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New Rec: Citizens Financial (CFG: $24.30) November 1, 2015

Position: Buy **Target: $31**

$Mil	Q215	Q315	Q415e	2015e	2016e	2017e
Rev	1,200	1,209	1,217	4,808	5,125	5,487
EPS$	0.40	0.40	0.41	1.60	1.85	2.20
Y/Y	7%	12%	5%	13%	15%	19%
PE	n/a	n/a	n/a	15.0	13.0	10.9
PSR	n/a	n/a	n/a	3.2	3.0	2.8
P/TBV	n/a	n/a	n/a	0.97	0.92	0.88
Cons.	n/a	n/a	n/a	1.60	1.90	2.18

Shares Out: 527M **Market Cap: $12.5B** **FYE: December**

Concept:

1. RBS is nearing the sale of its remaining CFG stake, removing a major overhang on CFG shares. RBS, which is controlled by the UK gov't, under invested in CFG and was conservative in lending following the financial crisis. CFG is overcapitalized and is under earning.

2. New management plans to increase return on tangible equity (ROTE) via broad cost reductions, a better asset mix and a repositioning of the overcapitalized balance sheet. ROTE was <4% under RBS. New management has increased it to 6.8%, with a goal to reach 10% before the end of 2017. Peer banks earn 12%-13%.
3. CFG has a valuable franchise with an extensive footprint of branches (11 states) concentrated in relatively affluent and business-centric geographies in the northeast US. It is the 13th largest US bank ($136B assets) and has the #2 deposit share in New England. CFG is a logical acquisition target. We estimate a 2016 PMV of $34-$38 based on multiples from similar transactions over the past 5 years. This should provide a substantial margin of safety.
4. CFG shares are inexpensive at 0.95x TBV (vs. peer set at 1.35x) and 12.6x 2016e EPS. The balance sheet is solid with low NPLs and a Tier 1 capital ratio of 11.8%. CFG has repurchased $835M of its shares since the IPO. We expect additional accretive repurchases in 2016 and 2017. Management owns significant equity.

Summary: Citizens Financial Group (CFG) offers a compelling risk-reward investment with a considerable margin of safety. We have tracked CFG since it was floated via IPO in September 2014. After rising for several quarters, CFG shares have recently declined. Investors are concerned that the Fed will keep rates near zero for longer than expected, thus extending CFG's compressed net interest margin (NIM). Management also recently pushed out its target for achieving a 10% ROTE – the result of a lower forward rate curve as well as a more challenging ramp in hiring for its mortgage and wealth management endeavors. This further impacted sentiment. However, it appears that investor expectations have now been reset. CFG shares are trading at a discount to its $24.52 TBV. We think this has created an attractive opportunity to purchase the stock.

CFG has considerable upside now that it is separated from RBS (which acquired it in 1988). During the recent economic crises, RBS required a bailout by the UK government. As a subsidiary, CFG was forced to divest assets, and it was subsequently managed in an ultra-conservative manner with insufficient investment in the brand and in key technology. Under RBS, CFG's return on tangible equity (ROTE) was ~4% and its efficiency ratio was above 70%. Beginning with the 2014 IPO, RBS has reduced its ownership in CFG to 20.9% and is in the process of selling the remaining stake, well ahead of a YE 2016 mandate. This should remove a significant overhang on CFG shares.

As a separate entity, there is much to like about CFG. Although it continues to under-earn its potential, profitability has been improving. Under a new and highly-incentivized management team, ROTE has increased from ~4.5% to 6.7% in the most recent quarter. Free from the constraints of RBS, management is optimizing the asset mix with a focus on increasing lending for high quality commercial loans, prime auto and a differentiated private student loan offering. Deposits have grown by 17% (to $102B) over 2 years. And CFG is building scale in key businesses such as mortgages, treasury management, credit cards, wealth

management and capital markets, all of which should drive fee revenue. Fees make up just 29% of CFG revenue compared to ~40% at its regional peers.

CFG has a valuable franchise comprised of a strong brand and an irreplaceable physical footprint across 11 states in the Northeast, mid-Atlantic and Midwest. CFG is the 13th largest US bank with $136B in assets, 3,200 ATMs and 1,200 branches concentrated in markets with relatively affluent demographics and diverse economies. It has the #2 deposit market share in New England – slightly behind Bank America – and recently has gained share. This franchise value should provide a considerable margin of safety for investors. In our view, if management does not succeed in growing the business, a larger bank could acquire CFG. The shares appear to be trading at a substantial discount to private market value. Using our conservative estimates combined with multiples for similar transactions over the past 5 years, we peg PMV at $34-$38 at the end of 2016.

CFG has a stellar balance sheet with a clean loan profile, strong liquidity and a Tier 1 equity capital ratio of 11.8% (down from 14% in 2013). Its peer group average is ~10%. The loan portfolio is 55% consumer/45% commercial. Under RBS, CFG was overcapitalized and lacked scale in several key areas. However, new management has been recapitalizing the balance sheet via an increase in low cost debt, share repurchases and the investment of excess capital into technology and fee based business platforms. It has also used tuck-in portfolio acquisitions to increase near-term returns, while it builds its origination platforms. CFG has repurchased $834M in shares since the IPO and plans to repurchase a minimum of $250M in 2016. Management has hinted that it could increase this amount. We anticipate additional buybacks in 2017. Repurchasing shares near TBV should be highly accretive for CFG. CFG also pays an annual dividend of $0.40 that should increase over time.

Management has also reduced expenses, while still investing in necessary infrastructure. It has targeted ~$240M in annual expense savings by YE 2016, with a meaningful portion of that to be reinvested in technology. It has been overspending on technology to offset RBS' underinvestment. After 2016, however, the technology spend should decline markedly, to a more normal level (~$150M/year vs. ~$250M), which should provide a tailwind to earnings in 2017. Over the past several years, real estate square footage has been reduced by 21% while overall headcount is down ~10%. In Q315, CFG's efficiency ratio was 66% compared to 68.7% for all of 2014. Management's objective is to drive this ratio toward 60% and to increase the ROTE to 10% over the next several years (and higher long-term). The peer group average ROTE is >12%.

CFG has a moderately higher-than-average sensitivity to interest rates vs. its peer group. Thus, as the fed begins to increase short-term rates, CFG's net interest

income should benefit. However, following the recent Fed decision to abstain from the first rate hike in a decade, the futures curve has shifted downward, which suggests continued yield compression for CFG. Importantly, management has other levers to help offset some of the NIM compression in the near term, as we discuss in the report.

CFG shares seem inexpensive at 0.9x TBV and 10.5x 2017e EPS, with a 1.6% dividend yield (the dividend could grow meaningfully). Moreover, CFG is positioned to grow EPS at a much faster rate than its regional banking peers. Through a combination of mid-single digit loan growth, an improved asset mix (better yields), progressive expense reductions, and accretive share repurchases, EPS should increase from $1.42 in 2014 to $2.20 in 2017 (and to $2.40 in 2018). At yearend 2017, we project TBV to be $27.41. Our 2017 estimates assume ROTE of 8.24%. As overall returns improve, we expect CFG shares to re-rate. As discussed in the report, based on a blended average of PE and P/TBV multiples, we establish an initial 12-18 month price target of $31. Downside should be minimal (~10%). At <1x TBV, investors are getting free call options on an eventual increase in ST interest rates and a potential acquisition of the company. CFG is a logical buyout candidate at an estimated PMV in a range of $35-$38.

Background:

Citizens Financial Group (CFG) is the 13th largest U.S. bank with $136B in assets and $102B in total deposits. The company provides a broad array of retail and commercial banking services. It has ~17,500 employees. CFG operates in New England, the Mid-West and Mid-Atlantic regions. It divested its Chicago operations in Q214. CFG completed its IPO in September 2014, prior to which it had been a wholly owned subsidiary of the Royal Bank of Scotland (RBS) since 1988. Following the IPO and several subsequent secondary offerings, RBS currently owns 20.9% of CFG. The company is headquartered in Providence, RI.

Discussion:

1. CFG combines the attractive dynamics of a spin-off with that of a turnaround led by new, incentivized management. Moreover, the stock is priced like a deep value situation and has genuine takeover potential. CFG also lacks the large trading operations of a major bank, which should make earnings less volatile over time. CFG shares seem cheap, with low risk. Over the past several months, the shares have retreated and currently trade at a discount to TBV.

Three factors appear to have driven the retreat in valuation. First, management reduced guidance when it reported Q215 results and maintained that guidance with Q315 results. It acknowledged the future interest rate curve that had

downshifted since its original guidance, which should result in lower future revenues and profits (all else equal). In addition, management noted that it is requiring a greater effort to hire quality employees for its mortgage origination and wealth management divisions. As a result, it pushed out by one year its targeted objectives for both businesses, which translates into lower fee growth in the near term. Finally, following the Fed's decision (in late Sept.) to abstain from raising the Fed Funds rate, the forward rate curve has downshifted further and the consensus has become "lower rates for longer." Since CFG has greater than average asset sensitivity, any delay in rate hikes would impact earnings growth. Thus, while we are not surprised that CFG is trading at a depressed valuation, it also may have created an opportunity for patient investors.

2. CFG was acquired by RBS in 1988 and grew organically and through acquisitions over the subsequent two decades. However, when the financial crisis hit in 2008, a highly levered RBS (with $2T in assets) became impaired and required a UK government restructuring. With RBS under government ownership, the main priority was ensuring solvency through the sale of assets and the building of capital. As a result, CFG became an orphan, of sorts, and was managed not for growth or profitability, but for the benefit of RBS' recapitalization. CFG's loan portfolio was reduced by >20%, and new loans were concentrated in ultra-prime areas with low yields and subpar returns on assets. Moreover, CFG's capital base increased to an excessive level.

RBS also failed to provide the necessary investments in CFG's technology infrastructure, its origination platforms and its brand. These factors, combined with the company's shrinking scale and excess capital, acted as an enormous drag on CFG's earnings, growth and return metrics. For several years post-2008, CFG's ROTE was consistently ~4% and its Tier 1 ratio was >14%.

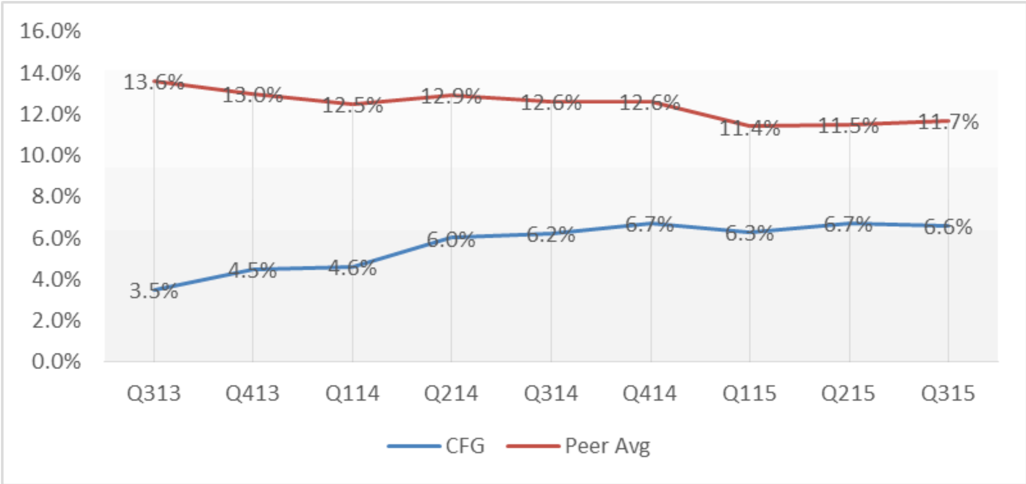
As a condition of RBS's bailout, the UK/EU has mandated that it divest its entire stake in CFG by the end of 2016. Following the 2014 IPO (RBS sold 29.5%) and several secondary offerings, RBS's ownership has been reduced to 20.9%. Several days ago, RBS filed to sell its remaining stake. This should remove a significant overhang on CFG shares. More importantly, however, a full separation from RBS should set the stage for CFG to diversify and grow profitably over time. As a separate entity, management should have the requisite flexibility (and direct economic incentive) to grow the balance sheet in a value-enhancing manner. We note that CFG has a scalable operating platform with the capacity to accommodate a significantly larger balance sheet than it has today.

In anticipation of its separation from RBS, CFG has assembled a new management team with extensive experience in the banking industry. It continues to target senior executives from the biggest, most heavily regulated banks. In

October 2013, Bruce Van Saun was appointed CEO after serving as the Finance Director for RBS. Prior to that he was CFO at BoNY Mellon and has more than 30 years' experience in financial services. In March 2015, CFG made two key hires. It named Eric Aboaf as its new CFO. He was formerly the Global Treasurer at Citigroup and has a deep understanding of the bank balance sheet. It also hired Donald McCree to head the commercial banking division. McCree was formerly with JP Morgan (and predecessor banks) for 31 years. More recently, CFG hired key executives to run consumer banking, wealth management, retail distribution and mortgages. It also added a Federal Reserve alum to its board.

3. The key to the CFG investment case, in our view, is CFG's potential to increase return on tangible equity (ROTE). As we detail in Table 1, CFG has made meaningful progress on increasing its returns under the new CEO. However, it still lags its peer group average by a substantial margin. Management has stated that it aims to achieve a 10% ROTE within several years. After pushing out its timeline, it appears that the goal is to hit the 10% mark (annual run-rate) by the end of 2017. Based on the peer average, this does not seem a heroic target. Longer term, in a more normal interest rate environment, CFG could drive ROTE above 11%. We note that our estimates assume a return of 8.24% for 2017.

Table 1: ROTE progression



Source: SNL Financial; CFG filings; peer filings.
Peer Group: BBT, CMA, FITB, KEY, MTB, PNC, RF, STI

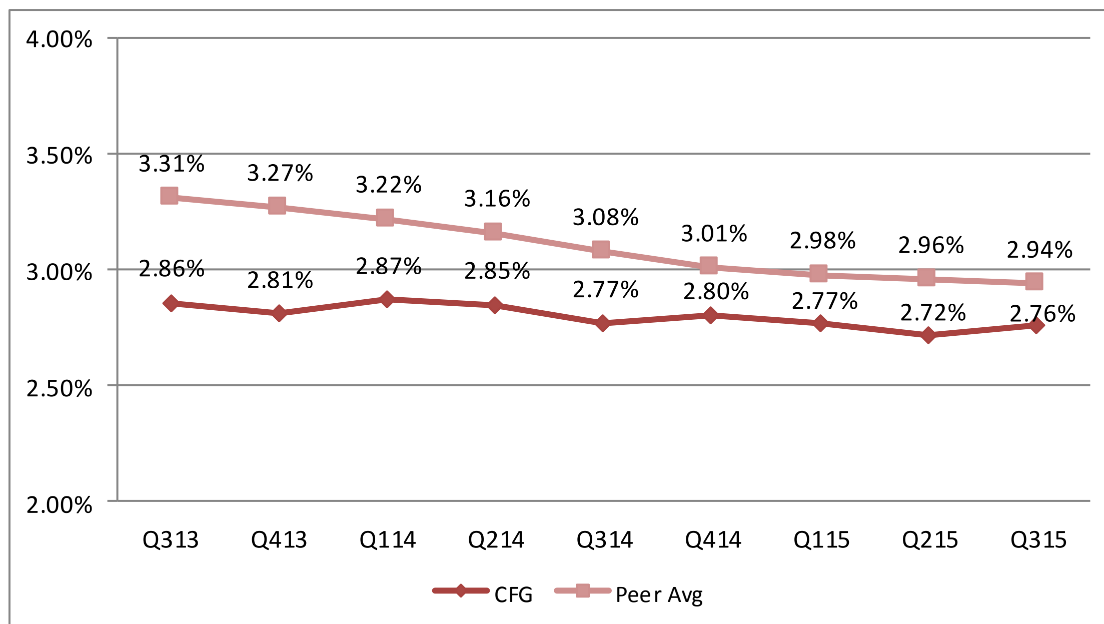
CFG remains overcapitalized with a Basel III common equity Tier 1 ratio of 11.8% at Q315. While this is a decline from 12.9% at Q314, we expect management to target a ratio of 11% by the end of 2016. Moreover, we think CFG could operate at a <10% level over time. As CFG deploys its excess capital, ROTE should increase.

There are multiple potential levers for CFG to increase its ROTE including the following:

- Invest in organic growth
- Optimize the asset mix to generate a higher yield
- Use excess and internally generated capital to repurchase undervalued shares
- Increase fee-based income by investing in fee-driven businesses
- Reduce non-interest expenses – improve the efficiency ratio
- Implement pricing strategies in commercial lending and treasury services
- Allow non-core portfolio and pay-fixed rate swaps to continue to run off

By investing excess capital into organic growth capabilities, CFG can drive revenue growth to better utilize its large asset base. More importantly, by targeting higher yielding asset categories, it can improve the net interest margin (NIM) while concurrently reducing the level of tangible equity. NIM has been compressed by the under management of assets and the persistent ultra-low interest rate environment. Despite these headwinds, management appears to have stabilized NIM over the past year, as we highlight in Table 2. This is being driven by an improvement in CFG's asset mix: management has targeted growth in better yielding assets within commercial business loans, commercial real estate, high-quality student and auto loans, residential mortgages and franchise finance.

Table 2: Net Interest Margin vs. Peer Group



CFG has been investing in capital markets capabilities and treasury/cash management solutions. Management sees a large opportunity in cash management services where its market share is only half of its potential given the deposit base. CFG is also targeting pricing improvements in several commercial product areas.

For instance, in treasury management, it has not implemented a price increase in 5 years despite having waivers based on committed volumes. Most of its peers have continued to take annual price adjustments and have been diligent with the waiver compliance. We note that Don McCree (new head of commercial) ran cash management at JPM.

CFG is also making a push to grow its fee-based revenue, which, as a % of total revenue, is well below the peer group average (29% vs. 40%). CFG is markedly underpenetrated in wealth management (trust/investment services) despite a higher-than-average median HH income across its footprint. CFG's wealth management revenue accounts for just 0.18% of its deposit base compared with 0.42% for its peer group. CFG's market share in residential mortgage origination is also far below its potential. Management has been investing in its mortgage platform, with good early results. In the most recent quarter, most of its growth was from self-originated (vs. purchased) mortgages.

However, growing the fee stream is taking longer than expected, as CFG is finding it difficult to hire qualified mortgage and wealth management personnel. Our forecasts for CFG's total fee revenue seem conservative, and assume annual fee growth of just ~3%. Thus, if management executes on its plan, there could be upside to our estimates.

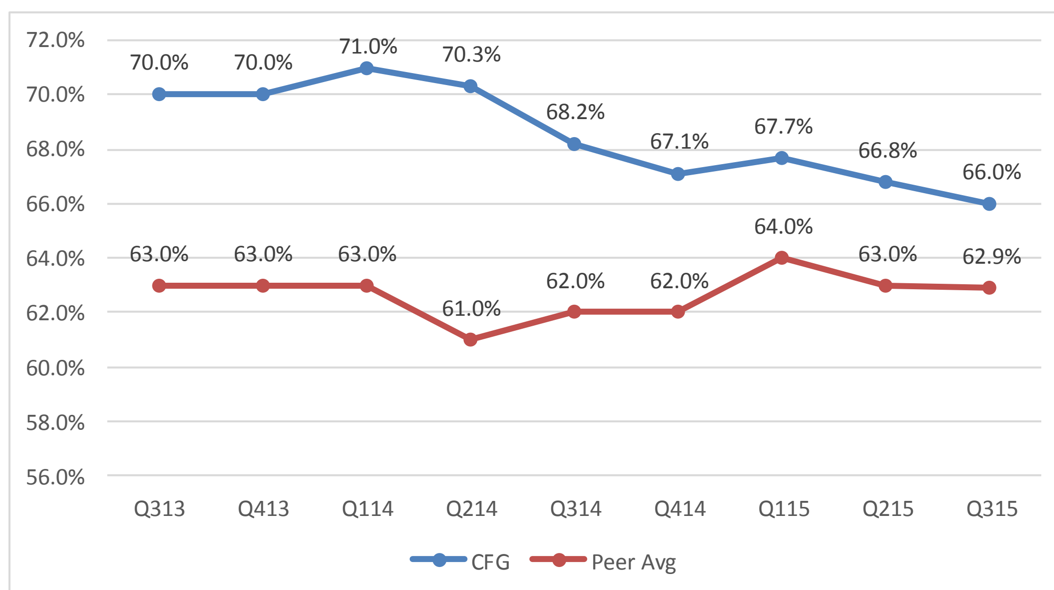
4. Targeted expense reductions have been a key focus of CFG's new management, which foresees a large runway to grow revenue faster than expenses, thus driving operating leverage. CFG has made good progress on the expense front. Total headcount has declined 21% from 2008. It has also reduced the branch square footage by >20% since 2009 and is gradually moving toward smaller branch formats. As leases expire, we think CFG could continue to reduce branch/occupancy costs.

At the time of the IPO (Sept. 2014), management unveiled a plan to reduce annual operating expenses by $200M by the end of 2016 (vs. a 2013 base). A large part of the projected savings is being invested in technology, new business development and risk/compliance capabilities in the near term. As of Q315, CFG's initial expense plan remains on track. Management has also been clear that if revenue growth lags expectations based on a persistent low-rate environment, it will turn to expense management to defend CFG's profitability improvement. More recently, CFG announced a plan to achieve incremental savings of $40M-50M via vendor consolidation, organizational efficiencies and additional cost reduction efforts. It also unveiled a plan to achieve incremental revenues through targeted pricing initiatives ($20M-$25M) and increased cross selling. We expect these savings could offset a meaningful % of potential lost revenue if rates stay low for long.

As noted above, CFG (under RBS) underinvested in technology and is playing catch up. It has spent $1.3B in technology since 2010 – roughly $500M above its natural tech spending ($150/yr.) – with an additional $490M planned for 2015/2016. These investments, which are designed to reduce costs and improve customer experience, include a new teller system (2013), contact centers, an upgrade of the ATM network (2013), and new origination platforms for commercial loans, auto loans and mortgages. Tech spending should peak in 2016 and decline markedly in 2017 and beyond.

Finally, there are substantial non-core (legacy) expenses that are scheduled to run off through 2016. These are comprised mostly of pay-fixed swaps that were implemented to manage interest rate exposure. From a peak of $200M in 2013, these expenses declined to $100M in 2014 and are estimated to be $60M and $25M in 2015 and 2016 respectively. This combined with the anticipated reduction in technology spending should provide a meaningful tailwind to earnings in 2017 and beyond.

Table 3: CFG Efficiency Ratio vs. Peer Group

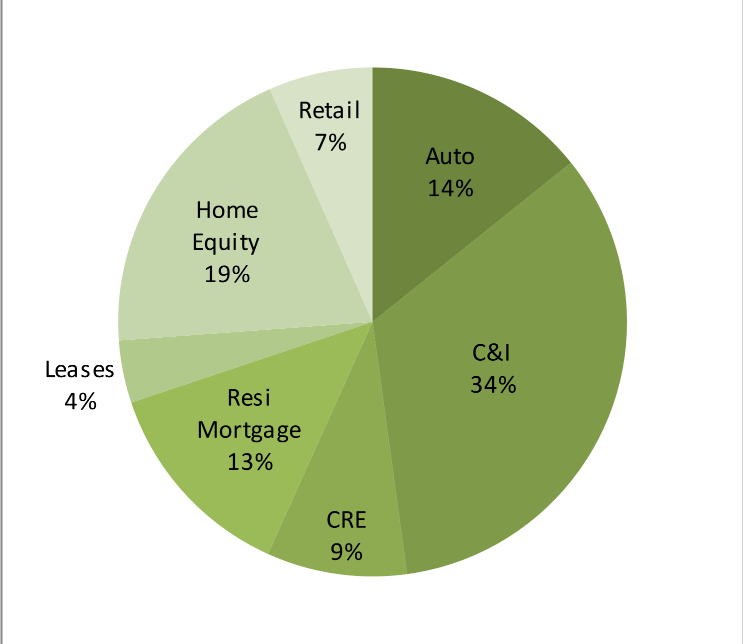


As is highlighted in Table 3, the expense initiatives are bearing fruit. CFG's efficiency ratio (non-interest expenses/total revenue) has been closing the gap with its peer group. In Q315, its efficiency ratio was 66.0% vs. 68.2% in Q314 and ~70% in the full year 2014. We think the efficiency ratio could approach 60% within 2-3 years.

5. CFG has a $97B loan portfolio that is balanced between consumer (55%) and commercial (45%) loans. Management is targeting a 50/50 mix. An estimated 55% of the loans have a variable interest rate. In Table 4, we detail CFG's loan portfolio

by product type at 9/30/15. Commercial and industrial loans represent 34% of the portfolio, followed by home equity (19%), residential mortgages (13%), auto (14%) and commercial real estate (9%). It is important to note that energy loans comprise <1% of the total. Moreover, in Q315, just 10% of y/y loan growth was from purchased loans, as CFG has continued to develop its originations capabilities.

Table 4: CFG loan portfolio (Q315)



In the consumer banking segment, CFG has increased its presence in the private student loan market. This is a much different market than the government-run market (which accounts for 93% of all student loans). In addition to its core True Fit student loan, CFG has developed a unique refi product that has experienced very strong demand. It targets borrowers who are already out of school with an established job (typically in their early 30s) and an average FICO of 780. We discussed this product when we wrote about some of the competitive problems that SLM was facing. According to management, the product generates very attractive returns, with only a few competitors in the space. Yields are in the 5.5% range with terms 60% fixed–40% variable. Importantly, CFG can convert some of these young borrowers into lifelong customers. Student loans comprise ~4.5% of CFG's total loan portfolio.

CFG has also renewed efforts in auto lending and has broadened its reach to more dealers (7,000 in 44 states). It implemented a new origination platform in 2013 that has enabled it to move into the prime category, whereas it was previously lending solely to super-prime borrowers (as dictated by RBS). This has led to increased average yields. The average FICO score in its auto portfolio is ~755 and

<3% are subprime. Based on strong recent origination volume, CFG has sharply reduced its auto loan purchases, which it had initially used to jumpstart the auto initiative. CFG grew auto loans by 14.9% in Q315 to $13.8B.

CFG is also investing in its mortgage origination capabilities where it has been significantly under represented. At the end of 2013, CFG had a 350-person operation and was ranked #25 in originations, despite a deposit rank of #12. It has since grown its origination force to >470 with a goal of reaching 700 by the end of 2017. We note that this target has been pushed back from the original date (2016) given the highly competitive hiring environment in residential mortgages. Year to date, CFG's mortgage loans have increased by 15%. CFG also has a growing credit card business and it recently entered into an exclusive agreement with Apple to provide iPhone installment financing. CFG's CEO recently noted that the initial pilot program has been exceptional.

In Commercial banking, CFG provides lending for commercial real estate, middle-market corporate finance, leases, trade services and asset-based lending services. It is also a top provider of capital to leading franchises including McDonald's, Taco Bell, Dunkin Donuts, Buffalo Wild Wings, and Applebee's. CFG currently has a growing presence in healthcare, technology, manufacturing and agriculture, and is pursuing increased penetration of gas station/convenience dealers. Although CFG remains underpenetrated in many key industry-specific verticals (consumer products, commercial real estate, and finance/insurance), it is seeking to build its presence in more specialty areas. This could provide potential growth for the commercial division. In Q315, total commercial loans increased 10% y/y including a 16% increase in commercial real estate.

At Q315, non-core loans amounted to $2.5B, down 22% y/y. These are loans that are inconsistent with strategic goals as a result of location, industry, product type or risk level. Since June 2009, CFG has actively reduced non-core loans by $18B via principal repayments, charge-offs, transfers back to core status and loan sales. The largest portion of non-core is the home equity serviced by others (SBO) portfolio. The SBO portfolio is a liquidating portfolio consisting of pools of home equity loans purchased between 2003 and 2007. The SBO balance was $1.5B (1.5% of total loans) at Q315 with a charge-off rate in the quarter of 1.2%. The credit profile of SBO is weaker with an average FICO of 713 and a combined LTV of 92%. Moreover, 95% is second lien (subordinated) with 72% in out of footprint geographies (CA, NV, AZ, FL). That said, credit quality is improving, as the weakest credits have already been charged off. A stronger housing market and economy should provide a larger equity cushion within the properties.

6. CFG has somewhat higher interest-rate sensitivity vs. its peer group. At Q315, management estimates that a gradual 200bp increase in short-term interest rates

would result in a 7.1% increase in net interest income (vs. ~4% for peers). Nearly 80% of CFG's asset sensitivity is centered in the very short end of the yield curve (<1 year). Thus, earnings should benefit from any hikes in the Fed Funds rate.

According to the company, 82% of the commercial loan portfolio and 50% of the home lending portfolio has a floating rate of interest. These should begin to reprice off the short-end of the curve as soon as rates begin to increase. We note that CFG also uses interest-rate swaps to hedge its balance sheet exposure to rate sensitivity. On the funding side, management estimates the company's beta on interest-bearing deposits (the % of increase that gets passed on to depositors) to be ~60% through a tightening cycle.

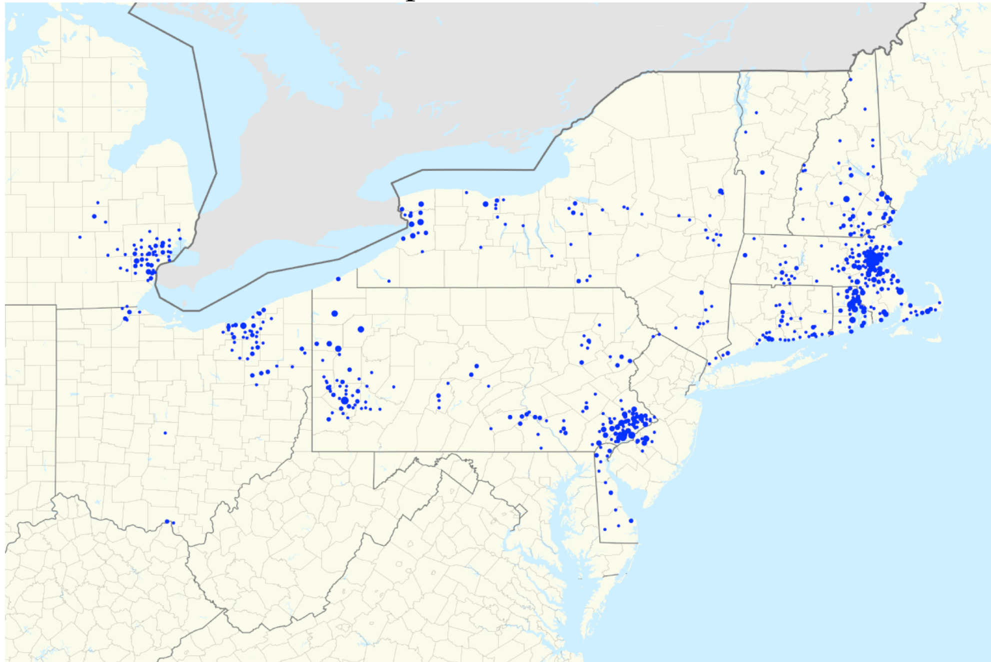
Table 5: Fed Funds Rate (1995-2015)

Thus, one risk to CFG's future earnings growth is if the Fed were to refrain from any rate hikes for a considerable period. Following the Fed's decision in September to abstain from its first rate hike in nearly a decade, CFG shares declined as earnings expectations were reduced. Current Fed funds futures imply a rate of ~1.4% at yearend 2017. We highlight a historical chart of the Fed Funds rate in Table 5. However, as we previously discussed, management has several levers to offset a meaningful portion of any potential impact resulting from an extended low rate environment. It could also choose to reduce its rate sensitivity in the future. Regardless, we think that expectations have been sufficiently reset.

7. CFG has built a unique and valuable franchise over the past several decades and has grown to become the 13th largest bank in the US. Its branch network (1,200 branches) extends across 11 states in New England, Mid-Atlantic and Midwest regions and through its online and mobile banking platforms. Within this footprint are an estimated 30M households and 3M businesses representing relatively

diverse economies and demographics that skew toward the affluent. In Table 6, we provide a map of the CFG network.

Table 6: CFG Branch Footprint (2015)



CFG has a long banking history in New England, where it has built a formidable consumer brand. It has the #2 market share in deposits in New England (slightly behind Bank America) with a #1 share in Providence, RI and Manchester, NH. Outside of New England, CFG has a #2 share in both Pittsburgh, PA and Albany, NY and a #5 share in Philadelphia. It also has a strong presence in upstate NY and Eastern Ohio. In 2014, CFG divested its Chicago retail branch network and realized a $288M gain on the sale. CFG had a relatively small market share in Chicago. It is reinvesting the proceeds into higher-return growth opportunities within markets where it holds stronger positions.

Given its scale, strong brand, and concentrated footprint in attractive geographies, we think CFG is a logical acquisition target for a larger regional bank or foreign financial institution that is seeking a foothold in the US. Although we are not predicting a future buyout of CFG, we think the considerable discount from our estimated private market value offers investors a substantial margin of safety.

In an attempt to calculate a realistic estimate of CFG's private market value (PMV), we analyzed >50 historical acquisitions of US banks (with at least $5B in total assets) going back to 2004. As we detail in Table 7, we looked at myriad valuation parameters including PE, P/TBV, P/Assets and implied deposit premiums. Over the 11-year period, the average P/TBV multiple on these transactions was 2.9x compared to CFG's current multiple of <1x. To be

conservative, however, we focused on acquisitions that took place after 2010 to account for the apparent reduction in deal multiples following the 2008/2009 financial crisis. Within just the past several days, KeyCorp agreed to acquire First Niagara, an underperforming ($40B assets) bank situated in upstate NY. The $4.1B deal implies a multiple of 1.7x TBV and 18.7x FTM EPS.

Based solely on the post 2010 transaction data, the historical average P/TBV was 1.6 and the average FTM PE was 18.7. Not surprisingly, as the TBV multiple shrunk in the more recent period, so did the average core deposit premium – from 23.8% for the entire 11-year period to 9.4% for the post-2010 period. We note that in 2014, CFG sold its Chicago retail banking operation for a reported deposit premium of 6%. We would argue that its remaining operations are worth more than the Chicago business. Thus the 7% deposit premium that is implied from our PMV calculation seems reasonable.

Table 7: Historical US banking acquisition metrics

Average Multiples	P/TBV	FTM PE	P/Assets	Deposit Premium	Blended PMV
2004-2015	2.9	19.2	21.2%	23.8%	
2011-2015	1.6	18.7	17.2%	9.4%	
CFG current	0.9	12.9	11.4%	NA	
CFG PMV 2015e*	$38.81	$34.60	$39.29	7.1%	**$37.57**
CGG PMV 2017e *	$42.83	$41.10	$45.10	7.0%	**$43.01**

* based on acquisition multiples from 2011-2015

If we apply the more conservative average multiples (post-2010) to CFG’s current financials, we arrive at a PMV range of $35−$40. If we apply the same metrics to our yearend 2017 estimates, we arrive at a PMV of $41−$45 per share. While our PMV analysis is far from an exact science, it nonetheless highlights the substantial current discount of CFG shares. As an aside, the previous financial company we recommended (Symetra Financial) was recently acquired for $32, or roughly 3x our recommendation price.

8. There are a number of risks to an investment in CFG. As with most domestic banks, the key risk is a significant deterioration in the US economy, which would result in increased credit impairments and lower loan growth. Persistent low interest rates are another risk to CFG, especially given the higher than peer asset sensitivity. Management’s failure to execute on its operating plan could also lead to subdued earnings growth. Finally, rapid increases in technology eventually could render branch-based banking to be a high cost method of delivering financial services.

9. Recent results

For the most recent quarter (Q315), CFG reported adjusted EPS of $0.40 vs. $0.36 in Q314. Net interest income increased 4.4% to $856M and fee income increased 3% to $353M. Total revenue increased 4.2% to $1.2B. Non-interest expenses increased 0.8%. This operating leverage drove a 200bp improvement in the efficiency ratio to 66.0% in Q315. The net interest margin improved sequentially from 2.72% to 2.76% despite persistent low interest rates. Increased loan yields and a reduction in cash and securities more than offset a slight increase in deposit costs. Average diluted shares declined 5% y/y due to share repurchases. The tax rate also ticked up by 100bp to 34%.

Total loans increased 7.4% y/y to $97.4B, led by strong growth in commercial real estate, auto originations and residential mortgages. Average deposits grew 10% y/y to $101B resulting in a loan to deposit ratio of 96%. Credit trends remained strong, with non-performing loans down 2% sequentially and 4% y/y. The net charge-off ratio was 0.31%. The loan loss reserve was flat sequentially at $1.2B or 1.23% of total loans. CFG's capital position remained extremely strong, with a common equity tier 1 ratio of 11.8%. At 9/30/15, TBV was $24.52 – up 6.5% y/y.

10. Financial projections

For 2016, we estimate total average interest earning assets to grow by 5% to $129B. This growth rate should be driven primarily by a 5.7% increase in total loans offset somewhat by a reduction in cash/securities and a 4.2% increase in deposits. Next, we estimate a 7.7% increase in net interest income to $3.6B or a 2.82% NIM, up from 2.76% in 2015, based on a moderate increase in the average loan yield and a relatively stable cost of deposit funding. Non-interest income should increase by 4.0% to $1.5B. This results in total revenue of $5.1B for 2016, a 6.7% y/y increase. Next, we estimate provision expense of $417M (22.3% of net revenue) vs. $298M (18.6%) in 2015 as we expect credit trends to normalize (including the relative absence of large credit recoveries). Net charge-offs are estimated at 0.4% vs. 0.31% in 2015. Non-interest expense increases by 2% to $3.3B, driven by continued expense control and a reduction in legacy costs. This positive operating leverage results in a 10% increase in pretax income and an efficiency ratio of 63.8% in 2016. After deducting income taxes and a preferred dividend, 2016 EPS is $1.85 on a 3.6% reduction in average shares. We assume CFG repurchases $450M of its shares in 2016. Our estimates imply a return on average tangible equity (ROTE) of 7.3% vs. 6.7% in 2015. Moreover, at 12/31/16, we forecast a CET1 ratio of 11.3% and a loan/deposit ratio of 97.4%. TBV is estimated at $25.99. This assumes a 2016 dividend of $.50 vs. $0.40 in 2015.

For 2017, we estimate total average interest earning assets to grow by 4.7% to $135B. This growth rate should be driven primarily by a 4.6% increase in total loans, offset somewhat by a reduction in cash and investments and a 3.6% increase in deposits. Next, we estimate an 8% increase in net interest income to $3.94B, or a 2.92% NIM, up from 2.82% in 2016, based on a moderate increase in the average loan yield. Non-interest income should increase by 4% to $1.54B. This results in total revenue of $5.5B for 2017. We estimate provision expense of $515M vs. $417M. Net charge-offs are estimated at 0.5% vs. 0.4% in 2015. Non-interest expense increases by 1.2% to $3.3B, driven by continued expense control and the normalization of technology spending. This positive operating leverage results in a 16% increase in pretax income and an efficiency ratio of 60.3% in 2017. After deducting income taxes and a preferred dividend, 2017 EPS is $2.20 on a 2.5% reduction in average shares. We assume CFG repurchases $450M of its shares in 2017. Our estimates imply a return on average tangible equity (ROTE) of 8.24% vs. 7.26% in 2016. At 12/31/17, we forecast a CET1 ratio of 11.0% and a loan/deposit ratio of 98%. TBV is estimated at $27.41.

11. CFG shares seem compelling on a risk-reward basis, especially relative to current alternative equity investment opportunities. We like the spin-off like dynamic, the overcapitalized balance sheet, the accretive buybacks and the higher-than-peer EPS growth profile**.** CFG also has a miniscule exposure to energy loans. Moreover, if bank M&A continues to accelerate, it could drive multiple expansion for CFG. CFG shares are inexpensive at 0.95x TBV. Through a combination of mid-single digit loan growth, an improved asset mix, progressive expense reductions, and accretive share repurchases, EPS should increase from $1.42 in 2014 to $2.20 in 2017 and $2.40 in 2018. At yearend 2017, we project TBV to be $27.41. Our estimates assume ROTE of 8.24% in 2017.

At <1x TBV, we think investors are getting two free call options: one on an eventual increase in ST interest rates; and another on a potential acquisition of the entire company. CFG is a growing regional bank with considerable scale ($136B in assets) and a valuable, well-situated and difficult-to-replicate footprint. CFG is a logical future acquisition candidate. We estimate PMV in a range of $35-$38. Our 12-18 month price target is $31, which implies a P/TBV of 1.12 based on our 2017 forecast. Longer term, we think the share price could move significantly higher than our target price. Importantly, the downside should be minimal based on the discount to TBV, the strong balance sheet, the buyback program and the large discount from PMV.

12. Financial Tables

a. annual projections	2013	2014	2015e	2016e	2017e	2018e
Avg. interest earning assets	107,100	116,200	122,953	129,347	135,426	141,655
Average deposits	93,300	92,600	99,500	103,281	106,896	110,637
Net interest margin (NIM)	2.86%	2.84%	2.76%	2.82%	2.91%	2.93%
Total funding cost	0.61%	0.45%	0.53%	0.55%	0.57%	0.59%
Total Interest Income	3,501	3,664	3,847	4,145	4,476	4,724
Total Interest Expense	443	363	455	493	529	567
Net Interest Income (NII)	3,058	3,301	3,392	3,653	3,947	4,157
Total Noninterest Income	1,632	1,390	1,416	1,472	1,540	1,580
Total Revenue	4,690	4,691	4,808	5,125	5,487	5,737
provision for credit losses	479	319	297	417	515	630
Revenue net of provision	4,211	4,372	4,511	4,708	4,972	5,107
Total Noninterest expense	3,218	3,223	3,201	3,262	3,294	3,343
Pretax income	993	1,149	1,310	1,446	1,678	1,764
Income tax expense	322	359	440	473	554	582
Preferred dividend	0	0	7	14	14	0
Adjusted net income	671	790	863	959	1,111	1,182
EPS	$1.20	$1.42	$1.60	$1.85	$2.20	$2.40
Average shares - FD	560	558	538	519	506	493
Y/Y % Change						
Avg. interest earning assets		8.5%	5.8%	5.2%	4.7%	4.6%
Average deposits		-0.8%	7.5%	3.8%	3.5%	3.5%
Net interest margin (NIM)		-0.5%	-2.9%	2.4%	3.2%	0.7%
Total Interest Income		4.7%	5.0%	7.8%	8.0%	5.5%
Total Interest Expense		-18.1%	25.3%	8.3%	7.5%	7.1%
Net Interest Income (NII)		7.9%	2.8%	7.7%	8.1%	5.3%
Total Noninterest Income		-14.8%	1.9%	4.0%	4.6%	2.6%
Total Revenue		0.0%	2.5%	6.6%	7.1%	4.6%
provision for credit losses		-33.4%	-6.9%	40.4%	23.5%	22.3%
Revenue net of provision		3.8%	3.2%	4.4%	5.6%	2.7%
Total Noninterest expense		0.2%	-0.7%	1.9%	1.0%	1.5%
Pretax income		15.7%	14.0%	10.4%	16.1%	5.1%
Income tax expense		11.6%	22.4%	7.6%	17.1%	5.1%
Adjusted net income		17.7%	9.3%	11.1%	15.8%	6.4%
EPS		18.2%	13.2%	15.3%	18.7%	9.2%
Average shares - FD		-0.4%	-3.5%	-3.7%	-2.4%	-2.5%
TBV/share		3.8%	5.9%	4.7%	5.4%	5.6%

Other Key Metrics	2013	2014	2015e	2016e	2017e	2018e
Pretax income/revenue	21.2%	24.5%	27.2%	28.2%	30.6%	30.7%
Tax rate	32.4%	31.3%	33.6%	32.7%	33.0%	33.0%
Efficiency ratio	68.6%	68.7%	66.6%	63.7%	60.0%	58.3%
Non-interest expense/earning assets	3.0%	2.8%	2.6%	2.5%	2.4%	2.4%
Provision/PT income	32.5%	21.7%	18.5%	22.4%	23.5%	26.3%
Net charge-off/loans	0.59%	0.36%	0.31%	0.40%	0.48%	0.58%
Loan/Deposit ratio	89.7%	97.6%	95.9%	97.4%	97.9%	98.9%
CET1 ratio	13.5%	12.4%	11.7%	11.3%	11.0%	10.8%
Return on tangible equity	5.1%	6.1%	6.7%	7.3%	8.2%	8.5%
TBV/share	$22.61	$23.46	$24.84	$26.01	$27.41	$28.94

b. quarterly projections	Q415e	Q116e	Q216e	Q316e	Q416e
Total Interest Income	979	999	1,022	1,061	1,063
Total Interest Expense	118	120	122	125	126
Net Interest Income (NII)	861	879	900	936	937
Total Noninterest Income	356	361	366	371	374
Total Revenue	1,217	1,240	1,266	1,307	1,311
provision for credit losses	86	94	99	105	119
Revenue net of provision	1,131	1,146	1,167	1,202	1,192
Total Noninterest expense	802	809	814	820	819
Pretax income	329	337	353	382	373
Income tax expense	109	112	116	126	118
Preferred dividend	0	7	0	7	0
Adjusted net income	220	218	236	249	255
EPS	$0.41	$0.41	$0.45	$0.48	$0.49
Average shares - FD	530	530	526	519	516
Y/Y % Change					
Avg. interest earning assets	4.7%	4.0%	3.7%	5.3%	5.7%
Total Interest Income	4.1%	6.1%	7.3%	9.0%	8.6%
Total Interest Expense	16.8%	12.7%	8.5%	5.9%	6.8%
Net Interest Income (NII)	2.5%	5.2%	7.2%	9.4%	8.9%
Total Noninterest Income	5.0%	4.0%	1.7%	5.1%	5.1%
Total Revenue	3.2%	4.9%	5.5%	8.1%	7.8%
provision for credit losses	19.4%	62.1%	28.6%	38.2%	38.4%
Revenue net of provision	2.2%	1.9%	3.9%	6.1%	5.4%
Total Noninterest expense	1.4%	1.1%	1.6%	2.8%	2.1%
Pretax income	4.2%	3.9%	9.6%	14.2%	13.5%
Income tax expense	10.1%	2.3%	8.7%	10.8%	8.3%
Adjusted net income	1.4%	1.4%	10.1%	16.4%	16.1%
EPS	5.4%	5.2%	13.1%	19.7%	19.2%
Average shares - FD	-3.8%	-3.6%	-2.6%	-2.7%	-2.6%

(amounts in $000, except ratios)			
Current debt		10,014,000	
Current Equity		19,353,000	
Current tangible BV		12,939,000	
Current market value		16,199,980	
Current cash		2,119,000	
Current DSO		NA	
Current DIO		NA	

FYE December	2014	2015e	2016e
EBIT	1,149,000	1,309,894	1,453,747
EBITDA	1,151,700	1,312,594	1,456,647
Free cash flow	797,270	869,126	970,297
Surplus cash flow (NI+D&A - capex)	781,638	852,085	951,272
Capex	11,000	14,000	16,000
EV/EBITDA	20.9	18.4	16.5
EV/(EBITDA-capex)	21.1	18.6	16.7