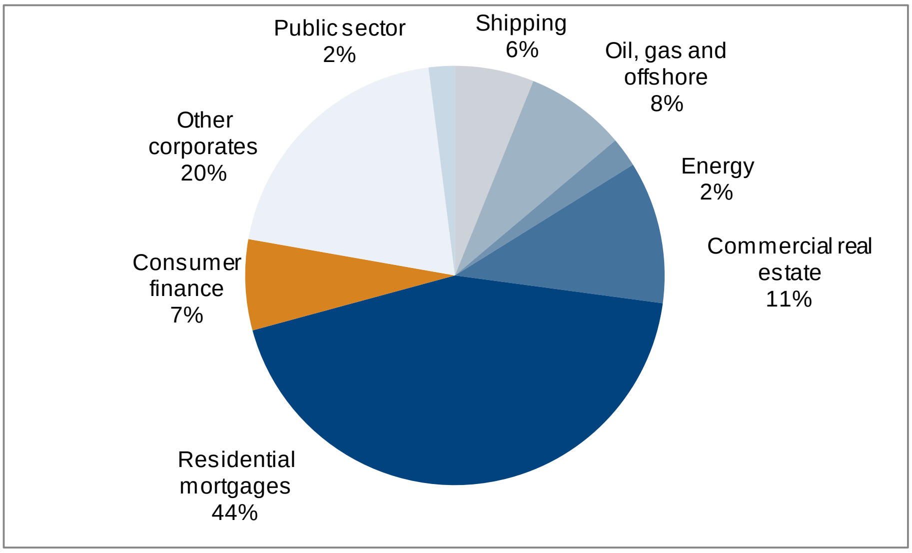
DNB Bank: Oil-Related and Shipping Exposures Appear Manageable

Expected impairments of up to NOK 18bn in 2016-2018 appear manageable in light of DNB's strong earnings generation. Scope notes, however, that were actual impairments significantly higher it would be more challenging for the group to achieve and maintain its c.15.5% CET1 ratio target. DNB's long- and short-term ratings are A+ and S-1, respectively, both with Stable Outlook.

As of end-June 2016, the shipping, oil, gas and offshore, and energy sectors accounted for NOK 313bn in exposure at default (EAD) (16% of total). These sectors are included in the group's Shipping, Offshore and Logistics (SOL) (NOK 192bn EAD) and Energy (NOK 135bn EAD) divisions.

Figure 1: Exposure at default (EAD) by customer segment as of 30 June 2016



Note: Total EAD of NOK 1,939bn.
Source: Company data, Scope Ratings

The offshore sector (NOK 56bn EAD), which is part of the SOL portfolio, accounts for the bulk of the negative migration in credit quality. Other sectors such as dry bulk and containers appear to be somewhat less impacted by the market environment. DNB has been provisioning for these two sectors over the last eight quarters and expects them to stabilise.

Oil-related portfolio accounts for 8% of group EAD

DNB has identified a NOK 151bn oil-related portfolio, which includes the offshore sector. In addition to offshore, the portfolio includes the oil and gas (NOK 66bn EAD) and oilfield services (NOK 28bn EAD) sectors. Within the oil-related portfolio, 36% is considered investment grade, 27% in the BB category, 28% in the B category and below and 10% non-performing and doubtful.

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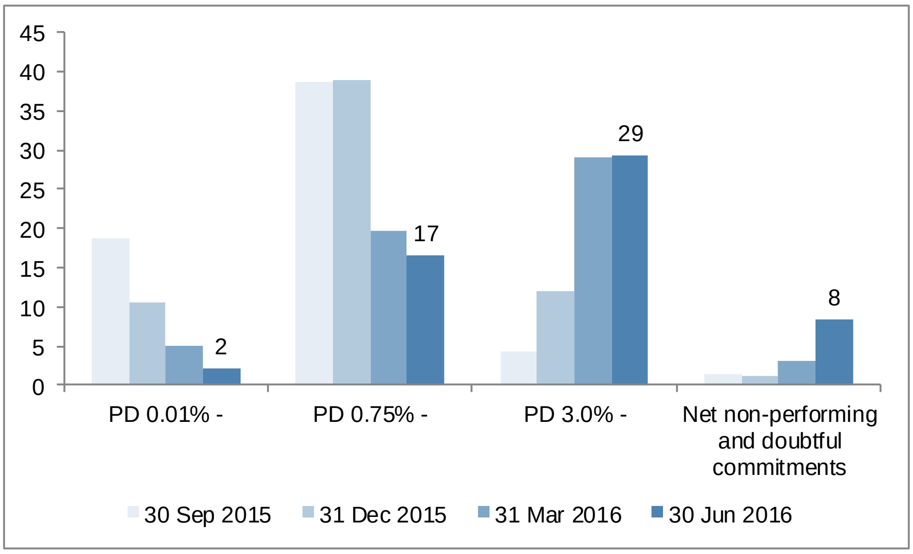
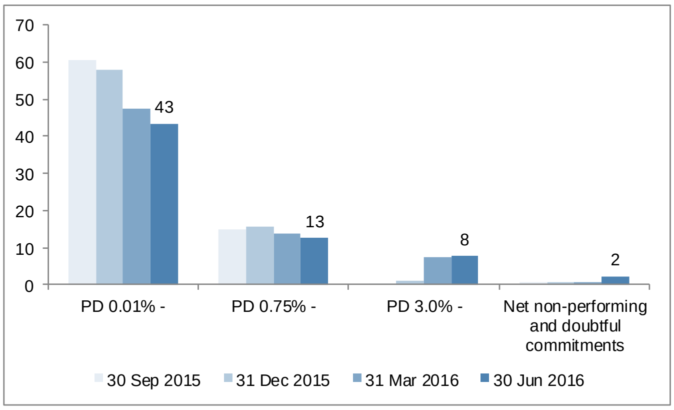
Figure 2: Offshore sector migration (NOK 56bn EAD)



Source: Company data, Scope Ratings

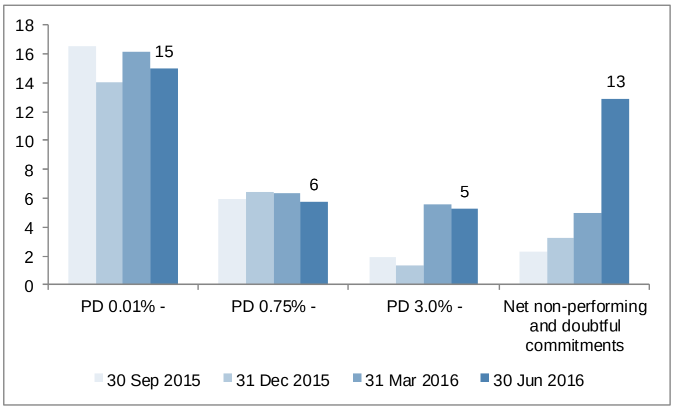
Figure 3: Migration of other oil-related sectors

Oil & gas sector (NOK 66bn EAD)



Source: Company data, Scope Ratings

Oilfield services sector (NOK 28bn EAD)



Source: Company data, Scope Ratings

Management perspectives

The improvement in oil prices is seen as supportive for energy clients like upstream companies, with most coping well in a USD 50 environment. As well, DNB's economists foresee further recovery in oil prices, towards the USD 65 level. However, the offshore sector is expected to remain difficult through 2018 and possibly into 2019-2020.

Management is well aware that the offshore sector is a cyclical industry driven by oil prices, E&P spending and new vessel capacity. There continues to be less demand and excess supply in the sector. For the market to improve, higher oil prices are probably not sufficient; part of the fleet will need to be removed and oil companies need to adjust to lower offshore oil field development costs. It remains difficult to gauge recovery values as there have been few restructurings.

DNB considers itself to be a long-term financier and financial adviser to the industry. In difficult conditions, the group's approach is to proactively work with clients to find "balanced solutions" with all stakeholders participating. This may involve the waiver of covenants, the injection of new equity, asset sales and the restructuring of debt.

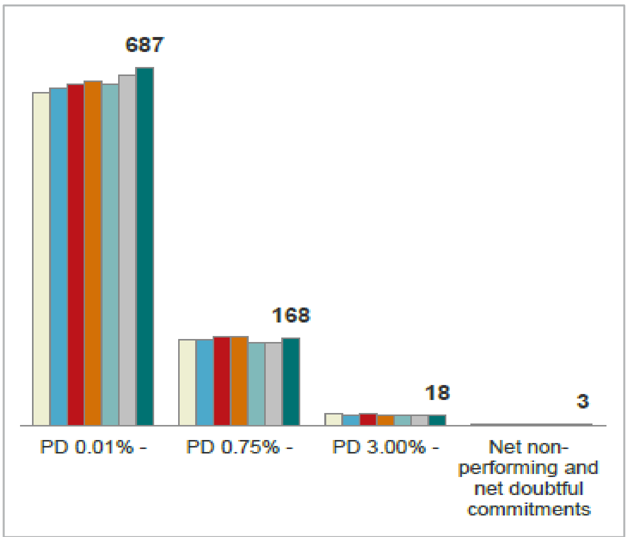
Overall asset quality remains reassuring

Except for the oil-related portfolio, the asset quality of DNB's loan book remains reassuring. As of end-June 2016, the net non-performing and net doubtful loan and guarantees ratio was 1.19%, up from a five-year low of 0.76% at year-end 2015. For the oil-related portfolio, cumulative collective and individual impairment losses totalled approximately NOK 3.1bn or 3.8% of the total drawn amount.

Group net non-performing loans and doubtful loans and guarantees amounted to NOK 20.7bn with a provision ratio of nearly 43%. Over the coming quarters, management has communicated that the provision level is likely to increase. Including collateral, the coverage ratio was nearly 105%.

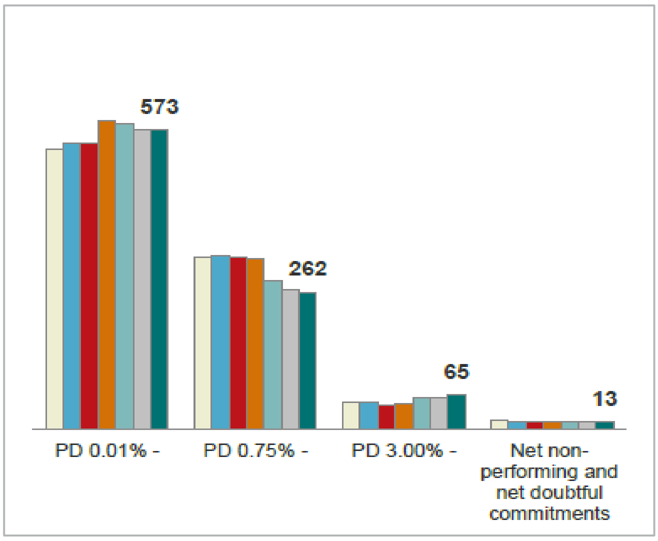
Figure 4: Credit migration from 31 Dec 2014 to 30 June 2016

Personal customers



Source: Company data

Corporate customers excl. oil-related portfolio



Source: Company data

While the fall of oil prices began in autumn 2014, DNB's loan portfolio was mostly unaffected until 2Q 2016. Management remains positive about the credit quality of personal and corporate customers, excluding those related to oil. The weaker NOK bolsters the mainland economy and the government have resources to provide further support if needed. The group's economists expect mainland GDP growth to be less than 1% this year but to gradually recover to just over 2% in 2019. Meanwhile, unemployment is expected to reach levels of around 5% during this period, up from 4.4% as of year-end 2015.

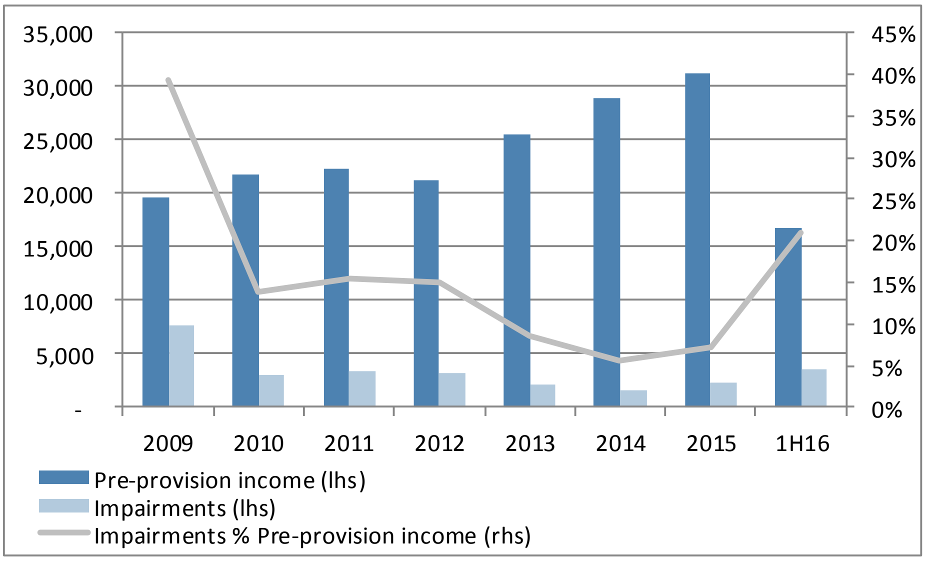
Of the NOK 2.3bn of impairments in 2Q 2016, nearly 70% was related to the offshore sector with the remainder for the shipping sector. DNB reiterated the guidance provided in 1Q 2016; losses in 2016 to 2018 are estimated to be up to NOK 18bn. There had been some uncertainty about the timing but now management believes that more of the losses will be frontloaded in 2016 and maybe the beginning of 2017. Impairments are expected to be over NOK 6bn in 2016.

For the most challenged segments of the offshore sector, offshore supply vessels and rigs (NOK 41bn EAD), the group's own stress tests indicate maximum potential impairments of around NOK 8bn for these two segments through 2019.

The level of expected impairments can be comfortably covered by the group's strong earnings. We note, however, that if actual impairments were significantly higher it would be more challenging for the group to achieve and maintain its around 15.5% CET1 ratio target.

For 1H 2016, DNB reported a profit of NOK 9.8bn, supported by loan growth and higher volume-weighted interest rate spreads. The group's capital metrics remain solid with a CET1 capital ratio under Basel 1 transitional rules of 15.2% and a leverage ratio of 6.8%.

Figure 5: Pre-provision income and impairments (NOK bn)



Source: Company data, Scope Ratings

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