

16 December 2019

Market data

EPIC/TKR Private
Price (p) n/a

Description

B-North is being developed to serve the huge UK SME lending market. It has state-of-the-art technology, a regional hub model and experienced managers to deliver a best-in-class service to SMEs and commercial brokers. It will be funded through best-buy retail deposit comparison websites. The model should have a material cost advantage over competitors, and credit risk is being tightly managed.

Company information

CEO Jonathan Thompson
CFO David Broadbent
Chairman Ron Emerson CBE

investor@b-north.co.uk
b-north.co.uk

Key shareholders

Directors/management £1m+
Greater Manchester Six-figure
Combined Authority sum
HNWI Balance

Diary

4Q'19 £2m capital raise
1Q'20 £20m capital raise
1Q'20 Banking licence (tbc)
2Q'20 Start lending
4Q'20 Start retail deposit-taking

The seed round top-up capital raise is £2m (13.3m shares at a price of 15p). Investors can subscribe on the *Growthfunders* and *Crowdcube* platforms, which are expected to be live until the end of the year. Investors can invest directly (through contact with David Broadbent, Founder & CFO, Suite 20A, Manchester One, 53 Portland Street, Manchester, M1 3LD) if they are investing more than £50k.

Details of later issues will be disclosed in due course.

Analyst

Mark Thomas 020 7194 7622
mt@hardmanandco.com

B-NORTH

Unquoted SME lender with unique proposition

B-North is raising capital ahead of getting its banking licence (due spring 2020). It will then attack the huge, profitable and poorly-served SME lending market. B-North combines i) state-of-the-art technology (built from scratch to address customers' needs), ii) offering the £20bn+ p.a. commercial broker market an unparalleled service and an innovative remuneration model, and iii) experienced bankers based in empowered regional hubs. It should be more efficient than its peers, and will use technology to be close to customers. The financial model assumes a market share of just 2.5% in 2027. Delivery of this sees a highly profitable, and valuable, business, in our view.

- **Near-term capital raises:** B-North is currently raising up to £2m through private subscriptions through the *Growthfunders* and *Crowdcube* platforms. It anticipates raising a further £20m (through Berenberg), conditional on the approval of the banking licence due in March 2020. Further raises are planned.
- **"Reality-check":** We have reviewed the company assumptions and believe them to be ambitious but credible. We have considered the absolute performance and the level of lending that peers have achieved. Importantly, B-North has multiple options to address any volume shortfall – most at a modest cost.
- **Valuation:** Given the growth profile of the company and associated uncertainties, any valuation must be treated with extreme caution. We provide a range of approaches (p48-50) that, on average, indicate B-North's value in 2027 could be treble the amount of equity raised. We also provide a range of sensitivities.
- **Risks:** Credit risk is key for any bank. B-North will establish independent credit functions, and its technology will bring it close to customers interfacing directly with its management information. It has multiple options to address any loan growth shortfall. The economic cycle is important. The model is yet to be tested.
- **Investment summary:** B-North is still at the pre-revenue stage. Its model should be low-cost and deliver a superior service to customers and intermediaries. It has a conservative credit culture and uses state-of-the-art technology, written from scratch, to originate, service and manage its business. Funding will be via the deep best-buy retail deposit comparison sites. The potential market is huge, profitable and under-served, and major incumbents have selectively become uncompetitive.

Financial summary and valuation – eight-pod scenario

Year-end Sep (£m)	2019	2020E	2021E	2022E	2023E	2024E	2025E	2026E	2027E
Net interest income	0.0	0.5	3.9	14.5	37.4	72.7	116.2	160.7	203.6
Costs	-2.9	-7.0	-18.0	-28.3	-36.0	-41.3	-45.5	-47.8	-52.0
Impairments	0.0	0.0	-0.2	-1.0	-3.1	-7.4	-8.9	-10.1	-10.7
Pre-tax profit	-2.9	-6.5	-14.2	-14.3	-0.6	25.9	64.7	106.5	145.4
Net interest margin	n/m	1.4%	4.0%	4.3%	4.1%	4.2%	4.2%	4.3%	4.3%
Cost:income ratio	n/m	n/m	n/m	n/m	-93%	-55%	-38%	-29%	-25%
RoE	n/m	-14%	-15%	-12%	0%	11%	20%	23%	24%
Loans	0	15	100	470	1,100	1,925	2,850	3,700	4,550
Deposits	0	0	12	329	770	1,424	2,098	2,745	3,393
Equity	1	72	86	102	154	217	298	393	502
Value at 12x P/E *	n/m	n/m	n/m	n/m	n/m	252	629	962	1,303
Value v cum. equity issued	n/m	n/m	n/m	n/m	n/m	1.1	2.3	2.9	3.4

Source: Hardman & Co Research * Investors should consider the range of valuations detailed on p48-50

Table of contents

Executive summary	3
Investment positives	9
Market opportunity	9
B-North as the alternative	15
Fin-tech platform run by bankers	17
Strong corporate governance	19
Deposit funding	20
More efficient and operational gearing	21
Management's "skin in the game"	22
Reality check: base-case assumptions credible	23
Investment neutrals.....	27
Why not a Metro/Amigo/Funding Circle	27
New business in established market	27
Loans volume opportunity in downturn.....	28
Liquidity.....	28
Interest rate sensitivity	28
Credit risk	30
Summary	30
Some basic principles	31
Below-average risk factors.....	32
Factors with uncertain effects	33
Above-average risk factors.....	35
Other risks	37
Addressing any loan origination shortfall	37
Other risks	38
Capital	39
Financials	42
Profit and Loss.....	42
Scenario testing	44
Valuation.....	47
Company matters.....	51
Appendix.....	53
Bank authorisation process.....	53
Disclaimer	55

Executive summary

B-North will disrupt huge and profitable UK SME lending market by i) using its FinTech-enabled lending platform to deliver significantly better service than large incumbents, ii) delivering unique economic proposition that supports large, fast-growing and fragmented broker channel, and iii) having experienced bankers in empowered, regional hubs

We have tested base-case scenarios and found them credible

Key driver: volume growth with a target 2.5% share by 2027

Huge market to target

Major players partially withdrawn

Some other competition, but on the margins

B-North is raising capital ahead of obtaining its banking licence (due spring 2020). It will then attack the huge, profitable and poorly-served SME market. B-North's proposition combines:

- ▶ State-of-the-art technology, built from scratch to directly address customer needs. The opportunity to tailor IT to its customers, intermediaries and own needs is unique to a new business with no legacy issues or risk aversion around the model of "don't change because it works". Such technology can interface with customers in ways that were simply unimaginable even a few years ago. This not only delivers good service but also enhances credit management tools.
- ▶ Offering the £20bn+ p.a. commercial broker market an unparalleled service and an innovative remuneration model. B-North estimates that this channel will deliver 70% of new business; it is currently underserved by major incumbents.
- ▶ Experienced bankers based in empowered regional hubs, who bring not only knowledge of the market but also extensive connections. The expectation is that these relationship managers will be in situ for many years – addressing another customer complaint that managers at existing providers turn over too frequently.

The model should be materially more efficient than that of its peers, driving a much better cost:income ratio. This competitive advantage can be used for superior returns or fed back into investment for superior growth. We have "reality-checked" the company's assumptions and found them to be credible. The target market share is just 2.5% in 2027, and delivery on this would see a highly-profitable business.

B-North is targeting a huge market, with SME loans of ca.£150bn, overdrafts of ca.£10bn, and asset finance of £15bn-£20bn. It also has a proposition for the professional buy-to-let market, which generates around £3bn in new lending every month. We believe this is a profitable segment of the market to attack, given the structural imbalances between the users and providers of SME finance.

Additionally, in B-North's chosen niches, the partial withdrawal by mainstream banks has further improved pricing. We believe this withdrawal is driven by i) automation driving major banks into mainstream lending, ii) historical losses driving higher capital requirements, and iii) portfolio management requirements. The opportunity for smaller players to pick up share from the majors is huge. Furthermore, government policy is to encourage diversity in funding with a number of initiatives through the British Business Bank (BBB), a drive that has been reinforced by the Royal Bank of Scotland's Alternative Remedies Package.

There is some competition from other challenger banks, debt investment companies and Peer to Peer (P2P) lenders. However, we believe it is only relevant to part of B-North's business and, given the scale of the market, there should be more than enough business to go around.

B-North

B-North's approach different. IT built from scratch to directly meet customer needs.

This, and experienced staff in empowered regional pods, forms the basis for superior service and low cost.

B-North's approach is different. It has identified a range of shortcomings in the service provided by existing players, and has built a model to address these. With no legacy systems or procedures to worry about, B-North has engineered solutions that directly address customer needs. With this, a regional pod infrastructure and state-of-the-art technology, it will offer a much faster service, clarity in decision-making and have much closer, long-term, relationships between the customer and the lending manager. Its systems will also integrate with both borrowers (accessing their management information – so allowing much more timely discussion on potential problems) and critically, and nearly uniquely, commercial finance brokers. The latter are expected to account for ca.70% of new business. We outline below how B-North can make these brokers' lives easier, improve their relationships with their customers and give them more opportunities to generate sustainable income. All these aspects give B-North clear competitive advantages over incumbent majors and other competitors.

IT will also interface with customers' management information and improve efficiency

B-North's IT is outsourced to market leaders, providing state-of-the-art analytical tools and interfaces with market information and customer management accounts. Being built from a blank canvas means it can match customer needs, not the bank's legacy operational procedures. This accelerates basic administration, provides better service to originators, especially brokers, and up-to-date credit assessment and monitoring, reducing both probability of default and loss in the event of default.

Strong corporate governance by board and regulator

B-North has strong corporate governance, with an experienced, proactive and independent board, which has proven experience in running established businesses and building new banks. It is also regulated with an independent examination of every aspect of B-North's business model, procedures, personnel and culture – all challenged in detail for their robustness.

Retail deposits (from 4Q'20) are flexible, cheap, sticky and diverse

Retail deposits are likely to be taken from 4Q'20 (initial lending will be funded by equity and warehouse lines). The sums that B-North is looking to raise from best-buy table comparison websites are tiny by comparison with the market, and many other banks have raised significantly larger sums very quickly. Such funding is highly flexible, has low administration costs, has a very deep market, is usually less mobile than wholesale funding, and provides significant diversification.

Low-cost model generating strategic flexibility and superior returns

B-North has material cost advantages over major incumbents. These include i) significant automation of administrative functions, ii) low-cost office space, iii) no infrastructure required to service high-cost money transmission, iv) state-of-the-art technology, with more efficient interfaces with both customers and intermediaries, and v) appropriate outsourcing. The business model also has significant operational gearing, with the majority of costs fixed. As B-North grows, this should see significant improvements in profitability.

Managers' interests aligned with shareholders

The managers' interests are aligned with shareholders through a £1m investment upfront and founder shares that only vest on achieving specific value-enhancing targets. There will only be one class of shares with shareholders having control.

Reality check of assumptions shows they are credible in likely economic outturn

We have done a "reality check" of B-North's financial targets. Our conclusion is that the targets are stretching but credible in a most likely macroeconomic outturn. We explore a range of sensitivities in the financial section below. Some of the key considerations are:

Loan target 2.5% market share in 2027

- Our analysis concludes that the target loan growth is below the average achieved by a portfolio of comparable banks at the same stage of development. It is more conservative than the growth that OakNorth, its closest direct peer, delivered. It represents a ca.2.5% market share in 2027, and is also credible in absolute terms – we believe lending represents one to two deals per relationship manager per month once the business is mature.

B-North

Tested on real deals

- ▶ B-North has tested its proposition with actual broker-completed deals to validate the various assumptions. The conclusion was that the B-North offer was likely to be the best in 18 of the 40 cases, and it was competitive in a further 15.

Yields in line with current market pricing

- ▶ Gross lending yields of ca.6.5%-7% (weighted for business line mix) are in line with our understanding of comparable market pricing and levels reported by peers. With a drag from a liquidity portfolio (reasonably assumed at 13% of assets), the target yield appears sensible.

Target cost:income ratio under 30%

- ▶ The target cost:income ratio of 30%, or under, at maturity is around half that of the major banks (which have business models that include high-cost money transmission). It compares with 35% at OakNorth, which has yet to reach maturity, when a lower ratio may be expected. We outlined above the cost advantages B-North has that make this target credible.

Funding costs in line with current pricing and other banks' experience

- ▶ Looking at current best-buy tables, as well as the likely duration of funding and swap costs, we believe a weighted average cost of retail deposits of ca.2% is credible. Interbank lines, secured by assets, for a bank such as B-North are currently around the same level, but we see the potential for this to fall. We note that the cost of Tier 2 debt is in line with Arbuthnot Banking Group's recent raise. Overall, a steady run- rate target net interest margin (NIM) of ca.4.2% appears credible.
- ▶ We believe the impairment rate will be very heavily dependent on business mix, but, on the likely mix, a through-the-cycle loss of ca 30bps p.a. appears reasonable. This will vary by product, but equates to a lifetime loss of ca60bps.

In the section in this report entitled *Investment neutrals*, we detail i) how B-North differs from recent financial IPO disappointments and Metro Bank, ii) that, while it is a new business, it is using experienced people in a very well-established market, iii) the opportunities, as well as threats, from an economic downturn, iv) how liquidity and interest rate risks are managed, and v) the fact that employees have been identified but have yet to join.

Credit hugely important, and we believe approach is conservative

Credit risk is hugely important, and we have devoted an extensive section to this. In our notes on other clients (RM Secured, Real Estate Credit Investments, 1pm) and, in some detail, in our sector review, [*Debt Investment Companies: Diving deep finds you the treasure*](#), published on 25 February 2019, we have emphasised the importance of the basic principles that we believe apply to all good lending. How these canons of lending will be adopted by B-North is detailed below. We have also previously highlighted how important management culture is to all aspects of credit risk – the lending decision, monitoring, collections and accounting. A conservative culture, which we believe B-North has, is likely to show through in all areas of credit risk.

Below-average risk, given i) conservative culture, ii) experienced team, iii) security, iv) state-of-art analytics and live interface with customer management information

- ▶ The key features suggesting that B-North has below-average risk include: i) culture: our dealings with management indicate a high awareness of risk and a conservative approach to its management, which may be expected to flow through to how it accounts for impairments, as well as lending decisions; ii) an experienced team: B-North has an experienced board, and lenders and risk controllers with relevant market knowledge doing what they have done for many years; iii) security: most lending will be backed by real estate security (target LTV 60%-70%) – it is looking to get BBB guarantees on where there is not such good-quality security; and iv) state-of-the-art technology: B-North's technology will access social media and interface with customers' own live financial reporting systems to bring B-North as close as possible to the companies – importantly, this and its state-of-the-art analytics technology are viewed as tools for risk management and are not the driver to a credit decision.

B-North

Uncertain features: unknown effect of IFRS9, systems untested, forbearance

- ▶ The cyclicity of IFRS9 is an uncertain feature. Additionally, while B-North is adopting a sensible collections process, balancing between internal early-stage relationship management involvement and outsourced late-stage enforcement, this process is untested at present. There is also an increased regulatory market-wide focus on forbearance/treating customers fairly, but business-to-business lending should be lower-risk than retail.

Above-average risk: de-centralising decision-making (but B-North has put processes in place to mitigate this)

- ▶ Another above-average risk for investors, either real or sentiment-related, could come from B-North decentralising credit decisions, valuations and legal services. This should enhance customer service, but carries the risk that there could be less independence in vital risk-control functions. B-North has addressed this risk with structured staff incentives, underwriters and valuers in pods reporting to the Chief Risk Officer, external valuations where situations are complex, professional accreditation of staff, and detailed central audits, especially in the early stages.

Other risk issues include physical distance from customer, adverse selection, late-in-cycle lending and some higher-risk products

- ▶ Other factors that could increase the perception that the risk profile is above-average include i) regional pods not always being physically close to the customer, ii) the risk that the applications will be weighted towards those unable to obtain finance from their banks, iii) late-cycle lending being higher-risk, and iv) development finance having been a high loss area historically (although this is expected to be a small proportion of the book).

Multiple options to address any loan growth shortfall and systems in place to identify cause of any miss at early stage

We noted above the positive gearing B-North is expected to see with volume growth generating income from a platform with significant fixed costs. The flipside to this is that if, for any reason, volume growth disappoints, then there will be negative leverage. Management has a range of alternative strategies to address such a scenario, driven by the root cause of any underperformance. Options include more staff, more pods, greater broker incentivisation, more marketing and potentially reviewing credit criteria (in light of the experience on loans that have been lost but the performance of which will be tracked). Each pod's Key Performance Indicator (KPI) review should identify whether there is a pod-specific issue. We noted earlier the competitive environment and why B-North has significant cost and service advantages over the major incumbents and challenger banks. These provide B-North with the space to take whichever option is likely to address the shortfall at the least cost. We therefore believe that the financial impact is more about the option cost than the risk of a major shortfall in volumes.

Sentiment adverse and credit risk will rise in downturn

Other risks include the credit and sentiment impact of a macroeconomic downturn (with potential offsets from volume and pricing opportunities, and noting that B-North has no back book), the political environment and cyber-risk. In the section on capital in this report, we detail the expected capital raises to fund the business before it becomes fully self-funding (our model assumes £2m in 2019, £20m and then a further £53m in 2020, and a further £300m in the years 2022-25).

Our base case is close to B-North's. We recommend investors focus on scenarios including i) four-pod rather than eight-pod rollout, ii) option cost to address loan shortfall, iii) delayed pod rollout, iv) higher impairments, v) lower yields

In the financials section, we detail our assumptions, and the resulting profit and loss and balance sheet based on an eight-pod rollout by 2027. Given that our review found the management's base case to be stretching but credible, it should not come as a surprise that our base case is broadly similar to theirs. It takes approximately 18 months for a pod to break even and we understand that the full rollout in our forecast will be contingent on the delivery of, and lessons learnt from, the initial first four pods. Our model of new pods through to 2022 depresses short-term profit with investments and delays breakeven to 2024, but it sees 2027 post-tax profits of £108.6m. We recognise that there is considerable uncertainty, and so provide investors with a range of scenarios to consider in more detail. These include:

- ▶ Our base case assumes that there will be eight pods rolled out by 2027. This is at the lower end of range that management indicates would achieve national coverage. We are encouraged that B-North has phased the rollout to ensure that the lessons from the earlier pods can be fully adopted in new ones. There are some

scenarios where we could see the rollout could be delayed or cancelled (inter alia a macro economic downturn, unexpected competition, changes in intermediaries' behaviour, unexpected impairments). These do not form part of our base-case expectations, but we provide investors with a scenario which only includes those pods that are currently in an advanced state of development (i.e. a four-pod model). This requires materially less equity support and sees profitability a year earlier in 2023.

- ▶ Detailed consideration of the action management action could take to mitigate slower-than-expected loan growth. Our conclusion here is that the mitigation costs would be significantly below the cost of doing nothing.
- ▶ Other scenarios include a delay to the rollout plan, higher impairments and lower yields. Each downside, again, has credible mitigation to reduce the loss.

Given the uncertainties, investors should consider multiple valuation approaches and not rely on a single number. On our base case earnings and applying only average multiples, the 2027 valuations imply a value ca.3x the total capital raised. Early investors may expect to see higher returns commensurate with their greater risk.

We provide investors with a range of valuation methodologies, noting again that a number of scenarios should be considered – not just one. The closest quoted peers are currently trading on an average historical P/E of ca.11.2x and 1.7x price/book value (P/BV). Unquoted peers are trading at much higher multiples of prospective returns (some remain significantly loss-making). Applying a multiple of 12 to our 2027 forecasts indicates a valuation of £1.3bn, more than 3.4x the equity raised (£378m). A Gordon Growth Model (GGM), on our assumptions, would suggest a P/BV of 2.2x or a 2027 valuation of £1.1bn (2.9x cumulative equity issued). In our dividend discount valuation model (DDM), we assume a modest initial payout ratio in 2027 (30%), before rising to 66% for most of the 20-year model. With growth fading down to 5% p.a. by 2031, and discounting the implied dividends at an 11% cost of capital and with a 12x terminal value implies a valuation of £973m (2.6x cumulative equity issued). We would expect the initial equity investors, who have taken more risk, to be rewarded by higher returns than average.

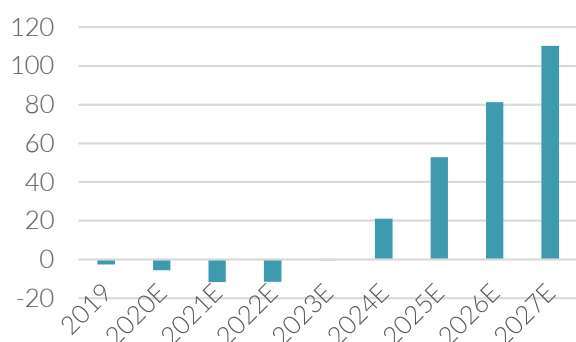
Using our P/E multiple approach, where the 2027 value is £1,303m, the impact of a range of other scenarios is i) if investors value the expected growth at 15x, the value is £1.6m, iii) on a four-pod model, the value is £580m, 3.1x the equity raised for that scenario, and iv) management action to offset delayed loan growth could reasonably see £120m+ downside.

In terms of scenario analysis, there is not only a wide variance between valuation methodologies, but other assumptions can be hugely important. These include:

- ▶ Time: With a business whose profits are growing rapidly, applying an earnings multiple sees a rapid growth in valuation. Applying a multiple of 12 to our 2025 forecasts indicates a valuation of £629m, £962m in 2026 and £1,303m in 2027.
- ▶ Multiple: It may be argued that a business where investors are confident of growth would attract a higher earnings rating. Applying a multiple of 15 to our 2027 earnings sees the value rise from £1,303m to £1,628m.
- ▶ Number of pods: If we use our four-pod model, rather than the eight-pod model, applying a multiple of 10 to 2027 earnings (lower growth seeing a lower multiple than the base case) sees a valuation of £580m, instead of £1,303m. This still represents 3.1x the equity issued (which is materially lower given less loan growth).
- ▶ On the downside, a delay of one year in lending at 12x earnings would see a valuation of ca.£1bn in 2027. If, as we believe and detail in the financial sections above, management would take action to mitigate slower loan growth, the cost of this action was £10m post-tax per year, this would knock £120m off the valuation, less than a third of the value lost from slower growth. It would still leave the 2027 value in excess of 3x the equity raised.

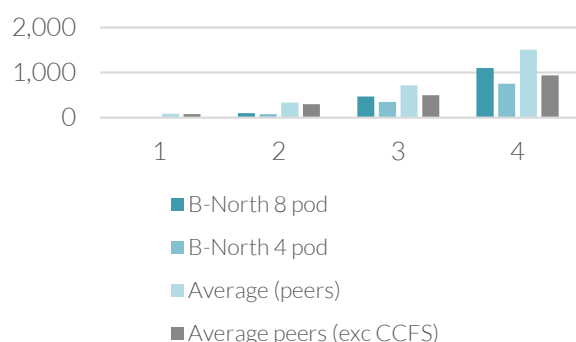
B-North

Post-tax profit profile (£m) in the base-case, eight-pod model



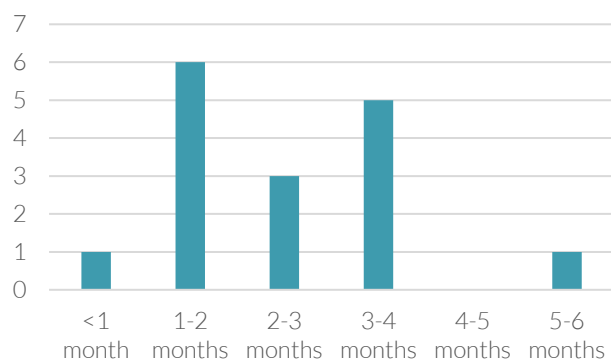
- ▶ We expect B-North to show losses in the years 2020-23, with investment in infrastructure and staffing, and relatively low initial loan balances.
- ▶ We expect breakeven in 2024.
- ▶ We forecast rapid growth thereafter, reflecting operational gearing and a growing book.
- ▶ Our model is based on an expected macroeconomic outturn, which assumes gentle credit deterioration in the initial years and an improvement in later years.

Targeted loan growth (£m) compared with peers



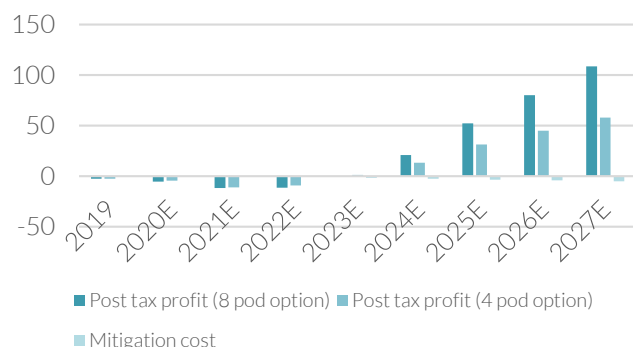
- ▶ To test the reasonableness of B-North's assumptions, we compared the targeted loan growth with the actual growth seen at peers. B-North's growth is below that of its peers.
- ▶ B-North has major competitive advantages in borrower and intermediary services – taking share from huge incumbents.
- ▶ Market share target is ca.2.5% in 2027.
- ▶ Note: competitors include OakNorth, Secure Trust Bank (Real Estate only), Arbuthnot Banking Group (Commercial Banking only), Paragon (Development Finance only) and Charter Court Financial Services.

Time taken for customers to get cash after loan approved (sourced from B-North's loan validation survey)



- ▶ B-North has dummy-run its loan offering through brokers. The conclusion was that, out of 40 cases, 18 were likely wins and 15 were where B-North's offer would be competitive.
- ▶ Part of that review looked at speed to delivery. B-North is aiming for two to three weeks to complete the process. Over half the deals in the survey (which reflected the best option for the borrower at the time) took over two months.
- ▶ The borrower service proposition also includes regional hubs, and relationship managers who are experienced and who will be *in situ* for many years.

Scenario tests: post-tax profit (£m) in base-case (four pods) and eight-pod models, and mitigation cost if loan growth slows



- ▶ Our eight-pod model increases short-term losses, defers breakeven by one year to 2024, but materially increases longer-term profits.
- ▶ There are a range of options to offset disappointing loan growth. The scenarios in the chart show the cost of a 20bp increase in commissions applying to the whole book.
- ▶ A macroeconomic downturn presents risks (lower market demand, higher impairments) but also opportunities (improved pricing, market share gains).

Source: Company data, Hardman & Co Research

Investment positives

Market opportunity

Summary

Huge market to target

B-North is targeting a huge market, with SME loans of ca.£150bn, overdrafts of ca.£10bn and asset finance of £15bn-£20bn. It also has a proposition for the professional buy-to-let market, which generates around £3bn in new lending every month. We believe this is a profitable segment of the market to attack, given the structural imbalances between the users and providers of SME finance.

Major players partially withdrawn

Additionally, in B-North's chosen niches, the partial withdrawal by mainstream banks has further improved pricing. We believe this withdrawal is driven by i) automation driving major banks into mainstream lending, ii) historical losses driving higher capital requirements, and iii) portfolio management requirements. The opportunity for smaller players to pick up share from the majors is huge. Furthermore, government policy is to encourage diversity in funding with a number of initiatives through the British Business Bank (BBB), a drive that has been reinforced by the Royal Bank of Scotland's Alternative Remedies Package.

Some other competition, but on the margins

There is some competition from other challenger banks, debt investment companies and P2P lenders. However, we believe this is only relevant to part of B-North's business and, given the scale of the market, there should be more than enough business to go around.

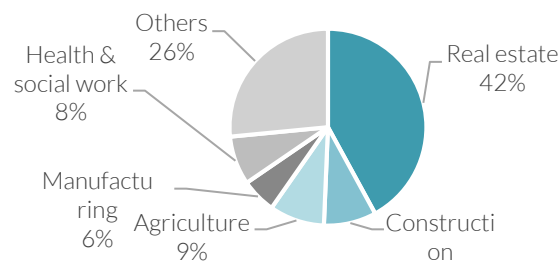
Huge market

New annual lending ca.£23bn to SMEs.
Stock of total SME finance ca.£180bn (including overdrafts and asset finance).
Our 2027 forecast represents market share of just 2.5%.

Small crumbs dropping from the majors' tables are transformational for smaller players. Specifically, in terms of SMEs, the outstanding loan market is ca.£150bn. Within this huge sum, the largest sectors are given in the chart below and are areas where B-North can add value. Additional finance is provided by way of overdrafts (ca.£10bn) and asset finance (Finance and Leasing Association indicates ca.£25bn of commercial asset finance)¹. UK Finance, the industry body for lenders, produces regular statistics on the SME market. The data for FY'18² indicate £23bn of new lending in England to ca.235k SMEs. Also, the BBB estimates that there is £48bn of unmet loan demand each year. Our 2027 forecast loan book for B-North (£2.5bn) is likely to represent a market share of just 2.5%.

Buy-to-let further £3bn origination per month

Monetary financial institutions' loans to UK SMEs by industry (£m)



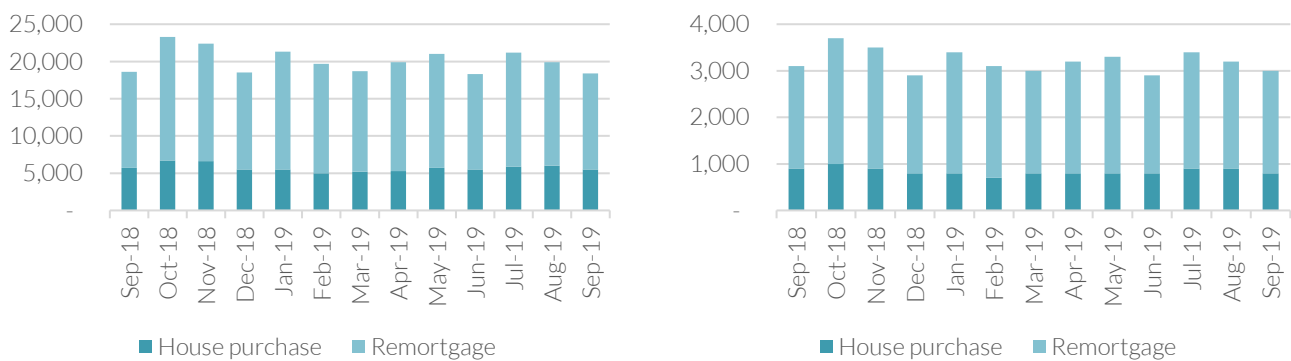
Source: Bank of England, BankStats Table 8.1.1, Hardman & Co Research

¹ <https://www.flc.org.uk/business-information/documents/asset-finance-summary/>

² <https://www.ukfinance.org.uk/system/files/SME-Update-Q4-Press-copy-final.pdf>

Additionally, B-North is targeting the professional buy-to-let market. UK Finance statistics indicate that buy-to-let gross lending was around £3bn per month over the past year. The market trend has been for an increasing professional investor, often using corporate structures and cross-collateralisation, which may not fit mainstream bank lending criteria, but which do fit B-North's pod approach.

UK buy-to-let market – number of new loans per month (LHS) and value of new lending (£m, RHS)



Source: UK Finance, Hardman & Co Research

Broker distribution huge and growing

We understand that the NACFB (National Association of Commercial Finance Brokers) advises that its members originate ca.£20bn of debt every year, predominantly on five-year terms. B-North anticipates that 70% of its originations will come from this source, which we believe represents a market share of 4%-5% of flow. Given the competitive advantages in servicing and incentives, this appears credible.

Market is profitable because of pricing power of major providers compared with borrowers, high historical losses driving high capital requirement and the partial withdrawal of major incumbents, which, in turn, has driven up pricing

Profitable market

In addition to being a huge market, we believe the provision of SME finance should be profitable. This is a structural issue, which we believe is explained by:

- ▶ Relative pricing power: historically, the market has reflected oligopolistic, rather than competitive, pricing. This not only reflects the relative size of the banks compared with SMEs, but also the historical inertia, which meant SMEs would go primarily to their own bank for finance.
- ▶ With high historical loss levels and regulatory conservatism, the capital requirements to support many business lines have increased sharply. These product-specific increases mean that pricing in certain areas has increased further and that bank appetite to lend has reduced.
- ▶ As major banks have focused on mainstream customers, and so partially withdrawn from other parts of the market, the pricing in those areas has improved.

Major incumbents have focused on mainstream

In addition to improved pricing, the major banks' partial withdrawal from selected parts of the SME market creates volume opportunities. We believe this will continue, as it is driven by several reasons, none of which we expect to change materially for the foreseeable future. These include:

- ▶ Banks have higher credit requirements on elements of corporate lending (especially real estate development) and so have to work harder to earn the same return on equity.

Major banks focusing on mainstream lending

B-North

Major bank models do not serve many SMEs well, as i) automation cannot capture borrower-specific stories, ii) front-line staff are divorced from ownership of loans, and iii) portfolio managers' constraints may overlay specific deal opportunities

- ▶ Mainstream bank business models are sub-optimal for this market:
 - SME lending in major banks has become significantly automated, but many SMEs have a story that is not captured well by statistical/historical modelling. This also applies to certain segments of the personal market (e.g. self-employed) and drives major bank lending towards mainstream customers only.
 - Front-line bankers have become divorced from the ownership of the loans they originate. Many bankers are not responsible for the collection of loans. It is common practice for the legal side of the business to be conducted by specialist departments or outsourced, with little direct involvement of the banker who originated the loan. Relationship managers in major banks have a propensity to churn relatively quickly, and so may not be *in situ* when a loan needs restructuring/collecting. All of these factors mean the banker does not take the pain when a loan goes wrong.
 - Perfectly good propositions may be declined for portfolio concentration reasons. If Bank A is "full" on its property sector exposure nationally, it has to decline new propositions – whatever its merits.
 - Additionally, post the financial crisis, bank funding constraints meant that perfectly good propositions had to be declined. A certainty of getting finance when required is an important consideration for borrowers.
- ▶ Unsurprisingly, the credit track record of many lenders through the cycle has been poor (this ultimately is the reason for higher capital requirements). Memories of such losses mean that there can be an over-restriction in lending appetite when conditions worsen.

Major incumbents dwarf all new competitors combined

To put the opportunity into perspective, the table below shows the competitive environment and how it continues to be dominated by six big players. Small crumbs dropping from their tables can make a huge difference to smaller players.

Competitive environment for UK banks and similar peers			
Segment	Total assets	Description	Examples
Big 6	ca.£1,800bn	The six largest deposit-taking institutions	LBG, Barclays, RBS, HSBC, Nationwide, Santander
Micro	<£5bn	Deposit-taking institutions with assets of <£1bn	Cambridge & Counties Bank, Hampshire Trust Bank, Masthaven Bank, OakNorth Bank, Redwood Bank, United Trust Bank
Specialist	ca.£50bn	Deposit-taking institutions focusing on specialist lending products, rather than the provision of current account services	Aldermore Bank, OneSavings Bank, Vanquis Bank, Close Brothers Group, Paragon Bank, Secure Trust Bank, Shawbrook Bank
Other Building Societies	ca.£35bn	Smaller building societies with assets of <£10bn	West Bromwich, Nottingham, Newcastle, Cumberland
Mid-Tier	ca.£360bn	14 banks and building societies with assets of >£10bn in the main (13 following the acquisition of Virgin Money by CYBG)	AIB Group (UK), Bank of Ireland (UK), The Co-operative Bank, CYBG, Coventry Building Society, Handelsbanken, Leeds Building Society, Metro Bank, Principality Building Society, Sainsbury's Bank, Skipton Building Society, Tesco Bank, TSB Bank, Virgin Money, Yorkshire Building Society
FinTech	<£1bn	New wave of technology-led banks	Atom Bank, Fidor Bank, Monzo, Starling Bank, Tandem Bank

Source: UK Finance "MID-TIER BANKING: CREATING A LEVEL PLAYING FIELD FOR COMPETITION", April 2019, Handelsbanken added by Hardman & Co Research

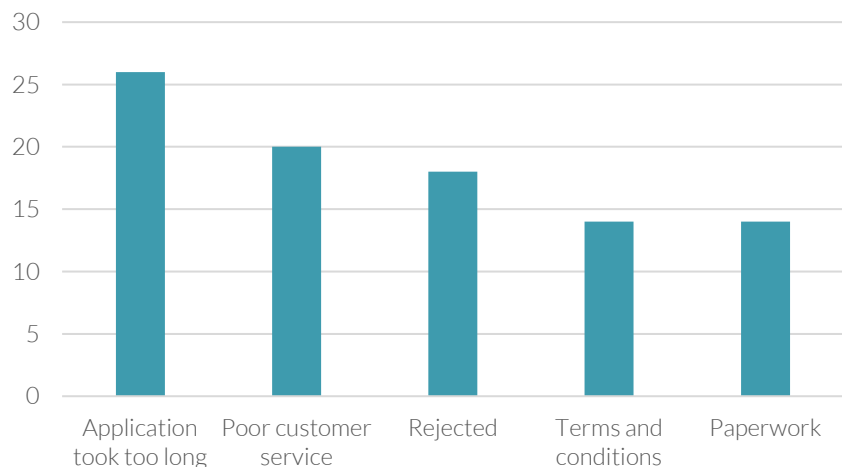
BBB established to encourage competition and diversification in funding

Government policy: encourage diversification

Government policy is to encourage competition/diversity in SME financing. Part of this has been conducted through the BBB (<https://www.british-business-bank.co.uk/>). Slides 26-50 in the slide-deck accompanying its 2018/2019 *Annual Small Business Finance Markets* highlight a number of interesting trends for the market that B-North is targeting, including i) 35% of SMEs now seek commercial mortgages from a non-bank source (slide 29), ii) just 33% (2017 36%) went directly to their main bank to speak with first, when finance need was identified (slide 33), iii) 42% (2012 29%) actually contacted more than one provider (slide 36) and only 46% sought their finance from one of the five main banks (slide 39), and iv) looking forward, 47% of SMEs are likely to seek advice and say they are likely to pay for independent advice to help them obtain this finance (slide 50). B-North's unique positioning in the broker market is partially to address the growing demand for advice.

It is interesting that, for the big five banks in 2018, the experience of raising finance was 15% better than expected and 21% worse than expected, while, for those seeking finance from other providers, the proportion was 24% better and 13% worse. In particular, drivers to an adverse experience in the big banks were i) applications taking too long (31%), ii) poor customer service (20%), and iii) strict terms and conditions (20%). The overall market experiences, covering all providers, are shown in the chart below.

Why experience of raising finance was worse than expected in 2018 (%)



Source: Slides 46 in the slide-deck accompanying BBB's 2018/2019 Annual Small Business Finance Markets, Hardman & Co Research

When RBS could not sell Williams and Glynn, it had to offer over £0.7bn to encourage SME account mobility

RBS state aid: Alternative Remedies Package

When RBS failed to sell Williams and Glynn, under EU rules, it had to fund schemes that would encourage SMEs to migrate to other providers. The Alternative Remedies Package was implemented by Banking Competition Remedies Limited (BCR <https://bcr-ltd.com/>) and has two measures.

- ▶ The Incentivised Switching Scheme is allocating up to £275m to assist SME customers within the Williams & Glynn business to move to challenger banks. A further maximum sum of £75m has been set aside within RBS to cover customers' switching costs.
- ▶ The Capability and Innovation Fund of £425m is being allocated to encourage eligible bodies to develop and improve their capability to compete in the provision of banking services to SMEs, and also to develop and improve the financial products and services that are available to SMEs. The winners are i) Pool A

(announced February 2019) – Metro £120m, Starling £100m and ClearBank – in partnership with business bank Tide – £60m, ii) Pool B (May 2019) – Nationwide £50m, Co-operative and Investec £15m each, iii) Pool C (August 2019) – Atom, Currency Cloud, iwoca and modulr Finance £10m each, and iv) pool D (June 2019) – Codat, Fluidly Limited, Form3, Funding Options and Swoop Finance £5m each.

While B-North is not a direct beneficiary, anything that makes SMEs more mobile is likely to be a positive

The relevance to B-North is that there is a major and well-funded package designed to increase SME mobility in the market. We believe that, once SMEs become more mobile, they are more likely to consider alternative finance providers such as B-North. Of the recipients of only the funds above, we do not consider that any represent direct competition. The pool A recipients are targeting whole banking relationships with SMEs, rather than being focused loan providers or having a different channel to market (e.g. Starling). For others, such as iwoca, they are focused on a different part of the market, (loans up to £200k).

Challenger banks fall into three groups – classic, contemporary (largely online) and Nouveau. We believe only first group represents major competitive challenge.

Other competition: challenger banks

The BBB Small Business Finance Report 2019, p64-67³, detailed a review of challenger banks. It uses a KPMG classification identifying the competition in three groups: i) classic challengers, which have elements of traditional banking, e.g. physical branches, accepting deposits and offering loans – however, they are flexible enough to exploit new technology and have business models for innovative, customer-focused services; ii) contemporary challengers, who operate largely or solely online or via a mobile application (“app”) and partner with, or consider themselves to be, financial technology (FinTech) companies; and iii) Nouveau challengers, who tailor their services to customers in underserved markets, around cutting-edge technologies or with services outside the boundaries of traditional banking. We believe that only the first group is B-North’s primary competitor and, even then, not in all product areas and not in broker distribution. As we identified above, the fallout from the major banks is of such a size that there are significant opportunities for all these players.

B-North has competitive advantage in unique broker relationships and state-of-the-art technology. It may also, in initial phase, have targeted incentives for introducers.

While B-North’s competitive advantages compared with such challenger banks may be fewer than those relative to major banks, some of the reasons why customers would choose B-North over these players include:

- ▶ Unique broker relationships with state-of-the-art technology to make customers’ lives easier and with good-performer annual incentives. We understand that there may also be targeted, and carefully-costed, specific incentives programmes during the start-up phase. This brings a cost for new business origination, but it helps achieve the initial scale economies. In our discussions with management, the financial pay-back has been clearly identified.
- ▶ Several are also more focused on retail distribution channels, rather than the commercial mortgage broker market.
- ▶ Brand-new technology with no legacy systems. B-North designed in detail an end-to-end lending journey and customer experience before any solution choices or technical work started. It has not merely installed solutions “out of the box”, but it has tailored nCino and Salesforce processes and workflow, to include all roles in commercial lending. B-North highlights that even systems just a few years-old may not interface with the cloud and customer systems as well as current ones.
- ▶ Some of the target markets addressed by challenger banks do not overlap with B-North. We understand, for example, that OakNorth is currently more focused on larger transactions with an average ticket size of ca.£10m.

³

https://www.british-business-bank.co.uk/wp-content/uploads/2019/02/British_Business_Bank_Small-Business-Finance-Report-2019_v3.pdf

Debt investment companies are likely to compete at the higher-risk end of B-North's product range. Many are more focused on higher-value loans, and competition risk is thus modest.

Other competition: debt investment companies

Our sector review, *Debt Investment Companies: Diving deep finds you the treasure*, published on 25 February 2019, looked at the a range of debt investment companies. We divided the group into companies with similar characteristics, and those closest to B-North are identified on pages 27-30 of that report. Detailed reports on our clients, RM Secured Direct Lending and Real Estate Credit Limited, can also be found on our website (<https://www.hardmanandco.com/research/>). In terms of competition with B-North:

- ▶ The investment companies are often targeting higher-yielding assets (RMDL average 8.88%, RECI 7.2%). These may compete with certain B-North products (e.g. development loans), but not across all product lines.
- ▶ The investment companies typically target larger loans (ca.70% of RMDL's portfolio is in loans over £5m, with an average position of £6m).
- ▶ Typically, lending is from one centralised office only, and there is often a greater sector speciality (e.g. RMDL has a niche with "sponsor-backed" deals, i.e. private equity).
- ▶ The management fee for investment companies is typically lower than the cost: income ratio targeted by B-North. They do not incur the costs of a banking licence, but also do not benefit from low-cost deposit funding and the associated gearing that this can provide.

Accordingly, we believe the investment companies represent competition only on the margin.

P2P appears to be peaking. After above-expected losses for a number of players, there has been a tightening of credit standards.

Other competition: Peer to Peer (P2P)

The BBB reports that the outstanding marketplace lending to business (i.e. P2P) was down 2% at end-1H'19 vs. 1H'18, with tighter lending criteria among some of the larger players. In 2018, the total flow of P2P business lending was estimated at £2.3bn⁴. Again, many of the participants are targeting a different market (e.g. *LandBay* offers a 3.09% two-year buy-to-let mortgage), while *ThinCats* (<https://www.thincats.com/businesses/business-loans>) offers loans from £1m to £15m – its expected interest rate was 10%-12%, with default rates in the mid-20% and loss rates of 9%-10% (on 2015-16 cohorts and ca.2x the expected loss rate at origination)⁵ – a very different business from B-North. We also note, on the statistics page, that, up to May 2019, on its retail investor P2P platform, ThinCats had made just one loan of £271k in the year, compared with £41m originated in 2018 and has now closed this model to new business (it also originated ca £200m of loans through its institutionally funded business which is closer to B-North's target loan market). On 5 December, Landbay (the buy-to-let lender) announced that it had exited the retail P2P market, with existing investors receiving their money back.

⁴ Figure 1: https://www.british-business-bank.co.uk/wp-content/uploads/2019/02/British_Business_Bank_Small-Business-Finance-Report-2019_v3.pdf

⁵ <https://www.thincats.com/investors/statistics> accessed 29 November 2019

B-North as the alternative

Summary

B-North's approach is different. IT built from scratch to directly meet customer needs. This, and experienced staff in empowered regional pods, forms the basis for superior service and low costs.

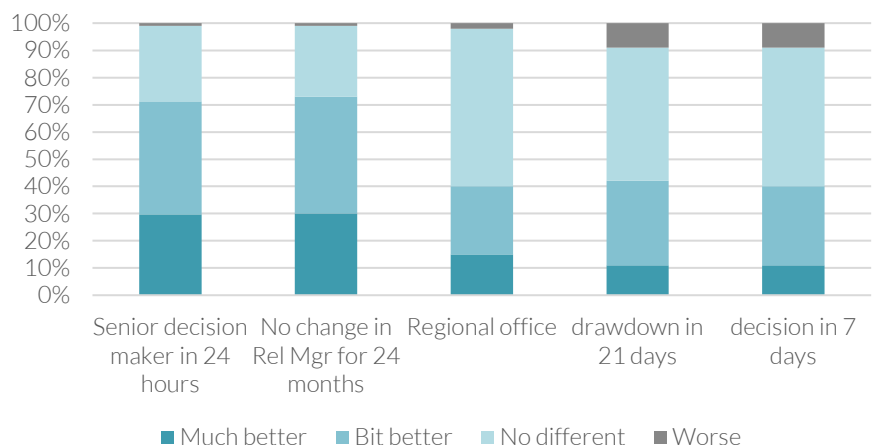
B-North's approach is different. It has identified a range of shortcomings in the service provided by existing players, and has built a model to address them. With no legacy systems or procedures to worry about, B-North has engineered solutions that directly address customer needs. With this, a regional pod infrastructure and state-of-the-art technology, it will offer a much faster service, as well as clarity in decision-making, and have much closer, long-term relationships between the customer and the lending manager. Its systems will also integrate with both borrowers (accessing their management information, and so allowing much more timely discussion on potential problems) and, critically, and nearly uniquely, commercial finance brokers. The latter are expected to account for ca.70% of new business. We outline below how B-North can make these brokers' lives easier, improve their relationships with their customers and give them more opportunities to generate sustainable income. All these aspects give B-North clear competitive advantages over incumbent majors and other competitors.

What the customers want

Consistent market feedback is that SMEs want quicker service, long-term relationship management and access to key decision-makers

B-North's strategy started with what customers actually wanted – not legacy infrastructure and procedures. It is not intending to win business by under-pricing relative to the competition (indeed, one of the key metrics we will be tracking will be NIM by product by pod to ensure that no-one is “buying” business), but rather by giving borrowers and intermediaries a high-quality service. Recognise (owned by City of London) surveyed 423 of its customers to identify what was important to customers and where its service compared with providers. This is shown in the table below, and we believe reflects the issues that B-North's model addresses.

Survey of service compared with existing bank, conducted by Recognise



Source: Recognise Bank investor presentation (<https://www.cityoflondongroup.com/wp-content/uploads/2018/07/Recognise-Bank-Investor-presentation-Jun-2018-v4-Peel-Hunt.pdf>),
Hardman & Co Research

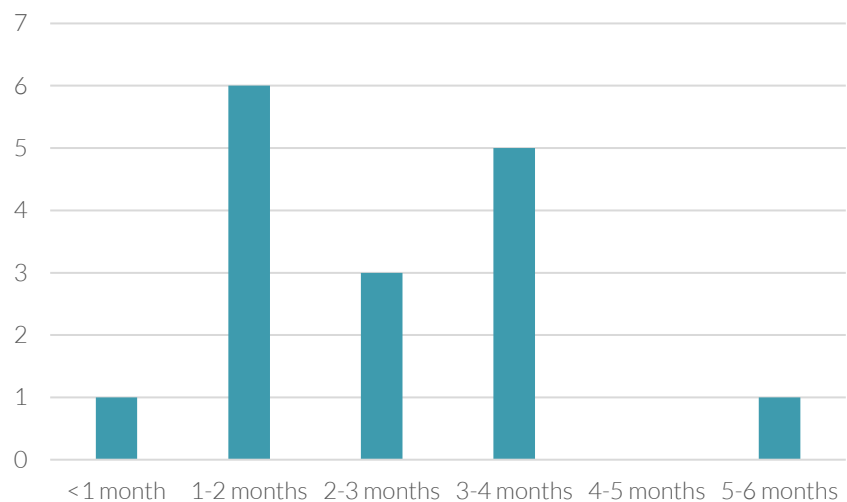
B-North will deliver through decentralised, regional, low-cost offices, materially improving customer service. The model builds in long-term customer relationships and rapid turnaround for new customers.

How B-North will deliver faster and better service

B-North will adopt a decentralised “pod” model, which has many services and significant lending discretion at the front line. With state-of-the-art technology, and valuation and legal services near the customer, B-North is expected to deliver a much-accelerated service proposition. New customers to the bank should be able to draw down on loans within a few weeks, rather than taking months with incumbent banks. The pods (offices) do not need to attract passing trade, and so can be in much cheaper office locations – either on peripheries of city centres or on higher floors in a building. This is again a cost advantage over banks needing a central, high-street presence for their money transmission businesses.

B-North has tested its model by running exercises with brokers to see if it would win business and to understand the market characteristics. As can be seen from the chart below, just one in 16 of the loans actually drew down within a month, and nine out of 16 took over two months. These data reflect the experience of borrowers with the winners of business, which may reflect the service seen from major incumbent banks, who may have lost the business.

Time to drawn down loan once it has been sanctioned (B-North survey of completed deals)



Source: B-North, Hardman & Co Research

Pod valuation quicker and cheaper for customers

It is also worth noting that, if the in-house valuer feels qualified to undertake the instruction (expected to be ca.60% of new instructions, and 80%-90% including revaluations), then there will be no cost to the client. If the valuation is more complex and the valuer is required to instruct an external firm, then the client will need to pay the full valuation cost charged by the external valuer. Where the valuation is conducted in-house (i.e. the majority of cases), there is a visible saving to the client.

Access broker distribution

Broker distribution is a growing market. B-North aims for 70% of business from this source, with targeted service, IT and remuneration structures in place.

The National Association of Commercial Finance Brokers (NACFB, <https://www.nacfb.org>) is an advice network of over 1,800 experienced commercial finance individuals, with members spread across the whole of the UK. The latest statistics (2015-16) indicated that they were responsible for introducing over £20bn of funding into the market, and B-North believes its product suite can service around two-thirds of this demand. Management is targeting 70% of new business origination from such intermediaries.

We believe the key requirements for successful broker distribution are i) to make their lives easier, ii) to enhance their reputation with their customers, and iii) to give them

Aims to make brokers' lives easier, ensure broker reputation with clients remains high, provide a credible, well-funded alternative finance provider, and allows the broker good opportunities to generate income

more income. B-North addresses all these points in a sensible way. Its competitive advantages over a range of other providers include:

- ▶ An easy life for the broker, using state-of-the-art technology to reduce the administrative workload. We expect B-North to have a focus on a broker service that is materially higher than at other banks – for these banks, a broker service is seen as competition for the branch network and not a distribution channel.
- ▶ Brokers can diversify their business when there is funding from a well-financed provider. Their lives are made easier if they are not dependent on a single provider, and if they know that the bank/finance house will consistently be in the market and is well-funded itself.
- ▶ High service levels to end-borrowers mean that the broker reputation is not harmed. If a broker's customers have a bad experience, then the broker will not direct business to that provider again.
- ▶ Greater income to broker: in addition to the introduction fee (typically ca.75bps upfront), B-North is intending to introduce a "good" performer commission, whereby the broker then receives a further, smaller commission on each loan, which continues to perform to agreed standards (subject to the overall performance of the broker from a quality, conduct and compliance perspective). We understand that this will be based on each loan, rather than the portfolio introduced by the broker. For the broker, it represents a material uplift in income (for modest incremental work), while, for B-North, it is both an incentive for brokers to focus on the best business and introduce new business. It also provides a modest element of counter-cyclicality to earnings.

Product synergies include focus on real estate backing, broker distribution and customer financing preferences

Synergies across product range and group

The core product is a standard five-year commercial term loan, with other products likely to account for under 10% of total volume each. There are synergies across the product set, in that the majority will be secured against real estate and hence the bank's regional pod model, including internal valuation capability and legal capability, can be leveraged. Additionally, this product set dovetails well with the product set traditionally supported by the commercial finance broker channel. Finally, B-North's revolving credit facility is a product well-suited to professional property developers or investors who hold a portfolio of properties, as it will enable them to trade in and out of properties, without having to go through a new underwriting process on every transaction.

Can share experience and expertise across pods

The product range is relatively simple compared with a full-service bank. Pods will have experienced bankers with specialist skills in either real estate or trading businesses, and corporate business development managers with greater specialist debt finance skills, i.e. cashflow lending. B-North will also have the ability to share expertise between pods, if necessary; for example, we understand that the plan is to have one valuer per branch, with holiday cover and short-term periods of excess demand covered between the pods.

Fin-tech platform run by bankers

B-North's IT is outsourced to market leaders, providing state-of-the-art analytical tools and interfaces with market information and customer management accounts. Being built from a blank canvas means it can match customer needs, not the bank's legacy operational procedures. This accelerates basic administration, provides better service to originators, especially brokers, and up-to-date credit assessment and monitoring, reducing both probability of default and loss in the event of default.

B-North

B-North's IT is outsourced to market leaders, providing state-of-the-art analytical tools and interfaces with market information and customer management accounts. Being built from blank canvas means it can match customer needs, not the bank's legacy operational procedures

Systems have proven delivery from partners with global franchises

Accelerates basic administration, providing better service to originators, especially brokers, and up-to-date credit assessment and monitoring, reducing both probability of default and loss in the event of default

Key advantages include automation, integration and spread development costs, unhindered by "don't change it because it works" inertia

B-North claims an agile and configurable IT infrastructure with the latest generation platform, leveraging strategic partnerships to enable rapid innovation of product and features. Its technology strategy focuses on a central platform for integration with current best-of-market apps. Unnecessary functionality has been disabled, as unused features add complexity and maintenance against clean design and lean processes. B-North has, however, added functionality in the underlying salesforce platform to support a number of roles and processes that it believed were not addressed by the technology solutions on the market. This state-of-the-art automated platform may be compared with the traditional core banking model, some of which evolved as far back as the 1970s and 1980s.

With the digitalisation of the "back office", B-North has clean and accurate operational information, which enables it to track and performance-manage every aspect of the business. State-of-the-art management information should help further optimisation of processes and systems to sustain the competitive advantage.

It should be noted that B-North typically has used systems where there is a proven track record of delivery. While the exact systems have been designed to B-North's specification, the platform has been tested, and B-North will not be exposed to the first-user risk. Another key consideration is that the system is scalable. The key operational partners are:

- ▶ nCino (<https://www.ncino.com/>), which claims that, on average, nCino client institutions have experienced a 127% increase in account-opening completion rates, a 40% reduction in loan-closing times and a 22% increase in efficiency. Other UK clients include OakNorth, Secure Trust Bank and the Yorkshire Building Society.
- ▶ Mambu (<https://www.mambu.com/>), which claims, "As the industry leader in cloud banking, we are taking on the \$250B market of banking technology worldwide, and service more than 150 customers with over 14M end users." Other UK users include OakNorth and RBS.
- ▶ B-North also claims that its credit decisioning will be enhanced by sentiment analysis, integration with client financial reporting systems and the innovative use of open-data sources and artificial intelligence (AI).

What does this mean for the business? The end-to-end lending journey and customer experience were designed in detail before any solution choices or technical work started. B-North has not just installed solutions "out of the box", but it has tailored nCino and Salesforce processes and workflow to include all roles in commercial lending. Furthermore, it has fully integrated the broker experience and connected the systems together to provide automation and high-quality decision-making. We understand that some competitors have selected specific services to add onto a pre-established core platform, and so their systems may not be totally integrated and may only use limited functionality within, say, the nCino platform. B-North believes its technology stack will produce a more efficient and more effective customer journey.

Quantifying the advantages of IT from the outside is notoriously difficult, but we believe:

- ▶ Many processes, such as Know-Your-Customer (KYC) and data entry, should be open to significant automation.
- ▶ New systems are likely to be much easier to integrate with other systems than legacy ones. B-North highlights that a unique broker app is part of its competitive advantage in that market, and new systems are more open to this.

- ▶ B-North should see the usual benefits from outsourcing. Product development costs are borne across all its partners' client bases, allowing market-leading systems development at an acceptable cost. However, there are risks. We asked B-North why its requirements would be given sufficient priority by a partner who might have a conflicting demand on its resources by a bigger client. It noted that SME lending was not a sector where you generally needed to bring a new product to market at rapid speed. The systems being used have state-of-the-art functionality to be able to structure deals to meet the borrower requirements, as the fundamentals do not change.
- ▶ In many established firms, a conservative risk function can be an impediment to change. If the system works, changing it incurs risk. The analyst of this report, on joining NatWest in 1986, was told that the core mainframe was the one used in 1968 on the merger of District Bank, National Provincial Bank and Westminster Bank, because "it worked". B-North, by starting from scratch, faces none of this risk-aversion impediment.

Strong corporate governance

B-North has strong corporate governance, with an experienced, proactive and independent board, which has proven experience in running established businesses and building new banks. It is also regulated with an independent examination of every aspect of B-North's business model, procedures, personnel and culture – all challenged in detail for their robustness.

Strong board

We detail the board in the *Company matters* section of this report. We believe important characteristics include i) a balance between members of the board with deep experience in the relevant market and those with a broad experience to share market-wide best practice, ii) members with a track record suggesting they will challenge an entrepreneurial management, and iii) market contacts to enhance the business model. We particularly note the recent Chairman appointment as a key component to B-North's corporate governance. The board's independence will be further enhanced, as it is expected that, over the coming months, B-North will appoint two more non-executive directors, with one founder director stepping down.

The management team has a balance between members with experience in large, established banks/financial institutions (CEO was MD at Santander UK, CFO was CFO of International Personal Finance, CTO at HSBC and Treasurer at Barclays) and those who have helped establish new banks (Programme Director held this role at Allica, NED was founder of Atom Bank and MD Savings secured bank licences for Atom and Metro Bank).

Regulatory oversight

A further corporate governance feature is the detailed regulatory oversight that B-North has been through to get its banking licence. We detail a summary of the process in the *Appendix* in this report, but we believe equity investors can take some comfort in the evaluation of the downside risk, as all aspects of B-North's business model, procedures, personnel and culture have been examined in detail for their robustness. The regulators are, of course, interested primarily in protecting depositors and the financial system – and so B-North's focus is to ensure that risks are well-managed, rather than focusing on the upside optionality.

As a bank, B-North will have to be compliant with:

- ▶ The Senior Managers and Certification Regime (Financial Conduct Authority, FCA).

Strong corporate governance from an experienced, proactive and independent board, with proven experience in running established businesses and building new banks

Downside risk has been evaluated by independent regulator, and all aspects of B-North's business model, procedures, personnel and culture have been examined in detail for their robustness

- ▶ The FCA's Approach to Authorisation and feedback statement.
- ▶ European Banking Authority (EBA) guidelines.
- ▶ UK Corporate Governance Code (Financial Reporting Council).
- ▶ The Prudential Regulatory Authority (PRA) Supervisory Statement (5/16).
- ▶ The PRA's governance rules and risk management rules, in particular General Organisational Requirements, Risk Control and Remuneration.

We understand that the FCA's Firm Assessment Model includes some of the categories highlighted in the table below.

FCA's Firm Assessment Model	
Assessment Category	Assessment Group
Business Model & Strategy	How significant could the influence of external factors be on the firm's business model?
	Is the firm's business model viable and sustainable?
	How significant are the inherent drivers of harm in the firm's business model and strategy?
Culture	How effective is the firm's purpose in reducing the potential harm arising from the firm's business model?
	How effective is the firm's leadership in reducing the potential harm arising from the firm's business model?
	How effective are the firm's people policies in reducing the potential harm arising from the firm's business model?
	How effective is the firm's governance in reducing the potential harm arising from the firm's business model?
	How effective are the firm's systems & controls in reducing the potential harm arising from the firm's business model?
	How effective is the oversight of the business in reducing the potential harm arising from the firm's business model?

Source: FCA/PRA new bank seminar October 2019, Hardman & Co Research

Expected portfolio stress-tested in range of scenarios as part of ICAAP

Part of the regulatory oversight is B-North's Internal Capital Adequacy Assessment Process (ICAAP), where there is rigorous stress-testing, including i) the BoE 2018 stress tests, whereby corporate insolvencies broadly double and under which commercial real estate prices fall by 40%, and ii) a further stress test based on the 1990-93 recession, during which corporate insolvencies were broadly double again. We understand that B-North was able to withstand both of these scenarios after applying sensible management actions.

Multi-layered approach to regulation

Deposit funding

B-North expects to receive its banking licence in 1Q'20. This initial licence is classified as "Authorised With Restriction", which means that B-North will be a bank, but will have to successfully complete a "Mobilisation" period before it is able to fund its lending activities through retail fixed-term deposits. B-North expects to conclude this Mobilisation period and commence deposit-taking in 4Q'20 (initial lending will be funded by equity and warehouse lines). The sums B-North is looking to raise from best-buy table comparison websites are tiny by comparison with the market, and many other banks have raised significantly larger sums very quickly. Such funding is highly flexible, has low administration costs, has a very deep market, is usually less mobile than wholesale funding, and provides significant diversification.

B-North

Retail deposits likely to be taken from 4Q'20 (initial lending funded by equity and warehouse lines)

The sums B-North is looking to raise from best-buy table comparison websites are tiny by comparison with market. Many other banks have raised significantly larger sums very quickly.

We detail in the *Appendix* the extensive process that companies have to go through to get a banking licence. This comes with significant effort and costs (S&U reported in excess of £1m before it aborted its bank application), and is a material barrier to entry. Apart from giving investors comfort from a material regulatory oversight, the other key advantage is that it allows retail deposit-gathering. The regulators require proof that the business can be run operationally before deposits are taken, a process that means B-North is expected to start deposit-taking in 4Q'20. In the meantime, initial lending will be funded from equity and a whole-note warehousing facility (short-term interbank credit).

We believe B-North will face greater competition in the deposit best-buy table market than on the lending side. A significant number of existing and challenger players are active here, and once a banking licence has been obtained, the marginal barriers to entry are small, and B-North will have to compete on price. B-North has outsourced all the savings operations and technology. The good news is that the market is huge, and, as noted, the sums B-North is looking to raise are tiny by comparison. We note that Arbutnot Direct raised £85m in quick order to fund a mortgage book acquisition. Industry sources suggest a couple of hundred million can be raised in very quick order by being at the very top of the table. Over a longer timescale, Paragon has built a deposit base of £6.4bn. We do not believe that accessing sufficient volumes of retail deposits will be problematic for B-North.

More efficient and operational gearing

B-North has material cost advantages over major incumbents. These include i) significant automation of administrative functions, ii) low-cost office space, iii) no infrastructure required to service high-cost money transmissions, iv) state-of-the-art technology, with more efficient interfaces with both customers and intermediaries, and v) appropriate outsourcing. The business model also has significant operational gearing, with the majority of costs fixed. As B-North grows, this should see significant improvements in profitability.

Management has highlighted its long-term cost:income ambitions (at 30% or under) and noted that the mainstream banks are in a range of 50%-60%. We believe that, while factually true (e.g. Lloyds Banking Group's "Commercial Banking" division's cost:income ratio in 1H'19 was 51.5%, RBS's in 3Q'19 was 59.2%), this is somewhat distorted by business mix issues. A third of the income at Lloyds is non-interest income, and many fee-based businesses have a lower capital requirement but higher cost:income ratios.

OakNorth reported a 2018 (year 4) cost:income ratio of 35%, which we believe is a fairer like-for-like comparison. We would expect some further efficiency gains from operational leverage, and so B-North's 30%, or under, target appears to be in line with where these competitors will be at a mature like-for-like stage.

Additionally, it is worth noting that i) B-North has fully-integrated systems and significantly automated processes, and ii) in part, the company is leveraging the infrastructures of the commercial finance brokers for a variable fee. As noted above, there is some synergy in that valuers can work across pods to cover busy periods, and we understand that the legal side will partially involve outsourcing to a small number of national firms who will place members of their teams in B-North's pods.

B-North

High operational gearing, with majority of costs fixed

The majority of costs across the life of the plan are fixed, with around two-thirds representing staff costs. Technically, bonus costs will be, to some extent, variable but, as we note in the section below, B-North has a range of options to increase volumes and so, in practice, they may also be considered fixed. Additionally, there are the relatively fixed central costs, and elements of IT/deposit gathering that are also fixed. The operational gearing from growing the business is significant.

Managers have put ca.£1m upfront, which is also incentivised by founder shares that only crystallise on key valuation metrics

Management's "skin in the game"

Management is aligned with shareholder interests through:

- ▶ a £1m investment in initial seed capital; and
- ▶ founder shares linked to key valuation milestones (banking licence, launch, breakeven and £30m annual EBITDA (after funding costs).

Reality check: base-case assumptions credible

Our conclusion is that the targets are stretching but should be achievable in the consensus macroeconomic outturn

We have done a “reality check” of B-North’s financial targets. Our conclusion is that the targets are stretching but credible in the most likely macroeconomic outturn. We explore a range of sensitivities in the financial section below. Some of the key considerations are:

- ▶ Our analysis concludes that the target loan growth is below the average achieved by a portfolio of comparable banks at the same stage of development. It is also more conservative than the growth OakNorth, its closest direct peer, has delivered (year four growth 15% below OakNorth actual). The ca.2.5% market share B-North targets for in 2027 is credible in absolute terms – we believe the lending target represents one to two deals per relationship manager per month, once the business is mature.
- ▶ B-North has tested its systems with actual broker-completed deals to validate the various assumptions. The conclusion was that the B-North offer was likely to be the best in 18 of the 40 cases, and it was competitive in a further 15.
- ▶ Gross lending yields of ca.6.5%-7% (weighted for business line mix) are in line with our understanding of comparable market pricing and levels reported by peers. With a drag from a liquidity portfolio (reasonably assumed at 13% of assets), the target yield appears sensible.
- ▶ The cost:income ratio target of 30%, or under, at maturity is around half the level of the major banks (who have business models including high-cost money transmission). It compares with 35% at OakNorth, which has yet to reach maturity. We outlined above the cost advantages B-North has that make this target credible.
- ▶ Looking at current best-buy tables, the likely duration of funding and swap costs, we believe a weighted average cost of retail deposits of ca.2% is credible. Interbank lines, secured by assets, for a bank such as B-North, are currently around the same level, but we see the potential for this to fall. We note that the cost of Tier 2 debt is in line with Arbutnot Banking Group’s recent raise. Overall, a steady run-rate target NIM of ca.4.2% appears credible.
- ▶ We believe the impairment rate will be very heavily dependent on business mix, but, on the likely mix, a through-the-cycle loss of ca.30bps p.a. appears reasonable. This will vary by product, but equates to a lifetime loss of ca.60bps.

Loan growth to £4.5bn by end-year 2027

B-North validated plans with actual broker loans

B-North has done a dummy run of actual broker-completed deals to validate the various assumptions, risk appetite, lending criteria, application of policy and other lending processing factors considered for each lending application

In order to validate its proposed lending proposition, B-North has undertaken two exercises, where it requested that a number of intermediaries provide real-world examples of several types of lending deals that they had recently placed with other banks or lenders. The purpose of these exercises was to validate the various assumptions, risk appetite, lending criteria, application of policy and other lending processing factors considered for each lending application – providing an assessment of each loan as to whether the bank, once trading, would consider and write the loan, or whether the loan would be declined. The two exercises collated details of 40 recent customer deals presented to lenders through intermediaries and their respective outcomes, to assess and review a range of relevant factors.

B-North

Conclusion was it was highly likely to win 18 and likely to win a further 15 of the 40 deals in the samples

Our analysis concludes the target loan growth is below the average achieved by a portfolio of comparable banks at the same stage of development. Also, more conservative than OakNorth, the closest direct competitor.

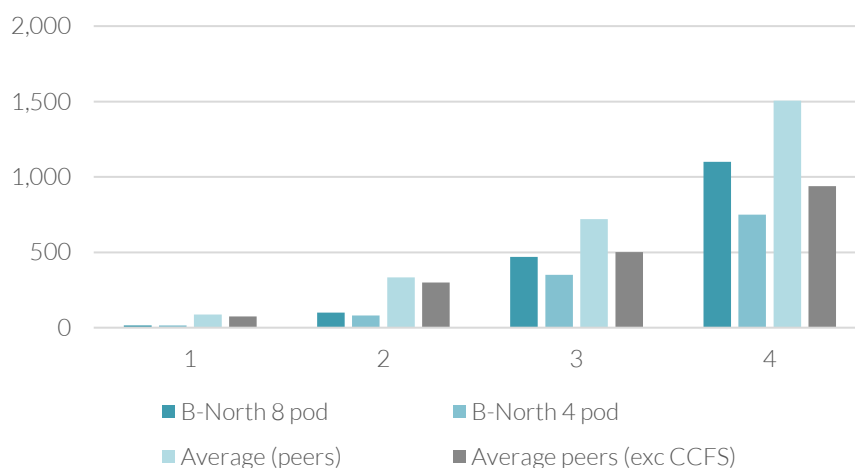
The outcome was that the future bank would be “highly likely” to win 18 of those deals – mainly down to its flexibility and speed. A further 15 deals fell into the “likely” to win category. There were also seven deals out of the 40 that would fall outside the bank’s appetite, whether because the loan sizes were too low or too high or they simply did not fit with its risk appetite and policy.

Peer bank growth record

In considering the reasonableness of B-North’s base plan (eight-pod model), we believe investors should consider what other lenders have achieved since their authorisations.

- ▶ As can be seen in the chart below, B-North is assuming slower loan growth than the average of a group of comparable challenger banks in each of its first four years. The comparable includes Charter Court Financial Services, with a bias to buy-to-let, but even if we strip out that bank, B-North appears conservative.
- ▶ Taking OakNorth as the closest comparator in the first two years of operation, the lending is broadly in line with the actual run-rate achieved by OakNorth. However, by year 3 and in year 4, B-North’s plan is below the level achieved by OakNorth.
- ▶ Compared with, say, Arbuthnot Banking Group (Commercial Division) or Secure Trust Bank (STB’s Real Estate Lending division), B-North appears a little conservative in the early years, but has stretching targets in years 3 and 4.

Loan balances (£m) under B-North base case and actual loan balances achieved by average of comparable bank group



Source: Competitor Report and Accounts, Hardman & Co Research
Competitors include OakNorth, Secure Trust Bank (real estate only), Arbuthnot Banking Group (commercial banking only), Paragon (development finance only) and Charter Court Financial Services

Target is ca.2.5% market share, and represents one to two deals per month per business development manager

Gross yields of ca.6.5%-7% (weighted for business line mix) are in line with our understanding of comparable market pricing and levels reported by peers

Targeted cost:income ratio of sub-30% at maturity looks credible

Retail deposits over likely duration B-North seeks are currently costing 1.65%-2.1%. Wholesale funding currently broadly in line with retail deposits. Comparable Tier 2 debt cost at Libor +775bp. Weighted average cost appears credible.

Market share and scale of pod origination

Putting it another way, we forecast that, by 2027, B-North's market share will still be ca.2.5% of its total market. The loan origination that year will be between £150m and £200m per pod, or between one and two deals per week. This is likely to be equivalent to one to two deals per month per business development manager, which does not appear over-stretching.

Gross loan yield averaging ca.6.5%-7%

We believe the yield reflects many inter-playing factors, including i) the risk-free rate (current five-year rate ca.1%), ii) the cost of risk (see paragraph on impairments below), iii) the cost of delivery, iv) capital requirements, v) duration of facility, and vi) premium for better service. We understand that the range of interest rates will be from ca.2.5% up to 10%, reflecting these factors. The product yields are consistent with what peers are achieving and our view of market pricing. The overall group yield will be dependent on mix.

We have assumed that the liquidity portfolio will represent ca.13% of total assets and that, because of its liquid, low-risk nature, it will yield 0.75% p.a. Given these rates and mix of business, the yield on average interest-earning assets is expected to settle at 6.2% for FY'23 and beyond.

Cost:income ratio under 30% at maturity

We noted earlier a number of factors driving B-North's competitive advantages. We also reiterate that i) B-North has fully-integrated systems and significantly automated processes, and ii), in part, the company is leveraging the infrastructures of the commercial finance brokers for a variable fee. By way of immediate peer comparisons, OakNorth reported a 2018 (year 4) cost:income ratio of 35%, which we believe is a fairer like-for-like comparison. We would expect some further efficiency gains from operational leverage, and so, B-North's 30%, or under, target appears to be in line with where these competitors will be at a mature like-for-like stage.

Weighted average cost of funds

In the section below, we look at the three key interest-bearing liabilities – retail deposits, interbank funding and Tier 2 debt:

- ▶ Retail deposits are expected to account for 70% of B-North's funding over the long term, with durations from one year to five years (to significantly, at least, match the duration of lending). According to [moneysupermarket.com](https://www.moneysupermarket.com), at the end of November, the best-buy table rates were: one year 1.65%, two years 1.85%, three years 1.95%, four years 2.05% (only one offering), and five years 2.1%. On that basis, the 70% of funding from this source is likely to average ca.1.9%. Given the depth of the deposit market, B-North may need to raise more funding in the short term and use swaps to hedge the interest rate exposure from the duration of its lending. In our model, we have built in a 2% total cost.
- ▶ The cost of the interbank facility is likely to be dependent on its duration and nature. Current market conditions remain unfavourable for a new bank seeking unsecured facilities, and this is why B-North is looking to do warehouse/securitised wholesale funding, where the exposure is asset-backed for the other bank. We understand that such lines, even to a well-capitalised bank, are broadly in line with retail deposit rates. This may change over time, and we would expect B-North to exploit the optimal wholesale funding available at any time.
- ▶ In terms of Tier 2 debt, we note that Arbuthnot Banking Group [announced](#) on 3 June 2019 that, for a £25m five-year facility, it had paid 7.75% plus LIBOR. Clearly, a lot will depend on B-North's equity position, loan growth and other

Sustainable NIM in excess of 4% is credible, with some volatility in NIM in early years from timing issues

Impairments will be driven by business mix issues

business mix, and one might expect that a larger issue would have cheaper funding.

Given the interest-earning yield of 6.2%, the interest-bearing costs above and non-interest-bearing equity financing at ca. 10% of the balance sheet, the company's base-case sustainable NIM of around 4.2% should be achievable. It should be noted that, at the early stages of development, the NIM may show some volatility, equity will finance all the balance sheet at the start, and expensive Tier 2 capital raises are likely to be lumpy – so the sustainable NIM of 4.2% may take a few years to achieve.

Impairments at ca.30bps p.a. through cycle (60bps through loan lifetime)

We expect a broad range of impairments across the product range (this is reflected in the yields) and through the cycle. For the professional buy-to-let market, we would expect 8-10bps p.a. through the cycle, rising to materially higher numbers for bridging finance and development loans. The commercial term loan market should be somewhere in the middle. The actual outcome will reflect which business lines show the fastest growth. We detail in the section *Credit risk* in this report the company-specific drivers to whether impairments may be above or below market levels for each product.

Investment neutrals

In this section, we detail i) how B-North differs from recent financial IPO disappointments and Metro Bank, ii) while it is a new business, it is using experienced people in a very well-established market, iii) the opportunities, as well as threats, from an economic downturn, iv) how liquidity and interest rate risks are managed, and v) the fact that employees have been identified but have yet to join.

A number of banks/financials have been disasters for investors

B-North's different position: not starting from high rating, taking share in established market, has culture consistent with its underlying business, has business rather than retail customers, and so faces much lower regulatory risk

Why not a Metro/Amigo/Funding Circle

In the past three years, Metro Bank's share price has fallen from a peak of 4,022p to 186p, Amigo Holdings' from 308p (July 2018) to 63p, and Funding Circle's from 453p (October 2018) to 100p. The record for recently-floated specialist lender/banks has not been good.

It is important to recognise how B-North differs from these companies:

- ▶ It does not start with inflated ratings.
- ▶ B-North is operating in a long-established market, where it intends to meet a proven demand better than the incumbents, rather than creating a new market.
- ▶ Unlike Metro, B-North aims to be profitable within a reasonable period of formation, with an end to the investment phase within a few years.
- ▶ We do not believe Funding Circle sees itself as a lender, given its vision statement: "By combining cutting-edge technology, sophisticated data analytics and dedicated customer service, we help SMEs access finance that allows them to grow and expand." Looking at the most recent results presentation, it highlighted the UK risk performance only at slide 24. We believe credit businesses need to be run as such, and not be driven as technology businesses.
- ▶ On Funding Circle's statistics page (<https://www.fundingcircle.com/uk/statistics/>), we note expected annualised loan loss rates on 2018 origination of 3.6%-4.6%, against a projected gross yield of 9.7%. This is a very different market from B-North.
- ▶ B-North's product set is addressing a known B2B market only.
- ▶ Amigo has faced regulatory pressures, compounded by high losses, as it piloted new products to retail customers. Much of Metro's decline has again followed regulatory issues, which are compounded, we believe, by the perceived threat of litigation risk.

New business in established market

B-North will be operating in a well-established market, with well-established products, with market-tested and leading IT, and with employees who are highly experienced in their field. This materially reduces the risk of being a new business with an untested model – but there is still a risk.

B-North is not trying something radically new, but just meeting a well-established demand better than the competition. However, as a new business, it is as yet unproven.

Impact of downturn on loans unclear. Likely to be less demand, but pricing likely to improve and major bank appetite likely to reduce further, allowing market share gain opportunities.

Loans volume opportunity in downturn

We address a more general risk of disappointing volumes and what B-North will do about them in the section below. Many of the options available to B-North could also be applied in a downturn. Looking specifically at that scenario, the demand for many of the products is likely to weaken, and sentiment to bank stocks is likely to worsen. Having said that:

- ▶ Mainstream banks are likely to have even less appetite to lend, allowing greater market share gains for B-North, albeit in a smaller market. This is most likely to be seen in high-yielding, high-loss areas, such as development finance.
- ▶ Historically, competitor Paragon has emphasised that professional buy-to-let investors are likely to increase their portfolios if house prices weaken. There is less appetite from small, private landlords, but demand from long-term professionals is increasing.
- ▶ As major banks tighten their lending criteria, this is also likely to feed through to improved pricing.

B-North could thus see higher spreads on new lending, and greater volumes to compensate.

Liquidity comes at a cost. As B-North is a new bank, we would expect this to be above-average, and for it then to trend down as the business becomes more established.

Liquidity

A key feature for any bank is managing liquidity. For a new bank, this is an area of great focus for the regulators, and we would expect B-North to initially maintain a higher liquidity buffer than the established banks. In essence, it has to raise longer-term funding and invest in highly-liquid assets such as gilts. The depth of the retail deposit market may make long-term funding more difficult. It may be that B-North will have to raise one- to two-year retail deposits, and then hedge the interest rate exposure through swaps. In such circumstances, it will need to hold more liquid assets, as its liabilities will mature more quickly. Liquid portfolios come with a cost – within our model, we assume that 13% of assets will be held in a liquidity portfolio, and they come at a net cost of 1.25% p.a. The effect is relatively modest (we estimate ca.8%-9% of medium-term profits), and could reduce as the group grows its franchise and alternative funding sources.

Interest rate sensitivity broadly neutral, with match-duration funding and limited gapping opportunities

Interest rate sensitivity

Like any bank, there is a sensitivity to the macro environment that is associated with the interest rate environment. Looking at B-North, the direct impact of changes in interest rates, we believe, should be modest. Taking a rising rate environment: i) there should be a modest benefit from that portion of the book that is funded by non-interest-bearing equity capital (Hardman & Co estimates just over 10% of assets over the long term; and ii) in terms of the loan book interest rate sensitivity, we understand the expectation will be ca.70% variable and 30% fixed (of mixed durations), although this will be dependent on the actual product mix. Longer-duration lending will be match-funded with retail deposits of a similar duration, where available, or shorter-term deposits will be raised and swapped back to match the liability profile. Consequently, we do not expect the stock of business to be materially affected by short-term rate changes, and it is probable that the effect on the flow of business will also be broadly neutral. With best-buy table products, we expect B-North's funding costs to rise immediately with market rate rises, and for there to be limited opportunities for gap benefits (i.e. B-North will not be able to delay passing on rate increases to savers while immediately re-pricing borrowers).

Staffing identified

*Stage 1 done (employees identified) but,
as may be expected, they are still
employed at other providers*

We have seen the anonymised, short CVs for a number of target front-line staff. The heads of pods typically have around 20 years' relevant experience, business development managers 15 to 20 years, and relationship managers 20 years. Five or six potential employees have been identified for each pod, with a range of sector-specific experience (e.g. real estate). The fact that key employees have been identified is clearly a positive, but as all are currently employed, there can be no certainty that they will move over, and at what cost.

Credit risk

Summary

Credit hugely important, and we believe approach is conservative

In our notes on other clients (RM Secured, Real Estate Credit Investments, 1pm) and, in some detail, in our sector review, *Debt Investment Companies: Diving deep finds you the treasure*, published on 25 February 2019, we have emphasised the importance of the basic principles that we believe apply to all good lending. How these canons of lending will be adopted by B-North is detailed below. We have also previously highlighted how important management culture is to all aspects of credit risk – the lending decision, monitoring, collections and accounting. A conservative culture, which we believe B-North has, is likely to be conservative in all areas of credit risk.

B-North below-average risk, given i) conservative culture, ii) experienced team, iii) security, iv) state-of-the-art analytics and live interface with customer management information

- ▶ The key features suggesting that B-North is below-average risk include: i) culture: our dealings with management indicate a high awareness of risk and a conservative approach to its management – this may be expected to flow through to how it accounts for impairments, as well as the lending decision; ii) an experienced team: B-North has an experienced board, and lenders and risk controllers with relevant market knowledge doing what they have done for many years; iii) security: most lending will be backed by real estate security (target LTV 60%-70%) – it is looking to get BBB guarantees on where there is not such high-quality security; and iv) state-of-the-art technology: B-North's technology will access social media and interface with customers' own live financial reporting systems to bring B-North as close as possible to the companies. Importantly, this and its state-of-the-art analytics technology are viewed as tools for risk management, and are not the driver to a credit decision.

Uncertain features: unknown effects of IFRS9, systems untested, forbearance

- ▶ Uncertain features include the cyclical nature of IFRS9. Additionally, while B-North is adopting a sensible collections process, balancing between internal early-stage relationship management involvement and outsourced late-stage enforcement, this is untested at present. There is an increased regulatory market-wide focus on forbearance/treating customers fairly, but business-to-business lending should be lower-risk than retail.

Above-average risk: de-centralising decision-making (but we note B-North has put processes in place to mitigate this)

- ▶ Another above-average risk for investors, either real or sentiment-related, could come from B-North decentralising credit decisions, valuations and legal services. This should enhance customer service, but carries the risk that there is less independence in vital risk-control functions. B-North has addressed this risk with structured staff incentives, underwriters and valuers in pods reporting to the Chief Risk Officer, external valuations where situations are complex, professional accreditation of staff, and detailed central audits, especially in the early stages.

Other risk issues include physical distance from customer, adverse selection, late-in-cycle lending and some higher-risk products

- ▶ Other factors that could increase the perception that the risk profile is above-average include i) regional pods not always being physically close to the customer, ii) the risk that the applications will be weighted towards those unable to obtain finance from their banks, iii) late-cycle lending being higher-risk, and iv) development finance having been a high loss area historically.

Some basic principles

Assessing credit

We believe that the basic principles of lending apply to all balance sheet lenders. They are sometimes called the “Canons of Lending” or the “CAMPARI and ICE” analysis, as detailed below.

CAMPARI and ICE: the Canons of Lending		
Requirement		Hardman & Co comment
Character	Critically, B-North will meet all borrowers multiple times to understand how they run their businesses and assess whether they will be willing to repay if they have the ability to do so. The intent is to establish long-term deep relationships with customers.	
Ability	After an initial assessment, B-North’s technology will interface with customers’ own accounting systems in order to have current information on the customers’ finances and ability to repay.	
Means	The borrowers’ means will be established <i>inter alia</i> by B-North staff, with the appropriate qualifications in each pod.	
Purpose	B-North has a series of products with niches in specific areas. It is not applying generalist skills/products.	
Amount	Facilities will be £0.5m to £5m, a size identified as less competitive than either larger loans (more capital market competition) or smaller ones (which may be more suitable for major banks’ automated systems).	
Repayment	There will be a mix of bullet repayment (development finance), amortisation (commercial term loans, buy-to-let) and revolving credit.	
Interest	As noted above, B-North has a risk-adjusted pricing model, with the interest rate related to risk.	
Insurance	Most lending will be secured on real estate with a portfolio LTV below 70%. B-North is seeking BBB guarantees on elements without real estate security.	
Commissions	There may be an element of early repayment charges, but non-interest income will not be a material part of the business.	
Extras	B-North is not looking to generate material fees outside its core lending proposition.	

Source: Hardman & Co Research

Risk decision should be separate from origination

Value of security is only what it can be sold for – often in forced sale conditions

Properly executing security is vital. This sounds simple and basic, but, for example, HBOS had issues with ca.52% of cases

Governance

An important governance point is that loans should be sanctioned by a risk function, and not by the team that originates and assesses the loan.

Value of security

Investors should appreciate that the nature of security materially affects its value to a lender. For example, there is likely to be a lower realisation if the assets i) have limited secondary markets, e.g. specialist equipment or highly-regulated assets, ii) are subject to technological obsolescence, and iii) are highly mobile and so may be “lost” in the collection process.

Execution of security

One further consideration is that execution risk is a material issue. By way of example, we highlight s344 p88 of the FCA’s *“the Failure of HBOS PLC A report by the FCA and PRA”* (Hardman & Co emphasis), where over half of the security HBOS had taken may not have been effective.

“The risk was increased by failures to perfect the security arrangements. In a meeting with the FSA it was reported that following a sample check of security 52% had issues. Similarly, the Bank of England, when reviewing a pool of property loans put forward as collateral, noted that HBOS had not registered its security interest on the property for a third of the loans. However, risks to the adequacy of security had been known: the CCRC recorded that valuation clauses were often negotiated out of contracts, or that clients would only accept a valuation every seven years, and that in practice it was difficult to get valuations. In February 2007, it had been discovered that almost 20% of valuations recorded in the division’s systems were unattributed and therefore could not be relied upon. In effect HBOS had no or very weak security against a significant proportion of commercial property loans and was aware its security cover was potentially ineffective.”

Both customers and value of security need to be monitored regularly. You cannot just do it when the loan is originated.

Collections vital to level of end-loss

Our dealings with management indicate a high awareness of risk and a conservative approach to its management

Experienced board, lenders and risk controllers, with relevant market knowledge, doing what they have done for many years

Most lending will be backed by real estate security (target LTV 60%-70%). Looking to get BBB guarantees on balance.

Monitoring and review once a loan has been made

The early identification of accounts at risk is crucial to limiting credit losses. This means that lenders need to have effective monitoring of, and to establish a close working relationship with, their borrowers. Where ongoing control is simply left to waiting to see whether payments are made, and then chasing at a later stage, the probability of loss will be higher.

Collection process

Collecting debts can be just as important to ultimate returns as the initial lending decision. We believe that a balance is required so that the front-line lenders feel some personal “pain” if their lending decision goes wrong, while still optimising returns by having specialist collection skills when required.

Below-average risk factors

Culture

B-North has invested heavily upfront to build risk control and infrastructure ahead of commencing lending. While this is part of a bank’s licence authorisation process, B-North notes that its application has accelerated past that of some other applicants, which indicates that its investments, on a relative basis, have been viewed as appropriately conservative. Our meetings with management have not only confirmed its awareness of the risks but also that it has a conservative approach to its management.

Experienced team

Experience is important across all the levels of the company:

- ▶ We detail the board members in the *Company matters* section of this report. We believe they have an appropriate level of skill and experience.
- ▶ The pods will initially be heavily-weighted to more experienced staff and ones with relevant sector/product experience.
- ▶ We understand that the Chief Risk Officer (designate) has worked and controlled an underwriting function for a bank that had 50+ underwriters in six teams based in three locations, in addition to a decentralised delegated authority regime (up to £2m).

Security

We note that the majority of B-North’s lending is likely to be secured by real estate, which should be better-quality than other types of security. We are of the view that a forced sale real estate value is around 70% of an open market value, and thus any lending above this level should be regarded as higher-risk. We understand that B-North is targeting an overall LTV of the portfolio of 60%-70%, but it will be prepared to accept some deals that may be higher, and that will carry a higher margin as a result. This will also be managed within the concentration risk policy where LTVs above 70% cannot exceed a set percentage of the overall portfolio.

It is worth noting that the bank envisages being a member of the BBB’s EFG (Enterprise Funding Guarantee) scheme, which will support loans that are not secured with real estate collateral.

B-North's technology will access social media and interface with customers' own live financial reporting systems to bring B-North as close to company as possible

Having good management information and being willing to share are integral parts of credit assessment of potential borrowers

IFRS9 anticipates future losses reducing current profits but increasing later ones

Range of outcomes reflects management culture

Technology interface: timely customer information

Given that all of B-North's lending has a "story", the involvement of an experienced lender in conjunction with advanced technology is a crucial part of the business model. We take comfort that B-North appears to see IT/statistical modelling as a tool for the lenders to use, rather than being the driver to the credit decision. We believe over-reliance on IT and statistics can generate complacency in lending and is extremely dangerous in itself. Such techniques rely on past customer behaviour, and human intervention is likely to be much better at spotting changing customer behaviour in advance. In addition, soft factors, such as perceptions of management, can be hugely important and, in many cases, there may not be a relevant history/track record to rely on.

Having said that, state-of-the-art IT should help better identify potential losses earlier, thereby reducing both the probability of default and the loss in the event of default. B-North advises that its IT will access on-line databases, timely internal financial reporting (i.e. current management information and not just annual statutory returns nine months late) and social media. The scale of B-North's borrowers is such that they are likely to have timely management information; indeed, this and being willing to share it are likely to be part of the lending decision. In terms of social media, the example provided was where the ongoing trading for a hotel could be judged by the hotel's internet ratings by customers. Such information allows the relationship manager to open informed discussions with the borrower at a much earlier stage, and early intervention is likely to reduce losses.

Additionally, if B-North feels that the data from the accounting source are insufficient, it will retain the ability and right to request management information in an appropriate format. B-North will also be monitoring credit reference data, which itself can show risks earlier than the main bank accounts, and it is investigating the use of sentiment analysis.

Factors with uncertain effects

Accounting

IFRS9, which we understand will be the accounting treatment once the loan book is established, brings forward the recognition of impairments from when the loan becomes distressed to when it is originated. It moves the recognition from an incurred-loss to an expected-loss basis – so there is less profit upfront and more later. The effect can be material – for the Funding Circle SME income fund, the unaudited 2018 interim profit was £677k after the impairment charge had been increased by £3.7m due to IFRS9.

The IFRS9 calculation of impairments requires a range of possible outcomes and assigns a probability to each.

- Anecdotally, we understand that the range of outcomes used by different companies adopting IFRS9 has been broad (with, for example, a move to the worst-case scenario from the base-case scenario seeing a very wide 40%-250% increase in provisions), making precise comparisons between companies difficult. Accordingly, we revert to our opening comment and recommend investors recognise that companies whose culture is conservative (as we believe to be the case at B-North) are likely to show this trait in their provisioning assumptions too.

B-North

Provisioning pro-cyclical

- ▶ If a recession becomes more likely, a higher weighting is applied to the downside scenario outcomes, and this introduces cyclicity into the calculation. Investors need look no further than the Non-Standard Finance [announcement](#) on 15 November, when a move from an 85% base case, 10% downside, 5% upside mix to 50% downside and a 50% base weighting was expected to reduce 2019 earnings by 6%-8%, even though there had been no change in customer behaviour/repayments. Lower-risk businesses are likely to be less affected by IFRS9 than higher-risk ones and, again, the effect on B-North will be dependent on the lending mix between lower-risk buy-to-let portfolios and higher-risk development.

Early identification means problems can be addressed, at a time when the customer may still recover. Initially, pod staff will be involved in restructuring, although full recovery will be outsourced to professionals. Part of incentive would also be clawed back.

Collections

B-North's approach to recovery is:

- ▶ Close monitoring of customer ability and means, so that, wherever practical, direct interfaces with the customers' own management information systems, as well as external automated feeds, present the opportunity for early engagement.
- ▶ With relationship managers having a longer duration in posts, there should be a level of trust built up with customers. The bank's proposals will not be seen as "Big-Brother" impositions but, hopefully, rather as constructive advice, which is more likely to be taken on board at an earlier stage.
- ▶ We understand that B-North is exploring a partnership with a big insolvency practitioner to bring in the latter's expertise at an early stage, so that the client can discuss options that may not be available if their trading deteriorates further. The pod relationship managers will be involved in these discussions and will have to spend time on this, rather than generating new business. We understand that B-North would also expect significant engagement from the broker at this stage too.
- ▶ In addition to any lower bonus associated with less new business if the manager is focusing on account restructuring, as discussed above, the pod incentivisation scheme has claw-backs and deferred payments. The broker introducing the business will also not see its "good payer" bonus.
- ▶ Where situations become more likely to be terminal, the enforcement process will be outsourced to experts in the field to optimise returns and allow lenders to focus again on new business. This is a business decision, as some time on initial collection may be a good use of manager resources, helping to ensure lenders have ownership of loans.

Increased regulatory market-wide focus on forbearance/treating customers fairly, but business-to-business lending should be lower-risk than retail

B-North will retain responsibility under the customer harm considerations (i.e. treating customers fairly/forbearance, etc.), and is working closely with an external specialist in this sector. This is evolving, but the risks are likely to be materially lower than for retail lending.

Above-average risk factors

De-centralised model

One of the key aspects of B-North's service proposition is the delegation of power to the pods, which can then respond much more quickly to customer demand. The key elements are:

- ▶ Lending discretion – we understand that up to £1m will be sanctioned by the pod underwriter, assuming that the proposition meets certain key, lower-risk policy criteria. These include factors such as the strength of a company (assessed by risk grade) and low risk (LTV 70% or lower) assessed via a matrix.
- ▶ Valuations will be carried out by RICS professionally-qualified staff within each branch, rather delays being incurred through seeking multiple external valuations.
- ▶ Legal services will be significantly automated, with each branch accessing pre-prepared documents digitally.

While such an approach is, we believe, likely to accelerate customer service, it is not risk-free. Many would argue that having risk-control functions in a physically separate mid-office, clearly segregated from front-line staff, is likely to increase their independence and so effectiveness. Where valuers have to face pod managers and lenders every day, there is the risk that they are more likely to give a valuation that the managers want. Similarly, the risk of fraud from collusion is materially higher, and the impact of a rogue office is very evident from HBOS's well-publicised experience in Reading.

B-North has addressed this risk in a number of ways:

- ▶ The remuneration package for pod staff will incorporate an on-market base salary with the ability to earn a further annual bonus for the achievement of an on-target performance, which will be determined primarily by loan originations (but with claw-back provisions in circumstances where there are issues with quality, cost or conduct). The bonus element will be split between 50% in cash and 50% in equity, with the equity element deferred over the subsequent three years (again with malus and clawback provisions).
- ▶ The underwriters and valuers in the pods will sit in the second line of defence, reporting into the CRO, not the Head of the pod. Their remuneration will be weighted towards a fixed salary, and any bonus will be linked to quality, and not business performance, to ensure independence.
- ▶ For new transactions, B-North estimates that ca.40% of valuations will still have external input. Over time, 80%-90% of revaluations will be performed in-house, bearing in mind a regular three-year revaluation cycle. This will save customers further fees, but will also ensure that the bank's asset valuations are maintained up to date. The higher proportion of new lending conducted by external valuers ensures that there is appropriate independence when required.
- ▶ All valuers will be RICS-accredited and will have to maintain this. Underwriters will be accredited using an external validation tool (likely to be Moody's Analytics), before having a delegated lending authority approved, and they will have to maintain this accreditation on a regular basis. The level of delegated authority will be subject to accreditation.
- ▶ In the early days (minimum six months), we understand that all approvals and valuations will be overviewed by the head-office functions. Post that, a sample of

B-North will be decentralising credit decisions, valuation and legal services. This should enhance customer service, but risk that there will be less independence in vital risk-control functions.

B-North addressed the risk with structured staff incentives, underwriters and valuers in pods reporting to the Chief Risk Officer, external valuations with complex situations, professional accreditation of staff, and detailed central audits, especially in early stages

deals will be overviewed on a monthly basis across pods, underwriters, valuers and front lines, with, for valuations, additional external oversight provided by an independent valuation firm to ensure that market metrics are maintained. Furthermore, the core lending platform will provide granular detail on all lending transactions for head-office teams, thereby providing complete visibility and oversight of the day-to-day underwriting process in the regional pods.

- We also note that using in-house valuers in the pods means that there will not be professional indemnity (PI) insurance cover. Management highlights that PI cover only covers losses from negligence – valuers can be wrong; but, provided they have adopted a recognised and appropriate methodology, there is unlikely to be any liability. So, PI is more theoretical than real cover, and management also highlights that successful claims against a valuer's PI cover are rare, time-consuming and expensive to pursue.

Regional pods will not always be physically close to customers

Distance from customer

Historically, the risk of loss rose exponentially with the distance of the customer from the bank manager. At its heart, the local manager is much more likely to know whether a major employer is likely to close/reduce hours and especially the contagion effect this will have across a community. While modern technology means that there is much more information readily available on distant customers, we believe that, in principle, remote lending is riskier than close lending. B-North believes that the experience of lenders, combined with technology that can interface with customers' own accounting systems, reduces this risk significantly. The effectiveness of such measures will only be apparent with time.

Risk that applications will be weighted towards those who could not get finance from their bank

Risk of adverse credit selection

Slides 40 in the slide-deck accompanying BBB's 2018/2019 *Annual Small Business Finance Markets* highlighted that around 82% of applicants obtain the full finance requested from their first provider, while slide 45 indicates that just 13% talk to another provider if they do not get the full amount requested (nearly half either cancel their plans or defer finance). There is always a risk that the applications seen by any alternative lender are weighted towards those who could not get finance from their first provider (usually their own bank).

Late-cycle lending is higher-risk, as it may reflect more adverse risk selection and has less opportunity to grow security cover

Stage of cycle

The market has already seen early signs of credit deterioration. Lenders later in the cycle typically incur higher losses, as i) marginal credits should be the first declined by the banks, ii) there may be less of a track record of the business with both its customers and financials, and iii) a historical LTV may have improved with rising asset prices before any downturn. As noted above, the flipside of this may be that more perfectly good propositions are declined, as major banks' policies tighten credit across the board, and pricing may also improve.

Development finance has historically been high loss area

Some higher-risk lending products

We noted above that the expected interest rate range is 2.5%-10%. The higher end of this range reflects, in part, risk. In terms of products, these include development finance and short-term bridging facilities. We understand that the intent is to limit development finance to under 10% of the total loan book, but even at that level, a well-above-average loss rate could be visible.

Other risks

Addressing any loan origination shortfall

Summary

Multiple options to address any loan growth shortfall and systems in place to identify cause of any miss at early stage

We noted above the positive gearing that B-North is expected to see, with volume growth generating income from a platform with significant fixed costs. The flipside to this is that if, for any reason, volume growth disappoints, then there will be negative leverage. Management has a range of alternative strategies to address such a scenario and one that is driven by the root cause of any underperformance. Options include more staff, more pods, greater broker incentivisation, more marketing and potentially reviewing credit criteria (in the light of experience on loans, which have been lost but the performance of which will be tracked). Each pod's KPI review should identify whether there is a pod-specific issue. We have discussed the competitive environment, and why B-North has significant cost and service advantages over the major incumbents and challenger banks. These provide B-North with the space to take whichever option is likely to address the shortfall at the least cost. We therefore believe that the financial impact is more about the option cost than the risk of a major shortfall in volumes.

Customer inertia is reducing but is still high

Customer inertia remains relatively high and a barrier to B-North achieving full potential

The trend in customers looking for new providers is moving in B-North's favour. However, the base is very low. The 2019 BBB Small Business Finance Report⁶ noted that 47% of SMEs are permanent non-borrowers and that 34% are content with providers – leaving just 20% who may be considered B-North's target. Page 20 of that report noted that just under 10% of SMEs gave ease of application as the main reason for choosing a finance provider. Page 170 of the BVA/BDRC SME Finance Monitor Q2_2019⁷ noted that just 7% of SMEs looking to take action on funding would approach a broker (although this was 11%-12% for the larger SMEs targeted by B-North), while 19% would apply to a finance provider they were not currently using; in contrast, nearly half would apply to their bank.

Economic downturn

We noted earlier that the effect on B-North's volumes of an economic downturn is by no means certain. Lower overall demand is likely to result, but B-North may be able to offset much of this with market share gains. It is probable that investors will be more sceptical of strong growth in such circumstances.

Pod management

We noted that the rollout of pods is being carefully planned and that the lessons from earlier pods will be adopted in new ones. This does not mean that the pod rollout will be easy or risk free and any delays in that will see slower loan growth. Some of the issues which may affect this include staffing, the macro-environment, unexpected competition and operational constraints. We are encouraged that management has repeatedly stated that it would not chase volumes at compromised credit quality if loan growth disappointed because of pod management issues. It has stated that the root cause of the problem would be identified and addressed with a range of other mitigation issues.

⁶ https://www.british-business-bank.co.uk/wp-content/uploads/2019/02/British_Business_Bank_Small-Business-Finance-Report-2019_v3.pdf

⁷ http://www.bva-bdrc.com/wp-content/uploads/2019/09/BVABDRC_SME_Finance_Monitor_Q2_2019.pdf

Remedial action will depend on cause of disappointing growth. Options include more staff, more pods, greater broker incentivisation, more marketing and, as loans that are lost will also be monitored, potentially reviewing credit criteria. Each pod's KPI review should identify whether there is a pod-specific issue.

Remedial actions available to B-North

It is important to recognise that B-North's management will not merely sit and watch if volumes disappoint (within an over-riding policy set by the board, which has no appetite to chase business at heavily-discounted rates). Part of the remit of the Asset and Liability Committee will be to review the performance of every pod against a detailed set of core KPIs formally on a monthly basis. The bank will also implement weekly KPIs, so that any deviation from plan will be identified early and dealt with accordingly. While B-North is confident that it can achieve its targets (and, as noted earlier, they appear credible to us too), there are a range of options to address any shortfall. Critically, the actions would depend on the underlying root cause, with options including:

- ▶ Tweaking of credit policy and underwriting – the central team will have visibility of all transactions from initial enquiry to ultimate fulfilment. Part of its remit will be to understand the rationale for cases that have been declined, as well as reviewing approved cases. This will enable the team to assess whether i) the underwriters are being unnecessarily risk-averse, which can be addressed through training, and ii) whether certain aspects of underwriting standards are too restrictive and may need to be reviewed by the risk committee.
- ▶ The nCino platform's workflow management functionality will track every potential loan through each stage of the process, and it will be very straightforward, therefore, to see whether there are any operational bottlenecks in the lending process that need to be addressed.
- ▶ With a projected cost:income competitive advantage, B-North will have the ability to increase i) the size of its front-line teams, ii) the amount of marketing spend to build brand awareness, particularly when a new pod has been opened, and iii) broker incentives. We review the potential economic impact of these in our sensitivity sub-section in the *Financials* section of this report.
- ▶ One of the stress tests that B-North performed as part of its regulatory submission was a 100bp reduction in the NIM. In this scenario, the projected time for breakeven moved out from Year 3 to Year 4, and Year 5 profitability was reduced by £15m. This is consistent with our stress-testing in the *Financials* section of this report. While not the preferred option, it demonstrates that the bank could reduce its pricing and increase broker procurement fees to drive increases in volume, and still generate strong profitability, with the fundamental business proposition remaining valid.

Mitigation costs much lower than letting volumes slip

We review the potential financial impact of these options in the *Financials* section. In summary, they all equate to a materially lower hit to profit than letting volumes slip.

Other risks

Political risk cannot be ignored, even with the recent election result

While the election has given a degree of short-term certainty, the investment horizon to IPOs is likely to stretch over the next election. At least one party is likely to significantly increase corporation tax, has a long-standing aversion to financial services, and may introduce more borrower-friendly debt recovery.

Cyber security

Any financial institution is at risk of cyber-attack. We believe that this is compounded if the institution has extensive and close interfaces with outside parties' systems. It may be that the customer is hacked and, through this, the hacker can then access the bank's systems. We believe that B-North is fully cognizant of this risk and that its outsourcing counter-parties have the resources to ensure that the firewalls and defences are as robust as possible.

Capital

Capital raise and how to apply

To date

To date, B-North has raised £4.8m through a combination of founders/management (nearly half, with the largest individual holding under 10%) and Greater Manchester Combined Authority (GMCA), which has invested a substantial, six-figure sum; the rest of the investors are high-net-worth individuals.

2019

£2m to be raised end-2019

The current seed round top-up proposed capital raise is £2m, with 13.333m shares on offer at a price of 15p. The new shares will account for 12.5% of the new register (total shares in issue 106.7m) and give a post-raise implied valuation of £15.8m. The new shares are priced in line with existing holdings. Investors can subscribe for shares in this round on the *Growthfundrs* and *Crowdcube* platforms, which are expected to be live until the end of the year. If investors are looking to put in more than £50k, they can invest directly through contact with David Broadbent, Founder & CFO (investor@b-north.c.o.uk) or Suite 20A, Manchester One, 53 Portland Street, Manchester, M1 3LD).

1Q'20 spring

Further £20m in 1Q'20

There is expected to be a series A round of £20m to provide the initial capital to take the bank through the mobilisation phase to full authorisation and with the ability to take retail deposits. The aim of the funding is to be in place with the banking licence. Berenberg has been engaged to lead this round. The aim is to have funding in place by the end of February to support lending once the licence is received, which is likely to be in March. Terms are yet to be finalised, but the minimum ticket size is likely to be much higher than the current seed top-up issue at £0.5m+. Further details will be announced in due course.

Later in 2020

£50m later in FY'20

We expect a further capital raise of around £50m in FY'20, the terms of which will be released in due course.

Other

In our modelling, we have assumed a further £300m of equity issues through to the end of 2027. The exact timing and terms of such issues will clearly be set by the performance of the company and market conditions.

The founders and other exco members were allocated 50m of founder shares. There are no special rights attached to these, and there is only one class of shares. We discussed these shares in the section on the *Management's "skin in the game"* section earlier in this report.

Capital generation starts to exceed amount required to fund growth by end of 2027

We expect B-North on its 8-pod model to be capital self-generative by the end of 2027 and for it to declare a dividend for that year (paid in FY'28). It may decide to broaden the product range into related areas (e.g. asset finance), which would see further growth requiring capital support, and thus an initial dividend at a later stage. There is the opportunity to introduce further gearing with more Tier 2 debt, and we expect management to keep the mix of debt/equity, and relative cost, under regular review.

Capital calculations

As a new bank, B-North is subject to capital requirements that are different from an established bank. The processes and procedures are outlined on slides 47-62 of the “New Bank Start up Unit Seminar” presentation of 15 October 2019 by the FCA/PRA.⁸ These are, however, the basic principles, and company-specific buffers, wind-up costs, etc, will be considered in determining the final capital requirement. The credit risk average weighting will be driven by the business mix, but is likely to be around 80%-85%. Pillar 1 operational risk-weighted assets (RWAs) will be set at 15% of forecast year 3 income for years 1 to 3. The Operational Risk Pillar 2a Capital loading will be agreed with the PRA in the Supervisory Review and Evaluation Process (SREP process); we understand that £2m of Pillar 2a capital for years 1 to 3 will take care of implementation and system risks is the expected level. The PRA will also set a Pillar 2b capital amount, which will exceed the likely regulatory minimal requirement for the Counter Cyclical buffer (1.5%) and Capital Conservation Buffer (2%), as mandated in the EU’s Capital Requirements Directive IV (CRD IV). We understand that the combined buffers will be about the same size as the PRA Pillar 2b by the end of year 2 (so 3.5%), but higher in year 1 because the wind-down scenario is higher.

Capital buffers are calibrated to protect the firm in a severe but plausible stress scenario. Riskier business models require larger capital buffers to achieve this. ICAAP for new banks, reliant on rapid growth, should include an assessment of the capital required to wind down the business under stress.

The table below shows our forecast capital position. It again needs to be treated with caution. If B-North stays at a the four-pod model, it will need to only £189m in equity against the £379m in our eight-pod forecast. Similarly, if the bank chooses to go for slower growth, it will need to raise less. We cannot know the outcome of company-specific discussions with the regulator. Our model is also conservative in the mix of capital, and there could be an element of re-gearing through the issuance of more Tier 2 debt.

⁸ <https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/new-bank/seminar-slides-151019.pdf>

Capital calculations								
Year-end Sep (£m)	2020E	2021E	2022E	2023E	2024E	2025E	2026E	2027E
Tier 1 capital								
Share capital	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Share premium	78.9	103.9	128.9	178.9	228.9	278.9	328.9	378.9
Retained earnings & other	-6.9	-17.8	-27.0	-25.6	-12.1	19.2	64.2	122.2
Goodwill	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other intangibles	-2.5	-5.7	-8.4	-8.5	-3.6	-1.5	-1.5	-1.5
Core equity Tier 1	69.5	80.4	93.6	144.8	213.3	296.6	391.6	499.7
Tier 2								
Subordinated liabilities	0.0	0.0	25.0	50.0	50.0	50.0	50.0	50.0
Less ineligible portion				0.0	0.0	0.0	0.0	-5.0
Total Tier 2	0.0	0.0	25.0	50.0	50.0	50.0	50.0	45.0
Total capital	69.5	80.4	118.6	194.8	263.3	346.6	441.6	544.7
Total assets	15.0	100.0	470.0	1,100.0	1,925.0	2,850.0	3,700.0	4,550.0
Average weighting	85%	85%	85%	85%	85%	85%	85%	85%
Credit RWAs	12.8	85.0	399.5	935.0	1,636.3	2,422.5	3,145.0	3,867.5
Operational RWAs	11.6	11.6	11.6	21.4	71.4	121.4	171.4	221.4
Total RWAs	24.3	96.6	411.1	956.4	1,707.6	2,543.9	3,316.4	4,088.9
CET1 ratio	285.7%	83.3%	22.8%	15.1%	12.5%	11.7%	11.8%	12.2%
Total ratio	285.7%	83.3%	28.8%	20.4%	15.4%	13.6%	13.3%	13.3%
Leverage ratio	102.1%	64.0%	18.4%	12.0%	9.7%	9.0%	9.2%	9.5%

Source: B-North September 2019 Report and accounts, Hardman & Co Research

Financials

Profit and Loss

Our base case is close to B-North's. We recommend investors focus on scenarios including i) four-pod rather than eight-pod rollout, ii) option cost to address loan shortfall, iii) delayed pod rollout, iv) higher impairments, v) lower yields

In this section, we detail our assumptions, and the resulting profit and loss and balance sheet based on an eight-pod rollout by 2027. It takes approximately eighteen months for a pod to break even and we understand that the full rollout in our forecast will be contingent on the delivery of, and lessons learnt from, the initial first four pods. Our model of new pods through to 2022 depresses short-term profit with investments and delays breakeven to 2024, but it sees 2027 post-tax profits of £108.6m. Given that our review found the management's base case to be stretching but credible, it should not come as a surprise that our base case is broadly similar to theirs. We recognise that there is considerable uncertainty, and so provide investors with a range of scenarios to consider in more detail. These include:

- ▶ Our base case assumes that there will be eight pods rolled out by 2027. This is at the lower end of range that management indicates would achieve national coverage. We are encouraged that B-North has phased the rollout to ensure that the lessons from the earlier pods can be fully adopted in new ones. There are some scenarios where we could see the rollout could be delayed or cancelled (inter alia a macro economic downturn, unexpected competition, changes in intermediaries' behaviour, unexpected impairments). These do not form part of our base case expectations, but we provide investors with a scenario which only includes those pods that are currently in an advanced state of development (i.e. a four-pod model). This requires materially less equity support and sees profitability in 2023.
- ▶ Detailed consideration of the action management action could take to mitigate slower-than-expected loan growth. Our conclusion here is that the mitigation costs would be significantly below the cost of doing nothing.
- ▶ Other scenarios include a delay to the rollout plan, higher impairments and lower yields. Each downside again has credible mitigation to reduce the loss.

Our key assumptions in the eight-pod case scenario are detailed below. We have not assumed any change in the interest rate environment over this period. While lending rates would rise, as a best-buy deposit gatherer, the flexibility to manage savings rates is relatively modest.

Base-case key assumptions in eight-pod model

Year-end Sep (£m)	2020E	2021E	2022E	2023E	2024E	2025E	2026E	2027E
Yield on loans	7.00%	7.00%	7.00%	7.00%	7.00%	7.00%	7.00%	7.00%
Yield on liquidity portfolio	0.75%	0.75%	0.75%	0.75%	0.75%	0.75%	0.75%	0.75%
Cost of deposits	2.00%	2.00%	2.00%	2.00%	2.00%	2.00%	2.00%	2.00%
Cost of short-term wholesale funding	2.00%	2.00%	2.00%	2.00%	2.00%	2.00%	2.00%	2.00%
Cost of Tier 2	9.50%	9.50%	9.50%	9.50%	9.50%	9.50%	9.50%	9.50%
Fees and comms. rec. as % of loans	0.10%	0.10%	0.10%	0.10%	0.10%	0.10%	0.10%	0.10%
Impairments as % of loans	-0.25%	-0.30%	-0.35%	-0.40%	-0.50%	-0.35%	-0.30%	-0.25%
Loan book by pod (£m)								
Manchester	0.0	30.0	125.0	225.0	375.0	450.0	550.0	625.0
Leeds	0.0	20.0	75.0	150.0	275.0	400.0	475.0	550.0
London	0.0	20.0	100.0	250.0	350.0	500.0	625.0	750.0
Midlands	0.0	10.0	50.0	125.0	225.0	350.0	450.0	575.0
Pod 5		10.0	50.0	125.0	225.0	350.0	450.0	575.0
Pod 6		10.0	50.0	125.0	225.0	350.0	450.0	575.0
Pod 7			10.0	50.0	125.0	225.0	350.0	450.0
Pod 8			10.0	50.0	125.0	225.0	350.0	450.0

Source: Hardman & Co Research

We have assumed a macroeconomic environment in line with consensus, i.e. slower-than-expected long-term growth, but no major downturn. Our key assumptions are:

- ▶ **Volumes:** the growth we estimate for each pod is in the table above. We discuss below the sensitivity to volume growth, which is a key driver to profitability. As can be seen, the pods are expected to have a phased introduction with the latter ones only starting once the model has been proved in the initial pods. At this stage, we expect no cannibalisation between pods.
- ▶ **Margin:** the margin forecast variables include i) a mix of high-yield, high-risk assets (e.g. development loans) compared with low-risk, low-yield assets (e.g. buy-to-let), ii) a change in mix between liquid assets and loans, iii) pre-payment rates that are likely to be greater in high-risk products, while there will be greater persistence in amortising loans (commercial loans, buy-to-let), iv) a proportion of funding in higher-cost Tier 2 debt – likely to be in lumpy blocks and, in our numbers, in years 2 and 4, v) a proportion of funding from non-interest-bearing equity – initially high and then falling, and vi) a duration of saving products/swaps, with five-year funding being up to 30bps-40bps higher than in one year. In initial periods, the timing of drawdowns may also be a factor in the NIM reported in any year.
- ▶ **Costs:** for each branch, there is an investment upfront, with profitability expected 12-18 months after launch. We have assumed heavy central costs in the first few years, associated with the start-up expenses, capital raises and professional fees.
- ▶ **Impairments:** we assume that credit will gently deteriorate for the initial years of the forecast period, before showing some improvement. This is based off the macroeconomic outlook, rather than any material correction. In later years, more reasonable economic growth would allow a more balanced IFRS9-weighted probability, rather than one weighted to the downside. Other key variables will include mix and how successful B-North's plans are once put into practice.

Profit & Loss – base-case, eight-pod scenario									
Year-end Sep (£m)	2019	2020E	2021E	2022E	2023E	2024E	2025E	2026E	2027E
Interest receivable	0.0	0.5	4.3	20.3	55.8	107.6	169.8	233.0	293.4
Interest payable	0.0	0.0	-0.4	-5.8	-18.4	-34.9	-53.6	-72.3	-89.8
Net interest income	0.0	0.5	3.9	14.5	37.4	72.7	116.2	160.7	203.6
Fees and commissions	0.0	0.0	0.1	0.5	1.1	1.9	2.9	3.7	4.6
Operating income	0.0	0.5	4.0	15.0	38.5	74.6	119.1	164.4	208.2
Impairments	0.0	0.0	-0.2	-1.0	-3.1	-7.4	-8.9	-10.1	-10.7
Costs	-2.9	-7.0	-18.0	-28.3	-36.0	-41.3	-45.5	-47.8	-52.0
Pre-tax profit	-2.9	-6.5	-14.2	-14.3	-0.6	25.9	64.7	106.5	145.4
Tax	0.3	1.2	2.7	2.7	0.1	-4.9	-12.3	-26.4	-36.9
Post-tax profit	-2.6	-5.3	-11.5	-11.5	-0.5	21.0	52.4	80.2	108.6

Source: B-North September 2019 Report and Accounts, Hardman & Co Research

The balance sheet is driven by the loan assumptions above. We assume that retail deposits will account for ca.70% of the balance sheet over the medium term, with a couple of modest Tier 2 issues (£25m each in years 2 and 4) and the creation of a liquidity portfolio (ca.13% of total assets), which will have a modest drag effect on earnings.

Balance sheet – base case eight-pod model

@30 Sep (£m)	2019	2020E	2021E	2022E	2023E	2024E	2025E	2026E	2027E
Intangibles	0	1	2	2	2	2	2	2	2
Fixed assets	0	1	2	2	2	2	2	2	2
Loans (over one year)	0	12	80	376	880	1,540	2,280	2,960	3,640
Total non-current assets	0	14	83	379	883	1,543	2,283	2,963	3,643
Trade and other receivables	0	1	4	8	12	16	20	24	28
Cash/central bank/loans to banks/debt sec.	1	55	28	72	167	292	431	559	687
Loans (under one year)	0	3	20	94	220	385	570	740	910
Total current assets	1	57	52	174	399	693	1,021	1,323	1,625
Total assets	2	73	135	553	1,282	2,236	3,304	4,286	5,268
Trade and other payables	0	1	4	8	12	16	20	24	28
Deposits (under one year)	0	0	6	165	385	674	998	1,295	1,593
Financial liabilities (ST interbank lines)	0	0	32	89	297	529	838	1,074	1,296
Total current liabilities	0	1	42	262	694	1,219	1,856	2,393	2,917
Deposits (over one year)	0	0	6	165	385	750	1,100	1,450	1,800
Financial liabilities (Tier 2)	0	0	0	25	50	50	50	50	50
Total non-current liabilities	0	0	6	190	435	800	1,150	1,500	1,850
Net assets	1	72	86	102	153	217	298	393	502

Source: B-North September 2019 Report and Accounts, Hardman & Co Research

Scenario testing

Investors should consider a range of scenarios

Given the macro uncertainties, we believe base-case forecasts need to be treated with extreme caution. Investors must consider a range of sensitivities and what management action may be in the event of these scenarios. For example, we do not believe the cost of mitigating an unexpected loan growth shortfall would be anything like as great as letting the shortfall continue.

Four-pod rollout by 2027

Opening fewer pods sees lower short-term investment and accelerated breakeven, but substantially lower long-term profits

Not unsurprisingly, the key messages from this scenario are i) short-term profits are accelerated with less investment in the new pods, ii) it takes one year less to reach profitability, iii) the equity required to fund growth is materially lower and iv) longer-term profits are sharply lower. We discuss the valuation implications in the section below – while the group will be much smaller, the multiple return on total capital issued is broadly similar. For modelling this scenario, we do not expect material cannibalisation and that the overall structure of the balance sheet will not be materially different.

Profit & Loss in four-pod scenario

Year-end Sep (£m)	2019	2020E	2021E	2022E	2023E	2024E	2025E	2026E	2027E
Interest receivable	0.0	0.5	3.9	15.6	39.2	70.3	104.0	135.2	163.6
Interest payable	0.0	-0.3	-1.2	-7.3	-14.2	-25.5	-35.1	-43.9	-52.2
Net interest income	0.0	0.2	2.7	8.4	25.0	44.8	69.0	91.3	111.4
Net fees and commissions	0.0	0.0	0.1	0.4	0.8	1.2	1.7	2.1	2.5
Operating income	0.0	0.2	2.8	8.7	25.7	46.0	70.7	93.4	113.9
Impairments	0.0	0.0	-0.1	-0.8	-2.2	-4.9	-5.1	-5.7	-5.8
Costs	-2.9	-5.6	-16.0	-19.3	-22.0	-24.5	-27.0	-29.5	-32.0
Pre-tax profit	-2.9	-5.4	-13.4	-11.3	1.5	16.5	38.5	58.2	76.1
Tax	0.3	1.0	2.5	2.1	-0.3	-3.1	-7.3	-13.3	-18.2
Post-tax profit	-2.6	-4.4	-10.8	-9.1	1.3	13.4	31.2	44.9	58.0
Base-case post-tax profit	-2.6	-5.3	-11.5	-11.5	-0.5	21.0	52.4	80.2	108.6

Source: B-North September 2019 Report and Accounts, Hardman & Co Research

Balance sheet changes

@ 30 Sep (£m)	2019	2020E	2021E	2022E	2023E	2024E	2025E	2026E	2027E
Loan book	0.0	15.0	80.0	350.0	750.0	1,225.0	1,700.0	2,100.0	2,500.0
Reduction against base case	0.0	0.0	20.0	120.0	350.0	700.0	1,150.0	1,600.0	2,050.0

Source: B-North September 2019 Report and Accounts, Hardman & Co Research

With a loan book of £2.5bn by end-2027 in the four-pod scenario, we estimate that this would be ca1% market share of the target. It also requires in our model £189m of equity issuance against the £379m in our base-case eight-pod model.

Management mitigation in the event of lower loan volumes

We have taken an extreme view to demonstrate the point about the importance of management action. All else being equal, if loan growth were to halve, the operational gearing is such that 2027 forecast profits would be £36m rather than the £109m in our base case, i.e. a fall of 67%. Action to reduce this loss could include:

- ▶ more front-line staff – £1m could allow an extra four (relatively junior) employees per pod;
- ▶ increasing direct marketing expenses;
- ▶ paying brokers an incremental 20bps for all outstanding loans – the cost in 2027 would be £5m, a tenth of the fall in profits if volumes disappointed; and
- ▶ opening more pods, to get to the upper end of the national coverage range of eight to 10 offices – as discussed earlier, this would see an upfront cost for a bigger, later benefit.

Sensitivity analysis for lower loan volumes

Year-end Sep (£m)	2019	2020E	2021E	2022E	2023E	2024E	2025E	2026E	2027E
Base-case post-tax profit	-2.6	-5.3	-11.5	-11.5	-0.5	21.0	52.4	80.2	108.6
Scenario post-tax profit	-2.6	-5.3	-12.6	-16.9	-15.2	-6.8	7.2	23.3	35.9
Change before management action	0.0	0.0	-1.1	-5.4	-14.7	-27.8	-45.2	-56.8	-72.7
% change	0%	0%	10%	47%	2,939%	-133%	-86%	-71%	-67%

Possible management mitigation

Extra 20bps of outstanding loans as broker commissions	0.0	0.0	-0.2	-0.9	-2.2	-3.9	-5.7	-7.4	-9.1
--	-----	-----	------	------	------	------	------	------	------

Source: B-North September 2019 Report and Accounts, Hardman & Co Research

Delayed rollout

This scenario assumes that the revenue rollout is delayed by one year. This could happen for a range of reasons, including a delay in regulatory approval or problems finding staff/appropriate premises. The effect is a delay in moving to profitability but the group remaining very profitable in later years. As noted above, there are significant options open to management to accelerate loan growth at a much lower cost than simply sitting back and watching the delay happening.

Sensitivity analysis for loan growth delayed by one year

Year-end Sep (£m)	2019	2020E	2021E	2022E	2023E	2024E	2025E	2026E	2027E
Base-case post-tax profit	-2.6	-5.3	-11.5	-11.5	-0.5	21.0	52.4	80.2	108.6
Scenario post-tax profit	-2.6	-5.3	-13.5	-20.2	-19.2	-5.8	19.1	49.0	78.1
Change before management action	0.0	0.0	-2.0	-8.7	-18.7	-26.8	-33.3	-31.2	-30.5
% change	0%	0%	14%	43%	97%	459%	-174%	-63%	-39%

Source: B-North September 2019 Report and Accounts, Hardman & Co Research

Higher impairments

As can be seen in the table below, the importance of impairments as a percentage of the profit and loss changes significantly over time. Accordingly, the sensitivity of the group to changes in impairments will also vary. If we take 2027 as a near-mature base case, impairments are just 7% of profit and, so, even if they were to double, the profit and loss sensitivity would be small.

Sensitivity analysis for higher impairments

Year-end Sep (£m)	2019	2020E	2021E	2022E	2023E	2024E	2025E	2026E	2027E
Base-case pre-tax profit	-2.9	-6.5	-14.2	-14.3	-0.6	25.9	64.7	106.5	145.4
Base-case impairments	0.0	0.0	-0.2	-1.0	-3.1	-7.4	-8.9	-10.1	-10.7
Impairments as % of pre-tax profit	0%	0%	1%	7%	539%	-28%	-14%	-9%	-7%

Source: B-North September 2019 Report and Accounts, Hardman & Co Research

Lower yield

The table below shows the impact of a 10bp fall in the yield. Once the business is established, the impact is ca.3% of profit. If the fall in the yield were driven by a lower-risk profile, part of this could be expected to be offset by slightly smaller provisions.

Sensitivity analysis for 10bp fall in yield

Year-end Sep (£m)	2019	2020E	2021E	2022E	2023E	2024E	2025E	2026E	2027E
Base-case post-tax profit	-2.6	-5.3	-11.5	-11.5	-0.5	21.0	52.4	80.2	108.6
Scenario post-tax profit	-2.6	-5.3	-11.5	-11.7	-1.1	19.8	50.4	77.8	105.5
Change before management action	0.0	0.0	0.0	-0.2	-0.6	-1.2	-2.0	-2.4	-3.1
% change	0%	0%	0%	2%	55%	-6%	-4%	-3%	-3%

Source: B-North September 2019 Report and Accounts, Hardman & Co Research

Valuation

Summary

Given the uncertainties, investors should consider multiple valuation approaches and not rely on a single number. On our base case earnings and applying only average multiples, the 2027 valuation imply a value ca.3x the total capital raised. Early investors may expect to see higher returns commensurate with their greater risk.

Using our P/E multiple approach, where the 2027 value is £1,303m, the impact of a range of other scenarios is i) if investors value the expected growth at 15x, the value is £1.6m, iii) on a four-pod model, the value is £580m, 3.1x the equity raised for that scenario; and iv) management action to offset delayed loan growth could reasonably see £120m+ downside.

We provide investors with a range of valuation methodologies, noting again that a number of scenarios should be considered – not just one. The closest quoted peers are currently trading on an average historical P/E of ca.11.2x and 1.7x price/book value (P/BV). Unquoted peers are trading at much higher multiples of prospective returns (some remain significantly loss-making). Applying a multiple of 12 to our 2027 forecasts indicates a valuation of £1.3bn, more than 3.4x the equity raised (£378m). A Gordon Growth Model (GGM), on our assumptions, would suggest a P/BV of ca.2.2x or a 2027 valuation of £1.1bn (2.9x cumulative equity issued). In our dividend discount valuation model (DDM), we assume a modest initial payout ratio in 2027 (30%), before rising to 66% for most of the 20-year model. With growth fading down to 5% p.a. by 2031, and discounting the implied dividends at an 11% cost of capital and with a 12x terminal value implies a valuation of £973m (2.6x cumulative equity issued). We would expect the initial equity investors, who have taken more risk, to be rewarded by higher returns than average.

In terms of scenario analysis, there is not only a wide variance between valuation methodologies, but other assumptions can be hugely important. These include:

- ▶ **Time:** With a business whose profits are growing rapidly, applying an earnings multiple sees a rapid growth in valuation. Applying a multiple of 12 to our 2025 forecasts indicates a valuation of £629m, £962m in 2026 and £1,303m in 2027.
- ▶ **Multiple:** It may be argued that a business where investors are confident of growth would attract a higher earnings rating. Applying a multiple of 15 to our 2027 earnings sees the value rise from £1,303m to £1,628m.
- ▶ **Number of pods:** If we use our four-pod model, rather than the eight-pod model, applying a multiple of 10 to 2027 earnings (lower growth seeing a lower multiple than the base case) sees a valuation of £580m, instead of £1,303m. This still represents 3.1x the equity issued which is materially lower given less loan growth.
- ▶ **On the downside,** a delay of one year in lending at 12x earnings would see a valuation of ca.£1bn in 2027. If, as we believe and detail in the financial sections above, management would take action to mitigate slower loan growth, the cost of this action was £10m post-tax per year, this would knock £120m off the valuation, less than a third of the value lost from slower growth. It would still leave the 2027 value in excess of 3x the equity raised.

Peer comparisons

As noted earlier, the valuation below should only be regarded as indicative. There is a broad range across the peers.

Quoted peers

In the table above, we give some of the valuation metrics for quoted banks that may be regarded as broadly comparable to B-North. As can be seen, these indicate an average P/E based on the last reported earnings (i.e. historical) of 11.2x and a P/BV of 1.7x (1.3x excluding PCF). For completeness, we have included some other banks in this space, although, for company-specific reasons, we do not believe them to be truly comparable.

Peers trading on 11.2x historical P/E and 1.7x book value

Some valuation metrics for potentially comparable banks

Multiple	Mkt cap (£m)	P/E (x)	P/BV (x)	Comment
Close Bros (CBG)	2,318	12.2	1.6	Includes elements of non-banking business
One Savings Bank (OSB)	1,788	7.9	1.2	Recently merged with Charter Court Financial Services
Paragon (PAG)	1,254	10.8	1.1	Also has personal lending business
PCF	84	14.8	3.3	Small but growing strongly
Secure Trust Bank (STB)	270	10.2	1.1	Multiple lines of business
Average		11.2	1.7	
Arbuthnot Banking Group (ARBB)	2,616	n/m	0.5	ABG is still deploying capital generated from the partial sale of its Secure Trust stake, and rapid earnings growth is expected in future years
Virgin Money (VMUK)	343	n/m	0.2	Different core target market
Metro Bank (MTRO)	183	36.3	0.9	Issues include regulatory problems and potential for litigation, as well as lost confidence in model/management

Source: London Stock Exchange, Accessed cob 13/12/19, Hardman & Co Research

Unquoted peers

The valuations for the unquoted companies have been taken largely from press reports following capital raises. To give some sense of comparability, we have included the most recent earnings from these businesses.

OakNorth last valued at \$2.8bn, with profits of £27m in 2018

- OakNorth: In February 2018, SoftBank provided \$390m of a \$440m capital raise into OakNorth, which, at that time, would have given a value of \$2.8bn (£2.2bn) for the company. A Reuters article reported a value of \$2.3bn (pre that raise). OakNorth reported post-tax profit of £26.6m in 2018 (£9.5m in 2017) and, by end-2018, it had achieved cumulative profits of £31.1m.

Loss-making Tide valued at £176m-£265m

- Tide is not a bank: The Tide current account is an e-money account provided by Prepay Solutions (PPS), which holds an e-money licence from the FCA and must comply with its rules on capital and safeguarding. Tide also holds an FCA licence as a credit broker, and has teamed up with iwoca for credit. In the year to May 2018, Tide lost £7m (2017: £2m). On 7 October, *AltFi reported* a valuation on Tide of £200m. *Tech Nation* indicates a valuation range of £176m-£265m.

iwoca valued at £267m and loss-making

- iwoca: In its March 2019 report and accounts, Augmentum FinTech valued its 2.8% stake in iwoca at £7.5m, indicating a valuation of £267m. In 2018, the business reported a post-tax profit of £1.3m (2017 loss of £2.6m and cumulative losses to end-2018 of £14.8m).

Monzo valued at £2bn and significantly loss-making

- For completeness, we also include Monzo, although, in our view, this is being valued as a technology business – not a bank. This non-SME digital bank was reported in the *Financial Times* (24 June 2019) as having a valuation of £2bn, after raising £113m and doubling since its capital raise eight months before. The post-tax loss for the year was £47m (2017: £31m), bringing cumulative losses to £86m.

P/E-based

Valuation based off range of P/Es and eight-pod model				
Year-end Sep (£m)	2024E	2025E	2026E	2027E
Value at 8x P/E	168	419	641	869
Value at 10x P/E	210	524	801	1,086
Value at 12x P/E	252	629	962	1,303
Value at 15x P/E	315	786	1,202	1,628

Source: Hardman & Co Research

12x earnings sees implied value of £1.3bn in 2027E, 3.4x cumulative equity raised

15x rating puts 2025E value at £1.6bn

The table above shows the implied value for B-North across a range of valuation years and with a range of P/E multiples. It may be argued that B-North should trade on a premium to the quoted peers identified above because of its growth prospects (FY'26E post-tax profits up 53% on FY'19 and FY'27E up 35% on FY'26E).

Gordon Growth Model (GGM)

We believe the GGM recognises well both the growth prospects and value added by a business. In essence, it looks at whether a business is adding value over its cost of capital and whether a growing, profitable business has more value than a stable one. The calculation is: price to book value (P/BV) = (return on equity (RoE) – Growth (G))/(cost of equity (CoE) – Growth (G)). Thus, if a business earns a 15% RoE, has a 10% CoE and is growing at 5% p.a., it should trade at a 2x P/BV (i.e. (15-5)/(10-5)). All of the return, costs and growth assumptions should be long-term, sustainable measures, and there can be an adjustment when short-term performance differs from the long-term assumptions.

GGM and key sensitivities				
	Base	+1% RoE	+1% CoE	+0.5% G
RoE	15	16	15	15
CoE	11	11	12	11
G	5	5	5	5.5
P/BV (x)	1.7	1.8	1.4	1.7
Discount/premium re near-term performance	33%	33%	33%	33%
P/BV (x)	2.2	2.4	1.9	2.3
BV Sep 2027 (£m)	501.5	501.5	501.5	501.5
Valuation (£m)	1,111.6	1,222.8	952.8	1,152.1
Variance (£m)		111.2	-158.8	40.4

Source: Hardman & Co Research

B-North's assumptions: RoE 15% (i.e. below levels of 2025-27E), CoE 11%, growth 5%. With premium for short-term performance implies value of £1.1bn in 2027, which is 2.9x cumulative equity issued

Taking B-North, we estimate 2027 equity at £502m. In that year, we are forecasting RoE of 24% (after 20% in 2025 and 23% in 2026). Over the long term, we believe that B-North will be cost-efficient, with competitive advantages over mainstream banks, and that its long-term sustainable profitability should thus be above what major banks can achieve, albeit below the level expected for 2025-27. We have therefore used 15% as a base case. The CoE for a new provider is likely to be above-average, and hence we have assumed 11%. We have assumed 5% long-term sustainable growth – logically, a business should not be able to grow above the growth in the market over the long term, but we believe some recognition should be given in this assumption to the growth prospects for the next 10 years. These assumptions imply that B-North should trade at 1.7x P/BV. Given that there would be further short-term outperformance against these assumptions in both RoE and G, we have assumed a nominal 33% premium to this long-term rating.

First dividend declared in 2027. Assuming two-thirds dividend payout ratio in medium term implies value of £973m, 2.6x cumulative equity issued.

Dividend Discount Model (DDM)

For modelling purposes, we have assumed that equity will be retained to fund growth until 2027 (we understand that this is in line with management expectations). Assuming i) a relatively low 30% payout ratio in 2027/2028, ii) this then rising to a sustainable level of 66% (RoE 15%, funding growth 5%), and iii) growing the dividend at 15% p.a. in 2028-30 implies that there will be a £32m dividend declared in 2027, rising to £37m in 2028, £93m in 2029 and £107m in 2030. We then grow this by 5% for a further 15 years to 2045, applying a multiple of 12 to the 2046 dividend. Then discounting it all back at an 11% CoE implies a value of £973m (of which 27% is in the terminal value). In terms of sensitivity, a 50% sustained payout ratio would see the value cut to £750m, an 11.5% discount rate would see the value reduced to £700m, and a cut in growth to 4% would see the value also at £905m (although such a fall would actually justify an increase in the payout ratio, as less equity would need to be retained to fund growth).

Company matters

Registration

Incorporated in the UK under the name Commercial and Northern Ltd, with company registration number 11030672

Board of Directors/Management

Ron Emerson, CBE – Non-executive Chairman

Ron was the founding Chairman of the BBB (BBB), the UK government's economic development bank aimed at improving access to finance for the small and mid-sized business sector. During his three years at the helm of BBB, the bank mobilised around £7bn of new money for this sector, funded more than 40,000 new start-ups and worked with more than 80 new partners to provide finance from debt to equity, and delivered the Northern Powerhouse and Midlands Engine funds totalling in excess of £600m. He was awarded a CBE in 2017 for services to International Banking and the financing of small and mid-sized businesses. A long career in banking has included a period as a Senior Banking Advisor at The Bank of England, including the UK regulator, which was combined with a number of diverse NED roles, and 20 years as a member of the Faculty of Management Studies at Oxford University.

Jonathan Thompson – Founder & Chief Executive Officer

Jonathan is a professionally qualified banker with 26 years' experience, gained in established and challenger UK banks, having additionally worked in corporate finance and capital advisory as a Director for Deloitte. The majority of his career has been spent in business, commercial and corporate banking and prior to founding B-North, he was with one of the UK's leading scale challenger banks, Santander, where he was a Divisional Managing Director in its business and commercial bank.

Dave Broadbent – Founder and Chief Financial Officer

David is a prize-winning Chartered Accountant who has nearly 20 years of financial services experience in international regulated markets, having served as CFO and CCO of IPF, a FTSE 250 provider of consumer finance. He was a member of the executive management team that developed the business from start-up to IPO. He was also instrumental in the establishment of IPF's Digital Lending Division. He has an MBA and graduated from Harvard Business School's Advanced Management Programme.

Craig Iley – Non-Executive Director

Craig is a professionally qualified career banker with 36 years' experience gained in front and back office roles including credit and risk; both in the UK and Spain. With his strong emphasis on commercial banking, he was also a founder and MD for Business Banking of Atom a UK challenger bank established in 2014.

Robin Churchouse – Independent Non-Executive Director

Robin is an independent non-executive director and Chair of B-North's Board Risk Committee. He has over 30 years' financial services experience in leading finance, risk, operational and strategic planning teams in a wide range of regulated financial services organisations. After studying law at Cambridge, he qualified as a chartered accountant with Price Waterhouse, spent some time as a financial services regulator and then as a strategy consultant with KPMG. Following that he worked as finance and commercial director for a number of mortgage servicing companies before holding a variety of senior executive roles from 2004 to 2017 at the Yorkshire Building Society Group as CFO principally but also covering operational and risk roles.

Robin is also a non-executive director at Belmont Green Finance who specialise in non-standard residential mortgage lending, where he chairs the Board Audit Committee.

Jon Hogan – Non-Exec Director

Jon, one of the B-North founders, is a chartered accountant with over 20 years' of executive and non-executive experience in international financial services, who has had significant NED exposure to UK banking start-ups in the last 8 years. He was a member of the main board and risk and audit committees and chaired the Remuneration Committee at Atom Bank, one of the UK's first successful "fintechs", for its first 4 years, through build, licencing and launch. Prior to this, he was a NED and audit/risk member at ING Australia, a large wealth management conglomerate, in Sydney for 4 years. Previous executive roles include CFO of ANZ Australia, one of Australia's "big 4", and he was also CFO, COO and Deputy CEO at first direct bank, part of the HSBC UK business. Jon is also currently on the board of Zopa Bank, a London based fintech start-up bank.

Nancy Butler – Founder & Commercial Director

Nancy has over 36 years' experience in business/commercial banking with a strong focus on business development and is well respected by intermediaries. She has vast knowledge of the intermediary market and lead generation and was RBS's top performing regional BDM for 7 consecutive years and best in the UK for 3 years. At A&L and Santander Commercial, she was the top performing Relationship Director in the UK. Recently, she spent time building a new brand in the marketplace for Atom Bank.

Richard Baker – Founder & Products Director

Richard is a start-up bank specialist with 30 years in technology and operational leadership, including at First Direct and HSBC's UK Direct Banking division. He has deep knowledge of the regulatory approval process, was the programme director behind the launch of Metro Bank and has advised several start-up banking businesses. More recently, he was part of the team that built and launched technology-led challenger bank, Atom Bank. He has an MBA, an MSc in AI and an Honours degree in computing.

Keith Ollier – Chief Risk Officer (Designate)

Keith is a qualified banker with vast experience across Retail & Business banking in his 40-year career at HSBC and CYBG. During this time, amongst other things, he was responsible for setting up new roles and products, including a new SME digital lending platform. As Head of Business Credit at CYBG he integrated four teams and expanded into two new areas (Participations and S&FI), also streamlining Credit Policies & Processes coupled with greater empowerment of the underwriting and front-line teams.

Appendix

Bank authorisation process

Since 2013, the regulators have had 110 initial meetings, with companies seeking a banking licence, of which 31 have led to applications, and 19 firms have received authorisation (six doing SME lending, five retail digital banking, four specialist retail lending, one private banking, and three in other areas). It usually takes 12-24 months from the initial meeting to reach the application stage (B-North did this in 16 months). During this time, the regulator reviews all the business models, financial plans, staff, etc., addressing key questions, such as i) how the company plans to become profitable, ii) what the key risks and harms are, iii) how it will identify and mitigate these risks and harms, and iv) the priority areas on which to focus. By way of example, we have seen the comprehensive submission on pod risk management, which is, as may be expected, detailed on the nature of the risk, how management information will monitor exposure and identify risk, and the management and controls that will be put in place, including multi-layered limits.

Having submitted the application in September 2019, B-North is hopeful of getting its banking licence in 1Q'20 (again, this appears faster than average, as this stage often takes up to a year, which again could reflect the quality of its application, proposition and staff).

On receiving its banking licence, B-North will enter a voluntary "mobilisation" phase. This will give it the opportunity to build the bank as an authorised institution, including attracting more investment, further developing IT and recruiting individuals. This means that systems can be tested live, rather than through the helpful but only theoretical case studies run through brokers previously. At this stage, B-North will start lending, but it will not take retail deposits (the initial lending is funded by equity and a warehouse-secured bank line facility). To exit mobilisation and move to full operations, B-North will have to submit to regulators i) a credible exit plan and board attestation that the bank is ready to exit, ii) proof of capital coverage for the next 12 months, iii) a credible recovery plan, and iv) a plan for how systems and controls are expected to develop. We do not expect any of these to be problematic, and the company's target is to be fully operational and so take deposits in 4Q'20.

Notes

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).

No part of this document may be reproduced, stored in a retrieval system or transmitted in any form or by any means, mechanical, photocopying, recording or otherwise, without prior permission from Hardman & Co. By accepting this document, the recipient agrees to be bound by the limitations set out in this notice. This notice shall be governed and construed in accordance with English law. Hardman Research Ltd, trading as Hardman & Co, is an appointed representative of Capital Markets Strategy Ltd and is authorised and regulated by the FCA under registration number 600843. Hardman Research Ltd is registered at Companies House with number 8256259.

(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.

