VM Wealth Management Limited

Bond Analysis: Llyods 8.00% Perpetual Call 2029 (9M 2023)

VMWM Research | November 9, 2023

876-960-5000 vmwmclientservices@myvmgroup.com vmwealth.myvmgroup.com 53 Knutsford Boulevard, Kingston 5

- **Bond Recommendations:**

Conservative Risk Appetite: UNDERWEIGHT
Moderate Risk Appetite: OVERWEIGHT
Aggressive Risk Appetite: OVERWEIGHT

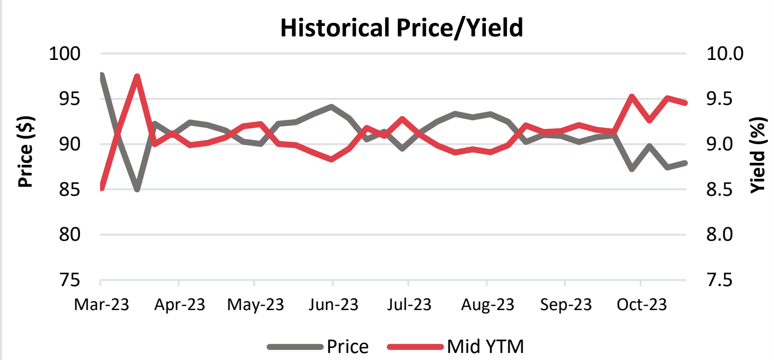
ABOUT THE COMPANY

Lloyds Banking Group plc (Llyods) was incorporated as a public limited company and registered in Scotland under the United Kingdom (UK) Companies Act 1985 on October 21, 1985. Lloyds is a major banking and financial services company based in the UK and is one of the largest and oldest banks there. Lloyds operations include retail and commercial banking, insurance, and wealth management, with a dominance in the UK mortgage franchise and strong market shares across credit cards, unsecured lending, and commercial banking.

Lloyds comprises of various well-known brands, including Lloyds Bank, Bank of Scotland, and Scottish Widows. The bank offers a wide range of products and services, such as savings and current accounts, mortgages, personal loans, and insurance products.

Lloyds has played a significant role in the UK's financial history and continues to be a prominent player in the country's banking sector.

Barclay's PLC: Bond Term Summary	
Parent Company	Lloyds Banking Group PLC
Issuer	Lloyds Banking Group PLC
Currency	USD
Issued Amount	1,250,000 (M)
Issue Date	03/13/2023
Tenor	Perpetual/Call
Industry	Finance (Banking)
Ask Yield to Worst (As of November 8, 2023)	10.32%
Call Price (Ask Price to Worst)	$100
Coupon	8.00%
Issuer Credit Rating (S&P)	BBB+
Outlook (S&P)	Stable
Maturity Type	Perpetual/Call Next Call date: 09/27/2029
Maturity	Perpetual/Call
Day Count Basis	30/360
Use of proceeds	General Corporate Purposes; Repurchase or Refinance Existing Debt



Recommendation: Despite its limited geographic diversification, Lloyds maintains a prominent position in the UK banking sector and has been enhancing its profitability. In the first nine months of the current fiscal year, Lloyds nearly doubled its net profit, improved its cost-to-income ratio, and increased the net interest margin. While the 8% perpetual bond carries some risk, the combination of an adequate liquidity coverage ratio (142%), stable funding choices, and the issuer's investment-grade credit rating makes it an attractive high-yield option, especially for moderately to aggressively inclined bond investors.

ECONOMIC OVERVIEW (UNITED KINGDOM)

The UK economy grew by 0.20% in August 2023, which was driven primarily by the services sectors, while the manufacturing and construction sectors contracted. The IMF projects that the UK economy is expected to contract from a growth rate of 4.10% in 2022 to a growth rate of 0.50% in 2023. This projection is influenced by the implementation of tighter monetary policies aimed at controlling persistently high inflation and the continued effects of a terms-of-trade shock resulting from elevated energy prices. The Bank of England (BOE) has lifted the policy rate to a 15-year high of 5.25% over 14 consecutive rate hikes. Despite a recent pause by the BOE, the policy rate is expected to remain elevated for an extended period of time, which will negatively impact growth.

On October 20, 2023, S&P Global Ratings (S&P) affirmed its 'AA/A-1+' unsolicited long- and short-term foreign and local currency sovereign credit ratings on the UK. The outlook for these ratings continues to be stable. This decision is based on the UK's strong economic performance, which has remained resilient despite facing various challenges. Additionally, there is an expectation that government deficits will gradually decrease over the next two to three years.

NINE MONTHS ENDED SEPTEMBER 30, 2023 (9M 2023)

GBP (millions)	FY 2021	FY 2022	9M 2022	9M 2023
Net Income	15,763	18,048	12,772	13,700
Operating Costs	9,759	10,800	6,316	6,654
Net profit	5,555	5,885	2,941	4,284
Return on tangible equity	13.80%	13.50%	9.60%	16.60%
Banking net interest margin	2.54%	2.94%	2.84%	3.15%
Cost-to-income ratio	61.00%	50.40%	50.10%	49.50%
Loan to deposit ratio	94.00%	96.00%	94.00%	96.00%
Total assets	886,525	877,829	888,800	893,100
Total Equity	53,152	47,521	44,500	45,000
Liquidity coverage ratio	135.00%	144.00%	146.00%	142.00%
Asset quality ratio	(0.31)%	0.32%	0.30%	0.25%
Common Equity Tier 1 ratio	17.30%	15.10%	15.00%	14.60%

For the nine months ending September 30, 2023, Lloyd's Bank reported a net income of £13.70 billion, representing a 7.27% YoY increase compared to the £12.77 billion recorded during the same period in the previous year. This growth was primarily driven by a 9.64% increase in net interest income due to wider interest rate spreads resulting from the Bank of England's tighter monetary policy and higher structural hedge earnings resulting from the rising rate environment. This was partly offset by deposit mix effects and margin compression, especially in the mortgage book. Llyods also experienced an 8.45% increase in underlying other income, amounting to £3.84 billion, attributed to growth in retail, commercial banking, insurance, pensions, and investments.

Operating costs rose by 5.35% (£338.00 million) to £6.65 billion, mainly due to increased spending on planned strategic investments, new business costs, and inflationary impacts. However, continued cost efficiency efforts helped to mitigate the magnitude of the cost increase. Despite the rise in operating expenses, the cost-to-income ratio improved by 60 basis points, decreasing from 50.10% in Q3 2022 to 49.50% in Q3 2023, indicating better efficiency by the company. The net profit saw a substantial increase of 45.66%, reaching £4.28 billion compared to £2.94 billion in 2022. This boost in net profit significantly improved the return on tangible equity (ROTE), which increased by 700 basis points (bps) from 9.60% at the end of Q3 2022 to 16.60% at the end of the reporting period, indicating enhanced efficiency in generating profits from the tangible equity base.

As of the end of Q3 2023, Lloyds Bank reported a slight year-on-year growth of 0.48% in its asset base, reaching £893.10 billion. Notably, the bank's liquid assets, primarily consisting of cash and government bonds, maintained a stable liquidity coverage ratio (LCR) of 142%, exceeding regulatory requirements. These assets are effectively hedged against interest rate risk. Additionally, the net stable funding ratio, a newly implemented measure in banking used to assess long-term liquidity, remained strong at 130%, consistent with the ratio at the end of 2022. Lloyds' loan to deposit ratio also remained steady at 96%, reflecting robust funding, strong liquidity, and the potential for future lending growth.

The Common Equity Tier 1 (CET1) ratio for the bank stood at 14.60% at the end of Q3 2023, compared to 15.00% in the comparative period. CET1 is a crucial measure of capital adequacy in the banking industry, with a Basel III benchmark of 4.50%. It represents the highest quality capital that a bank holds, and serves as a financial buffer to absorb losses, ensuring the stability and solvency of the bank. CET1 capital is used to assess a bank's ability to withstand financial stress, even during challenging economic conditions.

ISSUER RATINGS ANALYSIS

Standard & Poor’s: BBB+/Stable

On April 20, 2023, S&P affirmed Lloyds' credit rating at 'BBB+' and maintained a Stable outlook. The decision was based on Lloyds' extensive and comprehensive UK financial services business. Lloyds holds a prominent position in the UK mortgage market and maintains significant market shares in credit cards, unsecured lending, and commercial banking. The Stable outlook reflects S&P's belief that Lloyds' strong capitalization and competitive standing in the UK market act as a solid safeguard for its credit rating, even in the face of inflation and sluggish economic growth. S&P anticipates that robust revenue generated from gradually improving margins will continue to bolster the bank's capital reserves, while sound provisioning practices will offer ample protection against potential declines in asset quality.

Moody’s: A3/Stable

On June 7, 2023, Moody's assigned an A3/P-2 credit rating to Lloyds’ senior unsecured debt while maintaining a Stable outlook. The A3 long-term senior unsecured debt rating for Lloyds is based on several factors: the group's standalone creditworthiness, as indicated by an a3 Baseline Credit Assessment (BCA); a moderate loss given failure, resulting in no uplift under the Advanced Loss Given Failure (LGF) analysis; and a low probability of support from the UK government, leading to no uplift. The Stable outlook on the company's senior ratings reflects Moody's expectation that the bank's solvency and liquidity metrics will continue to align with their current assessment, which includes moderate asset risk, solid profitability, high capitalization, and substantial liquidity that mitigates wholesale funding exposures.

Fitch Ratings’: A/Stable

On December 15, 2022, Fitch affirmed Lloyds’ Long-Term Issuer Default Rating (LT IDR) at 'A' and Viability Rating (VR) at 'a', while maintaining a Stable outlook. Fitch's decision was based on several factors, including Lloyds' consistent and strong profitability, which compares favourably with its peers. Fitch expects Lloyds to maintain an operating profit/risk-weighted assets (RWAs) ratio above 2.50% in 2023-2024, supported by ongoing margin improvement and expectations for manageable increases in loan impairment charges and funding costs. Fitch also highlighted the low-risk nature of Lloyds' mortgage loans, which are underpinned by conservative collateralization. This assessment contributes to the bank's overall creditworthiness.

BOND RATINGS ANALYSIS

Standard & Poor's: BB-

In May 2023, S&P assigned a 'BB-' credit rating to the 8% perpetual bond, lower than the issuer's 'BBB+' rating. The rating difference arises because perpetual subordinated bonds fall into the category of junior debt, making them relatively riskier for creditors. In the event of a default by the borrower, creditors of perpetual subordinated loans will only receive repayment after the borrower's unsubordinated loans are settled. Given the heightened risk associated with subordinated loans, they typically come with higher interest rates compared to unsubordinated bonds. Perpetual bonds provide issuers with a means to raise capital without the requirement of repayment, offering investors a continuous stream of interest payments indefinitely.

OUTLOOK

The Business Model Remains Robust

The retail portfolio, which accounts for more than 50% of the company's revenue, remains robust and prepared to face the ongoing macroeconomic challenges of rising interest rates, inflation, and lower productivity. Risk management has improved since the previous financial crisis, featuring strict controls for new lending to ensure affordability and manage indebtedness. Despite external pressures, there are minimal signs of deterioration in the portfolios, with low arrears rates, often below pre-pandemic levels. New lending maintains strong credit quality, and overall performance remains steady. As revenue stays afloat and additional strategic initiatives are implemented, the company is anticipated to see further improvements in its cost to income ratio, asset quality and ROTE, which will reduce the likely risks of default on this relatively risky note.

Balance Sheet Continues to Benefit from a Diverse Wholesale Funding Base

Based on an adequate net funding ratio, S&P views Lloyds' funding and liquidity profile as largely on par with other banks in the UK, despite the bank's loan-to-deposit ratio being at the higher end of its peers in the universal banking sector within the country. Over the last five years, Lloyds has experienced substantial growth in its deposit base, with approximately £83 billion in deposits added since 2018. As a result, deposits now constitute 84% of its funding base, up from 76% in 2018, further strengthening an already diversified and stable funding base. This solid funding base will ensure that Lloyds has adequate liquidity to meet its short and long-term financial obligations, while assisting in maintaining solvency.

COMPARABLES ANALYSIS

When compared to a few peers of a similar S&P credit rating in the table below, the coupon on LLOYDS 8% Perp is equivalent to BACR 8% Perp and HSBC 8% Perp. However, the ask yield, which is the lowest possible yield an investor can expect to receive from a bond, is above the comparable average, with the longest period until the first call date in September 2029 (Barclays: March 2029).

Issue	Current Price	Bond Rating (S&P)	Tenor	Ask Yield	Spread
Llyods 8% Perp	90.419	BB-	2029*	10.316	5.679
Barclays 8% Perp	89.7255	BB-	2029*	10.678	6.041
HSBC 8% Perp	99.896	BBB**	2028*	8.021	3.384
US 5Y***	101.0391	AA+	2028	4.637	-

(***) Benchmark
(**) Fitch Ratings
(*) Call Date
Source: Bloomberg (November 6, 2023)

INVESTMENT POSITIVES

1. **Stable Funding Profile:** The company's funding and liquidity profile is strong, bolstered by a substantial deposit base stemming from its prominent retail franchise in the UK and favourable access to wholesale funding markets.
2. **Strong Asset Quality:** Llyod's loan quality remained robust throughout the COVID-19 pandemic, thanks to government support measures, and challenges related to borrowers' ability to repay loans have not yet impacted asset performance.
3. **Strong Income Potential:** Lloyds holds a prominent position in the UK's mortgage market and boasts strong market shares in credit cards, unsecured lending, and commercial banking. Furthermore, the sustained high-interest rate environment in the UK will keep bolstering Lloyds' revenue, with continued advantages from its structural hedge playing a significant role.
4. **Stable Issuer Ratings:** Both Standard & Poor's and Moody's affirmed Llyod' issuer ratings in the last 12 months, indicating stable creditworthiness and financial stability.
5. **Consistently Robust Financial Performance:** The company has been able to grow profit annually, while improving key financial metrics such as ROTE and liquidity coverage ratio, which highlights its ability to maintain interest payments to bondholders.
6. **Strong Capital Base:** A stable CET1 ratio indicates Llyods' strong capital base, which enhances its financial stability by providing a buffer against unexpected losses and economic downturns, reducing the likelihood of financial distress or defaults.

INVESTMENT NEGATIVES

1. **Increasing Expenses:** While Barclays has improved efficiency, it is projected that operating expenses will grow in the mid-single digits in 2023. This could potentially impact profitability.
2. **Bond Rating Lower Than Issuer:** The bond rating of the 8.0% Perpetual Bonds is lower than the issuer's rating because they are classified as Junior Subordinated debt, implying a lower claim in case of financial distress or default. This lower bond rating suggests higher credit risk for bondholders.
3. **Lack of Strong Geographic Diversity:** The company's strong geographic focus on the UK, which has been characterized by slow economic growth in 2023, constrains its growth potential and amplifies the risks associated with an underperforming UK economy.
4. **Slow UK Economic recovery:** Elevated interest rates, persistent uncertainties, and sluggish productivity may pose challenges for the UK in maintaining economic stability, which could negatively impact the demand for Llyods' products and services, while deteriorating its existing portfolios.
5. **Elevated Inflation May Lead to an Increase in Non-Performing Loans:** Increasing inflation and higher interest rates are expected to have a negative impact on households' disposable income and their ability to manage debt payments.

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CONCLUSION

While not extensively diversified across geographies, Lloyds maintains a strong presence in the UK banking sector and is improving profitability. In the first nine months of the current fiscal year, Lloyds nearly doubled its net profit, improved its cost-to-income ratio, and increased its net interest margin. While the 8% perpetual bond carries some risk, the combination of an adequate liquidity coverage ratio (142%), stable funding choices, and the issuer's investment-grade credit rating makes it an attractive high-yield option, especially for moderately to aggressively inclined bond investors.

Therefore, we recommend that investors consider buying Llyods 8.0% Perpetual Bonds for their strong appeal as follows:

Conservative Risk Appetite: UNDERWEIGHT (Due to the Perpetual bonds being consider Junior Subordinated Debt)

Moderate Risk Appetite: OVERWEIGHT

Aggressive Risk Appetite: OVERWEIGHT

SOURCES

LLYODS' COMPANY WEBISTE, LLYODS COMPANY FINANCIALS, IMF, REUTERS, FITCH RATINGS, BLOOMBERG, STANDARD & POORS, MOODY'S INVESTOR SERVICES

DEFINITIONS

- **OVERWEIGHT** - Security is deemed to be undervalued and is expected to outperform compared to the average market return and/or return of comparable securities in the same sector or industry.
- **MARKETWEIGHT** – Security is expected to provide similar returns compared to the market in general or at the same pace as comparable companies; neither strongly positive nor negative.
- **UNDERWEIGHT** – Security is deemed to be overvalued and is expected to underperform compared to the average market return and/or return of comparable securities in the same sector or industry.
- **ZEROWEIGHT** – This security is substantially distressed or at risk of a shock which may significantly impair its value.