Equity Research; RBS

COLLINS SARRI STATHAM INVESTMENTS

Research Report

Report Date

1st August 2016

Analyst

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Collins Sarri Statham Investments Ltd

Stock Rating: BUY

Target Price	250p
Share Price	184p
Yr/Hi/Low	361p/149p
Shares o/s	11.755bn
Market Cap	£21.6bn
Avg Daily Vol	19.3m
Dividend Yield	0%

Website:

www.rbs.com

Key Risks to Price Target

i) RBS has significant pension deficit liabilities, recent £4.2bn injection may be insufficient

ii) Significant US liabilities relating to RMBS

iii) Sensitive to UK credit demand, rate spreads

Please note the risk warnings and disclaimers

RBS ; objectives on track

RBS has stumbled on the way back to profitability held back by ongoing provisions, PPI costs, higher conduct expenses, and competition in its core UK / Eire franchise. However RBS has made major steps towards right sizing, exiting Citizens Bank which scales back its US business substantially and cutting non-core assets.

RBS has until the end of 2017 to sell Williams & Glynn to comply with rules on EU State Aid. Williams & Glynn is a new UK consumer bank, a branch unit entity to be carved out of the NatWest network. It will reduce the RBS network, and create a new "challenger bank" competitor.

To recap:-

At Q1 RBS set out a number of goals as part of Phase 2 of its restructuring plan:-

a) Maintain RBS above a Common Equity Tier 1 ratio of 13% - CET1 is the part of the balance sheet capable of absorbing losses without the bank being required to stop trading.
b) Reduce operating expenses by another £800m (as part of a commitment to getting to a cost/ income ratio below 50%)
c) Achieve 4% growth in the PBB (Personal & Business Banking) and CPB (Commercial Banking) loan book.
d) 12% returns on equity
e) Stable revenues and positive income "jaws" meaning a positive sum for revenue growth minus expense growth – (i.e. if revenue growth was 1% and cost reduction was 2% the "jaws" would be 3%).

Interim results due on 5th August 2016 should identify progress on these targets.

RBS – US "RMBS" settlement is a key issue

At Q1 RBS Chairman Howard Davies stated that RBS remained "hopeful" of reinstating an ordinary dividend for FY17 but "we have a lot of wood to chop before we can be firm". RBS has now repaid the "B" shares (the "dividend access" share held by the UK government) that had blocked the payment of an ordinary share dividend.

RBS is clearly not intending paying a dividend over FY2016 and H1 2017 a period during which clarity should emerge on US litigation liabilities covering US residential mortgage backed securities (RMBS). RMBS were the bonds that were backed by US sub-prime loans made on US property in the last decade.

The US RMBS settlement provision currently stands at £3.8bn it increased £1.5bn over 2015. Total global legal provisions and conduct *on the last page of this document.*

RBS is a leading UK bank owning Nat West, RBS, Ulster Bank and Coutts.

provisions total £6.1bn. The level of provision represents intelligent guesswork as to actual loss.

The issue is whether the US RMBS settlement provision is sufficient. Since the provision was revised up, the USD value of the provision has declined from $5.7bn to $4.95bn increasing the risk of further provisions.

Even assuming the current provision is adequate for US liabilities there remains uncertainty over UK PPI, LIBOR etc. The FCA is seeking an orderly conclusion for PPI liabilities by introducing a payment deadline in Q1 2018. This is mildly positive as unused UK provision could be deployed against US costs.

RBS revenues and margins are stabilizing

RBS has seen lower IEA "interest earning assets" (cash on deposit/ loans outstanding) these declined from £444.7bn at Q1 2014 to £403.4bn in Q1 2016 – this decline reflects the decline in RBS Capital Resolution where IEA assets are down from £108bn to £30.7bn at Q1. However RBS has lifted its interest margin to 1.81% with 0.34% from interest free accounts. This equates to net interest margin of c 2.15%. RBS has a number of growth divisions, "PBB" personal & business banking, Ulster Bank and Commercial Banking are growing loan books between 5%-11%.

"IEA" division	Q1 2016	Loan Book Growth	Q1 2016 net interest margin	COMMENT
UK "PBB"	£135.7bn	6%	3.02%	Growth/ High Margin
Ulster Bk	£24.2bn	4%	1.75%	Growth
Commercial Banking	£114.8bn	11%	1.88%	Growth/ Low Margin
Private Banking	£16.2bn	4%	2.80%	Growth/ High Margin
RBS Intl	£21.1bn	2%	1.43%	Near static
Corp & Inst	£11.5bn	-19%	0.66%	Ex growth
Cap Resol	£30.7bn	-63%	1.22%	Run-off
Will & Glynn	£23.3bn	3%	2.79%	Exit in 2017
RBS Total	£403.4bn	-3%	2.15%	Decline is slowing

RBS operating costs are coming down

RBS is targeting a cost run rate of £8.6bn over FY2016 a reduction of

£800m in operating expenses over 2015 (£9.4bn). At Q1 operating expenses were £2.15bn ie on track for FY16 - RBS booked restructuring charges of £238m in relation to costs to achieve.

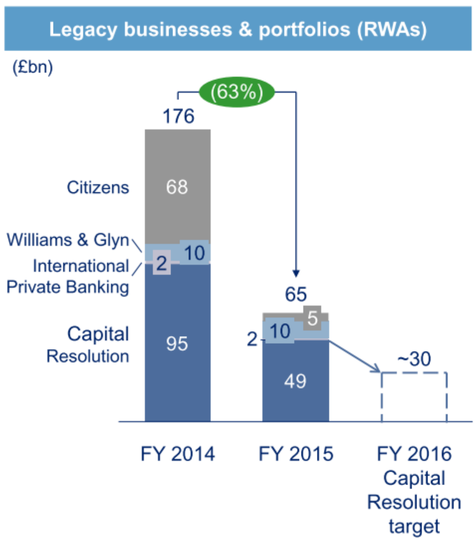
In 2015 RBS took £983m out of costs beating its initial £800m target. We are broadly confident the board will deliver to plan again in 2016. Indeed it is possible operating expenses will be lower than £8.6bn.

RBS faces challenges in the post "Brexit" environment managing interest rate spreads and a likely weaker credit demand outlook.

The board signed an agreement with RBS Main Scheme Trustee to inject £4.2bn into the scheme. The pension fund deficit has been impacted by very low gilt yields increasing the present value of future liabilities.

Improvement in legacy businesses & portfolios (RWAs)

RBS has made progress cutting non-core assets risk weighted assets (RWA) (assets multiplied by their risk weight ie a £100,000 UK gilt has a 0% risk weight and is worth £0 in RWA) which have declined from £174bn at end FY2014 to £65bn end 2015 and is on track to meet £30bn by end 2016.

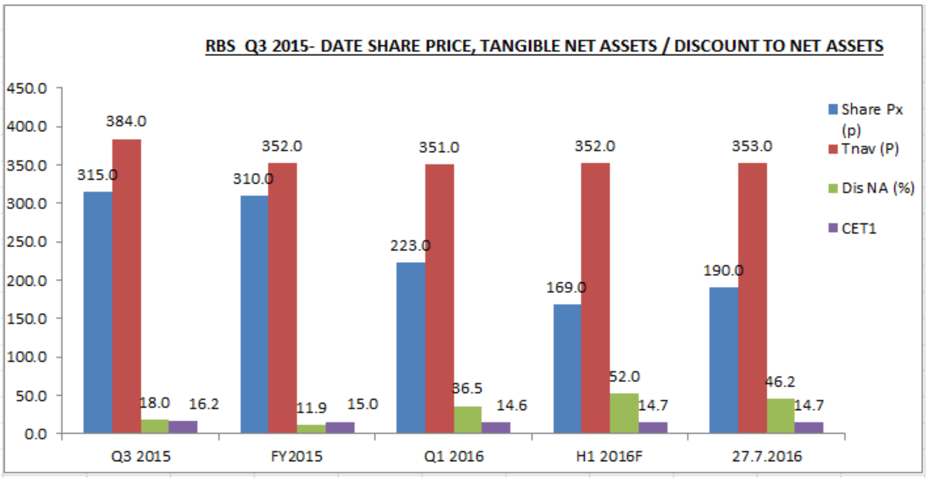


Moving parts FY2016
*Sale/ Split of Williams & Glynn will cut £10bn from RWA – a possible early sale option to Santander would achieve disposal ahead of the 31/12/2017 Euro Commission deadline.
*Citizens - £5bn exit achieved
*Capital Resolution – continues to run-off predictably though rate of decline may slow as RBS reaches core bad debt.

Source; RBS

The bulk of the non-core legacy portfolio going forward (c. 2/3rds of the total portfolio) is RBS Capital Resolution (RCR) (£30bn RWA expected end 2017) which contains RBS most troublesome loans. This has run down from £258bn in 2009 and contains bad commercial property loans, £9bn of Ulster Bank impaired loans, overseas lending and investment bank leveraged loans. The worst part of non-core will probably take longer to exit than planned. Under the EU stress test – RBS capital fell to 8.1% under the adverse scenario for 2016-18.

Valuation: Discount to Tangible Net Assets (TNAV) remains high



Source: CSS Investments Ltd

The discount between RBS share price and TNAVc. 46% - this is a high level. Tangible net assets are the RBS balance sheet net assets less intangible assets.

Conclusion

Broadly we take a positive view on RBS cost savings, the drop in RBS Capital Resolution and a high discount to TNAV. RBS interim results due 5th August 2016 should provide a positive catalyst as restructuring progress continues.

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NEUTRAL (Not Rated): The analyst does not maintain a view in either direction

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RBS **Relevant disclosures: <2>**

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