

S&U

H118 results

Strong loan growth continues

First half loan growth at S&U's motor finance business remained strong at 30%, even though lending criteria have been tightened following a previous mix change towards higher-risk customers. Impairments are set to stabilise as the portfolio rebalances, while the company's focus on providing hire purchase loans to non-prime borrowers for used vehicles using a well-established underwriting system should provide reassurance to investors concerned about the wider motor finance market.

Year end	Revenue (£m)	PBT* (£m)	EPS* (p)	DPS (p)	P/E (x)	Yield (%)
01/16	45.2	19.5	132.4	76.0	15.7	3.7
01/17	60.5	25.2	169.1	91.0	12.3	4.4
01/18e	80.0	30.3	201.9	105.0	10.3	5.1
01/19e	95.6	35.5	235.8	117.4	8.8	5.7

Note: *PBT and EPS reported from continuing operations. FY16 DPS excludes exceptional payment of 125p.

H118 results

First half receivables growth was 30% compared with H117 and revenue growth reached 33%, reflecting both loan book growth and a move in the loan portfolio mix towards higher-risk, higher-reward business. This in turn generated a rise in P&L impairment provisions (+73%), but pre-tax profits and earnings per share still increased by more than 20% to £14.3m and 95.3p respectively. An interim dividend of 28p was proposed (+17%). The Aspen Bridging pilot is now in operation, although still at an early stage with outstanding loans at the period end of less than £2m compared with the target investment of £20m.

Outlook

While there is regulatory concern over the growth in consumer lending in general, including the overall motor finance market, S&U does not offer PCP contracts, which have been the main source of growth and concern in this area. With most of its lending being used to fund used cars (average loan c £6,200), which provide customers with transport to work, S&U sees its main risk exposure as being to a worsening of credit conditions generated by higher unemployment rather than a fall in motor residual values (see page 5). Meanwhile, although unit sales of second-hand cars have softened, there is still scope for S&U to gain market share (from c 1%) and it reports robust and good quality demand.

Valuation: Still cautious

Taking into account our peer comparison and a valuation based on an ROE/COE model, we maintain our valuation at 2,700p per share suggesting significant upside from the current share price. Reversing the ROE/COE calculation suggests that the current price is factoring in a cautious cost of equity of nearly 12%.

Financial services

5 October 2017

Price **2,073p**
Market cap **£248m**

Net debt (£m) at end July 2017 80.7

Shares in issue 12.0m

Free float 26%

Code SUS

Primary exchange LSE

Secondary exchange N/A

Share price performance



% 1m 3m 12m

Abs 6.8 1.9 (15.9)

Rel (local) 5.8 0.0 (21.0)

52-week high/low 2,517.5p 1,883.50p

Business description

S&U's Advantage motor finance business lends on a simple hire purchase basis to lower and middle income groups that may have impaired credit records which restrict their access to mainstream products. It has over 50,000 customers currently. The pilot Aspen Bridging finance business is now open.

Next events

Third quarter trading update 7 December 2017

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H118 results commentary

S&U's first half results were broadly similar to our expectations with motor finance receivables ahead of our estimate, while revenue was slightly above and pre-tax profit slightly below our forecast. Compared with H117 receivables and revenue growth were both above 30%, while pre-tax profits and earnings per share increased by over 20%. Key points from the figures are summarised below with percentage changes from H117 unless stated.

- Advantage motor finance gross and net receivables increased by 31% and 30% respectively (the stock of provisions as a percentage of gross loans was slightly higher at 13.9% versus 13.3%).
- The number of new loans increased by 21% to more than 12,500 with the rate of transactions in relation to loan applications (440,000) broadly stable at 2.9%.
- Revenue growth was 33%, reflecting growth in the loan book and an earlier mix change towards higher-risk, higher-return loans.
- The P&L impairment charge increased by 73% to £8.6m equivalent to an annualised 8.2% of average receivables compared with 6.2%. As a percentage of revenue this was 22.9%, up from 17.5%. S&U indicates that this was mainly a reflection of product mix. For further discussion of the portfolio mix and credit trends see below.
- Other costs of sales increased by 30% H118/H117 and 38% sequentially, reflecting growth in the number of new loans and higher broker commission costs (see Exhibit 5 and further discussion below). Administration expenses rose by 19%, leaving a pre-tax profit increase of slightly over 20% to £14.3m. Advantage recorded its 17th year of profits growth. Earnings per share increased by 21% to 95.3p (normalised fully diluted basis) and a first interim dividend of 28p was proposed (+17%).
- The Aspen Bridging finance pilot has been launched and at the half year end had gross assets of £2m. The intention remains to invest £20m in the pilot, albeit the initial pace of lending has been slower than originally planned, reflecting a prudent approach as the business establishes itself.

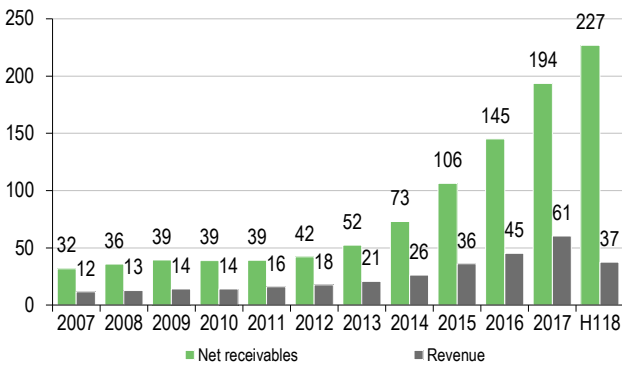
Exhibit 1: H117 results analysis					
£m unless stated	H117	H217	H118	H118/H117 (%)	Sequential change (%)
Motor finance net receivables	173.9	193.5	226.8	30.4	17.2
Number of new loans	10,363	9,679	12,542	21.0	29.6
Revenue	28.3	32.2	37.6	32.8	16.5
Impairments	(5.0)	(7.2)	(8.6)	73.2	18.7
Other cost of sales	(6.6)	(6.2)	(8.6)	30.3	38.3
Administration expenses	(4.0)	(4.3)	(4.8)	19.3	10.0
EBITDA	12.7	14.4	15.6	22.5	7.9
Depreciation	(0.1)	(0.1)	(0.1)	11.8	(0.7)
Operating profit / loss	12.6	14.3	15.4	22.6	7.9
Finance expense	(0.7)	(0.9)	(1.2)	58.7	22.3
Pre-tax profit	11.9	13.4	14.3	20.4	6.9
Tax	(2.4)	(2.5)	(2.8)	16.0	13.1
Net profit	9.5	10.9	11.5	21.6	5.5
Normalised fully diluted EPS (p)	78.5	90.5	95.3	21.4	5.3
Dividend per share (p)	24.0	67.0	28.0	16.7	

Source: S&U, Edison Investment Research

Exhibit 2 provides context by showing the longer-term evolution of the Advantage loan book and revenues, with particularly strong growth recorded from 2013 onwards. S&U notes that Advantage still has less than 1% of the used car market. The next chart shows the risk-adjusted revenue yield (calculated by deducting the P&L impairment charge from revenues and expressing the result as a

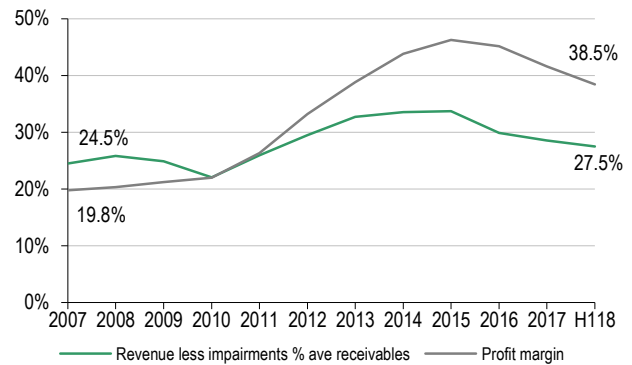
percentage of average receivables) and pre-tax profit margin over the same time period. This shows some erosion of the risk-adjusted revenue yield in recent periods, in part reflecting the removal of insurance revenue in FY15 and, from FY15 to September 2016, a short-term experimental shift in the risk criteria towards higher-risk borrowers, which was terminated as it did not generate commensurate returns. Nevertheless, between 2007 and H118 risk-adjusted return improved from 24.5% to 27.5%, which can in part be attributed to a continuous process of refinement in Advantage's customised credit scoring system (current version is Delphi 10).

Exhibit 2: Motor receivables and revenue history (£m)



Source: S&U

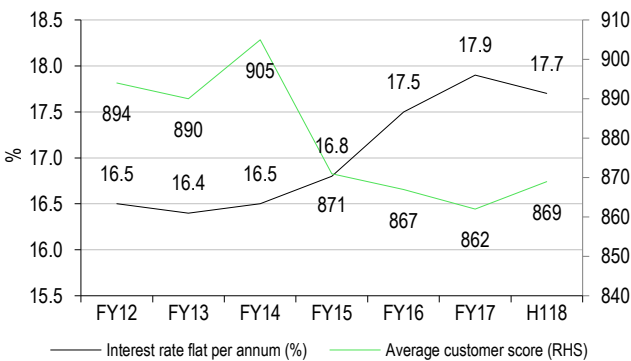
Exhibit 3: Risk adjusted revenue yield & profit margin



Source: S&U, Edison Investment Research

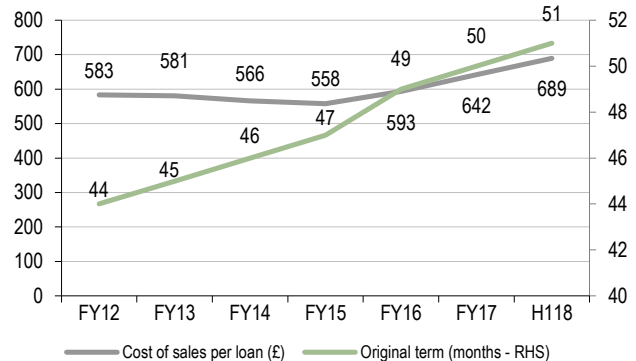
Next (Exhibit 4), we show the trends in Advantage's average customer credit score and the flat interest rate by period of origination. This shows that there has been a balance between pricing and risk with rates rising as the mix was adjusted towards lower credit scores. S&U reports that Advantage has more recently tightened both backward-looking credit scoring and forward-looking affordability criteria. This is evident in the modest uptick in the average credit score in H117, but the delayed effect of changes in the mix within the portfolio also meant that the live portfolio at the time of the announcement had a slightly higher average yield and lower credit score because the high-scoring FY12-14 originations had largely settled. The arrears profile (not shown) has previously shown a decline in the percentage of receivables where payments are up to date (for FY17 this was 86.75% compared with 91-92% for the previous three years), but in the first half there was a small increase to 86.95% signalling stabilisation as Advantage adjusts its criteria.

Exhibit 4: Customer credit score and flat interest rates



Source: S&U. Note: Internal credit quality score and interest rate by year of origination.

Exhibit 5: Cost of sales and original loan term



Source: S&U. Note: Cost of sales represents acquisition costs mainly arising from commission paid to brokers.

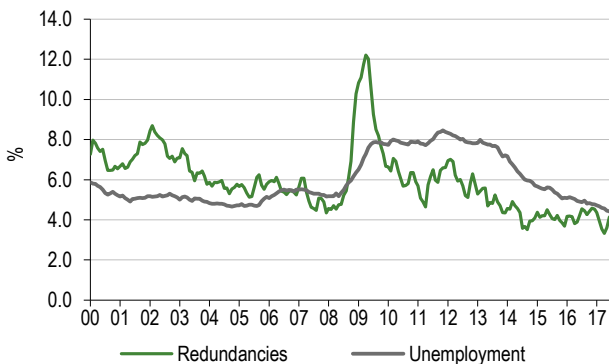
Exhibit 5 shows two metrics that have been influenced by competitive behaviour in the market. The original duration of loans has increased over the period shown from 44 months to 51 months, which helps attract customers as it reduces the monthly payments but does imply some increase in risk for the lender (potentially compensated for by the interest rate). The chart also shows a rise in the cost of sales per loan. After initially falling, this has increased noticeably over the last three years,

largely reflecting the increase in payments to the brokers which originate most of the loans. The increasing role of the larger internet brokers plays a role as well as competitor behaviour.

Market background and outlook

Despite uncertainties surrounding Brexit, the UK economy has shown resilience and estimates for GDP growth and unemployment for both 2017 and 2018 have been stable recently. Exhibit 6 highlights the positive trend in the level of unemployment and redundancies since the financial crisis. Consumer confidence, here measured by the EC indicator (Exhibit 7), has followed a more bumpy path over the same period, softening somewhat recently, although still well above the lows recorded during the crisis. Further weakening in confidence could affect the appetite for borrowing in the car market, although the segment within the overall UK market addressed by Advantage is arguably less sensitive to this.

Exhibit 6: UK redundancies and unemployment



Source: ONS

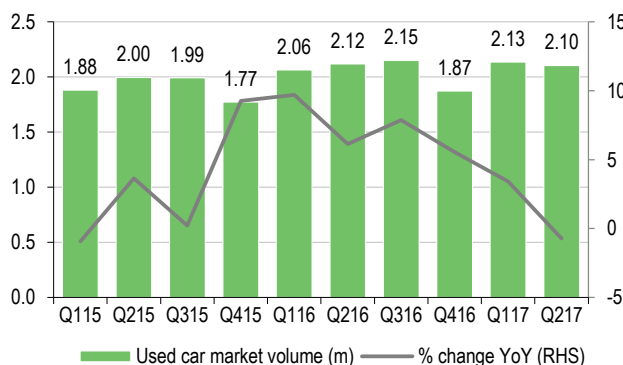
Exhibit 7: UK consumer confidence indicator



Source: European Commission

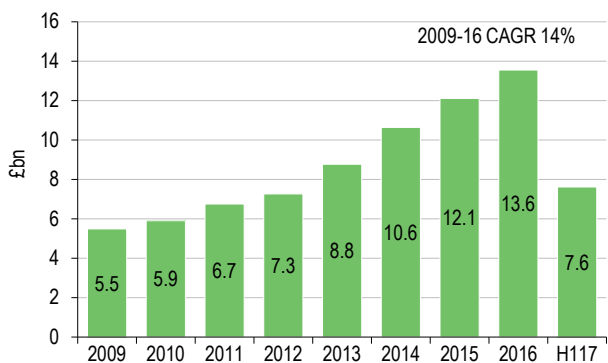
Used car market volumes and used car finance (Exhibits 8 and 9) remain at relatively high levels, although the unit volume figures from the SMMT showed a marginal year-on-year decline for the second quarter. Used car finance has continued to show year-on-year growth of 9.7% in the first half.

Exhibit 8: UK used car market volume



Source: SMMT

Exhibit 9: Used car finance through dealerships



Source: Finance and Leasing Association

Prospectively, maintenance of GDP growth as currently expected and low unemployment and redundancy levels should be favourable for S&U, both in terms of impairment levels and appetite for loans. Competition remains a factor, but S&U reports that there have not been notable changes here in recent months (it remains to be seen whether Provident Financial's difficulties with its home credit operation will have any impact on its Moneybarn, motor finance subsidiary). While overall

growth in second-hand car transactions may be softening, demand for finance has been more robust and within this Advantage has good scope to increase its c 1% market share.

Regulators have been paying attention to the high level of growth in consumer finance, including motor finance, and this has played a part in the FCA undertaking work on the market for motor finance. This appears likely to be focused on Personal Contract Purchase (PCP), which has been the main source of finance for new cars. Under these contracts, at the end of the agreement the customer can choose to buy the car for a guaranteed future value (normally set at 85-95% of the expected value), enter a new contract or simply give the car back. Because of the guaranteed future value that forms part of the contract, the lenders (frequently subsidiaries of car manufacturers) are exposed to potential weakness in second-hand car values.

S&U does not operate in this market as its contracts are conventional hire purchase contracts with an average loan of £6,200. Most of its transactions involve used vehicles, which have already experienced the period of most rapid depreciation so the sensitivity to weaker used prices may be reduced. There have been specific concerns relating to the value of used diesel engine cars that account for c 48% of the Advantage book. Here S&U reports that it has not experienced any softness in auction values to date and, prospectively, any price weakness for these cars would mean that new customers might obtain 'more car' for a given value.

S&U management notes that it would be more concerned by deterioration in the economy and credit experience rather than the impact of a potential decline in second-hand values or increase in voluntary terminations (an option HP customers have once they are halfway through their contract and currently running at 8-9% of loans). It illustrates this with a scenario in which there is a 15% incidence of bad debts, 10% of borrowers opt for voluntary termination and there is a £400 (20%) loss on the value of a £2,000 car. Although these are cautious assumptions this would only mean an average loss of £100 compared with a typical profit on a contract of £2,000. We estimate increasing the rate of voluntary terminations to around 15% (double S&U's historical experience) might have a further £100 impact on profitability reflecting both increased exposure to the lower sale price assumed in the scenario and a lower return as a result of early termination. These scenarios would represent negative developments, but would be manageable for the business.

Aspen Bridging finance remains at a formative stage so the outlook here depends on the pace at which the business develops. As noted, lending has been slower than expected, but the conservative approach taken is reassuring with capital protection remaining a priority rather than growth. Even so, we assume lending picks up more strongly from here now that relations with brokers have become more established.

Financials

We have made only marginal changes to our pre-tax profit and earnings estimates for FY18 and FY19, reflecting the trends seen in the first half with a higher revenue yield offset by a somewhat higher level of provisioning.

Exhibit 10: Changes to estimates

Year end	Revenue (£m)			PBT (£m)			EPS (p)			DPS (p)		
	Old	New	Change (%)	Old	New	Change (%)	Old	New	Change (%)	Old	New	Change (%)
2018e	75.2	80.0	6.4	30.1	30.3	0.8	199.1	201.9	1.4	104.4	105.0	0.6
2019e	89.8	95.6	6.5	35.4	35.5	0.4	234.2	235.8	0.7	116.7	117.4	0.6

Source: Edison Investment Research

Further investment, mainly in the motor finance loan book, meant that net debt (not including preference shares) increased by £31.5m to £80.7m. Net debt to equity at the end of July stood at 56% compared with 35% at the year end. Since the period end, the group increased its borrowing

facilities through the addition of a £20m rolling credit facility (to March 2021), taking the total to £115m. On our revised estimates, growth in the motor finance and bridging finance loan books could take net debt to c £133m by end FY19 and debt to equity to 79%.

Valuation

We have updated our valuation comparison table, which includes peers involved in non-standard lending or that have motor finance as one of their activities. S&U trades below the average P/E and has an above-average yield (Provident Financial's historical yield is excluded given its cautionary August trading statement). S&U's return on equity is above average (also ex-Provident Financial) and the price to book is similar to the group average. The small sample size and differences between the businesses qualify this comparison, but S&U appears moderately valued in this context.

Exhibit 11: Peer comparison						
	Price (p)	Market cap (£m)	2017 P/E (x)	Yield (%)	ROE (%)	Price to book (x)
S&U	2,070.0	248.0	10.4	4.4	15.2	1.7
1PM	51.0	42.7	6.6	0.0	12.5	1.0
Close Brothers	1,475.0	2,238.5	11.1	4.1	16.4	1.8
Private and Commercial Finance	28.5	60.5	14.3	0.0	11.4	1.8
Provident Financial	830.5	1,231.0	12.3	N/A	N/A	1.7
Secure Trust Bank	1,770.0	327.0	12.9	4.2	11.9	1.4
Average			11.2	2.5	13.5	1.6

Source: Bloomberg, Edison Investment Research. Note: P/Es adjusted to CY17. Priced at 29 September 2017.

Using unchanged assumptions (return on equity of 17%, cost of equity of 10% and growth of 5%), our ROE/COE model gives a value of 2,871p (2,825p previously) reflecting an increase in the NAV. Given this modest change and taking account of the peer valuations we maintain our valuation at 2,700p, suggesting c 30% upside from the current share price.

Exhibit 12 shows recent share price performance for the peer group. The salient feature here is the severe impact Provident Financial's difficulties have had on its share price, but all the stocks are significantly below their 12-month highs. Given the track record of the Advantage business and potential to continue to achieve good growth, the performance of S&U's shares can be seen as offering an opportunity for investors.

Exhibit 12: Share price performance comparison					
	One month	Three months	One year	Ytd	From 12-month high
S&U	3.5	2.2	(18.3)	(6.0)	(18.8)
1PM	4.6	28.3	(21.1)	(19.2)	(25.6)
Close Brothers	(3.2)	(1.9)	7.0	2.1	(14.0)
Private and Commercial Finance	17.5	16.3	13.0	3.8	(10.8)
Provident Financial	(8.4)	(65.8)	(72.2)	(70.8)	(75.6)
Secure Trust Bank	4.7	(12.9)	(27.0)	(17.7)	(29.2)
Average (unweighted)	3.1	(5.6)	(19.8)	(18.0)	(29.0)

Source: Bloomberg

Exhibit 13: Financial summary

£'000s	2015	2016	2017	2018e	2019e
Year end 31 January	IFRS	IFRS	IFRS	IFRS	IFRS
PROFIT & LOSS					
Revenue	36,102	45,182	60,521	80,014	95,623
Impairments	(5,863)	(7,611)	(12,194)	(18,252)	(21,366)
Other cost of sales	(6,674)	(8,980)	(12,871)	(17,763)	(20,559)
Administration expenses	(6,957)	(7,131)	(8,332)	(10,162)	(12,144)
EBITDA	16,608	21,460	27,124	33,836	41,554
Depreciation	(163)	(209)	(253)	(348)	(626)
Op. profit (incl. share-based payouts pre-except.)	16,445	21,251	26,871	33,489	40,928
Exceptionals	0	0	0	0	0
Non-recurring items	0	0	0	0	0
Investment revenues / finance expense	(1,680)	(1,782)	(1,668)	(3,146)	(5,384)
Profit before tax (FRS 3)	14,765	19,469	25,203	30,343	35,544
Profit before tax (norm)	14,765	19,469	25,203	30,343	35,544
Tax	(2,920)	(3,583)	(4,861)	(5,997)	(7,109)
Discontinued business after tax	6,615	53,299			
Profit after tax (FRS 3)	18,460	69,185	20,342	24,346	28,435
Profit after tax (norm)	11,845	15,886	20,342	24,346	28,435
Average Number of Shares Outstanding (m)	12.0	12.0	12.0	12.1	12.1
Diluted EPS (p)	154.3	576.5	169.1	201.9	235.8
EPS - normalised (p)	99.0	132.4	169.1	201.9	235.8
Dividend per share (p)	66.0	201.0	91.0	105.0	117.4
EBITDA margin (%)	46.0%	47.5%	44.8%	42.3%	43.5%
Operating margin (before GW and except.) (%)	45.6%	47.0%	44.4%	41.9%	42.8%
Return on equity	15.7%	15.2%	15.2%	16.7%	17.7%
BALANCE SHEET					
Non-current assets	76,781	103,653	138,004	182,253	219,322
Current assets	68,578	61,903	57,763	79,351	97,837
Total assets	145,359	165,556	195,767	261,604	317,159
Current liabilities	(8,945)	(6,850)	(17,850)	(8,401)	(23,180)
Non-current liabilities inc pref	(54,950)	(30,450)	(38,450)	(100,450)	(125,450)
Net assets	81,464	128,256	139,467	152,753	168,529
NAV per share (p)	689	1,084	1,177	1,275	1,407
CASH FLOW					
Operating cash flow	(13,404)	(16,017)	(27,431)	(34,873)	(21,543)
Net cash from investing activities	(1,096)	80,716	(308)	(1,618)	(1,618)
Dividends paid	(6,734)	(23,090)	(9,548)	(11,380)	(12,977)
Other financing (excluding change in borrowing)	8	55	21	2	0
Net cash flow	(21,226)	41,664	(37,266)	(47,869)	(36,138)
Opening net (debt)/cash	(32,339)	(53,565)	(11,901)	(49,167)	(97,036)
Closing net (debt)/cash	(53,565)	(11,901)	(49,167)	(97,036)	(133,174)

Source: S&U accounts, Edison Investment Research. Note: FY16 DPS includes an exceptional payment of 125p.

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