

Thematic analysis — 4Q 2022
Credit Suisse

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Credit Suisse continues to face cyclical and structural challenges and the dramatic evolution of its share price and credit default swaps have been in the focus over the past few weeks, with some investors raising the question of a potential takeover or even a breakdown of the bank.

In this note, we will assess what are the key issues facing Credit Suisse; what are the company's strategic options and why we still prefer not to own Credit Suisse shares at this stage.

What is the problem?

With a CET1 ratio at 13.5% (regulatory minimum of 10.7%) and leverage at 4.3%, solvency is below the company's target but largely above the minimum requirement. Liquidity is also fine with an average LCR (liquidity coverage ratio) of 191% and NSFR (net stable funding ratio) at 132% in the second quarter 2022. Consequently, we do not believe that Credit Suisse faces any near-term capital shortfalls. However, as the bank is loss making and given recent downgrades

by credit agencies, the high level of uncertainty (continuing litigation risk, higher restructuring costs), and that the closest peers (UBS, Bear) have CET1 ratio target of 13-14%, Credit Suisse should consider a CET1 ratio of 13% as a red line not to cross. At this stage, the main risk is a lack of capital flexibility and thus a weaker competitive position.

The key issue for Credit Suisse is its profitability, as the company is loss making. These losses are partly due to litigation costs (cumulative CHF 3.1bn since the fourth quarter 2020), but also more fundamentally, the company is loss making with declining revenues and increasing costs. Underlying revenues may have bottomed while the cost base should stabilize in the fourth quarter. However, in the Wealth Management and Asset Management divisions, weaker markets are driving down asset under management and thus earnings expectations. In the Investment Bank, Credit Suisse faces cyclical headwinds too as its footprint is skewed towards poorer performing segments (Capital Markets, Credit, Leverage finance) and are relatively smaller in areas which have fared better (Rates). The Investment Bank also faces structural challenges due to its lack of scale which translates into a suboptimal cost to income ratio.

Fig.1: CET1 ratio

Source: Credit Suisse

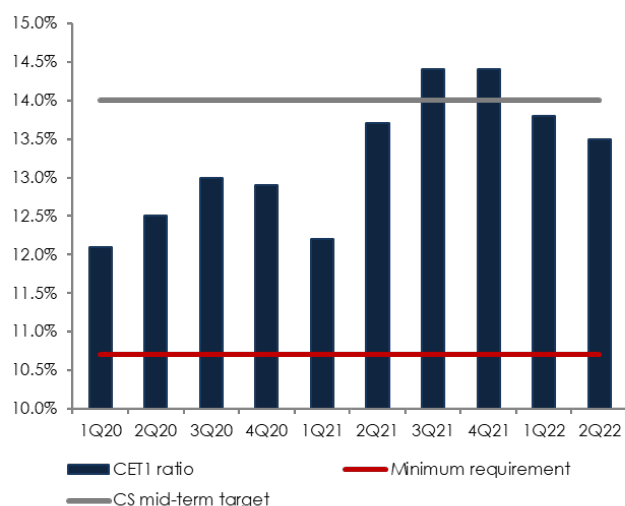
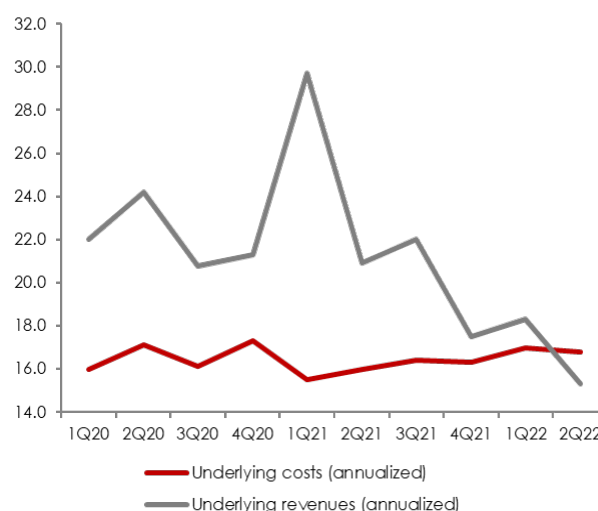


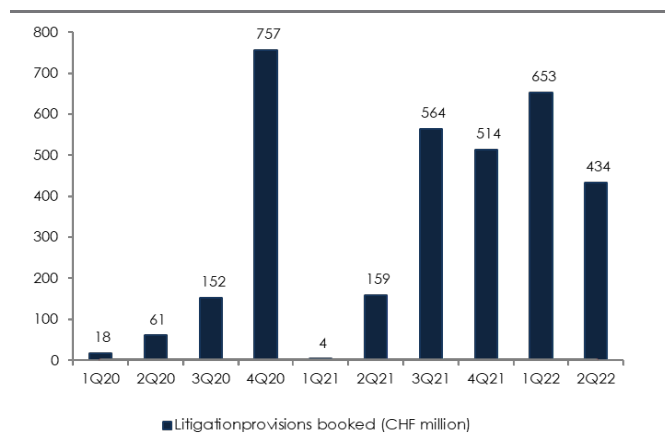
Fig.2: Underlying revenues and costs

Source: Credit Suisse



Credit Suisse's management will present the results of their new strategic review on 27 October, together with third quarter results. The pressure is high for them to deliver as this is the second strategic review in just a year's time (last one in November 2021). Of course, we do not presume decisions of the new management, but fixing the company's profitability at a limited cost while maintaining a sufficient level of solvency is going to be a difficult equation to solve.

Fig.3: Litigation costs provisioned
Source: Credit Suisse



Which issues in which divisions?

The *Investment Bank* needs some significant restructuring. It has been loss making in 2021 and should remain so in 2022. It is the division that consumes the largest proportion of capital within the group, thereby putting a particularly important burden on the group's return on capital. The division could refocus on a few key activities where Credit Suisse has a competitive edge or scale, or on activities which are necessary to support the key franchises in Wealth Management and the Swiss Bank.

Wealth Management will be affected by cyclical factors and macro headwinds as client's activity which drives transaction fees typically decrease during bear markets and asset under management is reduced. But beyond cyclical factors, there is room to reduce the cost base as it seems that the focus on ultra-high net worth individuals in Asia is very costly.

The *Swiss Bank* is the bright spot of the group. It is currently the most profitable division and the most recurrent and less volatile source of profit. In addition, it should benefit from the higher rates environment.

Asset Management is a business that typically consumes a limited amount of capital and therefore usually generates

the best capital return within a banking group. However, the profitability of this division has significantly declined, from over 50% in 2018 to 16% in 2022. This is because asset under management have declined, fee margin is under pressure and the cost base has remained sticky. This evolution is partly cyclical (equity bear market) but also reflects compliance and risk management issues.

The *Corporate Center* tends to be overlooked as it is not an operating division, but it is important for the group's return on capital as it concentrates 18% of the bank's Risk Weighted Assets (RWA) while posting a loss.

What are Credit Suisse's strategic options?

Credit Suisse faces the dilemma of restoring profitability while maintaining adequate level of solvency, which implies increasing its capital base. Weaker earnings in addition to RWA inflation and the risk of continued litigation and restructuring costs have created capital pressures.

There are a few ways to build CET1 capital: the best way is by retained earnings, but considering the bank is lossmaking, this option is not credible, at least in a near future. The most credible option is via capital gains upon asset sales, and/or via reducing the Risk Weighted Asset base, which can be done by balance sheet deleveraging, asset sales or deconsolidation. A rights issue could also be an option, but at current market capitalization, it would be very dilutive.

Asset disposals: Credit Suisse confirmed they are exploring strategic options for the Securitized Products business to attract third-party capital. Press articles have also mentioned potential disposals of other businesses within the group and the LATAM ex Brazil wealth management business has been mentioned.

Could Credit Suisse become a takeover target?

On paper, the rationale for a potential buyer would be that the significant discount at which the bank's shares are trading (0.26x book value, or a theoretical 74% discount to current book value) would create a large amount of goodwill, which could help the acquirer fund the restructuring, litigation costs and upcoming regulatory headwinds. In such a scenario, the potential buyer could alleviate some regulatory risk by an IPO of the Swiss Bank. However, we are not aware of any potential acquirer having made any public comments around a potential takeover. International bank mergers are not so common and rarely successful.

Why we still prefer not to own Credit Suisse's shares at this stage

We think that concerns about a potential breakdown of Credit Suisse are overdone and recognize that current valuation may provide trading opportunities. However, the fundamental situation is that Credit Suisse has serious issues to solve: revenues are trending down, costs are trending up, capital is below target and capital generation is still at risk (litigation costs, restructuring costs). Recent announcements (management change, cost cutting targets, potential asset sales, new strategic review) have just bought time, pending details due 27 October with the third quarter results. To summarize our position, there is no easy and quick fix for Credit Suisse, and we think there are better investment opportunities elsewhere in the banking sector.

Fig.4: 10 years of share price evolution (CHF rebased to 100)
Source: Bloomberg

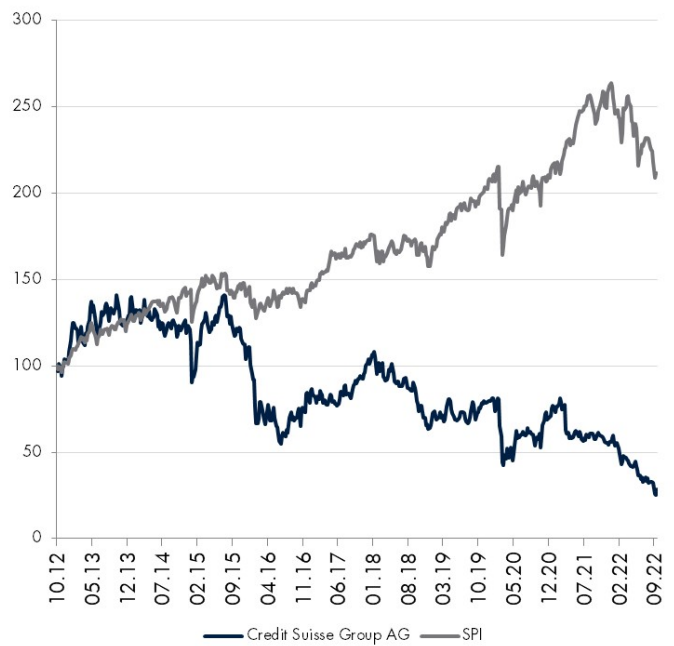


Fig.5 : Long term total return performance, CHF
Source: Bloomberg

