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SPECIAL REPOR

RBS - royal mess or jewel in the crown?

Two years ago, RBS was valued at over £240 billion. It has since needed an additional £60 billion of fresh capital pumped in from the private and public sectors. The 300 year old institution has suffered capital destruction on a nuclear scale. Can the fallen giant be put back on its feet?

Big but not clever

Being big didn't help the dinosaurs. In the banking world, being big has backfired and there is no better example than RBS. Here's a summary of its biggest achievements in recent times:

October 2007, RBS led the biggest banking takeover in world history consortium, "winning" the bid battle for ABN Amro.

February 2008, RBS was ranked as the biggest company in the world by assets according to Forbes rankings.

April 2008, RBS announced the UK's biggest ever rights issue of £12 billion.

February 2009, RBS announced the UK's biggest ever annual loss of £24 billion.

Mind the gap

The demise of RBS is well documented. Since the credit crunch began, RBS has sucked up far more private and public money than any other UK bank. Around £60 billion in fresh capital has been raised through a combination of disposals, rights issues and government bail-out schemes, yet its current market value stands at around £20 billion. In other words, RBS would have gone the same way as Northern Rock had it not been placed on government life support. Luckily for RBS shareholders it's been deemed too big too fail, both financially and politically.

The UK government could easily have chosen to nationalise RBS without compensation. It's actually a rather simple argument. RBS would be broke without taxpayer support, so the government can do what they want (see Northern Rock). That's why shareholders should be grateful for the Asset Protection Scheme.

Any talk of whether the Asset Protection Scheme is good or bad for shareholders is pointless. A negotiation is only real if you have a choice in the matter.

The broad terms of the APS have been agreed but the plan is awaiting execution. RBS is hiving off the worst bits of its balance sheet – a mere £325 billion - but will remain liable for the first £19.5 billion of losses and 10% of losses thereafter.

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While it's de-risked the balance sheet, it leaves RBS very close to full nationalisation. The dilution will be worth it though if it provides the resolve RBS needs to begin its recovery. Not only can RBS have greater confidence in customer lending, but other banks can have greater confidence in lending to RBS, which is even more important.

RBS still faces a funding gap. Its customer loans are greater than its customer deposits by around £225 billion.

The latest trading update shows that the ratio of loans to deposits stands at 150%, unchanged from the previous update. This gap needs to be plugged from external sources, known as wholesale markets. Other big financial institutions basically lend RBS the money to balance their books.

It's easy to forget that around six months ago RBS almost collapsed as wholesale markets began to shut the door on RBS. Rolling over wholesale funding is normally a routine exercise taking just a few hours. So when RBS was having problems, it caused panic. If the money hadn't been found quickly, RBS would have been declared insolvent.

Executives at RBS immediately held crisis talks with the Bank of England. The Bank of England decided to hit the phones themselves and reassure (beg) creditors in New York and Tokyo to keep faith in RBS. They were buying time. The Treasury then announced a few days later that it would offer a state guarantee when British banks borrow from other banks and financial institutions. The crisis may have blown over, but the funding gap remains.

Alphabet assets

RBS lost around £1 billion in the first three months of this year. The investment banking division was the only real star, almost doubling its profits. Before you get too excited, the performance is not likely to be repeated going forward– not to mention it is the same division responsible for a lot of the impairments.

The retail banking divisions saw profit margins falling due to low interest rates, rising funding costs and the need to boost liquidity by holding more low-yielding gilts. All three of these factors will remain in place for the foreseeable future. The three foreign divisions all moved into loss – not helpful when you're trying to sell some of these. Insurance profits were down, but the division remains a good earner.

Impairments came in at almost £5 billion. The scary thing is, this scale of write-offs almost feels normal these days. Management estimate 75% to 85% of the losses relate to assets earmarked for the APS, but RBS still have to absorb the first £19.5 billion of losses from these toxic assets anyway.

Mr Hester has been busy since taking the helm having raised more capital, devised a new strategy,

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completed an entire board reshuffle and beginning the disposal programme.

Despite all the recent initiatives, the RBS balance sheet is still a £2 trillion monster loaded with alphabet assets.

You only have to look at the recent results to see the billions still sitting in RMBS, CMBS, CDOs, CLOs and ABSs. We are meant to be reassured because many are hedged by CDPCs and monolines. Confused and concerned? You should be. Cleaning up the mess is going to take a long time – years not months.

Boring is back

Looking beyond the recession, the new RBS will be smaller and more focused. 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 strategy is simple – expand in the UK and US, shrink everywhere else. In corporate speak, the new company will be "anchored in the UK".

A UK anchored RBS will certainly suit its biggest shareholder. It wants RBS to deploy its capital on these fine shores and help get credit flowing through the economy again before election time. The government's not interested in RBS spreading its capital around the globe.

RBS plan to regain a double A credit rating by reducing both its leverage and reliance on wholesale funding. Lowering its risk profile will mean the days of 20+% returns on capital will be out of reach. RBS management still believes a 15% return on capital can be achieved. The era of deregulation that kicked off under Thatcher's Big Bang will go into reverse. Regulators will keep a closer eye on banks and enforce a more rule based regime. Banks will need to hold more capital in safe instruments, such as Gilts. Deposits will need to be a greater proportion of loans. The alphabet assets will eventually be offloaded. Banking will become boring again.

The new CEO has a huge challenge ahead of him, but just like President Obama, he can at least blame the problems on his predecessor.

This is clearly a factor in Mr Hester's more sober outlook compared to his peers at Barclays, Lloyds and HSBC. The top dogs at the other banks are still holding onto their jobs, so need to put on a brave face and talk up hopes of recovery. The RBS board of directors is a brand new bunch having now purged every one of Sir Fred's crew. Its best they get the bad news out now while they can still deflect the blame. Given RBS is also in the process

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of cutting many jobs, it helps if you give a downbeat outlook. So don't be put off by the dour tone of RBS, management are best served being bearish for now. Likewise don't get carried away with the hype from green shoot gang. As always, the truth lies somewhere in the middle.

A look under the hood

The market has largely focused on trying to guess the book value of the banks, including RBS. This seems a very narrow view of a banks value. A bank's book value is the value of its assets minus all the money it owes to creditors.

Book value just gives a fuzzy snapshot of what a bank already has on its books. 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. Imagine if you valued Coca Cola just based on their factories and the stock already sat in their warehouses. Book value is valuing a company as dead rather than alive.

Book value misses the real value of a company, which is to generate profits or cash for shareholders in the future.

The best way to analyse RBS is at an operating level and apply reasonable earnings multiples to the respective business divisions.

The branch networks are the backbone of the company, selling straightforward products to individuals and businesses.

The main brands are well established and their customers tend to stick around. In the UK, the brands are Natwest, RBS and Ulster which serve England, Scotland and Northern Ireland respectively. In the US, Citizens and Charter One are also deep-rooted. Margins are healthy, so impairments in bad times tend to dent profits rather than swing the division to loss. It may not be exciting, or offer enormous growth prospects, but it is solid. The branch networks will continue to be the biggest generator of profits.

The insurance division is another gem. It's Britain's second-largest general insurer, the largest provider of motor cover and is a major player in travel, home and pet insurance. Direct Line's little red phone and Churchill's nodding dog are strong brands. The division's financial performance has continued to be solid and it has fat profit margins. Sir Fred tried to sell it for £7 billion in a desperate effort to avoid part nationalisation. The sales process has since been abandoned due to a stalemate on price. The best bid came in at around £6 billion. In the end, RBS has held onto the division. Most of the key business metrics have remained stable throughout the financial turmoil, which demonstrates the quality of its earnings.

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The operations in Europe, the Middle East and Asia lack scale to compete with bigger regional players. They're not big contributors to overall financial performance and should they get sold off, they won't be missed. The fact they've moved into loss this year is an indication of their non-core, sub-scale nature.

Global Transaction Services is basically an add-on to Global Banking and Markets (GBM) – the investment banking arm (we're leaving this until last). It cross sells services to big corporate customers like trade finance and commercial cards. As the plan is to "right-size" GBM – shrink it to focus on Europe, this will probably dent Global Transaction Services as well. It's not a bad business, but will be affected if RBS retreat from many international markets. However, so far its performance has held up well and the division has incurred minimal impairments, demonstrating its resilience and low risk profile.

That brings us to the infamous GBM, or should it be re-named "GBH". This division is the epicentre of the storm and the latest figures do nothing to change the situation. The fact it had a great first quarter but was the main contributor to impairments shows just how sporadic its performance is. It's a low quality earnings stream, but RBS seem determined to salvage something from the ABN Amro purchase.

The CEO has blamed the legacy losses on a motley crew of 500 traders, most of whom have already been shown the door. The party may be over, but the damage remains.

The first signs of political interference have emerged. GBM has lost hundreds of staff recently as they defect to more cavalier competitors. It's common knowledge that investment bankers are driven by bonuses, not salaries. RBS has decided it will now pay bonuses in the form of subordinated debt over three years and allow RBS to claw back some of the payments if certain performance targets are not met. This would be fine if it were legislated across the industry, but competing investment banks are still prepared to offer old-style cash bonuses. As a result hundreds of staff have headed to rivals. It's another reason not to get too carried away with the first quarter performance from investment banking.

Sum of parts

The combined value of the UK and US retail and commercial banking divisions should be worth around £30 billion based on an earnings multiple of 8 times 2008 earnings. Bear in mind that profits in 2008 were well down from 2007 peak levels. In the UK they declined around 20% and in the US they dropped 55%. Some would argue 2009 earnings

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may be even lower, but we have used a modest earnings multiple.

Europe and Middle East are sub-scale and have been even hit harder than the operations in the UK and US. Profits in 2008 were down 85% on 2007. A valuation of £1.5 billion looks reasonable.

The Asian operations are up for sale. The division actually made a small loss last year, but is positioned in high growth economies. Bids are rumoured to be coming in near £1 billion, which looks reasonable.

A value of £6 billion for RBS Insurance looks conservative. It implies a multiple of 8 times 2008 earnings and the division offers decent growth prospects. The highest bid for the division also came in around this level in a distressed market.

Valuing the combined operations of Global Banking & Markets and Transaction Services is the tough part. Transaction Services looks a good business, albeit it's reliant on the corporate relationships which are partly dependent on the Banking & Markets side. Global Banking & Markets in a slimmed down form could be more consistent, with a focus on client services than proprietary trading. If we assume each part can make £1 billion in profits and a low multiple of 5 times earnings given the highly cyclical earnings, this would give a combined value of £10 billion.

Our sum-of-parts value is £48.5 billion, or around 120p a share.

Any valuation requires a judgement taking into account many factors such as track record, sector prospects, competitive position and quality of earnings. You could adjust both earnings multiples and normalised earnings, but the key point with RBS is the shares trade at a substantial discount to our sum of parts, indicating there is still plenty of potential upside.

So why is the share price so low?

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The fear factor

The shares trade at a big discount to its sum of parts because of fear and uncertainty over its future. There are a lot of balls still up in the air:

- are legacy losses under control;
- does RBS have enough capital to avoid full nationalisation;
- how restrictive will the new regulatory regime be;
- will political interference hold back commercial success;
- will the new slimmed down RBS be able to compete with broader banks;
- when will the government try and sell its majority stake.

RBS has required three huge capital injections already, but the APS is a turning point in significantly de-risking the balance sheet and containing legacy losses. While further losses are inevitable, the key test is whether RBS has enough capital to absorb the hits.

After the APS is taken into account, RBS had a core tier one capital ratio of 12.2% at 31 March 2009 (13% at 31 December 2008). This is around double the level considered reasonable prior to the credit crunch. In fact, the Financial Services Authority says it will eventually allow banks to move down to a minimum core tier one ratio of 4%, which would imply RBS has triple the minimum cushion. It's what many would consider bullet-proof and looks enough to combat a severe recession.

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. The biggest losers may be executives as they are less able to cash in on the boom times.

The political interference has been minimal so far and the new bonus structures make sense, even if it has led to hundreds of staff defections. The difficulty is that sensible reforms will be strongly resisted in the mercurial world of investment banking. In a global marketplace, the UK government can't bring about change alone. However, it is worth noting that the UK government has a broader interest in RBS than political issues such as economic stability and job protection. Not only is the government the largest shareholder in RBS (and Lloyds), its tax receipts have been highly dependent on the UK's success in banking and finance. It will be careful not to kill the golden goose.

A question mark remains over whether a slimmed down RBS will lose some of its competitiveness to broader based banks. The evidence would suggest

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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. Diversification has ended up "diworsification". A slimmed down RBS should be embraced.

The government will want to cash in its chips at some point but will wait until the patient is in good health, which is years away. It's not an immediate problem and if anything it has brought a stable shareholder on board.

The Final Say

From a trading perspective, the recent sector and market rallies, has left bank shares vulnerable to a correction. The risk-reward ratio looks unattractive over the short term. The 50 day moving average has represented a proxy level of resistance for RBS over the last year. The shares broke to the upside in late March and have been trending up since.

35p is the nearest level of support and represents an optimal entry point. A breach of 30p would be bearish as the 50 day moving average may have reasserted itself as resistance. 70p looks achievable as a 2009 target.

For longer term investors, it's going to be a long road back to health. A full recovery looks three years away. More suffering should be expected this year and next. 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.