Deutsche Bank AG

COLLINS SARRI STATHAM INVESTMENTS

Research Report

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Analyst

Ravi Lockyer MSc Llb

Collins Sarri Statham Investments Ltd

Deutsche Bank needs to get to a US settlement

Deutsche Bank (DB) is experiencing problems, but it is possible to draw various conclusions.

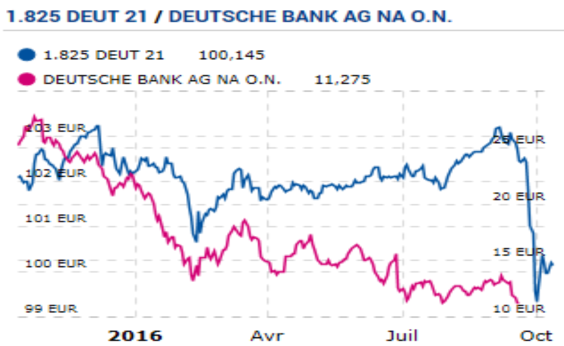
Firstly DB is not expected to fail, it is "too big to fail":-

a) Deutsche Bank credit default swaps (CDS) prices as shown below, have not shown much net movement this year. Credit default swaps are instruments purchased as insurance against bond default – the price of 222.8 basis points means that the cost of insuring $1m of DB debt is $22.28k. This is not a price that would suggest investor concern over a DB default. DB is not expected to default.

Source: www.boursorama.com

Secondly bond investors are expecting shareholders to inject further funds:-

b) Deutsche bonds (pink line below) whilst slightly lower over 2016 (c. -2%) are not at elevated yield levels that would indicate high risk – current five year yield to redemption are 1.8%. This is despite S&P recent downgrade of DB to BBB+. When compared to the collapsing share price (->50% YTD) (blue line below) the inference is equity investors are expecting new capital issuance. Bond holders are confident they will be repaid (out of new equity capital).



Source: www.boursorama.com

c) Deutsche shares are depressed because investors now expect a large new capital issue, possibly another €8bn- €10bn to restore depleted capital levels. Unlike previous rights issues, this time new equity could be issued to sovereign wealth funds or even via a partial nationalization. The Qataris have expressed an interest in increasing their stake to 25% from 10% presently (this would raise c. €3bn). The German government is

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thought to have a plan to take a 25% stake in DB in the event of an "emergency" – this is thought to mean as a last resort (another €5bn of new capital).

In terms of equity dilution, existing holders could be diluted 30-35% if DB goes down the route of a €8bn - €10bn raise. The problem for equity investors is the US Department of Justice $14bn fine (possibly to be settled at $4bn-$6bn) is virtually the entire Deutsche Bank's €5.4bn litigation loss provision. But thousands of other litigation actions are underway against DB. Post the DoJ settlement these would require fresh provisions. Deutsche Bank reported €7bn losses in 2015 due to higher litigation expenses/ provisions. It could be the case that 2016 is a similar result for the same reasons.

Are asset sales a credible short term plan for DB?

DB has started asset sales which will raise capital to the extent the proceeds of sale exceed their book value. This is part of Strategy 2020 to slim down DB (which would increase reliance on the US operation). However it is not obvious what will/ will not be sold. Possible asset sales include Postbank (worth c.€6.6bn), and Deutsche Asset Management (DAM worth c €8bn). However DB has not decided to sell Postbank or DAM.

Of these, Postbank has a net book value of €4.5bn hence would realise €2.1bn of new capital assuming a sale takes place in 2017. But DB has no current plans to sell Postbank (it acquired the business in 2010) and CEO John Cryan recently ruled out a sale of DAM. Asset sales recently include Abbey Life (£935m) and a 20% stake in Hua Xia for $4bn. Due to timing and pricing issues asset disposals are unpredictable and at best a partial solution.

Quarterly trends are weak

Q2 trends (net revenue down 19% to €7.4bn), net income just €18m (from €796m (cost / income ratio 91%), restructuring costs €207m mean DB is very vulnerable from the standpoint of capital which stood at 10.8% end June. This is at the low end of EU lenders and very low relative to other "bulge bracket" US firms. Deutsche Bank is very dependent on its US operation (the former Bankers Trust) for profits.

Hence DB'S Stategy 2020 programme is aimed at lifting capital ratios to 12.5% but only by 2020 and via asset sales, staff cuts and equity generation (i.e. profits). In the current environment, this sort of plan "shrink to fit" proves problematic, as key people/units leave or are sold and profitability suffers.

Conclusion

DB has c. €67bn of equity supporting a €1.6trn total assets hence a 25/1 leverage ratio. Currently the market is attributing this equity value as worth just €19bn. This is a negative view that reflects DB's current issues and equity risk. DB is very unlikely to go under, that is clear from the pricing data. DB has liquidity access of €220-€247bn from the ECB/ US Federal Reserve. Confidence should improve when there is a settlement and fresh capital is raised. In the meantime the best course is to await developments. NEUTRAL

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Collins Sarri Statham Investments Ltd. 6th Floor, 5 Lloyds Avenue, London, EC3N 3AE

T +44 (0)20 7264 2360 **F** +44 (0)20 7264 2361 **W** www.css-investments.com **E** info@css-investments.com