EQUITY RESEARCH
LLOYDS BANKING GROUP (LLOY) SELL

COLLINS SARRI STATHAM
INVESTMENTS

Research Report
ADVISORY SERVICES

Report Date
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Collins Sarri Statham Investments Ltd

Stock Rating: SELL

Target Price............... 70p
Share Price...................79p
Yr Hi/Low:...86.3p/54.05p
Shares o/s.................71.37bn
Market Cap..............£56.2bn
Avg Daily Vol..............5.32m
Dividend Yield.............NA
Fiscal Year......31 Dec 2014
Website:
www.lloydsbankinggroup.com

Key Risks to Price Target
i) Sensitive to regulatory pressures

ii) UK holds 24.5% stake in Lloyds which is likely to be sold prior to the 2015 General Election

iii) LBG EPS are sensitive to trends in net interest margin and impairment losses

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LBG is a leading UK Bank engaged principally in lending activities to UK consumers, SME and life assurance operations via Scottish Widows.

Strong Q1 trends in place

Lloyds Banking Group (LBG) Q1 2014 showed strong progress and we summarise key features below:-

a) Stronger guidance for Net Interest Margin (NIM 2014 guidance 2.4% +0.1%) helped by gains from the Enhanced Capital Notes buyback. Current net interest margin of 2.32% has jumped 36 basis points since Q1 2013 due to lower funding costs. Net interest income rose to £2.81bn (+10%).
b) High Capital levels – CET1 ratio 10.7% +0.4%- with strong momentum.
c) Impairments declined to £431m from over £1bn in Q1 2013 or 35 bps.
d) No new PPI provisions (current provision £9.8bn of which £2.28bn unused) suggesting the board are confident existing provisions will suffice.
e) Overall strong cost control, total costs dell 5% to £2.29bn during Q1 due to the Simplification programme, disposals and the run off in non-core. Simplification has saved £1.58bn by Q1 14 on track for £2bn by end 2014.
f) The ECN offer has concluded and it was a resounding success from LBG's viewpoint with the original £8.4bn of high yield ECN's exchanged into notes yielding c6.375%- 7.875% below the 9.3% average for ECN's– whilst the precise P&L read depends on the degree Lloyds used swaps to hedge the original coupon cost- there will be significant savings helping to lift NIM. The remaining ECNs c. £414m (excluding the 15% 2019 "make whole" ECNs) are just 5% of the original issue. The ECN offer delivered the notable one off benefit of lowering funding costs but the potential for further savings from bond buybacks appears limited. The board are unlikely to use the ruse of the "regulatory par call" elsewhere as we are not aware of other issues to which this clause applies.
g) TNAV (tangible net asset value) rose to 50.7p from 48.5p (end 2013) this rare gain in TNAV is positive and a further lift of c 5p is possible over FY14.
h) Q1 net profit £1.15bn (EPS 1.6p) leaves LBG on track to meet broker EPS consensus of 6.5p (FY14) however the margin for slippage is fairly tight (+/- 0.5p). But EPS upgrades for 2014 and 2015 are likely post interims.
i) To summarise the negatives, there is disappointment at the continued lack of clarity on the dividend – the board expect to apply to the FCA during 2H 2014 and have consistently suggested a progressive dividend will return however the FCA appear keen for LBG to continue building its capital organically as rapidly as possible. In short we view consensus 2014 dividend expectations of 2p per share as too high and view 1p-1.25p as nearer the likely outcome. This is likely to disappoint holders.
j) TSB IPO is on track for June 2014 IPO however the valuation at c£1.5bn (632 branches via Project Verde) will need to be low to entice investors. There is a sneaking suspicion that ahead of the IPO of TSB, Lloyds may have already tried to cherry pick the best customers.
k) LBG reported an exceptional gain of £394m from the sale of its 21% stake in St James Place (LSE:STJ).

PRA capital tests to consider LBG vulnerability in a UK property crisis

Stringent new capital stress tests to be conducted by the PRA will test the UK bank sectors' resilience in the event of a 35% decline in UK property prices and a 4% Base rate. The PRA made clear that even if the banks "appeared to pass" the stress tests, they could still be required to up capital levels i.e. increase loss absorbing equity capital. Under the new stress tests LBG needs to maintain a 4.5% ratio of capital to RWA throughout the downcycle (2013 RWA £263.9bn). Broadly the test is, could LBG absorb downcycle losses of c £27.5bn?

The stress tests raise the prospect of further equity issues from the sector, and may impact the timing of the UK's plans to dispose of its balance 24.5% stake in Lloyds. The government is against further equity participation itself.

The MPC is concerned about UK property prices. We note the statement from Deputy Governor Sir Jon Cunliffe "dangerous to ignore the momentum that has built up in the UK housing market….a major overshoot in prices and debt build up in debt followed by a sharp correction with negative equity". In our view this rhetoric makes it more likely that Base Rates will rise in Q4 2014 and possibly to 1% prior to the May 2015 General Election.

An environment of rising base rates would negatively impact LBG credit demand and cause a rapid increase in provisions and credit impairments. We note current impairment levels (35 bps) could mark a near trough if base rates move up in Q4.

LBG valuation – very frothy

The main bear point surrounding LBG is its very high premium to TNAV relative to its peers. Given a cursory look at the UK peer group this factor is beyond dispute. The more relevant issue is the speed at which the premium can normalise- we put this at c./ 3-4 years assuming TNAV growth to 65p. The table below suggests LBG is at a significant premium to its peers on the basis of premium to tangible net assets.

Company	P/E historic 2013 (x)	P/E forward 2014 (x)	TNAV (p)	Premium/ (Discount) to TNAV
Barclays	14.8	10.1	284	(13)
HSBC	12.0	10.6	558	8.8
LBG	**NA**	**12.1**	**50.7**	**55.8**
RBS	NA	17.9	376	(12)
Standard Chart	10.6	9.9	962	33.1
Average	**NM**	**12.1**	**NM**	**14.5**

Source; CSS Investments Ltd

Conclusion

Six years on from its rescue, the UK government wants a full exit from LBG. Should the government go the retail route for the balance, it will need to offer a significant discount to the current share price to entice retail investors. The UK could proceed via more 7% stake sales (hence getting a better price). But LBG faces key risks from mature rate cycle issues and in our view could be facing a reverse of key performance ratios looking ahead 6-18 months. Finally we are mindful of LBG's very high relative valuation, lack of dividend support and a plateau in EPS momentum as recent one off gains drop out.

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