We may suspend our issuer rating and bond level recommendation on specific issuers from time to time when OCBC is engaged in other business activities with the issuer. Examples of such activities include acting as a joint lead manager or book runner in a new issue or as an agent in a consent solicitation exercise. We will resume our coverage once these activities are completed.

Withdrawal ("WD") – We may withdraw our issuer rating and bond level recommendation on specific issuers from time to time when corporate actions are announced but the outcome of these actions are highly uncertain. We will resume our coverage once there is sufficient clarity in our view on the impact of the proposed action.

Analyst Declaration
The analyst(s) who wrote this report and/or her or his respective connected persons did not hold financial interests in the above-mentioned issuer or company as at the time of the publication of this report.

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