

Arbuthnot Banking Group

Q314 trading update

Delivering growth as promised

ABG's trading statement was positive for both businesses. We note the retail bank has delivered an 87% increase in gross lending (Q314 on Q313) with growth from existing consumer businesses and the new SME initiatives. Credit quality remains excellent. The private bank is reporting payback on investments. Both businesses continue to invest heavily. We have modestly increased our revenue, pre-tax and EPS estimates. The increased market value of STB in our sum-of-the-parts model and higher profit forecasts raise the average of our valuation approaches to £15.4.

Year end	Revenue (£m)	PBT* (£m)	EPS* (p)	DPS (p)	P/E (x)	Yield (%)
12/12	65.6	9.7	27.1	25.0	42.3	2.2
12/13	100.0	16.8	49.1	**44.0	23.4	3.8
12/14e	125.8	28.2	92.3	27.0	12.4	2.4
12/15e	157.6	39.8	115.2	28.0	10.0	2.4

Note: *PBT and EPS are normalised, excluding intangible amortisation, exceptional items and share-based payments. **Including 18p anniversary dividend.

Retail bank (STB) trading update

Lending across the group appears strong and the loan book at the end of September exceeded £500m (H114 £443m, our previous full-year estimate £555m). There have been SME drawdowns in the quarter (both property and invoice finance), but these businesses were only recently launched (the latter only on 1 September). We expect an acceleration of drawdowns into Q4. In the consumer book, management highlights cycle and motor finance as the strongest, with overall consumer volumes materially higher than Q313. Credit quality remains better than expected.

Private Bank trading update

Management comments that its investments in distribution are being rewarded with a good flow of new client introductions, attractive loan opportunities and further increases in funds under management. The Dubai branch has celebrated its first anniversary and remains on track to break even in 2015 as planned.

Outlook

As we detail in our contemporaneous [note on STB](#), the SME operations are running ahead of plan and we have incorporated further uplifts in lending, income and costs to support this accelerated roll-out. Overall we have increased STB 2014/15 pre-tax profit by £1m. This should be conservative and we will review 2015 growth rates with the January trading statement and results in March. In the private bank, we have increased both revenue and costs.

Valuation: Uplift to £15.4

We have seen an uplift in STB market capitalisation feeding through to our sum-of-the-parts model. The modest uplift to earnings estimates (and associated retained reserves) has also been a small benefit. Overall, our valuation is increased to £15.4 from £14.8.

Arbuthnot Banking Group is a research client of Edison Investment Research Limited

Banks

20 October 2014

Price 1,148p
Market cap £171m

Net debt/cash (£m)	N/A
Shares in issue	14.9m
Free float	43%
Code	ARBB
Primary exchange	LSE
Secondary exchange	N/A

Share price performance



%	1m	3m	12m
Abs	9.3	(5.2)	11.4
Rel (local)	171	1.1	15.9
52-week high/low	1,490p		1,010p

Business description

Arbuthnot Banking Group (ABG) is engaged in retail and private banking. It owns 53% of the rapidly growing Secure Trust Bank. Private banking is conducted through Arbuthnot Latham.

Next event

Trading statement	January 2015
Full-year results	March 2015

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[Edison profile page](#)

Valuation

The average of our absolute valuation methods is £15.4 (previously £14.8). The increase is primarily driven by the sum-of-the-parts model and the increase in the market value of the STB stake.

Peer valuations increase

In our note on STB we have reviewed a number of SME finance providers and challenger banks. ABG lacks exact peers, but we note a number of additional potential comparators below.

Exhibit 1: Peer comparators			
	P/E 2014 (x)	P/E 2015 (x)	Yield 2014 (%)
ABG (Edison estimates)	12.4	10.0	2.4
STB (Edison estimates)	18.2	15.4	2.6
Other growth financials			
Hargreaves Lansdown (June)	24.6	N/A	3.9
Brooks MacDonald (June)	15.4	N/A	2.2
Specialist lenders			
Provident Financial	16.1	14.0	4.8
Paragon (Sept)	10.5	9.3	2.7
S&U	12.5	10.5	3.5
Tungsten (following April)	loss	13.8	0.0
Other wealth managers			
Ashcourt Rowan (March following year)	12.5	9.4	0.0
Brewin Dolphin (Sept)	15.1	12.7	4.2
Charles Stanley (March following year)	36.3	16.1	4.0
Close Bros (July)	11.4	n/a	3.8
Rathbone Brothers	18.1	15.2	2.8

Source: Thomson Datastream consensus estimates, Edison Investment Research. Note: Prices as at 15 October 2014.

Sum-of-the-parts model (£14.7 vs £13.7 previously)

The key driver is the market value of STB, which has risen since our [last report](#). We continue to apply a 10% discount to the market price to reflect a more probable achievable price if ABG decides to sell a further material stake. We note the current tax regulations should not lead to any tax leakage on sale. The multiple of private banking earnings reflects a conservative view of the wealth managers above. For centrals, we have applied a 10x multiple.

Exhibit 2: Sum-of-the-parts model				
2015 estimates (£000s)	Pre-tax	Post tax	Multiple (x)	Value (£m)
UK private banking	5,500	4,400	12.8	56,320
Secure Trust (90% of market value of its 53% holding)	N/A	N/A	N/A	214,744
Centrals	(6,515)	(5,147)	10.0	(51,469)
Total				219,596
Per share (£)				14.7

Source: Edison Investment Research

Gordon's growth model (£16.0 vs £15.9 previously)

We continue to assume a long-term sustainable ROE of 17.5%, a 70% long-term payout, giving growth at 5.3% and cost of equity of 10.75%. The implied price to book is 2.2x, which, on the estimated 2015 NAV, generates a value of £16.0 (previously £15.9). Since our last report, the equity has increased with the modestly higher estimates.

Exhibit 3: Gordon's growth model and sensitivities

	Base	1% ROE	1% growth	1% COE
ROE (%)	17.50	18.50	17.50	17.50
Growth (%)	5.25	5.25	6.25	5.25
COE (%)	10.75	10.75	10.75	11.75
P/B	2.23	2.41	2.50	1.88
2015e NAV (p)	717	717	717	717
Implied target price (p)	1,597	1,727	1,793	1,351
Impact of near-term performance	0	0	0	0
Valuation (p)	1,597	1,727	1,793	1,351
Difference (p)		130	196	-246

Source: Edison Investment Research

Financials

STB

The key driver to changed assumptions is the speed of the SME roll-out. At this stage, we have accelerated the growth of business by bringing into 2014 revenues and costs that may have been expected in 2015 (and in 2015 from 2016). Accordingly, profits for both years have been increased by £1m. This should prove conservative and we will review the rate of growth for 2015 with the results in March.

In detail, we have once again raised lending assumptions (end 2014 was £555m, now £580m; end 2015 was £821m, now £850m). We have increased motor lending by £10m in both years with the balance in SME lending. This leads to higher revenue (2014/15 NII up £1m). We have also assumed an accelerated profile for fee generation in the invoice business (fees up £0.5m). Some of this has been absorbed by higher costs (up £0.5m) leading to a 3% increase in profits and EPS estimates for 2014 and 2015.

Private bank

Given the confidence in the payback on investments we have increased NII (2014: £0.25m, 2015: £0.75m) and fees (2014: +£0.25m and 2015: £0.75m), although we have also increased divisional costs (+£0.6m in 2014 and £1.75m in 2015).

Changes to estimates

Exhibit 4: Changes to estimates

	Edison normalised EPS (p)			Normalised PBT (£m)			Revenue (£m)		
	Old	New	% chg.	Old	New	% chg.	Old	New	% chg.
2014e	89.7	92.3	3	27.3	28.2	3	123.8	125.8	2
2015e	113.7	115.2	1	39.0	39.8	2	154.6	157.6	2

Source: Edison Investment Research

Profit and loss

Exhibit 5: Key financials – profit and loss account (£000s)				
Year end 31 December	2012	2013	2014e	2015e
Gross interest income	62,300	93,329	114,235	147,085
Interest expense	(17,514)	(20,279)	(20,750)	(24,000)
Net interest income	44,786	73,050	93,485	123,085
Fee & commission income	24,116	31,816	36,750	39,500
Fee & commission expense	(3,347)	(4,846)	(4,400)	(4,950)
Net non-interest income	20,769	26,970	32,350	34,550
Total operating income	65,555	100,020	125,835	157,635
Total G&A expenses (exc non-recurring items) below	(53,043)	(73,631)	(84,600)	(94,500)
Operating profit pre impairments & exceptionals	12,512	26,389	41,235	63,135
Impairment charges on loans	(10,984)	(18,807)	(19,750)	(26,050)
Other income	396	1,183	100	100
Operating profit post impairments	1,924	8,765	21,585	37,185
STB non-recurring costs	9,830	0	0	0
Other Non-recurring items	839	6,948	0	0
Pre-tax profit (reported)	12,593	15,713	21,585	37,185
Pre-tax normalised (Edison basis)	9,718	16,799	28,186	39,778
Pre-tax normalised (Company basis)	11,555	19,549	26,870	39,778
Tax	(1,128)	(4,198)	(5,393)	(7,731)
Profit after tax (FRS3)	11,465	11,515	16,192	29,454
Minority interests	(3,077)	(3,585)	(7,756)	(14,318)
Net income attributable to equity shareholders	8,658	7,930	8,436	15,136
Edison adjusted Net income to equity shareholders	4,040	7,304	13,748	17,145
EPS - FRS3 (p)	52.6	51.9	55.2	99.1
Normalised EPS (p)	27.1	49.1	92.3	115.2
DPS (p)	25.0	44.0	27.0	28.0

Source: ABG, Edison Investment Research

Adjusted profits

Exhibit 6: Key financials – adjusted profit (£000s)				
	2012	2013	2014e	2015e
Statutory pre tax	12,593	15,713	21,585	37,185
Bargain Purchase gain of acquisition of ELL	(9,830)	0	0	0
ELL Fair value amortisation	3,056	4,066	2,608	100
ELL management incentive	1,700	0	0	0
STB acquisition costs	1,428	854	0	0
STB share options	1,610	2,221	1,600	1,600
V12 FV amortisation	0	893	893	893
Gain from bargain purchase	0	(413)	0	0
One-off costs SME build out	0	0	1,500	0
STB adjustments (sub Total Edison basis)	(2,036)	7,621	6,601	2,593
Gain on sale of Head office	0	(6,535)	0	0
Gain on disposal of International Private bank	(839)	0	0	0
Total Edison basis adjustments	(2,875)	1,086	6,601	2,593
Edison adjusted statutory profit	9,718	16,799	28,186	39,778
Company additional adjustments				
STB: Excess funding costs of acquisition	1,900	0	0	0
Acquired portfolio	(363)	1	184	0
Add back SME costs	0	0	(1,500)	0
Gain from bargain purchase	0	413	0	0
STB company adjustments	1,537	414	(1,316)	0
AL hiring of new executives	300	0	0	0
ABG group share options	0	1,021	0	0
Dubai office investment	0	879	0	0
180th year anniversary costs	0	436	0	0
Company additional adjustments	1,837	2,750	(1,316)	0
Company normalised pre-tax	11,555	19,549	26,870	39,778
Edison pre-tax adjusted profits	9,718	16,799	28,186	39,778
Tax charges at standard rate on adjusted	(2,381)	(3,906)	(6,060)	(8,055)
Effect of non-taxable adjusting items	(1,865)	(462)	753	201
Edison adjusted post-tax profits	5,472	12,431	22,879	31,924
Reported minority	(3,077)	(3,585)	(7,756)	(14,318)
Effect of adjustments on minority	1,645	(1,541)	(1,375)	(461)
Edison adjusted attributable	4,040	7,304	13,748	17,145
Edison adjusted no shares (exc treasury)	14.9	14.9	14.9	14.9
Edison adjusted EPS (p)	27.1	49.1	92.3	115.2

Source: ABG, Edison Investment Research

Balance sheet

Exhibit 7: Key financials – balance sheet (£000s)				
Assets				
Cash and balances with central bank	203,683	193,046	193,046	100,000
Derivative financial instruments	648	508	508	508
Interbank loans	144,391	105,061	118,140	239,572
Customer loans, gross	607,616	763,042	1,063,000	1,405,000
Less impairment provision	(20,648)	(31,033)	(43,000)	(55,000)
Net customer loans	586,968	732,009	1,020,000	1,350,000
Debt securities	13,526	19,466	50,000	50,000
Trading positions	0	0	0	0
Assets classified as held for sale	0	0	0	0
Current tax asset	0	0	0	0
Goodwill and other intangibles	8,326	13,103	12,000	11,000
Property, plant and equipment	22,487	5,522	5,798	6,088
Deferred tax and Other assets inc financial investments	19,980	24,139	30,000	30,000
Total Assets	1,000,009	1,092,854	1,429,492	1,787,168
Liabilities				
Interbank deposits	373	2,003	1,000	1,000
Total customer deposits	894,545	957,791	1,205,000	1,537,500
Debt securities in issue	11,980	12,232	12,232	12,232
Other liabilities	24,463	33,914	33,914	33,914
Total liabilities	931,361	1,005,940	1,252,146	1,584,646
Minority interests	16,376	20,327	81,449	95,767
Book value of shareholders' equity	52,272	66,587	95,897	106,755
Number of shares (m) - net of treasury	14.9	14.9	14.9	14.9
Pure equity NAV (p)	351.1	447.2	644.1	717.0

Source: ABG, Edison Investment Research

Divisional forecasts

Exhibit 8: Key financials – divisional forecasts (£000s)				
	2012	2013	2014e	2015e
STATUTORY				
Private banking (Arbuthnot Latham)	2,058	7,728	3,650	5,500
Retail Banking (Secure Trust)	17,253	17,193	24,700	38,200
Operating divisions	19,311	24,921	28,350	43,700
Centrals and internal adjustments	(6,718)	(9,208)	(6,765)	(6,515)
Group pre-tax profit	12,593	15,713	21,585	37,185
ADJUSTED Edison basis				
Private banking (Arbuthnot Latham)	2,058	1,193	3,650	5,500
Retail Bank ongoing exc Everyday Loans accounting FV and fee unwinds	15,217	24,814	31,301	40,793
Operating divisions	17,275	26,007	34,951	46,293
Centrals and internal adjustments	(7,557)	(9,208)	(6,765)	(6,515)
Group continuing ops pre-tax profit (excluding except.)	9,718	16,799	28,186	39,778
ADJUSTED company basis				
Private banking (Arbuthnot Latham)	2,358	2,072	3,650	5,500
Retail Bank ongoing exc Everyday Loans accounting FV and fee unwinds	16,754	25,228	29,985	40,793
Operating divisions	19,112	27,300	33,635	46,293
Centrals and internal adjustments	(7,557)	(7,751)	(6,765)	(6,515)
Group continuing ops pre-tax profit (excluding except.)	11,555	19,549	26,870	39,778

Source: ABG, Edison Investment Research

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