

17 March 2005

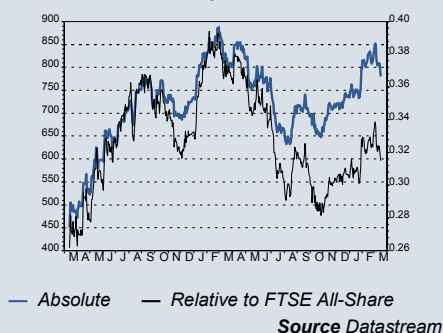
Equity Research

INITIATION OF COVERAGE

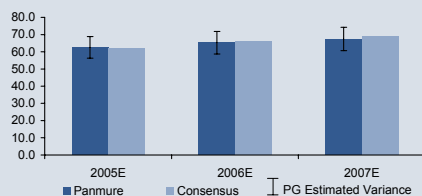
Key Data

Price	782p
Price Target	725p
Market Cap	£1,128m
FTSE All-Share	2,481
Sector	Specialty & Other Finance
Stock codes	GBG.L / CBG LN
Next Event	Final results – 26 Sep
Gearing	Cash

Absolute & relative performance



Panmure Gordon EPS rel to consensus



Source Reuters, Panmure Gordon

CLOSE BROTHERS GROUP

SELL

Tough times ahead

Close faces a number of challenges to medium-term earnings growth. In addition to reduced organic loan growth, the return on loan assets looks set to decline due to recent and forthcoming regulatory changes, and the potential for a return to mid-cycle loan loss provisioning.

- **Reduced banking fees and commissions.** New general insurance regulations look set to reduce insurance income at Close's asset finance businesses, particularly used car finance. We estimate profits at risk of £5m–£10m.
- **Reduced early redemption income.** The abolition of the Rule of 78 in May is likely to reduce the group's consumer credit net interest margins. We estimate profits at risk of around of £5m.
- **Rising loan loss provisions.** Currently at the bottom of management's 'across the credit cycle' 1–2% range, a reversion to mean loan loss provisioning would equate to a £10m increase in the provisions charge.
- **Buying loan growth.** Close recently raised €500m in debt finance and in January purchased £200m of loan assets, which should help offset some of the structural and cyclical headwinds it currently faces.
- **Valuation.** Our forecasts incorporate some deterioration in banking returns due to regulation and rising provisions, but less than implied by our earnings at risk analysis. Based on our sum of the parts, we consider 725p a fair value for the shares.

Year end	Income	PBTA	EPS	PE	DPS	Yield
July	(£m)	(£m)	(p)	(x)	(p)	(%)
2004A	401.2	118.9	57.1	13.7	27.0	3.5
2005E	448.7	131.1	62.5	12.5	28.0	3.6
2006E	478.9	136.7	65.3	12.0	30.0	3.8
2007E	512.5	141.1	67.4	11.6	32.0	4.1

Source Company Data, Panmure Gordon

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INVESTMENT CASE

Close's diversified and countercyclical blend of banking and investment banking businesses has in the past protected group earnings from adverse conditions in any one business unit. Currently, however, Close faces a number of challenges that together could compromise its earnings growth outlook.

Banking faces structural and cyclical headwinds

The banking division, which accounts for approximately half the group's profits, faces a number of challenges.

- The FSA's new general insurance regulations, introduced in January, look set to reduce insurance broking profits in Close's asset finance businesses, particularly used car finance (we estimate profits at risk of £5m–£10m).
- The abolition of the Rule of 78 in May will reduce the 'early redemption' element of consumer credit net interest margins (profits at risk estimated at some £5m).
- Currently at the bottom of management's 'across the credit cycle' 1–2% range, a reversion to mean loan loss provisioning would equate to a £10m increase in the provisions charge.

Investment banking is more difficult to predict

A slowdown at the banking division will shift responsibility for growth to the investment banking activities, which are by nature market-sensitive and whose earnings are therefore more difficult to predict. Robust market volumes and rising equity markets augur well for a pick-up in Market-Making profits, although recent private equity realisations, which buoyed first half Asset Management earnings, cannot be relied upon to recur.

Buying growth is more dependable

Unable to depend upon market-sensitive activities to drive earnings growth, Close has put its surplus capital to good use. Since the beginning of 2005, Close has purchased a £133m used-car loan book from Singer & Friedlander and £68m of loans when it acquired Cattles' commercial asset finance business. Our forecasts factor in a contribution to banking division profits from these acquisitions of around £3m in the second half, and £6m next year, thus offsetting some of the impact of regulation and a 'reversion to mean' loan loss provisioning.

The outlook is for lower growth and reduced visibility

The quid pro quo of increased reliance on market-sensitive earnings and/or acquisitions is reduced visibility (and hence quality?) of Close's earnings, which could weigh on the rating. Based on our DCF and sum-of-the-parts analysis, we consider 725p fair value for the shares. This equates to 11.6x our 2005E estimate and 11.1x 2006E, and at that level the shares would yield a prospective 3.9%.

CATALYSTS

- News flow from other consumer finance businesses regarding the impact of regulation on their businesses.
- News flow from other lenders on credit quality and provisioning.
- Stock market volumes. The LSE publishes detailed monthly data on market activity, a key driver behind profitability at Winterflood.
- Final results for the year to July 2005 will be announced in September. To date, the company has not published pre-close trading statements.

RISKS

The main risk to our cautious stance on Close is better than forecast earnings growth.

Less impact from regulation

Since new insurance broking regulation was introduced in January, and with changes to the Consumer Credit Act coming in May, there is little empirical evidence of the impact of these changes on corporate earnings. The used-car dealers that are part of Close's motor finance network may choose to become regulated and hence be able to sell finance-associated insurance products as before. In addition, Rule of 78 may be replaced with other early redemption charges.

Winterflood recovery

Market-Making profits are linked to market direction and new issuance activity as well as secondary market volumes. A significant pick-up in private client investor activity could result in better than forecast earnings growth. A decision by the LSE not to extend SETSmm would be positive for both earnings and sentiment.

Asset management growth

New management has been appointed to coordinate what has been to date a fairly disparate group of asset management activities. Improved efficiency, marketing and/or investment performance, together with stronger than expected stock markets, could result in better than forecast profits from this division.

Private equity realisations

The first half saw 'notable realisations' from Close's private equity investments. Our forecasts for asset management assume lower investment gains, and hence better than expected private equity returns would underpin group results ahead of our estimates.

Purchased loan book growth

Slower organic loan growth implies reduced working capital strain and hence increased surplus capital generation. We estimate that surplus capital generation over the next two years would allow Close to purchase an additional £600m in loans while maintaining its 12% banking tier-1 ratio.

OUR CENTRAL CASE

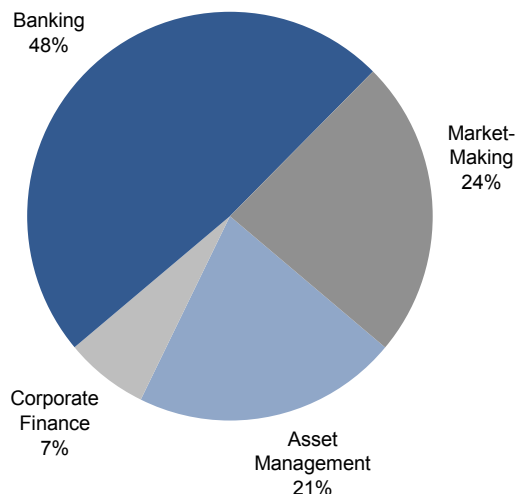
Close faces a number of challenges to earnings growth over the next couple of years. In addition to reduced organic loan growth, the group's return on loan assets looks set to decline as a result of recent and forthcoming regulatory changes, and the potential for a return to mid-cycle loan loss provisioning.

BANKING AND INVESTMENT BANKING

Close combines corporate and consumer credit with market-making, asset management and corporate finance

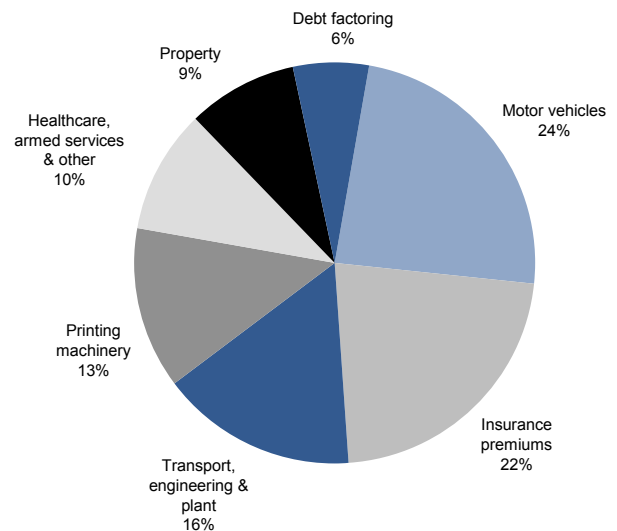
Close is a diversified banking and investment banking business operating in a number of high-margin niches. The banking division maintains a diversified spread of loan assets on its balance sheet, and focuses on specialist corporate lending and consumer finance. Around 80% of the loan book is fixed rate, about three-quarters of which is hedged using interest rate swaps. The majority of the loans are to SMEs, the main exception being the used-car business (Close Motor Finance), which accounted for 24% of the book at end-January 2005.

Profit by division*: half-year to end-January 2005



* Before central costs

Banking division loan book: end-January 2005



Source Company, Panmure Gordon

Banking accounted for 48% of pre-central cost profit mix in the half-year to January 2005, while the 'investment banking' businesses accounted for 52%. Of these, market-maker Winterflood Securities (WINS) was the largest, followed by Asset Management.

BANKING: FACING STRUCTURAL & CYCLICAL HEADWINDS

Banking faces structural and cyclical challenges which look set to reduce returns on loan assets

The company's banking division is currently facing a number of structural and cyclical headwinds which, given the division's importance to total profits, look likely to weigh heavily on the group's medium-term growth outlook.

Regulation & margin erosion

The structural headwinds relate to new insurance and consumer credit regulation

The key regulatory issues relating to Close Brothers are:

- **Insurance broking.** New regulations introduced in January have yet to be fully reflected in Close's results; however, the primary impact is likely to be seen in those of the group's lending businesses that also earn insurance broking commissions. Close Motor Finance in particular is likely to be affected.

The cyclical headwinds are reduced loan growth and rising loan loss provisions

- **Consumer credit.** Changes to the Consumer Credit Act to be introduced at the beginning of June will affect all of Close's businesses that apply the Rule of 78 in calculating interest paid and principal outstanding on loans redeemed early.

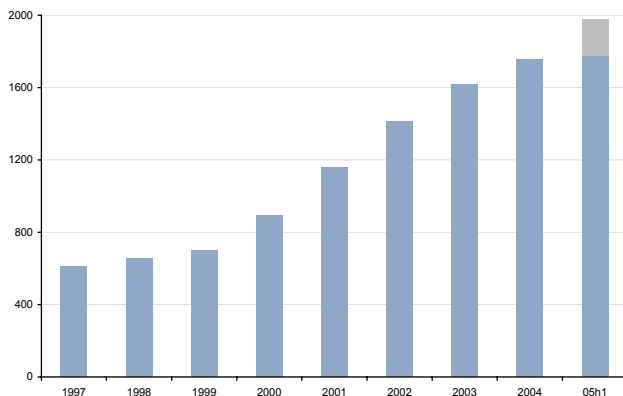
The first is set to reduce banking fees and commissions. The second looks likely to reduce the division's net interest margin.

Mean reversion in loan growth & provisions

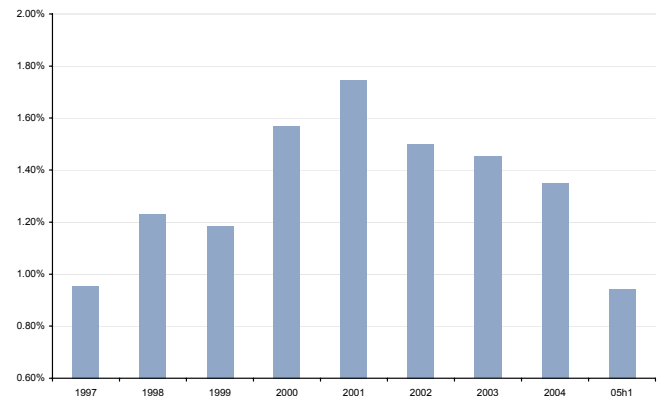
Organic loan growth slowed to only 6% in the first half this year, following growth rates of 22%, 15% and 9% in the last three full years. Strong loan growth in 2002–04 was driven by particularly strong growth at premium financing, as insurance premium inflation plus rising customer numbers turbocharged loan book growth. The more recent softening of premiums has had the opposite effect, resulting in very low growth from a segment which now accounts for more than a fifth of the total loan book.

Provisions as a percentage of average loans are now at a seven-year low. Management has long talked of a 1–2% 'risk tendency' for loan loss provisions.

Loan growth: organic plus purchases (£m)



Provisions/average loans (%)



Source Company

We can derive a more detailed income and expenses breakdown than in Close's statutory disclosures

Deriving a more detailed income breakdown

Close's divisional disclosure provides only operating income and operating profit by division (and net assets in its annual report and accounts). However, we can derive more detailed divisional income and expense accounts from the group's consolidated presentation if we are willing to make the following assumptions:

- that all provisions for loan losses are attributable to the banking division;
- that all of Winterflood's income is dealing income, and that any group dealing income in excess of Winterflood's income is attributable to asset management (e.g. market-making in in-house retail funds);
- that most of the group's 'other income' is asset management income (private equity realisations and/or other investment gains). We allocate some 'other income' to Banking to reflect operating lease rental income within Close Asset Finance. In the year to July 2004 this was £1.058m (2003: nil);
- that all of the Corporate Finance division's income is fee & commission income.

Based on these assumptions, we derive the following income and expenses breakdown for Banking.

Banking: income & expenses* (£m)

Year end July	2002A	2003A	04H1	04H2	2004A	05H1	05H2E	2005E	2006E	2007E
Net interest income	109.9	124.4	67.5	64.8	132.3	68.6	77.7	146.2	161.6	169.2
Net fees & commissions	27.2	33.2	18.0	23.1	41.1	21.7	15.3	37.0	33.0	33.0
Other operating income	0.0	0.0	0.0	1.1	1.1	1.0	1.0	2.0	2.0	2.0
Total operating income*	137.1	157.6	85.5	88.9	174.4	90.4	94.8	185.2	196.6	204.2
Operating expenses	-62.8	-72.7	-40.7	-41.2	-82.0	-46.4	-48.1	-94.5	-98.3	-102.1
Pre-provision profit	74.3	84.9	44.8	47.7	92.4	44.0	46.8	90.8	98.3	102.1
Provisions	-19.3	-22.0	-10.4	-12.4	-22.8	-8.8	-11.2	-20.0	-24.6	-30.6
Operating profit	55.1	62.9	34.4	35.3	69.7	35.2	35.6	70.8	73.7	71.5
Customer loans	1,411	1,616	1,684	1,757	1,757	1,978	2,062	2,062	2,166	2,274
Net assets	208.8	209.7			228.5			265.1	277.5	290.5
Net interest/avg loans (%)	8.5	8.2	8.2	7.5	7.8	7.3	7.7	7.7	7.6	7.6
Income/avg loans (%)	10.5	10.4	10.4	10.3	10.3	9.7	9.4	9.7	9.3	9.2
Provisions/avg loans (%)	-1.48	-1.45	-1.26	-1.44	-1.35	-0.94	-1.11	-1.05	-1.16	-1.38
Provisions/pre-provision profit (%)	-25.9	-25.9	-23.2	-26.0	-24.6	-20.0	-23.9	-22.0	-25.0	-30.0
Expense ratio (%)	-45.8	-46.1	-47.6	-46.4	-47.0	-51.3	-50.7	-51.0	-50.0	-50.0
Net assets/customer loans (%)	14.8	13.0			13.0			12.9	12.8	12.8
Pre-tax RoAvgNAV (%)	27.5	30.1			31.8			28.7	27.2	25.2

*Operating income breakdown estimated

Source Company, Panmure Gordon

Note: The 05H1 margins on unweighted average loans as calculated above do not take into account the group's purchase of around £200m of loans towards the very end of the half-year. Based on weighted average loans, we estimate an underlying net interest margin of 7.7%, a total income margin of 10.1% and a provisions to loans charge of 1.0% (the latter as reported by the company in its interim results).

Our analysis suggests the following.

- Last year, around £40m (23%) of the division's £174m of total income was due to fees and commissions (e.g. arrangement/administrative fees and finance-related insurance commissions).
- Accordingly, Banking's 2004 total income margin on average loans of 10.3% can be segmented into a net interest margin of 7.8% and non-interest income margin of 2.5%;
- The division's provision charge last year amounted to 25% of pre-provision profits, and 20% in the six months to January 2005 (as compared with 21% for HBOS, 19% for Barclays and 18% for Royal Bank of Scotland in calendar 2004).

We use this breakdown to quantify the potential impact on Banking profits of new regulation and rising provision.

Income and profit at risk

We estimate Close earned more than £40m in finance related fees & commissions last year

Insurance broking commissions. Since new insurance broking regulation will make it more difficult for used-car dealers to 'broke' associated insurance products – credit protection and GAP insurance – at the point of sale, and since (excluding the S&F loan book purchase) used cars accounts for around 20% of the loan book, pro-rating banking fees and commissions across the loan assets suggests used-car-related insurance commissions of around £5m-£10m p.a. could be at risk from H2 FY2005 onwards.

The Rule of 78 has boosted consumer credit margins on loans repaid early

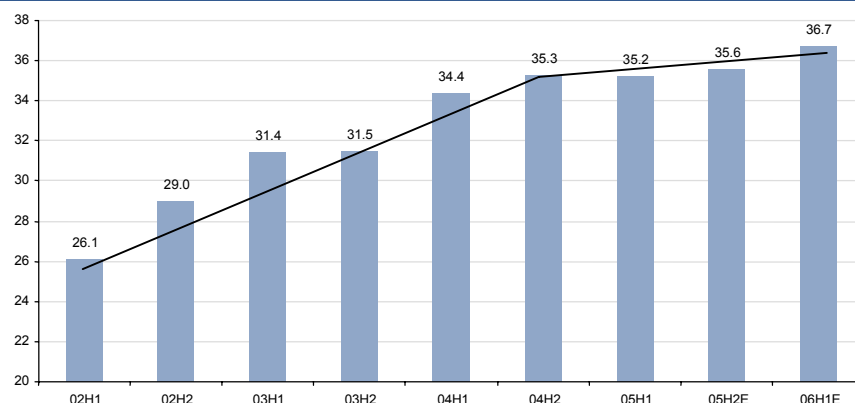
Early redemption income. The abolition of the Rule of 78 is likely to affect Close's net interest margins. Industry-wide, it is estimated that a substantial proportion of unsecured loans are repaid early (the DTI estimates 40%-plus; Datamonitor has estimated as much as 70%). We estimate that a 4-year Close Motor Finance car loan repaid after three years earns a little over 1% more than a loan held to maturity. Given the size of Close's car loan book, a prepayment experience in line with Datamonitor's estimate could put 'early redemption' income of up to £5m p.a. at risk from June onwards.

In total, we estimate that up to £20m of Close's profits are 'at risk' to regulatory change and a reversion to mid-cycle provisioning

Provisions. With a £2bn end-January loan book, a 50bp rise in the provisions charge (a reversion to mean, or mid-cycle provisioning) would imply a £10m increase in the provision charge.

Hence, according to our estimates, the combined impact of reduced net interest income due to the loss of Rule of 78 early redemption income, reduced lower insurance-related commissions following CP187, and the outlook for mean reversion in provisioning translates into annual banking division earnings at risk of around £20m (some 30% of the division's profits and 15% of the group's).

Banking profits: a lower growth outlook (£m)



Source Company, Panmure Gordon

The outlook for slower growth in Banking profits will focus attention on the Investment Banking businesses

INVESTMENT BANKING: MARKET-SENSITIVE AND MORE VOLATILE

The medium-term outlook for slower growth at the banking division has shifted responsibility for growth to the investment banking activities, which are by nature market-sensitive; hence their earnings are more difficult to predict.

We consider the prospects for these businesses in turn below.

Market-Making: highly market-sensitive

Accounting for 28% of last year's profit before central costs, and 24% in the first half this year, Winterflood (WINS) is the second largest contributor to profit after banking, and potentially the division most likely to make up for reduced banking earnings growth.

Formed in 1988 and owned by Close since 1993, Winterflood is a market-maker in more than 5,000 different securities including some 2,600 UK equities (from AIM to FTSE100 plus about 500 investment trusts, all of which are available on the company's 'Winner' electronic dealing service), UK gilts, preference shares and corporate bonds, and selected Continental European and North American equities. WINS' main business is that of a retail service provider (RSP) to its core client base, the private client stockbrokers.

Market-making profits are driven by retail stock market volumes and average profit per trade

Earnings drivers. WINS' profits are driven by the number of bargains/deals it transacts multiplied by the average profit earned per bargain. (The business has highly variable staff costs and hence the operating profit margin has been relatively stable.)

Bargains transacted. The number of 'retail' bargains (we define these as non-FTSE100 UK equity market bargains of less than £10,000 in value) has in the past proved to be a reasonable proxy for bargain volumes at Winterflood itself.

Profit per bargain. The average profit per bargain at Winterflood is driven by many factors, including:

Since Winterflood holds market-making inventory on its balance sheet, its profits are also linked to market direction

- bid-offer spread, which is driven by business mix (the smaller/less liquid the stock, the higher the spread, usually), and spread trends generally (which reflect competitive conditions, e.g. new entrants, the introduction of SETSmm);
- market direction, since WINS generally carries net long positions (in equities and bonds, see the table below), which should earn principal profits in rising markets (hence improving average profit per bargain);
- new issuance activity, since IPO stocks tend to be priced to show a healthy premium in early trading.

Market-Making: net equity and bond positions (£m)

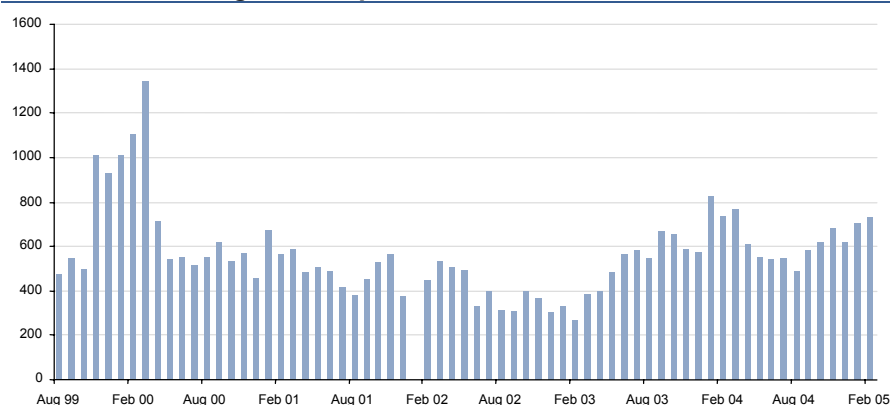
Six months to:	Jan 03	Jul 03	Jan 04	Jul 04	Jan 05
Equities – long positions	30.4	24.4	41.3	34.7	41.2
Equities – short positions	-7.4	-19.4	-10.3	-14.4	-19.9
Net equity position	23.0	5.0	31.0	20.3	21.3
Bonds – long positions	53.6	60.7	50.3	54.5	56.0
Bonds- short positions	-46.1	-54.1	-47.9	-52.8	-45.4
Net bond position	7.5	6.6	2.4	1.7	10.6

Source Company

Retail bargain volumes have in the past been a good indicator of activity levels at Winterflood

The chart below shows UK 'retail' equity bargain volumes since the beginning of the group's financial year to July 2000.

Non-FTSE 100 bargains of up to £10,000 in value



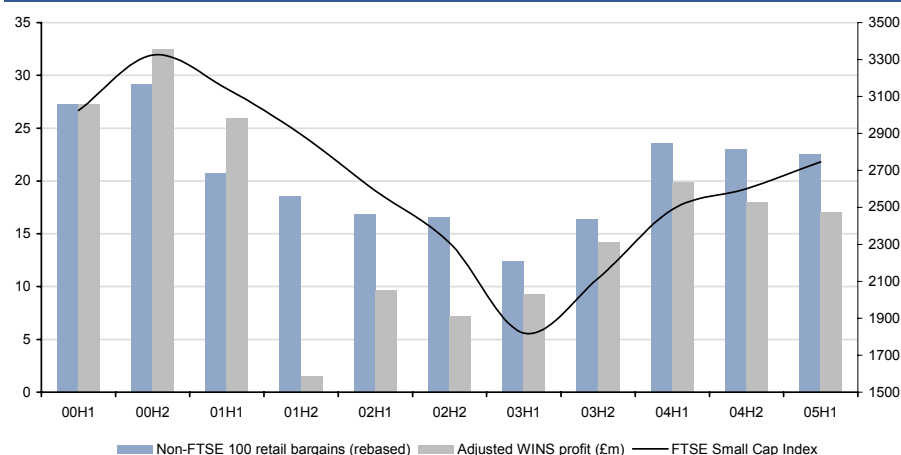
Source London Stock Exchange

This clearly highlights the impact on bargain volumes of the dot-com boom in 1999–2000. WINS contributed profits of £109m that year, £50m of which management described as 'exceptional'.

Winterflood's profits show correlation with retail volumes and market direction

In the following chart we compare the above volume data (aggregated into six-monthly totals to match Close's half-years) with WINS' 'pre-exceptional' profit – stated profit less the £50m 'exceptional' in FY2000 spread equally over the two half-years. We have overlaid the FTSE Small Cap Index to give some idea of market direction. The chart highlights the sensitivity of Winterflood's profits to market volumes and direction.

'Pre-exceptional' Winterflood profits, market volumes & direction



Source Company, London Stock Exchange, Datastream

Extending SETSmm into the Small Cap and AIM stocks could threaten Winterflood's business model

A decision from the LSE seems imminent

The outlook is for strong underlying growth from Asset Management; however, first half profits were flattered by investment gains

Competitive backdrop: SETSmm

The London Stock Exchange's SETSmm trading service for mid-cap stocks has been seen as a possible reason for somewhat disappointing results from WINS. However, according to Close's management, SETSmm has had little impact since it is focused on the upper end of the mid-cap spectrum, as compared with WINS' focus on small-cap and AIM stocks.

Looking forward, SETSmm could become more of a threat, since the LSE proposes to extend SETSmm to include FTSE small caps and the more liquid AIM stocks. A final decision has been deferred until the end of a consultation period with retail stockbrokers and the outcome of some external research. Since this was due to be completed by 18 February, a decision by LSE seems imminent.

In conclusion, the near-term outlook for WINS is far from clear. Based on February's solid equity market volumes and the rise in the FTSE Small Cap index since the end of January, the second half of the current year looks to have started well for WINS.

Asset Management: private equity gains have reduced visibility

The doubling of the division's first-half profits offset disappointing performances from Banking and Market-Making, and increased the Asset Management contribution to group operating profits from 13% in 2004 to 21% in H1 2005. However, since management commented that the first half result included 'some notable realisations' from private equity, we do not extrapolate this performance into the second half or into 2006E.

The main realisation resulted from the sale by Close Brothers Private Equity (CBPE) of Park Resorts to ABN Amro Capital Partners for £165m. CBPE, a Limited Partnership in which the group has an undisclosed economic interest, reported a return of close to 8x its original £12.25m investment, which implies a gain of around £100m. We have guesstimated that a 5% share of this – about £5m – was booked in Close's first half. Lumpy, but less than 10% of Close's total H1 PBT of £65m, and hence not quite material enough to be reported as an exceptional item. Nevertheless, as CBPE's most successful investment, the chances of a repeat performance over the near term are slim, in our opinion.

As a result, we forecast something of a flat year for asset management next year (to July 2006E), reflecting continued strong fee income growth offset by reduced 'other income'.

Asset Management: income & expenses* (£m)

Year to July	2002A	2003A	04H1	04H2	2004A	05H1	05H2E	2005E	2006E	2007E
Net fees & commissions	62.7	60.5	35.4	48.0	83.4	44.7	50.8	95.5	107.9	120.1
Dealing income	1.8	2.0	1.7	1.6	3.3	3.5	3.5	7.0	7.0	7.0
Other operating income	1.5	3.1	1.5	4.7	6.2	9.6	4.4	14.0	8.0	8.0
Total operating income	66.0	65.6	38.6	54.3	92.9	57.3	59.2	116.5	122.9	135.1
Operating expenses	-50.1	-57.5	-31.4	-44.1	-75.5	-42.1	-47.6	-89.7	-98.3	-108.1
Operating profit	15.9	8.1	7.2	10.2	17.4	15.2	11.6	26.8	24.6	27.0
Assets under management	3,100	3,700	5,000	5,500	5,500	6,100	6,325	6,325	6,958	7,653
Net assets	120.3	136.9			136.3			136.3	136.3	136.3
Income/ avg AUM (%)	2.13	1.93	1.77	2.07	2.02	1.98	1.91	1.97	1.85	1.85
Expense ratio (%)	-75.9	-87.7	-81.3	-81.2	-81.3	-73.5	-80.4	-77.0	-80.0	-80.0
Pre-tax RoAvgNAV (%)	13.5	6.3			12.7			19.7	18.0	19.8

*Operating income breakdown estimated

Source Company, Panmure Gordon

A good business, but too small to make a significant impact at the group level

Corporate Finance

Close's purchase of the bulk of this business from Lloyds TSB for £1m in 1996 was a great deal but, since Corporate Finance consistently accounts for less than 10% of the profit mix, it would need to double or treble its profits to offset banking division profits potentially at risk.

BUYING GROWTH INSTEAD

Unable to count on further strong Investment Banking growth, management has leveraged the balance sheet and bought loan growth

Last November, Close issued a €500m (about £350m) floating rate note, priced at a 24bp spread over 3-month Euribor. By early January, it had purchased a £133m used-car loan book from Singer & Friedlander (for £131m) which will be run off over the next two years. A week later, Close bought £68m of additional loans when it acquired Cattles' commercial asset finance business for a £2m premium to net assets. These transactions boosted Close's loan growth from an organic 6% to an actual 11%, and our forecasts factor in a contribution of around £3m to banking profit in the second half, and £6m next year, thus mitigating some of the impact of regulation and a 'reversion to mean' loan loss provisioning.

Internal capital generation

Surplus capital generation over the next two years will support additional purchases if needed

One of the consequences of slowing loan growth is a reduced 'working capital' requirement (retained earnings required by the banking division to maintain an equity:loans ratio of around 12%) and hence, in principle, an accumulation of surplus capital within the group.

As shown below, we forecast surplus capital generation of around £80m in the three years to July 2007 (the S&F and Cattles purchases reduced surplus capital generation in the current year). Based on the 8x leverage, this capital generation could support additional loan book purchases amounting to £300m in each of FY2006 and FY2007.

Surplus capital generation (£m)

Year to July	2002A	2003A	2004A	05H1	05H2E	2005E	2006E	2007E
Retained earnings	7.9	13.8	26.7	27.6	14.1	41.7	51.2	51.5
Loan growth	254.6	204.6	141.5	221.1	84.3	305.4	103.1	108.3
Working capital (at 12%)	-30.6	-24.6	-17.0	-26.5	-10.1	-36.7	-12.4	-13.0
Surplus capital generation	-22.7	-10.8	9.8	1.0	4.0	5.0	38.9	38.5

Source Company, Panmure Gordon

SUMMARY: LOWER GROWTH, REDUCED VISIBILITY

Regulatory and cyclical headwinds do not bode well for organic banking profits in 2006E and 2007E. Hence we are reliant upon market-sensitive investment banking businesses and/or loan book purchases for medium-term earnings

growth. The quid pro quo of increased reliance on market-sensitive earnings and/or acquisitions is reduced visibility (and arguably quality) of Close's earnings. This combination of lower growth and reduced visibility could weigh on the group's rating.

Based on our DCF and sum-of-the-parts analysis, we think 725p per share represents fair value. This equates to 11.6x our 2005E estimate and 11.1x 2006E, and at that level the shares would yield a prospective 3.9%.

ANALYSIS OF FORECASTS

In the absence of additional Banking acquisitions, we expect a shift in the earnings mix towards Investment Banking

We forecast Banking ROA to fall from last year's 2.9% to 2.3% by 2007E

Our forecasts for Banking incorporate some reduction in returns to reflect regulatory changes and rising provisions, but less than implied by our earnings at risk analysis. For Investment Banking, we forecast a strong recovery in earnings at Winterflood, offset by lower private equity profits in Asset Management.

Banking

The key assumptions are modest organic loan growth (we assume 5% for 2006E and 2007E), and reduced returns on loan assets. We forecast a modest decline in the division's net interest margin, to reflect the loss of some 'early redemption' interest. For non-interest income, we are forecasting a reduction of £4m this year and a further £5m in 2006E to reflect the impact of new general insurance regulations.

We forecast the provisions charge to grow faster than average loans, leading to an increase in the provisions to loans ratio from 1.0% in the first half of the current year to 1.4% by 2007E.

Banking: analysis of returns on average loans (%)

Year to July	2002A	2003A	2004A	2005E	2006E	2007E
Net interest income (%)	8.5	8.2	7.8	7.7	7.6	7.6
Net fees & commissions (%)	2.1	2.2	2.4	1.9	1.6	1.5
Other operating income (%)	0.0	0.0	0.1	0.1	0.1	0.1
Total operating income (%)	10.5	10.4	10.3	9.7	9.3	9.2
Operating expenses (%)	-4.8	-4.8	-4.9	-4.9	-4.7	-4.6
Pre-provision profit (%)	5.7	5.6	5.5	4.8	4.7	4.6
Provisions (%)	-1.5	-1.5	-1.4	-1.0	-1.2	-1.4
Operating profit (%)	4.2	4.2	4.1	3.7	3.5	3.2
Tax (%)	-1.3	-1.2	-1.2	-1.1	-1.0	-1.0
Net profit (%)	3.0	2.9	2.9	2.6	2.4	2.3
ROA (%)	3.0	2.9	2.9	2.6	2.4	2.3
Leverage (loans/NAV)	6.5	7.2	7.7	7.7	7.8	7.8
ROE (%)	19.3	21.1	22.3	20.1	19.0	17.6

Source Panmure Gordon

We forecast strong growth in AUM and in management fees; however, we assume a lower private equity investment gains going forward

Solid volumes and rising markets bode well for continued growth at Winterflood

Asset Management

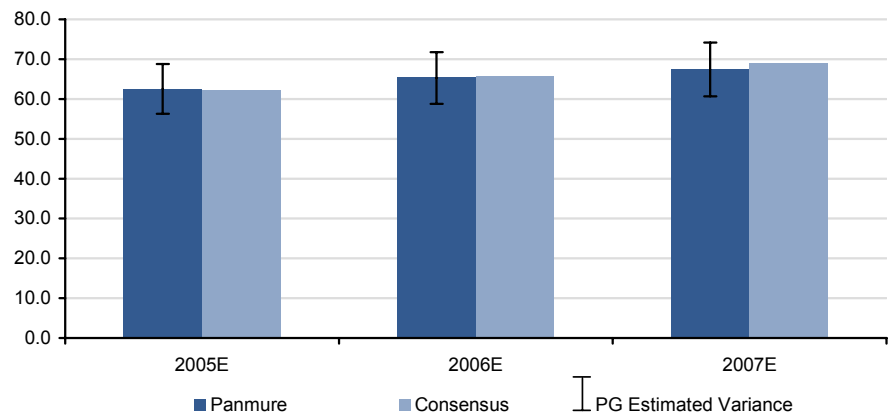
We forecast 15% growth in AUM for the full year this year, following strong growth in H1. For 2006E and 2007E we forecast AUM growth of 10%. We forecast a broadly maintained management fee margin on average AUM (we estimate 1.6% for the first half). However, we factor in a reduction in the total income margin on AUM since we do not forecast private equity profits of the size the division looks to have earned in the first half. Our profit estimates assume an operating profit margin reverting to 20% in the second half (it was 26.5% in the first half) and onward, reflecting reduced investment equity gains.

Market-Making

We forecast a strong recovery in profits at Winterflood during the second half of the current year, reflecting solid equity market volumes and what is traditionally the stronger of the two halves. For 2006E and 2007E, we forecast profits growing by 13% and 10% respectively.

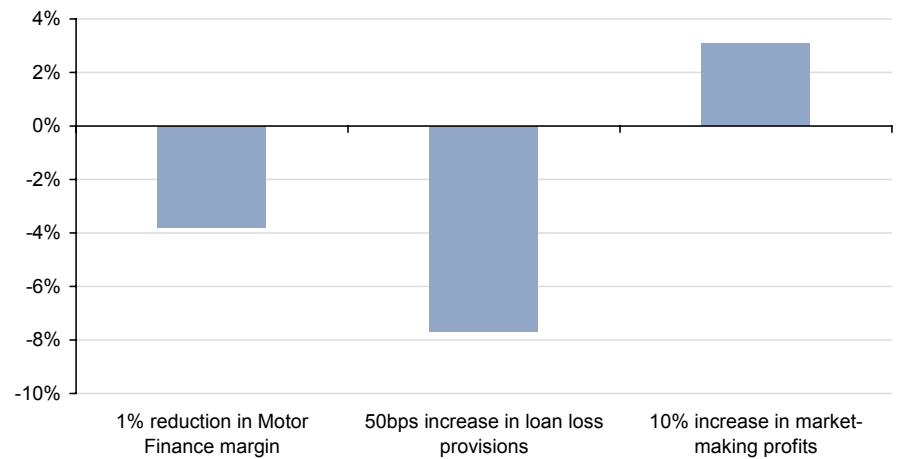
Our estimates are broadly in line with the current market consensus. In terms of mix, we believe we are less positive on Banking and more positive on Investment Banking

Panmure Gordon relative to consensus forecasts (EPS, p)



Source Reuters, Panmure Gordon

Sensitivities for Panmure Gordon 2005E forecasts



Source Panmure Gordon

Net interest and non-interest margins and loan loss provisions are the key sensitivities within the Banking division. Stock market activity is the key driver at Market-Making

Combining DCF with sum-of-the-parts, we derive a fair value estimate for the shares of around 725p

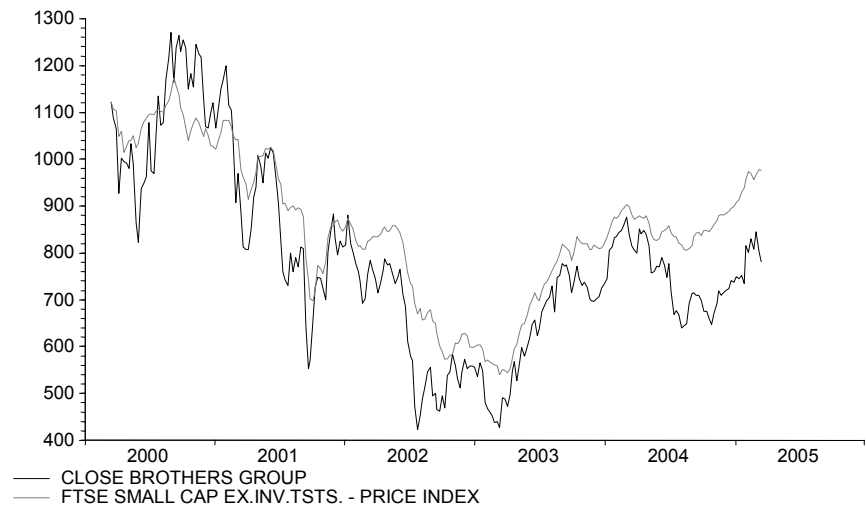
Close has shown strong correlation with the FTSE Small Cap Index

VALUATION

We value Close Brothers on a sum-of the-parts basis, incorporating DCF valuations for Banking and Asset Management divisions. Based on relatively cautious longer-term growth assumptions, particularly for Banking, we derive a current fair value for the shares of around 725p.

A PROXY FOR UK SMALL COMPANIES?

Close Brothers: a proxy for UK smaller companies?



Source Datastream

As shown above, Close's share price has shown a strong correlation with the UK Small Cap Index. Since both Banking (loan growth and credit quality) and Corporate Finance earnings reflect the fortunes of UK SMEs, this is not altogether surprising. The group's underperformance since the beginning of 2004 is could be due to concerns over Market-Making and the impact of SETSmm (launched in late 2003).

We value the Banking and Asset Management divisions on a similar discounted free cash flow basis

VALUATION

Banking

Our discounted free cash flow analysis is set out below. The key assumptions are:

- Our detailed forecasts for operating profits and loan growth out to 2007E. We have taxed profits at 30% and apportioned £1.5m of our forecast for the group minority charge of £2.2m to Banking.
- We project net operating profit after tax (NOPAT) forward for another 10 years based on sustainable loan growth and return assumptions. We have cautiously assumed 4% loan growth and a reduction in the NOPAT return on average loans to 2.1% by 2008 (2.5% in 2005E).
- We 'charge' 12% of annual loan growth to operating profits in deriving free cash flow estimates to reflect the marginal capital requirement of this growth.
- We calculate a terminal value based upon a 9% cost of capital and zero growth (i.e. a terminal PE of 11.1x).

Banking: DCF valuation (£m)

Steady state loan growth (%)	4													
Steady state ROA (%)	2.100													
Discount rate (%)	9													
Terminal multiple	11.1													
	2005E	2006E	2007E	2008E	2009E	2010E	2011E	2012E	2013E	2014E	2015E	2016E	2017E	Terminal
Average loans	1,910	2,114	2,220	2,309	2,401	2,497	2,597	2,701	2,809	2,921	3,038	3,159	3,286	3,286
Asset growth (%)	17	5	5	4	4	4	4	4	4	4	4	4	4	
Operating profit	70.8	73.7	71.5											
less tax	-21.2	-22.1	-21.4											
less minorities	-1.5	-1.5	-1.5											
NOPAT	48.1	50.1	48.5	48.5	50.4	52.4	54.5	56.7	59.0	61.3	63.8	66.3	69.0	
RoAvgLoans (%)	2.517	2.370	2.186	2.100	2.100	2.100	2.100	2.100	2.100	2.100	2.100	2.100	2.100	
less working capital	-36.7	-12.4	-13.0	-10.7	-11.1	-11.5	-12.0	-12.5	-13.0	-13.5	-14.0	-14.6	-15.2	
Free cash flow	11.4	34.6	35.5	37.8	39.3	40.9	42.5	44.2	46.0	47.9	49.8	51.8	53.8	766.7
PV (free cash flow)	11.0	33.5	29.0	28.3	27.0	25.7	24.6	23.4	22.4	21.3	20.4	19.4	18.5	242.1
NPV (free cash flow)	546.7													
NPV/share (p)	376													

Source Panmure Gordon

Our Banking fair value implies a 2005E P/E of 11.2x and a 2.4x price:book multiple

The DCF indicates a current fair value for the banking division of a little under £550m, approximately 2.4x end-July 2004 book value for the division, and 11.2x 2005E earnings.

Asset Management

We value Asset Management on a similar basis to Banking, but for the omission of a working capital charge. We have assumed a 7% longer-term growth rate for assets under management, and a net return on assets of 0.25% (as compared with 0.30% in 2005, boosted by first half private equity gains).

Our Asset Management fair value implies a 2005E PE of 16.7x and 5.0% of AUM

The analysis indicates a fair value for Asset Management of £306m, which equates to 5.0% of the division's end-January assets under management, and around 17x 2005E earnings (21x excluding an estimated £5m private equity gains in the first half).

Asset Management: DCF valuation (£m)

Steady state AUM growth (%)	7													
Steady state RoAUM (%)	0.250													
Discount rate (%)	9													
Terminal multiple	11.1													
	2005E	2006E	2007E	2008E	2009E	2010E	2011E	2012E	2013E	2014E	2015E	2016E	2017E	Terminal
Average AUM	6,229	6,641	7,305	7,817	8,364	8,949	9,576	10,246	10,963	11,731	12,552	13,431	14,371	14,371
Asset growth (%)	35	7	10	7	7	7	7	7	7	7	7	7	7	
Operating profit	26.8	24.6	27.0											
less tax	-8.0	-7.4	-8.1											
less minorities	-0.7	-0.7	-0.7											
Free cash flow	18.1	16.5	18.2	19.4	20.9	22.2	23.7	25.4	27.2	29.1	31.1	33.3	35.6	396.0
RoAvgAUM (%)	0.301	0.259	0.259	0.250	0.250	0.250	0.250	0.250	0.250	0.250	0.250	0.250	0.250	
PV (free cash flow)	17.5	14.7	14.8	14.5	14.2	14.0	13.7	13.5	13.2	13.0	12.7	12.5	12.3	125.1
NPV (free cash flow)	305.6													
NPV/share (p)	210													

Source Panmure Gordon

Sum of the parts

In the sum of the parts below, we have made the following additional assumptions:

- We value Market-Making/WINS at £200m, or around 4x last year's book value. Whilst this equates to only 7.2x our 2005E estimate, it reflects our relatively optimistic forecast for Winterflood in the second half this year (we forecast second-half profits of £22.6m, up from £17.0m in the first half).
- We value Corporate Finance at £50m, or around 7x 2005E earnings, reflecting the low visibility of the division's earnings and its historical volatility (2001–04 profits of £11.9m, £2.1m, £5.3m and £9.8m).
- We include group surplus capital at 80% of par value, and apply a 10x PE to central costs.

Sum of the parts valuation (£m)

Year to July 2005E	PBT	Tax	Minorities	PAT	NAV	ROE (%)	P/NAV	PE (x)	£m	p
Banking	70.8	-20.5	-1.5	48.8	228.5	21	2.4	11.2	546.7	376
Asset Management	26.8	-7.8	-0.7	18.3	136.3	13	2.2	16.7	305.6	210
Corporate Finance	10.0	-2.9		7.1	11.0	63	4.5	7.1	50.0	34
Market-Making	39.6	-11.5		28.1	51.3	54	3.9	7.1	200.0	138
Operating divisions	147.2	-42.7	-2.2	102.3	427.1	24	2.6	10.8	1,102.2	759
Central costs	-16.1	4.7		-11.4				10.0	-114.2	-79
Group capital		0.0			82.2		0.8		65.8	45
Total	131.1	-38.0	-2.2	90.9	509.3	18	2.1	11.6	1,055.4	726

Source Panmure Gordon

In aggregate, the analysis suggests a current fair value of around 725p per share, which represents downside of 7.3% to the market price.

THE NUMBERS

Financial summary (£m)

Year end July	04H1	04H2	2004A	05H1	05H2E	2005E	2006E	2007E
Income & expenses								
Net interest income	65.4	68.2	133.6	68.6	79.7	148.2	163.8	171.6
Net fees & commissions	72.9	87.5	160.4	87.8	88.0	175.9	186.4	201.0
Net dealing income	54.7	45.3	100.0	48.1	60.4	108.6	118.7	129.9
Other income	1.5	5.7	7.2	10.6	5.4	16.0	10.0	10.0
Operating income	194.5	206.7	401.2	215.1	233.5	448.7	478.9	512.5
Administrative expenses	-122.0	-126.7	-248.6	-136.2	-150.1	-286.2	-305.7	-328.2
Depreciation	-4.4	-6.4	-10.8	-5.1	-6.3	-11.4	-11.9	-12.5
Bad debt provisions	-10.4	-12.4	-22.8	-8.8	-11.2	-20.0	-24.6	-30.6
Operating expenses	-136.7	-145.5	-282.2	-150.1	-167.5	-317.6	-342.3	-371.4
Pre-exceptional PBT	57.8	61.1	118.9	65.1	66.0	131.1	136.7	141.1
Goodwill amortisation	-4.5	-13.2	-17.6	-4.2	-4.3	-8.5	0.0	0.0
Profit before tax	53.4	48.0	101.3	60.9	61.7	122.6	136.7	141.1
Taxation	-16.8	-17.1	-33.9	-18.7	-19.3	-38.0	-39.6	-40.9
Post-tax profit	36.6	30.9	67.4	42.2	42.4	84.6	97.0	100.2
Minorities	-1.1	-1.1	-2.2	-1.0	-1.2	-2.2	-2.2	-2.2
Attributable profit	35.5	29.7	65.2	41.2	41.2	82.4	94.8	98.0
Dividends	-13.0	-25.5	-38.5	-13.6	-27.0	-40.7	-43.6	-46.5
Retained profit	22.5	4.2	26.7	27.6	14.1	41.7	51.2	51.5
Balance sheets								
Total assets	3,288.5	3,880.4	3,880.4	4,390.2	4,185.9	4,185.9	4,289.0	4,397.3
Customer loans	1,684.2	1,757.1	1,757.1	1,978.1	2,062.5	2,062.5	2,165.6	2,273.9
Shareholders' funds	504.3	509.3	509.3	538.4	551.0	551.0	602.2	653.7
Ratios (%)								
Net interest margin	7.93	7.92	7.92	7.34	7.89	7.76	7.75	7.73
Bad debts % loans	1.26	1.44	1.35	0.94	1.11	1.05	1.16	1.38
Cost income ratio	65.0	64.4	64.7	65.7	66.9	66.3	66.3	66.5
ROE	14.4	11.7	13.2	15.7	15.1	15.5	16.4	15.6
ROA	2.07	1.66	1.75	1.99	1.92	2.04	2.24	2.26
Equity:assets	15.3	13.1	13.1	12.3	13.2	13.2	14.0	14.9
Tax rate	29.1	28.0	28.5	28.8	29.2	29.0	29.0	29.0
Per share data								
Avg shares (m)	144.3	144.3	145.0	145.2	145.3	145.3	145.3	145.3
Period-end shares (m)	144.3	144.3	144.3	145.2	145.3	145.3	145.3	145.3
EPS (p)	24.6	20.4	45.0	28.4	28.3	56.7	65.3	67.4
Adjusted EPS (p)	27.7	29.4	57.1	31.2	31.3	62.5	65.3	67.4
Net dividend (p)	9.0	18.0	27.0	9.5	18.5	28.0	30.0	32.0
Cover (x)	3.1	1.6	2.1	3.3	1.7	2.2	2.2	2.1
NAV (p)	349.6	353.0	353.0	370.8	379.2	379.2	414.5	449.9
Divisions								
Asset Management	7.2	10.2	17.4	15.2	11.6	26.8	24.6	27.0
Corporate Finance	4.5	5.3	9.8	4.9	5.1	10.0	10.5	11.0
Banking	34.4	35.3	69.7	35.2	35.6	70.8	73.7	71.5
Market-Making	19.9	18.0	37.9	17.0	22.6	39.6	44.7	49.2
Operating profit	66.0	68.8	134.8	72.3	74.9	147.2	153.5	158.7
Central costs	-8.2	-7.7	-15.9	-7.2	-8.9	-16.1	-16.8	-17.5
Profit before tax	57.8	61.1	118.9	65.1	66.0	131.1	136.7	141.1

Source Company, Panmure Gordon

The increase in 'other income' accounted for 44% of the increase in total group income in 2005H1

The reduction in 2005H1 provisions accounted for 90% of sequential PBT growth

But for £200m of loan purchases, end-January 2005 loan balances would have been only 1% up on end-July 2004

Rising equity:assets and equity:loan ratios due to lower loan growth and hence surplus capital generation ...

... underpins DPS growth in excess of EPS growth in 2006E and 2007E

Banking contribution estimated to have fallen to 45% of operating profit by 2007E (52% in 2004)

Banking (£m)

Year end July	04H1	04H2	2004A	05H1	05H2E	2005E	2006E	2007E
Net interest income	67.5	64.8	132.3	68.6	77.7	146.2	161.6	169.2
Net fees & commissions	18.0	23.1	41.1	21.7	15.3	37.0	33.0	33.0
Other operating income	0.0	1.1	1.1	1.0	1.0	2.0	2.0	2.0
Total operating income*	85.5	88.9	174.4	90.4	94.8	185.2	196.6	204.2
Operating expenses	-40.7	-41.2	-82.0	-46.4	-48.1	-94.5	-98.3	-102.1
Pre-provision profit	44.8	47.7	92.4	44.0	46.8	90.8	98.3	102.1
Provisions	-10.4	-12.4	-22.8	-8.8	-11.2	-20.0	-24.6	-30.6
Operating profit	34.4	35.3	69.7	35.2	35.6	70.8	73.7	71.5
Customer loans	1,684	1,757	1,757	1,978	2,062	2,062	2,166	2,274
Net assets			228.5			265.1	277.5	290.5
Net interest/avg loans (%)	8.2	7.5	7.8	7.3	7.7	7.7	7.6	7.6
Income/avg loans (%)	10.4	10.3	10.3	9.7	9.4	9.7	9.3	9.2
Provisions/avg loans (%)	-1.26	-1.44	-1.35	-0.94	-1.11	-1.05	-1.16	-1.38
Provisions/pre-prov profit (%)	-23.2	-26.0	-24.6	-20.0	-23.9	-22.0	-25.0	-30.0
Expense ratio (%)	-47.6	-46.4	-47.0	-51.3	-50.7	-51.0	-50.0	-50.0
NAV/loans (%)			13.0			12.9	12.8	12.8
Pre-tax RoAvgNAV (%)			31.8			28.7	27.2	25.2

*Operating income breakdown estimated

Source Company, Panmure Gordon

Market-Making (£m)

Year end July	04H1	04H2	2004A	05H1	05H2E	2005E	2006E	2007E
Dealing income	53.0	43.7	96.7	44.6	57.0	101.6	111.7	122.9
Total operating income	53.0	43.7	96.7	44.6	57.0	101.6	111.7	122.9
Operating expenses	-33.1	-25.7	-58.8	-27.6	-34.3	-61.9	-67.0	-73.7
Operating profit	19.9	18.0	37.9	17.0	22.6	39.6	44.7	49.2
Net assets			51.3			52.0	52.0	52.0
Expense ratio (%)	-62.5	-58.8	-60.8	-61.9	-60.3	-61.0	-60	-60
Pre-tax RoAvgNAV (%)			73.9			76.7	85.9	94.5

Source Company, Panmure Gordon

Asset Management (£m)

Year end July	04H1	04H2	2004A	05H1	05H2E	2005E	2006E	2007E
Net fees & commissions	35.4	48.0	83.4	44.7	50.8	95.5	107.9	120.1
Dealing income	1.7	1.6	3.3	3.5	3.5	7.0	7.0	7.0
Other operating income	1.5	4.6	6.2	9.6	4.4	14.0	8.0	8.0
Total operating income*	38.6	54.3	92.9	57.3	59.2	116.5	122.9	135.1
Operating expenses	-31.4	-44.1	-75.5	-42.1	-47.6	-89.7	-98.3	-108.1
Operating profit	7.2	10.2	17.4	15.2	11.6	26.8	24.6	27.0
AUM	5,000	5,500	5,500	6,100	6,325	6,325	6,958	7,653
Net assets			136.3			136.3	136.3	136.3
Income/ avg AUM (%)	1.77	2.07	2.02	1.98	1.91	1.97	1.85	1.85
Expense ratio (%)	-81.3	-81.2	-81.3	-73.5	-80.4	-77.0	-80.0	-80.0
Pre-tax RoAvgNAV (%)			12.7			19.7	18.0	19.8

*Operating income breakdown estimated

Source Company, Panmure Gordon

Corporate Finance (£m)

Year end July	04H1	04H2	2004A	05H1	05H2E	2005E	2006E	2007E
Net fees & commissions	16.9	19.0	35.9	21.4	22.0	43.4	45.6	47.8
Total operating income	16.9	19.0	35.9	21.4	22.0	43.4	45.6	47.8
Operating expenses	-12.4	-13.6	-26.0	-16.5	-16.9	-33.4	-35.1	-36.8
Operating profit	4.5	5.3	9.8	4.9	5.1	10.0	10.5	11.0
Net assets			11.0			11.0	11.0	11.0
Expense ratio (%)	-73.4	-71.8	-72.6	-77.1	-76.9	-77.0	-77.0	-77.0
Pre-tax RoAvgNAV (%)			87.2			90.5	95.1	99.8

Source Company, Panmure Gordon

Declining net fees & commissions due to new general insurance regulations ...

... and rising loan loss provisions ...

... are reflected in reduced total income margin and provisions to loans ratio

Strong growth in Market-Making revenues forecast

Private equity realisations flattered 2005H1 income and profits

Central Costs (£m)

Year end July	04H1	04H2	2004A	05H1	05H2E	2005E	2006E	2007E
Net interest income	0.6	0.7	1.3	0.9	1.1	2.0	2.2	2.4
Total operating income	0.5	0.8	1.3	0.9	1.1	2.0	2.2	2.4
Operating expenses	-8.7	-8.5	-17.2	-8.1	-10.0	-18.1	-19.0	-19.9
Operating profit	-8.2	-7.7	-15.9	-7.2	-8.9	-16.1	-16.8	-17.5
Net assets			82.2			86.6	125.4	163.9

Source Company, Panmure Gordon

Close Brothers Group (£m)

Year end July (£m)	04H1	04H2	2004A	05H1	05H2E	2005E	2006E	2007E
Net interest income	68.1	65.5	133.6	69.5	78.8	148.2	163.8	171.6
Net fees & commissions	70.3	90.0	160.4	87.8	88.0	175.9	186.4	201.0
Dealing income	54.7	45.3	100.0	48.1	60.4	108.6	118.7	129.9
Other operating income	1.5	5.7	7.2	10.6	5.4	16.0	10.0	10.0
Total operating income	194.5	206.7	401.2	214.6	234.1	448.7	478.9	512.5
Operating expenses	-126.3	-133.1	-259.5	-140.7	-156.9	-297.6	-317.7	-340.7
Pre-provision profit	68.2	73.6	141.7	73.9	77.2	151.1	161.3	171.8
Provisions	-10.4	-12.4	-22.8	-8.8	-11.2	-20.0	-24.6	-30.6
Operating profit	57.8	61.1	118.9	65.1	66.0	131.1	136.7	141.1
Goodwill amortisation	-4.5	-13.2	-17.6	-4.2	-4.3	-8.5	0.0	0.0
Taxation	-16.8	-17.1	-33.9	-18.7	-19.3	-38.0	-39.6	-40.9
Minorities	-1.1	-1.1	-2.2	-1.0	-1.2	-2.2	-2.2	-2.2
Dividends	-13.0	-25.5	-38.5	-13.6	-27.0	-40.7	-43.6	-46.5
Retained earnings	22.5	4.3	26.7	27.6	14.1	41.7	51.2	51.5
Customer loans	1,684	1,757	1,757	1,978	2,062	2,062	2,166	2,274
AUM	5,000	5,500	5,500	6,100	6,325	6,325	6,958	7,653
Net assets			509.3			551.0	602.2	653.7
Expense ratio (%)	-65.0	-64.4	-64.7	-65.6	-67.0	-66.3	-66.3	-66.5
Pre-tax RoAvgNAV (%)			24.0			24.7	23.7	22.5

*Operating income breakdown estimated

Source Company, Panmure Gordon

Distribution of investment ratings (as of 31st December 2004)

Overall Global Distribution (Banking Client*)		
Buy	Hold	Sell
45% (34%)	39% (13%)	15% (3%)

* Indicates the percentage of each category in the Overall Distribution that were Panmure Gordon banking clients in the previous 12 months

Rating: GUIDELINE (return targets may be modified by risk or liquidity issues)

Buy	Expected to produce a total return of 15% or better in the next 12 months
Hold	Fairly valued: total return in the next 12 months expected to be $\pm 10\%$
Sell	Stock is expected to decline by 10% or more in the next 12 months

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17 March 2005

Equity Research

COMPANY PROFILE

Business Profile

Close Brothers is a diversified banking and investment banking business operating in a number of high-margin niches. The banking division maintains a diversified spread of loan assets on its balance sheet, and focuses on specialist corporate lending and consumer finance. The investment banking activities include market-making, asset management and corporate finance.

Recent News

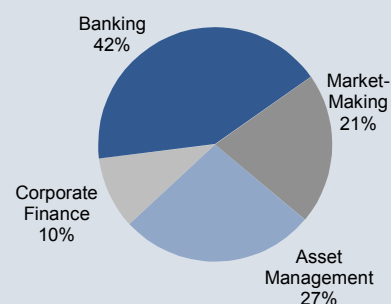
Interim results for the six months to end-January 2005 were announced on 7 March. Pre-goodwill PBT and EPS rose by 13% to £65.1m and 31.2p respectively, while the interim dividend was raised by 6% to 9.5p per share. Banking profits increased by 2% to £35.2m, while investment banking profits rose by 17% to £37.1m, including the doubling of profits from asset management to £15.2m.

In commenting on the full year outlook, management commented that investment banking should 'continue to move forward', but that banking 'will continue to find trading tough'.

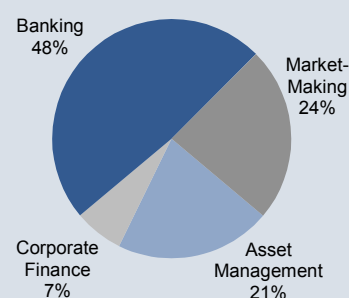
Company Information

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Chairman	Sir David Scholey
Chief Executive	Colin Keogh
Finance Director	Peter Winkworth
IR Officer	Anne Donaldson

2005H1 income by division (%)



2005H1 profit by division (%)



Source Datastream

Major Shareholders (%)

Caledonia Investments	12.45
M&G Investment Management	9.8
Scottish Widows	7.10

Financial Diary

Next statement	Final results
Next results	26 September (FY July 2005)
Next ex dividend	October (final dividend)

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