ARBUTHNOT BANKING GROUP

Acquisition of Asset Alliance

We have long argued that ABG's strong funding and capital position give it a competitive advantage in doing cheap deals in uncertain markets. On 10 December 2020, ABG announced *the acquisition of Asset Alliance* (AA), a vehicle finance and related services provider, predominantly in the truck & trailer and bus & coach markets. The expected consideration is £4.1m, against an NAV of £8.1m (with acquisition adjustments, the expected negative goodwill (an equity uplift) is £1.7m)). AA has leases with a net book value of ca.£150m. ABG expects 2021 EBITDA of £5.5m, and, with lower-cost refinancing, we expect bottom-line profitability.

- **ABG's competitive advantage:** With strong capital and access to retail deposits (including the flexibility through the best-buy comparator market via Arbuthnot Direct), ABG is in a position to buy companies whose access to finance is less certain or ones who need a strong backer in uncertain times.
- **Why AA:** ABG has been building its SME finance business through a series of deals and team builds. AA's customers' markets include bus & coach finance, which will have been especially hard-hit by COVID-19. We suspect that the bank providers of credit would be looking for a material increase in their interest.
- **Valuation:** Our forecast scenarios, and multiple valuation approaches, see a broad range of valuations. Our base-case range is 871p to 1,652p. Our upside scenario is 1,044p to 1,918p, and our downside 783p to 1,412p. The share price is 62% of the 1H'20 NAV (1,248p).
- **Risks:** Short term, the impact of lower base rates is critical. Going forward, the key risk is credit. Historically, ABG has been very conservative in lending and security taken. Its financial strength means that it can take time to optimise recoveries. 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 a number of 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 below book value is an anomaly.

Financial summary & valuation – central case

Year-end Dec (£000)	2016	2017	2018	2019*	2020*	2021*
Operating income	41,450	54,616	67,905	72,465	70,293	82,818
Total costs	-46,111	-54,721	-64,982	-70,186	-69,773	-75,822
Cost:income ratio	111%	100%	96%	97%	99%	92%
Total impairments	-474	-394	-2,731	-867	-4,400	-4,600
Reported PBT	-1,966	2,534	6,780	7,011	-2,300	5,396
Adjusted PBT	1,864	3,186	4,388	5,800	-300	7,396
Statutory EPS (p)	1,127.3	43.9	-134.5	41.1	-12.6	29.5
Adjusted EPS (p)	17.1	47.5	22.7	32.8	-2.0	40.0
Loans/deposits	76%	75%	71%	77%	76%	79%
Equity/assets	18.5%	12.8%	9.0%	8.0%	7.2%	6.9%
P/adjusted earnings (x)	45.0	16.2	33.9	23.5	-376.5	19.2
P/BV (x)	0.51	0.50	0.60	0.57	0.62	0.63

IFRS9 basis; Source: Hardman & Co Research

Financials

Source: Refinitiv

Market data

EPIC/TKR	**ARBB/ARBN**
Price (p)	**770/790**
12m High (p)	1,428
12m Low (p)	625
Shares (m)	15.4
Mkt Cap (£m)	119
Loan to Deposits 2021E	76%
Free Float*	42%
Market	AIM/NEX

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

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Key shareholders

Sir Henry Angest	56.1%
Liontrust	7.0%
Slater Investments	3.9%
Miton Asset Mgt.	3.6%
R Paston	3.6%
M&G IM	3.5%

Diary

Feb'21	Trading statement (tbc)

Analyst

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Asset Alliance

Deal terms

Consideration ca.£4m against NAV of ca.£8m. Even after acquisition adjustment, should see uplift to ABG's equity of £1.7m.

The consideration is based on an agreed discount to the tangible net assets of AA at completion, after adjusting for the fair value of the assets available for lease. The consideration is expected to be £4.1m. AA had adjusted net assets of £8.1m as at 31 August 2020. The acquisition should generate a net negative goodwill accounting adjustment of £1.7m, following a conservative valuation of assets in the fair value adjustment. Deal costs of £0.8m are expected to be expensed in the 2020 results.

EBITDA expected to rise to £5.5m in 2021

AA reported EBITDA of ca.£7.2m for 2019 (up from £5.2m in 2018), and is expecting to record £2.3m in 2020. This is anticipated to increase to £5.5m in 2021, with lower impairments and a resumption of growth.

Under ABG's ownership, materially lower funding costs

AA has been reporting pre-tax losses with material interest charges (last accounts at Companies House showing a 2018 cost at £7.5m). It currently has a revolving credit facility of ca.£140m, which is expected to be refinanced by Arbuthnot soon after the completion date, with much lower-cost retail deposits. It is probable that the bank providers (HSBC, RBS Clydesdale, Shawbrook and AIB) would have been seeking a material increase in the rate they charged for the AA standalone entity, which would have been likely to report further losses in 2020 and 2021.

Earnings-accretive and equity uplift in year 1

ABG expects the deal to be earnings-accretive in 2021, and this is in line with our forecasts. Clearly, there is some uncertainty around the speed of the recovery, especially in the bus & coach market, where we would expect a surplus of second-hand vehicles, as smaller operators fail. However, the group was growing strongly before the COVID-19 crisis, and the target EBITDA is in line with what was delivered in 2018; in addition, ABG will see incremental profit benefits from lower funding costs.

Can fund more growth

Looking forward, ABG will be able to fund a much faster rate of growth than AA would likely have been able to as a standalone business. In the near term, standalone losses would have dented its equity, and banks would likely have demanded much higher interest rates. With ABG's retail deposits, neither of these is an issue.

What does the deal show strategically?

Highlights opportunity for ABG to do value-enhancing deals. Effectively, sellers are distressed sellers, and so ABG can negotiate very favourable terms.

For us, the important point about this deal is not the deal itself but, rather, what it says about the opportunities for a well-funded and capitalised bank like ABG. We expect a number of non-retail-deposit financing businesses to face increasing funding challenges through any downturn. With increasing arrears and bad debts, their profitability is likely to be sharply lower, and their capacity to lend into any recovery becomes minimal, if any. A backer such as ABG sees material refinancing advantages, and also enables a much faster growth rate in any recovery. As noted above, AA would have been likely to face losses as a standalone business, while it is likely to be profitable under ABG's ownership.

About the business

AA (website: *https://assetalliancegroup.co.uk/asset-alliance-group-2/*) provides vehicle finance and related services, predominantly in the truck & trailer and bus & coach markets. Operating from five locations, it is the UK's leading independent end-to-end specialist in commercial vehicle financing, and it has over 4,000 vehicles under management. As at 31 August 2020, AA had assets for lease with a net book value of ca.£150m. We understand that the significant majority of the business is truck & trailer (it is also a broker for coach lending).

Commercial motor describes the truck side of the group as follows:

"As one of the largest independent sellers of new trucks and used trucks in the country, Asset Alliance Truck and Trailer Sales can provide a huge range of services to make the buying process as straightforward as possible. They have sites in Wolverhampton, Lanarkshire and Ipswich and are able to provide repair and maintenance services, customisation, refurbishment and general servicing of all makes and models of vehicle. The Asset Alliance Truck and Trailer Sales group also includes the former businesses of ATE Truck and Trailer Sales, which operated for more than 25 years, as well as Hanbury Riverside – with more than 35 years of experience in the used truck marketplace.

They sell a wide range of high quality used trucks from makers including Volvo, DAF, Scania and Mercedes-Benz trucks. There is also a sizeable choice of both rigid and tractor units, so you can get anything from a Scania R-series or a DAF XF down to a Mercedes-Benz Antos or a MAN TGS. In addition to their heavy truck sales, Asset Alliance also sell a large range of trailers from manufacturers including SDC and Montracon, with a choice of curtainsiders or more specialised equipment like refrigerated trailer units or step-frame machinery trailers. Lawrence David, Krone, Gray & Adams and Schmitz Cargobull are just some of the makes you'll find in their extensive stocklist.

Asset Alliance also export to more than 60 countries across the world, and provide a range of other services to help with the buying process, particularly in the area of truck finance. Asset Alliance are specialists in asset finance and can offer a number of finance packages with contract hire, operating lease, flexihire, spot rental, finance lease and hire purchase all available.

With contract hire packages, Asset Alliance can also offer a fleet management service, covering maintenance and servicing as well as other important aspects of running a fleet such as fuel management, accident management and overall fleet efficiency."

Financials and valuation

Profit and loss – central case					
Year-end Dec (£000)	2017	2018	2019*	2020E*	2021E*
Interest income	47,427	65,290	76,870	76,000	92,175
Interest expense	-6,334	-10,107	-18,233	-18,900	-23,300
Net interest income	**41,093**	**55,183**	**58,637**	**57,100**	**68,875**
Fees and comms. income	13,805	12,956	13,935	13,293	14,043
Fees and comms. expense	-282	-234	-107	-100	-100
Net fees and comms.	13,523	12,722	13,828	13,193	13,943
Operating income	**54,616**	**67,905**	**72,465**	**70,293**	**82,818**
Net impairment on financial assets	-394	-2,731	-867	-4,400	-4,600
STB dividend income	0	0	1,500	0	1,000
Other income	3,033	6,588	4,099	1,580	2,000
Operating expenses	**-54,721**	**-64,982**	**-70,186**	**-69,773**	**-75,822**
Profit before tax from continuing operations	**2,534**	**6,780**	**7,011**	**-2,300**	**5,396**
Income tax	-448	-1,121	-835	391	-917
Profit after tax from continuing operations	2,086	5,659	6,176	-1,909	4,478
Profit from discontinued operations after tax	4,437	-25,692	0	0	0
Profit for year	**6,523**	**-20,033**	**6,176**	**-1,909**	**4,478**

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

Balance sheet – central case							
@ 31 Dec (£000)	2015	2016	2017	2018	2019*	2020E*	2021E*
Cash and balances at central bank	115,938	368,611	195,752	405,325	325,908	344,165	278,327
Loans and advances to banks	31,844	28,578	36,951	54,173	46,258	46,258	100,000
Debt securities held to maturity	91,683	87,728	107,300	342,691	442,960	442,960	400,000
Assets classified as held to sale	0	118,456	0	8,002	7,617	7,000	7,000
Derivative financial instruments	2,707	1,490	1,516	1,846	1,804	1,804	1,804
Loans and advances to customers	**1,158,983**	**1,579,512**	**758,799**	**1,224,656**	**1,599,053**	**1,646,000**	**1,796,000**
Other assets	16,866	16,894	11,939	12,716	86,443	86,443	86,443
Financial investments	1,277	2,685	2,145	35,351	30,919	30,919	30,919
Deferred tax	2,588	1,784	1,665	1,490	1,815	1,815	1,815
Investments in associates	943	943	82,574	0	-	-	-
Intangible assets	11,318	10,874	8,522	16,538	20,082	19,582	19,082
Property, plant and equipment	12,475	14,004	4,782	5,304	5,813	5,813	5,813
Right of use property	0	0	0	0	19,944	20,559	20,559
Investment property	0	0	53,339	67,081	6,763	6,763	6,763
Total assets	**1,446,622**	**2,231,559**	**1,265,284**	**2,175,173**	**2,595,379**	**2,660,081**	**2,754,525**
Deposits from banks	27,657	55,305	3,200	232,675	230,421	230,421	230,421
Derivative financial instruments	1,067	135	227	188	319	319	319
Deposits from customers	**1,194,285**	**1,929,838**	**997,649**	**1,714,286**	**2,084,903**	**2,167,000**	**2,261,000**
Liabilities relating to assets classified as held for sale	0	8,700	0	0	-	-	-
Current tax liability	3,612	3,366	147	236	633	633	633
Other liabilities	34,984	31,977	17,082	18,549	13,500	13,500	13,500
Lease liabilities	0	0	0	0	20,431	20,882	20,882
Debt securities in issue	11,448	10,834	12,621	13,283	36,837	36,837	36,837
Total liabilities	**1,273,053**	**2,040,155**	**1,030,926**	**1,979,217**	**2,387,044**	**2,469,592**	**2,563,592**
Share capital	153	153	153	153	154	154	154
Retained earnings	114,641	123,330	235,567	209,083	209,171	207,262	206,306
Other reserves	-1,263	34	-1,362	-13,280	-990	-16,927	-15,527
Total to owners of the parent	113,531	123,517	234,358	195,956	208,335	190,489	190,933
Non-controlling interests	60,038	67,887	0	0	-	-	-
Total equity	**173,569**	**191,404**	**234,358**	**195,956**	**208,335**	**190,489**	**190,933**

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

Our financial assumptions are unchanged from our last report, except for i) 2020 added £0.8m to costs, and ii) 2021 added £150m to commercial division loans, £100m to deposits, £13m to interest income (for simplicity), £8m to costs and £4m to interest expense. We will discuss with the company, in due course, the exact breakdown that it will report – as a standalone business, AA reports turnover with roughly half from contract hire but over a third from the sale of vehicles and a range of other services.

Valuation

Range of valuations broad – driven by scenario of assumptions, but also methodology. Central balance sheet-driven approach derives £16.52.

We have not changed our Dividend Discount Model (DDM) central scenario (£8.71), and we have made only minor changes to our Gordon Growth Model (GGM) central scenario (£16.52). We do not believe that the implied price to book on the higher valuation is overly demanding, being 1.3x book value for a business that has delivered significant long-term value in the past. The range of valuations across our scenarios and models is given in the table below.

Summary of different valuation techniques by scenario

(£)	Downside	Central	Upside
GGM	14.12	16.52	19.18
DDM	7.83	8.71	10.44

Source: Hardman & Co Research

GGM

Our GGM is based off 2020E equity, and so sees a small reduction for the acquisition costs. If we rolled forward to 2021, this would be more than offset by the negative goodwill effect.

GGM and sensitivities (central scenario)

	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%	10%	11%	10%
Growth	5%	5%	5%	5.5%
Price/book value (x)	1.7	1.9	1.4	1.8
Prem. for near-term outperf.	-25%	-25%	-25%	-25%
Adjusted price/book value (x)	**1.3**	**1.4**	**1.1**	**1.3**
Book value 2020E (£m)	190.5	190.5	190.5	190.5
Valuation (£m)	242.9	271.4	202.4	254.0
Valuation per share (p)	**16.52**	**18.47**	**13.77**	**17.28**
Variance (p per share)		28.6	-40.5	11.1

Source: Hardman & Co Research

DDM

Assumed uncovered dividend and then delayed previous dividend growth

In our central case, we assume that ABG will pay 37p dividends in 2021 and 2022, even though the dividend is uncovered. The dividend we had previously assumed for 2021 (65p) is now not paid until 2023. Overall, this produces a valuation of £8.71 (unchanged on unchanged base-case forecasts). In our downside scenario, we assume a 50% dividend cut for three years, and then 65p, which results in a valuation of £8.71.

SOTP

Earnings-driven SOTP model no longer useful, given our forecasts are based off depressed 2021 level

Our SOTP model was based on year 1 prospective earnings, which we do not believe accurately reflect ABG's long-term value creation, and so we have withdrawn this model for the moment. The rise in STB's share price adds ca.30p to ABG's valuation.

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(Disclaimer Version 8 – Effective from August 2018)

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