



Europe

RBS

Q4 '11: Losing Money to Gain Advantage, Sell Senior CDS, Buy Tier 1

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■ **Events:** RBS reported Q4 '11 statutory pre-tax net loss of £1.8bn, on revenues of £5.6bn, missing analysts' estimates. Excluding a long list of 'one-offs', operating losses were reported at £246m in the quarter. Operating profits are further split between core & non-core operating results. Core and non-core operating profits were £1.06bn and -£1.3bn in the quarter. Accelerated de-risking and de-leveraging are driving the results. RBS continues to transform to a retail & commercial bank by shrinking onto itself while maintaining high liquidity pool levels. CEO Stephen Hester noted that the UK economy is flat on its back. Taken together with regulatory pressures, this has return implications and RBS lowered return on equity guidance to meeting its cost of capital. RBS does not anticipate tapping the unsecured wholesale funding markets in 2012 and the bank stated that they believe they can avoid a short-term rating downgrade by Moody's to P-2.

■ **Results Analysis:** RBS continues to present a mixed bag of results. At first sight, the large pre-tax loss of £766m appears troubling, in particular as this includes a fair value gain on own debt of £1.8bn for the year; however, after stripping out 11 one-off items, 9 of which occurred in 2010 as well, RBS managed an operating profit of £1.8bn. In the Core business area, Retail and Commercial banking drove revenues and operating profits in Q4, although these declined q-on-q. Impairments at the Ulster Bank subsidiary were flat q-on-q, which is good news in our view. Global Banking & Markets remains a restructuring area after delivering a small core loss in Q4 due to Fx and Credit market conditions. The bank lowered expectations on GBM improvements over the next 2 years. RBS reported a Core Tier 1 ratio of 10.6% at year-end. 90bps of the CT1 ratio is due to risk-weighted asset reductions from the UK Asset Protection Scheme (APS). RBS has paid £2.6bn in fees related to the APS, slightly exceeding the minimum fee requirement. Management noted that they may exit the APS later in the year and would not be overly concerned with dipping below a 10% CT1 ratio. In our view, leaving the APS is not credit positive, but is also not a done deal in the current economic environment. We are less convinced that RBS may avoid a short-term rating downgrade to P-2 by Moody's but note that CP & CD levels are more manageable at £21bn now, down from £45bn last year. In addition, £11bn of ABCP is outstanding.

■ **How to trade it:** Buy RBS Trust Preferred Tier 1 or sell senior CDS protection, depending on your risk tolerance. Credit expectations resolve around restarting coupons, potential liability management exercises (LME) and the UK ICB implications. RBS is prohibited by the EU from paying optional coupons and calls until 30 April 2012. In the conference call for fixed-income investors, RBS noted that it will make and announce decisions on restarting optional coupon payments in due course. We expect that calls will be undertaken on an economic basis-only after EU restrictions expire. However, RBS re-iterated that paying coupons will be a step to becoming a more normal bank again. The Trust Preferred Tier 1 securities have 'capital-stoppers' that inhibit the buy-back of these securities until 12 months of coupons are accrued. Management confirmed that they may not be subject to a LME until 2013. Nonetheless, we see re-starting Tier 1 coupon payments as a first step towards becoming a normal bank that pays dividends. At current price levels, we believe that if you wait until the decision on coupon payments are announced, you risk missing the opportunity to capture potential LME gains over time. For less aggressive, non-cash investors, we recommend selling 5 year senior CDS protection at approximately 285 or 1.3x senior iTraxx. UK ICB proposals on primary loss absorption capital are still a long way off and in the interim; it is the recovery at RBS which should drive senior CDS levels, in our view. We think the systemic Moody's downgrade is now priced-in and this event could go management's way. We recommend stop losses at 1.45x iTraxx and take profits at 1.15x iTraxx.

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RBS: Group full-year P&L (in GBP millions)

	2006	2007	2008	2009	2010	2011
Net Interest Income	10,596	12,069	18,675	13,388	14,209	12,679
Net Fees	7,116	8,278	9,831	8,738	8,193	6,384
Net Trading Income	2,675	1,836	- 8,135	3,923	5,013	3,583
Other Operating Income	4,888	3,509	3,113	1,872	1,544	2,870
Total Revenues	25,275	25,692	23,484	27,921	28,959	25,516
Operating Expense	- 12,346	- 13,834	- 21,495	- 17,054	- 18,218	- 15,271
Pre-Provision Profits	11,007	9,665	397	8,077	8,530	8,785
Loan Loss Reserves	- 1,878	- 1,968	- 8,072	- 13,899	- 9,256	- 8,709
Operating Profits	9,129	7,697	- 8,469	- 5,822	726	76
Pre-Tax Profit	8,995	9,832	- 40,836	- 2,647	399	766
Taxes	- 2,689	- 2,044	2,323	429	634	- 1,250
Net Income	6,202	7,549	- 23,710	- 2,672	1,001	1,997

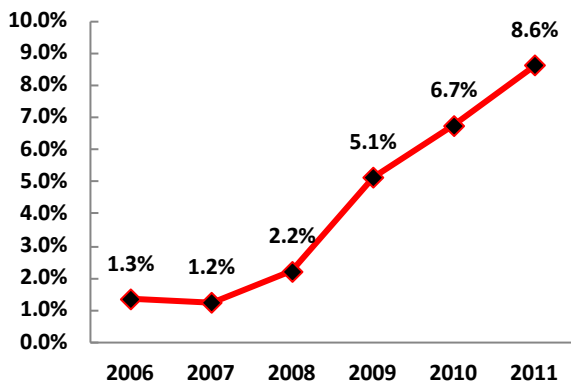
Source: SG Cross Asset Research, Bloomberg, Company Data

RBS: Balance Sheet Data & Regulatory Ratios under Basel II (in GBP millions unless stated otherwise)

	2006	2007	2008	2009	2010	2011	% of Assets
Cash & Due From Bank	88,727	237,326	150,597	144,014	157,532	224,073	14.9%
Net Loans	466,893	828,538	874,722	728,393	555,260	454,112	30.1%
Trading Securities	137,086	331,367	273,365	272,116	231,184	216,783	14.4%
Intangible Assets	18,904	49,916	20,049	17,847	14,448	14,858	1.0%
DTA	na	3,119	7,082	7,039	6,373	3,878	0.3%
Net Fixed Assets	18,420	18,745	18,949	19,397	16,543	11,868	0.8%
Goodwill	17,889	42,953	15,562	14,264	12,528	na	
Total Assets	871,432	1,840,829	2,401,652	1,696,486	1,453,576	1,506,867	
Total Deposits	320,238	682,363	581,369	545,849	428,599	502,955	33.4%
Core Tier 1 Capital	na	27,324	46,190	59,524	49,604	46,000	
RWA	400,300	609,000	695,800	541,000	465,500	439,000	
Core tier one Ratio	na	4.49%	6.64%	11.00%	10.66%	10.48%	
Tier one ratio	7.50%	7.28%	10.04%	14.13%	12.92%	12.98%	
Capital Ratio	11.73%	11.16%	14.11%	16.13%	14.03%	13.90%	

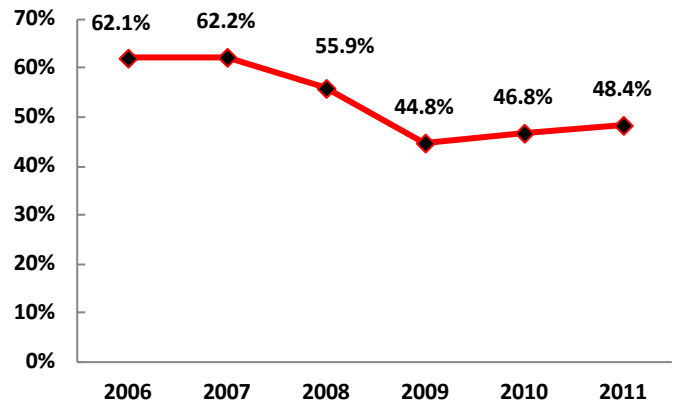
Source: SG Cross Asset Research, Bloomberg, Company Data

**Reduced Lending Levels drive Asset Quality metrics, as Loan Shrinkage Outpaces Impairment Rises
(Impaired Loans / Gross Loans)**

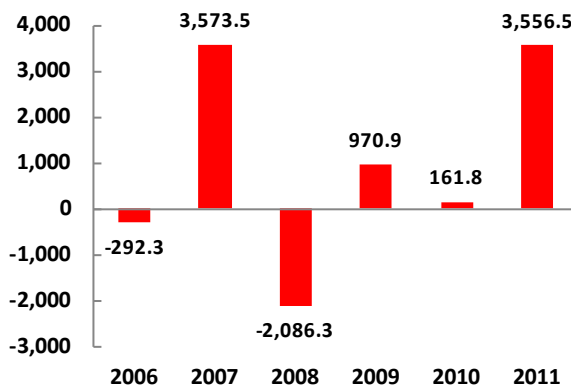


Source: SG Cross Asset Research, Bloomberg, Company Data

**RBS : Loan Loss Coverage Ratios remains stable
(Loan Loss Reserves / Impaired Loans)**

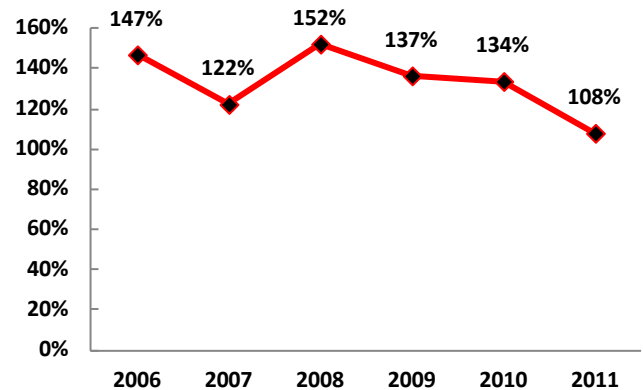


**RBS continues to enhance its liquidity profile
(Liquidity Jaws: growth in deposits – growth in lending in bps)**

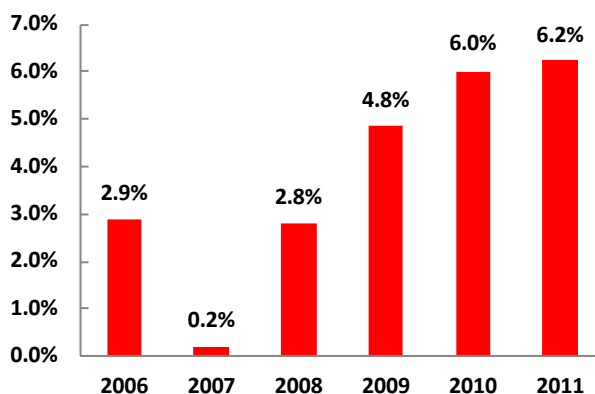


Source: SG Cross Asset Research, Bloomberg, Company Data

RBS Loan to deposit ratio continues to improve

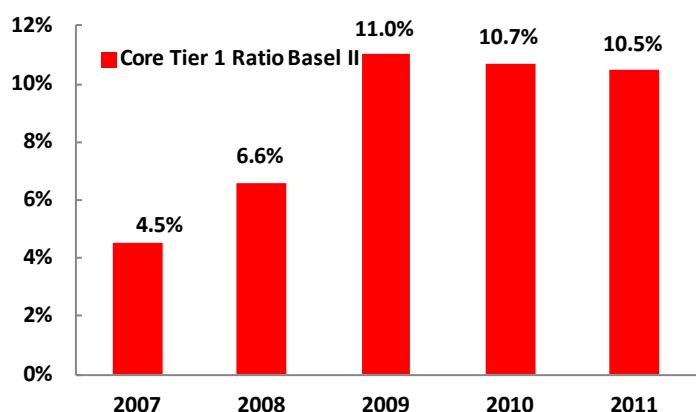


**RBS leverage decreases:
(Tangible Equity / Tangible Assets – derivatives)**



Source: SG Cross Asset Research, Bloomberg, Company Data





RBS's Basel II Core Tier 1 Ratio decreases a little but remains above the 10% threshold.



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Hold: Indicates likely to be within 5% of the performance of its iBoxx subsector

Sell: Indicates likely to underperform its iBoxx subsector by 5% or more

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SG Credit research evaluates its expectation of how the 5 year CDS is going to perform vis-à-vis its sector.

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