

Paragon Group (PAG LN)

Overweight (V)

Target price (GBPp)	180
Share price (GBPp)	135
Potential return (%)	33.8

Sep	2009a	2010e	2011e
HSBC EPS	9.54	14.30	13.76
HSBC PE	14.1	9.4	9.8
Performance	1M	3M	12M
Absolute (%)	-8.9	-0.2	81.8
Relative^ (%)	-7.7	7.0	53.6

Note: (V) = volatile (please see disclosure appendix)

OW(V): Undervalued, with additional potential upside on return to new lending

- ▶ **Paragon is temporarily closed to new lending but not a business in run-off, in our view**
- ▶ **Strategic priorities are optimising the value of the back-book, developing new income streams, and preparing the business for a return to new lending**
- ▶ **Inexpensive existing business valuation, plus new lending option for free; we assume coverage at OW(V), and raise our TP from 140p to 180p**

Buy-to-let bargain?

Business model uncertainty: The group's lending activities are temporarily closed but positioned for a return to new lending if and when conditions in the wholesale funding markets permit. While management is confident that it will be able to secure the warehouse and securitisation funding required for a return to profitable new lending, the economics of new lending are still vague. Whether Paragon's business model will be able to deliver returns in excess of the cost of equity on new lending is the key issue.

Already priced in: Trading at a 35% discount to end-March book value and at a 20% discount to our estimate of the value of the existing businesses and closed loan books, the current market value not only affords zero value to the potential for a return to profitable new lending, but appears to be discounting a substantial deterioration in back-book credit quality.

Attractive core valuation: We estimate a core value for the closed loan books and new initiatives of 183p per share, a 20% discount to end-March NAV per share of 225p (which is broadly consistent with the 7% annualised ROE these activities generated in the half-year to end-March 2010).

Plus option value for free: In addition to this core value estimate, we estimate additional value of around 55p per share, based on a range of new business volume assumptions, prepayment rates, asset and liability interest spreads, ancillary income margins and marginal overhead and credit cost assumptions.

Assume coverage at Overweight (V): We assume coverage with an Overweight (V) rating and set a target price of 180p, up from 140p previously, which represents a potential return of 34%. The shares currently trade on 9.4x our EPS forecast for the year to September 2010, and yield a prospective 2.6%.

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This report must be read with the disclosures and the analyst certifications in the Disclosure appendix, and with the Disclaimer, which forms part of it

Index^	FTSE ALL-SHARE
Index level	2,685
RIC	PARA.L
Bloomberg	PAG LN

Source: HSBC

Free float (%)	98
Market cap (USDm)	595
Market cap (GBPm)	402

Source: HSBC

Financials & valuation

Financial statements

Year to	09/2009a	09/2010e	09/2011e	09/2012e
P&L summary (GBPm)				
Net interest income	135	136	125	116
Net fees/commissions	0	0	0	0
Trading profits	0	0	0	0
Other income	16	15	14	14
Total income	151	151	139	130
Operating expense	-39	-41	-41	-41
Bad debt charge	-66	-50	-40	-34
Other	-3	0	0	0
HSBC PBT	42	60	57	55
Exceptionals	0	0	0	0
PBT	42	60	57	55
Taxation	-13	-17	-16	-15
Minorities + preferences	0	0	0	0
Attributable profit	29	43	41	39
HSBC attributable profit	29	43	41	39

Balance sheet summary (GBPm)

Ordinary equity	534	567	598	627
HSBC ordinary equity	534	567	598	627
Customer loans	8,599	8,123	7,782	7,472
Debt securities holdings	649	716	690	666
Customer deposits	0	0	0	0
Interest earning assets	9,684	9,135	8,792	8,478
Total assets	11,154	10,829	10,533	10,261

Capital (%)

RWA (GBPm)	4,932	4,695	4,486	4,300
Core tier 1	0.0	0.0	0.0	0.0
Total tier 1	13.2	14.6	15.9	17.3
Total capital	15.6	17.1	18.5	20.0

Ratio, growth & per share analysis

Year to	09/2009a	09/2010e	09/2011e	09/2012e
Year-on-year % change				
Total income	-9.6	-0.1	-7.8	-6.2
Operating expense	4.0	5.5	-0.3	-0.3
Pre-provision profit	-13.6	-2.1	-10.6	-8.7
EPS	-55.9	49.9	-3.8	-4.5
HSBC EPS	-55.2	47.6	-3.8	-4.5
DPS	10.0	5.0	5.0	5.0
NAV (including goodwill)	6.0	6.1	5.5	4.8

Ratios (%)

Cost/income ratio	26.1	27.5	29.8	31.6
Bad debt charge	0.7	0.5	0.5	0.4
Customer loans/deposits				
NPL/loan	0.0	0.0	0.0	0.0
NPL/RWA	0.0	0.0	0.0	0.0
Provision to risk assets/RWA	0.0	0.0	0.0	0.0
Net write-off/RWA	0.0	0.0	0.0	0.0
Coverage	0.0	0.0	0.0	0.0
ROE (including goodwill)	5.5	7.8	7.1	6.4

Per share data (GBPp)

EPS reported (fully diluted)	9.54	14.30	13.76	13.14
HSBC EPS (fully diluted)	9.54	14.30	13.76	13.14
DPS	3.30	3.46	3.64	3.82
NAV	178.50	189.31	199.74	209.27
NAV (including goodwill)	178.50	189.31	199.74	209.27

Core profitability (% RWAs) and leverage

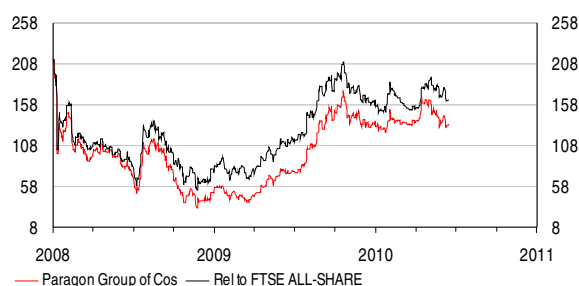
Year to	09/2009a	09/2010e	09/2011e	09/2012e
Net interest income	2.6	2.8	2.7	2.6
Trading profits	0.0	0.0	0.0	0.0
Other income	0.3	0.3	0.3	0.3
Operating expense	-0.8	-0.9	-0.9	-0.9
Pre-provision profit	2.2	2.3	2.1	2.0
Bad debt charge	-1.3	-1.0	-0.9	-0.8
HSBC attributable profit	0.6	0.9	0.9	0.9
Leverage (x)	9.9	8.7	7.9	7.2
Return on average tier 1	4.4	6.3	5.8	5.3

Valuation data

Year to	09/2009a	09/2010e	09/2011e	09/2012e
PE*	14.1	9.4	9.8	10.2
Pre-provision multiple	3.6	3.7	4.1	4.5
P/NAV	0.8	0.7	0.7	0.6
Equity cash flow yield (%)	14.3	14.8	13.9	13.1
Dividend yield (%)	2.5	2.6	2.7	2.8

Note: * = Based on HSBC EPS (fully diluted)

Price relative



Source: HSBC

Note: price at close of 14 Jun 2010

Summary

- ▶ Temporarily closed to new business, but not a business in run-off, Paragon is poised for a return to new lending when funding availability and pricing permit
- ▶ In the meantime, management is focused on optimising the value of existing loan assets and developing new income streams
- ▶ The shares are inexpensive in relation to net assets and the embedded value of the existing business; we assume coverage at Overweight (V), with a target price of 180p (from 140p)

Investment case

Back-book secured. The 2008 rights issue allowed Paragon to refinance with new equity the first-loss investments, subordinated loans and cash reserves in its existing securitisation vehicles, replacing the previous working capital facility. This ensured that economic interests in these vehicles and their underlying loan assets remained with Paragon's shareholders.

Temporarily closed to new lending. Since then, however, Paragon has been effectively closed to new customer lending, and it will remain closed until: (i) it can arrange new warehouse facilities on commercial terms; and (ii) it can securitise warehoused loans for acceptable returns on capital. This will depend upon the future availability and cost of securitisation funding, the gross margins available on new lending, and the quantum of equity Paragon will be required to commit.

Future funding the key issue. Until there is greater clarity as to the future availability and cost of warehouse facilities and securitisation funding,

our forecasts assume Paragon remains closed to new business. From an investment perspective, we highlight both the value of the existing business – essentially the back-book – and also the 'option value' representing the probability that Paragon is able to re-open to profitable business.

Upside to 'closed' valuation. We value the existing business primarily in relation to the net assets of the group, predominantly 'credit enhancement and other financial collateral' held within securitisation vehicles. Our fundamental fair value methodology discounts to present value the release of this collateral, together with our forecast for dividend flows. We value the existing businesses at GBP557m or 183p per share, which compares with end-March NAV per share of 225p.

New lending option for free. That Paragon's shares trade at a discount to the estimated in-force value of the existing business tells us that either the in-force estimate is wrong (and way too high) – presumably due to overly optimistic loan loss impairment and/or redemption rate assumptions – or that Paragon will not be able to return to profitable new lending. (By

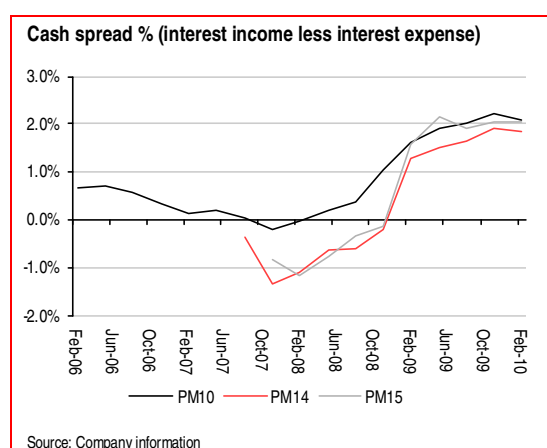
profitable new lending we mean new business that can generate a return on equity capital in excess of cost of equity.)

We have estimated the potential upside that would result from a return to new lending under a number of scenarios (see *Valuation* section below). In our central case, which assumes Paragon returns with a modest GBP400m of new lending in 2011 for net returns in the high-teens, we value this new business at GBP166m or 55p per share. This suggests a further 30% potential return to our core fair value estimate, upon which we have based our 180p target price.

Investment positives

EIR versus cash interest margin

IFRS accounting requires that Paragon uses Effective Interest Rate (EIR) methodology in recognising income on its loan assets. The EIR itself will reflect the expected gross income and interest expense associated with loan assets to be spread over the expected life of the loan, and so, for example, teaser rates at the beginning of a loan will be amortised over the loan term.



This results in the EIR interest margin being different from the cash margin. In the initial period of a loan the cash margin can be negative because the initial discounted rate is below the cost of funding, for example.

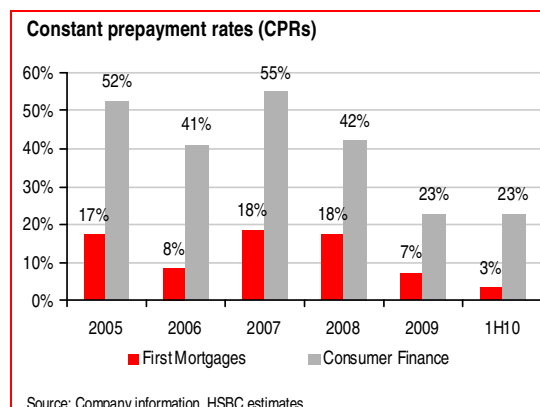
As shown in the chart above, the cash spread being earned in recent First Mortgages (FM) securitisations is running at around 2%, which compares with a most recently reported EIR spread of 1.1%. Hence the cash flow return from Paragon's back-book of loan assets is materially higher than its accounting return.

Strong back-book cash generation

The strong cash return on Paragon's loan assets has resulted in strong cash generation: unrestricted cash balances stood at GBP128.1m at end-March 2010, up from GBP84.0m – a net cash flow of GBP44.1m, as compared with operating profits of GBP29.7m for the same period. Annualised, this represents a 14% cash flow return on average equity capital employed over the period.

Longevity (low CPR)

Very low interest rates, and a reduction in the number of products available, have resulted in substantially reduced re-mortgaging activity and a corresponding reduction in redemption or constant prepayment rates (CPRs) within the BTL (buy-to-let) segment.



Partly as a result of this industry trend, and partly due to Paragon's competitive pricing, the FM CPR has fallen from around 18% in 2008 to only 3% in the first half of 2010. This implies an increase in the longevity of the mortgage portfolio, which means earning a positive spread

on loan assets for longer, thus increasing the in-force or embedded value of the portfolio.

Receiver of rent

In the BTL sector it is common to appoint a 'receiver of rent' (ROR) as an alternative to taking possession of a property when mortgage payments are in arrears. When this occurs, the property may continue to be tenanted, and the receiver collects rent from the tenant and passes it to the lender.

Although technically the loan is deemed to be in arrears, the lender is still receiving income associated with the loan. For this reason, Paragon and other BTL lenders will quote arrears figures including and excluding those where an ROR has been appointed.

As at end-March 2010, Paragon's BTL accounts three months or more in arrears stood at 117bp, as compared with the Council of Mortgage Lenders (CML) BTL average of 271bp. Excluding ROR, Paragon's arrears stood at 20bp, as compared with the CML's 181bp.

As at end-March 2009, 86% of Paragon's 3 months plus arrears were subject to ROR, and 94% of these ROR properties were let.

Investment concerns

UK housing market

Despite the additional protection ROR provides against rising arrears, Paragon's earnings are exposed to a decline in UK house prices, principally through formulaic IFRS impairment-charging methodologies. At end-March, the weighted average loan-to-value (LTV) of Paragon's mortgage loan book stood at around 80%, which provides substantial headroom to a fall in property values. However, loan loss impairments are partially determined by LTVs and hence a precipitous fall in values could result in a material increase in impairments.

Consumer Finance portfolio credit risk

Although the Consumer Finance (CF) loan portfolio represented only 5% of the end-March 2010 loan book, the division accounted for almost half of the group's impairment charge for the six months to end-March, amounting to GBP12.5m as compared with a pre-impairment operating profit of GBP19.3m. Furthermore, the group's investment in first-loss equity in CF securitisations is substantial, some GBP54m in total. The underlying loan assets – unsecured personal loans, secured loans, car loans and retail credit – involve much greater credit risk than BTL mortgages, in our view, and this is where the majority of Paragon's credit risk lies.

Rising interest rates/prepayment risk

The group's existing loan portfolios were largely originated between 2001 and 2007, when base rates averaged 4.6%, and so payment strain should not be a major problem for borrowers should interest rates rise (the 10% of the loan book still on fixed rates averaging 5.5% show arrears of 1.29% as against the whole book level of 1.17%).

A more material risk in our view is the impact of rising rates on CPRs, which tend to increase as interest rates rise, since a substantial rise in CPRs would see the currently closed portfolios run off more quickly.

ABS step-ups

Paragon's securitisations were designed so that the duration of the loans matched the duration of securitisation. However, since CPRs of around 15%-20% suggested an average mortgage 'life' of five to seven years, most of the asset-backed securities issued included call dates (at around five years for consumer finance securitisations and seven years for mortgage deals). To incentivise Paragon to exercise these call options, step-ups in coupon were built into the terms of these securities.

In the current market environment, where CPRs are so low and existing deals cannot be part-refinanced with new ones, it is unlikely that Paragon will exercise these calls when they become due. Step-ups were triggered on a number of Paragon issues in April (PPAF No.3) and May (PM7 and PM9) 2010, and further step-ups will be triggered in October (PM8) and December (PM10) 2010, as well as in 2011 (PM11, PM12 and PM13) and in 2012 (FF7, PM14 and PM15). Step-ups for senior classes tend to be around 20bp, rising to 80-100bp for the most junior tranches, and will ultimately result in an average increase in the cash cost of funding by around 30bp, we believe.

Implicit duration mismatch

Paragon's securitisation funding model implicitly involves a duration mismatch: while loan assets are being warehoused on its balance sheet prior to securitisation, long-duration assets are being financed by short-duration liabilities. (Once securitised, however, these loan assets are match-funded by long-duration mortgage backed securities)

Paragon's previous warehouse facility, provided by a syndicate of banks, included a term-out option, which allowed the short-term warehouse facility to be swapped into a long-term loan, in exchange for a step-up in interest cost (this option was exercised in 2008 to match-fund some GBP1.6bn of warehoused mortgages). It seems unlikely that future warehouse funding facilities will include such a term-out option.

In order to secure cheaper funding, and greater visibility as to funding availability, it is possible that forward securitisation flow would be offered to a single provider in exchange for warehouse finance.

Regulation

The FSA published its UK Mortgage Market Review in October 2009. Key issues for Paragon are proposals concerning second-charge secured

lending, BTL mortgages, and the regulation of non-deposit-taking lenders. Specifically, the review expressed concern over the unregulated nature of the BTL market, suggesting that similar standards should be applied to it as to other mortgage market segments. The regulation of second-charge lending is to be switched from the OFT to the FSA (although no date has been set for implementation) and a similar switch for BTL is under consideration. The OFT will publish a consultation paper of non-deposit-taking lenders in Q3 2010. Our initial concerns are limited to additional compliance costs.

Capital gains tax

The government's proposal to realign capital gains tax with income tax could see the tax levied on BTL investors raised from 18% to as much as 50%; this is seen as a risk to new BTL property purchases (and hence demand for new BTL mortgages), and to the UK property market as a whole.

Valuation summary

In summary, we estimate a core value for Paragon's existing businesses of 183p per share. In addition to this core value, we see the potential for additional value creation through a return to new lending. Based on new advances of GBP400m for 2011, and a range of growth and prepayment speed assumptions, our analysis indicates incremental value of approximately 55p per share.

Rounding down our core value estimate, we set a target price for Paragon of 180p per share, which implies a 34% potential return. Under HSBC's research model, the Overweight (V) classification requires the implied return to exceed the hurdle rate of 8% by at least 10%. Given that our 180p target price implies a potential total return greater than 18%, we assume coverage of Paragon with an Overweight (V) rating.

Risk factors

Risks to our Overweight (V) rating include:

- ▶ Margin pressure – step-ups in ABS coupons in 2010-12 could lead to net interest margin shrinkage and lower-than-forecast interest income.
- ▶ Uncertain UK house price developments – a sharp decline in UK house prices would result in higher loan loss impairments.
- ▶ CF credit risk – forecasts are exposed to risk of rising arrears and impairments.
- ▶ Interest rates – rising interest rates could result in payment strain for Paragon's borrowers and lead to increased arrears and loan losses.
- ▶ Unemployment – rising unemployment could undermine the positive outlook for the private rented sector.
- ▶ Taxation – and increase in CGT could reduce the attractiveness of BTL investment and diminish demand for BTL mortgage lending
- ▶ Regulation – changes to the regulation of second-charge and, potentially, BTL mortgage lenders could lead to higher costs and reduced profitability.

Valuation

- ▶ We derive a core ‘embedded value’ for the group’s existing businesses and closed loan books of 183p per share
- ▶ In addition we estimate ‘option value’ for a potential return to new lending of 55p per share
- ▶ Target price of 180p per share based on core valuation only

Existing business

We estimate a core ‘embedded value’ for Paragon in terms of its existing, closed loan portfolios, and its new business initiatives.

Fundamental fair value model

The table below summarises the deployment of the group’s capital employed, and shows that, since the rights issue in 2008, securitisation investments have been funded through a combination of equity and the term debt.

Deployment of group capital employed				
Year to September (GBPm)	2007	2008	2009	H110
Assets				
Property, plant & equipment	21.9	18.5	13.5	12.2
Tax assets	16.1	10.3	4.5	2.3
Other receivables	6.7	6.6	5.5	6.2
Unrestricted cash	50.4	73.2	84.0	128.1
Retirement asset	4.2	0.0	0.0	0.0
ESOP cash	2.2	2.5	1.7	1.7
Intangibles	0.6	0.4	9.6	9.4
Investment in associate	0.5	15.5	0.0	0.0
SPV investments/cash	606.9	612.4	648.8	622.0
	709.5	739.4	767.6	781.9
Financed by				
Equity	313.3	621.5	650.8	664.9
Corporate bond	115.8	117.9	116.8	117.0
Working capital facility	280.4	0.0	0.0	0.0
	709.5	739.4	767.6	781.9

Source: Company information, HSBC

securitisation ‘financial collateral’ – the first-loss equity, subordinated loans and cash reserves of the group’s special-purpose vehicles (SPVs).

These SPV investments (with a face value of 210p per share) are tied up in securitisation vehicles and released only as the underlying loan assets run down.

We therefore argue that the ‘in-force’ or embedded value of the group’s back-book is the NPV of the capital and restricted cash released from the SPVs over time, plus the NPV of the cash flows generated from the loan portfolios as they run down.

We try to capture these elements of embedded value in our fundamental fair value approach.

There are three parts to this estimate:

- ▶ The terminal value of normalised equity capital at end-2015e, based upon terminal return on equity and cost of equity assumptions. We assume ROE equals COE at termination and hence value this equity at its book value only;

Of equity and term debt capital totalling GBP782m at end-March 2010, GBP622m was deployed in

Fundamental fair value estimate

Year to Sep (GBPm)	2010e	2011e	2012e	2103e	2014e	2015e
Customer loans	8,956	8,629	8,328	8,049	7,789	7,545
Memo: loan growth	-8%	-4%	-3%	-3%	-3%	-3%
Normalised equity/loans	3.2%	3.2%	3.1%	3.1%	3.1%	3.1%
Normalised equity	288.2	274.3	262.0	251.1	241.3	232.4
Equity	683.7	714.9	743.5	768.9	791.7	812.0
Surplus capital	395.5	440.6	481.4	517.8	550.4	579.6
Attributable profit	42.9	41.3	39.4	36.9	34.7	33.0
Return on surplus capital	-4.0	-4.4	-4.8	-5.2	-5.5	-5.8
Normalised profit	39.0	36.9	34.6	31.7	29.2	27.2
Normalised ROE	13.5%	13.4%	13.2%	12.6%	12.1%	11.7%
Dividends	10.0	10.1	10.9	11.4	12.0	12.6
Discount factor	1.044	1.138	1.240	1.352	1.474	1.606
PV dividends	9.6	8.9	8.8	8.5	8.2	7.9
Sustainable ROE	9.0%					
Sustainable growth	0.0%					
Discount rate	9.0%					
Fair value price/book	1.00					
2015 terminal value	232.4					
2015 surplus capital	579.6					
NPV terminal value	144.7					
NPV dividends	51.7					
NPV surplus capital	360.8					
Fair value	557.2					
Diluted shares (m)	304					
Value per share (p)	183					

Source: HSBC estimates

- Surplus equity capital present on the balance sheet at end-2015e. As First Mortgage and CF loan balances decline due to prepayment, the equity required to support these loan books is released and becomes surplus. Based on our forecast assumptions, we estimate surplus capital will amount to GBP580m by end-September 2015, reflecting the release of SPV financial collateral and unutilised internal capital generation;
- The expected dividend flow to 2015e.

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 existing businesses of GBP557m, which equates to 183p per share.

Potential new lending

A return to profitable new lending, in our view, should be interpreted as lending that generates a positive economic profit – a return on the required equity in excess of the cost of equity.

New lending economics

Minimum target ROE	9%
Equity/loan assets	5%
Required ROA	0.45%
Tax rate assumption	28%
Required pre-tax ROA	0.63%
Impairment assumption	0.30%
Required pre-provision, pre-tax ROA	0.93%
Expense ratio assumption	30%
Required income margin	1.32%
Ancillary income margin assumption	0.15%
Required net interest income margin	1.17%

Source: HSBC estimates

The above table sets out some basic new lending economics. In order to achieve a 9% ROE, given 20x equity leverage, a 28% tax rate, 30bp impairment charge, and a 30% expense ratio, new lending will need to yield 132bp. If 15bp of this is available from non-interest sources, this implies a required net interest income margin of 117bp.

In the table overleaf, we have set out a scenario in which Paragon returns to new lending in 2011. We have assumed GBP400m of advances in the first year, with advances growing at 10% pa thereafter. In projecting redemptions/prepayments, we have assumed a CPR of 5% pa.

Our liability spread assumption (a cost of funding rate applied to 95% of average loans – the other 5% being ‘interest-free’ group capital) is loosely based on recent UK RMBS spreads of a little below 200bp. We then derive our assumption for asset spread, ie the spread required to deliver a required net interest margin – in this case, the spread required to deliver an 18-19% ROE.

We then value this new lending as follows:

- We discount to present value the net cash flows generated between 2011 and 2020.

Return to new BTL lending scenario. (Key assumptions – GBP400m advances in 2011, growing at 10% pa; 5% CPR)

Year to Sep (GBPm)	2011e	2012e	2013e	2014e	2015e	2016e	2017e	2018e	2019e	2020e
Opening loan assets	0	400	820	1,219	1,598	1,958	2,300	2,625	2,934	3,227
Advances	400	440	440	440	440	440	440	440	440	440
Prepayments	0	-20	-41	-61	-80	-98	-115	-131	-147	-161
Closing loans	400	820	1,219	1,598	1,958	2,300	2,625	2,934	3,227	3,506
Average loans	200	610	1,020	1,409	1,778	2,129	2,463	2,780	3,081	3,367
Asset spread	3.50%	3.50%	3.50%	3.50%	3.50%	3.50%	3.50%	3.50%	3.50%	3.50%
Liability spread*	-1.75%	-1.75%	-1.75%	-1.75%	-1.75%	-1.75%	-1.75%	-1.75%	-1.75%	-1.75%
Net interest margin	1.75%	1.75%	1.75%	1.75%	1.75%	1.75%	1.75%	1.75%	1.75%	1.75%
Ancillary income	0.15%	0.15%	0.15%	0.15%	0.15%	0.15%	0.15%	0.15%	0.15%	0.15%
Admin expenses	-0.30%	-0.30%	-0.30%	-0.30%	-0.30%	-0.30%	-0.30%	-0.30%	-0.30%	-0.30%
Credit costs	-0.30%	-0.30%	-0.30%	-0.30%	-0.30%	-0.30%	-0.30%	-0.30%	-0.30%	-0.30%
Net margin	1.30%	1.30%	1.30%	1.30%	1.30%	1.30%	1.30%	1.30%	1.30%	1.30%
Gross cash flow	2.6	7.9	13.3	18.3	23.1	27.7	32.0	36.1	40.0	43.8
Tax	-0.7	-2.2	-3.8	-5.3	-6.7	-8.0	-9.3	-10.5	-11.6	-12.7
Earnings	1.9	5.7	9.4	13.0	16.4	19.7	22.7	25.7	28.4	31.1
Returns:										
Average loans	200	610	1,020	1,409	1,778	2,129	2,463	2,780	3,081	3,367
Equity @ 5%	10.0	30.5	51.0	70.4	88.9	106.5	123.1	139.0	154.0	168.3
Earnings	1.9	5.7	9.4	13.0	16.4	19.7	22.7	25.7	28.4	31.1
ROE	19%	19%	18%	18%	18%	18%	18%	18%	18%	18%
Valuation:										
Discount rate	9%									
Price:book	2.1									
NPV (earnings)	92.8									
Terminal equity	168.3									
Terminal value	350.1									
Incremental value	181.8									
PV (incremental value)	73.6									
Value	166.4									
Value/share (p)	55									

Source: HSBC estimates.

- We calculate a value for 2020 equity capital based on ROE relative to COE. We then discount the incremental value – the valuation less the equity capital invested (because we are already valuing Paragon's capital at face value in our existing business valuation) – and discount this to present value.
- The aggregate of these two present values is our estimate of the incremental value of new lending. In this scenario we estimate an incremental value of GBP166m or 55p per share.

Clearly the income and expense margins and the new lending volumes are the key assumptions. Prepayment speed is also an important value driver. In the table below we set out a number of alternative scenarios based on different assumptions for CPR and new lending growth.

New lending valuation – sensitivity analysis (value, p)

Advances growth:	0%	4%	8%	12%	16%
CPR:					
5%	50	52	54	56	57
10%	43	45	46	48	49
15%	37	39	40	41	43
20%	33	34	35	36	37

Source: HSBC estimates

Activities

- ▶ A specialist lender focused on the UK BTL mortgage market
- ▶ Additional consumer credit activities and a portfolio of closed loan books in run-off
- ▶ Group capital, short-term warehouse facilities and securitisation are the funding sources

Specialist mortgages and consumer finance

Paragon 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. Headquartered in Solihull, Paragon employs around 600 people.

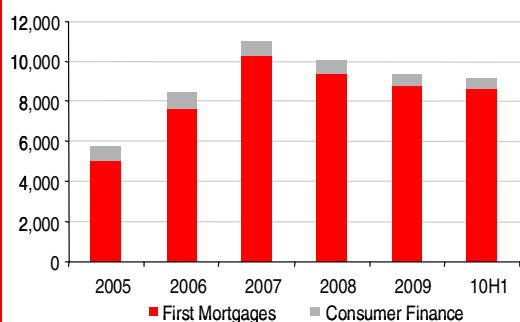
The company is organised into two main operating divisions: FM, which includes BTL and owner-occupied mortgage lending and other sources of income derived from first-charge mortgages; and CF, which includes secured lending, car and retail finance and a residual unsecured loan book.

Paragon has become increasingly focused on BTL mortgage lending over the past 10 years, partly as a result of the acquisition of Mortgage Trust in June 2003 and the shrinkage of run-off portfolios, and partly as a result of stronger BTL new lending volumes.

As at end-March 2010, the group's loan portfolio comprised GBP8,458m of BTL mortgages (some 93% of the group's loan balances) GBP165m of owner-occupied mortgages (2% of loan balances), and GBP488m of consumer finance loans (5% of the total).

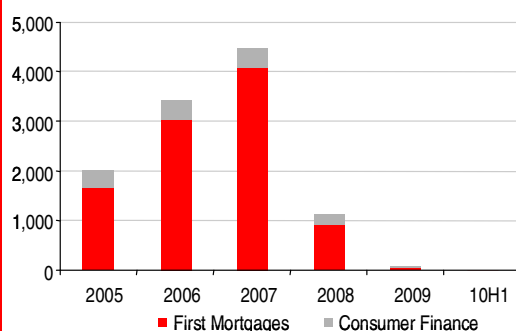
Currently, both divisions are closed to new customers, although further advances can be made to existing borrowers.

Loan balances by operating division (GBPm)



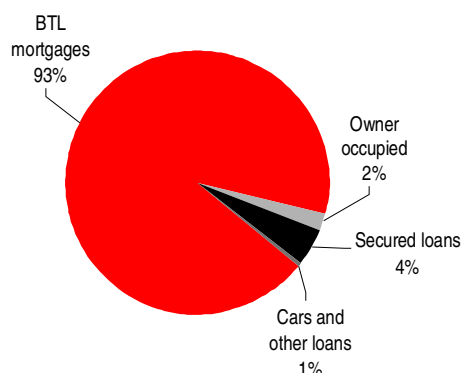
Source: Company information

New lending by operating division (GBPm)



Source: Company information

Loan book mix at end-March 2010



Source: Company information

FM: The core FM division operates two mortgage brands – Paragon Mortgages and Mortgage Trust – which, at end-March, managed GBP8.46bn of BTL mortgages and a further GBP165m of owner-occupied mortgages in run-off.

CF: The CF division managed assets of GBP488m at end-March, GBP427m of which consisted of second mortgages and secured personal loans, with a further GBP61m in used-car finance, point-of-sale retail finance (furniture, floor coverings and specialist hi-fi) and a small portfolio of unsecured consumer credit loans in run-off.

Income and expenses

The FM division accounted for 68% of total income in the first half this year, 66% of profit before loan impairments, 53% of impairments and 77% of operating profit.

Net interest income accounted for 90% of total income and other income 10% (principally loan account fees, insurance commissions and mortgage servicing fees).

The annualised net interest margin on FM loans averaged 115bp in the six months to end-March, while the impairment charge was 33bp. The CF net interest margin was 731bp with impairments at 512bp.

Half-year to March 2010 – Financial snapshot by division

(GBPm)	FM	%	CF	%	TOTAL
Net interest income	49.0	71%	20.4	29%	69.4
Other operating income	3.8	48%	4.2	53%	8.0
Total operating income	52.8	68%	24.6	32%	77.4
Operating expenses	-15.7	75%	-5.3	25%	-21.0
Pre-impairment profit	37.1	66%	19.3	34%	56.4
Impairment charge	-14.2	53%	-12.5	47%	-26.7
Operating profit	22.9	77%	6.8	23%	29.7
FV gains/losses	-0.9	100%	0.0	0%	-0.9
Profit before tax	22.0	76%	6.8	24%	28.8
Customer loans	8,623	95%	488	5%	9,111
Net interest margin	1.15%		7.31%		1.53%
Total income margin	1.19%		9.48%		1.68%
Impairments/avg loans	0.32%		5.12%		0.58%
Expense ratio	29.7%		21.5%		27.1%

Source: Company information, HSBC estimates

For the group as a whole, the net interest margin was approximately 153bp, the other income margin 15bp, and the impairment charge 58bp, giving a risk-adjusted income margin on average loans of 110bp.

Expenses were approximately 46bp on average loans (a 27% expense ratio) giving a pre-tax return on assets of 64bp. The tax rate for the half year was 28%, which implies a net return on assets of 46bp. Since the end-March equity to loans ratio was 7.3%, this ROA corresponds to an annualised return on equity of around 6.3%.

Loan book mix – September 2005 to March 2010

Year to September (GBPm)	2005	2006	2007	2008	2009	H1 2010
FM						
Advances	1,668	3,038	4,079	904	25	9
Loan balances	5,032	7,644	10,325	9,419	8,764	8,623
CF						
Advances	350	372	357	222	60	0
Loan balances	695	783	710	634	550	488

Source: Company information

Funding model

Paragon's funding model is built around securitisation. Before it was closed to new business in early 2008, the process was as follows:

- ▶ Paragon would originate loan assets and warehouse them on its balance sheet using a short-term credit facility provided by a syndicate of banks.
- ▶ It would periodically clear the warehouse by securitising the loan assets. At the time of securitisation, Paragon would inject capital into the securitisation vehicles – the first-loss equity, subordinated debt and cash reserves required for credit enhancement – funded through a combination of its own equity, long-term corporate debt and short-term working capital facilities.
- ▶ The chart below details the group's securitisations between 2001 and 2007.

Capital employed

The group's loan portfolio is currently funded through a combination of

- ▶ Asset-backed loan notes (GBP8.8bn);
- ▶ The termed-out warehouse facility (GBP1.4bn);

- ▶ A corporate bond (GBP116m);
- ▶ Shareholders' funds (GBP665m).

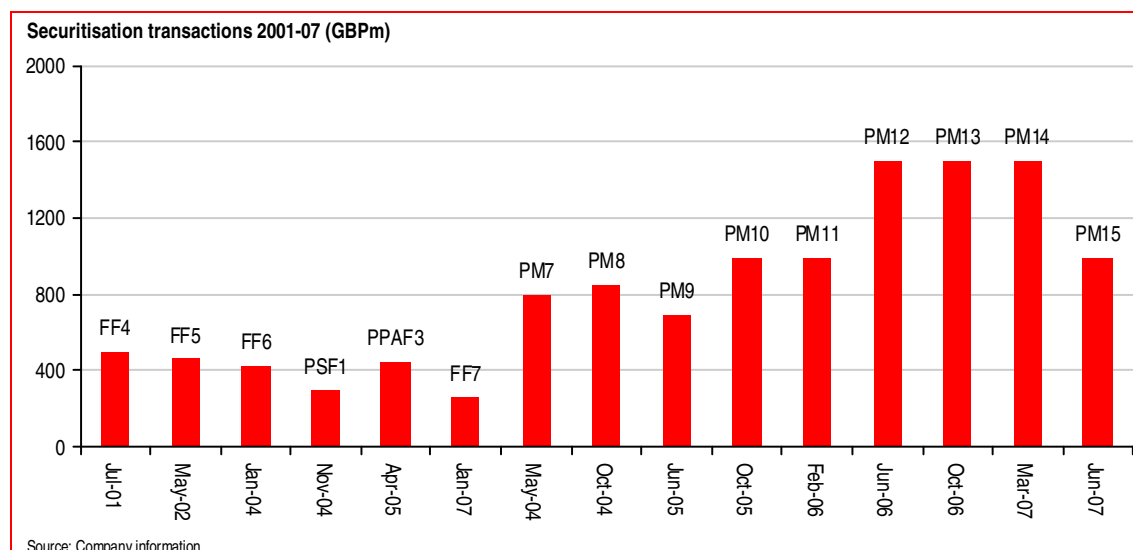
The asset-backed loan notes have maturity dates ranging from November 2035 to May 2043; the warehouse facility a final repayment date in February 2050 (although substantial repayments are likely over the next five years as the underlying mortgage pools repay or refinance). The 7% callable subordinated notes (the corporate bond) have a final maturity date in April 2017, and are callable in April 2012 at Paragon's option.

New businesses

Following temporary closure to new lending in 2008, management sought to expand the range of its activities. New activities are: (i) the acquisition of loan portfolios; (ii) additional products and services for existing borrowers; and (iii) servicing third-party loan portfolios.

In the half-year to March 2010 these new initiatives delivered a pre-tax profit of GBP2.4m (5% of group operating profits) and are expected to contribute some GBP3.5m in the full year to end-September 2010.

In addition, last year's repurchase of GBP37.7m nominal of the group's RMBS (at a cost of



GBP18.9m) and GBP10m of the subordinated bond (for GBP5.3m) generated an exceptional profit after costs of GBP18.4m. In the first half of the current year another GBP1.5m of debt was repurchased at a cost of GBP1.0m, creating an exceptional profit of GBP0.5m

Acquisition of loan portfolios

Paragon formed the investment company, Idem Capital, to participate in a joint venture with CarVal Investors, a credit-focused investment manager founded by Cargill in 1987 and currently with around USD9bn in assets under management. The joint venture was formed to allow Paragon and CarVal to co-invest in the purchase of mortgage portfolios, and in September 2009 it acquired a small portfolio of second-charge loans. Although Paragon continues to review portfolios when they become available, it has made no additional purchases.

Services for existing customers

Paragon offers a range of services to the private rented sector through its Redbrick brand. These have included the provision of energy performance certificates, survey and valuation services, tenant credit checks, and specialist landlord insurance.

Third-party services

Moorgate Loan Servicing and Arden Credit Management provide third-party loan servicing and arrears management services, respectively. These services make use of Paragon's existing administration and collecting skills and, at end-September last year, had more than GBP1bn of third-party loans under management.

Recent trading

Interim results for the six months to end-March 2010 were announced on 18 May.

Interim results – 6m to March 2010

6m to March (GBPm)	2009	2010	Ch	Ch %
FM				
-Interest receivable	281.5	121.5	-160.0	-57%
-Interest payable	-228.8	-72.5	156.3	-68%
Net interest income	52.7	49.0	-3.7	-7%
Other income	6.2	3.8	-2.4	-39%
Total operating income	58.9	52.8	-6.1	-10%
Operating expenses	-14.7	-15.7	-1.0	7%
Pre-impairment profit	44.2	37.1	-7.1	-16%
Impairment charge	-19.8	-14.2	5.6	-28%
Operating profit	24.4	22.9	-1.5	-6%
FV gains/losses	-3.0	-0.9	2.1	-70%
Profit before tax	21.4	22.0	0.6	3%
Advances	11	9	-2	-15%
Customer loans	8,900	8,623	-277	-3%
CF				
-Interest receivable	34.0	24.7	-9.3	-27%
-Interest payable	-18.7	-4.3	14.4	-77%
Net interest income	15.3	20.4	5.1	33%
Other income	2.3	4.2	1.9	83%
Total operating income	17.6	24.6	7.0	40%
Operating expenses	-4.2	-5.3	-1.1	26%
Pre-impairment profit	13.4	19.3	5.9	44%
Impairment charge	-18.9	-12.5	6.4	-34%
Operating profit	-5.5	6.8	12.3	-224%
FV gains/losses	0.0	0.0		
Profit before tax	-5.5	6.8	12.3	-224%
Advances	58	0	-58	
Customer loans	614	488	-126	-21%
Group				
-Interest receivable	315.5	146.2	-169.3	-54%
-Interest payable	-247.5	-76.8	170.7	-69%
Net interest income	68.0	69.4	1.4	2%
Other operating income	8.5	8.0	-0.5	-6%
Total operating income	76.5	77.4	0.9	1%
Operating expenses	-18.9	-21.0	-2.1	11%
Pre-impairment profit	57.6	56.4	-1.2	-2%
Impairment charge	-38.7	-26.7	12.0	-31%
Operating profit	18.9	29.7	10.8	57%
FV gains/losses	-3.0	-0.9		
Profit before tax	15.9	28.8	12.9	81%
Advances	69	9	-60	-87%
Customer loans	9,514	9,111	-403	-4%

Source: Company information

- ▶ Operating profit at FM fell 6% to GBP22.9m, reflecting a 10% fall in operating income; this was offset by a 28% reduction in impairment charges.
- ▶ CF reported profit of GBP6.8m, as compared with a loss of GBP5.5m in 2009, reflecting net interest income growth and reduced impairments.

Strategic objectives

- ▶ Protecting the embedded value of the group's back-book while the business remains closed to new lending
- ▶ Developing new income streams from the group's existing customer franchise and core competencies
- ▶ Positioning the business for an eventual return to new lending if/when market conditions permit

Background

Paragon has effectively been closed to new business since February 2008, when the threat of imminent withdrawal of working capital and short-term funding facilities necessitated an emergency rescue rights issue to safeguard the group's loan books (and the income streams associated with them) from creditors.

- ▶ **Protected through warehouse term-out option.** In designing the group's funding model, Paragon's management had prudently built term-out clauses into its short-term warehouse facilities so that it could switch these into long-term debt if need be – thus matching funding its entire loan portfolio to maturity.
- ▶ **Exposed through working capital facility.** However, following a capital management programme which saw Paragon repurchase its equity, the group's securitisation investments were partially funded through short-term working capital facilities. This exposed the group to potential solvency issues in late 2007 and its banking syndicate threatened to withdraw these facilities at the end of February 2008.

- ▶ **Rescue rights issue.** Since defaulting on this facility would have meant surrendering virtually all of the group's assets (its securitisation investments, together with their residual income entitlements), management was forced into an emergency rights issue: in January 2008, Paragon announced a 25 for 1, deeply discounted rights issue to raise GBP287m before expenses; it repaid the GBP280m working capital facility from the net proceeds.
- ▶ **Exercising the term-out.** Separately, but at the same time, Paragon was unable to renew its warehouse facilities on acceptable terms and hence triggered the term-out option on its existing warehouse facility at the end of February 2008, following which it had neither warehouse nor access to securitisation funding. As a result, Paragon effectively closed to new business.

Temporary closure

Limited to recycling existing loans within securitisation vehicles (further advances for existing borrowers and, for a limited period, 'substitution' loans within its consumer finance

securitisation), Paragon's management has since focused on three key strategic objectives:

- ▶ Protecting and optimising the in-force value of the group's back-book;
- ▶ Developing new income streams from the existing franchise and from core competencies;
- ▶ Positioning the business for an eventual return to new lending.

Protecting and optimising the in-force value of the back-book

Management has protected the value of the back-book primarily by the careful management of arrears and good customer retention. Paragon's BTL accounts three months or more in arrears stood at 117bp at end-March 2010, as compared with 271bp for the CML measure of BTL arrears and 222bp for the CML All Mortgages figure. The BTL redemption rate (or CPR) stood at only 3% at end-March, as compared with a longer-term average of around 20% – the longer the group's mortgages continue to earn an interest spread within the securitisations, the greater the in-force value of the back book. Although Paragon has benefited from a weak remortgage market generally, which has reduced industry CPRs, competitive pricing and fixed-rate switch offers have also helped customer retention.

Management has received approaches from third parties, including a bid for the entire company: on 15 September 2008, Paragon confirmed that this could have led to an offer for the company at a price of 125p in cash. However, the board did not consider this acceptable and rejected it on the grounds that it substantially undervalued the group's embedded value.

Developing new income streams

Since closure to new business in 2008, Paragon has developed four new businesses. Moorgate

Loan Servicing and Arden Credit Management provide third-party loan servicing and arrears management services, while Redbrick-branded companies provide a range of services to the private rented sector including tenant referencing and specialist landlord insurance. Idem Capital invests alongside CarVal Investors, purchasing loan portfolios. In the half-year to March 2010 these new initiatives delivered a pre-tax profit of GBP2.4m (5% of group operating profits) and they are expected to contribute some GBP3.5m in the full year to end-September 2010.

Positioning the business for a return to new lending

A return to new lending is a key objective, and management has continued to monitor market conditions to this effect. The key factors here are:

- ▶ Underlying landlord demand for the BTL mortgage product;
- ▶ The availability and cost of warehouse and securitisation funding generally;
- ▶ Investor appetite for new Paragon mortgage-backed securities;
- ▶ Whether the economics of the new business model will allow for a profitable return to new lending.

Landlord demand

The longer-term fundamentals of the UK BTL mortgage market remain positive, with rising tenant demand and robust rental yields, although volumes are well down on a couple of years ago: the CML reported gross BTL mortgage lending of GBP2.1bn in the three months to end-March 2010 following GBP8.5bn of gross lending in 2009, which compares with gross lending of GBP27.2bn in 2008 and GBP44.6bn in 2007.

Availability and cost of funding

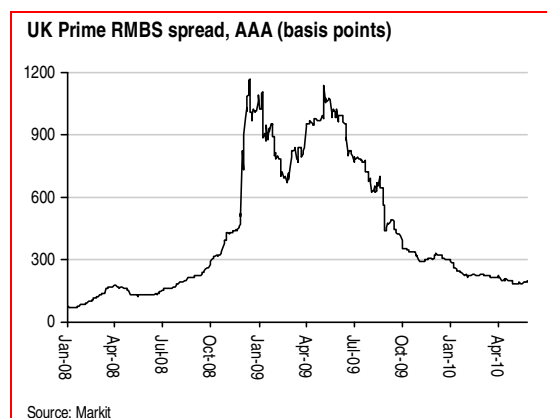
The cost of securitisation funding was prohibitively expensive for most of 2008 and

2009, and this, in large part, explains the reduction in lending volumes in segments of the UK mortgage market traditionally at least part-financed through the mortgage-backed securities market. However, a number of sizeable RMBS transactions were completed in the second half of 2009 – albeit essentially for maturity extension rather than true new funding.

In September, Lloyds completed a GBP4bn deal, followed by a GBP3.5bnbn deal by Nationwide Building Society in October 2009.

In January 2010 Lloyds sold a further GBP2.5bn of RMBS, with US-dollar-denominated tranches priced at LIBOR plus 115bp and sterling tranches at LIBOR plus 130bp.

In total, some GBP7bn of RMBS were issued and distributed in Paragon's first half, and a further GBP2.7bn has been issued since end-March.



These new transactions have resulted in a significant tightening of AAA RMBS spreads, from peaks in excess of 1000bp post-Lehman Brothers to below 200bp currently.

Appetite for Paragon MBS

In Q1 2010, Paragon's management team completed an extensive bond investor roadshow – visiting 50 investors in five jurisdictions – to assess the appetite for new Paragon mortgage-backed securities. According to management, the reception was positive, and reflected recognition of the high quality

of Paragon RMBS. In particular, investors were reported to be interested in A and AA tranches, as well as AAA-rated bonds.

Business model economics

Even with healthy demand for BTL mortgages, and the availability of reasonably priced securitisation funding, a number of additional issues will determine whether Paragon can successfully return to new lending.

Warehouse funding. Paragon will require access to short-term funding to build mortgage pools on balance sheet before parcelling up and securitising these assets. Following interim results, management reported that it had already received a number of proposals regarding warehouse funding which it had rejected, presumably on price grounds.

Capital. In 2007, Paragon's BTL securitisations required a minimum first-loss equity investment by Paragon equal to 1.9% of the total value of the issue; in a return to new lending management is guiding that the regulatory requirement would be for a minimum 5% investment in the vehicle (although this could comprise a lower first-loss investment, topped up with proprietary investment in the securitisation's A or AA-rated bonds).

Returns. The question is then whether the net return on new lending – the net interest spread, plus ancillary non-interest income, less administrative and credit costs, and tax – will be sufficient to generate an economic return on the capital invested.

BTL market opportunity

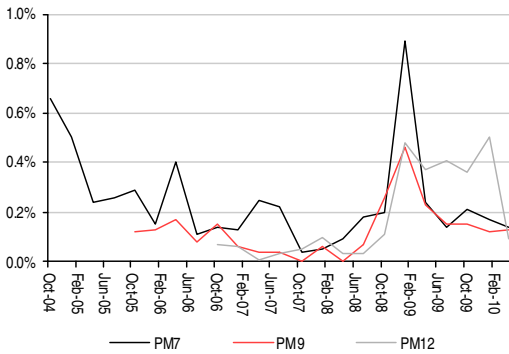
Data published by the CML shows that the number of BTL loans fell by 15% to 22,000 in the first three months of 2010, while the value of lending was down by 12% to GBP2.1bn. Adjusted for the impact of last year's stamp duty holiday, BTL lending was broadly flat.

Low interest rates have continued to result in an improvement in BTL arrears. The number of BTL properties taken into possession in the first quarter of 2010 totalled 1,400, an increase from 1,200 in the preceding quarter but unchanged from the total in 2009. Cases where a receiver of rent had been appointed totalled 11,200 at end-March, down from 11,900 three months earlier but up from 9,200 in Q1 2009.

Prospects for the rental market remain good, but uncertainty over house prices, interest rates and the availability of mortgage funding continue to constrain the BTL market.

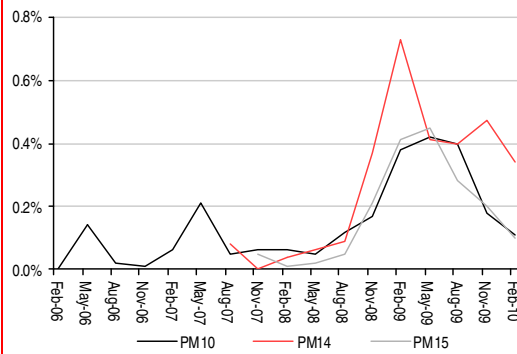
Back-book credit quality trends

Paragon Mortgages Nos. 7, 9, 12 – Arrears > 3 months



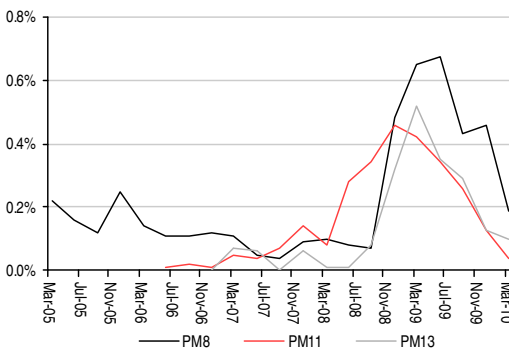
Source: Company information

Paragon Mortgages Nos. 10, 14, 15 – Arrears > 3 months



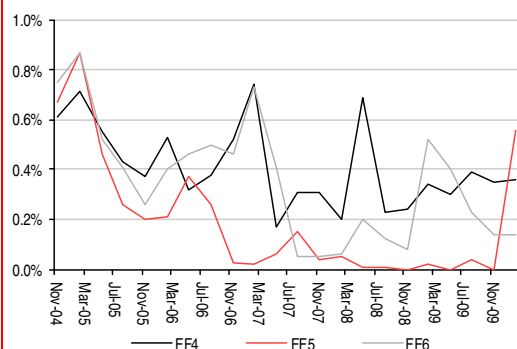
Source: Company information

Paragon Mortgages Nos. 8, 11, 13 – Arrears > 3 months



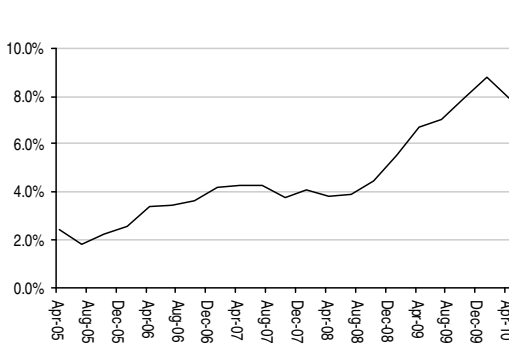
Source: Company information

First Flexible Nos. 4, 5, 6 – Arrears > 3 months



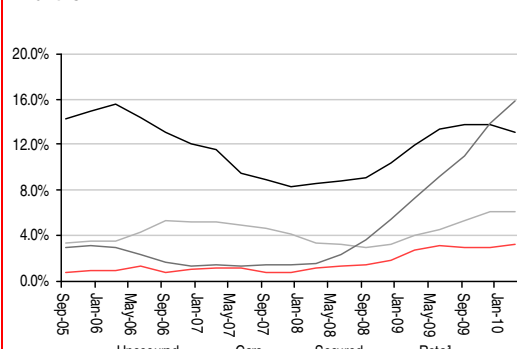
Source: Company information

Paragon Secured Finance (No.1) PLC – Arrears > 3 months



Source: Company information

Paragon Personal and Auto Finance (No.3) PLC – Arrears > 3 months



Source: Company information

Forecasts

- ▶ Our forecasts assume business remains closed to new lending
- ▶ We assume step-ups in ABS coupons will be offset by increased income on capital employed in SPV investments
- ▶ We assume that prepayment rates in BTL remain low

Forecast summary

Our forecasts are summarised in the table below and set out in detail in the following pages.

Forecast summary						
Year to Sep (GBPm)	2010e	2011e	2012e	2013e	2014e	2015e
Operating income	150.6	138.9	130.3	123.1	117.3	112.4
Operating expenses	-41.5	-41.3	-41.2	-41.1	-41.0	-41.0
Pre-provision profit	109.1	97.5	89.0	82.0	76.2	71.4
Provision for losses	-49.6	-40.2	-34.3	-30.8	-27.9	-25.6
Operating profit	59.6	57.4	54.8	51.2	48.3	45.8
Advances	20	20	20	20	20	20
Loan balances	8,956	8,629	8,328	8,049	7,789	7,545
Equity	683.7	714.9	743.5	768.9	791.7	812.0
Diluted EPS (p)	14.3	13.8	13.1	12.3	11.6	11.0
DPS (p)	3.5	3.6	3.8	4.0	4.2	4.4
NAV/share (p)	228	239	248	257	264	271

Source: HSBC estimates

Key assumptions

- ▶ The key assumption underlying these forecasts is that Paragon remains closed to new lending. (The GBP20m pa forecast for advances reflects further advances to existing borrowers within specific securitisations.)
- ▶ At the same time, these forecasts assume that Paragon remains a going concern, positioned for an eventual return to new lending, and not a business in run-off.
- ▶ The result is a decline in income as loan assets repay, but broadly flat expenses as the operating infrastructure is maintained.
- ▶ Prepayment rates: Consistent with our base-case assumption that Paragon remains closed to new lending due to funding constraints, our forecasts for loan balances assume lower-than-average prepayment rates – a 3% pa CPR for FM and a 21% pa CPR for CF.
- ▶ Net interest margins: We have assumed broadly stable net interest margins, with a rising return on group capital employed in securitisation investments that offsets compression in liability spread caused by ABS coupon step-ups triggered in 2010-12.
- ▶ Non-interest margins: Our forecasts assume that non-interest income declines, but at a slower rate than average loan balances as new income sources offset a reduction in loan-related fees and commissions.
- ▶ Impairments: We have assumed a modest improvement in credit quality and a resultant reduction in loan loss impairments as a percentage of average loans. We forecast FM impairments to fall from 35bp in 2009 to 25bp by 2012, and CF impairments to fall from 5.9% in 2009 to 4.5% by 2012.

Paragon Group: forecast summary

Year to September (GBPm)	2008	2009	2010e	2011e	2012e	2013e	2014e	2015e
Income & expenses								
Interest receivable	820.9	508.2	289.2	272.6	258.3	245.8	234.8	225.0
Interest payable	-680.5	-373.4	-153.6	-147.8	-142.5	-137.6	-133.1	-128.8
Net interest income	140.4	134.8	135.7	124.8	115.8	108.2	101.7	96.1
Other income/associates	26.5	16.0	14.9	14.0	14.5	15.0	15.6	16.2
Operating income	166.9	150.8	150.6	138.9	130.3	123.1	117.3	112.4
Operating expenses	-37.8	-39.3	-41.5	-41.3	-41.2	-41.1	-41.0	-41.0
Pre-provision profit	129.1	111.5	109.1	97.5	89.0	82.0	76.2	71.4
Provision for losses	-62.2	-66.2	-49.6	-40.2	-34.3	-30.8	-27.9	-25.6
Operating profit	66.9	45.3	59.6	57.4	54.8	51.2	48.3	45.8
Fair value gains	-5.4	-3.4	0.0	0.0	0.0	0.0	0.0	0.0
Profit before tax	53.7	54.3	59.6	57.4	54.8	51.2	48.3	45.8
Taxation	-16.6	-13.2	-16.7	-16.1	-15.3	-14.3	-13.5	-12.8
Attributable profit	37.1	41.1	42.9	41.3	39.4	36.9	34.7	33.0
Dividend	-2.9	-9.2	-10.0	-10.1	-10.9	-11.4	-12.0	-12.6
Retained earnings	34.2	31.9	32.9	31.2	28.5	25.4	22.7	20.4
Loan growth								
Opening balance	11,035	10,053	9,314	8,956	8,629	8,328	8,049	7,789
Advances	1,126	86	20	20	20	20	20	20
Redemptions	-2,108	-825	-378	-347	-321	-299	-280	-264
Closing balance	10,053	9,314	8,956	8,629	8,328	8,049	7,789	7,545
Average balance	10,544	9,684	9,135	8,792	8,478	8,189	7,919	7,667
Redemption rate	19%	8%	4%	4%	4%	4%	3%	3%
Balance Sheets								
Avg customer loans	10,544	9,684	9,135	8,792	8,478	8,189	7,919	7,667
Customer loans	10,053	9,314	8,956	8,629	8,328	8,049	7,789	7,545
Equity	621.5	650.8	683.7	714.9	743.5	768.9	791.7	812.0
Subordinated debt	117.9	116.8	116.8	116.8	116.8	116.8	116.8	116.8
Intangible assets	0.4	9.6	9.6	9.6	9.6	9.6	9.6	9.6
Tangible equity	621.1	641.2	674.1	705.3	733.9	759.3	782.1	802.4
Ratios								
Net interest margin	1.33%	1.39%	1.49%	1.42%	1.37%	1.32%	1.28%	1.25%
Other income margin	0.25%	0.17%	0.16%	0.16%	0.17%	0.18%	0.20%	0.21%
Total income margin	1.58%	1.56%	1.65%	1.58%	1.54%	1.50%	1.48%	1.47%
Provisions:avg loans	-0.59%	-0.68%	-0.54%	-0.46%	-0.40%	-0.38%	-0.35%	-0.33%
Provisions:pre-provision profit	-48.2%	-59.4%	-45.4%	-41.2%	-38.5%	-37.5%	-36.7%	-35.9%
Cost:income ratio	-22.6%	-26.1%	-27.5%	-29.8%	-31.6%	-33.4%	-35.0%	-36.5%
ROE	10.2%	5.1%	6.4%	5.9%	5.4%	4.9%	4.5%	4.1%
Equity:loans	6.2%	7.0%	7.6%	8.3%	8.9%	9.6%	10.2%	10.8%
Effective tax rate	-30.9%	-24.3%	-28.0%	-28.0%	-28.0%	-28.0%	-28.0%	-28.0%
Per share data								
Reported EPS (p)	17.9	13.9	14.3	13.8	13.2	12.3	11.6	11.0
Diluted adjusted EPS (p)	23.2	10.8	14.3	13.8	13.1	12.3	11.6	11.0
DPS (p)	3.0	3.3	3.5	3.6	3.8	4.0	4.2	4.4
NAV/share (p)	209.2	220.5	228.3	238.7	248.3	256.8	264.4	271.2

Source: Company information, HSBC estimates

Paragon Group: forecasts by division

Year to September (GBPm)	2008	H1 09	H2 09	2009	H1 10	H2 10e	2010e	2011e	2012e	2013e	2014e	2015e
FM												
Net interest income	85.0	52.7	43.3	96.0	49.0	47.8	96.8	94.1	91.5	89.0	86.5	84.2
Other operating income/associates	17.1	6.2	5.2	11.4	3.8	4.0	7.8	7.6	7.4	7.2	7.0	6.8
Total operating income	102.1	58.9	48.5	107.4	52.8	51.8	104.6	101.7	98.9	96.1	93.5	90.9
Operating expenses	-35.2	-14.7	-16.5	-31.2	-15.7	-15.4	-31.1	-31.9	-32.7	-33.4	-34.0	-34.6
Pre-impairment profit	66.9	44.2	32.0	76.2	37.1	36.4	73.5	69.7	66.2	62.8	59.5	56.4
Impairment charge	-10.9	-19.8	-11.7	-31.5	-14.2	-11.7	-25.9	-22.7	-20.4	-19.9	-19.3	-18.8
Operating profit	56.0	24.4	20.3	44.7	22.9	24.6	47.5	47.1	45.8	42.9	40.2	37.6
FV gains/losses	-5.2	-3.0	-0.6	-3.6	-0.9	0.9	0.0	0.0	0.0	0.0	0.0	0.0
Profit before tax	50.8	21.4	19.7	41.1	22.0	25.5	47.5	47.1	45.8	42.9	40.2	37.6
Advances	904	11	15	25	9	11	20	20	20	20	20	20
Customer loans	9,419	8,900	8,764	8,764	8,623	8,521	8,521	8,285	8,057	7,835	7,620	7,412
Average loans	9,872	9,160	9,092	9,092	8,693	8,643	8,643	8,403	8,171	7,946	7,728	7,516
Net interest margin	0.81%	1.09%	0.95%	1.02%	1.11%	1.11%	1.12%	1.12%	1.12%	1.12%	1.12%	1.12%
Total income margin	0.98%	1.22%	1.07%	1.14%	1.19%	1.20%	1.21%	1.21%	1.21%	1.21%	1.21%	1.21%
Expenses/avg loans	-0.36%	-0.32%	-0.36%	-0.34%	-0.36%	-0.36%	-0.36%	-0.38%	-0.40%	-0.42%	-0.44%	-0.46%
Impairments/avg loans	-0.11%	-0.43%	-0.26%	-0.35%	-0.33%	-0.27%	-0.30%	-0.27%	-0.25%	-0.25%	-0.25%	-0.25%
Impairment/pre-imp profit	-16.3%	-44.8%	-36.6%	-41.3%	-38.3%	-32.3%	-35.3%	-32.5%	-30.9%	-31.6%	-32.5%	-33.3%
Expense ratio	-34.5%	-25.0%	-34.0%	-29.1%	-29.7%	-29.8%	-29.8%	-31.4%	-33.1%	-34.7%	-36.4%	-38.0%
CF												
Net interest income	55.4	15.3	23.5	38.8	20.4	18.5	38.9	30.7	24.3	19.2	15.1	12.0
Other operating income	9.4	2.3	2.3	4.6	4.2	2.9	7.1	6.5	7.1	7.8	8.6	9.5
Total operating income	64.8	17.6	25.8	43.4	24.6	21.4	46.0	37.2	31.4	27.0	23.7	21.4
Operating expenses	-10.4	-4.2	-3.9	-8.1	-5.3	-5.0	-10.3	-9.4	-8.5	-7.8	-7.0	-6.4
Pre-impairment profit	54.4	13.4	21.9	35.3	19.3	16.4	35.7	27.8	22.8	19.2	16.7	15.0
Impairment charge	-51.3	-18.9	-15.8	-34.7	-12.5	-11.1	-23.6	-17.5	-13.8	-10.9	-8.6	-6.8
Operating profit	3.1	-5.5	6.1	0.6	6.8	5.3	12.1	10.3	9.0	8.3	8.1	8.2
FV gains/losses	-0.2	0.0	0.2	0.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Profit before tax	2.9	-5.5	6.3	0.8	6.8	5.3	12.1	10.3	9.0	8.3	8.1	8.2
Advances	222	58	2	60	0	0	0	0	0	0	0	0
Customer loans	634	614	550	550	488	435	435	343	271	214	169	134
Average loans	672	624	592	592	519	492	492	389	307	243	192	151
Net interest margin	8.25%	4.90%	7.94%	6.55%	7.86%	7.51%	7.90%	7.90%	7.90%	7.90%	7.90%	7.90%
Total income margin	9.61%	5.64%	8.72%	7.36%	9.48%	8.71%	9.35%	9.56%	10.21%	11.12%	12.39%	14.15%
Expenses/avg loans	-1.55%	-1.35%	-1.32%	-1.37%	-2.04%	-2.05%	-2.10%	-2.42%	-2.78%	-3.19%	-3.67%	-4.22%
Impairments/avg loans	-7.64%	-6.06%	-5.34%	-5.86%	-4.82%	-4.52%	-4.80%	-4.50%	-4.50%	-4.50%	-4.50%	-4.50%
Impairment/pre-imp profit	-94.3%	-141.0%	-72.1%	-98.3%	-64.8%	-67.9%	-66.2%	-63.0%	-60.5%	-56.8%	-51.6%	-45.3%
Expense ratio	-16.0%	-23.9%	-15.1%	-18.7%	-21.5%	-23.5%	-22.5%	-25.3%	-27.2%	-28.7%	-29.7%	-29.9%

Source: Company information, HSBC estimates

Paragon Group: loan growth assumptions by division

Year to September (GBPm)	2008	H1 09	H2 09	2009	H1 10	H2 10e	2010e	2011e	2012e	2013e	2014e	2015e
FM												
Opening balance	10,325	9,419	8,900	9,419	8,764	8,623	8,764	8,521	8,285	8,057	7,835	7,620
Advances	904	11	15	25	9	11	20	20	20	20	20	20
Redemptions	-1,810	-530	-151	-680	-150	-113	-263	-256	-249	-242	-235	-229
Closing balance	9,419	8900	8,764	8,764	8,623	8,521	8,521	8,285	8,057	7,835	7,620	7,412
Average balance	9,872	9,160	8,832	9,092	8,693	8,572	8,643	8,403	8,171	7,946	7,728	7,516
Redemption rate	18%	11%	3%	7%	3%	3%	3%	3%	3%	3%	3%	3%
CF												
Opening balance	710	634	614	634	550	488	550	435	343	271	214	169
Advances	222	58	2	60	0	0	0	0	0	0	0	0
Redemptions	-298	-78	-66	-144	-63	-53	-116	-91	-72	-57	-45	-36
Closing balance	634	614	550	550	488	435	435	343	271	214	169	134
Average balance	672	624	582	592	519	461	492	389	307	243	192	151
Redemption rate	42%	25%	22%	23%	23%	22%	21%	21%	21%	21%	21%	21%
Group												
Opening balance	11,035	10,053	9,514	10,053	9,314	9,111	9,314	8,956	8,629	8,328	8,049	7,789
Advances	1,126	69	17	86	9	11	20	20	20	20	20	20
Redemptions	-2,108	-608	-217	-825	-213	-166	-378	-347	-321	-299	-280	-264
Closing balance	10,053	9,514	9,314	9,314	9,111	8,956	8,956	8,629	8,328	8,049	7,789	7,545
Average balance	10,544	9,784	9,414	9,684	9,212	9,033	9,135	8,792	8,478	8,189	7,919	7,667
Redemption rate	19%	12%	5%	8%	5%	4%	4%	4%	4%	4%	3%	3%

Source: Company information, HSBC estimates

Appendix

Alternative embedded value approach

The following tables set out an alternative approach to valuing Paragon's closed loan books. We attempt to separately value the cash flow and capital backing elements of the two divisional loan books, and add these to current unrestricted cash.

The key assumptions are as follows:

- ▶ Loan book balances are projected out to 2031 based on CPR rates of 5% p.a. for FM and 20% p.a. for CF.
- ▶ Asset margins are based on those reported for the first half of the current year.
- ▶ All cash flows are discounted at 9%.
- ▶ FM loans require equity of 1.9% of loan assets (this is the minimum first-loss percentage for most of Paragon's PM securitisation vehicles).
- ▶ CF loans require equity 7.5% of loan assets (based on the weighted average of the PPAF3 first loss of 9%, and the PSF1 first loss of 4.5%).
- ▶ We allocate capital to each division on the basis of these percentages and estimated average 2011 loan assets.

We then value the business as the sum of: (i) the net present value (NPV) of FM net cash flows plus FM required equity; (ii) the NPV of CF net cash flows plus CF required equity; and (iii) end-March unrestricted cash.

The result is a fair value estimate of 186p per share, 124p of which (68%) is due to the FM division, 17p (9%) to CF, and 42p (23%) to unrestricted cash balances.

Alternative embedded value approach

	GBP	
FM:		
-NPV net cash flows	75	40%
-Equity	52	28%
	124	68%
CF:		
-NPV net cash flows	7	4%
-Equity	10	5%
	17	9%
Unrestricted cash	42	23%
	186	100%

Source: HSBC estimates

Alternatively, 55% of the fair value estimate is due to required equity and unrestricted cash, and 45% to the NPV of forecast net cash flows.

FM – back-book in-force value estimate (5% CPR assumption)

Year to Sep (GBPm)	2011e	2012e	2013e	2014e	2015e	2016e	2017e	2018e	2019e	2020e	2021e	2022e	2023e	2024e	2025e	2026e	2027e	2028e	2029e	2030e	2031e
Opening loan assets	8,521	8,095	7,690	7,306	6,940	6,593	6,264	5,951	5,653	5,370	5,102	4,847	4,604	4,374	4,155	3,948	3,750	3,563	3,385	3,215	3,055
Run-off	-426	-405	-385	-365	-347	-330	-313	-298	-283	-269	-255	-242	-230	-219	-208	-197	-188	-178	-169	-161	-153
Closing assets	8,095	7,690	7,306	6,940	6,593	6,264	5,951	5,653	5,370	5,102	4,847	4,604	4,374	4,155	3,948	3,750	3,563	3,385	3,215	3,055	2,902
Average assets	8,308	7,893	7,498	7,123	6,767	6,429	6,107	5,802	5,512	5,236	4,974	4,726	4,489	4,265	4,052	3,849	3,657	3,474	3,300	3,135	2,978
Asset spread	2.80%	2.80%	2.80%	2.80%	2.80%	2.80%	2.80%	2.80%	2.80%	2.80%	2.80%	2.80%	2.80%	2.80%	2.80%	2.80%	2.80%	2.80%	2.80%	2.80%	2.80%
Liability spread	-1.68%	-1.68%	-1.68%	-1.68%	-1.68%	-1.68%	-1.68%	-1.68%	-1.68%	-1.68%	-1.68%	-1.68%	-1.68%	-1.68%	-1.68%	-1.68%	-1.68%	-1.68%	-1.68%	-1.68%	-1.68%
Net interest margin	1.12%	1.12%	1.12%	1.12%	1.12%	1.12%	1.12%	1.12%	1.12%	1.12%	1.12%	1.12%	1.12%	1.12%	1.12%	1.12%	1.12%	1.12%	1.12%	1.12%	1.12%
Ancillary income	0.09%	0.09%	0.09%	0.09%	0.09%	0.09%	0.09%	0.09%	0.09%	0.09%	0.09%	0.09%	0.09%	0.09%	0.09%	0.09%	0.09%	0.09%	0.09%	0.09%	0.09%
Admin expenses	-0.36%	-0.36%	-0.36%	-0.36%	-0.36%	-0.36%	-0.36%	-0.36%	-0.36%	-0.36%	-0.36%	-0.36%	-0.36%	-0.36%	-0.36%	-0.36%	-0.36%	-0.36%	-0.36%	-0.36%	-0.36%
Credit costs	-0.25%	-0.25%	-0.25%	-0.25%	-0.25%	-0.25%	-0.25%	-0.25%	-0.25%	-0.25%	-0.25%	-0.25%	-0.25%	-0.25%	-0.25%	-0.25%	-0.25%	-0.25%	-0.25%	-0.25%	-0.25%
Net margin	0.60%	0.60%	0.60%	0.60%	0.60%	0.60%	0.60%	0.60%	0.60%	0.60%	0.60%	0.60%	0.60%	0.60%	0.60%	0.60%	0.60%	0.60%	0.60%	0.60%	0.60%
Gross cash flow	49.8	47.4	45.0	42.7	40.6	38.6	36.6	34.8	33.1	31.4	29.8	28.4	26.9	25.6	24.3	23.1	21.9	20.8	19.8	18.8	17.9
Tax	-14.0	-13.3	-13.0	-12.4	-11.8	-11.2	-10.6	-10.1	-9.6	-9.1	-8.7	-8.2	-7.8	-7.4	-7.0	-6.7	-6.4	-6.0	-5.7	-5.5	-5.2
Earnings	35.9	34.1	31.9	30.3	28.8	27.4	26.0	24.7	23.5	22.3	21.2	20.1	19.1	18.2	17.3	16.4	15.6	14.8	14.1	13.4	12.7
Returns:																					
Average assets	8,308	7,893	7,498	7,123	6,767	6,429	6,107	5,802	5,512	5,236	4,974	4,726	4,489	4,265	4,052	3,849	3,657	3,474	3,300	3,135	2,978
Required equity @ 1.8%	157.9	150.0	142.5	135.3	128.6	122.1	116.0	110.2	104.7	99.5	94.5	89.8	85.3	81.0	77.0	73.1	69.5	66.0	62.7	59.6	56.6
Earnings	35.9	34.1	31.9	30.3	28.8	27.4	26.0	24.7	23.5	22.3	21.2	20.1	19.1	18.2	17.3	16.4	15.6	14.8	14.1	13.4	12.7
ROE	23%	23%	22%	22%	22%	22%	22%	22%	22%	22%	22%	22%	22%	22%	22%	22%	22%	22%	22%	22%	22%
Valuation:																					
Discount rate	9%																				
Discount factors	1.138	1.240	1.352	1.474	1.606	1.751	1.909	2.080	2.268	2.472	2.694	2.937	3.201	3.489	3.803	4.145	4.518	4.925	5.368	5.851	6.378
Earnings	35.9	34.1	31.9	30.3	28.8	27.4	26.0	24.7	23.5	22.3	21.2	20.1	19.1	18.2	17.3	16.4	15.6	14.8	14.1	13.4	12.7
PV (earnings)	31.5	27.5	23.6	20.6	17.9	15.6	13.6	11.9	10.4	9.0	7.9	6.9	6.0	5.2	4.5	4.0	3.4	3.0	2.6	2.3	2.0
NPV (earnings)	229.5																				
Shares (m)	304.5																				
NPV/share (GBP)	75																				

Source: HSBC estimates.

CF – back-book in-force value estimate (20% CPR assumption)

Year to Sep (GBPm)	2011e	2012e	2013e	2014e	2015e	2016e	2017e	2018e	2019e	2020e	2021e	2022e	2023e	2024e	2025e	2026e	2027e	2028e	2029e	2030e	2031e
Opening loan assets	435	348	278	223	178	143	114	91	73	58	47	37	30	24	19	15	12	10	8	6	5
Run-off	-87	-70	-56	-45	-36	-29	-23	-18	-15	-12	-9	-7	-6	-5	-4	-3	-2	-2	-2	-1	-1
Closing assets	348	278	223	178	143	114	91	73	58	47	37	30	24	19	15	12	10	8	6	5	4
Average assets	392	313	251	200	160	128	103	82	66	53	42	34	27	22	17	14	11	9	7	6	5
Asset spread	9.60%	9.60%	9.60%	9.60%	9.60%	9.60%	9.60%	9.60%	9.60%	9.60%	9.60%	9.60%	9.60%	9.60%	9.60%	9.60%	9.60%	9.60%	9.60%	9.60%	9.60%
Liability spread	-1.70%	-1.70%	-1.70%	-1.70%	-1.70%	-1.70%	-1.70%	-1.70%	-1.70%	-1.70%	-1.70%	-1.70%	-1.70%	-1.70%	-1.70%	-1.70%	-1.70%	-1.70%	-1.70%	-1.70%	-1.70%
Net interest margin	7.90%	7.90%	7.90%	7.90%	7.90%	7.90%	7.90%	7.90%	7.90%	7.90%	7.90%	7.90%	7.90%	7.90%	7.90%	7.90%	7.90%	7.90%	7.90%	7.90%	7.90%
Ancillary income	1.45%	1.45%	1.45%	1.45%	1.45%	1.45%	1.45%	1.45%	1.45%	1.45%	1.45%	1.45%	1.45%	1.45%	1.45%	1.45%	1.45%	1.45%	1.45%	1.45%	1.45%
Admin expenses	-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%	-2.10%	-2.10%	-2.10%	-2.10%
Credit costs	-4.80%	-4.80%	-4.80%	-4.80%	-4.80%	-4.80%	-4.80%	-4.80%	-4.80%	-4.80%	-4.80%	-4.80%	-4.80%	-4.80%	-4.80%	-4.80%	-4.80%	-4.80%	-4.80%	-4.80%	-4.80%
Net margin	2.45%	2.45%	2.45%	2.45%	2.45%	2.45%	2.45%	2.45%	2.45%	2.45%	2.45%	2.45%	2.45%	2.45%	2.45%	2.45%	2.45%	2.45%	2.45%	2.45%	2.45%
Gross cash flow	9.6	7.7	6.1	4.9	3.9	3.1	2.5	2.0	1.6	1.3	1.0	0.8	0.7	0.5	0.4	0.3	0.3	0.2	0.2	0.1	0.1
Tax	-2.7	-2.1	-1.8	-1.4	-1.1	-0.9	-0.7	-0.6	-0.5	-0.4	-0.3	-0.2	-0.2	-0.2	-0.1	-0.1	-0.1	-0.1	-0.1	0.0	0.0
Earnings	6.9	5.5	4.4	3.5	2.8	2.2	1.8	1.4	1.1	0.9	0.7	0.6	0.5	0.4	0.3	0.2	0.2	0.2	0.1	0.1	0.1
Returns:																					
Average assets	392	313	251	200	160	128	103	82	66	53	42	34	27	22	17	14	11	9	7	6	5
Required equity @ 7.5%	29.4	23.5	18.8	15.0	12.0	9.6	7.7	6.2	4.9	3.9	3.2	2.5	2.0	1.6	1.3	1.0	0.8	0.7	0.5	0.4	0.3
Earnings	6.9	5.5	4.4	3.5	2.8	2.2	1.8	1.4	1.1	0.9	0.7	0.6	0.5	0.4	0.3	0.2	0.2	0.2	0.1	0.1	0.1
ROE	24%	24%	23%	23%	23%	23%	23%	23%	23%	23%	23%	23%	23%	23%	23%	23%	23%	23%	23%	23%	23%
Valuation:																					
Discount rate	9%																				
Discount factors	1.138	1.240	1.352	1.474	1.606	1.751	1.909	2.080	2.268	2.472	2.694	2.937	3.201	3.489	3.803	4.145	4.518	4.925	5.368	5.851	6.378
Earnings	6.9	5.5	4.4	3.5	2.8	2.2	1.8	1.4	1.1	0.9	0.7	0.6	0.5	0.4	0.3	0.2	0.2	0.2	0.1	0.1	0.1
PV (earnings)	6.1	4.5	3.2	2.4	1.7	1.3	0.9	0.7	0.5	0.4	0.3	0.2	0.1	0.1	0.1	0.1	0.0	0.0	0.0	0.0	0.0
NPV (earnings)	22.6																				
Shares (m)	304.5																				
NPV/share (GBP)	7																				

Source: HSBC estimates

Disclosure appendix

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The following analyst(s), economist(s), and/or strategist(s) who is(are) primarily responsible for this report, certifies(y) that the opinion(s) on the subject security(ies) or issuer(s) and/or any other views or forecasts expressed herein accurately reflect their personal view(s) and that no part of their compensation was, is or will be directly or indirectly related to the specific recommendation(s) or views contained in this research report: Tony Cummings

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For each stock we set a required rate of return calculated from the risk free rate for that stock's domestic, or as appropriate, regional market and the relevant equity risk premium established by our strategy team. The price target for a stock represents the value the analyst expects the stock to reach over our performance horizon. The performance horizon is 12 months. For a stock to be classified as Overweight, the implied return must exceed the required return by at least 5 percentage points over the next 12 months (or 10 percentage points for a stock classified as Volatile*). For a stock to be classified as Underweight, the stock must be expected to underperform its required return by at least 5 percentage points over the next 12 months (or 10 percentage points for a stock classified as Volatile*). Stocks between these bands are classified as Neutral.

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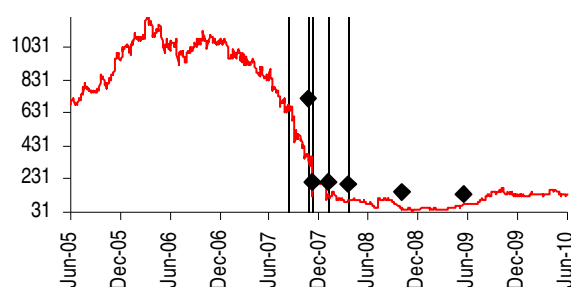
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Share price and rating changes for long-term investment opportunities

Paragon Group of Cos (PARA.L) Share Price performance GBP Vs HSBC rating history



Source: HSBC

Recommendation & price target history

From	To	Date
Overweight	N/A	24 August 2007
N/A	Overweight	06 November 2007
Overweight	Neutral	21 November 2007
Neutral	Neutral (V)	15 January 2008
Neutral (V)	Overweight (V)	02 April 2008
Target Price	Value	Date
Price 1	N/A	24 August 2007
Price 2	717	06 November 2007
Price 3	207	21 November 2007
Price 4	207	15 January 2008
Price 5	200	02 April 2008
Price 6	150	17 October 2008
Price 7	140	28 May 2009

Source: HSBC

HSBC & Analyst disclosures

Disclosure checklist

Company	Ticker	Recent price	Price Date	Disclosure
PARAGON GRP OF COS	PARA.L	1.35	14-Jun-2010	2, 4, 6, 7

Source: HSBC

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