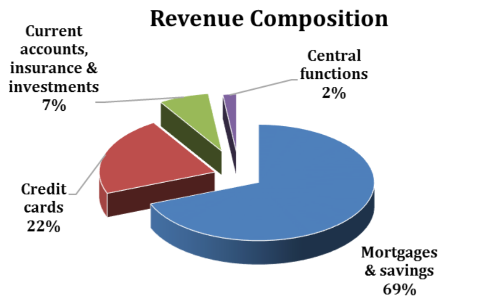
VIRGIN MONEY: (7.875% 07/29/49)

Sector: Financials, Banks

(At1 capital instruments)

Type	Convert to Equity
Conversion at Stock Price	£ 2.96
If CET1 ratio falls below:	7%
MDA trigger (HY2016)	8.3%
Current CET1 ratio (30/06/16)	15.3%
Year End CET1 ratio (31/11/16)	17.5%



Company Description

The Virgin Money Group is a UK based retail only bank and is primarily focused on providing residential mortgages, savings and credit cards, along with a range of financial products including investments and insurance. The Virgin Money Group's approach to banking reflects its corporate ambition of making "everyone better off". Virgin Money commenced operations as Virgin Direct in 1995, initially offering personal equity plans (known as PEPs) and later personal pensions, ISAs and various forms of insurance.

SWOT

Strength	Weaknesses
- Stable bank, relatively safe. - Currently experiencing historically low loss experience in residential mortgage portfolio. - Loan over three months arears 0.16% of book. - High coupon rate of 7.875%	- Falling CET1 ratio, lowest in three years. - RWA assets increasing way higher than common equity tier 1 capital. - As you move towards the CET1 ratio, volatility in at1 bond prices.
Opportunities	**Threats**
- Strong demand for mortgage and credit cards. - Brexit seems helpful rather than hurting.	- MDA calculation is complex & management avoided the question in recent analyst call. - Total Debt/T. Equity ratio higher than peers.

Analyst Role

The analyst's input is three-fold and a bit different than the normal bond valuation. Normal bond has cashflows printed on it and analyst must discount them till maturity & off course that also includes a second -and most vital- judgment on certainty of business going forward. Cocos add more to that role since regulatory considerations must be included to the analysis. Firstly, one must determine the general direction of the issuer's CET1 ratio. In our case, management forecasts minimum of 12% which indicates that CET1 ratio is well expected to fall -in the short run- from the current 15.3%. Secondly, one must determine whether required capital buffer requirements are met and if not, then besides the "trigger" scenarios, coupon payment is also not certain. For that, even more complicated measure of Maximum Distributable Amount (MDA) must be calculated. So, the coco analyst has to figure out the general going concern value of business, its capital ratio and its MDA trigger ratio which if breached -in case of losses - results in restrictions on the payments that a bank can make. Consider Virgin Money, all portfolios are experiencing strong growth, meaning RWA's (denominator) are increasing faster than the CET1 capital (numerator), CET1 *ratio* is falling, the company now indicates MDA trigger around 8.3% which is also guided to be at worst at 9.2% giving a ~ 3% headroom for management when compared against the lowest CET1 ratio *can fall per management;* 12%

AT1 CLASS: CHEAP

Price (23-11-16)	95.53
52 weeks High	100.91
52 weeks Low	86.84
Principle Amount (m)	£ 230
Integral Multiple	£ 1000
Transfer Minimum (m)	£ 0.2
YTM:	Perpetual
ISIN:	XS1090191864
Currency:	British Pound
Home Market:	Luxembourg

CREDIT RATING

Issuer	Fitch
Short Term	F2
Long Term	BBB+
Outlook	Stable
Last Affirmed	3/10/2016

AT1 SPECIFIC

(m)	
Pre-2016 at1 value	160
At1 interest paid (2015)	12,6
Current at1 value	360
Future At1 interest payable	30,7
PBT for year 2015	138

EQUITY SPECIFIC

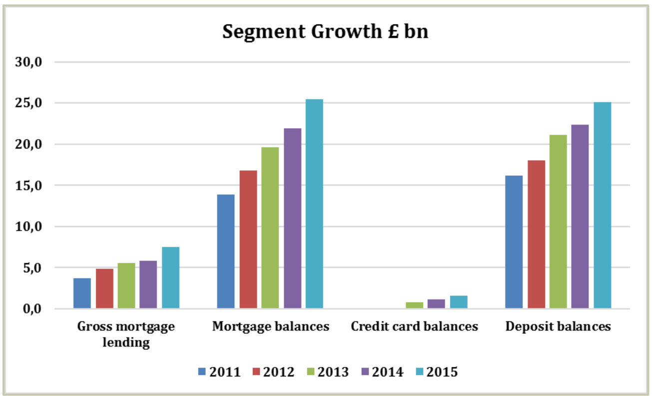
S. Price *p*. (23-11/16)	323
Market Cap. (£ bn)	1.42
P/E ratio (TTM)	11.34
P/B value (MRQ)	1.04

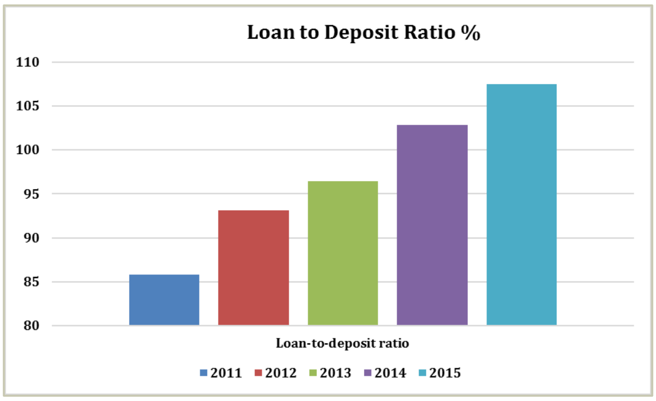
Investment Summary

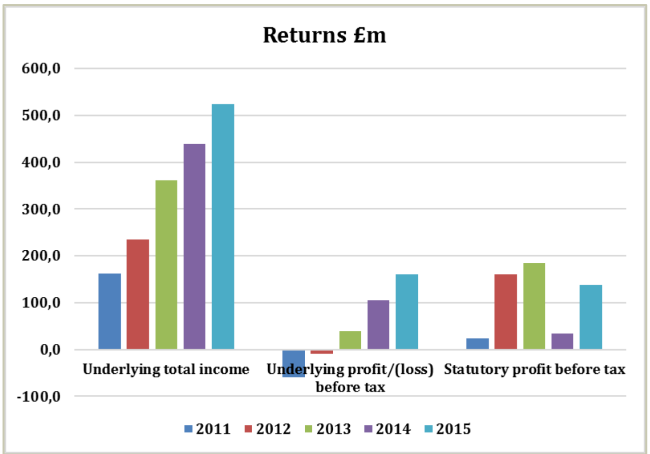
The tier1 capital ratio (7% in this case) which under all circumstances must not be breached is scheduled to fall from current levels but management forecasts a floor of 12%. Secondly, the MDA trigger was recently indicated at 8.3% and worst case scenario of 9.2%, which still gives around 3% of capital excess comparing to CET1 low of 12%. The business is seeing strong demand across all operations with quality of loans relatively high and historically low loss experience in residential portfolio. Business and the coupon do seem certain (at least for a year) as the only volatility in bond price will be due to falling CET1 ratio as RWA increase. Virgin Money's CET1 ratio is falling but underlying business is still doing fine where quality of mortgages is still high. I do think that the at1 bonds in this case are relatively safe and provide a good coupon, plus price return incase business momentum continues, especially if forecasted profit before taxes are higher and stable.

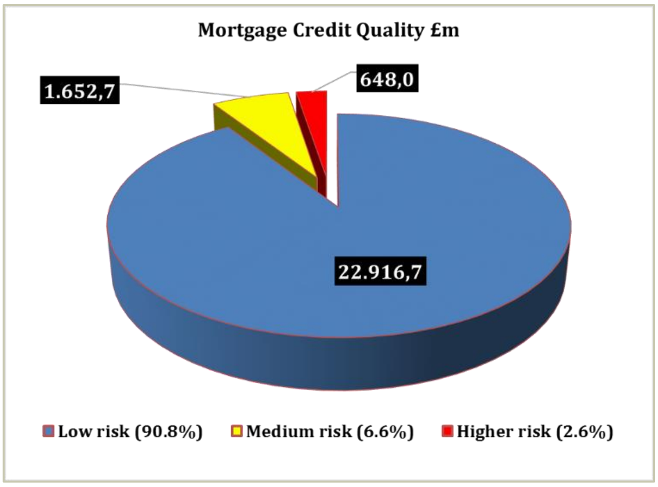
Company Revenues & Specifics Source: Annual Report/Company Website

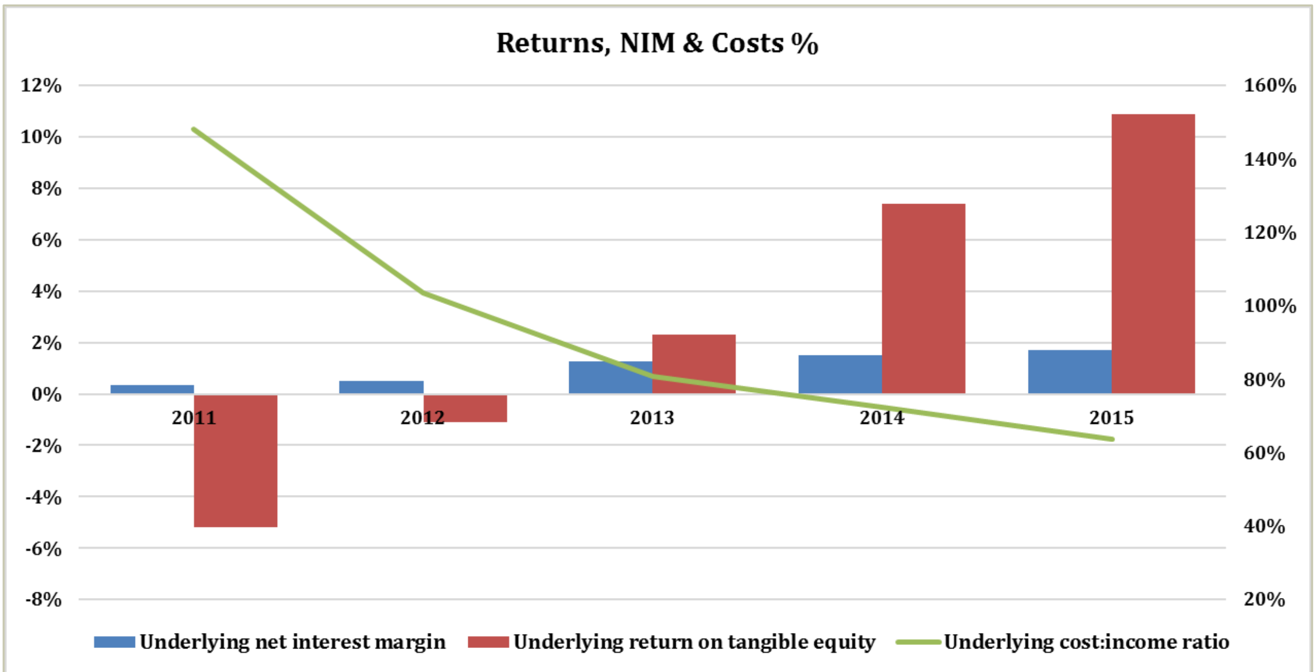
- All segments posting growth as loan to deposit ratio crosses 100%.
- Return on tangible equity increasing, NIM's stable and costs falling.
- Bank does appear to be in a stable shape.











Company Capital Ratios

VIRGIN MONEY GROUP
2016 HALF-YEAR RESULTS

STRONG CAPITAL STRUCTURE

Capital ratios and risk-weighted assets

		At 30 Jun 2016	At 31 Dec 2015	Change
Common Equity Tier 1 capital (CET1)	£ million	**1,128.1**	1,070.0	**5.4%**
Risk-weighted assets (RWAs)	£ million	**7,377.8**	6,110.4	**20.7%**
Common Equity Tier 1 ratio	%	**15.3**	17.5	**(2.2)pp**
Tier 1 ratio	%	**17.4**	20.1	**(2.7)pp**
Total capital ratio	%	**17.5**	20.2	**(2.7)pp**
Leverage ratio	%	**3.8**	4.0	**(0.2)pp**

Note: inclusive of verified profits for H1 2016

The continued growth in our mortgage and credit card balances, and the resulting increase in RWAs, was the main driver behind the reduction in our CET1 capital ratio to 15.3 per cent at the end of the first half from 17.5 per cent at the end of 2015. The 20.7 per cent growth in RWAs was partly offset by a 5.4 per cent increase in CET1 capital.

Our total capital ratio was 17.5 per cent at the end of June 2016, down from 20.2 per cent at the end of 2015, due to the same drivers as the reduction in CET1 capital ratio.

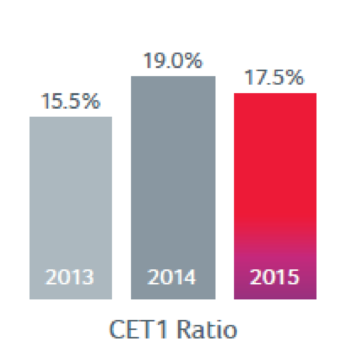
As a consequence of the increase in leverage ratio eligible assets our leverage ratio was 3.8 per cent at the end of the first half, compared to 4.0 per cent at the end of 2015.

CAPITAL ADEQUACY

The Virgin Money Group's capital position under CRD IV is set out in the table below:

	30 June	31 December	
	2016*	2015	2014
Issuer			
Common Equity Tier 1 ratio	15.3%	17.5%	19.0%
Tier 1 ratio	17.4%	20.1%	22.0%
Total capital ratio	17.5%	20.2%	22.1%
Leverage ratio	3.8%	4.0%	4.1%

* unaudited



Explanation

- CET1 ratio has been falling due to RWA increasing *more* than the CET capital. Primary reason has been extensive business demand and moreover company mentions that extremely high real estate prices for UK also lead to recalibration of models, thus further increasing RWA and reducing the resulting CET1 ratio.

Reporting Quality

Reporting	Extensive
Auditor's Opinion	KPMG: Unmodified (Pass)
ESG & Sustainability reporting	Average but good for a mid-tier bank.
Quantitative Identification of all resource usage (water, energy etc.)	✓
Usefulness of ESG metrics in current scenario?	Not much. Even as a mid-tier bank, company does plays an effective role in ESG monitoring. Goals include Zero green House Gas (GHG) emissions by 2030 & finalizing a transparent defining methodology for GHG emissions by 2016. Actual metrics reported indicate towards a rising waste production and the need to come up a clear ESG blue print of rules of engagement with its suppliers.