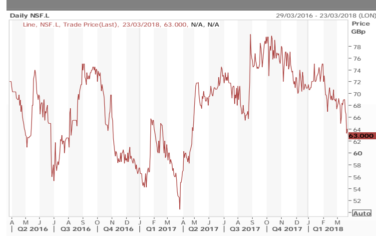
27th March 2018

hardman&co

Financials



Source: Eikon Thomson Reuters

Market data

EPIC/TKR	**NSF**
Price (p)	63.0
12m High (p)	78.75
12m Low (p)	50.5
Shares (m)	314
Mkt Cap (£m)	198
EV (£m)	280
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

Tel: +44 (0)2038699026

www.nonstandardfinance.com

Key shareholders (31st Jan-18)

Invesco	28.5%
Woodford Investment	26.8%
Marathon Asset Mgt.	10.7%
Aberforth Partners	10.2%
Quilter Cheviot AM	3.6%
ToscaFund	3.0%

Next event

14th May-18	AGM

Analysts

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Non-Standard Finance

Strong profit growth path confirmed

Until the F2017 results, NSF was, to a certain degree, a 'jam tomorrow' story, with infrastructure investment holding back returns. This is significantly complete and, with its market-leading franchises and payback from historical investments starting to come through, its target 20% EBIT ROA and minimum 20% loan book growth should start to be achieved in 2018 for Loans at Home, and in 2019/20 for the other divisions. Rolling forward the valuation base year has a big effect due to the strong forecast profit growth (2019E P/E ca.10x vs. ca.17x 2018E). The average of our absolute measures (see *assumptions* in valuation section) is now 101p.

- **2017 results detail:** Like-for-like (LFL) loan book growth was 30% (21% in branch business, 53% in home collect, 35% in guarantor loans) and drove underlying revenue growth of 48%. Impairments were up 22%, administration costs rose 57% and finance costs trebled. Normalised operating profit growth was 71%.

- **Outlook post results:** On a LFL basis, we have increased LAH investment forecasts, reflecting 2H17 costs. NSF guided on the IFRS9 impact in 2018: it will significantly reduce profit estimates and, to a lesser degree, receivables and NAV forecasts. However, there is no impact on cash or the profitability of each loan.

- **Valuation:** Rolling forward our base valuation year to end-2019 increases our absolute valuation measures by more than the effect of estimate reductions (range now 100-102p vs. 91-100p per share). Until consensus adopts a uniform IFRS9 approach across companies, peer comparisons have limited value.

- **Risks:** Credit risk remains the biggest issue, and part of NSF's model is to accept higher credit risk where a higher yield justifies it. NSF is innovative and may incur losses piloting new products, customers and distribution. Regulation is an issue, and we note 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 significant 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 9.8x 2019E P/E and getting a 5.0% yield.

Financial summary and valuation (normalised basis)

Year-end Dec (£000)	2016	2017	2018E	2019E
Revenue	95,124	121,682	166,098	197,000
Impairmts. (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)	18.7	18.3	16.9	9.8
P/BV (x)	0.8	0.9	0.9	0.9
P/tangible book	2.0	2.6	2.7	2.5
Yield (%)	1.9	3.5	4.0	5.0

Source: Hardman & Co Research

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2017 results summary

Most KPI targets met apart from those affected by heavy franchise investment

As can be seen in Figure 1, most of the group's KPIs have shown a material improvement since the half-year, with accelerated loan book growth, broadly stable yields and improving impairments – and thus better risk-adjusted margins – in all businesses. The 2017 returns on assets in each division make the 20% target (on the old IAS 39 accounting basis) an achievable goal in the near term.

Positive trend, with KPIS improving on 1H'17

Figure 1: KPIs (rolling 12 months to December 2017 and June 2017)

%	Everyday Loans (Branch-Based)		Loans at Home (Home Collect)		GB*/TrustTwo (Guarantor)	
	FY'17	1H'17	FY'17	1H'17	FY'17	1H'17
Loan book growth	21.0	16.0	53.0	16.0	35.0	43.8
Normalised revenue yield	45.8	45.3	147.0	152.6	35.8	31.7
Risk-adjusted margin	37.0	35.7	101.3	95.4	30.3	27.4
Impairments/Revenue	19.1	19.6	31.1	37.5	15.3	15.3
Operating profit margin	37.2	37.9	12.4	4.5	37.3	11.7
Return on assets	17.0	17.2	18.2	6.9	13.4	3.7

*Source: NSF, Hardman & Co Research; * George Banco*

Positive operating trends across all divisions

Everyday loans (ELL) saw pro-forma normalised operating profit rise to £22.7m (2016 £19.4m), with a £12.8m increase in total revenue, impairments up £1.2m and costs £8m higher. Loans at Home (LAH) saw increases of £8.6m, £0.4m and £7.2m, respectively, with operating profit rising to £3.1m from £1.9m. Guarantor loans (GLD) saw rises of £5.6m, £1m and £2.5m, respectively, with operating profits up to £2.7m from £0.7m. Finance costs rose across the group owing to the new, long-term committed facilities and increased lending.

Statutory numbers continue to be distorted by acquisition-accounting adjustments (£20m) and exceptional costs (£6.3m), with the group reporting a statutory pre-tax loss of £13m (2016 £9.3m). We believe that the underlying performance of the business is best represented by the normalised figures.

IFRS9 impacts lead to estimate reductions in 2018

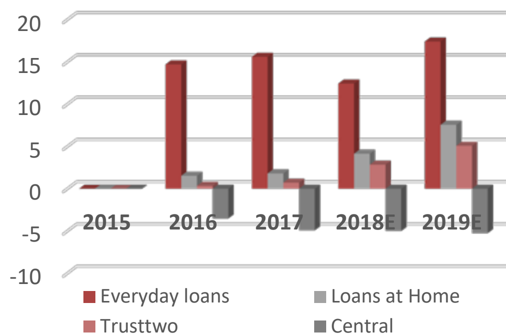
There has been a 3% reduction in LFL 2018 EPS estimates. We have now included IFRS9 impacts (see later section), which reduce profit forecasts over our forecast horizon (however, as the profitability of each loan is unaffected by the adoption of IFRS9, at some point in the future, these reductions will be reversed).

Figure 2: Estimate changes

	2017			2018E			2019E
	Old	New	% chg.	Old *	New	% chg.	New
Profit and loss (£000)							
Reported revenue	122,209	119,756	-2%	169,311	166,098	-2%	197,000
Total impairments (incl. IFRS9)	-29,907	-28,795	-4%	-41,131	-39,728	-3%	-46,208
Total costs (excl. dep.)	-65,699	-67,706	4%	-82,827	-85,596	3%	-93,760
EBITDA	26,602	25,181	-8%	45,353	35,443	-22%	50,638
PBT	14,633	13,203	-10%	25,511	14,424	-43%	24,798
Pro-forma norm. EPS (p)	3.73	3.44	-8%	6.53	3.72	-43%	6.40
DPS (p)	2.25	2.20	-2%	3.25	2.50	-23%	3.15
Balance sheet (£m)							
Amounts receivable	244.9	259.8	6%	326.9	293.6	-10%	361
Borrowings	184.3	199.3	8%	263.8	228.8	-13%	289
Shareholders' equity	239.1	233.0	-3%	235.6	221.7	-6%	222

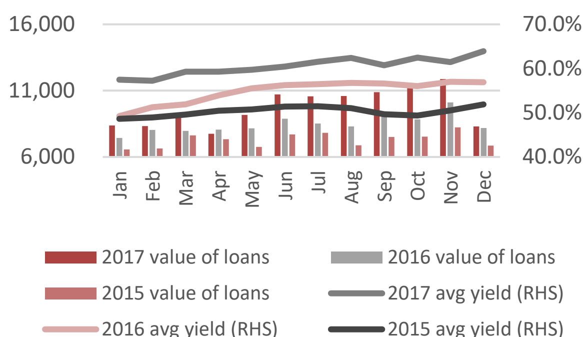
*Source: Hardman & Co Research; * prior year re-stated to exclude IFRS9.*

Figure 3: Divisional pro-forma adjusted PBT (£m), 2015-19E



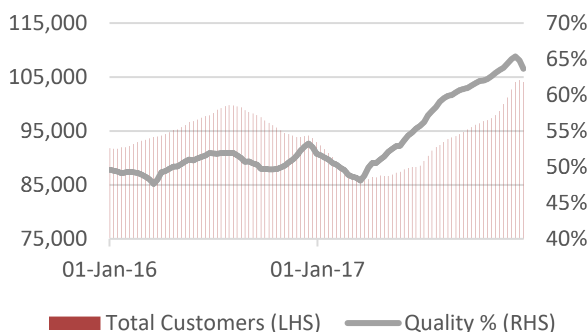
- Strong growth forecast across all three operating divisions
- Concentration in ELL reducing and should reduce further in 2018, with full-period benefit of agent hires in LAH business and full year's contribution from recently acquired George Banco
- Scale-generating operational leverage forecast and, over 2016-19, central costs forecast to be down from 21% to 13% of combined operating unit profits

Figure 4: Branch-based lending (ELL, £000)



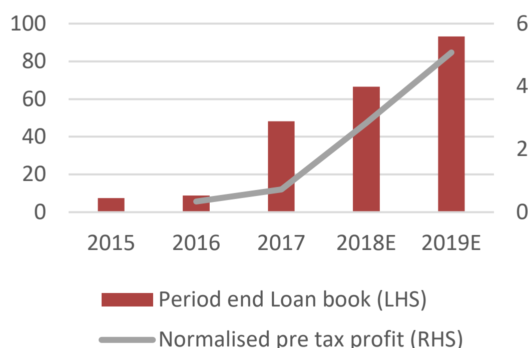
- ELL branch opening programme increased geographical footprint and lead generation, resulting in improving conversion rates from leads to sales, with best practice adopted across the division
- Steady volume increase month on month (average 2017 £9.8m per month vs. £8.5m in 2016 and £7.3m in 2015)
- Yields have also risen, with mix of re-pricing and a modest rise in appetite for higher-risk, higher-yield lending (average yield 2017 61% vs. 55% in 2016 and 50% in 2015)

Figure 5: Home Collect customer numbers and percentage of high-quality customers (LAH)



- Trials of different agents saw rise in 2016 customer numbers but proportion of customers paying 70% of due payments in prior 13 weeks was poor, and management's focus on quality reduced overall customer numbers – but quality began to rise and rate of impairments fell
- 2017 Provident Financial (PFG) opportunity saw sharp rise in customer numbers but also in proportion of customers with better payment records
- Full benefit of loans made late in 2017 will be visible in 2018 revenue and profit

Figure 6: Guarantor loans (£m)



- Business transformed by acquisition of George Banco in August 2017; market growth of ca.30% and some market share gains are expected to fuel rapid business and profit expansion
- Financial brokers keen to support viable alternative to market leader
- Potential to increase cross-referrals from ELL from 5% of new loans up to 15%
- Credit quality stable, with loss rates below market leader

Source: Company data; Hardman & Co Research

Everyday Loans (ELL)

ELL is NSF's largest business, representing ca.60% of the group total loan book, 51% of revenue and 86% of pro-forma normalised operating profit (74%, 53% and 89%, respectively, in 2016). NSF completed the acquisition of branch-based lender EL on 13 April 2016.

Key features from results

We identify three key issues with the 2017 results.

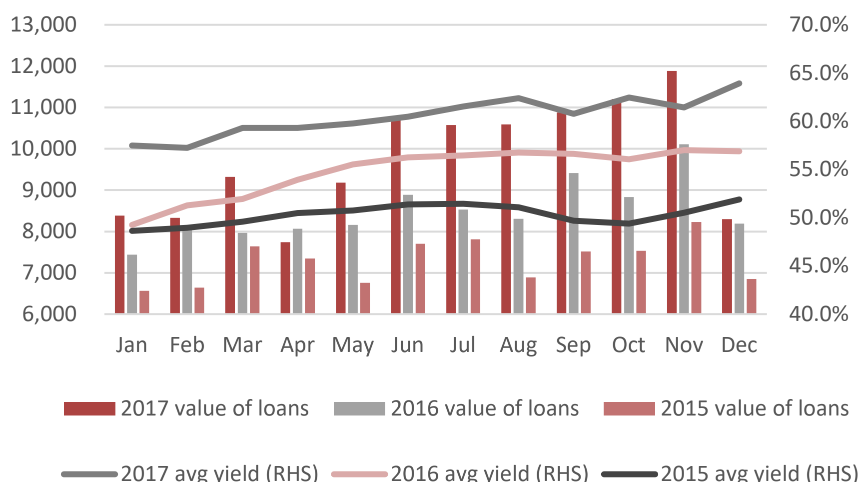
Branch expansion as promised (YE 53 vs. 41 end-2016). Risk on new opening mitigated by using existing, experienced staff.

- Management has delivered the branch footprint growth it promised. 2017 saw 12 new branch openings, taking the total to 53. A further 12 are targeted for 1H'18 (most in 1Q'18). Management is concentrating its branch opening programme so that staff training can be much more structured and effective. It has highlighted how the risk of this expansion is being carefully managed with the transfer of significant numbers of existing staff/management to the new branches. Local customers are usually migrated so that branches are kept at an optimal size (ca.£3m-£4m of loans, 1,000 customers).

Further increases in monthly lending and expansion of revenue yield

- Volume growth and re-pricing have been delivered exactly as promised. More than 1 million leads were processed in 2017 (2016 860k), helped by the expanded branch network. As can be seen in Figure 7, 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).

Figure 7: ELL new loans issued (£'000s) and average yield by month (%), 2015-17



Source NSF, Hardman & Co Research

Best practice across the division improves the conversion rate

- There is increasing evidence of group best practice being adopted. Management has, for example, focused on the operational performance of the top-five branch managers and tried to apply it across the branch network. A simple example was prioritising new branch leads from brokers who had introduced the best business rather than, say, the size of the loan, or alphabetically. ELL has also introduced six area managers who now oversee between two and four branches to help ideas to cross-fertilise. Further such appointments are expected in 2018. Some relatively simple procedural changes can have meaningful effects, with the conversion rate of leads into new borrowers increasing by 15% in 2017 alone (to 2.23% from 1.97% in 2016).

Change in outlook with these results

Underlying business EBITDA broadly unchanged. IFRS9 impact £1.5m.

We have tweaked our 2018 underlying estimates, with revenue growth of 25% (was 26%), impairments up 28% (was 33%) and costs up 21% (was 24%). The net effect on operating profit is a £0.2m increase in underlying profit. We forecast the IFRS9 impact to be an adverse £1.5m on profit and to reduce receivables by £1.4m. We assume that there will be no repeat of the gain on the sale of historical non-performing debt, which saw other income of £1.9m in 2017. We have increased finance costs to fully reflect the higher rate paid but also the fact that new business is effectively 100% debt-funded.

2019E profits up by nearly a half on 2018E

The 2019 forecasts reflect a continuation of the trends seen in 2017 and expected in 2018 – strong loan growth (20%), stable yields and credit (and so risk-adjusted margins), and operational leverage seeing improving cost to income ratios.

Figure 8: Financial summary and ratios, ELL

	Pro-forma normalised			
Year-end Dec (£000)	**2016**	**2017**	**2018E**	**2019E**
Reported revenue	50,088	60,937	76,305	91,095
Other income	450	1,926	-	-
Total revenue	**50,538**	**62,863**	**76,305**	**91,095**
Impairments	-10,484	-11,654	-14,879	-17,764
IFRS9 impairments	0	0	-1,488	-1,776
Revenue less impairments	40,054	51,209	59,937	71,555
Administration expenses	-20,631	-28,555	-34,511	-38,638
Operating profit	**19,423**	**22,654**	**25,426**	**32,917**
Net finance costs	-4,720	-7,051	-12,988	-15,506
Profit before tax	**14,703**	**15,603**	**12,438**	**17,412**
Number of branches	41	53	65	70
Period-end customer numbers (000s)	39,600	47,000	56,000	64,400
Period-end loan book (excl. FV)	122,400	148,500	176,200	211,440
Average loans	113,400	133,000	162,350	193,820
Ratios				
Revenue (pre-FV) as % average loans	44.2%	45.8%	47.0%	47.0%
Impairments as % pre-FV revenue	-20.9%	-19.1%	-21.5%	-21.5%
Risk-adjusted margin	35.3%	37.1%	37.8%	37.8%
Cost as % pre-FV revenue	-41.19%	-46.86%	-45.23%	-42.42%
Operating % pre-FV revenue	38.43%	36.04%	33.32%	36.13%
Net finance costs as % pre-FV revenue	-9.42%	-11.57%	-17.02%	-17.02%
Impairment as % average loans	-9.25%	-8.76%	-9.17%	-9.17%
Costs as % average loans	-18.19%	-21.47%	-21.26%	-19.94%
Net finance cost as % average loans	-4.16%	-5.30%	-8.00%	-8.00%
Average loan per customer (£)	3,091	3,160	3,146	3,283
Pre-FV revenue per customer (£)	1,264.8	1,296.5	1,362.6	1,414.5

Source: Hardman & Co Research

Home Credit: Loans at Home (LAH)

Based on 2017 results, LAH is NSF's second-largest business, with ca.21% of the group's total loan book, 42% of revenue and 10% of pro-forma, normalised operating profit (20%, 45% and 9%, respectively, in 2016). LAH is the UK's third-largest home collect credit business in terms of numbers of customers. NSF completed the acquisition of SD Taylor (which trades as LAH) on 4th August 2015 and it received its full FCA permissions on 16th May 2017.

Key features from results

Provident Financial (PFG) opportunity

One-off opportunity to increase agent numbers (primarily 1H'17) and quality (2H'17). Experienced agents delivering ahead of plan.

Having underperformed in FY16, with impairment levels higher than expected due to a period of experimentation with three different agent-hiring practices, 2017 reflected disruption for much more positive reasons. The self-imposed restructuring by PFG (the market leader) saw a marked increase in the number of experienced agents trying to join LAH. Compared with 785 agents at end-2016, 229 agents joined in 1H'17 and another 213 in the 2H'17. This has been partially offset by the departure of some agents, as NSF has sought to shed poorly performing agents, and due also to the usual agent attrition. By the end of 2017, the total number of agents had increased to 1,005 (up from 986 at the half year, and representing a 28% increase over the year as a whole). Operationally, the interviewing, hiring, training and integration of these agents resulted in some disruption to the day-to-day operations, and this, in turn, resulted in a temporary deterioration in collections in 1H'17, as resources were necessarily focused on securing this one-off opportunity for franchise growth. The influx of new agents also meant that there was an increase in temporary agent commissions (£3.2m vs. £1.8m in 2016). NSF has reported that the new agents are delivering profits ahead of plan, with collections and impairments significantly ahead of the business as a whole. We believe most agents had a six-month restriction on approaching their old clients – so the full benefit is unlikely to be felt until FY'18.

Heavy investment in support staff and infrastructure required to ensure expansion, and impairments remained tightly controlled.

Learning from the experience of 2016, management invested heavily in 2H'17 (£2.1m) in support staff and infrastructure. LAH has added 100 support staff, including 55 new business managers and 23 new area managers. Each business manager now has around six agents under his/her control. We believe this span on control is low (PFG talked about increasing its span of control to 16 customer experience managers for each area manager at its investor day in April 2017) and reflects a desire to ensure that the risk from new hires is well controlled. Management has indicated no intention to change the ratio over the immediate future, but we believe there may be scope to increase the ratio of agents to managers, as technology improvements increase operational efficiency. The infrastructure also includes new offices (22 added) but the cost is modest, as these sites tend to be small and, as they are not customer-facing, tend to be in non-prime locations.

Business developments

Focus on quality of book has seen impairment charges fall

In a broadly flat market, LAH grew its loan book by 53% in 2017. The increase in customers was only 11%, with the average loan per customer increasing from £357 in 2016 to £492. This increase reflects a focus on better-quality customers, to whom LAH is willing to make greater advances, as well as the drop-off of new customers (with small balances) acquired in 2016. The focus on quality and a slight lengthening of the average term saw a small reduction in the yield (147% vs. 153%), but this was more than compensated for by lower impairments (31.1% of revenue vs. 36.3%). Risk-adjusted margins thus improved.

Change in outlook with these results

Core estimates reflect full run of investment. LAH sees biggest impact of IFRS9, given material growth.

Our 2018 forecast operating profit has been reduced. We have built in a ca.£1m drop in revenue, offset by a £0.9m drop in impairments, but we have increased 2018 costs to reflect 10% growth on 2H'17 annualised costs (the expense associated with agent hires and infrastructure were not at full run rate in 2H'17). IFRS9 has a significant impact on this division, which has shown material growth. Receivables drop by around a fifth (from £51.2m at end-2017 to £40.6m), and impairments as a percentage of revenue in 2017 would have risen by nearly a third to 40% of revenue. Looking forward, the slower growth forecast for 2018 means that the impact of IFRS9 is less, but we now include a £2.8m charge for it. There has also been a small increase in funding cost forecasts. Overall, the divisional pre-tax profit forecast reduces from £10.5m to £4.1m. We forecast 20% loan growth in 2018, but this is offset by the reduction in receivables due to IFRS9 leaving year-end receivable balances broadly unchanged. Given this reduction, there is a rise in average yields, as revenue is unaffected by the change.

Profits expected to nearly double into 2019

Our new 2019 loan growth forecast is, we believe, below management guidance, in that we have assumed just 10% loan growth. We expect the new agents to be near fully operational in 2018 – so incremental gains into 2019 are modest. The incremental cost increase has reduced to 2.5%. We agree with management that there should be some upside from smaller providers withdrawing from the market, given their age profile and the increasing regulatory burden. We forecast profits nearly doubling on 2018.

Figure 9: Financial summary and ratios, LAH

	Pro-forma normalised			
Year-end Dec (£000)	**2016**	**2017**	**2018E**	**2019E**
Reported revenue	42,170	50,741	70,855	77,941
Impairments	-15,313	-15,776	-21,965	-24,162
IFRS9 impairments			-2,834	-3,118
Revenue less impairments	26,857	34,965	46,056	50,661
Administration expenses	-23,229	-28,679	-40,000	-41,000
Temporary agent comms.	-1,771	-3,184	0	0
Total expenses	-25,000	-31,863	-40,000	-41,000
Operating profit	1,857	3,102	6,056	9,661
Net finance costs	-323	-1,299	-1,915	-2,107
Profit before tax	1,534	1,803	4,141	7,555
Number of offices	47	69	70	70
Number of agents	785	1,005	1,050	1,100
Period-end customer numbers (000s)	93,600	104,100	125,000	130,000
Period-end loan book (excl. FV)	33,400	51,200	50,840	55,924
Average loans	27,600	34,500	38,300	42,130
Ratios				
Revenue (pre-FV) as % average loans	153%	147%	185%	185%
Impairments as % pre-FV revenue	-36.3%	-31.1%	-31.0%	-31.0%
Risk-adjusted margin	97.3%	101.3%	127.7%	127.7%
Pre-tax return (excl. FV) on avg. loans	5.6%	5.2%	10.8%	17.9%
Cost to % pre-FV revenue	-59.3%	-62.8%	-56.5%	-52.6%
Operating % pre-FV revenue	4.4%	6.1%	8.5%	12.4%
Net finance costs as % pre-FV revenue	-0.8%	-2.6%	-2.7%	-2.7%
Impairment as % average loans	-55.48%	-45.73%	-57.35%	-57.35%
Costs as % average loans	-90.58%	-92.36%	-104.44%	-97.32%
Net finance cost as % average loans	-1.17%	-3.77%	-5.00%	-5.00%
Average loan per customer (£)	357	492	407	430
Pre-FV revenue per customer (£)	451	487	567	600

Source: Hardman & Co Research

Guarantor loans (GLD): TrustTwo/George Banco

In 2017, GLD was the smallest of NSF's three business and represented 19% of the group's 2017 loan book, 7% of revenue and 4% of pro-forma normalised operating profit (5%, 3% and 2%, respectively, in 2016). It offers loans to non-standard customers who are able to get someone else, often a family member, with a good credit rating to guarantee their loan. With the guarantee, the interest rate that the borrowers have to pay is significantly lower than if they were to borrow on their own, making the loan much more affordable. TrustTwo was acquired as part of EL on 13th April 2016. The acquisition of George Banco (GB) was completed on 17th August 2017.

Key features from results

Delivered on promises to show strong loan growth (35%), rising cross-referrals, stable credit and investing in the franchise

The business mix has modestly changed with the inclusion of GB since August 2016. GB had a higher-yielding, marginally higher-risk and so higher risk-adjusted margin book than TrustTwo. Normalised pre-tax profit rose to £719k in 2017 from £340k in 2016, with revenue up from £2.4m to £8.1m, respectively. Impairments remained stable, at around 15% of revenue. This level is around the historical level of the market leader, although, in the nine months to December 2017, its impairments were 21% of revenues (Amigo was piloting a number of new guarantor scorecards over this period). Costs fell to 49% of revenue (from 58%) – a trend we expect to continue as the group sees increasing economies of scale.

Market growth of ca.30% p.a. and market share gains both look credible

Market growth of ca.30% p.a. appears to be the consensus. We note that the regulator appears to view guarantor loans favourably because of their better affordability aspects, and we believe that, as the product gets greater scale, it will have more appeal. On top of this market growth, management is expecting market share gains. It believes that by offering a broad range of products, and being a well-funded, credible alternative to the market leader, brokers will be encouraged to distribute their business widely, diversifying their own risk and allowing NSF to gain market share. We also note that referrals from the branch network accounted for just 5% of new business, a proportion management believes can increase significantly over the medium term. We concur with these trends, and our forecasts include 40% loan growth in 2018 and 2019.

Change in outlook with these results

Core estimates unchanged. Modest effect from IFRS9.

Our 2018 underlying estimates are largely unchanged, with a £0.4m reduction in income and a £0.1m fall in impairments, with costs unchanged. We have trimmed loan growth to 40% from 45%. The introduction of IFRS9 sees an incremental £1m in impairments, with 2018 forecast operating profit now at £7.5m.

2019E normalised pre-tax nearly double 2018E

Our new 2019 estimates reflect 40% loan growth, a small improvement in risk-adjusted margins, and continued operational leverage seeing costs fall as a proportion of revenue.

Figure 10: Financial summary and ratios, GLD

	Pro-forma normalised			
Year-end Dec (£000)	**2016**	**2017**	**2018E**	**2019E**
Reported revenue	2,416	8,078	18,939	27,964
Impairments	-358	-1,365	-2,884	-4,283
IFRS9 impairments	0	0	-1,009	-1,499
Revenue less impairments	2,058	6,713	15,045	22,182
Administration expenses	-1,402	-3,965	-7,500	-10,600
Operating profit	**656**	**2,748**	**7,545**	**11,582**
Net finance costs	-316	-2,029	-4,700	-6,500
Profit before tax	**340**	**719**	**2,845**	**5,082**
Period-end customer numbers (000s)	3,300	17,400	24,360	32,886
Period-end loan book (excl. FV)	8,800	48,200	66,580	89,883
Average loans	7,700	40,400	57,390	78,232
Ratios				
Revenue (pre-FV) as % average loans	31.9%	35.8%	33.0%	35.0%
Impairments as % pre-FV revenue	-14.8%	-15.3%	-15.2%	-15.3%
Risk-adjusted margin	26.7%	30.3%	28.0%	29.6%
Pre-tax return (excl. FV) avg. loans	4.4%	1.8%	5.0%	6.4%
Cost to % pre-FV revenue	-58.0%	-49.1%	-39.6%	-37.9%
Operating % pre-FV revenue	27.2%	34.0%	39.8%	41.4%
Net finance costs as % pre-FV revenue	-13.1%	-25.1%	-24.8%	-23.2%
Impairment as % average loans	-4.6%	-5.5%	-5.0%	-5.4%
Costs as % average loans	-18.2%	-9.8%	-13.1%	-13.3%
Net finance cost as % average loans	-4.1%	-5.0%	-8.2%	-8.1%
Average loan per customer (£)	2,667	2,770	2,733	2,733
Pre-FV revenue per customer (£)	732	464	777	809

Source: Hardman & Co Research

Credit

Results comment

As with any lender, credit remains a critical issue for NSF. With these results, the trends were all positive. In particular, we note that impairment to revenue improved FY'17 on 1H'17 in both ELL and LAH, and was stable in GLD.

Figure 11: Rolling 12-month impairments to revenue

%	ELL (Branch-Based)		LAH (Home Collect)		GB/TrustTwo (Guarantor)	
	FY'17	1H'17	FY'17	1H'17	FY'17	1H'17
Impairments/Revenue	19.1	19.6	31.1	37.5	15.3	15.3

Source: NSF, Hardman & Co Research

We note several business drivers:

Positive macroeconomic backdrop

- The macro credit environment remains robust for non-standard lending, with low unemployment, and those on low incomes seeing their earnings rising faster than average. Inflation has also started to come down, thereby improving the financial position of consumers. As outlined in previous notes, we believe that, in a recession (Brexit-driven or otherwise), while impairment would certainly rise, margins would quickly adjust and then widen, as there would be increased demand for non-standard lending, which would offset higher impairments. Well-run, non-standard lending businesses have rising profits in times of uncertainty.

ELL seeing falling provisions despite higher risk appetite

- In ELL, the improving loss ratio had occurred despite a controlled increase in appetite for higher-risk loans, in addition to rapid loan growth (both of which generate a significant proportion of new customers and would normally see higher impairments).

LAH shows benefit of focus on quality

- In LAH, the increase follows management action in 2016 to focus on better-quality customers. This resulted in customer numbers initially falling before the PFG agent hires saw rapid growth. At 31% of revenue, impairments remain above the top end of the range guided by the peer Morses Club (27%), but LAH has seen very rapid loan growth. It still uses historical modelling for losses, although the cohort of lending through the new PFG agents appears better than historical averages.

GLD stable

- In GLD, we note that Amigo recently reported loss ratios well above the ca.15% reported by NSF, although we understand that this was driven by piloting different cohorts of guarantor. The current losses at NSF are close to the run rate average for Amigo.

Provision coverage

Coverage ratio due to mix effects. Management indicates customer behaviour patterns do not give concern with a rising proportion of early-stage arrears.

The provision coverage (see Figure 12) has fallen from 79% of impaired loans in 2016 to 58% in 2017. This drop is not affected by the sale of historical non-performing debt, where both loans and provisions had been 100% written off. We understand that, even allowing for the debt sale, there has been a mix change, with a greater proportion of early impaired loans, which require less coverage. Management comments that the rise in early impaired loans is not a concern, noting that customers who miss say that a one-monthly payment in ELL or GLD or four-weekly

payments in LAH often get back on track. Management believes there is nothing in the customer behaviour to date to suggest that the current higher proportion of early-stage arrears is a warning sign of more provisions to come.

Figure 12: Provision coverage

£m	2016	2017
Net impaired loans	6,350	18,087
Provisions	23,362	24,480
Gross impaired loans	29,712	42,567
Provisions as % gross	79%	58%

Source: Hardman & Co Research

Unwind of discount

Unwind of discount down for same mix reason

Investors will note that the unwind of discount in provisions fell from £2.5m in 2016 to £0.7m in 2017. In 2016, relatively speaking, LAH had a lot of slow-paying, poor-performing debt, for which NSF released revenue each week in excess of the contractual amount, and then impaired it back out again. In 2017, as noted above, LAH had the opposite, with a greater proportion of new, early-stage, longer-term debt, which reduced the gross-up significantly.

IFRS9

No change in cash or ultimate profit – just a different timing of provisions

Growth in LAH sees greatest impact

Groupwide operating profit down 22% in 2017

We highlight once again that the change in accounting is not a cash item and does not affect the ultimate profit generated from a loan. However, IFRS9 does see provisions recognised earlier, a feature that penalises faster-growing businesses and flatters shrinking ones. With these results, NSF has given a more detailed breakdown of the effect on 2017 numbers. As can be seen in Figure 13, the divisional effects are markedly different. In LAH, the 53% loan growth means that the accelerated provisions have a much more dramatic effect than on the other divisions, with a 70% drop in normalised operating profit against a group average fall of 22% (we note that the impairment at PFG's home credit business would have benefited from a credit under IFRS9, as its business was in significant decline in 2017). Similarly, the effect on the balance sheet is more marked, with a 21% reduction in receivables for LAH against a group average reduction of 5%. The impact on the balance sheet (2017 - £13.2m less £2.5m of deferred tax) is 5% of NAV.

Figure 13: Impact of IFRS9 on operating profit and balance sheet in 2017

£m	IAS 39	IFRS9 Adj.	% change	IFRS9
Normalised operating profit				
ELL	22.7	-1.3	-6%	21.4
LAH	6.3	-4.4	-70%	1.9
GLD	2.7	-0.3	-11%	2.4
Centrals	-4.8	0	0%	-4.8
Group	26.9	-6.0	-22%	20.9
Balance sheet				
Receivables				
ELL	148.5	-1.7	-1%	146.8
LAH	51.2	-10.6	-21%	40.6
GLD	48.2	-0.9	-2%	47.3
Total receivables	247.9	-13.2	-5%	234.7
Other	-14.7	2.5	-17%	-12.2

Source: Hardman & Co Research

We forecast a 13% reduction in 2018 profits, as slower growth is expected in LAH

Management also provided some guidance as to the effect on 2018 profits. In ELL, impairments as a percentage of revenue are expected to increase by 1-3%, in LAH by 2-4% and in GLD by 5-7%. The increase in LAH is around half the level seen in 2017 because loan growth is expected to be materially slower. In both ELL and GLD, the incremental effect is similar to than seen in 2017. In our estimates, we have included an incremental £5.3m for IFRS9 in 2018, which reduces normalised operating profits by 13% (compared with the 22% reduction for 2017).

In terms of income, there are several moving parts. Management advises that the net effect is to leave income broadly unchanged under the new accounting policy.

Other issues

Regulation

We summarise NSF's regulatory comments as being that there is a lot going on, but NSF's current practices mean that the economic impact should be modest.

High Cost Credit Review focuses on re-financing, which NSF does not actively pursue

- The FCA High Cost Credit Review focus appears to be on customers who incur permanent debt by re-financing existing loans. LAH has been reducing the volume of such re-financing (down materially in 2017 on pre-acquisition levels). The payday loan cap was not extended to Home Collect Credit (HCC) removing this potential uncertainty. Some of the FCA comments on HCC imply a greater appreciation of the value it provides to customers.

- FCA creditworthiness consultation – NSF, across all its divisions, believes its practices meet all likely requirements.

- The HM Treasury consultation on breathing space should not have an impact, given the forbearance built into HCC. NSF believes the practices in its other businesses mean the effect of any new regulations is likely to be very modest.

- Regarding staff incentives, NSF notes that commissions-only structures (per LAH) are likely to be accepted as long as the provider can prove that appropriate controls are in place. NSF believes it will meet any standard likely to be required.

- It is unclear whether LAH's self-employed agent model would see any changes following Matthew Taylor's review of the gig economy. Agents choose their hours, plan their own routes and can delegate to third parties at their own discretion. Based on recent case law, all these features make the agents' status clearly self-employed. Even if the self-employed agent status is changed, NSF's modelling of the costs (holiday and sickness pay, etc.) is that it would not be material to group earnings.

Financials

Figure 14: Statutory profit and loss (£000)

Year-ended 31 December	2015	2016	2017	2018E	2019E
Business interest income	14,657	81,099	119,756	166,098	197,000
Other operating income	0	450	1,926	0	0
Fair value unwind on acquired portfolios	-5,456	-8,342	-11,985	-8,292	-8,292
Total revenue	9,201	73,207	109,697	157,806	188,708
Underlying business impairments	-1,885	-21,162	-28,054	-38,987	-45,467
Unwind of provision discount	-1,973	-2,489	-741	-741	-741
Business impairments	-3,858	-23,651	-28,795	-39,728	-46,208
IFRS9 impairments				-5,331	-6,393
Gross profit	5,343	49,556	80,902	112,746	136,107
Administration expenses	-11,340	-44,074	-69,203	-87,011	-95,488
Amortisation of intangibles	-4,030	-10,714	-7,897	-10,328	-5,158
Operating profit	-10,027	-5,232	3,802	15,407	35,460
EBITDA	-5,799	6,172	12,518	27,151	42,346
Exceptional Items	-6,135	-626	-6,342	0	0
Net finance (cost)/income	70	-3,484	-10,481	-19,603	-24,112
Profit before tax	-16,092	-9,342	-13,021	-4,196	11,348
Income tax	3,022	1,344	2,686	797	-3,098
Profit after tax	-13,070	-7,998	-10,335	-3,398	8,250
Avg. no shares for EPS calculation (m)	61.50	307.32	316.90	313.95	313.95
Statutory EPS (p)	-21.25	-2.60	-3.26	-1.08	2.63
Adjusted EPS (p)		3.37	3.44	3.72	6.40
DPS (p)	-	1.20	2.20	2.50	3.15

Source: NSF Hardman & Co Research

Figure 15: Normalised profit and loss (£'000)

Year-ended 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 16: Balance sheet (£000)

@ 31 December	2015	2016	2017	2018E	2019E
Non-current					
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 NCI*

Figure 17: Cashflow statement (£000)

Year-ended 31 December	2015	2016	2017	2018E	2019E
Profit (loss) before tax	-16,162	-5,858	-2,540	15,407	35,460
Taxation paid	-350	-1,341	-2,226	-1,226	-1,226
Depreciation	198	690	1,497	1,415	1,728
Share-based payments	0	0	291	291	291
Amortisation of intangibles	4,030	10,714	7,897	10,328	5,158
FV unwind on acquired loan book	5,456	8,342	11,985	8,292	8,292
Loss on disposal of fixed assets	51	-363	-416	0	0
Decrease in inventories	6	3	0	0	0
Increase in amounts receivable from customers (net of FV)	-5,394	-21,039	-54,437	-42,076	-75,248
Increase in receivables	-16,445	-7,737	-51	-491	-515
Increase in payables	19,078	-6,952	1,000	2,000	2,000
Net cash outflow from operating activities	**-9,532**	**-23,541**	**-37,000**	**-6,059**	**-24,060**
Cashflows from investing activities					
Purchase of prop, plant and equipment	-341	-3,514	-4,931	-3,500	-3,500
Purchase of subsidiaries	-81,111	-230,784	-16,442	0	0
Net cash outflow - investing activities	**-81,452**	**-234,298**	**-21,373**	**-3,500**	**-3,500**
Cashflows from financing activities					
Net finance Income	70	-3,484	-7,974	-19,603	-24,112
Proceeds from issue of share capital	98,234	172,869	0	0	0
Purchase of own shares	0	0	-1,357	-843	
Proceeds from borrowing	0	87,300	77,882	29,500	60,000
Repayment of borrowing	0	0	0	0	0
Dividends	0	-951	-4,439	-7,850	-9,891
Net cash inflow - financing activities	**98,304**	**255,734**	**64,112**	**1,204**	**25,997**
Net change in cash/cash equivalents	7,320	-2,105	5,739	-8,355	-1,563
Opening cash and cash equivalents	0	7,320	5,215	10,954	2,599
Closing cash and cash equivalents	7,320	5,215	10,954	2,599	1,036

Source: NSF, Hardman & Co Research

Valuation

Summary

Average valuation upside on absolute measures 60%

Our absolute valuation techniques imply average upside potential of 60%. At present, we do not believe peer valuations are helpful, as it is unclear to what extend consensus is consistently applying IFRS9 across all companies.

Figure 18: Summary of different valuation techniques

	Implied price (p)	Upside (%)
Gordon Growth Model (GGM)	102.1	62%
Discounted Dividend Model (DDM)	100.0	59%
Average absolute measures	101.0	60%

Source: Hardman & Co Research

We detailed our assumptions in our initiation note, published on 11 November 2016, Carpe Diem **The key changes are:**

- **GGM:** Our assumptions on return and equity, cost of equity and growth are unchanged. There is an uplift of 8p in moving our base year forward to 2019, but this has been offset by our introduction of a 10% discount for near-term performance. Equity is broadly flat over the forecast period (statutory earnings being below adjusted earnings, and so offset by a dividend pay-out). While the ROE is forecast to rise, it remains below our long-term assumptions.

Figure 19: GGM and sensitivities

	Base	+1% to ROE	+1% to COE	+0.5% to G
Return on equity (%)	30	31	30	30
Cost of equity (%)	11	11	12	11
Growth in equity (%)	5.5	5.5	5.5	6
P/BV (ROE-G)/(COE-G)	4.5	4.6	3.8	4.8
Discount re near-term perf. (%)	-10%	-10%	-10%	-10%
P/BV (x)	4.0	4.2	3.4	4.3
BV 2019 (£m)	79.9	79.9	79.9	79.9
Valuation (£m)	**320.4**	**333.5**	**271.1**	**345.3**
Variance (£m)		13.1	-49.3	24.8
Valuation per share (p)	**102**	**106**	**86**	**110**

Source: Hardman & Co Research

- **DDM:** Moving forward our base year captures an extra year of superior growth in our DDM model. Given that the rate of growth (2019E normalised EPS 40% higher than 2018) is well above that assumed in our model for growth over the next five years (15.5%), moving forward a year sees a material increase in valuation which is moderated by our earnings reductions with a net increase from 91p to 100p.

Notes

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