HOLD

QUARTERLY **INSIGHTS**

HOLD ASSET MANAGEMENT — THE CENTRAL-EUROPEAN VALUE-BASED EQUITY SPECIALIST

FIRST (ERSTE) IN QUALITY, LAST IN PRICE PERFORMANCE?

Q2 - 2022

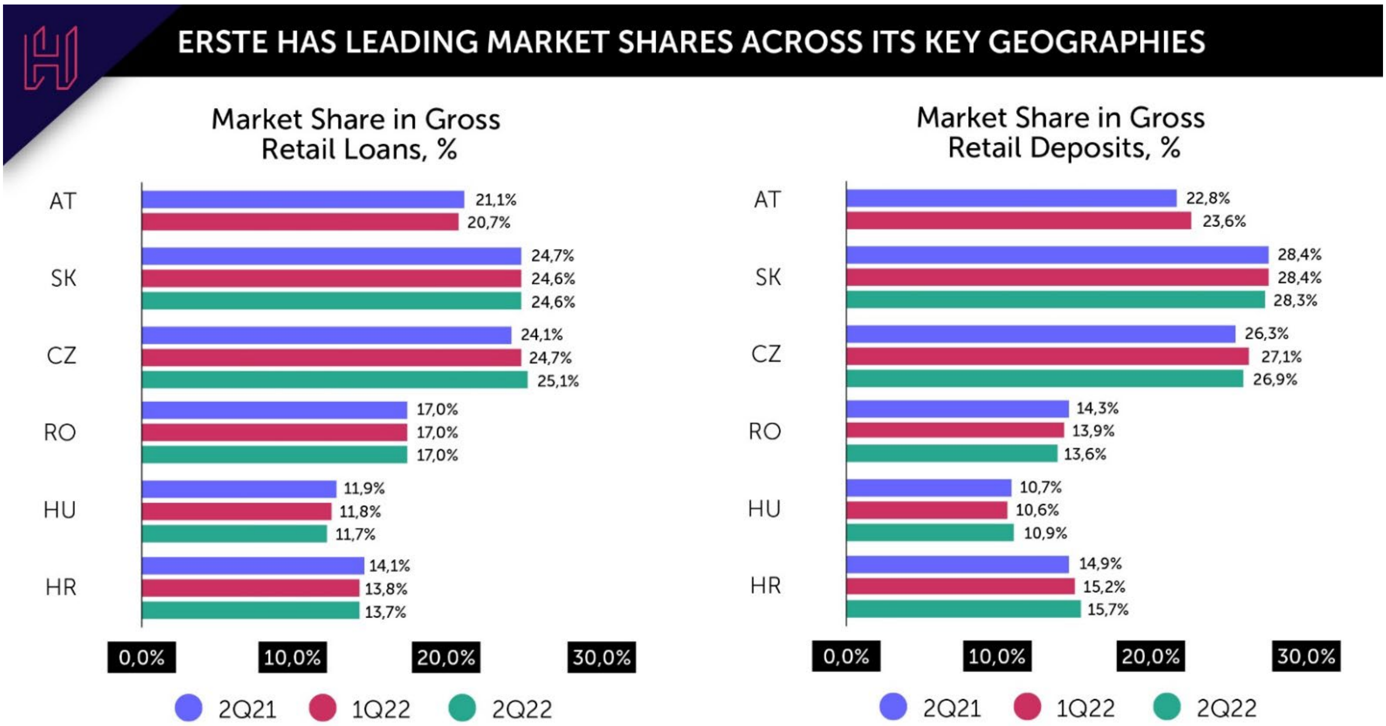
Russia's invasion of Ukraine presented Central Eastern European (CEE) economies with difficult challenges. In this uncertain macroeconomic backdrop share prices of regional banks dropped significantly. Some banks' subsidiaries directly impacted by the conflict through Russian exposures, while others face unresolved issues of carrying risky loan books and struggle with inadequate capital levels. Erste Bank clearly stands out with a clean slate, however its price performance tells a different story. We are looking to get to the bottom of it whether its weak performance is warranted or an attractive buying entry point is right in front of us?

MARGINAL EXPOSURE, MASSIVE DROP IN PRICE

Needless to say that the current war has negatively impacted regional banks with subsidiaries in the Ukraine, Russia or Belarus. OTP and Raiffeisen among the ones hit hardest, however Erste's share price declined by almost as much despite not having material exposure to the conflict zone. Russian, Ukrainian, and Belarusian direct exposure amounts to only 0.02% of Erste Group's balance sheet.

REGIONAL CHAMPION ON CHEAP MULTIPLES

Erste bank is the largest regional bank with a pronounced retail focus, servicing sixteen million clients in seven countries with two thousand branches and forty-five thousand employees. A leading banking group in the region, having the largest market share in most countries. As a result of its positioning, efficiencies of scale should translate into effective pricing power. However, Erste's 0.6 P/BV hints that the market is pricing in long-term value destruction. Icing on the cake is a recent „HOLD" recommendation put out by a sell side analyst of a leading global investment bank in anticipation of a 40% appreciation potential.



Source: Morgan Stanley, HOLD Asset Management

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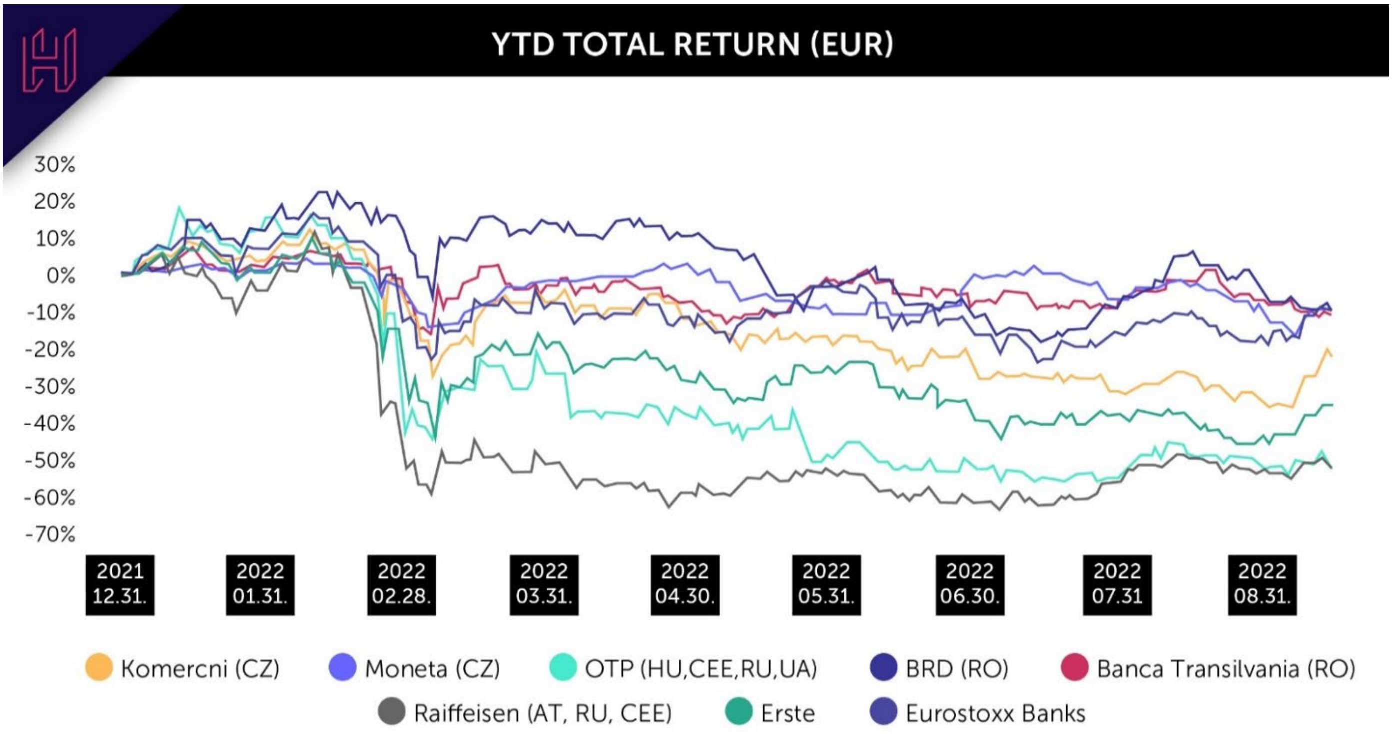
WHEN THE SUM OF THE PARTS DO NOT ADD UP

The Czech and the Austrian operation contributes most to Erste Bank's value but the Slovakian and Romanian markets are just as important with first or close second market position in these countries. Should we take the weighted average loss of regional competitors' share prices, Erste's pricing is not justified by any means. Erste's -35% year to date total return significantly underperforms its Austrian (Eurostoxx Bank Index) -9%, Czech (Komercni -22%, Moneta -10%), Romanian (Banca Transilvania -11%, BRD -9%) benchmarks. Only the two directly impacted competitor (OTP, Raiffeisen) lag behind Erste.



Source: Bloomberg, HOLD Asset Management

YTD TOTAL RETURN (EUR)

Erste	Eurostoxx Banks	Komercni (CZ)	Moneta (CZ)	Raiffeisen (AT, RU, CEE)	OTP (HU, CEE, RU, UA)	BRD (RO)	Banca Transilvania (RO)
-35%	-9%	-22%	-10%	-51%	-51%	-9%	-11%

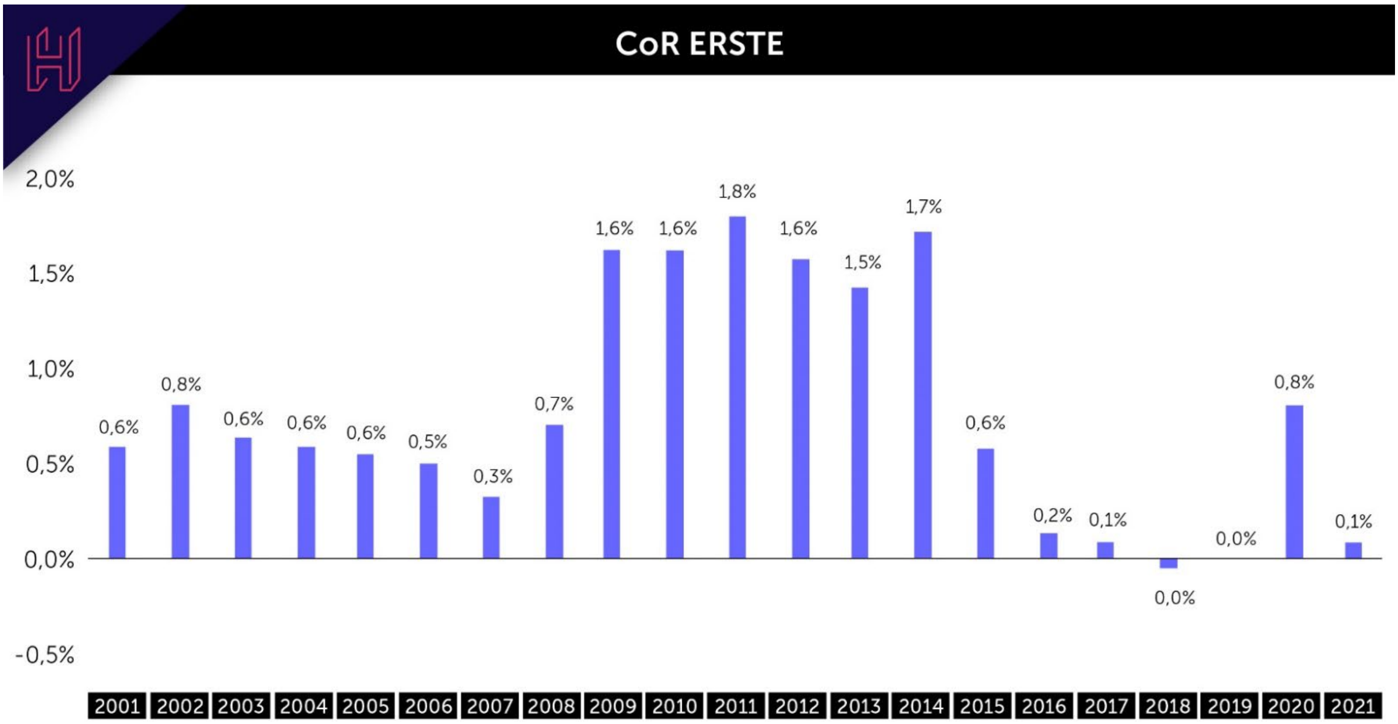
Source: Bloomberg, HOLD Asset Management

NII HAS ALREADY IMPROVED, MOREOVER ECB HIKE IS ON THE VERGE

CEE Central Banks have been hiking interest rates for quite some time now, which could benefit banks' net interest income up to a certain point. Primary drivers for Erste are the ECB and CNB policy rates. As the Czech National Bank (CNB) already hiked its policy rate to 7%, ECB followed by moving away from negative rates thereby primarily helping Austrian (and Slovakian) operations. Considering that these rate increases trickle down, the Czech and ECB moves likely increase income by EUR 300 million and EUR 250 million respectively, resulting in a 2.7% ROE increase.

THE BIG QUESTION MARK IS THE COST OF RISK

Without doubt the key going forward is determining how negatively the upcoming recessionary environment and energy crisis will impact the asset quality of banks. Looking at the Great Financial Crises (GFC) as a guidepost to aid us in our understanding of the current dynamic, Erste struggled with increasing losses on its loan books for several years. Six years prior to GFC, Erste operated with 0.6% CoR, which moved up to 1.6% thereafter and stayed at such an elevated level for the following six years, which increased loan loss by 1% annually for the full term. One can view this additional write-off as an expense. Assuming the current conflict inflicts the same magnitude of cumulative loss of 6% on the loans, Erste's share price should have fallen by EUR 18.5. In fact, its share price dropped by EUR 27 since the onset of the war.

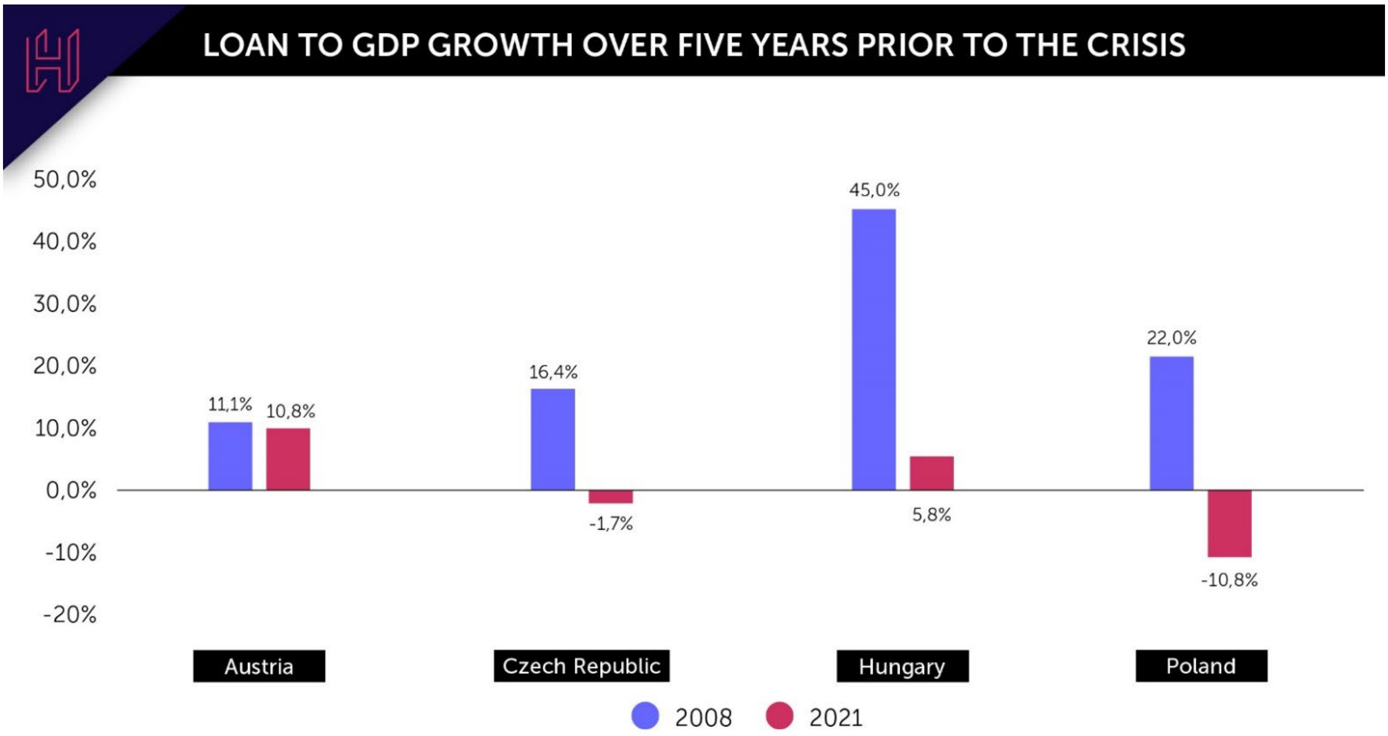


Source: Bloomberg, HOLD Asset Management

CALCULATING WITH 2008 IS STILL TOO PESSIMISTIC

To put it all in perspective, we want to emphasize that the 2008 GFC was the largest financial crises since 1929 and parallels to that era are somewhat misleading. Leading up to 2008, in countries where Erste Bank operates lending standards were not as prudent compared to those in the years prior to 2022. What's more, foreign currency lending, the main culprit of loan losses of the time, almost completely diminished. Including corporate loans, total foreign currency loan exposure stands only at 10%, needless to say a manageable credit risk stemming from FX fluctuations. On top of that, since 2008 regulatory standards improved and stricter Basel framework, and debt service, LTV requirements were put in place. Moreover, the GFC was a deflationary crisis, meanwhile currently we are experiencing an inflationary crisis. The former is much harmful for the financial sector due to the collapse of collateral values.

We are of the view that the Russia-Ukraine conflict will have a less severe economic impact hence the loan loss equivalent to EUR 18.5 per share presumes the most negative outcome.



Source: Bank for International Settlements, HOLD Asset Management

Currently Erste Bank has a stable loan portfolio with NPL of 2.2% and 91.8% cash coverage.

Erste's CET1 ratio currently stands at 14.2%, which is comfortably over the regulatory requirement of 10.4%. Clearly a much stable position than the one the bank had during GFC. Although regulation and the assessment (calculation method) of capital has gone through major changes hence an apple to apple comparison is rather difficult, the main point regarding capital standing remains valid. However, Tier1 Risk Based Capital Ratio is available for both periods, and shows a notable increase from 7% in 2007 to 16.5% in 2022Q2.

In conclusion, the deterioration of the macro environment in Central Eastern Europe, the lower growth outlook along with increasing losses on the loan book are more than priced into Erste' shares. Additionally, increasing local rates are beneficial for interest income of banks in general, which partially offsets losses on the loan books. In addition to its low 0.6 P/BV ratio, Erste Bank trades below 6 P/E, even if we calculate with its 2023's earnings, which contains an elevated cost of risk level. All in all, this valuations offers a good entry point for a market leader quality bank with an outstanding risk reward currently hence among one of our top picks in our portfolios.