

ISSUER COMMENT

Erste Group's Capital Raise Will Help Repay State Aid, a Credit Positive

From [Credit Outlook](#)

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Last Monday, Austria's [Erste Group Bank AG](#) (A3 negative, D+/baa3 negative)¹ announced its plans to raise around €660 million of equity and fully repay participation capital of €1.76 billion, both sometime in the third quarter. These measures are credit positive for Erste because they allow the bank to exit state support and address the declining regulatory capital eligibility of participation capital proactively.

The repayment covers a €1.2 billion capital injection from the Austrian government and €559 million of private investor money, both issued in spring 2009, and hinges on the bank's success in raising the €660 million of equity.

We consider the decline in the bank's capitalization from the smaller equity raise relative to the repayment of the participation capital to be manageable, given Erste's efforts to reduce risk over recent quarters. These efforts include disposing of non-core assets, including credit default swaps, and changing its business mix towards a larger portion of mortgage loans. As a result, risk-weighted assets declined to €105 billion in first-quarter 2013 from €120 billion in December 2010. During the same period, Erste also increased its on-balance sheet loan-loss reserves to €7.7 billion from €6.1 billion, thereby improving its coverage ratio to 62.4% from 60.1%.

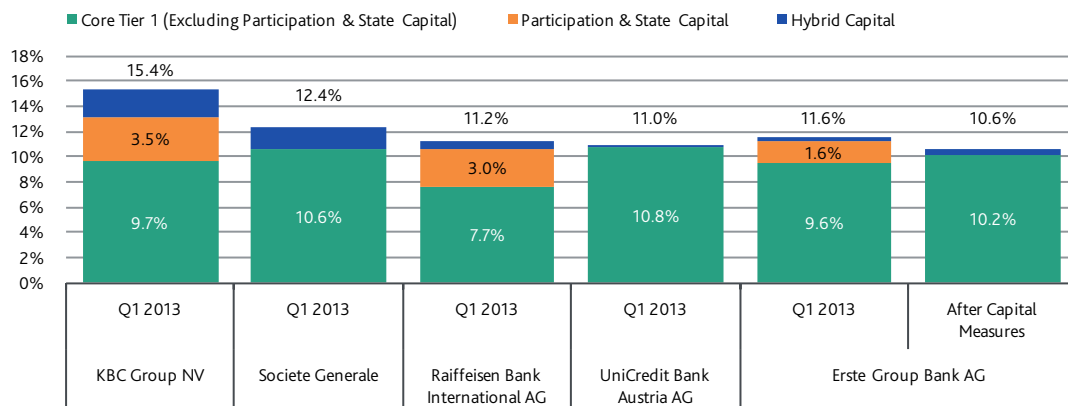
As of 31 March, Erste's reported Tier 1 ratio was 11.6%. Pro forma a successful capital raise and the bank repaying the participation capital, the ratio should decline to 10.6% and continue to include approximately 40 basis points of hybrid capital components. As a result, Erste's capital will weaken in comparison to other banks with operations in Central and Eastern Europe, while the composition of its Tier 1 capital will improve.

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¹ The bank ratings shown in this report are the bank's deposit rating, its standalone bank financial strength rating/baseline credit assessment and the corresponding rating outlooks.

Tier 1 Capital Ratios of Banks with Central and Eastern European Operations



Source: Company reports

The bank's decision to fully redeem the outstanding participation capital was also based on the rise in coupon payments that begin in 2014. As such, with the contemplated repayment, Erste's earnings will improve, all else equal, by around €150 million annually (post-tax). However, as part of the ad hoc announcement, Erste also lowered its earnings outlook for the current fiscal year, primarily reflecting a persistently challenged operating environment of lower-than-expected loan growth and net interest margin. Nevertheless, the bank maintained its guidance on credit costs (loan-loss provisions) declining by 10%-15% from last year's €2.0 billion.

Despite this setback against the bank's earlier expectations, we still consider Erste's future earnings capacity to be sufficient in reaching its stated Basel III fully loaded common equity Tier 1 target of 10% by 31 December 2014. Adjusting for the bank's estimate for the introduction of the Basel III capital regime (30 basis points) and the planned implementation of an internal ratings-based approach in one of Erste's core markets, Romania, by 2015 (40 basis points), Erste's fully loaded Basel III capital ratio would have been 9.5% as of 31 March on a pro forma basis.

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