

Change in recommendation

United Kingdom

# Abbey National<sup>[g]</sup>

## For Sale?

Banks

30/04/04

452.50p

**Abbey management is, we believe, under pressure to demonstrate better performance in the retail bank or put the bank up for sale. We have upgraded our stance to BUY on the increased chance of a bid being accepted.**

**Our previous view was that consolidation rumours reported in the UK press were likely to prove premature.** We thought a serious bid was unlikely until Abbey had shown improved performance in the core retail bank (the PFS).

**However, press reports over the weekend suggest frustration** at recent performance means that the bank is now coming under pressure from large shareholders to listen to serious offers.

**We have downgraded our 2004 forecasts for trading EPS by 7%** to 37.2p following Abbey's 1Q04 announcement, and upgraded our target price and recommendation, based on a 50% probability that a deal goes through in the next six months. We believe currently a realistic premium is 20% to today's price or £5.40, but our target price reflects a 50% chance that a bid will not materialise.

### PFS Forecasts and ratios

Yr to Dec	Total income (£m)	Trading PBT (£m)	Reported PBT (£m)	Trading EPS (p)	EPS (p)	DPS (p)	Yield (%)	Adj PER (x)	P/BV (x)
2003	2,789.0	1,021.0	235.0	41.7	-52.4	25.3	5.6	10.9	1.2
2004F	2,769.8	931.5	803.5	37.2	N/A	25.3	5.6	12.2	1.5
2005F	2,872.5	956.8	928.8	38.2	N/A	25.3	5.6	11.8	1.4
2006F	3,132.7	1,127.8	1,099.8	46.2	N/A	25.3	5.6	9.8	1.3

Source: Company data, ING estimates

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Previously: Hold

# Buy

4 May 2004

Target price: 12 month  
 501.61p

Reuters  
 ANL.L

### Key ratios

	2003	2004F
Net int margin (%)	1.7	1.5
NPLs (%)	84.0	84.8
Cost/income (%)	56.5	59.2
ROA (%)	0.3	0.3
ROE (%)	11.1	11.1

### Performance (%)

	12m	3m	Target
Absolute	1.8	(22.0)	10.8
FT 100	3,926.0	4,390.7	4,430.0
E300 Banks	724.1	883.7	
<b>Relative to</b>			
FT 100	(11.0)	(23.7)	12.4
E300 Banks	(15.8)	(21.2)	

### Share data

No. of shares (m)	1,445.2
Volume	44,274,500
Free float (%)	100.0
Market cap (£m)	6,539.5
Enterprise value (£m)	6,539.5
BVPS(p)	362.1

### Share price performance (rebased)



Source: ING

## Disappointing 1Q04

### *The problem was in the core retail business*

On Thursday, 22 April Abbey reported disappointing results for 1Q04. Although reporting a return to profitability at a group level, guidance for the half year that spreads were likely to fall by 15bp was taken as a profit warning. This was particularly disappointing because the problem was in the core retail business, and was coupled with net lending falling by 16% in 1Q04 and net deposit outflows of £1.2bn. The numbers imply that the re-branding exercise has not been going well, and that Abbey has been finding it hard to manage the trade-off between market shares and margins, with both falling in 1Q04.

According to management the fall in spread was caused by lower level of redemption fees being booked, as rising interest rates meant customers were less likely to remortgage. In theory a lower level of remortgaging should have been positive for Abbey which still has 15% of its back book on free to go SVR. Certainly none of the other UK banks reported similar problems in their 1Q trading statements.

Management did say that the decline should be materially lower in 2H04. However, it tempered this with caution at the analyst conference call, saying that the organisation was undergoing a large amount of change, which made firm forecasts difficult.

## Open to offers

The Abbey board is currently debating whether to encourage offers now (effectively put the bank up for auction), or wait until the benefits of its recovery plan show through, according to an article published in the *Sunday Times*. The article suggests that a sizeable minority of US value investors were concerned that the bank rejected Banco Santander's approach out of hand.

### *Current management skills best suited to the first part of the turnaround process*

Shareholders may feel that while Luqman Arnold (chief exec) and Stephen Hester (FD) were well suited to the first part of the turnaround process (disposing of the 'bad bank' assets), they lack experience running, let alone rebuilding, a retail bank. Thus, it would be better if they talked to potential buyers now, rather than risk further disappointing news at the half-year stage.

## Cross-border deal more likely

### *Friendly takeover not merger of equals*

Although cost synergies are likely to be lower than an in-market merger, we believe a cross-border deal is more likely. This is because we think a large UK bank is unlikely to risk the deal being blocked by the UK government, which is increasingly anxious to portray itself as consumer friendly. In contrast, unlike many other European countries, the government and the Bank of England are unconcerned with creating 'domestic champions' and thus blocking foreign banks from making acquisitions. Abbey also represents an unusual opportunity, since an acquisitions would be positioned as a 'friendly takeover' not a 'merger of equals'. This means a firm offer would be subject to satisfactory due diligence, but there would be no uncertainty around which bank's management would be left in charge.

There are also a couple of other less explicit reasons. Abbey has been loss making for the past two years, in which case a deal might be structured to take account of the bank's tax shield. This is a complicated area, given that a sizeable proportion of the loss incurred has been due to goodwill writedown.

Also, we believe both IAS (due 2005) and the revised Basel Capital accord (due end of 2006) could be relevant as they could substantially alter the amount of capital needed to support Abbey's assets. Under BIS the three main impacts are potentially: reduction

in mortgage risk weighting to 35% on the standardised basis, eliminating the regulatory capital benefits of securitisation and capital deductions of life businesses made from tier 1 and tier 2 capital in equal measure. If Abbey attains the more onerous Advanced Internal Ratings Based Approach (as opposed to the standardised approach) mortgage risk weightings could fall further.

In effect, this would mean that a bank acquiring Abbey, would initially have to support mortgage RWA at 50% weighting; however, within a couple of years this would fall substantially, meaning that capital could potentially be upstreamed to the acquiring bank, to make buybacks or further acquisitions.

So far Abbey management has been cautious about making public statements concerning potential excess capital in light of the BIS and IAS changes, and has recently downplayed expectations of a buyback.

### **Still substantial excess capital**

On our estimates, under the BIS standardised approach, bringing back securitised assets onto the balance sheet and deducting the £771m pension fund deficit from regulatory equity, Abbey's 2003 tier 1 ratio would fall from the current 10.1% to 8.0%, still leaving substantial excess capital.

### **Value then**

In September 2002 Bank of Ireland approached Abbey with a detailed proposal, and then published the terms a month later, after the offer was rejected. Bank of Ireland estimated it could achieve £400m of synergies, of which £220m were operational cost synergies (or 15% of Abbey's 2001 trading expenses). The terms of the deal valued Abbey at between 770p to 805p, an 18-24% premium to its price before the bid. Since then Abbey has disposed of £50bn of PBU assets (only £10bn remain).

### **Value now**

When Banco Santander reportedly approached Abbey six weeks ago the price was around the current level of 450p. We believe the premium would have been smaller in absolute terms, but similar (around 20%) as a percentage of market cap.

Much now depends on both sets of shareholders. Abbey's retail shareholders vented their fury at management at the company's AGM. We suspect management has also been given a rough ride by institutions behind closed doors. Banco Santander shareholders are likely to need some persuading that the logic of the deal makes sense, and that they are not gaining exposure to two housing market bubbles rather than one. It should also be remembered that Royal Bank has a 2.83% stake in Santander.

### **We are assuming a 50% probability a deal goes through**

We have downgraded our forecasts for trading EPS by 7% to 37.2p following Abbey's 1Q04 announcement, and upgraded our target price (previously 491p) and recommendation. Although there is clearly much to be resolved, we believe there is a 50% probability that a deal will go through in the next six months. Our standalone fair value for Abbey is 465p, and including a 50% probability of a bid at 540p we arrive at a target price of 502p, giving 11% upside. We also believe the risk of the deal not being forthcoming is limited given that the shares are yielding 5.6% (and the bank has already cut its dividend).

### Comments on financials

- We have updated our numbers following Abbey's 1Q trading update. We expect spread erosion in 1H of 15bp to slow, so that the FY number is 20bp erosion in total.
- This effect is slightly offset by a lowering provisions charge. Management said that the absolute charge would be around the level of last year, with volume growth and improvement in asset quality cancelling each other out.
- This gives us Trading Profit of £931m for the FY and trading EPS of 37.2p. This is an 11% fall on 2003 numbers, and is a 7% downgrade on our previous estimates.

### Income statement (£m)

Yr to Dec	2003	2004F	2005F	2006F
Net interest income	1,795.0	1,723.1	1,775.9	1,948.4
Net fees and commissions	427.0	455.8	483.2	521.8
Trading profit	0.0	0.0	0.0	0.0
Insurance profit	(39.0)	248.5	356.6	385.1
Other operating income	227.0	242.3	256.9	277.4
Total income	2,789.0	2,769.8	2,872.5	3,132.7
% of average total assets	1.5	1.7	1.6	1.6
Total operating costs	(1,577.0)	(1,640.1)	(1,705.7)	(1,773.9)
% of average total assets	(0.9)	(1.0)	(1.0)	(0.9)
% of total income	(56.5)	(59.2)	(59.4)	(56.6)
<b>Net operating income</b>	<b>1,212.0</b>	<b>1,129.7</b>	<b>1,166.8</b>	<b>1,358.8</b>
Provisions	(191.0)	(198.2)	(210.1)	(231.1)
<b>Trading profit</b>	<b>1,021.0</b>	<b>931.5</b>	<b>956.8</b>	<b>1,127.8</b>
Adjustments	(729)	(200)	0.0	0.0
Goodwill amortisation	(28.0)	(28.0)	(28.0)	(28.0)
<b>Pre-tax profit</b>	<b>235.0</b>	<b>803.5</b>	<b>928.8</b>	<b>1,099.8</b>

Source: Company data, ING estimates

### Balance sheet (£m)

Yr to Dec	2003	2004F	2005F	2006F
Total assets	156,598	170,692	180,933	199,027
Customer loans	99,656	108,626	115,143	126,657
% of total assets	63.6	63.6	63.6	63.6
Other interest-earning assets	48,287	28,287	28,287	28,287
Customer deposits	76,766	76,766	76,766	76,766
% of total assets	49.0	45.0	42.4	38.6
Other interest-bearing liabilities	72,253	72,253	72,253	72,253
Shareholders' funds	5,206.9	4,494.2	4,858.9	5,018.0

Source: Company data, ING estimates

**Per share and other data (p)**

Yr to Dec	2003	2004F	2005F	2006F
<b>Per share data</b>				
Adj EPS	41.7	37.2	38.2	46.2
EPS after amort of goodwill	-52.4	N/A	N/A	N/A
DPS	25.3	25.3	25.3	25.3
BVps	362.1	311.0	334.5	343.8
Adj BVps	420.6	371.2	396.4	407.2
<b>Solvency and profitability ratios (%)</b>				
Tier 1 BIS ratio	10.1	10.7	10.0	9.5
Tier 2 BIS ratio	9.8	10.7	9.9	9.2
Total BIS ratio	13.3	14.3	13.4	12.8
ROE	11.1	11.1	11.9	13.7
<b>Credit quality</b>				
Gross NPLs (m)	772.2	849.4	934.4	1,027.8
Accumulated provisions (m)	358.0	393.8	433.2	476.5
Coverage ratio (%)	0.5	0.5	0.5	0.5
Net NPLs (m)	414.2	455.6	501.2	551.3
As % of shareholders funds	8.0	10.1	10.3	11.0
As % of net operating income	34.2	40.3	43.0	40.6

Source: Company data, ING estimates

**Company profile**
**Abbey National History**

The Abbey National Building Society was formed in 1944 from two long-standing building societies. In 1989, Abbey National converted to become a bank and was listed on the London Stock Exchange. Following a group restructuring, the bank will increasingly focus on its UK Personal Financial Services operations.

**Personal Financial Services**

Although undergoing transformation, PFS starts with around 16m UK customers, and has the second largest market share of UK mortgages. The group has 741 branches, over half of which are currently franchised. PFS also distributes pension, insurance, investment and savings products through its branches and third-party IFAs. Abbey National business provides a range of banking and finance services to SMEs in the UK. These services include banking and investments, commercial mortgages, asset finance, invoice finance and insurance.

**Portfolio Business Unit**

PBU consists of businesses in which the group has limited competitive advantage. PBU is mainly the bank's international operations and the asset-based portfolios (loans, leasing and bonds), representing the majority of the risk in the wholesale bank. This portfolio is being managed to maximise value for shareholders and the pace of the wind-down will be dependent on market conditions. Currently, management expects the bank to be 'de-risked' by 2004.

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