HARDMAN & CO.

18 October 2019

ARBUTHNOT BANKING GROUP

3Q19: loans +33%, deposits +17%, investment rising

The key message from the 3Q'19 trading statement was of continued strong franchise growth (loans +33% to £1.6bn, deposits +17% to £2bn). The Private Bank has been adding ca.40 clients per month, although it takes time to generate revenue growth from them. Arbuthnot Direct has raised £85m of deposits since August, and other new business areas have shown strong grown (Renaissance Asset Finance loans £101m, +22%, Asset Based Lending £106m). There have been a limited number of credit situations with impairments rising, as may be expected at this stage of the cycle. Investment has been accelerated relative to our prior estimates and the wealth management division is being restructured.

- **3Q update:** The key messages continue – strong franchise growth, diversification by product and customer base, and a capital/liquidity structure that allows profitable, opportunistic acquisitions. Arbuthnot Direct has proven deposit flexibility. Its impairments remain modest, and are in line with our forecasts.

- **Outlook:** ABG is not immune from market uncertainty delaying deal conversion. Relative to the franchise growth, it is modest. As the expected franchise growth has been delivered, ABG is now investing a little ahead of our previous expectations. It has also restructured the wealth management business.

- **Valuation:** The average of our approaches is now £16.42 (previously £17.92), 1.3x 2020E NAV. Two of our models are based off 2020 earnings estimates, which now include accelerated investment but not the payback for it. The share price is well below the 1H'19 NAV (1,321p).

- **Risks:** As with any bank, the key risk is credit. ABG's existing business should see below-market volatility, and so the main risk lies in new lending. We believe management is cognizant of the risk, and has historically been very conservative. Other risks include reputation, regulation and compliance.

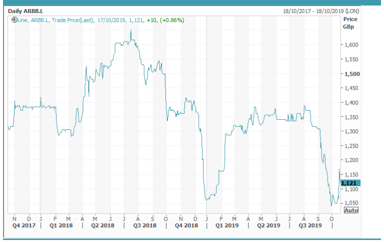
- **Investment summary:** ABG offers strong-franchise and continuing-business (normalised) profit growth. Its balance sheet strength gives it wide-ranging options to develop organic and inorganic opportunities. The latter are likely to increase in uncertain times. Management has been innovative, but also very conservative, in managing risk. Having a profitable, well-funded, well-capitalised and strongly- growing bank priced below book value is an anomaly.

Financial summary and valuation

Year-end Dec (£000)	2015	2016	2017	2018	2019E*	2020E*
Operating income	34,604	41,450	54,616	67,905	77,471	89,588
Total costs	-35,926	-46,111	-54,721	-64,982	-71,595	-80,157
Cost:income ratio	104%	111%	100%	96%	92%	89%
Total impairments	-1,284	-474	-394	-2,731	-2,877	-2,965
Reported PBT	-2,606	179	2,534	6,780	6,799	9,831
Adjusted PBT	2,982	4,009	3,186	7,416	8,799	11,831
Statutory EPS (p)	86.3	1,127.2	43.9	-134.5	37.5	54.0
Adjusted EPS (p)	13.5	17.1	47.5	40.3	48.2	64.6
Loans/deposits	82%	76%	75%	71%	79%	80%
Equity/assets	5.5%	18.5%	12.8%	9.0%	7.6%	7.1%
P/adjusted earnings (x)	86.7	68.4	24.6	29.0	24.3	18.1
P/BV (x)	1.46	0.77	0.76	0.91	0.92	0.90

**IFRS9 basis; Source: Hardman & Co Research*

Financials



Source: Refinitiv

Market data

EPIC/TKR	ARBB/ARBN
Price (p)	1,170/1110
12m High (p)	1,640
12m Low (p)	1,065
Shares (m)	15.4
Mkt Cap (£m)	178
Loan to Deposits (2020E)	80%
Free Float*	42%
Market	AIM/NEX

**As defined by AIM Rule 26*

Description

Arbuthnot Banking Group (ABG) has a well-funded and capitalised private bank, and has been growing commercial banking very strongly. It holds a 9.85% stake in Secure Trust Bank (STB).

Company information

Chair/CEO	Sir Henry Angest
COO/CEO Arb. Latham	Andrew Salmon
Group FD, Deputy CEO Arb. Latham	James Cobb

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Key shareholders

Sir Henry Angest	56.1%
Liontrust	6.5%
Miton AM	4.4%
Slater Investments	4.0%
R Paston	3.6%
M&G IM	3.5%

Diary

Feb'20	Pre-close trading update

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Positive takeaways from update

Value-adding mortgage deal completed and performing ahead of expectations

ABG confirmed the £265m acquisition of the mortgage portfolio at a 2.7% discount, which was completed in August. This deal demonstrates that ABG's strong liquidity and capital strength mean it can take advantage of attractively-priced acquisition opportunities and so add value to shareholders. Since acquisition, the loans have been performing ahead of the models used in pricing the deal, although we have not yet factored this into our forecasts.

Arbuthnot Direct proved flexible and delivered deposit growth when wanted

Since the mortgage book acquisition, Arbuthnot Direct has raised £85m in funding. ABG stated, when it was building out this online deposit platform, that its intent would be to use it for flexible deposit gathering as and when the need arose. It also allows deposits with different durations, and so helps manage interest rate and liquidity risk.

Group surplus liquidity ca.£300m

At the quarter-end, the group's surplus liquidity was in excess of £300m of the amount required to be held in reserve, with deposits exceeding £2bn.

Private bank attracting more customers

In the core Private Bank, the focus was shifted from lending to identifying and attracting new clients, and the number of new clients that have joined in the first nine months of 2019 has been averaging ca.40 per month. As a result, the net inflows of customer balances into the Investment Management business have been positive for each of the three months in the third quarter. It takes time for this to feed through to revenue, but the franchise growth is encouraging.

New lending lines delivering strong growth

In other new business lines:

- Renaissance Asset Finance (RAF) ended the quarter with a lending balance of £101m, an increase of 22% compared with the same time in the prior year, with the business recording above-average volumes in July and August. Management comments that the market has also seen a number of competitors withdraw from the market, which it expects to be beneficial in the long term.

- The Arbuthnot Asset Based Lending (ABL) business has continued to source new lending opportunities and has increased its customer facilities to £106m, a rise of 278% on the prior year.

Impairments rising gently, in line with our forecasts. ABG's model likely to see lumpy impairments – not helped by way IFRS9 recognises them. Impairments are, as expected at this stage of the cycle, rising, but only in line with our forecasts, which are unchanged

- Private banking is very situation-specific, and therefore lumpy. Management comments that it "continue to work through a small number of longstanding impaired loans. However, the resultant IFRS 9 provisions that arise when the outlook for economic scenarios used in the stress testing worsen, have seen a small increase. In addition there are now provisions associated with the grossing up of interest, which were not previously required." Our forecast impairment for the full year is £1.5m, with £0.7m in 2H.

- In RAF, "the business has experienced a small number of credit impairment events which will temper the otherwise overall good performance of the business." Our forecast 2H impairments are £467k, against £202k seen in 1H.

- In ABL, "The business also experienced its first potential credit event as one of its customers suffered a downturn in its trading performance. However, Arbuthnot's team managed to facilitate a rescue of the business via a trade sale." Our forecast 2H impairments are £139k, against £66k seen in 1H.

Reduction to estimates from update

Timing issues

Pipeline strong, but deal conversion slow given market uncertainty

Management reports that, while it has been active on new lending propositions, the uncertain macroeconomic outlook has led to a delay in the drawdown of these loans. As a result, the underlying loan balances (excluding the mortgage portfolio purchase) are behind where management had anticipated, but it believes this to be simply a timing issue, rather than a fundamental change. The intense competition for prime low-LTV mortgages has continued. To be conservative, we have trimmed 2020E NII by £250k.

Hedge cost may hit 2019 NII by £0.5m, with offsetting gain recognised through life of loan, i.e. hit to 2019 with gain in later years

ABG has a number of interest rate derivatives that are hedging approximately £26m of fixed-rate loans. During the year, these derivatives have generated a mark-to-market loss of ca.£500k, which will flow into the year-end results. This again is purely timing, as the offsetting gain is in interest income, where the interest received in future periods is above the comparable interest rate that would be earned on the loan at that time. Consequently, over the full term of the derivative contracts, the overall economic effect will result in a net zero impact to the profit and loss of the group, but there could be a "hit" of £500k to 2019 NII and profit.

ABL full launch delayed because of platform problems

While ABL has been performing strongly and ahead of our expectations, Arbuthnot Specialist Finance has lent only £1m, as it remains in a soft-launch phase due to an aborted initial search for a technology provider for its customer-facing loans platform. A new provider is now engaged, and the platform should be fully operational in 2020.

Business restructuring

Wealth management model fundamentally restructured. Potential business disruption from that, and lower AUM impacts fees.

In 2017/2018, the wealth management division produced disappointing results, and so new management was introduced and, with it, a new pricing model. In July, the business ceased charging clients for ongoing annual advice reviews and moved to an event-based model, with clients being charged wealth planning fees when they need specific advice. On transition, there is a period where fewer fees are generated, and consequently the wealth planning division is expected to be loss-making this year. Our forecast 2019 fees and commissions in the private bank were broadly flat on 2018, and we have reduced them by £1m for 2020 to reflect potential upcoming disruption and the lower level of AUM.

Further investment

Pace of investment ahead of our previous forecast, reflecting strong franchise growth being delivered

ABG is using part of the anticipated profit growth from its loan and franchise expansion to re-invest in its core proposition. With the update, we note it is implementing i) a new Salesforce CRM System, which will "transform the way in which the bank interacts with clients", ii) a new website for Arbuthnot Latham, which will enable the business to establish a digital marketing channel for the first time, and iii) in conjunction with Oracle, ABG has been developing the API (Application Programming Interface) connections to the wider payment systems, to be fully compliant with the Second Payment Services Directive ("PSD2"). Investment was expected, but we have increased 2020 costs by £1m to reflect the initiatives in the announcement. While investment was always expected, the pace of it appears to be somewhat ahead of our previous estimates.

Financials

Impact on estimates

The only change in 2019E has been to cut NII by £500k for the hedge. For 2020E, we have cut NII by £0.2m, to reflect the delayed timing, and we have reduced our fees and commission estimate for 2020 by ca.£1m. We have trimmed the assumed STB dividend in line with the latest holding and consensus dividend forecasts. 2020E costs have been increased by £1m, reflecting further investments.

Estimate changes						
		2019E			2020E	
Year-end Dec	Old	New	% change	Old	New	% change
Profit and loss (£000)						
Operating income	77,574	77,471	0%	90,340	89,588	-1%
Costs	-71,595	-71,595	0%	-79157	-80,157	1%
Impairments	-2,877	-2,877	0%	-2965	-2,965	0%
Associates and other income	4,197	3,800	-9%	3782	3,365	-11%
Statutory PBT	7,299	6,799	-7%	12,000	9,831	-18%
Ordinary DPS (p)	38.0	38.0	0%	41	41	0%
Balance sheet, @ 31 Dec (£m)						
Loans and Advances	1,643	1,643	0%	1,828	1,828	0%
Deposits	2,069	2,069	0%	2,294	2,294	0%
Equity	197	197	0%	202	200	-1%

Source: Hardman & Co Research

Profit & loss

Profit & loss				
Year-end Dec (£000)	2017	2018	2019E*	2020E*
Interest income	47,427	65,290	80,000	95,000
Interest expense	-6,334	-10,107	-17,320	-20,803
Net interest income	41,093	55,183	62,680	74,197
Fees and comms. income	13,805	12,956	15,091	15,691
Fees and comms. expense	-282	-234	-300	-300
Net fees and comms.	13,523	12,722	14,791	15,391
Operating income	**54,616**	**67,905**	**77,471**	**89,588**
Net impairment on financial assets	-394	-2,731	-2,877	-2,965
STB dividend income	0	0	1,300	1,365
Other income	3,033	6,588	2,500	2,000
Operating expenses	-54,721	-64,982	-71,595	-80,157
Profit before tax from continuing operations	**2,534**	**6,780**	**6,799**	**9,831**
Income tax	-448	-1,121	-1,156	-1,671
Profit after tax from continuing operations	2,086	5,659	5,643	8,160
Profit from discontinued operations after tax	4,437	-25,692	0	0
Profit for year	6,523	-20,033	5,643	8,160

**IFRS9 basis; Source: ABG, Hardman & Co Research*

Balance sheet

Balance sheet						
@ 31 Dec (£000)	2015	2016	2017	2018	2019E*	2020E*
Cash and balances at Central Bank	115,938	368,611	195,752	405,325	364,279	415,665
Loans and advances to banks	31,844	28,578	36,951	54,173	54,173	54,173
Debt securities held to maturity	91,683	87,728	107,300	342,691	342,691	342,691
Assets classified as held to sale	0	118,456	0	8,002	15,000	7,000
Derivative financial instruments	2,707	1,490	1,516	1,846	1,846	1,846
Loans and advances to customers	**1,158,983**	**1,579,512**	**758,799**	**1,224,656**	**1,643,000**	**1,828,000**
Other assets	16,866	16,894	11,939	12,716	12,716	12,716
Financial investments	1,277	2,685	2,145	35,351	27,467	27,467
Deferred tax	2,588	1,784	1,665	1,490	1,490	1,490
Investment in associates	943	943	82,574	0	-	-
Intangible assets	11,318	10,874	8,522	16,538	18,000	17,500
Property, plant and equipment	12,475	14,004	4,782	5,304	5,304	5,304
Right of use property	0	0	0	0	20,559	20,559
Investment property	0	0	53,339	67,081	69,446	69,446
Total assets	**1,446,622**	**2,231,559**	**1,265,284**	**2,175,173**	**2,575,971**	**2,803,857**
Deposits from banks	27,657	55,305	3,200	232,675	232,675	232,675
Derivative financial instruments	1,067	135	227	188	188	188
Deposits from customers	**1,194,285**	**1,929,838**	**997,649**	**1,714,286**	**2,069,000**	**2,294,000**
Liabilities relating to assets classified as held for sale	0	8,700	0	0	-	-
Current tax liability	3,612	3,366	147	236	236	236
Other liabilities	34,984	31,977	17,082	18,549	18,549	18,549
Lease liabilities	0	0	0	0	20,882	20,882
Debt securities in issue	11,448	10,834	12,621	13,283	37,658	37,658
Total liabilities	**1,273,053**	**2,040,155**	**1,030,926**	**1,979,217**	**2,379,188**	**2,604,188**
Share capital	153	153	153	153	153	153
Retained earnings	114,641	123,330	235,567	209,083	209,910	212,796
Other reserves	-1,263	34	-1,362	-13,280	(13,280)	(13,280)
Total to owners of the parent	113,531	123,517	234,358	195,956	196,783	199,669
Non-controlling interests	60,038	67,887	0	0	-	-
Total equity	**173,569**	**191,404**	**234,358**	**195,956**	**196,783**	**199,669**

**IFRS9 basis; Source: ABG, Hardman & Co Research*

Valuation

Average valuation £16.42, implying 40% upside potential

Following these results, the range of our valuations is £11.83 to £23.27 (previously £13.88 to £23.51), with the average at £16.42 (previously £17.92), implying upside potential of 40% on the current share price. The lowest forecast is the Dividend Discount Model (DDM), which forecasts dividends based off 2020 earnings. Given that the cuts to forecasts are related primarily to timing/investments, with incremental payback in 2021 and beyond, we would expect this valuation to rise when we adopt 2021 forecasts with the results in spring next year. The fall in the Sum-of-the-Parts (SoTP) model has the same issue, with the 2020 highly-rated private bank profits falling without building in any of the incremental future profit growth. The small fall in the Gordon Growth (GGM) model reflects the modest drop in equity forecasts for end-2020.

Summary of different valuation techniques

	Implied price (£)	Upside potential
GGM	23.27	99%
DDM	11.83	1%
SoTP	14.18	22%
Average absolute measures	**16.42**	**40%**

Source: Hardman & Co Research

GGM

The impact on equity, and so on the GGM, of our forecast changes in small.

GGM and sensitivities

	Base	+1% RoE	+1% CoE	+0.5% G
RoE	13.5	14.5	13.5	13.5
CoE	10.0	10.0	11.0	10.0
Growth	5.0	5.0	5.0	5.5
Price/book value (x)	1.7	1.9	1.4	1.8
Premium for near-term outperformance	-5%	-5%	-5%	-5%
Adjusted price/book value (x)	**1.6**	**1.8**	**1.3**	**1.7**
Book value 2020E (£m)	211.8	211.8	211.8	211.8
Valuation (£m)	**342.0**	**382.3**	**285.0**	**357.7**
Valuation per share (p)	**23.27**	**26.00**	**19.39**	**24.33**
Variance (p per share)		40.2	-57.0	15.6

Source: Hardman & Co Research

SoTP

The fall in private banking profits has a material effect on the SoTP.

SoTP assumptions

£m	2020E earnings	Rating (x)	Value
PB	2.9	20	58.6
CB	7.1	12	84.9
RAF	1.9	10	18.7
Other divisions	4.8	12	57.0
Central division	-8.5	4	-33.9
Holding in STB			23.1
Group total			208.4
Value per share (p)			14.18

Source: Hardman & Co Research

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