Citizens Financial Group Inc. (NYSE – CFG) – Long
Price: $23.73 at close on November 18, 2014
Market Cap: $13.0 billion
30 Day Average daily volume: 1.4 million shares, $33 million
Shares Outstanding / Float: 545.9 million / 161.0 million
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Citizens Financial Group – Long, ~$29 near term target – paraphrasing Howard Marks, even mediocre assets can be good investments if bought cheaply enough

Base case: ~$29 / share
Upside case: ~$32 / share
Downside case: ~$23 / share

Risk / Reward: +20% base case, -3.5% downside
Duration: ~1 year

Overview

Citizens Financial Group (CFG) is the 13th largest retail bank holding company in the US by assets. It was spun off by Royal Bank of Scotland (RBS) as part of a series of planned divestitures to strengthen its balance sheet under pressure from the UK government. Including the underwriters' exercised option, CFG sold 161 million shares at $21.50 in the September 24th IPO. On October 8, CFG issued $334 million in 10 year subordinated notes and used the proceeds to repurchase 14,297,761 shares from RBS at $23.36 per share. After this transaction, RBS owns 70.5% of the remaining 545.9 outstanding shares and has committed to sell its remaining shares by the end of 2016. This overhang along with lackluster performance and the traditional spinoff dynamics has created a favorable risk / reward opportunity for investors.

Background

Citizens was purchased by RBS in 1988. They then acquired more than 25 financial institutions from 1988 to 2007. Today, CFG has more than 1,200 branches across 11 states in the New England, Mid-Atlantic, and Midwest regions. Citizens has an enviable market share of deposits in several attractive metro areas. They are #1 in Providence and Manchester, NH, #2 in Boston and Pittsburgh, and #4 in Philadelphia, Buffalo, Albany, and Rochester. Additionally, they are #5 in Cleveland and #6 in Detroit. This large, low cost deposit base is an extremely attractive aspect of CFG and will become more so as interest rates rise. To that point, in the Sept. 30, 2014 10-Q, Citizens estimated a gradual 200 basis point rise in interest rates would yield +6.3% in net income.

While Citizens is a large banking organization, it is largely a plain vanilla operation of loan making and deposit taking. It does have some business lines that are more complex such as capital markets, but they are small in scale relative to the overall size of the company. While Citizens has not yet been around long enough to file a 10-K, their Sept. 30, 2014 10-Q and investor presentation do a decent job describing their operations, so I won't rehash them here. The loan portfolio is relatively high quality with non-performing loans and net charge-offs steadily declining over the past year. Non-performing loans are 1.19% of total loans, and loan loss reserve is 1.32% of total loans for a coverage of 111%. Interest-earning assets are comprised of investments (23%), commercial real estate (6%), commercial (29%), residential mortgage (10%), home equity (18%), auto (10%), and other consumer (4%).

Management appears capable and is focused on the right things. They have laid out several restructuring initiatives to increase efficiency and reduce costs now that Citizens is a stand-alone company. As an example, on January 7, 2014 Citizens announced the sale of its Chicago area branches to US Bancorp in order to better focus on its core markets. The sale included 94 branches, $5.3 billion in deposits, and $1.1 billion in loans for a deposit premium of $315 million.

Ownership

RBS	384.7 million shares
Greenlight Capital	8.0 million
Samlyn Capital	5.0 million
Glenview Capital	3.7 million
Anchorage Advisors	3.0 million
Discovery Capital	2.3 million
Lakewood Capital	2.2 million
Officers & Directors	874,310 shares

The CEO owns ~313,000 shares personally, which is a roughly $7.4 million stake. That equates to 1.3 times his 2013 comp of $5.67 million.

Financial Info – The Bad News

The title referred to CFG as a mediocre asset for a reason. Among its comps, Citizens is either last or next to last in return on average assets, return on average tangible common equity, net interest margin, and efficiency ratio. While some of this is understandable as CFG is a newly separate company, the fact remains that Citizens has work to do to become merely average in its peer group. Management is addressing these challenges. They expect higher net income and a lower efficiency ratio in the next quarter. Going forward, metrics should improve as CFG faces lower regulatory costs than under RBS, no separation expenses, and a number of efficiency opportunities, particularly in consumer banking. These initiatives appear to already be bearing fruit, as adjusted EPS was up 38% from a year ago and adjusted return on tangible common equity was 6.2% from 4.3% in the third quarter of 2013. As if bottom rung performance metrics weren't enough, the Federal Reserve objected to Citizens' 2014 capital plan. CFG has been allowed to pay a $0.10 quarterly dividend, equivalent to a 1.69% annual yield.

Financial Info – The Good News

The good news is that despite performance metrics that lag behind almost all of its peers, CFG has one of the strongest capital bases. Their total capital ratio is 16.1%, well above the peer group mean of 13.7% .Management intends to utilize the excess capital to invest into earning assets with a goal of reaching a return on average TCE of 10.0%+ and a return on average assets of 1.0%+ by the end of 2016. They also expect to cut costs to achieve an efficiency ratio of ~60% by the same date.

Valuation – The Even Better News

While Citizens may currently be last in its peer group performance metrics, it is being priced as if performance is deteriorating instead of improving. 1.04 times tangible book value is a cheap price to pay for a bank that is solidly profitable and has been for the past four years. CFG's closest comps are KeyCorp and Comerica, both of which have performance metrics only marginally better than Citizens. KeyCorp and Comerica trade at 1.29 and 1.20 times tangible book respectively. With several levers to pull to increase performance easily within reach, Citizens should be valued at the KEY/CMA level today. **Base case valuation – 1.25 times tangible book, $28.64 as of Sept. 30, 2014 (+20.7%)**

Given time to execute on management's strategic initiatives and the elimination of the RBS overhang, Citizens should be able to achieve a valuation in line with the peer mean of 1.38 times tangible book value. That peer mean excludes US Bancorp as it trades at 3.10 times tangible book and executes far better than the rest of the comps. **Upside case valuation – 1.40 times tangible book, $32.07 as of Sept. 30, 2014 (+35.1%)**

On the downside, it is difficult to see a case for Citizens to trade below tangible book. No bank with a market cap over $1 billion currently trades below tangible book. CFG's TTM P/E is 16.13 which is reasonable and provides support to the idea that the shares are not presently overvalued, again particularly given the upward trajectory of performance. **Downside case – 1.00 times tangible book, $22.91 as of Sept. 30, 2014 (-3.5%)**

There has not been any recent M&A activity where banks of Citizens size have been purchased. However, BB&T acquiring Susquehanna Bancshares for 1.69 times tangible book provides a little support to our valuation levels. Susquehanna had a $2.4 billion market cap and an ROA nearly identical to CFG's (0.72% for SUSQ vs. 0.71% for CFG). To be fair, Susquehanna's return on average TCE and net interest margin were both much better than CFG's.

<u>Comps</u>

BB&T Corp.
SunTrust Banks
Fifth Third Bancorp
M&T Bank
Regions Financial
KeyCorp
Comerica
Huntington Bancshares
PNC Financial Services Group
US Bancorp

<u>Risks</u>

- Disorderly liquidation of RBS' 70.5% stake – while we view this as unlikely given that RBS will want to get the best price possible for its shares in its timeline, it is conceivable that the UK government and/or regulator forces their hand and makes them unload their stake quicker than planned
- Deterioration of national and/or regional economic conditions
- Weakness in the MBS market – 96% of the available for sale securities and all of the held to maturity securities are MBS, the vast majority of which are agency MBS. Additionally, 86% of the available for sale portfolio and all of the held to maturity portfolio have maturities over 10 years. Any weakness in those markets could prompt impairment in the securities portfolio
- Management is somewhat unproven and may not be able to achieve the strategic goals – mitigating this is that the base case valuation does not require them to reinvent the wheel, merely to make incremental and easily attained improvements

<u>Catalysts</u>

- RBS completing the sale of their majority stake by the end of 2016
- Management executing on improvements
- Increased sell-side research and awareness as post-spin dynamics fade

<u>Conclusion</u>

Citizens Financial Group will likely never be mistaken for a standout like US Bancorp. We appreciate a good compounder that can be held forever, but CFG isn't one. However, that doesn't mean that it can't be a good investment. Often times, it is easier to sell stocks like CFG because of that fact. We think that CFG can be a good source of decent return with low risk.

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