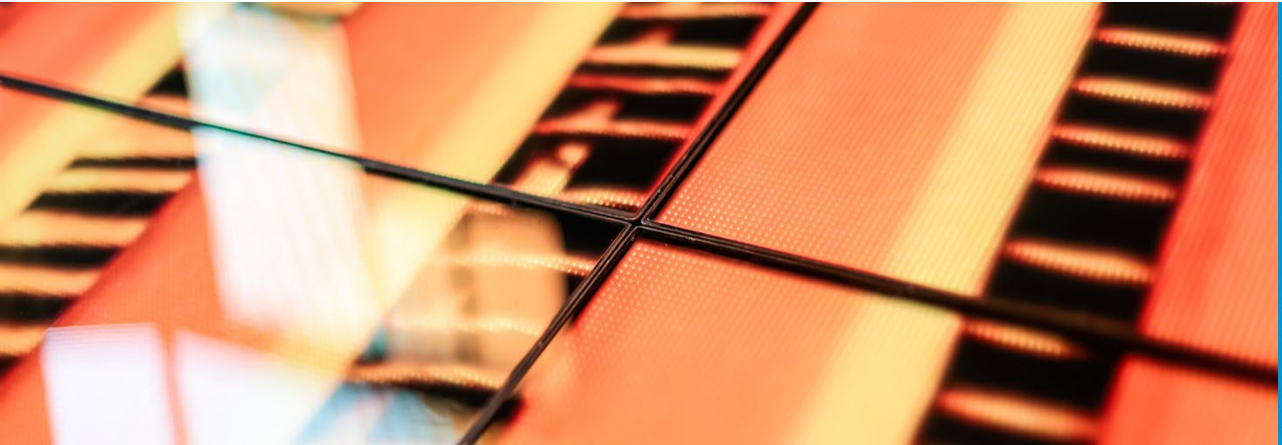
Unlocking Opportunities The Power of Subordinated debt

Gregoire Mivelaz, Fund Manager, GAM
Hong Kong, 27th of September 2023



BEYOND THE OBVIOUS

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Key advantages of subordinated debt

- ✓ ***Steady and attractive income:*** *reliable income comparable to high-yield securities, backed by investment-grade issuers*
- ✓ ***Yield enhancement:*** *offers a yield advantage of ca. 2-3% per annum over the economic cycle compared to senior unsecured → Yield to call currently of ca. 10%*
- ✓ ***Resilience to interest rate changes:*** *bonds usually callable within 5 years. In the event of a non-call, coupon becomes variable, mitigating interest rate risk*
- ✓ ***Very liquid market:*** *issuance size ca. 1-2bn, holders tend to exhibit strong commitment*
- ✓ ***Highly regulated market:*** *predominantly comprised of financial institutions subject to rigorous regulation. Regulators prioritize sector stability, so indirectly acting on behalf of bondholders*

Source: Atlanticomnium. The views are those of the manager and are subject to change. The mentioned financial instruments are provided for illustrative purposes only and shall not be considered as a direct offering, investment recommendation or investment advice.

Key challenges in subordinated debt investing

- ✓ ***Complexity of non-harmonized bonds:*** *bond diversity requires a deep understanding of individual prospectuses beyond just credit risk assessment*
- ✓ ***Dynamic regulatory environment:*** *regulatory changes can create both risks and opportunities, necessitating vigilance and adaptability from investors*
- ✓ ***Callable and perpetuals bonds:*** *bonds often have callable and perpetual structures, introducing extension risk and potential volatility.*
- ✓ ***Market accessibility and high barrier to entry:*** *both related to primary as well as secondary market. Minimum ticket size of usually $100-200k and time-consuming prospectus analysis can pose entry challenges.*

→ **Consider investing via specialists or investment funds to mitigate these complexities and benefit from diversification and access to the market**

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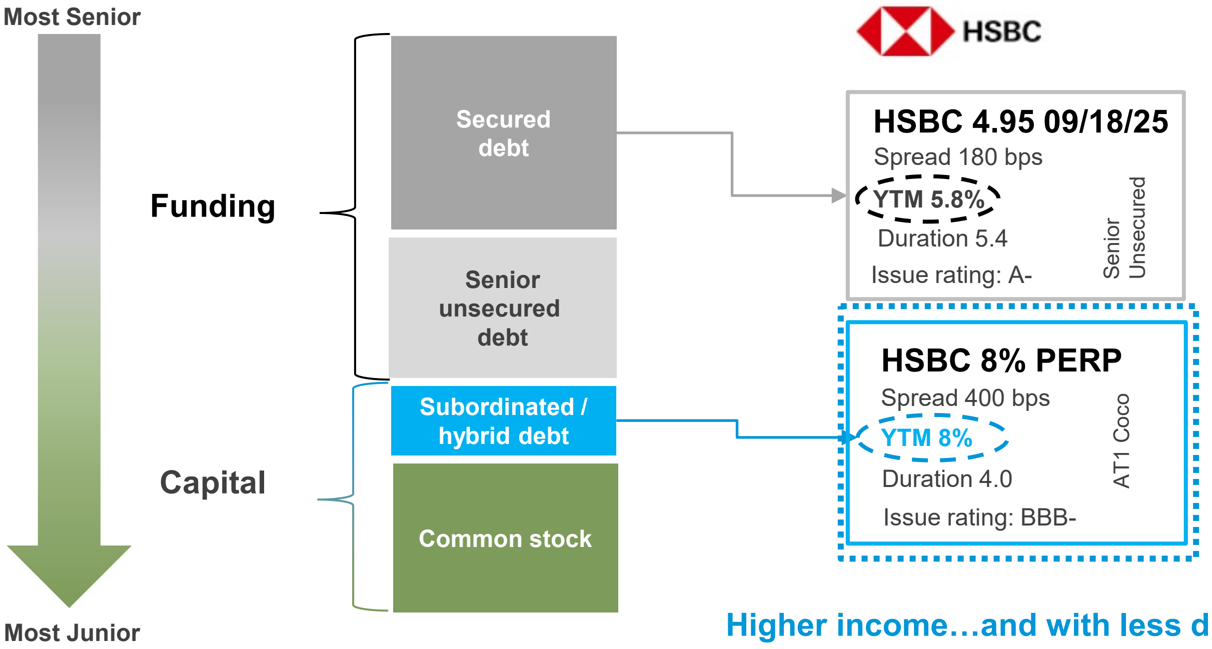
Subordinated for capital enhancement

A closer look at HSBC's approach

Unlike funding, capital is expensive. Which explains why HSBC is willing to pay an income of 8% on its subordinated debt



Higher income…and with less duration

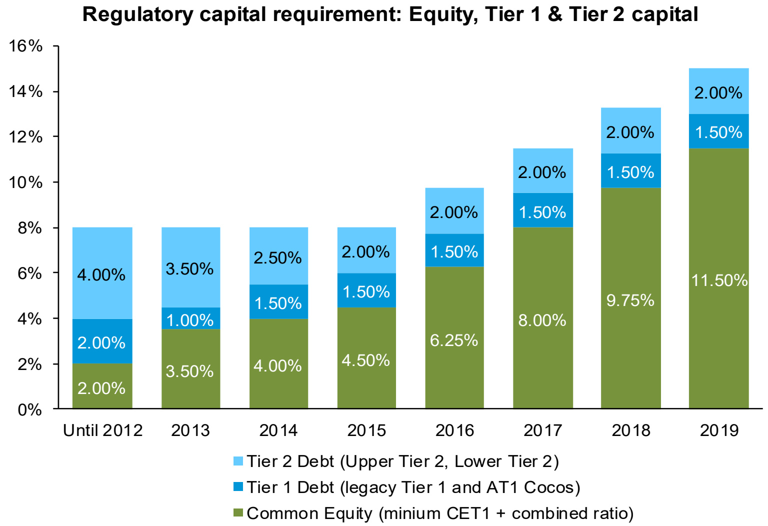
Source: Atlanticomnium, Bloomberg, September 2023.

For illustrative purposes only. The securities listed were selected from the universe of securities covered by the portfolio managers to assist the reader in better understanding the themes presented. The securities included are not necessarily held by any portfolio or represent any recommendations by the portfolio managers.

The regulatory backbone of subordinated debt

An integral component of capital enhancement

- ***Purpose of subordinated debt:*** *it serves as a vital tool for banks for bolstering capital reserves. Regulators permit banks to partially fulfill capital requirements with such bonds*
- ***Cost efficiency of subordinated debt:*** *while it carries a high coupon (e.g. 8% for HSBC, 8.5% for BNP, 9.25% for Barclays), it remains a cost-effective alternative*
- ***Historical context:*** *1988 Basel Capital Accord. Eligible capital = equity + subordinated debt*
- ***Size of the market:*** *significant growth to ca $ 1 trillion. Key segments include banks $600bn, insurers $200bn, corporates hybrids $200bn*



Resilience of EU Banks…a pillar of stability

Due to on-going regulatory pressure, sector has never been so strong

Capital ratios → Strong

Good for stability of the sector as well as bondholders

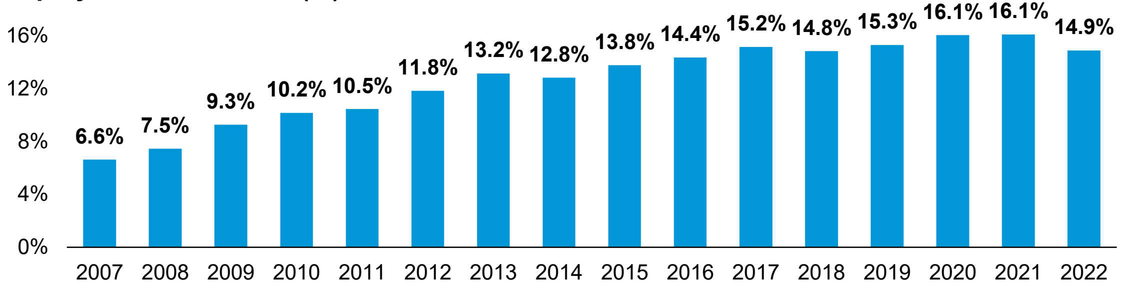
Asset quality → Strong

More than a decade of de-risking has led to a radical **clean-up of banks' balance sheets**

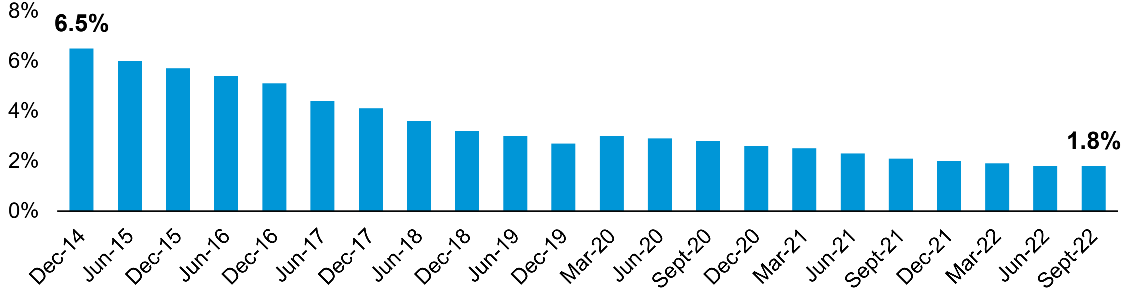
Liquidity → Strong

European Banks' average regulatory **liquidity ratios of >160%** vs 100% requirement

Equity buffer i.e. CET1 (%)



Non-performing loans (%)



Source: Atlanticomnium and Bloomberg as at March 2022. CET1 = common equity Tier 1. The views are those of the manager and are subject to change.
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Current environment is supportive for financials

Sound fundamentals boosted by profitability

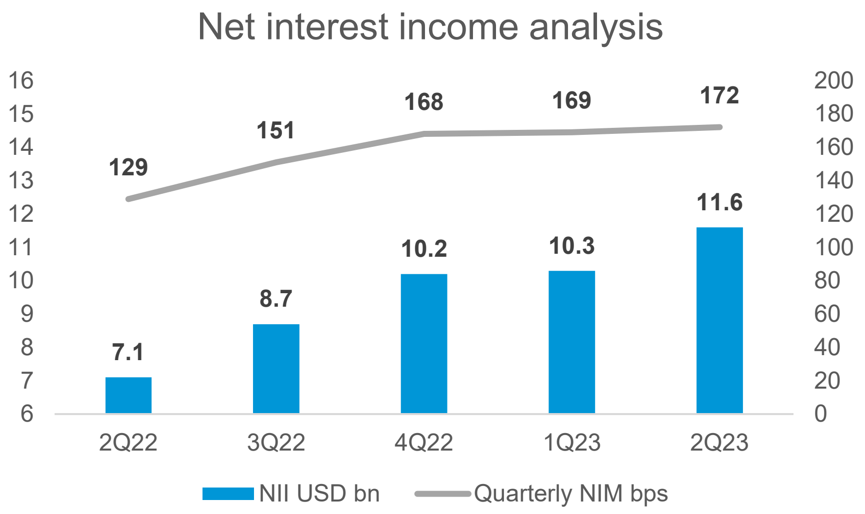
A backdrop of higher for longer interest rates

- Is good for net interest margins and profitability

And stronger than expected macro data

- Is good for asset quality, as indicated by low NPLs, provisioning and cost of risk

→ **Net interest income's expansion** remains the primary driver, effectively counterbalancing potential concerns related to **asset quality**



Q2 earnings showcase sector strength

Ticking all the right boxes for bondholders

Taking HSBC as an example:

- ✓ ***Rock solid capital:*** *CET1 ratio of 14.7% vs requirement of 10.9%, so an excess capital of USD 32bn*
- ✓ ***Robust asset quality:*** *NPLs remain low at 2.1% and cost of risk of only 35bps, so below guidance*
- ✓ ***Strong tailwinds from higher rates:*** *1H's revenue up 56% to $37bn, NII up 42% to $18bn, 22.4% RoTE*
- ✓ ***Stable deposits:*** *USD 1.6tn*
- ✓ ***Strong liquidity buffer:*** *LCR of 132%, USD796bn in high-quality liquid assets*
- ✓ ***Chinese CRE*** *exposure of USD 14bn* ***vs*** *1H23* ***profit before tax*** *of USD 21bn*

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Exploring the case for subordinated debt

Four compelling reasons

1. Subordinated debt trades cheap to high yield

- Both on an absolute as well as relative basis

2. Subordinated debt trades cheap to equity

- Recovery so far has lagged but normalization is underway

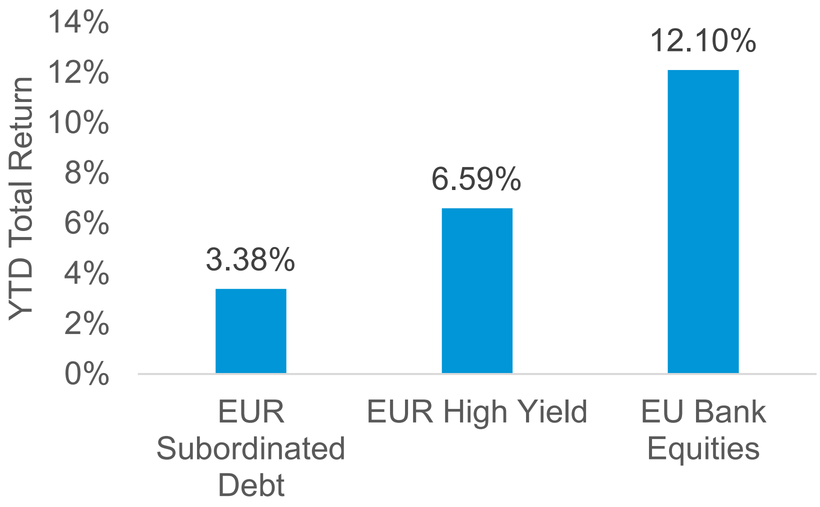
3. Subordinated debt trades cheap to senior

- An opportunity given the so-called pull to par

3. Extension risk is currently mispriced

- An opportunity to capture price appreciation

Despite strong performance of bank equities, subordinated debt has lagged so far this year



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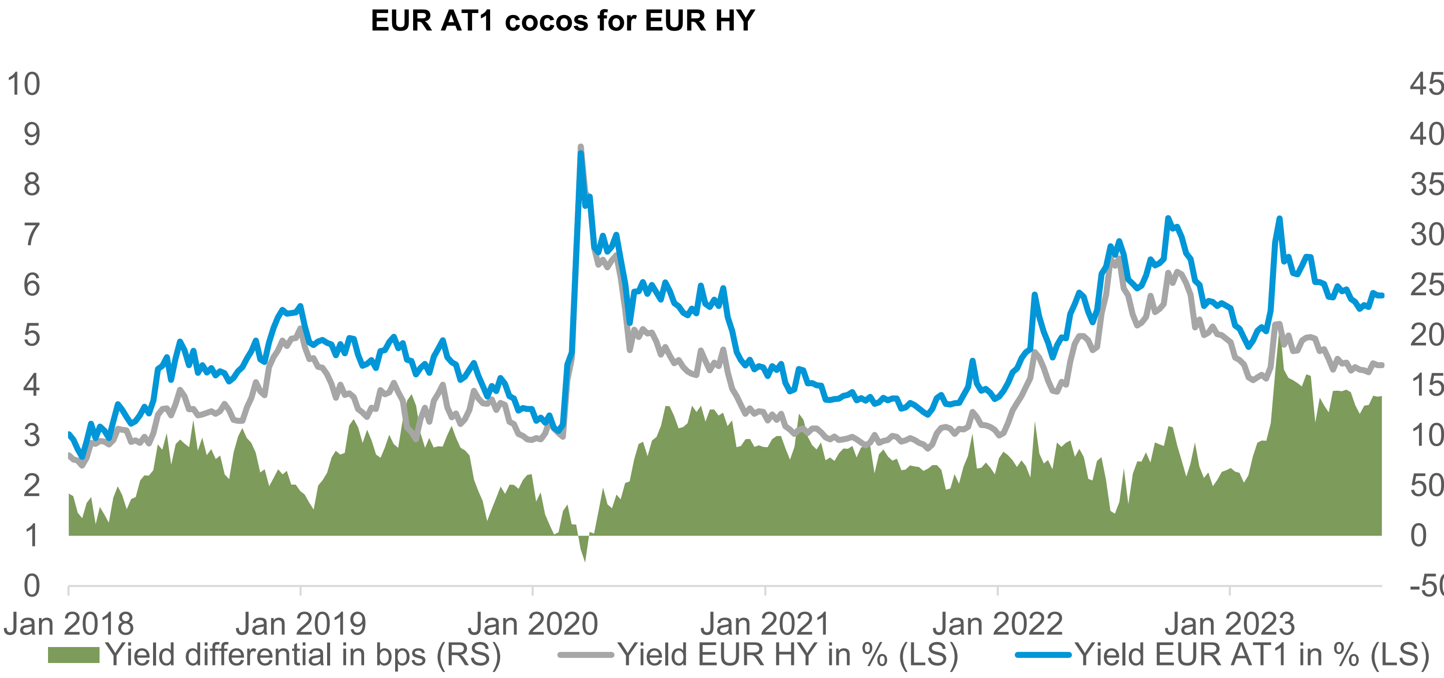
1. Subordinated debt trades cheap to High Yield

And this despite its stronger credit quality



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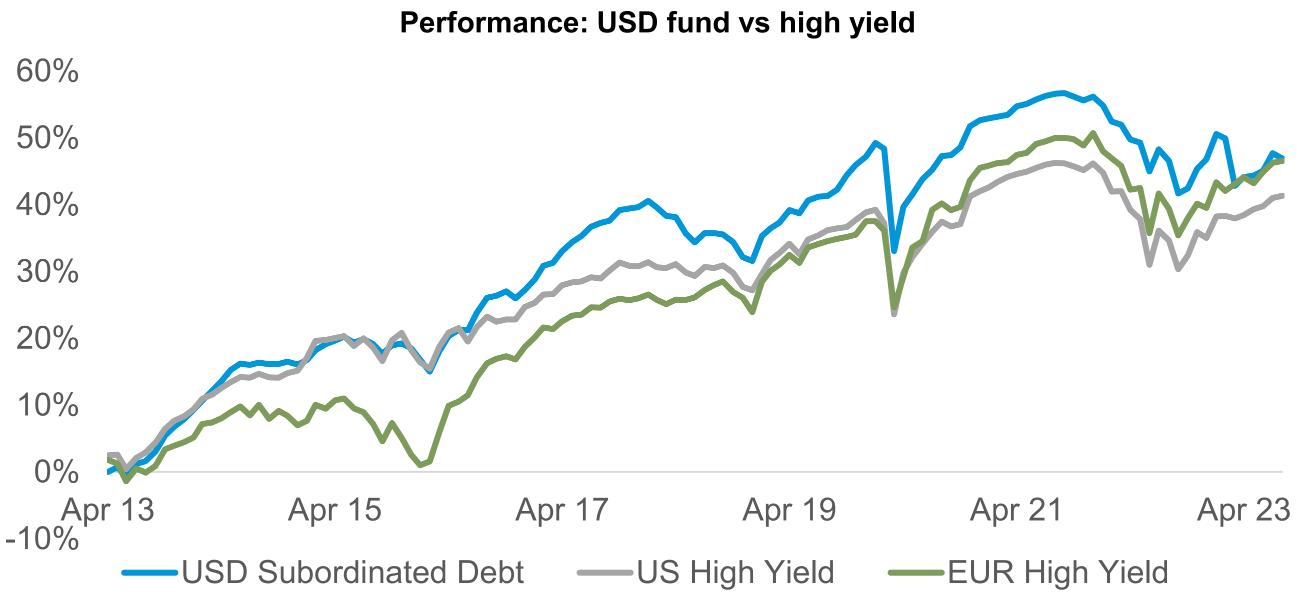
Subordinated debt

An asset class that has **outperformed** EU and US **high yield**



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Financials poised to outperform corporates

High rates means a profitability boost for banks vs. higher funding costs for corporates

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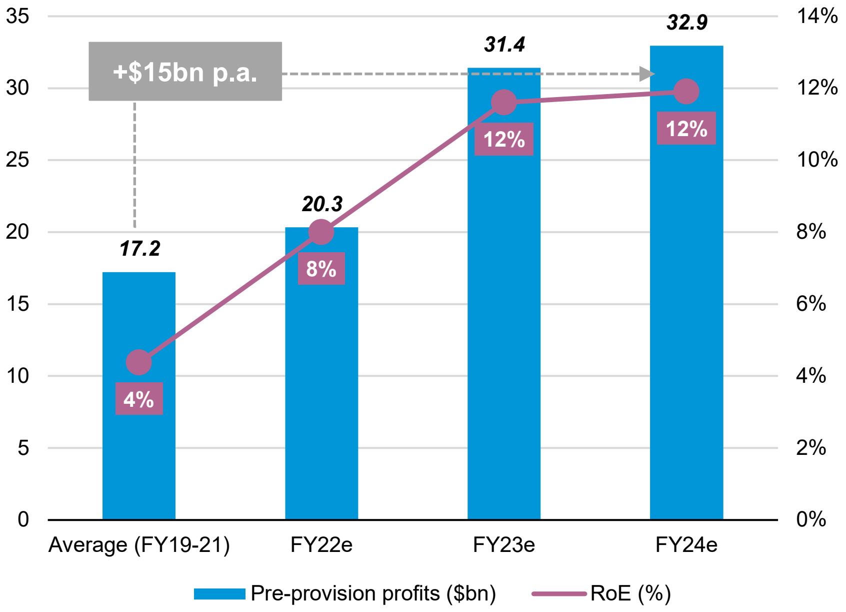
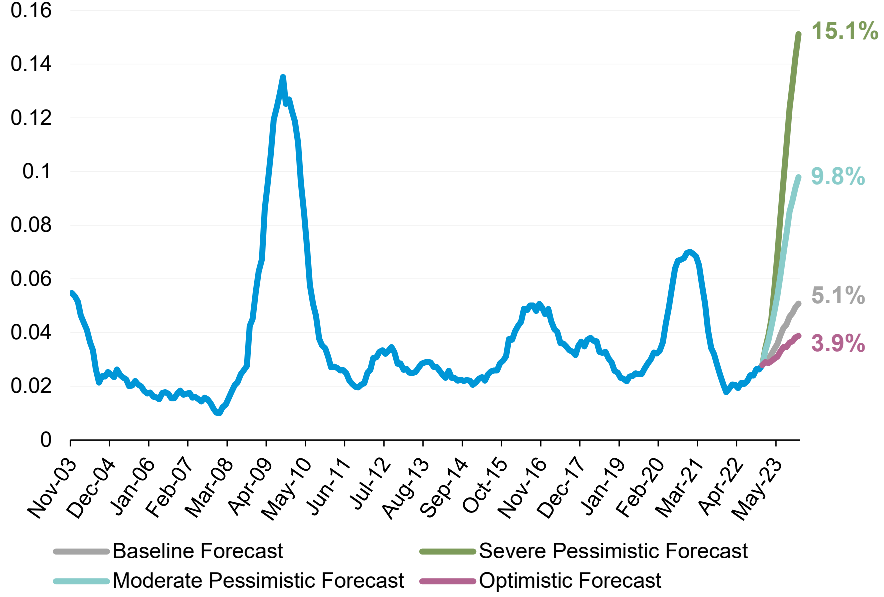
HSBC Pre-Provision Profits and RoE



Moody's Global HY Default Rates Forecasts



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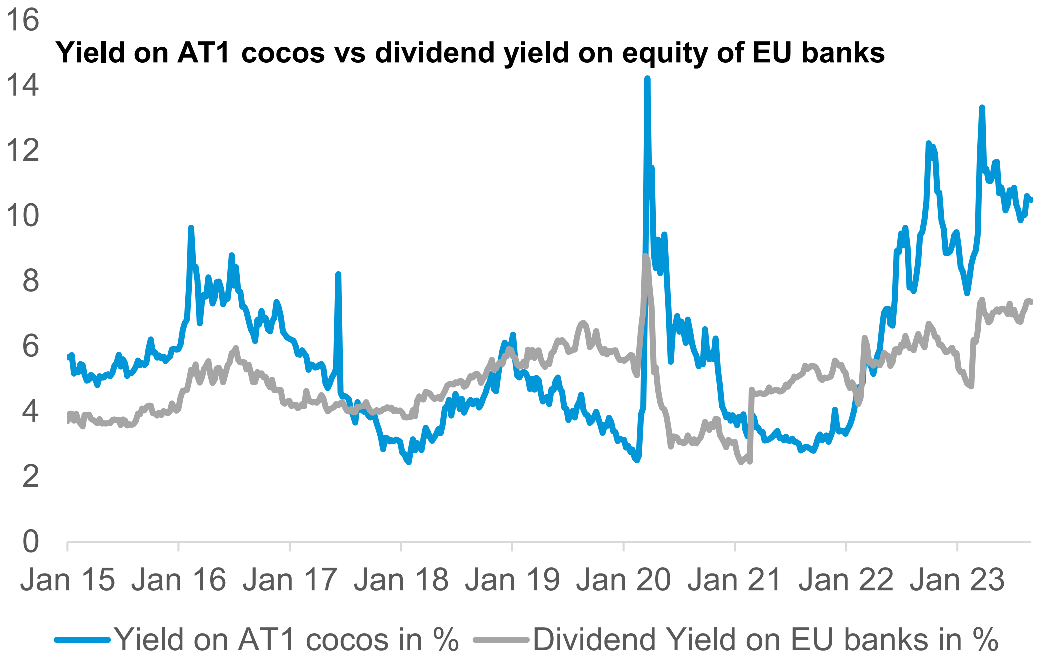
2. Subordinated debt trades cheap to equity

Shareholders should be compensated more than bondholders



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Positive earnings story reflected in equity price

While subordinated debt from European banks has lagged the rally

Investors needed validation of Basel III framework

- The sector's resilience post Credit Suisse indicates that Basel III regulations are effective, preventing contagion
- Equity performance has been impressive (TR of 18%) and with notable stock gains, e.g. Unicredit +57%, UBS +36%, BBVA +24%

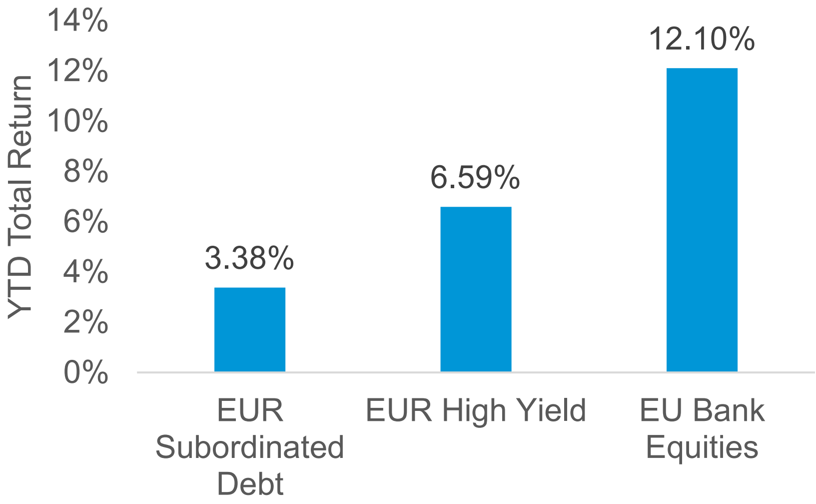
Banks have been calling as expected

- Which suggests that regulators are comfortable with banks 'capital levels, adding to investor confidence

Primary market has re-opened

- Transactions have been significantly oversubscribed, indicating the strong demand from global investors

Despite strong performance of bank equities, subordinated debt has lagged so far this year



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Source: Atlanticomnium and Bloomberg as at September 2023. The views are those of the manager and are subject to change.

3. Subordinated debt trades cheap to senior unsecured

…Spreads on senior debt have already reverted back to historical averages

GAM Investments

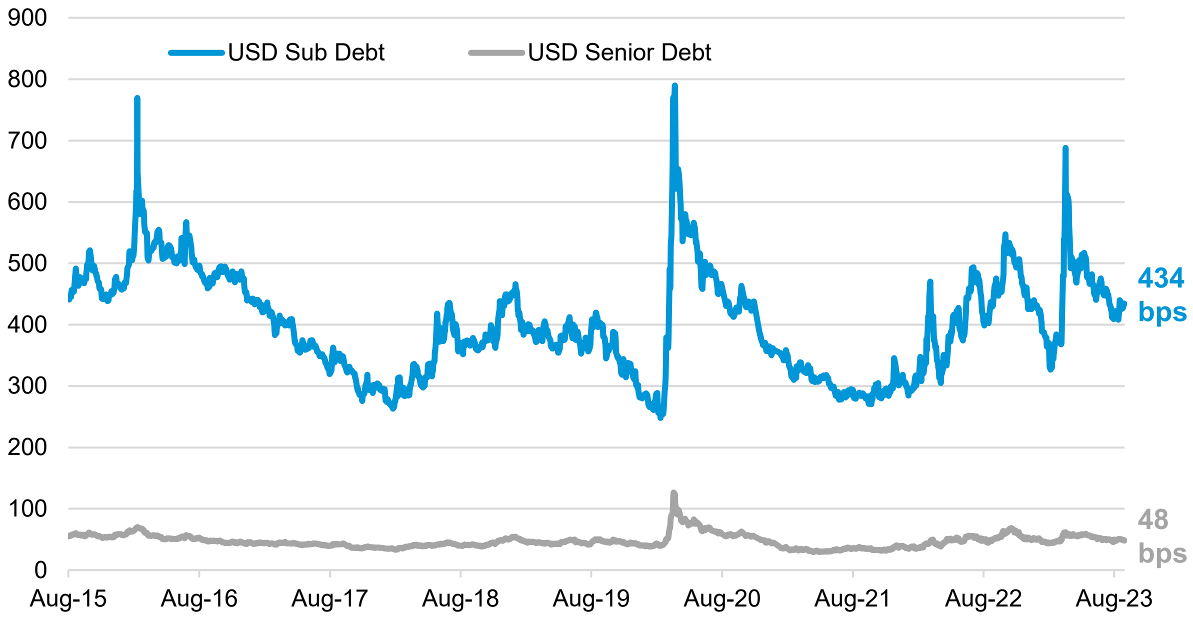
Subordinated debt

- Spread reflects **credit risk** + **subordination risk** + **other risks** such as extension risk, etc.

Senior unsecured bonds

- Spread reflects **credit risk**

Spreads on subordinated debt are wide



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4. Extension risk is currently mispriced

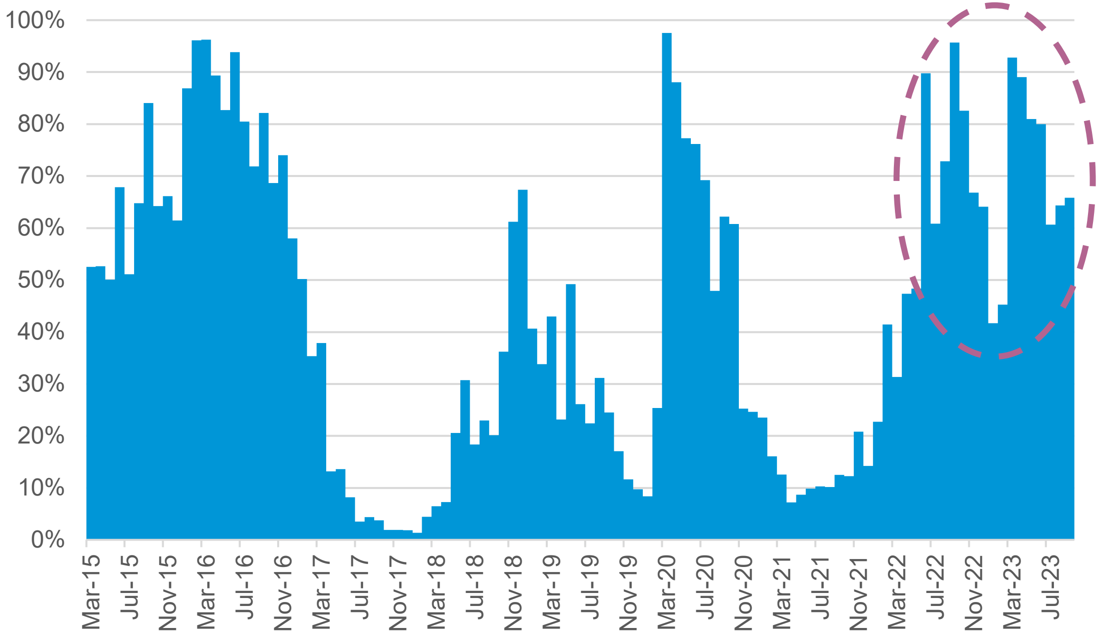
Creating an opportunity for bondholders

During risk-offs, investors tend to re-price callable perpetuals ***to maturity*** (the so-call extension risk)

- Right now, ***65%*** of AT1 CoCos are priced to maturity vs. a historical call rate of 90%
- Huge ***gap between perception vs. reality***

Implication for investors?
Large upside on a re-pricing to call

% of AT1 CoCo Market Priced to Perp



Past and current trends should not be relied upon as an indicator of future trends.

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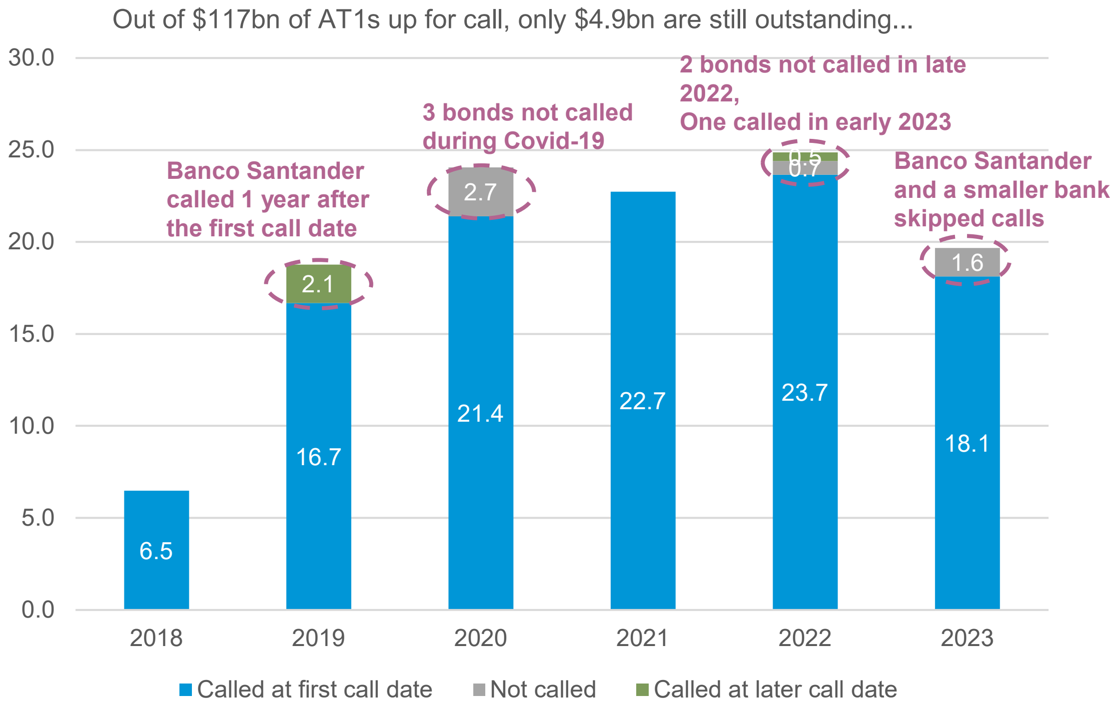
Extension risk

What is the actual risk of not being called?

- Historically **only ~6% AT1s have not been called, and only ~4% still outstanding**
- Extension risk is **much lower than perceived by the market**
- **European issuers bondholder friendly, typically call at the first call date**
- In 2023 only two AT1s not called, $18bn called as expected
- **Nevertheless, bond selection remains key to avoid those with downside potential**



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AT1 cocos callable in 2023

Net supply is expected to be very tight…creating very supportive technicals

We expect 93% of callable bonds this year to be called at first call date

Security	Announcement of call	Currency	Spread at issuance	Yield to Call	Yield to Maturity	amt_issued
UBS 5 PERP	05/12/2022	USD	243			2,000,000,000
SABSM 8.735 PERP	18/01/2023	EUR	605			400,000,000
BACR 7 1/4 PERP	02/02/2023	GBP	674			1,250,000,000
HSBC 6 1/4 PERP	30/01/2023	USD	345			2,350,000,000
STANLN 7 3/4 PERP	01/03/2023	USD	572			1,000,000,000
PBBGR 8.474 PERP	Not Called, but coupon increased from 5.75% to 8.5%	EUR	538	19.0	12.3	300,000,000
UCGIM 6 5/8 PERP	27/04/2023	EUR	639			1,250,000,000
LLOYDS 7 5/8 PERP	28/04/2023	GBP	529			1,494,392,000
BACR 7 3/4 PERP	27/07/2023	USD	484	9.8	9.1	2,500,000,000
CABKSM 6 3/8 PERP	28/07/2023	EUR	622	7.1	9.5	500,000,000
BBVASM 5 7/8 PERP	21/07/2023	EUR	566	7.4	8.9	1,000,000,000
HSBC 6 PERP	03/08/2023	EUR	534	5.0	8.6	1,000,000,000
SANTAN 5 1/4 PERP	Not Called, but coupon to incrase from 5.25% to 8.2%	EUR	500	13.1	8.4	1,000,000,000
ABANCA 7 1/2 PERP	03/08/2023	EUR	733	8.8	10.6	250,000,000
SOCGEN 7 3/8 PERP	21/08/2023	USD	430	8.0	8.5	1,250,000,000
SOCGEN 7 7/8 PERP	Pending	USD	498	10.3	9.2	1,750,000,000
						19,294,392,000

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New issuances so far this year

High coupon and high back-end = a **vintage** year

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Attractive bonds as…

- High coupon = great for carry
- Attractive spread at issuance
- Relatively short call dates

Name	Currency	Spread at issuance	Yield to call	Duration	Issuance Size	Pricing date
ACAFP 7 1/4 PERP	EUR	444	7.6	4.1	1,250,000,000	03/01/2023
SABSM 9 3/8 PERP	EUR	683	9.9	3.8	500,000,000	04/01/2023
BNP 7 3/8 PERP	EUR	463	7.8	5.1	1,250,000,000	04/01/2023
LLOYDS 8 1/2 PERP	GBP	514	10.3	3.9	750,000,000	09/01/2023
SOCGEN 7 7/8 PERP	EUR	523	8.6	4.5	1,000,000,000	11/01/2023
CAZAR 9 1/8 PERP	EUR	683	10.1	3.8	350,000,000	18/01/2023
ALPHA 11 7/8 PERP	EUR	931	11.7	3.3	400,000,000	01/02/2023
BAERVX 6 5/8 PERP	EUR	385	9.2	5.0	400,000,000	07/02/2023
INTNED 7 1/2 PERP	USD	371	9.5	4.1	1,000,000,000	07/02/2023
SWEDA 7 5/8 PERP	USD	359	9.5	3.9	500,000,000	16/02/2023
BKTSM 7 3/8 PERP	EUR	471	8.7	4.0	300,000,000	06/02/2023
BACR 9 1/4 PERP	GBP	564	11.7	4.1	1,500,000,000	27/02/2023
HSBC 8 PERP	USD	386	8.2	4.0	2,000,000,000	28/02/2023
CABKSM 8 1/4 PERP	EUR	514	8.9	4.6	750,000,000	01/03/2023
LLOYDS 8 PERP	USD	391	10.2	4.6	1,250,000,000	06/03/2023
BBVASM 8 3/8 PERP	EUR	554	8.6	4.1	1,000,000,000	13/06/2023
BNP 8 1/2 PERP	USD	435	8.7	3.9	1,500,000,000	07/08/2023
ISPIM 9 1/8 PERP	EUR	626	9.0	4.8	1,250,000,000	31/08/2023
KBCBB 8 PERP	EUR	493	8.1	4.4	750,000,000	29/08/2023
ERSTBK 8 1/2 PERP	EUR	546	8.7	4.4	500,000,000	05/09/2023
BBVASM 9 3/8 PERP	USD	510	9.4	4.3	1,000,000,000	11/09/2023
					19,200,000,000	

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Outlook for 4Q23

Embracing strength amidst challenging market conditions earlier this year

GAM Investments

1

Resilient fundamentals

- The sector is running with **excess regulatory** capital and **excess liquidity**
- Investment grade issuers are by nature **defensive**, so providing a hedge against the risk of economic downturns

2

Compelling valuations

- Valuations levels for subordinated debt remain **highly appealing**, poised to revert to historical averages

3

Favourable technicals

- Net supply is expected to be limited, fuelled **by strong demand from global investors**
- **Extension risk** should be seen as **an opportunity**, especially in the context where banks have once again demonstrated their ability and willingness to call at first call date

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