



Rating
Hold

Asia
China

Utilities
Utilities

Company
Kunlun Energy

Reuters 0135.HK	Bloomberg 135 HK	Exchange HKG	Ticker 0135
ADR Ticker KLYCY	ISIN US50126A1016		

Date
27 March 2015

Results

Price at 26 Mar 2015 (HKD)	7.55
Price target - 12mth (HKD)	7.80
52-week range (HKD)	13.46 - 6.93
HANG SENG INDEX	24,528

Michael Tong	Yingying Dong, CFA
Research Analyst (+852) 2203 6167 michael.tong@db.com	Research Associate (+852) 2203 6207 yingying.dong@db.com

More pressure in 2015

FY14 results largely in line, but not fully reflecting headwinds

Kunlun's FY14 results were 6% above our estimate but 4% below consensus. While we are likely to see the pipeline transmission volume grow steadily and the long-term outlook of the LNG business remain positive, we expect its E&P business to dip into loss in 2015 due to a sharp decline in the oil price. Moreover, the potential loss of new LNG liquefaction could be realized once the plants are transferred from work-in-progress. Nevertheless, we believe further downside is limited as the share price appears to mainly reflect the value of its defensive midstream pipeline and LNG terminal assets, with little value ascribed to upstream E&P and downstream gas assets. Maintain Hold.

FY14 net profit down 18% yoy; only one of five businesses saw growth

Kunlun's FY14 earnings were down 18% yoy to HK\$5.61bn, 6% above our expectation but 4% below consensus (HK\$5.83bn). The earnings decline was mainly due to the 30% yoy decline in profit from the E&P business, 56% decline from natural gas sales business, and 8% profit decline from LNG terminal business, offset by an 8% yoy increase in contributions from the natural gas pipeline business. LNG processing fell into loss in 2014.

2015 outlook: growth in transmission offset by loss in E&P business

We expect volume growth from the midstream transmission pipeline business to be offset by the loss-making E&P business as a result of the collapsing oil price. Moreover, two new LNG liquefaction plants will weigh on the earnings outlook when they are transferred out of work-in-progress, with additional depreciation and interest burdens but low margin and utilization levels. Impairment is also likely if the LNG plants remain loss-making. Overall, we expect a 19% yoy decline in reported earnings in FY15E.

Sum-of-the-parts valuation of HK\$7.8; risks

Our HK\$7.8 target price comprises mainly the midstream/downstream gas business (>95%). Key risks: lower/higher-than-expected demand and utilization of the mainland gas business, and a lower/higher-than-expected oil price (see page 6 for target price derivation and risk details).

Price/price relative



Performance (%)	1m	3m	12m
Absolute	-1.4	3.1	-41.0
HANG SENG INDEX	-1.5	5.0	12.1

Source: Deutsche Bank

Forecasts And Ratios

Year End Dec 31	2012A	2013A	2014E	2015E	2016E
Sales (HKDm)	32,953	43,430	43,824	46,876	51,043
EBITDA (HKDm)	15,680	17,255	15,406	16,024	17,441
Reported NPAT (HKDm)	6,518	6,851	5,306	4,557	5,796
DB EPS FD (HKD)	0.831	0.848	0.657	0.564	0.717
DB EPS growth (%)	7.0	2.1	-22.6	-14.1	27.2
PER (x)	16.1	16.5	11.5	13.4	10.5
Price/BV (x)	2.9	2.2	1.1	1.1	1.0
EV/EBITDA (x)	8.1	8.3	6.0	6.3	6.2
DPS (net) (HKD)	0.230	0.230	0.184	0.170	0.216
Yield (net) (%)	1.7	1.6	2.4	2.2	2.9
ROE (%)	17.4	14.4	10.1	8.2	9.7

Source: Deutsche Bank estimates, company data

¹ DB EPS is fully diluted and excludes non-recurring items

Deutsche Bank AG/Hong Kong

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Model updated:09 February 2015

Running the numbers

Asia

China

Utilities

Kunlun Energy

Reuters: 0135.HK

Bloomberg: 135 HK

Hold

Price (26 Mar 15) HKD 7.55

Target Price HKD 7.80

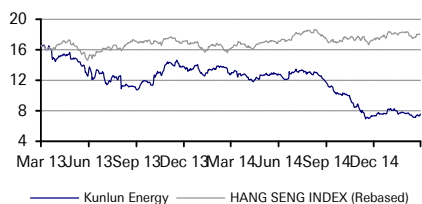
52 Week range HKD 6.93 - 13.46

Market Cap (m) HKDm 60,614
USDm 7,816

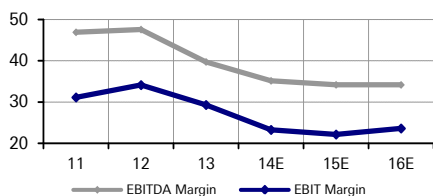
Company Profile

Kunlun Energy (formerly known as CNPC (Hong Kong)) is principally engaged in the midstream and downstream gas sales in mainland China. The company also involves in the exploration and production (E&P) of oil and gas in mainland China, Kazakhstan, Oman, Peru, Thailand, Azerbaijan, and Indonesia. China National Petroleum Corporation, through PetroChina (0857.HK), is the controlling shareholder of the company holding c.57% stake.

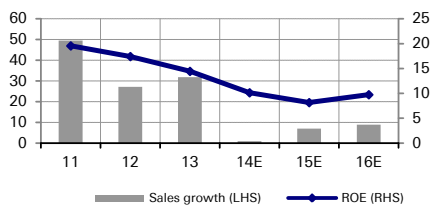
Price Performance



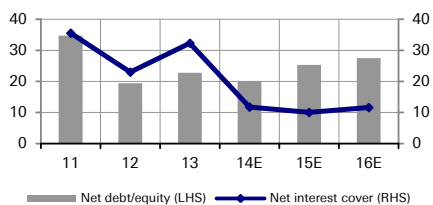
Margin Trends



Growth & Profitability



Solvency



Fiscal year end 31-Dec

	2011	2012	2013	2014E	2015E	2016E
Financial Summary						
DB EPS (HKD)	0.78	0.83	0.85	0.66	0.56	0.72
Reported EPS (HKD)	0.78	0.83	0.85	0.66	0.56	0.72
DPS (HKD)	0.22	0.23	0.23	0.18	0.17	0.22
BVPS (HKD)	4.2	5.5	6.3	6.7	7.1	7.6
Weighted average shares (m)	7,151	7,802	8,059	8,062	8,062	8,062
Average market cap (HKDm)	85,538	104,399	112,761	60,614	60,614	60,614
Enterprise value (HKDm)	108,780	127,089	143,792	92,895	100,930	107,447
Valuation Metrics						
P/E (DB) (x)	15.4	16.1	16.5	11.5	13.4	10.5
P/E (Reported) (x)	15.4	16.1	16.5	11.5	13.4	10.5
P/BV (x)	2.61	2.93	2.18	1.12	1.06	0.99
FCF Yield (%)	nm	nm	nm	2.8	nm	nm
Dividend Yield (%)	1.9	1.7	1.6	2.4	2.2	2.9
EV/Sales (x)	4.2	3.9	3.3	2.1	2.2	2.1
EV/EBITDA (x)	8.9	8.1	8.3	6.0	6.3	6.2
EV/EBIT (x)	13.5	11.3	11.3	9.1	9.7	8.9

Income Statement (HKDm)

Sales revenue	25,915	32,953	43,430	43,824	46,876	51,043
Gross profit	14,748	18,408	20,532	19,063	19,171	20,929
EBITDA	12,159	15,680	17,255	15,406	16,024	17,441
Depreciation	4,089	4,433	4,525	5,208	5,642	5,388
Amortisation	0	0	0	0	0	0
EBIT	8,070	11,247	12,730	10,197	10,382	12,053
Net interest income/(expense)	-227	-489	-394	-867	-1,035	-1,038
Associates/affiliates	2,577	2,641	2,061	1,162	633	873
Exceptionals/extraordinaries	0	0	0	0	0	0
Other pre-tax income/(expense)	67	-93	-44	0	0	0
Profit before tax	10,487	13,306	14,353	10,493	9,980	11,888
Income tax expense	2,291	3,392	3,845	2,572	2,434	2,836
Minorities	2,575	3,396	3,657	2,615	2,989	3,256
Other post-tax income/(expense)	0	0	0	0	0	0
Net profit	5,621	6,518	6,851	5,306	4,557	5,796
DB adjustments (including dilution)	0	0	0	0	0	0
DB Net profit	5,621	6,518	6,851	5,306	4,557	5,796

Cash Flow (HKDm)

Cash flow from operations	9,351	10,021	13,475	11,499	12,526	13,418
Net Capex	-13,507	-15,391	-15,405	-9,810	-16,837	-15,814
Free cash flow	-4,156	-5,370	-1,930	1,689	-4,311	-2,395
Equity raised/(bought back)	96	10,605	-57	0	0	0
Dividends paid	-1,516	-4,076	-3,799	-1,486	-1,367	-1,739
Net inc/(dec) in borrowings	9,647	3,701	-1,409	5,901	17,805	16,387
Other investing/financing cash flows	-1,089	2,715	1,846	484	-54	293
Net cash flow	2,982	7,575	-5,349	6,588	12,074	12,545
Change in working capital	-1,539	-3,265	-1,084	-468	-1,084	-148

Balance Sheet (HKDm)

Cash and other liquid assets	11,718	19,592	14,897	21,485	33,558	46,104
Tangible fixed assets	56,677	69,225	82,943	87,545	98,740	109,166
Goodwill/intangible assets	0	0	0	0	0	0
Associates/investments	7,890	7,147	7,284	7,962	8,649	9,229
Other assets	7,922	12,578	14,338	14,935	15,190	15,539
Total assets	84,207	108,542	119,462	131,927	156,138	180,037
Interest bearing debt	27,575	31,673	31,350	37,251	55,056	71,443
Other liabilities	10,974	14,691	15,844	15,973	16,199	16,399
Total liabilities	38,549	46,364	47,194	53,224	71,255	87,842
Shareholders' equity	30,383	44,422	50,406	54,226	57,416	61,473
Minorities	15,275	17,756	21,862	24,477	27,466	30,722
Total shareholders' equity	45,658	62,178	72,268	78,703	84,882	92,196
Net debt	15,857	12,081	16,453	15,766	21,498	25,339

Key Company Metrics

Sales growth (%)	49.5	27.2	31.8	0.9	7.0	8.9
DB EPS growth (%)	33.8	7.0	2.1	-22.6	-14.1	27.2
EBITDA Margin (%)	46.9	47.6	39.7	35.2	34.2	34.2
EBIT Margin (%)	31.1	34.1	29.3	23.3	22.1	23.6
Payout ratio (%)	28.2	27.5	27.1	28.0	30.0	30.0
ROE (%)	19.6	17.4	14.4	10.1	8.2	9.7
Capex/sales (%)	52.1	46.7	35.5	22.4	35.9	31.0
Capex/depreciation (x)	3.3	3.5	3.4	1.9	3.0	2.9
Net debt/equity (%)	34.7	19.4	22.8	20.0	25.3	27.5
Net interest cover (x)	35.6	23.0	32.3	11.8	10.0	11.6

Source: Company data, Deutsche Bank estimates



FY14 results review and outlook

Kunlun Energy announced FY14 results on 26 March after market close. Reported net profit was down 18% yoy to HK\$5,610m, 6% above our estimate. The earnings decline was mainly due to a 30% yoy decline in profit from the E&P business, 56% decline from the natural gas sales business, and 8% profit decline from the LNG terminal business, offset by an 8% yoy increase in contributions from the natural gas pipeline business. A final dividend of HK\$0.20/share was declared (down from HK\$0.23 a year ago), representing a 29% payout. We show a yoy comparison in Figure 1.

Figure 1: Kunlun Energy's FY14 summary P&L

Summary P&L (HK\$m)	FY13	FY14	yoy	Deutsche Bank comment
Revenue	43,430	48,044	11%	
E&P business	5,660	5,336	-6%	Up on expansion of natural gas business Down on lower oil selling price
Natural gas sales	22,073	26,291	19%	Up on rising volumes and gas price hike
Natural gas pipeline	11,787	12,679	8%	Up on increase in transmission volume but partly offset by tariff cut
LNG terminal	2,512	1,946	-23%	Down on diversion of contracted LNG to other terminal
LNG processing	1,398	1,792	28%	Up on higher volume from new liquefaction capacity additions
Purchases, services & others	(21,303)	(26,354)	24%	
Employee compensation	(2,046)	(2,368)	16%	
Exploration expenses	(11)	-	-100%	No exploration activities
SG&A	(2,878)	(2,777)	-4%	Less E&P related expense
Tax other than income taxes	(746)	(737)	-1%	
EBITDA	16,446	15,808	-4%	Higher NG business offset by lower E&P and LNG business
<i>EBITDA margin</i>	<i>38%</i>	<i>33%</i>		
Depreciation and amortisation	(4,528)	(5,392)	19%	
Profit from operation	11,918	10,416	-13%	
<i>Operating margin</i>	<i>27%</i>	<i>22%</i>		
Other gain/(loss)	768	837	9%	mainly VAT refunds during transition of VAT reform
Interest income	228	217	-5%	
Finance costs	(622)	(486)	-22%	On higher capitalized interests (HKD1,035mn)
Share of profits from JCs	415	256	-38%	Down on decrease in crude oil price and HKD150mn impairment
Share of profits from associates	1,646	716	-57%	Down on decrease in crude oil price and oil production volume and FX loss
Profit before tax	14,353	11,956	-17%	
E&P business	3,647	2,302	-37%	down mainly due to lower contributions from Kazakhstan
Natural gas sales	1,754	1,420	-19%	down due to lower average gas sales margin
Natural gas pipeline	7,774	8,141	5%	Lower profit growth vs. volume growth due to transmission tariff cut
LNG terminal	1,135	806	-29%	down on reduced processing volumes
LNG processing	158	(338)	-314%	Loss due to low processing margin and low plant utilisations
Others	(115)	(375)	226%	
Total	14,353	11,956	-17%	
Tax	(3,845)	(3,080)	-20%	
<i>effective tax rate</i>	<i>27%</i>	<i>26%</i>		
Minority interest	(3,657)	(3,266)	-11%	
Net profit	6,851	5,610	-18%	
E&P business	2,226	1,550	-30%	
Natural gas sales	947	415	-56%	
Natural gas pipeline	3,358	3,624	8%	
LNG terminal	435	401	-8%	
Others	(115)	(380)	230%	

Source: Deutsche Bank, company data

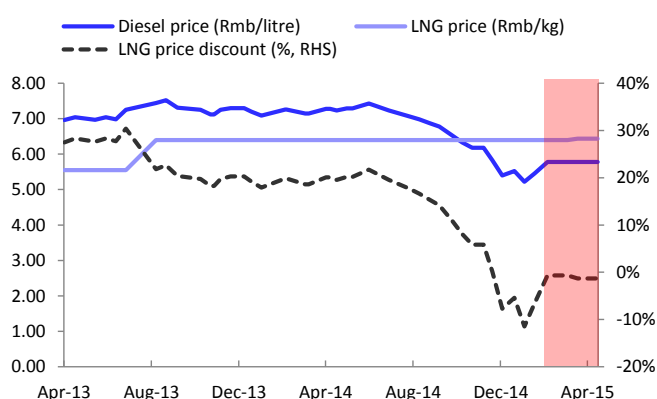
Natural gas business

- Natural gas sales volume was up 10% yoy to 6.845bcm in FY14 (Figure 4), mainly due to more gas sales from city gas projects and increased CNG/LNG sales. However, the volumes of LNG receiving terminals were down 24% due to the LNG diversion to the Caofeidian LNG receiving terminal (currently held by PetroChina, not by Kunlun Energy), which dragged down profit by 29%.
- Natural gas transmission volume was up 21% yoy to 30.69bcm in FY14, largely driven by the rising utilization of Shaanxi Beijing Pipelines off a low base in 2013. But earnings growth fell below the volume growth at only 7% due to the transmission tariff cut in early 2014.



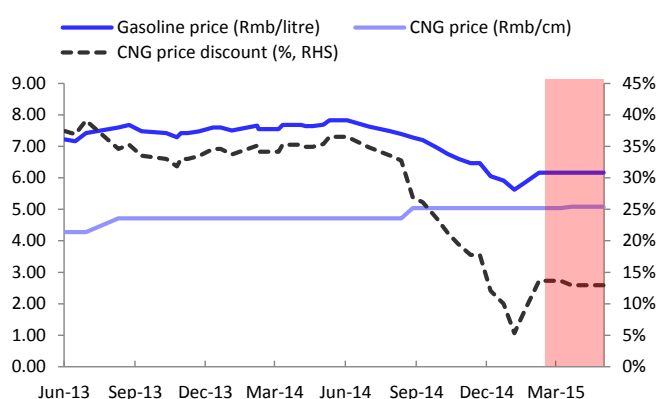
- Looking into 2015, we expect further downside in the natural gas sales business, which is mainly composed of CNG/LNG vehicle gas sales, with the outlook clouded by a sharp decline in the diesel price despite the recent cut in the incremental gas price. Despite the tariff cut in “incremental volume”, the pricing competitiveness of natural gas vs. alternative fuels remains unfavorable, given the sharp oil price decline over the past 12 months – the price of converged natural gas vs. LPG and diesel will remain at a 1-13% premium (vs. a 20% discount in February 2014). For more details, please refer to “China Gas Utilities: Small cut in blended gas price won't help,” published on 2 March 2015.
- However, we expect the earnings contribution from the midstream transmission business (Shaanxi-Beijing pipelines) to increase due to the expected mid-term volume growth and a stable pricing trend.

Figure 2: LNG price vs. diesel price (Shandong)



Source: Deutsche Bank, WIND

Figure 3: CNG price vs. gasoline price (Shandong)



Source: Deutsche Bank, WIND

Figure 4: Key operating statistics for Kunlun

Key operating statistics	FY13	FY14	yoy	Deutsche Bank comment
Upstream E&P business:				
Sales vol. (mil. bbl)	17.46	16.88	-3%	small sales volume decline
Realized oil price (US\$/bbl)	97.30	84.47	-13%	Lower realized oil price on more domestic sales mix at lower price
Mid-/downstream gas business:				
Natural gas sales (mil. cm)	6,222	6,845	10%	Pick up in 2H14 after a flat yoy trend in 1H14
Natural gas transmission (mil. cm)	25,336	30,693	21%	98% volume from Shaanxi-Beijing Pipelines
LNG processing (mil. cm)	927	912		Lower plant utilization despite several new processing plants into operation
LNG terminal (mil. cm)	6,837	5,181	-24%	down due to LNG diversion to Caofeidian LNG terminal
Tariff (Rmb/cm):				
Natural gas	2.81	3.10	10%	Up on non-residential city-gate gas tariff hike in 2013/14
Pipeline transmission	0.37	0.33	-10%	down on ShaanJing pipeline transmission tariff cut in early 2014
LNG terminal re-gasification	0.29	0.30	4%	
Segment profit margin before deprec. (Rmb/cm):				
Natural gas	0.29	0.29	-1%	Gas price hike mostly passed-through
Pipeline transmission	0.30	0.27	-10%	A results of transmission tariff cut
LNG processing	0.29	(0.11)		Loss-making due to feedstock gas price hike and low plant utilization on industry overcapacity
LNG terminal re-gas	0.23	0.23	0%	Stable margin given regulated re-gasification tariffs

Source: Deutsche Bank, company data

LNG liquefaction business

- Two of Kunlun’s major LNG plants (Hubei Huanggang: 5m cm/day and Shandong Taian: 2.6m cm/day) have yet to be put into operation despite construction work having been done, which is due to the significant overcapacity situation for LNG liquefaction facilities in China and high



feedstock gas costs relative to the prevailing LNG market prices. The capitalized interest in FY14 was Rmb1,035m, which is similar to HK\$1,260m in FY13 due to the delayed commissioning of LNG processing plants.

- We believe these two plants will continue to weigh on Kunlun's earnings outlook once depreciation and the interest burden kick in when these two plants are transferred out of work-in-progress.
- Despite the recent tariff cut for incremental gas starting from April 2015, we do not expect an improvement in the LNG liquefaction business given the low LNG market price amid weak demand from LNG vehicles following the diesel price decline.

LNG receiving terminals

- With the commissioning of the PetroChina Caofeidian LNG receiving terminal in December 2013, Kunlun incurred a diversion of PetroChina's contracted LNG from the Rudong and Dalian LNG receiving terminals to the Caofeidian LNG receiving terminal in 2014. Consequently, the utilization of LNG receiving terminals came down in 2014, which dragged profit by 8% yoy to HK\$401m.
- Looking into 2015, the utilization level is likely to improve when additional long-term LNG contracts under PetroChina begin their first year of LNG supply. In addition, with a significant decline in the spot LNG price, there could be a higher volume of spot purchases flowing through the terminal. Hence, we expect some recovery in profit contribution from the receiving terminals.
- The phase II of the Rudong LNG receiving terminal received approval from the NEA in May 2014. The phase II project is expected to start operation in 2016E, with additional processing capacity of 3m tons p.a.

E&P business

- Kunlun sold 16.88m barrels of crude oil in FY14, down 3% yoy. However, profit contributions from the E&P business were down 30% yoy to HK\$1,550m, mainly due to (i) a 13% lower realized crude oil selling price, and (ii) a c.HK\$500m FX loss (HK\$300m attributable to Kunlun) due to the depreciation of local currency from the Aktobe E&P project in Kazakhstan.
- Looking into 2015, we expect a net loss of HK\$400m due to the sharp decline in the oil price in late 2014. We use Deutsche Bank's WTI crude oil price forecast of US\$55/barrel in our model. In addition, we expect the E&P business to show a stable declining production profile in the coming few years, with earnings volatility from higher operating costs.

Asset transfer from PetroChina

We see the potential for PetroChina Kunlun Gas and PetroChina Kunlun Natural Gas Utilisation (both wholly owned by PetroChina currently) to be transferred to Kunlun Energy. We also believe it makes sense for Kunlun to acquire the profit-making Caofeidian LNG receiving terminal from PetroChina. However, there is no specific timetable at this point, and the timing is difficult to gauge. Moreover, the price of the asset injection is unlikely to be as attractive as in previous cases.



Valuation and risks

Our target price is based on a sum-of-the-parts valuation that uses DCF (with WACC determined by business sector), with over 95% of the value coming from the midstream/downstream gas business and the remaining value largely from the upstream E&P business. (Midstream gas pipelines represent the 60% stake in Shaanxi-Beijing Pipelines; LNG receiving terminals include Rudong LNG [55%] and Dalian LNG [75%]; downstream gas mainly includes the CNG/LNG vehicle gas business.)

Figure 5: Sum-of-the-parts valuation of Kunlun Energy

Business	HK\$ m	%	Deutsche Bank comment
Gas business	60,231	97%	
Midstream gas pipelines	44,629	72%	represents the 60% stake in Shaanxi-Beijing Pipelines, based on DCF using a Ke 8.4%.
LNG receiving terminals	13,501	22%	Incl. Rudong LNG (55%) and Dalian LNG (75%), based on DCF using Ke of 8.9%.
Downstream gas	2,100	3%	Mainly incl. CNG/LNG vehicle gas business, based on DCF using Ke of 8.9%.
E&P business	1,831	3%	Incl. debt and cash at holdco, based on DCF using WACC of 9.6%.
Others	(140)	0%	
Equity value	61,922	100%	
Share outstanding (mil.)	8,062		
Equity value per share (HK\$)	7.8		Set as our target price

Source: Deutsche Bank, company data

Key risks

Key risks for the mid- and downstream gas business include (1) a higher/lower natural gas tariff, which would potentially lead to less competitive pricing for vehicle gas vs. diesel and gasoline, and lower/higher utilization of the midstream gas infrastructure; (2) lower capacity utilization due to insufficient natural gas supply; (3) changes in the regulatory regime for the midstream and downstream gas business; (4) changes in PetroChina's strategy for Kunlun Energy and (5) over-/under-paying for the parent's assets.

Key risks for the upstream E&P business could come from (1) oil price fluctuations, resulting in lower/higher realized oil product prices; (2) lower-/higher-than-expected production output and higher-/lower-than-expected capex and (3) a lack of project operatorship may mean the company has limited control over its sales volumes.



Appendix 1

Important Disclosures

Additional information available upon request

Disclosure checklist

Company	Ticker	Recent price*	Disclosure
Kunlun Energy	0135.HK	7.57 (HKD) 26 Mar 15	1,7,14,17

*Prices are current as of the end of the previous trading session unless otherwise indicated and are sourced from local exchanges via Reuters, Bloomberg and other vendors. Data is sourced from Deutsche Bank and subject companies.

Important Disclosures Required by U.S. Regulators

Disclosures marked with an asterisk may also be required by at least one jurisdiction in addition to the United States. See Important Disclosures Required by Non-US Regulators and Explanatory Notes.

1. Within the past year, Deutsche Bank and/or its affiliate(s) has managed or co-managed a public or private offering for this company, for which it received fees.
7. Deutsche Bank and/or its affiliate(s) has received compensation from this company for the provision of investment banking or financial advisory services within the past year.
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Please also refer to disclosures in the Important Disclosures Required by US Regulators and the Explanatory Notes.

1. Within the past year, Deutsche Bank and/or its affiliate(s) has managed or co-managed a public or private offering for this company, for which it received fees.
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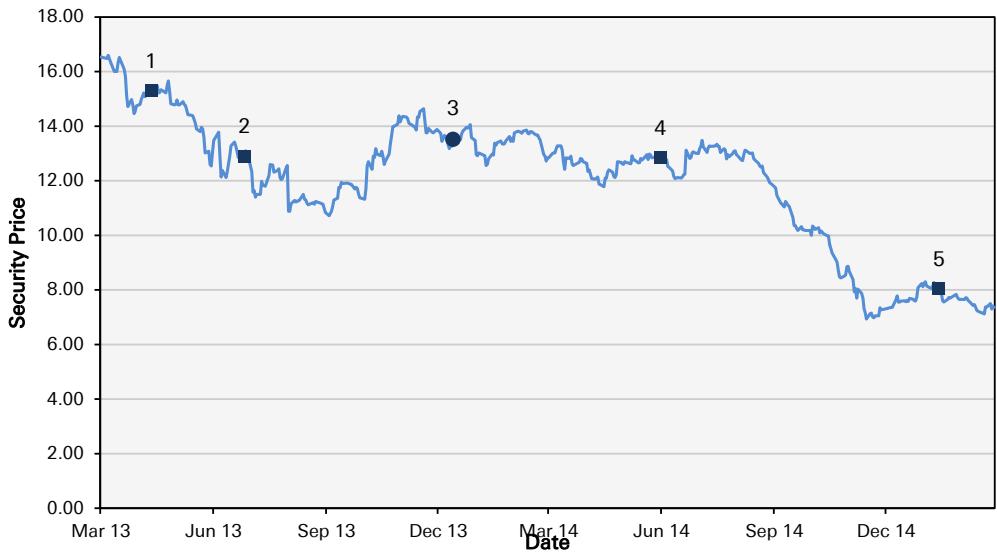
For disclosures pertaining to recommendations or estimates made on securities other than the primary subject of this research, please see the most recently published company report or visit our global disclosure look-up page on our website at <http://gm.db.com/ger/disclosure/Disclosure.eqsr?ricCode=0135.HK>

Analyst Certification

The views expressed in this report accurately reflect the personal views of the undersigned lead analyst(s) about the subject issuer and the securities of the issuer. In addition, the undersigned lead analyst(s) has not and will not receive any compensation for providing a specific recommendation or view in this report. Michael Tong



Historical recommendations and target price: Kunlun Energy (0135.HK)
 (as of 3/26/2015)



Previous Recommendations

- Strong Buy
- Buy
- Market Perform
- Underperform
- Not Rated
- Suspended Rating

Current Recommendations

- Buy
- Hold
- Sell
- Not Rated
- Suspended Rating

*New Recommendation Structure as of September 9,2002

1. 08/05/2013:	Buy, Target Price Change HKD16.00	4. 27/06/2014:	Hold, Target Price Change HKD12.50
2. 23/07/2013:	Buy, Target Price Change HKD14.80	5. 09/02/2015:	Hold, Target Price Change HKD7.80
3. 09/01/2014:	Downgrade to Hold, Target Price Change HKD14.00		

Equity rating key

Buy: Based on a current 12- month view of total share-holder return (TSR = percentage change in share price from current price to projected target price plus projected dividend yield) , we recommend that investors buy the stock.

Sell: Based on a current 12-month view of total share-holder return, we recommend that investors sell the stock

Hold: We take a neutral view on the stock 12-months out and, based on this time horizon, do not recommend either a Buy or Sell.

Notes:

1. Newly issued research recommendations and target prices always supersede previously published research.

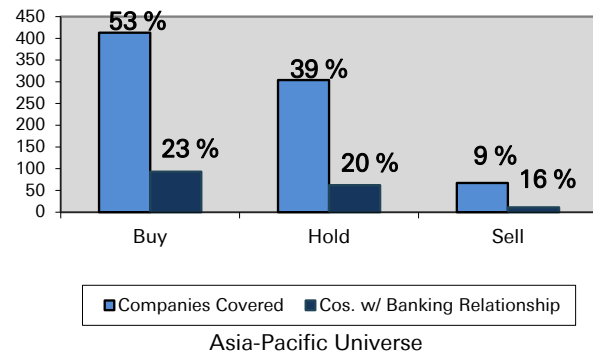
2. Ratings definitions prior to 27 January, 2007 were:

Buy: Expected total return (including dividends) of 10% or more over a 12-month period

Hold: Expected total return (including dividends) between -10% and 10% over a 12-month period

Sell: Expected total return (including dividends) of -10% or worse over a 12-month period

Equity rating dispersion and banking relationships





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David Folkerts-Landau
Group Chief Economist
Member of the Group Executive Committee

Raj Hindocha
Global Chief Operating Officer
Research

Marcel Cassard
Global Head
FICC Research & Global Macro Economics

Richard Smith and Steve Pollard
Co-Global Heads
Equity Research

Michael Spencer
Regional Head
Asia Pacific Research

Ralf Hoffmann
Regional Head
Deutsche Bank Research, Germany

Andreas Neubauer
Regional Head
Equity Research, Germany

Steve Pollard
Regional Head
Americas Research

International locations

Deutsche Bank AG

Deutsche Bank Place
Level 16
Corner of Hunter & Phillip Streets
Sydney, NSW 2000
Australia
Tel: (61) 2 8258 1234

Deutsche Bank AG

Große Gallusstraße 10-14
60272 Frankfurt am Main
Germany
Tel: (49) 69 910 00

Deutsche Bank AG

Filiale Hongkong
International Commerce Centre,
1 Austin Road West, Kowloon,
Hong Kong
Tel: (852) 2203 8888

Deutsche Securities Inc.

2-11-1 Nagatacho
Sanno Park Tower
Chiyoda-ku, Tokyo 100-6171
Japan
Tel: (81) 3 5156 6770

Deutsche Bank AG London

1 Great Winchester Street
London EC2N 2EQ
United Kingdom
Tel: (44) 20 7545 8000

Deutsche Bank Securities Inc.

60 Wall Street
New York, NY 10005
United States of America
Tel: (1) 212 250 2500

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