PROGRESSIVE EQUITY RESEARCH

22 April 2013

Financial Comment

General Financials

GROWTH

Large lenders under pressure

Mainstream banks have been berated for not lending enough but must juggle that demand with higher capital requirements and fluctuating funding costs. Bank of Ireland's move to raise the differential over base rates for its UK mortgage borrowers was met with incredulity but is symptomatic of that tricky balancing act. The Bank of England's recent news release on capital requirements may have been in the middle of expectations but it emphasised the pressure on banks to hold more capital. In this note, we look at some of the recent data on lending and funding.

Nimble players take advantage

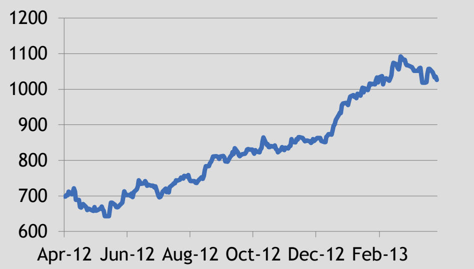
Outside the mainstream lenders, we highlight four businesses (two with banking licences) that continue to achieve growth in their loan books while maintaining control of credit quality, funding and capital. They have dealt with the challenges of the financial crisis and retain an edge over many of their larger rivals.

- **Close Brothers (CBG.L)** has managed its capital ratios (which remain robust), made its funding more efficient and has achieved strong growth in the loan book of its Banking division. That growth may moderate if price competition returns to its markets but a contra-cyclical approach to lending has proved successful.
- **Paragon Group (PAG.L**) suffered when securitisation markets closed at the start of the financial crisis. Now, it has expanded its funding resources, returned to buy-to-let lending, has acquired loan portfolios and has a thriving third party loan servicing business.
- **Provident Financial (PFG.L)** has diversified its funding sources, lengthened the maturity of banking facilities while expanding lending in its credit card business. The group is funded into 2015 and generates enough capital to remain above regulatory requirements while pursuing growth.
- **S&U (SUS.L)** has generated cash from its Home Credit business while funding growth in its Motor Finance loan book. Accelerated growth in the latter will continue and group borrowing is likely to rise as the group expands lending to an evolving customer base.

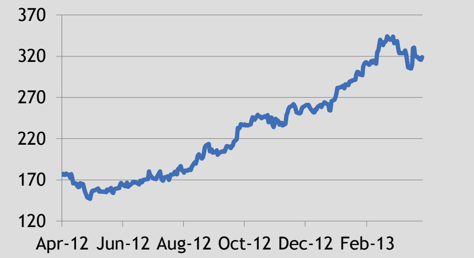
COMPANY	YEAR END	PRICE (p)	EPS (p)	PER (x)	DPS (p)	YIELD (%)
Close Brothers	Jul-13	1024	83.6	12.2	44.5	4.3
Paragon Group	Sep-13	319	25.8	12.4	7.0	2.2
Provident Financial	Dec-13	1563	111.8	14.0	84.9	5.4
S&U	Jan-14	1160	100.8	11.5	50.0	4.3

Source: Consensus, FT.com

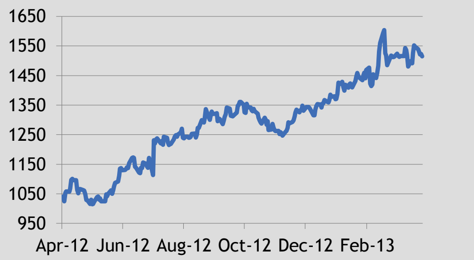
CLOSE BROTHERS



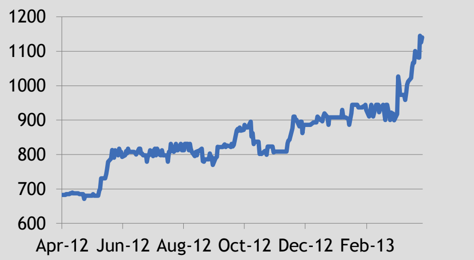
PARAGON GROUP



PROVIDENT FINANCIAL



S&U



Share price data source: LSE data

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THE BALANCING ACT

The need to encourage lending

To borrow or not to borrow

The balance between lending and funding has been a crucial influence on the availability of new money from the banks for retail and corporate customers since the financial crisis took hold. On the other side of the equation, demand for new lending has varied as borrowers have made decisions on whether to gear up further or to reduce debt.

We have heard a great deal about the lack of lending by the mainstream UK banks recently. Politicians want the banks to lend more and suggest that SMEs want to borrow more but can't persuade their banks to lend to them. Undoubtedly, there are businesses that have genuine grievances in that regard. However, with the demands by regulators for the banks to hold more capital against their loans, there is less scope to increase lending while trying to grow the proportion of capital held on the banks' balance sheets. That point is not helped by the Bank of England's comment that the UK banks are short of up to £50 billion of capital.

The Bank of England's concerns

The Bank of England (BOE) has noted that market concerns are likely to reflect uncertainty about the levels of bank capital adequacy. In particular, the BOE has highlighted the underrecognition of expected future losses on loans. It said that expected losses on loans are in some cases greater than current provisions and regulatory capital deductions for UK banks' expected losses. On top of that, UK banks have also underestimated the costs for conduct redress - for instance, for payment protection insurance mis-selling. Alongside these and other conduct issues, the BOE suggested that the UK banks' capital positions could also be overstated because of aggressive application of risk weights. This simply adds to the pressure on new lending.

With mixed prospects for profitability, some UK banks are unlikely to build capital buffers through retaining earnings. They could raise external capital, but there was not much sign of that in 2012. The Governor of the Bank of England, Sir Mervyn King, said that he did not necessarily expect banks to raise new equity and that any capital shortfall would probably be met through other means – one example being contingent convertible debt such as Barclays' U$3 billion coco issue. They could also dispose of assets and we have seen banks do just that in order to reduce risk and capital requirements.

Financial Stability

In its November 2012 Financial Stability Report, the Bank of England's Financial Policy Committee (FPC) made a recommendation that the FSA took action to ensure that the capital of UK banks and building societies *"reflects a proper valuation of their assets, a realistic assessment of future conduct costs and prudent calculation of risk weights"*. If the FSA decides that capital buffers need to be strengthened to absorb losses and sustain credit availability in the event of stress, it should ensure that firms either raise capital or take steps to restructure their business and balance sheets in ways that do not hinder lending to the real economy.

That last point is important because it highlights the problem that the banks have in balancing the requirement to improve capital ratios and to increase lending. Part of the consideration is credit quality. If the banks lend to poor risks and start to incur larger loan losses, will anyone thank them for increasing lending? Higher loan impairment charges will mean lower retained earnings to boost capital, which would in turn mean less capital available to back future lending.

The BOE comments on work by the FSA

On 27 March 2013, the Bank of England made public its discussions on the work by the Financial Services Authority (FSA) in response to its November 2012 recommendations.

It noted that the FSA had advised that expected losses on specific high-risk loan portfolios which might arise over a three year period could exceed existing provisions by around £30 billion and that identified future conduct costs arising over a three year period could exceed provisions by around £10 billion. It also said that a more prudent approach to risk weights in the banking book would raise risk-weighted assets by some £170 billion which was 'equivalent to roughly £12 billion of capital at a 7% equity capital ratio'. In combination, that equated to around a £50 billion reduction in the regulatory capital of the major UK banks and building societies.

An immediate objective of a 7% capital ratio

In response, the FPC has said that the immediate objective should be to achieve a common equity tier 1 capital ratio of at least 7% of risk-weighted assets by end 2013. That implies an aggregate capital shortfall at the end of 2012 of around £25 billion. Going forward, further increases in capital ratios will be required. The banks will have to transition to full Basel III compliance and meet the surcharge on systemically important banks. They will also need to meet the recommendations of the Independent Commission on Banking.

Minutes of the last FPC meeting

Subsequently (on 5 April 2013), the FPC released the minutes of its meeting held on 19 March 2013. It made six policy recommendations for action by the new Prudential Regulation Authority (PRA) which reflected its previous comments on capital ratios. They included the 7% objective and the need to ensure that major UK banks and building societies have *'credible plans to transition to meet the significantly higher targets for capital and the leverage ratio that will come into effect in 2019 after full implementation of Basel III'*. It also said that the PRA should consider applying higher capital requirements to any major UK bank or building society with *'concentrated exposures to vulnerable assets, where there are uncertainties about assets not covered in the FSA's assessment of future expected losses or risk weights analysis, or where banks are highly leveraged relating to trading activities'.*

In short, capital pressure on banks will remain in place for some years.

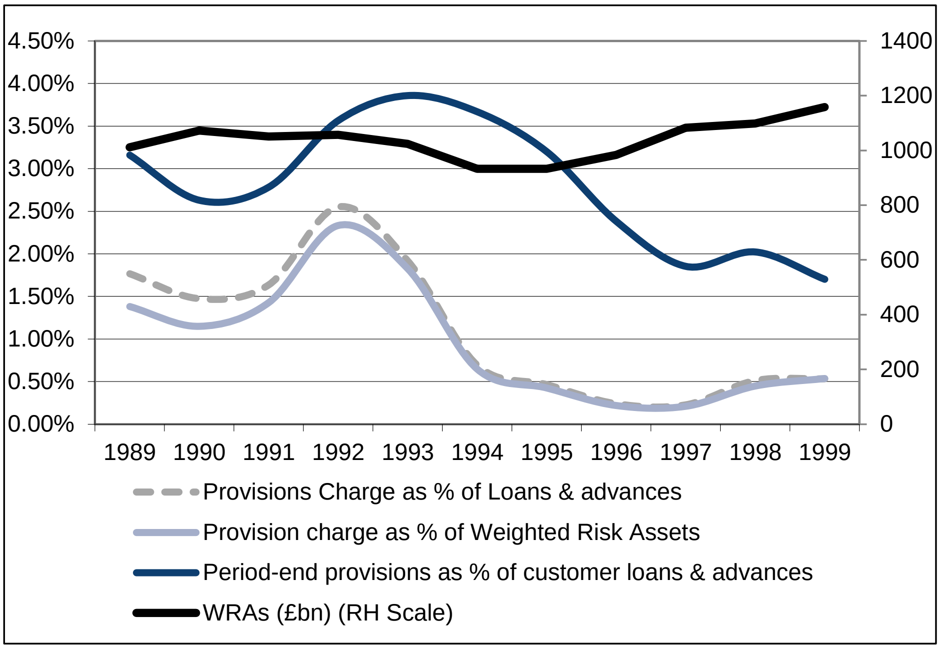
History lessons

This is reminiscent of the years after the 1990-92 recession. At that time, the banks were wary of lending and tightened risk criteria. Equally, many borrowers took the view that it was not the right time to borrow more and many actively repaid existing debt. As we note above, that is also happening now.

It's worth revisiting the experience of the banks in the aftermath of the 1990-92 recession. Barclays' experience shows how its provisions charges increased towards the end of the actual period of recession and then improved. The weighted risk assets (WRAs) declined until 1994 before levelling off and then increasing. WRAs passed the 1992 level again in 1997. Customer loans and advances followed a similar trend over the period.

The current financial crisis has limited lending and the BOE has taken various actions to support and encourage new lending. One of the most recent examples is the Funding for Lending Scheme.

Barclays' provisioning (%) and WRA (£bn) evolution in the 1990s



Source: Barclays

The Funding for Lending Scheme

The Bank of England's (BOE) Funding for Lending Scheme (FLS), launched in July 2012, was set up to encourage more lending to the UK economy than would have been the case in the absence of the scheme. At the time it was set up, the BOE judged that UK bank lending was more likely to decline than increase over the subsequent 18 months. Essentially, that view reflected the points we touch on elsewhere in this document as the banks adjust their business models. The intention was that the level of bank lending to households and companies would reduce less than would otherwise have been the case.

The FLS incentivises banks to boost their lending by reducing bank funding costs. However, the BOE noted that it would take time for the benefit to show up in lending volumes because of the lead time from application to drawdown. In its 2012 results review, Barclays noted that its loans and advances to UK customers and clients grew £7 billion, including an estimated £4.4 billion under the FLS where the group had committed to pass all associated funding cost benefits to its customers.

The BOE has noted that measures of UK banks' longer-term funding spreads have fallen, on average, by more than European bank funding spreads have. That probably reflects UK-specific factors, including the availability of cheaper funding through the FLS, which has reduced banks' need to issue debt in public markets. Additionally, changes in Financial Services Authority (FSA) liquidity guidance may have been associated with some UK banks using existing funding to pay down debt rather than financing liquid assets.

Credit Conditions

As part of its monitoring of monetary and financial stability, the Bank of England conducts quarterly surveys of credit conditions. Lenders are asked about trends and developments in the past three months and the coming three months. It covers secured and unsecured lending to households and corporate lending (including SMEs).

The Q1 2013 survey - supply

The BOE's Q1 2013 Credit Conditions Survey noted that the availability of secured credit to households was reported to have increased in the three months to the beginning of March 2013. A further increase is expected by lenders over the next three months. Unsecured credit to households also rose in Q1 and is expected to rise again in Q2. Lending to the corporate sector was reported to have increased in Q1. However, within that, small and medium-sized companies (SMEs) were reported to have experienced little change in credit availability. Lenders expected overall credit availability to the corporate sector to be little changed in Q2 2013.

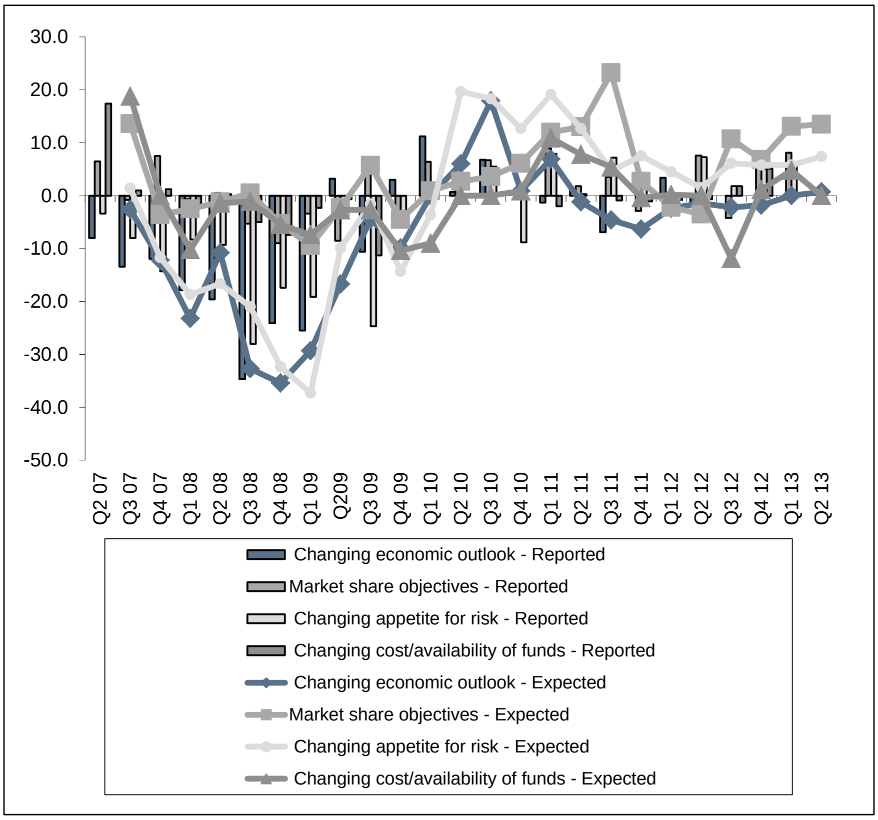
The Q1 2013 survey - demand

Demand for secured lending for house purchase was reported to have risen slightly in Q1 2013. Interestingly, lenders expected a significant increase in Q2, spread across demand for prime lending and buy-to-let lending. Demand for total unsecured lending was reported to be little changed in Q1 2013, but was expected to rise in Q2 2013. Perhaps surprisingly, given the political pressure to lend, lenders reported a significant decrease in demand for credit from small companies in Q1 and a slight reduction in credit demand from medium-sized companies. There was little change in demand from large companies. Overall credit demand from corporates was expected to increase in Q2 – particularly from small and large companies.

The four lending businesses that we feature in this document are predominantly involved in in lending to individuals – although Close Brothers also has quite a substantial SME lending business and its lending book is predominantly secured. The two charts below show the factors affecting unsecured lending.

This chart shows the generally more favourable outlook for the availability of unsecured credit.

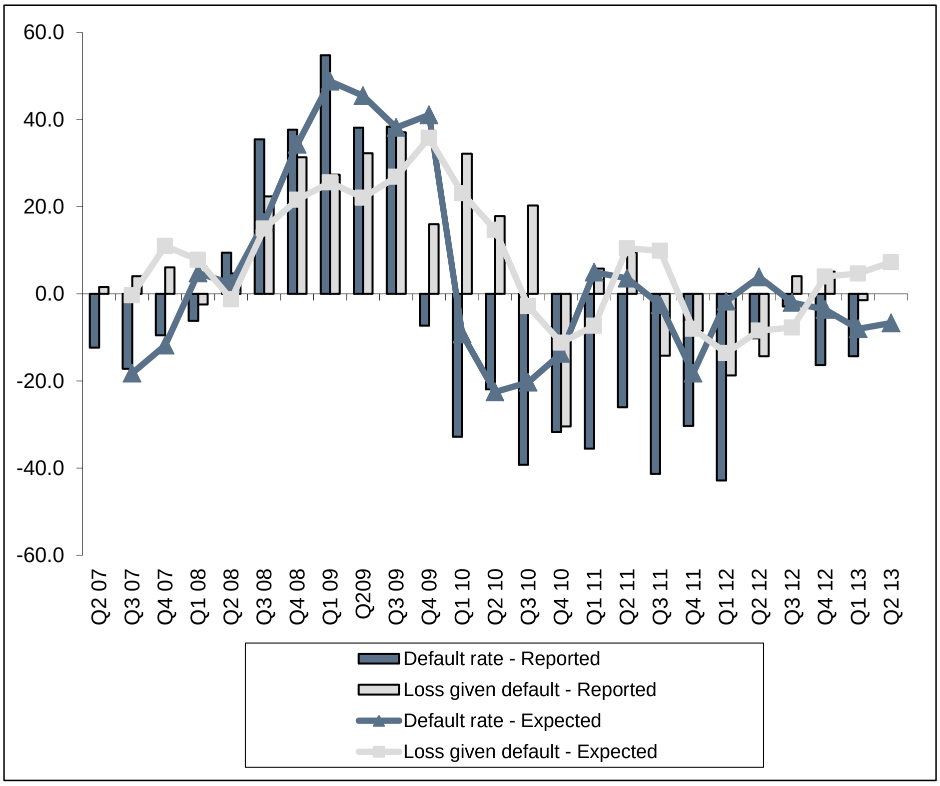
How are the factors affecting the availability of unsecured credit changing?



Source: Bank of England

The second chart shows that default rates on total unsecured loans fell in 2013 Q1, with a further slight fall expected in Q2. Losses given default on total unsecured loans were little changed in Q1, with a slight increase expected in Q2.

How are default rates and losses evolving for unsecured lending?



Source: Bank of England

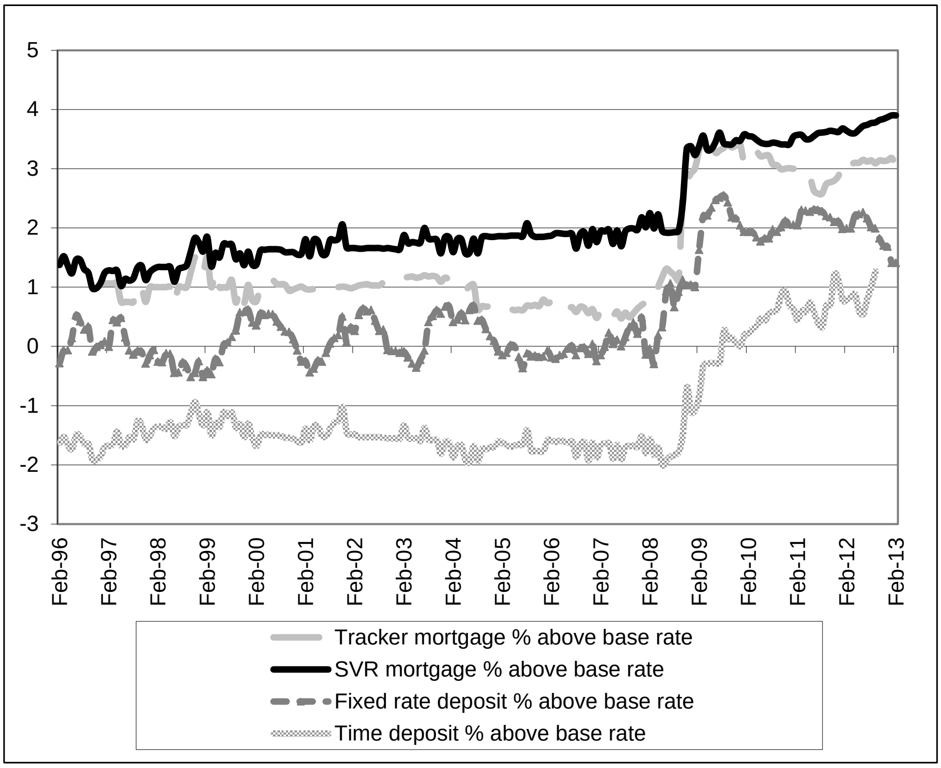
When interpreting the Credit Conditions Survey and the two charts above, *"positive balances indicate that lenders, on balance, reported/expected demand/credit availability/defaults to be higher than over the previous/current three-month period, or that the terms and conditions on which credit was provided became cheaper or looser respectively".*

What about funding?

One point of particular interest in the survey relates to the issue of funding that we cover elsewhere in this note. Lenders reported that overall spreads on secured lending rates to households had tightened significantly again in the period covered in the Q1 2013 survey. Lenders cited the pass-through of cheaper funding costs and increased competition among lenders among the reasons for this tightening. Importantly, the Funding for Lending Scheme was mentioned by many lenders as a factor behind reduced bank funding costs and, in turn, lending rates. Lenders expected a further significant tightening in spreads over the next three months.

The chart below shows that the differential earned above the BOE base rate on fixed rate deposits has reduced in recent months. Conversely, secured lending costs have increased for borrowers, in line with the direction of Bank of Ireland's mortgage rates for certain customers.

Lending and deposit rate differentials versus BOE base rates (%)



Source: Bank of England

The impact of regulation on lending decisions

Bank of Ireland raises interest rates…

We recently saw the news that the Bank of Ireland is to raise its mortgage rate for residential customers from 1 May. It is set to increase its supplement to the base rate from 1.75% to 2.49% on 1 May 2013 and then to 3.99% from 1 October 2013. For buy-to-let customers, a single increase to 4.49% appears likely to apply from the first date.

…and blames capital requirements

Bank of Ireland has blamed European capital requirements for the decision and said it was triggering a special condition clause in loan agreements which allowed it to increase the differential in the event of a serious adverse change in market conditions. Aside from obvious interest in the contract terms, one immediately wonders what effect the likely substantial increase in repayments will have on credit quality of Bank of Ireland's loan portfolio.

The Treasury Committee asks questions…

Bank of Ireland's decision prompted a letter from Andrew Tyrie MP, the Chairman of the Treasury Committee to the Financial Services Authority managing director Martin Wheatley. He asked "what action the conduct arm of the FSA will be taking in response to the action by the Bank of Ireland".

In addition, he sent a list of questions to Mr Wheatley, including:

- Will you treat this as a prima facie case of product mis-selling?
- Will you be investigating whether the mortgage agreements concerned contained unfair clauses?

- What discussions have you had with the Financial Ombudsman Service (FOS) about the Bank of Ireland decision?
- What contacts and discussions have you had with the Bank of Ireland about this decision, and at what level of seniority?

...but it doesn't like the answers…

The reply from the FSA noted that the mortgages in question fell outside its rules due to age or type (buy-to-let isn't regulated by the FSA as yet). It also said that a firm's conduct was of 'some relevance to FSA regulation' and that it had been involved in discussions with Bank of Ireland prior to its decision to increase the differential. The FSA does not plan to treat it as a prima facie case of mis-selling nor had it discussed the matter with the FOS.

…and asks some more

The FSA's response has provoked further questions from the committee in a letter which notes that the FSA's initial response 'does not address the main issues'. The Treasury Committee asks for more detail on a number of fronts. In particular, it wants to know how the requirements and briefs of the Financial Conduct Authority and the Prudential Regulatory Authority (the two bodies into which the FSA has been split) affected the issue. The dialogue continues but it reflects the ongoing changes in regulation of financial services businesses.

Barclays' recent capital ratios

An example of the large movements which affect capital ratios for the mainstream banks can be seen in Barclays' FY 2012 results. Barclays reported that its Core Tier 1 ratio decreased to 10.9% reflecting a reduction in Core Tier 1 capital of £0.9 billion which was partially offset by a reduction in risk weighted assets.

The payment of dividends and the provisions for PPI and interest rate hedging product redress limited retained earnings to £1.8 billion. That was more than offset by a £1.2 billion increase in the adjustment for defined benefit pensions and £1.6 billion of foreign currency movements. The impact of the latter movement on capital ratios was offset by similar movements in risk weighted assets.

Away from the mainstream banks, other lenders also need to balance their own funding requirements against customer demand. Those who have banking licences need to address regulatory capital requirements just as the mainstream banks do.

So, how have some of the non-mainstream lenders fared? Below, we look at a selection of lending businesses which have reported results or provided trading updates recently. The key points are funding, growth prospects and, where relevant, capital adequacy.

Lenders who have successfully managed to fund and grow lending

Below, we highlight four lending businesses that have successfully coped with the financial crisis and have grown at least part of their loan books while controlling credit quality. This table summarises some of the salient points.

Companies by bullet points

Company	Business	Performance	Credit quality	Notes
Close Brothers	Banking	Strong contra-cyclical performance. Loan book growth of 20% p.a. for three years followed by more moderate growth in last six months.	Bad debts improved in the Property and Commercial businesses and remain at historically low levels in the Retail book.	Group senior management changes in 2008 (FD) & 2009 (CEO)
Paragon	Buy-to-let lending	Management of tight/closed funding markets and subsequent re-opening of funding markets Provides expert market commentary	A more normal charge within the First Mortgages division was more than offset by a reduction in the impairment charge in the Consumer Finance division. Overall, at the group level, the charge was steady at 0.28%.	Heavily discounted rights issue 2008
	Portfolio management and acquisition	Rationale for growth of business established. Successful acquisitions made.		
Provident Financial	Consumer Credit	Control of credit quality Funding requirements addressed Impact of changing regulation addressed	Annualised impairment to revenue was 33.0% at December 2012 - up from 32.1% at the end of December 2011.	Consistent strategy implemented by experienced management team
	Credit cards	Rationale for strong risk adjusted growth Successful deposit taking	Impairment as a percentage of revenues fell again in 2012 and the risk-adjusted margin of 34.8% was similar to that of the prior year.	
S&U	Consumer Credit	Control of credit quality Funding requirements addressed	The impairment charge increased by £0.7 million producing a tick-up in the impairment rate as a percentage of revenues.	Consistent strategy implemented by experienced management team
	Motor Finance	Rationale for strong risk adjusted growth	Advantage produced a lower impairment charge in the financial year to the end of January 2013 despite growing the loan book further during the year.	

Source: Progressive Equity Research

Close Brothers

Year end	Share price (p)	Market Cap. (£m)	EPS (p)	PER (x)	DPS (p)	Yield (%)	1 Yr share price performance
Jul-13E	1024	149	83.6	12.2	44.5	4.3	37%

Source: Consensus FT.com

Recent results saw Banking produce another strong performance

On 12 March 2013, Close Brothers reported interim results to the end of January 2013. It has three businesses: Banking, Securities and Asset Management. In the Securities business Winterflood remained profitable despite difficult market conditions. The Asset Management business has been through a period of investment and transformation and is moving back towards profitability. Banking has been the stand-out contributor to profits recently.

A bigger, better business

Close's Banking business produced a 26% increase in adjusted operating profit in the half year. It saw loan book growth of 6% and an improved bad debt ratio of 1.2%. In recent years, the contra-cyclical nature of the business has produced annual growth in the loan book of around 20% per annum. Its focus on strong returns and credit quality means that any increase in competition via pricing is likely to see more moderated growth in Close's loan book. The business is bigger than it was four years ago after significant investment in infrastructure and headcount. Consequently, we wouldn't expect to see the loan book reduce in size even if competitive pricing was more prevalent elsewhere in the market.

The Banking division focuses on sustainable growth within a specialist lending model. The quality of the loan book has improved further over the first six months of its current financial year. The loan book remains small ticket, mainly secured, with an average maturity of 13 months.

Funding

Like other successful lenders in a difficult economic environment, Close has developed and diversified its funding base over the last five years. It was already prudent but under the current management it has become more efficient as well. The funding base includes deposits by customers, drawn and undrawn banking facilities, a group bond and its equity base.

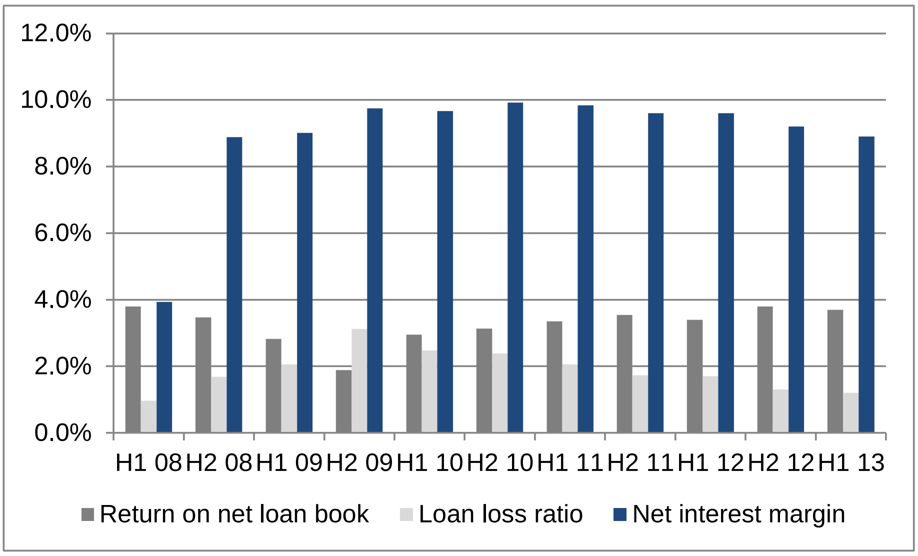
Capital

Close Brothers has strong funding, liquidity and capital. At the end of January 2013, the group's core tier 1 capital ratio of 12.7% was little changed on a year earlier after strong profitability and continued loan book growth. The group does not expect its core tier 1 capital ratio to be materially affected by Basel III. Management had previously flagged a reduction in the capital ratio while the loan book exhibited such strong growth (20% per annum over the last three years versus an average long term rate of 11%). If that growth is to moderate, we would expect the capital ratio to stabilise then increase – particularly if the Securities and Asset management businesses see an improvement in profitability. At that time, the group would be able to consider what options it had for any surplus capital.

Credit quality

The credit quality in the Banking book improved further in the half year to the end of January 2013. The bad debt ratio of 1.2% reduced from 1.7% in the comparable period of the previous year. Bad debts improved in the Property and Commercial businesses and remained at historically low levels in the Retail book. The return on the net loan book improved to 3.7% compared to 3.4% in H1 2012 and a ten year average of 3.6%.

Close Brothers Banking business metrics (%)



Source: Close Brothers

Paragon Group

Year end	Share price (p)	Market Cap. (£m)	EPS (p)	PER (x)	DPS (p)	Yield (%)	1 Yr share price performance
Sep-13E	319	953	25.8	12.4	7.0	2.2	75%

Source: Consensus FT.com

Successful return to funding and lending

Paragon is a buy-to-let mortgage lender and a specialist loan servicer for third parties. After securitisation markets effectively closed at the beginning of the credit crunch, the group had a deeply discounted rights issue and essentially stopped new mortgage lending. With funding markets open again, Paragon has demonstrated that it can again access warehouse funding and the securitised funding markets and it has established a strong asset purchase franchise. Its businesses are again providing strong cash generation.

In addition to its more traditional funding routes, Paragon has issued 6% retail bonds and, in December 2012, it announced that it was considering the acquisition of Hampshire Trust, a wholly owned bank subsidiary of National Counties Building Society. Those discussions terminated in January 2013 but Paragon said that it will continue to explore other avenues for the development of its business, including the establishment of a banking subsidiary in the Group. That would increase the regulatory capital requirements of the group but, in our view, Paragon is well-placed on that front.

A lack of competition

Interestingly, the redemption rate on Paragon's buy-to-let back book remained low at 2.2% in its last financial year with alternative offerings from other lenders remaining unattractive as a result of generally higher funding and capital costs – Bank of Ireland being a prime example.

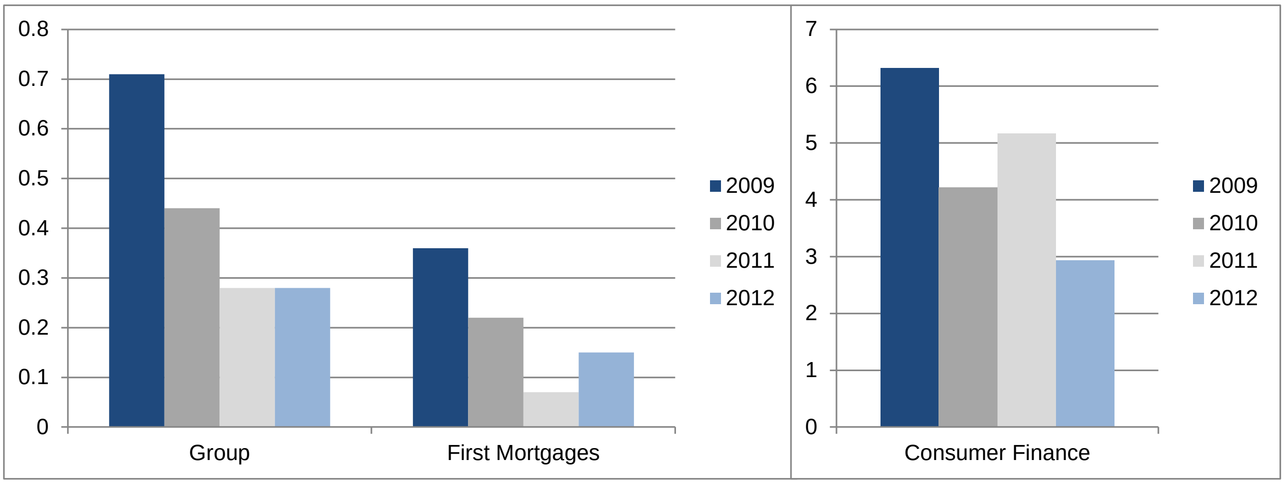
Capacity for further growth

With the developments of its funding capacity - including the completion of two public securitisation transactions - Paragon is well enough funded to support further growth in its buy-to-let business. Its strong cash generation means that it can continue to pursue further portfolio acquisitions and servicing deals. The latter opportunities, in particular, are a result of the continued de-leveraging of banks and other financial institutions.

Credit quality

Paragon's charge for impairment provisions in the last financial year was £24.1 million compared to £24.4 million in 2011. As the chart below shows, a more normal charge within the First Mortgages division was more than offset by a reduction in the impairment charge in the Consumer Finance division. Overall, at the group level, the charge was steady at 0.28%.

Paragon Group credit quality: impairment charge as % of total loan assets



Source: Paragon Group

The low interest rate environment has continued to act favourably on affordability for customers and that has reduced the incidence of new arrears. The percentage of loans three months or more in arrears was 0.48% as at 30 September 2012 compared to 0.63% a year earlier – Paragon's numbers continue to compare favourably with the respective market averages of 1.51% and 1.90%.

Provident Financial

Year end	Share price (p)	Market Cap. (£m)	EPS (p)	PER (x)	DPS (p)	Yield (%)	1 Yr share price performance
Dec-13E	1563	2100	111.8	14.0	84.9	5.4	36%

Source: Consensus FT.com

Credit cards experiencing strong growth

Provident Financial operates two main businesses. Its Consumer Credit Division (CCD) offers Home Credit loans through a network of local agents. Vanquis Bank is a credit card and savings business. CCD has produced stable performances over the last few years in the face of cautious customer and agent behaviour and is currently experiencing moderating demand for credit. In contrast, Vanquis Bank is experiencing strong growth as it services an underserved UK non-standard credit card market. Crucially, both businesses are exhibiting excellent control of credit quality.

Exemplary development of funding capacity

Provident Financial has significantly developed its funding profile over recent years. Both its funding and liquidity positions are strong with gearing of 3.2 times – below its 3.5 times internal limit and banking covenant of 5.0 times. Among its funding sources, Provident Financial's core syndicated bank facility of £382.5m runs to May 2015, it continues to access the retail bond market and Vanquis Bank's deposit-taking programme has been a resounding success. Headroom on the group's committed facilities amounted to £192m at the end of 2012. Including the additional capacity available for Vanquis Bank to take retail deposits, total funding capacity amounted to £394m. Overall, the group has sufficient resources to fund contractual maturities and projected growth in the business until May 2015.

Funding costs to reduce

Given the greater proportion of deposits in the mix of funding, the group expects the funding cost of Vanquis Bank to fall by 1% to around 6.2% in 2013. Interestingly, the group noted a fall in average market deposit rates of 150bps over the previous twelve months - almost wholly attributable to market rates being driven down by the Bank of England's Funding for Lending Scheme. The overall group funding rate during 2012 was 7.2%, down from 7.6% in 2011 - again benefiting from the Vanquis Bank retail deposits programme. The group's funding rate is expected to moderate further to around 7% for 2013.

Capital

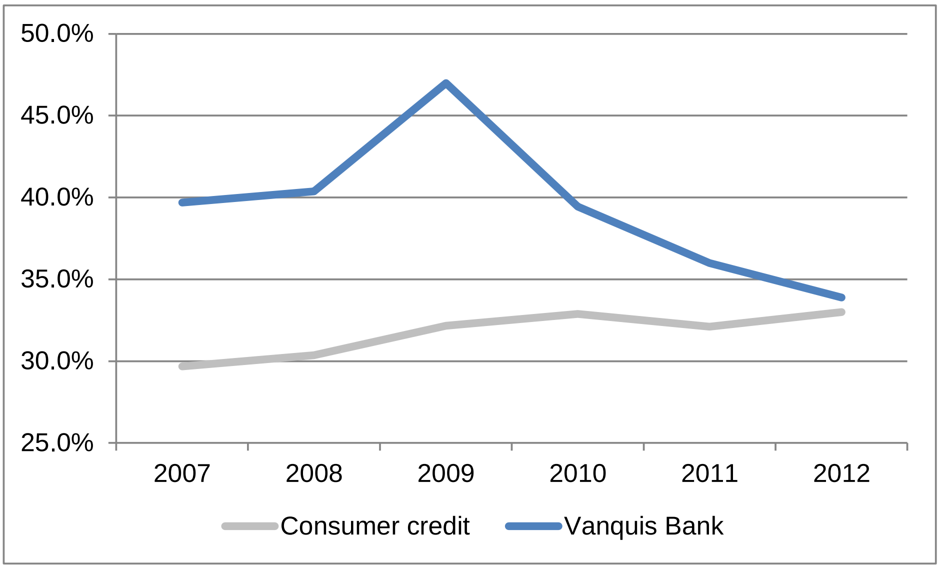
The group's capital position is strong. Group equity grew by £49.6 million in 2012. Vanquis Bank generated surplus capital over and above the amount needed to fund its own growth and maintain its regulatory capital base. It paid dividends of £5.0m to Provident Financial in March 2012 and £15.0m in February 2013.

Credit quality

In the Consumer Credit Division, the ratio of annualised impairment to revenue was 33.0% at December 2012. That represented an increase from 32.1% at the end of December 2011 – a year which had contained an improvement in the arrears profile resulting from changes to the agents' commission scheme.

In Vanquis Bank, arrears levels were stable and the impairment charge increased at a slower rate than average receivables (respectively 24.7% and 37.4%). Impairment as a percentage of revenues fell again in 2012 and the risk-adjusted margin of 34.8% was similar to that of the prior year. That margin is expected to reduce towards 33% given that the arrears levels have stabilised.

Provident Financial impairment charges as % of revenues



Source: Company

S&U

Year end	Share price (p)	Market Cap. (£m)	EPS (p)	PER (x)	DPS (p)	Yield (%)	1 Yr share price performance
Jan-14E	1160	136	100.8	11.5	50.0	4.3	60%

Source: Consensus FT.com

Another good year

S&U reported strong results for the year to the end of January 2013 on 26 March. It has two businesses. Loansathome4u provides home credit facilities to non-standard customers via 520 agents across the UK. Its Motor Finance business, Advantage, has grown rapidly over the last four years. It operates in the non-prime market sector and has benefited from a lack of competition in that market allowing the business to improve credit quality while growing the loan book.

Home Credit

In the Home Credit business, the trading experience is similar to that of Provident Financial. The economic environment, benefit changes and a preference for shorter term borrowing have constrained sales in comparison to the record figures of the previous year.

Motor Finance

Advantage produced another record year in FY 13 and saw its best ever transactions and collections figures during the normally more subdued final quarter. It produced 17% growth in revenue as the loan book increased. For S&U, the growth in the motor finance book reflects a further evolution in its customer base with more high quality customers. Having completed 400 deals in December and 700 in January, the outlook for further good quality growth looks encouraging. Management has said that the return of other lenders to the market has not had a noticeable impact. The group wants to continue the acceleration in lending.

Funding

S&U has balanced investment in its debtor and customer base with careful financing. Recent years have seen investment in the motor finance business as the home credit business has provided good cash flow.

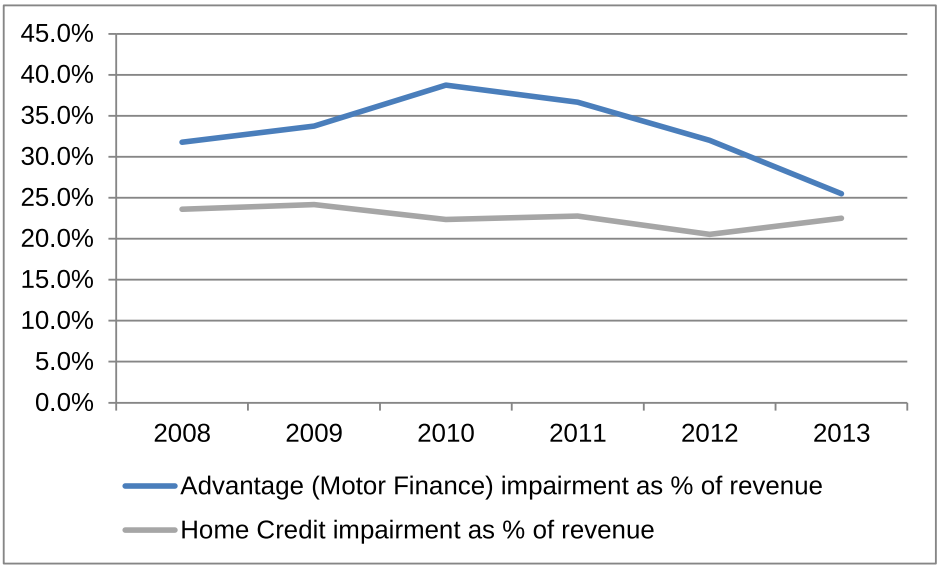
Over the last year this has culminated in an increase in borrowings and we would expect that to continue with the rate of growth in Advantage. Group gearing at the end of January 2013 remained stable compared to a year earlier at 33.7% reflecting additional net investment of around £5 million in Advantage during the year.

Credit quality

In the Home Credit business, the impairment charge increased by £0.7 million producing a tick-up in the impairment rate as a percentage of revenues - although collections were up 2%.

S&U's Motor Finance business, Advantage, produced a lower impairment charge in the financial year to the end of January 2013 despite growing the loan book further during the year. Management noted that credit quality improvements since 2008 continued to feed through, citing the metric of 89% of live receivables up to date compared to 85% and 81% in the group's FY 12 and FY 13 numbers respectively.

S&U impairment as % of revenues



Source: Company

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