

(LSE:LLOY)5,F

Lloyds Banking Group

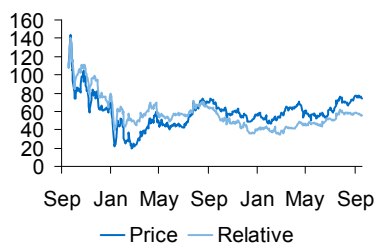
HOLD

Share price 74p
Target price 72p

3% Downside

Market cap (£m) 50,578.9
Return on equity (%) 0.0
No. of shares (m) 68,073.9
Free float (%) 59.0
Price/book 1.0
Average daily vol (3m) 170,413
Dividend yield (%) 0.0
PE at target price (Y+1) 10.9
Sector PE 9.0
Sector dividend yield (%) 0.0
12 month high/low (p) 78/47

(%)	1m	3m	12m
Absolute	+0.8	+34.1	+16.2
FTA relative	-2.1	+16.4	+3.4

Price & price relative (-2yr)


Source: Datastream

Share price as at close: 29 September 10

Next news
Q3 results, 2nd November
Business

Lloyds is a UK bank, formed from Lloyds TSB and HBOS in 2009.

www.lloyds.com

The customer is capital

When a business delivers services that enough customers value, the business generates excess capital available to fund growth or return to owners. LLOY may well have wider margins and excess financial capital, but we voice concern about the source of this excess.

We highlight the structural challenges an incoming Chief Executive of LLOY will face

If inflation remains above interest rates, we think the new Chief Executive may struggle to attract deposits while maintaining NIM. Lloyds customer deposits grew 1.3% year on year, helped by rule changes which meant over-50s were able to invest £5,100 in a cash ISA, we believe.

We can get to a target price above 100p, but there are other scenarios

We struggle to value Lloyds. The bull case is well understood: rising NIM and sustainable loans/deposit ratio. But most industries which are recipients of Government subsidies are not known for value creation; we draw a comparison between UK bankers and European dairy farmers.

We keep our HOLD rating and target price of 72p

We have moved our forecast for FY 2010 down to £1.8bn PBT pre exceptional (previously £2.9bn, and consensus £1.35bn). Near-term eps movements have minimal significance for valuation in our view. For now our recommendation remains HOLD, TP 72p.

5 Please see regulatory disclosure notes at the end of this document

F Forecast change

Year end	Sales (£m)	PBT* (£m)	Tangible P/Tangible Bk (p)	F.Dil. EPS* (p)	PER (x)	Div yield (%)
May						
2008A	21,355.0	(5,761.0)		(50)	-1.5x	n/a
2009A	23,964.0	(11,633.0)	62p	1.2x	-2.8x	0.0
2010E	25,019.9	1,809.9	70p	1.1x	2.2	34.3x
2011E	25,159.3	6,483.4	76p	1.0x	6.4	11.5x
2012E	25,247.2	11,295.5	87p	0.8x	11.7	6.4x
2013E	25,568.8	11,702.9	98p	0.8x	11.6	6.4x

* excludes exceptional items and amortisation of intangibles.

Source: Seymour Pierce Ltd, Company data

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THE WIDOW MAKER

The bull case on LLOY is well understood: Net Interest Margin could recover to 2.5% and the loans to deposit ratio of over 1.6x is sustainable (scenario A).

But there are other scenarios. The Loans/Deposit ratio could shrink to 1.4x (scenario B) may have to shrink further to below 1.0x (scenario C) and/or Net Interest Margin may disappoint (scenario D and E).

Valuation scenarios

£m unless otherwise stated	A	B	C	D	E
Loans/Deposits	1.6	1.4	1.0	1.6	1.0
NIM	2.50%	2.50%	2.50%	2.00%	2.00%
AIEA	631,829	560,000	400,000	631,829	400,000
Net Interest Income	15,796	14,000	10,000	12,637	8,000
Non II	10,454	10,454	8,886	10,454	8,886
Income	26,250	24,454	18,886	23,091	16,886
Costs	-10,500	-10,500	-10,500	-10,500	-10,500
Cost/Income ratio (%)	40	43	56	45	62
Surplus	15,750	13,954	8,386	12,591	6,386
Impairments	-3,278	-2,905	-2,075	-3,278	-2,075
PBT	12,472	11,049	6,311	9,313	4,311
Post tax	9,354	8,287	4,733	6,985	3,233
NoSH	68,074	68,074	68,074	68,074	68,074
Normalised EPS	14p	12p	7p	10p	5p
Target P/E	9.0x	9.0x	9.0x	9.0x	9.0x
	124p	110p	63p	92p	43p
Discount back 2 years	100p	89p	51p	75p	35p

Source: Seymour Pierce Ltd

Extreme ways will be back again

The term “widow maker” has recently been used to describe a spread trade in the energy market, but the term comes from New England ship captains a couple of hundred years ago. When a clipper ship, no matter how well designed and constructed, began to have fatal “accidents”, the owners did not redesign or rebuild the ship. They broke it up as fast as possible¹.

Whenever a job defeats two people in a row, who in previous roles had performed well, a company has a widow maker on its hands. An example of such a role that springs to mind is England football manager.

Shareholder value a millstone

Rather than blame a couple of poor acquisitions for the last decade of share price performance, our concerns are structural: the loans to deposit ratio and the expectation of unsustainably high profits.

The Chief Executive remuneration policy has recently been changed, and does now include elements of customer satisfaction and employee engagement but the bulk is we believe economic profit and EPS growth targets. We still harbour concerns that unless these are changed, the job will likely defeat the third appointee.

For now our recommendation remains HOLD, TP 72p. We believe this is probably unlikely to be the price in 12 months time, but instead reflects an outcome across a range of different scenarios.

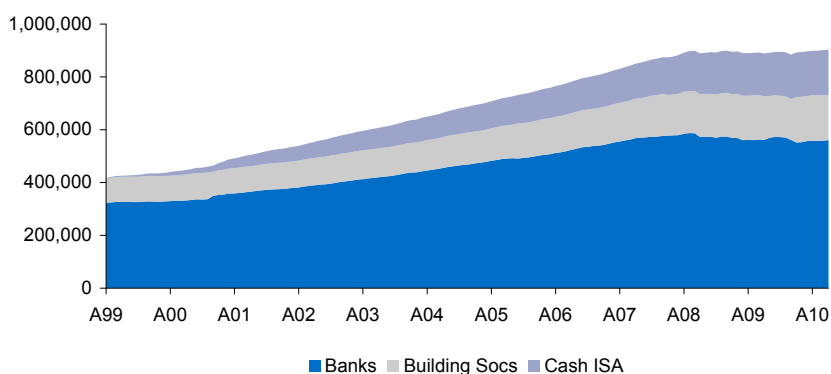
¹ Peter Drucker *The Essential Drucker*

DEPOSITS

Group deposits were £375bn ex repos, +1.4% y-o-y. Retail savings deposits were the main driver of growth (ISAs and instant access) up by 3% to £231bn, rather than expensive term deposits. However, this is still a lower level of growth than RPI. Moreover, we believe deposit inflows may have been helped by rule changes which meant over-50s were able to invest £5,100 in a cash ISA.

On an industry level, balances in cash ISAs have been a huge part of growth in retail customer deposits. At the start of 2000, balances outstanding were less than £10bn, but this has now grown to over £170bn.

UK Deposit growth



Source: Seymour Pierce Ltd, Bank of England

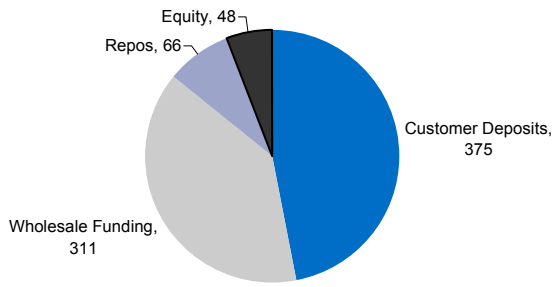
Bullish commentators have focussed on the ability of Lloyds to reprice the HBOS mortgage book back to SVR and hence the 58bp improvement in UK Retail NIM improved to 2.44%. We were sceptical Lloyds management would be able to increase NIM in a low interest rate environment, and they deserve credit for pushing through the increase to borrowers. But if we see sustained levels of RPI, term saving deposits may turn out to have been a cheap source of funding after all.

Both inflation and deflation pose hazards

Given the high level of indebtedness among UK consumers, both a deflationary and inflationary environment pose dangers for LLOY shareholders. In a deflationary environment, the likelihood is that the share price performance mirrors that of the large Japanese banks in the last two decades. We think this is well understood, and much discussed and argued over.

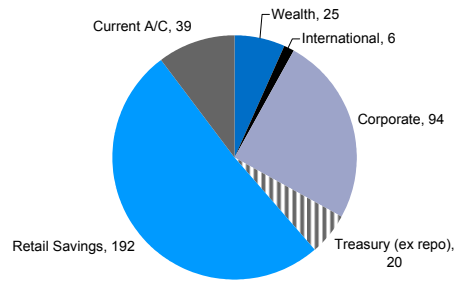
However, in an environment of sustained mid single digit inflation (CPI has been above target 41 out of the past 50 months) we wonder if UK banks will be able to attract deposits unless they offer interest rates well above inflation.

LLOY funding split (amounts £bn)



Source: Seymour Pierce Ltd

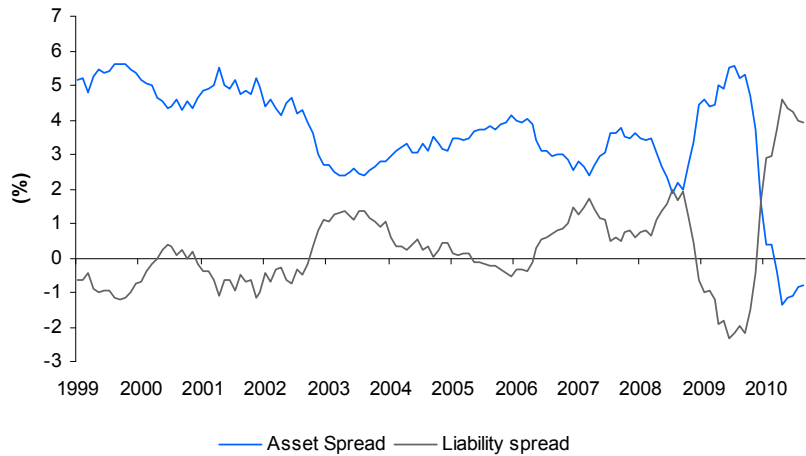
Of which: split of customer deposits (£bn)



Source: Seymour Pierce Ltd

To demonstrate this point we show UK banks spreads. On the asset side we use Standard Variable Rate (SVR) for UK mortgages, on the liability side we use sight deposits. The twist is, rather than showing how much the spread over the bank's cost of borrowing (3 month Libor is normal) we show relative to inflation.

UK Bank sector Asset and Liability spread



Source: Bank of England, ONS

What savers want

We have done this because we think this is what a bank's customers do. That is, savers want a rate that is close to, or even beats inflation. On the other hand, when customers borrow they are probably more concerned by the direction of future interest rates, but ultimately future interest rates are set by inflation expectations.

Conventional analysis would suggest LLOY is currently making attractive returns from its mortgage customers. We, on the other hand, believe that on an inflation-adjusted basis depositors are currently paying for the credit crisis.

Peak and Trough spreads

(% unless otherwise stated)

Asset Spread	Date	SVR	RPI	Spread
Peak	Sep-99	6.7	1.1	5.6
Trough	Apr-10	4.0	5.3	-1.4
Average				3.6
Liability Spread		Sight deposits	RPI	Spread
Peak	Apr-10	0.8	5.3	4.6
Trough	Jun-09	0.8	-1.6	-2.3
Average				-0.3

Source: Seymour Pierce Ltd, Bank of England

Fair enough, perhaps? Deposit holders benefit from a Government guarantee, so perhaps should expect to do worse than inflation over the long term. But we would highlight the rate at which depositors were seeing their savings eroded peaked at 4.6% in the first half of the year.

Given that a large amount of customer deposits are held by baby boomers, who saw the high levels of inflation in the 1970s erode the savings of their consol-owning parents, we believe this is a key issue. If UK inflation gets out of control, rather than the investment bankers, it could be the UK customer deposits that end up in Switzerland.

HIGH MARKET SHARE AND GOVT SUBSIDIES = SUPERNORMAL PROFIT?

Perhaps high market share and Government support for LLOY funding will result in many years of supernormal profits? Much of the re-rating in the LLOY share price came after regulators decided the Net Stable Funding ratio would be delayed, we believe.

The first point to note is that officials from the Bank of England, including the Governor, have repeatedly asserted that Lloyds will need to fund without the help of the Central Bank.

A central bank should not allow its liquidity operations to become, or even to be perceived as a source of sustained funding for banks or for any other form of medium-term lending. The only medium-term source of commercial bank funding, and hence for their lending, is private sector savings, whether channelled through retail or wholesale markets. A central bank does not have access to those private sector savings.

Source: Paul Fisher, Managing Liquidity in the System: The Bank's Liquidity Insurance Operations 30 Sept 2010 to the LMA Syndicated Loans Conference

But even if UK banks were to receive support indefinitely, the experience from the other side of the Atlantic suggests this would not be a positive for shareholders. The Government Sponsored Entities between mid 2007 and August 2010 lost \$226bn according to their regulator the Federal Housing Finance Agency. 73% of the losses came from mortgages originated in 2006 and 2007.

This is despite at least one US politician warning that GSE subsidies would distort the market and might cause a financial crisis, and would need to be bailed out by tax payers when the housing bubble burst (*Ron Paul, October 2005*).

Government subsidies: for the cows

We highlight an extreme example of recipient Government subsidies not generally known for their shareholder value credentials: European farmers. According to figures from the World Bank, the European Union subsidises dairy farmers at a rate of \$913m per cow annually. In 2003 there were around 1 billion people worldwide who scrape by on just \$1 a day, while European Union cows were subsidised to the tune of an average \$2 per day (*NY Times Harvesting Poverty; the Rigged Trade Game* quoted in Bazerman/Watkins).

Some of the dairy subsidies were later removed when prices rose, only to re-introduce them when prices fell. While we believe that the UK Government was right to step in and save the banking system, we struggle to understand why equity investors should provide more capital until structural reform has been implemented. Subsidies are as addictive as hard drugs.

CUSTOMER GOODWILL

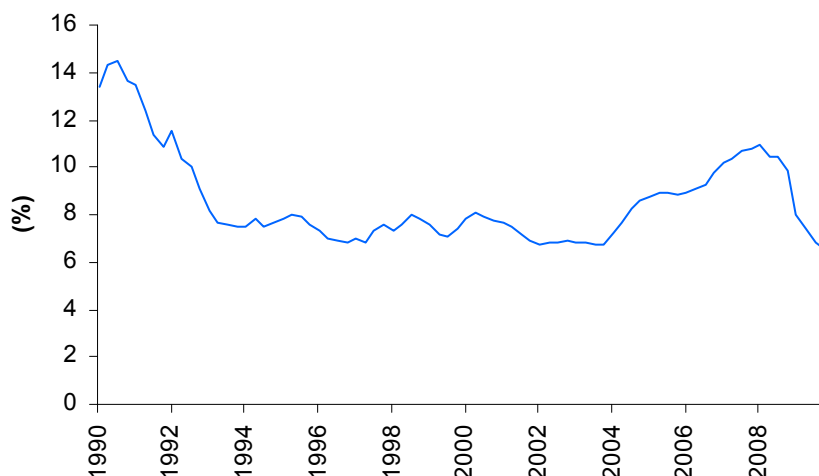
It is very hard to think of businesses which generate a high Return on Capital through the cycle, but where customers are unhappy with the main product. When we canvassed opinion from friends, Microsoft Vista and “any foreign owned utility company” were suggestions which kept cropping up. But we can’t think of any others. Normally businesses that offer an attractive service can charge enough to self finance growth without running out of capital.

Self financed growth

Banking is a little different in that banks tend to be unpopular with overleveraged customers in a recession. But we are concerned that in the first half of the year Lloyds received more than 280,000 complaints according to the FSA (albeit this is less than 1% of 30 million customers).

But most recessions, including the Nordic banking crisis which saw bank nationalisations, were followed by interest rates above the level of inflation. LLOY may need to offer retail savers interest rates above the level of inflation. If so, then if interest rates were 5% and mortgage spreads were at current levels then income gearing would be almost twice as high as currently reported (12.7% v 6.6% Dec 09 actual) according to the Bank of England. Despite low interest rates 7% of loans are non performing with interest rates at 0.5%.

Income gearing



Source: Bank of England

That is, there is a chance that the Government stake in Lloyds will be offered to the market, at a time when the bank is reporting peak profitability but high levels of customer dissatisfaction. We believe investors should be more concerned about the latter.

Financial model

LLOY

£m unless otherwise stated	FY'08 A	FY'09 A	FY'10 E	FY'11 E	FY'12 E	FY'13 E
Net interest income	14,903	12,726	13,941	14,080	13,947	13,929
Other Non NII	6,452	11,238	11,079	11,079	11,300	11,639
Total Non NII	6,452	11,238	11,079	11,079	11,300	11,639
Total income	21,355	23,964	25,020	25,159	25,247	25,569
Total costs	(12,236)	(11,609)	(11,509)	(11,070)	(11,181)	(10,957)
Trading surplus	9,119	12,355	13,511	14,089	14,066	14,612
Impairments	(14,880)	(23,988)	(11,701)	(7,606)	(2,770)	(2,909)
PBT	(5,761)	(11,633)	1,810	6,483	11,295	11,703
Exceptionals	6,521	12,675	377	0	300	0
Published PBT (IFRS)	760	1,042	2,187	6,483	11,595	11,703
Tax	38	1,911	(612)	(1,686)	(3,479)	(3,511)
Profit after tax	798	2,953	1,575	4,798	8,117	8,192
Minority interests Preference Shares	(26)	(126)	(126)	(126)	(126)	(126)
Attr. Profit	772	2,827	1,449	4,672	7,991	8,066
Dividend	(648)		0	0	0	0
Retained earnings	124	2,830	1,448	4,674	7,992	8,066
Number of shares Average	11,581	66,900	67,569	68,245	68,927	69,616
	11,581	37,674	67,235	67,907	68,586	69,272
Dividend per share			0.0p	0.0p	0.0p	0.0p
NAV per share	0p	62p	70p	76p	87p	98p
EPS Reported	6.7p	7.5p	2.2p	6.9p	11.7p	11.6p
EPS Adj	-49.6p	-26.1p	2.2p	6.4p	11.7p	11.6p
		-47%	-108%	199%	81%	0%

Source: Seymour Pierce Ltd

THE COST OF INACTION

Many investors we speak to seem to believe that the Government subsidies for the banking sector are a positive for shareholders. They also believe that the US banks lobbying effort in Washington will be positive for the industry. We strongly recommend investors read Max Bazerman and Michael Watkins' book *Predictable Surprises*. Bazerman and Watkins cite several examples of industry lobbying (accountants reluctant to separate auditing and consulting, fishermen disbelieving that fish stocks were in danger) which was counter productive, but the first chapter of the book is the most powerful.

Safety measures too costly in economic terms

The lobbying by the US airline industry between December 1988 (Lockerbie bomb) and September 2001 (World Trade Centre) is worth highlighting. Following the Lockerbie bomb, the Airport Transport Association (ATA) balked at proposals requiring fingerprinting and criminal background checks of airport workers. Congress finally mandated screener background checks in 1996, but they were of little value; current employees were exempt, while many of the new screeners hired were recent immigrants whose background couldn't be verified.

The explosion of TWA 800 in July 1996 put the spotlight back on security, and the "Gore Commission" was set up, led by the then Vice President. Also part of the commission was CIA Director John Deutch and several relatives of the air disaster. The airlines lobbied fiercely against safety measures such as matching baggage with customers on domestic flights (international bag matching was already required) because the economic cost of implementing measures would be too high. Meanwhile American Airlines, Delta, Northwest, Southwest and US Airways spent millions on lobbying.

Victoria Cummock, who had lost a relative on Pan Am 103, resigned in disgust when the security measures were watered down in the final version of the report. Kathleen Flynn, who lost a child on the same flight, told the *Boston Globe* she believed the final report to have been influenced by political donations.

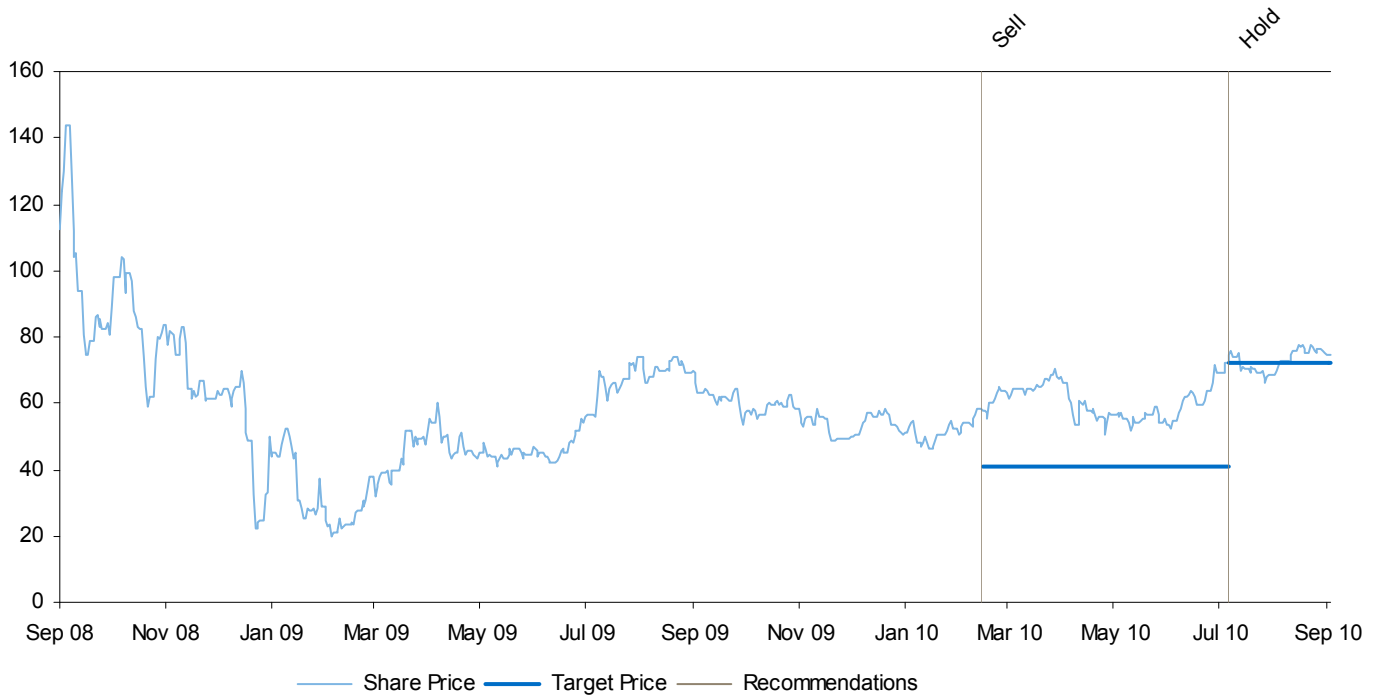
The FAA estimated that the cost of the enhanced security measures was roughly equal to \$1.7bn. But the costs of inaction turned out to be much higher. Perhaps, terrorists would still have been able to mount the attacks, even with the enhanced measures.

But what we do know is the cost of the attacks on the World Trade Centre, which was put at \$83bn, according to the New York City comptroller, was far higher than the cost of the proposed safety measures. Congress designated \$40bn for disaster relief after September 11, and agreed to give the airlines \$15bn in an emergency bail out package. A couple of the airlines which had lobbied for watered down regulation still filed for Chapter 11 (US Airways and United Airlines). The human cost was thousands of lives.

Hindsight is 20/20. Security experts and analysts who recommend tighter measures can be just as self serving as everyone else. But we would not see weaker regulatory action as a positive for shareholders *per se*.

Predictable Surprises Max Bazerman, Michael Watkins.

Target Price & Recommendation History



Source: Datastream, Seymour Pierce Ltd

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Rating	Definition
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Outperform	Absolute return expected to increase by between 5% and 10%
Hold	Absolute return expected to change by between -5% and +5%
Underperform	Absolute return expected to decrease by between 5% and 10%
Sell	Absolute return expected to decrease by more than 10%

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Outperform	9.0%	43.8%
Hold	20.8%	18.9%
Underperform	3.9%	14.3%
Sell	6.2%	0.0%

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