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Fines Still Shadow RBS

Even bad banks can turn good.

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Some six years on from the height of the financial crisis, this still sounds optimistic. But in the case of Royal Bank of Scotland the U.K. bank most damaged by the meltdown and in which the U.K. government still has an 80% **stake** its worst assets may be better than they look. However, investors have other reasons to tread carefully.

RBS surprised the market last month by releasing its results a week early because they were materially better than the market expected. The boost to revenue and profit was due to a GBP 93 **million** ($154.4 **million**) recovery from bad-loan provisions after the bank managed to sell some assets at prices above where they were held in the bank's books.

RBS's management was still cautious on its outlook, and most analysts said such write backs or releases from provisions are unlikely to be repeated. But there are reasons to believe they might.

Analysts at Jefferies compare the level of bad-debt provisions in RBS's core businesses in Ireland to those of Bank of Ireland and in the U.K. to those of Lloyds Banking **Group**. Assuming those peers are good proxies, RBS may have overprovisioned by about GBP 2.4 **billion**.

On top of that, RBS's noncore bad bank may have another GBP 2.3 **billion** in excess provisions. RBS gave its Irish **commercial** real-**estate** loans a 77% discount to face value. But National Asset Management Agency, Ireland's bad bank, has **sold** assets at much lower discounts. NAMA's 56% average haircut on its assets could be reasonable for RBS, too.

Even without adding back excess provisions, Jefferies sees RBS's earnings improving because it needs no further impairments to loans this year, and much smaller ones in the next three. The coming **sale** of Citizens in the U.S. should boost capital at a time when RBS is already using less as it winds down its investment bank.

The catch is the uncertainty surrounding litigation and potential fines, which continue to batter the banking industry. The probe into foreign-exchange trading, notably, remains outstanding.

Jefferies expects just GBP 1.7 **billion** of further charges at RBS, which compares with Credit Suisse's GBP 4.1 **billion** forecast.

The difficulty is that such fines are virtually impossible to predict, particularly with multiple investigations continuing for RBS on both sides of the Atlantic. The bank has yet to settle with the authorities on any of the major issues, including interest-rate fixing or U.S. mortgage-bond underwriting.

RBS trades in line with its forecast tangible book value. That may be a chunky discount to Lloyds's multiple of 1.5 times, but is close to the average for European banks at 1.1 times.

Then there is the overhang created by the U.K. government's eventual need to sell its **stake**, and the risk of political meddling in the meantime.

Most investors will need more reassurance before they see RBS as cheap.

-- Paul J. Davies

Hewlett-Packard's New Approach

Hewlett-Packard may be contemplating a return to the M&A game. Thankfully, chief Meg Whitman seems to remember well the turmoil that got her the top job in the first place.

It has been three years since H-P announced its $10 billion acquisition of Autonomy. That deal quickly soured and sealed the fate of the company's previous chief, elevating Ms. Whitman to the top spot. Since then, the company has stayed far away from big deals, focusing instead on a multiyear restructuring effort to reduce its workforce and boost cash flow.

That is showing results. The company said Wednesday that cash flow from operations jumped by 36% year over year in its fiscal third quarter. It now expects to end the current fiscal year in October with free cash flow of about $9 billion well above the range of $6 billion to $6.5 billion that it projected at the beginning of the period. H-P's stock has jumped more than 29% since Jan. 1 and is now at a three-year high.

The improved finances and robust stock gains will fuel more speculation that H-P could return to its deal-making ways. The company also said Wednesday that its share-buyback activity for the quarter was limited by "material nonpublic information" that it didn't detail, but is believed by many to be a major acquisition that was being considered.

This could make some investors nervous, given the company's checkered history in this area. And valuations aren't exactly cheap, at least among the types of high-growth companies that H-P might consider. Stocks in the BVP Cloud Index compiled by Bessemer Venture Partners are up by an average of nearly 8% in the past three months, and more than half the companies in that group carry market caps of more than $1 billion. Most of these companies also carry valuations far in excess of H-P's.

Ms. Whitman signaled a cautious approach Wednesday, saying that while M&A will be part of the company's strategy going forward, it will be "returns-based." This suggests H-P won't simply chase big game that may goose its top line but end up being highly dilutive. She added that, "given a choice, I would rather invest organically."

H-P remains growth-challenged, like its other large-cap tech peers. It is telling that one of the biggest positive surprises to come from Wednesday's earnings report was the fact that revenue grew by just 1% year over year making its first period of quarterly revenue growth in three years. H-P has benefited from a surprising rebound in the PC market, but this business will remain challenged in the long term, as well as the printing segment that is still a key part of the company's profits.

In this light, it makes sense for the company to do some careful shopping. But having just regained some financial footing, H-P needs to step carefully.

-- Dan Gallagher

BofA Exorcises

Crisis-Era Ghost

Bank of America has finally made it to No. 1.

Back when the bank struck its deal to purchaseCountrywide Financial in 2008, then-chief Kenneth Lewis explained the strategy was simply to make Bank of America "No. 1" in mortgage lending. That didn't happen. BofA is now the third-largest mortgage lender, behind Wells Fargo and J.P. Morgan Chase.

But it can lay claim to the top rank in a less desirable category: The $16.65 billion mortgage deal it agreed to Thursday is the largest government settlement by a company in U.S. history.

BofA said the settlement would reduce pretax third-quarter earnings by $5.3 billion, a bigger charge than many expected. With this, the bank will have taken a total of $33.9 billion in litigation charges since 2010. In addition, the bank has spent or reserved $37.3 billion to repurchase faulty mortgages from investors.

That makes clear that the profits of the housing boom were illusory. In fact, the bank wound up with a combined litigation and repurchase tab that amounts to 106% of the net income the bank reported from 2004 to 2007.

This isn't quite the last of BofA's mortgage-legacy legal woes. It is still in a legal battle with Ambac Financial Group, and it is fighting a $1.27 billion judgment in a case stemming from Countrywide's unfortunately named "Hustle" mortgage program. Those, however, shouldn't be big drains on earnings given reserves that are likely in place.

The settlement does lift the biggest cloud of uncertainty that hovered over the bank. For the first time in several years, investors can focus on earnings power rather than worry about outsize litigation costs.

The bill for Mr. Lewis's folly has at last been paid.

-- John Carney

Another

Stop for

Chinese

Economy

Investors should be getting used to China's start-stop economy. It seems time for another stop.

HSBC's preliminary manufacturing purchasing managers index, among the earliest reads on economic activity in the month, fell sharply in August to 50.3 from 51.7 last month. Just above the expansion level of 50, it confirms other recent data that the mini economic rally of the past few months is petering out. It also is a sign that more stimulus is in the cards.

The slowdown in growth momentum fits a pattern of the past few years. As the economy wanes, the government steps in with cheaper lending, project approvals and other moves to keep the official growth rate heading toward Beijing's target. Each time, though, the stimulus is a bit less, as officials are wary of reinflating credit bubbles, resulting over the longer term in a slow deceleration in China's growth rate.

The trajectory toward slower growth is a policy priority and shouldn't surprise investors. Beijing knows slower growth is more sustainable growth. Without a deceleration, it becomes nearly impossible to implement a raft of necessary changes such as interest-rate liberalization in the banking system, restructuring of state companies and deleveraging of local governments. Top officials have hinted they will again lower the GDP growth target, currently 7.5%, to 7% next year.

At the same time, leaders don't want to let the economy slow too much. Therefore, every time the growth rate drops below their comfort zone, another batch of growth-boosting measures is unleashed.

The part of the economy that seems most at risk of falling out of the government's control right now is the property market. Property prices and construction activity continue to drop, posing risks to the banking system, personal wealth and local government finances. The relaxation of curbs against property speculators, already implemented in several cities, may yet have a positive impact. More moves appear likely.

China's Shanghai Composite Index has risen 12% since March, but has wobbled on the latest data. It will take another go signal from Beijing to restore momentum.

-- Alex Frangos

Overheard

Treasury Wine Estates isn't letting the small matter of circling buyout firms crimp its style.

As TPG and a consortium led by KKR check the vintner's books, Chief Executive Michael Clarke told analysts he is in the market for luxury-wine acquisitions in the U.S.

It is enough to make investors a little nervous. The U.S. is a thorn in Treasury's side. It destroyed thousands of gallons of expired Beringer-brand wine there last year amid a glut of low-end vintages, prompting calls to sell the division.

That said, on the high end, luxury-wine volumes grew 15% in the U.S. last financial year.

With low leverage, Treasury has room to buy more sources to satiate increasingly discerning palates.

But is now the time? Treasury announced a A$101 million (US$94 million) net loss for the fiscal year ended in June, putting no pressure on TPG or KKR to raise their bids.

Shares fell back to the A$5.20 offer price the two bidders have lobbed in.

Investors are realizing this deal isn't getting better the longer it is exposed to the air.

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