Financials

Source: Refinitv

Market data

EPIC/TKR	**NSF**
Price (p)	26.2
12m High (p)	70.0
12m Low (p)	26.2
Shares (m)	312.4
Mkt Cap (£m)	82
EV (£m)	334
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
Chairman	Charles Gregson

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Key shareholders

Invesco	26.9%
Alchemy	19.3%
Aberforth Partners	17.0%
Marathon Asset Mgt.	11.5%
Tosca Fund	3.9%

Diary

Nov'19	Trading statement
Dec'19	Capital markets day

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NON-STANDARD FINANCE PLC

Franchises now built, profits to follow

NSF has reached the turning point in its strategic development. Having invested heavily in infrastructure, controls and people, it has built a substantial franchise. The pace of investment will now slow, at the same time as payback from historical investment becomes more visible. Lending has been curtailed to match the economic outlook. Despite this, we expect profit growth to accelerate sharply, driven by wider jaws between revenue and costs in the branch business and guarantor loans, efficiency improvements in home collect, and improving credit. NSF looks likely to secure additional lower-cost funding; we expect funding costs to relatively reduce, and the funding mix to improve.

- **Strategy:** After the aborted bid for Provident Financial, NSF is now all about delivery of profit growth from its market-leading franchises in branch-based lending, guarantor loans and home collect. We expect strong loan growth driving revenue, costs to rise at a much slower pace and well-controlled credit quality.

- **Outlook:** The 15 November trading statement saw 2020/2021 estimates cut by 16%-18% due in large part to an accounting assumption change and tighter loan growth. Investors should not lose track of the fact that the 2021 adjusted profit before tax is still 2x the 2018 level. Exceptionally strong real growth is still expected.

- **Valuation:** Our absolute approaches now indicate a range of 86p-97p. On the current price, the 2021 prospective PE is 3.3x (2020E 4.3x) for a business whose impairment provisioning already significantly reflects a downside scenario. The yield is now double-digit.

- **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 6.4x 2019E P/E and getting a 11.5% yield.

Financial summary and valuation

Year-end Dec (£000)	2017	2018	2019E	2020E	2021E
Reported rev./other inc.	121,682	168,128	184,013	202,836	224,607
Total impairments	-28,795	-42,688	-47,513	-51,707	-55,623
Total costs	-69,203	-89,564	-93,281	-97,298	-106,137
Normalised EBIT	23,684	35,876	43,219	53,832	62,847
Adjusted PBT	13,203	14,769	15,822	24,341	29,881
Statutory PBT	-13,021	-1,590	-19,835	21,212	28,350
Pro-forma EPS (p)	3.44	3.70	4.10	6.43	7.94
DPS (p)	2.20	2.60	3.00	3.20	3.95
P/adjusted earnings (x)	7.6	7.1	6.4	4.3	3.3
P/BV (x)	0.4	0.4	0.4	0.4	0.4
P/tangible book (x)	1.1	1.4	1.8	1.4	1.1
Dividend yield	8.4%	9.9%	11.5%	11.8%	15.1%

Source: NSF, Hardman & Co Research; all years after 2017 are on IFRS 9 basis

Executive summary

Growth expectations

Growth forecasts

£m	2018 (actual)	1H'19 actual	2H'19 implied	2019E	2020E	2021E
Adj. op profit	35.9	19.5	23.7	43.2	52.8	62.8
Finance costs	-21.1	-13.2	-14.2	-27.4	-29.5	-33.0
Adjusted PBT	14.8	6.3	9.5	15.8	23.3	29.9
Adjusted EPS (p)	3.7	1.64	2.46	4.10	6.15	7.94
DPS (p)	2.6	0.7	2.3	3.0	3.1	3.95

Source: NSF, Hardman & Co

Our 2021E profits are ca.2x 2018 level despite recent downgrade

Our estimates indicate 2021 PBT, and EPS will be more than double the 2018 levels. The forecasts have seen a ca.15%-20% reduction since the August results (see trading statement section below) but the changes do not alter the fundamental message of substantial profit growth, which the valuation does not reflect.

Levers for growth

We detail below the levers that we believe NSF has at its disposal to grow.

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

We are forecasting profits for the Everyday Loans (ELD) branch business 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 in the second half over the 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 during 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 end 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 at the half year as the take-up of refinanced 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 the political climate), 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). 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 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 onboarding of significant numbers of PFG agents, 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.

Key takeaways: results and trading statement

The key takeaways were:

Revenue +12%, impairments and costs up 8% and 6%, respectively

Interim results to August: normalised revenue was up 12% to £88.3m, impairments rose 8% to £22m, costs increased by 6% to £47.3m. With costs and impairments rising significantly more slowly than revenue, normalised operating profit was up 28% to £19.5m. Normalised PBT was up 12% to £6.3m (2018: £5.6m), as finance costs rose 38%. There was an exceptional charge of £25.3m, which included fees and costs associated with the offer for PFG of £12.7m and an unexpected LAH goodwill impairment of £12.5m. The goodwill write-down was driven by falling peer share price ratings and came despite the normalised operating profit being up 110%. The total net loan book was up 26%.

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

Trading statement: slower loan growth in guarantor loans and branch-based lending as scorecards tightened. Also, more conservative accounting assumptions have increased impairments.

November Trading statement: There were two key takeaways driving the 10%-13% shortfall to 2019 consensus estimates. First, volume growth is lower in guarantor loans – this was largely down to some temporary operational disruption at the division's guarantor loans operations in Bourne End Buckinghamshire. The company has not seen any slowdown in demand for the guarantor loans product. Across branch-based lending and guarantor loans, there has been a clear focus on maintaining credit quality, which in conjunction with a reduction in the rate of loan book growth means that the group is well positioned ahead of any potential recession or financial downturn. Secondly, IFRS9 impairment calculations include a weighting to different economic scenarios. NSF has changed its weightings from 85% base, 10% downside and 5% upside to 50% base and 50% downside. This more conservative approach reflects current economic uncertainty and means that NSF is more in line with/more conservative than many of its peers. With no change in current customer behaviour, the more conservative approach results in higher impairments. Such a view is likely to be maintained until there is more economic clarity or until there is evidence of better-than-expected collections performance.

Normalised profit and loss

Year-end Dec (£000)	2016	2017	2018*	2019*	2020E *	2021E*
Business interest income	94,674	119,756	166,502	183,013	201,836	223,607
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	184,013	202,836	224,607
Impairments	-26,155	-28,795	-42,688	-47,513	-51,707	-55,623
Gross profit	**68,969**	**92,887**	**125,440**	**136,500**	**151,130**	**168,984**
Administration expenses	-50,290	-69,203	-89,564	-93,281	-98,358	-106,137
Amortisation of intangibles	0	0	0	-4,500	-4,500	-4,500
Operating profit	**18,679**	**23,684**	**35,876**	**43,219**	**52,772**	**62,847**
EBITDA	**19,369**	**25,181**	**37,648**	**47,719**	**57,272**	**67,347**
Net finance (cost)/income	-5,623	-10,481	-21,107	-27,397	-29,490	-32,965
PBT	**13,056**	**13,203**	**14,769**	**15,822**	**23,281**	**29,881**
Income tax	-2,688	-2,313	-3,197	-3,006	-4,074	-5,080
PAT from continuing operations	**10,368**	**10,890**	**11,572**	**12,816**	**19,207**	**24,801**

*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**	**358,005**	**404,476**	**463,781**
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	24,801	21,240	20,839
Total current assets	46,010	195,337	280,601	332,475	387,806	430,715	490,371
Total assets	**102,023**	**350,278**	**447,908**	**494,538**	**547,363**	**586,398**	**642,906**
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	-	-	-	(1,125)	(2,329)	(2,654)
Total current liabilities	16,860	8,005	10,353	17,242	19,776	20,572	22,247
Net current (liabilities)/assets	*29,150*	*187,332*	*270,248*	*315,233*	368,030	410,143	468,123
Non-current liabilities							
Financial liabilities – borrowings	-	87,300	199,316	266,322	336,322	366,322	406,322
Lease liability					9,000	9,000	9,000
Deferred tax	-	5,890	4,996	252		-	(0)
Total non-current liabilities	**-**	**93,190**	**204,312**	**266,574**	**345,322**	**375,322**	**415,322**
Total liabilities	**16,860**	**101,195**	**214,665**	**283,816**	**365,098**	**395,894**	**437,569**
Net assets	**85,163**	**249,083**	**233,243**	**210,723**	**182,265**	**190,504**	**205,336**

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

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