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ISSUER COMMENT

EU Approval of Hypo Alpe-Adria Nationalization Is Credit Positive, but Challenges Remain

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On 4 August, the European Commission approved the acquisition of Hypo Group Alpe-Adria (Baa3 negative, E/Caa2 stable)[1] by the Republic of Austria at the end of 2009. The decision is credit positive as it confirms the Republic of Austria as the bank's single owner. Nevertheless, the bank continues to face significant challenges.

The bank has an ambitious restructuring plan ahead of it with major asset divestments across its international business operations; these assets have been moved into a restructuring unit. The plan was imposed on the bank to compensate for massive government support and remains subject to EU approval.

New management arrived at the end of March 2010 and undertook a review of the loan portfolio, which now requires an additional €1 billion in loan provisioning. A liquidity line from former shareholder Bayerische Landesbank (A1 stable, D-/Ba3 stable) remains in place as part of the rescue package and management expects to maintain the bank's solvency ratio at around 10%, a rate well above the 8% required by the Austrian regulator. The Tier 1 capital ratio, which excludes €900 million in sub-debt, is considerably lower at around 6.6% as of year-end 2009.

But amid the challenge of deleveraging and restructuring, the bank also faces the daunting task of re-establishing itself as a significant player in the region. Hypo Alpe-Adria expanded its business before the crisis on the basis of government-guaranteed funding and shareholder support. As a result, Hypo Alpe-Adria was able to issue significant amounts of debt ahead of the crisis and relies on €20 billion of debt guaranteed by the Austrian federal state of Carinthia, one of the former owners of the bank (see exhibit below). These funds account for about half of the bank's balance sheet and most of it matures by 2017. Some of these funds will need refinancing despite the ongoing restructuring. Access to the capital markets will require Hypo Alpe-Adria to have a viable business case in place.

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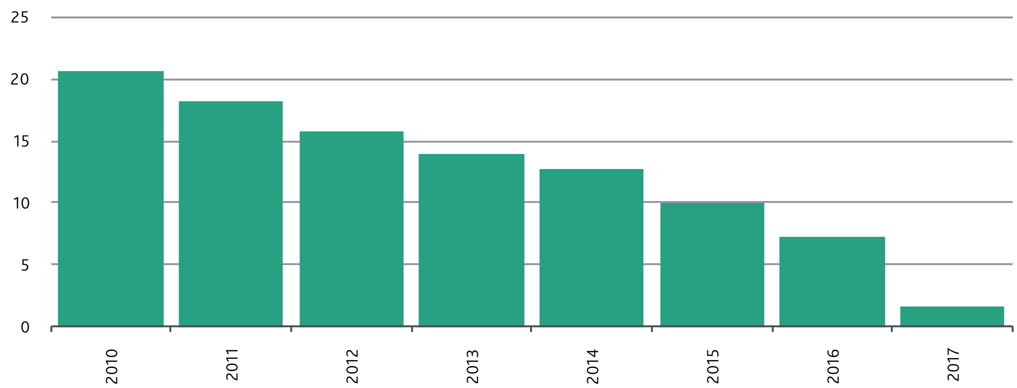
[1] The bank ratings shown in this article are the bank's deposit rating, its standalone financial strength rating mapped to the long term scale, and the corresponding rating outlooks

Hypo Alpe - Adria:
Cumulative volume of outstanding debt guaranteed by the federal state of Carinthia in € billion



Source: Bloomberg, Moody's

State intervention as a way to rescue banks continues to be a major theme of the financial crisis. In the European Union, these interventions are under scrutiny by the European Commission in order to avoid distortions in the competitive landscape. In the case of Hypo Alpe-Adria, state intervention included the nationalization of a privately owned bank, which required a separate EU approval. It marks the second time the EU has approved the nationalization of a private bank during the financial crisis, following Germany's takeover in October 2009 of Hypo Real Estate Group with its two operative subsidiaries, Deutsche Pfandbriefbank and Depfa plc (both rated A3 negative, E+/B3 negative).

Initially a regional bank in the Austrian federal state of Carinthia, Hypo Alpe-Adria pursued an aggressive growth strategy beginning in the 1990s to establish itself as a leading player in southeastern Europe with significant operations in the former Yugoslavia. The bank was hit by the financial crisis in a dramatic way in 2009, recording a €1.6 billion loss that erased the major part of its Tier I capital of €2.7 billion. As a result, a recapitalization was needed to avoid insolvency. After a final capital injection of more than €1 billion by the bank's former owners, the Austrian government decided to rescue and nationalize the bank at the end of 2009.

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