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Tracy Yu
Research Analyst
(+852) 2203 6191
tracy.yu@db.com

Sukrit Khatri
Research Associate
(+852) 2203 5927
sukrit.khatri@db.com

Why are we fundamentally not worried about spikes in SHIBOR?

Compelling entry points despite short-term headwinds; prefer big four banks

We think the market has misunderstood the fundamental impact of the sharp spikes in SHIBOR on banks and has over-reacted to the yield curve inversion. Unlike other countries, Chinese banks are less affected by the term structure of the yield curves, as seen in the 18.3% yoy rise in NPAT for the H-share banks from July 2011 to June 2012 when 3M and 10Y spreads were inverted by c.180bps. This is because loans and deposits are priced against the PBOC's benchmark rates with a LDR cap of 75% and there exists no direct transmission between SHIBOR and the borrowing cost prevalent in the shadow banking system, leading to little reliance on net interbank funding.

The curious case of interbank rate spikes and yield curve inversion in China

Unlike other countries, Chinese banks are less affected by the term structure of the yield curves as both loans and deposits are priced against the PBOC's benchmark rates and there exists no direct transmission between SHIBOR and the borrowing cost prevalent in the shadow banking system, except for commercial papers and bank acceptance, which we estimate contribute 15% of the outstanding total social financing (TSF). Although we expect the spikes in SHIBOR to be temporary, history shows that even a persistent yield curve inversion, as seen July 2011 to June 2012, would not affect earnings, as NPAT of H-share banks rose 18.3% yoy in the period, when 3M SHIBOR averaged 5.5%, leading to an average yield curve inversion of 1.8%. Overall, the H-share listed banks are small net lenders to the money markets, with net lending making up just 0.2% of their average interest yielding assets (AIYA). While the big four banks have the lowest gross interbank borrowing, MSB and BoCom are the most exposed.

Paving the way for gradual deregulation of interest rates

Our earnings forecasts already incorporate the negative impact of a 25bps rate cut and a rise in the floating range of deposits to 1.2x (previous: 1.1x), PBOC's benchmark rates, leading to a regulatory loan/deposit spread of 0.6% to -1.3% for the term structure of 3 months to over 5 years. We quantify the impact to be 2.1% and 10.5% of our FY13E and FY14E NPAT. However, we think China is not ready to move away from the system of pricing loans and deposits in accordance with the PBOC's benchmark rates, given high SHIBOR volatility.

We stay positive despite mounting near-term headwinds; risks

Despite the sharp spikes in SHIBOR, the PBOC does not believe there to be a structural abnormality in the money market, with only a minimal increase in interest creating a burden on corporates (DBe: 23bps more if the 3m SHIBOR stays at the current level in the next 12m), explaining the lack of immediate policy intervention to regulate the market. On our estimates, the H-share listed Chinese banks trade at 0.9x 2013E P/B, 5x 2013E P/E, with ROAE of 19.3%, and the low valuation should compensate investors for the mounting short-term headwinds. Our top picks are the big four Chinese banks and we see the normalization of SHIBOR as a positive catalyst. Key downside risks: weaker-than-expected economic growth and deteriorating sector liquidity. (See pages 9-11 for valuation and risk detail.)

Top picks	
ICBC (1398.HK),HKD4.57	Buy
China Construction Bank (0939.HK),HKD5.15	Buy
Agri. Bank of China (1288.HK),HKD3.09	Buy
Bank of China (3988.HK),HKD3.08	Buy

Companies Featured	
ICBC (1398.HK),HKD4.57	Buy
China Construction Bank (0939.HK),HKD5.15	Buy
Agri. Bank of China (1288.HK),HKD3.09	Buy
Bank of China (3988.HK),HKD3.08	Buy
Bank of Communications (3328.HK),HKD5.32	Buy
China Merchants Bank-H (3968.HK),HKD13.28	Buy
China CITIC Bank (0998.HK),HKD3.68	Buy
China Minsheng Bank (1988.HK),HKD8.02	Hold
Chongqing Rural Bank (3618.HK),HKD3.39	Buy

Chinese banks: fundamentally misunderstood, in our view

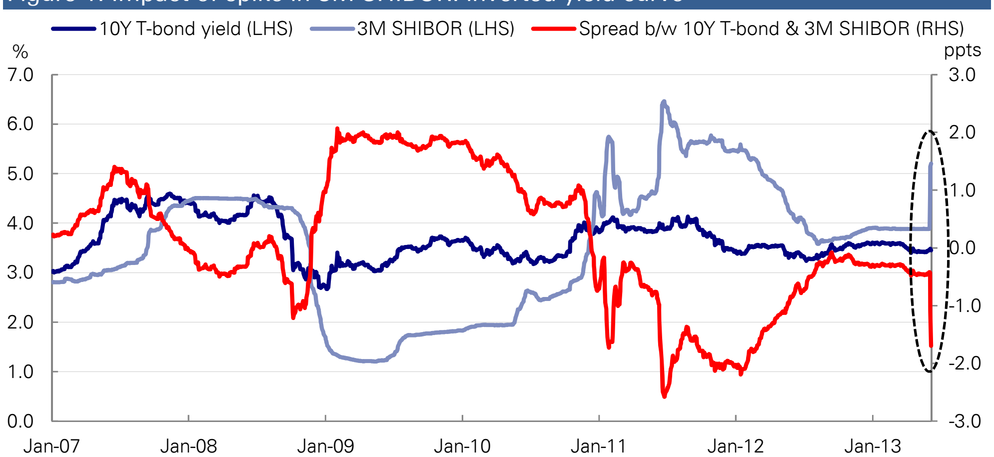
While headwinds persist, the market seems to have overreacted to SHIBOR spike

With regard to the sharp spikes in SHIBOR, our understanding is that the PBOC does not believe there to be a structural abnormality in the money market, with only a minimal increase in interest creating burden for corporates (DBe: 23bps more if the 3m SHIBOR were to stay at the current level in the next 12 months), explaining the lack of immediate policy intervention to regulate the market.

Moreover, we believe this step could be intended to test banks' ability to manage their liquidity through market mechanism instead of policy intervention when faced with strong seasonal demand for funds. However, in the unlikely scenario that the banks have difficulty in rolling over their inter-bank loans due to the spike in SHIBOR, we believe the PBOC would step in and intervene through liquidity injection or a reduction in reserve requirement ratio.

Figure 1 illustrates the recent trends in the 3M SHIBOR versus the 10Y long term yield, which has led to the yield curve inversion of 1.8%, with China's interbank rate rising to 8.5% (overnight rate), 9.7% (1 month rate), and 5.8% (3 months rate). This corresponds to a rise of 2.5 ppts, 4.6 ppts and 1.9 ppts, respectively, since 6 June 2013.

Figure 1: Impact of spike in 3M SHIBOR: inverted yield curve



Source: Deutsche Bank, Bloomberg Finance LP

Starting from 2008, we have identified three periods when the spread between the 10-year long bond and 3-month were inverted by over 100bps, which coincided with a fall in share prices of the big banks and the HSCEI market indices. In fact, in the most recent period, 15 June 2011 to 21 May 2012, when the 3M SHIBOR had averaged 5.5%, the average spread to the 10Y long bond yield had inverted by 1.8%, with the share prices of banks down 21-27% and the HSCEI Index down 23% in the same period.

Figure 2: Historical performance of the big banks and the index when the yield curve had inverted by 1% or more

Period	Average 3M SHIBOR	Average 10Y bond yield	Average spread	HSCEI	HSCE Finance Index	ICBC	CCB	BOC
9 Oct 2008 - 13 Nov 2008	4.1%	3.1%	-1.0%	-12%	-16%	-9%	0%	-24%
24 Jan 2011 - 12 Feb 2011	5.5%	4.0%	-1.5%	-4%	-5%	-3%	-5%	-5%
15 June 2011 - 21 May 2012	5.5%	3.7%	-1.8%	-23%	-24%	-21%	-25%	-27%

Source: Deutsche Bank, Bloomberg Finance LP

While the share prices of banks reflected market fears over the inversion of the yield spread, the bank earnings showed that these fears were completely unjustified on fundamental grounds. Instead of seeing pressure on margins, the earnings fundamentals for the H-share banks actually improved over that period, with NPAT rising 18.3% yoy, while the net interest income rose by 19.2%. Thus, history provides evidence that, even during a sustained period of yield curve inversion, the fundamentals of Chinese banks were not affected.

Figure 3: NPAT and net interest income of H-share listed Chinese banks in the most recent period of yield curve inversion (RMB bn)

	NPAT			Net interest income		
	2H10-1H11	2H11-1H12	Change	2H10-1H11	2H11-1H12	Change
ICBC	190.0	221.9	16.8%	334.9	392.3	17.1%
CCB	156.9	182.7	16.4%	279.4	328.6	17.6%
ABC	115.6	135.8	17.5%	275.2	330.2	20.0%
BOC	119.0	129.3	8.7%	212.3	241.9	13.9%
BoCom	45.1	55.4	22.9%	94.7	112.3	18.6%
CMB	31.2	40.9	31.3%	66.4	84.2	26.8%
CNCB	25.5	35.2	37.7%	55.6	72.2	30.0%
MSB	22.6	33.1	46.0%	54.3	73.1	34.8%
CRCB	3.6	4.8	32.2%	8.9	11.9	34.0%
H-share	**709.5**	**839.1**	**18.3%**	**1,381.7**	**1,646.8**	**19.2%**

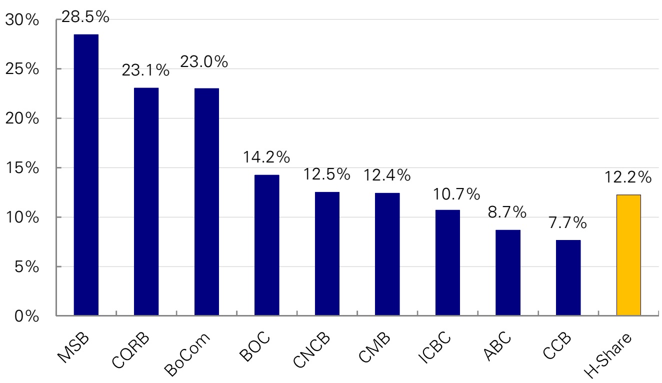
Source: Deutsche Bank, company data

The curious case of Chinese banks: loans and deposits are priced against the PBOC benchmark, not the interbank rate

The reason why the Chinese banks' earnings are not affected by the term structure of the yield curves is because, unlike other countries, loans and deposits in China are not priced against the interbank rates. Instead, Chinese banks price their loans and deposits to the PBOC decided benchmark rates, which shields them from the volatility of the interbank market. Hence, we believe that even if the 3M SHIBOR continues to stay at an elevated level for a sustained period of time, its impact on banks' fundamental earnings is expected to be minimal, if any.

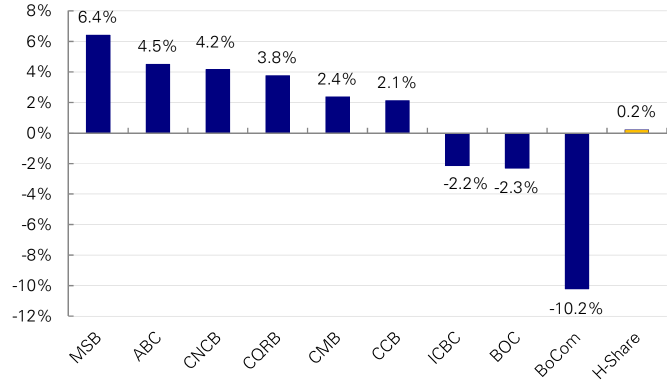
Also, as Chinese banks have to adhere to the 75% LDR cap imposed by the CBRC, it ensures sufficient liquidity for the banking system to finance its assets. As such, the H-share listed banks have little reliance on the interbank market to fund themselves, with gross interbank liabilities accounting for 12.2% of the average interest bearing liabilities (AIBL). Among the H-share listed banks, CCB (7.7% of AIBL), ABC (8.7%) and ICBC (10.7%) have the lowest interbank borrowing from the interbank markets, whereas MSB is the most exposed (28.5%). On a net exposure perspective, net lending makes up just 0.2% of their average interest yielding assets (AIYA).

Figure 4: Interbank liabilities as % of average interest yielding liabilities



Source: Deutsche Bank, company data

Figure 5: Net exposure as % of average interest yielding assets (1Q13)

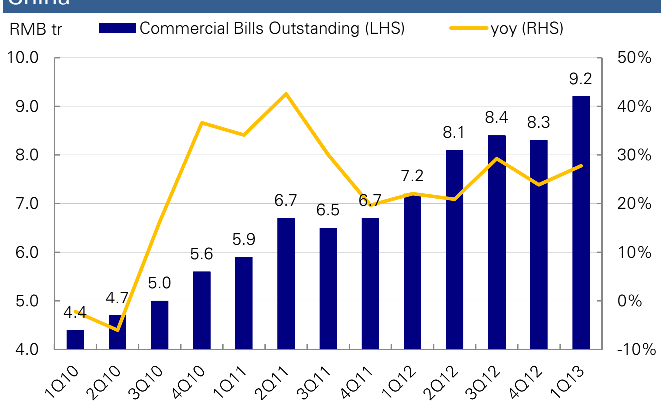


Source: Deutsche Bank, company data

In addition, there is no direction transmission mechanism between China's interbank rates and the borrowing cost prevalent in the shadow banking system, except for the commercial papers issued by the corporations and bank acceptance, which we estimate to account for approximately 15% of the total social financing and 10.9% of the total assets of the banking sector. According to WIND, the outstanding amount of commercial papers amounted to RMB9.2tr as of March 2013 (Figure 6) and we estimate the size of bank acceptance to be RMB6.2tr.

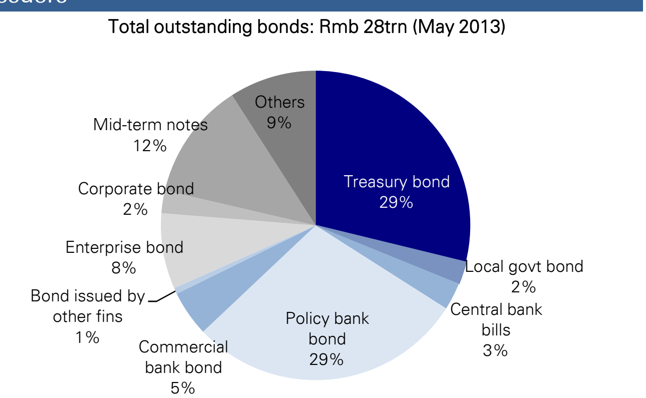
Assuming that the average borrowing cost for corporates in China is around 7% (100bps above the 1-year benchmark rates) and the spikes in SHIBOR cause a rise in short-term financing cost of 1.5% for both commercial papers and bank acceptance for the full year, we estimate the corporates need to pay 23bps more in interest payment for their financing. This suggests that the default risks should not materially rise and the banks' asset quality should remain fairly stable in the absence of a major deterioration in the banking sector's liquidity.

Figure 6: Amount of commercial bills outstanding in China



Source: Deutsche Bank, WIND

Figure 7: Outstanding bonds categorized by different issuers



Source: Deutsche Bank, WIND, CEIC

Figure 8 shows the exposure of the H-share listed banks to bank acceptance as of end 2012, and using that data (9.4% of 2012 loans), we estimate the system exposure to be RMB6.2tr.

Figure 8:H-share banks: bank acceptance total and as % of loans, deposits, tier 1 capital and RWA

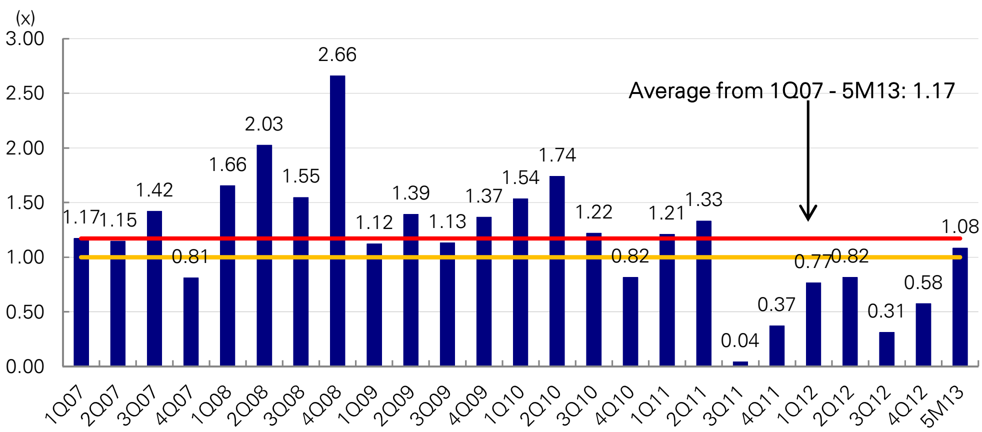
2012 (RMB m)	ICBC	CCB	ABC	BOC	BoCom	CMB	CNCB	MSB	CRCB	H-Share
Bank Acceptance Total	341,033	344,848	397,311	396,460	517,946	301,399	666,007	586,654	4,667	3,556,325
Bank acceptance as % of										
Total Deposit	2.5%	3.0%	3.7%	4.3%	13.9%	11.9%	29.5%	30.5%	1.6%	6.4%
Total Loan	3.9%	4.6%	6.2%	5.8%	17.6%	15.8%	40.1%	42.4%	2.7%	9.4%
Total Tier 1 Capital	32.6%	39.4%	56.7%	49.9%	141.6%	170.8%	339.7%	357.1%	15.2%	81.8%
RWA	3.6%	4.5%	5.5%	5.5%	16.0%	14.5%	34.2%	29.0%	1.9%	8.6%

Source: Deutsche Bank, company data

System liquidity is abundant, despite the 'dodgy' export data

As the deposit generation data shows, after six consecutive quarters of tight sector liquidity, 2013 has seen a change for the better, with the improving corporate cash flow situation driving up the deposit generation rate to 1.08 for the first 5 months of this year.

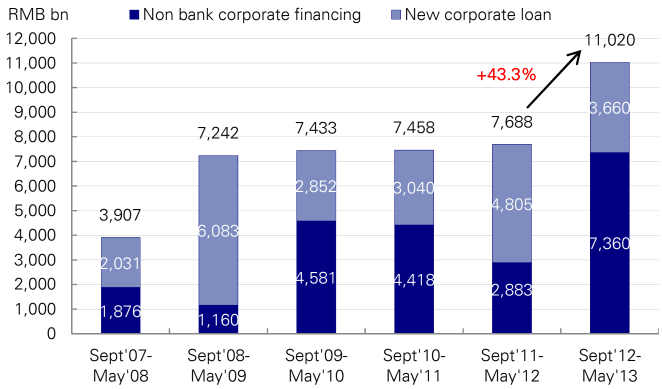
Figure 9: China adjusted DGR: increase in average deposit balance as a ratio of new loans



Source: Deutsche Bank, CEIC

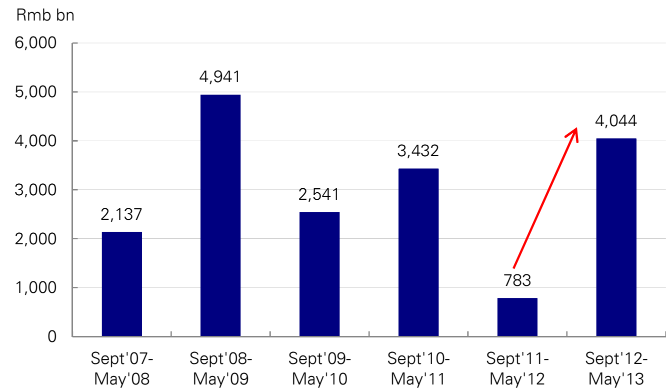
From September 2012 onwards, more than RMB11tr of new corporate financing has been issued in China, with RMB7.4tr coming from non-bank corporate financing and RMB3.7tr in new corporate loans. This has translated into a notable improvement in cash flow for the corporate sector, as evidenced by the RMB4.04tr of new deposits generated by them. This convinces us that the liquidity is no longer a constraint for growth in China.

Figure 10: Breakdown of total corporate financing for the months of September to May



Source: Deutsche Bank, CEIC

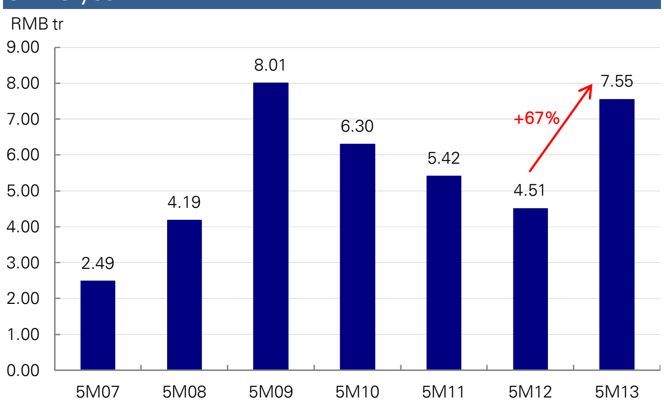
Figure 11: Improving corporate cash flow for the corporate sector, as evidenced by the increase in corporate deposits



Source: Deutsche Bank, CEIC

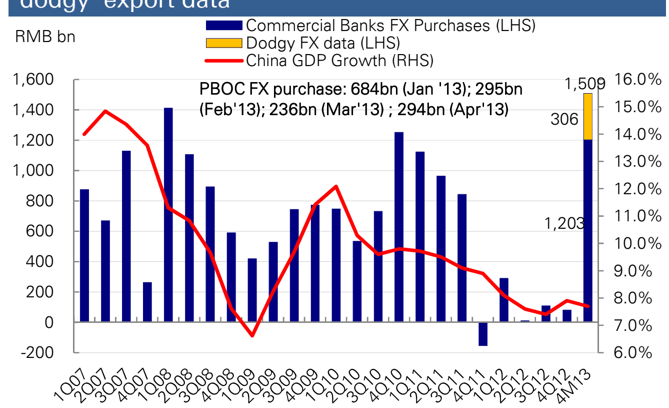
Driven by the very impressive turnaround in capital inflows this year, the deposits generated in the first 5 months of 2013 have been the highest recorded since the comparable period in 2009. Even if we adjust for the over-invoicing of export orders (equivalent to RMB306bn), the capital inflow in the first 5 months of the year was still more than RMB1tr, driving new deposit growth in the same period up by 67% yoy to RMB7.55tr. Hence, in the presence of ample liquidity in the banking system, we are not overly concerned about the sharp spikes in SHIBOR seen since 6 June 2013.

Figure 12: China deposits generated in the first 5 months of the year



Source: Deutsche Bank, CEIC

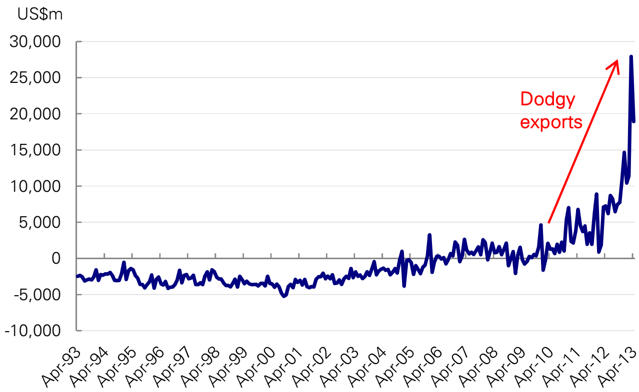
Figure 13: Chinese bank's FX purchases – adjusted for 'dodgy' export data



Source: Deutsche Bank, CEIC

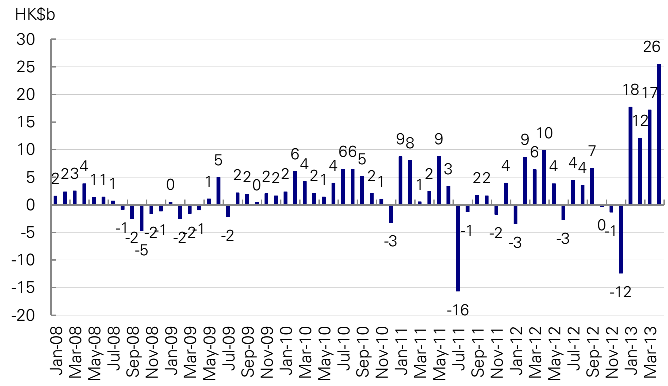
We calculate the 'dodgy' export data as the difference between the reported China exports to HK and HK imports from China since RMB began to appreciate, and find it to be US$50bn (or RMB306bn) for the period between November 2012 and April 2013, or 20% of the total capital inflows into China for the first 4 months of the year.

Figure 14: Difference between HK and China trade data (China exports to HK minus HK imports from China)



Source: Deutsche Bank, CEIC

Figure 15: Monthly change in trade finance for use outside Hong Kong



Source: Deutsche Bank, CEIC

Additionally, as Figure 15 shows, judging from the rise in trade finance for use outside Hong Kong during this period of time, we believe only US$9.3bn of these fake trade flows (or 18.6%) were financed by offshore borrowing in Hong Kong (with onshore guarantee), with the remainder being supported by repatriation of overseas funds of the mainland's offshore subsidiary firms. While the search for arbitrary profits arising from the gap between interest rates and FX differences between RMB and HKD/USD is an obvious reason for rising trade finance, we believe the underlying reason behind these activities could be the repatriation of funds that had left China prior to the leadership change in October 2012.

Paving the way for a gradual deregulation of interest rates

Our earnings forecast already accounts for a 25bps rate cut

Expecting a gradual deregulation of interest rates, our FY13 and FY14 earnings forecasts already incorporate the negative impact of a 25bps rate cut and a rise in the floating range of deposits to 1.2x (previous: 1.1x) the PBOC's benchmark rates. As Figure 16 shows, this would lead to regulatory loan/deposit spreads changing by only 0.6% to -1.3% for the term structure of 3 months to over 5 years.

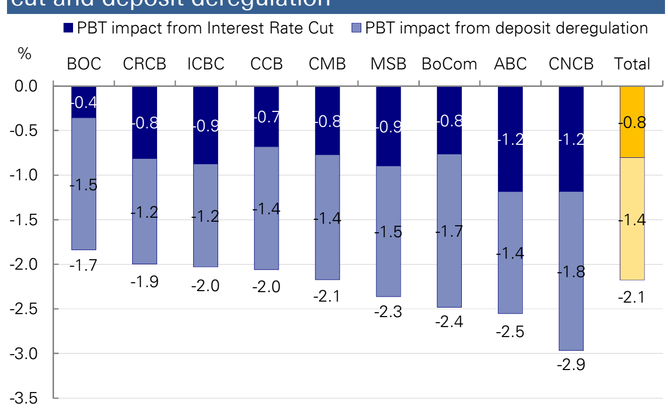
Figure 16: Term structure of interest rates and assuming a 25bps cut in the PBOC's benchmark rates

	Lending rates	Deposit rates	Lending rate post 25bps rate cut	Lending rates post 30% discount	Deposit rates at 20% premium	Regulatory spreads
Demand	5.60%	0.35%	5.35%	3.7%	0.42%	3.3%
3M	5.60%	2.60%	5.35%	3.7%	3.12%	0.6%
6M	5.60%	2.80%	5.35%	3.7%	3.36%	0.4%
1 Year	6.00%	3.00%	5.75%	4.0%	3.60%	0.4%
2 Year	6.15%	3.75%	5.90%	4.1%	4.50%	-0.4%
3 Year	6.15%	4.25%	5.90%	4.1%	5.10%	-1.0%
5 Year	6.40%	4.75%	6.15%	4.3%	5.70%	-1.4%
Over 5 Year	6.55%	4.75%	6.30%	4.4%	5.70%	-1.3%

Source: Deutsche Bank

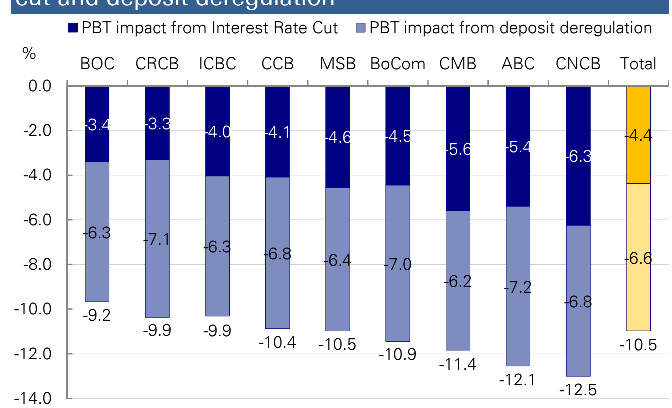
In Figures 17 and 18, we quantify the negative impact of the interest rate deregulation and 25bps rate cut to be 2.1% and 10.5% of our FY13 and FY14 NPAT forecasts. However, we think China is not ready to move away from the system of pricing loans and deposits in accordance with the PBOC's benchmark rates, given the high volatility in China's interbank rates.

Figure 17: Impact on 2013 PBT of a 25bps interest rate cut and deposit deregulation



Source: Deutsche Bank estimates

Figure 18: Impact on 2014 PBT of a 25bps interest rate cut and deposit deregulation



Source: Deutsche Bank estimates

Valuation and risks

Valuation of Chinese Banks

We value Chinese banks based on an ex-growth valuation (2018 onwards), computed using a three-stage Gordon Growth Model (PV= (ROE-g)/(COE-g)). Our ex-growth prices assume zero growth in book value from 2018 in perpetuity, and our target price calculations are based on 2013E book values.

On our estimates, H-share listed Chinese banks are trading at a 2013E P/B of 0.9x and 2013E P/E of 5.0x, offering 58% and 50% potential upside assuming the sector trends back to its average historical valuation of 1.4x P/B and 7.4x P/E (2009-12).

Our top picks are the big four Chinese banks and the key downside risk to our view is that the banking sector's improving liquidity driven by capital inflows proves to be a necessary but insufficient condition for China's economy to recover.

Our valuation assumes a near-term (2013-15E) ROE of 13%-19%, medium-term (2016-18E) ROE of 12-16%, and terminal ROE of 9-12%, with COE of 11-12%.

Figure 19 highlights our valuation comparisons for listed banks.

Figure 19: Chinese banks' valuation summary

	Ticker	Rating	TP	Price	Upside	Mkt. Cap	P/E (x)			P/B (x)		P/PPOP		ROAE		ROAA		Div. Yield (%)	
					(%)	(US$mn)	12A	13E	14E	13E	14E	13E	14E	13E	14E	13E	14E	13E	14E
ICBC-H	1398.HK	Buy	6.80	4.62	47.2%	51,704	5.4	5.1	5.4	1.0	0.9	3.4	3.4	20.7%	17.1%	1.35%	1.14%	5.89%	5.51%
CCB-H	0939.HK	Buy	7.45	5.19	43.5%	160,888	5.4	5.0	5.6	0.9	0.8	3.3	3.4	20.1%	16.1%	1.39%	1.14%	5.97%	5.39%
ABC-H	1288.HK	Buy	4.49	3.08	45.8%	12,208	5.5	5.0	5.6	0.9	0.8	3.1	3.0	19.4%	15.1%	1.18%	0.94%	5.99%	5.25%
BOC-H	3988.HK	Buy	4.28	3.07	39.4%	33,102	4.9	4.8	4.7	0.7	0.7	3.1	2.9	15.7%	14.4%	0.99%	0.92%	6.18%	5.91%
BCOM-H	3328.HK	Buy	6.90	5.22	32.2%	23,565	5.3	5.1	4.7	0.7	0.7	3.2	2.8	15.1%	13.8%	1.08%	0.99%	5.94%	5.99%
CMB-H	3968.HK	Buy	18.97	13.16	44.1%	6,636	5.0	5.6	6.1	1.0	0.9	3.6	3.6	20.7%	15.5%	1.36%	1.12%	3.95%	3.62%
CITIC Bank-H	0998.HK	Buy	5.65	3.64	55.2%	6,985	4.4	4.1	3.6	0.6	0.5	2.4	2.2	15.4%	15.6%	1.04%	1.07%	5.55%	6.37%
Minsheng-H	1988.HK	Hold	9.82	7.85	25.1%	5,848	4.8	4.3	4.3	0.9	0.8	2.6	2.6	23.0%	19.2%	1.20%	1.07%	5.31%	5.21%
CRCB	3618.HK	Buy	5.00	3.37	48.4%	1,092	4.7	4.2	4.8	0.7	0.6	3.6	3.4	17.2%	13.7%	1.25%	0.97%	7.07%	6.23%
H-share sector mean							**5.3**	**5.0**	**5.3**	**0.9**	**0.8**	**3.3**	**3.2**	**19.3%**	**15.9%**	**1.29%**	**1.09%**	**5.92%**	**5.49%**

Note: Closing price of Jun 21, 2013

Source: Deutsche Bank, Bloomberg Finance LP

In Figure 20 we highlight the valuation methodology used to derive our target prices for the listed banks under our coverage.

Figure 20: Valuation methodology of Chinese banks

	ICBC	CCB	ABC	BOC	BoCom	CMB	CNCB	MSB	CRCB
Stage 1 (2013E-2015E)									
ROE	19%	18%	19%	15%	13%	18%	15%	19%	15%
Growth	13%	12%	13%	11%	10%	14%	11%	15%	11%
COE	11%	11%	11%	11%	11%	11%	11%	11%	12%
Payout ratio	30%	30%	30%	30%	20%	20%	25%	20%	30%
Stage 2 (2016E-2018E)									
ROE	16%	15%	14%	12%	12%	14%	13%	13%	12%
Growth	11%	9%	9%	6%	8%	10%	9%	10%	7%
COE	11%	11%	11%	11%	11%	11%	11%	11%	12%
Payout ratio	30%	35%	30%	50%	30%	30%	30%	25%	45%
Terminal stage									
ROE	11%	11%	11%	10%	10%	12%	9%	10%	11%
Growth	5%	4%	4%	4%	5%	5%	4%	4%	4%
COE	11%	11%	11%	11%	11%	11%	11%	11%	12%
Payout ratio	60%	60%	60%	60%	50%	60%	60%	60%	65%
Target P/B	1.5	1.4	1.4	1.1	1.0	1.5	1.0	1.1	1.0
Estimated value (HK$)	6.80	7.45	4.49	4.28	6.90	18.97	5.65	9.82	5.00
Upside implied from current price	49%	45%	45%	39%	30%	43%	54%	22%	47%
Current price (HK$)	4.57	5.15	3.09	3.08	5.32	13.28	3.68	8.02	3.39

Source: Deutsche Bank estimates; Closing price as at June 20, 2013.

Key risks for Chinese banks

Sector risks

- Downside risks: 1) improving DGR proves unsustainable; 2) consensus earnings downgrades on the back of: a) the policy move by the PBOC, b) asset quality deterioration on weaker-than-expected economic growth, and c) slowing loan growth in 2013.
- Upside risks: 1) strong and coordinated global policy easing; 2) larger-than-expected stimulus package in China; and 3) a more relaxed policy on capital and provisioning.

Additional company-specific risks

- **ICBC** – Key downside risks: rising competition that undermines its number one market position. Overseas M&A is also a key risk.
- **CCB** – Downside risks are more intense competition for mortgage loan pricing and higher-than-expected operating cost growth, resulting in negative jaws. In addition, CCB is vulnerable to sector risks such as asset quality deterioration and policy risks translating into lower spreads, and higher provisioning and capital requirements.
- **ABC** – Key downside risks: factors leading to slower economic growth in the country areas and asset quality deterioration.
- **BOC** – Key downside risks: we believe BOC is vulnerable to slower export growth, a slower-than-expected rate of RMB internationalization, and M&A.
- **BOCOM** – Key downside risks: we believe BoCom is most vulnerable to renewed market concerns over inflation or any other factors that could lead to a meaningful rise in China's interbank rates, given its disproportionately large exposure to interbank liabilities.

- **CMB** – Key downside risks: equity-raising overhang; asset quality deterioration. Key upside risks: slower-than-expected margin compression; RRR cut; and improvements in operating efficiency.
- **CNCB** – Key downside risks: greater-than-expected increase in deposit costs negatively affecting the bank's NIM given its relatively poor retail franchise; and one-off provisions to meet the gross loan coverage ratio of 2.5%.
- **Minsheng** – Key downside risks: MSB is vulnerable to credit and economic risks and any policy changes that could result in lower loan pricing and service charges for SMEs, given its loan mix. Other risks include policy risks, deteriorating asset quality, and asymmetric rate cuts. Key upside risk: better-than-expected asset quality in SME business.
- **CRCB** – Key downside risks: a high concentration in Chongqing, making the bank vulnerable to natural disasters and the regional economic slowdown, and making it hard for it to deploy capital more efficiently in other high-growth areas; execution risks; and earnings misses.

Appendix 1

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Equity rating key

Buy: Based on a current 12- month view of total share-holder return (TSR = percentage change in share price from current price to projected target price plus pro-jected dividend yield) , we recommend that investors buy the stock.
Sell: Based on a current 12-month view of total share-holder return, we recommend that investors sell the stock
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Notes:

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Buy: Expected total return (including dividends) of 10% or more over a 12-month period
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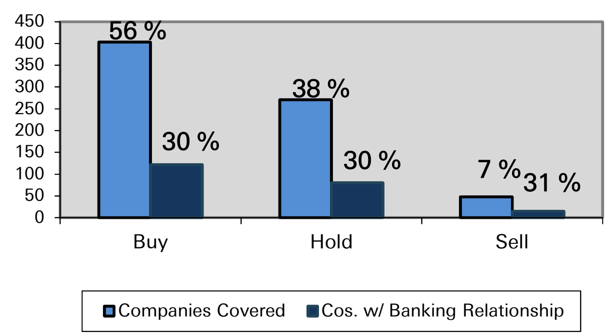
Sell: Expected total return (including dividends) of -10% or worse over a 12-month period

Equity rating dispersion and banking relationships



Asia-Pacific Universe

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David Folkerts-Landau
Global Head of Research

Marcel Cassard
Global Head
CB&S Research

Ralf Hoffmann & Bernhard Speyer
Co-Heads
DB Research

Guy Ashton
Chief Operating Officer
Research

Richard Smith
Associate Director
Equity Research

Asia-Pacific
Fergus Lynch
Regional Head

Germany
Andreas Neubauer
Regional Head

North America
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Regional Head

International locations

Deutsche Bank AG
Deutsche Bank Place
Level 16
Corner of Hunter & Phillip Streets
Sydney, NSW 2000
Australia
Tel: (61) 2 8258 1234

Deutsche Bank AG
Große Gallusstraße 10-14
60272 Frankfurt am Main
Germany
Tel: (49) 69 910 00

Deutsche Bank AG
Filiale Hongkong
International Commerce Centre,
1 Austin Road West,Kowloon,
Hong Kong
Tel: (852) 2203 8888

Deutsche Securities Inc.
2-11-1 Nagatacho
Sanno Park Tower
Chiyoda-ku, Tokyo 100-6171
Japan
Tel: (81) 3 5156 6770

Deutsche Bank AG London
1 Great Winchester Street
London EC2N 2EQ
United Kingdom
Tel: (44) 20 7545 8000

Deutsche Bank Securities Inc.
60 Wall Street
New York, NY 10005
United States of America
Tel: (1) 212 250 2500

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