EARNINGS CALL
TRANSCRIPTION

Q3 2023

17 October 2023 at 10:00 CEST

SPEAKERS:
ANAS ABUZAAKOUK
ENVER SIRUCIC

BAWAG Group

Anas Abuzaakouk: Good morning, everyone. I hope everyone is keeping well, I'm joined this morning by Enver, our CFO.

Let us start with a summary of the third quarter results on slide three. We delivered another strong set of quarterly results with third quarter net profit of € 186 million, earnings per share of € 2.25 and a return on tangible common equity of 27.6%.

The operating performance of our business was very strong with pre-provision profits of € 268 million and a cost-income ratio of 31.3%. Total risk costs were € 22 million, translating into a risk-cost ratio of 21 basis points. We utilised our management overlay for the first time, with our ECL management overlay now at € 80 million, more than sufficient to address idiosyncratic risks in the portfolio and still equal to almost a full year of risk costs. Credit performance remains solid across all businesses, with a low NPL ratio of 1%.

In terms of balance sheet and capital, average customer loans were down 3% and average customer deposits were up 1% quarter-over-quarter. Average customer funding, which is made up of customer deposits and AAA-rated mortgage and public sector covered bonds, was up 1% quarter-over-quarter.

We generated over 90 basis points of gross capital from earnings and landed at a CET1 ratio of 14.2%, net of € 453 million of capital distributions in the form of the year-to-date dividend accrual of € 278 million and the € 175 million share buyback program, which was approved on October 4th and is currently being executed. We have a fortress balance sheet with excess capital of € 386 million, ample liquidity with cash and cash equivalents of approximately € 11 billion – equal to 21% of our balance sheet, an LCR of 218%, and one of the lowest NPL ratios across European banks of 1% reflecting the strong asset quality. This will allow us to ultimately play offence as we stay patient and liquid in the current market environment.

With our strong operating performance during the first three quarters of the year, we are on track to deliver a record year of earnings for the franchise and expect to meet or exceed all 2023 targets despite an overall subdued market and cautious consumer sentiment.

We have a resilient franchise across all cycles with very strong earnings, strong capital generation, conservative and disciplined underwriting, and a diversified and robust funding stack with granular retail deposits and long-dated covered bonds that is the foundation of our funding. This will allow us to consistently deliver quality results. We continue to remain vigilant in managing risks, requiring us to be patient, always focused on risk-adjusted returns, and not be distracted by irrational lending or short-termism.

We focus on the things that we can control: our investments, our risk appetite, the daily operations of the bank, and being good stewards of capital. We target completing the € 175 million share buyback program by the end of the year, and we will address further capital distributions with our year-end results based on current M&A prospects, market developments, and subject to regulatory approvals.

Moving to slide four. We delivered net profit of € 186 million, up 40% versus prior year. Overall, strong operating performance with operating income of € 390 million and a total expense of € 122 million, up 16% and 2%, respectively, versus prior year. Total pre-provision profits were € 268 million, up 23% versus prior year. Underlying risk costs were € 22 million, down 38% versus prior year.

Tangible book value per share was € 33.23, up 6% versus prior year and 3% versus prior quarter net of the year-to-date dividend accrual and share buyback program.

Moving to slide five. At the end of the third quarter, our CET1 ratio was 14.2% after deducting € 453 million of capital distributions in the form of the year-to-date dividend accrual and the share buyback program. For the quarter, we generated approximately 90 basis points of gross capital from earnings. As of third quarter, we have € 386 million of excess capital above our stated CET1 target of 12.25%.

We have more than sufficient dry powder for organic and inorganic opportunities and will address further capital distributions with our year-end results as we will have a firmer view on the M&A opportunities at that point. The acquisition of Peak Bancorp in the United States is still pending regulatory approval. Overall, we are well-positioned to address multiple market opportunities, given our strong earnings, capital, and liquidity.

On slide six, our Retail & SME business delivered net profit of € 137 million, up 24% versus the prior year and generating a very strong return on tangible common equity of 39% and a cost-income ratio of 29%.

Average customer assets were € 21.9 billion and average customer deposits were € 26.3 billion, both down 1% quarter-over-quarter. Average retail customer funding was € 37.2 billion, which is a combination of customer deposits and AAA-rated Austrian mortgage covered bonds, which was flat versus prior quarter.

Pre-provision profits were € 206 million, up 20% compared to the prior year, with operating income up 13% and operating expenses down 1%. Risk costs were € 22 million, reflecting our current run-rate of risk costs.

The trend in asset quality remains strong across our customer base, with a low NPL ratio of 1.8% and a risk-cost ratio of 40 basis points. We expect continued solid performance in the Retail & SME business in the fourth quarter but muted loan growth, given the current economic environment and overall cautious consumer sentiment.

On to slide seven. Our Corporate, Real Estate & Public Sector business delivered net profit of € 42 million, up 19% versus the prior year and generating a strong return on tangible common equity of 23% and a cost-income ratio of 26%.

Average assets for the quarter were € 13.6 billion, down 5% versus prior quarter. Average customer deposits were € 5.8 billion, up 8% versus prior quarter. Average customer funding, which is a combination of public sector and corporate deposits as well as AAA-rated Austrian public sector covered bonds was € 7.3 billion, up 4% versus prior quarter.

Pre-provision profits were € 57 million, down 4% compared to the prior year. Risk costs were effectively zero. However, we utilised € 20 million of our management overlay to address an idiosyncratic risk in our US office exposure. The trend in the overall asset quality continues to be solid, with our NPL ratio at 90 basis points for the entire segment.

We pride ourselves on disciplined underwriting focusing on risk-adjusted returns, which factor in losses across all cycles and avoiding blindly chasing volume growth, specifically during the benign credit cycle we witnessed over the past few years. We will continue to be disciplined and will have the capital and liquidity to support our customers as well as capitalise on any dislocations.

Heading into the fourth quarter, we have a solid pipeline of opportunities and more broadly see credit repricing across various asset classes.

On slide eight, an update on the real estate portfolio. We experienced a 1% reduction quarter-over-quarter in our real estate loans. The portfolio continues to perform well, reflecting the underlying exposure to residential, logistics, and industrial assets, which make up 65% of the total portfolio and 72% of our US exposure. Our office exposure in the United States stands at € 472 million. We utilised € 20 million of our management overlay on a US office exposure during the third quarter, which was the most challenged of our US office exposures and idiosyncratic in nature. The remaining portfolio is performing with a debt yield of approximately 10%, a weighted average lease term of 6.5 years, and an LTV below 60%. The performing US office portfolio represents approximately less than 1% of total assets, approximately 1% of total customer loans and 8% of our total real estate assets.

We are confident that we will be able to address any potential issues in the real estate portfolio and believe our recent EBA stress test results, with a cumulative loss rate under 2% over a three-year period, which applied a reduction in collateral values of over 50% given various add-ons, is a good proxy for stressed loss assumptions across the portfolio, which is less than the remaining € 80 million management overlay.

As I have stated before, the stress we are seeing in certain asset classes, commercial real estate being one, will differentiate banks in terms of underwriting and asset quality. With that, I will hand over to Enver.

Enver Sirucic: Thank you, Anas. I will continue on slide ten.

Again, a very strong quarter with net profit of € 186 million and a return on tangible common equity of 27.6%. Core revenues were up 1% versus prior quarter, with net interest income up 1% and stable net commission income. Compared to prior year's third quarter, core revenues were up 17%. Operating expenses up 1% and cost-income ratio relatively stable at 31.3% for the quarter. Risk costs of € 22 million, in line with prior quarters with a risk-cost ratio of 21 basis points. We utilised our management overlay for the first time, with our ECL management overlay now at € 80 million.

On slide eleven, we show key developments of our balance sheet. Overall, a quite stable trend in the third quarter. Customer loans were down 1% and average customer deposits were up 1% quarter-over-quarter. Our position of cash and cash equivalents stands at € 11 billion or 21% of the balance sheet, leaving us with a very comfortable liquidity buffer to address potential organic and inorganic market opportunities in the quarters to come.

In terms of capital, we again generated approximately 90 basis points of gross capital from earnings, and after accounting for the ongoing €

175 million share buyback and a € 278 million year-to-date dividend accrual, CET1 ratio came in at 14.2%, leaving us with an excess capital of € 386 million.

On slide twelve, our customer funding, which is made up of customer deposits and AAA-rated mortgage and public sector covered bonds grew by 1% quarter-over-quarter to around € 45 billion, cash position now at € 11 billion. In terms of customer deposits, no relevant structural changes in the third quarter, repricing continues in line with our expectations, and overall, deposit betas now at around 20%, and expected to grow further to below 40% in the coming quarters.

With that, moving on to slide thirteen, core revenues. Positive net interest income trend continues at a lower pace in Q3, up 1% versus Q2 despite lower customer loans. Net interest margin now at 297 basis points for the quarter, improved by another 6 basis points despite ongoing deposit repricing. In terms of net commission income, overall good and stable performance in Payments & Advisory business, with customers shifting more into fixed income products.

For 2023 we expect core revenues to grow by more than 14%, and for the fourth quarter we expect to see a very similar development compared to Q3, so around 1% growth.

Slide fourteen, operating expenses, completely in line with expectations and fully on track to meet our target of 2% year-over-year. For the quarter, operating expenses were up 1% and our cost–income ratio remained largely stable now at 31.3%. We have started working on different initiatives to address future inflationary pressures and will continue to focus on absolute cost targets also in the coming years.

Slide fifteen, risk costs. Overall, stable underlying trends and strong asset quality with a continued low NPL ratio of 1%. The risk-cost run-rate stands at € 22 million for the quarter, which is in line with the underlying trend of the past couple of quarters and with a risk-cost ratio now of 21 basis points. We utilised our management overlay for the first time to address a single case in our US office exposure, with our ECL management overlay now at € 80 million, and we do not expect any further releases in 2023.

On slide sixteen, we wanted to reiterate our 2023 targets.

Our previously updated 2023 targets remain unchanged and after another strong quarter, we are further on track to a record year of earnings in 2023, meeting or exceeding all targets. And with that operator let's open up the call for questions. Thank you.

Operator: Instructions

Gabor Kemeny (Autonomous Research):

Hi team, thank you for the presentation. I have a couple of questions. Firstly, on CRE. Can you elaborate a little bit further on how this specific US Office exposure has been provisioned, and what triggered the top-up here? Also, I think you mentioned that you are not expecting further overlay releases this year. How do you think about changing, tweaking your overlay provisions over the next year?

And finally, a broader question on CRE. What reassurance can you give to investors that this US office default was not the kind of canary in the coal mine and was indeed an idiosyncratic case?

My final question would be on costs, obviously early days, but you have been very proactive with managing your cost base in the past. What is your sense of the cost outlook going into 2024 if inflationary pressure would persist? Thank you.

Anas Abuzaakouk: Thanks, Gabor. Very good questions. I will take the commercial real estate and then Enver, maybe you want to address the cost.

Enver Sirucic: Yes, sure.

Anas Abuzaakouk: Gabor, as we stated during the presentation, this is a unique idiosyncratic exposure. The very reason of having the management overlay was to address these types of risks. This exposure we had on the watch list. I would tell you this is the worst of our office exposures, not just in the US, Europe, across the board in terms of different asset classes. However, I think only time will kind of bring that to fruition, as you see our quarterly developments in fourth quarter and then going into 2024.

As far as NPL build-up, we are at 1% for the entire franchise, we are at 1.4% in the real estate. I think those are the levels you will see kind of steady out, and this is given just kind of a declining asset balance. So potentially it improves from there. We do not see any further build up in NPLs.

The overlay, which now stands at € 80 million. We think we were more than conservative in how we addressed this particular exposure, we effectively marked it at an 8.5% cap rate. If you think about US office going back as far as the data is available, I think the peak did not even reach 10% cap rate. So we feel good about the overall remaining exposure, the € 400 million or so that is performing. I mentioned in the presentation the debt yield is around 10%. If you even used a 10% cap rate on the remaining US office exposure, the overlay of € 80 million is sufficient to cover that. And that is a tail risk. Never say never, but we feel that we are well-positioned. We do not see anything on the horizon. This particular case was idiosyncratic. It was on the watch list, and we would rather address it head-on. We did it in the third quarter as opposed to end of year, and we feel pretty good about the remaining exposures that we have. However, I think this is going to be one where you just have to see our development quarter over quarter to understand how we have underwritten these loans and the quality of the portfolio. I think there was a question on cost.

Enver Sirucic: Yes. Gabor, on the cost side, we are experiencing a bit of higher inflation rate in Austria versus the rest of Europe. So, we started early addressing inflation. It is a bit early to give an outlook for the coming years, but I think we have been very consistent in messaging in the last couple of quarters and also years. My kind of direction that I would give you is probably in the context of what you are seeing, 2023. In terms of OPEX increase, it is probably around the number that we also would think about also for the coming years. Assuming inflation stays high; if inflation comes down, obviously that could be a better number.

Anas Abuzaakouk: But we are assuming the worst on that, in terms of year-over-year.

Gabor Kemeny: Impressive. Thank you.

Enver Sirucic: Thanks, Gabor.

Johannes Thormann (HSBC):

Good morning, everybody. Johannes from HSBC, some questions as well on US commercial real estate, just on the yield and debt, which is nicely high with 10%. But, what kind of risk did you take for it? And sorry to come back on the default case, can you give us more details on city or type of office building or the tenant structure, so we can understand what is different to the normal business, and what makes this the worst of your exposures?

Probably in hindsight, Captain Hindsight is the smartest broker, I know, but what has been done wrong in this deal, and then probably just on a little bit, you increased your shopping exposure by a minor percentage. What has been driving this?

Last but not least on your NII outlook for 2024. Did we see the peak in Q3, or do you still expect a moderate uplift? But the increase level was very small compared to the previous quarters. Thank you.

Anas Abuzaakouk:

Thanks, Johannes. All very good questions. Let me take the commercial real estate, and then I'll defer to Enver on the NII development.

Johannes, as far as the commercial real estate, what I mentioned to Gabor is this is unique. We classify all of the properties that we have as Class A. What happened on this particular property, which was underwritten in 2019, was effectively just the rent roll. The potential sponsor in this, which is, by the way, the only deal that we have with this particular sponsor, made a projection on rent rolls in the ability to lease up the building. That did not come to fruition, you could say COVID, you could say the market turned. It is what it is. When we underwrote the loan, we felt pretty good about the overall credit metrics, and this is one that unfortunately did not go our way. So what we did was we took a full assessment in terms of what we believe the value is today at an 8.5% cap rate, which, I think, is quite conservative if you benchmark that where other people are valuing assets. And we think this is the worst is behind us.

As far as the remaining US office exposure, I think the 10% debt yield and the 6.5-year weighted average lease term, those are really powerful. The quality of the tenants and the particular sponsors give us a lot of comfort that I think we are going to be in a good place. However, like everything else, Johannes, you will have to see it in every quarterly development. I understand the scepticism in the market, and that is why we feel pretty good going into the coming quarters and going into 2024 that the worst is behind us. However, I think this is going to be one where just time will tell.

Enver Sirucic: Johannes, on the NII trends, so it is not peak in terms of NII, so we still expect NII to grow, just at a slower rate, as we have seen in Q3. The reason for that is we are coming probably close to the end of the rate cycle and that just trickles through then into the run-rate. Deposit betas are going up as expected, pretty much in line, even a bit slower than what we thought, and still, we are nicely offsetting that with the replication income on the other side. The question is going to be, as I think I mentioned on the Q2 call, is the development on the asset side. We have seen some stabilisation in the second quarter, how this will develop over the next couple of quarters, that could drive NII a bit higher than what we are seeing today. Otherwise, I would say Q3 is a good proxy in terms of kind of growth rate for the next quarters.

Johannes Thormann: Okay, understood. Thank you. Just coming back on the US shopping exposure, what triggered your move back into this niche?

Enver Sirucic: Honestly, I think it is just a technical, but let me come back to you. I think just the denominator is a bit lower and that is why there was that.

Anas Abuzaakouk: There was no retail shopping loan, Johannes.

Johannes Thormann: Okay. Thank you.

Tobias Lukesch (Kepler Cheuvreux):

Yes, good morning. Three questions from my side as well, please. One on the loan book, one on M&A and capital return, and the last one, again, touching quickly on the NII. On the loan book, could you elaborate a bit more on the trend in the fourth quarter and how you expect actually the loan book to develop over the next twelve months? You mentioned the discipline, you mentioned now a solid pipeline and a credit repricing. So where does that bring us? If we compare that, of course, to the last quarter and also to the year-on-year comparison, that looks down 2.5% on Retail & SME, 12.5% on Corporate & Real Estate, and Treasury also down 3% over year. So looks quite negative. So where is the turnaround? Where do you see the bank going here?

Anas Abuzaakouk: Hi Tobias, let me go ahead and take the first one, and then we can address, I think, you have two other questions. As far as overall customer loan, it has been anaemic year-to-date. I think we have consistently mentioned that if you look at the overall market dynamics, volumes, let me just focus on the retail front. When you look at mortgages in the different markets that we are in, have collapsed, 50-60%. So that is one dynamic. And then what remains in the market, just we do not think the risk-adjusted pricing makes a lot of sense. So that contributes a lot to the quarter over quarter development of customer loans on the retail front.

As far as the Corporate, Real Estate & Public Sector, that is more transactional in things where I would say you have a standstill for the first half of the year. And then at least at the latter part of the third quarter, we started to see some development, and we have actually, I think, built up a decent pipeline. We will see if it comes to fruition in the fourth quarter and the first half of next year. These things have a bit of a lead time, but we think things are now stabilising. Plus, we see credit risk repricing. I have mentioned this before, but now we are starting to see some traction on the Corporate front, more so than we have seen in the past. So we will see. We are going to be disciplined, Tobias. We have the capital and liquidity to support customers to be able to provide credit to the real economy. But, at the same time, we need to be disciplined and that is something that we will be patient on.

Tobias Lukesch: Thanks a lot, Anas, and if I understand you correctly, so base case would be slightly down potentially over the next 12 months. In a good scenario, you could be flattish. Is that fair to say?

Anas Abuzaakouk: No, I would say, Tobias, I think you will see things starting to stabilise in the fourth quarter. Retail is probably going to be a little more challenged from a mortgage standpoint, but I think on other parts of the business, Corporate, Real Estate & Public Sector as well as securities, which is more on the treasury side, we are starting to see opportunities, spreads are widening, and we will hopefully be able to allocate capital liquidity. So I think I do not want to call a bottom, but I think you are going to see positive development in the fourth quarter and obviously going into 2024. That is part of I think your question on the NII, a lot of that is really dependent on where the customer loans are at. We are trying to be conservative when we say fourth quarter is going to look like third quarter in terms of just where overall interest-bearing assets or customer loans are at. However, you really do not have line-of-sight until you see kind of where your customer loans stabilise at for 2024.

Tobias Lukesch: Understood. Very good. You just mentioned NII, Anas. Enver said Q3 is a good proxy as a run-rate. We had that kind of 1.1% NII growth quarter-on-quarter. A kind of 1%, is that a fair assumption over the next coming quarters, so to say, did I get that right, on a quarterly basis?

Anas Abuzaakouk: 2024 will be greater than 2023 on a total basis.

Tobias Lukesch: On total basis, sure. But, quarterly-wise if Q3 is a good run-rate that was really the comment on the NII, right? NII Q3 good proxy going forward.

Enver Sirucic: That is correct, Tobias.

Tobias Lukesch: Great. Thanks, Enver. And then thirdly, on the M&A and capital return, could you maybe give again a bit of an update on M&A opportunities, i.e., do you already have built up enough excess capital right now with € 386 million for a potential deal that you are seeing? And on the capital return, maybe could you give a bit more details if and when you would announce or even start a new share buyback? Thank you.

Anas Abuzaakouk: Tobias, without getting into the specifics of any particular deal, we are looking at a few opportunities. We had mentioned earlier this year with our year-end results in February that we were anticipating a particular deal that got pushed to the second half. That is in the pipeline of opportunities that we are looking at in the fourth quarter and a few other opportunities. I think this time around, come our year-end results, we will have a lot more clarity in terms of potential M&A opportunities and where we stand if we are successful. And if we are not, we will have a discussion around capital distributions. And I think this time it will be a lot clearer, just given the overall timelines of the things that we are looking at. We have € 386 million of excess capital. Everything that we are looking at would be self-funded. We have more than enough capital, we have more than enough liquidity to be able to address these potentially unique opportunities. Obviously, cannot go into more detail on what those opportunities are, but it is going to be an interesting fourth quarter.

Tobias Lukesch: Yes, maybe last one. So, if this is the timeline with a year-end results, and you apply for a share buyback, then it is potentially not going to start before June, July. But, on this approval timeline and the many months it took basically to get that share buyback approved, which is now up and running, and given the great stress test result you had, could you share one or two thoughts? Like, a) why this took so long, and b) has there been communication or an indication by the regulator that next time that period could be shortened?

Anas Abuzaakouk: Tobias, this was the third buyback that we had approved. I think we are at a total of € 900 million. We have a very good and constructive dialogue with the regulator. We are obviously not going to share any of the details with those discussions. Just take comfort and assurance from the fact that we have consistently executed on buybacks, and we will have that discussion at year-end results based on how everything else develops.

Tobias Lukesch: Noted. Thank you.

Anas Abuzaakouk: Thanks for joining the call. To everybody who joined both on the conference call as well as on the web, we look forward to talking to you at our year-end results on February 1st. Take care and have a great day.