HARDMAN & CO.

15 January 2020

MORSES CLUB PLC

Value-added, customer-driven expansion from core

MCL's recent results (see our 21 October note, *Interim FY'20 results: steady core, deal upside*) highlighted the strength of Home Collect (HCC). The division showed operational efficiency improvements, the appropriate use of technology and improving credit. It also generated double-digit underlying profit growth, despite a stable market and without compromising the agent-driven model. In this note, we explore MCL's strategy to expand from this strong core business. The strategy is driven by extensive customer surveys, and could see a doubling in both the number of customers and the share of wallet over the medium term. Investment is being paced to balance short- and long-term profitability.

- **Strategy:** Over many years, MCL has surveyed its customers to find out what products they want and how they want them delivered. From this, MCL has identified opportunities to retain more customers, acquire new ones and target 59% of the customer wallet against a current proposition that serves 27%.

- **Outlook:** MCL has stretching targets for the online lending business, with guidance of pre-tax, pre-interest profits in the range of £2m-£4m for FY'22 (likely pre-tax £1m-£2m). The current account business opportunities are incremental to this. Both acquisitions require integration, which is the FY'20 primary focus.

- **Valuation:** We detailed our valuation approaches and sensitivities in our initiation note of 2 February 2017, *Bringing home collect into the 21st century*. The range in absolute valuation methodologies is now 167p to 197p (unchanged). Superior medium-term growth from new businesses provides further upside potential.

- **Risks:** Credit risk is high (albeit inflated by accounting rules), but MCL adopts the right approach to affordability and credit assessment. Regulatory risk is a factor, although high customer satisfaction suggests a limited need for change. MCL was the first major HCC company to receive full FCA authorisation.

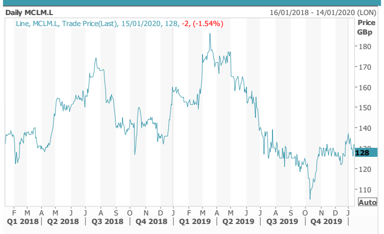
- **Investment summary:** MCL is operating in an attractive market, and it has a dual-fold strategy that should deliver an improved performance from existing businesses and new growth options. It conservatively manages risk and compliance, especially in new areas. The self-employed agent network is a competitive advantage in credit management. The valuation appears an anomaly. We forecast a 6.3% FY'20 dividend yield, with cover of 1.6x (adjusted earnings).

Financial summary and valuation

Year-end Feb (£m)	2016	2017	2018*	2019*	2020E*	2021E*
Reported revenue	90.6	99.6	110.4	117.0	136.5	151.7
Total impairments	-18.8	-24.3	-24.7	-26.2	-30.0	-40.2
Total costs	-53.4	-56.7	-65.6	-67.1	-83.6	-85.1
EBITDA	19.3	19.9	20.1	23.7	22.9	26.4
Adjusted PBT	16.8	17.7	18.6	22.0	19.9	22.9
Statutory PBT	10.4	11.2	15.5	20.2	16.5	21.5
Statutory EPS (p)	6.1	6.6	9.7	12.5	10.3	13.6
Adj. EPS (p)	10.2	10.8	11.4	13.6	12.2	14.0
P/adj. earnings (x)	12.7	12.0	11.5	9.6	10.7	9.3
P/BV (x)	3.0	2.7	2.5	2.4	2.3	2.1
P/tangible book (x)	3.7	3.3	2.9	2.8	3.1	2.8
Dividend yield	N/M	4.9%	5.4%	6.0%	6.3%	7.7%

IFRS9 basis (2018 pro-forma); Source: Hardman & Co Research

Financials



Source: Refinitiv

Market data

EPIC/TKR	**MCL**
Price (p)	130.0
12m High (p)	186.0
12m Low (p)	105.0
Shares (m)	131.0
Mkt Cap (£m)	170.2
EV (£m)	185.5
Free Float*	60%
Market	AIM

**As defined by AIM Rule 26*

Description

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

Company information

CEO	Paul Smith
CFO	Andrew Hayward
Non-ex. Ch.	Stephen Karle

Tel: +44 330 045 0719

www. morsesclubplc.com

Key shareholders

Hay Wain	36.41%
Premier Miton Group	13.71%
J.O. Hambro	6.90%
Artemis Inv. Mgt.	5.82%
Legal & General	4.01%
Canaccord Genuity	3.49%

Diary

End-Feb'20	Trading statement

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How the strategy was formulated

Strategy driven by direct customer feedback on what customers want and how they want it delivered

Some companies formulate their strategy from the CEO's perception of what customers may want. Others, like MCL, dive deep into the customers' actual preferences through surveys, feedback and behavioural analysis. We believe the latter is a more robust approach to setting a strategy to meet customer demand. MCL's CEO, in the recent results meeting, advised that the proposition now being advanced was derived from more than 100 surveys over several years. While the core HCC business has many attractions, it is clear that there is significant potential to retain and win more customers, and serve a greater part of their wallet than offering this product in isolation. We note that, in its recent Capital Markets day, Provident Financial reported many of the same customer demands, while outlining its approach to Provident Direct.

What MCL has learnt about its customers

	%
Customer satisfaction	
Good customer outcomes (includes 50% who will not be re-served by MCL to reduce any bias that the survey could be completed by people wanting a new loan)	97
Customer satisfaction (monthly survey with anonymised returns)	97
Customer satisfaction with portal	81
Choice of channel	
Visits to website from mobile phones (hence a mobile first strategy)	80
SMS as marketing preference	86
Customers who have paid remotely (i.e. by phone or portal)	57
Customers who have made cashless payments (i.e. includes Chip and Pin on doorstep)	61
% of transactions by volume that are now cashless	42
Customers with valid email accounts (2018: 45%)	66
Product preference	
Number of customers with Morses Club Card (end-August)	33k
Number of customers using portal (end-September)	40k+
Proportion of users requesting credit through portal	68
Customers interested in a Morses Club current account	51

Source: Hardman & Co Research

In addition to new initiatives detailed below, MCL, in its core HCC customer base, has a number of programmes already in place to deliver on these customer preferences:

- The Club Card, at end-August 2019, had 33k users and loan balances of £15.9m (up from 27k customers and balances of £13.1m at end-February 2019). The card allows customers access to pay on the internet and so get better-priced deals. It provides MCL with information of spending habits (important for credit), as well as building customer loyalty.

Customer portal will see whole opportunity and key development – being sold by agents whose buy-in is shown by rapid growth in portal user numbers

- The customer portal is an important part of the strategy. It i) provides customers with information regarding their account balance, payment history and MCC account, ii) enables customers to see their eligibility for further credit at any time, and iii) will offer content and rewards from third parties. The e-money product is being rolled out this financial year, and the plan is to fully integrate this into the customer portal. It will thus offer customers ease of administration, credit products, banking products and access to discounts they would not otherwise be able to see. MCL plans to monetise the business primarily through the credit products. It expects to earn some income from third parties for hosting their products, but these may be regarded as covering costs, rather than profits.

Opportunity is significant

We see the following key opportunities for MCL.

Better penetration of customer wallet. Can now serve 59% of existing customer base wallet compared with 27% in HCC alone.

MCL advises[1] that, for HCC customers, home collect is, on average, only 27% of their total debt. Customers additionally hold nearly 20% in credit cards and overdrafts, 11% in unsecured personal loans, a couple of percent in high-cost, short-term credit, and the balance in things like store cards, catalogue debt, motor finance, etc. The expanded product and distribution range now offered is believed to serve 59% of the customer wallet, compared with 27% in HCC alone.

Better retention of customers. Current movers represent ca.12% p.a. of customer base.

The HCC market is very fluid, with many customers improving their finances every year and so no longer needing HCC; this is broadly offset by those falling back into the market for such debt, having had a better credit profile before. For MCL, around 40,000 customers (ca.20%) leave every year, although, over time, around 16,000 of these will ultimately return to the company for credit at some future date. While some of the 24,000 permanent leavers no longer need credit, the vast majority take credit from other providers at a lower cost, as their credit records have improved. Having a range of service options is also important for a variety of other reasons (customers may not want to be seen as needing HCC, or they or the agent may move, etc). Retaining a proportion of such customers could be material – they represent ca.12% of the base in a market that has had broadly stable customer numbers for many years.

Portal should also help retention

MCL will be getting closer to customers through the portal. *Inter alia*, this will offer non-credit products at discounted prices from third-party providers. By allowing its customers access to what is, effectively, MCL's bulk-buyer power, it will not only generate significant behavioural data but will also align the customer with MCL.

Winning new customers. New lines already account for 19% of the total customer base, and organic growth targets take this to around half the customer base in FY'21.

Having online lending opens up an entirely new customer base. Delivering on its plans means that MCL is targeting ca.200k new loans to this channel in FY'21. While most loans are of three to six months' duration (and with lower lifetime profitability than an HCC relationship), the pool of customers will expand significantly. It is worth noting that, on acquisition of the online lending business (26 February 2019), there were 49k customers; this reduced to ca.36k at end-August, as MCL withdrew payday-type products and was not fully operational because the IT systems were being migrated onto the MCL platform. Also, the acquisition of U Holdings added ca.16k online current account customers. At the end of August, HCC had 224k customers, and the new lines already account for 19% of the total customer base.

While we noted an element of short-term noise in the 1HFY'20 results, we believe the targets below confirm that the new businesses should add value to shareholders.

Online lending target is monthly run-rate profitability by end-FY'20 and 200k customers by end-FY'21, with strong profitability thereafter

- In online lending: i) to deliver breakeven on a monthly basis by the end of FY'20; ii) to generate profits into FY'21, such that there will be a positive return after the cost of funding off the back of ca.200k short-term loans p.a. (49k customers on acquisition in February 2019); and iii) to deliver profit before interest and tax from FY'22 and beyond of between £2m and £4m. We believe the post-interest profit is likely to be £1m-£2m for FY'22, adding 5%-10% to FY'19 adjusted pre-tax profits of £22m.

In current account business, aiming for profitability in FY'21

- In current account: in the 24 June 2019 acquisition announcement, MCL advised, "post integration and restructuring, the losses incurred in the remainder of FY20 will be in the range of £1.4m to £1.7m. Management are confident that the acquisition will be earnings accretive thereafter." We understand that these remain management's expectations, including any buy-out consideration.

[1] Sourced: FS17/2: High-cost credit and review of the high-cost short-term credit price cap

New business lines

Online lending

Online lending capacity transformed by CTL acquisition

As we detailed in our note, Home collect and online lending acquisitions, published on 15 March 2019, MCL's online lending operations were transformed by the acquisition of CURO Transatlantic (CTL) for a consideration of ca.£8m. This was updated in our 21 October note, Interim FY'20 results: steady core, deal upside.

In summary:

Gross receivables already seen cash collection in excess of £11m vs. £8m consideration

MCL has acquired i) gross receivables that, to date, have seen cash collections of £11m, against the consideration of £8m, ii) all the existing infrastructure of CTL, and iii) a call centre and online lending capabilities. Not included in the purchase were i) more than 90% of customers who could be considered higher-risk, ii) any mis-selling liability for historical business activity, iii) the potentially toxic brand, Wage Day Advance, and iv) Juo Loans (set up in 2017 to offer guarantor loans – but very few were written).

Stretching growth target credible given what the business has delivered in the past

We believe the key considerations for whether the renewed platform can deliver the growth in loans (as noted, MCL targets 200k loans p.a. by end-February 2021, vs. 49k customers on acquisition in February 2019) and profits are as follows: i) historically, CTL did deliver very strong growth in this area; ii) the acquired analytics have been based on huge datasets of customers; iii) intermediaries are always looking for new suppliers of credit; iv) the potential market is huge; v) we believe that, if economic conditions weaken, a number of peripheral players will withdraw; and vi) the redress for historical mis-selling is likely to put pressure on some other lenders in the same way as it did on CTL.

Target pre-interest profit of £2m-£4m in FY'21

Delivering MCL's targets will be challenging. The conservative nature of the company is such that we do not believe it would put into the market expectations for 200k new loans p.a. by end-February 2021 without having a high degree of confidence that it would achieve them.

U Holdings Limited (acquisition announced 24 June 2019)

On 24 June, MCL announced the acquisition of U Holdings Limited (which trades as U Account) for an initial cash consideration of £5.8m, financed from existing MCL cash and debt facilities, and a deferred consideration of up to £5m, payable in cash over the next four years to February 2023, conditional upon certain net profit criteria being met.

Based in Sheffield, U Account is a leading digital current account provider. As well as providing card services with its current accounts through contactless Mastercard debit cards, U Account offers in-app features and functionality to help customers manage their finances more effectively. U Account focuses on customers who are underserved by traditional banks. MCL has acquired U Account's technology and e-money banking platform, as well as its 20,000 current active customers.

U Holdings on track. Losses were expected this financial year, with earnings accretion expected thereafter.

While U Account has historically been loss-making (in the year-ended 28 February 2019, U Account – then trading under the ownership of Ffrees Family Finance Ltd – generated unaudited revenue of £1.7m and an unaudited operating loss of £4.0m), in its June announcement, management said it expected that, post-integration and restructuring, the losses incurred in the remainder of FY20 would be in the range of £1.4m to £1.7m. Management was confident that the acquisition would be earnings-accretive thereafter.

Impact on Group

Fundamental approach is low-risk, carefully considered expansion in areas of competitive advantage and known customer demand

For some lenders in the sub-prime space, expanding beyond their historically profitable core businesses has been an unmitigated disaster. However, MCL's approach is fundamentally different. The core business model is unchanged and is a cash/profit generator that can fund new business lines. The new businesses have been driven by known customer demand. The pace of investment is measured with a clear pathway to profitability in the near term and significant profitability over the medium term. MCL has not "bet the bank", but rather carefully and considerately targeted growth in a risk-averse manner.

Core HCC business

New business lines and technology do not change fundamental self-employed agent model

MCL has been clear on a number of issues, which give us some comfort:

- The core agent/customer relationship is unchanged. The knowledge and insight that agents bring to HCC are invaluable in assessing credit in that market.
- Technology means that this relationship can be enhanced and allow a much more efficient delivery of service. Taking remote payments means agents can visit less frequently, but this does not mean that the agent is not close to the customer.
- Agent buy-in is critical to limiting disruption. The adoption of the portal is driven by agents recommending its use to customers – not some centralised, remote campaign.
- Agent income rises when technology allows agents to do their jobs more efficiently.

Improved proposition for self-employed agents who have actively bought into the strategy

At heart, we believe the new initiatives can only improve the core business, and we have not noted any of the disruption seen at some of MCL's competitors, who have tried to grow too quickly or have forced a change in the model on self-employed agents. Retaining more customers for longer periods can only help income.

As we outlined in our 21 October note, Interim FY'20 results: steady core, deal upside, the integration of the new products, channels and distribution should enable MCL to operationally improve efficiency. It will also allow differentiated agent remuneration (i.e. less for non-cash transactions), while still allowing agents to increase their income for the same amount of hours.

Pace of investment

118118 Money, Likely Loans and Satsuma reported combined loss of £131m in their start-up phases (2013-16), whereas MCL has seen ca.£7m cumulative losses and clear path to profitability

We believe that the initial share price weakness on the day of MCL's results was driven primarily by a worse-than-expected performance in the new business lines. The acquired businesses' performances required incremental investment, and initial lending appears slightly behind track, but these issues are short-term, and management has reiterated its stretching guidance for FY'20 and FY'21. With management on the road and re-confirming its plans, the share price has recovered. Acquired growth, with integration issues, new technologies and marketing requirements, introduces less certainty into forecasts and thus the potential for noise, but it is important to bear in mind the overall culture of the group. As we highlighted on page 9 of our note, Quality street, published on 19 July 2018, 118118 Money, Likely Loans and Satsuma reported a combined loss of £131m in their start-up phases (2013-16), whereas MCL has seen ca.£7m cumulative losses (including £1.2m of acquisition-related adjustments taken in 1H'FY20). There are also clear targets to deliver monthly run-rate profitability in the near future (end-FY'20 for online lending) and significant profits on a three-year outlook.

Financials and valuation

We have not changed our estimates or valuation with this report.

Profit & Loss							
Year-end Feb (£m)	**2015**	**2016**	**2017**	**2018***	**2019***	**2020E***	**2021E***
Existing operations	22.5	84.7	96.2	110.4	116.8	118.0	150.7
Acquisitions during period	67.4	5.8	3.3		0.2	18.5	1.0
Total revenue	**89.9**	**90.6**	**99.6**	**110.4**	**117.0**	**136.5**	**151.7**
Impairment charge	-22.9	-18.8	-24.3	-24.7	-26.2	-30.0	-40.2
Ongoing agent commission	-17.7	-18.5	-21.2	-23.6	-26.6	-27.6	-27.6
Temporary agent commissions		-0.7	-1.2	-4.4	-1.7	-0.5	-0.3
Gross profit	**49.3**	**52.6**	**52.9**	**57.7**	**62.5**	**78.4**	**83.6**
Administration expenses (pre-excep. and intang. amort.)	-32.8	-33.3	-33.0	-37.6	-38.8	-55.5	-57.2
Depreciation (incl. goodwill impairment, amort. of IT)	-0.9	-0.9	-1.3				
Operating profit (pre-excep. and amort.)	15.6	18.4	18.6	20.1	23.7	22.9	26.4
Adjusted financing costs	-2.6	-1.6	-0.9	-1.5	-1.7	-3.0	-3.5
Adjusted PBT	**13.0**	**16.8**	**17.7**	**18.6**	**22.0**	**19.9**	**22.9**
Income tax	-2.7	-3.5	-3.7	-3.9	-4.4	-4.0	-4.6
Adjusted PAT	**10.3**	**13.3**	**14.0**	**14.7**	**17.6**	**15.9**	**18.3**

**IFRS9 basis (2018 pro-forma basis); Source: MCL, Hardman & Co Research*

Balance sheet							
@ end-Feb (£000)	**2015**	**2016**	**2017**	**2018**	**2019***	**2020E***	**2021E***
Goodwill	294	1,326	2,834	2,834	3,501	13,281	13,947
Intangible assets	10,391	9,052	7,058	5,520	6,221	6,148	5,079
Property, plant and equipment	936	1,182	763	822	378	4,377	4,377
Amounts receivable from customers	1,507	679	395	265	206	100	100
Deferred tax	0	0	0	0	958	920	920
Total non-current assets	13,128	12,239	11,050	9,441	11,264	24,826	24,423
Current assets							
Receivables	53,976	56,152	60,833	72,563	72,840	85,000	98,500
Trade/other receivables, incl. stock	26,216	1,554	2,019	2,039	2,369	3,000	3,000
Cash and cash equivalents	8,650	3,755	3,985	4,868	7,893	1,777	3,444
Total current assets	88,842	61,461	66,837	79,470	83,102	89,777	104,944
Total assets	101,970	73,700	77,887	88,911	94,366	114,604	129,367
Current liabilities							
Trade and other payables	-3,274	-7,452	-5,892	-6,695	-1,830	-2,830	-3,830
Tax payable					-7,482	-7,482	-7,482
Lease liabilities						-3,519	-3,519
Total current liabilities	-3,274	-7,452	-5,892	-6,695	-9,312	-13,831	-14,831
Net current (liabilities)/assets	85,568	54,009	60,945	72,775	73,790	75,946	90,113
Non-current liabilities							
Financial liabilities – borrowings	0	-9,000	-10,000	-15,552	-14,075	-26,000	-35,000
Deferred tax	-2,614	-1,879	-617	-144	0	0	0
Total non-current liabilities	-2,614	-10,879	-10,617	-15,696	-14,075	-26,000	-35,000
Total liabilities	-5,888	-18,331	-16,509	-22,391	-23,387	-39,831	-49,831
Net assets	96,082	55,369	61,378	66,520	70,979	74,773	79,536

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

We detailed all the assumptions used in our valuation methodologies in our note, Bringing home collect into the 21st century, published on 2 February 2017, and updated them in our 21 October note, Interim FY'20 results: steady core, deal upside.

Summary of different valuation techniques		
	Implied price (p)	**Upside potential**
GGM	196.6	51%
DDM	166.7	28%
Average absolute measures	**181.6**	**40%**

Source: Hardman & Co Research

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(Disclaimer Version 8 – Effective from August 2018)

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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

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