Credit Suisse: Restructuring EMEA and Americas

- Credit Suisse's Mar-16 Strategy Update failed to immediately reassure investors. The bank expects a 40-45% year-on-year drop in Global Markets' trading revenue, and a loss in 1Q16
- In our view, Credit Suisse has the 'wrong kind of fixed income' for their strategy and current markets

The March 2016 Strategy Update

Last week, Credit Suisse provided further detail on their updated strategy, first indicated at the time of the FY15 announcement. Global Markets (GM) and, to a lesser extent, IB&CM (new units, encompassing EMEA and Americas, and excluding APAC) are firmly in focus for the 'accelerated' restructuring drive. Highlights are:

- The CEO unveiled losses in secondary US CLOs (where exposure totalled US$840m in 4Q15) and distressed credit (exposure US$2.9bn). By mid-Mar-16, CS had already reduced these positions to US$300m and US$2.1bn (writedown US$99m) respectively, taking significant writedowns: US$115m in Securitised Products (including US$64m in US CLOs), US$99m in distressed credit, and US$44m in leveraged finance underwriting (this is in addition to US$495m of writedowns in these products that were booked in 4Q15). In mid-Mar-16, the bank stated that it expects 1Q16 trading revenue to drop by 40-45% versus 1Q15, and a 1Q16 loss in Global Markets.
- The end-2018 cost-savings target for GM and IB&CM has tripled, from CHF400m/US$410m in Oct-15 to US$1.2bn. This is an ambitious target - equal to 14% of GM and IC&BM's US$8.7bn FY15 total operating costs, excluding 4Q15 goodwill amortisation - but the bank seems determined to achieve it, and based on Credit Suisse's track record in achieving its cost-cutting targets (see overleaf), we expect it will.

  GM is exiting distressed credit, securitised product trading in Europe and long-term illiquid financing; and consolidating developed and emerging markets FX Cash and Options into STS operations, which are part of Swiss Universal Bank (note: in Oct-15, FX was deemed a 'strategic focus' product area). GM announced 2,000 layoffs, on top of the previous 4,000 which cut across all divisions but with emphasis on GM FICC. While GM and IB&CM's reported comp expenses remained unchanged between FY15 and FY14, we expect reductions in future years, over and above the reduction in headcount: Credit Suisse Group reduced the deferred comp element of bonus pool from 56% in FY13 and 48% in FY14 to just 41% in FY15, which suggests a drop-off in future years. The main impact of this move will be felt in capital markets divisions.

  The remaining GM portfolio will consist of three units: Equities (with large investment in prime brokerage and flow financing, cash and AES, and ECM); Credit (investment in LFCM and IGCM, but rationalisation, equal to 35% of RWA, in all other areas); and Solutions (investment in US Rates, but a 16% RWA cut for EMEA and APAC Macro, equity and corporate derivatives, converts, structured, FLP, and EM financing).
- The new end-2016 target reduction for RWA is US$60bn (versus US$75bn achieved by end-FY15); the new Leverage target is US$290bn (end-FY15: US$317bn). The Credit division's RWA is slated for the reduction of 13% versus end-FY15; at the product level, distressed trading and customer financing will all but disappear, flow trading will see a slight reduction, but capital markets will almost double to 40% of the Credit division's total RWA. The Securitised Products' target RWA is 41% below end-FY15 level; EU trading will be shuttered, and both US trading and global asset finance will suffer significant reductions; the target split for the latter two is 43/57.

  In 2Q16, GM will transfer US$10-15bn of RWA to Strategic Resolutions Unit (SRU); this and other actions (including business and asset disposals, which is expected to contribute $1bn+) aim to free up c.US$400m of Group capital by end-2017. Credit Suisse will provide an update on cost and run-off plans once the transfers have been completed.

Credit Suisse's Strategy Update did not immediately reassure investors: the share closed at CHF14 on the day after the announcement, down 10% in a week and 42% below from CHF24 in late Oct-15, the date of the previous update. We suspect there are two main reason for the continued weakness in the share price. First, the top management's statement that traders increased their positions in distressed debt and other illiquid positions without senior leaders' knowledge: in Oct-15 strategy update, the same management stood by both credit and securitised products.

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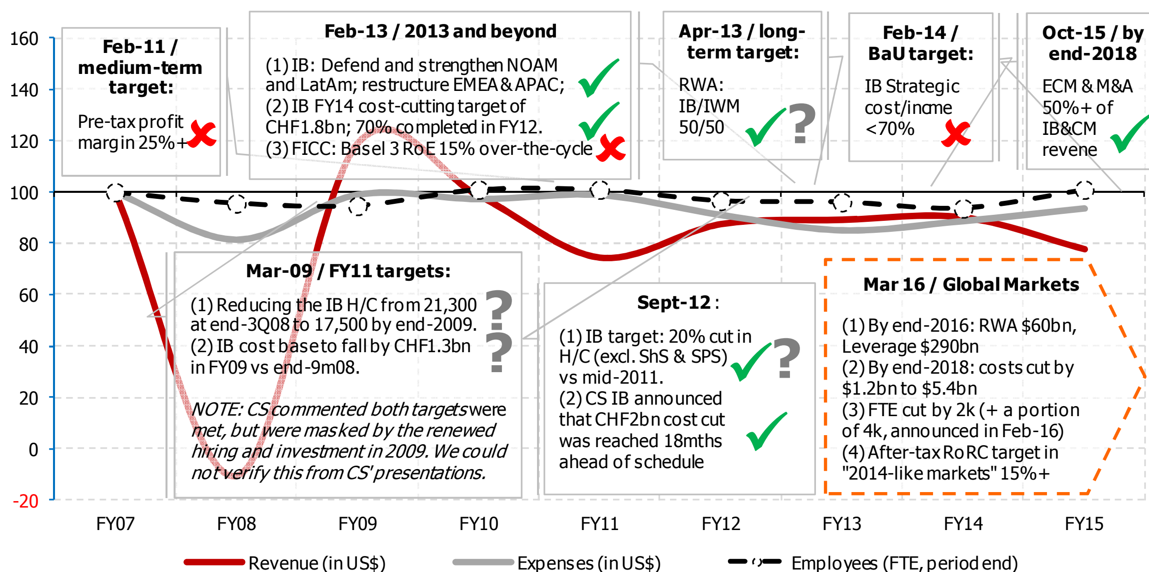
Second, the bank's track record in achieving its financial targets has been somewhat spotty over the years, especially with regards to adjusting its cost base to revenues (in contrast to 'straight' cost-cutting, where it was generally successful). In the chart below, we highlight some key financial targets over the past nine years. Information has been drawn almost exclusively from CS' investor presentations, as these are documents where banks communicate key issues and targets. Among the targets shown, the latest three are:

- In Feb-13, CS announced its long-term goal of having RWA split 50-50 between capital markets (Investment Bank, under the pre-4Q15 structure) and wealth management units. This is an old target, but there are clear parallels with the bank's current goals. In 3Q15, under the old structure and excluding CC & Shared Services, Strategic IB accounted for 57% RWA, versus 38% for Private Banking and Wealth Management. In FY15, under the new structure (and based on our estimates of RWA allocations in Swiss Universal Bank and APAC), capital markets consumed US$114bn of RWA versus US$56bn for wealth management units. However, we expect that Credit Suisse will meet its target - announced in Mar-16 - of reducing Global Markets' RWA to US$60bn by the end of 2016, thus likely achieving the 50-50 target split.
- Thus far, capital markets divisions (previously known as Strategic Investment Bank) missed their Feb-14 long-term 'business-as-usual' cost/income target of <70%, albeit narrowly: excluding goodwill amortisation in 4Q15, the three capital markets divisions reported cost/income of 69% and 71% in FY13 and FY14 (the latter being a 'normal year' according to the bank's new RoRC target) and a whopping 87% in a very difficult FY15.
- In its Oct-15 Investor Day, IB&CM (ex-APAC) stated that it will focus on M&A/Advisory and ECM revenue: by end-2018, these areas, for which CS projects CAGR of 18% and 6%, respectively, will aim to generate 50%+ of IB&CM's total revenue excluding securitised products. The division is already very close to achieving this goal: our calculation (which includes underwriting revenues booked in GM) suggests that M&A and ECM fees accounted for 38%, 42% and 47% of the division's total FY13, FY14 and FY15 revenue. Credit Suisse also projects a reduction in leverage finance fees from 46% of the FY14 total to just 33% in FY18, which will contribute to the target.

Financial targets: assessing outcomes (FY07-FY15, indexed to FY07, US$)



Source: Credit Suisse, Tricumen analysis. Notes: (1) This chart builds on our previous publications: 'Capital Markets planning' (Apr-13); and 'Credit Suisse: Prime Service, IB targets and achievements (Dec-14). Both reports are available on http://www.tricumen.com. (2) Dates in textboxes indicate the date of the announcement; the symbols indicate whether the targets was achieved during the period specified when the announcement was first made, or updated. (3) Operating revenue excludes DVA/equivalents and items that occurred outside of the regular course of business. (4) Operating expenses exclude commission, provision for credit losses and goodwill amortisation; litigation-related items, severance payments, losses on disposal of assets and similar items are all included, as they all occurred in the course of regular business. (5) FY11-FY15 financials and FTEs are shown as reported in the post-4Q15 structure; Tricumen adjusted prior years.

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Cross-selling opportunities

Credit Suisse assessed all product divisions on four criteria: 'resource' (capital) usage; quality of earnings (volatility, counter-cyclicality, and operating leverage); client connectivity; and the current competitive market position and the outlook.

The competitive positioning and client connectivity are critical: under the post-4Q15 structure, capital markets units' primary role seems to be supporting wealth management and primary/issuance units. For example, Prime Services failed Credit Suisse's internal test on after-tax RoC *and* RWA/leverage usage, but the bank deems its connectivity to IWM 'medium' and its competitive standing in the Top 3, and will (selectively) invest in this area. Macro products - which also fail RoC and RoRWA tests and have 'medium' connectivity - will, with the exception of US Rates, be the subject of further cuts.

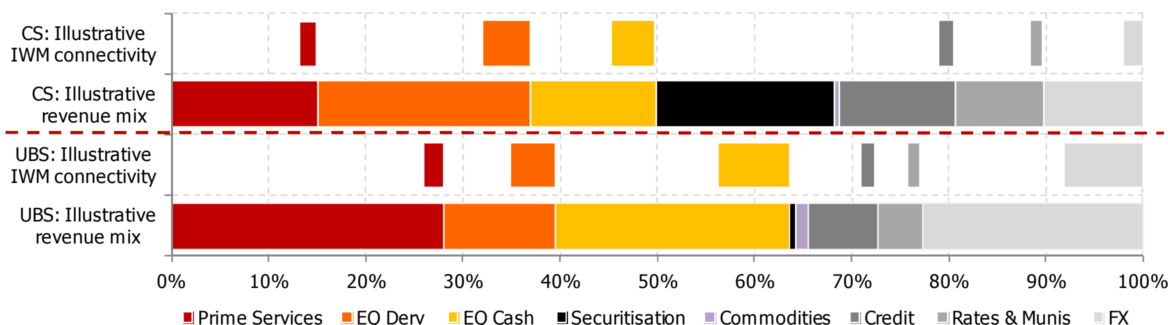
The bank's maintain/invest approach to equities makes sense: it has competitive and RoRC-profitable franchise. Connectivity with IWM is strong for both cash equity and retail structured equity derivative products, although there are dangers in having an equity derivatives business that is wholly reliant on retail structured products, as this can lead to too much one way risk: retail and HNWI investors tend to follow trends.

The bank's greatest challenge is in its FICC business mix, which has historically been skewed towards spread products, including MBS, flow, structured and distressed credit. The greatest potential synergies with wealth management, however, are in macro products. In the chart below, we compare Credit Suisse's and UBS' revenue mix. The latter has a product revenue mix that is better suited to gaining the most out of the wealth client base. Credit Suisse, by contrast, has not, despite years of effort, managed to grow its FX and rates trading businesses to a level where they can provide a meaningful support to wealth management.

The biggest stand out is Credit Suisse's securitisation business, which has no connectivity with IWM. In the past, this has been a stand-alone business with its own client base, high revenues and return on capital. In recent quarters, however, issuance and trading outside agencies has significantly declined; this, coupled with writedowns mentioned above, has put a significant dent in the bank's fixed income revenues. The rationalisation of the US franchise and exit from the European market is a sensible start.

In short, the bank has, in our view, the 'wrong kind of fixed income' for their strategy and current markets.

Business mix and cross selling opportunity: Credit Suisse vs UBS



Source: Tricumen.

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Situated near Cambridge in the UK, Tricumen is almost exclusively staffed with senior individuals with an extensive track record of either working for or analysing banks; and boasts what we believe is the largest capital markets-focused research network of its peer group.

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