S&U

Full year results

Strong growth, strong balance sheet

Financial services

Following last year's profitable sale of its stable but relatively low-growth home credit activity, S&U is now focused on its well-established and fast-growing motor finance business, Advantage. It is also looking for opportunities to invest in a new business, but will not do so unless the right opportunity appears. In the meantime, Advantage continues to make strong progress and S&U appears cautiously valued.

Year end	Revenue (£m)	PBT* (£m)	EPS* (p)	DPS (p)	P/E (x)	Yield (%)
01/15	36.1	14.8	99.0	66.0	22.6	2.9
01/16	45.2	19.5	132.4	76.0	16.9	3.4
01/17e	58.3	25.7	171.4	89.6	13.1	4.0
01/18e	71.7	30.4	202.8	109.5	11.0	4.9

Note: *PBT and EPS are normalised, excluding amortisation of acquired intangibles, exceptional items and share-based payments. **FY16 DPS ex-exceptional payment of 125p.

FY16 results

On a continuing basis (excluding the home credit business) revenues increased by 25% to £45.2m and profits 32% to £19.5m, reflecting 36% growth in motor finance receivables. While the impairment charge increased by 30% as a proportion of revenues, the increase was only modest, from 16.2% to 16.8%, and remains low by historical standards. The ordinary dividend was increased by 15% to 76p and there was an exceptional payment of 125p following the home credit sale in August, which generated a profit on disposal of £50.1m.

Outlook

The macroeconomic outlook has become less certain and global/UK GDP growth estimates have been trimmed this year, while the UK's EU referendum could give rise to additional volatility. However, absent a further significant worsening in background, the prospects for Advantage appear promising and it has recently reported an acceleration in its transactions growth rate. Competitor activity has picked up over the last three years according to S&U and other players also report very strong lending growth, but there has been no softening in pricing and the withdrawal of mainstream lenders since the financial crisis leaves substantial scope for profitable growth. The group is also undertaking a search for an investment in a new business following the home credit sale, with the strong returns and growth at Advantage and the board's commitment to maintaining "steady, sustainable growth" as standards to measure potential additions against.

Valuation: Cautious despite a record of growth

In the context of a selection of non-standard lending peers, S&U's valuation appears in line when comparing its return on equity and price/net asset value multiple. However, on our ROE/COE model the market appears to be making conservative assumptions on prospective ROE and/or growth with the current price, on our assumptions, pointing to an ROE of c 15%, below prospective returns. Our updated base case assumptions point to a value of c 2,600p (page 6).

20 May 2016

Price	**2,240p**
Market cap	**£267m**

Net debt (£m) at 31 January 2016 (including preference shares)	12.4
Shares in issue	11.9m
Free float	26%
Code	SUS
Primary exchange	LSE
Secondary exchange	N/A

Share price performance

%	1m	3m	12m
Abs	2.9	(3.3)	7.4
Rel (local)	8.1	(5.4)	22.4
52-week high/low		2,560.0p	1,992.5p

Business description

S&U's Advantage motor finance business lends on a simple hire purchase basis to lower and middle income groups who may have impaired credit records that restrict their access to mainstream products. It has over 32,000 customers currently.

Next event

Half year end	September 2016

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Edison profile page

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Company description: Shifting emphasis

During 2015 S&U underwent a fundamental change with the sale of Loansathome4u, the home credit company that grew from the credit drapery business originally founded in 1938 by the chairman's grandfather, Clifford Coombs. As a result S&U now comprises the fast-growing Advantage motor finance business, while management are looking for opportunities for investment/acquisition, focusing on areas within specialist credit.

Advantage was formed in 1999 and is based in Grimsby with over 90 employees. The majority of the management team have been with the company since launch. Growth has been rapid with 30% compound growth in customer receivables over the last five years to £145m at the end of January 2016. It has 35,600 live customers and recorded 15,100 new transactions last financial year (FY16), an increase of 27%. Advantage focuses on the non-prime area of the market and its lending is primarily through about 40 brokers (85%), with the balance through dealerships or, to a limited extent, to existing customers. The brokers in turn source their business through dealer relationships and the internet. Most loans are in the £5,000 to £7,000 range, with a maximum deal size set at £12,000.

Advantage has achieved 16 years of consecutive profit growth, reflecting growth in the loan book together with successful credit control underpinned by the continuous refinement of a bespoke underwriting and scoring system developed in conjunction with Experian. The provisional approval rate for loan applications has been broadly stable in recent years and in the last financial year was 28%, with 140,000 approved out of 500,000 applications. As noted, just over 15,000 actually signed up: 3% of the original applications.

FY16 results and trading update

Key points from the results for the year to end January 2016 are listed below, with figures on a continuing basis, excluding the home credit business, unless stated.

- Revenues increased by 25% to £45.2m.
- Pre-tax profit of £19.5m was 32% ahead.
- Motor receivables were 36% up at £145.1m.
- The impairment charge was up 30%, but only rose modestly from 16.2% of sales to 16.8%.
- Basic earnings per share were 133.6p versus 100.1p.
- The total ordinary dividend for the year is 76p (+15%).
- The home credit business was sold for £82.4m, generating a profit on disposal of £50.1m.
- £14.9m of the proceeds were returned to shareholders through an exceptional dividend of 125p.

Exhibit 1 sets out the results from 2011 to 2016 on a continuing basis. The strong growth in **receivables** over the period, reflecting healthy demand for second-hand cars and the reduced availability of mainstream finance after the financial crisis, was the driver of revenues. The level of **revenue yield** on average receivables had been in a range between 40% and 45% until FY16 when it was 36%, 4.3 percentage points lower than FY15, reflecting a combination of business mix and the effect of taking away the offer of insurance policies (such as gap and breakdown insurance). Offsetting this, the removal of the insurance offer has made the processing of applications much simpler and faster, helping Advantage provide a competitive service and contributing to strong growth.

Exhibit 1: Results for the ongoing business, financial years to end January 2011-16

£m except where shown	2011	2012	2013	2014	2015	2016
Accounts receivable	**39.3**	**42.3**	**52.5**	**73.0**	**106.4**	**145.1**
Profit and loss						
Revenue	16.2	17.9	20.9	26.2	36.1	45.2
Cost of sales	(2.3)	(2.7)	(3.6)	(4.8)	(6.7)	(9.0)
Impairment	(6.1)	(5.9)	(5.3)	(5.1)	(5.9)	(7.6)
Administration expenses	(4.2)	(4.6)	(5.1)	(6.1)	(7.0)	(7.3)
Finance costs	(1.1)	(0.6)	(0.6)	(0.7)	(1.7)	(1.8)
Profit before tax	**2.5**	**4.1**	**6.3**	**9.5**	**14.8**	**19.5**
% of revenues						
Cost of sales	14.2	15.1	17.2	18.3	18.6	19.9
Impairment	37.7	33.0	25.4	19.5	16.3	16.8
Admin expenses	25.9	25.7	24.4	23.3	19.4	16.2
Finance costs	6.8	3.4	2.9	2.7	4.7	3.9
Pre-tax profit	15.4	22.9	30.1	36.3	41.0	43.1
% of average receivables						
Revenue	41.4	43.9	44.1	41.8	40.3	35.9
Impairment	15.6	14.5	11.2	8.1	6.6	6.1
Revenue less impairment	25.8	29.4	32.9	33.6	33.7	29.9

Source: S&U, Edison Investment Research

The somewhat lower revenue yield contributed to a rise in the **cost of sales** as a percentage of revenue. Measured against average receivables they fell from 7.7% to 7.1% over the last two years, but over the whole period shown the cost of sales has risen on both measures, perhaps reflecting a tendency for commissions paid to brokers to increase triggered by volume thresholds.

Impairment costs as a proportion of either revenue or receivables have fallen substantially since FY11, reflecting the efficacy of S&U's scoring/underwriting system and the relatively benign background in terms of credit risk and robust demand for loans. This has enabled S&U to expand its book rapidly but without incurring undue cost of risk. In the final row of Exhibit 1 we have shown how revenue less the impairment charge (risk-adjusted margin) has increased as a percentage of average receivables over the period, albeit softening in FY16 compared with the level of the prior three years.

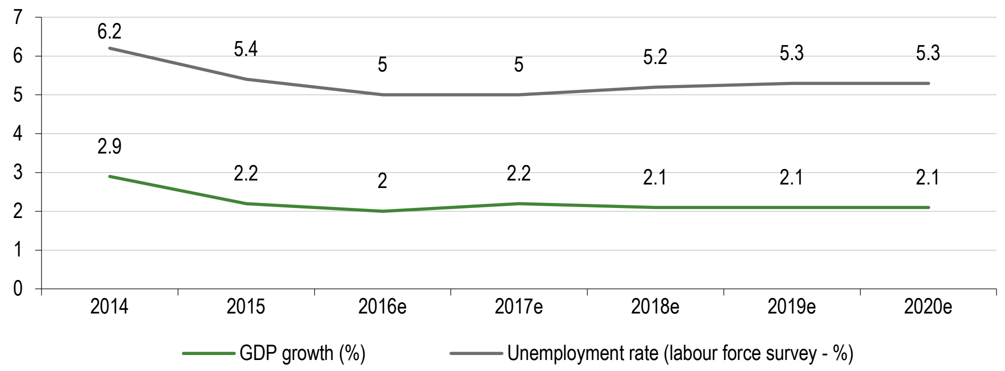
S&U reports that there has been increased **competitor activity** since the end of 2014, although indicating this has not affected its pricing. Advantage does compete on service and has allowed the term of loans to be slightly longer (this has risen from 47 to 49 months) to help win business. Notable among the competitors is Moneybarn (acquired by Provident Financial in August 2014), which addresses a similar segment of the market. With the benefit of its parent's financial backing, Moneybarn's receivables grew by 45% in 2015 to £220m. It comments that the non-standard car finance market has suffered from an approximate halving in lending volume from the pre-financial crisis level, suggesting significant further potential growth for suppliers of credit in this area.

At the time of its AGM (17 May) S&U gave a positive **trading update,** reporting that Advantage has seen an acceleration in its transactions growth rate. The number of customers increased by 3,000 or 9% in the first three and a half months of FY17 while net receivables were up by more than 10% to over £160m. The company indicate that its finance facilities can accommodate the run rate of investment in Advantage (£4m per month) and that its projections suggest gearing should not exceed 55% as the business matures (gearing 19% at the time of the statement and our estimated net debt/equity for end FY17 is 33%). S&U also noted that collections, profit margins and average loan sizes were all on budget.

Outlook

In terms of the macroeconomic background, estimates globally and for the UK have generally been reduced this year. The Office for Budget Responsibility (OBR), for example, reduced its estimated UK GDP growth for this calendar year and next by 0.4 and 0.3 percentage points to 2.0% and 2.2%, respectively (Exhibit 2). Even so, if this proves to be close to the outcome and unemployment matches the expected level of 5%, only rising to 5.3% by 2020, then the trading background for S&U would be benign. There are risks to this central scenario, including the result of the EU membership referendum in June, which could give rise to increased volatility for a period. A sharper slowdown in growth or a renewed recession accompanied by increased unemployment would be likely to push up the current relatively low level of impairments experienced by S&U and its peers.

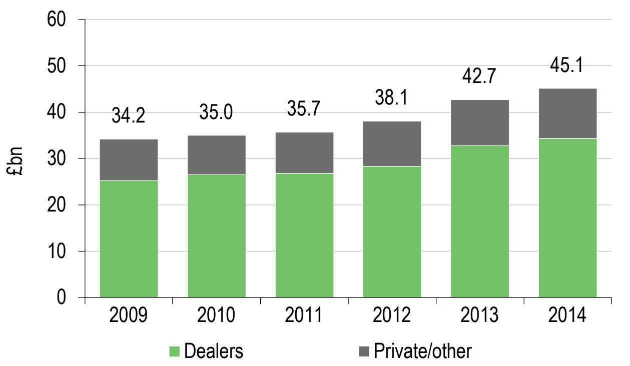
Exhibit 2: UK economic growth and unemployment estimates (OBR)



Source: Office of Budget Responsibility

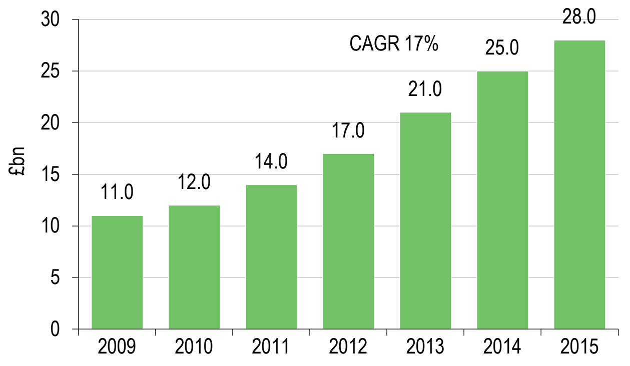
While there are economic uncertainties, trends in the used car market have been positive, with the volume of transactions running at around 7m compared with 6.3m in 2009; the value of transactions has increased at a compound rate of 6% between 2009 and 2014 (Exhibit 3). The growth in car finance for new and used cars[1] has been at a faster pace with a compound growth rate of 17% (2009-14, Exhibit 4). Providing there is not a significant worsening in conditions, there is potential for growth to continue although it may not match historical levels.

Exhibit 3: UK used car market value by source



Source: BCA 2015 report TNS-BMRBB/Buckingham

Exhibit 4: Car finance through dealerships



Source: Finance Lease Association

The increase in competitor activity mentioned by S&U does flag an area to monitor, but the withdrawal of mainstream lenders from this area following the financial crisis does suggest there is still significant scope to increase lending without seeing pricing or lending criteria become markedly less attractive. Moneybarn cites a market share of 20-25%, but S&U notes that this reflects a

[1] Over the 12 months to end February 2016, used cars accounted for 43% of lending.

narrower market definition than it would use and believes Advantage has a market share of at most 15%, with closer to 3% appropriate on a broader definition. On anything but the narrowest definition this would suggest there is still a good opportunity for share gains even in a more subdued market.

Following the sale of the home credit business, S&U has been reviewing opportunities to invest in a new business that would be consistent with the skills and experience the management team have. This and the intention to avoid diluting sustainable return on capital is likely to mean that any purchase would be in the non-prime lending area. There is a team of two engaged in the search, with a good supply of ideas to assess, but the board feels no compulsion to make a move if an appropriate opportunity does not arise. The growth and returns at Advantage set the bar high for any new business; this is a reassuring feature for investors in S&U, given the risks involved in any acquisition.

Financials

In Exhibit 5 we show the changes in our estimates for FY17 and new numbers for FY18. At the earnings level, the continuing business beat our expectation by 6% for FY16 and our estimate for FY17 is increased by a similar percentage (7%).

Exhibit 5: Estimate revisions

	Revenue (£m)		PBT (£m)		EPS (p)	
Year end 31 January	Old	New	Old	New	Old	New
2016e/actual	43.5	45.2	18.8	19.5	124.8	132.4
2017e	57.0	58.3	23.9	25.7	159.2	171.4
2018e	N/A	71.7	N/A	30.4		202.8

Source: Edison Investment Research. Note: 2016 numbers exclude the discontinued business.

We have assumed that receivables growth for FY17e is 25% followed by 19% in FY18e, that the revenue yield is modestly lower than FY16 and that impairment provisions are stable at 17% (they were 16.8% in FY16).

Following the home credit disposal, the level of net debt to equity has been substantially reduced even after payment of the exceptional dividend (Exhibit 6). This leaves room for further growth in the Advantage loan book and for the acquisition/development of an additional activity should an attractive opportunity present itself.

Exhibit 6: Cash flow and gearing

	FY15	FY16
Net debt brought forward	**(32.4)**	**(53.6)**
Collections	154.8	132.1
Disposal proceeds – home credit		82.4
Exceptional dividend		(15.0)
Advances and other outflows	(176.0)	(157.8)
Net debt carried forward	**(53.6)**	**(11.9)**
Gearing (excluding £0.45m preference shares)	65.8%	9.3%

Source: S&U. Note: The net debt shown in the financial summary includes preference shares.

Valuation

As a starting point we show S&U's valuation measures in the context of a group of companies that include non-standard lending and motor finance as part of their activities. They constitute a diverse set of companies serving different parts of the market, but each may be of interest to investors seeking exposure to the growth in non-standard lending against the backdrop in which major banks are focusing on their core activities and building up their capital bases. Here we can see that S&U

has a calendar 2016e P/E that is below the average, an above-average yield and an ROE and price/NAV that are both below average.

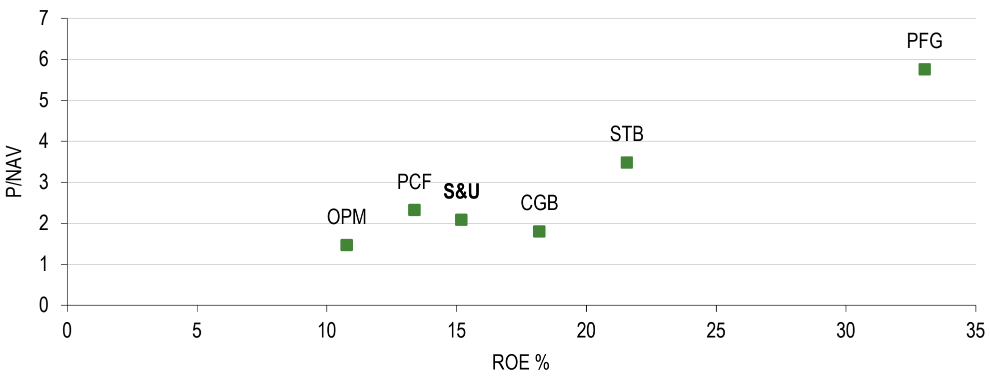
Exhibit 7: Peer comparison

	Price (p)	Market cap (£m)	P/E ratio (x)	Yield (%)	ROE (%)	Price/NAV (x)
S&U	**2,240.0**	**267.5**	**13.4**	**3.4**	**15.2**	**2.1**
1PM	70.0	36.8	11.8	0.5	10.8	1.5
Close Brothers	1,233.0	1,848.6	10.2	4.3	18.2	1.8
Private and Commercial Finance	32.5	51.7	15.9	0.0	13.4	2.3
Provident Financial	2,764.0	4,080.0	16.0	4.3	33.0	5.7
Secure Trust Bank	2,700.0	491.2	15.3	2.7	21.6	3.5
Average			**13.8**	**2.5**	**18.7**	**2.8**

Source: Bloomberg, Edison Investment Research. Note: Figures for P/E ratio are for calendar 2016e, whereas yield, ROE and NAV are historical. Prices as at 19 May.

The next chart plots the ROE and price/NAV together. While this is a small selection of differentiated companies, S&U does not appear obviously out of line on this comparison (incidentally the same would be true were we to include the challenger banks in the chart). Much will depend on its relative growth and whether it is able to invest the capital released by the home credit sale profitably (organically and otherwise).

Exhibit 8: Return on equity and price/NAV for S&U and selected peers



Source: Bloomberg. Note: OPM (1PM), PCF (Private and Commercial Finance), CBG (Close Brothers), PFG (Provident Financial). Based on historical numbers for ROE and NAV. As at 19 May.

As a final step we have refreshed our ROE/COE valuation, assuming as a base case a sustainable return on equity of 17%, a cost of equity of 10% and a growth rate of 5% (this is a somewhat more conservative set of assumptions than we have used previously). This points to a price/NAV of 2.4x and a value per share of c 2,600p, 16% above the current share price. Our previous central valuation was 2,989p, within a wide range. Given the potential for more rapid use of the balance sheet capacity and hence arguably a higher ROE target, we note that adding one percentage point to the ROE assumption pushes the value up by 217p. Alternatively, leaving the other assumptions unchanged, the current share price implies a sustainable ROE similar to last year's figure (15.2%) and our estimate for FY17 (15.3%) but below our FY18 forecast of 16.4% .

Exhibit 9: Financial summary

£'000s	2014	2015	2016	2017e	2018e
Year end 31 January					
PROFIT & LOSS					
Revenue	60,823	36,102	45,182	58,305	71,688
Impairments	(12,847)	(5,863)	(7,611)	(9,912)	(12,187)
Other cost of sales	(6,866)	(6,674)	(8,980)	(11,953)	(14,839)
Administration expenses	(22,519)	(6,957)	(7,131)	(8,746)	(10,753)
EBITDA	18,591	16,608	21,460	27,695	33,908
Depreciation	(577)	(163)	(209)	(311)	(440)
Op. profit (incl. share-based payouts pre-except.)	18,014	16,445	21,251	27,384	33,469
Exceptionals	0	0	0	0	0
Non recurring items	0	0	0	0	0
Investment revenues / finance expense	(727)	(1,680)	(1,782)	(1,649)	(3,030)
Profit before tax (FRS 3)	17,287	14,765	19,469	25,735	30,439
Profit before tax (norm)	**17,287**	**14,765**	**19,469**	**25,735**	**30,439**
Tax	(3,955)	(2,920)	(3,583)	(5,147)	(6,088)
Discontinued business after tax		6,615	53,299		
Profit after tax (FRS 3)	13,332	18,460	69,185	20,588	24,351
Profit after tax (norm)	13,332	11,845	15,886	20,588	24,351
Average Number of Shares Outstanding (m)	11.9	12.0	12.0	12.0	12.0
EPS - normalised (p)	**112.0**	**99.0**	**132.4**	**171.4**	**202.8**
Dividend per share (p)	54.0	66.0	201.0	89.6	109.5
EBITDA margin (%)	30.6%	46.0%	47.5%	47.5%	47.3%
Operating margin (before GW and except.) (%)	29.6%	45.6%	47.0%	47.0%	46.7%
Return on equity	**20.5%**	**15.7%**	**15.2%**	**15.4%**	**16.6%**
BALANCE SHEET					
Non-current assets	52,212	76,781	103,653	135,967	161,661
Current assets	57,739	68,578	61,903	61,696	75,048
Total assets	109,951	145,359	165,556	197,663	236,709
Current liabilities	(10,091)	(8,945)	(6,850)	(7,266)	(7,678)
Non current liabilities inc prefs	(30,650)	(55,150)	(30,650)	(50,650)	(75,650)
Net assets	69,210	81,264	128,056	139,747	153,380
NAV per share (p)	588	689	1,084	1,181	1,296
CASH FLOW					
Operating cash flow	(5,407)	(13,404)	(16,017)	(23,352)	(10,117)
Net cash from investing activities	(736)	(1,096)	80,716	(840)	(903)
Dividends paid	(5,664)	(6,734)	(23,090)	(9,397)	(11,218)
Other financing (excluding change in borrowing)	33	8	55	0	0
Net cash flow	(11,774)	(21,226)	41,664	(33,588)	(22,238)
Opening net (debt)/cash	(21,015)	(32,789)	(54,015)	(12,351)	(45,939)
Closing net (debt)/cash	**(32,789)**	**(54,015)**	**(12,351)**	**(45,939)**	**(68,177)**

Source: S&U accounts, Edison Investment Research. Note: Net debt includes £0.45m preference shares

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