EDISON

Secure Trust Bank

Upbeat trading update

Trading update

Banks

Secure Trust Bank's (STB) trading update seems to vindicate its decision to step away from mortgages for now and focus on segments where the risk-reward pricing is more attractive. The retail and motor finance segments (both with net revenue margins above 10%) have been doing well and earnings are slightly ahead of management expectations in the first four months of this year. We are not changing our forecasts, but may revise them if interims in July confirm the good news.

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	13.3	5.1
12/18	151.6	36.7	162.0	83.0	9.5	5.4
12/19e	167.8	42.0	183.7	87.2	8.4	5.6
12/20e	185.0	52.2	225.1	91.5	6.9	5.9
12/21e	203.5	60.1	254.9	92.6	6.1	6.0

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

Risk-reward benefits

The retail and motor finance segments have the highest net revenue margins (after impairments) in STB's portfolio. The trading update indicates that these two areas are growing well and boosting earnings. STB's decision to stand back temporarily from mortgage lending was a bold one, since mortgages had been slated as one of the legs for growth in the bank. However, management felt that as competition increased in the mortgage segment, what was intended as a defensive segment was becoming more problematic. Lower margins not only mean lower profitability, but also increase operational gearing and earnings risk. STB has not changed its risk appetite (it remains wary of the macro outlook), but seems to be finding risk-adjusted margins in selected, unsecured segments more profitable.

Funding advantage

STB's balance sheet comments were very positive. Credit quality trends are stable, while capital and funding positions remain strong. This balance sheet strength has helped STB gain business so far this year at the expense of some non-bank lending competitors that have struggled with funding, in some cases even ceasing new business. The company believes the continued unwinding of the Funding for Lending and Term Funding schemes may lead to more non-bank lenders facing similar problems, to STB's advantage.

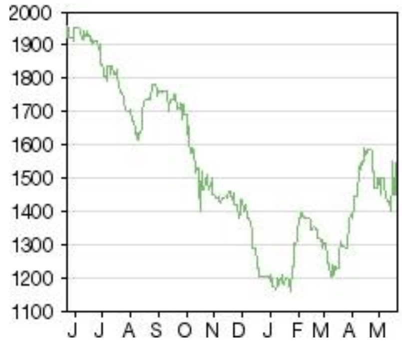
Valuation: Unchanged at 2,428p

We make no changes to our forecasts and maintain our fair value at 2,428p per share (based on a dividend discount model), equivalent to a 2019 P/NTA of 1.9x. STB's shares are up 22% ytd, but the bank's P/NTA is still trading at only 1.1x. We believe that if STB continues to perform well in the next two months, the interim results in July should reflect this and we may revise our numbers.

21 May 2019

Price	**1,545p**
Market cap	**£286m**
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	(2.5)	14.9	(21.2)
Rel (local)	(0.5)	13.6	(15.8)
52-week high/low		1960p	1158p

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

Interim results	July 2019

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Edison profile page

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Risk-reward benefits

STB announced a mortgage hiatus at the beginning of this year. This was a bold step given that STB had chosen mortgages as one of the legs for future growth. Furthermore, this was part of the general balance sheet de-risking strategy as STB grew more concerned with macro uncertainty resulting from Brexit and the evidence of a general slowdown.

Several banks (including some larger players) have been increasing competitive efforts in the mortgage market, largely due to the lower risk profile of mortgages. This has led to some margin compression, especially in the higher-margin segment of the sector (such as higher LTV, lower borrower quality). Management's view is that this is not attractive on a risk adjusted basis. STB believes that this made profitability in this segment more challenging and, paradoxically, also meant higher earnings risk, especially if the economic slowdown became more severe than expected.

In the first four months of this year, the retail finance and motor finance divisions performed well and this seems to be behind the upbeat trading update. The retail finance and motor finance net revenue margins were 10.3% and 15.3% in 2018, respectively, the highest-margin segments in their loan book (mortgages was 2.6%). STB is still following a cautious risk strategy (eg motor finance has been migrating from subprime to near-prime), but at the same time is looking at its risk-adjusted margins carefully and altering its lending direction accordingly.

By way of comparison, CYBG announced its 2019 interims on 15 May, and we note that its six-month net interest margin dropped to 1.71% from 1.84% a year ago. Mortgage lending accounted for 11bp out of this 13bp contraction. While 11bp may seem small at first glance, it is significant at 7% of net interest income. We also note that CYBG indicated that margin pressures would likely remain and that it would proactively reduce its lending in certain mortgage segments as a result of margin compression and competition. Tesco also just announced that it is looking for a buyer for its mortgage portfolio and ceasing new business, quoting 'challenging market conditions'.

Forecasts unchanged

We are keeping our forecasts unchanged despite the upbeat trading update. However, the interims in July may give us reason to revise our numbers.

We forecast loan growth of 20% y-o-y in 2019, stronger in commercial finance (26% y-o-y) than retail lending (15%). We expect growth to be balanced between the two areas in 2020 and 2021.

We continue to expect that some cost investments and one-offs will push the cost/income ratio up from 55.7% in 2018 to 58% in 2019. This will offset some of the benefits from the lower loan loss charge and volume growth. We forecast PBT on a continuing basis to rise from £34.7m in 2018 to £40.2m in 2019.

We forecast the cost to income ratio to improve from 2020 onwards, falling to 56% in 2020 and then 54.5% in 2021.This will be driven by balance sheet growth and the benefits of operating leverage and use of capital. We see pre-tax earnings on a continuing basis rising from £40m to £50m in 2020 and then to £60m in 2021.

We forecast the bank's ROE will increase from 12.8% in 2018 to 18.7% in 2021. By 2021, the bank's CET1 will have dropped to 11% which, although an acceptable level of capital, would require growth beyond 2021 to be funded by self-generated capital.

Valuation

STB's shares have risen by 22.3% ytd. However, the bank was trading below its tangible net assets. This means the shares are now at a 2019 P/NTA of only 1.1x, while our fair value at (2,428p) remains at a P/NTA 1.9x (forecast tangible net asset of 1,298p). Our fair value is derived using a dividend discount model. Note that we forecast a ROTE of 18.0% in 2020 and 19.8% in 2021, hence a fair value well in excess of tangible book value is fully justified in our view.

Exhibit 1: Recent share price performance in context

	One month	Three months	One year	Ytd	From 12m high
Secure Trust Bank	**-8.5**	**8.2**	**-26.1**	**22.3**	**-27.1**
1PM	0.0	-5.4	-9.8	7.3	-29.9
Close Brothers	-3.8	0.7	-3.9	4.3	-10.7
CYBG	-8.0	4.2	-35.2	9.0	-46.2
Metrobank	-30.5	-57.1	-82.6	-65.5	-83.4
OneSavings Bank	-3.5	17.1	2.9	23.0	-6.1
Paragon	0.5	10.4	-15.3	19.7	-17.2
PCF Group	3.9	-9.4	-20.3	-8.6	-24.8
S&U	20.2	2.6	-20.7	1.9	-22.2
Average	**-2.6**	**-4.6**	**-23.1**	**-1.1**	**-30.1**
Average ex-Metro	**1.3**	**2.9**	**-14.6**	**8.1**	**-22.5**

Source: Refinitiv, Edison Investment Research. Note: Priced at 15 May 2019.

Exhibit 2 compares STB's market multiples with some of its challenger and specialist lender peers. Excluding the outlier Metro Bank, STB's 2018 and 2019 P/E ratios are in line with the peer average. It is trading on a 2018 PBV of 1.1x, which is 15% below its peers. Its ROE of 9.8% is 32% below its peers since optically on this metric it does not look comparatively good value. However, we expect STB to have a significant uplift in profitability in 2020 (ROE of 17.1%) and then reach 18.7% in 2021. On this basis, it would suggest that the 15% discount looks attractive.

We reiterate our view that, as the market gains confidence that STB's repositioning is indeed working, this will be reflected in its rating. If STB continues to do as well as it indicated in the trading update, we believe the interims in July will support this view.

Exhibit 2: Challenger/specialist lender comparative table

	Price (p)	Market cap (£m)	P/E (x) CY0e	P/E (x) CY1e	Dividend yield (%)	ROE (%) last reported	P/BV (x) last reported
Secure Trust Bank	**1,455**	**270.0**	**9.0**	**7.9**	**5.7**	**9.8**	**1.12**
1PM	44	38.7	6.0	5.5	1.5	13.0	1.00
Close Brothers	1,502	2283.1	11.0	10.9	4.2	16.3	1.69
CYBG	198	2844.2	7.6	7.9	1.6	10.6	0.55
Metrobank	584	571.4	13.9	18.4	0.0	2.9	0.41
OneSavings Bank	431	1060.2	8.0	7.0	3.4	22.3	1.55
Paragon	462	1211.5	9.5	8.9	4.2	10.3	1.19
PCF Group	33	82.9	15.4	10.4	0.9	11.0	1.65
S&U	2,170	262.5	6.4	5.7	3.1	17.6	1.68
Average			**9.7**	**9.3**	**2.4**	**13.0**	**1.21**
Average ex-Metro			**9.1**	**8.0**	**2.7**	**14.4**	**1.3**
STB vs average ex-Metro			(2%)	(1%)	112%	-32%	-15%

Source: Refinitiv, Edison Investment Research. Note: Priced at 15 May 2019.

Exhibit 3: Financial summary

Year-end December	2016	2017	2018	2019e	2020e	2021e
£m except where stated						
PROFIT AND LOSS						
Net interest income	92.5	114.6	133.7	148.5	162.1	177.8
Net commission income	14.5	14.9	17.9	19.3	22.8	25.7
Total operating income	107.0	129.5	151.6	167.8	185.0	203.5
Total G&A expenses (exc non-recurring items below)	(64.3)	(71.3)	(84.5)	(97.3)	(103.5)	(110.9)
Operating profit pre impairments & exceptionals	42.7	58.2	67.1	70.5	81.5	92.7
Impairment charges on loans	(23.3)	(33.5)	(32.4)	(30.3)	(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	40.2	50.3	60.1
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	40.2	50.3	60.1
Corporation Tax	(5.2)	(5.1)	(6.4)	(6.8)	(8.5)	(10.2)
Tax rate	26.8%	20.4%	18.4%	17.0%	17.0%	17.0%
Bank tax surcharge	0.0	0.0	0.0	(1.2)	(2.0)	(2.8)
Profit after tax - continuing basis	14.2	19.9	28.3	32.1	39.7	47.1
Discontinued business	123.3	3.9	0.0	0.0	0.0	0.0
(Loss)/profit for year	137.5	23.8	28.3	32.1	39.7	47.1
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	32.1	39.7	47.1
Company reported pre-tax earnings adjustments	7.9	2.0	2.0	1.8	1.9	0.0
Reported underlying pre-tax earnings (ex-discontinued 2015/16)	27.3	27.0	36.7	42.0	52.2	60.1
Reported underlying earnings after tax	20.6	21.5	29.9	33.9	41.6	47.1
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**	**172.9**	**213.6**	**253.4**
Underlying diluted EPS (p)	113.0	116.4	162.0	183.7	225.1	254.9
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%	6.67%	6.15%	5.84%
Impairments/average loans	2.04%	2.30%	1.79%	1.36%	1.18%	1.07%
Cost income ratio	60.1%	55.1%	55.7%	58.0%	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	354.7	424.6	411.7
Total liabilities	1,274.0	1,642.5	2,207.2	2,603.3	3,007.7	3,420.6
Net assets	236.0	249.1	237.1	253.7	277.2	314.6
Minorities	0.0	0.0	0.0	0.0	0.0	0.0
Shareholders' equity	236.0	249.1	237.1	253.7	277.2	314.6
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	1,373	1,500	1,703
Tangible NAV per share (p)	1,229	1,292	1,230	1,298	1,425	1,638
Return on average equity	72.9%	9.8%	11.6%	13.1%	15.0%	15.9%
Normalised return on average equity	9.9%	8.9%	12.8%	14.4%	17.1%	18.7%
Return on average TNAV	**10.3%**	**9.3%**	**13.4%**	**15.1%**	**18.0%**	**19.8%**
Average loans	1,134.6	1,484.6	1,863.7	2,228.7	2,430.1	2,635.0
Average deposits	1,067.5	1,321.7	1,655.4	2,085.3	2,264.9	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%**	**12.0%**	**11.1%**	**11.0%**

Source: Edison Investment Research, company data