

1 August 2014 | 68 pages

Regional Banks
Western Europe | United Kingdom

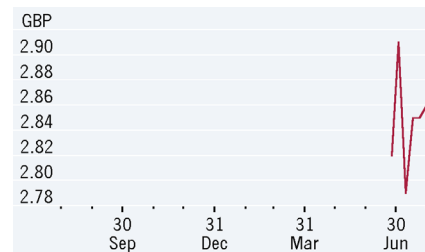
TSB Banking Group (TSB.L)

2020 Vision - Initiate Coverage With A Neutral Rating*

■ Initiation of Coverage

Neutral	2
Price (31 Jul 14)	£2.86
Target price	£3.00
Expected share price return	4.9%
Expected dividend yield	0.0%
Expected total return	4.9%
Market Cap	£1,430M
	US\$2,415M

Price Performance (RIC: TSB.L, BB: TSB LN)



- **Pure-Play UK Retail Bank** — TSB is the only listed pure-play retail bank in the UK. The business model is very simple, focused on servicing retail and micro-SME customers within the UK, with zero international business and no corporate and/or investment banking exposure. TSB is the 12th largest UK retail lender, accounting for only 2% of mortgages, but 4% of personal current accounts and 6% of branches.
- **Strong Growth Potential** — We assess TSB's target 40-50% growth in the stock of franchise lending over the next five years, including an analysis of the regional split and productivity of the branch network relative to peers. We conclude that TSB's established branch infrastructure, coupled with new product launches, re-entry into intermediary mortgages and digital capability should enable TSB to grow rapidly.
- **Geared to Rising Interest Rates** — TSB's secured asset margin is low with 65% of mortgages on a SVR capped at 2% over base rates, lower than the current front-book gross yield, at c3.5%. As base rates increase the SVR will rise and customers should re-mortgage, transitioning to front-book rates. In addition liability spreads should widen. Overall we believe TSB is more geared to rising rates than UK peers.
- **Low Credit Risk; No Legacy Conduct Issues** — Secured mortgages account for 90% of total loans and the average LTV is only 46%. The Group loan loss ratio was only 53-55bps in 2012-13 and is expected to remain at c55-60bps in 2014 and broadly stable thereafter. TSB also has indemnity coverage, provided by Lloyds, for any losses arising from pre-IPO breaches of laws and regulations, to include PPI.
- **Near-Term Pressures; Long-Term Opportunities** — In 2013 TSB stopped selling intermediary mortgages. This will weigh on revenues near-term, while the cap on SVR mortgages, plus investment spend, will also limit profitability. Re-launch of intermediary mortgages, coupled with rising rates, offers the potential for attractive returns and dividends, but this is unlikely to materialize until 2017-18. TSB target a double-digit RoE by mid-2019 "with momentum" and payout of c40-60% over time.
- **Neutral Rating** — We believe TSB will only approach a 'normalized' RoE by 2020, at which point we forecast a RoE of 15.6%. This presents significant option value if TSB can successfully execute upon its strategy. However the glide path towards a 'normalized' return is likely to be long, with the uplift back-end-loaded. We see few positive catalysts near-term and initiate with a Neutral rating, target price 300p.
- ***Correction:** We amend Fig 32 on page 18 to correct the quarterly numbers.

TSB Banking Group (GBP)

Year to 31 Dec	2012A	2013A	2014E	2015E	2016E
Net Income (£M)	11.4	54.6	32.7	-14.8	26.8
Diluted EPS (p)	2.3	10.9	6.5	-3.0	5.4
Diluted EPS (Old) (p)	2.3	10.9	6.5	-3.0	5.4
PE (x)	125.1	26.2	43.7	-96.8	53.4
P/BV (x)	na	na	0.9	0.9	0.8
DPS (p)	0.0	0.0	0.0	0.0	0.0
Net Div Yield (%)	0.0	0.0	0.0	0.0	0.0
ROE (%)	na	na	7.0	2.8	5.7

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See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

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Fiscal year end 31-Dec	2012	2013	2014E	2015E	2016E
Valuation Ratios					
P/E adjusted (x)	125.1	26.2	43.7	nm	53.4
P/E reported (x)	49.7	8.3	12.7	31.7	14.8
P/BV (x)	na	na	0.9	0.9	0.8
P/Adjusted BV diluted (x)	na	na	0.9	0.9	0.8
Dividend yield (%)	0.0	0.0	0.0	0.0	0.0
Per Share Data (p)					
EPS adjusted	2.3	10.9	6.5	-3.0	5.4
EPS reported	5.8	34.3	22.6	9.0	19.4
BVPS	0.0	0.0	321.6	330.6	349.9
Tangible BVPS	0.0	0.0	321.6	330.6	349.9
Adjusted BVPS diluted	0.0	0.0	321.6	330.6	349.9
DPS	0.0	0.0	0.0	0.0	0.0
Profit & Loss (£m)					
Net interest income	558	635	764	749	823
Fees and commissions	0	0	0	0	0
Other operating Income	179	163	143	153	165
Total operating income	737	798	907	902	988
Total operating expenses	-580	-576	-699	-726	-748
Oper. profit bef. provisions	157	222	209	175	240
Bad debt provisions	-117	-110	-104	-109	-128
Non-operating/exceptionals	0	-46	37	-10	10
Pre-tax profit	40	66	143	57	121
Tax	-11	105	-30	-11	-25
Extraord./Min. Int./Pref. Div.	0	0	0	0	0
Attributable profit	29	171	113	45	97
Adjusted earnings	11	55	33	-15	27
Growth Rates (%)					
EPS adjusted	-71.8	377.6	-40.1	-145.1	281.4
Oper. profit bef. prov.	-40.8	41.4	-6.0	-15.9	36.7
Balance Sheet (£m)					
Total assets	24,953	28,382	27,054	28,182	29,415
Avg interest earning assets	24,159	24,018	22,744	22,271	23,380
Customer loans	24,453	23,582	21,907	22,635	24,125
Gross NPLs	353	324	0	0	0
Liab. & shar. funds	24,953	28,382	27,054	28,182	29,415
Total customer deposits	22,900	23,100	24,283	25,367	26,502
Reserve for loan losses	0	0	0	0	0
Shareholders' equity	0	0	1,608	1,653	1,750
Profitability/Solvency Ratios (%)					
ROE adjusted	na	na	2.0	-0.9	1.6
Net interest margin	2.31	2.64	3.36	3.36	3.52
Cost/income ratio	78.7	72.2	77.0	80.5	75.7
Cash cost/average assets	2.4	2.2	2.5	2.6	2.6
NPLs/customer loans	1.4	1.4	0.0	0.0	0.0
Reserve for loan losses/NPLs	0.0	0.0	na	na	na
Bad debt prov./avg. cust. loans	na	na	na	na	na
Loans/deposit ratio	106.8	102.1	90.2	89.2	91.0
Tier 1 capital ratio	na	na	na	na	na
Total capital ratio	na	na	na	na	na

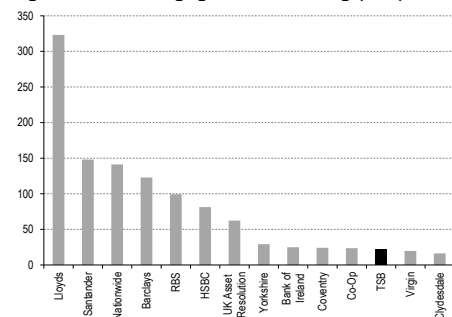
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Company Snapshot

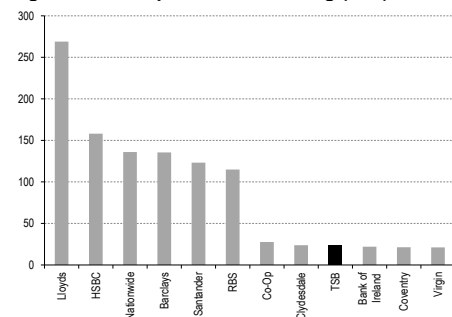
TSB is the 12th largest retail lender in the UK, according to our calculations, accounting for 1.7% of mortgages outstanding¹ and 4.2% of personal current accounts, with 4.5m retail customers and 110k micro-SME customers. The bank has national, multi-channel distribution via 631 branches and a full digital, mobile and telephony capability and currently employs 8,600 staff. It offers a full product suite of current accounts, savings, mortgages, unsecured personal lending, business lending and insurance.

Figure 1. UK Mortgages Outstanding (£bn)



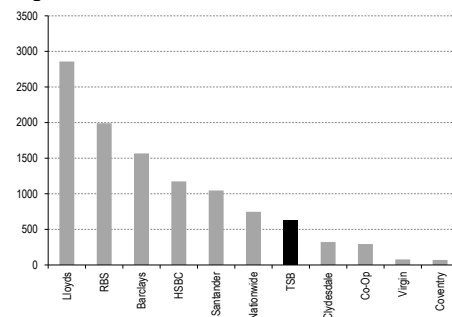
Source: Individual Company Reports, end-2013

Figure 2. UK Deposits Outstanding (£bn)



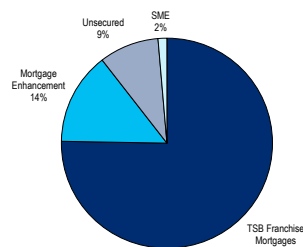
Source: Individual Company Reports, end-2013

Figure 3. UK Branch Numbers



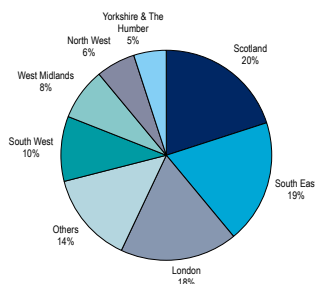
Source: Individual Company Reports, end-2013

Figure 4. TSB – Loan Portfolio Breakdown



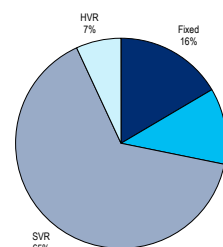
Source: Company Reports, 2Q14

Figure 5. TSB – Mortgages by Region



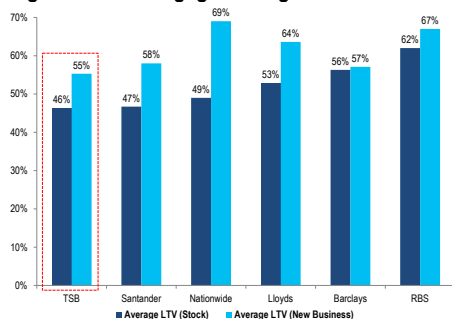
Source: Company Reports, 1Q14

Figure 6. TSB – Mortgages by Product



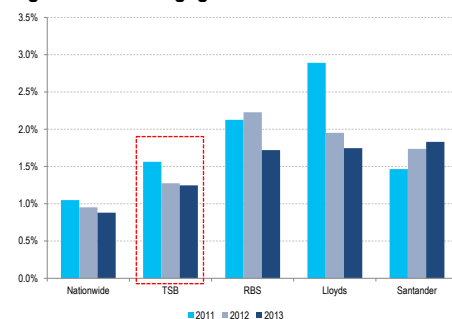
Source: Company Reports, 1Q14

Figure 7. UK Mortgage Average LTVs



Source: Individual Company Reports, end-2013

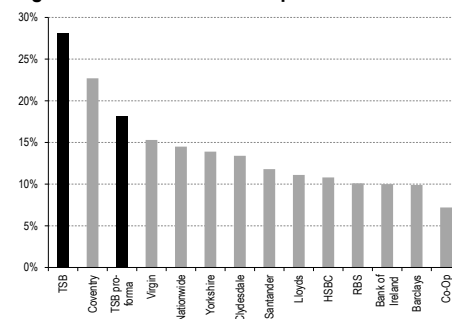
Figure 8. UK Mortgage NPL Ratio



Source: Individual Company Reports.

Note: Lloyds and TSB NPLs based on mortgage cases >90 days in arrears, rather than the company definition (> 180days) in order to be consistent with peers

Figure 9. UK Banks CET1 Capital Ratios



Source: Individual Company Reports, Latest Available

¹ Based on TSB mortgages outstanding divided by BoE Mortgage Lenders & Administrators Return (MLAR) total loans outstanding (regulated and non-regulated, unsecured and securitised)

Investment Attractions

Simple retail bank with direct exposure to UK economy – TSB is the only listed pure-play retail bank in the UK. The business model is very simple, focused entirely on servicing retail and micro-SME customers within the UK, with zero international business and no large corporate and/or investment banking exposure. It therefore offers direct exposure to the UK economy, which is expected to be the fastest-growing G7 economy in 2014 according to the latest IMF forecasts.

Strong growth potential – TSB has a c6% branch market share, but only a c1.7% mortgage market share and c4.2% personal current account (PCA) market share. The established branch infrastructure, to include the 'upgraded' C&G branches, coupled with a re-entry into the intermediary mortgage market, and deployment of the digital capability, should enable TSB to grow rapidly. TSB targets 40-50% growth in stock of franchise lending, both secured & unsecured, in the five years post IPO. If net industry growth is c20% over these five years, then this would imply TSB aims to capture a c2.8-3.2% market share of net new mortgage lending. TSB also aims to take a market share of new PCA flow in excess of 6% over the same period.

Established branch & distribution network – TSB has 631 branches across the UK, to include 467 "established" branches and 164 "new" Cheltenham & Gloucester branches. 46% of the UK population is within 2 miles of a TSB branch. Brand recognition is high with 87% of the population demonstrating spontaneous/prompted awareness (source: Ipsos MORI). TSB also has a full digital, mobile and telephony capability dealing with 11m calls per year and over 17m mobile log-ons in 2013.

Geared to rising interest rates – TSB's current asset margin is low, with 65% of mortgages on a SVR that is capped at 2% over base rates. In contrast the TSB front-book has a gross yield which is 1% higher, at c3.5%. As base rates increase, the SVR will rise and customers are expected to re-finance to front-book rates. In addition liability spreads should widen as PCAs account for 26% of overall deposits, where base rates are unlikely to be passed on (in full) to the customer, while the income from the structural hedge should also gradually improve.

Low credit risk loan book and no legacy conduct issues – Secured mortgages account for 90% of total loans. These mortgages have an average LTV of 46% and mortgages in >3 months arrears represent only 1.3% of the total. The Group loan loss ratio was only 53-55bps in 2012-13 (with a mortgage loss ratio of c2-3bps) and is expected to remain at c55-60bps in 2014 and broadly stable thereafter. TSB also has indemnity coverage, provided by Lloyds, for any losses arising from pre-IPO breaches of laws and regulations. This includes PPI conduct charges, for example.

Well capitalized bank – TSB has a CET1 ratio of 28.1%. Pro-forma for full IRB adoption, expected by end-2015, this ratio would still be c18.2%. This is notably higher than listed UK peers and places TSB in a strong position to grow loans without being capital constrained. The leverage ratio is also strong, at 5.9%.

High RoE & payout potential in long-term – The strong growth outlook, combined with positive interest rate sensitivity, should enable TSB to grow profitability over time. By 2018 we forecast a RoE of 5.8%, nearing TSB's aspirations to generate double-digit RoE by mid-2019 "with momentum" and believe this could potentially rise further, to an RoE of 15.6% in 2020. The company plans to distribute 40-60% of underlying earnings in the long term, with an inaugural dividend in 2017.

Experienced management team – The TSB management team have a wealth of banking experience. CEO Paul Pester, has previously served as Managing Director of Lloyds Consumer business and CEO of Virgin Money. He also led the integration of A&L and B&B at Santander UK. CFO Darren Pope was one of the founders of Egg and was previously Finance Director of Lloyds' mortgage division. Please see Appendix 2 for full details of the senior management team.

Investment Risks

Inability to capture market share – Revenue growth is likely to be challenging in 2014-15, resulting from a number of earlier decisions which were made in response to the previous potential buyer's requirements. For example 40% of TSB's existing mortgage book was intermediary originated, but new intermediary business ceased in 1Q13 and is now not expected to re-launch until early 2015. Any delay in this re-launch and/or a lack of success on new product launches could severely impact on TSB's ability to capture market share and achieve its desired growth targets.

Base rates lower for longer – If base rates are lower for longer, this could severely impact future profitability. TSB's current asset margin is low with two-thirds of mortgages on a SVR capped at 2% over base rates ie. 2.5%. This compares to an industry SVR average of c4.4%. If base rates fail to rise, then these customers are unlikely to re-mortgage and will remain a drag on TSB's overall profitability. Likewise liability margins would remain under pressure and the income contribution from the structural hedge, which is based on 5-year swap rates, would continue to erode.

TSB reliant upon Lloyds' service agreements – TSB's operating model will utilise service agreements with Lloyds, for up to 10 years. This includes IT, payments and document management. On the positive side TSB will automatically receive access to all of Lloyds' capabilities in these areas, as well as any advancement made by Lloyds, subject to an appropriate time delay. However this reduces TSB's independence, will result in a step-up in costs in both 2014 and 2017 and a decision will have to be taken on how to develop the IT capability once the LTSA ends, which could potentially impact on customers. A carve out, costing c£50m, or a migration to a new third party provider are both being considered.

Lloyds non-compete agreement set to end – A non-compete agreement is currently in place with Lloyds which covers both the targeted marketing of TSB customers and the opening of Lloyds branches within an agreed distance of TSB branches. This non-compete agreement is, however, set to end within c2 years.

Loss of mortgage enhancement income – In the medium-term TSB will benefit from the economics of the low cost, low risk, mortgage enhancement book, a non-TSB branded, Lloyds administered portfolio. Lloyds has a call option to repurchase this portfolio once it has generated £230m of profits, expected to occur by 2018.

Scottish independence; Weak(er) presence in South East – TSB Bank is incorporated in Scotland. 30% of TSB's branches are located here and 20% of TSB's mortgage loans outstanding. The impact of a 'yes' vote in favour of Scottish independence is uncertain and could have a material impact on compliance costs, tax and cost of funding. In contrast only 19% of branches are based in the fastest-growing regions of London & South East, which is low compared to peers.

Regulatory uncertainties – Capital rules continue to evolve in the UK and it remains unclear what supplementary 'add-ons' the regulator may enforce for sectoral capital requirements and stress testing. Specific to TSB the regulator has also requested a capital 'add-on' relating to the service agreements with Lloyds. In addition any bank with >£25bn of deposits will get captured by the ring-fencing requirements outlined in the Financial Services Bill. While we expect TSB would be able to place its entire operations within a ring-fenced entity, thereby limiting additional capital & funding costs, there could still be unintended operations risks and costs attached to this. We await greater clarity from the secondary legislation.

Overhang risk – With the IPO on 20 June 2014, at 260p, Lloyds reduced its stake in TSB to 65%. A 90-day lock-up now exists until 18 September 2014, at which point Lloyds is free to sell more shares. Lloyds has agreed with the European Commission to exit TSB in full by end-2015, so stock overhang risks exist.

Valuation

We rate TSB Neutral with a 300p target price (based on warranted P/E and P/B).

TSB is a somewhat unique proposition in the UK banks sector

The near-term is likely to prove challenging...

... but we do see significant option value in the longer-term, driven by the potential for strong growth and rising base rates

We believe TSB will only approach a 'normalized' RoE in 2020, by which point we forecast an RoE of 15.6%

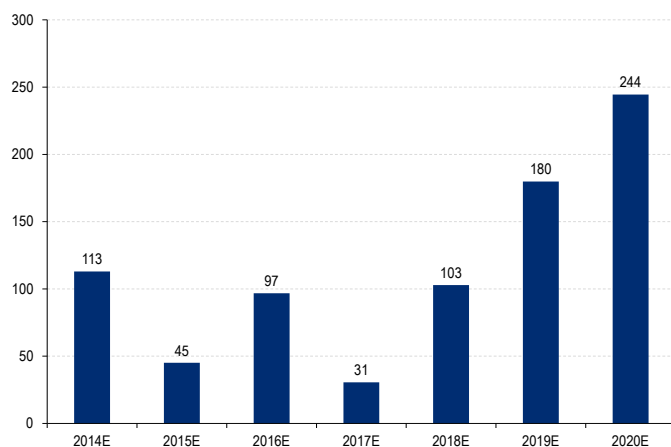
We view TSB as a somewhat unique proposition in the UK banks sector. The near-term is likely to prove challenging, with the exit from the intermediary mortgage channel and discontinuation of AVA and protection products in 2013, likely to weigh on revenues in 2014. Furthermore TSB already has an extensive branch network (and associated costs) in place and expects further incremental investment spend in 2014. We therefore expect TSB to move to a small underlying loss, ex mortgage enhancement income, in 2015, hindered by the aforementioned factors and the poor profitability of the legacy SVR back-book in a low rate environment. If either (i) base rates remain unchanged, or (ii) TSB fails to deliver any growth, then TSB is unlikely to generate a (decent) underlying profit any time soon, in our view.

However we do see significant option value in the longer-term. The strong capital position, low loan-to-deposit ratio and extensive branch network place TSB in a position to grow its loan book rapidly from 2015 onwards. The 40-50% growth rate being targeted by management is far above that of incumbent listed peers, while rival challenger banks do not have the benefit of TSB's established infrastructure. This rapid growth potential therefore sets TSB aside from peers. Coupled with rising base rates, to which TSB is also more sensitive than peers, this could result in TSB nearing a double-digit RoE by 2018E if the bank is able to deliver on its growth targets – we forecast a 5.8% RoE in 2018, rising to 10.8% in 2019.

Positive earnings momentum at TSB could continue into later years, albeit the incremental benefit to returns is likely to slow as time progresses. Why? Firstly the incremental benefit from rising base rates will slow as the size of the legacy SVR back-book shrinks. Secondly any additional loan growth, beyond the company target, will need to be matched by deposit growth in order to ensure that an LDR close to 100% is retained. This implies that TSB will need to either slow its loan growth from 2019 onwards – as we model – or gather deposits at a quicker rate. Either way the incremental profit benefit will be smaller from 2019 onwards, due to lower incremental interest income on loans or greater incremental interest expense on deposits. Taking all of this into account we believe TSB will eventually reach a 'normalized' RoE in 2020, at which point we forecast a RoE of 15.6%. However, we concede that this does require a leap of faith from today's lowly levels.

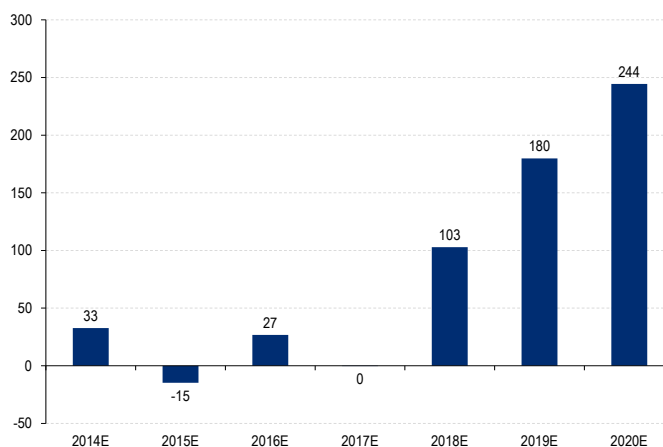
In the following charts below we present the different drivers of TSB's valuation – attributable profit, book value and RoE – from 2014-2020.

Figure 10. TSB – Reported Net Profit



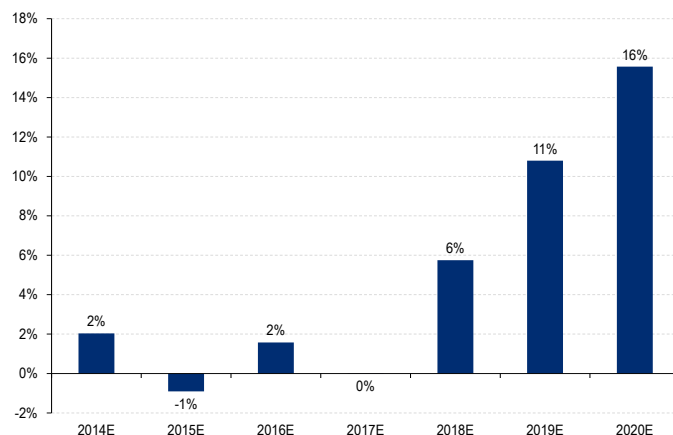
Source: Citi Research Estimates

Figure 11. TSB – Underlying Net Profit (ex Mortgage Enhancement)



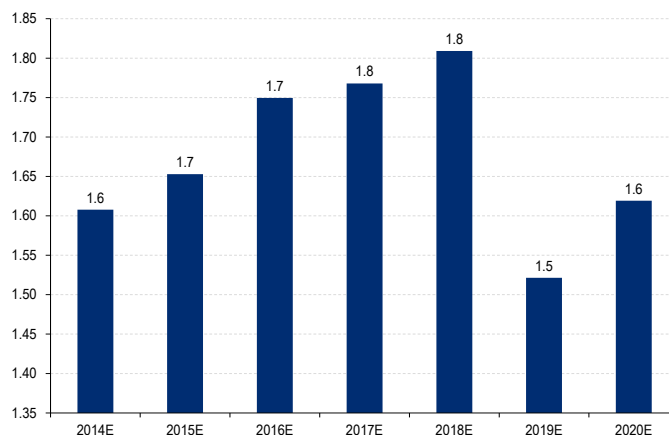
Source: Citi Research Estimates. Note: Underlying/adjusted numbers exclude mortgage enhancement income and other gains/losses

Figure 12. TSB – Underlying RoE Outlook



Source: Citi Research Estimates. Note: Intangibles = zero. Underlying numbers exclude mortgage enhancement income and other gains/losses

Figure 13. TSB – Shareholders' Equity Outlook



Source: Citi Research Estimates. Note: Intangibles = zero.

Comparative multiple analysis, while relatively crude, is a common metric used to assess the value of banks. Below we illustrate the peer group multiples for all of the UK & Irish listed banks, although none of these are ideal peers. With the exception of Lloyds, they all have large wholesale operations and/or a diverse geographical mix. The listed UK & Irish banks (ex-TSB) currently trade on P/E multiples of c6-11x 2016E earnings and P/TB multiples of 0.7-1.4x for 2016E RoTEs of 6-13%.

Figure 14. UK & Irish Bank Valuations

Bank	RIC	P/E				P/TB			RoTE				Div Yield		
		2013	2014E	2015E	2016E	2013	2014E	2015E	2013	2014E	2015E	2016E	2014E	2015E	2016E
Bank of Ireland	BKIR.I	<0	29.4x	15.1x	9.5x	1.4x	1.3x	1.2x	-9.4%	5.8%	9.6%	13.1%	0.0%	0.0%	0.0%
Barclays	BARC.L	8.0x	9.4x	7.7x	6.3x	0.7x	0.7x	0.7x	1.2%	4.0%	8.2%	10.0%	3.8%	5.3%	7.1%
HSBC	HSBA.L	12.8x	12.3x	12.0x	11.0x	1.4x	1.3x	1.3x	11.7%	11.6%	11.2%	11.6%	4.6%	5.1%	5.6%
Lloyds Banking Grp	LLOY.L	11.4x	9.3x	9.3x	9.0x	1.5x	1.4x	1.3x	-1.2%	10.3%	13.2%	12.3%	2.0%	4.7%	5.4%
RBS	RBS.L	<0	10.7x	13.4x	11.3x	1.0x	1.0x	1.0x	-16.4%	2.7%	3.1%	6.4%	0.0%	2.8%	4.2%
Standard Chartered	STAN.L	12.7x	11.1x	10.0x	9.1x	1.3x	1.2x	1.1x	10.6%	11.4%	11.8%	12.0%	3.8%	4.0%	4.4%
TSB	TSB.L	25.9x	43.2x	na	52.7x	na	0.9x	0.9x	na	2.0%	-0.9%	1.6%	0.0%	0.0%	0.0%
UK/Ireland		11.7x	11.4x	11.0x	9.9x	1.3x	1.2x	1.1x	3.4%	9.0%	10.1%	10.9%	3.2%	4.5%	5.3%

Source: Citi Research, dataCentral pricing as of 1 Aug 2014.

Figure 15. UK/Irish Banks – 2016 P/E v 2013-16 GOP CAGR

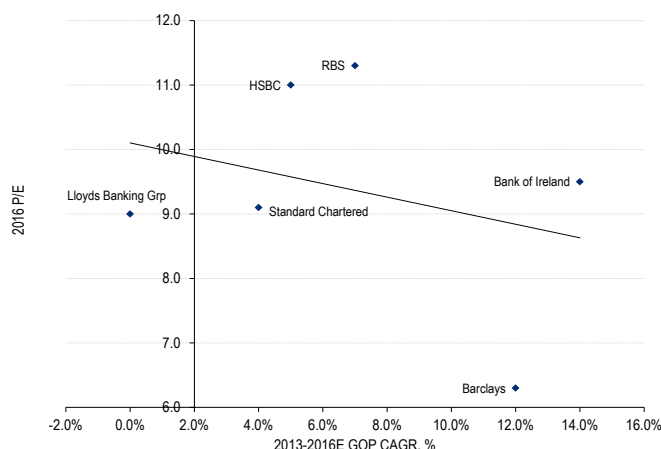
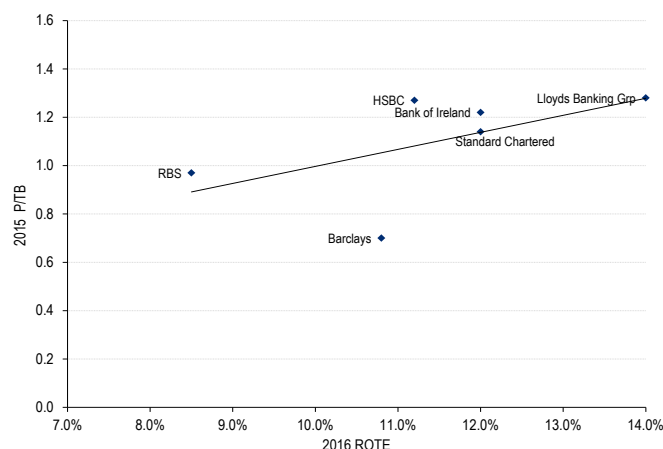


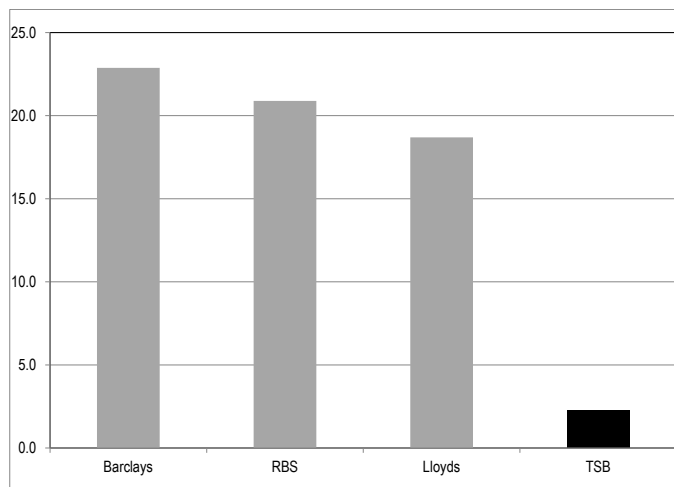
Figure 16. UK/Irish Banks – 2015 P/TB v 2016 RoTE



Source: Citi Research Estimates. Note: GOP = Gross operating profit (ie. pre-provision profit) and is a measure of underlying growth, excluding the credit cycle.

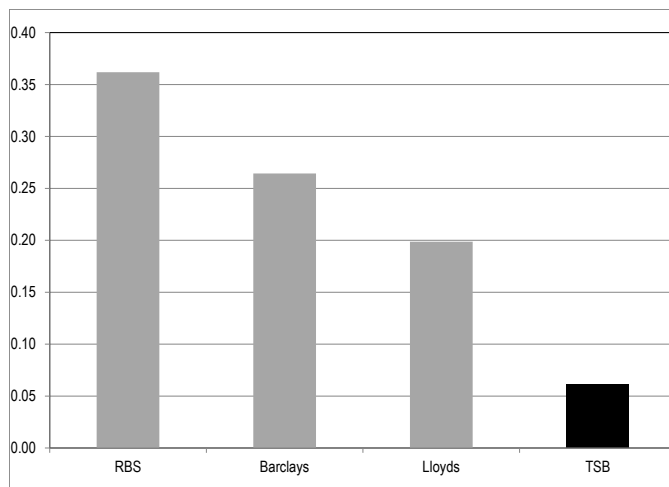
As an aside alternative valuation metrics such as price-to-branches and price-to-deposits are a common tool used to observe US regional banks. Again we believe this is of limited use for the UK banks given their wide-ranging business models, but for reference we illustrate how TSB compares to peers in the charts below.

Figure 17. UK Domestic Banks - Price / Branches



Source: Company Reports and Citi Research

Figure 18. UK Domestic Banks - Price / Retail Deposits



Source: Company Reports and Citi Research

We believe the best way to value TSB is to use a theoretical P/B and P/E approach

Theoretical Valuation Basis

As none of the listed UK peers are direct comparables, in our view, our primary valuation methodology is to instead compute a theoretical 'warranted' P/TB multiple and fair value P/E multiple. In both vases we utilise the Gordon Growth formula of:

- Warranted P/TB = (Sustainable RoTE - Growth) / (Cost of Equity - Growth), where 'Growth' equals a long-term sustainable growth rate in earnings
- Normalised P/E = Long-Term Payout Ratio / (Cost of Equity - Growth)

The cost of equity can be implied by current market prices (back solved) or derived using the CAPM model using the following formula: Cost of Equity = (1-year forward 10-year Risk-Free Rate) + Beta x Equity Market Risk Premium. We use a cost of equity of 10% and long-term growth-rate of 5%. The former is similar to UK peers, while the latter is consistent with our 2019-20 loan growth forecasts, by which point we believe TSB will be closer to a "steady state" run-rate. In addition we give credit for the dividends paid prior to the period used as a terminal value and for any excess capital that remains at this point, which could potentially be redeployed.

However this still results in a broad range of outcomes depending on which year is elected as the 'terminal year'. We summarise the outcome of our theoretical P/B and P/E analysis in the table below, which results in a range from 164-434p, using 2018-20 as the terminal year. The lower end of the range gives no credit for the embedded option value in the TSB business model, including its operation gearing, nor the ability for TSB to eventually re-leverage its balance sheet. In contrast the upper-end of the range requires a leap of faith from today's lowly profit levels.

We set our target price at 300p

Overall, we therefore believe it is most appropriate to set the average of these valuation approaches, of 300p, as our target price for TSB.

Figure 19. TSB – DDM and Capital-Adjusted Warranted Equity Valuation

1. Dividend Discount Model (DDM)	2014e	2015e	2016e	2017e	2018e	2019e	2020e
Annually paid DPS	0	0	0	2	12	94	29
PV'd dividend	0	0	0	2	8	56	16

	2014-18	2014-19	2014-20
Total Dividend PV (GB pence) (1)	10	66	82

2. Terminal value (P/B WEV)	2018e	2019e	2020e
RoTE	5.8%	10.8%	15.6%
CoE	10.0%	10.0%	10.0%
Long-term growth	5.0%	5.0%	5.0%
Theoretical TBVM	.15x	1.16x	2.11x
TBVPS	362	304	324
Terminal value	54	353	685
Basel 3 CET1 ratio	18.4%	14.5%	14.6%
Capital surplus/(deficit) per share vs 14%	84	10	13
Capital-adjusted terminal value	139	363	698
PV of TV (GB pence) (2)	91	216	379

Final Theoretical P/B valuation

Total PV (GB pence) (1+2)	101	282	460
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3. Terminal value (P/E WEV)	2018e	2019e	2020e
Long-term payout ratio	60%	60%	60%
CoE	10.0%	10.0%	10.0%
Long-term growth	5.0%	5.0%	5.0%
Theoretical P/E	12.0x	12.0x	12.0x
EPS	20.6	36.0	48.9
Terminal value	247	432	587
Basel 3 CET1 ratio	18.4%	14.5%	14.6%
Capital surplus/(deficit) per share vs 14%	84	10	13
Capital-adjusted terminal value	331	441	600
PV of TV (GB pence) (3)	217	263	326

Final Theoretical P/E valuation

Total PV (GB pence) (1+3)	227	329	407
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Source: Citi Research Estimates

Figure 20. TSB – Summary Valuation

Terminal Year	P/B	P/E	Average
2018	101	227	164
2019	282	329	305
2020	460	407	434
Average	281	321	300

Source: Citi Research Estimates

Financial Review

In this section we outline TSB's financial targets as well as our own financial forecasts for TSB.

Financial Targets

We outline TSB's financial targets...

Assuming TSB delivers on its strategic plans and the UK interest rate environment and economic outturn is aligned with the current market view, then TSB expects to achieve the following financial targets over the five year period from IPO:

Figure 21. TSB – Financial Targets

	Latest*	Financial Targets In Five Years Post IPO to Mid-2019
Loan Growth	-5% YoY	40-50% growth in secured and unsecured loans outstanding
PCA Growth	+11% YoY	50% increase in share of flow
Group LDR	95%	Maintain LDR c100%
Group NIM	3.58%	Maintained near-term before modest widening
Cost Growth	-1% YoY	<3% pa post 2015 (ex LTSA step-up)
Loan Loss Ratio	0.47%	55-60bps in 2014 and broadly stable thereafter
RoE	Na	Double-digit with momentum
Tier 1 Ratio	18.2%	>16%
Dividend Payout Ratio	na	40-60% long-term; inaugural dividend 2017+

Source: Citi Research

*Note: Growth based on 2013 vs 2012. Spot = 1H14 annualised.

... and compare these to listed peers

We discuss how these assumptions and targets compare to UK peers below:

- The growth targets are far beyond anything outlined by the incumbent UK banks which are listed. This reflects TSB's (relatively) small existing loan and deposit book and the potential to grow into its established branch network and infrastructure. TSB also doesn't have the capital constraints of incumbent peers.
- The Group LDR target appears prudent and is towards the low-end of UK peers. RBS is also <100%, while Lloyds is <120% and Santander UK <130%.
- The trajectory of Group NIM expectations appears consistent with UK peers.
- The loan loss ratio guidance is broadly consistent with Lloyds expectation of a c50-60bps through-the-cycle loan loss ratio and RBS c40-60bps.
- TSB's double-digit RoE target "with momentum", compares to Lloyds old RoE target of 12.5-14.5%, RBS' RoE target of 9-11% (medium-term) and >12% (long-term), and Santander UK RoTE target of 13-15%. Barclays also had an old UK Retail & Business Bank divisional RoE target of "high-teens".
- Domestic UK peers have all set core tier 1 ratio targets ranging from 10.5%-12.0%. TSB has not disclosed a core tier 1 ratio target, but has indicated a tier 1 ratio target of 16%. Assuming TSB eventually moves to a structure of 85-90% common equity and 10-15% additional tier 1 capital (currently 100%/0%) then this would translate to a c14% core tier 1 ratio, still at the top-end of peers, due to the PRA surcharge relating to the service agreements with Lloyds.
- The prospective dividend payout ratio of 40-60% compares to 40-50% at Barclays and >50% at Lloyds.

Revenues

TSB has ambitious growth targets relative to listed peers...

... while TSB's other financial targets appear to be broadly consistent

We model asset and liability yields for each individual product below

We view TSB's loan growth targets, of c40-50% over the five years post IPO (mid-2014 to mid-2019), as the most debatable of all of the company targets. While other targets are broadly consistent with listed peers, the growth target is clearly far more ambitious. There are, of course, very good reasons why TSB should grow at a much faster than incumbent peers, but nonetheless we expect the achievability of this growth target will be a key point of debate in any valuation discussion.

We elaborate further on TSB's growth prospects in the section '[Ambitious Growth Plans](#)'. On margins we highlight our assumptions below, to include future base rate expectations (based on our economists' projections which are slightly ahead of consensus), asset yields and funding costs. We assume no additional capital, or wholesale funding is raised until 2019, with all new lending supported by growth in deposits. We model asset and liability yields for each individual product below. Overall every 1% rise in base rates adds c5% to revenues. For more detail on the assumptions behind this please see the section '[Interest Margin Sensitivity](#)'.

Figure 22. TSB – Aggregate Product Yields, 2011-20E

Aggregate Yields:	2011	2012	2013	2014E	2015E	2016E	2017E	2018E	2019E	2020E
Fixed	-	5.0%	4.7%	4.4%	4.0%	3.8%	3.7%	3.6%	3.9%	4.1%
Tracker	-	2.7%	2.1%	2.1%	3.2%	4.2%	4.6%	5.0%	5.1%	5.1%
SVR	2.5%	2.5%	2.5%	2.5%	3.6%	4.6%	5.0%	5.4%	5.5%	5.5%
HVR	-	4.0%	4.0%	4.0%	4.9%	5.7%	6.0%	6.3%	6.4%	6.4%
Mortgages	3.1%	3.1%	3.1%	2.9%	3.8%	4.5%	4.7%	4.7%	4.8%	4.8%
Personal unsecured	15.1%	15.8%	16.3%	15.7%	16.5%	17.2%	17.5%	17.8%	17.9%	17.9%
Small business banking	3.1%	3.0%	2.9%	3.0%	3.8%	4.6%	4.9%	5.2%	5.3%	5.3%
Total TSB Franchise	-	4.4%	4.4%	4.4%	5.3%	6.0%	6.2%	6.2%	6.3%	6.3%
Mortgage Enhancement	3.8%	3.9%	3.9%	3.5%	4.9%	5.7%	6.0%	6.3%	6.4%	6.4%
Total	-	4.4%	4.4%	4.2%	5.2%	6.0%	6.1%	6.2%	6.3%	6.3%
PCAs	-0.4%	-0.4%	-0.5%	-0.5%	-0.6%	-1.0%	-1.2%	-1.4%	-1.4%	-1.4%
Savings	-1.3%	-1.7%	-1.5%	-1.2%	-2.3%	-3.0%	-3.2%	-3.4%	-3.5%	-3.5%
Small business banking	-0.1%	-0.1%	-0.1%	-0.1%	-0.3%	-0.6%	-0.7%	-0.8%	-0.8%	-0.8%
Subtotal	-	-1.3%	-1.2%	-1.0%	-1.8%	-2.4%	-2.6%	-2.8%	-2.8%	-2.8%
TSB Franchise NIM	-	2.51%	2.91%	3.59%	3.38%	3.51%	3.65%	3.85%	4.01%	4.16%
Total NIM	-	2.31%	2.64%	3.48%	3.36%	3.52%	3.63%	3.85%	4.01%	4.16%
Base Rates	0.50%	0.50%	0.50%	0.75%	2.50%	2.75%	3.25%	3.50%	3.50%	3.50%
Average Base Rates	0.50%	0.50%	0.50%	0.53%	1.63%	2.63%	3.00%	3.38%	3.50%	3.50%
5-Yr Swap Rate	1.56%	1.02%	2.14%	2.30%	3.00%	3.25%	3.50%	3.75%	3.75%	3.75%
Rolling 5-Yr Swap Rate	3.78%	2.89%	2.17%	1.97%	2.00%	2.34%	2.84%	3.16%	3.45%	3.60%
Average Rolling 5-Yr Swap Rate	4.06%	3.34%	2.50%	2.07%	1.99%	2.17%	2.59%	3.00%	3.31%	3.53%

Source: Company Reports and Citi Research Estimates

Other operating income is likely to shrink further near-term

Other operating income accounts for a much smaller proportion of TSB's overall revenues – only 20% in 2013 – and is likely to shrink further in the near-term as TSB stopped offering AVAs in branches in January 2013 (re-launch planned in early-2015), stopped offering protection products in July 2013 (in discussion with a third party for a re-launch in 2H14) and stopped selling investment products in 2012 ahead of the Retail Distribution Review (RDR) implementation.

Figure 23. TSB – Other Operating Income

	2011	2012	2013	2014E	2015E	2016E	2017E	2018E	2019E	2020E
Current account & other fees	73	76	68	64	67	71	75	79	84	89
Credit & debit card fees	57	56	57	50	54	60	66	73	77	81
Investment & protection	54	34	11	4	4	5	5	6	6	6
Household insurance	13	13	27	26	27	30	33	38	41	43
Total	197	179	163	143	153	165	180	196	208	219

Source: Company Reports and Citi Research Estimates

We model 50% growth from mid-2014 to mid-2019, which is consistent with the top-end of the target of 40-50% growth in five years post IPO

On volumes we model the following:

- New mortgage volumes of 15% in 2015, rising to 22% in 2016 and 25% in 2017-18, before falling back to 10% in 2019 and 5% in 2020 as TSB hits a 100% LDR;
- 10% of SVR borrowers refinance in 2015-16, rising to 15% in 2017 and 20% in 2018;
- 20% of TSB's SVR borrowers that re-mortgage are lost and 80% are retained;
- Two-thirds of new and re-financing customers choose fixed, one-third tracker
- Unsecured growth of 8% in 2015, rising to 10% in 2016, and 11% in 2017-18 before reverting back to 5% in 2019-20, again due to LDR constraints;
- PCAs grow by 6% pa and savings by 4% pa from 2014-20.

Figure 24. TSB – Net Interest Income (£m)

	2011	2012	2013	2014E	2015E	2016E	2017E	2018E	2019E	2020E
Fixed	201	167	143	118	118	161	224	314	438	527
Tracker	110	95	55	42	67	115	168	247	317	361
SVR	269	291	301	282	374	430	407	362	296	237
HVR	0	2	26	53	90	133	159	171	177	195
Mortgages	580	555	525	495	650	839	958	1,094	1,228	1,321
Personal unsecured	385	367	358	324	349	398	447	504	547	574
Small business banking	22	22	20	9	10	13	15	17	19	21
Other	0	0	14	24	25	25	25	25	26	27
Total Interest Income (TSB Franchise)	987	944	917	852	1,034	1,275	1,446	1,641	1,820	1,942
Mortgage Enhancement	95	113	128	110	133	127	51	0	0	0
Total Gross Interest Income	1,082	1,057	1,045	962	1,167	1,402	1,497	1,641	1,820	1,942
PCAs	-21	-22	-27	-33	-43	-71	-90	-111	-120	-127
Savings	-211	-276	-243	-200	-396	-546	-603	-664	-703	-731
Small business banking	-1	-1	-1	0	-2	-4	-5	-6	-6	-7
Subtotal	-233	-299	-271	-233	-441	-621	-698	-780	-829	-864
Net interest rate swap flows	-29	9	35	50	57	81	128	178	223	263
LBG liquidity and capital costs	-91	-121	-78	0	0	0	0	0	0	0
Tier 1/2 capital	0	0	0	-9	-20	-24	-25	-26	-52	-52
Allocation adjustment	0	0	0	39	31	31	5	0	0	0
Total Interest Expense (TSB Franchise)	-353	-411	-314	-153	-373	-532	-590	-629	-658	-653
Mortgage Enhancement	-70	-88	-96	-45	-45	-47	-21	0	0	0
Total Gross Interest Expense	-423	-499	-410	-198	-418	-579	-612	-629	-658	-653
Total Net Interest Income (TSB Franchise)	634	533	603	699	661	743	855	1,012	1,162	1,289
Mortgage Enhancement	25	25	32	65	88	80	30	0	0	0
Total Net Interest Income	659	558	635	764	749	823	885	1,012	1,162	1,289

Source: Company Reports and Citi Research Estimates

Figure 25. TSB – Gross Loan and Deposit Split (£bn)

	2011	2012	2013	2014E	2015E	2016E	2017E	2018E	2019E	2020E		2012	2013	2014E	2015E	2016E	2017E	2018E	2019E	2020E
Fixed	3.5	3.2	2.9	2.4	3.5	5.0	7.2	10.2	12.2	13.7		-9%	-9%	-17%	45%	43%	45%	41%	19%	12%
Tracker	4.0	3.0	2.2	1.8	2.3	3.1	4.2	5.7	6.7	7.4		-26%	-25%	-19%	30%	32%	37%	36%	17%	11%
SVR	10.9	12.2	11.7	10.9	9.8	8.8	7.5	6.0	4.8	3.8		12%	-4%	-7%	-10%	-10%	-15%	-20%	-20%	-20%
HVR	0.0	0.3	0.9	1.6	2.1	2.6	2.8	2.7	2.8	3.3			196%	68%	35%	20%	8%	-3%	6%	15%
Mortgages	18.4	18.7	17.7	16.6	17.7	19.4	21.7	24.6	26.5	28.2		1%	-5%	-6%	7%	10%	12%	14%	8%	6%
Personal unsecured	2.4	2.2	2.1	2.0	2.2	2.4	2.7	3.0	3.1	3.3		-7%	-4%	-5%	8%	10%	11%	11%	5%	5%
Small business banking	0.4	0.4	0.3	0.3	0.3	0.3	0.3	0.4	0.4	0.4		-1%	-14%	-18%	5%	8%	8%	8%	8%	8%
Total (TSB Franchise)	21.2	21.3	20.2	18.9	20.2	22.1	24.7	27.9	30.1	31.9		0%	-5%	-6%	7%	10%	11%	13%	8%	6%
Mortgage Enhancement	2.7	3.2	3.4	3.0	2.4	2.0	0.0	0.0	0.0	0.0		20%	6%	-13%	-18%	-18%	-100%			
Total	23.9	24.5	23.6	21.9	22.6	24.1	24.7	27.9	30.1	31.9		2%	-4%	-7%	3%	7%	2%	13%	8%	6%

Source: Company Reports and Citi Research Estimates

Expenses & Loan Losses

Incremental investment spend in 2014 and a higher service agreement charge in 2017 will result in a larger expense base

TSB expects the expense base to increase by up to £130m, driven by FTE ramp-up, broader investment spend (branch updating, repositioning, product launches, etc) and other costs (FSCS, etc). Not all of this will be visible in the 2014 expense base, but the full run-rate effect should feed through by 2015.

In addition a large proportion of TSB's expense base will be allocated to the service agreement fees payable to Lloyds. We elaborate further on the services being provided by Lloyds and the associated costs in the section '[Service Agreements](#).' This service charge will effectively double in 2017 from c£100m to c£204m, following the end of the Transitional Service Agreement and switch to the Long-Term Service Agreement (which runs for up to a further 7.5 years). In addition there is likely to be a small additional cost at this point due to the 18 services no longer covered by the Service Agreements, which TSB will now have to run independently. Excluding this one-off step-up, TSB envisages cost growth of c3% pa from 2015-18.

Figure 26. TSB – Expense Base (£m)

	2011	2012	2013	2014E	2015E	2016E	2017E	2018E	2019E	2020E
Staff Costs	-201	-190	-192	-392	-407	-420	-500	-516	-542	-569
Premises & Equipment	-59	-61	-62	-74	-77	-80	-95	-98	-103	-108
Other Expenses	-316	-315	-306	-214	-222	-229	-272	-281	-295	-310
Depreciation & Amortisation	-14	-13	-15	-16	-17	-18	-21	-22	-23	-24
TSB Franchise Operating Expenses	-590	-579	-575	-697	-724	-746	-888	-916	-962	-1,010
Mortgage Enhancement Costs	-1	-1	-1	-2	-3	-2	-1	0	0	0
Total Expenses	-591	-580	-576	-699	-726	-748	-890	-916	-962	-1,010

Source: Company Reports and Citi Research Estimates

TSB loan losses are expected to remain at c55-60bps in 2014 and broadly stable thereafter. We are more conservative

Secured mortgages account for 90% of total TSB Franchise loans, with an average LTV of only 46%, the lowest among the UK banks. The Group loan loss ratio was only 53-55bps in 2012-13 and is expected to remain at c55-60bps in 2014 and broadly stable thereafter. We make slightly more conservative assumptions, based on rising base rates reducing mortgage affordability in later years. We elaborate further on the outlook for TSB loan losses in the section '[Risk Management & Asset Quality](#)'

Figure 27. TSB – Loan Loss Ratio (£m)

<u>Loan Loss Ratio</u>	2011	2012	2013	2014E	2015E	2016E	2017E	2018E	2019E	2020E
Mortgages	0.01%	0.03%	0.02%	0.01%	0.02%	0.04%	0.05%	0.05%	0.06%	0.06%
Unsecured portfolio	6.79%	4.56%	4.47%	4.62%	4.75%	5.00%	5.10%	5.10%	5.20%	5.20%
Business banking	2.00%	1.50%	1.70%	1.80%	1.80%	1.90%	2.00%	2.00%	2.00%	2.00%
Total	0.86%	0.55%	0.53%	0.53%	0.56%	0.61%	0.63%	0.62%	0.63%	0.62%

Source: Company Reports and Citi Research Estimates

A stressed scenario would double the loan loss charge

TSB has assessed itself against the two PRA anchor scenarios being employed in the 2014 stress tests, including the stressed scenario which assumes a 27% decline in HPI, a 50% rise in unemployment (unemployment rate to 12.0%), a 6% rise in base rates and a 35% peak-to-trough decline in residential house prices. Under this scenario, TSB calculates that the loan loss charge would increase by c60bps, so essentially double. Customers on the existing SVR portfolio would account for approximately 50bps of the 60bps increase. In this highly unlikely event, it would reduce the CET1 ratio by <2ppt and tangible equity by c8%.

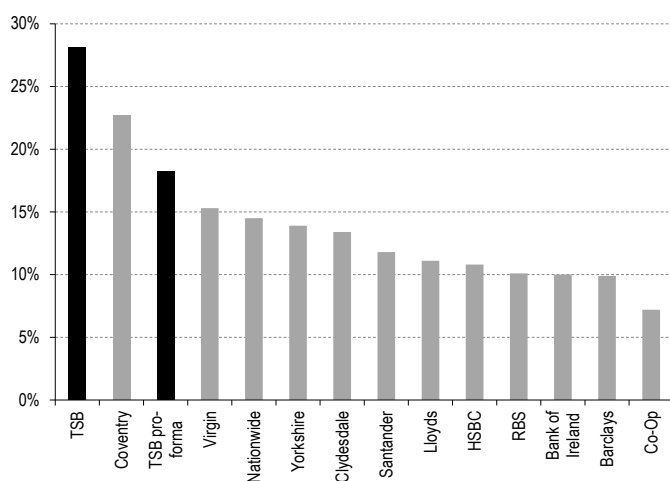
Capital & Dividends

TSB's capital ratios are notably higher than listed peers...

TSB has a CET1 ratio of 28.1%. Pro-forma for full IRB adoption, expected by end-2015, this ratio would still be c18.2%. This is notably higher than listed UK peers and places TSB in a strong position to grow loans without being capital constrained. The leverage ratio is also strong, at 5.9%, or c5.6% pro-forma. Board "risk appetite" is for a tier 1 ratio of >16.0%. It has not been specified exactly how this is reached, but TSB management have confirmed that the PRA has requested a capital add-on (via pillar 2 capital and operational RWAs) to reflect the inter-connectivity with Lloyds, and subsequent contagion risk, due to the long-term service agreements.

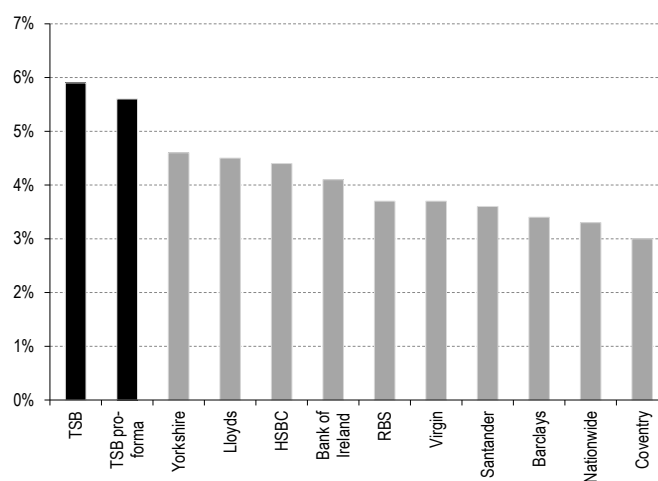
Currently TSB's capital consists entirely of common equity capital. We doubt TSB will issue AT1 in the near future as current profitability would not be enough to absorb the additional annual coupon payments. However by 2019 we believe this may be possible. We model issuance of c£250m of AT1 in 2019, coupled with a c£350m (c70p) special dividend payment. This would reduce the core equity tier 1 ratio to c14.5%, but allow the bank to retain a tier 1 ratio of c17% (ie. a 1% buffer in excess of the 16% target), which would still place TSB at the top-end of peers.

Figure 28. UK Banks CET1 Capital Ratios, Latest



Source: Individual Company Reports

Figure 29. UK Banks Leverage Ratios, Latest



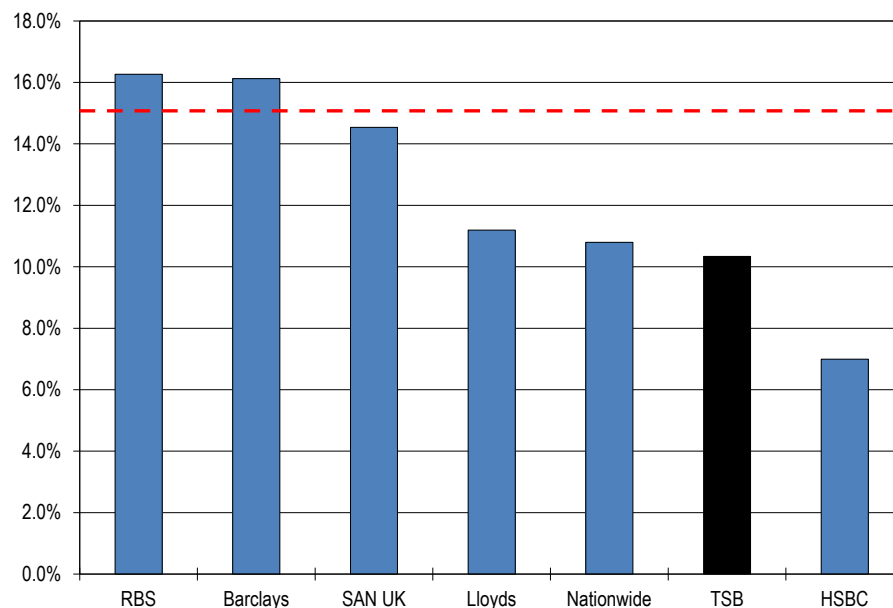
Source: Individual Company Reports

... but risk-weights on UK mortgages are relatively low versus peers

In 2013 the PRA was asked to assess the capital adequacy of the eight largest UK lenders after making a number of capital adjustments. This included, among others, a 15% risk-weight floor for UK mortgages. There has since been no reference to a formal introduction of risk-weight floors, but within the June Financial Stability Report, it did state that the adjustments used in the 2013 capital exercise will be "embedded into the PRA's ongoing supervisory regime and into stress testing". HSBC, TSB and Lloyds all have average UK mortgage RWAs of <15%.

We calculate that TSB has an average UK mortgage risk-weight of 10.3% on the franchise portfolio (the mortgage enhancement portfolio will remain on a standardized basis, so has a 35% risk-weighting). If the regulator were to enforce a 15% risk-weight floor at a later date, then it would serve to reduce TSB's pro-forma CET1 ratio by c1.4%, to 16.8%, which would still be slightly ahead of the target >16.0% tier 1 ratio. We therefore view this risk as manageable.

Figure 30. UK Banks – Average Risk-Weight on UK Mortgages



Source: Company Reports and Citi Research

Dividend payout ratio of 40-60% anticipated from 2017 onwards

The reported excess capital position implies that TSB's 40-50% growth plans are already pre-funded and we estimate that the CET1 ratio will remain above 16%, partly helped by the profit contribution from the mortgage enhancement book. This opens up the potential for significant capital return in the long-term, provided we see no regulatory change to TSB's existing capital requirements and risk-weights. The Directors have made the following statement on the subject of dividends:

"The Directors believe that the Company will, in time, be able to support a dividend distribution of 40-60% of underlying earnings, reflecting the strength of the capital position and franchise of the Company. In the near term however, as TSB grows its earnings and balance sheet, the Directors will have particular regard to the low level of profitability of the underlying business and the need to preserve capital to support the growth strategy. Taking this into account, it is the Board's current expectation that the Company's inaugural dividend would be in respect of the financial year ending 31 December 2017. The Directors intend to review on an ongoing basis the expected timing and quantum of any dividend payments in the context of progress on delivery of TSB's strategy and the broader operating environment."

We model a dividend payout ratio of 40% in 2017, rising to 60% in 2018.

Summary Financials

Figure 31. TSB – Summary P&L and Balance Sheet (£m, except where stated)

	2011	2012	2013	2014E	2015E	2016E	2017E	2018E	2019E	2020E
TSB Franchise net interest income	634	533	603	699	661	743	855	1,012	1,162	1,289
Mortgage enhancement net interest income	25	25	32	65	88	80	30	0	0	0
Net interest income	659	558	635	764	749	823	885	1,012	1,162	1,289
Other income	197	179	163	143	153	165	180	196	208	219
Total income	856	737	798	907	902	988	1,065	1,208	1,369	1,508
Operating expenses	-591	-580	-576	-699	-726	-748	-890	-916	-962	-1,010
Operating result	265	157	222	209	175	240	175	292	407	498
Impairment charge	-183	-117	-110	-104	-109	-128	-147	-163	-181	-191
Profit before tax (management basis)	82	40	112	105	67	111	28	129	226	307
Other gains/losses	0	0	-46	37	-10	10	10	0	0	0
Profit before tax	82	40	66	143	57	121	38	129	226	307
Income taxes	-25	-11	105	-30	-11	-25	-8	-26	-46	-62
Net profit	57	29	171	113	45	97	31	103	180	244
Dividends	0	0	0	0	0	0	-12	-62	-468	-147
Retained Earnings	57	29	171	113	45	97	18	41	-288	98
Underlying profit before tax (ex-mortgage enhancement)*	58	16	81	42	-19	34	0	129	226	307
Underlying net profit (ex-mortgage enhancement)*	41	11	55	33	-15	27	0	103	180	244
Per share data (p)										
Underlying Basic EPS*	8.1	2.3	10.9	6.5	-3.0	5.4	-0.1	20.6	36.0	48.9
Dividend Per Share				0.0	0.0	0.0	2.4	12.3	93.5	29.3
BVPS (outstanding shares)				322	331	350	354	362	304	324
Tangible BVPS (outstanding shares)				322	331	350	354	362	304	324
Profitability Ratios										
Franchise net interest margin		2.51%	2.91%	3.59%	3.38%	3.51%	3.65%	3.85%	4.01%	4.16%
Total net interest margin		2.31%	2.64%	3.48%	3.36%	3.52%	3.63%	3.85%	4.01%	4.16%
Cost income ratio	69.0%	78.7%	72.2%	77.0%	80.5%	75.7%	83.6%	75.8%	70.3%	67.0%
Loan loss charge	0.86%	0.55%	0.53%	0.53%	0.56%	0.61%	0.63%	0.62%	0.63%	0.62%
Effective tax rate	30%	28%	-158%	21%	20%	20%	20%	20%	20%	20%
Reported ROE				7.0%	2.8%	5.7%	1.7%	5.8%	10.8%	15.6%
Adjusted ROE				2.0%	-0.9%	1.6%	0.0%	5.8%	10.8%	15.6%
Payout ratio				0%	0%	0%	40%	60%	260%	60%
Balance Sheet (£bn)										
Franchise customer lending	21.2	21.3	20.2	18.9	20.2	22.1	24.7	27.9	30.1	31.9
Mortgage enhancement assets	2.7	3.2	3.4	3.0	2.4	2.0	0.0	0.0	0.0	0.0
Liquid assets	0.0	0.0	4.1	4.2	4.6	4.3	4.8	2.4	1.5	1.1
Other assets	0.5	0.5	0.7	0.9	0.9	1.0	1.1	1.3	1.4	1.5
Total assets	24.4	25.0	28.4	27.1	28.2	29.4	30.6	31.7	32.9	34.4
Customer deposits	21.8	22.9	23.1	24.3	25.4	26.5	27.7	28.9	30.3	31.6
Other liabilities	0.2	0.2	0.3	0.5	0.5	0.5	0.5	0.5	0.5	0.5
Net investment from LBG	2.3	1.8	4.9	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Wholesale funding	0.0	0.0	0.0	0.3	0.3	0.3	0.3	0.0	0.0	0.0
Tier 1 securities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.3	0.3
Tier 2 securities	0.0	0.0	0.0	0.4	0.4	0.4	0.4	0.4	0.4	0.4
Total liabilities	24.3	24.9	28.3	25.4	26.5	27.7	28.9	29.9	31.4	32.8
Shareholders' equity	0.0	0.0	0.0	1.6	1.7	1.7	1.8	1.8	1.5	1.6
Capital (£bn)										
Shareholders' Equity (statutory)				1.6	1.7	1.7	1.8	1.8	1.5	1.6
Regulatory adjustments				0.0	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1
Core Tier 1 capital				1.6	1.6	1.7	1.7	1.8	1.5	1.6
T1 hybrid capital instruments				0.0	0.0	0.0	0.0	0.0	0.3	0.3
Tier 1 capital				1.6	1.6	1.7	1.7	1.8	1.7	1.8
Tier 2 securities				0.4	0.4	0.4	0.4	0.4	0.4	0.4
Total Capital				2.0	2.0	2.1	2.1	2.1	2.1	2.2
Risk-Weighted Assets				4.9	8.0	8.5	8.5	9.5	10.1	10.7
CRD IV Exposures				27.7	28.9	30.1	31.3	32.4	33.7	35.2
Core Tier 1 ratio				32.5%	20.0%	20.0%	20.2%	18.4%	14.5%	14.6%
Tier 1 ratio				32.5%	20.0%	20.0%	20.2%	18.4%	16.9%	17.0%
Total Capital ratio				40.4%	24.8%	24.5%	24.7%	22.5%	20.7%	20.6%
Leverage ratio				5.8%	5.5%	5.6%	5.5%	5.4%	5.1%	5.2%
Loan to deposit ratio (ex mortgage enhancement)	97%	93%	87%	78%	80%	84%	89%	97%	99%	101%

Source: Company Reports and Citi Research Estimates. *Note: Underlying/adjusted numbers exclude mortgage enhancement income and other gains/losses

Figure 32. TSB – Summary P&L and Balance Sheet by Quarter (£m, except where stated)

	1Q14	2Q14	3Q14E	4Q14E
TSB Franchise net interest income	179	178	172	170
Mortgage enhancement net interest income	16	18	16	15
Net interest income	195	196	188	186
Other income	37	36	35	35
Total income	232	231	223	221
Operating expenses	-153	-181	-183	-183
Operating result	79	51	41	38
Impairment charge	-27	-24	-26	-26
Profit before tax (management basis)	52	26	14	12
Other gains/losses	24	26	-6	-6
Profit before tax	76	52	8	6
Income taxes	-16	-11	-2	-1
Net profit	60	42	6	5
Non-controlling interests	0	0	0	0
Attributable profit	60	42	6	5
Dividends	0	0	0	0
Retained Earnings	60	42	6	5
Underlying profit before tax (ex-mortgage enhancement)*	36	9	-1	-2
Underlying net profit (ex-mortgage enhancement)*	28	7	-1	-2
Profitability Ratios				
Franchise net interest margin	3.62%	3.64%	3.56%	3.58%
Total net interest margin	3.63%	3.44%	3.36%	3.37%
Cost income ratio	65.9%	78.1%	81.8%	82.6%
Loan loss charge	0.54%	0.50%	0.54%	0.55%
Effective tax rate	21%	22%	21%	21%
Reported ROE	15.5%	10.4%	1.6%	1.2%
Adjusted ROE	7.2%	1.8%	-0.2%	-0.4%
Balance Sheet (£bn)				
Franchise customer lending	19.7	19.4	19.2	18.9
Mortgage enhancement assets	3.3	3.1	3.0	3.0
Liquid assets	3.3	3.0	3.6	4.2
Other assets	0.7	0.9	0.9	0.9
Total assets	27.0	26.5	26.7	27.1
Customer deposits	23.3	23.7	24.0	24.3
Other liabilities	0.3	0.5	0.5	0.5
Net investment from LBG	0.0	0.0	0.0	0.0
Wholesale funding	1.5	0.3	0.3	0.3
Tier 1 securities	0.0	0.0	0.0	0.0
Tier 2 securities	0.4	0.4	0.4	0.4
Total liabilities	25.5	24.9	25.2	25.4
Shareholders' equity	1.6	1.6	1.6	1.6
Capital & Funding (£bn)				
Shareholders' Equity (statutory)	1.5	1.6	1.6	1.6
Regulatory adjustments	0.0	0.0	0.0	0.0
Core Tier 1 capital	1.5	1.6	1.6	1.6
T1 hybrid capital instruments	0.0	0.0	0.0	0.0
Tier 1 capital	1.5	1.6	1.6	1.6
Tier 2 securities	0.4	0.4	0.4	0.4
Total Capital	1.9	2.0	2.0	2.0
Risk-Weighted Assets	6.9	5.7	4.9	4.9
CRD IV Exposures	27.9	27.1	27.4	27.7
Core Tier 1 ratio	21.6%	28.1%	31.8%	32.5%
Tier 1 ratio	21.6%	28.1%	31.8%	32.5%
Total Capital ratio	27.2%	34.9%	39.6%	40.4%
Leverage ratio	5.3%	5.9%	5.8%	5.8%
Loan to deposit ratio (ex mortgage enhancement)	85%	82%	80%	78%

Source: Company Reports and Citi Research Estimates. *Note: Underlying/adjusted numbers exclude mortgage enhancement income and other gains/losses

TSB – Growth, Capabilities & Risks

Ambitious Growth Plans

How realistic are TSB's 40-50% loan growth targets over the next five years?

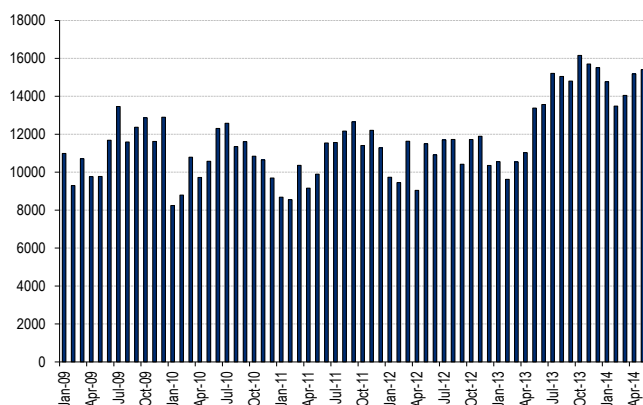
We view TSB's loan growth targets, of c40-50% over the next five years post-IPO, as the most debatable of all of the targets that the company has set. While the other targets are broadly consistent with existing listed peers, the growth target is clearly far more ambitious. There are, of course, very good reasons why TSB should grow at a much faster than incumbent peers, but nonetheless we expect the achievability of this growth target will be a key point of debate in any valuation discussion. With outstanding TSB mortgages almost certain to contract in 2014, due to TSB's exit from the intermediary distribution channel in 1Q13, this implies that growth of >10% pa is required from 2015-18 to achieve the company targets. How realistic is this?

UK Mortgage Market Is Recovering

The UK mortgage market has rebounded over the past 18 months

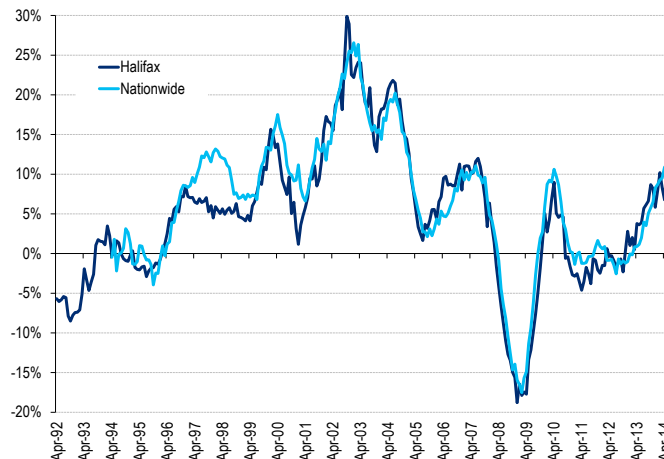
We start by considering the outlook for the UK mortgage system as a whole. The UK mortgage market has demonstrated a strong recovery over the past 18 months, with lending volumes, approvals and transactions all accelerating during 2013, driven by an improvement in economic sentiment and supply-side initiatives, such as the government sponsored "Help to Buy". This strong momentum has continued into 2014. This in turn has fed through to rising house prices with both the Halifax and Nationwide house price indices up sharply over the same period. The RICs survey indicates further house price appreciation is likely in the medium-term.

Figure 33. Gross Mortgage Lending (£m)



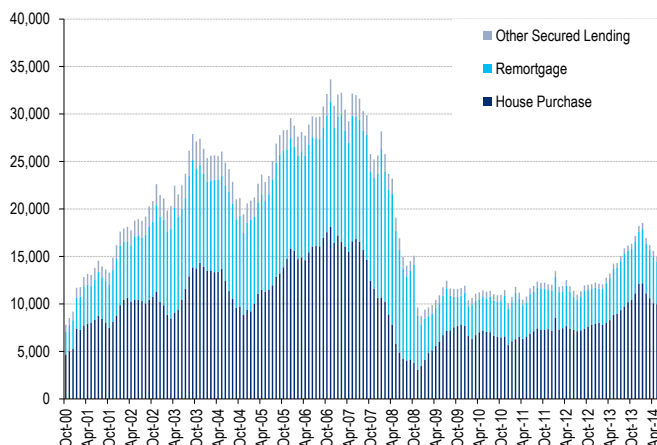
Source: BoE, Citi Research

Figure 34. Halifax and Nationwide House Price Indices, 1992-2014



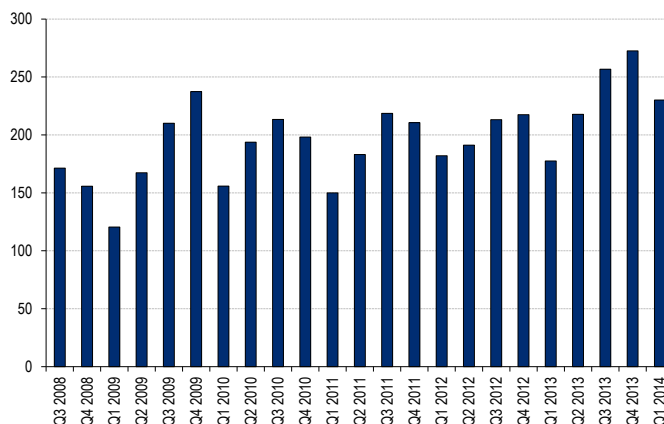
Source: Datastream, Citi Research

Figure 35. Value Loans Approved for House Purchase (£m), 2000-2014



Source: Datastream, Citi Research

Figure 36. No. of Housing Transactions in England, 3Q08-1Q14 ('000s)



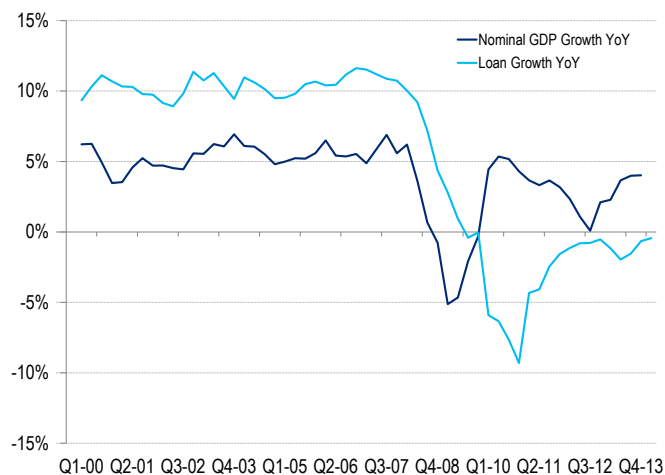
Source: Datastream, Citi Research

Loan growth has historically run at c1-2x nominal GDP

We envisage a return to growth, of c2%, in 2014, rising thereafter

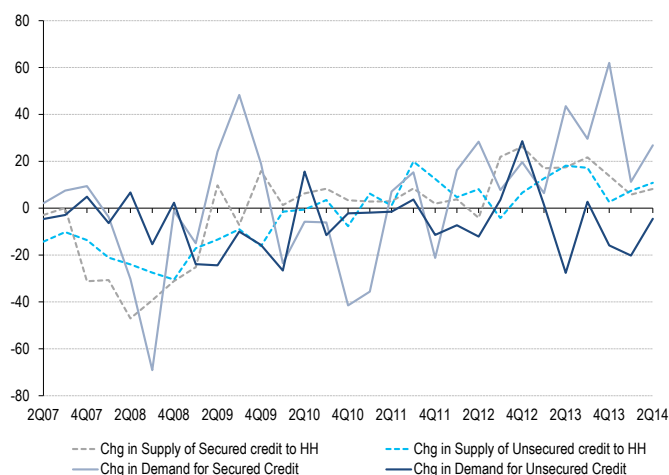
Historically UK system loan growth has had a very close correlation to nominal GDP growth, running at c1-2x GDP growth from 2000-07. Post the financial crisis there was a disconnect as the UK suffered a double-dip recession. Instead private sector deleveraging resulted in a contraction in lending from the start of 2010 to end-2013. We expect system-wide lending will return to growth in 2014, after three years of contraction, but we doubt that we will initially see anything close to the magnitude of the historic run-rate of 1-2x nominal GDP growth, which would imply c3-6% loan growth. Underlying system loan growth of c2% is more likely in our view, somewhat below our economists' nominal GDP growth forecast of c5%, although demand for secured credit does continue to gather pace so this could surprise to the upside.

Figure 37. UK Household Loan Growth and Nominal GDP Growth



Source: BoE, Datastream, Citi Research

Figure 38. BoE Household Credit Conditions Survey



Source: BoE, Citi Research

Challenger banks have struggled to gain market share in recent years...

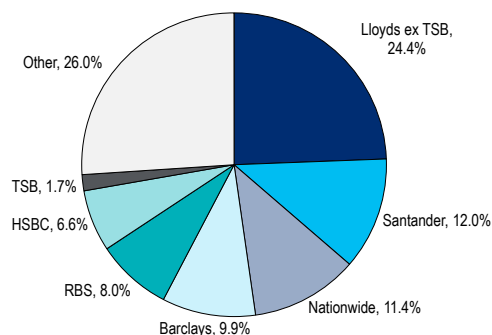
... hindered by high barriers to entry

Challengers Have Struggled To Gain Traction in the UK

The six largest lenders dominate the UK mortgages with a combined 72% market share (Figure 39). In contrast with a mortgage portfolio of £17.4bn at end-2013, or £21.1bn including the mortgage enhancement book, we calculate TSB has a market share of less than 2%. Despite a number of new entrants in recent years we note that the mortgage market has been relatively stable. Our analysis shows that the top six lenders have lost less than 3% mortgage market share between 2009 and 2013, despite significant restructuring as these banks looked to repair their balance sheets. Banks that have lost share, such as Lloyds, have mainly lost this share to large rivals, such as Barclays, rather than to new entrants or smaller lenders. TSB's market share in UK mortgages has remained broadly stable over the past 4 years.

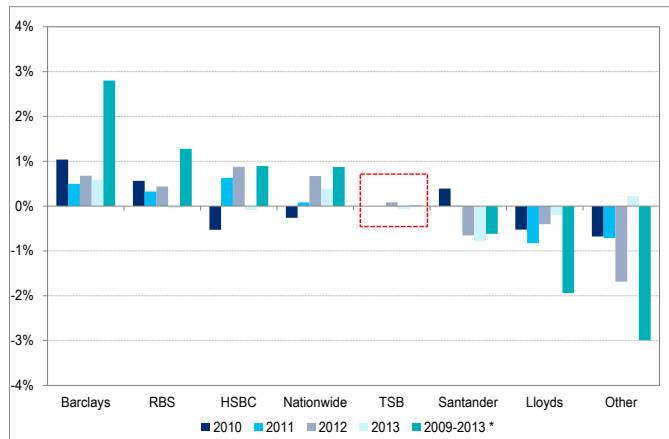
Challengers in the UK banking sector typically face significant challenges. Barriers to entry are high due to a combination of capital, funding, technology and regulatory constraints. However the greatest barrier to entry comes from the difficulty in attracting retail and SME customers. Customers tend to have a preference for banks with an extensive branch network, with internet banking often viewed as a complement, rather than a substitute. Switching rates have also been very low historically, due to a combination of customer inertia and a lack of confidence in switching. The new 7-day switching rule was supposed to assist on the latter, but has seemingly had only a small impact on overall switching rates since its launch.

Figure 39. Market Share of UK Mortgages Outstanding, end 2013



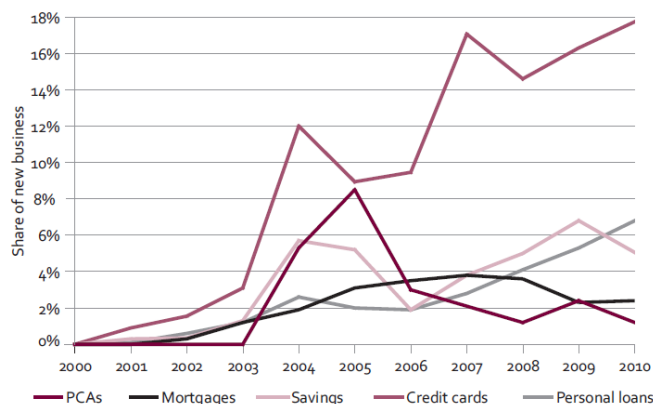
Source: Individual Company Reports, BoE and Citi Research
Note: 'Others' based on BoE industry total less six largest lenders and TSB

Figure 40. Change in UK Mortgage Market Share, end-2009 to end-2013



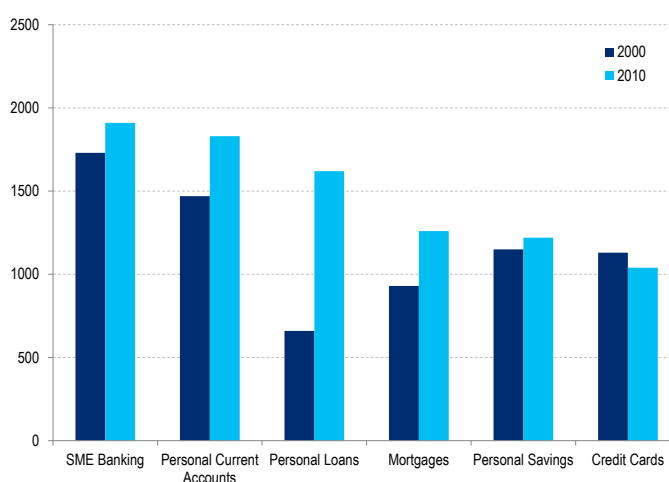
Source: Individual Company Reports, BoE, Citi Research.
Note: 'Others' based on BoE industry total less six largest lenders & TSB;
*TSB market share gain is from 2011-2013

Figure 41. UK Share of New Business Each Year For New Entrants



Source: ICB Final Recommendations, GfK FRS.

Figure 42. HHI Index for UK Banking Products, 2000 vs 2010



Source: ICB Final Recommendations, GfK FRS, TNS and Charterhouse

New entrants have historically struggled to capture share in PCAs and mortgages

The ICB previously illustrated that new entrants managed to capture <4% market share per annum from 2000-2007 in PCAs and mortgages and this then declined post the financial crisis as these new entrants were forced to retreat and/or exit entirely. In contrast new entrants had far more success in cards, for example, which are less reliant upon branch distribution and tend to have higher churn rates. Consequently the UK credit card sector is the most fragmented of all of the UK banking products, while SME banking and PCAs is the least fragmented.

What Makes TSB Different?

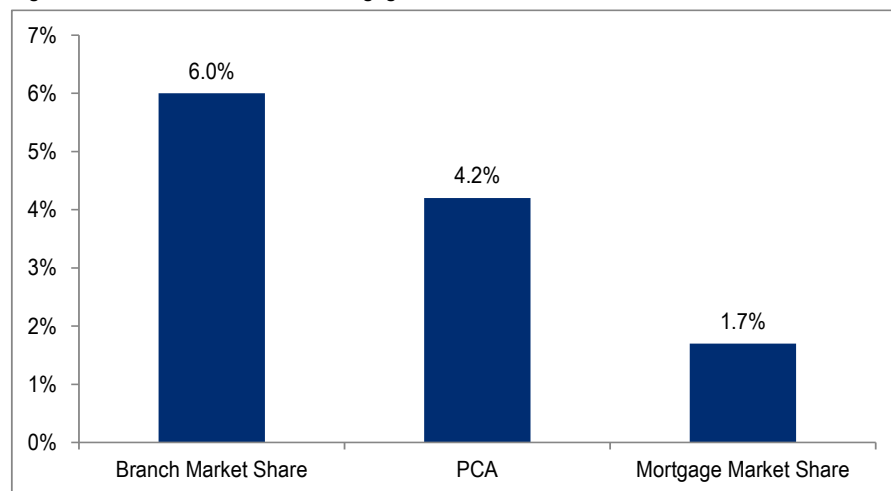
Positive Growth Driver: Established Branch Network

TSB has a 6% market share of branches, but only 4% PCAs and 2% mortgages

The established branch network is a key differentiator vs. other challenger banks in TSB's ability to capture market share...

TSB has a total of 631 branches across UK, of which 164 are newly converted 'Cheltenham & Gloucester' (C&G) branches. This makes TSB the 8th largest UK bank in terms of branch network with a 6% branch share, but TSB only has a 4% PCA share and 2% mortgage share. We therefore believe TSB has significant potential to grow its market share by growing into its comprehensive branch network. We elaborate further on the branch network in the next chapter.

Figure 43. TSB Branch, PCA and Mortgage Market Share

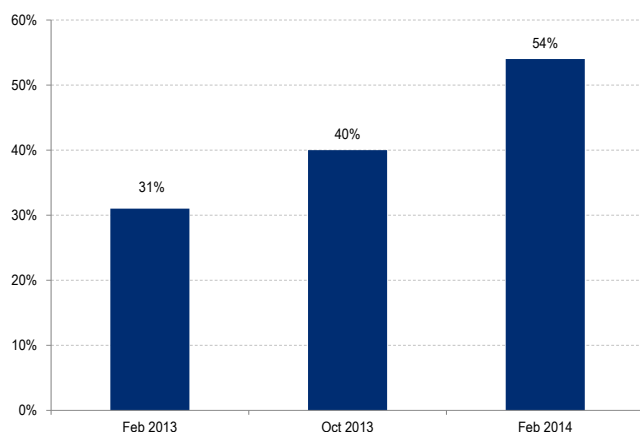


Source: Company Reports, Bank of England and Citi Research Estimates

... and the productivity of the "new" C&G branches should continue to improve

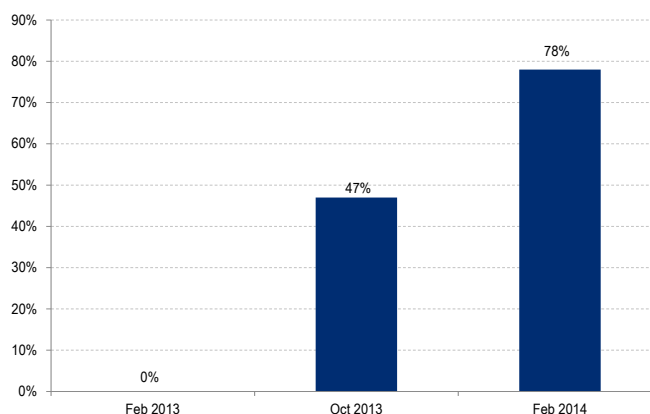
TSB should also benefit from transformation of the Cheltenham & Gloucester (C&G) branches, mainly located in London, South East and West of England. In 2013 all of these branches underwent chip & pin upgrades, counter positions were replaced, headcount was re-allocated and re-trained, branches re-branded, management integrated and a current account functionality was launched (C&G historically focused on mortgages & savings). In 1H14 unsecured lending will also be offered in these branches, advisors introduced and new ATMs rolled out. Progress to date is encouraging with total sales per branch running at 54% of the level of the established TSB branches, as at February 2014, up from 31% a year beforehand.

Figure 44. C&G Total Sales Per Branch vs Established Sales Per Branch



Source: Company Reports

Figure 45. C&G PCA Sales Per Branch vs Established Sales Per Branch



Source: Company Reports

TSB has launched two new flagship product sets, which have proved to be very popular with strong sales figures

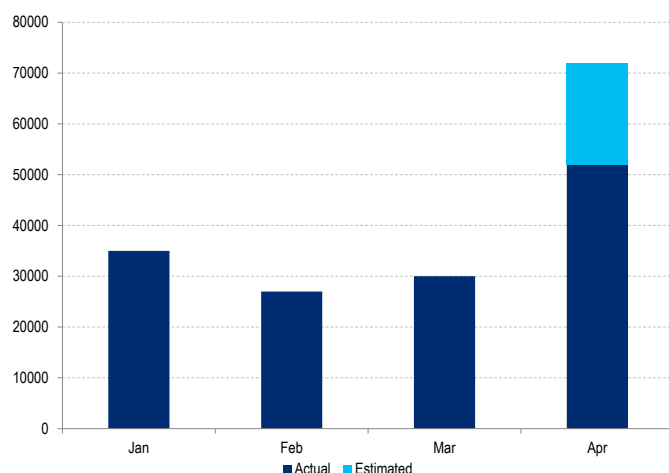
Positive Growth Driver: Success Of New Product Launches

In recent months TSB has launched two new flagship product sets:

- A new set of mortgage products, where TSB offers to pay the stamp duty on behalf of the customer for properties worth <£250k
- The "Classic Plus" PCA, offering a 5% interest rate on balances up to £2k

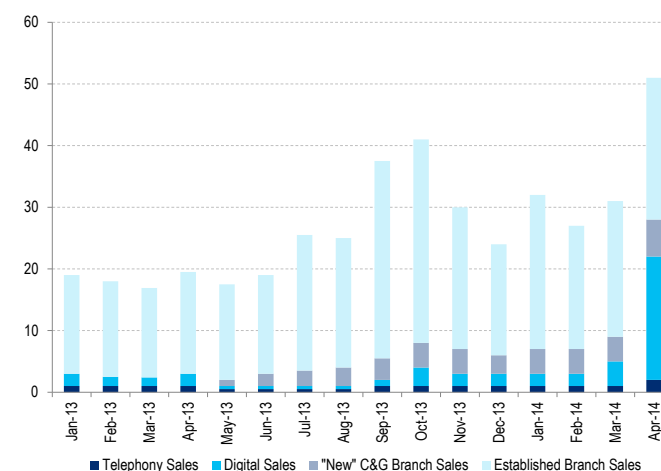
The former was launched in January and the latter in April. Both are differentiated products and initial sales have been positive. The weekly average PCA sales in the first three weeks of the Classic Plus launch have been c17k, c40% higher than PCA sales pre-launch. With TSB planning to fund its loan book with a 100% LDR, the ability to gather deposits and grow PCA market share is key to fund its ambition of growing its loan book by 40-50% in the next 5 years. In addition PCA customers have a higher propensity to hold additional products with the same provider. 85% of customers that have held a PCA with TSB for over 10 years also have a savings account, 31% also have a credit card and 11% also have a personal loan.

Figure 46. TSB – Number of PCA Sales



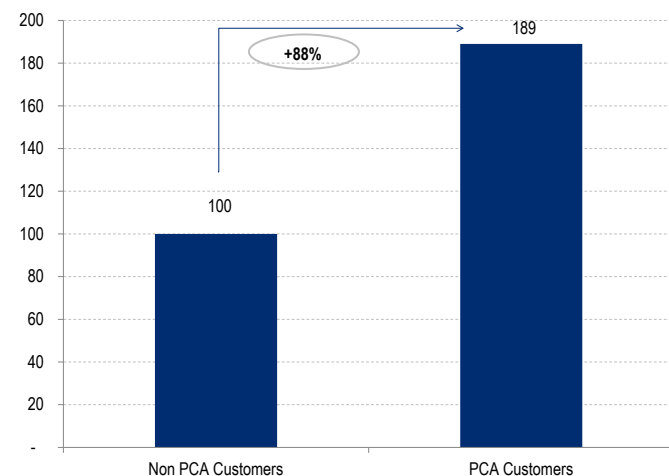
Source: Company Report. Note: Actual for April is based on data to 18 April.

Figure 47. TSB – Number of PCA Sales by Distribution Channel



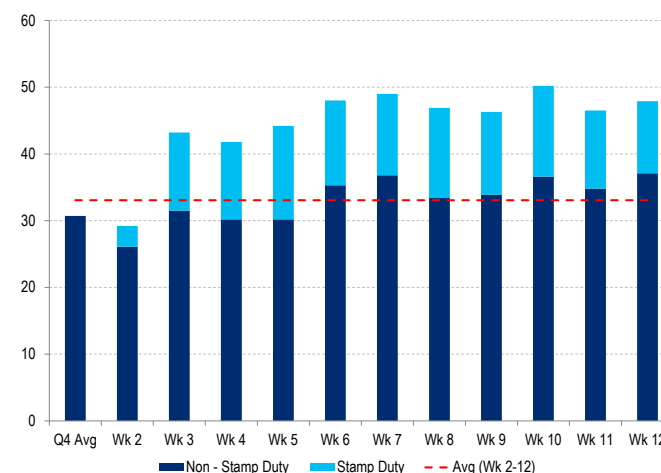
Source: Company Report. Note: Actual for April is based on data to 18 April.

Figure 48. TSB – Average Product Holdings Per Customer (Indexed)



Source: Company Reports

Figure 49. TSB – Mortgage Application Values (£m)



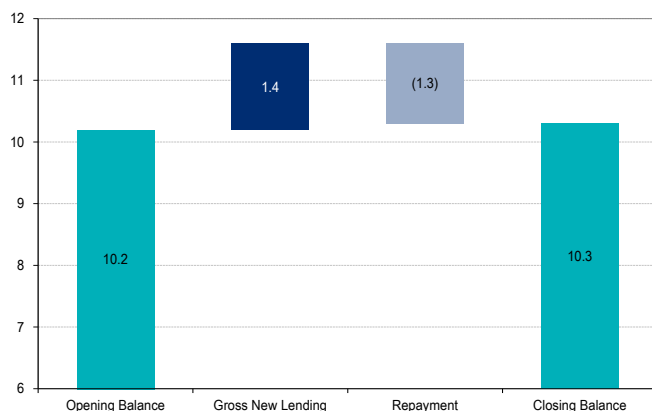
Source: Company Reports

TSB's exit from intermediary mortgages in 2013 will weigh on growth near-term...

Positive Growth Driver: Return To Intermediary Mortgage Channel

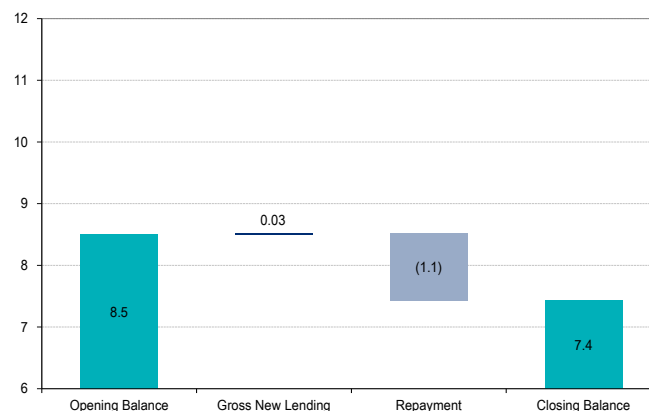
Revenue growth is likely to be challenging in 2014-15, resulting from a number of earlier decisions which were made in response to the previous potential buyer's requirements. For example 40% of TSB's existing mortgage book is intermediary originated, but TSB was forced to exit from this intermediary channel in 1Q13 (C&G closed in March 2011 and LTSG in January 2013). However TSB now plans to re-enter the mortgage intermediary channel in early 2015. We view the success of this re-launch as a key driver in achieving the desired 40-50% growth in volumes.

Figure 50. TSB – Change in Direct Mortgages in 2013 (£bn)



Source: Company Reports

Figure 51. TSB – Change in Intermediary Mortgages in 2013 (£bn)

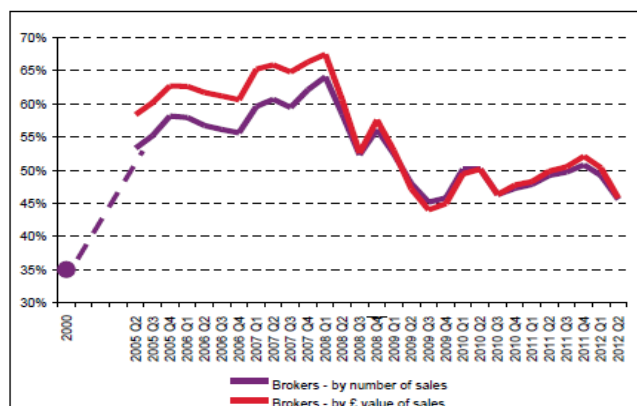


Source: Company Reports

In 2009 the European Commission produced a study on credit intermediaries and concluded that they play a vital role in the UK mortgage market. In the UK over 50% of mortgage sales are via intermediaries, the highest among European countries. The FSA's mortgage market review showed mortgage sales via intermediaries almost doubled to more than 65% during 2002-2007 before falling to 45% in 2012, as some of the specialist lenders who relied on intermediaries exited the market.

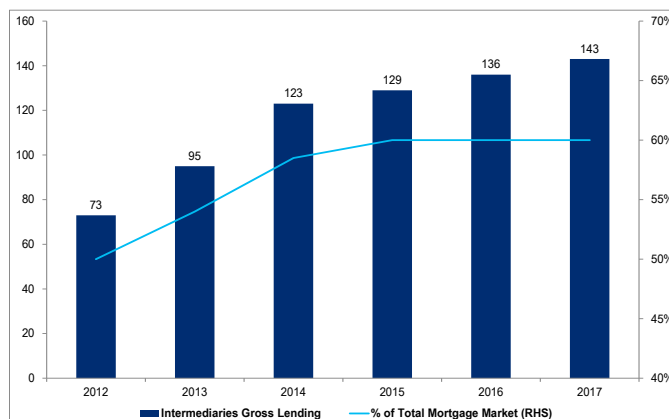
In 2013 lending through intermediaries returned to 55% of total gross lending and TSB now expects this to grow both in terms of gross lending as well as a proportion of overall mortgage lending in coming years (Figure 53). Why? Compared to direct channels mortgage intermediaries offer four times as many products. Moreover, customers' value independent advice and the convenience of using a broker.

Figure 52. Share of Mortgage Sales by Intermediaries



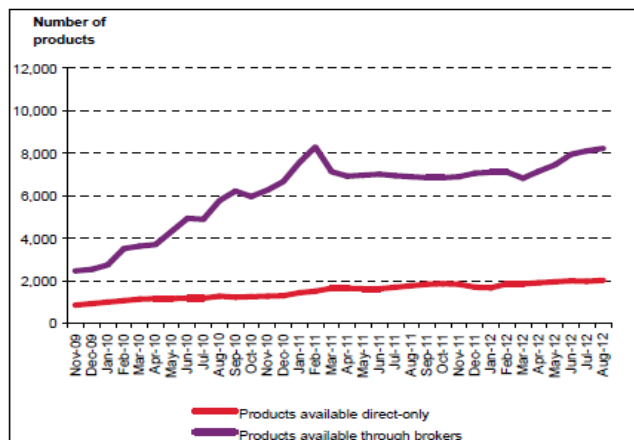
Source: FSA MMR Data Pack, Mintel (2000), FSA PSD (2005-2012)

Figure 53. Intermediaries Market Is Expected to Grow Further



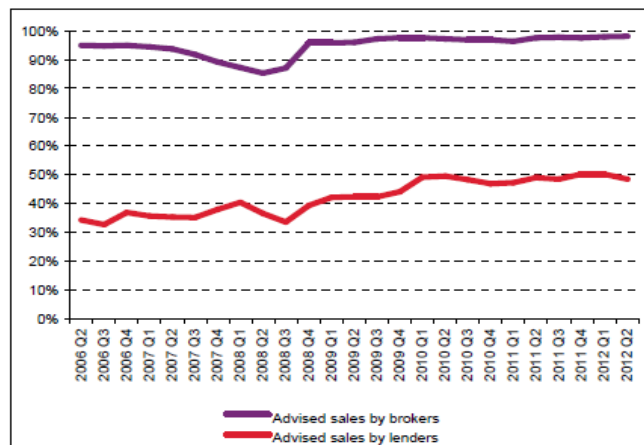
Source: TSB internal data, and TSB estimates

Figure 54. Number of Products Sold Direct versus Intermediaries



Source: FSA MMR Data Pack, Mortgage Brain

Figure 55. Proportion of Sales Which Are Advised by Channel

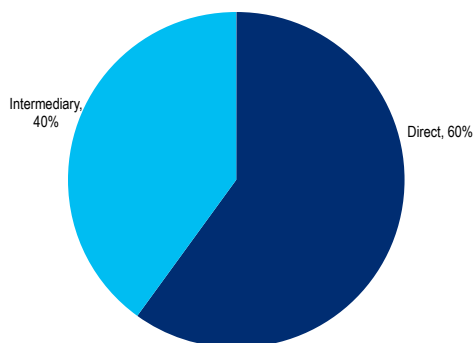


Source: FSA MMR Data Pack, FSA PSD

... but TSB expects to re-enter in 2015...

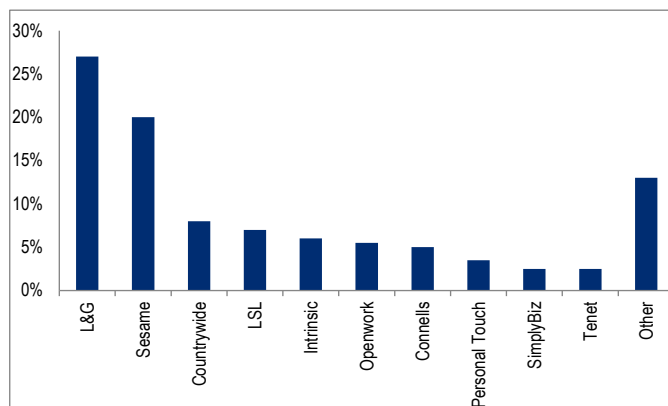
TSB's re-entry into the intermediary mortgage channel in early-2015 will leverage on LBG/Halifax's established intermediary platform. The system and risk control framework is a replica version of what is already working in Halifax intermediaries. TSB plan to proceed with a balanced roll-out, with a product mix to reflect the overall market mix and competitive, but not aggressive pricing. To achieve this TSB plans to develop a broad strategic relationship with ten key intermediary partners, which account for nearly 85% of lending undertaken in the sector (Figure 57).

Figure 56. Origination of Existing Stock of TSB Mortgages



Source: Company Reports

Figure 57. Market Share of Intermediary Lending



Source: Company Reports, Touchstone (January to November 2013)

... targeting c£4bn of mortgage lending p.a. through intermediary channels

The re-entry will be phased in order to control volumes and protect service delivery. We therefore doubt that the intermediary mortgage channel will be up to 'full speed' until late 2016. This is another reason why we expect the 40-50% desired loan growth in the five years post IPO to be weighted more towards the later years. TSB's eventual target is to become a medium-sized player in the intermediary mortgage market, similar to Yorkshire Building Society and Virgin Money, with c£4bn of mortgage lending per annum through intermediary channels.

Two-thirds of TSB's mortgage book is attributable to legacy SVR mortgages, capped at 2% over base rates

As base rates rise more SVR customers are expected to remortgage

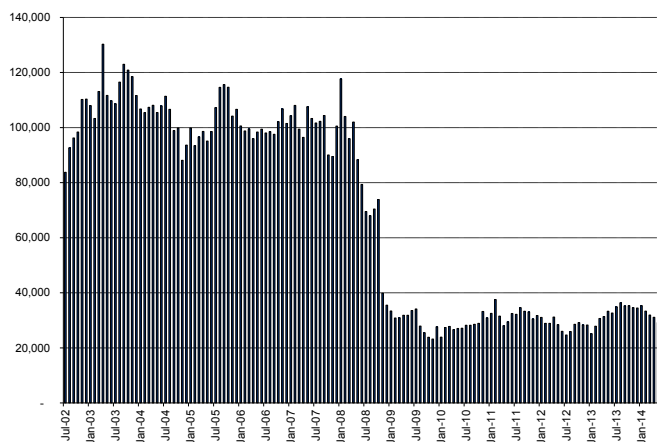
Negative Growth Driver: SVR Back-Book Run-Off (But Good For NIMs)

Two-thirds of TSB's mortgage book is attributable to legacy SVR mortgages, capped at 2% over base rates. Customers are expected to remortgage off of these products as they either move house, or as they seek better deals. Furthermore fixed mortgages issued after June 2010 revert to the new HVR, rather than the SVR, so the SVR portfolio will inevitably shrink going forward. While this is beneficial for net interest margins and overall profitability, it could hinder TSB's ambition to grow the overall mortgage portfolio by 40-50%. There are, however, two key questions:

- How quickly will the SVR book shrink?
- What proportion of the customers which refinance will be retained by TSB?

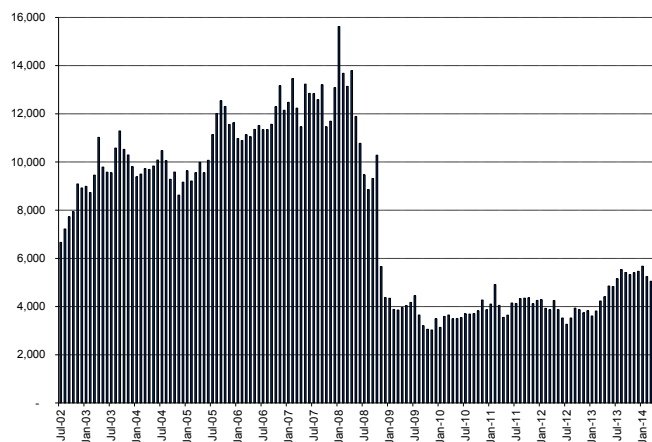
While base rates remain at record lows there is little incentive for customers on the SVR to refinance, as they would struggle to achieve a better rate elsewhere. While 2-year fixed products are being offered with a rate of <2.5%, most of these require a deposit of 30%+. We therefore expect the run-off rate of the SVR book to be small initially. However, this should accelerate as base rates increase and the SVR rises accordingly, making it less attractive to the customer. The higher (and quicker) that base rates climb, the greater the churn from SVR to front-book is likely to be.

Figure 58. UK Remortgaging by Number, 2002-14



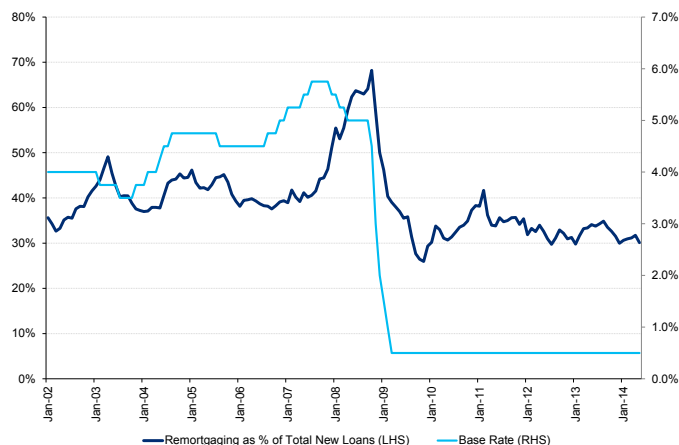
Source: Datastream

Figure 59. UK Remortgaging by Value, 2002-14 (£m)



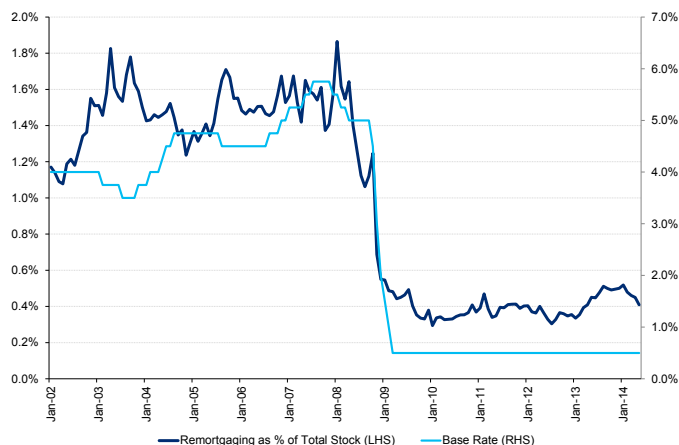
Source: Datastream

Figure 60. UK Remortgaging as a Proportion of New Lending



Source: Datastream and Citi Research

Figure 61. UK Remortgaging as a Proportion of Outstanding Mortgages



Source: Datastream and Citi Research

A high retention rate is key if TSB wishes to deliver on the 40-50% growth target

Retention rates of mortgage customers that choose to refinance are usually relatively high, as banks often offer preferential remortgage rates to existing borrowers (loyalty rates), and customers' typically wish to avoid the additional administrative hassle that comes from switching to another mortgage provider. However much depends on the competitive dynamics and the rates being offered by peers at the time of refinancing. According to data collected by the Independent Commission on Banking, mortgage switching rates peaked at c10% from 2003-08, but then declined in 2009-10, reflecting the overall reduction in remortgaging.

Attrition levels have been low to date...

Negative Growth Driver: Customer Attrition Risk To Lloyds

To date PCA attrition levels from TSB have been very low at c5-8% in 2012-13. In 2013 the 8% attrition rate included 1.3% of assets in dormant bank accounts, which were transferred to the government's unclaimed asset scheme. A further 1.4% of customers were lost to Lloyds following the TSB re-branding and separation in September 2013. Of the remaining 5.6% attrition, 3.5% was deemed to be non-preventable by TSB and only 2.1% deemed to be preventable.

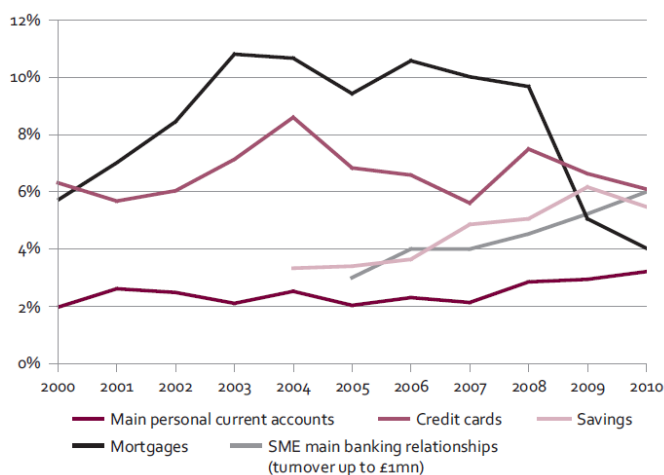
... but could increase post July 2014...

Although TSB has operated with a completely separate brand to Lloyds since September 2013, TSB customers have still been able to use Lloyds' branches to date. In order for customers to continue using Lloyds branches, some personal information held by TSB has been shared with Lloyds, to include account balances and a sample of customers' signatures, for example, but since 26 July 2014, this information has no longer been shared and TSB customers now have to use branches of their own bank. While we expect customer attrition rates to Lloyds will remain low they may therefore increase from the 2013 level of 1.4%.

... and after the Lloyds non-compete agreement ends in c2 years' time

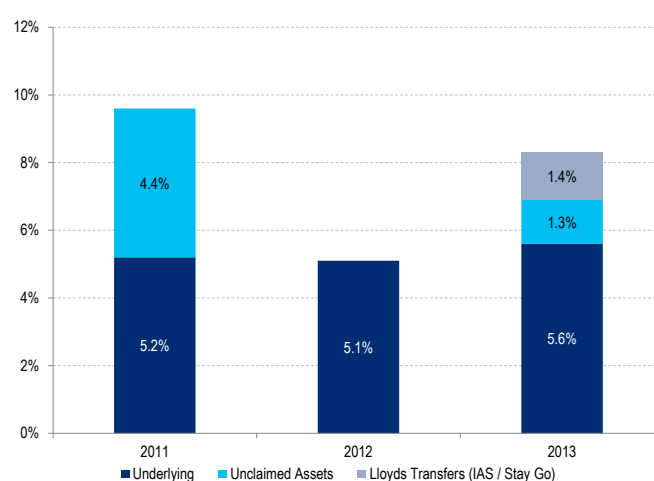
In addition a non-compete agreement is currently in place with Lloyds which covers both the targeted marketing of TSB customers and the opening of Lloyds branches within an agreed distance of TSB branches. This non-compete agreement is, however, set to end within c2 years, at which point there is a risk that the customer attrition level to Lloyds could again step-up

Figure 62. UK Annual Switching Rates



Source: ICB Final Recommendations, GfK FRS, Charterhouse and TNS

Figure 63. TSB – PCA Attrition Rates



Source: Company Reports

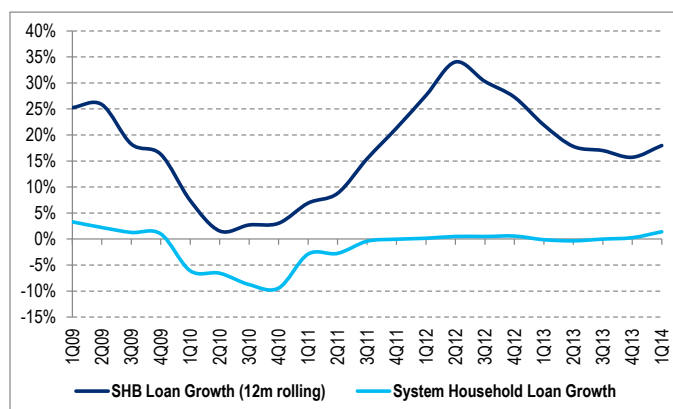
We observe the growth shown by SHB
UK, Northern Rock (pre-crisis) and
Commerce Bancorp (in the US)

High Growth Retail Banks – Some Precedents

TSB's potential growth opportunity in the UK – with a target 40-50% loan growth over five years – makes it a very different investment case to other listed UK banks. From 2008-13 most of the other listed UK banks have been focused on restructuring, creating and divesting non-core units and internal consolidation and cost reduction. To find UK retail banking growth stories similar to TSB, we either have to look to new UK entrants such as Svenska Handelsbanken, or to the pre-crisis period, where institutions such as Northern Rock observed rapid growth. Alternatively we can look to the US for comparables, where the larger market size and greater fragmentation tends to create opportunities for market share growth stories such as Commerce Bancorp (subsequently purchased by TD Bank).

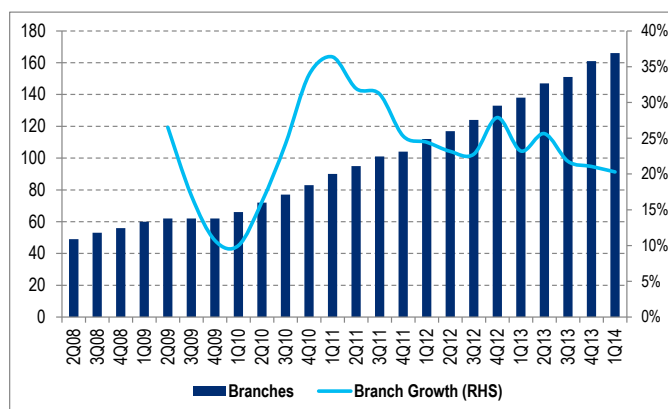
Svenska Handelsbanken (SHB) is currently one of the highest-profile UK retail banking growth stories and has received much positive media and political comment in the past few years. Its most recently reported financials (1Q14) disclosed UK loan growth of 15% yoy (in GBP). SHB has a total UK loan book of £12.5bn and a deposit base of £6.4bn. Similar to TSB, SHB has a locally focused business model, but unlike TSB, SHB also devolves far greater pricing, marketing and credit decision autonomy to the local branch level managers. Also, SHB's UK business model is based on a rapid roll-out of new branches, unlike TSB, and the customer base is either high-net-worth or mass-affluent. One other difference: SHB UK has an LDR ratio of 196% (supported by parent funding) versus TSB's 99%.

Figure 64. Handelsbanken Loan Growth vs UK Household Loan Growth



Source: SHB Company Reports; BoE

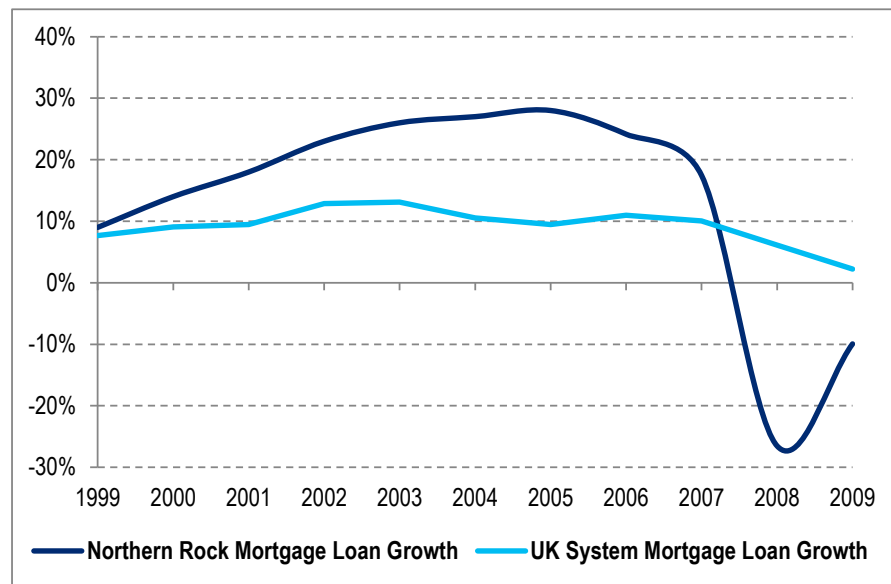
Figure 65. Handelsbanken – Number of Branches and Branch Growth



Source: SHB Company Reports

Probably the best example of a UK retail bank growth story pre-crisis was Northern Rock. At its peak in the mid-2000s, Northern Rock was growing its mortgage loan book at c30% per annum, or 3x faster than the UK market growth. The Northern Rock story ended infamously with a run on the bank by retail depositors and subsequent bail-out by the UK government. While the TSB business plan also focuses on growth, crucially its funding model is very different: NRK had an LDR of 167% at end-2007 versus TSB 99% today. Northern Rock was also aggressive on loan underwriting standards, offering LTVs of above 95%. As an offshoot of Lloyds, TSB is a much more cautious underwriter. Its average LTV of 46% (and 55% on new lending) is one of the lowest amongst UK mortgage lenders.

Figure 66. Northern Rock – Mortgage Loan Growth vs UK Household Loan Growth

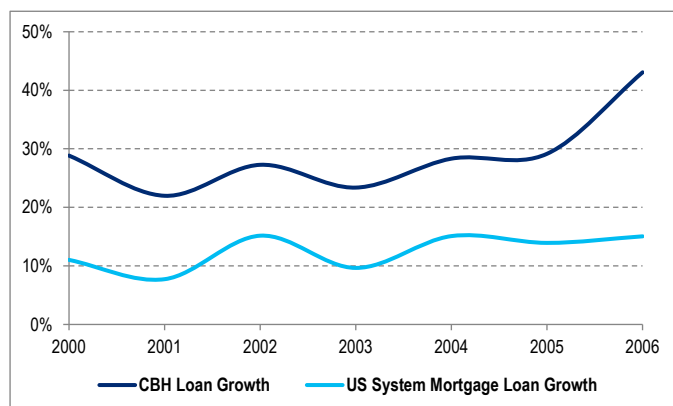


Source: Northern Rock Company Reports; BoE

Commerce Bancorp was acquired for c2.8x book in 2008

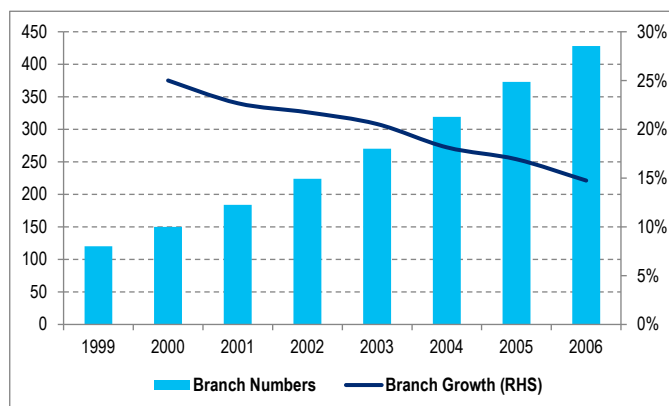
Looking outside the UK, the larger and more fragmented US banking markets offers us a source of comparable retail bank growth stories. One of the best is probably Commerce Bancorp (founded by Vernon Hill who is backing the UK challenger Metrobank). The Commerce business model combined an aggressive organic branch expansion strategy with an aspiration to best-in-class customer service and brand and superior execution. Commerce out-spent peers on branch locations and had higher staff per branch ratios. In 2008, TD Bank of Canada bought Commerce for \$8.3bn (around 2.8x book).

Figure 67. CBH Loan Growth vs US System Mortgage Loan Growth



Source: CBH Company Reports; Federal Reserve

Figure 68. CBH – Number of Branches and Branch Growth



Source: CBH Company Reports

We model 50% growth in secured and unsecured lending from mid-14 to mid-19

Assuming net industry mortgage growth of c2% in 2014, rising to c4% per annum in 2015-18, would imply cumulative system growth of c20% over five years

TSB would therefore be capturing a flow market share of c3.2% of net new mortgage lending

Growth Forecasts

We model 50% growth in both secured and unsecured loans from mid-2014 to mid-2019, consistent with the top-end of the company target to grow the loan book by 40-50% in the five years post-IPO. However it is worth noting that the TSB growth target over 5-years is really a 40-50%+ target over 4.5 years given the strong probability of a contraction in outstanding mortgage volumes during 2H14 following the exit from the intermediary mortgage channel. In deriving our growth forecasts we therefore make the following key assumptions:

- We model PCA growth of 6% pa and savings of 4% pa from 2014-20
- We model 8% growth in unsecured loan growth in 2015, rising to 10% in 2016, and 11% in 2017-18. We then model a slowdown in 2019 and 2020 to 5%, as we forecast TSB to reach a 100% LDR by mid-2019. Further loan growth is therefore constrained by the pace of deposit gathering from this point onwards.
- We assume new customer mortgage volumes of 15% in 2015, rising to 25% in 2017 and 2018, before slowing in 2019-20 to 5%, again due to LDR constraints. We assume a third of new customers opt for trackers and two-thirds for fixed.
- We assume c10% of SVR (and HVR) customers choose to refinance in 2015 and 2016, rising to 15% in 2017 and 20% thereafter. We therefore model a cumulative c50% decline in the SVR portfolio from mid-2014 to mid-2019.
- We assume c20% of TSB's SVR (and HVR) customers that decide to re-mortgage are lost and c80% are retained. In turn we assume a third of the customers that are retained opt to take a new tracker mortgage with TSB and two-thirds instead opt to take out a new fixed mortgage with TSB.

These assumptions would imply 2017-18 new mortgage customer growth rates that are getting close to the annual growth experienced by Northern Rock, Commerce Bancorp and SHB UK at their peak, albeit we do not view any of these peers as directly comparable for the aforementioned reasons on funding & business mix.

We assume net industry mortgage growth of c2% in 2014, rising to c4% per annum in 2015-18, broadly in-line with nominal GDP growth. This would imply cumulative system growth of c20% over the five year period from 2013-18. Our forecast growth assumptions would therefore imply that we expect TSB to capture a flow market share of c3.2% of net new mortgage lending. This does not seem implausible. Of course if the industry were to grow at a slower rate, then TSB may need to be more aggressive on pricing and/or move up the risk curve to achieve its growth target.

Geographical Footprint & Customer Profile

Comprehensive Branch Network Coverage

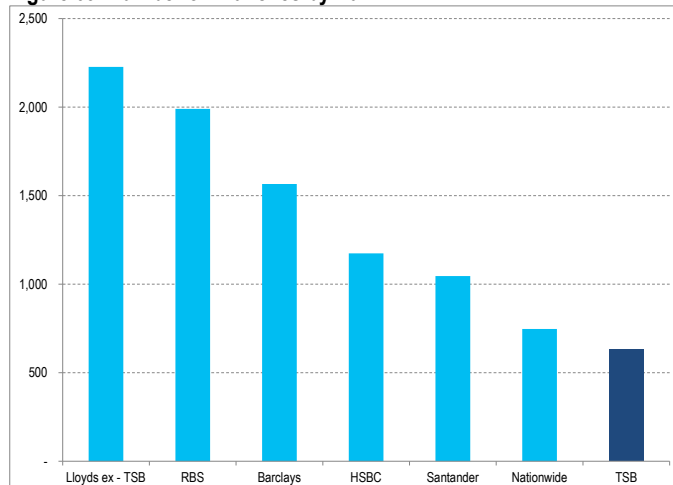
TSB has significant potential to grow its market share by leveraging its comprehensive branch network coverage

TSB has a total of 631 branches across Britain, with 46% of the population within 2 miles of a TSB branch. This makes TSB the 8th largest UK bank in terms of the size of the branch network, yet TSB has a much smaller market share of mortgages. Including the mortgage enhancement book, TSB has £20.7bn of mortgage loans as of 1Q14, which is dwarfed by the c£130bn of outstanding mortgage loans at Nationwide, even though Nationwide's branch share is only c1% higher. We therefore believe TSB has significant potential to grow its market share by leveraging its comprehensive branch network coverage.

The branch network has a high concentration in Scotland versus peers

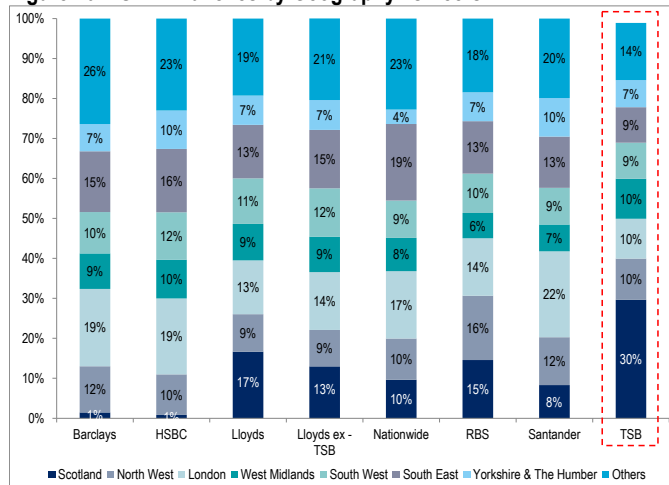
Without doubt, the comprehensive branch network is one of TSB's biggest assets, although 30% of TSB branches are concentrated in Scotland. This is 20% higher than the six largest lenders in UK, which on average have only c10% of branches located in Scotland. Meanwhile TSB's branch concentration in London and South East, at only 10% and 9% respectively, is c5-6% below peers (Figure 71)

Figure 69. Number of Branches by Bank



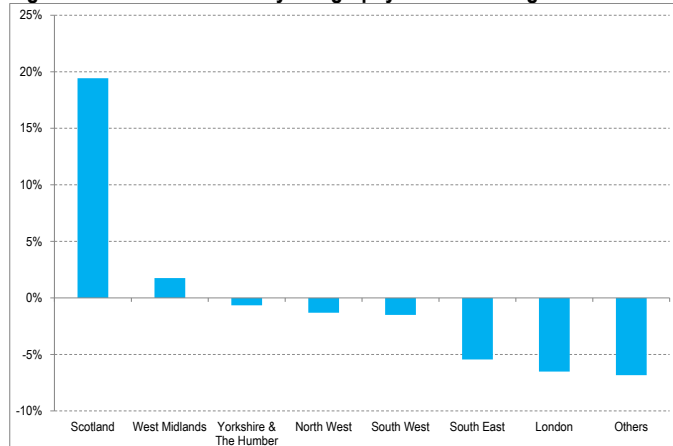
Source: Company Reports, Company Website (Branch Locator) and Citi Research

Figure 70. TSB – Branches by Geography vs Peers



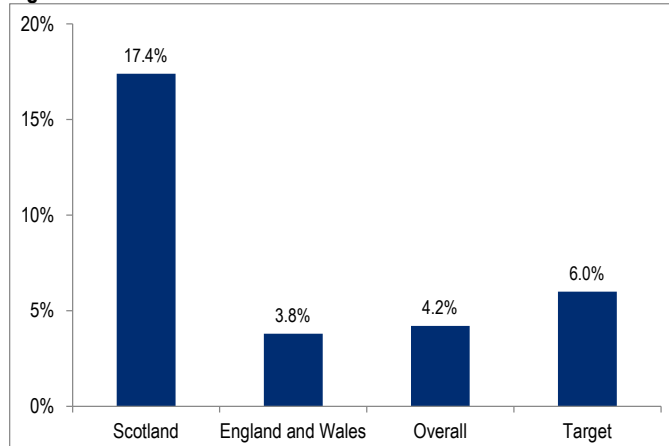
Source: Company Reports, Company Website (Branch Locator) and Citi Research; Others include East Midlands, East of England, North East and Wales

Figure 71. TSB – Branches by Geography Relative to Big 6 UK Lenders



Source: Company Reports, Company Website (Branch Locator) and Citi Research; Others include East Midlands, East of England, North East and Wales

Figure 72. TSB - PCA Market Share

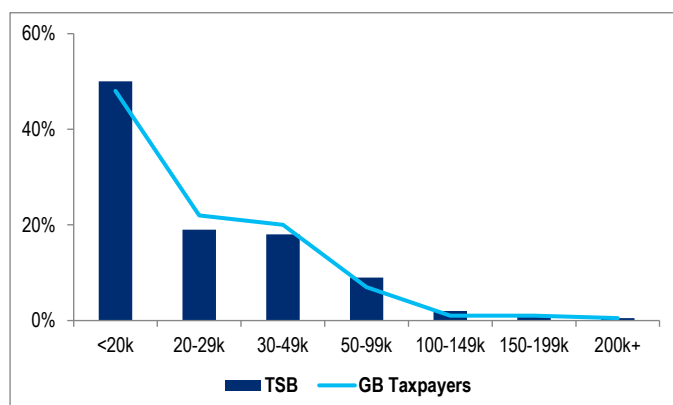


Source: Company Reports

TSB has a balanced customer profile

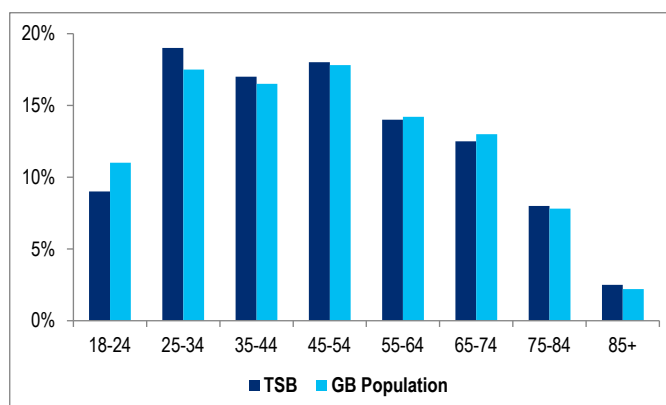
Through this branch network TSB services a total of 4.5m customers in UK, of which more than 70% have been banking with TSB for longer than 6 years. The profile of these customers closely matches the general profile of UK population in terms of both income and age. For example, around half of its customers have an annual income of below £20k and around 90% of its customers have annual income below £50k. This is in-line with the income profile of UK tax-payers (Figure 73).

Figure 73. TSB Customer Income Compared to GB Taxpayers Profile



Source: Gov.uk, 2012-2013 data; Company Reports

Figure 74. TSB Customer Age Compared to General Population



Source: ONS, 2012-based 2014 population projection; Company Reports

The income distribution of TSB's customers fits well with TSB's community-focused brand: "we exist to help create a Britain where people and the communities they live in, and thrive together. We will do that by being an economic force for good, fuelling growth in local communities throughout Britain". TSB is not focusing on mass-affluent and wealthy customers; it is a local, community bank.

TSB customers are concentrated around ages 25-54, representing more than half of the total customer base, slightly higher than the demographics of the general UK population. The largest proportion is attributable to the 25-34 age range, an age group that tends to be among the most active banking users. They are working age, need access to both current & savings accounts and at the same time are most likely to be seeking first-time buyer, higher-margin, mortgage products.

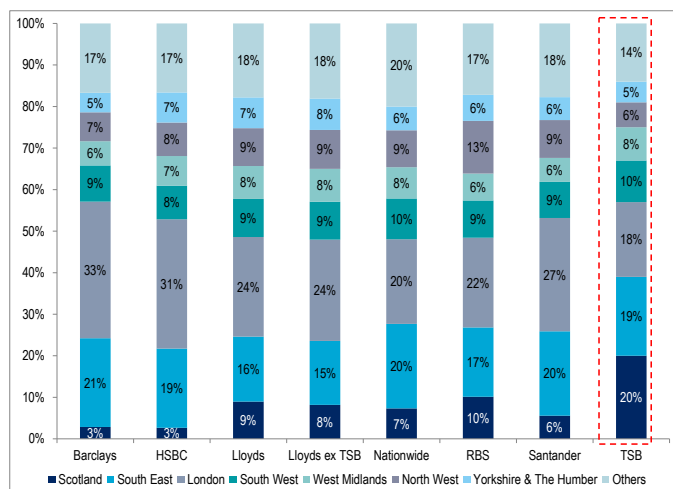
PCA & Mortgage Portfolio Weighted Towards Scotland

The high concentration of the branch network in Scotland is also reflected in the mix of TSB's outstanding PCAs and mortgages. TSB's PCA market share is as high as 17.4% in Scotland, declining to only 3.8% in England and Wales. Nonetheless, TSB still has an overall PCA market share of only 4.2% far below its branch share of 6%. TSB plans to bridge the gap over time to reach a target PCA market share of 6%.

The mortgage portfolio is concentrated in three key markets: Scotland, South East and London, which together contribute close to 60% of total mortgages (Figure 75). Relative to the six largest mortgage lenders in UK, TSB's portfolio is overweight Scotland and underweight London (Figure 76). Lending to Scotland is 20% of total lending and 13% higher than peer average. At the other end of the spectrum, lending to London, despite a significant weight of 18%, is c7% below peer average. Again this maps directly to the geographic breakdown of TSB's branch network.

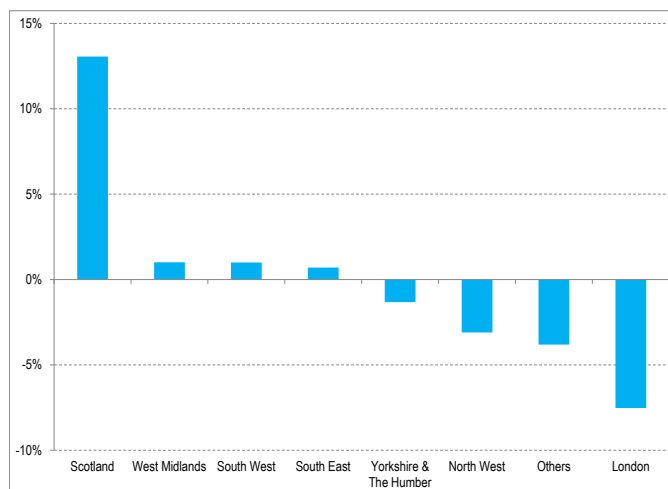
TSB has a much larger market share in Scotland relative to England & Wales in both PCAs and mortgages

Figure 75. TBS – Mortgage Portfolio by Geography vs Peers



Source: Company Reports, Company Website (Branch Locator) and Citi Research Estimates; Others include East Midlands, East of England, North East and Wales

Figure 76. TBS – Mortgage Portfolio by Geography Relative to Big 6 UK Lenders



Source: Company Reports, Company Website (Branch Locator) and Citi Research Estimates; Others include East Midlands, East of England, North East and Wales

TSB outstanding mortgage loans per branch are low relative to peers...

... indicating that TSB could grow rapidly without the need for significant additional infrastructure investment...

... although the geographical mix of branches will eventually need to be better spread across the UK

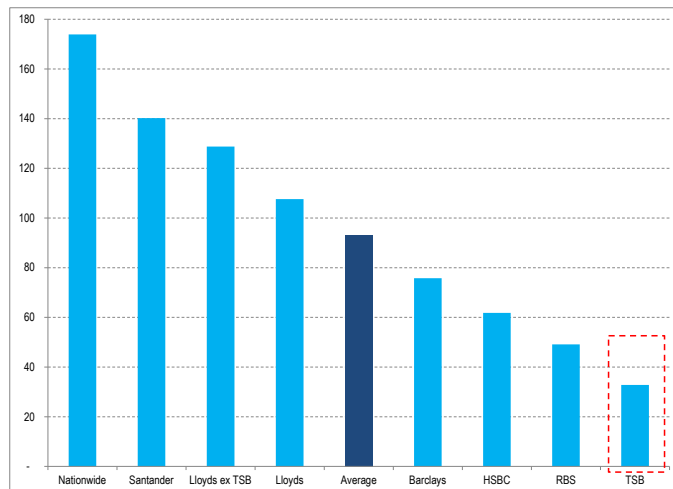
Branch Productivity

Taking this analysis further, we can measure TSB's productivity using the proxy of mortgage loans issued per branch. This gives an indication of (i) how much TSB could potentially grow, without the need to expand the branch network; and (ii) in which regions TSB has the greatest loan growth potential going forward.

Currently TSB has a much lower 'productivity' level relative to UK banking peers (Figure 77). If TSB can deliver on its target to grow the TSB Franchise mortgage portfolio by 40-50% in the next 5 years, while limiting branch growth to c10-15 additional branches, then mortgage loans per branch would move into line with the position of RBS today. This would still be well below the UK average, suggesting that further growth is possible, beyond 2018, without the need for significant infrastructure upgrades. That said, the regional location of TSB's branch network, dominated by Scotland, may need to come under review for it to grow further.

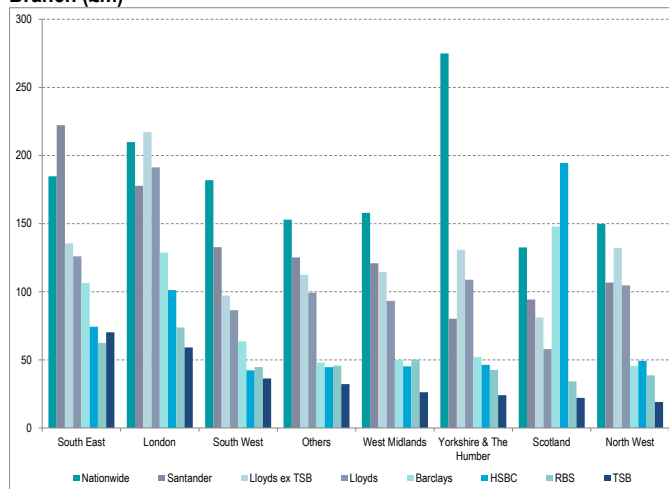
The most 'productive' regions for both TSB (and the wider industry) are London and South East. At TSB these two regions each contribute c18-19% of the overall mortgage portfolio, despite only c9-10% of branches being located here. This is equivalent to c£60-70m of mortgages per branch, double the TSB average. Nonetheless TSB still has among the lowest productivity in these regions, relative to peers. Furthermore the productivity gap between TSB and peers is even greater in West Midlands, Yorkshire, Scotland and North West (Figure 78). These regions therefore present the greatest growth opportunity near-term without the need for incremental investment. However, longer-term a stronger presence in London and South East is also likely to be required.

Figure 77. UK Lenders – Outstanding Mortgage Loans Per Branch (£m)



Source: Company Reports, Company Website (Branch Locator) and Citi Research Estimates;

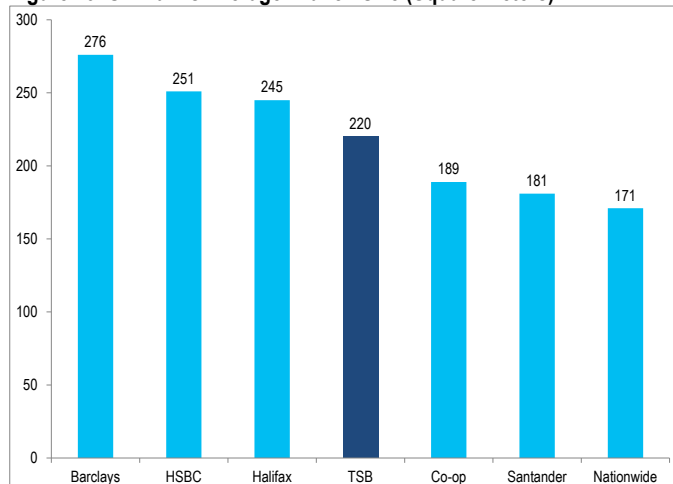
Figure 78. UK Lenders – Outstanding Regional Mortgage Loans Per Branch (£m)



Source: Company Reports, Company Website (Branch Locator) and Citi Research Estimates; Others include East Midlands, East of England, North East and Wales

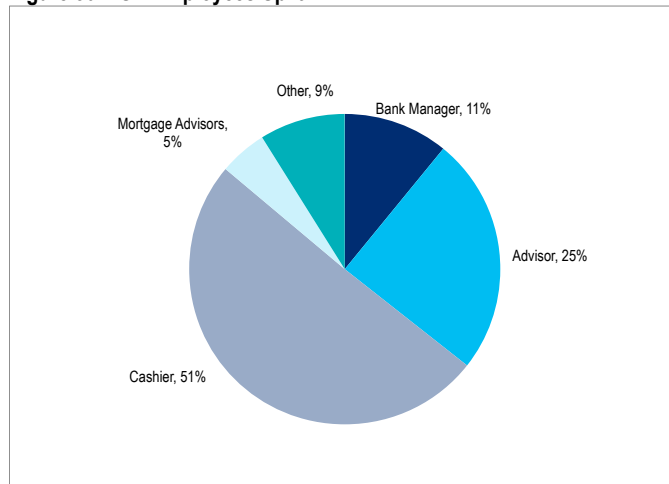
TSB's average branch size is already in the middle of the peer group – smaller than Barclays and HSBC, but larger than Santander and Nationwide. However the split of TSB employees is heavily weighted towards cashiers. We believe one way to improve productivity would be to re-train more staff to act as mortgage advisors. This could help to ensure that TSB grows into its branch network.

Figure 79. UK Banks Average Branch Size (Square Meters)



Source: GOAD data, Oct-13

Figure 80. TSB Employees Split



Source: Company Reports

Branch Locations Matter

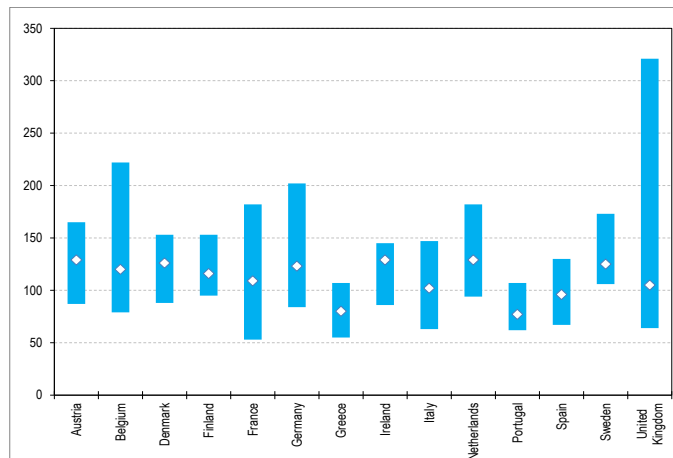
London is growing at a much faster rate than the UK average ...

According to Eurostat, the UK has one of the highest internal dispersions of GVA per head within Europe (Figure 81). For example, Inner London's GVA per head is more than 180% of national average, while the GVA per head in West Wales is less than 80% of the national average. Only Russia (Moscow) and Turkey (Istanbul) show a greater internal dispersion on a global basis. This is why we view a strong presence in London and (to a lesser extent) South East as a strategic advantage.

... although Scotland also screens well

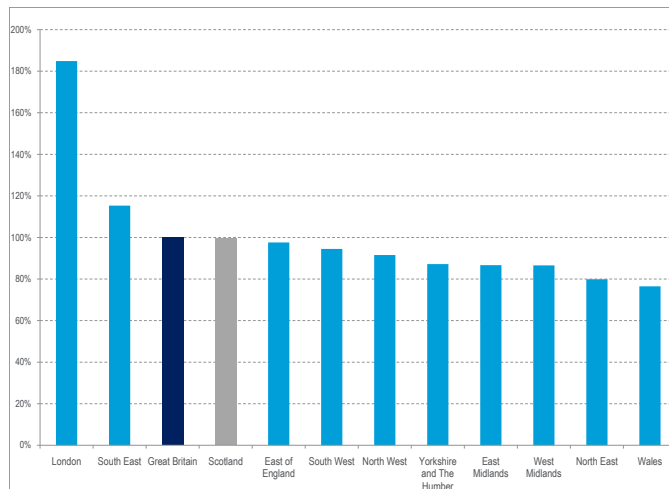
London and South East together contribute almost 40% of UK's total GVA and more than 30% of household disposable income. Furthermore, London has the highest CAGR in GVA and disposable income in the UK over the past 10 years. TSB's underweight branch position in the region, relative to peers, may therefore limit its ability to fully benefit from future UK economic growth (led by London). However it is worth noting that Scotland's GVA is towards the high-end and Scotland also has the second-highest gross disposable income growth over the past 10 years.

Figure 81. Range in GVA Per Head Between Sub-Regions as % of EU Average



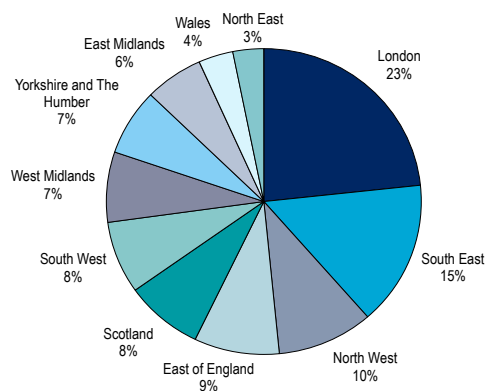
Source: Eurostat and Citi Research. Note: PPP adjusted.
◇ = National Average. Range for UK is for Inner London to West Wales.

Figure 82. Gross Value Added Per Head as % of GB Average



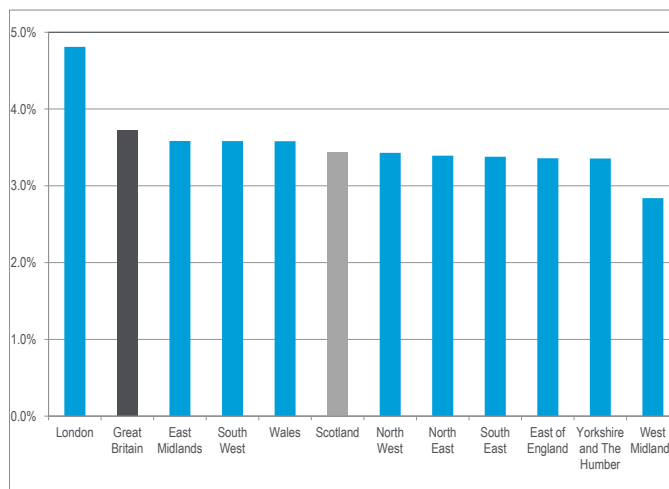
Source: ONS and Citi Research. Note: Workplace based estimates of economic output, based on the incomes of individuals allocated to their place of work.

Figure 83. Great Britain Gross Value Added (GVA) By Region



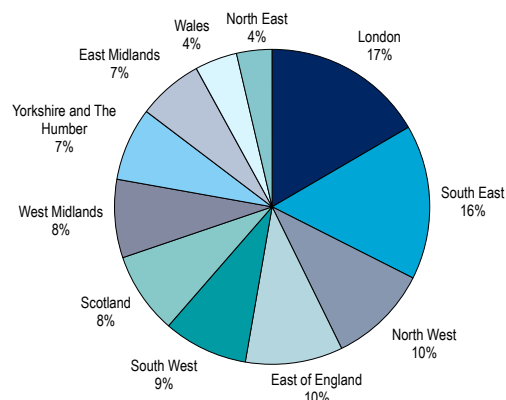
Source: ONS and Citi Research. Note: Workplace based estimates of economic output, based on the incomes of individuals allocated to their place of work.

Figure 84. Great Britain Gross Value Added CAGR In Past 10 Years



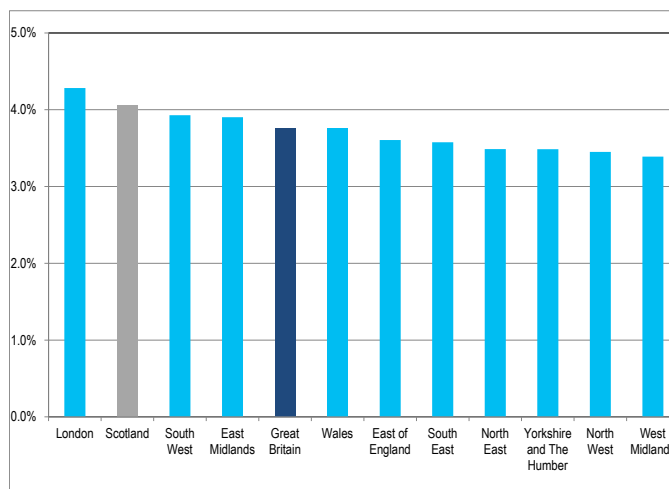
Source: ONS and Citi Research. Note: Workplace based estimates of economic output, based on the incomes of individuals allocated to their place of work.

Figure 85. Great Britain Gross Disposable Income By Region



Source: ONS and Citi Research. Note: Income received by households net of tax payments, social security contributions and benefits

Figure 86. GB Gross Disposable Income CAGR In Past 10 Years

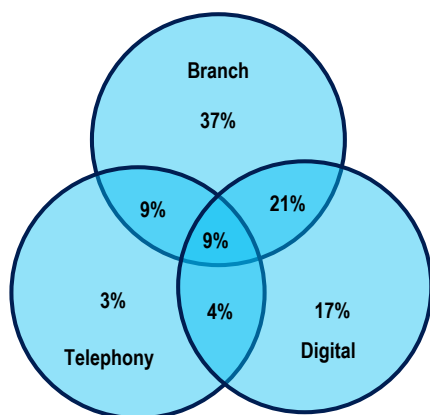


Source: ONS and Citi Research. Note: Income received by households net of tax payments, social security contributions and benefits

A “yes” vote to Scottish independence could result unknown consequences

Finally, geography matters because of politics, and more specifically the possibility of Scottish independence. TSB Bank is incorporated in Scotland. The impact of a ‘yes’ vote in favour of Scottish independence remains highly uncertain, with a number of material issues, to include currency and the shape and role of Scotland’s monetary system, still undecided. Consequently the outcome of a “yes” vote could have a material impact on compliance costs, the tax position, and cost of funding for the Group among other factors. Other Scottish incorporated companies, such as Standard Life, have already indicated that they would “take whatever action we consider necessary – including transferring parts of our operations from Scotland – in order to ensure continuity and to protect the interests of our stakeholders.”

Figure 87. TSB Cross Channel Usage in Q4-13 for Current Account Customers



Source: Company Reports; 31% of current account customers did not use any channel in Q4-13

Beyond Branches

Of TSB’s three distribution channels – branch, telephony and digital – branches are still the most important channel of distribution. Around 70% of its 4.5m customers have used a branch in the past 12 month and more than 40% have used a branch in the past 3 month. Around 88% of current accounts are still opened in a branch, 85% of mortgage applications are completed in a branch and 71% of personal loans are applied for in a branch.

However, TSB supplements its extensive branch network with a full digital, mobile and telephony capability. Around 40% of customers choose to bank across multiple channels (Figure 87). The digital offering benefits from the service agreement between TSB and Lloyds, enabling TSB to use the LBG Galaxy platform. So far, around 40% of TSB’s customers have registered a digital banking account and the number is increasing at around 10k a month. Lastly, TSB’s telephony business functions are based in UK, operating 24 hours a day, 365 days a year.

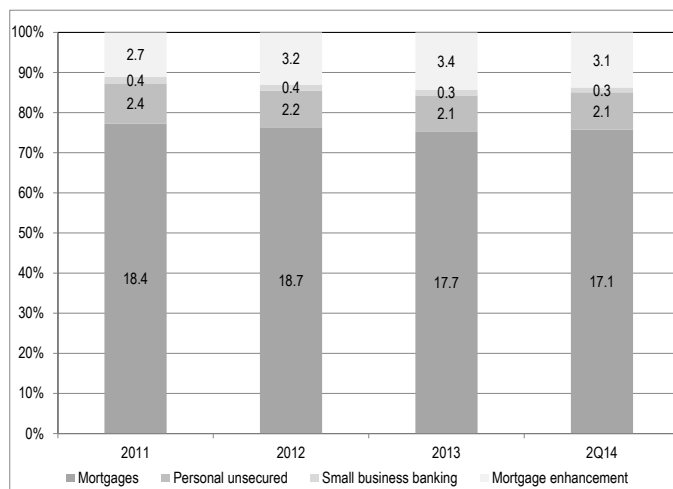
Interest Margin Sensitivity

Asset Pricing & SVR Churn

TSB's current asset margin is low due to the cap on the SVR back-book...

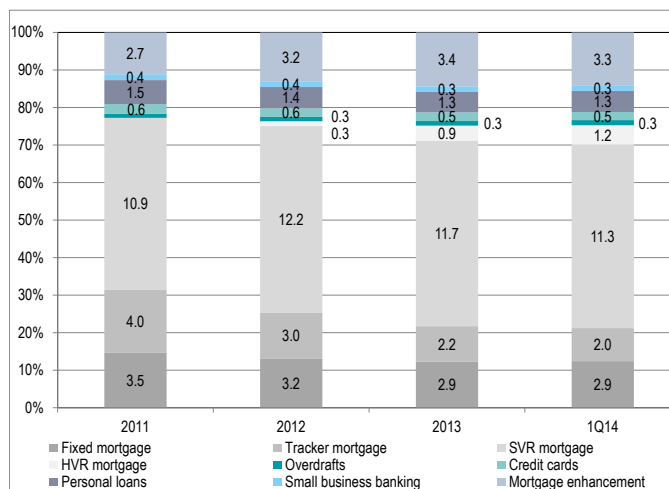
TSB's current asset margin is low. Over 90% of the TSB Franchise loan book is attributable to mortgages and in turn two-thirds of these mortgages are still on a SVR that is capped at 2% over base rates, ie. 2.5% today. All new mortgages written since June 2010 revert to the HVR at 4% (which has no cap), instead of the SVR, so the legacy SVR book has started to shrink, but while base rates remain at record lows there is little incentive for these customers to re-finance, so the run-off rate on the SVR book is likely to small initially. This remains a serious impediment to net interest margins and overall profitability in the current low interest rate environment.

Figure 88. TSB – Loan Book Breakdown, 2011-2Q14



Source: Company Reports

Figure 89. TSB – Detailed Loan Book Breakdown, 2011-1Q14

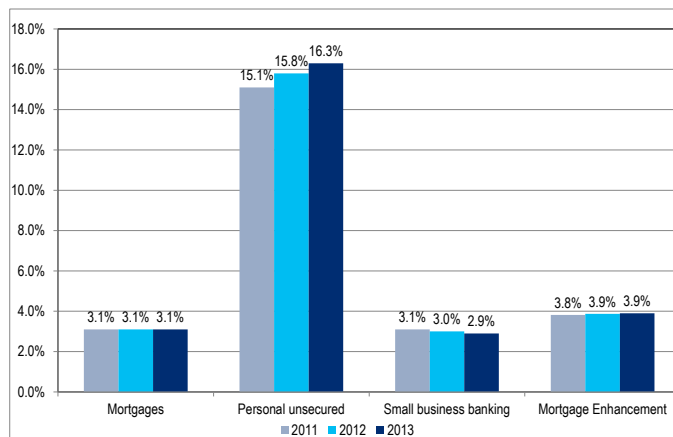


Source: Company Reports

... but this should improve as base rates rise and customers transition onto new front-book rates...

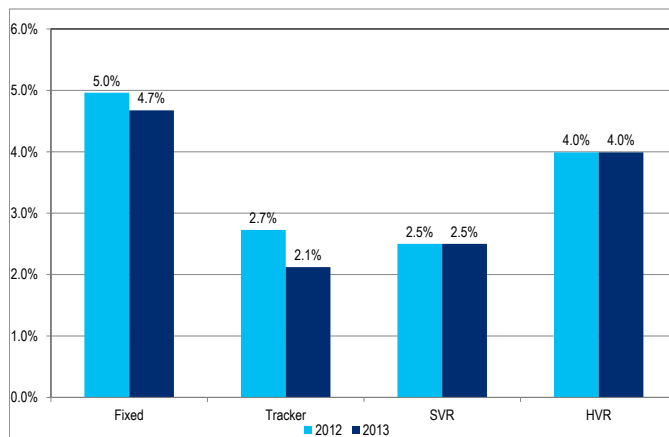
In contrast, the TSB front-book has a gross yield of c3.5% (split c4.7% fixed, c2.1% tracker), resulting in an overall mortgage yield of 3.1%. As base rates increase, the SVR will rise accordingly. Furthermore customers are also expected to re-finance and transition to front-book rates, as the economic benefit of staying on the SVR becomes more marginal. The higher (and quicker) that base rates climb, the greater the churn from SVR to front-book is likely to be, boosting NIMs.

Figure 90. TSB – Gross Asset Yields, 2011-13



Source: Company Reports

Figure 91. TSB – Gross Mortgage Yields, 2012-13



Source: Company Reports and Citi Research

... but in the near-term further asset margin compression appears likely

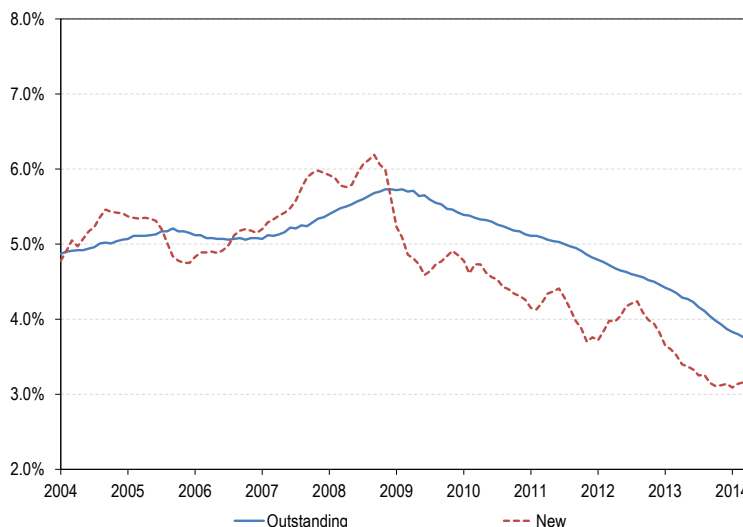
In the absence of a base rate rise in the near-term, asset yields are likely to remain under pressure. TSB offers a range of fixed and tracker mortgages which we list below. The fixed rates on offer are somewhat below the existing gross yield on the TSB's outstanding fixed mortgages, suggesting that the blended mortgage yield is more likely to decline, than increase, in the near-term. This is a trend that mirrors the experience of the wider industry (Figure 93).

Figure 92. TSB – Mortgage Rates Currently On Offer

Product	Fixed Period	Loan Amount	LTV	Product Fee	Initial Rate
Fixed	2-Year	£200k-1,000k	<60%	£1,995	1.59%
Fixed	2-Year	£5k-1,000k	<60%	£995	2.04%
Fixed	2-Year	£5k-1,000k	<60%	£0	2.44%
Fixed	2-Year	£5k-1,000k	60-75%	£995	2.14%
Fixed	2-Year	£5k-1,000k	60-75%	£0	2.49%
Fixed	2-Year	£5k-1,000k	75-80%	£995	2.84%
Fixed	2-Year	£5k-1,000k	75-80%	£0	3.14%
Fixed	2-Year	£5k-1,000k	80-85%	£995	3.19%
Fixed	2-Year	£5k-1,000k	80-85%	£0	3.29%
Fixed	2-Year	£5k-1,000k	80-85%	£0	3.49%
Fixed	2-Year	£5k-750k	85-90%	£995	4.59%
Fixed	2-Year	£5k-750k	85-90%	£0	4.69%
Fixed	2-Year	£5k-750k	85-90%	£0	4.89%
Fixed	5-Year	£5k-1,000k	<60%	£995	3.30%
Fixed	5-Year	£5k-1,000k	<60%	£0	3.54%
Fixed	5-Year	£5k-1,000k	60-75%	£995	3.44%
Fixed	5-Year	£5k-1,000k	60-75%	£0	3.64%
Fixed	5-Year	£5k-1,000k	75-85%	£995	4.54%
Fixed	5-Year	£5k-1,000k	75-85%	£0	4.54%
Fixed	5-Year	£5k-1,000k	75-85%	£995	4.74%
Fixed	5-Year	£5k-750k	85-90%	£0	4.89%
Fixed	5-Year	£5k-750k	85-90%	£995	4.99%
Tracker	2-Year	£5k-1,000k	<60%	£1,995	1.09%+base
Tracker	2-Year	£5k-1,000k	<60%	£0	1.94%+base
Tracker	2-Year	£5k-1,000k	60-75%	£0	1.99%+base
Tracker	2-Year	£5k-1,000k	75-80%	£995	2.34%+base
Tracker	2-Year	£5k-1,000k	75-80%	£0	2.64%+base
Tracker	2-Year	£5k-1,000k	80-85%	£995	2.59%+base
Tracker	2-Year	£5k-1,000k	80-85%	£0	2.69%+base
Tracker	2-Year	£5k-1,000k	80-85%	£0	2.89%+base

Source: Company Website

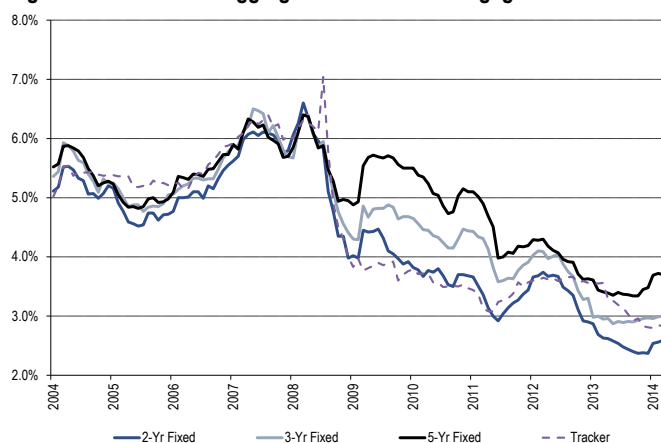
Figure 93. UK Banks – Aggregate Fixed Mortgage Rates: Outstanding vs New



Source: Bank of England. Note: Based on 75% LTV.

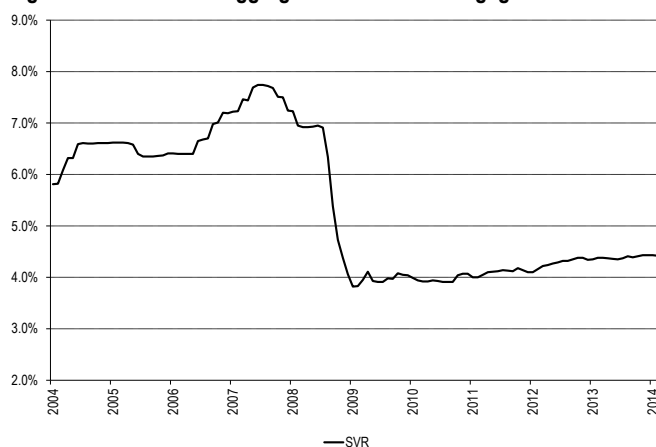
Eventually rising rates should provide some offset to this. Indeed front-book rates (and spreads) have shown some modest signs of stabilising in recent months as banks have started to re-price upwards following the steepening in the UK yield curve. Furthermore while tracker mortgages are directly linked to the base rate by their very definition, it is also very common for UK banks to increase back-book SVRs at the same time as any rate rise, or shortly thereafter.

Figure 94. UK Banks – Aggregate Front-Book Mortgage Rates



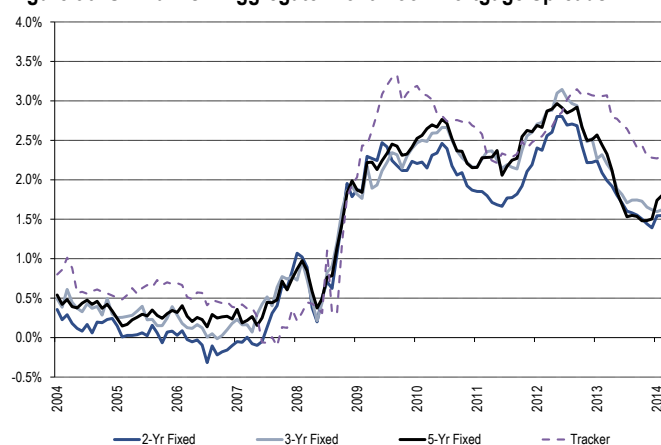
Source: Bank of England. Note: Based on 75% LTV.

Figure 95. UK Banks – Aggregate Back-Book Mortgage Rates



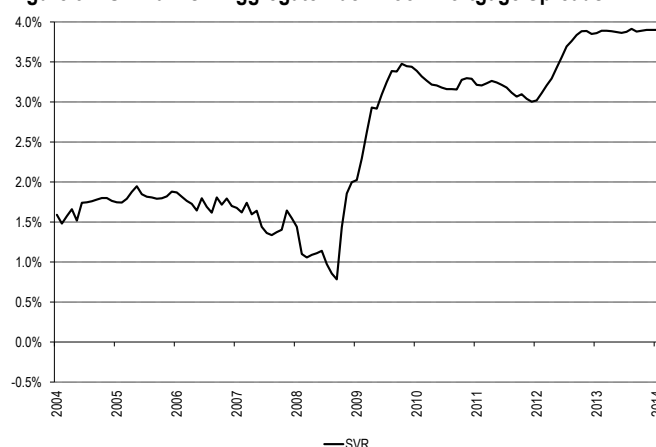
Source: Bank of England

Figure 96. UK Banks – Aggregate Front-Book Mortgage Spreads



Source: Bank of England. Note: Based on 75% LTV. Fixed mortgage spreads calculated relative to corresponding rolling IR swap rate at matched maturity. Tracker mortgage spread relative to 3M LIBOR.

Figure 97. UK Banks – Aggregate Back-Book Mortgage Spreads

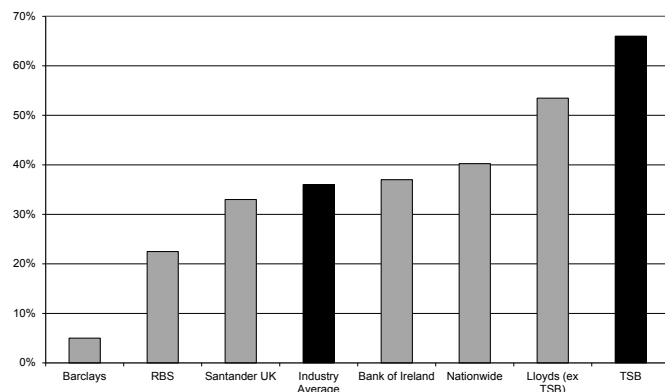


Source: Bank of England. Note: SVR mortgage spread relative to 3M LIBOR.

TSB interest margins are more sensitive to base rates than peers

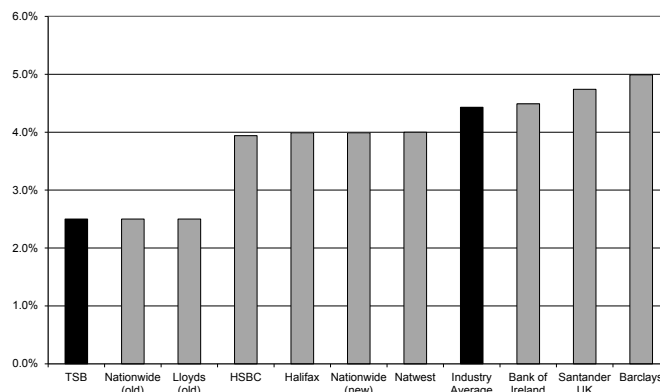
Among the UK lenders, TSB has the largest proportion of customers on SVR mortgages and also offers the lowest rate. The only other lenders to offer a rate of 2.5% are Lloyds and Nationwide, who are also in the process of phasing this out. The banks with highest SVRs are Barclays, via Woolwich, at 4.99%, followed by Santander UK on 4.74%, post a 50bps increase in October 2012. The aggregate UK SVR, at 4.4%, is already above aggregate front-book rates and substantially ahead of TSB's 2.5%. While all UK bank will see asset yields improve as base rates increase, the additional potential benefit to NIMs from an increase in churn from the mortgage back-book to front-book is therefore very specific to TSB. In contrast, this churn will be a headwind to NIMs for the rest of the listed UK banks (Figure 100).

Figure 98. Select UK Banks – Proportion of Mortgages on SVR



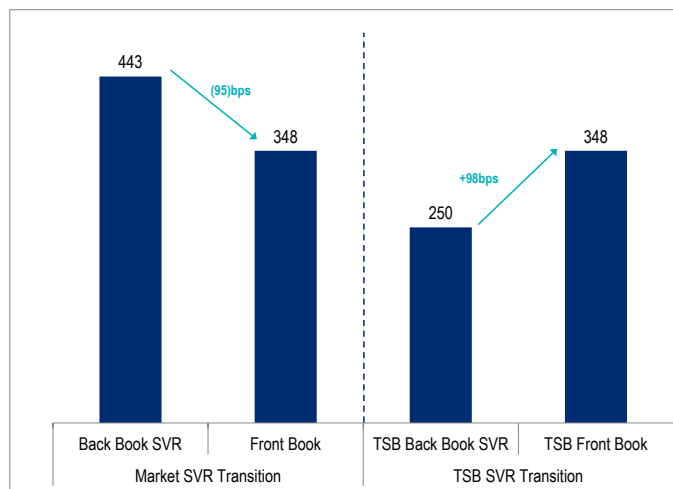
Source: Company Reports, CML and Citi Research Estimates

Figure 99. Select UK Banks – Example Standard Variable Rates (SVRs)



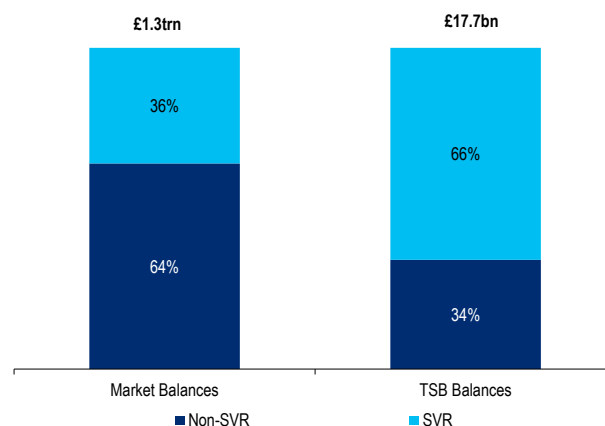
Source: Company Reports, Bank of England and Citi Research Estimates

Figure 100. Transition of NIMs As Mortgage Back Book Refinances



Source: Company Reports, Bank of England

Figure 101. Market Balance vs TSB Balance on SVR



Source: Company Reports, CML

It is this churn between the back-book and front-book which makes TSB's overall NIM much more sensitive to base rates than listed peers. There is therefore likely to be an inverse correlation at TSB between overall mortgage growth and net interest margins, as a greater level of SVR redemptions may potentially hinder growth (depending on how many of the customers are retained) but would result in a significant uplift to interest margins. For more detail on the link between base rates and remortgaging we refer you to the previous section 'What Makes TSB Different?'

We model an increase in the gross asset yield from 4.4% in 2013 to c6.3% in 2020

Based on this analysis we make the following assumptions in our model forecasts:

- We model a decline in aggregate fixed yields over time, reflecting the lower rates that TSB is currently offering on new lending. Offsetting this we assume c80% of base rate rises are passed on directly to new borrowers and existing customers who choose to re-mortgage with TSB. This implies that from 2014-16 we assume new fixed mortgages are issued at a rate below the outstanding aggregate, but by 2017-18 they are issued at rates above those on the outstanding aggregate. For example by 2018 we model a gross yield of 3.6% on the fixed portfolio but within this we assume that new fixed mortgage loans are issued at c4.3%.
- We assume that tracker and SVR rates follow the trajectory of base rates.
- We assume c80% of base rate rises are passed on directly to the HVR.
- We assume c75% of base rate rises are passed on to personal unsecured and small business lending rates, based on the assumption that the majority of these loans are issued on a variable basis.

Overall we therefore model an increase in the gross asset yield from 4.4% in 2013 to c6.2% in 2018 and c6.3% in 2020.

Figure 102. TSB – Aggregate Asset Yields, 2011-20E

<u>Aggregate Yields:</u>	2011	2012	2013	2014E	2015E	2016E	2017E	2018E	2019E	2020E
Fixed	-	5.0%	4.7%	4.4%	4.0%	3.8%	3.7%	3.6%	3.9%	4.1%
Tracker	-	2.7%	2.1%	2.1%	3.2%	4.2%	4.6%	5.0%	5.1%	5.1%
SVR	2.5%	2.5%	2.5%	2.5%	3.6%	4.6%	5.0%	5.4%	5.5%	5.5%
HVR	-	4.0%	4.0%	4.0%	4.9%	5.7%	6.0%	6.3%	6.4%	6.4%
Mortgages	3.1%	3.1%	3.1%	2.9%	3.8%	4.5%	4.7%	4.7%	4.8%	4.8%
Personal unsecured	15.1%	15.8%	16.3%	15.7%	16.5%	17.2%	17.5%	17.8%	17.9%	17.9%
Small business banking	3.1%	3.0%	2.9%	3.0%	3.8%	4.6%	4.9%	5.2%	5.3%	5.3%
Total TSB Franchise	-	4.4%	4.4%	4.4%	5.3%	6.0%	6.2%	6.2%	6.3%	6.3%
Mortgage Enhancement	3.8%	3.9%	3.9%	3.5%	4.9%	5.7%	6.0%	6.3%	6.4%	6.4%
Total	-	4.4%	4.4%	4.2%	5.2%	6.0%	6.1%	6.2%	6.3%	6.3%
Base Rates	0.50%	0.50%	0.50%	0.75%	2.50%	2.75%	3.25%	3.50%	3.50%	3.50%
Average Base Rates	0.50%	0.50%	0.50%	0.53%	1.63%	2.63%	3.00%	3.38%	3.50%	3.50%
5-Yr Swap Rate	1.56%	1.02%	2.14%	2.30%	3.00%	3.25%	3.50%	3.75%	3.75%	3.75%
Rolling 5-Yr Swap Rate	3.78%	2.89%	2.17%	1.97%	2.00%	2.34%	2.84%	3.16%	3.45%	3.60%
Average Rolling 5-Yr Swap Rate	4.06%	3.34%	2.50%	2.07%	1.99%	2.17%	2.59%	3.00%	3.31%	3.53%
Memo: New Fixed				2.0%	2.9%	3.7%	4.0%	4.3%	4.4%	4.4%

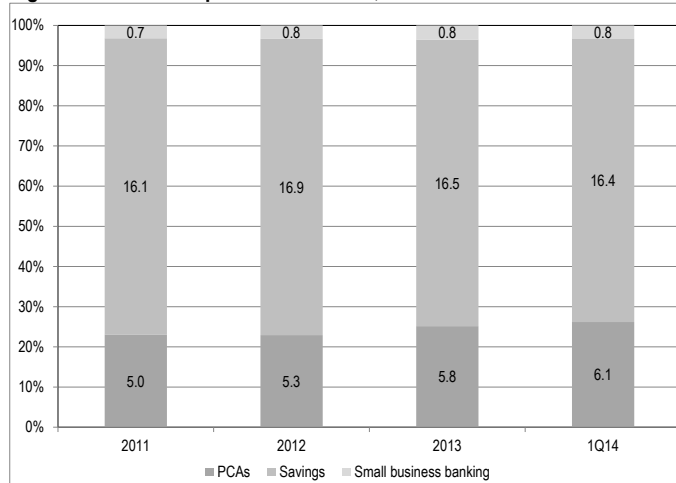
Source: Company Reports and Citi Research Estimates

Liability Pricing

In the medium-to-long term rising base rates should also result in wider liability spreads, especially on PCAs

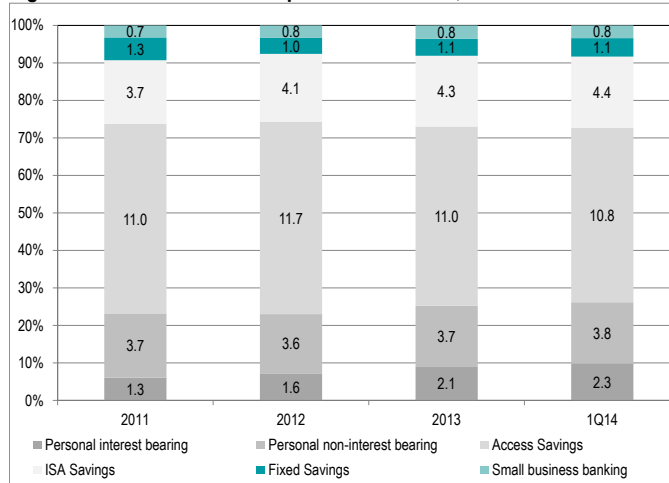
Rising base rates should also result in wider liability spreads, as only a proportion of any base rate rise is likely to be passed on to the customer, with TSB instead retaining part of the economic benefit. This is especially true for PCAs, where the customer is often less price-sensitive, instead using the account for day-to-day use. PCAs account for 26% of overall TSB deposits and are expected to grow at a faster rate than savings going forward. Of these accounts over 60% are still non-interest-bearing, albeit this proportion is set to shrink over time given the success of TSB's Classic Plus launch, which offers a 5% rate on balances of <£2,000.

Figure 103. TSB – Deposits Breakdown, 2011-1Q14



Source: Company Reports

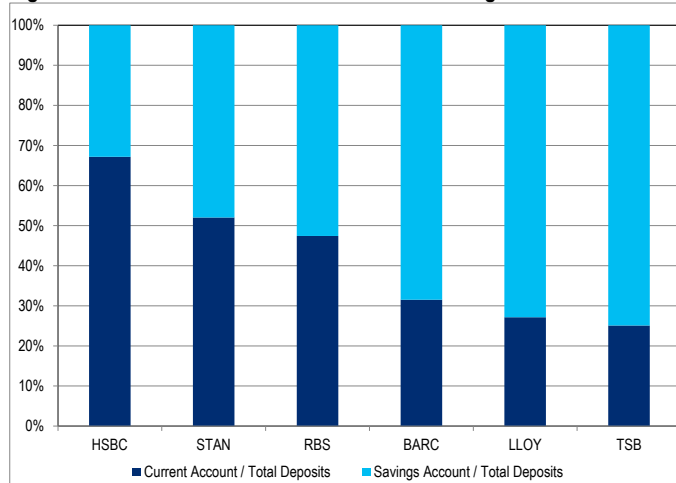
Figure 104. TSB – Detailed Deposits Breakdown, 2011-1Q14



Source: Company Reports

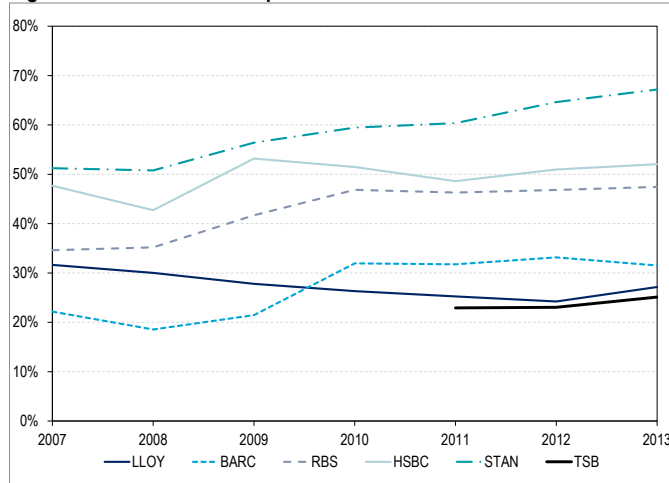
At 26% TSB has a similar proportion of its deposit mix attributable to PCAs. This is broadly similar to Lloyds and Barclays. In contrast RBS, HSBC and Standard Chartered have a higher proportion of deposits in PCAs versus savings accounts. This is, however, predominantly in regions outside of the UK – RBS has a high PCA presence in the US and HSBC & Standard Chartered in Hong Kong.

Figure 105. UK Banks – Current Accounts vs Savings Accounts



Source: Individual Company Reports and Citi Research

Figure 106. UK Banks – Proportion of Current Accounts

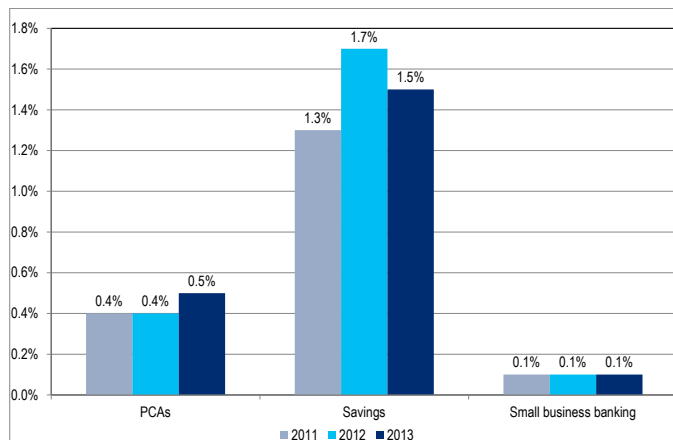


Source: Individual Company Reports and Citi Research

In the near-term the Classic Plus account is likely to result in higher PCA interest expense...

The average gross cost of PCAs was 0.5% in 2013, up from 0.4% in 2012. We expect this to increase further as the Classic Plus account gains traction. In contrast the aggregate cost of TSB's savings deposits are much higher, at 1.5%, as these customers tend to be more price-sensitive. This rate has however been declining, down from 1.7% in 2012, mirroring the wider industry trend as competition has eased. TSB offers a range of savings products and three of the largest products – the cash ISA saver, the eSavings account and the Easy Saver – all offer rates that are below 1.5%, suggesting that the aggregate rate paid on TSB's savings products is likely to fall further in 2014. We model an aggregate rate of c1.2%.

Figure 107. TSB – Gross Deposit Cost, 2011-13



Source: Company Reports

Figure 108. TSB – Deposit Rates Currently On Offer

Product	Initial Rate
Cash ISA Saver	1.00%
2-Year Fixed Rate Cash ISA	2.00%
Online Step Bond	1.95%
eSavings Account	1.00%
Easy Saver	0.75%
Monthly Saver	2.00%
Online Fixed Bond	1.75%
Classic PCA	0%
Classic Plus PCA	5% on balances <2k; 0% on balances >2k

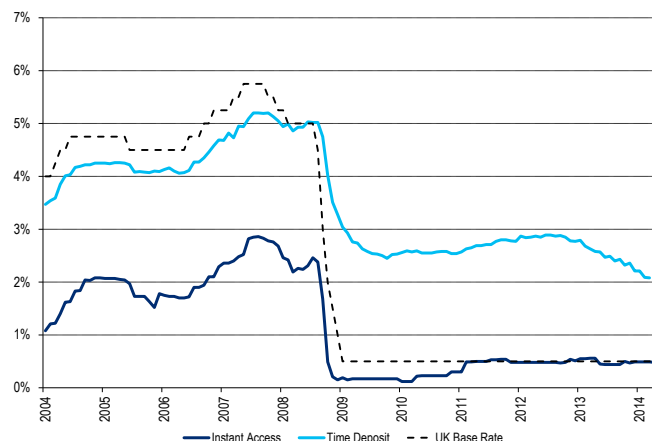
Source: Company Website

... offset by lower Savings expense

The aggregate rate paid on instant access accounts across the industry is currently at 0.5% and has held broadly steady around the low base rate in recent years. Meanwhile aggregate outstanding time deposit rates have been declining and are now at 2.2%, still a 170bps premium to base rates. However the average rate on new time deposits is only 1.6%, suggesting the outstanding industry aggregate still has further to fall. This is consistent with our thoughts on TSB, above.

We illustrate this in Figure 109 and Figure 110. These charts also demonstrate the link between deposit rates and base rates. While instant access rates are similar to the base rate today, they were less than half the base rate from 2004-08. Similarly time deposit rates were below the base rate during this period, albeit by a much smaller c30-60bps. This reinforces our point that liability spreads are likely to widen as base rates increase, which could result in a significant uplift to TSB's Group NIM.

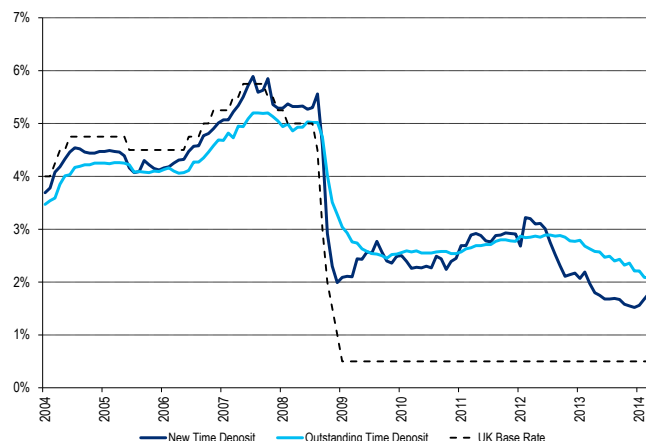
Figure 109. UK Banks – Aggregate Deposit Rates vs Base Rate



Source: Bank of England

Note: Instant access has a series break at end-2011. Instant access based on interest-bearing accounts only. Time deposits include both fixed rate bonds and ISAs.

Figure 110. UK Banks – New vs Outstanding Time Deposit Rates



Source: Bank of England

Note: Time deposits include both fixed rate bonds and ISAs.

Based on this analysis, we make the following assumptions in our model forecasts:

- We assume that the aggregate cost of PCAs increases over time, as the Classic Plus account continues to gain traction. We also assume TSB does not pass on the first four base rate rises, but then passes on c25% of any rate rise thereafter.
- On savings we assume that TSB passes on the first four base rate rises in full, and c75% of the next four base rate rises to the customer, before then falling to c50% thereafter, thereby retaining more of the economics in later years.

Overall we therefore model an increase in TSB's overall deposit interest expense from 1.2% in 2013 to c2.8% in 2018. However this c160bps increase is less than the c190bps increase we model in the TSB Franchise asset yields. Combined with the churn from back-book to front-book mortgages, this helps to explain the overall uplift to the Group NIM that we forecast in all three of our scenarios.

Figure 111. TSB – Aggregate Deposit Costs, 2011-20E

Aggregate Yields:	2011	2012	2013	2014E	2015E	2016E	2017E	2018E	2019E	2020E
PCAs	-0.4%	-0.4%	-0.5%	-0.5%	-0.6%	-1.0%	-1.2%	-1.4%	-1.4%	-1.4%
Savings	-1.3%	-1.7%	-1.5%	-1.2%	-2.3%	-3.0%	-3.2%	-3.4%	-3.5%	-3.5%
Small business banking	-0.1%	-0.1%	-0.1%	-0.1%	-0.3%	-0.6%	-0.7%	-0.8%	-0.8%	-0.8%
Subtotal	-	-1.3%	-1.2%	-1.0%	-1.8%	-2.4%	-2.6%	-2.8%	-2.8%	-2.8%
Base Rates	0.50%	0.50%	0.50%	0.75%	2.50%	2.75%	3.25%	3.50%	3.50%	3.50%
Average Base Rates	0.50%	0.50%	0.50%	0.53%	1.63%	2.63%	3.00%	3.38%	3.50%	3.50%

Source: Company Reports and Citi Research Estimates

Separately on wholesale funding we assume that TSB chooses to draw down c£0.4bn of the LBG RMBS funding facility at a cost of LIBOR + 60bps (with a 30bps commitment charge on the remainder of the £2.5bn facility). This facility provides additional funding flexibility should TSB's loan growth outpace deposit growth by more than expected. In addition TSB has recently issued £0.4bn of tier 2 instruments at a cost of LIBOR +3.5%. We assume no additional capital, or wholesale funding is raised until 2019, with all new lending up to this date instead supported by growth in deposits. In 2019 we assume TSB issues £250m of AT1 capital at a cost of LIBOR +6.5%, as it looks to re-leverage the balance sheet.

Structural Hedge

Income from the structural hedge will also increase as base rates rise, but subject to a time lag

The final component to consider when modelling the interest margin sensitivity to rising interest rates is TSB's structural hedge position. All of the UK banks operate structural hedges, swapping insensitive balances (mainly PCAs, equity) into long-dated swap rates. This serves to smooth net interest margin volatility over time and as rates increase becomes an important source of long-term value, save for any material shifts in the behavioural life of the underlying liabilities. As an example we illustrate the impact on Barclays, in the table below, where the contribution from the structural hedge rose to as high as 27% of Group NII, before declining to 11%.

Figure 112. Barclays – Interest Rate Hedge Contribution to Net Interest Income (£m)

	2008	2009	2010	2011	2012	2013	%Chg
Total RBB, Corporate & Wealth Hedge Contribution	756	2,163	2,134	1,992	1,220	1,051	-14%
BarCap & Head Office Equity Structural Hedge	0	363	1,057	1,285	517	184	-64%
Total NII Hedge Contribution	756	2,526	3,191	3,277	1,737	1,235	-29%
Gains on Sale of Gilts	0	0	500	963	0	0	na
Carry on Hedge Portfolio	756	2,526	2,691	2,314	1,737	1,235	-29%
Total NII Hedge Contribution	756	2,526	3,191	3,277	1,737	1,235	-29%
Customer Net Interest Income	10,713	9,392	9,332	8,924	9,902	10,365	5%
Hedge Net Interest Income	756	2,526	3,191	3,277	1,737	1,235	-29%
Total Group Net Interest Income	11,469	11,918	12,523	12,201	11,639	11,600	0%
% Hedge Contribution	6.6%	21.2%	25.5%	26.9%	14.9%	10.7%	-29%

Source: Citi Research, Company Reports

In the case of TSB, £7.1bn of insensitive balances are swapped into (mainly) 5-year swaps invested in 60 monthly tranches, giving an average term of c2.5 years. For comparison the weighted average life of structural hedge portfolios at peers is c3-5 years at Barclays, c1.5-2 years at HSBC and c5 years at Lloyds and RBS. In 1Q14 the TSB structural hedge portfolio contributed income of £12m, or £48m annualised, equivalent to 7% of total TSB Franchise net interest income in the quarter. A 50bps increase in the rolling average 5-year swap rate would equate to a further c£36m of incremental income.

We expect interest income from the structural hedge to exceed £100m by 2017 and £250m by 2020

Although we expect the 5-year swap rate to increase this year, the rolling 5-year swap rate is likely to decline as 2009 drops out. We therefore foresee a small decline in the structural hedge contribution in 2H14 versus 1H14, before stabilizing in 2015, and rising in 2016-18. Overall we expect interest income from the structural hedge to exceed £100m by 2017 and £250m by 2020, driven by a combination of higher rolling swap rates and a larger PCA balance to swap.

Figure 113. TSB – Structural Hedge Contribution, 2011-20E

	2011	2012	2013	2014E	2015E	2016E	2017E	2018E	2019E	2020E
Rate Insensitive Balances (£bn)			5.5	7.7	8.1	8.5	8.9	9.4	9.9	10.4
Net Interest Rate Swap Flows (£m)	-29	9	35	50	57	81	128	178	223	263
5-Yr Swap Rate	1.56%	1.02%	2.14%	2.30%	3.00%	3.25%	3.50%	3.75%	3.75%	3.75%
Rolling 5-Yr Swap Rate	3.78%	2.89%	2.17%	1.97%	2.00%	2.34%	2.84%	3.16%	3.45%	3.60%
Average Rolling 5-Yr Swap Rate	4.06%	3.34%	2.50%	2.07%	1.99%	2.17%	2.59%	3.00%	3.31%	3.53%

Source: Company Reports and Citi Research Estimates

Service Agreements

TSB will have service agreements in place with Lloyds, run on an arms-length basis, to assist with distribution, hubbing, manufacturing & core functions

Eighteen services will last for 2.5 years, sixteen services for 10-years and three services, including payments, for longer

TSB has operated with a completely separate brand to Lloyds since September 2013. All branches, ATMs, internet and telephony channels have been re-labelled accordingly. Lloyds Bank and TSB customers have been able to use branches of both banks, but this formally ended on 26 July 2014, with customers now required to use branches of their own bank.

TSB will, however, continue to have service agreements in place with Lloyds, run on an arms-length basis, to assist with distribution, hubbing, manufacturing and core functions. In total 37 services will initially be covered, 18 of which will be exited by the end of the 'Transitional Service Agreement' (TSA) after 2.5 years. At this point TSB is expected to have identified a new supplier, or hired an internal capability. A further 16 services are expected to be taken on for up to 10-years to mid-2024, due to TSB's reliance on Lloyds IT systems as well as the complexity of exiting these services. Finally, two services are expected to remain in place for an "extended basis" due to the requirement to access historical, archive data and documents held by Lloyds, and one service – the payments service – is expected to be retained on an ongoing basis. This gives access to BACS, CHAPs and cheque & credit clearing.

Figure 114. TSB – Bank Capability Model & Service Agreements

Function	Capability	Support
Distribution	Brand Management	Standalone TSB
	Sales Planning & Management	Standalone TSB
	Customer Relationship Management	Standalone TSB
	Marketing Products & Services	Standalone TSB
	Channel Management & Integration	TSB + TSA
	Service	TSB + LTSA
	Sales	TSB + LTSA
	Intermediary Management	Built by Lloyds, to be owned by TSB
Hub	Customer Management	Standalone TSB
	Product Management	TSB + LTSA
	Service Management & Integration	TSB + LTSA
Manufacturing	Customer Manufacturing	Standalone TSB
	Credit Assessment & Decisioning	TSB + LTSA
	Application Fulfilment	TSB + LTSA
	Account Servicing	TSB + LTSA
	Collections & Recoveries	TSB + TSA
	Security Perfection	Standalone TSB
	Credit Risk Management	Standalone TSB
	Product Portfolio Management	Standalone TSB
	General Insurance	Standalone TSB
	Life, Protection, Investments	Standalone TSB
	Payments	TSB + TSA + LTSA + Ongoing
	Fraud Management	TSB + TSA
	Manufacturing Management & Integration	Standalone TSB
	Document Management	LTSA
Corporate Core	Risk Management	TSB + TSA + LTSA
	Corporate Affairs	Standalone TSB
	Legal	Standalone TSB
	Finance	TSB + TSA + LTSA
	Economic Research	Standalone TSB
	Treasury	TSB + TSA + LTSA
	Human Resources	TSB + TSA
	Property Management	TSB + TSA
	IT	TSB + TSA + LTSA
	Change Management	Standalone TSB
	Procurement	Standalone TSB
	Third Party Management	Standalone TSB

Source: Company Reports. Note: TSA = Term Service Agreement. LTSA = Long-Term Service Agreement.

This gives TSB access to a proven platform and infrastructure...

... while retaining a high degree of internal flexibility...

... but will result in a step-up in costs in 2017 when the TSA ends and LTSA starts

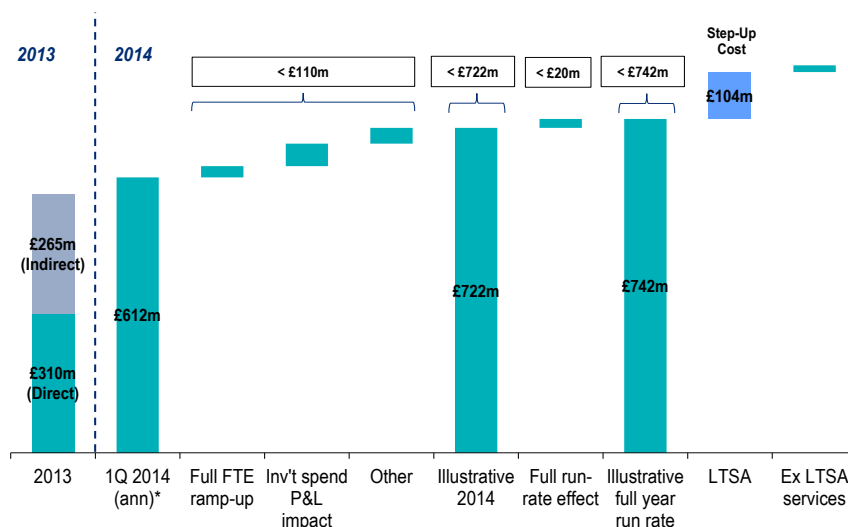
Incremental Costs

These service agreements will provide TSB with access to infrastructure and applications which already support the largest UK banking network (Lloyds, Halifax, Bank of Scotland) and which have proved to be highly reliable in the past. In addition TSB will automatically receive access to Lloyds' innovation and upgrades in shared systems, subject to an appropriate time delay. TSB will therefore benefit directly from Lloyds ongoing investment, at no additional cost to itself. Lloyds will also cover incident management processes and service recovery. Service credits are payable to TSB where Lloyds does not perform to standard.

TSB also retains significant flexibility to support its own strategy. There are no restrictions during the TSA/LTSA period on opening new branches, adding ATMs, expanding the digital offering, on offering new products within the existing sales systems, changing product pricing parameters or on changing credit risk infrastructure. M&A is also not ruled out. If TSB is acquired there is a provision to exit and migrate to the acquirers' platform. Alternatively TSB is allowed to acquire and integrate another business, although in reality this is likely to be practically constrained during the TSA period. In fact the only (major) restrictions are that TSB cannot launch a secondary savings brand, nor can it restructure its banking licenses (except in the event of Scottish independence).

During the TSA period from mid-2014 to end-2016 there will be a fixed charging period, with 3% inflation, with TSB also then paying incremental costs for volumes over and above a pre-agreed volume plan to 2017. Assuming no incremental costs the fixed service charge would be c£95m in 2014, c£98m in 2015 and £100m in 2016. However at the end of the TSA period, TSB will move onto a different LTSA charging model for the remaining 7.5 years to mid-2024 (assuming no exit beforehand). The initial impact of this change in charging model is expected to result in a c£104m step-up in the core service charge in 2017 alone, to a new fixed cost of c£204m – a sizeable increase in the overall expense base. In addition there is likely to be a small additional cost at this point due to the 18 services no longer covered by the Service Agreements, which TSB will now have to run independently.

Figure 115. TSB – Cost Evolution



Source: Company Reports. *Annualised

We expect TSB to proceed with a carve-out in due course at a cost of £50m

Exit Options

Importantly any early exit from the Service Agreements is solely at TSB's discretion (except in the event of non-payment to Lloyds or where required by regulators/law). While we doubt an exit would occur during our forecast timeframe, out to 2018, we do see it as a real possibility before the LTSA expires in mid-2024. There are two options available to TSB by which it can exit the LTSA:

- **Carve-Out.** TSB would make a one-time £50m contribution to Lloyds, separating all applications onto TSB hardware, granting perpetual license to TSB for Lloyds-owned Intellectual Property Rights and carving out the IT platform to be run by a new IT partner of TSB's choosing (an event that is not expected to be visible to TSB customers). In the first year post IPO Lloyds and TSB will complete a high level technical and commercial plan for a carve-out, to be reviewed annually.
- **Migration.** A migration would be made to a third-party provider, utilising an entirely different IT system. Lloyds would contribute up to £450m towards this exercise with TSB then bearing any additional cost. This also applies in any M&A scenario – e.g. if TSB acquired another bank (and its systems), or if TSB was acquired itself and the parent company then migrated TSB onto its systems.

Our expectation is that TSB is likely to (eventually) proceed with the first option, a carve-out. Firstly the maximum potential cost to TSB is a known entity under this option and secondly the impact on the end customer is likely to be much smaller. In contrast a systems migration can typically involve much greater impact to customers, including, but not limited to, changes to products terms & conditions.

Regulatory Risks

Ring-fencing rules need to be clarified

Any bank with >£25bn of deposits is set to be captured by the ring-fence requirements outlined in the Financial Services Bill, which passed through parliament in December 2013. While we expect TSB will be able to place its entire operations within a ring-fenced entity, thereby limiting any additional capital and funding costs, there could still be unintended operations risks and costs attached to this. We await greater clarity from the secondary legislation, due in July 2014, which should provide greater detail on the "height" of the ring-fence. Following publication of this legislation the PRA is set to start a consultation, with the final rules converted into regulation and then published in 2016. Implementation is currently envisaged by 2019 albeit there is still a strong possibility that this gets pushed back in our view.

It remains to be seen how permissible TSB's service agreements would be under this new ring-fence structure. This could accelerate exit from the LTSA

What might the unintended consequences be for TSB? The current bill does not permit ring-fenced banks to have exposure to other financial institutions, except in the areas of payments and trade finance. The aim of this is to reduce the inter-connectivity of the system, as a single failure may be easily resolved, while this may not be the case if we see contagion to other financial institutions in a financial crisis. It remains to be seen how permissible TSB's service agreements with Lloyds would be under this new ring-fence structure. This could accelerate exit from the LTSA.

The current payments infrastructure may also need to be re-worked, resulting in higher operational costs for TSB

In addition the Financial Services Bill proposes that ring-fenced banks should join payments systems directly, unless there are viable reasons not to. In 2012 interbank clearing (BACs, CHAPs, Faster Payments and cheques), accounted for 7.1bn transaction in the UK, or £77bn by value. It is therefore vital for a UK bank to either be a direct member of these schemes – as the majority of the leading banks are, or have access to, these payments schemes via third-parties. TSB is currently planning to follow the latter approach, even post the end of the LTSA period, with Lloyds acting as the agency bank. Again it remains to be seen if this will be permissible. The minimum number/value of payment transactions that a bank needs to process before direct membership becomes obligatory is still unclear. If the current model is not permitted, this could result in higher operational costs as TSB is forced to re-work its payments infrastructure.

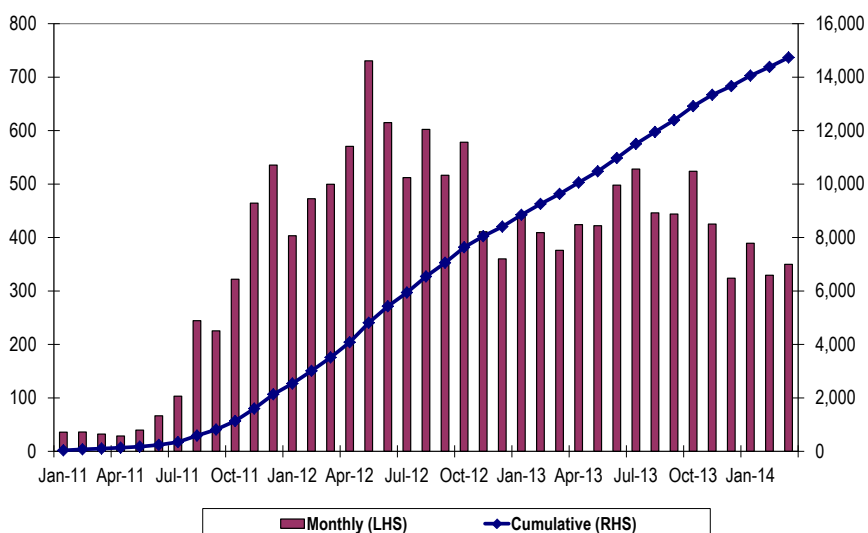
Risk Management & Asset Quality

No Exposure To Legacy Conduct Risks

The UK banking industry has spent more than £14bn on PPI Redress since 2011

Over the past few years UK retail banks have been forced to book sizeable litigation and redress charges, relating to legacy conduct issues, such as miss-selling of payment protection insurance (PPI) and interest rate hedging products (IRHP). Other products are now also coming under heavy scrutiny from the FCA, such as packaged accounts, for example. The UK banking industry has together already spent more than £14bn on PPI Redress since 2011 (Figure 116). Yet PPI redress costs for the industry still remain at an elevated level of more than £300m a month. The largest four lenders have to take the biggest provisions for PPI. Between them, Barclays, Lloyds, RBS and HSBC have now set aside over £20bn of provisions.

Figure 116. Cumulative Industry Wide PPI Redress (£m)



Source: FCA

Figure 117. Cumulative PPI Provisions Relative to Cumulative Redress (£m)

	Provisions	Redress	% Utilised
Barclays	4,850	3,556	73%
Lloyds	10,425	8,157	78%
RBS	3,250	2,659	82%
HSBC	3,153	1,786	57%
Total	21,678	16,158	75%

Source: Individual Company Reports;

Note: Data for BARC, LLOY and RBS at 2Q14. HSBC at 1Q14; redress includes processing costs for some banks.

TSB is free from legacy conduct issues

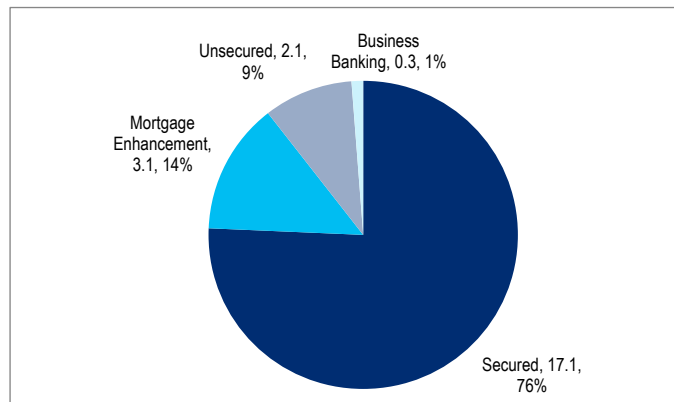
In sharp contrast TSB is free from legacy conduct issues. Through an agreement with Lloyds it is indemnified for losses arising from breaches of law or regulation in relation to customer agreements and related security that happened pre-IPO. TSB can make a claim under this indemnity agreement over the full lifetime of a product, deemed to be 30 years for mortgages and 10 years for unsecured products. Save in certain limited circumstances, actions and omissions of TSB post IPO (e.g. on new product issuance) are not covered by the indemnity.

90% of TSB's loan portfolio is attributable to mortgages

Low Credit Risk Portfolio

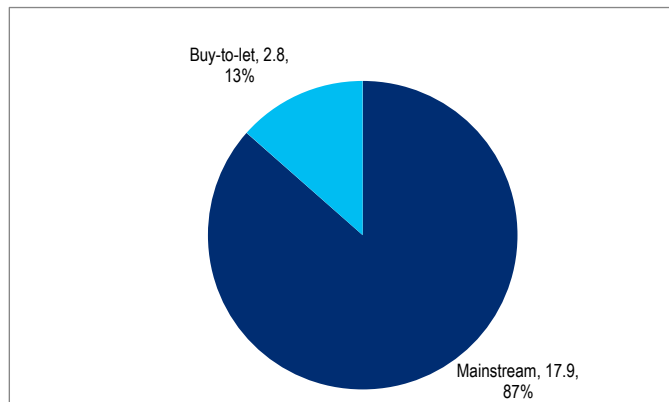
TSB's £22.5bn UK loan portfolio is relatively straightforward. It largely consists of mortgages (90%) and unsecured lending (9%), with a small allocation to business banking (c1%). The mortgage portfolio, secured and enhancement together, is split 87% mainstream mortgages and 13% buy-to-let properties. The unsecured portfolio is mainly personal loans (62%), credit card (25%) and overdrafts (13%). Lastly, the well-diversified business banking portfolio has exposures across different sectors.

Figure 118. TSB – Loan Portfolio by Type (£bn)



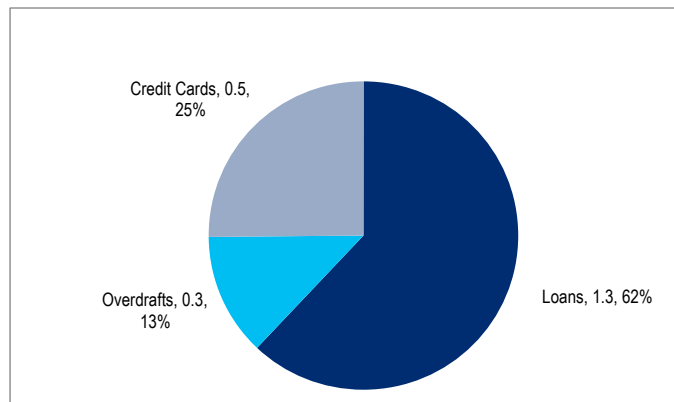
Source: Company Reports

Figure 119. TSB – Mortgage Portfolio by Type (£bn)



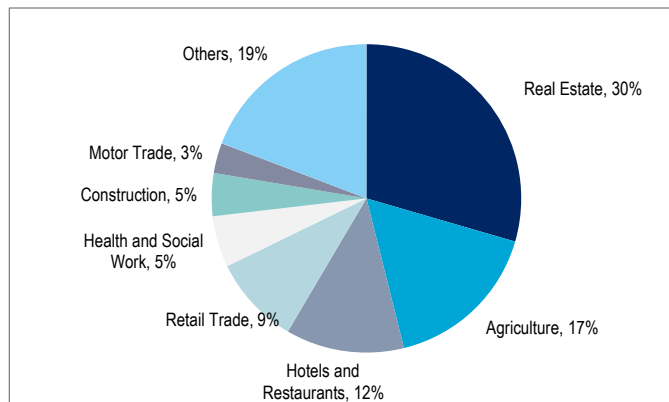
Source: Company Reports

Figure 120. TSB – Unsecured Portfolio by Type (£bn)



Source: Company Reports

Figure 121. TSB – Business Banking Portfolio by Type (£bn)



Source: Company Reports

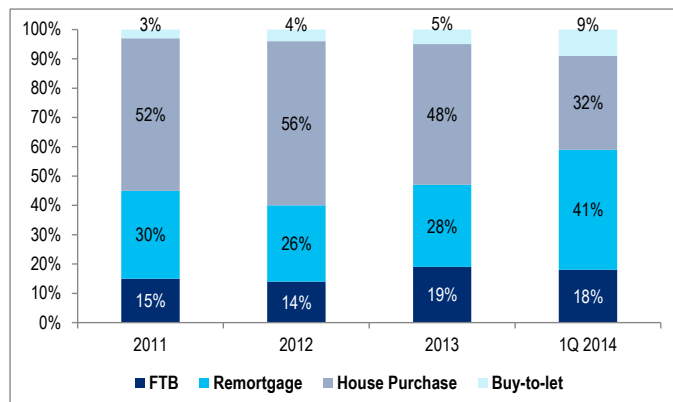
The mortgage enhancement portfolio is likely to be called by Lloyds in 2017/18

Mortgage Portfolio

The mortgage portfolio is comprised of £17.1bn of TSB franchise mortgages and a £3.1bn mortgage enhancement portfolio. The mortgage enhancement portfolio is a non-TSB-branded, Lloyds-administered high-margin, low-risk portfolio, which has been selected to enhance the profitability of TSB's business in the short term (at the prerequisite of the OFT). TSB has a put option on the portfolio at any time; LBG has a call option conditional on the portfolio generating £230m of economic profit for TSB with a minimum profit contribution of £30m in 2017.

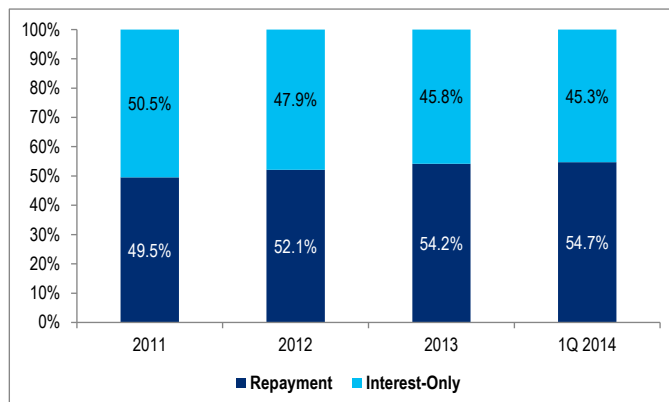
Close to 90% of TSB's own franchise mortgage portfolio relates to mainstream buyers, with 10% buy-to-let mortgages. Recent flow trends point to a rise in remortgaging, while the proportion of interest-only mortgages is declining.

Figure 122. TSB – Flow Of Mortgage Products



Source: Company Reports

Figure 123. TSB – Stock Of Mortgages By Repayment Type

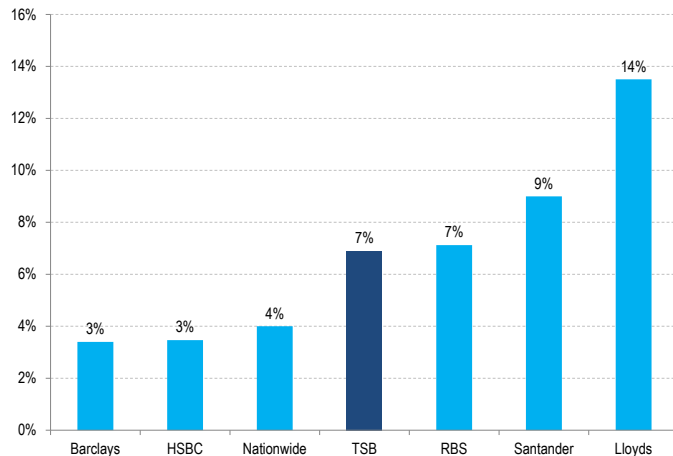


Source: Company Reports

TSB's mortgage portfolio has a low LTV compared to peers

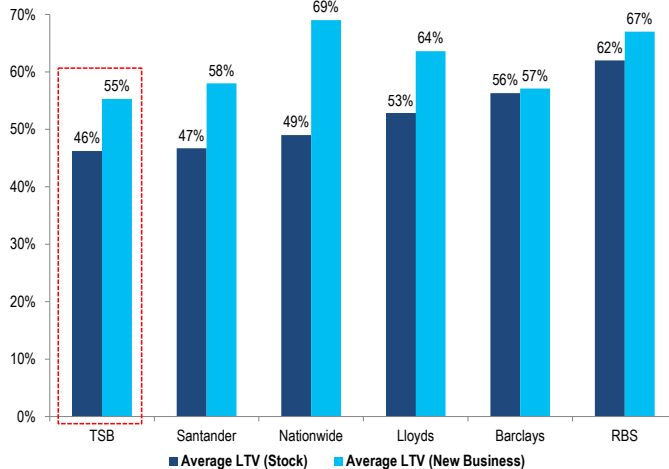
TSB's mortgage portfolio has a relatively low LTV compared to peers. Only 7% of its mortgages have an LTV of greater than 90% (Figure 124) and the average LTV outstanding is only 46%. New business average LTVs, at 55%, are also the lowest among peers (Figure 125), with half of new issuance done at LTVs of <70%. Management expect LTVs to increase marginally as the economy improves and business mix changes, but do not expect to move meaningfully up the risk curve.

Figure 124. UK Banks – Outstanding Exposure To >90% LTV Mortgages



Source: Individual Company Reports. Note: Based on UK-only mortgages, except Lloyds & HSBC Bank Plc (UK subsidiary). Data end-2013, except Nationwide 1H13.

Figure 125. UK Banks – Average LTV on Stock and New Lending



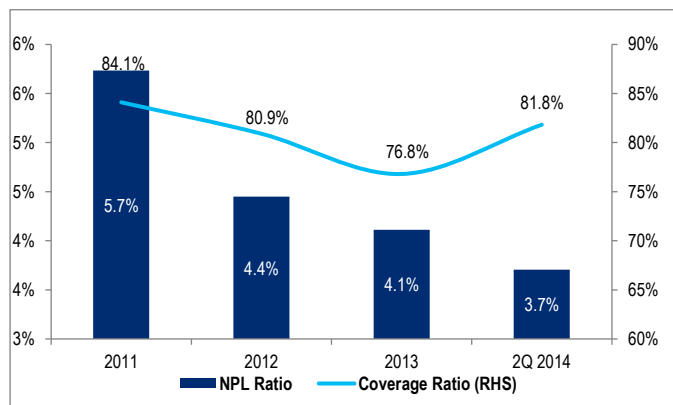
Source: Individual Company Reports at end 2013 except Nationwide, which is 1H13.

Unsecured and Business Banking Portfolio

Unsecured arrears are low and stable

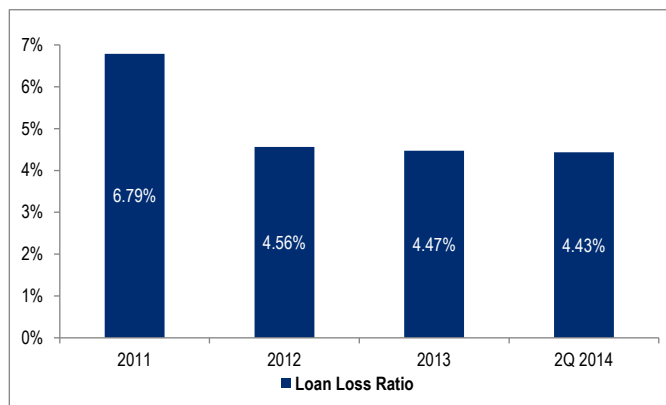
The unsecured and business banking portfolios accounts for only 10% of total loans but contributes 96% of loan losses and 32% of total NPLs. One, two and three month arrears continue to trend downwards across the unsecured portfolio, with new business arrears low and stable. Improvement in arrears has, however, started to slow and impairment levels are expected to remain broadly stable from here.

Figure 126. TSB – Unsecured Portfolio NPL Ratio and Coverage Ratio



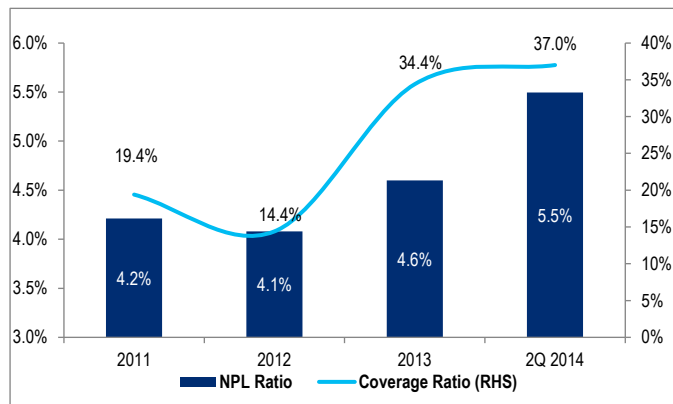
Source: Company Reports; NPL definition: Balances 6 or more months in arrears plus cases in possession, bankruptcy and fraud divided by total book balance

Figure 127. TSB – Unsecured Portfolio Loan Loss Ratio



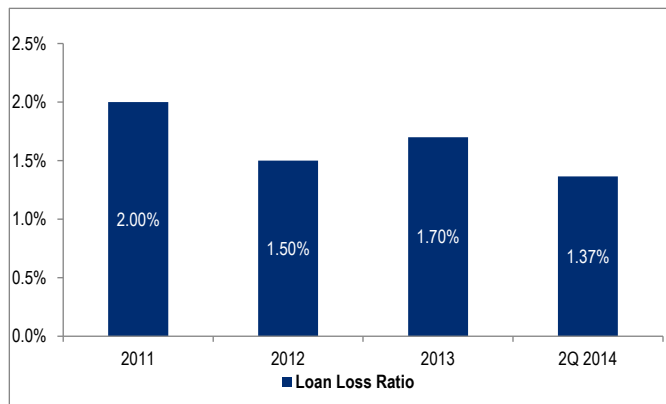
Source: Company Reports

Figure 128. TSB – Business Banking Portfolio NPL and Coverage Ratio



Source: Company Reports; NPL definition: Balances 6 or more months in arrears plus cases in possession, bankruptcy and fraud divided by total book balance

Figure 129. TSB – Business Banking Portfolio Loan Loss Ratio



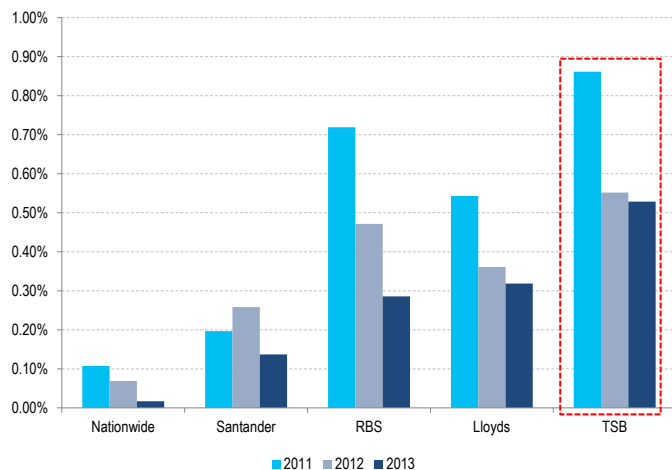
Source: Company Reports

Benign Loan Loss Environment (For Now)

TSB's mortgage NPL ratio is lower than most UK peers

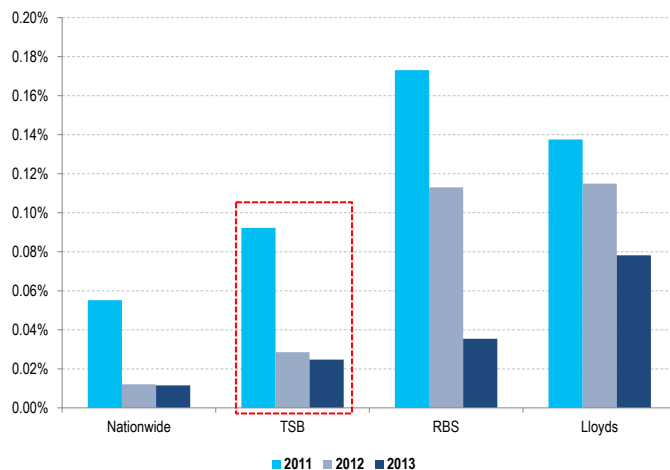
TSB's overall loan loss experience has been slightly higher than UK retail banking peers, but nonetheless remains benign and the trend is a favourable one, with the loan loss ratio declining from 85bps in 2011 to slightly above 50bps in 2013 (Figure 130). The higher loss ratio is due entirely to the unsecured portfolio. In contrast the loan loss ratios on the mortgage book, was only 2bps in 2013, among the lowest in the industry. TSB's mortgage NPL ratio (on a >90 day arrears basis) of 1.2% is also better than most peers (Figure 132), although the corresponding coverage ratio, at c11%, is towards the low-end, albeit it has risen from 8% (Figure 133).

Figure 130. UK Retail Banking Divisions – Loan Loss Ratios



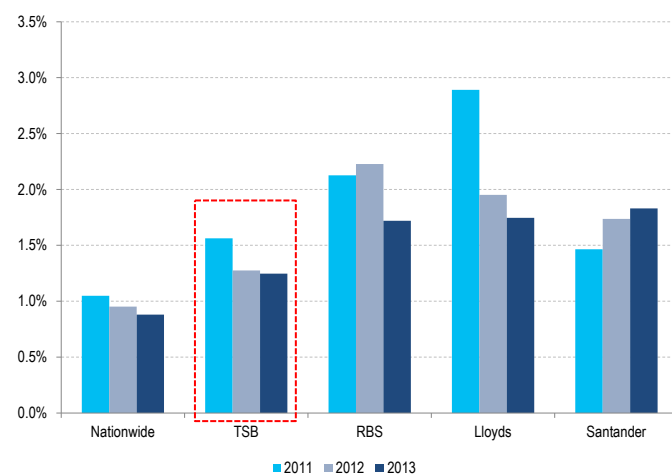
Source: Individual Company Reports

Figure 131. UK Mortgage Lending – Loan Loss Ratios



Source: Individual Company Reports

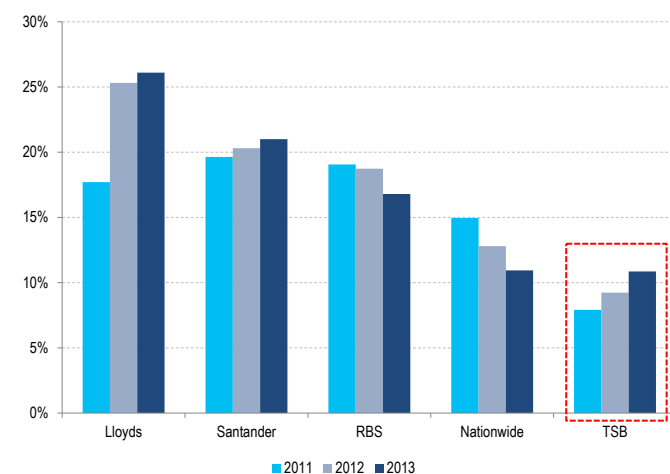
Figure 132. UK Mortgages – Comparison of NPL Ratios



Source: Individual Company Reports and Citi Research

Note: Lloyds and TSB NPLs based on mortgage cases >90 days in arrears, rather than the company definition (> 180days) in order to be consistent with peers.

Figure 133. UK Mortgages – Comparison of Coverage Ratios



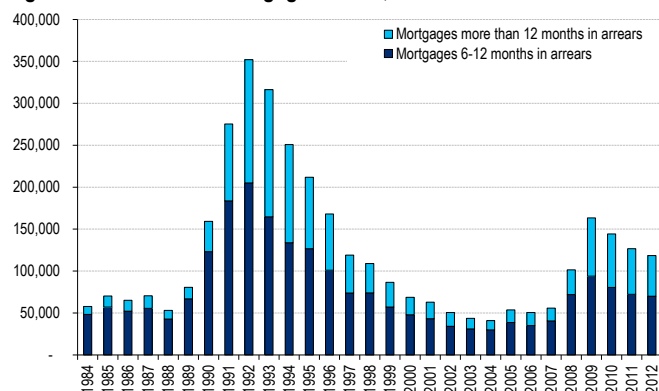
Source: Individual Company Reports and Citi Research

Note: Lloyds and TSB NPLs based on mortgage cases >90 days in arrears, rather than the company definition (> 180days) in order to be consistent with peers

Mortgage loss experience in the UK has thus far proved to be muted

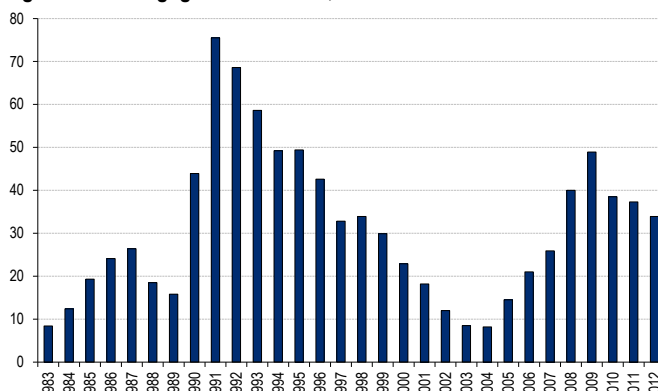
The mortgage loss experience in the UK has thus far proved to be muted during the latest credit cycle. After peaking in 2009, at half the level of the 1992 peak, arrears (and possessions) have trended downwards ever since. In 2012 the number of mortgages in arrears declined 6% in 2012, to 118,400, a trend which continued into 2013. The muted losses during the latest economic downturn can be attributed to two primary factors: (i) lower rates have improved mortgage affordability; (ii) unemployment has remained low and stable among the adult population aged 25+. To a lesser extent, lenders have also been willing to restructure existing mortgages

Figure 134. Number of Mortgage Arrears, 1984-2012



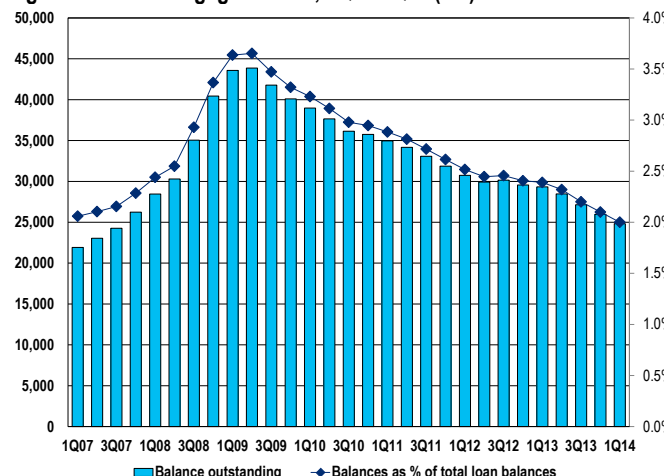
Source: Datastream, Citi Research

Figure 135. Mortgage Possessions, 1983-2012



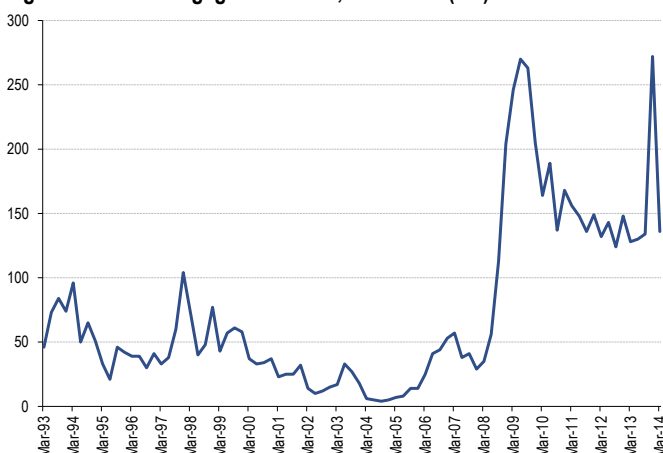
Source: Datastream, Citi Research

Figure 136. UK Mortgage Arrears, 1Q07-1Q14 (£m)



Source: MLAR

Figure 137. UK Mortgage Write-Offs, 1993-2014 (£m)



Source: Bank of England. Note: Includes Banks and Building Societies

Rising base rates will reduce mortgage affordability

21% of borrowers do not have enough savings to cover even one month of mortgage payments

Although the loan loss environment has been benign in recent years, this may be set to change. Our economists expect UK base rates to start rising in late-2014. In the past higher base rates have inevitably led to falling house prices and an increase in impairments, partly offsetting any improvement in net interest margins. We expect the same this time around, albeit the pace of deterioration in asset quality, relative to the speed at which interest margins improve, may well differ.

UK base rates have been low for an extraordinarily long period of time. While the affordability indices that we track look reassuring – mortgage payments as a percentage of disposable income is still near record lows (Figure 139) – we worry that this could deteriorate quickly, especially as a larger proportion of borrowers are now on variable rates relative to history. TSB estimate that for every 50bps rate rise only 1% of customers on the SVR portfolio would run into financial difficulty. We believe this is understating the true impact. A recent survey by NMG, commissioned by the Bank of England, indicated an increasing number of floating-rate mortgage debt holders would need to find extra money as rate rises (Figure 141), by cutting back on spending, working longer hours, etc. Another BoE survey indicated 21% of mortgage borrowers do not have enough savings to cover even one mortgage payment and 38% do not have enough to cover three monthly payments.

Figure 138. House Price to Earnings Ratio, 2004-14



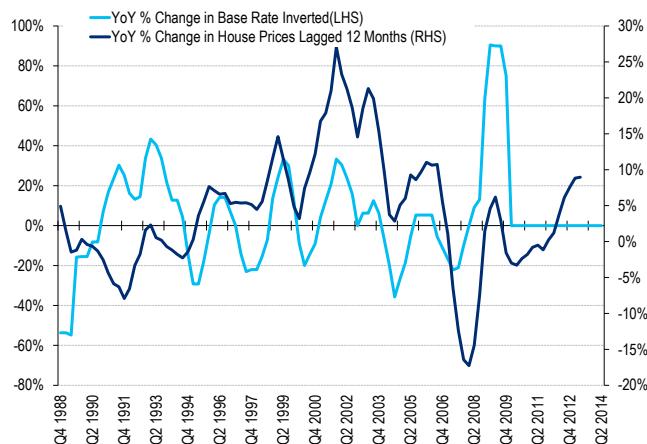
Source: DataStream, Halifax

Figure 139. Mortgage Payments as % of Post-Tax Income, 2004-2014



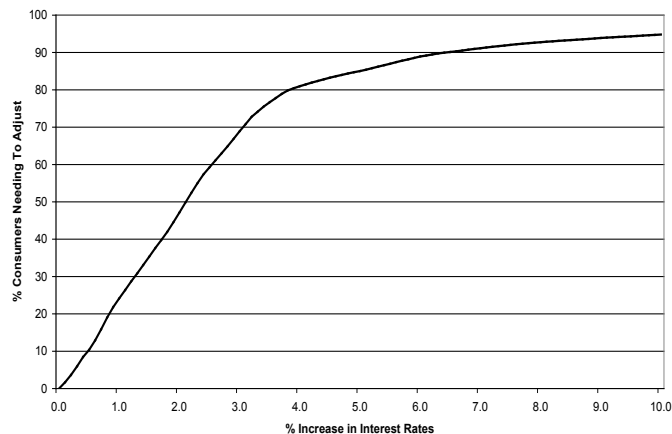
Source: DataStream, Barclays/Woolwich

Figure 140. Annual Change in UK Interest Rates vs. House Prices (Lagged 12 Months), 1988-2014 (%)



Source: DataStream, BoE

Figure 141. Percentage of Consumers Holding Variable Mortgage Debt That Would Need To Find Extra Money If Interest Rates Increased



Source: BoE, NMG Consulting Survey

We forecast an increase in the loan loss ratio to c62-63bps (versus 53bps in 2013)

For this reason we make slightly more conservative assumptions than TSB's own guidance. TSB expect overall impairments to be c55-60bps in 2014 (versus 53bps in 2013), which we believe is realistic, but then expect the loan loss ratio to remain broadly stable thereafter. In contrast we forecast a slightly heavier Group loan loss ratio in later years, of c62-63bps. This is based on the loan loss ratio climbing to 6bps for mortgages by 2019 (from c2bps in 2013), 520bps for unsecured lending (from c450bps) and 200bps for business banking (from c170bps).

Figure 142. TSB – Loan Loss Ratio (£m)

Loan Loss Ratio	2011	2012	2013	2014E	2015E	2016E	2017E	2018E	2019E	2020E
Mortgages	0.01%	0.03%	0.02%	0.01%	0.02%	0.04%	0.05%	0.05%	0.06%	0.06%
Unsecured portfolio	6.79%	4.56%	4.47%	4.62%	4.75%	5.00%	5.10%	5.10%	5.20%	5.20%
Business banking	2.00%	1.50%	1.70%	1.80%	1.80%	1.90%	2.00%	2.00%	2.00%	2.00%
Total	0.86%	0.55%	0.53%	0.53%	0.56%	0.61%	0.63%	0.62%	0.63%	0.62%

Source: Company Reports and Citi Research Estimates

Appendices

Appendix 1 - Biographies

Paul Pester, Chief Executive Officer (CEO)

After receiving his degree from Manchester University and a doctorate from Oxford University, Paul spent 10 years in management consultancy — the majority of which was at McKinsey & Company. Paul took-up his first senior executive role as the Group CEO at Virgin Money in 2000. Having established the business in the UK, Australia and South Africa, Paul moved to Lloyds TSB as the Managing Director of Consumer Banking in 2005. Paul then joined Santander UK in 2008 where he led the acquisition of Bradford & Bingley and the subsequent integration of Abbey, Alliance & Leicester and Bradford & Bingley to create a single UK business.

In 2010 Paul joined Lloyds Banking Group where he took up the role of Managing Director of Consumer Banking and Payments. In 2011 Paul was appointed CEO of the Verde programme through which he led the development and establishment of the new TSB Bank within Lloyds Banking Group. In 2013 Paul was appointed as CEO of TSB Bank plc.

Darren Pope, Chief Finance Officer (CFO)

Darren started his career at Prudential plc where he led the development of the Prudential Bank, which subsequently became Egg. As one of the founders of Egg, Darren served as the internet credit card and savings provider's UK Finance Director following its 2000 IPO.

Darren moved to Lloyds TSB in 2005 as Finance Director for the mortgage division where he was responsible for Europe's largest mortgage book on the acquisition of HBOS. It was from here that Darren was appointed to Project Verde where he led all financial aspects of the programme before moving into the CFO role in 2011.

Helen Rose, Chief Operating Officer (COO)

Helen is a Fellow of the Institute of Chartered Accountants having qualified at Coopers Lybrand. Helen spent 15 years in the retail sector where she held a variety of senior finance roles at Dixons, Forte and Safeway.

In 2005, Helen joined Lloyds TSB as Finance Director for the Community Bank. She subsequently joined the Retail Board and was responsible for leading the integration of the Retail Divisions of Lloyds TSB and HBOS. She joined Verde in 2011 as COO to lead the development and build of TSB as a new multi-channel challenger bank on the UK high street. Following completion of the build programme, Helen now has responsibility for operations, payments, IT, customer relations, property, telephony call centres and branch and ATM support teams.

Peter Navin, Managing Director, Branch and Business Banking

Peter started his career as an international economist with ICI in the chemicals and pharmaceutical sector, before joining the (original) TSB in 1989. Here he held a number of roles including Director of Strategy for retail banking and insurance before moving into IT and operations. Within Lloyds TSB, Peter was Corporate Banking Director having previously been Product and Marketing Director for the same division.

Peter was appointed to the Scottish Executive Committee of Lloyds Banking Group in 2009. He was also appointed as Executive Director of Lloyds TSB Scotland plc in the same year and was made Chief Executive shortly afterwards, a position he held until June 2013. During this time, the business was prepared for its future new role within TSB. Peter was appointed into his current role in 2011.

Neeta Atkar, Chief Risk Officer

Neeta is an experienced Risk Professional with over 20 years' experience working in the financial services private and public sectors across a range of risk disciplines. As Chief Risk Officer for TSB, Neeta provides Risk leadership and strategic direction to enable the Bank to meet its business objectives within a risk and compliance framework.

Prior to joining the TSB Executive Team, Neeta was Lloyds Banking Group's Financial Crime & Operational Risk Director, responsible for setting the Group's risk appetite, high level policies and strategies for financial crime and operational risk. Neeta joined Lloyds in August 2007 and, prior to moving to Group Risk in January 2009, she held both the role of Operational Risk Director and Regulatory Risk Director for the Lloyds TSB retail bank.

Neeta started her career at the Bank of England. During her 10 years there, she undertook a variety of roles, including responsibility for supervising banks, roles in the Bank's own banking department and policy roles representing the Bank in Basel. She moved to the Financial Services Authority on its creation, at which time she was responsible for developing policy in relation to market risks and involved in various projects relating to the integration of the heritage regulatory bodies.

Ian Firth, Treasurer

Ian's career started at Barclays and during his 20 years at the bank, his roles included Chief Dealer and Head of Funding. He also gained international experience having headed up the Asia Pacific Markets Division. Ian is a director of the Scottish Widows Global Liquidity Fund and was, for many years, a member of the Bank of England's Money Market Liaison Group.

Having joined Lloyds TSB in 1999, Ian has held a number of roles at the Group and was appointed Treasurer of TSB in 2012 where he holds responsibility for management of TSB's balance sheet.

Nigel Gilbert, Chief Marketing and Communications Officer

Nigel Gilbert is TSB's Chief Marketing and Communications Officer with responsibility for all aspects of the Bank's marketing, communications and customer experience strategy. He joins from Virgin where he spent three years, latterly with Virgin Management, as Key Projects Director. Nigel arrived at Virgin Media in January 2011 as the company's first ever Chief Marketing Officer.

Prior to joining Virgin, Nigel was Group Marketing Director of Lloyds Banking Group. He joined Lloyds TSB in a similar role in October 2006. During his first couple of years he led the reinvigoration of the Lloyds TSB brand with a new customer proposition, "for the journey..." and secured the first official sponsorship of the London 2012 Olympic Games. He was also voted 'Marketer of the Year' by the Financial Services Forum.

Before joining Lloyds TSB, Nigel spent his career in advertising, in London and around the world. At Lowe Worldwide he was Chairman and CEO of Lowe Asia Pacific, based in Singapore, prior to which from London he headed the global team that created the HSBC brand proposition 'the world's local bank'. Before Lowe, Nigel worked at Y&R Europe out of Stockholm and London where he ran global communications work for Ericsson mobile phones and prior to that he ran Dentsu, Y&R's agency in Hong Kong. He began his advertising career in London at Allen Brady & Marsh before spending 10 years at Collett, Dickenson, Pearce, latterly as Director of European Operations.

Appendix 2 – History of TSB

Early History and Expansion

TSB, short for Trustee Savings Bank, has a long history dating back to 1810, when the first savings bank was established by Dr. Henry Duncan in Ruthwell Dumfriesshires *'for the advantage of the labouring classes and the lower orders of society'*. *Their aim was to encourage 'habits of industry, economy and sobriety among the poor and labouring population'*.

The Ruthwell example was quickly followed elsewhere in Scotland. The idea also spread south of the border, into England and Wales with more than 465 savings banks across the UK by 1818. Savings banks were regulated by Rose's Act passed in 1817, which required funds to be invested in government bonds or deposited at Bank of England.

The trustees were upstanding members of the local community, who voluntarily gave their time to oversee the running of the bank. The customers were the 'industrious poor' such as artisans, labourers, smaller farmers and servants.

War Time Growth and Consolidation

The savings bank movement continued to expand during the First World War because of the government's campaign to boost savings. The war time bonds were also popular among depositors. TSBs deposit base grew rapidly during this period.

The pass of the Mutual Assistance Scheme in 1947 allowed richer banks to lend to poorer ones. Regional TSBs merged to form larger TSBs. By 1970 the number of savings banks decreased to around 70 with £2.8bn in total assets. TSBs were still restricted in the services they could offer: they could not give loans to their customers. Only after the ensuing Trustee Savings Banks Act in 1976 were TSBs allowed to offer services equivalent to those of clearing banks. But it also required, in the space of one year, the number of independent TSBs to be reduced to 16.

Flotation and Merger with Lloyds Bank

In 1983, the last 16 savings banks were merged into yet larger regional groupings: TSB England and Wales; TSB Scotland; TSB Northern Ireland; and TSB Channel Islands. In 1986, the shares of TSB Group plc were floated on the London Stock Exchange for £1.2bn. Another milestone in TSB's history was the merger with Lloyds bank in 1995. The merger created the largest domestic lender by market share. It also combined the strength of Lloyds in mortgages and small businesses with TSB's strength in savings and insurance.

The New TSB

Lloyds TSB was renamed to Lloyds Banking Group in 2008 following its acquisition of HBOS. As the financial crisis deepened, the government was forced to inject capital into Lloyds Banking Group, as part of a rescue package in September 2008, taking a 43% equity stake. In order to comply with European Commission state aid requirements, LBG was in turn required to spin off 631 branches. In response to this requirement the new TSB business was formed consisting of Lloyds TSB Scotland branches, all of the Cheltenham and Gloucester branches and some of Lloyds TSB branches in England and Wales. After the initial agreement to sell TSB to the Co-operative Banking Group fell through in early 2013, LBG decided to divest TSB via an IPO. The new TSB bank began operations on 9 September 2013.

TSB Banking Group

Company description

TSB is the 12th largest retail lender in the UK. The bank has national, multi-channel distribution via 631 branches and a full digital, mobile and telephony. It offers a full product suite of current accounts, savings, mortgages, unsecured personal lending, business lending and insurance. The business model is very simple, focused on servicing retail and micro-SME customers within the UK, with zero international business and no corporate and/or investment banking exposure. TSB accounts for only 2% of UK mortgages, but 4% of personal current accounts and 6% of branches.

Investment strategy

We rate TSB Neutral. In 2013 TSB stopped selling intermediary mortgages. This will weigh on revenues near-term, while the cap on SVR mortgages, plus investment spend, will also limit profitability. However re-launch of intermediary mortgages, coupled with rising rates, offers the potential for attractive returns and dividends, albeit this is unlikely to materialize until 2017-18. TSB target a double-digit RoE by mid-2019 “with momentum” and payout of c40-60% over time. We believe TSB will only approach a ‘normalized’ RoE by 2020, at which point we forecast a RoE of 15.6%. This presents significant option value if TSB can successfully execute upon its strategy. However the glide path towards a ‘normalized’ return is likely to be long, with the uplift back-end-loaded. We see few positive catalysts near-term.

Valuation

As none of the listed UK peers are direct comparables, in our view, our primary valuation methodology is to instead compute a theoretical ‘warranted’ P/TB multiple and a fair value P/E multiple. We use a cost of equity of 10% and long-term growth-rate of 5% and apply this to 2018, 2019 and 2020 as terminal years. We then take the average of these valuation approaches to derive our target price of 300p.

Risks

TSB is not without risk, not least in regard to the outlook for the UK economy and UK regulation, which continues to evolve. The risk remains that economic conditions could deteriorate again, leading to reduced levels of activity and higher impairment losses. Alternatively if base rates are lower for longer this could continue to impair TSB's profitability. Regulatory risks also remain, especially with regard to proposals on capital and ring-fencing, given TSB's outstanding service agreements. Other risks include Scottish independence and overhang risk. If the impact of these risk factors is more or less negative than we anticipate, then the share price might fail to reach or exceed our target price.

Appendix A-1

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IMPORTANT DISCLOSURES

TSB Banking Group (TSB.L)

Ratings and Target Price History
Fundamental Research



	Date	Rating	Target Price	Closing Price
1	8-Oct-11	Stock rating system changed		

* Indicates change

TSB Banking Group (TSB.L)

Ratings and Target Price History
Best Ideas Research
Relative Call (3 Month)



* Indicates change

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