Bank of Ireland

Lower Tier II: Defying Logic

Europe Financials Research

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- In our opinion the current pricing levels of Bank of Ireland LTII instruments are difficult to justify within the context of a more assertive policymaker stance on burden sharing for the subordinated debt of Irish banks. **We think that there is significant downside risk for these instruments given the greater likelihood of more aggressive liability management exercises which would be executed at much lower cash prices levels.** We fail to understand the 'bull' thesis which is supporting current valuations and according to which the LTII bondholders would be offered to exchange debt for Bank of Ireland equity at prevailing market levels, both in terms of the bond and equity prices. We think that this logic is potentially flawed and does not take into consideration the likely collateral impacts of such an exercise, both for the Irish government and the existing shareholders which includes the National Pensions Reserve Fund.

- We think that the greatest obstacle to such an investor-friendly approach debt-for-equity exchange is that existing shareholders would be materially diluted. This would not normally be a concern for Governments given that their view may well be that shareholders in failing banks should suffer the consequences. However we note that the reference shareholder in Bank of Ireland is the National Pensions Reserve Fund with a 35.97% stake as a result of a €3.5bn capital injection. In addition to the current MTM loss on this stake given Bank Of Irelands market cap of €1.2bn, we think that the Government would want to avoid further losses for this strategic investor which would result from excessive dilution. According to our estimates, if the outstanding €1.8bn of LTII had to be converted into equity at an average price of 55cents, this would create €990mn of new share capital. Assuming that the shares from this exchange would be issued at the current market price of 0.22, this would result in the creation of 4.4bn of new shares and which would have a materially dilutive impact on the National Pensions Reserve Fund reducing their overall stake to an estimated 19.5% post conversion. We note that there is likely to be additional dilution as part of the raising of the required €5.2bn capital.

- We believe such a level of dilution would be extremely unpalatable, particularly if it would imply that bondholders would end up holding a 45% equity stake from such an exchange. In addition to undermining the current shareholders, significant potential upside would be given to the bondholders which would go against the grain of recent liability management exercises, most notably that of Anglo Irish. We think that such considerations effectively undermine the bull case for the LTIIs and suggest that less market friendly approaches are more likely.

See page 3 for analyst certification and important disclosures.

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- In our opinion the rational strategy for raising the required €5.2bn of capital for Bank of Ireland would be to focus on non-dilutive forms of capital raising, which would range from asset sales to liability management exercises. As such, we think that it is possible that a more aggressive liability management exercise is considered, potentially involving the application of a SLO (Subordinated Liabilities Order) to Bank of Ireland and which would tend to maximize the potential capital generation from any subsequent tender. In the event that the LTIIs had then to be tendered at a level around 25pts, the capital generation would be €1.35bn (gross of tax) and crucially would not result in any dilution for the existing shareholders such as the National Pensions Reserve Fund. **In our, opinion this would be the major consideration and would tend to suggest potentially more punitive outcomes for the LTII bondholders in order to avoid diluting existing shareholders.** Politically we believe such an outcome would be more palatable given that it would avoid giving any equity upside in Bank of Ireland to existing bondholders.

- We note that through successive rounds of intervention in the banking sector, the Irish policymaker approach in raising capital through liability management has become consistently less investor-friendly, which is understandable within the context of a bank bailout which has had a crippling impact on public finances. We think that it would be very surprising if Irish policymakers deviate from this course and we note recent comments from the Minister of Finance to the effect that legal challenges to the application of the Stabilisation Act legislation would in no way deter from the achieving appropriate levels of burden sharing for institutions such as Bank of Ireland consistent with other exercises previously undertaken in the sector. In our opinion this is a very strong statement of intent and would tend to undermine the view that Bank of Ireland LTII bondholders would somehow be given more favorable treatment as part of the capital raising exercises. A further consideration which may undermine the bull case of the LTIIs would be that even with a favorable exchange into equity, it is unclear what the real value of that equity stake will be in the context of aggressive dilution and limited visibility on earnings power given the challenging operating environment.

- In terms of recommendations across the capital structure, we would be short Lower Tier IIs in Bank of Ireland given the above considerations. However we would hold the senior part of the liability structure given repeated policymaker commitments not to burden share senior debt as part of the recapitalization exercises. Additionally we note that the €5.2bn of capital will shore up regulatory solvency and place the issuer in a better position to deal with the challenging operating environment.

Table 1:Bank of Ireland Lower Tier II

ISIN	Issue size (m)	Price	Coupon	Currency	Maturity
XS0186652557	201	54/56	4.625	Eur	27/02/2019
XS0381705549	272	54.5/56.5	9.25	GBP	07/09/2020
XS0487711573	747	60/62	10	Eur	12/02/2020
XS0487711656	87	59/61	10	GBP	12/02/2020

- Source:, J. P. Morgan Prices as at 12/05/2011 at 12:23

- In this note we transfer coverage of Bank of Ireland to Roberto Henriques.

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