

## Equities

22 February 2012 | 24 pages

# KBC (KBC.BR)

## Better Core Capital & Outlook – Reiterate Buy, TP €22

- Company Update
- Estimate Change

- **Prize Assets Deliver** — KBC generates 100-120bps of CT1 capital on a sustainable basis, one of the highest in Europe. While management points to the Belgian and Czech businesses as major drivers of profitability, we believe that until the capital issue is resolved these "prize assets" will remain under-appreciated by investors.
- **Less State Capital Repayment** — Based on EU guidance, KBC now needs to repay €4.7bn by end-2013, down from previous expectations of €7bn – a form of "EU forbearance". And it can use the *pari passu* exception to repay €3bn to the Belgian state in 2012 at the lower 15% penalty – a 50 bps benefit to 2013E capital (Fig. 4).
- **€2.4bn Capital Shortfall** — A credible path toward a 9% Basel 3 core Tier 1 ratio by end-2013 is the best insurance against two important risks: (1) a change in the regulatory stance of the Belgian regulator; and (2) deposit outflows and/or a sharp increase in KBC's funding costs. And given EU forbearance we now give KBC credit for state capital at end-2013: our new €2.4bn estimate of capital shortfall is based on an average of KBC's Basel 3 "look-through" and "phased-in" ratios. However, as state capital would still constitute 23% of core Tier 1 capital (down from 48% at end-2011) we increase our cost of equity to 12.5% from 10.0% (Fig. 6).
- **Deposit Outflows Manageable** — KBC lost €1.5bn of Belgian retail deposits and €18bn of corporate deposits in 4Q11. The LDR is now 103% from 96% qoq (Citi). Management attributed the loss of Belgian retail deposits to the Belgian state retail bond while the outflow of merchant bank deposits seems to have been driven by the downgrade of KBC's short-term rating to A2 by S&P at the end of 2011. Despite the outflows, KBC reported a net short-term cover ratio well above 100%. (Fig. 15-18).
- **Reiterate Buy, TP €22** — We update our earnings estimates (down 8-15% for 2012-14). Our lower estimates are driven by lower margins (in Belgian retail and CSOB) and higher provisions (in Merchant Banking). Most bad news continues to be priced into the shares, in our view. We reiterate our €22 target price and Buy (1H) rating on the shares with 29% ETR (Fig. 1).

<b>Buy/High Risk</b>	<b>1H</b>
Price (22 Feb 12)	€17.06
Target price	€22.00
Expected share price return	29.0%
Expected dividend yield	0.1%
<b>Expected total return</b>	<b>29.1%</b>
Market Cap	€6,105M
	US\$8,084M

### Price Performance (RIC: KBC.BR, BB: KBC BB)



### KBC (EUR)

Year to 31 Dec	2010A	2011A	2012E	2013E	2014E
Net Income (€M)	1,861.0	381.0	822.7	1,259.4	1,722.0
Diluted EPS (€)	5.48	1.11	2.39	3.65	5.00
Diluted EPS (Old) (€)	5.48	1.10	2.79	4.32	5.42
PE (x)	3.1	15.3	7.1	4.7	3.4
P/BV (x)	0.5	0.6	0.6	0.6	0.5
DPS (€)	0.75	0.01	0.01	0.01	0.25
Net Div Yield (%)	4.4	0.1	0.1	0.1	1.5
ROE (%)	17.9	-0.4	10.5	12.9	16.5

### Stefan Nedialkov

+44-20-7986-4188  
stefan.nedialkov@citi.com

### Florent Nitu

+44-20-7986-3907  
florent.nitu@citi.com

### Kinner Lakhani

kinner.lakhani@citi.com

### Sentoor Kanagasabapathy

sentoor.kanagasabapathy@citi.com

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Fiscal year end 31-Dec	2010	2011	2012E	2013E	2014E
<b>Valuation Ratios</b>					
P/E adjusted (x)	3.1	15.3	7.1	4.7	3.4
P/E reported (x)	3.1	nm	5.8	4.7	3.4
P/BV (x)	0.5	0.6	0.6	0.6	0.5
P/Adjusted BV diluted (x)	0.5	0.6	0.6	0.6	0.5
Dividend yield (%)	4.4	0.1	0.1	0.1	1.5
<b>Per Share Data (€)</b>					
EPS adjusted	5.48	1.11	2.39	3.65	5.00
EPS reported	5.48	-0.11	2.96	3.65	5.00
BVPS	32.81	28.31	28.23	28.57	31.85
Tangible BVPS	26.17	22.80	24.02	24.37	27.65
Adjusted BVPS diluted	32.81	28.51	28.23	28.57	31.85
DPS	0.75	0.01	0.01	0.01	0.25
<b>Profit &amp; Loss (€m)</b>					
Net interest income	6,246	5,479	5,113	5,083	5,169
Fees and commissions	1,224	1,165	441	800	850
Other operating Income	847	1,352	674	860	865
<b>Total operating income</b>	<b>8,317</b>	<b>7,996</b>	<b>6,228</b>	<b>6,744</b>	<b>6,884</b>
Total operating expenses	-4,436	-4,396	-3,739	-3,863	-3,912
<b>Oper. profit bef. provisions</b>	<b>3,881</b>	<b>3,600</b>	<b>2,489</b>	<b>2,881</b>	<b>2,972</b>
Bad debt provisions	-1,657	-2,123	-1,591	-1,185	-689
Non-operating/exceptionals	0	-742	276	0	0
<b>Pre-tax profit</b>	<b>2,224</b>	<b>735</b>	<b>1,174</b>	<b>1,696</b>	<b>2,282</b>
Tax	-81	-320	-337	-420	-544
Extraord./Min. Int./Pref. Div.	-282	-453	182	-16	-17
<b>Attributable profit</b>	<b>1,861</b>	<b>-38</b>	<b>1,020</b>	<b>1,259</b>	<b>1,722</b>
Adjusted earnings	1,861	381	823	1,259	1,722
<b>Growth Rates (%)</b>					
EPS adjusted	175.4	-79.7	114.4	53.1	36.7
Oper. profit bef. prov.	nm	-7.2	-30.9	15.8	3.1
<b>Balance Sheet (€m)</b>					
<b>Total assets</b>	<b>320,823</b>	<b>285,382</b>	<b>258,238</b>	<b>245,326</b>	<b>237,966</b>
Avg interest earning assets	304,782	271,113	245,326	233,060	226,068
Customer loans	155,703	143,525	137,087	139,595	142,523
Gross NPLs	11,082	11,234	10,434	8,347	7,930
<b>Liab. &amp; shar. funds</b>	<b>320,823</b>	<b>285,382</b>	<b>258,238</b>	<b>245,326</b>	<b>237,966</b>
Total customer deposits	197,870	165,226	164,645	168,966	174,583
Reserve for loan losses	5,037	5,241	5,718	5,680	5,723
Shareholders' equity	<b>11,147</b>	<b>9,756</b>	<b>9,727</b>	<b>9,846</b>	<b>10,976</b>
<b>Profitability/Solvency Ratios (%)</b>					
ROE adjusted	17.9	3.6	8.4	12.9	16.5
Net interest margin	2.05	2.02	2.08	2.18	2.29
Cost/income ratio	53.3	55.0	60.0	57.3	56.8
Cash cost/average assets	1.4	1.5	1.4	1.6	1.6
NPLs/customer loans	7.1	7.8	7.6	6.0	5.6
Reserve for loan losses/NPLs	45.5	46.7	54.8	68.0	72.2
Bad debt prov./avg. cust. loans	1.1	1.4	1.1	0.9	0.5
Loans/deposit ratio	78.7	86.9	83.3	82.6	81.6
Tier 1 capital ratio	12.6	12.3	11.6	11.2	11.5
Total capital ratio	16.5	15.6	15.3	15.1	15.3

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CIRADataServicesEMEA@citi.com or +44-207-986-  
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# Contents

<b>Better Core Capital &amp; Outlook – Reiterate Buy, TP €22</b>	<b>4</b>
4Q11 Results: What We Liked (and Not)	5
<b>1. Capital Shortfall of €2.4bn</b>	<b>6</b>
<b>2. Merchant Banking in Focus</b>	<b>9</b>
Ireland	9
<b>3. Deposit Outflows &amp; Funding</b>	<b>12</b>
<b>4. Legacy Assets</b>	<b>13</b>
<b>New Earnings Estimates</b>	<b>14</b>
<b>Earnings Model</b>	<b>15</b>
<b>KBC</b>	<b>19</b>
Company description	19
Investment strategy	19
Valuation	19
Risks	19
<b>Appendix A-1</b>	<b>20</b>

We update our estimates for KBC's capital shortfall and our earnings estimates. Our lower estimate for capital needed is driven by the repayment of a 50% penalty on a portion of the Flemish capital over a longer period of time and a new benchmark

We reiterate our target price of €22 and Buy (1H) rating on the shares with expected total return of 29%

## Better Core Capital & Outlook – Reiterate Buy, TP €22

KBC shares rose 7% over SX7P on the day of 4Q11 results. We believe this was driven by the company's statement on state capital: the EU Commission confirmed that KBC would need to repay "only" €4.7bn of state capital by end-2013, a form of "EU forbearance". Markets had been expecting the full €7bn and seemed to have liked the fact that potentially less capital may need to be raised over the next 12-24 months.

In this note, we update our estimates for KBC's capital shortfall (down to €2.4bn from €4.6bn) and our earnings estimates (down 8-15% for 2012-14).

Our lower estimate for capital needed is driven by the repayment of a 50% penalty on a portion of the Flemish capital over a longer period of time. We also benchmark KBC's capital position on the basis of an average of the bank's look-through / phased-in Basel 3 ratios at end-2013 (6.8%). Previously we benchmarked to the look-through ratio alone (5.3%). EU forbearance gives us comfort that some state capital is acceptable to the market and we currently assume 23% state capital "content" at the end of 2013, down from 48% at end-2011. We also raise our cost of equity assumption to 12.5% from 10.0% to account for the higher risk of regulatory stance change – by virtue of KBC having some state capital at end-2013 vs. none in our previous estimates.

Our lower earnings estimates are driven by lower margins (in Belgian retail and CSOB) and higher provisions (in Merchant Banking). Our new estimates result in a fair value of €22 – we thus reiterate our target price and Buy (1H) rating on the shares with expected total return of 29% (Figure 1).

Figure 1. KBC – Valuation

<b>Valuation</b>	
2014E Net Profit	1,722
CoE	12.5%
Growth rate	1%
2014E P/E	8.7
Valuation at end-2013	14,974
Valuation at end-2012	13,442
Capital shortfall	-2,430
Shares out pro-forma	507
<b>Value per share</b>	<b>22</b>
<b>Target Price</b>	<b>22</b>
Current Price	17
Upside	29%
<b>ETR</b>	<b>29%</b>

### Capital Shortfall Calculation

CET1 B3 Ratio - 2013E average of "look-through" & "phased-in"	6.8%
CET1 adjustment	0
RWA - 2013E	110,530
RWA adjustment	0
CET1 Ratio - adjusted 2013	6.8%
CET1 Ratio - Target	9.0%
<b>Capital Needed</b>	<b>2,430</b>
Raised at	15
Existing shares	345
New shares	162
Shares out	507

Source: Citi Investment Research and Analysis

### Good value vs. European banks sector

At the current price, the shares are trading at 0.9x P/TBV for a c.14.5% sustainable RoTE compared to the European banks sector trading at the same multiple for c.10% RoTE (Figure 2).

Figure 2. KBC – Valuation Metrics

Pro-forma	2011	2012E	2013E	2014E
BVPS	24.1	24.0	24.2	26.5
TBVPS	20.3	21.1	21.4	23.6
EPS	-1.15	1.02	1.99	3.10
ROE		4.2%	8.3%	12.8%
ROTE		5.0%	9.4%	14.5%

#### Valuation at Current Price €18

P/E	nm	17.6	9.0	5.8
P/BV	0.75	0.75	0.74	0.68
P/TBV	0.88	0.85	0.84	0.76

#### Valuation at Target Price €22

P/E	nm	21.6	11.0	7.1
P/BV	0.91	0.92	0.91	0.83
P/TBV	1.08	1.04	1.03	0.93

Source: Company reports, Citi Investment Research and Analysis

### Bad news priced in

In addition to a €2.4bn capital raise, we believe the market is currently implying an unrealistic scenario for legacy asset hits and contingent liabilities from Hungary: a 20-25% probability of the maximum negative impact occurring for both (Figure 3). We disagree with this pessimistic view and find value in the shares.

Figure 3. KBC – Risk Factors Discounted in the Share Price (€ in million), 21 February 2011

	Estimated max impact	Market-implied Probability	Reconciliation with Market
Citi underlying valuation			11,012
GIIPS debt - MTM & AFS Reserve	-70	100%	-70
Legacy assets - capital impact	-4,700	25%	-1,175
Hungary	-3,140	20%	-628
<b>Market valuation, 21/2/12</b>			<b>9,139</b>
Shares outstanding			507
<b>Market value per share, 21/2/12</b>			<b>18</b>

Source: Citi Investment Research and Analysis

## 4Q11 Results: What We Liked (and Not)

What We Liked More	What We Liked Less
<ul style="list-style-type: none"> <li>■ Cash cows: strong performance from Belgian retail and Czech Republic despite lower margins</li> <li>■ Ireland: management has acknowledged that more Irish provisioning is needed</li> <li>■ State capital flexibility through end-2013</li> </ul>	<ul style="list-style-type: none"> <li>■ Net deposit outflows: €1bn in Belgian retail and €18bn in Merchant Banking</li> <li>■ Merchant banking margins have suffered</li> <li>■ Belgian corporate asset quality has deteriorated</li> </ul>

Source: Citi Investment Research and Analysis: *KBC (KBC.BR) - 4Q11 Results - Initial Reaction*, 9 February

**We continue to believe that a credible path toward a 9% core Tier 1 ratio by end-2013 is the best insurance against two important risks**

## 1. Capital Shortfall of €2.4bn

We continue to believe that a credible path toward a 9% core Tier 1 ratio by end-2013 is the best insurance against two important risks: (1) a change in the regulatory stance of the Belgian regulator; and (2) deposit outflows and/or a sharp increase in KBC's funding costs.

- **Risk of Regulatory Stance Change** – While the Belgian regulator currently requires 11% Tier 1 ratio under Basel 2, there is no guarantee this will continue to be the case even during the course of 2012-13. As the experience with the Austrian banks showed, regulators can change stance under pressure from the markets and the rating agencies via the sovereign ratings channel.
- **Risk of Deposit Outflows** – While Belgium is not a peripheral country, its government debt relative to GDP is perceived to be on the higher end among the Euro area countries. This is reflected in the recent rating downgrades (S&P: AA, negative outlook) and exposes the sovereign rating to the risk of further downgrades should the sovereign situation in the Euro area take a turn for the worse.

KBC announced that the EU now requires it to repay back a minimum of €4.67bn of state capital before end-2013 if further “market leadership” sanctions are to be avoided. We believe the market was previously eyeing a €7bn repayment. While optically a positive for 2012-13 capital and earnings estimates, a slower speed of repayment means that it will take longer for KBC to reach a “normalised” level of earnings. Our new estimate for 2014 RoTE adjusted for the capital shortfall now stands at 14.5%, down from 16.2% previously.

**We now assume that €4.67bn of state capital would be repaid by end-2013, down from €7.0bn previously**

We now assume that €4.7bn of state capital would be repaid by end-2013, down from €7.0bn previously (Figure 4). The lower absolute amount of penalties paid means KBC can rebuild 160 bps of core Tier 1 capital under Basel 2 in the 2012-13 period (Figure 5). KBC also faces a smaller capital shortfall under Basel 3 at the end of 2013: 5.3% vs. 4.8% previously (Figure 6).

**Capital shortfall under Basel 3 = €2.4bn**

Given “EU forbearance” on state capital repayment we now give KBC credit for state capital at end-2013 and believe the market should be looking at an average of KBC's Basel 3 “look-through” and “phased-in” ratios, or 6.8% at end-2013 (average of 5.3% and 8.3% in Figure 6). **Benchmarking to 9% core Tier 1 ratio under Basel 3 produces our estimate of capital shortfall of €2.4bn (Figure 1).**

**However, as state capital would still constitute 23% of core Tier 1 capital (down from 48% at end-2011) we increase our cost of equity to 12.5% from 10.0% (Figure 1).**

Figure 4. KBC – Terms & Estimated Schedule of State Capital Repayments (€ in million)

	2011	2012E	2013E	2014E	2015E	2016E	2017E
<b>State Capital</b>							
Start of period	7,000	6,500	3,500	2,330	1,748	1,165	583
Belgian government	-500	-3,000	0	0	0	0	0
Flemish government *	0	0	-1,170	-583	-583	-583	-583
<b>End of period</b>	<b>6,500</b>	<b>3,500</b>	<b>2,330</b>	<b>1,748</b>	<b>1,165</b>	<b>583</b>	<b>0</b>

**Repayment penalties**

	50% cash or 15% if conversion option	50% cash or 15% if conversion option	50% cash or 20% if conversion option	50% cash or 25% if conversion option	50% cash or 30% if conversion option	50% cash or 35% if conversion option	50% cash or 40% if conversion option
Belgian government	50% cash	50% cash	50% cash	50% cash	50% cash	50% cash	50% cash
Flemish government	50% cash	50% cash	50% cash	50% cash	50% cash	50% cash	50% cash
<b>Total penalty payable</b>	<b>75</b>	<b>450</b>	<b>585</b>	<b>291</b>	<b>291</b>	<b>291</b>	<b>291</b>

Coupon **	8.50%	8.50%	8.50%	8.50%	8.50%	8.50%	8.50%
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Source: Citi Investment Research and Analysis, KBC.

\* The Flemish government has waived its pari passu clause through the end of 2012. \*\* Provided at least a minimum ordinary dividend of €0.01 is paid

Figure 5. KBC – Capital Bridge, 2012-2013E (€ in million)

	4Q11	KBL EPB	Fidea	WARTA	Kredyt Bank	Russia & Other	State (BE)	State (FLE)	Net Earn.	Divi & State Coupon	AFS Res.	State G'tee	Net RWA Growth	4Q13E
Shareholders Equity (ex min, ex state capital)	9,756			+233	-36		-450	-585	+2,083	-1,154	+0			9,846
Goodwill & Intangibles	1,898	-200		-150	-100									1,448
Minorities	516	0		0	-120									396
Sharecount	345													345
BVPS	28.3			+0.7	-0.1		-1.3	-1.7	+6.5	-3.3	+0.0			28.6
<b>TBVPS</b>	<b>22.8</b>	<b>+0.6</b>	<b>+0.0</b>	<b>+1.1</b>	<b>+0.2</b>	<b>+0.0</b>	<b>-1.3</b>	<b>-1.7</b>	<b>+6.5</b>	<b>-3.3</b>	<b>+0.0</b>	<b>+0.0</b>	<b>+0.0</b>	<b>24.4</b>
Tier 1 Capital	15,523	+200		+383	-56		-3,450	-1,755	+2,083	-857		+0		12,070
Common Equity Tier 1 Capital	6,349	+200		+383	-56		-450	-585	+2,083	-857				7,066
RWAs	126,332	-4,200	-1,800	-1,300	-6,800	-6,000							+1,298	107,530
<b>Tier 1 Ratio</b>	<b>12.3%</b>													<b>11.2%</b>
<b>Common Equity Tier 1 Ratio – Basel 2</b>	<b>5.0%</b>													<b>6.6%</b>
<b>Core Capital benefit (in bps)</b>		<b>0.33%</b>	<b>0.07%</b>	<b>0.35%</b>	<b>0.23%</b>	<b>0.24%</b>	<b>-0.36%</b>	<b>-0.46%</b>	<b>1.65%</b>	<b>-0.68%</b>	<b>0.00%</b>	<b>0.00%</b>	<b>-0.05%</b>	

Source: Citi Investment Research and Analysis, KBC

Figure 6. KBC – Capital Evolution under Basel 2 & 3, 2010-2015E (€ in million, basis points) \*

	2010	2011E	2012E	2013E	2014E	2015E
T1 Capital	16,656	15,523	12,867	12,070	12,634	13,380
CET1 Capital (incl state capital & gtee)	14,369	13,413	10,757	9,960	10,524	11,270
CET1 Capital (ex state capital & gtee)	6,923	6,349	6,693	7,066	8,213	9,541
Hybrid & State Capital as a % of T1 capital	58%	59%	48%	41%	35%	29%
Capital Deductions & State Capital	-8,245	-8,432	-5,337	-4,083	-3,428	-2,782
Look-Through T1 Capital	8,411	7,091	7,530	7,987	9,206	10,598
<b>Look-Through CET1 Capital</b>	<b>6,124</b>	<b>4,981</b>	<b>5,420</b>	<b>5,877</b>	<b>7,096</b>	<b>8,488</b>
RWAs (Basel 2)	132,034	126,332	111,225	107,530	109,660	114,332
Growth, %		-4%	-12%	-3%	2%	4%
+ Incremental Basel 2.5		0	0	0	0	0
+ Basel 3 + Solvency 2 + Shift to IRB		4,700	5,300	6,000	6,000	6,000
+ 'Other'		-3,000	-3,000	-3,000	-3,000	-3,000
<b>Pro-Forma RWAs</b>		<b>128,032</b>	<b>113,525</b>	<b>110,530</b>	<b>112,660</b>	<b>117,332</b>
<b>Capital Ratios</b>						
T1 Ratio (Basel 2) **	12.6%	12.3%	11.6%	11.2%	11.5%	11.7%
CET1 Ratio (Basel 2, incl state capital)	10.9%	10.6%	9.7%	9.3%	9.6%	9.9%
CET1 Ratio (Basel 2, ex state capital)	5.2%	5.0%	6.0%	6.6%	7.5%	8.3%
Look-Through T1 Ratio (Full Basel 3)		5.5%	6.6%	7.2%	8.2%	9.0%
<b>Look-Through CET1 Ratio (Full Basel 3)</b>		<b>3.9%</b>	<b>4.8%</b>	<b>5.3%</b>	<b>6.3%</b>	<b>7.2%</b>
Phased T1 Ratio		17.2%	14.4%	12.8%	12.4%	11.9%
<b>Phased CET1 Ratio</b>		<b>10.0%</b>	<b>9.0%</b>	<b>8.3%</b>	<b>8.4%</b>	<b>8.6%</b>
<b>Average of Look-Through &amp; Phased-in CET1 Ratios</b>		<b>7.0%</b>	<b>6.9%</b>	<b>6.8%</b>	<b>7.4%</b>	<b>7.9%</b>

Source: Citi Investment Research and Analysis, KBC

\* For penalty payable on state capital see Figure 4. \*\* 11% Tier 1 minimum according to current regulatory requirements.



## 2. Merchant Banking in Focus

Belgian retail and CSOB remained the “cash cows” of KBC – but Merchant Banking disappointed

Belgian retail and CSOB remained the “cash cows” of KBC. In Belgian retail, 4Q11 earnings were significantly higher than our (+23%) and consensus (+38%) estimates driven by stable margins and strong insurance income. Impressively, margins were better than expected despite the Belgian state tapping retail investors for €5.6bn in November 2011. The beat at the insurance income level was driven by net realised gains from AFS asset sales.

However, results in Merchant Banking disappointed driven by commercial banking. The net loss of -€153m was higher than our estimate of net loss of -€102m and consensus net loss of -€60m:

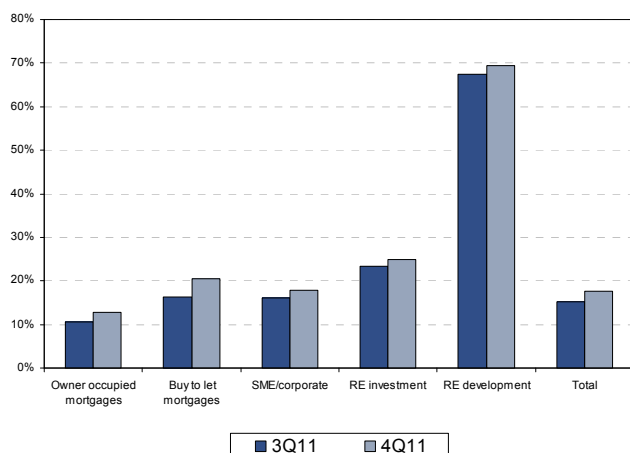
- **NIM declined meaningfully** to 146 bps (3Q11: 168 bps, 2Q11: 168 bps) as higher yielding bonds were sold to meet deposit outflows in the segment and on the back of “higher senior debt costs”. However, we believe that the margin should recover going forward as KBC buys higher yielding assets with funding from the ECB and other sources. While the recovery is unlikely to be “full”, we do expect margins to gradually recover to 160 bps by 4Q12.
- **Belgian corporate asset quality deteriorated** significantly as management “caught up” with coverage ratio targets at the end of the year. We believe provisions for Belgian corporates were c.€140m in 4Q11 compared to a “usual” range of €30-50m per quarter. We forecast a return to normalised levels in the coming quarters.

### Ireland

We believe KBC is under-provisioned in Ireland

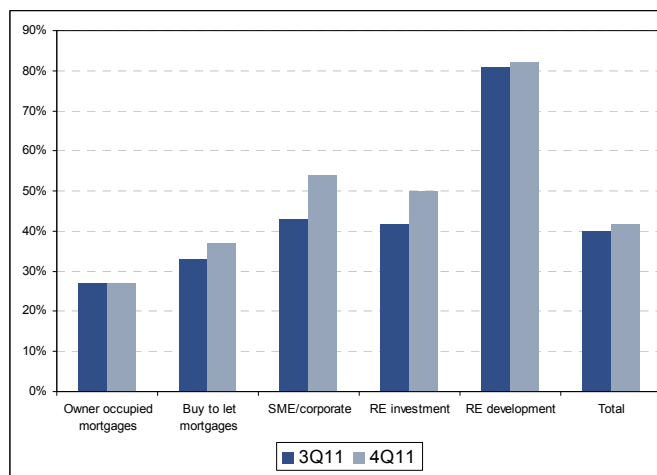
KBC took €228m provisions in Ireland in 4Q11 bringing the coverage ratio to 42% (from 40%) on 17.7% NPL ratio (up from 15.2%). The largest increase in the NPL ratio was in the buy-to-let category while SME/corporate coverage improved the most by 11 ppt (Figs. 7-8).

Figure 7. KBC – Ireland NPL Ratios by Product (%), 3Q11-4Q11



Source: Citi Investment Research and Analysis

Figure 8. KBC – Ireland Coverage Ratios by Product (%), 3Q11-4Q11



Source: Citi Investment Research and Analysis

Management upped Irish provisions guidance to an additional €500-600m in 2012 (from “a few quarters” previously). However, we estimate that KBC would need to take provisions of at least €800m in 2012 and €630m in 2013 for a total of €1.4bn over 2012-13 (Figure 9).

Figure 9. KBC – Irish Loan Book (€ in million)

Ireland loan book 4Q11	Outstanding	4Q11		Estimated Peak Level		Addl Provisions Needed
		NPL Ratio	NPL Coverage	NPL Ratio	NPL Coverage	
Owner occupied mortgages	9,600	12.7%	27%	20.0%	55%	727
Buy to let mortgages	3,200	20.4%	37%	30.0%	65%	382
SME/corporate	2,000	17.9%	54%	30.0%	55%	137
RE investment	1,400	25.0%	50%	40.0%	50%	105
RE development	500	69.5%	82%	90.0%	80%	75
<b>Total</b>	<b>16,700</b>	<b>17.7%</b>	<b>42%</b>	<b>26.9%</b>	<b>59%</b>	<b>1,426</b>

Source: Company reports, Citi Investment Research and Analysis

#### Two reasons for our bearish stance on KBC's Irish provisions guidance

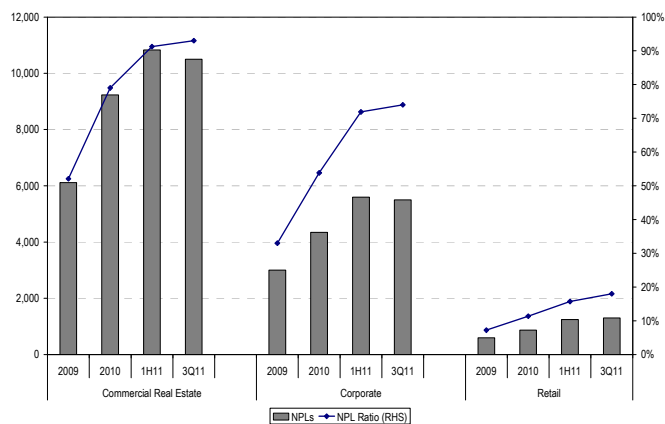
There are two reasons for our more bearish stance:

1. Our economists believe Ireland faces two tough years ahead ([Euro Weekly - Ireland — Tough Times Ahead](#), 17 February):

*Ireland's economy faces intense headwinds. Domestic demand should continue to be capped by household and banking sector deleveraging, plus fiscal retrenchment. Moreover, despite gains in export cost competitiveness, we believe exports will be capped by weakness in Ireland's key export markets. As a result, the tough fiscal plans are unlikely to deliver the planned trajectory for the general government gross debt/GDP ratio to level off below 120% of GDP in 2013 and then fall. We doubt the government will be able to regain anything like normal market access in 2012-13. Hence, we expect the Troika and government will accept that Ireland will need a longer period of fiscal austerity than current plans envisage — and some form of continued bailout or financial support beyond 2013.*

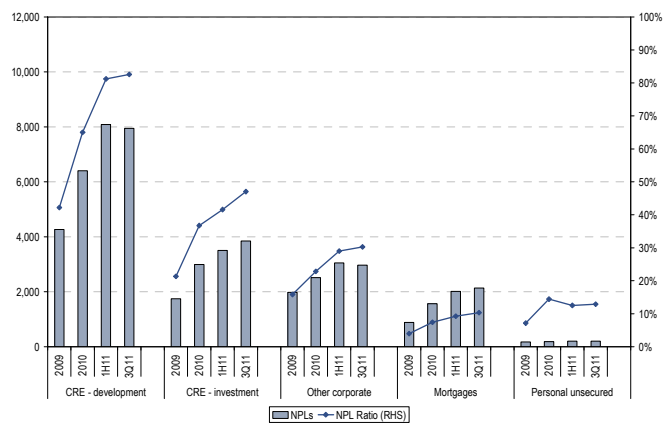
2. Compared to its peers (Lloyds; RBS; Bank of Ireland) KBC screens as having lower NPL and coverage ratios (Figs. 10-13). While the asset quality of the book may be better, we believe that KBC's asset quality will likely trend closer to peers over time. As KBC's peers could have used more aggressive underwriting criteria when the business was originated, our benchmarking aims to bring KBC coverage ratios closer to the lower end of peers' ratios rather than to be over and above them.

Figure 10. Lloyds – Irish NPLs and NPL Ratio (£m, %)



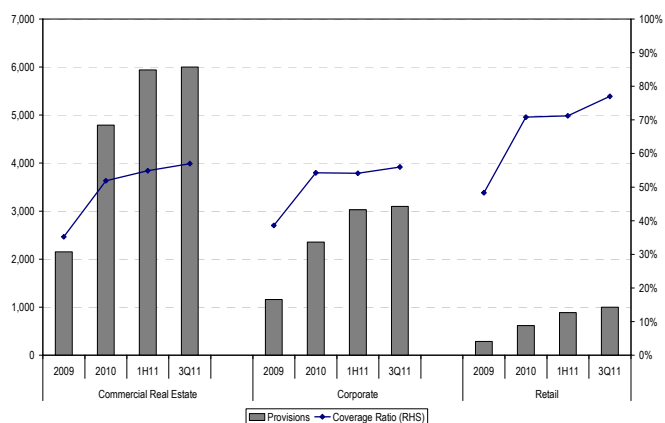
Source: Company Reports and CIRA

Figure 11. RBS – Ulster NPLs and NPL Ratio (£m, %)



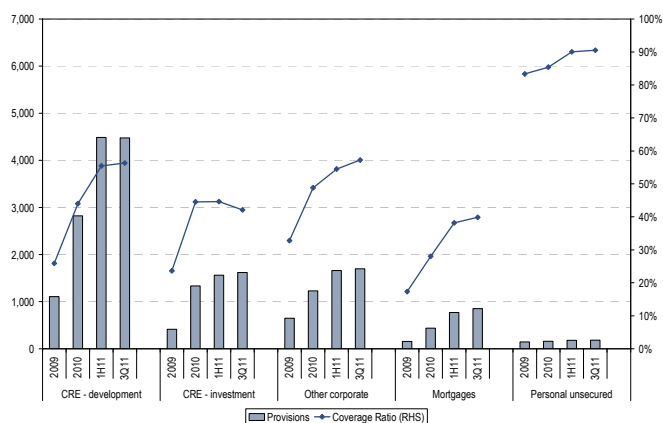
Source: Company Reports and CIRA

Figure 12. Lloyds – Irish B/S Provisions & Coverage Ratio (£m, %)



Source: Company Reports and CIRA

Figure 13. RBS – Ulster B/S Provisions & Coverage Ratio (£m, %)



Source: Company Reports and CIRA

### 3. Deposit Outflows & Funding

#### KBC lost €20bn of deposits in Belgian Retail and Merchant Banking in 4Q11...

KBC lost €1.5bn of Belgian retail deposits and €18bn of corporate deposits in 4Q11 which has pushed its Loans-to-Deposits to ratio to 103% from 96% in 3Q11 (Citi calculation, Figure 14 - Figure 15). Management attributed the loss of Belgian retail deposits to the Belgian state tapping retail investors for a €5.6bn retail bond in 4Q11. The outflow of merchant bank deposits seems to have been driven by the downgrade of KBC's short-term rating to A2 by S&P at the end of 2011.

Figure 14. KBC – Deposit Evolution by Division (€ in million) \*

Division	4Q10 *	1Q11 *	2Q11 *	3Q11 *	4Q11 *	qoq %	yoy %	qoq €m
Belgium	67,663	68,554	70,802	72,687	71,156	-2%	5%	-1,531
CEE	34,973	35,543	35,692	35,193	35,007	-1%	0%	-186
MB	61,360	60,175	56,010	51,474	33,535	-35%	-45%	-17,939
Group centre	18,477	9,221	8,884	8,329	9,687	16%	-48%	1,358
<b>TOTAL ex repos</b>	<b>182,473</b>	<b>173,493</b>	<b>171,388</b>	<b>167,683</b>	<b>149,385</b>	<b>-11%</b>	<b>-18%</b>	<b>-18,298</b>

Source: Company reports, Citi Investment Research and Analysis

\* 4Q10, 4Q11 = ex Centea, Fidea, WARTA; 1Q11, 2Q11 = ex Centea; 3Q11 = ex Centea, Fidea. QoQ comparisons may not be like-for-like due to differing composition of businesses.

Figure 15. KBC – Loans & Financial Investments Evolution (€ in million)

	4Q10 *	1Q11 *	2Q11 *	3Q11 *	4Q11 *	qoq %	yoy %	qoq €m
Bank loans & other credit inst	15487	14764	19225	21,794	19,158	-12%	24%	-2,636
Customer loans	143,183	147,625	143,182	143,451	138,284	-4%	-3%	-5,167
Equity instruments	3,576	3,695	3,337	2,661	2,501	-6%	-30%	-160
Debt instruments	79,681	85,144	81,807	71,401	62,535	-12%	-22%	-8,866
<b>TOTAL</b>	<b>241,927</b>	<b>251,228</b>	<b>247,551</b>	<b>239,307</b>	<b>222,478</b>	<b>-7%</b>	<b>-8%</b>	<b>-16,829</b>
<b>LDR</b>	<b>98%</b>	<b>96%</b>	<b>96%</b>	<b>96%</b>	<b>103%</b>			

Source: Company reports, Citi Investment Research and Analysis

\* 4Q10, 4Q11 = ex Centea, Fidea, WARTA; 1Q11, 2Q11 = ex Centea; 3Q11 = ex Centea, Fidea. QoQ comparisons may not be like-for-like due to differing composition of businesses.

KBC management stated that €6bn of the outflows were in the New York office, €4bn in the Irish offices, €2bn in London and €2.5bn in the dealing room among others. According to 4Q11 figures, demand, time and CD deposits showed the largest declines qoq. We believe KBC dealt with these large outflows in several ways:

- Non-renewed €5bn of term and €3bn of bank loans
- Sold a net of €8bn of public body bonds, and
- Obtained €3.3bn of LTRO and \$4bn of swap facility funding

...however its net short-term cover ratio  
is still well above 100% (4Q11: 180%,  
down from 280% qoq)

As a result of the above actions, we estimate that KBC's net short-term cover ratio declined to 180% from 280% qoq (Figure 16). While the decline is meaningful, KBC has stated that the outflows have now reversed. In addition, the availability of a second tranche of LTRO money with expanded eligibility collateral (Central Bank of Belgium is one of the seven central banks to establish such a programme) makes us relatively sanguine about liquidity. In addition, Reuters recently reported that "Belgium is poised to establish a new legal framework for covered bonds, which will allow the country's banks to use one of the most efficient form of public funding for the first time" – this form of funding has proved attractive to investors and should allow KBC to tap a new source of funding collateralized by its €138bn customer loan book.

Figure 16. KBC – Coverage of Net Short-Term Funding (€ in billion)

	3Q11	4Q11
CP/CD issues	8.1	5.4
Interbank deposits	20.8	19.4
Deposits at central bank	-10.8	-6.1
Net Short-Term funding (1)	18.1	18.7
Unencumbered eligible assets (2)	51.0	33.8
<b>Cover (2) / (1)</b>	<b>2.8</b>	<b>1.8</b>
Encumbered assets	6.0	14.6

Source: Company reports, Citi Investment Research and Analysis

## 4. Legacy Assets

Potential maximum capital impact from Legacy assets is €4.7bn – we believe the market is pricing in a 30% probability of this occurring

KBC sold €0.2bn of CDOs in 4Q11 at a minimal loss. In January, the bank de-risked €1.7bn of CDOs at a guided-to cost of €60-70m. In Figure 17 below we update our estimate for the additional maximum potential impact from legacy assets: €5.5bn to P&L and €4.7bn to capital. As discussed earlier in the note, we believe the market is currently implying a 30% probability of the maximum capital loss occurring – unlikely in our view given current marks of 36% (unhedged CDO) and 87% (Other ABS).

Figure 17. KBC – Estimating the Potential Future Maximum Impact from Legacy Assets (€ in million)

Guarantee breakdown by tranche	Nominal Amount	Max P&L impact	Max Capital impact	To-date P&L impact	To-date Capital impact	Potential P&L impact	Potential Capital impact
First tranche	1.9	-1.9	-1.9	-1.9	n/a	0.0	n/a
Second tranche	1.6	-1.6	-0.2	-1.6	n/a	0.0	n/a
Third tranche	10.3	-1.0	-1.0	-1.0	n/a	0.0	n/a
<b>Total guarantee</b>	<b>13.8</b>	<b>-4.5</b>	<b>-3.1</b>	<b>-4.5</b>	<b>n/a</b>	<b>0.0</b>	<b>n/a</b>
Non-guaranteed amount of Unhedged CDO	3.4	-3.4	-3.4	-0.6	n/a	-2.8	n/a
Other ABS	3.1	-3.1	-3.1	-0.4	n/a	-2.7	n/a
<b>Total legacy assets</b>	<b>20.3</b>	<b>-11.0</b>	<b>-9.6</b>	<b>-5.5</b>	<b>-4.9</b>	<b>-5.5</b>	<b>-4.7</b>

Source: Citi Investment Research and Analysis, KBC.

## New Earnings Estimates

We revise down our reported EPS estimates by **-14% (2012E) to €2.39**, by **-15% (2013E) to €3.65**, and by **-8% (2014E) to €5.00**. Our revisions are driven by lower revenues, partly offset by lower costs, and by higher provisions. We note that reported EPS figures include one-off and disposal charges but do not include the coupon on state capital.

As discussed earlier, we also increase our cost of equity to 12.5% from 10.0%. Despite the estimate cuts and the increase in the cost of equity, our target price is unchanged at €22 due to a lower estimated capital shortfall.

Figure 18. KBC – Summary Estimate Changes (2012E-2014E)

		2012E			2013E			2014E		
		Old	New	% Chg	Old	New	% Chg	Old	New	% Chg
Total operating income	Euro m	6,614	6,504	-2%	6,890	6,744	-2%	7,154	6,884	-4%
Total operating expenses	Euro m	-3,734	-3,739	0%	-4,016	-3,863	-4%	-4,133	-3,912	-5%
Operating profit pre provisions	Euro m	2,880	2,765	-4%	2,874	2,881	0%	3,021	2,972	-2%
Provisions	Euro m	-1,550	-1,591	3%	-912	-1,185	30%	-577	-689	20%
Profit before Tax	Euro m	1,330	1,174	-12%	1,962	1,696	-14%	2,444	2,282	-7%
<b>Net attributable, reported</b>	<b>Euro m</b>	<b>1,418</b>	<b>1,020</b>	<b>-28%</b>	<b>1,488</b>	<b>1,259</b>	<b>-15%</b>	<b>1,869</b>	<b>1,722</b>	<b>-8%</b>
<b>Net attributable, CIRA</b>	<b>Euro m</b>	<b>962</b>	<b>823</b>	<b>-14%</b>	<b>1,488</b>	<b>1,259</b>	<b>-15%</b>	<b>1,869</b>	<b>1,722</b>	<b>-8%</b>
<b>Net attributable, underlying</b>	<b>Euro m</b>	<b>1,041</b>	<b>973</b>	<b>-7%</b>	<b>1,488</b>	<b>1,259</b>	<b>-15%</b>	<b>1,869</b>	<b>1,722</b>	<b>-8%</b>
<b>EPS - adjusted, diluted</b>	<b>Euro</b>	<b>2.79</b>	<b>2.39</b>	<b>-14%</b>	<b>4.32</b>	<b>3.65</b>	<b>-15%</b>	<b>5.42</b>	<b>5.00</b>	<b>-8%</b>
DPS	Euro	0.75	0.01	-99%	0.75	0.01	-99%	1.00	0.25	-75%
No. shares	m	345	345	0%	345	345	0%	345	345	0%
<hr/>										
<b>Net Profit by Division Underlying</b>										
Belgium	Euro m	976	1,032	6%	1,038	1,057	2%	1,085	1,097	1%
CEE	Euro m	408	400	-2%	564	512	-9%	646	578	-10%
Merchant Banking	Euro m	-303	-284	-6%	-1	-185	nm	239	159	-34%
Group Centre	Euro m	-41	-176	327%	-114	-125	10%	-101	-112	11%

Source: Citi Investment Research and Analysis

## Earnings Model

Figure 19. KBC — Group P&L by Year

€m	2009	2010	% Chg	2011	% Chg	2012E	% Chg	2013E	% Chg	2014E	% Chg
Net interest income	5,817	6,246	+7%	5,479	-12%	5,113	-7%	5,083	-1%	5,169	+2%
Net fee & commission income	1,131	1,224	+8%	1,165	-5%	441	-62%	800	+81%	850	+6%
Net insurance revenues	372	347	-7%	535	+54%	523	-2%	257	-51%	269	+5%
Other revenues	-2,721	500	nm	75	nm	427	nm	603	+41%	596	-1%
<b>Total operating income</b>	<b>4,599</b>	<b>8,317</b>	<b>+81%</b>	<b>7,254</b>	<b>-13%</b>	<b>6,504</b>	<b>-10%</b>	<b>6,744</b>	<b>+4%</b>	<b>6,884</b>	<b>+2%</b>
Personnel expenses	-1,970	-2,528	+28%	-2,550	+1%	-2,169	-15%	-2,241	+3%	-2,269	+1%
General & administrative expenses	-2,521	-1,547	-39%	-1,511	-2%	-1,285	-15%	-1,328	+3%	-1,345	+1%
Depreciation of property & equipment	-287.0	-361.0	+26%	-335.0	-7%	-284.9	-15%	-294.3	+3%	-298.1	+1%
<b>Total operating expenses</b>	<b>-4,778</b>	<b>-4,436</b>	<b>-7%</b>	<b>-4,396</b>	<b>-1%</b>	<b>-3,739</b>	<b>-15%</b>	<b>-3,863</b>	<b>+3%</b>	<b>-3,912</b>	<b>+1%</b>
<b>Operating profit pre provisions</b>	<b>-179</b>	<b>3,881</b>	<b>nm</b>	<b>2,858</b>	<b>nm</b>	<b>2,765</b>	<b>-3%</b>	<b>2,881</b>	<b>+4%</b>	<b>2,972</b>	<b>+3%</b>
Impairment	-2,725	-1,657	-39%	-2,123	+28%	-1,591	-25%	-1,185	-25%	-689	-42%
<b>Profit before tax</b>	<b>-2,904</b>	<b>2,224</b>	<b>nm</b>	<b>735</b>	<b>nm</b>	<b>1,174</b>	<b>+60%</b>	<b>1,696</b>	<b>+44%</b>	<b>2,282</b>	<b>+35%</b>
Tax	256	-81	-132%	-320	nm	-337	+5%	-420	+25%	-544	+29%
Net profit before minorities	-2,547	1,889	nm	-4	nm	1,035	na	1,275	+23%	1,739	+36%
Minority interests	81	-28	-135%	-34	nm	-15	-56%	-16	+5%	-17	+5%
<b>Net profit (incl disposals, pre coupon)</b>	<b>-2,466</b>	<b>1,861</b>	<b>nm</b>	<b>-38</b>	<b>nm</b>	<b>1,020</b>	<b>-2783%</b>	<b>1,259</b>	<b>+24%</b>	<b>1,722</b>	<b>+37%</b>
<b>Adj Net profit (ex disp'sls, pre coupon)</b>	<b>-2,466</b>	<b>1,861</b>	<b>nm</b>	<b>381</b>	<b>-80%</b>	<b>823</b>	<b>+116%</b>	<b>1,259</b>	<b>+53%</b>	<b>1,722</b>	<b>+37%</b>
<b>PER SHARE FIGURES</b>											
<b>EPS - reported/basic</b>	<b>-7.26</b>	<b>5.48</b>	<b>nm</b>	<b>-0.11</b>	<b>nm</b>	<b>2.96</b>	<b>-2783%</b>	<b>3.65</b>	<b>+24%</b>	<b>5.00</b>	<b>+37%</b>
EPS - adjusted/diluted	-7.26	5.48	nm	1.11	-80%	2.39	+114%	3.65	+53%	5.00	+37%
Dividend per share	0.00	0.75	nm	0.01	-99%	0.01	nm	0.01	0%	0.25	nm
Payout Ratio	0%	14%	nm	1%	nm	0%	nm	0%	nm	5%	nm
Common equity per share	28.4	32.8	+15%	28.3	-14%	28.2	-0%	28.6	+1%	31.8	+11%
Tangible common equity per share	18.7	26.2	+40%	22.8	-13%	24.0	+5%	24.4	+1%	27.6	+13%
<b>OPERATING RATIOS</b>											
NII / Total Assets	1.71%	1.94%		1.81%		1.88%		2.02%		2.14%	
Compensation ratio	43%	30%		35%		33%		33%		33%	
<b>Cost / income ratio</b>	<b>104%</b>	<b>53%</b>		<b>61%</b>		<b>57%</b>		<b>57%</b>		<b>57%</b>	
Operating Profit / avg RWAs	-0.12%	2.82%		2.21%		2.33%		2.63%		2.74%	
Provision charge / customer loans	1.73%	1.06%		1.48%		1.16%		0.85%		0.48%	
Effective tax rate (ex goodwill etc)	9%	4%		44%		29%		25%		24%	
Return on avg RWAs	-1.7%	1.4%		0.3%		0.7%		1.2%		1.6%	
<b>RoE (adj net profit on common equity)</b>	<b>-24.2%</b>	<b>16.6%</b>		<b>3.6%</b>		<b>7.7%</b>		<b>12.9%</b>		<b>16.5%</b>	
<b>RoE (pre gov't coupon on reptd equity)</b>	<b>-14.3%</b>	<b>10.2%</b>		<b>2.2%</b>		<b>5.8%</b>		<b>10.4%</b>		<b>14.2%</b>	
<b>SHARES OUTSTANDING</b>											
Basic (period end, m)	340	340	+0%	345	+1%	345	+0%	345	+0%	345	+0%
Diluted (period avg, m)	340	340	+0%	342	+1%	345	+1%	345	+0%	345	+0%
<b>BALANCE SHEET ITEMS</b>											
Total Assets	324,231	320,823	-1%	285,382	-11%	258,238	-10%	245,326	-5%	237,966	-3%
Gross customer loans	157,310	155,703	-1%	143,525	-8%	137,087	-4%	139,595	+2%	142,523	+2%
Customer deposits	193,464	197,870	+2%	165,226	-16%	164,645	-0%	168,966	+3%	174,583	+3%
Loan / deposit ratio	79%	76%		84%		80%		79%		78%	
Shareholders equity ex mins & gov cap	9,662	11,147	+15%	9,756	-12%	9,727	-0%	9,846	+1%	10,976	+11%
<b>GROUP REGULATORY CAPITAL</b>											
Basel 2 Tier 1 ratio	10.8%	12.6%		12.3%		11.6%		11.2%		11.5%	
Basel 2 Core Tier 1 Ratio (co. defn)	9.2%	10.9%		10.6%		9.7%		9.3%		9.6%	
<b>Basel 2 Common Equity Tier 1 Ratio</b>	<b>3.9%</b>	<b>5.2%</b>		<b>5.0%</b>		<b>6.0%</b>		<b>6.6%</b>		<b>7.5%</b>	
<b>Basel 3 Common Equity Tier 1 Ratio</b>				<b>4.2%</b>		<b>5.3%</b>		<b>4.8%</b>		<b>6.1%</b>	
Equity / Assets	3.0%	3.5%		3.4%		3.8%		4.0%		4.6%	
Tangible Equity / Assets	2.0%	2.8%		2.8%		3.2%		3.4%		4.0%	

Source: Company Reports and CIRA Estimates

Figure 20. KBC — Group P&L by Quarter

€m	1Q10	2Q10	3Q10	4Q10	1Q11	2Q11	3Q11	4Q11	1Q12E	2Q12E	3Q12E	4Q12E
Net interest income	1,519	1,567	1,562	1,598	1,395	1,406	1,341	1,337	1,308	1,315	1,243	1,248
Net fee & commission income	322	336	259	307	300	297	281	287	92	104	116	129
Net insurance revenues	76	71	94	106	112	126	142	155	132	131	131	129
Other revenues	119	-478	319	540	611	-1	-1,037	502	7	148	134	138
<b>Total operating income</b>	<b>2,036</b>	<b>1,496</b>	<b>2,234</b>	<b>2,551</b>	<b>2,418</b>	<b>1,828</b>	<b>727</b>	<b>2,281</b>	<b>1,538</b>	<b>1,698</b>	<b>1,624</b>	<b>1,644</b>
Personnel expenses	-632	-609	-634	-653	-637	-648	-634	-631	-581	-568	-533	-550
General & administrative expenses	-348	-345	-407	-445	-421	-351	-407	-332	-373	-299	-342	-290
Depreciation of property & equipment	-92.0	-89.0	-88.0	-92.0	-84.0	-83.0	-88.0	-80.0	-80.6	-72.0	-74.0	-69.8
<b>Total operating expenses</b>	<b>-1,072</b>	<b>-1,043</b>	<b>-1,129</b>	<b>-1,190</b>	<b>-1,142</b>	<b>-1,082</b>	<b>-1,129</b>	<b>-1,043</b>	<b>-1,034</b>	<b>-938</b>	<b>-949</b>	<b>-910</b>
<b>Operating profit pre provisions</b>	<b>964</b>	<b>453</b>	<b>1,105</b>	<b>1,361</b>	<b>1,276</b>	<b>746</b>	<b>-402</b>	<b>1,238</b>	<b>505</b>	<b>760</b>	<b>675</b>	<b>734</b>
Impairment	-383	-299	-420	-555	-105	-332	-940	-746	-419	-422	-387	-362
<b>Profit before tax</b>	<b>581</b>	<b>154</b>	<b>685</b>	<b>806</b>	<b>1,171</b>	<b>414</b>	<b>-1,342</b>	<b>492</b>	<b>86</b>	<b>338</b>	<b>288</b>	<b>372</b>
Tax	-164	304	-124	-97	-334	-76	165	-75	-66	-87	-85	-99
Net profit before minorities	448	156	554	733	837	338	-1,622	443	20	251	400	273
Minority interests	-6	-6	-8	-8	-14	-6	-8	-6	-4	-4	-4	-3
<b>Net profit (incl disposals, pre coupon)</b>	<b>442</b>	<b>150</b>	<b>546</b>	<b>725</b>	<b>823</b>	<b>332</b>	<b>-1,630</b>	<b>437</b>	<b>16</b>	<b>247</b>	<b>396</b>	<b>270</b>
<b>Adj Net profit (ex dispsls, pre coupon)</b>	<b>411</b>	<b>452</b>	<b>553</b>	<b>701</b>	<b>823</b>	<b>332</b>	<b>-1,185</b>	<b>411</b>	<b>16</b>	<b>247</b>	<b>199</b>	<b>270</b>
<b>PER SHARE FIGURES</b>												
<b>EPS - reported/basic</b>	<b>1.30</b>	<b>0.44</b>	<b>1.61</b>	<b>2.13</b>	<b>2.42</b>	<b>0.96</b>	<b>-4.73</b>	<b>1.27</b>	<b>0.05</b>	<b>0.72</b>	<b>1.15</b>	<b>0.78</b>
EPS - adjusted/diluted	1.21	1.33	1.63	2.06	2.42	0.98	-3.44	1.19	0.05	0.72	0.58	0.78
Dividend per share	-	-	-	-	-	-	-	0.00	0.00	0.00	0.00	0.00
Payout Ratio	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%
Common equity per share	31.4	30.2	33.1	32.8	32.4	33.4	28.5	28.3	28.4	29.1	30.2	31.0
Tangible common equity per share	21.6	23.4	26.3	26.2	25.7	26.8	22.4	22.8	23.4	24.1	26.0	26.8
<b>OPERATING RATIOS</b>												
NII / Total Assets	1.83%	1.82%	1.84%	1.97%	1.73%	1.77%	1.74%	1.81%	1.84%	1.88%	1.84%	1.91%
Compensation ratio	31%	41%	28%	26%	26%	35%	87%	28%	38%	33%	33%	33%
<b>Cost / income ratio</b>	<b>53%</b>	<b>70%</b>	<b>51%</b>	<b>47%</b>	<b>47%</b>	<b>59%</b>	<b>155%</b>	<b>46%</b>	<b>67%</b>	<b>55%</b>	<b>58%</b>	<b>55%</b>
Operating Profit / avg RWAs	2.69%	1.28%	3.25%	4.11%	3.87%	2.30%	-1.30%	4.01%	1.63%	2.52%	2.33%	2.64%
Provision charge / customer loans	0.97%	0.74%	1.09%	1.43%	0.28%	0.90%	2.53%	2.08%	1.18%	1.19%	1.14%	1.06%
Effective tax rate (ex goodwill etc)	28%	nm	18%	12%	29%	18%	12%	15%	77%	26%	30%	27%
Return on avg RWAs	1.1%	1.3%	1.6%	2.1%	2.5%	1.0%	-3.8%	1.3%	0.1%	0.8%	0.7%	1.0%
<b>RoE (adj net profit on common equity)</b>	<b>16.2%</b>	<b>17.3%</b>	<b>20.6%</b>	<b>25.0%</b>	<b>29.7%</b>	<b>11.8%</b>	<b>-44.4%</b>	<b>16.8%</b>	<b>0.7%</b>	<b>10.0%</b>	<b>7.8%</b>	<b>10.2%</b>
<b>RoE (pre gov't coupon on reptd equity)</b>	<b>9.6%</b>	<b>10.4%</b>	<b>12.5%</b>	<b>15.4%</b>	<b>18.2%</b>	<b>7.3%</b>	<b>-26.8%</b>	<b>9.8%</b>	<b>0.4%</b>	<b>5.8%</b>	<b>4.6%</b>	<b>6.1%</b>
<b>SHARES OUTSTANDING</b>												
Basic (period end, m)	340	340	340	340	340	345	345	345	345	345	345	345
Diluted (period avg, m)	340	340	340	340	340	340	345	345	345	345	345	345
<b>BALANCE SHEET ITEMS</b>												
Total Assets	340,128	350,232	328,590	320,823	322,493	312,899	305,109	285,382	282,155	277,344	263,958	258,238
Gross customer loans	158,098	161,535	154,593	155,703	152,600	147,824	148,344	143,525	142,137	142,358	135,732	137,087
Customer deposits	203,367	205,108	198,825	197,870	192,412	188,116	184,453	165,226	165,082	164,937	164,791	164,645
Loan / deposit ratio	76%	77%	75%	76%	77%	76%	78%	84%	83%	83%	79%	80%
Shareholders equity ex mins & govt cap	10,677	10,259	11,245	11,147	11,011	11,500	9,834	9,756	9,772	10,019	10,415	10,684
<b>GROUP REGULATORY CAPITAL</b>												
Basel 2 Tier 1 ratio	11.0%	11.4%	12.1%	12.6%	13.3%	13.9%	13.6%	12.3%	0.0%	0.0%	0.0%	0.0%
Basel 2 Core Tier 1 Ratio (co. defn)	9.5%	9.7%	10.4%	10.9%	11.6%	12.1%	11.7%	10.6%	0.0%	0.0%	0.0%	0.0%
<b>Basel 2 Common Equity Tier 1 Ratio</b>	<b>4.2%</b>	<b>4.2%</b>	<b>4.8%</b>	<b>5.2%</b>	<b>6.0%</b>	<b>6.3%</b>	<b>5.4%</b>	<b>5.0%</b>	<b>0.0%</b>	<b>0.0%</b>	<b>0.0%</b>	<b>0.0%</b>
Equity / Assets	3.1%	2.9%	3.4%	3.5%	3.4%	3.7%	3.2%	3.4%	3.5%	3.6%	3.9%	4.1%
Tangible Equity / Assets	2.2%	2.3%	2.7%	2.8%	2.7%	3.0%	2.5%	2.8%	2.9%	3.0%	3.4%	3.6%

Source: Company Reports and CIRA Estimates



Figure 21. KBC — Divisional P&L by Year

€m	2009	2010	% Chg	2011	% Chg	2012E	% Chg	2013E	% Chg	2014E	% Chg
<b>RETAIL, BELGIUM (UNDERLYING)</b>											
Total operating income	3,263	3,320	+2%	3,261	-2%	3,306	+1%	3,391	+3%	3,525	+4%
Total operating expenses	-1,700	-1,703	+0%	-1,790	+5%	-1,744	-3%	-1,806	+4%	-1,895	+5%
Operating profit pre-provisions	1,563	1,617	+3%	1,471	-9%	1,562	+6%	1,585	+1%	1,630	+3%
Provisions	-76	-104	+37%	-312	+200%	-87	-72%	-75	-14%	-63	-17%
PBT	1,487	1,513	+2%	1,159	-23%	1,475	+27%	1,510	+2%	1,568	+4%
Tax	-433	-457	+6%	-355	-22%	-442	+25%	-453	+2%	-470	+4%
Net Profit	1,054	1,052	-0%	802	-24%	1,032	+29%	1,057	+2%	1,097	+4%
Cost/income ratio	52%	51%	-2%	55%	7%	53%	-4%	53%	1%	54%	1%
Provisions/RWAs	0.27%	0.36%		1.08%		0.30%		0.25%		0.20%	
Tax rate	29%	30%		31%		30%		30%		30%	
<b>CENTRAL &amp; EASTERN EUROPE (UNDERLYING)</b>											
Total operating income	2,454	2,700	+10%	2,468	-9%	2,046	-17%	2,086	+2%	2,173	+4%
Total operating expenses	-1,475	-1,531	+4%	-1,371	-10%	-1,220	-11%	-1,187	-3%	-1,233	+4%
Operating profit pre provisions	979	1,169	+19%	1,097	-6%	826	-25%	899	+9%	939	+5%
Provisions	-641	-462	-28%	-632	+37%	-367	-42%	-304	-17%	-266	-13%
PBT	338	707	+109%	465	-34%	459	-1%	595	+30%	674	+13%
Tax	-36	-85	+136%	-62	-27%	-60	-3%	-84	+39%	-97	+16%
Net Profit	162	413	+155%	296	-28%	400	+35%	512	+28%	578	+13%
Cost/income ratio	60%	57%	-6%	56%	-2%	60%	7%	57%	-5%	57%	0%
Provisions/RWAs	1.88%	1.39%	-26%	2.42%	74%	1.39%	-42%	1.10%	-21%	0.90%	-18%
Tax rate	11%	12%		13%		13%		14%		14%	
<b>MERCHANT BANKING (UNDERLYING)</b>											
Total operating income	1,777	1,540	-13%	1,235	-20%	1,114	-10%	1,039	-7%	998	-4%
Total operating expenses	-593	-577	-3%	-568	-2%	-530	-7%	-490	-8%	-464	-5%
Operating profit pre provisions	1,184	963	-19%	667	-31%	584	-12%	549	-6%	534	-3%
Provisions	-814	-796	-2%	-767	-4%	-923	+20%	-767	-17%	-320	-58%
PBT	370	167	-55%	-100	-160%	-339	+238%	-218	nm	213	-198%
Tax	-3	-18	+500%	5	-128%	71	+1322%	49	-31%	-37	-176%
Net Profit	297	132	-56%	-110	-183%	-284	+158%	-185	nm	159	-186%
Cost/income ratio	33%	37%	12%	46%	23%	48%	0%	47%	0%	47%	0%
Provisions/RWAs	1.52%	1.68%	+11%	1.82%	+8%	2.19%	+0%	2%	0%	1%	0%
Tax rate	1%	11%		5%		21%	+0%	0	+0%	0	+0%
<b>GROUP CENTRE (UNDERLYING)</b>											
Total operating income	1,593	1,127	-29%	1,157	+3%	513	-56%	228	-56%	188	-17%
Total operating expenses	-1,118	-1,022	-9%	-958	-6%	-570	-41%	-380	-33%	-320	-16%
Operating profit pre provisions	475	105	-78%	199	+90%	-57	nm	-152	nm	-132	nm
Provisions	-383	-161	nm	-197	nm	-213	+8%	-40	nm	-41	nm
PBT	92	-56	-161%	2	-104%	-270	-13623%	-192	-29%	-172	-10%
Tax	-34	-25	-26%	16	-164%	95	+492%	67	-29%	60	-10%
Net Profit	214	120	-44%	112	-7%	-176	-257%	-125	-29%	-112	-10%

Source: Company Reports and CIRA Estimates

Figure 22. KBC — Divisional P&L by Quarter

€m	1Q10	2Q10	3Q10	4Q10	1Q11	2Q11	3Q11	4Q11	1Q12E	2Q12E	3Q12E	4Q12E
<b>RETAIL, BELGIUM (UNDERLYING)</b>												
Total operating income	818	865	770	867	846	864	692	859	811	839	824	832
Total operating expenses	-407	-394	-414	-488	-429	-446	-462	-453	-422	-436	-437	-449
Operating profit pre-provisions	411	471	356	379	417	418	230	406	389	402	387	383
Provisions	-3	-39	-27	-35	-15	-74	-165	-58	-20	-22	-20	-25
PBT	408	432	329	344	402	344	65	348	369	381	367	358
Tax	-127	-133	-106	-91	-121	-105	-32	-97	-111	-114	-110	-107
Net Profit	279	298	222	253	280	239	32	251	258	266	257	251
Cost/income ratio	50%	46%	54%	56%	51%	52%	67%	53%	52%	52%	53%	54%
Provisions/RWAs	0.04%	0.55%	0.38%	0.49%	0.21%	1.02%	2.26%	0.80%	0.28%	0.30%	0.28%	0.34%
Tax rate	31%	31%	32%	26%	30%	31%	49%	28%	30%	30%	30%	30%
<b>CENTRAL &amp; EASTERN EUROPE (UNDERLYING)</b>												
Total operating income	658	655	679	708	698	690	537	543	508	512	513	514
Total operating expenses	-347	-356	-425	-403	-438	-393	-298	-242	-349	-288	-287	-296
Operating profit pre provisions	311	299	254	305	260	297	239	301	159	224	226	217
Provisions	-111	-116	-142	-93	-50	-111	-280	-191	-91	-93	-91	-92
PBT	200	183	112	212	210	186	-41	110	68	131	135	125
Tax	-32	-16	-10	-27	-44	-4	0	-14	-7	-18	-19	-17
Net Profit	113	113	53	134	100	138	-40	98	62	113	116	109
Cost/income ratio	53%	54%	63%	57%	63%	57%	55%	45%	69%	56%	56%	58%
Provisions/RWAs	1.29%	1.39%	1.70%	1.12%	0.59%	1.29%	4.30%	2.92%	1.40%	1.42%	1.39%	1.40%
Tax rate	16%	9%	9%	13%	21%	2%	0%	13%	10%	14%	14%	13%
<b>MERCHANT BANKING (UNDERLYING)</b>												
Total operating income	482	362	494	202	468	339	105	323	272	277	282	283
Total operating expenses	-140	-137	-142	-158	-152	-141	-143	-132	-135	-129	-142	-124
Operating profit pre provisions	342	225	352	44	316	198	-38	191	137	148	140	159
Provisions	-219	-91	-131	-355	-57	-112	-214	-384	-232	-230	-230	-230
PBT	123	134	221	-311	259	86	-252	-193	-95	-83	-90	-71
Tax	-35	-8	-63	88	-78	-22	61	44	20	17	19	15
Net Profit	85	122	153	-228	176	62	-195	-153	-78	-69	-75	-61
Cost/income ratio	29%	38%	29%	78%	32%	42%	136%	41%	50%	47%	50%	44%
Provisions/RWAs	1.69%	0.70%	1.10%	3.00%	0.50%	1.06%	2.15%	3.65%	2.19%	2.18%	2.19%	2.18%
Tax rate	28%	6%	29%	28%	30%	26%	24%	23%	22%	21%	21%	20%
<b>GROUP CENTRE (UNDERLYING)</b>												
Total operating income	323	315	258	231	262	267	314	314	152	161	96	105
Total operating expenses	-264	-263	-233	-262	-209	-175	-269	-305	-165	-165	-120	-120
Operating profit pre provisions	59	52	25	-31	53	92	45	9	-14	-4	-25	-15
Provisions	-22	-51	-61	-27	17	-36	-81	-97	-76	-77	-45	-15
PBT	37	1	-36	-58	70	56	-36	-88	-89	-81	-70	-30
Tax	-22	-31	6	22	-28	-8	-6	58	31	28	24	11
Net Profit	70	23	16	11	100	90	-45	-33	-58	-53	-45	-20

Source: Company Reports and CIRA Estimates

## KBC

### Company description

KBC was created in mid-1998 from the three-way merger of Kredietbank (commercial bank), ABB (insurance) and CERA (domestic agricultural co-operative bank). The group bought businesses in CEE countries mainly in 1992-2002, most notably in the Czech Republic/Slovakia, Poland and Hungary. It has also bought private banks in several major European countries, which keep separate brands. KBC pursues a bancassurance approach cross-selling banking, insurance, asset management and capital markets products through its multiple channels. Following an EU-approved plan, KBC is in the process of divesting a number of its non-core assets.

### Investment strategy

We rate KBC Buy. Common equity tier 1 remains worryingly low, in our view, but with profitability improving and KBC's restructuring plans now well under way, KBC has established a clear roadmap to rebuilding capital ratios and repaying state capital, mostly by the end of 2013. While execution risks do exist on the remaining earmarked disposals, the plans appear sensible and these look solid businesses in their own right.

We believe the currently earmarked divestments may not be enough for the group to repay the state through internal capital generation alone in the near future - hence our view that a capital raise will be needed. As the balance sheet is repaired, however, we expect focus to return to the high underlying profitability, leading to a re-rating of the stock.

### Valuation

We have a target price of €22 on KBC. We use a one-stage P/E model to value KBC, including a €2.4bn capital shortfall in our valuation. We also assume 1% growth at a 'normalized' 14.5% RoTE. We use a cost of equity of 12.5% based on the company's business mix and the assumption that the capital structure is 'de-risked' via a capital raise. We cross-check this valuation using: (1) comparable price-to-book valuation; and (2) comparable P/E valuation relative to the bank sector.

### Risks

We rate KBC High Risk because the bank's tangible common equity remains somewhat thin, leaving it highly vulnerable to losses from the regular credit cycle and/or peripheral sovereign debt exposure. However, equally, the very high leverage also allows rapid capital rebuild as we look beyond the current cycle. Through its CEE exposure KBC has emerging market risks of economic disruption, currency devaluation and greater credit risks and has the risk of margin compression and wage/cost inflation as markets mature. These risks could prevent the shares from reaching our target price.

## Appendix A-1

### Analyst Certification

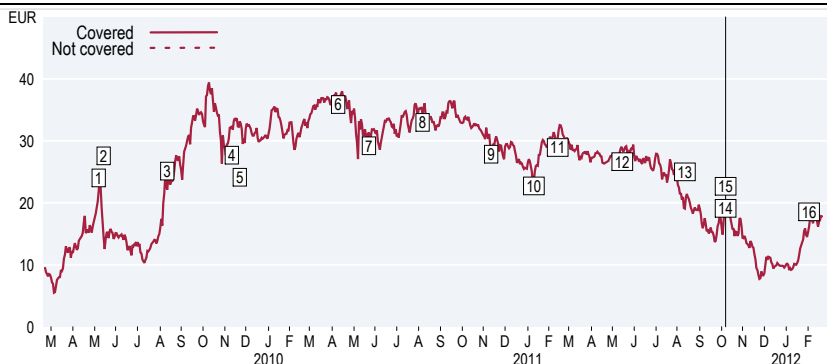
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### IMPORTANT DISCLOSURES

#### KBC (KBC.BR)

##### Ratings and Target Price History Fundamental Research

Analyst: Stefan Nedialkov  
Covered since November 3 2011



Date	Rating	Target Price	Closing Price
1 7-May-09	2H	*24.00	21.90
2 14-May-09	*2S	*15.00	14.34
3 12-Aug-09	2S	*25.00	22.11
4 11-Nov-09	2S	*34.00	32.41
5 23-Nov-09	*2H	*37.50	33.15
6 9-Apr-10	2H	*40.00	36.65

\* Indicates change

Date	Rating	Target Price	Closing Price
7 24-May-10	*1H	40.00	31.36
8 6-Aug-10	1H	*44.00	34.50
9 11-Nov-10	1H	*41.00	27.85
10 11-Jan-11	1H	*37.00	23.49
11 14-Feb-11	1H	*38.50	30.43
12 16-May-11	1H	*40.00	28.70

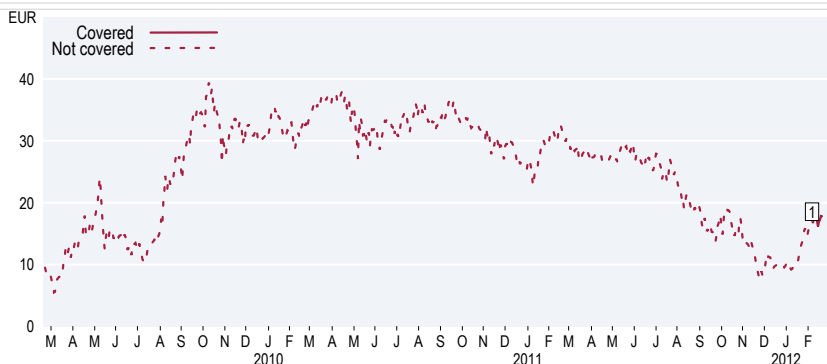
Date	Rating	Target Price	Closing Price
13 11-Aug-11	*1S	40.00	19.07
14 7-Oct-11	Stock rating system changed		
15 7-Oct-11	*1H	40.00	18.96
16 2-Feb-12	1H	*22.00	16.15

Rating/target price changes above reflect Eastern Standard Time

#### KBC (KBC.BR)

##### Ratings and Target Price History Best Ideas Research Relative Call (3 Month)

Analyst: Stefan Nedialkov  
Covered since November 3 2011



Date	Rating	Target Price	Closing Price
1 7-Feb-12	*ADD MP	-	17.22

\* Indicates change

Rating/target price changes above reflect Eastern Standard Time

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