

Project Wing - Northern Rock Executive Summary

The following is excerpt of Project Wing - the executive summary of a plan, put together by Merrill Lynch, Citi and The Blackstone Group, to sell stricken mortgage lender Northern Rock, code-named Blackbird. This "Briefing Memorandum" has been sent to all potential acquirers.

Blackbird is the UK's fastest growing mortgage company having grown residential mortgage assets by a CAGR of 22% to £77bn (2006) and underlying profit before tax by a CAGR of 16% to £588m (2006) since its conversion to a public company in 1997. During this time Blackbird increased its share of UK mortgage stock from 2.7% (31 December 1996) to 7.6% (30 June 2007) making it the UK's 5th largest mortgage lender by stock. Blackbird has consistently achieved a Top 3 net lending position since 2004.

Blackbird's business strategy is based on its low operating costs and high asset quality. It is the most cost efficient bank in the UK, and its mortgage arrears are less than half the industry average. This allows the company to generate high volume and high quality new assets through its distribution networks whilst retaining existing customers through its market leading customer retention proposition. Blackstone's funding model is highly diversified by channel and geography, and it sources its funding from retail, wholesale, securitisation and covered bond markets. Blackbird's Granite securitisation vehicle is Europe's largest mortgage backed securitisation programme.

Blackbird has a highly diversified UK distribution platform that utilises a mix of branches, telephone, post, e-commerce and intermediary distribution. In addition, Blackbird has a highly diversified retail funding franchise by geography, products and channels, with the potential for scaleable access to retail funding markets outside the UK.

Overview of the Transaction

Blackbird is currently pursuing a sale of its business as a whole ("WholeCo" or the "Whole Company"). This is Blackbird's preferred outcome. As an alternative to the sale of WholeCo and to assist interested parties, Blackbird has defined two discrete preferred asset sale structures, namely the acquisition of either (i) the Company's existing infrastructure/operational platform and/or Blackbird's retail deposits and matching assets ("PlatformsCo" or the "Platforms Company") or (ii) PlatformsCo plus further selected assets and liabilities, including the securitisation and covered bond funding programmes ("PrimeCo" or "Prime Mortgage Company"). Blackbird and its advisers encourage offers for assets and liabilities of the business which are different from those contemplated under the preferred structures. For example, this Memorandum also gives separate financial information on the retail deposits platform.

Any assets and liabilities not transferred to the purchaser will be retained within an entity called "FinCo."

FinCo is expected to remain listed and to be placed into a solvent run-off with the objectives of (i) orderly run down of the balance sheet; (ii) repayment of creditors; and, if appropriate, (iii) the return of residual value to Blackbird shareholders.

Blackbird invites recipients of this Memorandum to participate in a process for the acquisition of all or parts of the business. This Memorandum is intended to assist recipients in assessing, in particular, the WholeCo, PrimeCO and PlatformsCO structures, the ongoing new business potential, the nature of obligations with FinCo, and the corresponding value of the proposed new standalone entities.

Blackbird Investment Highlights

- Access to one of the best and most efficient mortgage distribution platforms and infrastructures in Europe

- Highly effective distribution - Leading intermediary distribution network with mortgage origination centred around strong IFA relationships, market leading service and processing systems,

the largest UK intermediary sales force and a scaleable integrated direct sales platform, facilitating multiple product distribution.

- **The most cost efficient lender in its sector** - Underlying cost income ratio of 26.6% for six months to 30 June 2007, achieved by low cost distribution and centralised processing and servicing, all underpinned by efficient IT systems.

- **Low risk loan portfolio** - Residential mortgage lending comprises only prime business, underwritten by proven credit scorecard system, resulting in a high quality mortgage book with average LTV of 59% and 3 months+ arrears, which is less than 50% of the industry average.

- **Successful retention policy and market leading infrastructure and process** - Ability to deliver lending growth without significant new gross lending. Market share of redemptions at H1 2007 of 5.9% vs 7.1% in opening stock.

- **Innovative mortgage product range** - c40% of new residential lending in lifestyle products with 60% in traditional price-led products.

- **Full retail savings and banking infrastructure** - Providing scale and geographic potential

- **Potential for attractive returns on equity**

Preferred Structure Investment Highlights

- **Provides immediate scale potential** - 76 branches, 6000+ employees and IT systems operational from day 1

- **Structure seeks to minimise ongoing funding requirements**

- **Access to valuable retail customer base** - Structure transfers over 1 million retail deposit customers to a potential purchaser

- **Ability to utilise funding from existing Blackbird business** - Under the PlatformCo and PrimeCo structures, a purchaser would gain access to existing unencumbered loans to support the purchaser's ongoing funding requirements. Furthermore, under the PrimeCo structure, a purchaser would also benefit from the funding advantages of the existing Granite and Covered Bond Securitisation programmes.

Bank of England

In this document, there are assumptions relating to the Bank of England facility. The Bank of England has not commented on or reviewed these assumptions and therefore has not approved the financial projections. Any potential purchaser/investor in Blackbird will need to have discussions with the Bank of England and its advisors before concluding any proposal.

Sale Process

Further information on the sale process can be found in the process letter accompanying this Memorandum. Interested parties are reminded that they should not assume at this stage that they would receive any ongoing financing or other support from the Bank of England or the continuation of the HM Treasury guarantee arrangements when formulating their proposals.

Structure I - “WholeCo”

Financial Projections Summaries

Current Position

Figure 7 demonstrates the current Blackbird plc funding position and forecasts for the year ending 31 December 2007.

Current Blackbird plc		
£ millions	18 Oct 07	2007E
Interest receivable	n.a.	£6,987.6m
Net interest income	n.a.	£760.5m
Total income	n.a.	£932.2m
Operating expenses	n.a.	(£309.2m)
Profit before non-recurring costs	n.a.	£510.5m
Profit after tax	n.a.	£326.7m*
Unencumbered residential assets	£16,855m**	n.a.
Encumbered residential assets	£73,902m	n.a.
Retail deposits	£13,979m	13,501m
Wholesale funding	£20,847m	12,056m
Existing funding (exc. Wholesale and retail finding)	£66,659m	73,902m
Capital – Core equity	£1,740m	1,817m
Capital – Other	£2,719m	2,719m

Note: Figures represent underlying profit excluding hedge ineffectiveness

* Profit after tax but before ROI, sub debt and preference share appropriations

** In addition £11,867m included within BoE collateral

1. Whole Company (“WholeCo”)

Normal Markets Case

- Whole Company is assumed to continue Blackbird plc’s current operations, albeit with a lower growth profile.
- Whole Company would thus be a significant mortgage lender funded through existing retail deposits, wholesale markets, a successful securitization and covered bond programme and a refinancing of the Bank of England facility (“Replacement facility”)
- Gross new lending forecast to reach c.£10-15bn per year so maintaining a mortgage franchise presence with internal retentions of £12bn in 2008, £8bn in 2009 and £9bn in 2010.
- Gross new lending offset by significant actively reduced redemptions - leading mortgage book to contract materially in 2008 and 2009 to allow a Replacement Facility to be reduced from £24bn in 2007 to £6bn by 2010. Redemptions forecast to be £18bn in 2008, £14bn in 2009 and £15bn in 2010.
- Securitisation programmes forecast to continue in line with contractual obligations.

Figure 8 summarise the key income statement and balance sheet items for WholeCo under normal credit markets.

WholeCo Summary – Normal Markets Case				
£ millions	1 Jan 2008E	2008E	2009E	2010E
Interest receivable	-	£6,851.4m	£6,220.8m	£6,169.6m
Net interest income	-	£462.3m	£738.9m	£966.4m
Total income	-	£533.0m	£798.7m	£1,032.7m
Operating expenses	-	(£278.6m)	(£294.2m)	(£307.1m)
Profit before non-recurring costs	-	£143.4m	£395.8m	£643.1m
Profit after tax*	-	£88.8m	£281.4m	£459.4m
Total residential assets	£89,350m	£78,860m	£75,520m	£74,760m
Retail deposits	13,501m	£13,501m	£13,501m	£13,501m
Existing wholesale funding	12,056m	£6,608m	£3,978m	£2,775m
Existing funding (exc. Wholesale and retail funding)	73,902m	£55,898m	£41,373m	£31,230m
New Funding balance	-	£15,513m	£26,131m	£35,638m
Capital – Core equity	£1,817m	£1,936m	£2,140m	£2,522m
Capital – Other	£2,719m	£2,839m	£2,839m	£2,839m
Return on core equity**	n.a.	0.6%	10.0%	16.4%

* Profit after tax but before RCI, sub debt and preference share appropriations

** Return on equity calculated on profit after tax and appropriations.

In this scenario, WholeCo's profitability increases with a 127.5% CAGR over the 2008-2010 period. By the end of 2010, the amount of replacement Bank of England funding drawn down by WholeCo is expected to be £5.9bn. *Constrained Markets Case* Under the constrained markets case, Blackbird has made broadly similar assumptions, but with lower projections for gross new lending and retention business. In addition, the reduction in residential lending would result in lower operating costs and a lower new funding requirement. *Figure 9 summarises the key income statement and balance sheet items for WholeCo under the constrained markets case.*

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WholeCo Summary – Constrained Markets Case				
£ millions	1 Jan 2008E	2008E	2009E	2010E
Interest receivable	-	£6,619.0m	£5,864.7m	£5,558.6m
Net interest income	-	£422.6m	£651.9m	£869.4m
Total income	-	£474.0m	£703.3m	£925.8m
Operating expenses	-	(£265.8m)	(£254.4m)	(£261.7m)
Profit before non-recurring costs	-	£108.8m	£346.2m	£584.3m
Profit after tax*	-	£63.9m	£245.6m	£417.1m
Total residential assets	£89,350m	£72,629m	£66,746m	£66,212m
Retail deposits	13,501m	£13,501m	£13,501m	£13,501m
Existing wholesale funding	12,056m	£6,608m	£3,978m	£2,775m
Existing funding (exc. Wholesale and retail funding)	73,902m	£55,898m	£41,373m	£31,230m
New Funding balance	-	£6,341m	£16,057m	£25,918
Capital – Core equity	£1,817m	£1,901m	£2,069m	£2,409
Capital – Other	£2,719m	£2,832m	£2,832m	£2,832
Return on core equity**	n.a.	(1.4%)	8.5%	15.2%

* Profit after tax but before RCI, sub debt and preference share appropriations

** Return on equity calculated on profit after tax and appropriations.

In this scenario, WholeCo's profitability increases with a 155.4% CAGR over the forecast period. By the end of 2010, the amount of replacement Bank of England funding drawn down by WholeCo is expected to be £5.9bn.

Structure II - “PrimeCo”

2. Prime Mortgage Company (“PrimeCo”)

Normal Markets Case

- PrimeCo is assumed to be a significant mortgage lender with a large book of residential assets, existing retail deposits and successful securitisation and covered bond programmes.
- The mortgage book is forecast to grow through gross new lending of between £9-£14bn per annum with retention business of £12bn in 2008, £8bn in 2009 and £9bn in 2010.
- Redemptions forecast in existing mortgage book. £16bn in 2008, £11bn in 2009 and £6bn in 2010 reduce funding requirements.
- Stable retail deposit base (assumes any maturing retail deposits are replaced)
- Securitisation programmes forecast to continue in line with contractual obligations
- Remainder of asset growth funded through blended mix of new funding
- PrimeCo is transferred as of 1 January 2008 and FinCo retains the Bank of England facility
- Management have taken a conservative assumption that 100% of tier 1 capital is in the form of equity. There remains an opportunity to leverage this with preference shares and hybrid capital in similar proportions to the existing Blackbird plc

Figure 10 summarises the key income statement and balance sheet items for PrimeCo under the normal credit markets case.

PrimeCo Summary – Normal Markets Case				
£ millions	1 Jan 2008E	2008E	2009E	2010E
Interest receivable	-	£5,297.2m	£5,188.5m	£5,408.4m
Net interest income	-	£689.7m	£722.0m	£920.5m
Total income	-	£616.5m	£786.6m	£990.4m
Operating expenses (Net of FinCo recharge)	-	(£216.7m)	(£230.2m)	(£243.9m)
Profit before tax	-	£378.2m	£523.1m	£720.9m
Profit after tax	-	£272.3m	£376.6m	£519.0m
Total residential assets	£76,013m	£70,394m	£70,357m	£71,167m
Retail deposits	£13,501m	£13,501m	£13,501m	£13,501m
Existing wholesale funding	£12,056m	£6,608m	£3,978m	£2,775m
Existing funding (exc. Wholesale and retail funding)	£55,029m	£44,140m	£34,392m	£26,853m
New Funding balance	-	£10,359m	£22,892m	£32,353m
Notional capital – Tier 1	£1,894m	£2,166m	£2,543m	£3,062m
Notional capital – Tier 2	£1,413m	£1,413m	£1,413m	£1,413m
Return on notional capital – Tier 1	n.a.	13.4%	16%	18.5%
Return on optimal capital*	n.a.	n.a.	24.6%	33.2%

* Optimal capital calculated as notional Tier 1 capital required under Basle II excluding 25% buffer

In this scenario, PrimeCo’s profitability increases with a 38.1% CAGR over the forecast period. This is based upon new wholesale funding of £10.4bn in 2008, £22.9bn in 2009 and £32.4bn in 2010, with notional Tier 1 capital of £1.9bn (excluding 2008 profits) required over the course of 2008 to capitalise the business on a standalone basis, based on management’s capital assumptions detailed above. *Constrained Markets Case* Under the constrained markets case, Blackbird has made broadly similar assumptions except with around 40% of the gross new lending and retention business in 2008 and 80% in 2009. In addition, the reduction in residential lending would result in lower operating costs and a lower new funding requirement. Figure 11 summarise the key income statement and balance sheet items for PrimeCo under the constrained credit markets case.

PrimeCo Summary – Constrained Markets Case				
£ millions	1 Jan 2008E	2008E	2009E	2010E
Interest receivable	-	£5,064.8m	£4,632.3m	£4,797.4m
Net interest income	-	£496.7m	£631.9m	£820.3m
Total income	-	£554.2m	£688.0m	£880.5m
Operating expenses (Net of FijCo recharge)	-	(£197.7m)	(£192.8m)	(£201.4m)
Profit before tax	-	£338.6m	£467.8m	£656.1m
Profit after tax	-	£243.8m	£336.8m	£472.4m
Total residential assets	£76,013m	£64,103m	£61,583m	£62,618m
Retail deposits	£13,501m	£13,501m	£13,501m	£13,501m
Existing wholesale funding	£12,056m	£6,608m	£3,978m	£2,775m
Existing funding (exc. Wholesale and retail funding)	£55,029m	£44,140m	£34,392m	£26,853m
New Funding balance	-	£3,191m	£12,825m	£22,594m
Notional capital – Tier 1	£1,745m	£1,989m	£2,325m	£2,798m
Notional capital – Tier 2	£1,545m	£1,545m	£1,545m	£1,545m
Return on notional capital – Tier 1	n.a.	13.1%	15.6%	18.4%
Return on optimal capital[*]	n.a.	n.a.	24.2%	33.7%

* Optimal capital calculated as notional Tier 1 capital required under Basle II excluding 2% buffer

In this scenario, PrimeCo's profitability increases with a 39.2% CAGR over the forecast period. This is based upon new cumulative funding of £3.2bn in 2008, £12.8bn in 2009 and £22.6bn in 2010, with notional Tier 1 capital of £1.7bn (excluding 2008 profits) required over the course of 2008 to capitalise the business on a standalone basis. The initial Tier 1 capital requirement here is lower than the normal markets case as the year end balance sheet is c. £7bn smaller than the normal markets case.

Structure III - “PlatformCo”

3. Platforms Company (“PlatformCo”)

Normal Markets Case

Under the normal markets case Blackbird has assumed that:

- PlatformCo is essentially a smaller mortgage lender with a book of residential assets and existing retail deposits
- The mortgage book is forecast to grow through gross new lending of c £9-14bn per year with additional retention business of £10bn, £7bn and £3bn in 2008, 2009, and 2010 from balances held by FinCo and through £2bn, £1bn and £6bn from retentions on residential assets transferred to PlatformCo
- Redemptions forecast to be £3bn in 2008 and 2009, £10bn in 2010
- Stable retail deposit base (assuming any maturing retail deposits are replaced)
- Remainder of asset growth funded through blended mix of new funding
- PlatformCo is transferred as of 1 January 2008
- Management have taken a conservative assumption that 100% of Tier 1 capital is in the form of equity. There remains an opportunity to leverage this with preference shares and hybrid capital in similar proportions to the existing Blackbird plc.

Figure 12 summarises the key income statement and balance sheet items under the PlatformCo structure assuming the normal credit markets case.

Platforms Company Summary – Normal Markets Case				
£ millions	1 Jan 2008E	2008E	2009E	2010E
Interest receivable	-	£1,581.0m	£2,874.0m	£3,714.7m
Net Interest Income	-	£264.1m	£504.9m	£669.6m
Total income	-	£345.0m	£575.3m	£745.4m
Operating expenses (Net of FinCo recharge)	-	(£136.4m)	(£172.0m)	(£197.7m)
Profit before tax	-	£194.0m	£373.7m	£524.7m
Profit after tax	-	£139.7m	£269.0m	£377.8m
Total residential assets	£13,501m	£29,796m	£45,143m	£53,048m
Retail deposits	£13,501m	£13,501m	£13,501m	£13,501m
New Funding balance	-	£18,076m	£34,477m	£43,007m
Notional capital – Tier 1	£1,067m	£1,207m	£1,775m	£2,153m
Notional capital – Tier 2	£685m	£685m	£988m	£988m
Return on notional capital – Tier 1	n.a.	12.3%	18.0%	19.2%
Return on optimal capital*	n.a.	n.a.	26.1%	30.6%

* Optimal capital calculated as notional Tier 1 capital required under Basle II excluding 25% buffer

In this scenario, the platform’s profitability increases with a 64.5% CAGR over the forecast period. This is based upon new cumulative funding of £18.1bn in 2008, £34.5bn in 2009 and £43.0bn in 2010, with notional Tier 1 capital of £1.1bn (excluding 2008 profits) required over the course of 2008 to capitalise the business on a standalone basis, based on management’s capital assumptions detailed above. In order to help assess the relative value of the Retail Deposits only platform, Figure 13 provides separate financial information for the Retail Deposits only platform under the normal credit markets case. Detailed financials for the platform are provided in Section 4.

Retail Deposits Only Platform Summary – Normal Markets Case				
£ millions	1 Jan 2008E	2008E	2009E	2010E
Interest receivable	-	£855.9m	£829.8m	£823.8m
Net interest income	-	£109.5m	£92.7m	£88.9m
Total income	-	£113.7m	£95.8m	£90.8m
Operating expenses	-	(£31.9m)	(£29.1m)	(£27.9m)
Profit before tax	-	£81.8m	£66.7m	£62.9m
Total residential assets	£13,501m	£8,756m	£5,455m	£3,924m
Retail deposits	£13,501m	£13,501m	£13,501m	£13,501m

Constrained Markets Case

Under the constrained markets case, Blackbird has made broadly similar assumptions except with approximately half the gross new lending and retention business in 2008 and 2009 and three quarters in 2010. In addition, the reduction in residential lending would result in lower operating costs and a lower new funding requirement.

Figure 14 summaries the key income statement and balance sheet items under the PlatformsCo structure assuming the constrained credit markets case.

Platforms Company Summary – Constrained Markets Case				
£ millions	1 Jan 2008E	2008E	2009E	2010E
Interest receivable	-	£1,199.1m	£1,775.9m	£2,413.5m
Net interest income	-	£178.5m	£273.3m	£391.6m
Total income	-	£229.2m	£320.4m	£451.4m
Operating expenses (Net of FinCo recharge)	-	(£116.0m)	(£127.0m)	(£149.2m)
Profit before tax	-	£104.5m	£176.5m	£285.1m
Profit after tax	-	£75.2m	£127.1m	£205.3m
Total residential assets	£13,501m	£19,817m	£27,677m	£36,043m
Retail deposits	£13,501m	£13,501m	£13,501m	£13,501m
New Funding balance	-	£7,466m	£15,977m	£25,002m
Notional capital – Tier 1	£785m	£861m	£1,101m	£1,374m
Notional capital – Tier 2	£490m	£490m	£620m	£755m
Return on notional capital – Tier 1	n.a.	9.1%	13.0%	16.6%
Return on optimal capital*	n.a.	n.a.	18.1%	24.0%

* Optimal capital/calculated as notional Tier 1 capital required under Basle II excluding 28% buffer

In this scenario, the platform's profitability increases with a 65.2% CAGR over the forecast period. This is based upon new wholesale funding of £7.5bn in 2008, £16bn in 2009 and £25bn in 2010, with notional Tier 1 capital of £0.8bn (excluding 2008 profits) required over the course of 2008 to capitalise the business on a standalone basis. The notional Tier 1 is different from the normal markets case as the year end 2008 total assets position is £11.2bn smaller, consequently the initial capital requirement is lower.

In order to help assess the relative value of the Retail Deposits only platform, Figure 15 provides separate financial information for the Retail Deposits only platform under the constrained markets case. Detailed financials for the retail platform are provided in Section 4.

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Retail Deposits Only Platform Summary – Constrained Markets Case				
£ millions	1 Jan 2008E	2008E	2009E	2010E
Interest receivable	-	£860.6m	£843.2m	£841.4m
Net interest income	-	£114.2m	£106.1m	£106.6m
Total income	-	£118.4m	£109.2m	£108.4m
Operating expenses	-	(£31.9m)	(£29.1m)	(£27.9m)
Profit before tax	-	£86.5m	£80.1m	£80.5m
Total residential assets	£13,501m	£8,756m	£5,455m	£3,924m
Retail deposits	£13,501m	£13,501m	£13,501m	£13,501m

Profitability under the constrained credit markets case is slightly higher than in the normal markets case due to the higher return on treasury assets assumed in the constrained markets case.