Graubündner Kantonalbank

Bad weather not a reason to hide at home

Banks | 2 August 2016

Rating: Market Perform

Price PC: CHF 1 700 ZKB Issuer Rating: AA+
Bloomberg: GRKP SE TK-Symbol: GRKP
Market Capitalisation: CHF 1.28 bn Free Float: 100%
Sustainable Investment Universe: Yes

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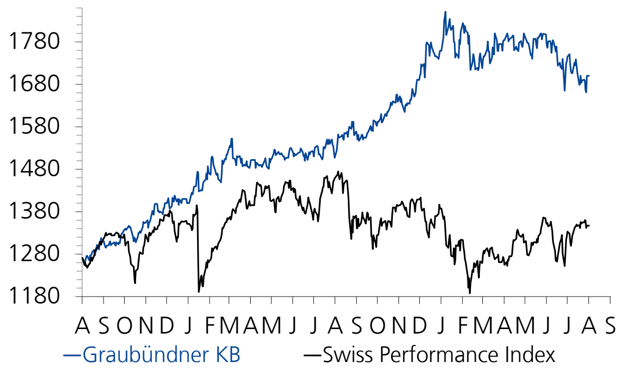


Key Figures

in CHF	2015	2016E	2017E		2015	2016E	2017E
EPS (adj.)	68.8	67.6	67.6	P/E	24.7x	25.1x	25.1x
– Change	–3.84%	–1.75%	0.00%	ROE (adj.)	7.43%	7.02%	6.79%
Dividend Yield	2.24%	2.24%	2.24%	Cost/Income Ratio	50.2%	50.6%	50.1%

Source: Zürcher Kantonalbank

Making the best out of a detrimental environment
Graubündner Kantonalbank reported a robust set of figures for the first half of 2016. Everything is proceeding as usual in the bank's core business, and so far there has been no sign of any increase in credit risk provisioning, as had been feared at the beginning of the year. The earnings guidance was affirmed. The bank has repositioned itself in wealth management by selling its investment in Private Client Bank (PCB) and acquiring a 25% stake in Albin Kistler AG. Graubündner Kantonalbank offers an attractive combination of a pleasantly boring core business and proactive management that is not resting on the laurels from its bread-and-butter business. But in light of the prevailing market environment, which is not very conducive for the banking business, we are sticking with our "Market Perform" rating, also because the participation certificate trades at a P/E 2017 of 25x, which doesn't exactly indicate undervaluation.

Change in scope of consolidation shapes the first half
Our estimates had not yet taken into account the effect on net commission income and costs that the deconsolidation of PCB had (retrospective sale as of 1 January 2016). Without this influence net commission income would have fallen by 1.9%, reflecting the general reluctance of the bank's clientele to undertake securities transactions. Net interest income rose by 5.4% thanks to the expected scale-back in the payer-swap overhang. Net trading income could not quite keep pace with last year's strong result, which had benefited from the SNB's decision to abandon the CHF-EUR exchange rate peg. Other operating income fell by 40% to CHF 3.6 million because virtually no gains on financial investments were realised in this half-year and there was no income any more from PCB's subleased properties. Costs would have risen by 1.8% without the PCB effect, primarily because of spending on digitisation projects. While about CHF 2.5 million in new risk provisions were established in the first half of 2015, this year a total of roughly CHF 3.7 million in provisions were reversed, of which about a third was due to credit risks, with the remainder stemming from other risk provisions. This reversal is the main reason behind the 2% year-on-year increase in net operating profit. The extraordinary result includes income totalling CHF 8.4 million from the PCB transaction, property sales and the Swisscanto earn-out. At the same time, however, the reserves for general banking risks were increased by CHF 9 million. The sale of the PCB stake also means that earnings attributable to minority interests have fallen, re-

sulting in adjusted group profit after minority interests that has even risen by 4.6%.

2016 half-year results

In CHF mn	ZKB E	Actual	Δ In % YoY
Income	187.0	175.5	-4.3%
Costs incl. depreciation	95.0	87.5	-3.6%
New risk provisions	4.0	-3.7	n.a.
Net operating profit	88.0	91.7	+1.9%
Group profit before min.	86.5	90.3	+2.0%
Extraordinary result	0.0	-0.6	n.a.
Group profit adjusted*	85.0	89.6	+4.6%
Cost/income ratio	50.8%	49.9%	+0.4 pp

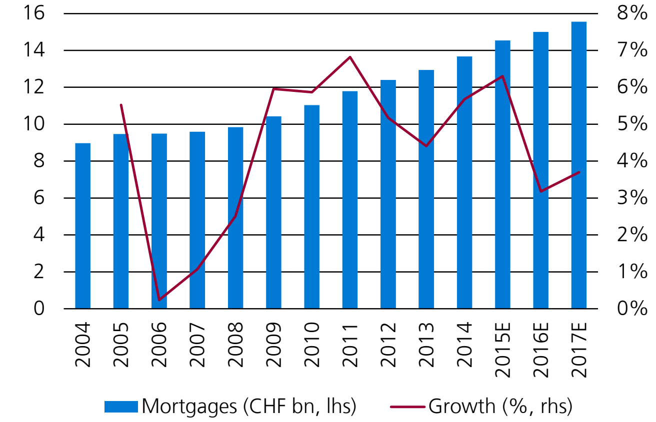
*After minorities

Source: Zürcher Kantonalbank

Lending growth slowed down to a normal pace

Loans to clients have grown by CHF 132.8 million or 0.8% compared with the start of the year. It appears this is starting to normalise following unusually strong growth in 2015. CHF 42 million of the growth in the first half was due to mortgages outside the canton, generated by intermediaries which are active throughout Switzerland (we assume it was Albin Kistler AG, see *page 3*).

Growth of the mortgage book

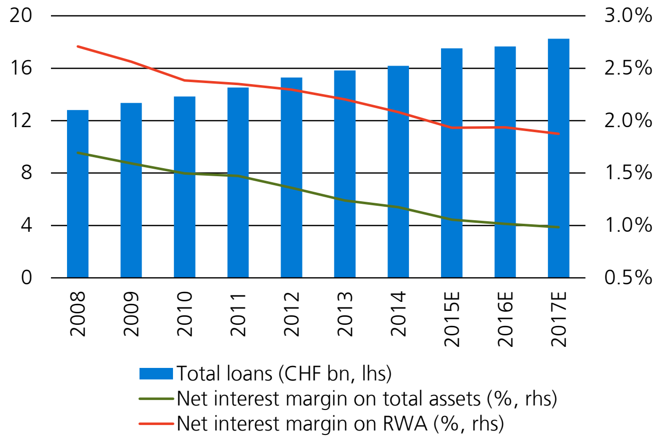


Source: Zürcher Kantonalbank

Unabated pressure on the interest margin

The adverse effects on net interest income caused by the costs of short-term hedges against a potential rise in interest rates have decreased significantly compared with the same period last year because the payer-swap overhang has diminished by itself due to natural maturities. We therefore also anticipate that net interest income for the full year 2016 will be higher than in 2015. Thereafter, however, stagnation is likely. Even though volume has risen, the yield curve has continued to flatten, making it probable that interest margins will fall even further. Overall, the negative interest rate policy has therefore steadily eroded the profitability of the lending business for banks in general – and thus for Graubündner Kantonalbank, too. Whether this policy will have a positive effect on the economy over the medium to long term is an open question.

Development of credit book and interest margins



Sources: Zürcher Kantonalbank, Graubündner Kantonalbank

Until now most banks have attempted to offset this trend by cutting costs, but according to CEO Alois Vinzens at the analyst conference, the end of what is realistically feasible is gradually being reached. He says "his" bank would consider passing on the negative interest rates to clients only if the substance of the bank were at risk over the long term, and that Graubündner Kantonalbank would "decide on its own" without taking account of what other institutions were doing.

Some dark clouds over the loan book might still come

Source: Michael Kunz

Credit risks (still) not an issue

Management warned in February that a few clouds might appear on the credit risk horizon, particularly in Grisons' tourism industry. This did not yet happen in the first half – but if pressure continues to mount, additional risk provisioning will be likely. Currently "not everything is grim" in Grisons' tourism industry (CFO Andreas Lötscher), and newspaper headlines about the sector's problems are by themselves not reason enough for the bank's auditor to allow risk provisioning as long as there are still no signs of difficulties appearing in the balance sheets of borrowers. We expect to see new risk provisioning in the second half that will negate the reversals of the first half, and that CHF 5 million in new provisioning will be recognised for both

2017 and 2018. This means that even though we anticipate revenues will grow slightly and cost control will remain good, net operating profit is likely to stagnate.

Forward defence in wealth management (WM)
The crumbling away of net commission income due to client inactivity is to be offset by the new offering of different types of asset management mandates with software-supported investment advice. In the meantime a third of the custody account business is in mandates. In addition, the bank's participations in wealth management have been revamped. As previously announced in April, the participation in PCB was sold because here the co-shareholders "wanted to go in a different direction" than Graubündner Kantonalbank. The participation in Bank Bellerive was fully acquired in a first step, although GKB's stake is to be reduced again to 55% in the second half through a secondary placement of shares to new shareholders. Graubündner Kantonalbank doesn't see itself as a financial investor, rather as an anchor shareholder in a "resource sharing community" (Bellerive CEO Daniel Wittmer). One of the things Bellerive likes about its service partner in Chur is its limited fluctuation, something which a Zurich-based provider could not grant.

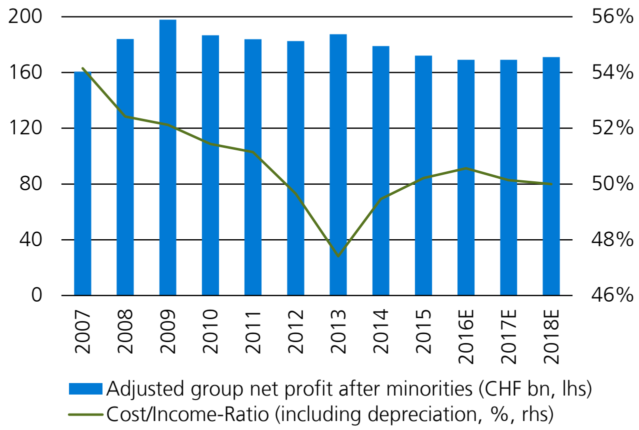
GKB headquarters in Chur – off to new shores in WM

Source: Graubündner Kantonalbank

Taking a stake in Albin Kistler AG
Graubündner Kantonalbank has acquired a 25% stake in the asset management company Albin Kistler AG in Zurich (with a representative office in Chur). The agreement includes the option to raise the stake to 51% within two to three years. This means Albin Kistler AG is getting an anchor shareholder that won't unduly interfere in its daily business. The two parties have had a business relationship for nearly ten years. Albin Kistler manages about CHF 4 billion, about one half each for institutional and private clients – all via mandates, and all for Swiss clients only. The founding partners, Norbert Albin and André Kistler, will remain active in the firm in their current roles. One area of cooperation with Graubündner Kantonalbank has been the mortgage business. If Albin Kistler clients wanted in the past to acquire an investment property, Graubündner Kantonalbank was the preferred partner. Regarding mortgage growth, GKB focuses on precisely the opposite end of the spectrum than e.g. Glarner or Freiburger Kantonalbank, with their online solutions for rather standardised residential properties. Last year's remarkably strong mortgage growth was already explained to be the result of "first-class mortgages outside the canton" via intermediaries. We assume that Albin Kistler played a role here.

Extraordinary effects in the second half of 2016
CFO Lötscher anticipates that GKB will record a write-down on its goodwill for Albin Kistler in the second half of 2016, subject to auditor approval. Our assessment of Graubündner Kantonalbank's management leads us to believe that the bank will try to write down the item as fast as it can in order to maintain the balance sheet as conservative as possible. This planned charge has prompted management to lower its forecast for the bank's business performance 2016 to CHF 154 to 158 million, down from around CHF 170 million previously. We treat write-downs on goodwill as a non-operating expense, i.e. it won't impact net operating profit, which we continue to see at CHF 175 million. The bank expects it will be able to offset this write-down with extraordinary income from the secondary placement of a 45% stake in Bank Bellerive. Management's profit forecast is therefore in line again with our calculations.

Trend and forecast for group profit and efficiency



Source: Zürcher Kantonalbank

Quality has its price
The operational quality and stability of Graubündner Kantonalbank as well as the relatively limited trading volume in its participation certificate mean that its stock trades at a considerable premium to the average of its peer group. This is due, in part, to better efficiency (lower cost/income ratio) and profitability (higher return on equity). Nevertheless, the valuation appears to us to be a bit too lofty to allow outperformance versus the broad Swiss market for an extended period. As a consequence, we are reiterating our "Market Perform" rating.

Peer group comparison*

Name	P/B 2017	P/E 2017	Dividend yield 2017	CIR 2017**	RoE 2017
BCV	1.6x	18.2x	5.0%	58.6%	9.1%
Glarner KB	0.7x	13.2x	3.7%	67.8%	5.7%
Graubündner KB	**1.7x**	**25.1x**	**2.2%**	**50.1%**	**6.8%**
Luzerner KB	1.4x	18.4x	3.1%	49.9%	7.6%
St. Galler KB	1.0x	15.9x	3.8%	61.3%	6.4%
Thurgauer KB	0.9x	15.2x	3.0%	56.6%	5.9%
Valiant	0.7x	13.1x	4.0%	62.5%	5.2%
Average	**1.1x**	**17.0x**	**3.6%**	**58.1%**	**6.7%**

*ZKB-E ** Cost/Income ratio incl. depreciation Source: Zürcher Kantonalbank

Company description

Graubündner Kantonalbank is a medium-sized cantonal bank. The parent company focuses on private and corporate client business in the Canton of Grisons. The bank also engages in private banking through its stake in Privatbank Bellerive (55% stake, assets under management of roughly CHF 4 billion, domiciled in Zurich) and Albin Kistler AG (25% stake with option for another 26%, assets under management of around CHF 4 billion, in Zurich, too). The Canton of Grisons holds 84.3% of the capital in the bank.

SWOT analysis

Strengths

- Above-average capitalisation
- Good cost and risk control
- Far-sighted and conservative management
- Relatively limited dependency on short-term market fluctuations
- State guarantee and a solid rating (ZKB debtor rating: AA+)

Weaknesses

- High dependency on interest rate environment (over 60% of income)
- Participation certificate trading volume is low
- Opportunities for cost reductions are declining
- Growth in the canton appears to be exhausted at the moment

Opportunities

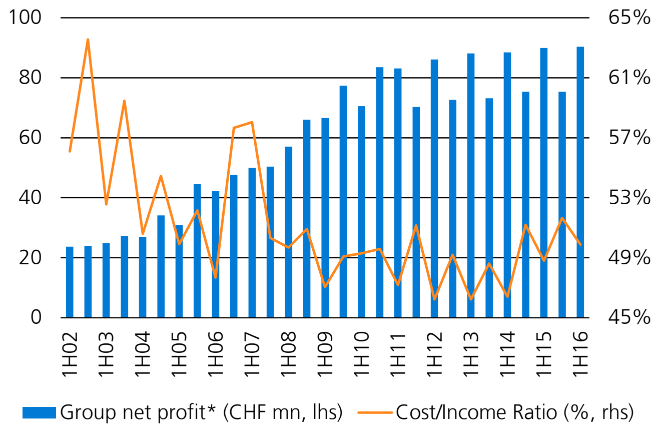
- Capital strength allows flexibility in capital measures
- Further expansion of participations with a good positioning in wealth management because of their focus on Swiss clients
- Results would strongly benefit from an improvement in the environment (markets, interest rates)

Risks

- Cash outflows in GKB parent company due to taxation changes
- Fall in real estate prices in overheated regions of the Canton of Grisons
- Collapse in the overall economy of the Canton of Grisons, resulting in higher loan defaults

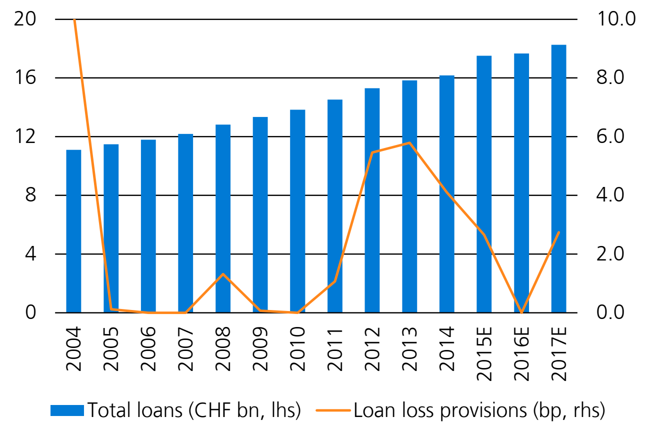
Source: Zürcher Kantonalbank

Trend in profit and efficiency



*Before minorities Source: Graubündner Kantonalbank, Zürcher Kantonalbank

Trend in loan portfolio and risk provisions



Source: Zürcher Kantonalbank

Financial Data

Graubündner Kantonalbank	2013	2014	2015	2016E	2017E	2018E
Balance sheet in CHF mn						
Total assets	20 001	20 588	23 284	21 569	22 095	22 174
– Change in %	3.29%	2.94%	13.09%	–7.37%	2.44%	0.36%
Shareholders' equity	2 182	2 264	2 363	2 450	2 527	2 606
– Change in %	4.03%	3.79%	4.38%	3.68%	3.14%	3.13%
BIS Tier 1 ratio in %	18.9%	18.9%	18.7%	18.8%	18.7%	18.9%
Total loans to customers	15 840	16 181	17 520	17 662	18 255	18 700
– Change in %	3.6%	2.1%	8.3%	0.8%	3.4%	2.4%
– Risk costs in %	0.06%	0.04%	0.03%	0.00%	0.03%	0.03%
Assets under Management in CHF bn						
Total Assets under Management	29.5	30.2	30.1	28.0	28.4	28.9
– Change in %	4.15%	2.19%	–0.26%	–6.91%	1.59%	1.56%
Income statement in CHF mn						
Net interest income	243.6	237.4	230.4	240.0	240.0	240.0
– Change in %	–3.8%	–2.6%	–3.0%	4.2%	0.0%	0.0%
– in % of operating income	63.0%	62.2%	62.4%	67.8%	66.5%	65.9%
Net fee and commission income	113.1	113.2	106.0	90.0	94.0	97.0
– Change in %	3.4%	0.1%	–6.4%	–15.1%	4.4%	3.2%
– in % of operating income	29.3%	29.7%	28.7%	25.4%	26.0%	26.6%
Net trading income	18.8	19.7	22.3	17.0	20.0	20.0
– Change in %	–4.48%	4.88%	13.17%	–23.84%	17.65%	0.00%
– in % of operating income	4.9%	5.2%	6.0%	4.8%	5.5%	5.5%
Net other income	11.0	11.5	10.4	7.0	7.0	7.0
– in % of operating income	2.86%	3.00%	2.82%	2.94%	1.94%	1.92%
Operating income	386.6	381.8	369.1	354.0	361.0	364.0
– Change in %	–1.35%	–1.24%	–3.34%	–4.08%	1.98%	0.83%
Operating expenses incl. depreciation and amortization	–183.3	–188.8	–185.3	–179.0	–181.0	–182.0
– Change in %	–5.81%	3.04%	–1.86%	–3.41%	1.12%	0.55%
– Cost/income ratio in %	47.4%	49.5%	50.2%	50.6%	50.1%	50.0%
Valuation adjustments, provisions and losses	–9.2	–6.6	–4.7	0.0	–5.0	–5.0
Net operating result	194.1	186.3	179.1	175.0	175.0	177.0
– Change in %	2.7%	–4.0%	–3.9%	–2.3%	0.0%	1.1%
Appropriation to reserves for general banking risks	–31.2	–22.7	–24.6	–10.0	0.0	0.0
Other extraordinary items	1.9	0.0	16.7	10.0	0.0	0.0
Taxes	–3.5	–2.5	–3.0	–3.0	–3.0	–3.0
Profit before minorities	161.3	161.1	168.2	172.0	172.0	174.0
Minorities	–5.0	–4.9	–4.0	–3.0	–3.0	–3.0
Net profit	156.3	156.2	164.1	169.0	169.0	171.0
– Change in %	2.0%	–0.1%	5.1%	3.0%	0.0%	1.2%
Adjusted net profit	187.5	178.9	172.0	169.0	169.0	171.0
– Change in %	2.7%	–4.6%	–3.8%	–1.8%	0.0%	1.2%
– Return on equity adjusted in %	8.8%	8.0%	7.4%	7.0%	6.8%	6.7%
– Net interest margin in %	1.2%	1.2%	1.1%	1.0%	1.0%	1.0%
Valuation						
P/E			24.7	25.1	25.1	24.9
Price/book			1.8	1.7	1.7	1.6
Price/tangible book			1.8	1.7	1.7	1.6
Dividend yield			2.2%	2.2%	2.2%	2.2%
Per share data in CHF						
Shareholders' equity	872.7	905.8	945.4	980.2	1011.0	1042.6
Tangible shareholders' equity	872.7	905.8	945.4	980.2	1011.0	1042.6
Net profit	62.5	62.5	65.7	67.6	67.6	68.4
– Change in %	2.0%	–0.1%	5.1%	3.0%	0.0%	1.2%
Adjusted net profit	75.0	71.6	68.8	67.6	67.6	68.4
– Change in %	2.7%	–4.6%	–3.8%	–1.8%	0.0%	1.2%
Dividend	38.0	38.0	38.0	38.0	38.0	38.0
Payout ratio in %	60.8%	60.8%	57.9%	56.2%	56.2%	55.6%

Capital structure	Par Value	Anzahl PS	Market Cap.	Free Float	TK Symbol	Swiss Sec. No.
Participation certificates	CHF 1 000	750 000	CHF 1 275 mn	100%	GRKP	134 020

Source: Zürcher Kantonalbank

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