December 23, 2014

Goldman Sachs

INITIATION

Virgin Money Holdings (VM.L)

Neutral

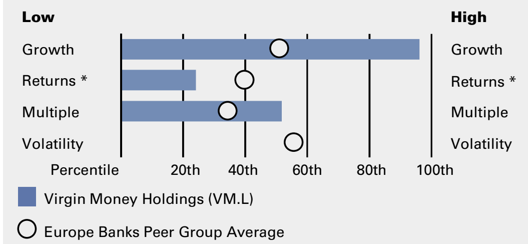
Equity Research

An uncomplicated domestic growth story; initiate as Neutral

Investment view

We initiate coverage of Virgin Money with a Neutral rating. Virgin Money is a leading UK challenger bank. It focuses primarily on growing its residential mortgage business. While it currently only has a market share of total mortgage assets in the UK of 1.6%, it is growing significantly faster than the market with a c.3% share of gross new lending. A larger asset base combined with a high level of scalability of its existing platforms, in particular within its mortgage platform, should allow Virgin Money to display positive cost jaws and in turn improve group returns. We forecast its ROTE to expand from 5.7% in 2014E to 13.4% in 2016E.

Investment Profile



* Returns = Return on Capital

For a complete description of the investment profile measures please refer to the disclosure section of this document.

Core drivers of growth

By competitively pricing its mortgage and saving deposits offering, Virgin Money plans to continue gaining market share in these markets. It further plans to build up a £3 bn credit card book over time. We estimate that Virgin Money will grow its loan book from £21 bn as of 1H14 to £37.7 bn by 2018E, implying a CAGR of 13%.

Risks to the investment case

Key risks to our estimates for Virgin Money include regulatory changes, margin compression owing to increased competition in mortgages and credit cards, a deteriorating credit cycle and a decline in house prices.

Valuation

We value Virgin Money using a 12-month ROTE/COE based framework. With a forecast 2016E ROTE of 13.4%, we obtain a 12-month price target of 320p, which is equivalent to 1.36x 2014E TBV.

Industry context

Virgin Money is one of the largest and fastest growing UK challenger banks, focusing mainly on residential mortgages and credit cards. Virgin Money has no legacy issues such as Libor, PPI affecting profitability.

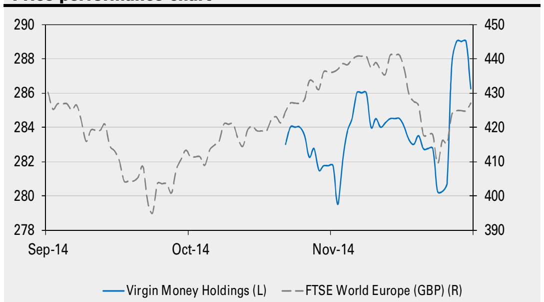
INVESTMENT LIST MEMBERSHIP

Neutral

Key data	Current
Price (p)	286.25
12 month price target (p)	320
Upside/(downside) (%)	12
Market cap (£ mn)	1,264.1
Tier 1 ratio (%)	18.2

	12/13	12/14E	12/15E	12/16E
GS Net income (£ mn)	163.3	(10.9)	97.0	158.6
GS EPS (p)	42.44	(2.75)	21.95	35.91
DPS (p)	0.00	0.00	4.39	7.18
BVPS (p)	241.31	243.44	261.01	289.75
GS P/E (X)	NM	20.4	13.0	8.0
Dividend yield (%)	NM	0.0	1.5	2.5
GS ROE (%)	1.8	5.5	8.7	13.0
P/BV (X)	NM	1.2	1.1	1.0

Price performance chart



Share price performance (%)	3 month	6 month	12 month
Absolute	--	--	--
Rel. to FTSE World Europe (GBP)	--	--	--

Source: Company data, Goldman Sachs Research estimates, FactSet. Price as of 12/22/2014 close.

Coverage View: Neutral

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Virgin Money Holdings: Summary Financials

Profit model (£ mn)	**12/13**	**12/14E**	**12/15E**	**12/16E**
Net interest income	311.2	360.2	439.2	526.0
Non-interest income	67.8	69.0	82.6	101.9
Total revenue	**379.0**	**429.2**	**521.8**	**627.9**
Total operating expenses	**(288.8)**	**(311.1)**	**(334.4)**	**(351.7)**
Operating income	**90.2**	**118.1**	**187.4**	**276.1**
Impairment charges	(50.7)	(27.2)	(37.0)	(48.6)
Other income/(expense)	13.9	9.9	0.0	0.0
Profit before tax and exceptionals	**53.4**	**100.7**	**150.4**	**227.5**
Exceptional income/(expense)	132.0	(83.0)	(16.6)	(16.6)
Pretax profit	**185.4**	**17.7**	**133.8**	**210.9**
Tax	(6.4)	(17.4)	(26.8)	(42.2)
Profit after tax	**179.0**	**0.3**	**107.1**	**168.7**
Minorities, pref dividends & other	--	--	--	--
Net income	**163.3**	**(10.9)**	**97.0**	**158.6**
GS net income	**15.5**	**55.3**	**97.0**	**158.6**
GS EPS (p)	**4.03**	**14.02**	**21.95**	**35.91**
BVPS (p)	241.31	243.44	261.01	289.75
DPS (p)	0.00	0.00	4.39	7.18
Dividend payout ratio (%)	0.0	0.0	20.0	20.0
Cost/income ratio (%)	76.2	72.5	64.1	56.0

Growth & margins (%)	**12/13**	**12/14E**	**12/15E**	**12/16E**
Income growth	44.9	13.2	21.6	20.3
Operating expenses growth	13.5	7.7	7.5	5.2
Pretax profit growth	(1.7)	(120.6)	279.6	65.7
GS net income growth	316.0	256.7	75.4	63.6
GS EPS growth	316.0	248.1	56.6	63.6
Impairment charges/loans	NM	NM	NM	NM
Pretax margin	83.7	(15.2)	22.5	30.9

Balance sheet (£ mn)	**12/13**	**12/14E**	**12/15E**	**12/16E**
Net customer loans and advances	20,351.2	22,730.2	26,276.9	30,077.5
Intangible assets	26.0	34.2	34.2	34.2
Total assets	**24,565.0**	**25,999.6**	**29,623.8**	**33,551.4**
Risk weighted assets	**5,201.1**	**4,788.5**	**6,640.4**	**8,427.9**
Customer deposits	21,121.4	22,485.3	25,264.5	28,120.1
Total liabilities	**23,630.1**	**24,924.5**	**28,471.2**	**32,271.8**
Ordinary shareholders' equity	934.9	1,075.0	1,152.6	1,279.5
Minority interest	0.0	0.0	0.0	0.0
Preference share capital	0.0	0.0	0.0	0.0
Total liabilities & equity	**24,565.0**	**25,999.6**	**29,623.8**	**33,551.4**

Ratios (%)	**12/13**	**12/14E**	**12/15E**	**12/16E**
GS ROE	1.8	5.5	8.7	13.0
GS ROTE	1.9	5.7	9.0	13.4
ROA	0.70	(0.04)	0.35	0.50
RORWA	NM	(0.22)	1.70	2.11
Equity tier 1 ratio	NM	NM	NM	NM
Tier 1 ratio	18.2	22.9	17.7	15.4
Total capital ratio	18.2	22.9	17.7	15.4
NPLs/loans	NM	NM	NM	NM
Coverage ratio	NM	NM	NM	NM
Loans/deposits	NM	NM	NM	NM

Valuation	**12/13**	**12/14E**	**12/15E**	**12/16E**
GS P/E (X)	NM	20.4	13.0	8.0
Dividend yield (%)	NM	0.0	1.5	2.5
P/BV (X)	NM	1.2	1.1	1.0
P/TBV (X)	NM	1.2	1.1	1.0

Note: Last actual year may include reported and estimated data.

Source: Company data, Goldman Sachs Research estimates.

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The prices in the body of this report are based on the market close of December 18, 2014.

Overview: An uncomplicated domestic growth story

Virgin Money is a challenger bank in the UK retail banking market. It is adequately capitalized and has ambitious loan growth plans for its mortgages, cards and complementary financial products businesses. On the funding side, it focuses on savings deposits, which allow it to operate a branch-light and scalable platform, but exposes it more to market risk. Building on the wider Virgin name, its brand is unique within the banking market, combining simplicity of offering and a lean cost structure.

An uncomplicated retail bank with a famous brand

Virgin Money is a UK retail-only "challenger" bank that focuses largely on residential mortgages and credit cards, and funds these primarily via savings accounts. It re-entered the mortgage market with the acquisition of Northern Rock's good bank, and plans to significantly expand in the medium term. It has a fresh approach to banking, seeking to combine simple products with transparent pricing and a branch-light cost structure.

An appealing domestic growth story

Virgin Money plans to significantly grow its loan book over the medium term. It plans to take a market share in gross new mortgage lending of 3%-3.5% going forward, in-line with its share over the last three years, but substantially above its current market share in mortgage loan stock of 1.6%. Similarly, in credit cards, it plans to build an on balance sheet loan book of £3 bn, a size it previously managed on behalf of MBNA. All-in, we forecast a strong loan growth CAGR of 13% (2013-18E). We believe loan growth is to be funded predominantly by increasing savings deposits, where it envisages taking a market share of up to 2% by 2017.

Development of net interest margin is key

We estimate that Virgin Money's underlying net interest margin will be broadly in line with the company target of 170 bp by 2017, driven by a higher share of credit card loans and an increase in mortgage net interest margins. The latter is driven by substantial deposit rate cuts in 1H14 only completely feeding through in 2H14 and the company's expectation that it will not have to fully pass on rate rises to depositors, as it continues to pay comparatively higher deposit rates versus the market.

Given its focus on the mortgage and savings deposits businesses, we believe Virgin Money is exposed to market risks, e.g., competitive pressures on both asset and savings rates. We note that a number of larger UK banks (HSBC, RBS and Nationwide) have indicated that they are aiming to increase their market shares in UK mortgages, and this could put mortgage margins under pressure.

Strong asset quality and low cost of risk

Virgin Money's group loan loss provisions are primarily driven by the size of its credit card book relative to the total loan book. Since returning to the mortgage market following the acquisition of Northern Rock's good bank, loan loss provisions in mortgages have been negligible, at a level of c.1-2 bp of loans per annum. Management has guided that over the medium term it expects loan loss provisions for the group of c.15-20 bp, owing to the higher share of credit card loans.

Cost control brings operating leverage

In terms of operating leverage, Virgin Money is committed to reducing the group's cost-income ratio to 50% in the medium term vs. 71% today. The majority of this efficiency benefit stems from the high level of scalability of its existing platforms, in particular within its mortgage platform, which management believes will allow it to display positive jaws (revenue growth less cost growth) consistently over the coming years.

A branch-light distribution model

With 75 branches across the UK, Virgin Money has a smaller branch network than other UK banks of a similar size (e.g. Virgin Money's loan book of £21 bn compares to TSB's loan book of £23 bn with c.630 branches). This is partly because it has a substantial non-branch distribution network:

- The primary distribution channel for Virgin Money's savings business in 2013 was online (53%), with only 30% branch-based.
- Consequently, the bulk of its deposits are savings deposits, with current account balances accounting for only £200 mn of total funding.
- Virgin Money's mortgage business is even less branch-based, with 87% of mortgage sales conducted via intermediaries.
- The company has access to a network of over 10,000 intermediaries, which it believes will be increasingly important going forward as more mortgage sales shift to intermediaries following the increased professionalism in sales required by the Mortgage Market Review. This gives it a broad reach, but with a limited number of branches and fixed costs.

The uniqueness of Virgin Money's distribution model mean that it has the potential to achieve its ambitious growth targets without the need for significantly expanding its distribution scale.

No material legacy issues

In contrast to many other UK banks, Virgin Money does not suffer from legacy issues or significant litigation. The bank did not sell any PPI and has not been involved in either the LIBOR scandal or derivatives misselling. The bank believes this reflects its prudent risk appetite and that its advice teams are centrally managed and are not incentivized by sales targets.

In addition, since Virgin Money acquired only the 'good' part of the former Northern Rock plc, it has minimal distressed asset portfolios.

Adequately capitalized to fund planned growth

Virgin Money's key constraint, from a regulatory capital perspective, remains the leverage ratio in our opinion. On our estimates, the leverage ratio will gradually decrease, from 4.4% immediately following the IPO, to a range of 3.8%-4.0%. As Virgin Money grows its loan portfolio, we expect the majority of capital generated from retained earnings to be utilized to fund growth.

Uncertainty remains as to the final regulatory leverage ratio requirement that Virgin Money will face as it is likely to fall under the regime for ring-fenced banks. The government stated that the systemic buffer requirements for ring-fenced banks will be 0%-3%, implying a leverage buffer of 0%-1.05%. If the final requirement would be at the upper end of the range, e.g., 4.05%, this could have a substantial negative impact on Virgin Money (owing to its low average risk weight given its business mix) and severely impact its business plan and growth ambitions.

There is some further AT1 issuance capacity as CET1 capital builds up, which could serve as an additional buffer (lifting the leverage ratio to the c.4.5% level, on our numbers) albeit at a cost.

Financials – Loan growth and operating leverage key drivers

We expect Virgin Money to reach a ROTE of 15.8% by 2017E, largely driven by strong loan growth, margin expansion and operating leverage. We forecast GS net income to grow from £16 mn in 2013 (affected by large overhead costs) to £210 mn by 2017E (and £266 mn by 2018E). We expect Virgin Money to commence paying dividends in 2015E, with a payout ratio of 20%.

Company profile: An uncomplicated retail bank

Virgin Money is a challenger bank in the UK retail banking market. It has ambitious loan growth plans for its mortgages, cards and complementary financial products businesses. At the same time, it operates a branch-light and scalable platform. Its brand is unique within the banking market, and seeks to represent a fresh approach to business, focusing on simple, transparent products.

A focused UK retail-only bank

Virgin Money is a retail-only bank that operates exclusively within the United Kingdom. It operates a simple business model: a loan book that as of 1H14 was primarily composed of residential mortgages (84%), buy-to-let mortgages (12%) and credit cards (4%) funded by retail deposits in the form of savings accounts. The bank also offers customers investment and insurance products through strategic partnerships with third parties.

The Virgin Money group was originally founded in 1995 under the Virgin Direct brand, offering investment products to retail customers. In 1997 the company introduced the first mass market offset mortgage in the UK, when it launched the 'One' account (which was subsequently bought by RBS in 2004). In 2007 the company purchased the Yeovil based bank Church House Trust, which importantly gave the group its banking license.

Acquisition of Northern Rock "good" bank transformational

On January 1, 2012, Virgin Money acquired Northern Rock from HM Treasury. Prior to its nationalization, Northern Rock ran a large (c.£90 bn) mortgage book via a securitization led business model. Having been nationalized in 2007 the bank was wholly-owned by HM Treasury. Following this the bank was split into a 'good' bank (subsequently acquired by Virgin Money) and a 'bad' bank which remained with UKAR. Under the terms of the acquisition Virgin Money paid £747 mn in cash, with a further £150 mn in tier 1 notes and an additional consideration of £72.9 mn relating to gilt gains and net asset value adjustments. A further consideration of £50 mn was paid to HM Treasury upon completion of the IPO. In addition, in 2012 Virgin Money purchased an additional mortgage portfolio from UKAR for £466 mn.

MBNA's exit paves the way for own credit card business

Virgin Money, with MBNA, has issued Virgin-branded credit cards for a number of years, although until now these have been through commission-sharing agreements, with the risk being borne on MBNA UK's balance sheet. Following MBNA's decision to exit certain markets Virgin Money acquired a portfolio of £1,042 mn in credit card balances from MBNA in 2013 for a cash consideration of £1,019 mn. Since the acquisition, all new credit card sales have been written to MBNA's balance sheet while Virgin Money builds its own credit card platform to support the business line. As of July 2014, the acquired portfolio was £749 mn in size and on December 1, 2014, the transaction was completed with the new card sales being transferred from MBNA to Virgin Money. As of December 1, 2014, the new card sales totalled £363 mn, hence Virgin Money now has a ~£1.1 bn book of credit card loans.

Part of the Virgin "family" – A unique brand proposition

A key differentiator of Virgin Money is its brand and the associated values it encompasses. The Virgin brand gives the bank significantly higher customer recognition than many of its peers and also a significant benefit from the marketing efforts of the Virgin Group as a whole.

A perpetual license agreement

Understandably this benefit also has an associated cost and under the terms of the brand license, in return for exclusive use of the brand within retail UK financial services, the bank must pay 1% of total group income per year (calculated as the sum of net interest income, net fee and commission income and other operating income) to the Virgin Group.

The license agreement is perpetual and can only be terminated in certain limited circumstances including if the Virgin Group proves that Virgin Money has caused material damage to the wider Virgin brand.

A unique approach: Simple and transparent throughout

In addition to the brand, Virgin Money is also proud of its customer-first, simple approach to banking. The company states that it constantly seeks to ensure that 'Everyone's better off' as a consequence of the business it performs.

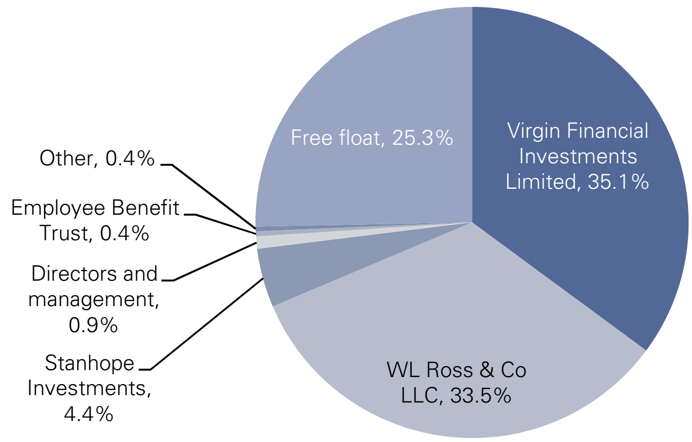
One of Virgin Money's main differentiating factors compared to other banks is its product approach:

- **'Plain-vanilla' product offering –** Virgin Money offers simple, transparent and uncomplicated financial products designed to meet customers' needs – examples include offering savings products without introductory bonuses, and offering the UK's simplest pension.
- **Transparent pricing –** Virgin Money typically offers the same pricing to both new and existing customers buying a new product across all distribution channels.
- **No cross-product subsidy –** Virgin Money prices all products on a standalone basis. This is partly to minimize conduct risk as in the case of Payment Protection Insurance which cross-subsidized much unsecured lending in the recent past.
- **Differentiated customer service –** Virgin Money operates a network of 75 "stores" (branches) and five lounges offering customers face-to-face support when they want it. The lounges are free to use for customers and offer customers a place to relax with tea, coffee and snacks as well as newspapers and wi-fi. They offer help and advice should customers want it, but are not intended as sales venues.
- **Lounges** deliver a unique customer experience in UK banking as well as creating valuable opportunities for both customer retention and customer recommendation. During the year, there was significant growth in footfall in the Lounges according to the company.

It launched a fully functional current account product during 2014 but does not currently plan to invest significantly in this business as Virgin Money believes the barriers to entry and associated costs to gain scale are too high and dilutive to shareholder value.

Shareholder structure

Exhibit 1: Virgin Money shareholder structure
Ordinary shareholder structure at December 13, 2014



Source: Virgin Money, Goldman Sachs Global Investment Research.

An experienced management team

The core of Virgin Money's executive management team joined the bank from 2007 onwards following extensive careers within the UK banking industry. We believe they are well placed to manage the growth of the bank going forward.

- **Jayne-Anne Gadhia, Chief Executive Officer**: Began her career as a Chartered Accountant, qualifying with Ernst and Young. Following this, she spent seven years in management roles at Norwich Union (now Aviva), before becoming one of the three founders of Virgin Direct in 1995. She launched the Virgin One account in 1998, with the business subsequently being acquired by RBS in 2001. She went on to lead a number of RBS business units, ultimately joining the RBS Retail Executive Board with responsibility for the group's mortgage business. She began her current position as Chief Executive Officer of Virgin Money in 2007.
- **Lee Rochford, Chief Financial Officer**: Started his career at British and Commonwealth Merchant Bank, before moving to BNP Paribas where he became Head of Northern European Securitisation. He then worked for seven years at Credit Suisse, where he was Head of European Asset Finance. Following this he joined RBS in 2007, where he was Head of the Financial Institution Group for EMEA. He took up his current role as Chief Financial Officer of Virgin Money in 2013.
- **Marian Watson, Chief Risk Officer**: A Chartered Accountant who qualified with Ernst and Young, she then joined the Britannia Building Society as Internal Audit Manager. Following this she spent four years at the Britannic Group where she was Head of Group Audit and Risk. Having joined RBS in 2004, she served as Risk Director first of the Group's consumer finance businesses, then of its mortgage business and then of Tesco Personal Finance. She joined Virgin Money in 2007.
- **Mark Parker, Chief Operating Officer:** His first IT Director role was at British Sugar, before joining HBOS Group in 2000 (now part of Lloyds Banking Group) as Group Services Director and Chief Information Officer. He subsequently became Managing Director of Intelligent Finance, before becoming Chief Operating Officer at Northern Rock. He joined Virgin Money in January 2012.

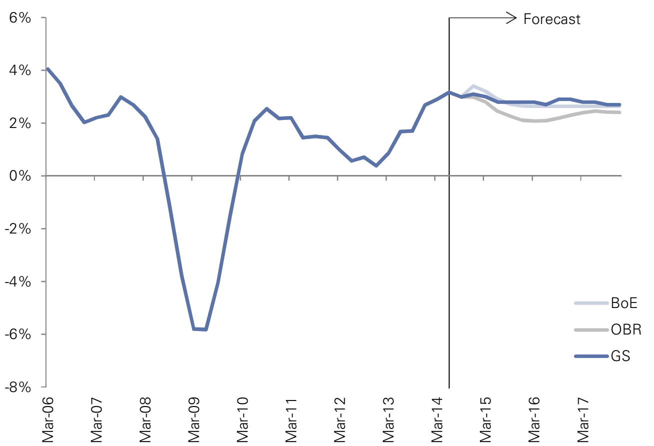
An appealing domestic growth story

Virgin Money plans to significantly grow its loan book over the medium term. It plans to take a market share in gross new mortgage lending of 3%-3.5% going forward, substantially above its current market share in mortgage loan stock of 1.6%, but in line with recent lending. Similarly, in credit cards, it plans to build an on balance sheet loan book of £3 bn, a scale it previously built in partnership with MBNA. All-in, we forecast a strong loan growth CAGR of 13% (2013-18E). Loan growth is to be funded predominantly by deposit growth, where Virgin Money envisages taking a market share of stock of under 2.0% by 2017.

Industry backdrop: Benefiting from a fast-growing UK economy

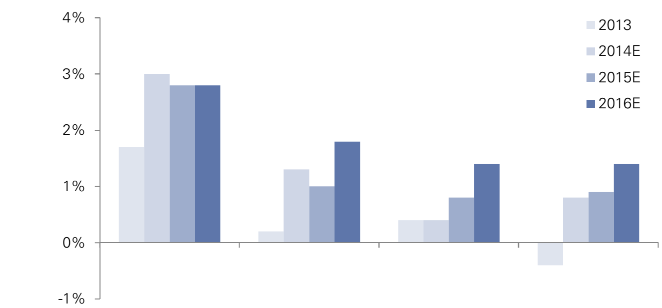
Since late 2012 activity in the UK economy has picked up markedly – GDP growth has accelerated from 0.1% yoy in 2Q12 to 3.0% in 3Q14. Our Economists believe that the momentum in the UK economy remains robust and they expect GDP to continue to grow at around 3% pa (2014-16E). This is in sharp contrast to other European economies, which continued to see relatively anaemic growth in 2013.

Exhibit 2: UK economic recovery in full swing…
Real GDP growth (% chg yoy)



Source: Bank of England, Office for Budget Responsibility, Goldman Sachs Global Investment Research.

Exhibit 3: …with the fastest GDP growth in Europe
Real GDP growth (% chg yoy)



Real GDP (% chg yoy)	UK	Germany	France	Euro area
2013	1.7%	0.2%	0.4%	-0.4%
2014E	3.0%	1.3%	0.4%	0.8%
2015E	2.8%	1.0%	0.8%	0.9%
2016E	2.8%	1.8%	1.4%	1.4%

Source: Goldman Sachs Global Investment Research.

Mortgage lending – moderate outlook

Forecasts predict a significant increase in mortgage lending over the next few years – the Bank of England in its Central scenario (published in the June *Financial Stability Report*) forecasts that secured lending will rise by 15% by 1Q17 (from 1Q14, Exhibit 4). The OBR forecasts even more rapid growth in secured lending of 21% by 1Q17 (from 1Q14) in its December 2014 outlook.

These relatively high growth rates of net mortgage lending (c. 5%-7% 2015-16E CAGR forecast by the BoE and OBR) are driven by expectations for continued low mortgage interest rates, rising income growth and continued rises in house prices (i.e. higher collateral values). However, we believe over the near term, there are several headwinds that could potentially restrict the growth rate of mortgages in the UK in our view:

- **Loan-to-income restrictions** – the FPC has recommended that no more than 15% of a bank's new mortgage lending can be at loan-to-income multiples of over 4.5x.

- **Impact from the MMR** – the Mortgage Market Review has required some lenders to both a) introduce new operational processes and b) adopt stricter affordability checks as part of underwriting.
- **Increase in base rates –** impacting affordability.
- **Increased capital intensity for residential mortgages** – either as a result of a) changes to the risk weights on residential mortgages, or b) a higher hurdle for the leverage ratio.

All-in, our outlook is cautious and we expect moderate growth in net new mortgage lending in the near term.

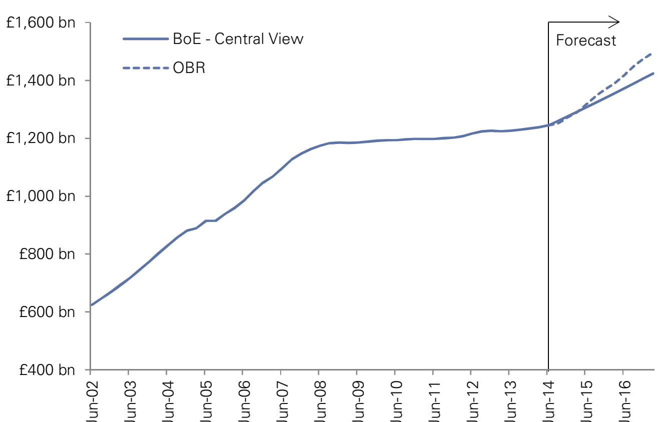
Unsecured lending – more attractive outlook

The positive outlook for real income growth in the UK contributes to a strong outlook for unsecured credit growth over the next few years. There are several drivers behind this:

- **Strong consumption growth:** Driven by rising incomes, the OBR expects private consumption to grow at an annual rate of c.2%-3% over the next three years.
- **Declining household saving:** The OBR also forecasts that households will increasingly reduce their net savings position. Consequently forecasters expect a significant increase in unsecured lending as households finance an increasing proportion of consumption using credit.
- **Low credit costs:** Aided by the strong recovery, write-off rates on unsecured lending have declined significantly. According to the BoE unsecured write-offs (as a % of loans) have declined from their peak of 702 bp in 2010 to 199 bp in 1Q14 (annualized), below the previous cyclical low of 202 bp in the year 2000.

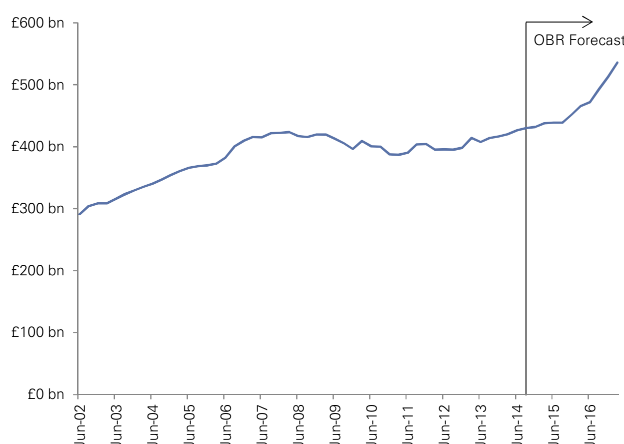
The forecasts suggest that unsecured credit should provide a significant growth area for UK banks over the coming years. We believe this growth provides a favourable background for Virgin Money to grow the size of its credit card book over the medium term.

Exhibit 4: Mortgage lending forecasts
Household financial liabilities secured on dwellings by UK MFIs, £ bn



Source: Office for National Statistics (2002-14), Office for Budget Responsibility (2014-17), Bank of England (2014-17).

Exhibit 5: Unsecured lending forecasts
Total household financial liabilities less financial liabilities secured on dwellings by UK MFIs, £ bn



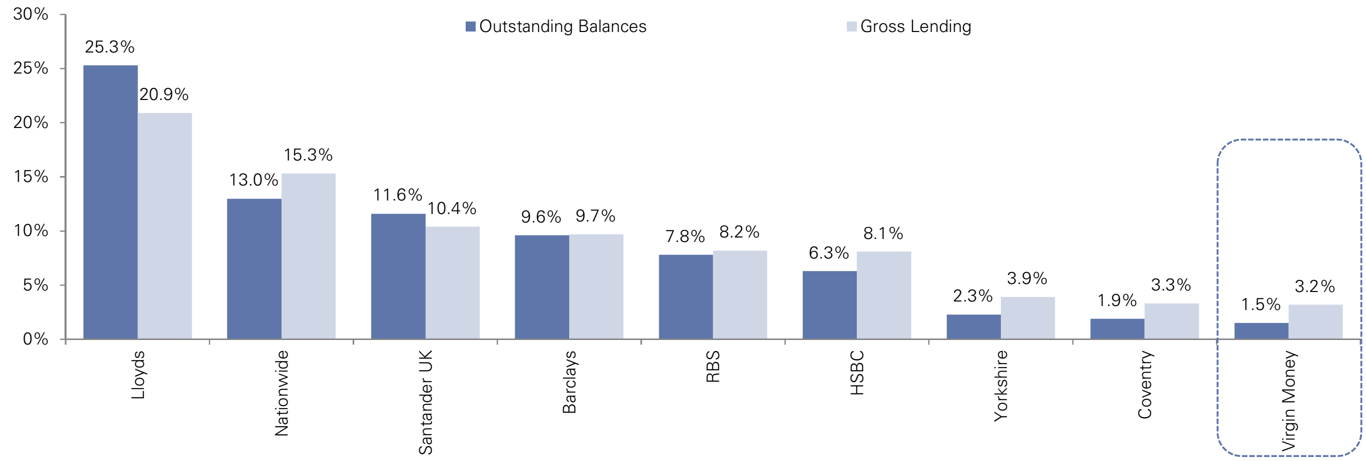
Source: Office for National Statistics (2002-14), Office for Budget Responsibility (2014-17).

Mortgages: Ambitious growth targets

Targeting 3%-3.5% market share in gross mortgage lending

At the end of 2013 Virgin Money had a market share of total mortgage assets in the UK of 1.6 %, making it the ninth largest mortgage lender in the UK (excluding UKAR). However with £5.6 bn of gross mortgage lending during 2013, corresponding to a 3.2% market share of gross lending, it is growing significantly faster than the market.

Exhibit 6: Virgin Money accounted for 3.2% of gross mortgage lending during 2013
Market shares in outstanding UK mortgage balances and gross mortgage lending - 2013



Source: Respective companies' data, Bank of England.

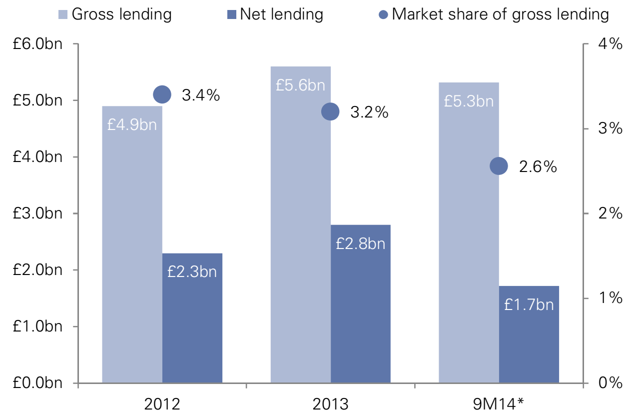
From gross lending to net lending – retention is key

With a market share of gross lending significantly above its market share of outstanding mortgage assets, we believe Virgin Money is well positioned to grow its mortgage book, even in a slow-growing market.

We believe key to translating above market growth in gross lending into a significant increase in net lending is having a low rate of existing customer attrition. When mortgage customers come to the end of their initial fixed term, they can either switch into another fixed rate term with their existing lender, move their mortgage to their lender's Standard Variable Rate (SVR) or remortgage to a different lender.

Historically, Virgin Money has been able to retain about 66%-70% of clients which come to the end of their fixed interest terms since 2012.

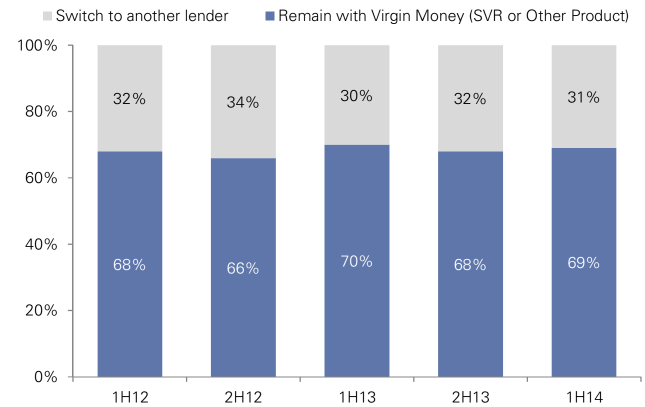
Exhibit 7: Continuing to gain market share…
Gross and net mortgage lending (£ bn) (excluding impact of acquisitions) and market share of gross lending (%)



* annualized

Source: Virgin Money, Bank of England.

Exhibit 8: …while retaining ~70% of existing clients
Residential product maturity retention performance (%)

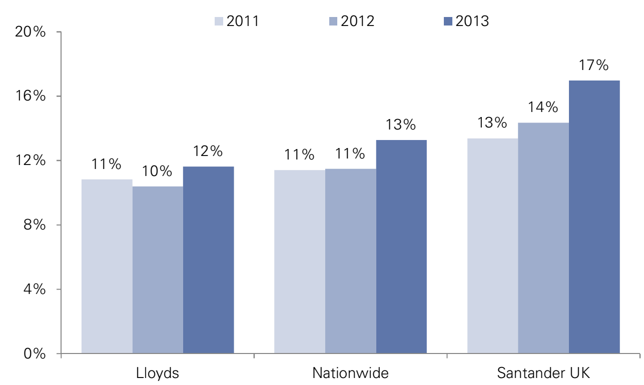


Source: Virgin Money.

We attempt to compare attrition rates with other major UK mortgage lenders. Based on a simplified calculation, we estimate that Virgin Money has a slightly higher attrition rate. Any significant increase however could impact Virgin Money's growth plans.

Virgin Money has indicated that going forward it will aim to keep its retention level at around 70%, implying that ultimately pricing would be the flexible element, in the event of competitive pressures.

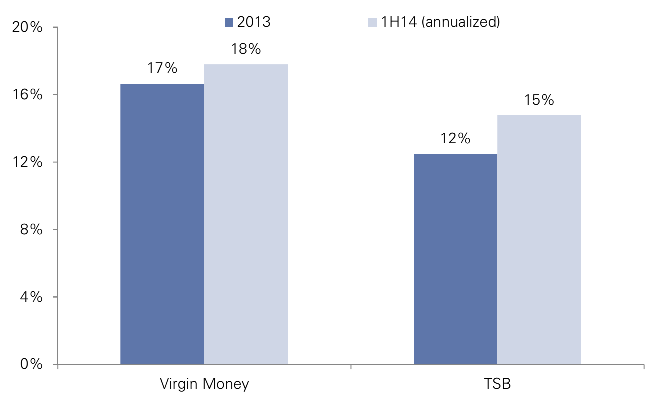
Exhibit 9: Peer group with attrition rates of 12-17%
Mortgage Customer Attrition Rates (%)



Note – Calculated as (Period start mortgages – (Period end mortgages - Gross lending))/ Period start mortgages

Source: Respective companies' data.

Exhibit 10: …Virgin and TSB slightly higher
Mortgage Customer Attrition Rates (%) – 1H14 annualized



Note – Calculated as (Period start mortgages – (Period end mortgages - Gross lending))/ Period start mortgage

Source: Respective companies' data.

Attractive mortgage growth prospects

In Exhibits 11-12 we assess the potential future path of Virgin Money's mortgage book depending upon both Virgin Money's market share of gross lending and the growth in overall gross market lending. We assume that Virgin Money has an annual existing customer attrition rate of 17%, similar to the level experienced in 2013. Our analysis shows that if Virgin Money has a 3.5% share of gross lending and the market grows at 6% pa, the overall mortgage book CAGR would be 12.2% (2013-18E), reaching £34.1 bn in 2018E.

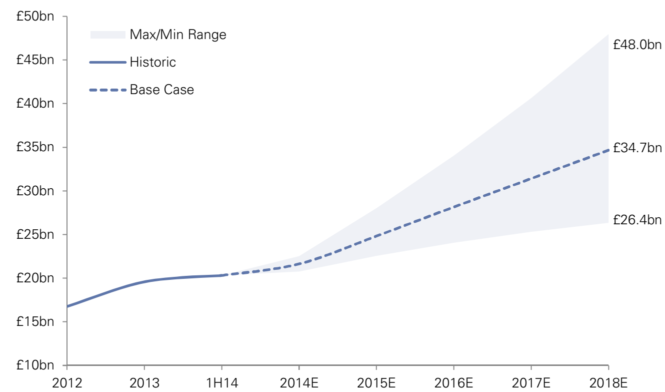
We assess the sensitivity of Virgin Money's mortgage book evolution to changes in its market share of gross lending and the overall growth rate of the market. In our lowest scenario, Virgin Money's mortgage book is £26.4 bn in 2018E (assuming market growth of 0% pa and a market share of 3%); if market growth is significantly faster (15%) and Virgin Money's market share is larger, then the company's mortgage book would grow to £48 bn by 2018E (a CAGR of 21%).

Exhibit 11: On current existing customer attrition, net mortgage lending grows over 6% pa in most scenarios…
1H14-2018E Net Mortgage Lending, Implied CAGR

Net Mortgage Lending CAGR (%)		Virgin Money - Gross Lending Market Share (%)				
		3.00%	3.25%	3.50%	3.75%	4.00%
Market - Gross Lending (% chg yoy)	0%	6.0%	7.2%	8.4%	9.6%	10.7%
	3%	7.7%	9.0%	10.3%	11.5%	12.7%
	6%	9.5%	10.9%	12.2%	13.5%	14.7%
	9%	11.3%	12.8%	14.2%	15.5%	16.8%
	12%	13.2%	14.7%	16.2%	17.5%	18.9%
	15%	15.1%	16.7%	18.2%	19.6%	21.0%

Source: Virgin Money for existing mortgage book size, Bank of England for historical market gross lending, Goldman Sachs Global Investment Research for calculations and estimates.

Exhibit 12: …and our base case sees VM's mortgage book growing at a 12% CAGR (2013-18E)
1H14-2018E implied range of total residential mortgage book, £ bn



Source: Virgin Money (2012-1H14) for existing mortgage book size, Bank of England for historical market gross lending, Goldman Sachs Global Investment Research for calculations and estimates.

No need for scale in distribution as a result of intermediaries

With 75 branches across the UK, Virgin Money has a smaller branch network than other UK banks with a similar size mortgage book. This is partly because it has a substantial non-branch distribution network with 87% of mortgage sales conducted via intermediaries.

The company has access to a network of over 10,000 intermediaries, which it believes will be increasingly important going forward as more mortgage sales shift to intermediaries as a result of the increased professionalism in sales required by the Mortgage Market Review.

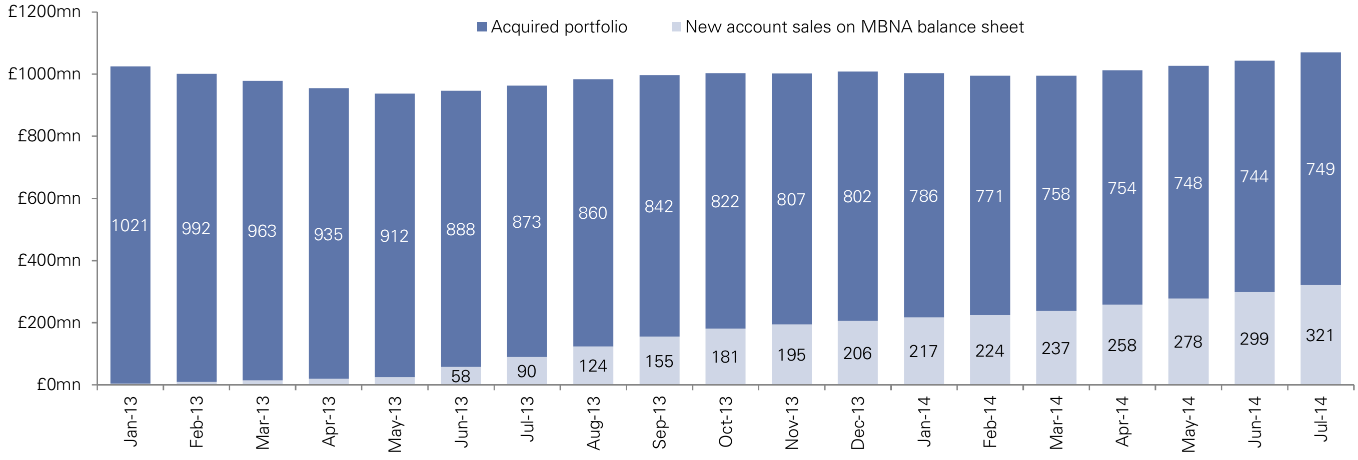
Credit cards – targeting a £3 bn portfolio by 2019

Virgin Money has issued Virgin-branded credit cards for a number of years, although until now these have been through commission-sharing agreements. The total credit card balance under these agreements has grown to about £3 bn from 2004 to 2008 and to a peak level of about £4.5 bn in 2009, with the risk being borne on MBNA UK's balance sheet. In 2012 Virgin Money acquired a portfolio of £1,042 mn in credit card balances from MBNA for a cash consideration of £1,019 mn.

Since the acquisition, all new credit card sales have been written to MBNA's balance sheet while Virgin Money builds its own credit card platform to support the business line. As of July 2014, the acquired portfolio was £749 mn in size and in December 2014 the transaction was completed with the new card sales being transferred from MBNA to Virgin Money.

Upon completion of the transaction the new card sales accounted for £0.3 bn of credit card loans, hence Virgin Money has a c.£1 bn book of credit card loans.

Exhibit 13: Total credit card portfolio is c.£1 bn including assets recently transferred from MBNA
Credit Card Balances (£ mn) – Acquired portfolio and new account sales previously on MBNA balance sheet



Source: Virgin Money.

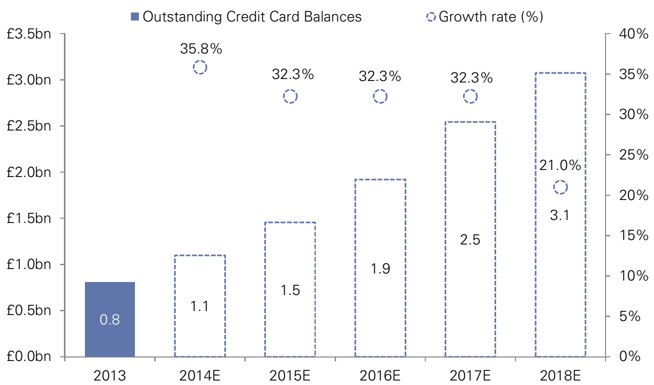
The credit card business is primarily distributed through the online distribution channel. Previously the credit card business earnt a yield (interest income/outstanding balances) of c.12% and following the completion of the second tranche of the MBNA acquisition this is expected to fall by up to 200 bp. Nonetheless, as a relatively higher margin business, the transfer of this business onto the balance sheet will boost the group net interest margin (NIM) by 14 bp (Exhibit 28) on a net basis by 2017E.

About 30% of the book is made up of balance transfer business. This usually charges an initial fee up front with 0% interest for an extended period at the beginning of the loan.

Following the completion of the MBNA transaction Virgin Money plans to grow the credit card book from c.£1 bn today to c.£3 bn within five years, by 2019. Previously c.£3 bn of Virgin-branded credit cards were outstanding under the partnership agreement with MBNA, hence we believe it is likely that, given the favourable macro environment for unsecured credit, the company can achieve this growth target.

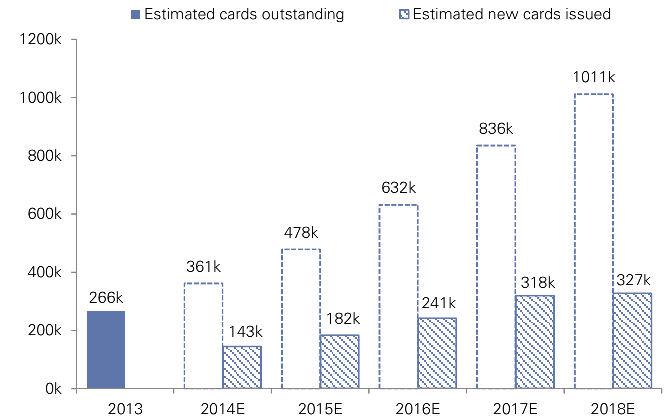
Our credit card loan forecasts imply that Virgin Money has to issue around 140,000-330,000 cards a year, assuming an average balance of £3,000, in order to meet its growth ambitions. This compares to between 100,000 and 600,000 cards issued per annum between 2000 and 2013.

Exhibit 14: We forecast a £3.1 bn portfolio by end 2018E…
Outstanding Credit Card Balances (£ bn) and year-on-year growth rate (%)



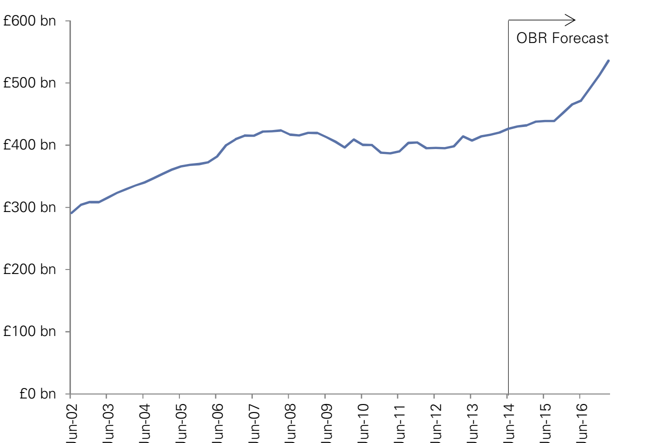
Source: Virgin Money (2013), Goldman Sachs Global Investment Research (2014-18E).

Exhibit 15: …driven by modest new card issuance relative to history
Estimated cards outstanding and estimated new cards issued, assumes constant average card balance of £3,041 and annualized attrition rate as for Jan-13 through Jun-14



Source: Virgin Money (2013), Goldman Sachs Global Investment Research (2014-18E).

Exhibit 16: Unsecured lending to grow strongly
Total household financial liabilities less financial liabilities secured on dwellings by UK MFIs, £ bn



Source: Office for National Statistics (2002-14), Office for Budget Responsibility (2014-–2017E).

Exhibit 17: A £3 bn credit card book equates to a c.5% market share today
Outstanding UK credit card balances, £ bn (adjusted for asset transfers)

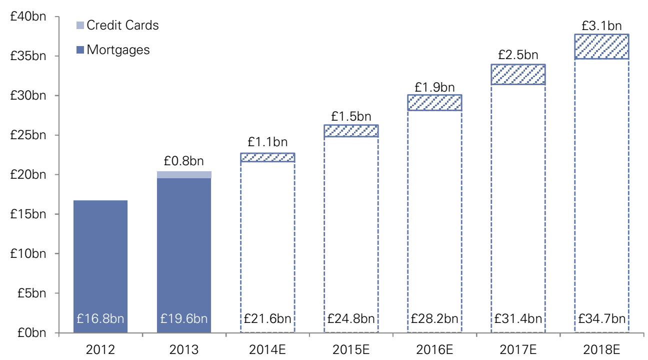
Source: Bank of England.

Total loan book to grow to £38 bn by 2018E – a 13% CAGR

On our analysis we believe Virgin Money will be able to significantly grow its balance sheet over the coming years. By 2018E we forecast the total loan book of Virgin Money will be £37.7 bn, composed of £34.7 bn of mortgages and £3.1 bn of credit card balances. This represents a net lending CAGR of 12% for mortgages and 31% for credit cards (2013-18E).

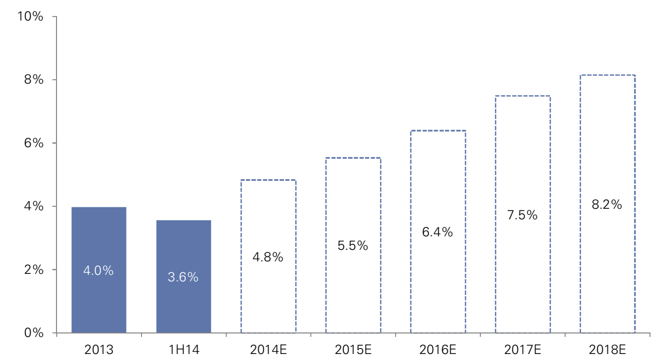
In addition to this significant organic loan growth potential, we note that Virgin Money management has indicated that although it has no current plans to grow inorganically, it would be open to acquiring lending businesses or portfolios (e.g. SME, personal loans) or a significant current account book were it to allow the company to achieve significant scale in the market. We have not assumed any purchases in our forecasts.

Exhibit 18: The loan growth story is set to continue…
Mortgage and Credit Card loans to customers, £ bn



Source: Virgin Money (2012 and 2013), Goldman Sachs Global Investment Research (2014-18E).

Exhibit 19: …with a gradual mix shift to credit cards
Credit Card Balances as % of Total Balances



Source: Virgin Money (2013 and 1H14), Goldman Sachs Global Investment Research (2014-18E).

Funding – Savings deposits to fund loan growth

Virgin Money's funding approach is predominately focused on savings deposits, with current account balances accounting for only about 1% of total deposits.

With the acquisition of Northern Rock, Virgin Money inherited £16.3 bn of deposits. This has since grown at a CAGR of 11%, reaching £21.1 bn at 1H14 (representing a loan to deposit ratio of 100%).

At the end of 2013 Virgin Money had a 1.4% market share in the savings market. Its savings products are primarily distributed through the online channel (53%), with only 30% branch-based. The company currently (1H14) has a loan-to-deposit ratio of 100% and is intending to increase this towards (but not above) 110% over the medium term.

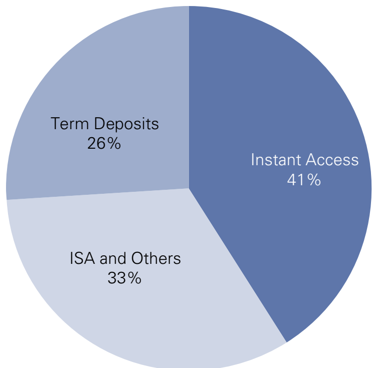
Some 41% of Virgin Money's deposits are instant access, with 26% term deposits and the remainder (33%) ISAs and other accounts. We believe this represents a smaller proportion of instant access accounts compared to the market as a whole, which partially reflects Virgin Money's limited existing current account offering.

Virgin Money has been able to more than offset the impact of falling mortgage spreads by cutting rates on its variable deposit books. Alone through that it was able to increase mortgage net interest margin by over 50 bp since 2012.

Given its reliance on savings deposits and only very limited current account balances, we believe that Virgin Money's deposit funding costs are likely to increase as rates rise. For a more current account funded bank, we would typically assume that overall deposit rates would rise at a slower pace compared to asset rates, owing to the share of non-interest paying current account deposits.

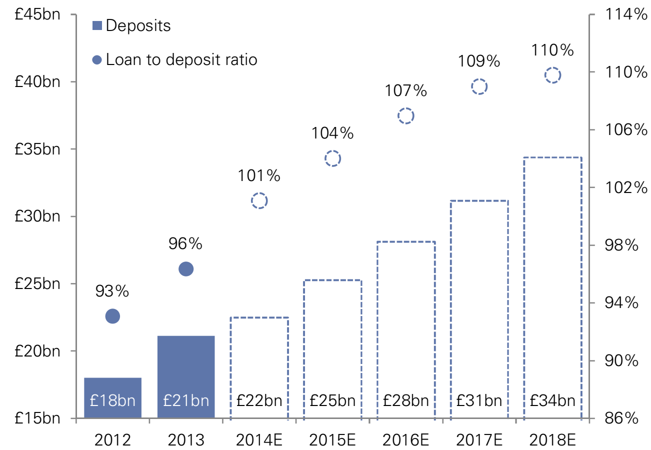
That said, Virgin Money further believes that it will be able to not fully pass on any increase in asset rates should rates increase, as despite the cut in rates it remains one of the higher payers on variable deposits. By doing so, it would narrow the gap to competition. It targets being at the bottom of the first quartile in terms of savings rates.

Exhibit 20: Most deposits at variable rates
Distribution of savings account balances across account classifications (%)



Source: Virgin Money.

Exhibit 21: We forecast growth in deposits to continue
Deposits (£ bn) and loan to deposit ratio (%)



Source: Virgin Money (2012-13), Goldman Sachs Global Investment Research (2014-18E).

Currently only a limited current account offering

At present Virgin has a small and straightforward current account offering consisting of around £200 mn of current account balances. In the current market structure, current accounts come at considerable costs given cross-subsidies, which means sub-scale participants face high operational costs without benefitting from a substantial cheap and 'sticky' funding source.

While larger incumbents in the market continue to offer free current accounts, management believes it would be detrimental to shareholder value to acquire organic volume at scale and consequently does not intend to grow its presence significantly over the medium term. However management would be open to profitable acquisitions of current accounts at scale.

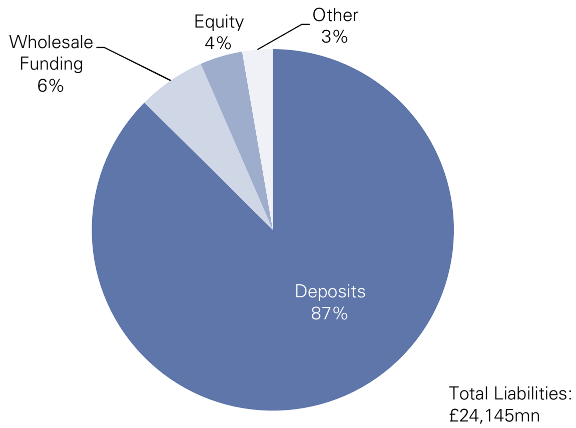
Wholesale funding to increase – focus remains on RMBS

Currently wholesale funding accounts for 6% of Virgin Money's total liabilities. However despite remaining a primarily retail funded institution, the company is intending to increase the amount of wholesale funding it uses (as it increases both its loan book and its loan to deposit ratio).

Within this the company plans to continue to be a regular issuer of RMBS (which currently accounts for 60% of its wholesale funding. In addition it also plans to diversify its wholesale funding into covered bonds and senior unsecured debt.

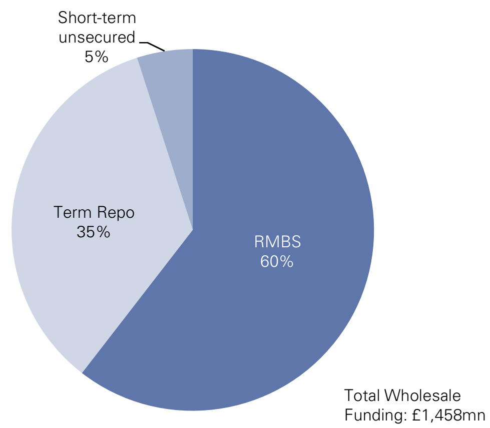
In addition to the £1,458 mn of on-balance sheet wholesale funding, Virgin Money also currently has £1,760 mn of drawings outstanding under the Funding for Lending Scheme (FLS). The company does not foresee any difficulty in substituting for FLS via wholesale resources.

Exhibit 22: Virgin has only limited wholesale funding…
Composition of Total Liabilities (%) – 1H14



Source: Virgin Money.

Exhibit 23: …with very little of it short-term
Composition of Wholesale Funding (%) – 1H14



Source: Virgin Money.

Development of net interest margin is key

Mortgage net interest margins to gradually expand as rates rise
Similar to other UK banks, Virgin Money has been able to more than offset the impact of falling asset yields by cutting deposit rates. The company believes it will be able to expand mortgage net interest margins by up to 10 bp pa in a rising interest rate environment, e.g., by not having to pass on the increased asset rates in full to deposits.

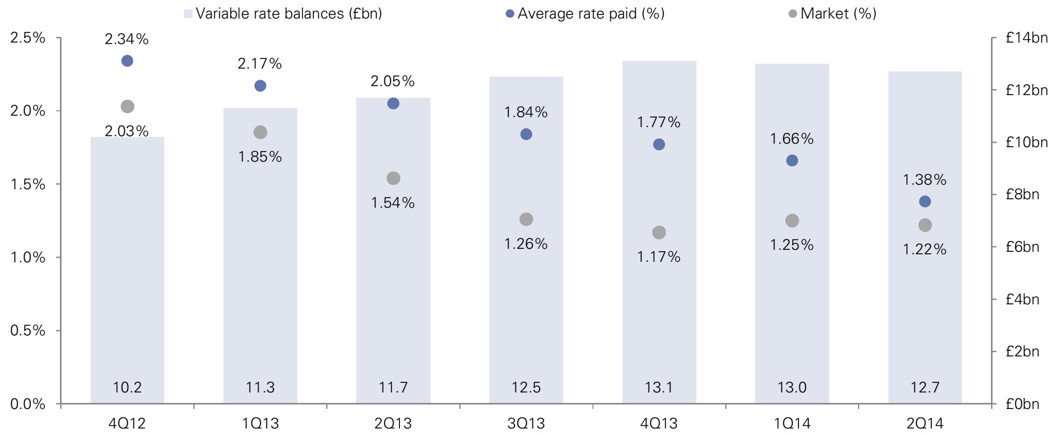
We believe that there is some room for Virgin Money to improve its mortgage net interest margin, as it continues to pay c.15 bp higher deposit rates compared to average market rates (Exhibit 24), and also given that previous deposit rate cuts (1H14) have not come through yet in full. Historically, as shown below, Virgin Money has been able to narrow the gap with market rates while maintaining similar deposit balances. However, there is the risk that in future competitive pressure could force Virgin Money to pass on base rate rises in full.

We are somewhat more conservative with our forecasts and expect Virgin Money to increase its mortgage net interest margin from 1.36% during 1H14, to 1.43% in 2015E and to 1.46% in 2016E, and thereafter to stabilize at that level, as its deposit pricing gap versus the competition narrows.

We see the risk of increased competition in mortgage lending, which could affect both mortgage margins and Virgin Money's planned expansion of its mortgage book. In this context we note that a number of large UK banks (e.g. HSBC, RBS, Nationwide) have indicated their ambitions to grow their respective market share in domestic mortgages. It is to be seen to what extent the introduction of the leverage ratio will counterbalance this.

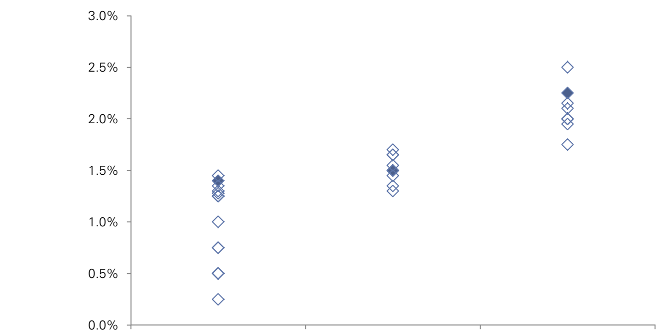
A second risk is that higher interest rates might impact affordability and with that the ability of the banks to pass through rates rises to borrowers in full, potentially negatively impacting margins.

Exhibit 24: Virgin Money has been able to significantly re-price and retain variable rate deposits
Variable rate balances (£ bn) and average rate paid on variable rate balances (%)



Source: Virgin Money, Bank of England for market data.

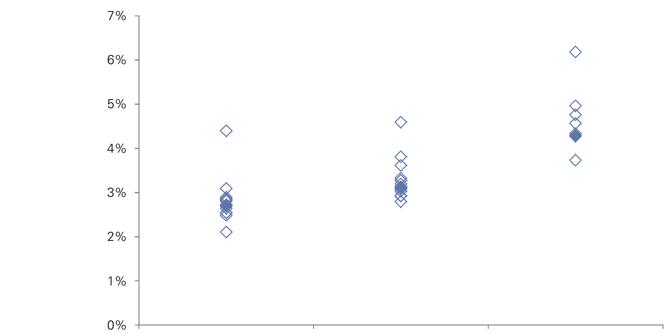
Exhibit 25: Virgin Money with competitive deposit pricing…
Deposit interest rates (%) on Instant access, 1 year fixed and 3 year fixed ISAs – Virgin Money in blue



Interest Rate (%)	Instant access ISA	1 year ISA	3 year ISA
Median	1.25%	1.50%	2.05%
Max	1.45%	1.70%	2.50%
Virgin Money	1.40%	1.50%	2.25%

Source: Moneysupermarket.com, pricing as of September 17, 2014.

Exhibit 26: …a similar picture in mortgage pricing, in particular in the 80% LTV segment
Effective (fee adjusted) interest rate on 2 year fixed remortgage (%), Virgin Money in blue



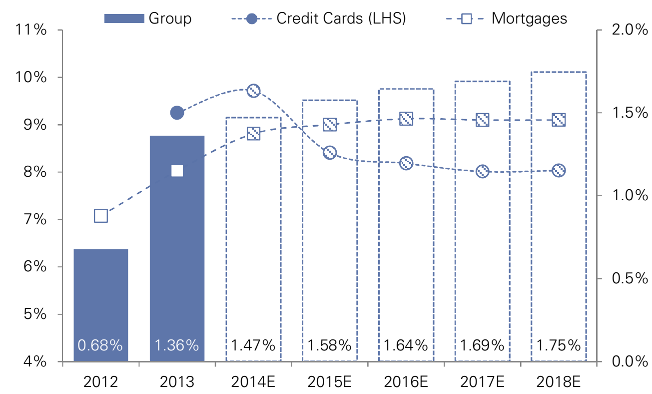
Interest Rate (%)	60%	80%	90%
Median	2.76%	3.12%	4.33%
Min	2.10%	2.79%	3.73%
Virgin Money	2.69%	3.11%	4.29%

Source: Virgin Money, respective companies' data as of August 6, 2014, Goldman Sachs Global Investment Research calculations.

Credit cards to add a further 14 bp

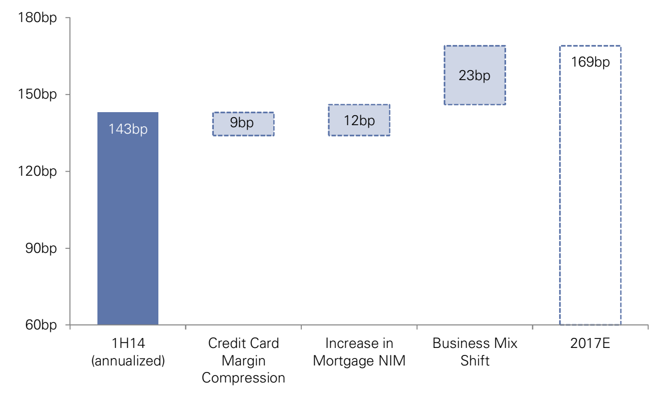
On our estimates, the share of credit card loans to total loans will increase from c.4% currently to about 8%. As the net interest margin on credit cards is substantially higher compared to mortgage margins, the higher share in card loans will contribute 14 bp (net) of the increase in group margins.

Exhibit 27: Net interest margin rising over time…
Net interest income/average loans for mortgages and credit cards, group statutory net interest margin (%)



Source: Virgin Money (2012-13), Goldman Sachs Global Investment Research (2014-18E).

Exhibit 28: …driven by mix shift and mortgages
Contribution to evolution of group statutory net interest margin (%)



Source: Virgin Money (1H14), Goldman Sachs Global Investment Research (2017E).

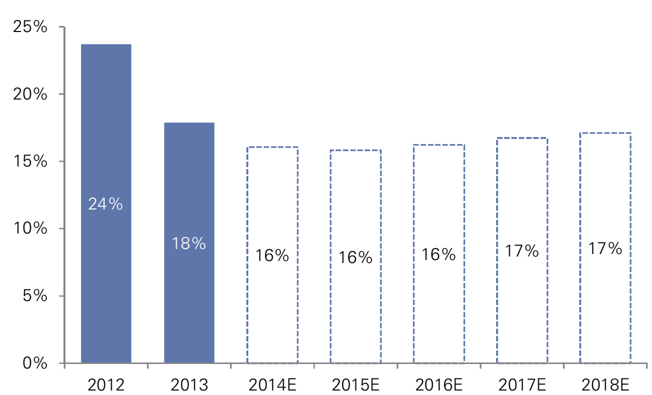
Complementary financial products to grow in line with NII

Virgin Money uses its established brand and customer base to sell insurance products, ISAs and personal pensions through strategic partnerships with third parties. The company emphasizes its low-risk approach particularly with regard to conduct risk as it operates a commission-based insurance business and does not give investment advice but instead sticks to providers offering execution-only capability.

Going forward management expects non-interest income to continue to account for a broadly similar proportion of total revenue as during 2013. The 2012 non-interest income figure was significantly higher, as Virgin Money then still benefited from the credit card agreements.

Virgin Money is to launch shortly its own life insurance products, sold in partnership with Friends Life. It intends to cross-sell these policies to its mortgage clients. In addition, Virgin Money has signed a letter of understanding with a major European insurer to offer broader general insurance, including home and motor.

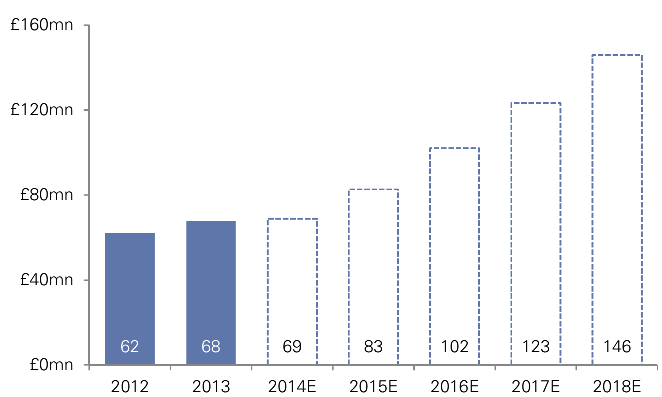
Exhibit 29: Non-interest income a constant proportion
Non-interest income (% of Total Group Income)



Note: 2012 excludes £64.3 mn of other operating income earned through credit card partnership agreement

Source: Virgin Money (2012-13), Goldman Sachs Global Investment Research (2014-18E).

Exhibit 30: …and to grow in-line with NII
Group non-interest income (£ mn)



Note: 2012 excludes £64.3 mn of other operating income earned through credit card partnership agreement

Source: Virgin Money (2012-13), Goldman Sachs Global Investment Research (2014-18E).

Cost control brings operating leverage

In terms of operating leverage, Virgin Money is committed to reducing the group's cost-income ratio from 71% in 1H 2014 to 50% in the medium term. The majority of this efficiency benefit stems from the high level of scalability of its existing platforms, in particular within its mortgage platform, which management believes will allow it to display positive jaws consistently over the coming years.

Group confident in achieving 50% cost income ratio

Virgin Money aims to reach a cost to income ratio, excluding the FSCS levy, of 50% over the near to medium term. This reflects the nature of the products it offers, low serving costs, the scalability of its largely non-branch model and the lack of legacy issues.

Direct costs – Scalable mortgage and savings platform

With the acquisition of Northern Rock's good bank, Virgin Money has not only acquired a mortgage loan book of £14 bn, but also an operating platform, which pre-crisis was able to service a mortgage portfolio in excess of £80 bn.

In-line with company guidance, we forecast only a moderate increase in direct operating costs going forward of about 2% pa, to reflect inflation, as:

- Its new business is largely originated from intermediaries (>80%), this means, there is limited need for an expansion of the branch network to support the growth plans.
- Most of the operating expenses in relation to the mortgage business are incurred at underwriting or repayment; the company has indicated that the current platform is sufficient to underwrite the new business volumes planned, without the need for material additional hiring.

Hence we see significant potential for operating leverage in the mortgage business.

Direct costs – Credit cards: Unit servicing costs to fall 30%-40% upon completion of MBNA transaction

Under the current agreement with MBNA, Virgin Money is incurring an elevated level of servicing costs in relation to its credit card business.

Virgin Money is near the completion of its own credit card operating platform, upon completion of which MBNA will cease servicing those cards – as a consequence, it anticipates c.30%-40% lower servicing costs. By way of an overview, servicing costs in 2013 were £28.4 mn, implying servicing costs of 3.5% on average credit card loans outstanding. In addition to the decrease, we note that there will be some benefit from economies of scale within this direct cost element.

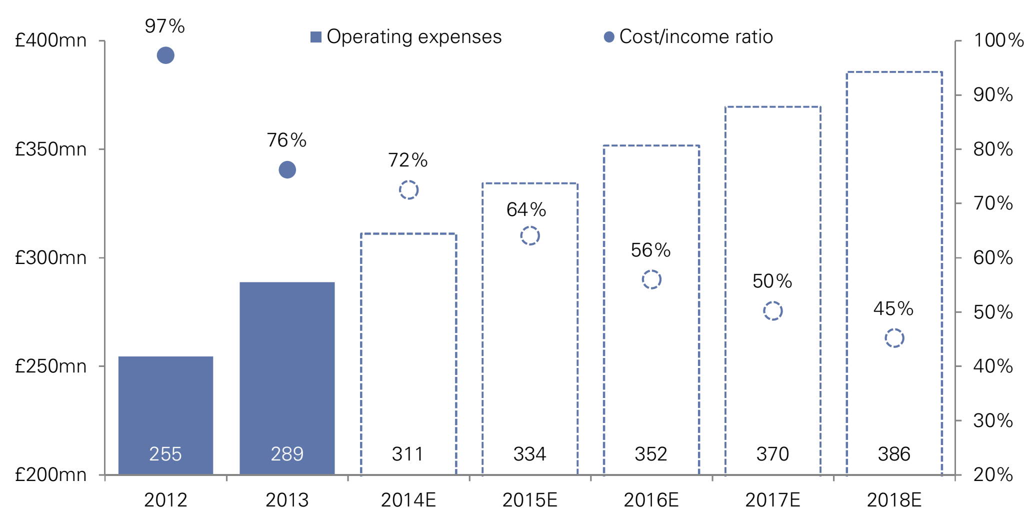
As a result, we expect per unit operating expenses in the card business to fall significantly upon completion of the MBNA transaction. Virgin Money will continue to incur sales and marketing costs, which we estimate at historically somewhere around £35-40 per card. All-in, management targets a cost income ratio (for direct, segmental costs only) of 30% or lower over the medium term.

Overheads – Planned investments to drive up costs, initially

The final major element in Virgin Money's cost structure is overheads. We note the following moving parts:

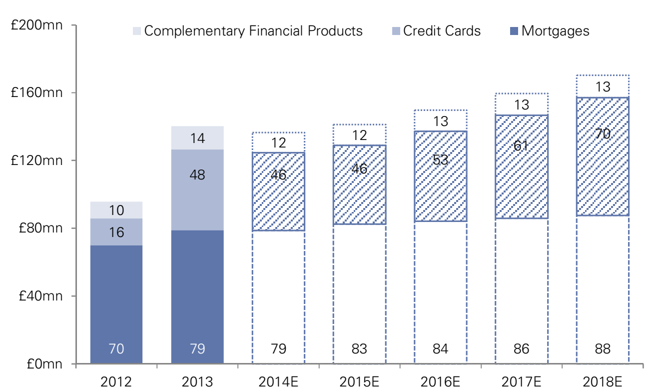
- Virgin Money has indicated that its workforce is to increase by 200 to 3,000, mostly front-loaded into 2015 to support the broader business platforms of cards, current account and non-interest income.
- Project and depreciation spend of £40 mn pa: The company has indicated that the current spend allocated for business integration and platform build (c.£40 mn pa) will continue once these projects have been completed, with the spend being diverted to other projects, including future platform development and lounge network expansion.

Exhibit 31: Group cost-income ratio to reach 50% by 2017E
Group operating expenses (£ mn) and cost/income ratio (%)



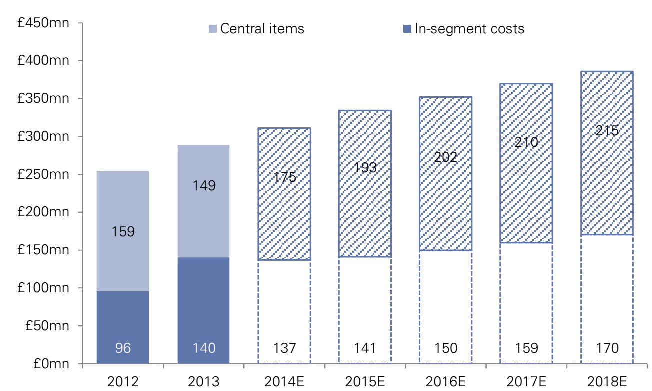
Source: Virgin Money (2012-13), Goldman Sachs Global Investment Research (2014-18E).

Exhibit 32: Direct costs to grow at a 4% CAGR by 2018E...
In-segment costs (£ mn), split by operating segment



Source: Virgin Money (2012-13), Goldman Sachs Global Investment Research (2014-18E).

Exhibit 33: ... but overheads by 8%, driven by investments in platforms (e.g., credit cards)
Total costs (£ mn) split by central items and in-segment costs



Source: Virgin Money (2012-13), Goldman Sachs Global Investment Research (2014-18E).

Strong asset quality and low risk costs

Virgin Money's group loan loss provisions are primarily driven by the size of its credit card book relative to the total loan book. Since returning to the mortgage market following the acquisition of Northern Rock's good bank, loan loss provisions in mortgages have been negligible, at a level of c.1-2 bp of loans per annum. Management guided that over the medium term it expects loan loss provisions for the group of c.15-20 bp, owing to the higher share of credit card loans.

A high quality mortgage book

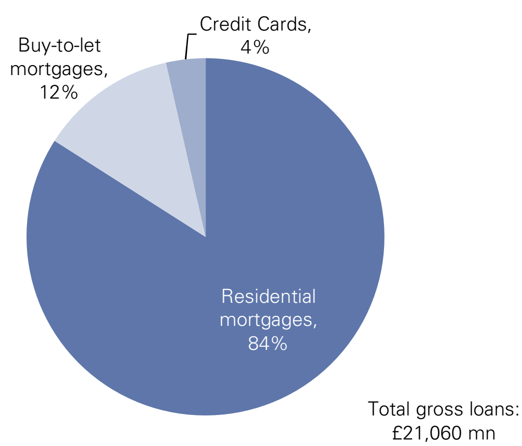
The mortgage book that Virgin Money acquired from Northern Rock has proved to have excellent asset quality so far. Since then, Virgin Money has grown its own book by more than 50%. The portfolio's asset quality has been very strong, with only 0.4% of gross mortgage loans impaired as at 1H14.

The average LTV of Virgin's mortgage book is 58.7% and 75.3% of Virgin Money's mortgage book is at an LTV below 70%. In addition Virgin Money's average LTV on new business is low at 67.9%.

While these ratios look higher than some of its UK peers (HSBC's average new business LTV of 60%, Lloyds Banking Group 64% and RBS at 71%), this might be explained by terms of distribution Virgin Money, given the higher cost of its savings deposit funding base, is likely to focus more on the middle of the LTV range (e.g. 70%), rather than having a wider spread comprising both sub 60% LTV mortgages and high LTV (85%+) mortgages.

The mortgage portfolio is mostly concentrated in Greater London and the South East, accounting for 51% of residential mortgages. However, we believe this is reflective of the wider UK mortgage market.

Exhibit 34: Residential mortgages account for the bulk of the loan book…
Gross loans and advances to customers by type (%), 1H14

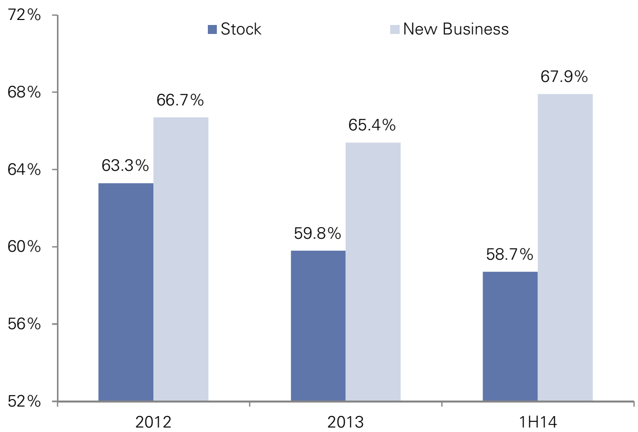


Source: Virgin Money.

Exhibit 35: …which have a typical domestic geographic spread
Geographic split of outstanding mortgages (%), 1H14

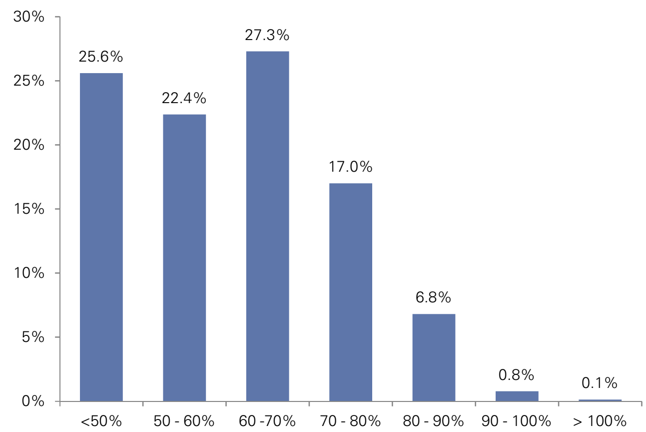
Source: Virgin Money.

Exhibit 36: Underwriting LTVs somewhat higher compared to industry peers…
Average Loan-to-Value ratio (%)



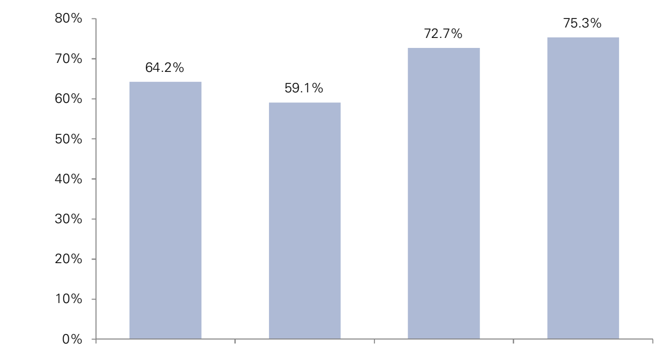
Source: Virgin Money.

Exhibit 37: …and 75% of mortgages are below 70% LTV
Residential mortgages by indexed LTV band (%) as of 1H14



Source: Virgin Money.

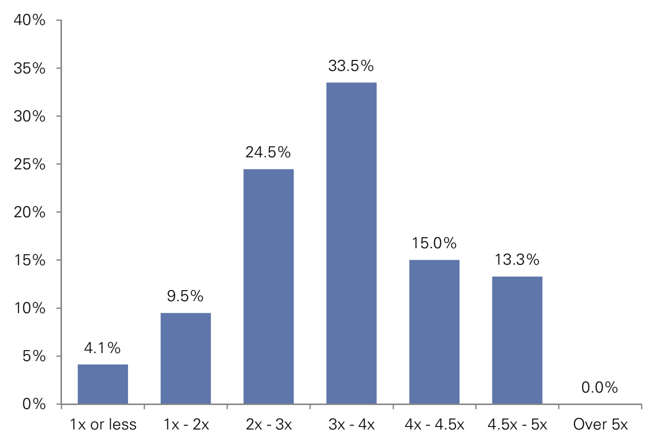
Exhibit 38: …likely driven by higher house prices
Residential mortgages with an indexed LTV < 70% (%) and outstanding residential mortgage loans (£ bn)



£ bn	2011	2012	2013	1H14
Residential mortgages	£0.02bn	£16.77bn	£19.58bn	£20.31bn

Source: Virgin Money.

Exhibit 39: 13% of new lending at high LTI multiples
New residential mortgage lending during 1H14, by LTI multiple (using only 50% of variable income)



Source: Virgin Money.

The loan to income profile of Virgin Money's new business in 1H14 showed that 13% of new business was written at loan-to-income multiples of above 4.5x. While this is still within the FPC recommended limit of 15%, we see the potential for this to affect new business if house prices continue to rise faster than incomes.

However, we believe that in practice borrowers are likely to scale back their leverage ambitions rather than to withdraw them altogether.

The historical impairment performance of the group's mortgage portfolio has been strong. During 2013 the cost of risk was 1 bp and in the first half of 2014, Virgin Money had net write-backs of 1 bp.

Clearly, at such low impairment levels, we forecast a gradual increase in impairments as the mortgage book seasons.

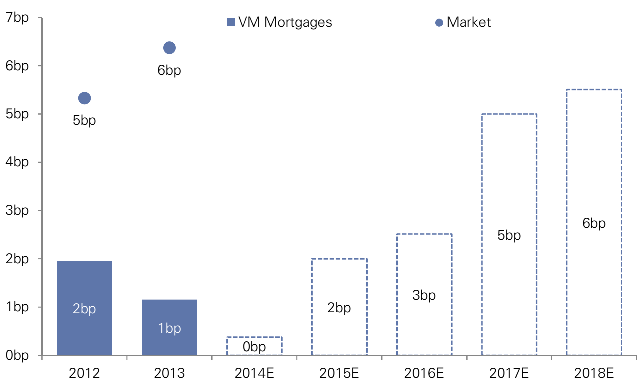
We believe a key risk for Virgin Money is a widespread downturn in the UK housing market.

Credit cards impairment to initially trend downwards

The credit card portfolio Virgin acquired from MBNA in 2013 was high quality, with no accounts more than 30 days in arrears.

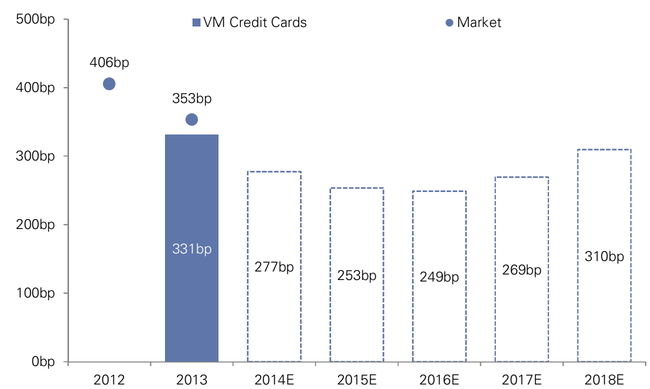
The cost of risk on the credit card book was 289 bp in 2013 and 313 bp during 1H14. Management guided that the cost of risk is likely to decrease, as the average portfolio's age is likely to shrink given the ambitious new lending targets, with that outweighing the impact of loan seasoning. Typically, for zero percent balance transfers, the loan loss profile deteriorates after the expiry of the initial interest free period, which we refer to here as "seasoning". Over the medium term management expects the credit card cost of risk to rise from the current level but to remain below 4%.

Exhibit 40: We forecast mortgage impairments to remain low…
Impairments/gross loans and advances (%) – mortgages



Source: Virgin Money (2012-13), Goldman Sachs Global Investment Research (2014-18E), Bank of England.

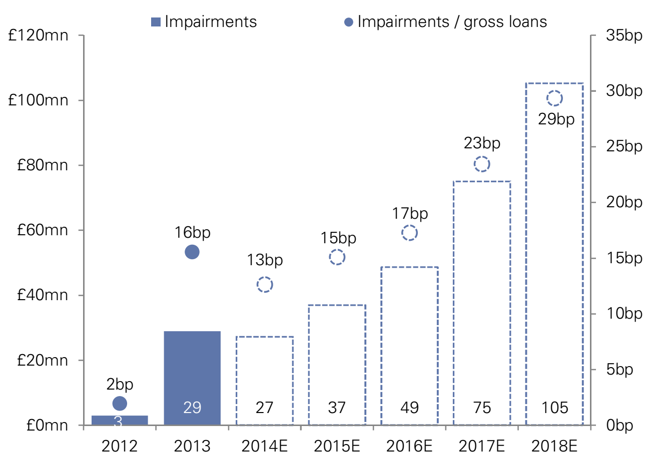
Exhibit 41: …with credit card impairments to improve initially…
Impairments/gross loans and advances (%) – credit cards



Note: 2013 excludes £21.8 mn of impairments related to US regulatory change applicable to the Credit Cards business

Source: Virgin Money (2012-13), Goldman Sachs Global Investment Research (2014-18E), Bank of England.

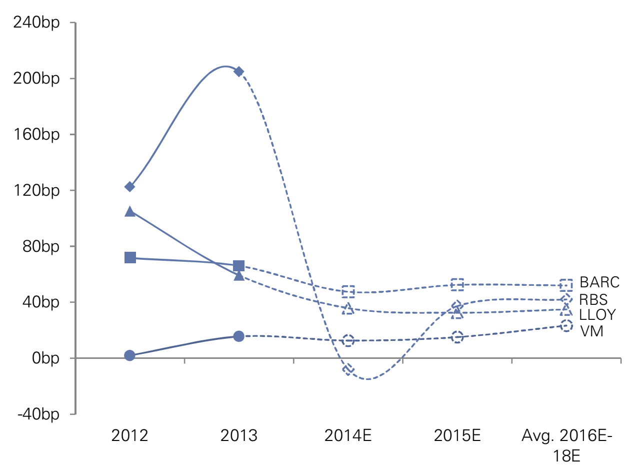
Exhibit 42: …while the mix shift towards cards pushes group impairments higher…
Group impairments (£ mn) and group impairments/gross loans (bp)



Note: 2013 excludes £21.8 mn of impairments related to discount on acquired portfolio

Source: Virgin Money (2012-13), Goldman Sachs Global Investment Research (2014-18E).

Exhibit 43: …but to a level still significantly lower than for other UK banks
Impairments (£ mn) and impairments/gross loans (bp)



Note: 2013 excludes £21.8 mn of impairments related to discount on acquired portfolio

Source: Virgin Money (2012-13), Respective companies data (2012-13), Goldman Sachs Global Investment Research (2014-18E).

Adequately capitalized to fund future growth

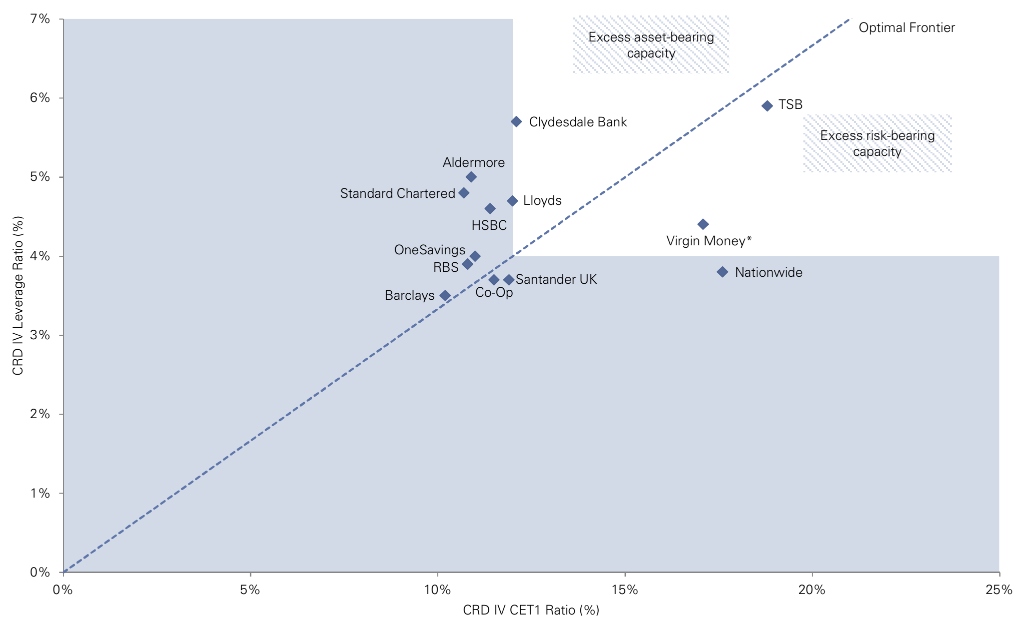
Virgin Money's key constraint – from a regulatory capital perspective – remains the leverage ratio, in our opinion. On our estimates, the leverage ratio will gradually decrease, from 4.4% immediately following the IPO, to a range of 3.8%-4.0%. As Virgin Money grows its loan portfolio, we expect the majority of capital generated from retained earnings to be utilized to fund growth.

Uncertainty remains as to the final regulatory leverage ratio requirement that Virgin Money will face as it is likely to fall under the regime for ring-fenced banks. The government has stated that the systemic buffer requirements for ring-fenced banks will be 0%-3%, implying a leverage buffer of 0%-1.05%. If the final requirement would be at the upper end of the range, e.g., 4.05%, this could have a substantial negative impact on Virgin Money (owing to its low average risk weight given its business mix) and severely impact its business plan and growth ambitions.

There is some further AT1 issuance capacity as CET1 capital builds up, which could serve as an additional buffer (lifting the leverage ratio to the c.4.5% level, on our numbers) albeit at a cost.

Pro-forma for the £150 mn primary issuance, Virgin Money is adequately capitalized with a CET1 ratio of 16.8% and a leverage ratio of 4.4%. Following a loss-given default (LGD) methodology change in July 2014, Virgin Money's RWAs decreased by c.£1 bn, lifting the CET1 ratio to ~21% following the IPO. The company however expects mortgage risk weights to gradually increase over time towards the low twenties, mainly driven by a seasoning of the mortgage portfolio and the company's through the cycle risk weight approach.

Exhibit 44: Finding the right balance – mortgage lenders typically with lower leverage ratios
CRD IV CET1 Ratio and Leverage Ratio (%), at September 30, 2014, except Co-Op, Virgin Money, Aldermore, Standard Chartered and OneSavings (June 30)



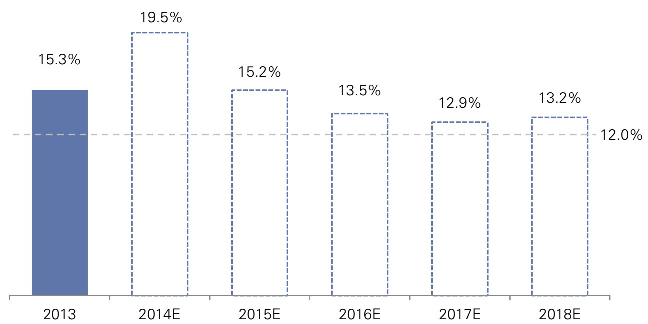
Note: Virgin Money shown pro-forma for £150 mn of primary issuance, but before the LGD-change.
Clydesdale Bank – CET1 and Leverage Ratios are calculated under transitional CRD IV regulation.

Source: Respective companies' data for CET1 and leverage ratio, Goldman Sachs Global Investment Research for Clydesdale Bank, Virgin Money.

We analyze the development of the group's CET1 ratio and leverage ratio over time as the company grows its loan book:

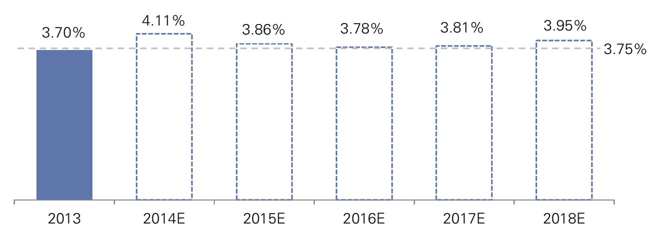
- **CET 1 ratio above 12% throughout:** Under our analysis the CET1 ratio never drops below 12.9% throughout the forecast period.
- **Leverage ratio key constraint, within 3.8%-4.0% range:** The leverage ratio, however, remains very close to the company's self-imposed target of 3.75%.

Exhibit 45: Comfortable above CET1 target…
Virgin Money Group CRD IV CET1 ratio and company target of 12%, 2013 to 2018E, %



Source: Virgin Money (2013), Goldman Sachs Global Investment Research (2014-18E).

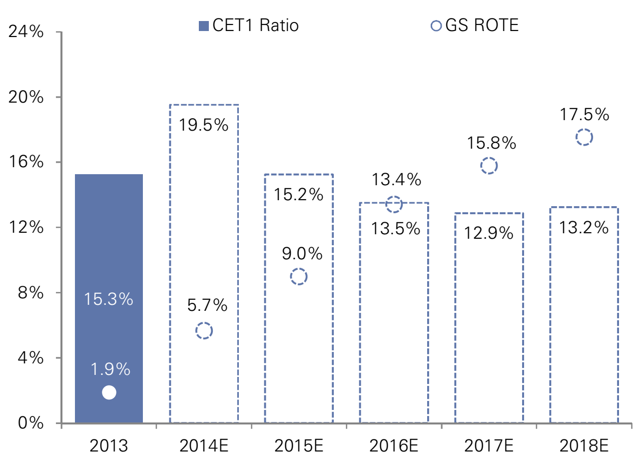
Exhibit 46: …but limited headroom to leverage target
CRD IV leverage ratio and company target of min. 3.75%, 2013 to 2018E, %



Source: Virgin Money (2013), Goldman Sachs Global Investment Research (2014-18E).

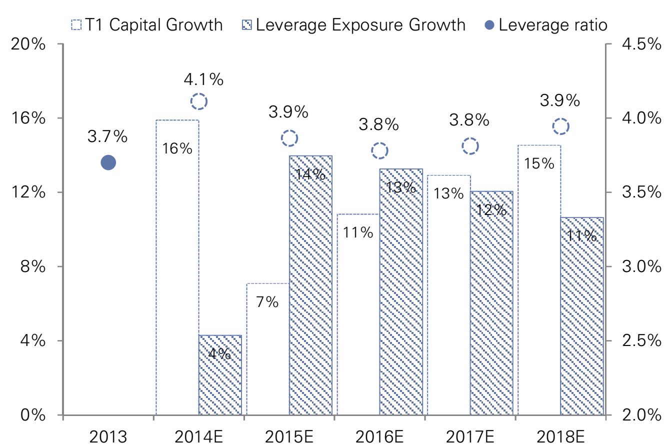
The muted progress on the leverage ratio over time is explained by total leverage exposure growing broadly at the same pace as capital.

Exhibit 47: A 14%-18% ROTE while having a 13% CET1 ratio
CET1 ratio vs. GS ROTE (%)



Source: Virgin Money (2013), Goldman Sachs Global Investment Research (2014-18E).

Exhibit 48: Retained earnings fund strong loan growth
Leverage ratio (%), Tier 1 capital and leverage exposure (% chg yoy)

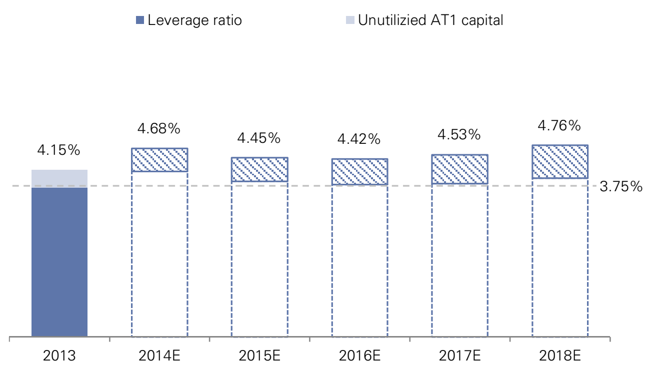


Source: Virgin Money (2013), Goldman Sachs Global Investment Research (2014-18E).

However, if we were to assume that Virgin Money would issue the maximum possible amount of AT1 capital so that it fully utilizes the 25% Tier 1 limit, then there is c.70 bp headroom to the company's targets (Exhibit 49).

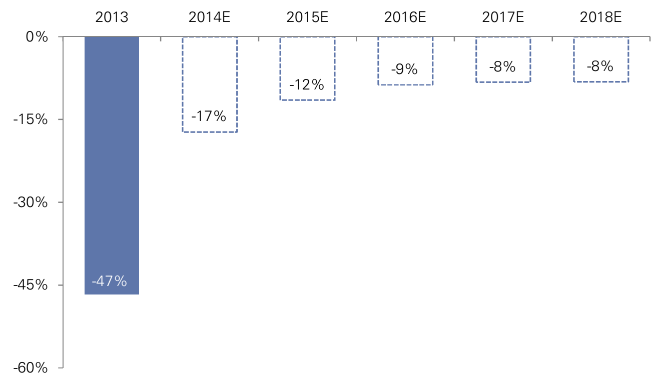
From an economic perspective, we see limited incentives for Virgin Money to issue additional AT1 debt at this stage, as this comes at a cost and would dilute earnings. We expect a better guidance on future AT1 issuance post the finalization of the leverage requirements by the PRA.

Exhibit 49: AT1 capacity provides headroom to leverage target, if needed…
CRD IV leverage ratio (assuming AT1 capital flat at £160 mn) and assuming maximum amount of AT1 capital is issued (e.g. 25% of Tier 1 capital), company target leverage ratio, %



Source: Virgin Money (2013), Goldman Sachs Global Investment Research (2014-18E).

Exhibit 50: …but would come at a cost, diluting 2016E earnings by ~9%
Earnings dilution arising from additional AT1 issuance, up to the maximum allowance of 25% of Tier 1 capital



Source: Goldman Sachs Global Investment Research.

The final leverage requirement for ring-fenced banks has not yet been calibrated, but is understood to be in the range of 3.0%-4.05% (a minimum of 3.0% plus 35% times a 0%-3% systemic buffer). With a deposit base of over £20 bn, Virgin Money is in our view likely to fall under the ring-fenced regime. In our view, Virgin Money is likely to have sufficient headroom to (1) fund its growth ambitions and (2) fulfill a leverage requirement of potentially up to 4.4% assuming current growth ambitions.

While there remain uncertainties with regard to the final calibration of the leverage ratio for ring-fenced banks, the final proposal was more benign than expected, in our view. Most UK banks will not be constrained by the leverage ratio, but instead by risk-based rules (CET1 ratio). We do not see any immediate pressure for building societies or other mortgage lenders which could affect new business, and this could over time result in increased competition in the domestic mortgage market.

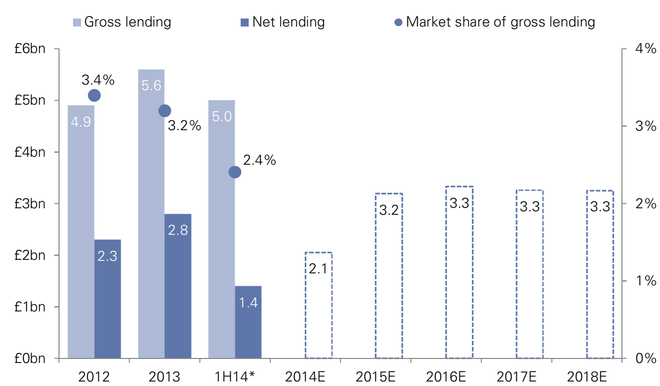
Financials: Loan growth and operating leverage key drivers

We expect Virgin Money to reach an underlying ROTE of 15.8% by 2017E, largely driven by strong loan growth, margin expansion and operating leverage. We forecast Virgin Money's GS net income to grow from £16 mn in 2013 to £266 mn by 2018E. We expect Virgin Money to commence paying dividends in 2015E, with a payout ratio of 20%.

Mortgages and savings – Forecasting 18% CAGR in revenues

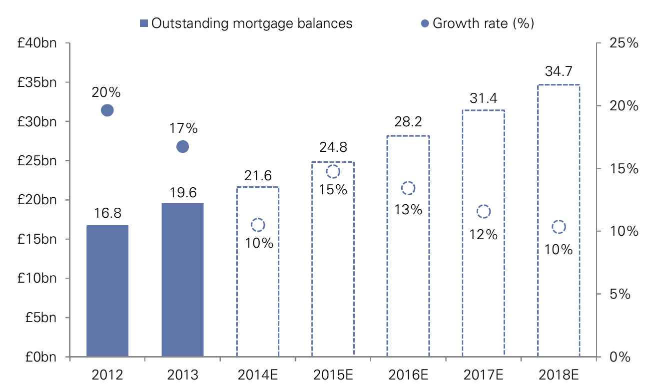
As described earlier, Virgin Money plans to maintain its gross mortgage lending market share of over 3% and to keep its retention rate stable at around 70%. We forecast net mortgage lending to gradually increase from £1.3 bn as of 9M14 towards £3.3 bn in 2018E, and its loan book to reach £34.7 bn by 2018E, implying a 2013-18E CAGR of 12%.

Exhibit 51: We forecast ~£3 bn pa net mortgage lending
Gross mortgage lending, net mortgage lending (£ mn) and market share of gross mortgage lending (%) - *annualized



Source: Virgin Money (2012-13 and 1H14), Goldman Sachs Global Investment Research (2014-18E).

Exhibit 52: ...resulting in an 2013-18E CAGR of 12%
Virgin Money's mortgage loan book and annual growth rate, £ mn and %



Source: Virgin Money (2012-13), Goldman Sachs Global Investment Research (2014-18E).

A scalable mortgage platform provides operating leverage

We note that the segmental cost disclosure does not include any overheads nor any charges in relation to the FSCS, which are shown as an own segment central function.

Our forecasts show that the direct cost income ratio of the mortgage and savings business, excluding overheads, decreases from 38% to 18% by 2018E, as more assets are brought onto Virgin Money's platform.

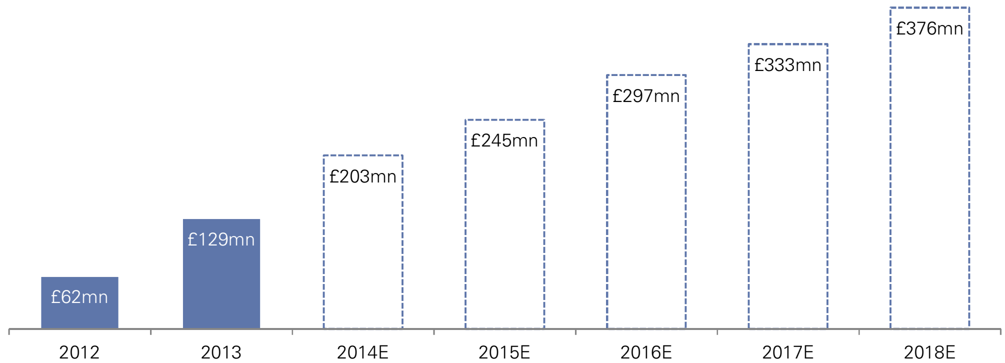
Mortgage impairments likely to remain limited over near to medium term

Historical loan loss provisions at Virgin Money's mortgage business were negligible, at around 1 or 2 bp of loans per annum; we expect loan loss provisions to gradually increase to 6 bp, but nevertheless to remain comparatively small.

Loan growth and operating leverage to lift PBT near £376 mn by 2018E

Incorporating all these assumptions for the mortgage and savings business, we forecast pre-tax income to increase to £376 mn by 2018, implying a 2013-18E CAGR of 24%.

Exhibit 53: Strong net income growth in mortgages and attractive returns, even on a 4% leverage basis
Pre-tax income estimates for Virgin Money's mortgage and savings division



Source: Virgin Money (2012-13), Goldman Sachs Global Investment Research (2014-18E).

Exhibit 54: Mortgages and savings – Loan growth and operating leverage as key earnings drivers
Key P&L and balance sheet items, Mortgages and savings, 2011 to 2018E, £ mn, unless stated otherwise

Mortgages and savings	2011	2012	2013	2014E	2015E	2016E	2017E	2018E	14/13E	15/14E	16/15E	17/16E	18/17E	13-18E CAGR
Net interest income	0.3	135.3	209.2	283.2	331.9	387.9	433.9	481.5	35%	17%	17%	12%	11%	18%
Net interest margin (%)	*0.00%*	*0.88%*	*1.15%*	*1.37%*	*1.43%*	*1.46%*	*1.46%*	*1.46%*	22 bp	5 bp	4 bp	-1 bp	0 bp	6 bp
Other income	0.0	-0.4	1.2	-0.7	0.0	0.0	0.0	0.0						
Total income	0.3	134.9	210.4	282.5	331.9	387.9	433.9	481.5	34%	18%	17%	12%	11%	18%
Operating expenses	(2.3)	(70.0)	(78.9)	(78.7)	(82.5)	(84.2)	(85.9)	(87.6)	0%	5%	2%	2%	2%	2%
Cost/Income ratio	*766.7%*	*51.9%*	*37.5%*	*27.8%*	*24.9%*	*21.7%*	*19.8%*	*18.2%*	-10 pp	-3 pp	-3 pp	-2 pp	-2 pp	-4 pp
Pre-provision profit	(2.0)	64.9	131.5	203.8	249.4	303.7	348.0	393.9	55%	22%	22%	15%	13%	25%
Impairment costs	-	(3.0)	(2.1)	(0.8)	(4.6)	(6.7)	(14.9)	(18.2)	-63%	501%	43%	124%	22%	54%
Impairment costs / loans (bps)	*0*	*2*	*1*	*0*	*2*	*3*	*5*	*6*	-68%	433%	26%	99%	10%	37%
Pre-tax profit	(2.0)	61.9	129.4	203.0	244.7	297.0	333.1	375.7	57%	21%	21%	12%	13%	24%
Risk-weighted assets	-	3,210	4,016	3,353	4,716	5,913	6,911	7,626	-17%	41%	25%	17%	10%	14%
Loans	14,016	16,769	19,577	21,631	24,823	28,155	31,412	34,665	10%	15%	13%	12%	10%	12%
Deposits	-	18,007	21,121	22,485	25,265	28,120	31,150	34,376	6%	12%	11%	11%	10%	10%
Loan to deposit ratio	-	93%	93%	96%	98%	100%	101%	101%	4 pp	2 pp	2 pp	1 pp	0 pp	2 pp

Source: Virgin Money (2011-13), Goldman Sachs Global Investment Research (2014-18E).

The path to a £3 bn credit card book

The credit card business currently comprises £749 mn of credit card loans, and a further £363 mn of zero-balance transfer portfolio that were transferred on December 1 2014, bringing the total balance to ~£1.1 bn. We forecast broadly linear loan growth of its credit card loan book towards the £3 bn target, which we forecast will be reached by end-2018E. This figure is below the peak level of the previously Virgin-branded credit cards issued by MBNA of £4.5 bn.

Credit card margins to decline following transfer of zero percent balance book

The second and final tranche of credit card loans transferred from MBNA is a zero-percent balance portfolio, which has an accounting effective interest rate of 7.5%, significantly below the c.12% yield of the pre-existing book. Consequently, the transfer will reduce the net interest margin of Virgin Money's credit card segment by up to c.200 bp, which we incorporate in our forecasts accordingly.

Strong growth leads to lower relative risk provisioning, initially

Owing to the strong growth targets and the focus of new business on zero percent balance transfer cards, we forecast loan loss provisions to initially rebase downwards on a relative (basis points) basis, before gradually increasing again.

Exhibit 55: Credit cards – key financials

2013 NII and impairments adjusted for the £21.8 mn impairment allowance reflected in the purchase price of acquired credit card portfolio

Credit cards	2011	2012	2013	2014E	2015E	2016E	2017E	2018E	14/13E	15/14E	16/15E	17/16E	18/17E	13-18E CAGR
Net interest income	0.0	0.0	80.2	77.1	107.3	138.1	178.8	225.6	-4%	39%	29%	29%	26%	23%
Net interest margin (%)	-	-	*10.34%*	*9.72%*	*8.41%*	*8.18%*	*8.01%*	*8.03%*	-63 bp	-131 bp	-22 bp	-17 bp	2 bp	-46 bp
Fees and commission income	97.3	63.7	27.0	25.1	40.1	53.1	70.2	88.6	-7%	60%	32%	32%	26%	27%
Total income	97.3	63.7	107.2	102.1	147.4	191.2	249.0	314.2	-5%	44%	30%	30%	26%	24%
Operating expenses	(16.3)	(15.9)	(47.7)	(45.9)	(46.4)	(53.1)	(60.8)	(69.6)	-4%	1%	14%	14%	14%	8%
Cost/Income ratio	*16.8%*	*25.0%*	*44.5%*	*44.9%*	*31.5%*	*27.8%*	*24.4%*	*22.1%*	0 pp	-13 pp	-4 pp	-3 pp	-2 pp	-4 pp
Pre-provision profit	81.0	47.8	59.5	56.2	101.0	138.1	188.2	244.6	-5%	80%	37%	36%	30%	33%
Impairment costs	-	-	(26.8)	(26.5)	(32.3)	(42.0)	(60.1)	(87.0)	-1%	22%	30%	43%	45%	27%
Impairment costs / loans (bps)	-	-	*331*	*277*	*253*	*249*	*269*	*310*						
Pre-tax profit	81.0	47.8	32.7	29.8	68.7	96.1	128.1	157.6	-9%	131%	40%	33%	23%	37%
Risk-weighted assets	-	152	731	1,042	1,378	1,822	2,410	2,916	43%	32%	32%	32%	21%	32%
Loans	-	-	809	1,099	1,453	1,922	2,542	3,076	36%	32%	32%	32%	21%	31%

Source: Virgin Money (2011-13), Goldman Sachs Global Investment Research (2014-18E).

Complementary financial products to grow proportionally to net interest income

A key focus within complementary financial products will be the cross selling of life insurance products to mortgage clients. Virgin Money plans to launch products with strong links to the mortgage business, in particular life insurance and home/car insurance products. It has established a partnership regarding life insurance, which is ready to be launched shortly.

We forecast complementary financial products revenues to grow at a broadly similar pace as net interest income, at c.12% pa.

As the very nature of the business is a distribution agreement, we do not foresee any material increase in direct costs for this business on top of inflation.

Exhibit 56: Complementary financial products

Key financials, £ mn, unless specified otherwise

Complementary financial products	2011	2012	2013	2014E	2015E	2016E	2017E	2018E	14/13E	15/14E	16/15E	17/16E	18/17E	13-18E CAGR
Net interest income	-	-	-	-	-	-	-	-	–	–	–	–	–	–
Fees and commission income	28.3	32.4	33.2	36.4	42.5	48.8	53.0	57.4	10%	17%	15%	9%	8%	12%
Total income	28.3	32.4	33.2	36.4	42.5	48.8	53.0	57.4	10%	17%	15%	9%	8%	12%
Operating expenses	(9.7)	(9.8)	(13.6)	(12.1)	(12.3)	(12.5)	(12.8)	(13.1)	-11%	2%	2%	2%	2%	-1%
Cost/Income ratio	*34.3%*	*30.2%*	*41.0%*	*33.1%*	*29.0%*	*25.7%*	*24.1%*	*22.8%*	-8 pp	-4 pp	-3 pp	-2 pp	-1 pp	-4 pp
Pre-provision profit	18.6	22.6	19.6	24.3	30.2	36.3	40.2	44.3	24%	24%	20%	11%	10%	18%
Impairment costs	-	-	-	-	-	-	-	-	–	–	–	–	–	–
Pre-tax profit	18.6	22.6	19.6	24.3	30.2	36.3	40.2	44.3	24%	24%	20%	11%	10%	18%

Source: Virgin Money (2011-13), Goldman Sachs Global Investment Research (2014-18E).

Group central functions

Virgin Money currently does not allocate overhead costs to the various operating businesses, but instead reports them as a separate segment, Central Functions.

Virgin Money plans to increase the group head count from currently 2,800 to about 3,000, with much of the uplift likely to come in 2015, largely to support the broader business platforms in cards, current accounts and on-interest income. Accordingly, we expect the cost increase to be mostly front-loaded into 2H14 and 2015, and thereafter cost growth to flatten.

Exhibit 57: Central Functions key financials – We forecast higher costs owing to the planned increase in head count
£ mn, unless stated otherwise

Central functions	2011	2012	2013	2014E	2015E	2016E	2017E	2018E	14/13E	15/14E	16/15E	17/16E	18/17E	13-18E CAGR
Net interest income	1.4	-	-	-	-	-	-	-	--	--	--	--	--	--
Net interest margin (%)	-	-	-	-	-	-	-	-	--	--	--	--	--	--
Fees and commission income	0.0	30.6	6.4	8.2	0.0	0.0	0.0	0.0	28%	-100%	--	--	--	-100%
Total income	1.4	30.6	6.4	8.2	0.0	0.0	0.0	0.0	28%	-100%	--	--	--	-100%
Operating expenses	(70.9)	(158.8)	(148.6)	(174.5)	(193.1)	(201.9)	(210.1)	(215.3)	17%	11%	5%	4%	3%	8%
Cost/Income ratio	*nm*	*nm*	*nm*	*nm*	*nm*	*nm*	*nm*	*nm*	--	--	--	--	--	--
Pre-tax profit	(69.5)	(128.2)	(142.2)	(166.3)	(193.1)	(201.9)	(210.1)	(215.3)	17%	16%	5%	4%	3%	9%

Source: Virgin Money (2011-13), Goldman Sachs Global Investment Research (2014-18E).

We expect Virgin Money to achieve its mid-teens ROTE ambition

NIM to expand to 169 bp driven by larger card share and rising mortgage NIMs

We forecast Virgin Money's net interest margin to be broadly in-line with the medium-term target of 170 bp during 2017.

Cost income ratio to fall to 50%

We forecast Virgin Money to achieve its cost/income target of 50% by 2017E. While on a headline basis this does not strike us as particularly low compared to some industry peers, which already operate close to this level, one needs to consider the peculiarities of the Virgin Money model:

- **The funding model**, relying to a large extent on interest-bearing savings deposits and virtually no non-interest bearing current account deposits means that the top line, net interest margin, will be lower compared to its competitors.
- **Intermediaries costs taken out of revenues:** As it primarily relies on intermediaries to generate new business, the associated costs will also come off revenues owing to a lower margin/upfront fees payable of these loans.
- Consequently, as revenues are impacted by both funding and origination model, Virgin Money will **exhibit a higher cost/income ratio compared to its more classical branch based peers**. However, this is offset to some degree by a lower absolute level of fixed costs giving greater cost flexibility.

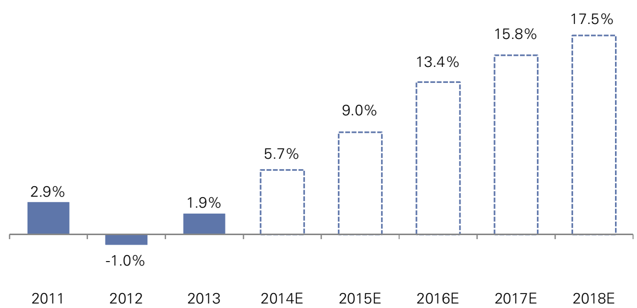
Forecast loan loss provisions in the range of 12-29 bp

In line with management guidance, we forecast loan loss provisions to initially decrease, from 16 bp in 2013 (excluding the £21.8 bn impairment charge related to the acquired credit card portfolio), and then to gradually increase to 29 bp, driven mainly by the larger credit card loan portfolio. The overall provisioning level of c.20 bp of loans is reflective of Virgin Money's profile as a largely mortgage lender.

Mid-teens ROTE and strong tangible book value formation

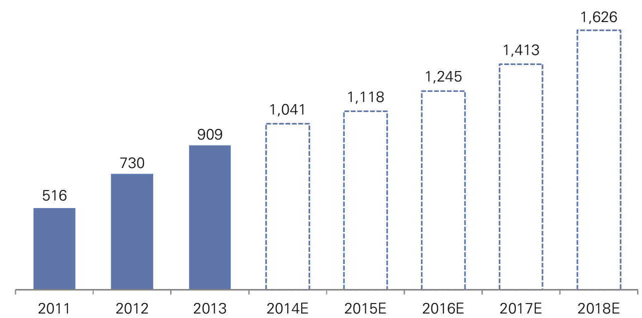
We forecast Virgin Money to reach a 16% ROTE by 2017E, in-line with company guidance of mid-teens in the medium term. Based on a 20% payout ratio, organic tangible book value progression is strong, at ~10% pa. Tangible book value formation is strong, as we do not forecast any material litigation charges.

Exhibit 58: We estimate VM to reach 18% ROTE in 2018E
GS ROTE, 2011-2018E %



Source: Goldman Sachs Global Investment Research.

Exhibit 59: Strong TBV formation
Tangible book value, 2011-2018E, £ mn



Source: Virgin Money (2011-13), Goldman Sachs Global Investment Research (2014-18E).

Exhibit 60: Group financials – Strong earnings growth driven by loan growth, margin expansion and operating leverage
Summary of our P&L and balance sheet forecasts, 2011 to 2018E, £ mn

Virgin Money Group - Key financials	2011	2012	2013	2014E	2015E	2016E	2017E	2018E	14/13E	15/14E	16/15E	17/16E	18/17E	13-18E CAGR
Net interest income	1.7	135.3	311.2	360.2	439.2	526.0	612.7	707.1	16%	22%	20%	16%	15%	18%
Net interest margin (%)	-	*0.68%*	*1.36%*	*1.47%*	*1.58%*	*1.64%*	*1.69%*	*1.75%*	11 bp	10 bp	7 bp	5 bp	6 bp	8 bp
Non-interest income	125.6	126.3	67.8	69.0	82.6	101.9	123.2	145.9	2%	20%	23%	21%	18%	17%
Total income	127.3	261.6	379.0	429.2	521.8	627.9	736.0	853.0	13%	22%	20%	17%	16%	18%
Operating expenses	(99.2)	(254.5)	(288.8)	(311.1)	(334.4)	(351.7)	(369.5)	(385.6)	8%	7%	5%	5%	4%	6%
Cost/Income ratio	*77.9%*	*97.3%*	*76.2%*	*72.5%*	*64.1%*	*56.0%*	*50.2%*	*45.2%*	-4 pp	-8 pp	-8 pp	-6 pp	-5 pp	-6 pp
Pre-provision profit	28.1	7.1	90.2	118.1	187.4	276.1	366.4	467.4	31%	59%	47%	33%	28%	39%
Impairment costs	-	(3.0)	(50.7)	(27.2)	(37.0)	(48.6)	(75.0)	(105.2)	-46%	36%	32%	54%	40%	16%
Impairment costs / loans (bps)	*0*	*2*	*27*	*13*	*15*	*17*	*23*	*29*	-54%	20%	14%	36%	25%	1%
FSCS levy	-	(6.7)	(13.4)	(16.6)	(16.6)	(16.6)	(16.6)	(16.6)	24%	0%	0%	0%	0%	4%
Pre-tax profit (before exceptionals)	28.1	(2.6)	26.1	74.2	133.8	210.9	274.8	345.6	184%	80%	58%	30%	26%	68%
Exceptionals	(4.6)	162.8	159.3	(56.5)	-	-	-	-	-135%	-100%	--	--	--	-100%
PBT (statutory)	23.5	160.2	185.4	17.7	133.8	210.9	274.8	345.6	-90%	655%	58%	30%	26%	13%
Tax	(10.5)	68.0	(6.4)	(17.4)	(26.8)	(42.2)	(55.0)	(69.1)	172%	54%	58%	30%	26%	61%
Interest/coupon on AT1 instruments	-	-	(15.7)	(11.2)	(10.1)	(10.1)	(10.1)	(10.1)	-29%	-10%	0%	0%	0%	-8%
Net Income	13.0	228.2	163.3	(10.9)	97.0	158.6	209.8	266.4	-107%	nm	64%	32%	27%	10%
GS Net Income	15.0	(7.2)	15.5	55.3	97.0	158.6	209.8	266.4	257%	75%	64%	32%	27%	77%
Dividends	-	-	-	-	(19.4)	(31.7)	(42.0)	(53.3)	--	--	64%	32%	27%	--
Payout ratio	*0.0%*	*0.0%*	*0.0%*	*0.0%*	*20.0%*	*20.0%*	*20.0%*	*20.0%*	0 pp	20 pp	0 pp	0 pp	0 pp	4 pp
Basic EPS (p)	6.3	59.3	42.4	-2.8	22.0	35.9	47.5	60.3	-106%	-897%	64%	32%	27%	7%
GS EPS (p)	6.9	-1.9	4.0	14.0	22.0	35.9	47.5	60.3	248%	57%	64%	32%	27%	72%
Shareholders' funds	535	765	935	1,075	1,153	1,280	1,447	1,660	15%	7%	11%	13%	15%	12%
Intangibles	19.0	34.8	26.0	34.2	34.2	34.2	34.2	34.2	32%	0%	0%	0%	0%	6%
Tangible book value	516	730	909	1,041	1,118	1,245	1,413	1,626	15%	7%	11%	13%	15%	12%
TBVPS (p)	133	188	235	236	253	282	320	368	0%	7%	11%	13%	15%	9%
GS ROTE	2.9%	-1.0%	1.9%	5.7%	9.0%	13.4%	15.8%	17.5%	4 pp	3 pp	4 pp	2 pp	2 pp	3 pp
CRD IV CET1 ratio (fully loaded)	-	-	15.3%	19.5%	15.2%	13.5%	12.9%	13.2%	4 pp	-4 pp	-2 pp	-1 pp	0 pp	0 pp
CRD IV Leverage ratio	-	-	3.70%	4.11%	3.86%	3.78%	3.81%	3.95%	41 bp	-25 bp	-8 bp	3 bp	13 bp	5 bp
Loans	-	16,769	20,386	22,730	26,277	30,078	33,954	37,740	11%	16%	14%	13%	11%	13%
Deposits	-	18,007	21,121	22,485	25,265	28,120	31,150	34,376	6%	12%	11%	11%	10%	10%
Loan to deposit ratio	-	93%	97%	101%	104%	107%	109%	110%	5 pp	3 pp	3 pp	2 pp	1 pp	3 pp

Source: Virgin Money (2011-13), Goldman Sachs Global Investment Research (2014-18E).

What could drive returns higher from here?

Over the long term, we see the following avenues for further improvement in returns:

- **Economies of scale:** Virgin Money's mortgage book in 2018E is still comparatively small, at £35 bn, c.2%-3% of total market. We believe the mortgage business has economies of scale, e.g., the larger the portfolio, the higher the returns. We note most large incumbents have mortgage books above £100 bn.
- **Current account funding**: The absence of current account deposits leads to higher funding costs for Virgin Money. We see the opportunity for Virgin Money to lower its funding costs via the acquisition or build-up of a sizeable current account book.

Valuation: Our 12m ROTE/COE based price target implies 11% upside potential

We value Virgin Money using the ROTE/COE approach which we use for European banks. We also cross check this fundamental approach against other banks' current trading levels. Our 12-month ROTE/COE based price target implies 11% upside potential.

We use a ROTE/COE approach

As a valuation methodology, we apply the ROTE/COE approach, which we generally use for our European banks coverage:

- **12-month-forward earnings**: The basis of our valuation is underlying earnings over the 12 months forward from the date of the valuation. For Virgin Money we use 2016E earnings.
- **ROTE/COE multiple**: We then derive the valuation multiple by dividing the return on tangible equity by our assumed cost of equity.
- **COE assumption**: For European banks, our COE assumptions range from 8% to 12%; we would assume a cost of equity for Virgin Money slightly above average, around 10.75%, owing to execution risks on the path to the mid-teens ROTE target, market risk in relation to mortgage net interest margins and the business risk (business largely focused on a single business line, mortgages).
- **Capital adjustment**: The final step in our valuation is to add on surplus capital to our valuation or deduct any capital shortfall. As we forecast Virgin Money's leverage ratio – its main capital constraint – to remain very close to its self-imposed target leverage ratio of 3.75% (Exhibit 46), we assume that there is no meaningful capital surplus or shortfall throughout the planning period (7p only).
- **Valuation:** As a final step, we determine the valuation by multiplying the ROTE/COE ratio with the tangible book value at the beginning of the respective earnings period, and adding capital surplus, if any.

We obtain a 12 month ROTE/COE based price target of 320p, a valuation of £1.41 bn, equivalent to 1.36x 2014E TBV.

Exhibit 61: Our 12-month ROTE/COE based price target implies 11% upside potential
GS valuation framework for Virgin Money

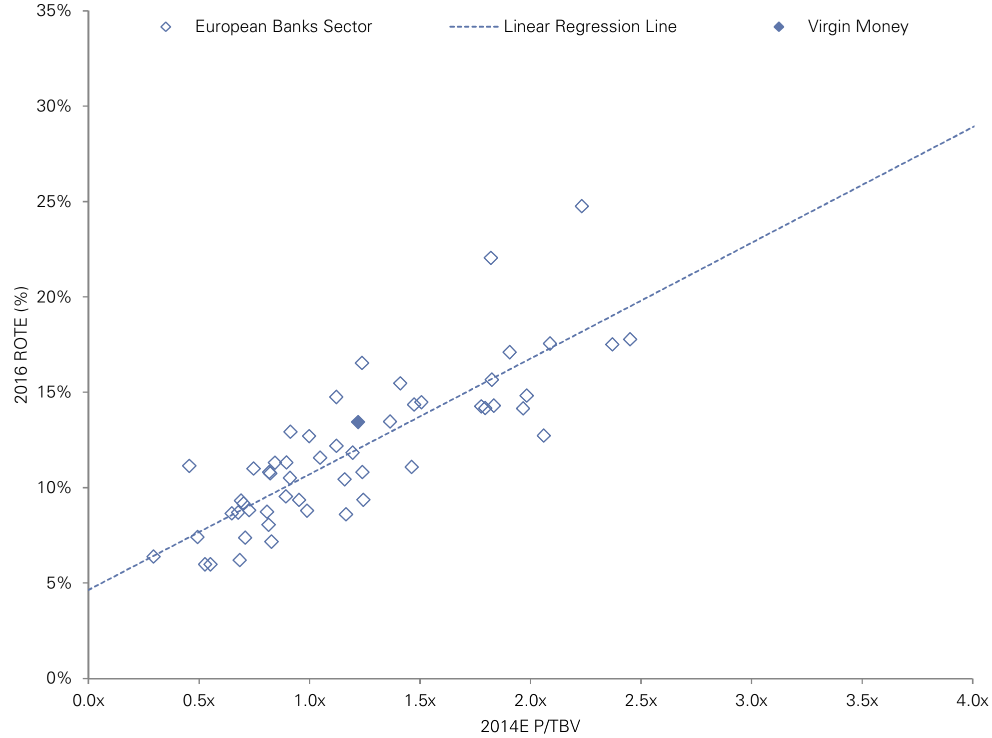
ROTE / COE model	
Month	12
TBV (12m fwd)	253.3
ROTE	13.4%
COE	10.75%
ROTE / COE implied P/TB	1.2x
Valuation before capital adjustment	316
Capital adjustment	7
Valuation after capital adjustment	320

Capital adjustment	2015E	2016E
CET 1 ratio	15.2%	13.5%
CET 1 threshold	12.0%	12.0%
Excess capital CET1 basis	3.2%	1.5%
RWA	6,640	8,428
Capital excess / deficit (CET 1)	215	128
Leverage ratio	3.86%	3.78%
Leverage threshold	3.75%	3.75%
Excess capital leverage basis	0.11%	0.03%
Leverage exposure	30,332	34,355
Capital excess / deficit (Leverage)	35	11
Excess	8	2
+ Dividend in 2015		4.4
Excess / deficit post div adjustment	8	7

Source: Goldman Sachs Global Investment Research.

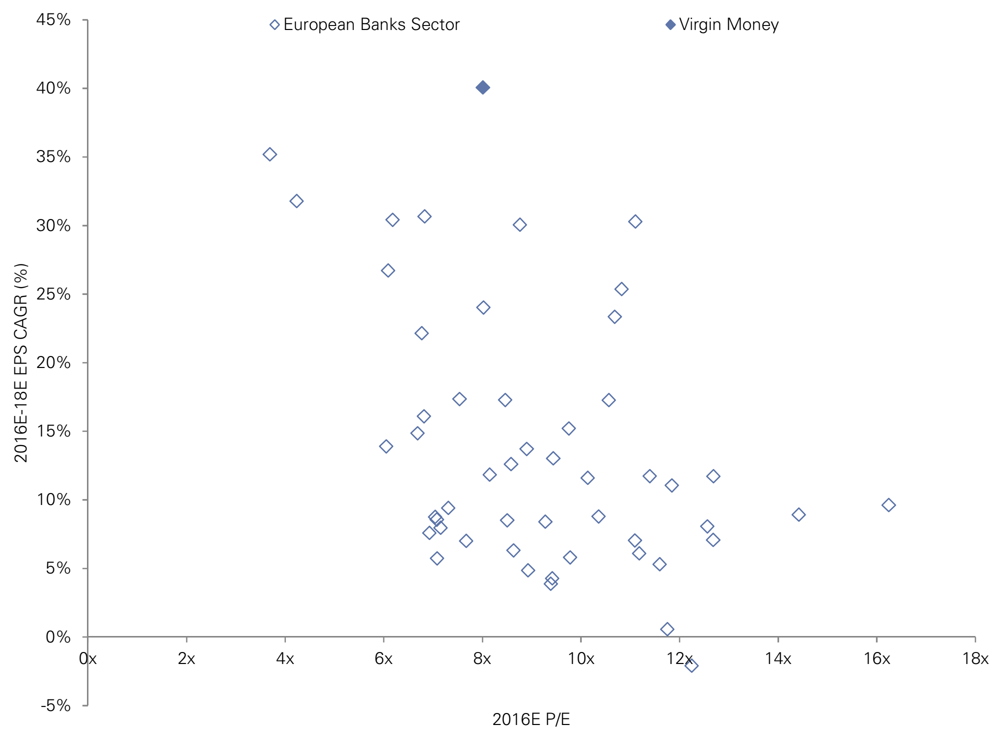
Exhibit 62 compares 2016E GS ROTE to 2014E P/TBV for European banks. It shows that our valuation lies broadly within the range implied by the regression.

Exhibit 62: Our valuation for Virgin Money compared to current market multiples
2016E ROTE (%) and 2014E P/TBV



Source: Goldman Sachs Global Investment Research.

Exhibit 63: Our valuation compared to the sector, putting growth in the mix
2016-18E EPS CAGR (%) vs. 2016E P/E for the European Banking Sector



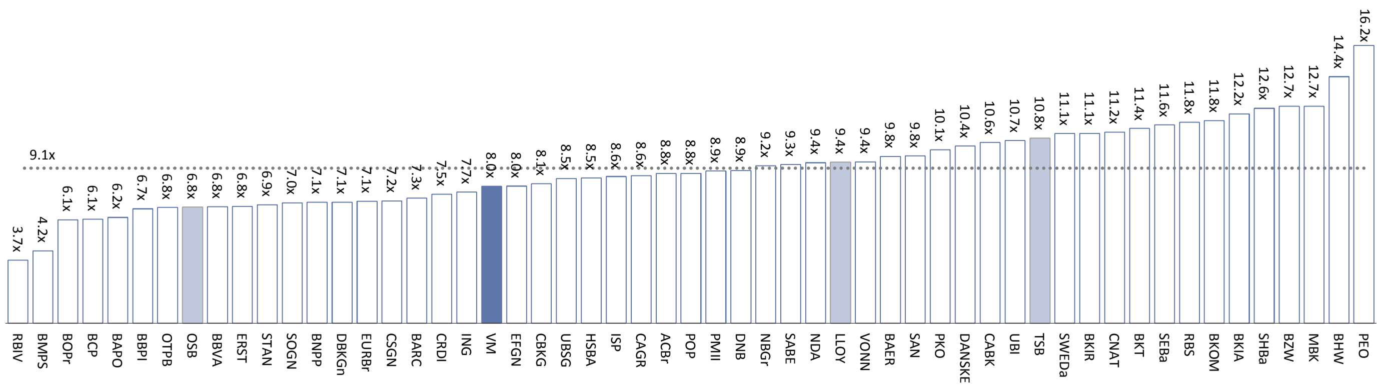
Source: Goldman Sachs Global Investment Research.

Comparing Virgin Money's valuation with European banking peer group

In the charts below we compare Virgin Money's valuation relative to earnings, tangible book value and dividend for the European banking sector.

Exhibit 64: Virgin Money's 8.0x 2016E P/E, broadly in line with European banking sector

2016E P/E

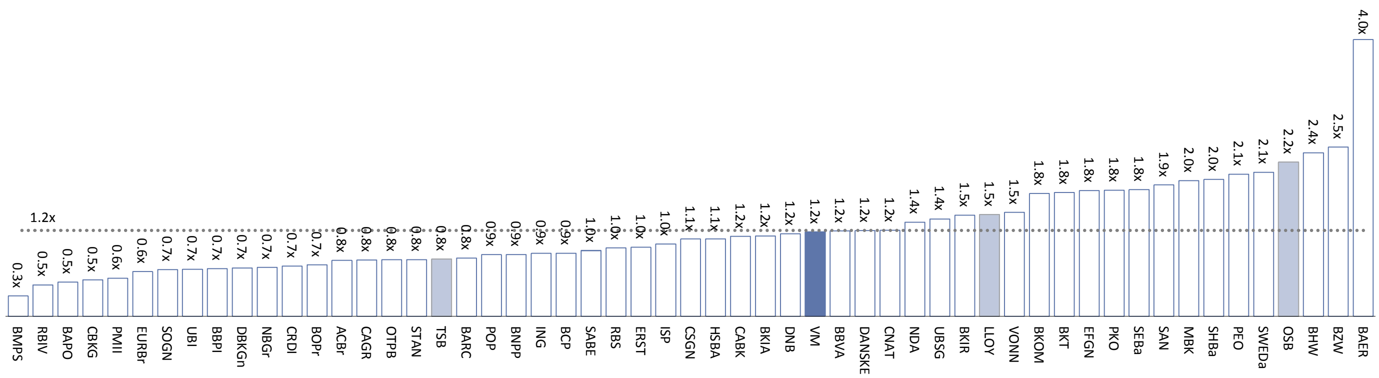


Consensus estimates for TSB and OSB as not covered

Source: I/B/E/S, Goldman Sachs Global Investment Research.

Exhibit 65: 2014E P/TBV of 1.22x in line with sector average…

2014E P/TBV

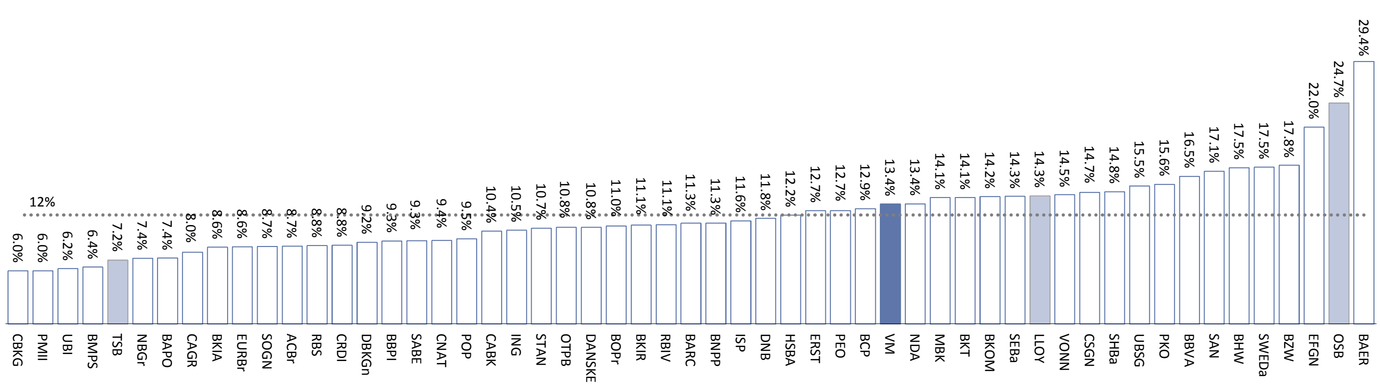


Consensus estimates for TSB and OSB as not covered

Source: I/B/E/S, Goldman Sachs Global Investment Research.

Exhibit 66: …driven by its slightly above sector average ROTE profile…

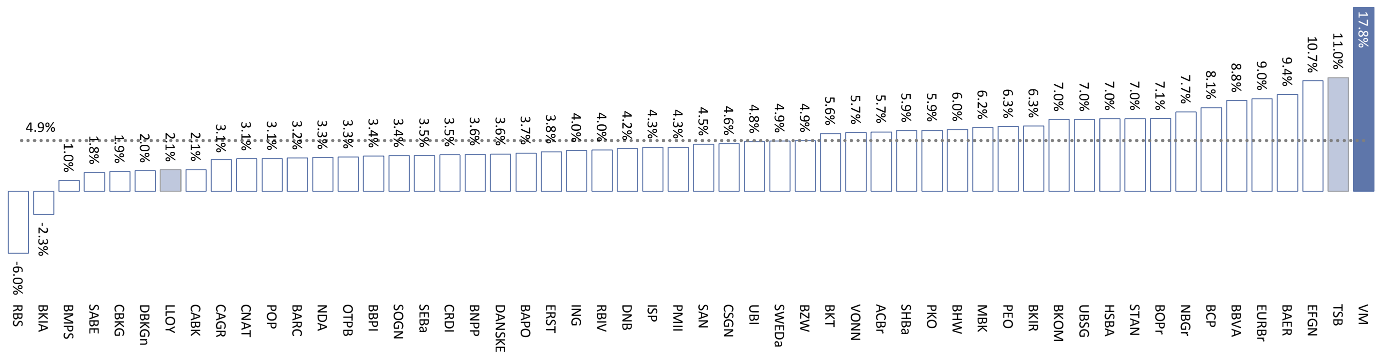
2016E GS ROTE (%)



Consensus estimates for TSB and OSB as not covered

Source: I/B/E/S, Goldman Sachs Global Investment Research.

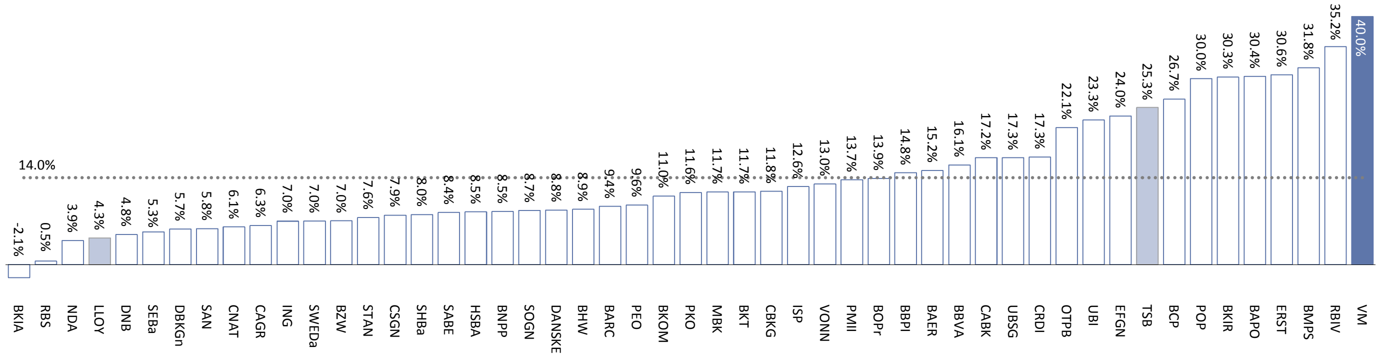
Exhibit 67: ...and its sector-leading revenue growth
2016-18E revenue CAGR (%)



Consensus estimates for TSB as not covered

Source: I/B/E/S, Goldman Sachs Global Investment Research.

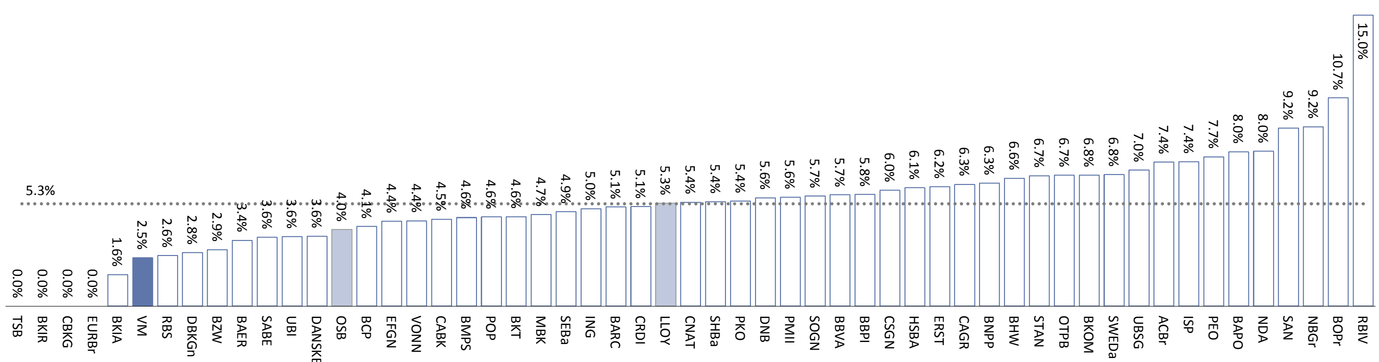
Exhibit 68: Operational leverage results in top-line growth filtering down to high EPS CAGR
2016E-2018E EPS CAGR (%)



Consensus estimates for TSB as not covered

Source: I/B/E/S, Goldman Sachs Global Investment Research.

Exhibit 69: Growth story means at lower end in terms of dividend yield
2016E dividend yield (%)



Consensus estimates for TSB and OSB as not covered

Source: I/B/E/S, Goldman Sachs Global Investment Research.

Risks include margin compression, regulation and house prices

Margin compression in mortgages

As discussed, we believe Virgin Money is likely to focus on loan growth and retention of existing mortgage clients, and as such is more likely to lower pricing in case of need. We see the risk that net interest margins on mortgages could decrease as a result of (1) competitive dynamics, as a number of market participants (e.g. HSBC, RBS, Nationwide) have indicated their desire to expand market share; this is particularly relevant for Virgin Money, as it is a price taker both on the asset side (mortgages) and on the liability side via its saving deposits funding base and it does not benefit from a probably less price sensitive current account deposit base, and (2) rising interest rates which might impact affordability and with that the ability of the banks to pass through rates rises to borrowers in full, potentially negatively impacting margins.

Regulation

We believe the main risk on the regulatory side for Virgin Money is the introduction of the leverage requirement in the UK. Uncertainty remains as to the final leverage ratio requirement for ring-fenced banks that Virgin Money will face. More stringent than expected requirements could have a substantial negative impact on Virgin Money (owing to its low average risk weight given its business mix) and severely impact its business plan and growth ambitions. A more benign outcome is an upside risk.

Deteriorating house prices

House prices in the UK are approaching previous peak levels, with a price to average annual earnings ratio of more than six times, still lower than the 2007 peak of more than seven times (source Bank of England Financial Stability Report June 2014). In London, which accounts for 27.4% of Virgin Money's loan book, the house price to earnings ratio now exceeds previous peak levels. The main risk going forward is a sharp deterioration in UK house prices, e.g., driven by higher interest rates, reduced affordability, in particular in London.

A significant decline in house prices would lead to lower asset recovery values in the event of borrower defaults, and hence result in higher loan impairments and lower profitability, potentially also affecting capital and tangible book values.

Interest rate risk

There are numerous ways in which interest rates affect Virgin Money's business. One of the main risks of a rising interest rate environment is that higher rates, if not followed by increases in disposable incomes, could result in an increase in loan defaults, as customers might no longer be able to afford mortgage/loan payments. Also, higher interest rates could affect loan demand, as customers are less able to borrow.

Acquisitions

An upside risk for Virgin Money would be the opportunity to acquire lending businesses or portfolios (e.g. SME, personal loans) or a significant current account book were it to allow the company to achieve significant scale in the market. We have not assumed any purchases in our forecasts .

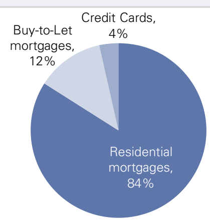
Appendix: Comparison with other challenger banks

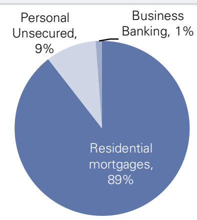
Exhibit 70: Virgin Money compared to TSB, Aldermore and OneSavings Bank

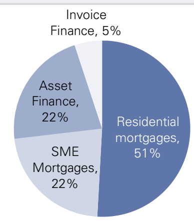
Key data for Virgin Money, TSB and Aldermore – Consensus estimates used for TSB and OneSavings as not covered. ROTE for TSB and OneSavings calculated as EPS/Average TBVPS using consensus estimates for both. Note gross loans shown for Virgin Money, TSB and OneSavings; net loans shown for Aldermore

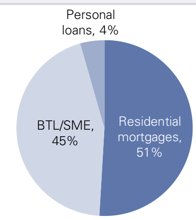
1H14 £ mn, unless otherwise stated	Virgin Money	TSB	Aldermore	OneSavings
History	Founded in 1995 Acquired bank formerly known as Northern Rock in 2012	Launched in 2013 after EC mandated divestment from Lloyds.	Launched in 2009 Offers savings, mortgages and commercial finance to SMEs and retail customers	Formed in 2011 Specialist retail and commercial lender
Geographic Focus	Solely lends in the UK; geographically diversified within the UK.	Most significant exposures in Scotland, London and the South East.	Most exposed to London, the South East and the North West.	Branches only in Southern England; lending more diversified across the UK
Branches	75	631	0	6
Loans	£21.1bn	£22.6bn	£4.0bn	£3.5bn
Deposits	£21.1bn	£23.7bn	£3.9bn	£3.6bn
Total Assets	£24.1bn	£26.5bn	£4.8bn	£4.2bn

Loan Book Composition









	Virgin Money	TSB	Aldermore	OneSavings
CRD IV CET1 Capital Ratio (%)	14.4%	18.2%	10.9%	11.0%
Leverage Ratio (%)	3.8%	5.9%	5.0%	4.0%
ROTE (%)				
2014E	5.7%	6.6%	--	23.4%
2015E	9.0%	5.6%	--	25.2%
2016E	13.4%	7.2%	--	24.7%
2016E-18E EPS CAGR (%)	40.0%	25.3%	--	--
Valuation Multiples	**Virgin Money - GS Estimate**	**TSB - Consensus**	**Aldermore**	**OneSavings - Consensus**
P/TBV				
2014E	1.22x	0.83x	--	2.23x
2015E	1.14x	0.80x	--	1.84x
P/E				
2015E	13.1x	14.5x	--	8.0x
2016E	8.0x	10.8x	--	6.8x
Dividend Policy	Inaugral dividend expected in respect of FY15 Initial payout ratio of 10-20%	Inaugral dividend expected in respect of FY17 Expects 40-60% payout ratio	Will consider paying an initial dividend from 2017, depending on growth opportunities	Initial dividend expected in respect of FY14 Targeting at least a 25% payout ratio

Source: Virgin Money (1H14), Goldman Sachs Global Investment Research for Virgin Money (2014E-18E), respective companies' data, I/B/E/S for TSB and OneSavings (2014E-18E).

Disclosure Appendix

Reg AC

We, Martin Leitgeb, CFA, Nick Baker and Jacqueline Cheung, hereby certify that all of the views expressed in this report accurately reflect our personal views about the subject company or companies and its or their securities. We also certify that no part of our compensation was, is or will be, directly or indirectly, related to the specific recommendations or views expressed in this report.

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Investment Profile

The Goldman Sachs Investment Profile provides investment context for a security by comparing key attributes of that security to its peer group and market. The four key attributes depicted are: growth, returns, multiple and volatility. Growth, returns and multiple are indexed based on composites of several methodologies to determine the stocks percentile ranking within the region's coverage universe.

The precise calculation of each metric may vary depending on the fiscal year, industry and region but the standard approach is as follows:

Growth is a composite of next year's estimate over current year's estimate, e.g. EPS, EBITDA, Revenue. **Return** is a year one prospective aggregate of various return on capital measures, e.g. CROCI, ROACE, and ROE. **Multiple** is a composite of one-year forward valuation ratios, e.g. P/E, dividend yield, EV/FCF, EV/EBITDA, EV/DACF, Price/Book. **Volatility** is measured as trailing twelve-month volatility adjusted for dividends.

Quantum

Quantum is Goldman Sachs' proprietary database providing access to detailed financial statement histories, forecasts and ratios. It can be used for in-depth analysis of a single company, or to make comparisons between companies in different sectors and markets.

GS SUSTAIN

GS SUSTAIN is a global investment strategy aimed at long-term, long-only performance with a low turnover of ideas. The GS SUSTAIN focus list includes leaders our analysis shows to be well positioned to deliver long term outperformance through sustained competitive advantage and superior returns on capital relative to their global industry peers. Leaders are identified based on quantifiable analysis of three aspects of corporate performance: cash return on cash invested, industry positioning and management quality (the effectiveness of companies' management of the environmental, social and governance issues facing their industry).

Disclosures

Coverage group(s) of stocks by primary analyst(s)

Martin Leitgeb, CFA: Europe-Pan-Euro Banks.

Europe-Pan-Euro Banks: Alpha Bank, Arrow Global Group, Banca Monte dei Paschi di Siena, Banca Popolare di Milano, Banco BPI, Banco Comercial Portugues, Banco Popolare, Banco Popular Espanol, Banco Sabadell, Banco Santander, Bank Handlowy, Bank of Ireland, Bank of Piraeus, Bank Pekao, Bank Zachodni WBK, Bankia, Bankinter, Barclays plc, BBVA, BNP Paribas, CaixaBank SA, Commerzbank AG, Credit Agricole SA, Credit Suisse, Danske Bank, Deutsche Bank, DNB, EFG International, Erste Bank, Eurobank Ergasias SA, HSBC, ING Groep N.V., Intesa Sanpaolo, Julius Baer Group, KBC Group NV, Komercni Banka, Lloyds Banking Group Plc, Mbank, National Bank of Greece, Natixis, Nordea, OTP Bank Plc, PKO BP, Provident Financial, Raiffeisen Bank International, Royal Bank of Scotland, SEB, Societe Generale, Standard Chartered, Svenska Handelsbanken, Swedbank, UBI Banca, UBS Group AG, UniCredit, Virgin Money Holdings, Vontobel.

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	Rating Distribution			Investment Banking Relationships		
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