SPECIAL REPORT

RBS – rising from the rubble

While the new management team still have plenty of work to do, they do at least have a clear plan to execute. Despite the big challenges lying ahead, we believe the market has yet to fully appreciate the medium term earnings potential of RBS.

1 YEAR TARGET 70p  
3 YEAR TARGET 120p

From bubble to rubble

From its humble beginnings in 1727, RBS rose to become a global giant. Not only did RBS lead the world’s biggest ever banking takeover, it was even ranked by Forbes as the biggest company in the world in terms of assets. Then the bubble burst.

While the timing of the ABN Amro acquisition plunged RBS into financial freefall, make no mistake, RBS was heading for a fall anyway. Its balance sheet was too bloated and its funding was too fragile. ABN Amro just accelerated the collapse. As part of its battle for survival, RBS is undergoing a radical makeover.

Easier said than done

The new RBS strategy is effectively a U-turn. Big and diversified are out, small and focused are in. Over the next three to five years the company will undergo a serious weight-loss programme. Jobs will be cut, assets will be sold and markets will be exited.

The new CEO has set very clear financial targets:

- The balance sheet is to shrink by 30%;
- Return on equity is to exceed 15%;
- The cost income ratio is to be less than 65%;
- The capital ratio is to remain above 8%;
- Loans should match deposits; and
- The credit rating should be AA or better.

Some of these targets are proving easier than others.

While good progress has been made reducing the balance sheet, RBS still remains far too reliant on wholesale funding.

Its loan-to-deposit ratio, which measures the amount of wholesale funding as a proportion of deposits, has only fallen by 8% to 144%. Of the UK banks, only Lloyds are in a worse position.

The CEO Stephen Hester knows just how important this task is "we have to fix the risk that nearly had us topple over". It was less than a year ago that the
SPECIAL REPORT

RBS – rising from the rubble

wholesale markets shut the door in the face of RBS. The Bank of England had to step in and offer backing from HM Treasury in order to prevent RBS from becoming insolvent.

Hard core

Part of the massive clean-up has involved splitting the assets of RBS into core and non-core.

In order to achieve the targeted shrinkage, RBS literally needs to sell billions in assets and/or run-off (not renew) billions in loans. The planned run-off is so big that a specialist team has been set up to manage the process.

17% of the assets on the balance sheet have been identified as “non-core”. That’s a banks way of saying we don’t want you as a customer anymore. If you’re a property developer who banks with RBS, it’s time to look for a new bank.

RBS have even started to split their results into "core" and "non-core" divisions. Its core units made a huge £6.3 billion profit in the first half, while the non-core units lost £9.6 billion. Unfortunately there is no magic wand to offload all the non-core assets but it helps the market get a feel for what earnings might be going forward once the mess has been cleaned up.

There is a lot of uncertainty about how difficult and expensive it will be to offload the £163 billion of loans earmarked as non-core. Apparently they have been set aside because they don’t fit in with the new focused strategy, but we suspect it’s because they are of poor quality. Over 12% of the total is already “non-performing” (can’t pay). It makes you wonder how bad the £300 billion or so of loans are that are earmarked for the Asset Protection Scheme.

Challenges remain

RBS will still have plenty of challenges to deal with going forward including:

- how restrictive will the new regulatory regime be;
- will the EU Competition Commission force disposals;
- will political interference hold back commercial success; and
- will the new slimmed down RBS be able to compete with broader banks;

The new regulatory regime will certainly force down returns on equity, but should provide better quality earnings.

Having highly cyclical (boom-bust) earnings holds back sector valuations. Investors prefer steady and reliable earnings. If banks are perceived as safer and more predictable by the market, then they may be rewarded with higher price to earnings multiples.

The political interference has been minimal so far, however the new RBS bonus structures haved moved RBS away from short-term non-recourse cash bonuses. It makes sense but it has led to hundreds of staff defections to investment banks that still offer the old style bonuses. Unless these types of bonuses are outlawed globally, RBS will...
RBS – rising from the rubble

struggle to hold on to staff who can be lured away by more aggressive rivals.

The UK government doesn’t want to damage the competitiveness of RBS. It has some political motives such as economic stability and job protection, but ultimately it is the largest shareholder in RBS and desperately needs the tax receipts from the banking and finance sectors. It will be careful not to kill the golden goose through over-regulation and interference.

A further uncertainty is that RBS may see part of its small business banking operation curtailed. The European Competition Commission has stuck its nose in because RBS received state aid. They have the right apparently. RBS has a 20-30% dominant position in small business banking. It’s the EU’s job to create a level playing field.

The timing couldn’t be worse for the UK government, who seem to be fighting Brussels harder than RBS. Kick starting lending to small business (a great source of jobs) is critical to the UK’s economic recovery. Handicapping the leading player in the market won’t help matters. In the first half of 2009, RBS’s mortgage and general business lending was strong but there was a 37% in loan applications from small businesses. RBS seems to be doing the job for the Europeans.

A question mark remains over whether a slimmed down RBS will lose some of its competitiveness to broader based banks. The evidence would suggest the idea of a being a global player is more about ego than performance. Not only has it done RBS no favours, look at Citigroup and AIG as companies that tried to be all things to all people. Diverse businesses are harder to manage so there has got to be a strong justification for the strategy. Having global reach was meant to spread financial risk, but in an era of global trade and finance, the benefits of regional diversity are superficial.

Having looked at the list of the world’s 50 safest banks 2009 (performed by Global Finance) it jumps out at you that almost all of them are regional specialists.

Banking is a business of risk. Having a strong understanding of your core markets seems to be an advantage. A slimmed down RBS should be embraced.

The merchant of doom

Mr Hester has become the merchant of doom among his UK banking peers.

Losses last year were “terrible”. The performance for this year will be “poor” and loan losses will “remain high”. While he’s seen some green shoots they were “short in duration”. The bumper results from investment banking could be “unsustainable”. Even Eric Daniels over at struggling Lloyds believes bad debt impairments have peaked.

Mr Hester has an advantage over the other CEOs. He can’t be blamed for the sins of the past, so is best talking down the current situation – “look at the mess these guys created”. It will only make the inevitable recovery seem a direct result of his hard work and tough decisions. It’s a case of under-promising so he can over-deliver.

For the time being, the market is ignoring Mr Hester’s cautious tone and pricing RBS for recovery.
RBS – rising from the rubble

Mind the Gaps

The creation of the government’s Asset Protection Scheme (GAPS) was a key turning point for RBS. RBS jumped as much as 40% on the day it agreed the broad terms. It meant the RBS balance sheet was no longer perceived as a bottomless pit.

In short it allows RBS to limit the losses on the worst bits of its balance sheet for a fee. At the time, with its share price in tatters, RBS was hardly in a position to negotiate. The fee due to the government will be paid in RBS shares not cash, meaning the government’s stake in RBS is set to rise even further from 70% to around 84%.

Without trying to sound ungrateful, RBS and its investors now believe the deal doesn’t look that attractive anymore. Although the deal was struck only a little over six months ago, the world is a very different place now. Toxic assets have been shooting up in value as buyers return to the market. Many hedge funds, insurance companies and other big financial institutions are now keen buyers of distressed debt.

Complete avoidance of the Asset Protection Scheme looks a step too far. In order to convince the FSA that RBS doesn’t need to join the scheme, it’s been estimated that a rights issue of as much £35 billion would be needed. That’s Mission Impossible.

RBS also believes it might be able to pay the fee with cash rather than have the government own even more of its shares. RBS is now actively considering its options such as disposals or another rights issue.

The disposals programme has been disappointing so far. The sale of the Asian operations ended up a complicated process and hasn’t raised the money that was initially estimated. The aircraft leasing and fund management businesses are both currently for sale, but neither is likely to raise enough money to make any major difference to the bank’s balance sheet. RBS is also saying it’s in no hurry to offload these non-core operations and that they won’t be sold unless they are happy with the price.

If more capital is to be raised in the short term it looks likely to be through a modest rights issue of around £3-£4 billion. It won’t allow RBS to wriggle free from the Asset Protection Scheme but it will keep the government’s stake from rising much further.

Who will the government sell its stake to?

The UK government has already stated clearly that other UK banks would be prohibited from buying its stakes in Northern Rock, Lloyds and RBS. The European regulators are already concerned with the lack of competition in UK banking. New entrants (foreign money) will be actively encouraged.

Serious discussions have already started with sovereign wealth funds. Sovereign wealth funds are the only obvious buyers. US and European banks are in a similar mess to UK banks, so can be ruled out in the short term. Even the biggest private equity funds would struggle to raise the cash needed to buy the RBS or Lloyds stakes. Another problem with private equity funds is they tend to be medium term rather than long term investors. The government is looking for rich, passive and long

Risk Warning Notice: Galvan Research And Trading Ltd is authorised and regulated by the Financial Services Authority (FSA). Whilst every attempt is made to ensure the accuracy of the information provided, no responsibility can be accepted for any inaccuracy. The information provided cannot be relied upon as constituting a recommendation, nor construed as any offer to sell, or any solicitation of any offer to buy investments. No liability is accepted for any loss whether direct or indirect, incidental or consequential, arising out of any of the information being untrue and / or inaccurate, except to the extent caused by the wilful default or gross negligence of Galvan Research And Trading, its employees, or which arises under the Financial Services And Markets Act 2000.

Winner: Best Equity Derivatives Advisor, Best CFD Advisor
term investors. That leaves sovereign wealth funds, but are they actually interested?

At present, sovereign wealth funds seem more interested in resource plays than financials. Many are still nursing big losses from previous investments in the sector. However the worst of the financial crisis appears well and truly over, and financials still offer a lot of potential upside.

Our view is that the government stake in RBS is likely to be sold off in multiple tranches to multiple buyers. Middle Eastern and Asian money are the obvious sources.

The timing may be favourable too as there are clear indications that many sovereign wealth funds want to increase their diversification and target higher returns. Their policy of simply recycling their trade surpluses into US treasuries is gradually being replaced with a more equity-based bias.

A lot depends on the sale of these government stakes in banks. Not only is it our money on the line, the Labour government’s reputation is as well. If the Prime Minister has any chance of winning the next election, he needs to demonstrate economic recovery. What better way than to re-privatise (partly or fully) the banks.

To score any political points, the government must also turn a profit. The key price for RBS is 50.4p, as that’s the government’s average entry price. As RBS has been trading above this level for well over a month now, the sale of the first tranche could be imminent. RBS also looks the most likely bank to start the re-privatisation process. Lloyds is still trading well below 120p, which is the government’s average entry price. Northern Rock still looks financially weak and reliant on state aid to continue operating, so the government is along way from getting its (our) money back.

What are the shares potentially worth?

Over the short term we believe gains in the RBS share price will be capped as loan impairments and restructuring costs hold back investor enthusiasm.

Short-term we have set a 70p target price for the shares. The recently announced pay package for Mr Hester sets 70p as the share price target for him to achieve full pay-out, so management will be gunning for this level. Other than a rising stock market, there are a number of near term catalysts that could drive the price to this level such as a part sale of the government’s stake, levelling out of loan impairments, mark to market gains from improving toxic asset values, or talk of a significant disposal (Coutts for example).

Although book value is by no means a precise measure, the shares are currently trading slightly above their estimated book value, which has led many analysts to be cautious. As we have said many times before, book value is a very narrow view of a banks worth. It’s like valuing a car based on its scrap value, rather than trying to value it as a working car. Most companies, including banks, would be worth far less if their assets were simply liquidated. It misses the real value of a company, which is its earnings potential.
RBS – rising from the rubble

Over the medium term we expect the market to move away from book value (liquidation) value and focus more on the earnings potential of the core operations.

The best way to analyse the longer term potential of RBS is at an operating level. We have looked at each business division separately and arrived at an estimated level of earnings based on recent trading history (last 5 years), then applied a reasonable earnings multiple (8 to 10 times depending on earnings prospects).

Based on our sum-of-parts analysis, we value RBS at £48.5 billion, or around 120p a share.

Around two thirds of that aggregate value is attributable to the key divisions, which are UK and US retail-commercial banking (Natwest, RBS, Ulster, Coutts, Citizens, Charter One) and insurance (Churchill, Direct Line).

The final say

It’s going to be a long road back to full health. A complete recovery looks at least three years away. Loan impairments will probably keep RBS in the red for both this year and next.

Right now RBS remains only for the pioneers and the patient but the potential upside is substantial and we stand by our 120p a share aggregate value for the underlying businesses.

Strengths

• New and respected management team
• Clear and conservative strategy
• High capital ratio
• Low expectations
• Government sale may trigger rally

Weaknesses

• Reliance on wholesale funding
• Losses from conventional loan book yet to peak
• Less exciting prospects going forward
• Threat of political interference