Arbuthnot Banking Group

FY14 results

Delivering loan growth across group

Banks

ABG is delivering growth across the group. Its business model of fostering a range of financial services has worked most successfully with the retail bank (Secure Trust) but the private bank is also delivering substantial underlying profit and franchise growth (loans up 57% but still has a divisional loan to deposits ratio of 92%). Group pre-tax profits of £22.5m were ahead of our forecast of £21.8m. We have accelerated loan growth and costs following these results.

Year end	Revenue (£m)	PBT* (£m)	EPS* (p)	DPS (p)	P/E (x)	Yield (%)
12/12	100.0	16.8	49.1	**44.0	29.9	3.0
12/13	126.3	30.9	101.3	27.0	14.5	1.8
12.14e	165.4	37.6	108.2	28.0	13.5	1.9
12/15e	201.0	46.0	135.2	29.0	10.8	2.0

Note: *PBT and EPS are normalised, excluding intangible amortisation, exceptional items and share-based payments. **2013 included 18p special dividend

2014 results

Both the retail and private banks delivered excellent franchise and profit growth. ABG owns 52% of Secure Trust Bank which saw lending up 59% (from £391m to £622m), driven by increases in business lending (from £2m to £143m) and across the personal books. These drove a 24% growth in revenue with operational improvements (costs growth of 22%). Impairments were better than expected despite the above forecast loan growth. Statutory profit before tax increased by 53% to £26.1m (2013: £17.1m) while our underlying profit before tax increased from £24.7m to £34.5m. STB remains well capitalised (core tier 1 capital ratio 23% (2013: 20%)) and funded (loan to deposit ratio 102% (2013: 90%)).

The private bank is also well capitalised and despite 57% loan growth in 2014, (organic growth was 26%, an acceleration on the 18% seen in 2013), had a loan to deposit ratio of 92% (2013 66%). It saw reported profits drop to £3.6m from £7.7m. However 2013 included a £6.5m one off property gain and underlying (Edison basis), profits trebled.

2015 Outlook

We have materially increased loan forecasts for the group (2015e up £0.2bn to £1.6bn), of which half was due to higher real estate lending. We have assumed vigorous deposit gathering, keeping the group loan to deposit ratio below 100%. Fees were a little disappointing and costs above forecast. We have further accelerated investment spend with the net effect of a small trim to pre-tax profit and EPS estimates (but still 20%+ growth in pre-tax profits).

Valuation: Upside over 30%

The average of our valuation approaches is £19.3 which is equivalent to an undemanding 14.3x 2016e earnings. This has increased from our previous valuation (£16.6), primarily because we have rolled forward our valuation base year and the near term forecast growth is materially above our long term assumptions.

25 March 2015

Price	**1,467p**
Market cap	**£218m**

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

Share price performance

%	1m	3m	12m
Abs	(4.8)	11.3	26.4
Rel (local)	(5.9)	4.4	17.2
52-week high/low		1,570p	1,010p

Business description

Arbuthnot Banking Group (ABG) is engaged in retail and private banking. It owns 52% of the rapidly growing Secure Trust Bank. Private banking is conducted through Arbuthnot Latham.

Next event

AGM	May 2015

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Investment summary

Company description: Growing retail bank and private bank

The retail bank is forecast to deliver around 80% of the 2015e total operating units' profits, driven by both personal unsecured lending and the new SME businesses. We have issued a separate update on STB detailing its opportunities. We expect the private bank profits to grow with payback for investments made over the past couple of years in staff, new offices and a mortgage portfolio. The group remains well capitalised and funded.

Valuation: Considerable upside on STB stake

We consider three valuation techniques, the average of which indicates a price of c £19.3. The sum-of-the-parts model is £18.2, being significantly driven by the market value of ABG's 52% holding in STB. Our Gordon's growth model valuation (£20.7) has increased from our previous estimate (£15.9) due to rolling forward the base valuation year and the inclusion in ABG's equity of part of the STB equity issue.

Financials: Modest estimates cuts, profit growth still 20%+

In the financials section below we have given a detailed review of changes in estimates. The key headlines are that loan growth at both banks was well ahead of forecasts and this has led to some revenue upgrade, partially offset by weaker than expected fees. Costs were above forecasts and going forward we have carried this trend into 2015/2016 with further accelerated investment. This has led to a modest trimming of estimates but we are still forecasting over 20% profit growth.

Exhibit 1: Key estimate changes

	Edison normalised EPS (p)			Normalised PBT (£m)			Revenue (£m)			Dividend		
	Old	New	Chg (%)	Old	New	Chg (%)	Old	New	Chg (%)	Old	New	Chg (%).
2014	93.1	101.3	9	28.4	30.9	9	126.0	126.3	0	27.0	27.0	0%
2015e	113.2	108.2	(4)	39.8	37.6	(5)	164.1	165.4	1	28.0	28.0	0%
2016e	N/A	135.2	N/A	n/a	46.0	N/A	N/A	202.0	N/A	N/A	29.0	0%

Source: Edison Investment Research

Sensitivities: Macro-economy and regulation key sensitivities

- Credit risk – credit costs will lag the growth in lending but losses should be manageable. Rapid expansion in new areas increases the risk that systems are not established to deal with potential problem loans.
- Interest rate risk – overall, we believe ABG will benefit from an increase in interest rates.
- Regulation – market-wide regulation will increase costs and reduce flexibility, but capital changes may lead to loan opportunities. Despite being conservatively run, the administration cost and complexity of meeting ever more burdensome regulation is a real drag on profits especially for a smaller institution with less critical mass over which to spread the cost.
- Reputation – reputation is always an issue for private banking (as evidenced by HSBC's trevails). We believe Arbuthnot Latham is conservatively managed and domestically orientated which should reduce this risk. The expansion in Dubai potentially increases this risk.
- Competition – we expect the large banks to continue to focus on restructuring their balance sheets and have limited appetite to lend. This also means funding for traditional non-bank lenders is likely to remain challenging. However, there are a number of bank challengers and new entrants such as peer-to-peer lenders in the retail bank space.
- Acquisition risk – we believe the organic opportunities mean acquisition risk is less than it was in the past.

Company description: Well-funded, well-capitalised growing retail and private bank

ABG's mix of profits is given in Exhibit 2. The retail bank is the key contributor and is using its strong capital and deposit ratios to exploit market opportunities across a range of products. While currently focused on personal customers, STB is building an infrastructure to offer invoice financing and property lending to SMEs, especially residential property developers. The private bank is a traditional UK, onshore private bank offering a range of services to higher net worth individuals. Having been solely UK focused, in June 2013 it opened an office in Dubai.

Exhibit 2: Divisional breakdown (£000s)

	2012	2013	2014	2015e	2016e
STATUTORY					
Private banking (Arbuthnot Latham)	2,058	7,728	3,628	7,150	8,630
Retail Banking (Secure Trust)	17,253	17,193	26,339	35,600	42,750
Operating divisions	**19,311**	**24,921**	**29,967**	**42,750**	**51,380**
Centrals and internal adjustments	(6,718)	(9,208)	(7,452)	(7,130)	(6,630)
Group pre-tax profit	**12,593**	**15,713**	**22,515**	**35,620**	**44,750**
ADJUSTED Edison basis					
Private banking (Arbuthnot Latham)	2,058	1,193	3,628	7,150	8,630
Retail Bank	15,217	24,814	34,766	37,593	43,950
Operating divisions	**17,275**	**26,007**	**38,394**	**44,743**	**52,580**
Centrals and internal adjustments	(7,557)	(9,208)	(7,452)	(7,130)	(6,630)
Group continuing ops pre-tax profit (excluding except.)	**9,718**	**16,799**	**30,942**	**37,613**	**45,950**
ADJUSTED company basis					
Private banking (Arbuthnot Latham)	2,358	2,072	4,826	7,150	8,630
Retail Bank	16,754	25,228	33,266	37,593	43,950
Operating divisions	**19,112**	**27,300**	**38,092**	**44,743**	**52,580**
Centrals and internal adjustments	(7,557)	(8,772)	(7,452)	(7,130)	(6,630)
Group continuing ops pre-tax profit (excluding except.)	**11,555**	**18,528**	**30,640**	**37,613**	**45,950**

Source: Arbuthnot Banking Group, Edison Investment Research

Retail banking (Secure Trust Bank)

We review STB's 2014 results in detail in our note Taking the opportunity . STB has both strong capital ratios (core tier 1: 23%) and liquidity (deposits £608m, loans £622m). It has also seized the opportunity created by funding and portfolio issues for major banks and specialist lenders to create rapid growth and a sustainable, diversified lending portfolio across multiple, carefully targeted niches including a range of personal lending products. We expect heavy investment to build an SME financing business initially focused on property and invoice finance.

Deposits

Deposits – the end year loan to deposit ratio thus increased from 75% (end 2012) to 102% (end 2014). We expect the group to manage to around 100% over the medium term. In 2013 STB was also approved for the Funding for Lending Scheme (FLS). While its use of the programme has been modest to date (end 2014 £16m), FLS does give STB immediate access to liquidity, and has allowed it to bring deposit volumes in line with lending, having previously been over-funded. STB uses comparison best-buy tables to distribute at low administration costs. Most recently it has been topping the best-buy tables for five- and seven-year bonds which not only locks in funding but also provides some protection against a rising interest rate environment (when it eventually happens). We believe STB's sustained position on the best-buy tables gives investors an indication of the strength of its lending (noting that at any specific time there may be particular factors having an influence – such as pre-funding deposits ahead of the government issuing highly attractive pensioner bonds).

Lending

STB has shown great innovation in identifying and exploiting growth opportunities created by potential competitors withdrawing from the market. Retail point of sales is expected to more than quadruple 2016 on 2012 while business finance is expected to grow from under 1% to over half of the book in just three years (see Exhibit 3). We review the detailed breakdown of lending in our STB note.

Exhibit 3: Loan balances (£m)

	Dec 12	Dec 13	Dec 14	Dec 15e	Dec 16e
Personal loans	142.0	159.2	181.4	210.0	240.0
Motor loans	89.6	114.7	137.9	160.0	185.0
Retail point of sale	64.2	114.4	156.3	220.0	275.0
Business Finance	0.0	1.8	143.3	405.0	795.0
Other	1.8	0.9	3.6	5.0	5.0
Total	**298**	**391**	**623**	**1,000.0**	**1,500.0**

Source: Secure Trust Bank, Edison Investment Research

SME lending initiative

Residential property development (main element of real estate finance)

Having started in mid-2014, STB completed 47 deals by the year-end advancing £133.7m (average deal size £2.8m). We note from the accounts, a further £96m has been committed but not yet drawn down. Demand appears strong and with a market size in the identified niche likely to be in the tens of billions, significant further growth has been built into our forecasts. The revenue accrued in 2014 was £2.4m which implies an effective interest rate (ie including amortised fees) of around 7-8%.

STB has identified a particular niche of property lending, an area where major banks have limited appetite to lend, given its capital and liquidity requirements and losses in downturns. The economics are attractive. We estimate the long-term cost-income ratio for this business should not exceed 20%. Assuming total income of 7.5% (per section above), less funding costs of 2.5% (2015e), less administration costs of 1%, less 0.5% credit loss), the pre-tax profit should be c 3.5%. This generates a post-tax return on equity of 28% (assuming a 100% risk-weighting and 10% core tier 1 ratio).

Key features include:

- Residential development is the key element.
- Typical size £1-3m.
- Leverage is capped at 60%.
- Established developers.
- Fixed interest rates (pre-fees) of 5-7%.
- Personal guarantees.

Invoice finance

STB has ambitious plans to grow in the invoice-financing market (where a number of its executives have spent a significant part of their careers). The market is vast and STB should benefit as large banks manage their balance sheets. While non-bank competition is increasing with a range of traditional finance companies and peer-to-peer platforms, STB has an advantage over many new entrants given the experience of the existing and new teams. STB Invoice Finance will typically operate in the £0 to £5m turnover sector of the market and it estimates there are currently c 36k customers with £4bn exposure. Typical industries to be targeted are manufacturing, distribution, wholesale and service. The company's expectation is that business will be sourced through accountants (typically regional tier two/three firms and c 45% of new business), brokers (35%) and self-generated from data mining, customer/debtor introductions etc (20%). The business was only launched in H214 and had period end balances of £5m.

Asset Finance

The asset finance business launched in Q414 through a partnership with Haydock Finance. The latter is originating and servicing the deals while STB funds them and assesses the credit risk. Haydock receives a modest upfront commission and then has a profit-share arrangement accounting for the bulk of its remuneration. Period end balances of £4.5m were reported.

Credit risk

Exhibit 4: Key credit metrics (£000s)

December	2010	% gross	2011	% gross	2012	% gross	2013	% gross	2014	% gross
Neither past due nor impaired	**79.9**	**82%**	**144.3**	**88%**	**282.4**	**90%**	**371.3**	**89%**	**581.9**	**89%**
Past due but not impaired	0.1	0%	0.4	0%	0.6	0%	0.4	0%	0.3	0%
Past due up to 90 days and impaired	5.6	6%	11.0	7%	19.8	6%	23.4	6%	30.3	5%
Past due after 90 days and impaired	11.6	12%	7.8	5%	11.0	3%	23.9	6%	44.1	7%
Gross	**97.3**	**100%**	**163.4**	**100%**	**313.9**	**100%**	**418.1**	**100%**	**656.6**	**100%**
Less: allowance for impairment	(7.8)	-8%	(8.9)	-5%	(16.2)	-5%	(27.1)	-6%	-34.1	-5%
Net	**89.5**	**92%**	**154.6**	**95%**	**297.6**	**95%**	**391.0**	**94%**	**622.5**	**95%**

Source: Secure Trust Bank, Edison Investment Research

The exhibit above gives the trends over the past five years. The key message is great stability despite the rapid loan growth over this period. We provide a more detailed analysis is our Secure Trust note.

Funding analysis

Of its £608m of deposits at end-2014, £331m were in fixed-term bonds (2013 £193m), £239m in notice accounts (2013 £207m) and £38m in current/sight accounts (2013 £36m). The first two are distributed through best-buy comparator websites. This has three key advantages. Firstly, very low administration costs (no costly branch network or cash management). Secondly, considerable flexibility (deposits can be raised by taking a top position in any of the key categories but can be turned off equally quickly once required funding has been achieved). Thirdly an enhanced ability to manage liquidity (eg by topping five-year tables rather than say four-year tables, funding can be locked in for longer periods). STB indicate that they believe funding volumes in the best-buy tables are such they can raise hundreds of millions of pounds at acceptable pricing in very short periods.

There are however, a number of downsides. Firstly, UK customers attracted to internet savings accounts by high interest rates historically proved very price sensitive. Secondly, we believe best-buy savers may be more attracted to the higher rates offered in the peer-to-peer market than standard savers. Thirdly, there are few barriers to entry meaning that any bank can access this channel.

The best-buy market cannot be viewed independently of the whole savings market. Bulls will argue that: (i) big banks do not need deposits; and (ii) the Bank of England is unlikely to withdraw the Funding for Lending Scheme until it is certain sufficient market liquidity is available. Additionally, regulatory changes may cause movement in the tens of billions of savings in mainstream savings accounts. On the downside, once major banks sort out the historic problems and focus on generating new business they are likely to see more demand for savings, and banks will not run with the same wholesale-funding dependency they did in the past.

The introduction of the Funding for Lending Scheme gave the banks a back-stop for liquidity which meant they did not need to compete as aggressively for deposits and savings rates fell (see figure 5, p23 of the FCA report). At some stage the Bank of England will fully remove this scheme but deposit costs may not reverse their previous fall given banks have access to liquidity under the new sterling monetary framework.

STB has flexibility in its savings strategy. First, it has a (limited) branch network through the Everyday Loans network. Its relationship with SMEs may also see some deposit opportunities. We note that Tungsten Corporation which bought FIBI bank on 10 June 2014 announced on 9 March it was looking to take SME deposits and STB could do likewise. In addition Tungsten has raised institutional money to support its invoice financing business, which is another option for STB. In the near term, our forecasts assume a further improvement in average funding costs in 2015 (deposits from 2.7% in 2014 to 2.5% in 2015e despite a lengthening average duration and equity funding a smaller proportion of book in 2015 than in 2014), before a small rise in average funding cost in 2016.

Private banking: Arbuthnot Latham (AL)

With a reinvigoration of the business in the mid-1990s, this 180-year-old bank's private client base is mainly new money. AL provides high service levels for appropriate fees or large deposits. The private bank is also well capitalised and, despite 57% loan growth in 2014, (organic growth was 26% against 18% in 2013), has a loan to deposit ratio of 92% (2013 66%) as part of the surplus liquidity was reduced with the announced mortgage portfolio acquisition. AL has been approved by the Bank of England for access to the Funding for Lending Scheme (FLS), which we expect to be used modestly as a back-up liquidity facility. Most lending is property related and often secured with a charge over the customer's whole portfolio including their equity investments. The loan to value of the book remains low with annual impairments remaining under 1%, the majority of which continue to be driven by a small number of historic exposures in a department now closed.

Some key recent trends include:

- **2014 profit before tax growth** – statutory profits dropped from £7.7m to £3.6m but 2013 included a £6.5m property gain. Excluding this, on our adjusted basis, underlying profits grew from £1.2m to £3.6m. The company underlying profits, which also excludes certain investment spend, rose from £2.1m to £4.8m. Profit growth was driven by loan growth of 57% (to £536m), deposit growth of 12% (£586m) and assets under management growth of 26% (to £666m).
- **Payback for 2012/2013 investment in new account managers** – in 2012 and 2013 AL hired experienced private bankers, and it is now benefitting with organic loan growth of 26% (it typically takes 12-18 months for a hired account manager to be at full run rate). We expect some further modest growth into 2015 as these staff reach maturity.
- **Investment in Dubai office –** a new office in Dubai opened on 28 July 2013. It remains on track to break even as planned in 2015. On 26 February 2015 featured in CEO Middle East Magazine.
- **Investment in regional office –** AL has opened a new office in Manchester (at cost in 2014 of c £0.2m) expanding its regional network (previously a twenty year presence in Exeter). Again we would expect a payback in 12-18 months from the new office.
- **Investment in commercial banking** – Citywire reported on 26 February that Coutts executive director Rob Stapledon and associate director Michele Coomber were the first appointments joining AL's newly-launched commercial banking business focusing on the media sector clients.

The strategic focus is leveraging existing private banking relationships and skills rather than an expansion into new business lines in the way that the retail bank has done.

- **Purchase of mortgage portfolio** – ARB announced on 18 December 2014 the purchase of a residential mortgage portfolio from the administrators of the Dunfermline Building Society (DBS). The portfolio has been in run-off since 2009, with the balances geographically distributed around the UK. The portfolio consists of loans totalling £117.6m, of which 58% are residential buy-to-let and the remaining are owner-occupied. The average loan to value is 72%, with a current expected yield of approximately 4%. The consideration of £106.3m is a discount to the face value and has been satisfied by cash from the group's resources. This transaction will further diversify AL's asset base, which may be offered as collateral under the Funding for Lending Scheme. As we noted in our January 2015 report we added £3m to gross interest income, £1m to interest expense and £0.5m to costs for this portfolio. Expected levels of impairments will be included in the acquisition cost. While we believe AL would be open to similar such deals, this acquisition used significant surplus liquidity and any further acquisitions would need to be manageable in size and priced appropriately.
- **Tax evasion risk** – following the disclosures around HSBC's Swiss operations, tax evasion and even avoidance by clients is a key reputational and regulatory risk for any private bank. We believe for AL though the risk is small. It only conducts onshore business (even Dubai customers have UK-based accounts), it does not have any tax specialist advisers, it is not involved in tax based lending, and it does not provide 'hold post' accounts. It does provide wealth planning services including standard products such as ISAs and pensions but it is not in the advice space.
- **Underlying segmental income** – the private bank includes within other income, a nominal rent charged to group for surplus office space in the new headquarters, (2014 £2.1m). It also incurs as expense, the rent on the whole building, inflating both sides of its income and expense lines. We expect the surplus to reduce as the private bank expands and other income is replaced by interest and fee revenue.

Group as incubator for financial services

ABG has shown a consistent willingness to be an incubator for a diverse range of financial services. Some of these have worked spectacularly well (eg Secure Trust), others have washed their face (eg Gilleat Financial services, a Swiss private bank) and others have been exited at modest losses (eg investment banking). While this approach has led to more complex statutory financial results, we believe over time it has added value. We also believe that the most recent realisation of some of the Secure Trust holding (releasing £25m in cash) was to enable the group to develop new business lines with the same incubator approach.

Sensitivities

The key sensitivities are:

- Macro environment – as with any lender, there is an exposure to the macroeconomic environment and particularly a fall in employment. While the majority of the retail book may now be considered prime customers, a drop in employment would see a rise in credit impairments.
- Regulation – as banks, AL and STB are both subject to regulatory impositions more suitable to larger companies. In 2014/2105 notable changes include the documentation required by the new senior management regime which is likely to prove time consuming and expensive.

- Changes in customer behaviour – any changes in customer behaviour would potentially make statistical modelling inaccurate. STB/ABG would incur higher impairments and lower lending while the new behaviour is built into risk models.
- Reputation – the private bank is critically dependent on its reputation. We believe it is conservatively managed, partly to protect its good name.
- Competition – ABG and STB have benefited from large banks needing to restructure their balance sheets post the financial crisis. We believe there are several more years before this process is completed, creating the opportunity to build substantial, sustainable platforms.
- Acquisition risk – we believe STB will consider inorganic as well as organic growth, with all the usual acquisition risks of over-paying, integration and organisational complexity. Current successes can also prompt management to make larger deals, with a consequent escalation in risks.

Valuation

The average of our absolute valuation methods is £19.4 (previously £16.6), with the increase driven by rolling forward our valuation by one year. The market value for the STB stake, a key valuation metric, is broadly unchanged from our last report. The peer-relative approaches show ABG is materially undervalued relative to other high-growth financial companies.

Peer valuations

ABG lacks exact peers, but we note a number of potential comparators below.

Exhibit 5: Peer comparators

	P/E 2015 (x)	P/E 2016 (x)	Yield 2015 (%)
ABG (Edison estimates)	**13.5**	**10.8**	**1.9**
STB (Edison estimates)	**17.9**	**16.5**	**2.6**
Other growth financials			
Hargreaves Lansdown (June)	34.7	30.1	2.7
Brooks MacDonald (June)	16.5	13.9	2.0
Specialist lenders			
Provident Financial	18.3	16.6	4.2
Paragon (Sept)	12.2	11.0	2.6
S&U (following Jan)	12.8	12.1	3.5
Other wealth managers			
Brewin Dolphin (Sept)	17.2	14.4	3.7
Charles Stanley (March following year)	23.3	15.0	3.3
Close Bros (July)	14.1	12.6	3.3
Rathbone Brothers	18.8	16.6	2.5

Source: Thomson Datastream consensus estimates, Edison Investment Research. Note: Prices as at 25 March 2015

Sum-of-the-parts model (£17.8 vs £17.2 previously)

The key driver is the market value of STB, which is broadly unchanged 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. The multiple of private banking earnings reflects a conservative view of the wealth managers above. For centrals, we have applied a 10x multiple. The increase from our last report is due to rolling forward the private bank base year.

Exhibit 6: Sum-of-the-parts model

2015 estimates (£000s)	Pre-tax	Post tax	Multiple (x)	Value (£m)
UK private banking	7,150	5,720	12.8	73,216
Secure Trust (90% of market value of its 52% holding)	N/A	N/A	N/A	**248,497**
Centrals	(7,130)	(5,633)	10.0	(56,327)
Total				**265,386**
Per share (£)				**17.82**

Source: Edison Investment Research

Gordon's growth model (£20.73 vs £15.94 previously)

We continue to assume a long-term sustainable ROE of 17.5%, a 70% long-term pay-out, giving growth of 5.3% and cost of equity of 10.75%. The implied price to book is 2.2x, which, on the estimated 2016 NAV, generates a value of £20.73 (previously £15.94). Half the increase comes from rolling forward the base year to 2016 (which increased the valuation by £2), as near-term growth is well ahead of long-term forecast assumptions. We had previously incorrectly allocated all the new share issuance by STB to minority interests rather than including 52% for accounting purposes as shareholders equity for ABG.

Exhibit 7: Gordon's growth model and sensitivities

	Base	1% ROE	1% g	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
2016e NAV (p)	931	931	931	931
Implied target price (p)	**2,073**	**2,242**	**2,327**	**1,754**
Impact of near-term performance	0	0	0	0
Valuation (p)	**2,073**	**2,242**	**2,327**	**1,754**
Difference (p)		169	254	(319)

Source: Edison Investment Research

Financials

Changes to Secure Trust bank estimates

Net interest income in 2014 was in line with expectations. Our forecasts reflect the effect of:

- significantly more real estate lending (2015 was £300m now £405m, 2016e £795m) – positive for volumes but has adverse mix effect on reported spread.
- small reductions in volumes of higher margin personal loans and motor. In personal loans, management note increased market availability of credit cards providing an alternative source of finance. In car loans, we had been somewhat optimistic in our forecasts, although market commentary is that competition is intensifying somewhat.
- significantly greater deposit volumes (2015e was £900m now £1bn, 2016e £1.5bn). We continue to expect STB to match fund its lending with similar duration retail deposits.
- interest cost as a percentage of average deposits in 2015 is forecast at 2.5% against 2.4% before (2014 2.7%) – the already forecasted falling cost of retail funding is marginally offset by longer duration financing to match fund real estate lending.

Overall our 2015 interest income forecast has been increased by £1m to £110m. Fees and commissions have been cut by £1m in 2015 reflecting 2014 performance. Costs have been increased by nearly £4m to reflect the greater volume of business together with a further acceleration of investment. The mix of costs also has an adverse effect on adjusted pre-tax profits as we have trimmed some of the adjustments. While 2014 impairments came in below forecast (£15.3m v £17.5m) this was significantly driven by a one-off adjustment to assumptions to better reflect market pricing. The arrears performance though remains better than expected so we have trimmed 2015 expectations by £1m. We are assuming only a nominal charge for real estate lending in its first full year.

Changes in Private Bank

In the private bank, interest income was well ahead of expectations (organic loan growth of 26% was approximately twice our expectations), although fees were somewhat disappointing. We have carried both trends forward with the total income forecast rising by c £1m to £35m. Costs were also above expectations but this was partially due to the segmental allocation of rent, (private bank bearing whole new office rent and then charging centrals (reported in other income) for unoccupied space). We have carried forward the £2m extra spend and a further £1m to reflect further expansion of the group (eg full period costs from the regional office in Manchester). Impairments were disappointing and continue to reflect a limited further provisioning against a number of historic cases. Looking forward we have forecast c 0.5% of loans as the annual charge (with greater loans this increases the impairment charge by c £250k).

Changes in centrals

We continue to forecast a material incubation spend taken in centrals pushing up 2015/2016 costs by £1m compared with 2014. The 2014 loss is a little higher than we had been forecasting but this included £2.1m of negative income associated with surplus space and re-charged from the private bank (a figure we are forecasting to reduce in 2015e to £1m and then to £0.5m in 2016e).

Exhibit 8: Financial summary – profit and loss (£000s)

Year end 31 December	2012	2013*	2014	2015e	2016e
Gross interest income	62,300	93,329	117,624	160,870	204,000
Interest expense	(17,514)	(20,279)	(19,371)	(26,000)	(38,500)
Net interest income	44,786	73,050	98,253	134,870	165,500
Fee & commission income	24,116	31,816	29,963	34,000	39,000
Fee & commission expense	(3,347)	(4,846)	(1,930)	(3,500)	(3,500)
Net non-interest income	20,769	26,970	28,033	30,500	35,500
Total operating income	65,555	100,020	126,286	165,370	201,000
Total G&A expenses (exc non-recurring items) below	(53,043)	(73,631)	(85,180)	(103,750)	(118,250)
Operating profit pre impairments & exceptionals	12,512	26,389	41,106	61,620	82,750
Impairment charges on loans	(10,984)	(18,807)	(18,591)	(26,000)	(38,000)
Other income	396	1,183	0	0	0
Operating profit post impairments	1,924	8,765	22,515	35,620	44,750
STB non-recurring costs	9,830	0	0	0	0
Other non-recurring items	839	6,948	0	0	0
Pre-tax profit (reported)	12,593	15,713	22,515	35,620	44,750
Pre-tax normalised (Edison basis)	9,718	16,799	30,942	37,613	45,950
Pre-tax normalised (Company basis)	11,555	19,549	30,640	37,613	45,950
Tax	(1,128)	(4,198)	(5,499)	(7,434)	(9,143)
Profit after tax (FRS3)	11,465	11,515	17,016	28,186	35,607
Discontinued business	(347)	0	0	0	0
(Loss)/profit for year	11,118	11,515	17,016	28,186	35,607
Minority interests	(3,077)	(3,585)	(8,382)	(13,656)	(16,399)
Net income attributable to equity shareholders	8,041	7,930	8,634	14,530	19,208
EPS - FRS3 (p)	48.6	51.9	54.6	95.1	125.7
Edison Normalised EPS	27.1	49.1	101.3	108.2	135.2
DPS (p)	25.0	44.0	27.0	28.0	29.0

Source: Arbuthnot Banking Group, Edison Investment Research *2013 included 18p special dividend.

Adjusted profits

ABG statutory accounts are still distorted by a number of acquisition-related adjustments (and their unwinds) together with profits and investment costs associated with a range of operational expansions. We detail the changes below. As can be noted the impact on adjusted profits going forward is expected to significantly reduce.

Exhibit 9: Financial summary – adjusted profits (£000s)

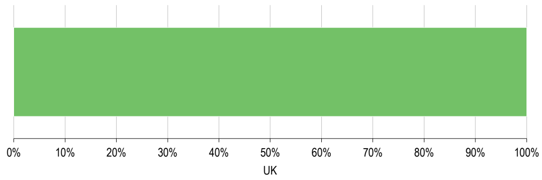
	2012	2013	2014	2015e	2016e
Statutory pre tax	**12,593**	**15,713**	**22,515**	**35,620**	**44,750**
Bargain Purchase gain of acquisition of ELL	(9,830)	0	0	0	0
ELL Fair value amortisation	3,056	4,066	4,294	200	200
ELL management incentive	1,700	0	0	0	0
STB acquisition costs	1,428	854	198	200	200
STB share options	1,610	2,221	1,542	700	600
V12 FV amortisation	0	893	893	893	200
Gain from bargain purchase	0	(413)	0	0	0
One-off costs SME build out	0	0	1,500	0	0
STB adjustments (sub Total Edison basis)	(2,036)	7,621	8,427	1,993	1,200
Gain on sale of Head office	0	(6,535)	0	0	0
Gain on disposal of International Private bank	(839)	0	0	0	0
Total Edison basis adjustments	(2,875)	1,086	8,427	1,993	1,200
Edison adjusted statutory profit	**9,718**	**16,799**	**30,942**	**37,613**	**45,950**
Company additional adjustments					
STB: Excess funding costs of acquisition	1,900	0	0	0	0
Acquired portfolio	(363)	1	0	0	0
Add back SME costs	0	0	(1,500)	0	0
Gain from bargain purchase	0	413	0	0	0
STB company adjustments	1,537	414	(1,500)	0	0
AL hiring of new executives	300	0	0	0	0
ABG group share options	0	1,021	0	0	0
Regional office	0	0	217	0	0
Dubai office investment	0	879	981	0	0
180th year anniversary costs	0	436	0	0	0
Company additional adjustments	1,837	2,750	(302)	0	0
Company normalised pre-tax	**11,555**	**19,549**	**30,640**	**37,613**	**45,950**
Edison pre-tax adjusted profits	9,718	16,799	30,942	37,613	45,950
Tax charges at standard rate on adjusted	(2,381)	(3,906)	(6,653)	(7,617)	(9,305)
Effect of non-taxable adjusting items	(1,865)	(462)	1,115	221	81
Edison adjusted post-tax profits	5,472	12,431	25,405	30,218	36,726
Reported minority	(3,077)	(3,585)	(8,382)	(13,656)	(16,399)
Effect of adjustments on minority	1,645	(1,541)	(1,942)	(446)	(197)
Edison adjusted attributable	4,040	7,304	15,081	16,115	20,131
Edison adjusted no shares (exc treasury)	14.9	14.9	14.9	14.9	14.9
Edison adjusted EPS (p)	**27.1**	**49.1**	**101.3**	**108.2**	**135.2**

Source: Arbuthnot Banking Group, Edison Investment Research

Exhibit 10: Financial summary – balance sheet (£000s)

Year end 31 December	2012	2013	2014	2015e	2016e
Assets					
Cash and balances with central bank	203,683	193,046	115,938	100,000	100,000
Derivative financial instruments	648	508	2,707	2,707	2,707
Interbank loans	144,391	105,061	31,844	45,552	90,519
Customer loans, gross	607,616	763,042	1,197,394	1,655,000	2,205,000
Less impairment provision	(20,648)	(31,033)	(38,411)	(55,000)	(55,000)
Net customer loans	**586,968**	**732,009**	**1,115,983**	**1,600,000**	**2,150,000**
Debt securities	13,526	19,466	91,683	91,683	91,683
Goodwill and other intangibles	8,326	13,103	11,318	11,000	11,000
Property, plant and equipment	22,487	5,522	12,475	13,099	13,754
Deferred tax and Other assets inc financial investments	19,980	24,139	21,674	30,000	30,000
Total Assets	**1,000,009**	**1,092,854**	**1,446,622**	**1,894,041**	**2,489,663**
Liabilities					
Interbank deposits	373	2,003	27,657	1,000	1,000
Total customer deposits	**894,545**	**957,791**	**1,194,285**	**1,644,454**	**2,208,899**
Debt securities in issue	11,980	12,232	11,448	11,448	11,448
Other liabilities	24,463	33,914	39,663	39,663	39,663
Total liabilities	931,361	1,005,940	1,273,053	1,696,565	2,261,010
Minority interests	16,376	20,327	60,038	73,694	90,093
Book value of shareholders equity	**52,272**	**66,587**	**113,531**	**123,782**	**138,560**
Pure Equity NAV (p)	**351.1**	**447.2**	**762.5**	**831.4**	**930.6**

Source: Arbuthnot Banking Group, Edison Investment Research

Contact details	Revenue by geography
Arbuthnot House 7 Wilson Street London EC2M 2SN Phone +44 (0)20 7012 2400 Website http://www.arbuthnotgroup.com/	

CAGR metrics 2016e on 2014		Profitability metrics		Balance sheet metrics		Sensitivities evaluation	
Revenue	26%	CIR	67.5%	Equity to Assets 2014	12.00%	Litigation/regulatory	●
Costs	18%	NIM	7.2%	Equity to Assets 2016e	9.18%	Pensions	○
Impairments	43%	B&DD as % loans	-1.4%	Loans to deposits 2014	93.44%	Currency	○
Stat pre tax	41%	Effective tax rate	-24%	Loans to deposits 2016e	97.33%	Stock overhang	◖
Edison adj pre-tax	22%	Adjusted ROE 2014	13%	Stock provisions to gross loans 2014	3.2%	Interest rates	●
Loans	36%	Adjusted ROE (2016e)	15%	Stock of provisions to gross loans 2016e	2.9%	Macro economy	●

Management team

CEO and Chairman: Henry Angest

Mr Angest was born in Switzerland and read law before becoming an international executive with Dow Chemicals. He led the management buy-out of Secure Trust Banking Group in 1985 and has since led Arbuthnot Banking Group.

COO: Andrew Salmon

Mr Salmon was appointed a director on 8 March 2004. He joined the company in 1997 and is COO and head of business development. He was previously a director of Hambros Bank and qualified as a chartered accountant with Peat Marwick (now KPMG).

CFO: James Cobb

Mr Cobb joined the board on 1 November 2008 as group finance director. He was previously deputy CFO and controller of Citigroup's Global Consumer Group in Europe, the Middle East and Africa. He qualified as chartered accountant with Price Waterhouse.

Principal shareholders	(%)
Henry Angest	55.1
Liontrust Investment Partners LLP	5.2
Prudential	4.7
R Paston	3.5
Treasury stock	2.6

Companies named in this report

Secure Trust Bank (STB), Hargreaves Lansdown (HL.), Brooks MacDonald (BRK), Paragon (PAG), Provident Financial (PFG), S&U (SUS), Brewin Dolphin (BRW), Charles Stanley (CAY) Close Bros (CBG), Rathbones (RAT).