2nd February 2017

hardman&co

Financial Services

Source: Eikon Thomson Reuters

Market data

EPIC/TKR	MCL
Price (p)	118.5
12m High (p)	132.5
12m Low (p)	84.6
Shares (m)	129.5
Mkt Cap (£m)	153.5
EV (£m)	156.2
Free Float*	44%
Market	AIM

** 1% shareholding of directors*

Description

MCL is number two in UK home credit. It is growing this business organically and by acquisition, and is developing a range of related products where it has competitive advantage.

Company information

Non Exec Chr	Stephen Karle
CEO	Paul Smith
CFO	Andy Thomson

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Key shareholders

Perpignon Limited	51.00%
Schroder Investment Mgt	9.39%
Miton Asst mgt	6.72%
JO Hambro	4.70%
Andy Thompson	4.38%
Soros Fund Mgt	4.03%
Blackrock	3.51%

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Morses Club (MCL)

Bringing Home Collect into the 21st Century

Having completed a major integration, management is now focussing on carefully controlled growth. Technology is driving efficiency improvements, aiding credit management (impairments are at the lower end of expectations) and improving compliance and controls. MCL is the number 2 in UK home-collect credit (HCC) market, and is around twice as large as the number 3. It is attracting and acquiring performing agents and portfolios of loans. Revenue margins have been increased and MCL is introducing new products where it has a competitive advantage from existing operations, or risk management expertise. We see 28% valuation upside.

- **HCC is an attractive market**: HCC is a product valued by customers (95-97% overall satisfaction). Market-wide high credit risk and administration costs are reflected in appropriate interest costs, generating profitability and cashflow for investors. A well-managed business, like MCL, is significantly counter-cyclical.
- **MCL strategies should add value:** MCL is improving the operational efficiency of the business, has raised revenue yields and focussed on better quality, lower risk customers. Looking forward, it has developed a range of profit growth options from the existing business and related areas of competitive advantage.
- **Valuation:** Our range of absolute valuation approaches indicates a fair value would be around 152p with the Gordons growth model (which capture both value added and growth) having the highest valuation at 168p. The average peer group relative measure has 20% upside (to 142p).
- **Risks:** Credit risk is high (albeit inflated by accounting rules) but MCL adopts the right approaches for this market. Regulatory risk is an issue for all financial companies, but HCC has already been reviewed and high customer satisfaction would suggest limited need for change. MCL has no pension risk.
- **Investment strategy:** We believe MCL is operating in an attractive market and has a dual-fold strategy which should deliver an improved performance from existing businesses and deliver new growth options. MCL conservatively manages risk and compliance, especially in new areas. The agent network is the competitive advantage over remote lenders. The valuation has material upside and we forecast a 2017E dividend yield of 5.3% with cover of 1.7x (adj. earnings).

Financial summary and valuation

Year end Dec (£m)	2015	2016	2017E	2018E	2019E
Reported revenue	89.9	90.6	98.5	104.2	113.2
Total impairments	-22.9	-18.8	-23.1	-25.0	-28.3
Total costs	-51.4	-53.2	-56.9	-59.6	-63.5
EBITDA	16.5	19.6	19.7	20.9	23.2
Adjusted pre tax	13.0	16.9	17.5	18.5	20.4
Statutory pre tax	58.5	10.4	11.3	14.1	13.7
Statutory EPS (p)	46.5	6.1	6.9	8.7	8.6
Adj EPS (p)	8.1	10.3	10.7	11.4	12.6
P/ Adj Earnings (x)	14.6	11.5	11.1	10.4	9.4
P/BV (x)	1.6	2.8	2.7	2.6	2.5
P/tangible book	1.8	3.4	3.3	3.0	2.8
Yield	n/m	n/m	5.3%	5.8%	6.3%

Source: Hardman & Co Research

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Executive summary

HCC offers investors good returns, with well managed risk through a product which is of real value to the customer

We believe the HCC market offers excellent risk-rewards opportunities for investors. Customers who are unable to access mainstream lending have a convenient product, whose price may appear high relative to mainstream products, but is appropriate to the high cost face to face model and credit experience of the business. Interest rates are well below most available alternative finance sources available to these customers, a feature recognised by the regulator. The agent relationship embeds MCL in the community to which it is lending and is essential to the effective management of credit. MCL's strategy in this market is two-fold – firstly improve the operational delivery by the core business and second to develop related growth options where the group has a clear competitive advantage:

MCL is adding value to existing business with focus on higher quality credits, improving yields, using IT to improve efficiency and attracting good agents

Improving operational delivery has several strands including:

- Focusing on higher quality customers who incur less credit loss, administration expenses and earnings volatility. This policy comes at the cost of customer numbers although the "cleansing" of the large SFS book is now largely complete.
- Shortening loan duration which improves revenue yield – nearly completed.
- Improve operational efficiency by using technology to automate processes reducing inefficient paper practices, reducing error rates, upgrading compliance and management information. There was a 7% productivity improvement in H1FY17 and we expect expenses as a proportion of revenue to continue to fall.
- Attract and retain the best agents. MCL has shown flexibility in terms of agent working practices, not requiring for example agents to work full time unlike the market leader. This has a modest operational inefficiency which is more than compensated for by a motivated workforce.

Growth is expected from agent and portfolio acquisitions, targeted marketing and new products. All these should see greater economies of scale develop.

Growth options include:

- Territory builds via the recruitment of experienced agents. In H1FY17 c5% was added to the agent network on a selective basis – asset quality has been good.
- Acquisitions of books – in H1FY17 this added c5% of the customer base – many HCC business have mature owners facing increasingly burdensome regulation.
- Targeted marketing of the core product. Historically, new customers were primarily acquired by word of mouth recommendation but management is introducing technology which opens new channels, especially digital ones. In H1FY17 web introductions accounted for nearly 10% of the total customer base.

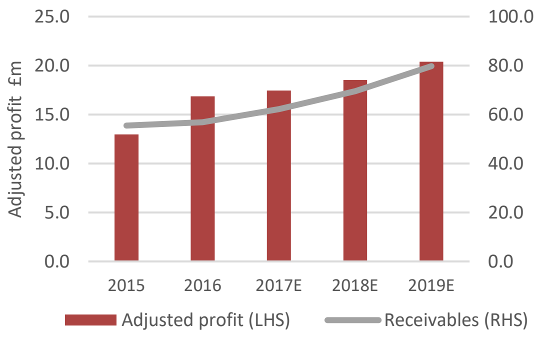
New products exploit existing advantages and carefully introduced

- New products including Morses Club Card, remote collect and on-line lending. For each, MCL is looking to exploit an existing competitive advantage such as the flow of traffic through its website, customer contact, credit assessment and management, databases, and servicing and administration infrastructures.

HCC attractive market. Agent is core to HCC and is major barrier to entry.

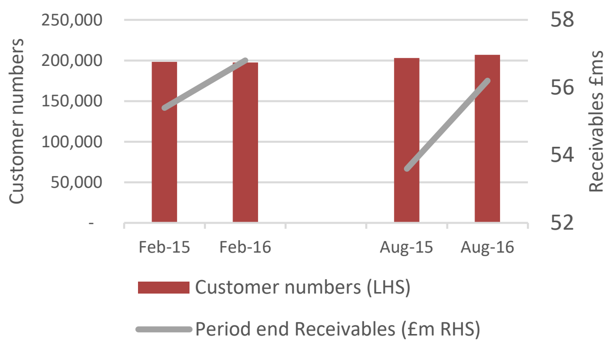
HCC will see relatively high impairment losses relative to prime lending and this is reflected in appropriate pricing. Risk control is greatly enhanced by having the agent embedded in the borrowing community. In periods of uncertainty the demand for HCC rises offsetting the credit cyclicality. Customer satisfaction is high (95-97% overall), a major factor mitigating potential regulatory risk.

Adjusted pre-tax profits and customer receivables (£ms) 2015-2019e



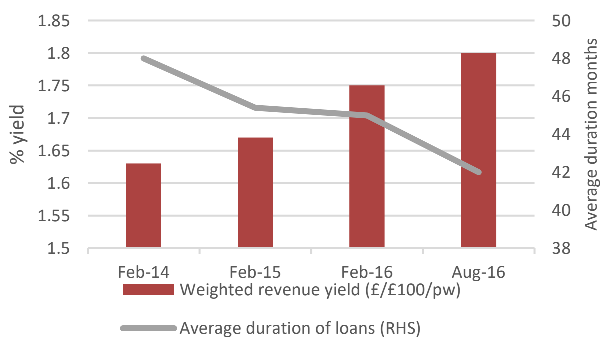
- 2017e profit growth impacted by impairments rising to more normal levels and above-normal temporary commissions paid to attract new agents.
- 2018e / 2019e profit growth (7% and 10% respectively) as drag from these issues is less of a factor.
- Technology seeing steady improvement in cost income ratio with admin cost growth c half income growth
- Much more stable growth (consistently mid-single digit) expected in receivables. This should be a conservative assumption.

Recent customer numbers and receivables outstanding



- Seasonal business with peak at Xmas, so this chart shows like for like growth for each accounting period end.
- The year to February 2017 will see the tail end of the post SFS acquisition clean-up exercise reducing numbers of lower quality credits.
- Acquisition of books likely to continue over next few years. Also seen "organic" growth from new agents.
- This growth is before any benefits from the new products initiatives outlined below.

Revenue yield and average duration of loans



- Average duration being managed down – new customers limited to 20/33 week products, the 78 week product only now available to customers who already have it.
- Falling duration helps increase yield. The theoretical revenue yield (see definition later) up a tenth (from 1.63% Feb 2014 to 1.80% August 2016).
- Increase in yield despite reducing higher risk accounts.
- Management expect average duration to stabilise around 40 weeks which is likely to see yields stabilise around 1.85%-1.90%

New business lines development pipeline

	Roadmapped	Infrastructure in place	Internally Trialled	Expected launch
Morses Club Card	Y	Y	Y	Y
Remote Collect	Y	Y	Y	Y
Online Lending	Y	Y	H1FY18	H1FY18
E-Money	Y	Q1FY18	Q2FY18	Q3FY18
Revolving Credit	TBC	TBC	TBC	TBC
Mobile Wallet	TBC	TBC	TBC	TBC

Source: MCL, Hardman & Co Research

- Club card sales in H1FYY17 were strong and give management early data for further product roll out.
- Remote collect primarily to HCC customers with established track record but who want different repayment structure / channel.
- Online lending plans accelerated by acquisition in January 2017 of Shelby Finance. We expect steady progressive build out ensuring credit controls are robust.
- Range of other potential products with key feature being the ability to exploit an existing competitive advantage.

Source: Company data; Hardman & Co Research

HCC Market

Market overview

Agent is core to HCC business and essential part of credit approval process. They establish who is willing to repay not just their ability to repay

The HCC market is believed to have around 3m regular customers of whom 1.5-2m are actively borrowing at any given time. The consumer credit association (the industry body - http://www.ccauk.org/) has around 420 UK provider members. Approximately 6 million UK HCC transactions are executed each year with an approximate aggregate annual value of £1 billion. While technology can improve efficiency, and make part of the credit assessment, at the core of the business is the relationship between the self-employed agent and the customer. The agent is usually part of the community which they serve. They are often personally well known to the borrower, in similar financial circumstances and like the customers are typically a middle-aged woman (63% of MCL agents are female), working part time. A core part of the agent's job is to assess whether the borrower has the character to repay. Computer modelling filters on the ability to repay but the agent has the final decision. Being part of the community and knowing the borrower and their social group well, are core to getting the credit assessment right.

Credit assessment cannot be solely computer driven – willingness to repay v ability is crucial

This is a high credit risk business (although the accounting rules materially inflate the charge). Historically, a flaw of standard lenders moving down into sub-prime (which they did when economic conditions were strong and competitive pressures eroded prime market returns) has been an over-reliance on statistical modelling. In the non-standard market, money is so tight that even a few pounds makes a difference to the customer. Judging whether they will use those few pounds to consistently meet their debt obligations or spend on other things, is critical to the credit decision. To date computer modelling alone has not been able to accurately forecast this. We believe the variable nature of customer income, together with the lack of reliable credit reference and behavioural data, mean this will continue over the foreseeable future.

Higher credit losses of new customer but less so where relationship is with an established agent

New customers tend to incur greater losses than experienced ones. This is typically managed by offering them shorter term loans (incurring a higher APR) and smaller loans (higher administration cost). New customers, thus generate higher revenue margins but lower nominal income, greater costs and more impairments with net effect being that their profitability is lower.

Management of credit once in difficulties is different from main stream

Managing arrears requires different practices from those seen in the prime and near prime markets. While banks have historically loaded charges onto customers who miss payments/go overdrawn unexpectedly, this is not a feature of the MCL's business where forbearance is an integral part of the model. Volatile customer income means their ability to keep to payment plans can be variable and getting into arrears on payment plans is more normal rather than exceptional. Applying penalties which may well never be collected is rather pointless and industry practice is to add to the length of a loan if the customer misses a payment. The cost of this is factored into the high yield earned on the loans. Knowing when to chase payments and to limit losses is not simple, and needs a detailed knowledge of the customer and their likely behaviour if a loan is extended.

The market is significantly counter-cyclical

At times of economic distress, the number of customers who drop out of prime status increases thus expanding the pool of potential customers in the non-standard market. Additionally, MCL's ability to re-price is significantly higher – it is easier to add 20% to a loan with an APR of 400% than 1% to a mortgage charging 3%. Impairments rise, as does the funding cost, but the bottom line resilience of well-run businesses such as PFG (2007 profit £115m, 2009 profit £130m) or S&U (2007 profit

£6m, 2009 £6m) proves the sector's inherent counter-cyclicality through the last major downturn. There is zero overlap with Secure Trust's unsecured lending and no read across from it.

High administration cost business

Administration expenses are also high as a percentage of revenue reflecting: (i) a low average size of loan, (ii) high credit management costs including collection, and (iii) manually intensive processes for collection and credit assessment with a sizeable supporting infra-structure. Technology can help the process but the core of the business remains the agent's personal relationship and so the high cost.

Simple products focusing on cost per week not APRs

The customer base is not generally financially sophisticated and so the product range needs to be kept simple. In HCC, pricing typically reflects just the loan duration. The key issue for the customer is how much does the loan cost every week and what is the total amount that they pay back, rather than them having a detailed understanding of the technicalities of APRs. Figure 3 shown on page 9 shows the current product range. No default fees or interest is payable in the event that they miss one or more payments and the customer gets certainty thus allowing them to budget.

Regulatory risk should be mitigated by high customer satisfaction and HCC being a much lower cost option than alternatives. Previous reviews have seen relatively minor operational changes (e.g. price comparison website). HCC carved out from FCA definition of high interest short term credit.

The high credit risk and high administration cost make this a high interest rate business. This exposes the sector to perceptions of over-charging and it has faced anti-competitive investigations in the past. We note from an international perspective there have been several countries imposing regulatory caps on equivalent businesses and at the end of November 2016 in the UK, the FCA announced a review of high cost credit. Previous reviews of the HCC market have not resulted in any material business model changes or adverse profit impact. In the May-August 2016 independent survey of customer satisfaction, 95-97% of customers were either fairly satisfied or very satisfied (latter being 87%). This compares with a figure of 44% for Wonga and is important when considering whether the regulator will consider the product a good one. MCL's business does not meaningfully overlap with payday lenders and it is not exposed to any of the remedies proposed for that market (its interest rates are around half the FCA imposed cap of 0.8% per day). We believe the decision by the FCA to specifically carve out HCC from its definition of high interest short term credit is a very positive indicator of its view on the market.

Rent to buy area most at risk given poor customer affordability

Historically several companies provided finance for goods such as TV's on terms which meant the failure to repay the debt led to the goods being re-possessed. We believe this area is most at risk from the FCA review as the affordability of borrowing has become a major focus and this may see half the customers becoming ineligible to borrow on current terms. Around £800m of goods was purchased this way in 2014 and some of it may need an alternative source of funding.

Regulation incurs costs but is also an effective barrier to entry and driver of consolidation.

Out of 576 home credit companies just over 400 have received the permanent FCA approval. None of the top 3 and only 1 of the top ten is fully authorised as it appears that the FCA has been granting licences first to those firms with the least systemic risk. The key areas for regulatory focus are:- agent oversight, affordability checking, arrears and collection, management of vulnerable customers and remuneration. As we detail in the sections on credit and regulation below we believe MCL's systems and practices are very robust and are overseen by a compliance team of 17 people (out of an employed workforce of 620, both as at last reporting date in spring 2016). While this incurs material cost, it is indicative of how regulation is also a barrier to entry and that it may also drive smaller HCC businesses out of the market. The competitive advantage of scale increases with greater levels of regulation creating inorganic growth opportunities for MCL.

Competition limited as it is a niche business serving specific customer needs.

The average income level of customers as well as the size and duration of loans means the overlap between MCL's businesses and payday lending is very limited and such lenders are not substantial competitors to MCL. Credit Unions are limited in their operations and do not offer the same product functionality but are an alternative source for finance. Pawn brokers are also in HCC lending space but have different product functionality. Non-standard credit cards are not generally available to HCC customers.

MCL operations

MCL is number 2 in HCC following acquisition and integration of Shopacheck

MCL is now the number 2 HCC business in the UK with a market share of approaching 15% having started HCC in 1997. It was the number four provider when in 2014 it took over Shopacheck Financial Services (SFS). That business was established in 1933 when Cattles plc extended into UK HCC and was the second largest provider at the time. Since then, management have fully integrated the two businesses with an initial focus on improving the quality of the SFS loan book as well as developing a range of a growth options.

New customer process involves two visits from the agent before a cash loan is given … this gives the borrower and agent time to consider whether a loan is right and helps mitigate potential mis-selling claims / ensure customers are treated fairly

Renewals by existing customers represent the greatest part of gross lending with c89% of customer numbers and 94% of loans by value being second or later loans extended to existing customers. Totally new customers who are interested in a loan contact MCL via the web, phone or via direct agent contact. After collecting some basic details to allow a credit check to be done, an agent will then visit the customer at home. At this visit, the agent will discuss the possibility of taking out a loan and obtain written consent to call back. The agent arranges for a second visit to the customer's home to explain how the process works and then the agent undertakes appropriate affordability checks (automated) and tries to understand the customer's individual circumstances (discretionary). If, after the agent recommendation, MCL decides that they want to make the loan, the customer is provided with a contract which clearly sets out the total amount payable, the APR, the number of weekly payments and the amount of each weekly payment. Once the customer has signed the contract, the agent provides them with a loan and agrees a weekly collection regime.

Management of accounts reflects customers lack of financial sophistication

Customers make their weekly repayments in cash (or debit card). This reduces the risk of amounts being taken from customer bank accounts without their knowledge, triggering financial difficulties due to the unforeseen timing of the deduction. This evidences another difference in customers from the prime market. There, a direct debit on the bank account is advantageous as it gives greater certainty of repayment and any penalties for the customers are relatively small and manageable. For HCC customers, bank charges could be both crippling and put repayment of the loan at greater risk. Incidents of fraud and theft are rare and evidence the value of the agent to the community they serve and to MCL's security training and procedures.

The average customer indebtedness (including interest) in August 2016 was £552 (August 2015 £566).

Customer numbers at end August 2016 were 207k with an average balance in August 2016 of £552 (loan principal and all interest due). This represents about 5% of their annual income and total principal and interest repayments are typically around £24p.w. or c10% of income, a much lower proportion of income than mainstream households. These customers do not have the large debts such as mortgages or student loans, and while interest costs are high, the customers are not over-indebted. We note that the customer demographic has been changing somewhat with customers aged under 35 accounting for 31.3% of loans in August 2016 against 26.9% in August 2015. Given the repeat nature of the business, this is indicative of an embedded value built within the customer base.

Agents typically get 10% cash collected, not sales

A typical commission structure for an agent would be approximately 10% of the cash collected (which equates to c22% of revenue). Agents are not paid on sales and have no incentive to make poor loans, an important issue for both credit and regulatory compliance reasons. Annually the commission equates to nearly £10k p.a. per agent but many are part time only.

MCL has a tiered management structure with a regional network of around 100 branches (August 2016). Managers have weekly agent meetings, conduct training, ensure compliance requirements are met and initiate more focussed impaired credit collections, where necessary.

Company KPIS and targets

We detail below the key KPI's outlined by the company and a couple of additional measures. We highlight a strong profitability (ROA c 20%) which we believe will be improved with operational efficiency, economies of scale and potentially more debt gearing.

Figure 1: Company KPIs and targets

KPI	2015	2016	H1FY17	Comment
Adjusted profit before tax (£m)	13.0	16.8	8.6	Company basis (see financials section below), H1FY17 saw impairments revert to norm and temp agent comms.
Adjusted EPS (p)	8.1	10.2	5.3	As above.
Cost Income ratio (%)	36.5%	36.4% *	35.2%	Should see productivity improvement (7% in H1FY17) and economies of scale
Return on assets (%)	15.5%	20.2% *	19.5%	Should increase with operational efficiency
Return on equity (%)	21.5%	27.9% *	25.4%	Should increase with operational efficiency and potentially more debt gearing in due course
Tangible equity / average receivables (%)	n/m	85.3%	91.7%	Should reduce with more debt gearing (see Funding section)
Number of customers	198,171	198,727	207,258	Underlying increase masked by loss of acquired customers who do not meet MCL's credit standards
Number of agents	1893	1839	c1,800	Can fluctuate with part time agents. MCL management focus is on attracting high quality agents.
Credit Issued (£ms)	112.0	122.2	66.0	Up 17% in H1FY17
Impairment / revenue (%)	25.5%	20.8%	22.5%	Target range 22-27%
Other important indicators				
Dividend cover (x) / policy	n/m	n/m	2.0x	Distribute majority of adjusted earnings over medium term
Period end receivables (£m)	55.6	56.8	56.2	Seasonality impacts H1 v FY. Underlying growth in quality credits is mid-single digit percentage
Agent Commissions as % revenue	17.7	18.0	23.1	Increase in H1FY17 due to new agent subsidiaries rising to £0.7m with greater number of new agents.
Revenue Yield (as % avg rec)	n/m	164%	169%	Increasing with greater proportion of short term loans

*Source: MCL, Hardman & Co Research * Includes £1.5m of acquisition costs*

Competition

Provident Financial

PFG strategic decision to optimise returns and limit credit volatility has seen it dramatically reduce agent and customer numbers.

One key business opportunity is the strategic direction of the market leader, Provident Financial. It re-focused its HCC business some years ago. The 2014 PFG report and accounts noted *"Last year we set ourselves a number of actions to reposition the home credit business as a smaller but leaner, better-quality, more modern business focused on returns. These included: (i) tightening the underwriting and implementing standardised collections processes throughout the organisation to improve the quality of the receivables book; (ii) rightsizing the cost base to maintain profitability; and (iii) deploying technology throughout the field organisation to improve efficiency and effectiveness and deliver high levels of compliance."* PFG agent and customer numbers were already in decline and this accelerated with the change in strategy. Given its small scale, we believe that MCL can grow materially into this space without incurring excessive risk.

MCL taking 1 in 5 of the PFG reduction since 2013 would increase its agent numbers by nearly 50%

While the strategy adopted by MCL is different from PFG, it is important to recognise the relative scale of businesses. MCL agent numbers could increase 50% from here and that would represent around 10% of PFG's end 2013 number. MCL can achieve its strategic growth ambitions by selectively targeting dis-affected agents from competitors rather than taking undue risk. We discuss the carefully managed creditworthiness of MCL's territory builds in the credit section below.

Figure 2: Provident Financial Agent and customer numbers

	2011	2012	2013	2014	2015	Nov 16
Agent number	10,500	9,800	9,000	7,700	5,500	5,237*
Cust number (ms)	1.8	1.8	1.5	1.1	0.9	0.85*

*Source: PFG report and accounts, Hardman & Co Research * PFG website accessed 11Nov 2016*

Non Standard Finance (Branded Loans at Home LAH)

NSF more aggressive growth ambitions in H116 with associated higher impairments. Current strategy is for steadier growth.

LAH is the third largest provider and is approximately half the size of MCL. NSF bought the long-established platform from S&U and has since then grown strongly the number of agents and infrastructure. It has also invested heavily in technology although much of this may be regarded as a catch-up. LAH has a different strategy to PFG and MCL in that it is willing to lend to higher risk customers on the basis that it will see significantly faster volume growth, can charge wider margins and will see increasing economies of scale. We detailed the business in our report 'Carpe Diem' issued in November 2016.

Other HCC competitors include:

Over 400 smaller HCC businesses.

Around 500k active customers, are served by over 400 smaller HCC businesses.

Key product comparisons

MCL pricing in line with NSF and both are cheaper like for like than PFG.

The product ranges for the key providers are given below.

Figure 3: Morses Club product range (£)

Term in weeks	Charges per £100	Total Payable	Weekly Rate	APR (%)
20	50.00	150.00	7.50	765.5
33	65.00	165.00	5.00	433.5
52	82.00	182.00	3.50	272.5
78	95.00	195.00	2.50	172.0

Source: MCL, Hardman & Co Research

Figure 4: Loans at Home (NSF) product range (£)

Term in weeks	Charges per £100	Total Payable	Weekly Rate	APR (%)
24	60.00	160.00	6.67	732.7
33	65.00	165.00	5.00	433.4
45	80.00	180.00	4.00	340.0
75	87.50	187.50	2.50	163.8

Source: NSF website accessed 15/01/2016, Hardman & Co Research

Figure 5: Provident Financial product range (£)

Term in weeks	Charges per £100	Total Payable	Weekly Rate	APR (%)
13	43.00	143.00	11.00	1557.7
26	56.00	156.00	6.00	535.3
52	87.20	187.20	3.60	299.3

Source: Provident Financial – website accessed 15/01/2016, Hardman & Co Research

On www.lenderscompared.org.uk for larger loans, PFG also has a 78 week and 104 week product with APRs of 191% and 164% respectively.

Peer KPI comparison

MCL between PFG and NSF in terms of optimising franchise returns compared with growth

PFG may be regarded as a mature franchise which is generating strong profitability but which has modest growth expectations. LAH in contrast is at an earlier, and heavier, stage of investment, which is depressing financial performance over the short term. Strategically MCL is between the two and its performance should be viewed in this light.

We have made arbitrary allocation of central costs at NSF/PFG.

In the table overleaf we compare some of the key KPIs for MCL and the major peers. We have allocated central division costs (20% at NSF to LAH, 30% to PFG CCD). The comparison with PFG is potentially distorted as their Consumer Credit Division (CCD) includes the start-up losses from Satsuma and its guarantor loan business glo. Given the very different strategy for Loans at Home under the ownership of Non-Standard Finance we have not included any prior year comparisons for that company.

Figure 6: Peer group comparisons (£'000s)

£'000s	Morses Club H115	Morses Club H1FY17	Change	PFG – CCD H115	PFG – CCD H116	Change	Loans at Home H116
Revenue	43,646	47,221	8%	268,200	255,200	-5%	20,487
Impairments	(8,000)	(10,600)	33%	(72,100)	(70,400)	-2%	(7,849)
Agent commission	(9,200)	(10,900)	18%	n/d	n/d	n/m	(3,700)
Admin expenses	(20,074)	(18,624)	-7%	(143,400)	(127,200)	-11%	(7,313)
Group Central Costs	-	-		(2,250)	(2,400)	7%	(363)
Operating profit	6,372	7,097	11%	50,450	55,200	9%	1,262
Exceptional items	32	(2,104)	-6675%		-	n/m	(1,002)
Net finance cost	3	(435)	-14600%	(14,700)	(14,100)	-4%	(176)
Pre-tax profit	6,407	4,558	-29%	35,750	41,100	15%	84
Adjusted PBT	8,801	8,593	-2%	35,750	41,100	15%	297
Agent numbers (closing)	1,800	1,800	0%	n/d	5,500	n/m	840
Customer numbers (closing)	203,000	207,258	2%	1,011,000	875,000	-13%	98,000
Credit issued	56.4	66.0	17%	n/d	n/d	n/d	up 27%
Loan Book (£m closing)	53.6	56.2	5%	498	511	3%	27
Loan book (£m opening)	55.5	56.8	2%	588	545	-7%	28
Loan book (£m average)	n/a	55.6	n/m	512	498	-3%	28
NAV (opening)	n/m	55.4	n/m	128	135	5%	31
NAV (closing)	n/m	58.9	n/m	139	141	2%	25
Revenue ratios							
Annualised revenue as % average loan book (1)	n/a	170%	n/m	105%	103%	-2%	148%
Impairments as % revenue (2)	18%	22%	22%	23%	21%	-9%	38%
Admin exp as % revenue inc allocated central costs (3)	-46%	-39%	-14%	-54%	-51%	-6%	-37%
Agent comm as % revenue (3)	-21%	-23%	10%	n/d	n/d	n/d	-23%
Loan book ratio							
Annualised impairments as % average loan book (2)	n/a	-38%	n/m	-28%	-28%	0%	-57%
Annualised finance cost as % average loan book (4)	n/a	-1.5%	n/m	-5.9%	-5.5%	-7%	-1.3%
Pre tax statutory ROA (5)	15.8%	16.4%	4%	14.0%	16.5%	18%	0.6%
Pre-tax normalised ROA (5)	32.3%	30.9%	-4%	14.0%	16.5%	18%	2.1%
Co rep adjust post tax ROA (5)	18.5%	19.5%	5%	19.7%	22.3%	13%	n/d
NAV Ratios							
Pre tax statutory ROE (6)	n/m	16.0%	n/m	53.6%	59.7%	11%	n/m
Pre-tax normalised ROE (6)	n/m	30.1%	n/m	53.6%	59.7%	11%	n/m
Co rep adj post tax ROE (6)	27.4%	25.4%	-7%	n/d	n/d	n/d	n/d
Business ratio							
Customers per agent (7)	113	115	2%	n/d	159	n/m	117
Closing loan per agent (7)	29,778	31,222	5%	n/d	92,836	n/m	32,024
Annualised revenue per agent (7)	48,496	52,468	8%	n/d	92,800	n/m	48,779
Adj profit per agent (7)	4,889	4,774	-2%	n/d	7,473	n/m	354
Closing loan per customer (8)	264	271	3%	492	584	19%	274
Annualised revenue per customer (8)	430	456	6%	531	583	10%	418
Adj profit per customer (8)	43.4	41.5	-4%	35.4	47.0	33%	3.0

Source :Company interim reports, Hardman & Co Research

The key business messages we draw are:

MCL revenues above average because it is book is shorter term – its acquired books and new business do not have the same duration as established customers

(1) Revenue as % loan book. As can be seen MCL has the highest revenue as measured against average loans. We detail the product pricing in Figure 3-5 above, but would generally observe that, like for like, PFG has the higher average rate for each product. Mix is thus the driver to higher revenue as a percentage of loans with MCL having a shorter duration book. There are three main reasons for this. MCL has a newer loan book (11% on first loan by number, 7% by value) and it takes time for new customers to progress through to longer loans. Second, acquired loan books tend to be of a shorter duration as the previous owner / operators rarely have access to third party capital and therefore need high cash yielding short term products. Third, management policy has been to shorten the average duration as we detail in the section on growth options below. PFG has a longer-term product range including a 104-week product (per page 10). MCL's longest product is 78 weeks and this is restricted to existing borrowers of the product. Consequently, 78 week loans are a rapidly diminishing proportion of MCL's book. There is a small distortion at the divisional level from c2% of PFG's CCD loans being lower margin glo guarantor loans (with APRs of c50%) but we do not believe the distortion is material.

MCL impairments now within target range.

(2) Impairments:

- MCL impairments as a percentage of revenue are well below LAH reflecting the more rapid growth in new customers (including ones from inexperienced agents) at the latter.

Adjusting for growth appears lower % of revenue than at PFG

- We note that circa one third of the PFG customer numbers reduction was due to the sale of under-performing loans, but it still saw a c9% underlying fall in customer numbers. Adjusting for the impact of above average losses on new customers, implies that the underlying impairment experience measured against revenue at MCL was better than PFG in H1FY17.

Although mix of business means it is a higher % of assets.

- Measured against the average loan book MCL's experience was worse than PFG. Its book is on average higher margin higher loss overall, giving MCL a better underlying risk adjusted margin.

(3) Expenses

MCL and NSF expenses as % revenue are in line. Both appear higher than PFG reflecting economies of scale although part of this is temporary agent costs

- Taking administration and agents costs together, MCL and LAH are both broadly around 60% of revenue (including the allocation of central costs above). The much larger PFG does have demonstrable economies of scale with its ratio just over 50% despite investments in Satsuma and glo. It is indicative of the potential for MCL as it targets improving efficiency.
- PFG does not strip out agent costs. Both MCL and LAH have incurred additional temporary costs by offering incentives to recruit new agents.

High proportion of equity funding gives MCL a low overall funding cost

(4) Finance costs – Both MCL and LAH are relatively immature businesses and have a materially greater proportion of equity over debt funding. This leads to a lower average funding cost. We note PFG's divisional cost of funding (i.e. the rate paid for debt) is reported at 7.1%.

Overall similar ROE

(5) Return on assets – the overall effect of the factors above gives MCL a broadly similar ROA to PFG. Both are higher than NSF where the key drag is new business impairments.

But PFG's higher gearing gives it a higher ROE

(6) Return on equity -the higher debt element in PFG's balance sheet gives it a much higher return on equity for a similar return on assets.

MCL and NSF more willing to use part time agents distorting ratios using agent numbers.

(7) On these measures, MCL and NSF are broadly similar. There is some potential distortion when comparing with PFG from using simple agent numbers for comparisons as both MCL and NSF advise they have a greater willingness to use part time agents than PFG. By having more part time agents, the customers per agent, loans per agent and revenue per agent at MCL and NSF are depressed relative to PFG.

- Investors should also note that the measures above reflect the accounting loan size. Compared with customer balance it is materially lower as it excludes unearned interest and includes the significant provisions (and associated discounting) held against accounts. While all three major players impair at two weeks not paid (except NSF which impairs existing customers at four weeks not paid), the higher rates charged by MCL will see a greater discounting and unearned income not recognised.
- Agent quality a management focus not agent numbers
- It also does not give any indication of the experience of the agent and as noted in the credit section below this is a key driver to impairments.

Customer metrics reflect greater proportion of new customers as mix important driver

(8) MCL has more new customers, where typical loans are smaller than established customers, reflecting the conservative approach to new risks. Despite its higher revenue margin, this lower volume means MCL thus reports a lower revenue and profit per customer.

Credit assessment and management

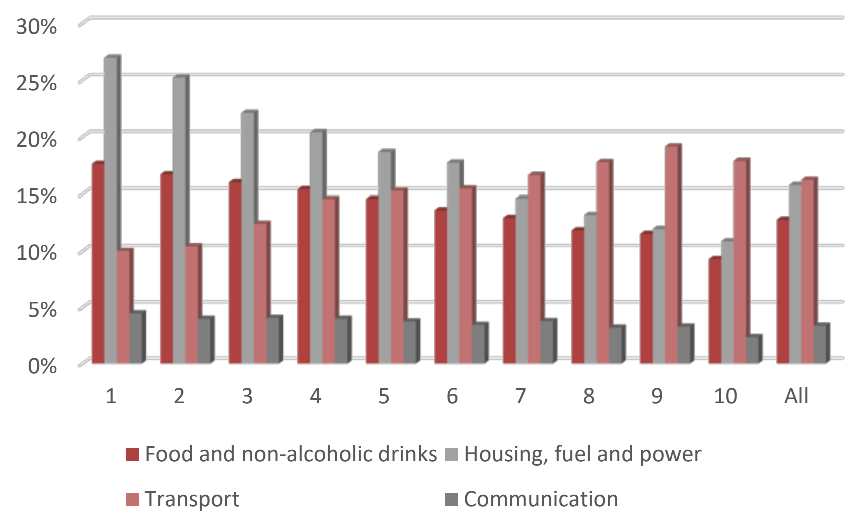
Summary

Customers different from prime with different risk profile

Customers income and expenditure are different from mainstream. Computer modelling can capture some of this but not all.

Managing credit is key to any lending business. In HCC employment tends to be biased to more casual, temporary and part time employment, and household income is often significantly greater than the borrower's individual resources. It is quite common for all the household members to contribute into a central fund which is then controlled by the unit's matriarch, who is the actual borrower. The proportion of expenditure spend on non-discretionary items is much higher than for wealthier income deciles, giving HCC customers a different exposure to inflationary pressures.

Figure 7: Proportion of expenditure by income decile in the UK (%)



Source: Hardman & Co Research, Table 3.1 ONS Family spending , https://www.ons.gov.uk/peoplepopulationandcommunity/personalandhouseholdfinances/incomeandwealth/compendium/familyspending/2015/familyspending2015referencetables

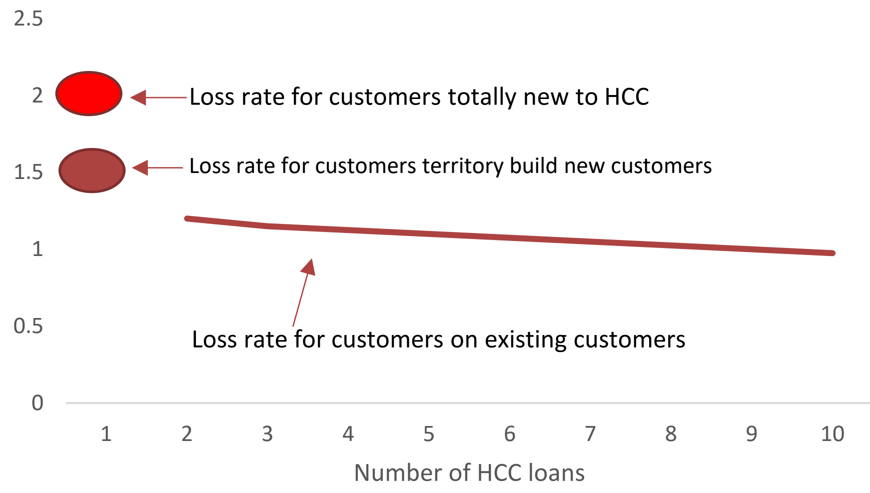
In this section, we review both how credit is initially assessed and how it is managed once a customer is on board. The agent relationship is key to both. Details of the accounting, especially the gross up effect which inflates the accounting impairment (and revenue) compared with real losses are given in Appendix 1.

Managing new customers is very important

Risk on first loans (i.e. new customers) is higher than established borrowers and so these customers are managed more tightly.

Lending to new customers is always risker, especially to those without home credit experience. The customer intent to pay is less certain than one known by the agent. However, for MCL it needs to be understood in terms of new customers gained through territory builds by an experienced agent and customers they have had no relationship with beforehand. MCL indicate the loss experience on a totally new customer is 2x-that of an experienced HCC borrower, while the loss rate on new customers acquired though territory builds is c1.5x. MCL only implement a territory build with an experienced agent, and new recruits are dropped into existing vacant rounds – this is different from NSF where c50% of NSF new agents in H1FY17 were inexperienced agents. Figure 8 illustrates the relative risk compared with customers who have more experience of HCC.

Figure 8: Relative loss by no of products and new business channel



Source: Hardman & Co Research

Agent control overlaid by policy of "Low and Grow" – i.e. new customer get smaller, shorter term loans to prove track record in making weekly repayments.

While new customer are c20% of book by number, they are just 7% of the loans advanced

New customers are managed at the local level. They typically may be offered lower value loans – the "Low and Grow" approach - and only have access to 20 and 33 week loans up to a maximum of £200 (in £100 increments). In contrast to long-standing repeat customers who may borrow over £1,000. While new customers account for c20% of customer numbers they are just 7% of loans by value. Credit is additionally controlled by: (i) monthly vintages reports where we can drill down into new customer performance and (ii) credit risk meetings every other month where new customer performance is reviewed. In line with keeping products simple, there is no differential in interest rate between new and existing customers. Shorter duration is an industry wide approach to managing new customer credit keeping product lines simple and helping meet the regulators requirement of treating all customers fairly.

Figure 9: Historic loans per customer by % of total current loan volume

Band	Feb 15	Aug 15	Feb 16	Aug 16
1	4.6	6.3	5.9	7.0
2-5	23.4	20.8	22.1	24.1
6-10	18.4	18.5	18.5	17.9
11-15	12.1	12.0	12.3	11.7
16-20	6.8	6.8	6.9	6.6
20+	34.8	35.6	34.4	32.6

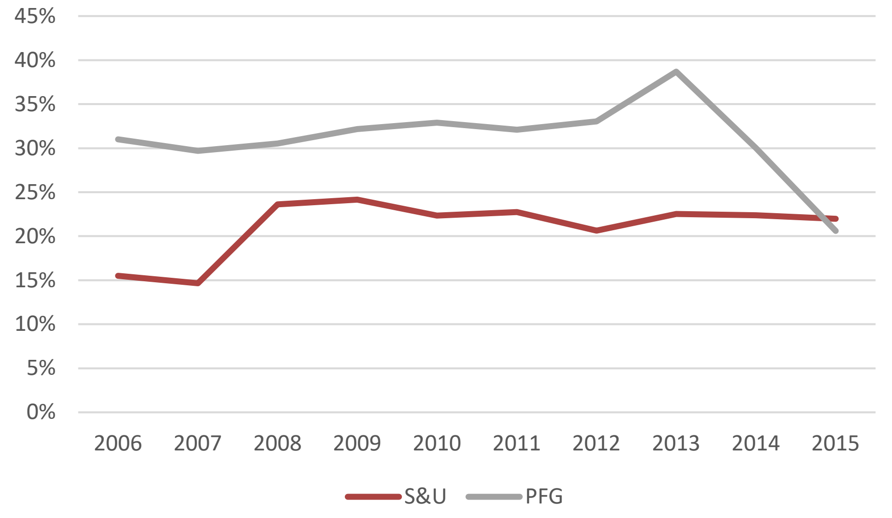
Source: MCL, Hardman & Co Research

MCL target impairment range 22-27% revenue

Target range of 22-27% is consistent with industry experience and growth ambitions

MCL has set itself a target impairment range of 22-27% of revenue (this is defined as accounting revenue and impairments and so includes the gross up effect detailed in Appendix 1). This target appears credible. The 2006-2015 average at S&U (which is the cleanest comparative data available) was 21.1% but that business showed modest growth (2006 receivables £49m, 2015 £53m). PFG's CCD division which is primarily HCC saw a much higher charge, average 31%, reflecting its higher risk book. We believe MCL has more ambitious growth expectations than S&U and as new business is riskier, a higher impairment loss to revenue ratio may be expected. Investors should also note that through the financial crisis there was not a marked change in impairment charge as percentage of revenue – portfolio mix is a significant driver to loss rather than economic conditions.

Figure 10: PFGs and S&U's consumer credit charge as a % of revenue



Source: S&U & PFG Report and accounts, Hardman & Co Research

Credit assessment

The Canons of Lending analysis is given in Figure 11. One issue is that the borrower is the controller of family finances but may well not be the biggest income earner. The agent is likely to be much closer to the family circumstances than a remote computer model alone can ever be. By way of illustration, the agent is much more likely to know much earlier if a customer becomes pregnant, adult children may leave or whether a relationship is stable. They should also know if the local factory is laying off workers or hiring staff. Personal judgement on ability to repay is necessary in addition to statistical modelling is also a critical advantage from using experienced agents. MCL needs to know that a few spare pounds will be used to repay debt rather than anything else.

Agent knows customer, and particularly the social dynamics affecting that individual. Should also know local economic conditions and relevant employment prospects on the ground.

Figure 11: CAMPARI analysis of credit process

Canon	Comment
Character	Assessed by agent who lives in same community, is likely to be known by the borrower, often for many years, Typical borrower is female aged 40.
Ability	Annual income £10-15k. Some incomes may be variable, some may be paid in cash, often part time and manual and received only weekly.
Means	The borrower is often the person controlling the family finances but may not be the main earner in the household, typically the family matriarch.
Purpose	Lumpy event driven living expenses which have not been budgeted for.
Amount	£200-£1,000, average loan size c£300. New customers get smaller loans
Repayment	20/33/52 weeks. 85% of customers take 33 or 52 week products
Interest	20 weeks 766%, 33 weeks 434% 52 weeks 273%

Source: MCL, Hardman & Co Research

Credit management

Customers with variable income need flexibility

The nature of the customer base means that even the best payers will miss some payments. HCC businesses recognise this and give the borrower certainty. The total amount repayable by a customer (i.e. principal advanced plus all interest) is unchanged regardless of the time taken for the customer to repay the loan. This allows payments to be deferred or reduced over a longer term without penalty to the customer. There is little point in loading such customers with heavy penalties which they will never be able to repay.

Agent and local management control customers up to 13 weeks of arrears. 4 weeks of central department's further attempts and then loan sold.

The relationship with the agent is key at the initial stages of arrears. The first missed payment is logged centrally and reported to operations management in the form of a 'missed-payment' report. Missed payments are reviewed with agents in the weekly meeting, and collections strategies are adopted that are appropriate to the customer's specific circumstances. This may include demonstrating forbearance, or taking reduced or catch-up payments. Typically, in the event of 13 weeks of non-payment, a customer account is transferred from the relevant agent to the Company's customer services centre in Birstall, Leeds. Loans are sold to a debt collection company four weeks later as potential central recoveries are small once local action has been exhausted. Accounts which have made irregular nominal payments will be sold.

Commissions to agents paid on collections not sales

As remuneration paid to collection agents is largely commission-based, the impact of any deterioration in collections is partially offset by a saving on commission that would otherwise be paid.

Overlaid by management information control.

One tool MCL uses to monitor credit is to split accounts between High Quality Loans (a loan to a customer of the Company who qualifies to be re-lent to under the Company's existing credit policy and practices) and Low Quality Loans (where they do not). It has actively been managing down the latter so that the proportion of the loan book made up of High Quality Loans is increasing. It is worth noting that slow paying debt cycles more slowly than fast paying debt. If you had 3 customers, 2 paying well and one not paying well, and the two customers paying well paid twice as quickly as the one in arrears, then on average 50% of your debt would be high quality but 67% of your customers would be good customers.

Initial accounting impairment at 2 weeks of arrears. Modelling across portfolio using 3 years of experience. Customers who miss payments but then keep to schedule see initial provision reversed.

Receivables are impaired when the cumulative amount of two or more contracted weekly payments have been missed in the previous 13 weeks. Models estimate likely future cash flows based off historic experience for the portfolio and are regularly tested for their accuracy. Accounting provisions are calculated a portfolio basis, by product by 13 week payment performance band. If a client misses two payments but then makes 14 weekly payments on time, the provision would reduce, reflecting the reduced risk of the customer now paying 100% to terms for 14 weeks. Customers can therefore move up and down the performance bands and with the nature of this product frequently do. For example, if a customer misses for two weeks because on holiday then the calculated risk (provision) goes up, but once they are back into their normal payment routine it goes back down again. MCL use a sample of 3 years data, evaluating each quarter (so 12 data sets per band per product) and assess trends as well as the precise score. As noted in Figure 10 above, the key drivers to loss are mix and credit standards which are directly under management control. While using three years of data clearly does not capture the last recession, a marked change in impairment is much more likely to be driven by ambitious new lending growth, or a change in agent experience and not the economy.

Also an IBNR provision which may help offset some of the IFRS 9 impact (see appendix)

MCL also raises an incurred but not yet realised (IBNR) provision as the portfolio included accounts which have not yet missed two payments but which are likely to incur loss. This IBNR provision (amount not disclosed) may partially offset the impact of FRS9 which we review in the Appendix. It can also provide an element of smoothing through an economic cycle.

Churn of book means best measure of impairment is against revenue not lending. Noting that, the balance sheet measures appear to indicate improving asset quality in line with management claims.

The short duration of lending means that HCC is driven by the churn of business rather than the arrears position at any given time of year. This is why management, and we, focus on impairments as a proportion of revenue rather than impairments as a percentage of spot balance sheet assets. For information, we have given in Figure 12 the analysis of overdue loans. We note the amounts written off in FY16 were more than the impaired loans at the start of the year reflecting the churn effect. This table also demonstrates that the management's claim re cleaning up the lending book would appear to be supported with impaired loans falling to 34% of the total end February 2016 against 32% end February 2015 (and the pre SFS ratio being 30%).

Figure 12: Analysis of overdue loans and write offs

Category of loan (£'000s)	Feb 14	Feb 15	Feb 16	Aug 16
Neither past due nor impaired	9,423	35.959	38,568	39,677
Past due not impaired	304	488	277	225
Impaired	4,184	19,036	17,986	16,298
Impaired as % total	30%	34%	32%	29%
Write off in period	5,097	24,664	21,740	n/d

Source: MCL, Hardman & Co Research

MCL Profit Growth Options

The market, while attractive, is not expected to show strong volume growth …… MCL has several levers to generate profit growth

The HCC market is expected to show only modest structural growth. For many migrants, who have the low and variable incomes most suited to HCC, it has not been a feature of their indigenous markets and so they are less used to the product. Notwithstanding slow market growth, MCL has opportunities to deliver good profit and franchise growth over the forecast period (H1FY16 revenue growth 8%, credit issued growth 17%) and we explore both the core business and new product options below.

Profit growth options in core HCC

Attracting more agents organically

MCL careful in its territory builds focussing on established agents achieving high payment to terms.

Once on board, agents typically stay with MCL for a long time. More than a third have been with the company for more than 5 years and 22% for over 10 years. Attracting successful new agents builds a long term embedded value and this is a strategic priority for the group. MCL terms its new agents from competitors as "territory builds" and has accelerated the rate of new agent hiring (twelve months to August 2016 114 against 68 over same period to August 2015). The territory builds have already bought on board 7,500 customers (i.e. an average of 66 per agent when the average for whole portfolio is c115). MCL's focus is experienced agents and we note payment to terms on new agents has been 92% (against a comparable number for the whole book of c80%). MCL also considers the capacity of each branch / regional manager to oversee new agents in order to ensure effective controls and compliance are in place.

MCL will pay a transferring agent a temporary commission so that their income does not drop too much on the transfer (H1FY17 £0.7m, H1FY16 £0.3m). The way the payments work at MCL is that the agent agrees with MCL what its target number of customers will be a year time (say 100). At week 1, when the agent has no customers, the subsidy is equivalent to what they would have earned with 100 customers. At week 2, when the agent has 5 customers the subsidy is equivalent to 95 customers. Critically, it is reviewed continuously and the agreement can be terminated with notice. There is no upfront payment giving MCL control over the whole process and the ability to manage out under performing agents with minimal loss.

MCL is attractive to agents as it is committed to market with proven management and IT which makes agents life easier . MCL is also very willing to consider part-timers.

MCL believes it is an attractive partner for the self-employed agent (c95% of the agent network – the c5% of agents who are employees came from historic acquisitions). Firstly, it is clearly committed to expanding and investing in the business – unlike the strategic retrenchment by the market leader. Second, the management team have a long history in business and so understand what agents require. Third, with the introduction of time-saving automation, MCL has made the agent life easier. MCL has not required the agents to source additional new business with freed up time, but left it up to them to do so if they wish. Fourth, MCL is willing to sacrifice some efficiency by having part-time agents as well as those seeing it as a full-time job (average number of customer per agent at MCL is 115, against 159 at Provident Financial). The marginal overhead cost is small as the length of a review meeting is determined by the number of customers. (2 agents with 50 customers take the same time to review as 1 agent with 100). Agent commissions are fully automated so the overheads are mostly the contract time on set up and equipment provision together with elements of training and compliance.

Focus throughout is on quality not number of agents

From a management perspective, the level of agent numbers is unimportant as a business driver because agents work a broad range of hours from a few evenings a week to full time. Noting this caveat, the total number of agents is broadly unchanged in H1FY17 despite MCL acquiring 79 agents with book acquisitions and 114 new territory builds. There is normal attrition reflecting changing agents' circumstances (they may move or want full time employment) and some acquired agents may not fit MCL's culture. Newer agents may simply find they are unsuited to the job. The important driver is being able to attract the right type of agent and management focus more on the experience of agents than the number. At flotation 58% of agents had 2+ years' experience, this had increased to 63% by August 2016.

Book acquisitions

Over 400 small providers service 500k customers, 2.5x MCL level. MCL most active acquirer and many vendors are mature and getting squeezed by regulatory and financing pressures.

Currently adding c10% p.a. to agent and customer base and can continue at this rate for foreseeable future

There are over 400 small HCC providers who are members of the CCA (the industry body). Many are small, have mature owners (5 vendors of acquired businesses in H1FY16 had average age of 79) and face an increasingly burdensome regulatory environment. Other factors include being unable to invest in technology in scale as well as difficulties getting financing themselves. In H1FY17 MCL bought 3 books of business with a total of 79 agents, c10,500 customers, and balances of £3.2m, all roughly 5% of the existing numbers. For H2FY17 it has already announced a further 3 deals with a further 9,500 customers, 80 agents and balances of £3.8m. In FY16 MCL acquired 8 books of business in aggregate, £11.3 million of gross receivables, 133 agents and over 26,000 customers. The 2016 experience was that 60% of customers acquired in that year remained customers at the year-end which is a similar proportion to the overall HCC market. The recent annualised 10% growth from book acquisitions comes at a time when the membership of the CCA has fallen by c130 to just over 400. Looking forward, such growth appears sustainable over our forecast three years and beyond – given the directional trend for more regulation and the age of owners, the number of participants could, over the long term, fall by two thirds to three quarters. As noted on p9, we believe smaller players service c500k customers, 2.5x MCL's current portfolio and offering a material growth option.

Average price paid 86p in £1 leading to gains on acquisitions in the accounts.

As may be expected, due diligence includes taking extracts from the book and looking at payments patterns in detail and reviewed again at the date of completion. MCL has standardised procedures in place allowing a very quick decision to be given to potential vendors. Deals are also typically structured so that MCL only assumes specific agreed liabilities with the residual risk remaining with the vendor. We note the profile of loans acquired has typically been shorter duration than the average for the MCL book.

Accounting is conservative as goodwill largely reflects customers at time of acquisition. As they leave, goodwill has to be written down as no benefit is given for new customers added by that agent.

Investors will note from the accounts that MCL has regularly seen goodwill write-downs hitting its P&L. We believe this reflects the overly conservative accounting standard (and market-wide approach) which MCL is required to adopt. Goodwill is mainly attributable to the customer base. MCL's track the customer numbers on acquisition and then it writes down the goodwill directly in line with the decrease in those customers from that time. This is a very harsh approach because it is not mitigated by new customers added by an acquired agent and so does not reflect the real value of the business acquired. Apart from the usual client turnover, there has historically been a proportion of customers that do not meet MCL's lending criteria and so losing "bad" customers can ironically incur a goodwill impairment. Additionally, the gross receivables figures noted above include unearned interest and so is higher than the accounting value recorded in the accounts. A gross receivable of £100 might translate to an accounting value (post bad debt and deferred income) of £50 and if MCL pays £70 then there is £20 goodwill between the book value and the sale price.

Use of technology to attract new customers

Website has been generating significant new customer referrals

Historically, repeat customers and word of mouth referrals generated virtually all new customers and loans. However, MCL has built a website which attracts up to 110k hits per month (up 30% H1FY17 on H1FY16). While many potential customers will actually be seeking online finance (see below), this and affiliate (broker) referrals produced c20k customers in H1FY17, nearly 10% of all customers. By way of comparison the customer refer-a-friend programme has typically been adding c4k customers per annum. These customers still have the agent relationship and their profiles and credit experiences are not materially different from those sourced by customer introduction.

Use of technology to improve efficiency

Efficiency being steadily improved as technology removes burdensome paper processes, reducing error rates and time spent on managing them.

The HCC market is all about the agent and the customer. Both relationships can be enhanced where technology delivers a better and faster service to the customer and an easier life for the agent. Technology is not taking over the relationship but improving it. MCL has invested heavily (FY16 £3.7m, medium term range £1-£1.5m p.a.) including tablets for agents with the results that:

- Customer decision can be accelerated and their experience professionalised.
- Increasing proportions of administration is now straight through processed whereas a few years ago the majority was paper based. This is quicker and less hassle for the agent and MCL. Management note a 7% productivity improvement in H1FY17
- Error rates reduce, saving both agent and management time.
- Processes can be automated improving management information and very importantly the audit trail for compliance purposes.
- There will be depreciation costs associated with the investments and we do not expect nominal costs to fall. However, we do expect administration costs as a percentage of revenue to show steady improvement especially as the technology allows greater economies of scale in a growing business.

Improving yield by shortening loan duration

Shorter duration loans have higher yields.

In HCC, one way that yield is increased is by shortening the duration of lending and MCL management has been doing this (August 2016 42 weeks against 44 February 2016 and 48 weeks in February 2015). Management has indicated it expects the duration to stabilise around 40 weeks which is broadly in line with the duration Morses Club had as a stand-alone entity before the SFS acquisition. Duration management takes time as it feeds through new loans issued – given the lower cash repayments on longer loans it is very rare for a customer to want to reduce the duration of an existing loan.

Shorter loans from product management, new customer acquisition and acquired portfolios (vendors typically more difficulty finding finance so churn faster)

The shorter duration is driven by several factors. MCL introduced in October 2015 a 20-week loan product, and management focus on better quality credits also means its takes longer for a newer customer to be eligible for a 52-week loan than it was historically under SFS credit policies. The proportion of the 78-week product is down to 5% (from 8%) as it is now only available to customers who already have that product and is not provided to the whole customer base. Additionally, as noted above, acquired loan books tend to be of a shorter duration as the previous owner / operators rarely have access to third party capital and therefore need high cash yielding short term products. There is a marginal increase in administration cost in shorter loans but this is more than compensated for by higher yields (see the product APRs in Figure 13).

Figure 13: Weighted cash and revenue yield

	Feb 14	Feb 15	Feb 16	Aug 16
Weighted cash yield (£/£100/wk)	3.75	3.89	4.18	4.40
Weighted revenue yield (£/£100/wk)	1.63	1.67	1.75	1.80

Source: MCL, Hardman & Co Research Note: Investors should note that these measure are management tools and reflect the theoretical yield reflecting what would be expected should all the loans perform according to their contractual obligations. We give the actual revenue yields in the section on financials below.

Process is now largely complete

The process of shortening duration is nearly complete. Assuming the business stabilises at around 40 weeks, we believe the average weighted revenue yield will increase from £1.80 per week per £100 loan to between £1.85 and £1.90.

New product areas

Range of new products which exploits existing competitive advantages

MCL has announced a number of new products in the pipeline. Their relative stage of development is outlined in Figure 14 below and details on the products and their launch is detailed in the section below. We believe MCL has competitive advantages in the huge online lending market but believe it will evolve carefully into the market given the different risk profile compared with its historic business.

Figure 14: New initiatives timeline

	Roadmapped	Infrastructure in place	Internally Trialled	Expected launch
Morses Club Card	Y	Y	Y	Y
Remote Collect	Y	Y	Y	Y
Online Lending	Y	Y	H1FY18	H1FY18
E-Money	Y	Q1FY18	Q2FY18	Q3FY18
Revolving Credit	TBC	TBC	TBC	TBC
Mobile Wallet	TBC	TBC	TBC	TBC

Source: MCL, Hardman & Co Research

Morses Club Card – incurs some cost but benefits include customer retention, greater security and data harvesting which should allow targeted marketing.

The Morses Club Card, launched in February 2016, is a pre-paid VISA card which allows customers to receive loans via card rather than cash. With the interim results on 6th October management announced it had issued more than 5k cards. While MCL incurs a card administration fee (market rates would suggest c2% of the loan value although this is not disclosed) which an agent re-cycling cash does not, this is more than offset by the key advantages of:

- The card allows customers to pay for goods and services electronically as well as access cash via cash machines. This is important for customer without access to bank cards who want to take advantage of cheap internet offerings.

- Greater security both for agents, who are not required to carry cash, and for customers, as the cards are PIN protected. Although agents are rarely mugged, the potential for this and fraud is reduced by using card distribution.

- The card will allow MCL to appropriately gather data on customer spending habits, thereby providing the opportunity for targeted offers and rewards.

- The card is potentially seen as a good retention tool offering an additional option to existing, well regarded, customers.

The 5K cards issued in the first six months will give MCL considerable data on which to develop the product and exploit these advantages. Given their conservative culture, we would expect a considered further roll out of the product while they analyse this data.

Remote Collect & Lend

The central operations team will liaise directly with customers, offering alternative methods for payment and access to further lending products noting the current FCA home collect licence. The scheme has already been successfully piloted and MCL has near zero customer acquisition costs as the product is primarily being offered to existing customers and administration costs are modest given centralised processing and no agent collection costs. We expect roll out to be modest and if a new customer does not want an agent and they pass the credit checking, in future they will be offered an online loan.

Online Lending - target implementation H1FY18 through Shelby acquisition. Target customer profile closer to prime than HCC and management will take time to ensure credit models are appropriate

Many of these customers hitting the MCL website do not want home credit but do want an online lending product (estimated by company at three quarters of the 100k+ pm hits it receives). This product can target the 9m non-standard customers who do not take the HCC product, Management have indicated an initial focus on customers who are 25-35 (more comfort with technology), in socio-economic groups C1,C2,and D (i.e. better than the average HCC) and with household earnings of up to £30k (2-3x the HCC level). We would expect management to build the business steadily in order to understand the differences in this totally different demographic group compared with HCC and initial trials have been completed. Initial indications are that new loans will be in the range of just £200-£400 as MCL builds the business. MCL has indicated it expects a higher loss experience in its online lending but that this will be offset by lower agent and administration costs (centralised customer services are much lower cost than face to face agent servicing) leaving the overall profit margin in line with its existing businesses. In line with MCL's conservative nature we do not expect targets to be announced until the product has been fully tested and a reasonable period for credit loss experience established.

Key advantages include 100K+ hits on the website most of which want credit but not HCC, infrastructure including customer support is in place, near zero upfront marketing costs, credit experience and controls and substantial funding lines in place.

MCL's key advantages in a very transparent and competitive market include:

- The product will emulate MCL's HCC product in terms of forbearance, flexibility and simplicity. MCL has direct experience managing this type of product feature.

- Low incremental investment and operating cost as there is an existing customer portal and IT infrastructure to underpin this venture. MCL already has support staff in place, from customer service through to accounts payable.

- Initial incremental marketing costs are small as many of the customers (over 100k per month) are already looking at the website.

- Large actual credit experience which can be overlaid onto market-wide available data sources when setting scorecards. A change in behaviour in HCC may be a lead indicator to changes in behaviour for online customers.

- Additionally, there may be existing HCC customers who no longer want the agent calling and whose credit record is sufficiently good for them to be offered online products by other providers. MCL's broader product range can deepen and extend the life of its relationships.

- MCL has access to substantial funding at most lower rates than smaller players. While not an advantage over the likes of Satsuma (PFG) it is a competitive advantage over much of the market.

The MCL proposition is very different from Satsuma (the PFG online product) which is forecast to break even in 2016 after several years of losses since launch in 2013. The price of technology has changed significantly and MCL is clearly managing the product within its overall business rather than as a separate silo. MCL has been conservative in its new product development both for cost but also in terms of credit assessment. Overall we would not expect the same duration of investment before payback that has been seen at Satsuma.

Shelby acquisition brings plans for online instalment loans back on track

On 11 January 2017 MCL announced the acquisition of Shelby Finance Ltd, a provider of online instalment loans. No financial information on the terms were given and it is probable that the evolution of Shelby under MCL makes historic comparisons of limited value. Shelby Finance is fully authorised by the FCA to provide online instalment loans and will operate as a subsidiary of MCL bringing the launch of a new, branded online instalment loan product back on track. We note at the interims the expected launch date was Q417 but it is now H1FY18 (i.e. calendar Q217).

E-money – potentially attractive as retention tool

E-money (formerly known as Banking-Lite - target implementation in Q3FY18) .This product will enhance the existing Morses Club Card product, by using the sort code and account number already associated with the Morses Club Card to allow payments (such as wages or benefits) to be transferred into such account. The service will provide customers with features associated with standard bank accounts, which are often unavailable to the Company's typical customers. The Directors expect the product to promote customer retention as they remain engaged beyond repayment of their loans.

Mobile Wallet / Revolving credit (probable target implementation in FY18 onwards) –

MCL recognises that customers will increasingly expect flexible access to funds via mobile devices in the future. This initiative aims to ensure that the Company's products and services keep pace with consumer trends.

Natural attrition rates

Natural attrition from shortening book, applying MCL high credit standards, customers position and agent turnover.

The growth in receivables is offset by natural attrition from: (i) Bad debts written off; (PFG in recent announcement has attributed half to a third of its customer number reductions to the sale of delinquent low value customer balances to third party debt purchasers) (ii) Shortening loan durations mean that the book needs to churn more rapidly. This factor mirrors the improvement in yield and is largely complete. (iii) MCL credit standards typically see between a third and 40% of acquired customers not renewed. While the SFS clean-up is largely complete there will be drag from new book acquisitions made each year. (iv) Some acquired customers will have been given larger balances than MCL systems would support and so the individual borrowings will fall. (v) Good quality customers become eligible for cheaper forms of finance. (vi) Natural turnover of agents – as noted above agents can stop for a variety of reasons including moving house, their own employment prospects and life changes as well as moving to competition.

Group Funding

Balance sheet under-geared and likely to remain so. Only major acquisition / dividend would see gearing rise to 1:1 (PFG currently nearly 3x debt to tangible equity)

Liquidity is crucially important to a company such as MCL. It remains a relatively small business with modest product diversification. Management has adopted a very conservative balance sheet structure and strong operational cash flow generation is likely to see this continue for the forecastable future. Even several major acquisitions for cash (say players in range of no 4-10 in HCC) would be unlikely to see gearing go over 100%.

MCL has a £25m facility from Shawbrook which expires in March of 2019. The August 2016 drawing was £8.5m and management has previously stated that it expected the Christmas seasonal peak to exceed £20m in December 2016. The expected growth to end calendar 2017 would appear to be safely within current facilities. As noted above we do not expect the roll out of new products to be materially cash consumptive.

The following issues are material in considering MCL's liquidity:

Cash generation

Core business highly cash generative – profitable business model and short term nature of HCC loans

HCC is very cash generative. It is highly profitable, with profits feeding directly to cash generation, but also c99% of loan principal should be repaid within the next twelve months.

Existing Balance sheet structure

Figure 15: Balance sheet structure of MCL and Provident Financial

Summer 2016 £m	MCL (August)	Provident Financial (June)
Loans	56.2	2,055.8
ST debt	Cash of £5.7m	245
LT debt	8.5	1,382.4
Net asset value	58.9	734.4
Tangible net asset value	49.0	579.8
Ratios		
ST debt to LT debt	n/a	18%
Total debt to NAV	14%	222%
Total debt to tangible NAV	17%	281%
Debt to loans	15%	79%

Source: Company Report and accounts, Hardman & Co Research

Figure 15 above shows both the absolute and relative capacity for MCL to gear up its currently under-geared balance sheet. Its debt to NAV is just 14% and to tangible NAV just 17%. Getting a more market type of gearing (i.e. 3x) would imply an additional c£140m of debt which would fund lending c3.5x the current level. Figure 15 also shows the relative gearing compared with Provident Financial.

Access to other funds

Range of options beyond bank debt. Pricing of each changes over time so which option is chosen will depend on circumstances at time

Given MCL's high level of cash generation we believe a number of other banks would be willing to provide any foreseeable facilities. At present the private placement market would also be an option for long term finance as potentially would a retail bond such as that issued by Provident Financial. We note a number of other financials have adopted or considered banking licences directly (Vanquis in PFG, Paragon Bank, S&U pre disposal of its HHC business) while others have looked at in house P2P platforms (Orchard Funding). There is a wide range of options available to MCL.

Regulation

Background

2004 OFT review enforcement notices in 2007 and 2011. Effectiveness reviewed in 2013

HCC has been subject to several regulatory reviews. In December 2004, the OFT referred this market to the Competition Commission (CC) for investigation. The CC's final report entitled "*Home credit market investigation*" was published in November 2006. The CC's remedy package to address the competition problems identified was implemented through an enforcement order made in September 2007 and was subsequently varied in February 2011 as a result of the introduction of the European Union Consumer Credit Directive. In February 2013 the Competition Commission further reviewed the effectiveness of the remedies proposed (http://webarchive.nationalarchives.gov.uk/20140402141250/http:/www.competition-commission.org.uk/assets/competitioncommission/docs/2013/remedies/130228_home_credit_evaluation.pdf).

Pricing comparison website mandatory but fundamental nature of business unchanged.

None of the reviews have fundamentally changed the nature of the business nor the role of the agent. There have been some operational requirements (e.g. home credit lenders must post details of all but their smallest loan products on www.lenderscompared.org.uk and customers can compare prices and terms (this website also includes details of some credit union loans) but the fundamental nature of the business has not changed.

We expect the FCA's approach to regulation to prove stricter than the OFT.

Since 1 April 2014, home credit firms have been regulated by the FCA, which took over responsibility for the regulation of consumer credit from the OFT. Under the new regime, the FCA has substantially greater supervisory and enforcement powers (e.g., it can issue greater fines, ban activities or products being sold and issue public notices or instigate investigatory action).

FCA Nov 16 review (report due mid 2017) looking at all high cost products but unlikely to see major changes for home collect – more focus on rent to own and effectiveness of Payday Cap.

On 29th November 2016, the FCA announced that it was seeking evidence and feedback to further inform its work on high-cost credit, including the expected review of the payday loan price cap. The FCA is asking for responses by 15 February 2017. The FCA will look across all high-cost products (which includes payday loans, HCC, catalogue credit, some rent-to-own, pawn-broking, guarantor and logbook loans) to build a full picture of how these are used, whether they cause detriment and, if so, to which consumers. This will enable the FCA to consider whether further policy interventions are needed. There appears to be a focus on rent to own (where some market commentators estimate that up to £400m of loans, 50% of the total, would fail affordability checks) and on how the payday lending cap is working.

Factors mitigating regulatory risk

There are several factors indicating HCC is a valued product, which does not require incremental regulation. These include:

The Lenderscompared website showed 9 HCC loans for this analyst's postcode.

- The 2013 review of remedies emphasised the importance of web-comparisons as a method of increasing competition with the implication that any further remedies would be operational rather than price caps. When this analyst entered his home (south coast) postcode into www.lenderscompared.org.uk seeking a £500 loan over 23-40 weeks, nine loans were available from four providers. His birth post code (Leeds) had ten loans from seven providers.

Satisfaction in high 90's at current pricing

- MCL in line with other HCC lenders, emphasises the high degree of customer satisfaction (95-97% overall satisfaction compared with c44% at Wonga) which is indicative that customers value the product on its current pricing levels.

HCC embedded in community

- HCC is embedded in the community in which it lends in a way that a remote lender never could be. Consequently it is likely to be more sensitive to specific customer needs, a key regulatory concern

Processes in place to treat customers fairly

- Treating customers fairly, another core FCA principle is embedded in the business. The forbearance of missed payments makes HCC much less of a strain on customer than alternative sources of finance. Vulnerable customers, e.g. those who have developed mental health issues, are flagged on MCL systems and their debts are not passed on to the debt collectors but are simply written off. Quality assurance is embedded into MCL's procedures.

No2 and No 3 now seeking growth

- The emergence of Non Standard Finance and MCL with ambitious growth plans, together with the reduction in the share of the market leader (from c70% to c50%) mean the competitive environment has changed.

Technology ensures compliance

- Technology adopted by the three largest providers means that procedures are much more standardised and compliance with regulations is better enforced. Unacceptable accidental breaches of policy are less likely with current technology than under old paper-driven systems. MCL, like all the major companies, give regulatory compliance a high priority and technology helps deliver that strategic objective.

Home credit is not in FCA definition of HCST loans and so is not subject to payday regulations including the price cap.

- Home credit lending was not subject to the price cap (introduced 2 January 2015) which applies to certain high-cost short-term (pay-day) credit products. Under the FCA's rules, home credit loan agreements are excluded from the definition of "high-cost short-term credit". It is interesting that the regulator should, after several reviews, expressly did so and prima facie supports the view that HCC is seen as part of the solution not the problem for non-standard customers.

Regulatory risk potential:

Regulatory risk cannot be ignored for the following reasons:

More at risk than standard firms of legal liability

- Despite the high infrastructure costs and impairment losses, the high-interest charges and high post-tax returns on equity, could be interpreted as pricing power over the customer and mean a HCC firm may be at a greater risk than a mainstream financial firm. The 2013 review of remedies noted that pricing had not changed materially with the implication that it was still high.

Adverse sector publicity could increase costs

- Publicity around this could see MCL face an increased number of customer complaints, claims made to the U.K. Financial Ombudsman Service or the courts (both increasing costs) and, more generally, alter customers' behaviour in making repayments. We note, however, that the numbers of FOS complaints for HCC are particularly low.

Investor sentiment to regulation is an issue

- Sentiment to regulation will remain an issue for such businesses. Some investors will continue to worry that future regulation could impact on the business even if the current regulatory outlook is benign. Such sentiment was not helped by the recent 50% fall in International Personal Finance's share price when the Polish government announced proposed amendments to non-interest cost caps.

Other Issues

Share liquidity

Currently low but 51% shareholder may be expected to sell down in due course

As noted on the front page, Perpignon (Jamie Constable, the specialist in corporate restructuring that initially bought MCL and then bought SFS from Cattles) and management own c55% of shares with a further 28% held by just 5 institutional holders. At some stage Perpignon may be expected to sell down further holdings (it is now free from the IPO lock-in although tied in until April 2017 with orderly market constraints) but until there is a further disposal, liquidity is likely to remain tight.

Status of the self-employed agents

Wide ranging review in place

Most of the agents are self-employed and thus MCL is not responsible for things like holiday, sickness pay, employers national insurance and a range of other employee status benefits. Given changes in UK-wide employment patters the Parliamentary Business, Energy and Industrial Strategy Committee has launched an inquiry into the workers' rights and their legal status. There could be adverse cost implications although HCC agents are not the priority target for this review.

Seasonality

Highly seasonal business so comparisons needed to be treated with caution

Home credit loan volumes traditionally tend to be higher in the run-up to the Christmas holidays. Collections performance is also affected by seasonality. The peak lending and collections periods mean MCL has a materially higher draw down on debt facilities in certain months. This is important given the February / August reporting periods ends (and when making comparisons with other HCC businesses with December and June reporting ends).

Cyber-security

Below average exposure to cyber attacks

MCL currently has a relatively low cyber-security exposure. Other than normal creditors, it is not moving large amounts of money via the internet, and its online business is currently small (albeit growing). Currently customers do not access their accounts online and so MCL is not, at present, exposed to their accounts being hacked.

Pension risk

DC scheme only

MCL only operates a defined contribution scheme and so does not carry defined benefit related market or longevity risks

Financials

Highlights from interim results

Key highlights were revenue and loan growth mid-single digits, slight drop in adjusted profit with impairments reverting to more normal level and heavy investment

The key highlights from the interim results to 27 August 2016 were:

- Revenue up 8% to £47.2m (H1FY16: £43.6m).
- Net loan book growth of 5% to £56.2m (H1FY16: £53.6m).
- Impairments as a percentage of revenue for the period 22.5% (H1FY16: 18.3%), remaining at the lower end of the target range.
- 2.1% increase in customer numbers to over 207,000 (H1FY16: 203,000). This growth reflected (i) three acquisitions with total gross receivables of £3.3m and c10.5k customers; (ii) Strong territory builds momentum with 114 active territory builds over the prior twelve months (year to H1FY16: 68) adding c7.5k customers, more than offsetting (iii) continued run down in lower quality credits.
- Over 5,000 Morses Club Cards issued.
- Company basis adjusted profit before tax slightly down at £8.6m (H1FY16: £8.8m); reported profit before tax £4.6m (H1FY16: £6.4m), adjusted1 EPS 5.3p (H1FY16: 5.4p); basic EPS 2.7p (H1FY16: 3.7p) reflecting continued investment.
- Maiden interim dividend declared of 2.1p per share (H1FY16: nil).

MCL reported falling adjusted profits in H1FY17 despite the growth in customer numbers as well as improving revenue yield and receivable balances. These positive factors were more than offset by:

- Impairments reverting to a more normal level – effect £1.6m. H1FY16 was unusually low as management had focussed on improving asset quality with a lower new business strain). In H1FY17 impairments were back in the company's estimated range, albeit at the lower end of the range. Stronger new business growth is likely to see a further strain from increased impairments (Hardman E FY17 24% loss rate).

- Territory build subsidiaries increasing from £0.3m to £0.7m. As these agents get up to speed, the full period benefit to income is likely to be visible in FY18.

Profit & Loss

IFRS9 could be major issue in 2018 – see Appendix

Figure 16 below gives our detailed profit and loss estimates. We are presenting our numbers on the same basis as management do (i.e. adjusted profit) as we concur that this gives the best explanation of how the underlying business is performing. A reconciliation to statutory numbers is given below.

With all the management initiatives in place we are forecasting mid-to-high single digit percentage annual organic revenue growth. The total impairment charge in the second half is typically higher than the first. We have a modest rise in 2019e with faster receivables growth. IFRS9 effects in FY19E are in the statutory adjustments section below. We expect agent commission to drop as a percentage of revenue – in 2018 because there will be a lower effect from temporary incentives to attract new agents and in 2019 as the mix of lending should see a greater proportion online. However, the fall is modest as shorter duration lending has a higher proportionate cost. Overall efficiency is expected to improve with the growth in automated online lending and the full period benefits from IT operational improvements. Our dividend forecasts assume that MCL will look through the accounting distortions from IFRS9 and ensure a smooth dividend progression reflecting the underlying business metrics.

Figure 16: Profit and Loss (£ms)

Year ended February	**2015**	**2016**	**2017E**	**2018E**	**2019E**
Existing operations	22.5	84.7	94.5	100.2	109.2
Acquisitions during period	67.4	5.8	4.0	4.0	4.0
Total revenue	**89.9**	**90.6**	**98.5**	**104.2**	**113.2**
Impairment charge	(22.9)	(18.8)	(23.1)	(25.0)	(28.3)
Agent commission	(17.7)	(19.2)	(22.2)	(22.9)	(24.9)
Gross profit	**49.3**	**52.6**	**53.2**	**56.2**	**60.0**
Administration expenses pre excep and intang amortisation	(32.8)	(33.0)	(33.5)	(35.3)	(36.8)
Depreciation (inc goodwill impairment, amortis of IT)	(0.9)	(1.0)	(1.2)	(1.4)	(1.8)
Operating profit pre excep and amortisation	**15.6**	**18.6**	**18.5**	**19.5**	**21.4**
Adjusted financing costs	(2.6)	(1.7)	(1.0)	(1.0)	(1.0)
Adjusted profit before tax	**13.0**	**16.9**	**17.5**	**18.5**	**20.4**
Income tax	(2.7)	(3.5)	(3.6)	(3.7)	(4.1)
Adjusted post tax profit	**10.3**	**13.4**	**13.9**	**14.8**	**16.3**
Average number of shares	126.70	129.50	129.50	129.50	129.50
Statutory EPS (p)	46.47	6.15	6.87	8.70	8.58
Diluted EPS (p)	46.47	6.10	6.82	8.64	8.52
Adjusted EPS (p)	**8.12**	**10.32**	**10.72**	**11.44**	**12.60**
Total dividend (p)	n/m	n/m	6.30	6.90	7.50
Dividend cover (adjusted EPS)	n/m	n/m	1.70	1.66	1.68
Ratios (%)					
Tangible ROE	n/m	21%	30%	30%	31%
Adjusted tangible ROE	n/m	12%	19%	23%	21%
Adjusted pre-tax ROA	n/m	30%	29%	28%	27%
Impairments as % revenue	-25%	-21%	-24%	-24%	-25%
Agent cost as % revenue	-20%	-21%	-23%	-22%	-22%
Admin cost as % revenue	-36%	-36%	-34%	-34%	-33%
Total costs as % revenue	-56%	-58%	-57%	-56%	-55%
Finance costs as % average debt	n/m	n/m	11.1%	9.8%	6.9%
Revenue yield (revenue as % average receivables)	n/m	164%	167%	159%	152%
Tax Rate	21%	21%	21%	20%	20%
Number of clients	198,171	198,727	210,000	225,000	245,000
No agents	1,893	1,839	1,800	1,825	1,850
Clients per agent	105	108	117	123	132
Revenue per client (£)	453	456	469	463	462
Revenue per agent (£s)	47,472	49,247	54,720	57,077	61,179
Agents comms per agent (£s)	9,350	10,440	12,312	12,557	13,459
Profit per client (£)	295	52	51	66	79
Profit per agent (£)	30,894	5,633	5,985	8,104	10,411
Receivables per client (£)	280	286	296	309	326

Source: MCL, Hardman & Co Research

In Figure 17 below we detail the adjustments we make to reach an adjusted profit level. The biggest single element is amortisation of intangibles. There is an argument that this is a real cost to business (to grow the franchise organically, if possible, would require heavy investment) but we include it in the adjustments as it is non-cash item.

Figure 17: Adjusted profits (£ms)

Year ended February	2015	2016	2017E	2018E	2019E
Adjusted pre-tax	**13.0**	**16.9**	**17.0**	**18.5**	**20.4**
Exceptional items inc IPO, Restructuring	(0.8)	(1.9)	(2.5)	(0.75)	(0.5)
Amortisation of intangibles	(8.3)	(5.7)	(3.7)	(3.7)	(3.7)
Parent interest charge adjustment	2.6	1.1	-	-	-
IFRS9 adjustment	-	-	-	-	(2.5)
Reported PBT on ordinary activities	**6.5**	**10.4**	**11.3**	**14.1**	**13.7**
Gains on acquisition	52.0	-	-	-	-
Statutory pre-tax profit	**58.5**	**10.4**	**11.3**	**14.1**	**13.7**
Adjusted tax	(2.7)	(3.5)	(3.6)	(3.7)	(4.1)
Tax effects of adjustments	3.1	1.1	1.2	0.9	1.5
Statutory post tax earnings	**58.9**	**8.0**	**8.9**	**11.3**	**11.1**

Source: MCL, Hardman & Co Research

Balance Sheet

Figure 18 details the expected balance sheet. The expected strong growth in lending is the key feature.

Figure 18: Balance sheet (£000s)

Year ended February	2015	2016	2017E	2018E	2019E
Non-current					
Goodwill	294	1,326	2,300	3,000	3,500
Intangible assets	10,391	9,052	7,008	4,553	2,098
Property Plant and equipment	936	1,182	1,591	2,296	2,648
Amounts receivable from customers	1,507	679	400	300	200
Total Non-current assets	**13,128**	**12,239**	**11,299**	**10,149**	**8,446**
Current assets					
Receivables	**53,976**	56,152	61,768	69,180	79,557
Trade / other receivables	26,216	1,554	1,554	1,554	1,554
Cash and cash equivalent	8,650	3,755	1,011	705	554
Total current assets	88,842	61,461	64,333	71,439	81,665
Total assets	**101,970**	**73,700**	**75,632**	**81,588**	**90,111**
Current liabilities					
Trade and other payables	(3,274)	(7,452)	(8,452)	(9,452)	(10,452)
Total current liabilities	**(3,274)**	**(7,452)**	**(8,452)**	**(9,452)**	**(10,452)**
Net Current (liabilities) / assets	85,568	54,009	55,881	61,987	71,213
Non-current liabilities					
Financial Liabilities – borrowings	-	(9,000)	(9,000)	(11,500)	(17,500)
Deferred tax	(2,614)	(1,879)	(1,952)	(1,952)	(1,952)
Total non-current liabilities	(2,614)	(10,879)	(10,952)	(13,452)	(19,452)
Total liabilities	**(5,888)**	**(18,331)**	**(19,404)**	**(22,904)**	**(29,904)**
Net assets	**96,082**	**55,369**	**56,228**	**58,684**	**60,207**
NAV per share (£)	0.74	0.43	0.43	0.45	0.46
Tangible NAV (£)	0.66	0.35	0.36	0.39	0.42
Total debt to NAV (%)	0%	16%	16%	20%	29%
Total debt to tangible NAV (%)	0%	20%	19%	22%	32%
Debt to loans (%)	0%	16%	14%	17%	22%

Source: MCL, Hardman & Co Research

Cashflow

The strong lending requires funding but as can be seen the strong profitability of the business largely covers this.

Figure 19: Cashflow (£000s)

Year ended February	**2015**	**2016**	**2017E**	**2018E**	**2019E**
Profit (loss) before tax	58,565	10,374	11,263	14,089	13,723
Depreciation,	596	736	591	796	1,148
Impairment of goodwill	56	42	42	42	42
Amortisation of intangibles	8,574	5,683	(4)	(4)	(4)
Share based payment expense	-	-	120	120	120
Gain on acquisition	(51,961)	(32)	-	-	-
Loss on disposal of plant property and equipment	40	146	134	-	-
(Increase)/decrease in debtors	(14,803)	27,532	1,772	(930)	(3,684)
Dividend in Specie to Perpignon	-	(31,129)	-	-	-
Increase / decrease in creditors	4,768	2,548	(1,000)	(1,000)	(1,000)
Interest paid	1	647	1,000	1,000	1,000
Taxation paid	(800)	(1,737)	(4)	(4)	(4)
Net cash inflow / (outflow) from operating activities	**5,036**	**14,810**	**13,914**	**14,110**	**11,342**
Cashflow from investing activities					
Purchase of intangibles	(416)	(2,523)	(1,000)	(1,480)	(1,280)
Purchase of property, plant and equipment	(343)	(1,152)	(1,000)	(1,500)	(1,500)
Disposals of assets	-	501	-	-	-
Purchase of subsidiaries	-	(7,383)	(5,500)	(4,000)	(4,000)
Cash acquired on acquisitions	5,120	-	-	-	-
Net cash outflow from investing activities	**4,361**	**(10,558)**	**(7,500)**	**(6,980)**	**(6,780)**
Cashflows from financing activities					
Net borrowing	-	9,000	-	2,500	6,000
Interest Paid	(1)	(647)	(1,000)	(1,000)	(1,000)
Dividends	(2,000)	(17,500)	(8,159)	(8,936)	(9,713)
Net cash inflow from financing activities	**(2,001)**	**(9,147)**	**(9,159)**	**(7,436)**	**(4,713)**
Net increase in cash and cash equivalents	7,396	(4,895)	(2,744)	(306)	(151)
Opening cash and cash equivalents	1,253	8,650	3,755	1,011	705
Closing cash and cash equivalents	8,650	3,755	1,011	705	554

Source: MCL, Hardman & Co Research

Valuation

Summary

Average valuation upside on absolute measures 28%

Our absolute valuation techniques imply an average upside of 28%. The peer valuations have 3% upside.

Figure 20: Summary of different valuation techniques

	Implied Price (p)	Upside (%)
Gordon's Growth	168.0	42%
DDM	136.1	15%
Average absolute measures	**152.1**	**28%**
Peer 2017 PE	135.1	14%
Peer 2017 yield	148.6	25%
Average of peers	**141.8**	**20%**

Source: Hardman & Co Research

Gordon's Growth Model

GGM captures both value added and growth. Upside 42%

Our preferred valuation approach is to consider the value added by a business. The GGM assumes that the price to book should be equivalent to the (sustainable return on equity – growth in equity) / (sustainable cost of equity – growth in equity). A business delivering above its cost of capital should thus trade above book value. Critically this model captures growth which simple comparisons of P/BV against ROE do not. A business growing strongly and delivering 5% above its cost of equity is more valuable than one with no growth delivering 10% above.

Figure 21: Gordon's Growth model and sensitivities

	Base	+1% ROE	+1% COE	+0.5% G
ROE (%)	25	26	25	25
COE (%)	11	11	12	11
G (%)	5.5	5.5	5.5	6
P/BV (x)	3.5	3.7	3.0	3.8
Discount re near term (%)	20%	20%	20%	20%
P/BV (x)	4.3	4.5	3.6	4.6
BV 2018 (£m)	51.1	51.1	51.1	51.1
Valuation (£m)	217.5	228.7	184.1	233.2
Valuation per share (p)	**168**	**177**	**142**	**180**
Variance (p)		11.2	-33.5	15.6

Source: Hardman & Co Research

Assumed ROE is 25%

Assumed COE 11%

Assumed G 5.5%

Premium added to reflect accounting equity under-valuing business

Taking MCL specifically we have focussed on tangible book value (Hardman 2018E 51.1p) and associated returns, cost and growth. Our assumed long run sustainable ROE is 25% reflecting the high barriers to entry into non-standard lending, pricing power over customers and a more efficient gearing structure than at present. This return is in line with that achieved by Morses Club in H1FY17. We have assumed a long-term cost of equity of 11% to reflect the relatively high risk profile of the customer base and the company's relative immaturity (noting the executives are highly experienced). Growth we have assumed to be marginally above nominal GDP – while in theory this would in perpetuity see MCL bigger than the UK economy, we are comfortable that it gives appropriate credit for the business's growth opportunities over the next decade. Given our forecast profitability and growth, we would not normally include any premium / discount for near term performance compared with our long-term assumptions. However, we believe the accounting equity does not fully reflect the most-likely real value in the business at the reporting date (see Appendix) and accordingly include a 20% premium to reflect this. Sensitivity to the assumptions is given in Figure 21.

Dividend Discount Model

DDM upside 15%

We have built a dividend discount model using forecast dividends to 2017-2019E, followed by a step change to the pay-out ratio. In order for retained equity funds to fund growth and assuming superior ROE is returned, the medium-term pay-out ratio would be 78%, well ahead of current management guidance. We have assumed 8% growth for five years beyond our forecast period and then 5.5% growth for twenty years. We have applied a 10x multiple to the terminal value and all cashflows have been discounted at the cost of equity (i.e. 11%). This produces a valuation of 136.1p of which just 21% is in the terminal value. As the base year valuation rolls forward, and so we capture more maturing growth, we would expect this valuation to increase year on year.

Peer comparisons

MCL one of the lowest year 1 prospective PE ratio and the joint highest forecast yield

MCL is still an immature business. MCL has one of the lowest 2017 forecast PE. The forecast dividend yield is above average.

For the sake of completeness, we have included the price to book relatives in Figure 22. We note MCL is above the peer average (3.3x v 2.3x) but the group is under-geared and the real value of equity is not captured by the accounting equity. Given the relevant discount rates, this distortion is potentially materially greater for MCL than peers and so we have not included a P/BV measure in our average peer valuation.

Figure 22: Peer valuation comparisons

	Shr price (p)	Market Cap (£m)	2017 PE (X)	2017 Yield (%)	P latest tangible BV
Morses Club (Feb 18)	**118.5**	**162**	**11.1**	**5.3%**	**3.3**
NSF (Dec)	2688	3972	14.5	5.3%	4.6
PFG (Dec)	65.5	184	11.7	3.4%	1.9
S&U (Jan 18)	2077	248	10.3	5.3%	1.9
H&T	280	104	12.8	3.6%	1.4
STB (Dec)	2215	409	13.7	3.6%	1.8
Peer average			12.6	4.2%	2.3
MCL at peer average (p)			135.1	148.6	

Source: Hardman & Co Research

Appendix 1: Accounting Issues

Accounting equity understates real value

Discounting uses the customer interest rate. This rate is appropriate for a high administration cost business but is not therefore appropriate rate to use when discounting the cash flow as it does not reflect the risks to that cash flow.

Investors will note a large difference between gross receivables (such as those quoted by the company for new business) and the balance sheet recognition of them. Gross receivables include unearned income and may be considered as the most likely value of the assets currently on the books. The accounting rule is that customer receivables are initially recognised only at the amount loaned to the customer. After initial recognition, the amounts receivable from performing customers are subsequently measured at amortised cost.

However, once a loan is impaired, it is valued on the basis of discounting all the future cash flows expected from the customer. The critical issue is the discount rate because the accounting rule is to use the customer's rate which for HCC is clearly a high number reflecting the administration costs of the business. Taking a 33 week loan the APR is 433% (nearly 8% per week). A customer who missed two payments on a £100 but is then on track would see the accounting value of the loan fall from £100 to just £46.8 even though they are now paying to terms. Applying a discount rate equivalent to our expected long term ROE (i.e. 25%) would actually see the loan value increase as the expected cash flows would include interest. We are not advocating such an approach but it shows the sensitivity of the accounting value to the discount rate.

Figure 23: Impact of different discounts rates on loan value recognition

	Discount at customer rate	Discount at 25%
Loan made to customer	100	100
Interest over 33 weeks	65	65
Less impairment at 25% rev	**(16.25)**	**(16.25)**
Gross receivable value	148.75	148.75
Discount rate	433%	25%
NPV	46.8	137.2

Source: Hardman & Co Research

Undervaluation solely because of using an excessively high discount rate could run into tens of millions of pounds

Current disclosure means we are unable to quantify the effect. However, the nature of the business is that significant numbers of customers will fall into arrears and be classified as impaired even though they eventually pay all the contractual amounts due. With our forecast receivables at February 2017 of around £62m, we believe the discounting effect could easily run into tens of millions of pounds compared with our forecast February 2017 equity of £46.9m.

Impairment accounting

Gross up / Unwind of the discount

Accounting rules gross up interest income and impairments in the same accounting period (H1FY17 by £2m) to reflect income earned where loan periods have been extended and the NPV effect

Accounting standards mean the recognition of revenue does not track the actual cash received. The effective interest rate (EIR) of the loan (calculated at initiation) is applied to the loan balance outstanding. If the customer misses a couple of payments, for accounting purposes, the outstanding balance still earns interest income even though the customer is not charged any additional interest. To ensure the right overall profit (and reserves), the theoretical revenue generated, which will not be paid, is provided against with an exactly matching loan impairment. Figure 24 gives an illustrative example where the EIR is 30% per period and two payments are missed. In this case, income would be grossed up to 135 from 75 and with a provision raised of 60 (both the income gross up and impairment provision are taken in the same accounting period). In practice the matter is much more complicated – loan balances do not reduce on a straight-line basis as initially interest is a much higher proportion of any collection – but the principle is clear. The gross up is greatest where interest rates are high and rescheduled periods a big proportion of the initial expected loan. HCC is most affected by this accounting issue.

Figure 24: Illustrative example of extended loan duration on the gross up

Period	1	2	3	4	5	6	7	Total
Loan Balance Planned	100	75	50	25	0			
Revenue	30	22.5	15	7.5	0			75
Rescheduled	100	100	100	75	50	25	0	
Revenue	30	30	30	22.5	15	7.5	0	135

Source: Hardman & Co Research

Additionally, when there is evidence of impairment, MCL calculates the net book value of the expected cashflows on the loan using the effective interest rate as the discount rate. This NPV is compared with the original loan and the gap is provided for. Like any present value calculation, over time it unwinds. For HCC loans, the discount rate is very high (2015 328% see note 17 report and accounts) and so the unwind of the discount is material.

Again, a simplified example may help to explain the principle. Assume the original loan had an outstanding balance of £20 and under the new agreement three instalments of £5 were required. On the 30% discount rate the NPV of this £15 is now £7.7 (provision £12.3), while the end loss is only £5. In this case (detailed in Figure 25) the discounting factor is more than the final provision required.

Figure 25: Illustrative example of effect of present valuing on the gross up

Period	1	2	3	Future cash	Cash recd	Total value	Provision	Unwind
Expected cash flow	5.0	5.0	5.0					
NPV rate	70%	49%	34%					
NPV now	3.5	2.5	1.7	7.7	0.0	7.7	12.3	
NPV yr 1		3.5	2.5	6.0	5.0	11.0	9.1	3.3
NPV yr 2			3.5	3.5	10.0	13.5	6.5	2.6
NPV yr 3				0	15	15.0	5.0	1.5

Source: Hardman & Co Research

Figure 26 shows the experience at MCL. We believe the real loss is better seen by write-offs of provisions although we understand this is still over-conservative as small elements of recoveries which are included in the unwind of discount line.

Figure 26: MCL provisions account

Year ended February	2014	2015	2016
Opening provision	**9,193**	**7,312**	**40,782**
Charge in period	4,368	22,695	22,588
Write off in period	(5,097)	(24,664)	(21,741)
Unwind of discount	(1,151)	(9,020)	(9,203)
Acquired	0	44,459	3,670
Closing	**7,312**	**40,782**	**36,086**
Unwind as % charge	-26%	-40%	-41%
Write off as % charge	-117%	-109%	-96%

Source: MCL, Hardman & Co Research

IFRS 9

Will impact on 2019 statutory earnings

IFRS 9 will replace IAS 39 as the accounting standard governing the classification, measurement, impairment and hedge accounting of financial instruments, including loan assets. IFRS 9 will take effect for accounting periods commencing 1 January 2018 (MCL's relevant year end will commence on 1 March 2018 and so the effect will be on results reported as FY19). MCL does not intend to adopt any changes in respect of IFRS 9 prior to this time. While the effect is still uncertain, IFRS 9 is likely to also include a grossing up effect.

Earlier recognition of losses….. total profits unaffected… it is just a timing issue

Whilst there will be no impact on cash, for consumer lending businesses such as MCL, the adoption of IFRS9 is likely to mean that future expected credit losses over the life of a loan will be recognised earlier than at present - either on issue of loans or early in the loan term, whereas currently impairment provisions are only recognised where a "loss event" has been experienced.

As the carrying value of loans under IFRS 9 is based on the present value of future expected cash flows, discounted using the contractual effective interest rate of the loan, the discounting element of the impairment provision is also likely to be high for the Group.

Effect unknown and so we have built in directional estimates only

The impact of IFRS 9 has yet to be quantified for the Group, but we believe it could impact on the carrying value of the loan book of the Group. Although the profit recognised over the life of the loan will be unchanged, this accounting policy change will result in earlier recognition of impairment losses and therefore later recognition of profits.

No guidance has yet been given on the details of the implementation of IFRS 9. We believe discussions are ongoing on a range of issues including for example whether it is more appropriate to use implied behavioural interest rates rather than contractual ones. The resulting reduction in the discount on the cash flows may well offset the "cost" of converting IBNR to full predicted loss basis. It would also affect reported income as it would greatly reduce the grossing up making the accounts more representative of reality. At this stage, we have included a nominal effect to highlight the issue. We expect the FY19 statutory effect will be stripped out of adjusted profits and so we have forecast on that basis.

Company matters

Registration

Incorporated in the England and Wales with company registration number: 06793980.

Board of Directors

Independent Non-Executive Chairman: Stephen Karle

Stephen Karle was appointed to the Board on 20 January 2015 and is the Chairman of the Board. He has a wide range of financial services experience and is a director of Karle & McCleery Limited, a strategic advice and executive business coaching company operating across a wide range of business sectors. He was, until recently, Chairman of BCRS Business Loans, a small business loans company supporting regional business growth. He is a former CEO of West Bromwich Building Society.

Chief Executive Officer: Paul Smith

Joined the Company in October 2014 and has been responsible for growing Morses Club by acquisition and organically. Experience in mobile payment technology as Managing Director of EZ Pay Ltd, a prepaid MasterCard organisation, from 2009 to 2012 prior to its sale to BC Partners. Started his career in the global software market before joining Phones 4U Group in 1998, where he became an MD and was an integral part of the management team until its sale for £1.4bn in 2006

Chief Financial Officer: Andy Thomson

Joined the Company in 2009. He is Chartered Management Accountant with public company experience which includes roles at Morgan Sindall, Tesco and Cadbury Schweppes. He has extensive experience in Commercial, Legal, Internal Audit, Insolvency and IT and was involved in the acquisition and integration of Morses Club/SFS

Independent Non-Executive Director: Joanne Lake

Joanne Lake was appointed to the Board on 14 April 2016. She has over 30 years' experience in accountancy and investment banking primarily with Panmure Gordon, Evolution Securities, Williams de Broe and Price Waterhouse. She is Deputy Chairman of Mattioli Woods plc, a wealth management and employee benefits firm, and Main Market listed Henry Boot plc and is also a non-executive director of Gateley (Holdings) plc. She was also a non-executive director of CIT Bank Limited.

Independent Non-Executive Director: Sir Nigel Knowles

Sir Nigel Knowles was appointed to the Board on 14 April 2016. He was previously Global Co-Chairman and prior to that Global Co-CEO and Managing Partner for nearly twenty years of DLA Piper, one of the world's largest global business law firms with a turnover in excess of USD2.5 billion.

Independent Non-Executive Director: Patrick Storey

Patrick Storey was appointed to the Board on 14 April 2016. He is a Chartered Accountant and founding member and Senior Partner of Grant Thornton's financial services group and head of its regulatory team. He has 30 years' experience with Grant Thornton working in the financial services sector, specialising in governance and the practical implications of regulations for banks, lenders and other financial institutions.

Non-executive Director: Peter Ward

Peter was appointed to the Board on 1 March 2015. He was a co-founder of Rcapital Partners LLP. In 2001 Peter co-founded his own corporate advisory business, Three V Corporate Venturing LLP to provide fund raising and interim management services. Prior to this, Peter held senior management positions within the UK Commercial and Corporate Banking division at NatWest/Royal Bank of Scotland group for 23 years hardman&co

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