

Company In-Depth

SMALL &
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9 November 2006 | 40 pages

Paragon Group (PAG.L)

More Than Buy-to-Let Mortgages

- **Strong loan growth outlook** — New business volumes are set to increase by 70% this year to £3.4bn, including Buy-To-Let (BTL) volumes of more than £3bn. The outlook is for continued strong growth from BTL due to a strong residential property investment case, driven by high tenant demand and rising rental yields, and increased penetration of the group's target market.
- **More than Buy-To-Let** — Although BTL Mortgages is the key growth division, it accounted for only 60% of operating profit in 1H06, and less than 40% of operating income. The other activities – consumer finance and closed loan books in run-off – bring higher credit risk and the potential for more volatile impairment provisions.
- **Shift in mix releasing capital** — A shift in mix from higher risk consumer finance and closed book assets to lower risk BTL mortgages is releasing capital. We forecast an additional ~£100m release of capital over the next four years, which should be available for additional share repurchases and/or higher dividends.
- **Limited re-rating potential** — Strong recent price performance has reflected earnings growth and re-rating, and the shares are now being valued broadly in line with larger mortgage market peers. We see limited potential for further near-term re-rating.
- **Start at Hold** — We set a 12-month target price of 720p, which together with our dividend forecasts equates to an expected total return of 8%. We therefore initiate coverage with a Hold/ Medium Risk rating. Next news is preliminary results for the year to September 2006 that will be announced on 22 November.

See page 37 for Analyst Certification and important disclosures.

Paragon Group (GBP)

Year to 30 Sep	2004A	2005A	2006E	2007E	2008E
Net Income (£M)	54.7	56.6	67.2	68.9	79.4
Diluted EPS (p)	46.2	47.6	56.9	59.3	68.3
Diluted EPS (Old) (p)	46.2	47.6	56.9	59.3	68.3
PE (x)	14.8	14.4	12.0	11.6	10.0
P/BV (x)	3.1	3.4	2.5	2.2	1.9
DPS (p)	9.6	12.6	17.0	20.9	25.9
Net Div Yield (%)	1.4	1.8	2.5	3.1	3.8
ROE (%)	21.9	22.1	24.1	20.4	20.3

Hold/Medium Risk	2M
Price (08 Nov 06)	£6.85
Target price	£7.20
Expected share price return	5.1%
Expected dividend yield	2.5%
Expected total return	7.6%
Market Cap	£796M
	US\$1,517M

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



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Fiscal year end 30-Sep	2004	2005	2006E	2007E	2008E
Valuation Ratios					
P/E adjusted (x)	14.8	14.4	12.0	11.6	10.1
P/E reported (x)	14.8	14.4	12.0	11.6	10.1
P/BV (x)	3.1	3.4	2.5	2.2	1.9
P/Adjusted BV diluted (x)	3.0	3.3	2.6	2.2	1.9
Dividend yield (%)	1.4	1.8	2.5	3.0	3.8
Per Share Data (p)					
EPS adjusted	46.2	47.6	56.9	59.3	68.3
EPS reported	46.2	47.6	56.9	59.3	68.3
BVPS	223.9	202.4	270.1	312.4	359.8
Tangible BVPS	212.2	202.1	269.9	312.2	359.5
Adjusted BVPS diluted	226.9	205.4	266.2	312.4	359.8
DPS	9.6	12.6	17.0	20.9	25.9
Profit & Loss (£M)					
Net interest income	81	97	140	143	151
Fees and commissions	0	0	0	0	0
Other operating Income	40	36	31	33	35
Total operating income	121	133	171	176	186
Total operating expenses	-44	-44	-49	-49	-50
Oper. profit bef. provisions	77	89	123	128	136
Bad debt provisions	-11	-16	-43	-32	-25
Non-operating/exceptionals	5	0	1	0	0
Pre-tax profit	71	73	80	96	112
Tax	-16	-16	-13	-27	-32
Extraord./Min. Int./Pref. Div.	0	0	0	0	0
Attributable profit	55	57	67	69	79
Adjusted earnings	55	57	67	69	79
Growth Rates (%)					
EPS adjusted	32.8	2.9	19.7	4.2	15.1
Oper. profit bef. prov.	10.5	15.2	38.4	4.1	6.8
Balance Sheet (£M)					
Total assets	4,934	7,091	8,996	10,900	12,536
Avg interest earning assets	5,619	6,115	7,357	9,385	11,155
Customer loans	5,951	6,529	8,433	10,338	11,973
Gross NPLs	0	0	0	0	0
Liab. & shar. funds	4,934	7,091	8,996	10,900	12,536
Total customer deposits	0	0	0	0	0
Reserve for loan losses	0	0	0	0	0
Shareholders' equity	268	364	434	483	538
Profitability/Solvency Ratios (%)					
ROE adjusted	21.9	22.1	24.1	20.4	20.3
Net interest margin	1.4	1.6	1.9	1.5	1.4
Cost/income ratio	36.3	33.3	28.4	27.6	26.8
Cash cost/average assets	1.1	0.7	0.6	0.5	0.4
NPLs/customer loans	0.0	0.0	0.0	0.0	0.0
Reserve for loan losses/NPLs	na	na	na	na	na
Bad debt prov./avg. cust. loans	0.2	0.3	0.6	0.3	0.2
Loans/deposit ratio	na	na	na	na	na
Tier 1 capital ratio	7.9	6.1	6.5	6.4	6.5
Total capital ratio	7.9	9.1	9.0	8.5	8.3

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Contents

Investment summary	4
BTL driving loan growth	4
Capital release	4
Margin pressure	5
Credit risk	5
Fully valued	6
Valuation	7
Relative valuation analysis	7
Absolute valuation analysis	8
Company snapshot	11
Customer loans	11
Financial Snapshot	12
Current trading	13
Key management	14
Strategy & Growth Outlook	15
Buy-to-let growth	15
Capital management	17
The other levers	20
Summary	22
Financial Results	23
Full-year 2007 pre-close trading update	23
2006 Interim results	23
Forecasts	25
Divisional disclosure and IFRS	25
Forecast summary	25
Divisional summary	26
Detailed forecasts by division	27
APPENDIX – Appraisal Values	29
Company description	33
Investment thesis	33
Valuation	33
Risk	33
Analyst Certification Appendix A-1	37

Investment summary

The key positives of the Paragon investment case are the group's strong position in the high-growth UK Buy-To-Let (BTL) mortgage market and the outlook for additional substantial capital release and its repatriation to shareholders.

Offsetting concerns are competitive pressure on BTL income margins, the uncertain outlook for the group's less well known consumer finance activities (which in 1H06 accounted for 30% of group PBT), the potential for rising loan losses from the ~£400m of closed first mortgage and unsecured consumer finance books in run-off, and the relatively full valuation which in our view limits the potential for further re-rating.

BTL driving loan growth

Paragon has an estimated 10% share of the high-growth UK BTL 'specialist prime' segment of the UK mortgage market. Group new business volumes are set to increase by 70% to £3.4bn in the year to September 2006 and include BTL advances up ~85% to £3.0bn. Based on the group's BTL new business pipeline in September, the near-term outlook is positive.

BTL mortgages have grown rapidly over recent years. According to the Council of Mortgage Lenders (CML), the value and number of mortgages outstanding have grown by 54% and 46% pa respectively between 1999 and 2005. Relative to the overall UK mortgage market, BTL has increased its share from 1% of outstanding mortgages at end-1999 to more than 8% at end-June-2006.

The outlook is for continued growth, in our view, due to the large available target market (according to the CML, there were 767,000 BTL mortgages outstanding at end-June 2006, as compared with around 2.5m properties that can be considered as BTL candidates), and a strong residential property investment case (tenant demand remains high, due to record numbers of students in higher education and increasing immigration into the UK, which has driven up rental yields).

Capital release

Management has actively managed Paragon's capital position since 2002, when it was announced that internal capital generation was in excess of that required to fund loan growth. Moreover, at the 2005 interim results announcement in May last year, management announced that, due to the on-going shift in loan book mix from unsecured to secured lending and the run-off of closed books, it had identified substantial surplus capital.

As a consequence, dividend cover has been reduced substantially, from 6.8x in 2001 to 3.8x in 2005, and management has announced that it would grow dividends at roughly three times the rate of earnings growth until dividend cover was reduced to around the average for the UK market as a whole (between 2.0x and 3.0x). In addition, a share repurchase programme has been established which, following the sale of the closed NHL book in July, was increased to £40m, of which approaching £30m has been completed to date.

Based on our analysis, the on-going shift in Paragon's loan book mix could release capital amounting to around £140m between 2006E-2010E, which suggests the potential for an additional ~£100m-worth of share repurchases and/or special distributions over the next four years (~13% of Paragon's current market value).

Margin pressure

There is evidence of increasing competition in other specialist mortgage markets, such as the non-conforming and sub-prime segments, and perhaps some early signs of competitive pressures building in BTL. In its interim results announcement for the six months to March 2006, Paragon reported that “improvements in funding costs compensated for more competitive pricing in the buy-to-let book”.

The risk is that new entrants into the BTL market push down asset spreads on new business, creating a “back book/front book” pricing gap, which in addition to potentially driving down blended margins could also lead to increased prepayment rates, as investors look to refinance away from Paragon at finer rates.

Credit risk

Although BTL mortgages is the key growth activity at Paragon, it accounted for only 60% of the group's operating profit in 1H06, and less than 40% of group operating income. The group's other activities – a range of consumer finance businesses and closed loan books in run-off – bring increased credit risk and the potential for more volatile impairment charges.

First half 2006 impairment provisions came in at £23.6m, an annualized 0.7% of average customer loans and around 38% of pre-impairment provision profit. This compared with £20.7m on a proforma basis in the first half of 2005, an increase of 14%. In relation to average loans, this remained relatively constant. However, bearing in mind the shift in loan mix over the period – average BTL loans up ~30%, average non-BTL loans down ~25% – and the fact that impairments on BTL loans are negligible (less than 1bp in 1H06), this suggests non-BTL impairments as a percentage of non-BTL average loans have increased significantly.

Figure 1. 2006 H1 Income & Expenses by Division

Half year to March 2006 (£m)	Buy-to-Let Mortgages	Consumer Finance	Other Operations	TOTAL
Net interest income	28.4	9.2	33.7	71.3
Other operating income	3.7	8.6	2.9	15.2
Total operating income	32.1	17.8	36.6	86.5
Operating expenses	-9.0	-4.4	-11.4	-24.8
Pre-impairment profit	23.1	13.4	25.2	61.7
Impairment charge	-0.1	-1.3	-22.2	-23.6
Operating profit	23.0	12.1	3.0	38.1

Source: Company Reports

The lack of comparable IFRS proforma data at the segmental level makes further analysis difficult. However, in our view it seems reasonable to conclude that the vast majority of the credit risk at Paragon lies within businesses and loan books that are rarely discussed in any great depth by management.

Fully valued

As discussed in more detail in the Valuation section of this note, Paragon's share price performance has reflected both earnings growth and re-rating, to the extent that it is now being valued on a prospective PE broadly in line with its larger mortgage market peers. Our fundamental analysis suggests a fair value for the shares of between 712p and 730p, some 5-8% above current levels.

We therefore see limited potential for further re-rating, at least over the near-term, and since a rising tax charge could dampen earnings growth in the year to September 2007, little to drive further strong price performance.

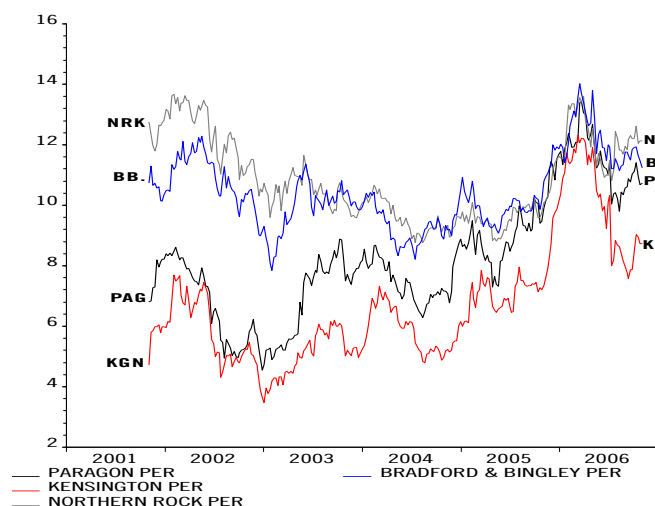
Valuation

Our relative valuation work suggests end-September 2007 fair values within a wide range of 623p-818p and with a central estimate of 722p. Our fundamental analysis suggests current fair values within a 712p to 730p range, an average of 721p. With reference to both absolute and relative methodologies, we set a 12-month target price of 720p per share, at which level the shares would trade on a 2007E PE of 12.1x and a 2007E yield 2.7%.

Relative valuation analysis

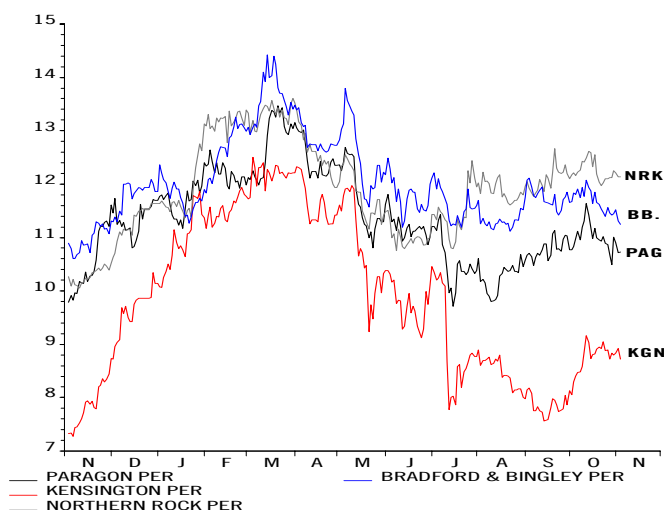
The charts below, which are based on IBES consensus estimates, show how ratings on the UK mortgage market specialists have converged over the past five years. In particular, the charts highlight Paragon's relative re-rating.

Figure 2. UK Mortgage Stocks – Prospective PER (Last 5 Years)



Source: Datastream

Figure 3. UK Mortgage Stocks – Prospective PER (Last 12 Months)



Source: Datastream

The table below compares Paragon's prospective PE ratios and dividend yields with those of its peers.

Figure 4. Peer Group PE Ratios and Yields

	Price	Mkt Val	Year-end	P/E Ratio		Dividend Yield	
				2006E	2007E	2006E	2007E
Bradford & Bingley	63	2,936	Dec	12.2x	11.2x	4.3%	4.7%
Kensington Group	927	487	Nov	10.5x	9.0x	2.8%	3.2%
Northern Rock	1190	5,013	Dec	13.8x	12.4x	2.9%	3.4%
Average				12.2x	10.9x	3.4%	3.8%
Paragon Group	685	796	Sep	12.0x	11.6x	2.5%	3.1%

Source: Citigroup Investment Research. *Prices at close 8 November.

The shares currently trade on 12.0x estimated EPS for the year to September 2006E (17% tax) and 11.6x September 2007E (28% tax). Based on CIR 2007E estimates, this values Paragon at a 4% PE premium to Bradford & Bingley (which is probably the closest comparative in terms of BTL mortgage market exposure), a 6% discount to Northern Rock, and a 29% premium to Kensington Group.

Figure 5. Relative Valuation Analysis

Paragon 2007E EPS	59.3
Peer avg 2006 PER	12.2
September 2007E Fair Value	722

Source: Citigroup Investment Research

In estimating an end-September 2007 fair value, we have applied the peer group consensus PE ratio for 2006 to our Paragon EPS estimate for 2007. This suggests a fair value of 722p per share.

Using individual peer group PE ratios for 2006 applied to our Paragon EPS estimate for 2007 suggests an end-September 2007 fair value range of 623p (based on Kensington's 2006 PE) to 818p (based on Northern Rock's PE ratio).

Absolute valuation analysis

We use two methodologies for estimating fundamental fair value – our preferred price to book approach and an alternative, sum-of-the-parts approach based on divisional appraisal values. The latter allows for an implied valuation on BTL, based on current market value and our valuations for Consumer Finance and Other Operations.

Fundamental price to book

Our preferred valuation approach is summarised in the table below.

Figure 6. Fundamental Price to Book Valuation

Year to September (£m)	2006E	2007E	2008E	2009E	2010E
Receivables	8,433	10,338	11,973	13,403	14,626
Memo: receivables growth	29%	23%	16%	12%	9%
Equity/receivables ratio - normalised	4.3%	4.0%	3.7%	3.5%	3.4%
Normalised equity	365.4	409.4	443.9	475.5	504.5
Equity	314.1	363.0	417.7	476.8	539.6
Surplus capital	-51.4	-46.4	-26.2	1.2	35.2
Attributable profit	67.2	68.9	79.4	89.6	98.7
Return on surplus capital	2.1	1.9	1.0	0.0	-1.4
Normalised return	69.2	70.8	80.4	89.5	97.3
Normalised RoE	18.9%	17.3%	18.1%	18.8%	19.3%
Dividends	15.2	20.0	24.6	30.5	35.8
Discount factor		1.100	1.210	1.331	1.464
PV dividends		18.2	20.4	22.9	24.5
Sustainable return on NTAV	18.0%				
Long-term growth assumption	3.0%				
Cost of equity	10.0%				
Fair value P/NTAV	2.1				
2010 terminal value	1081.0				
2010 surplus capital	35.2				
NPV terminal value	738.3				
NPV dividends	85.9				
NPV surplus capital	24.0				
Fair value	848.3				
Shares in issue	116				
Fair value per share (p)	730				

Source: Citigroup Investment Research

The objective is to estimate a fundamental current fair value for the shares. 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 our estimate of a fair market value for the group of £848m, which equates to 730p per share.

Appraisal value methodology

As an alternative to the price to book approach, we have also considered a sum-of-the-part methodology based on the divisional appraisal values set out in the table below.

Figure 7. Front and Back Book Appraisal Values

	£m	p	%AUM
Buy-to-Let			
In-force value	163	141	2.2%
New business value	477	411	6.6%
Appraisal value	640	552	8.8%
Consumer Finance			
In-force value	30	26	4.5%
New business value	178	153	26.1%
Appraisal value	208	179	30.5%
Other Operations			
In-force value	10	8	2.0%
Appraisal value	10	8	2.0%

Source: Citigroup Investment Research

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

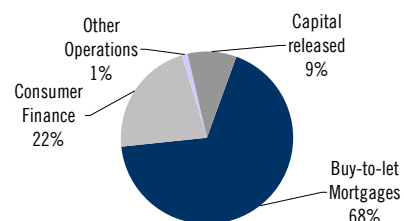
- We have estimated the value of existing mortgage assets under management (the back book) for each of the BTL, Consumer Finance and Other Operations divisions.
- These estimates are based on historic gross margins, a set of assumptions regarding credit losses and other costs, a prepayment speed or run-off rate, and a discount rate to calculate net present values.
- We then estimate the value of new business for the core BTL and Consumer Finance businesses based on our explicit new business volume assumptions out to 2010E, and long-term new business growth rates for following years.
- We have deducted Paragon's £120m of subordinated debt from our estimate of the value of the enterprise and included £75m for our estimate of capital released in the four years to 2010E.

The results of the approach are summarised in the table and chart below. The analysis suggests that around 68% of Paragon's enterprise value is accounted for by the BTL division, 22% to Consumer Finance, and 10% by the combined value of capital released (9%) and the in-force value of the closed books in run-off (1%).

Figure 8. Sum of the Parts Valuation

	£m	p	%
Buy-to-let Mortgages	640	552	68%
Consumer Finance	208	179	22%
Other Operations	10	8	1%
Capital released	88	76	9%
Fair enterprise value	946	815	100%
Subordinated debt	-120	-103	-13%
Fair market value	826	712	87%

Figure 9. Components of Enterprise Value



Source: Citigroup Investment Research

Source: Citigroup Investment Research

Isolating BTL Mortgages

In the table below, we have isolated implied PE multiples on Paragon's BTL division by subtracting estimated appraisal values for the Consumer Finance and Other Operations divisions. We calculate Paragon's enterprise value as being equal to market value plus subordinated debt, less our estimate of the net present value of capital released over the four years to 2010E.

Figure 10. Isolating BTL Mortgages

Current market value	770				
Subordinated debt	120				
Enterprise value	880				
NPV capital released	-88				
Consumer Finance	-208				
Other Operations	-10				
BTL enterprise value	685				
Year to September	2006	2007	2008	2009	2010
BTL earnings (29% tax)	35.3	48.2	59.8	70.1	79.2
PER	16.6x	12.1x	9.8x	8.3x	7.4x

Source: Citigroup Investment Research

The key messages from this analysis are:

- Based on estimated earnings from BTL in the year to September 2006, the BTL division appears relatively expensive, "trading" on an implied 16.6x earnings, as compared with a peer group average of around 12.1x, and 13.9x for Northern Rock. (Note that normalizing 2006E group earnings for a 29% tax charge would put Paragon's shares on a 2006 PE ratio of 14.0x.)
- Due to strong forecast BTL earnings growth, this high implied 2006 PE multiple falls quickly - to 12.1x for 2007 (around a 12% premium to the peer group average) and to below 10x by 2008.

Company snapshot

Paragon Group is a specialist lender focused on the UK buy-to-let (BTL) mortgage market, with additional consumer credit activities and a portfolio of closed loan books in run-off. The core BTL Mortgages division operates two mortgage brands - Paragon Mortgages and Mortgage Trust - which currently manage mortgage assets of around £7bn. The Consumer Finance division manages assets of around £700m and division includes second mortgage lending, secured personal loans, used car finance and point-of-sale retail finance (focused on furniture, floor covering and specialist hi-fi outlets). The Other Operations division includes a portfolio of owner-occupied mortgages and some unsecured consumer credit loans, in total amounting to around £500m, all in run-off.

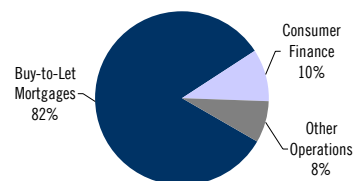
Customer loans

Figure 11. Loan Assets by Continuing Businesses

As at March 2006	£m	%
<u>Continuing businesses:</u>		
-BTL mortgages	5,965	82%
-Consumer finance	704	10%
<u>Other (run off balances):</u>		
-Unsecured consumer credit	83	1%
-First mortgages	481	7%
Total	7,233	100%

Source: Company Reports

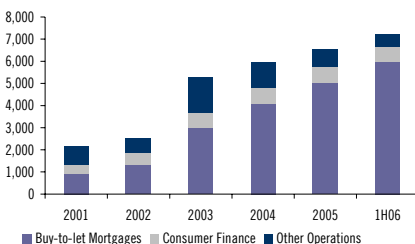
Figure 12. Loans Book Mix as at May 06



Source: Company Reports

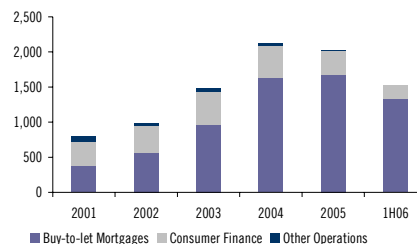
As at end-March 2006, some 82% of the group's loan balances were BTL mortgages, with around 10% secured consumer loans and the remaining 8% in run-off balances. Unsecured consumer credit balances accounted for only 1% of the loan book.

Figure 13. Loan Balances by Segment (£m)



Source: Company Reports

Figure 14. New Lending by Segment



Source: Company Reports

BTL Mortgages

The BTL proportion has been increasing over time, partly due to the acquisition of Mortgage Trust in June 2003 and the natural shrinkage of the closed books, but also as a result of stronger new lending volumes.

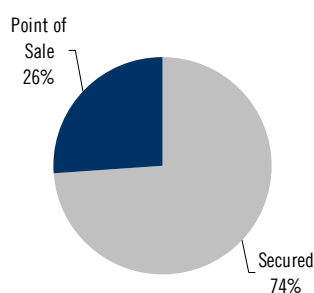
Figure 15. Net New BTL Business

Year to September (£m)	2002	2003	2004	2005	1H06
Opening BTL balances	909	1,326	3,007	4,064	5,032
Advances	564	963	1,637	1,668	1,335
Redemptions	-147	-182	-580	-700	-402
Net new lending	417	781	1,057	968	933
Acquisitions (Mortgage Trust)		900			
Closing BTL balances	1,326	3,007	4,064	5,032	5,965
Advances/opening balances	62%	73%	54%	41%	53%
Redemption rate	-16%	-14%	-19%	-17%	-16%
Net new/opening balances	46%	59%	35%	24%	37%

Source: Company Reports

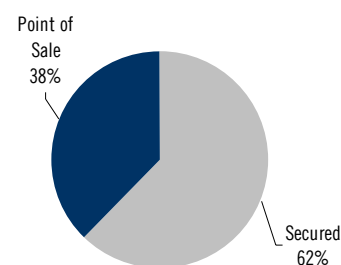
Consumer Finance

Figure 16. Consumer Finance Balances



Source: Company Reports

Figure 17. Consumer Finance 1H06 Advances



Source: Company Reports

Financial Snapshot

Figure 18. Half-Year to March 2006 – Financial Snapshot

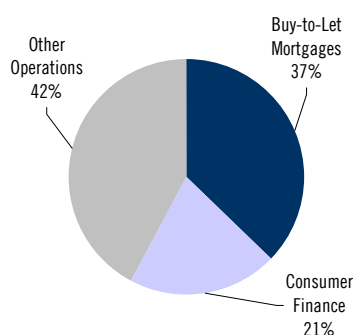
Half-year to March 2006 (£m)	Buy-to-Let Mortgages		Consumer Finance		Other Operations		TOTAL
		%		%		%	
Net interest income	28.4	40%	9.2	13%	33.7	47%	71.3
Other operating income	3.7	24%	8.6	57%	2.9	19%	15.2
Total operating income	32.1	37%	17.8	21%	36.6	42%	86.5
Operating expenses	-9.0	36%	-4.4	18%	-11.4	46%	-24.8
Pre-impairment profit	23.1	37%	13.4	22%	25.2	41%	61.7
Impairment charge	-0.1	0%	-1.3	6%	-22.2	94%	-23.6
Operating profit	23.0	60%	12.1	32%	3.0	8%	38.1
FV gains/losses	0.0	0%	0.0	0%	0.9	100%	0.9
Profit before tax	23.0	59%	12.1	31%	3.9	10%	39.0
Customer loans	5,965	82%	704	10%	564	8%	7,233
Average loans	5,499	80%	700	10%	683	10%	6,881
Net interest margin	1.03%		2.63%		9.87%		2.07%
Total income margin	1.17%		5.09%		10.72%		2.51%
Impairments/avg loans	0.00%		-0.37%		-6.50%		-0.69%
Net interest/total income	88.5%		51.7%		92.1%		82.4%
Expense ratio	-28.0%		-24.7%		-31.1%		-28.7%

Source: Company Reports

Revenue and profit mix

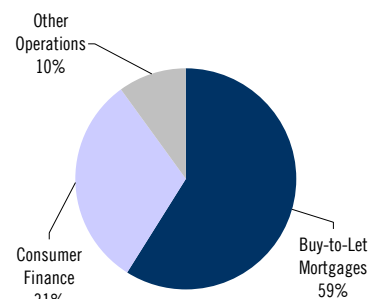
As shown in the charts below, the main operating divisions, BTL Mortgages and Consumer Finance, currently account for around 60% of the group's operating income, with the closed portfolios in run-off the remaining 40%. In terms of revenue mix, the Consumer Finance division accounts for around half of the group's non-interest income – mainly payment protection insurance commissions. The profit contribution of the core divisions is much higher at around 90% of the group total, reflecting the much higher impairment charges of the closed books in run-off. In the six months to March, the Other Operations division accounted for 94% of the group's credit costs.

Figure 19. Operating Income (1H06 - £86.5m)



Source: Company Reports

Figure 20. Profit before Tax (1H06 - £39.0m)



Source: Company Reports

Current trading

On 19 September, Paragon issued a trading statement in advance of its September 2006 year-end. Preliminary results will be announced on 22 November. The key messages were:

Management expects the results for the year to end-September 2006 to be in line with market expectations. According to Reuters, the average of analysts' expectations is for PBT is £81.6m, EPS of 55.2p (range 52.5p-60.8p), DPS of 16.9p. We forecast PBT of £80.5m, EPS 55.3p and DPS of 17.0p.

Lending volumes for the year as a whole are expected to be ~70% higher than in 2005, with most growth due to the BTL businesses. This implies aggregate new business volumes of ~£3.4bn, and BTL advances of ~£3.0bn, up around 85% on 2005. The new business pipeline, when compared with the pipeline at the same time last year, augurs well for further growth in 2007.

Key management

Nigel Terrington, Chief Executive - Joined the group in 1987 and became Chief Executive in June 1995, having held the positions of Treasurer and Finance Director. Nigel is a board member of the Finance and Leasing Association (FLA) and is Vice-Chairman of the FLA Consumer Finance division. He was previously Chairman of the Intermediary Mortgage Lenders Association and a member of the Executive Committee of the Council of Mortgage Lenders (CML).

Nicholas Keen, Finance Director - Joined Paragon in May 1991 and became Finance Director in June 1995 having previously held the position of Treasurer. Prior to joining Paragon, Nick worked in Corporate Banking, Treasury and Capital Markets. He is Chairman of the Paragon Credit Committee.

John Heron, Director of Mortgages - Joined Paragon in January 1986 and appointed Marketing Director in 1990. In 1994 played a pivotal role in re-establishing Paragon's mortgage lending operations as Managing Director of Paragon Mortgages. Now responsible for both Paragon Mortgages and Mortgage Trust, John is a Fellow of the Chartered Institute of Bankers and a member of the Executive Committee of the Council of Mortgage Lenders.

Pawan Pandya, Chief Operating Officer - Joined the group in December 1988 and appointed as Chief Operating Officer in July 2002, responsible for all operational and IT areas of the Group. Prior to joining Paragon, Pawan worked in foreign exchange, credit risk management, marketing and corporate finance.

Recent director share transactions

On 20 September, Nigel Terrington, Nick Keen and John Heron each sold shares acquired as a result of exercising options approaching expiry. The sale price was £6.59 per share. On 5 July, Pawan Pandya exercised options and share awards, acquiring 68,421 shares at £1.865 per share and 22,807 shares at nil cost. He sold 48,724 of these shares, also at £6.59.

Figure 21. Recent Director Share Transactions

Director	Position	Date	Shares Acquired	Shares Sold	Price (£)	Value (£)	Remaining Shares	%NOSH
Nigel Terrington	Chief Executive	20 September 2006	63,684	159,210	6.59	1,049,194	120,170	0.10%
Nick Keen	Finance Director	20 September 2006	46,316	115,790	6.59	763,056	54,390	0.05%
John Heron	Director of Mortgages	20 September 2006	21,930	54,825	6.59	361,297	14,303	0.01%
Pawan Pandya	Chief Operating Officer	5 July 2006	91,228	48,724	6.59	321,091	117,365	0.10%
Total			223,158	378,549		2,494,638	188,863	0.16%

Source: Company data.

Strategy & Growth Outlook

Paragon's growth strategy is focused upon (i) strong growth in its buy-to-let (BTL) mortgage activities, (ii) disciplined growth in its secured consumer credit activities, (iii) the run-off of its closed unsecured consumer credit and first mortgage loan books, and (iv) good cost control and credit management. The group's capital management strategy reflects its growth strategy, repatriating capital released as a result of the on-going shift in its business mix.

Buy-to-let growth

Multi-branded strategy

Paragon follows a multi-brand strategy in the UK BTL mortgage market. Paragon Mortgages (PM) is focused on larger scale professional BTL investors who have an average portfolio of 12 properties, and targets its marketing on existing customers (70% of PM's new business volumes from existing customers) and a network of specialist intermediaries. Mortgage Trust (MT) focuses on smaller scale private investors with an average of seven properties, although this includes a growing number of amateur investors – "pension refugees" – with 1-2 property portfolios. MT uses a broader network of intermediaries for distribution, where advanced credit profiling technology and cost effective processing and administration are the core competencies.

The BTL market

According to the Council of Mortgage Lenders, BTL mortgages have grown rapidly over recent years. The value and number of mortgages outstanding have grown by 54% and 46% pa respectively between 1999 and 2005, whilst the value and number of advances have grown by 41% and 31% pa respectively. Relative to the overall UK mortgage market, BTL has increased its share from 1% of outstanding mortgages at end-1999 to more than 8% at end-June-2006. BTL advances have increased their share of overall mortgage advances from 2.5% of new lending in 1999 to 11% in the first half of 2006.

Figure 22. BTL Mortgages – Stocks, Flows and Market Shares

	1999	2000	2001	2002	2003	2004	2005	1H06
<u>BTL mortgages outstanding:</u>								
Mortgages outstanding (£m)	5,400	9,100	14,700	24,200	39,000	52,200	73,400	83,900
Mortgages outstanding (number)	73,200	120,300	185,000	275,500	417,500	526,300	701,900	767,600
BTL mortgages % total (by value)	1.1%	1.7%	2.5%	3.6%	5.0%	5.9%	7.6%	8.3%
<u>BTL advances:</u>								
Gross advances (£m)	3,100	3,900	6,900	12,200	19,200	21,800	24,500	17,500
Gross advances (number)	44,400	48,400	72,200	130,000	187,600	217,700	223,800	152,500
BTL advances % total (by value)	2.5%	3.5%	4.6%	5.4%	7.5%	6.7%	9.0%	11.0%

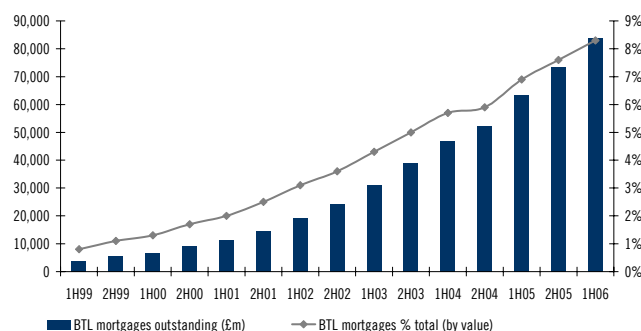
Source: Council of Mortgage Lenders (CML)

The outlook is for continued growth, in our view, for the following reasons:

- **Large available target market.** According to Department for Communities & Local Government (DCLG) research, there are approximately 3m private rented properties in the UK, a little above 10% of the UK total housing stock, of which around 2.5m can be considered potential BTL properties. Since according to CML estimates only 767,000 BTL mortgages were outstanding at end-June 2006, this implies a target market penetration of only 30%.

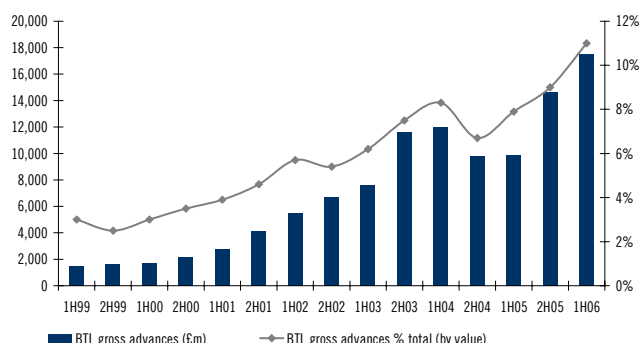
- **Strong residential property investment case.** Uncertainty in the wider housing market has reduced competition for properties, which has provided buying opportunities for longer-term investors. Tenant demand remains high, due to record numbers of students in higher education and increasing immigration into the UK. This has resulted in higher rents and rising rental yields.

Figure 23. Buy-To-Let Mortgages – Outstanding Balances



Source: Council or Mortgage Lenders

Figure 24. Buy-To-Let Mortgages – Gross Advances



Source: Council or Mortgage Lenders

Paragon market share

Paragon's share of this growing market has itself been increasing, from around 4% three years ago to around 10% currently, aided by the acquisition of Mortgage Trust in 2003. We are forecasting £3.1bn of gross BTL advances from Paragon in the year to September 2006, which compares with gross industry BTL advances in the twelve months to June 2006 of around £32bn, which also implies a near 10% share of new lending.

The outlook for additional market share gains will depend to a degree on whether the attractive margins and superior credit performance of Paragon's mortgage book (significantly better than the wider mortgage market and the BTL market as a whole) attract additional competition.

There is evidence of increasing competition in other specialist mortgage markets, such as the non-conforming or sub-prime segments. Our BTL loan growth forecasts (set out below) are based on reduced new business volume growth, which is consistent with continued BTL market growth and a broadly maintained Paragon market share.

Figure 25. BTL Growth Forecasts

Year to September (£m)	2004	2005	2006E	2007E	2008E	2009E	2010E	CAGR
Opening balance	3,007	4,064	5,032	7,271	9,293	11,008	12,487	
Advances	1,637	1,668	3,094	3,403	3,574	3,681	3,754	15%
Redemption rate	19%	17%	17%	19%	20%	20%	20%	
Redemptions	-580	-700	-855	-1,381	-1,859	-2,202	-2,497	28%
Closing balance	4,064	5,032	7,271	9,293	11,008	12,487	13,744	23%
Average balance	3,536	4,548	6,151	8,282	10,150	11,747	13,115	24%

Source: Company Reports and CIR Estimates

Capital management

Management has actively managed Paragon's capital position since 2002, when it was announced that internal capital generation was in excess of that required to fund loan growth and that as a consequence, dividend cover would be progressively reduced from 2001's 6.8x to "a dividend cover ratio more in line with our sector". In 2002-2004, dividends grew at around twice the rate of earnings, which reduced dividend cover from 6.8x to 4.8x.

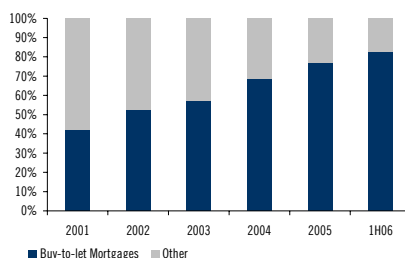
At the 2005 interim results announcement in May last year, management announced a more aggressive capital management strategy:

- Due to the on-going shift in loan book mix from unsecured to secured lending, and the run-off of closed books, management had identified substantial surplus capital;
- As a result, management announced that it would grow dividends at roughly three times the rate of earnings growth until dividend cover was reduced to around the average for the UK market as a whole (between 2.0x and 3.0x).
- In addition, a £20m share repurchase programme was established, and ~£18m of shares were repurchased in the year to May 2006. At this time, the programme was increased by an additional £10m to £30m, and following the sale of the closed NHL book in July, further increased to £40m, of which approaching £30m has been completed to date.

Shift in loan mix

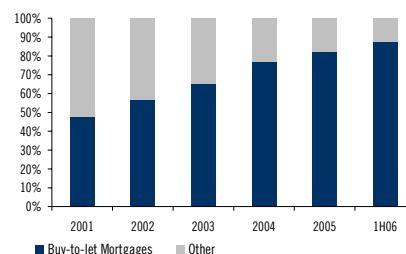
Core to the capital management programme has been the shift in loan book mix – (i) from consumer credit to BTL mortgages, (ii) within consumer credit, from unsecured to secured loans, and (iii) the run-off of closed loan books.

Figure 26. Percentage of Loan Balances



Source: Company Reports

Figure 27. Percentage of New Business Volumes

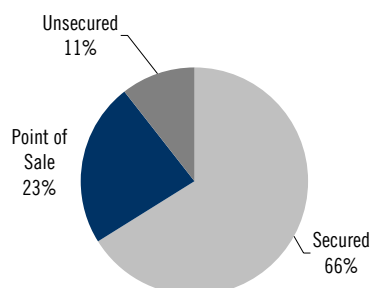


Source: Company Reports

As shown above, the BTL mortgage percentage of the overall loan book has risen from 42% in 2001 to 82% in 1H06. In terms of new business volumes, the BTL proportion has risen from 48% to 88%. The Consumer Finance proportion of the loan book mix has fallen from 20% in 2001 to 10% in 1H06, and the run-off books from 38% in 2001 to 8% in 1H06.

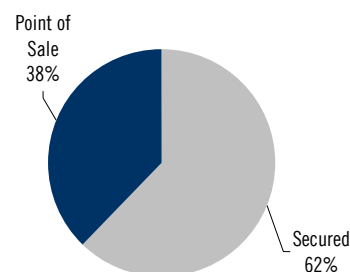
As at end-March 2006, total consumer credit receivables amounted to £787m, including £83m of unsecured loans in run-off. During the half-year to end-March, consumer credit advances totaled £189m, of which £118m were secured loans (second mortgages) and £72m point of sale finance.

Figure 28. March 2006 Consumer Credit Book



Source: Company Reports

Figure 29. 1H06 Consumer Credit Advances



Source: Company Reports

The mix effect of the differing growth rates of the BTL mortgage and Consumer Finance books, and the impact of the run-off of closed first mortgage and unsecured consumer credit portfolios is set out in the following table.

Figure 30. Loan Book Mix – September 2001 to March 2006

Year to September (£m)	2001	2002	2003	2004	2005	1H06
Buy-to-let Mortgages						
-Advances	382	564	963	1,637	1,668	1,335
-Loan balances	909	1,326	3,007	4,064	5,032	5,965
Consumer Finance						
-Advances	332	390	471	450	350	189
-Loan balances	428	553	680	726	695	704
Other Operations						
-Advances	84	40	44	37	8	0
-Loan balances	812	643	1,601	1,161	802	564
Total						
-Advances	798	994	1,478	2,124	2,026	1,524
-Loan balances	2,149	2,522	5,288	5,951	6,529	7,233

Source: Company Reports

Economic capital requirements

In order to model the impact of the shift in loan book mix on Paragon's capital requirements – and hence the potential for additional capital release – we have looked at the 'economic capital' requirements of the different divisions.

In the table below we set out loan growth forecasts and economic capital requirements by division, based on a 3% economic capital-to-assets ratio for the BTL loan book, a 7.5% ratio for the Consumer Finance book, and a rising 20%-30% ratio for Other Operations in run-off (rising to reflect a likely decline in the credit quality of these closed books as they run down).

Clearly, as the 3% capital-to-assets element of the mix rises as a proportion of the total loan book, the blended capital-to-assets ratio declines; based on our assumptions the group-wide ratio falls from 5.6% in 2005 to 3.4% by 2010E.

Figure 31. Forecast Loan Book Mix and Economic Capital

Year to September (£m)	2005	2006E	2007E	2008E	2009E	2010E	CAGR
Buy-to-let Mortgages							
Customer loans	5,032	7,271	9,293	11,008	12,487	13,744	22%
Capital/customer loans	3.0%	3.0%	3.0%	3.0%	3.0%	3.0%	
Economic capital	151.0	218.1	278.8	330.2	374.6	412.3	22%
Consumer Finance							
Customer loans	695	681	708	730	751	767	2%
Capital/customer loans	7.5%	7.5%	7.5%	7.5%	7.5%	7.5%	
Economic capital	52.1	51.1	53.1	54.7	56.4	57.5	2%
Other Operations							
Customer loans	802	481	337	236	165	116	-32%
Capital/customer loans	20.0%	20.0%	23.0%	25.0%	27.0%	30.0%	
Economic capital	160.4	96.2	77.5	58.9	44.6	34.7	-26%
TOTAL							
Customer loans	6,529	8,433	10,338	11,973	13,403	14,626	18%
Equity/customer loans	5.6%	4.3%	4.0%	3.7%	3.5%	3.4%	
Economic capital	363	365	409	444	476	504	7%

Source: Company reports and Citigroup Investment Research estimates

This reduction in the economic capital ratio releases capital, as shown below:

Despite our forecast for near-30% loan growth in the year to September 2006, the reduction the capital/customer loans ratio from 5.6% to 4.3% of loan assets, in conjunction with our forecast for retained earnings, results in a release of capital amounting to £50m.

Figure 32. Release of Capital

Year to September (£m)	2005	2006E	2007E	2008E	2009E	2010E
Customer loans	6,529	8,433	10,338	11,973	13,403	14,626
Capital/customer loans	5.6%	4.3%	4.0%	3.7%	3.5%	3.4%
Economic capital requirement	363	365	409	444	476	504
Retentions required		-2	-44	-35	-32	-29
Net profit		67	69	79	90	99
Dividends		-15	-20	-25	-31	-36
Surplus capital generation		50	5	21	28	34

Source: Company reports and Citigroup Investment Research estimates

The implication of this analysis is that the on-going shift in Paragon's loan book mix could release capital amounting to around £140m over the five years to 2010E. Bearing in mind the current programme is targeting share repurchases totaling £40m, this suggests the potential for an additional £100m worth of share repurchases and/or special distributions over the next few years.

Economic capital and equity

In the above, we have talked on economic capital rather than equity. Based on historic loan book totals, our divisional economic capital ratio assumptions for end-September 2005 require a total economic capital of £363m, which is £119m greater than the group's £244m of equity capital at end-2005.

The shortfall between our estimate of economic capital required to support the end-2005 loan book and actual equity capital was effectively made up with subordinated debt. In April 2005, the group issued £120m 7% Callable Subordinated Notes due 2017. This long-term capital has helped provide the economic capital required to support the loan book whilst at the same time allowing for higher dividend payouts and share repurchases – a debt for equity swap which has re-leveraged Paragon's equity capital in line with the less risky (and lower margin) BTL and secured consumer credit portfolios.

The other levers

Although the high growth potential offered by BTL mortgages and re-leveraging are key earnings drivers, the other factors influencing the earnings growth profile are income margins, the outlook for administrative and credit costs, and the group's tax charge.

Figure 33. Half-Year to March 2006 – Financial Snapshot

Half-year to March 2006 (£m)	Buy-to-Let		Consumer		Other		TOTAL
	Mortgages	%	Finance	%	Operations	%	
Net interest income	28.4	40%	9.2	13%	33.7	47%	71.3
Other operating income	3.7	24%	8.6	57%	2.9	19%	15.2
Total operating income	32.1	37%	17.8	21%	36.6	42%	86.5
Operating expenses	-9.0	36%	-4.4	18%	-11.4	46%	-24.8
Pre-impairment profit	23.1	37%	13.4	22%	25.2	41%	61.7
Impairment charge	-0.1	0%	-1.3	6%	-22.2	94%	-23.6
Operating profit	23.0	60%	12.1	32%	3.0	8%	38.1
FV gains/losses	0.0	0%	0.0	0%	0.9	100%	0.9
Profit before tax	23.0	59%	12.1	31%	3.9	10%	39.0
Customer loans	5,965	82%	704	10%	564	8%	7,233
Average loans	5,499	80%	700	10%	683	10%	6,881
Net interest margin	1.03%		2.63%		9.87%		2.07%
Total income margin	1.17%		5.09%		10.72%		2.51%
Impairments/avg loans	0.00%		-0.37%		-6.50%		-0.69%
Net interest/total income	88.5%		51.7%		92.1%		82.4%
Expense ratio	-28.0%		-24.7%		-31.1%		-28.7%

Source: Company Reports

Margins

Although the recent shift to IFRS and Effective Interest Rate (EIR) accounting makes an historical analysis of margin trends difficult, the outlook is for a gradual reduction in net interest margin due to shift in mix – the margin on the faster growing BTL book being lower than the margin on Consumer Finance loans. The stand-alone BTL net interest margin has held up well, although this has reflected cheaper funding costs compensating for some pressure on gross lending margins. The outlook is for continued pressure on gross BTL margins, in our view.

The group's total income margin is set to decline more substantially, again due to mix, as a result of the higher non-interest income margin on the lower growth Consumer Finance segment of the loan book – primarily commission income from the sale of creditor insurance on second mortgages.

Expense ratio

The group's expense ratio has continued to fall, reflecting the scalability of the platform. Although not strictly comparable due to the shift in accounting standards (IFRS inflates both operating income and impairment charges by a similar amount), the expense ratio has fallen from 45% in 1999 to 35% in 2003 to 29% in 1H06. Although future improvements are unlikely to be of a similar magnitude, we expect additional efficiency gains and forecast the expense ratio falls to just over 25% by 2010E.

Credit costs

The outlook for impairment charges will reflect the outlook for mix and the speed at which the closed books are run-off or sold. The performance of the group's BTL mortgages portfolio has been excellent, with negligible arrears, losses and hence impairment charges. Accounts more than three months in arrears currently amount to only 7bps in relation to average loans, whilst 1H06 annualised impairment charges were less than a basis point.

Consumer Finance impairments are also low in relation to wider industry averages, and falling due to a focus on quality as opposed to volume. The closed books represent something of a wild-card as far as impairments are concerned, with 1H06 impairments amounting to an annualized 6.5% of average loans. However, with substantial provisions already held against these loans, and following the sale of the majority of the NHL book, the impact of these operations on overall profitability is diminishing.

Tax charge

Paragon has benefited from a low tax charge since it was re-financed and re-focused in the mid-1990's, primarily due to carried-forward tax losses that were topped up following the acquisition of Britannic Money (now Mortgage Trust) in 2003. The charge has consistently been in the 20%-22% range, although it fell to 16.7% in 1H06 due to an exceptional credit of £4.3m as a result of the settlement of a prior year item. We expect a similarly low second half charge and hence an unusually low 16.5% year full-year charge.

However, from 2007 onwards, we expect the charge to rise to close to the standard rate. Management has guided the market to expect a charge of around 28% in 2007 and in the 28%-30% range thereafter (we have assumed 29%). This is likely to result in a year of low earnings growth in 2007 – we forecast EPS growth of 4%, despite strong growth in profit before tax.

Summary

- Management's multi-branded focus on the UK BTL mortgage market should continue to deliver top-line asset and revenue growth, whilst its scalable platform should also allow for efficiency gains, which should result in strong pre-provision profit growth.
- The group's credit costs should decline as a result of the on-going shift in mix to lower risk, secured loans, although the run-off of the closed first mortgage and unsecured consumer credit portfolios does add some uncertainty to the outlook.
- The outlook for a substantial increase in the group's tax charge could dampen after-tax profit growth in 2007.
- The potential for a further release of capital and hence additional share repurchase should underpin earnings per share growth.
- Dividend growth should substantially exceed earnings growth until dividend cover falls to around 2.5x (we forecast this will occur in 2008).

Financial Results

Full-year 2007 pre-close trading update

On 19 September, Paragon issued a trading statement in advance of its September 2006 year-end. Preliminary results will be announced on 22 November. The key messages were:

- Management expects the results for the year to end-September 2006 to be in line with market expectations. According to Reuters, the average of analysts' expectations is for PBT is £81.6m, EPS of 55.2p (range 52.5p-60.8p), DPS of 16.9p. We forecast PBT of £80.5m, EPS 55.3p and DPS of 17.0p.
- Lending volumes for the year as a whole are expected to be ~70% higher than in 2005, with most growth due to the BTL businesses. This implies aggregate new business volumes of ~£3.4bn, and BTL advances of ~£3.1bn, up around 86% on 2005. The new business pipeline, when compared with the pipeline at the same time last year, augurs well for further growth in 2007.

2006 Interim results

Figure 34. 2006 Interim Results Summary

Half-Year to March (£m)	2005*	2006	Ch £m	Ch %
Income & Expenses				
Interest receivable	240.0	254.9	14.9	6%
Interest payable	-178.6	-183.6	-5.0	3%
Net interest income	61.4	71.3	9.9	16%
Other income	14.9	15.2	0.3	2%
Operating income	76.3	86.5	10.2	13%
Operating expenses	-21.1	-24.8	-3.7	18%
Pre-provision profit	55.2	61.7	6.5	12%
Provision for losses	-20.7	-23.6	-2.9	14%
Core PBT	34.5	38.1	3.6	10%
Exceptionals/FV gains		0.9		
Profit before tax	34.5	39.0	4.5	13%
Taxation	-7.9	-6.5	1.4	-18%
Attributable profit	26.6	32.5	5.9	22%
Balance Sheet				
Avg customer loans	6259.4	6880.9	621.5	10%
Customer loans	5990.0	7233.0	1243.0	21%
Equity	295.3	262.1	-33.2	-11%
Subordinated debt	120.0	120.0	0.0	0%
Ratios				
Net interest margin	2.53%	2.07%		
Total income margin	3.01%	2.51%		
Cost:income ratio	-27.7%	-28.7%		
Expenses:avg IEA	-0.67%	-0.72%		
Provision charge:avg loans	-0.66%	-0.69%		
ROE	17.6%	25.7%		
ROA	0.85%	0.94%		
Equity:customer loans	4.9%	3.6%		
Effective tax rate	-22.9%	-16.7%		
Per share data				
Reported EPS	22.4	28.8	6.4	29%
Adjusted EPS	22.4	26.6	4.3	19%
DPS (p)	5.2	6.9	1.7	33%
NAV/share	258.6	231.9	-26.6	-10%

Source: Company Reports. *Proforma basis.

Figure 35. 2006 Interim Results by Division

Half-Year to March (£m)	2005	2006	Ch £m	Ch %
<u>Buy-to-let Mortgages</u>				
Net interest income	17.1	28.4	11.3	66%
Other operating income	5.5	3.7	-1.8	-33%
Total operating income	22.6	32.1	9.5	42%
Operating expenses	-8.3	-9.0	-0.7	8%
Pre-impairment profit	14.3	23.1	8.8	62%
Impairment charge	0.5	-0.1	-0.6	-120%
Profit before tax	14.8	23.0	8.2	55%
Customer loans	4,400	5,965	1565.0	36%
<u>Consumer Finance</u>				
Net interest income	8.0	9.2	1.2	15%
Other operating income	8.3	8.6	0.3	4%
Total operating income	16.3	17.8	1.5	9%
Operating expenses	-3.8	-4.4	-0.6	16%
Pre-impairment profit	12.5	13.4	0.9	7%
Impairment charge	-4.4	-1.3	3.1	-70%
Profit before tax	8.1	12.1	4.0	49%
Customer loans	711	704	-7.0	-1%
<u>Other Operations</u>				
Net interest income	20.0	33.7	13.7	69%
Other operating income	4.2	2.9	-1.3	-31%
Total operating income	24.2	36.6	12.4	51%
Operating expenses	-9.0	-11.4	-2.4	27%
Pre-impairment profit	15.2	25.2	10.0	66%
Impairment charge	-4.6	-22.2	-17.6	383%
Operating profit	10.6	3.0	-7.6	-72%
FV gains/losses	0.0	0.9		
Profit before tax	10.6	3.9	-6.7	-63%
Customer loans	879	564	-315.0	-36%
<u>TOTAL</u>				
Net interest income	45.1	71.3	26.2	58%
Other operating income	18.0	15.2	-2.8	-16%
Total operating income	63.1	86.5	23.4	37%
Operating expenses	-21.1	-24.8	-3.7	18%
Pre-impairment profit	42.0	61.7	19.7	47%
Impairment charge	-8.5	-23.6	-15.1	178%
Operating profit	33.5	38.1	4.6	14%
FV gains/losses	0.0	0.9		
Profit before tax	33.5	39.0	5.5	16%
Customer loans	5,990	7,233	1243.0	21%

Source: Company Reports. *Statutory basis.

Forecasts

Divisional disclosure and IFRS

The 2006 interim results included new divisional disclosure: Buy-to-let Mortgages, Consumer Lending and Other Operations. Essentially, Buy-to-let Mortgages aggregates the BTL mortgage lending activities of Paragon Mortgages and Mortgage Trust, whilst Consumer Lending includes secured lending (Mortgage Trust's second mortgages), car finance and the retail finance businesses. Other Operations principally comprises the closed NHL and Mortgage Trust first mortgage books in run-off.

Forecast summary

Figure 36. Forecast Summary

	UK GAAP		IFRS					
Year to September (£m)	2004	2005	2005	2006E	2007E	2008E	2009E	2010E
Income & Expenses								
-Interest receivable	412.0	484.4	484.4	533.5	642.7	743.0	831.7	909.7
-Interest payable	-331.4	-387.5	-387.5	-393.6	-499.4	-592.1	-672.4	-742.0
Net interest income	80.6	96.9	96.9	139.9	143.4	150.9	159.3	167.8
Other income	40.2	35.9	35.9	31.3	32.9	35.3	37.5	39.5
Operating income	120.8	132.8	132.8	171.2	176.3	186.2	196.8	207.2
Operating expenses	-43.9	-44.2	-44.2	-48.6	-48.7	-49.9	-51.1	-52.2
Pre-provision profit	76.9	88.6	88.6	122.6	127.6	136.3	145.6	155.1
Impairment charges	-11.1	-15.9	-15.9	-43.0	-31.8	-24.5	-19.5	-16.1
Operating profit	65.8	72.7	72.7	79.6	95.8	111.8	126.1	139.0
Goodwill amortisation	5.2	4.1	0.0	0.0	0.0	0.0	0.0	0.0
Core PBT	71.0	76.8	72.7	79.6	95.8	111.8	126.1	139.0
Exceptionals/FV gains	0.0	0.0	0.0	0.9	0.0	0.0	0.0	0.0
Profit before tax	71.0	76.8	72.7	80.5	95.8	111.8	126.1	139.0
Taxation	-16.3	-16.1	-16.1	-13.3	-26.8	-32.4	-36.6	-40.3
Attributable profit	54.7	60.7	56.6	67.2	68.9	79.4	89.6	98.7
Dividend	-11.0	-14.4	-12.5	-15.2	-19.8	-24.3	-30.1	-35.3
Retained earnings	43.7	46.3	44.1	52.0	49.2	55.1	59.4	63.3
Balance Sheet								
Avg customer loans	5,619	6,240	6,115	7,357	9,385	11,155	12,688	14,015
Customer loans	5,951	6,529	6,529	8,433	10,338	11,973	13,403	14,626
Equity	268.4	308.0	244.4	314.1	363.2	418.3	477.7	541.1
Subordinated debt	0.0	120.0	120.0	120.0	120.0	120.0	120.0	120.0
Ratios								
Net interest margin	1.43%	1.55%	1.58%	1.90%	1.53%	1.35%	1.26%	1.20%
Total income margin	2.81%	2.69%	2.17%	2.33%	1.88%	1.67%	1.55%	1.48%
Expense ratio	-36.3%	-33.3%	-33.3%	-28.4%	-27.6%	-26.8%	-26.0%	-25.2%
Impairments:avg loans	-0.20%	-0.25%	-0.26%	-0.59%	-0.34%	-0.22%	-0.15%	-0.11%
ROE	20.1%	19.6%	20.5%	21.6%	20.4%	20.3%	20.0%	19.4%
ROA (RoAvgLoans)	0.88%	0.91%	0.93%	0.91%	0.73%	0.71%	0.71%	0.70%
Equity:customer loans	4.5%	4.7%	3.7%	3.7%	3.5%	3.5%	3.6%	3.7%
Effective tax rate	-23.0%	-21.0%	-22.1%	-16.5%	-28.0%	-29.0%	-29.0%	-29.0%
Per share data								
Reported EPS	46.2	51.0	47.6	56.9	59.3	68.3	77.0	84.9
Adjusted EPS	41.8	47.6	47.6	56.9	59.3	68.3	77.0	84.9
DPS (p)	9.6	12.6	12.6	17.0	20.9	25.9	30.4	33.5
NAV/share	223.9	255.0	214.4	266.8	308.4	354.9	405.1	458.5

Source: Company Reports and CIR Estimates.

Divisional summary

Figure 37. Forecasts by Division

Year to September (£m)	2005	2006E	2007E	2008E	2009E	2010E
<u>Buy-to-let Mortgages</u>						
-Interest receivable	298.2	379.8	519.3	636.4	736.6	822.3
-Interest payable	-263.7	-318.1	-434.8	-532.9	-616.7	-688.6
Net interest income	34.5	61.8	84.5	103.5	119.8	133.8
Other operating income	13.7	9.1	12.4	15.2	17.6	19.7
Total operating income	48.2	70.9	96.9	118.8	137.4	153.4
Operating expenses	-18.2	-20.0	-26.5	-31.5	-35.2	-38.0
Pre-impairment profit	30.0	50.9	70.4	87.3	102.2	115.4
Impairment charge	-1.2	-1.2	-2.5	-3.0	-3.5	-3.9
Operating profit	28.8	49.7	67.9	84.2	98.7	111.5
FV gains/losses	0.0	0.0	0.0	0.0	0.0	0.0
Profit before tax	28.8	49.7	67.9	84.2	98.7	111.5
Advances	1,668	3,094	3,403	3,574	3,681	3,754
Customer loans	5,032	7,271	9,293	11,008	12,487	13,744
Average loans	4,474	6,058	8,282	10,150	11,747	13,115
<u>Consumer Finance</u>						
-Interest receivable	84.7	60.2	60.1	62.2	64.1	65.7
-Interest payable	-68.6	-41.8	-41.7	-43.1	-44.4	-45.5
Net interest income	16.1	18.4	18.4	19.1	19.6	20.1
Other operating income	17.2	17.1	17.0	17.6	18.1	18.6
Total operating income	33.3	35.5	35.4	36.7	37.8	38.7
Operating expenses	-7.9	-8.7	-8.7	-9.0	-9.3	-9.5
Pre-impairment profit	25.4	26.8	26.7	27.7	28.5	29.2
Impairment charge	-4.6	-2.6	-2.8	-2.9	-3.0	-3.0
Operating profit	20.8	24.2	24.0	24.8	25.5	26.2
FV gains/losses	0.0	0.0	0.0	0.0	0.0	0.0
Profit before tax	20.8	24.2	24.0	24.8	25.5	26.2
Advances	350	350	354	357	361	364
Customer loans	695	681	708	730	751	767
Average loans	711	696	695	719	741	759
<u>Other Operations</u>						
-Interest receivable	102.9	93.4	63.4	44.4	31.1	21.7
-Interest payable	-58.5	-33.8	-22.9	-16.0	-11.2	-7.9
Net interest income	44.4	59.7	40.5	28.3	19.8	13.9
Other operating income	7.0	5.1	3.5	2.4	1.7	1.2
Total operating income	51.4	64.8	44.0	30.8	21.5	15.1
Operating expenses	-19.1	-19.9	-13.5	-9.4	-6.6	-4.6
Pre-impairment profit	32.3	44.9	30.5	21.3	14.9	10.5
Impairment charge	-10.1	-39.2	-26.6	-18.6	-13.0	-9.1
Operating profit	22.2	5.7	3.9	2.7	1.9	1.3
FV gains/losses	0.0	0.9	0.0	0.0	0.0	0.0
Profit before tax	22.2	6.6	3.9	2.7	1.9	1.3
Customer loans	802	481	337	236	165	116
Average loans	930	603	409	286	200	140

Source: Company Reports and CIR Estimates

Detailed forecasts by division

Figure 38. BTL Mortgages

Year to September (£m)	05H1	05H2	2005	06H1	06H2E	2006E	2007E	2008E	2009E	2010E
Net interest income	17.1	17.4	34.5	28.4	33.4	61.8	84.5	103.5	119.8	133.8
Other operating income	5.5	8.2	13.7	3.7	5.4	9.1	12.4	15.2	17.6	19.7
Total operating income	22.6	25.6	48.2	32.1	38.8	70.9	96.9	118.8	137.4	153.4
Operating expenses	-8.3	-9.9	-18.2	-9.0	-11.0	-20.0	-26.5	-31.5	-35.2	-38.0
Pre-impairment profit	14.3	15.7	30.0	23.1	27.8	50.9	70.4	87.3	102.2	115.4
Impairment charge	0.5	-1.7	-1.2	-0.1	-1.1	-1.2	-2.5	-3.0	-3.5	-3.9
Operating profit	14.8	14.0	28.8	23.0	26.7	49.7	67.9	84.2	98.7	111.5
FV gains/losses	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Profit before tax	14.8	14.0	28.8	23.0	26.7	49.7	67.9	84.2	98.7	111.5
Advances	631	1,037	1,668	1,335	1,759	3,094	3,403	3,574	3,681	3,754
Customer loans	4,400	5,032	5,032	5,965	7,271	7,271	9,293	11,008	12,487	13,744
Average loans	4,232	4,716	4,474	5,499	6,618	6,058	8,282	10,150	11,747	13,115
Economic capital	132.0	151.0	151.0	179.0	218.1	218.1	278.8	330.2	374.6	412.3
Net interest margin	0.81%	0.74%	0.77%	1.03%	1.01%	1.02%	1.02%	1.02%	1.02%	1.02%
Total income margin	1.07%	1.09%	1.08%	1.17%	1.17%	1.17%	1.17%	1.17%	1.17%	1.17%
Impairments/avg loans	0.02%	-0.07%	-0.03%	0.00%	-0.03%	-0.02%	-0.03%	-0.03%	-0.03%	-0.03%
Net interest/total income	75.7%	68.0%	71.6%	88.5%	86.1%	87.2%	87.2%	87.2%	87.2%	87.2%
Capital/customer loans	3.0%	3.0%	3.0%	3.0%	3.0%	3.0%	3.0%	3.0%	3.0%	3.0%
Fully taxed RoCE	15.7%	13.0%	13.4%	18.0%	17.1%	15.9%	17.1%	17.9%	18.4%	18.9%
Expense ratio	-36.7%	-38.7%	-37.8%	-28.0%	-28.3%	-28.2%	-27.4%	-26.5%	-25.6%	-24.8%

Source: Company Reports and CIR Estimates

Figure 39. Consumer Finance

Year to September (£m)	05H1	05H2	2005	06H1	06H2E	2006E	2007E	2008E	2009E	2010E
Net interest income	8.0	8.1	16.1	9.2	9.2	18.4	18.4	19.1	19.6	20.1
Other operating income	8.3	8.9	17.2	8.6	8.5	17.1	17.0	17.6	18.1	18.6
Total operating income	16.3	17.0	33.3	17.8	17.7	35.5	35.4	36.7	37.8	38.7
Operating expenses	-3.8	-4.1	-7.9	-4.4	-4.3	-8.7	-8.7	-9.0	-9.3	-9.5
Pre-impairment profit	12.5	12.9	25.4	13.4	13.4	26.8	26.7	27.7	28.5	29.2
Impairment charge	-4.4	-0.2	-4.6	-1.3	-1.3	-2.6	-2.8	-2.9	-3.0	-3.0
Operating profit	8.1	12.7	20.8	12.1	12.1	24.2	24.0	24.8	25.5	26.2
FV gains/losses	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Profit before tax	8.1	12.7	20.8	12.1	12.1	24.2	24.0	24.8	25.5	26.2
Advances	181	169	350	189	161	350	354	357	361	364
Customer loans	711	695	695	704	681	681	708	730	751	767
Average loans	719	703	711	700	693	696	695	719	741	759
Economic capital	53.3	52.1	52.1	52.8	51.1	51.1	53.1	54.7	56.4	57.5
Net interest margin	2.23%	2.30%	2.27%	2.63%	2.67%	2.65%	2.65%	2.65%	2.65%	2.65%
Total income margin	4.54%	4.84%	4.69%	5.09%	5.11%	5.10%	5.10%	5.10%	5.10%	5.10%
Impairments/avg loans	-1.22%	-0.06%	-0.65%	-0.37%	-0.39%	-0.38%	-0.40%	-0.40%	-0.40%	-0.40%
Net interest/total income	49.1%	47.6%	48.3%	51.7%	52.2%	52.0%	52.0%	52.0%	52.0%	52.0%
Capital/customer loans	7.5%	7.5%	7.5%	7.5%	7.5%	7.5%	7.5%	7.5%	7.5%	7.5%
Fully taxed RoCE	21.3%	34.1%	27.9%	32.1%	33.0%	33.1%	31.6%	31.7%	31.7%	31.9%
Expense ratio	-23.3%	-24.1%	-23.7%	-24.7%	-24.3%	-24.5%	-24.5%	-24.5%	-24.5%	-24.5%

Source: Company Reports and CIR Estimates

Figure 40. Other Operations

Year to September (£m)	05H1	05H2	2005	06H1	06H2E	2006E	2007E	2008E	2009E	2010E
Net interest income	20.0	24.4	44.4	33.7	26.0	59.7	40.5	28.3	19.8	13.9
Other operating income	4.2	2.8	7.0	2.9	2.2	5.1	3.5	2.4	1.7	1.2
Total operating income	24.2	27.2	51.4	36.6	28.2	64.8	44.0	30.8	21.5	15.1
Operating expenses	-9.0	-10.1	-19.1	-11.4	-8.5	-19.9	-13.5	-9.4	-6.6	-4.6
Pre-impairment profit	15.2	17.1	32.3	25.2	19.7	44.9	30.5	21.3	14.9	10.5
Impairment charge	-4.6	-5.5	-10.1	-22.2	-17.0	-39.2	-26.6	-18.6	-13.0	-9.1
Operating profit	10.6	11.6	22.2	3.0	2.7	5.7	3.9	2.7	1.9	1.3
FV gains/losses	0.0	0.0	0.0	0.9	0.0	0.9	0.0	0.0	0.0	0.0
Profit before tax	10.6	11.6	22.2	3.9	2.7	6.6	3.9	2.7	1.9	1.3
Customer loans	879	802	802	564	481	481	337	236	165	116
Average loans	1,020	841	930	683	523	603	409	286	200	140
Economic capital	175.8	160.4	160.4	112.8	96.2	96.2	77.5	58.9	44.6	34.7
Net interest margin	3.92%	5.81%	4.77%	9.87%	9.94%	9.90%	9.90%	9.90%	9.90%	9.90%
Total income margin	4.75%	6.47%	5.53%	10.72%	10.79%	10.75%	10.75%	10.75%	10.75%	10.75%
Impairments/avg loans	-0.90%	-1.31%	-1.09%	-6.50%	-6.50%	-6.50%	-6.50%	-6.50%	-6.50%	-6.50%
Net interest/total income	82.6%	89.7%	86.4%	92.1%	92.1%	92.1%	92.1%	92.1%	92.1%	92.1%
Capital/customer loans	20.0%	20.0%	20.0%	20.0%	20.0%	20.0%	23.0%	25.0%	27.0%	30.0%
Fully taxed RoCE	8.4%	10.1%	9.7%	4.8%	4.0%	4.8%	3.5%	3.2%	3.0%	2.7%
Expense ratio	-37.2%	-37.1%	-37.2%	-31.1%	-30.1%	-30.7%	-30.7%	-30.7%	-30.7%	-30.7%

Source: Company Reports and CIR Estimates

Figure 41. Group Total

Year to September (£m)	05H1	05H2	2005	06H1	06H2E	2006E	2007E	2008E	2009E	2010E
Net interest income	45.1	49.9	95.0	71.3	68.6	139.9	143.4	150.9	159.3	167.8
Other operating income	18.0	19.9	37.9	15.2	16.1	31.3	32.9	35.3	37.5	39.5
Total operating income	63.1	69.8	132.9	86.5	84.7	171.2	176.3	186.2	196.8	207.2
Operating expenses	-21.1	-24.1	-45.2	-24.8	-23.8	-48.6	-48.7	-49.9	-51.1	-52.2
Pre-impairment profit	42.0	45.7	87.7	61.7	60.9	122.6	127.6	136.3	145.6	155.1
Impairment charge	-8.5	-7.4	-15.9	-23.6	-19.4	-43.0	-31.8	-24.5	-19.5	-16.1
Operating profit	33.5	38.3	71.8	38.1	41.5	79.6	95.8	111.8	126.1	139.0
FV gains/losses	0.0	0.0	0.0	0.9	0.0	0.9	0.0	0.0	0.0	0.0
Profit before tax	33.5	38.3	71.8	39.0	41.5	80.5	95.8	111.8	126.1	139.0
Advances	812	1,206	2,026	1,524	1,928	3,452	3,765	3,939	4,049	4,127
Customer loans	5,990	6,529	6,529	7,233	8,433	8,433	10,338	11,973	13,403	14,626
Average loans	5,971	6,260	6,115	6,881	7,833	7,357	9,385	11,155	12,688	14,015
Economic capital	361	363	363	345	365	365	409	444	476	504
Net interest margin	1.51%	1.59%	1.55%	2.07%	1.75%	1.90%	1.53%	1.35%	1.26%	1.20%
Total income margin	2.11%	2.23%	2.17%	2.51%	2.16%	2.33%	1.88%	1.67%	1.55%	1.48%
Impairments/avg loans	-0.28%	-0.24%	-0.26%	-0.69%	-0.50%	-0.59%	-0.34%	-0.22%	-0.15%	-0.11%
Net interest/total income	71.5%	71.5%	71.5%	82.4%	81.0%	81.7%	81.3%	81.1%	81.0%	81.0%
Capital/customer loans	6.0%	5.6%	5.6%	4.8%	4.3%	4.3%	4.0%	3.7%	3.5%	3.4%
Fully taxed RoCE	13.0%	14.8%	13.8%	15.8%	15.9%	15.4%	16.4%	17.6%	18.6%	19.3%
Expense ratio	-33.4%	-34.5%	-34.0%	-28.7%	-28.1%	-28.4%	-27.6%	-26.8%	-26.0%	-25.2%

Source: Company Reports and CIR Estimates

APPENDIX – Appraisal Values

As an alternative to peer group relative analysis and our primary price to book valuation methodology, we have valued Paragon's loan assets under management and its ability to generate new business by key BTL Mortgages and Consumer Finance divisions, and its closed books in run-off, 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. We have used a 17% prepayment rate for BTL Mortgages and 20% for Consumer Finance and Other Operations. We have discounted all cash flows using 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 annual growth rates of 5% pa for both BTL Mortgages and Consumer Finance.

Figure 42. Front and Back Book Appraisal Values

	£m	p	%AUM
Buy-to-Let			
In-force value	163	141	2.2%
New business value	477	411	6.6%
Appraisal value	640	552	8.8%
Consumer Finance			
In-force value	30	26	4.5%
New business value	178	153	26.1%
Appraisal value	208	179	30.5%
Other Operations			
In-force value	10	8	2.0%
Appraisal value	10	8	2.0%

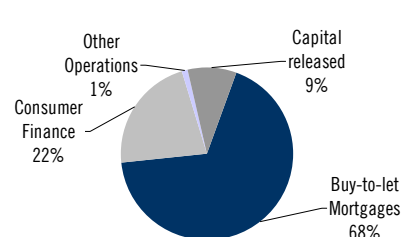
Source: Citigroup Investment Research

Figure 43. Sum of the Parts Valuation

	£m	p	%
Buy-to-let Mortgages	640	552	68%
Consumer Finance	208	179	22%
Other Operations	10	8	1%
Capital released	88	76	9%
Fair enterprise value	946	815	100%
Subordinated debt	-120	-103	-13%
Fair market value	826	712	87%

Source: Citigroup Investment Research

Figure 44. Components of Enterprise Value



Source: Citigroup Investment Research

Figure 45. Buy-to-Let Mortgages – In-Force Value of Existing MAUM (Prepayment Rate 17%, Discount Rate 10%)

Year to September	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
Balances	7271	6035	5009	4157	3450	2864	2377	1973	1638	1359	1128	936	777	645	535	444	369
Average MAUM	6058	6653	5522	4583	3804	3157	2620	2175	1805	1498	1244	1032	857	711	590	490	407
Interest margin		0.95%	0.95%	0.95%	0.95%	0.95%	0.95%	0.95%	0.95%	0.95%	0.95%	0.95%	0.95%	0.95%	0.95%	0.95%	0.95%
Ancillary income		0.17%	0.17%	0.17%	0.17%	0.17%	0.17%	0.17%	0.17%	0.17%	0.17%	0.17%	0.17%	0.17%	0.17%	0.17%	0.17%
Admin expenses		-0.15%	-0.15%	-0.15%	-0.15%	-0.15%	-0.15%	-0.15%	-0.15%	-0.15%	-0.15%	-0.15%	-0.15%	-0.15%	-0.15%	-0.15%	-0.15%
Credit costs		-0.03%	-0.03%	-0.03%	-0.03%	-0.03%	-0.03%	-0.03%	-0.03%	-0.03%	-0.03%	-0.03%	-0.03%	-0.03%	-0.03%	-0.03%	-0.03%
Net margin		0.94%	0.94%	0.94%	0.94%	0.94%	0.94%	0.94%	0.94%	0.94%	0.94%	0.94%	0.94%	0.94%	0.94%	0.94%	0.94%
Gross cash flow		62.5	51.9	43.1	35.8	29.7	24.6	20.4	17.0	14.1	11.7	9.7	8.1	6.7	5.5	4.6	3.8
Tax		-17.5	-15.1	-12.5	-10.4	-8.6	-7.1	-5.9	-4.9	-4.1	-3.4	-2.8	-2.3	-1.9	-1.6	-1.3	-1.1
Net cash flow		45.0	36.9	30.6	25.4	21.1	17.5	14.5	12.0	10.0	8.3	6.9	5.7	4.7	3.9	3.3	2.7
PV (cash flows)		40.9	30.5	23.0	17.3	13.1	9.9	7.4	5.6	4.2	3.2	2.4	1.8	1.4	1.0	0.8	0.6
NPV (cash flows)	163																
NPV/share (p)	141																

Source: Citigroup Investment Research

Figure 46. Buy-to-Let Mortgages – New Business Value (Prepayment Rate 17%, Discount Rate 10%, L/T New Business Growth Rate 5%)

Year to Sep	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
New business	3403	3574	3681	3754	3942	4139	4346	4563	4792	5031	5283	5547	5824	6116	6421	6742	
2007	1557	2585	2145	1781	1478	1227	1018	845	701	582	483	401	333	276	229	190	
2008		1635	2714	2253	1870	1552	1288	1069	887	736	611	507	421	350	290	241	
2009			1684	2795	2320	1926	1598	1327	1101	914	759	630	523	434	360	299	
2010				1718	2851	2367	1964	1630	1353	1123	932	774	642	533	442	367	
2011					1804	2994	2485	2062	1712	1421	1179	979	812	674	560	465	
2012						1894	3144	2609	2166	1797	1492	1238	1028	853	708	588	
2013							1988	3301	2740	2274	1887	1566	1300	1079	896	743	
2014								2088	3466	2877	2388	1982	1645	1365	1133	940	
2015									2192	3639	3020	2507	2081	1727	1433	1190	
2016										2302	3821	3171	2632	2185	1813	1505	
2017											2417	4012	3330	2764	2294	1904	
2018												2538	4213	3496	2902	2409	
2019													2665	4423	3671	3047	
2020														2798	4644	3855	
2021															2938	4877	
2022																3085	
Earnings assets	1557	4220	6543	8546	10322	11958	13486	14931	16318	17665	18989	20305	21624	22957	24315	25704	
Interest margin	0.95%	0.95%	0.95%	0.95%	0.95%	0.95%	0.95%	0.95%	0.95%	0.95%	0.95%	0.95%	0.95%	0.95%	0.95%	0.95%	0.95%
Ancillary income	0.17%	0.17%	0.17%	0.17%	0.17%	0.17%	0.17%	0.17%	0.17%	0.17%	0.17%	0.17%	0.17%	0.17%	0.17%	0.17%	0.17%
Admin expenses	-0.30%	-0.30%	-0.30%	-0.30%	-0.30%	-0.30%	-0.30%	-0.30%	-0.30%	-0.30%	-0.30%	-0.30%	-0.30%	-0.30%	-0.30%	-0.30%	-0.30%
Credit costs	-0.10%	-0.10%	-0.10%	-0.10%	-0.10%	-0.10%	-0.10%	-0.10%	-0.10%	-0.10%	-0.10%	-0.10%	-0.10%	-0.10%	-0.10%	-0.10%	-0.10%
Net margin	0.72%	0.72%	0.72%	0.72%	0.72%	0.72%	0.72%	0.72%	0.72%	0.72%	0.72%	0.72%	0.72%	0.72%	0.72%	0.72%	0.72%
Gross cash flow	11.2	30.4	47.1	61.5	74.3	86.1	97.1	107.5	117.5	127.2	136.7	146.2	155.7	165.3	175.1	185.1	
Tax	-3.1	-8.8	-13.7	-17.8	-21.6	-25.0	-28.2	-31.2	-34.1	-36.9	-39.6	-42.4	-45.2	-47.9	-50.8	-53.7	
Net cash flow	8.1	21.6	33.4	43.7	52.8	61.1	68.9	76.3	83.4	90.3	97.1	103.8	110.5	117.4	124.3	131.4	
PV (cash flows)	7.3	17.8	25.1	29.8	32.8	34.5	35.4	35.6	35.4	34.8	34.0	33.1	32.0	30.9	29.8	28.6	
NPV (cash flows)	477																
NPV/share	411																

Source: Citigroup Investment Research

Figure 47. Consumer Finance – In-Force Value of Existing AUM (Prepayment Rate 20%, Discount Rate 10%)

Year to Sep	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
Balances	681	545	436	349	279	223	179	143	114	91	73	59	47	37	30	24	19
Average AUM	613	490	392	314	251	201	161	129	103	82	66	53	42	34	27	22	
Interest margin	2.65%	2.65%	2.65%	2.65%	2.65%	2.65%	2.65%	2.65%	2.65%	2.65%	2.65%	2.65%	2.65%	2.65%	2.65%	2.65%	2.65%
Admin expenses	-0.15%	-0.15%	-0.15%	-0.15%	-0.15%	-0.15%	-0.15%	-0.15%	-0.15%	-0.15%	-0.15%	-0.15%	-0.15%	-0.15%	-0.15%	-0.15%	-0.15%
Credit costs	-0.40%	-0.40%	-0.40%	-0.40%	-0.40%	-0.40%	-0.40%	-0.40%	-0.40%	-0.40%	-0.40%	-0.40%	-0.40%	-0.40%	-0.40%	-0.40%	-0.40%
Net margin	2.10%	2.10%	2.10%	2.10%	2.10%	2.10%	2.10%	2.10%	2.10%	2.10%	2.10%	2.10%	2.10%	2.10%	2.10%	2.10%	2.10%
Gross cash flow	12.9	10.3	8.2	6.6	5.3	4.2	3.4	2.7	2.2	1.7	1.4	1.1	0.9	0.7	0.6	0.5	
Tax	-3.6	-3.0	-2.4	-1.9	-1.5	-1.2	-1.0	-0.8	-0.6	-0.5	-0.4	-0.3	-0.3	-0.2	-0.2	-0.1	
Net cash flow	9.3	7.3	5.8	4.7	3.7	3.0	2.4	1.9	1.5	1.2	1.0	0.8	0.6	0.5	0.4	0.3	
PV (cash flows)	8.4	6.0	4.4	3.2	2.3	1.7	1.2	0.9	0.7	0.5	0.3	0.3	0.2	0.1	0.1	0.1	
NPV (cash flows)	30																
NPV/share (p)	26																

Source: Citigroup Investment Research

Figure 48. Consumer Finance – New Business Value (Prepayment Rate 20%, Discount Rate 10%, L/T New Business Growth Rate 0%)

Year to Sep	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
New business		354	357	361	364	364	364	364	364	364	364	364	364	364	364	364	364
2007		159	255	204	163	130	104	83	67	53	43	34	27	22	17	14	11
2008			161	257	206	165	132	105	84	67	54	43	35	28	22	18	14
2009				162	260	208	166	133	106	85	68	54	44	35	28	22	18
2010					164	262	210	168	134	107	86	69	55	44	35	28	23
2011						164	262	210	168	134	107	86	69	55	44	35	28
2012							164	262	210	168	134	107	86	69	55	44	35
2013								164	262	210	168	134	107	86	69	55	44
2014									164	262	210	168	134	107	86	69	55
2015										164	262	210	168	134	107	86	69
2016											164	262	210	168	134	107	86
2017												164	262	210	168	134	107
2018													164	262	210	168	134
2019														164	262	210	168
2020															164	262	210
2021																164	262
2022																	164
Earning assets	159	415	623	792	929	1038	1125	1195	1251	1296	1332	1360	1383	1402	1416	1428	
Interest margin	2.65%	2.65%	2.65%	2.65%	2.65%	2.65%	2.65%	2.65%	2.65%	2.65%	2.65%	2.65%	2.65%	2.65%	2.65%	2.65%	2.65%
Ancillary income	2.50%	2.50%	2.50%	2.50%	2.50%	2.50%	2.50%	2.50%	2.50%	2.50%	2.50%	2.50%	2.50%	2.50%	2.50%	2.50%	2.50%
Admin expenses	-1.25%	-1.25%	-1.25%	-1.25%	-1.25%	-1.25%	-1.25%	-1.25%	-1.25%	-1.25%	-1.25%	-1.25%	-1.25%	-1.25%	-1.25%	-1.25%	-1.25%
Credit costs	-0.40%	-0.40%	-0.40%	-0.40%	-0.40%	-0.40%	-0.40%	-0.40%	-0.40%	-0.40%	-0.40%	-0.40%	-0.40%	-0.40%	-0.40%	-0.40%	-0.40%
Net margin	3.50%	3.50%	3.50%	3.50%	3.50%	3.50%	3.50%	3.50%	3.50%	3.50%	3.50%	3.50%	3.50%	3.50%	3.50%	3.50%	3.50%
Gross cash flow	5.6	14.5	21.8	27.7	32.5	36.3	39.4	41.8	43.8	45.4	46.6	47.6	48.4	49.1	49.6	50.0	
Tax	-1.6	-4.2	-6.3	-8.0	-9.4	-10.5	-11.4	-12.1	-12.7	-13.2	-13.5	-13.8	-14.0	-14.2	-14.4	-14.4	-14.5
Net cash flow	4.0	10.3	15.5	19.7	23.1	25.8	28.0	29.7	31.1	32.2	33.1	33.8	34.4	34.8	35.2	35.2	35.5
PV (cash flows)	3.6	8.5	11.6	13.4	14.3	14.6	14.4	13.9	13.2	12.4	11.6	10.8	10.0	9.2	8.4	7.7	
NPV (cash flows)	178																
NPV/share	153																

Source: Citigroup Investment Research

Figure 49. Other Operations – In-Force Value of Existing AUM (Prepayment Rate 20%, Discount Rate 10%)

Year to Sep	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
Balances	481	385	308	246	197	158	126	101	81	65	52	41	33	26	21	17	14
Average AUM		433	346	277	222	177	142	114	91	73	58	47	37	30	24	19	15
Interest margin		9.90%	9.90%	9.90%	9.90%	9.90%	9.90%	9.90%	9.90%	9.90%	9.90%	9.90%	9.90%	9.90%	9.90%	9.90%	9.90%
Ancillary income		0.85%	0.85%	0.85%	0.85%	0.85%	0.85%	0.85%	0.85%	0.85%	0.85%	0.85%	0.85%	0.85%	0.85%	0.85%	0.85%
Admin expenses		-3.30%	-3.30%	-3.30%	-3.30%	-3.30%	-3.30%	-3.30%	-3.30%	-3.30%	-3.30%	-3.30%	-3.30%	-3.30%	-3.30%	-3.30%	-3.30%
Credit costs		-6.50%	-6.50%	-6.50%	-6.50%	-6.50%	-6.50%	-6.50%	-6.50%	-6.50%	-6.50%	-6.50%	-6.50%	-6.50%	-6.50%	-6.50%	-6.50%
Net margin		0.95%	0.95%	0.95%	0.95%	0.95%	0.95%	0.95%	0.95%	0.95%	0.95%	0.95%	0.95%	0.95%	0.95%	0.95%	0.95%
Gross cash flow		4.1	3.3	2.6	2.1	1.7	1.3	1.1	0.9	0.7	0.6	0.4	0.4	0.3	0.2	0.2	0.1
Tax		-1.2	-1.0	-0.8	-0.6	-0.5	-0.4	-0.3	-0.3	-0.2	-0.2	-0.1	-0.1	-0.1	-0.1	-0.1	0.0
Net cash flow		3.0	2.3	1.9	1.5	1.2	1.0	0.8	0.6	0.5	0.4	0.3	0.3	0.2	0.2	0.1	0.1
PV (cash flows)		2.7	1.9	1.4	1.0	0.7	0.5	0.4	0.3	0.2	0.2	0.1	0.1	0.1	0.0	0.0	0.0
NPV (cash flows)	10																
NPV/share (p)	8																

Source: Citigroup Investment Research

Paragon Group

Company description

Paragon Group is a specialist lender focused on the UK buy-to-let (BTL) mortgage market, with additional consumer credit activities and a portfolio of closed loan books in run-off. The core BTL Mortgages division operates two mortgage brands - Paragon Mortgages and Mortgage Trust - which currently manage mortgage assets of around £7bn. The Consumer Finance division manages assets of around £700m and this division includes second mortgage lending, secured personal loans, used car finance and point-of-sale retail finance. The Other Operations division includes the NHL mortgage book, a portfolio of owner-occupied mortgages and some unsecured consumer credit loans, in total amounting to around £600m, all in run-off.

Investment thesis

Paragon has an estimated 10% share of the high-growth BTL segment of the UK mortgage market. Group new business volumes are set to increase by 70% this year to £3.4bn, including BTL volumes of more than £3bn. The scalability of the group's BTL platform should allow for further operating efficiencies as mortgage assets under management increase. To this end, management has indicated a willingness to acquire additional BTL mortgage assets/businesses. The shift in loan book mix from higher-risk consumer credit and run-off assets to lower-risk mortgage loans is releasing capital; we forecast the release of ~£100m over the next four years which should be available for additional share repurchases and/or higher dividends. Offsetting this is the outlook for lower income margins and the potential for higher impairment charges as the closed books are wound down.

Valuation

Paragon currently trades on 11.9x 2006E earnings and 11.4x 2007E, broadly in line with the UK quoted mortgage banks but at a substantial premium to Kensington Group. 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-September 2006 fair value for the shares of 730p. Our appraisal value approach, which takes into account the run-off of the closed books, produces a lower valuation of 712p per share. We have set our 12-month target price of 720p in relation to the average of these current fair value estimates. At 720p the shares would trade on 12.7x 2006E, 12.1x 2007E and yield a prospective 2.4%.

Risk

We rate Paragon Medium 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: strong BTL volume growth has in part been due to lower asset pricing, as Paragon has passed on lower funding costs to its borrowers, which potentially leaves the net interest margin and/or future volumes exposed to rising MBS spreads going forward; the potential for increased losses and impairment charges as the closed mortgage and unsecured consumer credit books are run-off. These factors could cause the shares to deviate from our target price.

Bradford & Bingley (BB.L)**2M; £4.59 current price****Company description**

Bradford & Bingley was formed in 1964 as a result of the merger of the Bradford Equitable Building Society and the Bingley Building Society and it demutualised in 2000. Its Lending business provides residential mortgages focused on the 'specialist' markets such as Buy-to-Let, Self-Certification and Lifetime products. It also provides secured commercial property loans secured by income-producing property or pre-let development schemes and loans to Housing Associations. The Retail business offers savings products through its network of 300 branches, online and via the post and telephone. Bradford & Bingley also distributes general insurance, wealth and personal loan products provided by third parties.

Investment thesis

We have a HOLD rating on Bradford & Bingley shares. It has enjoyed strong loan growth as the Buy-to-Let mortgage market has grown significantly faster than mainstream lending. However, we expect increasing competition to put both Bradford & Bingley's market share and margins under pressure. This is likely to be exacerbated by an increasing pricing differential between new and existing business and a greater reliance on more expensive wholesale funding. Bid speculation may continue to provide support to the share price, leading to a premium rating that does not reflect the future earnings profile of the stock.

Valuation

We set a target price of £4.75. Our primary valuation tool is the fundamental fair value price to book model which gives a final valuation that equals the sum of 1. The expected dividend flow to 2010E, 2. Surplus capital present on the balance sheet at end-2010E and 3. The terminal value of the normalised equity tier 1 capital in 2010E based on sustainable assumptions of returns and growth - all discounted to a NPV using the group's cost of equity. An alternative valuation tool calculates implied target prices based on the five year average 12 month forward PE relative to both the UK market and the European bank sector.

Risk

We rate Bradford & Bingley Medium Risk as it has limited exposure to higher risk banking activities, such as derivatives and high yield bonds and it operates in the lower risk areas such as the mortgage market. Risks which could cause the share to deviate significantly from our target price include continued strength in the UK mortgage market which could increase new business volumes and a less competitive pricing environment, relieving margin pressure, particularly if new entrants in the specialist area of the market are less effective than we anticipate. Alternatively, rising UK interest rates could increase mortgage arrears and a hard landing for UK house prices could result in negative equity for borrowers. A sharp rise of the short end of the yield curve could affect Bradford & Bingley's margins, as its mortgage book is increasingly wholesale funded.

Kensington Group (KGN.L)**1H; £9.36 current price****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 10.5x 2006E earnings and 9.0x 2007E, a 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.

Northern Rock PLC (NRK.L)

3M; £11.85 current price

Company description

Northern Rock converted from building society to public limited company in 1997. Its core business is the provision of UK residential mortgages mainly funded in the wholesale markets where it is a major issuer of UK mortgage securitisations. Northern Rock also provides secured commercial lending and personal unsecured lending products. Its retail distribution platform consists of c70 branches and mortgage centers, postal, telephone and Internet operations. A large proportion of residential mortgage business is sourced through the UK financial intermediary market.

Investment thesis

We have a SELL rating on Northern Rock shares. The company's existing high level of cost efficiency reduces the scope for cost cutting in our view. In the context of a slowing UK mortgage market we see the company's asset growth targets as overly ambitious, particularly as Basel II is likely to penalise Northern Rock for its lack of diversification and for a bias towards high loan to value business. We also remain skeptical that Northern Rock is a realistic bid target, offering little in the way of synergies and protected by the "poison pill" established under the terms of Northern Rock's demutualisation. We continue to see the shares as fully valued.

Valuation

We set a target price of £10.70. Our primary valuation tool is the fundamental fair value price to book model which gives a final valuation that equals the sum of 1. The expected dividend flow to 2010E, 2. Surplus capital present on the balance sheet at end-2010E and 3. The terminal value of the normalised equity tier 1 capital in 2010E based on sustainable assumptions of returns and growth - all discounted to a NPV using the group's cost of equity. An alternative valuation tool calculates implied target prices based on the five year average 12 month forward PE relative to both the UK market and the European bank sector.

Risk

We rate Northern Rock Medium Risk as it has limited exposure to higher risk banking activities, such as derivatives and high yield bonds and it operates in the lower risk areas such as the mortgage market. Risks which could cause the share to deviate significantly from our target price include continued strength in the UK mortgage market which could increase new business volumes and a less competitive pricing environment, relieving margin pressure which could be further eased by a reversion of the negative spread between three month Libor and UK base rates. Alternatively, rising UK interest rates could increase mortgage arrears and a hard landing for UK house prices could result in negative equity for borrowers. A sharp rise of the short end of the yield curve could affect Northern Rock's margins, as it is primarily wholesale funded.

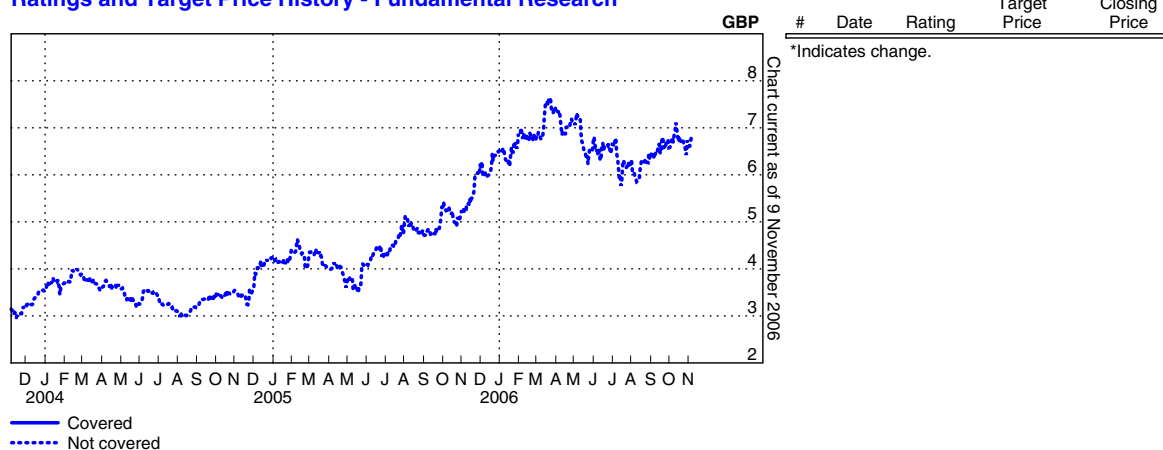
Analyst Certification Appendix A-1

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Paragon Group (PAG.L)

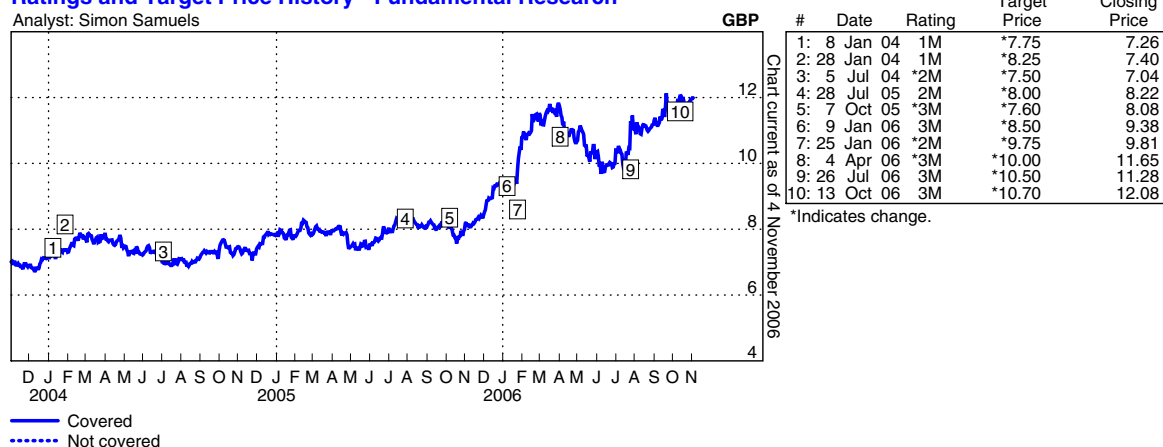
Ratings and Target Price History - Fundamental Research



Northern Rock (NRK.L)

Ratings and Target Price History - Fundamental Research

Analyst: Simon Samuels



Bradford & Bingley (BB.L)**Ratings and Target Price History - Fundamental Research**

Analyst: Simon Samuels

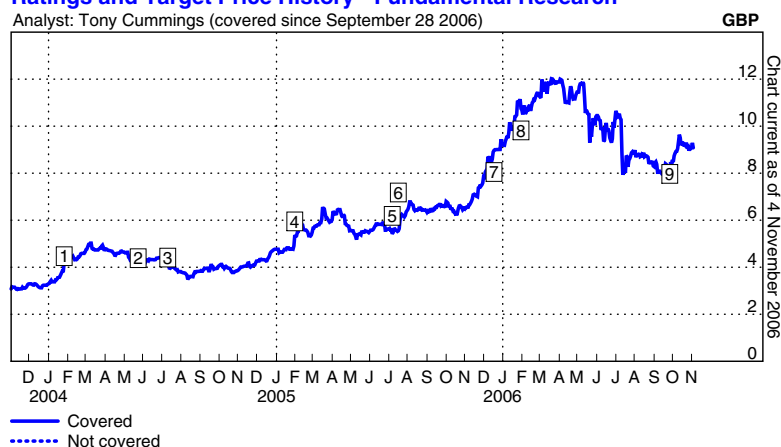


#	Date	Rating	Target Price	Closing Price
1:	8 Jan 04	*1M	*3.35	3.05
2:	8 Jan 04	1M	3.35	3.05
3:	5 Jul 04	*2M	*2.80	2.68
4:	6 Jan 05	2M	*3.20	3.44
5:	9 Aug 05	2M	*3.25	3.26
6:	21 Sep 05	2M	*3.20	3.25
7:	9 Jan 06	2M	*4.10	4.11
8:	16 Feb 06	2M	*4.40	4.49
9:	6 Jul 06	2M	*4.60	4.69
10:	13 Oct 06	2M	*4.75	4.77

*Indicates change.

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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Data current as of 30 September 2006

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<i>% of companies in each rating category that are investment banking clients</i>	93%	84%	83%
Diversified and Speciality Finance -- Europe (18)	72%	22%	6%
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