VM Wealth Management Limited

# Bond Analysis: Credit Agricole SA 8.125% Perpetual (9M 2023)

VMWM Research | November 30, 2023

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CRÉDIT AGRICOLE

- **Bond Recommendation:**

**Conservative Risk Appetite: UNDERWEIGHT**

**Moderate Risk Appetite: OVERWEIGHT**

**Aggressive Risk Appetite: UNDERWEIGHT**

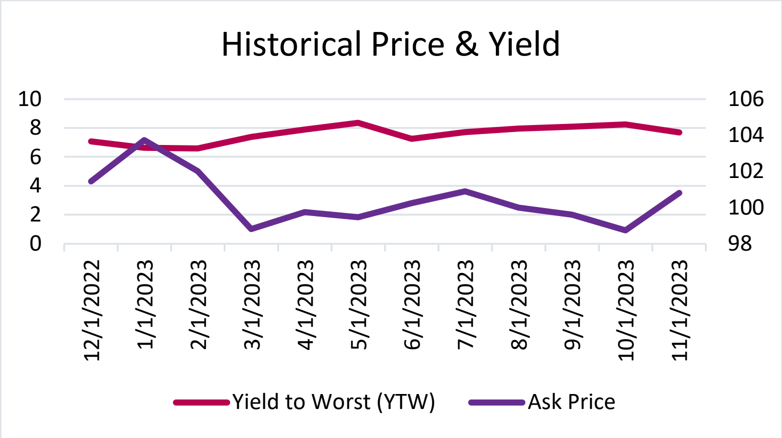
## ABOUT THE COMPANY

Crédit Agricole SA (Ticker: ACAFP) is a financial institution that functions as a holding company for a bank. It provides a range of financial services through its various subsidiaries, including traditional banking, insurance, consumer financing, leasing, and factoring. It also offers an array of financial products and has a global customer base.

The Company originated in 1894 as an agricultural credit organization and is primarily owned by approximately 40 local French banks that form the Crédit Agricole Group. Crédit Agricole SA is tasked with the Group's more complex banking services, which encompass asset management, investment banking, capital markets, insurance, leasing, and private banking, among others. The firm boasts over 11 million mutual shareholders and operates around 2,400 local banks.

ACAFP has also established a prominent position in various sectors within Europe. It is recognized as the leading private employer in France, the top retail bank in the European Union in terms of retail banking clientele, the foremost insurer in France by revenue, and a significant financier of the European economy, as well as a major asset manager across Europe.

| CREDIT AGRICOLE SA: Bond Term Summary | |
|---|---|
| **Parent Company** | Groupe Credit Agricole |
| **Issuer** | Credit Agricole SA |
| **Currency** | USD |
| **Issued Amount** | 1,250,000 (M) |
| **Issue Date** | 19/01/2016 |
| **Tenor** | Perpetual/Callable |
| **Yield to Worst (As of November 30, 2023)** | 7.690% |
| **Coupon** | 8.125%; resettable on the First Call Date (December 23, 2025) and on each five-year anniversary thereafter |
| **Bond Credit Rating (S&P)** | BBB- |
| **Issuer Credit Rating (S&P)** | A+ |
| **Issuer Outlook (S&P)** | Stable |
| **Rank** | Junior Subordinated |
| **Maturity Type** | Perpetual/Callable<br>Next Call date: 12/23/2025 |
| **Day Count Basis** | 30/360 |
| **Use of proceeds** | General corporate purposes |




**Recommendation:** Investors with a Moderate Risk appetite can **OVERWEIGHT** the ACAFP 8.125% Perps because the yield is slightly higher than the average of comparable securities. ACAFP presents an acceptable investment characterized by robust core earnings, market leadership, and a solid capital foundation, which are key positives that position it well for future expansion and profitability. However, challenges like the anticipated economic slowdown in Europe and inflationary pressures pose risks to its financial stability and growth. The potential impact of rising interest rates and credit risk in sectors like housing loans could further affect its performance. Notwithstanding, ACAFP's strengths seem to counterbalance the negatives, suggesting a cautiously optimistic investment outlook.

## ECONOMIC OVERVIEW (FRANCE)

According to Bloomberg, ACAFP generated most of its Revenues from France during FY 2022 at 51.6%, followed by Italy and the Rest of Europe at 16.8% and 13.2% respectively. As of June 2, 2023, S&P Global Ratings (S&P) affirmed France's sovereign credit ratings at 'AA' while maintaining a Negative outlook[1]. France's wealthy economy and strong institutions underpin its creditworthiness. The French economy, the world's seventh largest, is open and diversified. S&P anticipates France's economy should grow by an average of 0.8% in 2023-2024, down from 2.5% in 2022. This slowdown is due to factors like the European Central Bank's monetary tightening, inflation, and a broader European economic downturn. These elements are expected to dampen consumer spending, which constitutes over half of France's GDP, and investment. France saw a modest real GDP increase of 0.2% in the first quarter of 2023 compared to the last quarter of 2022. Positive contributions to GDP came from foreign trade, notably tourism and the manufacturing of cars and aircraft, while investment spending fell, and private consumption remained flat. Looking ahead, S&P forecasts a recovery in economic growth, averaging 1.5% in 2025-2026. This rebound should be supported by accelerated economic growth in Europe and public investment initiatives, such as the France 2030 Program, which focuses on sectors like biotechnology and industry decarbonization.

Inflation is projected to slow to 5.4% in 2023 from 5.9% in 2022. However, a decrease in core inflation may be delayed due to rising wage pressures and lingering high costs for producers and energy. France's comparatively low inflation in 2022 within the euro area was mainly due to government interventions, such as capping gas and electricity prices and offering fuel rebates, which reduced inflation by more than two percentage points on average last year. The first quarter of 2023 saw an inflation increase due to rising regulated electricity and gas prices and the cessation of the fuel rebate. The government plans to maintain a cap on electricity prices for two more years and remove the gas price cap. Additionally, planned tax reductions, including cuts on local taxes for primary residences, should aid household purchasing power.

## NINE MONTHS ENDED SEPTEMBER 30, 2023 (9M23)

| EUR (In Millions) | FY 2020/21 | FY 2021/22 | 9M22 September 30, 2022 | 9M23 September 30, 2023 |
|---|---|---|---|---|
| **Revenue** | 22,657 | 23,801 | 16,525 | 19,140 |
| **Operating Income** | 8,836 | 9,222 | 6,495 | 8,709 |
| **Net Income** | 6,849 | 6,316 | 4,174 | 5,785 |
| **Total Assets** | 2,073,955 | 2,143,300 | 2,259,000 | 2,170,000 |
| **Total Loans** | 464,885 | 497,939 | 495,858 | 522,028 |
| **Total Deposits** | 779,053 | 825,600 | 808,200 | 817,200 |
| **Book Value of Equity** | 63,329 | 51,511 | 64,300 | 60,200 |
| **Tier 1 Common Equity Ratio (%)** | 11.9 | 11.2 | 11.0 | 11.8 |
| **Cost-to-Income Ratio (%)** | 59.3 | 58.5 | 56.8 | 51.8 |
| **Loan-to-Deposit Ratio (%)** | 59.6 | 60.3 | 61.3 | 63.8 |
| **Return on Tangible Equity (RoTE) (%)** | 13.1 | 12.6 | 12.5 | 13.5 |

**Source: Bloomberg, ACAFP Financials/Press Releases**

[1] Source: https://www.spglobal.com/ratings/en/research/articles/230602-research-update-france-aa-a-1-ratings-affirmed-outlook-remains-negative-12748639#:~:text=On%20June%202%2C%202023%2C%20S%26P,already%20elevated%20general%20government%20debt

For the nine months ending September 30, 2023, ACAFP's Revenue rose to EUR 19.1 billion from the EUR 16.5 billion recorded in the previous year for the same period, representing growth of 15.8% year-over-year (YoY). Several factors, such as broad-based business line growth across all segments, consolidation of European Operations of RBC and a growth in deposits, drove higher revenue. These factors collectively demonstrate ACAFP's comprehensive approach to growth, leveraging a mix of strategic consolidation, adaptation to market conditions and strong performance across a diverse range of business lines.

Operating expenses increased to EUR 9.9 billion from the EUR 9.3 billion recorded in the previous year, representing a growth of 5.8% YoY. This was attributed to several factors, such as prevailing inflationary conditions, scope effects due to the consolidation of CA Auto Bank and RBC, as well as investments in business expansion and development. It's important to note that while operating expenses increased, the revenue growth outpaced this increase, resulting in improved profitability. This indicates that the higher expenses were likely considered strategic investments contributing to the bank's overall growth and success. Consequently, Operating Income grew 34.1% to EUR 8.7 billion from the EUR 6.4 billion recorded in the previous year.

Net Income grew to EUR 5.7 billion from EUR 4.1 billion, showing an increase of 38.6%. This was due to the combination of solid revenue growth across business lines, effective cost management and beneficial specific items such as the reversal of the home purchase savings provision and gains from the reorganisation of particular business activities. Such one-time gains provided a substantial boost to the net income figure.

Total Assets decreased to EUR 2.1 trillion from EUR 2.2 trillion, representing a fall of approximately 3.94%. The decrease was driven primarily by a EUR 102.9 billion decrease in cash and cash equivalents. This suggests a reallocation of liquid assets, possibly into high-yielding investments or used for lending. Total Liabilities marginally fell to EUR 2.10 trillion compared to EUR 2.18 trillion, representing a decrease of 3.90%. This was driven by a 121.6 billion decrease in short-term borrowing, indicating a shift in the bank's funding strategy, possibly moving towards more stable, long-term sources of financing. Total Equity decreased to EUR 69.4 billion from EUR 73.1 billion, an approximately 5.0% YoY decrease.

There was an improvement in the Tier 1 Common Equity Ratio to 11.8% from 11.0 in the previous year. This ratio measures a bank's core equity capital compared to its total risk-weighted assets. Tier 1 capital is the core measure of a bank's financial strength from a regulator's point of view. An increase in this ratio indicates more robust financial stability and resilience. It means the bank has more core capital to absorb potential losses, making it safer and more reliable for depositors and investors. It also suggests that the bank is well-positioned to meet regulatory requirements and withstand financial stress.

The Loan-to-Deposit Ratio increased to 63.8% from 61.3%. This ratio compares a bank's total loans to its total deposits. It indicates how much of a bank's deposits are used for lending, which is a primary revenue-generating activity. An increasing loan-to-deposit ratio suggests that the bank effectively utilises its deposits to generate loans, which can lead to higher Income from interest. However, if the ratio gets too high, it might indicate potential liquidity risk, as the bank could struggle to cover withdrawals or other liabilities.

There was an increase in the Return on Tangible Equity (RoTE) Ratio to 13.5% from 12.5%. RoTE measures the return generated on the tangible equity capital invested in the business. Tangible Equity excludes intangible assets like goodwill. An increase in this ratio indicates better profitability relative to the equity capital deployed in the business. It's a key performance metric, showing how effectively a bank uses its physical or tangible assets to generate profits.

The foregoing ratios collectively provide insights into a bank's financial health, efficiency, profitability, and risk management. They are crucial for investors, regulators, and the bank's management for decision-making and assessing the bank's performance and stability.

## OUTLOOK

**S&P Forecasts Steady Earnings Amid Rising Interest Rates and Credit Risks**
Standard & Poor's (S&P) provides a comprehensive financial outlook for Groupe Crédit Agricole (GCA), projecting that it should uphold robust core earnings in 2023-2024, with an expectation of around EUR 8.5 billion. This projection considers the minority interests and the costs associated with junior subordinated notes. Reflecting on the past performance, GCA's net income in 2022 was slightly below €8.9 billion, with core earnings calculated by S&P to be near €8.4 million. Looking forward, S&P predicts that GCA's revenue should remain resilient in 2023 and experience growth in 2024 while maintaining cost efficiency below 65%. These estimates are predicated on a gradual rise in net interest margin, alongside some anticipated cost inflations. Furthermore, S&P expects the increase in interest rates to partially offset revenue pressures, although the full benefits may only materialize in the subsequent year. The forecast also considers a slowdown in the generation of new loans, cautious repricing of assets, and the constraints due to usury laws. Moreover, the net interest margin is not expected to receive the same support from targeted longer-term refinancing operations as before, with an increased cost of funding anticipated due to regulated savings deposits, which reached a 3% interest rate in February of this year, potentially leading to margin compression in 2023 due to higher overall interest rates. Despite potential challenges, including credit risk, S&P does not see GCA as highly susceptible to asset-quality stress. The stable performance of the housing loan sector in France, a substantial portion of GCA's portfolio, is expected to persist, bolstering the group's financial stability. For bondholders, this well-grounded financial forecast by S&P is good news. It suggests that GCA should maintain a stable flow of earnings and effectively manage its funding costs despite the challenging economic environment. The Group's strong position in the French housing loan market, which is anticipated to remain robust, provides additional assurance of GCA's creditworthiness. These factors collectively indicate a low probability of default and the potential for bond value preservation or appreciation, making GCA's bonds an attractive investment from a risk perspective.

**Leading Market Presence with Strong Balance Sheet and Capital Adequacy Expected to Continue**
GCA stands out as one of Europe's leading bank-insurance groups, marked by its diverse business operations and a significant retail presence, especially in France and Italy.S&P highlights the Group's robust balance sheet, underscored by a strong capital foundation. The increase in the Tier 1 Common Equity ratio to 11.8% during the nine months ending September 30, 2023, signifies a favourable position on a global scale. The improvement in the Capital Adequacy ratio is attributed to robust retained earnings and controlled exposure growth. Sufficient capital is forecasted to continue based on the expectation of continued solid business performance, managed growth in exposures at default, a modest dividend payout consistent with the cooperative business model, and the ongoing issuance of new cooperative shares. For bondholders, this indicates a strengthened credit profile of the Group, suggesting enhanced safety for their investments. The solid capital position and the anticipated rise in the RAC ratio may lead to greater confidence in the Group's ability to meet its financial obligations, potentially leading to more favourable borrowing terms and bond pricing for the issuer.

**Credit Agricole's 2025 Vision: Digital Transformation and Mobility Sector Expansion**
GCA's 2025 strategy bodes well for bondholders, as it underscores an achievable roadmap focusing on core business stability and digital innovation. The Group's commitment to environmental sustainability and societal values, along with strategic diversification into the mobility sector through a joint venture with Stellantis and the expansion of Crédit Agricole Auto Bank, indicates a forward-looking approach aimed at securing new revenue streams and enhancing operational efficiency. Such strategic initiatives not only suggest a strong potential for sustained profitability and growth but also imply a prudent management approach that is likely to support the Company's capacity to fulfill its debt obligations, thereby preserving bondholder investments.

## ISSUER RATINGS ANALYSIS

**Standard & Poor's: A+/Stable**

On May 2, 2023, S&P affirmed ACAFP's rating at 'A+' while maintaining a stable outlook. The rating reflects the institution's leadership in the French retail banking market, generating adequate and predictable risk-adjusted earnings. It also reflects its increasingly diverse business model and income sources, with leading franchises, retail banking, insurance, and asset management. ACAFP also shows sound earnings, which support internal capital generation. Key risks include the expectation of only a gradual benefit from increasing interest rates and some inflation pressure on costs. The deteriorating environment can also drive credit risk, particularly in small and midsize corporate enterprises. Relatively high economic risk exists in Italy, which the Group considers its second home market.

**Fitch Ratings: A+/Stable**

On October 4, 2023, Fitch affirmed ACAFP's rating at 'A+' while maintaining a stable outlook. The rating reflects a diversified business model with leadership in multiple segments. Its low-risk appetite, robust capitalization, sound asset quality and profitability, along with stable funding, are notable compared to other large French and European banks. ACAFP maintains a low-risk appetite and prudent lending standards, contributing to its sound asset quality. Despite recent economic challenges, ACAFP's impaired loans ratio remains stable and below the average for large European banks. Despite its strong rating, ACAFP faces risks that could impact its future financial stability. Economic downturns, especially in France and the Eurozone, pose a significant threat to its operations and profitability. A key concern is the potential rise in the impaired loans ratio, which, if it exceeds 3%, could indicate deteriorating asset quality.

## BOND RATINGS ANALYSIS

**Standard & Poor's: BBB-**

It's important to note that the bond rating of the 8.125% Perpetual Bonds is lower than ACAFP's issuer rating (A+/Stable). This rating discrepancy arises because the 8.125% Perpetual Bonds are categorized as Junior Subordinated debt in the creditor hierarchy. In a company's capital structure, different types of debt securities have varying levels of seniority when it comes to repayment in the event of financial distress or default. Senior debt holders are typically higher in the hierarchy and have a greater claim on the company's assets and cash flows than junior or subordinated debt holders. The 'BBB-' rating for the 8.125% Perpetual Bonds indicates they are of lower credit quality than the overall issuer. This lower rating signifies that, in the event of financial difficulties or bankruptcy, holders of the 8.125% Perpetual Bonds may have a lower priority in receiving repayment than holders of higher-ranked debt securities issued by ACAFP.

## BOND FEATURES & COMPARABLES ANALYSIS

**Fixed-Rate Resettable Feature:** From the Prospectus, it's clear that the bonds initially bear interest at a fixed rate of 8.125% per annum, payable quarterly, from the issue date of January 19, 2016, until December 23, 2025, which is referred to as the First Call Date. After this date, the interest rate may reset to a variable rate, typically based on a benchmark rate plus a specified spread. The Prospectus did not make clear how the reset would be determined. This structure allows the issuer to benefit from potentially lower interest costs if market rates decrease, while investors initially receive a higher fixed return, which compensates for the risk of future rate fluctuations. The rate of interest will reset on the First Call Date and on each five-year anniversary thereafter (known as the "Reset Date").

**Convertibility Feature:** The 8.125% Perpetual Bonds have provisions for convertibility. According to the terms of the notes, there is a possibility for the forced conversion of all or a portion of the bonds due into shares, other securities, or other obligations of the issuer. In summary, the conversion of debt into equity under The European Bank Recovery and Resolution Directive (BRRD) and French law is a mechanism used to stabilize banks in distress, by converting creditors' claims (debt) into ownership stakes (equity), thereby recapitalizing the bank and avoiding the need for a taxpayer-funded bailout. This convertibility feature is a common characteristic of additional Tier 1 (AT1) instruments, allowing for the conversion of debt into equity under certain stressful conditions. This provision is part of the broader regulatory framework aimed at enhancing the resilience of financial institutions by allowing for the absorption of losses in situations of financial distress. **Based on ACAFP's current strong financial position, we view this forced conversion to be unlikely for the foreseeable future.**

| Security | Ask YTW | Country of Risk | S&P Credit Rating | Next Call Dt | Maturity Type |
|---|---|---|---|---|---|
| Avg of Comparables | 7.533 | -- | -- | -- | -- |
| **ACAFP 8 1/8 PERP** | **7.690** | **FRANCE** | **BBB-** | **12/23/25** | **PERP/CALL** |
| BNP 7 3/8 PERP | 7.340 | FRANCE | BBB- | 08/19/25 | PERP/CALL |
| BNP 9 1/4 PERP | 7.570 | FRANCE | BBB- | 11/17/27 | PERP/CALL |

**Comparables:** When compared to peers of a similar S&P credit rating and industry, the coupon on ACAFP 8.125% Perps is slightly below the peer average of 8.250%. However, the ACAFP 8.125% Perps have a yield to worst (YTW) of 7.690%, which is slightly higher than the average of 7.533%. Therefore, the security is expected to slightly outperform the pace of comparable companies. We assessed the YTW calculated by Bloomberg because it considers the possibility of the bond being called at the earliest callable date.

## INVESTMENT POSITIVES

1. **Robust Core Earnings:** ACAFP is projected to maintain strong core earnings of around EUR 8.5 billion in 2023-2024, which indicates solid financial performance despite a challenging economic environment.
2. **Market Leadership:** ACAFP's dominant position in the French retail banking market, with diversified business lines across retail banking, insurance, and asset management, suggests stable and predictable earnings.
3. **Capital Strength:** An increase in the Tier 1 Common Equity ratio to 11.8% signifies financial stability and positions ACAFP favorably for regulatory requirements and financial stress.
4. **Growth Strategy:** ACAFP's growth strategy, including its France 2030 Program focusing on sectors like biotechnology and industry decarbonization, indicates a strong potential for future profitability and business expansion.
5. **Effective Cost Management:** Despite increased operating expenses, ACAFP's revenue growth has outpaced expenses, showing effective cost management and improved profitability.
6. **Low Inflation Impact:** Government interventions have significantly contained inflation, which bodes well for consumer spending and economic stability, benefiting businesses like ACAFP that generate significant revenue domestically.

## INVESTMENT NEGATIVES

1. **Economic Slowdown:** The anticipated average economic growth slowdown to 0.8% in 2023-2024 from 2.5% in 2022 due to factors like monetary tightening and a broader European economic downturn could negatively impact banking operations and profitability.
2. **Negative Outlook:** S&P has maintained a negative outlook on France's sovereign credit ratings, which might indicate potential challenges ahead for ACAFP given its revenue reliance on the French market.

3. **Decrease in Total Assets:** The decrease in total assets suggests a possible reduction in ACAFP's operational scale or a reallocation of assets that could affect long-term revenue streams.
4. **Inflationary Pressures:** Rising wage pressures and lingering high costs for producers and energy, along with the end of certain government interventions like the fuel rebate, could erode margins and increase operational costs.
5. **Credit Risk Concerns:** The stable outlook from credit rating agencies takes into account potential asset-quality stress, particularly in the housing loan sector, which if materializes, could affect ACAFP's financials.
6. **Rising Interest Rates:** While interest rate hikes could eventually benefit net interest margins, they may also lead to margin compression in the short term due to the higher cost of funding, notably from regulated savings deposits with increased interest rates.

## CONCLUSION

Investors with a Moderate Risk appetite can **OVERWEIGHT** the ACAFP 8.125% Perps because the yield is slightly higher than the average of comparable securities. Based on the analysis, ACAFP presents an acceptable investment case characterized by robust core earnings, market leadership, and a solid capital foundation, which are key positives that position it well for future expansion and profitability. However, challenges like the anticipated economic slowdown in Europe, cautious economic outlook for France, asset reduction, and inflationary pressures pose risks to its financial stability and growth. The potential impact of rising interest rates and credit risk in sectors like housing loans could further affect its performance. Notwithstanding, ACAFP's strengths seem to counterbalance the negatives, suggesting a cautiously optimistic investment outlook.

**Conservative Risk Appetite: UNDERWEIGHT (The bond's rating of 'BBB-' is the lowest category of Investment Grade; Features such as the potential Convertibility to Equity and an unknown Maturity Date also indicate that risk is more moderate.)**

**Moderate Risk Appetite: OVERWEIGHT (Based on the yield, the bond is expected to outperform peers.)**

**Aggressive Risk Appetite: UNDERWEIGHT (The bond is investment grade and may not carry enough risk/return dynamic for Aggressive Investors.)**

**SOURCES**

**ACAFP COMPANY WEBISTE, ACAFP COMPANY FINANCIALS, ACAFP MD&A PRESS RELEASES, ACAFP BOND PROSPECTUS, REUTERS, FITCH RATINGS, BLOOMBERG, OPPEHNHEIMER & CO., STANDARD & POORS, MOODY'S INVESTOR SERVICES**

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**DEFINITIONS**

- **OVERWEIGHT** - Security is deemed to be undervalued and is expected to outperform compared to the average market return and/or return of comparable securities in the same sector or industry.
- **MARKETWEIGHT** – Security is expected to provide similar returns compared to the market in general or at the same pace as comparable companies; neither strongly positive nor negative.
- **UNDERWEIGHT** – Security is deemed to be overvalued and is expected to underperform compared to the average market return and/or return of comparable securities in the same sector or industry.
- **ZEROWEIGHT** – This security is substantially distressed or at risk of a shock which may significantly impair its value.