

**Market data**

EPIC/TKR	ARBB
Price (p)	1,624
12m High (p)	1,675
12m Low (p)	1,265
Shares (m)	15.3
Mkt Cap (£m)	248.1m
Loans to deposits (2016E)	70%
Equity Leverage ratio (2016E)	18%
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£100m to invest in new organic or acquired businesses.

Company information

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

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<http://www.arbuthnotgroup.com>**Key shareholders**

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

Next event

Mar-17	FY16 results
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Analysts

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Arbuthnot Banking Group**Big special dividend, accelerated investment**

In its recent trading statement Arbuthnot Banking Group (ABG) advised it would make a special dividend of 300p per share (cost £45m) in Q416 against our forecast 150p. Additionally, it has accelerated its expansion into commercial banking and expects to hire six additional experienced staff early in 2017 as well as opening a Manchester office. It also advised that Q316 drawdowns had been a little slower than expected. The overall effect is to see a reduction in 2016/2017 earnings estimates, primarily from higher investment costs, while 2018 is broadly unchanged with the new staff starting to deliver greater business growth.

- ▶ **Special Dividend of £3 per share:** Given the capital gains ABG made earlier this year, we had been expecting a further 150p p/shr special dividend. In the event a further special dividend of 300p p/shr (cost of c £45m) was declared. It will be paid on 18 November 2016 to shareholders on the register on 21 October 2016.
- ▶ **Accelerated investment in commercial banking.** Management also advised that it was accelerating investment as “the disruption in the larger UK banks has led to a number of direct approaches from experienced bankers”. We have built an extra £1m of cost into our forecasts in 2017 with payback starting in 2018.
- ▶ **Other issues:** Management note that drawdown of approved lending is a little slower so we have reduced our 2016 year end loan book by £15m (2017 by £20m). As expected, the fall in interest rates will squeeze deposit margins. There was no comment on the 18.9% associate Secure Trust Bank’s performance.
- ▶ **Valuation:** Our base case valuation is now 1920p (formerly 2009p) giving an upside of 18%. The sum of the parts uses 2017 estimates which have been reduced (on 2018 numbers the fall would be marginal). In our Gordons Growth model, we value the capital repatriated at par rather than at a 1.5x multiple.
- ▶ **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 18% upside, rising to 26% 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	40,865	50,719	66,143
Total costs	(76,231)	(66,165)	(35,926)	(44,163)	(47,630)	(56,472)
Cost income ratio	76%	72%	103%	108%	94%	85%
Total impairments	(18,807)	(11,953)	(1,284)	(846)	(1,072)	(1,425)
Reported pre-tax	15,713	13,931	-2,395	-298	7,095	14,086
Adj pre-tax	18,528	15,327	3,187	5,952	9,595	15,586
Statutory EPS (p)	77.3	58.0	86.3	1,120.3	41.5	84.7
Adj EPS (p)	92.1	78.2	20.5	24.4	55.4	93.2
Loans / deposits (%)	76%	97%	82%	70%	78%	83%
Equity / assets (%)	6.1%	7.8%	5.5%	17.6%	15.3%	13.1%
P/Adj Earnings (x)	17.6	20.8	79.4	66.5	29.3	17.4
P/BV (x)	3.7	2.2	2.0	1.1	1.1	1.0

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

Valuation

Summary

Wide range of strategic options and so valuations

Base case valuation around 1920p

We have updated our range of strategic outcomes and their resultant valuations. We do not believe applying a single valuation approach is sensible. The average valuation in our base case scenario is 1920p, 18% above the current price. The average across all our scenarios falls c7% from 2084p to 1940p due to:

- ▶ Across all scenarios in the sum of the parts model we are using 2017 earnings estimates and these have been cut. The effect of using 2018 would have been marginal as these estimates are unchanged. We will be rolling forward our valuations to use 2018 estimates in March next year.
- ▶ The higher than expected special dividend reduces the base case 2017e net asset value and so the Gordons growth model valuation falls (retained equity being valued at 1.5x book value while paid out capital is valued at par). We have modestly reduced our discount for near term performance as the growth in equity and ROE will both be higher given the lower equity base.
- ▶ The DDM increases in the base case as we assume higher earnings in 2019 and so a higher dividend. It falls in the organic growth model as the incremental loan growth is less (the capital paid to shareholders now would in this scenario have been used to fund loan growth).
- ▶ The “all capital returned” scenario is unchanged except for the effect of lower 2017 estimates in the sum of the parts model.
- ▶ The organic investment scenario is most affected as we assume lower incremental loan growth as more capital has been returned.

Exhibit 1: New range of strategic options and valuations (£ p p/sh)

Scenario	Gordons growth	Sum of Parts	Dividend DM	Average
Base case	23.32	19.58	14.70	19.20
All surplus capital returned	23.51	17.98	14.35	18.61
Organic investment	25.57	20.47	15.12	20.39

Source: Hardman & Co Research

Exhibit 2: Previous Range of strategic options and 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

Financials

Estimate changes

We have trimmed loan growth in 2016/2017 but accelerated it for 2017. This feeds through to lower interest income (and impairments) for the first two years. Costs have been increased to reflect higher investment.

Exhibit 3: Previous Range of strategic options and valuations (£ p/sh)

Scenario	2016e			2017e			2018e		
	Old	New	% change	Old	New	% change	Old	New	% change
Profit and Loss (£'000s)									
Operating income	41,333	40,865	-1%	52,176	50,719	-3%	66,001	66,143	0%
Costs	(43,642)	(44,163)	1%	(46,852)	(47,630)	2%	(56,034)	(56,472)	1%
Impairments	(856)	(846)	-1%	(1,094)	(1,072)	-2%	(1,406)	(1,425)	1%
Associate and other income	3,846	3,846	0%	5,078	5,078	0%	5,840	5,840	0%
Statutory Pre-tax profit	682	(298)	-144%	9,308	7,095	-24%	14,401	14,086	-2%
Adjusted EPS	30.4	24.4	-20%	69.2	55.4	-20%	95.4	93.2	-2%
Ordinary DPS	31.0	31.0	0%	33.0	33.0	0%	35.0	35.0	0%
Special DPS	175.0	325.0	86%	-	-	n/m	-	-	n/m
Balance Sheet (£ms)									
Loans and Advances	750	735	-2%	1,000	980	-2%	1,250	1,300	4%
Deposits	1,050	1,050	0%	1,250	1,250	0%	1,500	1,560	4%
Equity	255	232	-9%	259	233	-10%	266	240	-10%

Source: Hardman & Co Research

Profit & Loss

Exhibit 4: 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	38,752	49,133	65,377
Interest expense	(17,514)	(20,279)	(19,371)	(7,779)	(8,886)	(10,888)	(13,183)
Net Interest income	44,786	73,050	68,027	25,022	29,866	38,245	52,194
Fees and Comms 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	40,865	50,719	66,143
Net impairment on Financial assets	(10,984)	(18,807)	(11,953)	(1,284)	(846)	(1,072)	(1,425)
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)	(44,163)	(47,630)	(56,472)
Profit before tax from continuing operations	12,593	15,713	13,931	(2,395)	(298)	7,095	14,086
Income tax	(1,128)	(4,198)	(3,444)	121	(1,263)	(973)	(1,596)
Profit after tax from continuing operations	11,465	11,515	10,487	(2,274)	(1,561)	6,123	12,490
Profit from discontinued operations after tax	(347)	-	6,529	28,798	228,110	-	-
Profit for year	11,118	11,515	17,016	26,524	226,549	6,123	12,490
Attributable to non-controlling interests	-	-	(8,382)	(13,798)	(61,426)	-	-
Attributable to equity shareholders	11,118	11,515	8,634	12,726	165,123	6,123	12,490

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

Exhibit 5: 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	41,163	51,430	66,854
Group centre	(62)	(613)	(506)	(472)	(299)	(711)	(711)
STB	46,887	78,982	63,660	92,089	-	-	-
ABG Total	65,555	100,020	92,049	126,693	40,865	50,719	66,143
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	7,719	9,728	15,957
Group centre	(6,718)	(9,208)	(7,452)	(8,604)	(10,199)	(7,711)	(7,711)
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	(298)	7,095	14,086
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	9,404	12,228	17,457
Group centre	(7,557)	(8,772)	(7,452)	(8,604)	(7,895)	(7,711)	(7,711)
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	5,952	9,595	15,586
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 6: 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	1,120.3	41.5	84.7
Diluted EPS (p)	74.7	77.3	57.3	85.2	1,116.6	41.4	84.5
Adjusted EPS (co basis)	60.8	92.1	78.2	20.5	24.4	55.4	93.2
Interim dividend (p)	11	11	11	12	13	14	15
Final dividend (p)	14	15	16	17	18	19	20
Special dividend (p)	-	18	-	-	325	-	-
Total dividend (p)	25	44	27	29	356	33	35

Source: Hardman & Co Research

Exhibit 7: 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)	(298)	7,095	14,086
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	-	0	0	0
V12 amortisation	-	893	-	-	-	-	-
Company adjusted basis	11,555	18,528	15,327	3,187	5,952	9,595	15,586

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

Balance sheet

Exhibit 8: 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	304,892	257,548	250,503
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	735,000	980,000	1,300,000
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	1,317,017	1,519,251	1,837,546
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	1,560,000
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	1,597,474
Share capital	153	153	153	153	153	153	153
Retained earnings	53,372	67,901	114,641	123,330	232,710	233,944	241,239
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	231,543	232,777	240,072
Non-controlling interests	16,376	20,327	60,038	67,887	-	-	-
Total equity	68,648	86,914	173,569	191,404	231,543	232,777	240,072

Source: Hardman & Co Research

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