Banks **4 July 2008**

Bradford & Bingley (BB/ LN)

SELL | **Target price: 0p** | **Price: 49p**

Walking, or running away?

We have downgraded BB/ to SELL and reduced our Target Price to Zero (previously, Neutral TP 130p). We believe deposit-holders' money is safe, but from an equity shareholder perspective, we believe that the investment is unattractive on a risk/reward basis. An 'embedded value' type approach (with admittedly pessimistic assumptions on margins and cumulative write-offs) suggests a Net Present Value of -14p on a stand-alone basis. The closer to this value BB/ falls, the greater the likelihood of a bid from another UK bank (30% of BB/ operating costs £280m, taxed and put on 10x multiple would suggest synergy value alone of 129p per share), but we doubt that much of this synergy value would accrue to BB/ shareholders in the form of a bid premium.

Reasons for TPG withdrawing

Moody's has announced that it has downgraded BB/'s senior unsecured and long-term debt ratings to Baa1 from A3, on: i) substantial deterioration in the bank's asset quality so far in 2008; ii) The expectation that asset quality will weaken over the rest of the year; and iii) BB/'s obligation to acquire mortgages from GMAC.

That is the reasons given for the downgrade are already in the public domain: the rating agency is simply catching up with events.

TPG has invoked a clause in its agreement with BB/ allowing it to withdraw from the capital raise if the company is downgraded; however M&G, Legal & General, Insight Investment and Standard Life will support the entire £400m rights issue at 55p/share.

Given pressure on rating agencies to be quicker to downgrade, we think that an agency downgrade to BB/ was probable, in which case we have to wonder why its Executive Chairman allowed TPG to insert the clause.

Cost of funding or bad debts?

Possibly the clause was not up for negotiation because TPG knew its investment case was highly sensitive to BB/'s cost of wholesale funds (in FY 07, BB/'s interbank and wholesale funding was over £25bn). But BB/ Investor Relations denied this was true when we spoke to them, saying that the downgrade would not make much difference to the bank's cost of funds. We asked for a second opinion from a contact in the debt markets who told us that, to a large extent, the money markets had 'priced in' the well-known problems at the bank. The five-year senior CDS spreads were already trading at 270bp before the news broke, and rose another 100bp following the downgrade. Note that although this level of pricing does reflect concerns in the debt market, it is not indicative of the entire bank's cost of funding: for example, maturities of less than one year (which is where all UK banks are currently funding at the moment), were expected to rise by 5-10bp on the news of the downgrade according to our source. But to put this into context, 10bp equates to £25m of the entire wholesale book, versus FY 07a PBT ex write-downs of £350m. So based on that information, we think it is unlikely that the downgrade really changed the investment case for TPG.

It is possible that the Chairman agreed to the clause because he knew a rating downgrade would not be a 'deal breaker', but in that case he effectively handed TPG a valuable 'free option' to walk away. We seriously question his logic in denying Clive Cowdery access to the books on the grounds that TPG offered "certainty".

Instead of a changed cost of funding, there is also the probability that more information became available to TPG on the arrears deterioration of the Self Cert and Buy to Let books, and the downgrade provided an escape route. This would have negative implications for HBOS in our view, although the Specialist book at HBOS only accounts for one-third of total mortgages, and HBOS, on the latest data, is reporting a lower level of 3-month+ arrears (1.89% end May) than BB/ (2.49% end April).

Embedded value

The now-withdrawn approach from Clive Cowdery has inspired us to try a (simple) 'embedded value' type approach for valuing BB/ existing loan book, implicitly assuming that the bank will close to new business. We prefer this to our previous 'through the cycle' ROIC-based approach, because we think it is easier to show the key variables (cumulative write-offs over the next five years, versus possible net interest margin improvement) in this embedded value approach.

Key assumptions

- Margin expansion of 10bp. This may be too pessimistic: assuming a 60bp improvement and keeping our other assumptions (listed below) constant would suggest a target price of 55p, in line with rights issue price. However, we have yet to see signs of margin improvement at UK banks, and with BB/ mortgage borrowers highly indebted in a rising rate environment, and rental yields below the cost of finance, we would like to see evidence before we give the bank benefit of the doubt.

- Cumulative write-offs from the £40bn mortgage book of £1.6bn pre-tax. Although this seems ridiculously high, given the £22m impairment loss in 2007, this cumulative number equates to arrears levels of 20%, and losses given arrears of 20% on the £40bn mortgage book. This is below the level of losses on US subprime, where delinquency levels are well over 30%, and losses given serious delinquency 37.5% (75% PD x LGD 50%), according to BoE Financial Stability Review in April 2008. We also highlight that the 400bp of losses that £1.6bn equates to is below the level of UK commercial property write-downs banks saw during the last recession, and although there was no Buy to Let in the early 1990s, there are perhaps parallels with the economics of commercial property.

Other assumptions

- BB/ does successfully manage to raise £400m in its rights issue.

- It manages to shrink the mortgage book by 5% per annum until 2012.

- Reducing 'Other income', due to no further sale and leasebacks on property assets, 'other' gains on financial instruments, and general insurance cross sales.

- Operating cost reductions of 5% per annum till 2012.

- A terminal value exit multiple of 10x (which is generous, in our view).

Clearly our model shows some subjective assumptions. BB/'s equity was leveraged around 40x to total assets 2007a, so with more optimistic assumptions on write-offs or margin improvements, investors could see substantial upside.

Embedded value for BB/

Inputs	£m		Notes				
Market cap	-327						
Capital raising	-400						
Credit costs	-1131		Post tax, pre tax would be £1.6bn				
Upfront costs £m	(1,858)						
Assumptions							
Cumulative credit losses	-4.00%						
Growth in mtg balances	-5%						
Margin expansion (%)	0.10%						
Cost of Equity	10%						
Exit Multiple 2012 (x)	10						
Equity value							
NPV	-194	-14p	Assumes 1,522m shares outstanding				
Mortgage balances (£m)	40,400	38,380		36,461	34,638	32,906	31,261
Total income margin (%)	1.41	1.41		1.51	1.51	1.51	1.51
Total income (£m)	569	541		550	523	497	472
Costs (£m)		-280		-266	-253	-240	-228
PBT ex credit costs (£m)		261		284	270	257	244
Taxed		183		199	189	180	171

Source: Subject company data, Pali International estimates.

Other thoughts

Cash flow: With arrears growing 50% in the first four months of the year, and given the circumstances of the housebuilders, we wonder what BB/'s monthly cash flow looks like currently. We would expect repossessions to take at least 12 months for BB/, after borrowers who are in arrears eventually default and BB/ realises value at auction. As of December 2007, BB/ had £688m positive cash flow during the year (£407m cash flow from operating activities), but we highlight that this number is worth following.

Shrinking: The experience of Northern Rock shows how difficult it is to shrink a bank's balance sheet. In the case of BB/, we think it will be particularly hard to shrink the book, given that £23bn of the £40bn mortgage book is Buy to Let, which is predominantly interest only. That is, unlike a bank with repayment mortgages on its book, BB/ will achieve very little 'natural' decline as customers repay their debts.

The risks to our call include a bid from a UK bank which is able to extract cost synergies, perhaps encouraged by the large institutions who approached Clive Cowdery. Also, the BoE aggressively cutting interest rates could give substantial upside.

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