16 May 2018

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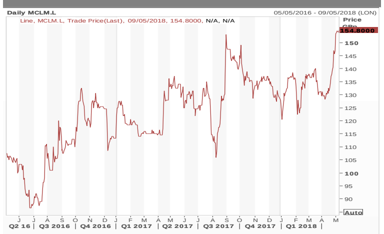
Financial Services



Source: Eikon Thomson Reuters

Market data

EPIC/TKR	**MCL**
Price (p)	152.75
12m High (p)	154.8
12m Low (p)	105.5
Shares (m)	129.5
Mkt Cap (£m)	197.8
EV (£m)	177.4
Free Float*	46%
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

Non-Ex Chr	Stephen Karle
CEO	Paul Smith
CFO	Andy Thomson

Tel: +44 (0)330 045 0719
www. morsesclubplc.com

Key shareholders (28 Feb 2018)

Hay wain	36.82%
Woodford Inv. Mgt.	8.79%
Miton Asset Mgt.	7.47%
Artemis Inv. Mgt.	6.95%
Majedie Asset Mgt.	5.34%
JO Hambro	5.32%
Blackrock	3.03%

Next event

Late June	AGM
Late August	Trading update
October	Interim results

Analysts

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Morses Club

FY18: carefully controlled, sustainable growth

The FY18 results saw adjusted pre-tax profits £1m and statutory profits £2.7m ahead of our expectations. MCL has focused resources on optimising the potential from the market leader's self-inflicted woes and so increased its agent franchise by over 20%, adding high-quality customers. This focus meant that, despite the strong lending growth, impairments as a percentage of revenue fell in 2H on 1H. Historical conservative provisioning sees the conversion to IFRS9 having a much smaller impact on receivables than peers. New business streams are being introduced to continue growth. Our range of valuation methodologies is currently 171-197p.

- **FY18 results**: Revenue grew 17%. Impairments rose as a percentage of revenue (to 26.1% from 24.4% in FY17) but were lower in 2HFY18 than 1HFY18. MCL has focused growth on the best-quality customers. Efficiency improved 6%. Excluding exceptionals and one-offs, underlying pre-tax profit rose 29%.

- **Outlook:** The results confirmed MCL's strategy to deliver sustainable growth. There is upside from the agents hired in FY18, and Morses Club Card has grown (Feb 2018: 21k customers, £10.6m loan balances, vs. Feb 2017: £10k, £3.9m). New online portal products should help customer retention and acquisitions.

- **Valuation:** We detailed a range of valuation approaches and sensitivities in our note, Bringing home collect into the 21st century, and do so again in the section below. Both the higher earnings forecasts and equity see an increase in our valuation, with the range now 171p to 197p (average 184p).

- **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 get 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. MCL conservatively manages risk and compliance, especially in new areas. The agent network is the competitive advantage over remote lenders. The valuation has material upside, and we forecast a 5.0% February 2019 dividend yield, with cover of 1.6x (adj. earnings).

Financial summary and valuation

Year-end Feb [£m?]	2015	2016	2017	2018	2019E*	2020E *
Reported revenue	89.9	90.6	99.6	116.6	119.0	127.2
Total impairments	-22.9	-18.8	-24.3	-30.4	-26.6	-27.6
Costs (inc temp com)	-51.4	-53.4	-56.7	-65.6	-69.2	-74.3
EBITDA	16.5	19.3	19.9	22.1	24.9	27.3
Adjusted PBT	**13.0**	**16.8**	**17.7**	**19.2**	**21.4**	**23.6**
Statutory PBT	58.5	21.2	11.2	16.1	18.2	20.7
Statutory EPS (p)	46.5	6.1	6.6	10.1	11.4	13.0
Adj. EPS (p)	8.1	10.2	10.8	11.7	13.2	14.6
P/adj. earnings (x)	18.8	14.9	14.2	13.0	11.6	10.5
P/BV (x)	2.1	3.6	3.2	3.0	2.9	2.7
P/tangible book	2.3	4.4	3.8	3.4	3.3	3.0
Dividend yield	n/m	n/m	4.2%	4.6%	5.0%	5.6%

*Source: Hardman & Co Research *IFRS9 basis*

FY18 results

Key messages

FY18 material beat to forecasts on revenue and credit…

…but also says a lot about culture of business

For us, the key message from these results is not just the financial beat in the period but also what it tells us about the business model and culture. It is a continuation of the messages from the first half, with management delivering on its promises to sustainably grow the business for the long term, with a clear focus on adding quality agents and customers. In particular, we note the following.

Growth carefully controlled

- It is no accident that the growth in territory builds (ca.25%) was less than the surplus operational capacity that MCL reported at end-FY17 (28% more customers could be managed). Not all new agents that applied to MCL were accepted (e.g. minimum two years of HCC experience required, super-agents with agents below them not accepted), and the total growth was such that the core HCC business did not face operational disruption.

Resources prioritised in areas of optimal return

- The opportunity from the PFG fall-out enhanced the agent network, and should produce revenue and profit streams that recur over many years. This is clearly a higher priority than building new, untested product lines, or acquiring books of business (some of this business is likely to be non-recurring, as it does not meet MCL's credit policies). Resources were focused on maximising returns.

Pilots of new products kept small

- In particular, the pace of investment in Dot Dot Loans has been kept very modest – until operational experience is gained.

Funding risk conservatively managed

- Facilities have been arranged well in advance of being needed.

Financial highlights

Net loans +19%, revenue +17%, customers numbers +6%. Quality of customers much improved.

- Revenue rose 17% to £116.6m (ca.£2.5m better than forecast). Total credit issued increased 21% to £174.3m, with the gross loan book up over 12%. The net loan book grew 19% (an improving quality seeing proportionately less need for provisions, so net lending grew faster than gross lending). Over the year, there was a 6% annual increase in customer numbers to 229k (this was down on the 233k at the interim stage, as management focused on quality customers). The proportion of loans attributable to the company's highest-tier customers increased by 18%. Higher revenue and loan book growth were generated despite the reduction in customer numbers from the interim stage.

2HFY18 impairments as % of revenue down on 1HFY18 despite strong growth

- Impairments as a percentage of revenue for the period were 26.1% (FY17: 24.4%, 1HFY18 26.6%, forecast 27.5%), keeping within the target range of 22-27%. A growing business is likely to see higher impairments to revenue, and we note that MCL is applying historical experience assumptions to new lending in its new territory builds. Actual customer behaviour indicates that this is likely to prove a conservative assumption. Accounting requirements also inflate the charge relative to cash losses and, again, the effect increases with a growing book. There is no sign of underlying credit strain.

6% efficiency improvement

- Administration costs as a percentage of income declined to 56.3% (FY17: 56.9%) – a 6% efficiency improvement on the prior year despite higher compliance costs. Total costs, including territory builds, were barely changed.

Underlying adjusted profits up 29%

- Adjusted profit before tax increased 8.5% to £19.2m. Excluding temporary agent costs and the Dot Dot investments, underlying PBT grew 29% to £24.4m. Reported profit before tax was £16.1m. Adjusted EPS was 11.7p, up 8.3%. Basic EPS was up 53% to 10.1p. The total FY18 dividend was 7.0p (FY17: 6.4p).

Company KPIs and targets

We detail below the key KPIs outlined by the company, and a couple of additional measures. The trends are virtually all positive.

Figure 1: Company KPIs and targets

KPI	2015	2016	2017	2018	1H18	Comment
Adjusted profit before tax (£m)	13.0	16.8	17.7	19.2	8.7	Underlying PBT £24.4m, up 29% on £18.9m in 2017, excl. temporary commissions and Dot Dot loan
Adjusted EPS (p)	8.1	10.2	10.8	11.7	5.3	8% growth
Admin. cost income ratio (%)	36.5	36.8	33.1	32.2	32.5	6% efficiency improvement
Return on equity (%)	21.5	27.9	27.2	26.5	26.1	Growth in equity above forecasts
Tangible equity/avg. recs. (%)	n/m	85.3	93.5	92.6	90.0	Gearing still very low
Number of customers	198,171	198,727	216,000	229,000	233,000	Fall on 1H given focus on quality
Number of agents	1,893	1,839	1,826	2,030	2,124	Books consolidated in 2H
Credit issued (£m)	112.0	122.2	144.1	174.4	82.3	21% growth
Impairment/revenue (%)	25.5	20.8	24.4	26.1	26.6	2H down on 1H, with focus on quality
Period-end receivables (£m)	55.6	56.8	61.2	72.8	65.2	12% growth in gross, 19% in net lending

Source: MCL, Hardman & Co Research

Impact on estimates

FY18 outperformance carried through to FY19. Individual P&L lines affected by IFRS9.

2018 saw revenue £2.5m ahead of forecasts, impairments £1m better and costs £2.2m worse. The net loan book was £1.1m ahead of our forecast, and its quality was better. We have carried forward these trends. The major driver to specific P&L line estimate revisions is the inclusion of the effect of IFRS9 (see later section), which reduces both income and impairments (small net negative only), and also equity.

Figure 2: Estimate changes

		2018			2019E*		2020E*
Year-end Feb	Old	Actual	% change	Old	New	% change	New FCST
Profit and loss £ms							
Reported revenue	114.1	116.6	2%	125.8	119.0	-5%	127.2
Total impairments	-31.4-	-30.4	-3%	-34.0	-26.6	-22%	-27.6
Total costs (inc. temp. comm.)	-63.4	-65.6	4%	-68.5	-69.2	1%	-74.3
EBITDA	20.7	22.1	6%	23.2	24.9	7%	27.3
Adjusted pre-tax	18.1	19.2	6%	19.9	21.4	7%	23.6
Statutory pre tax	13.4	16.1	20%	13.1	18.2	39%	20.7
Statutory EPS (p)	8.3	10.1	22%	8.2	11.4	39%	13.0
Adjusted EPS (p)	11.2	11.7	5%	12.3	13.2	7%	14.6
Dividend (p)	7.0	7.0	0%	7.7	7.7	0%	8.5
Balance sheet (£m)							
Amounts receivable	71.7	72.8	2%	82.3	74.0	-10%	79.0
Borrowings	13.5	15.6	15%	20.0	16.0	-20%	16.0
Equity	63.2	66.5	5%	63.9	67.6	6%	73.9

*Source: Hardman & Co Research *IFRS9 basis*

Strategy and outlook

Opportunity from market changes

Agent network up over 20%. Full period benefit will not be seen until FY19, with further growth opportunities.

Provident Financial Group (PFG) saw significant self-inflicted harm, as it changed a business model that had worked for 100 years, and then initially implemented the changes poorly. This has resulted in significant numbers of dissatisfied staff leaving PFG, with MCL cherry-picking those with the best cultural/economic fit. MCL reported over 600 agent and manager hires and a gross 463 (1HFY18: 411) territory builds, adding ca.25% to its agent network. The total number of agents increased from 1,826 to 2,030, with some natural attrition and the replacement of underperforming agents by new ones. It is worth noting that the new agents are already performing ahead of plan. There have been incremental temporary commissions and some build-out of infrastructure (MCL already had some spare capacity). The full period benefit from credit issued in FY18 will only be seen in FY19. Additionally, there is capacity for further good-quality growth from these agents in FY19, albeit probably not at the same rate as seen this year.

May see temporary blip-up in agent commission rate, as MCL retains good agents who are not yet at full run rate

We believe MCL has been conservative in its risk appetite, and this may lead to some agents taking a little longer to get to their full rate of customer numbers. Commission rates in FY19 may therefore be a little above the usual level, as MCL will want to keep performing agents on board, and the delay in reaching targeted numbers reflects MCL's risk appetite and not the competence of the agent. There is also the full-year impact, as most territory builds were in July/August 2017, so additional commission subsidies would be normal in H1/FY19.

Core business growth

Some opportunity for core business growth, as resources devoted back to this

With the focus on new PFG agents and their effective integration, MCL did not devote resources to normal growth to the degree that is has done historically. It did not, for example, make the same investment in web-based marketing. The company estimates that, in FY18, this reduced credit by £2.8m and customers by up to 3,500 (noting that the profit effect was offset by cost savings, lower impairments and better-quality business).

HCC acquisition opportunities re-appearing

No book acquisitions, but this is a temporary issue. MCL has reported an increase in reasonable approaches, which may lead to deals in FY19/20.

In FY18, MCL made no loan book acquisitions. The market had slowed in FY17, and it is likely that some smaller players will be waiting to see the fall-out from PFG before deciding to sell. They could reasonably be expecting more business and so a higher value. Additionally, MCL management has been more focused on effectively managing the short-term opportunity from the released PFG agents. Looking forward, MCL reports an increase in potential sellers approaching the company and encouraging MCL to do due diligence to establish an appropriate price. We believe that, as the regulator moves to more intensive supervision (rather than approval), there may be more opportunities – probably in FY19 /FY20. We do not expect there to be 400 HCC providers over the medium term.

New product areas

Morses Club card growth continuing, at ca.5k every six months

We note that Morses Club Cards in issue have risen steadily (ca.5k every six months to 21k in FY18 vs. 11k in FY17, and the gross loan book is now £10.6m (8% of the total)), and have proved especially popular with the 18-35 year-old age bracket. MCL believes the incremental data on spending will prove a valuable asset and that having a product that is popular with younger customers is a good acquisition and retention tool.

Online lending now launched, and in trial period to gather data before accelerating growth in due course

Online lending activities were accelerated with the Shelby Ltd acquisition in January 2017, although, in FY18, management was focused on the core home collect opportunity. The low-cost, low-risk soft launch (branded Dot Dot Loans in March 2017) saw activity primarily around building the right IT infrastructure, linkages and risk models. Experience to date has led to less appetite for short-term (i.e. three-month) loans, and there has been limited customer loyalty. We expect more resources to be devoted to Dot Dot loans this year, as the number of loans is expanded from the 2k achieved in FY18 to a target of7.5k by end-FY19. MCL expects the operating loss (£0.8m FY18) to reduce in FY19.

Looking at range of products to sell to customer base and likely to involve partnerships with partners who have the product but not the customer base

With regard to the customer portal and associated IT infrastructure, MCL has reported that it is likely to see a full product launch later this year (test launch January 2018). There was commentary about products offering discounts, reward schemes, banking services and price comparisons using the extensive data likely to be available through the customer portal. Appropriate customer approvals to use their information have been incorporated, and management advises that products such as insurance, utilities and mobile comparisons will be provided by third parties. There may be a lending product, but the primary objective is customer retention and acquisition, rather than the portal being a revenue and profit generator in its own right.

Customer, agent and staff satisfaction

Customer, agent and staff satisfaction levels all high

Management has highlighted the importance of motivated staff, as well as customers (95% are satisfied with the service). In particular, there has been an improving trend in all aspects of engagement, with an overall agent satisfaction rate of 77% (up from ca.70% two years ago), and agency vacancies are trending at less than 3%. At the interim results, MCL reported that the first poll of new territory builds indicated a 92% overall satisfaction level and, despite PFG's attempt to lure them back in 2H, MCL is aware of only ca. 20 returning.

Risk

Credit

The underlying credit environment for HCC remains favourable

MCL focuses on improving its own asset quality

We note that low incomes are rising faster than both average incomes and inflation. Additionally, the trends in unemployment and employment are good. Despite this environment, there has been the potential for operational risk in the rapid expansion of the agent network, and management has focused on acquiring quality customers. There is multiple evidence confirming that this strategy has been applied, as we show below.

- New customers incur higher losses than historical ones but, despite rapid loan growth, impairments as a percentage of revenue fell in 2H (25.6%) on 1H (26.6%).

Impaired loans a smaller percentage of group

- As can be seen in the table below, there has been modest growth in impaired loans, but this growth is well below the growth in the net book as a whole. Impaired loans now account for 27.6% of the net book, against 29.4% a year ago. Had the mix been unchanged, impaired loans would have been £1.3m higher than those reported.

Figure 3: Mix of net loan book by overdue status

£000s	FY17	% book	FY18	% book
Neither past due nor impaired	42,990	70.2%	52,544	72.4%
Past due not impaired	224	0.4%	23	0.0%
Impaired	18,014	29.4%	20,053	27.6%

Source: Hardman & Co Research

High-quality customers now 84% of net loans

- Management also refers to the mix of high-quality lending, where a customer's repayment record is such that MCL would be willing to lend again to this customer. The proportion of the gross loan book in this category has risen from 66.2% in FY17 to 69.6% at end-FY18. As a proportion of the net lending book, it is now 84%.

Technology helping credit assessment

- In assessing creditworthiness, MCL has invested heavily in IT and data support. It advises that 73% of customers can now get their income verified by the agent at the point of sale using a module on their tablet. The investment in technology also provides a detailed audit trail of compliance, with responsible lending criteria reducing regulatory/mis-selling risk.

Mix within impaired loans also improving

- The stock of provisions has fallen from £34.8m to £33.9m, reflecting the fact that not only have impaired loans fallen as a proportion of the total book, but also that the severity of impaired loans has reduced. The mix is more weighted to early-stage impairments than in the past. .

Using historical loss rates for new business, which, at present, is performing better than expected

New to group lending generally is a higher loss rate than lending to established customers. Even though the actual experience of customers brought on board by experienced PFG agents has been better than average, MCL has continued to apply historical loss rates. This is prudent, as there is no long-term record of such customers yet, but it may prove conservative assuming their good repayment patterns continue.

Funding and other issues

Funding

£5m funding headroom cushion against our peak debt forecasts through to February 2020

In August 2017, MCL increased its debt facility from £25m to £40m, with a major high-street bank joining the existing provider, Shawbrook Bank. The expiry date of the facility was also extended from March 2019 to August 2020. The current facility is sufficient to meet the company's immediate strategic objectives. The peak drawdown was £28.0m in December 2017 (ca.£13m above the end-February level). On our estimates, the peak debt is likely to be below £35m throughout the forecast period. MCL advises that it remains focused on increasing gearing in order to maximise equity returns, but not to a degree that it would put the group at a significantly higher level of financial risk.

Management also advises that a level of acquisitions can be funded from existing resources/facilities. We have built £5m for such deals into our numbers, but clearly this is an unknown variable. We would expect a material deal to see the group take higher gearing, but it would then be even more diversified by customers.

Regulation

Likely to see further rises in compliance costs. HCC not key target for regulator.

May drive acquisition opportunities

While not always the case, a highly satisfied customer, who repeatedly returns to the provider for more product, is not the most likely target for further regulation. There are aspects of the business that have raised concerns, e.g. affordability and renewed lending keeping a customer in permanent and expensive debt. MCL appears well positioned in these areas. Without changing the customer relationship, technology materially reduces the risk of inadvertent breaches of lending policy and provides a much clearer audit trail for regulatory review. There has been an increase in compliance costs, but as smaller providers get squeezed by regulation and its costs, then the greater the probability that MCL will be able to make more acquisitions.

Financials

Profit & Loss

Figure 4: Profit and Loss (£m)

Year-end February	2015	2016	2017	2018	2019E	2020E
Existing operations	22.5	84.7	96.2	116.6	118.5	123.2
Acquisitions during period	67.4	5.8	3.3	0	0.5	4.0
Total revenue	**89.9**	**90.6**	**99.6**	**116.6**	**119.0**	**127.2**
Impairment charge	-22.9	-18.8	-24.3	-30.4	-32.1	-33.1
IFRS9 impairments, net effect					5.5	5.5
Ongoing agent commission	-17.7	-18.5	-21.2	-23.6	-26.0	-29.9
Temporary agent commissions		-0.7	-1.2	-4.4	-3.0	-1.0
Gross profit	**49.3**	**52.6**	**52.9**	**58.2**	**63.4**	**68.8**
Administration expenses pre-excep. and intang. amortis.	-32.8	-33.3	-33.0	-36.1	-38.5	-41.5
Depreciation (incl. goodwill impairment, amortis. of IT)	-0.9	-0.9	-1.3	-1.5	-1.7	-1.9
Operating profit pre-excep. and amortisation	**15.6**	**18.4**	**18.6**	**20.6**	**23.2**	**25.4**
Adjusted financing costs	-2.6	-1.6	-0.9	-1.5	-1.8	-1.8
Adjusted profit before tax	**13.0**	**16.8**	**17.7**	**19.2**	**21.4**	**23.6**
Income tax	-2.7	-3.5	-3.7	-4.0	-4.3	-4.7
Adjusted post-tax profit	**10.3**	**13.3**	**14.0**	**15.2**	**17.1**	**18.8**
Impairments as % revenue (exc. IFRS9 from both)	-25.5%	-20.8%	-24.4%	-26.1%	-25.7%	-24.8%
Impairments as % revenue, IFRS9 basis					-22.4%	-21.7%
Agent costs as % revenue	-19.7%	-20.4%	-21.3%	-20.2%	-21.8%	-23.5%
Admin. costs as % revenue	-36.5%	-36.8%	-33.1%	-31.0%	-32.4%	--32.6%
Total costs as % revenue	-56.2%	-57.2%	-54.4%	-51.2%	-54.2%	-56.1%
Finance costs as % average debt	n/m	n/m	9.5%	11.7%	11.4%	11.3%
Revenue yield (revenue as % average receivables)	n/m	164%	170%	175%	163%	167%
Number of clients	198,171	198,727	216,000	229,000	240,450	252,473
Number of agents	1,893	1,839	1,826	2,030	2,080	2,130
Adj. profit per client	66	84	82	84	89	93
Receivables per agent	29,310	30,903	33,531	35,876	35,558	37,100

Source: MCL, Hardman & Co Research

Impact of discounting

Management has previously highlighted that the accounting requirement to gross up income and then provide against it (in situations where the customer has missed a payment but is still expected to repay) distorts the balance sheet and profit and loss. As can be noted in the table below, with a growing book, the distortion increases.

Figure 5: Underlying asset value

£m	Feb 16	Aug 16	Feb 17	Aug 17	Feb 18
Gross balances*	117.6	114.3	122.9	127.8	137.7
Gross cash project.**	**87.8**	**86.6**	**93.9**	**99.1**	**110.2**
Impact of discounting	-31.0	-30.4	-32.7	-34.0	-37.4
IFRS bal. sheet value	**56.8**	**56.2**	**61.2**	**65.1**	**72.8**
Marginal impact on P/L of discounting		0.6	-2.3	-1.3	-3.4

** cash amount contractually due, ** cash actually expected to be received*
Source: Hardman & Co Research

IFRS9 impact

2019 statutory earnings

IFRS9 will replace IAS39 as the accounting standard governing the classification, measurement, impairment and hedge accounting of financial instruments, including loan assets. IFRS9 takes effect for accounting periods commencing 1 January 2018 (MCL's relevant year-end will commence on 1 March 2018, and so the effect will be on results reported in FY19).

Accounting does not affect cash or ultimate profitability

- The accounting does not affect actual cash flow or losses. IFRS9 is likely to bring forward impairments, and thus defer profit recognition, but it does not change ultimate cash received from the customer.

Growing business likely to have adverse effect, but modest for MCL

- There is an argument that, for a constantly growing business, under IFRS9, the amount of accelerated provision will always exceed the unwind of previously accelerated provisions, and so profits will be permanently reduced. Figure 6 gives a simplified example, where the extra provisions associated with growth affect each year's profit and loss. This argument, though, is intellectually flawed because the actual cashflows and losses are unchanged. At some stage in the future, the accelerated provisions would have to be recognised.

Figure 6: Impact of IFRS9 is negative if book grows

	Period 1	Period 2	Period 3	Period 4
Accelerated provisions	-20	-25	-30	-35
Provisions that would have been recognised in period	0	20	25	30
Net impact on P/L	-20*	-5	-5	-5

**in practice, this is likely to be taken as a prior year balance sheet re-statement*

Source: Hardman & Co Research

Relative comparisons

It is not surprising to us that the implementation of IFRS9 has thrown up some different trends between companies. Indeed, it does so within companies with NSF, PFG and IPF all reporting different effects for varying divisions. This reflects not only their relative stages of growth (e.g. PFG shrinking home collect compared with growth in Vanquis) but also the assumptions being used (e.g. different dates for categorisation between IPF Home Credit and IPF digital – see slides 9 and 18-19 IFRS 9 presentation). We note the following.

Hit to receivables around half of peers – reflects historical conservative approach to IBNR

- MCL is reporting a materially lower impairment of receivables (4%-6%). This is around half the level reported by peers. In their results updates, NSF reported an HCC reduction from £51m to £41m, PFG from £391m to £347m and IPF of 11%-13%. We understand that MCL has historically adopted a conservative approach to its recognition of impairments, which economically reduces the effect of IFRS9 in bringing forward impairments on performing loans.

Bigger gross-up for MCL means both income and provisions reduce. Less impact on peers as they possibly included other offsetting items in their gross-up numbers.

- Eliminating gross-up means that MCL will report £6m lower revenue and provisions (no net effect), a much greater degree of reduction than its peers. NSF has indicated no material change to income under IFRS9, with other factors offsetting the gross-up effect. PFG did not explicitly comment on this, which we interpret to mean it was not a material issue. IPF commented that revenue would be recognised more quickly under IFRS9 (slide 12, IFRS 9 presentation).

- We understand that MCL, in its gross-up, includes the effect of income being recognised in excess of the contractual amount due (which happens when, for example, a customer misses a couple of payments and extends the life of the loan). Under current accounting, income is generated for this period and then immediately provided against. We believe that some other companies may have calculated income by applying interest to the net loan book after provisions whereas MCL's contractual amount approach would apply it to the higher gross balance.. As a consequence of using a smaller loan balance in the calculation, the peers historically reported both lower income and lower provisions in the gross up. It also means that when comparing impairments as a percentage of revenue, MCL's number would be inflated relative to peers as it included this accounting-generated higher level of gross-up income and impairments. On changing to IFRS9, MCL mathematically sees impairments fall as a percentage of revenues, as it loses revenues and impairments of the same amount. In contrast, MCL's peers, who do not see such a large elimination of gross-up, are indicating a higher impairment to revenue ratio.

Balance sheet

Figure 7: Balance sheet (£000)

@ end-February	2015	2016	2017	2018	2019E	2020E
Non-current						
Goodwill	294	1,326	2,834	2,834	3,334	4,000
Intangible assets	10,391	9,052	7,058	5,520	4,328	3,504
Property, plant and equipment	936	1,182	763	822	869	883
Amounts receivable from customers	1,507	679	395	265	200	100
Total non-current assets	**13,128**	**12,239**	**11,050**	**9,441**	**8,731**	**8,486**
Current assets						
Receivables	**53,976**	**56,152**	**60,833**	**72,563**	**73,760**	**78,924**
Trade/other receivables	26,216	1,554	2,019	2,039	1,554	1,554
Cash and cash equivalents	8,650	3,755	3,985	4,868	7,376	9,735
Total current assets	88,842	61,461	66,837	79,470	82,690	90,213
Total assets	**101,970**	**73,700**	**77,887**	**88,911**	**91,421**	**98,699**
Current liabilities						
Trade and other payables	-3,274	-7,452	-5,892	-6,695	-7,695	-8,695
Total current liabilities	**-3,274**	**-7,452**	**-5,892**	**-6,695**	**-7,695**	**-8,695**
Net current (liabilities)/assets	85,568	54,009	60,945	72,775	74,590	80,713
Non-current liabilities						
Financial liabilities – borrowings	0	-9,000	-10,000	-15,552	-16,000	-16,000
Deferred tax	-2,614	-1,879	-617	-144	-144	-144
Total non-current liabilities	-2,614	-10,879	-10,617	-15,696	-16,144	-16,144
Total liabilities	**-5,888**	**-18,331**	**-16,509**	**-22,391**	**-23,839**	**-24,839**
Net assets	**96,082**	**55,369**	**61,378**	**66,520**	**67,582**	**73,860**

Source: MCL, Hardman & Co Research

Cashflow

Figure 8: Cashflow statement (£000s)

Year-end February	2015	2016	2017	2018	2019E	2020E
Profit (loss) before tax	58,565	10,374	11,219	16,133	18,240	20,666
Depreciation	596	736	544	563	575	608
Impairment of goodwill	56	42	0	0	0	0
Amortisation of intangibles	8,574	5,683	4,412	2,950	2,630	2,890
Share-based payment expenses	0	0	126	431	431	431
Gain on acquisitions	-51,961	-32	0	0	0	0
Loss on disposal of plant, property and equipment	40	146	134	0	0	0
(Increase)/decrease in debtors	-14,803	27,532	-1,918	-11,604	-1,942	-774
Dividend in Specie to Perpignon	0	-31,129	0	0	0	0
Increase/decrease in creditors	4,768	2,548	-1,640	1,846	1,000	1,500
Interest paid	1	647	927	1,456	1,800	1,800
Taxation paid	-800	-1,737	-4,078	-4,536	-4,750	-5,250
Net cash inflow/(outflow) from op. activities	**5,036**	**14,810**	**9,726**	**7,239**	**17,984**	**21,871**
Cashflows from investing activities						
Purchase of intangibles	-416	-2,523	-1,029	-1,412	-1,531	-2,082
Purchase of property, plant and equipment	-343	-1,152	-125	-622	-622	-622
Disposal of assets	0	501	0	0	0	0
Purchase of subsidiaries	0	-7,383	-5,695	0	-2,000	-4,000
Cash acquired on acquisitions	5,120	0	0	0	0	0
Net cash outflow from investing activities	**4,361**	**-10,558**	**-6,849**	**-2,034**	**-4,153**	**-6,704**
Cashflows from financing activities						
Net borrowing	0	9,000	1,000	6,000	448	0
Interest paid	-1	-647	-927	-1,904	-1,800	-1,800
Dividends	-2,000	-17,500	-2,720	-8,418	-9,972	-11,008
Net cash inflow from financing activities	**-2,001**	**-9,147**	**-2,647**	**-4,322**	**-11,324**	**-12,808**
Net increase in cash and cash equivalents	7,396	-4,895	230	883	2,508	2,359
Opening cash and cash equivalents	1,253	8,650	3,755	3,985	4,868	7,376
Closing cash and cash equivalents	8,650	3,755	3,985	4,868	7,376	9,735

Source: MCL, Hardman & Co Research

Valuation

Average valuation upside on absolute measures ca.20%

We detailed all the assumptions used in our valuation methodologies in our note, Bringing home collect into the 21st century, [published on 2nd February 2017]. Post these changes, our absolute valuation techniques now imply an average of 184p (previously 178p). The peer valuations are weakened, as it is unclear to what extent IFRS9 has been consistently applied within consensus.

Figure 9: Summary of different valuation techniques

	Implied price (p)	Upside (%)
Gordon Growth Model (GGM)	196.9	29%
Dividend Disc. Model (DDM)	171.1	12%
Average absolute measures	184.0	208%

Source: Hardman & Co Research

GGM

Figure 10: GGM and sensitivities

	Base	+1% ROE	+1% COE	+0.5% G
Return on equity (%)	25	26	25	25
Cost of equity (%)	11	11	12	11
Growth (%)	5.5	5.5	5.5	6
Price/book value (x)	3.5	3.7	3.0	3.8
Premium for near-term outperformance (%)	20%	20%	20%	20%
Adjusted Price/book value (x)	4.3	4.5	3.6	4.6
Book value 2019E (£m)	59.9	59.9	59.9	59.9
Valuation (£m)	254.9	268.0	215.7	273.2
Valuation per share (p)	**196.9**	**207.0**	**166.6**	**211.0**
Variance (per share)		10.1	-30.3	14.1

Source: Hardman & Co Research

Broad peer comparisons

We caution against over-reliance on peer comparisons, as it is unclear the extent to which IFRS9 has been consistently adopted within consensus estimates. The numbers below are for indicative purposes only.

Figure 11: Peer valuation comparisons

	Shr price (p)	Market cap (£m)	2018 PE (x)	2018 yield (%)
MCL (Feb 19)	152.75	198	11.6	5.0%
NSF (Dec)	64.8	203	17.4	3.9%
PFG (Dec)	637	1,613	15.4	1.3%
S&U (Jan 19)	2,780	334	13.1	4.3%
H&T	324.5	122	10.6	3.5%
Ramsdens (Mar13.1 19)	192.5	59	13.8	3.5%

Source: Hardman & Co Research

Notes

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