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Least to beast

"Can you tell me the name of the worst bank in the entire world back in 2008 to 2009—not in the U.S., but in the entire world—that still exists today," a paid-up subscriber called this office to inquire. The answer to the question, and the subject of the following bullish analysis of a collection of preferred securities, is the Royal Bank of Scotland Group Plc. (RBS on the London Stock Exchange).

You wonder if the originally named Company of Scotland Trading to Africa and the Indies, founded in 1695, wasn't born under a dim star. Granted a monopoly on trade with India, Africa and the Americas, the Scotsmen bungled it. There was a bailout—not the last—in 1707. Twenty years later was chartered the Royal Bank of Scotland. Fittingly, it was RBS, the very next year, that invented the bank overdraft—or, as bankers will be bankers, maybe the overdraft fee came first.

We'll hurry by the next 250 years. A fatal worldwide acquisition drive began in 1988. It culminated in the 2007 purchase of ABN AMRO Holding N.V., the eighth-largest bank in Europe. In the 20 years leading up to the annus horribilis 2008, RBS's footings grew at a 26.5% compound annual rate, to £2.4 trillion from £21.7 billion.

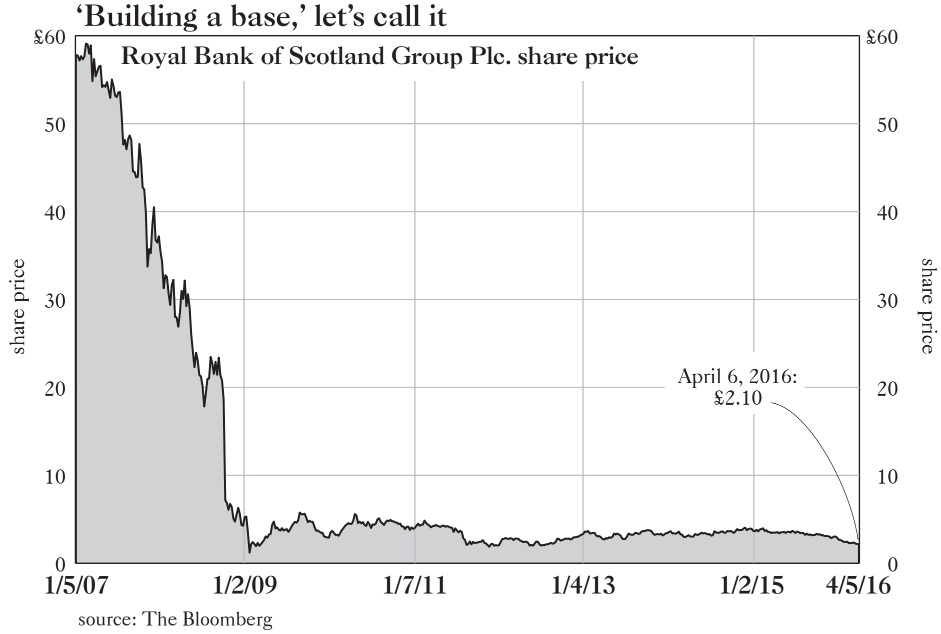
The ABN deal was too big for RBS alone to swallow. Fortis N.V. and Banco Santander S.A. shared in the purchase, then the carving up, of the Dutch target. By year-end 2007, the RBS balance sheet was weighing in at £1.8 trillion ($3.7 trillion at the then prevailing exchange rate). Only slightly smaller was RBS than the sum of Citigroup, Inc. ($2.2 trillion in assets) and Bank of America Corp. ($1.7 trillion), at the time the first and second largest banks in the U.S. by assets.

Pretty soon, it was 1707 all over again, except that RBS, the petitioner for another government bailout, showed assets in excess of a full year's GDP of the country that was supposed to save its bacon (£2.4 trillion in bank assets vs. £1.5 trillion of British GDP). In all, between December 2008 and December 2009, Her Majesty's Treasury infused £45 billion ($64 billion at current exchange rates) into its shipwreck, more, even, than the $45 billion that Citigroup cadged from the American Treasury.

While the U.S. government is no longer a Citigroup shareholder, the UK government still holds a majority stake—no less than 72%—in RBS. It's not something that Daniel O'Keefe, a portfolio manager at Artisan Global Value Fund, a much smaller owner of RBS common, says that he worries about. "That investment is overseen by a bunch of people who formerly worked in the private sector," O'Keefe tells colleague Evan Lorenz. "They are managing that investment for value just the way any investor would. There is no political interference in RBS."

Over the past seven years, RBS has applied itself to undoing what it had recklessly done. From year-end 2008 peak bloat till year-end 2015, its assets declined by 66% to £815.4 billion. Over the same seven years, its ratio of assets to equity was sawed in half, to 15.1 times from 29.8 times. Not only are the assets fewer, but they are also better.

'Building a base,' let's call it



source: The Bloomberg

So are the liabilities. In 2008, the loan-to-deposit ratio reached 146%, a sign that the bank tapped the capital markets for funding—and that it positively depended on them for survival. Today, RBS's loan-to-deposit ratio stands at a respectable 91%.

If CEO Ross McEwan can deliver on the timetable he's set, RBS will be earning more than 12% on common equity by 2019, as opposed to a minus 3.6% return on equity in 2015. Who said that Wagner's music isn't as bad as it sounds? RBS's recent results aren't as bad as they look. Source of the £2 billion net loss in 2015 was the £2.9 billion in integration and restructuring costs and £3.6 billion in litigation and "conduct" costs. The latter relate to past misdeeds, like selling the exploding cigars called residential mortgage-backed securities in the years leading up to the 2008 big bang. Abstracting from those penalties, RBS says that its core businesses returned 11.2% on equity last year.

It will take £5 billion in restructuring costs to fix RBS, by McEwan's reckoning, of which £2.9 billion has already been spent. To speed the day of black ink, McEwan aims to refocus the company on businesses in the UK and a select number of Western European markets (it once had outposts in 50 different countries). Disposals of non-core operations will cost an additional £1 billion, the CEO warns.

RBS has achieved some genuine success with its balance sheet. Its ratio of core equity capital to risk-weighted assets—its so-called tier-1 capital ratio—came to 15.5% on Dec. 31, six percentage points higher than the regulatory bare minimum. (McEwan's target is for a 13% ratio.) Non-performing loans were as high as 9.5% of total loans at year-end 2013; by the close of 2015, they had shriveled to 3.9%. Reserves in place would absorb 58.7% of any future credit losses from slow loans.

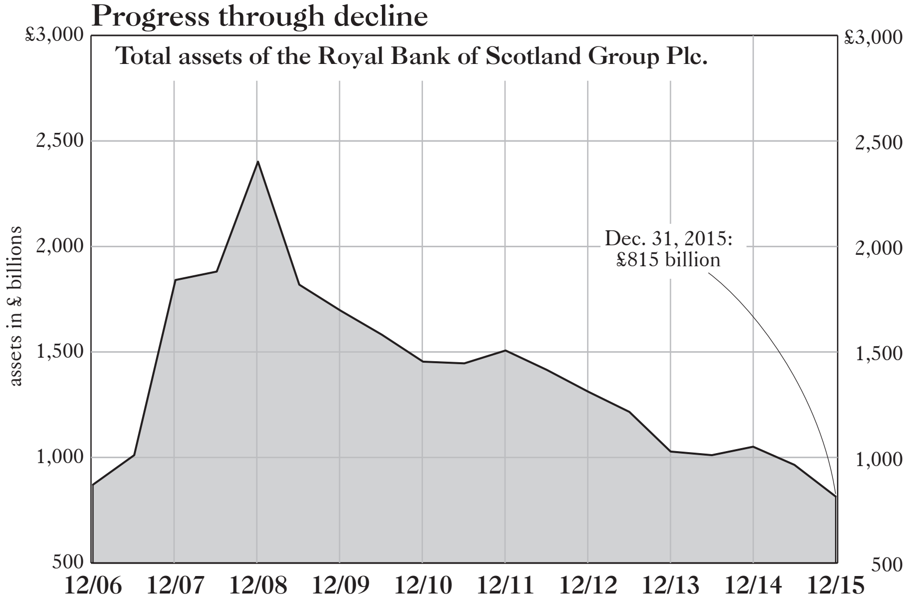
All bad things come to an end, even for the former Worst Bank in the Entire World. Still, one wonders, come the happy day of release from the bondage of restructuring charges and legal settlements, what will be left for the owners?

"At the end of the rainbow here is a very profitable, plain vanilla retail and commercial-banking franchise in the United Kingdom," O'Keefe tells Lorenz. "That business will generate a strongly double-digit ROE and will be operating in a fairly concentrated market: the UK. In the banking world, concentration tends to equal profitability, hence the assumption of a strongly double-digit ROE.

"Now, to get there you have to go through further restructuring," O'Keefe continues. "The business has assets to run down from the financial crisis as well as from business lines that it is basically exiting. This was a huge rollup under Sir Fred Goodwin leading up to the financial crisis. We all know it was a disaster. The company is going through a journey of refocusing back to its roots as a UK banking franchise. You still have some rundown to go. They are effectively exiting their investment-banking operations. There is further restructuring to go as a result of paring that down. As I said, we have this fantastic franchise within the organization and we have a very, very strong balance sheet."

RBS is quoted at 46% of book value. Anyone willing to speculate on the success of the McEwan redemption program could buy the common, which pays no dividend. What might those shares be worth? RBS's core businesses generated £4.1 billion in operating earnings last year, i.e., before restructuring costs, litigation and losses on disposals. Tax those operating earnings and assign a 12-times multiple, and you get around 300 pence per share in value, as O'Keefe does the numbers. With a 15.5% common-equity tier-1 capital ratio, the bank has more capital than it needs. It will, to be sure, incur restructuring costs, payout settlements related to boomtime sin. The excess capital, adjusting for expenses and profits over the next few years, works out to another 185 pence per share, O'Keefe estimates. Which gives RBS a value of 485 pence per share vs. the current price of 210 pence.

Progress through decline



source: The Bloomberg

There is another avenue available to profit on RBS, and an interest-bearing one at that. The company's very restructuring program creates potentially rewarding opportunities even if the CEO should happen to miss his targets.

RBS Holdings N.V. (henceforth, N.V.), a wholly owned subsidiary of parent Royal Bank of Scotland Group Plc., comprises the rump of assets acquired in the 2007 ABN deal. It's N.V. that has suffered most under the knife since RBS Group started its asset-shrinkage program. Between year-end 2008 and June 30, 2015 (the most recent period audited figures are available for the business unit, which files its own, separate financial reports), assets in N.V. have evaporated to £18.5 billion from £666.8 billion.

As for capital, N.V. would seem to have enough. The unit's common-equity tier-1 ratio stands at 17%, its total capital ratio at 35%; common equity represents 19.2% of plain, unadjusted assets.

The fact is that, from the parent's vantage point, N.V. is a regulatory ball and chain. Post-crisis protocol requires that each distinct, regulated unit of RBS Group come up with its own recovery and resolution plan. The authorities have pushed banks to raise so-called total loss-absorbing capital (securities that can be written down during a crisis) and for that capital to be lodged at the holding company level. Having an overabundance of capital in an insignificant Amsterdam subsidiary would seem to serve no one well—except, perhaps, the holders of certain N.V. securities.

"N.V. has three classes of dollar-pay preferred securities in the aggregate par value of $3.3 billion," Lorenz observes: "the 6.08% series G, which are priced at $23.58 to yield 6.6%; the 5.9% series E, which are quoted at $23.69 to yield 6.2%; and the 6.25% series F, which change hands at $23.73 to yield 6.6%. Aside from differing coupons, each of the three is broadly similar: perpetual, non-cumulative, $25 par. As income from these preferreds counts as qualified dividends, an individual is taxed on that dividend income at the capital-gains rate rather than at one's (typically higher) ordinary income rate.

"Not until the parent repurchased each of the three preferreds in toto could the RBS front office achieve its evident ambition of making the N.V. subsidiary go away (along with its pesky regulatory expenses)," Lorenz winds up. "Which is to say that an investor in the series E, F and G stands to receive some possible capital appreciation as well as a 6%-plus yield. Take the series G. By retiring it one year hence at $25 a share, the parent would be handing today's holders a 12.5% all-in, pretax return. As it almost goes without saying, Mr. Market may have plans of his own. During the February stock-market swoon, each of the N.V. preferreds dipped below $23."

To reiterate, we are bullish.

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