



Pan-European Equities: Banks Sector

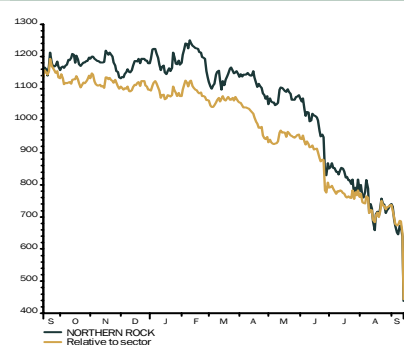
SELL **438p**
Target price: **280p**

17 September 2007

| Stock data | |
|---------------------|------------------------|
| Ticker (Bloomberg) | NRK LN |
| ADR | NHRKF US |
| Market cap (£m) | 1960 |
| Shares in issue (m) | 400 |
| Sector | Banks |
| Relative index | FTSE Euro1st 300 Banks |

Source: Bloomberg.

Price and price relative



| Performance | 1mn | 3mn | 12mn |
|----------------|------|------|------|
| Absolute | -40% | -57% | -61% |
| Rel. to market | -41% | -55% | -66% |
| Rel. to sector | -38% | -52% | -61% |

Price as of 14 September 2007 close
Source: Thomson Datastream

Next event

3rd profit warning?

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Northern Rock

Light at the end of the tunnel...

Northern Rock shocked the market with the announcement that it had sought emergency funding from the Bank of England. Although this was temporary solution to the bank's funding difficulties, we believe the flaw in the wholesale funded model has been starkly revealed and value is now permanently impaired. NRK does not have a viable stand-alone strategy: it must either seek a buyer (in these markets?) or raise prices and let the book run off, in our view. The uncapped liquidity facility from the BoE should provide relief, however "the light at end of the tunnel" may only be the express train coming in the opposite direction. We have downgraded our recommendation to SELL (from Neutral). New TP 280p.

- ▶ We have downgraded our earnings estimates by a whopping 35% for 2007, to 74p underlying, and by 54% in 2008 to 53p, driven by lower balance sheet growth, higher margin pressure, lower disposal gains and higher impairment charges. Our 2007 PBT forecast on Northern Rock's 'underlying' basis is £530m (Company guidance £500-540m)
- ▶ We think a bid close to book value, including the Foundation shares' 15% conversion dilution (ie 400p + 60p), is unlikely given 'the credit crunch' which has heightened CEOs' appreciation of retail deposits. Photos of pensioners queuing outside branches suggest the bank may see large deposit outflows and certainly could not claim a 'deposit franchise'. No limit has been placed on amounts that can be withdrawn, so far.
- ▶ From an industry perspective, we are worried about the impact of the wholesale funded £321bn 'other specialist lenders' balances, up from only £48bn six years ago. We notice this model has never been tested 'through the cycle' in the UK, and could cause 'collateral damage' to the listed banks. Northern Rock's book value could fall well below 400p if deposit outflows and asset quality deterioration combine.
- ▶ For now we think 70% of book (280p) might represent a floor.

Key data

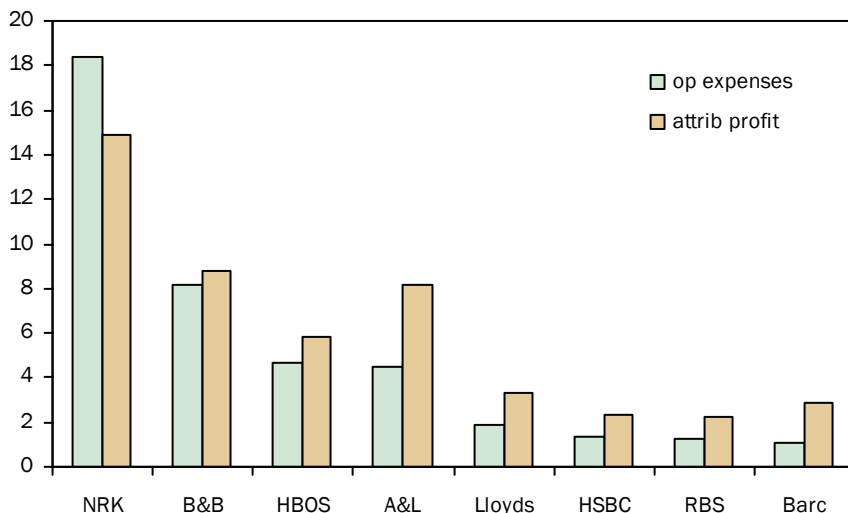
| Year end Dec | 2005a | 2006a | 2007e | 2008 | 2009e |
|--------------------|-------|-------|-------|------|-------|
| Pre-tax (£m) | 495 | 627 | 480 | 410 | 288 |
| EPS (p) | 74 | 88 | 74 | 53 | 29 |
| P/E (x) | 5.8 | 4.9 | 5.8 | 8.2 | 14.7 |
| Net income (£m) | 301 | 395 | 269 | 213 | 120 |
| Rep. BVPS (£m) | 374 | 418 | 443 | 451 | 433 |
| ROE (%) | 20.3 | 23.5 | 14.6 | 11.0 | 6.2 |
| P/Rep. BVPS (x) | 1.15 | 1.03 | 0.97 | 0.95 | 0.99 |
| ROIC (%) | 11.1 | 11.7 | 8.6 | 7.1 | 5.1 |
| P/IC (x) | 1.13 | 1.07 | 1.03 | 1.01 | 1.01 |
| Dividend yield (%) | 6.9 | 8.3 | 8.5 | 6.0 | 6.0 |

Source: Subject company data, Pali International estimates.

Cost of liabilities

Every equity salesman (and even the odd trader) knows about Northern Rock and its c30% cost income ratio. A less well known ratio is that interest costs are over 18x operating costs and 15x attributable profits H1 07.

Interest expense/operating expense

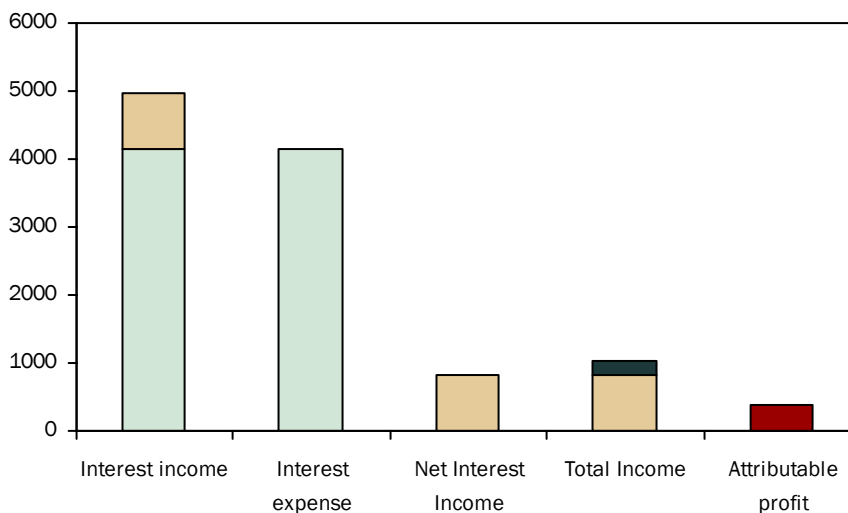


Source: Subject company data, Pali International.

For this reason, we think a bid for the bank is possible, rather than probable. If a bid does not materialise, the bank may have to close to new business and let the back book of customers run off. This process could be accelerated by raising pricing (by increasing asset spreads).

An old analysis rule of thumb suggests that book value should provide a floor. However at £1.9bn (vs £113bn total liabilities), this is far from certain. The graph below shows that if interest expense rose around 40% (all else being equal), this would be enough to wipe out book value. Instead we prefer to value the bank at 70% of book value (280p), based on German banks in c2002.

NRK P&L FY 06



Source: Subject company data, Pali International.

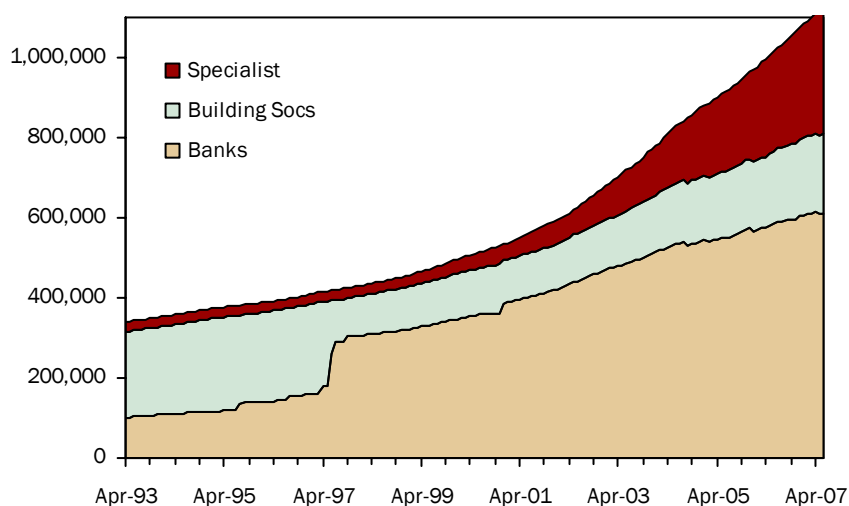
Hedges?

Although management have pointed to 'hedges', we continue to be troubled by the £8bn 'Available for Sale' (AFS) portfolio. At the H1 analyst presentation, management said that losses on this portfolio would not be recognised in the P&L (as the assets would simply be held to maturity). This statement is rather contradicted by the £3m AFS loss in H1 06, restated in the P&L this year. There was a £31m negative markdown in reserves in H1 last year, which did not go through the P&L, but was an adjustment to equity. While our 30% discount to book value implies a c£600m write-down, which might be too negative, we believe the burden of proof lies with the management.

Other specialist lenders

We are also getting nervous about growth in the wholesale funded 'other specialist lenders', which has risen by +37% CAGR in the last six years.

UK mortgage market, balances outstanding (£m)



Source: Bank of England.

These non-banks were c28% of the £1.1trn mortgages outstanding in H1 07, and outstanding balances have grown to £321bn, from only £48bn, in the last six years. By their nature they are wholesale funded (on the BOE definition of the category) and many are unlisted.

Perhaps, some will argue, the removal of competitors and widening margins is a reason to buy banks with retail savings. But we have never seen a time when asset yields rising is good for banks, since it suggests a *a priori* mispriced risk.

Multiplier effect driving the housing market?

As a general observation, we notice that economists and Bloomberg talking heads are not drawing attention to the 'multiplier effect' of easier credit conditions. This concept broadly states that a deposit can be recycled in such a way that more than its original value is lent out.

For example: If you deposit £100 pounds with a bank, the bank lends £90 to someone else, who then buys a widget from a third person who then deposits £60 in the bank. The bank then lends out £54 (90% of £60) or £144 from the original deposit.

We think something similar has happened in the UK housing market. How this unwinds is a rather uncomfortable thought and we wonder why investment bank 'house economists' are not drawing attention to it. Funny that...or perhaps not.

Collateral damage

"Sell the UK banks because there is going to be a house-price crash" was not a particularly good (or well argued) investment case in 2002-03. However, five years later, we do notice a lot of complacency about property as an investment class, suggesting it is worth revisiting the topic:

- ▶ Repossessions were up +36% in Q2, according to the Royal Institute of Chartered Surveyors. This should be a lagging indicator but is rising much faster than 3-6M arrears for Northern Rock, and the industry as a whole. Conditions are likely to have been favourable for selling, explaining the £2m provisions impairment charge NRK took on residential mortgages balances of £87bn.
- ▶ To be clear, we do not think that Northern Rock is deliberately under provisioning. Under Basel II the process has become much more mechanical (Northern Rock's CEO has warned that the charge is likely to be more volatile going forward, and he would have preferred to 'tuck away' provisions when times were good).
- ▶ Of Northern Rock's new borrowers, 19% had a deposit of 10% or less (ie a 90% Loan-to-Value (LTV) or higher), suggesting that this group would be particularly sensitive to house price declines. As we note later, BIS II tends to penalise banks with more high LTV customers.

Lifestyle products, +36%

In addition, we are concerned about the growth rates in some of the 'Lifestyle' products Northern Rock offers.

- ▶ Together grew by 34% H1-on-H1 last year. This product is akin to 125% LTV as it combines a secured and unsecured loan at one interest rate and one monthly payment. The unsecured component has, up until now, performed better than traditional personal loans, as the single monthly payment psychologically makes a default less likely. However, if house prices do begin to fall, negative equity could be a problem for this type of borrower.
- ▶ Buy to Let increased even faster, at above 60%. At this point in the cycle, we just don't think growing BTL is good business practice. Estate agents quoted in the national press suggest that yields are currently 3-4% (when the risk free rate is 5.75%).

Lifestyle product growth rates

| | Together | Lifetime | Buy to Let | Total |
|----------------------|----------|----------|------------|--------|
| H1 07 | 23.8% | 2.5% | 7.1% | 33.4% |
| H1 06 | 22.7% | 2.9% | 5.6% | 31.2% |
| Absolute (£m) | | | | |
| H1 07 | 20,800 | 2,185 | 6,205 | 29,189 |
| H1 06 | 15,576 | 1,990 | 3,842 | 21,408 |
| Growth (%) | 34% | 10% | 61% | 36% |

Source: Subject company data.

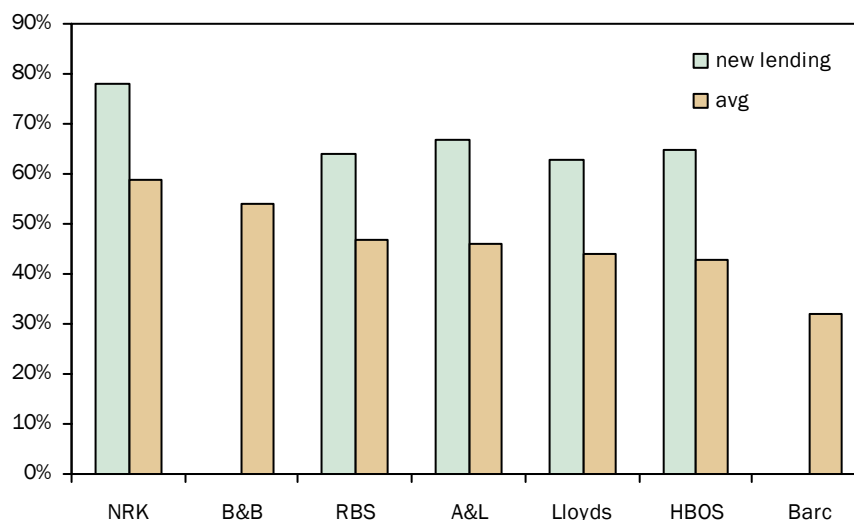
Basel II and bid speculation

Northern Rock saw an 81% reduction in 2006 RWA to £17bn on a 2006 Basel II basis. Yet we believe investors should at least question the logic that Northern Rock is a bid target due to lower BIS II capital requirements. Aside from the recent credit crunch, conditions have sharpened CEOs' appreciation of retail deposit funding, and we believe Northern Rock's customer base has become less valuable.

Comments in *Risk* magazine, August 2007, suggest that BIS II tends to favour banks with a back book of customers who are 15-20 years into their mortgage, with LTV of perhaps 30% or lower. Currently, these low-risk customers are probably cross-subsidising riskier lending at an industry level under BIS II. These customers are likely to be doubly valuable, as acquisition through a price-led strategy should prove hard, given that the lower balances they hold would suggest a large amount of inertia. To us it makes sense to access these customers through acquisition.

But Northern Rock has grown assets by 2.5x in the last five years, and we don't think these high-value, low-balance customers represent the bulk of Northern Rock's customer base. We feel this is confirmed by Northern Rock having one of the highest published average LTV ratios in the sector (on new lending and average of balances outstanding).

Loan to value comparisons



Source: Subject Company data, Pali International.

We also struggle to identify who would like to buy (er...bail out?) Northern Rock.

A UK bank might be put under pressure by the Bank of England, however management also have a duty to their shareholders. Notoriously, Barclays bought Woolwich in 2000, and net mortgage market share fell from 8% in 2001 and 2002, to negative in 2005, as synergies were achieved but underlying profits went backwards.

US investment banks now seem to be in trouble, and are sacking many of their staff as securitisation volumes dry up. Lehmans buys Northern Rock's subprime mortgages, however its shares are now down 31% since mid June and up until last week had only just outperformed Northern Rock!

From a European bank perspective, most Continental investors we have spoken to in the past think that the UK mortgage market is a bubble driven by cheap finance and availability of credit. We would be surprised if European bank managements thought differently, or could persuade their shareholders that Northern Rock was of strategic value and worth paying a premium for (including buying out the NRK Foundation shares).

As a final thought on BIS II, we should also dismiss the idea that only 'large, sophisticated, listed' banks could benefit from the Internal Ratings Based (IRB) approach. This is rather undermined by the Norwich and Peterborough BS, Europe's first IRB qualifier, with total assets of just £3.7bn.

The risks

If the cost of funding returns to normal levels, and credit conditions are favourable, Northern Rock may be able to achieve earnings growth despite the flaws exposed in the wholesale funded model by the spike in 3M Libor and overnight rates. A bid from a bank under political pressure from the Bank of England is also a possibility, but we think a premium is unlikely.

Earnings forecasts

Forecasting Northern Rock's earnings is a particularly challenging (and perhaps pointless) exercise at the moment. We were previously assuming 3M Libor at c20bp above Base rates in H2 (vs more than 100bp currently).

We have taken out £25m AFS gains in 2008, as we don't think these should be relied upon, or included in underlying earnings, until the company gives greater clarity on how these are achieved. We have also reduced gains on the disposal of unsecured assets in 2008 by £10m, to £30m, as we believe there will be fewer buyers for unsecured assets in the current environment.

We are expecting flat income, flat costs and a 76% rise in the impairment charge from our previous estimate, based on a more negative view of the UK housing market and keeping more unsecured lending on balance sheet.

In total, this leads to a downward revision to 2008 underlying EPS of 54%. Our 2009 forecast of 29p leaves some question over the dividend.

Northern Rock income statement

| Year end Dec (£m) | FY05a | FY06a | FY07e | FY08e | FY09e |
|-----------------------------|-------------|-------------|-------------|-------------|-------------|
| AIEA | 72,730 | 88,788 | 110,985 | 116,534 | 122,360 |
| NIM | 0.97 | 0.88 | 0.64 | 0.60 | 0.57 |
| Net interest income | 707 | 778 | 714 | 699 | 697 |
| Growth (%) | 15 | 10 | (8) | (2) | (0) |
| Other operating income | 129 | 153 | 189 | 210 | 200 |
| Growth (%) | 15 | 18 | 24 | 11 | (5) |
| Total income | 836 | 931 | 903 | 910 | 897 |
| Growth (%) | 15 | 11 | (3) | 1 | (1) |
| Operating expenses | (274) | (309) | (351) | (354) | (354) |
| Growth (%) | 15 | 13 | 14 | 1 | - |
| Operating profit | 562 | 622 | 552 | 555 | 543 |
| Growth (%) | 16 | 11 | (11) | 1 | (2) |
| Credit provisions | (57) | (81) | (126) | (176) | (256) |
| Growth (%) | 29 | 43 | 55 | 39 | 46 |
| Net operating income | 505 | 541 | 426 | 380 | 288 |
| Growth (%) | 14 | 7 | (21) | (11) | (24) |
| AFS, Disposals & Swap gains | 0 | 45 | 105 | 30 | 0 |
| Hedge ineffectiveness | (10) | 41 | (51) | 0 | 0 |
| Integration charge | 0 | 0 | 0 | 0 | 0 |
| Pre-tax | 495 | 627 | 480 | 410 | 288 |
| Growth (%) | 12 | 27 | (23) | (15) | (30) |
| Tax (%) | 29 | 29 | 30 | 30 | 30 |
| Tax | (145) | (184) | (144) | (123) | (86) |
| Minorities & prefs | (49) | (49) | (67) | (74) | (82) |
| Post-tax extraordinaries | | | | | |
| Attributable profit | 301 | 395 | 269 | 213 | 120 |
| Growth (%) | 11 | 31 | (32) | (21) | (44) |
| Number of shares (m) | 421 | 426 | 430 | 434 | 438 |
| Average shares (m) | 415 | 417 | 410 | 406 | 410 |
| EPS (p) | 71.5 | 92.7 | 62.5 | 49.0 | 27.3 |
| Growth (%) | 11 | 30 | (33) | (22) | (44) |
| Underlying EPS (p) | 74.4 | 88.1 | 74.2 | 52.5 | 29.2 |
| Growth (%) | 13 | 18 | (16) | (29) | (44) |
| DPS (p) | 30.1 | 36.2 | 37.1 | 26.2 | 26.2 |
| Growth (%) | 14 | 20 | 3 | (29) | - |

Source: Subject company data, Pali International estimates.

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