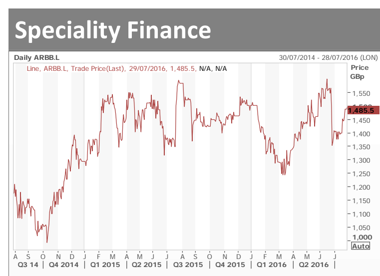
Speciality Finance



Source: Eikon Thomas Reuters

Market data

EPIC/TKR	ARBB
Price (p)	1,495
12m High (p)	1,631
12m Low (p)	1,265
Shares (m)	15.3
Mkt Cap (£m)	228.4m
Loans to deposits (2016E)	71%
Equity Leverage ratio (2016E)	19%
Free Float* (%)	43.4%
Market	AIM

*As defined by AIM Rule 26

Description

ABG now has three legs to its business. Its private bank is well funded and capitalised and has been growing very strongly. It holds an 18.9% stake in Secure Trust Bank. It has c£150m to invest in new organic or acquired businesses.

Company information

Chair / CEO	Sir Henry Angest
COO	Andrew Salmon
Group FD	James Cobb

Tel: +44 (0)20 7012 2400
http://www.arbuthnotgroup.com

Key shareholders

Sir Henry Angest	55.1%
Liontrust Inv Ptnrs LLP	5.2%
Unicorn Asset Mgmnt	4.8%
Prudential plc	5.7%
R Paston	3.5%

Next event

Trading statement	Nov 2016
FY16 results	March 2017

Analysts

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Arbuthnot Banking Group

Tripedalism – three legs are better than two

Arbuthnot Banking Group (ABG) now has three legs to its business, each offering good growth options. First, the Private Bank, Arbuthnot Latham (AL) has invested heavily in staff, products and new offices with the profit payback now visible. Secondly, ABG owns a 18.9% stake in Secure Trust Bank the rapidly growing challenger bank (market value £76m). Finally, we estimate ABG has c£150m of surplus capital. With surplus liquidity, it has the capacity for significant organic or inorganic growth. The options to deploy this capital are virtually limitless. Our capital fully deployed valuation basis is 55% above the current price.

- **Strategy**: The capital released by selling 6m STB shares gives ABG enormous flexibility. It has built an infrastructure for growth but can now accelerate this dramatically. In uncertain times, niche lending opportunities may offer excellent returns and value-added acquisition opportunities may be more available.
- **H116 results**: In H116 AL delivered further excellent growth with lending up 13%, deposits up 22% and assets under management up 14%. Underlying divisional profits grew from £3.8m in H115 to £4.3m. The sales of Everyday Loans Ltd and STB saw a net post-tax, post minority gain of £167m.
- **Valuation:** Our base case valuation is £20.09 slightly above the current NAV. Using assumptions based off deploying all the surplus capital, this increases to £23.23 with further upside potential from acquisitions. These valuations provide both significant current upside and steady progressive growth going forward.
- **Risks:** As with any bank the key risk is credit. AL's existing business should see below market volatility and so the main risk lies in new lending. We believe management is cognisant 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 profit growth. Its balance sheet strength means it has wide ranging strategic options to develop organic and inorganic opportunities. The latter are likely to increase in uncertain times. Management has been both innovative but also very conservative in managing risk. Our base case valuation has 34% upside, rising to 55% on the full deployment of capital.

Financial summary and valuation

Year end Dec (£000)	2013 *	2014 *	2015	2016E	2017E	2018E
Operating income	100,020	92,049	34,815	41,333	52,176	66,001
Total costs	(76,231)	(66,165)	(35,926)	(43,642)	(46,852)	(56,034)
Cost income ratio	76%	72%	103%	106%	90%	85%
Total impairments	(18,807)	(11,953)	(1,284)	(856)	(1,094)	(1,406)
Reported pre-tax	15,713	13,931	-2,395	682	9,308	14,401
Adj pre-tax	18,528	15,327	3,187	6,932	11,808	15,901
Statutory EPS (p)	77.3	58.0	86.3	1,126.4	55.4	87.0
Adj EPS (p)	92.1	78.2	20.5	30.4	69.2	95.4
Loans / deposits (%)	76%	97%	82%	71%	80%	83%
Equity / assets (%)	6.1%	7.8%	5.5%	19.0%	16.7%	14.8%
P/Adj Earnings (x)	15.5	18.3	69.9	47.0	20.7	15.0
P/BV (x)	3.3	1.9 **	1.8	0.9 **	0.8	0.8

Source: Hardman & Co Research * Includes fully consolidated STB **NAV increased with STB share sales

Disclaimer: Attention of readers is drawn to important disclaimers printed at the end of this document

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Executive summary

Bull arguments

- Since 2009 the private bank has delivered over 20% CAGR in loans, deposits and assets under management establishing a strong organic track record.
- ABG is well funded (deposits £940m, loans £657m) and strongly capitalised (Core Tier 1 over 40%) and can fully exploit further both organic and inorganic growth opportunities. Management has already put in place the infrastructure and experienced staff to expand AL geographically and into commercial banking.
- The uncertain macro-environment is likely to see some competition be more cautious in lending. This creates opportunities in niche markets including real estate, which could be significant to a small bank like ABG.
- These conditions may also put pressure on potential sellers of businesses, especially those who are not well funded or relatively immature.
- The private bank is likely to show low credit risk and volatility through-the-cycle from its core business.
- The shares trade at an 11% discount to 2016e NAV despite ABG being profitable and growing strongly. We believe that valuing the full deployment of surplus capital means ABG should trade at c1.4x 2016e NAV, or £23.23 per share.

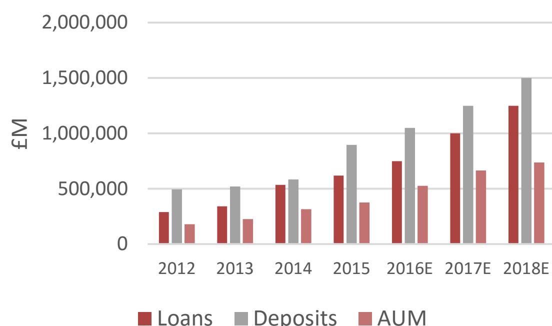
Neutral

- Credit risk in Secure Trust has been rising with both a maturing of a rapidly growing book and actual losses being closer to the level anticipated when loans were written (and so built into the interest rate charged). While the business still meets hurdle returns, how investor sentiment will react to further rising charges in uncertain economic conditions remains unclear.
- With so many potential options for investment there is uncertainty as to what the group will look like in 3-5 years. Even though most likely deployments should earn returns safely above cost of capital, it is unclear whether investors will value the business above book until there is more clarity.
- While re-valued to the market value on 15 June 2016, the accounting for the residual stake in STB will over time bear a reducing resemblance to its realisable value. A material rise in STB's share price would not be reflected in ABG's NAV.

Bear

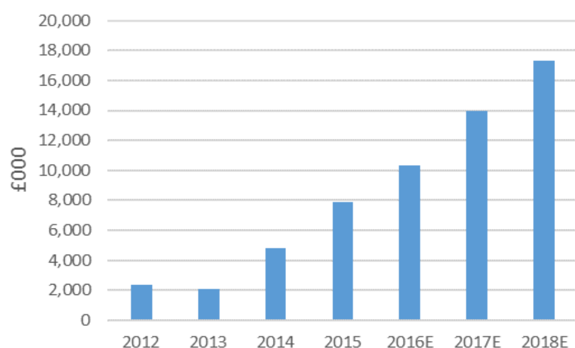
- The expansion into commercial lending is not without risk. Banks who lend later in the economic cycle typically incur larger losses than ones lending earlier.
- Over the years, ABG's incubator approach has led to a number of investments some of which has been successful and some of which have not. Getting a clear, consistent view of the underlying business excluding exceptional items is far from easy.
- Liquidity in the shares remains low with total turnover in 2015 £15.7m, an average bargain size of £14k and the Chairman holding 55% of the shares.

Exhibit1: Arbuthnot Latham Loans, deposits and assets under management



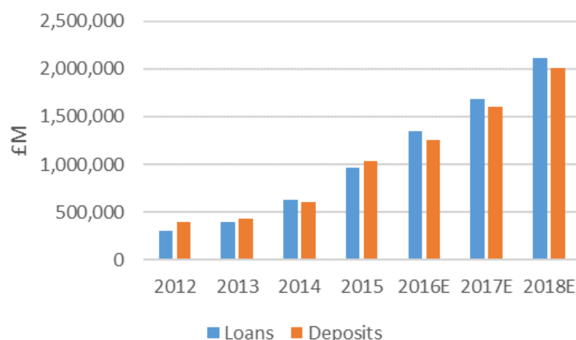
- AL has consistently had more deposits than loans. H116 (deposits £940m, loans £657m).
- Deposit growth in 2015 (53%) was driven by increased customer numbers following prior year recruitment of private bankers. H116 growth 22%, CAGR since 2009 20%.
- Loan growth expected to accelerate with expansion into commercial banking
- Starting from a low base, assets under management shown rapid growth (CAGR since 2009 26%)

Exhibit 2: Arbuthnot Latham profit growth



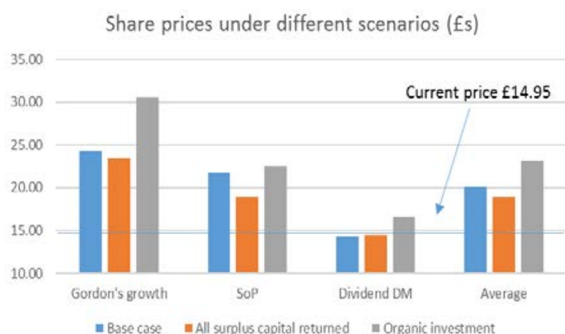
- Arbuthnot Latham has shown strong profit growth
- Payback now for historic investments in people, offices and product range.
- Further rapid expansion can be funded given capital generated by ABG following sale of Secure Trust Stake in addition to the new initiative in commercial banking, it is likely to make acquisitions of loan portfolios and premises. and generate rapid organic loan growth.

Exhibit 3: Secure Trust still making significant contribution



- STB has delivered strong profit and franchise growth.
- ABG still owns 18.9% of Secure Trust Bank and will consolidate as associate income this proportion of STB post tax earnings.
- Market value of residual stake is now £76m. This and the surplus capital (£150m) total £226m against ABGs own market cap £228m.

Exhibit 4: Range of Valuations given strategic optionality



- All scenarios average valuations above current share price.
- Base case (average valuation £20.09 p p/sh) has mix or organic growth, acquisitions and capital return.
- Lowest valuation if all surplus capital returned as it would only be valued at par (average £18.93 p p/sh).
- Organic growth has 55% upside (average £23.23 p p/sh).
- Acquisitions have significant potential further upside but timing, amount and nature all uncertain.

Source: Company data; Hardman & Co Research

Arbuthnot Latham (AL)

Summary

AL delivered CAGR 20%+ franchise growth 2009-H116. Despite heavy investment, excellent profit growth also delivered....

..prospective growth excellent

AL is a long established private bank with operations in London, Manchester, Exeter and Dubai. Compared to many private banks, it generates more of its income from banking products, which have grown strongly (loan CAGR 2009-H116 22% to £657m, deposit CAGR 20% to £940m) driven by an increased number of private bankers and geographic expansion. Although still modest in scale, assets under management have grown CAGR 26% since 2009 to £797m at end H116. We see multiple market and company specific drivers to further strong growth, most notably from recent investment in commercial banking activities. AL remains risk averse and we expect any investments to be carefully controlled.

Company description

History

Long history with current model over 30 years old

Conservatively managed and so profitable through financial crisis

Founded in 1833, AL started as a merchant of produce from India then expanding into financial services. By 1914 it joined the founding members of the Accepting Houses Committee. In 1981 the family decided to sell up. Arbuthnot saw many different owners over the next decade, resulting in the business being almost unrecognisable before Sir Henry Angest, eventually took a majority shareholding. He restored the more traditional approach to banking with the balance sheet structured very conservatively. With a good buffer of deposits over loans, the bank was left relatively unharmed from the credit crunch starting in 2008 and it continued to be profitable throughout these turbulent times.

Products

AL generates a much greater proportion of its income from net interest income (H116 67% against market c35%) rather than investment / advice related fees

As noted earlier, AL has historically been a balance-sheet driven institution although assets under management have been increasing. At different times raising deposits and lending have been given different priority, but net interest income has been key.

- Banking services include: Current Account, Debit Card, Deferred Debit Card, Money Transmission, Borrowing, Money Market Deposits (all major currencies), Notice Accounts, Treasury (including foreign exchange, money market, fiduciary deposits, fixed-term deposits and precious metals). Standard banking fees are waived where over £500k is kept on deposit.
- Wealth management including: Lifestyle (from moving house to establishing a charitable trust), Budgeting, Liquidity, Protection, Borrowing, Retirement, Investment, Tax and Estate Planning.
- Investment management to personal, joint or family portfolios, pension funds, and charity / trusts, including: (i) Core Investment Service - discretionary investment management services cover the entire spectrum of assets, from equities to bonds, property, hedge funds and commodities, with the appropriate level of risk and reward for your specific objectives. A portfolio comprising client choice of either a selection of ‘best of breed’ external managers, or a mix of these with direct investments chosen by AL in-house team of analysts. Services are offered in Sterling, Euros or US Dollars, providing options for international clients or British expatriates. (ii) Higher Income Service where capital growth and income are kept separate, to be deployed to different beneficiaries with different interests. (iii) Execution & Custody - Assets can be held in London,

Geneva, Singapore or Hong Kong. (iv) Tailored where AL constructs and manages a mix of investments, each focused on specific current and relevant market themes that we expect to generate excellent risk-adjusted returns. (v) Absolute Return designed to generate a positive return irrespective of market conditions.

Historic growth – Balance sheet CAGR over 20% since 2009

Exhibit 5 shows the growth over a number of years at AL using a range of measures since 2009. We would highlight:

Franchise growth CAGR over 20% since 2009

- Loan growth since 2009 has been a CAGR of 22% (15% in 2015, 13% H116) while deposit growth has been a CAGR of 20% (53% in 2015, 22% H116). AUM growth has been fastest at 26% (11% in 2015, 14% H116). These growth rates have been achieved through hiring additional private bankers, increasing penetration rates with existing customers, acquisition of loan portfolios and broadening the geographic reach. There have been no corporate acquisitions.

The growth in profitability has accelerated dramatically since 2013 following period of heavy investment

- The group was profitable on both a statutory and underlying base throughout the financial crisis. In 2008 it reported a statutory profit of £2.1m and break even on an underlying basis after some one-off gains. Income still benefitted from relatively high interest rates allowing a good deposit spread. AL revenue then fell by c10% 2009 on 2008 as the effect of falling interest rates hitting savings floors squeezed the liability margin. The group actually increased its underlying profitability with good cost control. More recently AL has seen payback for its historic investments in new private bankers, portfolio deals and offices.

The group's deposits have exceeded its loans at all times

- AL has always had a conservative approach to its balance sheet. It has never been dependent on market funding for growth and has raised deposits before growing its lending book. This culture applied across the whole of ABG.

Exhibit 5: Historic growth in AL

Metric (£m)	2009	2010	2011	2012	2013	2014	2015	H116
Loans	177.7	210.8	238.2	289.3	341.0	536.5	618.9	657.1
Deposits	292.0	349.5	420.0	495.7	521.2	585.9	896.8	939.6
Assets Under Management	180.0	225.0	315.0	376.6	527.9	665.9	738.8	797.1
Operating income	13.1	14.4	17.7	18.9	21.7	28.1	35.1	19.4
Costs	11.6	14.9	16.0	17.9	21.3	24.0	29.7	16.2
Pre-tax profits	0.2	1.0	2.0	2.1	7.7 *	3.6	6.0	4.5
Underlying pre-tax (co basis)	0.7	1.0	2.0	2.4	2.1	4.8	7.9	4.3

*Source: Hardman & Co Research * included large property gain*

Growth opportunities going forward

Market growth

Market should growth with increasing self-employment, inter-generational transfer of wealth, rising per capita GDP, increasing self-provision by an ageing population and greater need for advice

We expect private banking, and higher net worth wealth management, to grow well ahead of GDP, driven by a number of factors. In particular, we note:

- Increasing self-employment seeing more entrepreneurs in AL's target wealth bracket.
- Inter-generational wealth transfer, increasingly ahead of death, has led to significant assets passing to people with relatively little experience in managing them. In the UK in the tax year 2012/2013 there were over 7k estates valued at over £1m with total gross capital value in excess of £15bn. AL's sector specialism in sport and media may also see a younger customer base again with below average wealth management experience for its entrepreneurs.

- As GDP grows wealth management generally takes a greater proportion of GDP. There is a greater need for more sophisticated, higher-margin services and the absolute investable wealth increases (thus raising ad valorem fees). In 2009/10 the Association of Private Clients Investment Managers and Stockbrokers, APCIMS, members managed assets of £400bn. Its successor, The Wealth Managers Association, now manages in excess of £734bn.
- An ageing population with increasing need for self-provision.
- Increasing complex tax and savings/retirement regulation is driving greater demand for advice.

Company specific growth

AL has a number of company specific growth opportunities:

New offices will grow as they mature

- Geographic expansion: AL currently has offices in London, Manchester, Exeter and Dubai. In 2014, Exeter was strengthened and a new office opened in Manchester while Dubai only commenced business in 2013. In 2013 AL also agreed a client custody arrangement with Pictet one of the largest Private Banks in Geneva, that allows Arbuthnot Latham's clients to use their services in Switzerland, Singapore and Hong Kong.

Several new bankers also not yet at full run rate

- Increased numbers of private bankers. AL has been hiring additional private bankers across all its operations for a number of years. It typically takes between 12-18 months for a new hire to reach a normal revenue run-rate as it takes time for existing customers to migrate their assets and new clients to be won.

Expanding investment services

- Increasing penetration of wealth management products. As noted above AL earns significantly below average investment related fees. It already has the customer base and expanding the product range and cross sell should be good source of incremental growth.

Purchase of loan portfolios

- ABG / AL has been an active acquirer of medium-sized portfolios where the seller no longer has a strategic interest in the area. On 18 December 2014 it announced the purchase of a residential mortgage portfolio from the administrators of the Dunfermline Building Society ("DBS") for £106.3m. The portfolio has been in run off since 2009 and was previously acquired by DBS from other originators principally GMAC. The balances are geographically well distributed around the UK. At 31 October 2014, the portfolio was £117.6m (58% buy to let, 42% owner occupied). The average loan to value was 72 per cent with an expected yield c 4 per cent. We understand at the end of 2015, ABG was close to finalising a further, larger, loan book acquisition before the latest Basel proposals changed the capital requirements and so made the likely returns unattractive.

Purchase of property

- ABG has historically made material profits from investing in property (e.g. £6.5m gain in 2013). On 10 June 2016 it acquired 20 King Street/10 St James's Street, predominantly as an investment for AL. The property comprises 22.5k sq ft of office space and 7k sq ft of retail space. The purchase price was £50.2m (with associated costs of around £3.2m) and has a current net annual rental income of over £1.8m (i.e. gross yield 3.4%). In due course, these premises may allow Arbuthnot Latham to develop its presence in the West End, occupying part of the property for client purposes.

Interest rate increases in due course will help deposit led balance sheet

- AL is more dependent than the average bank on its balance sheet. Should interest rates rise this presents a greater than average opportunity to generate income by widening the deposit spreads. On current deposit level (£940m) every 0.25% widening is annually worth £2.35m or nearly half the statutory profits reported in 2015.

Risk

Credit risk

Exhibit 6: Historic impairments in AL

	2008	2009	2010	2011	2012	2013	2014	2015	H116
Impairment (£000s)	(444)	(1179)	(979)	(2,212)	(2,038)	(2,914)	(3,378)	(1,250)	(388)
Impairment as % average loans	0.28%	0.71%	0.50%	0.99%	0.77%	0.92%	0.77%	0.22%	0.12%
Impairment as % revenue	-3.04%	-9.16%	-6.78%	-12.51%	-10.79%	-13.46%	-11.69%	-3.56%	-2.00%

Source: Hardman & Co Research

Historic losses driven by specialist unit which is now closed. Core business should be loss low rate

As a private bank, the timing and scale of credit losses is different from mainstream lending. It is typically lumpy as individual exposures are high relative to the book and as the recovery process can take many years, impairments may not follow the economic cycle. While most lending is secured on property, other asset classes such as art, antique, specialist cars / yachts mean that the realised loss in the event of a default can be complicated. In AL's case, we understand there was secured lending from one specialist unit which closed to new business in 2008 but it has taken some time for these loans to be repaid or to finalise the sale of the security. This area was a significant driver to the losses since 2010. Even with this concentration, losses never exceed 1% of lending and in 2015 / H116 reverted to what may be considered a more normal charge rate (of 22bp / 12bp annualised respectively).

Other risks

Reputational risk and compliance risk core part of business

Reputational risk is an important issue for any private bank and compliance with tax authorities hugely important (as evidenced by HSBC's Swiss unit or Bordier, PBZ and PostFinance issues in the US). We note that AL's business has been balance sheet rather than investment driven. It has also been onshore (the Dubai office is predominantly to UAE residents) rather than being a tax shelter decision.

Relative financial performance

The table below compares AL with a number of peers. Direct comparisons need to be treated with caution given the specific nature of some of the private banks (e.g. Weatherbys's strong links with horse racing). We note:

Cost income ratio higher than peers as infrastructure put in place for much larger business

- Even adjusting for the investment in new IT, non-completed acquisition and commercial business investment, AL has a cost income ratio above peers. We believe this is driven by management building the infrastructure for a much larger business and so currently operating below an economic scale. Additionally, there has been: (i) recent hiring of new staff who have to yet to fully deliver revenue (ii) a greater bias to higher-cost London re operations.
- Impairments across the board are low. In H116 these fell to 0.12% of loans (annualised) and just 2% of income well below the peers in the table below.
- Equity to customer loans is high. Capital rich ABG provides capital to A&L as required and the stand alone ratio is somewhat mis-leading.
- Loans across the board were well below deposits. ABG ratio rose from 69% end 2015 to 70% in H116 and is not out of line with peers.

- Low interest payable in general helps support the margin. Indeed, in H116 the average rate paid fell to 0.87% from 1.04% in FY15. Should interest rates increase we would expect further widening of margins.

Exhibit 7: AL compared with selected peers

£000s	AL	AL adjust	Julian Hodges	Wetherbys
NII	25,283	25,283	5,638	15,074
Operating income	35,076	35,076	13,042	20,502
Admin expenses	29,722	27,822	6,748	13,534
Impairments	1,250	1,250	2,113	497
Other income / costs	1,894	1,894	866	1,058
Pre-tax profit	5,998	7,898	5,047	7,529
Customer Loans	618,900	618,900	557,507	276,621
Deposits	896,800	896,800	848,593	484,184
Equity	52,353	52,353	133,749	32,154
Cost Income ratio	84.74%	79.32%	51.74%	66.01%
Impairments as % avg loans	0.29%	0.29%	0.53%	0.19%
Equity to customer loans	8.46%	8.46%	23.99%	11.62%
Loans to deposits	69%	69%	66%	57%
NII as % total income	72%	72%	43%	74%
NIM	4.38%	4.38%	1.13%	5.91%
Interest payable as % avg deposits	1.04%	1.04%	3.73%	0.62%

Source: Hardman & Co Research

Customer base

Bias to new money

AL started life as a merchant bank and only placed a renewed focus on private banking in the 1980s. While it does have a number of “old money” customers, it has an above average proportion of new money including entrepreneurs. It has also developed a niche specialism in sports, media and entertainment sectors. Like most private banks the majority of its clients are sourced through recommendations and the personal networks of its private bankers. It provides a limited amount of niche marketing (e.g. motor racing or a 4X4 driving day at the Goodwood estate).

Private Banking market in the UK

By its nature private banking is relatively secretive and market statistics need to be treated with caution. The British Bankers Association in 2014 produced a report on private banking and wealth management with some insight (https://www.bba.org.uk/news/reports/a-wealth-of-opportunities/#.V3t2MrgrK1s). Some of the conclusions in this report included:

Private banking penetration is low

- Of the 255 investors in the survey with more than £1m in investable assets, only 28% use the services of a private bank (against 30% using a wealth manager, 48% using an IFA and 37% using an execution only stockbroker). The reasons given included cost and keeping control but it does indicate there are opportunities to take market share.

Market income is investment and advice driven

- The breakdown of revenue for private banks was 40% investment management, 35% treasury (i.e. interest income), and around 10% each from (i) commission and brokerage and (ii) wealth structuring and banking fees. There are also small income streams in custody, administration and investment product sales.

£234bn under management by UK private banks

- The survey indicated private banks looked after c32k portfolios in excess of £1m and 100k portfolios in the range of £250k to £1m with an average portfolio size of £494k. The total asset managed by UK private banks was estimated at £234bn.

AL margin estimated to be at / above market by 2018E

- The 2013 pre-tax profit margin was estimated as 21%, interestingly somewhat below that reported by wealth managers (23.8%). The currently sub-scale AL is well below the industry levels but this should be addressed assuming it delivers the growth profile we expect. Our base case pre-tax margin is 24% in 2018e.

Broader wealth management industry manages c£734bn

- The broader Wealth Mangers Association represent wealth manager members with over 4 million investors who manage assets in excess of £734bn, carry out over 20m trades a year and operate in over 580 branches across the UK, Ireland, the Channel Islands and the Isle of Man. It is too broad a comparator to be used for detailed analysis but does gives an indication of AL's tiny market share.

AL Management

Vice Chairman: James Fleming

James Fleming joined the Board of Directors in March 2012 as Chief Executive. Prior to joining Arbuthnot Latham, James held various executive positions at Coutts & Co including Head of International Private Banking and Managing Director of the UK Entrepreneurs, Landowners and Inpatriates businesses. James was also Managing Director of SG Hambros UK. James has over 25 years' experience in Private Banking and the Financial Services industry.

Chief Executive Officer: Ian Henderson

Ian Henderson joined the Board of Directors in April 2016, as Chief Executive of Arbuthnot Latham. Ian joined from Secure Trust Bank PLC where he held the position of Head of Strategic Business Development and Chief Executive Officer of Personal Lending and Mortgages. Previously he was Chief Executive Officer of Kensington Group Ltd and prior to this CEO of Shawbrook Bank; Ian has held senior executive roles in Barclays and RBS.

Finance Director: Stephen Kelly

Stephen Kelly joined the Board of Directors in 2009 as the Finance Director. He has over 20 years' experience within the Financial Services industry. Prior to joining Arbuthnot Latham, Stephen held senior positions at Citibank Consumer Group EMEA, and Egg Plc. He is a Chartered Global Management Accountant.

Secure Trust Bank (STB)

Summary

STB has shown excellent, multi-year growth both organically and through tactical acquisition. It has identified a number of niche areas where competition, especially from mainstream lenders, has been relatively modest allowing both rapid, but also profitable, expansion. At end H116 consumer lending was around half the loan book and to end H116 exhibited 35% growth on H115 in motor lending (to £206m in H116) and 66% growth in retail, point of sale, finance (to £272m). Business finance saw real estate lending rise 36% to £362m and asset finance nearly trebled to £112m as well as invoice discounting balances of £55m. It is well funded (loans to deposits 108%) and capitalised (common equity Tier 1 20% post sale of Everyday Loans) and has identified a number of new areas from which to continue its growth. Most notably it is intending to build a presence in specialist residential mortgages. As detailed below, it will now be treated as an associate for accounting purposes and strategically we believe it should be viewed as a financial investment rather than a core business.

History

STB was incorporated in 1954 and became a 100% owned subsidiary of ABG in 1985. Its strong growth profile was re-inforced with new management in 2010, including Paul Lynam, CEO. To assist funding this growth, STB was listed on AIM in 2011 and ABG saw its holding steadily reduce. In June 2016 ABG sold a further 6m shares, 33% of STB reducing its stake to 18.93%.

STB's growth history

Exhibit 8: Historic growth in STB (inc. ELL as continuing business)

Metric (£m)	2009	2010	2011	2012	2013	2014	2015	H116
Personal Loans (exc everyday Loans)	15	22	44	142	159	181	188	65
O/w ELL	*0*	*0*	*0*	*74*	*81*	*94*	*114*	0
Motor Loans	5	31	63	90	115	138	166	206
Retail point of sale Loans	6	16	21	26	70	117	220	272
Total consumer loans	**26**	**69**	**128**	**258**	**344**	**436**	**574**	**543**
Real Estate	0	0	0	0	2	134	368	362
Asset Finance	0	0	0	0	0	5	70	112
Invoice Finance	0	0	0	0	0	5	29	55
Business loans	**0**	**0**	**0**	**0**	**2**	**143**	**468**	**529**
Other	26	20	27	40	45	44	33	56
Total Loans	**51**	**89**	**155**	**298**	**391**	**622**	**1,075**	**1,128**
Total ex ELL	51	89	155	224	310	528	961	**0**
Deposits			**272**	**399**	**437**	**608**	**1,033**	**1,128**
Operating income	21.7	24.2	28.5	47.0	79.0	97.9	132.5	68.4
Administration expenses	11.5	12.4	14.3	29.3	45.7	50.3	68.0	37.5
Impairments	1.2	2.2	4.6	8.9	15.6	15.3	24.3	15.9
Pre-tax profits	8.5	9.6	7.3	17.2	17.1	26.1	36.5	15.0
Underlying pre-tax (co basis) *	n/d	3.6	7.9	16.6	25.2	33.3	39.3	19.9

*Source: Hardman & Co Research * exc acquired portfolios in 2010-11*

Organic growth has been key

STB's ability to grow is clearly demonstrated in the table above. STB is not dependent on acquisition for its growth. Indeed, the story above shows how strong organic growth has been across the board. Neither the motor book, nor commercial lending has benefitted from acquisitions at all. The retail point of sale saw the tactical acquisition of V12 in 2013 but noticeably has grown strongly in years without inorganic growth.

Financials

H116 results

The key points from the H116 results were:

Strong franchise growth

- Customer deposits increased to £1,043m; a 25% increase on H1015: £835.1m. Total customer numbers increased to 609k; a 35% increase on H115: 450k.
- Overall loan book increased to £1,128m; a 51% increase on H115: £747m with an average life of the total portfolio is less than 30 months.

Continuing business underlying profit growth over 50%

- Total profit after tax £129.1m (H115: £12.9m). Underlying (continuing business) profit before tax £17.4m (H115: £11.3m) up 54.0%
- Operating income £57.3m (H115: £42.8m) up 33.9%.
- Underlying annualised return on average equity 20.4% (H115: 23.6%) reflecting the increase in equity from the sale of ELG.
- Earnings per share 709.9p (H115: 70.8p). Underlying earnings per share 78.5p (H115: 50.1p).

Capital returned to shareholders

- Interim dividend per share of 17p in addition to special interim dividend of 165p per share already declared, (H115: 17p).

Outlook

More of the same going forward

We expect further strong growth from STB driven by continued strong lending in point of sale finance, motor finance and SME asset and invoice financing. Management have indicated that they have managed the real estate book closely in anticipation of uncertainty around the Brexit vote and report LTVs of c50% on its small (£31m) commercial real estate exposure. Overall we expect revenue growth of over 40% in 2016 and 26-27% in 2017-18. We expect cost growth to be modestly below this level seeing a further improvement in cost income ratio. We are however expecting a normalisation of charges with loss rates still below the level anticipated when loans were written despite an incremental £1.2m of collective provisions taken in H116. Overall we expect mid-high teens profit growth.

Financial effects of disposals

Sale of Everyday Loans

Gain of £117m but (for ABG accounts) nearly half attributable to non-controlling interests

On 13th April 2016, STB completed the sale of its subsidiary Everyday Loans Limited to Non Standard Finance Plc for a total consideration of £123m including 23.5m NSF shares. The gain on disposal was £117m as ELL had been initially acquired for just £1. At the time, the seller was facing major re-financing issues and STB's banking licence and access to low cost retail deposits solved this issue. At the date of the ELL sale, STB was a 51% owned subsidiary of ABG and so the minority interest charge was material (£57m, including profits to the date of disposal).

Sale by ABG of 33% stake in STB taking holding to 18.9%

STB now associate

On 15th June 2016 ABG's holding in STB was reduced to 18.9% through the sale of shares into the market. ABG no longer fully consolidates STB as a subsidiary and now treats it as an associated undertaking. Accordingly, ABG records within its comprehensive income statement, its share of Secure Trust's profit after tax.

Gain £100m

The sale has generated a group profit before tax of £100 million. We detail the impact on regulatory capital in the section on deploying surplus capital below.

In balance sheet fair valued to market value on date of sale

In the balance sheet, on 15th June STB was recognised at fair value (i.e. market price - 3.445m shares at £24.90 = £86m). Going forward ABG will include the proportionate share of STB's profit after tax. The value in ABG's balance sheet attributable to STB thus will bear less and less resemblance to either its market value or its share of net assets.

Tax

Sale should be tax free and defers timing when bank corporation tax surcharge likely to impact.

ABG's disposals to date are likely to be tax free given they can apply for the substantial shareholding exemption (SSE). In order to benefit from this exemption various conditions must be satisfied, including owning at least 10% of the shares. There are a variety of other requirements which must also be satisfied, meaning that SSE cannot be guaranteed even if it is likely. One advantage of the de-consolidation of STB, is that the taxable profits of ABG, at least initially, will fall below the £25m threshold for the 8% bank corporation tax surcharge. We estimate the saving will have been in excess of £1m in 2017 and rising rapidly thereafter.

Credit risk

Expect rising impairments as credit losses normalise with maturing book and new accounting rules.

For such a rapidly growing book, measuring impairment costs against loans is inherently dangerous. Measured against revenue, impairments have remained below 20% since 2011. There was a tick up in 2015 after some one-off assumption changes depressed the comparator number in 2014. Looking forward:

- Management indicate actual losses continue to be below the level expected when loans were written.
- A maturing book is likely to see a pick-up in losses to a more normal level. This is particularly the case in the real estate book which is still an immature lending book. We note most loans are well secured and to medium sized residential property developers (making concentration risk less of an issue).
- The macro-economic outlook is less favourable.
- IFRS 9, which effectively re-introduces general provisions, is likely to see an increase in the charge. In H116 collective provisions rose £1.2m.

Strategic outlook for STB within ABG

Now financial investment only

We believe the STB stake is now a financial investment rather than a core business. Looking forward should their stake fall down to 10% or below, any further disposals would be likely to incur tax. Should STB use its equity to make a material acquisition, ABG thus has a material tax advantage in selling down its entire stake at that time.

Deploying the surplus capital

Summary

ABG has a long history of innovation. Historically, it has incubated a number of businesses in the private bank including an operation Switzerland, a structured financial products business and more recently expansion in Dubai and the regional network. Outside the private bank, ABG's most obvious success has been Secure Trust Bank. Looking forward, we would expect a similar approach to deploying the proceeds from its sale of STB shares. Including pre-sale surplus capital, we estimate ABG could deploy c£150m into new operations, a figure increased further should the Group gear up an under-leveraged capital structure. The potential areas for expansion include commercial lending (with an initial focus on the media sector and potentially property related). We would not rule building distribution through direct, digital and intermediary channels.

Capital breakdown

High quality capital mix with debt < 10% total capital resources

We have used the disclosure with the interim results to highlight the likely changes in capital structure in Exhibit 9 below. ABG provides detailed capital break downs with its annual Pillar III disclosure (available on the web at http://www.arbuthnotgroup.com/investor_relations.html).

Exhibit 9: Estimated capital structure in H116

£000s	AL	AL adjust	H116e
Share capital	153	-	153
Retained Earnings	123,330	159,749	283,079
Other reserves	(1,111)	-	(1,111)
Non- Controlling Interests (NCI)	67,887	(67,887)	-
Deduction for NCI	(23,047)	23,047	-
Deduction for >10% holding in Fin Reg Co	-	(86,171)	(86,171)
Other adjustments	-	22,500	22,500
Goodwill	(2,695)	335	(2,360)
Deduction for other intangibles	(8,179)	3,835	(4,344)
Revaluation reserves	1,145	(2,926)	(1,781)
Total Tier 1 capital resources	**157,483**	**52,482**	**209,965**
Collective provisions	2,031	(2,000)	31
Debt securities in issue	10,834	1,354	12,188
Total Tier 2	**12,865**	**(646)**	**12,219**
Total Capital resources	**170,348**	**51,836**	**222,184**
Core Tier 1 ratio	11.7%	n/a	40.5%
Total Risk Exposure	1,348,513	(830,100)	518,413

Source: Hardman & Co Research

As can be seen the major movements are the retained earnings, the elimination of non-controlling interests, the introduction of a deduction for the value of the associate holding (partially offset in other adjustments). The large reduction in total risk exposure is driven by the loss of STB lending with a small benefit from lower operational risk (which is calculated at 15% of the average of the prior three years' operating expenses).

Surplus capital estimated at c£150m

Surplus capital around £150m H116

We note that the H116 core Tier 1 ratio was 40.5% (up from 11.7% at end 2015) and that the equity to assets ratio was 22.4%. These are multiples of the level required by the regulator, the market or management. We do not believe that management would be happy to see a core Tier 1 below a level of 12% or leverage ratio below 6%. Taking the tighter measure there is currently surplus capital of around £150m.

Would be increased by further c£65m should STB stake be sold down to zero

- This could be increased by the sale of further STB shares. The regulator treats as a deduction, holdings of more than 10% in a financially regulated company. For STB there is thus a deduction of £86m for its holding in STB (partially offset in other adjustments). Should the stake be reduced below 10% these would be eliminated and the capital released. We have not built this into forecasts and will clearly be dependent on the price at date of sale.
- The actual market value of the STB holding is not reflected in the accounts. At current levels the market value is nearly £10m below the level in the accounts. Clearly a sharp rise in STB price would see the market value exceed the accounting and regulatory level.

ABG on standardised approach where regulations are changing – ABG would be a loser on the rules as proposed but further revision highly likely

- ABG adopts the standardised approach to capital and these regulations are subject to change (http://www.bis.org/bcbs/publ/d347.pdf). The new capital requirement is typically driven a loan to value measure. Comments were received on the latest proposals by the Basel Committee in March 2016 with a detailed quantitative impact study being conducted through 2016. Changes are likely. While Basel indicated it expected no change in market-wide capital from the rule change, it had applied the new measures to all banks. Established banks with large, low LTV, book books who gain from the change are using advanced measures. Smaller, newer banks using the standard approach are likely to be penalised and the effect will be to increase the charge for banks using this approach. This appears contrary to the Basel's objectives. There is no explicit timeline for implementation, and given the uncertainty this is not surprising. However, they could be effective from 2018 and so apply to much new lending from here. Even though ABG losses are likely to remain low, it would be required to hold more capital under the new rules and indeed in 2015 it did not proceed with a possible mortgage book acquisition because of these proposals.
- ABG's overall capital structure is under-geared giving it the opportunity to introduce some non-equity elements to its capital structure.

Base case scenario

Base case is nearly doubling loan book to £1.25bn by end 2018E ….. partially achieved by portfolio acquisitions

We assume that ABG will rapidly accelerate its lending growth and our base model has loans nearly doubling from £657m to £1.25bn by end 2018. This will be through lending more to existing customers, lending to recently acquired and new customers, the commercial banking initiative and portfolio acquisitions. Additionally, ABG has historically expressed interest in real-estate related lending which is an area on which mainstream banks in uncertain times are likely to apply additional credit restrictions. This may create the opportunity for targeted, profitable lending.

The income which we expect to be generated from lending could be supplemented by further investment property acquisitions generating rental income rather than interest income. Our assumed growth though will not fully utilise the current surplus. There is room to pay special dividends and on our assumptions this would suggest £26.7m (175p) in 2016 (including the 25p special dividend already announced and paid on 27th July 2016). Additionally, we assume a further nominal £58m (present

value £42.4m) in 2019. The timing and amount of any returns will clearly be determined by market opportunities. We do not believe that management will either rush into making returns nor hold capital for unacceptably periods.

Capital return scenario

Some capital will be needed for future growth so we estimate £130m returnable now

One extreme would be for the group to repatriate all its surplus capital in 2016. We do expect some growth from historic investment and on the current scale, and so low profitability, ABG would not be able to self-finance this. Accordingly, we have assumed a £130m one-off distribution would be credible.

Full utilisation of capital in lending scenario

IF all used for lending we estimate extra £500m lending by 2018E

Assuming all capital is retained and used for organic growth (by which we include portfolio and team acquisitions), and with some incremental profit growth, we believe that c50% higher risk weighted assets than our base case could be supported. For our modelling this would be extra lending of £200m in 2017, £500m in 2018 and £900m ion 2019. Applying a 3% NIM, 30% marginal cost income ratio and a loss ratio of 70bp to average loans (a higher than current rate given the new SME lending). Expected profits would rise sharply (2020E £33.5m v £20.9m in base case).

Loan portfolio acquisitions likely and could be sizeable

We would include when announced

ABG has made several acquisitions of portfolios of loans from sellers who no longer considered them core. Indeed, it was close to concluding a further significant mortgage acquisition at the end of 2015 before revised capital requirements guidance made the purchase uneconomic. We believe ABG's record in this area, and it strong financial position, will make it a buyer of choice for sellers of portfolios in the range of £25-250m. With a willing seller and relatively low funding cost we would expect such deals to add value and could be a material source for growth.

Inorganic options

Could use acquisitions to expand current core competency, bring in new skills, exploit competitive funding advantage, build distribution or simply be opportunistic

There are virtually limitless options for inorganic growth including:

- Expanding existing competency and accelerating organic growth.
- Acquiring new specialist niche skills. This could be either a sector expertise or a new product line such as asset finance.
- Exploiting ABG's strong funding base – non-bank lenders may face continued difficulties in accessing financing and the value of the business to the seller is much less than it is to a well-funded bank such as ABG. The acquisition of Everyday Loans by Secure Trust would be an example.
- Building distribution - we believe that a Peer to Peer lender failure is quite likely. The business may have good loan origination which would be attractive to ABG.
- Opportunistic – in uncertain economic times, the probability of a business coming up for sale at an acceptable price increases.

Given the range of options it is important to review how acquisitions would be considered. Management has always been conservative in its approach. Historic deals (e.g. Everyday Loans, V12, Mortgage portfolio) have typically been where ABG has pricing power over the seller. ABG applies tight financial controls and walked away from a portfolio acquisition when the regulatory capital changes made the economic returns fall below hurdle rates. Critically acquisitions are optional. The core business has plenty of organic growth opportunities.

Valuation

Summary

Wide range of strategic options and so valuations

We assume most capital will be deployed organically.

Base case valuation around 2000p

Given the potential range of strategic outcomes we do not believe applying a single valuation approach is sensible. Instead we present a range of metrics below. A mix of these is most likely with some return of capital, some organic growth and some acquisitions. We believe organic growth is likely to use most of the group's capital. Our range of valuations is wide (1431p to 3057p) and the value of acquisitions could extend further the top end of the range. The average valuation in our base case scenario is 2009p, 34% above the current price. This is likely to steadily increase as the capital is put to work with the average of our capital fully deployed measures 2323p.

Exhibit 10: Range of strategic options and resulting valuations (£ p p/sh)

Scenario	Gordons growth	Sum of Parts	Dividend DM	Average
Base case	24.27	21.69	14.31	20.09
All surplus capital returned	23.47	18.89	14.43	18.93
Organic investment	30.57	22.55	16.55	23.23

Source: Hardman & Co Research

Simple Valuation approaches inappropriate

We do not believe that traditional valuation approaches based around the business as it stands today will give a fair value for ABG. In particular, we note:

Sustainable long term ROE will be above current level

- The group has generated c£150m in surplus capital. Until this resource is deployed, the group's ROE will be unnaturally depressed making measures based off this metric weak. The near term forecast ROE is well under cost of capital which would generate a theoretical valuation below book value - clearly an illogical conclusion as the company could return the capital at par.

Earnings depressed by investment, low interest rates and drag of surplus capital

- Earnings based measures are also weak. The statutory profits do not reflect the sustainable profit stream as they include significant investments the return on which may not be seen for some years. Additionally, as a deposit rich institution, ABG should benefit from any future interest rate increase making sustainable earnings well above current ones.
- ABG dividend policy has included several special dividends (including one announced for payment this year). Establishing a consistent track record for relative dividend valuation approaches is consequently weak,

No real peers with which to make comparison

- ABG is now in a unique position of being a profitable private bank with a large associate income and significant excess capital which may be deployed in several strategic directions. "Peer" valuations therefore need to be treated with caution.

In the valuations detailed below we have made adjustments to try and reflect these factors. Given that investors may not agree with all of our adjustments we have also provided a range of valuations and sensitivity analyses in each section.

Peer group ratings

Exhibit 11: Peer group comparisons

	Share price p	Market cap £ms	2017E PE	2017E Yield	2015 ROE	P/BV
Arbuthnot	1495	222.6	27.0	2.3	14.5%	0.8
Secure Trust	2212	402.4	13	4.1	21.8%	1.8
Wealth Management						
Brewin Dolphin (Sept)	252	713.1	13.8	5.6	15.5%	3.2
Brooks MacDonald (March)	1763	241.7	17.5	2.3	11.7%	3.2
Charles Stanley (June)	285	144.6	13.8	4.2	loss	1.7
IFG	183	192.9	15.5	3.2	8.9%	2.4
Rathbones	1810	874.8	14.7	3.4	11.7%	3.1
Average			15.1	3.74	11.9%	2.7
Hansard Global (EEV June)	113	155.3	18.9	8.7	1.3%	0.8
St James Place (EEV)	910	4797.2	22.4	4.1	15.6%	1.1
Average			20.7	6.4	8.4%	1.0
SME finance						
Paragon (Sept)	273	773.9	6.5	5.3	11.6%	0.8
1PM (May)	67.5	35.5	10.6	2.2	10.5%	1.4
PCF (March)	31	49.3	17.7	0.7	15.1%	2.2
Average			11.6	2.7	12.4%	1.5
Challenger Banks						
Aldermore	139	479.2	5.4	3.1	17.2%	0.9
CYBG	261	2301.0	15.7	1.2	2.0%	0.7
One Savings Bank	207	503.4	5.2	5.2	29.6%	1.6
Shawbrook	183	459.4	5.7	5.6	18.2%	1.2
Virgin Money	266	1183.2	7.6	3.2	10.9%	0.9
Average			7.9	3.7	15.6%	1.0
Metro Bank	2069	1661.4	68.7	0	n/m	2.1
Consumer finance						
Non-standard Finance	64	205.1	9.4	5.4	n/m	0.8
Provident Financial	2674	3948.2	14.6	5.4	33.0%	5.6
S&U (Jan)	2354	281.3	11.6	4.7	15.2%	2.2
Morses Club	111	143.1	9.90	7.1	14.3%	2.6
Average			11.4	5.7	20.8%	2.8

Source: Hardman & Co Research Priced as at 29 July 2016x

ABG's primarily UK private banking does not have an immediate quoted UK peer. Exhibit 11 shows the valuation of a range of possible comparator companies. In summary ABG is trading:

PE basis in line overall

- 2017E PE basis – above peers but ABG has better earnings growth potential from deploying the capital raised from the STB sale.

Yield lower than peers but option to increase it

- 2017E yield – below all peer averages but it has the resources for a much enhanced dividend.

P/BV well below peers given surplus capital

- P/BV – Well below SME finance, consumer and wealth managers but slightly below / in line with EEV P/BV for advisers and challenger banks. ABG on this measure has capital well above the level it needs to holds so depressing the P/BV measures.

UK wealth managers and international private banks not good comparators either

Compared with wealth managers a greater proportion of its long term profits will be generated from banking rather than fund management. For illustrative purposes we have given some UK quoted wealth managers including IFG, and Hansard Global. International private banking comparators also face their own issues including currency effects (Swiss), global tax regulation and review while ABG is predominately onshore UK private banking.

STB still a major contributor to earnings so consumer finance comparisons can still be made

We estimate the 18.9% residual holding in STB should still deliver a post-tax contribution of around £5.1m in 2017e only slightly below the level of the private bank. Accordingly, it is appropriate to include a number of specialist personal lenders in the peer group comparisons. In some ways S&U is the closest comparator in that it also made a disposal which means it is capital rich depressing returns and earnings below their long term sustainable levels.

Base case:

In our base case scenario, as outlined above, we have assumed a mix of surplus capital being deployed to fund growth and returned to shareholders.

Gordon's Growth model

We believe that one appropriate valuation measure for a bank is a Gordon's Growth model where the price to book value is equivalent to the sustainable return on equity (less sustainable equity growth) divided by the cost of equity (less growth). A premium or discount should be applied to reflect the near term performance relative to these sustainable rates. Taking these factors in turn:

ROE 13.5% reasonable

The private bank should deliver returns on intellectual capital as well as economic capital and consequently the accounting ROE should be mid -teens as a minimum. SME finance should also deliver returns safely over ten percent given that the bank typically has pricing power over its customers. We believe current market returns from SME business are likely to be inflated by impairments below the through the cycle level. While we cannot accurately forecast the mix of business we believe a ROE of 13-14% is reasonable.

COE c10%

We believe that long-duration market interest rates are likely to be depressed by current government policy and so do not apply a market driven COE. In terms of business risk, we would traditionally have put private banking into a lower cost of capital than mainstream lending with its earnings driven by advice and deposits. Recent market events around mis-selling and reputational risk (e.g. HSBC Swiss operations) however would suggest this discount should not apply to same degree. Additionally, the company has indicated appetite for property related lending which we believe to have an above average impairment volatility. Overall we consider a cost of equity around 10% fair.

Growth of c5% fair

We would expect private banking to grow ahead of nominal GDP with increasing wealth in economy, an ageing population and the inter-generational transfer of wealth. SME banking may also increase faster than GDP with the socio-logical growth in greater self-employment. Additionally, AL has the company specific growth outlined above. However, the model assumes growth to perpetuity and we have therefore built in a sustained growth in equity of 5% and have captured near term growth through the premium/discount adjustment.

10% discount for near term low ROE partially offset by lower COE

The model then needs adjusting for near term performance relative to long term expectations. We believe the surplus capital means that ABG will take some years to trend towards the 13.5% ROE. Assuming a trend of 4% ROE, followed by 6%, 7% and 8% implies a discount of c25% for the ROE assumption. The growth in equity would be below the 5% assumption. However, the immensely strong balance sheet makes ABG a lower risk business and so should generate a lower cost of capital over this period. Overall we have applied a 10% discount in our base case scenario.

Exhibit 12: Gordons growth model – base case and sensitivity analysis

	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
G	5.0	5.0	5.0	5.5
P/BV	**1.7**	**1.9**	**1.4**	**1.8**
Discount re near term	-10%	-10%	-10%	-10%
P/BV	**1.5**	**1.7**	**1.3**	**1.6**
BV 2016 e less 2019 cap return(£m)	197.2	197.2	197.2	197.2
Valuation (£m)	301.8	337.3	251.5	315.6
PV capital returned	**69.1**	**69.1**	**69.1**	**69.1**
Total Value (£m)	**370.9**	**406.4**	**320.6**	**384.7**
Variance (£m)		**35.5**	**-50.3**	**13.8**
Valuation per share (£)	**24.27**	**26.60**	**20.98**	**25.18**

Source: Hardman & Co Research

Sum of Parts

SoP value £21.69

In this scenario we value the cash returned at par, the holding in STB at 90% market value (discount reflecting size of the stake being sold), the private bank on a 18x multiple and central costs on 8x. The total valuation on this basis is £21.69.

Exhibit 13: Sum of parts – base case scenario (£m)

Valuation scenario	2017 earnings	Multiple	Value (£m)	Comment
Private bank	13.99	18.0	251.84	High growth
18.9% holding in STB			68.57	90% MV
Capital distributed			69.11	Per above
Centrals	-7.261	8.0	-58.09	
Group total (£m)			331.43	
Value per share			21.69	

Source: Hardman & Co Research

Dividend discount approach

DDM value £14.31

We assume a pay-out of c70% earnings, for the forecast period, growth in dividends thereafter of 5% p.a. for twenty years, a 10x multiple applied to the terminal value. We also assume a total 2016 capital return of £26.7m with a further nominal £58m in 2019. All these dividends / cash flows are then discounted at a cost of capital of 10%. This implies a valuation of £14.31.

Strategic option 1: Surplus capital returned

One thing is certain. ABG will not sit on an extra-ordinary amount of surplus capital and do nothing with it. One extreme scenario is that it returned all the surplus capital from its disposals and is left with the residual business which can grow at a reasonable but not high rate. The divisional profit stream could look something like Exhibit 14 below.

Exhibit 14: Divisional profit outlook – return capital scenario (£m)				
Valuation scenario	**2017E**	**2018E**	**2019E**	**2020E**
Private bank	11.5	12.0	12.4	12.9
18.9% holding in STB	5.1	5.8	6.7	7.7
Central costs	-6.5	-6.5	-7.2	-7.9
Group adjusted pre-tax	10.0	11.3	12.0	12.7

Source: Hardman & Co Research

Gordon's Growth Model

Lower value than base case as surplus capital value at par

Unsurprisingly the value under this scenario is lower than our base case (23.47p/sh against £24.27 p/sh) as we are assuming that £130m of capital is returned at par when our base case scenario assumed £45m would be deployed and valued at 1.5x book. ABG would still be earning a ROE well below our assumed sustainable level in 2020 and arguably would be strategically challenged as its infrastructure has been built for a much larger business. This could see a higher cost of capital which in any case may be expected to rise given the greater gearing in the balance sheet. The near term growth in equity on the lower equity base would be above our long term assumption. Overall we apply a slightly larger discount (i.e. 15%).

Exhibit 15: Gordon's growth model – base case and sensitivity analysis				
	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
G	5.0	5.0	5.0	5.5
P/BV	1.70	1.9	1.4	1.8
Discount re near term	-15%	-15%	-15%	-15%
P/BV	1.45	1.62	1.20	1.51
BV (£m) post capital returns	152.1	152.1	152.1	152.1
Valuation (£m)	219.8	245.6	183.1	229.8
Add value of capital return at par (£m)	130	130	130	130
Total value (£m)	349.77	375.62	313.14	359.82
Variance (£m)		25.85	-36.63	10.05
Valuation per share (£)	23.47	25.21	21.02	24.15

Source: Hardman & Co Research

Dividend discount approach

DDM value £14.43

We assume a pay-out of c70% earnings, for the forecast period, growth in dividends thereafter of 5% p.a. for twenty years, a 10x multiple applied to the terminal value, and an immediate capital return of £130m. All these dividends are then discounted at a cost of capital of 10%. This implies a valuation of £14.43.by this measure the present value of the extra capital all returned immediately actually offset the expected growth in dividends assume under our base case scenario.

Sum of Parts

SoP value £18.89

In this scenario we value the cash returned at par, the holding in STB at 90% of market value, the private bank on a 10x multiple and central costs on 8x. The total valuation on this basis is £18.89. We have a materially lower multiple on the private bank. The lower growth outlook is less attractive in itself but it also means the group remains sub-scale for a materially longer period.

Exhibit 16: Sum of parts model – return capital scenario (£m)

Valuation scenario	2017E earnings	Multiple	Value (£m)	2020e
Private bank	13.29	10	132.9	Slow growth
18.9% holding in STB			68.6	90% MV
Capital distributed			130.0	All in 2016
Centrals	-6.5	8	-42.9	
Group total (£m)			288.6	
Value per share			18.89	

Source: Hardman & Co Research

Strategic Option 2: Full deployment in loans

We have outlined above our assumptions for the materially greater balance sheet growth which the full deployment of surplus capital allows. The resultant profit outlook is given in Exhibit 17 below.

Exhibit 17: Divisional profit outlook – Full deployment in loans (£m)

Valuation scenario	2017E	2018E	2019E	2020E
Private bank (existing)	11.5	15.8	18.2	20.9
New loan net interest income	3.0	12.0	22.5	28.5
Impairments	0.0	-4.2	-6.3	-7.0
Costs	-0.9	-3.6	-6.8	-8.6
Revised private bank income	**13.6**	**20.0**	**27.6**	**33.9**
18.9% holding in STB	5.1	5.8	6.7	7.7
Central costs	-8.0	-8.0	-8.8	-9.7
Group adjusted pre-tax	**10.7**	**17.9**	**25.6**	**31.9**

Source: Hardman & Co Research

Gordon's Growth Model

GGM value increases to £30.57 with higher equity base and lower discount for near term performance

Unsurprisingly the value under this scenario is much higher than our base case (£30.57 p/sh against base £24.27 p/sh). However, even with the profits above, ABG would still be earning a ROE well below our assumed sustainable level over the forecast period and so some discount for near term performance would appear sensible. The capital accumulation is at the sustained rate within the forecast period. In this scenario we would thus reduce the near term performance discount to 5%. Over time this valuation may be expected to rise faster than our base case. The higher expected profit means that moving the NAV base year forward one year leads to a greater impact on the valuation (using 2017E NAV add c15p more than our base case).

Exhibit 18: Gordon's growth model – Full deployment in loans

	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
G	5.0	5.0	5.0	5.5
P/BV	1.70	1.9	1.4	1.8
Discount re near term	-5%	-5%	-5%	-5%
P/BV	1.6	1.8	1.3	1.7
BV 2016 e (£m)	278.3	278.3	278.3	278.3
Valuation (£m)	449.4	502.3	374.5	470.0
Variance		52.9	-74.9	20.6
Valuation per share (£)	30.57	34.17	25.48	31.97

Source: Hardman & Co Research

Dividend discount approach

DDM rises to £16.55

Assuming a pay-out of c70% earnings, until 2020, with a one off jump in earnings in 2021 to capture immediate growth beyond our forecast and then long term growth in dividends thereafter of 5% p.a. for twenty years (with a 10x multiple applied to the terminal value). There is no immediate capital return. All dividends are then discounted at a cost of capital of 10%. This implies a valuation of £16.55.

Sum of Parts

SOP to £22.55

In this scenario we value the holding in STB at 90% of market value, and the private bank on a superior 20x multiple to reflect incremental growth and profitability. Slightly higher central costs remain on a 8x multiple. The total valuation on this basis is £22.55.

Exhibit 19: Sum of Parts – Full deployment in loans

Valuation scenario	2017 earnings	Multiple	Value (£m)	2020e
Private bank	15.3	20.0	305.8	
18.9% holding in STB			68.6	90% MV
Centrals	-8.0	8.0	-42.9	
Group total (£m)			331.5	
Value per share £			22.55	

Source: Hardman & Co Research

Potential upside from of acquisition

V broad range of acquisition opportunities

ABG has key advantage in lower funding costs meaning target may be worth more to ABG than the seller.

The range of possible acquisitions is enormous and the impact on profitability varied and wide. Management has to date indicated an appetite for real estate finance and sector specific focus (currently media) but any targets in this space are likely to be private. One key ABG advantage is that it may be able to lower significantly a target's cost of funding. As a consequence, the profitability to ABG would be much higher than the stand-alone entity. Secure and cheap funding was the key reason ABG initially bought Everyday Loans so cheaply. We are unable to value such deals until a time they conclude.

P2P loan book or distribution platform could be attractive

Uncertain economic conditions may weaken the relative position of sellers. At this stage the effect of Brexit is uncertain although government action to mitigate adverse economic conditions appears unlikely. In these conditions the most likely weakened sellers would be companies which have recently started business. We would highlight the P2P market as one sector exposed to both sentiment and as a relatively new lender noting the recent developments at FundingKnight (GLIF buying operating subsidiaries from administrators). We do not believe ABG would be particularly interested in a failed P2P model but there may be opportunities to acquire either loan portfolios or distribution should one fail.

Quoted vehicles appear unlikely … but it could buy NSF at much lower multiple than it sold STB

There are a limited number of quoted speciality finance businesses and it is unclear that ABG would be interested in any of them. Having sold its shares in STB on a prospective PE of c12x it could of course consider re-investing in consumer finance (e.g. Morses Club, prospective PE 8x) but we do not believe this is a high priority.

Exhibit 20: Quoted speciality finance and consumer finance businesses

	Market cap £m	Comment
Speciality Finance		
1PM PLC	36	Loans, Lease, HP
PRIVATE & COMMERCIAL FINANCE GRP	49	Earnings dilutive
TUNGSTEN CORP PLC	67	Invoice processing, supply chain finance
SIGMA CAPITAL GROUP PLC	73	Private Rented Sector housing
GLIF	66	Range of mainly P2P platforms
FAIRFX GROUP PLC	30	multi-currency payments service
Consumer finance		
H & T GROUP	107	Sub-prime
MORSES CLUB PLC	143	Sub-prime
NON-STANDARD FINANCE	205	Sub-prime

Source: Hardman & Co Research. Sourced on 29 July 2016

Valuing the benefit of potential acquisitions at some future date is clearly fraught with potential error. However, to ignore the fact that a well-funded and capitalised bank, with a proven track record of several value added deals, has this opportunity is to under-value its potential worth.

Financials

Profit & Loss

The sale of Everyday Loans Limited and later de-consolidation of STB has had a dramatic effect on the constituent elements of ABG's profit and loss account. The key outlook message is that we are expecting a rapid deployment of capital, and that by 2018e we expect profits attributable to equity shareholders to be above the level reported in 2015. The pre-tax contribution will be lower but there should be a lower tax charge and non-controlling interest deduction.

Exhibit 21: Profit and Loss (£000s)

Year Ended 31 December	2012	2013	2014 *	2015 E**	2016E	2017E	2018E
Interest Income	62,300	93,329	87,398	32,801	39,183	50,140	64,515
Interest expense	(17,514)	(20,279)	(19,371)	(7,779)	(8,848)	(10,438)	(12,463)
Net Interest income	**44,786**	**73,050**	**68,027**	**25,022**	**30,334**	**39,702**	**52,052**
Fees and Comm income	24,116	31,816	25,841	9,999	11,249	12,749	14,249
Fees and Comms expense	(3,347)	(4,846)	(1,819)	(206)	(250)	(275)	(300)
Net Fees and Comms	20,769	26,970	24,022	9,793	10,999	12,474	13,949
Operating income	**65,555**	**100,020**	**92,049**	**34,815**	**41,333**	**52,176**	**66,001**
Net impairment on Financial assets	(10,984)	(18,807)	(11,953)	(1,284)	(856)	(1,094)	(1,406)
Other income	11,065	10,731	-	-	1,665	-	-
Associate Income (Post tax)				-	2,181	5,078	5,840
Operating expenses	(53,043)	(76,231)	(66,165)	(35,926)	(43,642)	(46,852)	(56,034)
Profit before tax from continuing operations	**12,593**	**15,713**	**13,931**	**(2,395)**	**682**	**9,308**	**14,401**
Income tax	(1,128)	(4,198)	(3,444)	121	(1,357)	(1,149)	(1,582)
Profit after tax from continuing operations	**11,465**	**11,515**	**10,487**	**(2,274)**	**(676)**	**8,159**	**12,819**
Profit from discontinued operations after tax	(347)	-	6,529	28,798	228,110	-	-
Profit for year	**11,118**	**11,515**	**17,016**	**26,524**	**227,434**	**8,159**	**12,819**
Attributable to non-controlling interests	-	-	(8,382)	(13,798)	(61,426)	-	-
Attributable to equity shareholders	**11,118**	**11,515**	**8,634**	**12,726**	**166,008**	**8,159**	**12,819**

Source: Hardman & Co Research ELL discontinued in 2014, ** STB discontinued in 2015*

The financial statements are complicated. In its 2015 results ABG re-presented its 2014 balance sheet with ELL as a discontinued business. There is thus a break between 2013 and 2014 trends. While the H116 results ABG gave H115 re-presented to also show STB on its now deconsolidated basis, it did not provide FY15 numbers. We have therefore estimated what this year will look like – the company will provide the actual numbers in March 2017 with its FY16 results.

In some ways, a better trend analysis can be seen by considering the divisional reporting given in Exhibit 22. This particularly highlights the steady progression in underlying profits that has been delivered and which we expect to continue to be delivered by the private bank.

Exhibit 22: Divisional forecasts (£000s)

Year Ended 31 December	2012	2013	2014	2015	2016E	2017E	2018E
Operating Income							
Private Banking	18,730	21,651	28,895	35,076	41,594	52,437	66,262
Group centre	(62)	(613)	(506)	(472)	(261)	(261)	(261)
STB	46,887	78,982	63,660	92,089	-	-	-
ABG Total	**65,555**	**100,020**	**92,049**	**126,693**	**41,333**	**52,176**	**66,001**
STB stand-alone (exc ELL 2014/2015)	46,887	78,982	63,660	92,089	129,864	164,038	208,139
Statutory pre-tax profit							
Private Banking	2,058	7,728	3,628	5,998	8,662	11,491	15,822
Group centre	(6,718)	(9,208)	(7,452)	(8,604)	(10,161)	(7,261)	(7,261)
STB	17,253	17,193	17,755	25,174	2,181	5,078	5,840
ABG Total	**12,593**	**15,713**	**13,931**	**22,568**	**682**	**9,308**	**14,401**
STB stand-alone (exc ELL 2014/2015)	17,253	17,193	17,755	25,174	29,864	34,538	40,139
Adjusted pre-tax profit (co basis)							
Private Banking	2,358	2,072	4,826	7,872	10,347	13,991	17,322
Group centre	(7,557)	(8,772)	(7,452)	(8,604)	(7,857)	(7,261)	(7,261)
STB	16,754	25,228	20,388	26,733	4,442	5,078	5,840
ABG Total	**11,555**	**18,528**	**17,762**	**26,001**	**6,932**	**11,808**	**15,901**
STB stand-alone (exc ELL 2014/2015)	16,754	25,228	20,388	26,733	29,864	34,538	40,139

Source: Hardman & Co Research

Exhibit 23: EPS calculation and dividends(p)

Year Ended 31 December	2012	2013	2014	2015	2016E	2017E	2018E
Average No shares (m)	15.28	15.28	15.28	15.28	15.28	15.28	15.28
Less treasury	0.39	0.39	0.39	0.39	0.39	0.39	0.39
Less ESOP	-	-	-	0.15	0.15	0.15	0.15
Avg no shares for EPS calculation	**14.89**	**14.89**	**14.89**	**14.74**	**14.74**	**14.74**	**14.74**
Diluted no shares	-	-	0.19	0.20	0.05	0.05	0.05
Statutory EPS (p)	**74.7**	**77.3**	**58.0**	**86.3**	**1,126.4**	**55.4**	**87.0**
Diluted EPS (p)	**74.7**	**77.3**	**57.3**	**85.2**	**1,122.5**	**55.2**	**86.7**
Adjusted EPS (co basis)	**60.8**	**92.1**	**78.2**	**20.5**	**30.4**	**69.2**	**95.4**
Interim dividend (p)	11	11	11	12	13	14	15
Final dividend (p)	14	15	16	17	18	19	20
Special dividend (p)	-	18	-	-	175	-	-
Total dividend (p)	25	44	27	29	206	33	35

Source: Hardman & Co Research

ABG has actively managed its portfolio of businesses and has regularly made significant investments both organically and inorganically. Acquisition accounting has further complicated the statutory accounts especially with fair value adjustments and subsequent amortisations. Getting a clean picture of what the business has actually been doing is thus complicated. Exhibit 24 below the adjustments identified by the company in order to give a better underlying view of the business trends. Some of the acquisition accounting is clearly one-off. However, investors may or may not choose to follow the company in all its adjustments – we would argue for example that investing in Dubai / Manchester office / new IT

systems, even though lumpy, is a normal course of business. It would also be logical to then strip out subsequent income if one strips out the upfront cost.

Exhibit 24: Adjusted Profit and Loss (£000s)

Year Ended 31 December	2012	2013	2014 *	2015 E**	2016E	2017E	2018E
Statutory pre-tax	**12,593**	**15,713**	**13,931**	**(2,395)**	**682**	**9,308**	**14,401**
Group adjustments							
Bonus payment in Group for ELL sale	-	-	-	-	2,304	-	-
Continuing income from associate for 6 mths ending June	-	-	-	3,708	2,261	-	-
180th anniversary	-	436	-	-	-	-	-
Arbuthnot Latham adjustments							
Cost of acquisition	-	-	-	418	200	200	200
Sale and leaseback	-	(6,535)	-	-	-	-	-
Gain on sale of Swiss subsidiary	(839)	-	-	-	-	-	-
Sale of Visa				-	(1,665)	-	-
Investment in operating system	-	-	-	1,123	600	-	-
Investment in AL commercial banking	-	-	-	333	1,250	1,000	-
Investment in new private bankers	300	-	-	-	-	-	-
Investment in regional offices / incremental office space		-	217	-	1,300	1,300	1,300
Investment in Dubai		879	981	-	-	-	-
STB adjustments							
Cost of option scheme	1,610	2,221	-	-	-	-	-
Gain on acquisition of Everyday Loans	(9,830)	-	-	-	-	-	-
ELL Fair value amortisation	3,056	4,066	-	-	-	-	-
Management incentives post acquisition	1,700	-	-	-	-	-	-
Excess funding prior to acquisition	1,900	-	-	-	-	-	-
Acquired portfolio	(363)	1	-	-	-	-	-
cost of acquisition	1428	854	198	-	-	-	-
V12 amortisation	-	893	-	-	-	-	-
Company adjusted basis	**11,555**	**18,528**	**15,327**	**3,187**	**6,932**	**11,808**	**15,901**

Source: Hardman & Co Research ELL discontinued in 2014, ** STB discontinued in 2015*

Balance sheet

There is a different de-consolidation effect in the balance sheet. We believe the key messages from the balance are:

- Strong funding base – deposits exceeding liabilities throughout.
- Strong capital base – equity ratios are amongst strongest in UK and 3-4x minimum required

Exhibit 25: Balance Sheet (£000s)

Year Ended 31 December	2012	2013	2014	2015	2016E	2017E	2018E
Cash and balances at Central Bank	203,683	193,046	115,938	368,611	313,697	263,388	266,672
Loans and advances to banks	144,391	105,061	31,844	28,578	18,578	18,578	18,578
Debt securities held to maturity	13,526	19,466	91,683	87,728	87,035	87,035	87,035
Assets classified as held to sale	-	-	-	118,456	-	-	-
Derivative financial instruments	648	508	2,707	1,490	1,490	1,490	1,490
Loans and advances to customers	**586,968**	**732,009**	**1,158,983**	**1,579,512**	**750,000**	**1,000,000**	**1,250,000**
Other assets	11,666	17,267	16,866	16,894	14,403	14,403	14,403
Financial Investments	3,257	1,975	1,277	2,685	2,685	2,685	2,685
Deferred tax	5,057	3,954	2,588	1,784	1,784	1,784	1,784
Investment in associate	-	943	943	943	89,030	94,108	99,948
Intangible assets	8,326	13,103	11,318	10,874	6,704	6,204	5,704
Property Plant and equipment	22,487	5,522	12,475	14,004	5,216	5,216	5,216
Investment Property	-	-	-	-	50,200	50,200	50,200
Total assets	**1,000,009**	**1,092,854**	**1,446,622**	**2,231,559**	**1,340,822**	**1,545,091**	**1,803,715**
Deposits from banks	373	2,003	27,657	55,305	1,986	1,986	1,986
Derivative financial instruments	462	371	1,067	135	-	-	-
Deposits from customers	**894,545**	**957,791**	**1,194,285**	**1,929,838**	**1,050,000**	**1,250,000**	**1,500,000**
Liabilities relating to assets classified as held for sale	-	-	-	8,700	-	-	-
Current tax liability	346	1,427	3,612	3,366	488	488	488
Other liabilities	23,655	32,116	34,984	31,977	20,000	20,000	20,000
Debt securities in issue	11,980	12,232	11,448	10,834	13,000	14,000	15,000
Total liabilities	**931,361**	**1,005,940**	**1,273,053**	**2,040,155**	**1,085,474**	**1,286,474**	**1,537,474**
Share capital	153	153	153	153	153	153	153
Retained earnings	53,372	67,901	114,641	123,330	256,515	259,784	267,408
Other reserves	(1,253)	(1,467)	(1,263)	34	(1,320)	(1,320)	(1,320)
Total to owners of the parent	**52,272**	**66,587**	**113,531**	**123,517**	**255,348**	**258,617**	**266,241**
Non-controlling interests	16,376	20,327	60,038	67,887	-	-	-
Total equity	**68,648**	**86,914**	**173,569**	**191,404**	**255,348**	**258,617**	**266,241**

Source: Hardman & Co Research

Company matters

Registration

Incorporated in the UK with company registration number: 1954085

Board of Directors

Exhibit 26: Board of Directors

Position	Name	Risk	Remuneration	Audit
Chairman / CEO	Sir Henry Angest	C	C	N
Chief Operating Officer	Andrew Salmon ACA	M	N	N
Group Finance Director	James Cobb FCA	M	N	N
Arbuthnot Latham CEO	Ian Henderson	M	N	N
Secure Trust CEO	Paul Lynam	M	N	N
Non-executive director	Ian Dewar FCA	N	N	C
Non-executive director	Sir Christopher Meyer	N	M	M
Non-executive director	Sir Alan Yarrow	N	N	N

Source: Company reports
Note: M = member; C = chair

Sir Henry Angest –Chairman & CEO

Sir Henry is Chairman and Chief Executive of Arbuthnot Banking Group PLC as well as Chairman of Arbuthnot Latham & Co., Limited and Chairman of Secure Trust Bank PLC. He gained extensive national and international experience as an executive of The Dow Chemical Company and Dow Banking Corporation. He was Chairman of the Banking Committee of the London Investment Banking Association and a director of the Institute of Directors. He is a past Master of the Worshipful Company of International Bankers.

Andrew Salmon – Chief Operating Officer

He joined the Company in 1997 and is Chief Operating Officer and Head of Business Development. He was previously a director of Hambros Bank Limited and qualified as a Chartered Accountant with KPMG.

James Cobb – Group Finance Director

James Cobb joined the Board on 1 November 2008 as Group Finance Director. He was previously Deputy Chief Financial Officer and Controller of Citigroup's Global Consumer Group in Europe, Middle East and Africa and qualified as a Chartered Accountant with Price Waterhouse.

Notes

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