SEYMOUR PIERCE

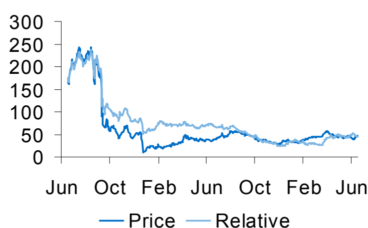
# Lloyds & RBS

(LSE:RBS,LLOY) 5

SELL

| | |
|---|---|
| **LLOY** | **62p** |
| **RBS** | **45p** |
| Target price | |
| LLOY | 41p |
| RBS | 36p |

**RBS**
**Price & price relative (-2yr)**




Source: Datastream

**Lloyds**
**Price & price relative (-2yr)**

Source: Datastream

Share price as at close: 2 July 10

**Next news**
H1 results – August 2010

**Business**
Lloyds is a UK bank, formed from Lloyds TSB and HBOS in 2009. RBS is a UK bank, currently undergoing a 5 year restructuring plan

www.lloyds.com
www.rbs.com

## Buridan's Ass

We expect LLOY and RBS to report falling impairments, improving profitability and stronger capital ratios at H1 results. Shareholders want this. Debt holders want this. Regulators want this. Haven't we forgotten someone?

Customers!

### Irreparable damage

We think the focus on short term profitability could be doing irreparable damage to the franchise value of Lloyds and RBS. We have voiced our concerns to the UKFI about unrealistic income growth aspirations (but the individual we wrote to has now left the UKFI and returned to investment banking).

### Are investment bankers too focused on short term gain?

We wonder if bankers are already positioning themselves for the mandate to sell the UK Government's bank stakes. A quick turnaround and sale may not be the best solution (Japan's Shinsei's share price rose 57% on the first day of IPO in 2004, but is since down -92%). By contrast the Norwegian government took longer to sell their bank stakes, while the Norwegian Banks Index rose 3.5x (Dec 94, Dec 04). At the time neither Government was under pressure to sell, but the Norwegians did have healthier public finances due to demographic trends and an oil resource windfall.

### Cui bono? Cui malo? (Who gains? Who loses?)

We view increasing income to the detriment of customers as stealing from the future. Since 2000, LLOY (proforma combined) and RBS's Income and Total Assets have doubled as a percentage of the UK GDP (currently 4% and 146% of GDP respectively). We think the idea that banks' income will have to grow more slowly than the UK economy is not yet factored into consensus. Our recommendation on RBS is SELL TP 36p and LLOY SELL TP 41p.

5 Please see regulatory disclosure notes at the end of this document

| Year end May | FY 09 | FY 10 | FY 11 | FY 12 | FY 13 |
|---|---|---|---|---|---|
| RBS (core) | | | | | |
| Price/TB | 0.90 | 0.98 | 1.00 | 0.94 | 0.86 |
| Price/Earnings | 3.59 | 5.96 | 6.07 | 6.36 | 7.24 |
| LLOY | | | | | |
| Price/TB | 1.0 | 1.0 | 0.9 | 0.8 | 0.7 |
| Price/Earnings | -2.4 | 102.1 | 33.9 | 9.3 | 9.2 |

* excludes exceptional items and amortisation of intangibles.
Source: Seymour Pierce Ltd

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## HELPFUL ANALYSIS

We believe a short term focus on shareholder value maximisation may do long term damage to the franchise of Lloyds and RBS and is at odds with "customer centric" strategies around loyalty and customer satisfaction. Loyalty as a strategy can be extremely valuable. But Dan Ariely, the behavioural economist points out, that companies can't have it both ways, a customer loyalty strategy with a short term focus on profit maximisation, will not work.

Banks can't maximise short term profits and be customer centric at the same time

We think the bank that understands this the best is HSBC (Buy, TP 800p). Stephen Green, the Chairman of HSBC in a speech to the British Bankers Association (BBA) this month quoted Peter Drucker "*Profit is not the explanation, cause or rationale of business behaviour and business decisions, but rather the test of their validity."* Barclays (HOLD TP 276p) seem to have taken this on board too.

The insidious part of shareholder value is that by applying a double digit discount rate to the future, it can be used justify both short term behaviour and/or an aggressive capital structure. Applying a steep discount rate creates a culture of poverty, we believe. Currently, we feel that pressure to generate an earnings recovery may be crowding out longer term value creation at LLOY and RBS. This is not the fault of management at RBS and LLOY, they appear to have been given conflicting goals and like Buridan's ass are mid way between a stack of hay and a pail of water.

Government bank stakes in Norway and Japan

We have looked at the disposal of Government stakes in banks after the banking crises in Norway and Japan. In Japan, Private Equity played a role in producing a quick turnaround, at the expense of long term value destruction we believe. In Norway, the Government wasn't prepared to sell stakes in a thin market and held on for half a decade and sold when it became clear that returns were sustainable. We also suggest that it may be better to break up banks given that there are a very limited number of buyers that could afford to take the place of the UK Government.

Short term behaviour vs. long term vision

We are unsure what discount rate to apply where the short term behaviour appears at odds with the longer term vision. Ultimately, we believe banks will not be able to grow income faster than the UK economy, and this has yet to be recognised by consensus expectations and management statements. We keep our SELL recommendations on RBS TP 36p and LLOY TP 41p, but are open to suggestions from clients on how to make our recommendations fit the likely share price performance over different time horizons. (Short term "buy" but long term "sell" or vice versa?)

## SELLING STAKES

At the same BBA conference where Stephen Green quoted Drucker, Andrew Tyrie MP, the new Chairman of the Treasury Select Committee, made a very interesting comment on selling the UK Government stakes in banks.

*"There's a risk of governmental conflict of interest here, too. Governments have an interest in maximising the yield from these sales. They also have a duty to maximise competition in the retail market.*

*I very much hope that, in the trade-off between benefiting the consumer and reducing the deficit, the government prioritises competition over yield, as previous governments have done when privatising the utilities."*

Trade-off between benefiting the consumer and reducing the deficit

We have looked at how selling government stakes has worked in the past in developed world banking crises (Norway and Japan).

## Japan: Long Term Credit Bank / Shinsei

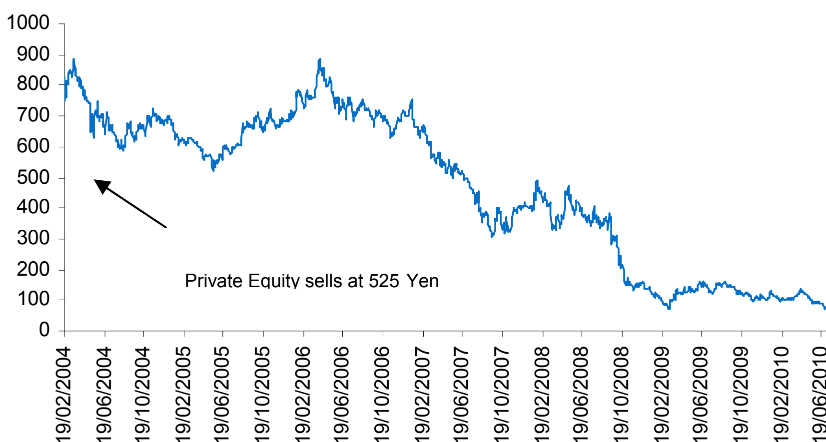
The Japanese Government recapitalised the banking system in the late 1990's and then in 2002 sold a $1.2bn stake in Long-Term Credit Bank to Ripplewood and JC Flowers. LTCB (renamed Shinsei) is often touted as one of the most successful private equity deals in history.

The private equity buyers put in new (American) management, a new IT system and cleaned up the loan book. Non-Performing Loans fell from $17bn in 2000 to $479m in 2005 (Business Week, June 13 2005) partly because Flowers and Ripplewood negotiated an option to sell Shinsei's worst assets back to the Japanese Government at cost.

Private Equity made outsized returns

The deal is said to have made 12 times the equity Flowers invested when the bank floated in 2004. On the first day the stock rose 57% but since 2004 the performance of the Shinsei share price (-92% peak to trough) suggests that it was better to be a seller in 2004 than a buyer. It should be noted that the US investors in Shinsei did not sell out completely in 2004 and continued to hold shares after the IPO.

**Shinsei share price performance (Yen)**




Source: Datastream

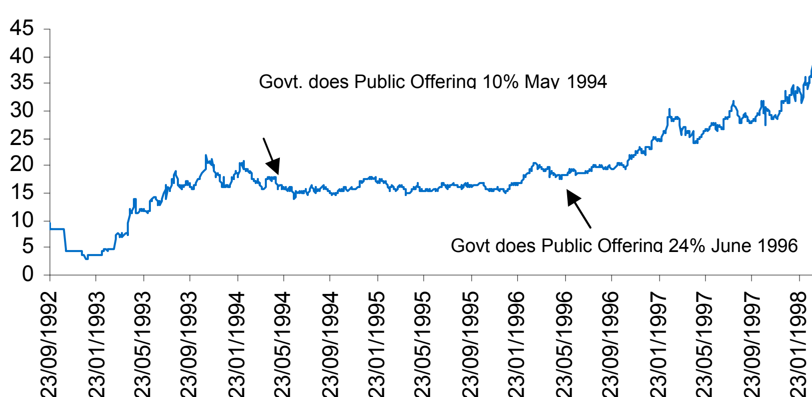
# Norway: DnB, Fokus and Christiania Bank

In the early 1990's the Norwegian Government wrote down the equity of both Christiania Bank and Fokus Bank. It also took an 87.5% ownership of Den Norske Bank (DnB) when it used its right to convert preference shares to ordinary equity in Dec 93. The Government was not interested in selling at a distressed price, and waited until May 1994 to sell 10% at a price of NOK 16.75, then another 24% in June 96 at 19.3 NOK per share.

Not interested in selling into a "thin" market

The Norwegian Government invested in banks through two vehicles: GBIF (crisis management) and SBIF (commercial basis investor, with more long term objectives). From 1995 state ownership became the sole responsibility of the SBIF, and was managed on a commercial basis.

**DnB share price**




Source: Datastream

By 2003, the Government still owned 48% of DnB, but in that year the stake was reduced further when DnB merged with Union Bank of Norway, which brought the size of the stake down to 28%. Then, the Government decided the stake should be increased to 34% by the end of 2004, the level at which it still remains today.

There were other Norwegian banks where the Government wrote down the equity to zero and effectively owned 100% of the equity: this happened to Christiania Bank and Fokus Bank in 1991. In 1995 the government reduced its Christiania stake to 51% by a public offering and then in 1999 to 35%. In 2000, Christiania Bank was bought by a Swedish bank, which went on to merge and become Nordea. Similarly, Fokus Bank was written down at the same time and was sold back to the public in 1995, before being eventually acquired by Danske Bank in 1999.

We would draw out several points:

- Nordic banks are an order of magnitude smaller than UK banks (particularly LLOY and RBS). Breaking up UK banks may actually make them easier to sell.

- The Norwegian Government could theoretically have sold soon after the banking crisis, but it was a "thin" market and was unlikely to realise the quoted price for DnB.

- The Government was under no pressure to sell and became an effective SWF-like long term holder. Norway had a positive current account balance as a percentage of GDP all through the 1990s (not true for Finland and Sweden).

- Norwegian banks were under capitalised (on a BIS I basis) going into the crisis but levels of indebtedness within the economy were much lower in Norway than the UK (loans/GDP less than 100%) compared to loans to GDP of 142% in the UK in 2008.

In the Nordic region banks with high loans to deposit ratios were more likely to be deemed insolvent, according to the IMF.

### Loans/Deposit ratio comparison

| Loans/ Deposit | Norway | Finland | Sweden |
|---|---|---|---|
| Insolvent Banks | 1.67 | 2.60 | 1.59 |
| Other Banks | 1.12 | 1.58 | 1.24 |

Source: IMF

By way of comparison Northern Rock's Loan/Deposit ratio was 3.1x, and Lloyds was 1.69x Dec 09. At the start of the crisis the whole UK banking system loans deposit ratio was 1.73x, higher than Norways banks deemed insolvent by the IMF.

Negative real savings rates preceded both crises

Another way of expressing the difference between the Nordic and UK banking crises, is the real after tax interest rates. In both Norway and UK ahead of the banking crises interest rates were at or below the level of inflation, discouraging saving and encouraging leveraged speculation. For this to reverse in the UK, interest rates would need to rise to at least 5%. However, the Bank of England notes that if this happened household income gearing would be around three quarters higher and at a level comparable with the early 1990's recession.

Norwegian real after tax interest rates expanded to 8%

By comparison in Norway post crisis, the after tax interest rate turned strongly positive as inflation fell in the early 1990, peaking at 8% (real, after tax). A similar interest rate in the UK would be above 10%, we view a "double dip" as a benign scenario compared to double digit interest rates.

### Did pensioners cause financial crises? Norway, UK and Japan

One aspect of financial crises we feel that might have been ignored, is the role an ageing population plays. As a greater proportion of workers approach 65 we wondered if this puts an unbearable strain on the financial services (perhaps because financial engineering is required to deliver on unrealistically optimistic expected return assumptions). The hypothesis may be true, but it is impossible to prove, because Norway and the UK have population age structures with less dramatic ageing trends than in Japan.

Japanese over 65 year olds doubled as a proportion of the population

In Japan the percentage of over 65 year olds as a proportion of the population has increased from 12% to 23% of the population, in the last two decades. Whereas, in the early 1990s the UK and Norway had 16% of the population of 65 or over, a third higher than Japan. It is possible demographics played a role in the Japanese crisis, so it is reassuring that the demographic trends look more benign in the UK.

### Percentage of the population 65 or over

| | 1990 | 2000 | 2010 | 2020 |
|---|---|---|---|---|
| Japan | 12% | 17% | 23% | 28% |
| UK | 16% | 16% | 16% | 18% |
| Norway | 16% | 15% | 16% | 19% |

Source: US Census Bureau

The UK does have a huge public sector pension liability, which the current Government appears more willing to address than the previous one.

## WE THINK LLOYDS SHOULD FOCUS ON ATTRACTING STICKY DEPOSITS

To repair its share price rating, we believe Lloyds needs to reduce loans to deposits to close to 1.0x. This will probably take a decade. Lloyds already has a 30% market share of the £1.3 trillion household and corporate deposit market. The size of deposit pool is unlikely to grow even if the savings ratio rises further. For instance, following the early 1990s recession, when the savings ratio averaged 11% for three years (higher than 2009 savings ratio 7%) household deposits grew more slowly than household loans, according to the BoE.

Lloyds already has 30% market share of UK deposits

A 30% market share in a competitive market means defending it's own position will be a significant achievement. As well as competition from other banks, retail mutual funds have seen large inflows over the past six months, according to the Bank of England’s June 2010 Financial Stability Report.

The table below shows that in the last decade loans grew at 9% roughly twice the rate of deposit growth.

### Loans and deposits £bn

| Loans | 1999 | 2008 | 2009 | CAGR |
|---|---|---|---|---|
| LLOY | 102 | 240 | | |
| HBOS | 171 | 437 | | |
| Combined | 273 | 677 | 627 | 9% |
| **Deposits** | **1999** | **2008** | **2009** | **CAGR** |
| LLOY | 93 | 171 | | |
| HBOS | 127 | 210 | | |
| Combined | 220 | 381 | 371 | 5% |
| Loans/Deposit | | | | |
| LLOY | 1.10 | 1.41 | | |
| HBOS | 1.35 | 2.08 | | |
| Combined | 1.24 | 1.78 | 1.69 | |

Source: Seymour Pierce Limited, and Company Accounts

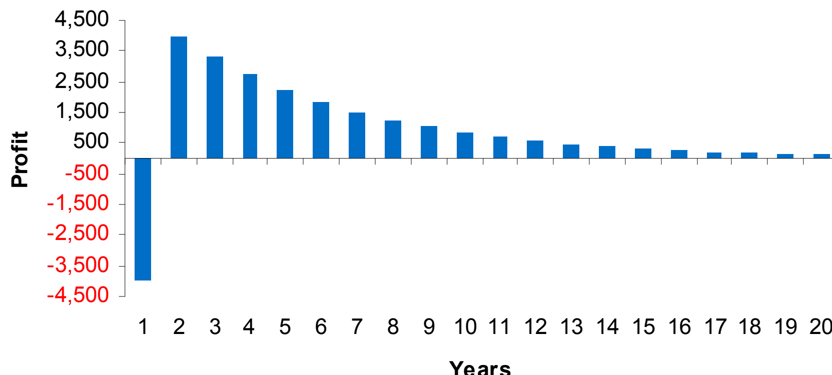
Recent history is not encouraging either. Excluding repos, Lloyds deposits stayed flat at £370bn from Jun 09 to Dec 09, as the price sensitive customers that had been attracted by high interest rates chased other deals.

This illustrates the point that a loans / deposit ratio is a very blunt instrument of analysis. Paying above libor for "cheap" internet based deposits doesn't look clever, if you factor in their lack of loyalty.

Embedded value of deposits

Clients familiar with the insurance industry will appreciate both how this works, and the analytical challenges it presents. The graph below assumes 100 customers, who in year 1 cost £40 to acquire, then generate a profit in year 2 of £50, which subsequently grows in line with inflation of 3% every year there after. The reason the chart fades, is that every year 20% of customers leave.

## Example 80% customer retention rate




Source: Seymour Pierce Ltd

This is, of course, a rough and ready "embedded value" calculation for a deposit customer. In banking, as in the insurance industry, with customer acquisition costs in year one, but pay back over subsequent years, the "lapse" rate has a huge impact on NPV. Retaining 10% more customers a year, can double NPV per customer.

## NPV per customer (flexed for different retention rates)

| Customer Retention Rate | NPV per customer* |
|---|---|
| 70% | 52 |
| 80% | 104 |
| 90% | 210 |
| 99% | 430 |

Source: Seymour Pierce Ltd

*20 years of profit discounted back at 10% each year

In an attempt to create loyal customers banks have tried to market themselves as social companions - that is, they'd like us to think that they and we are friends. This can be seen in the advertising slogans UK banks are currently using:

| | |
|---|---|
| Barclays | "lives made much easier " |
| Lloyds | "for the journey" |
| HSBC | "the world's local bank" |
| NatWest | "helpful banking" |
| StanChart | "here for good" |

But companies marketing themselves as social companions run a risk, if they do not fulfil their branding promises. Before banks started trying to convince customers that they were nice cuddly friends, the relationship was based on market norms. When a customer cheque bounced, the bank charged a fee, the customer shakes it off. While the fee is annoying, business is business.

Customer loyalty strategy has risks

In a social relationship, a late payment fee (rather than a friendly call from the manager, or an automatic waiver accompanied by a warning) is not only a relationship killer; it's a stab in the back. Customers will take personal offence. They'll leave the bank angry and spend hours complaining to their friends (and perhaps their MP) about this awful bank. After all, this was framed as a social exchange.

## WE THINK BOTH RBS AND LLOYDS SHOULD REDUCE WHOLESALE BANKING

Between 2000 and 2009 UK nominal GDP has grown by 43%, from just under £1trillion to £1.4trillion. Yet UK banking total income (including Wholesale Banking/GBM) at RBS and Lloyds has doubled as a proportion of the economy to 4% of GDP (of which the acquisition of ABN's wholesale business contributed around £4bn or 0.3% of income/GDP).

Banks have doubled balance sheets and income relative to the UK economy

Lloyds and RBS might claim this is because Wholesale or GBM is a global business, not linked to the prospects of the UK economy. However the same trend is seen internationally. According to data from *The Banker,* the largest 1000 banks in the world reported aggregate PBT of almost $800bn in 2007/8, almost 150% higher than in 2000/01. It's not possible for all global banks to be growing market share – either the market is growing at 14% per annum, well above the global GDP growth rate, or the contribution from the financial sector has been a miracle. Source: Andrew Haldane Bank of England (*The contribution of the Financial Sector, miracle or mirage?)*

It is always worth asking: C*ui bono? Cui malo?* Although it is clear who has profited, (global banks) but it is not clear who has paid for the party. Possibly Wholesale Banking profits have not been made directly at the expense of households, instead the banking sector may have been extracting excess profits from Non Financial Corporates or National Governments. But ultimately this will still be passed on to households in the form of higher prices or higher taxes.

### Comparison FY 2009 v FY 2000 (£m)

| LLOY | Retail | Wholesale | Total LLOY UK | RBS | Retail | CBFM | GBM | Wealth | Total RBS UK | LLOY + RBS |
|---|---|---|---|---|---|---|---|---|---|---|
| **FY 2000** | | | | | | | | | | |
| Income | 5,537 | 3,591 | 9,128 | | 4,916 | 5,404 | | 933 | 11,253 | |
| Assets | 192,522 | 168,432 | 360,954 | | 78,300 | | | 12,500 | 306,300 | |
| | | | | | | 215,500 | | | | |
| **FY 2009** | | | | | | | | | | |
| Income | 9,774 | 8,909 | 18,683 | | 4,947 | 3,582 | 11,009 | 1109 | 20,647 | |
| Assets | 371,000 | 345,600 | 716,600 | | 103,000 | 114,900 | 480,000 | 13700 | 711,600 | |
| **As % of GDP** | | | | | | | | | | |
| **LLOY** | **Retail** | **Wholesale** | **Total** | **RBS** | **Retail** | **UK Corporate** | **GBM** | **Wealth** | **Total** | **RBS+ LLOY** |
| **FY 2000** | | | | | | | | | | |
| Income | 0.6% | 0.4% | 0.9% | Income | 0.5% | 0.6% | 0.0% | 0.1% | 1.2% | 2.1% |
| Assets | 19.7% | 17.3% | 37.0% | Assets | 8.0% | 22.1% | 0.0% | 1.3% | 31.4% | 68.4% |
| **FY 2009** | | | | | | | | | | |
| Income | 1.0% | 0.9% | 1.9% | Income | 0.5% | 0.4% | 1.1% | 0.1% | 2.1% | 4.0% |
| Assets | 38.0% | 35.4% | 73.4% | Assets | 10.6% | 11.8% | 49.2% | 1.4% | 72.9% | 146.3% |

Source: Seymour Pierce Ltd

Ideally we think banks should be split up. But even if this doesn't happen both Lloyds and RBS need to reduce their reliance on Wholesale Banking (called Global Banking & Markets at RBS). Lloyds particularly, is often seen as a play on UK mortgage margins. But Total Income from Mortgages and Savings was just £3.7bn in 2009 less than half the £8.9bn in Lloyds Wholesale Banking division

We understand the argument that last year impairments in Wholesale Banking were at a cyclical high, and that as impairments fall there is potential for a huge uplift in profitability. But that assumes revenue is sustainable.

Huge amounts of liquidity have been injected into the financial system by Central Banks, which has increased market making activity in fixed income, currencies and commodity instruments, while banks have also widened bid ask spreads. But market making should not be a high return business, and if it is, there is something badly wrong.

If market making is a high RoE business there is something badly wrong

**Wholesale Banking Reliance**

| £m | Lloyds | RBS |
|---|---|---|
| | FY 09 | FY 09 |
| Wholesale banking | | |
| Income | 8,909 | 11,009 |
| Pre impairment profits | 4,803 | 6,349 |
| | | |
| Group | | |
| Income | 23,964 | 25,068 |
| Pre impairment profits | 12,335 | 7,667 |
| | | |
| WB Income % of Group | 37% | 44% |
| WB pre impairment PBT % of Group | 39% | 83% |

Source: Seymour Pierce Ltd

Signal to noise ratio

We also think focusing on quarterly reporting of short term trends in Wholesale and Investment Banking is a huge mistake. To be fair to RBS, some segments of the investor community have demanded detailed (184 pages in the case of Q1) quarterly disclosure. But quarterly noise detracts from big themes, that can develop incrementally over a long time period. To show how misleading we think an emphasis on quarterly reporting is, we quote directly for the Merrill Lynch Q1 2007 analyst conference call:

*I want to pause here to make a few comments about our U.S. subprime mortgage business, since I know it has been a topic of much discussion and speculation. Let me put this business into context. As we noted in our earnings release, if you looked at both last year and the first quarter of this year and added up all of the originations, securitization, warehouse lending, trading and servicing revenues, both directly in our subprime business as well as our CDO activity involving subprime, including all the retained interests, you would see that revenues from subprime mortgage-related activities comprise less than 1% of our net revenues for those five quarters. Even if you were to incorporate pro forma, the revenues of First Franklin as if it were a part of our firm for all of 2006, the aggregate contribution would still be less than 2%.*

## BUT MEGA BANK SAYS….

One common response from clients after our original sell notes on Lloyds and RBS in the first half of the year was "But Mega Bank says they could double".

It is reasonably easy for any corporate to record short term profits at the expense of long term value. Lloyds could make 15p of earnings per share in two years time, but this would probably be at the expense of customers and therefore long term value creation. So it is undoubtedly true, bank equity is a high leverage play on economic recovery, which explains the share price volatility, LLOY or RBS shares could double. The question to ask is: *and then what?*

Ad hominem arguments

In response to the ad hominem argument that "Mega Bank says…" we make the hopefully rather obvious points:

- There are some Mega Bank analysts that are bullish. Some clients have suggested that this is because Mega Bank corporate finance division is more likely to win the mandate to sell Government stakes if the analyst "helpfully" pushes the price up. Possible, but the one flaw in this argument is that at Credit Suisse, which has one of the strongest Financial Institutions' corporate finance teams, the research analysts are not particularly bullish on either RBS or LLOY.

- In several industries new entrants have discovered it is possible to make a fortune ignoring what customers say they want, and instead selling what they will actually pay a premium for. In financial services, retail customers often pay a high price for certainty and reassurance: a deposit account provides certainty but not security against inflation. We wonder if even sophisticated buy side clients are paying a premium price for a Mega Bank "noise" which is supposed to provide investor reassurance and confidence, but not, perhaps, assistance.

- Away from the investment banking arena, the political scientist Philip Tetlock has found that the most famous pundits tend to be the least accurate. The central error, Tetlock found, was that people crave certainty and the most famous pundits tended to be the most confident and wrong the most often, dismissing possibilities that didn't fit their argument. For an example of sheer bombast, we remind readers of one investment bank trader (at Lehmans) who told clients to "Load up on Northern Rock – for your children, your Mum, your goldfish…."

**LLOYDS INCOME STATEMENT**

## Lloyds

| £m | FY'08 A | FY'09 A | FY'10 E | FY'11 E | FY'12 E | FY'13 E |
|---|---|---|---|---|---|---|
| Net interest income | 14,903 | 12,726 | 13,871 | 13,178 | 12,914 | 13,302 |
| Fees & Commission | | | 0 | 0 | 0 | 0 |
| Dealing profits | | | 0 | 0 | 0 | 0 |
| Other Non NII | 6,452 | 11,238 | 10,714 | 10,714 | 10,714 | 10,714 |
| Total Non NII | 6,452 | 11,238 | 10,714 | 10,714 | 10,714 | 10,714 |
| | | 74% | -5% | 0% | 0% | 0% |
| Total income | 21,355 | 23,964 | 24,585 | 23,892 | 23,628 | 24,016 |
| | | 12% | 3% | -3% | -1% | 2% |
| Total costs | (12,236) | (11,609) | (11,309) | (10,512) | (10,618) | (10,724) |
| | | -5% | -3% | -7% | 1% | 1% |
| Trading surplus | 9,119 | 12,355 | 13,276 | 13,379 | 13,011 | 13,292 |
| | | 35% | 7% | 1% | -3% | 2% |
| Impairments | (14,880) | (23,988) | (13,077) | (11,770) | (6,338) | (6,655) |
| | | 61% | -45% | -10% | -46% | 5% |
| PBT | (5,761) | (11,633) | 199 | 1,610 | 6,672 | 6,637 |
| Exceptionals | 6,521 | 12,675 | 1,000 | 0 | 300 | 0 |
| **Published PBT (IFRS)** | **760** | **1,042** | **1,199** | **1,610** | **6,972** | **6,637** |
| | | 37% | 15% | 34% | 333% | -5% |
| Tax | 38 | 1,911 | 336 | (241) | (1,952) | (1,858) |
| Profit after tax | 798 | 2,953 | 1,534 | 1,368 | 5,020 | 4,779 |
| Minority interests | (26) | (126) | (126) | (126) | (126) | (126) |
| Preference Shares | | | | | | |
| Attr. Profit | 772 | 2,827 | 1,408 | 1,242 | 4,894 | 4,653 |
| | | 266% | -50% | -12% | 294% | -5% |
| Dividend | (648) | | 0 | 0 | 0 | 0 |
| Retained earnings | 124 | 2,830 | 1,408 | 1,242 | 4,897 | 4,653 |
| | | 2182% | -50% | -12% | 294% | -5% |
| Number of shares | 11,581 | 66,900 | 67,569 | 68,245 | 68,927 | 69,616 |
| Average | 11,581 | 37,674 | 67,235 | 67,907 | 68,586 | 69,272 |
| Dividend per share | | | 0.0p | 0.0p | 0.0p | 0.0p |
| NAV per share | 0p | 62p | 65p | 72p | 78p | 84p |
| EPS Reported | 6.7p | 7.5p | 2.1p | 1.8p | 7.1p | 6.7p |
| **EPS Adj** | **-49.6p** | **-26.1p** | **0.6p** | **1.8p** | **6.7p** | **6.7p** |
| | | -47% | -102% | 201% | 266% | 0% |

Source: Seymour Pierce Ltd

## RBS INCOME STATEMENT

**RBS**

| core | FY'08 A | FY'09 A | FY'10 E | FY'11 E | FY'12 E | FY'13 E |
|---|---|---|---|---|---|---|
| £m | | | | | | |
| Net interest income | 14,116 | 12,319 | 11,949 | 11,591 | 11,243 | 10,906 |
| Fees & Commission | 5,522 | 5,438 | 5,438 | 5,438 | 5,438 | 5,438 |
| Dealing profits | (1,090) | 8,967 | 8,070 | 7,263 | 7,263 | 7,263 |
| Other Non NII | 634 | 1,375 | 1,375 | 1,375 | 1,375 | 1,375 |
| | | | | | | |
| Total Non NII | 5,066 | 15,780 | 14,883 | 14,076 | 14,076 | 14,076 |
| | | 211% | -6% | -5% | 0% | 0% |
| Total income | 19,182 | 28,099 | 26,833 | 25,667 | 25,319 | 24,982 |
| | | 46% | -5% | -4% | -1% | -1% |
| Total costs | (13,505) | (14,954) | (14,655) | (14,801) | (14,949) | (15,099) |
| | | 11% | -2% | 1% | 1% | 1% |
| Trading surplus | 5,677 | 13,145 | 12,178 | 10,866 | 10,370 | 9,883 |
| | | 132% | -7% | -11% | -5% | -5% |
| Impairments | (2,496) | (4,678) | (4,210) | (2,947) | (2,652) | (2,785) |
| | | 87% | -10% | -30% | -10% | 5% |
| **PBT** | **3,181** | **8,467** | **7,968** | **7,918** | **7,717** | **7,098** |
| | | | | | | |
| Non Core | (27,487) | (12,074) | (8,981) | (5,967) | (2,943) | (1,412) |
| | | | | | | |
| **Published PBT (IFRS)** | **(24,306)** | **(3,607)** | **(1,014)** | **1,951** | **4,774** | **5,686** |
| | | | -72% | -293% | 145% | 19% |
| Tax | 1,280 | 339 | 507 | (546) | (1,337) | (1,592) |
| | | | | | | |
| Profit after tax | (23,026) | (3,268) | (508) | 1,402 | 3,439 | 4,094 |
| | | | | | | |
| Minority interests | (412) | (648) | (648) | (648) | (648) | (648) |
| Preference Shares | (596) | (935) | (935) | (935) | (935) | (935) |
| | | | | | | |
| Attr. Profit | (24,034) | (4,851) | (2,091) | (181) | 1,856 | 2,511 |
| | | -80% | -57% | -91% | -1126% | 35% |
| Dividend | | | | | | |
| | | | | | | |
| Retained earnings | (24,034) | (4,851) | (2,091) | (181) | 1,856 | 2,511 |
| | | -80% | -57% | -91% | -1126% | 35% |
| | | | | | | |
| Dividend per share | | | 0.0p | 0.0p | 0.0p | 0.0p |
| NAV per share | 74p | 51p | 47p | 46p | 49p | 53p |
| EPS Reported | -146.0p | -6.3p | -3.9p | -0.3p | 3.5p | 4.7p |
| **Core EPS Adj** | **14.7p** | **12.8p** | **7.7p** | **7.6p** | **7.2p** | **6.3p** |
| | | -13% | -40% | -2% | -5% | -12% |

Source: Seymour Pierce Ltd

## APPENDIX : THE UMPIRE'S WHITE COAT

In the summer of 1980, Gordon Richardson was in his prime. Among the qualities demanded of the Governor of the Bank of England, authority is the one that matters most, and Richardson exuded authority. Having overcome the banking crisis of 1973-4, without depositors losing money, the sterling crisis of 1976 and finally having brought the worst stretch of inflation in British history under control, Richardson had had a good innings.

Gordon Richardson, former Governor of the Bank of England

That summer, he spoke about Central Banking by comparing the games of cricket and squash. The occasion was the opening of the new squash courts at the Bank of England's ample playing fields in Roehampton. The speech is fully recorded only in the official history of the Bank's sports club. It deserves a wider audience.

The trouble with cricket, Richardson explained, is that it is uneconomical of manpower, that it takes up too much land and that it is riddled with restrictive practices; for example, in the batting side only two people are actually playing the game while the others stand or even sit idly around. This, Richardson explained, is a central banker's nightmare.

Cricket v squash

Squash, on the other hand, employs only two people who play very hard for a short period of time and then pass the court on to other players. "Squash" he continued, "like the City of London, depends largely on self regulation….squash players generally sort out their differences without the need for the referee's whistle or the umpire's white coat."

Richardson's speech contained an inference that he did not need to spell out to his audience. It was this: should the need for rules and umpiring decisions in the City arise, the Bank of England was well prepared to put on the umpire's white coat.

The analogy is not perfect though. The umpires in a village cricket match are required not due to each side's lack of trust. Often the waiting batsmen do not sit idle, but double as umpire, until it comes close to their turn to bat, at which point the opening batsmen, already dismissed, take up the umpire's role. Umpires/players are expected to rule against their own team members if a batsman is obviously out. The reason why the game of cricket requires two umpires, is because the rules are so arcane (e.g. Leg Before Wicket) that no player who is actually taking part in the game, is expected to be in the right position to make a decision.

Bowling alone

It is the unconscious assumptions in Richardson's speech which we find most interesting: the emphasis on efficiency and productivity as the ultimate goal of economic policy. 20 years later, an entirely different sport (ten-pin bowling) was used by Robert Putnam, of Harvard University, to show how "social capital" was being eroded. More Americans are bowling than ever before, but they are not bowling in leagues – they are *bowling alone* (the title of his book). Putnam draws on nearly 500 000 interviews to show how changes in work and family structure had contributed to social decline. Putnam argues that trust and a culture of co-operation are the bedrock of an economy, rather than productivity and efficiency.

An excessive focus on efficiency, can have terrible effects for both an economy and an individual company (e.g. sales targets at HBOS), we believe. We have quoted from Peter Drucker before: citing the difference between "efficiency" (doing things right) and effectiveness (doing the right things).

After all, what is the more productive? The investment analyst, working long hours and weekends at a "bulge bracket firm" churning out 100's of pages of guff. Or the analyst at a small independent broker, who can marshal his arguments into 14 pages, leaving time for the weekend.

We leave our clients to ponder.

(Source: *Portrait of an Old Lady,* Stephen Fay, *Bowling Alone,* Robert Putnam)

### RBS - Target Price & Recommendation History

Source: Datastream, Seymour Pierce Ltd

### Lloyds - Target Price & Recommendation History

Source: Datastream, Seymour Pierce Ltd

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|---|---|
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|---|---|---|
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