HARDMAN&CO.

24 October 2023

ARBUTHNOT BANKING GROUP

Trading update: taking ABG to the next level

In our view, the key takeaway from the recent *3Q trading statement* is how ABG is progressing strategically towards its "Future State 2" plan. In particular, we note i) specialist SME finance divisions generating the ambitious balance sheet growth in the plan, ii) optimising the core relationship banking franchise, which, in this period, saw 7% deposit growth – given the level of base rates, this is a profitable product for a relationship bank, and iii) continued investment, which, at times, requires a step change in cost rather than a gentle evolution. To meet expected multi-year demand, ABG is increasing its central London HQ office space by 45% at an annual increase in cost of ca.£5m (with further dual running costs until October 2024 as it is refitted).

- **Credit:** "*The book continues to perform robustly despite the increased credit risk inherent in the current environment. This was a result of a conservative credit appetite, which was tightened over a year ago*". At the interims, we detected the early signs of a gentle deterioration, and our loss expectations are unchanged.

- **Impact on estimates:** In 2023, we have increased income marginally to reflect the faster-than-expected and profitable deposit growth (also in balance sheet forecast). The profit/loss effect is offset by dual running costs, leaving the bottom line unchanged. 2024 is affected by the full-period effect of higher costs.

- **Valuation:** Our multiple approaches see a broad range of valuations: £11.58 DDM, £26.23 SOTP and £23.64 GGM (average £20.48, was £21.00), reflecting a marginally lower capital base, reducing the GGM and earnings mix changes. Trading at 57% of NAV is anomalous, in our view, with above the cost of capital returns and ABG's growth outlook.

- **Risks:** Margins may have peaked now, with the trend, and level, of interest rates a key driver to earnings. Credit is a risk, but ABG is conservative in lending, taking good security. Short-duration assets and a conservative culture mean there is no OSB read-across. Other risks: reputation, regulation and compliance.

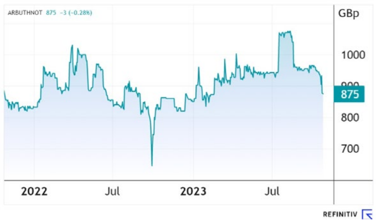
- **Investment summary:** ABG offers strong-franchise and continuing-business (normalised) profit growth. Its balance sheet strength gives it a number of wide-ranging options to develop organic and inorganic opportunities. The latter are likely to increase in uncertain times. Management has been innovative, but also very conservative, in managing risk. Having a profitable, well-funded, well-capitalised and strongly growing bank priced below book value is an anomaly, in our view.

Financial summary and valuation

Year-end Dec (£000)	2020	2021	2022	2023E	2024E
Group op. income	72,500	88,675	137,388	178,816	187,458
Total costs	(71,419)	(93,422)	(108,913)	(129,300)	(142,825)
Cost:income ratio	99%	105%	79%	72%	76%
Total impairments	(2,849)	(3,196)	(5,503)	(6,400)	(6,600)
Reported PBT	(1,090)	4,638	20,009	46,331	39,183
Adj. PBT (co. basis)	8,161	16,985	31,078	52,631	39,183
Statutory EPS (p)	(8.9)	45.2	109.0	211.9	177.5
Adj. EPS (co. basis) (p)	3.1	38.0	169.2	243.6	177.5
Loans to deposits	67%	66%	66%	61%	59%
Ord. dividend (p)	0.0	38.0	42.0	46.0	49.0
P/adj. earnings (x)	269.3	7.8	5.0	3.4	4.7
P/BV (x)	0.64	0.63	0.60	0.55	0.50

Source: Hardman & Co Research

Banks



Source: Refinitiv

Market data

EPIC/TKR	**ARBB/ARBN**
Price (p)	**840/895**
12m high (p)	1,150
12m low (p)	801
Shares (m)	16.3
Mkt cap (£m)	137
Loan to deposits, 2023E	61%
Free float*	32%
Country of listing	UK
Currency of listing	GBP
Market (UK)	AIM/AQSE

*As defined by AIM Rule 26

Description

Arbuthnot Banking Group (ABG) has a well-funded and capitalised private bank, and has been growing specialist high-margin commercial banking very strongly.

Company information

Chair/CEO	Sir Henry Angest
COO/CEO Arb. Latham	Andrew Salmon
Group FD/ Deputy CEO Arb. Latham	James Cobb

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Key shareholders

Sir Henry Angest	56.3%
Liontrust	11.5%
Slater Investments	7.0%
R Paston	3.6%

Diary

Mar'24	FY results

Analyst

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Trading statement key points

Growth in SME franchises

ABG, in recent years, has invested in a number of specialist finance businesses, which now reporting the strong growth inherent in the ambitious "Future State 2" plans

ABG, in recent years, has invested in a number of specialist finance businesses, which are now reporting the strong growth inherent in the ambitious "Future State 2" plans. These include:

- RAF finished the period with a loan book of £176m compared with £157m at the half-year, equating to an increase of 12% in the quarter to 30 September 2023 and a 33% increase since 31 December 2022. Growth has been across RAF's product range with consistent positive new business levels.
- AAG had Assets Available for Lease of £276m at 30 September 2023 compared with £259m at 30 June 2023 and £172m at 31 December 2022, with growth supported by recent portfolio transactions. The recent base rate increases have resulted in a slowing in demand for used trucks, as buyers defer decision-making as late as possible, albeit sales continue to achieve targeted margins.
- Despite the slow PE market activity, a major source of new business, Arbuthnot Commercial Asset Based Lending ("ACABL") maintained its loan book over the quarter to finish at £244m. The established loan book has resulted in an increase in opportunities to support existing clients with bolt-on opportunities and natural growth, as would be expected in a higher-inflation environment, with clients' invoices being at higher levels than before.

Optimising the core relationship franchise

Core bank relationship managers focused on raising deposits in current environment; 7% growth in quarter

In our previous notes, we have emphasised how ABG has built a relationship bank, which, in a period of rising interest rates, can offer competitive deposit products that are profitable to the bank. This suite has been the focus of marketing, given the interest rate outlook and its capital efficiency.

- It is encouraging that growth in the bank's client base has continued in the third quarter, from the existing franchise as well as from new segments, with deposit growth of £218m, to £3.5bn, as at 30 September 2023. This has seen us raise the full-year forecast by £150m, noting some non-relationship deposits, raised historically for liquidity purposes, are expected to mature in 4Q and ABG is not competing aggressively to retain them.
- The average cost of deposits increased to 291bps, at 30 September 2023, and ABG expects the rate to ultimately rise just above 310bps during 2024. This remains well below base rate, highlighting the profitable nature of deposit gathering, which, when re-invested at the Bank of England, carries no capital charge. Part of the cost increase is a shift into longer-term, fixed-rate deposits (40% end-September vs. 37% end-June) as customers anticipate that rate increases are coming to an end.
- The core-bank loan book was unchanged, reflecting conservative risk appetite and reduced demand, including clients paying down debt from cashflow to minimise the interest cost burden.
- Assets under Management closed at £1.43bn (end-June £1.38bn), as net inflows and market performance was positive. While the business saw strong inflows, outflows exceeded forecasts and are tracking above levels observed in the prior year. This has been largely as a consequence of rising interest rates, as clients elect to pay down debt or revert to holding cash.

Credit risk

No change in credit outlook

ABG's comments on credit are quoted on the front page of this note, and we have not changed our forecasts. In our view, credit costs will rise from historically low levels, but ABG's conservative approach to lending, which has been seen across multiple economic scenarios, and which includes high-quality security, limit both the probability of default and, the loss given default. Consequently, increases in credit cost appear manageable.

Investing for the next level

Expanding property can see step-change cost increases, especially for a business with high specification needs, such as the core bank

Some costs, such as property, by their nature, can see step changes for a strongly growing business. Following historical growth, ABG has had multiple central London sites and the current lease on the main HQ was coming to an end. Given the strong demand it expects over the period of the "Future State 2" plan, and the need for high-specification working space, client meeting and entertainment suites inherent in its relationship banking model, ABG has decided to take on 45% more central London space in a single site.

- There will be dual running costs until October 2024 and the increased footprint and depreciation of the fit-out costs will increase the annual expenditure on premises by ca.£5m, on a steady-state basis.

- The new site is expected to meet demand for several years to come (the lease is for 15 years) and, given the current central London commercial real estate market, negotiating a large, single site is likely to have been on relatively favourable terms.

Financials

We had previously built in a cushion in our estimates for the unknown interest rate environment and its impact on credit. With the trading update, we saw higher-than-expected deposit volumes, with the resulting profit and loss benefit then offset by higher property costs. We have trimmed the private bank 2024E loan volumes by £50m, reflecting the factors identified above. Group loan growth in 2024E is now £200m.

Changes to estimates

Year-end Dec (£000)	2023E			2024E		
	Old	New	% change	Old	New	% change
Group operating income	175,816	178,816	2%	185,100	187,458	1%
Total costs	(126,300)	(129,300)	2%	(134,825)	(142,825)	6%
Cost:income ratio	72%	72%	0%	73%	76%	4%
Total impairments	-6,400	(6,400)	0%	-6,600	(6,600)	0%
Reported PBT	46,331	46,331	0%	44,825	39,183	-13%
Adj. PBT (co. basis)	52,631	52,631	0%	44,825	39,183	-13%
Statutory EPS (p)	211.9	211.9	0%	202.3	177	-12%
Adj. EPS (co. basis, p)	243.6	243.6	0%	202.3	177	-12%
Loans to deposits	61%	61%	0%	64%	59%	-8%

Source: Hardman & Co Research

Profit and loss

Year-end Dec (£000)	2019	2020	2021	2022	2023E	2024E
Interest income	76,870	75,082	77,102	120,013	227,605	253,058
Interest expense	(18,233)	(17,024)	(13,027)	(20,932)	(89,900)	(113,500)
Net interest income	**58,637**	**58,058**	**64,075**	**99,081**	**137,705**	**139,558**
Fees and comms. Income	13,935	14,735	18,223	21,586	23,211	26,000
Fees and comms. Expenses	(107)	(293)	(100)	(537)	(100)	(100)
Net fees and comms.	13,828	14,442	18,123	21,049	23,111	25,900
Banking operating income	**72,465**	**72,500**	**82,198**	**120,130**	**160,816**	**165,458**
Leasing revenue	0	0	68,673	99,367	100,000	110,000
Leasing cost of sales	0	0	(62,196)	(82,109)	(82,000)	(88,000)
Gross profit from leasing	0	0	6,477	17,258	18,000	22,000
Group operating income	**72,465**	**72,500**	**88,675**	**137,388**	**178,816**	**187,458**
Total impairments	(867)	(2,849)	(3,196)	(5,503)	(6,400)	(6,600)
Other income	5,599	678	3,955	1,627	3,215	1,150
Profit from bargain purchase	0	0	8,626			
Loss on sale of King Street	0	0	0	(4,590)		
Operating expenses	**(70,186)**	**(71,419)**	**(93,422)**	**(108,913)**	**(129,300)**	**(142,825)**
Profit before tax from continuing operations	**7,011**	**(1,090)**	**4,638**	**20,009**	**46,331**	**39,183**
Income tax	(835)	(242)	2,148	(3,551)	(12,223)	(10,221)
Profit for year	**6,176**	**(1,332)**	**6,786**	**16,458**	**34,108**	**28,961**

Source: ABG, Hardman & Co Research

Divisional pre-tax profits

Year-end Dec (£000)	2021	2022	2023E	2024E
Banking	6,532	19,138	56,420	52,833
WM	(2,121)	(4,101)	(4,000)	(1,500)
AA	3,829	(2,074)	(4,500)	(3,050)
Mortgage books	5,634	3,760	500	400
RAF	(62)	194	1,950	2,750
ACABL	4,737	5,193	8,750	10,500
ASFL	(1,026)	(945)	(1,039)	(800)
Other divisions	(2,253)	11,700	6,000	2,800
Centrals	(10,632)	(12,856)	(17,750)	(24,750)
Group total	**4,638**	**20,009**	**46,331**	**39,183**

Source: ABG, Hardman & Co Research

Balance sheet						
@ 31 Dec (£000)	**2019**	**2020**	**2021E**	**2022E**	**2023E**	**2024E**
Cash and balances at central bank	325,908	636,799	814,692	732,729	1,004,454	1,224,526
Loans and advances to banks	46,258	110,267	73,444	115,787	100,000	100,000
Debt securities held to maturity	442,960	344,692	301,052	439,753	500,000	500,000
Assets classified as held to sale	7,617	3,285	3,136	3,279	3,000	3,000
Derivative financial instruments	1,804	1,843	1,753	6,322	6,322	6,322
Loans and advances to customers	**1,599,053**	**1,587,849**	**1,870,962**	**2,036,077**	**2,205,000**	**2,404,900**
Other assets	86,443	96,493	110,119	52,185	66,267	66,267
Financial investments	30,919	18,495	3,169	3,404	3,404	3,404
Deferred tax	1,815	1,009	2,562	2,425	2,425	2,425
Investments in associates	-	-	-	-	-	-
Intangible assets	20,082	23,646	29,864	32,549	32,049	31,549
Property, plant and equipment	5,813	4,905	125,890	175,273	225,273	275,273
Right of use property	19,944	17,703	15,674	7,714	7,714	7,714
Investment property	6,763	6,550	6,550	6,550	6,550	6,550
Total assets	**2,595,379**	**2,853,536**	**3,358,867**	**3,614,047**	**4,162,458**	**4,631,930**
Deposits from banks	230,421	230,090	240,333	236,027	197,384	197,384
Derivative financial instruments	319	649	171	135	58	58
Deposits from customers	**2,084,903**	**2,365,207**	**2,837,869**	**3,092,549**	**3,624,000**	**4,074,000**
Liabilities relating to assets classified as held for sale	0	0	0	0	0	0
Current tax liability	633	0	413	1,748	12,223	10,221
Other liabilities	13,500	7,606	26,216	26,144	32,573	32,573
Lease liabilities	20,431	18,305	16,214	7,872	7,872	7,872
Debt securities in issue	36,837	37,656	36,772	37,594	37,290	37,290
Total liabilities	**2,387,044**	**2,659,513**	**3,157,988**	**3,402,069**	**3,911,400**	**4,359,398**
Share capital	154	154	154	154	11,773	11,773
Retained earnings	209,171	207,839	201,026	212,037	239,367	260,841
Other reserves	-990	-13,970	(301)	(213)	(82)	(82)
Total equity	**208,335**	**194,023**	**200,879**	**211,978**	**251,058**	**272,532**

Source: ABG, Hardman & Co Research

Valuation

Range of valuations broad – driven by scenario of assumptions, but also methodology

Average is £20.48, more than double current price

The average valuation, on our assumptions, represents 1.3x 2023E book value for a business expected to deliver a near nine-fold increase in profits in 2024 on 2021.

Summary of different valuation techniques by approach

£ per share	GGM	SOTP	DDM
Implied valuation	23.64	26.23	11.58

Source: Hardman & Co Research

GGM

GGM £23.64

The assumptions and sensitivities in our GGM model are given below. There has been a small decline since our last report, reflecting lower retentions now expected.

GGM and sensitivities (central scenario)

	Base	+1% RoE	+1% CoE	+0.5% G
Return on Equity (RoE)	13.5%	14.5%	13.5%	13.5%
Cost of Equity (CoE)	10%	10%	11%	10%
Growth	5%	5%	5%	5.5%
Price/book value (x)	1.70	1.9	1.4	1.8
Premium for near-term outperformance	-25%	-25%	-25%	-25%
Adjusted price/book value (x)	**1.3**	**1.4**	**1.1**	**1.3**
Book value 2024E (£m)	272.5	272.5	272.5	272.5
Valuation (£m)	347.5	388.4	289.6	363.4
Valuation per share (p)	**23.64**	**26.42**	**19.70**	**24.72**
Variance (p per share)		40.9	-57.9	15.9

Source: Hardman & Co Research

SOTP

SOTP £26.23, from £27.43

We have included the higher net interest income in other divisions while costs are in centrals.

Sum-of-the-parts

	2024E post-tax	Rating	Value (£m)
Banking	39.1	10	391.0
WM			32.5
AA	(2.3)	12	(27.1)
Mortgage books	0.3	1	0.3
RAF	2.0	12	24.4
ACABL	7.8	12	93.2
ASFL	(0.6)	12	(7.1)
Other divisions	2.1	6	12.4
Centrals	(18.3)	5	(91.6)
Total			**428.1**

Source: Hardman & Co Research

DDM

ABG now has attractive 2023E yield of 5.1%

DDM model unchanged

Our DDM model reflects the strong earnings that we expect through our forecast period, before assuming 5% annual growth through to 2043 and a terminal value of 10x. At this stage, we have not changed our long-term dividend forecasts – so this valuation is unchanged.

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