

Secure Trust Bank

Trading update

Upbeat trading update

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.

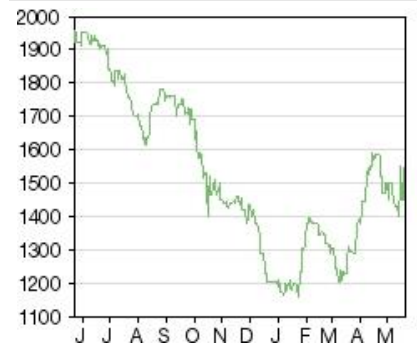
Banks

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

Next events

Interim results July 2019

Analysts

Pedro Fonseca +44 (0)20 3077 5700
 Andrew Mitchell +44 (0)20 3681 2500

financials@edisongroup.com

[Edison profile page](#)

**Secure Trust Bank is a
 research client of Edison
 Investment Research Limited**

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

General disclaimer and copyright

This report has been commissioned by Secure Trust Bank and prepared and issued by Edison, in consideration of a fee payable by Secure Trust Bank. Edison Investment Research standard fees are £49,500 pa for the production and broad dissemination of a detailed note (Outlook) following by regular (typically quarterly) update notes. Fees are paid upfront in cash without recourse. Edison may seek additional fees for the provision of roadshows and related IR services for the client but does not get remunerated for any investment banking services. We never take payment in stock, options or warrants for any of our services.

Accuracy of content: All information used in the publication of this report has been compiled from publicly available sources that are believed to be reliable, however we do not guarantee the accuracy or completeness of this report and have not sought for this information to be independently verified. Opinions contained in this report represent those of the Edison analyst at the time of publication. Forward-looking information or statements in this report contain information that is based on assumptions, forecasts of future results, estimates of amounts not yet determinable, and therefore involve known and unknown risks, uncertainties and other factors which may cause the actual results, performance or achievements of their subject matter to be materially different from current expectations.

Exclusion of Liability: To the fullest extent allowed by law, Edison shall not be liable for any direct, indirect or consequential losses, loss of profits, damages, costs or expenses incurred or suffered by you arising out of or in connection with the access to, use of or reliance on any information contained on this note.

No personalised advice: The information that we provide should not be construed in any manner whatsoever as, personalised advice. Also, the information provided by us should not be construed by any subscriber or prospective subscriber as Edison's solicitation to effect, or attempt to effect, any transaction in a security. The securities described in the report may not be eligible for sale in all jurisdictions or to certain categories of investors.

Investment in securities mentioned: Edison has a restrictive policy relating to personal dealing and conflicts of interest. Edison Group does not conduct any investment business and, accordingly, does not itself hold any positions in the securities mentioned in this report. However, the respective directors, officers, employees and contractors of Edison may have a position in any or related securities mentioned in this report, subject to Edison's policies on personal dealing and conflicts of interest.

Copyright: Copyright 2019 Edison Investment Research Limited (Edison). All rights reserved FTSE International Limited ("FTSE") © FTSE 2019. "FTSE®" is a trade mark of the London Stock Exchange Group companies and is used by FTSE International Limited under license. All rights in the FTSE indices and/or FTSE ratings vest in FTSE and/or its licensors. Neither FTSE nor its licensors accept any liability for any errors or omissions in the FTSE indices and/or FTSE ratings or underlying data. No further distribution of FTSE Data is permitted without FTSE's express written consent.

Australia

Edison Investment Research Pty Ltd (Edison AU) is the Australian subsidiary of Edison. Edison AU is a Corporate Authorised Representative (1252501) of Myonlineadvisers Pty Ltd who holds an Australian Financial Services Licence (Number: 427484). This research is issued in Australia by Edison AU and any access to it, is intended only for "wholesale clients" within the meaning of the Corporations Act 2001 of Australia. Any advice given by Edison AU is general advice only and does not take into account your personal circumstances, needs or objectives. You should, before acting on this advice, consider the appropriateness of the advice, having regard to your objectives, financial situation and needs. If our advice relates to the acquisition, or possible acquisition, of a particular financial product you should read any relevant Product Disclosure Statement or like instrument.

New Zealand

The research in this document is intended for New Zealand resident professional financial advisers or brokers (for use in their roles as financial advisers or brokers) and habitual investors who are "wholesale clients" for the purpose of the Financial Advisers Act 2008 (FAA) (as described in sections 5(c) (1)(a), (b) and (c) of the FAA). This is not a solicitation or inducement to buy, sell, subscribe, or underwrite any securities mentioned or in the topic of this document. For the purpose of the FAA, the content of this report is of a general nature, is intended as a source of general information only and is not intended to constitute a recommendation or opinion in relation to acquiring or disposing (including refraining from acquiring or disposing) of securities. The distribution of this document is not a "personalised service" and, to the extent that it contains any financial advice, is intended only as a "class service" provided by Edison within the meaning of the FAA (i.e. without taking into account the particular financial situation or goals of any person). As such, it should not be relied upon in making an investment decision.

United Kingdom

This document is prepared and provided by Edison for information purposes only and should not be construed as an offer or solicitation for investment in any securities mentioned or in the topic of this document. A marketing communication under FCA Rules, this document has not been prepared in accordance with the legal requirements designed to promote the independence of investment research and is not subject to any prohibition on dealing ahead of the dissemination of investment research.

This Communication is being distributed in the United Kingdom and is directed only at (i) persons having professional experience in matters relating to investments, i.e. investment professionals within the meaning of Article 19(5) of the Financial Services and Markets Act 2000 (Financial Promotion) Order 2005, as amended (the "FPO") (ii) high net-worth companies, unincorporated associations or other bodies within the meaning of Article 49 of the FPO and (iii) persons to whom it is otherwise lawful to distribute it. The investment or investment activity to which this document relates is available only to such persons. It is not intended that this document be distributed or passed on, directly or indirectly, to any other class of persons and in any event and under no circumstances should persons of any other description rely on or act upon the contents of this document.

This Communication is being supplied to you solely for your information and may not be reproduced by, further distributed to or published in whole or in part by, any other person

United States

The Investment Research is a publication distributed in the United States by Edison Investment Research, Inc. Edison Investment Research, Inc. is registered as an investment adviser with the Securities and Exchange Commission. Edison relies upon the "publishers' exclusion" from the definition of investment adviser under Section 202(a) (11) of the Investment Advisers Act of 1940 and corresponding state securities laws. This report is a bona fide publication of general and regular circulation offering impersonal investment-related advice, not tailored to a specific investment portfolio or the needs of current and/or prospective subscribers. As such, Edison does not offer or provide personal advice and the research provided is for informational purposes only. No mention of a particular security in this report constitutes a recommendation to buy, sell or hold that or any security, or that any particular security, portfolio of securities, transaction or investment strategy is suitable for any specific person.

Frankfurt +49 (0)69 78 8076 960
Schumannstrasse 34b
60325 Frankfurt
Germany

London +44 (0)20 3077 5700
280 High Holborn
London, WC1V 7EE
United Kingdom

New York +1 646 653 7026
1,185 Avenue of the Americas
3rd Floor, New York, NY 10036
United States of America

Sydney +61 (0)2 8249 8342
Level 4, Office 1205
95 Pitt Street, Sydney
NSW 2000, Australia