Deutsche Bank AG
Issuer Rating Report

Overview

We have downgraded Deutsche Bank AG's issuer rating from BBB+ to BBB and revised the Outlook to Stable from Negative. The senior preferred unsecured debt rating was lowered from BBB+ to BBB and the senior non-preferred unsecured debt rating from BBB to BBB-, both with a Stable Outlook.

Highlights

- The ratings downgrade of Deutsche Bank reflect our view that the road to successful business model recalibration and a return to sustainable profitability is still steep and fraught with uncertainties. Deutsche Bank's strategy as a global universal bank is increasingly under scrutiny, especially the US operations, which struggle to meet their costs and have suffered material reputational damage from a string of litigations and regulatory interventions.
- The investment bank remains the weak spot of the group. Like peers, the bank suffered from poor market conditions, but unlike peers the cost base has proven to be too high and rigid to absorb volatility. The cost of funding and collateral needs are likely to stay elevated for as long as profitability remains an issue.
- Although Deutsche Bank has been reducing costs in line with its Strategy 2020, the cost/income ratio has not improved due to the ongoing erosion of the revenue base, leaving the bank very little buffer to absorb the volatile investment banking revenues. Nevertheless, cost cutting has cut the losses and our stable outlook is based on the expectation that Deutsche Bank maintains a minimum level of recurring profits from here in line with management targets.
- The EUR 8bn rights issue in 2017 improved the bank's capital position. However, weak profitability and litigation costs over past two years has limited internal capital generation. In addition, while risk-based capital ratios are stable, the bank has yet to reach the incoming leverage ratio requirements.

Rating drivers (summary)

The rating drivers, in decreasing order of importance in the rating assignment, are:

- A challenged business model has a high cost base; new management team is tackling weaknesses, but at a relatively slow pace
- Prudent capital and liquidity ratios can only provide the bank with temporary stability to overhaul its business model. Increased reliance on MREL debt improves position of preferred creditors. AT1 interest cover constrained by lack of earnings power.
- Internal capital generation capacity remains clouded for the short and medium term due to uncertainties regarding litigation charges, reputational risk and asset valuations, though the loan quality of amortized cost book is very good.
- Previously resilient investment banking earnings are under pressure from general market shifts and heightened regulations. Commercial banking suffers from small market share, high cost and lack of growth. Asset management is exposed to a rapidly changing competitive environment.

Ratings & Outlook

Issuer rating	BBB
Outlook	Stable
Senior preferred debt rating	BBB
Senior non-preferred debt rating	BBB-
Tier 2 rating instruments	BB
Additional Tier 1 rating instruments	B-
Short-term debt rating	S-2

Lead Analyst
Dierk Brandenburg
d.brandenburg@scoperatings.com

Associate Analyst
Chaithra Vijaya Kumar
c.kumar@scoperatings.com

Team Leader
Dierk Brandenburg
d.brandenburg@scoperatings.com

Scope Ratings GmbH
Lennéstraße 5
10785 Berlin

Phone +49 30 27891 0
Fax +49 30 27891 100

info@scoperatings.com
www.scoperatings.com

Bloomberg: SCOP

Rating-change drivers

	Further restructuring of the retail banking franchise could provide efficiency and profitability gains in the medium to longer term, if revenues stabilize in the highly competitive, low-margin market.
	Decisive restructuring of the US operations of the investment bank and the asset management unit would resolve the key structural weaknesses of the global business model.
	Ongoing litigation and other regulatory disputes that negatively affect customer relations; higher-than-anticipated legal charges that undermine internal capital generation.
	Any further deterioration of the bank's profitability and a lack of progress in the areas of cost reduction and efficiency gains will put downward pressure on the bank's ratings and the viability of its global investment banking strategy.

Rating drivers (details)

Improved capitalisation can only provide the bank with temporary stability to overhaul its business model

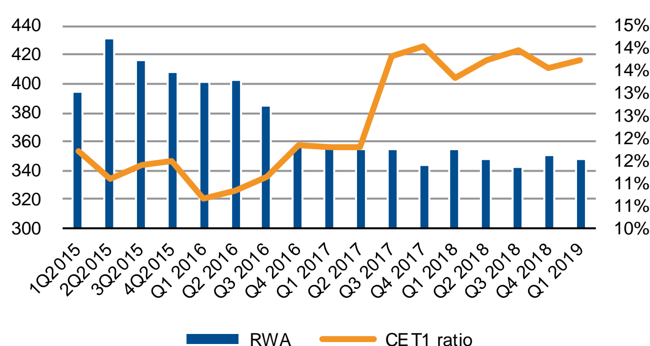
The CET1 ratio has improved since the EUR 8bn rights issue in 2017. However, the quarterly volatility of risk-weighted assets is high, and accounting and regulatory changes weigh on the outlook.

For Q1 2019, the bank reported a CET1 ratio of 13.7% compared to a minimum requirement of 11.8%. The latter includes a Pillar 2R requirement of 2.75% and a G-SIB buffer of 2%. The SREP requirement for total capital is 15.31%.

The reported ratio includes the effects of various accounting changes but not yet the full extent of the ECB's ongoing model review (TRIM), which is expected to reduce the ratio by around 20bps.

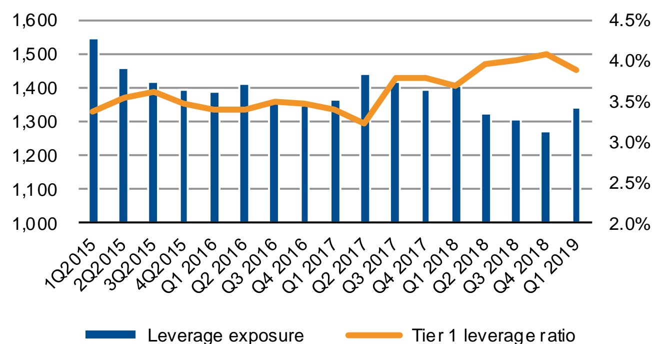
Unlike CET1, the bank's leverage ratio of 3.9% at the end of Q1 2019 remains either at or below the likely future minimum requirements of 4% from 2022. However, management is in negotiations to reduce its G-SIB classification under the FSB methodology, which is expected to lead to a slightly reduced minimum leverage ratio requirement in the future. Still, we consider the leverage ratio as a significant constraint on the business activity of the investment bank.

Figure 1: CET1 ratio



Source: Company data, Scope Ratings

Figure 2: Tier 1 leverage ratio



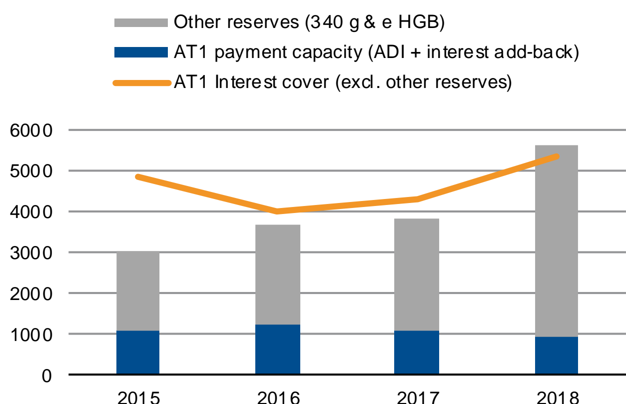
Source: Company data, Scope Ratings

AT1 Distributions constrained by lack of earnings power

Earnings per share has been negative in recent years, reflecting a negative net income as well as the deduction of annual AT1 coupon distributions from net profit. Nevertheless, Deutsche Bank continued to pay a modest dividend of EUR 0.11 per share (approx. EUR 231m) in 2018 compared to an earnings per share of EUR -0.01 after accounting for AT1 distributions of EUR 292m. For equity and AT1 distributions to be sustainable, net income will need to improve significantly from 2019.

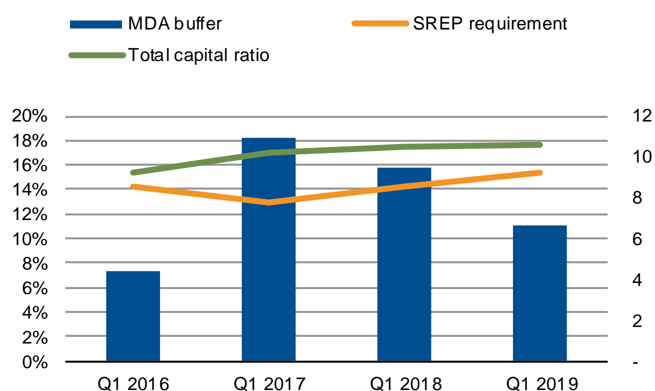
Available distributable reserves of the parent company have declined by EUR 317m to EUR 921m since 2016, though strengthened by the merger with Postbank, which added EUR 2bn of general reserves (340g) to the AT1 dividend cover. Management expects this constraint to fall away under the EU's CRR2, which will widen the reserves available for distribution. Rising SREP requirements have also reduced the MDA buffer since 2016, though at EUR 6.7bn this poses less of a constraint.

Figure 3: Available distributable reserves



Source: Company data, Scope Ratings

Figure 4: MDA buffer



Source: Company data, Scope Ratings

ISIN	Currency	Issue amount	Coupon %	Issue date	Next call date	Conversion type	Trigger %	Scope rating
XS1071551474	USD	1,250,000,000	6.25	5/27/2014	4/30/2020	Temporary write down	5.125	B-
DE000DB7XHP3	EUR	1,750,000,000	6	5/27/2014	4/30/2022	Temporary write down	5.125	B-
XS1071551391	GBP	650,000,000	7.125	5/27/2014	4/30/2026	Temporary write down	5.125	B-
US251525AN16	USD	1,500,000,000	7.5	11/21/2014	4/30/2025	Temporary write down	5.125	B-

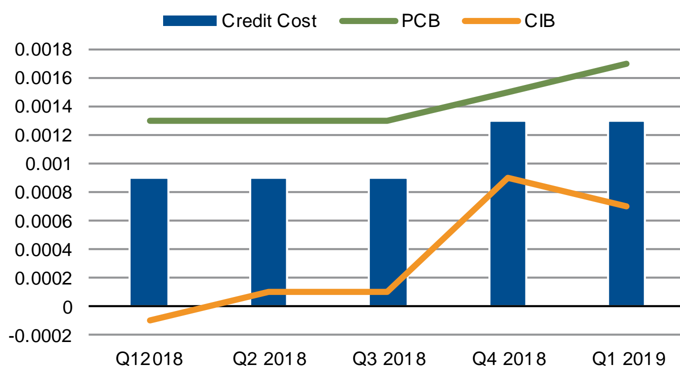
Internal capital generation capacity remains clouded for the short and medium term due to uncertainties regarding litigation charges, reputational risk and asset valuations, though the loan quality of amortized cost book is very good

Under the new forward-looking loan-loss accounting framework (IFRS 9), Deutsche Bank was required to set aside more provisions during 2018, especially at the corporate and investment bank.

Even so, credit costs are low overall at 13bps, and reserve coverage (44%) of the EUR 10bn NPL book (2.3% of stage 3 loans) is adequate. The loan book remains high quality with its large proportion of German retail mortgages.

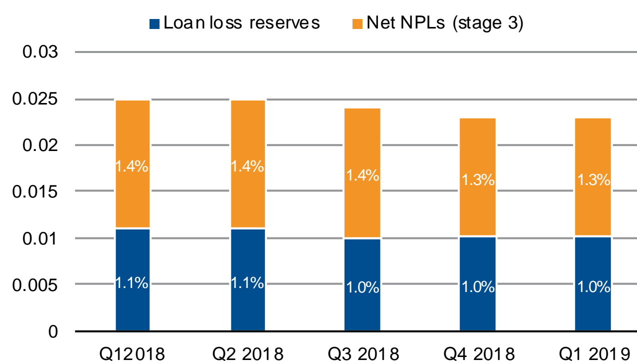
The legacy exposures of the investment bank, which include trading assets, fell by 37% since Q1 2018 to EUR 22bn if measured by leverage exposure, or by 30% in terms of risk-weighted assets (EUR 7bn), through a combination of asset sales (shipping), derivative maturities and compression trades. These changes were not matched, however, by a corresponding fall in Level 3 assets under IFRS, which remained constant at EUR 25bn over the period (~50% of tangible equity). While not of immediate concern, they pose a threat to the capital base in case of severe market stress.

Figure 5: Credit costs



Source: Company data, Scope Ratings

Figure 6: Non-performing loans



Source: Company data, Scope Ratings

Litigation risk

After settling an enormous amount of litigation over the past couple of years, litigation reserves were down to EUR 1.2bn at the end of the year compared to contingent liabilities of EUR 2.7bn. Compared to previous years, 2018 proved to be relatively quiet for litigation.

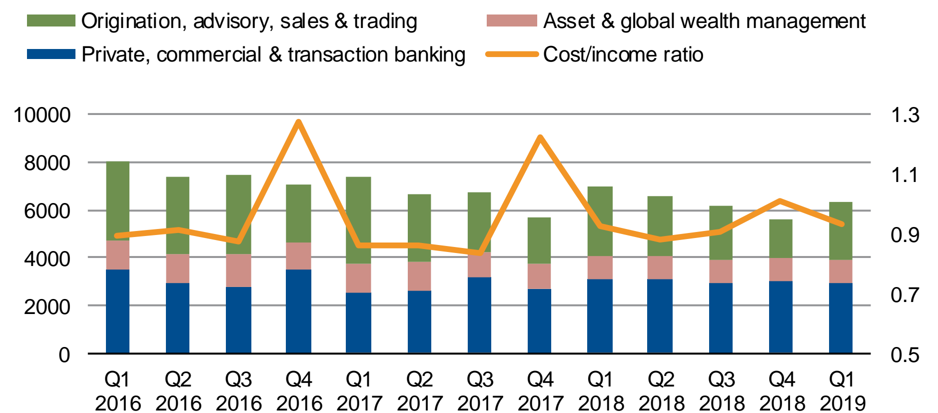
Not included are the recent developments in the Danske Bank case, where Deutsche acted as US clearer for USD 150bn of payments until 2015 that could be linked to Russian money laundering or tax evasion. It is still unclear whether any of the payments were due to poor controls at Deutsche Bank or indeed linked to individuals on the US sanctions list. The US has not brought any formal charges so far. Previously, Deutsche had already settled with US and UK authorities for USD 630m with regards to USD 10bn of assets linked to Russian clients. The bank has yet to settle with the US Department of Justice, however. Amount & timing of such settlement is difficult to assess, not at least in view of Deutsche Bank ties with politically exposed persons in the US.

In addition, the bank's Virgin Island operations (900 clients with EUR 311m of transactions between 2013 and 2018) were exposed as part of the Panama Papers leak. This led to a probe into several employees in the wealth management division, culminating into a highly publicised raid by 170 prosecutors and tax inspectors on the bank's Frankfurt headquarters in December 2018. Separately, German financial supervisor BaFin had already ordered Deutsche Bank to undergo a three-year external monitoring programme to improve its KYC process and prevent further money laundering.

Earnings: A challenged business model has a high cost base; new management team is tackling weaknesses, but at a relatively slow pace

Deutsche Bank achieved its cost-cutting goal in 2018 and took out more than EUR 4bn of costs over the past three years while spending EUR 1.2bn on restructuring. However, the group's underlying revenues fell by a similar amount, causing the cost/income ratio to stagnate above 90%, which is too high to absorb the volatility of the investment bank. Poor market conditions at the end of 2018 therefore led once again to a quarterly pre-tax loss of EUR 319m, though profitability recovered modestly to EUR 292m in Q1 2019. To stabilise earnings, Deutsche Bank would need a much lower cost base relative to earnings and/or a much wider revenue base to absorb the volatility of its investment bank. Having rejected a merger with Commerzbank as too risky, management has very limited room to manoeuvre other than to reduce costs further.

Figure 7: Net revenues and Cost/income ratio



Source: Company information

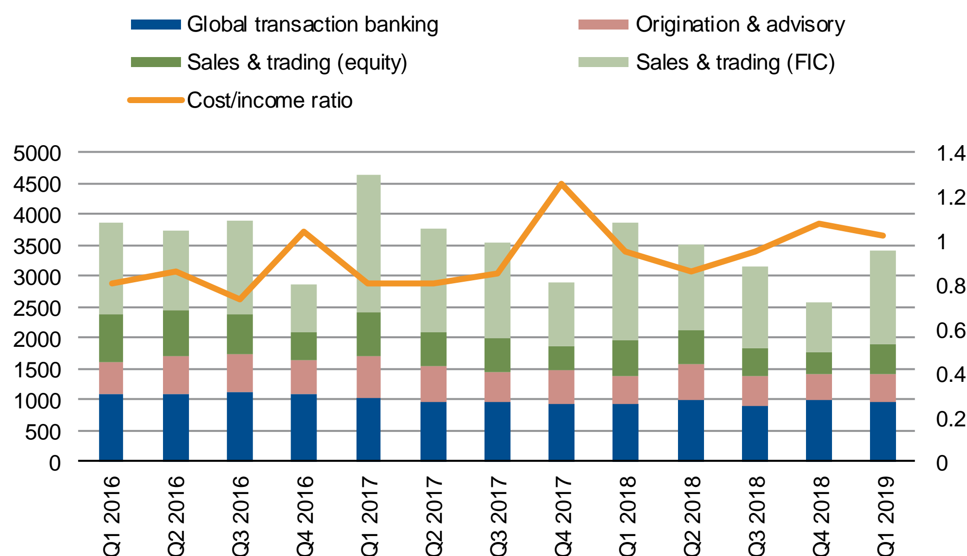
Previously resilient investment banking earnings are under pressure from general market shifts and heightened regulations

The annual pre-tax profit of the investment bank has halved every year since 2016. This decline is understated, however, because the stable and profitable transaction bank is reported as part of the CIB profit line. Based on allocated costs – thus, including liquidity and funding costs – the division reported losses in Q4 2018 and Q1 2019.

Part of the problem can be traced to the bank's weak position in the US and in equities, where management so far has made only minor adjustments to the cost base and may be forced to cut back further. However, following abandoned merger talks, Commerzbank management reiterated its intention to maintain a significant global footprint in investment banking.

Having failed its last CCAR, the US business had to resubmit a new capital plan to the Fed this year and needs to improve its risk management processes. The bank may fail the test again in 2019, thus forcing management to commit more liquidity and capital to an already under-performing US business.

Figure 8: CIB quarterly revenues vs costs



Source: Company data, Scope Ratings

Asset management is exposed to a rapidly changing competitive environment

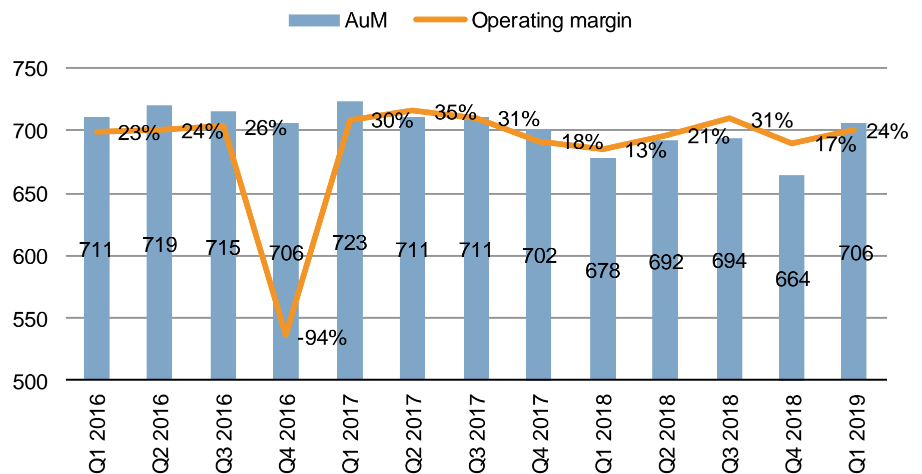
Following its IPO, DWS (77.5% owned after the IPO) suffered in terms of volume, flows and margins. This is partly a result of poor market conditions as well as home-made cost problems and a weak product mix. While asset management is an important diversifier for Deutsche Bank, the business is currently subscale in a rapidly consolidating market.

Deutsche Asset Management suffered four consecutive quarters of net outflows in 2018 (EUR -23bn in total). This trend only came to halt in Q1 2019 when the bank had net inflows of EUR 2bn, or EUR 7bn if movements out of low-margin cash products are excluded (8% of AuM). Deutsche attributes the flows to a turnaround in its US business (EUR +2bn net) and the increased use of strategic partnerships (EUR +3bn gross). The margin declined by 1bps year-over-year to 30bps in Q1 2018.

Together with market movements, this led to a recovery in AuM, from a low of EUR 664bn at the end of 2018 to EUR 706bn at the end of Q1 2019. Nevertheless, lower margins meant that DWS revenues declined by 4% compared to Q1 2018. While the cost/income ratio came down by 11pp to 76%, it remains above the 70% mid-term target.

Most of the outflows at DWS during 2018 can be traced to its US business (particularly in institutional fixed income), which represents more than a quarter of AuM, but should also be seen against the backdrop of the very difficult operating environment faced by the entire industry. While Deutsche Bank is keen to retain control over the business in view of revenue diversification, further industry consolidation is inevitable and will require M&A at some point in the future.

Figure 9: Assets under management and operating margin

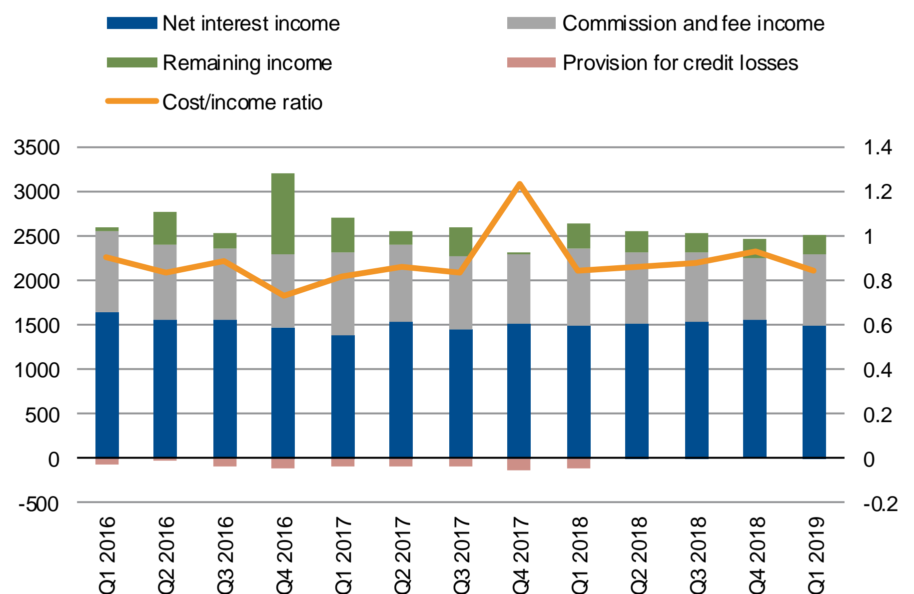


Source: Company data, Scope Ratings

Commercial banking: Small market share & high cost limits profitability and growth

The German retail and commercial businesses continue to suffer from a very low margin environment and strong competition in the corporate market. Revenues have been flat in recent years and restructuring has been slow, particularly regarding the integration of Postbank. The reported cost/income ratio in Q1 2019 was 84%, which is high by German and European standards. Further, costly restructuring is required, but it remains questionable whether Deutsche Bank can improve its position in a fiercely competitive market where foreign players and new technologies are making significant inroads. The fact that management has effectively ruled out in-market consolidation with a domestic rival such as Commerzbank further limits the options to improve profitability.

Figure 10: Private and commercial banking – revenues and cost/income ratio



Source: Company data

Achieving a stable minimum level of profitability is key to outlook

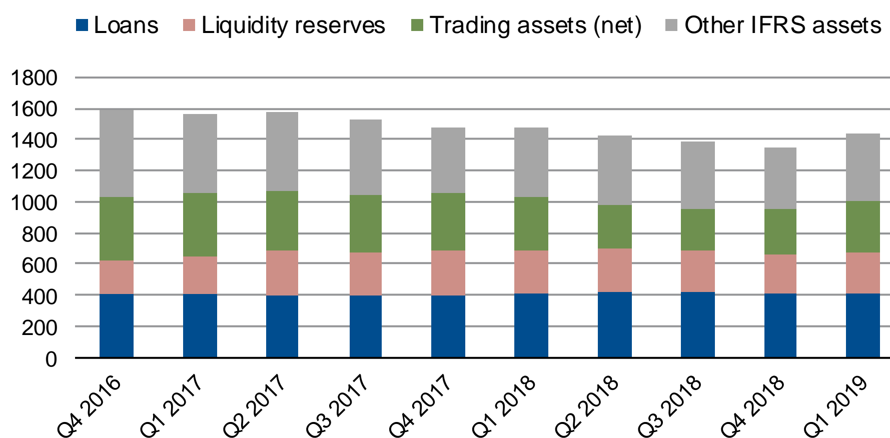
Following the EUR 409m net loss in Q4 2018, Deutsche Bank is guiding towards a recovery in profits in 2019, to which the first quarter has so far contributed EUR 201m. The Q1 improvement mainly reflects cost-cutting (EUR -400m compared to the same quarter in 2018), though revenues declined by a similar amount.

Management's key target this year is to reduce costs by a further EUR 600m, bringing down the cost base to EUR 21.8bn (-4.4% lower than in 2018). Together with a more aggressive reinvestment policy for excess liquidity, which is expected to add EUR 300m in revenues, management expects to achieve a ROTE of between 3%-4% by 2019, depending on market conditions. For comparison, the ROTE was 0.5% in 2018 and 1.1% in Q1 2019. A 3%-4% ROE target implies attributable net income of between EUR 1.5bn-2bn in 2019

Prudent liquidity management provided the bank with stability during a period of stress but management seeks to alleviate the cost of excess liquidity

Deutsche Bank's balance sheet contracted during 2018, as management reigned in costs and repositioned the business while high-profile investigations concerning alleged tax avoidance and money laundering put pressure on the bank's reputation. During the year to September 2018, trading assets fell by EUR 101bn to EUR 270bn (net) as Deutsche cut unsecured wholesale funding by EUR 41bn and repo and trading liabilities by EUR 44bn. Trading assets rebounded strongly in Q1 2019 to EUR 331bn (net); however, this was due to larger settlement balances. The fall in trading was partly compensated for by the loan book, which grew by EUR 27bn in the 12 months to September 2018 to EUR 423bn before falling back to EUR 415bn at the end of Q1 2019.

Figure 11: Quarterly balance sheet



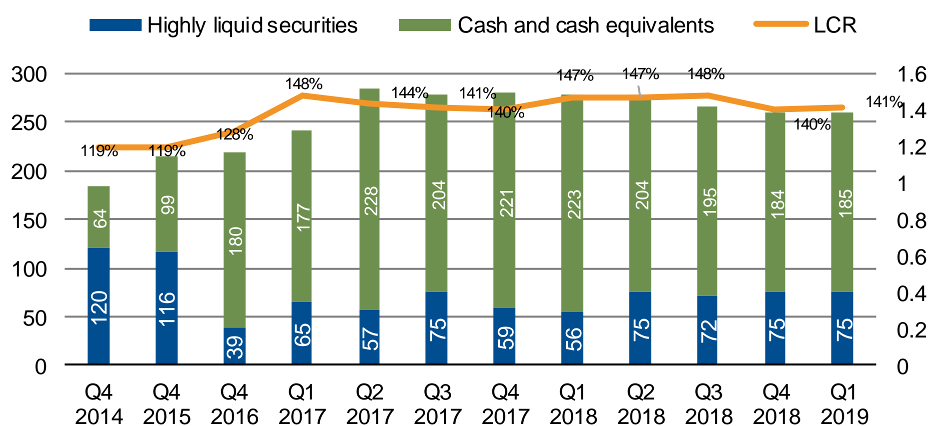
Source:Company data

Despite the stress on the balance sheet liquidity remained stable. From the beginning of 2018, Deutsche Bank's liquidity reserve fell by EUR 20bn to EUR 260bn, though the liquidity ratio at the parent company remained stable at 141%. Cash holdings dropped by EUR 26bn during the same period to EUR 185bn as the bank reallocated EUR 19bn assets out of cash into HQLA bond holdings and bought back its own debt to avoid penalty rates at the ECB. Management expects to raise EUR 300m of extra revenues from this policy in 2019.

On the downside, at least EUR 5bn-6bn of the EUR 23bn TLTRO assets will have to be refinanced by covered bonds unless the ECB offers an attractive replacement this year.

While liquidity is strong compared to global peer levels, the bank needs above-average buffers in view of its lower profitability and headline risk.

Figure 12: Liquidity position

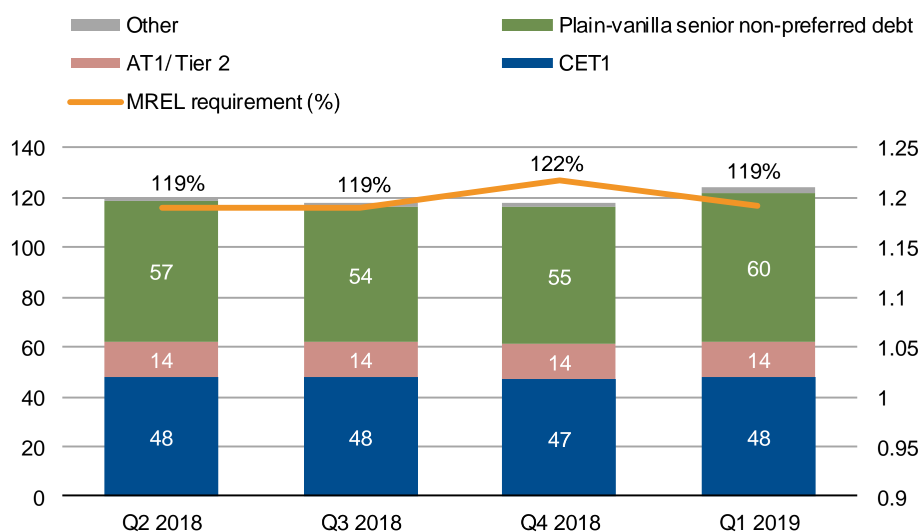


Source: Company data, Scope Ratings

Increased reliance on MREL improves the position of preferred creditors

Deutsche Bank's MREL requirement has been set by the SRB at 9.14% of total liabilities and own funds, or 29.27% of risk-weighted assets based on the 2016 balance sheet. At the end of March 2019, Deutsche Bank had an excess of EUR 19bn, including EUR 7bn of liabilities issued under UK law (at end 2018) that may no longer qualify as bail-in debt in case of Brexit.

Figure 13: MREL requirement



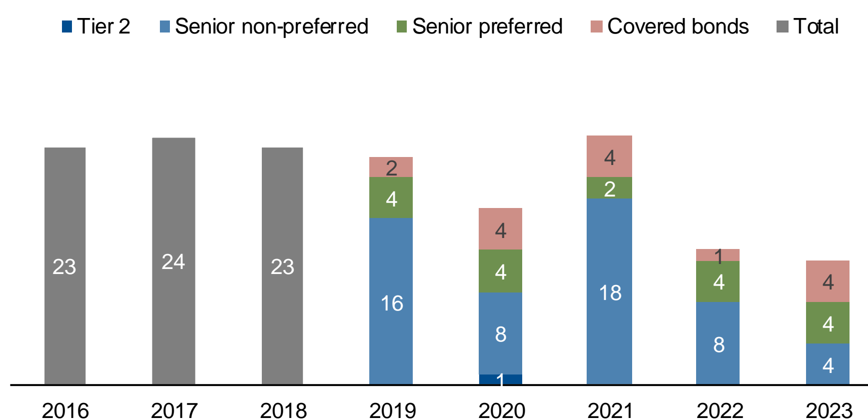
Source: Company data, Scope Ratings

Deutsche Bank plans to refinance only EUR 9bn-11bn of its EUR 16bn maturing senior non-preferred debt in 2019, thus shrinking its MREL base slightly, though this is more than enough to replace the EUR 8bn of MREL debt due in 2020 and is therefore disqualified already this year. The bank has issued EUR 6bn in Q1 2019 already. Management considers a strong MREL buffer as part of a wider capital management

exercise that seeks to optimise overall funding and hedging costs for its senior preferred and derivative liabilities.

At the same time, in response to elevated funding costs, the bank halved its senior preferred issuance to EUR 3bn-4bn in 2019, while covered bond issuance (EUR 3bn-4bn) will be mainly a function of TLTRO refinancing. The combined net effect of the funding plan will shrink Deutsche Bank's debt footprint in 2019, as only EUR 15bn-20bn will be refinanced out of EUR 22bn maturities (excluding TLTRO). This barbell strategy with a high emphasis on MREL debt at the expense of preferred liabilities should be beneficial to overall funding costs.

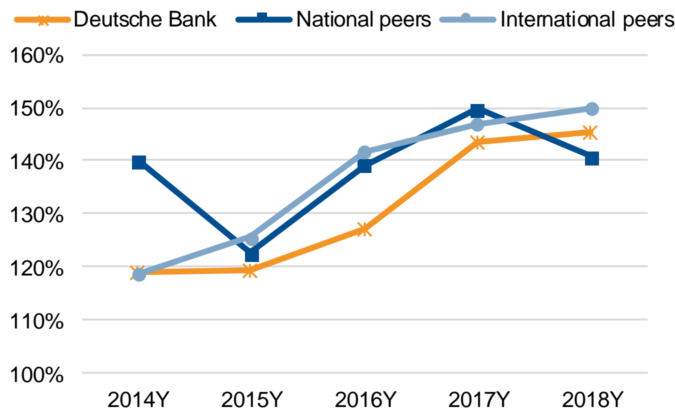
Figure 14: Maturity profile



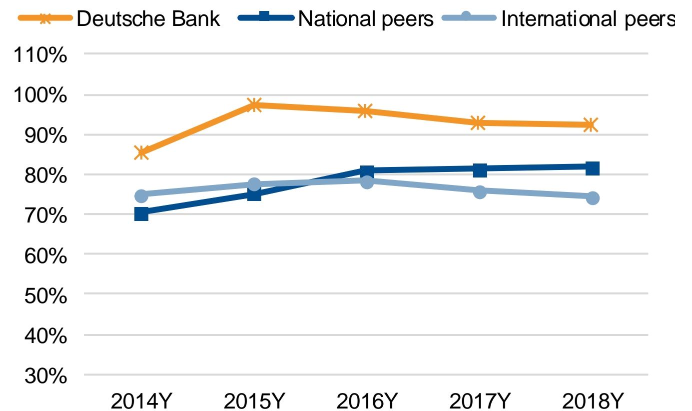
Source: Company information

I. Appendix: Peer comparison

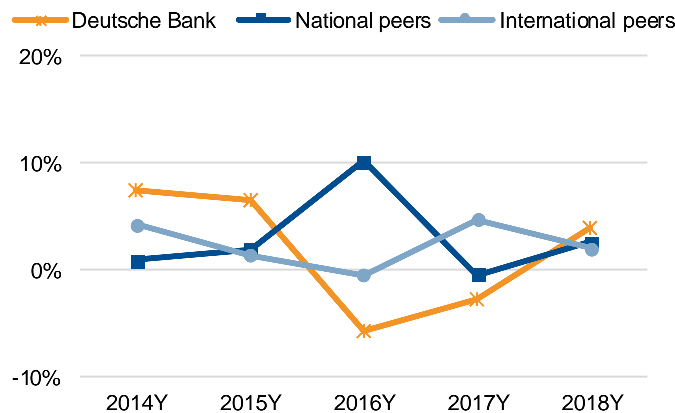
Liquidity coverage ratio



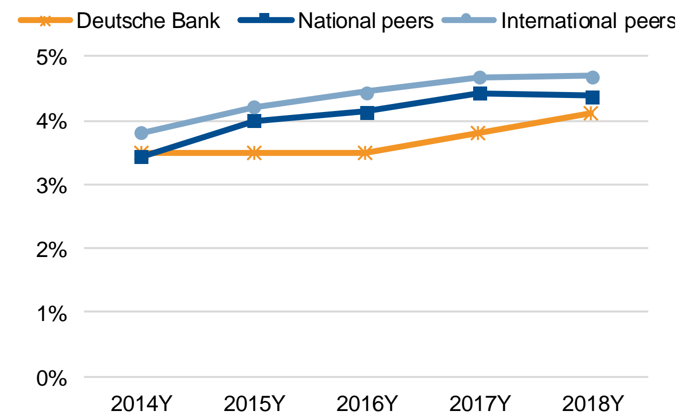
Cost/income ratio



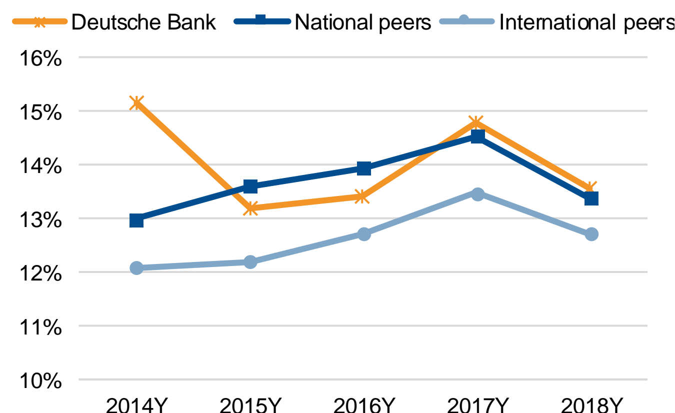
Net loans growth (%)



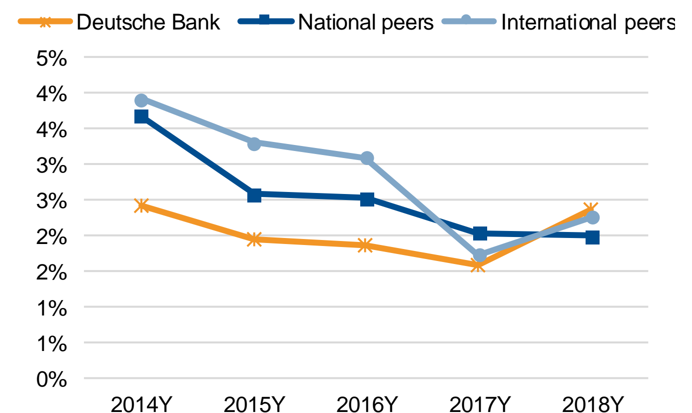
Leverage ratio (%)



CET1 ratio (%)



Problem loans/ Gross customer loans (%)



Source: SNL, Scope Ratings

*National peers: Commerzbank, Deutsche Bank, DZ Bank.

**International peers: BNP Paribas, Societe Generale, Deutsche Bank, UBS, Credit Suisse, Barclays, HSBC.

II. Appendix: Selected financial information – Deutsche Bank AG

	2014Y	2015Y	2016Y	2017Y	2018Y
Balance sheet summary (EUR m)					
Assets					
Cash and interbank assets	106,631	123,965	206,246	247,758	204,217
Total securities	1,020,363	922,603	819,640	701,030	609,878
of which, derivatives	634,361	518,730	488,666	364,185	323,086
Net loans to customers	417,444	444,577	419,090	407,225	422,986
Other assets	164,265	137,985	145,570	118,719	111,056
Total assets	**1,708,703**	**1,629,130**	**1,590,546**	**1,474,732**	**1,348,137**
Liabilities					
Interbank liabilities	108,350	119,065	NA	98,041	81,980
Senior debt	266,785	285,026	324,690	326,254	278,813
Derivatives	615,265	500,441	468,451	344,020	303,409
Deposits from customers	424,584	447,909	NA	483,832	482,425
Subordinated debt	16,965	14,845	14,135	13,590	10,312
Other liabilities	NA	NA	NA	NA	NA
Total liabilities	**1,635,481**	**1,561,506**	**1,525,727**	**1,406,633**	**1,279,400**
Ordinary equity	68,351	62,678	59,833	63,174	62,495
Equity hybrids	4,619	4,675	4,669	4,675	4,675
Minority interests	253	270	316	250	1,568
Total liabilities and equity	**1,708,703**	**1,629,130**	**1,590,546**	**1,474,732**	**1,348,137**
Core tier 1/Common equity tier 1 capital	60,103	52,429	47,782	50,808	47,486
Income statement summary (EUR m)					
Net interest income	14,272	15,881	14,707	12,378	13,192
Net fee & commission income	12,409	12,765	11,744	11,002	10,039
Net trading income	3,239	3,478	744	2,852	1,148
Other income	1,789	1,250	1,632	252	935
Operating income	**31,709**	**33,374**	**28,827**	**26,484**	**25,314**
Operating expense	27,079	32,417	27,659	24,612	23,409
Pre-provision income	**4,630**	**957**	**1,168**	**1,872**	**1,905**
Credit and other financial impairments	1,183	1,062	1,425	562	525
Other impairments	331	5,994	1,409	82	51
Non-recurring items	NA	NA	0	0	0
Pre-tax profit	**3,116**	**-6,097**	**-810**	**1,228**	**1,330**
Discontinued operations	0	0	0	0	0
Other after-tax Items	0	0	0	0	0
Income tax expense	1,425	675	546	1,963	989
Net profit attributable to minority interests	28	21	45	15	75
Net profit attributable to parent	**1,663**	**-6,794**	**-1,402**	**-751**	**267**

Source: SNL

III. Appendix: Ratios – Deutsche Bank AG

	2014Y	2015Y	2016Y	2017Y	2018Y
Funding and liquidity					
Net loans/deposits (%)	90.1%	92.3%	NA	NA	NA
Liquidity coverage ratio (%)	119.0%	119.3%	127.2%	143.6%	140.0%
Net stable funding ratio (%)	NA	NA	NA	NA	NA
Asset mix, quality and growth					
Net loans/assets (%)	24.4%	27.3%	26.3%	27.6%	NA
NPLs/net loans (%)	2.9%	2.4%	2.3%	2.1%	NA
Loan-loss reserves/NPLs (%)	46.6%	51.1%	50.4%	48.4%	NA
Net loan growth (%)	7.4%	6.5%	-5.7%	-2.8%	NA
NPLs/tangible equity and reserves (%)	17.6%	15.7%	14.9%	12.8%	NA
Asset growth (%)	6.0%	-4.7%	-2.4%	-7.3%	-8.6%
Earnings and profitability					
Net interest margin (%)	1.0%	1.0%	1.0%	0.9%	NA
Net interest income/average RWAs (%)	3.7%	3.8%	3.8%	3.5%	3.8%
Net interest income/operating income (%)	45.0%	47.6%	51.0%	46.8%	52.1%
Net fees & commissions/operating income (%)	39.1%	38.2%	40.7%	41.6%	39.7%
Cost/income ratio (%)	85.4%	97.1%	95.9%	93.1%	92.7%
Operating expenses/average RWAs (%)	7.1%	7.8%	7.1%	7.0%	6.7%
Pre-impairment operating profit/average RWAs (%)	1.2%	0.2%	0.3%	0.5%	0.5%
Impairment on financial assets /pre-impairment income (%)	25.6%	111.0%	122.0%	28.6%	28.3%
Loan-loss provision charges/net loans (%)	0.3%	0.2%	0.3%	0.1%	0.1%
Pre-tax profit/average RWAs (%)	0.8%	-1.5%	-0.2%	0.3%	0.4%
Return on average assets (%)	0.1%	-0.4%	-0.1%	0.0%	0.0%
Return on average RWAs (%)	0.4%	-1.6%	-0.3%	-0.2%	0.1%
Return on average equity (%)	2.6%	-9.2%	-2.0%	-1.1%	NA
Capital and risk protection					
Common equity tier 1 ratio (%, fully loaded)	11.7%	11.1%	11.8%	14.0%	13.6%
Common equity tier 1 ratio (%, transitional)	15.2%	13.2%	13.4%	14.8%	13.6%
Tier 1 capital ratio (%, transitional)	16.1%	14.7%	15.6%	16.8%	15.7%
Total capital ratio (%, transitional)	17.2%	16.2%	17.4%	18.6%	17.5%
Leverage ratio (%)	3.5%	3.5%	3.5%	3.8%	4.1%
Asset risk intensity (RWAs/total assets, %)	23.2%	24.4%	22.4%	23.3%	26.0%
Market indicators					
Price/book (x)	0.6x	0.6x	0.5x	0.6x	0.3x
Price/tangible book (x)	0.6x	NA	NA	NA	NA
Dividend payout ratio (%)	57.3%	NA	NA	NA	NA

Source: SNL

Scope Ratings GmbH

Headquarters Berlin

Lennéstraße 5
D-10785 Berlin

Phone +49 30 27891 0

Frankfurt am Main

Neue Mainzer Straße 66-68
D-60311 Frankfurt am Main

Phone +49 69 66 77 389 0

Paris

33 rue La Fayette
F-75008 Paris

Phone +33 1 8288 5557

London

Suite 301
2 Angel Square
London EC1V 1NY

Phone +44 20 3457 0444

Madrid

Paseo de la Castellana 95
Edificio Torre Europa
E-28046 Madrid

Phone +34 914 186 973

Milan

Via Paleocapa 7
IT-20121 Milan

Phone +39 02 30315 814

Oslo

Haakon VII's gate 6
N-0161 Oslo

Phone +47 21 62 31 42

info@scoperatings.com
www.scoperatings.com

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Scope Ratings GmbH, Lennéstraße 5, 10785 Berlin, District Court for Berlin (Charlottenburg) HRB 192993 B, Managing Directors: Torsten Hinrichs, Guillaume Jolivet.