Asia Credit Research

Earnings Review: Commerzbank AG ("CMZB")

Recommendation

- Solid loan growth in Private and Small Business Customers ("PSBC") and Corporate Clients ("CC") more than offset the drag from Europe's low interest rate environment and Germany's competitive banking environment.
- While higher operating expenses from bank levies and investment costs led to a y/y decline in operating profit, net operating profits in 1Q2018 were lifted by a fall in loan loss provisions and taxes.
- Implementation of IFRS9 has a positive impact on loan quality and CET1 ratios and with underlying fundamentals seemingly on firmer footing, we retain our Neutral (4) Issuer Profile on CMZB.
- In our recent Monthly Credit View, we were overweight the CMZB 4.875 '27c22 and 1Q2018 results do not alter our view. Compared to the LBBW 3.75 '27c22 (we also rate Landesbank Baden-Wuerttemberg at Neutral (4)), we see better value in CMZB 4.875 '27c22 given the spread pick up more than compensates for the weaker CET1 ratio. In addition, CMZB 4.875 '27c22 has a higher reset spread of 2.71% relative to 1.78% for the LBBW 3.75 '27c22.

Relative Value:

Bond	Maturity / Call date	CET1 Ratio	Ask Yield	Spread
CMZB 4.875 '27c22 (T2)	01/03/2022	13.3%	4.35%	200
LBBW 3.75 '27c22 (T2)	18/05/2022	15.7%	3.41%	104
SOCGEN 4.30 '26c21 (T2)	19/05/2021	11.2%	3.24%	99
BPCEGP 4.50 '26c21 (T2)	03/06/2021	15.4%	3.50%	125
STANLN 4.4 '26c21 (T2)	23/01/2021	13.9%	3.13%	93

Indicative prices as at 18 May 2018 Source: Bloomberg
Common Equity Tier 1 (CET1) Ratio based on latest available quarter

Issuer Profile: Neutral (4)

Ticker: **CMZB**

Background

Commerzbank AG ('CMZB') is Germany's second largest privately owned bank after Deutsche Bank AG. Headquartered in Frankfurt, it had total assets of EUR470.0bn as at 31 March 2018. Its largest single shareholder at 15.5% is Germany's Special Fund for Financial Market Stabilization, set up during the Global Financial Crisis to stabilize Germany's banking system. The remaining shareholdings comprise institutional (~45%) and private (~25%) investors.

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Key Considerations

- **Loan growth and lower loan loss provisions overshadowed by expenses:** Commerzbank announced its 1Q2018 results, with revenue including exceptional items down 3.7% y/y to EUR2.30bn (1Q2017: EUR2.39bn). Excluding exceptional items, underlying revenue inched up marginally by 0.8% y/y. This was due to higher loan growth across its two core segments, namely Private and Small Business Customers ("PSBC") and Corporate Clients ("CC"), which more than offset the drag on net interest income from Europe's low interest rate environment and Germany's competitive banking environment. Operating profit performance for 1Q2018 however was weaker (down 12.3% y/y) as a result of higher operating expenses (+3.8% y/y) from higher investment in digitalisation and growth as well as higher costs for regulatory projects and compulsory bank levies. Although this elevated the cost to income ratio to 84.1% in 1Q2018 (1Q2017: 78%, 4Q2017: 81.4%), net operating profits rose 9.2% y/y on the back of materially lower loan loss provisions and taxes on income this quarter. Loan loss provisions fell to EUR77mn (1Q2017: EUR195mn, 4Q2017: EUR251mn) due to the revaluation of the Ship Finance portfolio under IFRS9 as well as stable economic conditions in Germany, while lower taxes on income in 1Q2018 at EUR5mn (1Q2017:EUR 81mn) also helped the bottom line.

- **On track to meet 2018 net new customer targets:** CMZB's focus on its core operating segments, PSBC and CC, have proven to be effective as both segments enlarged their customer base and are well on track to achieving their customer growth targets for 2018. Net new customers for PSBC grew to 712,000 (target of 1m net new customers by 2018). PSBC segment's revenue grew to EUR1.2bn (1Q2017: EUR1.1bn) due to good loan growth, offsetting the impact of negative interest rates. The CC segment gained 1,000 net new corporate clients, bringing total clients to 6,500 (well ahead of its target to reach 7,000 by year-end). Despite increased volume of lending to German Mittelstand companies and large corporates, operating profit for CC was however down to EUR145mn

(1Q2017: EUR267mn) due to competitive pricing and muted client demand for capital market products in 1Q2018.

- **Asset & Capital Recovery (ACR) segment finally making profits:** Net interest income and operating expenses continue to fall within ACR as the segment continues to be wound down. With CMZB's efforts to dispose of bad shipping loans in 2017 and the introduction of IFRS9 (which caused ACR loans and securities to be revalued at fair value), the ACR segment did not incur any provision for loan losses this quarter (1Q2017: -EUR119mn, 4Q2017: -EUR59mn). This, along with a one-off write-back for a hedge position, led to a reversal in fortunes for the ACR segment with an operating profit of EUR18mn in 1Q2018 compared to a net operating loss of EUR33mn in 1Q2017. IFRS9 also had a positive impact on loan quality with the default portfolio reducing by 24.4% and loan loss provisions also falling 41.4%. This translated to the NPL ratio falling 3bps q/q to 1% in 1Q2018 (4Q2017: 1.3%) and coverage ratio falling q/q to 39% for 1Q2018 from 50% in 4Q2017 (62% coverage ratio as at 1Q2018 including collateral).

- **Underlying CET1 capital ratio stable:** CMZB's fully-phased in CET1 ratio rose 80bps y/y to 13.3% (1Q2017: 12.5%) however this was entirely due to the impact of IFRS9. Elsewhere, a 10bps improvement in capital from earnings was offset by a 10bps rise in risk weighted assets from aforementioned loans growth. CMZB expects its CET1 ratio to be at least 13% by the end of 2018 and expects this level to provide adequate buffer against regulatory minimums notwithstanding anticipated loan growth. This is due to the improvement in underlying fundamentals from ACR wind-down and on-going implementation of the Commerzbank 4.0 strategy, which remains broadly on track. In line with this, CMZB announced plans to resume dividend payments for 2018 which were previously ceased to mitigate expected higher restructuring and investment costs.

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<tr><th colspan="2"><u>OCBC Global Treasury</u></th></tr>
<tr><td><u>Treasury Advisory</u>
Corporate FX & Structured Products
Tel: 6349-1888 / 1881
Interest Rate Derivatives
Tel: 6349-1899
Investments & Structured Products
Tel: 6349-1886

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Explanation of Issuer Profile Rating / Issuer Profile Score

Positive ("Pos") – The issuer's credit profile is either strong on an absolute basis, or expected to improve to a strong position over the next six months.

Neutral ("N") – The issuer's credit profile is fair on an absolute basis, or expected to improve / deteriorate to a fair level over the next six months.

Negative ("Neg") – The issuer's credit profile is either weaker or highly geared on an absolute basis, or expected to deteriorate to a weak or highly geared position over the next six months.

To better differentiate relative credit quality of the issuers under our coverage, we have further sub-divided our Issuer Profile Ratings into a 7 point Issuer Profile Score scale.

IPR	Positive		Neutral			Negative	
IPS	1	2	3	4	5	6	7

Explanation of Bond Recommendation

Overweight ("OW") – The performance of the issuer's specific bond is expected to outperform the issuer's other bonds, or the bonds of other issuers either operating in the same sector or in a different sector but with similar tenor over the next six months.

Neutral ("N") – The performance of the issuer's specific bond is expected to perform in line with the issuer's other bonds, or the bonds of other issuers either operating in the same sector or in a different sector but with similar tenor over the next six months.

Underweight ("UW") – The performance of the issuer's specific bond is expected to underperform the issuer's other bonds, or the bonds of other issuers either operating in the same sector or in a different sector but with similar tenor over the next six months.

Other

Suspension – We may suspend our issuer rating and bond level recommendation on specific issuers from time to time when OCBC is engaged in other business activities with the issuer. Examples of such activities include acting as a joint lead manager or book runner in a new issue or as an agent in a consent solicitation exercise. We will resume our coverage once these activities are completed.

Withdrawal ("WD") – We may withdraw our issuer rating and bond level recommendation on specific issuers from time to time when corporate actions are announced but the outcome of these actions are highly uncertain. We will resume our coverage once there is sufficient clarity in our view on the impact of the proposed action.

Analyst Declaration

The analyst(s) who wrote this report and/or her or his respective connected persons did not hold securities in the above-mentioned issuer or company as at the time of the publication of this report.

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