

January 15, 2010

Investment Grade Credit

European Banks

Austrian Banks: Still Wary

Revisiting Austrian banks: While the developing world growth outlook is looking up, the valuation case for the Austrian banks still looks questionable to us.

RZB: Heavily exposed to Ukraine, where the growth rebound will be bumpy to say the least; in addition, future group earnings look thin and given the size and breadth of CEE and Russian exposures, any negative newsflow from these territories would hit RZB.

Erste: Better than RZB, but largely in the price. We see a close correlation of their Tier 1 performances and hence contagion risk from negative newsflow on RZB, and little chance of a large-scale tender/exchange following its open market buybacks.

Not all bad, with NPL formation slowing, low reliance on ECB funding and both banks still paying coupons, but not enough to convince to be long, in our view.

Sell into the rally as liquidity remains thin in both of these names and before RZB exits the IG indices. We'd be selling the RZB €5.169% Tier 1, bid at 54.5, and the Erste €5.294% Tier 1, bid at 61.5. We'd also look to buy senior protection in CDS in RZB for 155bp and Erste for 130bp, with spreads back at tight levels.

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Trade Recommendations

Sell the RZB €5.169% Tier 1, bid at 54.5;

Sell the Erste €5.294% Tier 1, bid at 61.5.

Buy protection on RZB at 155bp

Buy protection on Erste at 130bp

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European Banks

Austrian Banks: Still Wary

With a revival in the fortunes of the Central and Eastern European ('CEE') forecast for 2010, we revisit the Austrian banks. While growth in many CEE economies fell much more than expected, in 2010 we are expecting a rebound (with the benefit of external assistance for some of the weaker countries). As such, our macroeconomists see a split recovery in 2010, with developing countries growing more rapidly than developed countries (see "2010 Outlook: From Exit to Exit", [Global Forecast Snapshots](#), December 9, 2009, Joachim Fels).

In spite of this, we still remain nervous on the two biggest Austrian banks, given their large foreign loan books, the relatively weak transparency surrounding their exposures and the sensitivity to any negative newsflow from such a wide range of countries. While Erste is a better bank than RZB, in our view, this is largely reflected in the price and, given the high correlation of the two banks, we would expect Erste to be as affected as RZB by negative news coming out of the region. Even though we believe that neither would be permitted to fail and both are currently paying coupons, we would look to sell these banks into the current rally, given the risk of negative newsflow from the region and/or banks, weak liquidity in both names and the low likelihood of wide-scale liability management. This is in line with the thesis that we put in [Cutting Back to the Core](#), January 11, 2010, that weaker banks are less likely to get rid of non loss-absorbing Tier 1s, given the high cost of replacing them with new, compliant instruments.

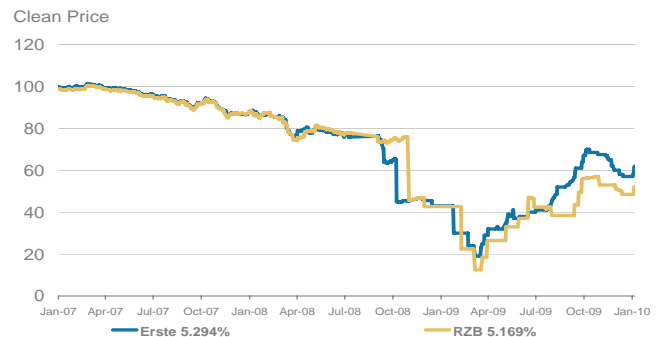
RZB: Weak Market Liquidity, Poor Transparency

Looking purely on a valuation basis versus peers, RZB is attractively priced, being the lowest cash price €Tier 1 that is still paying a coupon. However, from a fundamental perspective, it remains heavily exposed to higher-beta economies such as Russia and Ukraine, with significant amounts of corporate and FX lending. While these economies are set for growth in 2010, Ukraine (estimated to be €5.5 billion of exposure) is of a particular concern, given that the rebound in its GDP is technical and it is likely to be many months before it gets the next disbursement from the IMF. Therefore, we expect its recovery to be very bumpy, and any fresh concerns would only serve to reduce any liquidity (which is already poor) from RZB's Tier 1. With earnings

likely to remain weak in 2010, RZB also remains widely exposed to the rest of region, and while unlikely to benefit from any good economic news from any individual country, we believe that it would suffer on any bad news. Therefore, we would look to sell RZB €5.169%, currently bid at 54.5, into the rally while there is a degree of liquidity in the name.

Exhibit 1

Erste Bank €5.294% and RZB €5.169% Tier 1s



Source: Company data, Morgan Stanley Research

Erste: Contagion Risk from RZB

Erste Bank looks stronger than RZB on all measures (liquidity profile, exposures, earnings outlook), but as we can see in Exhibit 1, it has a very close correlation to RZB. While Erste does not have any material exposure to Ukraine, which is a positive, we believe that any concerns coming out of the CEE would equally have an impact on it. Further, while Erste has undertaken small-scale buybacks, these were opportunistic open market operations, and we do not believe that it will undertake a large-scale buyback, possibly preferring to allocate these funds to redeeming the Austrian government's capital injection. So, while Erste's small buybacks have served to support the price, they have also reduced liquidity in the name. Against this backdrop, given the correlation to RZB, we would equally look to sell the Erste Bank €5.294% Tier 1, currently bid at 61.5.

We'd also look to buy senior protection in CDS against RZB for 155bp and Erste for 130bp with these spreads now back at their recent tight. For those accounts that do not own bonds they can sell, this represents a cheap way of expressing a negative view on Austrian banks and any potential negative news coming out of the CEE and Russian territories.

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Exhibit 2

Tier 1 Sells

Bank	Currency	Coupon	Call	Price	YTC	YTP	Step	Structure/comment
RZB	€	5.169	16-May-16	54.5	17.6	10.8	3m Euribor+195bp	Vanilla Tier 1
Erste	€	5.294	28-Sep-16	61.5	14.7	9.9	3m Euribor+227bp	Vanilla Tier 1

Source: Morgan Stanley; YTC = yield to call; YTP = yield to perpetuity; *YTP stressed for missing two years worth of coupon.

No EC Restrictions

Although both Erste and RZB have received capital from the Austrian government, neither bank is under review from the EC, nor are they required to submit a formal restructuring plan. We understand from speaking to RZB that it has submitted its report to the EC to confirm this and justify its categorisation as a fundamentally sound institution. As we have previously noted (see [Consistently Inconsistent](#), November 16, 2009), one of the key metrics for determining whether an institution needs to submit a restructuring plan is whether the aid received is in excess of 2% of its RWAs. This is not the case for either RZB (€1.75 billion participation capital / €96.5 RWAs = 1.81%) or Erste (€1.224 billion participation capital / €106.6 billion = 1.14%). Therefore, at the present time, we would not expect either bank to face restrictions from the EC on hybrid coupons. In our view, this would only occur if either bank was required to get additional aid from the Austrian government. While this is not our base case at the present time, given the nature of RZB's exposures, we cannot rule this out as a possibility as we believe that the Austrian government would probably be the only source of capital available to RZB.

Coupons Not Pushed, Currently Paying

The RZB €5.169% is a non-cumulative perpetual Tier 1 and thus does not contain any write-down language. Coupons will only be paid if RZB records a balance sheet profit (RZB can transfer reserves into the P&L to ensure this happens) and, according to RZB, it has around €1.3 billion of free and hidden reserves available for this purpose. The bond contains pusher language and therefore if any payments are made on junior or parity instruments, this pushes the next coupon payment on the Tier 1. However, as the pusher only relates to a regular calendar year and looking at RZB's other outstanding securities, we believe that there are no coupon payments that will be made prior to the bond being paid in May that will push this coupon payment. The bank informs us that we can expect the coupon to be paid in 2010.

Erste Bank's €5.294% Tier 1 is also a vanilla Tier 1 with no express loss absorption and has pusher language linked to payments on junior and parity securities. However, looking at the details of its pusher language, coupon payments on the €

5.294% are only pushed if they occur within the next six months of a payment having occurred on a junior/parity security. Therefore, as the participation capital pays annually on December 31, this payment will not actually push the next coupon on the €5.294% due on September 28, 2010. However, based on Erste's 9M09 earnings of €720 million, we would expect Erste to pay on their CMS Tier 1s in June, which will ultimately push the payment on the €5.294%, in our view.

Tenders and Exchanges: Low Chance

In June 2009, RZB announced an exchange of its €5.169% at a price of 55% for a new 15% non-step Tier 1. At the time, we were dubious about the economics supporting this transaction, and ultimately the transaction was cancelled. We understand that this was due to a weak amount of interest as many holders did not want to take a haircut on their Tier 1 holding. **Given the small amount of hybrid securities that RZB has outstanding and the unsuccessful exchange, we assign a relatively low likelihood of RZB undertaking a large-scale fresh exchange/tender exercise in the near future.** Hence, for investors holding this bond purely for the low cash price on the expectation of a tender/exchange, we do not believe that this is likely to occur.

We understand that Erste opportunistically bought back some of its € Tier 1 5.294% during 2009, repurchasing a total of €64.39 million (equivalent to 16% of the issue), and it would appear that it had previously bought back €22.5 million of its CMS Tier 1 (issue size €275 million). While this type of activity provides a degree of valuation support for Erste's securities, the fact that it has done it in a form of open market buybacks suggests that it will only act opportunistically and may not give all holders a chance to exit, in our view. As such, while this activity will have given Erste's securities a degree of valuation support, it has also served to remove liquidity from the market. Equally, we believe there is an argument that the banks would prefer to try to redeem the Austrian government's capital injection than launch wide-scale tenders for its securities.

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Moody's Methodology: RZB to Fall Out of the Index

As we had previously described in [Moody's Hybrid Methodology](#), November 18, 2009, we believe that, as a result of the new Moody's hybrid rating methodology, RZB will fall out of the IG indices. The RZB €5.169% is currently rated Baa1/BBB-/NR and we would expect its Moody's rating to fall to around B1. While this is clearly negative, this should be largely expected by the market and so the impact should be relatively muted. However, as we highlight in [Say Hello to High Yield](#), January 7, 2010, we believe that investors should use the current market rally to exit bonds that will fall out of the index. Erste Bank's €5.294% Tier 1 was not included in the iBoxx indices as it was only rated by Moody's, although we would expect its rating to fall from A2 to a worst case of Ba2 under Moody's new methodology.

Systemic Support: Enduring

In line with our previous view (see [CEE: Reasons to be Fearful](#), December 3, 2008), we continue to believe that, as the two largest banking groups in Austria, neither Erste Bank nor RZB would be allowed to fail by the Austrian government. Since we last published, this view has been further backed up by the €1.75 billion capital injection made by the Austrian government into RZB as well as the government-guaranteed senior debt that both Erste and RZB have issued. Going forward, should either of these banks require additional capital or support from the Austrian government, we would fully expect it to be forthcoming, whether in the form of liquidity or capital. The key risk here is that if either bank were to receive additional capital, then this would trigger an additional review from the EC, which would likely result in the restriction of optional coupon payments.

Austrian Sovereign Strength

Given the large amounts of state support that have been used to support the European banking sector, it is clear that the strength of a country's banking system ultimately relies on the strength of the underlying sovereign. Looking at Austria, the economy has suffered the deepest recession in its post-war history, with real GDP set to have fallen by 3.5% in 2009, according to Morgan Stanley estimates. While public finances are set to worsen in 2010, our sovereign analyst Michelle Bradley does not view Austria's AAA/Aaa/AAA rating as coming under threat. Based on her fundamental analysis of European sovereigns' liquidity risk, fiscal position and debt sustainability, Austria comes firmly in the middle of the pack in terms of its ranking versus other European sovereigns (see [Tighter Range, More Supply but Continued Demand](#),

December 14, 2009). Further, we would highlight that Austria's AAA ratings were affirmed by S&P on December 7, 2009 based on the strong fundamentals and strategy for fiscal consolidation in 2010. Therefore, we attach a relatively low risk to concerns about the Austrian sovereign having a negative impact on the Austrian banks.

Exhibit 3

GDP Forecasts

%	Cz. Rep	Poland	Romania	Russia	Ukraine	Kazakhstan
2008	2.5	5.1	7.4	5.6	2.1	3.9
2009E	(3.8)	1.5	(6.8)	(9.0)	(15.0)	0.5
2010E	2.1	3.0	1.1	5.3	4.5	3.0
2011E	2.8	2.5	2.8	2.8	2.5	5.0

Source: Morgan Stanley Research estimates

2010: Developed Nations/Developing Nations – Split Recovery

Compared to the real GDP growth estimates in our last report on the Austrian banks (see [CEE: Reasons to be Fearful](#)), our economists' 2009 forecasts are set to come in universally worse than expected, most notably in Romania (2.3% forecast as at December 2008, current estimate of -6.8%), Russia (1.5%, -9.0%) and Ukraine (-3.5%, -15.0%). However, despite this weakening, 2010 estimates are now higher than had previously been forecast, with expectations of a strong rebound in Russia and Ukraine, in part lifted by the rapid support given to these countries by the IMF and EU. This ties into one of the key themes highlighted by our economists, namely that of a split recovery (see [2010 Outlook: From Exit to Exit](#)). However, this rebound is unlikely to be completely smooth, and we remain particularly concerned about Ukraine. As such, leaning on the work from our EM economists, we take a brief look at some of the higher-risk countries below (see [CEEMEA Economics: Rebounding, Still Far from Tightening](#), December 16, 2009, for more details).

Russia

Our economists remain positive on the outlook for the growth recovery in Russia in the near term, driven by large and late policy stimulus, and forecast 2010 growth to come in at 5.3%. Growth will also be boosted by their assumption of an average oil price of US\$82. However, in the longer term, they are more doubtful that a Russian resurgence will translate into strong, sustainable growth independent of oil prices. They see exchange rate appreciation and thus interest rates being forced down, leading to accelerating inflation in 2011, and believe that the longer-term environment for investment remains fragile.

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Ukraine

Unlike the rebound in Russian GDP, the recovery in Ukraine is largely technical, given how far Ukrainian GDP fell in 2009. Our economists believe that the forthcoming elections will prove to be a positive catalyst and expect the ultimate victor to reach a new deal with the IMF. However, they are concerned that the presidential elections will be followed by early parliamentary elections. This means it is unlikely that any deal with the IMF for the disbursement of funds can be reached prior to mid-year, leading to risks of rising inflation and falling FX reserves and meaning that perceptions of risk are likely to remain high in the interim period. However, Ukraine currently has a comfortable level of reserves, suggesting that six months without IMF support can be withstood without a new currency crisis. Our economists expect the recovery to be particularly bumpy but that sovereign default risk looks remote.

Theoretical CDS Price

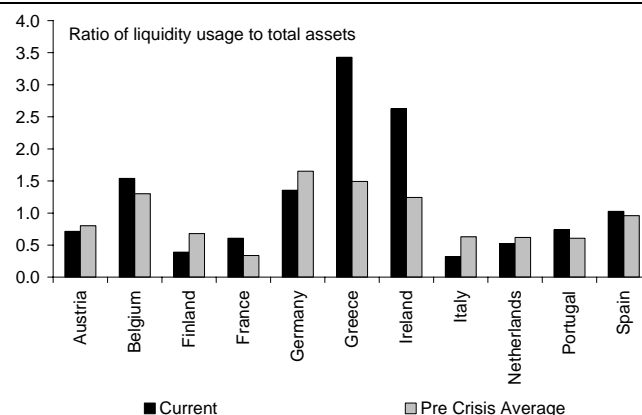
In our prior note, we calculated a theoretical CDS price based on a weighted average of both Erste and RZB's country exposures using sovereign CDS spreads. We update this analysis using 3Q09 exposures and current sovereign CDS spreads. Last time, RZB's theoretical CDS came out around 40% higher than its actual CDS price, supporting our view of buying protection, but this time the results show that Erste and RZB's theoretical CDS prices are pretty much line with the current trading levels of their 5-year senior CDS. This suggests that on this measure their current CDS spreads are around fair value.

ECB Liquidity Reliance: Low Risk

In the latter part of 2009, we saw a degree of systemic risk return to the market with concerns of the Greek banks' reliance on the ECB for funding. This all stemmed from what seemed like a reasonable request for banks to reduce their reliance on ECB funding, but the reaction in the market highlights the sensitivity of investors to the idea of liquidity withdrawal. As we can see in Exhibit 4, we do not believe that this will be an issue for the Austrian banks as they have a much lower reliance on the ECB for their funding compared with many of their European peers and their current usage is actually lower than their pre-crisis usage. To put this in context, RZB states that it is currently only receiving €3 billion of funding from the ECB.

Exhibit 4

ECB Liquidity Scheme – Current and Pre-Crisis



Source: Morgan Stanley Research

Liquidity: Short-Term Reliance Reducing

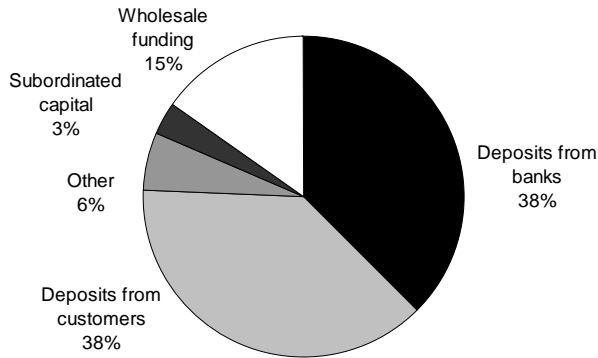
RZB remains very dependent on short-term funding, although the size of its maturity mismatch is shrinking. Looking at its balance sheet, we see that at 3Q09, €53.0 billion of its liabilities were funded by bank deposits, of which €37.2 billion came from money markets, equivalent to around 24% of its balance sheet. On the asset side, RZB has €37.9 billion of loans and advances to banks, of which €28 billion are held in money markets. While a €9 billion short-term maturity mismatch remains a source of concern, especially in light of forthcoming Basel requirements on liquidity, this has significantly reduced from a €21 billion short-term maturity at F2008. In fact, we actually remain relatively sanguine about the issue for the following reasons:

- We saw RZB's senior 5-year CDS spreads peak at around 530bp in early March 2009 (it is currently around 150bp), yet the bank was still able to fund itself, with money market funding peaking at €40.6 billion at 1Q09.
- While the market is focused on the ECB pulling back from providing liquidity to the market, we understand that RZB has around €18 billion of unencumbered assets that it could pledge to the ECB, which is more than sufficient to cover its short-term liability mismatch if required.
- Along with many other governments, Austria has a scheme for banks to issue government-guaranteed debt. As at 3Q09, only €19 billion of the €75 billion available had been drawn by the Austrian banks, of which RZB had taken only €4.25 billion. Therefore, there is still significant capacity for RZB to issue more government-guaranteed debt if required, with the scheme having been extended until end-2010.

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Exhibit 5

RZB Liquidity Profile (Total €141bn at 3Q09)

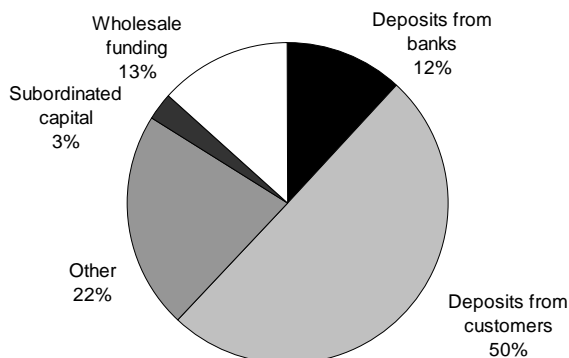


Source: Company data, Morgan Stanley Research

Erste has a better liquidity profile compared to RZB, with 60% of its funding coming from customer deposits compared with only 38% at RZB. Equally, Erste has managed to continue to grow its customer deposits over the course of 2009 (+3.7%), compared with a net outflow at RZB (-9.2% between F2008 and 3Q09). While Erste actually has a greater short-term funding mismatch than RZB (€13 billion between its deposits from banks and loans and advances to credit institutions), its overall reliance on short-term funding is significantly smaller. In a similar way to RZB, it has significantly reduced this mismatch since the start of the year, from €20.3 billion to the current €13 billion. Given our relatively sanguine view on RZB, with Erste's much greater deposit base and lower reliance on short-term funding, we are even more comfortable with Erste's liquidity profile.

Exhibit 6

Erste Bank Liquidity Profile (Total €189bn at 3Q09)



Source: Company data, Morgan Stanley Research

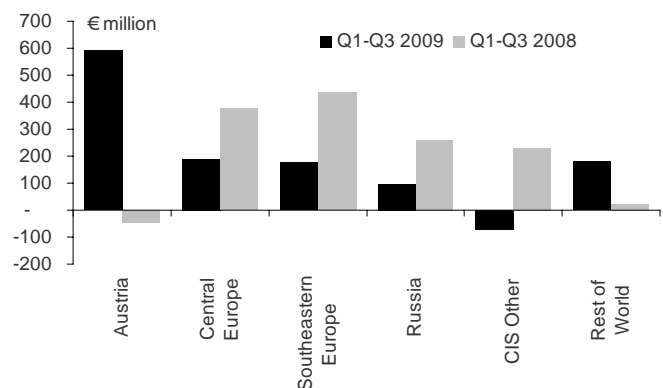
An Update on RZB

Earnings: Low Quality

Contrary to many expectations, RZB has remained profitable in the year to date, as we can see in Exhibit 7. Compared to 2008, PBT has been driven down across all its CEE/SEE/CIS operations by rising impairment charges. Against this, we see a marked increase in PBT in Austria, driven by the absence of write-downs and losses compared to 2008 and a strong trading performance, most notably in interest rate and FX trading. While the performance in the Austrian segment is positive, it is actually relatively low quality, having been driven by trading gains, and so this does not look sustainable to us. Further, looking at RZB's own earnings preview, it expects to record a PBT for 2009 of €600 million, thus implying a loss for 4Q09 (9M09 PBT: €805 million). Looking ahead, in their base case (70% probability), our equity analysts forecast RZB's 70%-owned subsidiary, Raiffeisen International, to remain marginally profitable in 2010 (PBT: €22 million), with PBT then growing in 2011 (€779 million). In their bear case (20% probability), our equity analysts forecast losses before tax of €1,029 million in 2010 and €441 million in 2011. So, it would seem that, at best, RZB will only be weakly profitable over the course of the coming year.

Exhibit 7

RZB: PBT 9M2008 versus 9M2009



Source: Company data, Morgan Stanley Research

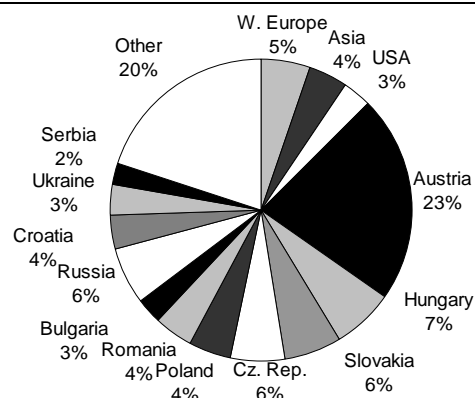
Loan Book: Falling Exposure but Still Heavily Exposed to CEE/SEE/CIS

Given the nature of RZB's business model, it remains heavily exposed to the developing countries of the CEE/SEE/CIS. However, with loan growth having shrunk/stopped, we note that, over the course of 2009, RZB has started to delever its balance sheet and its total loan book has shrunk by almost 10% to €76.6 billion. However, looking into the detail of this, it would appear that a sizeable portion is actually due to currency depreciation rather than risk reduction.

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Exhibit 8

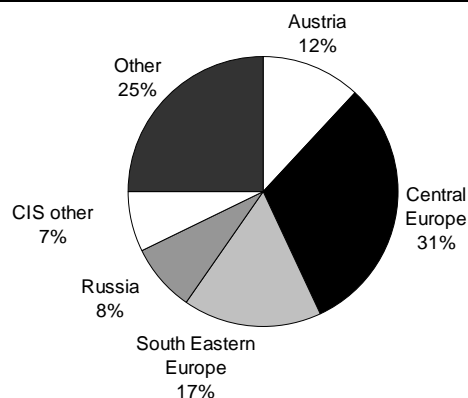
RZB: Concentration Risk (Total €173bn at 3Q09)



Source: Company data, Morgan Stanley Research

Exhibit 9

RZB: Loan Book by Country (Total €76.6bn at 3Q09)



Source: Company data, Morgan Stanley Research

With credit quality having weakened across the CEE/SEE/CIS countries, we focus on the weaker countries, and include those that have received emergency aid from the IMF (including Ukraine, Serbia and Romania). We also include Russia, given its importance to RZB. To measure this, we have used RZB's disclosed risk concentration, which encompasses loan and advances to customers and banks as well as off-balance sheet items. From Exhibit 10, it is clear that RZB's level of risk exposure to these higher-risk countries has reduced significantly from 608% of Tier 1 capital to 407%, mainly through a fall in its overall level of exposure. While the risk reduction is a step in the right direction, this degree of leverage to these countries remains a significant source of concern, in particular in Ukraine, given the higher-beta nature of these economies.

Exhibit 10

RZB: 'Higher-Risk' Country Risk Exposures

€million	30/09/09	% Tier 1	31/12/08	% Tier 1
Hungary	10,564	120%	11,711	157%
Romania	6,670	76%	7,456	100%
Ukraine	5,486	62%	6,748	90%
Serbia	3,424	39%	4,739	63%
Russia	9,850	112%	14,802	198%
Total	35,994	407%	45,456	608%
Tier 1 capital	8,834		7,471	

Source: Company data, Morgan Stanley Research

NPLs Slowing but Coverage Falling

As expected, asset quality has weakened considerably in 2009, with NPLs having risen from 2.3% to 5.0% over the year. As at 3Q09, it would appear that the rate of increase of NPLs is now starting to slow in most territories, as we can see from looking at *NPL – rate of change* in Exhibit 11. While this is tentatively positive, we would caution that we have only seen this trend over one quarter, and the absolute level of NPLs is set to continue growing. Further, in countries that have benefitted from external assistance, this will be reflecting the benefit of this aid, yet we would also expect further weakness in asset quality going forward as a result of the austerity packages that are normally associated with this type of aid.

Exhibit 11

RZB: NPLs, NPL Rate of Change and NPL Coverage

	Total loans				NPL ratio				NPL – rate of change			NPL coverage			
	30/09/09	30/06/09	31/03/09	31/12/08	30/09/09	30/06/09	31/03/09	31/12/08	3Q09-2Q09	2Q09-1Q09	1Q09-FY08	30/09/09	30/06/09	31/03/09	31/12/08
Austria	51,572	51,112	43,191	49,987	2.7%	2.4%	2.5%	1.7%	0.3%	-0.1%	0.8%	64%	71%	70%	73%
Central Europe	26,482	26,495	28,386	26,207	6.0%	5.1%	3.5%	3.1%	0.9%	1.6%	0.4%	56%	57%	64%	71%
Southeastern Europe	17,708	17,523	18,602	18,028	5.2%	4.7%	3.7%	2.1%	0.4%	1.0%	1.6%	69%	67%	67%	93%
Russia	7,060	7,728	9,976	9,036	8.8%	7.1%	2.8%	2.0%	1.7%	4.3%	0.9%	90%	108%	158%	207%
CIS other	6,334	6,381	7,158	6,947	15.3%	14.4%	9.6%	5.8%	1.0%	4.7%	3.9%	70%	63%	68%	83%
Other	5,187	5,790	6,720	6,236	4.3%	3.5%	3.4%	0.8%	0.8%	0.1%	2.6%	32%	33%	25%	102%
Total	114,343	115,029	114,033	116,441	5.0%	4.4%	3.5%	2.3%	0.6%	0.9%	1.2%	65%	68%	71%	87%

Source: Company data, Morgan Stanley Research

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Looking into RZB's loan book, we split out details of NPLs in RZB's corporate and retail loan book in Appendix 1. RZB is widely exposed to corporate lending, with large corporate customers accounting for 65% of RZB's customer loan book. In the corporate loan book, we see a generic slowdown in the rate of growth of NPLs, but the notable exception to this is for its Austrian corporate loans. While the absolute level of NPLs is lower (NPLs of 3.9% versus 6.3% for the corporate book), this is a source of concern as it is RZB's largest single exposure and, while collateral should be more assured, NPL coverage remains relatively low at 53%. In the CIS other category (which we regard effectively as Ukrainian lending), NPL formation has slowed, but as we see this has been quite erratic, with NPLs having grown from 5.3% at 1Q09 to 12.2% at 2Q09 and now 14.2% as at 3Q09. Therefore, it is tricky to extrapolate a clear trend from this, given the rapid growth in NPLs in 2Q09.

For retail loans, the generic trend of slowing NPL formation also mirrors what we have seen for corporate loans. The most notable exception is the CIS Other retail loans, where NPL formation continues to accelerate, and this is a source of concern with total NPLs of 23.1%. As we believe that this primarily relates to the Ukraine, this is a particular cause for concern. The current NPLs are relatively well covered (73.1% NPL coverage), but with total exposure of €2.2 billion (€1.6 billion after provisions), this remains material for RZB.

Overall, the generic slowing trend of NPL formation in RZB's CEE/SEE/CIS lending operations could be taken tentatively as a positive sign. However, this is based off of a very short history and NPLs continue to grow on an absolute basis. Further, there is also a potential issue relating to the non-accrual of interest on NPLs, although unfortunately, it is hard to assess the impact on net interest income as the accrual of interest on NPLs is treated differently region by region and as we lack sufficient disclosure. However, this remains an additional source of concern from an earnings perspective.

NPL Coverage Falling

One clear trend that is evident from Exhibits 12-13 is that RZB's NPL coverage has consistently declined since the start of the year, and this has clearly been an important driver behind its earnings performance. This is a trend that we have consistently seen with the major CEE and Western EU banks, and so it is not simply a trend that we are seeing at RZB. As our equity colleagues discuss, RI's NPL coverage is above the average level of NPL coverage of its peers; however, this is necessary, given its loan exposures (see [Raiffeisen International: Growth Prospects Limited + Challenges Ahead; UW](#), October 27, 2009, Ronny Rehn).

On a slightly more positive note, our equity colleagues now see RI's loan loss provisions peaking in 2009 and then staying flat, which should assist its NPL coverage going forward. Looking at the highest-risk parts of RZB's book, coverage of Russian and CIS Other NPLs remains relatively high at 90% and 70%, respectively. While this level of coverage is encouraging, it is not possible to get much certainty on collateral values, and we understand that there can be issues with taking over collateral in certain regions.

Exhibit 12

RZB: Corporate NPL Coverage Ratios

	30/09/09	30/06/09	31/03/09	31/12/08
Austria	53.7%	70.1%	76.3%	84.6%
Central Europe	52.6%	53.1%	61.6%	74.4%
Southeastern Europe	54.6%	50.6%	46.2%	79.3%
Russia	87.0%	113.4%	222.5%	481.8%
CIS other	66.8%	53.1%	80.9%	120.4%
Other	31.7%	33.0%	24.7%	102.0%
Total	58.0%	61.7%	68.8%	96.6%

Source: Company data, Morgan Stanley Research

Exhibit 13

RZB: Retail NPL Coverage Ratios

	30/09/09	30/06/09	31/03/09	31/12/08
Austria	133.3%	133.3%	114.3%	133.3%
Central Europe	62.3%	65.3%	66.8%	65.4%
Southeastern Europe	87.1%	89.0%	98.9%	107.1%
Russia	97.8%	102.3%	117.3%	115.7%
CIS other	73.1%	72.1%	62.0%	69.2%
Total	75.8%	78.8%	78.5%	82.7%

Source: Company data, Morgan Stanley Research

Unfortunately, RZB does not give information on restructured loans, so it is hard for us to grasp whether loans are bypassing the NPL category by effectively being restructured. Based on work by our equity analysts (see *Raiffeisen International: Growth Prospects Limited + Challenges Ahead; UW*), using disclosure from peers, they estimated the amount of sub-standard loan formation in the year to 2Q09 as being €2.9 billion. Then, based on their view of optimal marginal coverage of sub-standard loans at 23% and marginal NPL coverage at 58%, they estimated their earnings impact on RI. Ultimately, to have provisioned for these loans at an optimum level would have had a negative pre-tax impact of €671 million. This would effectively wipe out all of RZB's 2009 earnings, and we estimate that it would reduce RZB's core Tier 1 to around 8.0% based on 3Q09 figures. While this shows that RZB has the capacity to increase loan loss provisions, it also demonstrates the fine line for RZB between adequately provisioning for NPLs and remaining profitable (and hence generating capital organically).

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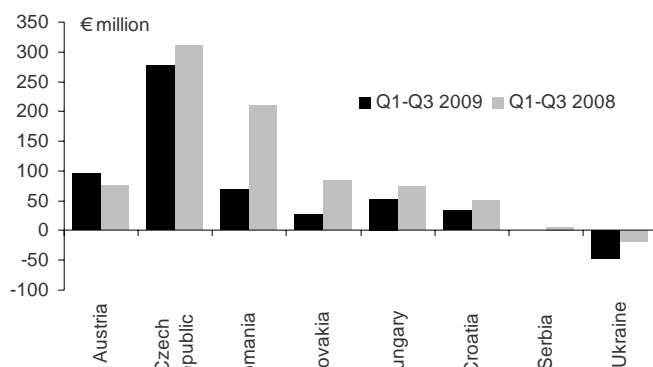
An Update on Erste

Earnings: Rising Impairments

Erste Bank's profits have fallen significantly compared to the prior year, as we can see on a segmental basis in Exhibit 14. The single-biggest driver of this decline has been the increase in impairment provisions, which have risen from €602 million in 9M08 to €1,449 million in 9M09, and equally as we saw with RZB, the bottom line has been boosted by a marked increase in net trading income from €185 million in 9M08 to €503 million. Despite the increase in provisions, our equity analysts expect provisions to peak in 2009 and stay at a similar level in 2010 as NPL formation slows. They also remain relatively constructive on Erste's earnings as we look ahead on the basis of good net interest income progression, and have significantly cut the likelihood of their bear case occurring (from 35% to 15%) while increasing their weighting of their base case to 70% (from 60%).

Exhibit 14

Erste Bank: PBT 1Q-3Q08 versus 1Q-3Q09



Source: Company data, Morgan Stanley Research

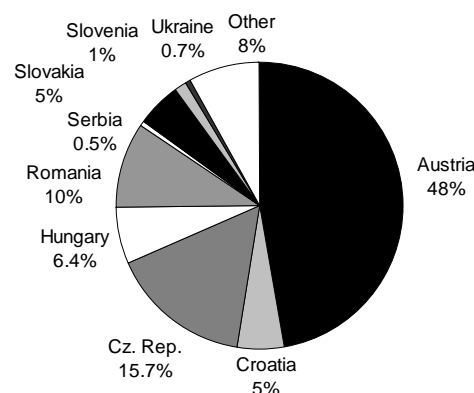
In their base case, our equity analysts expect Erste to record a net profit after minorities of €922 million in 2009, €689 million in 2010 and €1,101 million in 2011, and this will assist Erste in organically growing its core capital. Even in their bear case, they have Erste recording a net loss (after minority interests but before paying on their capital participation) of €528 million in 2010 and a €157 million profit in 2011. While previous concerns had focused on Erste's capitalisation, post its €1.7 billion rights issue, even in their bear case, core capital would trough in 2011 at a level of 6.4%, which is low but should still be manageable, in our view.

Erste Bank's exposures remain better diversified than those of RZB, with a relatively larger proportion of Austrian loans (38% versus 21% for RZB based on total exposure), which we regard as lower-risk compared to CEE/SEE/CIS loans.

Within its CEE book, Erste only has a relatively small exposure to Ukraine (€627 million) and its largest foreign exposure is to the Czech Republic, which is a more stable territory, according to our economists. However, it still has sizeable exposures to other countries (e.g., Romania), whose economies came under significant pressure over 2009.

Exhibit 15

Erste Bank: Total Loan Book (Total €130bn at 3Q09)

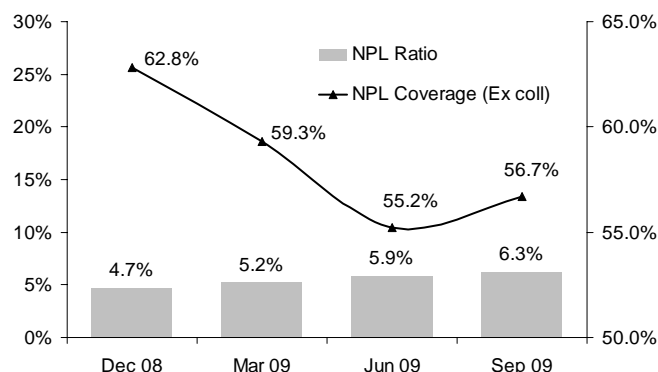


Source: Company data, Morgan Stanley Research

As we can see from Exhibit 16, on an aggregate level NPL formation has been slowing over the course of the year. This general trend is consistent with the improving macro environment in the CEE economies, whose loans have accounted for 83% of the growth in NPLs over the course of 2009. However as with RZB, we only saw the inflection point as at 3Q09 and, therefore, should be wary of reading too much into this.

Exhibit 16

Erste Bank: NPLs and NPL Coverage at 3Q09



Source: Company data, Morgan Stanley Research

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Exhibit 17

Erste Bank: NPLs, NPL Rate of Change and NPL Coverage

	Total exposure				NPL ratio				NPL – rate of change			NPL coverage			
	30/09/09	30/06/09	31/03/09	31/12/08	30/09/09	30/06/09	31/03/09	31/12/08	3Q-2Q	2Q-1Q	1Q-FY08	30/09/09	30/06/09	31/03/09	31/12/08
Retail SME	157,989	154,336	151,953	148,442	4.8%	4.6%	4.2%	3.8%	0.2%	0.4%	0.4%	54.9%	54.9%	57.9%	62.0%
Austria	86,156	85,472	84,810	82,091	5.0%	5.1%	5.0%	4.7%	-0.1%	0.1%	0.3%	50.0%	50.0%	50.9%	53.3%
EB	36,081	38,053	37,169	35,185	3.9%	3.8%	3.6%	3.5%	0.1%	0.2%	0.0%	46.6%	48.2%	52.5%	54.6%
Savings Banks	50,075	47,419	47,641	46,906	5.8%	6.2%	6.1%	5.6%	-0.4%	0.1%	0.5%	51.6%	51.0%	50.1%	52.6%
CEE	71,833	68,864	67,143	66,351	4.6%	4.0%	3.2%	2.7%	0.6%	0.8%	0.5%	61.5%	62.6%	71.6%	81.0%
Czech Republic	29,270	28,131	28,737	28,613	2.7%	2.3%	2.0%	1.9%	0.4%	0.3%	0.2%	60.1%	64.7%	59.8%	59.7%
Romania	15,137	13,862	13,138	13,243	7.9%	6.7%	5.2%	3.8%	1.2%	1.5%	1.4%	54.9%	57.8%	78.4%	106.0%
Slovakia	10,099	9,740	9,474	8,526	4.0%	3.6%	3.2%	3.2%	0.5%	0.3%	0.0%	77.4%	77.5%	81.9%	82.2%
Hungary	8,965	8,820	8,310	8,549	5.5%	5.4%	4.0%	2.9%	0.1%	1.4%	1.1%	46.2%	37.8%	39.5%	50.0%
Croatia	7,037	6,877	6,093	5,923	3.7%	3.3%	3.2%	3.1%	0.4%	0.1%	0.1%	85.1%	90.4%	97.5%	94.6%
Serbia	698	714	683	750	5.3%	4.9%	4.7%	3.9%	0.4%	0.2%	0.8%	121.6%	117.1%	125.0%	134.5%
Ukraine	627	720	708	747	12.1%	10.0%	3.0%	1.6%	2.1%	7.0%	1.4%	82.9%	83.3%	219.0%	258.3%
GCIB	41,831	44,007	46,833	46,250	2.6%	2.2%	1.6%	1.4%	0.4%	0.6%	0.2%	56.6%	60.4%	63.9%	61.9%
Group Markets	17,737	17,718	13,468	15,912	0.1%	0.1%	0.2%	0.3%	0.0%	-0.2%	0.0%	20.0%	9.1%	3.2%	2.4%
Corporate Centre	9,097	6,731	4,834	5,063	0.3%	0.2%	0.0%	0.0%	0.1%	0.2%	0.0%	480.0%	38.5%	100.0%	NA
Total	226,654	222,792	217,088	215,667	3.8%	3.6%	3.3%	2.9%	0.2%	0.3%	0.4%	56.3%	55.5%	58.3%	61.6%

Source: Company data, Morgan Stanley Research

However, this is consistent with our equity analysts' view that Erste's provisions will peak in 2009 and stay at similar levels in 2010. The reason why they do not see provisions declining is that they believe Erste will need to increase its marginal coverage levels of NPLs, especially as we see that in absolute terms its NPL coverage has fallen since the start of 2009 and is below that of RZB (57% versus 65%) – albeit its loan mix is somewhat less risky than that of RZB.

Exhibit 17 breaks out the development of Erste's NPLs in more detail. Looking on a micro country level, we see that the pace of NPL formation has slowed in all territories with the exception of the Czech Republic, Slovakia, Croatia and Serbia, although the pace of growth of NPLs in these countries remains relatively modest. As with RZB, Erste's Austrian NPL coverage looks relatively low at 50%, although we believe that recoveries should prove to be more predictable and therefore justify a somewhat lower coverage ratio to an extent.

Further, although NPL growth is slowing in Romania, it still increased by 1.2% in 3Q09 to 7.9% and remains an area of risk, given the size of Erste's exposure to the country and as NPL coverage has slipped from 106% at FY08 to 54.9% at 3Q09, and we believe that this territory remains a source of risk for Erste. Having said this, Erste has the capacity to increase NPL coverage; for example, to increase the NPL coverage of its entire risk exposures to 65% (equivalent to RZB's overall NPL coverage) would cost €756 million pre-tax, equivalent to around 70% of its 9M09 PBT) but, once again as with RZB, this would be at the expense of organic capital generation.

Exhibit 18

Higher-Risk Exposures

€million	30/09/09	% Tier 1	31/12/08	% Tier 1
Hungary	8,965	80%	8,310	109%
Romania	15,137	135%	13,138	172%
Ukraine	627	6%	708	9%
Serbia	698	6%	683	9%
Total	25,427	228%	22,839	299%
Tier 1 capital	11,173		7,641	

Source: Company data, Morgan Stanley Research *Pro forma for €1.7 billion equity raise.

Erste continued to increase its exposure to higher-risk countries over the course of the year. It looks like most of this increase has been in retail and SME lending, and we understand that new lending has been undertaken using tighter lending standards and that lending in CHF and USD loans for private individuals has been suspended. This lending has been supported by fresh capital, with Erste having raised €1.7 billion of participation capital (of which €1.224 billion was placed with the Austrian state and €540 million went to private investors) and €1.7 billion from a rights offer. It is this fresh capital that has driven down the relative level of exposures to higher-risk countries over the course of the year. While these exposures are still sizeable in the context of Erste's capital base, it has a relatively small exposure to the weakest countries (e.g., Ukraine, where it has a €564 million net exposure). Further, while Romania remains a source of concern, earnings from more benign territories (e.g., the Czech Republic and Austria) should help to mitigate losses arising in these territories.

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Appendix 1

RZB: NPLs, NPL Rate of Change and NPL Coverage: Corporate and Retail

Corporate (€million)	30/09/09	30/06/09	31/03/09	31/12/08	NPL ratio				NPL – rate of change		
					30/09/09	30/06/09	31/03/09	31/12/08	3Q09-2Q09	2Q09-1Q09	1Q09-FY08
Austria	20,834	21,942	21,274	22,002	3.9%	3.0%	2.8%	2.2%	0.9%	0.2%	0.6%
Central Europe	14,882	14,932	14,973	15,666	6.7%	5.9%	4.2%	3.1%	0.8%	1.7%	1.1%
Southeastern Europe	7,294	7,750	8,192	8,470	6.8%	6.0%	5.1%	2.2%	0.9%	0.9%	2.9%
Russia	4,593	5,151	5,869	6,486	9.2%	6.2%	1.9%	0.7%	3.0%	4.3%	1.2%
CIS other	3,298	3,537	3,972	3,934	14.2%	12.2%	5.3%	2.7%	1.9%	7.0%	2.5%
Other	3,396	3,868	4,299	4,503	6.5%	5.2%	5.3%	1.1%	1.3%	0.0%	4.2%
Total	54,297	57,180	58,579	61,061	6.3%	5.2%	3.7%	2.2%	1.1%	1.4%	1.5%

Retail (€million)	30/09/09	30/06/09	31/03/09	31/12/08	NPL ratio				NPL – rate of change		
					30/09/09	30/06/09	31/03/09	31/12/08	3Q09-2Q09	2Q09-1Q09	1Q09-FY08
Austria	122	109	88	97	4.9%	5.5%	8.0%	6.2%	-0.6%	-2.4%	1.8%
Central Europe	9,359	9,140	9,113	9,222	6.2%	4.9%	4.0%	3.5%	1.3%	0.9%	0.4%
Southeastern Europe	7,058	7,233	7,337	7,605	5.8%	5.0%	3.6%	2.6%	0.8%	1.4%	1.0%
Russia	1,958	2,184	2,353	2,669	9.5%	10.1%	7.1%	5.0%	-0.6%	3.0%	2.1%
CIS other	2,190	2,364	2,615	2,632	23.1%	20.5%	18.4%	11.1%	2.6%	2.1%	7.3%
Other	-	-	4	-			0.0%		0.0%	0.0%	0.0%
Total	20,687	21,030	21,510	22,225	8.1%	7.2%	6.0%	4.3%	0.9%	1.3%	1.7%

Source: Company data, Morgan Stanley Research

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Equal-weight/Hold	1093	45%	322	46%	29%
Not-Rated/Hold	23	1%	3	0%	13%
Underweight/Sell	376	15%	82	12%	22%
Total	2,445		693		

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European Banks

Austrian Banks: Still Wary

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