HARDMAN&CO.

05 November 2020

NON-STANDARD FINANCE PLC

1H'20 results:

NSF's *1H'20 results* reflected the pain from COVID-19, with i) less volume, ii) changes to business models, and iii) higher impairment, including an increased weighting of a severe macro downside, increasing IFRS9 cyclical impairment charges. Despite these pressures, both the branch (ELD) and home collect (HCC) businesses were profitable. A young customer demographic meant the guarantor loan division (GLD) was most impacted, with COVID-19 effects compounded by the recent FCA review in 2H'20. NSF is a going concern (end-September cash £70m), and the largest shareholder appears supportive of an equity raise post the FCA review.

- **Potential equity raise:** NSF's largest shareholder is currently supportive of an equity raise once the FCA review completes, which would be transformative for the group. Timing is uncertain, as the FCA has yet to review the proposals for redress, and the company is embargoed from discussing further details.
- **Going concern:** NSF's going-concern statements will attract significant investor interest. It is cash-rich, but is likely to breach covenants within 12 months, even in its base scenario. Lenders appear supportive, but material downsides from the base case would require waivers beyond those currently being discussed and/or an equity issue to strengthen the balance sheet.
- **Valuation:** Normal valuation approaches need to be treated with caution, given the level of uncertainty the group faces. We believe it is probable that any outturn will be binary – either the stress scenario (share value likely to nil) or a base case – in which case they will be a multiple of the current price.
- **Risks**: The key risks are i) the impact of current COVID-19-affected customers on trading performance, ii) the potential future impact of COVID-19, iii) the final cost of the GLD redress programme, iv) the outcome of lender discussions, and v) the support of Alchemy in completing an equity raise.
- **Investment summary:** Assuming NSF trades through the short-term uncertainty, substantial medium- and long-term value should be created, as i) demand for, and pricing of, non-standard finance is likely to be strong following the fallout from the COVID-19 crisis, ii) NSF has substantial committed medium-term debt funding, iii) competitors have withdrawn (and potentially more may do so), and iv) deleveraging will yield significant interest cost savings.

Financial summary and valuation (2020 and 2021 base case, no equity raise – see later section for scenario analysis)

Year-end Dec (£000)	2017	2018*	2019*	2020E*	2021E*
Reported rev./other inc.	121,682	168,128	184,611	172,429	166,283
Total impairments	-28,795	-43,738	-46,660	-69,997	-54,535
Total costs	-69,203	-89,082	-95,786	-97,644	-90,831
Normalised EBIT	23,684	35,101	42,165	4,788	20,917
Adjusted PBT	13,203	13,994	14,707	-22,971	-5,004
Statutory PBT	-13,021	-2,365	-75,976	-116,654	-6,204
Pro-forma EPS (p)	3.44	3.50	3.66	-6.07	(1.33)
DPS (p)	2.20	2.60	0.70	0.00	-
P/adjusted earnings (x)	0.9	0.9	0.9	-0.5	-2.3
P/BV (x)	0.0	0.0	0.1	0.9	1.7
P/tangible book (x)	0.1	0.2	0.2	1.7	3.9
Dividend yield	71.0%	83.9%	22.6%	0.0%	0.0%

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

Financials

Source: Refinitiv

Market data

EPIC/TKR	**NSF**
Price (p)	**3.1**
12m High (p)	70.0
12m Low (p)	3.1
Shares (m)	312.4
Mkt Cap (£m)	10
EV (£m)	313
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	Jono Gillespie

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Key shareholders (30 Sep'20)

Alchemy	29.95%
Hargreaves Lansdowne	11.82%
Marathon Asset Mgt.	9.98%
Neil Utley	7.96%
Interactive Investor	3.84%
IG Markets	3.67%

Diary

TBC	Conclusion of FCA review and announcement re discussions with shareholders on potential equity raise

Analyst

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1H'20 results summary

As noted on the front page, there were positives and negatives in the results.

Revenue up because of pre-COVID-19 loan growth. Normalised operating profit down to £5m.

- Normalised revenue was up 4% to £92m (reported revenue £91m vs. £87m). Credit impairments rose by £17m to £39m. Normalised costs rose by £1m to £49m. Normalised operating profit fell to £5m from £20m. The normalised pre-tax loss was £10m (profit £7m), as finance costs increased by £2m to £15m.

All goodwill written off, and £16m charge for guarantor loan redress and associated costs

- There was an exceptional charge of £91m, writing off all the historical goodwill (£76m), and a provision for redress to certain guarantor loan customers, totalling £16m. The FCA has not yet reviewed the proposed methodology but, once an agreement has been reached, the board will re-engage with major investors on the terms of an equity raise. Alchemy, the group's largest shareholder, has confirmed that it remains supportive of a substantial equity issue to strengthen the group's balance sheet.

Still a going concern, noting material uncertainties

- We believe there will be attention on the going-concern comments. In summary, there are material uncertainties, but the group remains a going concern because of the expected support from lenders and its largest shareholders. While the group has traded broadly in line with expectations since June 2020, should things not progress in line with the base case, such support cannot be guaranteed, even though it appears probable on current information.

Most strain in GLD

- As can be seen in the Key Performance Indictors (KPI) in the table below for the different businesses, HCC has seen improving profitability, ELD a modest decline and GLD a substantial decline.

KPI (%)			
1H'20 (1H'19 restated)	**ELD**	**GLD**	**HCC**
Loan book (£m)	188 (202)	88 (95)	34 (38)
Revenue yield	46.7 (47.0)	32.3 (31.7)	169.7 (165.5)
Risk-adjusted margin	34.2 (36.0)	12.4 (23.9)	123.8 (112.7)
Impairments/revenue	26.7 (23.5)	61.6 (24.5)	27.1 (31.9)
Impairments/average net loan book	12.4 (11.0)	19.9 (7.8)	45.9 (52.8)
Cost income ratio	45.2 (45.3)	41.8 (45.5)	59.4 (56.3)
Operating profit margin	26.2 (33.8)	-1.1 (28.3)	13.5 (11.8)
RoA	12.2 (15.9)	-0.4 (8.9)	23.0 (19.5)

Source: NSF results release and presentation, dated 30 October 2020

£70m cash

- At end-September 2020, there was £70m cash in bank (gross borrowings of £330m), after paying down £15m of the securitisation facility. The nature of the group's business models means that it has been substantially cash-generative when lending has been subdued.

Lending restarted and ELD/HCC loan books stabilised/growing

- Lending restarted in earnest in May 2020. September collections, as a percentage of pre-lockdown levels, were 89% in both ELD and HCC, and 82% in GLD (whose younger customer base has been even more adversely affected than most by COVID-19).

Key issues

Going concern

Base case will see breach of lending covenants in next 12 months, but discussions with lenders on waivers appear supportive. Waivers to cover stress scenario are not in current discussions.

As noted, we believe there will be attention on the going-concern comments. As a result of the expected cost of customer redress, under the base case, NSF expects to breach covenants in the next 12 months, and solvency will be dependent upon i) the ultimate cost of the proposed redress programme being equal to or less than the provision being made, ii) the cost of any waivers granted from lenders, and iii) any mitigating actions that could be implemented to offset any adverse movement from the base case, as the group may have to further restrict lending activities and/or exercise further financial levers around costs in order to maintain solvency. Therefore, in arriving at the conclusion that NSF is a going concern, the directors judge that, if required, the group would receive the requisite support from lenders and/or shareholders in the form of covenant waivers and/or further equity capital. As noted, Alchemy has confirmed that it remains supportive of a substantial equity issue, and is actively engaged with the group.

More detailed-than-normal review of regulatory risk, given FCA review of GLD

We note a much more detailed exploration of regulatory developments in this release, including i) support for consumers affected by COVID-19, ii) FCA draft guidance and a feedback statement on the fair treatment of vulnerable customers, iii) Kerrigan vs. Elevate Credit International Ltd, iv) an FCA multi-firm review of repeat lending by high-cost lenders, v) breathing space, and vi) the Financial Services Future Regulatory Framework Review. Given the developments in GLD, some caution on regulatory risk is only to be expected.

Guarantor loan division review

NSF review announced 3 August (i.e. post 1H period-end) as part of FCA multi-firm process

In its 3 August 2020 announcement, NSF commented "NSF announces that it has been informed by the Financial Conduct Authority ('FCA') that, following a visit to the Group's Guarantor Loans Division in March 2020 as part of a multi-firm review into the sector and having examined a selection of customer files, it has raised a number of concerns regarding certain aspects of the operating procedures and processes at the Division. NSF is now conducting an in-depth review, working closely with the FCA, to clarify the scope and scale of its concerns and to develop a possible redress methodology and will make a further announcement in due course. Pending the outcome of this review, the Group's consideration of a possible equity issue has been put on hold for the time being. Alchemy, the Group's largest shareholder, who was supportive of the proposed capital raise, has confirmed that it remains supportive of providing further capital to the Group and is engaging with the Board in this regard."

With results, NSF advised it had submitted proposed remedies (and associated provision taken), based off initial FCA guidance. No certainty on the FCA response, and NSF embargoed from discussing details.

With these results, NSF advised that, in conjunction with its advisers, it had developed a proposed redress programme, based on the general guidelines the FCA had previously sent to them. NSF now needs to await the outcome of the FCA's review of its proposals, and the company was not permitted to discuss with third parties the remedies or its proposals. We believe the company will have been rigorous in coming to the £15.8m provision taken in these results, but external parties are not in a position to assess whether this may prove too low or too high. NSF also confirmed that, once the proposed programme had been agreed with the FCA, it would then re-engage with shareholders about an equity raise and that, based on current information, Alchemy was supportive.

In addition to the remedies and costs, the division's performance is impacted by minimal new lending and increased arrears (see sections below). This is not expected to reverse until 2021. Additionally, as noted in Amigo's 3 November announcement,

there is a risk of increased activity by claims that management companies could see higher numbers of complaints and associated costs.

Financing and solvency

Main risk is around financing lines, and unclear what support would be provided in stress downside scenarios

Cash balances at end-September were £70m, and gross borrowings were £330m (with all facilities fully drawn to ensure the maximum gross liquidity). Cash payments on interest are second-half-weighted, and there may be some redress payments. We are expecting the fall in GLD loans to broadly match small increases in loans at HCC and ELD, leaving the group's gross cash position robust. As shown in 1H'20, if the group is not lending, regular repayments of principal make it strongly cash-generative.

With regard to solvency, NSF's net assets at end-1H'20 were £22m, and we are forecasting a further fall to £11m by the year-end. With intangible assets of £8m, the tangible net assets are minimal.

Potential equity raise

Main shareholder appears supportive and has done similar deals in other sectors. Will have to wait for FCA clarification before it can proceed. Likely range £30m to £55m.

NSF was already in advanced discussions with major shareholders about an equity raise before the guarantor loan review was announced. We understand that commentators had quite a range of outcomes (£15m to £40m), and we would expect this to increase by at least the amount of redress provisions (i.e. to £30m to £55m). Given Alchemy's current near-30% holding and the current market capitalisation (£10m), it is quite possible that Alchemy will become the majority shareholder.

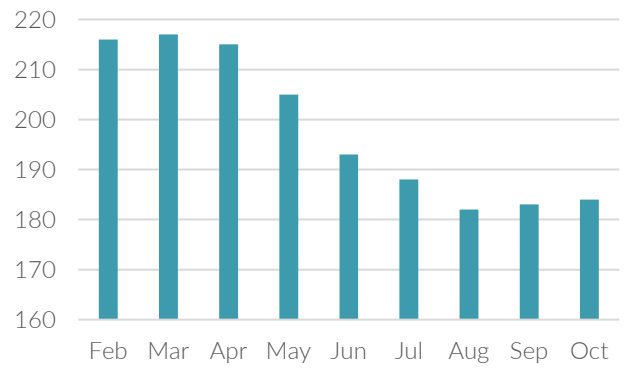
We note that, in the 22 October announcement of a *strategic investment by Alchemy in Countrywide*, i) there was a capital raise of £90m, well above Countrywide's (CWD) market capitalisation at the time, ii) Alchemy's stake potentially could rise to between 50.1% and 67.7%, iii) the equity raise included an open offer for existing shareholders, iv) there was a tender offer, and v) the listing was taken from a premium to standard listing. The issue price was 135p, against a closing price on 21 October of 184p. Clearly, any equity raise for NSF will be company-specific, but we consider the CWD deal an interesting precedent.

Return to growth in HCC and ELD

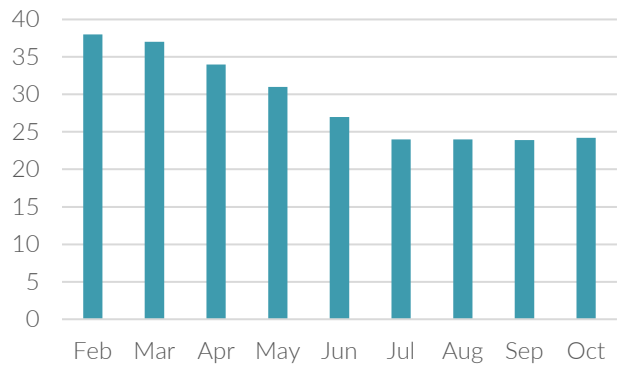
HCC and ELD showing early signs of loan growth (pre latest lockdown)

While GLD was very disappointing, both ELD and HCC performed better than we had expected. While the absence of new lending and continued repayments/impairment saw the book fall, both have, in recent months, seen new lending rise, and the book at ELD is now growing and just starting to grow in HCC.

Month-end loan books (£m) for ELD...



...and for HCC



Source: UK Finance, Hardman & Co Research

Divisional summary

Normalised divisional results						
1H'20 (£000)	ELD	GLD	HCC	Central costs	NSF total	1H'19
Revenue	47,914	17,032	27,277	-	92,223	88,287
Other operating income	888	-	-	-	888	221
Modification loss	-638	-58	-	-	-696	-505
Derecognition gain	192	494	-	-	686	1669
Impairments	-15,593	-15,727	-7,927	-	-39,247	-22,536
Admin. expenses	-22,238	-7,114	-16,382	-3,104	48,838	-47,340
Operating profit (loss)	10,525	-5,373	2,968	-3,104	5,016	19,796
Net finance cost	-9,603	-3,871	-774	-664	-14,912	-13,178
Profit (loss) before tax	922	-9,244	2,194	-3,768	-9,896	6,618

Source: NSF results announcement

ELD

Impact of COVID-19

The key impact from COVID-19 included i) the network expansion was put on hold, and five new branch openings were postponed, ii) lead volumes were reduced substantially (845,600 leads in 1H'20, -32% vs. prior year), and applications to branch (ATBs) were 154,550 (-34%), iii) restrictions impacted productivity, with a lower conversion rate for new borrowers (6.2% vs. 7.6%) on lower numbers of ATBs, resulting in 13,828 loans written, down 44%, with the value of loans issued down 50% at £35.5m, iv) customer numbers fell to 70,700 at end-June vs. 77,000 at end-March, and v) other income included the sale of non-performing loans and government furlough grants (£0.9m combined), some of which will recur in 2H.

Delinquency – now ca.6% COVID-flagged

After a sharp increase in April 2020, delinquency rates have since declined steadily, and an increasing proportion of those flagged have since returned to full or part payment. At the end of June, 12% of customers were marked as COVID-affected but, by the end of September, this had reduced to 6%. While collections overall have remained robust throughout the period, the higher delinquency of COVID-flagged customers, together with a marked increase in the risk weighting of a downside scenario (30% weighting to severe downside, from 15% at end-2019) as part of the IFRS9 provisioning, meant that impairment as a percentage of revenue increased to 26.7% (2019 restated: 23.5%) and, against average net receivables, it increased to 12.4% (2019 restated: 11.0%). We note that, despite this increase, the level of impairment has remained well below that seen in 2008-09.

Outlook: management wants to increase loan book, bring down rate of impairment, generate attractive rates of return and increase geographical coverage

Management advises that the plans for 2020 are "Our short-term focus is to rebuild the loan book and return it to growth whilst at the same time continuing to bring down the rate of impairment to more normalised levels that the business has delivered previously. Despite the challenges presented by further lockdowns and social distancing, we remain committed to the face-to-face lending model, one that is both popular with customers and capable of generating attractive rates of return.

Since the end of June 2020, lending volumes have continued to recover so that the net loan book has once again started to grow, while rates of delinquency have also improved. The challenging macroeconomic environment means that the demand for our products and services is expected to increase and our appetite to increase geographic coverage with further branches remains undiminished - we continue to see scope for a network of over 100 branches over the medium-term. The pace at which we are able to realise that vision will be dependent upon the Group securing additional equity capital that in turn should unlock access to further, lower cost debt funding."

ELD beat our expectations

Hardman & Co comment: *ELD beat our expectations, and we have carried that outperformance into 2021. Alchemy was a former owner of ELD, and so knows its downside credentials well. The long-term opportunity for ELD is there unless short-term losses from other divisions force the closure of the group/sale of the business to fund redress.*

GLD

GLD biggest impact, as its customer base younger and so more vulnerable to COVID-19 economic impacts

GLD saw the biggest impact of COVID-19 because its younger demographic saw more of an effect on employment and earnings. The key features were i) 23% of customers and 30% of the loan book were flagged as being affected by COVID-19, ii) accepted leads were down 31% to 0.8m, of which 164,510 passed through the scorecard, down 32%, iii) there was a marked reduction in top-up new business and an increase from price comparison websites, iv) there was a 57% reduction in the number of loans written, to 4,228, and a conversion rate of just of 2.6% (2019: 4.1%), reflecting a more cautious approach, v) there was a 60% reduction in the value of loans written, to £15.1m, and vi) despite a reduction in headcount versus the year-end, administration costs increased by 15% to £7.1m (2019: £6.2m), driven by an increase in professional fees and redundancy costs.

Most are making full or partial payments, but NSF cannot approach guarantors and, with increase in severe stress scenario, provision has risen very sharply

The majority of the division's customer base is under 40 years-old, and it is this demographic that has been one of the hardest-hit by the pandemic, with the result that approximately 30% of the loan book was "COVID-19-flagged" at the end of June 2020, which is significantly higher than for the other two divisions. However, of those flagged, approximately 50% are now making full payments, with 10% making part payments, 20% having asked for a second emergency payment freeze, and 20% currently making no payment. The increased risk weighting of a macroeconomic downside scenario, and an inability to approach guarantors of those customers that had opted for an emergency payment freeze, meant that impairment as a percentage of revenue over the past 12 months increased to 61.6% (2019 restated: 24.5%) and impairment as a percentage of the average net loan book increased to 19.9% (2019 restated: 7.8%). In the six months of 1H'20, impairments were 90% of revenue.

Outlook: management's priorities are concluding on proposed methodology for customer redress, executing the programme and embedding enhanced lending procedures

Management advises that the plans for 2020 are "Concluding on the proposed methodology for customer redress and then starting to execute the programme as well as embedding a series of enhanced lending procedures are the key priorities for the rest of 2020. We continue to believe that the guarantor lending model provides a valuable source of credit for thousands of borrowers and for most of them at a much more affordable rate of interest than if they were to apply for credit on their own. That said, we recognise the increasing regulatory demands and are therefore reviewing all aspects of our business model in order to ensure that we can meet the needs of consumers whilst also delivering attractive and sustainable returns for shareholders. Once complete, we intend to restart lending in earnest during 2021. In the meantime, we are continuing to focus on delivering good customer outcomes through careful management of our existing customers and through an effective collections process."

We expect losses through 2021

Hardman & Co comment: *We are now forecasting £3.1m losses in 2021, having previously expected close to breakeven. This may prove optimistic and will clearly be determined by what the FCA demands. We believe the core need for the product is there (and, indeed, is likely to have grown markedly given the impact of COVID-19), but the ability to continue to deliver the product in a way that meets the expectations of the regulator and delivers an attractive return remains unclear. With all the goodwill written off, it will be the balance of revenue growth, impairment, operating costs and redress that drive profitability.*

HCC

COVID-19 effects

In terms of the business model, HCC was the most at risk from stopping home visits. In the event, this proved manageable, and we note there was i) a shift from 28% remote collections (including cards and regular payments) to 100%, and from 0% remote lending to 100% in a few weeks, ii) support for agents has helped to maintain low vacancy rates and turnover, iii) lending restarted in a number of phases, initially 33 weeks and to existing customers only, followed by a gradually expanded product offering, as remote lending functionality increased, iv) collections have recovered well and remain strong, helping to reduce impairment to 27.1% of revenue (2019: 31.9%), and v) careful cost management saw the cost:income ratio increase to 59.4%, from 56.3%, despite the drop in revenue and a change in agent incentives to encourage remote activity.

Overall collections as percentage of book remained robust

While the absolute level of collections was impacted due to reduced levels of lending, overall collections as a percentage of the book remained robust, and the rate of impairment as a percentage of revenue declined from 31.9% to 27.1% for the 12-month period to 30 June 2020.

Outlook: management's focus is on stabilising loan book, rebuilding it and restoring active customer base

Management's plans for 2020: "As is the case for our other business divisions, the clear focus for the balance of 2020 is on stabilising and then rebuilding the loan book and active customer base. Having achieved modest loan book growth in August, we were pleased that this continued in September. While regional restrictions on social distancing and the threat of a second wave of infection present some challenges for agents, with the rollout of our latest remote lending capability now complete, we are confident that we can continue to make progress and are looking forward to the important seasonal lending period in November and December."

HCC profits been relatively resilient. Key time will be run-up to Xmas, and model now can lend remotely.

Hardman & Co comment: *The relative resilience of HCC's profits in the light of a fundamental threat to the model was encouraging, and better than we had expected. NSF now has the capability to do remote lending (which it didn't prior to the pandemic). The book starts significantly below last year's level (and we have reflected this in our forecasts), but the opportunity to grow from here is apparent, and we are about to enter the peak lending period.*

Central and exceptional costs

Rising professional fees

Despite a reduction in employee costs, normalised administrative expenses for the period increased by 3% to £3.1m (2019: £3.0m), reflecting higher professional fees. In addition, the group incurred a charge of £0.6m relating to the amortisation of intangible assets recognised on the acquisition of Everyday Loans and George Banco (2019: £2.6m).

Risk capitalised securitisation fee could have to be written off

Looking forward, we note that the capitalised cost of the securitisation facility (£6m) may be written off if drawings under it are unlikely, and this would be taken as an exceptional item. Should an equity raise progress, it is probable that this line would be drawn upon, and there would be no need for this exceptional item.

Financials

2020 unchanged, 2021 modest normalised profit

Our 2020 bottom-line forecast is broadly unchanged. We have assumed a worse GLD performance, offset by better-than-expected performances in ELD and HCC. Revenue was better than expected, and impairments and costs worse again, netting off at the bottom line. Our 2021 estimates have been reduced, with a lower growth rate than previously expected impacting on income and a markedly worse performance in GLD (normalised loss £10m against previous forecast loss of £250k). This division then drives a group normalised loss of £5m. We currently expect a broadly similar profit in 2022. We will provide detailed forecasts with the full-year results.

Normalised profit and loss (base case)

Year-end Dec	2020E			2021E		
	Old	New	% change	Old	New	% change
Profit and loss (£000)						
Revenue	163,457	172,429	5%	176,144	166,283	-6%
Impairments	-64,181	-69,997	9%	-49,797	-54,535	10%
Total costs	-91,946	-97,644	6%	-90,303	-90,831	1%
Normalised EBIT	7,331	4,788	-35%	36,044	20,917	-42%
Adjusted pre-tax profit	-22,886	-22,971	0%	5,928	-5,004	-184%
Pro-forma normalised EPS (p)	-6.04	-6.07	0%	1.64	-1.33	-181%
Dividend (p)	0.00	0.00	n/m	1.00	0.00	-100%
Balance sheet (£m)						
Amounts [Accounts?] receivable	161	145	-10%	176	154	-13%
Borrowings	318	341	7%	318	341	7%
Equity	101	11	-89%	103	6	-94%

Source: Hardman & Co Research

Base case

Our base-case scenario is detailed in the table below.

Reported profit and loss (base case)

Year-end Dec (£000)	2015	2016	2017	2018*	2019*	2020E*	2021E*
Business interest income	14,657	81,099	119,756	166,502	183,657	171,179	165,783
Other operating income	0	450	1,926	1,626	954	1,250	500
Fair-value unwind on acquired portfolios	-5,456	-8,342	-11,985	-7,678	-2,873	-1,200	0
Total revenue	**9,201**	**73,207**	**109,697**	**160,450**	**181,738**	**171,229**	**166,283**
Impairments	-3,858	-23,651	-28,795	-43,945	-46,660	-69,997	-54,535
Gross profit	**5,343**	**49,556**	**80,902**	**116,505**	**135,078**	**101,232**	**111,748**
Administration expenses	-11,340	-44,074	-69,203	-89,082	-95,786	-97,644	-90,831
O/W depreciation	-198	-690	-1,497	-1,772	-3,869	-4,500	-4,500
Amortisation of intangibles	-4,030	-10,714	-7,897	-8,681	-7,226	-1,200	-1,200
Operating profit	**-10,027**	**-5,232**	**3,802**	**18,742**	**32,066**	**2,388**	**19,717**
EBITDA	**-5,799**	**6,172**	**12,518**	**29,195**	**43,792**	**8,088**	**25,417**
Exceptional items	-6,135	-626	-6,342	0	-80,584	-91,283	0
Net finance (cost)/income	70	-3,484	-10,481	-21,107	-27,458	-27,759	-25,921
Statutory PBT	**-16,092**	**-9,342**	**-13,021**	**-2,365**	**-75,976**	**-116,654**	**-6,204**
Income tax	3,022	1,344	2,686	58	-332	3,923	1,055
PAT from continuing operations	**-13,070**	**-7,998**	**-10,335**	**-2,307**	**-76,308**	**-112,730**	**-5,149**
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	-0.74	-24.43	-36.08	-0.20
Pro-forma EPS (p)		3.37	3.44	3.50	3.66	-6.07	0.12
DPS (p)		1.20	2.20	2.60	0.70	0.0	0.0

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

Normalised profit and loss (base case)

Year-end Dec (£000)	2016	2017	2018*	2019*	2020E *	2021E*
Business interest income	94,674	119,756	166,502	183,657	171,179	165,783
Other operating income	450	1,926	1,626	954	1,250	500
Total revenue	**95,124**	**121,682**	**168,128**	**184,611**	**172,429**	**166,283**
Impairments	-26,155	-28,795	-43,738	-46,660	-69,997	-54,535
Gross profit	**68,969**	**92,887**	**124,183**	**137,951**	**102,432**	**111,748**
Administration expenses	-50,290	-69,203	-89,082	-95,786	-97,644	-90,831
Operating profit	**18,679**	**23,684**	**35,101**	**42,165**	**4,788**	**20,917**
EBITDA	**19,369**	**25,181**	**36,873**	**46,665**	**9,288**	**25,417**
Net finance (cost)/income	-5,623	-10,481	-21,107	-27,458	-27,759	-25,921
Adjusted PBT	**13,056**	**13,203**	**13,994**	**14,707**	**-22,971**	-5,004
Income tax	-2,688	-2,313	-3,050	-3,261	4,020	851
PAT from continuing operations	10,368	10,890	10,944	11,446	-18,951	-4,153

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

Balance sheet

@ 31 Dec (£000)	2015	2016	2017	2018*	2019*	2020E*	2021E*
Non-current assets							
Goodwill	40,176	132,070	140,668	140,668	74,832	-	-
Intangible assets	14,119	17,412	17,205	14,477	8,572	5,325	3,275
Other assets				241	1	1	1
Right of use asset					10,560	9,000	8,500
Property, plant and equipment	1,718	5,459	9,434	6,677	6,556	6,556	6,556
Deferred tax asset				230	1,677	400	25
Amounts receivable from customers				**198,631**	**185,269**	**144,835**	**153,830**
Current assets							
Amounts receivable from customers	**28,415**	**180,413**	**268,096**	**112,027**	**176,379**	**144,835**	**153,830**
Trade and other receivables	10,275	9,709	1,551	3,967	2,643	2,643	2,643
Cash and cash equivalent	7,320	5,215	10,954	13,894	14,192	94,096	59,951
Total current assets	46,010	195,337	280,601	129,888	193,214	241,573	216,424
Total assets	**102,023**	**350,278**	**447,908**	**490,812**	**480,681**	**407,690**	**389,540**
Current liabilities							
Trade and other payables	13,803	8,005	10,353	16,445	26,909	28,909	30,909
Provisions				589	1,466	17,650	2,650
Lease liability					1,830	1,250	1,250
Deferred tax liability	3,057	-	-	-	-	-	-
Total current liabilities	16,860	8,005	10,353	17,034	30,205	47,809	34,809
Net current (liabilities)/assets	29,150	187,332	270,248	112,854	163,009	193,764	187,083
Non-current liabilities							
Financial liabilities – borrowings	-	87,300	199,316	266,322	317,590	340,500	340,500
Lease liability					9,275	8,500	8,500
Deferred tax	-	5,890	4,996			0	0
Total non-current liabilities	-	93,190	204,312	266,322	326,865	349,000	349,000
Total liabilities	16,860	101,195	214,665	283,356	357,070	396,809	383,809
Net assets	**85,163**	**249,083**	**233,243**	**207,456**	**123,611**	**10,881**	**5,732**

IFRS9 basis; Source: NSF, Hardman & Co Research

Cashflow

Year-end Dec (£000)	2015	2016	2017	2018*	2019*	2020E*	2021E*
Profit/(loss) before and interest	-16,162	-5,858	-2,540	19,517	-48,518	-88,895	19,717
Taxation paid	-350	-1,341	-2,226	-1,164	3,067	500	0
Depreciation	198	690	1,497	1,772	3,869	4,500	4,500
Share-based payments	0	0	291	1,157	1,183	0	0
Amortisation of intangibles	4,030	10,714	7,897	9,661	9,595	4,247	3,050
Fair-value unwind on acquired loan book	5,456	8,342	11,985	7,678	2,873	1,200	0
Goodwill impairment					65,837	74,832	
Loss on disposal of fixed assets	51	-363	-416	-35	-16	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	-54,367	84,979	-17,991
Payments of provisions							-15,000
Increase in receivables	-16,445	-7,737	-51	5,844	-399	2,000	0
Increase in other assets				-241	240		
Increase in payables	19,078	-6,952	1,000	-4,132	709	2,000	2,000
Net cash inflow/(outflow) from op. activities	**-9,532**	**-23,541**	**-37,000**	**-35,116**	**-15,927**	**85,363**	**-3,724**
Cashflow from investing activities							
Net purchase of fixed assets	-341	-3,514	-4,931	-5,915	-6,535	-4,500	-4,500
Purchase of subsidiaries	-81,111	-230,784	-16,442	0	62	0	0
Net cash outflow from investing activities	**-81,452**	**-234,298**	**-21,373**	**-5,915**	**-6,473**	**-4,500**	**-4,500**
Cashflows from financing activities							
Net finance income	70	-3,484	-7,974	-14,121	-19,277	-22,759	-25,921
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	50,400	21,800	0
Dividends	0	-951	-4,439	-7,177	-8,425	0	0
Net cash inflow from financing activities	**98,304**	**255,734**	**64,112**	**43,971**	**22,698**	**-959**	**-25,921**
Net increase in cash and cash equivalents	7,320	-2,105	5,739	2,940	298	79,904	-34,145
Opening cash and cash equivalents	0	7,320	5,215	10,954	13,894	14,192	94,096
Closing cash and cash equivalents	7,320	5,215	10,954	13,894	14,192	94,096	59,951

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

Scenario analysis

Given uncertainties, scenarios need to be treated with extreme caution and be indicative of general direction only

Given the range of variables, we do not believe investors should place too much emphasis on the details of individual scenarios. We note that, in its own base-case stress-testing, NSF would breach its lending covenants within 12 months but that waivers for such a breach are in line with current discussions with lenders. Additionally, given the statement regarding shareholder support, once the FCA review is concluded, an equity raise would be probable.

Downside scenario is zero value for shares

The downside scenario is clear. Should the impact of COVID-19 be materially more than currently anticipated, or the FCA redress significantly higher than the current provision, and the crystallised securitisation cost be written off, then the breaches of warranties would be in excess of current discussions, and it is unclear what the lenders to NSF would do. Such conditions may also make the equity raise problematic. Accordingly, we now consider the worst-case scenario should be to assume that NSF's share price would fall to zero.

Upside is a profit approaching £10m in 2021

However, investors should also consider upside scenarios. In the equity raise scenario:

- Loan book growth increases faster than the base case, and this is compounded as wider-margin new business is a greater proportion of the book – this drives revenue up 15% versus the base case.
- Impairments rise, given the IFRS9 new business charge. However, with increased lending volumes through the group's revised scorecards, there should be an improvement in delinquency and, as there is spread widening contributing to revenue, the rise in impairments should be slower than revenue. When macro conditions improve, there will be a reversal of the IFRS9 cyclical charges, with an increased weighting to upside scenarios, which will reduce impairments.
- Costs rise significantly more slowly than revenue, with the usual economies of scale and capacity currently available in the branch network.
- There is an increase in the total funding cost but, again, this will be slower than revenue, as equity will be a higher proportion of the funding mix.
- In terms of EPS, it is probable that a proportion of any equity raise will be to fund growth through 2020 and 2021, and so there will be a drag from this factor. Given our lower base case, and with delays associated with the FCA review, our upside normalised profit in 2021 is now £3.5m, down from ca.£15m previously. We would expect a 2022 upside to show a significantly higher number, as that year would see the benefit of all the incremental growth added in 2021.

Upside scenario normalised profit and loss

FY'21 (£000)	Base	Upside	% base
Total revenue	166,283	191,226	115%
Impairments	-54,535	-59,988	110%
Revenue less impairments	111,748	131,237	117%
Administration expenses	-90,831	-95,373	105%
Operating profit	**20,917**	**35,865**	**171%**
Net finance (cost)/income	-25,921	-32,401	125%
Profit before tax	**-5,004**	**3,464**	**-69%**

Source: Hardman & Co Research

Valuation

Binary outcome – shares will either go to zero or a multiple of the current level

Our absolute valuation techniques imply some upside potential based off the base case of a going-concern business. We believe it is probable that any outturn will be binary – either the stress outturn develops, in which case the shares are likely to be valued at nil, or a base-case scenario, in which case they will be a multiple of the current price. Normal valuation approaches need to be treated with extreme caution, given the level of uncertainty the group faces.

Summary of valuation approaches

	Implied price (p)	Upside potential
Gordon Growth Model (GGM)	5.6	82%
Discounted Dividend Model (DDM)	7.8	152%
Average absolute measures	6.7	117%

Source: Hardman & Co Research

GGM

We detailed our approach to the GGM in our initiation note, Carpe Diem, published on 11 November 2016. Our assumptions are given in the table below. We have increased the sustained RoE and CoE to reflect the lower equity base, and we have kept a significant discount for short-term performance. However, these changes are overshadowed by the lower equity base's impact on the GGM, which sees a significant cut (from 23p to 6p)

GGM assumptions

	Base	+1% to RoE	+1% to CoE	+0.5% to G
RoE	35	36	35	35
CoE	12	12	13	12
Growth in equity	5.5	5.5	5.5	6
P/BV (RoE-G)/(CoE-G)	4.5	4.7	3.9	4.8
Discount re near-term perf.	-30%	-30%	-30%	-30%
P/NAV (x)	3.2	3.3	2.8	3.4
NAV 2020E (£m)	5.6	5.6	5.6	5.6
Valuation (£m)	17.6	18.2	15.3	18.8
Variance (£m)		0.6	-2.4	1.1
Valuation per share (p)	5.6	5.8	4.9	6.0

Source: Hardman & Co Research

DDM

Give the balance sheet weakness at present, we have assumed no dividends for 2020 and 2021, and only modest dividends thereafter, rising to 1p per share to 2026. The cut in near-term dividends dramatically reduces the DDM valuation.

SOTP

The peer ratings that we have previously used in our sum-of-the-parts (SOTP) model are extremely volatile and arguably of less use than normal. It is indisputable that they have fallen sharply since previous reports.

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