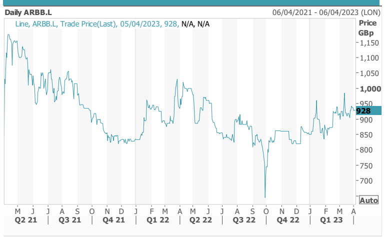
6 April 2023

Banks



Source: Refinitiv

Market data

EPIC/TKR	**ARBB/ARBN**
Price (p)	**927.5/930**
12m high (p)	1,038
12m low (p)	625
Shares (m)	15.4
Mkt cap (£m)	143
Loan to deposits 2023E	60%
Free float*	42%
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

Tel: +44 (0)20 7012 2400

www.arbuthnotgroup.com

Key shareholders

Sir Henry Angest	56.1%
Liontrust	11.5%
Slater Investments	7.0%
R Paston	3.6%

Diary

24 May	AGM
18 July	Interim results

Analyst

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ARBUTHNOT BANKING GROUP

2022: profits and growth in core and new franchises

ABG's 2022 results delivered the expected strong profit and franchise growth (pre-tax profit up from £4.6m to £20m). Core business profitability increased primarily because of widening spreads increasing the value of deposits. Core credit quality remained good. The scale of growth has been driven by the way in which ABG has managed its franchise, building a relationship bank with less price-sensitive deposits. In recent years, ABG has invested in multiple, new, specialised SME financing businesses. These delivered franchise/profit growth in 2022. There is no Silicon Valley Bank (SVB) read-across. The dividend rose by more than expected, and the medium-term Return on Capital (RoC) target was achieved early.

- **New franchise growth:** Asset-Backed Lending profits grew from £4.7m to £5.2m. RAF lending increased from £97m to £134m. Excluding the gain on purchase, Asset Alliance saw losses reduce from £4.8m to £2.1m. Internal funding costs grew by £8.8m, giving a £10m total 2022 "new unit" profit uplift.

- **Balance sheet strength:** End-2022 loans were £2.04bn (2021: £1.87bn), and deposits were £3.09bn (2021: £2.84bn). Unlike SVB, surplus liquidity is deployed primarily in accounts with the Bank of England (£0.7bn), and not in mis-matched duration government bonds. The total capital ratio was 14.0% (2021: 14.9%).

- **Valuation:** Our multiple approaches see a broad range of valuations: £11.58 DDM, £27.46 SOTP and £23.15 GGM. The average is £20.73, up from £16.67, reflecting the results, and moving forward the base year. Trading at 66% of NAV is anomalous with above cost of capital returns.

- **Risks:** The trend, and level, of interest rates will determine short-term profitability. Credit is a risk, but all the metrics remain positive. ABG is very conservative in lending. Its financial strength means that it can take time to optimise recoveries. Other risks include 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.

Financial summary and valuation

Year-end Dec (£000)	2020	2021	2022	2023E	2024E
Group op. income	72,500	88,675	137,388	169,727	183,994
Total costs	(71,419)	(93,422)	(108,913)	(126,600)	(135,300)
Cost:income ratio	99%	105%	79%	75%	74%
Total impairments	(2,849)	(3,196)	(5,503)	(3,250)	(3,350)
Reported PBT	(1,090)	4,638	20,009	40,119	45,586
Adj. PBT (co. basis)	8,161	16,985	31,078	45,119	46,886
Statutory EPS (p)	(8.9)	45.2	109.0	214.2	242.1
Adj. EPS (co. basis, p)	3.1	38.0	169.2	240.8	249.0
Loans to deposits	67%	66%	66%	60%	63%
Ord. dividend (p)	0.0	38.0	42.0	46.0	49.0
P/adj. earnings (x)	297.4	8.6	5.5	3.9	3.7
P/BV (x)	0.71	0.69	0.66	0.59	0.52

Source: Hardman & Co Research

2022 results summary

Business model delivering superior growth

The key strategic message is the value of being a relationship bank, which can manage margins in a steadily rising interest rate environment. We had expected a sharp rise in ABG's profitability (see our note, *Back to profitable growth with interest-rate kicker,* published on 7 April 2022), and the results were slightly ahead of our expectations.

Financial highlights

Reported profits nearly fourfold on widening margin

- Profit before tax increased nearly fourfold, to £20.0m (2021: £4.6m), while underlying profit before tax rose to £31.1m (2021: £17.0m). Group total operating income increased to £137.4m (2021: £88.7m), of which banking income was £120.1m (2021: £82.2m). The main driver to the group increase was a sharp rise in net interest income (£99.1m vs. £64.1m), with rising gross interest income (up £43m) and only a small fall in interest expense (up £8m), despite rising market interest rates and volumes (deposits £3.1bn vs. £2.8bn). ABG's relationship model and its decision to not compete for deposits have allowed it to widen margins.

Despite rising costs

- Operating expenses increased to £108.9m, from £93.4m (excluding the one-off £4.6m writedown of the King Street property). ABG is facing the marketwide competition for banking staff, which is causing sustained pressure on the cost base, in addition to the full-year effect of Asset Alliance Group (AA).

Divisionally, the key growth is in banking and treasury

Divisionally, the reported profits were (2021 numbers in brackets): i) **Banking** £19.2m (£6.5m), driven primarily by increased lending income and wider deposit margins; ii) **Mortgage Portfolio** £3.8m (£5.6m), down due to the non-recurrence of the profit on the £2.2m sale of the Tay portfolio; iii) **Renaissance Asset Finance (RAF)** £0.2m (loss £0.1m), after £3.3m paid to the bank for internal funding, with loan book growth of 38%; iv) **Arbuthnot Commercial Asset Backed Lending (ACABL)** £5.2m (£4.7m), with the loan book up 48%, to £269m, from £182m, more than offsetting a fraud-related impairment of £2m; v) **AA** loss £2.1m (£3.8m, but this included an £8.6m gain on a net bargain purchase), after inter-group interest of £4.9m (£2.3m for nine months in 2021); and vi) **Arbuthnot Specialist Finance Limited (ASFL)** loss £0.9m (loss £1.0m), and this unit is now being closed. Internal allocations mean that the reported profit of **"Other divisions"** of £11.7m (loss £2.3m) includes treasury, which has the benefit of internal funding at the base rate, and which bore the cost of the King Street writedown (£4.6m) and a range of other internal movements. The **Wealth Management (WM)** division reported a loss of £4.1m (£2.1m), but the transfer pricing does not give it full value for the deposits it raises (the credit is in treasury). Group Centre reported a loss of £12.9m (£10.6m).

Capital surplus £36m

- The capital surplus at end-June was £35.6m (FY'21: £50.1m), with a core equity Tier 1 ratio of 11.6% (FY'21: 12.3%). Net assets per share stood at £14.11 (31 December 2021: £13.37).

Operational highlights

Customer loans up 10% organic, deposits up 9% (and AUM strong inflows)

Customer loan growth was 10%, to £2.2bn. Customer deposits, having been stable in 1H'22, rose 9%, to £3.1bn, by year-end, despite the bank not competing aggressively for ca.£100m of term deposits as they matured. The overall cost of funding, after declining modestly in 1H'22, has now, as expected, started to rise (2022 average 0.61%, vs. 0.39% in 2021, with a December 2022 run rate of 1.30%). Once all term deposits have re-priced, and assuming no further base rate changes, we expect this to settle at ca.2%. AUM balances fell 2%, to £1.3bn, despite gross client inflows of £209m, which were 21% higher than in the prior year. Client numbers rose to 1,196, from 938.

Theme (1): managing interest rate sensitivity

ABG benefits from rising rates, given the structure of its balance sheet, including surplus liquidity

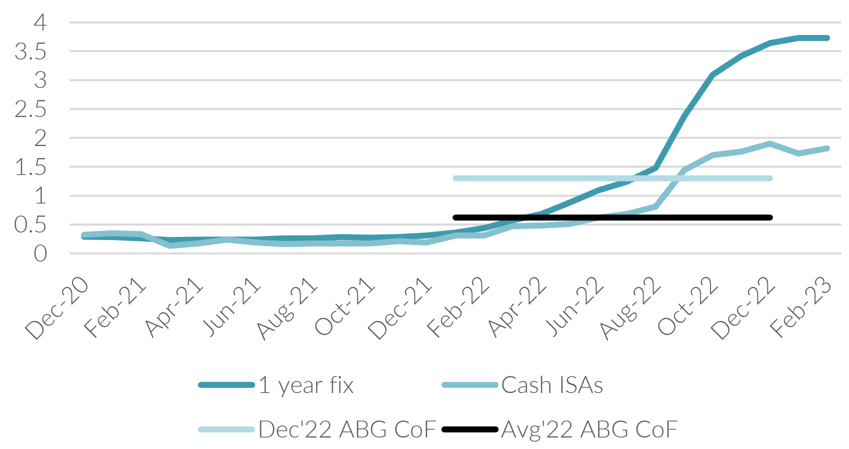
A key question in many investors' minds is how sensitive companies are to a higher inflation and interest rate environment. ABG is unusual in that it is a clear beneficiary of rising interest rates to date. ABG has a structural sensitivity, with more assets re-pricing than liabilities. It has surplus liquidity, which is held mainly in cash and balances at the Bank of England (BoE). As interest rates rise, it receives the full increase on its BoE accounts. Similarly, surplus liquidity held in interbank loans and short-term debt securities will also re-price quickly. Additionally, part of the balance sheet is funded by non-interest-bearing equity funding.

Despite rising market interest rates, ABG reduced costs of funds in 1H'22...

...and, on a full year, saw a fraction of the market increases

What is very evident from these results, however, is how ABG controls the balance sheet. Despite rising market interest rates in 1H'22, ABG achieved the remarkable feat of reducing its average cost of funds on 1H'21, while the full-year average cost was up just 22bps. This increase was around a third of the increase in the market cost of ISAs and a sixth of the rise in one-year fixed-term deposit rates. While ABG's cost of funds has been rising through the year (see chart below), its relationship banking model has a lower cost of funds than the market.

Monthly cost of retail deposits (one year and cash ISAs)



Source: Bank of England, Hardman & Co Research

Outperformance driven by management action, including building a relationship bank, not chasing hot money/best-buy tables, marketing focus

This superior performance has been driven significantly by management action, and reflects the following:

- ABG's business model has significant relationship banking balances, which are less rate-sensitive. These are both in the private bank (where large balances may be held for service reasons), but also, to an increasing degree, from its commercial customers (where balances may be held for transactional purposes and where savings offerings are less competitive than in the retail market). In its results, ABG emphasised the growth in the number of transactions it was processing on its new platform, which will help grow the latter.

- The bank chose to not compete for (£100m+) of term deposits as they matured. One consequence of this was that the loan-to-deposit ratio was stable (end-2021: 66%, end-2022: 66%). It remains extremely conservative, and, with an increased focus on the (now profitable) product, we forecast the ratio to fall further.

- It chose to not compete more widely in the best-buy tables, which have become even more competitive.

- Deposits have, once again, become a profitable product in their own right. Marginal deposits can be placed with the BoE and earn base rate, a positive spread over the rate paid to depositors, and with no capital requirement. They are now being prioritised for growth in a way not seen for some years. This is evident from the 10% growth seen in 2H'22, after a small fall in 1H'22.

- A rising rate environment has, helpfully, produced lag effects. Term deposits are locked in for the duration of their term, and so re-price only when they mature, and not immediately on the change in the base rate, and they thus lag the increase in base rates. Historically, it has taken ABG up to 18 months for its deposits book to effectively fully re-price to market changes. This can be seen in the December run-rate cost of funds of 1.30%, against the average in the year of 0.61%. We believe that, once all the deposits have re-priced, the run-rate cost (assuming no further changes in the base rate) should be around 2%.

- Further increases in interest rates will give the opportunity for more of the same, i.e. further lagging effects and relationship margin widening. However, we see the greatest uplift being generated from the initial rate increases, as, over time, it will become harder for ABG to not pass on the benefits to savers.

Best-buy tables now 160-210bps over ABG's Dec'22 run-rate cost of funds

The performance of ABG should be considered against the market as a whole in order to show the value of its relationship model. Marginal deposits are the most expensive, and, despite ABG's strong growth in 2H'22, its cost of funds is rising only steadily. At the time of writing, by way of comparison for the cost of marginal accounts, the top five easy-access accounts on GoCompare were paying 2.9%-3.4%. The chart on the previous page shows the rise in the average market cost of cash ISA savings and one-year fixed-rate accounts. By way of example, one-year fixed-term deposits are now paying 350bps more than they were at the start of 2022.

No Silicon Valley Bank (SVB) read-across

While ABG has significant surplus deposits, its approach to deploying them is totally different from the approach of SVB, and, consequently, it does not face the duration and accounting exposure that SVB did. In particular, we note:

- Most surplus deposits are held at the BoE in immediately callable accounts. ABG is not materially invested in long-term government bonds, whose prices have fallen with rising interest rates.

- SVB's problems were sharply compounded when the bank had to sell bonds to get liquidity – an action that crystallised previously unrealised losses and undermined confidence in the capital strength of the group. The BoE has a financing scheme for banks by which long-term government bonds can be used as security (with a haircut) to access immediate liquidity. Unrealised losses would thus not be crystallised, as the bonds are not sold.

Significant profit uncertainty – both positive and negative – from the rate environment

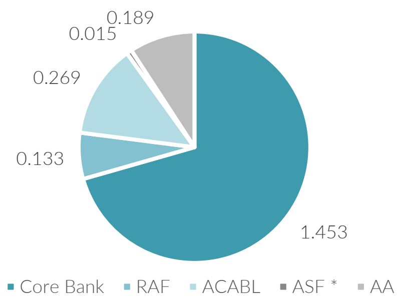
The level of interest rates introduces significant potential earnings volatility. In the same way in which ABG's net income has benefited from rising rates, falling rates are likely to see profits fall – potentially dramatically. The full impact on credit has not yet been seen; indeed, credit metrics improved in 2022. In our view, we are close to, if not at, levels where there are more marketwide impairments, as opposed to company-specific losses. For ABG, part of this has been captured by assumptions in IFRS9, and, at this stage, it remains a potential for loss, rather than actual losses materialising, as there is no current evidence of deterioration (see section on credit, *Theme (3): credit outlook*, below, for a detailed review).

Theme (2): strategic growth in commercial businesses

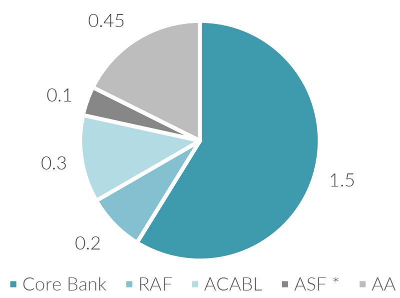
Strategic "future state" vision

The charts below highlight the impact of ABG's strategic vision. They are indicative, and not a company forecast. With the 2022 results, management indicated a possible (upward) revision to the "Future State" targets, reflecting market opportunities and the higher capital expected to be generated over the next couple of years. More details will be announced in due course.

Mix of customer loans, 2021 (£bn)

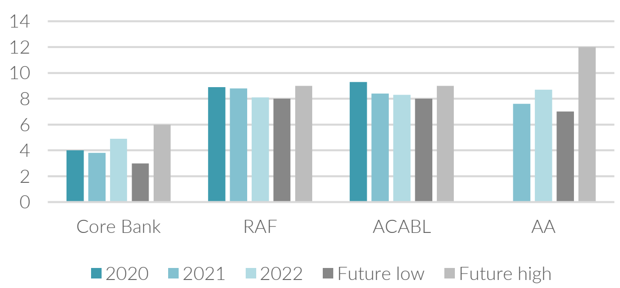


Mix of customer loans, "Future State" vision (£bn)

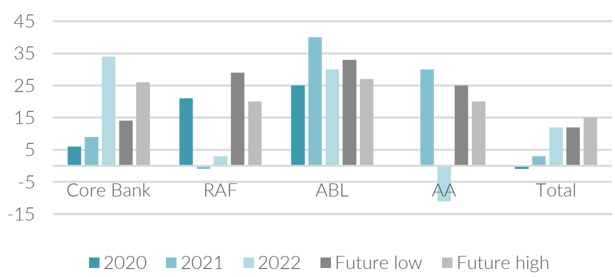


Source: ABG, Hardman & Co Research

Margin (%)

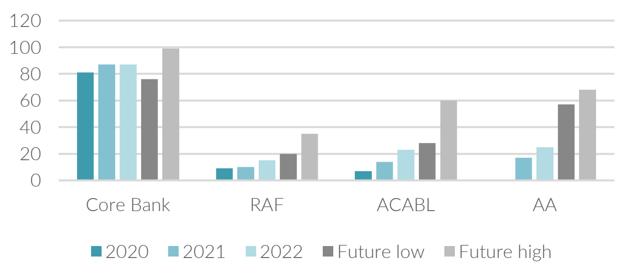


Pre-tax return on capital employed (RoCE) (%)

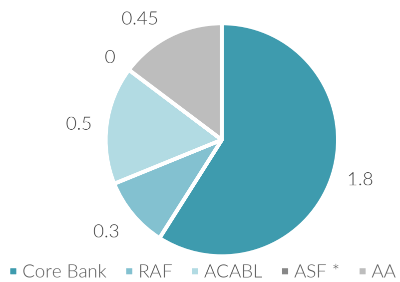


Note: Future low is low-end of current "Future State" ranges, high is upper-end of new potential range; Source: ABG, Hardman & Co Research

Capital (£m)



New "Future State 2" mix of customer loans (£bn)



Note: Future low is low-end of current "Future State" ranges, high is upper-end of new potential range; Source: ABG, Hardman & Co Research

Core bank will shrink as proportion of group – due partially to an originate and distribute agreement

The key points we highlight from the charts are:

- The core bank will shrink as a proportion of the group lending, due partially to an originate and sell agreement that ABG has signed with a non-bank counterparty for new commercial property lending. With commercial property loans maturing in the near future (and new ones going into this agreement), the balance sheet in the core bank is expected to be stable/show a slight fall. More positively, the average regulatory risk weighting and capital employed will also reduce. As margins in 2022 were well above what is likely to be a sustainable level, the RoCE is expected to fall in all scenarios.

AA and ACABL rise to be nearly half of group capital allocation

- AA and ACABL will see a sharp rise in capital employed. In the current "future state", they will account for nearly half of the group, compared with a third in 2022, with an expected pre-tax return of ca.25%-33%, well above the group average of 15%.

Group returns rise with economies of scale, improved capital efficiency and mix, offsetting pressure from normalised spreads in the core bank

- The "future state" margin is expected to fall in the core bank (loan spreads under pressure, as facilities come up for renewal, with the cost of funds rising and normalising deposit spreads). The improving group RoC is driven primarily by i) economies of scale, in operating units, but also with group costs falling across a much larger business, ii) the improved capital efficiency in the core bank, as commercial real estate falls as a proportion of its book, and iii) the increasing proportion of high-margin (23%-33%) SME businesses.

"Future State 2"

More details on potential upward revision to "Future State" aspirations in due course

Higher short-term profitability has increased capital and optionality.

Since the original "Future State" outlook was announced, ABG has benefited from the rising rate environment, with profitability in the core bank well ahead of previous expectations. Capital generation is above the original plans, which creates further options for the strategic development of the group. The 2022 results presentation (slide 7) gives a potential outline for "future state 2", which would see £304m of capital deployed, against the £223m assumed in "future state 1". All units would see higher capital allocations; this generates economies of scale, and, consequently, profitability is higher. The indications are preliminary at the moment, and a more detailed discussion of "Future State 2" is expected in due course.

AA

AA completed on 31 March 2021. With cheaper and more certain funding, AA can deliver strong growth and returns over medium term.

ABG announced the acquisition of AA, a vehicle finance and related services provider, predominantly in the truck & trailer and bus & coach markets, on 10 December 2020; we reviewed the impact in detail in our report, Acquisition of Asset Alliance, published on 11 December 2020. Strategically, with the low-cost refinancing available via ABG, we expect material bottom-line profitability and ongoing value creation, in addition to the immediate capital uplift.

After market-driven delay, 2022 saw strong growth in assets and in underlying profitability

As the table below shows, the unit reported a loss of £2.1m for 2022, against a nine-month positive contribution of £3.8m in 2021. The latter, however, included an £8.6m gain on purchase – so, on a like-for-like basis, the business contribution was a loss of £2.1m, against a loss of £4.8m. Even this is not a real reflection of the value added, because AA also paid £4.9m in 2022 in internal funding costs to ABG's treasury (2022: £2.3m). Taking account of that, the contribution would be a profit of £2.8m, against a loss of £2.5m. The truck shortage has slowed the ability of AA to grow, as new trucks have not been available, and so no finance was needed. Against our initial expectations, this delayed significant value creation by 12-18 months, but it is now starting to be delivered. The book, including fair value adjustments, showed a decline in 2H'21 and 1H'22, but then grew sharply in 2H'22 (assets available for lease: 1H'21 £132m, 2H'21 £122m, 1H'22 £115m, 2H'22 £172m).

AA – key data				
Year-end Dec (£000)	**2021**	**2022**	**2023E**	**2024E**
Interest income	190	664	750	1,000
Interest expense	(2,591)	(5,120)	(12,000)	(16,000)
Turnover	68,673	99,367	158,987	214,633
Cost of sales	(62,196)	(82,109)	(125,600)	(167,414)
Operating income	4,076	12,802	22,137	32,219
Operating expenses, direct	(7,872)	(14,507)	(20,000)	(25,000)
Gain on acquisition	8,626	-	-	-
Impairments	(1,001)	(369)	(750)	(1,000)
PBT	3,829	(2,074)	1,387	6,219

Source: ABG, Hardman & Co Research

£6.3m of truck acquisition revaluations still to be realised (£5.8m taken in 2012, £6.5m in 2022)

In 2021, there was a gain of £8.6m recorded in the income statement, attributable to a net bargain purchase. The most significant fair value adjustment arose from the valuation of the leased truck fleet, where second-hand trucks had risen in value, with the shortage of supply of new trucks (global scarcity of computer chips) and high demand for logistics. The gain effectively meant that future profits on the sale of the current fleet of trucks were recognised upfront. This accounting profit is turned into cash, once the trucks are sold. In 2021, £5.8m of actual profit was realised, with a further £6.5m in 2022. A residual balance of £6.3m remains, and the vast majority of this is expected to be realised in 2023. While the scale of profit reflects current market conditions, some gains are expected every year, and, to give a clearer view of ongoing profitability, these gains are added back to adjusted profits.

ACABL

Specialist asset-backed lender earning 8.5% yield on three- to five-year duration lending and average loan size of £2.67m in 2022

ACABL is specialist asset-based lender, focused on delivering facilities to UK family-owned/private-equity-backed SME and mid-tier businesses. It provides a full suite of asset-based lending facilities, including invoice discounting, stock finance, property, plant and machinery, and cashflow loans. Lending rates range from 2.25% to 5% over the base rate, with additional service fees contributing to an overall average gross yield in 2022 of 8.5% (2021: 8.4%). The average tenor is three to five years, and the average loan size is £2.67m (2021: £2.24m).

ACABL more than offset a £2m fraud loss to report profit growth

Going forward, we expect a material increase in contribution – reported and including the funding paid to ABG

ACABL reported profit before tax of £5.2m (2021: £4.7m, 2020: £2.0m). 2022 was after a fraud-related loss of £2m and a funding cost paid to the bank of £7.9m (2021: £2.7m). We understand that the impairment was due to a customer fraud. Unlike most of ACABL's clients, this was not a private-equity-backed business, where further support may have been provided in a challenging time. While such losses are unfortunate, they are an exposure in providing invoice financing. Accordingly, we consider this to be an isolated fraud-related incident, with no evidence of systemic failure in controls.

ACABL – key data					
Year-end Dec (£000)	**2020***	**2021***	**2022***	**2023E***	**2024E**
Interest income	4,316	8,010	14,665	26,000	28,000
Interest expense	(1,584)	(2,699)	(7,903)	(19,000)	(19,000)
Net fees and comms.	2,403	4,224	5,976	8,000	9,000
Operating income	**5,135**	**9,535**	**12,738**	**15,000**	**18,000**
Operating expenses, direct	(3,130)	(4,748)	(5,463)	(6,500)	(8,500)
Impairments	-	(50)	(2,082)	(250)	(500)
PBT	**2,005**	**4,737**	**5,193**	**8,250**	**9,000**
Loans and advances (£m)	87	182	269	400	600

**IFRS9 basis; Source: ABG, Hardman & Co Research*

At year-end 2022, ACABL reported drawn balances of £268.8m, (2021: £182.1m). Facility limits increased 40% on the prior year, to £523m (2021: £384m). ABG had the benefit of a strong balance sheet and no back book to worry about, meaning that it could focus on generating new business during the pandemic, and this manifested in strong growth in 2021-22.

RAF

Specialist asset finance provider

RAF is a specialist asset finance provider, acquired by ABG in 2017. It makes funding facilities available, both direct and via premium brokers, to the UK SME and high-net-worth individual markets. The main products are hire purchase, finance leases and refinance facilities for a range of assets, including motor vehicles, plant & machinery, engineering and manufacturing equipment, and business-critical soft assets. The average gross yield in 2022 was 8.1% (range 5%-12%, 2021: 8.8%), and the typical loan maturity is ca.43-44 months. The average loan size was £130k in 2022 (2021: £105k).

Strong growth in 2022, as supply chain pressures eased

Demand in 2022 was strong and accelerating (loan balances up 38% in the full year, vs. 5% in 1H'22), as supply chain issues for business assets eased. Loans under forbearance measures fell from their peak in 2020 (see *Theme (3): credit outlook* below), as the problems with London taxi clients have been increasingly resolved. RAF's contribution is after £3.3m paid to ABG for funding.

RAF – key data

Year-end Dec (£000)	2020	2021	2022	2023E	2024E
Interest income	8,687	8,300	8,898	14,500	17,000
Interest expense	(2,666)	(2,371)	(3,353)	(7,500)	(8,500)
Net fees and comms.	130	166	32	100	100
Operating income	**6,151**	**6,095**	**5,577**	**7,100**	**8,600**
	73	78	82	82	82
Operating expenses, direct	(2,975)	(3,943)	(4,697)	(5,500)	(6,000)
Impairments	(1,154)	(2,292)	(768)	(1,000)	(1,250)
PBT	**2,095**	**(62)**	**194**	**682**	**1,432**
Loans and advances (£m)	92	97	133	160	200

Source: ABG, Hardman & Co Research

In 2021, impairments included a £2.1m charge against Arena TV, which collapsed in November 2021. It appears to be a sophisticated fraud affecting 54 other lenders, and RAF financed a portfolio of filming equipment.

ASFL

Specialist bridging finance now being closed

ASFL acted as a specialist lender operating in the niche markets of short-term "bridging" and development finance. ABG's approach has been conservative, with only modest growth in lending in 2022. Given the outlook and experience to date, with the 2022 results, management announced the closure of this unit.

Theme (3): credit outlook

Current numbers

Stage 2 and 3 accounts falling in absolute terms, and as proportion of book

We review ABG's risk profile using its IFRS9 classification of loans into three stages, with Stage 1 being the best quality and Stage 3 the worst. The table below shows the trends across the divisions, which demonstrate that the combined Stage 2 and 3 accounts are down in nominal (and proportionate) terms since the end of 2021. ABG has provided both the detail of its assumptions in its expected loss calculation and a sensitivity analysis to it.

Breakdown of loans (net of expected credit loss provision) by IFRS (stage and division), £m

Divisions	Banking	Mortgages	RAF	ACABL	ASFL	AAG	All other	Total
Stage 1 2022	1,363	127	129	268	14	17	0	1,917
Stage 1 2021	1,298	158	83	182	10	n/a	8	1,738
Stage 1 2020	1,020	224	75	87	6	n/a	12	1,423
Stage 1 2019	1,004	306	101	76	7	n/a	12	1,505
Stage 2 2022	60	11	2	0	1	0	0	74
Stage 2 2021	70	14	11	0	0	n/a	0	95
Stage 2 2020	73	37	16	0	0	n/a	0	125
Stage 2 2019	66	0	1	0	0	n/a	0	66
Stage 3 2022	32	11	3	3	0	0	0	50
Stage 3 2021	31	7	6	0	0	n/a	0	44
Stage 3 2020	30	8	1	0	0	n/a	0	39
Stage 3 2019	26	0	1	0	0	n/a	0	27

Source: ABG, Hardman & Co Research

Weighting to range of economic outturns

Scenario	2018	2019	2020	2021	1H'22	2022	Impact of 100% probability
Extreme downside (severe decline)	1%	1%	2%	2%	2%	11%	(19.1)
Downside 2 (moderate decline)	3%	3%	15%	5%	7%	11%	(7.5)
Downside 1 (decline)	50%	50%	70%	16%	20%	12%	(2.0)
Baseline (no change)	21%	26%	9%	52%	53%	53%	1.0
Upside (growth)	25%	20%	4%	25%	18%	13%	0.7

Source: ABG, Hardman & Co Research

Outlook from here

No signs of pressure in the book

We explored with management what its lead indicators and anecdotal feedback from front-line lenders was telling ABG. The key message is that none of the lead indicators are flashing a cause for concern. Management highlighted that, given its business mix, RAF can be seen as a bellwether of its corporate sector exposures. It also pointed out that, to date, there were no pressures on the book, and, certainly, looking at the table above, there was no evidence in the Stage 2 and 3 data of accounts currently in difficulties. The historical COVID-19 forbearance situations are all either paying on time or providing additional directors' security, which is evidence of management's confidence in the future of the businesses.

Lending criteria tightened in 2H'22, which has seen even lower loan-to-value (LTV) lending

Individual situations can see problems, but we believe marketwide pressure is going to start to be felt only when interest rates are at 4% and above for a sustained period. While there is no pressure at the moment, should the current level of rates be sustained, there are likely to be more accounts with issues. ABG tightened its lending criteria in 2H'22, when its stress tests of 2% over the base rate meant that affordability was too stretched. The LTVs on new lending (which is typically above-average risk) are consequently below historical levels, providing further comfort on the credit outlook.

Other issues from the results

Costs

Costs were higher than expected, reflecting volume growth, performance-related pay and investment

While the group post-impairment operating income was ca.£8m better than our forecasts, costs were ca.£5m higher. We explored with management where the greatest strains were currently being felt, and noted that pressure is being seen across all divisions and markets. The greatest risk of staff loss was perhaps at the junior end, as may be expected. In response to the pressure, in July 2022, the board agreed a one-off payment to all staff of £1,500 (cost: £1m). Additionally, performance-related pay has increased, and investment in people reflects the new opportunities now available.

2023 likely to see average 5%+ salary increases, more investment and dual running costs on new head office

We are forecasting 16% growth in costs in 2023, driven by:

- Continued heavy investment in new businesses, reflecting the market opportunities and higher-than-expected capital generation in recent periods. Core banking costs are expected to rise by 6%.
- While the one-off payment in 2022 was to all staff, annual salary increases next year are likely to be significantly above historical experience. We would expect them to be much more tailored and targeted to specific staff, with average increases of 5%+ likely in April 2023.
- Performance-related pay is likely to increase, reflecting higher profits and franchise growth.

Capital

The total capital requirement ratio (TCR) has been reduced to 8.32% (31 December 2021: 8.69%). The reduction in the TCR is interesting, because ABG already starts from a relatively low level (8% is the lowest that can be allowed); so, for it to reduce further is indicative of how risky the regulator considers the bank to be. At end-2022, the total capital ratio was 14.0% (30 June 2022: 14.0%, 31 December 2021: 14.9%), while the CET1 capital ratio was 11.6% (30 June 2022: 11.4%, 31 December 2021: 12.3%). The NAV per share rose to £14.11 (30 June 2022: £13.00, 31 December 2021: £13.37).

End-2022 surplus £36m

The capital surplus at the end of 2022 was £35.6m, down from £50.5m at end-2021. This reduction reflected i) regulatory changes, including software intangibles (-£7m) and the adoption of counter-cyclical provisions (-£13.2m), offset partially by the regulator reducing the capital requirement (+£7.6m), ii) strong subsidiary loan growth (-£18.2m) and higher treasury assets (-£4.2m), and iii) capital generated from earnings (+£16.5m) and the sale of King Street (+£7.8m), offset by the dividend payment (£5.9m). Looking forward, we see a waterfall in terms of generating the capital, based on:

- Accelerating profit generation – ca.£70m post-tax over the next two years (a year ago, we had been forecasting only £27m).
- Further balance sheet optimisation, including the disposal of non-core assets and the originate and distribute deal for new commercial property lending in the core bank.

Adjusted profit

ABG makes several adjustments to get to a normalised profit, which we detail below.

Adjusted profit				
Year-end Dec (£000)	**2021**	**2022**	**2023E**	**2024E**
Profit before tax and group recharges	**4,638**	**20,009**	**40,119**	**45,586**
Acquisition costs	(8,626)			
Exceptional impact of base rates	11,492			
Arena TV	2,055			
Property writedowns	3,835	4,590		
Sale of Tay mortgages	(2,239)			
Profit on sale of trucks	5,830	6,479	5,000	1,300
Underlying profit	**16,985**	**31,078**	**45,119**	**46,886**

Source: ABG, Hardman & Co Research

Financials

Profit upgrade on margin assumptions, with increased costs

We have, again, significantly upgraded our estimates, primarily to reflect higher net interest income, only partially offset by materially higher costs. This has benefited the banking and other divisions (treasury) division. As noted above, there remains considerable uncertainty around the interest rate environment and its impact. We believe our numbers are conservative, and, should rates continue at their present level, there is room for upgrades through 2023.

Changes to estimates

Year-end Dec (£000)		2022			2023E		2024E
	Old	Actual	% change	Old	New	% change	New
Group op. income	125,866	137,388	9%	143,797	169,727	18%	183,994
Total costs	(107,337)	(108,913)	1%	(115,990)	(126,600)	9%	(135,300)
Cost:income ratio	85%	79%	-7%	81%	75%	-8%	74%
Total impairments	(3,150)	(5,503)	75%	(3,275)	(3,250)	-1%	(3,350)
Reported PBT	17,167	20,009	17%	25,239	40,119	59%	45,586
Adj. PBT (co. basis)	27,167	31,078	14%	29,239	45,119	54%	46,886
Statutory EPS (p)	94.4	109.0	16%	138.0	214.2	55%	242.1
Adj. EPS (co, basis, p)	160.6	169.2	5%	164.4	240.8	46%	249.0
Loans to deposits	67%	66%	-2%	59%	60%	3%	63%

Source: ABG, 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	155,840	158,375
Interest expense	(18,233)	(17,024)	(13,027)	(20,932)	(43,900)	(48,500)
Net interest income	**58,637**	**58,058**	**64,075**	**99,081**	**111,940**	**109,875**
Fees and comms. income	13,935	14,735	18,223	21,586	24,500	27,000
Fees and comms. expenses	(107)	(293)	(100)	(537)	(100)	(100)
Net fees and comms.	13,828	14,442	18,123	21,049	24,400	26,900
Banking operating income	**72,465**	**72,500**	**82,198**	**120,130**	**136,340**	**136,775**
Leasing revenue	0	0	68,673	99,367	158,987	214,633
Leasing cost of sales	0	0	(62,196)	(82,109)	(125,600)	(167,414)
Gross profit from leasing	0	0	6,477	17,258	33,387	47,219
Group operating income	**72,465**	**72,500**	**88,675**	**137,388**	**169,727**	**183,994**
Total impairments	(867)	(2,849)	(3,196)	(5,503)	(3,250)	(3,350)
Other income	5,599	678	3,955	1,627	242	242
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)**	**(126,600)**	**(135,300)**
Profit before tax from continuing operations	**7,011**	**(1,090)**	**4,638**	**20,009**	**40,119**	**45,586**
Income tax	(835)	(242)	2,148	(3,551)	(7,623)	(8,661)
Profit for year	**6,176**	**(1,332)**	**6,786**	**16,458**	**32,497**	**36,925**

Source: ABG, Hardman & Co Research

Divisional pre-tax profits

Year-end Dec (£000)	2021	2022	2023E	2024E
Banking	6,532	19,138	22,090	20,375
WM	(2,121)	(4,101)	(2,500)	(1,500)
AA	3,829	(2,074)	1,387	6,219
Mortgage books	5,634	3,760	750	400
RAF	(62)	194	682	1,432
ACABL	4,737	5,193	8,250	9,000
ASFL	(1,026)	(945)	(1,000)	(800)
Other divisions	(2,253)	11,700	24,800	24,800
Centrals	(10,632)	(12,856)	(14,340)	(14,340)
Group total	**4,638**	**20,009**	**40,119**	**45,586**

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	1,115,044	1,164,982
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	0	0
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**	**2,170,000**	**2,400,000**
Other assets	86,443	96,493	110,119	52,185	52,185	52,185
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**	**4,220,966**	**4,550,404**
Deposits from banks	230,421	230,090	240,333	236,027	236,027	236,027
Derivative financial instruments	319	649	171	135	135	135
Deposits from customers	**2,084,903**	**2,365,207**	**2,837,869**	**3,092,549**	**3,674,000**	**3,974,000**
Liabilities relating to assets classified as held for sale	0	0	0	0	0	0
Current tax liability	633	0	413	1,748	1,748	1,748
Other liabilities	13,500	7,606	26,216	26,144	26,144	26,144
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	37,594	37,594
Total liabilities	**2,387,044**	**2,659,513**	**3,157,988**	**3,402,069**	**3,983,520**	**4,283,520**
Share capital	154	154	154	154	154	154
Retained earnings	209,171	207,839	201,026	212,037	237,505	266,943
Other reserves	-990	-13,970	(301)	(213)	(213)	(213)
Total equity	**208,335**	**194,023**	**200,879**	**211,978**	**237,446**	**266,884**

Source: ABG, Hardman & Co Research

Valuation

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

Average is £20.73, more than double current price

With our higher estimates, the new fair value, on our assumptions, represents 1.3x 2023E book value for a business expected to deliver a near nine-fold increase in profits 2024 on 2021.

Summary of different valuation techniques by scenario

£ per share	GGM	SOTP	DDM
Implied valuation	23.15	27.46	11.58

Source: Hardman & Co Research

GGM

The assumptions and sensitivities in our GGM model are given below. There has been a sharp increase since our last report, reflecting moving forward the base year to 2024 and the higher retentions now expected.

GGM £23.15

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)	266.9	266.9	266.9	266.9
Valuation (£m)	340.3	380.3	283.6	355.8
Valuation per share (p)	**23.15**	**25.87**	**19.29**	**24.21**
Variance (p per share)		40.0	(56.7)	15.6

Source: Hardman & Co Research

SOTP

SOTP increases to £27.46, from £19.53, given the large increase in earnings and moving forward the base year

Our SOTP model has also increased sharply, with both higher earnings and the move to 2024. We have amended a number of our assumptions, including i) a 10x rating for banking (previously 12x), reflecting the above-normal profitability that we are still assuming for the division, ii) 12x for the SME higher, long-term growth businesses (previously 14x) – while the growth outlook for these businesses has improved, a range of listed peers has seen rating contractions, and iii) other divisions' rating cut from 10x to 6x, to again reflect the fact that 2024 may be a peak year of profitability in treasury funding for other divisions. We expect further volume growth from higher surplus deposits, but margins are likely to contract. Our 2.5% of AUM in WM is unchanged.

Summary of different valuation techniques by scenario

	2024E post-tax	Rating	Value (£m)
Banking	16.9	10	169.1
WM			32.5
AA	5.2	12	61.9
Mortgage books	0.3	1	0.3
RAF	1.2	12	14.3
ACABL	7.5	12	89.6
ASFL	(0.7)	12	(8.0)
Other divisions	20.6	6	123.5
Centrals	(11.9)	5	(59.5)
Total			**423.8**

Source: Hardman & Co Research

DDM

ABG now has attractive 2023E yield of 4.9%

DDM model indicates 1,158p

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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