Secure Trust Bank

Pre-close trading update

Controlled growth

Financial services

Secure Trust Bank (STB) remains on track with both its shift towards a lower risk loan book and near-term trading. The move to lower risk assets has trimmed returns, but loan book growth continues apace and the benefits in terms of revenue and impairments should become clear in FY18 and FY19, years in which we expect earnings growth of over 30%.

Year end	Revenue (£m)	PBT* (£m)	EPS* (p)	DPS** (p)	P/E (x)	Yield (%)
12/16	118.2	32.9	137.7	75.0	13.0	4.2
12/17e	136.5	30.7	132.8	79.0	13.5	4.4
12/18e	161.7	40.5	174.2	83.0	10.3	4.6
12/19e	182.2	55.5	234.4	90.0	7.6	5.0

Note: *PBT and EPS on an underlying basis, excluding amortisation of acquired intangibles, exceptional items and share-based payments. **2016 DPS ex 165p special dividend.

Pre-close update

STB reported that Q4 trading was in line with management expectations and that FY17 results are likely to be similar to market estimates. The bank has continued the strategic repositioning of its loan book to a lower-risk profile through a move away from unsecured consumer, subprime motor and large prime central London housebuilding lending. As previously announced, the exit from unsecured personal lending was completed in December with the sale of the remaining portfolio, generating a profit of c £0.5m and net proceeds of c £36.6m. The level of impairments is not mentioned, indicating a stable situation ahead of the expected improvement as the benefits of the changes in the book flow through from FY18. Growth in the Retail, Motor, Mortgage and SME lending balances has continued in a controlled (but still brisk) manner.

Outlook: Looking for organic and M&A growth

While STB takes a cautious view on the balance of risk and reward prevailing in parts of the market, it continues to find attractive opportunities to grow its retail, motor, mortgage and SME (including real estate and invoice financing) loan books. Reflecting STB's size, surplus capital and its ability to address parts of the market outside the focus of the large banks, our estimates assume loan book growth of more than 20% per annum between 2017 and 2019. M&A remains under consideration, with one option being a book acquisition to accelerate the scaling up of the mortgage business employing the personnel and systems already in place.

Valuation

We have not changed our estimates so, on the same assumptions, our dividend discount model gives an unchanged value of c 2,300p, which would imply an FY18e P/E of 13.2x and a P/NAV of 1.8x. This does not appear stretched in view of the potential for further growth and improving returns as STB employs its surplus capital while realising the benefits from the reshaping of its loan book.

23 January 2018

Price	**1,790p**
Market cap	**£331m**
Net debt/cash (£m)	N/M
Shares in issue	18.5m
Free float	79.9%
Code	STB
Primary exchange	LSE
Secondary exchange	N/A

Share price performance

%	1m	3m	12m
Abs	(0.4)	(4.4)	(23.0)
Rel (local)	(1.9)	(6.8)	(29.0)
52-week high/low		2455p	1625p

Business description

Secure Trust Bank is a well-established specialist bank addressing niche markets within consumer and commercial banking. It is launching a non-standard mortgage business. Former parent Arbuthnot Banking Group's shareholding is now less than 20%.

Next events

FY17 results	22 March 2018

Analysts

Andrew Mitchell +44 (0)20 3681 2500

Martyn King +44 (0)20 3077 5745

financials@edisongroup.com

Edison profile page

Secure Trust Bank is a research client of Edison Investment Research Limited

Other points from the trading update

STB notes that it has made further progress on preparing implementation of IFRS 9 (applies from FY18 onwards). At the H117 stage STB reported that it had systems in place to deal with the new standard and has been dual running old and new approaches. Since then regulatory and transitional arrangements have been clarified.

As a reminder, while underlying cash flows will not be affected, IFRS 9 introduces significant changes to disclosure and recognition of credit losses. The standard divides financial instruments into three stages of credit quality. In the first, performing category a 12-month expected credit loss will be recognised while for the second and third stages, comprising exposures where there has been a significant increase in credit risk or those where there is objective evidence of deterioration, an estimate of expected lifetime credit losses will be made. This is expected and intended to bring forward the recognition of credit losses. While this may smooth loss recognition, the new accounting could give rise to lumpiness in provisioning where loans move in and out of the category in which a lifetime assessment is made and at turning points in the economic cycle.

STB also references the changes to Basel III capital regulations agreed in December. Among the changes will be lower risk weightings on mortgages on the standardised approach and progressively increased minima for the internal ratings-based approach from 2022. This should be positive for STB's competitive position but clearly the benefits will take time to arrive.

Recent PRA and BoE commentary

Coincidentally, the Prudential Regulatory Authority (PRA) issued a statement on its review of consumer credit on the same day as STB's trading update. The focus of the PRA's work was on areas such as interest-free offers on credit cards that do not affect STB, but its concerns on possible market excesses in some areas are in tune with STB's own view. Interestingly, the PRA reports that it has seen evidence of a tightening in lending criteria and uptick in consumer loan pricing. Also, it sees signs of a less obvious adoption of assumptions that make greater allowance for the possibility of an economic downturn.

The latest Bank of England (BoE) Credit Conditions Survey (Q417) also talks about significantly reduced availability of unsecured consumer credit, a contraction which participants expected to continue in the current quarter.

In time these changes could reopen opportunities for STB, but for the moment can be seen as validating its repositioning.

Valuation

Our comparative valuation table (below) includes a selection of challenger banks and specialist lenders. Shawbrook is no longer in the list following completion of the takeover by private equity funds advised by Pollen Street Capital and BC Partners (on a multiple of c 2x FY16 NAV). Aldermore still features prior to completion of the recommended offer from FirstRand (at 313p – again on c 2x FY16 NAV).

Exhibit 1: Challenger/specialist lender comparative table

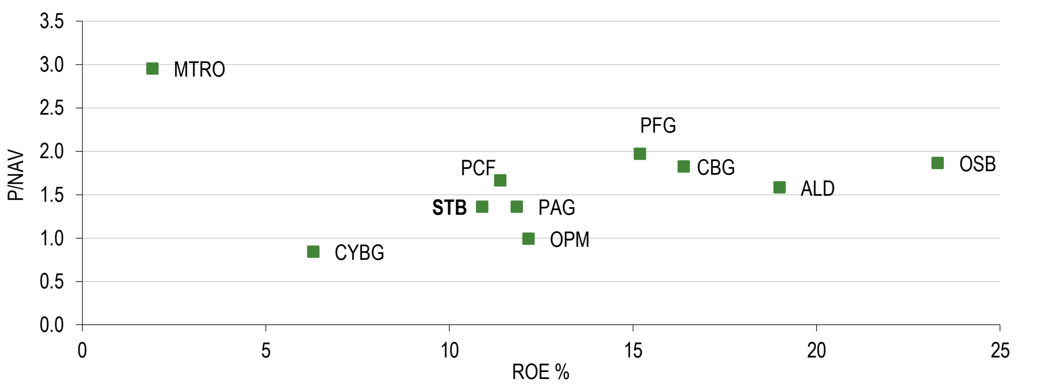
	Price (p)	Market cap (£m)	2018 P/E (x)	Yield (%)	ROE (%)	Price to NAV (x)
Secure Trust Bank	**1,790.0**	**330.7**	**10.3**	**4.2**	**10.9**	**1.4**
1PM	51.0	43.9	7.0	0.0	12.2	1.0
Aldermore	311.6	1,074.8	9.7	0.0	19.0	1.8
Close Brothers	1,467.0	2,221.2	10.9	4.1	16.4	1.8
CYBG	326.8	2,892.4	12.7	0.0	6.3	0.8
Metro Bank	3,670.0	3,247.1	50.3	0.0	1.9	3.0
OneSavings Bank	408.6	994.8	7.9	2.6	23.3	1.9
Paragon	514.0	1,355.5	10.4	3.1	11.8	1.4
Private and Commercial Finance	26.2	55.6	9.8	0.0	11.4	1.6
Provident Financial	1,790.0	330.7	10.3	4.2	10.9	1.4
S&U	2,300.0	275.8	11.2	1.7	15.2	1.9
Average			**10.0**	**1.6**	**12.8**	**1.7**

Source: Bloomberg, Edison Investment Research, company data. Note: Priced at 23 January 2018. Average P/E excluding Metro Bank.

STB trades on close to an average P/E but also offers one of the higher yields in this group and trades on a below average price to NAV (P/NAV), although its ROE is below average at this stage prior to deployment of surplus capital.

The next chart shows the trade-off between price to book and the ROEs earned by the peer group. STB appears centrally placed, but use of its surplus capital organically or through acquisition could allow the valuation to rise materially without appearing stretched. Metro Bank's seemingly anomalous position reflects its current marginal profitability, strong growth and the market's expectation that it will be able to deliver high profitability in future.

Exhibit 2: Challenger banks/specialist lenders P/NAV vs ROE



Source: Bloomberg, Edison Investment Research

Our ROE/COE calculation for STB is unchanged (assumptions include 15.5% sustainable ROE, 10% cost of equity and 5% nominal growth), giving a value of c 2,700p. The assumed return is above the prospective ROEs arising from our 2017 and 2018 estimates (10.2% and 12.6%), but just below the return on required equity reported for H117 of 16.0%. As in our last note we choose to focus more on the output of a dividend discount model that incorporates the profits progression in our forecast period and this produces a value of c 2,300p, which seems more plausible given the implied prospective P/E (13.2x FY18e) and P/NAV (1.8x) multiples.

Finally, for reference we include a table showing the recent share price performance of the peer group shown above. This shows a wide range of returns over the periods shown. Provident Financial has suffered badly from the problems in its home collected credit business and concerns over the regulatory investigation of Vanquis and Moneybarn, while Aldermore has been boosted by the bid. STB has seen noticeably weaker performance than average (ex-Provident Financial). This suggests the potential for significant upside as investors focus more on the growth potential in FY18 and beyond.

Exhibit 3: Recent share price performance in context (%)

	One month	Three months	One year	Ytd	From 12-month high
Secure Trust Bank	-0.4	-3.6	-23.5	-0.4	-28.4
1PM	14.6	4.6	-13.2	12.1	-16.6
Aldermore	0.4	2.7	47.1	0.4	-0.4
Close Brothers	0.1	4.7	1.9	1.3	-14.5
CYBG	-2.1	4.8	15.9	-3.8	-4.3
Metro Bank	3.3	1.0	15.8	2.4	-5.2
OneSavings Bank	0.6	-1.1	28.7	-1.0	-14.5
Paragon	4.4	11.2	26.6	4.7	-0.3
Private and Commercial Finance	-8.1	-4.7	2.9	-8.1	-18.1
Provident Financial	-17.9	-21.7	-73.8	-19.0	-77.9
S&U	3.4	12.6	12.2	0.7	-5.9
Average (ex-Provident Financial)	**1.6**	**3.2**	**11.4**	**0.8**	**-10.8**

Source: Bloomberg, Edison Investment Research. Note: Priced at 23 January 2018.

Exhibit 4: Financial summary

Year end December	2015	2016	2017e	2018e	2019e
£m except where stated					
Profit and loss					
Net interest income	78.9	103.7	120.7	144.8	165.3
Net commission income	13.2	14.5	15.8	16.9	16.9
Total operating income	92.1	118.2	136.5	161.7	182.2
Total G&A expenses (exc non-recurring items below)	(50.5)	(65.5)	(69.1)	(83.4)	(89.5)
Operating profit pre impairments & exceptionals	**41.6**	**52.7**	**67.5**	**78.3**	**92.7**
Impairment charges on loans	(16.8)	(27.7)	(38.1)	(38.6)	(38.0)
Other income	0.0	0.0	0.3	0.0	0.0
Operating profit post impairments	24.8	25.0	29.7	39.7	54.7
Non-recurring items	0.0	0.0	0.0	0.0	0.0
Pre-tax profit	**24.8**	**25.0**	**29.7**	**39.7**	**54.7**
Corporation tax	(5.5)	(6.3)	(5.7)	(7.0)	(9.7)
Tax rate	22.2%	25.2%	19.2%	17.7%	17.7%
Bank tax surcharge	0.0	(0.0)	(0.3)	(1.2)	(2.4)
Profit after tax - continuing basis	19.3	18.7	23.7	31.5	42.6
Discontinued business	9.4	118.8	0.0	0.0	0.0
(Loss)/profit for year	28.7	137.5	23.7	31.5	42.6
Minority interests	0.0	0.0	0.0	0.0	0.0
Net income attributable to equity shareholders	28.7	137.5	23.7	31.5	42.6
Company reported pre-tax earnings adjustments	(9.8)	7.9	1.0	0.8	0.8
Reported underlying pre-tax earnings (ex-discontinued 2015/16)	**26.7**	**32.9**	**30.7**	**40.5**	**55.5**
Reported underlying earnings after tax	20.8	25.1	24.5	32.2	43.3
Average basic number of shares in issue (m)	18.2	18.5	18.5	18.5	18.5
Average diluted number of shares in issue (m)	18.5	18.6	18.6	18.6	18.6
Reported diluted EPS (p)	104.1	101.8	127.6	169.6	229.4
Underlying diluted EPS (p)	**114.3**	**137.7**	**132.8**	**174.2**	**234.4**
Ordinary DPS (p)	**72.0**	**75.0**	**79.0**	**83.0**	**90.0**
Special DPS (p)	0.0	165.0	0.0	0.0	0.0
Net interest/average loans	9.97%	9.09%	8.17%	7.57%	6.36%
Impairments/average loans	2.12%	2.43%	2.58%	2.02%	1.46%
Cost income ratio	54.8%	55.4%	50.6%	51.6%	49.1%
Balance sheet					
Net customer loans	960.6	1,321.0	1,633.0	2,195.0	3,000.0
Other assets	286.8	189.0	288.2	328.0	448.3
Total assets	1,247.4	1,510.0	1,921.2	2,523.0	3,448.3
Total customer deposits	1,033.1	1,151.8	1,555.2	2,110.6	2,912.6
Other liabilities	73.1	122.2	117.4	147.2	243.3
Total liabilities	1,106.2	1,274.0	1,672.7	2,257.7	3,155.9
Net assets	141.2	236.0	248.5	265.2	292.4
Minorities	0.0	0.0	0.0	0.0	0.0
Shareholders' equity	**141.2**	**236.0**	**248.5**	**265.2**	**292.4**
Reconciliation of movement in equity					
Opening shareholders' equity	124.9	141.2	236.0	248.5	265.2
Profit in period	28.7	137.5	23.7	31.5	42.6
Other comprehensive income	0.0	(1.8)	2.8	0.0	0.0
Ordinary dividends	(12.6)	(13.1)	(14.0)	(14.8)	(15.5)
Special dividend	0.0	(30.0)	0.0	0.0	0.0
Share based payments	0.2	0.2	0.0	0.0	0.0
Issue of shares	0.0	2.0	0.0	0.0	0.0
Share issuance costs	0.0	0.0	0.0	0.0	0.0
Closing shareholders' equity	**141.2**	**236.0**	**248.5**	**265.2**	**292.4**
Other selected data and ratios					
Period end shares in issue (m)	18.2	18.5	18.5	18.5	18.5
NAV per share (p)	776	1,277	1,345	1,436	1,582
Tangible NAV per share (p)	738	1,229	1,292	1,383	1,529
Return on average equity	21.6%	72.9%	9.8%	12.3%	15.3%
Normalised return on average equity	15.9%	12.1%	10.2%	12.6%	16.4%
Average loans	821.9	1,134.6	1,493.3	1,907.8	2,222.3
Average deposits	827.9	1,067.5	1,339.7	1,830.6	2,142.8
Loans/deposits	93.0%	114.7%	105.0%	104.0%	103.0%
Risk exposure	998.5	1,270.1	1,540.1	1,921.1	2,452.8
Common equity tier 1 ratio	**13.6%**	**17.4%**	**15.1%**	**12.9%**	**11.2%**

Source: Edison Investment Research, Secure Trust Bank data. Note: Profit on sale of ELG in April 2016 of £116.8m is included with the discontinued business line for FY16.

Edison is an investment research and advisory company, with offices in North America, Europe, the Middle East and AsiaPac. The heart of Edison is our world-renowned equity research platform and deep multi-sector expertise. At Edison Investment Research, our research is widely read by international investors, advisers and stakeholders. Edison Advisors leverages our core research platform to provide differentiated services including investor relations and strategic consulting. Edison is authorised and regulated by the Financial Conduct Authority. Edison Investment Research (NZ) Limited (Edison NZ) is the New Zealand subsidiary of Edison. Edison NZ is registered on the New Zealand Financial Service Providers Register (FSP number 247505) and is registered to provide wholesale and/or generic financial adviser services only. Edison Investment Research Inc (Edison US) is the US subsidiary of Edison and is regulated by the Securities and Exchange Commission. Edison Investment Research Pty Limited (Edison Aus) [46085869] is the Australian subsidiary of Edison. Edison Germany is a branch entity of Edison Investment Research Limited [4794244]. www.edisongroup.com

Frankfurt +49 (0)69 78 8076 960
Schumannstrasse 34b
60325 Frankfurt
Germany

London +44 (0)20 3077 5700
280 High Holborn
London, WC1V 7EE
United Kingdom

New York +1 646 653 7026
295 Madison Avenue, 18th Floor
10017, New York
US

Sydney +61 (0)2 8249 8342
Level 12, Office 1205
95 Pitt Street, Sydney
NSW 2000, Australia