

12 July 2005

Equity Research

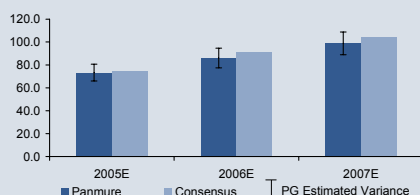
Key Data

Price	565p
Price Target	660p
Market Cap	£292m
FT All Share	2,557
Sector	Financials
Stock codes	KGN.L / KGN.LN
Next Event	Pre-close - November
Gearing	Cash

Absolute & relative performance



Panmure Gordon EPS rel to consensus



Source Reuters, Panmure Gordon

KENSINGTON GROUP HOLD

Trading margin for volume

Strong first half new business volumes and increased profit on sales more than compensated for lower underlying income margins and higher provisions. With record completions in June, and a current offer pipeline up 20%, H2 should bring more of the same.

- **Strong new business volumes.** Total new lending rose by 26% in H1, benefiting from strong first time contributions from Money Partners and Start Mortgages. Like-for-like Kensington Mortgages and TML volumes fell by 5%.
- **Good mortgage asset growth.** Strong volumes and a lower redemption rate allowed 13% growth in the group loan book since end November despite whole loan sales of £270m during the half year.
- **Profit on sales boosts first half results.** Whole loan sales amounted to 21% of H1 originations, well above the group's 15% full year target, which resulted in a 123% increase in profit on sales. This turned a 4% fall in pre-trading operating profit to a 10% increase post-trading profits.
- **Raising estimates, retaining recommendation.** We have increased our 2006E and 2007E earnings estimates by 6% and 7% respectively, to reflect stronger than previously expected volumes and loan growth. Ahead of further news on back-book mortgage performance, however, we retain our Hold recommendation.

Year end November	Revenue (£m)	PBTA (£m)	EPS (p)	P/E (x)	DPS (p)	Yield (%)
2004A	126.2	51.8	67.2	8.4	16.0	2.8
2005E	152.8	53.5	73.3	7.7	20.0	3.5
2006E	182.8	64.5	86.1	6.6	24.0	4.2
2007E	209.2	76.2	98.8	5.7	28.8	5.1

Source Company Data, Panmure Gordon

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INVESTMENT CASE

The case for investing in Kensington is the group's compelling valuation. Based on what seem to be conservative assumptions, our fair value estimate is well ahead of the current market value. The key unknown is how the business model performs in much tougher market conditions.

Strong new business volumes and loan growth. The interim results demonstrated the resilience of the front end of Kensington's business model. Despite a quieter UK mortgage market, Kensington managed to originate some £1.3bn of new mortgages during the first half, which represented more than 30% of opening mortgage assets under management. Even with an annualised 25% run-off rate, and with 20% of the first half's production sold on to Britannia Building Society and Derbyshire Building Society, Kensington still managed to grow its mortgage assets under management (MAUM) by 13% over the six months.

Lower returns on MAUM. Offsetting strong volume growth has been a reduction in returns on average MAUM. So far, there has been little pressure on the group's net interest margin, as lower funding costs have offset some asset margin erosion. How this progresses will depend on the future cost of MBS funding. The main elements to the reduction in ROA have been an increase in provisions, to reflect rising arrears and loan losses, and reduced net fees and commissions (there is potential for a recovery in non-interest income if prepayment speeds pick up and trigger higher early redemption charge income).

Increased balance sheet leverage. Management has responded to a reduced ROA by increasing balance sheet leverage, through dividend growth in excess of earnings growth and via share repurchase. The reduction in the group's equity:assets ratio from 4.7% in 2001 to 2.7% in H104 has maintained return on equity at around the 30% level.

RMS investor reports. Recent reports from the group's RMS 165 and RMS 16 securitisation vehicles have caused some concern, mainly in relation to the robustness of the business model rather than over potential future losses. However, with management forewarning that a further increase in arrears should be expected during the second half this year, the market will continue to focus on the performance of recent securitisations.

Retain Hold recommendation. We have upgraded our 2006E and 2007E forecasts, primarily to reflect higher than previously expected new business volumes and loan book growth. Ahead of further news on the performance of the group's back book (the RMS 15-18 securitisations in particular), we retain our Hold recommendation and 660p per share price target.

CATALYSTS

- **RMS Investor Reports.** Following news of insufficient excess spreads in RMS 15 and RMS 16 in the quarter to end May, and a warning that RMS 17 had experienced similar trends, the market will be looking for further news on the performance of Kensington's securitisation vehicles.
- **Pre-close trading update in November.** The second half of the current year looks set for continued strong volume growth offset by lower returns. The November trading statement should provide some detail on the trade-off.

RESULTS ANALYSIS

The key features of the interim results were strong new business volumes (up 26%, including new ventures), declining returns on mortgage assets managed (from 94bps to 80bps), and a broadly maintained ~30% return on equity due to increased balance sheet leverage.

2005 INTERIM RESULTS SUMMARY

Kensington's interim results for the six months to end May 2005 were reported on 7 July. The results are summarised in the table below.

2005 interim results (£m)

Year to November	H104	H204	2004	H105	H105/H104
Net interest income	40.0	43.7	83.7	50.0	25%
Net fees & commissions	15.2	22.9	38.1	15.3	1%
Profit on sale of mortgages	2.6	1.8	4.4	5.8	123%
Operating income	57.8	68.4	126.2	71.1	23%
Operating expenses	-30.2	-30.5	-60.7	-34.7	15%
Pre-provision profit	27.6	37.9	65.5	36.4	32%
Provision for losses	-4.8	-8.4	-13.2	-11.3	135%
Operating profit	22.8	29.5	52.3	25.1	10%
Associate income	0.0	-0.5	-0.5	-0.6	
Core PBT	22.8	29.0	51.8	24.5	7%
Exceptional items				0.1	
Goodwill amortisation	-1.2	-0.9	-2.1	-1.1	
Profit before tax	21.6	28.1	49.7	23.5	9%
Taxation	-7.0	-9.1	-16.1	-7.5	
Minorities	0.0	0.0	0.4	0.7	
Attributable profit	14.6	19.4	34.0	16.7	14%
Dividend	-2.8	-5.6	-8.4	-3.4	
Retained earnings	11.8	13.8	25.6	13.3	
Avg mortgage AUM	3361.0	3871.2	3628.1	4405.2	31%
MAUM	3604.1	4138.3	4138.3	4672.0	30%
Equity	110.6	113.9	113.9	126.3	14%
Provision balance	18.8	24.9	24.9	30.9	64%
Arrears	209.0	302.1	302.1	429.8	106%
Net interest:avg loans	2.38%	2.26%	2.31%	2.27%	
Total income:avg loans	3.44%	3.53%	3.48%	3.23%	
Expenses:avg loans	-1.80%	-1.58%	-1.67%	-1.58%	
Provision charge:avg loans	-0.29%	-0.43%	-0.36%	-0.51%	
Net interest:total income	69.2%	63.9%	66.3%	70.3%	
Cost:income ratio	-52.2%	-44.6%	-48.1%	-48.8%	
Provision:pre-provision profit	-17.4%	-22.2%	-20.2%	-31.0%	
Arrears:loans	5.8%	7.3%	7.3%	9.2%	
Provision balance:arrears	9.0%	8.2%	8.2%	7.2%	
Provision balance:loans	0.52%	0.60%	0.60%	0.66%	
ROE	30.1%	36.2%	33.9%	29.5%	
RoAvgMAUM	0.94%	1.05%	1.00%	0.80%	
Equity:MAUM	3.1%	2.8%	2.8%	2.7%	
Average diluted shares (m)	55.0	52.0	53.7	52.4	
Adjusted diluted EPS (p)	28.8	38.5	67.2	33.8	17%
DPS (p)	5.0	11.0	16.0	6.5	30%

Source Company, Panmure Gordon

Key features were:

- First half PBT increased by 8% to £24.6m, while EPS grew by 17% to 34.6p (33.8p fully diluted, according to our calculations). That EPS growth outpaced PBT growth was due to (i) earnings enhancement due to share repurchase, and (ii) a positive (below the line) minority offsetting the (above the line) recognition of start-up losses at Start Mortgages and Money Partners. The interim dividend was increased by 30% to 6.5p.
- Net new business, aided by first time contributions from Money Partners and Start Mortgages, rose by 26% to £1.31bn (£1.04bn). Like for like volumes at Kensington Mortgages and TML fell by 5% to £988m.
- While MAUM increased by 30% yoy, net interest and net fee and commission income rose by 18%, reflecting a reduction in the group's underlying income margin.
- The provision charge increased by 135% to £11.3m, which accounted for 31% of first half pre-provision profit (17% in H104) and 0.51% of average MAUM (0.29% in H104). Overall, the group's return on average MAUM fell from 0.94bps% to 0.80%.
- In part, the reduced return on MAUM reflects the impact of the new ventures. Money Partners and Start Mortgages incurred start-up losses of £2.4m between them, and the new Reading processing centre added £1.5m to costs. However, offsetting these items was an increase in profit on mortgage sales from £2.6m in H104 to £5.8m in H105.

NEW BUSINESS VOLUMES & LOAN BOOK GROWTH

Kensington's first half new business volumes, redemption rate, whole loan sales and end-period mortgage asset balances, are set out below.

Like for like volumes from Kensington Mortgage Company and TML were down 5% during the first half. Adding in first time contributions from Money Partners and Start Mortgages, total volumes increased by 26%.

Loan book analysis (£m)

Year to November	H104	H204	2004	H105	H105/H104
New KMC/TML lending	1,040	1,226	2,266	988	-5%
New MP/SM lending				323	
Total new lending	1040.0	1225.5	2265.5	1311.0	26%
Redemption rate	-29%	-33%	-31%	-25%	
Whole loan sales	-108	-101	-209	-270	150%
MAUM balances	3,604	4,138	4,138	4,672	30%
Average balance	3,361	3,871	3,628	4,405	31%

Source Company, Panmure Gordon

The impact of new business flows on end-period MAUM is dependent upon (i) the back-book redemption rate (or prepayment rate), and (ii) whole loan portfolio sales:

- First half redemptions slowed to 25% during the first half, down from 29% in H1 last year. The lower the redemption rate, the greater the growth in MAUM as less business runs off the back book.
- Whole loans sales of £270m during H1, some 21% of first half originations, as compared with £108m in H104 (10% of originations) and £209m for the full year last year (9% of originations). Management has increased the target for on-going whole loan sales from a 10%-15% range to the current ~15%. Either way, H104 sales were above "run-rate" and we expect some moderation in H2.

Whole loan sales provide Kensington with a means to manage loan book growth in the face of changing redemption rates. By selling on 20% of total originations during the first half – as compared with the targeted 15% – Kensington's management was able to limit loan book growth to 30% yoy.

OPERATING INCOME

First half net interest income up 25% in the face of average loans up 31% reflects a reduction in the group's net interest margin. Flat net fees and commissions primarily reflected lower income, while the 123% increase in profit on sale was broadly in line with higher whole loan sales.

Operating income (£m)

Year to November	H104	H204	2004	H105	H105/H104
Interest receivable	131.1	163.5	294.6	188.4	44%
Interest payable	-91.1	-119.8	-210.9	-138.4	52%
Net interest income	40.0	43.7	83.7	50.0	25%
-ERC income	21.4	29.5	50.9	24.6	15%
-TML fees/other fees	14.6	16.3	30.9	14.2	-3%
Fees & commissions receivable	36.0	45.8	81.8	38.8	8%
Fees & commissions payable	-20.8	-22.9	-43.7	-23.5	13%
Net fees & commissions	15.2	22.9	38.1	15.3	1%
Profit on sale of mortgages	2.6	1.8	4.4	5.8	123%
Operating income	57.8	68.4	126.2	71.1	23%
Net interest/total income	69%	64%	66%	70%	
ERC income/total income	37%	43%	40%	35%	
Net fees/total income	26%	33%	30%	22%	
Profit on sale/total income	4%	3%	3%	8%	

Source Company, Panmure Gordon

In aggregate, higher net interest income, flat net fees and commissions and significantly higher profit on sales, resulted in a 23% increase in total operating income. In relation to average mortgage assets, this represents an all-in reduction in Kensington's income margin from 3.44% in H104 to 3.23% in H105.

Excluding profit on sales, the underlying income margin fell from 3.28% to 2.96%.

UNDERLYING EARNINGS GROWTH

Since first half whole loans sales were above their targeted run-rate, the table below provides an analysis of operating income and operating profit before trading gains.

Adjusting for profit on sales (£m)

Year to November	H104	H204	2004	H105	H105/H104
Income (ex-profit on sales)	55.2	66.6	121.8	65.3	18%
Expenses	-30.2	-30.5	-60.7	-34.7	15%
Pre-provision profit	25.0	36.1	61.1	30.6	22%
Provisions	-4.8	-8.4	-13.2	-11.3	135%
Profit before trading gains	20.2	27.7	47.9	19.3	-4%
Profit on sale	2.6	1.8	4.4	5.8	123%
Operating profit	22.8	29.5	52.3	25.1	10%

Source Company, Panmure Gordon

Excluding profit on sale, first half income growth is reduced from 23% to 18%. With expenses growth of 15% (positive jaws of 3%, in banking parlance) this results in pre-provision, pre-trading profits up 22%. However, with the provision charge up 135%, post-provision profit fell by 4%. In short, 14% of Kensington's first half reported operating profit growth was due to growth in trading profits.

However, since the new Reading processing centre added £1.5m to costs, underlying earnings growth should exclude these costs, in our view. Adding back £1.5m, H105 operating profit growth amounted to 3%, and incorporating the share repurchase enhancement, we calculate underlying earnings growth of around 10%.

LEVERAGING A DECLINING ROA

A key conclusion of the above analysis of the interim results is that Kensington has experienced a decline in its overall return on MAUM, even after higher whole loan sale profits. The table below sets out the progression in the components of Kensington's ROA (return on mortgage assets under management).

Return on MAUM and ROE (%)

Year to November	2003	H104	H204	2004	H105
Interest receivable	7.30%	7.80%	8.45%	8.12%	8.55%
Interest payable	-4.95%	-5.42%	-6.19%	-5.81%	-6.28%
Net interest income	2.35%	2.38%	2.26%	2.31%	2.27%
Fees & commissions receivable	2.43%	2.14%	2.37%	2.25%	1.76%
Fees & commissions payable	-1.33%	-1.24%	-1.18%	-1.20%	-1.07%
Net fees & commissions	1.10%	0.90%	1.18%	1.05%	0.69%
Profit on sale of mortgages	0.05%	0.15%	0.09%	0.12%	0.26%
Operating income	3.50%	3.44%	3.53%	3.48%	3.23%
Operating expenses	-1.81%	-1.80%	-1.58%	-1.67%	-1.58%
Pre-provision profit	1.69%	1.64%	1.96%	1.81%	1.65%
Provision for losses	-0.21%	-0.29%	-0.43%	-0.36%	-0.51%
Operating profit	1.48%	1.36%	1.52%	1.44%	1.14%
Associate income			-0.03%	-0.01%	-0.03%
Core PBT	1.48%	1.36%	1.50%	1.43%	1.11%
Tax	-0.44%	-0.42%	-0.47%	-0.44%	-0.34%
Minorities	0.00%	0.00%	0.02%	0.01%	0.03%
Pre-goodwill net profit/ROA	1.04%	0.94%	1.05%	1.00%	0.80%
Leverage (avg MAUM/avg Equity)	27.0	32.0	34.5	34.1	36.7
ROE	28%	30%	36%	34%	29%

Source Company, Panmure Gordon

The decline in Kensington's ROA is clear – from 1.04% in 2003 to an annualised 0.80% in H105. Perhaps surprisingly, the decline in net interest margin has played a relatively small part, falling by only 8 bps over this period. The biggest negative levers have been net fees and commissions and provisions, the former down 41bps, the latter up 30bps. The offsetting positives have been the profit on sale element, up 21bps, and improved efficiency, with expenses as a percentage of MAUM down 23bps.

ROA levers – H104 versus full year 2003

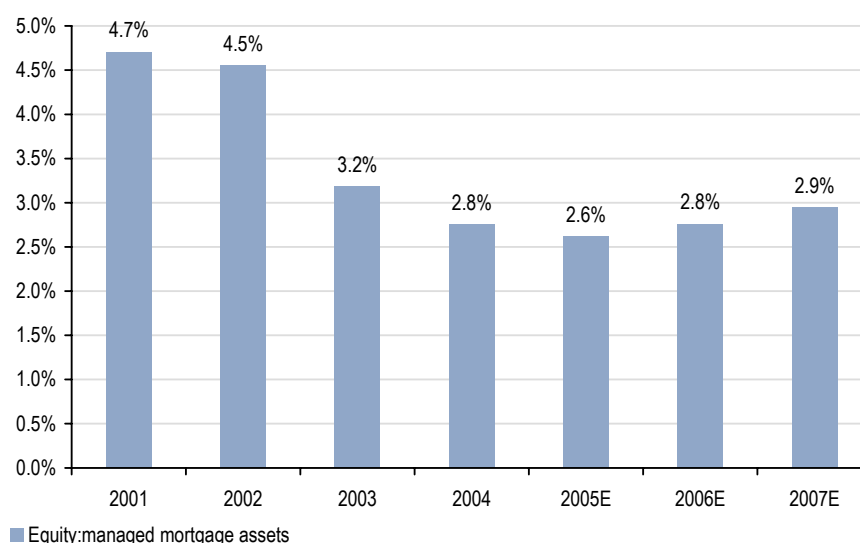
Year to September	2003	H104	Change
Net interest	2.35%	2.27%	-0.08%
Net fees & commissions	1.10%	0.69%	-0.41%
Profit on sale	0.05%	0.26%	0.21%
Income	3.50%	3.22%	-0.28%
Expenses	-1.81%	-1.58%	0.23%
Provisions	-0.21%	-0.51%	-0.30%
Operating profit	1.48%	1.13%	-0.35%

Source Company, Panmure Gordon

That Kensington has managed to broadly maintain its ROE in the face of its declining ROA is due to increased balance sheet leverage. The group's equity:MAUM ratio has fallen from 4.7% in 2001 to 2.7% in H105, and as shown below, we forecast a further fall to 2.6% for the full year 2005E. Inverted to

express leverage, the group's H105 assets:equity ratio of 36.7x means that a 10bps change in ROA would translate into a 3.7% change in ROE (essentially a 3.7% reduction in earnings).

Balance sheet leverage: equity to mortgage assets managed



Source Company, Panmure Gordon

EQUITY CASH FLOW & DIVIDEND CAPACITY

Assuming 10% growth in new business volumes and an increase in the redemption rate to 35% rate in 2006E and 2007E, we forecast equity cash flows of £18m and £26m in 2006E and 2007E respectively, comfortably above our dividend forecasts (which are for 20% growth in each of 2006E and 2007E). This results in internal capital generation of around £17m over the two years to end 2007E, which in theory could be available for additional dividend growth and/or share repurchases. In our figures, this capital generation is “used” to rebuild the group's equity:asset ratio to the 2.9% for 2007E shown above.

Equity cash flow & internal capital generation (£m)

Year to November	2002A	2003A	2004A	2005E	2006E	2007E
Loan growth	407.4	1209.9	1020.5	1223.5	914.6	873.6
Funding at 3%	12.2	36.3	30.6	36.7	27.4	26.2
Attributable profit	22.3	23.7	34.0	36.5	45.1	51.8
Equity cash flow	10.1	-12.6	3.4	-0.2	17.7	25.6
Dividend	-2.9	-5.2	-8.4	-10.2	-12.2	-14.6
Internal capital generation	7.2	-17.8	-5.0	-10.4	5.5	11.0

Source Company, Panmure Gordon

It is worth noting that the redemption/prepayment rate assumption is a significant factor in the calculations set out above. For example, assuming prepayment speeds remain at 25% until 2007E reduces internal capital generation from £17m to -£5.7m in 2006E-2007E.

RMS INVESTOR REPORTS

On Monday 27 June, Kensington's shares fell 5% as bond market concerns over losses at two of the company's securitisation vehicles filtered their way into the equity market.

- Quarterly reports on the RMS 15 and 16 vehicles showed that spreads for the quarter to end May were not enough to cover losses, and that as a result, both vehicles had to draw on their reserves. Realised losses in the quarter were 18 bps and 9 bps for RMS 15 and 16 respectively. The reports stated that RMS 17 had shown similar performance characteristics (RMS 17 runs on an end-July quarterly cycle and will reports in early August).
- The problem seems to have been a relatively small number of high severity losses on repossession. Of all sold repossessions during the quarter, 66% of those in RMS 15 recorded a loss, and 40% of those in RMS 16. Of total loss cases in both vehicles, 14 cases accounted for two-thirds of the total loss, of which 12 were located in Greater London and the Southeast.
- Two explanations were given for the losses: (i) loans in RMS 15-17 were originated in late 2002 to early 2004, the peak in house price inflation in London and the Southeast (which account for around half of RMS 15-17 mortgages by value) and the bottom of the interest rate cycle; (ii) Kensington has identified a number of counterparties (mortgage brokers, packagers and valuers) involved in the problem cases, counterparties that were dropped from the group's panel of introducers in 2003 and 2004.
- By end-May balances, 4.5% of RMS 15's mortgage assets and 3.9% of RMS 16's assets were mortgages originated by the problem counterparties. Of these amounts, only 40% were current with their payments in RMS 15 and only 42% were current in RMS 16. According to our calculations, this implies that some £10.4m of outstanding mortgages originated by problem counterparties are in some form of arrears in RMS 15, and £11.5m in RMS 16.
- According to the Standard & Poors report of 30 June, which affirmed its credit ratings on each of RMS 15 and RMS 16, Kensington's management "expects some further draws on the reserve funds in the coming quarters with perhaps a draw on the reserve in RMS 17 PLC too".

The key issues for equity investors are as follows:

1. Availability & cost of funding

Kensington's RMS investor reports caused weakness across the UK sub-prime MBS market. If MBS investors remain concerned, they could demand significantly higher spreads on Kensington's next securitisation, which would translate into higher funding costs and a reduced net interest margin.

2. Business model risks

The situation highlights Kensington's sensitivities to (i) rising rates (through rising arrears and hence repossessions), (ii) flat/falling house prices (through reduced LTV margins), (iii) introducers (the quality of its borrowers and underlying collateral). Since RMS 15, 16 and 17 currently account for around a third of Kensington's total mortgage assets under management this is significant even if other securitisations are performing well.

3. Quality control

Although the problems within RMS 15-17 look more localised than systemic to the entire loan portfolio, being largely due to a small number of "rogue" counterparties, it does raise the issue of quality control. Since Kensington's business model revolves around its ability to minimise losses in the face of rising

arrears, the quality of its collateral is paramount. That a sufficient numbers of introducers were able to slip through the group's vetting process and cause the spike in losses reported is a cause for concern.

The RMS 15 and 16 losses are in themselves relatively small and unlikely to significantly impact second half provisioning – in aggregate, RMS 15 and 16 drew only £1.2m during the quarter, from total reserve funds of £43.1m – although future RMS reports will need monitoring. The May reports stressed that the overall performance of Kensington's mortgage assets under management were within management's expectations.

FORECASTS

We have revised our forecasts to reflect the interim results and revised guidance.

Forecast changes (£m)

Year to November	2005E			2006E			2007E		
	Old	New	Ch	Old	New	Ch	Old	New	Ch
MAUM	4,733	5,362	13%	5,315	6,276	18%	5,911	6,713	14%
Income	133.1	152.8	15%	147.3	182.8	24%	162.8	209.2	29%
Expenses	-66.5	-74.9	13%	-71.8	-90.1	26%	-75.5	-101.5	34%
Provisions	-13.3	-23.8	79%	-15.1	-29.1	93%	-16.8	-33.6	100%
Core PBT	53.4	53.5	0%	61.1	64.5	6%	71.2	76.2	7%
EPS (p)	73.9	73.3	-1%	82.3	86.1	5%	93.0	98.8	6%
DPS (p)	20.0	20.0	0%	24.0	24.0	0%	28.8	28.8	0%

Source Panmure Gordon

The key assumption changes are (i) stronger new business volumes and hence increased MAUM, (ii) higher profit on mortgage sales, and (iii) substantially higher provisions.

VALUATION

Our preferred approach to valuing Kensington – discounted free cash flows – indicates an intrinsic value significantly in excess of the group's current market value.

The valuation approach set out below indicates a fair value for Kensington well in excess of current market value.

DISCOUNTED FREE CASH FLOWS

The DCF approach suggests a fair value of £400m, equal to 762p per share (35% upside). This assumes a further reduction in Kensington's return on MAUM, from 80bps in H104 to a steady-state 60bps by 2008E, and a reduction in the rate of MAUM growth to a steady-state 5% per annum. Our free cash flow estimates assume a working capital assumption – net profits required to support balance sheet growth – equal to 3% of the additional MAUM (essentially a steady-state 3% equity:MAUM ratio).

Discounted free cash flow valuation (£m)

Steady state RWA growth	5%													
Steady state RORWA	0.60%													
Discount rate	10%													
Terminal multiple	10.0													
Year to November	2005E	2006E	2007E	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	Terminal
Avg Mortgage AUM	4750	5819	6713	7049	7401	7771	8160	8568	8996	9446	9919	10414	10935	10935
Average asset growth	31%	23%	15%	5%	5%	5%	5%	5%	5%	5%	5%	5%	5%	
Pre-exceptional PBT	53	62	69											
less tax	-16	-19	-23											
less prior charges	1	0	-2											
NOPAT	38	43	45	42	44	47	49	51	54	57	60	62	66	
RoMAUM	0.81%	0.73%	0.67%	0.60%	0.60%	0.60%	0.60%	0.60%	0.60%	0.60%	0.60%	0.60%	0.60%	
NOPAT	38	43	45	42	44	47	49	51	54	57	60	62	66	656
less working capital	-37	-27	-26	-10	-11	-11	-12	-12	-13	-13	-14	-15	-16	
Free cash flow	2	15	19	32	34	36	37	39	41	43	45	48	50	
FCF RoMAUM	0.04%	0.26%	0.28%	0.46%	0.46%	0.46%	0.46%	0.46%	0.46%	0.46%	0.46%	0.46%	0.46%	
PV (free cash flow)	2	13	15	23	22	21	20	19	18	17	17	16	15	181
NPV (free cash flow)	400													
NPV/ share	762													

Source Panmure Gordon

The risks associated with this approach are (i) higher than forecast arrears and loan losses which would further reduce sustainable returns, (ii) lower new business volumes, which would lower sustainable MAUM growth, and (iii) a significant increase in redemption rates, which would reduce longer-term MAUM growth for a given level of new business.

THE NUMBERS

MAUM growth and returns on MAUM are the key earnings drivers

Financial summary (£m)

Year to November	2001A	2002A	2003A	2004A	2005E	2006E	2007E
Income & Expenses							
Net interest income	39.9	43.5	59.1	83.7	107.8	129.2	144.3
Net fees & commissions	8.8	17.1	27.7	38.1	35.4	44.8	55.2
Profit on loan sales			1.2	4.4	9.6	8.8	9.6
Operating income	48.7	60.6	88.0	126.2	152.8	182.8	209.2
Operating expenses	-17.8	-25.2	-45.5	-60.7	-74.9	-90.1	-101.5
Pre-provision profit	30.9	35.4	42.5	65.5	77.9	92.7	107.8
Provision for losses	-5.9	-5.2	-5.4	-13.2	-23.8	-29.1	-33.6
Operating profit	25.0	30.2	37.1	52.3	54.2	63.6	74.2
Associate income	0.0	0.0	0.0	-0.5	-0.7	0.9	2.0
Core PBT	25.0	30.2	37.1	51.8	53.5	64.5	76.2
Exceptional items	0.0	0.0	0.0	0.0	0.1	0.0	0.0
Goodwill amortisation	0.0	-0.4	-2.4	-2.1	-2.0	0.0	0.0
Profit before tax	25.0	29.8	34.7	49.7	51.6	64.5	76.2
Taxation	-7.5	-7.5	-11.0	-16.1	-16.0	-19.3	-22.9
Minorities	0.0	0.0	0.0	0.4	1.0	0.0	-1.5
Attributable profit	17.5	22.3	23.7	34.0	36.5	45.1	51.8
Dividend	-1.1	-2.9	-5.2	-8.4	-10.2	-12.2	-14.6
Retained earnings	16.4	19.4	18.5	25.6	26.3	32.9	37.2
Balance Sheet							
MAUM	1,501	1,908	3,118	4,138	5,362	6,276	7,150
Avg mortgage AUM	1,381	1,704	2,513	3,628	4,750	5,819	6,713
Equity	70.6	86.8	99.2	113.9	140.2	173.2	210.4
Provision balance	8.6	11.7	15.5	24.9	34.4	46.0	59.5
NPLs	120.0	143.1	227.6	302.1	536.2	627.6	715.0
Ratios							
Net interest margin	2.89%	2.55%	2.35%	2.31%	2.27%	2.22%	2.15%
Total income margin	3.53%	3.56%	3.50%	3.48%	3.22%	3.14%	3.12%
Cost:income ratio	-37%	-42%	-52%	-48%	-49%	-49%	-49%
Provision:pre-prov profit	-19%	-15%	-13%	-20%	-30%	-31%	-31%
Provision:avg loans	-0.43%	-0.31%	-0.21%	-0.36%	-0.50%	-0.50%	-0.50%
NPLs:loans	8.0%	7.5%	7.3%	7.3%	10.0%	10.0%	10.0%
Provision balance:NPLs	7.2%	8.2%	6.8%	8.2%	6.4%	7.3%	8.3%
ROE	28%	29%	28%	34%	30%	29%	27%
RoAvgMAUM	1.27%	1.33%	1.04%	1.00%	0.81%	0.78%	0.77%
Equity:MAUM	4.7%	4.5%	3.2%	2.8%	2.6%	2.8%	2.9%
Effective tax rate	-30%	-25%	-30%	-31%	-30%	-30%	-30%
Per share data							
Diluted EPS (p)	30.1	38.9	43.2	63.3	69.6	86.1	98.8
Adjusted EPS (p)	30.1	39.6	47.6	67.2	73.3	86.1	98.8
DPS (p)	2.0	5.0	10.0	16.0	20.0	24.0	28.8
Loan growth							
New KMC/TML lending	686.1	1018.3	2015.5	2265.5	2200.0	2420.0	2662.0
New MPL lending					700.0	770.0	847.0
Total new lending	686.1	1018.3	2015.5	2265.5	2900.0	3190.0	3509.0
Run-off rate	-35%	-41%	-42%	-31%	-30%	-35%	-35%
Whole loan sales				-209.0	-435.0	-398.8	-438.6
MAUM balances	1500.5	1907.9	3117.8	4138.3	5361.8	6276.4	7150.1
Average balance	1380.8	1704.2	2512.9	3628.1	4750.1	5819.1	6713.2

Source Company, Panmure Gordon

Distribution of investment ratings for equity research (as of 31 March 05)

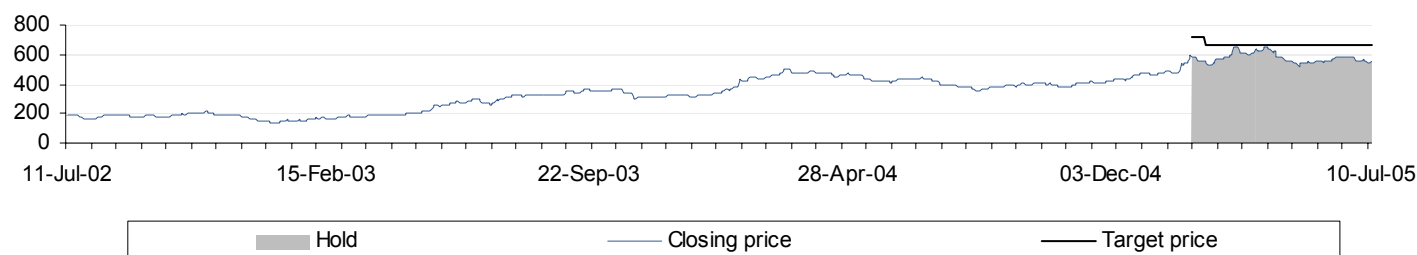
Overall Global Distribution (Banking Client*)

Buy	Hold	Sell
46% (29%)	38% (11%)	16% (3%)

* Indicates the percentage of each category in the overall distribution that were banking and/or corporate broking clients

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

Kensington Group

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Registered office: Moorgate Hall, 155 Moorgate, London EC2M 6XB, UK

12 July 2005

Equity Research

COMPANY PROFILE

Business Profile

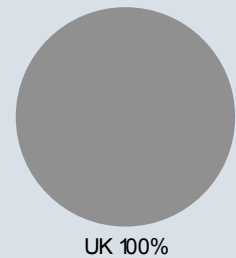
Kensington is a market leader in the UK non-prime mortgage market. The core subsidiary, Kensington Mortgage Company, is focused on underwriting, warehousing and securitising home loans. Its customers are those unable to satisfy mainstream credit scoring systems, including the self-employed, contractors, older borrowers and those with impaired credit histories.

Recent News

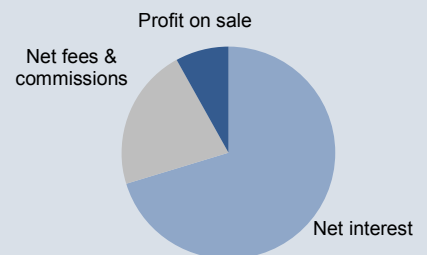
First half PBT increased by 8% to £24.6m, while EPS grew by 17% to 34.6p (33.8p fully diluted, according to our calculations). That EPS growth outpaced PBT growth was due to (i) earnings enhancement due to share repurchase, and (ii) a positive (below the line) minority offsetting the (above the line) recognition of start-up losses at Start Mortgages and Money Partners. The interim dividend was increased by 30% to 6.5p.

Net new business, aided by first time contributions from Money Partners and Start Mortgages, rose by 26% to £1.31bn (£1.04bn). Like for like volumes at Kensington Mortgages and TML fell by 5% to £988m.

Revenues by geography* (%)



Revenue by type* (%)



*Half year to May 04

Source Company

Company Information

Company	Kensington Group
Address	1 Sheldon Square, London W2 6PU
Tel no	+ 44 (0)20 7297 7600
Website	www.kmc.co.uk
Chairman	Peter Birch
Chief Executive	John Maltby
Finance Director	Steven Colsell

Major Shareholders (%)

Marty Finegold (Hurley Partners)	16.91%
Barclays Global Investors	6.66%
Morley Fund Management	5.61%
GSAM	5.56%
Columbia Wanger	5.39%

Financial Diary

Next Statement	Pre-close November 2005
Next Results	Finals January 2006
Next ex dividend	Final Jan/Feb 2006

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