PETRUSADVISERS

Andreas Arndt (CEO, Chief Financial Officer), Dr Günther Bräunig (Chairman of the Supervisory Board)
Deutsche Pfandbriefbank („**pbb**“)
Parkring 28
85748 Garching

London, 31 January 2023

Dear Mr Arndt, dear Mr Bräunig,

Petrus Advisers is an investor in pbb with a stake of just under 3%. We believe that pbb's current low valuation (0.36x book value[1]) reflects significant strategic shortcomings as well as a lack of vision and needs to be addressed urgently.

Since pbb's IPO in 2015, pbb has never earned its cost of capital, which we estimate to be at least 10-11%, (return on equity, RoE) and has generated close to no value for shareholders (2.1% annualised total shareholder return[2]). On average, you have generated an RoE[3] of 5.5% since 2017 and you are run-rating at 5.2%[4] with a downward trend compared to the previous year quarter. Despite this flagrant failure to meet reasonable minimum performance targets, you have not even bothered to define clear medium to long-term RoE targets for pbb, which makes pbb an exception to almost all listed European banks. At the same time, you have condemned pbb to further growth of its loan book and hence its risk weighted assets (RWA). You are thereby actively and deliberately destroying shareholder value by deploying further capital below your cost of capital. From the point of view of reason and sustainability, your actions are simply senseless. Even for state-owned companies, this behaviour is no longer acceptable in Western Europe – and even less so for a public company with no or only minor state participation.

The current market environment gives rise to fears of further negative developments in your operating results. pbb's narrow business model does not benefit from a generally higher interest rate level. On the contrary, the expiry of the ECB's TLTRO programme will result in pbb losing an interest rate 'subsidy' of approximately Euro 42[5] million per year. Management does not seem to be able to compensate these negative developments, e.g. with higher interest margins in new business with a similar risk profile. A comprehensive diversification of funding sources through deposits as well as the development of a proper commission and fee business has so far been neglected. The recently announced plan to establish a new segment "Real Estate Investment Management" has so far not been backed up by any concrete targets. Aareal Bank, the best benchmark for pbb in our view, has shown what is possible in the current market environment. While pbb has shrunk its RoE from 7.4% in Q3 2021 to 5.2% as per Q3 2022, Aareal's adjusted RoE has increased from 4.8% to 9.5%[6].

The lack of financial sustainability of your strategy is flanked by a lack of focus on ESG criteria or green lending in your core business. As of Q3 2022, only 4% of your REF[7] loan volume qualifies as green lending.

[1] P/BV per 31 January 2023.
[2] Factset per 31 January 2023, adjusted for dividends (pre-tax) and assuming a full re-investment of dividends in the pbb share.
[3] 'Return on equity' defined as net income after AT1 coupon / average shareholders' equity. Average of quarterly returns.
[4] Return on equity per Q3'22.
[5] Based on Euro 8.4 billion TLTRO III programme.
[6] Adjustments include one-off tax effects, M&A and restructuring costs as well as loan loss provisions for Russian loans.
[7] Real Estate Financing.

You are currently on a development curve pointing to 13% by the end of 2024, which compares to your loosely defined target of around 30% by 2024/25. You have neither defined concrete target metrics before 2024/25 nor tied the remuneration of pbb's management to the achievement of this sustainability target in any meaningful way. We consequently worry about further sustainability shortcomings at pbb.

In response to our concerns, you have been hiding behind pbb's high capitalisation to explain your lack of sustainable profitability. On the one hand, you have blamed this fact on the high level of capitalisation that pbb received from the federal government prior to the IPO, and on the other hand, you have referred to the high level of caution exercised by pbb's management. As investors, we value prudent risk-taking. However, it must not be abused to cover up a lack of management initiative and discipline – the capital market does not tolerate squirrel-like amassing of excess reserves.

To ensure the medium to long-term sustainable development of pbb, we urgently call for a comprehensive **strategic review**. In particular, the following levers must be analysed:

- **Net interest margin:** Aareal[8] has systematically increased its net interest margin per RWA over the last quarters from 351bps as at Q3 2021 to 409bps as at Q3 2022. pbb's net interest margin has stagnated in the REF segment as well as at group level over the same period and is significantly below Aareal. The expiry of the TLTRO programme will further increase pressure on pbb.
- **Commission and fee income**: Asset-light business can help increase pbb's return profile. Management should therefore present a concrete plan in a timely manner.
- **ESG focus:** The commercial real estate industry has a huge contribution to make to the energy transition. This offers many opportunities for lenders who can set the right ESG priorities. Unfortunately, you are lagging behind in green lending.
- **Cost base:** You have a concentrated loan book. The targeted cost-income-ratio of 45-47% (before 5-6% bank levy) therefore seems high.
- **Capital usage:** No relevant listed European bank that we are aware of has similar high capital ratios (CET1 ratio of 16.8%[9]) and buffer (7.9%[10]) on Basel IV fully-loaded basis. You have decided to neither pay a 2019 catch-up dividend nor to adjust your capitalisation via a special dividend or a share buyback programme. The ECB continues to give the green light to share buyback programmes (e.g. ING[11]) and also Commerzbank[12] recently kicking off the process. Currently, your capital buffer is shrinking because you are increasing risk weighted assets at a rate of return well below the cost of capital, thus destroying value.
- **Human resources**: pbb's average employee age has been increasing for years: While 32% of your employees were younger than 40 years in 2017, this ratio has decreased to 28% in 2021. At Aareal, this ratio has increased from 27% to 35% over the same period. Can you offer young and motivated employees an attractive career outlook at pbb contributing to securing the bank's sustainable future?
- **Going concern vs. sale or run-down:** In light of pbb's lack of sustainable performance, it must be questioned whether it makes sense to continue with the going concern. With the current strategy, you

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[8] Aareal refers to Aareal ex. Aareon. Net interest margin defined as net interest income (including TLTRO) / RWA B4 fully-loaded.
[9] Per Q3 2022. Basel IV, fully loaded.
[10] Per Q3 2022. Composed of 2.8% excess capital and 5.1% implied management buffer (CET 1 target ratio of 14.0% less SREP of 8.9%).
[11] https://www.ing.com/Investor-relations/Share-information/Share-buyback-programme.htm.
[12] At the sell-side analyst meeting on the Q2 2022 results, the CFO confirmed that discussions have started with the ECB SSM regarding a share buyback programme.

will continue to systematically destroy value. As it stands, a sale or, unfortunately, even a run-down would create significantly more value.

We have been maintaining a constructive dialogue with you and your team for years, but are not being heard. It is time to take off the blinkers and finally work sensibly, otherwise Deutsche Pfandbriefbank will not be able to survive sustainably as an independent institution.

Sincerely,

Klaus Umek
Managing Partner

Till Hufnagel
Partner