Asia Credit Research

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

Recommendation

- Top line performance for LBBW remains pressured by low interest rates and Germany's competitive banking sector but improved expense performance translated into y/y improvement in net consolidated profit.
- Similar to its peer Commerzbank AG, 1Q2018 results were also assisted by loans growth which indicates still solid operating conditions in Germany.
- A constructive economic outlook and improved expense performance is expected to keep LBBW's capital ratios above regulatory minimum capital requirements and as such we retain our Neutral (4) Issuer Profile on LBBW.
- Compared to the LBBW 3.75 '27c22, we see better value in CMZB 4.875 '27c22 (we also rate Commerzbank AG at Neutral (4)) given the spread pick up more than compensates for the weaker CET1 ratio. In addition, CMZB 4.875 '27c22 has a higher reset spread of 2.71% relative to 1.78% for the LBBW 3.75 '27c22.
- That said, the GBPCE Tier 2 papers look attractive against both German banks given its business profile and sound capital position. In our Monthly Credit View for June, we raised the bond level recommendation on the BPCEGP 4.50 '26c21 to overweight from neutral.

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 March 2018, it had total assets of EUR254bn. 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%).

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Relative Value:

Bond	Maturity / Call date	CET1 Ratio	Ask Yield	Spread
LBBW 3.75 '27c22 (T2)	18/05/2022	15.1%	3.75%	149
CMZB 4.875 '27c22 (T2)	01/03/2022	13.3%	3.99%	176
SOCGEN 4.30 '26c21 (T2)	19/05/2021	11.2%	3.97%	182
BPCEGP 4.50 '26c21 (T2)	03/06/2021	15.1%	3.96%	180
STANLN 4.4 '26c21 (T2)	23/01/2021	13.9%	3.11%	100

Indicative prices as at 6 June 2018 Source: Bloomberg
Common Equity Tier 1 (CET1) Ratio based on latest available quarter

Key Considerations

- **One-offs driving lower y/y performance but underlying business still pressured:** LBBW recently released its 1Q2018 results with total operating income down 7.9% y/y to EUR634mn. This was driven by a 41.8% y/y fall in net gains on disposal due to lower earnings from sale of securities and equity holdings and absence of non-recurring income from the prior year. Net interest income was down marginally y/y (-1.0% y/y as lending and deposit volumes partially offset on-going low interest rates and Germany's competitive banking environment) while net fee and commission income was also weaker y/y by 3.8% y/y as higher income from asset management was offset by lower financing commissions. While the trend in 1Q2018 y/y total operating income performance is weaker than FY2017 trends (total operating income was down 2.9% y/y to EUR2.51bn), of note is the better y/y net interest income performance in 1Q2018 and lower allowances for losses on loans and advances.

- **Bottom line growth however from lower costs**: Expense performance however continues to improve y/y due to well controlled administrative expenses (-5.6% y/y from inclusion of expenses in 1Q2017 from investment in new core banking systems) and absence of restructuring expenses and state guarantee commission following the sale of the Sealink portfolio. This more than offset higher 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. Combined with lower tax expense, net consolidated profit improved 6.3% y/y for 1Q2018 to EUR84mn. Consolidated profit before tax (PBT) was down 7.2% y/y.

- **Segment trends highlight operating environment and strategic intent**: In terms of PBT by segment under LBBW's new reporting segment model, Corporate Customers were down 20.7% due to absence of non-recurring equity sales, competitive pressures impacting margins and higher regulatory and growth expenses despite higher lending volumes to medium sized and large enterprises; the Real Estate/Project Finance segment was down 25.4% due to absence of one-off from 1Q2017, competition and weaker project financing growth compared to commercial real estate; and Capital Markets was down 53.5% from lower sales of securities and lower primary market activities. PBT from Private Customers/Savings Banks however improved materially due to lower administrative expenses and better deposit volumes which generated higher demand for investment solutions.

- **Business growth from strong operating environment despite ongoing competitive banking sector:** Germany's banking sector is highly fragmented with Landesbanks and Sparkassen (both as public sector banks) comprising one of Germany's three banking pillars. This fragmentation has resulted in a competitive banking landscape, with Europe's low interest rate environment compounding weak returns. Despite this, LBBW managed to increase lending volumes to medium-sized and large corporates as well as new commercial real estate loans while deposit volumes improved in the Private Customers/Savings Banks segment. This trend supports the European Commission's ('EC') recent Spring 2018 economic forecast for Germany with the economy expected to continue steady growth from solid domestic demand and foreign trade. Although business sentiment was weaker in 1Q2018, the EC opined that this was due to supply side constraints including a shortage of skilled labour. This is expected to support private consumption from upward pressure on real wages and rising household incomes. External rating agencies have similarly recently affirmed their constructive views on Germany's finances.

- **Capital ratios remain a strength despite accounting change impact**: Previously mentioned loans growth translated into a 3% q/q rise in risk weighted assets and together with first time adoption of IFRS9 (which resulted in a reduction in equity), LBBW's capital ratios weakened with LBBW's fully loaded CET1/CAR capital ratios at 15.1%/21.5% against 15.7%/22.2% as at 31 Dec 2017. This remains above regulatory minimum capital requirements, which have increased in line with the EU's Capital Requirements Regulations, which 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%. LBBW's leverage ratio also weakened to 4.2% as at 31 Mar 2018 against 4.6% as at 31 Dec 2017 but also continues to exceed the minimum 3.0% target.

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<tr><th colspan="2"><u>OCBC Global Treasury</u></th></tr>
<tr><td><u>Treasury Advisory</u>
Corporate FX & Structured Products
Tel: 6349-1888 / 1881
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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.

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