Royal Bank of Scotland

"Now you listen here…"

- Monty Python's Life of Brian

Recommendation	**Hold to SELL**
Price	**1655p**

Ask a crowd of people to guess the number of jelly beans in a glass jar, and the average answer will generally be closer than the estimate of the most accurate individuals; so, more often than not, with share prices. RBOS's desultory share rating reflects the diminishing returns achieved on a rapidly expanding capital base, even while the cost of capital has stayed relatively constant. Four factors threaten further deterioration:

1) Management's apparent self-belief in its ability to defeat the drag anchor of invested capital with growth and efficiency.

2) The regulatory treatment of goodwill.

3) Rising interest rates, increasing the cost of capital hurdle.

4) Normalising of loan-loss provisions - we estimate that a combination of: a) 'seasoning'; b) cyclicality; and c) the absence of fair value adjustments on acquisitions, would increase the charge to reported profits by £386m.

The fact that the share price has bounced around the 1600-1700p level for four years, while EPS estimates have risen by *c*70%, indicates that the market understands much of this. In our view, however, the sheer quantity of EPS continues to provide an artificial support for the shares which is unwarranted, given the clear message from management as to its investment intentions.

We believe that a share price in the 1450-1550p range would better reflect the underlying economics of the current business/strategy. With other banks trading much closer to (HBOS and LloydsTSB) or below (Barclays) assessed value and, critically, with economic profit rather than EPS hurdles in their management incentive programmes (Barclays and LloydsTSB), our recommendation on RBOS must be **SELL.**

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Please refer to risk warnings on back page

Executive Summary

The heavy preponderance of positive recommendations from sell-side analysts (22 positive, 1 negative, according to Multex) suggests that many view the low multiple applicable to RBOS's reported and forecasts earnings as unwarranted. In our view, it is more than justified.

On our calculations, the group has been growing its earnings at the expense of value, courtesy of a rapid expansion of its invested capital during a period of low/declining short-term interest rates. Although this is far from unique within the sector, both the extent thereof and the commitment to a continuation of the strategy do set RBOS somewhat apart. The fact that the management's incentive programme incorporates an EPS, rather than an economic profit, hurdle merely adds to our discomfort.

Thus, we find the low PER multiple neither unusual in a historic context (indeed, the sector has often traded lower on this notably blunt measure), nor unjustified in a valuation context. Of course, we have been consistently negative on the outlook for domestic UK bank shares for some while, reflecting our concerns over the sustainability of profitability after a number of years in which background conditions have been particularly favourable. The fact that returns on capital have trended lower during that period both adds to our unease and validates the derating process. We doubt that the competitive/regulatory pincers are about to relax and, not before time, the major players are waking up to the need to improve the service proposition to personal customers - we'd treat forecasts of a **genuine,** value added widening of the cost/revenue 'jaws' with considerable circumspection.

Adjusted for currently below-normal profit & loss provisioning (even if trading margins per WRA hold up) and the flattering impact of low interest rates on a highly leveraged capital structure, RBOS looks neither relatively nor absolutely cheap to us. Furthermore, we cannot entirely shake off the sense that fair value adjustments on acquisitions transfer some costs from the income statement to the balance sheet. In our note of 17 May, we stated that we thought the acquisition of Charter One was very expensive: our unease is growing.

Assessment of RoIC

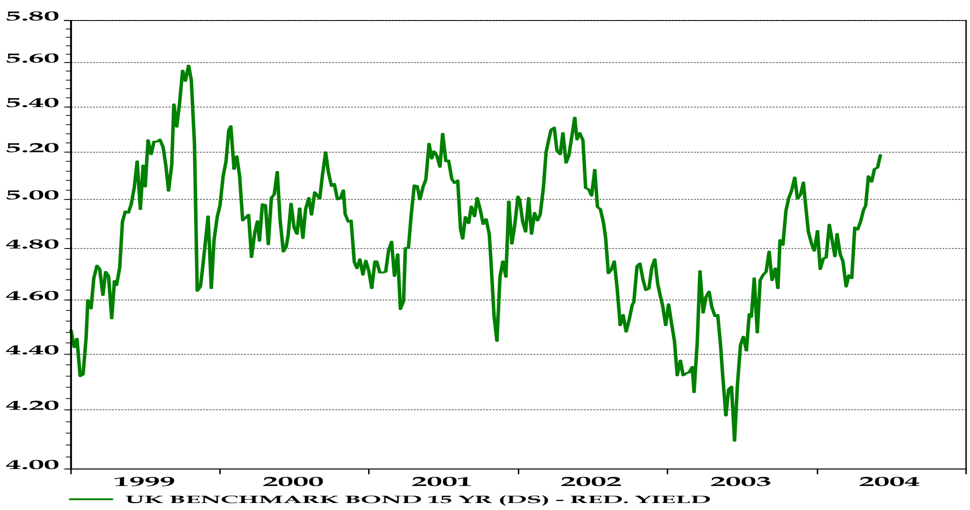
	2000	2001	2002	2003	2004E	2005E
Return (£m)**	3,980	4,893	5,569	5,798	6,364	7,078
Ave. Invest. Capital (£m)	33,352	43,233	49,404	54,939	63,162	70,924
RoIC (%)	*11.93*	*11.32*	*11.27*	*10.55*	*10.08*	*9.98*
Cost of Capital (%)	*8.4*	*8.4*	*8.4*	*8.4*	*8.4*	*8.4*
Value Added Margin (%)	*3.53*	*2.92*	*2.87*	*2.15*	*1.68*	*1.58*
VA (£m)	1,177	1,262	1,418	1,181	1,061	1,121
Reported Adj.: EPS (p)*	101.1	127.9	144.1	159.3	172.7	190.5
VA Per Share (p)	57.3	45.7	49.2	40.2	34.5	35.3
Ave. 'Book Value' (p)	942	970	1020	1158	1231	1323
MVA (on 1650p) (p)	708	680	630	492	419	327
MVA/VA (x)	12.4	14.9	12.8	12.2	12.2	9.3
RoIC ex Goodwill (%)	*15.9*	*17.7*	*17.0*	*15.4*	*14.8*	*14.6*
Average Goodwill (£m)	8,347	15,647	16,663	17,329	20,178	22,428
Ave. Shares Out. (m)	2,053	2,762	2,881	2,931	3,073	3,172

*Pre goodwill and integration costs. **Return is calculated post-tax, but before interest expense; the tax charge includes the full benefit of the tax deductibility of interest expense. Source: WdB estimates.

As demonstrated in the table above (and also the appendix for calculations) RBOS's RoIC has continued to decline and, using consensus earnings forecasts for 2004/05, will go on doing so. Mathematically, the doubling of invested capital between 2000 and 2004 will have raised returns by only 60%, with incremental investment yielding just 8.4%.

Applying a constant (if not overly scientific) cost of capital of 8.4% (no relation) - calculated on 60% equity at 10%, and 40% debt at 6% - reveals that value added (VA) per share has slipped each year; a progression that looks set to continue based on consensus earnings forecasts, let alone our own - rather more pessimistic - view of the world.

UK 15-Year Benchmark Bond (Redemption Yield)



Source: DATASTREAM

'Book' value per share has continued to move ahead, courtesy of a low dividend payout and (this year) the generosity of those subscribing for new shares at 1620p each. This has more or less compensated for the erosion in per share VA - hence a share price trading largely between 1600-1700p over the period. Note, however, that reported (adjusted) EPS have progressed strongly.

In theory, once an acquisition is completed, group RoIC should gradually improve as the economics of the underlying business begin to show through (goodwill reduces as a proportion of invested capital); in practice, where one acquisition leads to another, this doesn't happen. In our experience (both inside and outside the sector), the process generally only concludes with a bad deal.

Post-tax RoIC ex goodwill was 15.4% in 2003: if RoIC cum goodwill (currently 10.6%) moved towards the ex goodwill level… Sadly, the same observation could be made of 2000, 2001 and 2002. Further, RoIC will fall, not rise, in 2004 and 2005 - that is, even without additional acquisitions. Equally disappointing, RoIC ex goodwill has itself been trading downwards since 2001 and, again on consensus profit forecasts, will continue to do so in 2004 and 2005.

RBOS Return on Invested Equity

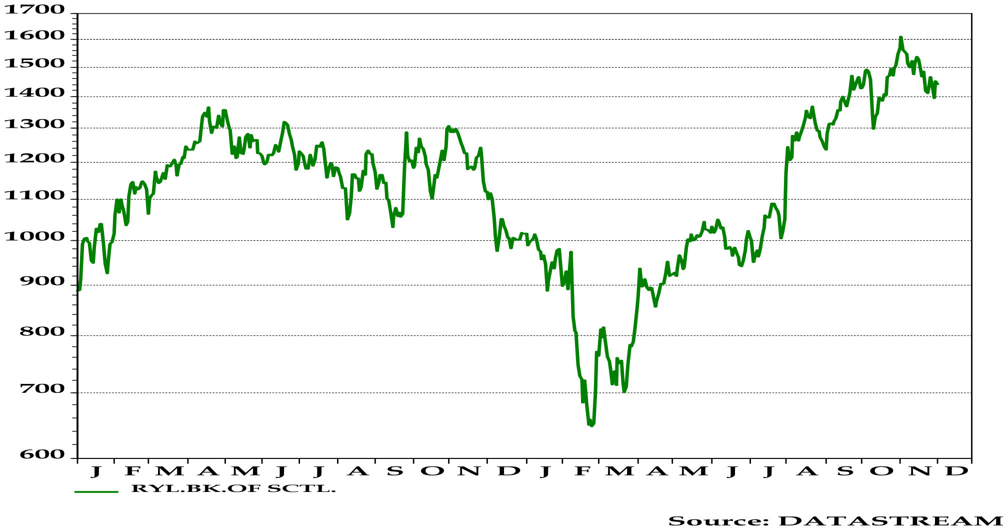
(£m)	1999	2000	2001	2002	2003	2004E	2005E
Total Invested Equity	14,457	24,220	29,379	32,632	35,257	40,472	43,306
Average Invested Equity	-	19,339	26,800	31,006	33,945	37,865	41,889
Adjusted Return	-	2,848	3,793	4,457	4,770	5,264	5,757
RoIE (%)	-	*14.7*	*14.2*	*14.4*	*14.1*	*14.0*	*13.7*

Source: WdB estimates.

The table above details Return on Invested Equity (RoIE) using the same methodology. Because the interest expense on debt capital through the profit & loss account has been low and falling, RoIE is higher and has declined more slowly than RoIC. As interest rates rise, we forecast that RoIE will suffer more than RoIC.

All this does rather give the lie to the argument that group RoIC is simply the (artificially depressed) product of the transformational NatWest acquisition. As an aside, in RoIC terms, RBOS enjoyed one substantial stroke of fortune in booking the NatWest acquisition: as the group's share price very temporarily collapsed at completion (see share price chart below), the price paid for NatWest was recorded in the group's accounts at £21bn, rather than the £26.3bn which would have applied at (say) a 1200p share price.

Share Price, 1999 and 2000



We believe that: a) the terms of the acquisition of Charter One (again, see our note of 17 May); b) the rationale thereof, which explicitly includes the expansion of Citizens' geographic sweet spot for acquisitions; and c) above all, the fact that the group chose to tap new shareholders for additional equity funding, all point clearly to the management's self belief in its ability to add value consistently through acquisitions. Dangerous game, that.

Although we have discussed the problem of goodwill within banks before, the issue warrants a revisit.

For most businesses, leverage capacity is determined by cash flow generation, hence the capitalisation, amortisation, and write-off or otherwise, of acquired goodwill is largely technical. For banks, however, leverage capacity is determined by capital availability, which is calculated net of goodwill. Hence, £100 of bank equity capital will support a maximum (4% Tier I ratio) of £2,500 of WRAs, but £100 of equity of which £25 is invested in goodwill, will support only £1,875 of WRAs.

Since the economics of commercial banks are dependent upon their ability to operate with high leverage, as return on assets will typically reside in the 0.75-1.25% range, the damage inflicted by acquired goodwill is real and permanent. In RBOS's case, £17.3bn - that is, 51% - of the £33.9bn of averaged invested equity in 2003 cannot be leveraged. That percentage looks set to rise further in 2004/05, with the acquisition of Charter One.

To some extent, this issue is visible from the variations in RoE across the group's various divisions (bear in mind, for these calculations, that 'E' is based on accounting figures and thus excludes *inter alia* integration costs, provisions and some, but not all, acquired goodwill).

Royal Bank of Scotland

For the purposes of this exercise, we have had to allocate £2.5bn of costs (Manufacturing and Corporate Centre) not captured within the revenue generating divisions, together with the £471m of unallocated capital costs (preference dividends and minorities).

Allocation of Costs to Revenue Generating Divisions

(£m)	Technology	Customer Support	Purchasing & Property	Central Costs	Central Funding	Prefs. & Minorities
CBFM	174	157	158	67	126	275
Retail Banking	336	303	305	131	35	77
Retail Direct	80	72	73	31	14	30
Wealth Management	61	55	56	24	7	17
Insurance	-	-	-	82		-
Ulster Bank	-	-	44	19	9	20
Citizens	-	-	-	60	24	52
Total	**651**	**588**	**636**	**414**	**215**	**471**

Source: WdB estimates.

Technology (£651m) and Customer Support, etc (£588m) are shared *pro rata* to staff numbers across CBFM, Retail Banking, Retail Direct and Wealth Management; Purchasing & Property (£636m) *pro rata* to staff numbers across those four plus Ulster Bank; Central Costs (£414m) *pro rata* to staff numbers across all divisions; and Central Funding (£215m) and unallocated capital costs (£471m) *pro rata* to WRAs across all divisions.

Estimated Divisional RoE

(£m)	'Pre-tax Profit'	Adj. to PTP	Prefs. & Minorities	Net Income	Equity*	RoE (%)
CBFM	3,620	682	275	1,893	13,540	*13.98*
Retail Banking	3,126	1,110	77	1,379	4,280	*32.22*
Retail Direct	873	270	30	407	1,400	*29.07*
Wealth Management	438	204	17	154	850	*18.12*
Insurance	468	82	-	274	1,630	*16.81*
Ulster Bank	273	72	20	129	1,290	*10.00*
Citizens	857	84	52	512	5,120	*10.00*
Total	**9,655**	**2,504**	**471**	**4,748**	**28,110**	***16.89***
Manufacturing	(1,875)					
Corporate Centre	(629)					
PTP	**7,151**					

*Divisional net assets. Source: WdB estimates.

In recent years, banks have circumvented the problem of goodwill eroding regulatory capital, to some degree, by increasing the proportion of capital-qualifying debt. From an EPS perspective, this has been pretty painless, as interest rates have been low/falling; the pre-tax cost of RBOS's debt capital within the profit & loss account has fallen from 8.1% in 2000 to 4.9% in 2003. But as that cycle reverses, life gets much harder.

Speaking of which… Rising interest rates won't do any of the banks any favours. Operationally, the opportunity to widen deposit margins/improve the return on free funds will be offset, in whole or in part, by the higher incidence and carrying cost of NPLs, and by reduced demand. The main issue, however, is the impact on cost of capital - more of an issue for banks than most other companies, because of their higher capital intensity. In that context, sensitivity is highest where the gap between return on capital and cost of capital is narrowest (grandmothers, eggs, etc).

Comparative RoIC, 2003

(£m)	Barclays	HBOS	LloydsTSB	RBOS
Return	3,704	3,541	3,160	5,798
Ave. Invested Capital	31,909	30,921	25,986	54,939
RoIC (%)	*11.6*	*11.5*	*12.2*	*10.6*

Source: WdB estimates.

In fact, RBOS's relative position may be somewhat worse than the table above implies. For valuation purposes, we have long used a through-the-cycle provisioning formula to adjust reported provisioning onto a 'normalised' basis. That exercise initially suggests that RBOS's 2003 profit & loss provisioning is perhaps £400m-500m below normal (also true of HBOS: Barclays and LloydsTSB appear to be much closer to par).

As best we can determine (disclosure is somewhat light), most of the shortfall arises firstly in Citizens and secondly in UK personal lending, especially credit card outstanding balances. We think the UK personal lending shortfall reflects:

1) 'Seasoning' - as with HBOS, provisioning has yet to 'catch up' with rapid loan growth; and

2) RBOS treats credit card fraud costs as an operating expense, rather than as loan losses.

In Citizens' case, the explanations are less certain. Clearly, part of the shortfall is cyclical. Substantially, all US regional banks are recording loan losses well below the Federal Reserve historic (thirteen-year) average of 94bp for Citizens' current mix; nevertheless, a 2003 figure of just 36bp seems extraordinary. There may, once again, be a seasoning element at work, given Citizens' rapid expansion, but we suspect that there may also be a contribution from the acquisition programme.

Fair Value Adjustments to Loan Books on Acquisition

(£m)	Loan Book Acquired	Adjustments	(%)
2000	4,178	(112)	*(2.7)*
2001	4,893	(124)	*(2.5)*
2002	427	(20)	*(4.7)*
2003	3,326	(11)	*(0.3)*
Aggregate	**12,824**	**(267)**	***(2.1)***

Source: Company data.

Looking back over the last three-to-four years (see table above), aggregate acquired loan books have, on average, seen fair value adjustments of 2.1% as part of total fair value adjustments on acquisitions, which typically reduce acquired net assets by around 18% (before integration costs, which are themselves typically a further 22% of acquired net assets).

Total Fair Value Adjustments on Recent Acquisitions

(£m)	Net Assets Acquired	Adjustments	(%)
2000	1,119	(174)	*(15.5)*
2001	87*	(119)*	*(136.8)**
2002	133	(71)	*(53.3)*
2003	1,217	(395)	*(32.5)*
Aggregate	**2,556***	**(759)***	***(29.7)****

*Figures exaggerated by acquisition of Mellon Retail Franchise, with zero net assets. Source: WdB estimates.

While it is entirely appropriate to expose acquired loan books to the fair value appraisal process, it is quite likely that such an exercise may have the unintended side effect of pre-empting subsequent provisioning through the profit & loss. In that sense, it may be that the P&L account obtains a temporary benefit. We would estimate that most of the £278m of loan book fair value adjustments since the NatWest acquisition arise in the US. Since Citizens' total profit & loss provisioning in the last three years has been just £252m in aggregate, the impact of this may have been material. We should add here that Citizens' stock of accumulated provisions appears wholly adequate.

It remains the case, however, that Citizens' has consistently enjoyed above-average credit quality within its markets, and that this should be reflected in the normalisation process, as is the case with the treatment of credit card fraud costs. Below is our revised calculation of the group's 'normal provisioning', which incorporates a 100bp reduction in credit card provisioning and a 25% reduction from Federal Reserve historic averages on Citizens' loan book, in each category.

Assessment of Normalised Provisioning

	(%)	% of Outstanding	Formula	Adj. Formula	Contribution (bp)
Loan Book	**UK**				
	Mortgages	18.9	0.15		0.028
	Other Personal	10.0	3.50	3.00	0.300
	Corporate, etc.	47.5	0.50		0.238
	Citizens				
	Mortgages/Home Equity	4.4	0.16	0.12	0.005
	Other Personal	2.7	2.32	1.75	0.047
	Corporate, etc.	3.9	1.00	0.75	0.029
	Other US				
	Corporate	4.1	1.00		0.040
	Europe				
	Mortgages	1.0	0.15		0.002
	Other Personal	1.0	3.00		0.030
	Corporate, etc.	5.8	0.50		0.029
	RoW				
	Corporate	0.7	0.50		0.004
	Ave. Loan Book (£bn)	**237.5**			**0.750**
	Other Risk Assets	**WRAs (£bn)**	**Formula**		
	Off Balance Sheet	36.4	0.20		
	Trading Book	12.9	0.20		
	Total	**49.3**	**0.20**		

Calculations (Based on 2003)

	(£m)
£237.5bn x 0.75% =	1,781
£49.3bn x 0.20% =	99
Formula Provisioning	1,880
Actual 2003	1,494
Shortfall	**386**

For the record, we are happy that RBOS's accumulated loan-loss provisions are wholly adequate in relation to the size and disposition of its current loan book.

Valuation

If we assumed that the group's RoIC stabilises at 2004 levels - as adjusted for the provisioning shortfall identified above - and the cost of capital stays at 8.4%, then:

2004 Forecast

	(£m)	
Return	6,364	
Provision Adjustment	(270)	(£386m less tax @ 30%)
	6,094	
Average Inv. Capital	63,162	
RoIC (%)	*9.65*	
Cost of Capital (%)	*8.40*	
Value Added Margin (%)	*1.25*	
Value Added pa	789	
Capitalised Value of VA	9,399	(£789m in perpetuity discounted at 8.4%)
Enterprise Value	72,561	(£63,162 + £9,399)
Less Debt	(27,989)	
Equity Value	**44,572**	
Per Share (p)	1450	

Applying the same process to 2005, and assuming no further acquisitions (an unlikely outcome in our view), points to 1608p - equivalent to 1504p in today's money. That increase - over the 1450p in 2004 - reflects the retention of profits, reinvested to earn 9.2% as per consensus forecasts, and the full-year benefit of the shares issued at 1620p each; based on the return achieved on incremental investments in recent years (8.4% 2000-04), that looks modestly optimistic. In the meantime, if interest rates rise, the £9.4bn of value added will erode rapidly.

For non-subscribers to the WdB provisioning formula, 2004 value ex our adjustment is indicated at 1555p per share.

So how can RBOS not be cheap at 1650p, on 9.5x forecast 2004 earnings?

1) Although current operational profitability (profit before loan-loss provisions per WRA) looks broadly sustainable at *c*3.5% (in line with four-year average), provisioning levels appear somewhat shy of normal. On our calculations (see above), normalised provisions would add £386m (£270m post tax) to the charge, equivalent to 9.2p off EPS.

2) Because banks are much more highly leveraged within their capital structure than the average of the rest of the market, EPS are 'flattered' in a low interest rate environment. On our calculations, while the banks' capital structure is 31/69 (debt/market cap.), the

rest of the market is 14/86. As a result, for the banks to trade at the same enterprise value multiple as the rest of the market, their PER ratio would need to stand at a 13% discount.

3) In 2003, we estimate that the post-tax profit & loss account cost of RBOS's debt capital was just shy of £800m. Implicitly (given an earnings multiple of 10.4) that values the debt capital at £8.3bn, or £10.7bn on pre-tax cost. Yet, on the face of the balance sheet, debt is (an average of) £20.9bn.

4) As RoIC is falling, the group's value added margin is declining; and while acquisitions continue apace, the market may reasonably be sceptical about the value of future growth as well (where RoIC equals cost of capital, the **rate** of growth become irrelevant for valuation).

5) On our calculations, value added per share has declined sharply since 2000 (Assessment of RoIC table, page 2). The multiple of value added pa to market value added (share price less book invested equity) has remained fairly constant, while the traditional PER multiple has dropped. To us, that is entirely logical.

Aren't All the Banks in the Same Position?

Yes, to an extent, but perhaps not to the **same** extent - as indicated in the following table:

Comparative Valuations, 2004

(£m)	Barclays	LloydsTSB	HBOS	RBOS
Average Invested Capital* ('E')	34,142	25,986	33,085	
Post-tax Profit*	3,036	2,361	3,205	
Add: Goodwill Amortisation	279	50	100	
Add: Interest on Subord. Debt	720	600	700	
Add: Provisions	1,426	1,000	1,200	
Sub-Total	**5,461**	**4,011**	**5,205**	
Deduct: 'Normal' Provisions	1,451	1,034	1,470	
Return	**4,010**	**2,977**	**3,735**	
RoIC (%)	*11.7*	*11.5*	*11.3*	*9.6*
*Cost of Capital (%)***	*8.6*	*8.8*	*8.4*	*8.4*
Value Added Margin (%)	*3.75*	*2.70*	*2.90*	*1.25*
Value Added pa	1,280	701	959	789
Capitalised Value of VA	14,887	7,973	11,422	9,399
Enterprise Value	49,029	33,959	44,507	72,561
Less Debt	13,505	11,181	17,005	27,989
Equity Value	**35,523**	**22,778**	**27,502**	**44,572**
Equity Value Per Share (p)	550	407	708	1450
Ave. Shares Outstanding (m)	6,454	5,595	3,885	3,073
Share Price (p)	480	425	710	1650
VA Per Share (p)	19.8	12.5	24.7	34.5
Book Value Per Share (p)	319	265	414	1231
MVA Per Share (p)	160	160	294	419
MVA/VA (x)	8.1	12.8	11.9	12.2

*Consensus 2004 Forecasts. **Using 10% cost of equity; 6% cost of debt. Source: WdB estimates.

Although RBOS may have been growing top-line revenue faster than its peer group average, the rate of increase in invested capital has severely limited the value of expansion, such that its value added margin is now less than half that of its peers.

It is intriguing to look at the various longer-term incentive programmes in place at each of the four banks. Although all contain a relative total shareholder return (TSR) target, there are important variations in the first qualifying hurdle. For RBOS, this is an EPS target of RPI+3% pa (which may not be overly demanding, particularly given the group's low dividend payout ratio), whereas both LloydsTSB and Barclays apply economic profit criteria. HBOS has EPS, RoE and PTP targets for its short-term plan and TSR for its long-term plan.

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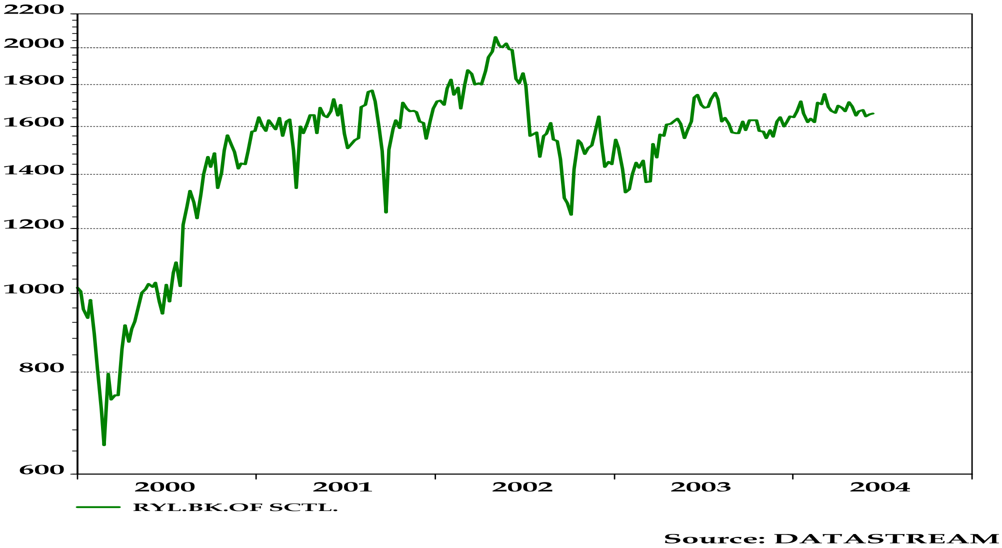
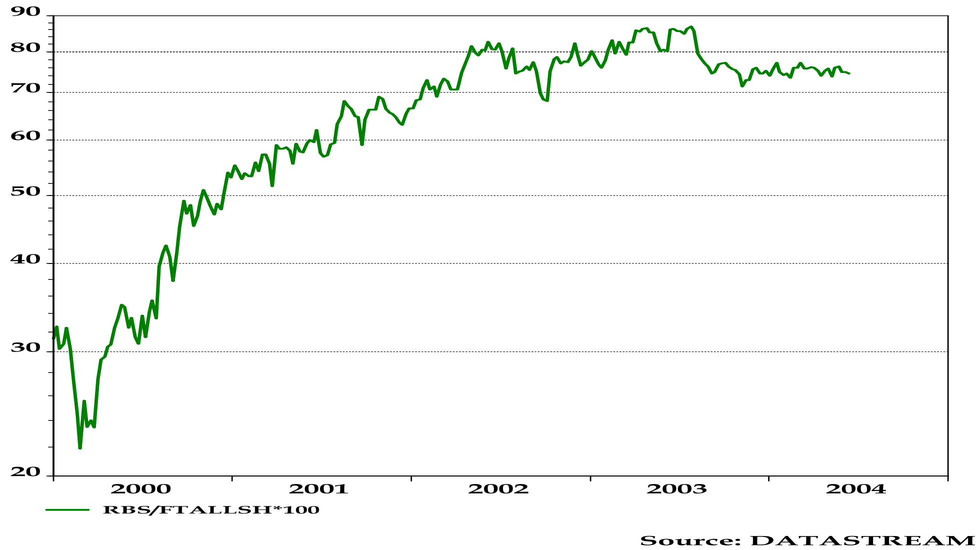
Share Price



Price Relative to the FTSE-All Share Index



Share Prices as of 15 June 2004

Unless otherwise stated, pre-tax profits and EPS are pre exceptionals & goodwill, EPS are diluted, and the source for tables and charts is companies for historical figures and Williams de Broë for estimates. Dividends are reported net.

Appendix

RoIC Calculations

(£m)	1999	2000	2001	2002	2003	2004E	2005E
Profit after Tax*		2,161	2,715	3,207	4,249	5,864	6,457
Add Back:							
Integration Costs		434	875	957	229		
Goodwill Amortisation		635	651	731	763		
Interest on Subord. Debt		750	652	674	557	500	625
Return		3,980	4,893	5,569	5,798	6,364	7,078
Subordinated Debt	10,573	10,801	12,530	13,965	16,998		
Preference Divs, etc	2,072	4,581	4,956	5,346	5,636		
Total Debt	12,645	15,382	17,486	19,311	22,634	27,989	29,948
Shareholders' Funds	11,716	19,081	2,287	23,545	25,176		
Adj.: Prop. Revl./Amt'n.	(47)	(40)	(113)	(80)	(80)		
Goodwill Written Off	844	1,479	2,130	2,861	3,624		
Integration Costs	113	547	1422	2379	2608		
Total Capital	25,271	36,449	43,212	48,016	53,962	64,038	68,521
Average Capital		30,860	39,830	45,614	51,011	59,000	66,279
Loan -loss Provision	1,831	3,153	3,653	3,927	3,929	4,423	4,733
Ave. Loan-loss Prov'ns.		2,492	3,403	3,790	3,928	4,139	4,502
Ave. Invested Capital		33,352	43,233	49,404	54,939	63,162	70,924

*Pre minorities and preferred stock dividends. Source: WdB estimates.

Williams de Broë Plc

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