DEXIA

DCL T1 Tender is attractive; Buy Senior debt and Sell CDS protection

Negative
(maintained)

Sector weighting

Tier 1	Underweight
Lower Tier 2	Underweight
Senior	Underweight

iBoxx index spread

Tier 1	500
Lower Tier 2	
Senior	

Market value

Benchmark	//-	
Spread (bp)	1744	
Senior CDS 5y	583	Positive

Rating

	LT	FSR	Outlook
MDY	Baa1*	E+*	RUR down
S&P	BBB+*	na	RUR down
Fitch	A+	C/D	Negative

Key financials

(€bn)	
Total assets	412.7
RWAs	83.4
Total equity	-2.0
Net income	-11.6

Key Ratios

(%)	
ROAE	NA
Cost/Income	NA
Tier 1 ratio	7.6
NPL ratio	NA

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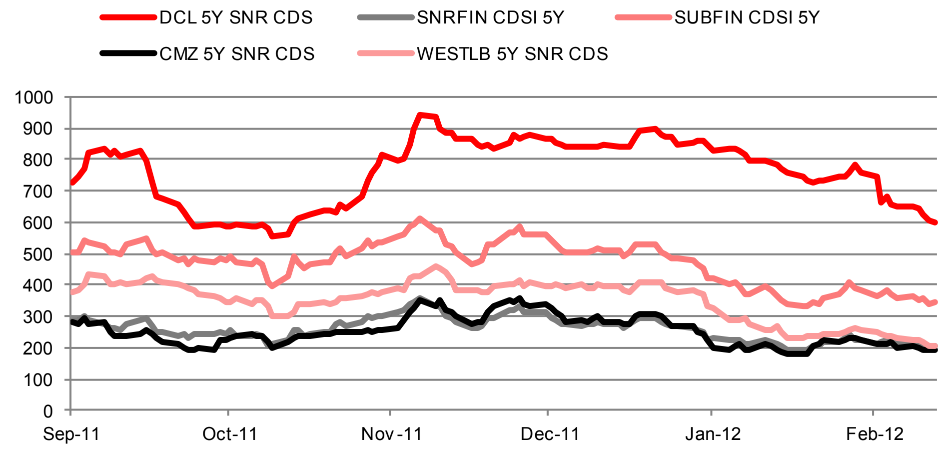
- **Event**: Dexia announced on Friday a tender offer for the outstanding €700m Dexia Credit Local (DCL) Tier 1 securities at a purchase price of 24% of the nominal value. The bonds recently traded at c. 15%, translating into a moderate pick-up.

- **SG Bond Recommendation**: With the unravelling of the Dexia group ongoing, we consider the tender offer attractive as a means to avoid being trapped into a long run-off process with uncertain prospects holding a non-coupon paying security. The recent tender offer of Dexia Funding Luxembourg's €500m Tier 1 closed with a 91.8% take-up. What remains of the group, namely the French public finance business and a portfolio of illiquid assets, offers little upside potential for investors and its credit value hinges solely on support provided by governments to the primary benefit of its senior obligors. We therefore reaffirm our Buy recommendation on Dexia's senior debt and Sell recommendation on senior CDS as we see the €90bn guaranteed issuance programme being put in place as a strong safety net for Dexia's liquidity in the coming years. We also believe that more risk tolerant investors could give consideration to some of the group's dated subordinated debts, such as the DEXGRP Float 17, which currently trades at 50%, on the expectation of further liability management. Subordinated debt pricing reflects potential losses in a liquidation scenario as the group's equity has turned negative and we see dim prospects of the solvency improving.

- **SG Credit Opinion**: The group's dismantling has translated into significant losses including €4bn and €1bn on the Dexia Bank Belgium and Dexia Municipal Agency sales, respectively, and €2.6bn on the Financial Products portfolio deleveraging. A 75% discount on its Greek sovereign exposure has led to €3.4bn provisions. The total 2011 €11.6bn loss has depleted solvency, given significant negative AFS reserves. Thanks to prudential filters, Tier 1 capital stands at €6.3bn and core Tier 1 at c. €6bn when taking into account the two Tier 1 tender offers.

- **How to trade it**: Further to the trades recommended in Dexia: To the victor, the spoils last October, we initiate a compression trade as we expect DCL's senior CDS to gradually come down relative to the iTraxx financial: Buy DCL Senior CDS, Sell Senior iTraxx Financials. As shown in the graph overleaf, DCL Senior CDS trades very wide (c. 400 bp) relative to the iTraxx. Core eurozone banks which have benefited from state support such as Commerzbank (193 bp) or West LB (208 bp) trade much tighter. Even after discounting the Commerzbank and WestLB "German premium", we believe DCL's risk premium fails to capture the benefit from the support provided by Belgian and French governments to senior creditors. The average CDS price of Belgium and France, weighted by their share in the Dexia guarantee scheme, is around 194 bp compared to Germany's 5Y CDS of 59, a 135 bp differential. We therefore see a potential tightening of DCL's CDS of up to 200-250 bp.

DCL, CMZ and WestLB Snr 5Y CDS relative to the iTraxx financial



Source: SG Cross Asset Research

Group dismantling proceeding as planned

Partial divestment of Dexia Municipal Agency

In February 2012, Dexia agreed to participate in the creation of a new bank jointly controlled by the French state (31.7%), Caisse des Dépôts (CDC-31.7%), Dexia Crédit Local (DCL-31.7%) and La Banque Postale (LBP-4.9%). This new bank will be the parent company of Dexia Municipal Agency (DEXMA), the group's main covered bond issuer, which will refinance new loans originated by the new bank, following the transfer by Dexia of relevant – but probably not all - staff and resources. Dexia incurred a €1bn loss on the sale of DEXMA to the new entity.

In our opinion, this transaction signals that Dexia/Dexia Credit Local will become the rump "bad" bank, concentrating on the run-off of its legacy bond portfolio of structured assets, foreign public finance loans (mostly in the US) and non-core subsidiaries (e.g. Denizbank, RBC-Dexia Investors Services, Dexia Asset Management, Dexia Sabadell, Dexia Crediop). DCL will continue to provide ancillary services to French local governments, but we view its loan origination capacity as being capped by its refinancing constraints. In effect, we expect the French public finance business to be subsumed in future by the new CDC-Dexia-LBP joint venture.

Solvency depleted – bleak prospects of improvement

Putting a price on this mixed bag of assets is difficult, knowing that profits on valuable assets such as Denizbank (estimated at 1.2-1.5 book value) may be offset by additional deleveraging losses. The carry of the loan back book may be barely sufficient to meet running costs and recurrent provisions. Accordingly, capital generation capacity could be barely positive or most likely negative. Any improvement in the regulatory solvency will come from declining risk weighted assets due to the portfolio's run-off and asset sales.

The total 2011 €11.6bn loss has depleted solvency, given significant negative AFS reserves. Thanks to prudential filters, Tier 1 capital stands at €6.3bn and core Tier 1 at c. €6bn when taking into account the two Tier 1 tender offers.

We do not exclude that Dexia/DCL may in future fail to meet minimum solvency ratios – particularly if its supervision is transferred from Belgium to France, where negative AFS reserves are excluded from prudential filters. As shareholders are unlikely to pump in more capital, DCL could see its banking licence withdrawn. This scenario is predicated on the bank no longer requiring any ECB liquidity support and therefore the successful deleveraging of its balance sheet. It could also trigger a restructuring of the bank's capital base and subordinated debts. However, we believe a structuring would spare senior debts, which are currently not available to be bailed-in. A default on senior obligations of a government controlled and supported entity also looks highly unlikely given the potential negative ramifications for France.

Government-guaranteed funding should be Dexia's lifeline

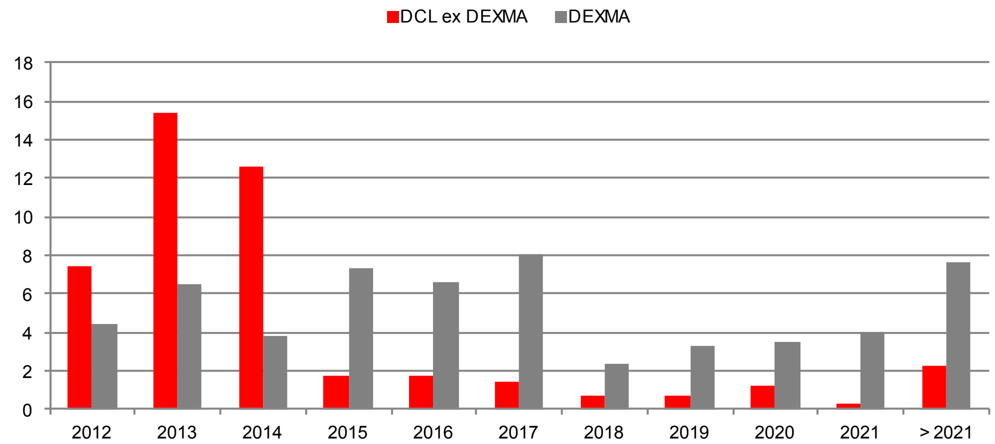
In late December 2011, the European Commission (EC) approved a temporary EUR 45 billion guarantee scheme shared 60.5% by Belgium, 36.5% by France and 3% by Luxembourg, for debts having an initial 3-year maturity. This guarantee extends to end-May 2012 and is expected to be increased to €90bn (as announced in October 2011) once the EC vets the final Dexia restructuring plan. In the short-term, Dexia intends to issue €35bn and €10bn in French domestic CDs (less than 1 year maturity) and MTNs (2-3 years), respectively.

The irrevocable and unconditional guarantee is not joint but ensures timeliness of payments, supporting a AA rating from S&P.

We believe that the €90bn was calibrated in order for Dexia (in effect, DCL and its remaining subsidiaries [excluding DEXMA]) to meet its debt maturities in the next nine years, and the temporary €45bn is sufficient to meet the next three years' maturities. According to Bloomberg data, DCL has around €103.3bn of long-term debt outstanding, of which €57.8bn was issued by DEXMA. In addition to the remaining €45.6bn, we have €25.7bn of French domestic debt reported in Banque de France systems, mostly CDs. Of this, €24bn is government guaranteed. Adding private placements plus any ECB refinancing (with various sources citing a €20bn take-up in the LTRO I and none in the LTRO II, possibly because of declining collateral availability), we arrive at a total of around €90bn. Without the detailed year-end 2011 financial statements, we must rely on estimates and may have overlooked private placements and other secured funding.

All-in-all, this tends to show that DCL will be able to meet debt payments as they come due by issuing new debt under the €90bn guarantee scheme. This assessment supports our recommendation to invest in DCL's senior debts as we expect cash will be available to make payments, either from the bank portfolio's run-off or from the governments.

Dexia long-term public debt profile – March 2012



Source: Bloomberg, SG Cross Asset Research

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APPENDIX

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