

# Secure Trust Bank

## Positive trading update

STB's Q318 trading update was upbeat. There are signs that the repositioning strategy is working, trading conditions are robust and it is on track to deliver guided earnings. The Tier 2 capital issue during the period added 268bp to capital, further positioning STB for future growth. Our estimates are unchanged (EPS growth 32% FY18). The shares now trade at PNAV of 1.2x, which compares favourably with our forecast ROTE.

Year end	Operating income (£m)	PBT* (£m)	EPS* (p)	DPS (p)	P/E (x)	Yield (%)
12/17	129.5	27.0	116.4	79.0	12.6	5.4
12/18e	152.9	34.9	154.8	83.0	9.5	5.7
12/19e	174.0	44.4	191.7	90.0	7.6	6.1
12/20e	196.4	52.7	224.6	100.0	6.5	6.8

Note: \*PBT and EPS are normalised, excluding amortisation of acquired intangibles, exceptional items and share-based payments. 2017 figures are on a continuing basis.

## Upbeat trading in uncertain markets

STB indicates that Q3 trading was strong and it is comfortable with full-year guidance, despite economic and Brexit concerns. We expect earnings and loans to grow by 32% and 28% in 2018, respectively. Repositioning has left STB with a lower risk book, focused on areas where the risk-reward pricing is currently better. STB notes that investments it made in collections in 2017 are having a positive impact on results this year.

## Ready for better times

The company is ready to increase its risk appetite when macro-political concerns decline and pricing is appropriate. STB has both operational and balance sheet headroom; the latter recently boosted by a Tier 2 level capital issue. Key drivers of our estimated loan growth are commercial finance and commercial real estate, but the emphasis may shift as the bank has shown a willingness to adapt to changing circumstances.

## Capital ratios bolstered

In Q318, STB raised £50m in fixed rate callable 10-year subordinated debt at 6.75%. While this has no impact on our CET1 year-end forecast of 13.2%, it adds 268bp of Tier 2 capital at a reasonable price. This takes our total capital ratio forecast to 15.9% by December 2018. This, combined with STB's internal capital generation, gives management flexibility to react positively should market conditions improve.

## Valuation: PNAV now only 1.2x

STB shares are down 21.5% ytd and trading at an eye-catching 1.2x PNAV. This seems an undemanding valuation, given our ROTE forecasts of 12.7% this year, followed by 15.9% and 18.0% in 2019 and 2020, respectively. We believe that the market is still not giving STB credit for success in moving to a lower risk profile and focusing on profit margins across the various products. We feel that STB retains strong growth potential, while also showing a pragmatic and nimble approach to lending strategy. The update suggests it is on track to meet our expectations.

## Q3 trading update

### Banks

18 October 2018

**Price** 1,465.0p  
**Market cap** £271m

Net debt/cash (£m)	N/M
Shares in issue	18.5m
Free float	81%
Code	STB
Primary exchange	LSE
Secondary exchange	N/A

### Share price performance



%	1m	3m	12m
Abs	(15.6)	(18.7)	(20.3)
Rel (local)	(12.1)	(12.0)	(15.2)
52-week high/low	2085.0p	1397.5p	

### Business description

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

### Next event

Pre-close trading update	January 2019
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## Repositioning paying off

STB's decision to reduce risk in its portfolio, including a move away from unsecured personal lending, seems to be paying off. The latest update indicates that Q318 trading has been robust and that it is on track to deliver on the guided earnings, despite the macro and political concerns.

Moving the loan mix towards lower interest rate products does not work if impairment charges do not drop correspondingly. The update reassuringly states that lower NPL charges continue to be a key earnings growth driver.

Repositioning a loan portfolio always carries with it some execution risk. STB has achieved this and is reaping the rewards (Q218 already had evidence of this, see our note [15 August 2018](#)).

### Forecasts remain unchanged

The dynamics for the strong EPS growth expected over our forecast period remain the same. We forecast loan growth of 28% y-o-y for 2018 and 2019, but with a tighter interest margin; the interest income grows less at 14% y-o-y. This is then offset by control over cost growth (+21% y-o-y) and a lower rate of impairment, resulting in pre-tax profit and underlying EPS growth of 32% and 33%, for FY18. We expect the shape of the growth drivers to be somewhat similar in 2019 and are forecasting 24% EPS growth. These are attractive growth numbers, given the existing market challenges.

<b>Exhibit 1: STB loan book forecasts</b>					
<b>Loans (£m)</b>	<b>2016</b>	<b>2017</b>	<b>2018e</b>	<b>2019e</b>	<b>2020e</b>
Real estate finance	451.0	580.8	850.0	1,150.0	1,285.0
Asset finance	117.2	116.7	25.0	0.0	0.0
Commercial finance	62.8	126.5	220.0	330.0	390.0
Personal excl ELG	65.5	0.0	0.0	0.0	0.0
Motor finance	236.2	274.6	280.0	300.0	350.0
Retail finance	325.9	452.3	580.0	680.0	770.0
Mortgages	0.0	16.5	50.0	100.0	150.0
Other	62.4	30.9	45.0	60.0	70.0
<b>Total group</b>	<b>1,321.0</b>	<b>1,598.3</b>	<b>2,050.0</b>	<b>2,620.0</b>	<b>3,015.0</b>
<b>Loan growth % (y-o-y)</b>	<b>37.5</b>	<b>21.0</b>	<b>28.3</b>	<b>27.8</b>	<b>15.1</b>
Source: STB data and Edison Investment Research forecasts					

## Tier 2 issue reinforces capital

STB recently issued £50m in a 10-year fixed rate subordinated debt. The notes are callable at five years and will be considered Tier 2 capital. STB previously had no Tier 2 instruments and the notes add an estimated 268bp to capital at the end of the year, raising the bank's total capital ratio to close to 16%. Our estimate for the CET1 ratio remains at 13.2% for the end of 2018. We believe that this provides good headroom for growth. Given the bank's robust profitability, this capital allows the bank to be able to significantly expand in the next three years, despite paying out close to half of its earnings as dividends. We forecast the CET1 will drop to 10.7% by the end of 2020, but this is still a healthy level of capital.

## Valuation

STB's share price has fallen 18.3% in the past three months and 21.5% year-to-date – one of the weakest performances within our selected peer group (Exhibit 2).

**Exhibit 2: Challenger/specialist lender share price performance**

	3 months	1 year	ytd	From 12m high
<b>Secure Trust Bank</b>	<b>(18.3)</b>	<b>(22.3)</b>	<b>(21.5)</b>	<b>(21.0)</b>
1PM	(19.1)	5.7	(7.0)	2.2
Close Brothers	(7.2)	(0.9)	2.7	4.0
CYBG	(17.0)	(16.2)	(10.4)	(18.6)
Metrobank	(6.0)	(20.5)	(26.0)	(26.5)
OneSavings Bank	(6.5)	(13.9)	(4.1)	(7.5)
Paragon	(4.2)	(15.1)	(6.1)	(11.1)
Private and Commercial Finance	(15.3)	(1.4)	27.9	24.6
S&U	(6.5)	(9.4)	10.0	0.7
<b>Average</b>	<b>(11.1)</b>	<b>(10.5)</b>	<b>(3.8)</b>	<b>(5.9)</b>

Source: Bloomberg

The shares are now trading at 2018 P/NAV of only 1.2x. This does not seem to be a demanding valuation in the context of our forecast ROTE of 12.7% for this year, rising to 18% for 2020. This is actually the same ROTE as the average for its peers in 2018 (see Exhibit 3). The average P/NAV of these peers is currently 1.7x; this suggests the scope for re-rating if STB is able to achieve our forecast profitability. We also note that STB offers the highest dividend yield among its peers, at 5.8% for FY18e.

We think that as the market gains confidence that STB's repositioning is indeed working, this will be reflected in its rating. On this basis, the trading update is clearly a positive indicator.

**Exhibit 3: Challenger/specialist lender comparative table**

	Price	Market cap	2018 PER	2019 PER	2018 yield	2018 ROTE	Price to NAV (x)
Secure Trust Bank	1,424.0	262.3	9.3	7.5	5.8	12.7	1.2
1PM	46.5	40.1	6.2	6.1	1.1	38.5	2.0
Close Brothers	1,506.0	2,280.8	11.0	10.5	4.2	18.4	2.0
CYBG	276.4	3,944.1	12.0	10.0	0.0	4.9	0.8
Metrobank	2,636.0	2,567.8	50.2	25.7	0.0	1.3	2.5
OneSavings Bank	381.6	932.9	7.1	6.6	3.3	24.8	1.5
Paragon	436.2	1,137.6	9.4	8.6	3.6	13.2	1.3
Private & Comm. Finance	35.5	75.3	19.9	13.5	0.0	9.6	2.4
S&U	2,300.0	276.3	11.2	9.6	2.0	16.7	1.8
Ave ex STB			15.9	11.3	1.8	15.9	1.8
<b>Ave ex STB, Metro</b>			<b>11.0</b>	<b>9.3</b>	<b>2.0</b>	<b>18.0</b>	<b>1.7</b>
<b>STB rel peers ex-Metro (%)</b>			<b>83.8</b>	<b>79.7</b>	<b>289.0</b>	<b>70.4</b>	<b>72.1</b>

Source: Bloomberg, Edison Investment Research. Note: Priced at 16 October 2018.

**Exhibit 4: Financial summary**

Year-end December (£m, except where stated)	2016	2017	2018e	2019e	2020e
Profit and loss					
Net interest income	92.5	114.6	134.0	150.3	170.8
Net commission income	14.5	14.9	18.9	23.8	25.6
Total operating income	107.0	129.5	152.9	174.0	196.4
Total G&A expenses (exc non-recurring items below)	(64.3)	(71.3)	(86.0)	(95.0)	(105.8)
Operating profit pre impairments & exceptionals	42.7	58.2	66.9	79.0	90.5
Impairment charges on loans	(23.3)	(33.5)	(34.0)	(35.9)	(37.9)
Other income	0.0	0.3	0.0	0.0	0.0
Operating profit post impairments	19.4	25.0	32.9	43.1	52.7
Non-recurring items	0.0	0.0	0.0	0.0	0.0
Pre-tax profit - continuing basis	19.4	25.0	32.9	43.1	52.7
Corporation Tax	(5.2)	(5.1)	(5.6)	(7.3)	(9.0)
Tax rate	26.8%	20.4%	16.9%	17.0%	17.0%
Bank tax surcharge	0.0	0.0	(0.4)	(1.5)	(2.2)
Profit after tax - continuing basis	14.2	19.9	26.9	34.3	41.5
Discontinued business	123.3	3.9	0.0	0.0	0.0
(Loss)/profit for year	137.5	23.8	26.9	34.3	41.5
Minority interests	0.0	0.0	0.0	0.0	0.0
Net income attributable to equity shareholders	137.5	23.8	26.9	34.3	41.5
Company reported pre-tax earnings adjustments	7.9	2.0	2.0	1.3	0.0
Reported underlying pre-tax earnings (ex discontinued 2015/16)	27.3	27.0	34.9	44.4	52.7
Reported underlying earnings after tax	20.6	21.5	28.6	35.4	41.5
Average basic number of shares in issue (m)	18.5	18.5	18.5	18.5	18.5
Average diluted number of shares in issue (m)	18.6	18.6	18.6	18.6	18.6
Reported diluted EPS (p)	77.3	107.0	144.9	184.7	223.2
Underlying diluted EPS (p)	113.0	116.4	154.8	191.7	224.6
Ordinary DPS (p)	75.0	79.0	83.0	90.0	100.0
Special DPS (p)	165.0	0.0	0.0	0.0	0.0
Net interest/average loans	8.15%	7.72%	7.34%	6.44%	6.06%
Impairments/average loans	2.04%	2.30%	1.87%	1.54%	1.34%
Cost income ratio	60.1%	55.1%	56.2%	54.6%	53.9%
Balance sheet			1.28		
Net customer loans	1,321.0	1,598.3	2,050.0	2,620.0	3,015.0
Other assets	189.0	293.3	306.3	391.5	450.5
Total assets	1,510.0	1,891.6	2,356.3	3,011.5	3,465.5
Total customer deposits	1,151.8	1,483.2	1,971.2	2,543.7	2,927.2
Other liabilities	122.2	159.3	149.4	213.3	259.9
Total liabilities	1,274.0	1,642.5	2,120.6	2,757.0	3,187.0
Net assets	236.0	249.1	235.7	254.5	278.5
Minorities	0.0	0.0	0.0	0.0	0.0
Shareholders' equity	236.0	249.1	235.7	254.5	278.5
Reconciliation of movement in equity					
Opening shareholders' equity	141.2	236.0	249.1	235.7	254.5
Profit in period	137.5	23.8	26.9	34.3	41.5
Other comprehensive income	(1.8)	2.9	(25.8)	0.0	0.0
Ordinary dividends	(13.1)	(14.0)	(14.8)	(15.5)	(17.6)
Special dividend	(30.0)	0.0	0.0	0.0	0.0
Share based payments	0.2	0.4	0.3	0.0	0.0
Issue of shares	2.0	0.0	0.0	0.0	0.0
Share issuance costs	0.0	0.0	0.0	0.0	0.0
Closing shareholders' equity	236.0	249.1	235.7	254.5	278.5
Other selected data and ratios					
Period end shares in issue (m)	18.5	18.5	18.5	18.5	18.5
NAV per share (p)	1,277	1,348	1,276	1,378	1,507
Tangible NAV per share (p)	1,229	1,292	1,213	1,315	1,445
Return on average equity	72.9%	9.8%	11.1%	14.0%	15.6%
Normalised return on average equity	9.9%	8.9%	12.2%	15.1%	17.1%
Return on average TNAV	10.3%	9.3%	12.9%	15.9%	18.0%
Average loans	1,134.6	1,484.6	1,831.6	2,335.0	2,817.5
Average deposits	1,067.5	1,321.7	1,686.3	2,262.2	2,735.4
Loans/deposits	114.7%	107.8%	104.0%	103.0%	103.0%
Risk exposure	1,264.0	1,446.1	1,818.4	2,291.7	2,583.8
Common equity tier 1 ratio	18.0%	16.5%	13.2%	11.2%	10.7%

Source: STB data and Edison Investment Research forecasts

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