Overview Of Royal Bank Of Scotland

About RBS

The RBS group provides banking and financial services to customers across UK & Ireland, Europe, Asia- Pacific and United States. It is headquartered in Edinburgh and offers a wide array of products and services to its clientele, which includes personal, commercial and large corporate and institutional customers. The RBS group operates through a range of brands included in its portfolio. These are:

1. Royal Bank of Scotland: Being committed to the service of its customers since its inception, RBS provided the world's first bank overdraft as well as first fully-fledged Internet banking service. It serves to the banking interest of its corporate, retail as well as financial institutional clients.
2. NatWest: Catering to the personal, private and business banking needs of the customers in the areas of England and Wales. It also offers business knowledge expertise in the areas of manufacturing and technology.
3. Ulster Bank: Recognized as Ireland's most responsible bank, Ulster bank services the banking needs of personal, small businesses, private and commercial customers. The bank services 60 rural locations and works towards the local causes through its community programs.
4. Coutts: Offering services ranging from wealth management to private and commercial banking, Coutts has won many industry awards. Powerful insights, extensive connectivity and exceptional services are some of the many opportunities that the customers enjoy being its clients.
5. Adam & Company: With customer service and client needs being the top priorities of this bank, it provides solutions specifically customized as per the needs of its customers. It provides services of financial planning, investment management and private banking to its clients.
6. Child & Co.: It is one of the oldest private banks in the UK. The bank is renowned in the legal circles and caters to the needs of UK's various biggest law and accounting firms. Child & Co. provides personal, private and business banking services to its clients.
7. Drummonds: Providing discrete and professional banking service to its clients, which include some of the biggest names of the UK, Drummonds is focused on welfare of its customers. It provides service ranging from personal and private to business banking solutions.
8. Holt's: This arm of the RBS group caters to the banking needs of the British military personnel, British army regiments, royal navy ships and royal air force stations.
9. Isle of Man Bank: This is the bank of the local community providing them with reliable solutions ranging from retail, private to business banking.
10. Lombard: This is the asset finance arm of the RBS group and the biggest in its field in the UK. It helps businesses obtain funds required for maintaining up-to-date machinery and technology and hence sustain in the existing competitive world.
11. RBS International: With an emphasis on the customer service, RBS International operates through local professional who work closely with the end customers to deliver tailored services matching the client needs. The key target sectors of the bank include

financing for real estate, funds and financial intermediaries.

12. NatWest Markets: Focused on solving the risk management and financing challenges faced by its customers, NatWest markets provides innovative solutions through its cross-products teams which provides a comprehensive and in- depth view of the situation.

The Bank was placed 5th in the world before being hit severely by the 2008 crisis when it posted a huge loss of £28 billion. The bank grew to its pinnacle in a span of seven years through aggressive acquisitions had eventually the UK government had to bail out the bank to support the British banking system. The Eurozone crisis and Brexit had also affected the bank. The bank since then has been focused on recovery, as part of which it is focused on consolidation of its operations.

About RBS India

RBS began its Indian operations in the year 1921. Since then, owing to the technical expertise of its professionals and leveraging on the strong global presence of the bank, it has been serving its clientele by providing advisory services and balance sheet structuring, providing access to debt capital markets and extending FX lines. The clients of the bank include large multinational corporations, Financial Institutions, Indian government and HNIs.

In an attempt to avoid what it witnessed back in 2008, the bank is focused on improving the lending quality and has emphasized on the credit rating of its clients. For this purpose, RBS set up its middle office function- Risk Hub India (RHI) in 2011 with the aim to support the global financial operations of the bank. This arm of the bank thus assumes significant importance in the overall functioning of the RBS.

RHI teams act as an extension of the global network oh the RBS and support the overall functioning by providing data, model analytics, credit risk assessment, quantitative and qualitative analysis and controls to enable it to develop and sustain a healthy risk environment.

It is the second largest risk division of the RBS after UK. It is split across two locations in India- Gurugram and Chennai. It covers a wide array of risk assessment, which includes Market risk, Operational risk, Credit risk, Credit models, Retail Analytics, Risk Information Services and Controls Assurance.

Under RHI, I interned in the credit risk team, which is responsible assessing the credit worthiness of institutional clients and corporates. The Credit Risk Team has two divisions- corporate team and Financial Institutional team. The Corporate team works on the credit analysis of corporate clients of the banks, whereas the Financial Institution team is involved in the credit analysis of bank, funds, financial institutions which borrow from RBS. I interned under the corporate team of RHI.

Credit Analysis Methodology - Corporates

Credit Rating at RBS is a vital and comprehensive process involving various steps. The function is of paramount importance as it enables analysis of the risks associated with each individual entity it engages in business with. It helps in reviewing the various facilities extended to the client and deciding whether a new loan should be extended or the current facility be continued.

Also, the unutilized amounts of the extended facilities (if any) need to be reviewed as these have a direct impact on the Risk Weighted assets (RWAs) of the bank.

The process of credit review involves the following steps:

- Understanding the Business Profile of the client:

  The first and foremost step in credit risk analysis of a corporate sector entity is to understand the underlying business of the company. Since, each company and sector is unique in its characteristics, it is a quintessential step in further process. This step helps to identify the revenue drivers, the underlying business model, the debt profile of the company etc. that is helpful in further steps of the process.

- Historical Trend Analysis:

  This involves aligning the financial statements of the client entity with the RBS proprietary model. Data is obtained from the annual report of the concerned entity and fed into the RBS model after making the necessary and required adjustments in the line items. The financial statements- Profit & Loss, Balance Sheet and Cash Flows are populated and the ratios are calculated in the model.

  This step not only takes care of the quantitative data of the company but also, the qualitative data. The entity is also analysed and assessed for various qualitative factors such as core management assessment, industry cyclicality, quality of information presented by the company, market volatility etc. These factors play a major role in rating the company.

- Debt Breakdown:

  This involves a comprehensive analysis of the debt structure of the client entity. The total debt of the entity is broken down with respect to:

- Seniority: This involves analyzing if the debt of the entity is obtained at senior level or the subordinate level.
- Structural Seniority: This involves analyzing if operating company or the holding company obtains the debt.
- Legal Structure: This involves analyzing whether the debt is secured or unsecured or a mix of both
- Source of Finance: This involves analyzing which source of funding the entity has utilized to obtain debt. This may include bonds, commercial paper, term loan, revolving credit facility etc.

All this assumes significant importance, as these are very crucial in determining the credit grade of the entity.

Forecast Spreading:

This involves forecasting the future risk exposure of the company based upon the industry analysis, macroeconomic factors, broker reports (equity reports) etc. A proper understanding of the current functioning of the industry, company and the current risk exposure of the company is necessary to do forecast analysis. Based upon all these factors, we evaluate the following:

Debt capacity of the company: This is important to understand how much debt can the company take without breaching its covenants or the risk appetite of the company.

Covenants: We also monitor any special covenant that the company has mentioned and is subjected to the debt of the company. This is useful if the loan has been provided to the company on special terms, such as, maintenance of certain level of debt to assets ratio etc.

Future performance: We closely monitor ratios that have an impact on the credit risk and are directly associated with the performance of the company, for ex, EBITDA margin, capital expenditure, operating margins, revenue growth etc. These ratios and parameters help us evaluate the company in correspondence to the industry standards.

Credit reporting:

The main purpose of reporting is to present the summary of all the analysis to the respective credit officer for evaluation. There were mainly 2 types of report formats prevalent in RBS credit analysis: Grading and Annual Review.

A common standard format of reporting involves the following:

Financial Commentary: This section involves analyst commentary and analysis based on the historic financials of the company. Various ratios are analyzed and commented upon in this section after reading through the annual report of the company and using the RBS proprietary model for credit analysis.

Key financials and ratios, which are analyzed, involve revenue position, operating margin, EBITDA margin etc. from the P&L statement. Also, it includes Debt service coverage, Net Debt/ EBITDA, Debt/Equity etc. from the balance sheet. Cash flow statement analysis majorly looks at cash flow from operations, free cash flows, etc.

- Forecast Commentary: This section deals with the forecast analysis prepared by the analyst. All the financials and ratios covered in the financial commentary section are also analyzed and commented upon, for the forecast prepared. Generally, a forecast involves a base case, which is basically the broker case (in case of listed companies) or analyst case based on the management projections. The complete credit analysis is not completed without a conservative approach and hence, sensitivity cases are also prepared by analysts to account for the worst of the situations that could occur. These provide as a measure of contingencies and sence, the bank prepares itself for the worst of the situation, if and when it may occur.
- Risk Exposure: This section indicates the various facilities offered by the bank to the entity and the risk exposure associated to each entity. Some of the common facilities extended by the bank are term loans, revolving credit facilities, supply chain financing, bridge financing, RRM lines, asset financing. Each facility carries with it certain exposure to risk based on the amount drawn from the facility.
- Key risks and mitigants: This section discovers the key risks that the entity faces. These

risks may severely impact the credit quality of the company and hence, it is important from bank's point of view to identify them. The impact of a risk is identified by its probability of occurrence and the severity of damage it could cause. The mitigants are the counter-measures the entity is taking to mitigate the risk or reduce its impact. These mitigants are not something that company should do, but moreover, what the company is actually doing.

- Sources of repayment: This section identifies various primary and secondary sources of repayment that the entity may use to repay its debt. The primary sources of repayment are the ones, which don't severely affect the balance sheet of the company such as operating cash flows, equity issuance, refinancing loan etc. Secondary source, on the other hand, could severely impact the balance sheet of the company such as liquidation of assets, debt on stricter terms or collateralized loan etc.

  It is imperative for bank to identify these sources of repayment and the extent to which their debt can be recovered from each situation.

- Request and Recommendation: This section primarily indicates the credit rating of the company and the exposure bank has with the entity. An approval to the rating is requested and recommendation on facilities extended is given based on the business profile of the entity and the analyst's estimate.

Work Summary

The work primarily consisted of credit analysis and rating of corporate clients. The internship project was focused on the Utilities sector. The sector was broadly divided into Generation, Transmission & Distribution, and Retail. Working under the Utilities coverage team, I wrote a Sector Paper for RBS' internal usage.

Industry Overview – Utilities (Europe)

The Utilities sector can be broadly divided into 3 categories - Generation, Transmission & Distribution (T&D), and Retail. Over the years, the sector has witnessed transformation from vertically integrated players to smaller niche players. The changing face of the sector is on the back of renewables push by the EU. The sector has witnessed an increasing number of downgrades over the past years. Some of the major players are – Engie SA (France), National Grid (UK), Enel (Italy), Iberdrola (Spain).

Generation – Europe generated a total of 3,244 TWh Energy in 2017. The major sources of generation are mainly Gas, Coal, Nuclear, Lignite, Renewables and other fossils. An increasing renewables capacity build out has put pressure on prices and has pushed conventional energy sources out of the merit order. The development of the renewables space with increasing competition and technological prowess has reduced costs significantly (Germany's zero subsidy off-shore bid contract).

There is a strong focus of European countries to meet the targets of the Clean Energy Package based on the Paris Agreement. In response to this, various governments, for example – Germany has committed to a complete coal based capacity phasing out by 2030.

Currently, in the last year, the power prices witnessed sharp recovery, on the back of steady increase in Coal Prices, nuclear outages in France and Pipeline burst in the North Sea.

Transmission and Distribution (T&D) – This operation front has good cash flow visibility due to its regulatory nature. Revenues are earned on the Regulated Asset Base (RABs), which are indexed to inflation. With inflation bottoming in European economies, the regulators across EU are increasing the WACCs, which will increase the cash flow generation for the T&D companies.

The sector is witnessing high capes due to increasing renewables capacity. Tennet is laying cables for off shore wind transmission is costing them EUR 28 Bn.

Retail – Regulations and Pricing play a key role in cash flow visibility. In the major markets of UK, currently the tariff structure is a variable one, commonly known as the standard variable tariff, which is based on the base rate of Bank of England. But, a recent change proposal by the conservatives led Government has proposed maximum price caps. This will hit margins of market players like British Gas. Innogy and SSE (Big 6 Operators of UK) have merged their UK retail operations as a response.

Case – ABC Company

ABC Co. is a European Utilities Major operating in the renewables space. The financials of the assumed company are also, hypothetical. However, these financials are as close as possible to a similar entity operating in the Utilities sector.

The financials also contain ratios calculated on the basis of balance sheet, income statement and the cash flow statements.

(in EUR Mn) 2016 2017

Revenue 5,800 6,000

EBITDA 850 1,150

EBITDA Margin 14.66% 19.17%

Interest Coverage 4x 5.5x

Gross Debt 3,100 3,630

Cash 260 400

Net Debt/EBITDA 3.5x 2.9x

NOCF 1100 870

FFO/Net Debt 40% 35%

Analysis

The EBITDA margins increased despite stress in the industry, this is on the back cost reduction and gains from selling capacity, i.e. considered a core operational activity by the company.

Net operating cash flow increased by 22%. This could be because of reduction in account receivables or increase in account payables. The working capital movement seems to be the main cause.

The company generates cash surplus in 2017 as compared to 2016. This would reflect better liquidity with increased cash and Short-term investments.

Gross debt increased and is justified by a similar increase in the asset value of the company. Company used the debt financing to construct new capacity.

The leverage ratio (Net Debt/EBITDA) reduced to 2.9x in FY17 indicating an increase in cash and cash equivalents of the company.

Then using RBS' internal grading software gives weight to qualitative factors based to derive a credit grade for the entity. The score developed is then mapped against the rating score developed by the bank.

Key Risk and Mitigant

The company has a high construction risk given the nature of business and requires high capex. Mitigant – The Company has a strong track record and technological expertise in its area of business. The Company has a strong cash flow stream through selling off its capacity, which helps it to leverage operational capabilities, diversify risk amongst projects while reducing reliance on 3rd party debt.

Recommendation

The company has strong cash flow visibility given its capacity sale model and kick starting of operations in newly constructed power capacity. The company has high debt maturity time period, and has healthy cash flows, at the same time; multiple credit lines are available for its disposal. Hence, the company has very low chances of default. The non-financial parameters are healthy given the performance of the company on other factors. Hence, the company was assigned a strong investment grade credit rating.

Key Learnings

Following are the key take-away from the internship at RBS:

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