Investment Banking / Hedge Fund / Equity Research Case Study: Projecting Shawbrook's Financial Statements, Valuing the Company, and Making Recommendations

As part of your evaluation process for Shawbrook, you have conducted "channel checks" where you spoke with key market participants to get a sense of the trends in different areas:

- **Loan Growth and Shawbrook's Market Share** – You spoke with several economists, real estate agents and mortgage brokers, and experts on consumer spending in the UK. You also spoke with several customers who were comparing different mortgage and loan options.

- **Regulations** – You spoke with several experts on the UK's banking regulations, and how the country might implement certain rules differently from what is suggested in Basel III and CRD IV.

- **Competition and Margins** – You spoke with several bank analysts to assess how much competition exists in Shawbrook's business segments, and how that may change over time; you also found information on the rates and terms for different products and how those compare to other companies' offerings.

You complete this type of exercise more often in hedge funds, asset management, and equity research than in investment banking, but bankers frequently adjust consensus estimates or "management's projections" by incorporating their views of the company.

Here are the comments you've collected:

Comments on UK Economic Growth and Interest Rates:

You spoke with a researcher at the **National Institute of Economic and Social Research**, who made the following comments:

- "In the best-case scenario, we might see around **3%** annualized nominal GDP growth over the next five years; in the worst-case scenario, there will be another 2009-style recession with a declining GDP over two years, followed by modest increases."

A faculty member at the **Warwick Economics Research Institute** added the following:

- "Expectations are for 2-3% nominal growth, falling to 2% over time. We think the Bank of England will keep interest rates low, despite statements to the contrary, due to fears of a slowdown in emerging markets."

Finally, a **Bank of England** junior employee made the following off-the-record comments to you:

- "You're unlikely to see interest rates above 1.0% for the next few years, and any rate increases will be gradual and will rise to a lower level than in past periods."

Comments on Addressable Loans Markets within the UK:

You reviewed some industry surveys and Shawbrook's IPO prospectus, and you have also spoken with market experts such as real estate agents and loan officers.

They made the following comments:

- **UK Commercial Mortgage Market:** Almost everyone expected the commercial mortgage market to remain stagnant, or, at worst, decline by several percentage points each year. The overall mortgage market has been declining for the past five years.
    - **"Buy-to-Let" Mortgages:** While this subsector has been growing more quickly, recent legislation proposed by George Osborne (higher taxes and stamp duty increases) means that continued 5-10% annual growth is unlikely.

Most sources seemed to agree that the **housing market** was due for a significant price correction. One real estate agent based in South Kensington made the following comments:

- "Sales of higher-end residences have been sluggish this year, and we've had to reduce prices in several cases to complete deals. Transactions are also taking about 20-30% longer to close than in past years. Foreign money is still flowing in, but the volume has decreased greatly."

You spoke with a representative at a local manufacturing firm who made the following comments about the **asset finance** market:

- "Asset finance is an increasingly critical way of funding our operations. It lets us complete transactions more quickly and with less hassle than traditional bank loans, and we plan to use it even more in the future."

You spoke with a credit analyst at the **IMF** who made the following comments about the other segments of the UK lending market:

- "Broadly speaking, we expect business credit and consumer lending to grow in-line with the economy as a whole. We may see slightly higher growth in these areas as consumers look to unsecured lending for their financial needs. The overall commercial mortgage market has declined, but the market for second-charge mortgages (i.e., second mortgages) has continued to perform reasonably well as homeowners take advantage of historically low rates."

Comments on Competition and Shawbrook's Market Share by Segment:

You spoke with an upper-middle class UK citizen who is currently renting out four properties in central London and considering a mortgage for his fifth. He made the following comments:

- "I have so many more options than I did even 2-3 years ago that I'm still undecided. I get better service from the smaller banks, but within that group, there's quite a bit of variance in pricing, with some banks charging **1-2%** more than others on similar mortgages."

Empirically, Shawbrook's gross yields on commercial mortgages are also higher than those of its competitors:

- **Shawbrook Gross Asset Yield:** 6.3%
- **Aldermore Gross Asset Yield:** 5.1% for residential and 6.0% for SME
- **OneSavings Bank Gross Asset Yield:** 5.8%

One real estate broker also made the following comments about buy-to-let mortgage lenders:

- "Shawbrook won the vast majority of competitive deals 2-3 years ago, but we've seen their win rate come down as more firms have entered the market. I could see them continuing to increase their share within the BTL and broader mortgage markets, but I don't think it will go above **1%** anytime soon, especially given the continued presence of the high street banks and more challengers popping up."

You also spoke with several corporate finance and treasury officials about the **asset finance** market, and received the following comments:

- "Our options have expanded greatly in the past few years, but we don't always pick the lowest-rate loan, as factors such as customer support and covenants, terms, and restrictions also come into play. We aim for **8-9% interest loans**, but we will accept higher rates than that depending on the deal."

One banking analyst who covers asset finance also made the following comments:

- "Shawbrook is likely to face increased competition in mortgages and BTL, but in asset finance it is more insulated because of its specialist focus (as opposed to Aldermore, which focuses on standard hard-asset deals). We expect its market share to increase, but it may not capture more than a few percentage points of the total addressable market."

Shawbrook's gross yields in asset finance are higher than those of its competitors:

- **Shawbrook Gross Asset Yield:** 10.0%
- **Close Brothers Gross Asset Yield:** 9.8%
- **Aldermore Gross Asset Yield:** 6.4% (Hard-asset focus rather than specialized lending)

A mortgage broker who specializes in second-charge mortgages (Shawbrook's "Secured Lending" segment) made the following comments:

- "Overall, Shawbrook's products are very competitive and almost certainly best of class in the second-charge market. The market is highly fragmented, but the company has been winning about 10% of the deals I've seen. I believe its win rate could go as high as 15%."

You were not able to gather much information on the company's other segments, but the general sentiment was that Shawbrook's market share would continue to rise at a steady pace across the board.

Competitive pressure seemed strongest in commercial mortgages.

Comments on Funding Costs:

Shawbrook is funded primarily with retail deposits, of which ~75% have fixed rates and ~25% have variable rates; approximately 50% of its deposits have terms of less than one year, and the remainder have terms of 1-5 years. It also has 10-year 11% Subordinated Notes.

One banking industry analyst at an **Oxford-affiliated group** made the following comments:

- "Although variable-rate deposits become more expensive when rates rise, the rates on fixed-rate deposits may also increase because loans are priced at the going market rates at the time of issuance. So if the bank specializes in short-term (<1 year) loans, you may not even see a huge difference in the cost of funding between fixed and variable-rate deposits."

Management has announced intentions to switch to a greater percentage of wholesale funding, but it is unclear when this will happen or what percentage will shift.

Comments on Risk-Weighted Assets and Regulatory Capital:

Currently, Buy-to-Let (BTL) mortgages in the UK receive a **35%** risk weight. However, the Basel Committee has suggested a **90%** risk weight for any loans with a 60% to 80% loan-to-value ratio, which is the typical LTV range for Shawbrook's loans.

Such a change would result in higher capital requirements for all the "challenger banks," including Shawbrook, but it is unclear how serious this risk is.

Equity research analysts made the following comments:

- "We continue to believe that the eventual effect on the exposed companies will be less onerous than outlined in the Basel proposal…"
- "We believe the PRA will continue to argue for national discretion on the basis of exceptionally low loss rates in the UK, and that it deems the macro-prudential powers over buy-to-let that will be granted to the Bank of England's Financial Policy Committee as sufficient to regulate the market, without further need for increasing risk weights."
- "Further, we note that the lead in time for any changes to capital requirements is long. If implemented, the Basel approach would not come into force until 2019."

However, other sources you spoke with at the **PRA (Prudential Regulation Authority)** and **Financial Services Authority (FSA)** made the following comments:

- "BTL mortgages have been quite contentious, and we expect some change to the risk weights, given the recent tax and stamp duty increases in the sector. It is unclear how much of the Basel proposals the authorities will adopt, but *some* amount of change seems likely, given the state of the UK housing market."

Management has set a target of a **13% Common Equity Tier 1 (CET 1) Ratio**; the policies of other challenger banks differ, but most have CET Ratios in a similar range.

Comments on Cost Structure and Employee Compensation:

Management has targeted a **40% cost-to-income ratio by 2017**. Most commentary suggests that this is plausible, given that larger banks have ratios in a similar or lower range.

One banking analyst made the following comments:

- "The 40% goal seems plausible, but it may not happen by 2017, especially if loan growth slows down and the company's net interest margin falls. We could see a scenario where it takes a year or two longer to get there."

You also spoke with several former employees of Shawbrook and other challenger banks, who said the following:

- "Compensation has been very generous at challenger banks, with salaries and benefits well above market rates at the high street banks. Even junior loan agents can expect to earn a premium to market compensation, and **pay is set to increase at a rate greater than inflation** over the next few years since it is difficult to find staff who are qualified for the manual underwriting that challenger banks specialize in."