Is this takeover fair value or a way to restore stability or "stakeholder" value?

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Banking on Economics

19 Nov, updated 2 Dec, 2008

http://bankingeconomics.blogspot.com/

http://creditcrunchimagery.blogspot.com/2008/10/financial-culloden.html

SUMMARY

Both LTSB and HBoS have been over-sold by any standard measure notwithstanding credit crunch and economic downturn. HBoS is double the size of LTSB, yet the share prices dictated at the time the takeover was agreed that LTSB was worth twice HBoS? Less than a month later (2 Dec.) HBoS is valued at 70% of LTSB. Clearly the stock market valuations are a poor guide. HBoS is worth (on fundamentals) several times current market valuation. Toxic assets, size or quality of mortgage book, construction and property exposure, or other consumer and corporate lending do not justify the HBoS share price or its price relative to LTSB. In NPV terms neither bank should be priced below respective capital reserves. HBoS at that minimum should be 7 times its current valuation and LTSB should 70% higher, making HBoS worth 217% that of LTSB!

Stock markets have driven many banks' capitalizations below book value, but there is no proportionate consistent logic why some banks fell more than others. Timing and management of new capital raising and short-selling (stock-lending, CFDs and 'puts') have hit some banks' share prices more than others. LTSB and HBoS boards (ostensibly supported by Government) claim that the takeover of HBoS by LTSB is "in the interests of all stakeholders and of financial stability in the UK". There is no evidence for either claim, and no good reason, not even expediency, for the takeover not to be referred to the UK Competition Commission (and/or its Brussels counterpart).

The quality and mix of assets, funding and funding ratios do not show dramatic weaknesses. The business performance of HBoS by mid 2008 is the superior of the two banks. HBoS's and LTSB's Tier 1 and Core Tier 1 ratios adequate and the same, but HBoS's total capital ratio is better by 90bp, a significant margin. HBoS's capital is over double that of LTSB. LTSB's reserve capital ratio, possibly £2+bn too low (amount needed and missing to cover insurance assets). Media opinion that LTSB was better capitalized, and the excessive exposure of HBoS to mortgage assets are wholly exaggerated! (see also Appendix 3)

HBoS's share value fell relative to other banks in June/July 2008 due to the bungling of its rights issue, when underwriters were left holding most of the issue, took a hedged loss, and one of them, Morgan Stanley, nakedly shorted HBoS shares (using £125m of borrowed HBoS stock!). The PR media handling of the rights issue, timing, underwriters, and assurances (sales prospectus etc.) to shareholders were major mistakes! This is what the bank and its stockholders are now being made to pay far too much for.

HBoS takeover by LTSB is a dirct cost to over 2 million small private shareholders (less to institutional investors who hold stock in both banks) and to UK domestic banking competition and to both banks because of the inevitable losses of trying to combine two banks of different cultures, via new integrated systems at considerable cost (£2-3bn) when business volume is falling and employee numbers severely cut.

Based on past experience of comparable mergers the new combined group will lose capacity faster than the rest of UK banking to result in a bank no bigger than HBoS is now i.e. losing capacity equal to the whole of LTSB. All shareholders will lose out, both of LTSB and from HBoS.

There are UK-political and Scottish economy aspects to this (not discussed in this paper) that the takeover is an indirect blow to the politics of the SNP, but at a direct cost to the Scottish economy. My view is that the blow to Scottish Nationalism is booked, but now the risk is to the Scottish Labour vote if the takeover goes through. If the Government now relents and agrees to more time including a reference to the Competition Commission and waits for full year 2008 accounts, and the result of this is to save HBoS's independence, then I firmly believe this will play massively and positively for Labour in Scotland, as well as being the only logical and correct outcome for the bank. The bank does need urgently new senior management.

The risks of the takeover are that external instability is added to by internal instability. The effect may be akin to past mergers of UK car companies that resulted in faster loss of market share.

The Deal

The timetable for Lloyds TSB (LTSB) shareholders to approve the acquisition of HBOS: -

- announcement, 18 September 2008
- capital raising, 13 October 2008)
- LTSB Shareholder Circular & HBoS announcement to shareholders, 3 November,
- LTSB GM where 96% shareholders approve acquisition & capital raising, 19 November (A1)
- Merger Action Group case before Competition Appeal Tribunal, 3 December
- HBoS General Meeting to vote on same, 12 December. (for more see Appendix A1)

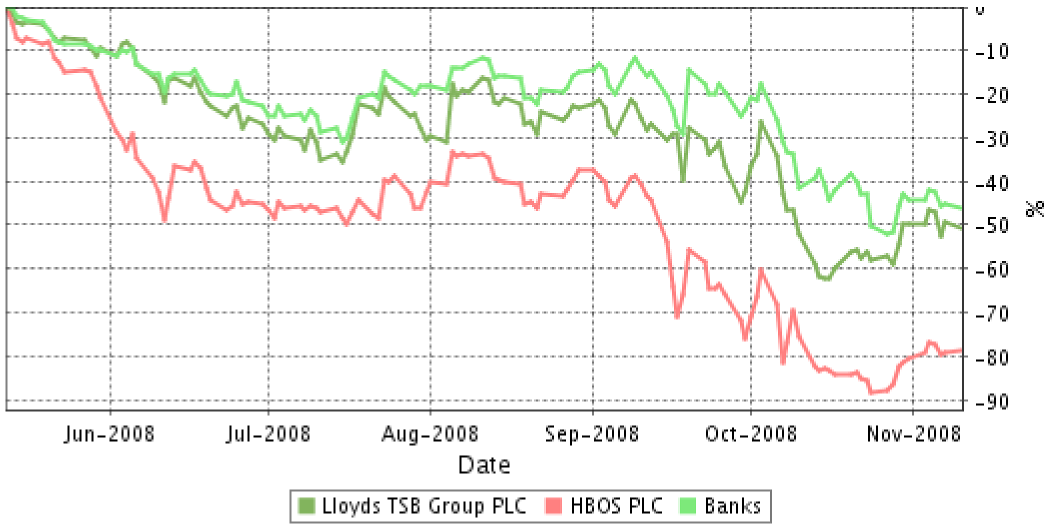
LTSB expects that acquisition and capital raising to be completed in January 2009. HBOS states: *"through an 'all share deal'. Both HBoS and Lloyds TSB shareholders will vote on the deal… Both companies will have general meetings. The acquisition is likely to be completed by the end of December 2008/early 2009. The government is supporting the deal, in the best interests of financial stability in the UK*. The basis for Government's support (implied by LTSB) is the two groups combined will find it easier to maintain a higher capital ratio (to risk weighted assets). The combination is short term defensive on HBoS's part and longer term aggressive by LTSB. HBoS's need is the basis for overriding *UK Competition* rules, (though an appeal could be made to EU rules?) The combined group equates to 30% of UK domestic banking (28% mortgages & 33% of current accounts at an original deal price of £600 per HBoS customer!) in turn equating to 40-50% of all UK customers (given that an average of more than one bank account)!

Part of the impetus behind the deal is uncertainty over **£156bn** in HBoS funding provisions due to mature within a year. That fear should not persist following the Government's SARP intervention. A bigger stick behind the deal was HBoS's share price falls, but now both banks are falling on disquiet over the takeover. A further concern is HBoS's until recently aggressive retail assets growthg especially mortgages and high interest current accounts (cause celebre of the Andy Hornby's boardroom coup that ousted James Crosby) that some say aped the Northern Rock model.[1] It is possible LTSB's £10bn loan (agreed in Sept/Oct) to HboS provided it with financing to maintain a 20% share of £50bn new and recontracted UK mortgages in 2008 – it also would have supplied added arm-twisting of HboS Board to agree to the takeover deal even though it is only a loan and probably at a near to market rate. But, it may also indicate that HboS was finding it impossible to book its next quarters' funding at economic rates?

The original 18 Sept. deal was for HBoS Shareholders to receive 0.83 LTSB Shares for every 1 HBoS Share. The offer valued HBoS at £12.2 billion (based on LTSB's closing price on 17 September 2008 of 279.75 pence). Existing LTSB Shareholders would own approximately 56% and HBoS Shareholders 44 %.

Then on 18 Oct., LTSB and HBoS announced that they intended to participate in the Proposed Government Funding with £5.5 billion of new capital to be raised by Lloyds TSB (consisting of £4.5 billion in ordinary shares and £1 billion in preference shares before costs) and £11.5 billion by HBoS (consisting of £8.5 billion in ordinary shares and £3 billion in preference shares before costs, with actual result of shares falling and Gov prefs of only £2bn). LTSB and HBoS also announced they'd agreed to proceed on revised terms, adjusted to 0.605 LTSB shares for every HBoS share.

At May 2008, the banks were already in '*sub-book value'* territory. HBOS shares fell steeply in May-June, September (-60%), and October (-40% in one day!). LTSB shares fell hardest in October if only marginally worse than for 'all banks'. Share values dipped again since.



Market Cap below Book Values

HBoS Key % Statistics Dec 2

52 Week Change (1 yr):	-87.05%
Div Yield:	36.18%
Div Payment:	31.48 %
Ex-Dividend Date:	12-Mar-08

HBoS Analysts Dec 2

EPS Est (next year) :	17.67
Revenue (next year) :	13.60B
Net Debt (next year) :	N/A
Avg Rec (current)* :	2.0

Today, HBoS share is priced at nearly 90p = £4.8bn with £2bn pref shares (when 5,407m ordinary shares), up from 9 Nov. when HBoS's Mkt. Cap. was £5.64bn (ordinary Shares, price 67.75p with £2bn Gov. owned prefs – originally to be £3bn), while LTSB's Mkt. Cap. Is £9.22bn + £1bn pref shares down from £12,133m at 9 Nov. (when ordinary Shares 6,052m price 182p) with £1bn Gov. owned prefs. The takeover valued HBoS at 110p = £9.16bn at premium to share price, but subsequently the premium as fallen to a miserly 4%! (at 18 Nov., shares in HBOS shares fell 15.4% to close at 63p. Lloyds TSB was also down, losing 12% to 131.2p. Note how much further LTSB shares fell in 2 weeks up to 19 Nov. General Meeting!) When key decisions were being taken the comparisons between LTSB and HboS at 9 Nov were:

Lloy at 9Nov		Bank peers	HBOS.L at 9 Nov		Bank peers
P/E(TTM)	4.90	**7.20**	P/E(TTM)	1.41	**6.78**
P/S(TTM)	1.03	**1.29**	P/S(TTM)	0.49	**1.18**
ROI(TTM)	--	**0.98**	ROI(TTM)	--	**0.98**
ROE(TTM)	20.97	**7.69**	ROE(TTM)	13.37	**8.96**
Analysts Consensus		**Hold**	**Analysts Consensus**		**Hold**
EPS Est. (2008)		**47.59**	EPS Est. (2008)		**58.34**
$ Revenue	$8,713 M		$ Revenue	$18,456 M	
Net $Income	$588 M		Net $Income	$950 M	
EPS	$0.10		EPS	$0.24	

After takeover was agreed, by November Gross EPS for LTSB was 3% and for HBoS 11% reflecting very different P/Es. Earnings paid out as dividends will fall to 40% (from 60%) and be in shares with cash payments expected to resume in 2009. HBoS's P/E was extraordinarily low reflecting a price below book value that when at 250p was already 45% below book value of £29bn (before selling BankWest for £860m plus £250m at 20% below book worth 28bp to Tier 1 capital with the main benefit being refunding of £8bn assets). (Note that as the stock market crash spread, now one third of FTSE 100 stocks are trading at or below book value.[2]) However, buying on the basis of a low price-to-book ratio alone should not be possible since the price should take account of other factors such as net asset value, the company's forward earnings and its ability to generate cash.

HBOS shares were <u>79% below book at 9 Nov, 82% below at 18 Nov, 62% below at 2 Dec)</u>! Even if assets are written down and book value (especially in corporate finance) is severely written down, the final deal may still be at half or less of book value. If HBoS's price remains at say 50% below or thereabouts after writedowns, then there is a severe discounting of future earnings. Can this be justified? HBoS shares fell 61% in September and 40% in one day in early October. It was said at the time that the price falls reflected investors' fears of whether the bank could survive mortgage losses. Yet, defaults were low and even if rising through 2009 should be accommodated within capital reserve. Defaults on HBoS mortgages in the banking book are normal to low (with LtVs in the 52% - 62% range and well below the 70% considered the prudential minimum and below 80%, which is the rate that mortgagees can seek to re-mortgage elsewhere).

Clearly, apart from short-sellers and the banks' inability to confound the sell-offs, the main anxiety must have focused on toxic assets and therefore on the market's refusal to believe HBoS's accounting for those assets!

LTSB Key Statistics Dec 2

52 Week Change (1 yr):	-60.23
Div Yield:	23.08%
Div Payment:	36.10
Ex-Dividend Date:	6-Aug-08

Analysts Dec 3

EPS Est (next year) :	38.72
Revenue (next year) :	13.90B
Net Debt (next year) :	N/A
Avg Rec (current)* :	2.1

LTSB's share value was 14% below book value at 9 Nov, 17% below at 18 Nov, and 35% below at 3 Dec. Its book value assets have not been written down. If their true value is reflected in stock values, are we to believe that HBOS's assets deserve to be 3-5 times more severely written down than for LTSB?

	9 Nov Ord Share Value £bn	18 Nov Ord Share Value £bn	2 Dec Ord Share Value £bn	Book Value £bn	
LTSB	12.13	11.7	9.25	14.1	
HBOS	5.64	5.27	4.84	19.4	After sale of WestBank
Lloyds offer	5.95	4.28	5.05		Insubstantial premium
New Group?	18.08	15.35	14.30	33.5	43% book before more writedowns

The press wrote of LTSB's offer being valuing HBoS at over £12bn and an offer worth £9bn, but was actually only £6bn by 9 Nov. Today that offer has fallen to £5bn. This assumes that 0.605 per LTSB share for each HBoS share still stands? The combined group would be merely 43% of book value. LTSB state they expect to writedown a substantial portion of HBoS assets, but it would seem to me that the criteria, if any can be determined for this, would apply equally well to LTSB assets and that would wipe out profit and dividends (in shares or whenever they are resumed as cash) for years, further damaging shareholders!

We can readily imagine a share rise if takeover goes smoothly or a fall if it does not. The latter is likely since it is clear HBoS staff are disaffected and lost confidence in management and are not supportive of the takeover, which is bound to result in culture clashes. But, can we imagine asset write-downs sufficient for say minus £10bn in book value? The acquisition proposal projects £1-1.5bn a year higher profit for the combined group by 2011 from annual cost savings (after a probably £2bn merger cost of redundancies and IT systems in which new systems & upgrades etc. will be booked to merger costs, when LTSB has anyway a creaking 30 year old core G/L that is incompetent to handle risk accounting – replacement cost likely to be £4-600m).

The blueprint for LTSB/HBOS merger is the RBS/NatWest merger 8 years ago - £2.4bn in merger costs. It generated £2bn in higher profits within 3 years but that was when the economy was growing well and business conditions for banks were very positive. Even if all that is achieved by the LTSB/HBOS merger is a £4bn profit gain over 3 years after say a £2bn merger cost, this offsets by £2bn an HBOS book value write-down. We may therefore legitimately ask where the write-down might be that could remotely justify a price of about a third only of HBOS's book value?

If a P/E of 7 is where the market is at on average for banks when LTSB is at 5 and HBOS at 1.5, and let's say we find grounds for believing HBOS is oversold and should be at a P/E of 4.0 and is therefore worth £15bn that is still a generous 23% discount to book value (close to the discount WestBank was sold for).

If annual net earnings are projected to rise *in excess of £1bn* directly from *cost synergies* of the merger that represents more than a doubling of 2008 profits in 3 years, how can LTSB's current purchase price of 110p be justified at little more than the HBOS underlying earnings per share of 106p in 2006 and 100.5p in 2007 or 60% above net profit (HBOS Profit before tax fell by 4% to £5,474m from £5,706m in 2006). HBOS 2008 underlying profit before tax in first half excluding negative fair value adjustments (nfva) is down 14% to £2,546m (first six months 2007 £2,962m) and including nfva down 51% to £1,451m (first 6 months 2007 £2,962m) and underlying earnings per share respectively down 13% to 47.4p and 52% to 26.4p.

Hence, LTSB's price is equivalent to only double this year's likely earnings per share. The fair value write-downs in first half 2008 were made up of 2 parts, £1,1bn in respect of debt securities in the Trading Book and £1.9bn of equities in the *Available For Sale Reserve* (which is code-speak for exposures moved from trading book to banking book?)

FROM PUBLISHED ACCOUNTS

HBOS £bn	June 2008		Dec.2007		Growth %
Loans total	456		430		12%
Corp Loans	117.8		96.5		22% before provisions
RWA Corporate assets		172.4		163.4	(HighRWA = which risks?)
Impaired loans	4.0	3.4%	3.2	3.3%	EAD = 44% from 53%
Wholesale funding implied	72.2	61.8%	65.2	59.6%	
Corporate Deposits	44.7	38.2%	44.1	40.4%	
International	78.5		67.1		34%
Retail (incl. Mtges)	255.8		253.4		2% (Ave Mtge LtV 48%)
Collateral & RWA	184.3	71.5	191.5	61.9	(Collateral cover –4.5%)
Wholesale funding implied	24.3	37.5%	33.2	37.5%	
Retail Deposits	160	62.5%	158.3	62.5%	
Trading Book	225.4		236.9		-4.9%
Total Assets	**681.4**		**666.9**		**2.2%**
Customer deposits		258.1		243.2	6.2%
Interbank Deposits implied		53.4		40.6	32%
Wholesale Funding		193.1		186.6	132.1 matures by mid'09
Total Depo Funding	**451.2**		**429.8**		**Assets Ratio 66%**
Impairment/Defaults	**16.01**	**2.35%**	**13.54**	**2.03%**	
Retail (incl. Mtges)	1.46	0.57%	0.53	0.49%	Impairment= 0.57%
Corporate	0.97	0.83%	0.66	0.61%	Impairments are double this
International	0.26	0.33%	0.13	0.20%	
Trading Book	**13.3**	**5.78%**	**12.2**	**5.16%**	**implied**

Net Income	6.47	6.43	0.95% & 1% RoA
Operating Costs	2.67	2.56	Ratio 41.2%

AuM flows £bn	Q1 - Q2 '08	Q3 – Q4 '07	
General Insurance	0.9	0.9	
Investmt Products	7.2	7.6	
Insight	8.7	6.0	
AuM	112		

In the above accounts we see HBoS has impairment/defaults of £16bn. That should (applying standard risk ratios) in a loss before recoveries of £7bn plus 6% haircut minus 55% collateral and other recoveries = £3.43bn loss. The level of defaults etc. observed by 3Q '08 may double next year (expected to be the bottom of the recession at –2.5% real GDP). But the losses and recoveries can be carried over 3 years, meaning a £2.5bn loss or a third of general annual profit. This is surely sustainable! Assuming the £56bn in roll-over funding required next year costs even an extra 200bp, this adds £1.1bn loss.

Therefore, 2009 profit will be say £4bn and if new business falls 30% say £2.5-3bn, which at a P/E ratio of 4 values the bank at £10bn at the cycle trough, or at £4bn more than LTSB are paying! If HboS losses are not out of line with other banks, then a much higher value emerges at a P/E of 7.

LTSB's accounts are less comprehensive and transparent than HBoS's. Amazingly, however, given the plight of HBoS by virtue of mortgage exposure, in LTSB's interim report for first half '08 it takes special pride in capturing 24.4% of new mortgages (three times its market share of outstandings) at an average LtV of 63%. It explains this by saying "*Our approach to risk has meant that we remain well positioned to capture growth opportunities at a time when others have pulled back from the market. As a result, we have been able to capture market share in a number of key areas and at higher margins without impacting the overall quality of our business*".

LTSB £bn	June 2008	Dec.2007	Growth %
Loans total	**232.5**	**212.4**	9.5%
Corp Loans	86.4	74.2	16.4%
Retail (incl. Mtgs 109bn)	143.6	135.8	6.5%
International	7.9	6.3	25.4%
Banks & MM funds	29.3	34.8	-16%
Trading Book	25* 96.9	20.1* 96.2	1.9%
Balancing Items	*1.4*	*3.3*	
Total Assets	**368**	**353**	**4.2%**
Customer deposits	162.1	156.5	3.6%
Retail deposits	85.6	82	4.4%
Corporate deposits	76.5	74.5	implied
Wholesale Funding	40.2 74.4	39.1 72.3	Bank depos £40 &39bn
Total Depo Funding	**236.5**	**228.8**	**Assets ratio 64%**
Impair/Loss/Defaults	**6.1**	**4.18**	
Retail (incl Mtgs)	0.65 0.53%	0.65 0.56%	Same as HBoS
Corporate	2.0 3.75%	1.75 3.1%	Far higher than HBoS
Wholesale	0.85 0.49%	0.28 0.17%	Lower than HBoS
Trading Book	**1.6**	**2.4**	**implied**

Net Income	4.6	5.1	RoA 1.4%
Operating Costs	2.93	2.81	Ratio 46.6 – 47.8%

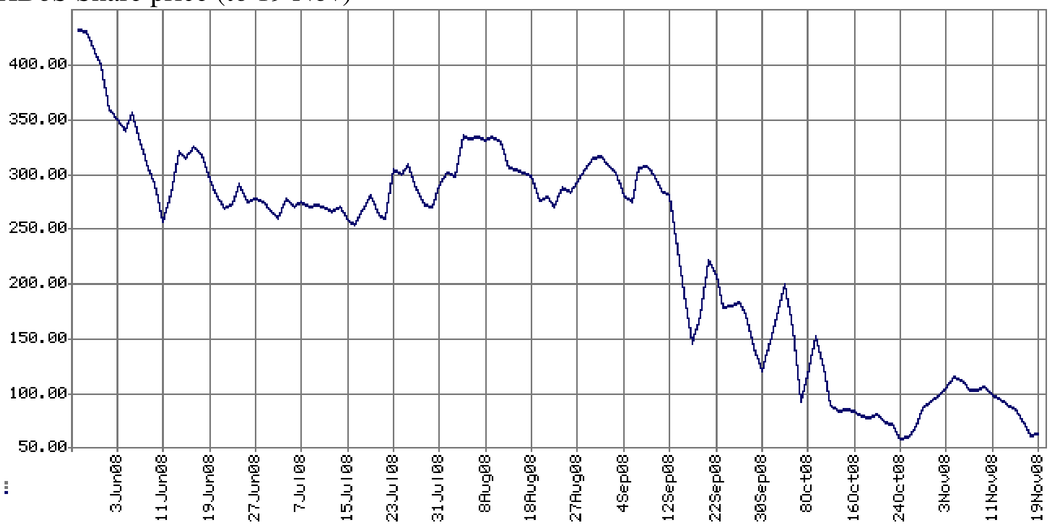
AuM flows £bn	Q1 - Q2 '08	Q3 – Q4 '07	Growth %
General Insurance	2 58	2.6 57	1.7%
Investmt Products	115	110	4.5%
AuM	95.5	102.7	-7.5%

* Available for sale assets: £7.6bn of this is Cancara, LTSB's SIV. At 30 June 2008, £24.4bn in Corporate Markets of which £7,64bn relates to ABS in SIV Cancara, £3.23bn US Student Loan ABS, £8,34bn government bond and short-dated bank CP & CD, and £5.2bn bank senior paper & ABS (requiring £0.6bn reserve adjustment). Total for Cancara = £11.65bn at 30 June 2008, comprising £7,64bn ABS and £4.0bn client receivables, 92% Aaa/AAA and no exposure either directly or indirectly to sub-primes. .A further £1.42bn exposures to MBS and SIVs took writedowns of £278m **but what is not disclosed is CP financing (indirect exposure to) of SPEs in USA where LTSB was a major player!**

HBoS has grown its retail and business (corporate) lending far more in the period that LTSB and it has grown retail deposits much faster than LTSB, but has significantly lower corporate deposits including in ratio to corporate loans. HBoS achieved higher growth in wholesale funding and bank deposits than LTSB!

HBOS Basel II capital ratios at 30 June 2008,
adjusted for the proceeds of £4bn rights issue:
- Tier 1 capital = £26.4bn = ratio **8.6%/** £308bn RWA, implied collateral = £373.4 (55%)
- Core Tier 1(2) capital £21.7bn = ratio **6.5%/** £308bn RWA
(excluding £19.6bn off balance sheet e.g. Grampian SIV, which is funded by £7bn from internal resources)
- Total capital £37.4bn = ratio **12.2%** / £308bn RWA
(Balance equity & other own capital = £20.1bn, even if share value has now fallen to about £5bn incl. SARP[4] pref. shares added)

HBoS Share price (to 19 Nov)



LTSB Basel II capital ratios at 30 June 2008,
LTSB neglected in its FSA ICAAP to calculate capital reserve for its insurance business and was allowed a year by the FSA to correct this. Thus its reserve capital ratios given below understate what they should really be about £2bn, and this has been a positive factor in its perceived share-value!:

Risk asset ratios (Basel II basis)
- Tier 1 capital = £13.2bn = **8.6%/**£154bn RWA (9.5% Dec.'07) collateral = £215bn (58%)
- Core tier 1 capital = £9,5bn = ratio **6.2%/**£154bn RWA (7.4% at Dec.'07)
- Total capital = £17.1bn = **11.3%/**£154bn RWA (11.0% Dec.'07 RWA £143bn)
(Balance of £1.4bn equity + £6.2bn other own capital = £7.6bn, even if share value has now fallen to about £11bn incl. SARP[4] pref. shares added)

LTSB Share price (to 19 Nov)

CONCLUSION

Both LTSB and HBoS have severely depressed share values measured by any standard notwithstanding recession conditions. The quality and mix of assets, funding and funding ratios are not showing any dramatic differences or dramatic weaknesses. If anything the business performance of HBoS by mid 2008 compared to end of 2007 is the superior of the two banks. Even taking LTSB as a good benchmark and given that HBoS is roughly double the size of LTSB, yet the share prices dictate LTSB is worth twice HBoS? Thus unless there are some enormous hidden toxic assets, the HBoS share price is at least one quarter of what it perhaps should be! Furthermore, it is questionable in NPV terms why either bank should be priced in the market at less than their respective capital reserves, in which case HBoS at that minimum should be seven times its current valuation and LTSB should be 70% higher, making HBoS worth 217% that of LTSB!

It is clear that HBoS's and LTSB's Tier 1 and Core Tier 1 ratios are the same, but HBoS's total capital ratio is better by 90bp, which is a significant margin. HBoS's own capital is more than double that of LTSB. It becomes yet more significant if LTSB's failure to include reserve capital ratio, possibly £2+bn for insurance assets in factored in. Hence, the media opinion that LTSB was better capitalized, which played a large part in the banks' respective share values, is wholly mistaken!

HBoS's share value fell mainly (relative to LTSB and other banks – Appendix 2A) in June/July 2008 at the time of its rights issue, when the two underwriters were left holding most of the issue in July and took a loss (that they hedged via possibly price-damaging puts) and one of them, Morgan Stanley, nakedly shorted the HBoS stock at the same time (using £125m of borrowed HBoS stock!). The PR media handling of the rights issue, its timing, the underwriters and assurances (sales prospectus etc.) to shareholders were unmitigated disasters!

HBoS management have agreed to the takeover by LTSB at a price that has been dictated by the equivalent of an operational and market risk because the management by their actions failed to defend the bank's shareholders etc. etc. The LTSB shareholders voted by 96% to back its management in the takeover of HBoS. Both banks have many of the same institutional shareholders. From their point of view whether the banks are one bank or two makes no perceptible difference at the present time. Looking ahead the difference could be much more marked. HBoS however has over 2 million small private shareholders and it is they principally who are being short-changed at the present time. It may be that their investment should they accept the LTSB offer will improve in value sufficiently for them in the next few years, but most probably for the reasons that this takeover may be unnecessary and is patently perverse they should oppose it.

The biggest loser should be the UK domestic banking market including the Government's competition policy. Both banks may themselves also be losers because of the inevitable major costs of trying to combine two banks with different cultures, build new integrated systems at considerable cost and yet keep employee and customer loyalty when business volume is falling and employee numbers will be severely reduced. The likelihood (based on past experience of comparable mergers in similar circumstances) is that the new combined group will lose capacity faster than the rest of the banking industry and will result in a bank no bigger than HBoS is now i.e. losing capacity equal to the whole of LTSB. In this case all shareholders will lose out, both from LTSB and from HBoS.

My firm conclusion to answer the question in the title of this paper is that this take-over of a big bank by a smaller bank will cut off the business legs of both. The stock market appears to agree so far as the values of both banks continue to flounder. Takeover merely introduces more instability, this time internally within the two banks, and that is dangerous.

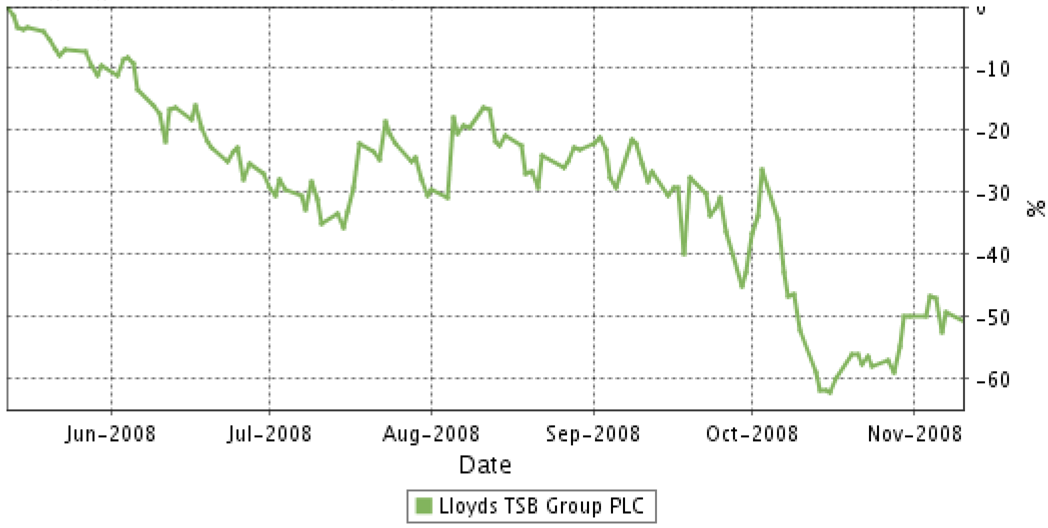
APPENDICES

A1 - Takeover Timetable Update

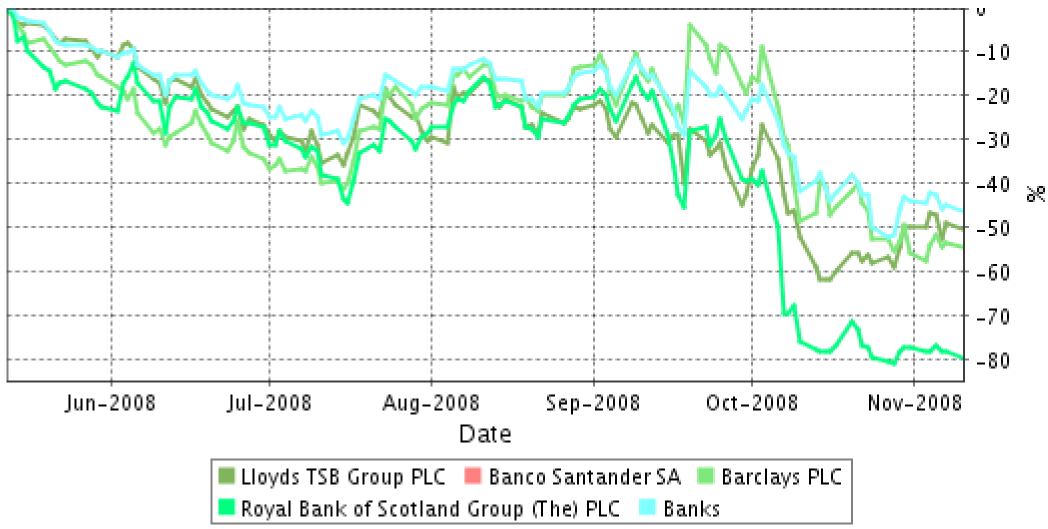
After publication of the circular on **3 November 2008**, the expected timetable was updated. The current expectation for key dates is set out below:
Lloyds TSB General Meeting 11.00 a.m. on **19 November 2008** **voting 96% for takeover.**
(Two Knights, Burt & Mathewson campaign against takeover abandoned – **20 November 2008.** This followed ambiguous warning by The Chancellor that pref. Shares capitalization and other share purchases by Government are not guaranteed –implying that a still independent HBoS cannot rely of this assistance – which in the circumstances is very questionable fear-mongering.)
Merger Action Group lodges case with Competition Appeal tribunal 29 November 2008.
Merger Action Group case heard by Competition Appeal tribunal 3 December 2008.
Open Offer Record Date for entitlement for Qualifying Shareholders 5.00 p.m. on **5 December 2008**
HBOS Court Meeting 10.00 a.m. on **12 December 2008 (10 minutes long?)**
HBOS General Meeting 10.10 a.m. on 12 December 2008 (The HBOS General Meeting will commence at the time above or as soon as the HBOS Court meeting is concluded or adjourned)
Despatch of Application Forms to Qualifying Non-CREST Shareholders **12 December 2008.** Latest date on which Existing Ordinary Shares trade cum entitlement **12 December 2008.** Ex-entitlement date for the Open Offer 8.00 a.m. on **15 December 2008.** Open Offer Entitlements and Excess CREST Open Offer Entitlements credited to stock accounts of Qualifying Shareholders in CREST by **15 December 2008.**
Recommended last time and date for withdrawing Open Offer Entitlements and Excess CREST Open Offer Entitlements from CREST 4.30 p.m. on **2 January 2009.** Latest time and date for depositing Open Offer Entitlements into CREST 3.00 p.m. on **6 January 2009.** Latest time and date for splitting Application Forms (bona fide market claims only) 3.00 p.m. on **7 January 2009.** Latest time and date for receipt of completed Application Forms and payment in full under the Open Offer and settlement of relevant CREST instructions (as appropriate) 11.00 a.m. on **9 January 2009.** Expected date of announcement of results of Open Offer **12 January 2009.** Scheme Court Hearing to sanction the Scheme **12 January 2009.** Open Offer Shares in un-certificated form expected to be credited to accounts in CREST by **13 January 2009.** Expected time and date of admission and commencement of dealings in Open Offer Shares on the London Stock Exchange 8.00 a.m. on **13 January 2009.** Suspension of listing and dealings in, and last time for registration of transfers of, HBOS shares. 6.00 p.m. on **14 January 2009.** Scheme Record Date 6.00 p.m. on **15 January 2009.** Reduction Court Hearing to confirm the Capital Reduction **16 January 2009.** Effective Date of the Scheme **16 January 2009.** Issue of Consideration Shares at or after 5.00 p.m. on **16 January 2009.**
Cancellation of HBOS listing 8.00 a.m. on 19 January 2009.
Consideration Shares in uncertificated form expected to be credited to accounts in CREST 8.00 a.m. on **19 January 2009**. Expected time and date of admission and commencement of dealings in Consideration Shares on the London Stock Exchange 8.00 a.m. on **19 January 2009.** Dispatch of share certificates in respect of Consideration Shares and Open Offer Shares to certificated holders by **30 January 2009.**

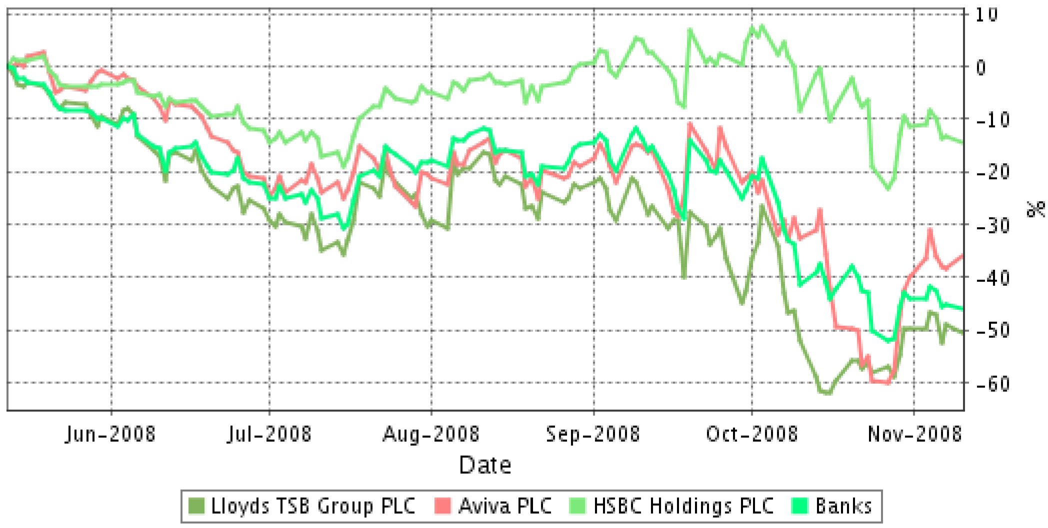
A2 9 November charts

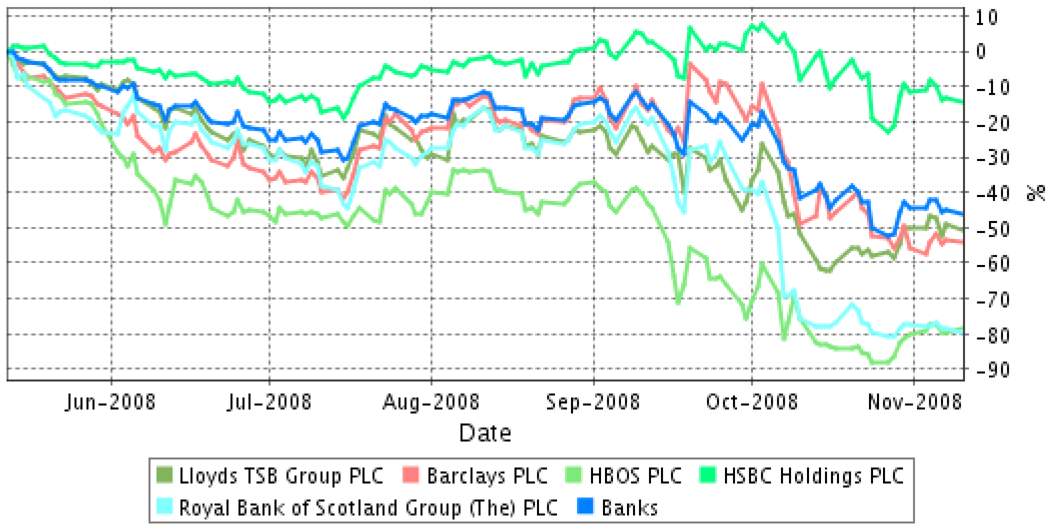
LTSB Shareholder Return Chart



comparisons



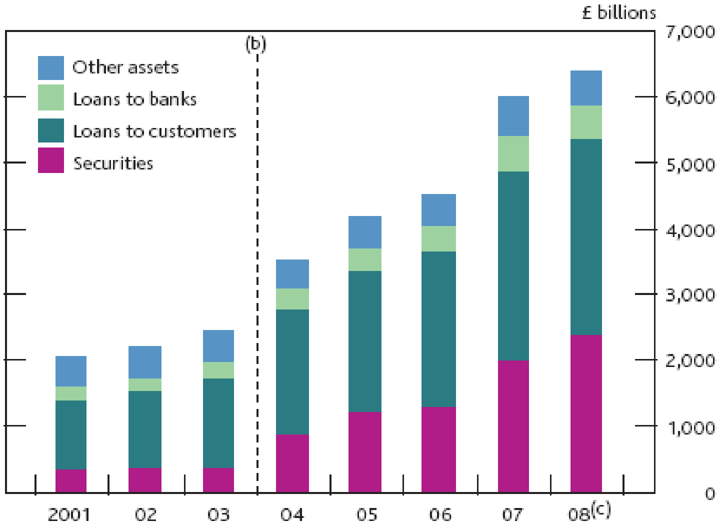




10
0
-10
-20
-30
-40
-50
-60
-70
-80
-90
%
Jun-2008
Jul-2008
Aug-2008
Sep-2008
Oct-2008
Nov-2008
Date
Lloyds TSB Group PLC
Barclays PLC
HBOS PLC
HSBC Holdings PLC
Royal Bank of Scotland Group (The) PLC
Banks

A3 UK Financial Sector: Banks

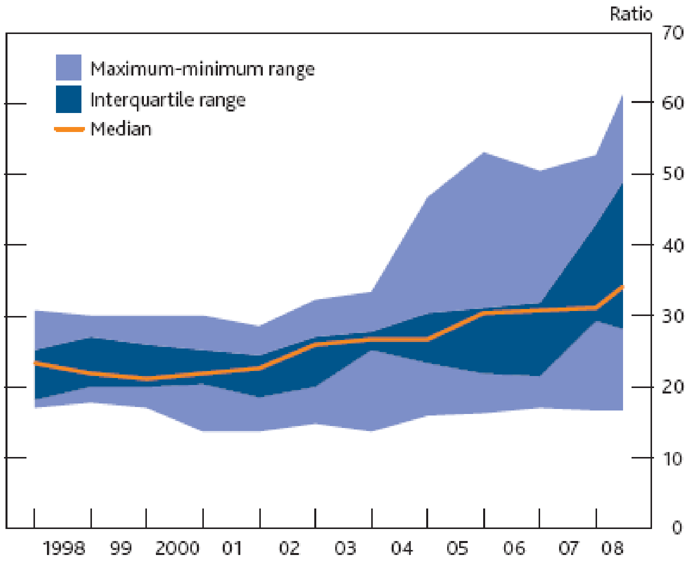
Major UK banks' assets[a]



Sources: BankScope published by Bureau van Dijk Electronic Publishing, published accounts and Bank calculations.
(a) Excludes Nationwide due to lack of interim data.
(b) IFRS break.
(c) 2008 H1.

The above represents a 215% ratio to GDP, compared to 250% ratio in case of US banks.

Major UK banks' leverage ratio[a][b]



Sources: Published accounts and Bank calculations.
(a) Leverage ratio defined as total assets divided by total equity excluding minority interest.
(b) Excludes Nationwide due to lack of interim data.

The HBoS ratio is 34 i.e. at the UK median. LTSB's is at 22, but its Life business assets are missing from the calculation!

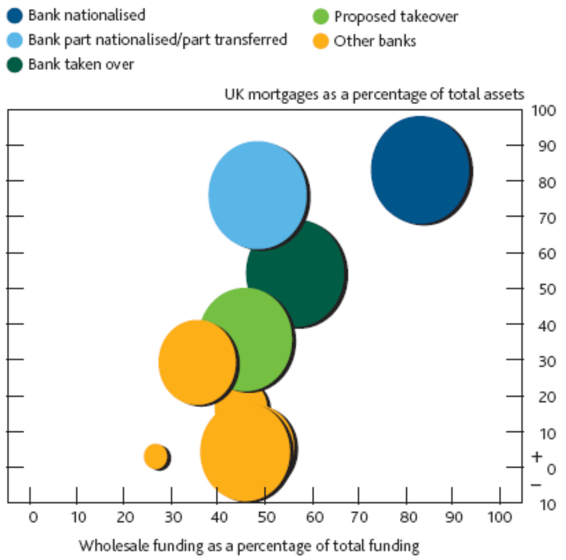
UK banks: source bank of England forecast of nominal losses pre-recoveries.

Mark-to-market losses on selected financial assets(a)(b)

	Outstanding amounts	Losses: Apr. 2008 *Report*	Losses: Oct. 2008 *Report*
United Kingdom (£ billions)			
Prime residential mortgage-backed securities	193	8.2	17.4
Non-conforming residential mortgage-backed securities	39	2.2	7.7
Commercial mortgage-backed securities	33	3.1	4.4
Investment-grade corporate bonds	450	46.2	86.5
High-yield corporate bonds	15	3.0	6.6
Total		62.7	122.6

From the above table: **with roughly 20% of UK domestic banking, HBoS nominal max. losses of £29.5bn = 24% of the above (by end September 2008). Ratio to mean = 1.47**
With roughly 8% of UK domestic banking, LTSB nominal max. losses of £13.3bn = only 10.8% of the above (by end September 2008). Ratio to mean = 1.35
But losses should be 55% recoverable.

Major UK banks' equity prices, mortgage lending and wholesale funding dependency(a)



Sources: Bloomberg, published accounts and Bank calculations.
(a) The size of the circles is proportional to the extent of equity price falls since 2 July 2007.

HBoS and LTSB are in light green circle with respectively 33% % 29% of mortgages in total assets.

Announced capital raising commitments from UK financial institutions

	Current Tier 1 capital: ratio (per cent)	Institution's capital raising commitments (£ billions): common shares	preference shares	other	dividend effect	Total	New Tier 1 capital ratio following capital raising (per cent)
Barclays	9.1	3.6	3.0	1.5	2.0	10.1	>11.0
HBOS	8.6	8.5	3.0	0.0	0.0	11.5	12.0
HSBC	8.8	0.75	0.0	0.0	0.0	0.75	8.8
Lloyds TSB	8.6	4.5	1.0	0.0	0.0	5.5	12.1
Combined Lloyds TSB and HBOS		13.0	4.0	0.0	0.0	17.0	
Nationwide	9.7			0.5		0.5	10.3
RBS	9.1	15.0	5.0	0.0	2.0	22.0	12.1–13.1
Abbey/ Alliance & Leicester	Circa 8	1.0	0.0	0.0	0.0	1.0	Raised by 1.25
Total						51.4	

Source Bank of England October 2008.

Note: above was published before taking account of 18 Oct., LTSB and HBoS announced that they intended to participate in the Proposed Government Funding with £5.5 billion of new capital to be raised by Lloyds TSB (consisting of £4.5 billion in ordinary shares and £1 billion in preference shares before costs) and £11.5 billion by HBoS (consisting of £8.5 billion in ordinary shares and £3 billion in preference shares before costs, with actual result of shares falling and Gov prefs of only £2bn.

This table shows 8.6% Tier 1 for HBoS (8.8% at June 30) but total capital reserve was over 12.2%, when LTSB was 11.3%. The LTSB capital raising is not completed until January. The combined LTSB/HBoS ratio neglects the capital raising that LTSB requires by then to cover its Life business.

Footnotes to text

[1] Lloyds TSB's acquisition of HBOS marks the end of demutualised building societies quoted on the stock market. Also in Sept. '08 Alliance & Leicester secured approval for its takeover by Spanish bank Banco Santander that owns former society Abbey National. The Woolwich is now part of Barclays and Northern Rock in government hands, that leaves Bradford & Bingley as the only former building society on the stock market - and it may be acquired as soon as new chief executive Richard Pym has tidied up its operations. While members of the mutuals who sold out quickly will have made healthy sums, those who held on for the long term lost heavily. Halifax shares were worth 732.5p when it demutualised 11 years ago and reached a peak of 1165p a year ago before losing 94% though Lloyds TSB's offer values the shares at 110p down from original offer of 215p. Santander's all-share offer for A&L is worth around 263p, less than half the 542.5p price when it floated; Northern Rock's shares climbed from 500p to a peak of more than 1200p in early 2007 before nationalisation this year made them worthless; Bradford & Bingley's shares stand at little over a tenth of their 248p demutualisation price. Mutual status has proven itself in a crisis. Coop Financial Services is merging with Britannia after it took over two small societies. Societies that succumbed early fared better: Abbey National's shareholders received 650p in shares from Santander compared with a 100p flotation price, while Barclays paid 352p for the Woolwich compared with 296.5p at demutualisation. Stock market pressure on these former societies to deliver rising profits was a badly managed risk factor. Higher profits means offering more or bigger loans and to finance that, the banks sought refunding via securitisations and the money markets, rather than relying on deposits. Loans growth drove up house prices, encouraging yet more borrowing by banks and their customers, a process now painfully unravelling.

[2] Fifteen of the FTSE 100 companies are now trading at less than half of their book value, with RBS ranked the lowest. Book value, also referred to as net asset value, is the net value of a company's assets as they appear on the balance sheet. When a company's price-to-book ratio falls below one it is often seen as buy signal by value investors - in theory it means that if the company was liquidated, it would be worth more than its stock market value. RBS's price-to-book ratio is 0.12. In other words its stock market value is just 12pc of its book value. The huge discount at RBS is partly explained by uncertainty over how the Government's bail out will be implemented and fears about the value of the assets it has bought from ABN Amro. Not far behind RBS in the discount stakes, is cruise ship company Carnival with a value of 0.21 and HBOS, also with a value of 0.21. BA' is currently valued at 0.45 and Kingfisher at 0.54. BA Chief Executive, Willie Walsh, faces the prospect of declining passenger numbers as the global economy softens, while Kingfisher Group Chief Executive, Ian Cheshire, looks to address falling customer demand for his company's DIY products. Barclays meanwhile has a value of 0.49, implying a 51pc discount to book value. It is worth noting though that the book value used in the calculations include both intangibles and goodwill. Intangibles include assets such as patents, trademarks, copyrights, franchises and goodwill. The value of the assets of many modern companies such as GlaxoSmithKline or Coca-Cola are often held in their intangible assets. If intangibles and goodwill are taken out, the discount will appear lower, because the book value itself will have declined. Excluding these assets, Barclays' ratio is 0.65, implying a 35pc discount to book value. With the UK thought to heading into a recession book value of some assets on balance sheets should be written down but with the FTSE 100 now so low much of that reduction is already factored into share prices.

Most undervalued FTSE 100 companies by Price to Book Ratio
(As at 30/10/08 – only companies with price to book ratio under 1)

1. **Royal Bank of Scotland 0.12**
2. Carnival ....… 0.21
3. **HBOS ....…..... 0.21**
4. Schroders ....…......... 0.25
5. Old Mutual 0.28
6. Friends Provident 0.32
7. Vedanta Resources ....…....... 0.34
8. Kazakhmys ....…......... 0.37
9. Hammerson ....…......... 0.42
10. British Land ....…........ 0.44
11. British Airways ....…........... 0.45
12. 3i Group ....…......... 0.48
13. Liberty International ....…......... 0.48
14. Barclays ....…..... 0.49
15. Land Securities ....…..... 0.49
16. Kingfisher ....….... 0.54
17. Aviva ....…...... 0.56
18. Xstrata ....….... 0.56
19. Wolseley ....…...... 0.61
20. Thomas Cook ....…........ 0.62
21. Legal & General ....…......... 0.71
22. Royal Dutch Shell 'A' 0.79

23. Vodafone Group 0.82
24. Lloyds TSB ....…........ 0.86
25. BHP Billiton 0.89
26. Sainsbury (J) ....…......... 0.95
27. WPP Group ....…....... 0.95
28. International Power 0.99
29. Standard Chartered ....…......... 0.99

Source: DigitalLookcom

[4] £50bn in the banking recapitalisations plus £250bn of new bank debt guarantees and adding £100bn to the existing Bank of England short-term loan scheme.

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