UBS Restructured

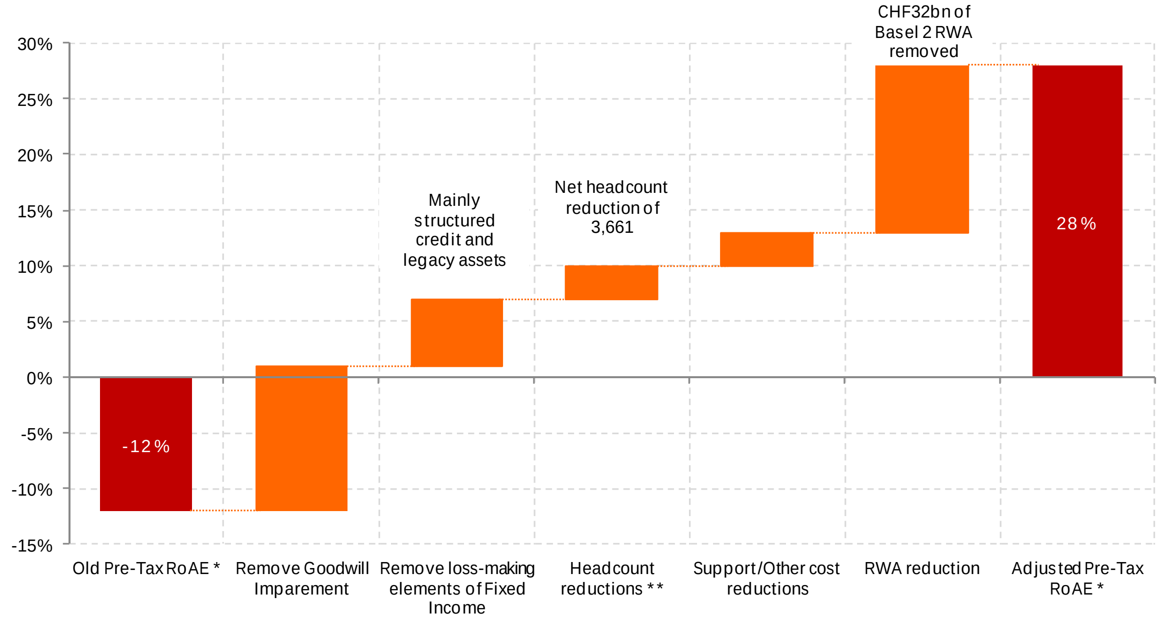
- As forecast in our Oct-12 note, UBS Investment Bank has, in 1Q13, had little trouble meeting its cost/income and return on allocated equity (RoAE) targets.
- There is no sign that fixed income clients are deserting the bank.
- UBS has retained some high margin/RWA-intensive businesses in their 'Financing Solutions' and FICC business units. This, in our view, was the correct decision.
- We maintain our FY13E forecast of cost/income of 79% and pre-tax RoAE of 18% - both comfortably above the bank's own target – for Investment Bank.

UBS reported its 1Q13 results in the new format: the 'new' UBS Investment Bank now comprises Corporate Client Solutions (CCS) and Investor Client Services (ICS) divisions. UBS' 1Q13 results provide the first opportunity to assess the effectiveness of the newly configured division.

We commented on UBS' FICC restructuring in our 31-Oct-12 note. At the time, we wrote that '…Investment Bank will have little trouble meeting [its cost/income and RoAE goals]'. In 1Q13, the bank handsomely exceeded both targets. Under the old reporting format, UBS Investment Bank had a pre-tax loss of CHF2.7bn in FY12; the reported cost/income ratio was 132% and RoAE was -11.5%. The improvement in 1Q13 was impressive, to say the least: the Investment Bank reported cost/income ratio of 65%, compared to 91% average for the previous 8 quarters. Even excluding the fees earned from a 'large private transaction' in 1Q13, which were booked in ECM, the cost/income was probably not much above 70%, and therefore near the low end of the Investment Bank's target 65-85% range. The reported RoAE reached 50%, suggesting some 31-34% without the private fee – 2x the stated 15%+ target. Seasonality aside, this was a strong result.

So how was this achieved? We carried out a detailed analysis comparing the original FY12 financials and the restated data, looking at the changes from the start the year to the year end to see how each had impacted RoAE.

FY12 RoAE: Old-vs-New Investment Bank reporting format



Source: UBS, Tricumen analysis. Notes: * 'Old Pre-Tax RoAE' is based on the average allocated equity reported during 1Q-4Q12 in the old reporting format. Conversely, 'Adjusted pre-tax RoAE' is based on the 1Q-4Q12 average allocated equity reported under the new reporting format. ** Net headcount reduction: year-end 2012 personnel FTE of 13,595 as reported at end-1Q13 (new structure) versus 17,256 as reported under the old structure for end-FY11.

The first material difference is the removal of a CHF3bn goodwill impairment cost relating to the 3Q12: this uplifts FY12 RoAE by 13%, from -12% to +1%, in effect providing the normalised baseline starting point. The closure of a number of lossmaking fixed income businesses (which we estimate were suffering quarterly losses of CHF164m on average) boosts RoAE by 6%; and cut in comp & benefits and other expenses added 3% each. Together, these adjustments lift the RoAE to 13%.

However, in our view it is the RWA reduction that had by far the greatest impact on RoAE. Under the old (Basel 2) reporting format the Investment Bank reduced its RWA from CHF119bn at end-FY11 to just CHF87bn at end-FY12; a 27% cut in a single year. In the new reporting format, which is also aligned with Basel 3, end-FY12 RWA stood at CHF64bn. Although there was a 7% growth in 1Q14, this was still well within the bank's <CHF70bn target. We estimate the bank's aggressive reduction of RWA added 15% to our adjusted RoAE – more than all other contributing factors put together.

Commenting on UBS' FICC (now called Foreign Exchange, Rates and Credit - FERC) restructuring plans at the time of the announcement, we forecast that Investment Bank would comfortably exceed its profitability targets. However, we also stated that UBS faced formidable challenges: that of maintaining DCM capability while exiting many FERC businesses; and execution risk associated with selective exit from hitherto interconnected businesses. While these risks remain, the bank's performance 1Q13 suggests that they are diminishing. 1Q13 DCM revenues (CHF249m) were strong; UBS also commented that credit flow revenues were higher, both of which suggest that fixed income clients are not deserting the bank, as some predicted.

Similarly, it appears that UBS still runs some of its profitable structured businesses within the confines of a reconfigured 'RWA-light' environment. UBS highlighted the positive performance of structured finance and special situations groups in the Financing Solutions unit. Similarly, in FERC, UBS attributed the strong performance in 1Q13, in part, to higher revenues in the rates solutions.

UBS' decision to retain structured finance, special situations, CMBS and rates solutions businesses appears to run contrary to their stated focus on 'flow'. However, we see these higher capital/higher margin units as useful components to the Investment Bank's portfolio of businesses, particularly as UBS has a good track record in many of them.

Looking ahead, the question is whether this performance can be sustained. In our view, the answer is 'yes' – though in inherently turbulent capital markets that is necessarily subject to a 'no major upheavals' caveat (including unfavorable regulatory moves). In our 31-Oct-12 note, we forecast Investment Bank's FY13E cost/income of 79% and pre-tax RoAE of 18% - both comfortably above the bank's own target. We see nothing in 1Q13 results that would prompt adjustment to these figures.

All of this will no doubt offer food for thought to banks that have struggling fixed income divisions. In particular, it highlights the importance of effective RWA management and analysis in the new financial order.

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