



GOOD Q2 2010 EARNINGS. STILL A CORE BUY

DNBNOR reported decent Q2 2010 results, driven by strong core net interest income, which was 4% ahead of our forecasts. Strength in NII appears driven mainly by loan book growth (the total loan book grew 14% QoQ). However, the modest improvement in margins is also an important indicator that the bank should now be benefitting from rising NIBOR. Loan losses disappointingly decreased only 7% QoQ versus our estimate of a 30% decrease, but were better than consensus forecasts. Overall, we believe the market will be pleased with both the revenue growth and loan loss development. We reiterate our BUY rating and increase our target price to NOK 90 from NOK 86, in line with our DCF valuation.

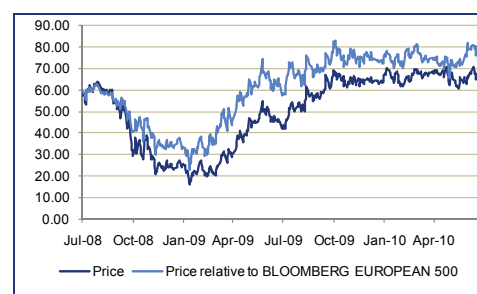
- Net income was NOK3.3bn, slightly below consensus and our estimates. However, there was a much higher tax charge than expected in the quarter, which management attributed to higher taxes being charged at DnB NORD (the Baltic and Polish subsidiary) and the weak development of the equity portfolio of Vital (its life insurance business). On a pre-tax level, earnings were 2% ahead of the consensus estimate.
- NII was particularly strong, better than our estimate by 4% and consensus by 3%. Our view is that this was driven mainly by strong loan book growth of 14% QoQ. Management indicated at their presentation a modest improvement in margins, which would also have contributed to the increase in NII. The improvement in Group NIM is mainly due to measures to reprice loans at DnB NORD, where the NIM improved to 2.41% from 1.91% last quarter. However, NIM at the domestic Retail Banking division also increased over the quarter by 7bps by our calculations, which, in our opinion, reflects the positive effect that increases in the NIBOR rate should now be having on liability spreads.
- Loan losses decreased by 7% QoQ. This performance was not as good as we were expecting, but was better than the consensus forecast by some 20%. The loan loss rate improved to -0.31% annualised from -0.34% in Q1 2010, representing a more modest improvement compared to the prior two quarters. NPLs % loans also improved to 1.85%, but the decrease QoQ was also a rather modest 9bps. Management reduced its loan loss expectation for 2010 to NOK 4–5bn, which should be taken positively by the market. We discuss later our view that even this reduced guidance is conservative, leaving room for full-year 2010 earnings to be better than forecast.
- The evaluation of the cooperation with NORD/LB and the possible purchase of its 49% ownership interest in DnB NORD, which was initiated at year-end 2009, has not yet been completed. It should continue through H2 2010.

Research

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Rating	BUY
Target price (NOK)	90.00
Share price (NOK)	69.90
Upside/downside to target price	31%
52-week range (NOK)	40.45 - 71.75
Projected dividend (NOK)	2.69
Market cap. (€m)	14.1
DCF valuation (NOK)	91.95
Bloomberg	DNBNOR NO

Year-end Dec (NOK)	2009A	2010E	2011E
EPS	5.22	7.70	9.08
NAV per share	55.87	61.96	68.35
P/E	13.39	9.07	7.69
Price/NAV	1.25	1.13	1.02
Dividend yield (%)	2.55	3.92	4.63
Net interest income	22,633	22,902	25,221
Total operating revenues	37,625	38,928	41,649
Operating costs	-18,911	-18,156	-18,500
Operating profit	18,714	20,772	23,149
Total provisions	-7,710	-3,621	-2,365
Pre-tax profit	11,030	17,151	20,783
ROA (%)	0.47	0.67	0.73
ROE (%)	9.77	12.12	13.03
ROTNV (%)	10.76	13.07	13.94
Cost/income (%)	-50.26	-46.64	-44.42
Payout ratio (%)	33.21	35.00	35.00
Net interest margin (%)	1.86	1.79	1.78
LLC % gross loans (%)	-0.67	-0.32	-0.20
NPL ratio (%)	1.78	1.50	0.80
Coverage ratio (%)	54.00	61.00	65.00
Loans % deposits (%)	188.73	183.95	179.30
Core Tier 1 ratio (Basle II) (%)	8.51	8.67	9.23
Core Tier 1 ratio (Basle III) (%)	7.78	7.94	8.49



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A More Detailed Look at Loan Losses

Looking at the divisional detail, loan losses at DnB NOR and the domestic Retail Banking divisions actually increased QoQ, somewhat offsetting the improvement at the Large Corporates & International division. The main area of concern is DnB NOR's Baltic exposure, where the economies should continue to be weak. As a result, loan losses are expected to remain at an elevated level in 2010, albeit lower than in 2009.

However, at the Group level, management has been comfortable enough to reduce loan loss guidance for 2010 to a range of NOK 4–5bn. We still believe this is conservative. We are forecasting loan losses for FY 2010 of NOK 3.6bn, which merely implies that loan losses in H2 2010 should be similar to the NOK 1.8bn reported in H1 2010.

Deterioration in Core Tier 1 Ratio Not a Concern

The Core Tier 1 ratio was weak at 8.2%, missing our estimate of 8.6% and deteriorating from the 8.5% achieved last quarter. Despite the solid earnings, there was a 4.6% increase in RWA, which drove the deterioration in the CT1 ratio. The increase in RWA was due to two main reasons: the depreciation of the Norwegian Krone versus the US\$ by nearly 10%, which caused an increase in credit exposure measured in Norwegian Krone; and an increase in market risk for the life operations (i.e. Vital), where the fall in equity markets and the long-term interest rate level raised the risk associated with policyholder's guaranteed rate of return.

We are not concerned by the deterioration in the Core Tier 1 ratio since we consider the negative effects largely one-off (unless the equity market falls further by a substantial amount). More to the point, DNB NOR is the only bank in our coverage universe which reports its capital ratios only on a transitional Basel II basis. Management indicated that its Tier 1 ratio under full Basel II principles would be about 11.9%, some 290bps higher than the currently reported Tier 1 ratio. On the basis that DNB NOR's Core Tier 1 ratio should enjoy a similar absolute improvement if also reported on a full Basel II basis, then the ratio would be about 11.1% rather than 8.2%. This makes DNB NOR one of the best capitalised banks in the sector, on both a Basel II and a Basel III basis by our analysis.

One-offs Should Not Detract From a Solid Core Performance

There were a number of one-offs to exclude in the analysis of quarterly trends. Operating costs included unexpected non-recurring write-offs of NOK591mn, relating largely to writedowns of DNB NOR's IT systems. There was also a NOK 1.2bn gain relating to the upwards revision of the book value of Nordito AS (the payment transactions company), which was merged with the Danish company PBS.

If we exclude these one-offs, then DNB NOR is still seen to achieve 3% growth in operating income QoQ and 15% growth in operating profit QoQ, which we consider impressive.

Vital again Shows Vulnerability to Weak Equity Markets

Vital, the life insurance subsidiary of DNB NOR, recorded a pre-tax operating loss of NOK 102m in the second quarter of 2010, while the figure for the year-earlier period was NOK 402mn higher. The reduction was due to the sharp fall in equity prices towards the end of the second quarter, which highlights the negative geared impact to shareholders of having to meet policyholder guaranteed rates.

Figure 1: DNB NOR Q2 2010 Earnings Table

DNB NOR ASA	Q1 2009	Q1 2010	Q2 2010E	Q2 2010E Cons.	Q2 2010	FY 2010E	FY 2011E	FY 2012E
INCOME STATEMENT (NOK m)								
Net interest income	5,633	5,561	5,536	5,600	5,744	22,902	25,221	28,193
Net fees & commissions	1,589	1,628	1,701		1,723	6,885	7,126	7,411
Trading profits/losses	2,229	1,298	1,233		1,754	6,183	6,278	5,855
Other revenue	1,372	566	1,518		1,318	2,959	3,024	3,101
Total operating revenues	10,823	9,053	9,989	9,900	10,539	38,928	41,649	44,560
Operating costs	-4,714	-4,115	-4,618		-5,304	-18,156	-18,500	-19,382
Operating profit	6,109	4,938	5,371	5,370	5,235	20,772	23,149	25,178
Total provisions	-1,598	-947	-667	-1,100	-879	-3,621	-2,365	-1,808
Impairments on other assets	0	0	0		0	0	0	0
Goodwill impairment	0	0	0		0	0	0	0
Net gains on fixed and intangible assets	19	0	26		0	0	0	0
Pre-tax profit	4,530	3,991	4,729	4,260	4,356	17,151	20,783	23,370
Taxes	-1,580	-1,081	-1,411		-1,524	-5,686	-6,117	-5,843
Minorities	159	199	196		442	1,082	132	-263
Other non-operating items	-1	0	0		0	0	0	0
Net profit	3,108	3,109	3,514	3,360	3,274	12,547	14,797	17,265
ASSETS (NOK m)								
Loans to customers	1,173,547	1,125,946	1,125,663		1,154,491	1,166,920	1,231,214	1,332,705
Interbank loans	75,977	75,514	76,269		213,009	217,290	226,113	235,294
Total securities	327,381	491,337	501,164		457,403	475,882	515,110	557,572
Intangible assets	8,028	7,431	7,431		6,884	6,884	6,884	6,884
Total assets	1,809,242	1,842,309	1,863,087		1,992,606	2,042,375	2,194,521	2,359,444
Net interest-earning assets	1,249,524	1,201,460	1,201,932		1,367,500	1,384,211	1,457,327	1,568,000
LIABILITIES (NOK m)								
Interbank borrowings	230,256	305,097	308,148		338,678	345,485	359,514	374,111
Customer deposits	1,144,113	1,084,631	1,095,477		1,197,493	1,221,563	1,322,259	1,431,255
Total shareholders' equity	79,810	101,776	102,414		102,488	108,652	119,058	131,143
Tangible net asset value	71,782	94,345	94,983		95,604	101,768	112,174	124,259
IMPORTANT FINANCIAL RATIOS								
ROA	0.68%	0.68%	0.75%		0.68%	0.65%	0.70%	0.76%
ROE	15.78%	12.44%	13.67%		12.79%	12.10%	13.00%	13.80%
ROTNV	17.63%	13.45%	14.74%		13.76%	13.02%	13.83%	14.60%
Cost/income	-43.56%	-45.45%	-46.23%		-50.33%	-46.64%	-44.42%	-43.50%
Tax rate	-34.99%	-27.02%	-30.00%		-34.99%	-33.15%	-29.43%	-25.00%
Payout ratio	0.00%	0.00%	0.00%		0.00%	35.00%	35.00%	35.00%
Net interest margin	1.80%	1.87%	1.84%		1.79%	1.79%	1.78%	1.86%
LLC % gross loans	-0.54%	-0.34%	-0.24%		-0.31%	-0.32%	-0.20%	-0.14%
Non-performing loans % gross loans	1.23%	1.94%	1.75%		1.85%	1.50%	0.80%	0.80%
NPL coverage ratio	45.69%	46.35%	58.00%		54.73%	61.00%	65.00%	65.00%
Loans % deposits	197.15%	192.20%	190.24%		185.64%	183.95%	179.30%	179.30%
Tier 1 ratio	6.85%	9.30%	9.36%		9.01%	9.47%	10.00%	10.61%
Core tier 1 ratio (Basel II)	6.03%	8.49%	8.55%		8.20%	8.67%	9.23%	9.87%
Core tier 1 ratio (Basel III)	5.30%	7.76%	7.75%		7.46%	7.94%	8.49%	9.13%
RWA % total assets	63.44%	57.32%	56.69%		55.43%	54.62%	52.89%	51.19%

Source: Matrix Research

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