14 May 2018

hardman&co

Non-Standard Finance plc

Everyday Loans: a heart of gold

The 14 May trading statement confirmed that all the 2017 trends have continued, leaving our strong growth forecasts unchanged. Rapid loan growth has been seen in each division, impairment continues to be in line with previous guidance (i.e. tightly controlled), and investment continues. In this note, we review the heart of the group, Everyday Loans (80% of 2017 normalised operating profits, 60% of net loan book and 50% of revenue). We believe it has strong competitive advantages in sales, costs and credit, and it has multiple levers to deliver sustainable earnings through an economic downturn. NSF's 2019E P/E of 9.6x is an anomaly with its growth and profitability outlook.

- **Trading update**: NSF's AGM trading update advised trading is in line with management expectations. Strong growth has been seen in each division (inc. being on target for 20% in home collect). Credit remains tightly controlled
- **Everyday Loans (EL):** In this note, we show how the product range and market positioning should increase sales sharply. We review the multiple economies of scale, from having a large branch network. We detail how this network improves credit assessment and collections. We also discuss how repricing and volume growth should offset rising impairments in a downturn.
- **Valuation:** Our absolute valuation measures for NSF group range from 100-103p per share. Until consensus adopts a uniform IFRS9 approach across companies, peer comparisons have limited value.
- **Risks:** For all lenders, credit risk is key noting EL has delivered strong growth, while controlling impairment. NSF is innovative and may incur losses in piloting products but these risks are kept proportionate. Regulation is an issue in home credit, and management is taking appropriate action to mitigate this risk.
- **Investment summary:** Substantial value should be created, as i) competitors have withdrawn, ii) NSF is well capitalised, with access to committed debt funding, (iii) macroeconomic drivers are positive, and iv) NSF has an experienced management team, delivering technological efficiency without compromising the key F2F model. Targets of 20% loan book growth and 20% EBIT RoA appear credible, and investors are paying 9.6x 2019E P/E and getting a 4.7% yield.

Financial summary and valuation

Year-end Dec (£000)	2016	2017	2018E	2019E
Revenue	95,124	121,682	166,098	197,000
Impairments (incl. IFRS9)	-26,155	-28,795	-39,728	-46,208
Total costs (excl. dep.)	-49,600	-67,706	-85,596	-93,760
EBITDA	19,369	25,181	35,443	50,638
PBT	13,056	13,203	14,424	24,798
Stat. PBT (co. basis)	-9,342	-13,021	-4,196	11,348
Pro-form. norm. EPS (p)	3.37	3.44	3.72	6.40
DPS (p)	1.20	2.20	2.50	3.15
P/adj. earnings (x)	18.2	17.9	16.5	9.6
P/B (x)	0.9	0.9	0.9	0.9
P/tangible book	2.1	2.8	2.8	2.6
Yield	1.8%	3.3%	3.7%	4.7%

Source: Hardman & Co Research

Financials

Source: Eikon Thomson Reuters

Market data

EPIC/TKR	**NSF**
Price (p)	61.5
12m High (p)	78.75
12m Low (p)	50.5
Shares (m)	314
Mkt Cap (£m)	192
EV (£m)	398
Free Float	99%
Market	Main

Description

In the UK non-standard lending market, NSF has the market-leading network in unsecured branch-based lending, and is number two in guarantor loans and number three in home credit.

Company information

CEO	John van Kuffeler
CFO	Nick Teunon
Exec Dir	Miles Cresswell-Turner

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Key shareholders

Invesco	28.7%
Woodford Investment	26.8%
Marathon Asset Mgt.	10.3%
Aberforth Partners	10.2%
Quilter Cheviot AM	4.1%
ToscaFund	3.8%

Next event

Early August	Interim results

Analysts

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14 May trading statement

NSF’s AGM trading statement is given below. There are few surprises and no reason at this stage to change our strong franchise and profit growth forecasts.

“Ahead of the Company's Annual General Meeting to be held later today, the Group has made the following trading statement:

Trading performance since the full year results on 13 March 2018 has been in line with management's expectations.

Having already opened 11 out of the 12 new branches scheduled for this year, Everyday Loans has continued to enjoy strong loan book growth whilst maintaining a tight control on impairment. As a result, risk adjusted margins remain strong and in-line with 2017.

The pace of growth in guarantor loans means that this is now the Group's second largest division. Both the George Banco and TrustTwo brands are enjoying record volumes month-on-month, reflecting strong market demand and our position as the clear number two in the sector. Impairment remains in-line with previous guidance.

As expected, in home credit, Loans at Home has continued to enjoy good loan book growth and we remain on course to achieve our target of 20% in the current year. The large numbers of new agents recruited in 2017 are continuing to increase the number of customers on their books while impairment remains in-line with previous guidance.

With long-term funding in place, we remain confident in the full year outlook.”

Everyday Loans review

Summary

Everyday Loans 80% of 2017 normalised operating profit

Everyday Loans (EL) is the core of NSF, representing, in 2017, ca.60% of the group loan book, 51% of revenue and 80% of normalised operating profit before central costs. NSF completed the acquisition of branch-based lender EL on 13 April 2016. We see competitive advantages helping to drive revenue, control costs and improve credit, thus generating an enviable profit and franchise growth outlook. We believe investors should focus on the following.

Competitive advantages in sales, operational efficiency and credit

- **Unique market position, with broad range of products generating cross-sales.**
- **Operational leverage allowing economies of scale, best practice cross-fertilisation, better control of risk.**
- **Core credit controls.**

Levers to manage downturn

- **Earnings stability in macroeconomic downturn.**

Unlike many, limited regulatory risk

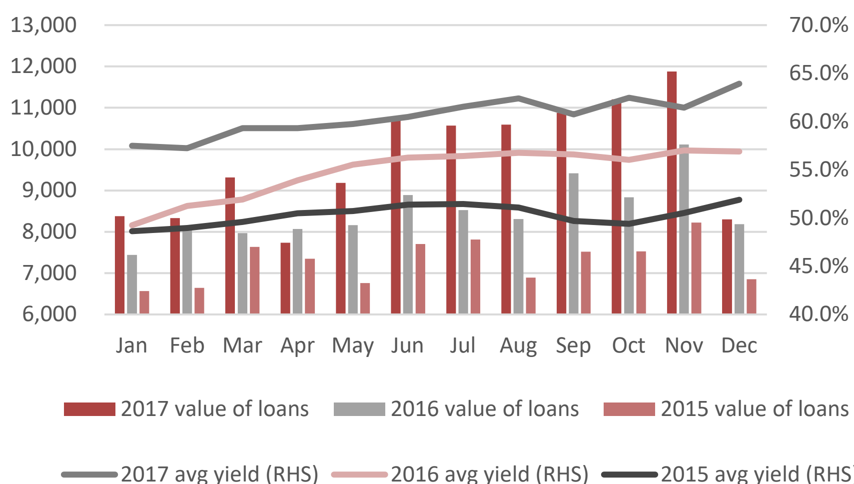
- **Limited regulatory risk.**

Business is profitable when peers do not have the same competitive advantage"

- **Strong existing profitability when peers are unprofitable.**

Performance since acquisition

Figure 1: EL new loans issued (£000s) and average yield (%)*, 2015-17



*Source NSF, Hardman & Co Research * before the amortisation of broker commissions*

When NSF acquired EL in April 2016, it promised to invest in new branches, grow lending, increase prices and adopt a slightly greater appetite for risk to earn higher yields. As can be seen in Figure 1, these have all been delivered.

Branch expansion as promised (53 at end-17 vs. 41 at end-2016).

- Management has delivered the branch footprint growth it promised: 2017 saw 12 new branch openings, taking the total to 53, after five being opened in 2016. It had targeted 12 for 1H'18, 11 of which are already open. Local customers are usually migrated to new branches, so that branches historically have been kept at an optimal size of ca.£3m-£4m of loans, (800-1,000 customers). We believe that future operating efficiencies may allow branches to manage even larger volumes providing further opportunities for growth, although this is not factored into our forecasts (pre-2008 operators such as Welcome and others operated branches with loan books of £10m or more).

Further increases in monthly lending and expansion of revenue yield

- Volume growth and re-pricing have been delivered exactly as promised. More than 1m leads were processed in 2017 (2016: 860k), helped by the expanded branch network. As can be seen in Figure 1, volumes are markedly higher (average £9.7m per month in 2017 vs. £8.5m in 2016 and £7.3m in 2015), and average pricing (before the amortisation of broker fees) has also risen (average 61% in 2017 vs. 55% in 2016 and 50% in 2015).

Unique market position

Product range and competitor comment

Product range means EL can capture the whole customer journey, as their credit quality improves

There are no national competitors in branch-based non-standard finance (most other branch networks closed down after the global financial crisis). As can be seen in Figure 2, EL offers a much broader range of APRs and amounts to be borrowed than a range of its competitors. This is important, as it means it can provide finance to the same customer, as it journeys from a poor credit rating through to near prime. The cheapest customer set to be acquired is an existing one; so this lower cost of acquisition is a competitive advantage. It is worth noting that, in 2017, EL obtained the FCA licence to undertake short-term lending, having previously lent only beyond 12 months. This further adds to the flexibility the company has in meeting customer demand.

Figure 2: Product range comparisons

Product range	Company					
	EL	Oakam/Link Loans	Credit Unions	Likely Loans	Avant	118 118 Money
Amount loaned (£s)	1k - 15k	200 – 5k	Varies	300-5k	1k - £25k	1k – 5k
Term (months)	12-60	3-12, 24	Varies	12-60	12 – 72	12, 18 or 24
APRs (%)	24.2 –299.9	98.8-1,421	13 - 43	39.9 – 99.9	11.8 – 49.8	35.9 - 99.9
Unsecured	Y	Y	Y	Y	Y	Y
Main distribution	Branch	Branch/Online	Branch	Online	Online	Online

Source: NSF, Hardman & Co Research

Some potential competitors include the following:

The second largest in branch-based lending competitor appears more focused on "FinTech" opportunities, reducing focus on its limited branch business

- Oakam: this is the second-largest branch-based lender. It was founded in 2006, and is backed by Cabot Square Capital LLP and a £35m debt investment from Victory Park Capital Advisors LLC, announced in December 2017. Since inception, Oakam has disbursed over 420,000 loans totalling £320m. Its branches are limited to London (14), Liverpool (1) and the Midlands (5). In its recent press releases, the company has emphasised a digital-first approach and described itself as a FinTech lender. Furthermore, there is a different customer focus, with Oakam concentrating on issuing smaller loans to those who are either un-banked, due to recently moving to the UK without a credit history, or those under-banked, due to getting into financial difficulties in the past. Oakam

is targeting the former, with staff speaking over 20 languages, and its residency requirement is just six months. As detailed in the section on profitability below, the latest filed report and accounts shows that Oakam is unprofitable.

Credit unions are generally small, not commercially organised and have a limited product range

- Credit unions: some credit unions charge less than 1% per month and, by law, they cannot charge more than 3% per month (APR 43%). At the higher end, credit unions are competition for EL's better-quality customers. According to Bank of England statistics, the total number of credit unions in the UK at the end of 2017 was 450 (down 4% from 471 at end-2016). Excluding Northern Ireland, the numbers were 302 and 321, respectively. Total membership rose from 1.702m to 1.749m over the period (1.148m to 1.179m excluding Northern Ireland). Total loans were £1.4bn at the end of 2017, up 8% on end-2016. Interestingly, loans in England rose 20% to £521m, and, in Scotland, they rose 11% to £313m. Credit unions are not a homogenous group. Some are run with the intent of lending small amounts (typically below EL's level) to those unable to get credit from a reputable lender. Others are run more commercially, and so are direct competitors. Even with a sector not run for profitability, its RoE was ca.12% in 2017; for some credit unions, this is a constraint on lending growth.

Online is competition but has a different risk assessment model

- Online lenders: in addition to heavily advertised online lenders, such as 118 118 Money, comparison sites such as uSwitch, www.money.co.uk and moneysupermarket.com all have separate sections specifically for those with bad credit records. The key differentiators of EL from these competitors include the broader credit spectrum EL can service and the branch credit assessment process (see section on credit below). It is also worth highlighting that all of the major online lenders are loss-making (see section below).

- Payday lenders: it is important to note that payday lenders are not competitors. Most are not prepared to lend the amount offered by EL, they are at much higher APRs and they tend to require much quicker repayment. This is important, as the regulatory and press pressures on payday lenders do not apply to EL.

Cross-sell

To existing customers

Existing and previous customers account for up to half of new lending, so offering products to capture their whole journey is important

Competitive advantage generates more sales at lower acquisition cost

Existing and former customers accounted for over half the gross new lending in 2016, although this proportion fell to ca.40% in 2017, with the new branch openings and a focus on attracting new customers. Being able to offer a broad range of interest rates is important in capturing the customer for an extended period as their credit evolves, and so maximising the opportunity from the existing customer base. A customer with a relatively recent CCJ is likely to be relatively high-risk, and so it is appropriate to charge a higher interest rate. However, assuming the customers make steady repayments on their loans, over time, their credit rating should improve, opening up borrowing opportunities at lower rates of interest. A lender such as Avant (maximum rate 49%) or even Likely Loans (maximum APR 99%) is unlikely to capture the customer early. Equally, a lender such as Oakam, with a minimum rate of 98.8%, is unlikely to keep the customer as the latter's credit improves. EL's broad product range means it can both attract and keep such customers. The key economic advantage is that a new loan to an existing customer has no acquisition cost.

Currently, just £60k per month out of a total £10m applications is referred to the guarantor loans division. A target of £200k per month looks very credible.

To guarantor loans businesses

EL is able to generate leads for its guarantor loan business where the creditworthiness of the customer means that they attract a high APR and whilst EL is happy to lend, the customer is unable to afford the regular payments for the loan amount on a stand-alone basis. By introducing a guarantor, the customer may obtain a loan at a lower APR and therefore can afford the loan. The investment in acquiring the customer is thus not wasted. We believe that the potential to leverage this unique source of additional traffic could be significant. Only 3% of applications convert to a loan at EL (ca.£10m per month in 2H'17). A further 3% have passed all the credit checks and the telephone interview, and they have been engaged enough to attend a branch but get declined at the branch. A further 16% fail at the telephone interview stage, having passed the initial credit scores and been willing enough to engage. To make a cross-sale in practice, we believe that the personal interface at the branch means that a referral to the guarantor business will carry more weight than one via the internet, and we note that, in 2017, branch referrals accounted for 5% of guarantor loans. Clearly not all the customers declined by EL will be able to find a willing guarantor, but, in 2H'17, the referrals accounted for ca.£60k per month of new lending, and the management target of ca.£200k per month looks achievable.

Figure 3: Waterfall opportunity (out of 100 applications)

Stage of process	Out of 100	Comment
Application	100	
Initial declines	66	Limited opportunity
No response	12	Likely to have gone elsewhere/not need loan
Telephone declines	16	Passed credit scoring and engaged enough to call
Declined at branch	3	Core opportunity of ca.£10m pm
Get loan from EL	3	

Source: NSF, Hardman & Co Research

Operational leverage

Economies of scale in procurement

We see multiple competitive advantages in having 65 branches, when the nearest competitor has just 20, and we believe these advantages will only increase as the business builds towards the 70-75 branches targeted by end-2020. There are the usual economies of scale in things like procurement/bulk buying. In addition to these general benefits, specifically for EL, we highlight the following points.

Spreading compliance/regulatory costs

In 2017, EL undertook 1,500 training days to both improve operational practice and ensure regulatory compliance. A smaller business would not have the resources to make such an investment. We also note that management is concentrating its branch opening programme so that staff training can be much more structured, reducing costs per trainee and ensuring they are effective as soon as they arrive at their branch.

Capacity to introduce new products

EL's scale means that it has the capacity to create new products that can suit the needs of its customers. For example, it has introduced a "Selfy" product targeted at the recently self-employed, who often find it difficult to borrow from mainstream banks as a result of their fluctuating levels of income.

Absorbing branch investment costs

Building the branch network does generate economies of scale over time but equally requires investment, thereby slowing the progression of RoA and RoE. In October 2017, EL commented that pre-opening costs were up to £75k per branch and first-year EBIT losses were, on average, £105k. Monthly breakeven (EBIT basis) is typically achieved at the end of the first year, and initial EBIT losses are not recouped until the end of year two. Having scale across its existing estate and by growing profitable branches means these losses can be absorbed.

Adoption of best practice

EL has highlighted how it seeks to spread best practice across its network, thereby raising overall performance. This has ranged from seminars with the best-performing managers to identify what they do differently through to the creation of an area manager structure, where such managers can then supervise/mentor several managers below them. Some of the changes in practice are simple – for example, prioritising new business applications by focusing on those from the highest-converting brokers, rather than by size of loan or alphabetically. Another opportunity from sharing best practice was to extend the branch opening hours from 10am to 6pm to 8am to 8pm. Cascading these best practices across the network in 2017 saw the conversion rate of leads into new borrowers increasing by 15% (to 2.23%, from 1.97% in 2016).

Depth of operational management talent

As well as improving productivity, EL has also been expanding geographically. The operational risk from such an expansion has been moderated by taking experienced staff from existing branches and making them managers in the new ones. It may be either the existing manager or the assistant manager that transfers, but the key message is that they already know EL's procedures, risk appetite and best practices. This materially reduces risk on a new branch opening. New junior staff joining the branch will have already undergone a rigorous two-week, classroom-based training programme and so can already write a loan using the Group's loan management system when they arrive in-branch.

Increased broker penetration

One feature on which management has commented is an increasing conversion of broker leads. While increased geographical coverage in having more branches helps to reduce the distance that customers have to travel to their nearest branch, it also generates greater credibility with financial brokers. They look for those lenders that are more likely to convert their application into a loan and therefore generate revenue for the broker. With greater conversion, brokers will want to send more leads.

Core credit controls

Customer base non-standard but largely near prime

While EL's customers do not fit easily into bank scorecards systems (and are thus non-standard), 42% of them earn over £2k per month (i.e. around the national average), over a quarter are homeowners, and 75% have been in the same job for over three years.

Absolutely essential to know customers' willingness to repay, not just their ability to do so, and face-to face interviews are critical in making that judgement.

At the core of EL's lending approach (and actually across the whole of NSF) is that, when lending in the non-standard space, understanding the customer's ability to repay a loan is only part of the equation. In isolation, though, it is insufficient when deciding whether or not to lend. EL and we believe it is absolutely essential to also know the customer's willingness or propensity to repay. While advances have been made in behavioural scoring, data analytics and other related technology, none of these assessment tools is able to give the same insight into a customer's attitude as can be gained from meeting them face to face, listening to their responses to detailed questions and gauging their commitment to honour their future obligations under the terms of the loan.

EL's impairments as a percentage of revenue range from half to a fifth of peers'

In Figure 3, we noted that 66 out of 100 applications are turned down through automated processes. While large databases of relevant customers are important in this process, we see little sustainable competitive advantage from EL's processes at this stage of the process. However, as the customer progresses through the waterfall, EL's competitive advantage increases. Only half the potential customers who actually attend a branch end up getting a loan, meaning that the influence of the branch staff at this stage of the selection process is critical to successfully assessing credit. We note, in the section on profitability below, that EL's impairments as a proportion of revenue (21%) compare favourably with ca.44% at Oakam, 57% at 118 118 Money and over 100% at Likely Loans (all numbers for 2016 as last comparable year).

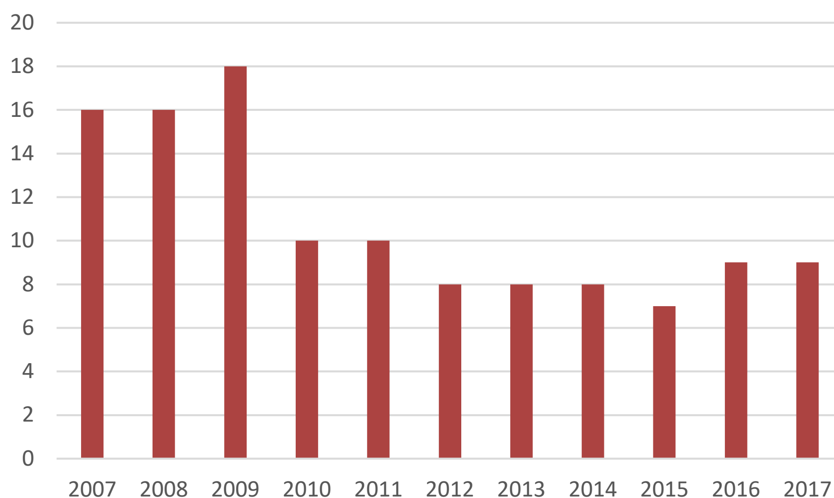
More advantages in collections process

As the branch is responsible both for issuing the loans and also for collections, there is a direct, visible and relatively rapid effect on them from making poor lending decisions. While no lender wants to make a bad loan, if the branch manager personally also has to sort out the collections of loans he/she has made, it is a further incentive to focus on lending to quality customers.

Impairments stable as a proportion of lending, despite growth in new customers and a higher risk appetite

Despite the strong loan book growth reported in Figure 1, and the fact that there has been an increase in the proportion of new (and therefore higher-risk) customers, together with a willingness to accept higher-risk customers (at a higher APR), impairments as a proportion of average net receivables have been stable under NSF's ownership. As the average yield on new loans issued has increased substantially, the risk-adjusted margin has improved.

Figure 4: EL's impairments as a percentage of average net receivables



Source NSF, Hardman & Co Research

Risks under a downturn scenario

Volume and pricing offset higher impairments

In a downturn, more customers become non-standard, allowing EL to grow volumes and cherry-pick customers

There is more opportunity to re-price too

While investors quite rightly are focused on credit quality when considering the impact of the next downturn on performance, the non-standard market has very different characteristics from that of the mainstream market. In particular, the relative volume and re-pricing opportunities in the non-standard market mean that, for a well-run and focused business, there should be the ability to both absorb a temporary increase in impairment (caused by, say, a spike in unemployment) but also the capacity to address the inevitable increase in volume, as previously mainstream customers are forced to seek credit from alternative providers. More volume, but with a higher credit threshold, leads to more sustainable earnings streams. This is not just theory – the financial performance of S&U and Provident Financial (PFG) through the financial crisis demonstrate this process in action (see Figure 5). We note that PFG's consumer credit division reported higher profit in each of 2008, 2009 and 2010 than it reported in 2007. At S&U, the drop in 2008 on 2007 was less than 10%, and profits grew each year thereafter. It is worth noting that John van Kuffeler, NSF's CEO, was at PFG before and through that downturn (having been appointed PFG CEO in 1991, Executive Chairman in 1997 and Non-Executive Chairman in 2002).

Figure 5: Key metrics for PFG and S&U, 2007-10

£m	2007	2008	2009	2010
PFG (consumer credit division)				
Revenue	590	646	674	701
Impairment	-175	-197	-217	-231
Risk-adjusted revenue	**415**	**449**	**457**	**470**
Costs	-257	-284	-288	-292
Pre-interest profit	159	165	169	178
Interest	-35	-36	-40	-49
PBT	124	129	129	129
Impairment as % revenue (%)	**29.7**	**30.5**	**32.2**	**32.9**
Customer receivables (31 Dec)	n/d	852	866	867
S&U (January following year)				
Revenue	46.0	46.2	45.8	48.0
Cost of sales (primarily impairment)	-15.7	-16.2	-16.0	-17.1
Risk-adjusted revenue	**30.3**	**30.0**	**29.8**	**30.9**
Costs	-19.4	-19.9	-19.3	-19.9
Pre-interest profit	10.9	10.1	10.4	10.9
Interest	-2.3	-1.9	-1.4	-1.1
PBT	8.5	8.3	9.0	9.8
Cost of sales as % revenue (%)	**34.1**	**35.1**	**34.9**	**35.6**
Customer receivables (31 Dec)	74.8	77.4	76.3	74.8

Source: Hardman & Co Research

At PFG, average yield rose ca.6% in 2010 vs. 2008

Easier to re-price new business given high yields on EL loans

More customers becoming non-standard creates bigger pool of potential borrowers, but also allows EL to cherry-pick better-quality ones

Impairments will probably rise but, as a percentage of revenue, the increases were less than 10% at both PFG and S&U over 2007 and 2010. Unknown effect of IFRS9 but it is likely to exaggerate increase in impairments.

Re-pricing opportunities

As can be seen in the table above, PFG's consumer credit division saw revenue rise from £646m in 2008 to £701m in 2010, up 8.5%, on receivables growth of 1.7%. The average yield on loans rose ca.6%, reflecting the higher risk on the portfolio.

It is also worth noting the sensitivity of customers to changes in rates. A 0.5% rise in mortgage costs for the mainstream market is likely to be more of an issue than a 5% increase in EL's pricing. The mortgage increase is a 30% hike from the current level (Bank of England average quoted rate 1.53% for two-year 75% LTV), while the EL increase is less than a tenth of its current yield. While NSF has not indicated that there are any plans to increase rates further, we believe it will be easier for EL to re-price its new business than it might be for more standard lenders.

Volume opportunities

As noted above, when there is an economic downturn, there is also typically an increase in the number of potential customers, as prime customers see their creditworthiness fall. This has two effects on EL: firstly, it has a larger pool of customers who will have difficulties in obtaining finance elsewhere; secondly, it will be able to cherry-pick better customers from the larger pool and, for the same volume of new lending, should attract better-quality customers.

In terms of the potential impact, we note the following.

- An increase in unemployment: from 2007 to 2010, the unemployment rate rose from 5.7% to 7.9%, with male unemployment rising to nearly 9%.
- The number of those in part-time work is likely to increase as employers seek to reduce cost and workers keep their jobs. *The Telegraph* reported, on 19 July 2009, "Recession forces a million to work part time".
- The run-up to 2008 saw a change in customer and lender behaviour around the Individual Voluntary Arrangement (IVAs) process. It is thus more appropriate to compare 2010 against 2008 to see a potential upside/downside trend in county court judgements. Specified money claims through the county courts were 40% higher in 2008 against 2010 (1.4m vs. 1m).

PFG saw customer numbers rise 5.4% in 2009 and a further 5.7% in 2010.

Credit effect

As can be seen from the performance of both PFG and S&U, impairments may be expected to rise materially (in the case of PFG they rose from £175m to £231m between 2007 and 2010), but the rise in impairments as a proportion of revenue is relatively modest. As revenue is a larger number, the 6% increase in yield over the period more than compensated for higher bad debt provisions, and the risk-adjusted margin increased.

Looking forward, it is probable that IFRS9 will increase the volatility of impairments, with higher impairments at the early stages of a recession and lower ones later in the cycle. This is likely to mean that the impact on reported rates of impairment will be greater than in the past (and why having high risk adjusted margins will be vital to ensure that lending businesses remain profitable through the cycle).

Cost control

Cost control only modest lever

One further tool for management is a tighter control of costs, especially over discretionary acquisition costs. However, this is partially offset by higher collection, field management and control costs, given the higher number of impaired loans. Depending on EL's balance between volumes and cherry-picking the best new customers, there may be an increase in administration costs. We therefore see cost control as only a modest lever in sustaining profitability through the downturn.

Impact on interest cost

EL not exposed to higher financing charges, as NSF has locked in funding until 2022/2023

Excluding management action, in a recession, interest rates may be expected to fall (although, from their current levels, the effect is modest). However, the increased perceived risk associated with a non-bank lender is likely to see a sharp rise in the spread it has to pay. Despite the modest rise in receivables, PFG saw its consumer credit division's interest costs rise from £36m in 2008 to £49m in 2010 – a 36% rise. Not only is pricing constrained but so is the amount of credit available. To eliminate this risk, NSF has already locked in committed lines of £225m of long-term funding through to 2023 and its £35m revolving credit line through to 2022.

What happened to the old competitors?

Ownership structures, credit modelling, financing policies and regulatory risk all very different models from those of EL

NSF has highlighted how the branch-based business used to have a number of national competitors and that total lending through this channel was in excess of £5bn in 2007. Management and we believe it is important to understand why these competitors withdrew/closed and what lessons have been learned, so that EL does not face the same business constraints.

Non-core subsidiaries in non-standard business at a time when large groups had much higher priorities…EL is the core of NSF and does not face this issue

Several competitors at the time were subsidiaries of major financial institutions, whose focus post the financial crisis was on de-risking and de-leveraging their balance sheets. Group management confidence in statistical risk modelling had been severely dented by the failings evidenced by the financial crisis. As non-core and non-standard units within much larger groups, the branch-based, non-standard finance businesses were closed for Group strategic priorities, rather than for purely economic reasons. This applies to Black Horse (subsidiary of Lloyds TSB), Citi-Financial (part of CitiGroup) and HFC/Beneficial (over 100 branches and a subsidiary of HSBC). The latter closed its much larger US sub-prime centres at the same time and reflected a group-wide-strategic decision.

Larger groups over-reliant on automated credit decision-taking and not on the importance of customer face-to-face interview

We believe, although it is hard to prove, that the larger groups' credit control functions had greater comfort with statistical modelling of risk rather than the personal effect. Household International, pre-acquisition by HSBC, had made a big play on having huge numbers of PHD-qualified mathematicians in its risk department. As noted above, we believe statistical modelling is necessary but not sufficient to adequately assess risk for this particular customer base, and over-reliance on modelling could be a factor in why several of these companies reported large increases in credit costs. We believe EL has the right balance by supplementing automated decision-taking with human discretion in its branches.

Financing difficulties: NSF recently negotiated long-term committed funding

Cattles (the owner of Welcome Finance) faced re-financing problems following accounting irregularities elsewhere in the Group. We note that financing has been addressed, with NSF having re-financed all of its banking arrangements in 2017, which has seen committed funding lines through the following six years.

Regulatory risk was greater for bank owners of non-standard lenders

In early 2008, London and Scottish Bank (52 branches) announced that it was stopping lending, and it entered administration in November that year (the first British bank to do so). The reason given was that credit losses had risen by ca.£22m above expectations, and this meant it no longer met its regulatory capital requirements. In 2008, HFC/Beneficial faced a then record fine for mis-selling PPI, well before it was an industry-wide issue. HSBC (the ultimate parent of HFC/Beneficial) would be highly sensitive to such reputational damage. Historically, non-standard lending had not been a core competency or focus for banking regulators and, in such a crisis, we believe risk aversion will have affected the regulators as much as the boards of the banking parents of competitor lenders. Clearly, EL would be exposed if it mis-sold products, but it does not face the same banking regulations as most of the ultimate owners of the 2007 branch-based lenders.

During 2007-09, the embryonic EL saw impairments at 16%-18% of average net receivables (around twice the current level). This was in part due to (i) the fact that it was a relatively new lender (it was a start-up with most of its people coming from CitiFinancial, backed by Alchemy in 2006) and so was likely receiving relatively poor quality leads from financial brokers, and (ii) its scorecard was relatively immature and took a couple of years to mature before settling down in the 8%-10% of average net receivables that it is today.

On our 2018 forecasts, were such a level of impairment to recur, it would increase impairment by ca.£8m-£14m, which would reduce current profitability but not result in losses. As we detail in the section on credit, we believe that, in a recessionary environment, there would also be a meaningful pick-up in demand and at increased pricing, which would offset these higher provisions but, even without them, EL is unlikely to be loss-making.

Limited regulatory risk

Product, distribution and procedures make regulation a low risk for EL

The FCA has had a number of reviews of different areas of high-cost credit and is, we believe, likely to keep the whole non-standard finance market under regular review. However, it is worth noting that the focus of its attention has been as follows.

- Affordability: Ensuring customers can afford the loans. Here, the branch-based incremental assessment is an important differentiating factor compared with other, higher-cost lenders.
- Communication: Ensuring the customer understands what it is buying. Again, the waterfall outlined in Figure 2, where the customer is taken through a telephone and face-to-face interview, differentiates branch-based lending.
- Cost: High cost loans, are where customers face the greatest financial challenge. The maximum branch-based APRs on the existing business are around a quarter of the current cap on high cost short-term credit (0.8% p/day or ca.1,200% APR), with the majority of business done at around a twentieth of the current rate cap.

NSF continues to invest in ensuring that EL remains at the vanguard of regulatory compliance, and the FCA has raised no concerns regarding unsecured, branch-based lending. While there may be noise around consumer credit regulation as a whole, we do not believe it represents any material threat to EL's business model or profitability. The fact that EL seeks to meet its customers face-to-face, before deciding whether or not to lend to them, is a key positive.

Strong profitability when peers unprofitable

NSF is profitable when its peers are not. The key driver is credit losses.

There are a range of potential distortions when making comparisons with peers, including inter-group transfers (with highly variable interest costs) and different stages of development (newer businesses typically incur higher credit losses than a long-established one like EL). However, the details below provide some benchmarks that we see as relevant when considering the performance of EL and also to reinforce the considerable barriers to entry that exist for any operator considering entering the market with a competing branch-based offer.

Looking in some more detail, we note the following.

- In 2017, NSF reported a normalised profit for EL of £15.6m. Most competitors have yet to file 2017 accounts, so the analysis below focuses on 2016 statutory numbers. In that year, EL reported a pre-tax profit of £11.6m and post-tax earnings of £9.1m.

Oakam loss-making

- Oakam Holdings Limited (to end-December 2016) showed turnover of £21.2m (up from £16.4m in 2015), and distribution expenses of £9.3m (which we believe to be primarily bad debts and 44% of turnover). Administration expenses were £14.3m and interest payable £14.6m, generating losses of £16.6m (2015 loss £13.5m, 2014 loss £9.4m). Gross trade debtors (loans) were £22.5m, with provisions of £1.8m and negative shareholder funds of £66m.

118 118 Money provisions ca.3x proportion of revenue as EL

- Madison CF UK Limited, the legal entity for 118 118 Money, reported a 2016 pre-tax loss of £19m. Interest income was reported at £44.5m, with impairments of £25.3m (57%), expenses at £30.7m and finance costs at £7.5m. Total loans and advances were reported at £74.6m, roughly half the level of EL. On this book, Madison CF UK limited incurred provisions more than double the level of EL (i.e. 4x worse impairments as a percentage of loans). The yield is higher but does not compensate for this risk.

Likely Loans' impairments greater than its revenue in 2016

- Oakbrook Finance Limited (the owner of Likely Loans) reported a pre-tax loss of £20.8m, with revenue of £24.8m more than offset by impairments of £25.5m (i.e. over 100% of revenue), costs of £9.4m and interest payable of £10.8m. The net debtors were £66m.

NSF financials and valuation

Our forecasts are unchanged following the trading statement. A detailed statutory profit and loss and cashflow statement are available in our recent FY17 Results Note, as are the valuation parameters and assumptions.

Figure 6: Normalised profit and loss (£000)

Year-end 31 December	2016	2017	2018E	2019E
Business interest income	94,674	119,756	166,098	197,000
Other operating income	450	1,926	0	0
Fair value unwind on acquired portfolios	0	0	0	0
Total revenue	**95,124**	**121,682**	**166,098**	**197,000**
Underlying business impairments	-23,155	-28,054	-38,987	-45,467
Unwind of provision discount	-3,000	-741	-741	-741
Business impairments	-26,155	-28,795	-39,728	-46,208
IFRS9 impairments			-5,331	-6,393
Gross profit	68,969	92,887	121,038	144,399
Administration expenses	-50,290	-69,203	-87,011	-95,488
Amortisation of intangibles	0	0	0	0
Operating profit	**18,679**	**23,684**	**34,027**	**48,910**
EBITDA	19,369	25,181	35,443	50,638
Exceptional items				
Net finance (cost)/income	-5,623	-10,481	-19,603	-24,112
Profit before tax	**13,056**	**13,203**	**14,424**	**24,798**
Income tax	-2,688	-2,313	-2,741	-4,712
Profit after tax	**10,368**	**10,890**	**11,684**	**20,087**

Source: NSF, Hardman & Co Research

Figure 7: Balance sheet (£000)

@ 31 December	2015	2016	2017	2018E	2019E
Non-current assets					
Goodwill	40,176	132,070	140,668	140,668	140,668
Intangible assets	14,119	17,412	17,205	6,877	1,719
Property, plant and equipment	1,718	5,459	9,434	11,519	11,519
Total non-current assets	**56,013**	**154,941**	**167,307**	**159,064**	**153,906**
Current assets					
Inventories	3	-	-	-	-
Amounts receivable from customers	**28,412**	**180,413**	**259,836**	**293,620**	**357,247**
Trade and other receivables	10,275	10,753	9,811	10,302	10,817
Cash and cash equivalent	7,320	5,215	10,954	2,599	1,036
Total current assets	46,010	196,381	280,601	306,521	372,429
Total assets	**102,023**	**351,322**	447,908	465,584	526,335
Current liabilities					
Trade and other payables	9,490	8,146	10,353	12,353	14,353
Deferred tax liability	14,275	-	-	-	-
Total current liabilities	23,765	8,146	10,353	12,353	14,353
Net current (liabilities) / assets	*29,150*	*188,235*	270,248	294,168	358,076
Non-current liabilities					
Financial liabilities – borrowings	-	87,300	199,316	228,816	288,816
Deferred tax	-	6,793	4,996	2,479	852
Total non-current liabilities	**-**	**94,093**	**204,312**	**231,295**	**289,668**
Total liabilities	16,860	102,239	214,665	243,648	304,021
Net assets*	**85,163**	**249,083**	**233,243**	**221,937**	**222,314**

*Source: NSF, Hardman & Co Research * incl. £255k of Non Controlling Interests*

Valuation

Average valuation potential upside on absolute measures 52%

Our absolute valuation techniques imply average upside potential of 52%. At present, we do not believe peer valuations are helpful, as it is unclear to what extent consensus is consistently applying IFRS9 across all companies. We note that the profit growth profile of both EL and the guarantor loans businesses is materially faster than the consensus forecasts for the quoted non-standard consumer credit companies as a whole, and investors should consider the appropriate rating for such growth once a consistent approach to accounting has been adopted.

Figure 8: Summary of different valuation techniques

	Implied price (p)	Upside (%)
Gordon Growth Model (GGM)	102.5	53%
Discounted Dividend Model (DDM)	100.4	50%
Average absolute measures	101.4	52%

Source: Hardman & Co Research

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