United Kingdom

Banks

30 August 2001

HBOS

Low risk growth potential

3734474

12M target: **1035p** | Commences trading 10 Sep 2001

Buy

Initiating coverage

BoS

Price
856p (€13.7, US$12.4)
Market Cap
£10.8bn (€15.7bn, US$17.2bn)
Reuters / SEAQ / Bloomberg
BSCT.L / 45338 / BSCT

Halifax

Price
856.5p (€13.7, US$12.4)
Market Cap
£19.3bn (€28.0bn, US$30.8bn)
Reuters / SEAQ / Bloomberg
HFX.L / 45384 / HFX

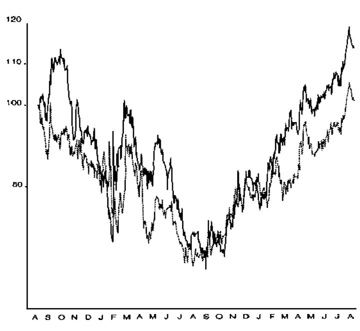
Tom Rayner
+44 20 7475 6907
tom.rayner@drkw com

Neil Baker
+44 20 7475 2325
neil.baker@drkw com

Lucy Wagenstein
+44 20 7475 6908
lucy.wagenstein@drkw.com

Marketing analysts:
Nick Collier
442074755664
nick.collier@drkw.com

Arturo de Frias
+44 20 7475 2530
arturo.defrias@drkw.com



The complementary nature of the HBOS merger can be seen in both the asset-liability breakdown and the business mix. Combining Halifax's strong capital and deposit base with **BoS's** wider lending capabilities produces a well-balanced group that can effectively grow its assets without encountering either capital or funding constraints.

- The merger of Halifax and Bank of Scotland (**BoS**) to become HBOS is primarily about combining complementary businesses to generate substantial revenue synergies as well as driving cost savings through the larger group.
- We prefer HBOS to either Lloyds TSB or Abbey National, the obvious peer group in the UK given the largely retail-dominated business mix, due to better growth potential in both long-term savings and corporate banking.
- Strategically, the lack of 'full service' banking capabilities and an obvious route into overseas markets leaves HBOS trailing Barclays and RBSG. However, we believe that the new management team are'capable of developing this group into the third **major** domestic banking group in the **UK.**
- Our fundamental dividend discount model gives current fair value of **950p**, implying a **12-month** target price of **1035p**. We are initiating coverage with a Buy recommendation, although the market will probably need further convincing that the merger synergies are fully achievable.

Year to end	PBT FRS3	Cash EPS	PIE ratio	Op profit	OPS	Net yield	NAV	P/NAV	ROE
2001E	3,071	56.5	15.1	3,692	25.2	2.9	323	2.7	17.7
2002E	3,482	66.4	12.9	4,195	28.0	3.3	361	2.4	18.5
2003E	4,238	79.7	10.7	4,717	30.9	3.6	396	2.2	20.5

Performance (%)	**1M**	**3M**	12M
Absolute	NA	NA	NA
Relative to FT All Share	NA	NA	NA
Relative to Eurotop 300	NA	NA	NA
Relative to Eurobanks	NA	NA	NA

Source: DKWR estimates

Online research: globeweb.drkw.com (European stocks); www.drkw.com/research (all others)

Summary

HBOS fits well within our 2001 European bank investment strategy of favouring growth at low to moderate risk. Both component banks have been committed to a volume-led strategy in either retail financial services (Halifax) or corporate banking (Bank of Scotland). The merger combines these complementary businesses and alleviates Bank of Scotland's (BoS) previous capital and funding constraints.

Abbey National and Lloyds TSB the core peer group

In the UK we see the new HBOS core peer group as including Lloyds TSB and Abbey National. The latter two banks both suffer from the twin problems of generating sustainable revenue growth with cost bases rising faster than the sector average. HBOS has the advantage of better internal cost control allied to cost synergies of c.£300m from the merger which, as we argue below, are readily achievable. Halifax and BoS have both pursued successful growth strategies and are prepared to use price-led competition as a method of winning market share.

Long-term savings winner

Although Bank of Scotland always favoured the 'distribution only' model for tackling long-term savings in the UK, we believe that the Halifax model is superior, Its range of distribution channels covers the entire spectrum, from those just wanting a cash ISA (individual savings account) purchased from the branch to high net worth individuals requiring a full personal service from St James's Place Capital (SJPC). This flexibility combined with market-leading manufacturing capabilities produces a powerful force in the industry.

Developing the corporate/SME franchise

We would argue that leveraging the Halifax/BoS franchise into the English heartland of SME banking will be one of the key challenges for the new HBOS Group. However, BoS has already shown that it has the expertise to win market share from the London-based clearing banks and, with the benefit of Halifax's branch network and strong brand recognition throughout England, should be able to significantly increase its levels of penetration.

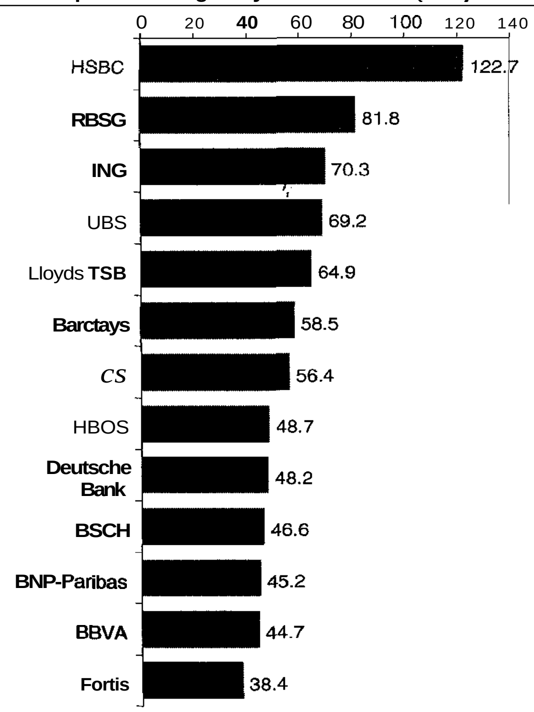
Valuation

At 11x 2003 cash EPS, HBOS should trade in line with its most obvious UK peers – Abbey National and Lloyds TSB. We feel that the strength of management and superior growth potential justifies a premium of c.10%. Assuming 100% of targeted synergies are achieved, we estimate the net present value to be 104p per share. Our fundamental dividend discount model (DDM) suggests current fair value of 950p, giving a 12-month target price of 1035p. The terminal assumptions used are a sustainable RoE of 16% (see page 21 for a detailed breakdown), long-term growth of 4.0% and a cost of equity of 9.0%.

A top 10 European bank by market value

On completion of the merger between Halifax and Bank of Scotland on 10 September the new company HBOS will become the eighth-largest bank in our research universe by market value. The MSCI weighting for HBOS will be 0.59%, with the previous weighting for Halifax (Bank of Scotland was not included in the index) only 0.38%. This implies that approximately 43m shares, around five days trading, need to be bought for the index tracker funds to fully rebalance. Furthermore, we estimate that UK institutions are currently 3.4% underweight HBOS, a figure that rises to 7.4% if we strip out the single biggest holding in Bank of Scotland.

European banks premier league by market value (€bn)



Source: DKWR estimates

Summary

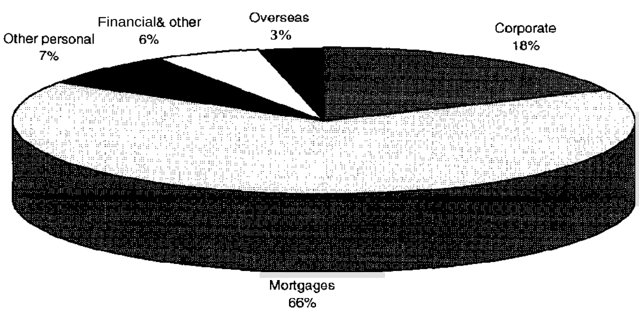
Contents

Operating trends

The new group will start life highly exposed to the UK mortgage market, representing around two-thirds of the pro forma loan book. However, the breakdown of profits is more favourable, with the potential for the insurance-based operations and consumer credit to expand rapidly. The high level of cost efficiency we expect will allow HBOS to use aggressive price-led competition to win market share in growth areas.

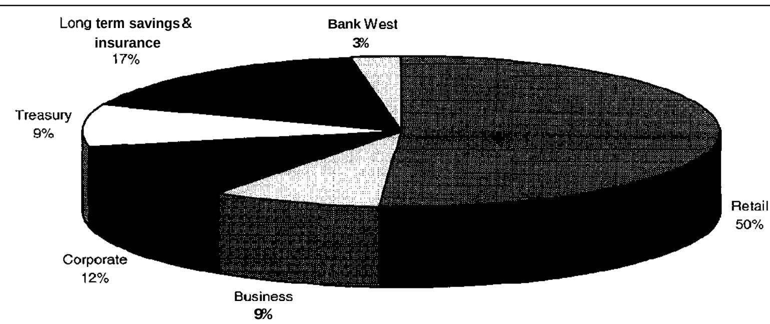
The HBOS loan book will be 66% UK mortgages, **18%** corporate, 7% other personal loans, 6% financial and other and **3%** overseas (Bank West). The new group can afford **to** relax its share of mortgages and focus strongly on growing unsecured lending, credit cards and SME and large corporate lending. However, the breakdown **of** profits is less polarised than the loan book may suggest, with retail accounting for **50%,** corporate lending 21% and long-term savings and insurance 17%.

HBOS pro forma loan book, 2000



Source: Company

HBOS pro forma we-tax profit, 2000

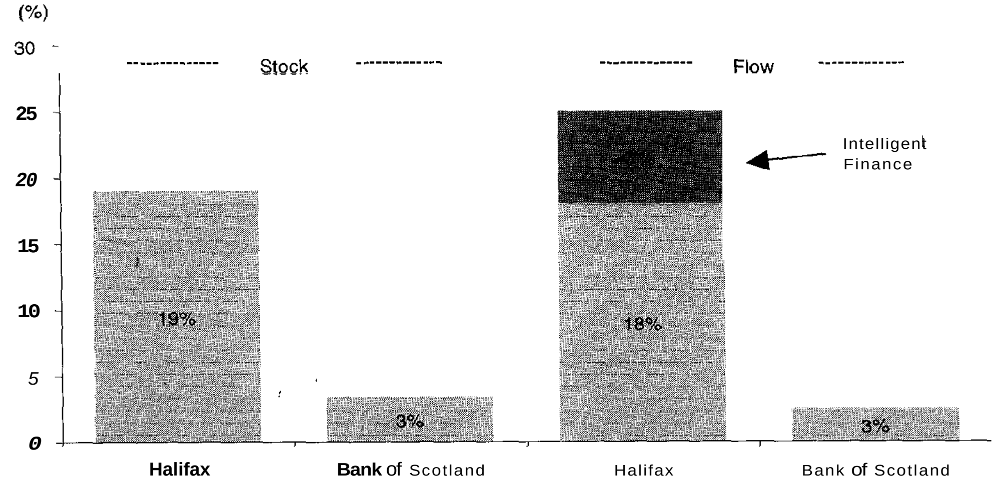


Source: Company

Mortgages: a core product

The H1 2001 results demonstrated the power of the Halifax brand in the UK mortgage market, taking a 25% share of net mortgage lending. This reflects the aggressive policy of actively re-pricing existing customers in order to improve retention and reduce the level of customer 'churn'. By extending the average life of the mortgage and raising the level of cross selling, Halifax hopes to offset the impact on the return on capital of lower net interest margins. The chart below shows the recent market share data for both Halifax and Bank of Scotland.

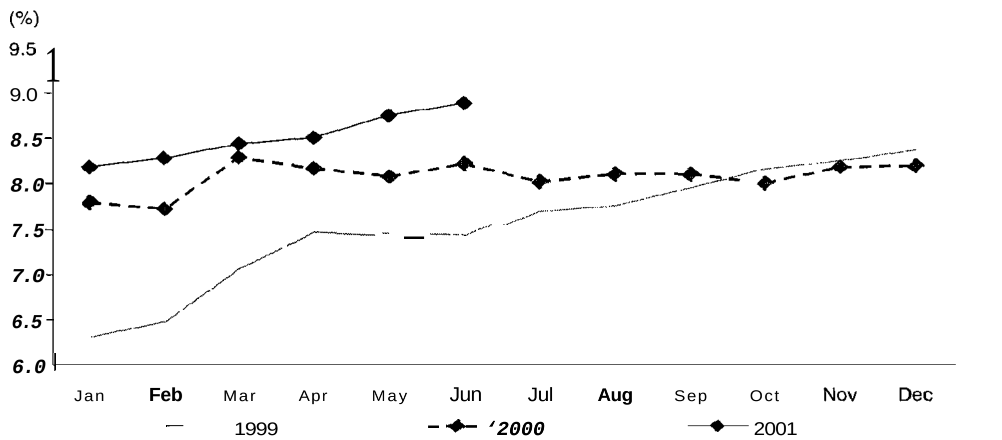
Market shares of mortgages, stock and flow, H1 2001



Source: Company, DKWR **estimates**

As the chart below shows, mortgage market conditions remain favourable in the UK with volume growth currently set to reach 9% this year. We expect the rapid pace of growth to cool in H2 2001, but for growth to still be at least *8%* for 2001 as a whole and then to fall to 7% and 6% for 2002 and 2003, respectively.

Cumulative mortgage lending – annualised



Source: BoE

This year should prove to have been the peak for re-mortgaging with margins starting to stabilise into 2002. In recent months the competitive pressures have moved on from just the new business, where discounts are prevalent, and onto the 'back book. The end game will arrive once the back book is fully re-priced to a sustainable level, which we believe will be consistent with a mortgage spread (asset spread plus retail deposit spread) of c.1.60%.

Long-term savings winner

Although HBOS should generate additional fee income by expanding new business areas such as current accounts and credit cards, successfully developing the long-term savings business is likely to prove far more important in terms of expanding non-interest income. In fact, it is becoming increasingly important for all banks **to** develop low cost, multi-channel distribution models in the area of long-term assurance. On a standalone basis, the Halifax already has one of the most comprehensive distribution models for all the UK banks.

This division, which made up over 25% of Halifax group profit, will be diluted to **17%** of pro forma HBOS profit although we believe that long-term savings will quickly grow to become *as* important to the new group as it is currently to Halifax alone. It will remain a key growth area and is one of the targeted areas for revenue synergies. The rating of HBOS should be supported by this fast growing, low risk revenue stream.

Halifax's approach to the long-term savings market

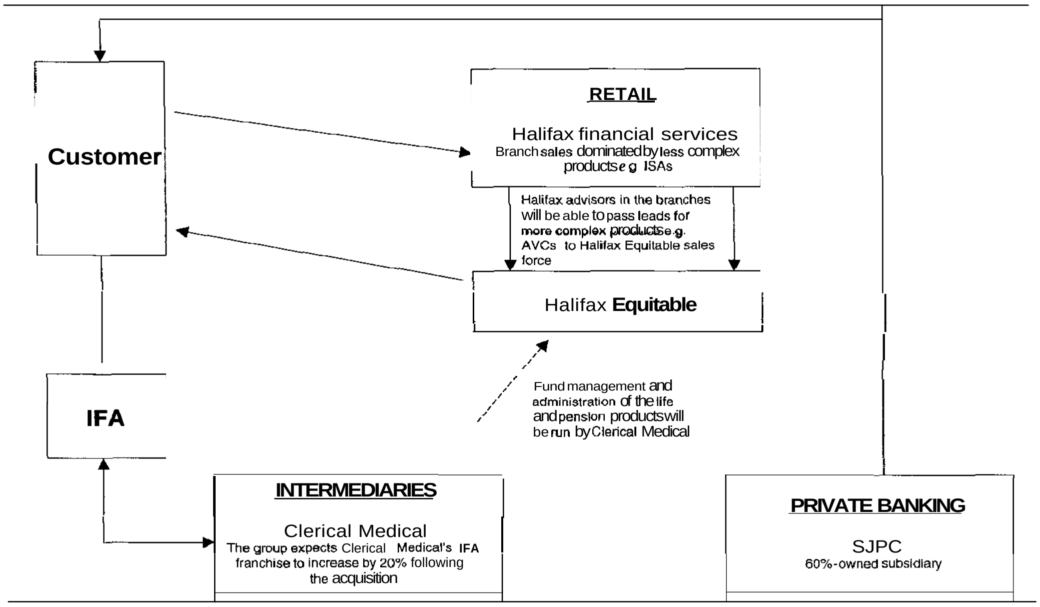
The Halifax distribution model covers three channels of long-term savings distribution, bancassurance, the IFA network and private clients. The retail channel is serviced via Halifax's own brand bancassurance business and was strengthened following the recent acquisition of the operating assets of The Equitable in February. The acquisition of the Equitable Life sales force by Halifax added a further dimension to the group's capabilities, especially in areas such as Additional Voluntary Contributions (AVCs), where it has been historically strong. It should be noted that Halifax has no liability to the closed fund and cannot be directly hurt by the ongoing problems surrounding The Equitable's guaranteed annuity policyholders.

The IFA channel is serviced via Clerical Medical and the private banking channel via St. James's Place Capital, which was added to the portfolio of long-term savings businesses in June 2000.

The Halifax model not only has the advantage **of** businesses targeting all client ranges from mass affluent (SJPC) to mass market but also the backing of a strongly capitalised group. James Crosby (Group CEO) stated at the recent Halifax interims that having strong capital ratios was a key competitive advantage especially in a bear market when IFAs steer client sales towards insurers with the strongest free asset ratios. Clerical Medical's free asset ratio of 16.5% is well ahead of Scottish Widows at 12.5%.

The next diagram attempts to show how the Halifax distribution model fits together.

Halifax's distribution model



Potential channel conflict

Following the purchase of the operating assets of The Equitable, Halifax has had to manage the potential for channel conflict between IFAs and the direct sales force carefully. Products offered by Clerical Medical to IFAs will differ from those marketed via the Halifax Equitable sales force, which in turn will be different from those offered in the branch network. Differentiation will be achieved not only by the level of product complexity, but also in areas such as pricing structure.

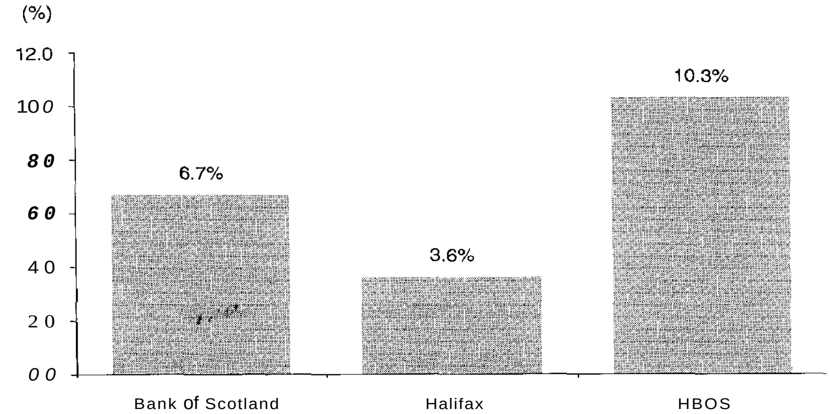
The challenge for the new group going forward will be to successfully cross-sell the Halifax long-term savings and insurance capabilities to the Bank of Scotland retail, SME and corporate customer base. This cross-selling is expected to be part of the £60m net revenue benefits associated with the retail and long-term savings and insurance division.

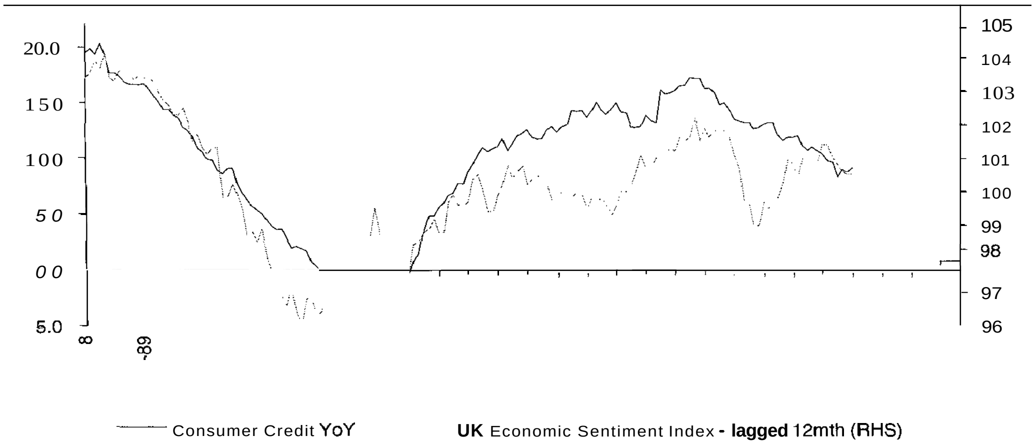
Consumer credit: a potential growth area

With the UK economy expected to remain robust and consumer confidence relatively high, a sharp slowdown in consumer credit growth rates appears unlikely. With a relatively small book, at just ***7%*** of the group loan book, and significant expertise at both Halifax and Bank of Scotland, there is no reason why the bank should not grow its personal loan assets far in excess of the market rate, which we expect to be 10% per annum to 2003.

The chart below shows the combined consumer credit loan books at Halifax and Bank of Scotland based on the most recently disclosed information.

Market shares of consumer credit – stock outstanding





Source: ***DKWR estimates***

Credit cards

Within the cost savings of £110m relating to the retail and long-term savings and insurance division is the combining of the personal loan and credit card operations of Bank of Scotland and Halifax to "generate savings in management, sales and processing activities".

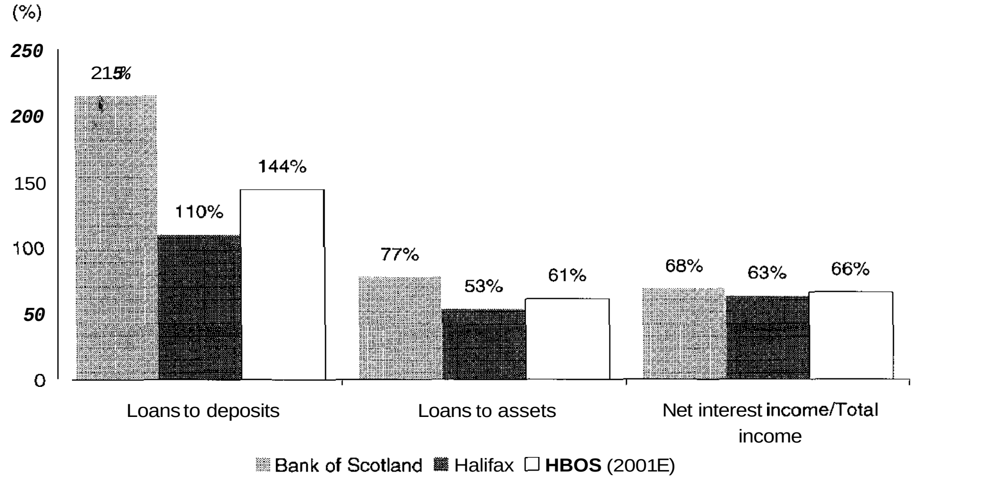
Both parties are already strong in credit cards, with the recent acquisition of Bank One's management team and the UK credit card operations by Halifax. However, with a combined market share of only 7% of cards in issue, against c.21% share of cards for Royal Bank of Scotland Group (RBSG) and c.25% of both cards and outstandings for Barclaycard, there is huge growth potential. Bank of Scotland adds an extensive web **of** affinity relationships, including the recent inclusion of British Gas and Saga.

Funding base

For Bank of Scotland, the merger will provide a critical retail-funding base. As shown below, loan growth has been fast outstripping deposit growth at Bank of Scotland, with the loan to deposit ratio reaching 215% by February 2001. **As** a combined entity, the loan to deposit ratio should fall to 144% by the end of this year, which is a far more comfortable level. Given Halifax's aggressive drive to attract retail funds through its pricing structure, rapid loan growth should be supported without the need for undue reliance on the wholesale markets.

It should be noted, however, that with a loan/deposit ratio of 110%, Halifax is not flush with surplus deposits, explaining why the simple replacement of wholesale funds at Bank **of** Scotland has not been put forward as a key revenue synergy.

Loans as a proportion of deposits and assets



Source Company, DKWR **estimates**

SME banking: a challenge for management

The new group plans to capture a "significant share of the attractive SME market" and we believe this to be one of the key challenges for management post the completion of the merger. SME banking in the UK has been a notoriously difficult market to penetrate with numerous barriers to entry. These include the lack of available credit histories for switching customers and the costs associated with establishing a branch network.

We believe, however, that barriers **to** entry in the SME market should eventually start to break down. The initial investigation into the SME market in the UK by the Department of Trade and Industry provided possible remedies to reduce the level of barriers to entry and increase competition including the regulation of charges such as interest paid on deposits, no discrimination allowed between personal and business accounts and the promotion of easy switching between accounts.

Furthermore, Bank of Scotland has had much success in SME banking in Scotland and its main barrier to penetrating further into the UK has been the lack of a widespread branch network and a recognisable brand. We believe the merger with Halifax provides them with the branch network necessary to leverage their expertise and a recognisable brand in the UK.

Sustainable margin can be raised by asset mix

A noticeable feature of the pro forma loan book breakdown is that the new group appears underweight consumer credit balances. This offers the potential to benefit from a changing asset mix, particularly if the experience and expertise of Bank of Scotland can be combined effectively with the 20m strong Halifax customer base. Halifax already has a highly experienced and well-respected management team running the credit card business, with Bank of Scotland able to add a wide range of affinity relationships.

The table below shows the impact that a shift in the asset mix could have on the sustainable margin for the group. This assumes that mortgages drop from 66% to 55% of the group loan book, other personal loans rise to 15% (compared to 20% at Barclays currently) and business and corporate loans rise from **18%** to 25%. Given these changes to the asset mix, the sustainable margin would increase fro 190bp to 225bp. Obviously the sustainable level of bad debts will also rise if the group develops along these lines but with the correct controls and solid brands, such movements should be possible without unduly sacrificing credit quality.

Sustainable margins by product line

(%)	% of book 2000	Sust margin 2000	% of book terminal	Sust margin terminal
Mortgage and savings	66.0	1.60	55.0	1.60
Other **personal**	7.0	5.00	15.0	5.00
Business	6.0	3.50	10.0	3.50
Corporate	12.0	1.50	15.0	1.50
Financial and other	9.0	1.00	*5.0*	1.00
Group	100.0	**1.90**	100.0	***2.25***

Source: DKWR estimates

Forecasting loan growth

The table below gives the most recent breakdown of the Bank of Scotland loan book.

Loan book breakdown for Bank of Scotland

Calendar year (year-end Feb +1) (fm)	1999	2000	% chg
Agriculture, forestry and fishing	887	972	9.6%
Energy	1203	1506	25.2%
Manufacturing	4756	5286	11.1%
Construction and property	6351	8096	27.5%
Hotels, restaurants and retail	4738	5403	14.0%
Transport and communication	1835	2473	34.8%
Financial	2596	5151	98.4%
Other services	6637	7783	17.3%
Mortgages	15898	16740	5.3%
Other personal	7977	8597	7.8%
Overseas	3591	5816	62.0%
Gross loans and advances	56469	67823	20.1%

Source: Company

It can be seen from the above table that BoS has experienced rapid loan growth in certain sectors of industry. Property and construction loans (+28%) is perhaps the key area of concern, although there **has** not as yet been any major negative surprises from other banks, such as RBSG, which have also lent aggressively in this area. At f8.1bn, property and construction loans represented 12% of BoS gross customer loans, although this falls to less than 5% of the combined loan book. Both mortgages and other consumer loans grew below the market rate, something that we do not expect **to** see for the new group. The table below breaks the BoS and Halifax loan book down into broader sections and provides our current growth forecasts.

Loan book breakdown (fbn)

Bank of Scotland	1999	2000	% chg	2001E	% chg	2002E	% chg	2003E	% chg
Corporate	26.4	31.5,	19.4	34.7	10.0	38.1	10.0	42.0	10.0
Mortgages	15.9	16.7	5.3	17.6	5.0	18.5	5.0	19.4	5.0
Other personal	8.0	8.6	7.8	9.5	10.0	10.4	10.0	11.4	10.0
Financial	2.6	5.2	98.4	5.7	10.0	6.2	10.0	6.9	10.0
Overseas	3.6	5.8	62.0	6.7	15.0	7.7	15.0	8.8	15.0
Group	56.5	67.8	20.1	74.1	9.2	80.9	9.3	88.5	9.3
Halifax	**1999**	**2000**	**% chg**	**2001E**	**% chg**	**2002E**	**% chg**	**2003E**	**% chg**
Corporate									
Mortgages	93.3	97.5	4.5	107.2	10.0	114.7	7.0	121.6	6.0
Other personal	2.6	3.7	40.7	5.2	40.0	5.9	15.0	6.8	15.0
Financial and other	1.2	4.6	283.4	6.9	50.0	7.4	8.0	8.0	8.0
Overseas									
Group	97.1	105.7	8.9	119.3	12.8	128.1	7.4	136.5	6.5
HBOS pro forma	**1999**	**2000**	**% chg**	**2001E**	**% chg**	**2002E**	**% chg**	**2003E**	**% chg**
Corporate	26.4	31.5	19.4	34.7	10.0	38.1	10.0	42.0	10.0
Mortgages	109.2	114.2	4.6	124.8	9.3	133.2	6.7	141.0	5.9
Other personal	10.6	12.3	15.9	14.6	19.0	16.3	11.8	18.3	11.8
Financial and other	3.8	9.7	156.8	12.6	28.9	13.7	8.9	14.9	8.9
Overseas	3.6	5.8	62.0	6.7	15.0	7.7	15.0	8.8	15.0
Group	153.6	173.6	13.0	193.3	11.4	209.0	8.1	224.9	7.6

Source: Company, DKWR **estimates**

Sustainable bad debt charge currently c.40bp

Credit quality has never been a major concern for Halifax, with its loan book dominated by mortgages, an area which has seen arrears drop to all time lows. However, the new group has exposure to corporate lending which has obviously raised the risk profile.

The table below gives the broad breakdown of the new loan book and applies the 'average' charge likely to be experienced throughout the cycle. The corporate loan portfolio is broken down into further detail below. It can be seen that if the asset mix change indicated in the margin section were to occur, the charge would rise from 40bp of average gross loans to **52bp.**

Pro forma loan book and associated sustainable bad debt charge as a % of loans

(%)	2000 business mix	Sust charge %	Terminal business mix	Sust charge %
Corporate	18.0	0.70	*25.0*	*0.70*
Mortgages	66.0	0.15	55.0	0.15
Other personal	7.0	1.50	15.0	1.50
Financial and other	6.0	0.70	5.0	0.70
Overseas	3.0	0.40	-	-
Group	100.0	**0.40**	100.0	**0.52**

Source: DKWR estimates

The table below gives the expected corporate loan breakdown in 2001 and applies the 'average' bad debt charge to be expected through the cycle.

Pro forma corporate loan book and associated sustainable bad debt charge as a % of loans

(£m)	2001E	% charge
Agriculture, forestry and fishing	1,069	0.30
Energy	1,657	0.30
Manufacturing	5,815	0.60
Construction and property	8,906	1.00
Hotels, restaurants and retail	5,943	0.30
Transport and communication	*2,720*	0.30
Other services	8,561	1.00
Total corporate	34,671	**0.70**

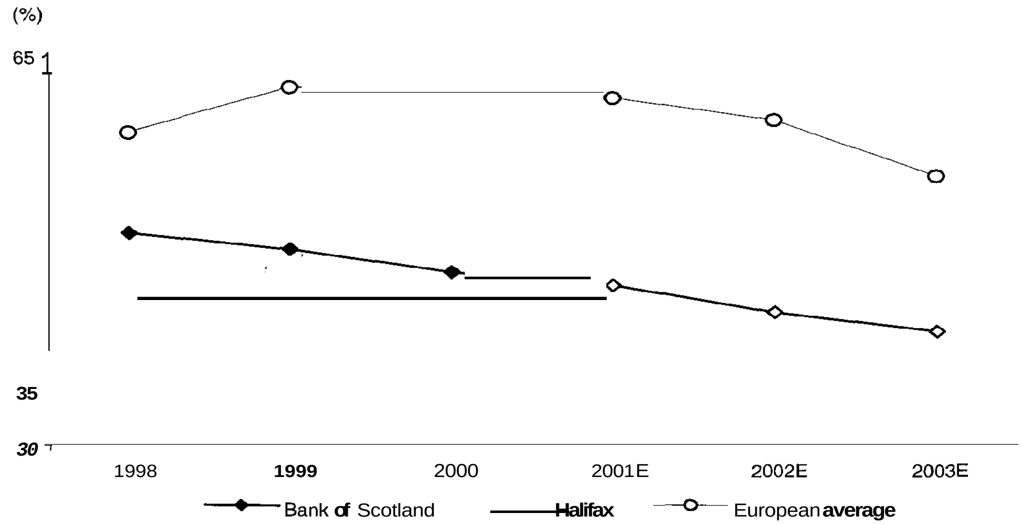
Source: DKWR **estimates**

Cost efficiency already high

It is a notable feature of this merger that cost synergies account for less than 50% of the total. This reflects the high level of **focus** on cost control at both Halifax and Bank of Scotland. The chart below shows the cost income ratios of both Halifax and Bank of Scotland from 1998 to 2000 and the expected cost income ratio of the HBOS Group to 2003. Of note is the level of cost income ratio at both banks compared to the average level in our Pan-European banks universe, where the average cost income ratio **is** expected to be 61% in 2001 compared to 44% for the HBOS Group.

It is vital that **HBOS** maintains a leading position in terms of costs as the group will need to use aggressive pricing in order to break into tough, closed markets such as SME banking and current accounts where they plan to take significant market share.

Cost:income ratios, 1998-2003 (%)



Source. Company, DKWR estimates

Dresdner Kleinwort Wasserstein Research

Achievement of synergies

RBSG's takeover of NatWest has re-written the rulebook in terms of what synergies can be achieved from banking consolidation. Although this deal is a friendly merger, perhaps limiting the speed with which savings can be realised, we have no reason to doubt the extent of the claimed synergies. Furthermore, the targeted level of £620m per annum (pre-tax) is far lower in both absolute **and** relative terms than the synergies now certain to be achieved from the NatWest takeover.

The table below gives a breakdown **of** the total synergies expected from the deal.

Breakdown of targeted synergies

(£m)	Costs	Net Revenue	Pre-tax synergy	Post-tax synergy
Retail and long-term savings and insurance	110	60	170	119
Increased, cross sales of products				
Savings tn operating and processing infrastructure				
Business banking	0	140	140	98
Combine BOS skills with HFX distribution and customer base **to** attack SME market				
Corporate banking and treasury	45	115	160	112
Leverage balance sheet strength and lending capacity				
Combine Treasury and Structured Finance operations				
Central and support functions	150	0	150	105
Single IT platform, eliminate common development costs				
Remove duolicated central costs				
Total synergies	305	315	620	434

Source: DKWR **estimates**

Revenue synergies account for > 50% of total

A key element of this merger is that it is far from **just a** cost driven story. In fact net revenue synergies represent 51% of the total targeted amount, compared to only 23% for **RBSG.** This should be taken positively as it is vital that management stay focussed on developing new revenue streams.

The table below shows targeted synergies as a percentage of both pro forma costs and revenue and how it compares to the **RBSG** targets.

Synergies as a percentage of pro forma costs and revenue

	2000	Synergies	% HBOS	% RBSG
Pro forma *costs*	2718	305	11.2	19.8
Pro forma revenue	6159	315	5.1	3.7

Source: DKWR **estimates**

Obviously there is far less for the management of HSOS to work on in relation to costs than at NatWest, which for many years were amongst the worst in the sector. This is reflected in the target which implies synergies of only 11% pro forma costs, almost half that expected to be achieved at NatWest.

The revenue estimates are somewhat higher, once associated bad debts and costs have been netted against the additional revenue. However, we always felt that Royal Sank of Scotland underestimated the revenue potential of the NatWest franchise.

Revenue synergies

The bulk of the revenue synergies are to be found in business and corporate banking but also in retail, with increased cross-selling possible on the back of Bank of Scotland's unsecured products and Halifax's secured loan and insurance products. Esure, the first internet branded general insurance company in the UK, being developed for Halifax by Peter Wood the founder of Direct Line, has the scalability necessary to expand into European markets.

The synergies in corporate banking are somewhat intangible, largely resulting from the benefit of having a stronger balance sheet to underwrite Bank of Scotland's businesses in acquisition and project finance and to support an expansion in overall lending capacity.

For SME banking, however, the potential benefits are more transparent with a number of Halifax deposit-only customers likely to take up the offer for a more integrated SME service. The task of challenging the Big 4 banks should not be underestimated, with any price-led initiative likely to be met with a competitive response. However, as the recent RBoS/NatWest deal has illustrated, additional synergies can often come to light once the integration process has begun.

Cost savings

The biggest cost savings are expected to come from the consolidation of the IT functions, the elimination of duplicated development costs and shared platforms. Other savings will come in retail, where the distribution networks can be made more efficient, processing integrated and the established credit card operations of both banks combined. Less significant savings will be found in Treasury from reduced funding costs and the combination of various back office functions.

Achievement of synergies

RBSG's takeover of NatWest has re-written the rulebook in terms of what synergies can be achieved from banking consolidation. Although this deal is a friendly merger, perhaps limiting the speed with which savings can be realised, we have no reason to doubt the extent of the claimed synergies. Furthermore, the targeted level of £620m per annum (pre-tax) is far lower in both absolute and relative terms than the synergies now certain to be achieved from the NatWest takeover.

The table below gives a breakdown of the total synergies expected from the deal.

Breakdown of targeted synergies

(£m)	Costs	Net Revenue	Pre-tax synergy	Post-tax synergy
Retail and long-term savings and insurance	110	60	170	119
Increased, cross sales of products				
Savings in operating and processing infrastructure				
Business banking	0	**140**	140	98
Combine BOS skills with HFX distribution and customer base to attack SME market				
Corporate banking and treasury	45	115	160	112
Leverage balance sheet strength and lending capacity				
Combine Treasury and Structured Finance operations				
Central and support functions	150	0	150	105
Single IT platform, eliminate common development costs				
Remove duolicated central costs				
Total synergies	**305**	315	620	**434**

Source: DKWR estimates

Revenue synergies account for > 50% of total

A key element of this merger is that it is far from just a cost driven story. In fact net revenue synergies represent 51% of the total targeted amount, compared to only 23% for **RBSG.** This should be taken positively as **it** is vital that management stay focussed on developing new revenue streams.

The table below shows targeted synergies as a percentage of both pro forma costs and revenue and how it compares to the RBSG targets.

Synergies as a percentage of pro forma costs and revenue

	2000	Synergies	% HBOS	% RBSG
Pro forma *costs*	2718	305	11.2	19.8
Pro forma revenue	6159	315	5.1	3.7

Source: DKWR estimates

Capital strength

A weakness in Bank of Scotland's business model **was** that internal capital generation was not sufficient to support the rapid asset growth resulting from its strong lending franchise. The reliance on wholesale funding was also beginning to pressure margins, thus exacerbating the problem. With securitisation never likely to fully alleviate the situation, asset growth could not have been maintained without fresh capital being raised. The merger with Halifax provides the balance sheet strength necessary to support further market share increases in corporate lending and consumer credit.

The table below shows the capital positions of both banks separately in 2000 and the pro forma situation compared to the minimum regulatory level. Although supervisory deductions at Halifax raise the minimum Tier 1 capital ratio for the group from 4% to 5%, the current situation is comfortable at over 8%. There is also room for further issuance of non-equity tax efficient Tier 1 securities for the enlarged group, currently accounting for 11% of dotal Tier 1 capital against a maximum allowance of 15%.

Pro forma capital structure 2000

(£m)	Halifax	Bank of Scotland	Pro forma
Share capital	444	326	770
Reserves	5,353	3,892	9,245
Non-eauitv	500	700	1.200
Tier 1 capital	6,297	**4,918**	11,215
Subordinate debt	3,201	2,921	6,122
General provisions	150	412	562
Tier 2 capital	3351	3,333	6,684
Supervisoty deductions	(2,400)	(288)	(2,688)
Total capital	7,248	**7,963**	15,211
Risk weighted assets	67,710	69,268	136,978
Tier 1 ratio	**9.3%**	**7.1%**	8.2%
Regulatory minimum Tier 1[1]	5.8%	4.2%	5.0%
Surplus capital'	677	277	954
Non-eauitv Tier 1 as % Tier 1 capital	7.9%	14.2%	10.7%

[1]Supervisory deductions effectively raise the minimum Tier 1 ratio by increasing the required level of total capital before deductions.of which at least 50% must be core
[2]Calculated by assuming that the bank must have a Tier 1 ratio of at least 2.5% above the regulatory minimum
Source: Company, DKWR estimates

Dividend policy

The interim dividend to be paid on 31 October 2001 will be set to be broadly in line with the Halifax dividend policy after which the strategy is: **"...to adopt a progressive dividend policy, taking into account the business profile and strategic requirements of the HBOS group and targeting a dividend cover of 2.5 times".**

Dividend cover of 2.5x compares to 2.0x in 2000 for Halifax and 3.1x for Bank of Scotland (12 months ending February 2001). The high level of dividend cover and, consequently, lower dividend yield at Bank of Scotland, reflects the high asset growth nature of the business. In other words, Bank of Scotland needed to retain a greater proportion of its earnings in order to support its faster asset growth.

Internal capital generation of 10% is possible

A cover of 2.5x implies a pay-out ratio of 40%. Our forecasts assume that the pay-out ratio will actually be 46% in 2001, falling to 40% by 2003. Based on our pro forma estimates, a pay-out ratio of 40% in 2003 would imply c.£1.4bn of retained earnings resulting in internal capital generation of 10%. Put simply, the new group would be able to grow its RWA's at c.10% without any deterioration in its capital position.

Valuation

We have built our pro forma numbers by adjusting our Bank of Scotland estimates to a December year-end and combining them with our Halifax forecasts. We separately analyse the targeted synergies and enter them as a one-line item in the group P&L. However, we prefer to value the group excluding synergies and add on the net present value of the synergies to produce the final valuation. This gives greater transparency to the valuation and allows for greater sensitivity analysis related to what percentage of targeted synergies will be delivered. Restructuring charges of £350m by December 2002 are treated as exceptional.

Pro forma estimates

The table below gives a summary breakdown of the pro forma estimates pre and post synergies. Detailed forecasts for Halifax and Bank of Scotland on a standalone basis can be found at the end of this research.

Pro forma estimates

(£m)	2001E	2002E	2003E
PBT (FRS3)	3071	3296	3804
Plus: synergies	0	186	434
PBT inc synergies	3071	3482	4238
Less: restructuring		(200)	(150)
Less: goodwill and exceptionals	(76)	(76)	(76)
Cash PBT	3147	3758	4464
Cash EPS	***56.5***	**66.4**	**79.7**

Source: DKWR estimates

Valuing the synergies

The table below sets out the synergies we expect **to** be achieved over the next three years. We have used the group's cost of equity (9%) as the discount rate to calculate the Net Present Value (NPV) of the synergies.

Value of synergies per HBOS share

(£m)	**Year 0** 2001E	**Year 1 2002E**	**Year 2 2003E**	**Year 3 2004E**
Percentage of targeted level (%)	0	30	70	100
Annual synergies achieved (pre-tax)	0	186	434	620
Annual synergies achieved (post-tax)	0	130	304	434
Value at P/E of 11x				4774
NPV at 9% discount rate				3686
No. of shares (m)				3561
NPV per share (p)				**104**

Source: DKWR estimates

P/E valuation

The table below applies a PE multiple to pro forma EPS estimates before provisions and **adds** on the net present value of future synergies. The correct PE multiple depends on the sustainable RoE, the long-term growth and the group's cost of equity. One method of capturing these factors is to look at the Implied Risk Premium (IRP: earnings yield minus 10 year bond yield), which for both stocks is currently at 2.2% using 12-month rolling consensus estimates.

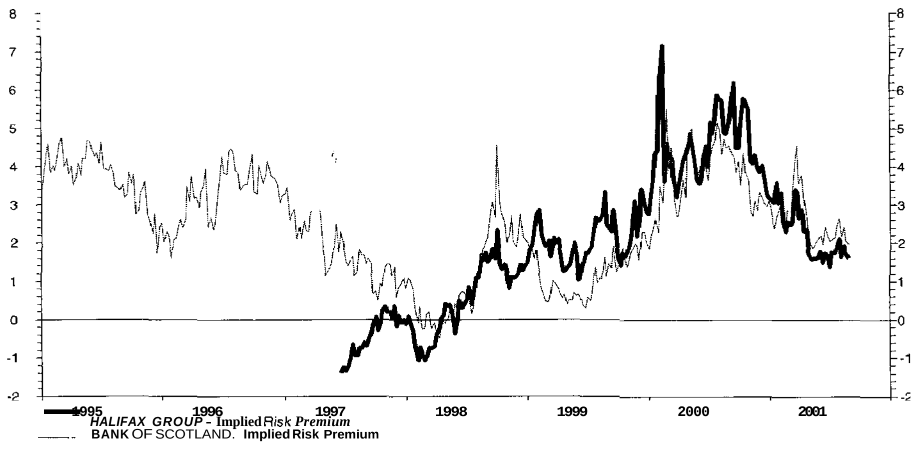
An **IRP** of 2.2% and the current 10-year bond yield of 4.8% imply that HBOS should trade at an earnings yield of 7.0%. This is consistent with a 12-month forward P/E of 14.3x, giving a year-end target price of 950p based on DKWR estimates. Stripping out the impact of synergies gives a P/E of 13.5x.

PIE valuation

	2000	**2001E**	**2002E**	**2003E**
EPS pre-synergies (p)	54.7	56.5	62.7	71.2
PIE x (12-month forward)	*13.5*	13.5	13.5	13.5
Target price (pre-synergies) (p)	763	847	961	
Value of synergies (100%) (p)		104	104	
Target price end year (p)		**950**	**1065**	
Synergies per share (p)			3.7	8.5
EPS including synergies (p)	54.7	56.5	66.4	79.7
PIE x (12-month forward)		14.3	13.4	

Source: DKWR estimates

Implied risk premium



Source: Thomson Financial Datastream, DKWR estimates

Dividend discount model

The table **below** gives the results and assumptions used **in** our DDM.

Fair value and 12-month target

Model	(p)
PV of explicit period	97.3
PV transition period	245.2
PV of terminal value	616.3
PV of capital surplus	-8.5
Fair value today	**950**
12-month target price	1,035
Last price	856
12-month total return	21%

Source: DKWR estimates

Terminal value assumptions

Terminal P/BV (x)	2.4
Sustainable RoE (%)	16.0
Long-term growth (%)	4.0
Cost of equity (%)	9.0

Source: DKWR **estimates**

Sustainable RoE assumptions

(%)	2000	2004E	Terminal
P&L assumptions			
Net interest margin	2.02	1.81	1.75
AIEA growth	10.6	7.9	4.0
Non-interest income margin	0.76	0.79	0.85
ATA growth	15.0	9.0	4.0
Non-interest income/total income	31.3	35.4	39.6
Cost/income ratio (ex goodwill)	44.1	40.1	45.0
Cost (ex goodwill)/ATA	1.08	0.90	1.02
Bad debt charge/Net loans	0.29	0.33	0.50
Net loans growth	11.1	7.7	4.0
Other/operating profit after credit risk	-5.4	7.8	0.0
Effective tax rate	28.7	30.0	30.0
Minorities, prefs etc./profit after tax	7.4	7.4	0.0
Equity structure assumptions			
Tier 1 ratio	8.2	7.7	8.0
Optimal Tier 1 ratio	8.0	8.0	8.0
RWA growth	14.8	8.8	4.0
Ordinary equity/Tier 1 capital	97.8	98.4	98.4
Stated RoE	18.7	20.2	15.6
Cash return on equity	**19.6**	**22.9**	**16.0**

Source: DKWR **estimates**

Valuation model results

Fair value and 12-month target

Model	**(p)**
PV of explicit period	97 3
PV transition period	245 2
PV of terminal value	616 3
PV of capital surplus	-8 5
Hidden reserves	0.0
Fair value today	**950**
12-month target price	1035
Last price	856
12-month total return	21%

Source DKWR estimates

Terminal value assumptions

Terminal P/BV (x)	**2.4**
Sustainable RoE (%)	16 0
Long-term growth (%)	4 0
Cost of equity (%)	9 0

Source DKWR estimates

Sensitivity analysis

Sustainable RoE (inc goodwill)

Cost of equity	14.5%	15.0%	**15.5%**	**16.0%**	**16.5%**	17.0%	17.5%
10.00%	724	743	**763**	782	802	822	841
9.75%	756	777	**798**	819	840	861	882
9.50%	791	814	**836**	859	881	904	926.2
9.25%	823	854	878	902	927	951	975
9.00%	872	898	924	- - -	- - -	1,002	1,028
8.75%	919	948	976	1,004	1,032	1,060	1,088
8.50%	972	1,002	**1,032**	1,063	1,093	1,123	1,154
8.25%	1,030	1,063	**1,096**	1,129	1,162	1,194	1,227
8.00%	1,096	1,131	**1.167**	1,203	1,239	1.275	1.310

Cost of equity	2.5%	3.0%	**3.5%**	**4.0%**	**4.5%**	5.0%	5.5%
10.00%	721	739	**759**	782	810	842	948
9.75%	750	769	**792**	819	850	888	1,006
9.50%	780	802	**828**	859	895	939	1,071
9.25%	812	838	867	902	945	997	1,145
9.00%	847	876	910	950	1,000	1,061	1,229
8.75%	885	918	957	1,004	1,061	1,134	1,327
8.50%	926	964	**1,008**	1,063	1,130	1,217	1,440
8.25%	971	1,014	**1,065**	1,129	1,209	1,313	1,574
8.00%	1,020	1,069	**1,129**	1,203	1,298	1,425	1,735

Long-term growth

Sustainable RoE	*2.5%*	3.0%	**3.5%**	**4.0%**	**4.5%**	5.0%	5.5%
14.0%	772	793	**818**	847	882	925	992
14.5%	791	814	**841**	872	911	959	1,031
15.0%	810	835	**864**	899	941	993	1,071
15.5%	828	855	887	924	970	1,027	1,111
16.0%	847	876	910	950	1,000	1,061	1,150
16.5%	866	897	933	976	1,029	1,095	1,190
17.0%	885	918	**956**	1,002	1,059	1,129	1,229
17.5%	903	938	**979**	1,028	1,088	1,162	1,269
18.0%	922	959	**1,002**	1,054	1,118	1,196	1,308

Timetable of key events

Expected timetable

Hearing by Court of Session of motion to sanction the Bank of Scotland scheme	3 September 2001
Hearing by High Court of motion to sanction the Halifax Group scheme	4 September 2001
Last day of dealing in Bank of Scotland Stock Units and Halifax Group shares	7 September 2001
Effective date of the Halifax Group Scheme and the Merger	10 September 2001
Commencement of dealings on the London Stock Exchange in HBOS Shares	10 September 2001
Payment of interim dividend to HBOS shareholders	31 October 2001

Source: Company data

This note assumes that the merger of Halifax and Bank of Scotland will complete as planned on 10 September 2001. However, the deal is conditional upon the courts sanctioning the schemes of arrangement by not later than 31 December 2001 or such later date as Bank of Scotland and Halifax may agree. It is also possible, but unlikely, that a third party may intervene by making an offer for one of both of the banks involved in this merger before the stocks cease trading on 7 September 2001.

Share prices of companies mentioned in this report

Lloyds TSB	729p
Abbey National	1130p
Barclays	2207p
RBSG	1775p
St James's Place Capital	390p

Notes

Bank of Scotland: summary information (consolidated)

Profit and loss account		H1 2000	2000	H1 2001E	2001E	2002E	2003E
Net interest income	£m	869	1794	938	1979	2143	2291
Non interest income	£m	409	834	433	892	944	991
Total income	£m	1278	2628	1392	2871	3087	3283
Staff costs	£m	(282)	(551)	(287)	(581)	(615)	(652)
Depreciation	£m	(40)	(90)	(42)	(92)	(99)	(107)
Total operating costs	£m	(585)	(1195)	(598)	(1232)	(1302)	(1376)
Operating profit	£m	693	1433	795	1639	1785	1907
Bad debt charge	£m	(172)	(385)	(213)	(426)	(480)	(525)
Exceptionals	£m	(66)	(96)	(0)	(0)	(0)	(0)
Associates and JV	£m	19	36	20	42	45	48
Fixed asset w/offs & oth.	£m	(5)	(7)	(2)	(5)	(5)	(5)
PBT **(FRS3 basis)**	£m	535	1077	600	1250	1345	1425
Tax	£m	(143)	(300)	(184)	(379)	(404)	(427)
Minorities – equity	£m	(17)	(34)	(18)	(37)	(39)	(41)
Attributable profit	£m	275	579	365	768	836	889
Retained profit	£m	208	381	253	536	575	602

Valuation measures		H1 2000	2000	H1 2001E	2001E	2002E	2003E
PBT (DKWR basis)	£m	535	1077	600	1250	1345	1425
EPS (FRS 3 basis)	p	21.9	45.8	29.1	58.6	63.4	68.7
Cash EPS (DKWR)	p	25.7	52.0	29.3	58.6	63.4	68.7
Net dividend	p	5.3	15.3	5.3	17.6	19.7	22.1
NAV	p	260	283	315	323	364	418
Tier 1 ratio	%	6.9	7.1	6.5	6.6	6.8	6.9

Performance ratios		H1 2000	2000	H1 2001E	2001E	2002E	2003E
Cost/income ratio	%	45.8	45.5	42.9	42.9	42.2	41.9
Dividend cover	x	4.1	2.9	3.3	3.3	3.2	3.1
Non interest inc./total inc.	%	32.0	31.7	31.1	31.1	30.6	30.2
Tax rate	%	30.5	30.5	30.6	30.3	30.0	30.0

Margin		H1 2000	2000	H1 2001E	2001E	2002E	2003E
Group margin	%	2.47	2.44	2.38	2.32	2.30	2.25

Profitability		H1 2000	2000	H1 2001E	2001E	2002E	2003E
Return on equity	%	18.1	18.2	20.3	19.4	18.5	17.4
Return on RWA	%	0.96	0.93	1.09	1.06	1.06	1.03
Return on total assets	%	0.57	0.48	0.59	0.58	0.57	0.55

Bad debt measures		H1 2000	2000	H1 2001E	2001E	2002E	2003E
Chge. as % of dom. adv.	%	0.55	0.56	0.59	0.56	0.58	0.58

Balance sheet items		H1 2000	2000	H1 2001E	2001E	2002E	2003E
Customer advances	£bn	61.0	67.8	70.9	74.1	80.9	88.5
Balance sheet assets	£bn	79.1	87.8	91.8	95.8	104.7	114.5
RWA	£bn	62.1	69.1	72.3	75.4	82.4	90.1
Average NOSH	m	1,255	1,263	1,255	1,309	1,319	1,295
Period end NOSH	m	1,264	1,304	1,264	1,314	1,324	1,300
Tier 1 capital	£m	4,285	4,458	4,711	4,997	5,574	6,179
Equity	£m	3,268	3,695	3,948	4,231	4.806	5,408

Source. Company accounts, DKWR estimates

Share information

Total number of shares	1,314m

Major shareholders:

Schroder Investment Management	6.4%
Scottish Widows Investment Partnership	4.1%

Dresdner Kleinwort Wasserstein Research

Halifax: summary information (consolidated)

Profit & loss acc.		H1 2000	2000	H1 2001	2001E	2002E	2003E
Net interest income	£m	1199	2386	1083	2289	2491	2641
Non interest income	£m	483	1062	645	1344	1526	1739
Total income	£m	1682	3448	1728	3633	4017	4380
Staff costs	£m	(386)	(739)	(391)	(815)	(847)	(880)
Depreciation	£m	(66)	(134)	(72)	(147)	(158)	(166)
Other costs	£m	(268)	(632)	(322)	(706)	(670)	(650)
Total costs	£m	(720)	(1,505)	(785)	(1,668)	(1,675)	(1,696)
Operating profit	£m	962	1,943	943	1,965	2,343	2,685
Bad debt charge	£m	(42)	(90)	(55)	(120)	(149)	(170)
Exceptional items	£m	(24)	(89)	(19)	(44)	(20)	(20)
Goodwill	£m	(11)	(38)	(28)	(56)	(56)	(56)
PBT (FRS3 basis)	£m	885	1,715	839	1,730	2,108	2,438
Tax	£m	(230)	(474)	(236)	(527)	(643)	(744)
PAT	£m	655	1,241	603	1,203	1,465	1,695
Preference dividend	£m	(25)	(53)	(33)	(66)	(66)	(66)
Minority interest	£m	(3)	(20)	(23)	(50)	(60)	(70)
Attributable profit	£m	627	1,168	547	1,087	1,339	1,559
Dividend paid	£m	(190)	(591)	(209)	(650)	(708)	(772)
Retained orofit	£m	437	577	338	437	631	786

Valuation measures		H1 2000	2000	H1 2001	2001E	2002E	2003E
PBT (FRS3 basis)	£m	885	1,715	839	1,730	2,108	2,438
PBT (DKWR basis)	£m	909	1,804	858	1,774	2,128	2,458
EPS (FRS3 basis)	p	28.1	52.4	24.5	48.7	60.0	69.8
Cash EPS (DKWR)	**p**	**27.1**	**55.2**	**24.6**	**52.5**	**63.1**	**72.9**
Net dividend	p	8.5	26.5	9.3	28.9	31.5	34.3
NAV	p	298	304	329	323	351	386
Tier 1 ratio	%	9.3	9.3	9.8	8.5	8.5	8.7

Performance ratios		H1 2000	2000	H1 2001	2001E	2002E	2003E
Cost/income ratio	%	42.8	43.6	45.4	45.9	41.7	38.7
Dividend cover	%	3.3	2.0	2.6	1.7	1.9	20
Non int. inc./total income	%	28.7	30.8	37.3	37.0	38.0	39.7
Tax rate	%	26.0	27.6	28.1	30.5	30.5	30.5

Net interest margins		H1 2000	2000	H1 2001	2001E	2002E	2003E
Retail bank margin	%	2.21	2.12	1.84	1.84	1.81	1.78
Group margin	%	1.79	1.76	1.48	1.49	1.48	1.47

Profitability		H1 2000	2000	H1 2001	2001E	2002E	2003E
Return on equity	%	20.6	19.0	17.1	17.1	19.3	20.4
Return on RWA	%	2.0	1.8	1.7	1.5	1.7	1.8
Return on total assets	%	0.8	0.7	0.6	0.6	0.6	0.7

Bad debt measures		H1 2000	2000	H1 2001	2001E	2002E	2003E
Bad debts/cust. adv.	%	0.08	0.09	0.10	0.10	0.12	0.13
Bad debts/RWA	%	0.13	0.13	0.16	0.15	0.17	0.18

Balance sheet items		H1 2000	2000	H1 2001	2001E	2002E	2003E
Customer advances	£bn	101.6	101.1	107.1	115.0	124.7	133.1
Balance sheet assets	£bn	173.4	182.5	201.1	213.1	233.5	252.8
RWA	£bn	66.5	67.7	70.8	79.0	86.6	93.8
Average NOSH	m	2,228	2,227	2,229	2,233	2,233	2,233
Period end NOSH	m	2,245	2,250	2,250	2,250	2,250	2,250
Tier 1 capital	£m	6,161	6,297	6,910	6,734	7,364	8,151
Equity (incl goodwill)	£m	6,692	6,832	7,400	7,269	7,900	8,686

Source. Company accounts, DKWR estimates

Share information	
Total number of shares	2,250m
Major shareholders:	
Halifax Shareholder A/C	34.3%
Barclays Global Investors	3.2%

Global Research

London
Dresdner Kleinwort Wasserstein Securities Limited
20 Fenchurch Street
London
EC3P 3DB
United Kingdom
+44 20 **7623** 8000*

London
Dresdner Bank AG London Branch
Riverbank House
2 Swan Lane
London
EC4R 3UX
United Kingdom
+44 20 **7623 8000'**

Frankfurt
Dresdner Kleinwort Wasserstein
Research GmbH
Jurgen Ponto Platz 1
60301 Frankfurt am Main
Germany
+49 69 263 0

Hong Kong
Dresdner Kleinwort Wasserstein Securities
(Asia) Limited
21/F, Cheung Kong Center
2 Queen's Road Central
Hong Kong
+852 2238 8888'

Kuala Lumpur
Dresdner Kleinwort Wasserstein Research
Sdn Bhd
5/F Wisma Genting
28 Jalan Sultan Ismail
50250 Kuala Lumpur
Malaysia
+603 202 3823*

Madrid
Dresdner Bank AG
Pinar. 2-4
28006 Madrid
Spain
+34 91 **745 81** 00*

Mexico City
Dresdner Bank AG
Bosques de Alisos 47-B 4 piso
Col. Bosques de las Lomas
05120 Mexico D F
Mexico
+52 5258 3000*

Milan
Dresdner Kletnwort Wasserstein Securities
SIM SpA
Via Olona 2
20123
Milan
Italy
+39 02 7245 1*

Mumbai
Dresdner Kleinwort Wasserstein
Securities (India) Private Limited
17"' Floor. Hoechst House
Nariman Point
Mumbai 400 021
India
+91 22 **232 9700'**

New York
Dresdner Kleinwort Wasserstein
Securities LLC
75 Wall Street 29th Floor
New York NY 10005-2889
United States
+1 212 **429 3434'** or
+1 888 2556611'

New York
Dresdner Kleinwort Wasserstein
Grantchester Inc
1301 Avenue of the Americas
New York NY 10019-6118
United States
+ 1 212 **969 2700'**

Paris
Dresdner Kleinwort Wasserstein
Securities France SA
108 bd Haussmann
75008 Paris
France
+33 1 44 70 85 00'

Rio de Janeiro
Dresdner Bank Brasil
Av Presidente Wilson. 231/17th floor
20030-021, Rio de Janeiro
Brazil
+55 21 **824 3500'**

Seoul
Dresdner Kleinwort Wasserstein Limited
Seoul Branch, 12th Floor
KorAm Bank Building
39 Da-Dong, Chung-ku
Seoul 100-180, South Korea
+822 311 3400'

Singapore
Dresdner Kleinwort Wasserstein Securities
(Singapore) Pte Limited
20 Collyer Quay
#14-01 Tung Centre
Singapore 049319
+65 534 0016'

Tokyo
Dresdner Kleinwort Wasserstein
(Japan) Limited
4-1-8 Toranomon. Minato-ku
Tokyo 105-0001
Japan
+813 5403 9500'

*** Telephone numbers are** for general and ...ative information via **he switc**
Any US investors should call DKWSLLC telephone: **(+1** 212) **429 2000**, or **DrKW** - G. ***telephone: (+1 212) 969 2700***, or **the** relevant ...

This report nas oeen prepared by Dresdner Kleinwort Wasserstein, by the specific legal entity named on the cover or inside cover page

United Kingdom: This report has been issued or approved for issue in the UK to professional and business customers only by ...dr Kleinwort Wasserstein Securities Limited, regulated by ... Securities and Futures Authority Limited and a Member Firm of the Lo... Stock Exchange. Dresdner Kleinwort Wasserstein Securities Limited ... not ... for, or advise or otherwise offer any other investment services to private customers.

European Economic Area: Where this report has been produced by a legal entit... outside of ... EEA, ... report ... re-issued by ... Kleinwort Wasserstein Securities Limited for distribution into the EEA.

United States: Where this ... approved for distribution in the US, such distribution is by either (i) Dresdner Kleinwort ...stei Securities LLC (DKWSLLC), (ii) Dresdner Kleinwort Wasserstein - Grantchester, Inc. (DrKW - G), or (iii) by other Dresdner Kleinwort Wass... to US Institutional Investors and Majo US Institutional Investors only. In each case DKWSLLC and/or DrKW - G accepts responsibility for this report in the US. Any US persons wishing to effect a transaction through Dresdner Kleinwort Wasserstein in any security mentioned in this ... may only do so through DKWSLLC, t... (+1 212) 429 2000, or DrKW - G, telephone: (+1 212) 969 2700.

Singapore: This report is being distributed in Singapore by Dresdner Kleinwort Wasserstein Securities (Singapore) Pte Ltd to clients who fall within the description of persons in Regulation 44 (b) (i) t (iii) of the Securities Industry Regulations.

Hong ... This report is being distributed in Hong Kong by ... Kleinwort Wasserstein Securities (Asia) Limited to persons whose business involves the acquisition, disposal or holding of securities.

Jap... Where this ... is being distributed in Japan, such distribution i... by either (i) Dr... Kleinwort ...tein (Japan) Limited, Toky... ...h (DKW(J)) or (ii) other Dresdner Kleinwort Wasserstein ..., to entities falling within Article 2, P... apt... the ... Ordi... for Enf... of the Foreign Securities Firms Act. Any Japanese per... falling ...ithin (ii) wishing to effect a transaction through D... Kl... W... ...tei... in any security mentioned in this report ma... only do so through DKW(J), telephone: (+ 813) 5403 9500.

India: Shares t... es within the Republic of India may normally only be purchased b... Foreign Institutional Investors registered with The Securities and Exchange Board of India ("SEBI") or individuals of Indian ... outside India ("NRIs") and overseas ... bodies ("OCBs") predominantly owned by such persons

The information and opinions in th... report constitute judgement as at th... date of this report and a... subject to change without notice. Dresdner Kleinwort Wasserstein and/or any of its clients may eff... transactions for their ... account in the securities mentioned in this report ... any related investments prior to your receipt of it. Dresdner Kleinwort Wasserstein may provide i... banking s... (including without limitation corporate finance services), or solicit such business, for the issuers of the securities mentioned in this report and may from time to time participate or invest in commercial banking transactions (including without limitation loans) with th... issuers of the securities mentioned in this report. Accordingly, information may be available to Dresdner Kleinwort W... which is not reflected in this report. Dresdner Kleinwort Wasserstein and its directors, officers, representatives and employees may have positions in or options on the securities ... in this report or a... rela... ...tments or may buy, sell or offer to buy or sell such securities or any related investments as principal or agent on the open market or otherwise. This report does not constitute or form part of, and should not be construed as, any offer for sale or subscription of, or any invitation to offer to buy or subscribe for, any securities, nor should it or any ... basis of, or be relied on in ... connection with, any contract or commitment whatsoever. The information and opinions contained in this report have been compiled or arrived at from sources believed to be reliable and in good fai..., but no representation or warranty, express or implied, is made as to their accuracy, completeness or correctness Dresdner Kleinwort Wasserstein accepts no liability whatsoever for any direct or consequential loss or damage arising from any use of this report or its contents. Whilst Dresdner Kleinwort Wasserstein may provide hyperlinks to web-sites of entities mentioned in this report, the inclusion of a link does not imply that Dresdner Kleinwort Wasserstein endorses, recommends or approves any materia on the linked page or accessible from it. Dresdner Kleinwort Wasserstein accepts no responsibility whatsoever for any such material, nor for any consequences of its use. This report is for the use of the addressees only, but is not to be relied upon as authoritative or taken in substitution for the exercise of judgement by any recipient. This report is being supplied to you solely in your capacity as a professional, institutional investor for your information and may not be reproduced, redistributed or passed on to any other person or published, in whole or in part, for any purpose, without the prior, written consent of Dresdner Kleinwort Wasserstein. In this notice "Dresdner Kleinwort Wasserstein" means Dresdner Bank AG and/or Dresdner Kleinwort Wasserstein Securities Limited and any of their affiliated or associated companies and their directors, officers, representatives or employees and/or any persons connected with them. **Additional information on the contents of this report is available on request**

DRESDNER **KLEINWORT WASSERSTEIN** RESEARCH – RECOMMENDATION DEFINITION

(Expected performance over next 12 months)

Buy	Outperform by 10% or more	Reduce	Underperform, but by less than 10%
Add	Outperform, but by less than 10%	Sell	Underperform by 10% or more
Hold	Track market		

Mailing list UALS UBAN PALS PBAN

HBOS: summary information (pro forma consolidated)

Profit & loss account		2000	H1 01E	2001E	2002E	2003E
Net interest income	fm	4233	2052	4356	4713	5085
Insurance income	fm	611	421	856	998	1167
Other operating income	fm	1315	688	1407	1497	1625
Non-interest income	fm	1926	1109	2263	2495	2792
Total income	fm	6159	3161	6619	7207	7876
Staff costs	fm	(1,296)	(683)	(1,412)	(1,480)	(1,574)
Deprectation	£m	(226)	(114)	(242)	(261)	(280)
Other costs	£m	(1,196)	(591)	(1,273)	(1,271)	(1,304)
Total costs	fm	(2,718)	(1,389)	(2,927)	(3,012)	(3,159)
Operating profit	**£m**	**3,441**	**1,772**	**3,692**	**4,195**	**4,717**
Bad debt charge	fm	(493)	(275)	(570)	(654)	(733)
Restructuring charge	fm	0	0	0	(200)	(150)
Exceptional items	£m	(176)	(3)	(20)	(20)	(20)
Goodwill	fm	(38)	(28)	(56)	(56)	(56)
Net synergies (pre-tax)	£m	0	0	0	186	434
Other	fm	18	17	25	32	45
PBT (FRS3 basts)	**£m**	**2,752**	**1,483**	**3,071**	**3,482**	**4,238**
Tax	£m	(789)	(433)	(931)	(1,045)	(1 271)
PAT	£m	1,963	1,050	2,139	2,438	2,966
Minorities (equity)	£m	(54)	(41)	(88)	(100)	(114)
Minorities (non-equity)	£m	(53)	(33)	(66)	(66)	(66)
Preference dividends	fm	(37)	(18)	(37)	(37)	(39)
Attributable profit	fm	1,819	958	1,948	2,235	2,748
Dividend paid	fm	(799)	(314)	(896)	(983)	(1,099)
Retained profit	£m	984	644	1,022	1,222	1,426

Profitability		2000	H1 01E	2001E	2002E	2003E
Return on equity	%	187	177	177	185	205
Return on RWA	%	091	088	087	089	1.01
Return on total assets	%	072	069	067	069	078

Bad debt measures %		2000	H1 01E	2001E	2002E	2003E
Bad debts/customer adv.	%	0.29	0.31	0.30	0.32	0.33
Bad debts/RWA	%	0.36	0.38	0.37	0.39	0.40

Balance sheet items		2000	H1 01E	2001E	2002E	2003E
Customer advances	£bn	169.0	178.0	189.1	205.7	221.6
Balance sheet assets	fbn	270.3	292.8	308.9	338.3	367.3
RWA	£bn	252.1	277.2	289.6	323.6	352.8
Average NOSH	m	3,490	3,484	3,556	3,516	3,559
Period end NOSH	m	3,554	3,514	3,558	3,518	3,561
Tier 1 capital	£m	10,755	11,621	11,731	12,938	14,329
Equity (incl goodwill)	£m	10,527	11,348	11,500	12,706	14,094

Share information	
Total number of shares	3,514m

Valuation measures		2000	H1 01E	2001E	2002E	2003E
PBT (FRS3 basis)	£m	2,752	1,483	3,071	3,482	4,238
PBT (**DKWR** basis)	fm	2,966	1,514	3,147	3,758	4,464
EPS (FRS3 basis)	p	52.1	27.5	54.8	63.6	77.2
Cash EPS	**p**	**54.7**	**28.3**	**56.5**	**66.4**	**79.7**
Net dividend	p	22.9	9.0	25.2	28.0	30.9
NAV	p	302	326	323	361	396
Tier 1 ratio	%	7.9	8.1	7.6	7.7	7.8

Performance ratios		2000	H1 01E	2001E	2002E	2003E
Cost/Income ratio	%	44.1	43.9	44.2	**41.8**	40.1
Dividend cover	x	2.4	3.1	2.2	2.4	2.6
Non interest inc./total inc	%	31.3	35.1	34.2	34.6	35.4
Tax rate	%	28.7	29.2	30.3	30.0	30.0
Net interest margins		**2000**	**H1 01E**	**2001E**	**2002E**	**2003E**
Group margin	%	2.02	1.82	1.82	**1.81**	1.81