S & U

H117 results

Motor finance drives growth, bridging an option

Financial services

S&U's car finance business, Advantage, continues to make strong progress and has recorded compound annual growth in customer receivables of 34% in the last five years. The business is set to remain the principal growth driver for the group, but S&U has identified secured bridging finance as a potentially attractive area in which to deploy some of its lending capacity and plans to launch a pilot business by the end of 2016. If fruitful, this business would provide both diversification and an additional avenue for growth.

Year end	Revenue (£m)	PBT* (£m)	EPS* (p)	DPS (p)	P/E (x)	Yield (%)
01/15	36.1	14.8	99.0	66.0	25.0	2.7
01/16	45.2	19.5	132.4	76.0	18.7	3.1
01/17e	61.7	25.8	171.0	90.0	14.5	3.6
01/18e	78.5	31.0	206.0	109.8	12.0	4.4

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

H117 results

The first half results were close to our expectations. Motor finance net receivables increased by 42% compared with H116 and 20% from the year end level. Revenues increased 39% from the same period last year. Costs and impairments increased at a faster pace than revenues, reflecting slightly higher payouts to brokers and an experimental increase in risk appetite respectively. Even so, earnings per share increased by 36% to 79.2p. The first interim dividend was raised by 20% to 24p. Investment in loan growth at Advantage has increased gearing from 9% at the year end to 29% (versus 45% H116). The group has raised its borrowing facility by £15m to £85m (H1 debt £38m) providing significant headroom for growth at both Advantage and the bridging finance pilot.

Outlook

With the UK economy proving more stable than feared following the Brexit vote and the labour market in particular remaining resilient, the outlook for Advantage appears promising absent a belated blow to confidence as exit negotiations get underway. The withdrawal of mainstream lenders still leaves room for substantial car finance growth even though competitive activity has increased in recent periods. Advantage has re-trimmed its risk appetite so the modest increase in impairments should stabilise in due course and, even if recent growth rates are not maintained progress should still be healthy. The bridging finance pilot is not expected to have a marked impact on results in the near term but is likely to contribute positively in FY18. Our earnings estimate for FY17 is essentially unchanged while our FY18 forecast is increased slightly (Exhibit 2).

Valuation: Still conservative

S&U's valuation does not appear demanding in the context of a selection of non-standard lenders (see page 5). Updating our ROE/COE calculation gives a central value of 2,650p (2,600p previously).

12 October 2016

Price	**2,475.00p**
Market cap	**£296m**

Net debt end June 2016 (£m)	38.4
Shares in issue	12.0m
Free float	26%
Code	SUS
Primary exchange	LSE
Secondary exchange	N/A

Share price performance

%	1m	3m	12m
Abs	4.1	10.2	(0.7)
Rel (local)	0.4	3.7	(9.3)
52-week high/low		2610.0p	1992.5p

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 40,000 customers currently.

Next events

Q3 update	8 December 2016

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Edison profile page

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Company description: Motor finance and now bridging

Founded in 1938 by the chairman's grandfather, S&U last year sold its long-established home credit business leaving the motor finance business Advantage Finance (Advantage) as its sole activity. A special dividend returned £15m of the £82.4m proceeds to shareholders and management has been engaged in a search to find a new investment opportunity to deploy capital in addition to the continued funding of strong growth at Advantage.

Advantage is based in Grimsby with approximately 100 employees and has achieved 17 years of profitable growth since its formation in 1999. Advantage focuses on the non-prime area of the market with most loans in the £5,000 to £7,000 range. Over the last five years to end July 2016, customer receivables have grown at an annual compound rate of 34% and for FY16 it recorded a pre-tax margin of 43%. Provision of a consistent, efficient service to brokers (85% of lending) and motor dealers, together with continued refinement of a bespoke credit scoring system developed with Experian have been among the key ingredients of Advantage's success.

With the interim figures S&U announced that it is to launch a pilot secured bridging finance business. This is planned to be a measured entry with up to £20m of investment in the first 15 months in loans with a nine-month duration.

H117 results

S&U's H117 results were broadly in line with our expectations. Advantage Finance continues to make good progress and the group has identified a new business area to pilot that appears to offer the potential for attractive returns without incurring undue risk.

The main features of the results were as follows (% changes versus H116 unless stated):

- Net customer receivables increased by 42% from H116 and 20% from the year-end level.
- Revenue increased by 39% to £28.3m.
- The cost of sales rose 72%.
- Impairments increased by 55% with the provision equivalent to 6.2% of average receivables compared with 5.6% for H116.
- Pre-tax profits increased by 35% to £11.9m.
- EPS were up 36%.
- The first interim dividend was raised by 20% to 24p.
- Gearing at the half year end stood at 29% compared with 45% at the same time last year.

Advantage received 370,000 loan applications in the first half of which c 120,000 were provisionally approved. The number of completed **loan transactions** was 10,363 which compares with 15,131 for the whole of FY16 and Advantage's expectation of c 20,000 for the whole of FY17. The company is not concerned by the high dropout rate as the web-based automated quotations Advantage offers via brokers or dealers do not impose significant costs and do provide an insight into trends in the market. The average loan size of £6,017 for the first half was similar to the last two years, while the duration has extended modestly from 47 months in FY14 to 49 months for H117.

While **revenue** growth was strong, it was held back modestly in comparison to H116 by the absence of income from the sale of insurance policies which ended in July 2015. This will no longer be a factor in the revenue comparison for H217 and has the positive effect that loan applications can be processed much more rapidly.

The faster growth seen in **cost of sales** is mainly attributed to the payment of slightly higher commissions to brokers, including leading internet brokers. This in turn reflects the growing importance of these online intermediaries and to some extent an increase in competitor activity in the sector. S&U has indicated that competitive pressures have not affected its pricing although the still strong pre-tax profit margin (41.9% - see Exhibit 1) would have been higher without the increased cost of sales, all else equal.

Exhibit 1: Results for the ongoing business, H115 to H117

£m except where shown	H115	H215	H116	H216	H117
Accounts receivable	**98.1**	**106.4**	**122.4**	**145.1**	**173.9**
Profit and loss					
Revenue	17.0	19.1	20.4	24.8	28.3
Cost of sales	(3.8)	(2.9)	(3.8)	(5.2)	(6.6)
Impairment	(2.4)	(3.5)	(3.2)	(4.4)	(5.0)
Admin expenses	(3.4)	(3.6)	(3.5)	(3.8)	(4.1)
Finance costs	(0.7)	(1.0)	(1.1)	(0.7)	(0.7)
Profit before tax	**6.7**	**8.1**	**8.8**	**10.7**	**11.9**
% of revenue					
Cost of sales	22.4	15.0	18.6	20.9	23.4
Impairment	14.2	18.1	15.7	17.8	17.5
Admin expenses	20.1	19.4	17.2	15.5	14.6
Finance costs	4.1	5.1	5.4	2.7	2.6
Pre-tax profit	**39.1**	**42.5**	**43.0**	**43.1**	**41.9**
% average receivables (annualised)					
Revenue	39.7	37.4	35.7	37.1	35.5
Impairment	5.6	6.7	5.6	6.6	6.2
Revenue less impairment	34.2	30.6	30.0	30.5	29.2

Source: S&U, Edison Investment Research. Note: Periods to end July (H1) and January (H2).

Impairments as a percentage of revenue and average receivables have increased in the last two half-year periods compared with the prior halves reflecting a small experimental shift towards higher risk, higher reward loans. This was also evident in a modest fall in the percentage of the loan book that is up to date in its payments from 92.3% to 89.7%. The changes in risk appetite were made in 2015 but were not seen as adding value so had already been reversed by the beginning of the first half. This is borne out by a chart Advantage has previously presented which shows that its own credit score metric declined during H116 with an increase evident during H216. The average H117 credit score of 854 compared with 871 for FY15.

On **funding**, as noted earlier, the level of gearing at 29% still leaves significant headroom for expansion at Advantage and to fund the bridging pilot (see next section). During the half year net debt increased from £12.4m to £38.4m. The group has subsequently agreed a £15m increase in its borrowing facilities to £85m at a slightly lower interest rate reflecting the change in risk profile following the sale of home credit.

Bridging finance pilot

S&U has been assessing alternatives for a diversifying investment of capital following the home credit sale last year. While it has considered a large number of potential acquisition candidates it has taken the view that these would involve a goodwill payment that would be difficult to justify; it believes an organic start up would have the advantage of greater control. The plan now is to launch a secured bridging pilot in the final quarter of calendar 2016.

While a relatively niche area, the secured property bridging market is still substantial at c £5bn per annum in England and Wales and is fragmented with about 100, generally smaller, players. There is a tendency for lenders to rotate in and out of the market according to market conditions and their own requirements. S&U report a Mintel forecast that the market could grow to £8.8bn by 2020. The Association of Short-term Lenders characterise the market as one where flexibility and speed of response is required on the part of lenders and this is what attracts borrowers who may wish to finance a property or use property as security to provide finance for their business.

Within this market S&U intends to confine itself to the ‘non-regulated’ segment which constitutes over 65% of the market (‘regulated’ loans include those to owner occupiers or consumer landlords). Loans will be for mortgage bridging, to enable completion of auction purchases, business rental and to fund refurbishments ahead of the arrangement of long-term finance. They will have a nine-month duration, will only be provided on a first charge basis and the loan to value ratio will be restricted to a maximum of 75%. Loans will be secured on ‘bricks and mortar’, not on land, agricultural land or a building that is about to be demolished. Geographically, the concentration is likely to be outside London.

Close attention will be paid to exit routes for the borrower and S&U believes its experience in dealing with non-standard borrowers should be helpful in enabling it to assess applicants. S&U will employ a panel of valuers together with an independent firm to vet these valuations to help ensure the quality of the security. A firm of lawyers with strong expertise in this area is to be employed to ensure the integrity of documentation.

S&U reports that the industry experience of losses is very low and with the controls and criteria it is putting in place sees a bigger risk that it may find itself running below its target lending level, which is to have invested £20m over the first 15 months. Loans will be sourced through brokers including five ‘super’ brokers who in turn source loans through other smaller brokers.

We assume no material impact on numbers in the current financial year and a modest positive contribution for FY18. Returns should be attractive as interest rates of over 1% per month (14% per annum) can be earned while remaining within the group’s criteria. Incremental overheads associated with the pilot should be limited as it will be run from Solihull by the team that has been assessing new business opportunities.

Outlook and estimate changes

The economic environment in the UK following the Brexit vote has remained stable and, in its latest update, the IMF nudged up its estimate for calendar 2016 GDP growth marginally to 1.8% while trimming the 2017 forecast slightly to 1.1%. The IMF refers to risks to its outlook, including those from Brexit and the rebalancing of China’s growth, but for S&U and the UK motor finance market the relative stability of the economic outlook currently and absence of any signs of worsening in the employment market are encouraging features. The used car market saw an increase of 8% in transactions in the first half of the calendar year (SMMT data), while the Finance and Leasing Association (FLA) has reported a 13% increase in the value of advances for used cars in the 12 months to end July and a 10% increase in the number of transactions. The FLA figures do also indicate a slowing of the growth rate with July alone showing only a marginal increase from July 2015. However, S&U indicates stable trends and continued strong trading.

Separately, Secure Trust Bank, which owns Advantage competitor, Moneyway, has issued a trading update (7 October). This talks about newer car finance competitors that had been offering low pricing and high broker commissions retrenching with at least one completely withdrawing from the market. This appears to be positive news for the more established players, including Advantage.

We have assumed slightly lower growth for Advantage in H217 with customer receivables increasing by 17% over the period compared with 20% for the first half. Our earnings estimate is essentially unchanged for FY17 and modestly increased for FY18 (see below and the financial summary, Exhibit 5).

Risks to be acknowledged include the potential negative effect on car finance market growth were there to be a significant worsening in the economy and the labour market. This could also impinge on the level of impairments and losses in the event of default. However, Advantage's depth of experience in the market and refined risk management system should be mitigating factors limiting the downside that would accompany such a scenario. For the bridging pilot the short duration of the loan book, once established, together with S&U's cautious approach would likely to be moderating factors in the event of a downturn.

Exhibit 2: Changes to estimates

	Revenue (£m)			PBT (£m)			EPS (p)			DPS (p)		
	Old	new	% change	Old	new	% change	Old	new	% change	Old	new	% change
2017e	58.3	61.7	5.9%	25.7	25.8	0.1%	171.4	171.0	-0.3%	89.6	90.0	0.4%
2018e	71.7	78.5	9.5%	30.4	31.0	1.9%	202.8	206.0	1.6%	109.5	109.8	0.3%

Source: Edison Investment Research

Valuation

Our peer group comparison (Exhibit 3) includes a diverse set of companies but all of them include non-standard lending or motor finance as part of their activities. S&U trades on a P/E multiple that is above the average for this group but is still noticeably below the most highly rated stocks, Provident Financial and Secure Trust Bank. The yield of over 3% is above average while both the return on equity and price to book ratios are below average.

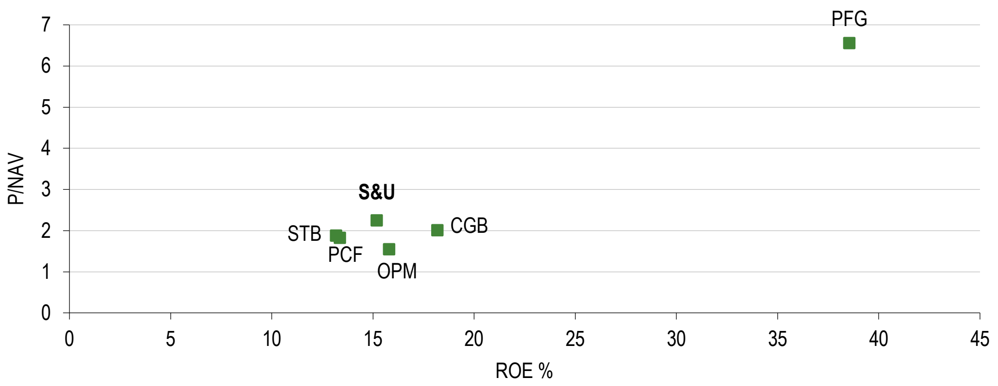
Exhibit 3: Peer comparison

	Price (p)	Market cap (£m)	2016 PER (x)	Yield (%)	ROE (%)	Price to book (x)
S&U	**2,464.0**	**294.4**	**14.7**	**3.1**	**15.2**	**2.2**
1PM	70.0	36.8	10.2	0.7	15.8	1.5
Close Brothers	1,378.0	2,066.6	11.1	3.9	18.2	2.0
Private and Commercial Finance	25.5	40.6	11.3	0.0	13.4	1.8
Provident Financial	3,259.0	4,812.0	19.1	3.7	38.6	6.6
Secure Trust Bank	2,350.0	427.5	16.1	3.1	13.2	1.9
Average			**13.8**	**2.4**	**19.1**	**2.7**

Source: Bloomberg, Edison Investment Research. Note: PER's adjusted to CY16. Priced at 7 October 2016.

Exhibit 4 plots the returns on equity against the book multiples. While we would not draw strong conclusions from such a small sample, S&U does not appear obviously out of line with the other companies. The relative performance of the shares in future is likely to reflect the comparative growth rates and returns each company achieves. As noted earlier, the prospects for further growth at Advantage remain favourable while, if successful, the bridging finance pilot could contribute both diversification and additional growth which would contribute to an improvement in return on equity.

Exhibit 4: 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 6 October 2016.

Updating our ROE/COE calculation (with unchanged assumptions including a return on equity of 17%, cost of equity of 10% and growth of 5%) gives a central value per share of c 2,650p (compared with 2,600p in our last note). Successful deployment of additional capital in the lending activities would benefit returns and we note that adding 1% to our sustainable ROE assumption would push up our central valuation by 230p.

Exhibit 5: Financial summary

£'000s	2014	2015	2016	2017e	2018e
Year end 31 January	IFRS	IFRS	IFRS	IFRS	IFRS
PROFIT & LOSS					
Revenue	60,823	36,102	45,182	61,748	78,521
Impairments	(12,847)	(5,863)	(7,611)	(10,847)	(13,492)
Other cost of sales	(6,866)	(6,674)	(8,980)	(14,343)	(18,452)
Administration expenses	(22,519)	(6,957)	(7,131)	(8,682)	(11,311)
EBITDA	18,591	16,608	21,460	27,876	35,265
Depreciation	(577)	(163)	(209)	(241)	(294)
Op. profit (incl. share-based payouts pre-except.)	18,014	16,445	21,251	27,635	34,971
Exceptionals	0	0	0	0	0
Non-recurring items	0	0	0	0	0
Investment revenues / finance expense	(727)	(1,680)	(1,782)	(1,863)	(3,964)
Profit before tax (FRS 3)	17,287	14,765	19,469	25,773	31,006
Profit before tax (norm)	17,287	14,765	19,469	25,773	31,006
Tax	(3,955)	(2,920)	(3,583)	(5,184)	(6,201)
Discontinued business after tax	0	6,615	53,299	0	0
Profit after tax (FRS 3)	13,332	18,460	69,185	20,589	24,805
Profit after tax (norm)	13,332	11,845	15,886	20,589	24,805
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	171.0	206.0
Dividend per share (p)	54.0	66.0	201.0	90.0	109.8
EBITDA margin (%)	30.6%	46.0%	47.5%	45.1%	44.9%
Operating margin (before GW and except.) (%)	29.6%	45.6%	47.0%	44.8%	44.5%
Return on equity	20.5%	15.7%	15.2%	15.4%	16.9%
BALANCE SHEET					
Non-current assets	52,212	76,781	103,653	146,235	184,874
Current assets	57,739	68,578	61,903	61,829	78,715
Total assets	109,951	145,359	165,556	208,064	263,589
Current liabilities	(10,091)	(8,945)	(6,850)	(8,900)	(9,501)
Non current liabilities inc prefs	(30,650)	(55,150)	(30,650)	(59,650)	(100,650)
Net assets	69,210	81,264	128,056	139,514	153,438
NAV per share (p)	588	689	1,084	1,179	1,297
CASH FLOW					
Operating cash flow	(5,407)	(13,404)	(16,017)	(38,373)	(28,384)
Net cash from investing activities	(736)	(1,096)	80,716	(392)	(580)
Dividends paid	(5,664)	(6,734)	(23,090)	(9,558)	(11,289)
Other financing (excluding change in borrowing)	33	8	55	20	0
Net cash flow	(11,774)	(21,226)	41,664	(48,303)	(40,254)
Opening net (debt)/cash	(21,015)	(32,789)	(54,015)	(12,351)	(60,654)
Closing net (debt)/cash	(32,789)	(54,015)	(12,351)	(60,654)	(100,908)

Source: S&U accounts, Edison Investment Research. Note: Net debt includes £0.45m preference shares. FY16 DPS includes an exceptional payment of 125p.