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Ratings

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Research Update:

Austria-Based Hypo Vorarlberg Bank Outlook Revised To Negative On Rising Asset Quality Risk; Affirmed At 'A+/A-1'

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Overview

- European commercial real estate markets remain under stress, which implies particular asset quality risks to development companies and could mean higher credit losses for Hypo Vorarlberg Bank AG (Hypo Vorarlberg).
- Hypo Vorarlberg has strong risk-adjusted capital and sound asset quality, but we see a risk of higher nonperforming assets, particularly in its sizeable exposures to the construction and real estate development sector.
- We therefore revised our outlook on the bank to negative from stable and affirmed our 'A+/A-1' long-term and short-term issuer credit ratings.
- The negative outlook indicates that we could lower our ratings on Hypo Vorarlberg over the next 12 months if tough real estate markets lead to asset quality deterioration and materially higher credit losses, or if capitalization weakens substantially.

Rating Action

On Dec. 12, 2023, S&P Global Ratings revised its rating outlook on Austria-based Hypo Vorarlberg Bank AG (Hypo Vorarlberg) to negative from stable.

At the same time, we affirmed our 'A+/A-1' long-term and short-term issuer credit ratings on the bank.

Rationale

We believe Hypo Vorarlberg's asset quality could deteriorate materially in the next 12 months. The bank's recent results for the nine months ended Sept. 30, 2023, show only a moderate amount of loan loss provisions of €10.5 million (or nine basis points of total customer loans) and stable after-tax profits of €62.7 million. However. we believe nonperforming loans and credit losses could increase sharply over the coming 12 months and materially reduce the bank's earnings. Tighter funding conditions and increasing refinancing risks for real estate companies could hurt the credit quality of borrowers, including those of Hypo Vorarlberg.

Hypo Vorarlberg has high exposures to the construction and real estate development sector, totaling about €2.7 billion as of Sept. 30, 2023. We view the loan concentration to this segment as a weakness compared to other rated banks in Austria because it adds up to 17% of Hypo Vorarlberg's total credit exposures. Recent stress at Signa Holding, one of the largest Austria-based real estate developers in the German-speaking region of Germany, Austria, and Switzerland, is an early indication that tighter financing conditions will test companies operating in riskier real estate segments, in our view. As a mitigating factor, a material share of Hypo Vorarlberg's exposures is to companies building residential real estate and not to borrowers in the higher-risk commercial real estate sector. We have revised our credit loss projections for Hypo Vorarlberg accordingly and now expect a materially higher cost of risk of 35 basis points (bps) in 2023 before it peaks at 60 bps in 2024.

Hypo Vorarlberg's risk-adjusted capital (RAC) buffers remain strong, but we see risks to our financial projections. Due to higher anticipated credit losses, we have revised down our forecast of the bank's RAC ratio to 10.5%-11.0% for the next 12-24 months from close to 12.0%. This compares to a ratio of 10.7% on Dec. 31, 2022. In our base case, we expect capital buffers to remain strong and to act as a buffer in case credit losses outpace preprovision operating income. However, higher-than-expected credit losses could put further pressure on earnings and, ultimately, on the bank's capital base, particularly if Europe's real estate markets experience materially higher stress in the next 12 months.

Further deterioration of earnings capacity could indicate structural weakness when benchmarked to other Hypo-type mortgage banks in Austria. As part of our revised forecasts, we project lower after-tax earnings compared to the last two years, ranging from €25 million to €50 million between 2023 and 2025. This translates into a return on equity ratio of only 1.5%-3.5%. However, this metric slightly understates the underlying profitability, given the bank's relatively large equity base. We expect Hypo Vorarlberg's earnings buffer to remain in the range of 0.1%-0.2% between 2023 and 2025. This is markedly weaker than the estimated median of 1.4% for Austrian and European banks in 2023, which indicates Hypo Vorarlberg's weaker capacity to absorb normalized credit losses with operating income through a full economic cycle.

We continue to believe that the bank's majority shareholder, the State of Vorarlberg, would support it, if needed. As a government-related entity (GRE), Hypo Vorarlberg is very likely, in our view, to receive government support from its majority shareholder, the State of Vorarlberg (AA+/Stable/A-1+) in times of stress. The state owns 77% of the bank's equity. As a result, we add three notches of uplift to our 'bbb+' assessment of the bank's stand-alone credit profile to derive the long-term issuer credit rating.

Outlook

The negative outlook reflects our view that Hypo Vorarlberg is facing heightened asset quality risk, which could increase its credit losses and reduce its after-tax earnings over the next 12 months.

We consider Hypo Vorarlberg a GRE and our rating on the bank is supported by our credit view of the owner. As such, a downgrade of the State of Vorarlberg by one notch would lead us to downgrade the bank. A change in Hypo Vorarlberg's role or link with the state could also lead us to reassess the bank's status as a GRE and result in a lower rating, although this is a remote scenario.

Downside scenario

We could lower our rating on Hypo Vorarlberg over the next 12 months if real estate markets remain challenging, leading to asset-quality deterioration and materially higher credit losses. Additionally, we could lower the rating if the bank's RAC ratio drops and remains below 10%, contrary to our current expectations. We could also lower the rating if Hypo Vorarlberg's business model and profitability prove to be structurally weaker than those of other rated Austrian Hypo-type mortgage banks.

Upside scenario

We could revise our outlook to stable over the next 12 months if Hypo Vorarlberg maintains a resilient balance sheet and stable sound asset quality amid difficult real estate markets. A precondition for an outlook revision is that the bank can sustain good financial performance with stabilizing profitability and cost efficiency in line with those of other rated Austrian Hypo-type mortgage banks'.

Ratings Score Snapshot

	To	From
Issuer Credit Rating	**A+/Negative/A-1**	**A+/Stable/A-1**
SACP	bbb+	bbb+
Anchor	a-	a-
Business position	Moderate (-1)	Moderate (-1)
Capital and earnings	Strong (+1)	Strong (+1)
Risk position	Moderate (-1)	Moderate (-1)
Funding and liquidity	Adequate and adequate (0)	Adequate and adequate (0)
Comparable ratings analysis	0	0
Support	+3	+3
ALAC support	0	0
GRE support	+3	+3
Group support	0	0
Sovereign support	0	0
Additional factors	0	0

SACP--Stand-alone credit profile.

Related Criteria

- General Criteria: Hybrid Capital: Methodology And Assumptions, March 2, 2022
- Criteria | Financial Institutions | Banks: Banking Industry Country Risk Assessment Methodology And Assumptions, Dec. 9, 2021
- Criteria | Financial Institutions | General: Financial Institutions Rating Methodology, Dec. 9, 2021
- General Criteria: Environmental, Social, And Governance Principles In Credit Ratings, Oct. 10, 2021
- General Criteria: Group Rating Methodology, July 1, 2019
- Criteria | Financial Institutions | General: Risk-Adjusted Capital Framework Methodology, July 20, 2017
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings, April 7, 2017
- General Criteria: Rating Government-Related Entities: Methodology And Assumptions, March 25, 2015
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011

Related Research

- Credit Conditions Europe Q1 2024: Adapting To New Realities, Nov. 28, 2023
- Banking Industry Country Risk Assessment: Austria, Aug. 1, 2023

Ratings List

Ratings Affirmed; Outlook Action

	To	From
Hypo Vorarlberg Bank AG		
Issuer Credit Rating	A+/Negative/A-1	A+/Stable/A-1