Key Call: Lloyds Banking Group
Ink spilled, trees felled, views unchanged

Despite today's to-ing and fro-ing, we expect bulls and bears are left unmoved
1Q16 underlying PBT was 4% above our estimates but in line with consensus if we add back the £58m benefit from a credit card accounting policy change booked in the quarter. All of management's targets for 2016 were reiterated: net interest margin, cost/income, loan losses and capital generation. But a lack of underlying revenue momentum and capital formation in the quarter will probably be enough to leave bears unmoved amidst current political uncertainty.

We see a bank under firm control, capable of improving efficiency…
Our estimates are broadly unchanged and so also is our view. In the numbers we see a bank under firm control. Income was down 2% QoQ excluding the card benefit, but cost reduction plans are in train to deliver the falling cost/income ratio targeted by management and which our branch-analysis suggests is a real medium-term opportunity. We expect the bank to sustain a ROTE of 14% through to 2020.

…and paying an 8.5% yield
LBG's common equity tier 1 ratio reported at 12.8%, 30bps below our 13.1% forecast, driven in roughly equal parts by larger below-the-line charges and increased deductions in regulatory capital. Unless these recur in equal scale in future, however – unfeasible in our view – LBG should deliver ~6p in capital generation this year, the driver of our 5.75p dividend forecast, an implied yield of 8.5%.

Valuation: 1.3x TNAV, 14% ROTE, 9.0x 2017 EPS, 8.5% 2016 yield
Assuming a fair yield of 5% in line with the European banks sector average, the market is discounting at least a 40% cut to our dividend forecast. We think this unrealistic and reiterate our Buy rating. Our sum-of-the-parts derived target price moves marginally to 86p from 88p on 3% lower EPS for 2017E (driven by modestly lower revenues), 26% capital upside.

Equities

United Kingdom
Banks, Ex-S&L

12-month rating	**Buy**
12m price target	**86p**
	Prior: 88p
Price	**69p**

RIC: LLOY.L **BBG:** LLOY LN

Trading data and key metrics

52-wk range	89p-56
Market cap.	£49.4bn/US$71.9bn
Shares o/s	71,370m (ORD)
Free float	91%
Avg. daily volume ('000)	137,080
Avg. daily value (m)	£90.9
Common s/h equity (12/16E)	£43.1bn
P/BV (12/16E)	1.2x
Tier 1 ratio	15%

EPS (UBS, diluted) (p)

	From	To	% ch	Cons.
12/16E	7.6	7.5	-2	7.6
12/17E	7.7	7.5	-3	7.6
12/18E	7.8	7.5	-3	7.6

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Highlights (£m)	12/13	12/14	12/15	12/16E	12/17E	12/18E	12/19E	12/20E
Revenues	18,805	18,368	17,637	17,733	18,027	18,571	19,320	20,151
Profit before tax	415	1,762	1,644	5,968	6,902	7,538	8,099	8,633
Net earnings (local GAAP)	(838)	1,187	546	3,992	4,638	5,173	5,583	5,961
Net earnings (UBS)	3,590	5,862	5,897	5,430	5,476	5,525	5,740	6,119
Tier 1 ratio %	10.3	15.0	15.2	15.4	15.8	15.4	15.6	15.5
EPS (UBS, diluted) (p)	5.1	8.1	8.2	7.5	7.5	7.5	7.8	8.3

Profitability/valuation	12/13	12/14	12/15	12/16E	12/17E	12/18E	12/19E	12/20E
ROE (UBS) %	8.9	14.2	13.9	12.9	12.7	12.9	13.4	13.9
P/PPOP (diluted)	5.0	6.2	6.6	5.8	5.6	5.4	5.1	4.8
P/BV x	1.2	1.3	1.4	1.2	1.2	1.2	1.2	1.1
P/BV (UBS) x	1.3	1.4	1.5	1.3	1.3	1.3	1.2	1.2
P/E (UBS, diluted)	12.8	9.5	9.7	9.2	9.2	9.2	8.9	8.4
Net dividend yield %	0.0	1.0	3.5	8.3	8.3	8.7	10.1	10.8

Source: Company accounts, Thomson Reuters, UBS estimates. Metrics marked as (UBS) have had analyst adjustments applied. Valuations: based on an average share price that year, (E): based on a share price of 69p on 27 Apr 2016 21:35 BST

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UBS Research THESIS MAP a guide to our thinking and what's where in this report

PIVOTAL QUESTIONS

Q: Does competition in UK retail lending markets mean 2016 consensus EPS is too high?

No. LBG has proved itself adept at managing new loan and deposit rates to defend net interest margin and revenue. We see more room for the bank to move on deposit costs than at large cap peers, providing a margin of safety for future returns.

Q: Can LBG deliver a 45% cost/income ratio at end 2019?

Yes, we think so. There are income risks, but we think these could be offset by a more aggressive cost stance. Changing customer habits and signs of branch over-saturation mean a longer-term cost opportunity of £1bn, a large enough cushion for the market to be more confident of success than the share price indicates, we think.

Q: What did we learn with the 1Q16 results?

LBG is a bank under tight control, seeing cost cuts brought forward to address the difficult revenue environment. Our forecasts moved little and we expect the same for market consensus, with bulls and bears remaining in their respective camps, for now.

more→

UBS VIEW

LBG is a bank under tight control, seeing cost cuts brought forward to address the difficult revenue environment. Our forecasts moved little and we expect the same for market consensus, with bulls and bears remaining in their respective camps, for now. Political considerations aside, we think the dividend potential of the bank is significantly undervalued at the current price.

EVIDENCE

LBG reported 2p in underlying EPS this quarter and reiterated its target of producing 6p of capital in 2016 before dividends. Our estimates are broadly unchanged: we expect EPS of 7.5p this year and a dividend of 5.75p in 2016, an 8.5% running yield.

WHAT'S PRICED IN?

At the 5% average yield at which Europe's banks currently trade, a dividend cut of at least 40% of our estimate is in the LBG price we think. We just don't think this is right. Given the long-term stability of returns in UK retail banking, we look for LBG to return to a yield under 5% when rates increase.

UPSIDE / DOWNSIDE SPECTRUM

Value drivers	2y loan growth	NIM	Cost/ income	Loan losses	EPS	Payout DPS	DPS	Yield	Implied P/E
105p upside	3.5%	2.65%	48.0%	0.24%	7.9	80%	6.3	6.0%	13.3
86p base	2.8%	2.65%	50.1%	0.24%	7.5	77%	5.8	6.7%	11.4
55p downside	2.0%	2.45%	52.0%	0.40%	6.0	60%	3.6	6.7%	9.0

Source: UBS

more→

COMPANY DESCRIPTION

Lloyds Banking Group is the UK's largest retail financial services provider and one of the country's largest commercial banks. It was formed through the acquisition of HBOS by...

more →

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PIVOTAL QUESTIONS

return ↑

Q: What did we learn with the 1Q16 results?

UBS VIEW

LBG is a bank under tight control, seeing cost cuts brought forward to address the difficult revenue environment. Our forecasts moved little and we expect the same for market consensus, with bulls and bears remaining in their respective camps, for now.

EVIDENCE

1Q16 underlying PBT was 4% above our estimates but in line with consensus if we add back the £58m benefit from a credit card accounting policy change booked in the quarter. All of management's targets for 2016 were reiterated: net interest margin, cost/income, loan losses and capital generation.

WHAT'S PRICED IN?

We have LBG trading at 1.3x TNAV for a 14% forecast ROTE and with a dividend yield in 2016 well above 8%. Given the low risk profile of the balance sheet, strong prospective capital generation and market-leading efficiency, we think the future payout profile of the bank is significantly undervalued.

1Q16 results: in-line

LBG's 1Q16 underlying PBT of £2,054m was 7% ahead of UBSe and 3% above consensus (Figure 1). However, sensibly deducting a £58m income boost from a change to the accounting approach for credit cards, adjusted profits were in line with consensus.

Figure 1: LBG underlying PBT was 7% ahead of UBS, 3% above consensus

	Q1 15	Q4 15	Q1 16	Q1 UBSe	vs UBSe	Y/Y	Q/Q
Net interest income	2,829	2,904	2,906	2,896	+0%	+3%	+0%
Other income	1,592	1,528	1,477	1,500	-2%	-7%	-3%
Total income	**4,421**	**4,432**	**4,383**	**4,396**	**-0%**	**-1%**	**-1%**
Total costs	-2,203	-2,443	-2,180	-2,300	-5%	-1%	-11%
Pre-prov profit	**2,218**	**1,989**	**2,203**	**2,096**	**+5%**	**-1%**	**+11%**
Impairments	-158	-232	-149	-180	-17%	-6%	-36%
Underlying profit	**2,060**	**1,757**	**2,054**	**1,916**	**+7%**	**-0%**	**+17%**
Statutory PBT	**1,214**	**-507**	**654**	**1,001**	**-35%**	**-46%**	**-229%**
Banking NIM	2.60%	2.63%	2.74%	2.64%	0.10%	0%	0%
Loans ex TSB (£bn)	455	449	457	449	+2%	0%	2%
TNAV p.s. (p)	**55.8**	**51.7**	**55.2**	**52.8**	**+5%**	**-1%**	**7%**
CET1 capital	31.4	28.5	28.5	29.2	-2%	-9%	0%
RWA	234.0	222.7	223.0	222.0	+0%	-5%	0%
CET1 ratio	**13.4%**	**12.8%**	**12.8%**	**13.1%**	**-0.30%**	**-0.60%**	**0.00%**

Source: UBS estimates, Company data

Relative to our estimates, net interest income and non-interest income were in-line, costs were 5% lower, and impairments better at a modest 14bps, assisted by 8bps worth of write-backs.

We do not expect market EPS forecasts to move on these numbers. Our own estimates are largely unchanged, which leaves the share trading at 1.3x TNAV for a 14% forecast ROTE, 9.0x 2017E EPS, and a yield well above 8% (Figure 2).

Figure 2: Our estimates are broadly unchanged, leaving the stock on 9.0x 2017E EPS, yielding 8.5%

£m	2011	2012	2013	2014	2015	2016e	2017e	2018e	2019e	2020e
UBS Adj. EPS (Prior, p)	0.8	1.4	5.1	8.1	8.2	7.6	7.7	7.8	8.0	8.4
UBS Adj. EPS (Current, p)	**0.8**	**1.4**	**5.1**	**8.1**	**8.2**	**7.5**	**7.5**	**7.5**	**7.8**	**8.3**
% change	**0%**	**0%**	**0%**	**0%**	**0%**	**-2%**	**-3%**	**-3%**	**-2%**	**-2%**
DPS (p)	0.0	0.0	0.0	0.8	2.8	5.8	5.8	6.0	7.0	7.5
TNAV per share (p)	59.2	52.7	48.5	54.2	51.7	54.4	54.6	53.5	54.9	56.0
CET1 % (Fully Loaded)	n/a	8.1%	10.3%	12.8%	12.8%	13.0%	13.2%	12.8%	12.8%	12.8%
T1 lev ratio (Fully loaded)	n/a	n/a	3.4%	4.9%	4.8%	4.8%	4.9%	4.7%	4.8%	4.7%
ROTE (Stated)	-6.9%	-3.8%	-2.3%	3.2%	1.4%	10.4%	11.7%	13.1%	14.0%	14.5%
ROTE (Adj.)	1.3%	2.6%	9.7%	15.9%	15.4%	14.1%	13.8%	14.0%	14.4%	14.9%
Market Cap (£m)	31,334	24,174	45,278	54,262	56,168	49,103	49,103	49,103	49,103	49,103
P/E (UBS Adj.) (x)	**57.0**	**24.5**	**12.8**	**9.5**	**9.7**	**9.1**	**9.0**	**9.0**	**8.7**	**8.2**
Div yield (%)	**0.0**	**0.0**	**0.0**	**1.0**	**3.5**	**8.5**	**8.5**	**8.8**	**10.3**	**11.0**
P/TNAV (x)	**0.8**	**0.7**	**1.3**	**1.4**	**1.5**	**1.3**	**1.2**	**1.3**	**1.2**	**1.2**
Excess cap over 13% as % MV	**n.m.**	**-66%**	**-16%**	**-1%**	**-1%**	**0%**	**1%**	**-1%**	**-1%**	**-1%**

Source: Company data, UBS estimates; Priced with LBG at 68p

Ink spilled, trees felled, views unchanged

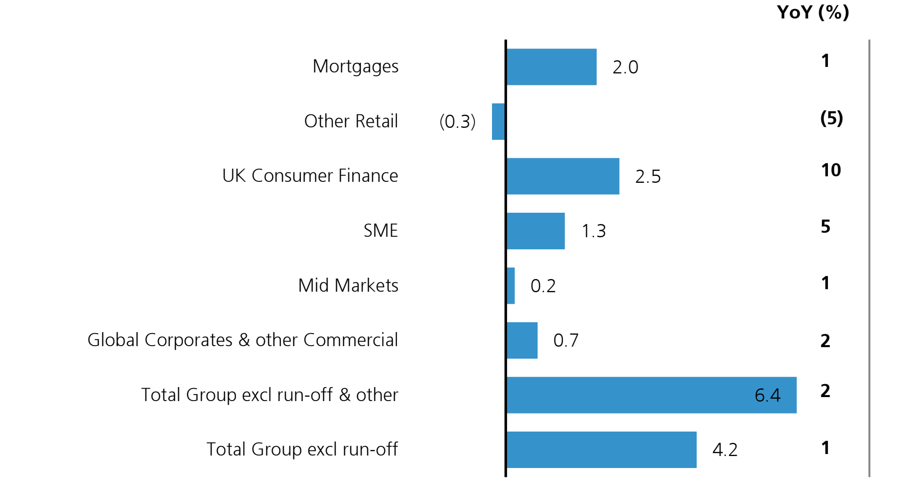
Despite the gallons of ink, forests of trees and trillions of pixels that will no doubt be devoted to covering the detail of LBG's results, we don't think the story for the stock has changed. Management, for its part, reiterated all targets for this year:

- Full-year guidance for net interest margin (~2.70%)
- Other operating income that is flat to slightly up on 2015's £6.1bn
- YoY improvement in cost/income ratio
- Loan losses of 20bps of average loans
- Capital generation of 200bps of RWAs, pre-dividend

The areas of debate centre around income and capital.

Sure, income momentum *is* low: Excluding the card income uplift, total underlying income is down 2% or £107m QoQ. With loan growth of 1% YoY and competitors such as Santander UK, Barclays and RBS cautious on domestic margin prospects in 2016, this should not be a surprise (Figure 3).

Figure 3: Slow loan growth puts strong revenues out of the question



Source: Company data; Note: YoY 1Q16 versus 1Q15

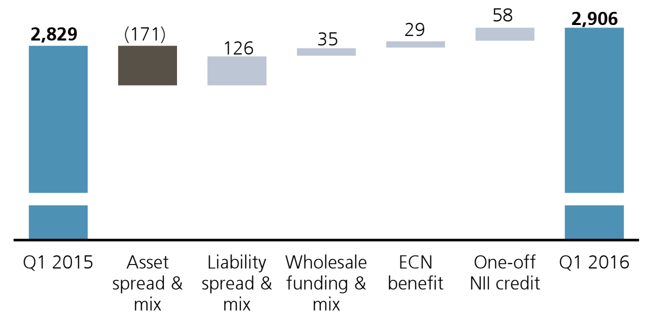
In income-land, LBG has a proven track record, we think, in managing well in this environment.

Two key differences are worth noting between LBG and Barclays/RBS as regards margin dynamics are concerned:

- **Barclays & RBS are trying to grow strongly in mortgages:** Attracting a higher share of flow mortgage lending requires tight pricing, which not only brings in new customers, but incentivizes existing ones to refinance internally, driving down back-book margins. LBG, writing ~16% of gross mortgage market lending in 2016, is forgoing modest market share in looking to protect net interest income and margins.

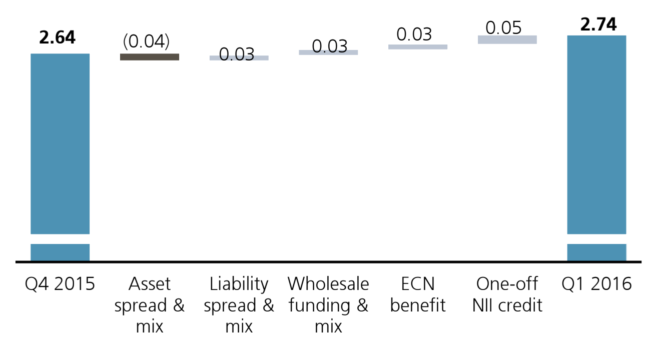
- **LBG has a high cost of deposits, giving it more room to adjust liability costs lower to offset asset spread compression.** Deposit and wholesale funding cost declines roughly offset asset spread and mix compression over the last twelve months (Figure 4 and Figure 5).

Figure 4: Net interest income bridge: 1Q15 to 1Q16 (£'m)



Source: Company data

Figure 5: Interest margin bridge (4Q15 – 1Q16, % AIEA)



Source: Company data

LBG's average balance sheet information makes this point strongly. Deposits cost an average 0.87% in 2015, down from 1.04% in 2014, while customer loan yields fell 3bps to 3.50% on average.

Figure 6: LBG's higher cost deposit rates and mix gives it more room to move

	Average balance (£'m)							Rate (%)						
Assets	2009	2010	2011	2012	2013	2014	2015	2009	2010	2011	2012	2013	2014	2015
Loans to banks	65,440	70,808	81,001	111,643	102,190	78,762	94,543	1.18	0.72	0.78	0.54	0.45	0.52	0.42
Loans to customers	673,226	592,120	594,152	548,350	518,734	504,246	464,012	3.72	4.41	4.03	3.94	3.84	3.53	3.50
Customer deposits														
Interest bearing deposits	341,292	344,138	365,418	393,820	397,881	416,651	380,137	3.27	2.48	1.61	1.69	1.54	1.15	0.87
No interest deposits	6,902	19,403	31,519	30,039	35,994	42,049	45,294	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Total deposits	348,194	363,541	396,937	423,859	433,875	458,700	425,431	1.27	1.48	1.53	1.57	1.41	1.04	0.78
Net loans/Dep spread	325,032	228,579	197,215	124,491	84,859	45,546	38,581	2.45	2.93	2.50	2.37	2.43	2.49	2.72

Source: Company data

On the conference call today, CFO George Culmer provided colour around a continuation of this trend in 2016 in protecting bank margin and income:

- **Mix change:** Retail savings are at £182bn, from £185bn at end 2015 and £194bn at 1Q15, while commercial deposits, which are around half the cost of retail deposits, are up, at £129bn at 1Q16 from £126bn at FY15.
- **Re-pricing:** Savings deposit costs are at 1% from 1.06% in 4Q15 and 1.30% at 1Q15. Examples of YTD action include: Fixed deposits, £26bn from £27bn at 4Q15, rate to 2.10% from 2.13%. Fixed rate ISA book, rate to 2.01% from 2.07% in 4Q15. Instant access deposits cost 0.50%, from 0.54% in 4Q15.

But firm cost control is also in evidence, with expenses ex. bank levy flat QoQ and higher restructuring spend leading to lower future operating expenses. We expect a new cost rationalization plan once the Simplification-linked branch and cost reduction programme is complete. We covered the upside we see from this in our recent detailed research.

We think LBG will be able to deliver the targeted YoY improvement in cost/income ratio for 2016 reiterated today, though the 47.4% rate delivered in 1Q (a quarter that does not include a ~£90m Financial Services Compensation Scheme due in 2Q or the ~£220m UK bank levy; adding these would take the ratio to 52%) still positions LBG as one of Europe's most efficient large caps.

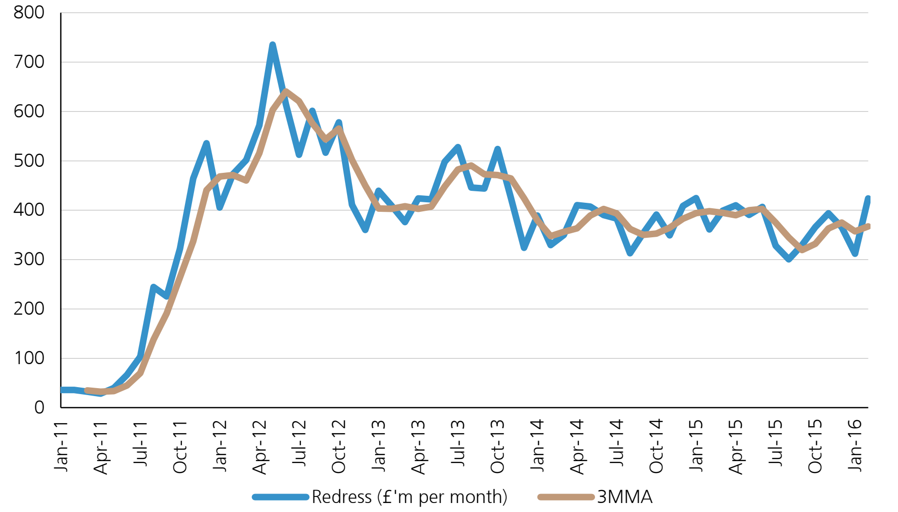
Capital generation to improve

What matters most, in our view, is payout potential. In 1Q16 LBG's capital ratio fell 20bps to 12.8%. This was 30bps lower than our 13.1% forecast, driven by more significant below-the-line items (15bps of miss) and larger deductions in regulatory capital (another 18bps).

The £1.4bn in below-the-line charges were £500m above our estimate, made up as follows: £790m charge for the Enhanced Capital Note redemption (UBSe £700m), £334m in market volatility (£50m), £161m in restructuring costs (£40m) and £115m in retail conduct provisions (£125m).

Unsurprisingly, there was no provision for PPI in today's numbers, given the £4bn provided last year. New claims averaged 8,500 per week in 1Q16, below the 10,000 modelled in provisions held by the company. We have allowed for a further £500m in provisions in 2017 and 2018 combined, but see the worst of the conduct-related TNAV-erosion as being behind the bank.

Figure 7: PPI complaint volumes in 1Q16 of 8.5k per week are 15% below the 10k per week assumed in LBG's provisioning



Source: Financial Conduct Authority

LBG's CT1 ratio of 12.8% included provision of one quarter of 2015's 2.25p ordinary dividend, in line with PRA regulations. Excluding this dividend accrual, CT1 would have reported at 13.0%. **Here too, LBG reiterated its target for 2016, aiming to generate 200bps of CT1 pre-dividend, ~6p in capital, the basis for our 5.8p dividend forecast.**

How big a dividend cut to justify 68p?

The bottom line here is that LBG made an underlying 2p in EPS this quarter and reiterated its target of producing 6p of capital in 2016 before payouts. Political considerations aside, therefore, the question is what a fair dividend yield for a low-growth, highly profitable bank in the UK should be? We expect a total payout – including special dividend or buyback – of 5.75p this year, a yield of 8.5%.

At the 5% average yield at which Europe's banks currently trade, a dividend cut of at least 40% of our estimate is in the price, we think. We just don't think this is right. Given the long-term stability of returns in UK retail banking, we would look for LBG to return to a dividend yield under 5% when rates increase.

Our LBG target price is derived by a sum-of-the-parts shown in Figure 8. In this, we apply peer-benchmarked P/E multiples to our 2017 divisional earnings estimates, discounted at an assumed 10% cost of equity to deliver a one-year forward target price. The small shift in our EPS estimate has our target move to 86p from 88p. With 26% capital upside and an 8.5% running yield, we have a Buy rating.

Figure 8: LBG sum-of-the-parts valuation

£'m	PBT (2017e)	PAT (2017e)	TNAV (ave. 2017e)	P/E (2017)	P/TNAV (2016e)	Value (£'m)	Value / share	ROTE (2017e)	% of earnings	% of val.
Retail	3,822	2,632	11,824	12.0	2.7x	31,585	43	22.3%	49%	46%
Commercial Banking	2,298	1,468	18,346	14.0	1.1x	20,549	28	8.0%	28%	30%
Consumer Finance	938	635	3,842	12.0	2.0x	7,624	10	16.5%	12%	11%
Insurance	867	634	1,870	11.0	n/m	6,977	10	n/m	12%	10%
Run-off	-52	-48	1,217	n/m	0.9x	1,096	2	-3.9%	-1%	2%
Central	28	-3	2,353	12.4	0.0x	-43	0	-0.1%	0%	0%
Operating divisions	7,902	5,318	39,452	12.7	1.7x	67,786	93	13.5%	100%	99%
Surplus capital (2017 > 13%)	n/a	n/a	376	n/a	n/a	376	0	n/a	n/a	1%
Total	7,902	5,318	39,828	12.8	1.7x	68,162	94			100%
Discounted							86			

Source: UBS estimates

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UPSIDE / DOWNSIDE SPECTRUM

return ↑

LBG is trading at 68p on 28 April 2016

Value drivers	2y loan growth	NIM	Cost/ income	Loan losses	EPS	Payout DPS	DPS	Yield	Implied P/E
105p upside	3.5%	2.65%	48.0%	0.24%	7.9	80%	6.3	6.0%	13.3
86p base	2.8%	2.65%	50.1%	0.24%	7.5	77%	5.8	6.7%	11.4
55p downside	2.0%	2.45%	52.0%	0.40%	6.0	60%	3.6	6.7%	9.0

Source: UBS

Risk to the current share price is skewed (3:1) to the upside

Upside (105p): Upside to our share-price target would come from better revenues and capital generation, providing greater raw material for payouts and placing less pressure on the organisation to reduce costs.

Base (86p): We forecast 7.5p of EPS, 5.75p of dividends and a 14% underlying ROTE in 2016. We see profitability remaining at broadly these levels through our forecast horizon.

Downside (55p): Downside risk relates to lower revenues and/or curbs on the bank's ability to distribute capital by dividends and/or buybacks.

COMPANY DESCRIPTION

return ↑

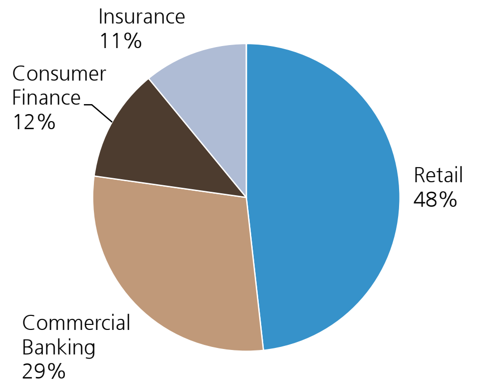
Market Cap	£50bn
Shares Outstanding	71bn
Industry	Banking
Region	Europe
Website	www.lloydsbankinggroup.com

Lloyds Banking Group is the UK's largest retail financial services provider and one of the country's largest commercial banks. It was formed through the acquisition of HBOS by Lloyds TSB in early 2009. The group operates through a number of brands, including Lloyds, Halifax, Bank of Scotland, Scottish Widows and Birmingham Midshires. Following a series of disposals, it is now focused on banking and insurance in the UK.

Industry outlook

UK retail banking is a highly profitable and capital-generative industry. Loan growth is modest in mortgages at around 3% at present but sustainable at 3-5% p.a. over the long term, we think. Loan losses are low and cost efficiency increasing across the market, driven by branch-led cost rationalisation in particular.

Forecast PBT by division (2017e)



Lloyds Banking Group (LLOY.L)

Profit & Loss (£m)	12/13	12/14	12/15	12/16E	% ch	12/17E	% ch	12/18E	12/19E	12/20E
Net income interest	10,885	11,761	11,482	11,613	1.1	11,625	0.1	11,926	12,409	12,961
Total non interest income	7,920	6,607	6,155	6,120	-0.6	6,402	4.6	6,646	6,911	7,189
Total income	**18,805**	**18,368**	**17,637**	**17,733**	0.5	**18,027**	1.7	**18,571**	**19,320**	**20,151**
Total cash expenses	(8,090)	(7,813)	(7,140)	(7,088)	0.7	(7,094)	-0.1	(7,211)	(7,379)	(7,586)
Pre-depreciation operating profit	**10,715**	**10,555**	**10,497**	**10,645**	1.4	**10,934**	2.7	**11,360**	**11,941**	**12,565**
Depreciation & amort (excl. goodwill)	(1,545)	(1,599)	(1,935)	(1,935)	0.0	(1,935)	0.0	(1,935)	(1,935)	(1,935)
Operating profit pre provisions	**9,170**	**8,956**	**8,562**	**8,710**	1.7	**8,999**	3.3	**9,425**	**10,006**	**10,630**
Total provisions	(3,004)	(1,200)	(568)	(772)	-35.9	(1,097)	-42.1	(1,437)	(1,707)	(1,797)
Operating profit post provisions	**6,166**	**7,756**	**7,994**	**7,938**	-0.7	**7,902**	-0.5	**7,988**	**8,299**	**8,833**
Income from associates & JVs (pre-tax)	0	0	118	0	-	0	-	0	0	0
Other pre-tax items	0	0	0	0	-	0	-	0	0	0
Profit before tax (UBS)	**6,166**	**7,756**	**8,112**	**7,938**	-2.1	**7,902**	-0.5	**7,988**	**8,299**	**8,833**
Exceptionals (incl goodwill)	(5,751)	(5,994)	(6,468)	(1,970)	69.5	(1,000)	49.2	(450)	(200)	(200)
Profit before tax	**415**	**1,762**	**1,644**	**5,968**	263.0	**6,902**	15.6	**7,538**	**8,099**	**8,633**
Tax	(1,217)	(263)	(688)	(1,570)	-128.2	(1,841)	-17.3	(1,924)	(2,058)	(2,195)
Profit after tax	**(802)**	**1,499**	**956**	**4,398**	360.1	**5,061**	15.1	**5,613**	**6,041**	**6,438**
Other post-tax items	0	0	0	0	-	0	-	0	0	0
Preference dividends	0	(225)	(314)	(330)	-5.0	(346)	-5.0	(363)	(382)	(401)
Minorities	(36)	(87)	(96)	(77)	20.0	(77)	0.0	(77)	(77)	(77)
Net earnings (local GAAP)	**(838)**	**1,187**	**546**	**3,992**	NM	**4,638**	16.2	**5,173**	**5,583**	**5,961**
Net earnings (before pref divs)	**(838)**	**1,412**	**860**	**4,321**	NM	**4,984**	15.3	**5,537**	**5,964**	**6,362**
Net earnings (UBS)	**3,590**	**5,862**	**5,897**	**5,430**	-7.9	**5,476**	0.9	**5,525**	**5,740**	**6,119**

Per share (p)	12/13	12/14	12/15	12/16E	% ch	12/17E	% ch	12/18E	12/19E	12/20E
EPS (local GAAP, basic)	(1.2)	1.7	0.8	5.6	NM	6.4	15.6	7.1	7.7	8.2
EPS (UBS, diluted)	5.1	8.1	8.2	7.5	-8.2	7.5	0.4	7.5	7.8	8.3
PPOP (diluted)	12.9	12.4	11.8	12.0	1.5	12.3	2.8	12.9	13.6	14.4
Net DPS	0.0	0.8	2.8	5.8	109.1	5.8	0.0	6.0	7.0	7.5
BVPS	55.4	60.7	57.8	60.0	3.8	60.0	-0.1	58.5	59.7	60.4
BVPS (UBS)	49.3	55.0	52.4	55.0	5.1	55.3	0.5	54.2	55.6	56.6

Balance sheet (£m)	12/13	12/14	12/15	12/16E	% ch	12/17E	% ch	12/18E	12/19E	12/20E
Banking assets (year end)	847,030	854,896	806,688	805,574	-0.1	813,324	1.0	827,032	848,972	871,315
Banking assets (average)	890,626	850,963	830,792	806,131	-3.0	809,449	0.4	820,178	838,002	860,143
Total assets (year end)	847,030	854,896	806,688	805,574	-0.1	813,324	1.0	827,032	848,972	871,315
Risk weighted assets (RWA) (year end)	271,078	239,734	222,747	222,705	0.0	226,616	1.8	231,590	238,412	245,547
Risk weighted assets (RWA) (average)	290,689	255,406	231,241	222,726	-3.7	224,661	0.9	229,103	235,001	241,979
Customer loans	493,468	483,107	449,659	453,483	0.9	462,688	2.0	475,327	492,633	510,669
Customer loans (average)	505,884	488,288	466,383	451,571	-3.2	458,086	1.4	469,008	483,980	501,651
Interest earning assets (average)	510,900	483,700	441,875	439,200	-0.6	445,084	1.3	455,442	469,905	487,019
Customer deposits	439,467	447,067	418,300	423,245	1.2	437,590	3.4	456,971	477,246	498,456
Common s/h equity (year end)	38,989	43,335	41,234	43,080	4.5	43,269	0.4	42,442	43,485	44,245
Common s/h equity (average)	40,443	41,162	42,285	42,157	-0.3	43,175	2.4	42,856	42,963	43,865
Total SHF (equity, pref & MI) (year end)	39,336	49,903	47,010	48,856	3.9	49,581	1.5	48,753	50,386	51,146
Total SHF (equity, pref & MI) (average)	40,959	44,620	48,457	47,933	-1.1	49,218	2.7	49,167	49,570	50,766
Net tangible assets	35,041	45,817	43,156	45,302	5.0	46,227	2.0	45,599	47,432	48,392

Balance sheet structure (%)	12/13	12/14	12/15	12/16E	% ch	12/17E	% ch	12/18E	12/19E	12/20E
Loans / banking assets (year end)	58.3	56.5	55.7	56.3	1.0	56.9	1.1	57.5	58.0	58.6
Deposits / banking assets (year end)	51.9	52.3	51.9	52.5	1.3	53.8	2.4	55.3	56.2	57.2
Loans / deposits	112.3	108.1	107.5	107.1	-0.3	105.7	-1.3	104.0	103.2	102.5
Total SHF / banking assets (year end)	4.6	5.8	5.8	6.1	4.1	6.1	0.5	5.9	5.9	5.9

Source: Company accounts, UBS estimates. (UBS) metrics use reported figures which have been adjusted by UBS analysts.

Lloyds Banking Group (LLOY.L)

Capital adequacy (£m)	12/13	12/14	12/15	12/16E	12/17E	12/18E	12/19E	12/20E
Tier 1 capital	27,925	36,044	33,860	34,336	35,726	35,629	37,105	38,008
Total capital	42,218	45,067	40,116	41,915	43,305	43,208	44,684	45,587
Risk weighted assets (RWA) (year end)	271,078	239,734	222,747	222,705	226,616	231,590	238,412	245,547
Core tier 1 ratio %	10.3	12.8	12.8	13.0	13.2	12.8	12.8	12.8
Tier 1 ratio %	10.3	15.0	15.2	15.4	15.8	15.4	15.6	15.5
Total capital ratio %	15.6	18.8	18.0	18.8	19.1	18.7	18.7	18.6
Tangible equity	34,694	39,249	37,380	39,526	39,915	39,288	40,531	41,491
Equity / assets %	4.6	5.1	5.1	5.3	5.3	5.1	5.1	5.1
Tangible equity to tangible assets %	4.1	4.6	4.7	4.9	4.9	4.8	4.8	4.8
Asset quality (£m)	**12/13**	**12/14**	**12/15**	**12/16E**	**12/17E**	**12/18E**	**12/19E**	**12/20E**
Non performing assets	32,259	14,308	9,590	9,308	10,482	11,398	12,652	12,895
Total risk reserves	15,707	7,625	4,172	4,259	4,035	3,930	4,131	4,136
NPLs / loans %	6.3	2.9	2.1	2.0	2.2	2.4	2.5	2.5
NPL coverage %	48.7	53.3	43.5	45.8	38.5	34.5	32.6	32.1
Provision charge / average loans %	0.6	0.2	0.1	0.2	0.2	0.3	0.4	0.4
Net NPAs / shareholders funds %	42.1	13.4	11.5	10.3	13.0	15.3	16.9	17.1
Profitability (%)	**12/13**	**12/14**	**12/15**	**12/16E**	**12/17E**	**12/18E**	**12/19E**	**12/20E**
Net interest margin (avg assets)	1.22	1.38	1.38	1.44	1.44	1.45	1.48	1.51
Provisions / operating profit	32.8	13.4	6.6	8.9	12.2	15.3	17.1	16.9
ROE (UBS earnings)	8.9	14.2	13.9	12.9	12.7	12.9	13.4	13.9
RoAdjE (UBS earnings & equity)	10.0	15.9	15.4	14.1	13.8	14.0	14.4	14.9
RoRWA (UBS)	1.25	2.33	2.59	2.47	2.47	2.45	2.48	2.56
RoA (UBS earnings)	(0.09)	0.18	0.12	0.55	0.63	0.68	0.72	0.75
Productivity (%)	**12/13**	**12/14**	**12/15**	**12/16E**	**12/17E**	**12/18E**	**12/19E**	**12/20E**
Cost income ratio	53.3	53.1	51.5	50.9	50.1	49.2	48.2	47.2
Cost / average assets	1.08	1.11	1.09	1.12	1.12	1.12	1.11	1.11
Compensation expense ratio	31.4	30.7	29.4	28.6	27.8	26.5	25.3	24.5
Growth (%)	**12/13**	**12/14**	**12/15**	**12/16E**	**12/17E**	**12/18E**	**12/19E**	**12/20E**
Revenue	2.3	-2.3	-4.0	0.5	1.7	3.0	4.0	4.3
Operating profit pre provisions	11.0	-2.3	-4.4	1.7	3.3	4.7	6.2	6.2
Net earnings (UBS)	258.7	63.3	0.6	-7.9	0.9	0.9	3.9	6.6
Net DPS	-	-	266.7	109.1	0.0	4.3	16.7	7.1
Total assets (year end)	-9.3	0.9	-5.6	-0.1	1.0	1.7	2.7	2.6
Customer loans	-4.8	-2.1	-6.9	0.9	2.0	2.7	3.6	3.7
Customer deposits	2.9	1.7	-6.4	1.2	3.4	4.4	4.4	4.4
Value (x)	**12/13**	**12/14**	**12/15**	**12/16E**	**12/17E**	**12/18E**	**12/19E**	**12/20E**
Market cap/revenues	2.4	3.0	3.2	2.8	2.7	2.7	2.6	2.5
Market cap/deposits	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
P/PPOP (diluted)	5.0	6.2	6.6	5.8	5.6	5.4	5.1	4.8
P/E (local GAAP, basic)	NM	46.4	NM	12.4	10.8	9.7	9.0	8.5
P/E (UBS, diluted)	12.8	9.5	9.7	9.2	9.2	9.2	8.9	8.4
Net dividend yield %	0.0	1.0	3.5	8.3	8.3	8.7	10.1	10.8
P/BV x	1.2	1.3	1.4	1.2	1.2	1.2	1.2	1.1
P/BV (UBS) x	1.3	1.4	1.5	1.3	1.3	1.3	1.2	1.2

Source: Company accounts, UBS estimates. (UBS) metrics use reported figures which have been adjusted by UBS analysts.

Forecast returns

Forecast price appreciation	+24.2%
Forecast dividend yield	8.3%
Forecast stock return	+32.5%
Market return assumption	5.5%
Forecast excess return	+27.0%

Valuation Method and Risk Statement

Lloyds Banking Group is predominantly dependent on the UK economy. Its interests span retail, small business and large corporate lending as well as life and non-life insurance.

Risks therefore include interest-rate volatility and credit risk, as well as competitive pressures in the UK market.

We set our LBG target price by using a sum-of-the-parts valuation, applying peer-benchmarked P/E multiples to our 2017 divisional earnings estimates. Excess capital at the end of 2017 – above a 13% minimum CT1 ratio – is discounted at a 10% cost of equity.

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12-Month Rating	Definition	Coverage[1]	IB Services[2]
Buy	FSR is > 6% above the MRA.	49%	32%
Neutral	FSR is between -6% and 6% of the MRA.	38%	26%
Sell	FSR is > 6% below the MRA.	14%	19%
Short-Term Rating	**Definition**	**Coverage[3]**	**IB Services[4]**
Buy	Stock price expected to rise within three months from the time the rating was assigned because of a specific catalyst or event.	<1%	<1%
Sell	Stock price expected to fall within three months from the time the rating was assigned because of a specific catalyst or event.	<1%	<1%

Source: UBS. Rating allocations are as of 31 March 2016.
1:Percentage of companies under coverage globally within the 12-month rating category.
2:Percentage of companies within the 12-month rating category for which investment banking (IB) services were provided within the past 12 months.
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UBS Limited: Jason Napier, CFA; Ivan Jevremovic.

Company Disclosures

Company Name	Reuters	12-month rating	Short-term rating	Price	Price date
Lloyds Banking Group[2, 4, 5, 7, 14, 16]	LLOY.L	Buy	N/A	69p	27 Apr 2016

Source: UBS. All prices as of local market close.
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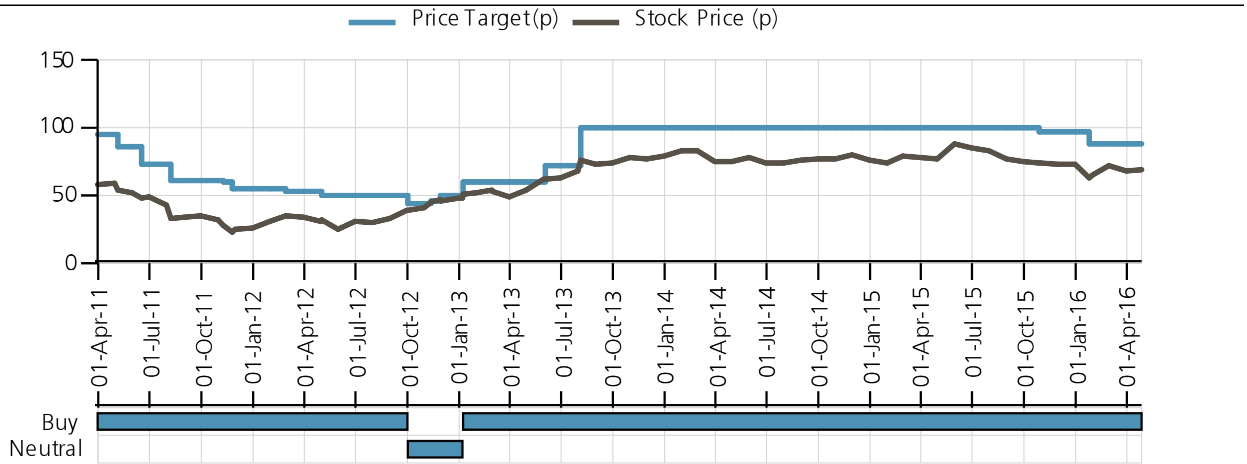
Lloyds Banking Group (p)



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