

S&U

Focus on growing car finance

Sale of home collect business

Financial services

Following an unsolicited offer, S&U is selling its home collect business. Strategically, the sale allows greater resource to be devoted to the higher-growth car finance business (cash proceeds £82.5m, NAV increased by £47m) and an as yet unquantified but significant capital repatriation. Our valuation shows a modest increase on the disposal. We have cut our near-term normalised earnings forecasts modestly as the benefit of the full deployment of the sale proceeds is unlikely in the forecast period.

Year end	Revenue (£m)	PBT* (£m)	EPS* (p)	DPS (p)	P/E (x)	Yield (%)
01/14	60.8	17.3	112.0	54.0	22.0	2.2
01/15	74.4	23.2	154.3	66.0	15.9	2.7
01/16e	66.2	22.5	149.9	75.0	16.4	3.0
01/17e	56.0	23.3	155.2	85.0	15.9	3.5

Note: *PBT and EPS are normalised, excluding intangible amortisation, exceptional items and share-based payments.

Positive development

S&U has sold its historic core, highly cash-generative business. The upfront cash proceeds (£82.5m) mean it can fully repay existing borrowing facilities and have pro forma net cash at end January 2015 of £26m. The disposal multiple was 12.5x last year's earnings and 2.5x book value. It will also see a post-tax and cost gain of c £47m increasing S&U's January 2015 NAV by 58%. These funds can be used to finance incremental loans in the vehicle finance business and the strong liquidity means S&U will temporarily defer the application for a banking licence (and associated regulatory costs and time commitment). It has indicated the exploration of new business areas, still leaving considerable scope for a further "significant" return of capital (details expected when the deal completes). Financially, the unit accounted for just over a third of our 2017 forecast earnings excluding central costs. We note that S&U's car business has shown more stable impairments than the home collect business and has seen a remarkable improvement since 2012.

2017e earnings reduced, but still up on 2015

The earnings on the cash proceeds will be below those generated by the home collect business pending their deployment in either the capital repatriation (expected before year-end 2016) or in the vehicle and SME finance operations. The amount of the capital repatriation is uncertain and we have not built it into our earnings forecasts. The full period benefit of the latter will only be seen in FY18. While forecast earnings have been reduced, we expect 2017 to be modestly up on 2015.

Valuation: Average valuation now £28.31

Our average valuation moves from £26.23 to £28.31. The dividend model has fallen due to lower forecast earnings, although our forecast period does not capture the full benefit from redeploying the sale proceeds. The Gordon's growth model has increased with the incremental equity. For both models we have factored in a one-off Edison notional £30m capital repatriation valued at par.

20 July 2015

Price 2,460p
Market cap £293m

Pro forma net cash (£m) at January 2015	26
Shares in issue	11.9m
Free float	46%
Code	SUS
Primary exchange	LSE
Secondary exchange	N/A

Share price performance



%	1m	3m	12m
Abs	4.0	22.1	37.1
Rel (local)	2.8	25.0	33.4
52-week high/low	2,520p	1,700p	

Business description

Post-disposal, S&U is a niche motor finance provider to the non-standard UK market. It has more than 26,000 customers, having made more than 12,000 new loans in FY15.

Next events

H1 report	Late September 2015
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Strategic implications of the disposal

Focus on growth

From 2006 to 2015 the home collect division saw CAGR in revenue of 2.7% and 0.9% in receivables. By contrast, the motor business grew by 13.9% and 14.4% respectively. The relative market dynamics mean the outlook for home collect remained very steady, while motor continues to offer much better growth for the foreseeable future. While the regulatory and competitive environment means home collect is increasingly challenging for smaller players, management noted that because of “the relatively small size of these home credit competitors, the Board have concluded that S&U is unlikely to benefit significantly from acting as a consolidator in the home credit market.”

New markets

Management notes that S&U already provides modest commercial vehicle finance to the self-employed. It is looking to expand this into broader SME finance. S&U is targeting a niche (loans averaging £12k and secured on the assets financed) and aims to have c 1,000 clients by January 2017. We note that the company plans to allocate £13m to this area over the next 18 months (a tiny fraction of the market) and intends to deploy just over a third of the £34m in its existing Advantage consumer car finance business. The growth of challenger banks (including Secure Trust) and P2P players such as Funding Circle suggests there is a ready market for the non-major business lenders and S&U can leverage an existing business line to access new clients.

Management also notes: “Although no specific funding has been earmarked, the Board is exploring areas of personal finance, initially in partnerships with well-established market participants.” We did not consider S&U funding constrained before, but its current high level of liquidity may open certain options that it would not have considered previously.

S&U has historically been very conservative in expanding into new markets. They will require new scorecards and risk modelling and we expect an evolutionary rather than revolutionary approach to these new business lines.

Credit trends in car finance more stable than home collect

A number of factors could lead to more volatility in car finance provisions than home collect. Firstly, the home collect business has a broader portfolio (100k customers vs 26k in the car finance business). Secondly, the value of car security is volatile, which means recovery rates can also vary. Thirdly, the size of the loan relative to income is typically larger, making it more exposed to life-changing events such as unemployment or divorce. Lastly, the spread of income on home collect includes a greater proportion of more certain income (eg benefits, multiple jobs) than the typical car finance deal.

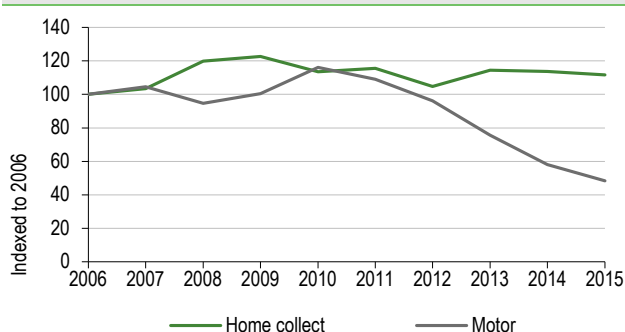
However, this has not been S&U's experience to date. As Exhibits 1 and 2 demonstrate, car finance losses measured against both income and advances have been considerably more stable. As can be seen from Exhibit 1, the 2006-12 peak in home collect as a percentage of revenue was 123 against 116 in the motor book (both indexed to 2006 levels). Using the same methodology, as a percentage of advances in home collect the peak was 116 against 105 in the motor book. There has also been a marked improvement in the car finance business against a modest deterioration in home collect one since 2012.

The key issues have been conservative approaches to credit scoring and the reluctance of mainstream lenders since the 2008 financial crisis to finance marginal cases, giving S&U the

opportunity to select good credit-quality customers. We believe the former is embedded in the S&U's culture and will continue for a considerable time. While mainstream lenders continue to have limited appetite to lend, other competition is increasing. We expect S&U to respond by seeing its margin fall rather than compromise its good credit-quality base.

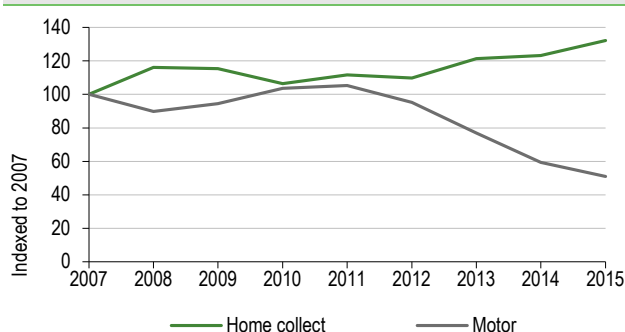
In summary, there is no certainty that removing the home collect business will see increased credit volatility and we have not changed our cost of equity for the deal.

Exhibit 1: Annual impairments as percentage of revenue indexed to 2006



Source: S&U, Edison Investment Research

Exhibit 2: Annual impairments as percentage of annual average advances indexed to 2007



Source: S&U, Edison Investment Research

Business disposed

S&U is selling Loansathome4U, its home credit division. In the financial year ended 31 January 2015 Loansathome4U produced revenues of £38.3m and profit before tax of £8.4m (previously reported as £6.5m; adjusted to £8.4m for central costs of £1.95m previously allocated to this unit, but which will still be borne by S&U). Net assets for Loansathome4U at 31 January, excluding an inter-company receivable balance of £16.3m, were £33.1m. The inter-company receivable represents cash lent to S&U, which will be retained as part of the proposed disposal.

This business was the historic core of the family-run S&U and there had been no indications of an intended disposal previously. The offer was unsolicited. We believe these factors will have ensured that the sale price achieved had to be considered by management as a good one. At 12.5x earnings and 2.5x book, the disposal price was c one-third of S&U's market capitalisation for a broadly similar percentage of earnings, but there was much slower growth in the unit sold (and as noted above it had seen a greater degree of impairment volatility) than the residual motor business.

The buyer, Non-standard Finance (NSF, admitted to LSE on 19 February 2015) has a more aggressive expansion strategy than S&U and in its announcement noted that it would expand the branch network and agent workforce to grow the customer base and that it would seek further acquisition opportunities as the home credit industry consolidates in the light of increasing regulation. It will also invest in systems and technology (including the deployment of mobile technology), compliance functions and management. NSF sees the acquired business as an excellent platform from which to grow much faster than S&U's culture would allow it to.

Valuation

We use a range of valuation approaches, the average of which is £28.31 (previously £26.23). The peer valuations has increased because of the price / NAV measures and an over 10% rise in the Provident Financial share price. We have increased our growth assumption (from 5% to 5.5%) to

reflect the better structural prospects of the motor business. We have left the cost of equity assumption unchanged at 10.5%, noting that the lower impairment volatility on the car finance book and lower gearing could justify a reduction in this number. The Gordon's growth model shows an increased valuation with the higher equity base more than offsetting a newly introduced discount of 15% for near-term performance (the higher equity means the near-term ROE is below our long-term assumptions, 2017e 13%). There has been a modest reduction in our dividend discount model. The reduction in our 2016/17 earnings estimates drives a lower dividend. We note that this forecast period does not fully capture the deployment of the cash proceeds, nor does it give credit for a balance sheet that could see significant capital repatriations and still be less geared than peers.

Peer valuations (3,434p previously 2,906p)

The different business models mean that peer valuations need to be treated with caution. In particular, S&U has net cash, while the peers have net debt typically c 4x their equity base. Unsurprisingly, given we have modestly cut forecast earnings, the earnings measures below have seen a fall since our last [note](#), while the book value measure has seen a sharp rise given the extra equity in the group.

Exhibit 3: Peer valuation metrics

	Price (p)	Market cap (£m)	P/E (x)		2016/15 growth	2016 yield	2016 payout ratio	Price/book value (x)	Equity to lending (%)
			2015	2016e					
S&U*	2,460	293	16.4	15.9	38%	3.0%	43%	2.2	106%
PFG	3,067	4,507	19.3	17.5	10%	3.8%	73%	7.4	33%
Secure Trust	2,875	523	16.8	13.1	28%	3.2%	53%	4.2	20%
Average PFG/STB			18.0	15.3	19%	3.5%	63%	5.8	27%
S&U at peer average (p)	3,434		2,747	2,415		2,193		6,381	

Source: Thompson Reuters. Note: *Our calculations are based on January of the following year (eg for year-end 2013 we use January 2014). Prices as at 7 July 2015.

As S&U deploys its surplus funds, we might expect the price-to-book matrix (the current big positive outlier) to reduce and for it to be offset by higher earnings and yield-based measures.

Gordon's growth model and sensitivity (3,563p from 3,384p)

Establishing the long-term return on equity is complicated by the expected level of equity gearing. We believe that leverage will increase over the medium term and so assume a long-term sustained return on equity of 25% (ahead of our 2017 forecast of 13%). We have built in a cost of equity of 10.5%, given S&U's low gearing and long track record. As noted above, we have increased our growth assumption to 5.5%. Given the depressed ROE, we have introduced a 15% discount to reflect near-term performance below our long-term assumption. We have also adjusted our equity for a one-off distribution of £30m, which we have valued at par. These assumptions suggest S&U should trade at 3.9x book value. Our new valuation is £35.63, which has increased due to higher equity post-disposal and capital repatriation and moving forward our valuation to January 2017.

Exhibit 4: Gordon's growth model and sensitivity (p per share)

	Base	+1% ROE	-1% COE	+1% growth
Return on equity (%)	25.0	26.0	25.0	25.0
Cost of equity (%)	10.5	10.5	9.5	10.5
Growth (%)	5.5	5.5	5.5	6.5
Price/book value (x)	3.9	4.1	4.9	4.6
Book value per share, January 2017 (p) excluding one-off distribution	998.3	998.3	998.3	998.3
Implied value pre near-term performance	3,893	4,093	4,867	4,617
Near-term performance discount/premium	-15%	-15%	-15%	-15%
Implied value ongoing business	3,309	3,479	4,137	3,925
One-off distribution	254	254	254	254
Implied total value	3,563	3,733	4,391	4,179
Variance from base		170	827	615

Source: Edison Investment Research

Dividend discount model (1,496p from 1,577p)

We take our explicit dividend forecasts for the years 2016-17. Beyond this, we grew earnings by 5.5% for 10 years and assume a pay-out ratio of 78%. The latter has been reduced (previously 80%) and is the result of retaining sufficient capital to fund growth of 5.5% (previously 5%) while earning an ROE of 25%. We then assume a residual value of 10x this dividend, with all the cash flows discounted at the cost of equity (10.5%). We also assume a one-off distribution equivalent to £30m. This generates a value of 1,496p (previously 1,577p). The reduction is due to lower earnings pending the deployment of the cash proceeds. We note the valuation could be increased further by rolling forward into 2018, when more of the proceeds are deployed, and re-gearing the balance sheet immediately through a larger than expected capital distribution, which introduces some gearing. For valuation purposes we have built in a £30m off-off, but there is significant capacity for a larger figure. If S&U reduced its equity-to-loans ratio to the peer level (average c 27%), it could theoretically repatriate more than £100m).

Financials

The changes to financials are material. At this stage, we have not restated the sold operation as discontinued businesses. We have assumed the deal will complete in early August, which means the division will continue to generate earnings and cash until disposal. In 2016e we forecast the disposed division will contribute revenue of £20.7m, impairments of £4.5m and costs including finance of £12.6m: thus pre-tax profits of £3.6m. While we expect a material capital distribution (and have built a notional £30m into our valuation), the uncertainties over the manner, scale and timing mean we have not built it into our financials estimates.

Some of the key changes to our 2017 forecasts since our last report are:

- elimination of the consumer division's revenues (previously £45m), impairments (£10m) and finance and administration costs (£27m), as well as the balance sheet items (including receivables of £40m net). We have included the reported gain on sale (£47m based on the end-January 2015 NAV), noting that it is still subject to (modest) revisions, up or down, on the final completion of the disposal;
- cash received for disposal of £80m is used to repay all short-term debt. The M&G drawn down facility of £30m (£15m to 2021 and £15m to 2022) will not be repaid. While our forecast is for significant cash balances, they are likely to be used in the special capital distribution and deployment into lending. There will be a carry cost in having gross cash and debt. We have also eliminated the customer accounts (previously assumed to be £15m) as the bank licence application is being deferred until a later date (as yet unspecified). We assume a modest 1% return on cash;

- we had £44m of increased lending in the motor division in January 2017 vs January 2015. We have now accelerated the growth to £63m, primarily reflecting the drawdown on the SME initiative (although as this is unlikely to launch until next year, our 2016 estimate is unchanged). The £63m of balance sheet growth over these two years is consistent with management guidance of an incremental £47m over the next 18 months as it includes lending in the past six months. The margin outlook is uncertain and we continue to forecast a reduction in both 2016 and 2017. Revenue in 2017, which now excludes home collect, is forecast to be £56m (up from £52.4m previously);
- we have added a modest incremental £250k to impairments, noting that SME finance is unlikely to see losses materialise in the first few months post-lending; and
- on costs, we include the £1.95m of central costs previously borne by the home collect business. We have assumed that the marginal investment cost in new business lines will be lower than the costs of pursuing the banking licence at this stage. Total cost of sales and expenses are thus forecast at £22m, an effective reduction of £1m in the underlying estimate (statutory numbers down from £45m to £22m, reflecting the exclusion of the consumer division costs).

Overall, while we have cut estimates, we still expect 2017 profits and EPS to be modestly up on 2015, despite having sold the home collect business.

Changes in estimates

Exhibit 5: Estimate revisions

Year end 31 January	Revenue (£m)			PBT (£m)			EPS (p)			Dividend (p)		
	Old	New	% chg	Old	New	% chg	Old	New	% chg	Old	New	% chg
2016e	86.9	66.2	(24%)	27.0	22.5	(17%)	180	149.9	(17%)	75.0	75.0	0
2017e	97.0	56.0	(42%)	29.9	23.3	(22%)	199.6	155.2	(22%)	85.0	85.0	0

Source: Edison Investment Research

Exhibit 6: Financial summary

£'000s	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016e	2017e
Year end 31 January											
PROFIT & LOSS											
Revenue	42,795	45,978	46,182	45,795	48,016	51,919	54,990	60,823	74,400	66,219	56,000
Cost of Sales (excl. amortisation and depreciation)	(31,848)	(34,624)	(35,537)	(34,906)	(36,660)	(38,654)	(39,664)	(42,241)	(48,943)	(41,058)	(30,538)
EBITDA	10,947	11,354	10,645	10,889	11,356	13,265	15,326	18,582	25,457	25,161	25,462
Depreciation	(478)	(478)	(514)	(452)	(423)	(453)	(515)	(577)	(603)	(653)	(703)
Amortisation	0	0	0	0	0	0	0	0	0	0	0
Op. profit (incl. share-based payouts pre-except.)	10,469	10,876	10,131	10,437	10,933	12,812	14,811	18,005	24,854	24,508	24,759
Exceptionals	0	0	0	0	0	0	0	0	0	0	0
Non-recurring items	0	0	0	0	0	0	0	0	0	47,000	0
Investment revenues / finance expense	(1,539)	(2,298)	(1,868)	(1,434)	(1,074)	(596)	(581)	(727)	(1,680)	(2,000)	(1,509)
Profit before tax (FRS 3)	8,930	8,578	8,263	9,003	9,859	12,216	14,230	17,278	23,174	69,508	23,250
Profit before tax (norm)	8,930	8,578	8,263	9,003	9,859	12,216	14,230	17,278	23,174	22,508	23,250
Tax	(2,691)	(2,613)	(2,388)	(2,522)	(2,816)	(3,281)	(3,350)	(3,955)	(4,714)	(4,558)	(4,650)
Profit after tax (FRS 3)	6,239	5,965	5,875	6,481	7,043	8,935	10,880	13,323	18,460	64,950	18,600
Profit after tax (norm)	6,239	5,965	5,875	6,481	7,043	8,935	10,880	13,323	18,460	17,950	18,600
Minority Interests	0	0	0	0	0	0	0	0	0	0	0
Average Number of Shares Outstanding (m)	11.7	11.7	11.7	11.8	11.8	11.9	11.9	11.9	12.0	12.0	12.0
EPS - normalised fully diluted (p)	53.2	50.8	50.0	55.1	59.5	75.1	91.5	112.0	154.3	149.9	155.2
EPS - FRS3 (p)	53.2	50.8	50.0	55.1	59.5	75.1	91.5	112.0	154.3	547.9	156.6
Dividend per share (p)	32.0	32.0	32.0	34.0	36.0	41.0	46.0	54.0	66.0	75.0	85.0
EBITDA margin (%)	25.6%	24.7%	23.1%	23.8%	23.7%	25.5%	27.9%	30.6%	34.2%	38.0%	45.5%
Operating margin (before GW and except.) (%)	24.5%	23.7%	21.9%	22.8%	22.8%	24.7%	26.9%	29.6%	33.4%	37.0%	44.2%
BALANCE SHEET											
Non-current assets	24,908	27,057	28,505	27,163	27,169	29,435	36,741	52,212	76,781	58,387	70,615
Current assets	50,491	50,939	51,555	53,055	49,831	50,314	51,973	57,739	68,578	117,805	116,891
Total assets	75,399	77,996	80,060	80,218	77,000	79,749	88,714	109,951	145,359	176,192	187,506
Current liabilities	(14,715)	(13,546)	(19,507)	(4,948)	(4,483)	(6,437)	(9,198)	(10,091)	(8,945)	(7,108)	(8,682)
Minority interests	0	0	0	0	0	0	0	0	0	0	0
Net assets	39,904	42,083	43,582	46,620	49,867	54,662	60,866	69,210	81,264	138,434	148,174
CASH FLOW											
Operating cash flow	715	4,596	3,864	8,569	9,347	7,896	3,848	(5,407)	(13,404)	(5,199)	(15,724)
Net cash from investing activities	(504)	(458)	(142)	(104)	(360)	(660)	(718)	(736)	(1,096)	78,904	(1,030)
Net cash from (used in) financing inc change in borrowing	(217)	(4,132)	(3,721)	(7,086)	(10,086)	(7,511)	(3,138)	6,146	15,423	(32,580)	(9,160)
Net cash flow	(6)	6	1	1,379	(1,099)	(275)	(8)	3	923	41,125	(25,914)
Opening net cash	(28,653)	(32,092)	(31,722)	(31,768)	(27,071)	(22,158)	(19,239)	(21,015)	(32,789)	(54,015)	11,610
Closing net cash	(32,092)	(31,722)	(31,768)	(27,071)	(22,158)	(19,239)	(21,015)	(32,789)	(54,015)	11,610	(14,304)

Source: S&U, Edison Investment Research

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