# Secure Trust Bank

Pre-close trading update

## Reassuring update

Banks

**Secure Trust Bank's (STB's) pre-close trading update was encouraging, indicating it expects to deliver results in line with management's and the market's expectations. The bank has proposed a stop on new mortgage origination, unhappy with current price pressure and loan to value metrics, but does not expect this to have a material impact on 2018 and 2019 numbers. The bank sees itself entering 2019 with positive business momentum and robust capital and is well placed to continue its selected growth strategy despite the current political uncertainty.**

| Year end | Operating income (£m) | PBT* (£m) | EPS* (p) | DPS (p) | P/E (x) | Yield (%) |
|---|---|---|---|---|---|---|
| 12/17 | 129.5 | 27.0 | 116.4 | 79.0 | 10.1 | 6.7 |
| 12/18e | 152.9 | 34.9 | 154.8 | 83.0 | 7.6 | 7.0 |
| 12/19e | 174.0 | 44.4 | 191.7 | 90.0 | 6.2 | 7.6 |
| 12/20e | 196.4 | 52.7 | 224.6 | 100.0 | 5.3 | 8.5 |

Note: *PBT and EPS are normalised, excluding amortisation of acquired intangibles, exceptional items and share-based payments.

## Prudence pays

At a time when the market is wary of negative trading updates, we see STB's statement as reassuring and the lending prudence well suited to the current environment. The bank feels vindicated in its earlier decision to reduce risk in the loan book. Profitability has been supported by this move through improved credit quality.

## Outlook: Unchanged with mortgage hiatus

Having previously shown some concern over contracting mortgage-lending margins and rising loan to value metrics in the market, management has announced a proposed stop on writing new mortgage business until conditions improve, potentially when the regulatory environment becomes more level from 2020. This decision is not expected to affect 2018/19 earnings materially. Otherwise STB's loan momentum remains strong: loans exceeded £2bn at the end of 2018 (versus £1.6bn 2017), similar to our forecast. The growth is driven by retail finance, motor finance (where it has migrated from sub-prime to near-prime, a larger target market) and SME lending (mostly invoice financing).

## Valuation: Below book

STB's shares are down 24.8% in the last three months and are now trading 9% below book value. This appears to discount a poor outcome with an ROE/COE model requiring an ROE of under 10% to match the current share price. We expect the bank to deliver an ROE of 11.1% in 2018, 14.0% this year and 15.6% in 2020. These are value-creating ROEs; as such, the bank is expected to trade at comfortably above its book value. Our DDM-based fair value of 2,443p suggests a P/BV of 1.8x. STB's 2018e P/E of 7.6x does not look demanding given our EPS growth forecasts of 34% and 42% for 2019 and 2020.

**18 January 2019**

| | |
|---|---|
| **Price** | **1,180p** |
| **Market cap** | **£218m** |

| | |
|---|---|
| Net debt/cash (£m) | N/M |
| Shares in issue | 18.5m |
| Free float | 81% |
| Code | STB |
| Primary exchange | LSE |
| Secondary exchange | N/A |

### Share price performance


| % | 1m | 3m | 12m |
|---|---|---|---|
| Abs | (4.8) | (19.5) | (33.6) |
| Rel (local) | (6.5) | (16.9) | (25.1) |
| 52-week high/low | | 2,085.0p | 1,162.5p |

### Business description

Secure Trust Bank is a well-established specialist bank addressing niche markets within consumer and commercial banking. It has launched a non-standard mortgage business. Former parent Arbuthnot Banking Group's shareholding is now less than 20%.

### Next events

| | |
|---|---|
| FY18 results | 28 March 2019 |

### Analysts


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## Mortgage pause

STB's decision to temporarily cease writing new mortgages might raise some eyebrows since this is an asset class that was one of the bank's bases for earnings growth in the future. STB management has not ruled out mortgages as a key area for growth. It still believes in the growth opportunities in serving the 4.6 million people who are self-employed, contract workers or have complex income or recently restored credit histories. A restoration of more attractive margins and terms, perhaps when the regulatory playing field is levelled in 2020, may provide the opportunity for a resumption of new lending.

However, management had been previously flagging that they were concerned about the aggressive pricing in this mortgage market segment and the high loan to value metrics being applied by some lenders. Furthermore, the current economic and political uncertainty favours additional prudence. As a result, the bank was guiding to lower mortgage lending expectations ahead of the 2020 regulation changes and our estimate for mortgage loans accounted for just 5% of the loan book by 2020, and 2% of interest income before this announcement.

## Forecasts unchanged

STB made clear in the update that trading remained strong and it expected to deliver 2018 results in line with management and market expectations. It also highlighted that the credit quality of new customer loans has been improving, with impairments in motor finance in particular falling significantly. The hiatus in new mortgage lending is not expected to have a material impact on our estimates which are unchanged at this stage. We still expect STB to retain its strong growth profile.

The ongoing political and economic question marks, particularly surrounding Brexit, mean there are heightened uncertainties over forecasts across the market. Nevertheless, STB's repositioning of its loan portfolio has moderated the level of risk it would face in the evident of an adverse outcome for the UK economy.

We note the consensus GDP growth estimate for the UK in 2019 is 1.5%. Wage growth is expected to be subdued, but unemployment is forecast to remain low in the UK (at below 5%). If delivered, this would be good news for lenders such as STB. The latest Bank of England survey data shows that lenders are tightening criteria in consumer lending; this is conceivably a positive trend in our view. On the negative side, there was little evidence in the survey of any significant trend to wider lending margins. They seem to still be dropping in the household segment, but are at least stable for SME lending. In this context we note that although there has been much focus on tougher times in the retail sector, the higher promotional activity this generates can actually help STB's retail finance business through the use of 0% or subsidised loans.

We are maintaining our loan growth forecasts of 28% and 15% for 2019 and 2020, respectively. De-risking and efficiency gains as the bank expands help drive our EPS growth estimates of 34% (2019) and 42% (2020). We expect the bank to deliver an ROE of 11.1% in 2018, then 14.0% and 15.6% in 2019 and 2020.

# Valuation

Weaker financial markets affected by economic and political concerns have contributed to share price weakness of several of challenger/specialist banks' shares. STB's share price has fallen 25% in the past three months and 44% from its 12-month high: one of the weaker performances within our selected peer group (Exhibit 1). STB's weaker than average share price is surprising given the rebalancing of the loan book it has undertaken.

**Exhibit 1: Challenger/specialist lender share price performance**

| | 1 month | 3 months | 1 year | YTD | From 12m high |
|---|---|---|---|---|---|
| Secure Trust Bank | -13.6 | -24.8 | -34.4 | -0.8 | -44.3 |
| 1PM | 9.8 | -1.3 | -11.7 | 12.0 | -26.9 |
| Close Brothers | 5.7 | -2.5 | 3.1 | 4.7 | -10.4 |
| CYBG | 3.5 | -34.4 | -42.8 | 4.0 | -48.7 |
| Metrobank | -1.0 | -30.8 | -49.5 | 10.5 | -53.9 |
| OneSavings Bank | 10.0 | -1.9 | -7.1 | 5.7 | -18.5 |
| Paragon | 5.2 | -10.3 | -18.9 | 5.8 | -26.9 |
| PCF Group | -3.5 | -9.0 | 36.5 | -1.9 | -19.3 |
| S&U | 1.2 | -5.5 | -8.7 | 0.7 | -23.1 |
| **Average** | **3.9** | **-12.0** | **-12.4** | **5.2** | **-28.5** |

Source: Refinitiv, Edison Investment Research

The drop in the share price has de-rated the company's shares and they are now trading below their book value at a price to book value of 0.9x. This is an eye-catching valuation given we expect the ROE in 2018 to be 11.1% (supported by STB's update that it was on track to meet market expectations) and we forecast ROE to rise to 14.0% in 2019 and then 15.6% in 2020. These are value-creating returns and the shares should theoretically be trading at a significant premium to their book value, not below. Our unchanged DDM-based fair value of 2,443p per share implied 1.8x book value.

Turning to earnings multiples, the bank is trading on a 2018 P/E of 7.6x, below the peer-average of 12.7x, (8.7x if we exclude outlier Metrobank).

We think that as the market gains confidence that STB's repositioning is indeed working, this will be reflected in its rating. On this basis, the trading update is clearly a positive indicator.

**Exhibit 2: Challenger/specialist lender comparative table**

| | Price | Market cap | 2018 P/E | 2019 P/E | 2018 yield (%) | 2017 ROE | Price to BV (x) 2017 |
|---|---|---|---|---|---|---|---|
| Secure Trust Bank | 1180 | 218.7 | 7.6 | 6.2 | 6.7 | 9.8 | 0.91 |
| 1PM | 45.9 | 40.3 | 6.2 | 6.0 | 1.4 | 13.0 | 0.82 |
| Close Brothers | 1507 | 2287.5 | 10.9 | 10.7 | 4.2 | 16.3 | 1.70 |
| CYBG | 188.4 | 2700.3 | 7.2 | 7.3 | 1.6 | 10.6 | 0.52 |
| Metrobank | 1870 | 1827.6 | 40.5 | 21.5 | 0.0 | 1.7 | 1.47 |
| OneSavings Bank | 369.8 | 907.0 | 6.8 | 6.4 | 3.5 | 25.5 | 1.55 |
| Paragon | 408.2 | 1068.1 | 8.4 | 7.7 | 4.8 | 10.3 | 1.05 |
| PCF Group | 35.5 | 76.3 | 16.1 | 10.7 | 0.8 | 11.0 | 1.77 |
| S&U | 2145 | 258.5 | 5.2 | 4.6 | 4.9 | 16.7 | 1.66 |
| **Average** | | | **12.7** | **9.4** | **2.6** | **13.1** | **1.32** |

Source: Refinitiv, Edison Investment Research. Note: Priced at 15 January 2019.

## Exhibit 3: Financial summary

| Year-end December | 2016 | 2017 | 2018e | 2019e | 2020e |
|---|---|---|---|---|---|
| £m except where stated | | | | | |
| Profit and loss | | | | | |
| Net interest income | 92.5 | 114.6 | 134.0 | 150.3 | 170.8 |
| Net commission income | 14.5 | 14.9 | 18.9 | 23.8 | 25.6 |
| Total operating income | 107.0 | 129.5 | 152.9 | 174.0 | 196.4 |
| Total G&A expenses (exc non-recurring items below) | (64.3) | (71.3) | (86.0) | (95.0) | (105.8) |
| Operating profit pre impairments & exceptionals | 42.7 | 58.2 | 66.9 | 79.0 | 90.5 |
| Impairment charges on loans | (23.3) | (33.5) | (34.0) | (35.9) | (37.9) |
| Other income | 0.0 | 0.3 | 0.0 | 0.0 | 0.0 |
| Operating profit post impairments | 19.4 | 25.0 | 32.9 | 43.1 | 52.7 |
| Non-recurring items | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Pre tax profit - continuing basis | 19.4 | 25.0 | 32.9 | 43.1 | 52.7 |
| CorporationTax | (5.2) | (5.1) | (5.6) | (7.3) | (9.0) |
| Tax rate | 26.8% | 20.4% | 16.9% | 17.0% | 17.0% |
| Bank tax surcharge | 0.0 | 0.0 | (0.4) | (1.5) | (2.2) |
| Profit after tax - continuing basis | 14.2 | 19.9 | 26.9 | 34.3 | 41.5 |
| Discontinued business | 123.3 | 3.9 | 0.0 | 0.0 | 0.0 |
| (Loss)/profit for year | 137.5 | 23.8 | 26.9 | 34.3 | 41.5 |
| Minority interests | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Net income attributable to equity shareholders | 137.5 | 23.8 | 26.9 | 34.3 | 41.5 |
| Company reported pre-tax earnings adjustments | 7.9 | 2.0 | 2.0 | 1.3 | 0.0 |
| Reported underlying pre-tax earnings (ex discontinued 2015/16) | 27.3 | 27.0 | 34.9 | 44.4 | 52.7 |
| Reported underlying earnings after tax | 20.6 | 21.5 | 28.6 | 35.4 | 41.5 |
| Average basic number of shares in issue (m) | 18.5 | 18.5 | 18.5 | 18.5 | 18.5 |
| Average diluted number of shares in issue (m) | 18.6 | 18.6 | 18.6 | 18.6 | 18.6 |
| Reported diluted EPS (p) | 77.3 | 107.0 | 144.9 | 184.7 | 223.2 |
| Underlying diluted EPS (p) | 113.0 | 116.4 | 154.8 | 191.7 | 224.6 |
| Ordinary DPS (p) | 75.0 | 79.0 | 83.0 | 90.0 | 100.0 |
| Special DPS (p) | 165.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Net interest/average loans | 8.15% | 7.72% | 7.34% | 6.44% | 6.06% |
| Impairments/average loans | 2.04% | 2.30% | 1.87% | 1.54% | 1.34% |
| Cost income ratio | 60.1% | 55.1% | 56.2% | 54.6% | 53.9% |
| Balance sheet | | | 1.28 | | |
| Net customer loans | 1,321.0 | 1,598.3 | 2,050.0 | 2,620.0 | 3,015.0 |
| Other assets | 189.0 | 293.3 | 306.3 | 391.5 | 450.5 |
| Total assets | 1,510.0 | 1,891.6 | 2,356.3 | 3,011.5 | 3,465.5 |
| Total customer deposits | 1,151.8 | 1,483.2 | 1,971.2 | 2,543.7 | 2,927.2 |
| Other liabilities | 122.2 | 159.3 | 149.4 | 213.3 | 259.9 |
| Total liabilities | 1,274.0 | 1,642.5 | 2,120.6 | 2,757.0 | 3,187.0 |
| Net assets | 236.0 | 249.1 | 235.7 | 254.5 | 278.5 |
| Minorities | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Shareholders' equity | 236.0 | 249.1 | 235.7 | 254.5 | 278.5 |
| Reconciliation of movement in equity | | | | | |
| Opening shareholders' equity | 141.2 | 236.0 | 249.1 | 235.7 | 254.5 |
| Profit in period | 137.5 | 23.8 | 26.9 | 34.3 | 41.5 |
| Other comprehensive income | (1.8) | 2.9 | (25.8) | 0.0 | 0.0 |
| Ordinary dividends | (13.1) | (14.0) | (14.8) | (15.5) | (17.6) |
| Special dividend | (30.0) | 0.0 | 0.0 | 0.0 | 0.0 |
| Share based payments | 0.2 | 0.4 | 0.3 | 0.0 | 0.0 |
| Issue of shares | 2.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Share issuance costs | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Closing shareholders' equity | 236.0 | 249.1 | 235.7 | 254.5 | 278.5 |
| Other selected data and ratios | | | | | |
| Period end shares in issue (m) | 18.5 | 18.5 | 18.5 | 18.5 | 18.5 |
| NAV per share (p) | 1,277 | 1,348 | 1,276 | 1,378 | 1,507 |
| Tangible NAV per share (p) | 1,229 | 1,292 | 1,213 | 1,315 | 1,445 |
| Return on average equity | 72.9% | 9.8% | 11.1% | 14.0% | 15.6% |
| Normalised return on average equity | 9.9% | 8.9% | 12.2% | 15.1% | 17.1% |
| Return on average TNAV | 10.3% | 9.3% | 12.9% | 15.9% | 18.0% |
| Average loans | 1,134.6 | 1,484.6 | 1,831.6 | 2,335.0 | 2,817.5 |
| Average deposits | 1,067.5 | 1,321.7 | 1,686.3 | 2,262.2 | 2,735.4 |
| Loans/deposits | 114.7% | 107.8% | 104.0% | 103.0% | 103.0% |
| Risk exposure | 1,264.0 | 1,446.1 | 1,818.4 | 2,291.7 | 2,583.8 |
| Common equity tier 1 ratio | 18.0% | 16.5% | 13.2% | 11.2% | 10.7% |

Source: STB data and Edison Investment Research forecasts

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