Company Results Review

SMALL & MID CAP

28 November 2006 | 17 pages

Kensington Group (KGN.L)

Managing Down Growth Expectations

Rating change ☐
Target price change ☑
Estimate change ☑

- 2006 pre-close trading update — Kensington's management expects profits before tax for the year to November 2006 to be within, but at the lower end of, the current market range. We have reduced our 2006 PBT estimate by 2%, from £66.4m to £65.0m. Final results for 2006 will be announced on 30 January 2007.
- Lower profit growth in 2007 — Management also expects profits growth in 2007 below that in 2006, which based on our 2006 estimate implies less than 14%. We reduce our 2007 PBT forecast by 12% to £70.0m, which implies 8% PBT growth.
- Good while it lasted — New entrants, attracted by the high risk-adjusted returns previously enjoyed by a relatively small number of specialist mortgage lenders, have driven down interest margins, and encouraged new customer behaviour patterns that have reduced early redemption income margins.
- Adapting the business model — Management has responded to this challenge by developing alternative revenue streams, both in the UK and internationally. The growth outlook at Kensington will be increasingly reliant upon UK sub-prime second mortgages, first mortgages in the Republic of Ireland, and in originate-to-sell of arrangements with mainstream lenders and/or investment banks.
- Buy/ High Risk — Down 18% since the pre-close on 22 November, the shares have now trade at a 30% discount to other UK-quoted mortgage lenders. We reduce our 12-month price target by 8% to 870p which implies an expected total return of 21%. We therefore maintain our Buy/ High Risk rating.

Buy/High Risk	1H
Price (28 Nov 06)	£7.44
Target price	£8.70
from £9.50	
Expected share price return	16.9%
Expected dividend yield	3.7%
Expected total return	20.6%
Market Cap	£391M
	US$758M

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	45.5	48.5	52.8
Diluted EPS (p)	67.2	76.0	86.0	91.7	99.9
Diluted EPS (Old) (p)	67.2	76.0	88.0	102.7	116.7
PE (x)	11.1	9.8	8.7	8.1	7.4
P/BV (x)	3.3	2.4	2.5	2.0	1.7
DPS (p)	16.0	21.5	25.8	27.5	30.0
Net Div Yield (%)	2.2	2.9	3.5	3.7	4.0
ROE (%)	33.9	29.5	29.1	28.3	25.5

See page 15 for Analyst Certification and important disclosures.

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Fiscal year end 30-Nov	2004	2005	2006E	2007E	2008E
Valuation Ratios					
P/E adjusted (x)	11.1	9.8	8.7	8.1	7.4
P/E reported (x)	11.1	9.8	8.7	8.1	7.4
P/BV (x)	3.3	2.4	2.5	2.0	1.7
P/Adjusted BV diluted (x)	3.5	2.5	2.6	2.1	1.7
Dividend yield (%)	2.2	2.9	3.5	3.7	4.0
Per Share Data (p)					
EPS adjusted	67.2	76.0	86.0	91.7	99.9
EPS reported	67.2	76.0	86.0	91.7	99.9
BVPS	223.3	307.8	298.6	365.1	437.6
Tangible BVPS	191.3	274.8	298.6	365.1	437.6
Adjusted BVPS diluted	211.5	300.1	291.0	355.9	426.6
DPS	16.0	21.5	25.8	27.5	30.0
Profit & Loss (£M)					
Net interest income	84	142	165	187	204
Fees and commissions	38	10	12	14	15
Other operating Income	4	16	17	17	18
Total operating income	**126**	**168**	**193**	**218**	**237**
Total operating expenses	-61	-80	-88	-95	-103
Oper. profit bef. provisions	**66**	**88**	**105**	**123**	**134**
Bad debt provisions	-13	-36	-48	-59	-66
Non-operating/exceptionals	-1	5	8	6	9
Pre-tax profit	**52**	**57**	**65**	**70**	**77**
Tax	-16	-18	-19	-21	-23
Extraord./Min. Int./Pref. Div.	0	1	0	-1	-1
Attributable profit	**36**	**40**	**45**	**48**	**53**
Adjusted earnings	36	40	45	48	53
Growth Rates (%)					
EPS adjusted	59.4	13.1	13.1	6.7	8.9
Oper. profit bef. prov.	54.1	34.4	19.7	17.0	9.0
Balance Sheet (£M)					
Total assets	**670**	**6,836**	**6,868**	**6,902**	**6,940**
Avg interest earning assets	3,628	4,917	6,448	7,644	8,501
Customer loans	4,138	5,695	7,200	8,088	8,915
Gross NPLs	302	518	720	849	981
Liab. & shar. funds	**670**	**6,836**	**6,868**	**6,902**	**6,940**
Total customer deposits	0	0	0	0	0
Reserve for loan losses	25	36	53	66	72
Shareholders' equity	**114**	**159**	**154**	**188**	**226**
Profitability/Solvency Ratios (%)					
ROE adjusted	33.9	29.5	29.1	28.3	25.5
Net interest margin	2.3	2.9	2.6	2.4	2.4
Cost/income ratio	48.1	47.7	45.5	43.5	43.3
Cash cost/average assets	9.7	2.1	1.3	1.4	1.5
NPLs/customer loans	7.3	9.1	10.0	10.5	11.0
Reserve for loan losses/NPLs	8.2	7.0	7.3	7.7	7.4
Bad debt prov./avg. cust. loans	0.4	0.7	0.8	0.8	0.8
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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Contents

Key investment issues

- Declining core returns. Returns from the traditional, first-charge mortgage business Kensington Mortgage Company (KMC) look set to continue to decline, due to a combination of declining interest margins, reduced early redemption charge (ERC) income and lower loan growth.

- Increasing importance of second charge and Ireland. The decline in core returns is being offset by (i) higher-margin second-charge mortgage volumes from recently launched Kensington Personal Loans (KPL) and from 57.5% owned Money Partners (MPL), and (ii) first charge mortgages in Ireland via 64%-owned Start Mortgages (SM).

- Speed of income replacement. According to the pre-close trading update, SM "is expected to contribute materially to group earnings growth from 2007". The speed at which new income and profit streams replace reduced profitability at the traditional business will be a key factor in whether profit growth recovers in 2008 and beyond.

- Purchasing minorities. The cost of acquiring minority shareholdings in MPL (in 2009) and SM (in 2010) could be substantial. So far, Kensington has acquired an unspecified minority interest in Bluestep in Sweden for £2.7m; the cost of additional investment in Sweden could also be significant.

- Rising whole-loan sale volumes. Lower profitability from UK first-charge mortgages has prompted an increase in whole-loan sale volumes. Amounting to approximately £1bn out of total 2006 originations in of around £4bn, whole loan sales accounted for around 25% of group originations, 30%-40% of UK first-mortgage volumes, and around 50% of KMC volumes.

- Declining whole-loan sale margins. We forecast whole-loan sale profits of £17m in 2006, a premium of around 1.7% on ~£1bn of sales. This compares with premiums of 2.2% in 2005 and 1H06, implying a premium of around 1.4% in 2H06E. With early redemption charge (ERC) income a substantial part of the in-force value of these portfolios, and with ERC income margins falling, profit on sale premiums look set to decline further.

- Leveraging. Following a write down of TML goodwill, we forecast the end-November 2006 equity/mortgage assets ratio will have fallen to 2.2%. While rising leverage has protected the group's ROE against a declining ROA, it has also increased earnings sensitivity to small changes in key margins.

- Asset mix and capital adequacy. A rising proportion of second-charge loans in the mortgage asset mix would suggest a higher capital requirement, all other things equal. Whole loan sales and the originate-to-sell programme should offset this requirement for additional capital but at the cost of lowering the outlook for mortgage asset growth.

- M&A. Kensington remains 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 could reduce the attractiveness of Kensington to the investment banks are (i) partial-ownership of the faster growing businesses and (ii) existing originate-to-sell arrangements.

Managing Down Growth Expectations

Kensington's 2006 pre-close trading statement was a wake-up call to those in forecasting high-teens annual earnings growth for the foreseeable future. The messages were clear: (i) full-year 2006 profits are likely to be within but at the lower end of the market range, implying profit growth of around 14%; (ii) 2007 PBT growth is likely to be lower than in 2006, i.e. less than 14%. We now forecast 8% PBT growth in 2007.

New earnings guidance

The key message of the pre-close update was that, whilst the group had continued to show solid growth, particularly in its newer markets in Ireland and second-charge mortgages in the UK, "the value from new business lending in the UK first-charge mortgage market has continued to decline as competition has reduced margins and lower income is being received from early redemption charges". As a result, management provided the following profit guidance:

- For 2006. Full-year 2006 profits are likely to be within, but at the lower end of the market range (which we believe to be £65m-£69m).
- For 2007. Pre-tax profit growth in 2007 is likely to be lower than in 2006. Based upon our revised 2006 PBT forecast, we interpret this as meaning lower than 14% growth in 2007, which compared with market expectations of closer to 20% growth.

Good while it lasted

When Kensington floated in November 2000, the original investment case for investing was that the group provided access to the high growth and high margins available in sub-prime UK (first-charge) mortgages. For much of its first four years, cyclically low credit losses meant that Kensington and other specialist lenders earned sub-prime margins on effectively prime quality assets. New entrants attracted by these 'supernormal' returns have driven down interest margins and encouraged customer behaviour patterns that have reduced early redemption income. Rising interest and unemployment rates have in the meantime normalised credit quality, further squeezing the returns available.

Focused on profitable volume growth

Faced with the choice of lowering underwriting standards and drastically reducing its product pricing in order to chase first-charge volumes, management has opted to maintain its credit criteria whilst balancing a reduction in its first-charge mortgage margins and volumes. Over the medium term, we believe this will prove to be the more profitable strategy.

Shifting the emphasis to Ireland and second-charge mortgages in the UK

In the meantime, management has responded to the income growth challenge by developing alternative revenue streams, both in the UK and internationally. Ultimately, we believe the growth outlook at Kensington will be reliant upon UK sub-prime second mortgages, first mortgages in the Republic of Ireland, and in originate-to-sell of arrangements with mainstream lenders and/or investment banks still attracted to the lower margins available in UK first-charge sub-prime mortgages.

Revised estimates

We have revised our earnings estimates as summarised below:

Figure 1. Revised estimates

Yea to November (£m)	2006E			2007E			2008E		
	Old	New	Ch %	Old	New	Ch %	Old	New	Ch %
Operating income	206.3	193.4	-6%	262.3	218.4	-17%	297.3	237.0	-20%
Profit before tax	66.5	65.0	-2%	79.8	70.0	-12%	90.3	76.9	-15%
EPS (p)	88.0	86.0	-2%	102.7	91.7	-11%	116.7	99.9	-14%
DPS (p)	25.8	25.8	0%	30.1	27.5	-9%	34.2	30.0	-12%

Source: Citigroup Investment Research

Our 2006 PBT estimate is reduced by 2% to £65m, which equates to EPS of 86p. This is despite higher than previously expected whole loan sales volumes (we now forecast £1bn in loan sales in 2006 as compared with £850m previously). For 2007, we have lowered our PBT estimate by 12% to £70m and EPS by 11% to 91.7p. The key changes behind this reduction are a lower EIR margin (which incorporates both a reduced interest spread and lower early redemption fee income) and lower loan growth assumptions.

Figure 2. Loan Growth Forecasts

Year to November (£m)	2006E	2007E	2008E	2009E	2010E
New KMC/TML lending	2,600	2,678	2,758	2,841	2,926
New MPL/Start lending	1,400	1,470	1,544	1,621	1,702
Total new lending	**4,000**	**4,148**	**4,302**	**4,462**	**4,628**
Run-off rate	-28%	-28%	-27%	-26%	-25%
Whole loan sales	-1000.0	-1244.4	-1290.6	-1338.5	-1388.4
MAUM balances	7,200	8,088	8,915	9,721	10,530
Average balance	**6,448**	**7,644**	**8,501**	**9,318**	**10,125**

Source: Citigroup Investment Research

The other significant change to our balance sheet forecasts relates to intangible assets. Following guidance that management will review goodwill resulting from the acquisition of TML in 2002, we have prudently assumed the impairment of all goodwill (£17m as at end-May 2006, the majority of which was created on the acquisition of TML).

Investment conclusions

Managing down expectations

In lowering earnings growth expectations, Kensington's management has in effect given itself breathing space, during which time it can focus on developing its alternative income streams, and perhaps look to accelerate the acquisition of key minority shareholdings.

Shares de-rated and oversold

The cost of lowering expectations has been an 18% fall in the group's share price over the past week, more than the amount by which earnings estimates have been reduced. Based on our new forecasts, Kensington's shares now trade on 8.6x 2006E and 8.1x 2007E, a 30% discount to the average of peers Paragon Group (PAG.L-£6.62; 2M), Bradford & Bingley (BB.L-£4.51; 2M) and Northern Rock (NRK.L-£11.73; 3M).

Valuation inexpensive

Recent price weakness has therefore left the shares inexpensive in relative terms and in comparison to our estimate of fair value; based on our preferred fundamental price to book methodology, we estimate a current fair value of 870p, 18% above current market levels.

Risks remain

We remained concerned, however, about (i) high balance sheet leverage — we forecast an end-November equity/mortgage assets ratio of around 2.2%, which gives means high earnings sensitivity to further reductions in key margins; (ii) the significance of ERC income to total income, given the reduction in ERC income margins during 2006; (iii) the potentially high cost of purchasing minority shareholdings the new businesses, given their increasing importance, should management choose to do so. We will continue to monitor relatively recent originate-to-sell arrangements such as those between Alliance & Leicester (AL.L - £10.87; 3M) and Lehman Brothers (LEH.N - US$74.17; 2H) and between Paragon and Morgan Stanley (MS.N - US$76.32; 1M) (in sub-prime second mortgages).

Maintaining Buy/ High Risk rating

In balance, we retain our Buy/High Risk rating and set a new 12-month target price of £8.70. Including the group's prospective dividend yield this implies a total expected return of 21%.

The Pre-Close Trading Update

The key elements of the pre-close trading update were as follows:

Volumes

- New business volumes for the 11 months to end-October were reported to be in excess of £3.7bn, up more than 19% on the same period in 2005 and which broadly equates to full year volumes of around £4bn, in line with our forecasts. The group's offer pipeline at end-October was reported to be over £430m, up 15% on October 2005.

- Within this total, new business completions in UK first-charge mortgages (KMC and MPL) were up 7%, reflecting intense competition in this segment and management's decision not to relax its underwriting criteria.

- Second-charge lending in the UK (through MPL) and first-charge lending in Ireland (SM) were reported to have delivered strong growth, with new business volumes for these segments more than double those seen in the comparable 11 months in 2005.

- Mortgage assets under management at end-October were up 22% over the 11 months to £7.1bn, and up 8% over the first 5 months of the second half.

Margins

- Gross new business margins were reported to have remained stable at 3.3% over LIBOR. This was despite a reduction in the UK first-charge lending margin from 3.0% to 2.7% and in UK second-charge lending from 8.3% to 8.0%, which reflects the shift in mix from first-charge to second-charge mortgages. Margins in SM remained stable at 3.7%.

- The group's ERC income was reduced as a result of lower redemption rates for UK first-charge mortgages and a shift in redemption patterns, with more customers remortgaging outside the early redemption charge period. As a result, average income per redemption fell to 2.8% in the 11 months to end-October as compared with 4.4% in 2005.

- The decrease in new business margins and lower ERC income has reduced the value of Kensington's new first-charge mortgages, and as a result, led to lower premiums on whole-loan sales.

Credit quality

- The positive news in the update was that credit performance has improved since the first half and that as a result, the group impairment charge for the second half is expected to be lower than for the first half.

Funding

- Demand for Kensington's mortgage-backed securities has remained strong and in the 11 months to October the group issued £1.65bn of MBS. The overall initial cost of funds increased to 0.33% over LIBOR compared to 0.30% in 2005 due to the increased proportion of second-charge mortgages.

- Kensington sold loan portfolios totalling ~£1bn in 2006, versus £740m in 2005. This amounts to around 25% of total new business volumes, up from a previously targeted 20%. Management expects to increase this proportion in future, and in particular, KMC has launched a pilot range of specialist prime first-charge mortgages and has sold these loans in two recent whole loan sales. Management intends rolling-out this "originate-to-sell" activity in 2007.

New initiatives

- SM was reported to have accelerated its growth programme and broadened its products and distribution sources. Management now expects SM to contribute materially to group earnings growth from 2007.

- In April, Kensington acquired a minority stake in the Swedish company Bluestep for £2.7m. This investment in the only non-conforming lender in Sweden has provided Kensington with an entry into this under-developed market. Bluestep was reported to be operating profitably and showing encouraging growth.

TML goodwill write-down

- The group's direct-to-consumer distribution business TML has continued to deliver low new business volumes to KMC; over the 11 months to end-October, TML generated only 5% of total new business completions. A new Managing Director was appointed at TML in July, and all aspects of the business model are currently being reviewed. Goodwill relating to the acquisition of TML will also be reviewed at the year-end and we have prudently assumed this will be written off.

Valuation

Fundamental price to book value

Our preferred valuation approach is summarised in the table below.

Figure 3. Fundamental Price to Book Valuation

Year to November (£m)	2006E	2007E	2008E	2009E	2010E
Mortgage assets	7200.0	8087.6	8915.2	9720.5	10530.0
Memo: MAUM growth	26%	12%	10%	9%	8%
Normalised equity/MAUM	3.0%	3.0%	3.0%	3.0%	3.0%
Normalised equity	216.0	242.6	267.5	291.6	315.9
Actual equity	155.1	189.4	226.8	268.0	313.2
Surplus capital	-60.9	-53.2	-40.6	-23.6	-2.7
Attributable profit	45.5	48.5	52.8	58.2	63.9
Return on surplus capital	2.4	2.1	1.6	0.9	0.1
Normalised return	47.9	50.6	54.5	59.1	64.0
Normalised return on equity	22.2%	20.9%	20.4%	20.3%	20.3%
Dividends	13.3	14.2	15.4	17.0	18.7
Discount factor		1.105	1.221	1.349	1.491
PV dividends		12.8	12.6	12.6	12.5
Sustainable return on NTAV	18.5%				
Long-term growth assumption	2.0%				
Cost of equity	10.5%				
Fair value P/NTAV	1.94				
2010 terminal value	613.2				
2010 surplus capital	-2.7				
NPV terminal value	411.3				
NPV dividends	50.6				
NPV surplus capital	-1.8				
Fair value	**460.2**				
Shares in issue	52.9				
Fair value per share (p)	**870**				

Source: Citigroup Investment Research

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

- The expected dividend flow to 2010E;
- Surplus equity capital present on the balance sheet at end-2010E;
- The terminal value of normalized equity capital at end-2010E based upon sustainable return on equity, cost of equity and long-term growth assumptions.

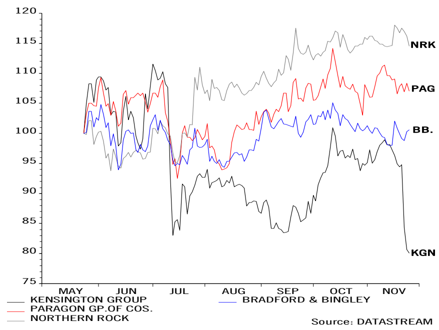
All three components are discounted to NPV using estimated cost of equity as the discount rate.

The sum of these three items produces a current fair value estimate for the group of £460m, which equates to 870p per share.

Price performance

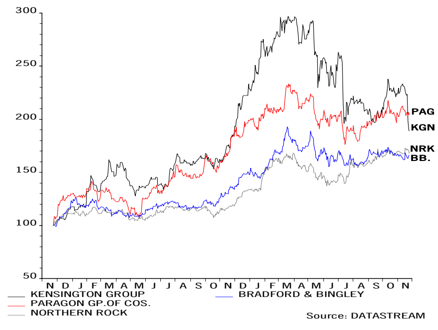
The shares have fallen in by 18% since the pre-close trading update on 22 November, underperforming the FTSE All Share Index by 15%

Figure 4. Performance Relative to Peers (6m)



Source: Datastream

Figure 5. Performance Relative to Peers (2yrs)



Source: Datastream

On a two-year view, recent weakness has only brought Kensington back in line with Paragon Group (PAG.L-£6.62; 2M), following Kensington's outperformance between October 2005 and March 2006. Over this time horizon, both stocks have outperformed their UK mortgage bank peers.

Peer group relatives

Following recent weakness, and despite reduced earnings estimates, Kensington currently trades at a 30% P/E discount to the average of its UK mortgage market peers, for both 2006 and 2007.

Figure 6. Peer Group P/E Ratios & Yields

	Price (p)*	MV (£m)	Year-end	P/E Ratio 2006E	P/E Ratio 2007E	Yield 2006E	Yield 2007E
Bradford & Bingley	451	2,861	Dec	11.9	10.9	4.5%	4.8%
Northern Rock	1173	4,941	Dec	13.6	12.2	3.0%	3.4%
Paragon Group	662	769	Sep	11.3	11.5	2.6%	3.2%
Average				**12.3**	**11.5**	**3.3%**	**3.8%**
Kensington Group	740	388	Nov	8.6	8.1	3.5%	3.7%

Source: Citigroup Investment Research. *Prices at close 27 November.

At our fundamental fair value estimate of 870p per share, Kensington would trade on a 2006E P/E of 10.1x, a 2007E P/E of 9.5x, and yield 3.0%.

Financial Forecasts

Forecast summary

Our financial forecasts are summarised below.

Figure 7. Forecast Summary

Year to November (£m)	2005	2006E	2007E	2008E	2009E	2010E
Income & Expenses						
Net interest income	142.1	164.7	187.1	203.6	222.9	242.1
Net fees & commissions	9.9	11.6	13.8	15.3	16.8	18.2
Profit on sale of mortgages	16.4	17.0	17.4	18.1	18.7	19.4
Operating income	**168.4**	**193.3**	**218.3**	**237.0**	**258.4**	**279.8**
Operating expenses	-80.4	-88.0	-95.0	-102.6	-109.8	-116.4
Pre-provision profit	**88.0**	**105.4**	**123.3**	**134.4**	**148.7**	**163.4**
Provision for losses	-35.8	-48.4	-58.9	-66.3	-72.7	-79.0
Operating profit	**52.2**	**57.0**	**64.4**	**68.1**	**76.0**	**84.4**
Associate income	-0.5	1.5	5.6	8.8	9.3	9.8
Change in FV derivatives	4.9	5.8				
Change in FV MPL/SM options	0.4	0.6				
Core PBT	**57.0**	**65.0**	**70.0**	**76.9**	**85.3**	**94.2**
Exceptional items	0.1					
Goodwill amortisation						
Profit before tax	**57.1**	**65.0**	**70.0**	**76.9**	**85.3**	**94.2**
Taxation	-17.7	-19.5	-21.0	-23.1	-25.6	-28.3
Minorities	0.8	0.0	-0.5	-1.0	-1.5	-2.0
Attributable profit	**40.2**	**45.5**	**48.5**	**52.8**	**58.2**	**64.0**
Dividend	-9.0	-13.3	-14.2	-15.5	-17.0	-18.7
Retained earnings	31.2	32.2	34.3	37.4	41.2	45.2
Balance Sheet						
Mortgage assets (MAUM)	5,695	7,200	8,088	8,915	9,721	10,530
Average mortgage AUM	4,917	6,448	7,644	8,501	9,318	10,125
Equity	159.8	155.1	189.4	226.7	267.9	313.2
Minorities	1.1	1.1	1.1	1.1	1.1	1.1
Intangible assets	17.0	0.0	0.0	0.0	0.0	0.0
Ratios						
EIR margin	2.99%	2.65%	2.45%	2.40%	2.39%	2.39%
Fee & Comm margin	0.20%	0.18%	0.18%	0.18%	0.18%	0.18%
Profit on sale margin	0.33%	0.26%	0.23%	0.21%	0.20%	0.19%
Total income margin	**3.52%**	**3.09%**	**2.86%**	**2.79%**	**2.77%**	**2.76%**
Provision charge:avg loans	-0.73%	-0.75%	-0.77%	-0.78%	-0.78%	-0.78%
Cost:income ratio	-47.7%	-45.5%	-43.5%	-43.3%	-42.5%	-41.6%
RoMAUM	0.82%	0.71%	0.63%	0.62%	0.62%	0.63%
Equity:MAUM	2.8%	2.2%	2.3%	2.5%	2.8%	3.0%
ROE	27.4%	28.9%	28.2%	25.4%	23.5%	22.0%
Effective tax rate	-31.1%	30.0%	30.0%	30.0%	30.0%	30.0%
Per share data						
Reported diluted EPS (p)	76.0	86.0	91.7	99.9	110.0	120.9
Adjusted EPS (p)	**75.8**	**86.0**	**91.7**	**99.9**	**110.0**	**120.9**
DPS (p)	21.5	25.8	27.5	30.0	33.0	36.3
NAV/share (p)	309.9	300.7	367.2	439.7	519.6	607.3

Source: Company Reports and CIR Estimates

Margins & returns

The margin and return estimates underpinning our forecasts are set out in the table below.

Figure 8. Return on Average Mortgage Assets & Return on Equity

Year to November	**2005**	**2006E**	**2007E**	**2008E**	**2009E**	**2010E**
EIR income*	2.99%	2.65%	2.45%	2.40%	2.39%	2.39%
Net fees & commissions	0.20%	0.18%	0.18%	0.18%	0.18%	0.18%
Profit on sale of mortgages	0.33%	0.26%	0.23%	0.21%	0.20%	0.19%
Operating income	**3.52%**	**3.09%**	**2.86%**	**2.79%**	**2.77%**	**2.76%**
Operating expenses	-1.64%	-1.36%	-1.24%	-1.21%	-1.18%	-1.15%
Provision for losses	-0.73%	-0.75%	-0.77%	-0.78%	-0.78%	-0.78%
Operating profit	**1.16%**	**0.97%**	**0.84%**	**0.80%**	**0.82%**	**0.83%**
Associate income	-0.01%	0.02%	0.07%	0.10%	0.10%	0.10%
Change in FV MPL/SM options	0.01%	0.01%				
Core PBT	**1.16%**	**1.01%**	**0.92%**	**0.90%**	**0.92%**	**0.93%**
Exceptional items	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%
Taxation	-0.36%	-0.30%	-0.27%	-0.27%	-0.27%	-0.28%
Minorities	0.02%	0.00%	-0.01%	-0.01%	-0.02%	-0.02%
Return on avg mortgage assets	**0.82%**	**0.71%**	**0.63%**	**0.62%**	**0.62%**	**0.63%**
Average mortgage assets	4916.7	6447.5	7643.8	8501.4	9317.9	10125.3
Average equity	146.8	157.4	172.2	208.1	247.3	290.5
Leverage (assets/equity)	33.5	41.0	44.4	40.9	37.7	34.8
Return on avg equity	**27.4%**	**28.9%**	**28.2%**	**25.4%**	**23.5%**	**22.0%**

Source: Citigroup Investment Research. *2005-06 EIR income has been grossed up for change in FV of derivatives.

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

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 870p. We set our 12-month target price of 870p in relation to this fundamental value estimate. At 870p the shares would trade on 10.1x 2006E, 9.5x 2007E and yield a prospective 3.0%.

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

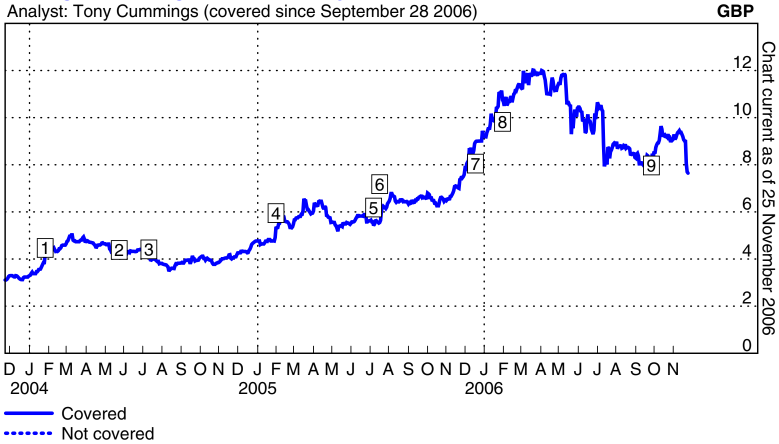
I, Tony Cummings, research analyst and the author of this report, hereby certify that all of the views expressed in this research report accurately reflect my personal views about any and all of the subject issuer(s) or securities. I also certify that no part of my compensation was, is, or will be directly or indirectly related to the specific recommendation(s) or view(s) in this report.

IMPORTANT DISCLOSURES

Kensington Group (KGN.L)

Ratings and Target Price History - Fundamental Research

Analyst: Tony Cummings (covered since September 28 2006)



#	Date	Rating	Target Price	Closing Price
1:	27 Jan 04	1M	*4.40	4.19
2:	25 May 04	1M	*4.80	4.17
3:	12 Jul 04	*2M	*4.64	4.14
4:	1 Feb 05	2M	*5.20	5.37
5:	7 Jul 05	2M	*5.59	5.43
6:	18 Jul 05	*1M	*6.65	5.55
7:	19 Dec 05	1M	*10.20	8.97
8:	31 Jan 06	*2M	*11.35	10.75
9:	27 Sep 06	*1H	*9.50	8.21

*Indicates change.

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% of companies in each rating category that are investment banking clients	93%	84%	83%
Brokers & Asset Managers -- North America (13)	46%	54%	0%
% of companies in each rating category that are investment banking clients	100%	71%	0%
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% of companies in each rating category that are investment banking clients	8%	0%	0%

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Investment ratings are determined by the ranges described above at the time of initiation of coverage, a change in investment and/or risk rating, or a change in target price (subject to limited management discretion). At other times, the expected total returns may fall outside of these ranges because of market price movements and/or other short-term volatility or trading patterns. Such interim deviations from specified ranges will be permitted but will become subject to review by Research Management. Your decision to buy or sell a security should be based upon your personal investment objectives and should be made only after evaluating the stock's expected performance and risk.

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