

TRADING BUY INTO 2009 RESULTS ON 25 FEBRUARY

On 19 January we initiated coverage on Lloyds Banking Group with a SELL rating and target price of 49p. Subsequently, the share price fell in line with our price target, prompting us to upgrade to HOLD on 17 February. We still expect Lloyds will have to sell its investments in other financial institutions (mainly Scottish Widows) to improve its Core Tier 1 capital ratio, which under the Basel III proposals is exceptionally low by our analysis.

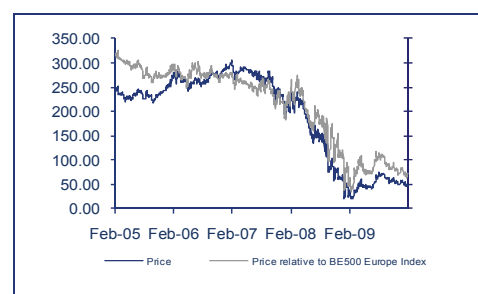
We believe that most market participants judge this to be a very bearish scenario. However, at the current price of 51p, we believe this is largely priced in (we explain below). Any better-than-expected news from the FY 2009 results (with respect to margins, loan losses or development of capital adequacy) would be likely to send the shares rising substantially. We therefore recommend a Trading BUY into the results. We also discuss the key details we will be looking at in the 2009 results that would make us more bullish.

- Our 49p price target is rationalised as follows. Our earnings model indicates 2012 EPS of 7.7p, which is only 8% below the consensus estimate. Our own estimate is unadjusted for Basel III. If, as is our expectation, Lloyds is forced to sell its investments in other financial investments because its Basel III Core Tier 1 ratio is too low, then this would solve its lack of capital adequacy, but would mean that group earnings would be negatively impacted by some 15%. This would result in our 2012 EPS estimate falling to 6.5p. Putting this on a 10x multiple, then discounting back at 10% for three years, results in our simple price target of 49p today.
- We believe most analysts would agree that if the Basel III proposals were implemented as of year-end 2009, then the impact would be significantly negative. Our own analysis points to a Core Tier 1 ratio of only 3.9% at year-end 2009 on this basis (see Figure 1). The key deduction against common equity is due to the investments in other financial entities, amounting to £10bn.
- Where the bullish and bearish analysts differ is on how much organic capital generation can be made from year-end 2009 to year-end 2012. This is a function of organic earnings generation and RWA reduction. We currently estimate that Lloyds can increase its Core Tier 1 ratio by only 0.82% to year-end 2012. Bullish analysts forecast an increase of some 400bps, (therefore avoiding the need to divest interests in other financial entities). However, this implies larger annual increases than that which the best performing banks usually generate. We are currently sceptical that Lloyds can achieve these lofty long-term ambitions, but at the current price, we believe this scepticism is priced in.

Andrew Lim +44 20 3206 7347 andrew.lim@matrixgroup.co.uk

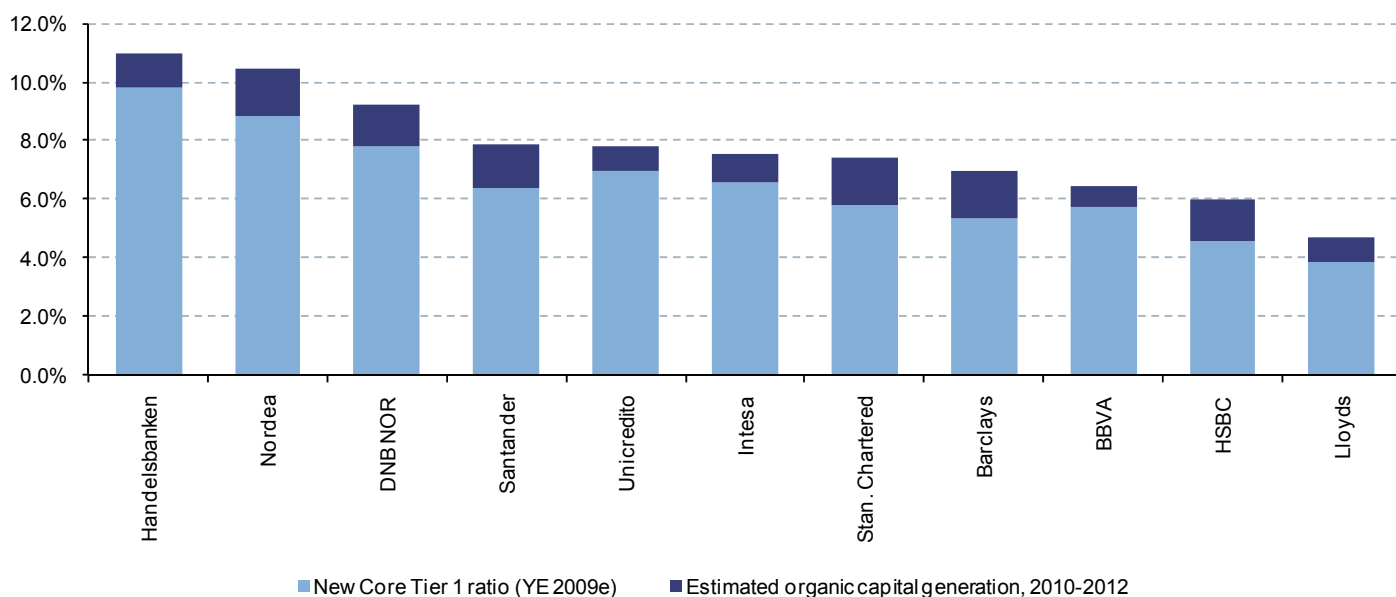
Rating	HOLD
Target price (p)	49.00
Yesterday's closing price (p)	50.52
Upside / Downside	-3%
Market cap (€b)	38.4
Market cap (£b)	33.8
Sector	Pan-European Banks

(GBP/£m)	2009A	2010E	2011E
Net interest income	13,406	14,615	14,343
Net fees & commissions	1,371	2,633	2,580
Trading profits/losses	700	1,387	1,318
Other revenue	9,102	7,755	7,755
Total operating revenues	24,580	26,390	25,996
Operating costs	-11,967	-12,831	-12,205
Operating profit	12,613	13,558	13,792
Total provisions	-22,822	-15,480	-10,510
Pre-tax profit	-10,287	-2,387	2,816
ROA	-0.48%	-0.13%	0.22%
ROE	-14.29%	-3.56%	5.74%
ROTNNAV	-17.41%	-4.27%	6.93%
Cost/Income	-48.69%	-48.62%	-46.95%
Payout	0.00%	0.00%	13.86%
Net interest margin	2.58%	1.97%	2.00%
LLC % gross loans	-3.34%	-2.39%	-1.70%
NPL ratio	8.50%	8.00%	7.00%
NPL coverage ratio	45.00%	50.00%	60.00%
Loans % deposits	169%	158%	150%
Core tier 1 ratio	8.06%	7.51%	8.03%
EPS	-10.34	-2.22	3.60
DPS	0.00	0.00	0.50
P/TNAV	0.94	1.01	0.94
Div yield	0.00%	0.00%	0.99%



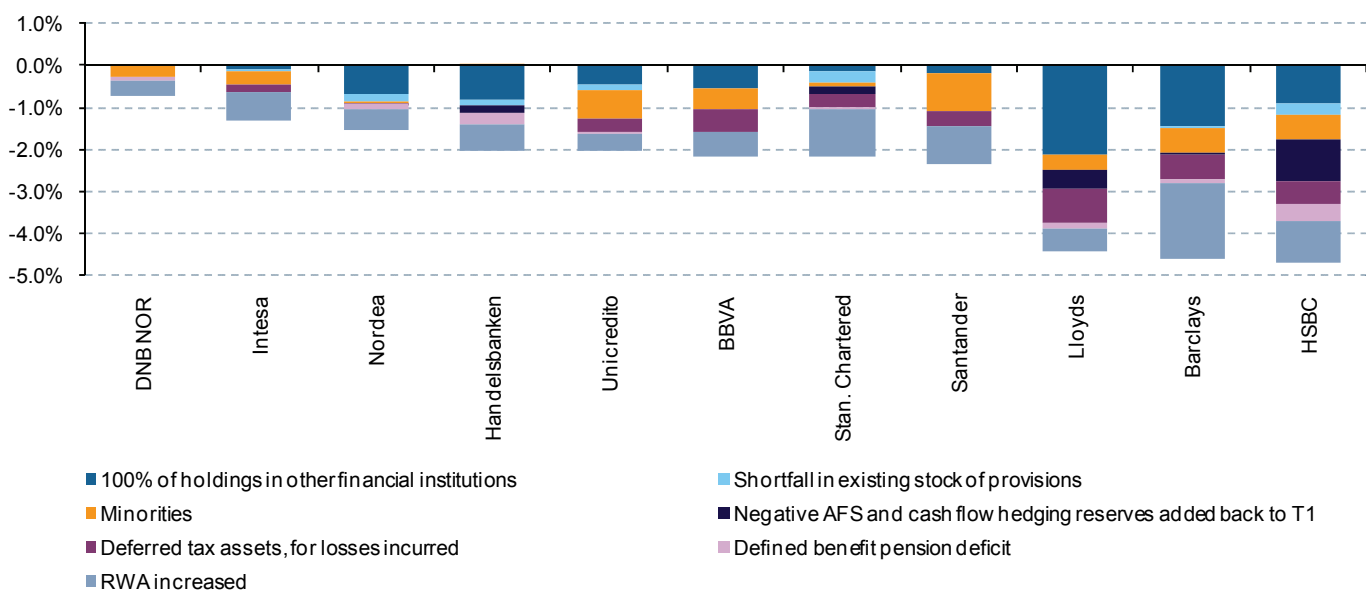
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Figure 1: Banks Ranked by Expected Core Tier 1 Ratio Under Basel III at Year-end 2012



Source: Matrix Corporate Capital Research

Figure 2: Individual Impacts on Core Tier 1 Ratio as at Year-end 2009



Source: Matrix Corporate Capital Research

Key Details to Look for in the 2009 Results

The 2009 results are expected to be littered with some large non-operating items which will be hard to predict, leading to a wide variation in analyst estimates. For example, we expect H2 2009 earnings to include some £2bn in fair value unwind of HBOS' own debt. Our own earnings table is in Figure 3 (below).

We believe it will be important to concentrate on the 'clean' figures, as below. The operating profit, including provisions but excluding FV unwind and other non-operating gains, will be the key line to look at, in our view. We expect a loss of £10.3bn.

Operating Revenues

We expect Group operating revenues to be £12.6bn in H2 2009, representing a 6.0% increase on H1 2009. The increase is driven by an expected increase in net interest income, where we see the net interest margin improving to 1.85% in H2 2009 from 1.72% in H1. Management guidance is for NIM to improve as wholesale funding costs decrease, to the extent that the NIM in 2010 should approach (but not exceed) the NIM achieved in 2008, which was 2.0% on a pro-forma basis.

If management reaffirms an expectation that the NIM should improve to 2008 levels, then we believe this should be taken positively. It would be even more bullish if management provided further guidance that the NIM could improve beyond this, due to the attractive margins on new business and the continued fall in funding costs.

Note that it is difficult to model the other items of operating revenues since an exact breakdown on a pro-forma basis has not been provided by the company.

Asset Quality

Management has been quite clear that H1 2009 included significant upfront provisioning for the commercial real estate portfolio that it acquired from HBOS. On this basis, loan-loss charges for H2 2009 should be much lower, but how much lower is very much open to debate (this is a key reason for the variability in analysts' earnings estimates). The loan-loss charge, on Matrix calculations, was -3.86% on average gross loans in H1 2009. We see this falling substantially to -2.80% in H2 2009. This implies total bad debts for 2009 of £22.8bn, compared to the consensus estimate of £23.5bn.

Guidance by management on loan losses expected for 2010 will be crucial, in our view, since there is a lot of variability on this metric among the analyst community.

Just as important will be the development of non-performing loans as an indicator of whether asset quality is stabilising, or indeed improving. On Matrix calculations, the NPL ratio was 7.2% in H1 2009. We see this deteriorating to 8.5% in H2 2009.

Core Tier 1 Ratio and Loan-to-Deposit Ratio

The conundrum for Lloyds is how to reduce its very high loan-to-deposit ratio of 170% to its soft target of ~140% over the next few years, without contracting its loan book to the extent that growth in net interest income is impaired, the earnings recovery is weak, and the Core tier 1 ratio (on a Basel III basis) remains low, such that it has to sell its investments in other financial entities (mainly Scottish Widows).

If management can convince the market that it is moving in the right direction in this respect, then it would be very positive for the stock. It would lead to the market perceiving the stock as having adequate capital, underpinned by strong normalised earnings and a high ROE. We are currently sceptical that this can be achieved, but concede that Lloyds is somewhat of a special case where allowing non-core assets (mainly pertaining to the HBOS loan portfolio) could lead to a greater than proportionate fall in RWA versus loans, thereby still maintaining strong NII.

In this respect, we would therefore be looking in the 2009 results at the development of:

- RWA versus loans
- The Core Tier 1 ratio
- The progress made in reducing the LTD ratio.

Figure 3: Lloyds Banking Earnings Table

	FY2008	H1 2009	H2 2009E	FY 2009E	FY 2010E	FY 2011E	FY 2012E
INCOME STATEMENT (£m)							
Net interest income	7,718	6,442	6,964	13,406	14,615	14,343	13,972
Net fees & commissions	2,537	0	1,371	1,371	2,633	2,580	2,580
Trading profits/losses	-9,186	0	700	700	1,387	1,318	1,252
Other revenue	8,799	5,497	3,605	9,102	7,755	7,755	7,755
Total operating revenues	9,868	11,939	12,641	24,580	26,390	25,996	25,559
Operating costs	-6,000	-5,718	-6,249	-11,967	-12,831	-12,205	-12,110
Operating profit	3,868	6,221	6,392	12,613	13,558	13,792	13,448
Total provisions	-2,876	-13,399	-9,423	-22,822	-15,480	-10,510	-6,530
Impairments on other assets	-136	0	-78	-78	-465	-465	-465
Goodwill impairment	-100	0	0	0	0	0	0
Pre-tax profit	756	-7,178	-3,109	-10,287	-2,387	2,816	6,454
Other income/loss	4	3,221	2,000	5,221	400	400	400
Taxes	38	1,203	310	1,513	556	-901	-1,919
Minorities	-26	-58	8	-50	14	-23	-49
Other non-operating items	0	-2	-1	0	0	0	0
Net profit	772	-2,814	-791	-3,602	-1,416	2,293	4,885
ASSETS (£m)							
Loans to customers	240,344	652,599	627,449	627,449	594,857	569,695	546,739
Interbank loans	38,733	37,398	37,398	37,398	38,146	39,687	41,290
Total securities	105,187	264,877	272,576	272,576	261,782	251,416	241,460
Intangible assets	2,453	6,574	6,574	6,574	6,705	6,976	7,258
Total assets	436,033	1,063,129	1,071,475	1,071,475	1,060,110	1,055,253	1,053,290
Net interest-earning assets	284,085	750,381	755,423	755,423	727,238	707,424	690,033
LIABILITIES (£m)							
Interbank borrowings	66,514	112,909	107,264	107,264	96,805	87,367	78,849
Customer deposits	263,904	700,637	711,282	711,282	715,605	719,972	724,382
Total shareholders' equity	9,393	35,026	41,026	41,026	38,596	41,275	45,551
Tangible net asset value	6,940	28,452	34,452	34,452	31,891	34,299	38,292
IMPORTANT FINANCIAL RATIOS							
ROA	0.20%	0.00%	-0.15%	-0.48%	-0.13%	0.22%	0.46%
ROE	7.17%	-15.91%	-4.25%	-14.29%	-3.56%	5.74%	11.25%
ROTNV	9.32%	0.00%	-5.16%	-17.41%	-4.27%	6.93%	13.46%
Cost/income	-60.80%	-47.89%	-49.43%	-48.69%	-48.62%	-46.95%	-47.38%
Tax rate	5.00%	0.00%	-28.00%	-29.88%	-28.00%	-28.00%	-28.00%
Payout	83.94%	0.00%	0.00%	0.00%	0.00%	13.86%	40.00%
Net interest margin	2.90%	1.72%	1.85%	2.58%	1.97%	2.00%	2.00%
LLC % gross loans	-1.25%	-3.86%	-2.80%	-3.34%	-2.39%	-1.70%	-1.10%
Non-performing loans % gross loans	3.53%	7.17%	8.50%	8.50%	8.00%	7.00%	6.00%
NPL coverage ratio	33.06%	42.23%	45.00%	45.00%	50.00%	60.00%	70.00%
Loans % deposits	140.60%	176.43%	168.78%	168.78%	158.43%	150.22%	142.74%
Tier 1 ratio	8.04%	8.62%	10.46%	10.46%	9.92%	10.43%	11.28%
Core tier 1 ratio	5.60%	6.28%	8.06%	8.06%	7.51%	8.03%	8.88%
Equity % total assets	2.15%	3.29%	3.83%	3.83%	3.64%	3.91%	4.32%
RWA % total assets	39.10%	45.38%	43.90%	43.90%	44.37%	44.58%	44.66%

Source: Matrix Corporate Capital Research

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Matrix Corporate Capital LLP

One Vine Street

London, W1J 0AH

+44 (0) 20 3206 7000