

UPGRADE TO BUY; SOVEREIGN CONCERNS UNWARRANTED

The positive interim management statement released by Lloyds on 27 April 2010, followed by weakness in the share price due to the current sovereign debt crisis (unwarranted in our opinion), leads us to upgrade our rating to BUY from HOLD, and increase our target price to 80p (from 68p). Our new price target represents 1.15x 2011E tangible NAV of 69.6p. We believe this is fair considering that we expect RoTNAV of 12.1% in 2011. Substantial further upside exists if Lloyds goes on to achieve a RoTNAV in 2012 that is consistent with our forecast of 15.9%.

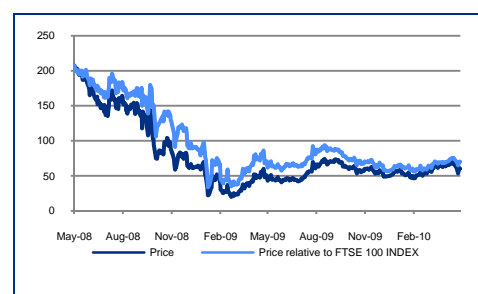
- We believe any concerns for Lloyds from the sovereign debt crisis are unwarranted for a number of reasons. The CDS spread for the UK has increased only modestly in recent days and weeks as the sovereign debt crisis has intensified. The CDS spread for Lloyds itself has increased, but less than for the large cap banks in the peripheral European countries. We believe this reflects the credit market's relatively relaxed attitude towards contagion risks for the UK, based primarily on the fact that the UK has its own freely floating currency (which helps its economy to automatically rebalance itself with its trade partners), and the fact that UK sovereign debt has an average maturity that is nearly double the average for the continental European countries.
- We also believe that any deterioration in NIM arising from higher funding costs (should they occur) would affect Lloyds' future earnings potential by only a small amount. In our opinion, the main reason for buying Lloyds shares is because of the normalisation of loan losses, where the company is ahead of schedule. Using Dupont analysis, we show that the normalisation of loan losses should contribute to a 207bps increase in ROA over 2009–2012, while the improvement in NIM to 2.05% (from the 1.70% achieved in H1 2009) should result in an improvement in ROA of only 31bps.
- We have increased our earnings estimates significantly to account for the fact that Lloyds already made a pre-tax profit in Q1 2010, mainly on the basis that loan losses were normalising much quicker than we had expected. We expect Lloyds to make a meaningful pre-tax profit (including fair value gains) of £1.1bn for H1 2010 and £3.6bn for FY 2010. This is substantially ahead of the current consensus forecasts of a pre-tax loss of £0.9bn for H1 2010 and profit of £0.8bn for FY 2010. We expect EPS of 8.0p and 12.0p in 2011 and 2012 respectively, putting Lloyds on P/E multiples that are approximately 22% and 38% cheaper for 2011 and 2012 compared to the peer group average of large cap lending banks.

Research

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| Rating | BUY |
|-------------------------------|----------------|
| Target price (p) | 80.00 |
| Yesterday's closing price (p) | 61.00 |
| Upside / Downside | 31% |
| Market cap (£bn) | 39.5 |
| Market cap (€bn) | 46.0 |
| Sector | Pan-Euro Banks |

| (€€m) | 2009 | 2010E | 2011E |
|------------------------------------|---------|---------|---------|
| Net interest income | 14,023 | 14,023 | 14,182 |
| Net fees & commissions | 0 | 0 | 0 |
| Trading profits/losses | 0 | 0 | 0 |
| Other revenue | 11,549 | 11,549 | 11,834 |
| Total operating revenues | 25,572 | 25,572 | 26,016 |
| Operating costs | -11,592 | -11,592 | -11,266 |
| Operating profit | 13,980 | 13,980 | 14,750 |
| Total provisions | -12,404 | -12,404 | -8,269 |
| Pre-tax profit | 3,570 | 3,570 | 7,111 |
| ROA | 0.25% | 0.25% | 0.53% |
| ROE | 5.71% | 5.71% | 10.48% |
| ROTNAV | 6.63% | 6.63% | 12.07% |
| Cost/Income | -45.33% | -45.33% | -43.30% |
| Net interest margin | 2.00% | 2.00% | 2.06% |
| LLC % gross loans | -1.95% | -1.95% | -1.38% |
| NPL ratio | 10.00% | 10.00% | 8.00% |
| NPL coverage ratio | 55.00% | 55.00% | 60.00% |
| Loans % deposits | 155% | 155% | 147% |
| Core tier 1 ratio (Basel II) | 8.29% | 8.29% | 9.05% |
| Est. Core tier 1 ratio (Basel III) | 4.49% | 4.49% | 5.27% |
| EPS | -12.22 | 3.99 | 7.95 |
| DPS | 0.00 | 0.00 | 0.00 |
| Payout ratio | 0.00% | 0.00% | 0.00% |
| P/E | -4.99 | 15.29 | 7.68 |
| P/TNAV | 1.05 | 0.98 | 0.88 |
| Div yield | 0.00% | 0.00% | 0.00% |



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CONTENTS

| | |
|--|----|
| Summary | 3 |
| Contagion From Sovereign Debt Crisis Limited | 5 |
| Average Maturity of UK Sovereign Debt is Very Long | 5 |
| Modest Increase in CDS Spread for the UK | 7 |
| LLC Normalisation the Key Driver of Earnings Improvement | 8 |
| Lack of Capital Strength can be Solved Easily | 11 |
| Earnings Estimates Revised Upwards | 13 |

SUMMARY

Contagion from Sovereign Debt Crisis is Limited in Our View

It is unclear exactly why Lloyds' share price has been particularly weak in recent weeks as sovereign debt concerns have intensified, but we speculate that the market has been worried about the costs and availability of its future funding requirements. This issue is exacerbated by the fact that Lloyds is particularly reliant on wholesale funding, as it switches over from the SLS and CGS government lending programmes.

Having said that, we believe any concerns for Lloyds from the sovereign debt crisis are unwarranted for a number of reasons. The CDS spread for the UK has increased only modestly in recent days and weeks as the sovereign debt crisis has unfolded. The CDS spread for Lloyds itself has increased, but less than that for the large cap banks in the peripheral European countries. We believe this reflects the credit market's relatively relaxed attitude towards contagion risks for the UK, based primarily on the fact that the UK has its own freely floating currency (which helps its economy to automatically rebalance itself with its trade partners via the weakening of sterling), and the fact that UK sovereign debt has an average maturity which is nearly double the average maturity of debt for the other European countries.

We also believe that any deterioration in NIM arising from higher funding costs (should they occur) would only affect Lloyds' future earnings potential by a small amount. In our opinion, the main reason for buying Lloyds shares is because of the normalisation of loan losses, where the company is ahead of schedule according to the IMS. We show, using Dupont analysis, that the normalisation of loan losses should contribute to a 207bps increase in ROA over 2009-2012, while the improvement in NIM to 2.05% (from the 1.70% achieved in H1 2009) should result in an improvement in ROA of only 31bps.

We View Lack of Capital Adequacy as a Minor Concern

The other minor concern with Lloyds (apart from funding), which we have talked about frequently in previous notes, is its level of capital adequacy under Basel III. In our opinion, Lloyds' Core Tier 1 ratio suffers substantially under the proposed regime, mainly due to the deduction of capital invested in other financial entities (mainly Scottish Widows and Clerical Medical) from common equity. Lloyds' shareholders would effectively be forced to pay the regulatory cost of investing capital in non-bank financial entities, which are considered to have undesirable correlated volatility with the banks sector. This deduction is currently made at the total capital level, as permitted by an FSA transitional provision.

The impact on Lloyds' Core Tier 1 ratio from these investments is some 230bps according to our estimates. Although the capital situation now looks markedly improved due to the view that organic capital generation should be that much stronger, we still see the Basel III Core Tier 1 ratio at only 6.6% at year-end 2012 (compared to our previous estimate of 5.8%). This is above what we would anticipate as a regulatory minimum of 6.0%, but only modestly so and, importantly, it is substantially below the average for the peer group of 8.3%.

The saving grace for Lloyds (unlike other undercapitalised banks which would have to raise dilutive equity) is that it could solve its relative lack of capital adequacy at a swipe, and with little execution risk, by simply demerging its investments in other financial entities by some 75%. This would give Lloyds shareholders shares in both the Lloyds parent bank and in a newly listed entity comprising the other financial entities. The minority 25% stake should also ensure that Lloyds' management would be able to continue generating cost and revenue synergies. The Core Tier 1 ratio under this scenario would improve to about 8.2% by our calculations.

CDS spreads for the UK have increased only modestly in the past few days and weeks that the sovereign debt crisis has intensified

Contagion risks for Lloyds should be relatively small due to: long average maturity of UK debt; freely floating currency of the UK; and relatively minor impact on Lloyds' earnings if funding costs do indeed increase

We estimate the impact on Lloyds' Core Tier 1 ratio to be 230bps due to its investments in other financial entities, under the proposed Basel III regulations

Lloyds' Basel III Core Tier 1 ratio would improve to 8.2% from 6.6% if it demerged its interests in other financial entities by 75% by our calculations

We upgrade Lloyds to BUY from HOLD, increasing our target price to 80p (from 68p). We increase our pre-tax profit estimates for 2010, 2011 and 2012 by 157%, 37% and 19%, respectively.

The positive interim management statement released by Lloyds on 27 April, followed by weakness in the share price due to the sovereign debt crisis (unwarranted in our opinion), leads us to take advantage of an opportune moment to upgrade our rating to BUY from HOLD, and to increase our target price to 80p (from 68p).

Substantial upside beyond 80p a share exists if Lloyds can achieve a RoTNAV consistent with our forecast of 15.9% in 2012

Our new price target of 80p represents 1.15x 2011E tangible NAV of 69.6p. We believe this is fair considering that we expect RoTNAV of 12.1% in 2011. Substantial further upside exists if Lloyds goes on to achieve a RoTNAV in 2012 consistent with our forecast of 15.9%.

We have substantially upgraded our earnings estimates to account for the fact that Lloyds already made a pre-tax profit in Q1 2010, mainly on the basis that loan losses were normalising much quicker than had been expected. We expect Lloyds to make a meaningful pre-tax profit (including fair value gains) of £1.1bn for H1 2010, and £3.6bn for FY 2010. This is substantially ahead of the current consensus forecasts of a pre-tax loss of £0.9bn for H1 2010 and profit of £0.8bn for FY 2010.

We expect EPS of 8.0p and 12.0p in 2011 and 2012 respectively, putting Lloyds on P/E multiples which are approximately 22% and 38% cheaper for 2011 and 2012 compared to the peer group average of large cap lending banks.

CONTAGION FROM SOVEREIGN DEBT CRISIS LIMITED

There are several reasons why we think the sovereign debt crisis has limited read-across to Lloyds, in our opinion. They are that:

- **The average maturity of UK sovereign debt is very long compared to countries in Europe**, and compared to the peripheral European countries specifically. The average maturity for UK sovereign debt is 13.8 years, whereas the immediate peer group has average maturities of 7-8 years.
- **The UK has a freely floating currency**. Without wanting to state the obvious, this allows the UK economy to automatically rebalance itself with its trade partners via the weakening of sterling, whereas the peripheral European countries must instead predominantly rebalance by the harsh cutting of their fiscal budgets.
- **The CDS spread for the UK has increased only modestly in the past few days and weeks during which the sovereign debt crisis has intensified. For Lloyds, the CDS spread has increased less so than for peers**. Used as a proxy for funding costs, the CDS spread for the UK has not moved up in tandem with the CDS spreads of the peripheral European countries (Greece, Portugal, Spain, Ireland and Italy). For Lloyds, the CDS spread has not moved up as much as for the banks domiciled in the peripheral European countries (such as BBVA, Santander and Unicredit).
- **Even if funding costs increased for Lloyds, the contraction in the NIM would represent a relatively minor impact on earnings and valuation, in our opinion**. Using Dupont earnings analysis, we show that the main reason for buying Lloyds shares is for the expected normalisation of its loan losses, not for the improvement in its NIM.

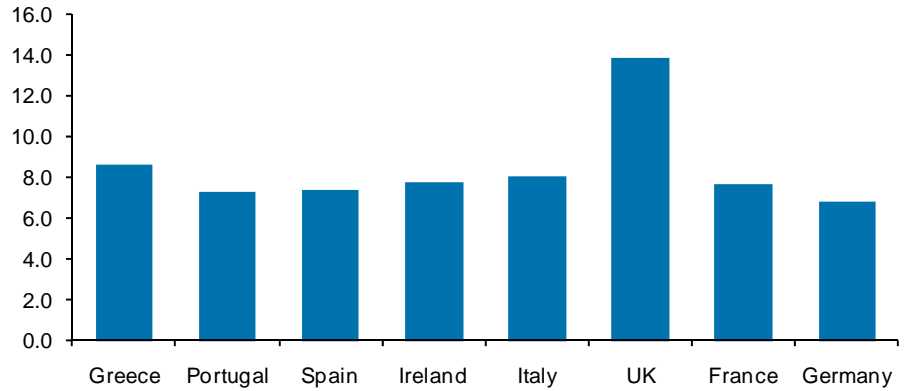
We provide more substantive evidence for our arguments below.

Average Maturity of UK Sovereign Debt is Very Long

Our calculations show that the UK has an average maturity for its sovereign debt of 13.8 years, almost twice as long as that for continental European countries. This means that it faces much less near-term refinancing risk. As such, we are of the opinion that this should mean less CDS contagion risk for Lloyds and, indeed, less competitive pressure for funds from the private market.

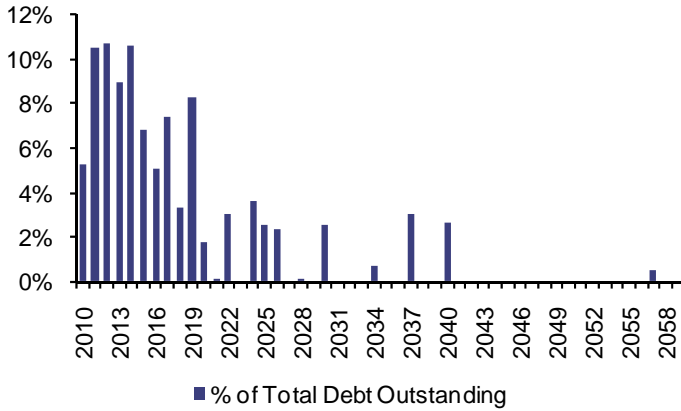
We note that, ironically, Greece has a slightly longer average maturity than the peer group, at 8.6 years.

Figure 1: Average Maturity of Sovereign Debt in years



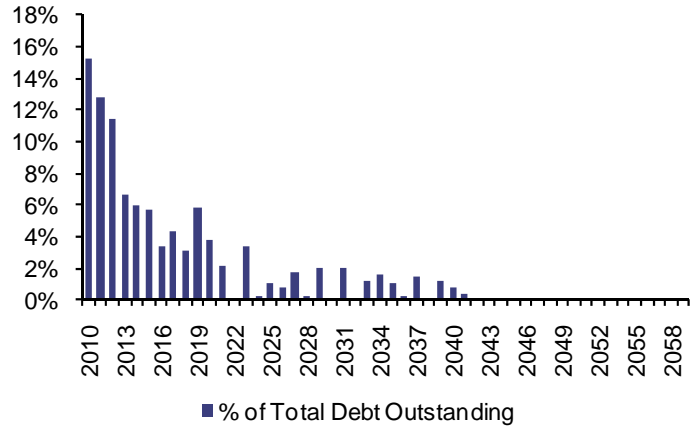
Source: Bloomberg, Matrix Research

Figure 2: Greece - Debt Maturing in Year % Total Debt Outstanding



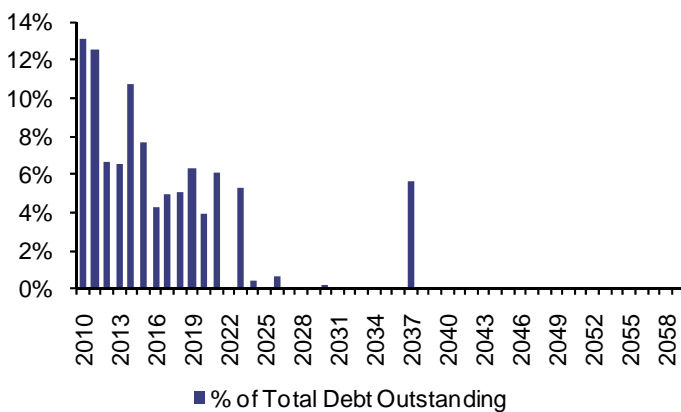
Source: Matrix Research

Figure 3: Italy - Debt Maturing in Year % Total Debt Outstanding



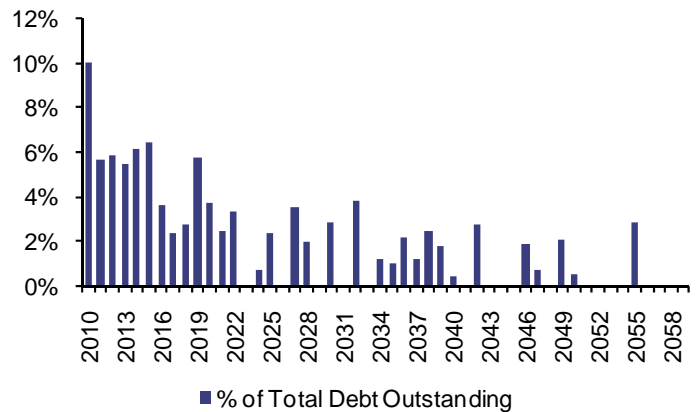
Source: Matrix Research

Figure 4: Portugal - Debt Maturing in Year % Total Debt Outstanding



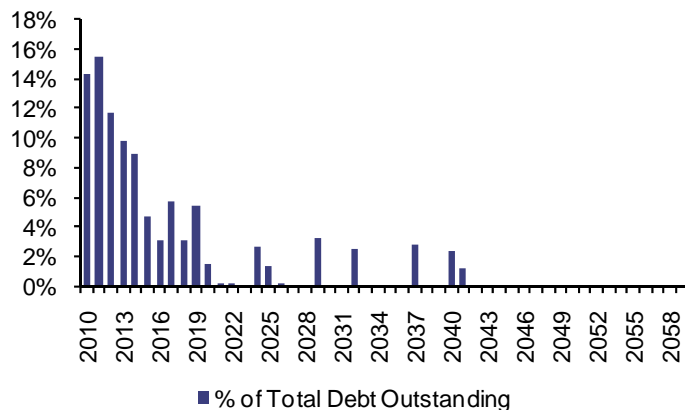
Source: Matrix Research

Figure 5: UK - Debt Maturing in Year % Total Debt Outstanding



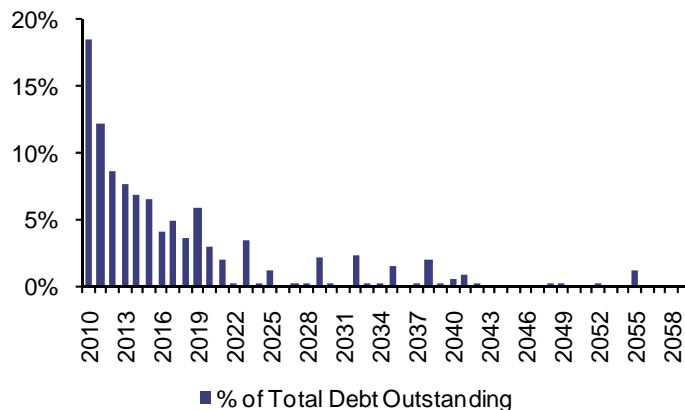
Source: Matrix Research

Figure 6: Spain - Debt Maturing in Year % Total Debt Outstanding



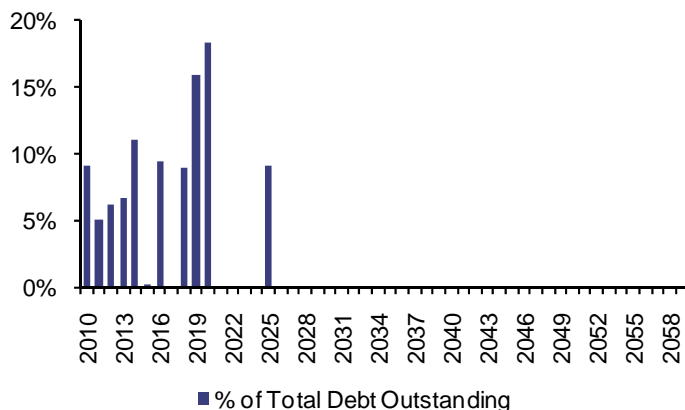
Source: Matrix Research

Figure 7: France - Debt Maturing in Year % Total Debt Outstanding



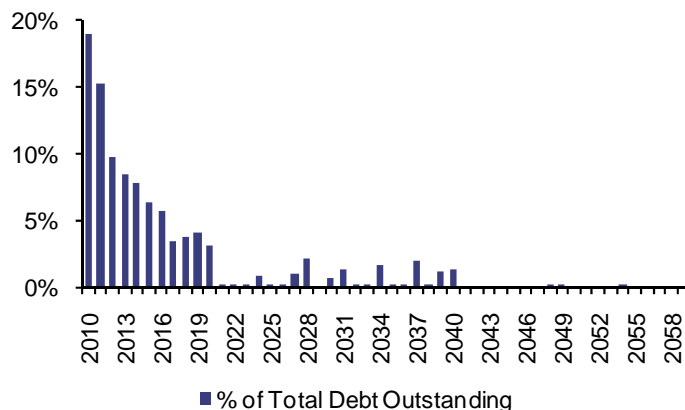
Source: Matrix Research

Figure 8: Ireland - Debt Maturing in Year % Total Debt Outstanding



Source: Matrix Research

Figure 9: Germany - Debt Maturing in Year % Total Debt Outstanding



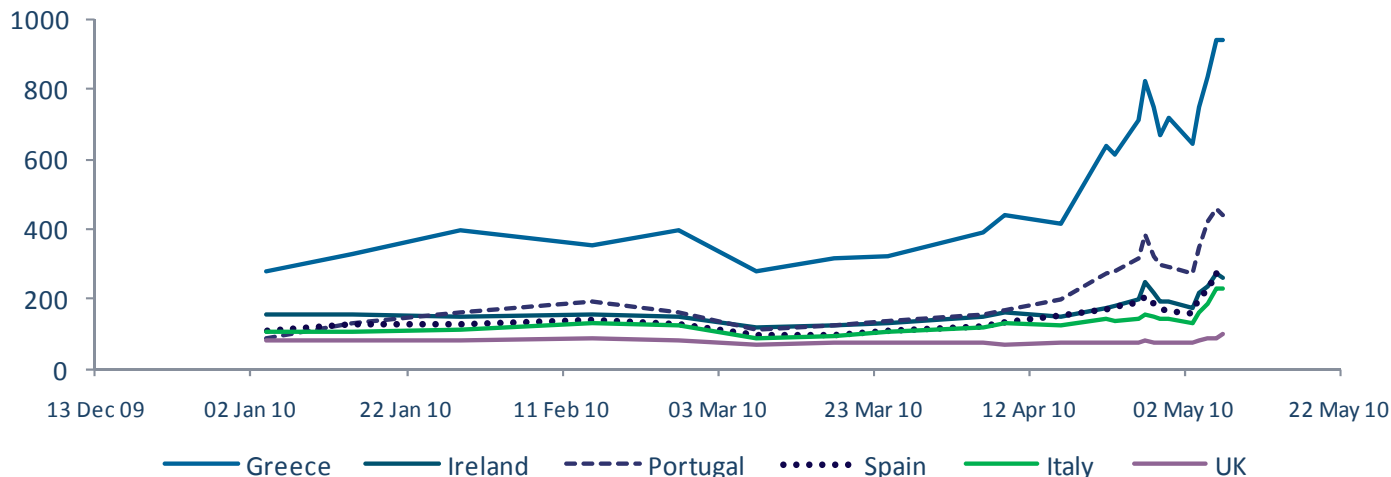
Source: Matrix Research

Modest Increase in CDS Spread for the UK

Figure 10 below shows the sovereign CDS spreads for the UK and the peripheral European countries since the beginning of 2010. It shows that the increase in the UK CDS spread has been relatively modest. The delta between the trough and the recent peak for the UK is only 33bps, whereas for the peripheral European countries, the delta ranges from 141bps for Italy, to as much as 692bps for Greece. The delta for Ireland, Portugal and Spain are 153bps, 376bps and 178bps, respectively.

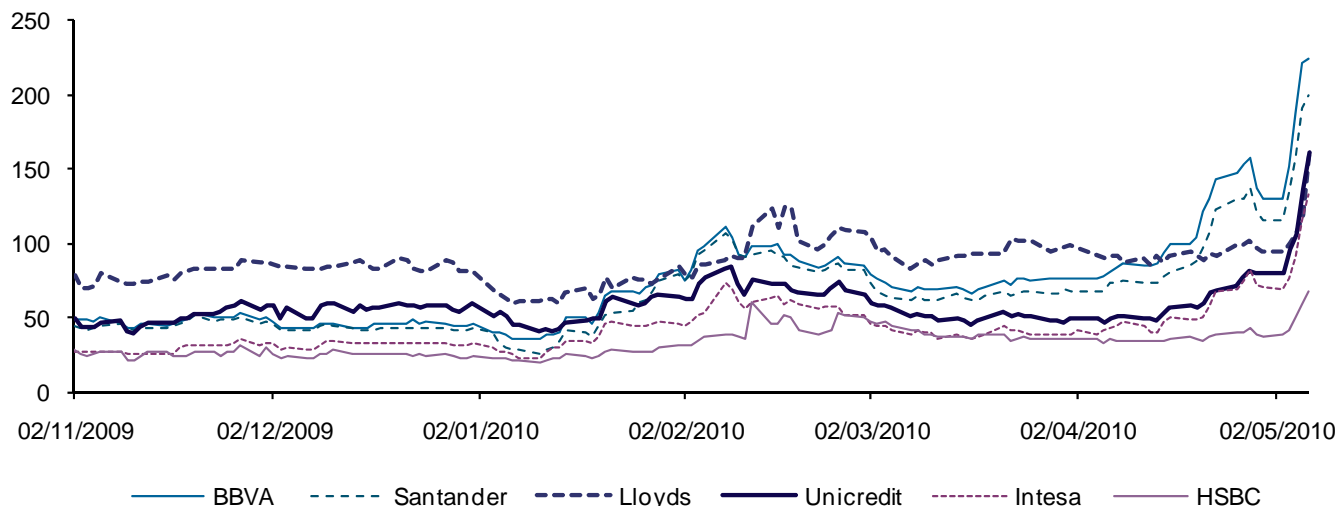
Figure 11 shows Lloyds' CDS spread versus the spreads for the other large cap lending banks domiciled in the peripheral European countries, namely BBVA, Santander, Unicredit and Intesa. We also show HSBC as a reference spread for a bank with little sovereign risk exposure. We see that Lloyds' CDS spread has indeed increased, but not as much as for the banks based in peripheral Europe. On an absolute basis, Lloyds' CDS spread is on par with Unicredit's, and higher than Intesa's, but we believe this is only fair for a bank with a much worse loan-to-deposit ratio compared to the Italian banks. Our point here is that the absolute increase in spread for Lloyds has not been as much as for the banks which, in our opinion, have genuine exposure to sovereign risk.

Figure 10: The sovereign CDS Spread for the UK has increased only modestly compared to the peripheral European countries



Source: Matrix Research

Figure 11: Lloyds' CDS Spread has increased in recent days and weeks, but the absolute increase has not been as much as for banks domiciled in the peripheral European countries, such as BBVA, Santander, Intesa or Unicredit



Source: Matrix Research

LLC Normalisation the Key Driver of Earnings Improvement

In our opinion, even if funding costs increased for Lloyds, the resulting contraction in NIM would represent only a minor impact on its earnings. We use Dupont analysis of earnings to show that the main driver for the improvement in Lloyds' earnings over 2010-2012 is the normalisation of loan losses.

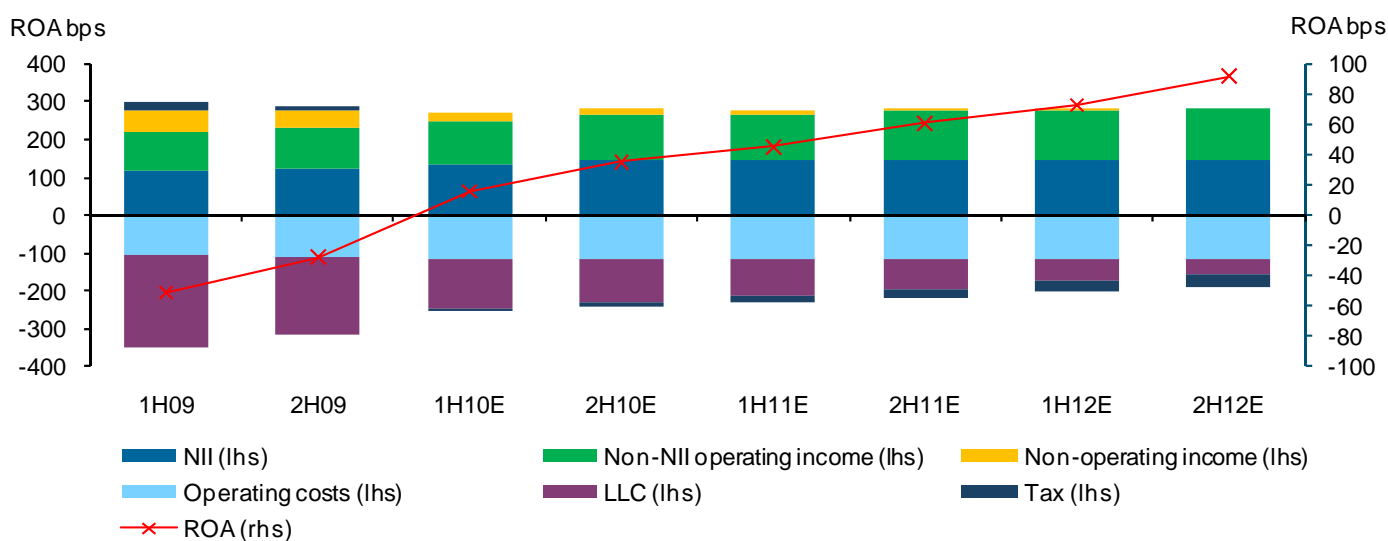
The figures below show the Dupont breakdown of earnings from 2009 to 2012E, in both numerical and chart form. We see that the contribution to the improvement in ROA over the period is 30bps from net interest income (i.e. 148bps minus 118bps). The contribution from the improvement in loan loss charges, however, is much more substantial at 208bps (i.e. from -245bps to only -37bps).

Figure 12: Dupont Breakdown of ROA for Lloyds, 2009–2012E

| | H1 2009 | H2 2009 | H1 2010E | H2 2010E | H1 2011E | H2 2011E | H1 2012E | H2 2012E |
|--------------------------|---------|---------|----------|----------|----------|----------|----------|----------|
| NII | 118 | 120 | 136 | 144 | 147 | 148 | 148 | 148 |
| Non-NII operating income | 100 | 110 | 110 | 120 | 118 | 128 | 126 | 135 |
| Non-operating income | 58 | 44 | 24 | 15 | 9 | 3 | 3 | -1 |
| Operating costs | -104 | -113 | -114 | -117 | -118 | -116 | -119 | -117 |
| LLCs | -245 | -203 | -134 | -113 | -93 | -79 | -57 | -37 |
| Tax | 22 | 14 | -6 | -14 | -18 | -24 | -29 | -36 |
| ROA | -51 | -28 | 16 | 35 | 45 | 61 | 73 | 92 |

Source: Matrix Research

Figure 13: Dupont Breakdown of ROA for Lloyds, 2009–2012E



Source: Matrix Research

Sensitivity Analysis Shows NIM Has Small Impact on Earnings

We have also undertaken a sensitivity analysis to demonstrate how a weaker NIM would only have a small impact on earnings, which is in keeping with the above analysis showing that the main driver of earnings improvement going forward is in fact the normalisation of loan losses.

Our base case expectation for the banking NIM is that it will improve to 2.00% in 2010, in line with management guidance. Thereafter, we expect the banking NIM will improve to a normalised level of 2.05%.

The first bear case scenario below assumes that the banking NIM improves to only 1.90% (rather than to 2.00% as per management guidance), and that it increases modestly to a normalised level of 1.95% thereafter. We see that the impact on earnings is only 6% in 2012 compared to our base case (although it is greater in earlier years by virtue of earnings still being depressed by high loan losses).

The second, even more conservative, bear case scenario is if we assume that the NIM stays relatively unchanged compared to FY2009, at 1.80%. We consider this highly unlikely given that Lloyds is already demonstrating margin improvements consistent with a projected banking NIM of 2.00% for 2010. We see that the impact on 2012 earnings is about 15%. We consider this minor within the context of a stock that would still be trading at 6.1x (a 22% discount to the peer group) were such a scenario to occur.

Figure 14: Base Case – Banking NIM increases to 2.00% in 2010 and improves further to normalised level of 2.05% thereafter

| (£m / %) | H1 2009 | H2 2009 | FY 2009 | H1 2010E | H2 2010E | FY 2010E | H1 2011E | H2 2011E | FY 2011E | H1 2012E | H2 2012E | FY 2012E |
|---------------------|------------|------------|------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|
| Banking NIM | 1.70% | 1.84% | 1.77% | 1.95% | 2.05% | 2.00% | 2.07% | 2.06% | 2.06% | 2.06% | 2.05% | 2.06% |
| Net interest income | 6,442 | 6,284 | 12,726 | 6,886 | 7,136 | 14,023 | 7,128 | 7,053 | 14,182 | 6,963 | 6,889 | 13,853 |
| Operating revenues | 11,939 | 12,025 | 23,964 | 12,486 | 13,086 | 25,572 | 12,864 | 13,152 | 26,016 | 12,873 | 13,135 | 26,008 |
| Pre-tax profit | -3,957 | -2,343 | -6,300 | 1,110 | 2,460 | 3,570 | 3,059 | 4,052 | 7,111 | 4,783 | 5,985 | 10,767 |
| Net profit | -2,812 | -1,451 | -4,263 | 791 | 1,753 | 2,545 | 2,181 | 2,888 | 5,069 | 3,409 | 4,266 | 7,675 |

Source: Matrix Research

**Figure 15: Bear Case 1 – Banking NIM improves to only 1.90% in 2010, then improves to normalised level of 1.95% thereafter
The impact on earnings is only 6% for FY2012E**

| (£m / %) | H1 2009 | H2 2009 | FY 2009 | H1 2010E | H2 2010E | FY 2010E | H1 2011E | H2 2011E | FY 2011E | H1 2012E | H2 2012E | FY 2012E |
|--------------------------------|------------|------------|------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|
| Banking NIM | 1.70% | 1.84% | 1.77% | 1.85% | 1.95% | 1.90% | 1.95% | 1.95% | 1.95% | 1.95% | 1.95% | 1.95% |
| Net interest income | 6,442 | 6,284 | 12,726 | 6,551 | 6,822 | 13,373 | 6,754 | 6,675 | 13,429 | 6,632 | 6,571 | 13,203 |
| Operating revenues | 11,939 | 12,025 | 23,964 | 12,150 | 12,772 | 24,922 | 12,490 | 12,774 | 25,264 | 12,542 | 12,817 | 25,359 |
| Pre-tax profit | -3,957 | -2,343 | -6,300 | 775 | 2,145 | 2,920 | 2,685 | 3,673 | 6,359 | 4,451 | 5,667 | 10,118 |
| Net profit | -2,812 | -1,451 | -4,263 | 552 | 1,529 | 2,081 | 1,914 | 2,618 | 4,533 | 3,173 | 4,039 | 7,212 |
| % change from base case | | | | | | | | | | | | |
| Net interest income | 0.0% | 0.0% | 0.0% | -4.9% | -4.4% | -4.6% | -5.2% | -5.4% | -5.3% | -4.8% | -4.6% | -4.7% |
| Operating revenues | 0.0% | 0.0% | 0.0% | -2.7% | -2.4% | -2.5% | -2.9% | -2.9% | -2.9% | -2.6% | -2.4% | -2.5% |
| Pre-tax profit | 0.0% | 0.0% | 0.0% | -30.2% | -12.8% | -18.2% | -12.2% | -9.3% | -10.6% | -6.9% | -5.3% | -6.0% |
| Net profit | 0.0% | 0.0% | 0.0% | -30.2% | -12.8% | -18.2% | -12.2% | -9.3% | -10.6% | -6.9% | -5.3% | -6.0% |

Source: Matrix Research

**Figure 16: Bear Case 2 – Banking NIM stays relatively unchanged compared to FY 2009 at only 1.80% going forward
The impact on earnings is 15% for FY2012E**

| (£m / %) | H1 2009 | H2 2009 | FY 2009 | H1 2010E | H2 2010E | FY 2010E | H1 2011E | H2 2011E | FY 2011E | H1 2012E | H2 2012E | FY 2012E |
|--------------------------------|------------|------------|------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|
| Banking NIM | 1.70% | 1.84% | 1.77% | 1.85% | 1.75% | 1.80% | 1.80% | 1.80% | 1.80% | 1.80% | 1.80% | 1.80% |
| Net interest income | 6,442 | 6,284 | 12,726 | 6,551 | 6,156 | 12,707 | 6,270 | 6,201 | 12,470 | 6,134 | 6,082 | 12,216 |
| Operating revenues | 11,939 | 12,025 | 23,964 | 12,150 | 12,107 | 24,257 | 12,006 | 12,299 | 24,305 | 12,044 | 12,328 | 24,372 |
| Pre-tax profit | -3,957 | -2,343 | -6,300 | 775 | 1,480 | 2,254 | 2,201 | 3,199 | 5,399 | 3,953 | 5,178 | 9,131 |
| Net profit | -2,812 | -1,451 | -4,263 | 552 | 1,055 | 1,607 | 1,569 | 2,280 | 3,849 | 2,818 | 3,691 | 6,508 |
| % change from base case | | | | | | | | | | | | |
| Net interest income | 0.0% | 0.0% | 0.0% | -4.9% | -13.7% | -9.4% | -12.0% | -12.1% | -12.1% | -11.9% | -11.7% | -11.8% |
| Operating revenues | 0.0% | 0.0% | 0.0% | -2.7% | -7.5% | -5.1% | -6.7% | -6.5% | -6.6% | -6.4% | -6.1% | -6.3% |
| Pre-tax profit | 0.0% | 0.0% | 0.0% | -30.2% | -39.8% | -36.8% | -28.1% | -21.0% | -24.1% | -17.3% | -13.5% | -15.2% |
| Net profit | 0.0% | 0.0% | 0.0% | -30.2% | -39.8% | -36.8% | -28.1% | -21.0% | -24.1% | -17.3% | -13.5% | -15.2% |

Source: Matrix Research

LACK OF CAPITAL STRENGTH CAN BE SOLVED EASILY

We have long argued, counter-consensually, that Lloyds fares quite badly under the proposed Basel III regulations. In our opinion, Lloyds' Core Tier 1 ratio suffers considerably mainly due to the deduction of capital invested in other financial entities (mainly Scottish Widows and Clerical Medical) from common equity. Lloyds' shareholders would effectively be forced to pay the regulatory cost of investing capital in non-bank financial entities, which are considered to have undesirable correlated volatility with the banks sector. This deduction is currently made at the total capital level, as permitted by an FSA transitional provision.

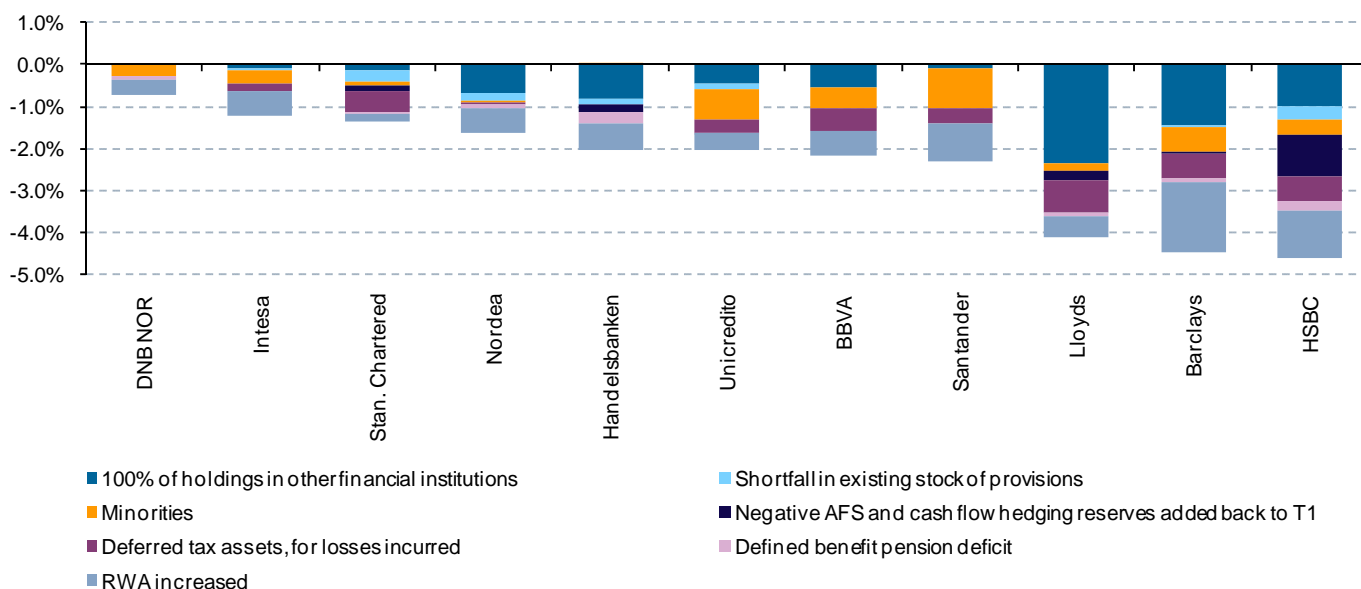
We estimate the impact on Lloyds' Core Tier 1 ratio to be 230bps due to its investments in other financial entities, under the proposed Basel III regulations

The impact on Lloyds' Core Tier 1 ratio from these non-bank financial investments is some 230bps by our estimates. Although the capital situation now looks markedly improved due to the view that organic capital generation should be that much stronger, we still see the Basel III Core Tier 1 ratio at only 6.6% at year-end 2012E (compared to our previous estimate of 5.8%). This is above what we would anticipate as a regulatory minimum of 6.0%, but only modestly so and, importantly, it is substantially below the average for the peer group of 8.3%.

Lloyds' Basel III Core Tier 1 ratio would improve to 8.2% from 6.6% if it demerged its interests in other financial entities by 75% by our calculations

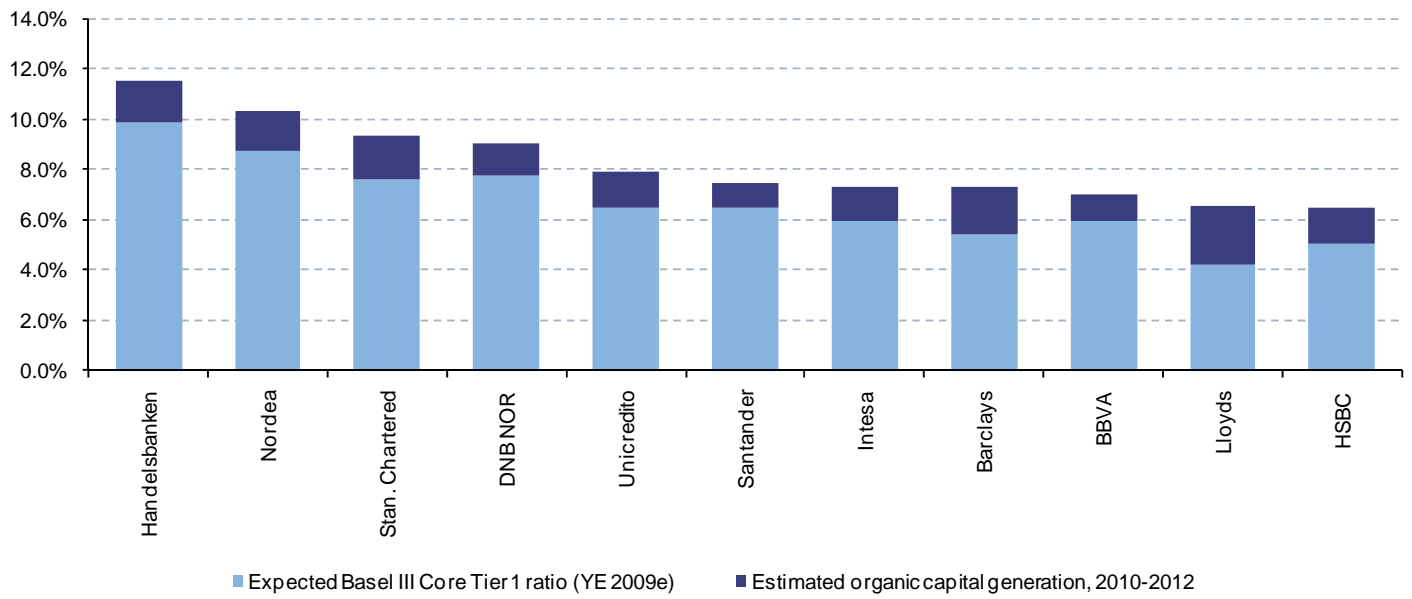
The saving grace for Lloyds (unlike other undercapitalised banks that would have to raise dilutive equity) is that it could solve its relative lack of capital adequacy at a swipe, and with little execution risk, by simply demerging its investments in other financial entities by some 75%. This would give Lloyds shareholders shares in both the Lloyds parent bank and in a newly listed entity comprising the other financial entities. The minority 25% stake should also ensure that Lloyds' management would be able to continue generating cost and revenue synergies. The Core Tier 1 ratio under this scenario would improve to about 8.2%, according to our calculations.

Figure 17: Impact on Core Tier 1 ratios When Transitioning to Basel III from Basel II



Source: Matrix Research

Figure 18: Estimated Basel III Core Tier 1 Ratios as at Year-end 2012



Source: Matrix Research

EARNINGS ESTIMATES REVISED UPWARDS

We upgrade our rating on Lloyds to BUY from HOLD, and increase our target price to 80p from 68p. We also raise our pre-tax profit estimates for 2010, 2011 and 2012 by 157%, 37% and 19%, respectively.

Our new price target of 80p represents 1.15x 2011E tangible NAV of 69.6p. We believe this is fair considering that we expect RoTNAV of 12.1% in 2011. Substantial further upside exists if Lloyds goes on to achieve a RoTNAV in 2012 consistent with our forecast of 15.9%.

The key driver of earnings improvement from now until 2012 will be the normalisation of loan losses, in our opinion. Management had given guidance at the FY2009 results that the 21% decrease in loan losses in H2 2009 from H1 2009 would be maintained for subsequent periods. However, it was subsequently disclosed at the Interim Management Statement of 27 April 2010 that the rate of decrease had accelerated. The actual rate of decrease achieved in the first quarter of 2010 was not disclosed, but we are comfortable with our forecast that a decrease of ~35% HoH can be achieved in H1 2010. We have conservatively forecast the HoH decline in H2 2010 to be only 18%, so there is still potential for our full year earnings estimates to be bettered, in our opinion.

We expect Lloyds to make a meaningful pre-tax profit (including fair value gains) of £1.1bn for H1 2010 and £3.6bn for FY 2010. This is substantially ahead of the current consensus forecasts of a pre-tax loss of £0.9bn and profit of £0.8bn for H1 2010 and FY 2010, respectively. Our new earnings estimates, compared to our old estimates, are shown in Figure 19 (below). We increase our pre-tax profit estimates for 2010, 2011 and 2012 by 157%, 37% and 19%, respectively.

We expect EPS of 8.0p and 12.0p in 2011 and 2012, respectively. The corresponding P/E multiples for 2011 and 2012 are 7.5x and 5.0x, which are approximately 20% and 36% less than the peer group average of large cap lending banks.

Figure 19: Lloyds Earnings Table, Showing New vs. Old estimates

| LLOYDS BANKING | H1 2010E Old | H1 2010E New | FY 2010E Old | FY 2010E New | FY 2011E Old | FY 2011E New | FY 2012E Old | FY 2012E New |
|---|-----------------|-----------------|-----------------|-----------------|-----------------|-----------------|-----------------|-----------------|
| Income Statement (£m) | | | | | | | | |
| Net interest income | 6,795 | 6,886 | 13,751 | 14,023 | 14,059 | 14,182 | 13,836 | 13,853 |
| Net fees & commissions | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| Trading profits/losses | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| Other revenue | 5,599 | 5,599 | 11,549 | 11,549 | 11,834 | 11,834 | 12,156 | 12,156 |
| Total operating revenues | 12,394 | 12,486 | 25,300 | 25,572 | 25,894 | 26,016 | 25,992 | 26,008 |
| Operating costs | -5,740 | -5,780 | -11,471 | -11,592 | -11,212 | -11,266 | -11,005 | -11,012 |
| Operating profit | 6,654 | 6,706 | 13,830 | 13,980 | 14,681 | 14,750 | 14,986 | 14,996 |
| Total provisions | -7,934 | -6,812 | -14,435 | -12,404 | -10,123 | -8,269 | -6,135 | -4,398 |
| Impairments on other assets | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| Goodwill impairment | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| Other income/loss (mainly fair value gains) | 1,217 | 1,217 | 1,994 | 1,994 | 630 | 630 | 170 | 170 |
| Pre-tax profit | -63 | 1,110 | 1,388 | 3,570 | 5,188 | 7,111 | 9,022 | 10,767 |
| Taxes | 18 | -311 | -389 | -1,000 | -1,453 | -1,991 | -2,526 | -3,015 |
| Minorities | 0 | -8 | -10 | -26 | -37 | -51 | -65 | -78 |
| Net profit | -45 | 791 | 990 | 2,545 | 3,698 | 5,069 | 6,431 | 7,675 |
| Assets (£m) | | | | | | | | |
| Loans to customers | | 599,465 | | 576,637 | | 546,210 | | 520,074 |
| Interbank loans | | 35,361 | | 36,068 | | 37,525 | | 39,041 |
| Total securities | | 224,680 | | 220,186 | | 211,467 | | 203,093 |
| Intangible assets | | 6,103 | | 6,225 | | 6,477 | | 6,738 |
| Total assets | | 1,001,908 | | 978,584 | | 944,205 | | 923,339 |
| Net interest-earning assets | | 676,211 | | 654,918 | | 627,653 | | 604,807 |
| Liabilities (£m) | | | | | | | | |
| Interbank borrowings | | 79,315 | | 75,349 | | 68,002 | | 61,372 |
| Customer deposits | | 398,606 | | 390,634 | | 382,860 | | 382,860 |
| Total shareholders' equity | | 44,069 | | 45,823 | | 50,891 | | 58,566 |
| Tangible net asset value | | 37,966 | | 39,598 | | 44,415 | | 51,828 |
| Important Financial Ratios | | | | | | | | |
| ROA | | 0.16% | | 0.25% | | 0.53% | | 0.82% |
| ROE | | 3.62% | | 5.71% | | 10.48% | | 14.02% |
| ROTNV | | 4.21% | | 6.63% | | 12.07% | | 15.95% |
| Cost/income | | -46.29% | | -45.33% | | -43.30% | | -42.34% |
| Tax rate | | -28.00% | | -28.00% | | -28.00% | | -28.00% |
| Payout ratio | | 0.00% | | 0.00% | | 0.00% | | 0.00% |
| Net interest margin | | 1.95% | | 2.00% | | 2.06% | | 2.06% |
| LLC % gross loans | | -2.50% | | -1.95% | | -1.38% | | -0.78% |
| Non-performing loans % gross loans | | 9.50% | | 10.00% | | 8.00% | | 6.00% |
| NPL coverage ratio | | 50.00% | | 55.00% | | 60.00% | | 60.00% |
| Loans % deposits | | 161.49% | | 155.34% | | 147.15% | | 140.11% |
| Tier 1 ratio | | 9.60% | | 9.78% | | 10.51% | | 11.94% |
| Core Tier 1 ratio (Basel II) | | 8.09% | | 8.29% | | 9.05% | | 10.48% |
| Est. Core Tier 1 ratio (Basel III) | | 4.25% | | 4.49% | | 5.27% | | 6.61% |
| RWA % total assets | | 50.22% | | 52.19% | | 55.18% | | 56.42% |

Source: Matrix Research

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|-----------------------------|------------|
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