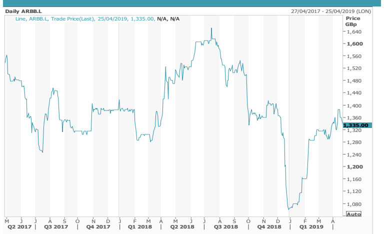
30 April 2019

Financials



Source: Eikon Thomson Reuters

Market data

EPIC/TKR	ARBB
Price (p)	1,325
12m High (p)	1,640
12m Low (p)	1,065
Shares (m)	15.3
Mkt Cap (£m)	202
Loan to Value	71%
Free Float*	42%
Market	AIM

**As defined by AIM Rule 26*

Description

Arbuthnot Banking Group (ABG) has a well-funded and capitalised private bank, and has been growing commercial banking very strongly. It holds a 9.85% stake in Secure Trust Bank (STB).

Company information

Chair/CEO	Sir Henry Angest
COO/CEO Arb. Latham	Andrew Salmon
Group FD, Deputy CEO Arb. Latham	James Cobb

Tel: +44 207 012 2400

www.arbuthnotgroup.com

Key shareholders

Sir Henry Angest	56.1%
Liontrust	6.5%
Miton AM	4.4%
Slater Investments	4.0%
R Paston	3.6%
M&G IM	3.5%

Diary

May'19	AGM
Jul'19	Interim results

Analyst

Mark Thomas 020 7194 7622

mt@hardmanandco.com

ARBUTHNOT BANKING GROUP

2018 results: growth and diversity

The 28 March *results* showed the great progress made in profitably deploying the capital ABG generated from the partial sale of its stake in Secure Trust Bank (STB). Underlying EPS rose from 17.6p in 2017 to 40.3p, loans grew 17% to £1,225m, and deposits increased 23% to £1,714m. New businesses are diversifying income and credit risk. Commercial Banking reported a £2.5m profit (2017: £2.1m loss), Asset-Based Lending facilities totalled £43m at end-December, Specialist Finance got its first loan sanctioned in 2019, and Arbuthnot Direct is live. The group is well funded (loans 71% of deposits) and capital ratios are strong (Core Tier 1: 15.9%).

- **2018 results:** The key financial highlights were i) PBT of £6.8m (2017: £2.5m), underlying PBT of £7.4m (£3.2m), ii) operating income up 24% to £67.9m, iii) costs up 19%, and iv) impairments of £2.7m (2017: £3.0m on IFRS9 basis). The statutory numbers reflect the change in accounting of the STB stake (£26m loss).
- **Outlook:** While there were many moving parts in these results, including the loss of £0.8m STB dividend income post the sale of shares, the net effect has been a 10% reduction to our 2019 PBT estimates, which still show 8% growth on 2018. Our 2020 forecasts show further payback for the investment in new businesses.
- **Valuation:** The average of our approaches is now £17.52 (previously £19.69), 1.3x 2020E NAV. The business development and new divisional disclosure see a lower proportion of profits from the highly-rated private bank. Despite the 2019 year-to- date rally, the current share price is still around the 2018 NAV (1,283p).
- **Risks:** As with any bank, the key risk is credit. ABG's existing business should see below-market volatility, and so the main risk lies in new lending. We believe management is cognizant 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 (normalised) profit growth. Its balance sheet strength gives it wide-ranging options to develop organic and inorganic opportunities. The latter are likely to increase in uncertain times. Management has been innovative, but also very conservative, in managing risk. Having a profitable, well-funded, well-capitalised and strongly growing bank priced close to book value is an anomaly.

Financial summary and valuation

Year-end Dec (£000)	2015	2016	2017	2018	2019E*	2020E*
Operating income	34,604	41,450	54,616	67,905	76,790	86,903
Total costs	-35,926	-46,111	-54,721	-64,982	-71,795	-77,484
Cost : income ratio	104%	111%	100%	96%	93%	89%
Total impairments	-1,284	-474	-394	-2,731	-1,860	-2,944
Reported PBT	-2,606	179	2,534	6,780	7,332	10,757
Adjusted PBT	2,982	4,009	3,186	7,416	9,332	12,757
Statutory EPS (p)	86.3	1,127.2	43.9	-134.5	40.7	59.7
Adjusted EPS (p)	13.5	17.1	47.5	40.3	51.4	70.4
Loans/deposits	82%	76%	75%	71%	77%	80%
Equity/assets	5.5%	18.5%	12.8%	9.0%	8.5%	7.8%
P/adjusted earnings (x)	98.1	77.5	27.9	32.9	25.8	18.8
P/BV (x)	1.64	0.86	0.86	1.03	1.03	1.01

** IFRS9 basis; Source: Hardman & Co Research*

2018 results summary

Financial highlights

PBT nearly trebled, driven by 24% income growth

- Profit before tax (PBT) came in at £6.8m (2017: £2.5m). Underlying PBT was £7.4m (2017: £3.2m). Operating income increased by 24% to £67.9m, and other income rose from £3m to £6.6m. Expenses grew by 19% to £65m. Impairments were £2.7m (2017: £0.4m), with IFRS9 accounting being a significant driver.

Negative EPS from discontinued business loss on change in accounting treatment of STB. Underlying EPS nearly trebled.

- Earnings per share came in at -134.5p (2017: positive 43.9p), including a £25.7m net loss on de-recognition of STB associate, recorded in discontinued operations.

- Continuing earnings per share were 38.0p (2017: 14.0p). Underlying earnings per share were 40.3p (2017: 17.6p).

Dividend up 5%

- The final dividend per share was 20p (2017: 19p), an increase of 5%. The total full- year dividend per share was 35p (2017: 33p).

- A bonus share issue was announced, to create a new class of non-voting shares (see section later in report on capital).

- Net assets were £196m (2017: £236m). Net assets per share were 1,283p (2017: 1,547p).

- Underlying return on deployed equity was 5.6% (2017: 4.2%).

Operational highlights

Loans up 17%

- Customer loans increased 17% to £1,225m (2017: £1,049m). Commercial division loans rose to £443m (2017: £305m). Written loan volume increased 1% to £469m (2017: £466m), with a focus on higher-margin business.

Margins up on mix effects

- The average net margin was 4.7% (2017: 4.5%). The private banking margin fell slightly (4.9% vs. 5.2%), with competitive pressure, but it rose sharply in commercial banking (4.0% vs. 3.2%), as ABG focused on higher-margin buy-to-let commercial lending, rather than lower-margin, higher-capital, commercial real estate loans.

Deposits up 23%

- Customer deposits increased 23% to £1,714m (2017: £1,391m), again with most of the growth in the commercial division (£567m vs. £308m).

AUM down 6%

- Assets under management (AUM) decreased 6% to £985m (2017: £1,044m). As we detail later in the report, management has been changed and a new focus has been brought into this area.

New business streams coming on line

- Arbuthnot Asset-Based Lending was launched in May 2018, issuing facilities of £43m.

- Arbuthnot Specialist Finance was developed, with the first loan approved in 2019.

- Arbuthnot Direct was established to provide deposit products direct to the retail market.

Secure Trust Bank (STB)

STB has been de-recognised as an associated undertaking, due to a loss of significant influence (ABG directors left the Board). It showed a further £14m mark-to-market loss (taken to reserves) since the date of the change in accounting treatment. We estimate half of the latter has since been recouped by STB's share price rise.

Strategy: diversified businesses

Growth

ABG has long history of strong growth in loans, deposits and AUM

Strong growth is a long-term feature of ABG. Looking at the Arbuthnot Latham legal entity, the average annual growth rate over the past 10 years has been loans 25%, deposits 22% and Funds Under Management (FUM) 22%. At different times, there has been a focus on different areas, but the trend has been for consistent, strong growth, conservatively managed so that deposits always exceed loans. In 2016, ABG generated a large realised gain from a partial sale of its stake in STB and the prior sale by STB of Everyday Loans. This capital is being deployed in a range of initiatives, with strong growth characteristics, and diversification of the group's income and risk profile. 2018 saw significant progress in a number of areas.

Historical growth in Arbuthnot Latham legal entity

Year-end Dec (£000)	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Loans	177.7	210.8	238.2	289.3	341.0	536.5	618.9	758.8	1,049.3	1,224.7
Annual growth		19%	13%	21%	18%	57%	15%	23%	38%	
Deposits	292.0	349.5	420.0	495.7	521.2	585.9	896.8	997.6	1,390.8	1714.3
Annual growth		20%	20%	18%	5%	12%	53%	11%	39%	
AUM	180.0	225.0	315.0	376.6	527.9	665.9	738.8	920.0	1,044	985
Annual growth		25%	40%	20%	40%	26%	11%	25%	13%	
Operating income	13.1	14.4	17.7	18.9	21.7	28.1	35.1	41.8	54.9	68.4
Costs	11.6	14.9	16.0	17.9	21.3	24.0	29.7	36.6	47.4	57.8
Pre-tax profit	0.2	1.0	2.0	2.1	7.7*	3.6	6.0	9.1	11.0	14.6

Source: Hardman & Co Research

Commercial Banking (CB)

Payback on prior investment saw commercial bank move from loss of £2.1m in 2017 to profit of £2.5m in 2018

Income up 141%, with loans up 46%, wider margins and full period effects of prior lending

CB generated a profit before tax of £2.5m (2017: loss of £2.1m). Income rose by 141% (from £6.7m to £16.4m), with customer loans up 46% to £140m, to close the year at £445m. The margin widened to 4.0% from 3.2%, reflecting a focus on higher-margin commercial buy-to-let and less of a focus on lower-margin (higher capital requirement) commercial real estate, although this also impacted new lending volumes (down 12% to £190m). The income growth also reflects the full-year effect of 2H'17 lending. Direct costs rose 23%, from £4.6m to £5.6m (again a full period effect), and allocated costs by 91% to £8.9m (reflecting the increasing proportion of the group). An impairment charge of £278k was recognised (1.6% or revenue, 6.2bps of closing balances). The commercial bank remained self-funding, with deposits up 84% to £567m.

Commercial Banking division

Year-end Dec (£000)	2017	2018	2019E	2020E
Interest income	6,720	16,384	21,737	26,796
Net fees and comms.	471	914	914	914
Operating income	**7,191**	**17,298**	22,651	**27,710**
Other income	0	0	0	0
Operating expenses, direct	-4,584	-5,636	-7,045	-8,102
Operating expenses, indirect	-4,670	-8,898	-10,233	-11,256
Impairment	0	-278	-504	-905
PBT	**-2,063**	**2,486**	4,869	**7,447**

Source: Hardman & Co Research

Outlook: continuation of same trends, with strong growth, wider margins, some more investment and a gentle rise in impairments

We expect strong growth to continue (loans rising by £125m in 2019 and 2020), with a modest further improvement in the margin (to 4.4%), again driven by mix. Costs will rise with the full period effect of historical investment, business growth and selected, marginal further hires. We expect a gentle deterioration in underlying credit. We note that ABG has submitted an application for £15m of the RBS remedies fund (it has already been selected as one of 11 banks accepted into the Incentivised Switching Scheme).

ABG applied for £15m of the RBS remedy funds

Renaissance Asset Finance (RAF)

Loans up 21% with new business lending up 59%. Yields fell slightly.

The purchase of RAF was completed on 28 April 2017. The 2018 results therefore include a full year for both operating income and direct costs. The customer loan balances increased by 21% to close the year at £86m (£71m), with new business up 59% to £56m. The implied redemptions and repayments of £41m, 58% of the opening book, were driven by normal amortisation and re-financing within RAF. The loan book growth was partially offset by modestly falling gross yields (9.6% vs. 9.9%). Looking forward, we are expecting similar loan book growth, stable margins and a gentle deterioration in credit.

Renaissance Asset Finance				
Year-end Dec (£000)	**2017**	**2018**	**2019E**	**2020E**
Interest Income	3,154	5,344	6,291	7,272
Net fees and comms.	75	137	150	175
Operating income	**3,229**	**5,481**	**6,441**	**7,447**
Other income	0	73	0	0
Operating expenses, direct	-1,690	-3,169	-3,708	-3,986
Operating expenses, indirect	0	0	0	0
Impairment	-86	-437	-651	-914
PBT	**1,453**	**1,948**	**2,082**	**2,547**

Source: Hardman & Co Research

Earn-out reviewed and less growth expected => credit to profit and loss. On current numbers, we estimate final consideration of £6m for business and PBT of £2.5m in 2020, or 3x post-tax earnings.

The consideration was structured in four staged amounts, all paid in cash. The first payment was equal to the net assets at completion of £2.1m. The remaining three payments are performance-related and will be based on the profits of RAF in each of the three calendar years 2018 to 2020. The maximum amount payable for the performance-based payments was limited to £6.5m. In 2017, ABG had conservatively accounted for the maximum consideration. Growth in 2018 was below the stretching targets and, consequently, the likely consideration has been re-assessed, and reduced by £2.6m. As the consideration has been recognised in full in the accounts, a one-off profit of £2.6m is recognised from this lower expected payout. For us, the important issue is that ABG bought a business that is expected to generate 2020 pre-tax profits of £2.5m for an expected total consideration of £6m, i.e. 3x post-tax earnings.

Other new initiatives

Asset-based lending

Team of seven hired for asset- based lending. 2H'18 saw first revenue contribution and end-2018 lending of £25m.

An asset-based lending team of seven was hired in January 2018 (with three subsequent hires); it made its first loan on 4 May. At end-June, there were four customers (loans £8.9m), with a pipeline of £76.5m. By the end of December, drawn loans totalled £25m, with facilities issued of £43m. The team previously managed a similar business in Shawbrook and, prior to that, in Centric Commercial Finance. Credit control is managed by the core ABG team. The loss on this business was ca.£0.9m in 2018.

Specialist Finance (short-term secured lending)

New bridging team got first loan approved in 2019. Expected to move to profitability in 2020, with annual investment of ca.£1m.

ABG also hired a new team of six to provide bridging finance for professional property businesses and entrepreneurs. The team started in 3Q'18, with the first loan approval in 1Q'19. ABG invested a net £0.3m in 2018, and it expects the new team to achieve monthly breakeven and be profitable during FY20 (i.e. after 18 months from start-up). Anecdotal evidence suggests that yields in the short-term bridging space have been coming under significant pressure, with a number of new entrants entering this space. ABG has hired an experienced team, with established contacts and a good track record. The group's reputation for being a conservative, but consistent, lender is also likely to be a competitive advantage. The scale of investment (ca.£1m annualised, under 2% of group costs) is not as if management is betting the bank on this one line.

Property fund

Property fund at breakeven but under review

The Arbuthnot Real Estate Fund was established in 2017, but progress has been slow. Management advises that "a decision on the future viability of this fund will be concluded in the first half of 2019", which we interpret as being likely that the project will be sold/closed. ABG has a track record of testing the water with new projects but, critically, it does not continue with them if they are unlikely to be viable. The ongoing cost of the fund was neutral in 2018.

Arbuthnot Direct

Launched online best-buy table savings platform. Increases flexibility (much lower-cost than holding excess liquidity) and builds brand.

Steady progress is also being made in its online offering (cost to date £0.2m). Access to the direct savings market will give the company flexibility to raise significant deposits in a short space of time. The option cost of doing this through establishing a best-buy online platform is significantly less than the group continually holding surplus liquidity. The proposition is targeting a modest book (of up to £20m-£50m), and management advises that progress to date is in line with achieving these plans. Its main purpose is strategic flexibility, and we would not expect material news on this line until ABG has a proposition that requires funding.

"Other division" financials

Reported within the other divisions were Investment Properties, with a profit of £1.8m (2017: £1.9m), New Ventures, with costs of £1.6m (2017: £nil), and central items, which this year contain the £2.6m adjustment to the RAF management earn-out liability and rental income earned on space in the Wilson Street offices. Forecasting this division is the most uncertain element, given the unknown timing of investments, when loans will be drawn and the mix of new business generated. We have assumed that lending will increase from the 2018 year-end total of £37m to £100m at end-2019 and £150m at end-2020, with a divisional margin of around 5.5%-6%. We forecast costs to rise significantly, and 2019 profits to fall, due primarily to the non-recurrence of the £2.6m RAF management earn-out adjustment and the investment in Specialist Finance. We forecast other income to fall, as ABG occupies part of the investment property portfolio.

Other divisions

Year-end Dec (£000)	2017	2018	2019E	2020E
Interest income		163	1,500	3,500
Net fees and comms.		177	500	1,000
Operating income	**0**	**340**	2,000	4,500
Other income	3,870	6,683	2,500	2,500
Operating expenses, direct	-230	-2,634	-4,000	-6,000
Operating expenses, indirect	0	0	0	0
Impairment	0	-50	-205	-375
PBT	**3,640**	**4,339**	**295**	**625**

Source: Hardman & Co Research

Private Banking (PB)

PB profits fell £2.1m to £5.8m, reflecting a number of pressures:

Profits down £2.1m, with impairments up £1.6m – primarily from IFRS9 treatment (LFL would be down)…

- Impairments rose £1.6m, reflecting both IFRS9 accounting but also a single incident, which is currently under litigation. We understand that interest is still being paid and ABG expects a full recovery in due course but, under the accounting rules, it is required to raise an impairment, even though it is expected to be reversed at some stage in the future. Looking at the section on credit below, investors can see that there is no real underlying deterioration in the book. PB provisions are lumpy and irregular, and do not have the same macroeconomic sensitivity as mainstream banking. Both impairments and recoveries can be volatile, and 2018 saw this compounded by a change in accounting.

…and competitive pressure for low LTV mortgages seeing less volume…

- While mainstream banks have had a limited appetite for many types of lending, one area where there *has been* a greater desire to lend has been very low loan-to-value (LTV) residential mortgages. This has been a core element of ABG's historical lending, but pricing has now become so fine that ABG considers it unprofitable, and origination fell by 9%. With this also affecting redemptions, the loan book shrank by 1% on end-2017.

…and lower wealth planning fees

- The wealth management side of the business saw not only market turbulence but also a lack of focus. In 2017, private bankers had been growing lending and were slow to shift to wealth management, as the market changed. The area where the lack of focus had more effect was in wealth planning fees, which fell by 46% to £1.2m, most of which dropped straight down to the bottom line.

- Gross inflows of £90m in AUM (ca.9% annualised) were more than offset by outflows (£124m, net -£34m) and negative market movements (-£25m). Overall AUM fell from £1,044m to £985m. The timing of market movements (fall in 4Q'18) meant that investment management fees were higher in 2018 than in 2017 (£8.2m vs. £7.9m), but this will clearly be a pressure going into 2019.

Summer 2018 saw management change, with renewed focus

On 11 July, ABG announced a new management structure within Arbuthnot Latham, with Andrew Salmon becoming CEO and James Cobb/Stephen Fletcher becoming deputy CEOs. We understand that one of their plans is to give greater product focus within the teams; for example, lending will now become specialised in one team, freeing up customer relationship managers to focus more on growing deposits and AUM. There has also been a change in management within Wealth Planning, which has been underperforming recently. These developments should, in due course, see the growth in AUM moving closer to historical averages (2009-17 average: 25%), which should also see further fee generation.

Private Bank

Year-end Dec (£000)	2017	2018	2019E	2020E
Interest income	31,528	33,763	34,101	34,442
Net fees and comms.	12,977	11,494	12,069	13,276
Operating income	**44,505**	**45,257**	**46,169**	**47,717**
Other income	-	2	0]	-
Operating expenses, direct	-14,420	-15,601	-15,913	-16,231
Operating expenses, indirect	-21,848	-21,891	-22,329	-22,999
Impairment	-308	-1,966	-500	-750
PBT	**7,929**	**5,801**	**7,427**	**7,737**

Source: Hardman & Co Research

Our divisional forecasts reflect modest book growth, and some recovery in wealth management, primarily in 2020.

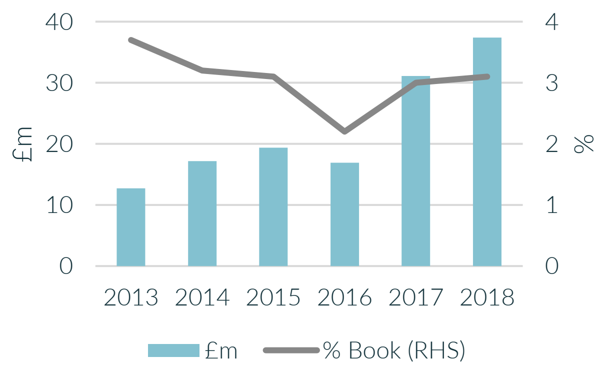
Credit risk

Credit risk

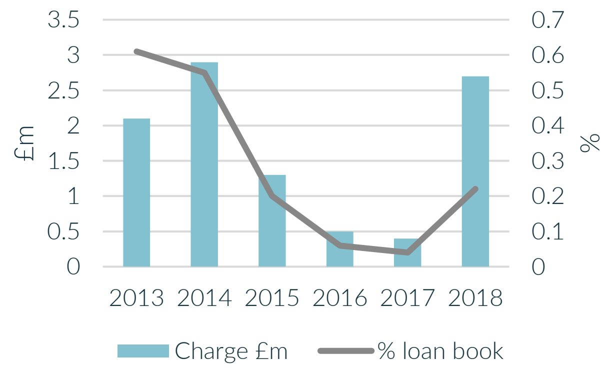
Measured against book, NPLS and provisions are around 2015 levels, and well below the levels of 2013-14

IRFS9 makes historical comparisons difficult, but it has materially improved disclosure. We believe the business message is that the book, excluding one account, has been stable, and that there is no deterioration in asset quality. As noted earlier, ABG views the one incident as being primarily a timing issue, which requires a provision now and is likely to see a full recovery in due course. As can be seen in the charts below, the non-performing loans (NPLs) and provisions, while higher than in 2017, are not reflective of a problem. Measured against book, both are around 2015 levels and well below the levels of 2013-14.

NPLs/stage 3, £m and % book



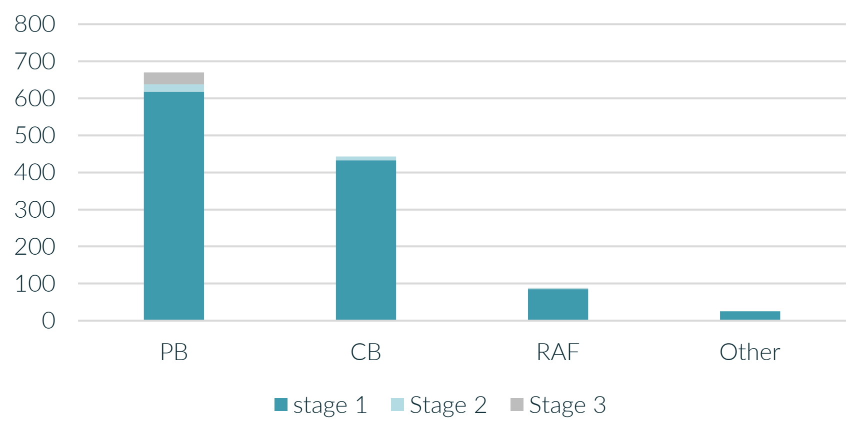
P/L provision charge, £m and % book



Source: ABG Hardman & Co Research

IFRS9 classifies loans into three stages, with stage 1 being best-quality and stage 3 worst. As note 22 of the company accounts shows, ABG has just £37.4m of its £1.2bn loans in stage 3 and a further £32.7m in stage 2. In 2018, £8m of loans improved from stage 2 to stage 1, and £1m moved from stage 3 to stage 2. Going the other way, £28m of loans moved from stage 1 to stage 2, and £9m from stage 2 to stage 3 (with £3m moving straight from stage 1 to stage 3). Against a loan book of £1.2bn, such moves are tiny and immaterial.

Breakdown of loan book by sector and stages 1, 2 and 3 (£m)



Source: ABG, Hardman & Co Research

Loans and collateral by LTV buckets (£000)	Private Bank		Commercial Bank	
	Loans	Collateral	Loans	Collateral
Less than 60%	312,478	698,621	249,446	559,271
Stage 1	297,674	659,650	238,071	532,671
Stage 2	8,701	25,830	11,375	26,600
Stage 3	6,103	13,141	-	-
60%-80%	224,782	309,329	165,954	259,917
Stage 1	211,737	288,994	165,954	259,917
Stage 2	9,458	14,535	-	-
Stage 3	3,587	5,800	-	-
80%-100%	64,649	49,740	6,540	9,400
Stage 1	52,968	37,161	6,540	9,400
Stage 2	531	550	-	-
Stage 3	11,150	12,029	-	-
Greater than 100%*	28,528	16,860	8,918	7,614
Stage 1	16,654	8,245	8,918	7,614
Stage 2	-	-	-	-
Stage 3	11,874	8,615	-	-

Source: ABG, Hardman & Co Research

In addition to property, other security is taken, including charges over Arbuthnot Latham Investment Management portfolios, other chattels and personal guarantees. The increase in LTV greater than 100% is due to an increase in exposures collateralised by other assets

New disclosure shows just £12m of stage 3 loans with physical security less than loan value. In most cases, other security, such as stocks and shares, is held.

The table above (from note 6 of the company accounts) shows the loans and collateral by division broken down by the LTV buckets. Thus, in the private bank, there are £312m of loans where the LTV is under 60%, and the total value of the collateral held against those loans is £698m. We like this disclosure because it shows the highest-risk elements. ABG has just £37m of loans where the loan to value is over 100% and, in most cases, there is non-property security, which is not included in the table above. Of this £37m, just £12m is in stage 3.

IFRS9 effect

On a like-for-like basis, the IFRS9 charge in 2017 would have been £3.0m, against the £2.7m taken in 2018

We note the comment in note 11 of the accounts that “The provision charge in 2018 has increased largely due to the transition to IFRS9; if 2017 were restated on an IFRS9 basis, the charge would have been £3.0m.” We note that the reported charge for 2018 was £2.7m. Compared with the old accounting standard, the key differences are:

- New lending, even when performing (and so categorised as Stage 1), requires provisions – hence a growing loan book will require higher provisions.
- The standard requires future economic scenarios to be modelled, and the result of these "stress tests" needs to be factored into the resultant provisions. As a probability is assigned to this extreme scenario, the “weighted” economic scenario will be worse than current conditions.
- The old accounting rules allowed for loans to be deemed "non-accrual", whereby interest ceased to be accounted for on underperforming loans. Now these are grossed up by continuing to record interest on these loans and, at the same time, increasing the offsetting provisions. This results in higher impairment losses but no overall change to net income.

Capital

Group well capitalised, with core Tier 1 ratio of 15.9%. The strong loan growth we expect means that, by mid-2021, the group's strategic options could start to be constrained. A range of options include:

- Further sale of STB shares (April 2019 saw ca £15.3m disposal proceeds)
- Gearing T1 with debt
- Equity

The key message on capital is that ABG is well capitalised, with a core Tier 1 ratio of 15.9%. This has fallen from 17.3% at end-2017, primarily because of incremental loans (£176m). We expect a similar type of lending growth over the next few years, together with the unwinding of the IFRS9 transition relief. Allowing for retentions and recognising that a conservative management will want a significant buffer over the minimum regulatory standard, by mid-2021, we believe that the existing capital structure could become a potential constraint on strategic growth. With funding, management took a low-cost option and developed an online best-buy option. Likewise, with capital, management has created a low-cost option to raise equity by creating a non-voting share to be listed on the NEX Growth Market. We believe the new class of share reflects the strong desire to maintain the existing control structure that ABG believes has allowed it strategic flexibility in the long term. We think the non-voting shares are likely to trade at a discount to the voting shares, but ABG has, for a minimal cost, created the option to issue equity without diluting control.

We believe this announcement was about creating optionality. Management has previously discussed gearing the Tier 1 with debt instruments and the sale of further STB shares. We believe that, when the need arises, management will take whichever option appears optimal at the time.

Capital structure

Year-end Dec (£000)	2017	2018
Share capital	153	153
Retained earnings*	237,171	209,083
Fair value/available-for-sale reserve	162	-12,169
Treasury shares	-1,131	-1,131
Capital redemption reserve	20	20
IFRS9, transitional add-back	-	1,986
Core Tier 1	**236,375**	**197,942**
Deduction for significant investment*	-83,804	-34,219
Add back 10% of CET1 (risk-weighted at 250%)*	22,038	18,137
Deduction for goodwill	-5,202	-5,202
Deduction for other intangibles	-10,793	-11,336
Prudent valuation deduction	-	-38
Total Tier 1 capital resources	**158,614**	**165,284**
Tier 2		
Tier 2 debt securities in issue	13,104	13,283
Total Tier 1 & Tier 2 capital resources	**171,718**	**178,567**
Core Tier 1 capital ratio (net core Tier 1 capital/Basel III total risk exposure)	**17.30%**	**15.90%**
Total capital ratio (capital/Basel III total risk exposure)	**18.80%**	**17.20%**

Source: ABG, Hardman & Co Research

**Deduction for significant investment. The portion of the investment representing up to 10% of ABG's Tier 1 is added back to capital resources and then risk-weighted at 250%, while anything above the 10% is deducted. The STB stake is a deduction and hence, even though there was an accounting writedown on the transition from associate accounting, this did not have a material impact on capital ratios.*

On 12 April, ABG announced that it had sold in an institutional placing of 1.05m STB shares at a price of 1,460 pence per share, raising gross proceeds of approximately £15.3m. The residual 1.82m shares (9.85% of STB) are locked in for 180 days. While the sale will see a £0.8m reduction in dividend income to ABG, it will also free up regulatory capital (currently deducted in the table above). The share price is also above the year-end level, which will see the negative "Fair value/Available-for-sale reserve" reduce. We expect this capital to be quickly deployed and the residual stake to be sold in due course.

Financials

Impact on estimates

We would expect a sharp acceleration in profit in 2021

On the transition to the new divisional structure, there has been a change in allocations and income recognition. Group central other income on the new basis in 2017 was £160k, against the previous disclosure of net -£837k, which we understand to be related to treasury activity now taken centrally. We have carried forward this £1m adjustment into our divisional forecasts, which feed through to the group estimates.

Compared with our previous estimates, we have trimmed the rate of 2019/20 expansion with lower income and expenses. This reflects the timing of when loans will be added. Market uncertainties see loans added later in the year, and thus generating less income, with investment timed to reflect this. We would expect a sharp acceleration in profit in 2021, as that year will see the full income benefits from the investments up to 2020, and the pace of cost increase should moderate significantly.

Estimate changes

	2018			2019E			2020E
Year-end Dec	Old estimate	Actual	% change	Old	New	% change	Initial
Profit and loss (£m)							
Operating income	66,431	67,905	2%	80,300	76,790	-4%	86,903
Costs	-63,686	-64,982	2%	-75,629	-71,795	-5%	-77,484
Impairments	-562	-2,731	386%	-675	-1,860	175%	-2,944
Associates and other income	2,263	6,588	191%	1,663	4,197	152%	4,282
Statutory PBT	4,445	6,780	53%	8,160	7,332	-10%	10,757
Ordinary DPS (p)	35	35	0%	38.0	38.0	0%	41
Balance sheet, @ 31 Dec (£m)							
Loans and Advances	1,200	1,225	2%	1,500	1,438	-4%	1673
Deposits	1,625	1,714	5%	1,875	1,869	0%	2094
Equity	208	196	-6%	209	197	-6%	201

Source: Hardman & Co Research

Profit and loss

Profit and loss

Year-end Dec (£000)	2017	2018	2019E*	2020E*
Interest income	47,427	65,290	80,000	95,000
Interest expense	-6,334	-10,107	-16,843	-23,461
Net interest income	41,093	55,183	63,157	71,539
Fees and comms. income	13,805	12,956	13,933	15,665
Fees and comms. expense	-282	-234	-300	-300
Net fees and comms.	13,523	12,722	13,633	15,365
Operating income	**54,616**	**67,905**	**76,790**	**86,903**
Net impairment on financial assets	-394	-2,731	-1,860	-2,944
STB dividend income	0	0	1,697	1,782
Other income	3,033	6,588	2,500	2,500
Operating expenses	**-54,721**	**-64,982**	**-71,795**	**-77,484**
Profit before tax from continuing operations	**2,534**	**6,780**	**7,332**	**10,757**
Income tax	-448	-1,121	-1,246	-1,829
Profit after tax from continuing operations	2,086	5,659	6,086	8,928
Profit from discontinued operations after tax	4,437	-25,692	0	0
Profit for year	6,523	-20,033	6,086	8,928

** IFRS9 basis; Source: ABG, Hardman & Co Research*

Balance sheet

Balance sheet						
@ 31 Dec (£000)	2015	2016	2017	2018	2019E	2020E
Cash and balances at Central Bank	115,938	368,611	195,752	405,325	357,467	352,621
Loans and advances to banks	31,844	28,578	36,951	54,173	54,173	54,173
Debt securities held to maturity	91,683	87,728	107,300	342,691	342,691	342,691
Assets classified as held to sale	0	118,456	0	8,002	-	-
Derivative financial instruments	2,707	1,490	1,516	1,846	1,846	1,846
Loans and advances to customers	**1,158,983**	**1,579,512**	**758,799**	**1,224,656**	**1,438,000**	**1,673,000**
Other assets	16,866	16,894	11,939	12,716	12,716	12,716
Financial Investments	1,277	2,685	2,145	35,351	35,351	35,351
Deferred tax	2,588	1,784	1,665	1,490	1,490	1,490
Investment in associate	943	943	82,574	0	-	-
Intangible assets	11,318	10,874	8,522	16,538	16,038	15,538
Property, plant and equipment	12,475	14,004	4,782	5,304	5,304	5,304
Investment property	0	0	53,339	67,081	67,081	67,081
Total assets	**1,446,622**	**2,231,559**	**1,265,284**	**2,175,173**	**2,332,157**	**2,561,811**
Deposits from banks	27,657	55,305	3,200	232,675	232,675	232,675
Derivative financial instruments	1,067	135	227	188	188	188
Deposits from customers	**1,194,285**	**1,929,838**	**997,649**	**1,714,286**	**1,869,000**	**2,094,000**
Liabilities relating to assets classified as held for sale	0	8,700	0	0	-	-
Current tax liability	3,612	3,366	147	236	236	236
Other liabilities	34,984	31,977	17,082	18,549	18,549	18,549
Debt securities in issue	11,448	10,834	12,621	13,283	14,283	15,283
Total liabilities	**1,273,053**	**2,040,155**	**1,030,926**	**1,979,217**	**2,134,931**	**2,360,931**
Share capital	153	153	153	153	153	153
Retained earnings	114,641	123,330	235,567	209,083	210,353	214,007
Other reserves	-1,263	34	-1,362	-13,280	-13,280	-13,280
Total to owners of the parent	113,531	123,517	234,358	195,956	197,226	200,880
Non-controlling interests	60,038	67,887	0	0	-	-
Total equity	**173,569**	**191,404**	**234,358**	**195,956**	**197,226**	**200,880**

Source: ABG, Hardman & Co Research

Valuation

Average valuation £17.52

Following these results, the range of our valuations is £12.82 to £23.40, with the average at £17.52 (previously £19.69), implying upside potential of 32% on the current share price. Out Dividend Discount Model (DDM) is £12.82, our Gordon Growth Model (GGM) £23.40, and our sum-of-the-parts (SoTP) model £16.34. We do not believe that the implied average price to book is at all demanding, being 1.3x 2020E book.

Summary of different valuation techniques

	Implied price (£)	Upside potential
GGM)	23.40	77%
DDM	12.82	-3%
SoTP	16.34	23%
Average absolute measures	**17.52**	**32%**

Source: Hardman & Co Research

GGM

We have rolled forward our forecast year to 2020 for the GGM (adding ca.70p to the valuation) and adjusted for the fair value reserve, which is likely to be driven by volatile share price movements. At end-December, it was -£12m, but we believe around half will have been recovered already by the rise in STB's share price since then. There is a small offsetting effect from lower earnings forecasts seeing a lower equity base. This approach now has a valuation using our assumptions of £23.40p, compared with £22.98 previously.

GGM and sensitivities

	Base	+1% RoE	+1% CoE	+0.5% G
Return on Equity (RoE)	13.5	14.5	13.5	13.5
Cost of Equity (CoE)	10.0	10.0	11.0	10.0
Growth	5.0	5.0	5.0	5.5
Price/book value (x)	1.7	1.9	1.4	1.8
Premium for near-term outperformance	-5%	-5%	-5%	-5%
Adjusted price/book value (x)	**1.6**	**1.8**	**1.3**	**1.7**
Book value 2020E (£m)	213.4	213.4	213.4	213.4
Valuation (£m)	**344.0**	**384.4**	**286.6**	**359.7**
Valuation per share (p)	**23.40**	**26.15**	**19.50**	**24.47**
Variance (p per share)		40.5	-57.3	15.7

Source: Hardman & Co Research

DDM

We take our forecast dividend for the next two years. In year three, we move to an earnings pay-out ratio of 63% (derived from 5% growth, being funded from a long-term RoE of 13.5%). We have 60% growth in 2021 (with full income benefits and reduced cost inflation), and two years of 30% p.a. profit growth, at which stage we revert to the long- term assumed 5% p.a. growth. This rather unusual profile reflects the final payback for investments, the pace of cost growth and deployment of all the surplus capital generated by the sale of the STB holding (to date), and is designed to reflect the group's long-term prospects. Overall, this produces a valuation of £12.82 (previously £13.6).

SoTP

We have i) re-worked our SoTP model for the new segmental information, ii) moved forward the base year to 2020, and iii) included the most recent STB share prices. On our assumptions, detailed below, this approach now has a value of £16.34, representing a significant fall from the previous level (£22.50). The drivers to this fall are:

- Historically, the group has been dominated by private bank profits, with areas such as commercial banking being a net drag on earnings. Looking forward, the mix of the group is changing significantly, and hence we support the greater segmental disclosure. The increasing proportion of profit in lower-rated divisions is now very visible. We believe that a commercial bank or asset lender is likely to have a lower rating than a private bank, and we forecast more profits generated by these lower-rated areas. Had all the operating profits been "kept" in the private bank, the business line valuation would have been ca.£68m (£4.64 higher). The transfer of £1m of treasury profits to the central division directly reduces our SoTP model by a further £12m (£0.82 per share).

- The sale of the stake in STB has reduced the SoTP by over £1 per share. The full financial benefits from deploying these proceeds will only be visible in 2021 earnings, and so will be captured when we move the valuation to that basis, but the value of the shares has been immediately removed.

- A reduction in the profitability of the private bank, reflecting the performance of the unit in 2018. Management has again indicated that the full benefit from the initiatives undertaken in 2019 is only likely to be felt in 2021.

SoTP assumptions

£m	2020E earnings	Rating (x)	Value
PB	6.8	20	136.3
CB	7.1	12	85.1
RAF	2.1	10	21.1
Other divisions	0.9	25	23.3
Centrals	-5.6	4	-25.2
Holding in STB			28.7
Group total			**240.1**
Value per share (p)			**16.34**

Source: Hardman & Co Research

We ascribe the "other divisions" such a high rating, as ABG is likely to just be seeing the initial payback for investment. Profit growth is likely to be significantly ahead of the other divisions.

Disclaimer

Hardman & Co provides professional independent research services and all information used in the publication of this report has been compiled from publicly available sources that are believed to be reliable. However, no guarantee, warranty or representation, express or implied, can be given by Hardman & Co as to the accuracy, adequacy or completeness of the information contained in this research and they are not responsible for any errors or omissions or results obtained from use of such information. Neither Hardman & Co, nor any affiliates, officers, directors or employees accept any liability or responsibility in respect of the information which is subject to change without notice and may only be correct at the stated date of their issue, except in the case of gross negligence, fraud or wilful misconduct. In no event will Hardman & Co, its affiliates or any such parties be liable to you for any direct, special, indirect, consequential, incidental damages or any other damages of any kind even if Hardman & Co has been advised of the possibility thereof.

This research has been prepared purely for information purposes, and nothing in this report should be construed as an offer, or the solicitation of an offer, to buy or sell any security, product, service or investment. The research reflects the objective views of the analyst(s) named on the front page and does not constitute investment advice. However, the companies or legal entities covered in this research may pay us a fixed fee in order for this research to be made available. A full list of companies or legal entities that have paid us for coverage within the past 12 months can be viewed at http://www.hardmanandco.com/legals/research-disclosures. Hardman may provide other investment banking services to the companies or legal entities mentioned in this report.

Hardman & Co has a personal dealing policy which restricts staff and consultants' dealing in shares, bonds or other related instruments of companies or legal entities which pay Hardman & Co for any services, including research. No Hardman & Co staff, consultants or officers are employed or engaged by the companies or legal entities covered by this document in any capacity other than through Hardman & Co.

Hardman & Co does not buy or sell shares, either for their own account or for other parties and neither do they undertake investment business. We may provide investment banking services to corporate clients. Hardman & Co does not make recommendations. Accordingly, they do not publish records of their past recommendations. Where a Fair Value price is given in a research note, such as a DCF or peer comparison, this is the theoretical result of a study of a range of possible outcomes, and not a forecast of a likely share price. Hardman & Co may publish further notes on these securities, companies and legal entities but has no scheduled commitment and may cease to follow these securities, companies and legal entities without notice.

The information provided in this document is not intended for distribution to, or use by, any person or entity in any jurisdiction or country where such distribution or use would be contrary to law or regulation or which would subject Hardman & Co or its affiliates to any registration requirement within such jurisdiction or country.

Some or all alternative investments may not be suitable for certain investors. Investments in small and mid-cap corporations and foreign entities are speculative and involve a high degree of risk. An investor could lose all or a substantial amount of his or her investment. Investments may be leveraged and performance may be volatile; they may have high fees and expenses that reduce returns. Securities or legal entities mentioned in this document may not be suitable or appropriate for all investors. Where this document refers to a particular tax treatment, the tax treatment will depend on each investor's particular circumstances and may be subject to future change. Each investor's particular needs, investment objectives and financial situation were not taken into account in the preparation of this document and the material contained herein. Each investor must make his or her own independent decisions and obtain their own independent advice regarding any information, projects, securities, tax treatment or financial instruments mentioned herein. The fact that Hardman & Co has made available through this document various information constitutes neither a recommendation to enter into a particular transaction nor a representation that any financial instrument is suitable or appropriate for you. Each investor should consider whether an investment strategy of the purchase or sale of any product or security is appropriate for them in the light of their investment needs, objectives and financial circumstances.

This document constitutes a 'financial promotion' for the purposes of section 21 Financial Services and Markets Act 2000 (United Kingdom) ('FSMA') and accordingly has been approved by Capital Markets Strategy Ltd which is authorised and regulated by the Financial Conduct Authority (FCA).

(Disclaimer Version 8 – Effective from August 2018)

Status of Hardman & Co's research under MiFID II

Some professional investors, who are subject to the new MiFID II rules from 3rd January, may be unclear about the status of Hardman & Co research and, specifically, whether it can be accepted without a commercial arrangement. Hardman & Co's research is paid for by the companies, legal entities and issuers about which we write and, as such, falls within the scope of 'minor non-monetary benefits', as defined in the Markets in Financial Instruments Directive II.

In particular, Article 12(3) of the Directive states: 'The following benefits shall qualify as acceptable minor non-monetary benefits only if they are: (b) 'written material from a third party that is commissioned and paid for by a corporate issuer or potential issuer to promote a new issuance by the company, or where the third party firm is contractually engaged and paid by the issuer to produce such material on an ongoing basis, provided that the relationship is clearly disclosed in the material and that the material is made available at the same time to any investment firms wishing to receive it or to the general public…'

The fact that Hardman & Co is commissioned to write the research is disclosed in the disclaimer, and the research is widely available.

The full detail is on page 26 of the full directive, which can be accessed here: http://ec.europa.eu/finance/docs/level-2-measures/mifid-delegated-regulation-2016-2031.pdf

In addition, it should be noted that MiFID II's main aim is to ensure transparency in the relationship between fund managers and brokers/suppliers, and eliminate what is termed 'inducement', whereby free research is provided to fund managers to encourage them to deal with the broker. Hardman & Co is not inducing the reader of our research to trade through us, since we do not deal in any security or legal entity.

research@hardmanandco.com

35 New Broad Street
London
EC2M 1NH

+44(0)20 7194 7622

www.hardmanandco.com