

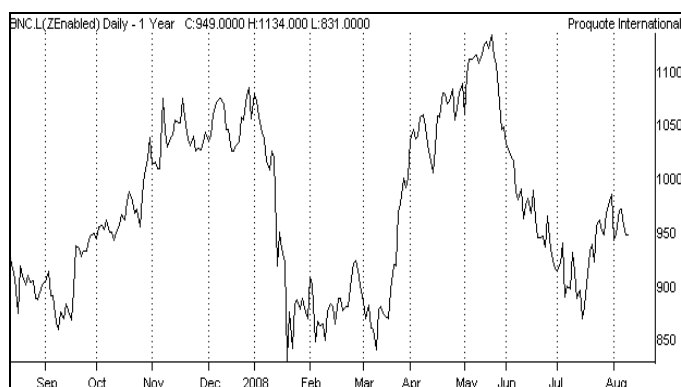
# Santander (LSE: BNC)

**Sector: European Banks Price: 954p (EUR 12.15) MktCap £59.7bn**



Santander adapted to the new cycle earlier than the majority of its peers. It is focused on credit quality, stability and balance sheet strength rather than asset expansion and market shares. That shift in business policy lies behind the increases in profitability, efficiency and margins. The Bank is sufficiently confident of continuing growth in after-tax earnings in the current year and further steady progress beyond.

- Santander achieved a pre-tax profit increase of 15% to EUR 6,099m (EUR 5,305m and 22% in attributable profit of EUR 4,730m (EUR 3,876m).
- Higher profits were achieved through growth of revenues substantially greater than costs (in excess of 11 ppts) and despite a rise in loan loss provisions.
- In contrast to many UK banks, zero exposure to the sub-prime market has avoided write-downs and kept the balance sheet strong.
- In Spain, good profit increases were gained by both Santander's branch networks which continue to attract customers and deposits.
- Latin America continued to show excellent profit increases. Although interest rates have risen to counter inflation, the region is still expected to show 4% GDP growth. *Banco Real* will strengthen the Group's position in Brazil.
- The difficult conditions prevailing in the UK put the focus on old fashioned safe and steady banking; Santander already occupies this space.



Official List Ticker: BNC.L  
[www.santander.com](http://www.santander.com)  
 Shares in issue: 6,254.3m  
 Diluted: 6,690.6m  
 Bk value/share: EUR 8.31  
 Nxt news: Q3 figs 28 Oct 08  
 Yr Hi/Lo (£): 1134p – 831p  
**Tony Cooper 13 Aug 2008**

Y/e 31 <sup>st</sup> Dec	Inc. pre- tax* EUR m	Net Income* EUR m	Tax EUR m	Tax rate %	EPS* EUR	PE x	Div EUR	Yield %
2006	8,622	6,582	1,947	22.6	1.053	11.5	0.52	4.3
2007	10,910	8,111	2,392	21.9	1.279	9.5	0.65	5.3
2008E	<i>Forecasts subject to change after results</i>							
<i>* Excluding extraordinary items.</i>								

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## Managing for change

*Strong results and confident outlook*

All UK-based banks, and the foreign owned with an international reach such as Santander, have adapted their business models to accommodate the pressures on their capital ratios. Santander moved more swiftly than most despite having a lesser need. The Bank has been more conservative than others, but combined this with an opportunist approach which has enabled it grow profits at a faster rate than its peers. Indeed, in April 2008, Santander stated that ...'we remain confident about our ability to outgrow our rivals by at least 5 pts a year' and achieve 15% compound annual EPS growth in 2008 - 2009. (Morgan Stanley Banks Conference). This of course reckoned on the ABN AMRO contribution but not Alliance & Leicester if that deal is completed.

*First interim dividend growth of 10%*

The first instalment of this performance looked very satisfactory. In the half year to 30<sup>th</sup> June 2008, Santander achieved attributable profit growth of 22% to EUR 4.730m (EUR 3.876m) and EPS growth of 14.3%. The difference between the two growth rates being the conversion of the *Valores Santander* bond issue, EUR 7bn, in October 2007. A first interim dividend for 2008 has been declared of EUR 0.1352, a rise of 10%. Santander pays dividends quarterly in sterling. The fourth and final dividend is usually larger and paid in May of the following year. The payout ratio is 50% of EPS.

This update is in three parts:

1. A summary of comments by the UK banks sector following their first half results.
2. Santander's first half figures.
3. Summary and conclusions.

## UK banking sector round up

*Focus has shifted towards capital strength*

Coverage of the sector has been focused on:

- Capital ratios and balance sheet strength
- Asset quality (in the context of risk management)
- Liquidity (sources and costs of funding)
- Efficiency and cost to income ratios
- Dividend issues – whether maintained or cut and cash versus shares

This period has been in sharp contrast to earlier ones when achieved profits and market shares were the main determinants of good performance. Santander compares well on almost all counts as shown by the ratios presented overleaf.

UK banks are either predominantly UK focused (HBOS, Lloyds TSB, Northern Rock, Alliance & Leicester) or international in scope (Barclays, HSBC, RBS and Standard Chartered). This makes for more difficult comparisons. Santander should be judged against the latter more than the former except that it is largely a retail bank (77% of pre-tax profits). Its UK subsidiary, Abbey, has a closer affinity to the former group.

*Building Society gaining deposits*

A feature of the UK retail savings market, about which seemingly little attention has been paid, is the presence of the building societies. Whilst attention has focused on the banks and their problems, the building societies have been increasing their share of deposits and will continue to be a competitor without having to worry about shareholders and the need to pay dividends. The Building Societies Association (BSA) reported that in the first six months of 2008, member societies' new savings inflows were £6.3bn, a rise of 63% from £3.86bn in H1 2007. On the other side of the coin, a fall of 60% in lending occurred, from £8.43bn to £3.45bn, as societies have protected the quality of their loan books by restricting their loans.

*Santander shows up well v. UK peers*

Among the major UK banks, apart from Standard Chartered, all results were deeply affected by the impact of write-downs. Underlying progress was not easily detectable, in sharp contrast with Santander. The latter also stands out well for efficiency as measured by the cost income ratio, only Alliance & Leicester having a superior ratio though this is for its retail banking side only. While there is substantial variability in the ratios due to differences in the business mix of each bank, Santander also does well in its return on equity.

	PBT dec./incr. %	Attrib prft dec./incr. %	Div dec./incr. %	Cost/Inc %	ROE %	NAV p	P/NAV*
Alliance & Leicester (1)	-99	-87	-4	38.8 (1)	n.a.	307	1.12
Barclays	-33	-35	no change	56.0	14.9	339	1.08
HBOS	-51	-57	-63	49.6	10.3	502	0.66
HSBC (2)	-22	-22	6	51.0	12.1	516	1.66
Lloyds TSB (3)	-70	-63	2	46.6	10.0	187	1.70
RBS (4 and 5)	-	-	n/a	48.2	12.2	382	0.63
Standard Chartered	31	30	11	56.4	17.8	744	2.15
Average	<b>-41</b>	<b>-39</b>	-	<b>49.5</b>	12.9	-	
<b>Santander</b>	<b>15</b>	<b>22</b>	<b>10</b>	<b>40.4</b>	<b>18.6</b>	<b>671</b>	1.42

Notes:  
1. Retail Banking only.  
2. Reports in US\$, and profit figures exclude dilution gains in H1 2007.  
3. Statutory basis.  
4. Change is from profit to loss.  
5. Interim div in form of capitalisation issue - 1 new share for every 40 held and in line with H1 2007.  
6. Converted at US\$1.92=£1.  
\* Share prices at close 8 August.

*Balance sheets strengthened...*

Looking first at capital ratios, three UK banks have had recourse to new equity to support their capital ratios (RBS, HBOS and Barclays). That has brought them into line under the new requirements of Basel II, now applicable throughout the Eurozone. The table overleaf shows the pattern. After the rights issues, all banks now have robust capital ratios, although maintaining these depends on subsequent market developments. A deterioration of credit quality, and rise in non-performing loans, would weaken balance sheets.

*...and liquidity is also a problem*

It has been reported that regulators in the US are now pressing the major banks to run tests on their balance sheets to see how they would fare in a liquidity shortage or sudden downturn in capital markets and urged them to make frequent checks on their liquidity positions.

	Core Tier 1 %	Total capital ratio %	Basel II RWA £bn
Alliance & Leicester	6.5	13.3	22.3
Barclays (1)	6.3	12.6	352.7
HBOS (2)	6.5	12.2	331.6
HSBC	7.7	11.9	618.2
Lloyds TSB	6.2	11.3	153.9
RBS (2)	5.7	13.1	491.7
Standard Chartered	6.1	14.9	103.0
<b>Average</b>	<b>6.4</b>	<b>12.8</b>	<b>296.2</b>
<b>Santander</b>	<b>6.3</b>	<b>11.4</b>	<b>365.8</b>
Notes:			
1. Pro forma June 2008 figure			
2. Includes the rights issue			

*Impact of  
BIS I  
virtually  
zero*

Santander has one of the strongest capital ratios with surplus equity equal to nearly EUR 16bn. The adoption of Basel II was effective from 10<sup>th</sup> June and the impact on Santander was virtually zero compared with the former computed BIS I ratios.

### Santander – H1 Results Highlights

Key components of the Income Statement - half year ended 30 June			
Figures in EUR million	2007	2008	Change (%)
Net interest income	7,414	8,490	+14.5
Gross operating income	12,986	15,080	+16.1
Operating expenses	(5,906)	(6,174)	+4.5
Net operating income	7,048	8,853	+25.6
Loan loss provisions	(1,498)	(2,475)	+65.3
<b>Income before taxes</b>	<b>5,305</b>	<b>6,099</b>	<b>+15.0</b>
Corporate income tax	(1,223)	(1,109)	(9.3)
Tax rate (%)	23.1	18.2	-
<b>Income after tax</b>	<b>4,082</b>	<b>4,990</b>	<b>+22.2</b>
<b>Net consolidated income</b>	<b>4,145</b>	<b>4,992</b>	<b>+20.4</b>
<b>Attributable income</b>	<b>3,876</b>	<b>4,730</b>	<b>+22.0</b>
Extraord. gains & write-downs	582	-	(100)
<b>Attributable income</b>	<b>4,458</b>	<b>4,730</b>	<b>+6.1</b>
Ordinary EPS (w/o cap gains)*	0.62	0.71	+14.3
<b>First interim div per share</b>	<b>0.1229</b>	<b>0.1352</b>	<b>+10.0</b>

*Fig's include a contribution from ABN AMRO, net attrib. profit of EUR 291m.  
The calculation of EPS for 2008 includes the conversion into shares of EUR 7,000m of convertible bonds (Valores Santander) issued in October 2007.*

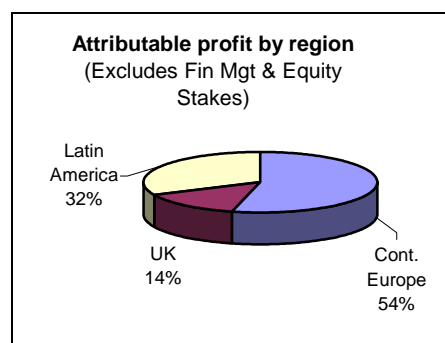
- **Balanced performance:** All geographical areas performed well with net attributable profit growth rates of +13% from the main units in Continental Europe, +20% in the UK, and Latin America +13%. (The latter on a like-for-like basis excluding the pension business sold in 2007 and in US\$).
- **Improved profitability:** focus on improvement of margins (spreads) through more selective lending growth. Loans grew more slowly than deposits.
- **Efficiency:** Across the Group, revenues rose over 11 ppts faster than costs. The efficiency ratio improved 4 ppts to 40.4%, one of the best among UK rivals, and Santander believes that it has not

even scratched the surface yet.

- **Provisions:** A 65% rise in impairment provisions to EUR 2.54bn (EUR 1.52bn) was largely cushioned by a strong (+16%) rise in net operating income. The main increases were in Spain (EUR 411m) and in Latin America (EUR 538m) due to credit expansion and changes in the mix.
- **High comfort zone:** Santander has a cushion of over EUR 10bn of provisions, of which EUR 6bn is generic and available for release if required.
- **Non-performing loans:** NPLs across the Group rose from 0.83% to 1.34%, but lower than the European bank average whilst NPL coverage is nearly double the average. Direct comparisons are more difficult because of the mix of business.
- **Capital strength:** Santander has maintained strong balance sheet ratios with core capital of 6.3% and Tier 1 11.4% under Basel II.

## The economic climate

Prospects for the global economy have deteriorated. For Santander, the key regions are the Eurozone and Latin America. At present, the profit split by region is weighted towards Europe as shown in the chart, but part of this weight is because of the inclusion of some wholesale banking profits.



*Profit shares from UK and LatAm will rise*

These weights will change with the addition of Alliance & Leicester in the UK. On last year's A&L numbers (£257m or EUR 342m of attributable profits), the UK share would have risen by nearly 4ppts to 17.9% of the enlarged figure. The Latin American share will also increase with the consolidation of *Banco Real* in Brazil. It is expected that *Banco Real* will be fully consolidated in Q3 2008. The separation of this unit from ABN AMRO and official clearance had not been achieved by 30<sup>th</sup> June; hence the net contribution from ABN AMRO, of which BR was the major part, was reported under the equity method of accounting rather than assigned directly to Brazil. This would have approximately doubled the Brazil figure on a pro forma basis.

*LatAm growth maintained but inflation up...*

Whilst it remains unclear whether the US economy will move into recession, the main change in the climate affecting the Latin American region is a rise in inflation. Expected GDP growth for the region is still centred on 4%, and slightly more in Brazil. That said, a sharp rise in inflation by 2ppts to 8% caused by oil and imported food prices has prompted rises in central bank interest rates.

*...leading to interest rate hikes*

The Central Bank in Brazil has to date (to end July) put its key short term interest rate up by 200 basis points (b.p.) to 13%; other central bank moves have been in Chile +175 b.p. to 7.25%, and in Mexico by 100 b.p. to 8%. These increases may have a delayed impact on business growth.

*...slower growth in Europe*

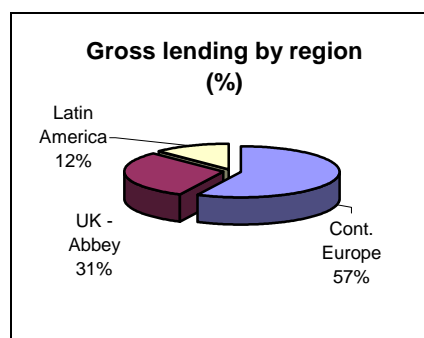
In the Euro zone, the weighted average growth rate of GDP is slowing. There have been marked downturns in Germany, Italy and Spain (where economic conditions are similar to those in the UK) and these are expected to continue for the rest of the year. Various factors are contributing to the slowdown. Having adopted an anti-inflation stance (Eurozone inflation is now averaging 4.1% and rising), the monetary and fiscal authorities have been reluctant to loosen policy. Combined with higher energy and other costs, this has put pressure on the consumer. Similarly in the UK, GDP growth is also slowing and a rising inflation rate has also impacted on consumer expenditure.

## The loan book

UK banks have been forced to de-leverage due to balance sheet constraints and the maintenance of capital ratios. Not only capital constraints but other pressures have forced cutbacks in lending such as liquidity. In Santander's case, it has had less need to worry about either but still adopted a cautious policy.

*8.5% credit growth reflects more selective lending*

Santander's gross customer loans expanded by 2% to EUR 572.6bn, with the geographical distribution as shown. Excluding exchange rate effects, gross lending rose by 8.5%. The slower rate of increase compared with last year reflects the adoption of a more selective lending policy.



*Off balance sheet funds could shrink further*

Customer funds under management amounted to EUR 759 bn, 5% lower due to exchange rates and last year's disposal of the pension fund business in Latin America. Of the total, over 80% was on balance sheet. The other part amounting to EUR 143bn, mutual and pension funds, managed portfolios and insurance, etc, was off balance sheet. Unlike other banks, Santander does not run conduits and structured investment vehicles (SIVs), which are higher level risks. All off balance sheet items are part of its normal business, although commentators have mentioned that Asset Management and Insurance are non-core activities that the Bank might opt to sell.

## Funding

*Deposits are the central resource...*

Santander's conservative approach seeks to match long term assets with long term funding and a high proportion of deposits. In a recent presentation, Santander referred to deposits as being of key importance because they are 'the centre of the client relationship' and also have valuable cross selling potential. Total customer

*... within a balanced funding context* deposits in H1 increased by 2.5% to EUR 342bn, equal to 60% of its total loans. This was supplemented by EUR 17bn of senior debt and EUR 1.43bn of covered bonds. In addition, Santander securitised EUR 30bn of mortgage and other loans, enabling the Bank to increase the total assets eligible for discounting at the European Central Bank to more than EUR 50bn though it is unlikely to utilise this other things being equal.

## Credit risk management

*Zero exposure to sub-prime and SIVs* Santander has zero risk in the subprime mortgage segment and very low activity in structured products. Hence balance sheet write-downs were absent, although a rise in non-performing loans occurred as a result primarily of less favourable economic conditions and an increase in the mix of Latin American business lending with higher risk premiums attached.

The following table focuses on two factors:

1. an increase in non-performing loans to 1.34% (0.83% a year ago) but still superior to its European peers (comparisons were made at the end of Q1 and not with UK banks);
2. an accompanying rise in provisions, both specific and generic.

Lending and credit risk management			
EUR million	2007H1	2008H1	Change (%)
Gross loans and credits	561,295	572,624	+2.0
Total credit loss allowance	8,610	9,522	+10.6
<b>Net loans and credits</b>	<b>552,686</b>	<b>563,101</b>	<b>+1.9</b>
Non-performing loans	5,354	8,604	+60.7
<b>NPL ratio (%)</b>	<b>0.83</b>	<b>1.34</b>	
Credit loss allowances:	9,056	10,212	+12.8
of which:			
Specific	3,136	3,921	+25.0
General purpose	5,920	6,292	+6.3
<b>NPL coverage (%)</b>	<b>169.2</b>	<b>118.7</b>	

*Modest NPLs albeit increasing* NPL percentages are still relatively modest against European banking sector averages. For Santander, the regional segments reported were:

- 1.05% in Spain (the average of the two retail banking networks and not expected to exceed 1.5% by year end);
- 0.70% in the UK;
- 2.16% in Latin America;
- 3.49% for Santander Consumer Finance but this is a different type of business.

*EUR 6bn cushion available for release* The increase in provisions has given Santander fairly comfortable coverage ratios. As mentioned in our previous write-ups on Santander, generic provisions have given it a substantial cushion, now over EUR 6bn, against the business downturn. They are based on a statistical average of losses over the whole cycle, built up in good times. This 'dynamic provisioning' framework imposed by the Bank of Spain requires provisions to increase with credit expansion, and these are available for the bad times when bad debts rise.

Rules apply to off bal. sheet assets

The Bank of Spain required provisions to be applied equally to off-balance sheet vehicles, i.e. to total assets including structured vehicles. That discouraged their creation and so Spanish banks tend to be 'cleaner' and have avoided the ensuing write-downs.

On a gross basis (i.e. before releases and recoveries), the increase in provisions was EUR 1,010m and the breakdown is as shown. The table shows that whilst specific provisions rose by EUR 1.1bn - necessitated by Spain and Latin America, but for different reasons – in Spain a downturn, in Latin America credit expansion - generic provisions declined by EUR 89m. With these changes in place, Santander's coverage ratios for doubtful debts remains healthy – Spain 165%, the UK 55% and Latin America 121%.

Increases in loan loss provisions by geographical region (EUR m)			
	Specific	Generic	Total
Europe	+544	-114	+430
UK	-11	-3	-14
Latin America	+538	-51	+487
Other	+28	+80	+108
<b>Total</b>	<b>+1,099</b>	<b>-89</b>	<b>+1,010</b>

### Results snapshot by main geographic region

Geographical segment results by main region								
EUR mills	Gross operating income	% ch'g	Net operating income	% ch'g	Pre-tax profit	% ch'g	Attrib. profit	% Ch'g
Cont Eur main retail units only	6,993	+7.8	4,387	+8.4	3,330	-4.2	2,388	-2.6
UK Abbey	6,038	+12.4	3,881	+16.9	2,910	+10.9	2,092	+13.2
Lat Am	1,832	-3.4	990	+3.7	837	+4.2	627	+4.2
	5,952	+20.6	3,585	+28.6	2,121	+10.2	1,420	+4.4

Within Continental Europe, the downturn of -2.6% in attributable income was due to the exceptional results achieved in wholesale banking last year which distort the comparison. The main retail units shown below, plus Santander Consumer Finance, achieved growth of over 13% in attributable profit despite more difficult trading conditions. Results from the main retail banking networks, *Santander Branch Network* and *Banesto* in Spain and *Santander Totta* in Portugal are summarised below.

	<i>Santander Branch Network</i>		<i>Banesto</i>		<i>Totta</i>	
EUR mill's	2008H1	Ch'ge (%)	2008H1	Ch'ge (%)	2008H1	Ch'ge (%)
Net interest	1,711	+26.3	802	+14.0	383	+6.5
Gross op inc	2,672	+13.8	1,226	+10.3	623	+0.8
Net op inc	1,699	+19.9	722	+14.1	351	0.0
Pre-tax inc	1,415	+13.2	610	+13.0	334	+4.6
<b>Attrib. inc.</b>	<b>1,032</b>	<b>+14.8</b>	<b>400</b>	<b>+18.5</b>	<b>278</b>	<b>+7.0</b>

Santander has performed well to date

Prime attention in this period was focused on the impact of a sharp decline in the Spanish economy affecting the property, housing markets and consumer markets. This has not hurt Santander significantly so far. The share of Group pre-tax income generated by the *Santander Branch Network (SBN)* and *Banesto* jointly declined by

just one percentage point from 34% to 33%. Part of this decline was not in retail banking but in wholesale. By comparison, the shares of the UK and Latin America also declined by just one per cent to 14% and 35% respectively, although these results were affected by exchange rates – an approximate 15% depreciation of both sterling and the dollar against the Euro.

*Selective lending and spreads management*

Santander has managed the downturn through selective lending and management of spreads. In Europe, total spreads increased as follows:

Spain		Portugal	
<i>SBN</i>	+40 bps	<i>Totta</i>	- 9 bps
<i>Banesto</i>	+8 bps		

Santander Consumer Finance - 47bps

Thus far at least the impact has been well contained and Santander is not heavily exposed to property developers. For *SBN*, attributable profits were +15% driven by net interest income (+26%). Net operating income rose nearly +20% at EUR 1.7bn, absorbing a 73% rise in loan loss provisions (EUR 284m).

*..and the successful IWTBYB strategy*

*SBN's* attributable profit emerged nearly 15% higher at EUR 1.03bn with the success of its retail strategy, 'We want to be your bank'. This has grown the customer base to 8.5m and created cross-selling opportunities for the Bank's products. Loans increased by 6% (more selective) and deposits by over 20%.

*Equally good results from Banesto*

The *Banesto* chain of retail banks also managed the conditions successfully with similar policies, particularly capturing savings. Net interest income was up 14%, driving net operating income by the same figure to EUR 722m. After deducting loan loss provisions, tax and minority interests, net attributable income increased over 18% to EUR 400m.

## Santander Consumer Finance

*Santander Consumer Finance*

*Santander Consumer Finance (SCF)* enjoyed good underlying growth demonstrating the benefits of geographical diversification with strong growth in both Germany (+30% rise in attributable profit) and the US (+22% in US currency). The total loan book rose by nearly 13% to EUR 48.2bn. Within this, the US business, *Drive*, accounts for less than 8% and its results were particularly good given that US car sales are at a 16 year low.

Despite weak markets for consumer car sales on both sides of the Atlantic (-2% car sales in Europe, -5% on financed units in the US), the downturn was well managed with overall attributable profits for the segment over 8% ahead to EUR 382m. The rise was constrained by 36% higher loan loss provisions to EUR 555m, effectively halving net operating income.

<b>Santander Consumer Finance</b>			
EUR mill's	2007 H1	2008 H1	Ch'ge (%)
Net interest income	1,021	1,141	+11.8
Gross operating income	1,295	1,517	+17.1
Net operating income	921	1,109	+14.1
Income before taxes	516	551	+13.0
<b>Attrib. income to the Group</b>	<b>352</b>	<b>382</b>	<b>+18.5</b>

SCF has borne the costs of new business initiatives for expansion. Businesses were launched last year in Denmark and Finland and other places including Russia and Mexico through the acquisitions of *Extrobank* and *Alcanza* finance company respectively. Joint venture initiatives with local partners in France (*Banco Accord*) and Chile have continued the expansion programme in the first half.

*Loans portfolio expanded by acquisitions*  
...

In Q1 Santander announced that it had acquired RBS's consumer finance business in Europe for EUR 336m. It gained 2.3m customers, plus a loan book of EUR 2.2bn (credit cards and direct credit businesses), to strengthen its position in its largest market, Germany, and the Netherlands. A second deal was struck with General Electric to exchange a shareholding in *Interbanca* for GE's money businesses comprising a EUR 9.1bn loan book in Continental Europe and the UK. Jointly the two deals added EUR 11.3bn or nearly 25% to the loan book which at the start of the year stood at EUR 45.7bn.

*...adding EUR 100m in synergies*

Santander expects that potential synergies from these two deals, e.g. the distribution of credit cards in the UK and cross-selling of products, could add EUR 100m to Group profit before tax though did not indicate by which year this might arise.

*Robust results in Portugal*

In Portugal, *Santander Totta*, the Portuguese banking chain, produced solid results from retail banking (pre-tax profit +12%) and also its Asset Management and Insurance business (+45%). It experienced a decline of 35% in Global Wholesale Banking affected by the turbulence in financial markets. That said, total loans were 10% higher at EUR 31.7bn and deposits 16% higher at EUR 13.7bn. Attributable profit rose 7%, but nearly 12% in retail banking by itself due to active and successful campaigns.

## The UK – Abbey

<b>Abbey</b>				
Results for 2008H1	£m	Ch'ge (%)	EUR m	Ch'g (%)
Net interest	<b>892</b>		<b>1,153</b>	+0.1
Gross op income	<b>1,417</b>	+10.9	<b>1,832</b>	-3.4
Net op income	<b>767</b>	+19.0	<b>990</b>	+3.7
Pre-tax income	<b>647</b>		<b>837</b>	+4.2
<b>Attrib profit</b>	<b>485</b>	+19.6	<b>627</b>	+4.2
<i>Average exchange rate £1 = EUR 1.2928</i>				

*Loans down, profits up* Abbey was described as having a 'brilliant year' by its CEO, with net profits nearly 20% higher at £485m, but the Bank has deliberately opted not to chase volumes. Profitability rather than volume is now the main criterion although, with its main competitors in difficulties, market share was gained, averaging 26% in net lending compared with 8% in 2007. The results are shown in both sterling and Euros on the previous page.

*Rising share of mortgage loans* Abbey's mortgage loan book was up 13% at £119bn from £105bn a year ago although offset by an 18% downturn in the other unsecured loan book to £503m. In new mortgages, gross lending rose in the half by 16% to £19.5bn. The rise is due both to writing new loans (with lower LTVs) and retention of existing customers. Lending quality is partly explained by the virtual absence of buy-to-let and self-certification mortgages.

*...with rising deposit backing* On the deposit side, Abbey's total deposits and annual premium income increased by 6% to nearly £75bn despite intense competition and, a particularly favourable feature, more new retail business is being funded via the deposit route. Also important has been a steady rise (42%) in the number of new current accounts opened (by 177,000). Interest rate spreads have been well controlled on both the loans and deposit side with a net overall margin of 195 bps, the same as in H1 2007 despite the worsening conditions.

Efficiency benefits continue to accrue with costs rising by 2.5% against gross operating income of nearly 11%, and the cost/income ratio down a further 4 ppts from 50.4% to 46.7%.

### **Adding Alliance & Leicester**

*Low execution risk* Santander will strengthen its UK position at relatively little cost and with low execution risk. The all share deal is one Santander share for every three ordinary shares in A&L. The cost at the time of announcement was just £1.22bn plus another £76m allowing for the inclusion of A&L's 18p interim dividend. At Santander's current share price of 954p, A&L is valued at 336p per share, or £1.42bn in total. A&L's share price is slightly ahead of the bid price but a counter-offer is generally considered unlikely given the weakness of most rivals.

*£30-£50m cost reductions before synergies...* Santander's plan to add 300 branches in the medium term will be accelerated via the acquisition, taking Abbey closer to its 1,000 branch target with a good geographic fit. In terms of cost efficiencies, Santander expects that, on a standalone basis, it can achieve cost reductions of £30-50m on an annual basis *before* any operating cost synergy gains.

*...with EPS enhancement from 2009 and RO1 19% by 2011* Based on previous operating experience, Santander expects to achieve total cost savings of £180m from synergies by the end of 2011. These will stem from already identified best practices, better procurement, IT, rationalisation of head office and support functions, and branch rationalisation. Santander estimates EPS enhancement from 2009 and ROI rising to 19% by 2011.

*SME market offers scope to expand commercial banking* Abbey's careful expansion in the commercial market will be facilitated. A&L has expanded more rapidly than Abbey in this area targeting corporates and SMEs and has stronger representation than Abbey in this area – £9bn loan book compared with c.£3bn. By utilising A&L's network of 20 UK business centres, Abbey will cut the budgeted cost of expansion by some £35m.

## Latin America

*Exchange rates* The impact of exchange rates on Santander's results and on half year end balances were negative due to the weaker US\$, Latin American currencies except the Brazilian Real and sterling against the Euro. The relevant rates are as shown. Depreciation reduced the balances for lending (6.5 ppts) and customer funds (5ppts).

	Key exchange rates against the EURO (1 Euro = )					
	Average H1 2007	Average H1 2008	Ch'ge %	HY/E 30/06/07	HY/E 30/06/08	Ch'ge %
US \$	1.33	1.53	-15	1.47	1.58	-7
GB £	0.67	0.77	-15	0.73	0.79	-8
Brazilian Real	2.72	2.59	+5	2.60	2.51	+4
New Mex. Peso	16.24	14.55	+11	16.07	16.23	-
Chilean Peso	709.03	712.12	-	733.03	821.38	-12

*Source: Santander*

Results from the Latin American region overall are summarised in the table below.

Latin America overall		
	EUR m	Change (%)
	2008H1	
Net interest	3,638	+18.6
Gross op income	5,952	+20.6
Net op income	3,585	+28.6
Pre-tax income	2,121	+10.2
<b>Attrib. inc.</b>	<b>1,420</b>	<b>+4.4*</b>

*The low increase at attributable level is due to the disposal of pension business which earned EUR 63m in 2007 H1.*

*LatAm banking results did not include Banco Real* Santander received clearance for the incorporation of the trading entities from ABN AMRO only after the half year end. In the first half results, it was announced that ABN AMRO had made a net attributable profit contribution of EUR 291m after financing costs of EUR 186m. This was generated by *Banco Real* in Brazil but attributed to the corporate centre (Equity Management and Financial Stakes) as it was not completed by 30<sup>th</sup> June.

*More selective lending policies* A 15% depreciation of the US\$ against the Euro restricted the rise in Latin America's attributable profit to EUR 1.42bn, +4.4%. On a like-for-like basis (excluding the pension business sold in 2007) net attributable profit increased by 8.5% in Euros and by 13% in local currency. This was driven by retail banking. Management expect to be able to maintain this progress and the region's economic progress has not so far been affected despite a rise in the inflation rate and central bank interest rate increases.

*GDP growth dipping, inflation up* Higher energy prices and weaker export markets have edged down GDP growth prospects for the region which nevertheless are still expected at c.4% p.a. for 2008 and slightly lower in 2009. The main change has been a rise in the regional inflation rate to 8% in the year to June forcing central banks to raise interest rates (now 13% in Brazil). Mortgage business is difficult to develop in these conditions but other lending and credit cards are still growing at c.20%. The rise in banking ('bancarisation') is a powerful driver of activity and Santander's market share of total business is now 8.5%. It also has 8.5m customers before inclusion of those in *Banco Real*.

*Spreads aiding margins except in Brazil* Apart from the strong growth in business volumes, interest spreads have generally been rising except in Brazil, and this process has assisted profit margins. In Brazil, the total spread, on both loans and deposits, declined by 165 bps as a direct result of the Central Bank pushing up its key discount rate. Elsewhere, spreads improved, by 51 bps in Mexico and by 126 bps in Chile. This testifies to Santander's ability to manage its policies effectively as well as less intensive competition than in the European banking context.

*Programa América sets the strategy* Santander's expects the pace of lending to individuals to slow, though not to corporates and SMEs. Santander's '*Programa América 2010*', ratified in 2007, sets out the strategy focused on customer linkages, winning deposits and other 'anchor products', those which capture other business such as payrolls. Despite a more targeted and selective approach, lending to individuals and SME's still rose 21% year-on-year.

The breakdown of results from the three core countries which account for 79% of total Latin American attributable profit are shown below.

EUR mill's	Brazil		Mexico		Chile	
	2008H1	Ch'g (%)	2008H 1	Ch'g (%)	2008H 1	Ch'g (%)
Net interest	1,338	+21.5	947	+2.9	630	+30.3
Gross op inc	2,489	+20.7	1,458	+21.2	840	+20.4
Net op inc	1,522	+25.6	976	+32.9	515	+25.6
Pre-tax inc	775	+9.9	613	+16.6	364	-3.9
<b>Attrib. inc.</b>	<b>501</b>	<b>+10.3</b>	<b>367</b>	<b>+14.0</b>	<b>259</b>	<b>-6.7</b>

## Secondary segments

*Corporate centre near tenfold profits rise* Financial Management and Equity Stakes, the corporate centre for Santander, contributed net attributable income of EUR 296m against EUR 30m in 2007 H1. A significant component was income from companies accounted for by the equity method which added EUR 608m of which ABN AMRO contributed EUR 477m. Gains from financial transactions, interest and exchange rate hedging, and capital gains.

*Sale of Santander City to be completed* A sale and leaseback on Santander's head office complex, Santander City in Madrid, was not fully completed at the half year end. When the deal is closed, a net capital gain of EUR 605m will be booked in the 2008 full year results.

*...EUR 3bn of unrealised gains* Santander has written down part of the value of its investment in the US-based *Sovereign* bank, and can increase its stake from the middle of next year if it were to choose to do so. Looking at the larger picture, Santander still has an estimated EUR 3bn of unrealised capital gains from listed company investments.

*GWB profits down* **Global Wholesale Banking (GWB)** profits were generated by trade and credit financing, corporate M&A, and equity market activities. Overall, the segment experienced worsened conditions in international markets, although the deterioration was mainly felt in Spain and Portugal. Comparison between 2008 and 2007 are distorted by those countries having enjoyed very good results in 2007 with nearly doubled revenues from trading, large gains in investment banking, plus the release of generic provisions. In terms of Continental Europe's customer revenues, the decline was from EUR 938m to EUR 904m.

In contrast, the UK and Latin America saw good increases at gross operating level. In the latter region, customer revenues were reported to have risen by 34% from EUR 452m to EUR 605m.

Overall, GWB's profit before tax emerged 22% lower, falling from EUR 1,458m to EUR 1,135m, and 19% of the Group. As stated, this does not give an entirely accurate picture of underlying performance.

*Customers switched towards Insurance* **Asset Management and Insurance** is a relatively small profit contributor to the Group. The scale of the business can be seen from the following table. In the table below, savings and insurance products were the only category to show strong rise, 23%.

...

Category	EUR bn
Mutual Funds	104.2
Pension funds	11.3
Managed portfolios	17.1
Savings-insurance policies	10.5
Other funds under management	143.1
Total	286.2

*...as a preferred form of savings* For the segment as a whole, pre-tax profits of EUR 295m, virtually unchanged on the year, were less than 5% of the Group. Insurance business performed well and its results were predictably better than asset management (mutual and pension funds). Premium income, mainly from life assurance policies, were 20% higher than in 2007 H1 at over EUR 5bn. Fee income is generated both by independent brokers but mainly by Santander's own retail bank networks which were credited with over EUR 1bn from these activities in H1.

*...loss of tax advantages* The factors associated with customers switching from mutual funds and other indirect savings to insurance based ones were:

1. Customers switching to deposits for improved returns with greater security;
2. Reduced personal tax advantages on contributions to pension plans in Spain.

Thus whilst revenues, largely fee income, from Insurance rose by 22% to EUR 1,124m, that achieved by Asset Management declined by 16% to EUR 795m.

*Speculation on segment disposal* The Asset Management and Insurance segment has not been considered by outside commentators as core to the Group and, in the context of developing the retail and wholesale bank franchises, such people have speculated that both parts could be sold. Nevertheless, in both sub-segments, Santander has developed business models to create products and distribution channels with global applicability.

## Summary and conclusions

*A bank for all seasons* As concern gather about the real state of the banking sectors on both sides of the Atlantic, most banks are unable to see what progress they will make in the short and medium terms. Santander outperformed most of its rivals in both the 'disinflationary' 1980s and 90s and also during the recent liquidity 'bubble'. It expects to continue to do with double digit earnings growth - even with the downturns in Spain and the UK.

*...customer-focused fits the new environment* Santander's has adapted well to the new environment with a customer-focused, branch banking model. It has more outlets (over 13,000 including *Banco Real*) than any other bank in the world and believes 'closeness' to the customer is the key to maintaining strong growth.

*...with minimal liquidity risk* With deposits growing faster than loans, liquidity risk is also minimised by a funding strategy that seeks to match long term assets with long term liabilities.

*...and strong balance sheet* No exposure to off-balance sheet SIVs and conduits exist and therefore write-downs will only arise from the normal course of lending. With a substantial cushion of generic provisions already in place, already adequate capital ratios are not threatened.

*Attractive markets* Latin America has not been affected by the financial turbulence and will continue to be a driver of profit growth. Adding *Banco Real* to its own *Banespa* network in Brazil, Santander will become the third largest bank, closing the gap on its competitors.

*Organic growth plus selected acquisitions* Organic growth is likely to supplemented by selected acquisitions. Adding Alliance & Leicester is not aimed at gaining market share, but improving profitability and the return on assets. Santander expects A&L to be earnings enhancing from 2009 and provide 19% ROI in 2011. In terms of banks' overall ROE performance, Santander's is ahead of its UK peers.

## Group Financial Record

Consolidated Income Statement		
Y/E 31 Dec (EUR m.)	2006	2007
<b>Net interest income</b>	<b>12,480</b>	<b>15,295</b>
Gross operating income	22,333	27,095
Operating costs net	-11,045	-12,208
<b>Net operating income</b>	<b>11,218</b>	<b>14,842</b>
Net provision for impairment	-2,551	3,549
<b>Income before taxes</b>	<b>8,662</b>	<b>10,910</b>
Tax	-1,947	2,392
<b>Net consolidated income</b>	<b>7,144</b>	<b>8,631</b>
Minorities	562	520
Net extraordinary gains	1,014	950
<b>Net attributable income</b>	<b>7,596</b>	<b>9,060</b>
Ordinary EPS	1.05	1.28
Dividends	0.52	0.65

Consolidated Bal Sheet - key data		
Y/E at 31 Dec (EUR m)	2006	2007
Total assets	833,873	912,915
Customer loans	523,346	565,477
Customer funds under mgt	739,223	784,995
Total managed funds	1,000,996	1,063,892
<b>Shareholders' equity</b>	<b>40,062</b>	<b>51,945</b>

Consolidated Cash Flow		
Y/E 31 December (EUR m)	2006	2,007
Adjusted profit	16,554	19,588
Change in net oper. assets	-68,690	-24,799
<b>Net cash from operations</b>	<b>-52,137</b>	<b>-5,210</b>
Net cash from investing	2,499	-21,144
<b>Net cash before financing</b>	<b>-49,638</b>	<b>-26,354</b>
Financing:		
Equity issued	-73	127
Incr/(decr) in debt	51,025	42,751
Dividends and other	-3,565	704
<b>Cash flows from financing</b>	<b>47,387</b>	<b>43,582</b>
<b>Increase in cash in period</b>	<b>-2,251</b>	<b>17,228</b>

**Activities**  
Santander is a Spanish bank listed on the Bolsa, one of the largest banks in world by market cap. Retail banking accounts for 77% of profit with some commercial banking and finance for consumer car loans. Based on 2008 H1, Continental Europe generated 54% of profit, Latin America 32% and the UK 14%. Santander has made an agreed bid for Alliance & Leicester. Through acquiring ABN AMRO, it will double its profits in Brazil and become third largest bank. Acquisitions of consumer finance businesses are more likely than another bank. The Bank believes that it can apply its global models in any region.

Financial Diary	
Next dates:	
Q3 results	28 Oct
Prelim. Results	(TBC) 7 Feb 09
Q1 results	(TBC) 29 Apr 09

Directors	
Emilio Botin	Chairman
Alfredo Saenz	Ch Exec
Plus 17 other directors	

Major Shareholders	%
as at 30th June 2008	
Main Board of Dir's	3.81
Institutions	61.99
Individuals	34.20

Santander shares are quoted on the following Stock Exchanges - Madrid, Frankfurt, Milan, Lisbon, New York, Buenos Aires, Mexico and London (a secondary listing). It is a constituent of both the FTSE Euro Top 100 and Dow Jones Eurostoxx 50.

Private clients can buy shares either

1. Through Lloyds TSB Registrars, the shares then being held in Santander Nominee accounts. Dividends will be paid quarterly and in sterling.
2. Directly on the Madrid Exchange, in which case the purchaser must have a Spanish bank account, be prepared to complete Spanish tax forms, and receive dividends in Euro.

This research may be viewed on [www.cityinsights.co.uk](http://www.cityinsights.co.uk) August 2008  
Corporate website: [www.santander.com](http://www.santander.com)