HARDMAN & CO.

29 August 2019

# NON-STANDARD FINANCE PLC

## "Now is the time for profit"

**NSF has reached the turning point in its strategic development. Having invested heavily in infrastructure, controls and people, it has substantially built the franchise. The pace of further investment is expected to now slow, at the same time as payback from historical investment becomes increasingly visible. We see profit growth accelerating sharply, driven by wider jaws between revenue and costs in the branch business and guarantor loans, efficiency improvements in home collect, and improving credit. Assuming NSF is successful in securing additional lower-cost funding, we expect funding costs to relatively reduce, and the funding mix to improve. Our strong growth forecasts are unchanged.**

- **1H'19 highlights:** Normalised revenue was up 12% to £88.3m (1H'18: £78.9m). Normalised operating profit rose 28% to £19.5m. Normalised PBT increased 12% to £6.3m. Exceptional charges were £25.3m (around half bid fees and half a goodwill write-down). DPS was up 17% to 0.7p.

- **Outlook:** Management says current trading is in line with market expectations, which implies a sharp acceleration of profit growth in 2H'19. We detail in this note why such an acceleration is credible and the multiple levers at NSF's disposal. Delivery on these forecasts may re-establish the share rating.

- **Valuation:** Our valuation approaches now indicate a 92p-109p range (previously 96p-109p). The Discounted Dividend Model, the highest valuation, is unchanged given unchanged estimates. Our Gordon Growth Model has reduced with lower tangible equity. The peer-rating-driven Sum-of-the-Parts is 67p.

- **Risks:** Credit risk remains the biggest threat to profitability. NSF's model accepts higher credit risk, where a higher yield justifies it. NSF is innovative, and may incur losses piloting new products, customers and distribution. Regulation is a market issue; management is acting to mitigate this risk.

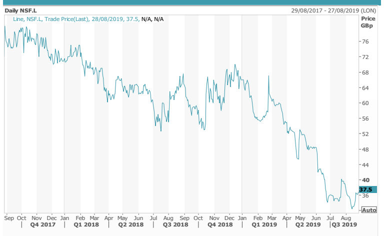
- **Investment summary:** Substantial value should be created, as i) competitors have withdrawn, ii) NSF is well capitalised, with committed debt funding, iii) macro drivers are positive, and iv) NSF's experienced management delivers operational efficiency without compromising the key face-to-face model. Management targets of 20% loan book growth and 20% EBIT RoA appear credible, and investors are paying 6.7x 2019E P/E and getting an 8.4% yield.

### Financial summary and valuation

| Year-end Dec (£000) | 2017 | 2018 | 2019E | 2020E | 2021E |
|---|---|---|---|---|---|
| Reported rev./other inc. | 121,682 | 168,128 | 189,346 | 216,831 | 247,048 |
| Total impairments | -28,795 | -42,688 | -45,767 | -52,511 | -59,796 |
| Total costs | -69,203 | -89,564 | -94,666 | -101,776 | -110,400 |
| Normalised EBIT | 23,684 | 35,876 | 48,913 | 62,543 | 76,852 |
| Adjusted PBT | 13,203 | 14,769 | 21,744 | 30,163 | 38,872 |
| Statutory PBT | -13,021 | -1,590 | -13,913 | 27,034 | 37,341 |
| Pro-forma EPS (p) | 3.44 | 3.70 | 5.64 | 7.97 | 10.34 |
| DPS (p) | 2.20 | 2.60 | 3.20 | 4.00 | 5.00 |
| P/adjusted earnings (x) | 11.1 | 10.3 | 6.7 | 4.8 | 3.7 |
| P/BV (x) | 0.5 | 0.6 | 0.6 | 0.6 | 0.5 |
| P/tangible book (x) | 1.6 | 2.1 | 2.3 | 1.8 | 1.3 |
| Dividend yield | 5.8% | 6.8% | 8.4% | 10.5% | 13.2% |

*Source: NSF, Hardman & Co Research; All years are on IFRS 9 basis*

### Financials



*Source: Refinitiv*

### Market data

| | |
|---|---|
| EPIC/TKR | **NSF** |
| Price (p) | **38.0** |
| 12m High (p) | 70.0 |
| 12m Low (p) | 32.45 |
| Shares (m) | 312.0 |
| Mkt Cap (£m) | 119 |
| EV (£m) | 371 |
| Free Float | 99% |
| Market | Main |

### Description

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

### Company information

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

+44 20 38699026
www.nonstandardfinance.com

### Key shareholders

| | |
|---|---|
| Invesco | 28.7% |
| Woodford Inv. Mgt. (08/07/19) | 23.9% |
| Aberforth Partners | 13.1% |
| Marathon Asset Mgt. | 12.7% |
| ToscaFund | 3.85% |

### Diary

| | |
|---|---|
| Nov'19 | Trading update |

### Analyst


Mark Thomas 020 7194 7622
mt@hardmanandco.com

# Turning point in strategic development

NSF at strategic turning point. With franchise investment significantly complete, it is now time for payback.

In the analyst meeting, management commented that "now is the time for profit". We believe this aptly summarises the strategic point of inflection that NSF has reached. Until now, there has needed to be significant investment building the infrastructure, controls and staffing necessary to achieve economies of scale, operational efficiencies and tight risk management. All three are critical to delivering sustained profit growth in the non-standard market.

Consensus and our forecasts for significant growth in 2H'19 appear credible

The management quote also reflects its statement that current trading is in line with market expectations. The table below shows consensus estimates before the interim results (post-results numbers not yet available). These forecasts imply a 2H'19 EBIT ca.50% higher than 1H'19, and even sharper growth in profit and EPS. This compares with a 36% uplift in EBIT in 2H'18 over 1H'18.

Consensus estimates (pre-results)

| £m | 2018 (actual) | 1H'19 actual | 2H'19 implied | 2019E | 2020E | 2021E |
|---|---|---|---|---|---|---|
| EBIT | 35.9 | 19.5 | 30.1 | 49.6 | 61.9 | 75.3 |
| Finance costs | -21.1 | -13.2 | -14.0 | -27.2 | -31.1 | -35.1 |
| Adjusted PBT | 14.8 | 6.3 | 16.1 | 22.4 | 30.9 | 40.2 |
| Adjusted EPS (p) | 3.7 | 1.64 | 3.2 | 5.8 | 8.1 | 10.6 |
| DPS (p) | 2.6 | 0.7 | 2.5 | 3.2 | 4.2 | 5.4 |

*Source: NSF website accessed 20 Augusts 2019*

## Levers for growth

We detail below the levers that we believe NSF has at its disposal to achieve this growth.

In ELD, it's about maturing branches delivering greater profitability without the drag from incremental investment in new branches

We are forecasting profits for Everyday Loans (ELD) to rise from £5.4m in 1H'19 to £10.1m in 2H'19, driven by an £8m increase in revenue and a rise of £0.5m in other income partially offset by rises of £2m in impairments, £1.4m in costs and £600k in interest expense. The 18% rise in revenue second half over first half is similar to increases seen in previous years (2018: 22%, 2017: 16%, 2016: 17%) and reflects the full period effect of prior lending. For example, in 1H'19, the contribution from the seven new branches (and the eighth that opened in July 2019) in ELD was minimal, but these branches incurred most of the cost (both staff and fixed assets). ELD typically opens its branches in 1H, with most of the fitting-out and training expenses in that period. Slide 27 of the *interim presentation* highlights the profit trend by branch and the sharp acceleration that could be expected over the first 18 months. We forecast a slight improvement in finance costs, with a small mix effect from greater equity funding with retained profits in the division.

In GLD, it's about payback from historical investment, market growth and a normalisation of credit

Our forecast profits for Guarantor Loans (GLD) rise from £0.9m in 1H'19 to £2.2m in 2H'19. The main drivers are revenue up £2.2m, broadly flat impairments, costs up £0.5m and finance costs up £0.3m. The revenue growth again is not out of line with historical increases (2018: 20%, 2017: distorted by acquisition, 2016: 13%) and, to put this into context, the 1H'19 loan book was £96.3m, up £13m (+16%) on the year-end. We have assumed slower growth in costs, with much of the infrastructure in place during 1H'19. One variant is flat impairments with this rising revenue. This is because we assume the operational difficulties that caused a spike in 1H'19 will be sorted and that the annual charge will be 21.8% – towards the top of management's target range of 20%-22%. This may be improved upon further if there are meaningful recoveries from situations not immediately resolved in 1H'19.

In HCC, it's about continued good credit

With Home Collect (HCC) customers borrowing in November and December, ahead of Christmas, this business has a natural seasonality (only somewhat reduced by IFRS 9 accounting taking provisions upfront). Our 2H'19 profit forecast is £5.6m, against £3.2m in 1H'19. Over the past few years, profit in the second half relative to the first half has been 1.8x 2016, 4.4x 2017 and 4.5x 2018, against the forecast 74% increase in 2H'19 on 1H'19. Management advised of a 6% fall in receivables as the take-up of rollover loans by existing customers was slower than expected. It is unclear whether this is affordability- driven (the customers' income levels are higher with rising employment and wages), due to market uncertainty (customers holding back until they have more clarity on Brexit), or due to a change in product mix (NSF offering shorter-term loans to former Provident Financial (PFG) customers who were used to longer-term products at lower weekly payments)). It is interesting that NSF advises that new customer bookings are robust, which suggests the slowdown was more company-specific and probably product-driven. In terms of profitability, the shorter-term loans are higher-yielding and typically have better credit quality.

Longer term, we see significant operational efficiency options in HCC

Looking further forward, we see significant opportunities to improve efficiency in HCC. This trend was seen in 1H'19 (cost income ratio 56.3% vs. 57.1%). In 2015, each agent served 170 customers and, on average, had a loan book of £53k. In 1H'19, each agent served 95 customers and had a loan book of £37k. There may have been a change in nature of agent (most PFG agents that came over would have wanted to work part-time only), but we also believe this change reflects NSF's own risk appetite. Following the 2016 problems with inexperienced agents, and the risks with onboarding significant numbers of agents from PFG, it may be expected that NSF will be conservative. Looking forward, as the agents are embedded and NSF has confidence in their decision-making, it may be expected that the customers per agent and loan balances will rise.

## Changes to estimates

Bottom-line estimates unchanged

As can be seen in the table below, any changes to our forecasts are of a tweak in nature, rather than substantial. There is no change to our bottom-line estimates, and the key message is about profit growth from here. The fall in equity is due primarily to the unexpected write-down in Loans At Home (LAH) goodwill; this does not affect our valuation approaches, which are based off tangible equity.

Estimate changes

| | 2019E | | | 2020 E | | | 2021E | | |
|---|---|---|---|---|---|---|---|---|---|
| Year-end Dec | Old | New | change | Old | New | change | Old | New | change |
| P&L (£m) | | | | | | | | | |
| Revenue | 192,108 | 189,346 | -1% | 219,634 | 216,831 | -1% | 251,183 | 247,048 | -2% |
| Impairments (incl. IFRS 9) | -48,221 | -45,767 | -5% | -53,359 | -52,511 | -2% | -59,316 | -59,796 | 1% |
| Total costs | -100,829 | -94,666 | -6% | -106,845 | -101,776 | -5% | -116,431 | -110,400 | -5% |
| EBITDA | 49,150 | 48,913 | 0% | 62,559 | 62,543 | 0% | 76,967 | 76,852 | 0% |
| Adjusted PBT | 21,762 | 21,744 | 0% | 30,248 | 30,163 | 0% | 38,859 | 38,872 | 0% |
| Pro-forma norm. EPS (p) | 5.65 | 5.64 | 0% | 8.00 | 7.97 | 0% | 10.34 | 10.34 | 0% |
| Dividend (p) | 3.20 | 3.20 | 0% | 4.00 | 4.00 | 0% | 5.00 | 5.00 | 0% |
| Bal. sheet (@ 31 Dec, £m) | | | | | | | | | |
| Amounts receivable | 382 | 385 | 1% | 457 | 454 | -1% | 549 | 546 | 0% |
| Borrowings | 326 | 336 | 3% | 382 | 386 | 1% | 454 | 456 | 0% |
| Equity | 202 | 187 | -8% | 215 | 200 | -7% | 235 | 219 | -7% |

*Source: Hardman & Co Research*

# 1H'19 results

## Group summary

Normalised revenue rose 12%, credit and efficiency improvements led to strong operating profit growth, volume- and mix-driven rise in funding costs saw PBT up 12%

While the evolution of the PFG deal and the perceived overhang from the Woodford holding (see below) have been key drivers to NSF's share price, investors should not lose track of what the company achieved in 1H'19. To recap, the key highlights were:

- Normalised revenue was up 12% to £88.3m (2018: £78.9m). Reported revenue came in at £87.1m (2018: £75.1m). Impairments rose 8% to £22m (including a modification adjustment and after what we believe will be a temporary spike in impairments at GLD). Costs rose 6% to £47.3m.
- With costs and impairments rising significantly more slowly than revenue, normalised operating profit was up 28% to £19.5m (2018: £15.2m), and reported operating profit came in at £15.7m (2018: £7.0m). Normalised PBT was up 12% to £6.3m (2018: £5.6m), as finance costs rose 38% (driven primarily by loan book growth of 26% and a mix change, with equity funding at 54% of receivables, against 77% in 1H'18).

Exceptional bid costs and goodwill write-down

- There was an exceptional charge of £25.3m (2018: £nil), which included fees and costs associated with the offer for PFG of £12.7m (2018: £nil) and an unexpected LAH goodwill impairment of £12.5m (2018: £nil), to give a reported loss before tax of £22.8m (2018: reported loss of £2.6m).
- The half-year dividend per share was up 17% to 0.7p (2018: 0.6p per share).

Current trading in line with market's strong growth expectations

- Current trading: NSF reported a good start to the year, in line with management's expectations.
- The total net loan book was up 26% to £335.6m (30 June 2018: £267.4m), before fair value adjustments: i) ELD lending up 22%, with seven new branches opened in the first half; ii) GLD up 53%, reflecting further investment and strong market demand; iii) HCC credit down 6%, but with a significant increase in operating profit.
- Despite the uptick in impairment at GLD, there was a further reduction in overall impairment as a percentage of normalised revenue, to 24.5% (1H'18: 25.6%).
- Overall customer numbers were up 7%, driven by branch-based lending (+22%) and guarantor loans (+36%) since 30 June 2018.
- As can be seen in the Key Performance Indictors (KPI) in the table below for the different businesses, loan growth has been slowing, yields are broadly stable, impairments are a mixed story, profit margins have shown a slight decline and, again, there is a mixed story on return on assets (RoA).

**KPI (%)**

| 1H'19 (Dec/FY'18) | ELD | GLD | HCC |
|---|---|---|---|
| Loan book growth | 22.3 (28.3) | 53.1 (61.0) | -6.1 (2.0) |
| Revenue yield | 46.2 (46.8) | 31.3 (32.2) | 165.5 (171.5) |
| Risk-adjusted margin | 36.1 (36.7) | 24.0 (25.8) | 112.7 (115.6) |
| Impairments/revenue | 21.8 (21.5) | 23.3 (20.0) | 31.9 (32.6) |
| Impairments/average net loan book | 10.1 (10.1) | 7.2 (6.4) | 52.8 (55.9) |
| Operating profit margin | 45.3 (45.9) | 44.3 (45.9) | 56.3 (57.1) |
| RoA | 15.3 (15.8) | 10.1 (11.3) | 19.5 (17.7) |

*Source: NSF results release and presentation, dated 20 August 2019*

# Divisional summary

**Normalised divisional results**

| Six months to end-Jun 2019 (£'000) | ELD | GLD | HCC | Central costs | NSF total | Change on 1H'18 |
|---|---|---|---|---|---|---|
| Revenue | 43,756 | 13,840 | 30,691 | 0 | 88,287 | 12% |
| Other operating income | 221 | 0 | 0 | 0 | 221 | -75% |
| Modification loss | -246 | -41 | 0 | 0 | -287 | n/a |
| Impairments | -9,335 | -3,241 | -8,828 | 0 | -21,404 | 7% |
| **Revenue less impairments** | **34,396** | **10,588** | **21,863** | **0** | **66,817** | **12%** |
| Admin. expenses | -20,558 | -6,212 | -17,560 | -3,010 | -47,340 | 6% |
| **Operating profit** | **13,838** | **4,346** | **4,303** | **-3,010** | **19,477** | **28%** |
| Finance costs | -8,399 | -3,453 | -1,108 | -218 | -13,174 | 38% |
| **PBT** | **5,439** | **893** | **3,195** | **-3,228** | **6,299** | **12%** |
| Taxation | 1,033 | -169 | -607 | 613 | -1,196 | 12% |
| **PAT** | **4,406** | **724** | **2,588** | **-2,615** | **5,103** | **12%** |
| | | | | | | |
| Normalised EPS (p) | | | | | 1.64 | 13% |
| DPS (p) | | | | | 0.7 | 17% |

*Source: NSF results release, dated 20 August 2019*

## ELD

**ELD financials**

The key divisional highlights from 1H'19 were: i) The net loan book was up 22% on 1H'18 to £204m (year-end 2018: £186.2m). A slight shift in mix meant that average revenue yields fell to 46.2% (1H'18: 46.8%). Overall revenue grew 22%; ii) Other income fell from £890k to £221k, reflecting a lower gain on the sale of non-performing loans (this income will be lumpy); iii) Impairments were stable, at 21.8% of revenue (1H'18: 21.5%); iv) Costs rose 16%, with heavy investment continuing. Seven new branches opened in 1H'19 (and a further one in July 2019), taking the total to 73; v) Finance costs rose by 49% to £8.4m, from £5.6m, reflecting strong volume growth (22%), the impact of IFRS 16 (ca.£400k), and a greater share of the cost of funding the full-year dividend and interest payments on the Alcentra facility.

**Key message: now time for payback**

The key message from ELD is that the pace of investment from here will slow, now that the branch size has doubled since acquisition and there is a complete national footprint. We also note that, as The Money Shop is now in administration and Oakam has moved entirely online, the threat of another land-based competitor has all but disappeared. The result is that we now expect that new branches will continue to be opened, but the pace will be slower and so the rate of cost growth is expected to slow. Equally importantly, the benefits from historically opened branches should become increasing visible, as they add receivables and move from initial losses of £200-£300k into profits of £600-£800k p.a. Our forecast 2019 PBT of £12.8m equates to £176k profit per branch. Our 2021 profit estimate is £400k per branch. When fully mature, a branch is expected to deliver £600k-£800k p.a., which shows the potential profit upside to our numbers over the medium term, even without any new openings.

## GLD

**GLD financials**

The key divisional highlights in 1H'19 were: i) The net loan book was up 53% to £96.3m. The revenue yield continued to reduce somewhat, to 31.3% (from 32.2%), reflecting a change in business mix. With full-period income effects from prior-year lending, revenue increased by 40% to £13.8m; ii) Impairments rose by 128% to £3.2m. The rate of impairment as a percentage of revenue was 23.3% (up from 20.0% in 1H'18). We understand this was driven by the consolidation of the collections departments into one operational site and that there was some disruption in the move. The early contact with a customer in difficulties is a material factor in ultimate loss and hence the rise in impairments.; iii) Costs increased by 35% (i.e. 5% below revenue), with continued investment in infrastructure and staffing; iv) Finance costs rose by 34%, with the net result being that normalised PBT fell by 32% to £0.9m.

Key messages: regulatory risk appears moderate and credit should revert within target range by end of year

The key messages for GLD are twofold:

- Firstly, will the ongoing FCA investigation into guarantor loans have a material impact on either the market or the company specifically? NSF believes its investments in infrastructure and controls mean that, operationally, the company has effective controls in place. The culture of the firm is to provide appropriate products for the customer and that guarantor loans meet a real need from a specific group of customers. NSF notes that the sector has been reviewed before, and it believes that the risk of any significant disruption to its current model is moderate.
- The second issue for GLD is bringing impairments back to within the 20%-22% revenue target range and re-establishing the effective collection process that was previously in place. We take on trust management's comments that it now has a handle on the matter. We would expect such an operational issue to be addressed quickly, as management credibility, a key factor in the share price re-rating, is dependent on effectively executing the post-bid-focused strategy.

# HCC

HCC financials

The key divisional highlights in 1H'19 were: i) The net loan book fell 6% to £35.5m. As noted above, the take-up by existing customers of new lending was below expectations. Average yields fell from 171.5% to 165.5%, because of mix effects and the weighting towards longer-term loans within the book. New loans have a shorter duration and a higher yield, but the impact of this has yet to be felt, given the weight of the historical book. Overall revenue fell 8% to £30.7m; ii) Impairments were down from 32.6% to 31.9% of revenue, reflecting the benefit of new management controls and oversight, and less new business (guidance range 33%-37%); iii) Costs fell 10%, with a revised operational structure that was put in place in January 2019 and the efficiency improvements outlined in the section above; iv) The net effect was that normalised operating profit was up 110% to £4.3m; v) Finance costs fell 13% (primarily volume-driven), with PBT rising from £-0.8m to £3.2m.

Key message: reason why existing customers' rollover rate has slowed is important

There are two key issues for HCC. Firstly, does the fall in further borrowings from existing clients become a trend, rather than a one-off factor? It is possible that former PFG customers will revert back to PFG if they can get the longer-term, lower-yield, lower weekly payment product they are used to (PFG reported, in its results, 15% growth in new customer acquisitions). Secondly, we see a significant medium-term operational efficiency opportunity for the reasons outlined above.

Goodwill write-down was in market (although not expected with these results). This was driven by peer rating changes and not material to current performance or strategy of group.

With these results, the goodwill asset for LAH was written down by £12.5m to £27.7m. In note 10 of the release, NSF explained the accounting details driving the write-down and how, despite the strong operational and financial performance in the period, the significant decline in the stockmarket rating of the group's peers triggered the need to impair. While this non-cash item was not expected by the market with these results, a potential write-down at some stage was in the public domain, not least during the PFG bid situation. Any implication that historical deals were over-priced is not welcome for management credibility; however, the recent decline in market multiples is clearly outside management's control, and we note that further acquisitions are not expected for the foreseeable future. NSF today is all about execution from the existing franchise, which has benefited from heavy investment.

# Central costs

Central costs rose by 8%, reflecting further investment in governance and risk-management controls.

# The Woodford effect

**Resolution at Woodford is unclear, but given rating and public support for management, NSF may not be first asset for sale**

We note that, on 8 July 2019, Woodford Investment Management Ltd reported it had reduced its shareholding in NSF from 25.02% to 23.90%, with the residual stake now worth ca.£28m. There has been speculation over what may happen to this holding in order to meet mandate transfers and potential redemptions. This speculation has included the transfer to investors/managers (as appears to be the case with half the stake in Amigo Holdings), through to potential sale, especially for the most liquid holdings (Woodford has already placed its entire stake in Morses Club).

We believe the key considerations are as follows.

- The risk of a large, forced seller cannot be ruled out, and will depend on the ultimate future of Woodford Investment Management Ltd.
- The value of the stake is equivalent to around 11 months of recent trading by value and around 1.3 years by number of shares. We note that a number of investors have been voluntarily introducing caps on their holdings, where there is a perceived liquidity issue, even for quoted companies. The FCA and Bank of England are also believed to be looking at liquidity for funds, and there may be regulatory changes in due course. It is therefore uncertain to what extent a major institutional would take a significant element of the Woodford holding.
- The de-rating of the shares (as measured by prospective P/E) since the start of the year has been ca.40%, making them significantly cheaper than before.
- Given the public support for the management, the relative size of the stake compared with other holdings, and the change in rating, it would appear likely that other holdings could be sold in advance of NSF.

# Financials

As stated earlier, our bottom-line forecasts are unchanged.

## Reported profit and loss

| Year-end Dec (£000) | 2015 | 2016 | 2017 | 2018* | 2019E* | 2020E* | 2021E* |
|---|---|---|---|---|---|---|---|
| Business interest income | 14,657 | 81,099 | 119,756 | 166,502 | 188,346 | 215,831 | 246,048 |
| Other operating income | 0 | 450 | 1,926 | 1,626 | 1,000 | 1,000 | 1,000 |
| Fair-value unwind on acquired portfolios | -5,456 | -8,342 | -11,985 | -7,678 | -4,291 | 0 | 0 |
| **Total revenue** | **9,201** | **73,207** | **109,697** | **160,450** | **185,055** | **216,831** | **247,048** |
| Impairments | -3,858 | -23,651 | -28,795 | -42,688 | -45,767 | -52,511 | -59,796 |
| **Gross profit** | 5,343 | 49,556 | 80,902 | 117,762 | 139,288 | 164,319 | 187,252 |
| Administration expenses | -11,340 | -44,074 | -69,203 | -89,564 | -94,666 | -101,776 | -110,400 |
| Amortisation of intangibles | -4,030 | -10,714 | -7,897 | -8,681 | -6,092 | -3,129 | -1,531 |
| **Operating profit** | **-10,027** | **-5,232** | **3,802** | **19,517** | **38,530** | **59,414** | **75,321** |
| **EBITDA** | **-5,799** | **6,172** | **12,518** | **29,970** | **49,122** | **67,043** | **81,352** |
| **Exceptional items** | -6,135 | -626 | -6,342 | 0 | -25,274 | 0 | 0 |
| Net finance (cost)/income | 70 | -3,484 | -10,481 | -21,107 | -27,169 | -32,380 | -37,980 |
| **PBT** | **-16,092** | **-9,342** | **-13,021** | **-1,590** | **-13,913** | **27,034** | **37,341** |
| Income tax | 3,022 | 1,344 | 2,686 | -89 | -2,174 | -4,745 | -6,362 |
| **PAT from continuing operations** | **-13,070** | **-7,998** | **-10,335** | **-1,679** | **-16,087** | **22,289** | **30,979** |
| | | | | | | | |
| Average no. shares for EPS calculation (m) | 61.50 | 307.32 | 316.90 | 312.71 | 312.05 | 312.05 | 312.05 |
| Statutory EPS (p) | -21.25 | -2.60 | -3.26 | -0.54 | -5.16 | 7.14 | 9.93 |
| Adjusted EPS (p) | | 3.37 | 3.44 | 3.70 | 5.64 | 7.97 | 10.34 |
| DPS (p) | | 1.20 | 2.20 | 2.60 | 3.20 | 4.00 | 5.00 |

*Source: NSF, Hardman & Co Research; *IFRS 9 basis*

## Normalised profit and loss

| Year-end Dec (£000) | 2016 | 2017 | 2018* | 2019* | 2020E * | 2021E* |
|---|---|---|---|---|---|---|
| Business interest income | 94,674 | 119,756 | 166,502 | 188,346 | 215,831 | 246,048 |
| Other operating income | 450 | 1,926 | 1,626 | 1,000 | 1,000 | 1,000 |
| Fair-value unwind on acquired portfolios | 0 | 0 | 0 | 0 | 0 | 0 |
| **Total revenue** | **95,124** | **121,682** | **168,128** | **189,346** | **216,831** | **247,048** |
| Impairments | -26,155 | -28,795 | -42,688 | -45,767 | -52,511 | -59,796 |
| **Gross profit** | 68,969 | 92,887 | 125,440 | 143,579 | 164,319 | 187,252 |
| Administration expenses | -50,290 | -69,203 | -89,564 | -94,666 | -101,776 | -110,400 |
| Amortisation of intangibles | 0 | 0 | 0 | 0 | 0 | 0 |
| **Operating profit** | **18,679** | **23,684** | **35,876** | **48,913** | **62,543** | **76,852** |
| **EBITDA** | **19,369** | **25,181** | **37,648** | **53,413** | **67,043** | **81,352** |
| Net finance (cost)/income | -5,623 | -10,481 | -21,107 | -27,169 | -32,380 | -37,980 |
| **PBT** | **13,056** | **13,203** | **14,769** | **21,744** | **30,163** | **38,872** |
| Income tax | -2,688 | -2,313 | -3,197 | -4,131 | -5,279 | -6,608 |
| **PAT from continuing operations** | **10,368** | **10,890** | **11,572** | **17,612** | **24,885** | **32,264** |

*Source: NSF, Hardman & Co Research; *IFRS 9 basis*

## Balance sheet

| @ 31 Dec (£000) | 2015 | 2016 | 2017 | 2018* | 2019E* | 2020E* | 2021E* |
|---|---|---|---|---|---|---|---|
| Non-current | | | | | | | |
| Goodwill | 40,176 | 132,070 | 140,668 | 140,668 | 128,216 | 128,216 | 128,216 |
| Intangible assets | 14,119 | 17,412 | 17,205 | 13,431 | 7,339 | 4,210 | 2,679 |
| **Other assets** | | | | 241 | 4,374 | 4,816 | 4,699 |
| **Right of use asset** | | | | | 11,187 | 10,000 | 8,500 |
| Property, plant and equipment | 1,718 | 5,459 | 9,434 | 7,723 | 8,441 | 8,441 | 8,441 |
| **Total non-current assets** | 56,013 | 154,941 | 167,307 | 162,063 | 159,557 | 155,683 | 152,535 |
| Current assets | | | | | | | |
| **Amounts receivable from customer** | **28,415** | **180,413** | **268,096** | **314,614** | **385,366** | **454,368** | **546,066** |
| Trade and other receivables | 10,275 | 9,709 | 1,551 | 3,967 | 5,000 | 5,000 | 5,750 |
| Cash and cash equivalent | 7,320 | 5,215 | 10,954 | 13,894 | 3,372 | 3,159 | 5,122 |
| Total current assets | 46,010 | 195,337 | 280,601 | 332,475 | 393,738 | 462,527 | 556,938 |
| **Total assets** | **102,023** | **350,278** | **447,908** | **494,538** | **553,295** | **618,210** | **709,473** |
| | | | | | | | |
| Current liabilities | | | | | | | |
| Trade and other payables | 13,803 | 8,005 | 10,353 | 17,242 | 19,242 | 21,242 | 23,242 |
| Lease liability | | | | | 1,659 | 1,659 | 1,659 |
| Deferred tax liability | 3,057 | - | - | - | | | |
| Total current liabilities | 16,860 | 8,005 | 10,353 | 17,242 | 20,901 | 22,901 | 24,901 |
| Net current (liabilities)/assets | 29,150 | 187,332 | 270,248 | 315,233 | 372,837 | 439,626 | 532,037 |
| Non-current liabilities | | | | | | | |
| **Financial liabilities – borrowings** | **-** | **87,300** | **199,316** | **266,322** | **336,322** | **386,322** | **456,322** |
| **Lease liability** | | | | | | | |
| **Deferred tax** | - | 5,890 | 4,996 | 252 | 9,000 | 9,000 | 9,000 |
| Total non-current liabilities | - | 93,190 | 204,312 | 266,574 | (0) | 0 | (0) |
| **Total liabilities** | 16,860 | 101,195 | 214,665 | 283,816 | 345,322 | 395,322 | 465,322 |
| **Net assets** | 85,163 | 249,083 | 233,243 | 210,723 | 187,072 | 199,986 | 219,250 |

*Source: NSF, Hardman & Co Research; *IFRS 9 basis*

## Cashflow

| Year-end Dec (£000) | 2015 | 2016 | 2017 | 2018* | 2019E* | 2020E* | 2021E* |
|---|---|---|---|---|---|---|---|
| Profit/(loss) before and interest | -16,162 | -5,858 | -2,540 | 19,517 | 13,256 | 59,414 | 75,321 |
| Taxation paid | -350 | -1,341 | -2,226 | -1,164 | -1,500 | -4,000 | -4,745 |
| Depreciation | 198 | 690 | 1,497 | 1,772 | 4,500 | 4,500 | 4,500 |
| **Share-based payments** | 0 | 0 | 291 | 1,157 | 1,157 | 1,157 | 1,157 |
| Amortisation of intangibles | 4,030 | 10,714 | 7,897 | 9,661 | 6,092 | 3,129 | 1,531 |
| **Fair-value unwind on acquired loan book** | 5,456 | 8,342 | 11,985 | 7,678 | 4,291 | 0 | 0 |
| Loss on disposal of fixed assets | 51 | -363 | -416 | -35 | 0 | 0 | 0 |
| Decrease in inventories | 6 | 3 | 0 | 0 | 0 | 0 | 0 |
| Increase in amounts receivable from customers (net of FV) | -5,394 | -21,039 | -54,437 | -75,173 | -75,043 | -69,002 | -91,698 |
| Increase in receivables | -16,445 | -7,737 | -51 | 5,844 | -680 | 0 | -750 |
| Increase in other assets | | | | -241 | | | |
| Increase in payables | 19,078 | -6,952 | 1,000 | -4,132 | 2,000 | 2,000 | 2,000 |
| **Net cash inflow/(outflow) from op. activities** | **-9,532** | **-23,541** | **-37,000** | **-35,116** | **-45,927** | **-2,802** | **-12,684** |
| | | | | | | | |
| Cashflow from investing activities | | | | | | | |
| Net purchase of fixed assets | -341 | -3,514 | -4,931 | -5,915 | -7,000 | -4,500 | -4,500 |
| Purchase of subsidiaries | -81,111 | -230,784 | -16,442 | 0 | 0 | 0 | 0 |
| **Net cash outflow from investing activities** | **-81,452** | **-234,298** | **-21,373** | **-5,915** | **-7,000** | **-4,500** | **-4,500** |
| | | | | | | | |
| **Cashflows from financing activities** | | | | | | | |
| Net finance income | 70 | -3,484 | -7,974 | -14,121 | -19,169 | -32,380 | -37,980 |
| Share capital issues/purchases | 98,234 | 172,869 | -1,357 | -2,102 | 0 | 0 | 0 |
| Net proceeds from borrowing | 0 | 87,300 | 77,882 | 67,371 | 70,000 | 50,000 | 70,000 |
| Dividends | 0 | -951 | -4,439 | -7,177 | -8,425 | -10,532 | -12,872 |
| **Net cash inflow from financing activities** | 98,304 | 255,734 | 64,112 | 43,971 | 42,405 | 7,088 | 19,148 |
| **Net increase in cash and cash equivalents** | 7,320 | -2,105 | 5,739 | 2,940 | -10,522 | -214 | 1,964 |
| **Opening cash and cash equivalents** | 0 | 7,320 | 5,215 | 10,954 | 13,894 | 3,372 | 3,159 |
| **Closing cash and cash equivalents** | 7,320 | 5,215 | 10,954 | 13,894 | 3,372 | 3,159 | 5,122 |

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

# Valuation

Significant upside potential on our valuation assumptions and models

Our absolute valuation techniques imply average upside potential of 164%. This has increased sharply following the share price fall associated with the bid situation and further falls, which we attribute to the Woodford overhang. We note that NSF is on a lower rating compared with its peers.

**Summary of valuation approaches**

| | Implied price | Upside potential |
|---|---|---|
| Gordon Growth Model (GGM) | 92.1 | 142% |
| Discounted Dividend Model (DDM) | 108.8 | 186% |
| Average absolute measures | 100.5 | 164% |
| | | |
| Sum-of-the-Parts (SoTP) | 67.2 | 77% |

*Source: Hardman & Co Research*

## GGM

We detailed our assumptions in our initiation note, Carpe Diem, published on 11 November 2016. Our assumptions are given in the table below. The only change has been to increase the RoE by 1.5% to 31.5%, to reflect the reduction in equity under IFRS 9. This model is based off tangible equity and is unaffected by the goodwill writedown.

**GGM assumptions**

| | Base | +1% to RoE | +1% to CoE | +0.5% to G |
|---|---|---|---|---|
| RoE | 31.5% | 32.5% | 31.5% | 31.5% |
| CoE | 11% | 11% | 12% | 11% |
| Growth in equity | 5.5% | 5.5% | 5.5% | 6% |
| P/BV (RoE-G)/(CoE-G) | 4.7 | 4.9 | 4.0 | 5.1 |
| Discount re near-term perf. | -10% | -10% | -10% | -10% |
| P/NAV (x) | 4.3 | 4.4 | 3.6 | 4.6 |
| NAV 2020E (£m) | 67.6 | 67.6 | 67.6 | 67.6 |
| **Valuation (£m)** | 287.4 | 298.5 | 243.2 | 310.1 |
| Variance (£m) | | 11.1 | -44.2 | 22.7 |
| **Valuation per share (p)** | 92.1 | 95.7 | 77.9 | 99.4 |

*Source: Hardman & Co Research*

## DDM

Our DDM now indicates a value of 109p, unchanged from our last report, as there has been no change in our estimates.

## SoTP

We have cut the ratings for all the operational divisions, given what has happened to peers' share prices. On these assumptions, there is still 77% upside potential to the current price.

**SoTP valuation**

| Division | 2020E earnings (£000) | Multiple (x) | Value (£000) | Comment |
|---|---|---|---|---|
| ELD | 18,283 | 9.0 | 164,543 | Rating cut from 11x to 9x |
| GLD | 3,783 | 6.0 | 22,695 | Rating cut from 10x to 6x |
| LAH | 7,935 | 8.0 | 63,476 | Rating cut from 9x to 8x |
| Central | -5,115 | 8.0 | -40,920 | Unchanged |
| Group | 24,885 | 8.4 | 209,794 | |
| **Value per share (p)** | | | 67.2 | |

*Source: Hardman & Co Research*

# Disclaimer

*Hardman & Co provides professional independent research services and all information used in the publication of this report has been compiled from publicly available sources that are believed to be reliable. However, no guarantee, warranty or representation, express or implied, can be given by Hardman & Co as to the accuracy, adequacy or completeness of the information contained in this research and they are not responsible for any errors or omissions or results obtained from use of such information. Neither Hardman & Co, nor any affiliates, officers, directors or employees accept any liability or responsibility in respect of the information which is subject to change without notice and may only be correct at the stated date of their issue, except in the case of gross negligence, fraud or wilful misconduct. In no event will Hardman & Co, its affiliates or any such parties be liable to you for any direct, special, indirect, consequential, incidental damages or any other damages of any kind even if Hardman & Co has been advised of the possibility thereof.*

*This research has been prepared purely for information purposes, and nothing in this report should be construed as an offer, or the solicitation of an offer, to buy or sell any security, product, service or investment. The research reflects the objective views of the analyst(s) named on the front page and does not constitute investment advice. However, the companies or legal entities covered in this research may pay us a fixed fee in order for this research to be made available. A full list of companies or legal entities that have paid us for coverage within the past 12 months can be viewed at http://www.hardmanandco.com/legals/research-disclosures. Hardman may provide other investment banking services to the companies or legal entities mentioned in this report.*

*Hardman & Co has a personal dealing policy which restricts staff and consultants' dealing in shares, bonds or other related instruments of companies or legal entities which pay Hardman & Co for any services, including research. No Hardman & Co staff, consultants or officers are employed or engaged by the companies or legal entities covered by this document in any capacity other than through Hardman & Co.*

*Hardman & Co does not buy or sell shares, either for their own account or for other parties and neither do they undertake investment business. We may provide investment banking services to corporate clients. Hardman & Co does not make recommendations. Accordingly, they do not publish records of their past recommendations. Where a Fair Value price is given in a research note, such as a DCF or peer comparison, this is the theoretical result of a study of a range of possible outcomes, and not a forecast of a likely share price. Hardman & Co may publish further notes on these securities, companies and legal entities but has no scheduled commitment and may cease to follow these securities, companies and legal entities without notice.*

*The information provided in this document is not intended for distribution to, or use by, any person or entity in any jurisdiction or country where such distribution or use would be contrary to law or regulation or which would subject Hardman & Co or its affiliates to any registration requirement within such jurisdiction or country.*

*Some or all alternative investments may not be suitable for certain investors. Investments in small and mid-cap corporations and foreign entities are speculative and involve a high degree of risk. An investor could lose all or a substantial amount of his or her investment. Investments may be leveraged and performance may be volatile; they may have high fees and expenses that reduce returns. Securities or legal entities mentioned in this document may not be suitable or appropriate for all investors. Where this document refers to a particular tax treatment, the tax treatment will depend on each investor's particular circumstances and may be subject to future change. Each investor's particular needs, investment objectives and financial situation were not taken into account in the preparation of this document and the material contained herein. Each investor must make his or her own independent decisions and obtain their own independent advice regarding any information, projects, securities, tax treatment or financial instruments mentioned herein. The fact that Hardman & Co has made available through this document various information constitutes neither a recommendation to enter into a particular transaction nor a representation that any financial instrument is suitable or appropriate for you. Each investor should consider whether an investment strategy of the purchase or sale of any product or security is appropriate for them in the light of their investment needs, objectives and financial circumstances.*

*This document constitutes a 'financial promotion' for the purposes of section 21 Financial Services and Markets Act 2000 (United Kingdom) ('FSMA') and accordingly has been approved by Capital Markets Strategy Ltd which is authorised and regulated by the Financial Conduct Authority (FCA).*



*(Disclaimer Version 8 – Effective from August 2018)*

# Status of Hardman & Co's research under MiFID II

*Some professional investors, who are subject to the new MiFID II rules from 3rd January, may be unclear about the status of Hardman & Co research and, specifically, whether it can be accepted without a commercial arrangement. Hardman & Co's research is paid for by the companies, legal entities and issuers about which we write and, as such, falls within the scope of 'minor non-monetary benefits', as defined in the Markets in Financial Instruments Directive II.*

*In particular, Article 12(3) of the Directive states: 'The following benefits shall qualify as acceptable minor non-monetary benefits only if they are: (b) 'written material from a third party that is commissioned and paid for by a corporate issuer or potential issuer to promote a new issuance by the company, or where the third party firm is contractually engaged and paid by the issuer to produce such material on an ongoing basis, provided that the relationship is clearly disclosed in the material and that the material is made available at the same time to any investment firms wishing to receive it or to the general public…'*

*The fact that Hardman & Co is commissioned to write the research is disclosed in the disclaimer, and the research is widely available.*

*The full detail is on page 26 of the full directive, which can be accessed here: http://ec.europa.eu/finance/docs/level-2-measures/mifid-delegated-regulation-2016-2031.pdf*

*In addition, it should be noted that MiFID II's main aim is to ensure transparency in the relationship between fund managers and brokers/suppliers, and eliminate what is termed 'inducement', whereby free research is provided to fund managers to encourage them to deal with the broker. Hardman & Co is not inducing the reader of our research to trade through us, since we do not deal in any security or legal entity.*

research@hardmanandco.com

35 New Broad Street
London
EC2M 1NH

+44(0)20 7194 7622

www.hardmanandco.com