Company In-Depth

SMALL & MID CAP

27 September 2006 | 32 pages

Kensington Group (KGN.L)

Competition, Income Margins & Asset Quality

Rating change ☑
Target price change ☑
Estimate change ☑

- Raising to Buy/ High Risk — Share price weakness has left the shares inexpensive and trading at a substantial discount to UK mortgage market peers. This presents a buying opportunity for risk tolerant investors. We raise our recommendation from Hold/ Medium Risk to Buy/ High Risk and set a new 12-month target price of £9.50.
- Traditional business under pressure — Key challenges facing Kensington Group are the impact of competition on gross margins, and the potential for rising loan losses and impairment charges to reduce returns and lead to lower-than-forecast earnings growth.
- Competition intensifying — Alliance & Leicester and Northern Rock have announced they will seek to originate-to-sell non-prime mortgages for Lehman Brothers; Nationwide Building Society has indicated it will roll-out the Portman sub-prime product offering to its customer base post-merger.
- Higher margin partially-owned businesses — Reduced returns in its traditional activities are being offset by higher-margin new business volumes from partially-owned businesses Money Partners and Start Mortgages, and from Kensington Personal Loans, the group's wholly-owned venture into the second mortgage market.
- More complicated — Reliance upon Money Partners for profitable new business volumes has made valuing Kensington difficult. We estimate that future MPL volumes account for a third of the group's value and, including ownership interests, the MPL value contribution rises to ~50%.

See page 30 for Analyst Certification and important disclosures.

Buy/High Risk	**1H**
from Hold/Medium Risk	
Price (27 Sep 06)	£8.19
Target price	£9.50
from £11.35	
Expected share price return	16.0%
Expected dividend yield	3.7%
Expected total return	**19.7%**
Market Cap	£430M
	US$815M

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

Kensington Group (GBP)

Year to 30 Nov	2004A	2005A	2006E	2007E	2008E
Net Income (£M)	36.1	40.2	46.6	54.3	61.7
Diluted EPS (p)	67.2	76.0	88.0	102.7	116.7
Diluted EPS (Old) (p)	67.2	73.0	93.9	113.6	136.7
PE (x)	12.2	10.8	9.3	8.0	7.0
P/BV (x)	3.7	2.7	2.5	2.0	1.7
DPS (p)	16.0	21.5	25.8	30.1	34.2
Net Div Yield (%)	2.0	2.6	3.2	3.7	4.2
ROE (%)	33.9	29.5	28.2	28.4	26.5

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Fiscal year end 30-Nov	2004	2005	2006E	2007E	2008E
Valuation Ratios					
P/E (adjusted) (x)	12.2	10.8	9.3	8.0	7.0
P/E (reported) (x)	12.2	10.8	9.3	8.0	7.0
P/BV (x)	3.7	2.7	2.5	2.0	1.7
P/Adjusted BV (x)	3.7	2.7	2.5	2.0	1.7
Dividend yield (%)	2.0	2.6	3.2	3.7	4.2
Per Share Data (p)					
EPS (adjusted)	67.2	76.0	88.0	102.7	116.7
EPS (reported)	67.2	76.0	88.0	102.7	116.7
BVPS	223.3	307.8	333.7	408.9	494.4
Tangible BVPS	191.3	274.8	304.8	380.0	465.5
Adjusted BVPS	211.5	300.1	325.3	398.6	482.0
DPS	16.0	21.5	25.8	30.1	34.2
Profit & Loss (£M)					
Net interest income	84	142	176	226	256
Fees and commissions	38	10	12	17	22
Other operating Income	4	16	18	19	19
Total operating income	**126**	**168**	**206**	**262**	**297**
Total operating expenses	-61	-80	-94	-117	-129
Oper. profit bef. provisions	**66**	**88**	**112**	**146**	**168**
Bad debt provisions	-13	-36	-54	-71	-85
Non-operating/exceptionals	-1	5	8	5	8
Pre-tax profit	**52**	**57**	**67**	**80**	**90**
Tax	-16	-18	-20	-24	-27
Extraord./Min. Int./Pref. Div.	0	1	0	-2	-2
Attributable profit	**36**	**40**	**47**	**54**	**62**
Reported net income	**36**	**40**	**47**	**54**	**62**
Adjusted earnings	36	40	47	54	62
Growth Rates (%)					
EPS (adjusted)	59.4	13.1	15.8	16.7	13.6
Oper. profit bef. prov.	54.1	34.4	27.8	29.4	15.4
Balance Sheet (£M)					
Total assets	**670**	**6,836**	**6,869**	**6,908**	**6,952**
Avg interest earning assets	3,628	4,917	6,733	8,610	10,041
Customer loans	4,138	5,695	7,772	9,449	10,633
Gross NPLs	302	518	777	992	1,170
Liab. & shar. funds	**670**	**6,836**	**6,869**	**6,908**	**6,952**
Total customer deposits	0	0	0	0	0
Reserve for loan losses	25	36	57	76	91
Shareholders' equity	114	159	172	211	255
Profitability/Solvency Ratios (%)					
ROE (adjusted)	33.9	29.5	28.2	28.4	26.5
Net interest margin	2.31	2.89	2.61	2.63	2.55
Cost/income ratio	48.1	47.7	45.5	44.5	43.5
Cash cost/average assets	-9.74	-2.14	-1.37	-1.69	-1.87
NPLs/customer loans	7.30	9.10	10.00	10.50	11.00
Reserve for loan losses/NPLs	8.2	7.0	7.3	7.6	7.8
Bad debt prov./avg. cust. loans	0.36	0.73	0.80	0.82	0.85
Loans/deposit ratio	na	na	na	na	na
Tier 1 capital ratio	na	na	na	na	na
Total capital ratio	na	na	na	na	na

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Note: Tony Cummings has assumed primary responsibility for the coverage of Kensington Group.

Investment summary

The Kensington investment case has become increasingly complicated, reflecting declining returns and profitability at core wholly-owned businesses, and the increasing importance of the partially-owned Money Partners. Low visibility of the latter's economics and in particular its originate-to-sell arrangement with Kensington has made valuation difficult.

The key investment issues are as follows:

- Core returns. The reduction in returns on traditional Kensington Mortgage Company (KMC) business, a combination of declining income margins and rising credit costs.
- Partially-owned businesses. The decline in core returns is being offset by growing, higher-margin new business volumes from the partially-owned businesses Money Partners (MPL) and Start Mortgages (SM).
- Valuation implications. This shift in importance from wholly-owned to partially owned businesses, and the economics of the relationship with MPL in particular, has implications for valuing the group.
- MPL value contribution. We estimate that MPL-generated volumes account for more than a third of the group's aggregate value, and that ownership interest in MPL accounts for a further 13%, taking the MPL contribution to ~50%.
- Exercising options. There is also the issue of the cost and funding of exercising options to acquire the outstanding shareholdings in these partially-owned businesses, should management choose to do so.
- Profit on whole loan sales. Income margin compression has led to increased whole loan sales, currently running at around 20% of gross originations, or around a third of KMC volumes. Whilst capital sparing, this has front-loaded the recognition of in-force value and flattered recent earnings announcements.
- Capital management. Although increased "originate-to-sell" volumes should allow for a release or reallocation of capital, a higher second-charge element to the mortgage mix would require additional capital, as would exercising the MPL and SM options.
- Leveraging equity shareholder returns. Recent capital management activity has focused on subordinated bond issuance and increased leverage of the group's equity capital. While this has supported the group's ROE in the face of declining ROA, it has increased earnings sensitivity to relatively small changes in key margins.
- New entrants. Both Alliance & Leicester and Northern Rock have announced they will in future look to originate-to-sell non-prime mortgages in conjunction with Lehman Brothers. Nationwide Building Society has indicated it will offer the Portman Building Society sub-prime product suite to its enlarged customer base post-merger.

- **M&A**. Kensington could pose a potential acquisition target for larger banks with access to cheaper retail funding and/or investment banks looking for origination volumes to feed their mortgage-backed securities businesses. Factors that potentially reduce the attractiveness of Kensington to investment bank acquirers are (i) only partial-ownership of the faster growing operating businesses and (ii) existing originate-to-sell arrangements that contribute to current profitability and hence the group's existing value.

Revised earnings estimates

We have revised our earnings estimates to reflect the competitive backdrop and our assessment as to the likely impact on Kensington's core returns.

Figure 1. Revised Estimates

Yea to November (£m)		2006E			2007E			2008E	
	Old	New	Ch %	Old	New	Ch %	Old	New	Ch %
Operating income	190.6	206.3	8%	223.4	262.3	17%	254.6	297.3	17%
Profit before tax	73.7	66.5	-10%	89.5	79.8	-11%	107.8	90.3	-16%
EPS (p)	**93.9**	**88.0**	**-6%**	**113.6**	**102.7**	**-10%**	**136.7**	**116.7**	**-15%**
DPS (p)	30.0	25.8	-14%	37.0	30.1	-19%	46.0	34.2	-26%

Source: Citigroup Investment Research

Investment conclusions

Share price underperformance over the past six months has left Kensington once again on a significant valuation discount to its UK mortgage specialist peers. This has left the shares inexpensive in relative terms and in comparison to our estimate of fundamental fair value. This is further supported by our appraisal value analysis of the group's existing mortgage assets under management and its new business potential.

Recent weakness has therefore presented a buying opportunity for risk-tolerant investors. We raise our recommendation from Hold/Medium Risk to Buy/High Risk and set a new 12 month target price of £9.50.

Risk rating

The key reason for our High Risk rating is high balance sheet leverage. Kensington's equity to mortgage assets ratio has fallen from 4.7% in November 2001 to only 2.6% at end-January 2006, which has increased the group's earnings sensitivity to relatively small changes in key margins. At current leverage levels, a 10bps reduction return on loan assets would lead to a 3.8% reduction in return on equity.

Valuation

Our fundamental analysis suggests end-November 2006 fair values within a 941p to 964p range, and an average of 953p. Based on these estimates, we therefore set a 12-month target price of 950p per share, at which the shares would trade on a 2007E PE of 9.3x and yield 3.2%.

Price performance

The shares are currently trading some 30% below their high of 1202p on 21 March, having underperformed the FTSE All Share Index by 33%, and the other focused UK mortgage stocks by between 21% and 32%.

Figure 2. Absolute & Relative Price Performance

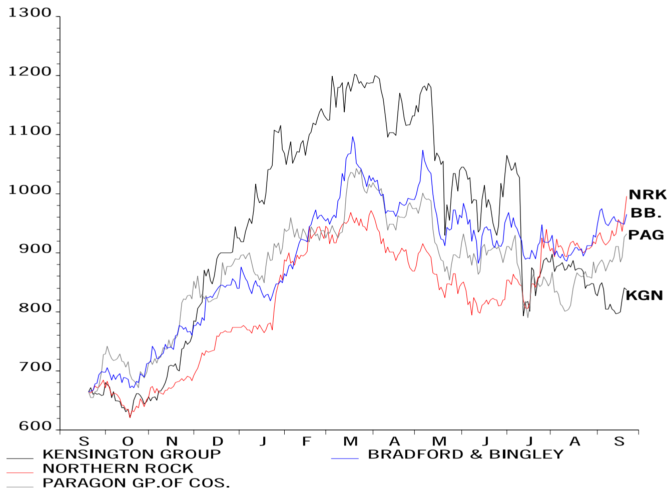
	1m	3m	6m	12m
Absolute	-3.7%	-12.5%	-32.6%	22.7%
Relative to FTSE All Share	-3.7%	-15.4%	-29.6%	12.1%
Relative to Paragon Group	-8.5%	-12.3%	-21.3%	-9.8%
Relative to Northern Rock	-8.9%	-25.3%	-31.8%	-13.6%
Relative to Bradford & Bingley	-6.3%	-14.1%	-24.0%	-11.3%

Source: Datastream

PER relative performance

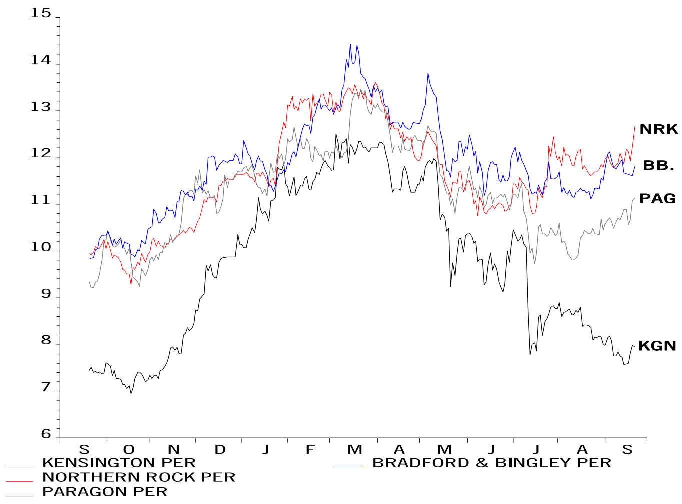
- A year ago, Kensington traded on a 2-3 PE point discount to the mortgage stocks, Paragon Group, Northern Rock and Bradford & Bingley (BB.L - £4.68; 2M) (see charts below).
- Against the background of strong performances by the UK banks in general, and mortgage banks in particular, during the four months to mid-January 2006, Kensington outperformed and was re-rated.

Figure 3. UK Mortgage Stocks – Price Performance



Source: Datastream

Figure 4. UK Mortgage Stocks – Prospective PER



Source: Datastream

- This re-rating reflected Kensington's better-than-expected new business volume growth, driven in part by new ventures Money Partners and Start Mortgages.

- The stock's underperformance since March has reflected cautionary comments regarding arrears at both the 1Q06 update and at the interim results, and evidence of rising arrears and losses in some of the group's securitization vehicles. The market's attention has shifted from volumes to margins and returns.

Peer group relatives

We have used a small group of UK mortgage specialists as Kensington's peers in the following comparative analysis.

Figure 5. Peer Group P/E Ratios & Yields

				P/E Ratio		Dividend Yield	
	Price* (p)	MV (£m)	Year-end	2006E	2007E	2006E	2007E
Bradford & Bingley	467	2,963	Dec	12.3x	11.3x	4.3%	4.6%
Northern Rock	1171	4,933	Dec	13.6x	12.2x	3.0%	3.4%
Paragon Group**	670	779	Sep	12.1x	11.5x	2.5%	3.1%
Average				**12.7x**	**11.5x**	**3.3%**	**3.7%**
Kensington Group	820	431	Nov	9.3x	8.0x	3.1%	3.7%

Source: Citigroup Investment Research. *Prices at close 27 September. **Reuters consensus estimates.

Fundamental Price to Book Valuation

Our preferred valuation approach is summarised in the table below.

Figure 6. Fundamental Price to Book Valuation

Year to November (£m)	2006E	2007E	2008E	2009E	2010E
Mortgage assets	7771.7	9449.1	10633.1	11230.7	11649.1
Memo: MAUM growth	36%	22%	13%	6%	4%
Normalised equity/MAUM	3.0%	3.0%	3.0%	3.0%	3.0%
Normalised equity	233.2	283.5	319.0	336.9	349.5
Actual equity	173.2	212.4	257.0	303.6	351.6
Surplus capital	-60.0	-71.5	-62.9	-34.7	0.2
Attributable profit	46.6	54.3	61.7	64.7	66.4
Return on surplus capital	2.4	2.8	2.5	1.3	-0.1
Normalised return	49.0	57.2	64.2	66.0	66.3
Normalised return on equity	21.0%	20.2%	20.1%	19.6%	19.0%
Dividends	13.3	15.5	17.6	18.5	19.0
Discount factor		1.105	1.221	1.349	1.491
PV dividends		14.1	14.4	13.7	12.7
Sustainable return on equity	18.5%				
Long-term growth	2.0%				
Cost of equity	10.5%				
Fair value price/book	1.94				
2010 terminal value	678.4				
2010 surplus capital	0.2				
NPV terminal value	455.0				
NPV dividends	54.9				
NPV surplus capital	0.1				
Fair value	**510.1**				
Shares in issue	52.9				
Fair value per share (p)	**964**				

Source: Citigroup Investment Research

The objective is to estimate a fundamental fair value for the shares as at end-November 2006. There are three parts to this estimate:

- First, we calculate a terminal value for the business at end-November 2010E. Based on attributable profit, we calculate annual returns on normalised equity (normalised to reflect a 3% equity:mortgage assets ratio). We use these returns to estimate a sustainable ROE for the fair value price to book formula: P/BV = (ROE - g) / (COE - g). This terminal value is discounted to NPV at end-December 2006E using an estimate of COE as the discount rate.
- Next, we calculate the NPV of unallocated capital: our forecast for end-December 2010E net assets includes a "surplus" that in theory could be distributed without altering the operating outlook.
- Finally, we calculate the NPV of our dividend forecasts for 2007E-2010E.

The sum of these three items produces our estimate of a fair end-November 2006E market value for the group of £510m, which equates to 964p per share.

The table below sets out the sensitivity of this fair value estimate to a range of alternative sustainable ROE and COE rate assumptions.

Figure 7. Fundamental Price to Book Valuation – ROE / COE Sensitivity Analysis

ROE / COE	17%	18%	19%	20%
9.0%	1110	1177	1244	1311
9.5%	1025	1086	1148	1209
10.0%	951	1007	1064	1120
10.5%	886	938	990	1042
11.0%	828	876	925	973
11.5%	776	821	866	911
12.0%	730	772	814	856

Source: Citigroup Investment Research

Appraisal value methodology

As an alternative to the fundamental price to book approach, we considered the following sum-of-the-parts valuation based on appraisal values.

Figure 8. Front and Back Book Appraisal Values

	£m	p	%MAUM
Kensington Mortgages			
In force value	51	96	2.0%
New business value	225	425	9.0%
Appraisal value	**276**	**521**	**11.1%**
Money Partners (volumes)			
In force value	43	82	5.0%
New business value	190	359	22.1%
Appraisal value	**233**	**440**	**27.1%**
Start Mortgages			
In force value	4	8	2.7%
New business value	41	77	25.5%
Appraisal value	**45**	**85**	**28.2%**
Kensington share (64%)	**29**	**54**	**18.1%**

Source: Citigroup Investment Research

Further details of the underlying calculations are set out in the Appendix. The approach is as follows:

- We have estimated the value of existing mortgage assets under management (the back book) for each of KMC, MPL and SM. These estimates are based on historic gross margins, a set of assumptions regarding credit losses and other costs, a prepayment speed or run-off rate, and a discount rate to calculate net present values.
- We then estimate the value of new business based on our explicit new business volume assumptions out to 2010E, and make long-term new business growth rates for following years. We have used a different set of margin assumptions for new business to reflect competitive pressure and rising loan losses.
- In addition to valuing mortgage assets sourced from MPL, we have also included an estimate of the value of Kensington's equity interest in MPL. This is discussed in detail in the Key Investment Issues section of this note.

- We include only 64% of our fair value estimate for SM, reflecting Kensington's ownership of this company. We have valued the Bluestep stake at cost.
- Finally, we have deducted Kensington's £125m of subordinated debt from our estimate of the value of the enterprise to derive a fair market value estimate.

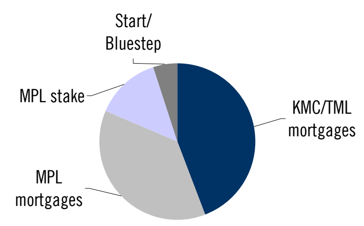
The outcome of this alternative approach is summarised below.

Figure 9. Sum of the Parts Valuation

	£m	p	%EV
KMC/TML mortgages	276	521	44%
MPL mortgages	233	440	37%
MPL stake (50%)	82	155	13%
Start stake (64%)	29	54	5%
Bluestep stake	3	6	0%
Enterprise value	**623**	**1177**	**100%**
Sub debt	-125	-236	-20%
Kensington Group	**498**	**941**	**80%**

Source: Citigroup Investment Research

Figure 10. Components of Enterprise Value



Source: Company reports and CIR

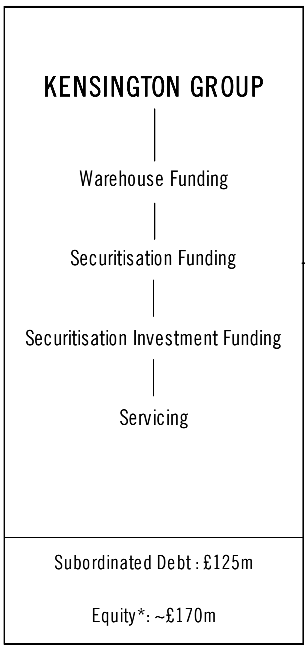
Company Snapshot

Kensington Group

Founded in 1995, Kensington Group is a leading provider of specialist residential mortgage products. The group provides secured loans to borrowers who do not conform to the underwriting criteria of traditional suppliers such as the self-employed, contractors, older borrowers, temporary employees, borrowers who require larger loans and those with an adverse credit history.

Kensington's operating structure is set out in the chart below.

Figure 11. Group Structure



Stake		Mortgage Assets* Under Management	New Lending 2005	New Lending 1H06	Gross Product Margin**	Securitisation Vehicles
100%	Kensington Mortgage Company	£4,300m (61%)	£2,105m (61%)	£939m (50%)	2.8%	RMS14-RMS22
20%	Money Partners Limited	£1,300m (18%)	£831m (24%)	£689m (36%)	4.9%	MP1-MP3
64%	Start Mortgages Limited	£240m (3%)	£209m (6%)	£178m (9%)	3.8%	LMS1
100%	TML Financial Solutions	-	£322m (9%)	£90m (5%)	2.8%	
Minority	Bluestep Capital	-	-	-		
	Warehouse	£1,200m (17%)				
	KENSINGTON	£7,040 (100%)	£3,467m (100%)	£1,896m (100%)	3.5%	

Source: Company reports and Citigroup Investment Research. *CIR estimates. **2005 average gross product margins

In response to increasing competition in its core market, management has adapted the business model as follows.

In the UK, Kensington has shifted its focus away from the competitive hot-spot. On the one hand it is increasingly originating lower margin prime or near-prime mortgages with a view to on-selling to building societies and/or investment banks – this generates up-front profit without tying up equity in low margin products. On the other hand, both MPL and the recently launched Kensington Personal Loans (KPL) are targeting higher margin products and second-charge mortgages – already ~25% of MPL new business volumes.

Outside of the UK, Kensington has successfully exported the non-conforming mortgage model to the Republic of Ireland with Start Mortgages (SM), and is in the process of entering the Swedish market in conjunction with Bluestep, in which Kensington has taken a minority shareholding.

Subsidiaries

Kensington Mortgage Company (KMC)

- KMC is the group's principal operating company and is the FSA regulated Arranger, Lender and Insurance Intermediary. It originates loans in its own name as agent for Residential Mortgage Securities (RMS) special purpose vehicles, via intermediaries or directly through the group's wholly-owned mortgage introducer, TML Financial Solutions (TML).

- KMC originates first-charge mortgages with an average loan to value (LTV) of around 75% and with no loans of more than 90% LTV. The company has increased its focus on lower risk, lower margin products which accounted for approximately 61% of new business in 2005 compared with 44% in 2004. During the second half of 2005, the number of accounts 90 days or more in arrears amongst the KMC portfolio had increased to 9.1% (up from 7.3% in 2004).

Kensington Personal Loans (KPL)

- KPL is a newly established business (it was launched on 19 September 2006) focused on originating second-charge mortgage loans. KPL will offer products to a range of borrowers, from near prime to unlimited adversity, with criteria such as self-certification up to 90% LTV and loan amounts up to £100,000.

TML Financial Solutions (TML)

- TML was acquired by Kensington in 2002 and is a direct to consumer distributor of specialist mortgages. It also introduces first- and second-charge mortgages to other lenders where customer needs cannot be met from the group's product range. On average the product margins of business originated through TMC are ~2.9% over LIBOR and have average LTVs below 72%. During 2005, over 90% of TML business was re-mortgages, as compared with the 50% for KMC.

Start Mortgages Limited (SM)

- Kensington owns 64% of SM, a non-conforming mortgage lender in the Republic of Ireland. SM started trading in November 2004 and during 2005 completed €309m of mortgages at an average LTV of below 62% and an average gross product margin of around 3.8%. Kensington has options to purchase the remaining equity in Start in early 2010.

- Start originates loans in its own name as agent for Lansdowne Mortgage Securities (LMS) special purpose vehicles.

Associates & Investments

Money Partners Limited (MPL)

- Launched in 2004, Kensington Group currently owns 20% of MPL together with one of two 'founder' shares which give it voting rights over key business decisions. Kensington has the right to acquire an additional 30% of MPL in early 2007, and the remaining 50% in early 2009.

- MPL offers a range of first- and second-charge mortgage products and accesses customers via intermediaries who have traditionally focused on the second-charge market and who have not historically distributed KMC products. MPL originates loans in its own name and sells these loans to Kensington Group, which then securities them through Money Partners (MP) special purpose vehicles.
- In 2005, 75% of MPL's originations were first-charge mortgages, 25% second-charge. Across the MPL product range, the average 2005 LTV was 73% and earned an average gross product margin of 4.9%.

Bluestep Capital

- In April 2006 Kensington acquired an undisclosed minority stake in Bluestep, the only non-conforming lender in Sweden, for £2.7m.

Kensington and its consolidated subsidiaries employ around 678, whilst Money Partners employs a further 151.

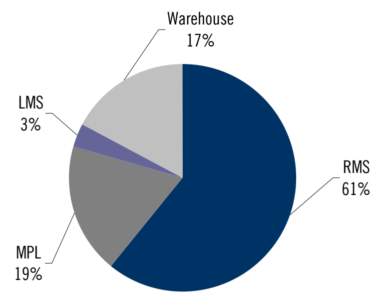
Loan growth

Figure 12. New Lending Volumes Mortgage Assets Under Management

Year to November (£m)	2004	2005	06h1	06h2E	2006E	2007E	2008E	2009E	2010E
New KMC/TML lending	2,266	2,427	1,029	1,592	2,621	2,752	2,807	2,835	2,835
New MPL/Start lending		1,040	867	745	1,612	1,773	1,862	1,899	1,899
Total new lending	**2,266**	**3,467**	**1,896**	**2,337**	**4,233**	**4,525**	**4,669**	**4,734**	**4,734**
Run-off rate	-31%	-21%	-22%	-21%	-23%	-25%	-27%	-30%	-30%
Whole loan sales	-209.0	-740.0	-420.0	-426.6	-846.6	-905.1	-933.8	-946.9	-946.9
MAUM balances	4,138	5,695	6,548	7,772	7,772	9,449	10,633	11,231	11,649
Average balance	**3,628**	**4,917**	**6,122**	**7,160**	**6,733**	**8,610**	**10,041**	**10,932**	**11,440**

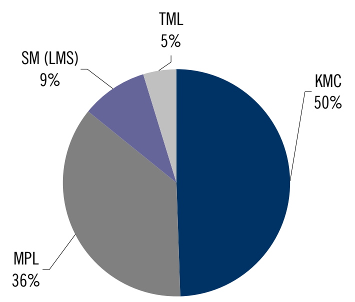
Source: Company Reports and CIR Estimates

Figure 13. Estimated Back-Book (~£7bn)



Source: Company Reports & CIR Research

Figure 14. 1H06 Volumes by Business Unit



Source: Company Reports

Key investment issues

The key investment issues are currently competition (and its effect on margins) and asset quality.

Competition

There have been a numbers of new entrants into Kensington's core market over the past twelve months, most of them investment banks – Bear Stearns, Investec, Deutsche Bank and Morgan Stanley – or prime lenders looking to expand into non-prime mortgages. Alliance & Leicester (AL.L - £11.13; 3M) and Northern Rock (NRK.L - £11.71; 3M) have announced they will 'originate-to-sell' sub-prime and near-prime mortgages for Lehman Brothers (LEH.N - US$73.55; 2H), whilst Nationwide Building Society has indicated it will offer the Portman Building Society sub-prime product suite to its customer base post-merger.

In order to win market share, new entrants have undercut on price, offered more generous commissions to distributors, and/or taken on greater credit risk (offering high LTV products to credit impaired borrowers for example). Kensington has been faced with the choice of competing with these new entrants on price or accepting lower volume growth.

Declining KMC first mortgage interest margins

In Kensington's 2006 interim results announcement, it was reported that during 1H06, UK first-charge mortgage gross margins averaged 2.7%, down from 2.9% at the end of 2005, which was in turn down around 0.2% on end-2004.

The table below presents a sub-set of the rates currently being charged on KMC mortgages. This is based on a new September price list following a 0.35% increase in KMC's 'base rate' – Kensington Variable Rate (KVR) – which was increased from 5.80% to 6.15% on 1 September.

Figure 15. Current KMC Pricing Matrix*

						--Product Loading --		
	Max LTV	3 Yr Discount	3 Yr Fixed	Variable/ Reversion rate	Self-Cert	Right-to Buy	Buy-to Let	Flexible Features
Pricing								
Minor	90%	5.99%	6.04%	7.09%	0.30%	0.25%	0.50%	0.10%
VeryLight	90%	6.19%	6.39%	7.29%	0.30%	0.25%	0.50%	0.10%
Light	90%	6.49%	6.49%	7.59%	0.30%	0.25%	0.50%	0.10%
Mid	85%	6.74%	6.74%	7.85%	0.25%	0.25%	0.25%	0.25%
Heavy	80%	6.79%	6.79%	7.89%	0.25%	0.25%	0.25%	0.25%
Unlimited	75%	7.04%	7.04%	8.14%	0.25%	0.25%	0.25%	0.25%
Spread over LIBOR**								
Minor	90%	0.99%	1.04%	2.09%	2.39%	2.34%	2.59%	2.19%
VeryLight	90%	1.19%	1.39%	2.29%	2.59%	2.54%	2.79%	2.39%
Light	90%	1.49%	1.49%	2.59%	2.89%	2.84%	3.09%	2.69%
Mid	85%	1.74%	1.74%	2.85%	3.10%	3.10%	3.10%	3.10%
Heavy	80%	1.79%	1.79%	2.89%	3.14%	3.14%	3.14%	3.14%
Unlimited	80%	2.04%	2.04%	3.14%	3.39%	3.39%	3.39%	3.39%

Source: Company reports. *Sample only – KMC offers additional products. **3M LIBOR assumed at 5.0%.

By subtracting 3M LIBOR from the various prices in the above table, we are attempting to estimate gross interest margins. Although we would need the relative volumes of these products being sold in order to estimate a weighted average front-book interest margin, it seems reasonable to assume that core margins have further to fall. Since lower margin products have been reported to have accounted for around 60% of KMC's new business in 2005, we think new business margins could be as low as 2.2%, with back book margins trending down to 2.5%.

Uncertain outlook for fees and whole loan sale margins

Interest income represents only a proportion of total first-charge mortgage income. Kensington also charges completion fees (£695 for discount products, £795 for fixed products) and early redemption charges. The latter are charged if a mortgage is redeemed within the first three years, and in periods when pre-payments are high (when interest rates are falling), their contribution to total income can be substantial.

In addition, KMC has increasingly originated lower margin mortgages with a view to selling them at a premium to face value to building societies or investment banks. Some 20% of Kensington Group's new business volumes are currently being sold-on at premiums of around 2.2%, although this looks to fall as more prime business is being 'originated-to-sell' to investment banks (at premiums closer to 1%). The advantages of whole loan sales and the originate-to-sell programme are: (i) they do not tie up group capital; (ii) profit recognition is up-front.

Higher margin ventures and second-charge mortgages

Offsetting the decline in KMC interest (and income) margins has been the increasing importance of higher margin new business volumes derived from new ventures. Last year Kensington earned a blended 4.8% on volumes sourced from MPL (a blend of first and second-charge mortgages) and 3.8% at SM. This has helped maintain the all-in group margin at around 3.4%. The recently launched Kensington Personal Loans, a Kensington-branded second mortgage venture, where we expect gross margins of 8%, should also help in this respect. Management has talked of up to 10% of future KMC volumes being second-charge loans.

Cheaper funding costs

The decline in core income margins has also been offset by cheaper warehouse and securitisation funding costs:

- Warehouse funding costs averaged 60bps in 1H06 as compared with 78bps in 2004;
- Weighted securitization funding costs averaged 26bps in 1H06 as compared with 30bps in 2004.

However, with a higher proportion of new business coming from higher margin first- and second-charge mortgages, we would expect the blended cost of securitization funding to creep up over time, and to an extent offset some of the gross margin benefits.

In summary, management has been able to defend its net interest and operating income margins to a degree through managing the product mix and securing cheaper funding. However these defensive measures have raised additional issues, and we consider these below.

Asset quality

There are a number of variables impacting Kensington's asset quality and its credit costs: (i) the credit environment, which will in turn reflect levels of indebtedness, disposable incomes and affordability, interest and unemployment rates; (ii) the group's credit policy; (iii) product mix.

- The credit environment has been described as challenging, not only by Kensington but by other players in the UK consumer credit and mortgage markets, although there are signs that the environment is at least stable. Clearly further significant increases in interest or unemployment rates could change this.
- On credit policy, there has been no relaxation in Kensington's standards – it still focuses on relatively low income multiples, low LTV's and diligent arrears and collections management.
- On product mix, the shift in KMC's focus to prime/near-prime on the one hand and second-charge mortgages on the other, and the increasing importance of new business from Money Partners (where ~25% of originations are also second-charge) is likely to impact upon credit quality.

The relationship between Kensington's asset quality and its credit costs requires an analysis of arrears, loan losses and impairment charges.

Arrears

Share price underperformance over the past six months began following the 1Q06 trading update in March, when management effectively warned that mortgage arrears (loans more than 3 months in arrears) had risen to the top of the 8-10% range previously targeted. This focused investors on arrears, and in particular what appeared to be high and increasing arrears at a number of Kensington's RMS securitization vehicles.

The arrears position in an individual vehicle reflects the performance of the characteristics of the underlying mortgages - when they were originated, how many were initially discounted or fixed rate mortgages, and which intermediaries introduced the business:

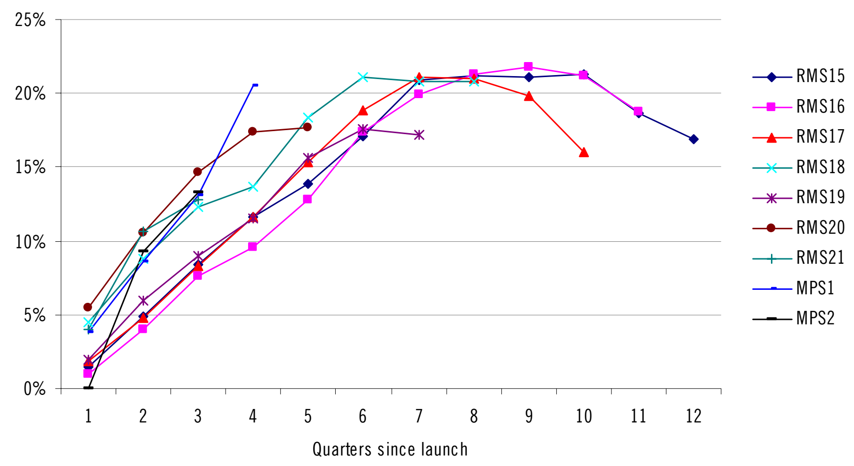
- Mortgages originated at the bottom of the interest rate cycle three years ago have resulted in high levels of arrears as borrowers have struggled to meet rising monthly repayments;
- Borrowers who took out two or three-year discounted or fixed-rate mortgages three years ago have been hit particularly hard over the past year as their discounted/fixed term ended and they reverted to significantly higher variable rates;

- Kensington has traced some poorly performing mortgage pools to a small number of introducers with whom Kensington has since terminated its relationship.

As a result of these factors, Kensington has a block of relatively poorly performing mortgages, originated around the bottom of the rate cycle two to three years ago, that are currently working their way through the loan book. This has caused Kensington some problems: last year, several of Kensington's RMS vehicles were required to draw on their reserve funds in order to meet scheduled interest payments; in May, the RMS 17 vehicle had to draw on its reserve fund following a sharp pickup in losses (losses for the quarter ended in May had increased by 28% on the previous quarter with 70% of sold repossessions in the quarter resulting in a loss).

As these loans are redeemed, or as losses are realized on repossession, their impact on arrears should diminish. The chart below — which tracks arrears performance for Kensington's RMS (and MP) vehicles in successive quarters since launch — seems to support this conclusion and helps explain why the group-wide arrears position appears to have peaked at just above 10% in 1Q06.

Figure 16. Arrears Trends – RMS and MP Vehicles in Quarters Since Launch (August 2006 Reports)



Source: Company Reports

Seasoning

The group-wide arrears figure is essentially a blend of recently originated low arrears (front-book) loans and seasoned higher arrears (back-book) loans. If the rate at which new loans added to the front of the book slows — or if the rate at which older loans are redeemed slows — then the blend will be re-weighted towards a higher arrears mix.

Asset mix

Group arrears will also reflect a shift in mix, particularly between first and second-charge loans.

- Whilst the increase in the proportion of second-charge mortgages (now 10% of the overall mix) has helped maintain the overall income margin, it could result in an increase in the blended arrears statistics.

- Second-charge mortgages are expected to show arrears some 2-3% higher than those on first mortgages, and management is targeting the second-charge proportion of the mix to increase from 10% to closer to 15% over time.

The table below shows how the seasoning of the existing book of mortgages could quite easily result in an increase in average arrears.

At the same time, it is clear to see that higher MP3 balances relative to RMS20 (similar vintage mortgage pools) would increase the weighted average. Since this is the way the loan book is developing — more MPL blended first and second-charge mortgages as a percentage of the total — this gives an indication as to the likely future trend in the overall arrears statistic.

Figure 17. Estimated Mortgage Assets Under Management & Arrears Scenarios

Vehicle	Estimated Current Balance	Mortgage Assets Mix by SPV	Estimated Current Arrears	Arrears When Seasoned?
RMS 22	790	11%	~0.0%	10.0%
RMS 21	846	12%	12.8%	13.0%
RMS 20	712	10%	17.7%	17.0%
RMS 19	488	7%	17.2%	16.0%
RMS 18	384	5%	20.8%	19.0%
RMS 17	414	6%	16.0%	15.0%
RMS 16	349	5%	18.8%	15.0%
RMS 15	200	3%	16.9%	15.0%
RMS 14	92	1%	11.0%	5.0%
MPL 3	626	9%	0.0%	5.0%
MPL 2	354	5%	13.3%	18.0%
MPL 1	322	5%	20.5%	20.0%
LMS 1	245	3%	3.5%	5.0%
Warehouse	1,200	17%	~0.0%	5.0%
	7,021	**100%**	**9.9%**	**12.0%**

Source: Company Reports and CIR Estimates. *Based on July Securitisation reports, CIR estimates

Losses & impairment charges

Loan losses include loss of principal — net proceeds on sale of les than the value of the loan outstanding — and lost interest income. The former is highly dependent upon LTVs and the quality of the collateral; the latter will reflect the speed to repossession and sale. In periods of high house price inflation (HPI) there is a trade off between the two in that the increase in the value of the collateral can more than offset the interest income lost, hence slower repossession speeds might be appropriate in such circumstances.

Kensington saw a sharp increase in losses during the first half of the current year – losses as a percentage of average mortgage assets increased from an annualized 21bps in 1H05 and 27bps in 2H05 to 60bps in 1H06. Management has explained this increase as being due to:

- A shortening of the time period between a loan going into arrears and repossession by around three months (which was prompted by lower HPI).

This brought forward into the first half losses that would otherwise have been realized in the second half.

- High loss severities have been experienced on a relatively small number of larger size loans. Now that these have been recognized, the outlook for losses should have improved.

Since losses tend to lag arrears — by the interval between a loan going into arrears and repossession — we expect losses will have continued to rise during the second half of this year, before reduced arrears in the second quarter are reflected in lower losses in 2007.

The outlook for income margins and credit costs

The outlook for margins is poor, in our view. We expect core KMC margins to continue to decline, partly as a result of increased competition, and partly as a result of the shift into near-prime/prime 'originate-to-sell' business. Whilst the shift into higher-margin products such as second mortgages will continue to offset this decline, we suspect margins in these products will also come under competitive pricing pressure.

The outlook for credit costs is far from clear. Whilst back-book arrears look to be easing as the block of poorly performing mortgages works its way through, the shift in the front-book mix to second-charge mortgages is likely to result in increased arrears and losses.

For forecasting purposes, we have assumed rising impairment charges as a percentage of average assets, which alongside our forecast for continued income margin compression, results in a reduction in the group's return on assets going forward. The outlook for earnings growth is therefore reliant upon continued volume growth and/or increased balance sheet leverage, in our view.

Money Partners options

Kensington currently has a 20% equity stake in MPL together with one of two 'founder' shares which give it voting rights over key business decisions. Kensington has the right to acquire an additional 30% of MPL in early 2007, and the remaining 50% in early 2009.

- The first option, which is exercisable during a three-month period following the publication of the 2006 report and accounts (February 2007). The exercise price of this option is not market based and hence is expected to be relatively small. However, as it takes the stake to 50%, this should result in a higher MPL profit contribution in Kensington's accounts.

- The second option is exercisable during the three months following the publication of the 2008 report and accounts (February 2009). The exercise price of this option will be based on a fair valuation of MPL. Three quarters of this valuation will be based on MPL's earnings in 2008 (the multiple based on Kensington's multiple but collared between 7x and 10x), with a quarter of the value based on 'mortgage contribution', which we believe will be linked to 2008 mortgage originations, and a deferred consideration payable in 2010 based on the 2009 'mortgage contribution'.

In order to estimate the potential cost of exercising the second option, we have to consider the financial relationship between Kensington Group and MPL in more detail.

MPL business model

- MPL originates and underwrites first and second-charge mortgages through intermediaries that have in the past focused on second-charge loans and hence have not previously introduced business to KMC. As part of this process MPL charges and retains a completion fee.
- MPL then sells mortgage pools to Kensington at a premium to face value, the premium reflecting whether the mortgages are first or second charge, their average LTV and their average gross margin. The premiums charged are higher than would be charged in the open market to part subsidise MPL's origination costs and to allow MPL to "share" in the profit Kensington earns on the loans purchased. 60% of the premium is paid up-front with 40% deferred.
- MPL's revenues therefore comprise arrangement fees, profit on sale and deferred profit on sale. Its costs are origination and administrative expenses, but not credit costs.

In the table below we set out some crude projections for MPL's profits out to 2010, based upon new business volumes already factored into our group forecasts.

Figure 18. Money Partners – Earnings Forecasts

Year to November (£m)	2005	1H06	2H06E	2006E	2007E	2008E	2009E	2010E
KMC initial fee	22.4	18.6	16.2	34.8	38.3	40.2	41.0	41.0
Arrangement fees	12.8	10.6	9.2	19.8	21.8	22.9	23.3	23.3
KMC trail fee	8.8	7.3	6.3	13.6	15.0	23.2	25.5	26.8
Total income	**44.0**	**36.5**	**31.7**	**68.2**	**75.0**	**86.2**	**89.8**	**91.1**
Origination costs	-8.3	-6.9	-6.0	-12.9	-14.2	-14.9	-15.2	-15.2
Marginal admin expenses	-6.6	-5.5	-4.8	-10.3	-11.3	-11.9	-12.1	-12.1
Net income	**29.0**	**24.1**	**20.9**	**45.0**	**49.5**	**59.5**	**62.5**	**63.8**
Fixed costs	-32.0	-19.8	-14.2	-34.0	-35.7	-37.5	-39.4	-39.4
Profit before tax	**-3.0**	**4.3**	**6.7**	**11.0**	**13.8**	**22.0**	**23.1**	**24.4**
Taxation	0.0	-1.3	-2.0	-3.3	-4.1	-6.6	-6.9	-7.3
Net profit	**-3.0**	**3.0**	**4.7**	**7.7**	**9.7**	**15.4**	**16.2**	**17.1**
Originations	831	689	599	1,288	1,417	1,488	1,517	1,517
Average mortgage	65,000	65,000	65,001	65,000	65,000	65,000	65,000	65,000
No mortgages	12,785	10,600	9,216	19,816	21,798	22,888	23,345	23,345
Blended margin	4.5%	4.5%	4.5%	4.5%	4.5%	4.5%	4.5%	4.5%
Origination costs	1.0%	1.0%	1.0%	1.0%	1.0%	1.0%	1.0%	1.0%
Marginal admin expenses	0.8%	0.8%	0.8%	0.8%	0.8%	0.8%	0.8%	0.8%
Kensington associate @ 20%	**-0.6**	**0.6**	**0.9**	**1.5**				
Kensington associate @ 50%					**4.8**	**7.7**	**8.1**	**8.5**

Source: Company reports and Citigroup Investment Research estimates

We have used these projections as the basis for estimating a potential future value for MPL.

- Based on a multiple of 10x 2007E earnings, we estimate an earnings-based element to the valuation of Money Partners at £115m; based on an "in-force" value for originations equal to 4.5% of the 2007E total, we estimate a "mortgage contribution" value of £67m; finally, we add a deferred consideration element of £17m, equal to just over 1% of estimated 2009E originations;

- In aggregate, we therefore tentatively value Money Partners at around £200m (and 50% at around £100m) in just over three years time, when Kensington's second option can be exercised.

In summary, we believe the wider market has yet to digest the financial and valuation implications of the group's partial ownership of MPL. On the one hand, Kensington is set to own 50% of something potentially very valuable following the exercise of its first option in 1H07; on the other hand, the cost of taking control of MPL in 2009 could be considerable.

A fuller explanation of the economics of Kensington's relationship with MPL, the rights of the 'founder' share Kensington holds in MPL, and the precise terms of the MPL options is required for investors to fully appreciate this potential.

M&A and MPL

Kensington appears likely to continue to be seen as an attractive acquisition opportunity for investment banks looking to boost their UK mortgage-backed businesses (Morgan Stanley (MS.N - US$72.33; 1M) and Merrill Lynch (MER.N - US$78.22; 1M) have recently bought US sub-prime mortgage origination businesses). Whilst we acknowledge the funding and other synergies potentially available to a buyer of Kensington, we are less convinced as to the business benefits. Since Kensington already 'originates-to-sell' on behalf of investment banks, they are effectively boosting their MBS pipelines without having to acquire Kensington. Furthermore, investment banks tend to want front-book flow rather than back- book assets under management and with an increasing proportion of Kensington's new business volumes coming from MPL, we suspect the latter might be the more attractive target.

Financials

Forecast summary

Figure 19. Forecast Summary

Year to November (£m)	UK GAAP 2004	2005	IFRS 2005*	2005	06h1	06h2E	2006E	2007E	2008E	2009E	2010E
Income & Expenses											
Net interest income	83.7	112.1	112.1	142.1	76.7	99.3	176.0	226.0	256.0	270.6	274.6
Net fees & commissions	38.1	27.3	34.0	9.9	5.4	6.7	12.1	17.2	22.1	26.2	29.7
Profit on sale of mortgages	4.4	16.4	16.4	16.4	9.2	9.0	18.2	19.0	19.1	18.9	18.9
Operating income	**126.2**	**155.8**	**162.5**	**168.4**	**91.3**	**115.0**	**206.3**	**262.3**	**297.3**	**315.7**	**323.2**
Operating expenses	-60.7	-69.1	-76.0	-80.4	-43.5	-50.4	-93.9	-116.7	-129.3	-134.2	-134.1
Pre-provision profit	**65.5**	**86.7**	**86.5**	**88.0**	**47.8**	**64.6**	**112.4**	**145.5**	**168.0**	**181.6**	**189.1**
Provision for losses	-13.2	-30.2	-30.2	-35.8	-24.5	-29.4	-53.9	-70.6	-85.3	-95.1	-100.7
Operating profit	**52.3**	**56.5**	**56.3**	**52.2**	**23.3**	**35.3**	**58.6**	**74.9**	**82.6**	**86.4**	**88.4**
Associate income	-0.5	-0.5	-0.5	-0.5	0.6	0.9	1.5	4.8	7.7	8.1	8.5
Change in FV derivatives				4.9	5.8	0.0	5.8				
Change in FV MPL/SM options				0.4	0.6	0.0	0.6				
Core PBT	**51.8**	**56.0**	**55.8**	**57.0**	**30.3**	**36.2**	**66.5**	**79.8**	**90.3**	**94.5**	**97.0**
Exceptional items		0.1	0.1	0.1							
Goodwill amortisation	-2.1	-2.1									
Profit before tax	**49.7**	**54.0**	**55.9**	**57.1**	**30.3**	**36.2**	**66.5**	**79.8**	**90.3**	**94.5**	**97.0**
Taxation	-16.1	-17.4	-17.4	-17.7	-9.3	-10.7	-20.0	-23.9	-27.1	-28.4	-29.1
Minorities	0.4	0.8	0.8	0.8	0.3	-0.3	0.0	-1.5	-1.5	-1.5	-1.5
Attributable profit	**34.0**	**37.4**	**39.3**	**40.2**	**21.3**	**25.3**	**46.6**	**54.3**	**61.7**	**64.7**	**66.4**
Dividend	-8.4	-11.1	-9.0	-9.0	-7.7	-5.6	-13.3	-15.5	-17.6	-18.5	-19.0
Retained earnings	25.6	26.3	30.3	31.2	13.6	19.7	33.3	38.8	44.1	46.2	47.4
Balance Sheet											
Avg mortgage AUM	3,628	4,917	4,917	4,917	6,122	7,160	6,733	8,610	10,041	10,932	11,440
Mortgage assets under management	4,138	5,695	5,695	5,695	6,548	7,772	7,772	9,449	10,633	11,231	11,649
Equity	113.9	139.9	149.1	159.8	168.5	173.2	173.2	212.0	256.1	302.3	349.7
Minorities	0.3	1.1	1.1	1.1	1.4	1.1	1.1	1.1	1.1	1.1	1.1
Intangible assets	16.3	14.9	17.0	17.0	17.0	14.9	14.9	14.9	14.9	14.9	14.9
Tangible equity	97.6	125.0	132.1	142.8	151.5	158.3	158.3	197.1	241.2	287.4	334.8
Provision balance	54.6	42.1	36.4	36.4	44.5	56.6	56.6	75.6	90.7	103.8	112.9
NPLs	302.1	518.2	518.2	518.2	628.6	777.2	777.2	992.2	1169.6	1291.5	1397.9
Ratios											
Net interest margin	2.31%	2.28%	2.28%	2.99%	2.70%	2.77%	2.70%	2.63%	2.55%	2.48%	2.40%
Fee & Comm margin	1.05%	0.56%	0.69%	0.20%	0.18%	0.19%	0.18%	0.20%	0.22%	0.24%	0.26%
Profit on sale margin	0.12%	0.33%	0.33%	0.33%	0.30%	0.25%	0.27%	0.22%	0.19%	0.17%	0.17%
Total income margin	**3.48%**	**3.17%**	**3.31%**	**3.52%**	**3.17%**	**3.21%**	**3.15%**	**3.05%**	**2.96%**	**2.89%**	**2.83%**
Cost:income ratio	-48.1%	-44.4%	-46.8%	-47.7%	-47.6%	-43.8%	-45.5%	-44.5%	-43.5%	-42.5%	-41.5%
Provision charge:avg loans	-0.36%	-0.61%	-0.61%	-0.73%	-0.80%	-0.82%	-0.80%	-0.82%	-0.85%	-0.87%	-0.88%
NPLs:loans	7.3%	9.1%	9.1%	9.1%	9.6%	10.0%	10.0%	10.5%	11.0%	11.5%	12.0%
Provision balance:NPLs	18.1%	8.1%	7.0%	7.0%	7.1%	7.3%	7.3%	7.6%	7.8%	8.0%	8.1%
Provisions balance:loans	1.32%	0.74%	0.64%	0.64%	0.68%	0.73%	0.73%	0.80%	0.85%	0.92%	0.97%
ROE	33.9%	31.0%	28.9%	27.4%	26.8%	29.6%	29.7%	28.2%	26.4%	23.2%	20.4%
RoAvgMAUM	1.00%	0.80%	0.80%	0.82%	0.69%	0.71%	0.69%	0.63%	0.61%	0.59%	0.58%
Equity:managed mortgage assets	2.8%	2.5%	2.6%	2.8%	2.6%	2.2%	2.2%	2.2%	2.4%	2.7%	3.0%
Effective tax rate	-31.1%	-31.1%	-31.2%	-31.1%	-30.7%	-29.4%	30.0%	30.0%	30.0%	30.0%	30.0%
Per share data											
Reported diluted EPS (p)	63.3	70.7	74.3	76.0	40.3	47.8	88.0	102.7	116.7	122.3	125.5
Adjusted EPS (p)	**67.2**	**74.5**	**74.1**	**75.8**	**40.3**	**47.8**	**88.0**	**102.7**	**116.7**	**122.3**	**125.5**
DPS (p)	16.0	21.5	21.5	21.5	8.0	17.8	25.8	30.1	34.2	35.8	36.8
NAV/share (p)	223.9	271.3	289.1	309.9	326.8	335.8	335.8	411.1	496.6	586.2	678.1

Source: Company Reports and CIR Estimates. *IFRS "light"

Margin analysis

Figure 20. Returns on Average Mortgage Assets (RoMAUM) and Return on Equity (RoE)

	UK GAAP				IFRS						
Year to November	**2001**	**2002**	**2003**	**2004**	**2005***	**06h1***	**2006E***	**2007E**	**2008E**	**2009E**	**2010E**
Interest receivable	9.86%	8.14%	7.30%	8.12%	9.03%	8.57%	8.55%	8.53%	8.50%	8.48%	8.45%
Interest payable	-6.97%	-5.59%	-4.95%	-5.81%	-6.04%	-5.88%	-5.85%	-5.90%	-5.95%	-6.00%	-6.05%
Net interest income	**2.89%**	**2.55%**	**2.35%**	**2.31%**	**2.99%**	**2.70%**	**2.70%**	**2.63%**	**2.55%**	**2.48%**	**2.40%**
Net fees & commissions	0.64%	1.00%	1.10%	1.05%	0.20%	0.18%	0.18%	0.20%	0.22%	0.24%	0.26%
Profit on sale of mortgages	0.00%	0.00%	0.05%	0.12%	0.33%	0.30%	0.27%	0.22%	0.19%	0.17%	0.17%
Operating income	**3.53%**	**3.56%**	**3.50%**	**3.48%**	**3.52%**	**3.17%**	**3.15%**	**3.05%**	**2.96%**	**2.89%**	**2.83%**
Operating expenses	-1.29%	-1.48%	-1.81%	-1.67%	-1.64%	-1.42%	-1.39%	-1.36%	-1.29%	-1.23%	-1.17%
Provision for losses	-0.43%	-0.31%	-0.21%	-0.36%	-0.73%	-0.80%	-0.80%	-0.82%	-0.85%	-0.87%	-0.88%
Operating profit	**1.81%**	**1.77%**	**1.48%**	**1.44%**	**1.16%**	**0.95%**	**0.96%**	**0.87%**	**0.82%**	**0.79%**	**0.77%**
Associate income				-0.01%	-0.01%	0.02%	0.02%	0.06%	0.08%	0.07%	0.07%
Change in FV MPL/SM options					0.01%	0.02%	0.01%				
Core PBT	**1.81%**	**1.77%**	**1.48%**	**1.43%**	**1.16%**	**0.99%**	**0.99%**	**0.93%**	**0.90%**	**0.86%**	**0.85%**
Exceptional items	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%
Taxation	-0.54%	-0.44%	-0.44%	-0.44%	-0.36%	-0.30%	-0.30%	-0.28%	-0.27%	-0.26%	-0.25%
Minorities	0.00%	0.00%	0.00%	0.01%	0.02%	0.01%	0.00%	-0.02%	-0.01%	-0.01%	-0.01%
Return on average mortgage assets	**1.27%**	**1.31%**	**0.94%**	**0.94%**	**0.82%**	**0.70%**	**0.69%**	**0.63%**	**0.61%**	**0.59%**	**0.58%**
Average mortgage assets	1380.8	1704.2	2512.9	3628.1	4916.7	6121.5	6733.3	8610.4	10041.1	10931.9	11439.9
Average equity	62.2	78.7	93.0	106.6	146.8	158.8	161.1	192.6	234.0	279.2	326.0
Leverage	22.2	21.7	27.0	34.1	33.5	38.5	41.8	44.7	42.9	39.2	35.1
Return on average equity	**28.1%**	**28.3%**	**25.5%**	**31.9%**	**27.4%**	**26.8%**	**28.9%**	**28.2%**	**26.4%**	**23.2%**	**20.4%**

Source: Company Reports and CIR Estimates. *FY05 and FY06 interest receivable has been grossed up for change in FV derivatives.

APPENDIX – Appraisal Values

As an alternative to peer group relative analysis and our primary price to book valuation methodology, we have attempted to value Kensington's mortgage assets under management and its ability to generate new business by key lending channel using a discounted cash flow approach. In doing so we have applied a number of assumed income and cost margins to average mortgage assets to derive future cash flows, which we tax and discount to net present value.

The key assumptions are:

- For existing (back-book) mortgage assets, we have made run-off or prepayment speed and discount rate assumptions. In all cases we have used a 25% prepayment rate and a 10% discount rate.
- For new business (front-book) volumes we have assumed the same annual volumes out to 2010 as factored into our group earnings forecasts. Thereafter we have assumed growth rates of 3% pa for MPL and 2.5% pa for SM, but a 2% pa decline for KMC.
- We have assumed lower front-book gross margins and higher credit costs for all channels, to allow for price competition and the potential for deterioration in credit quality.
- So that we can apply an average annual redemption charge 'margin' on new business volumes, we have assumed redemption after year three for all new business volumes, regardless of the prepayment speed assumption.

The results of this alternative analysis are summarised below and detailed over the following pages.

Figure 21. Front and Back Book Appraisal Values

	£m	p	%MAUM
Kensington Mortgages			
In force value	51	96	2.0%
New business value	225	425	9.0%
Appraisal value	**276**	**521**	**11.1%**
Money Partners (volumes)			
In force value	43	82	5.0%
New business value	190	359	22.1%
Appraisal value	**233**	**440**	**27.1%**
Start Mortgages			
In force value	4	8	2.7%
New business value	41	77	25.5%
Appraisal value	**45**	**85**	**28.2%**
Kensington share (64%)	**29**	**54**	**18.1%**

Source: Citigroup Investment Research

A sum-of-the-parts valuation for the group based on these appraisal values is set out in the Valuation section of this note.

Figure 22. Kensington Mortgages/TML - In-Force Value of Existing MAUM (Prepayment Rate 25%, Discount Rate 10%)

Year to November	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
Mortgage assets	4703	3527	2645	1984	1488	1116	837	628	471	353	265	199	149	112	84	63	47
Average MAUM		**4115**	**3086**	**2315**	**1736**	**1302**	**976**	**732**	**549**	**412**	**309**	**232**	**174**	**130**	**98**	**73**	**55**
Interest margin		2.8%	2.8%	2.8%	2.8%	2.8%	2.8%	2.8%	2.8%	2.8%	2.8%	2.8%	2.8%	2.8%	2.8%	2.8%	2.8%
Cost of funds		-0.5%	-0.5%	-0.5%	-0.5%	-0.5%	-0.5%	-0.5%	-0.5%	-0.5%	-0.5%	-0.5%	-0.5%	-0.5%	-0.5%	-0.5%	-0.5%
Origination costs		-0.8%	-0.8%	-0.8%	-0.8%	-0.8%	-0.8%	-0.8%	-0.8%	-0.8%	-0.8%	-0.8%	-0.8%	-0.8%	-0.8%	-0.8%	-0.8%
Other admin costs		-0.8%	-0.8%	-0.8%	-0.8%	-0.8%	-0.8%	-0.8%	-0.8%	-0.8%	-0.8%	-0.8%	-0.8%	-0.8%	-0.8%	-0.8%	-0.8%
Credit costs		-0.3%	-0.3%	-0.3%	-0.3%	-0.3%	-0.3%	-0.3%	-0.3%	-0.3%	-0.3%	-0.3%	-0.3%	-0.3%	-0.3%	-0.3%	-0.3%
Net margin		**0.4%**	**0.4%**	**0.4%**	**0.4%**	**0.4%**	**0.4%**	**0.4%**	**0.4%**	**0.4%**	**0.4%**	**0.4%**	**0.4%**	**0.4%**	**0.4%**	**0.4%**	**0.4%**
Pre-ERC cash flows		16	12	9	7	5	4	3	2	2	1	1	1	1	0	0	0
ERC income		18	9	3													
Gross cash flows		**34**	**21**	**13**	**7**	**5**	**4**	**3**	**2**	**2**	**1**	**1**	**1**	**1**	**0**	**0**	**0**
Net cash flows		24	15	9	5	4	3	2	2	1	1	1	0	0	0	0	0
PV (cash flows)		**22**	**12**	**7**	**3**	**2**	**2**	**1**	**1**	**0**	**0**	**0**	**0**	**0**	**0**	**0**	**0**
NPV (cash flows)	**51**																
NPV/share (p)	**96**																

Source: Citigroup Investment Research

Figure 23. Kensington Mortgages/TML - New Business Value (Prepayment Rate 25%, Discount Rate 10%, L/T New Business Growth Rate -2.%)

Year to November	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
New business		2,752	2,807	2,835	2,835	2,779	2,723	2,669	2,615	2,563	2,512	2,461	2,412	2,364	2,317	2,270	2,225
2007		1,204	1,806	1,355													
2008			1,228	1,842	1,382												
2009				1,240	1,861	1,396											
2010					1,240	1,861	1,396										
2011						1,216	1,823	1,368									
2012							1,191	1,787	1,340								
2013								1,168	1,751	1,313							
2014									1,144	1,716	1,287						
2015										1,121	1,682	1,261					
2016											1,099	1,648	1,236				
2017												1,077	1,615	1,211			
2018													1,055	1,583	1,187		
2019														1,034	1,551	1,164	
2020															1,014	1,520	1,140
2021																993	1,490
2022																	973
Earning assets		**1,204**	**3,034**	**4,437**	**4,483**	**4,472**	**4,410**	**4,322**	**4,236**	**4,151**	**4,068**	**3,987**	**3,907**	**3,829**	**3,752**	**3,677**	**3,604**
Interest margin		2.2%	2.2%	2.2%	2.2%	2.2%	2.2%	2.2%	2.2%	2.2%	2.2%	2.2%	2.2%	2.2%	2.2%	2.2%	2.2%
Arrangement fees		0.2%	0.2%	0.2%	0.2%	0.2%	0.2%	0.2%	0.2%	0.2%	0.2%	0.2%	0.2%	0.2%	0.2%	0.2%	0.2%
Cost of funds		-0.4%	-0.4%	-0.4%	-0.4%	-0.4%	-0.4%	-0.4%	-0.4%	-0.4%	-0.4%	-0.4%	-0.4%	-0.4%	-0.4%	-0.4%	-0.4%
Origination costs		-0.8%	-0.8%	-0.8%	-0.8%	-0.8%	-0.8%	-0.8%	-0.8%	-0.8%	-0.8%	-0.8%	-0.8%	-0.8%	-0.8%	-0.8%	-0.8%
Other admin costs		-0.8%	-0.8%	-0.8%	-0.8%	-0.8%	-0.8%	-0.8%	-0.8%	-0.8%	-0.8%	-0.8%	-0.8%	-0.8%	-0.8%	-0.8%	-0.8%
Credit costs		-0.2%	-0.2%	-0.2%	-0.2%	-0.2%	-0.2%	-0.2%	-0.2%	-0.2%	-0.2%	-0.2%	-0.2%	-0.2%	-0.2%	-0.2%	-0.2%
Net margin		**0.2%**	**0.2%**	**0.2%**	**0.2%**	**0.2%**	**0.2%**	**0.2%**	**0.2%**	**0.2%**	**0.2%**	**0.2%**	**0.2%**	**0.2%**	**0.2%**	**0.2%**	**0.2%**
Pre-ERC cash flows		2	6	9	9	9	9	9	8	8	8	8	8	8	8	7	7
ERC margin		**0.9%**	**0.9%**	**0.9%**	**0.9%**	**0.9%**	**0.9%**	**0.9%**	**0.9%**	**0.9%**	**0.9%**	**0.9%**	**0.9%**	**0.9%**	**0.9%**	**0.9%**	**0.9%**
ERC income		11	27	40	40	40	40	39	38	37	37	36	35	34	34	33	32
Gross cash flows		**13**	**33**	**49**	**49**	**49**	**49**	**48**	**47**	**46**	**45**	**44**	**43**	**42**	**41**	**40**	**40**
Net cash flows		9	23	34	35	34	34	33	33	32	31	31	30	29	29	28	28
PV (cash flows)		**8**	**19**	**26**	**24**	**21**	**19**	**17**	**15**	**14**	**12**	**11**	**10**	**9**	**8**	**7**	**6**
NPV (total)	**225**																
NPV/share (p)	**425**																

Source: Citigroup Investment Research

Figure 24. Money Partners - In-Force Value of Existing MAUM (Prepayment Rate 25%, Discount Rate 10%)

Year to November	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**	**2020**	**2021**	**2022**
Mortgage assets	1626	1220	915	686	515	386	289	217	163	122	92	69	52	39	29	22	16
Average MAUM		**1423**	**1067**	**800**	**600**	**450**	**338**	**253**	**190**	**142**	**107**	**80**	**60**	**45**	**34**	**25**	**19**
Interest margin		4.5%	4.5%	4.5%	4.5%	4.5%	4.5%	4.5%	4.5%	4.5%	4.5%	4.5%	4.5%	4.5%	4.5%	4.5%	4.5%
Cost of funds		-0.6%	-0.6%	-0.6%	-0.6%	-0.6%	-0.6%	-0.6%	-0.6%	-0.6%	-0.6%	-0.6%	-0.6%	-0.6%	-0.6%	-0.6%	-0.6%
Origination costs		-1.2%	-1.2%	-1.2%	-1.2%	-1.2%	-1.2%	-1.2%	-1.2%	-1.2%	-1.2%	-1.2%	-1.2%	-1.2%	-1.2%	-1.2%	-1.2%
Other admin costs		-0.8%	-0.8%	-0.8%	-0.8%	-0.8%	-0.8%	-0.8%	-0.8%	-0.8%	-0.8%	-0.8%	-0.8%	-0.8%	-0.8%	-0.8%	-0.8%
Credit costs		-0.6%	-0.6%	-0.6%	-0.6%	-0.6%	-0.6%	-0.6%	-0.6%	-0.6%	-0.6%	-0.6%	-0.6%	-0.6%	-0.6%	-0.6%	-0.6%
Net margin		**1.3%**	**1.3%**	**1.3%**	**1.3%**	**1.3%**	**1.3%**	**1.3%**	**1.3%**	**1.3%**	**1.3%**	**1.3%**	**1.3%**	**1.3%**	**1.3%**	**1.3%**	**1.3%**
Pre-ERC cash flows		18	14	10	8	6	4	3	2	2	1	1	1	1	0	0	0
ERC income		6	3	1													
Gross cash flows		**25**	**17**	**12**	**8**	**6**	**4**	**3**	**2**	**2**	**1**	**1**	**1**	**1**	**0**	**0**	**0**
Net cash flows		17	12	8	5	4	3	2	2	1	1	1	1	0	0	0	0
PV (cash flows)		**16**	**10**	**6**	**4**	**3**	**2**	**1**	**1**	**1**	**0**	**0**	**0**	**0**	**0**	**0**	**0**
NPV (cash flows)	**43**																
NPV/share (p)	**82**																

Source: Citigroup Investment Research

Figure 25. Money Partners - New Business Value (Prepayment Rate 25%, Discount Rate 10%, L/T New Business Growth Rate 3%)

Year to November	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**	**2020**	**2021**	**2022**
New business	1288	1417	1488	1517	1517	1563	1610	1658	1708	1759	1812	1866	1922	1980	2039	2101	2164
2007		620	930	697													
2008			651	976	732												
2009				664	996	747											
2010					664	996	747										
2011						684	1,026	769									
2012							704	1,056	792								
2013								725	1,088	816							
2014									747	1,121	841						
2015										770	1,154	866					
2016											793	1,189	892				
2017												816	1,225	919			
2018													841	1,261	946		
2019														866	1,299	974	
2020															892	1,338	1,004
2021																919	1,378
2022																	947
Earning assets		**620**	**1,581**	**2,338**	**2,392**	**2,427**	**2,477**	**2,551**	**2,628**	**2,707**	**2,788**	**2,871**	**2,958**	**3,046**	**3,138**	**3,232**	**3,329**
Interest margin		4.0%	4.0%	4.0%	4.0%	4.0%	4.0%	4.0%	4.0%	4.0%	4.0%	4.0%	4.0%	4.0%	4.0%	4.0%	4.0%
Arrangement fees		0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Cost of funds		-0.6%	-0.6%	-0.6%	-0.6%	-0.6%	-0.6%	-0.6%	-0.6%	-0.6%	-0.6%	-0.6%	-0.6%	-0.6%	-0.6%	-0.6%	-0.6%
Origination costs		-1.2%	-1.2%	-1.2%	-1.2%	-1.2%	-1.2%	-1.2%	-1.2%	-1.2%	-1.2%	-1.2%	-1.2%	-1.2%	-1.2%	-1.2%	-1.2%
Other admin costs		-0.8%	-0.8%	-0.8%	-0.8%	-0.8%	-0.8%	-0.8%	-0.8%	-0.8%	-0.8%	-0.8%	-0.8%	-0.8%	-0.8%	-0.8%	-0.8%
Credit costs		-0.8%	-0.8%	-0.8%	-0.8%	-0.8%	-0.8%	-0.8%	-0.8%	-0.8%	-0.8%	-0.8%	-0.8%	-0.8%	-0.8%	-0.8%	-0.8%
Net margin		**0.6%**	**0.6%**	**0.6%**	**0.6%**	**0.6%**	**0.6%**	**0.6%**	**0.6%**	**0.6%**	**0.6%**	**0.6%**	**0.6%**	**0.6%**	**0.6%**	**0.6%**	**0.6%**
Pre-ERC cash flows		3.7	9.5	14.0	14.4	14.6	14.9	15.3	15.8	16.2	16.7	17.2	17.7	18.3	18.8	19.4	20.0
ERC margin		**0.9%**	**0.9%**	**0.9%**	**0.9%**	**0.9%**	**0.9%**	**0.9%**	**0.9%**	**0.9%**	**0.9%**	**0.9%**	**0.9%**	**0.9%**	**0.9%**	**0.9%**	**0.9%**
ERC income		6	14	21	22	22	22	23	24	24	25	26	27	27	28	29	30
Gross cash flows		**9**	**24**	**35**	**36**	**36**	**37**	**38**	**39**	**41**	**42**	**43**	**44**	**46**	**47**	**48**	**50**
Tax		-3	-7	-11	-11	-11	-11	-11	-12	-12	-13	-13	-13	-14	-14	-15	-15
PV (cash flows)		**6**	**14**	**18**	**17**	**16**	**15**	**14**	**13**	**12**	**11**	**11**	**10**	**9**	**9**	**8**	**8**
NPV (total)	**190**																
NPV/share (p)	**359**																

Source: Citigroup Investment Research.

Figure 26. Start Mortgages - In-Force Value of Existing MAUM (Prepayment Rate 25%, Discount Rate 10%)

Year to November	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**	**2020**	**2021**	**2022**
Mortgage assets	302	226	170	127	95	72	54	40	30	23	17	13	10	7	5	4	3
Average MAUM		**264**	**198**	**148**	**111**	**84**	**63**	**47**	**35**	**26**	**20**	**15**	**11**	**8**	**6**	**5**	**4**
Interest margin		3.6%	3.6%	3.6%	3.6%	3.6%	3.6%	3.6%	3.6%	3.6%	3.6%	3.6%	3.6%	3.6%	3.6%	3.6%	3.6%
Cost of funds		-0.6%	-0.6%	-0.6%	-0.6%	-0.6%	-0.6%	-0.6%	-0.6%	-0.6%	-0.6%	-0.6%	-0.6%	-0.6%	-0.6%	-0.6%	-0.6%
Origination costs		-1.2%	-1.2%	-1.2%	-1.2%	-1.2%	-1.2%	-1.2%	-1.2%	-1.2%	-1.2%	-1.2%	-1.2%	-1.2%	-1.2%	-1.2%	-1.2%
Other admin costs		-0.8%	-0.8%	-0.8%	-0.8%	-0.8%	-0.8%	-0.8%	-0.8%	-0.8%	-0.8%	-0.8%	-0.8%	-0.8%	-0.8%	-0.8%	-0.8%
Credit costs		-0.4%	-0.4%	-0.4%	-0.4%	-0.4%	-0.4%	-0.4%	-0.4%	-0.4%	-0.4%	-0.4%	-0.4%	-0.4%	-0.4%	-0.4%	-0.4%
Net margin		**0.6%**	**0.6%**	**0.6%**	**0.6%**	**0.6%**	**0.6%**	**0.6%**	**0.6%**	**0.6%**	**0.6%**	**0.6%**	**0.6%**	**0.6%**	**0.6%**	**0.6%**	**0.6%**
Pre-ERC cash flows		2	1	1	1	1	0	0	0	0	0	0	0	0	0	0	0
ERC income		1	1	0													
Gross cash flows		**3**	**2**	**1**	**1**	**1**	**0**	**0**	**0**	**0**	**0**	**0**	**0**	**0**	**0**	**0**	**0**
Net cash flows		2	1	1	0	0	0	0	0	0	0	0	0	0	0	0	0
PV (cash flows)		**2**	**1**	**1**	**0**	**0**	**0**	**0**	**0**	**0**	**0**	**0**	**0**	**0**	**0**	**0**	**0**
NPV (cash flows)	**4**																
NPV/share (p)	**8**																

Source: Citigroup Investment Research

Figure 27. Start Mortgages - New Business Value (Prepayment Rate 25%, Discount Rate 10%, L/T New Business Growth Rate 2.5%)

Year to November	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**	**2020**	**2021**	**2022**
New business	324	356	374	382	382	391	401	411	421	432	443	454	465	477	489	501	513
2007		156	234	175													
2008			164	246	184												
2009				167	250	188											
2010					167	250	188										
2011						171	257	193									
2012							175	263	197								
2013								180	270	202							
2014									184	276	207						
2015										189	283	213					
2016											194	290	218				
2017												198	298	223			
2018													203	305	229		
2019														209	313	235	
2020															214	321	240
2021																219	329
2022																	225
Earning assets		**156**	**398**	**588**	**602**	**609**	**620**	**635**	**651**	**668**	**684**	**701**	**719**	**737**	**755**	**774**	**794**
Interest margin		3.3%	3.3%	3.3%	3.3%	3.3%	3.3%	3.3%	3.3%	3.3%	3.3%	3.3%	3.3%	3.3%	3.3%	3.3%	3.3%
Arrangement fees		0.2%	0.2%	0.2%	0.2%	0.2%	0.2%	0.2%	0.2%	0.2%	0.2%	0.2%	0.2%	0.2%	0.2%	0.2%	0.2%
Cost of funds		-0.6%	-0.6%	-0.6%	-0.6%	-0.6%	-0.6%	-0.6%	-0.6%	-0.6%	-0.6%	-0.6%	-0.6%	-0.6%	-0.6%	-0.6%	-0.6%
Origination costs		-1.2%	-1.2%	-1.2%	-1.2%	-1.2%	-1.2%	-1.2%	-1.2%	-1.2%	-1.2%	-1.2%	-1.2%	-1.2%	-1.2%	-1.2%	-1.2%
Other admin costs		-0.8%	-0.8%	-0.8%	-0.8%	-0.8%	-0.8%	-0.8%	-0.8%	-0.8%	-0.8%	-0.8%	-0.8%	-0.8%	-0.8%	-0.8%	-0.8%
Credit costs		-0.5%	-0.5%	-0.5%	-0.5%	-0.5%	-0.5%	-0.5%	-0.5%	-0.5%	-0.5%	-0.5%	-0.5%	-0.5%	-0.5%	-0.5%	-0.5%
Net margin		**0.4%**	**0.4%**	**0.4%**	**0.4%**	**0.4%**	**0.4%**	**0.4%**	**0.4%**	**0.4%**	**0.4%**	**0.4%**	**0.4%**	**0.4%**	**0.4%**	**0.4%**	**0.4%**
Pre-ERC cash flows		1	2	2	2	2	2	3	3	3	3	3	3	3	3	3	3
ERC margin		**0.9%**	**0.9%**	**0.9%**	**0.9%**	**0.9%**	**0.9%**	**0.9%**	**0.9%**	**0.9%**	**0.9%**	**0.9%**	**0.9%**	**0.9%**	**0.9%**	**0.9%**	**0.9%**
ERC income		1	4	5	5	5	6	6	6	6	6	6	6	7	7	7	7
Gross cash flows		**2**	**5**	**8**	**8**	**8**	**8**	**8**	**8**	**9**	**9**	**9**	**9**	**10**	**10**	**10**	**10**
Net cash flows		1	4	5	5	6	6	6	6	6	6	6	7	7	7	7	7
PV (cash flows)		**1**	**3**	**4**	**4**	**3**	**3**	**3**	**3**	**3**	**2**	**2**	**2**	**2**	**2**	**2**	**2**
NPV (total)	**41**																
NPV/share (p)	**77**																

Source: Citigroup Investment Research

Kensington Group

Company description

Kensington Group is a leader in the UK non-prime mortgage market. Its customers are those unable to satisfy mainstream lenders' credit scoring systems and include the recently self-employed, contractors, older borrowers, temporary employees and those with impaired credit histories. The core subsidiary is Kensington Mortgage Company and in 2004, the group entered into ventures with Money Partners in the UK and Start Mortgages in the Republic of Ireland to broaden its distribution channels.

Investment thesis

The strategic issues are declining returns and profitability at core wholly-owned businesses, and the increasing importance of partially owned businesses, and Money Partners in particular. The traditional business is suffering from declining returns, primarily as a result of increased competition which has driven down gross income margins, but also due to rising arrears and credit costs. The key investment issues are (i) whether strong new business volumes from new higher margin ventures and activities can more than offset declining core returns and hence maintain earnings growth momentum, and (ii) whether the group's market value has fully accounted for the increasing importance of Money Partners and the potential future cost of acquiring control of this business.

Valuation

Kensington currently trades on 9.3x 2006E earnings and 8.0x 2007E, significant discount to its UK quoted mortgage market peers, reflecting gross margin and arrears concerns. Based on our preferred fundamental price to book valuation methodology, which takes into account forecast loan growth and returns on equity out to 2010E, we estimate an end-November 2006 fair value for the shares of 964p. Our appraisal value approach, which takes into account faster growth from partially owned businesses, produces a lower valuation of 941p per share. We have set our 12-month target price of 950p in relation to the average of these estimates. At 950p the shares would trade on 10.8x 2006E, 9.3x 2007E and yield a prospective 3.2%.

Risk

We rate Kensington High Risk. The risk rating on the stock is derived after the consideration of industry-specific risks, financial risk and management risk. In addition, we consider historical share price volatility, based on the input of the Citigroup Investment Research quantitative research team, as a possible indicator of future stock-specific risk. Key concerns are: the group's exposure to an increasingly competitive environment in its core business, following a number on new entrants over the past year; the potential for arrears and loan losses to increase further as a result of rising UK interest rates and/or unemployment. Upside risks include M&A speculation, since Kensington may be seen as acquisition target for larger financial organisations, including investment banks looking to boost their securitisation businesses. These factors could impede the shares from achieving our target price.

Analyst Certification Appendix A-1

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