



18 November 2019

Financials



Market data

EPIC/TKR	NSF
Price (p)	27.0
12m High (p)	70.0
12m Low (p)	27.0
Shares (m)	312.4
Mkt Cap (£m)	84
EV (£m)	337
Free Float	99%
Market	Main

Description

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

Company information

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

Jan'20	Capital Markets day
Jan'20	Trading update

Analyst

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NON-STANDARD FINANCE PLC

Trading update: understand the accounting

NSF has issued a trading update highlighting a 4%-5% reduction in consensus estimates due to softer trading in 3Q (primarily lower loan volumes in guarantor loans, a market which has been affected by adverse press coverage) and a 6%-8% reduction associated with a step change in provisioning policy. The latter highlights yet again the importance of understanding the assumptions in provisioning. For the same arrears, a higher assumed probability of downside has increased provisions. This reflects the known cyclicity inherent in IFRS9. A downgrade is unwelcome, but it does not reflect current customer deterioration, only the Board's cautious approach. After today's reduction's, we still forecast 2021 adjusted profits at 2x the level of 2018.

- **Outlook:** NSF lowered its targets for loan book growth reflecting macro-uncertainty and a desire to position the group ahead of the next recession. The ongoing effect of the provisioning policy is less than the reduction in impairments from slower loan growth, so the forecast nominal provision charge is lower in 2020/2021. As a proportion of revenue, it is somewhat higher.
- **Strategy:** After today's reductions, we are forecasting 2019 adjusted pre-tax profits of £15.8m (2018: £14.8m) rising to £23.3m in 2020 and £29.9m in 2021. Therefore, 2021 is still double the 2018 level. The fundamental strategy of building a franchise to deliver strong profit growth remains intact.
- **Valuation:** Our absolute approaches now indicate a range of 79p-85p. On the current price, the 2020 prospective P/E is 4.4x for a business whose impairment provisioning already reflects a significant downside scenario. The yield is now double-digit.
- **Risks:** Credit risk is the biggest threat to profitability but the sizeable increase in provisions in today's announcement should mitigate this risk in the future. NSF's model accepts more credit risk, where a higher yield justifies it. NSF is innovative, and may incur losses piloting products, distribution and customers. 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 strong loan book growth and 20% EBIT RoA appear credible, and investors are paying 6.6x 2019E P/E and getting a 11.1% 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	-98,358	-106,137
Normalised EBIT	23,684	35,876	43,219	52,772	62,847
Adjusted PBT	13,203	14,769	15,822	23,281	29,881
Statutory PBT	-13,021	-1,590	-19,835	20,152	28,350
Pro-forma EPS (p)	3.44	3.70	4.10	6.15	7.94
DPS (p)	2.20	2.60	3.00	3.10	3.95
P/adjusted earnings (x)	7.9	7.3	6.6	4.4	3.4
P/BV (x)	0.4	0.4	0.5	0.4	0.4
P/tangible book (x)	1.1	1.5	1.8	1.5	1.1
Dividend yield	8.1%	9.6%	11.1%	11.5%	14.6%

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

Trading update

Arrears stable/better than expected

No deterioration in credit quality

Management commented that delinquency was stable to improving across all divisions: i) branch based “strong loan book growth; rates of delinquency in line with expectations”; ii) guarantor loans “delinquency in line”; and iii) home collect – “:far better than expected thanks to strong collections performance”. There is nothing in the statement to suggest that customer behaviour has deteriorated.

Lower volumes in guarantor loans

Volumes easing

On volumes, management’s comment is: i) branch based: “strong loan book growth although not quite at the same rate as in H1 19”; ii) guarantor loans “lower than expected but customer numbers up 30% in the year to September and overall loan book growth remains strong”; and iii) home collect – “: strong new customer growth offset by lower lending to existing customers” On the call, management said the net loan book is a bit lower than expected but the key issue for this division is Christmas trading, which has yet to begin.

Downside to expectations in guarantor loans – operational disruption, management change and adverse press coverage on market

The key driver to the 4%-5% trading downgrade is thus lower volumes in the guarantor loan business, especially in September and the expectation that, with the move to Trowbridge, there will be a period of disruption that will take a few months to get back to previous run-rates. Management noted a number of company-specific issues including a change in management and keeping two separate sales functions. We note there were record volumes in July, near record in August and the fall-off was primarily in September. This timing may also suggest that adverse market publicity has had an effect (although the company said there was no evidence to confirm this). To address the slower-than-expected loan book growth, NSF is accelerating the consolidation of all functions into one site by nine months, which should see cost savings ahead of expectations and also realise a number of operational efficiencies.

Looking forward, the cumulative effect of slower growth each year has a material impact on earnings. With this outlook, management believes that there should be scope to continue to manage costs tightly and that will act as a partial offset.

Impact of accounting change on provisions

IFRS 9 is known to be cyclical

It has always been known that IFRS9 has cyclicity. The methodology includes a weighted probability assigned to different economic outturns and as a recession approaches a greater weighting is likely to be assigned to downside scenarios than when the outlook is more positive. As losses in a downside are greater, the change in weighting increases provisions even if the customer behaviour has not changed (at this stage).

NSF moved from 85% base case, 10% downside 5% upside weighting to 50% base and 50% downside. Step change in 2019. In line with/above peers.

In the case of NSF, it has moved from an 85% base case, 10% downside, 5% upside mix to 50% downside and 50% base weighting. This brings it broadly in line with Amigo (54% downside) and above the levels of say Barclays (25%) or Lloyds (40%). The change in weighting applies to the existing loan books for both branch-based lending and guarantor loans and so, in 2019, there is a step-change effect. In future years, the effect is less as the higher weighting will only apply to new business.

No impact on home collect given historical stability of provisioning through cycle

It is also worth noting that the change in assumptions has had a material impact on provisioning in branch-based lending and guarantor loans but is not visible in home collect. This reflects the historical relative stability of credit in the business in a downturn and so there is less sensitivity to downside scenarios. We have in previous reports noted that, in recessions, PFG had seen rising profits and S&U as a home collect business stable profits.

Weightings change over time – will see uplift in due course

Over time, the weighting applied will change, as will the severity of each scenario. These accounting assumption changes were always known to introduce cyclicity into IFRS 9 and NSF's announcement today reflects that. Management has decided to apply these changes to its medium-term targets, although at some point in the future the cyclicity will of course go the other way. At least in theory, once a recession has happened, there should be a change so there is a greater weighting applied to upside scenarios with the result that there would then be a credit to the P&L from a write-back of provisions. Investors, therefore, may expect the guidance ranges to change down and up with the cycle.

Actual experience unchanged

It is also worth noting that actual losses will reflect the ultimate customer repayment patterns. To date, there has been no deterioration in customer behaviour and today's changes are thus anticipating future changes, which may or may not be realised.

Forecast changes

The table below shows the net effect of all the changes above. The revenue impact accelerates over time with slower volumes in each year. Provisions rise initially with the change in accounting assumption but then fall in nominal terms with lower volumes

Estimate changes									
Year-end Dec	2019E			2020E			2021E		
	Old	New	change	Old	New	change	Old	New	change
P&L (£m)									
Revenue	189,346	184,013	-3%	216,831	202,836	-6%	247,048	224,607	-9%
Impairments (incl. IFRS 9)	-45,767	-47,513	4%	-52,511	-51,707	-2%	-59,796	-55,623	-7%
Total costs	-94,666	-93,281	-1%	-101,776	-98,358	-3%	-110,400	-106,137	-4%
EBITDA	48,913	43,219	-12%	62,543	52,772	-16%	76,852	62,847	-18%
Adjusted PBT	21,744	15,822	-27%	30,163	23,281	-23%	38,872	29,881	-23%
Pro-forma norm. EPS (p)	5.64	4.10	-27%	7.97	6.15	-23%	10.34	7.94	-23%
Dividend (p)	3.20	3.00	-6%	4.00	3.10	-23%	5.00	3.95	-21%
Bal. sheet (@ 31 Dec, £m)									
Amounts receivable	385	358	-7%	454	404	-11%	546	464	-15%
Borrowings	336	336	0%	386	366	-5%	456	406	-11%
Equity	187	182	-3%	200	190	-5%	219	205	-6%

Source: Hardman & Co Research

Target changes

Targets for loan growth and impairments as percentage of revenue				
%	Loan book growth		Impairment as % revenue	
	Old	New	Old	New
Branch based	20	10-15	20-22	22-24
Guarantor loans	30	15-20	20-22	22-24
Home Collect	2-5	-5 to +5	33-37	30-33

Source: NSF website accessed 20 August 2019

Slowing volumes for next few years,
higher provisions given accounting
change, ROA unchanged given cost and
funding savings

Management has revised some of its medium-term targets (i.e. over the next three years or so) to reflect the current uncertain outlook and the change in provisioning. In essence, loan growth has been slowed through both management tightening scorecards and a weaker home collect market overall. The biggest volume reduction is in guarantor loans where having enjoyed a period of significant loan book growth (1H 2019 saw growth of 53% vs. the prior year) market growth is now expected to moderate to between 15% and 20% p.a. The higher downside scenarios in impairments more than offset the impact of slower growth that would otherwise be expected to result in an improvement in impairments (IFRS 9 is especially penal to new lending) so there is a net increase in impairments in both branch-based lending and guarantor loans while in home collect the net balance is a small improvement. Return on assets targets are unchanged with some offset from lower costs and funding (heads of agreement are signed for a new facility that is expected to be in place probably by year-end). Our reduction to 2020/2021 estimates is less than for 2019, reflecting an assumption that there will not be a further step-up in provisions but that the risk weighting remains at 50%, which we believe to be conservative.

Change in management

Nick Teunon handing over to deputy in
March next year

The CFO, Nick Teunon, will leave with the results in March and be replaced by Jono Gillespie, current Deputy Group CFO at NSF, having previously been CFO at Loans at Home, the group's home credit business since January 2016. Mr Teunon joined NSF in August 2014 and is leaving to pursue an opportunity in a different market sector. Prior to joining the group, Jono was at Provident Financial plc where he had held a number of senior management positions in the Consumer Credit Division.

Financials

Our revised forecasts are below.

Reported profit and loss							
Year-end Dec (£000)	2015	2016	2017	2018*	2019E*	2020E*	2021E*
Business interest income	14,657	81,099	119,756	166,502	183,013	201,836	223,607
Other operating income	0	450	1,926	1,626	1,000	1,000	1,000
Fair-value unwind on acquired portfolios	-5,456	-8,342	-11,985	-7,678	-4,291	0	0
Total revenue	9,201	73,207	109,697	160,450	179,722	202,836	224,607
Impairments	-3,858	-23,651	-28,795	-42,688	-47,513	-51,707	-55,623
Gross profit	5,343	49,556	80,902	117,762	132,209	151,130	168,984
Administration expenses	-11,340	-44,074	-69,203	-89,564	-93,281	-98,358	-106,137
O/W depreciation	-198	-690	-1,497	-1,772	-4,500	-4,500	-4,500
Amortisation of intangibles	-4,030	-10,714	-7,897	-8,681	-6,092	-3,129	-1,531
Operating profit	-10,027	-5,232	3,802	19,517	32,836	49,643	61,316
EBITDA	-5,799	6,172	12,518	29,970	43,428	57,272	67,347
Exceptional items	-6,135	-626	-6,342	0	-25,274	0	0
Net finance (cost)/income	70	-3,484	-10,481	-21,107	-27,397	-29,490	-32,965
PBT	-16,092	-9,342	-13,021	-1,590	-19,835	20,152	28,350
Income tax	3,022	1,344	2,686	-89	-1,049	-3,541	-4,833
PAT from continuing operations	-13,070	-7,998	-10,335	-1,679	-20,884	16,611	23,517
Average no. shares for EPS calculation (m)	61.50	307.32	316.90	312.71	312.40	312.44	312.44
Statutory EPS (p)	-21.25	-2.60	-3.26	-0.54	-6.68	5.32	7.53
Adjusted EPS (p)		3.37	3.44	3.70	4.10	6.15	7.94
DPS (p)		1.20	2.20	2.60	3.00	3.10	3.95

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

Normalised profit and loss						
Year-end Dec (£000)	2016	2017	2018*	2019*	2020E*	2021E*
Business interest income	94,674	119,756	166,502	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

Cashflow							
Year-end Dec (£000)	2015	2016	2017	2018*	2019E*	2020E*	2021E*
Profit/(loss) before and interest	-16,162	-5,858	-2,540	19,517	7,562	49,643	61,316
Taxation paid	-350	-1,341	-2,226	-1,164	-1,500	-4,000	-3,541
Depreciation	198	690	1,497	1,772	4,500	4,500	4,500
Share-based payments	0	0	291	1,157	1,157	1,157	1,157
Amortisation of intangibles	4,030	10,714	7,897	9,661	6,092	3,129	1,531
Fair-value unwind on acquired loan book	5,456	8,342	11,985	7,678	4,291	0	0
Loss on disposal of fixed assets	51	-363	-416	-35	0	0	0
Decrease in inventories	6	3	0	0	0	0	0
Increase in amounts receivable from customers (net of FV)	-5,394	-21,039	-54,437	-75,173	-47,682	-46,471	-59,306
Increase in receivables	-16,445	-7,737	-51	5,844	-680	0	-750
Increase in other assets				-241			
Increase in payables	19,078	-6,952	1,000	-4,132	2,000	2,000	2,000
Net cash inflow/(outflow) from op. activities	-9,532	-23,541	-37,000	-35,116	-24,260	9,958	6,907
Cashflow from investing activities							
Net purchase of fixed assets	-341	-3,514	-4,931	-5,915	-7,000	-4,500	-4,500
Purchase of subsidiaries	-81,111	-230,784	-16,442	0	0	0	0
Net cash outflow from investing activities	-81,452	-234,298	-21,373	-5,915	-7,000	-4,500	-4,500
Cashflows from financing activities							
Net finance income	70	-3,484	-7,974	-14,121	-19,397	-29,490	-32,965
Share capital issues/purchases	98,234	172,869	-1,357	-2,102	0	0	0
Net proceeds from borrowing	0	87,300	77,882	67,371	70,000	30,000	40,000
Dividends	0	-951	-4,439	-7,177	-8,436	-9,529	-9,842
Net cash inflow from financing activities	98,304	255,734	64,112	43,971	42,167	-9,020	-2,807
Net increase in cash and cash equivalents	7,320	-2,105	5,739	2,940	10,907	-3,562	-400
Opening cash and cash equivalents	0	7,320	5,215	10,954	13,894	24,801	21,240
Closing cash and cash equivalents	7,320	5,215	10,954	13,894	24,801	21,240	20,839

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

Valuation

Significant upside potential on our valuation assumptions and models

Our absolute valuation techniques imply average upside potential of 203%. This has increased sharply following the share price fall associated with the bid situation and further falls, which we attribute to the Woodford overhang and the trading statement. We note that NSF is on a lower rating compared with its peers.

Summary of valuation approaches

	Implied price (p)	Upside potential
Gordon Growth Model (GGM)	79.1	193%
Discounted Dividend Model (DDM)	84.5	213%
Average absolute measures	81.8	203%
Sum-of-the-parts (SOTP)	51.2	90%

Source: Hardman & Co Research

GGM

We detailed our assumptions in our initiation note, [Carpe Diem](#), published on 11 November 2016. Our assumptions are given in the table below. There has been a small reduction in equity (ca.5%), which affects the valuation.

GGM assumptions

	Base	+1% to RoE	+1% to CoE	+0.5% to G
RoE	31.5%	32.5%	31.5%	31.5%
CoE	11%	11%	12%	11%
Growth in equity	5.5%	5.5%	5.5%	6%
P/BV (RoE-G)/(CoE-G)	4.7	4.9	4.0	5.1
Discount re near-term perf.	-10%	-10%	-10%	-10%
P/NAV (x)	4.3	4.4	3.6	4.6
NAV 2020E (£m)	58.1	58.1	58.1	58.1
Valuation (£m)	247.1	256.6	209.1	266.6
Variance (£m)		9.5	-38.0	19.5
Valuation per share (p)	79.1	82.1	66.9	85.3

Source: Hardman & Co Research

DDM

Our DDM now indicates a value of 85p, reduced from 109p given the change in our estimates and associated dividends.

SOTP

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

SOTP valuation

Division	2020E earnings (£000)	Multiple (x)	Value (£000)	Comment
ELD	15,095	9.0	135,858	Rating at peer group average
GLD	2,911	5.0	14,556	Rating cut from 6x to 5x
LAH	6,316	8.0	50,526	Rating below MCL/PFG
Central	-5,115	8.0	-40,920	Unchanged
Group	19,207	8.3	160,019	
Value per share (p)			51.2	

Source: Hardman & Co Research

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