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Non-Standard Finance

"Carpe Diem"

In the UK, unsecured, non-standard lending market, NSF has the market leading network in branch-based lending, is number three in home credit, and has a scalable platform in the growing guaranteed loans market. It's medium term targets of 20% loan book growth and a 20% pre-tax return on assets look credible. NSF is under-geared and existing debt facilities will finance our projected growth through to mid-2018. Management is using technology to improve efficiency while not compromising the core personal relationships which are critical to managing credit. Our valuation methodologies indicate c67% upside.

- **Strategy**: NSF has made two acquisitions to build scalable platforms. It is now expanding rapidly by geography, staff, distribution channels, and the range of customers to which it will lend. It is being managed by experienced teams and should deliver strong volume growth, wider spreads, and improved efficiency.
- **Non-standard customers are different:** Non-standard customers are a broad group (from self-employed, through to historically impaired credits and those on low, variable and cash incomes). The common trait is that a lender must understand the customer's willingness to repay as well as their ability to repay.
- **Valuation:** The average of our absolute approaches is 101p (67% upside). The greatest upside (87%) is in our Gordons Growth model which we believe best captures NSF's long term growth and value added prospects. Peer valuations have 26% upside but we believe the whole sector is under-valued.
- **Risks:** Credit risk is high (albeit inflated by accounting rules) but NSF adopts the right approaches for this market which should be significantly counter-cyclical. Regulatory risk is an issue for all financial companies. The rapid growth strategy means progress has its own risks. NSF has no pension risk.
- **Investment summary:** Substantial value should be created as: (i) competitors' have withdrawn (ii) NSF is well-capitalised and has access to significant debt funding; (iii) positive macro-economic drivers both for demand and credit, and (iv) NSF has an experienced management team delivering technological efficiency without compromising the key model. Its 20% loan book growth and 20% ROA targets appear credible and investors are paying just 11x 2017 PE.

Financial summary and valuation

Year end Dec (£000)	2015	2016E	2017E	2018E
Reported revenue	9,201	80,575	102,088	139,196
Total impairments	(3,858)	(24,654)	(29,589)	(35,906)
Total costs	(15,370)	(55,282)	(64,348)	(71,240)
EBITDA	(5,799)	11,845	16,397	32,607
Reported pre-tax	(16,092)	(6,083)	790	16,754
Adj pre-tax (pro for)		15,526	20,197	25,681
Statutory EPS (p)	(21.3)	(1.6)	0.2	4.2
Adj EPS (Co basis p)	1.3	4.8	5.6	6.8
P/ Adj Earnings (x)	46.3	12.7	10.8	8.9
P/BV (x)	0.7	0.8	0.8	0.8
P/tangible book	2.1	1.9	1.8	1.6
Yield	0.0%	2.2%	3.7%	5.0%

Source: Hardman & Co Research

Financial Services

Source: Eikon Thomson Reuters

Market data

EPIC/TKR	NSF
Price (p)	60.25
12m High (p)	99.25
12m Low (p)	56.0
Shares (m)	317
Mkt Cap (£m)	191
EV (£m)	260
Free Float*	99%
Market	Main

** 1% shareholding of directors*

Description

In the UK, non-standard lending market, NSF has the market leading network in unsecured branch-based lending, is number three in home credit, and a scalable platform in the growing guaranteed loans market.

Company information

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Key shareholders

Invesco	26.69%
Woodford Investment	22.02%
Marathon Asset Mgt	10.18%
Secure Trust Bank	7.42%
Toscafund Asset Mgt	3.71%
Jupiter Asset Mgt	2.99%

Next event

Mar-17	FY16 results

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Executive summary

We believe the non-standard market offers excellent risk-rewards opportunities for investors. In particular, we note:

Growing demand

- The growing numbers of self-employed, increased county court judgements in 2014 /2015 meaning increasing numbers of impaired credits looking for loans in 2017/2018, and more numbers of migrants establishing a 3-year UK record.

Supply has reduced giving both volume growth but also re-pricing opportunities

- The largest branch based lenders of unsecured credit to sub-prime borrowers all withdrew in the financial crisis and the largest Home Collect business re-focussed two year ago, shrinking its business by broadly half. Regulation is making life harder for the smaller players especially in home collect. NSF has significant volume growth and re-pricing opportunities.

Technology can improve efficiency and not compromise model

- The internet increases NSF's brand reach allowing customers to be sourced and then directed to its existing channels. Technology makes life easier and quicker for home collect agents by removing historic burdensome paper chains. It also provides an audit trail, providing real-time data and improved record-keeping.

Barriers to entry are material

- The customer's character must be established, not just their ability to repay. Historically major bank forays into non-standard have been disasters as they relied excessively on automated assessment of the customers' ability to repay and insufficiently on their willingness to do so. Historic competitors who withdrew from the market will have brand difficulties in re-entering it. Many of them would also face regulatory capital challenges that would be required against any loans issued in the sub-prime space.

NSF acquired frameworks and is now investing to deliver much accelerated growth

NSF bought existing players with appropriate skills sets and broad infrastructures to target this market. The group then invested (and is continuing to invest) heavily in much-accelerated growth. This investment has been in the shape of new branches, people (both self-employed agents and staff), and technology. Whilst the scale and speed of this, is likely to produce some volatility in any individual period in the short-term we believe that the long-term investment thesis is attractive.

Investors are buying a business with higher growth, higher yields, greater economies of scale but higher risk profile customers.

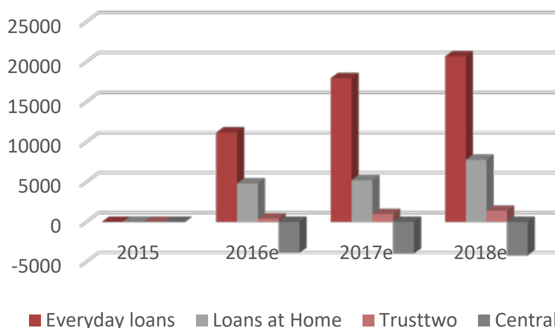
In branch based lending, NSF is expanding the pool of potential customers by agreeing to lend to some segments that the previous owners would have declined, as well as expanding its network of branches. We explore the key drivers to this approach in Figure 1. The degree of added value will depend on: (i) volume growth (ii) re-pricing - the increase in this table has already been seen on new loans issued. (iii) economies of scale, and (iv) credit deterioration.

Figure 1: Theoretical impact of moving down the risk curve

£'000s	Old model	New model				
		Base	More volume	1% more yield	1% efficiency	1% worse impairment
Loans	100.00	200.00	250.00	200.00	200.00	200.00
Income (yield increased from 51% to 56%)	51.00	112.00	140.00	114.00	112.00	112.00
Impairment (increased from 20% to 25%)	-10.20	-25.20	-31.50	-25.20	-25.20	-26.32
Costs (efficiency improvement from 45% to 42.5%)	-22.95	-47.60	-57.40	-47.60	-45.92	-47.60
Pre-tax profit	17.85	39.20	51.10	41.20	40.88	38.08
Pre-tax profit margin	**35.0%**	**35.00%**	**36.50%**	**36.14%**	**36.50%**	**34.00%**
Pre-tax ROA	**17.85%**	**19.60%**	**20.44%**	**20.60%**	**20.44%**	**19.04%**

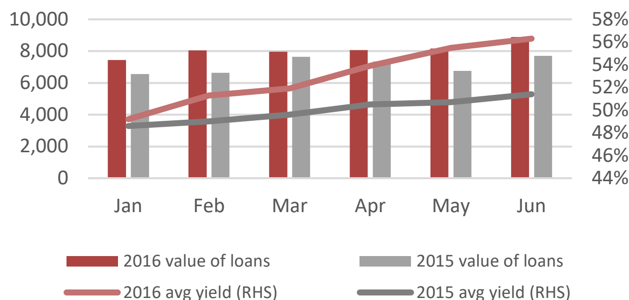
Source: Hardman & Co Research

Divisional pro-forma adjusted pre-tax profits (£000s) 2015-2018e



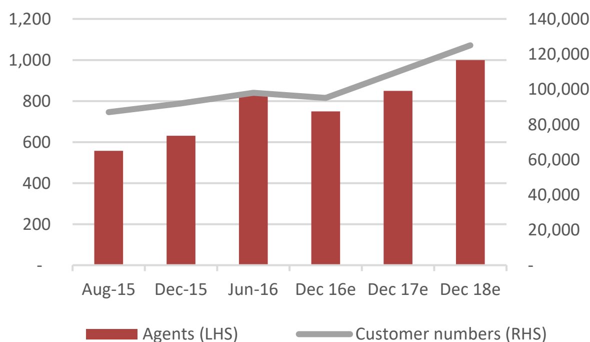
- Branch-based Everyday Loans (EL) expected to contribute 70% of 2018 business unit adjusted pre-tax profits.
- Home collect business showing good growth in 2017 as agents become fully operational with lower impairments.
- Trusttwo guarantor loans showing double digit growth with a careful roll out of the relatively new product.
- Group central costs held broadly stable

Everyday Loans (EL)



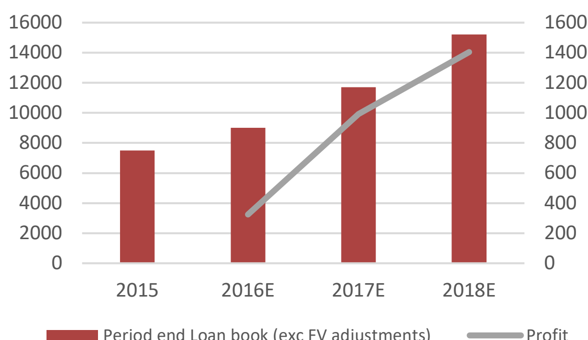
- Acquisition completed 13 April 2016 for £235M (Goodwill £92m, other intangibles £14m, FV adjustment £24m).
- Normalised H116 pro-forma post tax earnings £4.4m.
- Nearly 3% added to new business yield since the acquisition. H216 pricing c56%, c6% above level of H115 new loans
- Annual branch expansion nearly 3x historic average under Secure Trust's ownership, will see broader and deeper penetration of potential customer base.

Loans at Home (LAH)



- Acquisition completed 4 August 2015 for £82M (Goodwill £40m, other intangibles £18m, FV adjustment £6m).
- Home Collect business exploiting retrenching by market leader who has shed 10x LAHs customer numbers.
- Agent growth in 2016 expected to be 39%, still well ahead of long term plan and providing base for 2017 / 2018 loan growth.
- Some problems especially with inexperienced agents will see dip in H216 agent numbers. No change in long term prospects.

Trusttwo



- Acquired as part of EL. Now a stand-alone division. Should see focus where market leader reportedly makes £50m profit p.a.
- Guarantee lowers cost of loan to level where it is affordable to the customer and reduces probability of bad debts.
- Guarantors must pass near prime credit scoring. This lending has an element of prime security but earns sub-prime yields.
- Regulatory risk is uncertain. NSF aims to be compliance market leading to reduce this risk.

Source: Company data; Hardman & Co Research

Non-standard loan market – overview

Addressable market c £14bn against forecast NSF loans end 2018 of £264m

NSF is addressing the non-standard, personal unsecured lending market in the UK. The size of this market is estimated by management to be c£14 billion of annual advances giving NSF a 2018e market share of around 2%

Non-standard includes rising numbers of self-employed …

Customers of non-standard lending include a broad spectrum: (i) recently self-employed – it typically takes three years of accounts to establish a financial track record for a mainstream lender to consider a self-employed person prime again. ONS data shows the level of self-employment in the UK increased from 3.8 million in 2008 to 4.5 million in 2015;[1] (ii) people who had credit difficulties in the past but who now can afford debt; (iii) people whose jobs require frequent re-location (ONS data indicates that from 2012-2015 an average of 2.8m people moved internally in the UK annually up from 2.6m in 2002-2011); (iv) those who have good credit record outside UK but have yet to establish their UK record; and (v) those on low, variable, casual income which may be paid weekly in cash.

… as well as those whose historically impaired credit rating has now improved

The credit impaired market is material. Of most interest to NSF are those who were impaired some years before but whose track record has subsequently improved. Someone who was made redundant in 2013 may have a County Court Judgement (CCJ) against them in 2014 but on finding employment may be a perfectly good borrower by 2015. The credit data though still gives a heavy weighting to the CCJ in 2014. Market wide, we note the rise of CCJ incidences in 2014/2015 means that the potential stock of such improved customers in 2017/2018 is above the current level.

Figure 2: Total number of consumer County Court Judgements

	2011	2012	2013	2014t	2015
Number of CCJs	520,475	468,115	499,610	671,305	694,680

Source: Registry Trust report and accounts, Hardman & Co Research

The potential pool of migrants achieving three years of UK residency is also rising. ONS data shows gross immigration in the year to March 2016 was 633k compared with 493k in 2013 and 536k in 2012. With the number of immigrants arriving in the UK over the last three years higher than previous years the potential pool for non-standard lenders is greater.

New business strain re higher credit losses of new customer

New customers tend to incur greater losses than experienced ones. This is typically managed by offering them shorter terms loans (incurring a higher APR) and smaller loans (again a higher APR but also higher administration cost). New customers, thus generate higher revenue margins but lower nominal income, greater costs and more impairments with net effect being that their profitability is much lower at least in the short term (we examine LAH H216 specific new business issues in that unit's review below).

[1] http://www.ons.gov.uk/employmentandlabourmarket/peopleinwork/employmentandemployeetypes/datasets/selfemploymentjobsbyindustryjobs04

Credit assessment cannot be solely computer driven – willingness to repay v ability is crucial

This is a high credit risk business (although the accounting rules materially inflate the charge). Historically, a flaw of standard lenders moving down into sub-prime (which they did when economic conditions were strong and competitive pressures eroded prime market returns) has been an over-reliance on statistical modelling. In the non-standard market, money is so tight that even a few pounds makes a difference to the customer. Judging whether they will use those few pounds to consistently meet their debt obligations or spend on other things, is critical to the credit decision. To date computer modelling alone has not been able to accurately forecast this behaviour, we believe because the nature of their customer and their income is too variable.

Management of credit once in difficulties is different from main stream

Managing arrears is different from practices in the prime and near prime segments. While banks have historically loaded charges onto customers who miss payments/go overdrawn unexpectedly, this is not a feature of the NSF's business. Variable customer income means their ability to keep to payment plans can be weak and getting into arrears on payment plans is more normal rather than exceptional. Applying penalties which may well never be collected is rather pointless and industry practice is to add to the length of a loan if the customer misses a payment. The cost of this is factored into the high yield earned on the loans. Knowing when to chase payments and to limit losses is not simple and again needs a detailed knowledge of the customer and their likely behaviour if a loan extension option is available.

The market is however significantly counter-cyclical

At times of economic distress, the number of customers who drop out of prime status increases thus expanding the pool of potential customers in the non-standard market. Additionally, a non-standard lender's ability to re-price is significantly higher – it is easier to add 5% to a loan with an APR of 50% than a mortgage charging 3%. Impairments rise, as does the funding cost, but the bottom line resilience of well-run businesses such as PFG (2007 profit £115m, 2009 profit £130m) or S&U (2007 profit £6m, 2009 £6m) is high.

High cost business

Administration expenses are also high as a percentage of revenue reflecting: (i) a low average size of loan, (ii) high credit management costs including collection, and (iii) manually intensive processes for collection and credit assessment with a sizeable supporting infra-structure. Technology can help the process but the core of the business remains the personal relationship.

Simple products

The customer base is not generally financially sophisticated and so the product range needs to be kept simple. In home collect, pricing typically reflects just the loan duration, as the key issues for the customer are how much does this cost every week and what is the total amount that they pay back rather than them having a detailed understanding of APRs.

Competition has significantly reduced, especially for higher risk customers…. Materially enhancing NSF's potential profitability

Competition is primarily from other specialist lenders. There has been a retrenchment by existing specialists reducing supply. Most of the branch based lenders in 2007 were owned by large institutions for whom non-standard lending was either an expensive mistake or a non-core distraction. In recent years, the market leader in home collect decided to shift its strategic focus to become a smaller, more profitable business and has shrunk its number of self-employed agents and customers by half. Increasingly burdensome regulation and compliance requirements may result in the number of smaller home collect businesses falling in the future. The average income level of customers as well as the size and duration of loans means the overlap between NSF's businesses and payday lending is very limited and such lenders are not substantial competitors to LAH. With increased capital requirements, and the need to deal with legacy issues, mainstream banks are not expected to return to the non-standard segment for the foreseeable future. This retrenchment has significantly improved the market opportunity for NSF. Not only does it open much larger potential volumes but it also allows greater flexibility on

re-pricing. As noted on p3 NSF's potential to deliver profitable business through higher risk lending is greatly enhanced by both these trends.

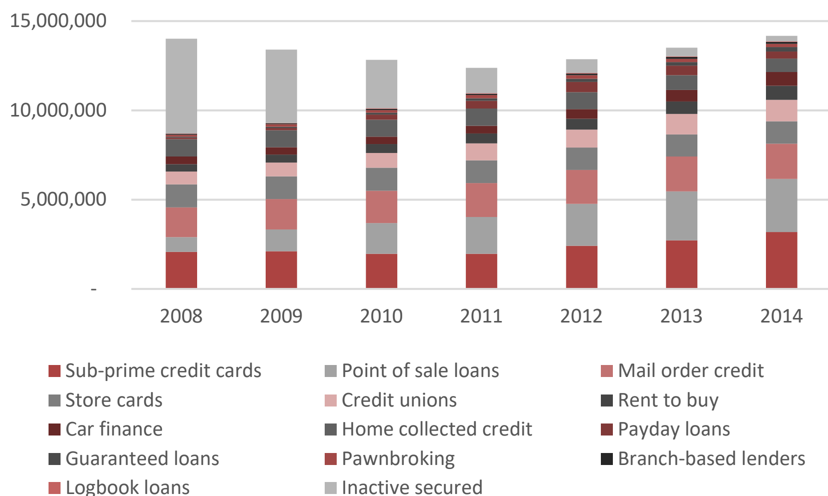
Regulatory risk

However, the high credit risk and high administration cost make this a high interest rate business. This exposes the sector to perceptions of over-charging and it has faced anti-competitive investigations in the past. We note from an international perspective there have been several countries imposing regulatory caps on equivalent businesses. The previous UK reviews of the home collect market have not seen any material changes and we note high levels of customer satisfaction with the service. We also note NSF has prioritised market leading compliance as a strategic objective. The branch based business has not faced any material review but its charges are significantly lower than home collect. NSF's business does not overlap with payday lenders to any great extent and it is not exposed to any of the remedies proposed for that market (its interest rates are significantly below the cap imposed by the FCA of 0.8% per day).

Market competition

NSF estimate the total market to be around £14bn. There are a range of potential providers of finance in this area and they are detailed in Figure 3 below.

Figure 3: Outstanding receivables (£000s) by type of provider



Source NSF, Hardman & Co Research

Rent to buy (brands such as BrightHouse, PerfectHome BuytoView) potentially lending £400m less than at present

Historically a number of companies provided finance for goods such as TVs on terms which meant the failure to repay the debt led to the goods being re-possessed. Following regulatory changes the affordability of borrowing has become a major focus and this may see half the customers becoming ineligible to borrow on these terms. Around £800m of goods was purchased this way in 2014 and some of it may need an alternative source of funding.

The largest element, sub-prime credit cards (Vanquis, Capital One, NewDay) is expected by NSF to grow by c10% p.a. for the foreseeable future. Credit cards though serve a different need from NSF's term loan businesses. NSF also believes point of sale, mail credit, car finance and store are typically targeted at nearer to the prime market. Credit Unions we believe are constrained by their corporate governance and will see steady but limited growth. Additionally, the cap of their interest charges means they are limited competition in the higher-loss sub-prime areas.

Divisional Summary

NSF shell formed 2014, first acquisition H215, second H116

NSF was formed as a shell company in July 2014 with the objective of raising capital to make acquisitions which could provide a strong infrastructure in the non-standard finance market. NSF management have had long experience in this sector and identified that demand would remain strong and the withdrawal of certain suppliers meant good, profitable growth opportunities for those with the right platform. NSF completed its first acquisition, SD Taylor (legal owner of LAH, the UK's third largest home collect business) on 4th August 2015. NSF completed the acquisition of EL (the UK's largest branch-based provider of unsecured credit that also had a nascent guarantor loams business) on 13 April 2016. The total consideration for these deals was £317m.

As we detail in the sections below, management has done exactly what it said it would

Since completing both acquisitions, NSF has introduced higher pricing, invested in branches and people (frontline, compliance and senior management) and has invested heavily in technology to enable greater efficiency without compromising the core business model. Volume growth has been strong and we expect an acceleration of customer acquisition, loan volumes and also revenue, as the group achieves payback in 2017 and 2018 from its investments in 2016. We expect this growth to continue well beyond our 2018 forecast period.

We recommend investor's focus on the adjusted profit growth as the acquisition accounting means the statutory numbers distort underlying business trends

Figure 4 provides a summary of the divisional businesses. Each is expected to show strong revenue and profit growth. EL remains the dominant element of the group although its statutory profits are depressed by acquisition accounting. LAH is expected to deliver strong growth in 2017 with a lower impairment charge. Our 2018 estimates across the group include higher provisions for the implementation of FRS9 which effectively re-introduces general provisions. The scale of this remains highly uncertain.

Figure 4: Divisional summary – key statistics (£000s)

	2015	2016E	2017E	2018E
Customer numbers				
EL	0	42,000	50,000	59,000
LAH	92,000	95,000	110,000	125,000
Trusttwo	0	3,300	3,960	4,752
Central	0	0	0	0
NSF Total	**92,000**	**140,300**	**163,960**	**188,752**
Normalised pro forma Revenue				
EL	-	49,625	61,583	77,259
LAH		44,075	49,341	61,901
Trusttwo		2,412	3,105	4,037
Central		-	-	-
NSF Total		**96,113**	**114,030**	**143,196**
Normalised pro-forma pre-tax				
EL	-	11,184	17,959	20,699
LAH		4,818	5,215	7,766
Trusttwo		427	993	1,404
Central		(3,874)	(3,970)	(4,188)
NSF Total		**15,526**	**20,197**	**25,681**

Source: NSF, Hardman & Co Research

Everyday Loans (EL)

Summary

Everyday Loans is NSF's largest business representing c75% of the group total loan book. NSF completed the acquisition of EL on 13 April 2016 for a total consideration of £235m (including £20m of shares which were issued to Secure Trust Bank, the lock-up of which expired on12 October). On a pro-forma normalised H116 basis, its post-tax contribution would have been £4.4m. Since acquisition loan volumes have been increasing on a higher yield, and management has begun to expand the branch network rapidly. The branch network is the core of the business. Historic analysis indicates that the loss ratio for a branch-based loan, compared with a like-for-like one made online, is around half. The local nature of each branch means that managers and staff should know what is going on in the local economy (if the local factory is at risk of closure for example) while a remote computer model cannot.

Description of business

EL established in 2006. Taken over by STB in 2012 and bought by NSF in 2016. Same management team throughout

EL was established by its management team and Alchemy Partners in 2006 as a specialist sub-prime lender using a branch network as its key distribution channel that also helped the business to develop a robust credit assessment process. The rate charged to customers (representative APR c80%) reflects both high expected credit losses (20% of revenue) but also the high cost of the branch network. Like many non-bank lenders, the financial crisis saw funding lines severely constrained and Secure Trust Bank acquired EL on 8 June 2012 for £1 (with £72m of debt re-funding). Access to STB's low interest cost bank deposits meant the business could return to growth (loan balances end 2013 £81m, 2015 £114m). The management team is led by Danny Malone, who co-founded EL in 2006.

Existing customer renewal biggest source of new loans

Loan applications are sourced from customer renewals (38%), via brokers (35%) and directly via the internet (both own website and search engine driven), phone and branch (total direct 27%).

Brokers generate circa a third of new business – widely sourced and economics of each broker reviewed monthly

Third party brokers are the second largest source of EL's business as many EL customers have been declined by at least one prime lender before they are referred to EL. Management indicate that the range of brokers is broad with the largest individual broker accounting for just 11% of new loan volumes in H116. EL incurs some costs related to potential customers that are referred but that are not converted into actual customers. EL reviews business from each broker monthly to ensure it is economically viable. Total broker commissions were c10% of EL advances on their introduced business. The proportion of new business coming through broker introductions has been falling (from c50% in 2012 to 35% now) and direct approaches have increased (10% to 27% now) with increased direct marketing. Under NSF management we expect this trend to continue.

Branch interview is critical part of process

Once sourced, borrowers go to a branch (37 full, 3 satellite now) to have their information verified and be interviewed before they can get the loan. Payslips or bank statements are requested to verify income. This branch interview, while incurring expense, is also vitally important in determining the character of the borrower. It helps establish whether they will have the intent to repay the debt once they have demonstrated the financial capacity to do so. In the non-standard space, it is not just about ability to repay but also willingness to do so. In a limited number

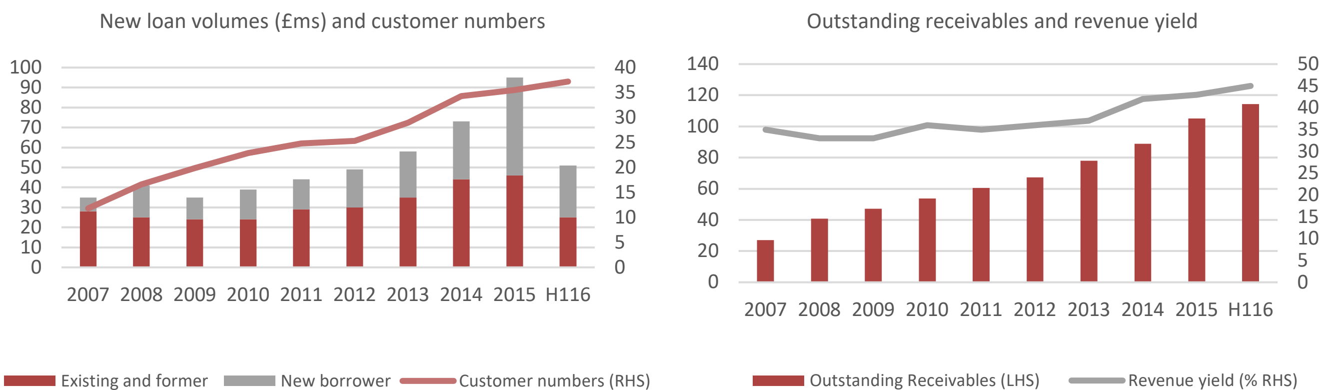
of cases where the customer has difficulty getting to a branch, EL staff may visit the customer at home.

10% of new business was done centrally with telephone interview and under tighter credit criteria

EL has historically done less than 10% of its loans through a central lending function (typically where the customer cannot access a branch). If this route is followed, once fixed criteria have been satisfied, the customer will be contacted by telephone for the interview process. Given the higher risk associated with this type of lending, credit scorecards were tighter (only customers in EL risk groups A1-A5 are accepted against A1-A9 in branches).

The ten-year business summary is given in Figure 5 below. As can be seen there has been a steady growth in customer numbers. Gross new lending by customers reflects the economic conditions at the time. In 2009 existing (or former) customers accounted for 69% of gross lending while in 2015 it was under 50%. Outstanding receivables have shown very steady growth. The jump in yield in 2014 was due to a re-pricing of loans when EL decided to no longer sell insurance products.

Figure 5: EL 10-year history of new loan volumes, customer numbers, receivables and revenue yield



Source NSF, Hardman & Co Research

Credit assessment

A standard approach to credit assessment is to consider the seven "canons of lending". The application of these principles is outlined in Figure 6 below. The typical customer has many prime characteristics – earnings close to national average, must have bank account – but will often have had an impaired credit in the past.

Figure 6: CAMPARI analysis of CANONs of lending

Canon	Comment
Character	*Customer is interviewed face to face in the branch to establish that they will repay the loan if they have the resources to do so.*
Ability	*Customers must have a bank account and a 3 year UK address history Customers must be in employment. 63% have no dependents.*
Means	*Typical customer is C2D socio-economic groups, earning c£24k (i.e. near national average). Around 20-25% are homeowners. 23% live with parents*
Purpose	*EL loans tend to be for material events -debt consolidation, home improvement, car and lifetime events (weddings) – rather than daily life.*
Amount	*Loans can range from £1k - £15k but usually £1k- £4k (average £3.3k, 63% £4k or less).*
Repayment	*The loan duration ranges from 24 months to 60 months (avg 31). £3k over 2 years at an interest rate of 59.9% p.a, costs £217.24 per month*
Interest	*The typical APR is 79.4% with a range from 24.2% to 299%. EL adopts customer specific risk adjusted pricing and hence its broad range of APRs.*

Source: Hardman & Co Research

76% rejected at application

9-10% customer rejects terms or declined by branch pre interview

12-13% declined at branch

Only 3% of applications are ultimately lent to. …85% of those approved by credit scoring get declined following branch review

Out of every 1,000 applicants, 76% are automatically rejected at the application stage using standard computer driven assessments of credit including ability to repay, credit histories from market data providers and EL proprietary models. This also strips out duplicated applications. A further 9-10% do not proceed complete as (i) the customer either rejects the terms, or (ii) the manager decides to decline the loan without an interview or (iii) the branch cannot contact the customer at all (some people will go on a website to get a quote without intending to proceed). A further 12-13% of applications are rejected by the branch (either on interview or during a preliminary pre-interview telephone call). Only 2-3% actually succeed and drawdown a loan. It is interesting to note that only around 10-15% of those that pass the initial credit scoring, drawdown a loan showing the importance of the branch review process.

Data flow has a value as well as a cost

The huge volumes flowing through the system mean that EL has a constantly updated view of the market. It also is a competitive advantage for a larger lender in that the fixed overheads in building the system can be spread over the widest potential client base. The marginal cost for a credit search by EL is small (EL has negotiated mass volume rates).

New customer lending losses much higher than renewals

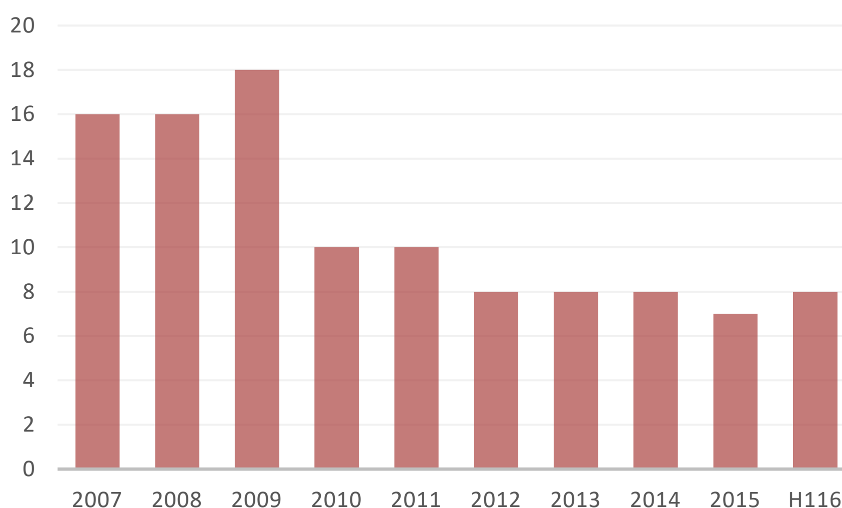
As with other non-standard lending the greatest loss rates occur on lending to totally new customers. Pre-acquisition around 40% of new loans by number were renewals by existing customers (c44% by value). The latest reported number is 38% given the new business volumes now being achieved.

Credit management once a loan is made

Restructuring debt is not uncommon… customer's willingness to communicate and trying to keep to new plan are important

Given the non-standard nature of the customer base, the management of credit once a loan has been made is critical to the profitability of business. The branch has the initial responsibility for collection and nearly half managers' performance targets are set on collections. The branch only relinquishes this responsibility when the account is charged-off (after 180+ days contractual delinquency at month end)

Figure 7: EL 10-year history of impairments as a % revenue



Source: Hardman & Co Research

The Group's policy on forbearance is that a customer's account may be modified to assist customers who are either in, or have recently overcome financial difficulties and have demonstrated both the ability and willingness to meet the current or modified loan contractual payments. These may be modified by way of a reschedule or deferment of repayments. Rescheduling of debts retains the customer's contractual due dates, whilst the deferment of repayments extends the payment schedule up to a maximum of four payments in a 12-month period.

Cost of debt collection can be high but has deterrent effect

Single debt collector to ensure it is done appropriately

Should loan restructuring be insufficient, debt recovery might include litigation, debt collection agents, trace and collect agents, debt purchase companies and organisations through which a customer has sought a debt management plan. The cost of court action is material (using the automated Money Claim Online route for a county court judgement costs £105 for £1.5k to £3k debt, £185 for £3-5k and £410 for over £5k) to which must be added the actual enforcement costs. While in theory these costs are recoverable from the borrower, in practice many of these fees would be unpaid. The process (especially a CCJ) does have a deterrent effect and may be used where concentrations of loss have been identified. Mindful of its regulatory obligations as well as the potential reputational risks EL uses a single debt collection agency to pursue debt recovery and exercises control over which actions the agency can take.

Regulation

EL received its full FCA licence on 21 June 2016. The thematic review which is most likely to have an impact on NSF is the one on early stage collection but processes have already been changed in this area. The standard loan terms are 24 months or longer so EL lending is not classified as high cost short term credit which would require a separate licence from the FCA – it may be something EL will pursue in the future but is not part of its present business.

Strategy under NSF

Up to 20 more branches broadening geographic spread of current 36

A new branch incurs trading losses of up to £300k before breakeven after 11 months

NSF has significant plans to increase its geographic coverage, aiming for 5 new branches in H216 and 3-5 pa thereafter (compared with just 7 branches opened under STB's ownership June 2012 to April 2016). By the end of 2016 80% of postcodes should be within a 5 mile / 30-minute drive of an EL branch (75% pre-acquisition). Management have indicated that a new branch incurs upfront capex of £50-75k, trading losses of £275k-£300k before breaking even after 11 months when receivables reach c£750k. Fully mature branches (i.e. 3-4 years post opening) generate a return on assets of over 20%. This, and an expanding brand presence is expected to see an even faster expansion in customer numbers (Hardman estimate c20% p.a.).

Yield been increased

NSF has already re-priced new loans since acquisition. On acquisition the range of APRs were 18.9% to 199% (it is now 24.2% to 299%) and the representative APR is now 79.4% (was 74.4% November 2015). The yield on new business has increased to 56% up from 50-51% a year ago

More products

NSF in addition to growing the footprint and customer base, has also indicated it intends to expand its product range. It has been reluctant to give too many details at this stage – we suspect for competitive reasons but also product development is preliminary. They have however suggested that self-employed loans is a priority. By way of example, this analyst went from super-prime to sub-prime overnight when he became self-employed, did not have trading accounts and had only a limited borrowing record. The demand for this product should be there.

Pre-crisis branch based sub-prime lenders

We note EL management commented that in 2006 they had advised their founders that the business would only reach a scale to be profitable in June 2009. Despite the financial crisis it delivered on this plan. In the run up to the financial crisis there were multiple other branch based lenders to the non-standard unsecured loan market with the top six accounting for over £5bn in lending. However, most were owned by large institutions for whom sub-prime was a time-consuming distraction and for many the approach to credit was too automated. Among the largest were:

Beneficial (125 branches) closed as part of wider HSBC closure of sub-prime branch network

- Beneficial Finance (owned by HFC) became part of HSBC when the latter took over Household in 2003. It had a network of c125 branches which closed in July 2009. HSBC at the time was closing most sub-prime branches globally and in the UK poor controls (including PPI mis-selling) introduced regulatory and compensation risks which were unacceptable to HSBC.

Citi (c90 branches) also strategically withdrew from sub-prime

- Citigroup had c90 branches across its Future Mortgages and CitiFinancial loan arms with the latter having around 66k customers with a typical loan of c£5k. It closed its branches in 2008 as part of a wider withdrawal from sub-prime lending. The Guardian reported the unit had incurred losses of c£50m in 2007 - www.theguardian.com/business/2008/feb/06/hsbcholdingsbusiness.citigroup.

- Welcome (part of Cattles) had c183 branches. London and Scottish Bank (c52 branches in 2007) went into administration in November 2008. Black Horse was owned by LTSB which strategically pulled back from sub-prime lending.

Current competition

EL is the largest branch based provider of unsecured non-standard loans in the UK. There are a range of competitors in this employed but impaired credit space although none has the range of products available to EL. These include:

342 Credit Unions but generally small, not commercially organised and with modest growth

- Credit Unions: The Association of British Credit Unions Ltd notes there are 342 credit unions in England, Scotland and Wales with total loans of £769m at end 2015. Loans growth in 2015 was 6%, broadly consistent with its ten-year average growth. Credit unions are not a homogenous group. Some are run with the intent of lending small amounts (typically below EL level) to those unable to get credit from a reputable lender. Others are run more commercially and so are direct competitors. Profitability is generally low leading to limited growth in capital and so a limited ability to grow lending. Some credit unions charge less than 1% per month and by law they cannot charge more than 3% pm (APR 43%).

Number 2 is c1/5th size and more focussed on migrants

- The second largest branch based lender is Oakam which was founded in 2006. Its branches are limited to London and the Midlands. Its customers are either un-banked due to recently moving to the UK without a credit history or those under-banked due to getting into financial difficulty in the past. Oakam is targeting the former with staff speaking over 20 languages and its residency requirement is just 6 months. EL is c 5x as large by accounts receivable.

Online is competition but 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 section specifically for those with bad credits records. The key differentiators from these competitors include the credit spectrum and loan size EL offers as well as the branch credit assessment process.

It is important to note that payday lenders are not competitors. Most are not prepared to lend the amount offered by EL and they tend to require much quicker repayment. This is important as the regulatory and press pressure on payday lenders do not apply to EL.

Financials

Steady growth in branches with faster growth in customers and loan balances.

Yields been increasing for all new business.

Efficiency gains expected.

but also higher impairments.

In our Hardman forecasts, we have grown branches by 5 p.a (low teens %), customer numbers by high teens and the loan book by c20%. We assume a steady increase in yield as the benefit of new loans, priced at a higher level becomes a greater proportion of the book. We have assumed impairments as a % of revenue rises modestly (from the pro forma rate H116 19.1% to 20%) reflecting the new business strain. For 2018 we have built in a 10% increase in impairments for FRS9. We have assumed a steady improvement in costs to revenue reflecting economies of scale. Finance costs rise as the proportion of lending funded by debt increases.

Figure 8: Financial summary and ratios Everyday Loans

	Pro forma normalised		
Year end Dec (£000)	**2016E**	**2017E**	**2018E**
Revenue	49,625	61,583	77,259
FV unwind on acquired loan portfolio			
Reported Revenue	49,625	61,583	77,259
Impairments	(9,776)	(12,317)	(15,452)
FRS9 impairment	-	-	(1,545)
Revenue less Impairments	39,849	49,267	60,262
Administration expenses	(23,160)	(24,633)	(30,904)
Operating profit	16,689	24,633	29,358
Net Finance Costs	(5,505)	(6,675)	(8,660)
Profit before tax	11,184	17,959	20,699
Number of branches	40	45	50
Period end customer numbers (000s)	42,000	50,000	59,000
Period end Loan book (exc FV adjustments)	127,238	152,686	183,223
Average loans	114,885	139,962	167,954
Ratios			
Revenue (pre FV) as % average loans	43.2%	44.0%	46.0%
Impairments as % pre FV revenue	-19.7%	-20.0%	-20.0%
Risk adjusted margin	34.7%	35.2%	36.8%
Pre-tax return (exc FV) on assets	9.7%	12.8%	12.3%
Cost as % pre FV revenue	-46.67%	-40.00%	-40.00%
Operating % pre FV revenue	33.63%	40.00%	38.00%
Net Finance costs as % pre FV revenue	-11.09%	-10.84%	-11.21%
Impairment as % average loans	-8.51%	-8.80%	-9.20%
Costs as % average loans	-20.16%	-17.60%	-18.40%
Net Finance cost as % average loans	-4.79%	-4.77%	-5.16%
Average loan per customer (£)	3,029	3,054	3,105
Pre FV revenue per customer (£)	1,181.5	1,231.7	1,309.5

Source: Hardman & Co Research

Loans at Home (LAH)

Summary

LAH is NSF's second largest business with c20% of the Group's total loan book. NSF completed the acquisition of SD Taylor (legal owner of LAH) on 4th August 2015. Management set itself the target of doubling its lending over three to four years with the aggressive recruitment of agents, including those released by the market leader. In H116 it was well ahead of plan (agents end 2015 540, H116 840). However, LAH trialled several, different sources of agent with c half being experienced and half new to the job. The latter particularly have proved disappointing from both business volumes and credit perspectives and have been loss making. This issue is being addressed rapidly and end 2016 agent numbers are forecast to be 750, i.e. down 90 on H116. While management should be applauded for innovation and rapid corrective action, the move to expand too quickly using large numbers of non-experienced agents has not worked. We estimate the expenses and credit cost to be c£2-3m (i.e. an immaterial <1% of NSF's market capitalisation). Looking forward we see the same market share opportunities as before and believe that the business can meet its longer-term objectives over the next 3-5 years.

Description of business

Agent is core to business and essential part of credit approval process. They establish who is willing to repay not just their ability to repay

The Home Collect market is believed to have around 3m regular customers of whom 1.5-2m are actively borrowing at any given time. LAH is in the process of being transformed into a modern home collect lender using technology to improve efficiency, and make part of the credit assessment. However, at the core of the business is the relationship between the self-employed agent and the customer. The agent is often part of the community in which they serve. They are usually well known to the borrower, often in similar financial circumstances and like the customers are typically a middle-aged woman (70% borrowers female), working c20 hours a week. A core part of the agent's job is to assess whether the borrower has the character to repay. Computer modelling helps filter out those who have the ability to repay but the agent can always decide not to lend, even if the credit engine has approved the loan. Being part of the community and knowing the borrower and their social group well, are core to getting the credit decision right.

LAH attractive to agents

LAH believes it is also an attractive partner for the self-employed agent. Firstly, it is clearly committed to expanding and investing in the business – unlike the strategic retrenchment by the market leader. The management team have a long history in business and so understand what agents require. With the introduction of time-saving automation, LAH has not required the agents to source additional new business but left it up to them to do so if they wish. LAH is also willing to sacrifice some efficiency by having part-time agents as well as those seeing it as a full-time job.

C90% agents income is commissions on amounts collected not lent

A typical commission structure for an agent would involve receipt of a small amount (usually around £20) for taking on a new customer plus 10% of the cash collected (8% on card collections). An established agent will typically receive more than 90% of their income from collections.

Process involves two visits from agent before cash loan given … gives borrower and agent time to consider whether loan is right and helps mitigate potential mis-selling claims

Renewals by existing customers represent the greatest part of gross lending with c90% of pre-acquisition loans being made to existing customers. Totally new customers who are interested in a loan will contact LAH via the web, phone or direct agent contact. After collecting some basic details to allow a credit check to be done, an agent will then be invited to visit that customer at home. At this visit, the agent will discuss the possibility of taking out a loan and obtain written consent to call back. The agent will arrange for a second visit to the customer's home to explain how the process will work and then the agent will undertake appropriate affordability checks (automated) and try to understand that customer's individual circumstances (discretionary). If the agent decides that they want to make the loan, the customer is provided with a contract which clearly sets out the total amount payable, the APR, the number of weekly payments and the amount of each weekly payment. Once the customer has signed the contract, the agent provides them with a cash loan and agrees a weekly collection regime.

Cost per week is key issue for customer

Customers with limited financial resource are primarily interested in what the loan will cost per week. Figure 9 below shows the current product range. No default fees or interest is payable in the event that they miss one or more payments and the customer gets certainty allowing them to budget.

Figure 9: Simple Product range (£)

Term in weeks	Charges per £100	Total Payable	Weekly Rate	APR (%)
24	60.00	160.00	6.67	732.7
33	65.00	165.00	5.00	433.4
45	80.00	180.00	4.00	340.0
75	87.50	187.50	2.50	163.8

Source: NSF, Hardman & Co Research

Management of accounts reflects customers lack of financial sophistication

Most (80%) LAH customers make their weekly repayments in cash with the remainder paying by means of bank transfer or bank debit card. This reduces the risk of amounts being taken from customer bank accounts without their knowledge, triggering financial difficulties due to the unforeseen timing of the deduction. This evidences another difference in customers from the prime market. There, a direct debit on the bank account is advantageous as it gives greater certainty of repayment and any penalties for the customers are relatively small and manageable. For home collect customers, bank charges could be both crippling and put repayment of the loan at greater risk. We also note that agents wandering around council estates with significant amounts of cash are rarely mugged – evidence of their value to the community they serve.

The average loan size is £272, with the average customer indebtedness £550 (most customer run multiple loans simultaneously).

Customer numbers at end June were 98,000 (with loans to multiple members of the family, the number of households is nearly 10% lower). In terms of profile 95% have a mobile phone, 88% have online access, 86% have a bank account (but just 22% have an overdraft facility). Home collect is not covered by the FCA price cap and it is not deemed to be high-cost short term credit (i.e. that requires a separate HCSTC licence).

Regional offices control the agents and supervise impaired credit management.

The self-employed agents are managed using a regional network of 44 branches (July 2016). Regional managers have weekly agent and branch manager meetings, conduct training and initiate more advanced impaired credit collections, where necessary. If a customer is identified as suffering financial difficulty e.g. missing multiple payments or advising of changed circumstances a new affordability assessment will be made and a formal payment arrangement agreed.

One key aspect of the business opportunity is the strategic direction of the market leader, Provident Financial. It re-focused its Home Collect business some years ago.

The 2014 PFG report and accounts noted "*Last year we set ourselves a number of actions to reposition the home credit business as a smaller but leaner, better-quality, more modern business focused on returns. These included: (i) tightening the underwriting and implementing standardised collections processes throughout the organisation to improve the quality of the receivables book; (ii) rightsizing the cost base to maintain profitability; and (iii) deploying technology throughout the field organisation to improve efficiency and effectiveness and deliver high levels of compliance*." PFG agent and customer numbers were already in decline and this accelerated with the change in strategy. Given its small scale, we believe that NSF can grow materially into this space without incurring excessive risk.

While the strategy adopted by NSF is different from PFG, it is important to recognise the relative scale of businesses. NSF agent numbers could increase 50% from here and that would represent less than 10% of PFG current agent numbers and less than 5% of its end 2013 number. NSF can achieve its strategic growth ambitions by selectively targeting dis-affected agents rather than taking undue risk.

Figure 10: Provident Financial Agent and customer numbers

	2011	2012	2013	2014t	2015	Nov 16
Agent number	10,500	9,800	9,000	7,700	5,500	5,237*
Cust number (ms)	1.8	1.8	1.5	1.1	0.9	0.85*

*Source: PFG report and accounts, Hardman & Co Research * PFG website accessed 11Nov 2016*

Credit assessment

Figure 11: CAMPARI analysis of credit process

Canon	Comment
Character	Assessed by agent who lives in same community, is likely to be known by the borrower, often for many years, Typical borrower is female aged 40.
Ability	Annual income £10-15k (average £14.5k). Some incomes may be variable, some may be paid in cash, often part time and manual and received only weekly. 50% of households have someone in full time employment. For typical customer, benefits only account for 12% of income
Means	The borrower is often the person controlling the family finances but may not be the main earner in the household. The "Ma Boswell" of the family. 89% rent
Purpose	Lumpy day to day living expenses which have not been budgeted for: 27% home improvement, 26% presents, 9% holidays, 5% car, 5% child expenses.
Amount	£200-£1,000, average loan size c£300. New customers get smaller loans
Repayment	24/33/45 weeks. Historically c83% of customers took 32 or 41 week products
Interest	24 weeks 733%, 33 weeks 433% 45 weeks 340%

Source: Hardman & Co Research

The Canons of lending analysis is given in Figure 11. One key issue is that the borrower is the controller of family finances but may well not be the biggest income earner. Lending to new customers is always risker, especially to those without home credit experience. LAH note that after 4 weeks nearly all experienced customers are up to date with their payments while the number for customers new to home collect is sub 90%. After 20 weeks the latter is c85%.

Credit management

Agent core to collections.

Collections performance is seasonal. Agents communicate regularly with customers in order to help them understand whether sufficient loan repayments have been made for them to be eligible for an additional loan. Typically, this results in an improvement in collections performance in Q4 as customers have an additional incentive to make-up any missed payments so as to be eligible for further lending in the peak Christmas lending period. Collections are adversely impacted in the final week of December with financial pressures on customers following the Christmas period, as well as lower collections activity by agents due to the reduced number of working days.

Customers with variable income need flexibility

The nature of the customer base means that even the best payers will miss some payments. Home Collect businesses recognise this and give the borrower certainty. The total amount repayable by a customer (i.e. principal advanced plus all interest) is unchanged regardless of the time taken for the customer to repay the loan. This allows payments to be deferred or reduced over a longer term without penalty to the customer. There is little point in loading such customers with heavy penalties which they will never be able to repay.

Commissions to agents paid on collections

As remuneration paid to collection agents is largely commission-based, the impact of any deterioration in collections is partially offset by a saving on commission that would otherwise be paid. With such small sums, the cost of collection through the courts is usually prohibitive.

H116 NSF conservative accounting policy saw impairments at 38% of revenue against long run average of 22% under S&U… impact was equivalent to £3.3m of charge

Under NSF's ownership, the impairment recognition has been brought forward (to 2 missed payments in past 13 for new customers and 4 for existing ones). This is earlier than S&U (10 weeks). We note in H115 S&U took a charge of £3.6m compared with the £7.8m NSF took in H116. Impairments in H116 were 38% of revenue compared with an average of c22% January 2103-2015 under S&U ownership. While this was conservative, it should be seen in the context of a business that was not growing. The huge growth in agents and customers in the seasonally quiet first half prompted a spike in impairments and as a result, management has taken a series of actions to rebalance the pace of growth with a lower level of impairment.

Regulation

Out of 576 home credit companies just over 400 have received the permanent FCA approval. None of the top 3 and only 1 of the top ten is fully authorised as it appears that the FCA has been granting licences first to those firms with the least systemic risk. The key areas for regulatory concern are agent oversight, affordability checking, arrears and collection, management of vulnerable customers and staff remuneration. LAH is targeting market-leading compliance and investment in automated processes should help evidence this.

Strategy under NSF

Target is double business in four years

NSF has a much more expansionary vision for the business than was seen under the family-run S&U. It aims to double the size of the business (by both customers and receivables) within 4 years and achieve a pre-tax, pre-amortisation return on assets in excess of 20% (defined as normalised EBIT/average loan book). The medium term targets appear eminently achievable given the 39% increase in agents expected in 2016. So far it has:

Hired additional management, agents, re-priced products and introducing more efficient technology.

- Hired new management including a new Chief Risk Officer who has overseen the continued development of the risk scorecard.
- In H116, it increased the number of agents from 630 to 840 (a 33% increase) including taking disgruntled agents from the market leader as they re-positioned their home collect business.

Non-experienced agents' costly expansion in H116 quickly actioned

- However, circa half the agents LAH hired were not experienced in home collect. A number of these did not generate the required volumes of business and also incurred an unacceptable rate of impairment. LAH note the rate of impairment as a percentage of revenue on new customers was 3x worse than for experienced customers and that the collections performance of experienced agents were materially better than that of inexperienced agents. In addition, LAH had been making temporary support payments (total £1.5m) so that agents did not lose income when starting this business. These payments were offered to both experienced and inexperienced staff and we estimate c£0.5m was for agents who will be released by end 2016 (agent numbers forecast by NSF to be down a net 90 in H216). Taking account of incentives, administration costs and credit losses, we believe the net cost of agents who will not be kept at c£2-3m. This is not an immaterial loss (c one third of 2017e profit) but in the group context is small (under 1% market capitalisation). When a high growth company operating in a high credit risk environment tests new initiatives, the unwelcome losses can prove expensive, but we note management has responded rapidly and we believe that the core business opportunity remains unchanged.

Tweaking to product range

- The product range now on offer is slightly different from that under S&U (a 32-week product is now 33 weeks, 41 weeks now 45). The former reflects a small price increase while the latter is designed to ensure customers have fully repaid their loan before they apply, for the next one within 12 months. With many customers slipping a few weeks payments, this is especially important for customers taking annual loans at Christmas time.

No card delivery of loans

- We note management is currently sceptical about delivering loans by pre-paid card rather than cash, an approach adopted by several competitors including Morses Club. With a high percentage of customers already having bank accounts, management believe customers already have access to internet shopping if they want it. Their experience has been that loans made to cards were simply withdrawn as cash immediately and the loan provider had incurred a higher transaction cost to deliver that cash onto a card. That said, management continues to monitor the progress of this product to ensure a competitive offering.

Catching up on technology should see efficiency improve

- Management is highlighting the opportunity to use technology to improve data management and processing efficiency, and as well as to source introductions (historically just 1% of new business comes via the internet). LAH launched a new website on 1 July). Customers will be met at home but more introductions are expected to come via the online channel. Mobile technology removes the need for paper returns, making the agent's life much easier and improving the management of data.

Competition

Morses Club (MCL)

MCL is now firmly back in growth mode.

MCL is the result of the combination in 2015 of two established brands in the home collected credit market, Morses Club and Shopacheck Financial Services. Immediately after the integration, MCL shrank its business as it focussed on better quality customers. It has 207k customers, spread throughout mainland UK and Northern Ireland, and the second largest market share. It has c1,800 agents across 100 locations throughout the UK. It has been actively expanding via territory builds (i.e. new agents, 114 in H116) as well as the acquisition of smaller portfolios (H116 it made three acquisitions totalling c£3.2m of loans outstanding, 79 agents, 10,500 customers). Overall though, customer (August 2016 207k v 203k August 2015) and agent numbers are stable reflecting the loss of higher risk customers and normal market attrition being offset by acquisition and organic growth. MCL is also expanding its product range including cards and online lending.

Other competitors include:

Over 500 smaller Home collect businesses. Also certain specialist retailers and pawn brokers. Not payday lenders

Around 500k active customers, are served by over 500 smaller home collect businesses. Mail order credit / Rent to own businesses mean the borrower can buy consumer durables from catalogue companies and specialist shops offering weekly payment terms. The FCA requirement for regulatory checks on affordability may see c£0.4bn less lending from these sources, increasing the scale of the opportunity for LAH. Pawnbrokers (such H&T, ticker HAT) typically lend smaller amounts and for a shorter duration. Payday lenders will lend similar amounts as home collect but tend to require borrowers to be in full time work and typically seek repayment over a shorter period. Consequently, the payday lenders APRs are materially higher than LAH.

Financials

Rapid growth in all aspects of the business in 2017/2018

With its trading statement in November 2016, NSF gave guidance on its expected agent numbers for the year end (750 down from 840 at H116), and 95K customers (H116 98k). We note this still represents 39% y-o-y increase in agents but just 3% increase in forecast customer numbers and the latter may prove conservative. September outstanding lending was £27.5m (we forecast end 2016 at £30.9m with the usual seasonal pick up). Going forward into 2017 we expect loan growth to accelerate as LAH gets increasingly comfortable with the business its new agents are introducing and as new customers establish good track records and move on to their second, third and fourth loans. We have assumed broadly stable revenue margins. We understand many new customers had a broadly similar duration profile as existing ones as experienced agents sought similar offerings for their new customers as their existing customers.

£1.5m agent incentive costs in 2016. Assumed beyond that it is an ongoing expense.

With regards expenses, we have factored £1.5m into 2016 statutory expenses (stripped out of pro forma normalised) for temporary agent commissions (this is additional payments made over and above the commissions paid on monies collected as new agents build up their agencies). The rapid growth in H116 is unlikely to be repeated and the degree of distortion going forward is likely to be small. We believe that recruiting some new (albeit experienced) agents is an ongoing business cost and accordingly, we have wrapped this expense into ongoing administration expenses for 2017 and beyond.

IFRS 9 timing issue but could impact 2018 performance significantly

We believe the group has been conservative in its H116 provisioning and that this will capture much of the losses seen from new agents. There is a slight improvement in credit in 2017. Investors will note we have assumed that the introduction of IFRS 9 will see a greater impact on the LAH business (20% increase in provision) than on the EL operation (10% increase in provision). This partially reflects the higher risk and shorter term nature of the book. Additionally, with roughly a third of lending made in the pre-Christmas period, the book has not fully developed its arrears profile by end December. The latent loss is thus higher than may be assumed from the actual arrears profile at the end of the year. It is important to recognise that IFRS 9 is a timing issue – it brings forward provisions that would otherwise have been recognised later – but it could distort specific period results, particularly in the early years following its introduction.

Figure 12: Financial summary and ratios Loans at Home

	Pro forma normalised		
Year end Dec (£000)	**2016E**	**2017E**	**2018E**
Revenue	44,075	49,341	61,901
FV unwind on acquired loan portfolio		-	-
Reported Revenue	44,075	49,341	61,901
Impairments	(15,887)	(16,776)	(19,808)
FRS9 impairment			(3,962)
Revenue less Impairments	28,188	32,565	38,131
Administration expenses	(23,000)	(26,950)	(29,915)
Operating profit	5,188	5,615	8,216
Net Finance Costs	(370)	(400)	(450)
Profit before tax	4,818	5,215	7,766
Number of branches	44	47	50
Number of agents	750	850	1,000
Period end customer numbers (000s)	95,000	110,000	125,000
Period end Loan book (exc FV adjustments)	30,935	37,122	48,259
Average loans	29,668	34,029	42,690
Ratios			
Revenue (pre FV) as % average loans	149%	145%	145%
Impairments as % pre FV revenue	-36.0%	-34.0%	-32.0%
Risk adjusted margin	95%	96%	99%
Pre-tax return (exc FV) on assets	n/a	7.7%	9.1%
Cost to % pre FV revenue	-52.18%	-54.62%	-48.33%
Operating % pre FV revenue	11.77%	11.38%	13.27%
Net Finance costs as % pre FV revenue	-0.84%	-0.81%	-0.73%
Impairment as % average loans	n/a	-49.30%	-46.40%
Costs as % average loans	n/a	-79.20%	-70.07%
Net Finance cost as % average loans	n/a	-1.18%	-1.05%
Average loan per customer (£)	326	337	386
Pre FV revenue per customer (£)	464	449	495

Source: Hardman & Co Research

Trusttwo

Summary

Trusttwo is the smallest of NSF's three business and represents c5% of the Group's loan book. It offers loans to non-standard customers who are able to get someone else with a good credit rating to guarantee their loan. With the guarantee, the interest rate is significantly reduced, making the loan much more affordable for the borrower. Trusttwo was acquired as part of EL on 13 April 2016. It is still an immature business with H116 loan balances of just £7.3m (Q316 £8.2m). Management believe the market size is currently c£350m (of which Amigo Loans has a share of c80%) and they expect market loan growth of 10-15%. Trusttwo should be capable of taking material market share given strong growth from two sources. Brokers do not like to be dependent on a single supplier (Amigo) and with such a high concentration in the market leader, they are likely to encourage other, well-funded lenders committed to this market. Second, Trusttwo has a unique competitive advantage in referrals from the EL branch network of applications that were declined on affordability grounds. Overall we have forecast 30% p.a. loan growth which we believe may be conservative relative to management plans.

Description of business

Online business

The business is sourced through Trusttwo's own website (32%), search engine and comparison websites (such as www.money.co.uk) 21%) referrals from the branch network (4%) and via brokers (43%) Renewal business is likely to be mixed. The successful completion of a multi-year Trusttwo loan may mean a borrower would pass prime lenders credit scores, with EL a natural provider for them to approach first. However, it is unclear that the improved credit would be sufficient for them to achieve a better interest rate than the one they have experienced with guarantor loan.

Applicants complete an online application form, in which they nominate a guarantor who then receives an online link enabling them to register as the applicant's guarantor.

Protection for the guarantors / regulatory risk

Complex product needed best service to borrower and guarantor

With a guarantor loan if the borrower does not repay on time, and ultimately goes into default the obligation falls on the guarantor. The guarantor can be a family member (90%), a friend or a work colleague, but not the spouse or partner (as these people are likely to be materially financially affected by the borrower's default). The guarantor needs to be 25 – 74, be a UK homeowner or tenant and have a good credit history (i.e. the guarantor would usually pass as a near prime credit in their own right and we note 85% score A1-A3 on EL scorecard).

From multiple aspects, including treating customers fairly, good business practice and limiting potential mis-selling compensation claims, the guarantor's responsibility has to be very clearly outlined before the loan is issued. Trusttwo has multiple approaches to ensure this is the case:

Separate interview

- The guarantor has a separate interview where the risks are outlined and they sign documentation saying they understand the risk. Having the interview separate from the borrower is designed to limit the risk of their being intimidated into being a guarantor.

- Trusttwo run through an affordability check to ensure both the borrower AND the guarantor would be in a position to service the responsibility should they be called upon to do. During the interview the possible impact on the guarantor's finances are clearly outlined and recorded.

Clear communication

- The website has a section clearly marked as "risks of being a guarantor".

- The full loan amount is paid into the guarantor's bank account to prevent fraud. They can then transfer the money straight to the borrower.

Credit assessment

The primary focus is on the borrowers' ability to repay. The status of the guarantor is a secondary issue. To date an average of c4% of guarantees are actually called upon. With a lower interest rate being charged because of the guarantee, the loan is likely to be much more affordable than if the borrower had to pay the interest charge they would attract on a stand-alone basis.

Figure 13: CAMPARI analysis of credit process

Canon	Comment
Character	The fact that someone known to the borrower is willing to guarantee the loans is strong evidence of their expected willingness to repay.
Ability	With the additional security of the guarantee, the interest burden to the customer is materially lower, helping assist affordability.
Means	The guarantor must pass credit scoring as a (near) prime customer in their own right. Borrower's means to repay are primary though.
Purpose	Loans can be used for almost any purpose but tend to be material events such as buying a car, consolidating finances, or home improvements.
Amount	£1k to £7.5k
Repayment	13-60 months
Interest	Rep 39.9%, Max APR 49.9%The interest rate charged is significantly lower than the borrower would the able to achieve in their own right.

Source: Hardman & Co Research

Two re-payers of loans mean credit costs close to prime levels

We note the pro forma H116 saw an impairment charge of 15.8% of revenue (well below the 19.1% for the rest of the EL portfolio). As a proportion of lending the H116 charge was an annualised 4.8%. For unsecured lending this type of loss is not far from the level that may be expected from prime borrowers.

Credit management

Contact with guarantor may see borrower behaviour change

The initial credit management is with the borrower direct. Only when this fails does NSF revert to the guarantee. We note that the prospect of calling on the guarantee often sees a change in the borrower behaviour and the regulator is currently considering how this can best be achieved and still see all customers treated fairly.

If NSF haven't had any contact from the applicant for 2 weeks from the payment due date they issue a default notification, a copy of which is sent to the guarantor. This is an opportunity for either the applicant/guarantor to make contact with them in the next 18 days to either make a payment/arrangement. If NSF doesn't receive any

contact from either customer of guarantor during this time, then they call the guarantor on the 19th day and reiterate their obligation and request a payment for arrears. NSF will only set up regular payments with the guarantor if either the applicant/guarantor have indicated that the applicant is unable to maintain their future payments or if the guarantor has decided to take on the regular payments voluntarily. The arrangement is reviewed every 2-3 months to see if the applicants circumstances may have changed and try and get the applicant to assume responsibility.

Strategy under NSF

NSF has segregated Trusttwo into a separately managed entity to give its management a direct focus on growing the business. It has hired senior management, introduced the branch referral scheme, internally restructured the teams and upgraded its web offering. It has also enhanced the default procedures.

Competition

The market leader is Amigo Loans (https://www.amigoloans.co.uk/). Its offering is broadly similar (£500-£7,500, 12-60 months, no fees, interest charged daily, fast pay-out, repayment by card, direct debit online, phone and at PayPoint locations). However, the representative APR is higher (49.9% v Trusttwo 39.9%), and Amigo is willing to have guarantors as young as 18. It is also willing to provide smaller loans.

Provident business also going through management re-structuring to encourage growth

PFG started a guarantor loan business in 2014 branded Glo. At H116 it had c5k customers, with loans ranging from £1k to £7k (average £1.6k) spread over 1-5 years. The development of Glo has been modest and recently it was suspended for new business. For Provident, the amount of management time involved relative to the size of group could make such a business non-core although we do expect a re-launch at some point during 2017. We note comparison websites have a range of smaller providers. The representative APR is wide but Trusttwo appears to be at the cheaper end of the spectrum.

Financials

We have assumed 30% loan growth, stable margins and credit and improving efficiency. This delivers strong bottom line growth.

Figure 14: Financial summary and ratios Trusttwo

	Pro forma normalised		
Year end Dec (£000)	**2016E**	**2017E**	**2018E**
Revenue	2,412	3,105	4,037
FV unwind on acquired loan portfolio		-	-
Reported Revenue	2,412	3,105	4,037
Impairments	(386)	(497)	(646)
FRS9 impairment	-	-	(129)
Revenue less Impairments	2,026	2,608	3,261
Administration expenses	(1,256)	(1,300)	(1,495)
Operating profit	770	1,308	1,766
Net Finance Costs	(343)	(315)	(362)
Profit before tax	427	993	1,404
Period end customer numbers (000s)	3,300	3,960	4,752
Period end Loan book (exc FV adjustments)	9,000	11,700	15,210
Average loans	8,250	10,350	13,455
Ratios			
Revenue (pre FV) as % average loans	29.2%	30.0%	30.0%
Impairments as % pre FV revenue	-16.0%	-16.0%	-16.0%
Risk adjusted margin	24.6%	25.2%	25.2%
Pre-tax return (exc FV) on assets	4.7%	4.8%	5.2%
Cost to % pre FV revenue	-52.06%	-41.87%	-37.04%
Operating % pre FV revenue	31.94%	42.13%	43.76%
Net Finance costs as % pre FV revenue	-14.22%	-10.14%	-8.97%
Impairment as % average loans	-8.58%	-4.80%	-4.80%
Costs as % average loans	-27.91%	-12.56%	-11.11%
Net Finance cost as % average loans	-7.62%	-3.04%	-2.69%
Average loan per customer (£)	2,727	2,955	3,201
Pre FV revenue per customer (£)	731	784	849

Source: Hardman & Co Research

Group Funding

Liquidity is crucially important to a company such as NSF. It was limited access to working capital that led to EL being sold to Secure Trust in 2012. The following issues are material in considering NSF's liquidity:

Cash generation

Core business highly cash generative – profitable business model and short term nature of home collect loans

Figure 15 examines the gross cash generation which NSF may expect. We have taken our full year cash flow forecasts and added back assumed repayments of principle. Our assumption of 95% for LAH reflects the duration of loans. When S&U owned this business, it reported total collections (i.e. interest and principle) closer to 90% of the outstanding balances in just six months (H115 collections £49.7m against opening balance of £53.6m).

Figure 15: Estimated annual gross cash generation

	Comment	£000s
Operating cashflow exc changes in working capital	FY16 operating cash forecast exc change in receivables	11,651
Capital repayments at ELL	20% O/S loans	21,420
Capital Repayments at LAH	95% O/S loans	25,555
Capital Repayments at Trusttwo	33% O/S standing	2,464
Gross cash generation		61,090

Source: Hardman & Co Research

Existing Balance sheet structure

Figure 16: Balance sheet structure of NSF and Provident Financial

H116 £m	NSF	Provident Financial
Loans (exc FV adjustment)	168.8	2,055.8
ST debt	0.0	245
LT debt	73.7	1,382.4
Net asset value	253.1	734.4
Tangible net asset value	98	579.8
Ratios		
ST debt to LT debt	0	18%
Total debt to NAV	29%	222%
Total debt to tangible NAV	75%	281%
Debt to loans	50%	79%

Source: Hardman & Co Research

Figure 16 above shows both the absolute and relative capacity for NSF to gear up its currently under-geared balance sheet. Its debt to NAV is just 29% and to tangible NAV just 75%. Getting the latter to the company's long term target of 3x would imply it would be willing on the current base to see debt rise from £74m to nearly £300m which would fund a more than doubling to the loan book. Figure 16 also shows the relative gearing compared with Provident Financial (PFG is highlighted as other peers such as Morses Club are similar to NSF in that for corporate activity reasons it has not yet reached a mature level of gearing).

Access to other funds

Existing facilities give plenty of headroom until mid 2018 on our forecasts

Management emphasised with the H116 results that it did not see the need for further equity issuance to fund growth. Current committed facilities have over £20m headroom with a further £25m committed “subject to bank consent”.

- With the acquisition of EL, NSF announced an £85m facility with the Royal Bank of Scotland and Shawbrook Bank providing a revolving credit facility of £55m (the "RCF") and STB provided a term loan facility of £30m. With the banks consent the RCF could be extended by £20m. These facilities expire on 4 December 2018. Details of the covenants were not disclosed but we would expect them to include standard interest and NAV covers.

- On 7th July 2016 NSF advised LAH had put in place a further three year £10m facility from Shawbrook (which could be increased by a further £5m at the bank consent) taking committed facilities to £95m (with the total increase to £120m if required).

Could bring in new bank

- NSF has indicated it may try and bring a further bank into the syndicate (existing banks have first right of refusal) which could see total facilities increased.

Bonds an option in due course.

- We understand that all-in borrowing costs for LAH are c7% and EL somewhat over 6%. Management has indicated it may consider a slightly higher funding cost for longer duration borrowing. In order to optimise borrowing costs in the capital markets, we would expect NSF to do a material deal and this may be when its requirements were somewhat larger than at present. We note the retail bond market has been relatively quiet with private bond placements recently being a more cost effective solution. We have not factored in any change in financing structure into our forecasts.

Other Risks

Regulation / Litigation

We expect the FCA's approach to regulation to prove stricter than the OFT.

Since 1 April 2014, home credit firms have been regulated by the FCA, which took over responsibility for the regulation of consumer credit from the OFT. Under the new regime, the FCA has substantially greater supervisory and enforcement powers (e.g., it can issue greater fines, ban activities or products being sold and issue public notices or instigate investigatory action).

More at risk than standard firms of legal liability

Despite the high infrastructure costs and impairment losses, the high-interest charges could be interpreted as pricing power over the customer and mean a non-standard consumer finance firm may be at a greater risk than a mainstream financial firm. Failure to comply, or be able to document compliance, with the strict requirements on dealing with customers could lead to legal liability.

Adverse sector publicity could increase costs

In addition, any publicity relating to breaches by NSF or competitors could result in an increased number of customer complaints, claims made to the U.K. Financial Ombudsman Service or the courts (both increasing costs) and, more generally, alter customers' behaviour in making repayments. We note, however, that the numbers of FOS complaints for home credit and branch-based lending are particularly low.

NSF strategic priority is market leading compliance

We note NSF has set market leading compliance as a strategic priority for the group. One focus of the technology is ensuring maximum compliance with operational procedure guidelines limiting the risk that staff do not meet requirements. It also provides detailed documentation of compliance and intent to comply.

Home credit is pay-day lending and so is not subject to its regulations including the price cap.

Home credit lending is not subject to the price cap which applies to certain high-cost short-term credit products under the FCA's rules as home credit loan agreements are excluded from the definition of "high-cost short-term credit". In addition, even if the price cap were to be applied to home credit loan agreements, LAH's products would fall well within the price cap.

Share liquidity

Approximately 2/3rds of shares in three holders

Nearly two thirds of the NSF shares are held by just three holders (Invesco, Woodford Investment, and Marathon Asset Mgt). With NSF only floating less than two years ago and with a major issuance in January 2016, the probability of major liquidity from these holders appears is low. We note the 7% Secure Trust Bank stake is now out of its lock in period. Management is addressing this illiquidity issue by building a communications programme across all types of investors.

Mis-selling

EL good record of claims to Ombudsman not been upheld but still incurs costs

EL used to offer certain insurance products to customers (including PPI) although it ceased offering such products in May 2015. Previously it had accounted for c10% of EL revenue. EL never sold single premium PPI and claims policies were sold based on customer need, as established during the loan application process, after confirmation that the loan had been unconditionally approved. The EL Group's success rates at the Financial Ombudsman Service (in terms of complaints not upheld) have consistently been amongst the best in the industry although there are administration costs involved in the process.

Financials

We have outlined the detail of our forecasts, and accounting policies for impairments, in each divisional review. Non-exceptional central costs from here are expected to show only a gentle increase. The pro-forma normalised numbers provide a clearer view of underlying business trends as the statutory numbers given below are impacted by the acquisitions and other accounting issues.

Profit & Loss

Figure 17: Statutory Profit and Loss (£000s)

Year ended 31 December	Statutory				Pro Forma normalised		
	2015	**2016e**	**2017e**	**2018e**	**2016e**	**2017e**	**2018e**
Business Interest Income	14,657	89,351	114,030	143,196	96,113	114,030	143,196
Fair value unwind on acquired portfolios	(5,456)	(8,776)	(11,942)	(4,000)	-	-	-
Total revenue	9,201	80,575	102,088	139,196	96,113	114,030	143,196
Underlying business impairments	(1,885)	(20,654)	(24,789)	(30,146)	(20,291)	(23,832)	(30,150)
Unwind of provision discount	(1,973)	(4,000)	(4,800)	(5,760)	(5,758)	(5,757)	(5,756)
Total Impairments	(3,858)	(24,654)	(29,589)	(35,906)	(26,049)	(29,589)	(35,906)
FRS9 adjustment				(5,636)	-	-	(5,636)
Gross profit	5,343	55,921	72,498	97,654	70,064	84,440	101,654
Administration expenses	(11,340)	(44,576)	(56,883)	(66,313)	(50,790)	(56,883)	(66,313)
O/w Depreciation	(198)	(500)	(783)	(1,265)	(500)	(783)	(1,265)
Amortisation of intangibles	(4,030)	(10,706)	(7,465)	(4,927)	-	-	-
Operating profit	(10,027)	638	8,150	26,414	19,274	27,557	35,341
EBITDA	(5,799)	11,845	16,397	32,607	19,774	28,339	36,607
Exceptional Items	(6,135)	(2,126)	-	-		-	-
Net finance (cost)/income	70	(4,595)	(7,360)	(9,660)	(6,718)	(7,360)	(9,660)
Profit before tax	(16,092)	(6,083)	790	16,754	12,556	20,197	25,681
Income tax	3,022	1,217	(158)	(3,351)	(2,511)	(2,546)	(4,151)
Profit after tax	(13,070)	(4,866)	632	13,403	10,044	17,650	21,531
Avg no shares for EPS calculation	61.50	305.93	317.05	317.05	305.93	317.05	317.05
Statutory EPS (p)	(21.25)	(1.59)	0.20	4.23	n/a	n/a	n/a
Adjusted EPS (p)	1.30	4.76	5.57	6.79	4.76	5.57	6.79
Total dividend (p)	-	1.30	2.25	3.00	1.30	2.25	3.00

Source: NSF Hardman & Co Research

Adjusted profits

Statutory numbers heavily distorted by acquisition accounting

As noted in Figure 18 below, the growth in adjusted profit is much more steady than the statutory numbers. The distortion from acquisition accounting is explored in more detail in the section below.

Figure 18: Statutory to adjusted pre and post tax profits (£000s)

Year ended 31 December	2015	2016e	2017e	2018e
Statutory pre-tax	**(16,092)**	**(6,083)**	**790**	**16,754**
FV adjustments	5,456	8,776	11,942	4,000
Amortisation of intangibles	4,030	10,706	7,465	4,927
Exceptional items	6,135	2,126	-	-
Adjusted pre-tax	**(471)**	**15,526**	**20,197**	**25,681**
Statutory tax	3,022	1,217	(158)	(3,351)
Tax effects of adjustments	(1,751)	(2,180)	(2,388)	(800)
Adjusted post tax earnings	**800**	**14,562**	**17,650**	**21,531**

Source: NSF, Hardman & Co Research

Balance Sheet

Figure 19 details the expected balance sheet. The expected strong growth in lending is the key feature.

Figure 19: Balance Sheet (£000s)

Year ended 31 December	**2015**	**2016e**	**2017e**	**2018e**
Non-current				
Goodwill	40,176	132,071	132,071	132,071
Intangible assets	14,119	17,258	9,793	4,866
Property Plant and equipment	1,718	5,218	8,435	11,170
Total Non-current assets	**56,013**	**154,547**	**150,299**	**148,107**
Current assets				
Inventories	3	3	3	3
Amounts Receivable from customer	**28,412**	**182,572**	**204,965**	**246,148**
O/w FV adjustment	426	15,399	3,457	(543)
Trade and other receivables	10,275	11,303	12,433	13,676
Cash and cash equivalent	7,320	7,734	5,612	5,617
Total current assets	46,010	201,611	223,012	265,444
Total assets	**102,023**	**356,158**	**373,312**	**413,551**
Current liabilities				
Trade and other payables	9,490	9,490	10,490	11,490
Deferred tax liability	14,275	14,453	10,731	10,993
Total current liabilities	23,765	23,943	21,221	22,483
Net Current (liabilities) / assets	*29,150*	177,668	201,792	242,961
Non-current liabilities				
Financial Liabilities - borrowings	-	80,000	104,000	137,500
Deferred tax	-	-	-	-
Total non-current liabilities	**-**	**80,000**	**104,000**	**137,500**
Total liabilities	16,860	103,943	125,221	159,983
Net assets	**85,163**	**252,215**	**248,091**	**253,568**

Source: NSF, Hardman & Co Research

Cashflow

The strong lending requires funding and hence we have strong borrowing as well.

Figure 20: Cashflow statement (£000s)

Year ended 31 December	2015	2016e	2017e	2018e
Profit (loss) before tax	(16,162)	(1,488)	8,150	26,414
Taxation paid	(350)	(1,503)	(1,503)	(1,503)
Depreciation,	198	500	783	1,265
Amortisation of intangibles	4,030	10,706	7,465	4,927
FV unwind on acquired loan book	5,456	8,776	11,942	4,000
Loss on disposal of fixed assets	51	-	-	-
Decrease in inventories	6	-	-	-
Increase in amounts receivable from customers (net of FV)	(5,394)	(23,776)	(34,335)	(45,184)
Increase in receivables	(16,445)	(1,028)	(1,130)	(1,243)
Increase in payables	19,078	(4,313)	1,000	1,000
Net cash outflow from operating activities	**(9,532)**	**(12,125)**	**(7,628)**	**(10,323)**
Cashflow from investing activities				
Purchase of prop, plant and equipmt	(341)	(4,000)	(4,000)	(4,000)
Purchase of subsidiaries	(81,111)	(230,784)	-	-
Net cash outflow - investing activities	**(81,452)**	**(234,784)**	**(4,000)**	**(4,000)**
Cashflows from financing activities				
Net finance Income	70	(4,595)	(7,360)	(9,660)
Proceeds from issue of share capital	98,234	172,869	-	-
Proceeds from borrowing	-	80,000	24,000	33,500
Repayment of borrowing	-	-	-	-
Interest Paid	-			
Dividends	-	(951)	(7,134)	(9,511)
Net cash inflow - financing activities	**98,304**	**247,323**	**9,506**	**14,329**
Net change in cash / cash equivalents	7,320	414	(2,122)	5
Opening cash and cash equivalents	-	7,320	7,734	5,612
Closing cash and cash equivalents	7,320	7,734	5,612	5,617

Source: NSF, Hardman & Co Research

Valuation

Summary

Average valuation upside on absolute measures 67%

Our absolute valuation techniques imply an average upside of 67%. The peer valuations are 26% upside but we believe the whole sector is under-valued.

Figure 21: Summary of different valuation techniques

	Implied Price (p)	Upside (%)
Gordon's Growth	112.9	87%
DDM	88.8	47%
Average absolute measures	100.8	67%
Peer 2017 PE	69.1	15%
Peer P/BV	82.1	36%

Source: Hardman & Co Research

Gordon's Growth Model

GGM captures both value added and growth. Upside 87%

Our preferred valuation approach is to consider the value added by a business. The GGM assumes that the price to book should be equivalent to the (sustainable return on equity – growth in equity) / (sustainable cost of equity – growth in equity). A business delivering above its cost of capital should thus trade above book value. Critically this model captures growth which simple comparisons of P/BV against ROE do not. A business growing strongly and delivering 5% above its cost of equity is more valuable than one with no growth delivering 10% above.

Assumed ROE is 25%

Assumed COE 11%

Assumed G 5.5%

Taking NSF specifically we have focussed on tangible book value (Hardman 2017 e 106p) and associated returns, cost and growth. Our assumed long run sustainable ROE is 25% reflecting the high barriers to entry into non-standard lending, pricing power over customers and a more efficient gearing structure than at present. This return is in line with that achieved by Morses Club in H116. We have assumed a long-term cost of equity of 11% to reflect the relatively high risk profile of the customer base and the company's relative immaturity under NSF's ownership and strategic direction (noting the executives are highly experienced). Growth we have assumed to be marginally above nominal GDP – while in theory this would in perpetuity see NSF bigger than the UK economy, we are comfortable that it gives appropriate credit for the business's growth opportunities over the next decade. We have applied a modest discount to reflect the fact the sustainable ROE will not be achieved in our forecast period. Sensitivity to the assumptions is given in Figure 22 below.

Figure 22: Gordon's Growth Model and sensitivities

	Base	+1% to ROE	+1% to COE	+0.5% to G
Return on Equity (%)	25	26	25	25
Cost of Equity (%)	11	11	12	11
Growth in equity (%)	5.5	5.5	5.5	6
P/BV (ROE-G)/(COE-G)	3.5	3.7	3.0	3.8
Discount re near term perf (%)	-5%	-5%	-5%	-5%
P/BV (x)	3.4	3.5	2.9	3.6
BV 2017 (£m)	106.2	106.2	106.2	106.2
Valuation (£m)	357.8	376.1	302.7	383.5
Variance (£m)		18.3	-55.0	25.7
Valuation per share (p)	113	119	95	121

Source: Hardman & Co Research

Dividend Discount Model

DDM upside 47%.

We expect this valuation to increase as the base year rolls forward

We have built a dividend discount model using forecast dividends to 2016-2018, a step change to the pay-out ratio (so retained equity funds growth and all superior ROE is returned leading to a medium term pay-out ratio of 78%), 15% growth for five years and then 5.5% growth for fifteen years. We have applied a 10x multiple to the terminal value and all cashflows discounted at the cost of equity (i.e. 11%). This produces a valuation of 89p of which just 25% is in the terminal value. While this approach produces a modest upside, we note that even in 2018 NSF will still be a relatively immature business. As the base year valuation rolls forward, and so we capture more maturing growth, we would expect this valuation to increase year on year.

Peer comparisons

NSF price to tangible book well below peers

NSF is still an immature business. 2017 results will also suffer above average new business pain with continued investment in expanding both the branch network at EL and the agent network at LAH. Despite this, NSF has the lowest 2017 forecast PE. The price to book is below the peer average of (2.0x v 2.7x) while the dividend yield is below average reflecting the company's early stage of development. We note our forecast 2018e dividend yield is 5%

Figure 23: Peer valuation comparisons

	Shr price (p)	Market Cap (£m)	2017 PE (X)	2017 Yield (%)	P latest tangible BV
NSF (Dec)	60.25	191	10.8	3.7%	2.0
PFG (Dec)	2909	4295.21	15.3	5.1%	5.0
Morses Club (Feb 18)	121	157	11.1	5.8%	3.2
S&U (Jan 18)	2247	268	11.00	4.6%	2.0
H&T	257	95	12.9	3.8%	1.2
STB (Dec)	2182	403	11.8	3.8%	1.8
Peer average			12.42	4.6%	2.7
NSF at peer average (p)			69.1		82.1

Source: Hardman & Co Research

Appendix 1 Divisional Statutory Forecasts

Figure 24: Financial summary and ratios Everyday Loans

	Statutory			Pro forma normalised		
Year end Dec (£000)	**2016E**	**2017E**	**2018E**	**2016E**	**2017E**	**2018E**
Revenue	42,505	61,583	77,259	49,125	61,583	77,259
FV unwind on acquired loan portfolio	(8,350)	(11,942)	(4,000)			
Reported Revenue	34,155	49,641	73,259	49,125	61,583	77,259
Impairments	(8,373)	(12,317)	(15,452)	(9,678)	(12,317)	(15,452)
FRS9 impairment			(1,545)	-	-	(1,545)
Revenue less Impairments	25,782	37,325	56,262	39,447	49,267	60,262
Administration expenses	(17,002)	(24,633)	(30,904)	(22,960)	(24,633)	(30,904)
Operating profit	8,780	12,691	25,358	16,487	24,633	29,358
Net Finance Costs	(3,500)	(6,675)	(8,660)	(5,505)	(6,675)	(8,660)
Profit before tax	5,280	6,017	16,699	10,982	17,959	20,699
Number of branches	40	45	50	40	45	50
Period end customer numbers (000s)	42,000	50,000	59,000	42,000	50,000	59,000
Period end Loan book (exc FV adjustments)	127,238	152,686	183,223	127,238	152,686	183,223
Average loans	85,612	139,962	167,954	114,885	139,962	167,954

Source: Hardman & Co Research

Figure 25: Financial summary and ratios Loans at Home

	Statutory			Pro forma normalised		
Year end Dec (£000)	**2016E**	**2017E**	**2018E**	**2016E**	**2017E**	**2018E**
Revenue	44,501	49,341	61,901	44,075	49,341	61,901
FV unwind on acquired loan portfolio	(426)	-	-		-	-
Reported Revenue	44,075	49,341	61,901	44,075	49,341	61,901
Impairments	(15,887)	(16,776)	(19,808)	(15,887)	(16,776)	(19,808)
FRS9 impairment			(3,962)			(3,962)
Revenue less Impairments	28,188	32,565	38,131	28,188	32,565	38,131
Administration expenses	(24,500)	(26,950)	(29,915)	(23,000)	(26,950)	(29,915)
Operating profit	3,688	5,615	8,216	5,188	5,615	8,216
Net Finance Costs	(370)	(400)	(450)	(370)	(400)	(450)
Profit before tax	3,318	5,215	7,766	4,818	5,215	7,766
Income tax	(664)	(1,043)	(1,553)	(964)	(1,043)	(1,553)
Segment profit (loss) post tax	2,655	4,172	6,213	3,855	4,172	6,213
Number of branches	44	47	50	44	47	50
Number of agents	750	850	1,000	750	850	1,000
Period end customer numbers (000s)	95,000	110,000	125,000	95,000	110,000	125,000
Period end Loan book (exc FV adjustments)	30,935	37,122	48,259	30,935	37,122	48,259
Average loans	29,668	34,029	42,690	29,668	34,029	42,690

Source: Hardman & Co Research

Figure 26: Financial summary and ratios Trusttwo

	Statutory			Pro forma normalised		
Year end Dec (£000)	**2016E**	**2017E**	**2018E**	**2016E**	**2017E**	**2018E**
Revenue	1,844	3,105	4,037	2,412	3,105	4,037
FV unwind on acquired loan portfolio	-	-	-		-	-
Reported Revenue	1,844	3,105	4,037	2,412	3,105	4,037
Impairments	(295)	(497)	(646)	(386)	(497)	(646)
FRS9 impairment			(129)	-	-	(129)
Revenue less Impairments	1,549	2,608	3,261	2,026	2,608	3,261
Administration expenses	(1,000)	(1,300)	(1,495)	(1,256)	(1,300)	(1,495)
Operating profit	549	1,308	1,766	770	1,308	1,766
Net Finance Costs	(225)	(315)	(362)	(343)	(315)	(362)
Profit before tax	324	993	1,404	427	993	1,404
Income tax	(65)	(199)	(281)	(85)	(199)	(281)
Segment profit (loss) post tax	259	795	1,123	342	795	1,123
Period end customer numbers (000s)	3,300	3,960	4,752	3,300	3,960	4,752
Period end Loan book (exc FV adjustments)	9,000	11,700	15,210	9,000	11,700	15,210
Average loans	6,148	10,350	13,455	8,250	10,350	13,455

Source: Hardman & Co Research

Appendix 2 Accounting Issues

Impairment accounting

Gross up / Unwind of the discount

Accounting rules gross up interest income and impairments in the same accounting period (H116 by £2m) to reflect income earned where loan periods have been extended and the NPV effect

Accounting standards mean the recognition of revenue does not track the actual cash received. The effective interest rate (EIR) of the loan (calculated at initiation) is applied to the loan balance outstanding. If the customer misses a couple of payments, for accounting purposes, the outstanding balance still earns interest income even though the customer is not charged any additional interest. To ensure the right overall profit (and reserves), the theoretical revenue generated, which will not be paid, is provided against with an exactly matching loan impairment. Figure 27 gives an illustrative example where the EIR is 30% per period and two payments are missed. In this case, income would be grossed up to 135 from 75 and with a provision raised of 60 (both the income gross up and impairment provision are taken in the same accounting period). In practice the matter is much more complicated – loan balances do not reduce on a straight-line basis as initially interest is a much higher proportion of any collection – but the principle is clear. The gross up is greatest where interest rates are high and rescheduled periods a big proportion of the initial expected loan. Home collect is most affected by this accounting issue.

Figure 27: Illustrative example of extended loan duration on the gross up

Period	1	2	3	4	5	6	7	Total
Loan Balance Planned	100	75	50	25	0			
Revenue	30	22.5	15	7.5	0			75
Rescheduled	100	100	100	75	50	25	0	
Revenue	30	30	30	22.5	15	7.5	0	135

Source: Hardman & Co Research

Additionally, when there is evidence of impairment, NSF calculates the net book value of the expected cashflows on the loan using the effective interest rate as the discount rate. This NPV is compared with the original loan and the gap is provided for. Like any present value calculation, over time it unwinds. For home collect loans, the discount rate is very high (2015 328% see note 17 report and accounts) and so the unwind of the discount is material.

Note: Rather unhelpfully the accounting term gross up in the accounts is the same as the unwind of the discount shown in the notes to accounts

Again, a simplified example may help to explain the principle. Assume the original loan had an outstanding balance of £20 and under the new agreement three instalments of £5 were required. On the 30% discount rate the NPV of this £15 is now £7.7 (provision £12.3), while the end loss is only £5. In this case (detailed in Figure 28) the discounting factor is more than the final provision required. In NSF's case the charge for 2015 was £3.9m but the final year end provision was just £1.9m as £2.0m of provisions unwound.

Figure 28: Illustrative example of effect of present valuing on the gross up

Period	1	2	3	Future cash	Cash recd	Total value	Provision	Unwind
Expected cash flow	5.0	5.0	5.0					
NPV rate	70%	49%	34%					
NPV now	3.5	2.5	1.7	7.7	0.0	7.7	12.3	
NPV yr 1		3.5	2.5	6.0	5.0	11.0	9.1	3.3
NPV yr 2			3.5	3.5	10.0	13.5	6.5	2.6
NPV yr 3				0	15	15.0	5.0	1.5

Source: Hardman & Co Research

Figure 29 shows the experience at S&Us Consumer credit, rentals and other trading division (which is largely LAH). On average 2010-2015 the NPV effect was to inflate provisions by 37%. The real loss suffered may be seen by write-offs of provisions which on average totalled 60% of the annual charge.

Figure 29: S&Us experience of gross up

Year ended January	2010	2011	2012	2013	2014	2015
Charge	7,731	7,061	7,043	7,704	7,760	8,418
Unwind of discount	2,927	2,731	2,751	2,828	2,878	2,564
Unwind as % charge	38%	39%	39%	37%	37%	30%
Write offs	4,329	4,221	4,241	4,457	4,984	5,418
Write off as % charge	56%	60%	60%	58%	64%	64%

Source: S&U report and accounts, Hardman & Co Research

IFRS 9

Will impact on 2018 earnings

IFRS 9 will replace IAS 39 as the accounting standard governing the classification, measurement, impairment and hedge accounting of financial instruments, including loan assets. IFRS 9 will take effect for accounting periods commencing 1 January 2018. NSF does not intend to adopt any changes in respect of IFRS 9 prior to this time. While the effect is still uncertain, IFRS9 is likely to also include a grossing up effect.

Earlier recognition of losses..... total profits unaffected... it is just a timing issue

Whilst there will be no impact on cash, for consumer lending businesses such as NSF, the adoption of IFRS 9 is likely to mean that future expected credit losses over the life of a loan will be recognised earlier than at present - either on issue of loans or early in the loan term, whereas currently impairment provisions are only recognised where a “loss event” has been experienced.

As the carrying value of loans under IFRS 9 is based on the present value of future expected cash flows, discounted using the contractual effective interest rate of the loan, the discounting element of the impairment provision is also likely to be high for the Group. This will increase the large unwind already seen.

Effect unknown and so we have built in directional estimates only

The impact of IFRS 9 has yet to be quantified for the Group, but we believe it could have a significant impact on the carrying value of the loan book of the Group. Although the profit recognised over the life of the loan will be unchanged, this accounting policy change will result in earlier recognition of impairment losses and therefore later recognition of profits.

No guidance has yet been given on the details of the implementation of IFRS 9. At this stage, we have included nominal effects to highlight the issue. Given it is a timing issue only (i.e. 2018 profits below current policies but 2019 higher) it is unclear what the market reaction will be.

Acquisition accounting

Acquisition accounting requires a fair /market value which is not the same treatment as an ongoing business

On acquisition, the accounting rules try to assess the fair (or market) value of all the assets and liabilities of the target. Focusing specifically on lending (in NSF accounts these are “amounts receivable from customers”) the matter is complicated. At acquisition the accounting rules no longer value a loan at its nominal value (impaired as appropriate) as ongoing accounts had done. The marking to market of the loan means future profits are recognised up-front. This increases the net assets of the target (and so lowers goodwill) but then needs to be stripped out of future earnings.

For loans this brings forward all the future profits … it then needs to be unwound over the life of the loan

A simplified example is given below. In this case the present valuing of future pre-tax profits leads to a gain on acquisition of £305. This leads to an unwind cost of £91 in the first-year post acquisition. Over the life of the loan the total gain is unchanged but its timing is distorted. The scale of adjustment will vary with the profitability of the business (high interest loans incur a greater distortion) and its expected duration (longer loans have a greater impact).

Figure 30: Theoretical example of fair value of loan

£	Year 0	Year 1	Year 2	Year 3
Ongoing basis				
Net Interest income	0	250	250	250
Admin costs	0	(75)	(75)	(75)
Impairment	0	(50)	(50)	(50)
Pre-tax (a)	**0**	**125**	**125**	**125**
Tax	0	(25)	(25)	(25)
Post-tax profit	**0**	**100**	**100**	**100**
Loan	1,000	1,000	1,000	0
Cash	0	0	0	370
Debt	(750)	(650)	(550)	0
Equity	**(250)**	**(350)**	**(450)**	**(550)**
Pre-tax profit (from (a) above)		125	125	125
PV of profit at 10% discount rate at date of acquisition		113	101	91
Outstanding cumulative PV of profit*	305	214	113	0
Post-acquisition				
Net Interest income	0	250	250	250
Unwind of FV adjustments (pre-tax)	**0**	**(91)**	**(101)**	**(113)**
Admin costs	0	(75)	(75)	(75)
Impairment	0	(50)	(50)	(50)
Pre-tax	**0**	**34**	**24**	**13**
Tax	0	(7)	(5)	(3)
Post-tax profit	0	27	19	10
Loan	1,000	1,000	1,000	0
FV gain (pre-tax)	**305**	**214**	**101**	-
Cash	-	-	-	370
Debt	(750)	(650)	(550)	-
Deferred tax liability	**(61)**	**(43)**	**(20)**	-
Equity	**(494)**	**(521)**	**(540)**	**(550)**

Source: Hardman & Co Research

** the outstanding cumulative PV reflects both the amount outstanding but also the fact the PV discount rate reduces as time elapses. Year 2 profits are discounted by a factor of 0.81 at acquisition but only 0.9x at the end of year 1*

Also introduces more intangibles which also are amortised over their "useful" lives

The rules also require NSF to include a value for the non-tangible things like brands and customer lists. The valuation is agreed with auditors but there is a material element of subjectivity to it (level three within the IFRS value hierarchy). As these intangibles are not deemed to have a permanent life there is an amortisation through the profit and loss. Additionally, any specific impairment to the intangible in any year has to be recognised in the accounting period it occurred (H116 £161k on brands following the change from Loansathome4U to Loans at Home). This is a non-cash item and stripped out for underlying earnings basis.

EL

Amounts receivable from customers

EL fair value of loans increased balance sheet value by 21%. Unwind will be nearly £10m p.a.

The fair value adjustment increased the value of loans recorded in the accounts by 21% (£24m) from £116m to £139m. This relatively high adjustment reflects the multi-year nature of the EL book. Post-acquisition, the loans earn revenue and incur impairments but as the profits have already been recorded in the acquisition adjustment, they need to be reversed out over the life of the loan. The accounting does this through a “fair value unwind on the acquired loan portfolio” which is treated as a single negative revenue item. For EL the £24m acquisition credit was offset in H116 by a £2.0m revenue item. This adjustment is excluded from our normal earnings.

Intangible assets

Another c£3m p.a. from amortisation of intangibles

Figure 31 shows the amounts and amortisation periods adopted by NSF with EL.

Figure 31: Intangible assets created on acquisition of EL

£’000s	Amount	Amortisation period
Customer lists	2,050	5-7 years
Broker relationships	4,233	2-3 years *
EL brand	1,447	1-5 years
Trusttwo brand	49	1-5 years
Technology	6,227	4 years
Total	14,006	

Source: NSF Hardman & Co Research PFG amortises its Moneybarn broker relationship over 10 years*

Deferred tax

Material deferred tax liability

The value created by the acquisition adjustments (£14m + £24m) leads to the creation of a deferred tax liability at 20% (£7.5m). This liability is then unwound alongside the asset. As the profit on the loans is realised the tax becomes payable and shows in the cash flow statement. In H116 there was thus a NSF group tax payment in cash of £1.5m even though the group reported a net tax credit.

LAH

LAH loan uplift c26% but 93% of it unwound in 2015 because of short loan duration.

The same principles applied to this earlier acquisition although there was a much larger credit given to the customer list. The increase in value of the loan book was £5.9m (26% of previous book value) partially offset by the recognition of a property provision (£0.7m). The short loan duration meant £5.5m (93%) of the loan value adjustment unwound in 2015 leaving only a modest distortion in 2016. With the intangibles, the deferred tax adjustment was £4.8m. Future amortisations will be a on a declining balance basis.

Figure 32 – Intangible assets created on acquisition of LAH

£’000s	Amount	Amortisation period
Customer lists	17,312	5-7 years
Agent network	540	20% reducing balance
Brand	297	1-5 years
Total	18,493	

Source: NSF Hardman & Co Research

Company matters

Registration

Incorporated in the UK with company registration number: 09122252

Board of Directors					
Position	**Name**	**Nominations**	**Remuneration**	**Risk**	**Audit**
Exec Chairman	Jon van Kuffeler	Y			
Chief Financial Officer	Nick Teunon				
Executive Director	Miles Cresswell-Turner				
Independent non-executive director	Heather Jane McGregor	Y	Y	Y	Y
Non-executive director	Charles Gregson	Y	Y	Y	Y

M = member; C = chair
Source: Company reports

Board of Directors

Executive Chairman Jon van Kuffeler

John was Chief Executive and then Chairman of Provident Financial plc for a combined total of 22 years until December 2013. John was Chairman of Marlin Financial Group Limited, the consumer debt purchasing company, for four years until its sale in February 2014, and was also Chairman of Hyperion Insurance Group Limited for five years until December 2013. John was previously Chief Executive of Brown Shipley Holdings PLC which included Medens Trust Limited, a consumer car finance company, and was Chairman of the credit committee of Brown Shipley Holdings PLC's main banking subsidiary, Brown, Shipley & Co. Limited

Chief Financial Officer Nick Teunon

Nick was Chief Financial Officer of Marlin Financial Group Limited, the consumer debt purchasing company, from August 2013 until June 2014. Prior to that, Nick spent five years as Chief Financial Officer of FTSE International. Nick also spent seven years as Group Finance & Strategy Director of the Press Association. At both FTSE International and the Press Association, Nick was responsible for all mergers and acquisitions activity and related debt funding, in addition to leading the finance function. Nick has previous experience as Finance Director of a public company based on his time at Water Hall Group plc

Executive director Miles Cresswell-Turner

Prior to becoming Executive Director, full-time, at NSF on 1 January 2016, Miles was a partner in Duke Street LLP who specialised in the finance sector and who led on the acquisitions by Duke Street LLP of Marlin Financial Group Limited and UKWM Limited. Before becoming a partner at Duke Street LLP, Miles was a partner at Palamon Capital Partners LLP from 1998 to 2008, where he led the investment in Towry Law plc. Prior to Palamon Capital Partners LLP, Miles spent seven years as a director in the Leveraged Finance Department of HSBC Investment Bank.

Independent Non-executive Heather Jane McGregor

Heather McGregor is Executive Dean of Edinburgh Business School, the Graduate School of Business of Heriot-Watt University and principal shareholder of the executive search firm Taylor Bennett, having bought the company from its founders in 2004. In her early career she worked in financial PR and investor relations before joining ABN Amro as a sellside analyst. She then spent eight years with the bank,

working in London, Hong Kong, Singapore and Tokyo, before joining Taylor Bennett in 2000. She has an MBA from the London Business School and a PhD from the University of Hong Kong. Heather was the founder of the Taylor Bennett Foundation, which works to promote diversity in the communications industry. She is also an experienced writer and broadcaster in the national media.

Non-Executive Director Charles Gregson

Charles is Chairman of ICAP Plc. Charles was Chairman of Wagon Finance Group Limited from 1996 to 2006, Non-Executive Director and Deputy Chairman of Provident Financial plc from 1998 to 2007 and Non-Executive Director of International Personal Finance Plc from 2007 to 2010. Charles is a former Chairman of CPP Group Plc and of St James's Place Plc. He is also a Non-Executive Director of Caledonia Investments Plc. Charles was Executive Director of United Business Media Plc (formerly MAI Plc) from 1985 to 2003 and Global CEO and Chairman of PR Newswire from 2003 to 2009. As part of his responsibilities at United Business Media Plc, Charles built Harlow Meyer Savage from a small money broking business into the international business of Garban PLC, a listed company with offices in 25 countries which later merged with ICAP Plc.

Management incentives

Base pay kept below market levels

c5%, 5m "Founder" shares which only vest on 25% increase in total shareholder value

This is in addition to 3m shares already held

Group policy is to align management and shareholder interests to an above peer level. Specifically, base pay is targeted to be lower than the market median for companies of a similar size and industry. There are the usual performance related bonuses but also, on IPO, the Executive Directors were awarded Founder Shares in Non-Standard Finance Subsidiary Limited. Under the terms of these shares the Executive Directors have the option to require the Company to purchase some or all of their Founder Shares, subject to: (i). the Group making acquisitions with a combined value of at least £50m; and (ii) within five years of acquisition, shareholders receiving a 25% increase in total shareholder value (i.e 125p) or 8.5% CAGR (measured on the basis of exceeding such price for 20 trading days out of 30 successive trading days).

The number of Ordinary Shares required to settle all such options is just over 5m (5% of the Ordinary Shares of the Company on Admission). While the Founder Shares are subject to performance, the conditions can be met one year post-acquisition and these shares do not provide a lock-in for participants. Once the Founder Shares have vested, the Committee would expect to seek to introduce a new long-term incentive plan. NSF also proposes to introduce a value creation plan in each of LAH and Everyday Loans in which key employees in those subsidiaries can participate. Participants in the plan will share in the growth in value of the subsidiaries above a compound annual growth rate of 15% over 3-4 years and thereby encourage participants to deliver growth as early as possible. Vested awards will be satisfied, at the Company's choice, in either cash or shares in the Company. NSF also propose to introduce a suite of all employee share plans subject to the usual 10% in 10 years dilution limit.

The directors shareholdings are material: Jon van Kuffeler (ordinary shares 2,114,434, Founder Shares 30), Nick Teunon (ordinary shares 55,921, Founder Shares 15), Miles Cresswell-Turner (ordinary shares 490,132, Founder shares 25), Charles Gregson (ordinary shares 223,553, Founder shares 20), and Heather Jane McGregor (ordinary shares 56,465).

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