Daiwa Capital Markets

Black Sea Trade and Development Bank

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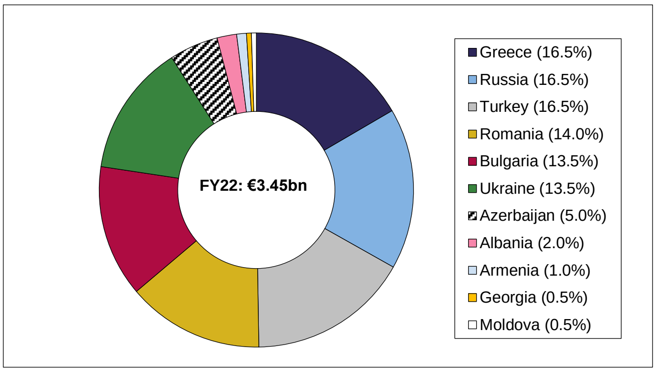
	Long-term	Short-term	Outlook
Moody's	**Baa2**	**P-3**	**Negative**
S&P	**BBB+**	**A-2**	**Negative**

Source: Moody's, S&P

Background and ownership

The Black Sea Trade and Development Bank (BSTDB), was established in 1997 by its 11 member states, which either border or are located in the vicinity of the Black Sea. It was formed as the financial pillar of the Black Sea Economic Cooperation (BSEC) and countries must belong to the BSEC to become BSTDB member states, though the establishment agreement also permits multilateral development banks (MDBs) and financial institutions to become shareholders. BSTDB started operations in June 1999 and has authorised capital of EUR3.45bn and subscribed capital of EUR2.3bn. All member states are both capital contributors and borrowers and are represented on the board of governors (BoG) in which all decision-making authority is ultimately vested.

Member states capital share



*Source: Company reports; *Authorised share capital*

The bank's preferred creditor status means debt repayments with respect to its loans, or those guaranteed by its member states are generally not rescheduled. Loans to private sector borrowers are also not rescheduled in the event of foreign exchange unavailability in the borrower's country. The dynamic between BSTDB members has been complicated by wars and conflicts in recent years. Russia's ongoing invasion of Ukraine and several short-lived assaults by Azerbaijan on Armenia have created tensions. Nevertheless, in March 2023, the BoG agreed the bank's most recent capital increase (pending completion), with all 11 members states subscribing, showcasing shareholder support. Whether Russia is able to participate due to sanctions and how this may affect its ownership stake remains to be disclosed. Meanwhile, the bank has taken steps to manage the relationship with Russia in the context of the invasion of Ukraine, including by removing its appointee from BSTDB's management team, replacing its sanctioned BoG representative, suspending new lending and reducing outstanding portfolio balances.

Main activities

BSTDB supports economic development and regional cooperation in the Black Sea Region through trade and project finance in the form of loans, guarantees, and equity participation in private enterprises and public entities in member countries. **Private sector** lending as a share of the total outstanding loan portfolio was 75.2% as at FY22, somewhat above BSTDB's strategy goal of a 65-70% share. Products on offer range from loans typically denominated in US dollars or euros, trade finance, SME financing through credit lines to local financial intermediaries, equity investments (typically 5-25% stake) both direct and via investment funds, guarantees and co-financing. BSTDB has a high exposure to financial institutions because it uses banks to direct loans to SMEs and for trade finance rather than lending directly, as well as leasing and subordinated lending. At the same time, increasing the share of **sovereign and public sector** operations to 35% is articulated as a strategy goal but BSTDB remained well behind this target at 24.8% in 2022 and below 30% over the past four years. The bank lists the pandemic and the war between Ukraine and Russia as contributing factors for this shortcoming but crucially highlights the inherently low relative competitiveness vis-à-vis 'AAA' rated MDBs who offer large-sized loans to the public sector at more favourable terms.

Medium-term business plan (2023-2026)

BSTDB has undergone nearly two decades of steady growth, which was disrupted in 2022 by a series of shocks and uncertainties caused by the war in Ukraine as well as challenging global financial conditions related to tighter monetary policy. The resulting economic downturn has reduced growth prospects and poses significant challenges for the bank, which it seeks to address with its new 2023-2026 business plan, presented in two parts:

1. **Phase 1 (2023-2024):** Focus on stabilisation and consolidation by implementing mechanisms to safeguard member states' investments as well as the institution's credibility towards key interlocutors. Main goal is to maintain financial sustainability and achieve operational consolidation. For this, BSTDB intends to limit new operational activity and focus on portfolio monitoring to prevent further asset quality deterioration and ensure recovery of exposures at risk. The lower level of new activity shall favour shorter operations of smaller size than has been the case in the recent past, focusing on post-war reconstruction activities and countries that have been under-served to date.

2. **Phase 2 (2025-2026):** Focus is on the return to growth and value creation. A greater level of operational activity will aim to return to the steady, managed growth of previous years. BSTDB will look to expand its infrastructure and green financing offering, in line with rising regional demand while further diversifying its portfolio by sector and geography.

Financial strength indicators

Profitability – Black Sea Trade and Development Bank closed 2022 with a net loss of EUR27.6m (1H23: net profit EUR40m), despite strong top-line revenue performance of EUR63.7m (+25% yoy). It's the first reported loss in BSTDB's history due to higher than usual recorded loan-loss provisions (LLP) that partially eroded its capital position thus limiting new lending. BSTDB was able to halt this development in 1H23 as it scaled back some of the over-provisioning it had undertaken during 2022. This culminated in a reversal of expected credit losses, booking a gain of EUR13.1m in 1H23. Leading up to the conflict in Ukraine, the bank had been recording steady annual net income results, averaging EUR14.5m over the past decade. This solid track record led BSTDB to announce an increase in subscribed capital by EUR816m in Oct-2021, highlighting shareholders' support and commitment to the bank's growth strategy at the time.

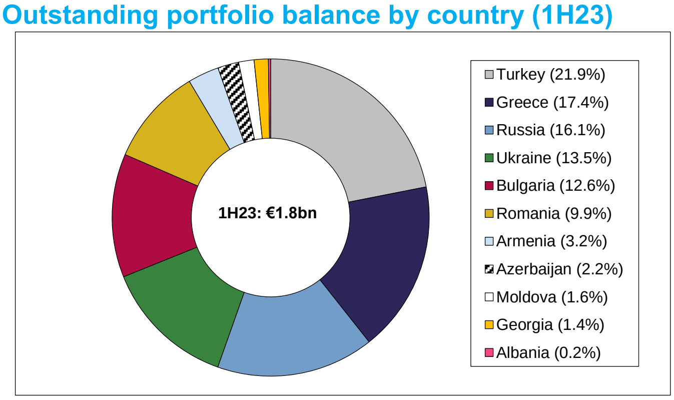
BSTDB – Key Data			
Key Ratios (%)	1H23	FY22	FY21
Capital adequacy ratio*	48.1	40.4	37.4
Stage 3 loan ratio	13.4	9.4	3.0
Stage 3 coverage ratio	31.3	35.8	54.5
Liquid asset ratio	n.a.	141.6	102.7
RoE	4.5	3.3	5.0
Balance Sheet (EURm)			
Total assets	2,519	2,935	3,235
Total loans	1,763	2,041	2,329
Total liabilities	1,640	2,099	2,349
Borrowings	1,479	1,916	2,274
Total member's equity	878.9	836.3	885.7
Income Statement (EURm)			
Operating income	39.1	63.7	51.0
o/w NII	44.0	96.6	60.4
Operating expenses	12.0	23.3	21.4
Loan loss provisions	13.1	-68.8	-38.6
Net income	40.0	-27.6	43.9

*Source: Company earnings reports; *Total equity / Outst.& disb. assets*

However, given the changes in the operating environment of its member states and in line with the bank's new strategy, new lending is expected to remain constrained over the foreseeable future and in the case of Russia it is currently suspended. In 1H23, revenues continued to benefit from the overall higher interest rate environment, resulting in the net interest income (NII) component rising +7.3% yoy (FY22: +60% yoy). Overall, stage 3 provisions were mainly held against outstanding balances in Russia and Ukraine, however BSTDB arguably navigated the conflict between its member states better than expected. Under its own baseline scenario in the 2023-2026 business plan the bank expected to record LLPs of EUR120m in 2022, compared with the much lower actual figure of EUR68.8m. The resulting net income loss due to LLPs was therefore expected to be much larger at EUR92.6m compared with the more moderate figure recorded.

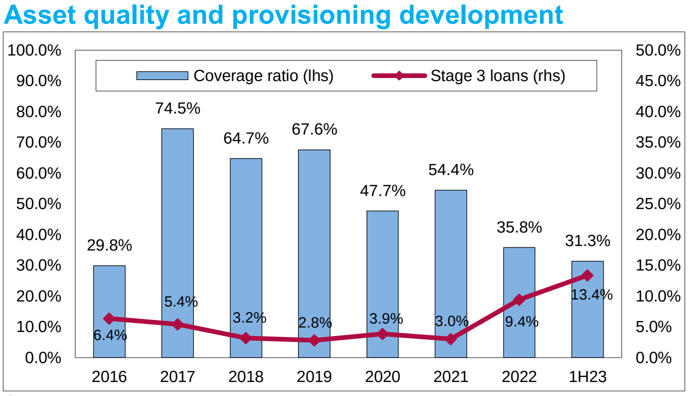
Asset quality – Total assets at 1H23 amounted to EUR2.5bn (-14.8% yoy), comprised of loans (70% of total), cash and balances due from banks (17%) and securities investments (5%). The outstanding lending portfolio is generally well diversified by country and sector, in line with historical trends. Credit risk exposures to Russia and Ukraine account for a combined 29.5% of total exposures. Sector concentration is moderate and geared towards utilities (25% of total), industrials (21%), financial institutions (12%) and materials (12%). As part of its strategic business plan, BSTDB made some conservative projections on continued portfolio developments under a base case scenario, expecting the portfolio to shrink by 14.5% by end-2024, resulting in a balance sheet reduction of 22.3% over the same period. After averaging EUR725m annually between 2018-2021, new commitments are expected to be limited to EUR368m in 2023 and 2024. Reduced lending activity over the next two years is considered positive for the capital position and liquidity preservation, but it may curtail the bank's policy importance should this situation endure beyond 'Phase 2 (2025-2026)' of the strategic plan, which specifically targets growth.

Outstanding portfolio balance by country (1H23)



Source: Company reports

Asset quality and provisioning development



Source: Company reports

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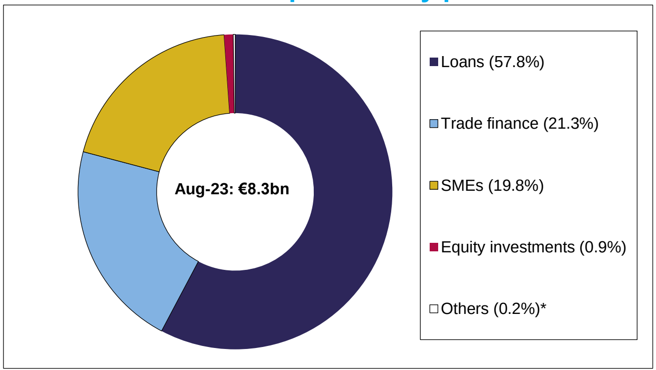
Asset quality has generally been robust, even throughout challenging periods such as the pandemic, when stage 3 loans only experienced modest upticks. In part this is due to BSTDB using public-sector guarantees for risk-sharing and by operating through financial intermediaries when lending to SMEs, thus benefitting from their due diligence processes and generally taking the risk of the intermediary and not that of the end recipients. The upturn in stage 3 loans since 2022 is primarily due to weakening asset quality among member states locked in conflict and we expect it to remain strained for the duration of the war. The most recent coverage ratio fell to a modest 31%, despite provisioning amounts essentially doubling since 2021, raising our expectation of further LLP increases in order to return to more adequate coverage levels.

Funding & Liquidity – Total liabilities, excluding members' equity, amounted to EUR1.6bn at 1H23 (-23.3% yoy), comprising debt in issue (70% of total), amounts due to financial institutions (20%), and derivatives (8%). The bank established its first EMTN programme in 2015 for EUR1bn and launched its second in 2020 for EUR2bn. BSTDB also utilises short-term financing facilities in the form of euro-commercial paper (ECP) for cash management purposes. Credit facilities from multilateral development banks (MDB) or national development banks (NDB) provide additional diversification to the issuer's funding profile and are expected to be extended, as capital market funding costs for the issuer are considered prohibitive at present.

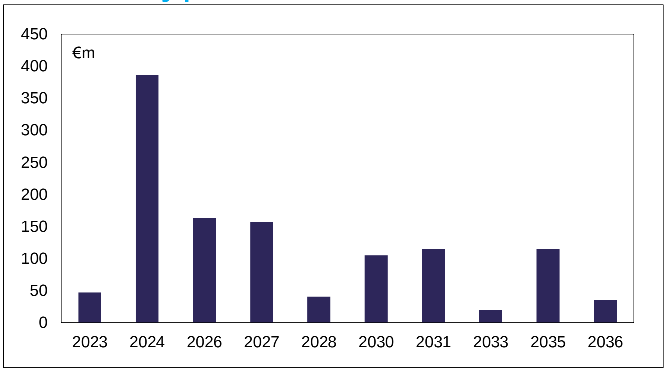
As at 1H23, EUR1.5bn in borrowing was held across a variety of currencies, including USD (42% of total), EUR (24%), CHF (10%), JPY (2%), AUD (1%) as well as other local-currencies of member countries. BSTDB's debt maturity profile highlights potential near-term liquidity challenges as the remaining USD412m of a euro-dollar note comes due in June-2024, the issuer's largest single debt maturity outstanding. However, we deem BSTDB's liquidity position as at end-2022 to be adequate, with liquid assets and undrawn credit facilities amounting to EUR820m, of which EUR208m comprise cash and equivalents. The bank improved its short-term liquidity position significantly over the past two years, comfortably covering short-term liabilities and disbursements with a liquid asset ratio of 142% as at end-2022 (FY20: 35%).

Cumulative disbursed portfolio by product



*Source: Company website; *Financial sector development; Guarantees; Special products*

Debt maturity profile



Source: Bloomberg

ESG activities and funding

BSTDB aims to promote environmental and social sustainability in its member states and therefore applies sustainability principles to its business management, and also requires its clients to follow them. These environmental and social principles relate to i) pollution prevention and mitigation; ii) respect for fundamental human rights in the working environment; iii) addressing climate change; iv) promoting sustainable use of natural resources; v) protection and conservation of biodiversity; and vi) disclosure of information on environmental and social performance of its operations. While BSTDB seeks to apply its principles in accordance with internationally recognised standards and principles, to our knowledge, alignment has not been assessed or verified by a third party so far.

The bank categorises its operations based on potential environmental and social risks and impacts. The five categories (A, B+, B, C, FI) signal high to low risk operations with the highest categories warranting impact assessments, public consultations and disclosures of additional related information to the public. In early 2021, BSTDB signed off on its climate change strategy with the main goal of better aligning its financing with climate priorities of its member states. Specifically, the bank commits to gradually reduce net emissions of its portfolio, increase the share of funding to climate positive operations and those with climate co-benefits to at least 30%. Renewable energy and green buildings and transportation systems are among BSTDB's financing priorities, while at the same time it seeks to gradually phase out support for carbon-intensive sectors. Comprehensive reporting on financed environmental and social projects appears to be limited and an assessment of the overall size is therefore not possible.

Capitalisation – The bank has paid-in share capital of EUR687m, which equates to 30% of the total subscribed share capital of EUR2.3bn. Together with reserves and retained earnings, total members' equity stands at EUR879m. A supporting element of the bank is the EUR816.5m capital increase agreed in October 2021 of which 30% (EUR245m) will be paid-in and 70% callable, bringing the total subscribed capital to EUR3.1bn. Payments were expected to be made across a number of instalments between 2023-2030 and shareholders' willingness to support the bank by approving this capital replenishment programme ensures their long-term commitment to BSTDB and its policy relevance. So far however, no payment has been made and according to BSTDB none are expected before 2025 as the matter of capital allocation could not be resolved at a recent board of governors meeting.

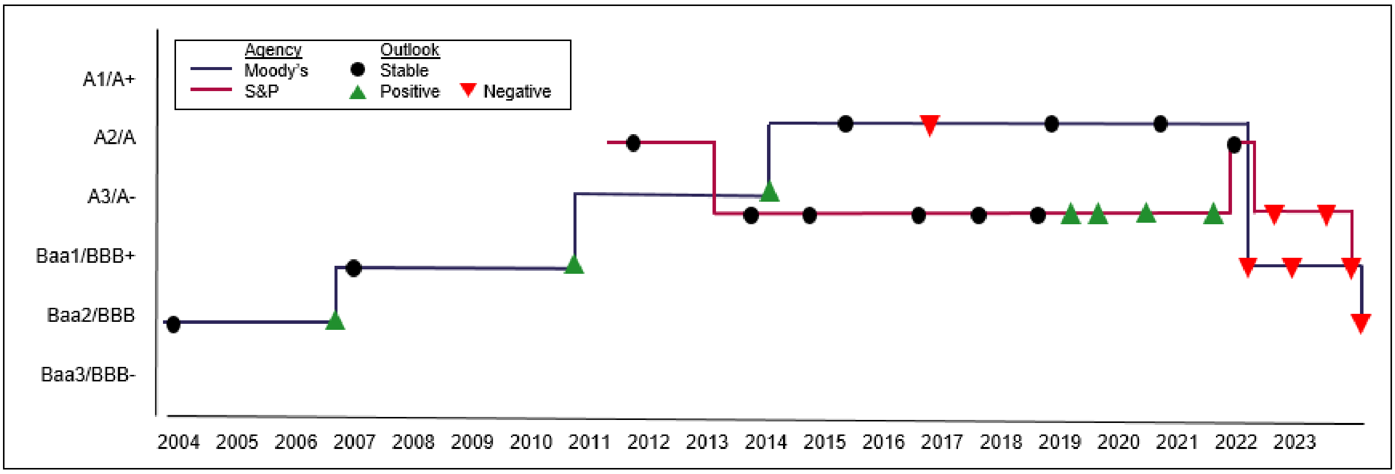
Shareholder willingness to participate remains unchanged as irrevocable letters of subscription were obtained by all member states, including two oversubscriptions, however regulatory risks and disagreements on allocation persist. The matter was therefore deferred to the bank's annual meeting in 2024 after which agreements at the government level of member states need to be reached. Despite the bank's current solid capital position, there remains uncertainty over the completion of the re-capitalisation process and the timing thereof. In spite of the nominally modest capital amount in question, this hold-up increases reliance on BSTDB's existing liquidity and capital position to address near-term obligations and any significant further delays in advancing the capital increase will constrain the bank's lending capacity and in turn diminish its policy role.

Rating agencies' views

Moody's: The rating action from October 2023 states that Black Sea Trade and Development Bank's (BSTDB) long-term issuer rating was downgraded to 'Baa2' from 'Baa1'. Concurrently, Moody's has downgraded the short-term issuer rating to 'P-3' from 'P-2', while the rating outlook remains negative. The downgrade reflects signs of weakened shareholders' cohesiveness given the lack of an agreement on the envisaged capital increase, which risks undermining the bank's strategic relevance in the region over time. The downgrade is also informed by a weaker assessment of capital adequacy due to the deterioration of asset performance in the context of the Russia-Ukraine war. The negative outlook reflects persisting risks to capital adequacy, reflecting potential pressures on asset quality and performance, as well as risks to liquidity due to the challenges related to the Russia-Ukraine war and challenging funding conditions, that are expected to continue in part given the lack of an agreement on the envisaged capital increase.

S&P: In September 2023 S&P ratings lowered its long-term issuer credit rating on Black Sea Trade and Development Bank (BSTDB) to 'BBB+' from 'A-' and affirmed the 'A-2' short-term issuer credit rating. BSTDB has been unable to finalise the terms under its capital replenishment programme because of shareholders' hesitance on the statutory treatment of an asymmetrical capital allocation and because of still unclear regulatory circumstances regarding Russia's participation. In S&P's view, the unexpected lack of a decision on finalising the capital replenishment creates heightened uncertainty about the bank's medium-term plan to bolster its policy relevance in the current geopolitical environment. The ratings remain on CreditWatch with negative implications reflecting S&P's view that they could lower their ratings on BSTDB in the coming months, possibly by more than one notch, if the shareholders fail to resolve obstacles related to the planned capital replenishment, and if the bank's access to funding markets does not normalise well ahead of its eurobond maturity in June 2024.

BSTDB RATING HISTORY



Source: Moody's; S&P

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1) As of 26 April 2016, Daiwa Securities Co. Ltd., its parent company Daiwa Securities Group Inc., GMO Financial Holdings, Inc., and its subsidiary GMO CLICK Securities, Inc. concluded a basic agreement for the establishment of a business alliance between the four companies.
As of end-December 2017, Daiwa Securities Group Inc. owned shares in GMO Financial Holdings, Inc. equivalent to approximately 9.3% of the latter's outstanding shares. Given future developments in and benefits from the prospective business alliance, Daiwa Securities Group Inc. could boost its stake in GMO Financial Holdings, Inc. to up to 20% of outstanding shares.

2) Daiwa Real Estate Asset Management is a subsidiary of Daiwa Securities Group Inc. and serves as the asset management company for the following J-REITS: Daiwa Office Investment Corporation (8976), Daiwa Securities Living Investment Corporation (8986).

3) Samty Residential Investment became a consolidated subsidiary of Daiwa Securities Group Inc. effective 10 September 2019.

4) On 30 May 2019, Daiwa Securities Group Inc. formalized an equity/business alliance with Samty, and as of 14 June 2019 it owned 16.95% of shares outstanding in Samty along with convertible bonds with a par value of Y10bn. Conversion of all of said convertible bonds into common shares would bring the stake of Daiwa Securities Group Inc. in Samty to 27.28%.

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- There is a risk that you will incur losses on your transactions due to changes in the market price of financial instruments based on fluctuations in interest rates, exchange rates, stock prices, real estate prices, commodity prices, and others. In addition, depending on the content of the transaction, the loss could exceed the amount of the collateral or margin requirements.
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- Before engaging in any trading, please thoroughly confirm accounting and tax treatments regarding your trading in financial instruments with such experts as certified public accountants.

* The amount of the trading commission cannot be stated here in advance because it will be determined between our company and you based on current market conditions and the content of each transaction etc.
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