S&U

Trading update

Strong growth continues

Financial services

S&U's December trading update was reassuring, confirming strong growth in both customer numbers and receivables in the Advantage motor finance business. While impairments relative to revenues have ticked up, this was in line with management expectations. Our estimates are essentially unchanged and the valuation appears conservative given continued growth potential at Advantage and the new opportunity that the bridging finance pilot may provide.

Year end	Revenue (£m)	PBT* (£m)	EPS* (p)	DPS (p)	P/E (x)	Yield (%)
01/15	36.1	14.8	99.0	66.0	21.9	3.0
01/16	45.2	19.5	132.4	76.0	16.4	3.5
01/17e	61.2	25.8	171.0	90.0	12.7	4.1
01/18e	77.9	31.0	206.0	109.8	10.5	5.1

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

Receivables growth of 30% from January

For the period between the end of its first half (31 July) and 7 December, S&U reported that Advantage's motor finance customer numbers were up 34% and transaction numbers 16% above the same period last year. Net receivables of £189m were nearly 9% ahead of the half-year level and 30% ahead of the end-FY16 figure. The rolling 12-month level of impairments did increase over the period, from 17.7% to 18.5% of revenues, but this should be seen in the light of the five-year average of 19.1% and a modest mix change towards loans with a higher-risk, higher-return profile. We have factored the update into our estimates, but this does not result in any material change.

Aspen Bridging Finance approaching launch

S&U continues to work on its Aspen Bridging Finance pilot launch, which is due to take place shortly. Over 15 months, Aspen may invest up to £20m in loans. S&U points to limited supply in the housing market and unmet demand as providing a sound background for development of the bridging finance market. Given that S&U's incremental overheads for the pilot are limited, subject to take up, it should make a small positive contribution in FY18.

Valuation: Cautious given yield/growth

Following a recent period of relatively weak share price performance versus peers, S&U is now rated at below peer average book or earnings multiples. Our central valuation, derived from an ROE/COE model, is unchanged at c 2,650p, suggesting scope for useful upside from the current share price.

15 December 2016

Price	2,169.00p
Market cap	£260m

Net debt (£m) at end July 2016	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	(3.6)	(9.9)	(12.5)
Rel (local)	(6.1)	(12.9)	(24.4)
52-week high/low		2,610.00p	1,992.50p

Business description

S&U's Advantage motor finance business lends on a simple hire purchase basis to lower and middle income groups that may have impaired credit records which restrict their access to mainstream products. It has approaching 42,000 customers currently.

Next events

Year-end update	10 February 2017
FY17 results	28 March 2017

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Trading update

S&U's trading update, covering the period from 1 August to 7 December, was issued on 8 December. Data points from the update were as follows (with percentage changes from the same period last year unless shown):

- Advantage's motor finance customer numbers were up 34% to nearly 42,000. This also compares with "over 40,000" at the end of H117 (July) and 32,600 at the end of FY16 (January).
- Transaction numbers increased by 16% and are on track to reach c 20,000 by the financial year-end compared with 15,100 for FY16.
- Net receivables of £189m were nearly 9% ahead of the half-year level and 30% higher than the level recorded at the end of FY16 (£145m).
- The rolling 12-month level of impairments did increase over the period from 17.7% of revenues to 18.5%, but this should be seen in the light of the five-year average of 19.1% and a modest mix change towards loans with a higher risk, higher return (see further comments below).
- From a regulatory perspective, important news is that Advantage Finance, which has been operating under interim permission from the FCA, has secured its full Consumer Credit permission from the FCA.

S&U has named its planned pilot bridging finance business **Aspen Bridging Finance**, with the launch due shortly. The group has previously indicated that it may invest up to £20m in bridging loans over 15 months. The secured bridging finance market in England and Wales is put at c £5bn per annum, has grown from c £2bn in 2012 and is forecast to grow to nearly £10bn by 2020 (Mintel estimates).The ability of bridging finance providers to offer tailored terms at short notice is a key attraction for many customers, while the relatively niche, fragmented nature of the market means that attractive returns are potentially available to a specialist lender such as S&U with substantial experience of credit control in non-standard areas of the market. Loans are to be secured on 'bricks and mortar' with a maximum loan to value of 75%. Aspen is likely to fine-tune the nature of its offering during the pilot period as it gains experience of the market.

Exhibit 1: Advantage Finance flat interest rate, customer score and impairment %

S&U financial year (end January)	Interest rate flat pa (%)	Average customer score	Impairment % of revenues
FY12	16.5	981	33.0
FY13	16.4	887	25.4
FY14	16.5	901	19.5
FY15	16.8	871	16.3
FY16	17.5	860	16.8
H117	17.9	854	17.5

Source: S&U. Note: Customer score is S&U's own bespoke credit measure.

Exhibit 1 puts the increase in **impairments** highlighted above into a longer-term context. As can be seen, there has been an upward trend in the average flat interest rate charged to customers, reflecting adjustment of the risk/reward balance as Advantage has used its bespoke credit scoring system to respond to competitive dynamics, seeking to achieve a risk profile that provided the best risk-adjusted return. Over the period shown, the average customer credit score has declined, but so has the level of impairments against the background of an improving economy and employment market. The downtrend in impairments partly reversed in H117 and this has continued, as reported in the trading update, reflecting a small experimental increase in risk (and interest rate) undertaken during FY16 and the earlier part of FY17. While the relatively modest increase in impairments is likely to be maintained in the near term, the company notes that the average customer score on more recent new business has increased, suggesting there should be a stabilisation and in due course potential improvement in this ratio.

Financials

As noted earlier, our estimates are little changed from those published in our last note in October, with only a marginal reduction in revenues for both years (see Exhibit 2).

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	61.7	61.2	(0.8)	25.8	25.8	0.0	171.0	171.0	0.0	90.0	90.0	0.0
2018e	78.5	77.9	(0.8)	31.0	31.0	0.0	206.0	206.0	0.0	109.8	109.8	0.0

Source: Edison Investment Research

On funding S&U has, as previously announced, agreed a £15m increase in bank facilities taking the total to £85m, which the company expects to be sufficient to fund growth at Advantage Finance over the next year and to launch Aspen Bridging Finance. At the half year end net debt stood at £38.4m and net debt to equity, 29%. We estimate this will have risen to c 37% by the year end.

Valuation

Our usual peer group comparison (Exhibit 3) includes companies that have non-standard lending or motor finance as part of their activities. S&U now trades on a P/E multiple that is below the group average and is still noticeably below the most highly rated stocks, Provident Financial and Private and Commercial Finance. The yield of over 3% is above average while the return on equity is mid-range but below the average; the price to book ratio is slightly below average.

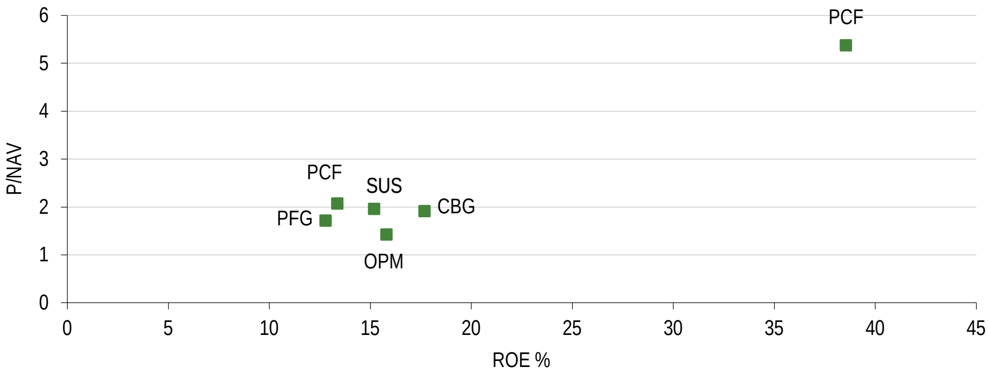
Exhibit 3: Peer comparison

	Price (p)	Market cap (£m)	2016 P/E (x)	Yield (%)	ROE (%)	Price to book (x)
S&U	2,147.5	256.9	12.8	3.5	15.2	2.0
1PM	64.5	35.1	9.7	0.8	15.8	1.4
Close Brothers	1,392.0	2,089.5	11.2	4.1	17.7	1.9
Private and Commercial Finance	29.0	49.3	18.1	0.0	13.4	2.1
Provident Financial	2,671.0	3,943.8	15.4	4.5	38.6	5.4
Secure Trust Bank	230.1	397.2	15.2	3.3	12.8	1.7
Average			13.7	2.7	18.9	2.4

Source: Bloomberg, Edison Investment Research. Note: P/Es adjusted to CY16. Priced at 13 December 2016.

Exhibit 4 plots returns on equity against book multiples. The small sample means that we should not draw a strong conclusion, but S&U appears broadly in line with these peers. Future relative performance is likely to reflect the comparative growth rates and returns each company achieves. Absent an unexpected turn for the worse in terms of economic background (which would also affect the peers), the prospects for Advantage remain positive, while the Aspen Bridging Finance pilot may open up a new avenue for diversifying growth.

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 13 December 2016.

Our ROE/COE calculation (with unchanged assumptions including a return on equity of 17%, cost of equity of 10% and growth of 5%) gives an unchanged central value per share of c 2,650p. On a medium-term view, successful deployment of additional capital in the lending activities would benefit returns, potentially justifying a higher assumption for the return on equity.

Finally, for reference, we have collated the recent performance of the peer group share prices in Exhibit 5. In terms of its performance since its 12-month high, S&U has been modestly weaker than the group average while over the shorter-term, one or three-month periods, it has lagged more noticeably, perhaps suggesting scope for period of relatively stronger performance following a reassuring trading update.

Exhibit 5: Share price performance comparison

	One month	Three months	One year	Ytd	From 12-month high
S&U	-5.1	-10.3	-10.2	-13.2	-18.4
1PM	-2.3	-11.3	-1.6	-11.3	-14.4
Close Brothers	6.5	0.3	4.1	4.7	-5.2
Private and Commercial Finance	0.9	-0.9	29.2	19.8	-17.9
Provident Financial	-4.4	-10.3	-22.0	-19.0	-23.8
Secure Trust Bank	3.6	-3.0	-31.2	-29.9	-32.7
Average (unweighted)	-0.4	-5.4	-3.0	-7.7	-17.3

Source: Bloomberg. Note: As at 13 December 2016.

Exhibit 6: Financial summary

£'000s	2014	2015	2016	2017e	2018e
Year end 31 January					
PROFIT & LOSS					
Revenue	60,823	36,102	45,182	61,232	77,924
Impairments	(12,847)	(5,863)	(7,611)	(11,349)	(14,224)
Other cost of sales	(6,866)	(6,674)	(8,980)	(13,387)	(17,115)
Administration expenses	(22,519)	(6,957)	(7,131)	(8,620)	(11,260)
EBITDA	18,591	16,608	21,460	27,876	35,325
Depreciation	(577)	(163)	(209)	(241)	(294)
Op. profit (incl. share-based payouts pre-except.)	18,014	16,445	21,251	27,635	35,030
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)	(4,024)
Profit before tax (FRS 3)	17,287	14,765	19,469	25,772	31,006
Profit before tax (norm)	17,287	14,765	19,469	25,772	31,006
Tax	(3,955)	(2,920)	(3,583)	(5,184)	(6,201)
Discontinued business after tax		6,615	53,299		
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%	45.5%	45.3%
Operating margin (before GW and except.) (%)	29.6%	45.6%	47.0%	45.1%	45.0%
Return on equity	20.5%	15.7%	15.2%	15.4%	16.9%
BALANCE SHEET					
Non-current assets	52,212	76,781	103,653	140,714	187,466
Current assets	57,739	68,578	61,903	67,310	81,138
Total assets	109,951	145,359	165,556	208,024	268,604
Current liabilities	(10,091)	(8,945)	(6,850)	(8,860)	(9,516)
Non-current liabilities inc prefs	(30,650)	(55,150)	(30,650)	(59,650)	(105,650)
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)	(30,586)	(39,829)
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	(40,517)	(51,699)
Opening net (debt)/cash	(21,015)	(32,789)	(54,015)	(12,351)	(52,868)
Closing net (debt)/cash	(32,789)	(54,015)	(12,351)	(52,868)	(104,567)

Source: S&U accounts, Edison Investment Research. Note: Net debt includes £0.45m preference shares. FY16 DPS includes an exceptional payment of 125p. FY14 P&L figures include the discontinued home credit business and are therefore not comparable with subsequent years.

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