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Considerations on Aareal

November 2020

Outline

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I Executive Summary

Executive Summary

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- In its current setup, Aareal Bank has not delivered an adequate RoE of at a minimum 8-10%[1], resulting in a significant P/B discount even before Covid-19 hit
- We deem 2019 a fair base case year for an analysis of potential value levers to bridge the RoE gap of Aareal Bank and have made the following key assumptions:
  - **Aareon:** for the ongoing RoE considerations, a spin-off of Aareon to shareholders has been assumed; only for capital related measures have we considered the capital gain of €180m from the sale of 30% in Aareon
  - **Payment Processing Business:** has been included as part of Aareal Bank including for the calculation of the CiR
  - **Bank Profitability:** we have not adjusted for any non-recurring 2019 income or expense items (in particular the reduction of the Italian NPL book) resulting in a 2019A net income of Aareal Bank of €121m
- We have analysed potential levers of RoE improvement including:

  (1) Cost Savings: of €30-50m for c. +100-150bps of RoE improvement

  (2) Reduction of Capital: in the Bank by c. €400m for c. +100bps of RoE improvement

  (3) More Asset Light Business Model: based on increased levels of CRE loan syndication for c. +15-30bps of RoE improvement

  (4) pbb Combination / Take-over: financed with 50% equity, est. pre-tax synergies of €165m for c. +300bps of RoE improvement
- We have not considered a repayment of the AT1 bonds as the result would be inferior to the capital reduction under (2)
- We conclude that even a combination of steps can only narrow the profitability gap, but will not achieve an 8-10% RoE[1]
  - Additional measures and strategic steps will have to be taken
  - We recommend a comprehensive strategic review led by experts and possibly supported by external consultants
  - A significant reduction of Aareal's loan book by means of syndication is in our view neither RoE accretive nor sustainable for the market position of the Bank
- Additional value potentials include monetizing the on-balance-sheet headquarter (prime real estate in the centre of Wiesbaden with current book value of €90m) and selling/taking all or part of the c. €450m of pension liabilities off balance sheet (estimated effect is a capital gain of €30-50m)

1) Post tax RoE.

Aareal Bank Status Quo - 5.1% Post-Tax RoE Achieved in 2019

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- **Payment processing: Benefit of cheaper financing offset by the additional administrative costs – overall slightly profitable but CiR dilutive**
- **The high admin costs per employee compared to a universal lender such as Erste are striking**
- **Aareal's capitalization is substantially more conservative than peers**

Benchmarking vs. Peers – Key Stats

	Aareal Bank (Excl. Aareon) 2019A	pbb - Group 2019A	Erste 2019A
Profitability			
% Gross Interest Margin	3.5%	3.8%	3.3%
% Net Interest Margin	2.0%	1.0%	2.2%
ROE (Post Tax)	5.1%	5.5%	10.7%
Cost Base			
Cost / Income Ratio[1]	**51.9%**	**43.5%**	59%
Admin Costs / FTE (EURk)[2]	333	293	90
Implied Blended Cost of Funding (Incl. AT1)	1.08%	2.48%	1.12%
Risk Cost Ratio (LLP / Avg. Loans)	33bps	11bps	7bps
AT1 Int. Expense as % of Net Income	13%	10%	6%
Capital Ratios			
RWA - B3 (EUR bn)	11.2	17.7	*n.a.*
RWA - B4 (EUR bn)	16.4	*n.a.*	*n.a.*
CET1 Capital - B3 (EUR bn)	2.2	2.7	*n.a.*
CET1 Capital - B4 (EUR bn)	2.2	*n.a.*	*n.a.*
CET1 Ratio (B3)	19.6%	15.9%	13.7%
Regulatory Minimum[3]	9.40%	9.8%	9.4%
CET1 Ratio (B4 - Est.)	13.5%	--	--
Capital Ratio (B3)	**29.9%**	**21.1%**	18.5%
Book Equity (Excl. AT1)	2,319[4]	2,938	14,129
% LTV (Real Estate Finance)	57%	53%	--

1) Cost/Income Ratio defined as Administrative Expenses to Operating Profit, Aareal excludes the Aareon business.
2)Calculated as Administrative Costs over average FTEs. Aareal Bank exludes the Aareon business.
3)CET1 minimum capital ratios and capital buffer requirements (SREP), Aareal (Pillar 1, 4.5%; Pilllar 2, 2,25%; Capital Conservation Buffer, 2.5%; Countercyclical Buffer, 0.16%); pbb (Pilar 1, 4.5%; Pilar 2, 2.5%; Capital Conservation Buffer, 2.5%; Countercyclical Buffer, 0.34%); Erste (CET1, 4.5%; Capital Conservation Buffer, 2.5%; Buffer for Systemic Vulnerability and for Systemic Concentration Risk, 2.0%; Countercyclical Capital Buffer, 0.41%).
4) Excludes EUR 184m attributed to Aareon.
Source: Companies' filings

Route to ~7.25% to ~7.9% Post-tax RoE Via A Combination Of Measures

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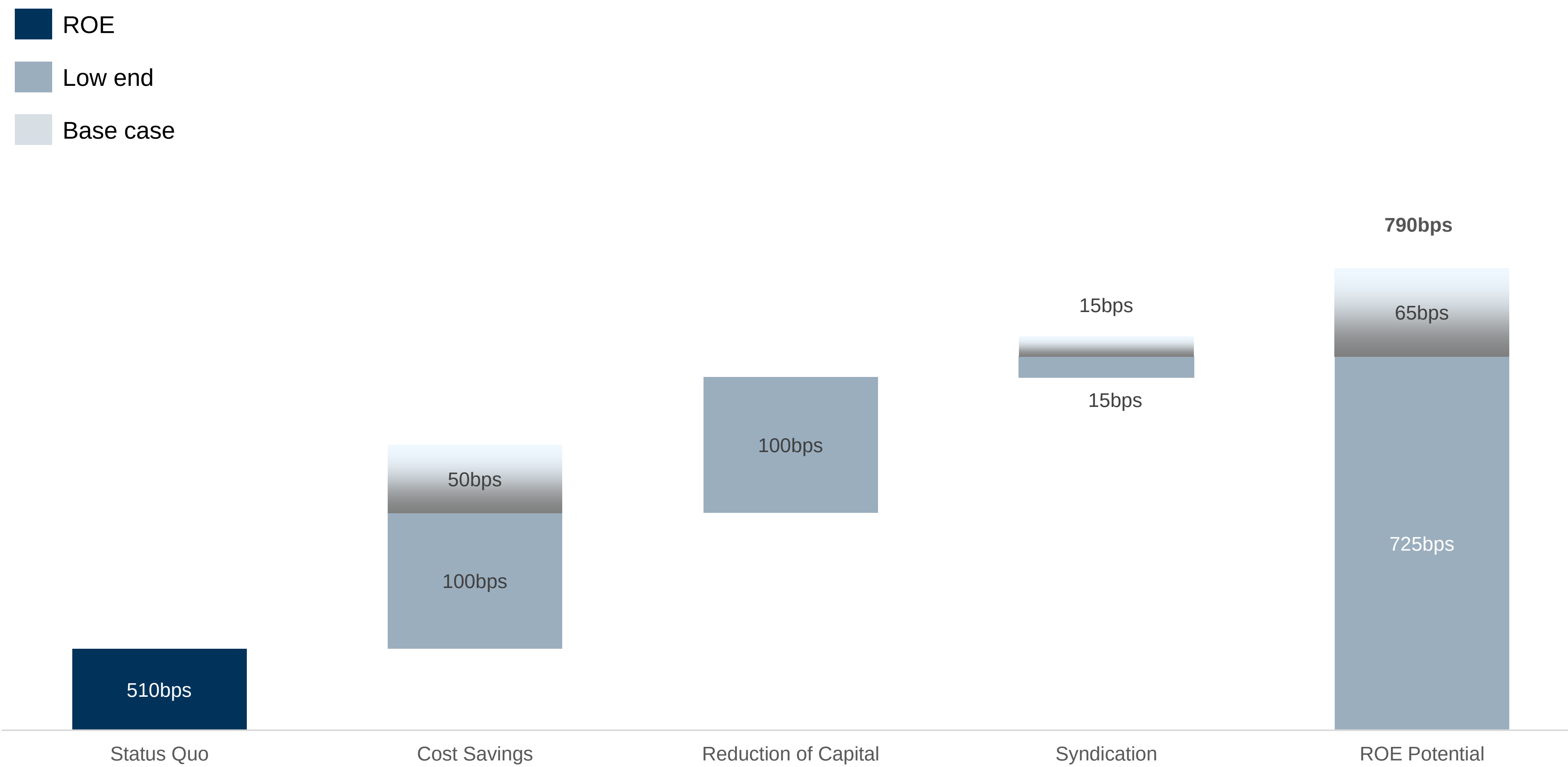
RoE Improvement Bridge



Source: Petrus Advisers

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II Cost Savings

A Concerted Lean Effort Could Bridge 100-150bps of the RoE Shortfall

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Using pbb as a benchmark, EUR50m of cost improvements appear realistic

Illustrative Cost Reduction Sensitivity

	Cost / Income Ratio	Cost cuts [EUR m.]	Implied Admin Costs / FTE [EUR m.]	Implied ROE[1]
Aareal	51.9%	0	333	5.1%
	50.2%	11	322	5.4%
	48.5%	21	311	5.7%
	46.8%	32	300	6.0%
	45.1%	42	290	6.2%
pbb DEUTSCHE PFANDBRIEFBANK	**43.5%**	**53**	**279**	**6.5%**
	41.8%	63	268	6.8%
	40.1%	74	257	7.1%

Potential 1.4% ROE improvement

1) Calculated on Post AT1 basis on Book Value of Aareal Group less Aareon, assuming 35% tax rate (FY 2019).

III Capital Reduction

Subject to the Outcome Of Basel IV, Reducing Capital Could Add More Than 100bps of RoE

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Illustrative Sensitivity Of Capital Releases

	CET 1 Ratio - B4 (incl. Aareon capital gain)	CET 1 Ratio - B4 (excl. Aareon capital gain)	CET 1 Ratio - B3 (excl. Aareon capital gain)	Released Capital	Est. CET1 Ratio B4 Buffer (incl. Aareon capital gain)	Est. CET1 Ratio B4 Buffer (excl. Aareon capital gain)	Implied '19 Book Equity (ex. Aareon)	Implied ROE[1]
Aareal	14.6%	13.5%	19.6%	0	5.2%	4.1%	2,319	5.1%
	14.0%	12.9%	18.7%	104	4.6%	3.5%	2,214	5.3%
	13.3%	12.2%	17.7%	209	3.9%	2.8%	2,110	5.6%
	12.7%	11.6%	16.8%	313	3.3%	2.2%	2,005	5.9%
pbb DEUTSCHE PFANDBRIEFBANK	12.0%	10.9%	**15.9%**	418	2.6%	1.5%	1,901	6.2%
	11.4%	10.3%	14.9%	522	2.0%	0.9%	1,796	6.5%
	10.8%	9.6%	14.0%	627	1.4%	0.2%	1,692	6.9%

Potential 1.1% ROE improvement

1) *Calculated on an Average Book Equity excl. Aareon, assumes release of capital at the beginning of the year.*
Source: Companies' filings, Petrus Advisers estimates

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IV Asset Light Business – Syndication

Overview Of Key Assumptions

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- Following analysis evaluates two scenarios:
  - i) Syndicating part of the existing loan book
  - ii) Syndicating newly originated loans in addition to the existing loan book and syndication level
- Under scenario i) the following assumptions have been made:
  - Aareal loses net interest income at 200bps net margin of the volume syndicated
  - Aareal is expected (base case) to generate a 20bps skimming spread on loans syndicated in Europe over an average 5 year period, and a one-off syndication fee of 60bps in the US
  - Associated loans are assumed to carry a 35% RWA weighting
  - Aareal is assumed to maintain its 19.6% CET1–B3 Ratio; as such CET1 and, accordingly, Book Equity is reduced by the amount attributable to syndicated loans
  - The analysis assumes constant fixed costs of Aareal Bank
  - Tax rate of 34% is applied to calculate RoE
  - RoE is calculated post AT1 coupon payment
- Under scenario ii) the following assumptions have been made:
  - Newly originated loans are syndicated immediately, as such there is no impact on Book Equity
  - Aareal is expected (base case) to generate a 20bps skimming spread on loans syndicated in Europe over an average 5 year period, and a one-off fee of 60bps in the US
  - The analysis assumes constant fixed costs of Aareal Bank
  - Tax rate of 34% is applied to calculate RoE
  - RoE is calculated post AT1 coupon payment

Syndicating the Existing Loan Book Portfolio is RoE Dilutive

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Illustrative Existing Loans Syndication Sensitivity Analysis on RoE

	Europe	US
Volume Syndicated [EUR m.]	**10,000**	**10,000**
Net interest margin	200bps	200bps
Lost Net Interest Income [EUR m.]	**200**	**200**
Syndication fee	0bps	60bps
Annual Fee [EUR m.]	**0**	**60**
Spread (5yrs)	20bps	0bps
Annual Fee [EUR m.]	**20**	**0**
RWA weight	35%	35%
RWA [EUR m.]	3500	3500
CET 1 Ratio	19.6%	19.6%
Δ CET 1 Capital [EUR m.]	686	686
Average Equity post syndication [EUR m.]	1704	1704
ROE Impact[1]	**-4.93%**	**-3.38%**

Europe: Sensitivity of ROE impact

Skimming Spread	Volume Syndicated [EUR m.]			
	1,000	3,000	5,000	10,000
10bps	-0.39%	-1.24%	-2.21%	-5.31%
15bps	-0.38%	-1.20%	-2.13%	-5.12%
20bps	-0.36%	-1.15%	-2.05%	-4.93%
25bps	-0.35%	-1.11%	-1.97%	-4.73%
30bps	-0.33%	-1.06%	-1.89%	-4.54%

US: Sensitivity of ROE impact

Syndication fee	Volume Syndicated [EUR m.]			
	1,000	3,000	5,000	10,000
50bps	-0.28%	-0.88%	-1.57%	-3.76%
55bps	-0.26%	-0.84%	-1.49%	-3.57%
60bps	-0.25%	-0.79%	-1.41%	-3.38%
65bps	-0.23%	-0.75%	-1.32%	-3.18%
70bps	-0.22%	-0.70%	-1.24%	-2.99%

Note: Assumes unchanged administrative costs structure. Assumes 1-time syndication effort.
1) Assumes 34% tax rate.

Growing Syndication Activity Beyond The Status Quo Can Offer Some ROE Expansion

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Illustrative Example Of Marginal Syndication

	Europe	US
Volume Syndicated per year [EUR m.]	**1,000**	**1,000**
Syndication fee	0bps	60bps
Annual Fee [EUR m.]	**0**	**6**
Spread (5yrs)	20bps	0bps
Annual Fee [EUR m.]	**2**	**0**
ROE Impact[1,2]		
Year 1	0.06%	0.17%
Year 2	0.11%	0.17%
Year 3	0.17%	0.17%
Year 4	0.22%	0.17%
Year 5	0.28%	0.17%

Europe: Sensitivity of ROE impact in Year 3

Skimming Spread \ Volume Syndicated	500	1,000	1,500	2,000
10bps	0.04%	0.08%	0.12%	0.17%
15bps	0.06%	0.12%	0.19%	0.25%
20bps	0.08%	0.17%	0.25%	0.33%
25bps	0.10%	0.21%	0.31%	0.41%
30bps	0.12%	0.25%	0.37%	0.50%

US: Sensitivity of ROE impact in Year 3

Syndication fee \ Volume Syndicated	500	1,000	1,500	2,000
50bps	0.07%	0.14%	0.21%	0.28%
55bps	0.08%	0.15%	0.23%	0.30%
60bps	0.08%	0.17%	0.25%	0.33%
65bps	0.09%	0.18%	0.27%	0.36%
70bps	0.10%	0.19%	0.29%	0.39%

1) Assumes constant administrative costs.
2) Assumes 34% tax rate.

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