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ISSUER COMMENT

Kommunalkredit: Unwinding exerts pressure on its financial profile, but remains credit positive for bondholders

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Whilst we expect the unwinding of Kommunalkredit Austria AG (KA; Baa3 stable, E/caa3)[1] to lead to a gradual erosion of its earnings and, potentially, its capital, we consider that the improved certainty for bondholders is credit positive, particularly in the context of the European Commission's (EC) approval, granted on 19 July.

KA's half-year results, published on 13 August, illustrate that the run-off of its banking business is exerting additional pressure on its already weak and volatile earnings. Net interest income, adjusted for a one-off effect, recorded a sharp 55% decline to €12 million; in addition, more than €9 million in deferred tax assets was written off as the bank had to adjust downward its future earnings forecasts in the context of the required unwinding of bank.

The EC approved KA's run-off, stating that previous support measures now comply with EU state aid rules as the Austrian authorities' failure to privatise the bank by the end of 2012 has been compensated for by KA's exit from the lending market.

The EC explicitly stated that the Austrian State will provide contingent capital and liquidity support, if needed, implying that additional state aid, if required, would not necessarily trigger renewed investigations from the anti-trust authorities. Although we do not rule out entirely the possibility that future changes in state-aid related regulation could challenge such renewed government support and the additional cost to taxpayers that such support would imply, we take the view that the latest EC decision enhances planning security for the benefit of the bank and its lenders.

1 The bank ratings shown in this report are the banks' deposit ratings, their standalone bank financial strength ratings/baseline credit assessments and the corresponding rating outlooks. KA's standalone E BFSR does not carry an outlook.

The EC's decision may also have positive implications for KA's ability to independently manage required funding in the market during the run-off, thus lowering the risk of KA requiring funding support in the future. In its half-year 2013 report, KA stated that its funding costs were elevated during the reporting period due to uncertainty over the bank's future after the Austrian government (Aaa negative) failed to meet the December 2012 deadline for KA's privatisation and stopped the divestment process in May 2013. With the prospect that KA will remain (almost) 100% owned by the government, and the government's implicit commitment to manage the unwinding in an orderly fashion, KA may be better able to fund the balance sheet during the run-off, and at more affordable cost.

We consider KA to be at risk of generating losses over the next few years as eroding interest income and decreasing economies of scale and efficiencies will result in operational shortfalls, although we note that KA expects to post a profit in 2014 and intends to further pursue its consultancy business (which is in compliance with the EC's decision). For 2013, we expect the bank to post a loss, as returns in H2 2013 will not suffice to compensate for the sizeable €17 million loss reported for H1 2013 (based on IFRS, at group level).

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