

ISSUER COMMENT

24 May 2017

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RATINGS

BAWAG P.S.K.

Deposit / Senior Unsecured Ratings	A2
BCA	baa1
Outlook	Positive

Source: Moody's Investors Service

KEY METRICS:

BAWAG P.S.K.

	2016	2015	2014
Problem Loans/Gross Loans	1.9%	2.3%	2.8%
TCE/RWA (1)	15.9%	15.7%	13.0%
NI/TA (2)	0.8%	1.1%	1.0%
Market Funds/TBA (3)	18.2%	22.1%	22.7%
Liquid Banking Assets/TBA	16.4%	16.8%	19.5%

(1) TCE: Tangible Common Equity, RWA: Risk-Weighted Assets; (2) NI: Net Income, TA: Tangible Assets; (3) TBA: Tangible Banking Assets

Source: Company Reports, Moody's Banking Financial Metrics

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BAWAG P.S.K.

BAWAG's announced acquisition of Suedwestbank would expedite the bank's strategic expansion in Germany

On 24 May, Austrian retail bank BAWAG P.S.K. (BAWAG, A2 positive/A2 positive, baa1)¹ [announced](#) it plans to fully acquire Germany's Suedwestbank AG (unrated) and currently negotiates the purchase with Suedwestbank's shareholders.

In this comment we provide our preliminary assessment of the benefits and challenges of such potential merger.

Strategic Focus of the Transaction

The planned acquisition is in line with BAWAG's strategic growth focus on retail banking in Austria and German-speaking neighboring countries. BAWAG already acquired several niche institutions over the past years, including the consumer business of SIX Payment Services (unrated) as well as the specialized mortgage lending businesses of start:bausparkasse (unrated) and IMMO-BANK (unrated), generally with a focus on leveraging the specialist knowledge of these while strengthening their efficiency towards the above-industry standard of BAWAG. We believe that Suedwestbank's value proposition for BAWAG is very similar, but that an additional benefit for BAWAG will be that the bank's presence through 28 branches with about 100,000 clients in the economically strong Land of Baden-Wuerttemberg (Aaa stable) will complement BAWAG's efforts to establish its direct banking subsidiary easygroup (unrated) in the German market. Easygroup obtained regulatory approval in the first quarter of 2017 to expand into Germany and plans to start originating loans during the second half of the year.

Capital

Based on a regulatory Common Equity Tier 1 (CET1) ratio of 11.9% as of 31 December 2016, we estimate Suedwestbank would add close to €6 billion to BAWAG's €171 billion of risk-weighted assets (as of 31 March 2017), based on a high – almost double of BAWAG's - risk-weighted asset density under the standardised approach employed for the regulatory measurement of Suedwestbank's asset risks. Whereas this suggests a potential initial decline in the future regulatory CET1 ratio of BAWAG, the overall capital position would largely depend on the terms of the acquisition. We believe BAWAG's management will seek to maintain a comfortable margin above regulatory requirements, as consistently communicated in the past to investors with a minimum target of a fully-phased 12% CET1 ratio.

Regional Focus and Profitability

With €7.4 billion of total assets as of year-end 2016, Suedwestbank is about one fifth of the current size of BAWAG, and it would make Germany the largest single country exposure of BAWAG outside of Austria, strengthening BAWAG's presence in markets with relatively low asset risk volatility. Suedwestbank received an in-kind equity injection in the form of a securities portfolio from its owner family in 2013, which the bank has been selling down from 2015 through 2017. This has allowed Suedwestbank to temporarily report extraordinarily high profit levels against a background of German retail banking margin pressure in the low interest rate environment and of rising regulatory expenses. Without the merger, we believe Suedwestbank would report cost-income ratios more in line with its reported 2012-2014 cost-income ratios of 60%-70%. Its higher cost basis offers significant scope for improvement towards BAWAG's recent years' cost-income ratios of between 40-45%.

Funding

Close to three quarters of Suedwestbank's total assets are funded by deposits, which provide a stable, but currently also costly refinancing tool. In 2016, Suedwestbank obtained the necessary approvals to issue German mortgage covered bonds, which the bank aims to start on a private placement basis in 2017. The issuance of German mortgage covered bonds out of Suedwestbank could offer BAWAG another attractively priced channel to further enhance its already well-diversified funding mix. However, we believe that in the case BAWAG opts for a tight integration of Suedwestbank that would facilitate cross-border resolution, BAWAG will also need to step up its senior unsecured and subordinated debt issuance plans in order to broadly preserve its current liability structure and mitigate the relative seniority slippage of unsecured creditors within a consolidated balance sheet.

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Moody's Related Research

Special Comment

- » [BAWAG's Acquisition of Paylife's Consumer Business Is Credit Positive](#), March 2017
- » [Issuer In-Depth: BAWAG P.S.K.: Strong, Sustainable Profits Buck Trends in the Austrian Banking Sector](#), June 2016

Credit Opinion

- » [BAWAG P.S.K.: Update following Recent Upgrade](#), May 2017

Rating Action

- » [Moody's upgrades BAWAG's ratings to A2; outlook positive](#), April 2017

To access any of these reports, click on the entry above. Note that these references are current as of the date of publication of this report and that more recent reports may be available. All research may not be available to all clients.

Endnotes

- 1 The ratings shown are BAWAG's deposit rating and outlook, its senior unsecured rating and outlook and its Baseline Credit Assessment.

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