

Secure Trust Bank

Q319 trading update

A reassuring trading update

Secure Trust Bank's (STB's) trading update for Q319 had a reassuring tone. The business trends and 'overall results are in line with management expectations'. Management noted that demand slowed in September, but this is not a surprise given Brexit deadline concerns. STB has been in de-risking mode for several quarters and has been repositioning its loan book in anticipation of economic and political uncertainties. At the same time, the short duration of its loan book allows it to respond quickly as the lending environment changes. We are not making changes to forecasts or our fair value of 2,428p per share.

| 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 | 11.4 | 5.9 |
| 12/18 | 151.6 | 36.7 | 162.0 | 83.0 | 8.2 | 6.2 |
| 12/19e | 170.9 | 42.1 | 179.5 | 87.2 | 7.4 | 6.6 |
| 12/20e | 186.2 | 52.7 | 227.3 | 91.5 | 5.9 | 6.9 |

Note: *PBT and EPS are normalised, excluding amortisation of acquired intangibles, exceptional items and share-based payments.

Brexit uncertainty

The Brexit uncertainty has led to some borrowers holding back ahead of the 31 October deadline. This has been mainly in the real estate finance division (representing 29% of STB's H119 lending revenue net of impairments). STB warned that political developments could have an impact on the economy and STB's Q419 results. However, this slowdown could lead to a pronounced catch-up in activity after the Brexit outcome becomes clearer. Retail demand has been little affected, as unemployment remains low and wage growth is good.

Unaffected by FCA motor fee changes

The Financial Conduct Authority (FCA) announced on 15 October it was planning to ban some commission arrangements between lenders and some car retailers and motor finance brokers. These are commissions that are linked to the interest rate the customer pays that the broker has the power to set or adjust. STB does not expect any negative impact from these proposed changes as it has never employed any of these commission structures across its business.

Valuation: Unchanged at 2,428p per share

We are not changing our forecasts but are reassured by the update. We are expecting a normalised return on equity of 14.4% in 2019 and see this reaching 18.7% by 2021. Our dividend discount model-derived fair value remains 2,428p implying a 2019 P/NAV of 1.8x. We forecast STB to continue to deliver returns considerably above its 10% cost of equity. As such, a significant premium to the current P/BV of 1.0x seems justified. STB is paying an attractive current year dividend yield of 6.6%, which is set to grow.

Banks

17 October 2019

Price 1,330p
Market cap £246m

| | |
|--------------------|-------|
| Net debt/cash (£m) | N/M |
| Shares in issue | 18.5m |
| Free float | 84.5% |
| Code | STB |
| Primary exchange | LSE |
| Secondary exchange | N/A |

Share price performance



| | | | |
|------------------|--------|----------|-------|
| % | 1m | 3m | 12m |
| Abs | 0.8 | (8.9) | (4.8) |
| Rel (local) | 2.4 | (5.1) | (6.7) |
| 52-week high/low | 1,590p | 1,157.5p | |

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 Arbutnot Banking Group's shareholding is now less than 20%.

Next events

FY19 trading update January 2019

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FCA planned motor changes

The consultation paper issued on 15 October followed the FCA's findings of its investigation into the motor finance commission practices published in March 2019. In the report, the FCA was concerned about commission models linked to motor finance interest rates that the brokers had a 'wide discretion to set or adjust'. This generated a conflict of interest (no pun intended) where the higher the interest rate set by the broker, the bigger the commission. The FCA estimated that this was costing customers as much as £300m a year when compared to flat fee models.

These discretionary commission models generally had three formats: (1) increasing difference in charges (DIC), (2) reducing DIC and (3) scaled commission models. In the first format, there is a minimum interest rate and the broker is paid according to how much higher than the minimum they are able to charge their customer. In the second, there is a maximum interest rate and what the broker receives is based on the difference between interest they are charging and the maximum allowed. In the last format, the fee paid varies directly with the interest rate within certain parameters.

The FCA made the point that the first two are more damaging than the scaled commission models, but all of them are unhealthy and the FCA is planning to ban these arrangements. It wants to sever the link between interest rates paid by customers and broker fees. The FCA proposal would allow for variable commission models for brokers, but not one based on customer interest rates. This would allow, for example, higher fees being charged for customers who required more work from the broker.

In addition, the FCA also found high levels of non-compliance in terms of disclosure requirements as described in its Consumer Credit sourcebook. The FCA is planning to make some minor changes to make compliance easier and with greater certainty.

The finalisation of these new rules is expected by the beginning of Q220.

Since STB does not operate with these discretionary commission models it does not expect to have any negative impact from these changes. STB expects that as a result of these changes, there may conceivably be some increase in new car prices, with a knock-on positive effect on the used car market. This would help STB as its V12 Vehicle Finance partnership with Aston Barclay is focused on working with dealers in the used car finance segment, including dealer stock funding.

Exhibit 1: Financial summary

| Year end 31 December | 2016 | 2017 | 2018 | 2019e | 2020e | 2021e |
|--|---------|---------|---------|---------|---------|---------|
| £m except where stated | | | | | | |
| Profit and loss | | | | | | |
| Net interest income | 92.5 | 114.6 | 133.7 | 148.8 | 162.1 | 177.8 |
| Net commission income | 14.5 | 14.9 | 17.9 | 22.1 | 24.0 | 27.2 |
| Total operating income | 107.0 | 129.5 | 151.6 | 170.9 | 186.2 | 205.0 |
| Total G&A expenses (exc non-recurring items below) | (64.3) | (71.3) | (84.5) | (97.4) | (104.2) | (111.7) |
| Operating profit pre impairments & exceptionals | 42.7 | 58.2 | 67.1 | 73.5 | 82.0 | 93.3 |
| Impairment charges on loans | (23.3) | (33.5) | (32.4) | (33.2) | (31.2) | (32.5) |
| Other income | 0.0 | 0.3 | 0.0 | 0.0 | 0.0 | 0.0 |
| Operating profit post impairments | 19.4 | 25.0 | 34.7 | 40.3 | 50.8 | 60.8 |
| Non-recurring items | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Pre-tax profit - continuing basis | 19.4 | 25.0 | 34.7 | 40.3 | 50.8 | 60.8 |
| Corporation Tax | (5.2) | (5.1) | (6.4) | (7.8) | (8.6) | (10.3) |
| Tax rate | 26.8% | 20.4% | 18.4% | 19.3% | 17.0% | 17.0% |
| Bank tax surcharge | 0.0 | 0.0 | 0.0 | (1.0) | (2.1) | (2.9) |
| Profit after tax - continuing basis | 14.2 | 19.9 | 28.3 | 31.5 | 40.1 | 47.6 |
| Discontinued business | 123.3 | 3.9 | 0.0 | 0.0 | 0.0 | 0.0 |
| (Loss)/profit for year | 137.5 | 23.8 | 28.3 | 31.5 | 40.1 | 47.6 |
| Minority interests | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Net income attributable to equity shareholders | 137.5 | 23.8 | 28.3 | 31.5 | 40.1 | 47.6 |
| Company reported pre-tax earnings adjustments | 7.9 | 2.0 | 2.0 | 1.8 | 1.9 | 0.0 |
| Reported underlying pre-tax earnings | 27.3 | 27.0 | 36.7 | 42.1 | 52.7 | 60.8 |
| Reported underlying earnings after tax | 20.6 | 21.5 | 29.9 | 33.2 | 42.0 | 47.6 |
| Average basic number of shares in issue (m) | 18.5 | 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 | 18.6 |
| Reported diluted EPS (p) | 77.3 | 107.0 | 152.2 | 169.5 | 215.8 | 256.1 |
| Underlying diluted EPS (p) | 113.0 | 116.4 | 162.0 | 179.5 | 227.3 | 257.7 |
| Ordinary DPS (p) | 75.0 | 79.0 | 83.0 | 87.2 | 91.5 | 92.6 |
| Special DPS (p) | 165.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Net interest/average loans | 8.15% | 7.72% | 7.37% | 6.68% | 6.15% | 5.84% |
| Impairments/average loans | 2.04% | 2.30% | 1.79% | 1.49% | 1.18% | 1.07% |
| Cost income ratio | 60.1% | 55.1% | 55.7% | 57.0% | 56.0% | 54.5% |
| Balance sheet | | | | | | |
| Net customer loans | 1,321.0 | 1,598.3 | 2,028.9 | 2,428.5 | 2,841.4 | 3,249.6 |
| Other assets | 189.0 | 293.3 | 415.4 | 428.6 | 443.5 | 485.6 |
| Total assets | 1,510.0 | 1,891.6 | 2,444.3 | 2,857.0 | 3,284.9 | 3,735.2 |
| Total customer deposits | 1,151.8 | 1,483.2 | 1,847.7 | 2,248.6 | 2,583.1 | 3,008.9 |
| Other liabilities | 122.2 | 159.3 | 359.5 | 345.3 | 361.8 | 379.4 |
| Total liabilities | 1,274.0 | 1,642.5 | 2,207.2 | 2,603.3 | 3,007.4 | 3,419.6 |
| Net assets | 236.0 | 249.1 | 237.1 | 253.7 | 277.5 | 315.6 |
| Minorities | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Shareholders' equity | 236.0 | 249.1 | 237.1 | 253.7 | 277.5 | 315.6 |
| Reconciliation of movement in equity | | | | | | |
| Opening shareholders' equity | 141.2 | 236.0 | 249.1 | 237.1 | 253.7 | 277.5 |
| Profit in period | 137.5 | 23.8 | 28.1 | 31.5 | 40.1 | 55.1 |
| Other comprehensive income | (1.8) | 2.9 | (25.8) | 0.0 | 0.0 | 0.0 |
| Ordinary dividends | (13.1) | (14.0) | (14.8) | (15.5) | (16.3) | (17.1) |
| Special dividend | (30.0) | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Share based payments | 0.2 | 0.4 | 0.5 | 0.6 | 0.0 | 0.0 |
| Issue of shares | 2.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Share issuance costs | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Closing shareholders' equity | 236.0 | 249.1 | 237.1 | 253.7 | 277.5 | 315.6 |
| Other selected data and ratios | | | | | | |
| Period end shares in issue (m) | 18.5 | 18.5 | 18.5 | 18.5 | 18.5 | 18.5 |
| NAV per share (p) | 1,277 | 1,348 | 1,283 | 1,424 | 1,840 | 1,878 |
| Tangible NAV per share (p) | 1,229 | 1,292 | 1,230 | 1,364 | 1,779 | 1,828 |
| Return on average equity | 72.9% | 9.8% | 11.6% | 12.6% | 13.3% | 13.9% |
| Normalised return on average equity | 9.9% | 8.9% | 12.8% | 14.1% | 17.3% | 18.9% |
| Return on average TNAV | 10.3% | 9.3% | 13.4% | 14.8% | 18.0% | 19.8% |
| Average loans | 1,134.6 | 1,484.6 | 1,826.4 | 2,253.5 | 2,442.5 | 2,635.0 |
| Average deposits | 1,067.5 | 1,321.7 | 1,655.4 | 2,024.8 | 2,234.6 | 2,427.8 |
| Loans/deposits | 114.7% | 107.8% | 109.8% | 108.0% | 110.0% | 108.0% |
| Risk exposure | 1,264.0 | 1,446.1 | 1,824.6 | 2,175.8 | 2,522.0 | 2,878.9 |
| Common equity tier 1 ratio | 18.0% | 16.5% | 13.8% | 12.1% | 11.2% | 11.1% |

Source: Secure Trust Bank accounts, Edison Investment Research

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