

Deutsche Bank: Keep Calm and Carry On



After a recent capital increase, Deutsche Bank's second-quarter results have been in the spotlight. The messages are mixed, however, and may even disappoint at first glance, given the decline in the bank's revenue base and the relatively weak results in the Corporate & Investment Bank (CIB) segment.

Given the bank's volatile performance and market access in 2016, as well as the large restructuring measures currently underway, we would not expect any longer-term or fundamental change in performance before mid-2018. The bank's global market shares have weakened and it remains uncertain how the bank will manage to reposition itself in Germany and Europe.

Nevertheless, the cornerstones for restructuring have been set and were most recently readjusted in March this year. Therefore, the bank's performance should, in our view, be measured more in line with the progress of its restructuring, rather than against competitors, such as stronger US peers.

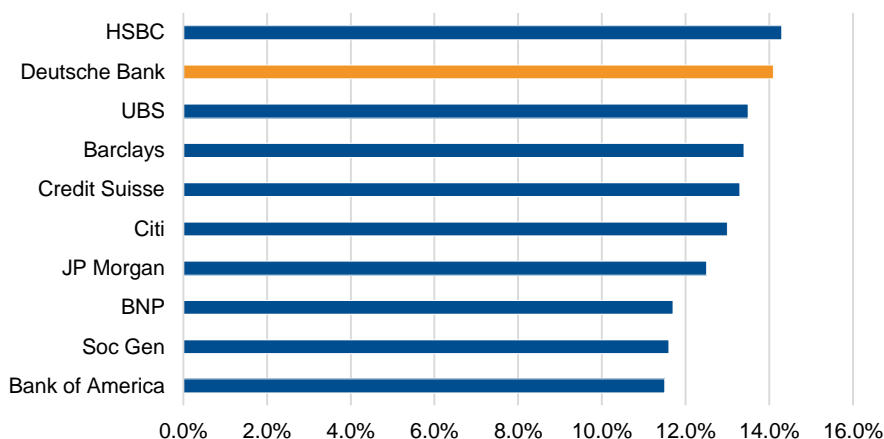
Deutsche Bank's Issuer Rating is A- and its senior unsecured debt ratings are BBB+, all with Negative Outlook.

Weaker overall results; for once, CET 1 capital is not an issue

For once, the issue of Deutsche Bank's capital is out of the limelight, as the recent EUR 8bn capital increase returns the bank to levels which are even above those of its main peers. Although a prudent capital ratio will help buy some time for the bank's restructuring, via improved client and counterparty confidence, this can only be regarded as a less central contributor to better profitability and performance.

On a peer comparison basis, Deutsche Bank's fully loaded CRR/CRD IV Common Equity Tier 1 (CET 1) ratio is, at 14.1%, now exceeding that of its peers (Figure 1). However, the bank's 3.8% Leverage Ratio (fully loaded), a measure strongly focused on by US banks, still lags behind (Figure 2).

**Figure 1: Selected Common Equity Tier 1 capital ratios (fully loaded)
Deutsche Bank peers**



Source: Reports, SNL, Scope Ratings

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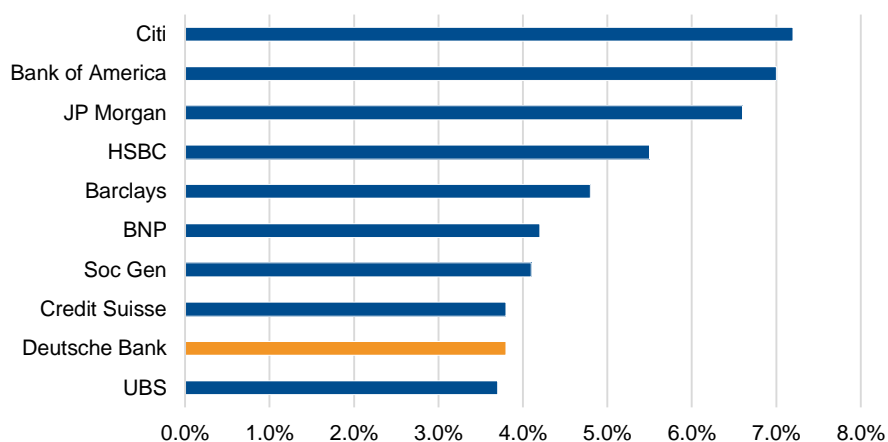
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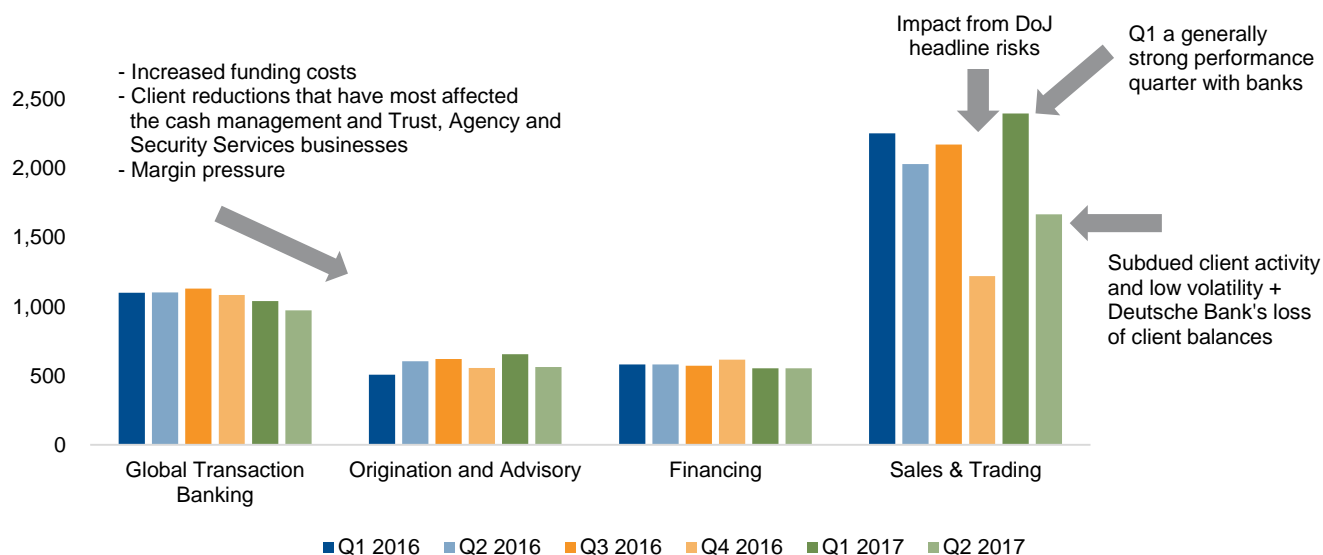
Figure 2: Selected leverage ratios (fully loaded) Deutsche Bank peers

Source: Reports, SNL, Scope Ratings

Corporate and Investment Bank business segments seem to bear the brunt of lost confidence in the bank

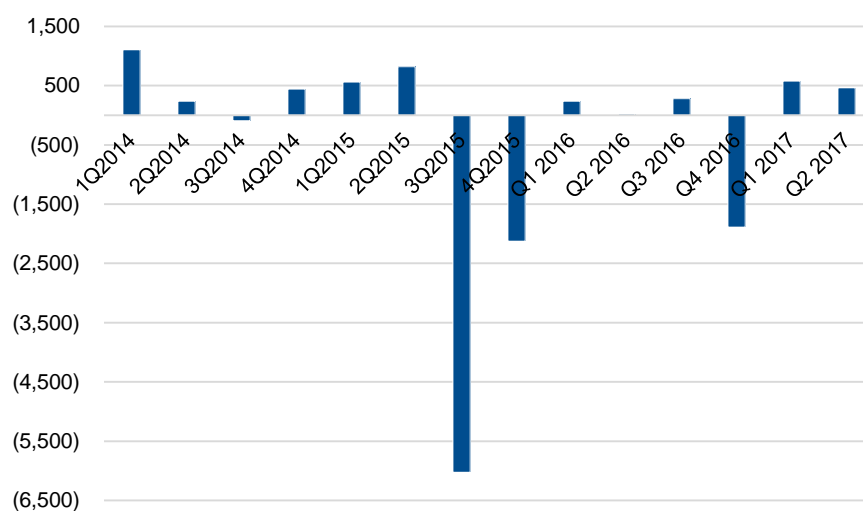
Looking at Deutsche Bank's performance across business segments, results have been influenced by more muted client activities in general as well as low market volatility in combination with continued low eurozone interest rates. Although the bank's peers have encountered the same market issues, their earlier-restructured businesses, combined with higher efficiencies and less headline risk, have resulted in comparatively better results.

Deutsche Bank's performance in Corporate and Investment Bank (CIB), its core segment, is in particular focus. Over the past years, the bank's general performance has been supported by resilient, good results in the underlying segments. However, CIB seems to have been hit hardest by the ongoing crisis of confidence affecting the bank. In recent presentations, the CEO and CFO have stated that some of the bank's lost client relationships, mainly during the past two years, have been regained, but the full impact is difficult to ascertain.

Figure 3: Corporate & Investment Bank – selected past net revenues and recent performance-influencing factors


Source: Deutsche Bank reports, SNL, Scope Ratings

Considering that Deutsche Bank's weak overall net income results over the last quarters have been influenced heavily by the bank's litigation expenses (Figure 4) and excluding further larger litigation costs, as well taking into account a more streamlined business model in line with the bank's strategic restructuring plan, it is not implausible to expect Deutsche Bank's overall results to improve and become more consistent going forward.

Figure 4: Deutsche Bank historic quarterly net income results


Source: Deutsche Bank Quarterly reports, SNL, Scope Ratings

In addition, any improvement with regard to the bank's cost base is an important factor to watch, as well as progress made in restructuring. Deutsche Bank's cost reduction programme is making some progress. These measures include the optimisation of its branch network, the digitalisation of processes, and the streamlining of its infrastructure functions (including headcount reductions). In the first half of 2017 adjusted costs were 6% lower than during the same period in 2016. The bank states that this has partly been driven by tangible reductions in the number of full-time employees (December 2016: 99,744 to June 2017: 96,652) and increased discipline over costs.

We believe that cost reductions are better achieved via more efficient processes. Although we appreciate that headcount reductions are usually part of such efforts, we nevertheless notice such measures to release cost savings have effects only with a longer-time delay. This is due to higher redundancy costs based on delayed and subsequent bonus payments, high compensations for lay-offs, as well as a general rise in salaries to retain existing staff and increased costs for new hires, as these are typically regarded as highly qualified and difficult to attract.

IT costs have taken a surprising turn: down by 4% despite higher depreciation for internally developed software. According to the bank, lower costs for external IT development and maintenance services have driven these costs savings in IT. In addition, professional service fees are down 22% mainly due to lower business consulting fees. This is relatively new analytical territory, with little track record and the true benefits and efficiencies of these outsourcing efforts will emerge over time. Deutsche Bank is investing around EUR 2bn a year in projects to change the bank, especially its IT infrastructure. Management expects this amount to remain unchanged for the foreseeable future.

Deutsche Postbank integration might provide some hidden income

Deutsche Bank's strategy regarding a cooperation with Postbank has, in our view, been rather half-hearted over the past years. Given the difference in customer-service cultures between the two institutions, and Deutsche Bank's focus on its international and CIB businesses, we believe that the potential for close cooperation or integration has not been fully evaluated in the past. However, in view of the changed circumstances and the bank's decision to combine businesses with private and commercial clients of Deutsche Bank and Postbank, we would expect improved cooperation among the bank's business segments and a stronger focus on cross-selling. According to the recent interim report, foundations for the Postbank integration have been laid with the establishment of a joint integration and governance structure. Furthermore, Deutsche Bank intends to streamline operations and structures and to share one IT platform across its corporate 'Private & Commercial Bank' division, combining the businesses with private and commercial clients of Deutsche Bank and Postbank.

Excluding special effects (e.g. previous quarters were impacted by the sale of stakes in VISA Europe Limited and a negative impact related to the termination of a legacy trust preferred security), Postbank's underlying revenues increased in H1 2017 versus last year, driven by loan growth and higher fee income. We believe that in addition to a consistent profitable business of Postbank itself, going forward, parts of the client base of Postbank could also provide an additional income stream to, for example, Deutsche Asset Management.

Non-quantifiable soft factors will most likely remain in focus for some time

One of the biggest challenges Deutsche Bank had to face over the past years is reputation risk. Although the recent capital increase has brought some relief, with investors and clients looking ahead with more confidence, there are nevertheless factors that still influence performance, which the bank can only partly control. Notable examples include the still-long list of pending litigations, which bear a financial and reputation burden. A recent headline that has amply caught the media attention relates to Deutsche Bank's reportedly extensive financing of President Trump's US business.

Deutsche Bank's management understandably remains cautious over litigation costs, which are inherently difficult to forecast. The bank has made some progress regarding negotiations and settlements of litigations and regulatory investigations, reflected in the



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net reduction of provisions, by around EUR 700m in Q2 2017, to around EUR 2.5bn. Management cautions that any material litigation that settles as late as mid-March 2018 may impact 2017 financials as a subsequent event. Deutsche Bank anticipates that litigation expenses will be higher in H2 2017 compared to H1, but nevertheless below 2016 levels. We believe that any unexpectedly higher costs for litigation could undermine efforts to prove progress made on the bank's conduct and governance.



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