Credit Note

Financials ▪ Global

KGI CHINA DEVELOPMENT FINANCIAL

BPCE 4.5% 06/03/26

(BPCEGP)

Intermediate-Term Carry

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Company Background: Groupe BPCE is the 2nd largest banking group in France with 31 million clients spread over two retail banking networks, Banque Populaire and Caisse d'Epargne. The group has various subsidies including Natixis, Credit Foncier and Banque Palatine. As of 30 September 2018, the group has total assets exceeding 1.28tn EUR.

Credit Considerations:

Excluding exceptionals, 3Q18 results shows positive trend with low risk loan book. The group's income before tax dropped 9.9% YoY to EUR 1.4bn due to an increase in operating expenses which rose 6.1% YoY to EUR 4.2bn, driven by transformation and reorganization costs of EUR 250m. Excluding exceptional items, the group's underlying income grew 3.8% to EUR 1.66bn as net banking income (+2.1% YoY) outgrew operating expenses (+1.5% YoY).

For 9M18, the group's underlying income grew 1% to EUR 18.08bn due growth in insurance revenues and commission income across business lines helped to offset the decline in net interest income, which continues to be impacted from the effects of a persistently low interest-rate environment. Due to a conservative risk policy, the group's cost of risk continued to remain low, with the cost of risk improving by 2bps to 17bps as compared to 9M17.

Exceptional costs will remain until 2020. As part of the group's digital transformation plan (TEC 2020), BPCE plans to boost key hires in IT and investments to 600 million per year by 2020. The transformation will take 3 years from 2018 – 2020 with key financial targets for revenues, costs and capital adequacy. As of 9M18, the group's performance remains on track to hit 2020 targets, with TLAC ratio already exceeding its 2020 target.

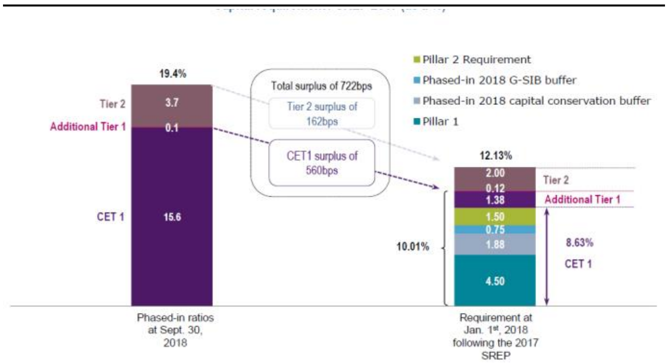
Figure 1: 9M18 Performance vs. TEC 2020 Financial Targets

	9M-18	TEC 2020 strategic plan[1]: Financial targets	
REVENUES	€18.1bn[2]	> €25bn	In 2020 (full year)
COMMISSIONS: BP/CE (EXCL. ERF[3])	+4.4%[4]	~ 3%	2017/2020 compound annual growth rate
COST/INCOME RATIO[2]	RB&I ≈ 65.7%[7] AM ≈ 67.5%[7] CIB ≈ 60.9%[7]	RB&I ≈ 64% AM ≈ 68% CIB ≈ 60%	In 2020
REVENUE SYNERGIES	€203m	€750m	In 2020 (full year)
CET1 RATIO	15.4%[5]	≥ 15.5%	As soon as possible during the life of the plan
TLAC RATIO	22.4%[6]	> 21.5%	At January 1st, 2019

Source: Company Data, KGI Research

Capital adequacy continues to remain strong, driven by organic capital creation. Excluding deductions from TEC 2020's initiatives, the group's CET1 ratio rose to 15.6% from 15.2% at 1 January 2018, driven by retained earnings and a change in risk-weighted assets (RWA) which saw contributions from the retail banking & insurance segment increase to 73% from 72% in 2017.

Figure 2: Capital Adequacy Ratio vs. Requirements



Source: Company Data, KGI Research

Besides having ample capital adequacy with CET1 and total surpluses of 560bps and 722bps respectively, the group also passed 2018 stress tests with a CET1 ratio of 10.7% in an adverse scenario, which is higher than the European weighted average and stronger than 4 of the other 5 french banks tested by the European Banking Authority (EBA).

Credit Recommendations: While BPCE's 2026 have been rated investment grade by S&P (BBB+), Moody's (Baa2) and Fitch (A), the bond is a subordinated issue which may be subject to mandatory write-down or conversion to equity if the issuer becomes subject to a resolution procedure.

Given the group's diversified revenue base with stable earnings, conservative risk policy and ample capital adequacy, we recommend exposure to BPCE's 2026 which is currently trading at 101.4 with a YTW of 3.8%. The issue has an optional redemption date on 3 June 2021 and a coupon reset at the 5-year SGD Swap Offer Rate + 245bps on 3 June 2021, which can help to migitate interest rate risks.

Financials

FYE 31 December

INCOME STATEMENT (EUR mn)	2016A	2017A	9M18A
Net Interest Income	10,904	10,232	-
Non Interest Income	13,254	13,488	-
Net Banking Income	24,158	23,720	18,157
Operating expenses	(16,673)	(17,098)	(13,066)
Operating Income	7,485	6,621	5,091
Cost of Risk	(1,423)	(1,384)	(903)
Profit Before Tax	6,321	5,513	4,380
Net Income	3,988	3,024	2,438
BALANCE SHEET (EUR mn)	**2016A**	**2017A**	**9M18A**
Total Assets	1,235,240	1,259,850	1,285,862
Total Customer Loans	666,898	693,128	651,306
Total Allowances	12,278	11,777	9,900
Total NPLs	23,427	22,918	22,100
Total Liabilities	1,166,104	1,188,649	1,213,677
Total Deposits	531,778	569,879	526,822
Total Equity	69,136	71,201	72,185
KEY RATIOS	**2016A**	**2017A**	**9M18A**
Net Interest Margin (%)	0.96	0.94	-
Cost/Income Ratio (%)	69.0	72.1	72.0
Loan/Deposit Ratio (%)	125.4	121.6	123.6
Non Performing Loans (%)	3.45	3.25	3.34
Equity/Assets (%)	5.60	5.65	5.61
CET1 (%)	14.20	15.40	15.60
CAR (%)	18.50	19.20	19.40
ROE (%)	6.9	4.8	5.9

Source: Company Data, KGI Research

KGI's Ratings

Rating	Definition
	KGI Securities Research's recommendations are based on an Absolute Return rating system.
BUY	>10% total return over the next 12 months
HOLD	-10% to +10% total return over the next 12 months
SELL	<-10% total return over the next 12 months

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