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A kind word for 'CoCos'

Evan Lorenz writes:

Investors, drawing no confidence from the March 19 shotgun marriage of ailing Credit Suisse Group A.G. and mammoth UBS Group A.G., turned their anxious gaze toward Europe's legacy problem child, Deutsche Bank A.G. Their anxiety was misplaced, we are about to contend. A bullish analysis of the German institution's junior-most bonds is the topic at hand. Trigger warning: This is a speculation.

What landed Deutsche Bank back in the news was a surge in the cost of its credit default swaps, to 194 basis points on March 24 from 169 the day before and 87 at the end of February. The ominous action set off "a rout that sent banking stocks tumbling, government bonds higher and CDS prices for lenders soaring, trimming about €1.6 billion off Deutsche Bank's market cap and more than €30 billion off an index that tracks European banking stocks," as Bloomberg reported last week.

If this story sounds familiar, it is. In early 2016, rumor had it that Deutsche Bank had plans to skip coupon payments on its contingent convertible (CoCo) bonds, a type of debt designed to be written down to zero in times of stress. Those worries sent the price of the bank's 7 1/8 perpetual CoCos reeling, to €68.80 on Feb. 8, 2016 from €91.03 at the start of that year, and likewise unsettled the share prices and junior bonds of other European banks (*Grant's*, Feb. 12, 2016).

However, the current panic is different. First, the source of the blow-off top in Deutsche's credit default swaps on March 24 was not so much a thumbs-down from Mr. Market as a single, hail-Mary €5 million ($5.4 million) trade. Second, Deutsche Bank's management made substantial headway during the past seven years in cutting costs, reducing risks and whittling away at legacy issues.

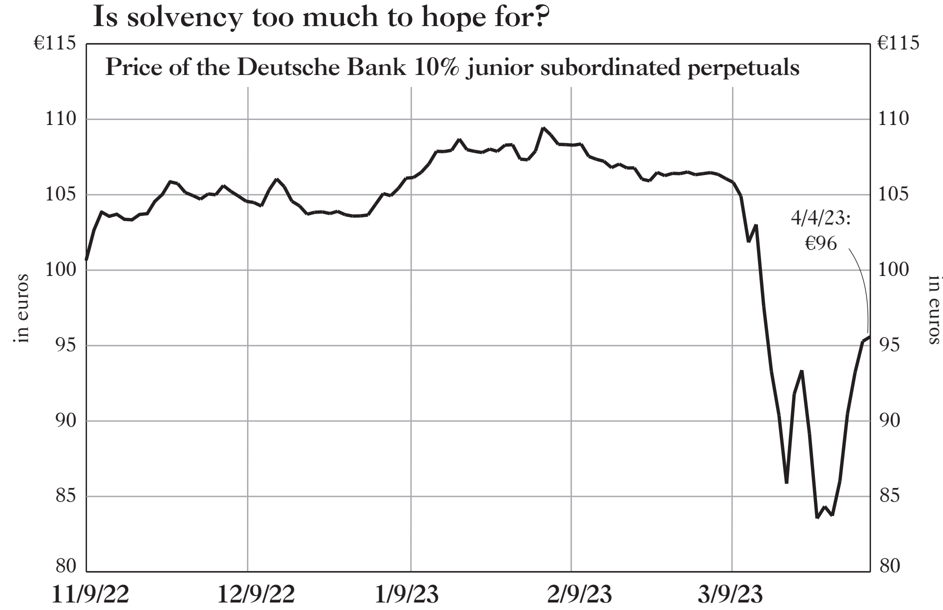
"Deutsche Bank was in real trouble back in 2015," advises Konstantin Fominykh, the CEO of TenViz, a company that designs AI-enhanced tools for investors, and the next four years proved it, with each and every one, through 2019, delivering a net loss, including a €6.8 billion deficit for 2015.

However, in 2022, the former sick man of German banking reported €5.5 billion in net income, its largest profit since 2007. Over the seven years of reorganization and rehabilitation, the bank increased its core equity Tier 1 (CET1) ratio by 2.3 percentage points, to 13.4% of risk-weighted assets, and shrunk the size of its balance sheet by 18%.

A sign of better days for Deutsche were the depositors who ran toward it, not away, following the March 10 failure of Silicon Valley Bank. "We have seen incoming deposits over the last three or four days because people are doing what is usual in these times," Deutsche CEO Christian Sewing remarked at the March 15 Morgan Stanley European Financials Conference: "Fly to quality."

As of Dec. 31, 2022, the biggest categories on the asset side of the €1.3 trillion Deutsche Bank balance sheet

Is solvency too much to hope for?



source: The Bloomberg

were financial assets (€482.4 billion; mostly bonds and interest rate derivatives), loans (€483.7 billion) and cash (€178.9 billion). Deposits (€621.5 billion) and equity (€62 billion) fund half of the balance sheet, with the remainder financed by the markets.

Normally, reliance on market financing is a sign of weakness in a bank, but it almost counts as a strength in our topsy-turvy world. The interest cost that American banks pay to retain deposits was already surging before the March runs, which should put further pressure on their net interest margins. "Wholesale funding is always repriced to market," Fominykh reminded colleague James Robertson, Jr. over the phone last week. "So, ironically, their wholesale financing is a source of stability."

In its 2022 annual report, Deutsche's management gauged the potential impact of a 200 basis-point increase in short- and long-term rates across the globe. In brief, it would be a mixed blessing: Though net interest income would rise by €1.9 billion, Tier 1 capital would decline by €4.6 billion, or 8.1%.

While Deutsche does show $33.4 billion in loans backed by commercial real estate, an amount equal to 54% of equity, that book of business is well diversified across geographies (51% in the United States, 36% in Europe and 13% in Asia) as well as asset classes (34% in office, 12% in hospitality and 10% in retail). The overall loan book is well-financed (the loan-to-deposit ratio is 78.7%) and, outside of the commercial real estate exposure, doesn't appear overly risky. Thus, German residential mortgages collateralize 32% of loans, and client corporate treasury services (e.g., trade finance and cash management) stand behind 21% of them.

Deutsche's balance sheet is likewise notable for what it doesn't contain: large mark-to-market bond losses. Hewing to European accounting conventions, Deutsche records most of its fixed-income investments at fair value while U.S. banks mark their (often sizeable) held-to-maturity securities at amortized cost.

While Deutsche's common stock appears cheap at five times estimated 2023 earnings per share and 35% of tangible book value, the bank is not yet earning its cost of capital and therefore should trade at a discount to book value. Adjusting for the write-up of a deferred tax asset last year, Deutsche generated a 6.7% return on tangible equity versus 19% for JPMorgan Chase & Co.

Sewing and team believe they can see their way to boosting returns on tangible equity to more than 10% by 2025 on the strength of a €2 billion-plus cost-cutting program. This builds on a prior reorganization, called "Compete to Win," that shaved off €3 billion in expenses between 2019 and 2022. Management anticipates that the hard work will yield a cumulative €8 billion for the shareholders through dividends and buybacks between 2021 and 2025.

If the C-suite executes on those goals, Deutsche's common stock will come to be seen as extraordinarily cheap today, though the road ahead is bumpy, to say the least. The war in Ukraine, the risk of an oil-driven stagflation, a global recession and the deflation of the everything bubble constitute just some of the potholes.

The bank's junior subordinated perpetual 10s have a lower bar to clear than the common. They will be seen as a commanding bargain if the bank just remains solvent. To be clear, CoCos are a species of contingent convertibles that are designed to be wiped out if Deutsche's CET1 ratio falls below 5.125%. If capital remains above that threshold, the 10s pay a 10% coupon through April 30, 2028; they will subsequently deliver a spread of 6.94% over the five-year euro swap rate (currently 3.1%).

Credit Suisse helped to create the CoCos opportunity by throwing that market into chaos. In last month's hastily arranged merger, UBS agreed to pay Credit Suisse shareholders $3.25 billion while, at the same time, Swiss regulators wiped out the target's $17 billion's worth of CoCos. Investors in contingent convertibles are (or should be) aware of the risks inherent in these unusual securities, but European Union regulators have reiterated that CoCos rank above common equity when it comes to impairments.

Anyway, investors dumped the junior-most bonds, sending the perpetual 10s down to €83.54 on March 24 from €103.60 at the end of 2022. This created an additional wrinkle in the value proposition. While CoCos must be perpetual securities to qualify as regulatory capital, the market convention is for banks to repurchase them on the first call date. As the cost to refinance the bonds soared during the selloff, investors began to fret that they would be stuck indefinitely with the bonds they perhaps wished they had never bought.

The perpetual 10s have since recovered to €96, to yield 11.2% if they are called on Dec. 1, 2027, or 10.5% if they are not. Each yield represents a pickup to the 7.2% that's on offer from the average European high-yield bond and the 8.3% from the average U.S. junk bond. A speculation, of course, but not an unreasonable one.

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