

Company In-Depth

SMALL &
MID CAP

22 January 2007 | 28 pages

Paragon Group (PAG.L)

More challenging times ahead

Rating change ☐

Target price change ☒

Estimate change ☒

- **Lowering estimates and price target** — We lower our earnings estimates, by 1% on 2007E, 5% in 2008E, and 9% in 2009E, primarily to reflect a combination of lower than previously forecast income margins, partially offset by stronger volumes. We reduce our target price by 13% from 720p to 625p per share.
- **Margins under pressure** — New entrants into the UK BTL market (including a recent entrant into Paragon's professional landlord niche) are competing on price and driving down income margins. Our new forecasts discount lower buy-to-let and second mortgage gross margins, stable rather than cheaper funding costs, and reduced non-interest income (e.g. PPI commissions).
- **Reduced scope for buy-backs** — The higher volume/lower margin trade-off within our new estimates has implications for the release of capital. We now estimate ~£20m of capital will be released over the four years to 2010E, as compared with ~£90m previously.
- **Relatively expensive** — Although the shares appear reasonably valued in relation to the UK mortgage banks, when we isolate the core BTL Mortgages division, by stripping out stand-alone valuations for the Consumer Finance and Other divisions, its implied valuation looks relatively expensive.
- **Remains a hold** — Despite recent weakness (the shares are down 9% over the past month) we see little scope for re-rating, and with earnings risk biased to the downside, in our view, we maintain a Hold/Medium Risk rating.

Hold/Medium Risk	2M
Price (19 Jan 07)	£6.02
Target price	£6.25
<i>from £7.20</i>	
Expected share price return	3.9%
Expected dividend yield	3.7%
Expected total return	7.6%
Market Cap	£698M
	US\$1,378M

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



See page 25 for Analyst Certification and important disclosures.

Paragon Group (GBP)

Year to 30 Sep	2005A	2006A	2007E	2008E	2009E
Net Income (£M)	55.7	68.8	67.6	74.3	80.4
Diluted EPS (p)	46.8	58.5	58.6	64.8	70.1
Diluted EPS (Old) (p)	47.6	56.9	59.3	68.3	77.0
PE (x)	12.9	10.3	10.3	9.3	8.6
P/BV (x)	3.0	2.1	1.8	1.6	1.4
DPS (p)	12.6	17.0	22.0	26.0	29.0
Net Div Yield (%)	2.1	2.8	3.7	4.3	4.8
ROE (%)	21.7	24.7	20.0	19.2	18.4

Tony Cummings¹

+44-20-7986-1989
 tony.cummings@citigroup.com

Andrew Coombs¹

andrew.coombs@citigroup.com

Carolyn Dorrett¹

carolyn.dorrett@citigroup.com

Daniel R Garrod¹

daniel.garrod@citigroup.com

Citigroup Research is a division of Citigroup Global Markets Inc. (the "Firm"), which does and seeks to do business with companies covered in its research reports. As a result, investors should be aware that the Firm may have a conflict of interest that could affect the objectivity of this report. Investors should consider this report as only a single factor in making their investment decision. Non-US research analysts who have prepared this report are not registered/qualified as research analysts with the NYSE and/or NASD.

¹Citigroup Global Markets Ltd

Fiscal year end 30-Sep	2005	2006	2007E	2008E	2009E
Valuation Ratios					
P/E adjusted (x)	12.9	10.3	10.3	9.3	8.6
P/E reported (x)	12.9	10.3	10.3	9.3	8.6
P/BV (x)	3.0	2.1	1.8	1.6	1.4
P/Adjusted BV diluted (x)	2.9	2.3	1.9	1.7	1.5
Dividend yield (%)	2.1	2.8	3.7	4.3	4.8
Per Share Data (p)					
EPS adjusted	46.8	58.5	58.6	64.8	70.1
EPS reported	46.8	58.5	58.6	64.8	70.1
BVPS	202.4	282.6	330.5	376.4	423.9
Tangible BVPS	202.1	282.0	329.9	375.8	423.3
Adjusted BVPS diluted	205.4	265.8	313.4	359.0	404.3
DPS	12.6	17.0	22.0	26.0	29.0
Profit & Loss (£M)					
Net interest income	131	143	140	141	145
Fees and commissions	0	0	0	0	0
Other operating Income	29	31	31	32	34
Total operating income	160	174	171	174	178
Total operating expenses	-45	-45	-43	-43	-45
Oper. profit bef. provisions	115	128	128	130	134
Bad debt provisions	-43	-48	-34	-26	-21
Non-operating/exceptionals	0	3	0	0	0
Pre-tax profit	72	83	94	105	113
Tax	-16	-14	-26	-30	-33
Extraord./Min. Int./Pref. Div.	0	0	0	0	0
Attributable profit	56	69	68	74	80
Adjusted earnings	56	69	68	74	80
Growth Rates (%)					
EPS adjusted	1.2	24.9	0.2	10.6	8.2
Oper. profit bef. prov.	49.7	11.3	-0.2	1.9	2.6
Balance Sheet (£M)					
Total assets	7,091	9,117	11,221	13,194	15,113
Avg interest earning assets	6,250	7,600	9,479	11,518	13,464
Customer loans	6,431	8,427	10,532	12,504	14,423
Gross NPLs	0	0	0	0	0
Liab. & shar. funds	7,091	9,117	11,221	13,194	15,113
Total customer deposits	0	0	0	0	0
Reserve for loan losses	0	0	0	0	0
Shareholders' equity	364	433	482	532	584
Profitability/Solvency Ratios (%)					
ROE adjusted	21.7	24.7	20.0	19.2	18.4
Net interest margin	2.1	1.9	1.5	1.2	1.1
Cost/income ratio	28.2	26.2	25.2	25.0	25.0
Cash cost/average assets	0.7	0.6	0.4	0.4	0.3
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	0.7	0.6	0.4	0.2	0.2
Loans/deposit ratio	na	na	na	na	na
Tier 1 capital ratio	6.1	6.5	6.2	6.1	6.0
Total capital ratio	9.1	9.0	8.3	7.9	7.6

For further data queries on Citigroup's full coverage universe please contact CIR Data Services Europe at CitiResearchDataServices@citigroup.com or +44-207-986-4050



Contents

Lowering Earnings Estimates & Target Price	4
Valuation	6
Growth Outlook & Key Forecast Assumptions	10
Forecast Summary	18
Company Snapshot	20
Analyst Certification Appendix A-1	25

Lowering Earnings Estimates & Target Price

We lower our earnings estimates, by 1% on 2007E, 5% in 2008E, and 9% in 2009E, primarily to reflect a combination of lower than previously forecast income margins, partially offset by stronger volumes. The volume/margin trade-off within our new estimates has implications for the release of capital: we now estimate ~£20m of capital will be released over the four years to 2010E, as compared with ~£90m previously. As a result of these changes, we reduce our target price by 13% from 720p to 625p per share.

Following several years of strong earnings and dividend growth, driven by a combination of very strong buy-to-let (BTL) mortgage new business volumes and loan growth and the group's capital release and share buy-back programmes, the outlook is more challenging, in our view:

- **Income margin compression.** New entrants into the UK BTL market (including a recent entrant into Paragon's professional landlord niche) are competing on price and driving down income margins, although lower funding costs have so far protected Paragon's BTL net interest margins. Our forecasts discount competitive pressure on BTL and second mortgage gross margins, stable rather than cheaper funding costs, and reduced non-interest income (payment protection insurance commissions in particular).
- **Other activities bring credit risk.** Although BTL Mortgages is the key growth division, it accounted for only 63% of 2006 operating profits, and only 40% of operating income. The other activities – consumer finance and closed books in run-off – accounted for 97% of last year's impairment charge and 73% of the group's non-interest income. These divisions bring higher credit risk and the potential for more volatile impairment provisions.
- **Cost:income pressures.** Since an element of the group's 'central costs' – the collections and IT departments, for example – are being charged to the declining income stream from the closed Other Operations in run-off, the reallocation of these costs to the continuing businesses could limit the potential for further significant reductions in the group's expense ratio.
- **Relatively expensive.** Although the shares appear reasonably valued in relation to the UK mortgage banks, when we isolate the core BTL Mortgages division, by stripping out stand-alone valuations for the Consumer Finance and Other divisions, its implied valuation looks relatively expensive. Hence, despite recent weakness (the shares are down 9% over the past month), we see little scope for re-rating.
- **Reduced scope for buy-backs.** As a consequence of stronger net new business assumptions, our new forecasts have a higher 'loan book funding requirement' and hence we now estimate ~£20m of capital will be released over the four years to 2010E, as compared with ~£90m previously. The 2006 final results presentation appeared to confirm this conclusion, highlighting a "significant increase in capital commitment to buy-to-let" and the "recycling potential" of capital released from the closed books in run-off.
- **Director share sales.** In our initiation of coverage note dated 9 November 2006, we highlighted that all four of the group's Executive Directors had recently sold shares (at 659p per share). On 9 January, Chief Executive Nigel

Terrington exercised options approaching expiry, purchasing 200,000 shares at 148.5p per share. He subsequently sold 200,000 shares at 670p per share, leaving his total shareholding in the company at 127,573 shares.

Forecast changes

Our revised earnings forecasts are summarized below. Full details of the changes are set out later in this note.

Figure 1. Forecast Changes

Year to September (£m)	2007E			2008E			2009E		
	Old	New	Ch %	Old	New	Ch %	Old	New	Ch %
BTL Mortgages	67.9	65.8	-3%	84.2	78.6	-7%	98.7	88.6	-10%
Consumer Finance	24.0	22.1	-8%	24.8	22.3	-10%	25.5	22.2	-13%
Other Operations	3.9	5.9	51%	2.7	3.8	39%	1.9	2.4	27%
Group PBT	95.8	93.8	-2%	111.7	104.6	-6%	126.1	113.2	-10%
Diluted EPS (p)	59.3	58.6	-1%	68.3	64.8	-5%	77.0	70.1	-9%
DPS (p)	20.9	22.0	5%	25.9	26.0	0%	30.4	29.0	-5%

Source: Citigroup Investment Research

Our new EPS estimates are approximately 2% and 4% below the IBES consensus for the years to September 2007 and 2008 respectively. Our dividend forecasts are a little ahead of consensus.

Investment recommendation

We forecast a slowdown in underlying earnings growth reflecting some moderation in UK mortgage market volume growth in 2008, and as competition begins to erode the group's BTL and second mortgage income margins. On a full rating (expensive for BTL Mortgages on a stand-alone basis) and with earnings risk biased to the downside in our view, the shares remain a Hold. Next news will be the group's half-year pre-close trading update in late March.

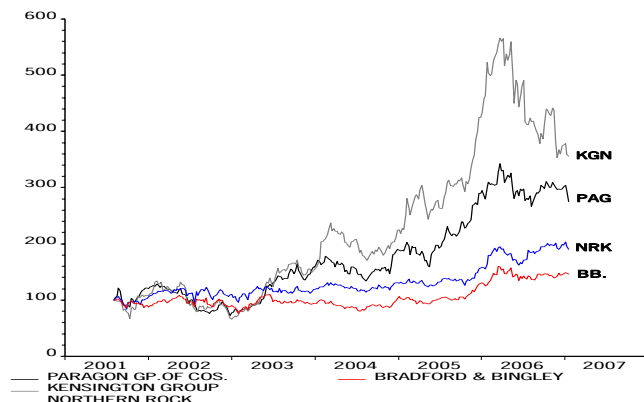
Valuation

Lower earnings forecasts and a reduced estimate for capital released from the closed loan books in run-off have led to lower fair value estimates upon which we have based our new 625p target price. Although the shares trade on a ~10% discount to Paragon's UK mortgage bank peers, our estimate of the stand-alone value of the core BTL Mortgages division suggests it is being afforded a premium rating.

Price performance & rating

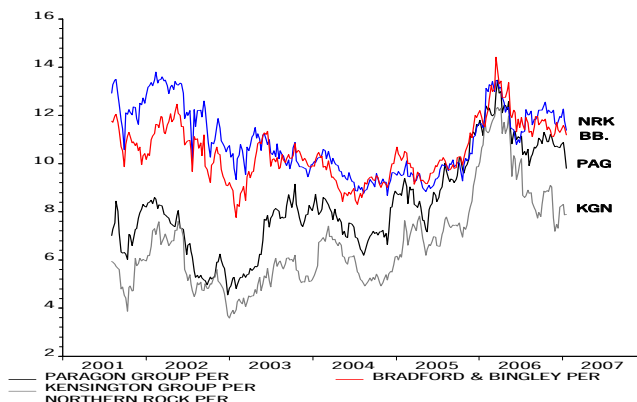
The charts below, based on IBES consensus estimates, show how the ratings afforded to the specialist UK mortgage market stocks have converged over the last 5 years, and that until fairly recently, Paragon had traded broadly in-line with the UK specialist mortgage banks Bradford & Bingley and Northern Rock.

Figure 2. UK Mortgage Stocks – Price Performance (Indexed)



Source: Datastream

Figure 3. UK Mortgage Stocks - Prospective PER



Source: Datastream

Relative valuation

The table below, based on Citigroup estimates, compares Paragon's P/E ratios and dividend yields with those of its UK mortgage market peers.

Figure 4. Peer Group PE Ratios and Yields

	Price (p)	MV (£m)	Y/e	2006E	PER	2007E	2008E	2006E	Yield	2007E	2008E
Bradford & Bingley	464	2,944	Dec	12.3	11.0	10.2	4.3%	4.7%	5.0%		
Kensington Group	741	389	Nov	8.6	8.1	7.4	3.5%	3.7%	4.0%		
Northern Rock	1161	4,890	Dec	13.7	12.3	10.6	3.0%	3.4%	3.9%		
Average				11.5	10.5	9.4	3.6%	3.9%	4.3%		
Paragon Group	602	698	Sep	10.3	10.3	9.3	2.8%	3.7%	4.3%		

Source: Citigroup Investment Research. Prices at close 19/1/2007

The shares trade on 10.3x estimated EPS for 2007 and 9.3x for 2008. As such, Paragon trades at about a 10% discount to the average of its UK mortgage bank peers, and about a 20% premium to its non-bank mortgage market peer Kensington Group.

Absolute valuation analysis

We use two methodologies for estimating fundamental fair value – a sum-of-the-parts approach and an alternative price to book valuation. The former allows for an implied valuation of the group's core operating division, BTL Mortgages, based on the group's current market/enterprise value and our stand-alone value estimates for the Consumer Finance and Other Operations divisions.

Sum-of-the-parts

Our sum-of-the-parts (SOTP) approach is summarized below.

Figure 5. Sum-of-the-Parts Valuation

Year to September 2007 (£m)	PBT	Tax	PAT	Capital	2007E	Sustainable Long-Term			P/BV	PER	Value £m	Value p
					ROE	ROE	COE	Growth				
BTL Mortgages	65.8	-19.1	46.8	283.7	16.5%	16.0%	9.5%	3.5%	2.1	12.6	591.1	515
Consumer Finance	22.1	-6.4	15.7	55.9	28.1%	27.0%	10.5%	1.0%	2.7	9.7	153.1	133
Other Operations	5.9	-1.7	4.2	75.5	5.5%						30.0	26
Divisional total	93.8	-27.2	66.6	415.2	16.0%					11.6	774.2	675
Leverage				-53.6							-53.6	-47
Group total	93.8	-27.2	66.6	361.5	18.4%						720.6	628

Source: Citigroup Investment Research Estimates

Based on our 2007E forecasts, the key assumptions underlying this valuation are:

- The economic capital allocations we apply in our capital management model – a 3% capital allocation to estimated BTL Mortgage loan balances, a 7.5% allocation for Consumer Finance, and a 20% allocation for Other Operations.
- These economic capital allocations underpin our 2007E ROE estimates (upon which we base long-term sustainable ROE estimates). In conjunction with our forecast for end-September 2007 group equity, they also provide an estimate for end-2007 'leverage' (i.e. required economic capital in excess of group equity).
- Cost of equity and long-term growth assumptions for BTL Mortgages and Consumer Finance. We have chosen rates to reflect the different growth and risk profiles of these two divisions.
- We have valued the Other Operations as the sum of the NPV of estimated after tax profits on run-off (~£10m) and the value of capital released as these books are wound down (~£20m).

Our sum-of-the-parts approach values BTL Mortgages on 12.6x estimated 2007 earnings, and Consumer Finance on 9.7x 2007E. The £10m estimate for the NPV value of the closed books equates to 2% of the division's end-September 2006 receivables, and 3% of estimated end-2007 receivables.

The approach values the group in aggregate at £721m, or 628p per share.

Isolating BTL Mortgages

In the table below, we have isolated implied P/E multiples on Paragon's BTL division by subtracting the estimated stand-alone values for the Consumer Finance and Other Operations divisions from our SOTP approach.

We calculate Paragon's enterprise value as being equal to market value plus subordinated debt.

Figure 6. Isolating BTL Mortgages

	£m				
Current market value	698				
Subordinated debt	120				
Group enterprise value	818				
Less Consumer Finance	-153				
Less Other Operations	-30				
BTL enterprise value	635				
Year to September	2006	2007E	2008E	2009E	2010E
BTL earnings (29% tax, £m)	36.8	46.8	55.8	62.9	68.6
EV/BTL NOPAT	17.3x	13.6x	11.4x	10.1x	9.3x

Source: Citigroup Investment Research

The analysis suggests an implied September 2007E P/E ratio for Paragon's BTL Mortgages division of 13.6x, falling to 11.4x for the year to September 2008. These compare with 12.3x and 10.6x estimates earnings in 2007 and 2008 for Northern Rock, the most highly rated of the UK mortgage market specialists.

Fundamental price to book

The objective is to estimate a fundamental fair value for the shares as at end-September 2007. There are three parts to this estimate: (i) the expected dividend flow to 2010E; (ii) surplus equity capital present on the balance sheet at end-2010E; (iii) 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 end-September 2007E market value for the group of £718m, which equates to 626p per share.

Figure 7. Fundamental Price to Book Valuation

Year to September (£m)	2007E	2008E	2009E	2010E
Receivables	10,532	12,504	14,423	16,320
Memo: receivables growth*	25%	19%	15%	13%
Equity/receivables ratio - normalised	3.9%	3.7%	3.5%	3.4%
Normalised equity	415.2	457.3	503.0	552.8
Equity	361.5	411.8	463.7	517.3
Surplus capital	-53.6	-45.5	-39.3	-35.5
Attributable profit	67.6	74.3	80.4	85.4
Return on surplus capital	2.1	1.8	1.6	1.4
Normalised return	69.7	76.1	82.0	86.8
Normalised ROE	16.8%	16.6%	16.3%	15.7%
Dividends	18.8	24.1	28.4	31.7
Discount factor		1.100	1.210	1.331
PV dividends		21.9	23.5	23.8
Sustainable ROE	15.0%			
Long-term growth assumption	2.0%			
Cost of equity	10.0%			
Fair value Price/Book	1.6			
2010E terminal value	898.4			
2010E surplus capital	-35.5			
NPV terminal value	675.0			
NPV dividends	69.2			
NPV surplus capital	-26.7			
Fair value	717.5			
Diluted shares in issue	115			
Fair value per share (p)	626			

Source: Citigroup Investment Research Estimates

Valuation summary

According to our fundamental analysis, the shares look reasonably fairly valued at current levels, trading at around a 4% discount to the average of our SOTP and price to book estimates for end-2007 fair value. The shares also appear reasonably valued in relation to the UK mortgage banks. However, when we isolate the core BTL Mortgages division, essentially by affording lower multiples to the low-growth Consumer Finance division and run-off Other Operations, its implied valuation looks relatively expensive.

Despite recent weakness (the shares are down 9% over the past month), we see little scope for re-rating.

Growth Outlook & Key Forecast Assumptions

Our earnings forecasts and key assumptions underlying them are set out in the table below. We forecast a slowdown in profit growth, from 15% in 2006 to 13% in 2007 and 11% in 2008. For the four years 2006-2010 we forecast a PBT CAGR of just below 10%, and a lower EPS CAGR of just over 6% reflecting an increase in the group's tax charge, partially offset by the accretive effects of the share repurchase programme.

Figure 8. Forecast Summary & Key Assumptions

Year to September (£m)	2005*	2006**	%Ch	2007E	%Ch	2008E	%Ch	2009E	%Ch	2010E	%Ch
Avg customer loans	6,250	7,600	22%	9,479	25%	11,518	22%	13,464	17%	15,372	14%
Net interest income	130.9	145.4	11%	140.1	-2%	141.5	1%	144.6	2%	148.3	3%
Other income	29.4	30.6	4%	30.8	1%	32.3	5%	33.8	5%	35.7	6%
Operating income	160.3	176.0	10%	170.9	-1%	173.8	2%	178.4	3%	184.1	3%
Operating expenses	-45.2	-45.4	0%	-43.1	-5%	-43.5	1%	-44.7	3%	-46.4	4%
Pre-provision profit	115.1	130.6	13%	127.9	0%	130.3	2%	133.7	3%	137.7	3%
Impairment charges	-43.4	-47.8	10%	-34.0	-29%	-25.7	-25%	-20.5	-20%	-17.5	-15%
Profit before tax	71.7	82.8	15%	93.8	13%	104.6	11%	113.2	8%	120.2	6%
Taxation	-16.0	-14.0	-13%	-26.3	88%	-30.3	15%	-32.8	8%	-34.9	6%
Attributable profit	55.7	68.8	24%	67.6	-2%	74.3	10%	80.4	8%	85.4	6%
Diluted EPS (p)	46.9	58.4	25%	58.6	0%	64.8	11%	70.1	8%	74.4	6%
DPS (p)	12.6	17.0	35%	22.0	29%	26.0	18%	29.0	12%	32.0	10%
Net interest margin	2.09%	1.91%		1.48%		1.23%		1.07%		0.96%	
Other income margin	0.47%	0.40%		0.33%		0.28%		0.25%		0.23%	
Total income margin	2.56%	2.32%		1.80%		1.51%		1.33%		1.20%	
Expenses:avg loans	-0.72%	-0.60%		-0.45%		-0.38%		-0.33%		-0.30%	
Impairments:avg loans	-0.69%	-0.63%		-0.36%		-0.22%		-0.15%		-0.11%	
PBT:avg loans	1.15%	1.09%		0.99%		0.91%		0.84%		0.78%	
Expense ratio	-28.2%	-26.2%		-25.2%		-25.0%		-25.0%		-25.2%	
Tax rate	-22.3%	-16.9%		-28.0%		-29.0%		-29.0%		-29.0%	

Source: Company Reports and CIR Estimates. *2005 pro forma. **2006 net Interest Income adjusted for fair value gains.

The main drivers of our estimates are loan growth, income margins, expense ratios and impairment charges.

Loan growth

BTL Mortgages

2006 saw strong BTL volumes and loan growth (up 82% and 43% respectively). Our forecasts for 2007 and 2008 BTL Mortgage advances and hence loan balances are driven by Council of Mortgage Lenders (CML) forecasts.

Published in December 2006, CML forecasts are for a 4% increase in UK gross mortgage advances in 2007, and a 19% increase in BTL advances, as the BTL share of the overall mortgage market rises from 11% to 12%. For 2008, CML forecasts are for flat total market advances, and a 9% increase in BTL advances as the BTL share rises to 13%.

Figure 9. CML Forecasts for Total UK Mortgage Advances & BTL Advances

£bn	2006	2007E	%Ch	2008E	%Ch
Total gross advances	345	360	4%	360	0%
Of which:-					
1. House purchase	169	186	10%	187	1%
-First-time buyers	46	51	11%	51	0%
-Home movers	103	113	10%	133	18%
-Buy-to-let	19	22	16%	24	9%
2. Remortgaging	141	140	-1%	139	-1%
-Home owners	122	118	-3%	115	-3%
-Buy-to-let	18	22	22%	24	9%
3. Other	35	34	-3%	34	0%
Of which:-					
Total buy-to let	37	44	19%	48	9%
Buy-to-let %	11%	12%		13%	

Source: Council of Mortgage Lenders (CML)

Although these forecasts are for calendar years, and Paragon has a September year-end, we have modeled Paragon's BTL advances on these BTL aggregates, which implicitly assume a broadly maintained market share. With our forecast of a slight pick-up in the group's BTL redemption rate, from 17% in 2006 to 19% in 2007 and 20% in 2008, this results in 31% BTL loan growth in 2007 (25% growth in average loans) and 22% growth in 2008 (22% growth in average loans).

Figure 10. Loan Growth Forecasts

Year to September (£m)	2005	2006	%Ch	2007E	%Ch	2008E	%Ch	2009E	%Ch	2010E	%Ch
<u>BTL Mortgages</u>											
Opening balance	4,064	5,032	24%	7,212	43%	9,458	31%	11,507	22%	13,462	17%
Advances	1,668	3,038	82%	3,616	19%	3,941	9%	4,256	8%	4,597	8%
Redemptions	-700	-858	23%	-1,370	60%	-1,892	38%	-2,301	22%	-2,692	17%
Closing balance	5,032	7,212	43%	9,458	31%	11,507	22%	13,462	17%	15,366	14%
Average balance	4,548	6,250	37%	8,335	33%	10,482	26%	12,484	19%	14,414	15%
Redemption rate	17%	17%		19%		20%		20%		20%	
<u>Consumer Finance</u>											
Opening balance	726	695	-4%	710	2%	746	5%	783	5%	823	5%
Advances	350	372	6%	391	5%	411	5%	431	5%	453	5%
Redemptions	-381	-358	-6%	-355	-1%	-373	5%	-392	5%	-411	5%
Closing balance	695	710	2%	746	5%	783	5%	823	5%	864	5%
Average balance	711	702	-1%	728	4%	765	5%	803	5%	843	5%
Redemption rate	52%	51%		50%		50%		50%		50%	
<u>Other Operations</u>											
Opening balance	1,161	802	-31%	505	-37%	328	-35%	213	-35%	139	-35%
Advances	8	2	-75%	2	0%	2	0%	2	0%	2	0%
Redemptions	-367	-299	-19%	-179	-40%	-117	-35%	-77	-34%	-51	-34%
Closing balance	802	505	-37%	328	-35%	213	-35%	139	-35%	90	-35%
Average balance	982	654	-33%	417	-36%	271	-35%	176	-35%	114	-35%
Redemption rate	32%	37%		35%		36%		36%		36%	
<u>Group Total</u>											
Opening balance	5,951	6,529	10%	8,427	29%	10,532	25%	12,504	19%	14,423	15%
Advances	2,026	3,413	68%	4,009	17%	4,354	9%	4,689	8%	5,051	8%
Redemptions	-1,448	-1,515	5%	-1,904	26%	-2,381	25%	-2,770	16%	-3,154	14%
Closing balance	6,529	8,427	29%	10,532	25%	12,504	19%	14,423	15%	16,320	13%
Average balance	6,240	7,478	20%	9,479	27%	11,518	22%	13,464	17%	15,372	14%
Redemption rate	24%	23%		23%		23%		22%		22%	

Source: Company Reports and CIR Estimates

Consumer Finance & Other lending

Consumer Finance advances and loan balances increased by 6% and 5%, respectively, despite the weak market backdrop and the adoption of tighter credit criteria. The sale of the NHL loan book last July accelerated the run-off of the closed books in Other Operations.

Looking forward, for Consumer Finance, we have assumed a modest 5% pa increase in advances which, with a maintained redemption rate, translates into 5% pa loan growth out to 2010. We have made no explicit assumptions as to the impact on Consumer Finance volumes (or margins for that matter) as a result of Paragon's 'originate-to-sell' agreement with Morgan Stanley. Paragon has agreed to originate sub-prime secured loans on behalf of Morgan Stanley International Bank; it will hold no principal position in these loans, earning a fee for their origination. For Other Operations, we have assumed a run-off rate maintained at ~35% pa.

Income margins

Our key margin assumptions are set out below by division.

Figure 11. Return on Average Loans by Division

Year to September (£m)	2006*	2007E	2008E	2009E	2010E
<u>BTL Mortgages</u>					
Net interest income	0.99%	0.95%	0.90%	0.85%	0.80%
Other operating income	0.13%	0.13%	0.13%	0.13%	0.13%
Total operating income	1.12%	1.08%	1.03%	0.98%	0.93%
Operating expenses	-0.27%	-0.26%	-0.25%	-0.24%	-0.23%
Pre-impairment profit	0.85%	0.82%	0.78%	0.74%	0.70%
Impairment charge	-0.02%	-0.03%	-0.03%	-0.03%	-0.03%
Profit before tax	0.83%	0.79%	0.75%	0.71%	0.67%
<u>Consumer Finance</u>					
Net interest income	2.69%	2.66%	2.63%	2.60%	2.56%
Other operating income	2.30%	2.22%	2.12%	2.00%	1.90%
Total operating income	4.99%	4.88%	4.75%	4.60%	4.46%
Operating expenses	-1.14%	-1.14%	-1.14%	-1.14%	-1.14%
Pre-impairment profit	3.84%	3.74%	3.61%	3.46%	3.32%
Impairment charge	-0.70%	-0.70%	-0.70%	-0.70%	-0.70%
Profit before tax	3.14%	3.04%	2.91%	2.76%	2.62%
<u>Other Operations</u>					
Net interest income	9.98%	9.98%	9.98%	9.98%	9.98%
Other operating income	0.94%	0.92%	0.90%	0.88%	0.86%
Total operating income	10.92%	10.90%	10.88%	10.86%	10.84%
Operating expenses	-3.17%	-3.15%	-3.15%	-3.15%	-3.15%
Pre-impairment profit	7.75%	7.75%	7.73%	7.71%	7.69%
Impairment charge	-6.37%	-6.34%	-6.34%	-6.34%	-6.34%
Profit before tax	1.38%	1.41%	1.39%	1.37%	1.35%
<u>GROUP</u>					
Net interest income	1.91%	1.48%	1.23%	1.07%	0.96%
Other operating income	0.40%	0.33%	0.28%	0.25%	0.23%
Total operating income	2.32%	1.80%	1.51%	1.33%	1.20%
Operating expenses	-0.60%	-0.45%	-0.38%	-0.33%	-0.30%
Pre-impairment profit	1.72%	1.35%	1.13%	0.99%	0.90%
Impairment charge	-0.63%	-0.36%	-0.22%	-0.15%	-0.11%
Profit before tax	1.09%	0.99%	0.91%	0.84%	0.78%

Source: Company Reports and CIR Estimates. *2006 net Interest Income adjusted for fair value gains.

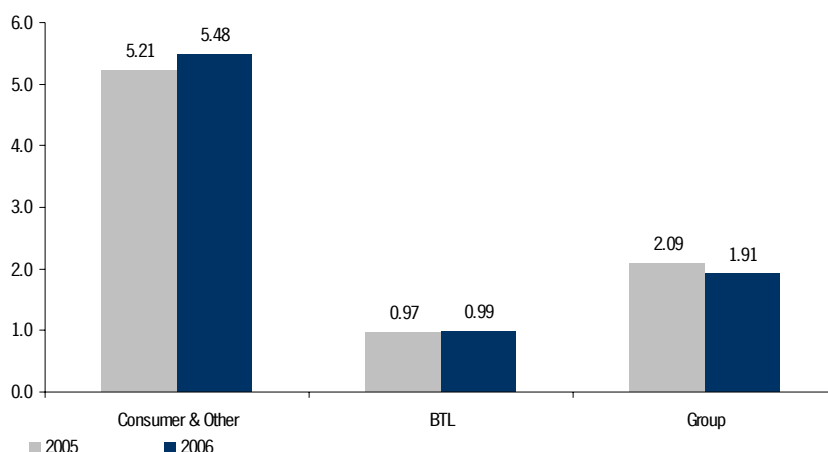
Although the recent shift to IFRS and Effective Interest Rate (EIR) accounting makes an historical analysis of margin trends difficult, the outlook is for a gradual reduction in net interest margin due to shift in mix – the margin on the faster growing BTL book being lower than the margin on Consumer 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.

Net interest margins and net interest income growth

Last year saw average loans up 22%, but net interest income up only 9%, reflecting the shift in mix to lower margin first mortgages (the 22% increase in group average loans comprised a 37% increase in average BTL loans and a 20% decrease in average Consumer Finance & Other loans).

Although net interest margins (NIMs) actually increased at BTL (from 97bps to 99bps) and Consumer Finance & Other (from 521bps to 548bps), the shift in mix led to a reduction in group NIM from 209bps to 191bps, i.e. a reduction of 18bps.

Figure 12. Net Interest Margins by Division (%)*



Source: Company Reports. *2005 proforma

Paragon's BTL margins have been surprisingly robust, give the UK market experience. UK BTL front book spreads are around 50bps, half the level they were in mid-2005 (see p23 of the Citigroup UK Banks team's research note "UK Banks in 2007", 8 January 2007). Moreover, there have been a number of new entrants into the market, and a new entrant into Paragon's professional landlord niche.

In July last year, Alliance & Leicester entered the specialist mortgage market with a range of BTL, self-certification and near-prime mortgages, and priced them competitively. On 1 December 2006, Alliance & Leicester announced it had launched a wholesale BTL product aimed at professional landlords with larger portfolios of predominantly residential investment properties – Paragon's

core BTL sub-segment. On 10 January 2007, Alliance & Leicester announced a new BTL deal – a 2-year Base Rate Tracker at 5.00% (a nil premium deal) – which compares with Paragon's equivalent product which charges a 25% premium to BBR.

Looking forward, we see competitive pressure reducing gross interest margins on Paragon's new BTL and Consumer Finance (primarily second mortgages) business, which together with our forecast for stable funding costs, results in lower net interest margins. We forecast a reduction in BTL NIM to 95bps in 2007E and 90bps in 2008E, and in Consumer Finance NIM from 269bps in 2006 to 266bps in 2007E and to 263bps in 2008E.

Combined with the run-off of the much higher margin closed loan books within Other Operations (where the NIM last year was ~1,000bps), we forecast a reduction in group NIM from 191bps to 148bps in 2007E and to 123bps in 2008E.

As a result of our blended asset growth, mix and NIM assumptions, we now forecast a 2% reduction in group net interest income this year, and only 1% growth in 2008.

Non-interest income

Last year, Paragon earned £30.6m in non-interest income (22% of total operating income), broadly flat on 2005's £29.4m. Around £16m was attributed to the Consumer Finance division, and we estimate that around £10m of this was due to commissions from selling Payment Protection Insurance (PPI) to secured loan customers.

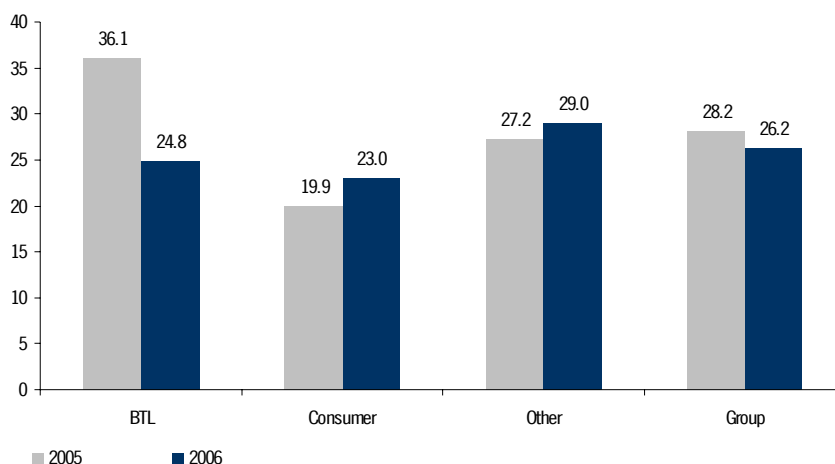
The 2006 results highlighted that such insurance related commissions had declined during the year. We expect non-interest income margins to continue to decline. From last year's 40bps on average loans, we forecast a decline to only 23bps by 2010, primarily due to lower Consumer Finance non-interest income, where we forecast the margin on the division's average loans will fall from last year's 230bps to 190bps by 2010. As a result, we forecast only 1% growth in group non-interest income in 2007 and 5% growth in 2008.

In total, our forecasts are for a 1% decline in group operating income this year followed by 2% growth in 2008.

Expenses

The group ratio has continued to fall, from 28.2% in 2005 to 26.2% in 2006, driven by the significant reduction in the BTL Mortgages expense ratio (which reflects the scalability of the platform), which fell from 36.1% in 2005 to 24.8% in 2006. 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 26% in 2006.

Figure 13. Expense Ratios by Key Segment (%)*



Source: Company Reports. *2005 proforma

However, in 2006, 45% of the group's operating expenses (£20.6m out of total costs of £45.4m) were allocated to Other Operations. Although there are variable costs associated with running-off these closed books, there are a number of fixed costs allocated to the division – general infrastructure costs, collection costs, central IT spend – that will remain as the books are wound down. These fixed costs will have to be reallocated to the continuing operations which could limit the scope for further reductions in their expense ratios.

Credit costs

The group's provision for loan losses amounted to £47.8m in 2006, up 10% on the proforma figure for 2005, equating to 37% of pre-provision profits (38% in 2005) and 63bps in relation to average loans (69bps in 2005). Excluding the closed books in run-off, impairment charges were minimal at less than 10bps of average BTL and Consumer Finance loans. BTL charges were less than 2bps.

The key drivers for credit costs going forward are credit quality in the Consumer Finance division (where last year the charge equated to 18% of pre-provision profits and 70bps to average loans) and the speed at which the closed books are run-off; we do not foresee any significant deterioration in BTL credit quality.

The Consumer Finance credit outlook is hard to assess, since the division includes used car finance, retail finance and second mortgages. The Other Operations division last year accounted for 87% of the group's impairment charge. All other things equal, the faster these books are run-off the faster the group's impairment charge is reduced.

All in, we forecast a 29% reduction in the charge this year, followed by a 25% reduction in 2008. However, with interest rates and unemployment rising, the risk is on the upside, in our view.

Profit before tax

Putting these income and expense estimates together, we now forecast 13% growth in PBT this year, followed by 11% in 2008 and 8% in 2009. The key drivers underlying this growth are (i) strong loan growth offset by lower margins due to shift in mix and income margin compression, (ii) good cost control resulting in further modest reductions in the group's expense ratio, and (iii) a significant reduction in provisions for loan losses as the higher-risk closed books continue to be wound down.

Tax & EPS growth

Paragon has benefited from a low tax charge since it was re-financed and re-focused in the mid-1990s, 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 16.9% in 2006 due to an exceptional credit of £4.3m as a result of the settlement of a prior year item. The step-down in the group tax charge last year had the effect of boosting EPS growth from an underlying 17% to a reported 25% increase.

Looking forward, the full utilization of carried forward losses in 2006 has led management to guide the market to expect a charge of around 28% in 2007 and 29% thereafter. As a result of this, our forecast for 13% growth in PBT in 2007 translates into zero growth in at the EPS level, and this is despite a ~3% EPS enhancement due to a reduction in average shares in issue following last year's share repurchases.

Dividends

As part of the group's capital management programme, management has targeted dividend growth 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).

Last year's 35% increase in the dividend was approximately 2x earnings growth, adjusted for the lower tax charge, which brought fully taxed EPS cover down to 2.9x, at the upper end of the targeted range. We continue to forecast strong dividend growth – 29% this year and 18% in 2008 – well in advance of forecast earnings growth, to further reduce cover. However, the outlook is for reduced dividend growth and, in the medium term, for dividend growth to pace earnings growth.

Capital management

As a consequence of stronger net new business assumptions, our new forecasts are based on £1.6bn of additional BTL loan balances and £100m of additional Consumer Finance loans as at end-September 2010. Since our economic capital model allocates 3% capital backing to BTL loans and 7.5% to Consumer Finance loans, these changes "require" additional capital backing of around £55m. As a result of these higher 'loan book funding requirements' we now estimate ~£20m of capital will be released over the four years to 2010E, as compared with ~£90m previously.

Loan mix and economic capital requirements

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. 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 14. Forecast Loan Book Mix & Economic Capital

Year to September (£m)	2006	2007E	2008E	2009E	2010E	CAGR
BTL Mortgages						
Customer loans	7,212	9,458	11,507	13,462	15,366	21%
Capital/customer loans	3.0%	3.0%	3.0%	3.0%	3.0%	
Imputed equity	216.4	283.7	345.2	403.9	461.0	21%
Consumer Finance						
Customer loans	710	746	783	823	864	5%
Capital/customer loans	7.5%	7.5%	7.5%	7.5%	7.5%	
Imputed equity	53.2	55.9	58.8	61.7	64.8	5%
Other Operations						
Customer loans	505	328	213	139	90	-35%
Capital/customer loans	20.0%	23.0%	25.0%	27.0%	30.0%	
Imputed equity	101.0	75.5	53.3	37.4	27.0	-28%
GROUP						
Customer loans	8,427	10,532	12,504	14,423	16,320	18%
Capital/customer loans	4.4%	3.9%	3.7%	3.5%	3.4%	
Imputed equity	371	415	457	503	553	11%

Source: Company Reports and CIR Estimates

This reduction in the economic capital ratio releases capital, as shown below. The reduction in the estimated economic capital/customer loans ratio from 4.4% in 2006 to 3.4% in 2010E, in conjunction with our forecast for retained earnings, results in a release of capital amounting to £22m over the next four years.

Figure 15. Release of Capital

Year to September (£m)	2006	2007E	2008E	2009E	2010E
Customer loans	8,427	10,532	12,504	14,423	16,320
Capital/customer loans	4.4%	3.9%	3.7%	3.5%	3.4%
Economic capital requirement	371	415	457	503	553
Retentions required	-7	-45	-42	-46	-50
Net profit	69	68	74	80	85
Dividends	-16	-19	-24	-28	-32
Surplus capital generation	46	4	8	6	4

Source: Company Reports and CIR Estimates

Forecast Summary

Figure 16. Forecast Summary

Year to September (£m)	2005*	2006	%Ch	2007E	%Ch	2008E	%Ch	2009E	%Ch	2010E	%Ch
Income & Expenses											
Net interest income	130.9	142.9	9%	140.1	-2%	141.5	1%	144.6	2%	148.3	3%
Other income	29.4	30.6	4%	30.8	1%	32.3	5%	33.8	5%	35.7	6%
Operating income	160.3	173.5	8%	170.9	-1%	173.8	2%	178.4	3%	184.1	3%
Operating expenses	-45.2	-45.4	0%	-43.1	-5%	-43.5	1%	-44.7	3%	-46.4	4%
Pre-provision profit	115.1	128.1	11%	127.9	0%	130.3	2%	133.7	3%	137.7	3%
Impairment charges	-43.4	-47.8	10%	-34.0	-29%	-25.7	-25%	-20.5	-20%	-17.5	-15%
Core PBT	71.7	80.3	12%	93.8	17%	104.6	11%	113.2	8%	120.2	6%
Fair value gains		2.5									
Profit before tax	71.7	82.8	15%	93.8	13%	104.6	11%	113.2	8%	120.2	6%
Taxation	-16.0	-14.0	-13%	-26.3	88%	-30.3	15%	-32.8	8%	-34.9	6%
Attributable profit	55.7	68.8	24%	67.6	-2%	74.3	10%	80.4	8%	85.4	6%
Dividend	-12.5	-16.1	29%	-18.8	17%	-24.1	28%	-28.4	18%	-31.7	12%
Retained earnings	43.2	52.7	22%	48.7	-8%	50.2	3%	51.9	3%	53.6	3%
Balance Sheet											
Customer loans	6,431	8,427	31%	10,532	25%	12,504	19%	14,423	15%	16,320	13%
Avg customer loans	6,250	7,600	22%	9,479	25%	11,518	22%	13,464	17%	15,372	14%
Equity	244.4	312.8	28%	361.5	16%	411.8	14%	463.7	13%	517.3	12%
Subordinated debt	120.0	120.0		120.0		120.0		120.0		120.0	
Ratios											
EIR margin	2.09%	1.91%		1.48%		1.23%		1.07%		0.96%	
Total income margin	2.56%	2.32%		1.80%		1.51%		1.33%		1.20%	
Expense ratio	-28.2%	-26.2%		-25.2%		-25.0%		-25.0%		-25.2%	
Impairments:avg loans	-0.69%	-0.63%		-0.36%		-0.22%		-0.15%		-0.11%	
ROE	20.2%	24.7%		20.0%		19.2%		18.4%		17.4%	
ROA (RoAvgLoans)	0.89%	0.91%		0.71%		0.64%		0.60%		0.56%	
Equity:customer loans	3.8%	3.7%		3.4%		3.3%		3.2%		3.2%	
Effective tax rate	-22.3%	-16.9%		-28.0%		-29.0%		-29.0%		-29.0%	
Per share data											
Reported EPS (p)	48.9	61.2	25%	61.4	0%	67.9	11%	73.5	8%	78.0	6%
Diluted EPS (p)	46.9	58.4	25%	58.6	0%	64.8	11%	70.1	8%	74.4	6%
DPS (p)	12.6	17.0	35%	22.0	29%	26.0	18%	29.0	12%	32.0	10%
Dividend cover (x)	3.7	3.4	-8%	2.7	-22%	2.5	-6%	2.4	-3%	2.3	-4%
NAV/share (p)	202.4	282.6	40%	330.5	17%	376.4	14%	423.9	13%	472.9	12%
Divisions											
BTL Mortgages	30.8	51.8	68%	65.8	27%	78.6	19%	88.6	13%	96.6	9%
Consumer Finance	25.4	22	-13%	22.1	1%	22.3	1%	22.2	0%	22.1	0%
Other Operations	15.5	9.0	-42%	5.9	-35%	3.8	-36%	2.4	-36%	1.5	-36%
	71.7	82.8	15%	93.8	13%	104.6	11%	113.2	8%	120.2	6%

Source: Company Reports and CIR Estimates. *2005 proforma

Figure 17. Forecasts by Division

Year to September (£m)	2005**	2006	%Ch	2007E	%Ch	2008E	%Ch	2009E	%Ch	2010E	%Ch
<u>BTL Mortgages</u>											
Net interest income	34.5	59.3	72%	79.2	34%	94.3	19%	106.1	12%	115.3	9%
Other operating income	13.7	8.4	-39%	10.8	29%	13.6	26%	16.2	19%	18.7	15%
Total operating income	48.2	67.7	40%	90.0	33%	108.0	20%	122.3	13%	134.1	10%
Operating expenses	-18.2	-16.8	-8%	-21.7	29%	-26.2	21%	-30.0	14%	-33.2	11%
Pre-impairment profit	30.0	50.9	70%	68.3	34%	81.8	20%	92.4	13%	100.9	9%
Impairment charge	-1.2	-1.5	25%	-2.5	67%	-3.1	26%	-3.7	19%	-4.3	15%
Operating profit	28.8	49.4	72%	65.8	33%	78.6	19%	88.6	13%	96.6	9%
FV gains/losses	0.0	2.4		0.0		0.0		0.0		0.0	
Profit before tax	28.8	51.8	80%	65.8	27%	78.6	19%	88.6	13%	96.6	9%
Advances	1,668	3,038	82%	3,616	19%	3,941	9%	4,256	8%	4,597	8%
Customer loans	5,032	7,212	43%	9,458	31%	11,507	22%	13,462	17%	15,366	14%
Average loans	4,548	6,250	37%	8,335	33%	10,482	26%	12,484	19%	14,414	15%
<u>Consumer Finance</u>											
Net interest income	16.1	18.7	16%	19.4	4%	20.1	4%	20.9	4%	21.6	3%
Other operating income	17.2	16.1	-6%	16.2	0%	16.2	0%	16.1	-1%	16.0	0%
Total operating income	33.3	34.8	5%	35.5	2%	36.3	2%	36.9	2%	37.6	2%
Operating expenses	-7.9	-8.0	1%	-8.3	4%	-8.7	5%	-9.2	5%	-9.6	5%
Pre-impairment profit	25.4	26.8	6%	27.2	2%	27.6	1%	27.8	1%	28.0	1%
Impairment charge	-4.6	-4.9	7%	-5.1	4%	-5.4	5%	-5.6	5%	-5.9	5%
Operating profit	20.8	21.9	5%	22.1	1%	22.3	1%	22.2	0%	22.1	0%
FV gains/losses	0.0	0.1		0.0		0.0		0.0		0.0	
Profit before tax	20.8	22.0	6%	22.1	1%	22.3	1%	22.2	0%	22.1	0%
Advances	350	372	6%	391	5%	411	5%	431	5%	453	5%
Customer loans	695	710	2%	746	5%	783	5%	823	5%	864	5%
Average loans	711	700	-1%	728	4%	765	5%	803	5%	843	5%
<u>Other Operations</u>											
Net interest income	44.4	64.9	46%	41.6	-36%	27.0	-35%	17.6	-35%	11.4	-35%
Other operating income	7.0	6.1	-13%	3.8	-37%	2.4	-36%	1.5	-36%	1.0	-36%
Total operating income	51.4	71.0	38%	45.4	-36%	29.5	-35%	19.1	-35%	12.4	-35%
Operating expenses	-19.1	-20.6	8%	-13.1	-36%	-8.5	-35%	-5.5	-35%	-3.6	-35%
Pre-impairment profit	32.3	50.4	56%	32.3	-36%	20.9	-35%	13.6	-35%	8.8	-35%
Impairment charge	-10.1	-41.4	310%	-26.4	-36%	-17.2	-35%	-11.2	-35%	-7.3	-35%
Operating profit	22.2	9.0	-59%	5.9	-35%	3.8	-36%	2.4	-36%	1.5	-36%
FV gains/losses	0.0	0.0		0.0		0.0		0.0		0.0	
Profit before tax	22.2	9.0	-59%	5.9	-35%	3.8	-36%	2.4	-36%	1.5	-36%
Advances	8	2	-75%	2	0%	2	0%	2	0%	2	0%
Customer loans	802	505	-37%	328	-35%	213	-35%	139	-35%	90	-35%
Average loans	982	650	-34%	417	-36%	271	-35%	176	-35%	114	-35%
<u>Group Total</u>											
Net interest income	95	143	50%	140	-2%	141	1%	145	2%	148	3%
Other operating income	38	31	-19%	31	1%	32	5%	34	5%	36	6%
Total operating income	133	174	31%	171	-1%	174	2%	178	3%	184	3%
Operating expenses	-45	-45	0%	-43	-5%	-43	1%	-45	3%	-46	4%
Pre-impairment profit	88	128	46%	128	0%	130	2%	134	3%	138	3%
Impairment charge	-16	-48	201%	-34	-29%	-26	-25%	-21	-20%	-17	-15%
Operating profit	72	80	12%	94	17%	105	11%	113	8%	120	6%
FV gains/losses	0	3		0		0		0		0	
Profit before tax	72	83	15%	94	13%	105	11%	113	8%	120	6%
Advances	2,026	3,413	68%	4,009	17%	4,354	9%	4,689	8%	5,051	8%
Customer loans	6,529	8,427	29%	10,532	25%	12,504	19%	14,423	15%	16,320	13%
Average loans	6,240	7,600	22%	9,479	25%	11,518	22%	13,464	17%	15,372	14%

Source: Company Reports and CIR Estimates. **2005 statutory basis (full proforma by division not disclosed)

Company Snapshot

Paragon's growth strategy is focused upon (i) continued strong growth in its 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, returning the capital released as a result of the on-going shift in business mix.

Figure 18. 2006 Financial Year – Segmental Analysis

Year to September 2006 (£m)	BTL Mortgages	%	Consumer Finance	%	Other Operations	%	Paragon Group
Net interest income	59.3	41%	18.7	13%	64.9	45%	142.9
Other operating income	8.4	27%	16.1	53%	6.1	20%	30.6
Total operating income	67.7	39%	34.8	20%	71.0	41%	173.5
Operating expenses	-16.8	37%	-8.0	18%	-20.6	45%	-45.4
Impairment charge	-1.5	3%	-4.9	10%	-41.4	87%	-47.8
Operating profit	49.4	62%	21.9	27%	9.0	11%	80.3
FV gains/losses	2.4		0.1		0.0		2.5
Profit before tax	51.8	63%	22.0	27%	9.0	11%	82.8
Customer loans	7,212	86%	710	8%	505	6%	8,427
Average loans	6,250	82%	700	9%	650	9%	7,600
Economic capital*	216.4	58%	53.2	14%	101.0	27%	370.6
Net interest margin	0.99%		2.69%		9.98%		1.91%
Total income margin	1.12%		4.99%		10.92%		2.32%
Impairments/avg loans	-0.02%		-0.70%		-6.37%		-0.63%
Net interest/total income	87.6%		53.7%		91.4%		82.4%
Expense ratio	-24.8%		-23.0%		-29.0%		-26.2%
Capital/customer loans*	3.0%		7.5%		20.0%		4.4%
Fully taxed RoEC*	16.8%		28.9%		6.2%		15.6%

Source: Company Reports and CIR Estimates. *Economic capital based on capital/customer loan assumptions

As shown above, the main operating divisions – BTL Mortgages and Consumer Finance – accounted for 59% of the group's operating income, with the closed portfolios in run-off the remaining 41%. In terms of revenue mix, the Consumer Finance division accounted for just over half of the group's non-interest income, of which approximately £10m was due to payment protection insurance commissions. The profit contribution of the core divisions was much higher at 90% of the group total, reflecting the high cost allocation to Other Operations (which accounted for around 45% of the group's operating expenses) and the much higher impairment charges of these closed books in run-off.

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 manage mortgage assets of around £7.2bn. The Consumer Finance division manages assets of around £710m 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 £500m, 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 increased by 68% in 2006 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 and/or 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 an additional ~£20m over the next four years which should be available for 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 trades on 10.3x 2007E earnings and 9.3x 2008E, a ~10% discount to the average of the UK quoted mortgage banks but at a ~20% premium to Kensington Group. Based on our fundamental price to book methodology, which takes into account forecast loan growth and returns on equity out to 2010E, we estimate an end-September 2007 fair value for the shares of 626p. Our sum-of-the-parts approach, which takes into account different growth rates of the group's three divisions, produces a slightly higher valuation of 628p. We have set our 12-month target price of 625p in relation to these fair value estimates.

Risk

We rate Paragon as 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

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/ Medium Risk rating on Bradford & Bingley shares. Demand for Buy-to-Let mortgages continues to surprise on the upside with no evidence of deterioration in credit quality. With a contract to acquire up to £12bn of mortgages from GMAC over the next three years, B&B appears to be getting more aggressive in terms of asset growth which we believe is indicative of the expected positive impact from Basel II on B&B. Although this should support revenue growth we have two concerns with the strategy. The first is that after paying an undisclosed premium to GMAC, the assets acquired may further dilute margins, already under pressure from increased competition and contracting liability spreads. The second is that the credit quality of the acquired assets may be more difficult to assess than own origination, raising the risk of a credit problem in the future. 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 that 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, and 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.

Northern Rock

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/ Medium Risk rating on Northern Rock shares. The company's existing high level of cost efficiency reduces the scope for cost cutting in our view. It enjoyed a strong relative performance in 2006 having increased its target range for earnings growth at the mid-year. We continue to view these targets as ambitious, relying on an unrealistically high level of asset growth. With other major players re-entering the market and competition increasing we believe that Northern Rock is at risk of disappointing consensus earnings estimates in the next year or two. Although the UK mortgage market has remained resilient, a number of big players appear to be competing more directly with Northern Rock in terms of both product — "Together" — and distribution channel. By reducing the level of churn in the market, larger banks can boost returns but make life more difficult for high-growth players such as Northern Rock.

Valuation

We set a target price of £10.75. 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 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.

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%.

Risks

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

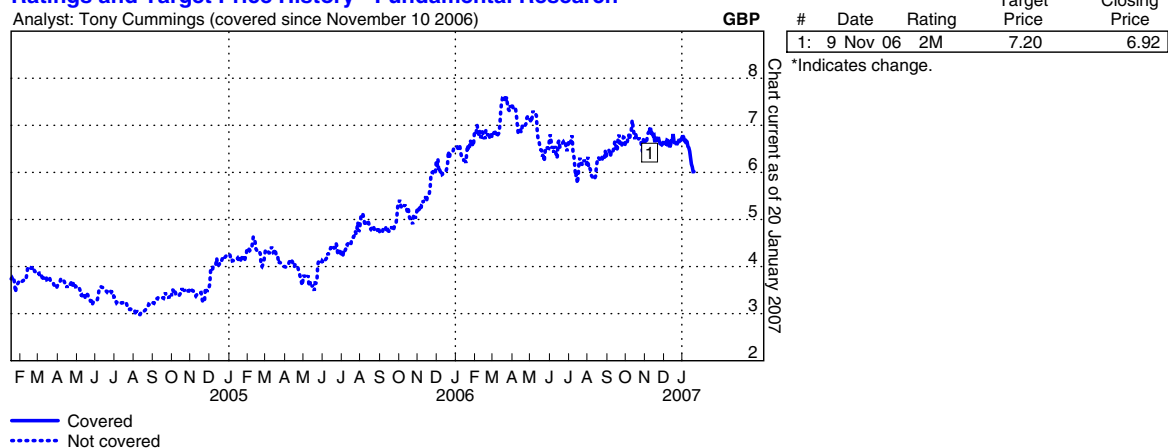
I, Tony Cummings, research analyst and the author of this report, hereby certify that all of the views expressed in this research report accurately reflect my personal views about any and all of the subject issuer(s) or securities. I also certify that no part of my compensation was, is, or will be directly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

IMPORTANT DISCLOSURES

Paragon Group (PAG.L)

Ratings and Target Price History - Fundamental Research

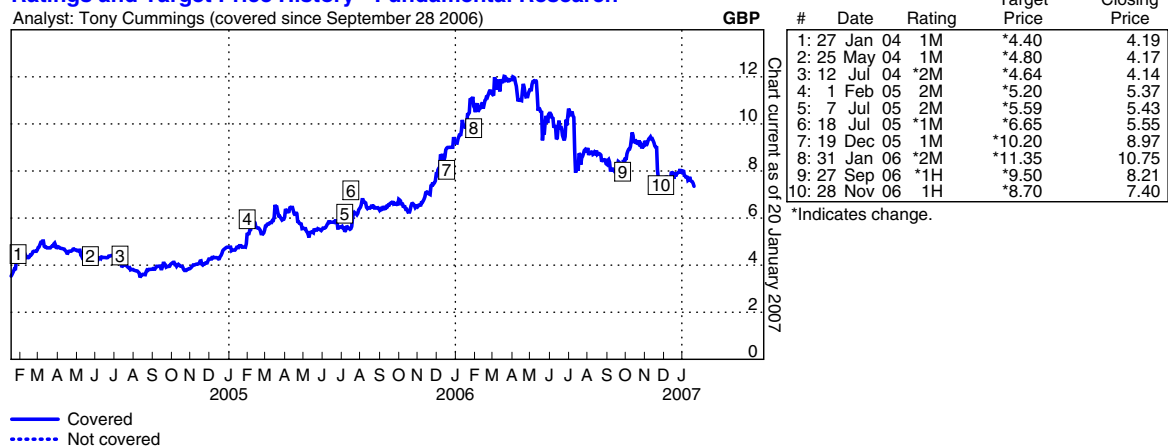
Analyst: Tony Cummings (covered since November 10 2006)



Kensington Group (KGN.L)

Ratings and Target Price History - Fundamental Research

Analyst: Tony Cummings (covered since September 28 2006)



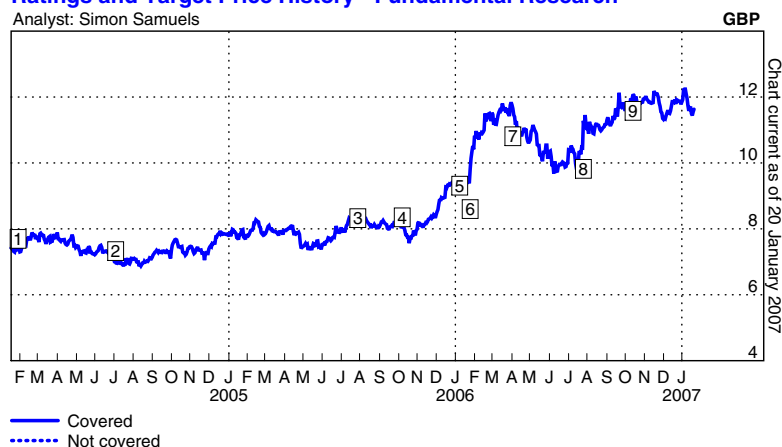
Paragon Group (PAG.L)

22 January 2007

Northern Rock (NRK.L)

Ratings and Target Price History - Fundamental Research

Analyst: Simon Samuels



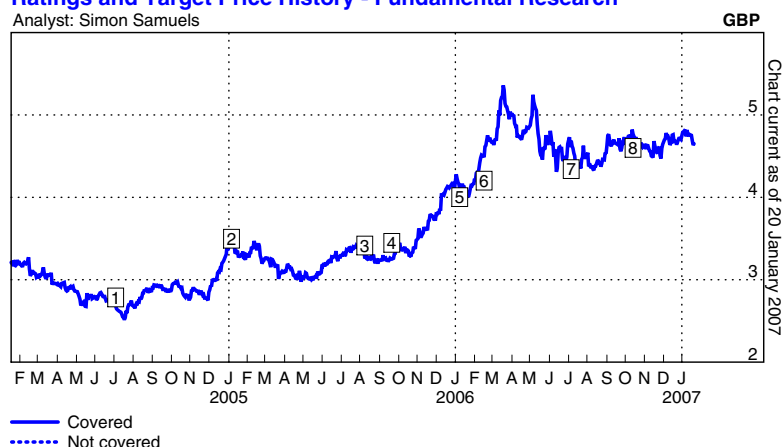
#	Date	Rating	Target Price	Closing Price
1:	28 Jan 04	1M	*8.25	7.40
2:	5 Jul 04	*2M	*7.50	7.04
3:	28 Jul 05	2M	*8.00	8.22
4:	7 Oct 05	*3M	*7.60	8.08
5:	9 Jan 06	3M	*8.50	9.38
6:	25 Jan 06	*2M	*9.75	9.81
7:	4 Apr 06	*3M	*10.00	11.65
8:	26 Jul 06	3M	*10.50	11.28
9:	13 Oct 06	3M	*10.70	12.08

*Indicates change.

Bradford & Bingley (BB.L)

Ratings and Target Price History - Fundamental Research

Analyst: Simon Samuels



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

*Indicates change.

Within the past 12 months, Citigroup Global Markets Inc. or its affiliates has acted as manager or co-manager of an offering of securities of Northern Rock.

Citigroup Global Markets Inc. or its affiliates has received compensation for investment banking services provided within the past 12 months from Northern Rock.

Citigroup Global Markets Inc. or an affiliate received compensation for products and services other than investment banking services from Bradford & Bingley, Kensington Group and Northern Rock in the past 12 months.

Citigroup Global Markets Inc. currently has, or had within the past 12 months, the following company(ies) as investment banking client(s): Bradford & Bingley, Kensington Group, Northern Rock and Paragon Group.

Citigroup Global Markets Inc. currently has, or had within the past 12 months, the following company(ies) as clients, and the services provided were non-investment-banking, securities-related: Bradford & Bingley, Kensington Group and Northern Rock.

Citigroup Global Markets Inc. currently has, or had within the past 12 months, the following company(ies) as clients, and the services provided were non-investment-banking, non-securities-related: Kensington Group and Northern Rock.

Citigroup Global Markets Inc. or an affiliate received compensation in the past 12 months from Kensington Group.

Analysts' compensation is determined based upon activities and services intended to benefit the investor clients of Citigroup Global Markets Inc. and its affiliates ("the Firm"). Like all Firm employees, analysts receive compensation that is impacted by overall firm profitability, which includes revenues from, among other business units, the Private Client Division, Institutional Sales and Trading, and Investment Banking.

The Firm is a market maker in the publicly traded equity securities of Kensington Group and Paragon Group.

For important disclosures (including copies of historical disclosures) regarding the companies that are the subject of this Citigroup Investment Research product ("the Product"), please contact Citigroup Investment Research, 388 Greenwich Street, 29th Floor, New York, NY, 10013, Attention: Legal/Compliance. In addition, the same important disclosures, with the exception of the Valuation and Risk assessments and historical disclosures, are contained on the Firm's disclosure website at www.citigroupgeo.com. Private Client Division clients should refer to www.smithbarney.com/research. Valuation and Risk assessments can be found in the text of the most recent research note/report regarding the subject company. Historical disclosures (for up to the past three years) will be provided upon request.

Citigroup Investment Research Ratings Distribution

Data current as of 31 December 2006

	Buy	Hold	Sell
Citigroup Investment Research Global Fundamental Coverage (3106)	43%	41%	15%
<i>% of companies in each rating category that are investment banking clients</i>	45%	41%	34%
Banks -- Europe (53)	49%	38%	13%
<i>% of companies in each rating category that are investment banking clients</i>	92%	90%	86%
Diversified and Speciality Finance -- Europe (15)	60%	33%	7%
<i>% of companies in each rating category that are investment banking clients</i>	11%	0%	0%

Guide to Fundamental Research Investment Ratings:

Citigroup Investment Research's stock recommendations include a risk rating and an investment rating.

Risk ratings, which take into account both price volatility and fundamental criteria, are: Low (L), Medium (M), High (H), and Speculative (S).

Investment ratings are a function of Citigroup Investment Research's expectation of total return (forecast price appreciation and dividend yield within the next 12 months) and risk rating.

For securities in developed markets (US, UK, Europe, Japan, and Australia/New Zealand), investment ratings are: Buy (1) (expected total return of 10% or more for Low-Risk stocks, 15% or more for Medium-Risk stocks, 20% or more for High-Risk stocks, and 35% or more for Speculative stocks); Hold (2) (0%-10% for Low-Risk stocks, 0%-15% for Medium-Risk stocks, 0%-20% for High-Risk stocks, and 0%-35% for Speculative stocks); and Sell (3) (negative total return).

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.

OTHER DISCLOSURES

The subject company's share price set out on the front page of this Product is quoted as at 19 January 2007 04:30 PM on the issuer's primary market.

Within the past 5 years, Citigroup Global Markets Inc. or its affiliates has acted as manager or co manager of an offering of equity securities of Bradford & Bingley.

Within the past 5 years, Citigroup Global Markets Inc. or its affiliates has acted as manager or co manager of an offering of fixed income securities of Bradford & Bingley and Northern Rock.

Citigroup Global Markets Inc. and/or its affiliates has a significant financial interest in relation to Bradford & Bingley and Northern Rock. (For an explanation of the determination of significant financial interest, please refer to the policy for managing conflicts of interest which can be found at www.citigroupgeo.com.)

Citigroup Global Markets Inc. or its affiliates holds a long position in any class of common equity securities of Kensington Group and Paragon Group.

For securities recommended in the Product in which the Firm is not a market maker, the Firm is a liquidity provider in the issuers' financial instruments and may act as principal in connection with such transactions. The Firm is a regular issuer of traded financial instruments linked to securities that may have been recommended in the Product. The Firm regularly trades in the securities of the subject company(ies) discussed in the Product. The Firm may engage in securities transactions in a manner inconsistent with the Product and, with respect to securities covered by the Product, will buy or sell from customers on a principal basis.

Citigroup Global Markets Inc. or its affiliates acts as a corporate broker to Bradford & Bingley and Kensington Group.

Securities recommended, offered, or sold by the Firm: (i) are not insured by the Federal Deposit Insurance Corporation; (ii) are not deposits or other obligations of any insured depository institution (including Citibank); and (iii) are subject to investment risks, including the possible loss of the principal amount invested. Although information has been obtained from and is based upon sources that the Firm believes to be reliable, we do not guarantee its accuracy and it may be incomplete and condensed. Note, however, that the Firm has taken all reasonable steps to determine the accuracy and completeness of the disclosures made in the Important Disclosures section of the Product. The Firm's research department has received assistance from the subject company(ies) referred to in this Product including, but not limited to, discussions with management of the subject company(ies). Firm policy prohibits research analysts from sending draft research to subject companies. However, it should be presumed that the author of the Product has had discussions with the subject company to ensure factual accuracy prior to publication. All opinions, projections and estimates constitute the judgment of the author as of the date of the Product and these, plus any other information contained in the Product, are subject to change without notice. Prices and availability of financial instruments also are subject to change without notice. Notwithstanding other departments within the Firm advising the companies discussed in this Product, information obtained in such role is not used in the preparation of the Product. Although Citigroup Investment Research does not set a predetermined frequency for publication, if the Product is a fundamental research report, it is the intention of Citigroup Investment Research to provide research coverage of the/those issuer(s) mentioned therein, including in response to news affecting this issuer, subject to applicable quiet periods and capacity constraints. The Product is for informational purposes only and is not intended as an offer or solicitation for the purchase or sale of a security. Any decision to purchase securities mentioned in the Product must take into account existing public information on such security or any registered prospectus.

Investing in non-U.S. securities, including ADRs, may entail certain risks. The securities of non-U.S. issuers may not be registered with, nor be subject to the reporting requirements of the U.S. Securities and Exchange Commission. There may be limited information available on foreign securities. Foreign companies are generally not subject to uniform audit and reporting standards, practices and requirements comparable to those in the U.S. Securities of some foreign companies may be less liquid and their prices more volatile than securities of comparable U.S. companies. In addition, exchange rate movements may have an adverse effect on the value of an investment in a foreign stock and its corresponding dividend payment for U.S. investors. Net dividends to ADR investors are estimated, using withholding tax rates conventions, deemed accurate, but investors are urged to consult their tax advisor for exact dividend computations. Investors who have received the Product from the Firm may be prohibited in certain states or other jurisdictions from purchasing securities mentioned in the Product from the Firm. Please ask your Financial Consultant for additional details. Citigroup Global Markets Inc. takes responsibility for the Product in the United States. Any orders by US investors resulting from the information contained in the Product may be placed only through Citigroup Global Markets Inc.

The Citigroup legal entity that takes responsibility for the production of the Product is the legal entity which the first named author is employed by. The Product is made available in Australia to wholesale clients through Citigroup Global Markets Australia Pty Ltd. (ABN 64 003 114 832 and AFSL No. 240992) and to retail clients through Citigroup Wealth Advisors Pty Ltd. (ABN 19 009 145 555 and AFSL No. 240813), Participants of the ASX Group and regulated by the Australian Securities & Investments Commission. Citigroup Centre, 2 Park Street, Sydney, NSW 2000. The Product is made available in Australia to Private Banking wholesale clients through Citigroup Pty Limited (ABN 88 004 325 080 and AFSL 238098). Citigroup Pty Limited provides all financial product advice to Australian Private Banking wholesale clients through

bankers and relationship managers. If there is any doubt about the suitability of investments held in Citigroup Private Bank accounts, investors should contact the Citigroup Private Bank in Australia. Citigroup companies may compensate affiliates and their representatives for providing products and services to clients. If the Product is being made available in certain provinces of Canada by Citigroup Global Markets (Canada) Inc. ("CGM Canada"), CGM Canada has approved the Product. Citigroup Place, 123 Front Street West, Suite 1100, Toronto, Ontario M5J 2M3. The Product may not be distributed to private clients in Germany. The Product is distributed in Germany by Citigroup Global Markets Deutschland AG & Co. KGaA, which is regulated by Bundesanstalt fuer Finanzdienstleistungsaufsicht (BaFin). Frankfurt am Main, Reuterweg 16, 60323 Frankfurt am Main. If the Product is made available in Hong Kong by, or on behalf of, Citigroup Global Markets Asia Ltd., it is attributable to Citigroup Global Markets Asia Ltd., Citibank Tower, Citibank Plaza, 3 Garden Road, Hong Kong. Citigroup Global Markets Asia Ltd. is regulated by Hong Kong Securities and Futures Commission. If the Product is made available in Hong Kong by The Citigroup Private Bank to its clients, it is attributable to Citibank N.A., Citibank Tower, Citibank Plaza, 3 Garden Road, Hong Kong. The Citigroup Private Bank and Citibank N.A. is regulated by the Hong Kong Monetary Authority. The Product is made available in India by Citigroup Global Markets India Private Limited, which is regulated by Securities and Exchange Board of India. Bakhtawar, Nariman Point, Mumbai 400-021. If the Product was prepared by Citigroup Investment Research and distributed in Japan by Nikko Citigroup Ltd., it is being so distributed under license. Nikko Citigroup Limited is regulated by Financial Services Agency, Securities and Exchange Surveillance Commission, Japan Securities Dealers Association, Tokyo Stock Exchange and Osaka Securities Exchange. Akasaka Park Building, 2-20, Akasaka 5-chome, Minato-ku, Tokyo 107-6122. The Product is made available in Korea by Citigroup Global Markets Korea Securities Ltd., which is regulated by Financial Supervisory Commission and the Financial Supervisory Service. Hungkuk Life Insurance Building, 226 Shinmunno 1-GA, Jongno-Gu, Seoul, 110-061. The Product is made available in Malaysia by Citigroup Global Markets Malaysia Sdn Bhd, which is regulated by Malaysia Securities Commission. Menara Citibank, 165 Jalan Ampang, Kuala Lumpur, 50450. The Product is made available in Mexico by Acciones y Valores Banamex, S.A. De C. V., Casa de Bolsa, which is regulated by Comision Nacional Bancaria y de Valores. Reforma 398, Col. Juarez, 06600 Mexico, D.F. In New Zealand the Product is made available through Citigroup Global Markets New Zealand Ltd., a Participant of the New Zealand Exchange Limited and regulated by the New Zealand Securities Commission. Level 19, Mobile on the Park, 157 Lambton Quay, Wellington. The Product is made available in Poland by Dom Maklerski Banku Handlowego SA an indirect subsidiary of Citigroup Inc., which is regulated by Komisja Papierów Wartościowych i Giełd. Bank Handlowy w Warszawie S.A. ul. Senatorska 16, 00-923 Warszawa. The Product is made available in the Russian Federation through ZAO Citibank, which is licensed to carry out banking activities in the Russian Federation in accordance with the general banking license issued by the Central Bank of the Russian Federation and brokerage activities in accordance with the license issued by the Federal Service for Financial Markets. Neither the Product nor any information contained in the Product shall be considered as advertising the securities mentioned in this report within the territory of the Russian Federation or outside the Russian Federation. The Product does not constitute an appraisal within the meaning of the Federal Law of the Russian Federation of 29 July 1998 No. 135-FZ (as amended) On Appraisal Activities in the Russian Federation. 8-10 Gasheka Street, 125047 Moscow. The Product is made available in Singapore through Citigroup Global Markets Singapore Pte. Ltd., a Capital Markets Services Licence holder, and regulated by Monetary Authority of Singapore. 1 Temasek Avenue, #39-02 Millenia Tower, Singapore 039192. The Product is made available by The Citigroup Private Bank in Singapore through Citibank, N.A., Singapore branch, a licensed bank in Singapore that is regulated by Monetary Authority of Singapore. Citigroup Global Markets (Pty) Ltd. is incorporated in the Republic of South Africa (company registration number 2000/025866/07) and its registered office is at 145 West Street, Sandton, 2196, Saxonwold. Citigroup Global Markets (Pty) Ltd. is regulated by JSE Securities Exchange South Africa, South African Reserve Bank and the Financial Services Board. The investments and services contained herein are not available to private customers in South Africa. The Product is made available in Taiwan through Citigroup Global Markets Inc. (Taipei Branch), which is regulated by Securities & Futures Bureau. No portion of the report may be reproduced or quoted in Taiwan by the press or any other person. No. 8 Manhattan Building, Hsin Yi Road, Section 5, Taipei 100, Taiwan. The Product is made available in Thailand through Citicorp Securities (Thailand) Ltd., which is regulated by the Securities and Exchange Commission of Thailand. 18/F, 22/F and 29/F, 82 North Sathorn Road, Silom, Bangrak, Bangkok 10500, Thailand. The Product is made available in United Kingdom by Citigroup Global Markets Limited, which is authorised and regulated by Financial Services Authority. This material may relate to investments or services of a person outside of the UK or to other matters which are not regulated by the FSA and further details as to where this may be the case are available upon request in respect of this material. Citigroup Centre, Canada Square, Canary Wharf, London, E14 5LB. The Product is made available in United States by Citigroup Global Markets Inc, which is regulated by NASD, NYSE and the US Securities and Exchange Commission. 388 Greenwich Street, New York, NY 10013. Unless specified to the contrary, within EU Member States, the Product is made available by Citigroup Global Markets Limited, which is regulated by Financial Services Authority. Many European regulators require that a firm must establish, implement and make available a policy for managing conflicts of interest arising as a result of publication or distribution of investment research. The policy applicable to Citigroup Investment Research's Products can be found at www.citigroupgeo.com. Compensation of equity research analysts is determined by equity research management and Citigroup's senior management and is not linked to specific transactions or recommendations. The Product may have been distributed simultaneously, in multiple formats, to the Firm's worldwide institutional and retail customers. The Product is not to be construed as providing investment services in any jurisdiction where the provision of such services would be illegal. Subject to the nature and contents of the Product, the investments described therein are subject to fluctuations in price and/or value and investors may get back less than originally invested. Certain high-volatility investments can be subject to sudden and large falls in value that could equal or exceed the amount invested. Certain investments contained in the Product may have tax implications for private customers whereby levels and basis of taxation may be subject to change. If in doubt, investors should seek advice from a tax adviser. Advice in the Product has been prepared without taking account of the objectives, financial situation or needs of any particular investor. Accordingly, investors should, before acting on the advice, consider the appropriateness of the advice, having regard to their objectives, financial situation and needs.

© 2007 Citigroup Global Markets Inc. Citigroup Investment Research is a division and service mark of Citigroup Global Markets Inc. and its affiliates and is used and registered throughout the world. Citigroup and the Umbrella Device are trademarks and service marks of Citigroup or its affiliates and are used and registered throughout the world. Nikko is a registered trademark of Nikko Cordial Corporation. All rights reserved. Any unauthorized use, duplication, redistribution or disclosure is prohibited by law and will result in prosecution. The information contained in the Product is intended solely for the recipient and may not be further distributed by the recipient. The Firm accepts no liability whatsoever for the actions of third parties. The Product may provide the addresses of, or contain hyperlinks to, websites. Except to the extent to which the Product refers to website material of the Firm, the Firm has not reviewed the linked site. Equally, except to the extent to which the Product refers to website material of the Firm, the Firm takes no responsibility for, and makes no representations or warranties whatsoever as to, the data and information contained therein. Such address or hyperlink (including addresses or hyperlinks to website material of the Firm) is provided solely for your convenience and information and the content of the linked site does not in anyway form part of this document. Accessing such website or following such link through the Product or the website of the Firm shall be at your own risk and the Firm shall have no liability arising out of, or in connection with, any such referenced website.

ADDITIONAL INFORMATION IS AVAILABLE UPON REQUEST