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 30 June 2018, it had total assets of EUR258.5bn. 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

- Improvement in expense performance supported LBBW’s bottom line despite a slight dip in revenue due to the competitive market environment.
- Increasing loan growth in Corporate Customers and Real Estate/Project Finance shows strong lending capacity and a positive operating environment.
- Although LBBW’s capital ratios weakened from loan growth, they remain above regulatory minimum capital requirements. As such we retain our Neutral (4) Issuer Profile on LBBW.
- While we see better value in the LBBW 3.75 ‘27c22 at this point given spreads for the CMZB 4.875 ‘27c22 having compressed, we remain mindful that CMZB 4.875 ‘27c22 has a higher reset spread of 2.71% compared to 1.78% for the LBBW 3.75 ‘27c22. Instead, we think the BPCEGP 4.50 ‘26c21 looks more attractive against both German banks due to its better capital position and better spread pick up despite having shorter maturity.

Relative Value:

Bond	Maturity / Call date	CET1 Ratio	Ask Yield	Spread
LBBW 3.75 ’27c22 (T2)	18/05/2022	14.9%	3.66%	154
CMZB 4.875 ‘27c22 (T2)	01/03/2022	13.0%	3.67%	157
SOCGEN 4.30 ‘26c21 (T2)	19/05/2021	11.1%	3.47%	143
BPCEGP 4.50 ‘26c21 (T2)	03/06/2021	15.2%	3.64%	160
STANLN 4.4 ‘26c21 (T2)	23/01/2021	14.2%	3.68%	167

Indicative prices as at 7 Sept 2018 Source: Bloomberg
Common Equity Tier 1 (CET1) Ratio based on latest half-year financial report

Key Considerations

- **Stable top-line performance despite challenging operating environment:** LBBW’s 1H2018 total operating income was down 4.8% y/y to EUR1.25bn. This was mainly driven by the lower gains from the disposal of securities and equity investments which was down 29.3% y/y as a result of the exceptional gain in 1H2017 due to the more favourable environment. Net interest income was stable y/y at EUR796mn (1H2017:797mn) despite the low interest rate environment and intense competition within the banking sector as these were offset by the increase in loans to corporate customers. Net fee and commission income was 3.0% lower y/y to EUR262mn (1H2017: EUR270mn) as the decline in income from brokerage business was partially offset by the increase in asset management activities including fund consulting services.

- **Expense performance continues to improve:** Notwithstanding the fall in total operating income, LBBW’s bottom line was marginally improved due to the continuous decline in expenses. Administrative expenses were down 2.2% y/y on the back of lower staff costs and the non-recurrence of expenses in the previous year (operational launch of new core banking system OSplus). While this mitigated the high investment in IT infrastructure, the bottom line growth was mainly due to the absence of the state guarantee commission following the sale of the Sealink portfolio as well as the absence of restructuring expenses. This more than offset the rise in bank levy and deposit guarantee fees, which are system wide expenses and 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. With tax expenses unchanged, the lower costs incurred led to a 2.5% y/y improvement in net consolidated profit for 1H2018 to EUR206mn (1H2017: EUR201mn).

- **Private customer business back in black while capital markets continues to be squeezed:** In terms of PBT by segment, Corporate customer was broadly stable at EUR155mn (1H2017: EUR158mn) on the back of margin pressure due to competition despite higher lending volumes to medium-sized and large enterprises. While there was also a higher volume in commercial real estate financing in 1H2018, Real Estate/project Financing was down 21.8% y/y to EUR104mn (1H2017: EUR133mn) as a result of the high non-recurring income recorded in 2017. Similarly, Capital Markets was significantly weaker y/y by 75.9% to EUR47mn (1H2017: EUR195mn) on the back of cautious customer sentiments which impacted business volumes and increasing credit spreads due to rising uncertainty on capital markets from political developments in Italy. Profit before tax from Private Customers/Savings Banks however improved to a EUR7mn profit (1H2017: EUR-15mn) due to a significant decline in IT expenses as well as higher mortgage transactions.

- **Capital ratios remain comfortable despite the growth in loans:** Risk-weighted assets rose slightly by 4.5% q/q to EUR79.1bn as a result of the growth in loan volumes from business expansion and adjusted customer ratings which were partially offset by the reduction of exposure risks for investment units. With tier 1 common equity (CET1) down marginally due to the one-time effect of the transition to IFRS 9 and the decline in revaluation reserve, LBBW's capital ratio weakened with LBBW's fully loaded CET1/CAR capital ratio at 14.9%/21.5% against 15.7%/22.2% as at 31 Dec 2017. This remains comfortably above the regulatory minimum phased in CET1/CAR requirements of 8.80%/12.30%.

- **Positioning itself in a competitive banking environment:** LBBW increased financing volumes in SMEs and large corporate clients, thus offsetting the pressure on margins from low interest rates, intense competition and weaker capital markets. At the same time, allowances for losses on loans and securities were lower y/y which indicates improved portfolio quality. LBBW continues to progress its four strategic priorities of business focus, digitalization, sustainability and agility with the Project Finance Business receiving an increasing number of financing contracts after its repositioning at the beginning of the year as well as the expansion of its international network with the opening of a representative office in Toronto, Canada. Increased financing volumes are also a consequence of constructive domestic operating conditions with Germany's GDP growth above the EU average. LBBW's expansion in digitalization activities can also be facilitated with Baden-Wurttemburg's emphasis on research and development.

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 securities in the above-mentioned issuer or company as at the time of the publication of this report.

Co.Reg.no.:193200032W