

## HSH Nordbank

Full steam ahead

- **We reiterate our Overweight recommendation on HSH Nordbank Lower Tier 2 as ‘must pay’ instruments with a hard final maturity.** The significant deleveraging over the past three years has reduced the risk profile of the HSH and we continue to see strong support for the bank by both state (83% shareholder) and federal governments (€46bn grandfathered liabilities at YE 2010).
- **We see value in HSH’s Tier I instruments given the expected resumption of coupon payments and full de-recognition of these instruments by 2021.** We note management’s expectations of resuming coupon payments on the silent participations by June 2013, based on 2011 and 2012 profits. This would be the best case scenario and assumes no further disruptions to the global economy. We note that even in alternative scenarios the Tier I instruments still offer good value at 51/53 (RESPARC II 7.5% €12P 51/53 COB 15.06.11) and assuming coupon resumption in June 2014, the Tier I’s would offer an attractive yield to perp of 11.5% and yield to 2021 of 13.6%, with the added option of early resumption of coupon payments and/or earlier redemption or tendering.
- **Guidance from management with regards to the amount of profit required under German GAAP accounting to resume coupon payments on HSH’s Tier I instruments was €700m.** This comprised €480m in write-ups, €50m in accumulated coupons and €170m of full coupons for the June 2013 payment. We view the reduction of guarantee expenses and reversal of loan loss provisions as they key to generating sufficient profits in order to resume silent participation coupon payments.
- **In our opinion key risks for HSH Nordbank remain within its shipping portfolio and more specifically the dry-bulk and tanker sectors.** The overhang of supply in 2011 & 2012 is likely to weigh on the dry-bulk sector thus providing headwinds to the loan credit quality.
- An initial ruling from the European Commission (EC) is expected by management at the end July, at the earliest with a potential extension resulting in a full decision at the end of September. **We expect that the EC will note the return to profitability as well as the reduction in the level of outstanding guarantees in their final decision.**

### Financials Credit Research

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*With this note, lead coverage of HSH Nordbank transfers to Alan Bowe*

Table 1: HSH Nordbank Lower Tier II instruments

ISIN	Issuer	Coupon	Call Date	Maturity	Amt	Ccy	Sub	Price	YTM	YTC
DE000HSH2H23	HSB NORDBANK AG	FRN	14/02/2012	14/02/2017	1,000m	EUR	LT2	68.5/69.5	Z+761	Z+5914
DE000HSH2H15	HSB NORDBANK AG	4.375	14/02/2012	14/02/2017	750m	EUR	LT2	70/71	11.0%	66.4%

Source: J.P. Morgan estimates, Company data. Prices as of COB 15.06.11

### See page 11 for analyst certification and important disclosures.

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## Subordinated Valuations

**We note that the amount of grandfathered liabilities, “Anstaltslast”, amounted to €46bn at YE 2010 which continue to benefit from a state guarantee and HSH is a continued participant in the Landesbank cross guarantee scheme.**

**We reiterate our Overweight recommendation on HSH Nordbank Lower Tier 2 as ‘must pay’ instruments with a hard final maturity.** The significant deleveraging over the past three years has helped to reduce the risk profile of the HSH and we continue to see strong support for HSH Nordbank by both state and federal governments.

In our opinion HSH Nordbank has undertaken a material deleveraging of its business with a reduction of €69bn (-33%) in assets since 2008. The pickup in global growth and continued demand for commodities throughout 2010 has meant that HSH’s shipping portfolio has been under less pressure and the rate of loan loss provisions have tended to normalise.

**Table 2: HSH Nordbank Lower Tier II instruments**

ISIN	Issuer	Coupon	Call Date	Maturity	Amt	Ccy	Sub	Price	YTM	YTC
DE000HSH2H23	HSH NORDBANK AG	FRN	14/02/2012	14/02/2017	1,000m	EUR	LT2	68.5/69.5	Z+761	Z+5914
DE000HSH2H15	HSH NORDBANK AG	4.375	14/02/2012	14/02/2017	750m	EUR	LT2	70/71	11.0%	66.4%

Source: J.P. Morgan estimates, Company data. Prices as of COB 15.06.11

In this note we examine HSH’s Tier I instruments and the different scenarios for the resumption of coupon payments. We note management expectations are that they will be able to resume servicing the silent participations by June 2013, based on 2011 and 2012 profits. However, we would point out, this assumption is the best case scenario and assumes no further disruptions to the global economy. We note however that this is the best case scenario, with the Tier I instruments still offering good value trading at 51/53 (RESPARC II 7.5% €12P 51/53 COB 15.06.11). Assuming the resumption of coupons in June 2014, the Tier I’s offer an attractive yield to perp of 11.5% and yield to 2021 of 13.6%, with the added optionality of early resumption of coupon payments as well as early call or liability management at a premium to secondary market values.

**Table 3: HSH Nordbank Tier I debt instruments - Yields assuming Resumed coupon in June 2013**

ISIN	Name	Issuer	Coupon	Call Date	Amt	Ccy	Cash	YTP	YT 2021	BV
XS0221141400	SPHERE	HSH NORDBANK	7.25	30/09/11	500m	USD	51/53	11.4%	13.9%	79.4%
DE0009842542	RESPARC II	RESPARCS FUNDING II	7.50	30/06/12	500m	EUR	51/53	12.6%	15.2%	79.4%
XS0159207850	RESPARC I	RESPARCS FUNDING LP I	8.00	30/06/12	300m	USD	51/53	12.3%	14.3%	79.4%
XS0142391894	SPARC Pv Placement	HSH NORDBANK LUX-	7.4075	30/06/14	500m ~400m	EUR EUR	51/53	11.0%	14.5%	79.4%

Source: J.P. Morgan estimates, Company data. Prices as of COB 15.06.11

**Table 4: HSH Nordbank Tier I debt instruments - Yields assuming Resumed coupon in June 2014**

ISIN	Name	Issuer	Coupon	Call Date	Amt	Ccy	Cash	YTP	YT 2021	BV
XS0221141400	SPHERE	HSH NORDBANK	7.25	30/09/11	500m	USD	51/53	10.4%	12.5%	79.4%
DE0009842542	RESPARC II	RESPARCS FUNDING II	7.50	30/06/12	500m	EUR	51/53	11.5%	13.6%	79.4%
XS0159207850	RESPARC I	RESPARCS FUNDING LP I	8.00	30/06/12	300m	USD	51/53	11.2%	12.9%	79.4%
XS0142391894	SPARC Pv Placement	HSH NORDBANK LUX-	7.4075	30/06/14	500m ~400m	EUR EUR	51/53	9.9%	12.9%	79.4%

Source: J.P. Morgan estimates, Company data. Prices as of COB 15.06.11

### Redemption/Exchange by 2021

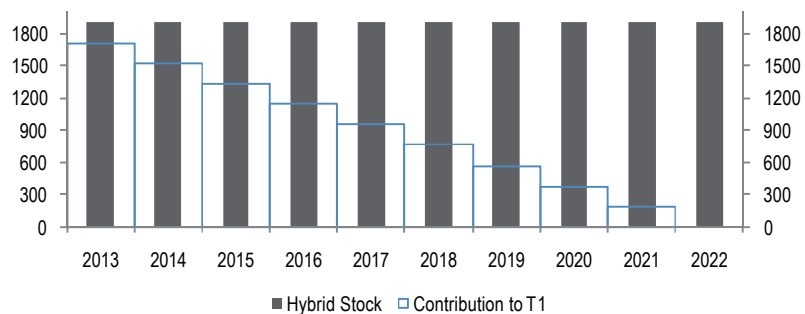
We note that under Basel III; capital instruments that do not meet the criteria for inclusion in Common Equity Tier I will be excluded from Common Equity Tier I as of 1st Jan 2013. However, instruments meeting the following three conditions will be phased out over grandfathering period from 2013-2021:

1. They are used by a non-joint stock company (i.e. issue voting common shares)
2. They are treated as equity under the prevailing accounting standards
3. They receive unlimited recognition as part of Tier I capital under current national banking law.

**Silent participations are expected to benefit from the entire grandfathering period up until 2021**

We believe the silent participations fall into this category and thus will amortise following the grandfathering rules using the full eight year benefit. We note HSH Nordbank would tend to take this view also, citing the investor presentation given on the 29.04.2011 page 10; “Basel III: Deduction of Silent Participations by 10% p.a. starting 2013.” Our view is that under these conditions, the issuer will be incentivised to either exchange the bonds into a Basel III compliant instrument, or if the economic conditions allow, call the instruments outright. As per the application of the amortization of the grandfathering threshold for the Tier I instruments, we note that these instruments will tend to be less efficient from a regulatory capital perspective.

Figure 1: HSH Nordbank: Tier I amortisation profile of silent participations under Basel III



Source: J.P. Morgan.

### Longer to the black under German GAAP

Before the HSH Tier I's can begin to pay coupon they must first generate enough profits to do the following:

1. Write the instruments up from their current book value of 79.41% to 100%
2. Generate sufficient profits to pay the accumulated coupons over the deferred period for a private placement participation of c.€400m
3. Generate sufficient profits to pay the coupons on all pari passu instruments in that current fiscal year

We note that management guided to amounts for each of these points in the Q1 2011 earnings conference call (26:13mins) suggesting a figure amounting to c€700m. This was made up of €480m in write-ups, €50m in accumulated coupons and €170m for full coupons for the June 2013 payment.

**Table 5: Break-down of profits required under German GAAP to resume full payments on Silent Participations**

€m	
Item	Amount required
Haircut Reversal	480
Payment of Accumulated coupons	50
Payment of Coupons due in June 2013	170
<b>Total required cumulative profit</b>	<b>700</b>

Source: HSH Q1 2011 Conference Call

**€400m private placement silent participation has cumulative coupon features that must be paid in order for coupons to be resumed on all publicly traded silent participations**

Although the public Tier I issues of HSH Nordbank are not cumulative, HSH Nordbank Investor Relations have guided towards a private placement of circa €400m which does have cumulative coupon features. We understand that this instrument has also been written down along with the four publicly traded silent participations and thus would be considered a pari passu instrument which must also be written up. Replenishment of the Silent Contributions will be made according to “Annual Balance Sheet Profits” as recorded in accordance with German GAAP on a pari passu basis after any profit participations have been written up. Due to the neutralization of the loss carry forward using HSH’s reserves this essentially amounts to the net income figure under German GAAP accounting.

**Table 6: Income statement of HSH Nordbank AG under German GAAP accounting**

€m				
	2008	2009	2010	
Net interest income	1,901	1,623	1,707	
Income from profit pooling	11	1	5	
Commission income	426	292	235	
Commission expenses	-133	-569	-582	
2nd Loss Guarantee	0	-364	-405	
Soffin Guarantee	0	-118	-114	
Other	0	-87	-63	
Net expenses from trading portfolio	-252	-55	-182	
Other operating income	126	120	188	
General administrative expenses	-801	-778	-784	
Depreciation, amortisation and impairments on fixed assets	-23	-18	-17	
Other operating expenses	-110	-45	-149	
<b>Operating result before risk provision/valuation</b>	<b>1,145</b>	<b>571</b>	<b>420</b>	
Risk provisions	-4,324	-2,189	-929	
Loans	-2,473	-1,997	-894	
Securities	-1,276	205	269	
Equity holdings	-575	-397	-304	
<b>Profit on ordinary activities</b>	<b>-3,179</b>	<b>-1,618</b>	<b>-509</b>	
Extraordinary income	0	49	153	
Extraordinary expenses	-164	-170	-383	
Income tax expenses	-101	364	416	
Income from the assumption of losses	351	559	104	
<b>Net income</b>	<b>-3092</b>	<b>-816</b>	<b>-218</b>	

Source: Company reports.

**Resumption of silent participation coupon is based on profits under German GAAP accounting, payments as soon as June 2013 is the best case scenario**

We note that the resumption of coupon payments in June 2013 is the best case scenario for investors with some moderate event risk from the asset quality headwinds from its shipping portfolio. Table 6 and Table 7 contrast the income statement of HSH Nordbank under German GAAP accounting and under IFRS. We note the difference of -€266m between the net income results for FY 2010. Hence whilst the IFRS results show a full year profit, the German GAAP results continue to show a

full year loss. Some of this differential can be partially explained by the balance sheet effects of the second loss guarantee in the IFRS income statement, producing a net gain during 2010. These balance sheet effects are expected to be unwound as loan loss provisions fall, under IFRS, below the €3.2m first loss piece, creating a negative P&L to reverse the previous gain in 2010.

We note the decreasing trend in operating result before risk provisioning. This is mainly driven by the deleveraging process in conjunction with explicit guarantee expenses causing a drag on profits. Management's intentions are to reduce the 2nd loss guarantee, with a reduction of €1bn during the first quarter and partial reduction during the second quarter having already taken place. We note the guarantee agreement stipulates that a maximum of €3bn can be cancelled per year up until the end of 2013.

**Reducing the expenses paid on both Soffin & Risk shelter guarantees will be the key to generating sufficient profits in order to resume Tier I coupon payments**

We believe, reducing the second loss guarantee and the run off of the Soffin guaranteed funding are key to generating sufficient profits under German GAAP in order to write up the silent participations. In mid-May HSH repaid €3bn from the Financial Market Stabilisation Fund (SoFFin) reducing the volume of state-guaranteed issues from €9bn to €6bn. The remaining two bonds mature in January and July 2012, thus reducing the expenses for the government guarantees which drag on earnings.

**Table 7: Income statement of HSH Nord Bank under IFRS**

	Q1 2009	Q2 2009	Q3 2009	Q4 2009	Q1 2010	Q2 2010	Q3 2010	Q4 2010	Q1 2011
Interest income	6,763	5,282	4,602	4,017	3,973	3,851	3,531	3,002	2,976
Interest expense	-6,255	-4,837	-4,187	-3,556	-3,529	-3,418	-3,104	-2,641	-2,612
Net income on hybrid financial instruments	-25	-28	-30	375	-37	-38	-40	-48	-39
Net interest income	483	417	385	836	407	395	387	313	325
Loan loss provisions	-424	-771	-646	-953	-329	22	55	123	76
Net commission income result from hedging	51	55	48	57	42	52	76	48	32
Net trading income	44	46	16	40	4	-1	6	-1	-14
Net income from financial investments	210	236	33	89	-132	-246	-233	252	-34
Admin expenses	-269	-44	154	-11	27	87	79	37	65
Other operating income	-214	-222	-213	-181	-197	-205	-215	-250	-207
Net income before restructuring	8	16	26	-20	8	-44	56	-78	0
Result from restructuring	-111	-267	-197	-143	-170	60	211	444	243
Expenses for government guarantees	-28	-44	-7	-45	1	-15	5	0	0
Net income before taxes	-20	-130	-136	-197	-151	-152	-90	-126	-112
income taxes	-159	-441	-340	-385	-320	-107	126	318	131
<b>Net income after taxes</b>	<b>-72</b>	<b>53</b>	<b>86</b>	<b>356</b>	<b>44</b>	<b>3</b>	<b>8</b>	<b>-24</b>	<b>-5</b>
	<b>-231</b>	<b>-388</b>	<b>-254</b>	<b>-29</b>	<b>-276</b>	<b>-104</b>	<b>134</b>	<b>294</b>	<b>126</b>

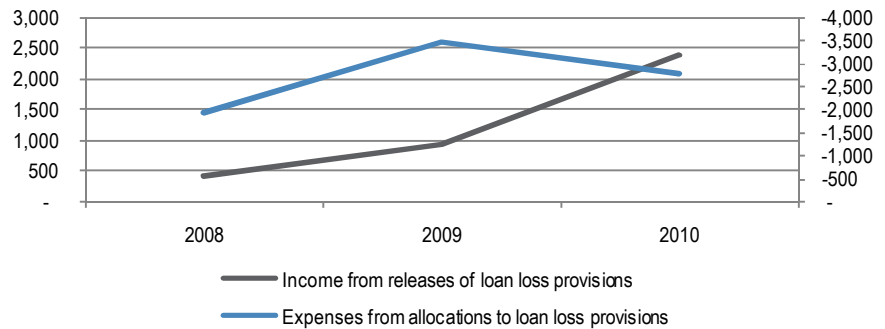
Source: Company reports.

**Reversal of net loan loss provisions could provide an import boost to profitability**

### Reversal of Loan loss provisions – the extra boost

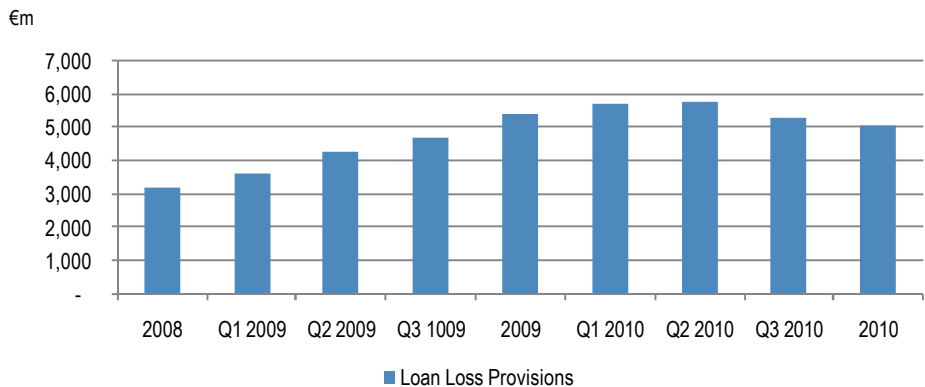
During the period 2007-2009, losses in the Credit Investment Portfolio (CIP) and increased provisions for loan losses were the main drivers of the significant losses. However, following the risk transfer and improving global economy, many of these loan loss provisions are beginning to be reversed. We believe the reversal of net loan loss provisions will be an important boost to profits during the course of 2011 and 2012. We note that each net reduction in loan loss provisions leads to an extraordinary gain under German GAAP accounting which will aid the generation of €700m net profits needed in order to resume coupon payments.

Figure 2: HSH Nordbank: Changes to allocations to loan loss provisions



Source: Company reports.

Figure 3: HSH Nordbank: Loan Loss Provisions



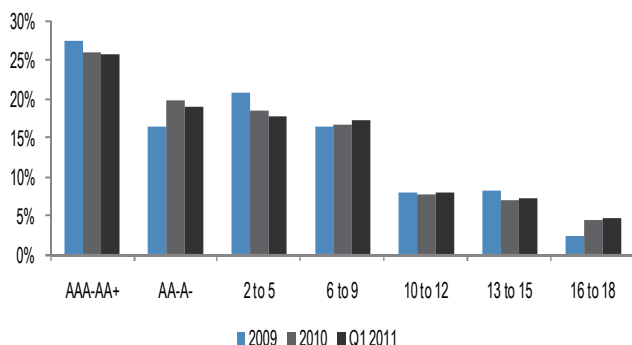
Source: Company reports.

We note loan loss provisions peaked in Q2 2010 and we expect overall they will continue to fall given the relatively more stable global back drop. Whilst we expect net risk provisioning to continue to decrease, we cannot rule out further risk provisioning for the shipping portfolio, especially for the dry-bulk portion of HSH's portfolio.

**HSH continues to face near term challenges with asset quality**

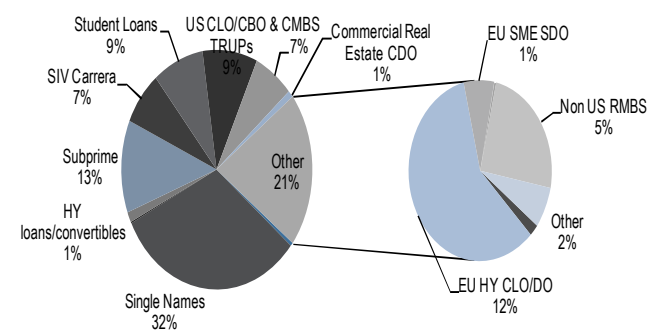
HSH Nordbank continues to reduce risk with a further reduction in total assets of 8% in the first quarter of 2011 to €139bn. This includes a reduction in the CIP by a further €1bn to €11.1bn from €16.6bn in Q1 2010. Nevertheless, the bank still faces near term challenges as asset quality continues to trend downward, with an increasing amount of assets falling into HSH's lowest credit category.

Figure 4: Financial Assets & Collateral neither impaired nor overdue



Source: Company reports.

Figure 5: HSH Nordbank: CIP asset break-down Q1 2011, €11.1bn



Source: Company reports.

In our view HSH requires both a decrease in guarantee expenses and reversal/reduced loan loss provisions in order to successfully generate the sufficient profits required in order to resume coupon payments on silent participations in June 2013.

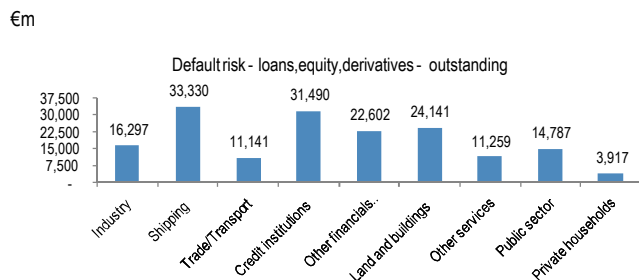
### Shipping is still a risk

HSH Nordbank's largest risks remain within its shipping portfolio where HSH has a combined default exposure of €33bn arising from €22bn from the core bank and €11bn from the restructuring unit. We believe the cyclical nature of shipping exposes HSH to the economic cycle more than other financial institutions and is likely to be the driver of further provisions going forward. We note the improvement of container and dry bulk trade volumes were boosted by global GDP growth in 2010 which improved the credit outlook for shipping. However, Moody's states "the current bulk order book represents about 54% of the tonnage on the water", with most of these "new vessels due for delivery in 2011 and 2012"<sup>1</sup> thus creating a severe supply-demand dynamic. Furthermore, we note a sustained period of high oil prices could further impede shipping credit quality.

**The overhang of supply in 2011 & 2012 is likely to weigh on the Dry-bulk sector and thus impede the credit quality of HSH's shipping loan book**

<sup>1</sup> Moody's: Dry-bulk Shipping: Oversupply May Impair Performance in 2011-2012, But 2013 could offer a recovery – 28 Feb 2011

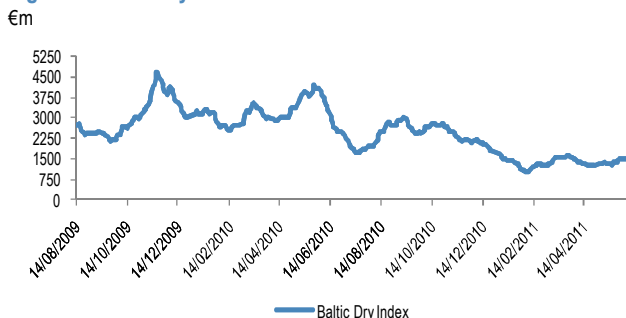
Figure 6: HSH Nordbank: Default risk FY 2010



Source: Company reports.

**The outlook of container shipping is more positive than that for Dry-bulk shipping which should benefit HSH which has 36% of its total shipping portfolio exposed to container shipping**

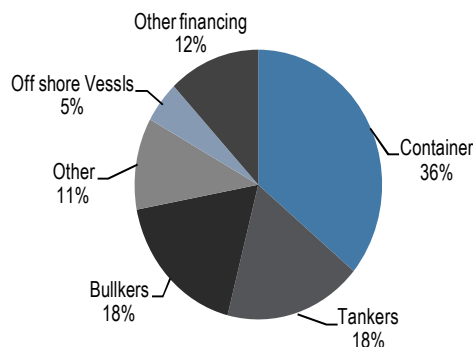
Figure 7: Baltic Dry Index



Source: Bloomberg

Container shipping represents 36% of HSH's shipping exposure as of FY 2010. A recent report from Moody's<sup>2</sup> suggests that the worst for the container shipping industry is over with the expectations of stabilising credit quality. We note that the reversal of loan loss provisions previously taken on the container shipping portfolio will both help to offset deteriorating credit quality in the dry bulk portfolio and generate profits to write-up the silent participations.

Figure 8: HSH Nordbank: Shipping Exposure FY 2010, €33bn



Source: Company reports.

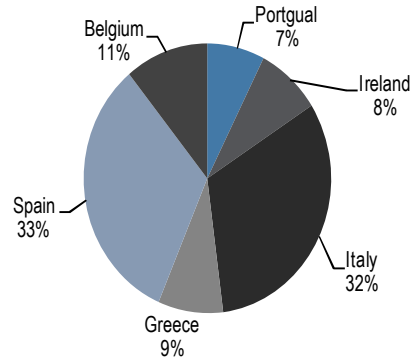
### Sovereign exposure not immaterial

**Greek sovereign exposure amounted to €295m at FY 2010**

We note sovereign and bank exposures of €3.8bn as of FY 2010 to the peripheral countries and Belgium. Although this represents only 2% of total assets; a peripheral haircut would materially impact HSH Nordbank's profits. A 50% haircut, for example, on Greek sovereign debt would lead to a write-down of €150m or 20% of the amount required to resume silent participation coupons. However, we highlight that such an event will not be material in terms of the overall solvency of the institution, but rather may lead to some slippage in the expected date in which coupons on the silent partnerships are resumed.

<sup>2</sup> Industry back on course after 2009 crisis – 16 May 2011

Figure 9: HSH Nordbank: Sovereign & Bank Exposure, FY 2010, €3.8bn



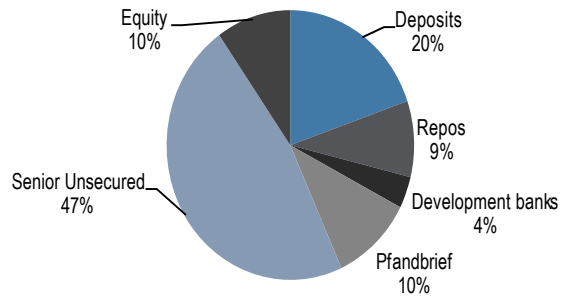
Source: Company reports.

### Funding

**HSH is heavily reliant on wholesale funding, however, we expect to see an increasing amount of covered bonds in HSH's funding profile**

We note that the European Commission has concerns with regard to HSH Nordbank's long-term viability given the lack of classical retail deposits and reliance on wholesale funding. Whilst we believe that more stable deposits would benefit HSH, we struggle to see a deposit franchise that would fit neatly with the business model of HSH. A more likely funding tool for HSH is covered bonds including both Schiffspfandbrief and Public Sector Pfandbrief, where HSH plan to issue a further €1.3bn during 2011. However, we would expect the demand for Schiffspfandbrief to remain limited and confined to domestic demand from Germany as a lower rated, less recognised instrument.

Figure 10: HSH Nordbank: Funding profile FY 2010, €132bn



Source: Company reports.

**EC ruling could be drawn out until the end of September**

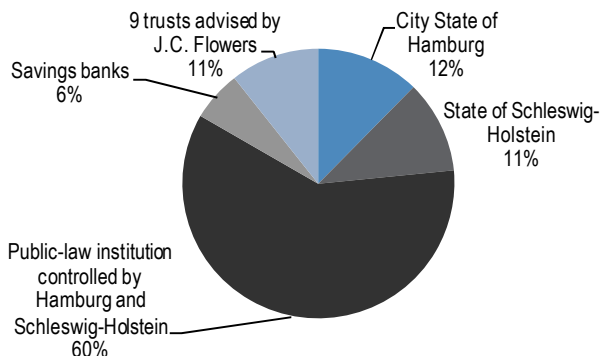
**We view four years of coupon deferral as sufficient losses for subordinated bond holders**

## Still awaiting the EU ruling

HSH Nordbank has been awaiting ruling from the European Commission (EC) since the initial investigation on the 22nd October 2009<sup>3</sup>. More recently management have guided towards an initial ruling from the EC by the end July at the earliest. However, this ruling is expected to be an extended process that may see the full decision being delayed until September. In particular, the EC is considering whether the non contributing shareholders unduly benefited from the €3bn capital injection provided by the German Länder of Hamburg and Schleswig-Holstein. Also under scrutiny were many aspects of the risk shield, including pricing, size and eligibility of assets, and whether or not the risk shield was compatible with state aid guidelines.

A point of contention is likely to be the losses that should be borne by subordinated bond holders. One could argue that due to the loss participation of the silent participations in the form of nominal write down, that losses on subordinated bond holders have been sufficient. However, we note that due to the write-up feature of these instruments, losses are limited to the loss of coupon for these publicly traded silent participations. We believe, that due to the expected loss of four years worth of coupons, the EC will view the losses borne by subordinated debt holders as sufficient.

Figure 11: HSH Nordbank: Shareholders FY 2010



Source: Company reports.

<sup>3</sup> [http://ec.europa.eu/competition/elojade/isef/case\\_details.cfm?proc\\_code=3\\_C29\\_2009](http://ec.europa.eu/competition/elojade/isef/case_details.cfm?proc_code=3_C29_2009)

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- **Other Significant Financial Interests:** J.P. Morgan owns a position of 1 million USD or more in the debt securities of HSH Nordbank.

### HSH Nordbank - J.P. Morgan Recommendation History

Date	Rating	Instrument
12 Oct 09	Overweight	5yr CDS

Recommendation changes made by J.P. Morgan Credit Research Analysts in the subject company over the past 12 months (or, if no recommendation changes were made in that period, the most recent change).

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EMEA Credit Research Universe	30%	50%	20%
IB clients*	52%	63%	53%

Represents Ratings on the most liquid bond or 5-year CDS for all companies under coverage.

\*Percentage of investment banking clients in each rating category.

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