Asia Credit Research

Earnings Review: Société Générale ("SG")

Issuer Profile: Neutral (4)

Ticker: **SOCGEN**

Background

Headquartered in Paris, Société Générale ('SG') offers advisory services and financial solutions to individuals, large corporates and institutional investors. It operates across 66 countries through three core businesses covering retail banking, corporate and investment banking, private banking, and wealth management. As at March 31, 2018, it had total assets of EUR1,271.9bn.

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Recommendation

- Solid capital ratios insulate SG's credit profile for now against earnings challenges and we retain our Neutral (4) Issuer Profile on SG.
- That said, earnings could remain under pressure from prevailing industry dynamics, on-going litigation and recent management changes. This could lead to additional restructuring activities on top of the execution of SG's 2020 Strategic and Financial Plan.
- We see the BNP 4.3 '25c20s as slightly better value considering fundamentals and spread across domestic peers. We rate BNP Paribas one level higher at Neutral (3) in view of its more geographically diversified business which protects against domestic pressures.

Relative Value:

Bond	Maturity / Call date	CET1 Ratio	Ask Yield	Spread
SOCGEN 4.30 '26c21 (T2)	19/05/2021	11.2%	3.25%	99
BPCEGP 4.50 '26c21 (T2)	03/06/2021	15.4%	3.58%	131
STANLN 4.4 '26c21 (T2)	23/01/2021	13.9%	3.05%	83
BNP 4.3 '25c20 (T2)	03/12/2020	11.6%	3.26%	105
CMZB 4.875 '27c22 (T2)	01/03/2022	14.1%	4.41%	207

Indicative prices as at 9 May 2018 Source: Bloomberg
Common Equity Tier 1 (CET1) Ratio based on latest available quarter

Key Considerations

- **Earnings challenges persist**: SG's 1Q2018 performance continues to reflect challenging industry dynamics with gross operating income down 14.5% y/y. Driving the weaker performance was a 2.8% y/y fall in net banking income from lower French Retail Banking and weaker markets performance. At the same time, the internal environment also faces headwinds with a 1.8% y/y rise in operating expenses from higher transformation and regulatory costs. Underlying performance (which is adjusted for non-economic and exceptional items as well as the impact of IFRIC 21) was slightly better with a 8.7% y/y fall in underlying gross operating income to EUR2.1bn.

- **International businesses performing better**: By segment, French Retail Banking performance continues to be weak due to low interest rates as well as lower prepayment and renegotiation fees and lower mortgage prepayment volumes y/y in 1Q2018, while Global Banking & Investor Solutions performance was also lower y/y due to a weaker dollar, weaker trading performance and comparing to a relatively strong 1Q2017. Conversely (and similar to BNP Paribas S.A.'s 1Q2018 results), International Retail Banking & Financial Services performance was improved y/y due to better performance in SG's overseas markets compared to France as well as improved insurance performance. On the expense front, French Retail Banking continues to be weighed down by transformation costs while cost inflation at International Retail Banking & Financial Services was due to business growth.

- **Cost of risk trend remains supportive**: SG's cost of risk continues to fall y/y in line with improvements in underlying operating environments, both domestically and abroad. Cost of risk trends also benefited from a write-back in provisions in the Global Banking & Investor Solutions segment. This helped reverse the weaker y/y gross operating income performance with operating income after risk costs up 12.8% y/y. In line with the trend in risk costs, the reported gross doubtful outstandings ratio was lower at 4.2% as at 31 March 2018 against 4.4% as at 31 December 2017 and 4.8% as at 31 March 2017. Despite the fall in risk costs, the reported gross coverage ratio for doubtful outstandings was slightly improved at 55% as at 31 March 2018 against 54% as at 31 December 2017.

- **Capital ratios protect credit profile for now:** SG's balance sheet was stable q/q but contained a 1.5% fall in net customer loan outstandings (excluding assets and securities sold under repurchase agreements). That said, risk weighted assets rose 1% q/q and this, along with implementation of IFRS9 (-14bps) and inclusion of Single Resolution Fund guarantees (-8bps) translated to a q/q fall in CET1 ratios to 11.2% as at 31 March 2018 (11.4% as at 31 December 2017). This still remains above SG's minimum phased in CET1 ratio requirement of 8.63% as disclosed in SG's annual report. Including senior non-preferred debt issues and other TLAC adjustments, SG's reported TLAC ratio was 21.8% as at 31 March 2018, up from 21.4% as at 31 December 2017 and above the Financial Stability Board's 2019 minimum requirement.

- **Management shake-up:** Concurrent with the release of 1Q2018 results, SG also announced a change in senior management composition following the departure of deputy CEO and head of Investment Banking Didier Valet. Four new deputy CEOs were named to oversee investment banking, international retail operations, compliance and French retail banking. As much as the change was driven by the departure of Mr Valet, the re-organization is seen as timely given subdued performance in investment banking and French retail banking. This could result in fresh restructuring initiatives on top of SG's 2020 Strategic and Financial Plan announced in late 2017 and dent SG's future profitability.

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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.

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