05 December 2018

NON-STANDARD FINANCE

Reading the runes: strong, controlled growth

Financials

Source: Eikon Thomson Reuters

Market data

EPIC/TKR	NSF
Price (p)	66.0
12m High (p)	75.0
12m Low (p)	52.6
Shares (m)	312.7
Mkt Cap (£m)	206.4
EV (£m)	394.7
Free Float*	99%
Market	Main

**As defined by AIM Rule 26*

Description

In the UK non-standard lending market, NSF has the market-leading network in unsecured branch-based lending, and 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

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Key shareholders

Invesco	28.7%
Woodford Inv. Mgt. (26/11))	25.0%
Aberforth Partners (28/08)	12.3%
Marathon Asset Mgt.	10.7%
Quilter Cheviot AM	4.1%
ToscaFund	3.8%

Diary

Early January	Trading statement
March 2019	FY'18 results

Analyst

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On 3 December, NSF held an investor day at the Reading branch of Everyday Loans (EL) and its head office in Bourne End. Investors and analysts thus got the opportunity to see the front-line operations and review the company's strategy. The former confirmed our view on the competitive advantages of a branch network and the operational synergies from being part of a group. The presentation confirmed the long-term, controlled growth opportunity from a business with an excellent market positioning and sustainable competitive advantages. We have not changed our forecasts following the update, and our absolute valuation range remains 91-101p.

- **Strategic outlook:** NSF highlighted the levers it has to deliver sustainable growth from using technology, expanding the network and upskilling staff to increase lead generation/conversion, while improving efficiency and managing credit. It confirmed our view outlined in our 14 May note, *Everyday Loans a heart of gold.*

- **Branch visit:** The branch visit confirmed how, in practice, credit risk is lowered from the customer knowledge and relationships that a face-to-face model brings. We also confirmed that group best practice is not only being adopted across the network, but that it is also viewed as an enhancement to the business, and not an imposition.

- **Valuation:** Our absolute valuation measures for NSF range from 91p to 101p per share. Our sum-of-the-parts model has an implied valuation of 85p. Peer comparators reach up to 81p. Our assumptions were outlined in our last report, published in August, entitled *1H'18 results*.

- **Risks:** Credit risk remains the biggest threat to profitability, and 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 taking appropriate action to mitigate this risk.

- **Investment summary:** Substantial value should be created, as i) competitors have withdrawn, ii) NSF is well capitalised, with committed six-year debt funding, iii) macro drivers are positive, and iv) NSF has a highly experienced management team, delivering operational efficiency without compromising the key F2F model. Targets of 20% loan book growth and 20% EBIT RoA appear credible, and investors are paying ca.10x 2019E P/E and getting a ca.5% yield.

Financial summary and valuation

Year-end Dec (£m)	2016	2017	2018E	2019E
Revenue	94,674	119,756	167,852	200,978
Impairments (incl. FRS 9)	-26,155	-28,795	-39,252	-47,259
Total costs (excl. depreciation)	-49,600	-67,706	-87,246	-94,135
EBITDA	19,369	25,181	37,132	53,192
PBT	13,056	13,203	14,660	24,725
Statutory PBT (co. basis)	-9,342	-13,021	-4,850	11,275
Pro-forma normalised EPS (p)	3.37	3.44	3.78	6.41
Dividend (p)	1.20	2.20	2.60	3.20
P/adjusted earnings (x)	19.6	19.2	17.4	10.3
P/BV (x)	0.8	0.9	1.0	1.0
P/tangible book	2.1	2.8	3.3	3.1
Dividend yield	1.8%	3.3%	3.9%	4.8%

Source: Hardman & Co Research

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Investor visit

Summary

Key message is confidence in sustained, controlled growth, with multiple levers to deliver it

The key message from the investor visit is the continued long-term growth opportunity that exists for a business with an excellent, sustainable market positioning. In particular, for the foreseeable future, the company can i) use technology to deliver an enhanced customer experience and operational efficiency (the opportunities from the latter are designed to enhance the face-to-face business model, not replace it), ii) generate more converted leads from deeper, broader broker relationships, expanding marketing and improving conversion rates, and iii) expand its branch network, with a long-term potential optimal size of the network now viewed as 100-120 branches (broadly double the current network and up from a previous medium-term target of 75-100), as well as upskilling staff.

Market dynamics

Market share currently ca.6% (by customer). Direct competition, if anything, easing. Credit environment favourable.

The overall market dynamics are, if anything, improving. There remain around 10 million non-standard borrowers, of whom around 1 million are in EL's target space (current customer numbers ca.60k, i.e. market share ca.6%). The total loan book of branch lenders was over £5bn in 2008 (EL June 2018 loan book ca.3% of this), and a range of alternative lending products is under regulatory threat (most recently rent to buy). Other branch-based competitors such as Oakam and Loans2go have either closed or are closing their networks. We note that EL has greater economies of scale and that its credit performance has been materially better than either of these businesses, meaning that it was profitable when they were not (see our note, *Everyday Loans a heart of gold,* published on 14 May 2018). The latest statutory accounts show strong profitability at EL, while many pure online lenders such as 118 118 Money and Likely Loans continue to report large losses, driven primarily by impairments at 2.5x to 3.5x EL's level. Again, we discussed this in our May note.

Face-to-face model a competitive advantage in credit assessment and management, prevention of fraud, and building customer relationships and satisfaction

We note that the critical competitive advantages from the face-to-face model are:

- Credit assessment using data and experience that cannot be replicated using technology.
- Minimal identity fraud, especially compared with online lenders.
- Relationship building with customers, which i) ensures they get the most appropriate product (this may be less debt than they applied for on affordability grounds, or perhaps more if, for example, debt consolidation is right for them), ii) helps the renewal business (29% of new loans), and iii) is likely to see greater engagement at early stages of difficulties, thus reducing credit losses. The importance of this is discussed in more detail in the section below on our Reading branch visit.

Customers are middle England on average salaries

Management also provided some current customer profile data:

- This is not a benefit-driven lending business. 96% of its customers are employed and 3% are self-employed.
- Customers' income is at the national average (41% have a net monthly income of £2k+).
- Relatively young customers (12% under 25, 31% 26-35, 26% 36-45).

Technology opportunity

Technology builds competitive advantage and does not replace face-to-face model

We found the section on technology enhancing the face-to-face model especially interesting (and it also reflects what has been done in the home collect business). The critical message is that it is being used to reinforce the competitive advantages from the branch network, and is not a replacement for it. Some of the areas we highlight are as follows.

Technology can improve customer experience – and so conversion and repeat business rates. Adopting practices already proven to work in George Banco.

- **Enhanced customer experience.** Conversion and collection rates are both enhanced where there is early and regular contact between the customer and EL. However, these do not necessarily need to involve the manual intervention of staff. Automated messaging can prompt a customer who is a day late in payments or make a potential new customer aware that EL is dealing with him/her. At present, an automated broker lead of a best-quality customer at, say, 8pm one evening may only be advised of EL's interest when the local branch opens the following day. By then, the potential customer may have already signed up with another lender. An automatic notification of EL's interest at 8pm that evening at least keeps the group in the running. We understand that improving all aspects of the customer experience, including areas like payments, is under consideration. Using technology in this way means that the lending process is unchanged, but that the customer experience improves and the conversion rate should increase. We understand that, in many of these processes, George Banco has been more advanced than EL, and the group is simply transferring practices that have already been proven to work.

Can deliver operational efficiency and financial leverage without changing business model's competitive advantages

- **Improved operational efficiency.** Technology allows the automation and centralisation of certain administrative processes. The small, but illustrative, example given was that there is a 3% time saving in printing letters centrally, rather than in each branch. The manager originates the letter in the branch, but its printing and distribution are central. Management also commented that the credit process could see further automation and noted, for example, that rule changes on Open Banking (which basically allows sharing of bank account data) could potentially save ca.25% of know-your-customer on-boarding time. We believe the flattening of the competitive advantage of branches reviewing bank statements is likely to be modest (see section on credit risk below), and note that EL is aiming to be current with its own capabilities to exploit opportunities and minimise threats.

Evolution, not revolution. Learnings lessons at each stage.

- **An evolutionary process.** EL is not looking to make transformational IT changes, but rather small, incremental steps, each of which can be tested and reviewed. We understand that, for example, tweaking the wording on broker emails post a loan application saw conversion rates increase almost three-fold. Critically, the impact on each broker was different, so each can now get a bespoke email, with data analytics and artificial intelligence being used to automate the learning process.

May open new distribution channels in due course

- **New distribution channels.** We note that the conversion rate where a customer is more than a 30-minute drive from the branch is around half that where the driving time is below this level. EL is thus exploring whether Facetime and video technology can deliver a face-to-face solution without the need to physically attend a branch. This could provide future operational efficiencies, especially out of hours, as well as better conversion of distant customers. Compared with competitors, we believe the experience of staff is important (in knowing what questions to ask), and we think EL has the right brand, as well as a long, cultural track record of building relationships with its customers. We believe such 'centralised' face-to-face lending will result in higher impairment than in-branch, for reasons such as the advantage of seeing a customer in the flesh and a lack of

local knowledge (the branch manager is still more likely to know if a local factory is being closed than a remote lender), but we would expect this to be reflected in the rate charged.

Lead opportunities

Multiple levers to increase numbers of leads

There are a range of opportunities to increase the number of quality leads coming into the network. These include i) improving broker service (with technology investment delivering much reduced response times – from 10 seconds to sub-3 seconds), specific rate quotes and in-principle approvals (better service increases the penetration of existing brokers and is also likely to increase the pool of brokers that are willing to send leads to EL, ii) technology to use data better, especially in areas like repeat applications and declines, iii) more targeted marketing, including own-brand on social media and TV to complement the already strong broker channel, iv) better customer experience, seeing increased repeat business, and v) better management of the referral process between EL and the guarantor loans business. Management spoke of an aspiration to be able to direct all applications across the group into one funnel, which could then identify the best product and customer journey for that applicant, rather than it going to one business and being referred to the other. The indication was that, over the medium term, the total numbers of leads could treble if such initiatives were successful.

Improving the conversion of applications to loans is also a priority, and this is being addressed through the adoption of best practice across the network, as well as through technology and staff training.

Branch network/staffing opportunities

Optimal branch network evolving, now indicating ca.100-120 likely. Current fully cost-allocated contribution ca.£600k per branch, with target to increase towards £1m. Implied "mature" business over longer term generated 5-10x current level of profit.

EL has previously advised that it believes the optimal size for a branch is ca.£4m of advances. Above this level, the mix of business changes between collection and sales (a larger back book takes more resources in collections). Management keeps the size under review (and, interestingly, in our discussions, it highlighted that certain branch managers had a better skill set to manage larger branches) but, despite this, the network is still expected to expand in number. Management has identified a further 18 locations (somewhere between five and 10 are expected to be opened in 2019) and, for the foreseeable future, it is likely that this pace of opening will continue. Historically, the medium-term target had been a network of 75-100 branches, but this has now increased to 100-120. This would still be smaller than most of the networks that competitors had before the financial crisis. As a reminder, EL has advised that pre-opening costs per branch are typically up to £75k, with the breakeven run rate at around nine months and cumulative breakeven at 21 months. The average profitability (including allocated costs) is currently ca.£600k for established branches, with a target to raise this towards £1m (current best branch is already close to this level, at over £900k). The guidance is necessarily broad, and no timescales have been given but, by implication, it implies a mature business, generating profits of £60m-£120m, against 1H'18 normalised profits of £6m.

Investing in staff can also expand capacity at existing branches

In addition to the number of branches, there are operational changes that involve changes in staff numbers and skill sets. Customer peak demand is Monday to Friday, 8am to 7pm, and Saturday, 10am to noon, but most branches open Monday to Friday, 10am to 6pm, and Saturday mornings as required. Extending the opening hours to the peak customer demand could result in as much as a 50% increase in working capacity, albeit this will necessitate changes in working practices/relocations. Work on how extended hours might be adopted will progress through 2019, with possible delivery in 2020.

Reading branch visit

Front-line feedback confirms the competitive advantage case and changes since NSF took over the EL business

Our 14 May 2018 report, Everyday Loans a heart of gold, highlighted a number of competitive advantages from having a branch network delivering unsecured non-standard lending. It was interesting to hear the branch manager's perspective on these issues and their sustainability into the future. Reading is EL's 15th best-performing branch, and so we believe it is a fair representation of the network as a whole.

Lower credit risk

EL peers' impairments to revenue 2.5x-3.5x EL level, reflecting advantage of face-to-face model. Peers' impairments represent 30% or more of revenue, while EL "pays" an extra 5% for its branch network.

In our view, one key competitive advantage is assessing and managing credit risk (noting that competitors are currently reporting impairment to revenue ratios at 2.5x-3.5x the level of EL). The incremental impairments at peers represent 30% or more of revenue, compared with an incremental cost to EL in paying for branches of around 5% of revenue. This appears a good payback for the investment made.

What we were particularly keen to see was why, in practice, applications were turned down by the branch, after having successfully passed automated credit checks. As a reminder, just 21% of applications get through to a telephone interview, of which just 6% then get through to a branch interview (15% decline or fail affordability on a telephone interview), and only 3% get a loan.

Our discussions with the manager identified three key aspects to this lower credit risk:

Branch visit confirms greater knowledge of customer

- **Greater knowledge of customer.** On an interview, you can get a sense of the borrower's personality and issues that may affect him/her – something that is impractical on a questionnaire. For example, is a customer who lives at home with parents more likely to leave and thus incur incremental living expenses, or is his/her job at risk? There is also an element built with experience as to whether the lender believes the borrower will always choose to repay when he/she has the capacity to do so. We do not believe this judgement can be replicated without seeing the customer face to face.

Detailed examination of documents, especially bank statements

- **Detailed examination of documentary evidence.** The lending process allows a detailed examination of documentary evidence and, in particular, bank statements. For example, a customer with extensive gambling-related debits may not have disclosed these as ongoing expenses, but this is a critical factor in assessing whether he/she is likely to be able to repay a loan or whether the loan will be used to fund a gambling problem. Theoretically, over the long term, the new regulations on open banking could give some remote lenders access to some of this information, but it is unclear how many customers will provide such access before they have a relationship with a lender (or even a broker), or whether lenders will choose to build the infrastructure necessary to automate this process.

Importance of relationship in managing credit once loan made

- **Engagement with the customer.** One aspect of the branch network we had not fully appreciated is the way in which it is used to build a personal rapport with the customer. The staff highlighted that part of their role was educational (e.g. you, the customer, have a low credit rating because of *this*, but if you do *that*, it will improve over the next 12 months) and that the interview built a personal relationship between the borrower and the branch. The customer sees not only the person making the loan but also, at the end of the interview, the manager meets every borrower just to confirm that everything has been understood. Such a relationship is critical if the customer faces difficulties in making repayments and the debt needs to reassessed. In EL, the branch is responsible for the customer up to 180 days in arrears and, so, it is a person the customer has met who makes the initial calls. We concur with the Reading branch manager that a borrower who may be worried about her/his finances is much more likely to respond to someone

she/he knows than an anonymous call centre staff member. Engagement is likely to improve collections, as well as assist in making sales.

Getting more data on application is difficult, as customers want an application to be as simple as possible

We note that technology does allow the automation of a lot of the credit process (especially through credit reference agencies). However, the incremental data collected on application are modest (customers have a very limited appetite to complete application forms, and those that take a long time to complete have a much lower usage). The incremental data and personal assessment of the customer appear to be structural competitive advantages over online lending.

Group synergies

We discussed with the branch manager a number of aspects of how working for EL had changed and some of the group synergies following its acquisition by NSF. We were trying to establish the degree to which group management claims were actually being seen on the shop floor and what was the staff attitude to them. Our conclusion was not only that the assertions on best practice were validated but also that there were incremental cultural aspects that had not been highlighted previously.

Adoption of best practice

Lead prioritisation had changed

For us, one important group management claim has been that the branch network had moved from being 41 mini-franchises to a network of entrepreneurs who could share best practice. We had previously been advised of away days where the best branch managers had identified what they were doing differently, and that this information had been disseminated across the network. We asked the manager of Reading what he had changed in his branch following this process, and he highlighted the way in which leads were prioritised as an example. From a cultural point of view, this sharing of best practice appeared to be viewed as positive for his business, rather than being a challenge to the way he had worked before, or an imposition from above.

Work opportunities

Greater opportunities for staff and higher motivation in growing business

One aspect that we had not fully appreciated was the positive effect on staff of the opportunities for personal development that a growing network could provide. This is reinforced when the company culture is primarily promoting from within (11 of the 12 new branches in 2018 had managers who were internal appointments). As branches grow too "big", the approach has been to split them with a new office being opened locally (e.g. Reading is partially splitting off to a new branch in Slough). This not only offers promotional opportunities but also cuts commuting times for staff who live closer to Slough. From a group perspective, having staff experienced with EL processes, regulations and procedures is clearly advantageous.

Managing branch splits

Branch splits not too disruptive

Given the forthcoming branch split, we asked the manager at Reading how he felt about losing around a third of his customers and staff, and the extent to which his "business" was being shrunk. He noted that, as targets were adjusted, there would be no impact from a financial point of view. We sensed that, while he would be disappointed to lose his staff (having worked closely with them, in some cases, for several years), it was a good thing for them. We also sensed that the balance of work would change. A large back-book requires more time to be spent on collections and less on sales, so breaking off some of the back-book rebalances this. Overall, we did not sense any issue with the forthcoming split – and so a limited disruption impact from it.

Financials and Valuation

Financials

Our financial forecasts are unchanged from our last report, 1H'18 results, published on 9 August 2018, with adjusted pre-tax profit forecast to grow from £13.2m in 2017 to £24.7m in 2019. The company is now providing consensus estimates on its website, NSF latest consensus. The implied 2019 P/E is under 10x and the 2020 P/E under 7x.

Market consensus estimates

Year-end Dec (£m)	2017	2018E	2019E	2020E
Total revenue	119.8	163.1	193.1	221.1
Operating profit ELG	22.7	26.1	33.1	41.5
Operating profit GLD	2.7	7.8	11.3	15.1
Operating profit LaH	3.1	6.6	10.8	14.0
Central costs	(4.8)	(5.2)	(5.4)	(5.6)
EBIT	23.7	35.3	49.9	65.0
Finance costs	(10.5)	(20.0)	(23.6)	(26.5)
Adjusted PBT	**13.2**	**15.3**	**26.3**	**38.5**
Adj. EPS (p)	3.4	3.9	6.8	10.1
DPS (p)	2.2	2.4	3.7	5.5

Source: NSF website accessed 4 December 2018, Hardman & Co Research

Valuation

Our absolute valuation techniques are unchanged and imply average upside potential of 46%. Peer multiples range from 58p (2019 P/E, with growth into 2020 not fully captured) to ca.81p on yield and P/BV.

Summary of different valuation techniques

	Implied price (p)	Upside potential (%)
Gordon Growth Model (GGM)	91.4	38%
Discounted Dividend Model (DDM)	101.3	53%
Average absolute measures	96.3	46%
Sum-of-the-parts (SoTP)	84.6	28%
Peer P/E	57.6	-13%
Peer yield	81.4	23%
Peer P/BV	81.0	23%

Source: NSF website accessed 4 December 2018, Hardman & Co Research

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