

10 June 2014 | 10 pages

Diversified Banks
Western Europe | Switzerland

Credit Suisse (CSGN.VX)

Wake-ing up to a Radical FICCx?

- **Project Wake** – The FT¹ reported that CS is considering a spin-off of its US government bond trading business, named Wake USA. This follows a recent Risk magazine article², which highlighted a project to transfer cleared interest rate swaps and listed derivatives to Wake, with technology provided by high-frequency trading firm Tower Research Capital. Key questions remain: (i) Will CS sell-down its stake to a minority level? (ii) To what extent regulators would allow for a deconsolidation to take advantage of lower capital requirements?
- **'No Smoke Without Fire'** – Earlier this year, CS announced that Jon Kinol, co-head of Macro Products & prior Head of Rates, had stepped down to lead a new electronic market-making venture for the bank. We suspect this reflects a more fundamental re-think of FICC strategy, notably in Rates, where returns remain distinctly sub-par. We estimate that CS has the 5th largest Rates book (by notional) – significantly increased on 2009 – and yet fails to make top-tier (Figure 1 and 2).
- **Leverage Remains Key Constraint** – CS' Swiss leverage ratio was 3.6% at 1Q14, pro forma for the [DoJ settlement](#), vs. the current 4% requirement by 2019. The key risk remains if leverage requirements were to go up in Switzerland. Indeed a review report on TBTF is expected to be published in early 2015. An increase in the leverage ratio to 5% would imply CS' minimum CET1 ratio requirements could go up to 12-13% thereby delaying the capital return story (see Figure 4).
- **Need For Further Action on Rates** – Assuming an 'alternative approach to execution of the most liquid, albeit low-margin, part of the Rates franchise could allow CS a much more aggressive wind-down of the Rates franchise. While UBS has targeted c.50% reduction of end-2012 IB leverage exposure, CS' targeted reduction is only 12-13% (see Figure 3). Meeting half-way in terms of targeted reduction would take CS' leverage exposure target to SFr900bn and allow CS to mitigate the impact of a potentially higher 5% leverage ratio.
- **CS Best-Placed To Exit FICC 'Trap'** – As highlighted in [FICC Tail Wags The Dog](#), relative FICC dependence is a key driver of wholesale bank valuations. A more radical approach to CS's underperforming FICC business could be a key catalyst to achieve 'escape velocity' from the FICC trap. We remain Buyers with a SFr33 PT.

1. FT.com, Credit Suisse eyes fixed income spin-off, 08-Jun-14

2. Risk Magazine, Investors poised as banks weigh fixed income spin offs, 02-Jun-14

Credit Suisse (CHF)

Year to 31 Dec	2012A	2013A	2014E	2015E	2016E
Net Income (SFrM)	970.0	1,765.0	3,659.9	5,442.2	5,961.7
Diluted EPS (SFr)	0.64	1.02	2.16	3.24	3.55
Diluted EPS (Old) (SFr)	0.64	1.02	2.20	3.28	3.60
PE (x)	43.3	27.2	12.8	8.5	7.8
P/BV (x)	1.0	1.0	1.0	0.9	0.9
DPS (SFr)	0.75	0.70	0.70	2.00	2.25
Net Div Yield (%)	2.7	2.5	2.5	7.2	8.1
ROE (%)	3.9	6.0	3.3	10.9	13.1

Estimate Change

Buy	1
Price (10 Jun 14)	SFr27.64
Target price	SFr33.00
Expected share price return	19.4%
Expected dividend yield	2.5%
Expected total return	21.9%
Market Cap	SFr44,117M
	US\$49,180M

Price Performance (RIC: CSGN.VX, BB: CSGN VX)



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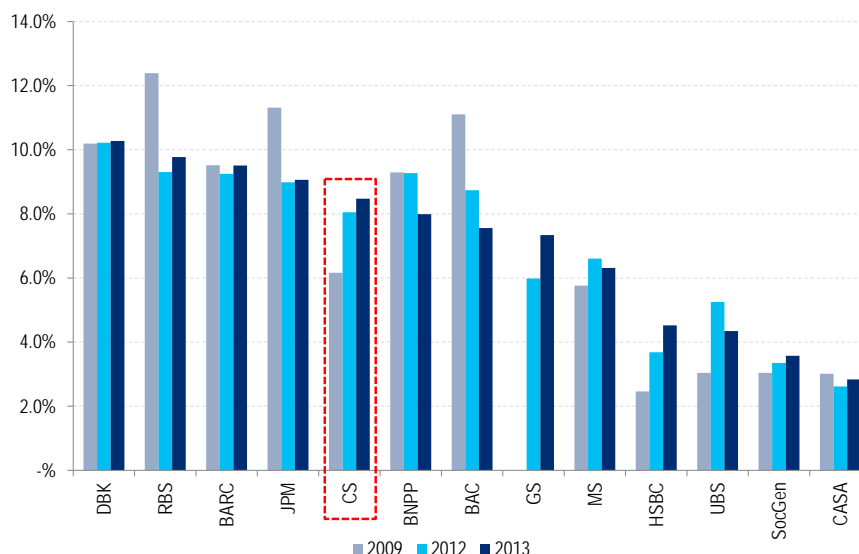
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Fiscal year end 31-Dec	2012	2013	2014E	2015E	2016E
Valuation Ratios					
P/E adjusted (x)	43.3	27.2	12.8	8.5	7.8
P/E reported (x)	31.1	20.6	34.0	9.5	7.4
P/BV (x)	1.0	1.0	1.0	0.9	0.9
P/Adjusted BV diluted (x)	1.0	1.0	1.0	0.9	0.9
Dividend yield (%)	2.7	2.5	2.5	7.2	8.1
Per Share Data (SFr)					
EPS adjusted	0.64	1.02	2.16	3.24	3.55
EPS reported	0.89	1.34	0.81	2.90	3.73
BVPS	27.44	26.50	26.86	29.23	31.18
Tangible BVPS	20.77	21.21	21.56	23.93	31.18
Adjusted BVPS diluted	26.34	26.98	26.75	29.27	31.22
DPS	0.75	0.70	0.70	2.00	2.25
Profit & Loss (SFrM)					
Net interest income	7,126	8,100	8,732	9,169	9,627
Fees and commissions	12,751	13,249	13,776	15,016	16,367
Other operating Income	3,374	3,868	1,811	1,968	1,916
Total operating income	23,251	25,217	24,319	26,152	27,910
Total operating expenses	-21,193	-21,546	-21,426	-19,496	-19,408
Oper. profit bef. provisions	2,058	3,671	2,893	6,656	8,502
Bad debt provisions	-170	-167	-191	-172	-140
Non-operating/exceptionals	0	0	0	0	0
Pre-tax profit	1,888	3,504	2,702	6,484	8,362
Tax	-465	-1,276	-1,343	-1,621	-2,091
Extraord./Min. Int./Pref. Div.	-74	98	21	4	4
Attributable profit	1,349	2,326	1,380	4,867	6,275
Adjusted earnings	970	1,765	3,660	5,442	5,962
Growth Rates (%)					
EPS adjusted	-53.2	59.3	112.0	50.2	9.5
Oper. profit bef. prov.	-30.1	78.4	-21.2	130.0	27.7
Balance Sheet (SFrM)					
Total assets	924,280	872,806	829,078	790,238	766,238
Avg interest earning assets	907,785	826,660	782,867	744,885	704,939
Customer loans	243,145	247,923	259,034	246,899	239,400
Gross NPLs	2,374	2,816	2,782	2,711	2,657
Liab. & shar. funds	924,280	872,806	829,078	790,238	766,238
Total customer deposits	308,312	333,089	358,852	342,041	331,653
Reserve for loan losses	922	869	892	850	850
Shareholders' equity	35,498	42,164	42,637	46,393	49,494
Profitability/Solvency Ratios (%)					
ROE adjusted	2.8	4.5	8.6	12.2	12.4
Net interest margin	0.78	0.98	1.12	1.23	1.37
Cost/income ratio	91.1	85.4	88.1	74.5	69.5
Cash cost/average assets	2.1	2.4	2.5	2.4	2.5
NPLs/customer loans	1.0	1.1	1.1	1.1	1.1
Reserve for loan losses/NPLs	38.8	30.9	32.1	31.4	32.0
Bad debt prov./avg. cust. loans	0.1	0.1	0.1	0.1	0.1
Loans/deposit ratio	78.9	74.4	72.2	72.2	72.2
Tier 1 capital ratio	22.1	12.9	14.0	15.4	17.3
Total capital ratio	22.1	15.1	16.9	19.0	21.0

Figure 1. Interest Rate Derivative Market Shares (Based on Notional) – 2009, 2012, 2013



Source: Company Reports and Citi Research

Figure 2. Wholesale Banks – Investment Banking Product Strength Matrix (2013)

Total Leadership Positions, 2013 And Change On 2012 Positions	JPM	GS	BAC	MS	DBK	CS	UBS	BARC	BNPP
	15	8	5	5	4	2	2	1	0

Origination & Advisory

Bond Underwriting				↑	↑	↓		↓	n/a
Loan Syndication	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a
ECM		↑	↓				↓		n/a
M&A		↓				↓			n/a
USD Clearing	↑		↑		↑				

FICC

G10 Rates					↑				n/a
G10 Credit		↑		↓	↓	↓		↑	n/a
G10 Foreign Exchange		↑						↓	n/a
Securitisation		↓			↑			↓	n/a
Emerging Markets						↓			n/a
Commodities			↓	↑	↓		↓		n/a
Municipal Finance	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a

Equities

Cash Equities									n/a
Derivatives & Convertibles			↑	↓		↓	↑	↓	n/a
Prime Brokerage	↑					↓			n/a
Futures & Options				↓		↓			n/a

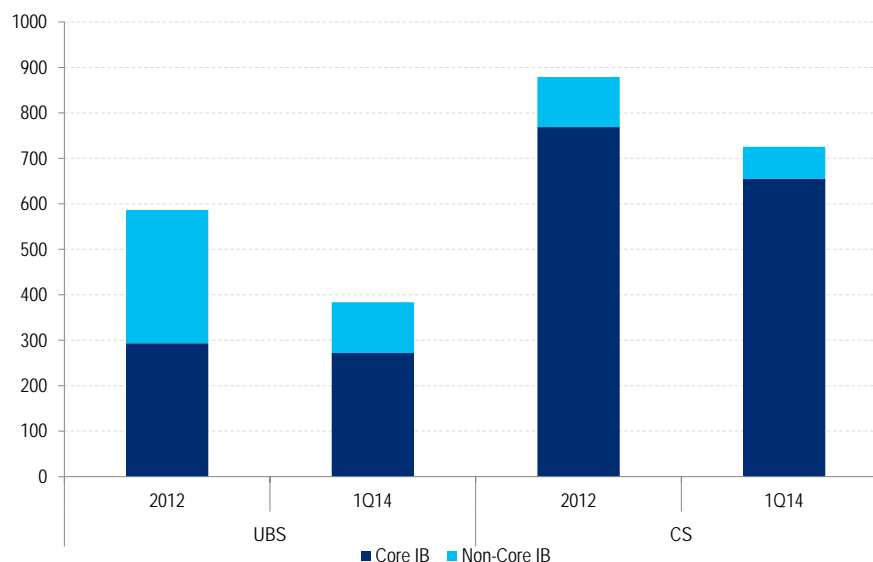
Key

Top 3	
2nd Tier	
3rd Tier	

Source: Company Reports (JP Morgan 2014 Investor Day, CIB Presentation), Citi Research Estimates

Note: 1. Arrows indicate change in position on 2012. 2. BNPP is a new entry so no comparison on 2012. 3. Loan syndication and Municipal Finance are new disclosures so no comparison on 2012.

Figure 3. CS vs. UBS IB Leverage Exposure Reduction Targets (SFr bn)



Source: Company Reports and Citi Research Estimates

Figure 4. Leverage Ratios – Scenario Analysis

	2013 Act	2014 Citi Est	2015 Citi Est	2016 Citi Est	Long Term Go To Level
Potential 'go-to' level					
CET1 Leverage Ratio (%)	3.0%	3.0%	3.0%	3.0%	3.0%
Swiss Total Capital Ratio (%)	5.0%	5.0%	5.0%	5.0%	5.0%
Min CET1 Capital requirement on 'go-to' leverage	33.9	32.7	31.5	30.8	30.0
Min CET1 Capital requirement on 11% CET1 ratio	29.3	28.9	28.2	27.6	27.5
Min CET1 Capital Ratio on 'go-to' leverage	12.8%	12.5%	12.3%	12.3%	12.0%
Surplus/(Deficit) CET1 capital on higher leverage reqt	(7.5)	(4.3)	(0.2)	4.4	-
Target Leverage exposure @ 11% CET1 ratio	975	963	939	920	916
Memo					
CET1	26.5	28.4	31.3	35.2	30.0
Swiss Total Capital	40.2	44.3	48.7	52.6	50.0
CET1 Leverage Ratio (%)	2.3%	2.6%	3.0%	3.4%	3.0%
Swiss Total Capital Ratio (%)	3.6%	4.1%	4.6%	5.1%	5.0%

Source: Company Reports and Citi Research Estimates

Changes in Estimates

- We reduce our cash EPS forecasts by 7% in 2014E, 2% in 2015E and 1% in 2016E.
- Declines reflect both a decrease in net interest margins, as a result of a weaker-than-expected macro environment, as well as an acceleration in non-core wind-down, which generates losses in the IB Non-Strategic Unit.
- The impact is greater in 2014E, as the changes are on a lower profit base, following significant litigation charges incurred during 2Q14 (already reflected in our numbers).

Credit Suisse

Company description

Credit Suisse Group is the second-largest bank in Switzerland (after UBS), and one of the largest investment groups in the world. The group acquired Winterthur (insurance) in 1997, but later sold it, and acquired Donaldson Lufkin & Jenrette (investment bank) in 2000, adding to the previous CSFB. The group is active in investment banking (54% of 2010 revenues), private banking (39%) and asset management (6%), all now unified under a common brand and a "one bank" integration programme.

Investment strategy

We have a Buy rating on Credit Suisse. CS weathered the credit crisis better than peers and is well capitalised. Its RWA and asset deleveraging plans will support its capital position whilst reducing its leverage. The investment bank has strong franchises in equities and credit trading. Meanwhile the private bank has a robust multi-shore franchise, that has enjoyed resilient inflows, and offers significant operational leverage. We believe that the stock offers re-rating potential given its attractive business mix, strong capital generation and strategic flexibility whether via bolt-on-acquisitions or more aggressive capital return to shareholders.

Valuation

We have a target price of SFr34 for Credit Suisse, calculated using a Dividend Discount Model (DDM) methodology. Our key assumptions are as follows: discounted valuation assuming 2016E RoTE of c.15%, and a cost of equity of c.10%.

Risks

The key risks to our investment thesis on Credit Suisse are: (1) changing capital markets conditions, with shifting valuations and volumes in the broader markets and, (2) the overhang risk from large shareholders should they choose to dispose of their holdings.

If any of these risk factors has a greater downside impact than we anticipate, the share price will likely have difficulty attaining our target price. Conversely, if the impact of any of these upside risks is greater than we anticipate, the stock could exceed our target price.

Appendix A-1

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IMPORTANT DISCLOSURES

Credit Suisse (CSGN.VX)

Ratings and Target Price History Fundamental Research

Analyst: Kinner Lakhani



	Date	Rating	Target Price	Closing Price
1	20-Jul-11	1M	*39.73	28.18
2	20-Sep-11	1M	*30.04	20.94
3	7-Oct-11	Stock rating system changed		
4	7-Oct-11	*1	30.04	23.13
5	21-Oct-11	1	*27.62	23.12
6	15-Jan-12	1	*25.68	20.87

* Indicates change

	Date	Rating	Target Price	Closing Price
7	8-Mar-12	1	*28.10	23.74
8	16-Mar-12	1	*30.04	26.36
9	19-Jun-12	1	*24.23	17.46
10	19-Jul-12	1	*22.29	16.80
11	26-Sep-12	1	*24.40	19.72
12	7-Nov-12	1	*26.36	21.46

	Date	Rating	Target Price	Closing Price
13	23-Jan-13	1	*34.17	25.69
14	21-May-13	1	*35.00	28.81
15	5-Nov-13	1	*34.00	25.98
16	2-Jun-14	1	*33.00	26.62

Rating/target price changes above reflect Eastern Standard Time

Credit Suisse (CSGN.VX)

Ratings and Target Price History Best Ideas Research

Relative Call (3 Month)

Analyst: Kinner Lakhani



	Date	Rating	Target Price	Closing Price
1	9-Aug-11	*REM MP	-	21.08
2	7-Jan-13	*ADD MP	-	23.80

* Indicates change

	Date	Rating	Target Price	Closing Price
3	8-Apr-13	*REM MP	-	23.77
4	11-Apr-13	*ADD MP	-	25.68

	Date	Rating	Target Price	Closing Price
5	25-Sep-13	*REM MP	-	27.46

Rating/target price changes above reflect Eastern Standard Time

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<i>Data current as of 31 Mar 2014</i>	12 Month Rating			Relative Rating		
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Citi Research Global Fundamental Coverage	49%	40%	12%	1%	98%	1%
% of companies in each rating category that are investment banking clients	55%	53%	45%	58%	53%	42%

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Citigroup Global Markets Ltd

Kinner Lakhani; Nicholas Herman

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