

## WORRIES ON CREDIT QUALITY AND BASEL III CAPITAL ADEQUACY

Our overall view is that BBVA is running very hard to maintain a semblance of managing credit quality, but it is now losing the battle to convince the market. There are two big negatives in the Q4 2009 results: very high loan losses (part of which management is asking the market to accept as one-offs) and a large goodwill write-off of €704m. We believe the market will be reluctant to accept the “one-offs” within loan losses and NPLs as exceptional at this moment in time and is more likely to revise earnings estimates downwards. We have also re-run our Basel III capital analysis of BBVA using the latest data released in the Q4 report. We see BBVA being one of the weaker lending banks with a CT1 ratio of only 6.65%, which is only just above an anticipated regulatory minimum of 6.0%. We have a HOLD rating on BBVA, but the near term expectation is that it will underperform more defensive stocks, especially the Nordic banks.

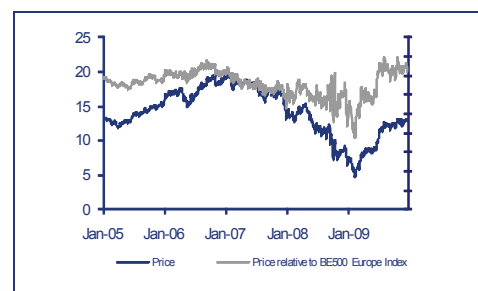
- Net earnings in Q4 2009 were €31m, significantly below the consensus estimate (€1.05bn) and our bottom-of-range estimate (€889m). One-off charges were the main reason for the bottom line miss: management indicated that these were €1.05bn in total, of which €704m related to a goodwill writedown and €346m related to exceptional provisioning. Both the one-off charges were for the Compass subsidiary in the US. Adding these one-off charges back (and here we are sceptical that the market will accept the part relating to loan losses as truly ‘one-off’), the net income would still have been a miss against consensus in our opinion, if we also account for the fact that there was a positive tax charge of €277m.
- The large loan losses were the big story of the day in our opinion. We discuss these in more detail later, but suffice to say here that we are not convinced that management is indeed undertaking a kitchen sinking exercise and that the underlying deterioration in credit quality is taking a turn for the worse. Looking at the operating profit (i.e. before loan losses), this was slightly ahead of expectations. NII was higher, as were fees and commissions, offset to some extent by higher costs. We are impressed by the underlying revenue strength of the bank, especially the strong NII, which was underpinned by an expansion in the NIM (with loan growth being flat q-o-q). However, we believe that the market will rightly be concerned about elevated loan losses for at least the next quarter and possibly the one after that which, if the current loan loss charge is maintained, would indicate earnings of only about €1bn per quarter. We believe therefore that BBVA will underperform more defensive banks in the near term (we favour the Nordic banks DNB NOR and Handelsbanken).

### Research

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Rating	HOLD
Target price (€)	14.25
Current price (€)	11.10
Upside / Downside	28%
Sector	Pan-Euro Banks
Market Cap (€bn)	41.5

(€/€m)	2009	2010E	2011E
Net interest income	13,881	13,752	14,464
Net fees & commissions	4,430	4,541	4,768
Trading profits/losses	1,544	1,648	1,681
Other revenue	811	977	1,013
Total operating revenues	20,666	20,917	21,925
Operating costs	-8,359	-8,599	-9,140
Operating profit	12,308	12,319	12,786
Total provisions	-5,931	-6,536	-5,704
Pre-tax profit	5,735	6,325	7,623
ROA	0.78%	0.81%	0.90%
ROE	15.32%	14.81%	16.33%
ROTNV	21.44%	19.68%	21.64%
Cost/Income	-40.45%	-41.11%	-41.69%
Payout	23.76%	40.00%	40.00%
Net interest margin	2.74%	2.67%	2.62%
LLC % gross loans	-1.63%	-1.79%	-1.46%
NPL ratio	4.70%	4.25%	3.50%
NPL coverage ratio	57.32%	50.00%	80.00%
Loans % deposits	127%	123%	120%
Core tier 1 ratio	7.97%	8.09%	8.43%
EPS	1.13	0.98	1.22
DPS	0.27	0.39	0.48
P/TNAV	1.89	1.74	1.57
Div Yield	2.40%	4.34%	5.24%



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## RESULTS ANALYSIS

### Credit Quality – Negative

Net profit of only €31m in Q4 2009 included €1050m of negative one-offs, of which €704m related to a goodwill writedown and the remaining €346m to exceptional provisioning. Both of these items are for the US subsidiary Compass. While the goodwill write-off should be accepted as a one-off, will the market also accept the provisioning as exceptional? We doubt it and are sceptical that this is a kitchen-sinking exercise as management seems to imply. It is two quarters in a row now that we have had huge loan losses. In Q3 2009 we had €830m in exceptional capital gains from the sale and leaseback of properties being booked to generic provisions. We were asked to accept the increase in the loan loss rate as a 'one-off', so most analysts must have modelled a decrease. However, there was a big warning sign - the generic provisions hardly increased and the coverage ratio stayed the same at 68% q-o-q. This was mainly because of higher specific losses, leading us to be sceptical that the increase in the loan loss rate would immediately revert back to a lower level.

Judging by the Q4 2009 results, our scepticism seems well placed. We now have large specific losses, an absence of offsetting one-off capital gains (in fact, we have large 'one-off' losses) and a massive increase in NPLs to €15,602m from €12,500m in Q3 2009. This is in spite of the €830m capital gain booked to generic provisions last quarter, which could have been interpreted as providing an increased buffer within reserves.

The loan loss charge has increased from 2.09% in Q3 2009 (which included the €830m one-off capital gain booked to generic provisions) to 2.16%. Management is asking us to accept that €346m of the loan losses, relating to Compass, is one-off. Even if we did, then loan losses would decrease from €1.8bn to €1.5bn (versus €1.7bn in Q3 2009) and the loan loss ratio would still be very high at 1.78% (albeit better than in Q3 2009).

The NPL development is also a big negative surprise. NPLs increased to €15.6bn (we were looking for €12.9bn, Q3 2009 was €11.5bn). The NPL ratio is now 4.7% (Matrix basis) compared with 3.7% in Q3 2009. Management indicates that some element of this is "anticipated provisioning"; i.e. provisioning more than is required under normal accounting and regulatory criteria. Management says that of the €4.1bn increase in NPLs (excluding €1.1bn of write-offs), €2.5bn should be considered as one-off, with €1.8bn relating to Spain and €644m relating to the USA. Management says that in the US, there has been a re-analysis of the CRE portfolio, resulting in a subjective reclassification of provisioning. It seems to be relating to the underlying collateral values being revised downwards. In Spain, the higher NPLs relate to consumer lending and real-estate developer loan books, as well as €1.8bn in lending that is still performing but has been booked as doubtful under a "one-off" reclassification exercise. We are doubtful in all these cases that the market will now accept these provisioning exercises as 'one-off' given what happened in Q3 2009 and now Q4 2009, and will prefer to err on the side of caution. We note, nevertheless, that management has now brought forward its original projection of the NPL ratio peaking in mid-2010 as a result of the increased provisioning.

Despite the large loan loss provisioning, the coverage ratio fell to 57% from 68%. This is in contrast to Popular, which had large loan losses, but mainly in the form of provisions, thereby increasing the coverage ratio to 50% from 45%. Within BBVA's total provisions, specific provisions increased to €6.0bn from €4.4bn, but generic provisions decreased to €3.0bn from €4.0bn. Total provisions therefore increased by only €0.5bn, a 6% increase versus the 25% increase in NPLs.

### **Operating Revenue – Positive**

Operating revenues were strong at €5,288m versus our estimate of €4,965m. Net interest income was ahead of estimates, with the NIM increasing q-o-q to 2.86% from 2.71% (we were expecting a flat NIM at 2.70%). The increase in asset spreads has more than offset the decrease in liability spreads. To BBVA's credit, it seems to be showing better resilience than Spanish competitors in combating the fall in asset yields, although we would like to question management further on whether there has been a strong contribution from the ALCO (Asset Liability Committee) to strong NII.

Apart from the NII beat, trading was also particularly strong.

### **Costs – Negative**

Costs were larger in absolute terms versus Q3 2009 and our own expectations, both with respect to personnel expenses and administrative expenses. The cost-income ratio was 42.6% versus our 40.9% forecast, although we accept that some of this will be seasonal (particularly comparing the development of costs to Q3 2008 and Q4 2008).

### **Capital – Worries Over Basel III Capitalisation**

The Core Tier 1 ratio was 8.0%, just below our expectation of 8.1% and unchanged from Q3 2009, which is unsurprising given that there were virtually no earnings in the quarter. On the conference call, management indicated an expectation of 20bps per quarter capital ratio generation on a normalised basis.

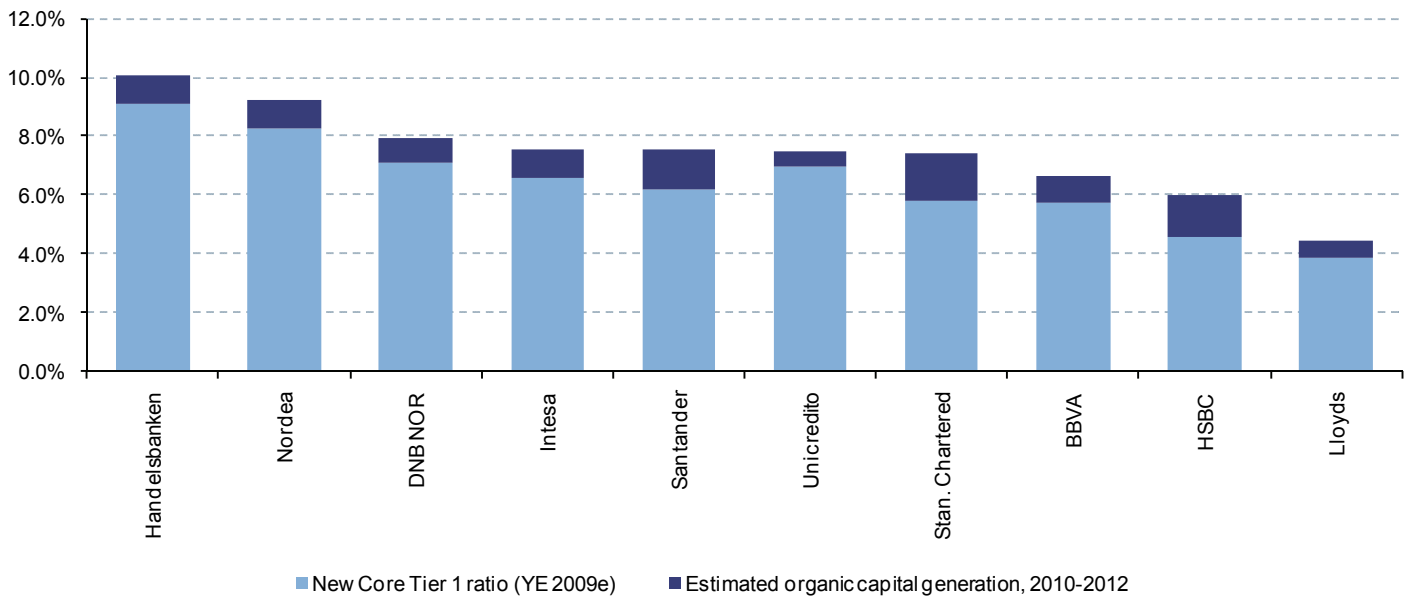
The Core Tier 1 ratio, of course, is on a full Basel II basis. We have re-run our Basel III capital analysis, to now include the new figures released in the Q4 2009 report. We have also made adjustments for the increase in BBVA's stake in China Citic Bank from €2bn to €3bn. (BBVA will, itself, reflect these changes in its capital disclosures in the Q1 2010 report). Of the €1bn increase in the stake, we estimate that €0.5bn relates to goodwill and €0.5bn relates to book value, both of which will have to be deducted from common equity under the new Basel III proposals. (It is important to note that BBVA already conservatively deducts 100% of its stakes in other financial institutions 50:50 from Tier 1 and Tier 2 capital under the Basel II regulations, rather than just that part which is above the 10% threshold).

Making the extra €1.0bn aggregate deduction has an impact on BBVA's Core Tier 1 ratio of 32bps by our calculations.

Taking the above into account, we estimate that the Core Tier 1 ratio at the end of 2012, including estimated organic capital generation from retained earnings, is only 6.65%, just above an anticipated regulatory minimum of 6.0%, and uncomfortably below the peer group average for the large cap lending banks. While BBVA would not be considered under-capitalised by this analysis, it would likely be within the buffer above the regulatory minimum that would result in a restriction on dividends being paid to shareholders and bonuses being awarded to employees, as per the proposal from the Basel consultation paper.

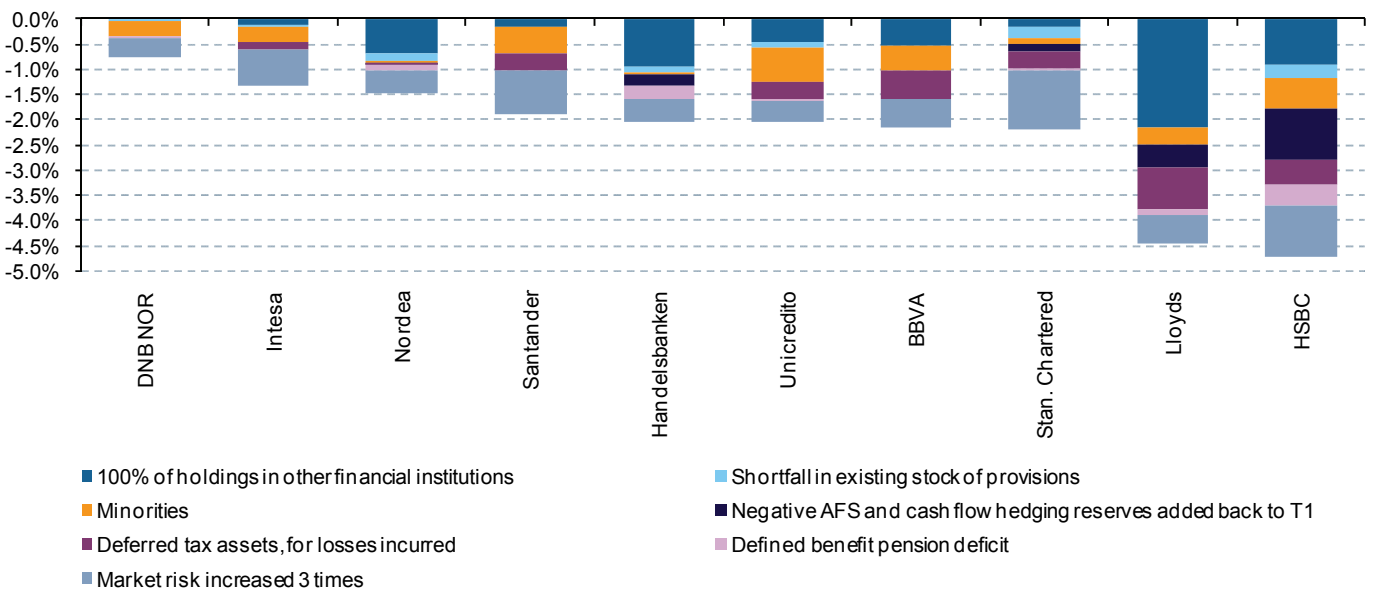
We believe, therefore, that it is unwise for BBVA's management to commit to paying out such a large dividend at this point in time (on 28 December 2009, BBVA paid a third interim dividend of €0.09 per share in cash against 2009 earnings, thus maintaining its dividend policy of a 30% cash payout). In our opinion, there is a fairly strong risk of dividends having to be cut in order to achieve greater organic capital generation and that the bank will have to halt increases in stakes in other financial institutions.

Figure 1: Large Cap Lending Banks Ranked By Estimated Core Tier 1 Ratio At The End Of 2012



Source: Matrix Corporate Capital Research

Figure 2: Banks Ranked By Estimated Change In Core Tier 1 Ratio Under Basel III Proposals, 2009E



Source: Matrix Corporate Capital Research

Figure 3: BBVA Earnings Table

BBVA	FY2008	Q4 2009E	Q4 2009	FY2009	FY2010E	FY2011E	FY2012E
<b>INCOME STATEMENT (€m)</b>							
Net interest income	11,686	3,418	3,589	13,881	13,752	14,464	15,187
Net fees & commissions	4,527	1,133	1,163	4,430	4,541	4,768	5,006
Trading profits/losses	1,558	181	420	1,544	1,648	1,681	1,714
Other revenue	1,206	233	116	811	977	1,013	1,051
Total operating revenues	18,977	4,965	5,288	20,666	20,917	21,925	22,958
Operating costs	-8,455	-2,030	-2,254	-8,359	-8,599	-9,140	-9,590
Operating profit	10,522	2,935	3,034	12,308	12,319	12,786	13,368
Total provisions	-4,371	-1,656	-2,011	-5,931	-6,536	-5,704	-3,313
Investment income	775	-31	-1,238	-641	542	542	542
Impairments on other assets	0	0	0	0	0	0	0
Goodwill impairment	0	0	0	0	0	0	0
Pre-tax profit	6,926	1,248	-215	5,735	6,325	7,623	10,597
Taxes	-1,541	-299	277	-1,141	-1,518	-1,830	-2,543
Minorities	-365	-57	-31	-384	-288	-348	-483
Other non-operating items	0	-2	-1	0	0	0	0
Net profit	5,020	889	30	4,210	4,518	5,446	7,570
<b>ASSETS (€m)</b>							
Loans to customers	335,260	323,001	323,878	323,878	338,258	363,616	393,266
Interbank loans	34,234	22,777	22,239	22,239	24,072	26,057	28,204
Total securities	128,115	144,010	141,027	141,027	152,652	165,236	178,856
Intangible assets	8,439	8,292	7,248	7,248	7,845	8,492	8,492
Total assets	542,650	544,968	535,065	535,065	579,162	633,441	687,316
Net interest-earning assets	510,514	508,267	501,151	501,151	530,144	572,082	620,657
<b>LIABILITIES (€m)</b>							
Interbank borrowings	66,804	75,253	70,312	70,312	76,108	82,382	89,173
Customer deposits	383,800	378,187	377,624	377,624	408,752	448,329	485,286
Total shareholders' equity	25,656	29,454	29,300	29,300	31,706	34,974	39,516
Tangible net asset value	17,217	21,162	22,052	22,052	23,861	26,482	31,024
<b>IMPORTANT FINANCIAL RATIOS</b>							
ROA	0.96%	0.66%	0.02%	0.78%	0.81%	0.90%	1.15%
ROE	19.04%	12.11%	0.42%	15.32%	14.81%	16.33%	20.33%
ROTNV	27.86%	16.78%	0.57%	21.44%	19.68%	21.64%	26.33%
Cost/income	-44.55%	-40.89%	-42.62%	-40.45%	-41.11%	-41.69%	-41.77%
Tax rate	-22.25%	-24.00%	-128.84%	-19.90%	-24.00%	-24.00%	-24.00%
Payout	37.41%	100.00%	1083.87%	23.76%	40.00%	40.00%	40.00%
Net interest margin	2.37%	2.70%	2.86%	2.74%	2.67%	2.62%	2.55%
LLC % gross loans	-0.89%	-1.90%	-2.16%	-1.63%	-1.79%	-1.46%	-0.73%
Non-performing loans % gross loans	2.46%	3.90%	4.70%	4.70%	4.25%	3.50%	2.40%
NPL coverage ratio	88.68%	62.00%	57.32%	57.32%	50.00%	80.00%	120.00%
Loans % deposits	131.35%	128.25%	127.42%	127.42%	122.94%	119.73%	119.63%
Tier 1 ratio	7.90%	10.47%	9.36%	9.36%	9.41%	9.67%	10.42%
Core tier 1 ratio	6.23%	8.06%	7.97%	7.97%	8.09%	8.43%	9.25%
Equity % total assets	4.73%	5.40%	5.48%	5.48%	5.47%	5.52%	5.75%
RWA % total assets	52.96%	52.78%	54.39%	54.39%	53.33%	51.74%	50.60%

Source: Matrix Corporate Capital Research

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