

7 April 2010

Produced by: The Royal Bank of Scotland N.V.

Overweight

Banks

Light after dark

We reiterate our positive stance on Irish bond spreads, highlight opportunities in the LT2 space, and take a more positive view on the equity valuations of the Irish banks following the developments last week. AIB (Buy, €1.75 TP) is our preferred pick in the sector.

Table 1 : Key forecasts

	2009*	2010F	2011F	2012F	2013F
AIB					
PI/P	2,962	2,441	2,066	2,141	2,290
EPS (c)	-211	-2	13	24	45
TCE	5.42	2.40	2.55	2.73	2.96
P/TCE	0.22	0.44	0.42	0.39	0.36
BoI					
PI/P	2,218	1,055	1,307	1,384	1,454
EPS (c)	-169	-162	12	21	17
TCE	1.56	1.07	1.24	1.43	1.67
P/TCE	1.04	1.57	1.35	1.17	1.01

*For BoI, 2009 figures reflect 9M from March to Dec-09
 Source: RBS

Irish sovereign bond valuations still look compelling

The impact on state finances from the capital requirements of the financial system looks muted, given the recourse to private monies and conversion of preference shares. The National Treasury Management Agency (NTMA) has clarified that it envisages no change in its plan to raise €20bn in bonds this year, which we see as tactically positive. Our view remains that the bond markets are still fighting the last war, given that the IRISH/BTP 10y spread is some +65bp. We expect this IRISH/BTP spread to push towards zero this year.

We see the biggest opportunity in AIB and BOI LT2 debt instruments

We view last week's efforts to stabilise the Irish banking system as a good outcome for Irish bank senior and subordinated (LT2) debt. Senior unsecured debt ranks *pari passu* with depositors and we are not concerned about senior holders becoming disadvantaged versus deposit holders in Ireland. We are optimistic on LT2 for both BKIR and AIB because we perceive the worst-case scenario for the LT2 bonds remains a finite period of call restrictions, with coupon payments remaining mandatory, which makes the bonds look attractive at current levels. Furthermore, the new Prudential Capital Assessment Review (PCAR) requirements of equity capital ratios of 7% should generate a healthy cushion of new equity beneath the LT2.

Turning more positive on equity valuations, AIB is our preferred pick

We are upgrading AIB from Sell to Buy, with a €1.75 TP (previously €0.7) and BOI from Sell to Hold, with a €1.70 TP (previously €0.52). AIB is currently trading at 0.4x its 2013F TCE, which we believe is unwarranted given our expectation that the bank will succeed in disposing of its two main foreign assets before the year end and that it will generate an RoTCE in-line with its CoE of 12% by 2013F. We see limited upside potential in BOI's share price at the current level as the market currently seems to be factoring in a strong degree of government support for the bank's independent survival, as well as its ability to generate an RoTCE of 19% by 2013F. Our view is that in order to turn more positive on the shares at these levels, one needs to believe that the RoTCE will exceed this expectation. We prefer to Buy a 'de-risked' AIB where the upside potential is 46% from current levels.

Important disclosures can be found in the Disclosures Appendix.

Sector performance

	(1M)	(3M)	(12M)
Absolute	71.2	23.9	323.1
Absolute (%)	9.9	3.1	69.7

BBG E300 Financials: 786.62
 Source: Bloomberg

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Executive summary

We reiterate our positive stance on Irish bond spreads, highlight opportunities in the LT2 space and take a more positive view on the equity valuations of Irish banks following last week's developments. AIB (Buy, €1.75 TP) is our preferred pick in the sector.

Irish sovereign bond valuations still look compelling

The impact on state finances from the capital requirements of the financial system looks muted, given the recourse to private monies and conversion of preference shares. The NTMA has clarified that it envisages no change to its plan to raise €20bn in bonds this year, of which €10.2bn have already been raised. The fact that the bailout of the Irish banking system has limited implications for NTMA borrowing is tactically positive. More structurally, it is still relevant to highlight that Irish paper has significant value because default risk has been tempered by the ECB balance sheet and most importantly by solid government budget action.

At the heart of any calculation is debt sustainability and the budget reform in Ireland has been impressive on several levels, in our view, ranging from swingeing budget cuts in primary spending that the consensus could barely believe and enhancements in competitiveness. Longer term, we are of the opinion that Ireland will be the new Belgium – a high debt country, but one that has the institutions (cultural/political) to mean that the debt dynamics are manageable. Our view remains that the bond markets are still fighting the last war, given that the IRISH/BTP 10y spread is some +65bp. We expect this IRISH/BTP spread to push towards zero this year.

We see the biggest opportunity in LT2 debt instruments

We view last week's efforts to stabilise the Irish banking system as a good outcome for Irish bank senior and subordinated (LT2) debt. Senior unsecured debt ranks *pari passu* with depositors and we are not concerned about senior holders becoming disadvantaged versus deposit holders in Ireland. We are optimistic on LT2 for both BKIR and AIB because we perceive the worst-case scenario for the LT2 bonds remains a finite period of call restrictions, with coupon payments remaining mandatory, which makes the bonds look attractive under current levels. Furthermore, the new PCAR requirements of equity capital ratios of 7% will generate a healthy cushion of new equity beneath the LT2.

Table 2 : AIB and BOI – LT2 recommendations

(ALL government guaranteed until 29 Sept 2010)

On a yield basis, the following high coupon LT2s look attractive to us:

BKIR € 10% bullet 02/20s offered at cash px 111.0, yield 8.4%

AIB € 10.75% bullet 03/17s offered at cash px 108.75, yield 9%

AIB £12.5% bullet 06/19s offered at cash px 117.8, yield 9.3%

The LT2 FRNs look cheap on a cash basis. For example:-

BKIR € 01/17s callable 01/12 FRNs offered at cash px 72.5.

AIB € 10/17s callable 10/12 FRNs offered at cash px 72.

Source: Company data, RBS

We remain cautious on Anglo Irish subordinated debt, as the outcome for bondholders remains highly uncertain with the proposed good/bad bank split. The government has proposed that the senior debt will move to the good bank and the subordinated debt to the bad bank but this has yet to receive EU approval. The possibility of an LT2 exchange remains.

With both Educational Building Society (EBS) and Irish National Building Society (INBS) potentially 100% government owned unless a sale to a private buyer or merger can be negotiated, we view the senior debt as fully secure. The subordinated debt at EBS is likely to see call restrictions but the coupons are mandatory. The possibility of a mutual capital instrument with loss absorption features or CoCo style exchange cannot be ruled out.

Turning more positive on equity valuations

We upgrade our ratings and target prices for both AIB and BOI on the back of last week's collective announcements by the finance minister, the financial regulator and the National Assets Management Agency (NAMA). We move to a Buy rating for AIB with a target price of €1.75 (previously Sell, €0.7) and to a Hold for BOI with a target price of €1.70 (previously Sell, €0.52).

We estimate AIB offers 46% upside potential from the current price

AIB and BOI must raise €10.1bn of capital in aggregate by 31 December 2010. This equates to 3.1x the combined market capitalisation of these banks. AIB has the more difficult task since its capital target is €7.4bn of the €10.1bn.

We expect AIB to sell its stakes in its Polish (BZWBK) and US bank, generating €3.9bn of capital and leaving a €3.5bn deficit to be funded by either private shareholders or the government through the conversion of some, or all, of its outstanding €3.5bn of preference shares in the bank. BZWBK is key to our estimates of the potential capital gain from disposals, accounting for 74% of our €3.9bn.

Assuming the remaining €3.5bn is raised at the current price, AIB is trading at 0.4x its 2013F TCE. We believe this discount is primarily being driven by concerns about the capital raising process. However as we have outlined, we expect the bank to succeed in securing the sale of two of its major foreign assets. We also believe that the level of capital is sufficient for us to have confidence in the bank's ability to absorb €6.6bn more cumulative losses on its loan book than we currently expect.

Table 3 : Following its capital raising, we believe AIB can absorb an additional €6.6bn of loan losses beyond our current estimates

BOI					
Cumulative losses	€m	Bp	Stressed cumulative losses	€m	Bp
Residential mortgages	1,006	166	Residential mortgages	1,643	270
- Ireland	698	262	- Ireland	1,335	500
- United Kingdom	308	90	- United Kingdom	308	90
Non-property SME and corporate	2,140	669	Non-property SME and corporate	3,199	1,000
Property and construction	7,179	2,101	Property and construction	7,862	2,301
Consumer	821	872	Consumer	821	872
Total	12,152	818	Total	15,168	1,113
			Net incremental	3,016	
2010E			2010E		
TCEPS	1.07		TCEPS	0.19	
Core Tier I ratio	7%		Core Tier I ratio	4.1%	

AIB					
Cumulative losses	€m	Bp	Stressed cumulative losses	€m	Bp
Residential mortgages	336	137	Residential mortgages	1,225	500
Non-property SME and corporate	3,042	681	Non-property SME and corporate	4,464	1,000
Property and construction	10,549	2,426	Property and construction	12,288	2,826
Consumer	1,051	1,135	Consumer	1,051	1,135
CEE	334	488	CEE	334	488
Total	12,698	987	Total	19,362	1,504
			Net incremental	6,664	
2010E			2010E		
TCEPS	2.40		TCEPS	0.97	
Core Tier I ratio	10%		Core Tier I ratio	4.4%	

Source: Company data, Irish Financial Regulator, RBS estimates

Valuation

The step change in visibility allows us to value the banks on 'normalised' levels, which is in line with our valuation methodology for our UK banking universe. We use 2013F as our 'normalised' year, given that we expect both AIB and BOI to return to profitability only in 2011.

We apply a multiple to our 2013F TCE in line with RoTCE performance against CoE. For BOI this implies a 1.6x P/TCE vs 1x for AIB. We discount this back to today to arrive at our target prices. This implies a 'go to' 2013F P/E of 9x for both BOI and AIB.

We use a 13x discount rate for BOI and 14x for AIB, to account for the differences in execution risk to the capital raising plans over the coming eight months instead of our typical 'normalised' discount rate of 12%.

Table 4 : BOI valuation (€)

P/TCE multiple (x)	11	12	13	14	15
1.4	1.54	1.48	1.46	1.38	1.33
1.5	1.65	1.59	1.56	1.48	1.43
1.6	1.80	1.74	1.70	1.62	1.56
1.7	1.86	1.80	1.77	1.68	1.62
1.8	1.97	1.91	1.87	1.77	1.71

Source: Company data, RBS forecasts

Table 5 : AIB valuation (€)

P/TCE multiple (x)	12	13	14	15	16
0.6	1.13	1.09	1.05	1.02	0.98
0.8	1.51	1.45	1.40	1.36	1.31
1	1.88	1.82	1.75	1.69	1.64
1.2	2.26	2.18	2.11	2.03	1.96
1.4	2.64	2.54	2.46	2.37	2.29

Source: Company data, RBS forecasts

We believe it is critical to point out that the number of shares used in our TCE/ps calculation assumes that all new capital is raised at the *current market price*. The implicit assumption is that every shareholder takes up his right and/or that the government preference shares are converted at the current market price. In the event that this were not to be the case (eg, if there was a substantial discount and/or if current investors chose not to exercise their right to participate in the capital raising or if the shares rallied strongly in the other direction), our target price would have to be adjusted accordingly. We provide sensitivity tables below to illustrate the potential wide range of outcomes based on share price movement.

Table 6 : BOI sensitivity

Discount/premium to current share price	# shares out	Diluted TCEp/s
50%	2,314	1.33
25%	2,539	1.21
0%	2,876	1.07
-25%	3,439	0.90
-50%	4,564	0.68

Source: Company data, RBS estimates

Table 7 : AIB sensitivity

Discount/premium to current share price	# shares out	Diluted TCEp/s
50%	3,266	3.17
25%	3,683	2.81
0%	4,309	2.40
-25%	5,353	1.94
-50%	7,439	1.39

Source: Company data, RBS estimates

Conclusion

While we accept that a degree of uncertainty and high execution risk remains over the coming months, we believe this provides a buying opportunity for investors interested in 46% upside potential. We believe AIB has the potential to re-rate from current levels to €1.75.

AIB, in our view, should deliver on its two material asset disposals by YE10 for a sum of €3.9bn, and it should generate an RoTCE in-line with its CoE by 2012F. As such, we believe the current level of discount is unwarranted.

While a 12% RoTCE in 2013F may seem unexciting, the current share price implies that RoTCE is likely to be 8% and/or the discount rate required to compensate investors for the high execution risk associated with the asset disposals is 25%. AIB is fully aware of the difficult task in front of it, and given how hard the bank has fought to remain out of majority government ownership thus far, we expect the bank to do its uppermost to limit the full €3.5bn conversion of the government preference shares which would take the direct government stake to 77%.

Table 8 : AIB (Buy; €1.75 TP)

	2009	2010F	2011F	2012F	2013F
PiP	2,962	2,441	2,066	2,141	2,290
EPS (c)	-211	-2	13	24	45
TCE	5.42	2.40	2.55	2.73	2.96
P/TCE	0.22	0.44	0.42	0.39	0.36

Source: Company data, RBS forecasts

We are of the opinion that two important details are currently being factored into BOI's share price. Firstly, that BOI has the privilege of being the Irish government's choice for survival. The significance of this should not be underestimated, especially when most of its peers appear destined for majority or complete government ownership. Secondly, that BOI will generate an RoTCE of 19% by 2013F. Our view is that in order to turn more positive on the shares at these levels, one needs to believe that the RoTCE will exceed this expectation. We prefer to Buy AIB where the conviction only needs to be that the bank will be able to complete the sale of BZWBK and M&T before YE10 and that the bank can generate its CoE by 2013F.

Table 9 : BOI (Hold; €1.7 TP)

	2009*	2010F	2011F	2012F	2013F
PiP	2,218	1,055	1,307	1,384	1,454
EPS (c)	-169	-162	12	21	17
TCE	1.56	1.07	1.24	1.43	1.67
P/TCE	1.04	1.57	1.35	1.17	1.01

*For BoI, 2009 figures reflect 9M from March to Dec-09

Source: Company data, RBS forecasts

Risk

There is a high degree of execution risk, given the magnitude of capital (€22bn-32bn) being raised by the NAMA-participating banks in a very short time. We believe uncertainty will remain until the details of the recapitalisation plans have been fleshed out, the EU has spoken, the NAMA transfers are complete and the capital shortfalls have been confirmed and addressed. An onerous response by the EU Commission, perceived delays or complications with the NAMA loan transfers or the capital raising process could weigh on the shares. Given AIB's plan to divest all of its major foreign assets, we believe the risk of a negative surprise from the EU is more likely at BOI where the deleveraging process has been slow.

Stabilising the Irish banking system

Last week, a number of long awaited details surrounding the survival plan and future shape of the Irish banking system were revealed, including an aggregate €22bn-32bn capital shortfall for the NAMA-participating banks.

Three key statements were released on 30 March. The financial regulator published the results of its stress tests for NAMA-participating banks as well as Ireland's view of the minimum 'new world' equity and core tier-1 ratios. The finance minister, Brian Lenihan, announced changes to the country's banking regulatory framework. He also outlined the intended participation and financing of potential government ownership in some Irish banks and building societies as part of the recapitalisation plans for these institutions, which are required to comply with a hard equity tier-1 ratio of 7% by the end of 2010. Lenihan also laid out the ownership structure of these holdings and commented on his intent to extend the current government guarantee scheme in some modified format. NAMA also published details on tranches 1 through 3 of the loans to be transferred across by the NAMA-participating banks.

Table 10 : Summary of capital shortfalls and recapitalisation plans

NAMA participating institution	Equity Capital Shortfall (€m)	Market Capitalisation (€m)	Shortfall as a % of Market Cap	Sources	Instrument	Other
Anglo Irish	8,300 (potentially 18,300)	n/a	n/a	Government	Promissory note, payable over a 10-15 year period	Target an exit from the lender in 5-7 years time. Split into good/bad bank.
Allied Irish Bank	7,400	1,103	671%	Sell UK, US and Polish Assets and find private capital. If this fails, government funds.	Ordinary equity (asset disposals and rights issue). May also involve conversion of government preference shares if private capital cannot be found.	
Bank of Ireland	2,700	2,135	126%	Private capital Government	Ordinary equity (rights issue, debt-to-equity swap and conversion of government preference shares)	Preference share conversion to be done on commercial terms, maximising full value for the state
Irish Nationwide	2,600	n/a	n/a	Government	€100m in Special investment shares; €2.6bn in a promissory note payable over a 10-15 year period	Government to seek swift sale or integration into another entity
EBS	875	n/a	n/a	Private capital if it can be found. Otherwise, the government.	€100m in Special investment shares; ordinary equity (strategic buyer/investor). May also involve a €775m promissory note if no private capital is forthcoming.	
Total	21,875 (31,875)					
Non-NAMA participating institution						
IL&P (as is)	0	791	0%			
IL&P (stand alone)	1,000	791	126%	Private Capital	Ordinary equity (rights issue) and debt restructuring	
Total	22,875 (32,875)					

Source: Central Bank of Ireland, Department of Finance (Ireland)

The 'stress test'

The major domestic-owned Irish banks and building societies have needed to raise capital for quite some time. However, the uncertainty surrounding the asset side of the balance sheet and the delays associated with NAMA amongst other things made it challenging for the banks to carry out this task. While the domestic institutions were relatively paralysed, foreign-owned banks have been injecting capital for a significant portion of the last two years and we expect this trend to continue through 2010.

The test needed to be robust enough to restore investor and taxpayer confidence in the banks. The result is an aggregate €22bn-32bn capital shortfall

The Irish regulator and the Irish government wanted to make sure that once a recapitalisation plan for the major domestic-owned Irish banks and building societies was formulated, it was robust enough to ensure that none of the publicly quoted banks would be back asking for more equity due to unforeseen troubles.

As such, the regulator carried out a PCAR, which incorporates a 'base' and 'stress' test. The underlying purpose of the test was to assess the capital requirements arising for the expected base and potential stressed loan losses, other financial developments, over three years (2010-12).

The basis for the stress capital requirement was a set of economic scenarios based on a 'hypothetical delayed economic recovery'. The main parameters involve negligible GDP growth in 2011 and 2012, persistent unemployment increasing to 14.7% in 2012, and a further cumulative house price decline of 24.8% from 2010-12 (the fall to date has been 31.5%).

While neither of the tests explicitly took Basel III into account, the Irish regulator did make note of the potential implications for Irish banks under the current proposals when formulating its view of the 'new world' target capital levels.

The target levels of 7% equity tier-1 capital and 8% core tier-1 capital under the base case and minimum 4% core tier-1 under the stress case are in line with capital levels required by other regulators which have carried out comparable exercises.

Table 11 : The PCAR map

Base capital calculation	Stress capital calculation
Start with current capital of bank and forecast operating results <i>Deduct</i> impairments on NAMA loans <i>Deduct</i> impairments on non-NAMA loans until 2012 Make Adjustments on bank specific basis: <i>Add/Deduct</i> : changes to NAMA volumes and % haircut <i>Deduct</i> : regulatory adjustment for loan loss uncertainty <i>Deduct</i> : adjustment for funding cost risk <i>Deduct</i> : Other amendments to forecast operating results <i>Amend</i> : Risk Weighted Assets to reflect impact of impairment and other changes Determine Capital Shortfall for base case ratios based on adjustments <i>Add</i> : Capital injection by 31 December 2010 Result: Target Base Capital of 8% Core Tier 1 of which 7% Equity	Start with current capital of bank and forecast operating results <i>Deduct</i> impairments on NAMA loans <i>Deduct</i> impairments on non-NAMA loans until 2012 Make Adjustments on bank specific basis: <i>Deduct</i> : changes to NAMA volumes and % haircut <i>Deduct</i> : hypothetical stress losses through to 2012 derived from the higher of: (a) the prescribed macroeconomic scenario (b) the prescribed portfolio level sensitivity loss rates <i>Deduct</i> : regulatory adjustment funding cost risk under stress scenario <i>Deduct</i> : Other amendments to forecast operating results (same as basis) <i>Add</i> : capital injection by 31 December 2010-03-25 or Contingent Capital Facility <i>Amend</i> : Risk Weighted Assets to reflect impact of impairment and other changes Determine Capital Shortfall for base case ratios based on adjustments <i>Add</i> : Capital injection by 31 December 2010 Result: Target Base Capital of 4% Core Tier 1

Source: Central Bank of Ireland

The 'base' and 'stress' test under the PCAR are similar to the scenarios carried out by the UK and US regulators. To date, the US regulator has been the most transparent concerning the inputs and outputs of the stress tests.

Table 12 : US Bank Holding Companies Supervisory Capital Assessment Program (SCAP)

	Baseline*		More adverse*	
	From	to	From	to
First lien mortgages	5	6	7	8.5
Prime	1.5	2.5	3	4
Alt-A	7.5	9.5	9.5	13
Subprime	15	20	21	28
Second / junior lien mortgages	9	12	12	16
Closed end junior	18	20	22	25
HELOCS	6	8	8	11
C&I Loans	3	4	5	8
CRE	5	7.5	9	12
Construction	8	12	15	18
Multifamily	3.5	6.5	10	11
Nonfarm, non residential	4	5	7	9
Credit Cards	12	17	18	20
Other consumer	4	6	8	12
Other loans	2	4	4	10

Note*: Indicative loss rates provided to Bank Holding Companies for SCAP (cumulative 2 year in percent)

Targets

Equity Tier I

Min. 4% at year-end 2010

Tier I

Min. 6% at year-end 2010

Source: Federal Reserve

The aggregate €22bn-32bn capital shortfall for NAMA-participating banks announced by the Irish Regulator (outlined in Table 13) is required to be filled by the end of 2010 and recapitalisation plans from all of the banks are due by 30 April. We walk through the details of AIB and BOI's recapitalisation plans in a subsequent section.

Although backing into the PCAR is a challenging exercise, given the unspecified adjustments for loan loss uncertainty, funding cost risk and other amendments to forecast operating results, we believe both AIB and BOI now have adequate capital resources to cope with severe stress. We have combined the known variables about the Irish stress test and the US stress test to illustrate that BOI and AIB could essentially double our loan loss expectations in 2010 and still remain above a 4% core tier-1 ratio. We caution that this assumes that all of the requisite capital has been raised in advance of the additional impairment losses in order to arrive at the core tier-1 capital ratios quoted in the table below.

Table 13 : Stress testing BOI and AIB

BOI					
Cumulative losses	€m	Bps	Stressed cumulative losses	€m	Bps
Residential mortgages	1,006	166	Residential mortgages	1,643	270
- Ireland	698	262	- Ireland	1,335	500
- United Kingdom	308	90	- United Kingdom	308	90
Non-property SME and corporate	2,140	669	Non-property SME and corporate	3,199	1,000
Property and construction	7,179	2,101	Property and construction	7,862	2,301
Consumer	821	872	Consumer	821	872
Total	12,152	818	Total	15,168	1,113
			Net incremental	3,016	
2010E			2010E		
TCEPS	1.07		TCEPS	0.19	
Core tier I ratio	7%		Core tier I ratio	4.1%	

AIB					
Cumulative losses	€m	Bps	Stressed cumulative losses	€m	Bps
Residential mortgages	336	137	Residential mortgages	1,225	500
Non-property SME and corporate	3,042	681	Non-property SME and corporate	4,464	1,000
Property and construction	10,549	2,426	Property and construction	12,288	2,826
Consumer	1,051	1,135	Consumer	1,051	1,135
CEE	334	488	CEE	334	488
Total	12,698	987	Total	19,362	1,504
			Net incremental	6,664	
2010E			2010E		
TCEPS	2.40		TCEPS	0.97	
Core tier I ratio	10%		Core tier I ratio	4.4%	

Source: Company data, Irish Financial Regulator, RBS estimates

Irish Life & Permanent will have to wait for its turn for a PCAR but we expect a €1bn capital shortfall for the bank as a stand alone entity

Although Irish Life & Permanent was not included in the first wave of the PCAR, the regulator has informed the bank that a PCAR will be carried out over the coming months on the back of its restructuring plans. Having said this, the group has been in touch with the regulator and believes that under its current structure it has adequate capital to withstand both the base and stress tests.

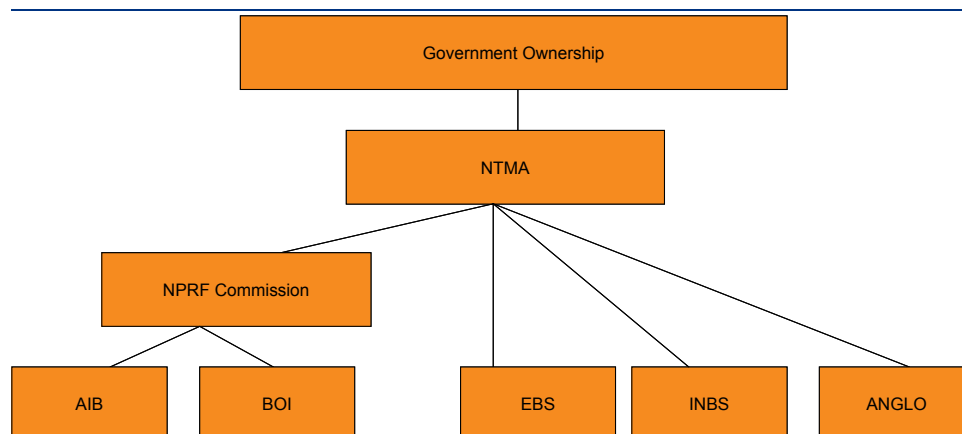
We have included Irish Life & Permanent in our capital shortfall table because we expect the regulator to assess the ability of the bank to operate under a stress scenario as a *standalone* entity as part of its PCAR. The current structure of the group allows the bank to rely on capital from the insurance operations. On a standalone basis, we believe the shortfall would be €1bn for Irish Life and Permanent. We discuss this further in our accompanying note, 'In the waiting room'.

Ownership and management of government investments

The government has outlined the arrangements for its interests in the banks in the light of the PCAR results and the initial transfer of loans to NAMA.

Investments in AIB and BOI are to be managed separately from the investments in Irish Nationwide Building Society (INBS), EBS and Anglo Irish Bank. Currently, the government's preference share investments in AIB and BOI are managed and funded through the National Pension Reserve Commission (NPRC). Upon conversion of some or all of the government's preference shares in either BOI or AIB, the NPRC will continue to manage these investments.

Figure 1 : Outline of government ownership structure for Irish bank stakes



Source: Department of Finance (Ireland)

The government's investment in Anglo Irish Bank is currently managed by the NTMA through a relationship framework and the probable direct interests to be taken in EBS and INBS are to be managed in the same fashion.

Arms length investments but potential for interference

The government has stated that due to the structure of the investments that each institution's board and management team will continue to run its business on an arm's length basis. However, we note that AIB and BOI will now be subject to a Credit Review process. The intent is to allow SMEs, sole traders and farmers, who have had credit refused or withdrawn, to apply for an independent review of the bank's decision.

In the event that the Credit Reviewer recommends that credit should be granted, the bank is required to comply with the recommendation or explain why it should not do so. Although we appreciate the government's focus in getting credit flowing again to emerge from recession, sustain the Irish economy and foster growth, we are concerned that banks could be forced to lend to unworthy borrowers.

We remain watchful of this situation.

A whole new world – banking regulation in Ireland

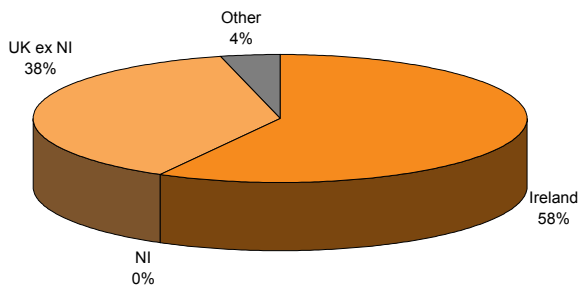
As outlined in June 2009, the Irish government brought forward a legislation last week called the Central Bank Bill. This bill allows for the establishment of a single fully integrated regulatory institution within the Central Bank of Ireland. The new Central Bank will be chaired by the Governor of the Central Bank and will be responsible for ensuring the stability of the financial system. The bank will have the power to assess the suitability and competence for key positions within financial institutions in Ireland.

Two further bills are expected to be brought forward. One will contain additional new and enhanced regulatory powers of the new Central bank while the other will consolidate all existing statutory arrangements. We believe the future bill concerning enhanced regulatory powers will allow for the Central Bank to take control of failing banks.

The first wave of NAMA

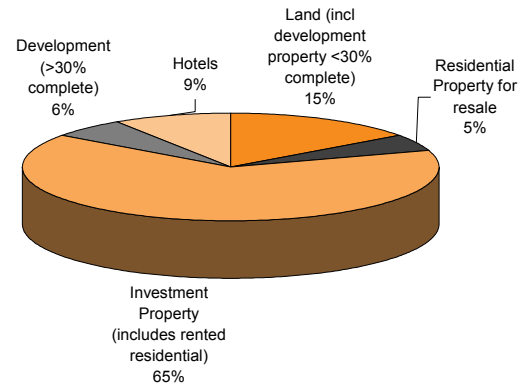
NAMA or Ireland's bad bank was announced in early April 2009 but progress has been slow to date. The first tranche of loans being transferred by participating banks to NAMA is expected to complete this week. Majority (58%) of the loans moving across are from Ireland with Anglo Irish being the largest contributor. The valuation work on Anglo Irish's loans is still ongoing but the weighted average haircut for the first tranche of loans is expected to be 47%.

Chart 1 : Geographical split (first tranche of loans)



Source: NAMA

Chart 2 : Sectoral split (first tranche of loans)



Source: NAMA

NAMA has bought the first tranche of loans either at market price or at a discount, while it had been originally suggested that NAMA would pay a premium after deducting its estimate of long term economic value (LEV).

We believe this is because since the original business plan was put forward, commercial property prices in Ireland, and therefore LEV valuations, have been falling. Furthermore, our understanding is that where NAMA has paid materially less than what might be expected, it is because there is discomfort with components surrounding the loan (eg, missing or inadequate documentation, security/collateral concerns, a wide range of valuations etc). We do not expect this dynamic to change as the process continues.

Table 14 : NAMA is paying a discount to or close to current market value for loans being transferred across

€bn	AIB	BOI	EBS	INBS	Anglo*	TOTAL
Loan Balances	3.29	1.93	0.14	0.67	10	16.03
Discount	43%	35%	36%	58%	50%	46.9%
	-1.41	-0.67	-0.05	-0.39	-5	-7.52
Total Consideration	1.88	1.26	0.09	0.28	5	8.51
Current market value of property (CMV)	1.87	1.26	0.1	0.36	5.85	9.44
Long term economic value of property (LEV)	2.04	1.41	0.1	0.41	6.55	10.51
LEV uplift as a % of consideration	8.5%	11.9%	11.1%	46.4%	31.0%	23.5%
LEV uplift as a % of CMV	9.1%	11.9%	0.0%	13.9%	12.0%	11.3%

Source: NAMA,

There is no set number of tranches. However, the original schedule did contain eight tranches of loan transfers. The plan envisaged one tranche moving across per month and we believe a similar schedule is likely, given that there are only eight months remaining in the year and all of the loan transfers are expected to be complete by 31 December 2010. On this basis, we believe 47% of the total loans expected to move across should be complete by mid-summer. However, we note that although the contents of the first three tranches of loans have been set out by NAMA, the remaining tranches will involve the participating banks putting up eligible loans to NAMA for consideration. Provided that the banks are well prepared with the appropriate supporting documentation, this could speed up the transfer process. To date, the banks have stated that either specific parties or NAMA have been the reason for the protracted timeline, so, hopefully, the banks can help shorten the remaining timeline and/or keep the schedule on track for its 4Q 2010 self-imposed deadline.

There is to be a market announcement from AIB and BOI as each tranche of loans is moved over to NAMA, which will enable the market to understand how the valuations are moving throughout this process. It is also our understanding that as well as a quarterly report, NAMA will provide key details on a tranche by tranche basis.

Table 15 : Overview of early NAMA tranches: AIB to transfer the least amount of loans (as a % of total loans)

Overview of early tranches	AIB	BOI	EBS	INBS	Anglo*	TOTAL
Total expected loan transfer	23	12	1	9	36	81
Number of loans in Tranche 1	222	348	39	36	600	1,245
Tranche 1 Transfer (€bn)	3.29	1.93	0.14	0.67	10	16.03
Tranche 1 as a % of total	14.3%	16.1%	14.0%	7.4%	27.8%	19.8%
Second tranche (expected transfer) - €bn	2.8	2.1	0.4	0.6	7.3	13.2
Tranche 2 as a % of total	12.2%	17.5%	40.0%	6.7%	20.3%	16.3%
Third tranche (expected transfer) - €bn	2	1.6	0.3	2.3	2.3	8.5
Tranche 3 as a % of total	8.7%	13.3%	30.0%	25.6%	6.4%	10.5%
Total - Tranches 1 to 3	8.1	5.6	0.8	3.6	19.6	37.7
First three tranches as a % of total	35%	47%	82%	40%	54%	47%
Number of Borrowers						100

Source: Company data, NAMA

In applying the average weighted discount of the first tranche of loans to the entire portfolio of loans moving across to NAMA, there is an €11bn (or 20%) difference between the original muted aggregate purchase price of €54bn and the current implied purchase price of €43bn. While scope remains for this figure to be revised upwards as later tranches move across, we have used the pricing of tranche 1 as our base case.

Table 16 : A 47% haircut against the aggregate amount of NAMA loans suggests a €43bn consideration (vs original €54bn)

€bn	AIB	BOI	EBS	INBS	Anglo*	TOTAL
<i>1st tranche of NAMA Loans</i>	3.29	1.93	0.14	0.67	10	16.03
Discount	43%	35%	36%	58%	50%	46.9%
	-1.41	-0.67	-0.05	-0.39	-5	-7.52
Total consideration	1.88	1.26	0.09	0.28	5	8.51
<i>Second tranche (expected transfer)</i>	2.8	2.1	0.4	0.6	7.3	13.2
Discount	43%	35%	36%	58%	50%	46.9%
	-1.2	-0.7	-0.1	-0.3	-3.7	-6.2
Total consideration	1.6	1.4	0.3	0.3	3.7	7.0
<i>Third tranche (expected transfer)</i>	2.0	1.6	0.3	2.3	2.3	8.5
Discount	43%	35%	36%	58%	50%	46.9%
	-0.9	-0.6	-0.1	-1.3	-1.2	-4.0
Total consideration	1.1	1.0	0.2	1.0	1.2	4.5
<i>Tranches 1 to 3 of NAMA loans</i>	8.1	5.6	0.8	3.6	19.6	37.7
Discount	43%	35%	36%	58%	50%	46.9%
	-3.5	-2.0	-0.3	-2.1	-9.8	-17.7
Total consideration	4.6	3.6	0.5	1.5	9.8	20.0
Total NAMA loans	36	23	12	9	1	81
Discount	43%	35%	36%	58%	50%	46.9%
	-15.5	-8.1	-4.3	-5.2	-0.5	-38.0
Total consideration	20.5	15.0	7.7	3.8	0.5	43.0

Source: Company data, NAMA

Next steps: plenty of key events still to come

Last week's announcement was just the beginning of a flurry of activity required to make all of the moving parts come together before the end of the year.

Table 17 : Timeline

2010				2011	
1Q	2Q	3Q	4Q	1Q	Event
29 March					Transfer of first tranche of loans from EBS and INBS
30 March					Statements by NAMA, Financial Regulator and Finance Minister Brian Lenihan
	2 April				Transfer of first tranche of loans from BOI
	Week of 5 April				Transfer of first tranche of loans from Anglo Irish and AIB
	30 April				Recapitalisation Plans due
	Prior to 1 June				Further details concerning the future guarantee of debt securities issued by Irish banks which will be extended in some form. Announcement to be made before the EU commission
	30 June				Applications for a downward reduction in capital requirements are due to the regulator
			31 December		Transfer of NAMA loans expected to be complete
			31 December		All banks must have the PCAR (prudential capital assessment review) determined capital requirement in place
				28 February	EU imposed deadline that all loans transferring to NAMA should be completed

Still unknown:

Timing of EU approval on restructuring and recapitalisation plans

Exact timing and number of tranches for NAMA loan transfers

Source: NAMA, Financial Regulator, Minister of Finance, EU Commission

Still some missing pieces

Uncertainty will remain until the details of the recapitalisation plans are been fleshed out, the EU has spoken, the NAMA transfers are complete and the capital shortfalls have been confirmed and addressed

The Irish government has taken decisive and deliberate steps throughout this financial crisis to keep the Irish banking system from falling over. However, the substantial amount of state aid given to most of the Irish banks means that the EU Competition Commission will need to weigh in with its thoughts in order to ensure that the burden of the bailing out the Irish banking system is adequately shared between the taxpayer, the debt holders and the ordinary shareholders. It also needs to be convinced that the actions taken to date will allow the banks to return to a viable state and that the level of state aid will not materially distort competition.

A number of the banks submitted restructuring plans to the EU back in November but all of these will need to be revised now that the results of the PCAR have been announced. We believe a decision is likely in 2Q following the 30 April deadline for recapitalisation plans. Despite all of the concessions made by AIB to date, we remain concerned that the EU may ask for sanctions closer to home. BOI is most at risk of a negative surprise, in our view. We continue to believe that its plans to wind down and/or dispose of its UK assets (market permitting) may be deemed to be inadequate and that other concessions may also be required.

We are of the opinion that execution risk still remains high on a number of fronts. Although we have a high level outline of how the banks intend to raise the requisite capital, the details are still elusive. The capital shortfall targets are not definitive as banks can apply until 30 June for a reduction in the overall requirement and asset disposals may alter the mix. The average discount on the loans being transferred will not be known until the end of the transfer process which is eight months away. There is €22bn-€32bn (€23bn-€33bn, including our estimates for Irish Life and Permanent) of capital to be raised between now and 31 December 2010.

We believe that its likely the banks will be reluctant to lend until there is more clarity surrounding these key events, which may force the government to apply more pressure on them.

AIB's recapitalisation plan

AIB has said it is committed to selling its UK, US and Polish assets. We view M&T and Poland as key parts of the recapitalisation plan but do not believe the UK will be sold. The remaining €3.5bn of required capital will come from private investors and the government.

Only two foreign assets to be sold, we estimate

Table 18 : Escape from majority government ownership is unlikely

AIB	£m	%
Disposals (M&T and BZWBK)	3,900	53%
Private capital/conversion of government preference shares	3,500	47%
Total shortfall	7,400	100%

Source: Company data, RBS estimates

As we have previously noted, AIB intends to sell its UK and Polish businesses as well as its minority stake in M&T Bank Corporation (an American bank in which AIB has a 22.8% stake). Our understanding is that the bank has yet to decide about its intentions surrounding the remainder of its CEE businesses. AIB has also refrained from commenting on plans for its 24.99% interest in Hibernian Life Holdings Limited.

We have provided our estimates of the potential capital benefit from disposing all of AIB's material foreign businesses below for illustrative purposes. The aggregate capital gain from selling all of these businesses would be €4.6bn, according to our calculations. The main driver of this gain would be the RWA reduction on the back of the UK disposal and the profit from selling the Polish business at a 20% premium to its current market price. The premium reflects peak levels seen in Bank Zachodni's share price back in 2007.

We anticipate the stakes in M&T and Bank Zachnodi will be sold, yielding a €3.9bn capital gain

However, although the assets captured in the table below reflect the options that AIB has at its disposal, we do not believe that the UK business will be sold. We outline our reasons in the subsequent section. We also think that it is unlikely the stake in Hibernian Life Holdings will be sold. This leaves only M&T and Bank Zachodni as likely disposal candidates. The combined gain of these two assets is €3.9bn on our numbers, which would leave the bank €3.5bn short of its €7.4bn target.

We should note that according to the Shareholders Circular, M&T has the first right of refusal should AIB wish to sell more than 2% of its shareholding to any one party. M&T has pledged not to unreasonably withhold consent, but it does mean that the disposal process may be lengthy.

Our understanding is that there are no regulatory restrictions with respect to the selldown (or full disposal) of BZWBK. If AIB's entire 70.5% stake were to be sold, the buyer would be required to bid for 100% of the company. Since the regulator would be keen to keep BZWBK as a listed bank, it is likely that some of the company's shares would have to be disposed of post-acquisition. This strategy would resemble other comparable transactions in the region.

Table 19 : AIB's disposal options

	TOTAL	AIB GROUP (UK) PLC	M&T	Bank Zachodni WBK S.A. (BZWBK)	Bulgarian American Credit Bank AD	Hibernian Life Holdings Limited
AIB's ownership		100.00%	22.80%	70.40%	49.99%	24.99%
Exchange listed?		No	Yes	Yes	Yes	No
Local currency		GBP	USD	PLN	BGN	EUR
Local corporate tax rate		28.50%	35.00%	19.00%	10.00%	12.50%
# of o/s			118.68	73.08	12.63	
Current market price			79.57	216.00	15.50	
Current market capitalisation (m)		9,443	15,784	196		
Value of AIB's stake		1,596	2,153	11,112	98	258
Current FX (v EUR)		1.12	0.75	0.26	0.51	
EUR (m)	6,379	1,596	1,605	2,870	50	258
Net assets	4,496	1,596	1,282	1,300	60	258
o/w goodwill	1,104	1	648	442	13	0
Net tangible assets	3,392	1,595	634	858	47	258
Equity minorities	437	0	0	437	0	0
Change in supervisory deductions	160	128	0	0	0	
Annual 2009 PBT	249	1	60	196	5	-13
RWAs	28,225	18,225	0	9,840	160	0
Disposal price	5,963	607	1,605	3,444	50	258
Net impact on disposal (calculated on a pre-tax basis)						
NAV gain	1,467	-990	323	2,144	-10	0
TCE gain	2,571	-989	971	2,586	3	0
NAVPS gain	128	-86	28	187	-1	0
TCEPS gain	224	-86	85	225	0	0
Core Tier 1 benefit						
RWA	-28,225	-18,225	0	-9,840	-160	0
Core Tier 1	2,134	-989	971	2,149	3	0
RWA	91,775	101,775	120,000	110,160	119,840	120,000
Core Tier 1	8,165	5,042	7,002	8,180	6,034	6,031
Core Tier 1 ratio	8.9%	4.95%	5.8%	7.4%	5.0%	5.0%
Capital gain (bp)	387.1	-7.1	80.9	239.9	0.9	0.0
Equivalent capital	4,645	-86	971	2,879	11	0
Capital gain (bp)	387	-7.1	80.9	239.9	0.9	0.0

Source: Company data, RBS estimates

The UK business is unlikely to be sold, in our view

If the UK business is sold, we believe it would receive 1x mark-to-market net asset value of €610m. AIB should not sell this asset now

We have never considered the sale of the UK business as a key component to AIB's 'self help' plan and we continue to hold that belief. We think AIB's UK business is unlikely to attract a great deal of buyers at this stage. This primarily because of the stand-alone balance sheet position of the business which we walk through in detail below. If buyers were to be interested, we do not think they would be willing to buy the business at anything above a material discount to book value.

On our analysis, such a deep discount to the book value would erode a significant proportion of the group's TCE. If the sale of the UK assets was completed on its own (eg, no other assets were sold), the equity loss would more than offset by the gain from the RWA reduction) although the combination of selling the UK alongside the sale of M&T and Bank Zachodni would yield an additional €700m gain to the €3.9bn figure we quoted above.

Limited buyers, given the balance sheet structure

AIB Group (UK) PLC operates in both Northern Ireland and the Great Britain. Its trading name in Northern Ireland is 'First Trust Bank' while it operates as 'Allied Irish Bank (GB)' in Great Britain.

In analysing the UK business a number of things become apparent. Firstly, the balance sheet structure is quite weak from both a liquidity and funding perspective. Although progress has been made since 2007 when only 1% of funded assets were invested in liquid assets, the bank still needs to improve its liquidity position. We believe the 'new world' target is 10-15%, which implies that the group needs another 2-7% of liquid assets to comply with the new liquidity standards.

Table 20 : AIB UK – liquidity and funding profile

£m	2007	2008	2009
Cost/income	43%	44%	34%
PIP (pre-impairment profit)	340	326	348
Shareholders' equity	1,300	1,415	1,421
Total assets	28,866	28,802	29,071
Total funded assets	28,571	28,507	28,907
Leverage (x)	22	20	20
Net loans to customers	17,612	18,749	16,139
Customer deposits	11,476	13,688	10,573
Loan-to-deposit ratio	153%	137%	153%
Loans as a % of funded assets	62%	66%	56%
Liquid assets	385	1,692	2,364
Liquid assets as a % of total assets	1%	6%	8%
Funding profile			
Customer deposits	11,476	13,688	10,573
<1 year wholesale	14,012	11,311	14,058
>1 year wholesale	1,783	2,093	2,855
Equity	1,300	1,415	1,421
Total funded assets	28,571	28,507	28,907
Customer deposits	40%	48%	37%
<1 year wholesale	49%	40%	49%
>1 year wholesale	6%	7%	10%
Equity	5%	5%	5%
Total	100%	100%	100%
Core tier I capital	1,300	1,415	1,421
Tier I capital	1,192	1,508	1,451
Risk weighted assets	18,271	19,636	18,225
Core tier I capital ratio	7.1%	7.2%	7.8%
Tier I capital ratio	6.5%	7.7%	8.0%

Source: Company data, RBS

Additionally, the bank runs a fairly high loan-to-deposit ratio at 153%. Although this dropped to 137% in 2008, this was primarily because the bank chased 'hot money' or non-sticky deposits during that year. Taking this in conjunction with the remainder of the funding for the business, it is clear that there is a high reliance on short-term wholesale funding. The main source of the UK subsidiary's funding is bank deposits (which are not sticky) and the bank is running a net interbank deficit of €6bn. In simple English, the UK subsidiary is relying on short-term funding from other banks to fund €6bn of its long-term asset base. We believe that any potential buyer would need to change this dynamic and increase the portion of funding from long term (>1 year) wholesale funding to comply with potential 'new world' funding requirements.

While the current leverage in the business is on par with other UK peers, we believe the UK banks are likely to trend towards 15x over the next few years versus current levels of 20-25x. If we apply this leverage ratio on a spot basis to the UK subsidiary, the funded asset base needs to shrink by up to £8bn or the business needs an additional £0.5bn in equity.

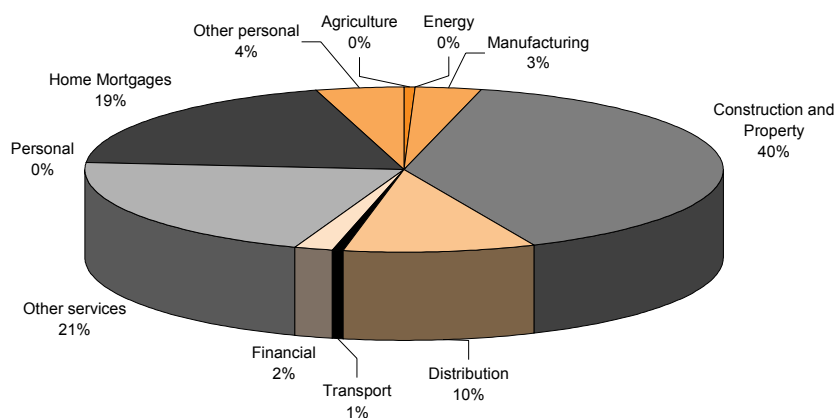
Table 21 : Backing into a 15x funded asset leverage multiple for AIB UK

	2009	2009
Balance sheet adjustments to get to 15x leverage		
Starting shareholders' equity	1,421	1,421
Additional equity	506	-
Ending shareholders' equity	1,927	1,421
Starting funded assets	28,907	28,907
Deduct funded assets	-	-7,592
Ending funded assets	28,907	21,315
Leverage	15	15

Source: Company data, RBS

While we do not believe that balance sheet issues are enough to prevent a sale, we do believe that they naturally limit the number of buyers. The funding, liquidity and leverage of the business indicate to us that it will take a relatively strong balance sheet to contend with fixing AIB UK's balance sheet.

The profile of the loan book may also limit potential buyers. Our understanding is that the loan book is split 1/3 Northern Ireland and 2/3 Great Britain. The business in Great Britain is primarily focused on mid-corporate. First Trust in Northern Ireland is a full service bank. In terms of sector concentration, there is a heavy bias towards the property and construction sector which accounts for 40% of the book. The other main component of the loan book is mortgages in Northern Ireland. While some buyers may be interested in taking only part of the business, our understanding is that AIB would prefer to sell the subsidiary in its entirety. AIB may be required to provide indemnities against certain assets or accept a lower price for a portion of the assets to get the entire asset base off its hands. We believe that most of this will be taken into account in the fair valuing of the balance sheet but there is a chance that the buyer may ask for more.

Figure 2 : AIB UK's loan book is primarily P&C and mortgages in Northern Ireland

Source: Company data, RBS forecasts

Negotiating power in the buyer's, not AIB's, hands

We find it challenging not to view AIB as a forced seller. With a nine-month time horizon to dispose three major assets, we think it would be natural for buyers to want to wait until the last minute before pulling the trigger. This would especially be true for assets where there isn't a significant number of natural buyers and/or where other assets are also for sale. There are a number of UK banking assets that buyers will be able to choose from over the coming months and it is not clear to us that AIB's business would feature as the most attractive amongst the beauty parade of assets. Northern Rock, RBS, Lloyds and Bank of Ireland are all looking to dispose UK assets and buyers may be more interested in acquiring some of these rather than AIB's offering.

We believe that AIB's time constraint could put pressure on the potential valuation and that the bank should funnel its energy into ensuring two strong sales rather than trying to flog all of its major foreign assets in such a short time. We also believe that any buyer would factor in the cost of terming out the wholesale funding profile of AIB UK. When we calculate the potential drag from terming out the balance sheet, we believe it consumes 15% of current pre-provision profit (Pip).

Table 22 : Adjusted underlying Pip for AIB UK – 15% reduction

Termining out the funding base	2009
Net loans to customers	16,139
Funding:	
Customer deposits	10,573
>1 year wholesale	1,421
Total	11,994
Shortfall	4,145
Avg incremental cost to term out the shortfall (bps)	37
Avg incremental cost to term out the shortfall £m	52
Current Pip	348
Incremental cost as a % of Pip	15%
New Pip	296

Source: Company data, RBS

Using 2009 as our base, if we include the funding drag and adjust for normalised levels of bad debts and tax, we think AIB UK would struggle to cover the cost of its capital. This does not bode well for valuation, especially when one considers that the bank is already quite efficient and the scope for synergies is limited. The cost-to-income ratio is 38%, including our estimates of the funding drag and we believe it will be challenging to reduce this much further unless there is significant pick-up in revenues. We note that we have not taken into account any asset margin expansion nor have we assumed any benefit from rising interest rates. While margins have been rising rapidly on mortgages and unsecured credit in the UK, corporate spreads have not followed the same upward trajectory. As such, we prefer to take the view of a cautious buyer's and exclude asset margin uplift from our calculations. However, we note that to increase our current estimated return of 11% RoTCE to 15% or 20% (which is the range of return that we expect for UK banks in our coverage universe), revenues would have to rise 14% (£74m) or 24% (£178m) respectively.

Table 23 : Adjusted underlying RoTCE for AIB UK – struggle to cover a 12% CoE

£m	2009
Cost/income	38%
PiP	296
loan losses	- 81
PBT	215
tax	-61
PAT	154
Avg shareholders' equity	1,418
ROTCE	11%

Source: Company data, RBS

Any potential buyer would be required to fairly value both the assets and the liabilities on the balance sheet. We haven't completed the fair value adjustment for the entire balance sheet but we have looked at the loan book as this is likely to be the largest source of any potential adjustment. HBOS' loan book required a 3% fair value adjustment when it was acquired by Lloyds. Applying this same adjustment to AIB UK's loan book would mean a reduction of £0.5bn in the bank's shareholder equity. Given the fact that the coverage ratio (allowance for impaired loans/impaired loans) is not particularly strong at 43% for AIB UK (we calculate a lower coverage ratio of only 28% for the loans held for sale to NAMA) and that Lloyds was subsequently forced to take sizeable impairment losses on HBOS' loan book, we believe it is prudent to make a 5% adjustment to AIB UK's loan book. We also think it is prudent for any potential buyer to subtract the value of the pension liability from the purchase price. In short, we think any potential buyer would negotiate strongly for a purchase price not greater than €610m or 1x mark-to-market net assets.

Table 24 : Valuing the UK business

FV to HBOS loan book		FV to AIB loan book		2009	FV to AIB loan book	2009
Loans to Customers	473,966	Loans to Customers	16,139	Loans to Customers	16,139	
FV adjustment (£m)	-13,750	FV adjustment (£m)	468	FV adjustment (£m)	807	
FV adjustment (%)	2.9%	FV adjustment (%)	2.9%	FV adjustment (%)	5.0%	
		Shareholder's Equity	1,421	Shareholder's Equity	1,421	
		Deduct	-468	Deduct	-807	
		Adjusted Shareholder's Equity	953	Adjusted Shareholder's Equity	614	
		Adjust for pension deficit	-72	Adjust for pension deficit	-72	
		Adjusted Shareholder's Equity	881	Adjusted Shareholder's Equity	542	
		FX (EUR/GBP)	0.8881	FX (EUR/GBP)	0.8881	
		Converted to Euros	992	Converted to Euros	610	

Source: Company data, RBS estimates

Given the low price that we expect potential buyers to offer AIB for its UK business, we are of the opinion that it makes sense for AIB to retain the business. We see greater shareholder value through focusing on two rather than three key disposals in such a short time, in fixing the AIB UK balance sheet position and restructure the earnings profile to reverse-engineer its way into the 15-20% RoTCE over time.

Limited benefit to selling the Great Britain NAMA-bound assets

AIB has come to an agreement with NAMA and the regulator whereby it can review the quantum of UK-based NAMA loans that it will transfer should it successfully engineer the sale of AIB UK before the end of 2010. AIB highlighted that the quantum of loans transferring across to NAMA could fall by as much as €1.5bn if NAMA were to approve the sale of these UK-based assets to the buyer of AIB UK.

At first glance it might appear that if these loans were not to be transferred that AIB might benefit from a €397m (5%) reduction in its €7.4bn capital requirement. However, when we work through the numbers, we find that the benefit is limited to €166m. This is because although AIB does not have to take a 43% haircut on the assets or account for the discount on the NAMA subordinated bonds, the bank loses its deferred tax asset.

We also believe that any buyer would want a discount on the overall purchase price to account for a higher level of coverage against these assets. We have already included this in our estimates of a 5% fair value adjustment to AIB UK's loan book but we have broken out part of this against these assets for illustrative purposes.

Table 25 : The net benefit of selling the UK-based NAMA assets to a buyer is not as big as one might presume

€m	
Impact of UK asset sale (A)	
Save haircut	397
Loss of deferred tax asset (B)	
Tax rate (28.5%)	-113
Gain on sub bond not received from Irish regulator ('C)	15
Impact on retained earnings (A+B+C = D)	299
Assume buyer asks for a discount to net assets to absorb losses (E)	
Discount	10%
	-133
UK impaired loans held for sale to NAMA	749
o/w Northern Ireland	524
o/w Britain	225
UK Provisions as a % of impaired loans held for sale to NAMA	28%
o/w Northern Ireland	28%
o/w Britain	28%
NAMA haircut as a % of impaired loans held for sale to NAMA	168%
o/w Northern Ireland	152%
o/w Britain	204%
Provision post-discount paid for assets (D+E)	87%
Net capital gain to AIB from not selling UK loans to NAMA	166

Source: Company data, RBS estimates

Addressing the remainder of the capital shortfall

On our base case numbers, which exclude the sale of all assets outside of M&T and Bank Zachodni, AIB will be €3.5bn (or 47%) shy of its €7.4bn capital shortfall. Although AIB has stated its preference is to raise private capital before the end of this year to cover any shortfall not met through asset disposals, we think this will be challenging to execute in its entirety given that the shortfall equates to 3.2x the bank's current market capitalisation. As such, we believe it is likely that the government will provide a significant portion of the shortfall which will be funded through the conversion of its €3.5bn government preference shares.

Majority government ownership can be avoided on our numbers if: 1) the bank gets €3.9bn capital equivalent for its US and Polish assets; 2) 50% of the €3.5bn shortfall (€1.75bn or 1.6x current market capitalisation) is funded by private investors; and, 3) the government converts its preference shares at the current market price.

We believe it would be in AIB's best interests to buy back these warrants at the current market price as BOI intends to do upon conversion of some of its €3.5bn government preference shares. On our estimates it would cost AIB €163m to buy back the warrants. We walk through the details in a subsequent section.

Table 26 : AIB can avoid majority government ownership

€m	
Ord capital to be raised	3,500
Asset sales/other	3,900
Total capital raised	7,400
Current price (€)	1.20
# outstanding shares	1,098
Market Cap	1,318
New equity	3,500
% private	50%
% government	50%
New Shares	2,917
Rights price	1.20
Discount to current price	0.0%
TERP	1.20
Value of 1 right	-
# new shares/existing ord share	2.66
Value of right/existing sh	-
Ex Rights price	1.20
Govt stake	
-direct	42%
-indirect (via) warrants	7%
Total	49%

Source: Company data, RBS estimates

The full conversion of the government's €3.5bn preference shares at the current market price would result in a direct government stake of 78%. If the government warrants remain outstanding, the indirect stake would take government ownership to 85%.

BOI's recapitalisation plan

In our view, the government has clearly thrown its support behind Bank of Ireland, which is why we deem it as the 'chosen one'. We think the importance of this support should not be understated. We believe BOI will be successful in its €2.7bn capital raising attempt.

In the driver's seat

BOI has its problems but it is still in the strongest position amongst the NAMA-participating banks coming out of the PCAR. BOI's €2.7bn capital shortfall will be met by a combination of private capital investment and the conversion of government preference shares. As BOI intends to buy back the government warrants upon conversion of some of the €3.5bn of government preference shares, only 35% of the shortfall needs to be funded by private investors (at the current share price) to keep government ownership below 50%.

Table 27 : Majority government ownership will be avoided, in our view

BOI	€m	%
Private Capital	950	35%
Conversion of government preference shares	1,750	65%
	2,700	100%

Source: Company data, Financial Regulator, RBS estimates

We believe the finance minister made it clear in his 30 March Banks Statement that he expected BOI to be successful in its capital raising efforts. He clearly stated that he believed the bank had a strong future and that he expected the government investment to remain below 50% post-recapitalisation.

Table 28 : Government ownership in BOI likely to be kept below 50%

€m	
Ord capital to be raised	2,700
Asset sales/other	-
Total capital raised	2,700
Current price (€)	1.60
# outstanding shares	1,189
Market Cap	1,902
New equity	2,700
% private	35%
% government	65%
New Shares	1,688
Rights price	1.60
Discount to current price	0.0%
TERP	1.60
Value of 1 right	-
# new shares/existing ord share	1.42
Value of right/existing sh	-
Ex Rights price	1.60
Govt stake	
-direct	45%

Source: Company data, RBS estimates

Buying back the warrants

We had hoped that a restructuring of the warrants in conjunction with the preference share conversion would be part of the recapitalisation announcement. This proved to be true for BOI but not for AIB as things currently stand. This is a sensible and prudent move by the government as it removes the overhang of further government ownership.

We have factored into our estimated the €333m cost of buying back the government warrants at the current price. If AIB were able to negotiate similar terms with the government, this would cost the bank €163m.

Table 29 : BOI to spend €333m buying back the government's warrants, on our estimates

€m	AIB	BKIR
Warrants	294,252	334,737
Core	155,780	177,214
Secondary	138,471	157,523
Notional Value	353,102	535,579
Core	186,936	283,542
Secondary	166,166	252,037
Strike		
Core	0.975	0.520
Secondary	0.375	0.200
Vol	25%	25%
% Intrinsic		
Core	19%	68%
Secondary	69%	88%
% Option Price		
Core	48%	76%
Secondary	77%	91%
% Put Value		
Core	29%	9%
Secondary	8%	3%
Warrant Adjust	0.75	0.75
Cash Value	163,118	333,067
Core	67,157	161,619
Secondary	95,961	171,448

Source: Company data, Bloomberg, RBS estimates

Beyond NAMA: A look at AIB and BOI

We believe non-NAMA loan losses have peaked, that margins will trough in 2010 and that both banks will return to profitability in 2011. Although the ships are being turned around, we expect RoTCE to struggle to exceed CoE until 2012-13.

We believe the banks will be profitable in 2011

The banks are guiding to a challenging operating environment for 2010 and we have no doubt that it will be. This is a transformational year for the two banks. Managing the NAMA transfer process, raising the requisite capital before the end of the year, running the underlying business and managing the balance sheet make-over will be challenging task. But light is at the end of the tunnel, in our view. We now expect the banks to return to profit in 2011. We believe this will primarily be driven by lower loan losses on non-NAMA assets. However, we also anticipate rising margins and stringent cost controls to bolster pre-impairment profits.

We estimate non-NAMA loan losses peaked in 2009

In looking at the cumulative losses that we expect from the beginning of January 2008 (March 2008 for BOI) through to December 2011, we believe that we have adequately provided for the losses on the UK and Irish loan books for both banks. On our numbers, we expect AIB and BOI to write off 9.9% and 8.2% of their 2007 YE loan books. This double-digit cumulative loss expectation is supplemented by the expectation of a transition back to more normalised levels of impairments by 2012F and 2013F.

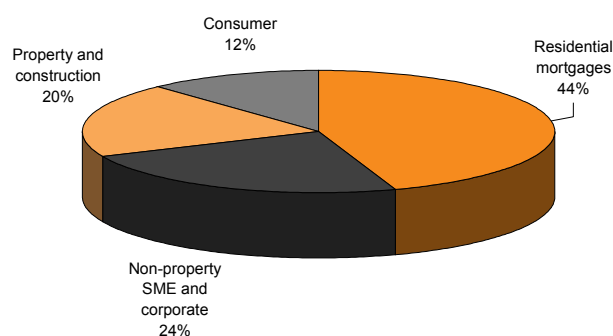
Table 30 : Cumulative losses

BOI	€m	Bps
Residential mortgages	1,006	166
- Ireland	698	262
- United Kingdom	308	90
Non-property SME and corporate	2,140	669
Property and construction	7,179	2,101
Consumer	821	872
Total	12,152	818
AIB	€m	Bps
Residential mortgages	336	137
Non-property SME and corporate	3,042	681
Property and construction	10,549	2,426
Consumer	1,051	1,135
CEE	334	488
Total	12,698	987

Source: Company data, RBS forecasts

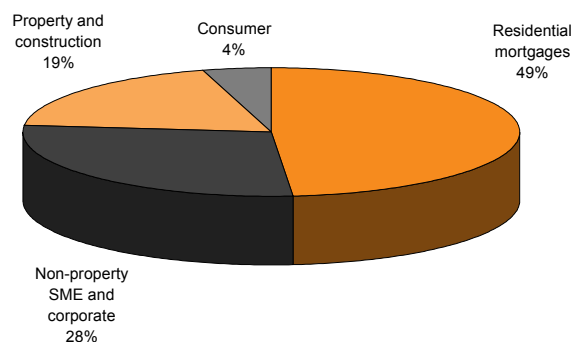
Our loan loss expectations for 2011-13 take into account the new profile of both banks' loan book post-NAMA. However, they account for our belief that 'normalised' loan losses will be above pre-crisis levels. We note that counter-cyclical provisioning is a regulatory risk. However, it does not form part of our base case at this stage.

Chart 3 : AIB post-NAMA loan book composition (FY10F)



Source: Company, RBS forecasts

Chart 4 : BOI post-NAMA loan book composition (FY10F)



Source: Company, RBS forecasts

The main difference between the two loan banks will mainly be geography as AIB does not have a mortgage book in the UK whereas 54% of BOI's overall mortgage book is UK-based. BOI's UK book is in run-off which although slow, implies that both AIB and BOI are retrenching back to Ireland as their main source of income and growth.

Margins to rise towards 2007 levels

We found it challenging to be enthusiastic about the potential pre-provision profit profile of the two banks a few months ago, given the difficulty in raising asset spreads in their domestic market. Aside from the lack of volume which has prevented widening new business spreads from having any material impact, there were two parts to this problem. One is structural while the other is behavioural. Firstly, approximately 60% of all of the major Irish banks' residential mortgage books consist of tracker mortgages. These mortgages cannot be re-priced. Secondly, Ireland is a relatively small country and the prospect of public outcry over rising margins prevented AIB and BOI from following Irish Life & Permanent's lead last fall. Irish Life and Permanent needs to increase the spreads on its SVR mortgages and re-priced its back book by 50bp.

Both AIB and BOI CEOs made it abundantly clear that asset spreads had to go up for the banks to draw a line under the downward pressure from rising funding costs and the effects of operating in a low-interest rate environment.

Last week, AIB raised its SVR by 50bp and also increased its fixed-rate mortgages. We expect a similar announcement from the Bank of Ireland in due course.

Previously we had expected depressed margins as the banks continued to be relatively inactive on this front. However, we have now incorporated rising spreads on most products. We do not factor in any changes to the portion of the book in tracker mortgages. To be conservative, we assume it takes the back book six years to fully reflect the increase in spreads. On this basis, the asset margin should widen by 10bp and 8bp on average per annum for BOI and AIB, respectively. We also incorporate increased funding costs. We assume the banks issue a combination of RMBS, senior secured and unsecured to arrive at a blended cost of 4bp and 8bp per annum for BOI and AIB.

Table 31 : Margins to rise to towards 2007 levels

	2004	2005	2006	2007	2008	2009	9M	2010F	2011F	2012F	2013F
AIB	2.45	2.38	2.26	2.14	2.22	1.92		1.81	1.84	1.93	2.07
BOI	2.16	2.00	1.79	1.77	1.86	2.07	1.69	1.59	1.68	1.71	1.78

Source: Company data, RBS forecasts

We believe that once the banks are able to wean themselves off of the government guarantees and issue unguaranteed debt at more palatable spread levels, the equity markets will start to be more comfortable with the potential ongoing cost of a more balanced funding profile.

Balance sheet structure transformed

Both AIB and BOI were heavily reliant on wholesale funding during the 'boom' years. However, their participation in NAMA should materially improve their balance sheet structures. We expect the loan-to-deposit ratio at AIB and BOI to reduce to 121% and 129% in 2013F respectively. This is a marked improvement from the peak ratios in 2007 of 157% for AIB and 173% for BOI.

Table 32 : AIB's funded asset profile

€m	2008	2009	2010F	2011F	2012F	2013F
Total funded assets	174,072	167,461	169,949	159,137	160,811	162,501
€m	2008	2009	2010	2011	2012	2013
Group Deposits	92,604	89,975	90,875	81,344	82,157	82,979
Wholesale < 1 yr	53,285	45,652	40,154	40,123	45,446	49,129
Wholesale > 1 yr	24,302	30,779	28,559	26,684	21,452	17,625
Conservative TCE	7,698	6,221	10,361	10,985	11,755	12,768
Total funded assets	174,072	167,461	169,949	159,137	160,811	162,501
LDR	140%	115%	114%	122%	122%	121%
% of loan funded assets	74%	62%	61%	62%	62%	62%
% other funded assets	26%	38%	39%	38%	38%	38%
Deposits	53%	54%	53%	51%	51%	51%
Wholesale < 1 yr	31%	27%	24%	25%	28%	30%
Wholesale > 1 yr	14%	18%	17%	17%	13%	11%
Conservative TCE	4%	4%	6%	7%	7%	8%

Source: Company data, RBS forecasts

In examining the funding profile of both banks over the coming years, we do believe the banks need to shift a material amount of short term into long term funding. Indeed, we believe AIB has adequate short-term wholesale funding post-NAMA and that BOI needs to transition only €1bn more into long term to ensure that its loan book is 100% funded from customer deposits and wholesale funding greater than one year. Where we do believe the banks will need to do some repositioning is on the duration. Both banks have a sizeable amount of refinancing over the next couple of years due to the amount of debt issued under the government guarantee schemes and we believe this will need to be termed out. We have built in additional funding costs into our margin estimates to account for this.

Table 33 : BOI's funded asset profile

€m	2008*	2009**	2010F	2011F	2012F	2013F
Total funded assets	175,469	163,067	160,284	155,461	150,781	146,243
Customer deposits						
Deposits	83,119	84,812	84,988	85,634	86,287	86,946
Wholesale < 1 yr	56,947	41,047	39,469	36,702	33,187	28,924
Wholesale > 1 yr	31,014	31,695	32,746	29,555	27,205	25,642
Conservative TCE	2,706	2,266	3,082	3,569	4,103	4,730
Total funded assets	175,469	163,067	160,284	155,461	150,781	146,243
LDR	152%	139%	135%	132%	129%	129%
% of loan funded assets	76%	79%	73%	74%	75%	77%
% other funded assets	24%	21%	27%	26%	25%	23%
Deposits	47%	52%	53%	55%	57%	59%
Wholesale < 1 yr	32%	25%	25%	24%	22%	20%
Wholesale > 1 yr	18%	19%	20%	19%	18%	18%
Conservative TCE	2%	1%	2%	2%	3%	3%

*12M to Mar 09, **9M to Dec 09
Source: Company data, RBS forecasts

In addition, we believe that due to the deleveraging process achieved through the material capital injections later this year, AIB's Funded Assets/TCE ratio will reduce from its peak of 27x in 2009 to 13x by 2013F while BOI will reduce from a peak of 72x in the nine months ended December 2009 to 30x over the same period. The divergence occurs because of the magnitude of capital that AIB is raising this calendar year and our cautious estimates of BOI's de-leveraging process. BOI has outlined €46bn of non-core assets and although we have factored in some run-off of this portfolio we note that 34% (€16bn) of the non-core is UK self-certified and buy-to-let mortgages, which we believe will take some time to run down.

Equity capital positions vastly improved

As we have already demonstrated earlier in the note, the equity tier-1 ratios are expected to be higher than the current minimum requirement of 7% at the end of 2010 and we believe the Irish banks have enough capital to withstand severe stress. If there is not a severe stress event and our forecasts are directionally correct, the capital shortfall injections into AIB and BOI will materially assist the banks in coping with the Basel III proposals. As is demonstrated in the table below, the Irish banks did not screen well under the new proposals at the end of 2009 on a spot basis.

Table 34 : AIB common equity tier-1 ratio under Basel 3 proposals, our estimate (€m)

€m	FY09	FY10F	FY11F	FY12F	FY13F
Shareholder's equity (1)	10,709	10,750	11,374	12,144	13,157
<i>Goodwill and other intangibles</i>	-782	0	0	0	0
<i>Preference shares & other non equity interests</i>	-3,467	0	0	0	0
<i>Minority interest</i>	-389	-239	-239	-239	-239
<i>Net deferred tax assets</i>	-446	-1,437	-1,423	-1,408	-1,394
<i>Investment in own shares</i>	0	0	0	0	0
<i>Non bank consolidated investment</i>	-1,641	-328	-328	-328	-328
<i>Expected loss shortfall</i>	-2,850	-1,850	-1,100	-350	0
<i>Cashflow hedge reserve</i>	0	0	0	0	0
<i>Own debt gains/losses</i>	0	0	0	0	0
<i>Pension Fund Assets</i>	0	0	0	0	0
<i>Other adjustments</i>	0	0	0	0	0
Total adjustments (2)	-9,575	-3,854	-3,090	-2,326	-1,961
Common Equity Tier I (1+2)	1,134	6,896	8,284	9,819	11,196
Common Equity Tier 1 ratio (%)	0.94	6.97	8.83	10.57	11.88
RWAs	120,380	98,983	93,810	92,893	94,245

Source: Company data, RBS forecasts

However, as time progresses, we now believe AIB is in a winning position under Basel III even if it does not address its pension deficit. The same cannot be said of BOI, however. Although the bank is close to the 6% minimum that is envisaged under Basel III (we are of the opinion that the core tier capital minimums are likely to be 6-8%), it still screens towards the bottom end of our banking universe. There are a number of levers that the bank can pull between now and 2013. We note that the bank is committed to addressing its pension deficit and this may be the most obvious way to close the gap in between our best-guess of the minimum core tier-1 ratio in a Basel III world. The bank may also benefit from running down its non-core assets faster than we expect. Although this would dampen revenue, it would help the bank contain its RWA growth.

Table 35 : BOI common equity tier-1 ratio under Basel 3 proposals, our estimate (€m)

	FY09	FY10F	FY11F	FY12F	FY13F
Shareholder's equity (1)	6,387	7,203	7,690	8,224	8,851
Goodwill and other intangibles	-507	-507	-507	-507	-507
Preference shares & other non equity interests	-3,521	-1,771	-1,771	-1,771	-1,771
Minority interest	-114	-114	-114	-114	-114
Net deferred tax assets	-341	-1,416	-1,420	-1,424	-1,428
Investment in own shares	0	0	0	0	0
Non bank consolidated investment	-797	-797	-797	-797	-797
Expected loss shortfall	-708	-533	-358	-183	0
Cashflow hedge reserve	510	510	510	510	510
Own debt gains/losses	0	0	0	0	0
Pension Fund Assets	0	0	0	0	0
Other adjustments	26	26	26	26	26
Total adjustments (2)	-5,452	-4,602	-4,431	-4,260	-4,081
Common Equity Tier I (1+2)	935	2,601	3,259	3,964	4,770
Common Equity Tier 1 ratio (%)	0.95	3.03	3.78	4.65	5.58
RWAs	98,333	85,861	86,152	85,182	85,551

Source: Company data, RBS estimates

Dividends to return in 2012F

The EU Commission has imposed a dividend restriction on both banks relating to the payment of tier-1 and Upper tier-2 capital instruments during its assessment of the two banks' restructuring plans, and the restrictions still apply. The banks can only pay dividends where there is binding legal obligation to do so and the "dividend stopper" is currently in place for a year. We believe that the EU Commission may impose dividend restrictions for a year or two more. This would be in line with the rulings of other banks in receipt of material state aid. As such, we have assumed that no dividends will be paid on such instruments or to ordinary common equity shareholders until 2012. We believe the non-payment of dividends and retention of own funds is also prudent pending the outcome of the current Basel III proposals.

Table 36 : Dividends for both banks to resume in 2012F, in our view

	FY10F	FY11F	FY12F	FY13F
AIB				
DPS ('c)	0.0	0.0	8.0	10.7
Payout ratio (%)	0%	0%	30%	30%
Coverage (x)	0.0	0.0	3.3	3.3
BOI				
DPS ('c)	0.0	0.0	6.9	8.4
Payout ratio (%)	0%	0%	30%	30%
Coverage (x)	0.0	0.0	3.3	3.3

Source: Company data, RBS forecasts

BOI emerges as the stronger RoTCE generator

On our numbers, BOI will generate an RoTCE ahead of its CoE by 2012. We expect the RoTCE at AIB to remain below the CoE until 2013F when the bank will achieve its cost of capital. Due to the material deleveraging of AIB's balance sheet, it is more challenging for AIB to generate superior returns. Over time, AIB may put the excess capital to work. However, for now, we assume the bank re-invests the capital at the risk-free rate of return.

Table 37 : BOI to achieve RoTCE ahead of CoE in 2012F

RoTCE	FY10F	FY11F	FY12F	FY13F
AIB	-32.87%	5.46%	9.41%	11.73%
BOI	-138.78%	12.20%	18.04%	19.49%

Source: Company data, RBS forecasts

Summary P&L

Our forecasts for both banks are included below.

Table 38 : AIB Summary P&L

Year ending 31st December	2009	2010F	2011F	2012F	2013F
NET INTEREST INCOME	3,233.0	2,791.4	2,738.1	2,830.6	3,039.8
TOTAL NON-INTEREST INCOME	1,626.0	1,381.3	754.7	789.0	835.9
OPERATING INCOME	4,859.0	4,172.6	3,492.8	3,619.6	3,875.7
TOTAL U/L INCOME	4,236.0	3,824.6	3,492.8	3,619.6	3,875.7
Total Expenses	(1,897.0)	(1,731.3)	(1,426.9)	(1,478.6)	(1,585.9)
TOTAL U/L EXPENSES	(1,897.0)	(1,731.3)	(1,426.9)	(1,478.6)	(1,585.9)
TOTAL Pre-Provision Profit	2,962.0	2,441.4	2,065.9	2,141.0	2,289.8
TOTAL U/L PRE-PROVISION PROFIT	2,339.0	2,093.4	2,065.9	2,141.0	2,289.8
Provisions for impairment of loans and receivables	(5,355.0)	(6,841.8)	(1,375.9)	(894.6)	(622.4)
Provisions for liabilities and commitments	(1.0)	(1.0)	0.0	0.0	0.0
Amounts written off financial investments	(24.0)	(24.0)	(24.0)	(24.0)	(24.0)
OPERATING PROFIT	(2,418.0)	(4,425.5)	666.0	1,222.4	1,643.4
TOTAL U/L OPERATING PROFIT	(3,041.0)	(4,773.5)	666.0	1,222.4	1,643.4
Share of results of associated undertakings	(262.0)	(12.0)	(3.0)	(3.0)	(3.0)
Share of restructuring costs in assoc. undertakings	0.0				
Amortisation of goodwill on acquis. Of assoc. undertakings	0.0				
Profit on disposal of property	23.0	2.0	2.0	2.0	2.0
Construction contract income	1.0	1.0	1.0	1.0	1.0
Profit/loss on disposal of businesses	0.0				
PROFIT ON ORDINARY ACTIVITIES BEFORE TAX	(2,656.0)	(4,434.5)	666.0	1,222.4	1,643.4
TOTAL U/L PBT	(3,279.0)	(4,782.5)	666.0	1,222.4	1,643.4

Source: Company data, RBS forecasts

Table 39 : BOI Summary P&L

Income Statement	March 2009	December 9m 2009/10F	December 2010F	December 2011F	December 2012F	December 2013F
NET INTEREST INCOME	3,670.0	2,179.0	2,495.1	2,519.4	2,565.2	2,632.2
Other operating income	73.0	31.0	31.0	31.0	31.0	31.0
Exceptional Income/Profit on disposal of business activity	0.0	1,037.0	(54.0)	0.0	0.0	0.0
TOTAL NON-INTEREST INCOME	(250.0)	2,882.0	434.5	487.6	504.6	520.6
TOTAL OPERATING INCOME	3,420.0	5,061.0	2,929.6	3,007.0	3,069.8	3,152.8
TOTAL U/L INCOME	3,420.0	4,024.0	2,983.6	3,007.0	3,069.8	3,152.8
Increase in insurance contract liabilities and claims paid	537.0	(1,462.0)	0.0	0.0	0.0	0.0
TOTAL OPERATING INCOME, NET OF INSURANCE CLAIMS	3,957.0	3,599.0	2,929.6	3,007.0	3,069.8	3,152.8
TOTAL U/L INCOME	3,957.0	2,562.0	2,983.6	3,007.0	3,069.8	3,152.8
Total costs	(2,425.0)	(1,381.0)	(1,874.6)	(1,699.5)	(1,686.1)	(1,699.0)
TOTAL U/L EXPENSES	(2,121.0)	(1,381.0)	(1,808.6)	(1,633.5)	(1,620.1)	(1,633.0)
TOTAL Pre-Provision Profit	1,532.0	2,218.0	1,055.0	1,307.5	1,383.7	1,453.8
TOTAL U/L PRE-PROVISION PROFIT	1,836.0	1,181.0	1,175.0	1,373.5	1,449.7	1,519.8
Impairment Losses	(1,513.0)	(4,057.0)	(3,349.6)	(945.6)	(586.1)	(456.4)
OPERATING PROFIT	19.0	(1,839.0)	(2,294.6)	361.9	797.7	997.4
TOTAL U/L OPERATING PROFIT	323.0	(2,876.0)	(2,174.6)	427.9	863.7	1,063.4
Profit on Disposal of Business	0.0	(3.0)	(6.0)	(6.0)	(6.0)	(6.0)
Share of Profit of associated undertakings and joint ventures	(42.0)	35.0	42.0	42.0	42.0	42.0
Other		(6.0)	0.0	0.0	0.0	0.0
PROFIT ON ORDINARY ACTIVITIES BEFORE TAX	(23.0)	(1,813.0)	(2,258.6)	397.9	833.7	1,033.4
TOTAL U/L PBT	281.0	(2,850.0)	(2,138.6)	463.9	899.7	1,099.4

Source: Company data, RBS forecasts

Sovereign view: positive on Irish spreads

RBS Euro Rates analyst Harvinder Sian highlights details of the first tranche of the NAMA bank reform and outlook for debt dynamics. His conclusion remains that notable spread compression is likely in this year and beyond.

Buy bad loans to clean the banks and then recapitalise

A key element of any banking crisis is the clean-up process of bad loans and institutions. Ireland has been discussing its solution via NAMA since mid-2009, with the agency formally established in December 2009. The idea behind NAMA is that bad loans will be bought by the sovereign at a discount (hair-cut to face value) and the banking system will be recapitalised with a combination of private and public funds. The details that emerged last week were the terms of the initial NAMA loan transfer, the bank recapitalisation needs and targets for core capital.

Technical considerations

The NAMA bonds that will be exchanged for bank loans can be used as eligible collateral at the ECB. We anticipate that a large part of the cash raised from Irish institutions' ECB refinancing operations will then be recycled into the government bonds markets and most likely into IRISH paper. The NAMA bonds cannot be sold into the market and so will not cannibalise demand for Irish sovereign paper.

Issuance risk: very limited

The impact on state finances from the capital needs of the financial system look muted, given the recourse to private monies and conversion of preference shares. The NTMA has clarified that it envisages no change to its plan of raising €20bn in bonds this year, of which €10.2bn has already been raised. It adds that if any government capital is required for Bank of Ireland or AIB it will be provided to the extent required from the National Pensions Reserve Fund (NPRF) by way of the conversion into equity in the first instance of the preference shares the Fund holds in both banks. The NPRF holds €3.5bn of preference shares in each of these banks.

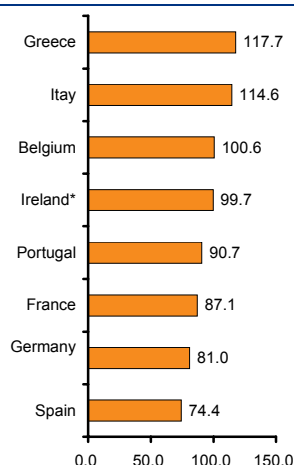
We always thought that the upfront issuance need for the Irish exchequer was limited anyway by virtue of two factors. Firstly, the state holds €24bn in cash balances (a significant 17% of GDP) and, secondly, there is €4bn in this year's overfunding anyway. We think the overfunding could be more notable because of demand for IRISH paper, in part because the new primary dealers are all pushing for market share.

It's all about public plus private sector liabilities

Ireland was priced at a high default risk last year, as the market aggregated the private and public sector liabilities and concluded that the economy really was not that different to Iceland. At that juncture, we thought EU policymaker intervention was needed to prevent default – and that is exactly what Ireland and other EMU countries got via access to the ECB balance sheet. This was the turning point, as it bought Ireland time, which was subsequently used well in a series of austere budgets that had a heavy expenditure-cutting agenda that not only made the debt consolidation look more plausible but also helped to alleviate concerns on intra-EMU competitiveness, given the public sector wage-cut components. At the same time, NAMA was intended to be a clean-up of the banking system via a purchase of bad loans at a hair-cut, but not at market prices.

The fact that the haircuts on the initial loan transfers are more aggressive than assumed a couple of weeks ago makes no difference to our view on IRISH bond valuations because it merely requires on the other side of the coin that the capital needs of the system are higher. Either way, there must be a risk and resource transfer from the private sector to the state (which was already assumed by the bond markets), and the announcement last week provides colour to how this is split. The idea that NAMA hangs on to these loans over 10 years is part of the solution.

Chart 5 : Debt/GDP in 2012F, with Irish data adjusted for NAMA and cash balances



Source: RBS forecasts, EIU

Valuations remain compelling

The net result is that we remain very constructive in our view on IRISH bond valuations. The NAMA loan transfers finally get the ball rolling on a Nordic style (early 1990s) financial system clean-up, which is necessary for Ireland's long-term economic health. The fact that this has limited implications for NTMA borrowing is tactically positive. The bigger picture, in our view, is that Irish paper has significant value because default risk has been tempered by the ECB balance sheet (admittedly a 2009 story but still a relevant observation) and, most importantly, via solid government budget action.

For instance, there is the simple but very powerful message from a macro value screener. At the heart of any calculation is debt sustainability and here the institutions in any country are important and, as detailed in the box on the previous page, the budget reform in Ireland (see highlighted panel below) has been impressive on several levels ranging from swinging budget cuts in primary spending that the consensus could barely believe to enhancements in competitiveness.

In terms of debt sustainability these reforms should give the market confidence but markets do not need to make a leap of faith. The table below details the debt/GDP trajectories for some EMU countries. Accordingly, to these projections, Ireland's debt/GDP level will be 83.9% in 2012. This number does not however include off-balance sheet items such as NAMA. If we add NAMA to the Irish sovereign balance sheet – as we think is necessary to truly assess risk (i.e. public + private liabilities) – then this debt burden jumps to 116.7% vs Italy's 114.6% in 2012. This is *still not* the correct calculation for net debt. Instead, we must now also deduct the vast amount of cash the state has in its coffers, presumably for precautionary purposes. Netting this out shows that Irish debt levels in 2012 will be materially below Italy's and just under Belgium's.

The bond markets are still fighting the last war, given that the IRISH/BTP 10y spread is some +65 bp. We expect this spread to push towards zero this year.

Longer term, the view remains that Ireland will be the new Belgium – a high debt country, but one that has the institutions (cultural/political) to mean that the debt dynamics are manageable.

Table 40 : Comparing Irish debt trajectory to EMU benchmarks (data from Stability Pact targets)

	1999	2001	2008	2009	2010	2011	2012	2013	2014
Germany	60.9	58.8	65.9	72.5	76.5	79.5	81.0	82.0	
France	58.9	56.9	67.4	77.4	83.2	86.1	87.1	86.6	
Belgium	113.7	106.6	89.8	97.9	100.6	101.1	100.6		
Italy	113.7	109.2	105.8	115.1	116.9	116.5	114.6		
Spain	62.3	55.5	39.7	55.2	65.9	71.9	74.4	74.1	
Portugal	51.4	52.9	66.3	77.2	86.0	89.4	90.7	89.8	
Greece	100.3	102.9	99.2	113.4	120.4	120.6	117.7	113.4	
Ireland	48.5	35.6	44.1	64.5	77.9	82.9	83.9	83.3	80.8
<i>Ireland plus NAMA</i>	48.5	35.6	44.1	64.5	77.9	115.7	116.7	116.1	113.6
<i>Ireland plus NAMA minus cash balances</i>	48.5	35.6	44.1	64.5	77.9	98.7	99.7	99.1	96.6

Source: EC, RBS

Irish budget austerity and other reforms

- Large cuts in primary spending
- Keeping Irish corporate tax advantages
- Enhance intra-EMU competitiveness

The Irish 2010 budget was widely praised by EU partners and the European Commission but markets should also be interested in the fact that this was the 5th initiative to cut the deficit, a process which began in mid-2008, well before the Lehman crunch, and before consensus had re-priced Irish sovereign risks.

The cumulative austerity measures total € 8 bn, or a whopping 5% of 2010 GDP at a time when the cumulative 2008-10 fall in nominal GDP is estimated at -15.4% by the EC. Much of the budget austerity comes from primary spending cuts which tend to be much longer lasting than the tax revenue based fiscal consolidations.

This is why Belgium trades at tight levels despite a high debt/GDP burden and is one source of our view that Ireland is the new Belgium.

The outline of the budget plan for the coming years involves a further €3 bn of cuts in 2011 and a further €5bn or so in the subsequent three years. (Ireland has pledged to get the deficit below 3% by 2014.) While this is likely to be painful, it is a notable improvement of near €3 bn on a cumulative basis compared to the Apr-09 supplementary budget forecasts – with improvement largely on a lower unemployment peak than envisaged.

One of the key features of the reform is that Ireland has maintained its sovereignty on budget affairs (unlike Greece) and this is important because Germany/France would surely have required some rises in corporation tax. Instead, the low level of tax here remains a competitive advantage for the country.

Finally, given the deep cuts in public sector wages, Ireland has enhanced its ability to compete inside the EMU area at a time when the market is intently focused on structural issues within the Euro area.

Credit view: opportunities in LT2

RBS Financials Credit analyst Kristy Hajiloizou says the PCAR review provides a significant cushion for subordinated debt and senior. She sees a number of LT2 opportunities in BKIR and AIB.

The haircuts on the first tranche of NAMA loans transferred, coupled with the broader implications of the recapitalisation requirements for the Irish Banks generated a largely positive response to spreads. It felt like a relief rally on the back of a generally “as good as can be expected” outcome for the banks. Furthermore, strict capital requirements to comply with by the end of 2010 (8% core tier-1 and 7% equity tier-1 with a minimum core tier-1 of 4% to meet a stress scenario) means a good cushion of equity below the subordinated debt (LT2) and senior. Both CDS (although this is illiquid) and cash bond spreads tightened.

- Bank of Ireland is emerging as the pick of the bunch as it seems well positioned to escape government majority shareholding. It is looking attractive in the LT2 space, considering the yields on offer.
- Allied Irish will unlikely avoid a majority government stake. However, in terms of the debt, as with Bank of Ireland, the LT2 bonds are supported by the equity capital requirements and yields also look attractive.
- The Anglo Irish situation has a long way to play out and the outcome for subordinated bond holders still hangs on a bit of a thread. Winding up the bank is not an option. Instead a good/bad bank split with the senior debt moving to good bank and subordinated debt to the bad bank, has been proposed which requires EC approval. This is over a long time horizon, possibly five to seven years, as finance minister Brian Lenihan refers to this timeline for a private sale of the good bank. We consider an exchange of the LT2 bonds outstanding as feasible. For now, €8.3bn of capital in the form of a promissory note spread out over 10-15 years will provide a steady stream of capital beneath the LT2 and senior bonds.
- We believe the best solution for EBS would be a private sale (according to Lenihan, a buyer is interested) considering the much touted merger between EBS, Irish Nationwide and IL&P looks to be off the table with independent solutions drafted out for each one. With the government holding full economic interest in EBS (with a special investment share issue of €100m), the senior debt remains fully secure and the subordinated debt will likely see call restrictions but the coupons are mandatory. Possibility of a mutual capital instrument with loss absorption features or CoCo style exchange cannot be ruled out.
- Irish Nationwide will be taken under full government control. Subordinated debt is safe at least in the short term as government looks to secure a sale or merger within the next three months. A promissory note of €2.6bn is in place over 10-15 years. Possibility of a mutual capital instrument with loss absorption features or CoCo style exchange cannot be ruled out.

BKIR and AIB

Despite last week's announcements evidently illustrating Irish banks' clear fundamental weakness, the outcome leaves us constructive on the debt. Senior unsecured debt ranks pari passu with depositors and we have no fears of senior holders becoming disadvantaged versus deposit holders in Ireland. We are optimistic on LT2 bonds for both BKIR and AIB, for the following two reasons:

- A worst-case scenario for the LT2 bonds remains a finite period of call restrictions, with coupon payments remaining mandatory, which makes the bonds look attractive under current levels; and,
- New PCAR requirements of equity capital ratio of 7% of RWAs should generate a healthy cushion of new equity beneath the LT2.

Recommendations (ALL government guaranteed until 29 Sept 2010).

On a yield basis, we like the following high-coupon LT2s –

BKIR € 10% bullet 02/20s offered at cash px 111.0, yield 8.4%

AIB € 10.75% bullet 03/17s offered at cash px 108.75, yield 9%

AIB £12.5% bullet 06/19s offered at cash px 117.8, yield 9.3%

The LT2 FRNs look cheap on a cash basis. For example:-

BKIR € 01/17s callable 01/12 FRNs offered at cash px 72.5.

AIB € 10/17s callable 10/12 FRNs offered at cash px 72.

Anglo Irish

As evidenced by the outcome of last week's announcements, the Anglo Irish situation has a long way to play out and the eventual conclusion for subordinated bond holders still hangs on a bit of a thread. As a result, we would be cautious on holding any subordinated debt. Winding up the bank is not an option; this has been confirmed and this is good news for debt holders as a full and rapid liquidation would have been a worst-case scenario. This was reflected in the CDS spreads reaction coming in by 11-15 points from trading at 30 points upfront. Instead a good/bad bank split, with the senior debt moving to good bank and subordinated debt to the bad bank, has been proposed, which requires EC approval (see Table 41 below). The senior unsecured is safe in the good bank sitting securely with the deposits. However, leaving the subordinated debt in a wound-down entity is a net negative in any kind of restructuring. The implication from the information we have (which is not much) is that this will happen over a long time horizon, possibly five to seven years, as Lenihan referred to this timeline for a potential private sale of the good bank. A temporary approval of the recent €8.3bn recapitalisation has been given (EC notice on 31 March 10) but the EC has demanded an in-depth investigation on Anglo as it requires it to "restructure profoundly". The EC quite often temporarily approves support schemes, looks into it a bit more, then approves it months later. So, we are not concerned about that. All we know is there is still a long way to go for Anglo but, in theory, the temporary authorisation lasts until 22 June 2010. The government needs to submit a revised restructuring plan by end of May 2010, taking into account the recent recap. So, a final response from the EC will likely not come until at least end-June 2010, possibly closer to the end of summer. What this suggests is that there may be some scope for a change to the proposal but we envisage nothing material from what is currently indicated.

Table 41 : Anglo Irish proposed good/bad bank structure

	Good Bank "new bank"	Bad Bank "Old Anglo"
Function	"to support the Irish economy as part of a third banking force or standalone business bank"	"will be wound down"
What gets transferred	Deposits Senior Debt Investments and Loans not transferring to NAMA or remaining in Old Anglo	Legacy Issues Loans to former Directors Significantly impaired loans which did not transfer to NAMA Subordinated debt Nama bonds

Source: Anglo annual accounts

Possibility of an LT2 exchange

We consider an exchange of the LT2 bonds outstanding as feasible.

There is a statement in the annual accounts from which we can infer that Anglo is considering an LM exercise: "The emphasis in the new leadership structure on capital management is indicative of the importance of ongoing vigilance in all areas of balance sheet management and will become a mainstay of the Group's strategy going forward."

According to last week's published annual accounts there is in total €2.3bn of outstanding subordinated debt. A large proportion of the tier-1 and preference shares were exchanged last year realising a capital gain of €1.8bn. So the majority (about €1.6bn) of the €2.3bn is LT2 outstanding. I would envisage the focus of an exchange will be on the LT2 in line with both BKIR and AIB's exchanges earlier this year.

Table 42 : Anglo Irish Outstanding subordinated debt

Pricing Date	Issuer	Security type	Currency	Amt Issued (local CCY)	Amt Issued (Eur equiv)	Amount outstanding (Eur equiv)	Coupon	Maturity Date	Call Date	ISIN
16-Jun-04	Anglo Irish Bank Corp plc	LT2	EUR	750,000,000	750,000,000	361,705,000	FRN	25-Jun-14	25-Jun-10	XS0194937503
07-Jun-06	Anglo Irish Bank Corp plc	LT2	EUR	500,000,000	500,000,000	500,000,000	FRN	21-Jun-16	21-Jun-11	XS0257752013
05-Jun-07	Anglo Irish Bank Corp plc	LT2	EUR	750,000,000	750,000,000	750,000,000	FRN	19-Jun-17	19-Jun-12	XS0305277807
27-Sep-05	Anglo Irish Bank Corp plc	UT2	GBP	300,000,000	441,208,912	44,312,950	5.25	Perpetual	05-Oct-15	XS0231391623
19-Sep-06	Anglo Irish Capital (2) UK LP	Tier 1	EUR	600,000,000	600,000,000	74,759,000	5.219	Perpetual	29-Sep-16	XS0268814125
17-May-07	Anglo Irish Capital (3) UK LP	Prefs	GBP	350,000,000	511,284,786	6,331,390	6.949	Perpetual	01-Jun-17	XS0292425344
15-Jul-02	Anglo Irish Asset Finance	Tier 1	GBP	160,000,000	250,195,465	33,831,070	7.625	Perpetual	23-Jul-27	XS0151811253
12-Jun-01	Anglo Irish Asset Finance	Tier 1	GBP	200,000,000	322,658,708	21,481,300	8.5325	Perpetual	28-Jun-11	XS0131475666
21-Sep-04	Anglo Irish Capital Funding Ltd	Tier 1 (CMS linked)	EUR	600,000,000	600,000,000	196,753,000	n/a	Perpetual	30-Sep-10	XS0201790317
03-Jun-05	Lambay Capital Securities	Prefs	GBP	300,000,000	339,000,000	339,000,000	6.250	Perpetual	16-Jun-15	XS0220428154
Total Outstanding						2,328,173,710				

Source: Dealogic

If a full exchange for the entire subordinated debt outstanding was offered, it would, in our view, be the best outcome for both Anglo Irish and the sub-holders and the more convinced one is of the likelihood of an exchange of the LT2 (into a more palatable high-coupon bullet LT2 instrument for example) the more comfortable we can get with a long LT2 trade at current distressed levels (cash px offered at 33c for the callable 11s and 12s for example). For Anglo, a very approximate ball park capital gain on the LT2 outstanding could be €800m (based on an average cash px of 40c and an 85% take-up from investors) which although a drop in the ocean relative to total capital requirements, would be a tax-payer-friendly move. For investors it is the opportunity to switch out of a position which could see them disadvantaged in a managed wound-down situation in the bad bank. Senior bond holders should remain money good and, for now, while we await the eventual resolution of the good/bad bank structure, the subordinated debt holders can benefit from €8.3bn of capital in the form of a promissory note spread out over 10-15 years which will provide a steady stream of capital beneath the LT2 (and senior of course).

EBS and Irish Nationwide

The most favourable solution for EBS, in our view, would be a private sale (according to Lenihan, a buyer is interested) considering the much touted merger between EBS, Irish Nationwide and IL&P looks to be off the table with independent solutions drafted out for each one. With the government holding full economic interest in EBS, the senior unsecured debt remains fully secure and the subordinated debt will likely see call restrictions but the LT2 coupons are mandatory. Irish Nationwide has been taken under full government control but the subordinated debt is safe, at least in the short term as government looks to secure a sale or merger in the next three months. Promissory note of €2.6bn in place over 10-15 years. The government has until 22 June 2010 to submit a restructuring plan to the EC, in line with state aid policy.

Possibility of issue of a new mutual capital instrument with loss absorption features or a CoCo style exchange on the existing debt cannot be ruled out as alternative capital solutions for the mutuals in Ireland, if they follow the route of some of the UK building societies and Rabobank in the Netherlands. The basic features of a mutual CoCo would be very much similar to what Basel 3 proposes for the banking sector. Notes would count as core capital, rank pari passu with tier-1, be typically bond-like in behaviour; i.e coupon, perpetual, deferral options, possibly with a variable coupon rather than fixed, to factor in instances when society cannot afford coupon and of course principal loss-absorption capability.

We would stick to senior unsecured bonds in EBS and Irish Nationwide in particular as we are not convinced yet that these two banks will escape a managed winding-down like Anglo if the government does not secure a sale or merger of the whole bank.

7 April 2010

Produced by: The Royal Bank of Scotland N.V.

AIB Group

Bucking bronco

Change of recommendation

Buy (from Sell)

Target price
 €1.75 (from €0.70)

Price
 €1.20

Short term (0-60 days)
 n/a

Sector view
 Overweight

Price performance

	(1M)	(3M)	(12M)
Price (€)	1.00	1.20	0.71
Absolute (%)	20.0	0.0	67.8
Rel market (%)	14.9	-3.7	16.7
Rel sector (%)	15.5	1.2	3.5


Market capitalisation
 €1.06bn

Average (12M) daily turnover
 €7.37m

 Market: FTSE Eurotop 300 Index
 RIC: ALBK.I, ALBK ID
 Priced €1.20 at close 1 Apr 2010.
 Source: Bloomberg

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We believe that the current implied execution risk associated with AIB's planned asset disposals is too penal. A 'de-risked' AIB, earning a CoE of 12% in 2013F, should trade at 1x p/TCE for 2013F discounted back to today, in our view. We upgrade from Sell to Buy.

Key forecasts

	FY08A	FY09A	FY10F	FY11F	FY12F
Reported PBT (€m)	1,034	-2,656	-4,434 ▼	666 ▲	1,222 ▲
Reported net profit (€m)	772	-2,413	-67.6 ▲	559.2 ▲	1,026 ▲
Reported EPS (€)	0.88	-2.11	-0.02 ▲	0.13 ▲	0.24 ▲
Normalised EPS (€)	0.88	-2.65	-1.47 ▼	0.13 ▲	0.24 ▲
Dividend per share (€)	0.31	0	0	0	0.08 ▼
Normalised PE (x)	1.37	n/m	n/m	9.25	5.04
Price/book value (x)	0.12	0.19	0.48	0.45	0.43
Dividend yield (%)	25.6	0.26	0	0	-6.66
Return on avg equity (%)	8.2	-37.5	-44.7	5.2 ▲	9.02 ▲

Use of ▲ ▼ indicates that the line item has changed by at least 5%.
 Accounting standard: IFRS
 Source: Company data, RBS forecasts

year to Dec, fully diluted

We acknowledge that AIB has been given a tall order to execute by the end of 2010

AIB needs to raise €7.4bn (7x current market capitalisation) before YE10. The bank has put forward a plan that we do not believe will be executed in full. Although the bank intends to sell its UK, Polish and US assets to fund most of its capital requirement, we assume only the US and Polish assets will be divested. These two disposals should generate €3.9bn, on our estimates. The €3.5bn shortfall should be met by a combination of private and government investment. If our estimated shortfall is 100% funded through conversion of government preference shares, government ownership would rise to 78%.

But AIB will be positively transformed on the back of the capital injection and NAMA

Our previous concerns stemmed from a lack of adequate capital, materially high impairment losses, a lack of momentum on the margin, as well as a high degree of uncertainty as to how the bank's participation in NAMA might affect the group. With most of these concerns now addressed, we view AIB as being substantially 'de-risked'. This should give the market the confidence it needs to invest in the bank, in our view. We have stress tested the bank post-capital raising and believe it could absorb another €6.6bn of losses, which equates to writing off a further 5% of the bank's loan book (current expectation is a three-year cumulative 10% write-off) before the share count would be at risk of increasing further.

We believe the current 50% discount is unwarranted and we move from Sell to Buy

Taking the €7.4bn capital raising into account (previously assumed to be €5.3bn), we estimate the bank is currently trading at a 46% discount to its fair value. On our numbers, AIB's RoTCE will meet its CoE of 12% in 2013. While this level of return is unexciting, the current share price implies that RoTCE is likely to be 8% and/or that the discount rate to compensate investors for the execution risk associated with the asset disposals is 25%. Given our expectation of €3.9bn in capital via asset disposals, we believe the current level of discount is unwarranted. We arrive at our new TP by applying 1.0x p/TCE to our 2013F TCE of €2.96 (previously we used a 2010F TCE). We discount this back to today at 14% (vs normalised 12%) to account for execution risk related to the €7.4bn capital raising. On this basis, we believe the shares will re-rate to €1.75. We upgrade from Sell to Buy.

Important disclosures can be found in the Disclosures Appendix.

Income statement

€m	FY08A	FY09A	FY10F	FY11F	FY12F
Net interest income	3867	3233	2791	2738	2831
Non-interest income	1201	1003	1033	754.7	789.0
Total income	5068	4236	3825	3493	3620
Operating costs	-2357	-1897	-1731	-1427	-1479
Goodwill (amort/impaired)	n/a	n/a	n/a	n/a	n/a
Other costs	0.00	0.00	0.00	0.00	0.00
<u>Pre-prov operating profit</u>	<u>2711</u>	<u>2339</u>	<u>2093</u>	<u>2066</u>	<u>2141</u>
Provisions charges	-1849	-5380	-6867	-1400	-918.6
<u>Operating PBT</u>	<u>862.0</u>	<u>-3041</u>	<u>-4773</u>	<u>666.0</u>	<u>1222</u>
Associates (pre-tax)	42.0	-262.0	-12.0	-3.00	-3.00
Other pre-tax items	130.0	647.0	351.0	3.00	3.00
Reported PBT	1034	-2656	-4434	666.0	1222
Taxation	-144.0	322.0	766.9	-106.8	-196.0
Minority interests	-118.0	-79.0	0.00	0.00	0.00
Preference dividends	n/a	n/a	n/a	n/a	n/a
Other post-tax items	0.00	0.00	3600	0.00	0.00
Reported net profit	772.0	-2413	-67.6	559.2	1026
Tot normalised items	0.00	623.0	3948	0.00	0.00
Normalised PTP	1034	-3279	-4782	666.0	1222
Normalised net profit	772.0	-3036	-4016	559.2	1026

Source: Company data, RBS forecasts

year to Dec

Balance sheet

€m	FY08A	FY09A	FY10F	FY11F	FY12F
Net loans to customers	129489	103341	103856	99133	100034
Other int earn assets	35691	34725	47835	47357	46883
Goodwill	774.0	782.0	0.00	0.00	0.00
Oth non-int earn assets	16220	35466	24329	27770	25599
Total assets	182174	174314	176020	174260	172517
Total customer deposits	92604	83953	90875	81344	82157
Oth int-bearing liabs	67918	68573	68619	67933	67253
Non int-bearing liab	11339	10453	5147	12944	10252
Total liabilities	171861	162979	164641	162221	159663
Share capital	8472	6820	10361	10985	11755
Reserves	0.00	0.00	0.00	0.00	0.00
Total equity (excl min)	8969	10709	10750	11374	12144
Minority interests	1344	626.0	628.4	664.9	709.9
Total liab & sh equity	182174	174314	176020	174260	172517
Risk weighted assets	133899	120000	98983	93810	92893
Est non-perf loans	n/a	n/a	n/a	n/a	n/a
Specific provisions	n/a	n/a	n/a	n/a	n/a
General provisions	n/a	n/a	n/a	n/a	n/a

Source: Company data, RBS forecasts

year ended Dec

Capital

€m	FY08A	FY09A	FY10F	FY11F	FY12F
Risk weighted assets	133899	120000	98983	93810	92893
Reported net profit	772.0	-2413	-67.6	559.2	1026
Opening risk assets	134091	133899	120000	98983	93810
Closing risk assets	133899	120000	98983	93810	92893
Change in risk assets	-192.0	-13899	-21017	-5174	-916.1
Capital required	0.00	0.00	0.00	0.00	0.00
Free capital flow	772.0	-2413	-67.6	559.2	1026
Ordinary dividend paid	-270.0	-270.0	0.00	0.00	-320.9
Share buy back/spec div	n/a	n/a	n/a	n/a	n/a
Equity / preference issue	n/a	n/a	n/a	n/a	n/a
Cash flow from financing	-270.0	-270.0	0.00	0.00	-320.9
Net capital flow	502.0	-2683	-67.6	559.2	705.5
Tier 1 capital	9937	8670	8622	9246	10016
Tier 1 capital ratio (%)	7.42	7.22	8.71	9.86	10.8

Lines in bold can be derived from the immediately preceding lines.

Source: Company data, RBS forecasts

year to Dec

7 April 2010

Produced by: The Royal Bank of Scotland N.V.

Bank of Ireland

The chosen one

Change of recommendation

Hold (from Sell)

Target price
€1.70 (from €0.52)

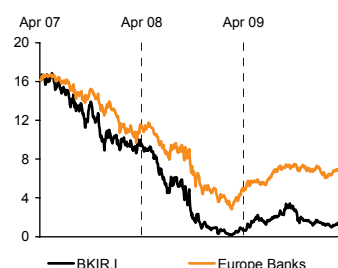
Price
€1.60

Short term (0-60 days)
n/a

Sector view
Overweight

Price performance

	(1M)	(3M)	(12M)
Price (€)	0.98	1.33	0.58
Absolute (%)	63.8	20.8	175.9
Rel market (%)	52.6	15.4	87.9
Rel sector (%)	48.1	17.9	57.2


Market capitalisation
€1.90bn

Average (12M) daily turnover
€9.91m

 RIC: BKIR.I, BKIR ID
 Priced €1.60 at close 1 Apr 2010.
 Source: Bloomberg

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Key forecasts

	FY09A	FY10F	FY11F	FY12F
Reported PBT (€m)	-1,813	-2,259	397.9	833.7
Reported net profit (€m)	-1,674	-2,036	335.1	608.7
Reported EPS (€)	-1.33	-1.62	0.12	0.21
Normalised EPS (€)	-2.97	-1.50	0.16	0.26
Dividend per share (€)	0.00	0.00	0.00	-0.07
Normalised PE (x)	n/m	n/m	9.75	6.06
Price/book value (x)	0.36	0.64	0.60	0.56
Dividend yield (%)	0.00	0.00	0.00	-4.52
Return on avg equity (%)	0.00	0.00	0.00	0.00

 Accounting standard: IFRS
 Source: Company data, RBS forecasts

year to Dec, fully diluted

Bank of Ireland has been given an official seal of approval, in our view

We believe Bank of Ireland has the privilege of being the Irish government's choice for survival. This significance of this should not be underestimated, especially when most of its peers appear destined for majority or complete government ownership. The Irish government is confident that its ownership level will remain below 50% and that BOI has a successful future in front of it. We expect BOI to raise enough private capital in order to fulfil the government's prophecy. On our numbers, only 35% of the €2.7bn capital requirement needs to come from private investors to prevent a majority government shareholding in the bank.

Normalised 19% RoTCE is the strongest amongst our Irish banking universe

On our estimates, BOI will generate an RoTCE of 19% by 2013 and be the only Irish bank in our coverage universe to generate an RoTCE ahead of its CoE in 2012. This should primarily be driven by margin expansion and normalised bad debt impairments. We expect margins to return to 2007 levels by 2013, and our numbers incorporate both widening asset spreads and incremental funding costs as the bank terms out the duration of its liabilities. Our bad debt impairment estimates come down substantially from peak 2009 levels to reflect the recovering Irish economy and the cleansing of the toxic loans offloaded in 2010 to NAMA.

However, the current share price already seems to reflect this level of return

We believe BOI's 19% RoTCE against a CoE of 12% deserves a valuation of 1.6x P/TCE. However, given the execution risk involved over the next eight months as NAMA-participating banks address the aggregate capital shortfall of €22bn-32bn that must be closed by YE10, we use 13% as our discount rate. The 2013F TCE/per share is €1.67. Applying 1.6x P/TCE (previously 1x 2010F TCE) and discounting this back to today at 13% results in our new €1.7 target price. Our view is that in order to turn more positive on the shares at these levels, we would have to believe that RoTCE may exceed our 19% expectation. We prefer to Buy AIB, where the shares trade at a material discount to our 2013 TCE expectations.

Important disclosures can be found in the Disclosures Appendix.

Income statement

€m	FY09A	FY10F	FY11F	FY12F
Net interest income	2179	2495	2519	2565
Non-interest income	2882	434.5	487.6	504.6
Total income	5061	2930	3007	3070
Operating costs	-2843	-1875	-1700	-1686
Goodwill (amort/impaired)	n/a	n/a	n/a	n/a
Other costs	0.00	0.00	0.00	0.00
<u>Pre-prov operating profit</u>	2218	1055	1307	1384
Provisions charges	-4057	-3350	-945.6	-586.1
<u>Operating PBT</u>	-1839	-2295	361.9	797.7
Associates (pre-tax)	35.0	42.0	42.0	42.0
Other pre-tax items	-9.00	-6.00	-6.00	-6.00
Reported PBT	-1813	-2259	397.9	833.7
Taxation	344.0	356.5	-62.8	-131.6
Minority interests	-205.0	-134.0	0.00	-93.3
Preference dividends	n/a	n/a	n/a	n/a
Other post-tax items	0.00	0.00	0.00	0.00
Reported net profit	-1674	-2036	335.1	608.7
Tot normalised items	2062	-150.8	-136.8	-151.1
Normalised PTP	-2850	-2139	463.9	899.7
Normalised net profit	-3736	-1885	471.9	759.9

Source: Company data, RBS forecasts

year to Dec

Balance sheet

€m	FY09A	FY10F	FY11F	FY12F
Net loans to customers	119439	117734	115189	113492
Other int earn assets	36053	43871	43418	42116
Goodwill	507.0	507.0	507.0	507.0
Oth non-int earn assets	25107	16211	13859	11670
Total assets	181106	178323	172974	167784
Total customer deposits	84812	84988	85634	86287
Oth int-bearing liabs	67100	67100	65087	63134
Non int-bearing liab	22757	18984	14511	10066
Total liabilities	174669	171072	165232	159487
Share capital	6387	7203	7690	8243
Reserves	0.00	0.00	0.00	0.00
Total equity (excl min)	6387	7203	7690	8243
Minority interests	50.0	48.1	51.1	54.4
Total liab & sh equity	181106	178323	172974	167784
Risk weighted assets	98333	85861	86152	85182
Est non-perf loans	n/a	n/a	n/a	n/a
Specific provisions	n/a	n/a	n/a	n/a
General provisions	n/a	n/a	n/a	n/a

Source: Company data, RBS forecasts

year ended Dec

Capital

€m	FY09A	FY10F	FY11F	FY12F
Risk weighted assets	98333	85861	86152	85182
Reported net profit	-1674	-2036	335.1	608.7
Opening risk assets	0.00	0.00	0.00	0.00
Closing risk assets	0.00	0.00	0.00	0.00
Change in risk assets	0.00	0.00	0.00	0.00
Capital required	0.00	0.00	0.00	0.00
Free capital flow	-649.3	-2067	264.2	523.6
Ordinary dividend paid	0.00	0.00	0.00	-208.2
Share buy back/spec div	n/a	n/a	n/a	n/a
Equity / preference issue	n/a	n/a	n/a	n/a
Cash flow from financing	0.00	0.00	0.00	-208.2
Net capital flow	-649.3	-2067	264.2	315.4
Tier 1 capital	9651	10467	10954	11507
Tier 1 capital ratio (%)	9.81	12.2	12.7	13.5

Lines in bold can be derived from the immediately preceding lines.

Source: Company data, RBS forecasts

year to Dec

Recommendation structure

Absolute performance, short term (trading) recommendation: A Trading Buy recommendation implies upside of 5% or more and a Trading Sell indicates downside of 5% or more. The trading recommendation time horizon is 0-60 days. For Australian coverage, a Trading Buy recommendation implies upside of 5% or more from the suggested entry price range, and a Trading Sell recommendation implies downside of 5% or more from the suggested entry price range. The trading recommendation time horizon is 0-60 days.

Absolute performance, long term (fundamental) recommendation: The recommendation is based on implied upside/downside for the stock from the target price and, except as follows, only reflects capital appreciation. A Buy/Sell implies upside/downside of 10% or more and a Hold less than 10%. For research produced by Nedbank Capital, a Buy/Sell implies upside/downside of 20% or more and a Hold less than 20%. For UK-based Investment Funds research, the recommendation structure is not based on upside/downside to the target price. Rather it is the subjective view of the analyst based on an assessment of the resources and track record of the fund management company. For research produced by Nedbank Capital and for research on Australian listed property trusts (LPT) or real estate investment trusts (REIT), the recommendation is based upon total return, ie, the estimated total return of capital gain, dividends and distributions received for any particular stock over the investment horizon.

Performance parameters and horizon: Given the volatility of share prices and our pre-disposition not to change recommendations frequently, these performance parameters should be interpreted flexibly. Performance in this context only reflects capital appreciation and the horizon is 12 months.

Sector relative to market: The sector view relative to the market is the responsibility of the strategy team. Overweight/Underweight implies upside/downside of 10% or more and Neutral implies less than 10% upside/downside.

Target price: The target price is the level the stock should currently trade at if the market were to accept the analyst's view of the stock and if the necessary catalysts were in place to effect this change in perception within the performance horizon. In this way, therefore, the target price abstracts from the need to take a view on the market or sector. If it is felt that the catalysts are not fully in place to effect a re-rating of the stock to its warranted value, the target price will differ from 'fair' value.

Distribution of recommendations

The tables below show the distribution of recommendations (both long term and trading). The first column displays the distribution of recommendations globally and the second column shows the distribution for the region. Numbers in brackets show the percentage for each category where there is an investment banking relationship. These numbers include recommendations produced by third parties with which RBS has joint ventures or strategic alliances.

Long term recommendations (as at 06 Apr 2010)

	Global total (IB%)	Europe total (IB%)
Buy	688 (0)	242 (0)
Add	0 (0)	0 (0)
Hold	383 (0)	173 (0)
Reduce	0 (0)	0 (0)
Sell	91 (0)	34 (0)
Total (IB%)	1162 (0)	449 (0)

Source: RBS

Trading recommendations (as at 06 Apr 2010)

	Global total (IB%)	Europe total (IB%)
Trading Buy	1 (0)	0 (0)
Rec	00 (00)	00 (00)
Trading Sell	0 (0)	0 (0)
Total (IB%)	1 (0)	0 (0)

Source: RBS

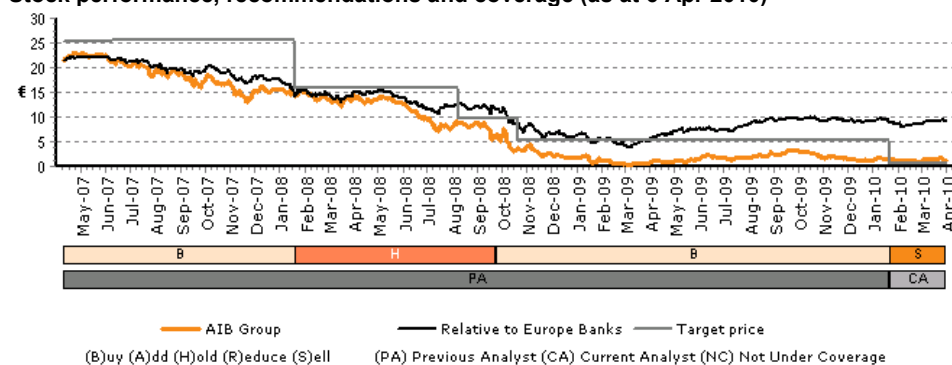
Valuation and risks to target price

Bank of Ireland (RIC: BKIR.I, Rec: Hold, CP: €1.60, TP: €1.70): We derive our target price by applying a 1.6x P/TCE multiple to a 2013F TCE adjusted for a €2.7bn capital issuance and the transfer of an estimated €12bn of loans to Ireland's bad bank (NAMA). We discount our 2013F valuation back to today at a 13% discount rate. If investors believe the bank can generate returns superior to our 19% RoTCE, or that the bank commands a higher premium than 1.6x P/TCE, there could be upside risk to our target price.

AIB Group (RIC: ALBK.I, Rec: Buy, CP: €1.20, TP: €1.75): We derive our AIB TP by applying a 1x P/TCE multiple to our 2013F TCE adjusted for the sale of M&T and Poland. We transfer an est. €23bn of loans to Ireland's bad bank. We discount our 2013F valuation back to today at 14% per annum. We factor in a €3.5bn capital increase at the current share price. Downside risk exists if AIB is unable to sell Poland in its entirety or for a premium to the current share price. A material fall in AIB's share price pre-capital raise would also put downward pressure on our TP.

AIB Group coverage data

Stock performance, recommendations and coverage (as at 6 Apr 2010)



Trading recommendation history (as at 07 Apr 2010)

Date	Rec	Analyst
	n/a	

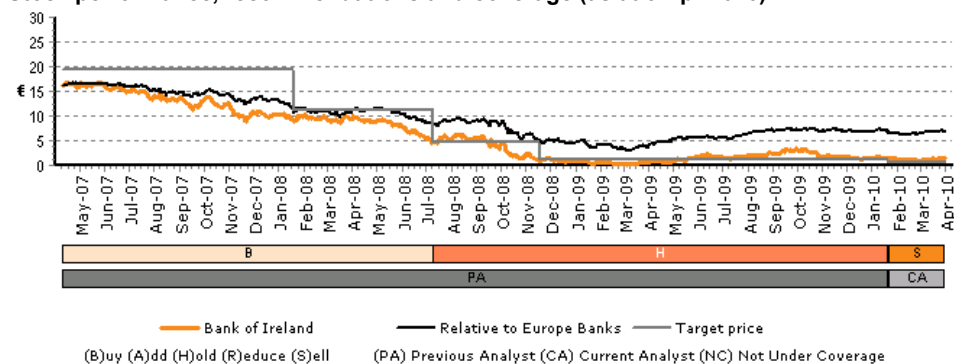
Source: RBS

Asheefa Sarangi, CFA started covering this stock on 21 Jan 10

Source: RBS

Bank of Ireland coverage data

Stock performance, recommendations and coverage (as at 6 Apr 2010)



Asheefa Sarangi, CFA started covering this stock on 21 Jan 10

Source: RBS

Trading recommendation history (as at 07 Apr 2010)

Date	Rec	Analyst
	n/a	

Source: RBS

Regulatory disclosures

Subject companies: **ALBK.I, BKIR.I**

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