RBS Group
We think it is time to buy RBS

Equities

United Kingdom
Banks, Ex-S&L

12-month rating	**Buy** *Prior: Neutral*
12m price target	**350p** *Prior: 363p*
Price	**262p**

RIC: RBS.L **BBG:** RBS LN

Trading data and key metrics

52-wk range	404p-254
Market cap.	£30.1bn/US$43.0bn
Shares o/s	11,500m (ORD)
Free float	30%
Avg. daily volume ('000)	10,383
Avg. daily value (m)	£30.9
Common s/h equity (12/15E)	£51.5bn
P/BV (12/15E)	0.6x
Tier 1 ratio	17%

EPS (UBS, diluted) (p)

	From	To	% ch	Cons.
12/15E	27.2	22.6	-17	26.0
12/16E	14.6	21.1	44	22.3
12/17E	26.6	22.3	-16	26.9

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Every excuse not to care has left RBS much too cheap

We believe the time to buy RBS has arrived. Until now, the bank's small index weight (0.6% of the FTSE100), large overhang (500 days of volume) and legacy issues have given investors sufficient excuse to avoid the share. But, the recent sell-off has seen RBS fall too far, in our opinion, leaving it a lower risk and more attractive return prospect than the market appreciates.

Excess capital, good mix, and modest regulatory risk

We estimate RBS had 69p per share of surplus capital at 3Q15 – 25% of market cap – a figure that will likely grow as deleveraging continues and an area in which management has proven strong. The shape of RBS is becoming more attractive as the investment bank (IB) shrinks and costs are radically reduced, targeting a 55% cost/income ratio in 2018. Risks from ring-fencing and other regulatory change are now considered much lower than at Barclays, for example. We think a legacy-free RBS should trade in line with Lloyds Banking Group (LBG) at 1.3x TNAV, as uncertainty begins to clear.

Resolution of legacy issues should allow significant capital returns

Crucially, unless legacy issues cost much more than the market appreciates, the shape of Go Forward RBS means that ROTE of more than 12% and a higher rating are only a matter of time, in our view. By our numbers, the market is applying a £19bn or 63% market cap discount for legacy issues. We think losses of this scale are extremely unlikely. Our numbers include £9.6bn in non-operating charges – estimates that we think are cautious – and yet we expect more than half of the market cap to be returned by dividend or buyback by end 2020. Buybacks are our favoured route for capital excess, delivering strong EPS accretion, eroding the overhang and increasing free-float index weightings.

Valuation: 350p SOTP-derived PT, 36% upside, dividends >50% of share price

Based on our new model and estimates, we have RBS trading at 12x 2016E adjusted EPS and 0.7x TNAV for an 8% forward ROTE. However, we believe this view misses entirely the stronger returns generated by the Go Forward Bank – rising above 12% in the medium term, we estimate – and the more than 50% of the share price we expect to see returned, starting in 2017. We think the share too cheap, upgrade to Buy from Neutral. Our SOTP-derived target price uses divisional earnings multiples analysis.

Highlights (£m)	12/12	12/13	12/14	12/15E	12/16E	12/17E	12/18E	12/19E
Revenues	22,085	19,442	18,197	13,252	12,740	13,297	14,050	15,041
Profit before tax	(5,277)	(8,243)	(1,351)	354	(493)	2,288	3,028	4,352
Net earnings (local GAAP)	(6,055)	(8,995)	(3,470)	672	(2,989)	534	1,474	2,496
Net earnings (UBS)	1,599	(2,620)	5,326	2,599	2,468	2,632	2,668	3,142
Tier 1 ratio %	12.4	8.6	11.2	17.5	18.0	17.1	15.5	14.4
EPS (UBS, diluted) (p)	14.5	(23.4)	46.9	22.6	21.1	22.3	22.4	26.1
Profitability/valuation	**12/12**	**12/13**	**12/14**	**12/15E**	**12/16E**	**12/17E**	**12/18E**	**12/19E**
ROE (UBS) %	2.4	(4.5)	10.1	5.0	4.9	5.6	6.4	8.4
P/PPOP (diluted)	3.6	6.8	6.8	7.6	7.5	6.1	5.2	4.6
P/BV x	0.4	0.7	0.7	0.6	0.6	0.7	0.8	0.9
P/BV (UBS) x	0.6	0.9	0.9	0.7	0.7	0.8	1.0	1.1
P/E (UBS, diluted)	17.5	(14.0)	7.4	11.6	12.4	11.7	11.7	10.0
Net dividend yield %	0.0	0.0	0.0	0.0	1.9	11.4	19.1	16.0

Source: Company accounts, Thomson Reuters, UBS estimates. Metrics marked as (UBS) have had analyst adjustments applied. Valuations: based on an average share price that year, (E): based on a share price of 262p on 22 Jan 2016 21:35 GMT

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UBS Research THESIS MAP a guide to our thinking and what's where in this report

OUR THESIS IN PICTURES →

PIVOTAL QUESTIONS

Q: Does RBS possess significant levels of surplus capital?

Yes, we think so. At 3Q15, we estimate RBS had 69p per share of surplus capital. There are legacy issues to resolve, but we expect this surplus to grow, allowing RBS to retire or return more than 50% of market cap between 2017E to 2020E.

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Q: What multiple should we pay for a clean, restructured RBS?

RBS is trading at 0.75x TNAV, but we believe it should trade at 1.3x, cleansed of legacy and restructuring burdens. Efficiency is improving, the business mix looks attractive, and the risks from future regulatory change are modest. A re-rating of the core bank is only a matter of time, we think.

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UBS VIEW

Too much pain in the price: RBS has a low index weight, large overhang and issues to settle. These factors have seen the price fall too far, in our opinion, leaving the risk/reward more attractive than the market appreciates.

EVIDENCE

The £9.6bn in legacy charges in estimates leaves ample room for payouts. Backed by analysis of past provisions and unresolved issues, we think our provision forecasts are cautious. Notwithstanding these, however, we expect dividends or buybacks worth 150p between 2017 and 2020.

WHAT'S PRICED IN?

We estimate a £19bn discount in the price for legacy items: Valuing the ongoing RBS at Lloyds-type multiples, and adjusting for guided restructuring and disposal losses see the equity market applying a £19bn discount for legacy issues – too much, in our opinion, considering there is £4.5bn in reserve on the balance sheet.

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UPSIDE / DOWNSIDE SPECTRUM

Value drivers	Extra PBT (£m)	EPS delta (p)	Marginal P/E	TNAV delta	Extra value per share (p)	2017E EPS (p)	2017E P/E	2016E P/TNAV
395p upside	700	4.4	10x	2,000	45	26.7	14.8x	1.1x
350p target	0	0	n/a	n/a	0	22.3	15.7x	1.0x
250p downside	-400	-2.5	10x	-2,000	-25	19.9	12.6x	0.8x

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COMPANY DESCRIPTION

RBS is a leading UK retail and commercial bank. Under new leadership, the firm is in the process …

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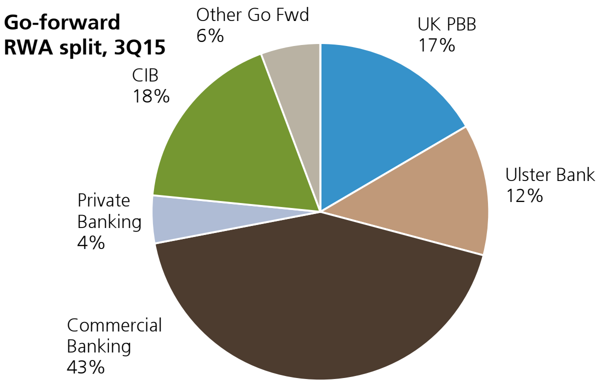
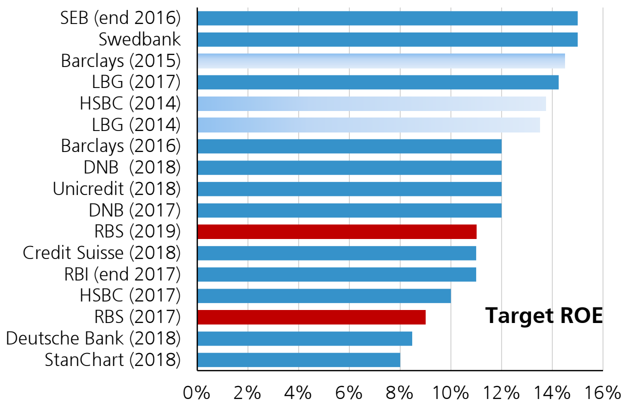
OUR THESIS IN PICTURES

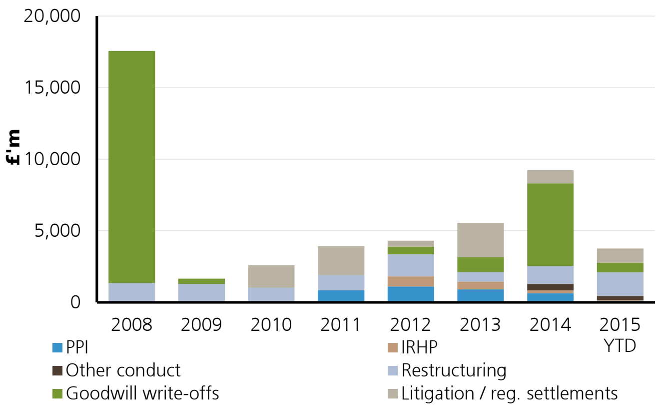
return ↑



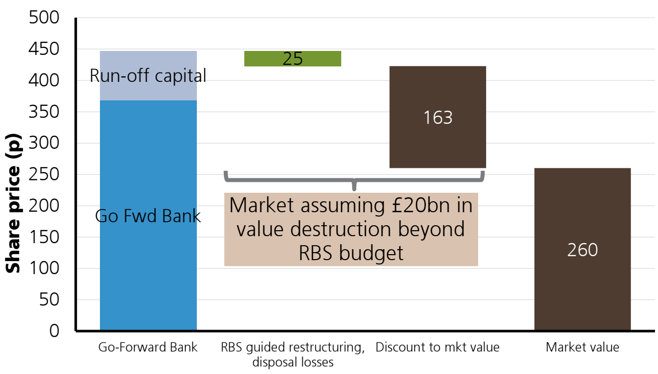
We believe RBS has an attractive business mix, even if the planned CIB turnaround fails to deliver. Regulatory risk is lower than for Barclays, we think.



The ongoing bank was producing a 10% ROTE in 3Q15. despite a breakeven CIB and Private Bank. Management promises better from both in the future.



There are drags to come from restructuring, asset disposals and legacy issues…



…but the £19bn or 163p market discount for legacy charges and share overhang is too much, in our opinion, especially considering £4.5bn in balance sheet reserves already in place

Sources for exhibits above: Company data, UBS Research

PIVOTAL QUESTIONS

return ↑

Q: Does RBS have surplus capital?

UBS VIEW

Yes, we think so. At 3Q15, we estimate RBS had 69p per share of excess capital. Buyback of the dividend blocker, and completion of restructuring and run-off take this to 76p in today's terms. We include £9.6bn in net one-offs to end 2020, but still expect RBS to retire or return more than 50% of market cap over this period.

EVIDENCE

We think MBS and shareholder litigation are the two biggest issues for the market. Both are due to start court proceedings in 2016. Our review sees us include £6.5bn in legacy and £3bn in restructuring provisions in estimates. These items are tough to forecast but we think are adequate. Despite this we expect capital to continue to build.

WHAT'S PRICED IN?

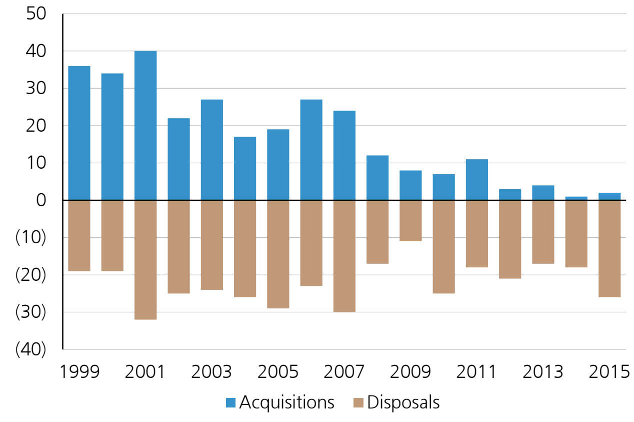
Valuing today's RBS at Lloyds-like multiples and adjusting for guided restructuring and disposal losses leaves a £19bn value gap, 63% of market cap. We think this is far too much for future required legacy provisions and think the share is undervalued.

The old RBS was driven by acquired earnings and integration synergies…

Under previous management RBS executed a strategy of organic growth bolstered by acquisition and integration. Between 1999 and the financial crisis, RBS made 246 acquisitions totaling $209bn. Portfolio management records 227 disposals worth US$69bn. Though the firm's history is defined by the largest deals – NatWest, Charter One and ABN AMRO – it is clear that RBS thought that experience in integration and an apparently efficient Manufacturing group format could consistently add value to acquired businesses.

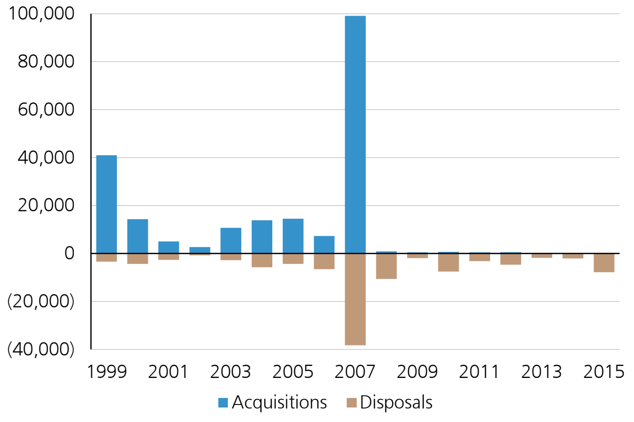
294 purchases since 1999: RBS' business model relied on bought earnings and integration gains

Figure 1: 246 purchases and 227 disposals between 1999 and the financial crisis; 3:1 disposals since then (# deals)



Source: Dealogic. Note: Data to 11 December 2015

Figure 2: $209bn on acquisitions pre-crisis and $69bn in disposals (most of which were the sold bits of ABN)



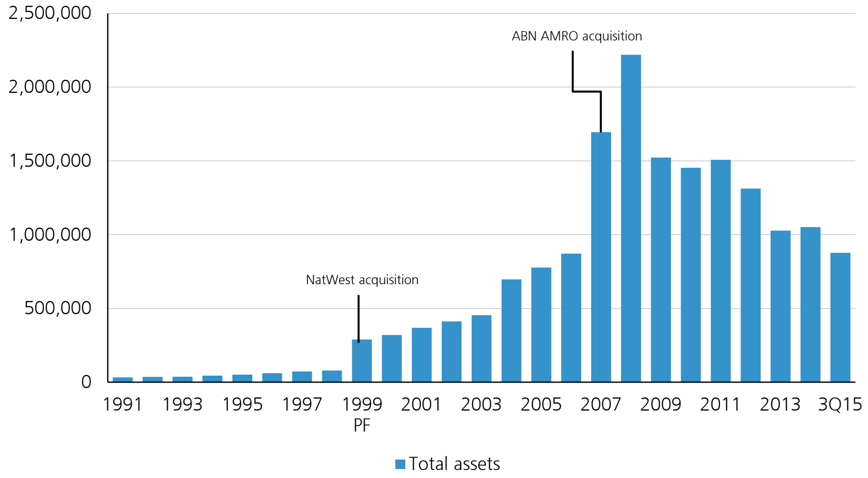
Source: Dealogic. Note: Data to 11 December 2015

…since then, RBS perhaps represents the most successful bank deleveraging operation ever

This dealmaking saw RBS' total asset base grow 40% p.a. from shortly before the NatWest deal to a 2008 peak of £2.2 trillion. Since then and following a £45.5bn UK government investment in the firm, RBS has been the most successful bank deleveraging case we have ever seen, with assets falling by £1.3 trillion, about 80% of UK GDP since the peak (Figure 3). This £200bn p.a. contraction in balance sheet is the rough equivalent of shrinking by two Northern Rocks **every year** for seven consecutive years. A significant, if necessary, achievement.

RBS assets grew 40% p.a. in 1998-08, before shrinking by two Northern Rock's p.a. – the most successful deleveraging effort we have ever seen

Figure 3: RBS' total assets grew 40% p.a. to peak, before shrinking by £1.3 trillion, 80% of UK GDP, the equivalent of two Northern Rock's each year, on average – probably the most successful bank deleveraging operation ever (£'m)



Source: Company data, UBS estimates

Deleveraging has not been cheap

This decline in total assets and balance sheet de-risking has been impressive but not cheap. We tally ~£50bn in below-the-line charges since 2008, including £24bn in goodwill write-offs, evidence that even early success in converting acquired earnings into EPS accretion should be cautiously received when European banks return to M&A (examined in our sector note).

Deleveraging and de-risking have not been cheap: £50bn in below-the-line charges…

Figure 4: RBS below-the-line charges total ~£50bn since 2008, excluding the £50bn in loan losses over the period (£'m)

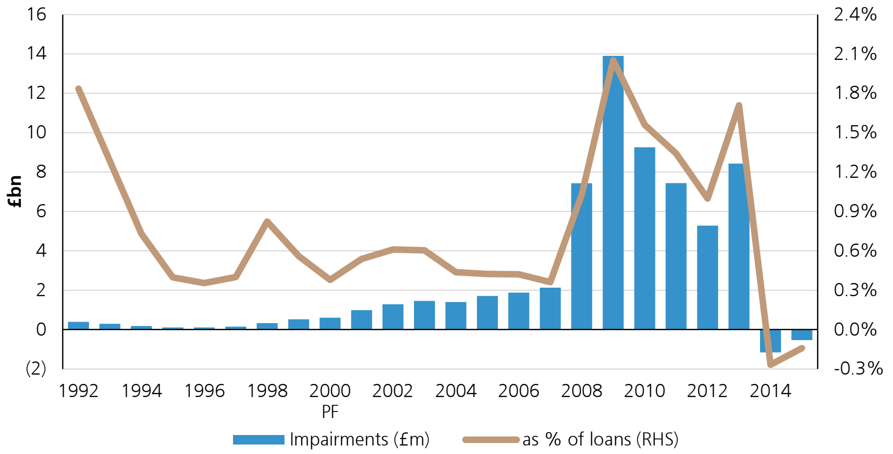
RBS	2008	2009	2010	2011	2012	2013	2014	2015 YTD	Total	Industry total	% of industry
PPI	0	0	0	850	1,110	900	650	100	3,610	27,057	13%
IRHP	0	0	0	0	700	550	185	69	1,504	4,234	36%
Other conduct	0	0	0	0	0	0	444	274	718	3,352	21%
Restructuring	1,357	1,286	1,032	1,064	1,550	657	1,257	1,644	9,847	16,206	61%
Goodwill write-offs	16,196	363	10	11	518	1,059	5,780	673	24,610	34,009	72%
Litigation/reg. settlements	0	0	1,550	2,005	425	2,394	915	1,001	8,290	20,003	41%
Total	17,553	1,649	2,592	3,930	4,303	5,560	9,231	3,761	48,579	104,861	46%

Source: Company data, UBS estimates. Note: 2015 data to end 3Q15

Of course, the ~£50bn in one-offs above exclude securities trading losses and elevated loan impairments observed during the period. Though more recent results have seen low/no charges – 9M15 saw a net £400m in write-backs – shareholders have borne very significant clean-up costs, with another ~£50bn in cumulative loan impairments since 2008 (Figure 5).

…and another £50bn in loan losses since 2008, to say nothing of securities trading hits

Figure 5: £50bn in loan losses since 2008 add to de-risking and restructuring costs. We expect modest write-backs in non-core near term



Source: Company data, UBS estimates. Note: 2015 is 9M15 annualised

69p per share in excess capital today and growing

Whether these restructuring charges ultimately represent value for money – or whether RBS had any choice in taking them – is moot. What matters in our opinion is that, despite ~£100bn in below-the-line charges and loan losses taken, success in cutting RWAs sees RBS holding significant excess capital today.

Despite £100bn in charges, deleveraging, underlying profit and balance sheet management now see RBS over-capitalised…

Including the capital consequences of selling the last of RBS's shares in Citizens Financial Group (CFG) on 30 October 2015, RBS had a Common Equity Tier 1 ratio of 16.2% at 3Q15. Compared with management's 13% CET1 ratio target, this implies excess capital of ~£8bn or an estimated 69p per share (Figure 6).

…holding an est. 69p a share of capital above its 13% CT1 target at 3Q15…

Figure 6: Surplus capital at 3Q15, growing as deleveraging completes

	3Q15	CFG decon.	Post CFG	DAS	Post DAS	Restruct.	Post restruct.	Cap res. losses	Post res. losses
Core tier 1	40.2	0.0	40.2	-1.2	39.0	-2.0	37.0	-0.9	38.1
RWAs	316.0	-67.0	249.0	0.0	249.0	0.0	249.0	-39.0	210.0
CT1 %	12.7%	3.5%	16.2%	-0.5%	15.7%	-0.8%	14.8%	2.3%	17.2%
Excess to 13% CET1 (£ bn)	-0.9		8.0		6.6		4.6		8.8
Excess to 13% CET1 (p.p.s.)	-8		69		57		40		76
Excess to market cap (%)	-3%		26%		22%		15%		29%

Source: Company data, UBS estimates

Deleveraging and restructuring continues, adding 100bps to CT1, taking excess to an estimated 76p a share, 29% of market cap: Stepwise, shown in Figure 6: i) RBS' required £1.18bn payment to the UK government to redeem the Dividend Access Share[1]– we assume in 1Q16 – causes CT1 to drop to 15.7%, 57p a share; ii) guidance for the remaining restructuring charges (£2.7bn pre-tax, £2bn post) and losses on disposal / run-off of Capital Resolution Unit assets (£1.3bn pre-tax, £0.9bn post), pro-forma CT1 goes to 17.2%, 76p excess, £8.8bn.

…rising to 76p post DAS repayment, deleveraging and remaining restructuring charges…

Our forecasts include £6.5bn in total conduct and legacy charges to 2020 and £9.6bn in total non-operating charges (Figure 7). Despite this, strong improvements in underlying profits and the deleveraging above should see capital continue to build strongly. We examine the case for legacy costs next.

…and despite £6.5bn in charges to 2020 in our numbers, capital builds further

Figure 7: We have £9.6bn in non-operating charges in our numbers – a cautious stance we think (£'bn)

One-off charges (pre-tax)	2014	2015e	2016e	2017e	2018e	2019e	2020e
Restructuring, conduct and litigation	3,348	4,500	4,580	2,580	1,340	700	400
o/w Conduct and litigation	1,154	1,800	3,500	1,500	800	500	200
o/w Restructuring	2,194	2,700	1,080	1,080	540	200	200
Disposal gains	191	-135	0	260	0	0	0
Total	3,157	4,635	4,580	2,320	1,340	700	400

Source: UBS estimates

Legacy charges to erode, but not offset excess

RBS CEO Ross McEwan and CFO Ewen Stevenson talk about possibly re-starting dividend payments in 2017[2]. This date is chosen as the point at which three obstacles are expected to have been negotiated[3]:

RBS CEO talks about a 2017 maiden dividend…

- Resolution of material outstanding legacy settlements, in particular with the Federal Housing Finance Agency (FHFA).
- Completion of the bulk of restructuring.
- A successful 2016 UK stress test outcome.

…once three challenges have been addressed

It seems to us that the first of the above is the most important outstanding issue for the firm from a market and from a surplus capital risk perspective. As we discuss under Pivotal Question 2, the biggest risk factor to the "Go Forward" bank profit and ROTE profile is whether the IB can be successfully restructured to produce adequate returns, where a halving of costs is planned with ongoing revenues broadly held constant. But even including an IB which made no money in 3Q15 the ongoing business made an 11% ROE, we estimate.

We think legacy issues are the driver of the £11bn discount to TNAV at which RBS trades…

[1] A single special share issued to the UK government during the crisis recapitalisation process which entitles the state to a dividend of the greater 7% of the aggregate issue price of B shares and 250% of the ordinary dividend rate. A material deterrent to paying dividends, RBS reached agreement in 2014 to retire the DAS for a total payment of £1.5bn. A first payment of £320m was made in 4Q14. If the balance outstanding is not paid by 31 December 2015 interest is calculated daily at a 5% annual rate until 1 Jan 2021, then 10% p.a. thereafter

[2] 3Q15 results conference call, CFO Stevenson: "But, as I keep saying, we don't expect to make capital distributions, and that includes both dividends and buybacks, before early 2017."

[3] 3Q15 results conference call, CFO Stevenson: "I've consistently said that there's three things that we need to solve for before we can get back to capital distributions and there's some technical points as well. But one is litigation on conduct; two is getting through the bulk of our restructuring; and three is having a good stress test result. So you need to see all three together."

The £11bn discount to TNAV at which RBS is currently trading we think is attempting to value potential near term charges which may not be provided for, rather than capturing a view that the firm will never make CoE. We think the FHFA issue is the largest concern in the market, examined first.

…with the FHFA and MBS lawsuits the ones we hear about most often from investors

RBS Greenwich was a major MBS market player

RBS' US investment banking operation – RBS Greenwich – was a significant player in the US debt markets before the crisis. Following several restructuring rounds the business is substantially smaller today but potentially significant provisions could attach to pre-crisis business undertaken by the unit, we think. The Dealogic data in Figure 8 has RBS ranked fourth by apportioned bookrunner volume of MBS issued between 2004 and 2007. Barclays' strong showing comes from legacy Lehman.

Pre-crisis RBS Greenwich was a large player in the US MBS market

Figure 8: US MBS 2004-07 bookrunner volumes give a sense of scale in the MBS business. RBS was a key player, ranking fourth on this basis over the period

Position	Bookrunner	Deal value (face) ($m)	Number
1	JPMorgan	780,270	1,391
2	Bank of America Merrill Lynch	681,152	1,576
3	Barclays*	427,527	830
4	RBS	313,523	612
5	UBS	285,718	632
6	Credit Suisse	255,120	604
7	Goldman Sachs	239,692	464
8	Deutsche Bank	226,341	486
9	Morgan Stanley	218,040	456
10	Citi	214,294	403
11	Wells Fargo Securities	83,917	80
12	Nomura	41,095	130
13	Ally Financial Inc	24,569	158
14	HSBC	22,112	64
15	Blaylock Beal Van LLC	20,817	106
16	Utendahl Capital Partners LP	14,052	71
17	First Tennessee Bank	9,449	62
18	CIBC World Markets	7,554	10
19	Myerberg & Co LP	7,358	45
20	WMIH Corp	6,689	16

Source: Dealogic (MBS with Deal Nationality USA, apportioned amount). *includes Lehman Brothers

At 1H15 RBS was involved in more than 25 individual and class action cases involving an aggregate issuance of US$45bn in MBS from 2005 – 2007. According to RBS, "In general, plaintiffs in these actions claim that certain disclosures made in connection with the relevant offerings contained materially false or misleading statements and/or omissions regarding the underwriting standards pursuant to which the mortgage loans underlying the securities were issued."[4]

RBS is involved in more than 25 cases relating to US$45bn in MBS issuance…

Post crisis, the Federal Housing Finance Agency (FHFA) opened lawsuits against sixteen financial institutions over the quality of MBS sold to Government Sponsored Entities (GSEs) Fannie Mae and Freddie Mac in previous years. RBS has yet to settle or complete court proceedings, as confirmed in the 1H15 results announcement:

…the largest of these relates to a FHFA lawsuit involving US$32bn in MBS

[4] 1H15 company release, page 102

"The primary FHFA lawsuit against RBS remains pending in the United States District Court for the District of Connecticut and it relates to approximately US$32 billion of MBS for which RBS entities acted as sponsor/depositor and/or lead underwriter or co-lead underwriter. Of these US$32 billion, approximately US$9.1 billion were outstanding at 30 June 2015 with cumulative write downs to date on the securities of approximately US$1.09 billion (being the recognised loss of principal value suffered by security holders)."

In September 2013, RBS was denied a motion to dismiss the FHFA's case. According to RBS "the preliminary phases of this matter, including discovery, are expected to continue into 2016[5]."

Past settlements with the FHFA average 10% of the original MBS, 9% median, 3.4% std deviation

We can observe from past settlements in MBS cases with the FHFA that these have been agreed at between 1% of MBS sold and 14%, with most around ~9% (median 9%, average 10%, standard deviation 3.4%) (Figure 9).

Figure 9: Median/average settlement of 10%/9% of sales to FHFA

Institution	Date settled	RMBS sold to FHFA	Settlement	Percent
Ally Financial	29-Oct-13	$6.0 bn	$475m	8%
Bank of America/Merrill/Countrywide	23-Mar-14	$57.5 bn	$5,830m	10%
Barclays Bank	24-Apr-14	$4.9 bn	$280m	6%
Citigroup	28-May-13	$3.5 bn	$250m	7%
Credit Suisse	21-Mar-14	$14.1 bn	$885m	6%
Deutsche Bank	20-Dec-13	$14.3 bn	$1,925m	13%
First Horizon National Corporation	29-Apr-14	$0.883 bn	$110m	12%
General Electric	23-Jan-13	$0.550 bn	$6.25m	1%
Goldman Sachs	22-Aug-14	$11.1 bn	$1,200m	11%
HSBC North America	12-Sep-14	$6.2 bn	$550m	9%
JP Morgan Chase	25-Oct-13	$33 bn	$4,000m	12%
UBS	25-Jul-13	$6.3 bn	$885m	14%
Morgan Stanley	07-Feb-14	$10.58 bn	$1,250m	12%
Societe Generale	27-Feb-14	$1.2 bn	$122m	10%
Total		$170.3 bn	$17,768m	10%

Source: RMBS amounts from FHFA filings, Settlement details from FHFA press releases, Percentages calculated by UBS

A 10% charge would be in line with £2.1bn in litigation provisions held by RBS for MBS issues at 3Q15

While this might be an interesting exercise, we do not know whether looking at past settlements will prove accurate in scoping potential future costs. With US$32bn in securities specified in the FHFA lawsuit[6], a 10% charge of US$3.2bn / £2.1bn, is in line with the £2.08bn in respect of *all* MBS-related claims and investigations held on RBS balance sheet at 3Q15[7]. These provisions were the majority of litigation reserves at that point (Figure 10).

It is worth noting here too that at 1H15 US$9.1bn of the US$32bn in securities in this matter were outstanding, with cumulative write-downs of US$1.09bn[8].

[5] 1H15 release, p102.
[6] FHFA filing in US District Court, District of Connecticut, against The Royal Bank of Scotland Group PLC, 2 September 2011
[7] Source: page 32, RBS 3Q15 Interim Management Statement
[8] Source: page 102, RBS Interim Results 2015

Figure 10: RBS' stock of provisions for redress, regulatory, and legal matters (£m)

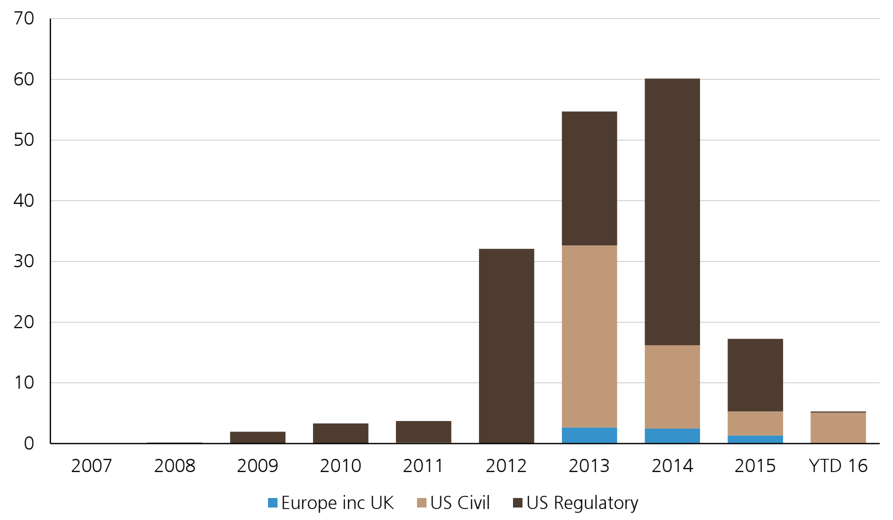
	PPI	IRHP	Other redress	FX related	Other regulatory	Litigation	Total
H1 15	697	283	699	514	160	2,241	4,594
Net income statement charge	-	-	9	-	-	120	129
Provision utilised	-84	-86	-70	-	-	-111	-351
Currency, transfers, and other	-	-		-45	1	156	112
Q3 15	613	197	638	469	161	2,406	4,484

Source: Company reporting, UBS calculations

Though we think the FHFA and DOJ cases loom largest in the market's mind as regards RBS legacy costs, other potential liabilities remain unresolved. RBS' 1H15 'Litigation, investigations and reviews' disclosures ran to twenty pages. As discussed in our sector note, our database of 344 settlements and payments totaling US$179bn across the sector – certainly incomplete – makes a tailing off of charges an appealing visual conclusion (Figure 11). We are concerned, however, that civil settlements which are much harder to track may yet be in their infancy compared with some of the larger regulatory provisions made so far, based on the outstanding matters reported in 21 pages of disclosure in RBS' 2015 Interim Results related to litigation, investigations and review.

Civil settlements are harder to track, but appear to be growing in number; we expect these to continue longer than regulatory cases

Figure 11: Bank fines split by type and geography (US$'bn)



Source: Company and regulator press releases, *Financial Times*, Bloomberg, Reuters, UBS calculations

In its 1H15 release RBS also shared expectations that UK shareholder litigation – relating to £4bn in shares subscribed to by a claimant group in the 2008 rights issue – will begin a trial in December 2016. This has since been delayed to March 2017[9].

In our view, further provisions should be included in estimates and UK bank valuations for the risk surrounding these issues.

Possible future losses should be included in stock valuations: the PRA allowed for £40bn in sector charges in its 2015 stress test; we have £9.6bn in non-operating charges in our RBS ests to 2020

We note that the PRA included £40bn in conduct and litigation provisions for the sector in its 2015 stress test, though it provided no information on which banks this pertained to or the issues it came from[10]. £30bn of the £40bn in the stress test was allocated to 2015-16 – for reference, all one-off charges for the sector in aggregate in 2015 YTD come to £10.7bn.

[9] http://uk.reuters.com/article/uk-rbs-lawsuit-shareholders-idUKKBN0TF1Y420151126
[10] Source: page 30 of "Stress testing of the UK banking system: 2015 results", BoE, 1 Dec 15

For RBS, we have included £9.6bn in our estimates to end 2020 for further one-off charges. These are split between PPI (£0.9bn) and other conduct charges (£1bn), restructuring (£3.1bn) and other legacy provisions (£4.6bn). Notwithstanding these inclusions we expect more than half of RBS market cap to be returned by dividend or buyback by end 2020 and strong capital ratios to be maintained.

What's priced in: Sensitivity analysis is best

We consider forecast risks here to be high. Our RBS estimates include £9.6bn in further charges for litigation, conduct and restructuring to 2020. Nearer term we think, roughly, that a settlement by RBS over the MBS issues for less than £2bn in additional charges – worth 60bps of a 16.2% pro-forma CT1 ratio – would be regarded as positive, £2-3bn as neutral, and £3bn as negative.

Our estimates include £9.6bn in one-off items to 2020 – a cautious forecast, we think. A £14bn charge today would move the stock to 1.0x TNAV and reporting a 10.6% CT1 ratio, with capital building as deleveraging of CIB continues. We think this assessment is much too cautious

How negative depends, obviously, on how big: each £1bn in charges is ~30bps of CT1 capital and 8p of TNAV, 2% of the 3Q15 total of 382p (all else being equal). This may be an area where the fear of not knowing beforehand is worse than the event. We calculate a £14bn charge, today, would be required to eliminate the discount to TNAV at which RBS trades, and the bank would still have a 10.6% CT1 ratio. We think this valuation is much too cautious: we don't think the market would say that a £14bn current day loss estimate is a reasonable expectation.

We show additional valuation work in What's Priced In section below.

PIVOTAL QUESTIONS

return ↑

Q: What multiple should we pay for a clean, restructured RBS?

UBS VIEW

We believe RBS should trade at least at 1.3x TNAV before excess capital, and legacy and restructuring costs. At 0.75x TNAV, we think there is too much legacy drag in the price.

EVIDENCE

RBS is being radically reshaped to cut costs, risk, and international and investment banking exposure. The Go Forward Bank made a 10% ROTE in 3Q15, a quarter in which the CIB consumed 18% of ongoing capital and made no profit. We believe RBS is becoming like LBG. A clean RBS should trade at 1.3x TNAV, in our view.

WHAT'S PRICED IN?

If we assume that our high-risk forecasts for legacy and disposal costs are right, we think the ongoing bank is trading at 0.8x.

Better mix, greater focus and radical cost reduction

RBS aims for a 9-11% ROTE in 2016/17 and more than 12% in 2019/20, driven especially by cost cuts

RBS announced its strategy under new CEO Ross McEwan in February 2014. Management plan to deliver a ROTE of 9-11% in 2016/17 and >12% in 2019/20, reducing the bank's cost/income ratio from 73% at the start to 55% and 50% at the two way points. The IB is being significantly reduced. The major cost reduction target: - £3.5bn by 2016/17, 30% of the cost base excluding Citizens Financial disposal impacts – is consistent with the view that RBS:

- Was carrying excess muscle, having shrunk assets by £1.3 trillion;
- Was far too complex, even in relatively simple core businesses like UK retail;
- Still devoted too much capital to investment banking;
- Had spent too little on IT renewal and stability.

RBS' plan at least does not require revenues to grow…

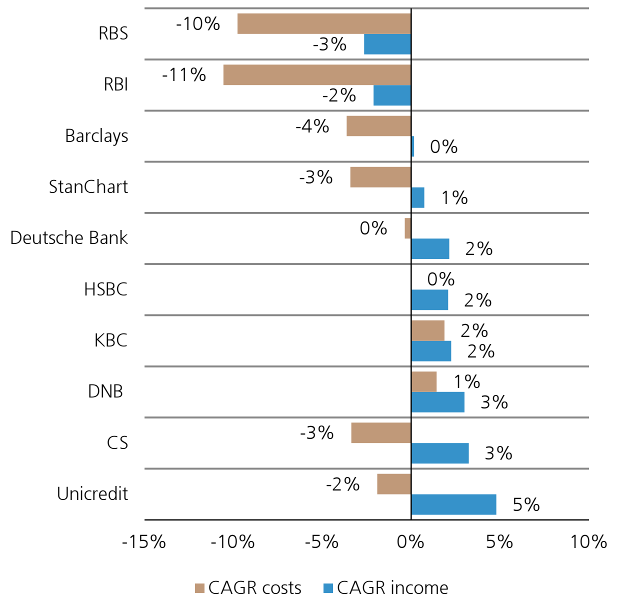
The RBS' plan is noteworthy amongst the 19 studied in our sector outlook (published today) for its scale of cost cuts and the fact that the firm was actually planning to shrink income (Figure 16). Most other strategy resets depend on accelerating or reversing income trends (Figure 12) to deliver remarkable cost/income jaws (Figure 13).

…though with costs to shrink 10% p.a. against income down 3% p.a., it does not lack ambition

This is not to say, however, that the RBS plan lacks ambition: targets which require revenues to shrink 3% a year while costs are down 10% p.a. to 2016/17 are not easy[11]! To 2020, income is planned to fall 1% p.a., costs by 8%. RBS' ROTE target, however, is in the bottom half of the plans we examined (Figure 15).

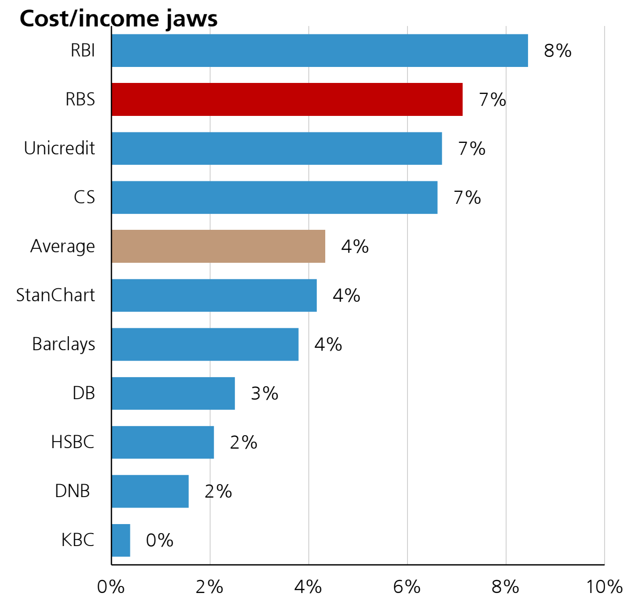
[11] These numbers exclude our estimate of the revenue and cost consequences of the sale of Citizens Financial Group

Figure 12: RBS at least was planning for significant income declines in its plan…



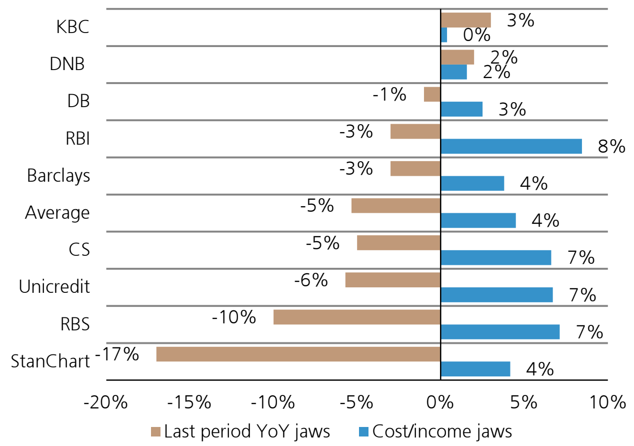
Source: Company data, UBS estimates

Figure 13: …though none would call a planned 7% p.a. cost/income jaws unambitious…



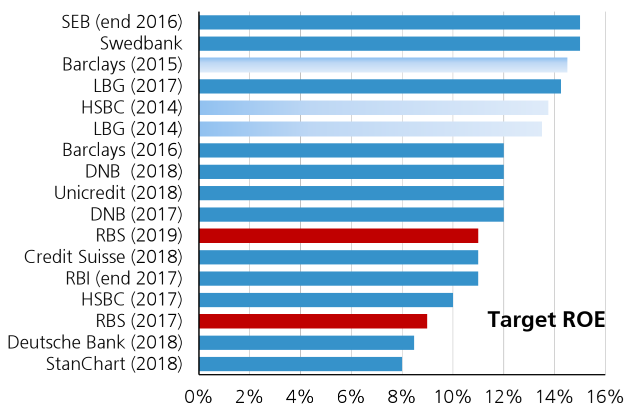
Source: Company data, UBS estimates

Figure 14: Income has fallen faster than planned at RBS; cost work will have to catch up for targets to be achieved



Source: Company data, UBS estimates

Figure 15: RBS' ROE targets are in the lower half of the pack; disappointment discounted in the share price



Source: Company data, UBS estimates. Note: Light bars are superseded earlier plans; HSBC, RBS (2019), DNB and Swedbank aim for more than these ROEs; Barclays target is for Core Bank.

Figure 16: Nineteen strategic plans benchmarked on key operating metrics: €22bn in restructuring charges (for the 10 banks that disclose plans)

Date	Co	CEO	Description	Target year	Target ROE (%)	Target ROTE (%)	Start C/I (%)	Target C/I (%)	Abs. ch. C/I (%)	% income	% costs	% gross save	% net save	Income CAGR	Cost CAGR	PPP CAGR	RWA CAGR	CTA/ gross save	CTA/ net save	Head cut
11-May-11	HSBC	Gulliver	$3.0bn saves, 9.5-10.5% CT1	2014	13.8	15.0	55	50	-5	n/a	n/a	8	0	n/a	n/a	n/a	n/a	n/a	n/a	n/a
30-Jun-11	LBG	Horta-Osorio	12.5-14.5% stat ROE 2014, CT1 >10%, LDR <130%	2014	13.5	14.5	46	43	-3	-24	122	14	9	-1	-3	1	-6	88	150	14
12-Feb-13	Barclays	Jenkins	Cost, RWA cuts, still large IB	2015	14-15	n/a	64	55	-9	36	68	n/a	9	2	-3	9	-2	n/a	155	14
27-Feb-14	RBS	McEwan	Med-term 9-11% ROTE plan	2017	9.0	10.0	72	55	-17	n/m	n/m	30	30	-3	-10	11	-13	n/a	146	n/a
27-Feb-14	RBS	McEwan	Long-term >12% ROTE plan	2019	> 11	> 12	72	50	-22	n/m	n/m	32	32	-1	-8	11	-9	n/a	136	n/a
08-May-14	Barclays	Jenkins	Bad bank incl 40% FICC RWAs, IB to 30% of group RWAs	2016	> 12.0 (core)	> 14.0 (core)	63	56	-7	5	96	n/a	10	0	-4	6	-3	n/a	135	10
17-Jun-14	KBC	Thijs	Rev CAGR >2.25%, C/I <53	2017	n/a	n/a	53	53	-1	n/m	n/m	n/a	-8	2	2	3	n/a	n/a	n/a	n/a
21-Oct-14	Swed-bank	Wolf	6% cost cut, Sparebank Öresund integration	2016	>15	n/a	45	n.a	n.a	n.a	n.a	n.a	6	n/a	-3	n/a	n/a	n/a	n/a	~5
28-Oct-14	LBG	Horta-Osorio	11% CT1, >4.5% lev, >50% med-term payout	2017	14.3	15.3	52	45	-7	n/a	n/a	11	n/a	n/a	n/a	n/a	n/a	40	n/a	11
27-Nov-14	DNB	Bjerke	C/I ~40% in 2017	2017	>12	> 13	42	40	2	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a
30-Jan-15	SEB	Falkengren	Cost cap at <SEK22.2bn	2016	15.0	n/a	50	n/a	n/a	n/a	n/a	n/a	n/a	n/a	0	n/a	n/a	n/a	n/a	n/a
10-Feb-15	RBI	Sevelda	Increase CET 1 FL 10% to 12%, Polish sale, RWA cuts	End 2017	11.0	n/a	63	50-55	-12	-24	110	n/a	20	-2	-11	11	-4	n/a	n/a	n/a
27-May-15	Nordea	Clausen	Cost CAGR of <1% 2016-18	2018	> Nordic peers	n/a	52	n/a	n/a	n/a	n/a	n/a	n/a	n/a	<1	n/a	~0	n/a	n/a	n/a
09-Jun-15	HSBC	Gulliver	Reallocate 25% of RWAs, 2017 costs flat on 2014	2017	> 10	>12	52	n/a	n/a	n/a	n/a	15	0	n/a	0	n/a	-3	89	n/a	9
21-Oct-15	Credit Suisse	Thiam	CHF3.5bn gross save, CHF2.0bn net, double PTP, 14% ROTE	2018	11.0	14.0	80	66	-14	51	54	17	10	3	-3	24	3	64	113	n/a
29-Oct-15	DB	Cryan	10% ROTE, 12.5% CT1	2018	8.5	10.0	75	70	-5	86	15	17	5	2	0	9	-4	86	260	11
03-Nov-15	StanChart	Winters	3% p.a. cost saving, target 8% ROE 2018, > 10% 2020	2018	8.0	9.0	62	55	-7	18	83	22	9	1	-3	7	-2	33	78	17
11-Nov-15	Unicredit	Ghizzoni	11% ROTE in 2018, 11.5% CT1	2018	n/a	11.0	61	50	-11	73	31	12	4	5	-2	12	2	63	167	10
25-Nov-15	DNB	Bjerke	Cost income <40%	2018	> 12	>13	42	40	-2	n/m	n/m	8	3	3	1	4	0	67	-133	n/a

Source: Company announcements, UBS estimates

A strong start

The plan which many thought too ambitious at the outset is on track in its early stages. The £800m absolute cost reduction planned for 2015 was increased in 2H15 to £900m and looks achievable to us. The core RBS (management's 'Go Forward' bank) is already delivering reasonable returns: we estimate a 10% ROTE in 3Q15 despite breakeven results in the Private Bank and CIB. These units consume £10.8bn in common equity capital.

Costs should be down £900m in 2015E; the core RBS is already producing a ROTE of more than 10%

Figure 17: RBS performance – Go-Forward versus run-down (3Q14, Adj., £ bn)

3Q15 (£ bn, Adj.)	UK PBB	Ulster Bank	Comm'l Banking	Private Banking	CIB	Other Go Fwd	Total Go Fwd	CIB Cap. Res.	W&G	Int. Pvt Banking	RCR	Other investments	Exit Bank	Total RBS
Income	1.2	0.2	0.8	0.2	0.3	-0.1	2.6	0.0	0.3	0.0	0.0	0.1	0.4	3.0
Operating expenses	-0.7	-0.1	-0.4	-0.2	-0.3	0.0	-1.7	-0.3	-0.1	0.0	-0.1	0.0	-0.5	-2.2
PPP	0.5	0.1	0.4	0.0	0.0	-0.1	0.9	-0.3	0.2	0.0	-0.1	0.1	-0.1	0.8
Impairments	0.0	0.1	0.0	0.0	0.0	-0.1	0.0	0.0	0.0	0.0	0.1	0.0	0.1	0.1
Operating profit	0.5	0.2	0.4	0.0	0.0	-0.2	0.9	-0.3	0.2	0.0	0.0	0.1	0.0	0.9
Funded assets	119	28	105	12	118	114	496	50	20	5	7	2	84	580
Net loans	112	21	101	11	15	0	260	27	20	3	4	0	54	314
Customer deposits	129	19	99	23	19	4	293	29	24	6	1	0	60	353
RWAs	29	22	75	8	31	10	175	39	10	2	12	11	74	249
Reg. cap 13% CT1	3.8	2.9	9.8	1.0	4.0	1.3	22.8	5.1	1.3	0.3	1.6	1.4	9.6	32.4
Cost/income	58%	50%	50%	100%	113%	0%	67%	n/m	33%	n/m	n/m	n/m	125%	75%
RORWA	6.9%	3.6%	2.1%	0.0%	-0.5%	-8.0%	2.0%	-3.1%	8.0%	0.0%	0.0%	3.6%	0.0%	1.4%
ROTE (UBSe)	35%	19%	11%	0%	-2%	-41%	10%	-16%	41%	0%	0%	19%	0%	7%

Source: Company data, UBS estimates; Note: We adjust 3Q15 stated figures for the expected impact of the transfer of the Western European loan portfolio and UK transaction services between Commercial Banking and CIB, and the elimination of the CFG RWAs expected with the 4Q results. ROE calculated as the return on regulatory capital adjusted for TNAV base 11% larger than CET1. RBS stresses that the cost base attached to W&G in the calculations above is not indicative of the standalone cost requirements. Therefore, ROTE is in the hands of the seller, rather than the buyer

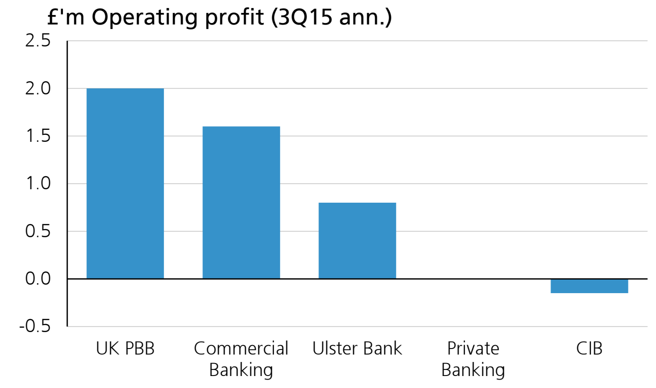
As at Barclays the biggest area of uncertainty at RBS is the firm's ability to deliver decent returns in the IB. RBS plans involve halving costs and holding revenues constant at 3Q15 run-rates. Figure 17 shows CIB was breakeven in 3Q15 at £300m of revenue and £300m of costs: management target revenues of £1.2bn per annum and costs around £600m. Though small, the private bank may also need to improve: rate hikes should help given a 50% funded asset/deposit ratio, but a more efficient IT and business footprint would seem to be needed to deliver a decent profitability and valuation for this part of RBS.

Within Go Forward, plans for the CIB are the highest risk, we think; the private bank also may need to improve; Both divisions are roughly breakeven at present…

Fortunately for investors, RBS' capital commitment to CIB is modest at 18% of Go Forward RWAs at 3Q15. We are unable to accurately estimate the size of mRWA inflation to come in 2018, but we're not worried about them for RBS (Figure 19).

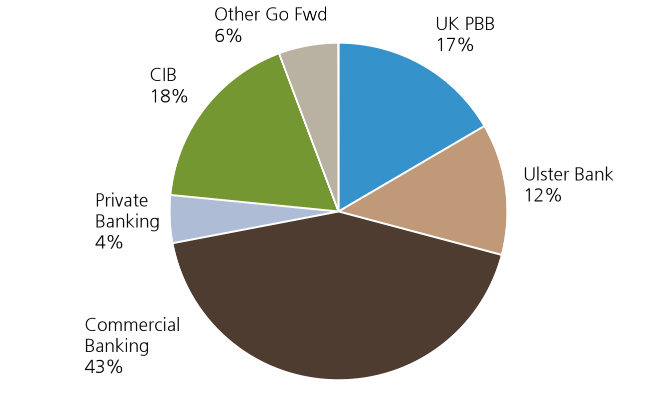
…but account for just 22% of Go Forward capital demand combined

Figure 18: The ongoing RBS is a retail and commercial bank from a profit perspective…



Source: Company data, UBS estimates. Note: Adjusted for expected impact of business transfers

Figure 19: …with modest capital commitment to markets: share of RWAs within the Go Forward bank at 3Q15

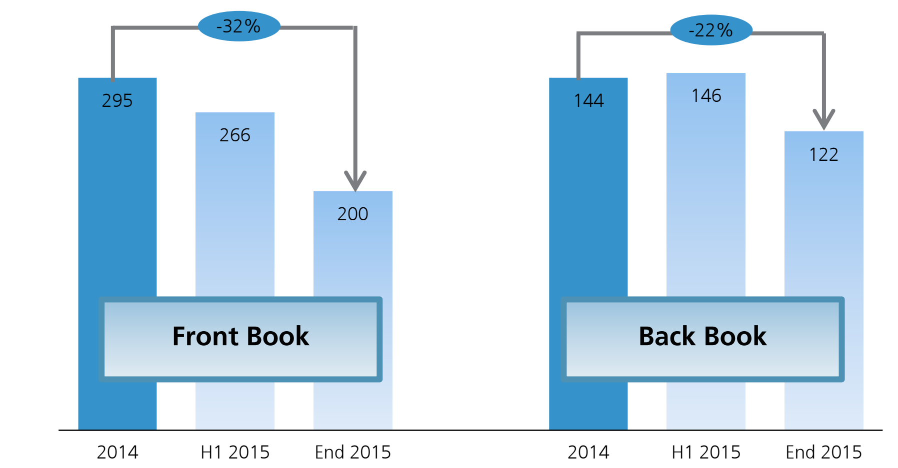


Source: Company data, UBS estimates. Note: Adjusted for expected impact of business transfers

Business simplification is helping reduce risk and costs…

Meanwhile, investment in de-risking the bank's product range and IT platform continues, both of which are necessary, we think to deliver on the strategic promises made. Products on sale are down by about a third since the plan began and back book product ranges are down about a fifth (Figure 20).

Figure 20: First step to a less complex, lower conduct risk bank: Radically cut products on offer and the systems backing them. RBS has reduced products on sale by a third, and savings and cards by more than a third over 18 months



Source: RBS company data

…but we think RBS in particular will be required to spend substantial amounts on IT renewal over the next 5-10 years

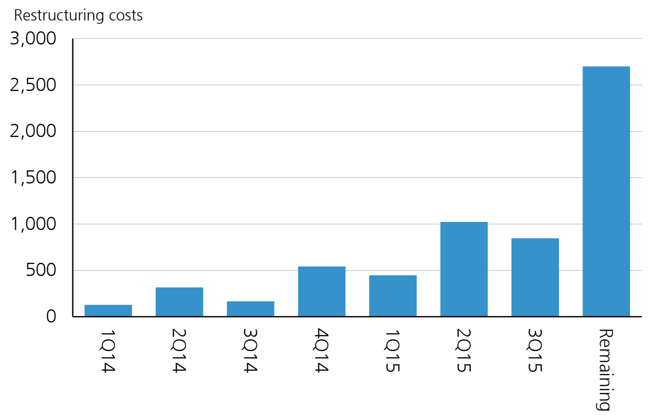
Relentless business simplification and substantial investment in new IT will be required for all UK banks over the next five years, we believe. RBS in particular has suffered a number of high profile IT failures, including one episode in summer 2012 when some customers were unable to access accounts for over a week in some cases[12]. The direct costs of this were low at £150m, but the brand damage (measured by net promoter scores) was meaningful. Most importantly, though, a high risk, multi-year IT project that will drive costs up is very difficult to implement

12 http://www.computerweekly.com/news/2240235066/FCA-fines-Royal-Bank-of-Scotland-42m-for-IT-failure

and regulators are likely watching this aspect with interest: we expect all banks will have to re-platform in the next 5-10 years, as discussed in our sector note.

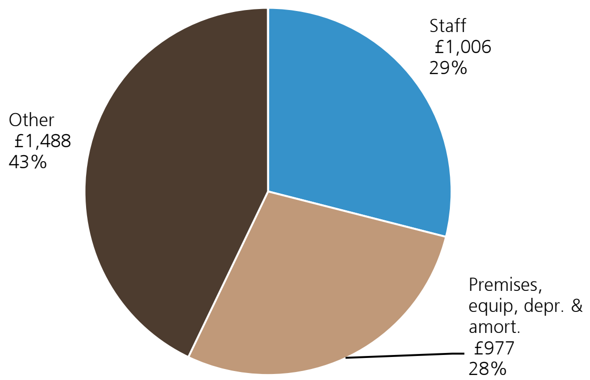
For now, part of this spend is being addressed through very substantial restructuring charges taken within the firm, totalling £3.5bn since end 2013 with £2.7bn still to go on management numbers, included in ours (Figure 21).

Figure 21: £3.5bn spent so far on restructuring; £2.7bn to go, included in our estimates (£'m)



Source: Company data, UBS estimates

Figure 22: Restructuring costs by type since end 2013 (£'m)



Source: Company data

UBS estimates assume revenues miss targets

We have been impressed by RBS senior management. We think the plan is the right one. The shape of the future bank radically reduces the business risks from regulatory change and maximises exposure to the attractive UK retail and commercial banking markets. Our estimates, however, do assume that the firm misses its revenue and cost targets in both 2018 and 2020.

We think RBS management is impressive. The plan appears to be the right one. We like the stock, despite expecting both income and costs to miss 2018 and 2020 targets

Figure 23: Our estimates assume that RBS misses both revenue and cost targets in 2018 and 2020. We think the market is pricing an even weaker outcome than this

	Forecasts			Targets		% rel. target	
Forecasts versus targets	2015e	2018e	2020e	2018e	2020e	2018e	2020e
Revenue	13,252	14,050	15,719	15,000	16,000	-6%	-2%
Operating costs	-9,278	-8,004	-8,260	-8,250	-8,000	-3%	3%
Pre-provision profit	**3,974**	**6,047**	**7,459**	**6,750**	**8,000**	**-10%**	**-7%**
Cost/income (%)	70%	57%	53%	55%	50%	n/a	n/a

Source: Company data, UBS estimates

How much for a more efficient, less risky RBS?

We think sum-of-the-parts is the best way to value RBS. As a restructuring case we think a better result is achieved by dividing the calculation into five parts. We arrive at a fair multiple for a legacy-free ongoing RBS of 1.3x even if CIB and Private Banking continue to consume £10bn in capital and make a zero return, as they did in 3Q15. Before considering restructuring, disposal and legacy costs and the value of excess capital, this approach leaves to a value of 306p for the bank, derived below. Adding non-core and excess capital this fair value rises to 447p, examined in the "What's Priced In" section.

We believe a clean RBS should trade at 1.3x TNAV before surplus capital and legacy liabilities; adding in non-core and excess capital, this means a clean value of 446p

We split this valuation as follows:

- **The Go Forward Bank**: Mostly UK, mostly Retail and Corporate, producing a 12% ROTE in 3Q15 and due to become more efficient as cost cuts play through. Using 3Q15 results and fair P/E and P/B multiples in Figure 24 we arrive at a fair value 291p per share for the Go Forward bank.

- **Williams & Glynn:** Though RBS' disclosures suggest a 40% current ROTE for W&G, the bank stresses that the cost base for an independent entity would be higher. W&G is a decent sized business with £4bn in excess liquidity (LDR: 83%) and UK SME exposure. We assume a 'normalised' ROTE of 10-15% and a sale price of 1.2x TNAV, 15p per share.

- **Excess capital:** ROTEs and TNAV figures in the Go Forward and run-off valuations are based a 13% CT1 ratio so we must add the value of capital already held above this level. Pro-forma for the CFG sale in October 2015 and £1.2bn DAS payment we expect in 1Q16 this is worth £7.3bn, 62p per share.

- **Run-off portfolios:** At 3Q15 RCR and CIB Resolution units had £51bn in RWAs, backed by £6.6bn in regulatory capital and £7.3bn in tangible equity. In the What's Priced In Section readers should look at company guidance and implied market discount for losses to attach to this capital. Our focus here is on the pre-loss value of the group. £7.3bn in tangible equity is 62p per share.

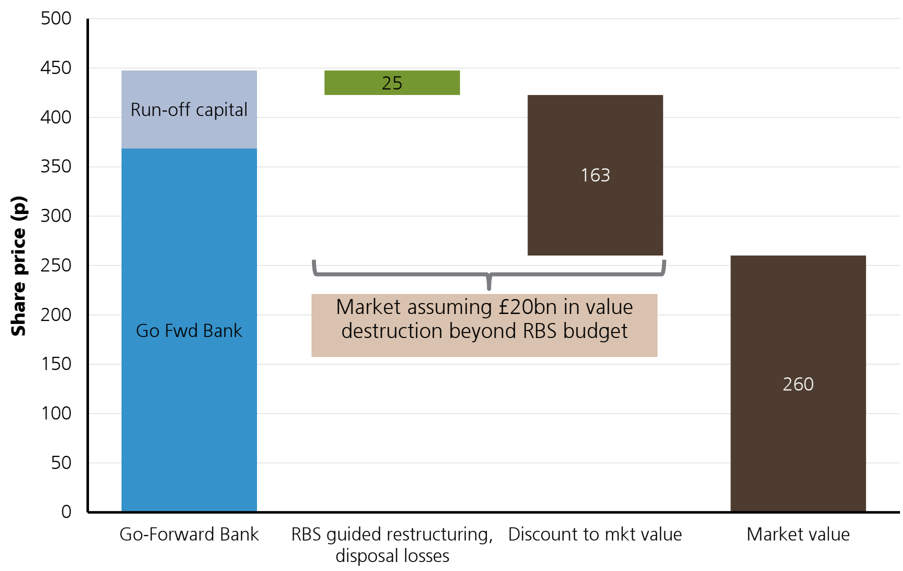
Figure 24: RBS is worth 447p – 171% of its current value – before accounting for future costs of restructuring, disposals and legacy liabilities

	Operating profit (3Q15 ann.)	Net profit (UBSe)	Reg. capital £ bn)	TNAV (£ bn)	ROTE (3Q15 ann.)	P/E	P/TNAV	Value	Value per share	% op profit	% valuation
UK PBB	2.0	1.3	3.8	4.2	32%	11.0	3.5	14.8	126	47%	34%
Ulster Bank	0.8	0.5	2.9	3.2	16%	7.7	1.2	3.8	32	19%	9%
Commercial Banking	1.6	0.9	9.8	10.8	8%	11.0	0.9	9.5	81	38%	22%
Private Banking	0.0	0.0	1.0	1.2	-3%	n/m	1.2	1.4	12	0%	3%
CIB	-0.2	-0.2	4.0	4.5	-5%	n/m	0.6	2.7	23	-4%	6%
Other Go Fwd	-0.8	-0.6	1.3	1.4	-43%	n/m	1.4	2.0	17	-19%	5%
Total Go Fwd	3.5	1.8	22.8	25.2	7%	18.8	1.4	34.1	291	81%	79%
W&G	0.8	0.6	1.3	1.4	41%	2.9	1.2	1.7	15	19%	4%
Total Core	4.3	2.4	24.1	26.6	12%	14.9	1.3	35.9	306	100%	83%
Excess Capital to 13%	n/m	n/m	6.6	7.3	n/m	n/m	1.0	7.3	62	n/a	17%
Go Fwd + Excess Capital	4.3	2.4	30.7	33.9	12%	18.0	1.3	43.2	368	100%	100%
Run-off units	-0.8		8.3	9.2	n/m	n/m	n/m	9.2	79	n/m	n/m
Group	3.5		39.0	43.1	6%	n/m	n/m	52.4	447	n/m	n/m

Source: UBS estimates. All items are historic other than reg. cap., which includes the assumed repayment of the DAS for £1.2bn.

WHAT'S PRICED IN?

return ↑



RBS is trading at 262p on 22 January 2016

The market is discounting too much destruction

Figure 24 shows our view that a clean, no-legacy cost RBS would be worth 447p. RBS guidance for future restructuring and disposal costs are a 25p deduction, leaving a 163p or £19bn value discount for legacy issues, overhang and so on. We show this graphically above and in table form in Figure 25.

We estimate clean RBS would be worth 447p; the market is applying a £19bn discount for legacy issues – 63% of market cap

Figure 25: Adjusting our valuation above for RBS guidance on restructuring and disposal losses, we see a market-implied discount of £19bn – 63% of market cap

	Reg. capital (£ bn)	TNAV (£ bn)	ROTE (3Q15 ann.)	P/E	P/TNAV	Value (£ bn)	Value per share
Go Fwd Bank & excess capital	30.7	33.9	12%	18.0	1.3	43.2	368
Run-off units capital	8.3	9.2	n/m	n/m	1.0	9.2	79
Disposal losses (post tax)	-0.9	-0.9				-0.9	-7
Restructuring costs (post tax)	-2.0	-2.0				-2.0	-17
Net valuation	36.1	40.3				49.5	423
Market cap						30.5	253
Value gap						19.0	170
% of market cap						63%	

Source: UBS estimates

Our estimates include £9.6bn in provisions for conduct risk (PPI, in particular, see our sector note published today), legacy litigation and civil settlements, and restructuring (Figure 26). Forecast risk is high, but we think the market-implied legacy loss is significantly higher than is likely, remembering that RBS already has £4.5bn in reserves on balance sheet to cope with these sorts of issues.

We have £9.6bn in our forecasts for future one-offs – enough, we think, remembering there is already £4.5bn in reserves in place

Figure 26: £9.6bn in legacy costs in UBS estimates, included in our valuation

Pre-tax one-off charges (£ m)	2014	9m15a	2015e	2016-20e
Restructuring	1,154	2,317	2,600	3,100
Conduct & litigation	2,194	1,444	1,800	6,500
o/w Conduct	1,279	443	543	1,900
o/w PPI	650	100	200	900
o/w Other conduct	629	343	343	1,000
o/w Litigation	915	1,001	1,257	4,600
Total	3,348	3,761	4,400	9,600

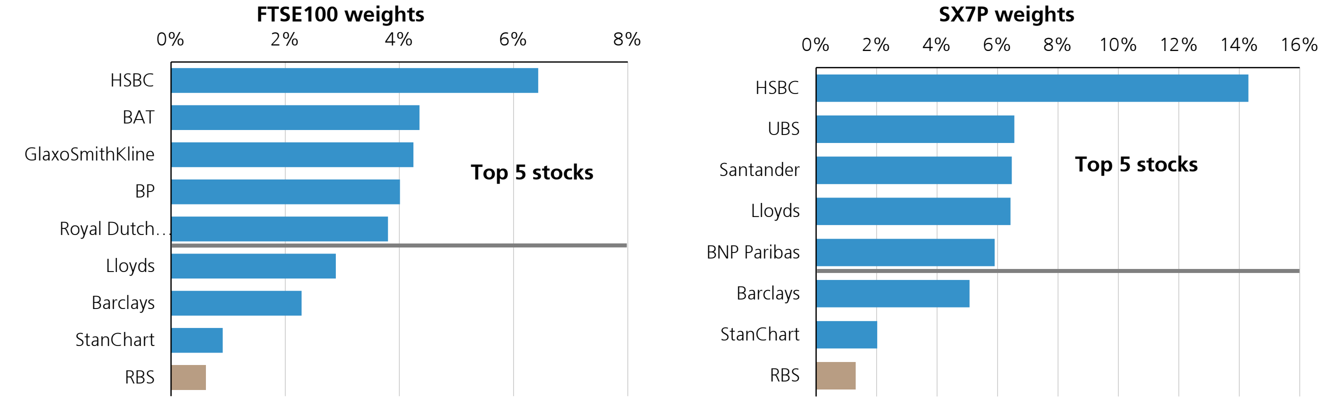
Source: UBS estimates

Harder to know what to discount for the overhang

Small index weight + large sell-down to come + uncertainty around one-offs = large required valuation discount

We see a significant discount in the RBS market cap for one-offs. Also important to consider is what value gap to include for share overhang. For investors to buy RBS ahead of multiple potential government sales, perhaps all at a discount to the previous day's close, for a company which represents just 0.6% of the FTSE100 index, requires the share to be cheap (Figure 27).

Figure 27: Running the risks of one-off charges and placing discounts for such a small weight in the index naturally requires significant measured upside



Source: UBS estimates

UKFI owns 8.43bn shares, 72.9% of the company – 500-600 days of trading volume

UKFI, the body tasked with managing the government stake in RBS and other lenders, made its first RBS disposal in August 2015, selling 630m shares by accelerated bookbuild at 330p for £2bn. UKFI hold 8.43bn shares, 72.9% of the company. At an average 15m / £50m in RBS shares traded daily in 2015 this amounts to an overhang of 500-600 days of trading volume.

RBS may look to buy as much of the government stake off-market as possible…

Whether the tradition in the LBG sale process of never selling below the previous placing price will apply here is hard to know. We think RBS may be looking to repurchase as much of the £25bn in government shares off-market from surplus capital as possible. As Figure 28 shows, to place the entire RBS stake in the market would be by a margin the largest UK capital raising in recent years, bigger than all crisis recaps and, for example, about 5x the size of the Imperial Tobacco rights issue for the Altadis acquisition.

Figure 28: We believe RBS may look to buy back as much stock direct from government as possible. In our view this route represents better value for UKFI and minority shareholders than accelerated book builds covering 500 days of trading volume

Date	Company	Raise value (£ m)
Current	Value of 72.9% RBS stake	21,974
9-Jun-08	Royal Bank of Scotland Group plc	12,336
06-Apr-09	HSBC Holdings plc	13,188
14-Dec-09	Lloyds TSB Group plc	7,961
02-Jul-09	Rio Tinto plc	7,454
04-Oct-13	Barclays plc	6,099
12-Jun-08	Imperial Tobacco Group plc	5,046
21-Jul-08	HBOS plc	4,124
26-Mar-14	Lloyds Banking Group	4,194
18-Jul-08	Barclays plc	3,847

Source: Dealogic

…driving higher free-float, lower overhang and about 15% EPS accretion, likely driving a re-rating of the share, in our view

Shares bought direct from the UKFI – a move which would require shareholder approval with government abstaining – reduces market drag and modestly increases free-float adjusted index weights without investors being offered an opportunity to participate. We estimate a £5bn repurchase – roughly in line with the post-DAS capital surplus – at an undisturbed share price around current levels would retire a fifth of the government stake, cost 2% of EPS but see EPS increase by 15%. We see this as a powerful step that would re-rate the share.

Figure 29: Higher free float, lower overhang, EPS accretion – a good idea (£'m)

	3Q15 (UBS adj., annualised)	Post £5bn buyback	% change
Adjusted profit (UBSe, 3Q15 annualised)	6,328	6,228	-2%
Shares (total)	11,546	9,879	-14%
Shares (UK government)	8,434	6,767	-20%
EPS (UBS Adj.)	**54.8**	**63.0**	**15%**
Free float	27.0%	31.5%	17%
Government stake	73%	68%	-6%

Source: UBS estimates

Our valuation approach

We value RBS by sum-of-the-parts based on our 2017 divisional profit forecasts. The P/E and P/TNAV multiples applied are set with reference to peers, adjusting for our view of differences in growth, risk and return. One-off items we forecast are discounted to net present value using a 10% CoE. Our target price RBS is set 350p, shown below (Figure 30).

Figure 30: RBS sum-of-the-parts valuation

£ m	Adj. PBT (£ m, 17e)	Adj. profit (£ m, 17e)	TNAV (16e, £ m)	ROTE (2017e)	P/TBV	P/E	Value (£ m)	Per share (GBP)	% of value	% earnings	% capital
UK Personal & Business Banking	3,014	2,096	6,889	29.5%	3.0x	10.0x	20,955	179	46%	73%	17%
Ulster Bank	129	59	2,815	2.2%	1.2x	57.5x	3,378	29	7%	2%	7%
Commercial Banking	1,872	1,232	9,835	12.8%	1.3x	10.5x	12,932	110	28%	43%	24%
Private Banking	144	80	1,602	4.8%	0.6x	11.0x	885	8	2%	3%	4%
CIB	-630	-600	10,503	-5.9%	0.7x	n/a	6,827	58	15%	-21%	25%
Go-fwd inc W&G, CIB Res, RCR	4,529	2,866	31,644	9.2%	1.4x	15.7x	44,977	384	99%	100%	77%
W&G adjustment		n.a.	n.a.	-0.7%	n.a.	10.0x	-5,580	-48	-12%	n/a	n/a
Conduct & Restructuring	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	-3,584	-31	-8%	n/a	n/a
Sub-total	4,529	2,866	31,644	8.5%	1.1x	12.5x	35,811	306	80%		
Capital surplus (gap to 13% pre special divs)	n/a	-91	9,145	-1.9%			9,145	78	20%		22%
Total	4,529	2,774	40,789	6.6%	1.1x	16.2x	44,955	384	100%	n/a	100%
							Discounted	350			

Source: UBS estimates

Upgrade to Buy

We have built a new model for RBS and changed our definition of adjusted EPS. On our new estimates we have RBS trading at 13x 2016 adjusted EPS and 0.7x TNAV for a forward ROTE of 8%. This view of valuation misses, however, stronger returns in the Go Forward Bank – of about 12% - and the >50% of market cap that we expect to see paid by dividend or buyback to the end of 2020. With 35% capital return and 11-19% dividend yield, we upgrade to a Buy rating.

Figure 31: RBS model summary with EPS and DPS changes

£m	2011	2012	2013	2014	2015e	2016e	2017e	2018e	2019e	2020e
Stated EPS (p)	-18.2	-55.0	-80.3	-30.6	5.8	-25.6	4.5	12.4	20.8	26.3
UBS Adj. EPS (Current, p)	10.9	14.5	-51.2	36.2	22.5	21.2	22.4	22.4	26.2	29.1
UBS Adj. EPS (Prior, p)	n/a	n/a	n/a	n/a	27.2	14.6	26.6	30.1	32.0	n.a.
% change	n.a.	n.a.	n.a.	n.a.	-17%	45%	-16%	-25%	-18%	n.a.
DPS (Current, p)	0.0	0.0	0.0	0.0	0.0	5.0	30.0	50.0	42.0	25.0
DPS (Prior, p)	n/a	n/a	n/a	n/a	0.0	0.0	5.0	10.0	15.0	n.a.
TNAV per share (p)	491.0	441.6	363.5	388.4	382.2	352.8	318.9	265.5	241.5	240.3
CET1 % (Fully loaded)	n/a	7.7%	10.9%	11.2%	16.7%	17.0%	15.9%	14.2%	13.0%	13.0%
T1 Lev ratio (Fully loaded)	n/a	3.1%	3.4%	4.2%	5.0%	4.9%	4.5%	3.9%	3.6%	3.7%
ROTE (Adj.)	2.2%	3.1%	-12.8%	9.7%	5.9%	5.8%	6.7%	7.7%	10.3%	12.1%
Market cap (£ m)	37,185	28,174	36,430	38,389	39,193	30,142	30,142	30,142	30,142	30,142
P/E (UBS Adj.) (x)	30.7	17.5	n.m.	9.5	15.2	12.4	11.7	11.7	10.0	9.0
Div yield (%)	0.0	0.0	0.0	0.0	0.0	1.9	11.4	19.1	16.0	9.5
P/TNAV (x)	0.7	0.6	0.9	0.9	0.9	0.7	0.8	1.0	1.1	1.1
Excess cap over 13% as % MV	n.m.	n.m.	n.m.	n.m.	n.m.	29%	21%	8%	0%	0%

Source: Company data, UBS estimates

UPSIDE / DOWNSIDE SPECTRUM

return ↑

RBS is trading at 262p, as of 22 January 2016

Value drivers	Extra PBT (£m)	EPS delta (p)	Marginal P/E	TNAV delta	Extra value per share (p)	2017E EPS (p)	2017E P/E	2016E P/TNAV
395p upside	700	4.4	10x	2,000	45	26.7	14.8x	1.1x
350p target	0	0			0	22.3	15.7x	1.0x
250p downside	-400	-2.5	10x	-2,000	-25	19.9	12.6x	0.8x

Risk to the current share price is heavily skewed (18:1) to the upside

RBS is trading at 262p as of 22 January 2016.

Upside (395p): In an upside scenario, the outcome on legacy settlements could leave RBS c£2bn better off. Additionally, RBS hitting its ambitious targets for the go-forward CIB (halving costs while keeping revenues flat) would drive an incremental c£700m of PBT. Together, these two would add c45p of value leading to a fair value upside share price of 395p.

Base (350p): Our base case price target of 350p is built on a sum-of-the-parts, taking into account an additional c£3bn of legacy provisions and an approximately breakeven go-forward CIB. This still leaves a significant amount of excess capital which we expect to see distributed.

Downside (250p): In a downside scenario, RBS could take an incremental c£2bn of legacy provisions vs our base case, and CIB restructuring could prove more difficult leading to c£400m less PBT. In isolation, this would remove c25p of value, but in addition to that we would expect the stock to de-rate given increased uncertainty around both future legacy outcomes and go-forward earnings power. As a result we could see the stock dropping back to 0.8x TNAV, leading to a fair value downside price of 250p.

COMPANY DESCRIPTION

return ↑

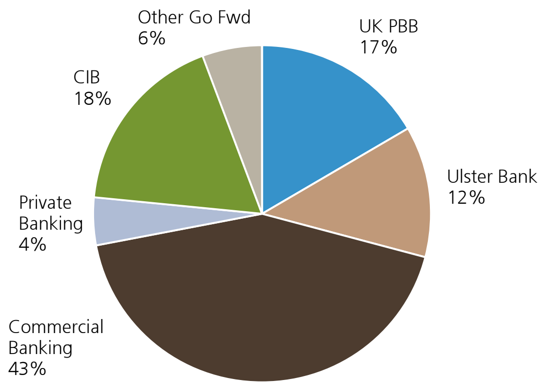
Market Cap	£30.1bn
Shares Outstanding	11.6bn
Industry and outlook	Banks
Region	Europe
Website	www.rbs.com

RBS is a leading UK retail and commercial bank. Under new leadership, the firm is undergoing continued significant restructuring. This includes one of the most ambitious cost-cutting plans in Europe, and a radical reduction in capital allocated to international and investment banking activities.

Industry outlook

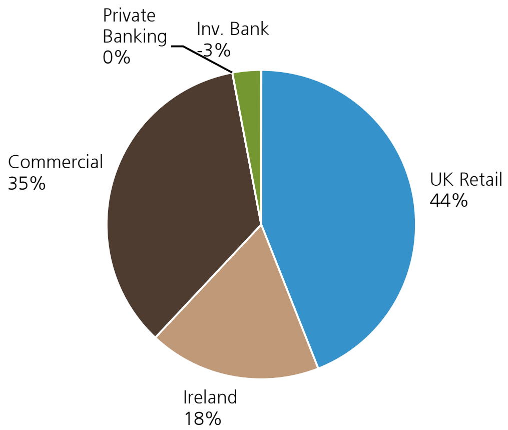
We expect UK retail and commercial banking to continue to perform well in 2016 driven by modest volume growth, steady margins and good cost control. Investment banking is expected to be challenged, again, by weak revenue generation, unavoidable regulatory cost inflation and systems investment demand.

Equity allocation by division – Go Forward Bank (%)



Source: Company data, 3Q15

Operating profit by division – Go Forward Bank (%)



Source: Company data, 3Q15

RBS Group (RBS.L)

Profit & Loss (£m)	12/12	12/13	12/14	12/15E	% ch	12/16E	% ch	12/17E	12/18E	12/19E
Net income interest	11,541	10,992	11,274	8,793	-22.0	8,744	-0.6	9,365	10,013	10,621
Total non interest income	10,544	8,450	6,923	4,459	-35.6	3,996	-10.4	3,933	4,038	4,420
Total income	**22,085**	**19,442**	**18,197**	**13,252**	-27.2	**12,740**	-3.9	**13,297**	**14,050**	**15,041**
Total cash expenses	(12,743)	(12,759)	(11,468)	(8,441)	26.4	(7,887)	6.6	(7,527)	(7,394)	(7,581)
Pre-depreciation operating profit	**9,342**	**6,683**	**6,729**	**4,811**	-28.5	**4,853**	0.9	**5,771**	**6,657**	**7,460**
Depreciation & amort (excl. goodwill)	(1,482)	(1,251)	(930)	(837)	10.0	(753)	10.0	(678)	(610)	(549)
Operating profit pre provisions	**7,860**	**5,432**	**5,799**	**3,974**	-31.5	**4,099**	3.2	**5,093**	**6,047**	**6,911**
Total provisions	(5,279)	(8,432)	1,155	591	-48.9	(12)	-	(485)	(878)	(1,058)
Operating profit post provisions	**2,581**	**(3,000)**	**6,954**	**4,565**	-34.4	**4,087**	-10.5	**4,608**	**5,168**	**5,852**
Income from associates & JVs (pre-tax)	0	0	0	0	-	0	-	0	(800)	(800)
Other pre-tax items	0	0	0	0	-	0	-	0	0	0
Profit before tax (UBS)	**2,581**	**(3,000)**	**6,954**	**4,565**	-34.4	**4,087**	-10.5	**4,608**	**4,368**	**5,052**
Exceptionals (incl goodwill)	(7,858)	(5,243)	(8,305)	(4,211)	49.3	(4,580)	-8.8	(2,320)	(1,340)	(700)
Profit before tax	**(5,277)**	**(8,243)**	**(1,351)**	**354**	-	**(493)**	-	**2,288**	**3,028**	**4,352**
Tax	(441)	(382)	(1,909)	(309)	83.8	(842)	-172.8	(1,023)	(1,034)	(1,310)
Profit after tax	**(5,718)**	**(8,625)**	**(3,260)**	**45**	-	**(1,335)**	-	**1,265**	**1,995**	**3,042**
Other post-tax items	0	0	(320)	0	-	(1,180)	-	0	0	0
Preference dividends	(301)	(398)	(379)	(364)	4.0	(382)	-5.0	(401)	(421)	(442)
Minorities	(36)	28	489	991	102.7	(92)	-	(330)	(99)	(104)
Net earnings (local GAAP)	**(6,055)**	**(8,995)**	**(3,470)**	**672**	-	**(2,989)**	-	**534**	**1,474**	**2,496**
Net earnings (before pref divs)	**(5,754)**	**(8,597)**	**(3,091)**	**1,036**	-	**(2,607)**	-	**935**	**1,896**	**2,938**
Net earnings (UBS)	**1,599**	**(2,620)**	**5,326**	**2,599**	-51.2	**2,468**	-5.0	**2,632**	**2,668**	**3,142**

Per share (p)	12/12	12/13	12/14	12/15E	% ch	12/16E	% ch	12/17E	12/18E	12/19E
EPS (local GAAP, basic)	(55.0)	(80.3)	(30.6)	5.8	-	(25.6)	-	4.5	12.4	20.7
EPS (UBS, diluted)	14.5	(23.4)	46.9	22.6	-51.9	21.1	-6.3	22.3	22.4	26.1
PPOP (diluted)	71.4	48.5	51.1	34.5	-32.5	35.1	1.8	43.2	50.7	57.4
Net DPS	0.0	0.0	0.0	0.0	-	5.0	-	30.0	50.0	42.0
BVPS	571.0	481.5	469.8	442.7	-5.8	412.9	-6.7	378.4	324.6	300.1
BVPS (UBS)	449.0	370.1	399.7	381.2	-4.6	352.0	-7.7	318.1	264.9	241.0

Balance sheet (£m)	12/12	12/13	12/14	12/15E	% ch	12/16E	% ch	12/17E	12/18E	12/19E
Banking assets (year end)	1,312,295	1,027,878	1,050,763	877,433	-16.5	775,433	-11.6	728,007	716,959	726,347
Banking assets (average)	1,409,581	1,170,087	1,039,321	964,098	-7.2	826,433	-14.3	751,720	722,483	721,653
Total assets (year end)	1,312,295	1,027,878	1,050,763	877,433	-16.5	775,433	-11.6	728,007	716,959	726,347
Risk weighted assets (RWA) (year end)	459,600	429,100	355,900	240,955	-32.3	219,651	-8.8	212,089	201,859	202,785
Risk weighted assets (RWA) (average)	447,750	444,350	392,500	298,428	-24.0	230,303	-22.8	215,870	206,974	202,322
Customer loans	500,135	440,722	378,238	350,370	-7.4	351,087	0.2	360,764	356,489	373,756
Customer loans (average)	507,871	470,429	409,480	364,304	-11.0	350,729	-3.7	355,925	358,626	365,122
Interest earning assets (average)	594,062	543,881	502,830	411,255	-18.2	409,328	-0.5	419,906	415,227	431,304
Customer deposits	521,279	470,880	391,639	362,800	-7.4	369,298	1.8	377,653	365,127	378,759
Common s/h equity (year end)	63,386	53,450	52,149	51,466	-1.3	48,477	-5.8	44,876	38,876	36,304
Common s/h equity (average)	66,019	58,418	52,800	51,807	-1.9	49,971	-3.5	46,676	41,876	37,590
Total SHF (equity, pref & MI) (year end)	70,448	59,215	60,192	57,917	-3.8	55,127	-4.8	51,746	45,988	43,682
Total SHF (equity, pref & MI) (average)	72,265	64,832	59,704	59,054	-1.1	56,522	-4.3	53,437	48,867	44,835
Net tangible assets	56,903	46,847	52,411	50,766	-3.1	47,976	-5.5	44,595	38,837	36,531

Balance sheet structure (%)	12/12	12/13	12/14	12/15E	% ch	12/16E	% ch	12/17E	12/18E	12/19E
Loans / banking assets (year end)	38.1	42.9	36.0	39.9	10.9	45.3	13.4	49.6	49.7	51.5
Deposits / banking assets (year end)	39.7	45.8	37.3	41.3	10.9	47.6	15.2	51.9	50.9	52.1
Loans / deposits	95.9	93.6	96.6	96.6	0.0	95.1	-1.6	95.5	97.6	98.7
Total SHF / banking assets (year end)	5.4	5.8	5.7	6.6	15.2	7.1	7.7	7.1	6.4	6.0

Source: Company accounts, UBS estimates. (UBS) metrics use reported figures which have been adjusted by UBS analysts.

RBS Group (RBS.L)

Capital adequacy (£m)	12/12	12/13	12/14	12/15E	12/16E	12/17E	12/18E	12/19E
Tier 1 capital	57,135	36,768	39,919	42,150	39,487	36,227	31,283	29,194
Total capital	66,800	45,501	48,636	50,481	47,402	43,745	38,426	35,980
Risk weighted assets (RWA) (year end)	459,600	429,100	355,900	240,955	219,651	212,089	201,859	202,785
Core tier 1 ratio %	10.3	8.6	11.2	16.7	17.0	15.9	14.2	13.0
Tier 1 ratio %	12.4	8.6	11.2	17.5	18.0	17.1	15.5	14.4
Total capital ratio %	14.5	10.6	13.7	21.0	21.6	20.6	19.0	17.7
Tangible equity	49,841	41,082	44,368	44,315	41,326	37,725	31,725	29,153
Equity / assets %	4.8	5.2	5.0	5.9	6.3	6.2	5.4	5.0
Tangible equity to tangible assets %	3.8	4.0	4.3	5.1	5.4	5.2	4.5	4.1

Asset quality (£m)	12/12	12/13	12/14	12/15E	12/16E	12/17E	12/18E	12/19E
Non performing assets	41,127	39,392	26,884	12,000	6,875	6,169	5,732	5,466
Total risk reserves	21,250	25,216	17,500	7,661	3,836	3,443	3,102	2,960
NPLs / loans %	7.9	8.5	6.8	3.4	1.9	1.7	1.6	1.5
NPL coverage %	51.7	64.0	65.1	63.8	55.8	55.8	54.1	54.1
Provision charge / average loans %	1.0	1.8	(0.3)	(0.2)	0.0	0.1	0.2	0.3
Net NPAs / shareholders funds %	28.2	23.9	15.6	7.5	5.5	5.3	5.7	5.7

Profitability (%)	12/12	12/13	12/14	12/15E	12/16E	12/17E	12/18E	12/19E
Net interest margin (avg assets)	0.82	0.94	1.08	0.91	1.06	1.25	1.39	1.47
Provisions / operating profit	67.2	155.2	(19.9)	(14.9)	0.3	9.5	14.5	15.3
ROE (UBS earnings)	2.4	-4.5	10.1	5.0	4.9	5.6	6.4	8.4
RoAdjE (UBS earnings & equity)	3.1	(5.8)	12.5	5.9	5.8	6.7	7.7	10.3
RoRWA (UBS)	0.37	(0.60)	1.23	0.54	1.11	1.37	1.34	1.60
RoA (UBS earnings)	(0.41)	(0.74)	(0.31)	0.00	(0.16)	0.17	0.28	0.42

Productivity (%)	12/12	12/13	12/14	12/15E	12/16E	12/17E	12/18E	12/19E
Cost income ratio	64.5	77.5	90.8	70.0	67.8	61.7	57.0	54.1
Cost / average assets	1.01	1.20	1.19	0.96	1.05	1.09	1.11	1.13
Compensation expense ratio	48.4	55.9	52.5	59.6	58.8	53.5	49.2	45.8

Growth (%)	12/12	12/13	12/14	12/15E	12/16E	12/17E	12/18E	12/19E
Revenue	-10.7	-12.0	-6.4	-27.2	-3.9	4.4	5.7	7.1
Operating profit pre provisions	-15.1	-30.9	6.8	-31.5	3.2	24.2	18.7	14.3
Net earnings (UBS)	33.6	-	-	-51.2	-5.0	6.6	1.4	17.7
Net DPS	-	-	-	-	-	NM	66.7	-16.0
Total assets (year end)	-12.9	-21.7	2.2	-16.5	-11.6	-6.1	-1.5	1.3
Customer loans	-3.0	-11.9	-14.2	-7.4	0.2	2.8	-1.2	4.8
Customer deposits	3.6	-9.7	-16.8	-7.4	1.8	2.3	-3.3	3.7

Value (x)	12/12	12/13	12/14	12/15E	12/16E	12/17E	12/18E	12/19E
Market cap/revenues	1.3	1.9	2.1	2.3	2.4	2.3	2.1	2.0
Market cap/deposits	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
P/PPOP (diluted)	3.6	6.8	6.8	7.6	7.5	6.1	5.2	4.6
P/E (local GAAP, basic)	NM	NM	NM	45.0	NM	57.9	21.2	12.6
P/E (UBS, diluted)	17.5	(14.0)	7.4	11.6	12.4	11.7	11.7	10.0
Net dividend yield %	0.0	0.0	0.0	0.0	1.9	11.4	19.1	16.0
P/BV x	0.4	0.7	0.7	0.6	0.6	0.7	0.8	0.9
P/BV (UBS) x	0.6	0.9	0.9	0.7	0.7	0.8	1.0	1.1

Source: Company accounts, UBS estimates. (UBS) metrics use reported figures which have been adjusted by UBS analysts.

Forecast returns

Forecast price appreciation	+33.5%
Forecast dividend yield	1.9%
Forecast stock return	+35.4%
Market return assumption	5.4%
Forecast excess return	+30.0%

Valuation Method and Risk Statement

RBS is restructuring to concentrate on UK retail and commercial banking in particular. This process involves a substantial asset disposal and cost reduction plan which exposes the group to both up- and down-side risks. RBS is also exposed to risks relating to legacy legal and litigation issues which remain unresolved. We value RBS by sum-of-the-parts using peer group divisional multiples.

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UBS Investment Research: Global Equity Rating Definitions

12-Month Rating	Definition	Coverage[1]	IB Services[2]
Buy	FSR is > 6% above the MRA.	48%	36%
Neutral	FSR is between -6% and 6% of the MRA.	39%	28%
Sell	FSR is > 6% below the MRA.	12%	22%
Short-Term Rating	**Definition**	**Coverage[3]**	**IB Services[4]**
Buy	Stock price expected to rise within three months from the time the rating was assigned because of a specific catalyst or event.	<1%	<1%
Sell	Stock price expected to fall within three months from the time the rating was assigned because of a specific catalyst or event.	<1%	<1%

Source: UBS. Rating allocations are as of 31 December 2015.
1:Percentage of companies under coverage globally within the 12-month rating category.
2:Percentage of companies within the 12-month rating category for which investment banking (IB) services were provided within the past 12 months.
3:Percentage of companies under coverage globally within the Short-Term rating category.
4:Percentage of companies within the Short-Term rating category for which investment banking (IB) services were provided within the past 12 months.

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UBS Limited: Jason Napier, CFA; Ivan Jevremovic.

Company Disclosures

Company Name	Reuters	12-month rating	Short-term rating	Price	Price date
RBS Group[2, 4, 16]	RBS.L	Buy	N/A	262p	22 Jan 2016

Source: UBS. All prices as of local market close.
Ratings in this table are the most current published ratings prior to this report. They may be more recent than the stock pricing date

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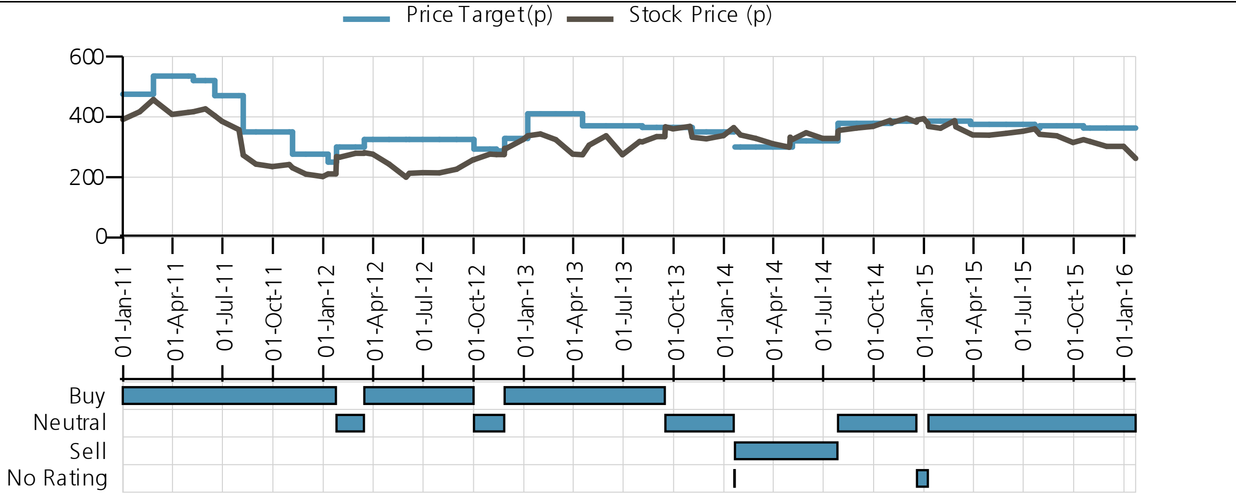
RBS Group (p)



Source: UBS; as of 22 Jan 2016

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