4th April 2018

hardman&co

Arbuthnot Banking Group

2017: capital deployed, adding value

ABG has a long track record of adding value. The partial sale of its Secure Trust Bank (STB) in 2016 saw significant capital generated, and ABG is now deploying this surplus to generate returns. Despite heavy investment, profits nearly doubled, with loans and deposits up over a third. Credit remains outstanding, with the secured nature of lending seeing 2H'17 impairments of just £51k on a £1bn loan book. The outlook is for further strong profit growth, more investment, and greater diversification by business line and risk exposure. The shares trading below NAV appears an anomaly, given ABG's track record and earnings growth outlook.

- **FY'17 results:** 2017 saw interest income up 25% (driven by loans up 38%), interest expense down 17% (despite 39% deposit growth), net fees and commissions up 23%, impairments down to a record-low 4bps of lending and cost growth of 19%. Underlying profit rose from £4m in 2016 to £7.6m in 2017.
- **Outlook:** ABG is only a third of the way through deploying its surplus capital. With the initiatives outlined recently, we see accelerated investment in 2018 (reducing our earnings forecast), but we still predict 37% profit growth. Our new 2019 profit forecast is higher than we had previously estimated for 2018.
- **Valuation:** The range of our fully deployed capital valuation methodologies is now 1,476p to 2,630p (previously 1,534p-2,641p), with the impact of lower 2018 earnings largely offset by rolling forward our valuation base year to 2019 from 2018. We note the shares currently trade at 1,355p vs. an NAV of 1,547p.
- **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 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 (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, capitalised and strongly growing bank, priced below book value, is an anomaly, in our view.

Financial summary and valuation

Year-end Dec (£000)	2015	2016	2017	2018E	2019E
Operating income	34,604	41,450	54,616	68,479	80,696
Total costs	-35,926	-46,111	-54,721	-65,735	-73,248
Cost:income ratio (%)	104	111	100	96	91
Total impairments	-1,284	-474	-394	-1,175	-1,400
Reported PBT	-2,606	179	6,971	8,942	15,393
Adj. PBT	2,982	4,009	7,623	8,942	15,393
Statutory EPS (p)	86.3	1,127.2	43.9	56.3	94.3
Adj. EPS (p)	13.5	17.1	47.5	56.3	94.3
Loans/deposits (%)	82	76	75	80	80
Equity/assets (%)	5.5	18.5	12.8	11.4	10.5
P/adj. earnings (x)	100.4	79.2	28.5	24.1	14.4
P/BV (x)	1.68	0.88	0.88	0.87	0.84

Source: Hardman & Co Research

Financials

Source: Eikon Thomson Reuters

Market data

EPIC/TKR	**ARBB**
Price (p)	1,355
12m High (p)	1,599
12m Low (p)	1,245
Shares (m)	15.3
Mkt Cap (£m)	207
EV (£m)	80%
Free Float*	42%
Market	AIM

**As defined by AIM Rule 26*

Description

ABG has a well-funded and capitalised private bank and has been growing very strongly, especially in its commercial banking division. It holds an 18.6% stake in Secure Trust Bank (STB) and has an asset finance unit. It has ca.£60m to invest in new organic or acquired businesses.

Company information

Chair/CEO	Sir Henry Angest
COO	Andrew Salmon
CFO	James Cobb

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Key shareholders

Sir Henry Angest	56.1%
Liontrust Inv. Ptnrs. LLP	6.3%
Prudential plc	4.2%
Slater Investments	4.0%
R Paston	3.6%
Miton	2.7%

Next event

5th May	AGM
19th July	Interim results

Analysts

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2017 results summary

Financial highlights

Statutory profit driven by strong revenue growth, lower interest expense and low impairments, partially offset by rising costs, including heavy investment

- 2017 statutory profit before tax: £7.0m (2016: £0.2m).
    - Gross interest revenue was up 25% to £47.4m, driven by balance sheet growth, partially offset by mix-driven yield compression.
    - There was a 17% reduction in interest expense (£6.3m vs. £7.6m), with (i) strong growth in low-rate commercial deposits, (ii) expensive deposits rolling over to lower-rate offerings, and (iii) a greater proportion of deposits in call accounts. In aggregate, these more than offset strong volume growth (deposits £393m, +39%).
    - Net fees and commissions rose 23%, from £11.0m to £13.5m, reflecting strong loan and AUM growth.
    - Impairments fell to £394k (2016: £474k; 2H'17: £51k). Lending is significantly secured on property.
    - Operating costs rose 19% (£54.7m vs. £46.1m), a little ahead of expectations, with further accelerated investment.

Underlying profits nearly doubled

- Underlying profit before tax: £7.6m (2016: £4.0m; 2H'17: £5.0m, vs. £2.7m in 1H'17).
- Earnings per share (continuing businesses: 43.9p (2016: loss 3.7p)
- Final dividend: 19p (2016: 18p), making total for year 33p (2016: 31p).

NAV of 1,547p well above current share price of 1,355p

- Net assets per share: £15.47 (2016: £15.33).

Operational highlights

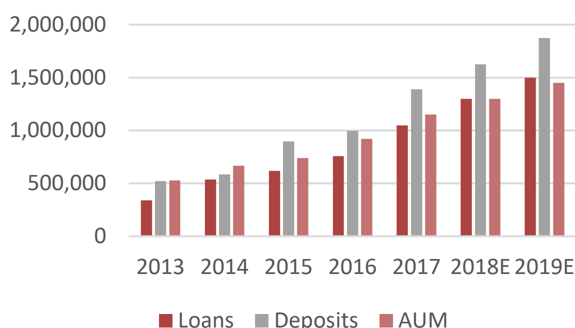
Strong loan growth, especially in commercial sector

- Customer loans: £1,049m (1H'17: £879m; 2016: £759m), up 38%. The private bank originations were a record £201m, but increased redemptions meant that loan book fell slightly. Commercial banking loans were £305m (1H'17: £147m; 2016: £76m), while Renaissance Asset Finance (RAF) had balances of £70m. Mix-driven changes saw the average yield fall from 5.6% to 5.3%. The average loan size was £987m, with 99.3% secured at an average loan to value of 53%.

Deposits up 39%, again with strong commercial performance

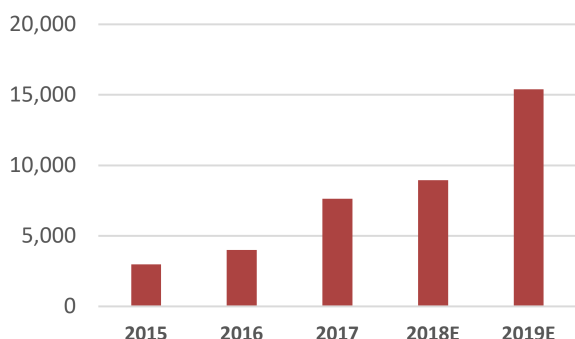
- Customer deposits: £1,391m (1H'17: £1,229m; 2016: £998m), up 39%. Commercial banking deposits were £308m (1H'17: £160m; 2016: £51m) and remained ahead of commercial loans. A specialist commercial deposit gatherer joined in 2H'17, significantly increasing volumes. The average cost of funds has fallen by ca.30bps, leaving the group margin at 475bps (2106: 476bps).
- Assets Under Management (AUM): £1,044m, up 13% (2016: £920m).
- The commercial bank is showing payback for historical investments, with strong loan and deposit growth. Revenue in 2017 was £6.149m vs. £0.508m in 2016, and customer numbers rose from 261 to 715.

Loans, deposits and AUM, 2013-19E



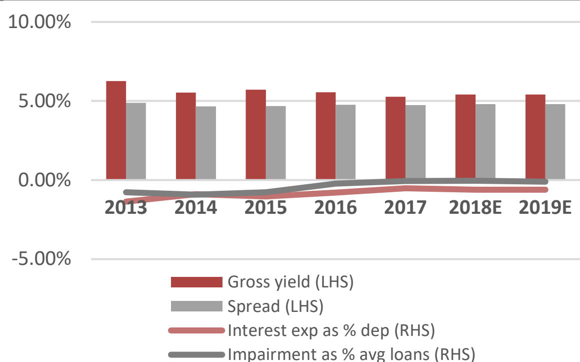
- 2017 loan growth of 38% reflects especially strong commercial loan growth. The total growth is an acceleration of the trend but not exceptional (average growth of 24% over 2009-16).
- Deposit growth of 39% in 2017 reflects commercial deposits rising nearly six-fold. Group growth is an acceleration of the trend but not exceptional (average 20% over 2009-16).
- AUM rose 13%.

Group-adjusted pre-tax profit, 2015-19E (£000)



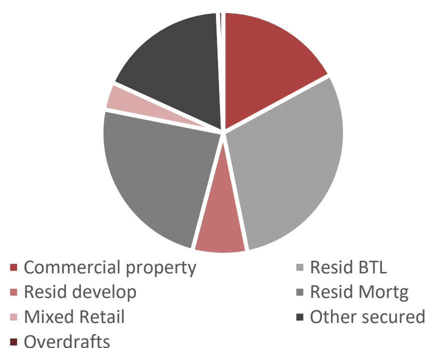
- Strong growth in adjusted pre-tax profit in 2017, with revenue growth (32%) well ahead of cost growth (19%), and falling impairments.
- In 2018, we forecast revenue growth of 25% and continued heavy investment, with costs rising 20%. A reversion of credit to more normal levels depresses profit growth.
- We forecast 2019 revenue growth of 18%, and cost growth of 11%, with a significant jump in profits that year.

Yield, spread, cost of funds and impairments (%)



- The gross yield has been declining from 2013 (6.25%) to 2017 (5.27%), primarily from mix. We expect a small mix rise in 2018.
- The spread has been much more stable (down 14bps 2013-17 to 475bps), with improving cost of funds (down from 136bps in 2013 to 52bps in 2017), offsetting a falling yield.
- 2017 impairment costs were at a record-low 4bps. The effect of IFRS9 was very modest, with no lead signs of credit deterioration, but we forecast a more normal 10bps for 2018 and 2019.

Lending well diversified (%)



- ABG's lending is 99.3% secured at an average LTV on specific physical assets backing each loan of 53%. Personal guarantees mean that the group can make recoveries from all its clients' assets, not just from specific property secured.
- Buy-to-let is the largest single concentration of lending, accounting for 30% of all loans. 61% of lending is related to residential property, including 24% owner mortgages.
- London accounts for 48% of all loans but is diversified within the city. Westminster, Kensington and Chelsea in aggregate account for ca.13% of total loan exposure.

Source: Company data; Hardman & Co Research

Strategic update

2017 developments

Capital returned to shareholders in 2016, and now being deployed in strong organic and acquisitive growth

Since selling part of its holding in STB, the key issue for ABG has been the speed and returns achieved from deploying its surplus capital. To date, we have seen:

- Capital returned to shareholders: 325p special dividend (2016), costing £44m.
- Organic core business growth, including:
  - geographical expansion:
    - (i) Dubai: originated loans £94m (2016: £74m), deposits £94m (2016: £64m), AUM £95m (2016: £78m). The loans are secured on UK property, and both loans and deposits are booked in London, and
    - (ii) regional UK offices;
  - hiring more private bankers; and
  - improving the penetration of investment products (AUM up 13%).
- New business lines, in particular the growth of the commercial business.

Renaissance Asset Finance (RAF) growth of 27% since start of year

- Acquisitions of portfolios (Duncan Lawrie), commercial property (part of which may be used to service private banking clients) and companies (RAF). The RAF loan book amounted to £70.2m as of 31st December 2017, an increase of 26.7% from the start of the year. It is expanding its offering into new niche markets, such as horseboxes and drainage, and is actively reviewing other markets, such as recovery vehicles and engineering & manufacturing. At present, the mix of loans is high-value cars (21%), commercial vehicles (19%), classic cars (17%) and other cars (14%). This business has opened up new distribution channels for ABG and is seen by management as the base from which it can develop further lending products for the asset-backed financing markets.

It is worth noting that strong growth is a continuation of a long-term trend, rather than an uncontrolled rush to expand. The average growth of loans, deposits and AUM over 2009-16 was 24%, 20% and 27%, respectively (see table below).

Historical growth in Arbuthnot Latham division

Metric (£m)	2009	2010	2011	2012	2013	2014	2015	2016	2017
Loans	177.7	210.8	238.2	289.3	341.0	536.5	618.9	758.8	1049
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	1,391
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
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
Costs	11.6	14.9	16.0	17.9	21.3	24.0	29.7	36.6	47.4
Pre-tax profits	0.2	1.0	2.0	2.1	7.7 *	3.6	6.0	9.1	11.0

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

2018 initiatives

Looking forward, we forecast a continuation of the strong trends generated by the programmes started in 2016/17. In addition, with the 2017 results, we got more detail on three new initiatives:

Property fund

Focus on properties yielding in excess of 7%

Arbuthnot Latham is in the process of establishing an open-ended property fund to be offered to its clients. It may provide initial seed funding, but the objective is to be a commercial offering. The fund will be focused on income-producing assets with a target yield of 7% p.a., with properties ranging in value from £5m-10m.

Asset-based lending

Team of seven hired for asset-based lending. 2H'18 will see first revenue contribution.

This initiative is currently in the set-up phase and is expected to be launched towards the end of 2Q'18. An asset-based lending team of seven has been hired; this team previously managed a similar business in Shawbook and, prior to that, in Centric Commercial Finance. The combined team has over 100 years of experience in the sector. Credit control is managed by the core ABG team.

Arbuthnot Direct

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

ABG is seeking to diversify its funding sources and also to give it flexibility to raise term and notice deposits quickly. It plans a direct-to-market savings platform, with origination driven via "best-buy tables" and products with a maximum deposit amount of £250k. The focus is expected to be on notice and time deposits with a tenor of up to five years.

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, as the platform will be serviced from the Exeter office, with a third-party service provider covering supplemental support in peak volume periods. The proposition will be launched in 3Q'18, initially targeting a modest book of up to £20m-50m.

ca.£60m surplus capital to deploy. We expect further initiatives through 2018, although higher investment costs will be a drag on that year's earnings.

We believe the group's surplus capital is now around £60m, having deployed a third of the surplus generated from the disposal of its STB stake. We think it is actively looking at new product/distribution areas. This may involve opportunistic acquisitions but is more likely to see further team hirings and continued organic investment. The scale of investment in 2H'17 was over £1m above our forecasts, and we have continued this and a further £2.5m increase in costs into 2018. While this depresses short-term earnings, we expect a relatively rapid payback. Our new 2019 profit estimates are above our previous 2018 forecasts.

Risk

Credit risk

Private banking risk tends to be lumpy. ABG loans secured on both property and other assets.

Credit risk in private banking is different from that in mainstream banking in a number of ways. First, losses tend to be irregular but large (making them hard to accurately forecast). Second, loans are often secured on assets other than the loan being financed, and this may take time to be realised. It also means that provisions may vary over time, as there are changes in recovery expectations. In ABG's case, lending is over 99% secured on average loans to values of 53%, which means that, even in some high-profile cases, actual losses may not be incurred. It also means that provisions as a percentage of impaired loans are low (2017 stock of provisions £1.4m, 4.4% of impaired loans of £31m). Third, many private clients have a more international exposure and may not be dependent on, say, the UK economy.

Record-low losses in 2017. Just £51k impairment on £1bn book in 2H'17.

Looking at the record of impairments, ABG saw losses over several years from one office, with a specialist high-net-worth risk exposure from loans made over a decade ago. This has now been resolved, and there are no remaining loans from this unit. Looking forward, we believe the current level of losses is unlikely to be sustainable. The losses in 2H'17 were just £51k on a £1bn+ loan book.

Historical impairments

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Impairment (£000)	-444	-1179	-979	-2,212	-2,038	-2,914	-3,378	-1,250	-474	-394
Impairment as % average loans	0.28%	0.71%	0.50%	0.99%	0.77%	0.92%	0.77%	0.22%	0.07%	0.04%
Impairment as % revenue	-3.04%	-9.16%	-6.78%	-12.51%	-10.79%	-13.46%	-11.69%	-3.56%	-1.13%	-0.73%

Source: Hardman & Co Research

Risk concentrations

The table below shows some of the concentrations in the loan book by type of loan, broad locations and London borough exposure. The key message is that the book is not only well secured but also very diversified.

Loan concentrations (%)

Type of loan	%	Location	%	London property loans	%
Commercial property	17	London	48	Westminster	19
		South East	20	Kensington and Chelsea	15
Residential buy-to-let	30	South West	8	Camden	14
Residential development	7	North West	7	Barking and Dagenham	7
Residential mortgages	24	Overseas	6	Hammersmith and Fulham	6
Total residential	61	Other	11	Wandsworth	4
				Barnet	4
Other	22			Other	30

Source: Hardman & Co Research

Loans secured on property and other assets

ABG should be considered as a secured lender whose average loan to value is just 53%. The statutory accounting requirement is unhelpful in understanding the security backing as, for example, the collateral disclosed in note 6 of the results release relates to only specific physical assets backing each loan, and it ignores

personal guarantees and portfolios of investments, which, for a private client lender, can be a material source of eventual repayment. The £45m of loans at LTVS of 100%+ (property collateral still £34m) is thus supported by significant other security. Management advises that 60% loan to value against realisable assets is standard and that 70% is seen as a maximum, which has to be justified by client-specific characteristics.

Commercial property exposure

Rapid growth but very low market share; should be able to cherry-pick best lending.

ABG has been rapidly growing its commercial business, especially commercial property. This has been driven by experienced lenders in this sector. While commercial property has caused significant problems in major banks, we note the following: (i) ABG's market share is so miniscule that it can massively increase lending and still cherry-pick the best propositions. (ii) Having built scale to cover infrastructure costs and establish a diversified portfolio, management can now focus on optimising the returns of each loan (i.e. higher return or lower regulatory risk on capital-weighted loans). We expect strong growth going forward, but not at the rate seen in 2017. (iii) Given the Chairman's shareholding, he has a direct personal interest in ensuring that appropriate controls are in place. Management is more closely aligned to shareholders than in many banks.

Rise in early-stage arrears is not lead indicator of problems

New IT system identifies arrears differently. Rise in up to 30 days is not a lead indicator of problems. Over 30 days arrears down.

Note 22 of the annual reports highlights an increase in early past-due accounts (up to 30 days arrears, rising from £1m to £115m). This rise is not business-driven but reflects the way the new IT systems identify arrears. By way of example, we understand that, historically, a loan arrears would not be identified as such if a customer's overdraft facility allowed the loan payment to be made, but the new IT system does not allow such netting. With December 31st 2017 falling on a Sunday, there were also clearing-related issues, which led to the new system identifying accounts as being in arrears. We understand that this past-due category fell sharply in the new year. The over 30 days of arrears were £16m in 2017 vs. £22m in 2016.

IFRS9

IFRS9 not material

The new accounting standard recognises provisions earlier than was the case under the old standard (IAS39), which is especially adverse for rapidly growing companies. It changes nothing in terms of cash, ultimate loss or risk, but does defer profit recognition. The low-risk nature of ABG's exposure means that the effect is, however, modest. With the 2017 results, management commented that the effect would be ca.1% of shareholder funds and that the effect on future profitability would not be material.

Other risks

With regard to liquidity, we note that ABG has a loan to deposit ratio of 75%. It has had a cautiously positioned balance sheet for many years and incurred material carry costs. As a consequence, the deposit base is increasingly diversified (by customer numbers and also with commercial depositors), and we will see the introduction of term/notice accounts with Arbuthnot Direct. The recent major IT upgrade should see a moderated operational risk, with state-of-the-art systems and cyber security. As with any private bank, ABG carries reputational risk. Management sees upside should the UK move to a rising rate environment, given the mix of deposits and the low-risk nature of its lending.

Capital

Core Tier 1: 17.3%

At end-2017, ABG had total Tier 1 capital resources of £159m and a core Tier 1 ratio of 17.3%. The £159m is lower than statutory equity (£236m) because the holding in STB leads to a significant deduction (in excess of £60m), which, with some smaller adjustments, sees total regulatory deductions of £78m. In its results release, management highlighted that the level of capital it will be required to hold is subject to significant variables. These include the following:

Lots of uncertainties on future regulatory positions mean that ABG may keep a bigger buffer

- Changes to standardised credit risk methodology published by the Basle Committee. As a low-risk bank, this should see material benefits to ABG, but the new rules will not be effective until 2022.
- The regulator has considered new buffers on relatively short notice. As a prudent bank, ABG maintains internal buffers over and above the regulatory ones, but the base line is less clear, requiring ABG to hold even more capital.
- New commercial lending may see a mix change on new business to lower-weighted lending.

Sale of STB stake likely to increase regulatory capital, even if it is at an accounting loss

- The sale of the holding in STB is likely to see significant capital released, as the regulatory deduction reduces. The group has an 18.6% interest in STB and, with management influence, this is treated as an associate. Accordingly, it is recorded in the group's balance sheet as an interest in associates, and recognised at the price when the stake was reduced to the current level and uplifted for the share of associate earnings since then. At 31st December 2017, it was carried at £83.8m (£24.33 per STB share). Accounting and regulatory capital do not recognise any increase in value if the market price is above this level, nor any loss if the price is below it (at end-2017, the market price of STB was £17.97 per share). If ABG were to sell its stake in STB at the end-2017 level, there would be an accounting loss of ca.£22m, but the elimination of the regulatory deduction would see its Tier 1 capital rise by ca.£40m.

We believe there is surplus capital of around £60m

Noting all these uncertainties, we believe ABG currently has surplus capital of up to £60m, which is available for deployment in the initiatives noted above. This surplus would increase if there were a further sale of STB shares, which, over the medium term, appears probable.

Financials and valuation

As identified above, we have materially increased costs to reflect ongoing investments. Impairments have been raised to more normal levels after a record low in 2017. The contribution from the associate is derived from market consensus estimates, and reflects IFRS9 accounting and the disposal of its personal loan portfolio on 21st December 2017.

Change in estimates (£000)

Scenario		2017			2018E		2019E
Year-end Dec	Old	New	% change	Old	New	% change	
Profit and Loss (£000)							
Operating income	53,589	54,616	2%	67,492	68,479	1%	80,696
Costs	-53,551	-54,721	2%	-60,201	-65,735	9%	-73,248
Impairments	-904	-394	-56%	-1,175	-1,175	0%	-1,400
Associate and other income	7,310	7,470	2%	8,203	7,373	-10%	9,345
Statutory pre-tax profit	6,444	6,971	8%	14,318	8,942	-38%	15,393
Ordinary DPS (p)	33.0	33.0	0%	35	35	0%	38
	0			0			
Balance sheet, @ 31 Dec (£m)							
Loans and Advances	1,050	1,049	0%	1,300	1,300	0%	1,500
Deposits	1,300	1,391	7%	1,625	1,625	0%	1,875
Equity	236	236	0%	243	239	-2%	248

Source: Hardman & Co Research

Profit and loss (£000)

Year-end 31 Dec	2015*	2016	2017	2018E	2019E
Interest income	32,801	38,071	47,427	63,256	75,426
Interest expense	-7,990	-7,626	-6,334	-9,182	-10,635
Net interest income	**24,811**	**30,445**	**41,093**	**54,074**	**64,791**
Fees and comms. income	9,999	11,430	13,805	15,305	16,805
Fees and comms. expense	-206	-425	-282	-900	-900
Net fees and comms.	9,793	11,005	13,523	14,405	15,905
Operating income	**34,604**	**41,450**	**54,616**	**68,479**	**80,696**
Net impairment on financial assets	-1,284	-474	-394	-1,175	-1,400
Other income	0	2,145	4,437	5,710	7,682
Associate income (post-tax)	0	3,169	3,033	1,663	1,663
Operating expenses	-35,926	-46,111	-54,721	-65,735	-73,248
Profit before tax from cont. operations	**-2,606**	**179**	**6,971**	**8,942**	**15,393**
Income tax	121	-720	-448	-582	-1,388
Profit after tax from continuing operations	**-2,485**	**-541**	**6,523**	**8,361**	**14,005**
Profit from discontinued operations after tax	29,009	228,110	0	0	0
Profit for year	**26,524**	**227,569**	**6,523**	**8,361**	**14,005**
Attributable to non-controlling interests	-13,798	-61,426	0	0	0
Attributable to equity shareholders	**12,726**	**166,143**	**6,523**	**8,361**	**14,005**

** STB discontinued in 2015*

Source: Hardman & Co Research

Balance sheet

Balance sheet (£000)					
@ 31 Dec	**2015**	**2016**	**2017**	**2018E**	**2019E**
Cash and balances at central bank	368,611	195,752	313,101	298,076	350,399
Loans and advances to banks	28,578	36,951	70,679	70,679	70,679
Debt securities held to maturity	87,728	107,300	227,019	227,019	227,019
Assets classified as held to sale	118,456	0	2,915	0	-
Derivative financial instruments	1,490	1,516	2,551	2,551	2,551
Loans and advances to customers	**1,579,512**	**758,799**	**1,049,269**	**1,300,000**	**1,500,000**
Other assets	16,894	11,939	20,624	20,624	20,624
Financial Investments	2,685	2,145	2,347	2,347	2,347
Deferred tax	1,784	1,665	1,527	1,527	1,527
Investments in associates	943	82,574	83,804	89,514	97,196
Intangible assets	10,874	8,522	15,995	15,495	14,995
Property, plant and equipment	14,004	4,782	3,962	3,962	3,962
Investment property	0	53,339	59,439	59,439	59,439
Total assets	**2,231,559**	**1,265,284**	**1,853,232**	**2,091,233**	**2,350,738**
Deposits from banks	55,305	3,200	195,097	195,097	195,097
Derivative financial instruments	135	227	931	931	931
Deposits from customers	**1,929,838**	**997,649**	**1,390,781**	**1,625,000**	**1,875,000**
Liabilities relating to assets classified as held for sale	8,700	0	0	0	-
Current tax liability	3,366	147	705	705	705
Other liabilities	31,977	17,082	16,239	16,239	16,239
Debt securities in issue	10,834	12,621	13,104	14,104	15,104
Total liabilities	**2,040,155**	**1,030,926**	**1,616,857**	**1,852,076**	**2,103,076**
Total to owners of the parent	**123,517**	**234,358**	**236,375**	**239,157**	**247,662**
Non-controlling interests	67,887	0	0	0	0
Total equity	**191,404**	**234,358**	**236,375**	**239,157**	**247,662**

Source: Hardman & Co Research

Valuation

Given the strategic optionality of the group, we reviewed a range of methodologies and scenarios for our valuation in our initiation note published on 1 August 2016 (Tripedalism - three legs are better than two). This report also reviews the basis for our underlying assumptions, which have not changed materially since then.

Base-case average now £18.44 (upside potential 36%), with more upside as capital is fully deployed (average £22.48)

Following these results, the average of our base-case valuations is £18.44, implying upside potential of 36% on the current share price. This average valuation represents a price to 2017 book of just 1.2x. The highest valuation continues to be the Gordon Growth Model (GGM), at £23.42, which we believe best captures the profitability and growth of the business. The average of our fully deployed capital models is now £22.33. The highest methodology in this scenario is the sum-of-the-parts model (SoTP), at £26.30, which reflects the significantly higher expected profits, and a higher rating on those profits, in the private bank.

Base-case valuations

Base case GGM has most upside, to £23.42, but this is still only 1.4x 2018E NAV

Given the multiples on which some banks trade (see peer group comparisons table), we do not believe that the implied price to book on our GGM is at all demanding, at 1.4x 2019E book.

GGM – 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 (x)	**1.7**	**1.9**	**1.4**	**1.8**
Discount re near term (%)	-15.0%	-15.0%	-15.0%	-15.0%
P/BV (x)	**1.4**	**1.6**	**1.2**	**1.5**
BV 2019E (£m)	247.7	247.7	247.7	247.7
Valuation (£m)	357.9	400.0	298.2	374.2
Valuation per share (£)	**23.42**	**26.18**	**19.52**	**24.49**
Variance (£)		2.76	-3.90	1.07

Source: Hardman & Co Research

SoTP model base case scenario

£m	Earnings	Multiple (x)	Value
Private bank (2019E)	14.7	18	265.47
18.6% holding in STB (10% discount)			60.14
PV of surplus capital return in 2019E			28.38
Centrals	-8.4	8	-67.40
Group total (£m)			286.59
£ per share			18.76

Source: Hardman & Co Research

The model is arguably a little generous, as the private bank benefits from group tax relief for the central division losses, but these are an ongoing feature of the business.

Our dividend discount model (DDM) takes our forecast for two years. We allow incremental profit growth of 25% and 15% in 2020 and 2021, respectively, before applying our long-term forecast growth of 5% for 20 years. We assume the dividend will be that proportion of annual returns (13.5%) not needed to fund growth (5%), with a payout of 63%. Overall, this generates a value of 1,313p per share, of which 13% is in the terminal value.

Peer group ratings

ABG is trading at around one-third the P/BV of wealth managers and around half that of bank peers

Bearing in mind that earnings forecasts do not reflect ABG's full deployment of surplus capital, we believe price to book comparators are more appropriate. As can be seen in the table below, ABG is trading at around a third of its wealth manger peers and half the level of most challenger banks.

Peer group comparisons	Share price (p)	Market cap (£m)	2019E P/E (x)	2019E yield (%)	P/BV (x)
Arbuthnot	1355	207.0	14.4	2.8	0.9
Secure Trust	19.4	358.5	7.7	5.3	1.4
Wealth Management					
Brewin Dolphin (Sept)	339	960.7	13.6	5.1	3.7
Brooks MacDonald (June)	1850	255.9	13.2	3	3.1
Charles Stanley (March)	340	172.5	9.6	4.3	1.9
St James Place	1064	5629.4	18.0	5.3	5.3
Rathbones	2432	1247.6	15.3	2.9	3.4
Average			13.9	4.12	3.5
SME Finance					
Orchard Funding (July)	101	21.6	13.4	3.3	1.6
1PM (May)	45.1	38.8	6.0	2.0	0.9
PCF (March)	32	67.9	11.3	1.3	1.8
Average			10.2	2.2	1.4
Challenger Banks					
Charter Court FS	296	707.8	6.3	3.6	2.1
Close Bros (July)	1412	2138.1	10.1	4.8	1.7
CYBG	289	2158.8	10.6	4.0	0.6
One Savings Bank	371	906.4	6.6	5.0	1.6
Virgin Money	262	1167.1	7.4	2.7	0.6
Average			8.2	4.0	1.3
Metro*	3518	3113.4	27.5	0	2.8

** Metro segregated so as not to distort averages*

Source: Hardman & Co Research; Priced as at 4 March 2018;

Notes

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