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Diversified Banks (GICS) | Banks (Citi)
Europe | United Kingdom

Royal Bank of Scotland Group PLC (RBS.L)

Alert: Potential Citizens IPO

Potential Citizens IPO — Over the weekend various media sources have reported that RBS is set to outline plans to IPO its US retail & commercial business, Citizens. *The Telegraph* (23 Feb 2013) reports that talks are still at an early stage and the process could take around two years to complete. According to the paper, RBS is expected to outline plans to initially sell a small stake in Citizens, of c25%, and will keep open its options for future disposals. RBS has made no comment on this.

Citizens in Context — Citizens is the 16th largest bank in the US by assets, focused on 12 states, within three geographic regions – Mid-West, Mid-Atlantic and New England. Business profitability is recovering, but remains weak. In 1H12, US R&C contributed 13% of total core Group revenues and 10% of pre-tax profits. In 2011 the core US R&C business generated a “normalized” RoE, excluding non-recurring items and based on a fixed 10% CT1 ratio, of ‘only’ 4.9% vs peers 9.4%. We wrote at length about this in our report ‘[The Future of Citizens](#)’ (18 Oct 2012).

Can The Business Be Turned Around? — The lackluster profitability of Citizens compared to peers is mainly due to weaker interest & commission income, which is partly a function of business mix (the bank is subscale in credit cards & mortgages). Citizens is attempting to improve interest margins and grow fee income, but has conceded that future margins are likely to be “broadly stable, but challenged.” In contrast on costs, asset quality & capital the business screens well relative to peers.

Potential Valuation – *The Telegraph* suggests a potential valuation of “more than £8bn”. In the aforementioned report, we observed the valuation of peers and of the latest M&A transactions in the US. Citizens has a tangible book value of \$13.2bn. The average transaction multiple on recent US bank M&A has been c1.3x, although larger transactions have been at c1.0x tangible book or below; eg. M&T announced the acquisition of Hudson City for 0.8x reported tangible book. Based on its sub-par profitability we argued it may be difficult for Citizens to achieve this kind of multiple in the near-term, but at 0.8x tangible book the implied valuation would be c£6.6bn.

Logic of IPO vs Trade Sale – The size of the business means that there is always going to be a lack of credible buyers, in our view, making any trade sale difficult. Furthermore, any acquisition would most likely be backed by shares, rather than cash, limiting any upfront capital benefit to RBS. An IPO is more credible in our view; however, the disadvantage is that the fundamental business mix of Citizens would be unchanged. This could limit the ability to improve the RoE versus a trade sale to another party, and could therefore be detrimental to any potential valuation.

Capital Impact – A valuation of c£6.6bn would provide a c115bps uplift to RBS’ core tier 1 capital ratio upon full disposal. However, the benefit from an IPO of a c25% stake would be much smaller, at c10bps under Basel 3, as a loss would be booked upfront, the RWAs still fully consolidated and any benefit from increased minorities is limited compared to Basel 2. Even in the case of a full disposal, we fear that this would be ‘trapped’ capital, which RBS would be unable to return to shareholders.

Least Preferred UK Bank — Our concerns on RBS are not focused on the Group’s capital position, but rather the poor medium-term return profile for the core business. A potential Citizens IPO, alongside plans to divest 316 UK branches and exit from Direct Line add execution risk. We have a Neutral rating, target price 360p.

■ Company Update

Neutral/High Risk	2H
Price (22 Feb 13)	£3.45
Target price	£3.60
Expected share price return	4.3%
Expected dividend yield	0.0%
Expected total return	4.3%
Market Cap	£39,222M
	US\$59,471M

Price Performance (RIC: RBS.L, BB: RBS LN)



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See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

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Royal Bank of Scotland Group PLC

Valuation

We set our target price at 360p based on a two-stage dividend discount approach combined with a capital-adjusted warranted-equity valuation to calculate a terminal value. This target price represents 0.75x 2012E TBV per share, a discount to the European banks sector average, which we believe is fair due to RBS's lower RoTE profile.

Risks

We set a High Risk rating to reflect its exposure to regulatory uncertainty. We view the risks to our target price as evenly balanced. Downside risks that could impede the share price from reaching our target price include risks associated with shrinking the non-core balance sheet and restructuring the Markets division, plus regulatory uncertainty. RBS also has potential upside surprise catalysts, that could result in it outperforming our target, such as a sharper credit recovery in Ireland than we anticipate, a turnaround in the US business, or further margin improvements in the UK following active central bank policy.

Appendix A-1

Analyst Certification

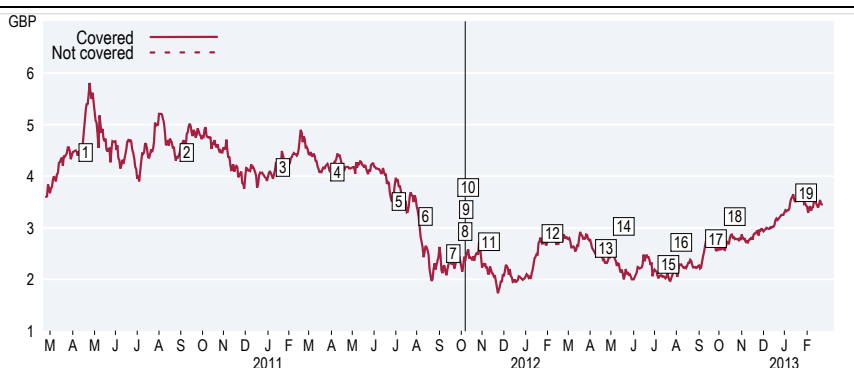
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Royal Bank of Scotland Group PLC (RBS.L)

Ratings and Target Price History Fundamental Research

Analyst: Andrew Coombs
Covered since July 6 2011



Date	Rating	Target Price	Closing Price
1 20-Apr-10	2H	*5.10	5.27
2 9-Sep-10	*1M	*5.70	4.82
3 24-Jan-11	1M	*5.60	4.41
4 11-Apr-11	1M	*6.10	4.44
5 6-Jul-11	1M	*5.00	3.79
6 12-Aug-11	1M	*4.60	2.65
7 21-Sep-11	1M	*4.20	2.34

Date	Rating	Target Price	Closing Price
8 7-Oct-11	Stock rating system changed		
9 8-Oct-11	*1	4.20	2.36
10 12-Oct-11	1	*3.10	2.58
11 10-Nov-11	1	*3.00	2.11
12 8-Feb-12	*2	3.00	2.88
13 24-Apr-12	*2H	*2.80	2.33
14 18-May-12	2H	*2.50	2.00

Date	Rating	Target Price	Closing Price
15 20-Jul-12	2H	*2.35	2.05
16 8-Aug-12	2H	*2.30	2.29
17 26-Sep-12	2H	*2.70	2.55
18 23-Oct-12	2H	*2.85	2.78
19 31-Jan-13	2H	*3.60	3.43

* Indicates change

Rating/target price changes above reflect Eastern Standard Time

Royal Bank of Scotland Group PLC (RBS.L)

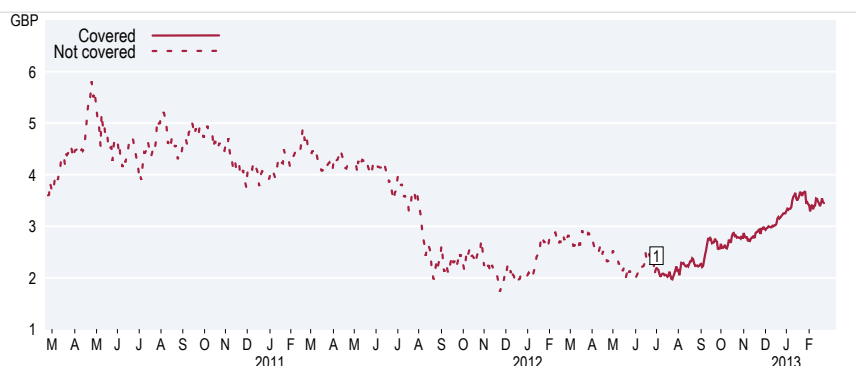
Ratings and Target Price History

Best Ideas Research

Relative Call (3 Month)

Analyst: Andrew Coombs

Covered since July 6 2011



Date	Rating	Target Price	Closing Price
1 2-Jul-12	*ADD LP	-	2.19

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% of companies in each rating category that are investment banking clients

12 Month Rating			Relative Rating		
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49%	38%	12%	7%	86%	7%
53%	49%	45%	60%	49%	55%

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