

15 February 2005

UK Equity Research

INITIATION OF COVERAGE

Key Data

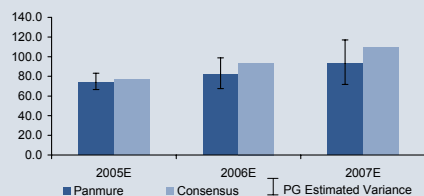
Price	580p
Price Target	660p
Market Cap	£284m
FTSE All-Share	2,533
Sector	Financials
Stock codes	KGN.L / KGN.LN
Next Event	Interims – July

Absolute & relative performance



Source Datastream

Panmure forecasts EPS rel to consensus



Source Reuters, Lazard

KENSINGTON GROUP

HOLD

So far, so good

We are initiating coverage with a Hold recommendation because, although longer-term prospects remain positive, the near-term outlook is for a slowdown in earnings growth as tougher mortgage market conditions are reflected in reduced returns on managed mortgage assets.

- Following 25%-plus compound annual earnings growth since flotation in November 2000, we forecast a slowdown in Kensington's earnings growth to 11% per annum over the next three years. Consensus estimates are for growth closer to 17% per annum.
- The core assumption in our base-case scenario is reduced loan growth and, as a result, reduced non-interest income, as increased commissions payable in relation to the acquisition of new business in the previous year outpace growth in early redemption charges.
- Our forecasts do not assume any deterioration in credit quality, and as such are at risk to a further pick-up in arrears and/or loan losses. Kensington's earnings are highly sensitive to rising provisions due to high balance sheet leverage.
- The shares remain inexpensive, despite strong recent price performance, trading on 7.0x 2006E earnings as compared with an average of 9.5x for a basket of UK mortgage market peers. Conservative estimates of mid-cycle returns and modest asset growth assumptions imply a fair value for the shares of around 660p.

Year end November	Revenue (£m)	Pre-prov PBT (£m)	PBTA (£m)	EPS (p)	PER (x)	Yield (%)
2004A	126.2	65.5	51.8	67.2	8.6	2.8
2005E	133.1	66.7	53.4	73.9	7.8	3.4
2006E	147.3	75.5	61.1	82.3	7.0	4.1
2007E	162.8	87.3	71.2	93.0	6.2	5.0

Source Company Data, Lazard

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INVESTMENT CASE

Kensington's shares continue to be a unique play on the high margins and longer-term growth potential available in the UK non-prime mortgage market. However, the near-term outlook is for a slowdown in earnings growth, as tougher mortgage market conditions are reflected in lower returns on managed mortgage assets.

Consensus earnings estimates appear overly optimistic. When we factor in a levelling-off in early redemption charge income, rising new business strain relating to earlier acquisition costs, and the up-front costs of longer-term growth initiatives, we forecast a slowdown in earnings growth over the next three years. Our 2005 estimates are around 4% below consensus, and our 2005E and 2006E estimates are 12% and 15% lower respectively.

In particular, we are concerned that the market's expectations are being formed on best-case assumptions. In our sensitivity analysis of 2007 earnings, quite small adjustments to the key margins – the income, expense and loan loss provision components of Kensington's ROA – produce significant changes to the group's ROE due to high balance sheet leverage. Stress testing our earnings model to a plausible degradation in margins and provisions (reflecting a worse than expected macroeconomic environment), it is frighteningly easy to construct a 2007E EPS forecast of 50p, as compared with our central case 93p (and the market's 109p).

On the other hand, Kensington's inexpensive valuation could be said to already factor in the probability of a 50p 2007 EPS outcome. Based on our estimates, the shares trade on just over 7.0x 2006E earnings; based on consensus, this falls to 6.7x, significantly below multiples being afforded to other UK mortgage specialists such as Bradford & Bingley (10.3x), Paragon Group (8.9x) and Northern Rock (9.2x). Discounting projected free cash flows, we can generate fair value estimates in the 700p–800p range based on conservative margin and asset growth assumptions. Whilst such valuations implicitly assume a well behaved, if more challenging, mortgage market backdrop, they do highlight the substantial “embedded value” potential within Kensington Group. Such potential is unlikely to have gone unnoticed by larger banks operating in the highly competitive and margin-pressured prime UK mortgage market.

Hold recommendation. The shares have been excellent performers in the run-up to and following the final results on 1 February, and are now up some 20% in the year to date. With near-term news flow more likely to be on the negative side (earnings revisions, IFRS implications for reported earnings, mortgage market statistics in general), we expect the shares to pause for breath ahead of the interim pre-close statement in May. Given the attractive valuation, and solid longer-term growth prospects, we suggest buying on weak days.

CATALYSTS

- **Trading updates.** The group's AGM in April, pre-close statement in May and interim results announcements in July will provide updates on current trading.
- **IFRS teach-in.** Management will be holding a teach-in on the impact of IFRS accounting ahead of the interim results, when the impact of IFRS on the group's results will be shown.
- **Mortgage/housing market news flow.** Despite Kensington's non-prime focus, the shares are sensitive to more general mortgage market and macroeconomic news flow.

RISKS

With our current Hold recommendation, the key upside risks are evidence of an improving outlook for the UK mortgage market, and the potential for Kensington to be acquired by a third party. The key downside risks are evidence of deteriorating credit quality and the availability and/or cost of funding given Kensington's reliance on securitisation and the mortgage backed securities market.

Upside risks

Improving mortgage market news flow would improve sentiment

Since our forecast for a meaningful slowdown in earnings growth over the next three years are based on a tougher UK mortgage market, more positive news flow (on house prices, housing market activity and/or mortgage market volumes) would underpin optimistic consensus estimates and hence continued share price outperformance.

Funding synergies could make Kensington an attractive acquisition target

As a non-bank mortgage lender without access to customer deposits or wholesale (interbank) funding and hence dependent upon securitisation and whole loan sales for funding, Kensington's net interest margins would be substantially improved if it were to be owned by a larger bank, particularly a deposit-rich one. Since we argue Kensington is inexpensive as a going concern based on its current funding structures, the company could be an attractive acquisition target.

Downside risks

High balance sheet leverage exposes earnings to rising provisions

Kensington's earnings are highly sensitive to relatively modest changes in key income margins and in loan loss provisions, due to high balance sheet leverage. Deterioration in asset quality – increasing arrears requiring an increase in provisions – appears to be the scenario most likely to result in a negative earnings surprise.

Kensington is almost wholly reliant upon securitisation as a source of funding

Kensington's ability to underwrite new business requires the continued availability of (short-term) warehouse finance and continued demand for mortgage-backed securities. Whilst the ongoing availability of funding represents a relatively small risk, the cost of funding can be volatile. Kensington has benefited from reduced funding costs in recent years, but a less positive macro-backdrop could increase funding costs.

The group's CEO and the company's founder have both recently sold stock

In the past week, Kensington's CEO John Maltby and the company's founder (and until recently non-executive director) Marty Finegold have sold reasonably large lines of stock. Both have significant retained shareholdings, with Finegold's interest, held through Notting Hill Partners, amounting to 18% post sale.

OUR CENTRAL CASE

When Kensington floated on the London Stock Exchange in November 2000, we viewed the non-prime mortgage market and Kensington's business model as high-risk, high-return. Four years on, with the shares double the flotation price, a reflection of 25%-plus compound annual earnings growth over the period, we might be forgiven for thinking that should have been low-risk, high-return.

As good as it gets?

Market conditions have been supportive since flotation

While some of Kensington's earnings performance since flotation can and should be attributed to management and its focus on risk management and disciplined growth, the fact is the market backdrop has been about as good as it gets. Low interest and unemployment rates, rising house prices and active mortgage markets have underpinned remarkable growth in Kensington's mortgage assets under management. From around £1.3bn at the time of the flotation, Kensington's mortgage assets had risen to £4.1bn by end-November 2004.

Demographics augur well for longer-term non-prime market growth

In the longer term, the outlook for Kensington's mortgage asset growth is good:

- The non-prime market continues to grow. The number of self-employed, contract and part-time workers continues to grow, as does the number of credit impaired, if last year's county court judgments (CCJs) are a reliable guide. The mortgage lenders' penetration of this non-prime customer base is still low at around 20%, around half that of the prime market.
- Kensington's share of the non-prime market looks set to increase, as it builds alternative distribution channels, such as Money Partners and Start Mortgages, which will give it access to new intermediaries and introducers.

However, last year saw a pick-up in arrears and loan losses

In the near term, the outlook is more challenging. Loan losses have been so low that for much of the past four years Kensington has been earning sub-prime margins on effectively prime quality assets. Rising interest rates did result in a modest pick-up in non-performing loans last year – accounts 90 days or more in arrears at end-November were 7.3%, up 5.2% at end-November 2003 – while loan losses also began to tick up, albeit from exceptionally low levels. Partly due to the impact of mortgage regulation, but also partly due to the general slowdown in the mortgage market, Kensington's new business pipeline stood at £300m at end-December 2004, as compared with £400m the previous year.

Despite defensive features ...

In recognition of the potential for non-prime credit quality to "normalise", Kensington has been shifting its business mix a little down the risk curve, with more near-prime and fewer 'severe credit impaired' customers on its books. The regional mix has also moved a little North. Only 40% of completions last year were in the South and only 6% in inner London. The group's weighted average LTV is low at 77% and, on an HPI-adjusted basis, 85% of loans are on an LTV of less than 65%.

... the near-term outlook is for reduced earnings growth

Peak cycle returns – the only way is down

Our concern is that consensus estimates, up sharply since the final results two weeks ago, ignore the potential for tougher conditions ahead. According to Multex, consensus expectations are for 17% p.a. compound growth over the next three years. We forecast 11% p.a.

The risks not fully discounted by market estimates are the potential for (i) declining non-interest income, (ii) increased loan loss provisions, and at the same time (iii) rising fixed costs.

Net fees & commissions take the strain in a slowing market

Amortisation of previous new business strain will weigh on net fees & commissions for another two years

Net fees & commissions – feeling the new business strain

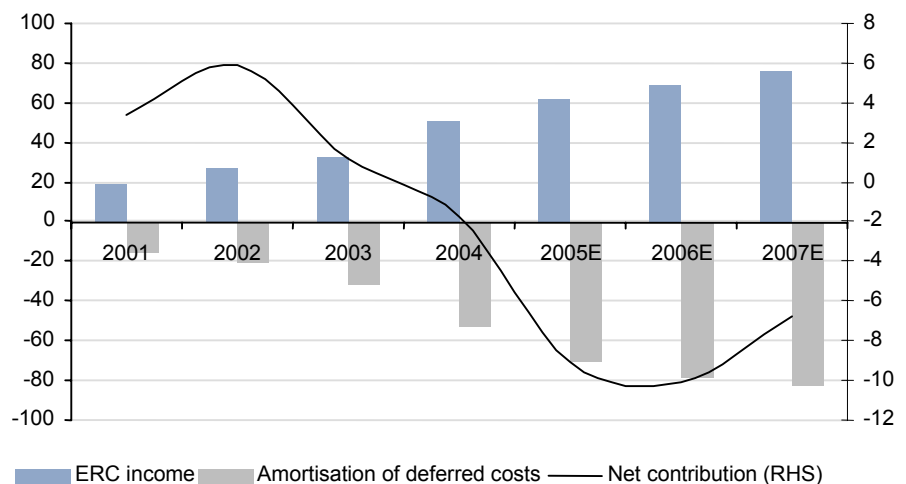
Early redemption charges (ERCs) account for virtually all of Kensington's fees and commissions receivable, while amortisation of deferred acquisition costs constitutes virtually all of its fees and commissions payable.

With acquisition commissions being amortised over three years, these charges to the profit and loss account can continue to rise in years beyond those in which in which they were actually incurred, especially after strong new business inflows.

ERC income, however, is more sensitive to prepayment speeds and the proportion of redemptions that trigger early redemption charges. Although Kensington's prepayment speeds have been fairly stable over recent years, last year's 57% increase in ERCs was due to a 69% increase in mortgages less than three years old, and hence in redemption penalty territory. A slowdown in new lending could stall growth in ERCs by reducing the percentage of sub-3-year customers in Kensington's mortgage assets.

Assuming a slowdown in loan growth, our analysis indicates slower growth in ERCs than in the amortisation of deferred acquisition costs over the next two years, which results in a fall in net fees and commissions this year, and a flat year in 2006.

Net fees & commissions – the new business strain effect



Source Company, Lazard

Profit on sales was a significant contributor to last year's PBT

Failure to deliver regular profits on sale could disappoint the market

The whole loan sales treadmill

More than 8% of last year's PBT was due to profit earned on whole loan sales. Since these profits represent the up-front realisation of in-force value, there is an element of 'more now, less later' as far as profit recognition is concerned. Since market estimates now include a profit on sale element, management will have to try to deliver these profits on a fairly regular basis in order not to "miss" market estimates.

To this end, management has built into Kensington's origination profile an element of new lending designed for sale. Arrangements are also in place with a number of third parties to try and ensure a sales pipeline going forward.

Provisions – the real swing factor

As at end-November 2004, 7.3% of Kensington's borrowers were 90 days or more in arrears. Assuming this translates to mortgage assets managed, we are talking £300m of 'non-performing loans' in banking terminology. Against this,

Arrears to losses performance in a downturn is the key issue

Kensington has a £25m balance sheet provision, topped up last year with a £13.2m annual provision charge. Actual losses last year were only £3.8m.

The key question is how the arrears to losses relationship works in a less benign macro-environment, and at what point significantly higher provisioning becomes necessary. As the table below shows, Kensington more than doubled its P&L provision charge last year to take the balance sheet provision up from 0.50% to 0.60% of closing mortgage assets.

Provisions for loan losses

Year to November (£m)	2001	2002	2003	2004	2005E	2006E	2007E
Opening b/s provision	5.7	8.6	11.7	15.5	24.9	33.8	43.8
Losses	-3.0	-2.1	-1.6	-3.8	-4.4	-5.0	-5.6
Provision charge	5.9	5.2	5.4	13.2	13.3	15.1	16.8
Closing b/s provision	8.6	11.7	15.5	24.9	33.8	43.8	55.0
Average mortgage assets	1,381	1,704	2,513	3,628	4,436	5,024	5,613
Closing mortgage assets	1,501	1,908	3,118	4,138	4,733	5,315	5,911
Actual losses/avg assets (%)	0.22	0.12	0.06	0.10	0.10	0.10	0.10
Provision/closing assets (%)	0.57	0.61	0.50	0.60	0.71	0.82	0.93

Source Lazard

An increase in loan losses from 10bp to 30bp in 2005 would reduce forecast PBT by 16%

Based on our current year forecasts, a provision charge equal to 0.3% of average mortgage assets and a loan loss maintained at only 0.1% results in a balance sheet provision of £34m, or 0.71% of closing assets. However, if the loan loss experience rose to 0.30%, for instance, an annual charge some £9m higher than we currently forecast would be required to maintain the balance sheet provision at 0.71%. This would reduce our pre-exceptional PBT estimate by 16%.

In conclusion, Kensington's annual provision charge could be highly sensitive to a further pick-up in loan loss experience, and management has clearly stated that last year's loan loss experience of 0.1% of managed assets is roughly half its central estimate for long-term losses. The 0.3% we hypothesise above certainly seems plausible in that context.

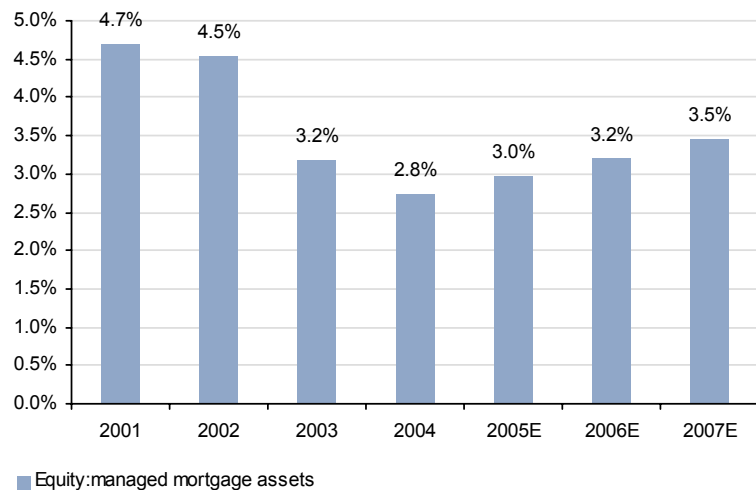
Increased leverage – higher returns on equity, greater earnings volatility

Management has intentionally leveraged equity returns

Kensington's earnings sensitivity to provisions is an example of a more general earnings sensitivity due to high balance sheet leverage. At end-November 2004, Kensington's equity to managed assets ratio stood at 2.8%, as compared with 3.2% in 2003, 4.5% in 2002. In effect, this translates into leverage of 36x in 2004, up from 22x in 2002 (in other words, a 10 basis point reduction in ROA would have reduced ROE by 3.6% in 2004 as compared with 2.2% in 2002).

This increase in leverage has been as much by design as due to strong balance sheet growth. Annual dividend growth has substantially exceeded earnings growth in each of the past three years, and last year, the group spent £13m on repurchasing shares for cancellation.

Balance sheet leverage: equity to mortgage assets managed



Source Company, Lazard

Kensington's high leverage makes a 2007E 50p EPS outcome frighteningly easy to construct

Stress testing the leverage – the 50p 2007 EPS scenario

In the table below, we highlight the potential impact on earnings of relatively modest changes to the ROA breakdown of our 2007E base case estimates.

Balance sheet leverage – ROE and earnings scenarios (%)

Year to November 2007	Returns on Average MAUM			
	Low	Base	High	Worst case
Net interest income	2.08	2.12	2.16	2.00
Non-interest income	0.76	0.78	0.80	0.66
Total income	2.84	2.90	2.96	2.66
Expenses	-1.36	-1.34	-1.32	-1.38
Pre-provision profit	1.48	1.56	1.64	1.28
Provisions	-0.40	-0.30	-0.20	-0.50
Associates	0.00	0.01	0.02	0.00
Core PBT	1.08	1.27	1.46	0.78
Tax	-0.32	-0.38	-0.44	-0.23
Minorities	-0.02	-0.03	-0.04	0.01
Attributable profit/ROA	0.74	0.86	0.98	0.55
Equity:MAUM	3.7	3.3	3.0	4.0
Leverage	27.0	29.9	33.0	25.0
ROE	20	26	32	14
Average 2007E equity (£m)	188	188	188	188
Earnings (£m)	37.3	48.3	60.8	26.0
EPS (p)	71.7	93.0	117.0	50.0

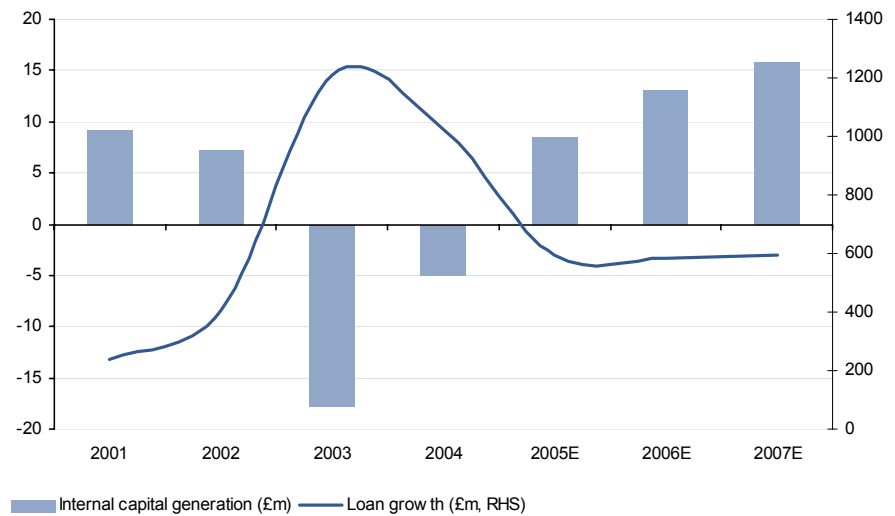
Source Lazard

Substantial internal capital generation could materially de-leverage Kensington's balance sheet by 2007

De-leveraging – a positive consequence of reduced loan growth?

A consequence of our forecast for reduced mortgage asset growth is a significant increase in equity cash flow from the 2005 onward, and despite an increased dividend payout assumption, substantial internal capital generation. This has the effect of de-leveraging the balance sheet, assuming no further share repurchases. We note that management will seek to renew its authority to repurchase up to 10% of the group's shares at the forthcoming AGM in April.

Loan growth & internal capital generation



Source Company, Lazard

In broadening the base of the business, management has traded margin for volume ...

Broadening the base – higher volumes but at lower margin

At the time of the flotation in 2000, Kensington was a focused underwriting business. Mortgage origination was wholly outsourced to brokers and packagers. The advantage was a highly variable cost base; the disadvantage being the high cost of new business acquisition. The acquisition in 2002 of TML – a direct to consumer distributor of specialist mortgages – was a first step in recapturing some of the commissions previously paid away. Money Partners Limited and Start Mortgages represent additional steps in this direction, as does the establishment of the group's new business service centre in Reading.

- **Money Partners Limited.** MOL is a new UK non-prime mortgage lender in which Kensington has a 20% stake with an option to acquire the remaining equity over the next four years. MOL started trading in November and offers first and second charge mortgages to brokers/introducers not currently distributing Kensington products. Kensington pays MPL commission for new lending sourced by it, with which it then shares the profit earned on the loans. Kensington's 20% allows it to recapture another 10% of the profit it shares with MPL (20% of MPL's 50%) and hence the all-in margin on MPL introduced business will be about 60% of that on business sourced through other channels such as TML. However, since we forecast £500m of originations from MPL this year, there is a considerable volume/margin trade-off.
- **Start Mortgages.** Kensington owns 60% of SM, a new non-prime mortgage lender in the Republic of Ireland. Since SM started trading in November 2004, the impact of including its income and expenses (and the minority charge it brings) in Kensington's accounts should only become fully evident in the current year.
- **Becoming a packager.** Kensington will become a packager itself when it establishes a new business service centre in Reading during the first quarter of this year. Ultimately, management expects to be able to reduce to 1% cost of using external packagers to only 0.5% on business taken through Reading.

... and increased the fixed element of the group's cost base

The net effect of these initiatives will be higher volumes, but at lower margin and returns. Lower net interest margin as a result of the MPL give-up, and lower net returns due to higher infrastructure and investment costs, at least initially. By bringing in-house some of the origination and packaging it used to outsource, Kensington has increased the fixed element of its cost base.

Loan Growth Assumptions (including MPL Impact)

Year to November (£m)	2001	2002	2003	2004	2005E	2006E	2007E
New KMC/TML lending	686.1	1,018.3	2,015.5	2,265.5	2,000.0	2,200.0	2,420.0
New MPL lending					500.0	550.0	605.0
Total new lending	686.1	1,018.3	2,015.5	2,265.5	2,500.0	2,750.0	3,025.0
Run-off rate (%)	-35	-41	-42	-40	-40	-40	-40
MAUM balances	1,500.5	1,907.9	3,117.8	4,138.3	4,733.0	5,314.8	5,911.4
Average balance	1,380.8	1,704.2	2,512.9	3,628.1	4,435.6	5,023.9	5,613.1

Source Company, Lazard

Returns on mortgage assets & ROE (%)

Year to November	2001	2002	2003	2004	2005E	2006E	2007E
Interest receivable	9.86	8.14	7.30	8.12	7.62	7.53	7.44
Interest payable	-6.97	-5.59	-4.95	-5.81	-5.36	-5.32	-5.32
Net interest income	2.89	2.55	2.35	2.31	2.26	2.22	2.12
Fees & commissions receivable	1.67	2.22	2.43	2.25	2.02	1.97	1.94
Fees & commissions payable	-1.03	-1.21	-1.33	-1.20	-1.41	-1.37	-1.28
Net fees & commissions	0.64	1.00	1.10	1.05	0.61	0.60	0.66
Profit on sale of mortgages	0.00	0.00	0.05	0.12	0.12	0.12	0.12
Operating income	3.53	3.56	3.50	3.48	3.00	2.93	2.90
Operating expenses	-1.29	-1.48	-1.81	-1.67	-1.50	-1.43	-1.34
Pre-provision profit	2.24	2.08	1.69	1.81	1.50	1.50	1.56
Provision for losses	-0.43	-0.31	-0.21	-0.36	-0.30	-0.30	-0.30
Operating profit	1.81	1.77	1.48	1.44	1.20	1.20	1.26
Associate income				-0.01	0.00	0.01	0.01
Core PBT	1.81	1.77	1.48	1.43	1.20	1.22	1.27
Tax	-0.54	-0.44	-0.44	-0.44	-0.36	-0.36	-0.38
Minorities	0.00	0.00	0.00	0.01	0.02	0.00	-0.03
ROA	1.27	1.33	1.04	1.00	0.87	0.85	0.86
Leverage (avg MAUM/equity)	22.2	21.7	27.0	34.1	34.9	32.3	29.9
ROE	28	29	28	34	30	28	26

Source Company, Lazard

Our key assumptions are a slowdown in mortgage asset growth over the forecast period, and reduced net fees & commissions in 2005

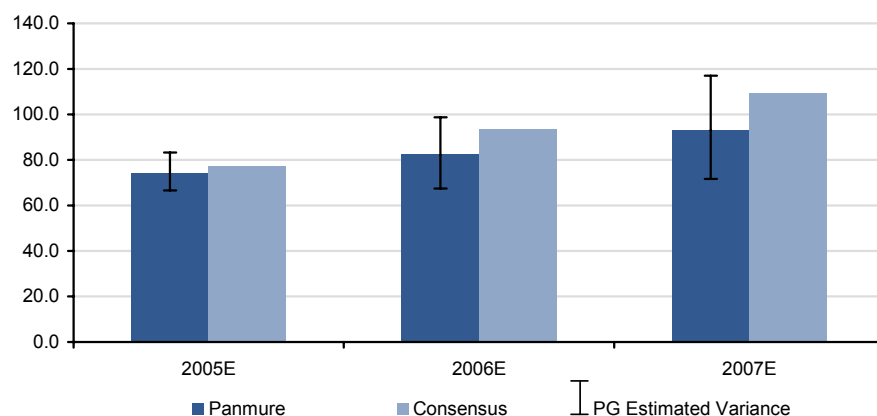
ANALYSIS OF FORECASTS

Our forecasts reflect a modest slowdown in like-for-like new lending volumes, a broadly maintained underlying net interest margin, and a declining non-interest income margin. The changing shape of the profit and loss account reflects the impact of last year's new ventures and the partial insourcing of mortgage packaging.

- We have assumed a fall in like-for-like new originations from last year's £2.2bn to £2.0bn this year, followed by 10% growth in 2006E and 2007E. In addition, we have assumed £500m of new originations in 2005 from Money Partners Limited (MPL), with which Kensington has a 50:50 profit share agreement and a 20% equity interest, followed by 10% growth in 2006E and 2007E.
- We assume a maintained 2.3% average interest spread on like-for-like new business in 2005, declining to 2.1% by 2007E. For Kensington's share of MPL generated net interest, we have assumed a spread of 1.6% in 2005, falling to 1.5% in 2007. We assume opening mortgage assets run-off at a rate of 40% per annum going forward (40% in 2004). Closing assets are assumed to equal opening assets less run-off plus gross new lending less portfolio sales.
- As the proportion of managed assets originated by MPL increases, the above spread assumptions imply a reduction in Kensington's blended net interest margin from 2.31% in 2004 to 2.12% by 2007E.
- Following a 57% rise in 2004, we forecast early redemption charge (ERC) income growth slows to 22% this year and 11% in 2006E, reflecting reduced new completions growth and a reduction in the number of mortgages in redemption charge territory. For other fees and commissions received, we assume movements broadly in line with new lending trends.
- Following a 68% rise in 2004, we forecast a 36% rise in the amortisation of deferred costs in 2005 – reflecting strong new lending in 2003 and 2004 and the smoothing of associated commission costs over three years. Thereafter, deferred cost growth moderates, broadly in line with ERC income growth.
- We have assumed continued profit on the sale of mortgage portfolios, equal to a 2.2% profit on the sale of 10% of gross new lending.
- Following 33% growth in 2004, operating expenses are assumed to increase by 9% in 2005E, followed by 8% and 5% in the following two years. Forecast provisions are assumed to be stable at 0.3% of average managed assets.
- These assumptions drive 10% EPS growth this year, 11% in 2006E and 13% in 2007E. Equity cash flow (attributable profit less notional loan growth funding at an assumed 3% equity:managed assets ratio) turns significantly positive in 2005E onwards, reflecting managed asset growth slowing from 33% last year to 14% this year (12% and 11% thereafter).
- Strong equity cash flow underpins our forecast for aggressive dividend growth in excess of earnings growth. We forecast 25% dividend growth in 2005E followed by 20% in 2006E and 2007E.
- Whilst these EPS and DPS forecasts imply dividend cover down from 4.2x last year to 3.2x by 2007E, Kensington's internal capital generation allows a recovery in its equity:managed assets from last year's 2.8% to 3.5% by 2007E. We have not assumed any share repurchase.

Our base case forecasts are 4% below consensus for the current year, and 12%–15% below for 2006–07. Best case assumes reduced total income margin erosion; worst case assumes higher provisions

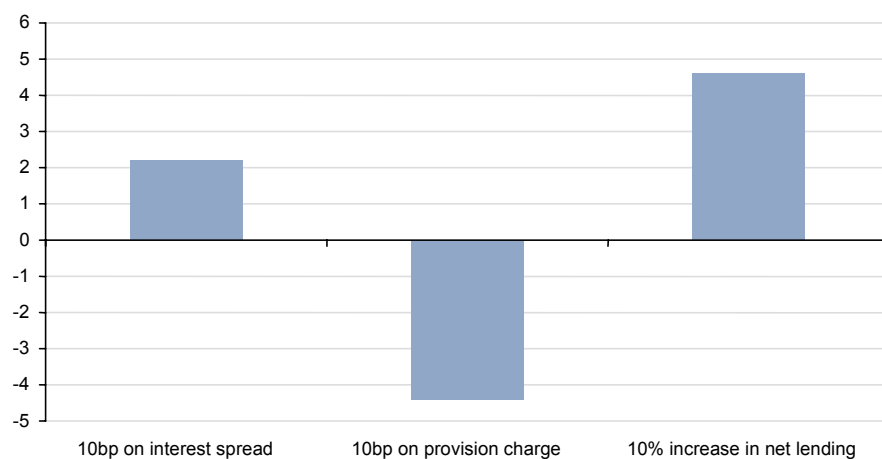
Panmure Gordon relative to consensus forecasts (EPS)



Source Reuters, Lazard

Sensitivities for Panmure Gordon 2005E forecasts

Net interest margin, provisions and new lending volumes are key sensitivities



Source Lazard

Discounted free cash flows based on longer-term profitability and asset growth scenarios suggest a 660p per share fair value

On a P/E basis, the shares look cheap in comparison to quoted peers

VALUATION

Valuations based on current profitability suggest Kensington's shares are cheap. But if current profitability reflects peak-cycle returns, these valuations could prove optimistic. Fair values based on estimates of mid-cycle returns are much closer to current price levels.

PRICE EARNINGS RATIOS

Based on our own and consensus estimates, Kensington's shares look cheap on a P/E basis. The table below compares Kensington with other quoted UK mortgage market stocks in terms of their prospective P/E multiples and dividend yields.

Kensington: comparisons with other quoted mortgage market stocks

	Kensington	Paragon Group	Northern Rock	Bradford & Bingley
Price (p)	580	454	820	343
P/E (x)				
2005E	7.8	9.8	10.0	11.0
2006E	7.0	8.9	9.2	10.3
Yield (%)				
2005E	3.4	2.6	3.6	5.3
2006E	4.1	3.1	4.0	5.5

Source Lazard, Reuters

DISCOUNTED FREE CASH FLOWS

In the DCF work summarised below, we examine a number of scenarios for Kensington's returns on average mortgage assets given a range of longer-term mortgage asset growth rates. (The returns on average mortgage assets managed broadly equate to the sensitivities set out in the earlier in this note.)

Scenario 1 – Peak Cycle

Assumes our profit forecasts out to November 2007E, followed by a maintained 0.87% return on managed assets for 10 years applied to average mortgage assets growing at 6% per annum, and a terminal value.

Scenario 2 – Mid Cycle

Assumes lower profits that we currently forecast for 2006 and 2007, reflecting an estimate of “mid-cycle” provisions, followed by a 0.74% return on managed assets from 10 years applied to average mortgage assets growing at 5% per annum, followed by a terminal value.

Scenario 3 – Recession

Assumes much lower profits than we currently forecast for 2006E and 2007E – essentially zero growth in those years – reflecting a significant rise in loan loss provisions, followed by a 0.55% return on managed assets for 10 years applied to average mortgage assets growing at 4% per annum, followed by a terminal value.

Scenario 1 – peak cycle returns on mortgage assets

Steady state RWA growth (%)	6													
Steady state RORWA (%)	0.86													
Discount rate (%)	12													
Terminal multiple	8.3													
Year to November (£m)	2005E	2006E	2007E	2008E	2009E	2010E	2011E	2012E	2013E	2014E	2015E	2016E	2017E	Terminal
Avg Mortgage AUM	4,436	5,024	5,613	5,950	6,307	6,685	7,086	7,512	7,962	8,440	8,946	9,483	10,052	10,052
Average asset growth (%)	22	13	12	6	6	6	6	6	6	6	6	6	6	
Pre-exceptional PBT	53	61	71											
less tax	-16	-18	-21											
less prior charges	1	0	-2											
NOPAT	38	43	48	51	54	57	61	65	68	73	77	82	86	
RoMAUM (%)	0.87	0.85	0.86	0.86	0.86	0.86	0.86	0.86	0.86	0.86	0.86	0.86	0.86	
less working capital	-18	-17	-18	-10	-11	-11	-12	-13	-14	-14	-15	-16	-17	
Free cash flow	21	25	30	41	44	46	49	52	55	58	62	65	69	
FCF RoMAUM (%)	0.46	0.50	0.54	0.69	0.69	0.69	0.69	0.69	0.69	0.69	0.69	0.69	0.69	
Discount factor	1.12	1.25	1.40	1.57	1.76	1.97	2.21	2.48	2.77	3.11	3.48	3.90	4.36	4.89
PV (free cash flow) (£m)	18	20	22	26	25	23	22	21	20	19	18	17	16	147
NPV (free cash flow) (£m)	414													
NPV (free cash flow)/share (p)	797													

Source Lazard

Scenario 2 – estimated mid-cycle returns on mortgage assets

Steady state RWA growth (%)	5													
Steady state RORWA (%)	0.74													
Discount rate (%)	12													
Terminal multiple	8.3													
Year to November (£m)	2005E	2006E	2007E	2008E	2009E	2010E	2011E	2012E	2013E	2014E	2015E	2016E	2017E	Terminal
Avg Mortgage AUM	4,436	5,024	5,613	5,894	6,188	6,498	6,823	7,164	7,522	7,898	8,293	8,708	9,143	9,143
Average asset growth (%)	22	13	12	5	5	5	5	5	5	5	5	5	5	
Pre-exceptional PBT	53	59	65											
less tax	-16	-18	-21											
less prior charges	1	0	-2											
NOPAT	38	40	42	44	46	48	50	53	56	58	61	64	68	
RoMAUM (%)	0.87	0.80	0.75	0.74	0.74	0.74	0.74	0.74	0.74	0.74	0.74	0.74	0.74	
less working capital	-18	-17	-18	-8	-9	-9	-10	-10	-11	-11	-12	-12	-13	
Free cash flow	21	23	24	35	37	39	41	43	45	47	50	52	55	
FCF RoMAUM (%)	0.46	0.45	0.43	0.60	0.60	0.60	0.60	0.60	0.60	0.60	0.60	0.60	0.60	
Discount factor	1.12	1.25	1.40	1.57	1.76	1.97	2.21	2.48	2.77	3.11	3.48	3.90	4.36	4.89
PV (free cash flow) (£m)	18	18	17	22	21	20	18	17	16	15	14	13	13	115
NPV (free cash flow) (£m)	339													
NPV (free cash flow)/share (p)	653													

Source Lazard

Scenario 3 – the recession scenario

Steady state RWA growth (%)	4
Steady state RORWA (%)	0.55
Discount rate (%)	12
Terminal multiple	8.3

Year to November (£m)	2005E	2006E	2007E	2008E	2009E	2010E	2011E	2012E	2013E	2014E	2015E	2016E	2017E	Terminal
Avg Mortgage AUM	4,436	5,024	5,613	5,838	6,071	6,314	6,567	6,829	7,102	7,386	7,682	7,989	8,309	8,309
Average asset growth (%)	22	13	12	4	4	4	4	4	4	4	4	4	4	
Pre-exceptional PBT	53	54	54											
less tax	-16	-18	-21											
less prior charges	1	0	-2											
NOPAT	38	35	31	32	33	35	36	38	39	41	42	44	46	
RoMAUM (%)	0.87	0.70	0.56	0.55	0.55	0.55	0.55	0.55	0.55	0.55	0.55	0.55	0.55	
less working capital	-18	-17	-18	-7	-7	-7	-8	-8	-8	-9	-9	-9	-10	
Free cash flow	21	18	13	25	26	27	29	30	31	32	33	35	36	
FCF RoMAUM (%)	0.46	0.36	0.24	0.43	0.43	0.43	0.43	0.43	0.43	0.43	0.43	0.43	0.43	
Discount factor	1.12	1.25	1.40	1.57	1.76	1.97	2.21	2.48	2.77	3.11	3.48	3.90	4.36	4.89
PV (free cash flow) (£m)	18	14	9	16	15	14	13	12	11	10	10	9	8	78
NPV (free cash flow) (£m)	238													
NPV (free cash flow)/share (p)	459													

Source Lazard

Based on the average of our “blue sky” and mid-cycle scenarios, we estimate current fair value at approximately 660p per share

Hence we consider the shares to be inexpensive at current levels rather than significantly undervalued

Valuations

Scenario 1 – the “blue sky” scenario – generates a November 2005 fair value estimate of 797p per share, equivalent to around 730p discounted to present value. Scenario 2 suggests a November value of 653p, and a present value of 596p. Scenario 3 – the recession scenario – suggests a November 2005 fair value of 459p, and a present value of 419p.

We use an average of scenarios 1 and 2 for fair value purposes, since this captures our existing forecasts and hence returns on average assets, but with an overlay to reflect the risk of our base case provision assumptions being too optimistic. The result is a fair value of 663p, which represents around 13% upside and a 2006E P/E of 8.1x – still below P/E valuations being afforded to the other three mortgage market peers in our comparatives table.

Conclusions

Kensington’s current market valuation clearly takes into account the probability of lower than consensus earnings over the next few years, and sustainable returns below what should be seen as peak-cycle recent returns.

We conclude that the shares are currently inexpensive rather than significantly undervalued, as our blue-sky DCF scenario might suggest. It is comforting that our ‘negative case’ scenario indicates relatively limited downside from current levels.

THE NUMBERS

Profit & loss (£m)

Year to November	2001A	2002A	2003A	2004A	2005E	2006E	2007E
Interest receivable	136.2	138.8	183.5	294.6	338.2	378.4	417.4
Interest payable	-96.3	-95.3	-124.4	-210.9	-237.8	-267.1	-298.5
Net interest income	39.9	43.5	59.1	83.7	100.4	111.3	118.9
+ERC income	18.8	26.9	32.5	50.9	62.3	69.0	76.0
+TML fees	0.0	5.8	21.9	21.7	19.2	21.1	23.2
+Other fees receivable	4.2	5.1	6.7	9.2	8.1	8.9	9.8
Fees & commissions receivable	23.0	37.8	61.1	81.8	89.5	99.0	109.0
+Amortisation of deferred costs/	-15.4	-21.0	-31.3	-52.6	-71.3	-79.1	-82.8
+Other fees payable	1.2	0.3	-2.1	8.9	9.0	10.0	11.0
Fees & commissions payable	-14.2	-20.7	-33.4	-43.7	-62.3	-69.1	-71.8
Net fees & commissions	8.8	17.1	27.7	38.1	27.2	30.0	37.2
Profit on sale of mortgages			1.2	4.4	5.5	6.1	6.7
Operating income	48.7	60.6	88.0	126.2	133.1	147.3	162.8
Operating expenses	-17.8	-25.2	-45.5	-60.7	-66.5	-71.8	-75.5
Pre-provision profit	30.9	35.4	42.5	65.5	66.7	75.5	87.3
Provision for losses	-5.9	-5.2	-5.4	-13.2	-13.3	-15.1	-16.8
Operating profit	25.0	30.2	37.1	52.3	53.3	60.4	70.5
Associate income	0.0	0.0	0.0	-0.5	0.1	0.6	0.7
Core PBT	25.0	30.2	37.1	51.8	53.4	61.1	71.2
Exceptional items	0.0	0.0	0.0	0.0	0.0	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	51.4	61.1	71.2
Taxation	-7.5	-7.5	-11.0	-16.1	-16.0	-18.3	-21.3
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	36.4	42.7	48.3
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	26.2	30.5	33.7

Balance sheet (£m)

Mortgage AUM	1,501	1,908	3,118	4,138	4,733	5,315	5,911
Avg mortgage AUM	1,381	1,704	2,513	3,628	4,436	5,024	5,613
Risk-weighted assets	750	954	1,559	2,069	2,366	2,657	2,956
Equity	70.6	86.8	99.2	113.9	140.1	170.7	204.3
Minorities				0.3	1.0	1.0	1.0
Intangible assets		15.6	21.2	16.3	14.3	14.3	14.3
Tangible equity	70.6	71.2	78.0	97.6	125.8	156.4	190.0
Provision balance	8.6	11.7	15.5	24.9	33.8	43.8	55.0
NPLs	120.0	143.1	227.6	302.1	331.3	372.0	413.8

Per share data

Avg diluted shares in issue (m)	58.1	57.4	54.8	53.7	51.9	51.9	51.9
Reported EPS (p)	30.1	38.9	43.2	63.3	70.1	82.3	93.0
Adjusted EPS (p)	30.1	39.6	47.6	67.2	73.9	82.3	93.0
DPS (p)	2.0	5.0	10.0	16.0	20.0	24.0	28.8
NAV/share (p)	123	156	188	224	276	336	402

Source Company, Lazard

Key ratios (%)

Year to November	2001A	2002A	2003A	2004A	2005E	2006E	2007E
Ratios							
Net interest margin (%)	2.89	2.55	2.35	2.31	2.26	2.22	2.12
Total income margin (%)	3.53	3.56	3.50	3.48	3.00	2.93	2.90
Net interest:total income (%)	82	72	67	66	75	76	73
Cost:income ratio (%)	-37	-42	-52	-48	-50	-49	-46
Expenses:avg MAUM (%)	-1.29	-1.48	-1.81	-1.67	-1.50	-1.43	-1.34
Provisions:pre-provision profit (%)	-19	-15	-13	-20	-20	-20	-19
Provision:avg MAUM (%)	-0.43	-0.31	-0.21	-0.36	-0.30	-0.30	-0.30
NPLs:loans (%)	8.0	7.5	7.3	7.3	7.0	7.0	7.0
Provision balance:NPLs (%)	7.2	8.2	6.8	8.2	10.2	11.8	13.3
ROE (%)	28	29	28	34	30	28	26
RoAvgMAUM (%)	1.27	1.33	1.04	1.00	0.87	0.85	0.86
Equity:managed mortgage assets (%)	4.7	4.5	3.2	2.8	3.0	3.2	3.5
Theoretical Tier 1 (%)	9.4	7.5	5.0	4.7	5.3	5.9	6.4
Effective tax rate (%)	-30	-25	-30	-31	-30	-30	-30

Source Company, Lazard

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

Overall Global Distribution (Banking Client*)		
Buy	Hold	Sell
49% (34%)	39% (14%)	13% (8%)

* Indicates the percentage of each category in the Overall Distribution that were Lazard 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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15 February 2005

UK Equity Research

COMPANY PROFILE

Business Profile

Kensington Group 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 lender's credit scoring systems, and includes the recently self-employed, contractors, older borrowers, temporary employees and those with impaired credit histories.

In 2002 Kensington acquired TML, a direct to consumer distributor of mortgages to partly insource mortgage origination. In 2004 the group entered into ventures with Money Partners in the UK and Start Mortgages in the Republic of Ireland to broaden its distribution channels.

Recent News

Kensington announced final results for the year to November 2004 on 1 February. Pre-goodwill PBT increased by 40% to £51.8m, EPS by 41% to 68.6p, full year DPS by 60% to 16p. New business volumes amounted to £2.3bn during the year, bringing end-November mortgage assets under management to £4.1bn.

Recent director dealings

Director	Dealing Date	Value (£)	No of shares	Price (p)	Change* (%)
John Maltby	10 Feb 2005	2,706,774	468,300	578p	-45
David Gareth Jones	1 Feb 2005	13,897	2,688	517p	+2

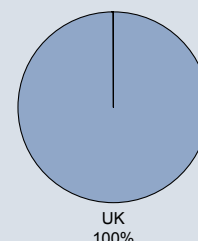
* of fd shareholding

Source RNS

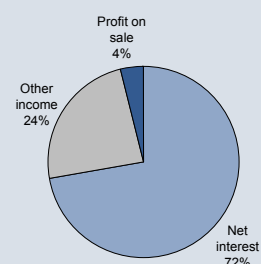
Company Information

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

Revenues by geography* (%)



Revenues by type* (%)



*For year ending 2004A

Source: Company data

Major Shareholders (%)

Marty Finegold	18.05
Fidelity	8.26
GSAM	5.70

Financial Diary

Next Statement	May 2005
Next Results	July 2005
Next ex dividend	23 March 2005

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