HARDMAN&CO.

MORSES CLUB

Quality Street

We have repeatedly asserted that providers of Home Collect Credit (HCC) need to understand their customers' thinking in order to lend profitably. Equally, to properly appreciate the risks and rewards that the HCC companies offer investors, we need to understand their corporate culture. In this note, we review MCL's focus on quality, giving practical examples of how the group aims to generate sustainable profit growth. Conservatism runs throughout MCL's lending, accounting, agents, customer selection and new product development. We have not changed our steady growth forecasts, and our valuation range remains 171p to 197p.

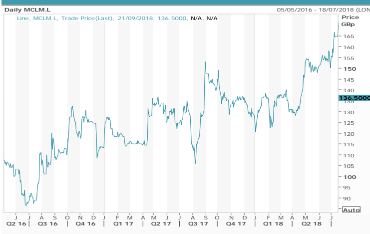
- **Focus on quality:** 70% of customers are now "high-quality" (58% three years ago). MCL was very selective in securing experienced agents and recruiting field managers to optimise the opportunity from the market leader's self-inflicted woes. Online lending start-up losses are a fraction of peers' establishment costs.
- **Impact:** Investors may expect good, sustainable growth for the period 2017-19. The focus on quality may also mitigate regulatory risk, requires modest funding and should carry much less macroeconomic downside risk. Investors wanting high growth but potentially volatile returns should look elsewhere.
- **Valuation:** We detailed a range of valuation approaches and sensitivities in our note, Bringing home collect into the 21st century (2nd Feb 2017), and in our *FY18 Results note (16th May 2018),* and we do so again in this report. Our absolute methodologies generate a valuation range of 171p to 197p.
- **Risks:** Credit risk is high, but MCL adopts the right approach to affordability and credit assessment. Regulatory risk is a factor, but consistently high customer satisfaction suggests a limited need for change. MCL was the first major HCC company to get full FCA authorisation. Funding risk is modest.
- **Investment summary:** MCL is operating in an attractive market, and it has a dual-fold strategy that should deliver an improved performance from existing businesses and new growth options. It conservatively manages risk and compliance, especially in new areas. The agent network is the competitive advantage over remote lenders. We forecast a 4.6% February 2019 dividend yield, with cover of 1.6x (adj. earnings), and a valuation range of 171p to 197p.

Financial summary and valuation

Year-end Feb (£m)	2015	2016	2017	2018	2019E*	2020E*
Reported revenue	89.9	90.6	99.6	116.6	119.0	127.2
Total impairments	-22.9	-18.8	-24.3	-30.4	-26.6	-27.6
Costs (inc temp com)	-51.4	-53.4	-56.7	-65.6	-69.2	-74.3
EBITDA	16.5	19.3	19.9	22.1	24.9	27.3
Adjusted PBT	13.0	16.8	17.7	19.2	21.4	23.6
Statutory PBT	58.5	10.4	11.2	16.1	18.2	20.7
Statutory EPS (p)	46.5	6.1	6.6	10.1	11.4	13.0
Adj. EPS (p)	8.1	10.2	10.8	11.7	13.2	14.6
P/adj. earnings (x)	20.6	16.3	15.5	14.2	12.7	11.5
P/BV (x)	2.3	3.9	3.5	3.3	3.2	2.9
P/tangible book	2.5	4.8	4.2	3.7	3.6	3.3
Dividend yield	n/m	n/m	3.8%	4.2%	4.6%	5.1%

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

Financials



Source: Eikon Thomson Reuters

Market data

EPIC/TKR	MCL
Price (p)	167
12m High (p)	154.8
12m Low (p)	105.5
Shares (m)	129.5
Mkt Cap (£m)	216.3
EV (£m)	195.8
Free Float*	46%
Market	AIM

**As defined by AIM Rule 26*

Description

Morses Club (MCL) is number two in UK home credit. It is growing this business organically and by acquisition, and is developing a range of related products, where it has a competitive advantage.

Company information

Non-ex. Ch.	Stephen Karle
CEO	Paul Smith
CFO	Andy Thomson

Tel: +44 (0)330 045 0719
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Key shareholders

Hay Wain	36.82%
Woodford Inv. Mgt.	8.79%
Miton Asset Mgt.	7.47%
Artemis Inv. Mgt.	6.95%
Majedie Asset Mgt.	5.34%
JO Hambro	5.32%
Blackrock	3.03%

Diary

Late August	Trading update
October	Interim results

Analysts

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Disclaimer: Attention of readers is drawn to important disclaimers printed at the end of this document

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Summary

In this note, we review MCL's focus on quality and why it may be expected to deliver steady, sustainable growth.

Lending

We believe MCL shows prudence in every stage of the lending process. The initial judgement remains agent-driven, 70% of applications are rejected (and investors should recognise that only a fraction of potential customers approach HCC compared with, say, online lending), customer cashflow affordability is key, and MCL's customers do not face the same principal repayment burden as prime customers. Once a loan has been made, controls are prudent, and we note that MCL has actively managed its portfolio to ensure impairments remain within its acceptable levels. In addition, 70% of customers are now of a standing to which MCL would re-lend (i.e. "high-quality"), compared with 58% just three years ago. We also note that MCL's IAS39 accounting for gross-up means its underlying credit quality is even better, compared with peers, than historically reported.

Accounting

We believe that the lower reduction in receivables on the transition to IFRS9 suggests conservatism in MCL's approach to accounting. It appears to have taken materially higher provisions in the past, most likely in the incurred but not reported (IBNR) category. This may be considered illustrative of MCL's cautious nature.

Agent selection and management

The core of the HCC model is its self-employed agents. We identify below some of the ongoing processes MCL has used to ensure it has selected the highest-quality agents. We note that, following the market leader's disruption to its salesforce, MCL was highly selective in the type and experience of agent secured. It did not, for example, hire super-agents, keeping in direct contact with all agents at all times. It structured temporary commissions to deliver sustainable, rather than rapid, growth. It used the opportunity to not only fill agency vacancies but replace less effective agents with more experienced ones. This meant that gross agent hires represented ca.25% of its historical franchise but net agent numbers increased by 11% (and indeed fell 4.5% in 2HFY'18). Additionally, MCL has carefully managed agents after acquisitions, and on an ongoing basis, as their circumstances change. We also note that MCL has maintained a cushion of field manager resources to not only support its agents but also to secure protection against unforeseen changes.

Customers

High-quality customers (i.e. ones to which MCL would lend again) increased from 58% of all customers in February 2015 to 70% in February 2018, despite the addition of new customers who, on average, are higher-risk than in an existing portfolio.

New product development

Online lending losses in the last year are one-twentieth of the level of 118 188 Money /Likely Loans. Peers have been consistently loss-making, whereas MCL forecast profits in the third year of operation.

Impact is lower regulatory, liquidity and credit risk business

A focus on quality, sustainable business is likely to see some incremental growth sacrificed in good market conditions. This is mitigated by the advantages of a better-quality franchise. We believe MCL should face lower-than-average regulatory risk (a demonstrably low credit risk indicates a more appropriate product for its customer base). We also think it will see lower incremental funding strain and customer acquisition costs. Most critically, a higher-quality franchise should see materially lower credit and earnings risk in an economic downturn. We highlight how well-managed, conservative HCC businesses had stable or growing profits through the financial crisis of 2007-08, and this is the model we see MCL adopting.

Focus on quality: lending

Summary

Quality in lending decisions, controls post loans, portfolio management and accounting. High-quality customers up from 58% in February 2015 to 70% in February 2018

We believe MCL shows prudence in every stage of the lending process. The initial judgement remains agent-driven, 70% of applications are rejected (and investors should recognise that only a fraction of potential customers approach HCC compared with, say, online lending), customer cashflow affordability is key, and MCL's customers do not face the same principal repayment burden as prime customers. Once a loan has been made, controls are prudent, and we note that MCL has actively managed its portfolio to ensure impairments remain within its acceptable levels. In addition, 70% of customers are now of a standing to which MCL would re-lend, compared with 58% just three years ago. We also note that MCL's IAS39 accounting for gross-up means its underlying credit quality is even better, compared with peers, than historically reported.

Lending assessment

We believe MCL's initial assessment of credit is prudent. We note the following.

Agent key, and MCL has right model

- Having good agents is critical to credit assessment. While technology can improve the efficiency of making decisions (e.g. 73% of customer income is now verified automatically), MCL continues, we believe rightly, to facilitate agents getting to know their customers on their own terms. Every loan involves a face-to-face assessment of the customer character. We believe it is essential to understand the customer's *willingness* to repay, not just their *ability* to repay, and this requires a good understanding of their character.

70% of applications rejected. Fewer apply than for online lending, so comparable rejection rate higher.

- In FY'18, 70% of applications were rejected (based on management accounts). We believe this number understates the real rejection rate. HCC is subject to much lower (i) multiple applications and (ii) speculative application than online lending. Although the internet is now the largest source of new business, MCL still sees a significant proportion of personal introductions from customers and through agents, and is not solely reliant on mass-marketing aimed at generating the maximum numbers of potential leads (internet introductions in FY'18 accounted for less than a quarter of new customers).

Affordability: 14% of customer income used for affordability

- We note that, on average, 14% of customer net disposable income is used for loan affordability (*net disposable* means after discretionary and core non-discretionary spend, including other debt repayment commitments). In assessing credit, MCL is focussed on net disposable income (not just salary), and so non-discretionary spend (such as rent, food and basic utilities) is taken into account in calculating affordability.

MCL customers do not have big principal repayments to make, unlike prime mortgage customers

- ONS data show that national household debt at end-2017 was ca.133% of disposable income – around three quarters of which is mortgages. By contrast, the average HCC debt per customer is £601 – under 5% of customer income. While HCC customers pay a higher interest rate, prime customers face a significant principal repayment strain on their mortgages, which we estimate to be ca.5% of average income p.a. (and significantly higher for younger borrowers).

Controls once a loan has been made

MCL has always kept surplus field management capacity to manage disruption to agents

The key to collections is the agent, and having good agents is core to good risk control once a loan has been made. The agents then have weekly meetings with field managers. MCL has always maintained a significant operational capacity buffer, so that its field managers have the resources to step in if there are any agent issues. If an agent is unable, or unwilling, to do his/her rounds, or leaves for any reason, there is a resource immediately available to moderate any disruption in the collection process. Additionally, technology is improving management information, allowing a rapid response at an early stage.

Worst-performing loans are sold, so resource is focused on where it can generate most value

When a customer misses his/her first payment, this is identified centrally so the field manager can discuss appropriate action with the agent at weekly meetings. At 13 weeks of non-payment, the account is transferred from the agent to a central team. Given that the vast majority of the collections work has already been done, it is generally held only for a short period in this team, with loans more than 17 weeks in arrears sold in blocks to a third party (typically once a month). This allows management to focus collection resources on those accounts most likely to yield returns, rather than having a large tail of accounts to administer.

Portfolio management

Management has taken action in advance of loss ratios exceeding target range

We note that reported impairments (see Figure 1) have largely been within the company's target range of 22%-27% of revenue. This is not an accident. Management has pro-actively managed the book to ensure that losses remain acceptable.

- The level in 2015 was towards the upper end of the range, following the Shopacheck acquisition. As noted in the section below, management filtered out higher-risk customers. This saw less focus on customer acquisition and, in 2016, the losses were a little below the target range.
- With the onboarding of significant numbers of new customers (note that a portfolio of new customers typically incurs higher impairments than a portfolio of existing ones), the ratio was rising towards the top of the range in 1HFY'18, and we believe management took action to reduce it in the full year, despite the addition of significant numbers of further new customers.

Figure 1: Company reported impairment ratios

%	2015	2016	2017	2018	2018 ex gross up	1H'18
Impairment/revenue	25.5	20.8	24.4	26.1	22.1	26.6
Impairment to average recs.	n/m	33.5	41.8	45.8	36.7	46.7
Impairment to credit issued	n/m	15.4	16.9	17.4	14.0	17.5

Source: MCL, Hardman & Co Research

Real losses lower. Gross-up took FY'18 impairments to 26.1% of revenue, up from 22.1% excluding this purely accounting effect.

Figure 1 includes gross-up, where, under IAS39 (the current accounting standard), income is recognised in excess of the contractual amount due. This happens when, for example, a customer extends the life of the loan. Income is generated for this period and then immediately provided against. With the FY'18 results, MCL reported that, for the first time, it had increased both impairments and revenue – by £6m. If we exclude this artificial accounting entry, the impairments to revenue in 2018 would be 22.1%, and the balance sheet ratios by around a fifth.

Impairments measured against balance sheet items, such as credit issued/average receivables, have been rising, but the risk-adjusted margin has been broadly stable. The higher impairment has been offset by increased yields.

Impact on net receivables on transition to IFRS9 around half level of peers, given historical conservative accounting

Also illustrates different approaches to gross-up. Relative to peers, MCL's approach reported both higher income and impairments.

Accounting

On the transition to IFRS9, MCL is reporting a materially lower reduction in receivables (4%-6%) than the level reported by peers. In their results updates, NSF reported an HCC reduction from £51m to £41m, PFG from £391m to £347m and IPF of 11%-13%. We understand that MCL has historically adopted a conservative approach to its recognition of impairments, which economically reduces the effect of IFRS9 in bringing forward impairments on performing loans.

When making comparisons between lenders, the accounting is important, and the transition to IFRS9 highlighted that MCL's approach to gross-up was inflating its impairments relative to peers. MCL calculated gross-up income by applying the interest rate to the contractually due loan amount. In contrast, peers applied the interest rate to the net loan book after provisions. As a consequence, MCL has been reporting higher income and provisions (no net profit effect) than if it had adopted the same approach as its peers. The effect is material, with both FY'18 income and impairments inflated by £6m and the impairment to revenue ratio increasing from 22.1% to 26.1%. While peers have not disclosed the exact details, our understanding is that the income effects from transitioning to IFRS9 are not expected to be material, suggesting that their ratios have not been substantially affected. MCL has already reported better-than-peer ratios, but they are even better when the accounting is taken into consideration.

On changing to IFRS9, MCL mathematically sees impairments fall as a percentage of revenues, as it loses revenues and impairments of the same amount. In contrast, MCL's peers, who do not see such a large elimination of gross-up, are indicating a higher impairment to revenue ratio.

Impact of discounting

The accounting rules mean that the balance sheet receivables, as reported by MCL, have to be discounted by an average of 35% to a present cash value (the discount rate reflecting the customer interest rate, rather than MCL's cost of capital, for example).

Figure 2: Underlying asset value

£m	Feb'16	Aug'16	Feb'17	Aug'17	Feb'18
Gross balances*	117.6	114.3	122.9	127.8	137.7
Gross cash project.**	**87.8**	**86.6**	**93.9**	**99.1**	**110.2**
Impact of discounting	-31.0	-30.4	-32.7	-34.0	-37.4
Bal. sheet value	**56.8**	**56.2**	**61.2**	**65.1**	**72.8**
% discount	**-35%**	**-35%**	**-35%**	**-34%**	**-34%**
Marginal impact on P/L of discounting		0.6	-2.3	-1.3	-3.4

*Source: Hardman & Co Research; * cash amount contractually due, ** cash actually expected to be received.*

Focus on quality: agents

Summary

Focus on quality in agent selection, how they are operationally managed, post acquisitions and when taking advantage of market opportunity

The core of the HCC model is its agents. We identify below some of the ongoing processes MCL has used to ensure it has selected the highest-quality agents. We note that, following the market leader's disruption to its salesforce, MCL was highly selective in the type and experience of agent selected. It did not, for example, engage with super-agents, keeping direct contact with all agents at all times. It structured temporary commissions to deliver sustainable, rather than rapid, growth. It used the opportunity to not only fill agency vacancies but also to replace less effective agents with more experienced ones. This meant that gross agent hires represented ca.25% of MCL's historical franchise but that net agent numbers increased by 11% (indeed fell 4.5% in 2HFY'18). We note that, excluding the recent PFG-related hires, over half of MCL's agents have been with the company for over two years and nearly a third for more than five years. Also, MCL has carefully managed agents after acquisitions, and on an ongoing basis, as their circumstances change. In addition, MCL has maintained a cushion of field manager resources to not only support its agents but also to ensure protection against unforeseen changes.

PFG saw 34% reduction in lending when it dealt badly with experienced agents

Getting the agent management wrong can have disastrous effects on the business. In the recent past, we have seen how disruptive it can be when companies change their working practices (PFG's consumer credit division's receivables at end-2017 were £391m, down 34% on the £585m end-2016 numbers, following an attempt to move to employed status), and also how trialling new types of agents can see a material increase in losses (NSF's HCC 2017 business impairments to revenue were 36.3% in 2017, vs. 26.3% in 2016). MCL has consistently focused on upgrading the quality of agents without making major, disruptive changes to a business model that works.

Ongoing business

MCL has always dealt with its agents proactively.

Ongoing control through network of business managers with appropriate experience and spans of control

It has sufficient field managers to operationally control the agents. We note that MCL has 287 field managers, with each, on average, managing 7.3 agents (although this average is rather simplistic – managing one agent who is full-time will take more time than two agents working one day a week each). Management focuses on customers per business manager, which has seen a steadily rising trend (2018 ca.800 vs. 2016 ca.700), as technology and improved management information have led to operational efficiencies. There has been no change in the risk appetite/pressure to increase spans of control for any other reason.

Market leader disruption opportunity

How MCL took advantage of the market leader's self-inflicted disruption is highly indicative of its overall approach. it saw around half the franchise growth of NSF, as it focused on quality.

MCL carefully selected which experienced agents to hire when it was approached by those disaffected by the market leader's imposition of new working practices. In 2017, MCL reported over 600 agent and manager hires and a gross 463 (1HFY'18: 411) territory builds, adding ca.25% to its agent network. The total number of agents increased from 1,826 in February 2017 to 2,030 in February 2018, with some natural attrition and the replacement of underperforming agents by experienced new hires. We recognise that the number of agents is not a management target but, directionally, we believe it gives an indication of business trends. The net increase in period-end agents was 11%, vs. 28% for NSF (1,005 at end-2017 vs. 785 at end-2016).

When considering the opportunity to recruit agents disaffected by the market leader's change of strategy, we highlight the following.

Experienced agents only

- MCL focused on agents with HCC experience (where a new territory was being established, rather than filling an existing one). MCL has a standard of two years' minimum experience for a territory build agent.

Commission packages for sustainable, not explosive, growth

- MCL structured temporary commission packages so as to ensure that the new agents did not rush out and grab business, but rather built long-term, sustainable customer portfolios. In addition to introducing the new agents to MCL's conservative culture, credit screening and operational controls, MCL ensured that the remuneration policy drove appropriate behaviour. It also extends temporary commissions where an agent has shown success in building his/her book but has not yet achieved all the growth targets, because MCL has been prudent in which business it will write.

Only agents who reported directly to MCL

- MCL did not hire "super-agents" who had other agents working for them. It took the view that it wanted a direct relationship with all its agents and not to have intermediaries who could disrupt the direct quality control.

Hired more field managers

- MCL maintained a cushion to operationally manage more agents than it had on its books, in order to prudently manage unexpected events. At the end of February 2017 (i.e. before the opportunity arose), this surplus capacity could have theoretically handled 28% more agents than MCL had on its books. Despite this cushion, when the PFG opportunity arose, MCL hired further line managers and control staff alongside the new agents.

Replaced poorly-performing agents with more experienced new hires

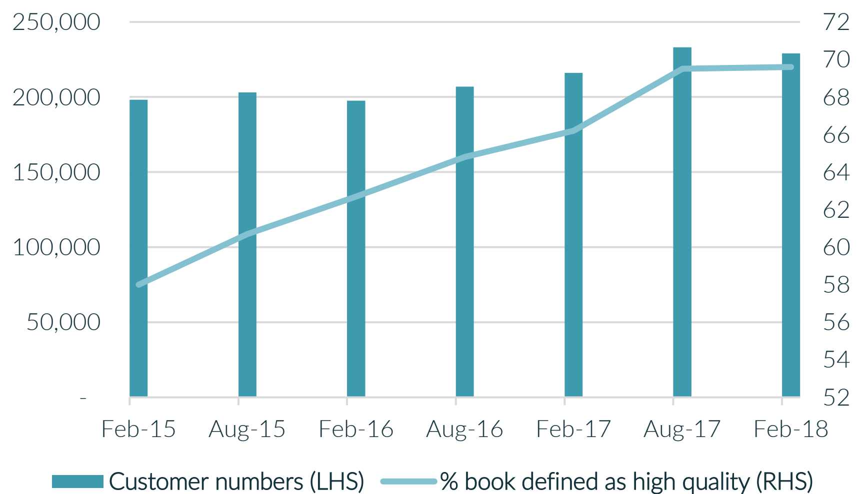
We note that, in FY18, MCL reported 463 territory builds but increased agents by only 204. In 2H, there were 52 territory builds, but agent numbers fell by 4.5% from 2,124 at end-August 2017 to 2,030 in February 2018. NSF reported stable agent numbers, at ca.1,000, from August 2017.

Focus on quality: customers

Growth in high-quality customers

The focus on quality customers is reflected in the lending described earlier. Management uses a "High-Quality Loans" KPI, which is defined as a loan to a customer who qualifies to be re-lent to under MCL's existing credit policy and practices. As can be seen in Figure 3, this cohort of lending has improved steadily, from 58% in February 2015 to 70% in February 2018. (This represented a 12% increase in customer numbers over the year.) Over this period, we believe credit policies have, if anything, been tightened, making the underlying improvement even better. The addition of new customers who, on average, were higher-risk than an existing portfolio caused a pause in the rate of growth, but there was still a modest improvement on 2HFY'18.

Figure 3: Customer numbers and proportion that are "high-quality"



Source: MCL Hardman & Co Research

Integrating Shopacheck saw stable customer numbers

We note that, through 2015/early 2016, management was focused on the integration of Shopacheck, an HCC business that was considerably larger than the initial Morses Club. With over half the loans having a duration of more than 50 weeks, managing down the customers who did not meet MCL's tighter credit processes took some time. As can be seen in Figure 3, customer numbers were stable, but the proportion of higher-quality customers improved from 58% at end-February 2015 to 65% by end-August 2016.

Around a third of customers not suitable for new loans

The steady growth in total customer numbers through to February 2017 masked two trends: a third of customers were not ones to which MCL would re-lend; in addition to those who may have defaulted. As these customers dropped off, MCL replaced them with new customers of a higher quality.

Customer numbers down in 2HFY'18, as MCL focused on quality. Should see further improvement in high-quality customer ratios, as they establish track records with MCL.

The customer number trends later in 2017 are interesting. By August, the agent hires noted above were only just starting to add new customers. The full benefit of new agents was not felt until calendar 2H'17. However, MCL reported 2% lower customer numbers in February 2018 than in August 2017. We believe that, as impairments to revenue rose to the higher end of MCL's target range, the company was even more selective about which customers were added. This should, in due course, see a further improvement in the proportion of high-quality customers, once those recently added establish more comprehensive track records with MCL.

Focus on quality: new products

MCL is introducing new product lines and revenue streams to enhance further growth. We believe these demonstrate a risk-averse approach, with the company starting small to learn the lessons in each niche market.

Online lending losses in last year one twentieth level of 118 118 Money/Likely Loans. Peers been consistently loss-making, when MCL forecasts profits in third year of operations.

- Online lending activities were accelerated with the Shelby Ltd acquisition in January 2017, although, in FY'18, management was focused on the core HCC opportunity. The low-cost, low-risk soft launch (branded Dot Dot Loans in March 2017) saw activity primarily around building the right IT infrastructure, linkages and risk models. Experience to date has led to less appetite for short-term (i.e. three-month) loans, and there has been limited customer loyalty. We expect more resources to be devoted to Dot Dot Loans this year, as the number of loans is expanded from the 2k achieved in FY'18 to a target of 7.5k by end-FY'19. MCL expects the operating loss (£0.8m FY'18) to reduce in FY19. As MCL tests the water, it is worth noting that losses have been a fraction of those of its peers, as detailed in Figure 4 below. We note that Satsuma lost a further £5m in 2017, bringing its cumulative losses to over £40m. We also note that PFG management, in its 2013 R&A (p.63), advised that it expected Satsuma to "make a financial contribution from 2015 onwards" (actual losses 2015-17 £29m). The 2017 accounts for private companies have not yet been filed, but the history below demonstrates significantly greater losses through the build-out phase than MCL would be willing to incur.

Figure 4: Peers' losses in online lending

£m	2013	2014	2015	2016	2013-16
Madison CF (118 118 Money)	4	9	21	19	53
Oakbrook Finance (Likely Loans)	3	6	11	21	41
Satsuma (PFG)	n/d	13	18	6	37

Source: Company Filings at Companies House (2016 most recent), Hardman & Co Research

Steady selective growth in Morses Club Card – ca.5% customer base p.a.

- Morses Club Cards in issue have risen steadily (ca.5k every six months to 21k in FY18, vs. 11k in FY17), and the gross loan book is now £10.6m (8% of the total). MCL believes the incremental data on spending will prove a valuable asset and that having a product that is popular with younger customers is a good acquisition and retention tool. In terms of risk appetite on a new product, we note that MCL has introduced the product carefully, with the penetration rate of customers under 10% over two years. While the product should logically be attractive to a much greater percentage of the customer base, MCL has introduced it steadily, thereby managing risk.

Steady rollout of portal

- With regard to the customer portal and associated IT infrastructure, MCL has reported that it is likely to see a full product launch later this year (test launch January 2018). There was commentary about products offering discounts, reward schemes, banking services and price comparisons using the extensive data likely to be available through the customer portal. Appropriate customer approvals to use MCL's information have been incorporated, and management advises that products such as insurance, utilities and mobile comparisons will be provided by third parties. There may be a lending product, but the primary objective is customer retention and acquisition, rather than the portal being a revenue and profit generator in its own right.

Focus on quality: impact

Summary

Some potential growth sacrificed for lower credit, regulatory and liquidity risk franchise

A focus on a quality, sustainable business is likely to see some incremental growth sacrificed in good market conditions. This is mitigated by the advantages of a better-quality franchise. We believe MCL should face lower-than-average regulatory risk (a demonstrably low credit risk indicates a more appropriate product for its customer base). It should also see lower incremental funding strain and customer acquisition costs. Most critically, a higher-quality franchise should see materially lower credit and earnings risk in an economic downturn. We highlight how well-managed, conservative HCC businesses had stable or growing profits through the financial crisis of 2007-08, and this is the model we see MCL adopting.

Growth

Some growth sacrificed for quality. Agent and customer numbers grew at half rate of LAH in most recent year.

One immediate effect of focusing on quality is that MCL is likely to sacrifice some franchise growth. We note that, in the year to end-February 2018, MCL saw agent numbers rise from 1,826 to 2,030 (up 11%) and customer numbers from 216k to 229k (up 6%). By contrast, in the year to end-December 2017, Loans at Home, NSF's HCC business, which has a greater risk appetite, saw agent numbers rise from 785 to 1,005 (up 28%) and customer numbers from 93.6k to 104.1k (up 11%).

Lower regulatory risk

Customer affordability is key, and lower loss rates than market indicate more appropriate products

The HCC market has enviably high customer satisfaction ratings (95%+ in MCL's case), and forbearance is a key product feature. Both these factors are likely to mean that it escapes from the most draconian of regulatory measures. It is probable that there will be some action, especially on customers who appear to be in permanent debt and where there may be issues on affordability. In terms of MCL, we believe that its focus on quality HCC customers should give it below-sector risk, because the lower-than-peer loss ratios imply it is more focused on customers who can afford repayments.

Less funding strain

Less volume means less need for funding. Lower-risk profile likely to be attractive to lenders, especially given balance sheet.

As we have noted in past reports, MCL operates with lower balance sheet gearing than its peers. At end-February 2018, equity funded 75% of its total balance sheet (and this ratio has been broadly stable). Its peers with December year-ends will see seasonally higher gearing, but the scale of the difference is extreme (NSF 52%, PFG 18%), and the peers have been increasing gearing. Looking forward, we believe MCL's gearing will remain broadly stable, unless there is an opportunity for large-scale inorganic growth. With a highly profitable business and a focus on better-quality (albeit fewer) customers, the model incurs less funding strain than some.

Lower acquisition costs

The cheapest customer to acquire is an existing one. As MCL manages its portfolio so that it has greater numbers of existing customers to whom it would lend again, we would expect the acquisition costs to fall.

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

There is more opportunity to re-price too

Sustainability of earnings in a downturn

While investors are quite rightly focused on credit quality, when considering the impact of the next economic downturn, the HCC market has very different characteristics from the mainstream market. In particular, the relative volume and re-pricing opportunities in HCC mean that, for a well-run and focused business, there should be the ability to absorb a temporary increase in impairments. This is not just theory – the financial performances of S&U and PFG through the financial crisis demonstrated this process in action (see Figure 5). We note that PFG's consumer credit division reported higher pre-interest-cost 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. Where a business such as MCL is focused on higher-quality customers, it is likely to see less of an increase in impairments, while still benefiting from market-wide pricing improvements and volume opportunities.

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

Impairment losses in this market will be significantly above prime lending, reflecting the nature of the risk. It is worth noting, though, that the relative volatility in a downturn is tempered by the fact that around two-thirds of borrowers have a primary source of income that is not sensitive to economic conditions, receiving either benefits (in addition to child benefit) or a pension. The affordability measures show 57% of income from these sources.

Financials

Figure 6: Profit & Loss

Year-end February (£m)	2015	2016	2017	2018	2019E	2020E
Existing operations	22.5	84.7	96.2	116.6	124.0	128.7
IFRS 9 income effect					-5.5	-5.5
Acquisitions during period	67.4	5.8	3.3	0	0.5	4.0
Total revenue	89.9	90.6	99.6	116.6	119.0	127.2
Impairment charge	-22.9	-18.8	-24.3	-30.4	-32.1	-33.1
IFRS9 impairments, net effect					5.5	5.5
Total Impairment	-22.9	-18.8	-24.3	-30.4	-26.6	-27.6
Ongoing agent commission	-17.7	-18.5	-21.2	-23.6	-26.0	-29.9
Temporary agent commissions		-0.7	-1.2	-4.4	-3.0	-1.0
Gross profit	49.3	52.6	52.9	58.2	63.4	68.8
Administration expenses pre-excep. and intang. amortis.	-32.8	-33.3	-33.0	-36.1	-38.5	-41.5
Depreciation (incl. goodwill impairment, amortis. of IT)	-0.9	-0.9	-1.3	-1.5	-1.7	-1.9
Operating profit pre-excep. and amortisation	15.6	18.4	18.6	20.6	23.2	25.4
Adjusted financing costs	-2.6	-1.6	-0.9	-1.5	-1.8	-1.8
Adjusted profit before tax	13.0	16.8	17.7	19.2	21.4	23.6
Income tax	-2.7	-3.5	-3.7	-4.0	-4.3	-4.7
Adjusted post-tax profit	10.3	13.3	14.0	15.2	17.1	18.8
Impairments as % revenue (exc. IFRS9 from both)	-25.5%	-20.8%	-24.4%	-26.1%	-25.7%	-24.8%
Impairments as % revenue, IFRS9 basis					-22.4%	-21.7%
Agent costs as % revenue	-19.7%	-20.4%	-21.3%	-20.2%	-21.8%	-23.5%
Admin. costs as % revenue	-36.5%	-36.8%	-33.1%	-31.0%	-32.4%	--32.6%
Total costs as % revenue	-56.2%	-57.2%	-54.4%	-51.2%	-54.2%	-56.1%
Finance costs as % average debt	n/m	n/m	9.5%	11.7%	11.4%	11.3%
Revenue yield (revenue as % average receivables)	n/m	164%	170%	175%	163%	167%
Number of clients	198,171	198,727	216,000	229,000	240,450	252,473
Number of agents	1,893	1,839	1,826	2,030	2,030	2,030
Adj. profit per client	66	84	82	84	89	93
Receivables per agent	29,310	30,903	33,531	35,876	36,434	38,928

Source: MCL, Hardman & Co Research

Figure 7: Balance sheet

@ end-February (£000)	2015	2016	2017	2018	2019E	2020E
Non-current assets						
Goodwill	294	1,326	2,834	2,834	3,334	4,000
Intangible assets	10,391	9,052	7,058	5,520	4,328	3,504
Property, plant and equipment	936	1,182	763	822	869	883
Amounts receivable from customers	1,507	679	395	265	200	100
Total non-current assets	13,128	12,239	11,050	9,441	8,731	8,486
Current assets						
Receivables	53,976	56,152	60,833	72,563	73,760	78,924
Trade/other receivables	26,216	1,554	2,019	2,039	1,554	1,554
Cash and cash equivalents	8,650	3,755	3,985	4,868	7,376	9,735
Total current assets	88,842	61,461	66,837	79,470	82,690	90,213
Total assets	101,970	73,700	77,887	88,911	91,421	98,699
Current liabilities						
Trade and other payables	-3,274	-7,452	-5,892	-6,695	-7,695	-8,695
Total current liabilities	-3,274	-7,452	-5,892	-6,695	-7,695	-8,695
Net current (liabilities)/assets	85,568	54,009	60,945	72,775	74,590	80,713
Non-current liabilities						
Financial liabilities – borrowings	0	-9,000	-10,000	-15,552	-16,000	-16,000
Deferred tax	-2,614	-1,879	-617	-144	-144	-144
Total non-current liabilities	-2,614	-10,879	-10,617	-15,696	-16,144	-16,144
Total liabilities	-5,888	-18,331	-16,509	-22,391	-23,839	-24,839
Net assets	96,082	55,369	61,378	66,520	67,582	73,860

Source: MCL, Hardman & Co Research

Figure 8: Statutory cashflow statement

Year-end February (£000)	2015	2016	2017	2018	2019E	2020E
Profit (loss) before tax	58,565	10,374	11,219	16,133	18,240	20,666
Depreciation	596	736	544	563	575	608
Impairment of goodwill	56	42	0	0	0	0
Amortisation of intangibles	8,574	5,683	4,412	2,950	2,630	2,890
Share-based payment expenses	0	0	126	431	431	431
Gain on acquisitions	-51,961	-32	0	0	0	0
Loss on disposal of plant, property and equipment	40	146	134	0	0	0
(Increase)/decrease in debtors	-14,803	27,532	-1,918	-11,604	-1,942	-774
Dividend in specie to Perpignon	0	-31,129	0	0	0	0
Increase/decrease in creditors	4,768	2,548	-1,640	1,846	1,000	1,500
Interest paid	1	647	927	1,456	1,800	1,800
Taxation paid	-800	-1,737	-4,078	-4,536	-4,750	-5,250
Net cash inflow/(outflow) from op. activities	5,036	14,810	9,726	7,239	17,984	21,871
Cashflows from investing activities						
Purchase of intangibles	-416	-2,523	-1,029	-1,412	-1,531	-2,082
Purchase of property, plant and equipment	-343	-1,152	-125	-622	-622	-622
Disposal of assets	0	501	0	0	0	0
Purchase of subsidiaries	0	-7,383	-5,695	0	-2,000	-4,000
Cash acquired on acquisitions	5,120	0	0	0	0	0
Net cash outflow from investing activities	4,361	-10,558	-6,849	-2,034	-4,153	-6,704
Cashflows from financing activities						
Net borrowing	0	9,000	1,000	6,000	448	0
Interest paid	-1	-647	-927	-1,904	-1,800	-1,800
Dividends	-2,000	-17,500	-2,720	-8,418	-9,972	-11,008
Net cash inflow from financing activities	-2,001	-9,147	-2,647	-4,322	-11,324	-12,808
Net increase in cash and cash equivalents	7,396	-4,895	230	883	2,508	2,359
Opening cash and cash equivalents	1,253	8,650	3,755	3,985	4,868	7,376
Closing cash and cash equivalents	8,650	3,755	3,985	4,868	7,376	9,735

Source: MCL, Hardman & Co Research

Valuation

Average valuation upside on absolute measures ca.10%

We detailed all the assumptions used in our valuation methodologies in our note, Bringing home collect into the 21st century (published on 2 February 2017). Post these changes, our absolute valuation techniques now imply an average of 184p (previously 178p). The peer valuations are weakened, as it is unclear to what extent IFRS9 has been consistently applied within consensus.

Figure 9: Summary of different valuation techniques

	Implied price (p)	Upside (%)
Gordon Growth Model (GGM)	196.9	18%
Dividend Disc. Model (DDM)	171.1	2%
Average absolute measures	184.0	10%

Source: Hardman & Co Research

GGM

Figure 10: GGM and sensitivities

	Base	+1% ROE	+1% COE	+0.5% G
Return on equity	25%	26%	25%	25%
Cost of equity	11%	11%	12%	11%
Growth	5.5%	5.5%	5.5%	6%
Price/book (x)	3.5	3.7	3.0	3.8
Premium for near-term outperformance	20%	20%	20%	20%
Adjusted price/book (x)	4.3	4.5	3.6	4.6
Book value 2019E (£m)	59.9	59.9	59.9	59.9
Valuation (£m)	254.9	268.0	215.7	273.2
Valuation per share (p)	**196.9**	**207.0**	**166.6**	**211.0**
Variance (per share)		10.1	-30.3	14.1

Source: Hardman & Co Research

Broad peer comparisons

We caution against over-reliance on peer comparisons, as it is unclear the extent to which IFRS9 has been consistently adopted within consensus estimates. The numbers below are for indicative purposes only.

Figure 11: Peer valuation comparisons

	Shr price (p)	Market cap (£m)	2018E P/E (x)	2018E yield (%)
MCL (Feb'19)	167	216.3	12.7	4.6%
NSF (Dec)	56.2	175	16.2	4.4%
PFG (Dec)	629	1594	13.7	1.6%
S&U (Jan'19)	2560	307	11.9	5.0%
H&T(Dec)	307	116	10.7	3.5%
Ramsdens (Mar'19)	161	50	11.4	4.0%

Source: Hardman & Co Research

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