Europe

# LLOYDS

## Q4 '11: Coupons but no Calls in 2012? Sell Senior CDS, Buy Tier 1

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- **Events**: Lloyds reported Q4 '11 pre-tax and fair value unwind (PTFV) profit of £759m, on revenues of £5.9bn. Excluding a long list of 'one-offs', core and non-core operating PTFV profits were £2.3bn and -£1.5bn in the quarter. Reduced operating costs drove the quarterly results as revenues slowed while impairments increased into year-end. Impairments may have peaked and management guided for lower levels in 2012. CEO Antonio Horta-Osorio noted that the UK economy is on its back and stated that Lloyds will generate lower revenues in 2012 while cost savings gather momentum over time. Lloyds anticipate issuing £20bn to £25bn of wholesale term funding in 2012. Including liability management exercises and pre-funded issuance in 2011, Lloyds noted that £15bn is already completed. The CEO stated that he believed the bank is prepared if Moody's downgrades their short-term rating to P-2.
- **Results Analysis:** Lloyds, like RBS, continues to present a mixed bag of results. At first sight, the large annual pre-tax loss of £3.5bn appears troubling; in particular as this includes liability management gains of £1.3bn for the year. However, after stripping out 10 one-off items, including the H1 '11 £3.2bn loss associated with settling Payment Protection Insurance costs, Lloyds managed an operating profit of £2.2bn**.** The Retail segment continues to drive revenues while the wholesale and the international areas drag returns. Within the international portfolio, exposure to Ireland is now £14.6bn, net of provisions, or 38% of Core Tier 1 capital. The gross Irish commercial real estate exposure of £17bn is 90% impaired with loan loss reserves covering 63% of this exposure. Lloyds achieved a CRD III Core Tier 1 ratio of 10.8% and reported a fully-loaded Basel III (CRD IV) ratio of 7.1% as of year-end 2011. Short-term borrowing levels that may be sensitive to losing the P-1 rating declined to 7% of total group funding at year-end from 11% one year earlier. Commercial paper and CD levels are now more manageable at £46bn, down from £75bn last year. Lloyds reported £57bn on deposit with central banks at year-end.
- **How to trade it:** Sell 5 year senior CDS, buy Tier 1 debt. There was both good news and not so good news signalled for debt investors in Lloyds' 2011 results release. The good news is that bank is taking steps to restart coupon payments on its Tier 1 hybrid securities. The not so good news is that Lloyds simultaneously signalled that it will most likely not call 2012-callable Lower Tier 2 debt. With respect to the hybrid security coupon payments, Lloyds stated that they have recommenced from 31 January 2012 and that they will issue new ordinary shares in the amount of £170m to pay these coupons in 2012. We anticipate that settlement of cumulative coupon payments may be made via Alternative Coupon Settlement Mechanisms, as well. With respect to LT2 debt, we note that LME gains in 2011 flattered both other income and net interest income. The net interest income impact is related to the change in the carrying value of securities with call options in 2012 that were not tendered. As we understand it, these bonds were previously accreting to first call, but the LME net interest income gain will be reversed as the securities accrete to par over their remaining life. This signals to us that the 2012 callable lower tier 2 bonds will remain outstanding until 2017. Although this is largely priced-in, we will not be looking for unexpected gains from par call on these securities in the near term. In CDS, we believe that the UK ICB proposals on primary loss absorption capital are still a long way off and in the interim; it is the recovery at Lloyds which should drive senior CDS levels. We think the systemic Moody's downgrade is now priced-in. We recommend selling 5 year senior CDS protection at approximately 270 or 1.25x senior iTraxx. We recommend stopping losses at 1.40 x iTraxx and taking profits at 1.10 x iTraxx.

### LLOYDS: Group full-year P&L (in GBP millions)

| | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 |
|---|---|---|---|---|---|---|
| **Net Interest Income** | 5,537 | 6,099 | 7,718 | 9,026 | 12,546 | 12,698 |
| **Net Fees** | 3,116 | 3,224 | 3,231 | 4,254 | 4,415 | 4,935 |
| **Net Trading Income** | 6,363 | 3,128 | na | 2,798 | 1,975 | na |
| **Other Operating Income** | - 3,066 | - 1,145 | - 387 | 8,717 | 7,702 | 4,529 |
| **Total Revenues** | 11,950 | 11,306 | 10,562 | 24,795 | 26,638 | 22,162 |
| **Operating Expenses** | - 5,301 | - 5,567 | - 15,263 | - 12,153 | - 11,092 | - 10,023 |
| **Pre-Provision Profits** | 5,803 | 5,139 | - 5,395 | 11,125 | 13,864 | 10,748 |
| **Loan Loss Reserves** | - 1,555 | - 1,796 | - 3,012 | - 16,673 | - 10,952 | - 8,094 |
| **Operating Profits** | 4,248 | 3,343 | - 8,407 | - 5,548 | 2,912 | 2,654 |
| **Pre-Tax Profit** | 4,248 | 4,000 | 760 | 1,042 | 281 | - 3,542 |
| **Taxes** | - 1,341 | - 679 | 38 | 1,911 | - 539 | 828 |
| **Net Income** | 2,803 | 3,289 | 772 | 2,827 | - 320 | - 2,787 |

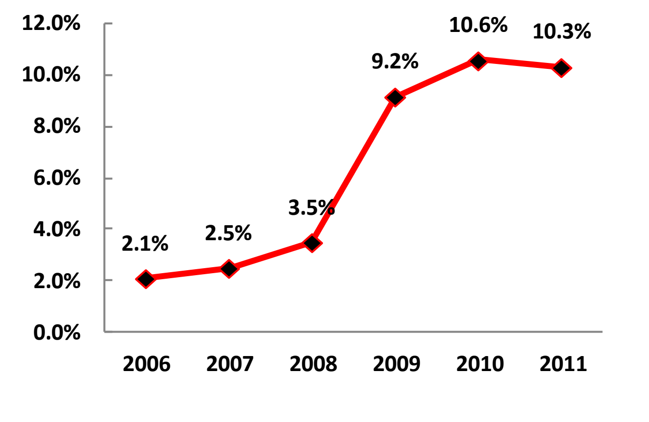
Source: SG Cross Asset Research, Bloomberg, Company Data

### LLOYDS: Balance Sheet Data & Regulatory Ratios under Basel II (in GBP millions unless stated otherwise)

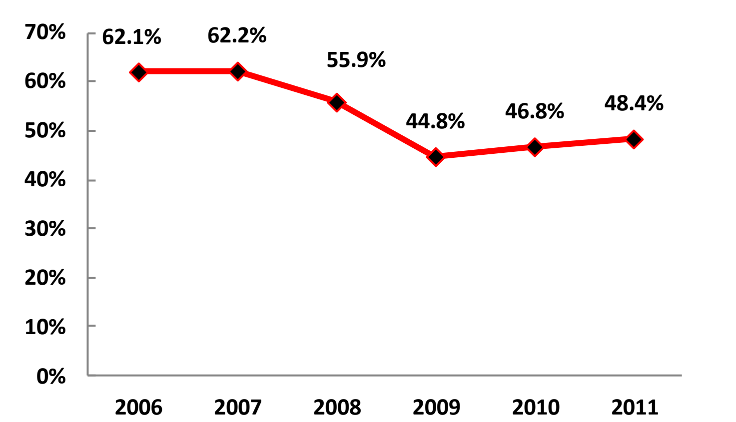
| | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | % of Assets |
|---|---|---|---|---|---|---|---|
| **Cash & Due From Bank** | 43,967 | 40,417 | 44,687 | 75,934 | 69,755 | 94,736 | 9.8% |
| **Gross Loans** | 188,285 | 209,814 | 240,344 | 626,969 | 592,597 | 565,638 | 58.3% |
| **Trading Securities** | 50,298 | 57,911 | 51,242 | 168,114 | 181,926 | 176,916 | 18.2% |
| **Intangible Assets** | 2,515 | 2,507 | 2,453 | 6,103 | 5,512 | 5,212 | 0.5% |
| **DTA** | na | na | 833 | 5,006 | 4,164 | 4,496 | 0.5% |
| **Net Fixed Assets** | 4,252 | 2,839 | 2,965 | 9,224 | 8,190 | 7,673 | 0.8% |
| **Goodwill** | 2,377 | 2,358 | 2,256 | 2,016 | 2,016 | na | 0.0% |
| **Total Assets** | 343,598 | 353,346 | 436,033 | 1,027,255 | 991,574 | 970,546 | |
| **Total Deposits** | 139,342 | 156,555 | 170,938 | 406,741 | 393,633 | 413,906 | 42.6% |
| | | | | | | | |
| **Core Tier 1 Capital** | na | 12,478 | 9,542 | 39,935 | 41,371 | 37,991 | |
| **RWA** | 156,043 | 142,600 | 170,490 | 493,307 | 406,372 | 352,341 | |
| **Core tier one Ratio** | na | 8.75% | 5.60% | 8.10% | 10.18% | 10.78% | |
| **Tier one ratio** | 8.22% | 9.78% | 8.04% | 9.63% | 11.60% | 12.49% | |
| **Capital Ratio** | 10.66% | 13.24% | 11.22% | 12.38% | 15.21% | 15.61% | |

Source: SG Cross Asset Research

**LLOYDS' Asset Quality Deterioration may have Peaked (Non-performing Loans / Gross Loans)**

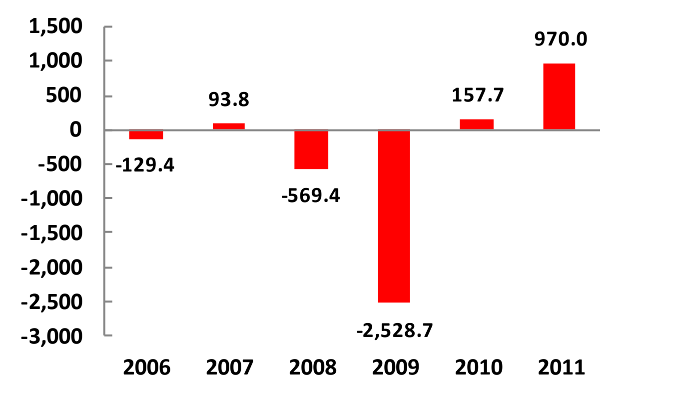



**LLOYDS Loan Loss Coverage Ratios remains stable (Loan Loss Reserves / Impaired Loans)**

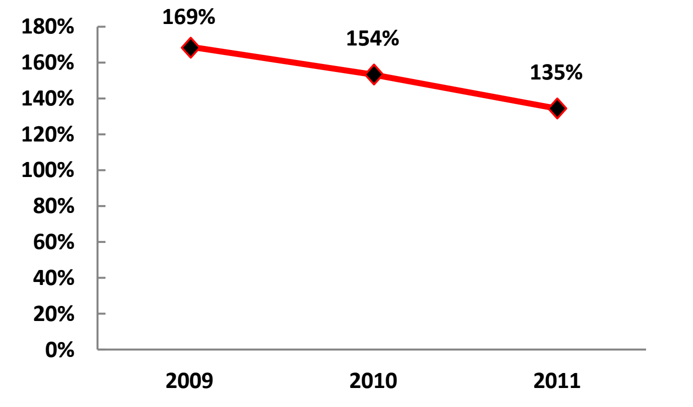



Source: SG Cross Asset Research, Bloomberg, Company Data

**LLOYDS continues to enhance its liquidity profile (Liquidity Jaws: growth in deposits – growth in lending in bps)**

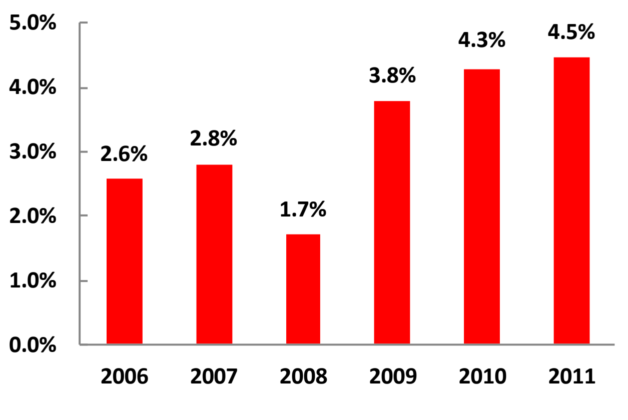



**LLOYDS Loan to deposit ratio continues to improve, but wholesale financing dependencies remain**

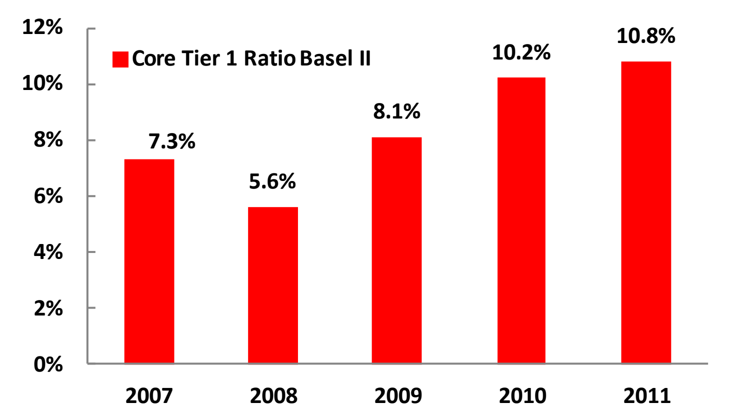



Source: SG Cross Asset Research, Bloomberg, Company Data

**LLOYDS leverage decreases: (Tangible Equity / Tangible Assets – derivatives)**




**LLOYDS's Basel II Core Tier 1 Ratio continues to improve.**




Source: SG Cross Asset Research, Bloomberg, Company Data

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# APPENDIX

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Buy: Indicates likely to outperform its iBoxx subsector by 5% or more
Hold: Indicates likely to be within 5% of the performance of its iBoxx subsector
Sell: Indicates likely to underperform its iBoxx subsector by 5% or more

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