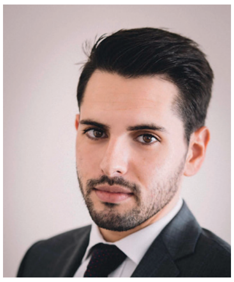
EDMOND DE ROTHSCHILD

MARKETING COMMUNICATION

AFTER THE REBOUND IN 2024, WHAT DOES THE FUTURE HOLD FOR SUBORDINATED FINANCIAL DEBT IN 2025?

Julien DE SAUSSURE

Benjamine NICKLAUS



Miguel RAMINHOS

Portfolio Managers Financial subordinated debt, Edmond de Rothschild Asset Management (France)

Following the sharp rate hikes of 2022 and 2023, which boosted profitability for banks and insurers but also caused strong liquidity pressures – that led to the spectacular collapse of Credit Suisse - 2024 was a pivotal year for the subordinated financial debt market.

Stronger balance sheets and the prospect of lower interest rates have since rekindled investor interest for these bond instruments. In today's calmer environment, positive inflows have gradually wiped the losses recorded in earlier years, paving the way for a dynamic 2025.

2024 - A VERY SOUND VINTAGE

2024 was a strong year for subordinated financial debt, which delivered robust returns across its different segments. Additional Tier 1 CoCos (AT1) hedged in euros also stood out, returning 11.02%[1].

Several factors supported this positive momentum:

- **Attractive carry levels** that appealed to investors,
- **High spread compression**[2].

These factors provided some respite and investors gradually returned to the asset class after two challenging years.

ROBUST FUNDAMENTALS AND A RESILIENT MARKET

Improved financial strength for banks

European banks raised their capital ratios in 2024 to levels well beyond the minimum requirements set by the European Central Bank (ECB). They now meet the capital requirements imposed by regulatory authorities with a comfortable margin. With an average excess capital of 400 to 500 basis points, banking institutions now enjoy considerable room for manoeuvre allowing them to absorb potential market shocks. Importantly, banks in Southern Europe -

*The identity of the managers presented in this document may change during the life of the product.

MARKETING COMMUNICATION: This is a marketing communication. Please refer to the UCITS prospectus and the Key Information Documents before making any final investment decision.

such as Italy, Spain, Greece and Portugal - seen as vulnerable in the past, are now in much better shape:

▸ **Intesa Sanpaolo** (Italy) can boast a CET1 ratio of 15.5%, with excess capital above 600 basis points[3].

▸ **Millennium BCP** (Portugal) now displays improved financial strength and attractive spreads.

Large capital inflows and a broadening investor base

Flows are also a supporting factor. In 2024, Investment Grade and High-Yield bond funds benefited from stable inflows that helped consolidate the market.

Another important development last year was the broadening of the investor base. After withdrawing massively in the wake of the Credit Suisse crisis, Asian investors have begun to return to niche segments, thereby diversifying the investor base and boosting market liquidity. Similarly, American Preferred Share funds are enjoying strong inflows and are increasing their allocation to AT1.

FAVOURABLE TECHNICAL FACTORS

On the technical front, several trends have bolstered investor confidence:

▸ **Call options[4] are now used in most cases:** it has become very rare for AT1s not to be redeemed by their call date.

▸ **The prefunding of 2025 issuances is well under way**, a guarantee of market fluidity.

These two factors cultivate a virtuous circle - whereby the margin on credit allows for a "cost-effective" refinancing of call options.

THE M&A MARKET IS BOOMING

The mergers and acquisitions (M&A) market recovered sharply in 2024 within the banking and insurance sector, particularly in Europe, where the consolidation of the industry is in full swing. In Italy and the United Kingdom, several deals were announced over the past year. Importantly, the return of cross-border deals - between UniCredit and Commerzbank, for instance - has attracted much attention.

The trend also extends to insurance companies: we have observed strategic moves and targeted acquisitions, notably within the asset management industry. Examples include deals between AXA IM and BNP Cardif or Banco BPM Vita and Anima. In both cases, the buyers are life-assurance subsidiaries owned by the banks. These benefit from a regulatory arbitrage known as the "Danish compromise" which reduces the cost in terms of capital.

These deals are generally positive for the sector and should contribute to spread compression - an additional supporting factor for subordinated debt. Furthermore, the execution risk associated with these deals seems to be under control, as many of the takeovers are partly financed with equity swaps. For bond investors, this is likely to be a better use of excess capital than equity buybacks or exceptional dividend payouts. Such deals foster diversification and profitability - ultimately the first line of defence when investing in subordinated financial debt.

2025: ATTRACTIVE OPPORTUNITIES AMID NORMALISING MONETARY POLICY

The outlook remains constructive for subordinated financial bonds in 2025. Against the backdrop of easing yields, the asset class continues to offer attractive carry:

▸ Euro-denominated Cocos entered 2025 yielding 5.8%[6],

▸ The yield on subordinated financial bonds is estimated at 4.9%[7].

The macroeconomic environment is also favourable:

▸ Disinflation in Europe could limit the risk of rates rising in the long term.

▸ The steepening yield and credit curve should offer opportunities for readjusting portfolios in favour of mid-duration bonds (5 to 7 years).

Overall, subordinated financial debt has got off to a very good start in 2025. With banks better capitalised than they were a few years ago, large inflows, and a stabilised bond market, the asset class should continue to appeal to investors.

While easing rates are supportive, we see opportunity in other factors: the spread compression momentum, the recovery in M&As, and a broader investment base will also serve as positive catalysts for the market.

1. Source: Bloomberg. Data as of 31/12/2024.

2. Credit spread compression occurs when the yield gap between Treasury bonds and other identical-maturity bonds shrinks. When Treasury bond prices fall and their yields increase, investors tend to switch to other debt instruments.

3. Source: Bloomberg. Data as of 31/12/2024.

4. Some convertible bond issuances come with a call option allowing the issuer to redeem the bonds at a pre-determined price.

5. The Danish compromise is a regulatory provision within the Capital Requirements Regulation (CRR) introduced in 2012, which allows banks with insurance subsidiaries to apply favourable capital treatment to their equity investments in insurance subsidiaries.

6. Source: Bloomberg. Data as of 31/12/2024.

7. Source: Bloomberg. Data as of 31/12/2024.

GLOSSARY

• Investment Grade securities are bonds issued by companies whose default risk ranges from very low (repayment almost certain) to moderate. They correspond to a rating scale ranging from AAA to BBB- (Standard & Poor's rating).

• High Yield securities are corporate bonds with a higher default risk than investment grade bonds but which pay out higher coupons.

• Debt is considered to be subordinated when its redemption depends on the earlier payment of other creditors. To offset the higher risk, subordinated Senior debt has priority over other debt instruments.

• AT1s belong to a family of bank capital securities known as contingent convertibles or "Cocos". Convertible because they can be converted from bonds to shares (or depreciated entirely) and contingent because this conversion only occurs if certain conditions are met, such as the issuing bank's capital strength falling below a pre-determined trigger level.

• The spread is the difference between the actuarial rate of return on a bond and the rate of return on a risk-free loan with the same maturity.

• The CET1 (Common Equity Tier 1) ratio is a key measure of a bank's financial strength, representing its capital base as a percentage of risk-weighted assets.

• US Preferred Shares funds invest primarily in US preferred shares, offering fixed or variable yields and priority over common shares in terms of dividend payments.

• A call option, often simply labeled a "call", is a contract between the buyer and the seller of the call option to exchange a security at a set price.

• Carry can be defined as the money an investor will earn by holding a bond over the long term, after deducting financing costs.

DISCLAIMER: This is a marketing communication.

March 2025. This document is issued by the Edmond de Rothschild Group. It is not legally binding and is intended solely for information purposes. This document may not be communicated to persons located in jurisdictions in which it would be considered as a recommendation, an offer of products or services or a solicitation, and in which case its communication could be in breach of applicable laws and regulations. This document has not been reviewed or approved by a regulator of any jurisdiction.

The figures, comments, opinions and/or analyses contained herein reflect the sentiment of the Edmond de Rothschild Group with respect to market trends based on its expertise, economic analyses and the information in its possession at the date on which this document was drawn up and may change at any time without notice. They may no longer be accurate or relevant at the time of reading, owing notably to the publication date of the document or to changes on the market.

The information on stocks should not be construed as an opinion of the Edmond de Rothschild Group on the foreseeable development of the said stocks and, where applicable, on the foreseeable development of the price of the financial instruments they issue. This information does not constitute a recommendation to buy or sell these securities.

This document is intended solely to provide general and introductory information to the readers, and notably should not be used as a basis for any decision to buy, sell or hold an investment. Under no circumstances may the Edmond de Rothschild Group be held liable for any decision to invest, divest or hold an investment taken on the basis of these comments and analyses. The Edmond de Rothschild Group therefore recommends that investors obtain the various regulatory descriptions of each financial product before investing, to analyse the risks involved and form their own opinion independently of the Edmond de Rothschild Group. Investors are advised to seek independent advice from specialist advisors before concluding any transactions based on the information contained in this document, notably in order to ensure the suitability of the investment with their financial and tax situation.

Past performance and volatility are not a reliable indicator of future performance and volatility and may vary over time, and may be independently affected by exchange rate fluctuations.

Source of the information: unless otherwise stated, the sources used in the present document are those of the Edmond de Rothschild Group. This document and its content may not be reproduced or used in whole or in part without the permission of the Edmond de Rothschild Group.

Copyright © Edmond de Rothschild Group – All rights reserved.

EDMOND DE ROTHSCHILD ASSET MANAGEMENT (FRANCE)

Société anonyme governed by an executive board and a supervisory board with capital of 11.033.769 euros

AMF Registration number GP 04000015 - 332.652.536 R.C.S. Paris

www.edmond-de-rothschild.com