Davy Credit Research

AIB H1 Results Preview

July 18 2016

DAVY

Margin gains and NPL improvement, but pension deficit weighs on capital generation

DAVY VIEW

AIB's H1 results (July 28th) are expected to show continued improvement in interest margins and new lending activity. Non-performing loans will reduce further, although at a slower pace, with write-backs also subsiding. Although trading performance may not benefit capital given the swing in the pension deficit, a FL CET1 ratio of c.13% still leaves the AT1s (10.5/10.9% yield) as attractive, in our view. UK operations will come under scrutiny following the referendum result, especially given the notable contribution (30%) to 2015 lending activity.

Margin gains drive underlying improvement

AIB's net interest margin (ex-ELG) grew from 1.97% in FY 2015 (2.02% exit) to 2.09% in Q1, and we anticipate a similar H1 2016 margin out-turn of 2.09% as banking margin gains are offset by reduced treasury income. The bank's most recent mortgage rate cuts only take effect from the start of July. Our full year forecast of 2.11% therefore sees further improvement in H2 as the uplift from the CoCo's redemption in July is partly offset by mortgage rate pressures. New lending activity grew by 17% during Q1, with strong activity noted across corporate, SME and personal lending sectors, following 49% growth during 2015.

Pace of asset quality improvement to slow

AIB's impaired loan balances have fallen substantially to €12bn as of Q1 2016, which represents a 60% decline from peak. The Q1 reduction represented a slowdown in the rate of improvement, falling by only €1bn versus €4.9bn in H2 2015 and €4.2bn in H1 2015, although AIB recorded a net write-back of €109m in Q1 versus €923m in FY 2015. Management previously targeted a further impaired loans reduction of €3-5bn of gross loans in H1 2016. We expect impaired loans to continue to reduce but at a slower pace, especially as Irish mortgages now represent nearly half of the outstanding.

Pension deficit swing to stall capital growth

AIB's CET1 capital ratio was relatively unchanged in Q1 2016 (13.1% fully-loaded (FL) /15.9% transitional) as profits were offset by an increase in the deficit in the Irish DB pension scheme mainly due to a lower discount rate. The bank disclosed a €500m swing in the first two months of the year, which we reflected in our 2016 forecasts, but €AA corporate bond yields have since declined by a further 52bps to the end of June (£ -28bps). Therefore AIB's H1 FL CET1 ratio is likely to be relatively unchanged on further pension pressures rather than our forecast 13.6% ratio.

Outlook for the UK operation is uncertain

AIB's UK operations will come under particular scrutiny at results, and we have yet to make any forecast adjustments. AIB UK accounted for 16% of group loans and 14% of 2015 pre-provision operating profits. Yet the UK contributed to 30% of new lending flows in 2015, which proved especially important at stabilising group loan balances as amortisations in the Irish mortgage book in particular continue to outpace new lending. Management previously indicated that an update on the group's UK strategy, focusing on owner-managed entities and SME customers, would be provided during 2016 but this will now prove difficult in the post-referendum landscape.

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Table 1: AIB financials run - 18/07/16

	Price (c)		Yield %	
Securities	Bid	Ask	Bid	Ask
AIB 2 5/8 07/16 (ACS)	100.1	100.1	-1.0	-3.0
AIB 4 7/8 06/17	104.8	104.9	-0.2	-0.3
AIB 3 1/8 09/18	106.9	107.1	-0.1	-0.2
AIB 0 5/8 07/20	102.6	102.8	0.0	-0.1
AIB 2 1/4 03/21	110.4	110.8	0.0	-0.1
AIB 0 5/8 02/22	102.8	103.1	0.1	0.1
AIB 0 7/8 02/23	104.0	104.4	0.3	0.2
AIB 2 7/8 11/16 (SNR)	100.9	101.1	0.3	-0.2
AIB 2 3/4 04/19	105.6	106.0	0.7	0.5
AIB 1 3/8 03/20	101.8	102.2	0.9	0.8
AIB 4 1/8 11/25 (T2)	94.3	95.0	5.6	5.4
AIB 7 3/8 12/49(AT1)	89.0	90.0	10.9	10.5

Source: Bloomberg; Davy

Profits boosted by €294m VISA sale as write-backs subside

We are forecasting a decline in H1 operating profit to €1,007m from the prior year result of €1.244bn, which was boosted by €543m of net provisions write-backs versus our forecast for a reduced €100m in H1 2016. However, the H1 2016 result benefits from AIB's €294m equity share in the VISA Europe sale. We would note that this was already booked in reserves and included in FL CET1 capital.

Highlights include:

- A 17bps yoy increase in the net interest margin, increasing net interest income by 4.8% to €1,003m despite a 4.6% contraction in interest earning assets.
- A 51% increase in 'other' income to €616m. However, if we exclude the VISA sale, this falls to €322m, which represents a decline of 21%/€87m as the prior year period benefitted from €67m of net trading income (which we do not model for) and €36m of higher 'miscellaneous/other' gains. We assume that underlying fees and commissions continue to improve, rising by €16m annually.
- We forecast a 9% rise in operating expenses, broken down between an increase of 4% to reflect the assumed accrued regulatory charge and 5% for higher wage costs and the on-going strategic IT programme.
- We previously forecast a €200m gross write-back from the bank's targeted H1 2016 gross impaired loans reduction of €3-5bn, which offset our full year underlying €200m charge (35bps). Therefore we are forecasting a net write-back of €100m in H1, although this may prove conservative given the reported Q1 write-back.

Table 2: Summary forecasts (€m)

	H1 2015	H2 2015	2015	H1 2016	H2 2016	2016	H116/H115	H116/H215	FY16/FY15
Net interest income (ex-ELG)	957	1000	1957	1003	1011	2014	4.8%	0.3%	2.9%
ELG payments	-17	-13	-30	-6	-4	-10	-64.7%	-53.8%	-66.7%
Other income	409	287	696	616	301	916	50.5%	114.5%	31.6%
Total Income	1349	1274	2623	1613	1307	2920	19.6%	26.6%	11.3%
Operating costs (inc. levies)	-648	-716	-1364	-707	-767	-1473	9.1%	-1.3%	8.0%
Op. profit pre-provisions	**701**	**558**	**1259**	**906**	**541**	**1447**	**29.3%**	**62.4%**	**14.9%**
Impairment charges	543	380	923	100	-101	0	-81.6%	-73.7%	-100.0%
Operating profit	**1244**	**938**	**2182**	**1007**	**440**	**1447**	**-19.1%**	**7.3%**	**-33.7%**
Associated undertakings	13	12	25	14	14	28	7.7%	16.7%	12.0%
Exceptionals	-22	-271	-293	0	0	0			
Profit before tax	1235	679	1914	1020	454	1474	-17.4%	50.3%	-23.0%
Income tax	-395	-139	-534	-153	-68	-221	-61.0%	10.8%	-58.6%
Profit/loss after tax	840	540	1380	867	38	1253	3.3%	60.6%	-9.2%
AT1				-19	-19	-38			
Retained profit	(410)	(7)	(425)	848	367	1253	1.0%	57.1%	-394.8%
Other comprehensive income	191	657	848	-975	-126	-1101	-610.5%	-248.4%	-229.8%
Net interest margin (ex-ELG)	1.92%	2.01%	1.97%	2.09%	2.13%	2.11%	17bps	8bps	14bps
Average interest earning assets	100,637	99,955	99,272	96,000	95,500	95,476	-4.6%	-4.0%	-3.8%
RWAs	13,559	12,210	12,210	12,009	11,808	11,642	-11.4%	-1.6%	-4.7%
Transitional CET1	17.4%	15.9%	15.9%	16.1%	16.6%	16.6%	(1.2ppts)*	0.3ppts	0.7ppts
Fully-phased CET1	**14.1%**	**13.0%**	**13.0%**	**13.6%**	**14.0%**	**14.0%**	**(0.5ppts)***	**0.6ppts**	**1ppts**

** reflects the €1.3bn repayment of state aid*

Source: AIB; Davy forecasts

Table 3: Summary historic financials and forecast estimates (€m)

Income statement €m	**2012**	**2013**	**2014**	**2015**	**2016F**	**2017F**	**2018F**
Net interest income	1494	1518	1746	1957	2014	2103	2091
Other income	318	508	843	696	916	650	628
Guarantee fees (ELG/CIFs)	-388	-173	-59	-30	-10	0	0
Total income	1424	1853	2530	2623	2920	2753	2720
yoy change	-20%	30%	32%	4%	11%	-6%	-1%
Operating expenses (inc. levies)	-1739	-1470	-1463	-1364	-1473	-1543	-1573
yoy change	3%	-15%	-7%	-7%	8%	5%	2%
Operating result pre-provisions	**-315**	**383**	**1067**	**1259**	**1447**	**1210**	**1147**
yoy change	-412%	-222%	140%	18%	15%	-16%	-5%
Total provisions	-2529	-1904	188	923	0	-169	-172
yoy change	-69%	-25%	-110%	391%	-100%	33740%	2%
Operating profit/loss	**-2844**	**-1521**	**1255**	**2182**	**1447**	**1041**	**975**
yoy change	-412%	-222%	-186%	74%	-34%	-28%	0%
Associated undertakings	10	7	23	25	27.5	30.25	32
Exceptional items	-996	-173	-167	-293	0	0	0
Profit/loss before tax	**-3830**	**-1687**	**1111**	**1914**	**1474**	**1071**	**1007**
Income tax	183	90	-230	-534	-221	-161	-151
AT1 coupon	0	0	0	0	-38	-93	-93
Retained profits	**-3647**	**-1597**	**881**	**1380**	**1215**	**817**	**763**
Key ratios							
Net interest margin (NIM)	0.91%	1.22%	1.63%	1.94%	2.10%	2.29%	2.31%
NIM (ex-ELG)	1.22%	1.37%	1.69%	1.97%	2.11%	2.29%	2.31%
Average interest earning assets	122,200	110,000	103,370	99,272	95,476	91,761	91,761
Other income-to-total income	18%	25%	33%	26%	31%	24%	0%
Cost-to-income ratio (ex-ELG)	96.00%	72.60%	62.90%	51.41%	50.27%	56.05%	57.84%
Loan loss charge (gross loans)	2.56%	2.22%	-0.24%	-1.23%	0.00%	0.22%	0.22%
Loans-to-deposits ratio	115%	100%	99%	100%	100%	99%	0%
CT1 ratio (B2)/B3 transitional	**15.1%**	**15.0%**	**10.5%**	**15.9%**	**16.6%**	**17.1%**	**17.2%**
CET1 ratio (B3 fully-phased)	**9.7%**	**10.5%**	**5.9%**	**13.0%**	**14.0%**	**14.9%**	**15.8%**
Leverage ratio							
Summary balance sheet							
Cash & interbank	6961	6180	7258	7289	7000	7000	7000
Customer loans	72972	65713	63362	63240	62600	63470	65548
NAMA bonds	17387	15598	9423	5616	4213	0	0
AFS securities/trading portfolio	16372	20370	20185	19972	18947	18216	17535
Intangibles	187	176	171	289	441.2	563	550
Deferred Taxation	3845	3828	3576	2897	2676	2515	2364
Other non-earning assets	4777	5869	3479	3819	3819	3819	3819
Total assets	**122501**	**117734**	**107455**	**103122**	**99696**	**95583**	**96817**
Monetary borrowing	22220	12725	3400	2900	3051	2274	1147
Interbank loans	5636	10396	13368	10963	8500	3000	3000
Customer deposits	63610	65667	64018	63383	62683	63937	65215
Debt securities in issue	10666	8759	7861	7001	7001	6326	6826
Subordinated debt	1271	1352	1451	2318	784	1284	1284
Pension deficit	762	94	1239	368	868	868	868
Other	7743	8241	4546	4546	4546	4546	4546
Shareholder's equity	3499	6994	8072	11648	11762	12349	12930
Preference Shares/AT1s	3500	3500	3500	500	500	1000	1000
Total liabilities including equity	**122501**	**117734**	**107455**	**103122**	**99696**	**95583**	**96817**

Source: AIB; Davy forecasts

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