Issuer Profile:

Neutral (4)

Neutral (4)

Ticker:

LBBW

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Landesbank Baden-Württemberg ("LBBW")

Recommendation

- **LBBW remains challenged by the operating environment although its fundamentals look sound given its stable credit metrics and expected state support given its public policy role.**
- **We remain comfortable with LBBW's Neutral (4) issuer profile. Performance indicates both solid business position and strategic importance. Management expect a recovery in profitability on a pick-up of economic activity both in Germany and the Eurozone and lower allowances for losses although loan quality pressure will persist as government support measures wind down.**
- **We remain overweight the LBBW 3.75% '27c22s on both a fundamental and technical basis given still decent yields. The bond looks marginally better value compared to Tier 2 papers from Commerzbank AG given current board level fluidity and its material restructuring plan.**

Relative Value:

Comparative Tier 2s/AT1s	Issuer Profile	Maturity / Call date	Reset Spread	Ask Price	Ask Yield	Spread	Recommen-dation
LBBW 3.75% '27c22s	Neutral (4)	18/05/2022	1.780%	100.2	3.58%	320bps	OW
STANLN 5.375% 'PERPc24s	Neutral (4)	03/10/2024	3.683%	103.9	4.15%	335bps	OW
BACR 3.75% '30c25s	Neutral (4)	23/05/2025	1.589%	104.7	2.53%	158bps	UW
CMZB 4.875% '27c22s	Neutral (4)	01/03/2022	2.710%	101.0	3.79%	343bps	OW
CMZB 4.2% '28c23s	Neutral (4)	18/09/2023	1.972%	100.1	4.13%	355bps	OW
SOCGEN 6.125% 'PERPc24s	Neutral (4)	16/04/2024	4.207%	104.5	4.52%	382bps	OW

Indicative prices as at 1 April 2021 Source: Bloomberg

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 2020, it had total assets of EUR276.4bn.
- As per its website, the bank is 40.5% owned by the Savings Bank Association of Baden-Württemberg, the state capital of Stuttgart (18.9%) and the Federal State of Baden-Württemberg (40.5%).

Key Considerations

- **Same old story due to COVID-19:** LBBW announced its 2020 results and while underlying revenue performance was solid, consolidated profit before tax ("PBT") fell 58.6% y/y to EUR252mn. This was due almost entirely to a ~260% y/y rise in allowances for losses on loans and securities from EUR151mn in FY2019 to EUR544mn in FY2020. The rise in allowances for losses on loans and securities reflected both anticipated impacts from COVID-19 (around 50% of total allowances or EUR276mn for model adjustments to consider the expected economic downturn) as well as a single exposure that was not related to COVID-19 (EUR160mn). Excluding these non-recurring items, risk provisioning would have been lower y/y.

- **Operating income performance is encouraging:** Otherwise, underlying revenue performance was solid with a 5.7% y/y rise in net interest income despite low interest rates. While record new business volume of EUR11.4bn from COVID-19 support programs likely assisted performance (per management, LBBW processed around 12,000 or EUR4.5bn in development loans for its own customers and those of its savings banks), net interest income was also assisted by solid performance in the Capital Markets business and from corporate finance products. This offset a 3.6% y/y fall in net fee and commission income from lower commissions from payments and brokerage. Operating expenses were contained falling 3.7% y/y from lower administrative expenses (staff costs, operating costs) and this translated to an improved cost to income ratio of 70.4% in FY2020 against 71.9% in FY2019.

- **All segments profitable:** By segment, Corporate Customers achieved PBT of EUR7mn (FY2019 PBT of EUR301mn) as solid underlying operating performance from cross selling that generated stable operating income y/y was almost eradicated by a ~220% rise in allowances for losses on loans and securities. Real Estate/Project Finance PBT fell 41.6% y/y to EUR205mn on lower operating income (likely due to lower interest rates and a high base in FY2019 from early loan repayments) and higher allowances for loan losses on model adjustments while financing volumes improved in commercial real estate and renewable energy project financing. PBT from Private Customers/Savings Banks was stable y/y at EUR27mn as the securities business and higher financing volume for high net worth individuals more than offset a fall in the brokerage business. The standout performer was the Capital Markets business with PBT up 66.9% y/y to EUR202mn given market volatility which positively impacted hedging and investment products (revenue +46% y/y) and Asset and Wealth Management (Assets under Management up 8% y/y to EUR119.4bn).

- **Loan quality should weaken but from a low base:** Loan quality looks solid with the reported non-performing loan ratio at 0.6% as at 31 December 2020, down from 0.8% as at 30 June 2020, although this remains heavily influenced by regulatory forbearance above all else. The ratio is stable y/y while the provision coverage ratio fell slightly y/y to 48.0% as at 31 December 2020 (48.4% as at 31 December 2019) and was down noticeably against the 53.7% as at 30 June 2020. This indicates a higher recognition of non-performing loans in 2H2020. This is not surprising given the challenging operating conditions in Germany and Europe as it continues to deal with COVID-19. We expect that non-performing loans will rise further in FY2021 despite a hopeful economic recovery as government support programmes start to wind down. That said, overall levels of non-performing loans remain manageable and should put undue stress on LBBW's credit metrics considering its market position within the relatively sizeable economy of Baden-Württemberg.

- **Strategy intact and on the right path:** LBBW's prior 2017 strategy of business focus, sustainability, digitalisation and agility has not changed as a result of COVID-19 and instead been reinforced following a review in the middle of 2020 with ongoing focus on targeted growth, disciplined risk policy and cost reductions. Corporate Customers will continue to be emphasized but targeted towards the pharmaceuticals and healthcare, utilities and renewable energy, telecommunications and media and electronics and IT sectors. The automotive sector will also continue to be a material exposure for LBBW (13% share of total exposures as at 31 December 2020) given the presence of automotive manufacturing plants in Baden-Württemberg, however given the focus on other less cyclical sectors, exposure to automotive companies will reduce over time. Other targeted growth initiatives include Corporate Finance (sustainability advisory, working capital management, mergers and acquisitions, structured finance solutions), Capital Markets (debt issuance, interest rate, currency and commodities management for Corporate customers) and Asset Management (increase in assets under management to EUR150bn by 2025 from EUR119bn as at 31 December 2020). Finally, cost reductions will continue given the likely challenging environment for returns and a 10 percentage point gap between the actual cost to income ratio and the below 60% long term target cost to income ratio with digitalisation and automation to result in staff reductions by 2021. Positive progress in FY2020 with some of these initiatives despite COVID-19 including volume expansion in Corporate Finance, Corporate Customer focus sectors and assets under management in Wealth Management indicate solid execution capability in our view.

- **Enough in its capital position for shareholders:** LBBW's capital ratios strengthened marginally y/y with its fully loaded common equity Tier 1 and total capital ratio at 14.8%/22.8% as at 31 December 2020 against 14.6%/22.9% as at 31 December 2019 (14.2%/21.8% as at 30 June

2020; 15.1/22.8 on phased-in basis as at 31 December 2020). This was due to higher growth in capital from earnings and risk weighted asset (“RWA”) management (focus on core businesses and higher return RWA along with sale of a non-strategic investment) against growth in RWA (+2.2% y/y) from asset re-ratings driven by the weaker operating environment. LBBW’s capital position is above its 2021 minimum common equity Tier 1 capital ratio regulatory capital requirement of 9.09% (previously 8.98% for 2020) which is set by the European Central Bank based on the Supervisory Review and Evaluation Process and includes the counter cyclical capital buffer and shortfall in AT1. It is also above LBBW’s longer term target CET1 of 13%. Given its capital position as a result of solid performance in FY2020 considering the circumstances, LBBW is seeking to pay EUR70mn in dividends for FY2019 in line with European Central Bank guidelines on capital distributions to shareholders. LBBW is also seeking approval to pay EUR99mn in dividends for FY2020 at its annual general meeting with EUR19mn to be paid initially.

Landesbank Baden-Württemberg

Table 1: Summary Financials

Year Ended 31st Dec	FY2018	FY2019	FY2020
Income Statement (EUR'mn)			
Net Interest Income	1,558	1,675	1,771
Non Interest Income	1,008	1,026	918
Operating Expenses	1,773	1,810	1,743
Pre-Provision Operating Profit	793	891	946
Provisions	141	151	544
Other Income/(Expenses)	-89	-102	-118
PBT	563	638	284
Income Taxes	136	167	80
Net Income to Common Shareholders	415	439	172
Balance Sheet (EUR'mn)			
Total Assets	241,197	256,667	276,448
Total Loans (net)	109,231	110,320	108,116
Total Loans (gross)	110,080	111,197	109,193
Total Allowances	849	877	1,077
Total NPLs	848	949	981
Total Liabilities	228,034	242,827	262,457
Total Deposits	82,481	90,319	95,288
Total Equity	13,162	13,840	13,991
Key Ratios			
NIM	0.98%	1.03%	1.07%
Cost-income Ratio	73.1%	71.8%	70.4%
LDR	132.4%	122.1%	113.5%
NPL Ratio	0.77%	0.85%	0.90%
Allowance/NPLs	100.1%	92.4%	109.8%
Credit Costs	0.13%	0.14%	0.50%
Equity/Assets	5.45%	5.38%	5.05%
CETier 1 Ratio	15.1%	14.6%	15.1%
Tier 1 Ratio	16.2%	16.5%	16.6%
Total CAR	22.0%	23.0%	22.8%
ROE	4.30%	4.60%	1.90%
ROA	0.18%	0.19%	0.08%

Source: Company

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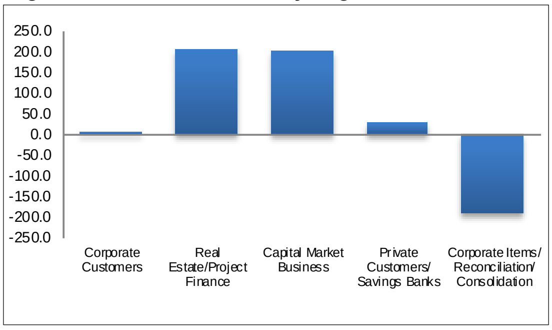
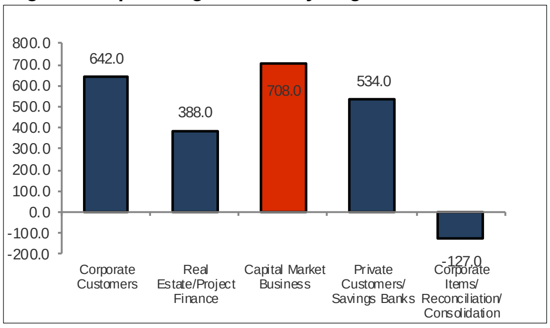
Figure 1: Profit Before Tax by Segment - FY2020



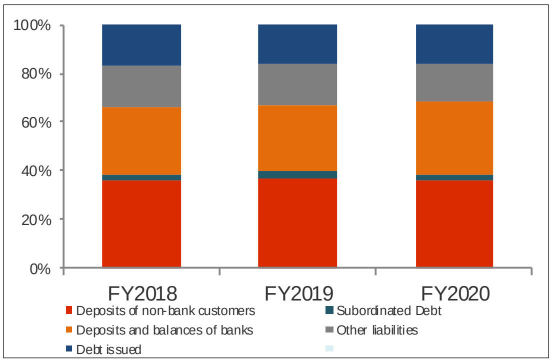
Source: Company

Figure 2: Operating Income by Segment - FY2020



Source: Company

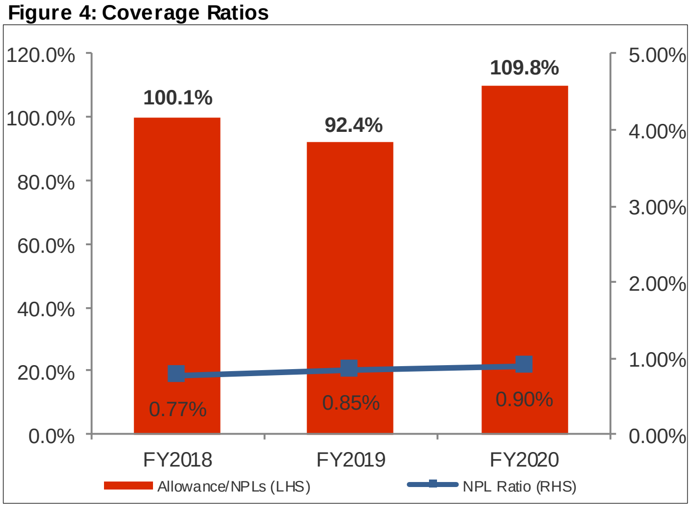
Figure 3: Liabilities Composition



Source: Company

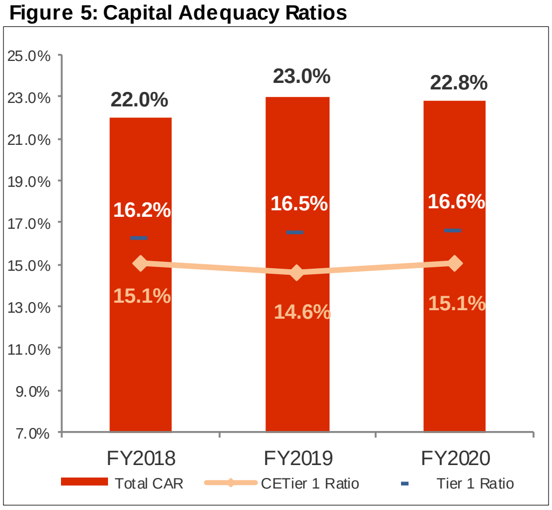
Source: Company

Figure 4: Coverage Ratios



Source: Company, OCBC estimates

Figure 5: Capital Adequacy Ratios



Source: Company

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

Please note that Bond Recommendations are dependent on a bond's price, underlying risk-free rates and an implied credit spread that reflects the strength of the issuer's credit profile. Bond Recommendations may not be relied upon if one or more of these factors change.

Explanation of Bond Recommendation

Overweight ("OW") – The bond represents **better relative value** compared to other bonds from the same issuer, or bonds of other issuers with similar tenor and comparable risk profile.

Neutral ("N") – The represents **fair relative value** compared to other bonds from the same issuer, or bonds of other issuers with similar tenor and comparable risk profile.

Underweight ("UW") – The represents **weaker relative value** compared to other bonds from the same issuer, or bonds of other issuers with similar tenor and comparable risk profile.

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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