GIBRALTAR ASSET MANAGEMENT

STOCKBROKERS & INVESTMENT MANAGERS

# Special Situations


## Provident Financial - Buy

11th November 2013

| | |
|---|---|
| Price | 1582p |
| 12 Month Price Target | 1970p |
| Risk Rating | Medium |
| Forward P/E Ratio | 11.5x |
| Forward Dividend Yield | 5.4% |

## Company Profile:

Established in 1880, Provident Financial Plc ("PFG") is listed on the London Stock Exchange and valued at £1.6 billion. It is one of the UK's leading suppliers of personal credit products to the non-standard lending market through the following divisions:

Home Collected Credit

Serves over 1.7m customers through a network of 9,500 agents, this business offers small loans (typically £300-£650 over one year) to their customers, typically lower-income families that have limited access to credit from mainstream providers (usually without a bank account) maybe due to limited or impaired credit histories.

The agent is at the heart of the home credit service who typically calls every week to collect the repayments. 69% of the agents are women and usually come from the same communities as their customers. Agents are paid commission based on what they collect, not what they lend, so it is in their interest to lend only as much as customers can afford to repay.

## Company Profile (cont):

Vanquis

This division, which supplies credit cards to sub-prime customers who cannot open bank accounts, recently surpassed 1m customers with customer growth running at 25% p.a. There is very little competition following the retreat of high street banks to their core markets following the credit crisis and the barriers to entry are large (customer analytics, credit scoring, collections process). It took Vanquis 6 years to break even and now with a 40% RoE, Vanquis is set to remain the dominant player for years to come. A conservative lending criteria has seen the loan book exhibit far less impairment volatility compared with prime lending loan books, even during the recent credit crisis.

Satsuma Loans

This new online product has been created for the customers sitting between the HCC and Vanquis propositions. Designed as '*the antidote to payday*', it is fully compliant with new regulations designed to clamp down on the payday industry, offering a fair, transparent and cheaper form of online lending. For example, the APR on a Satsuma loan is 794% versus a representative APR of 5850% at Wonga,

## Analysts View:

The investment analyst community is predominantly bullish on the stock with Numis setting a 1831p price target, J.P.Morgan Cazenove 1911p, Berenberg 1970p and Goldman Sachs 2100p.

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# Special Situations (cont)

## Catalysts to the share price:

*1) Modernising Home Collected Credit ("HCC")*

This 130 year old business is very paper intensive with 18m pieces of paper processed annually. This business can easily be transformed by cheap and simple technology - management forecasts that £18m of costs will be cut in the next few years through handheld technology used by their agents. This will speed up their processes, increase the speed and amount of information available to management and will also better support lending decisions. Investment bank Berenberg also believes that £20m in cost savings will be obtained from reducing back office and processing staff in the field and headquarters.

*2) Growth at Vanquis*

In addition to management forecasting that the division can reach 1.5m customers in the next few years, further growth is being achieved by developing new distribution channels (it recently introduced an Argos co-branded card). Now accounting for 50% of group earnings, the loan book is forecast to double to £1.5bn over the next 3/4 years. Management has also expanded into Poland, a market which could potentially be as large as the UK. Provident Financial is in a sweet spot and is able to reject around 75% of all loan applications.

*3) Growth at Satsuma Loans*

There is currently a large part of the sub-prime market not currently being served by HCC and Vanquis, as these customers are not of good enough credit quality to qualify for a credit card, but are also reluctant to borrow via a home credit agent. This product incorporates the appeal of payday lending (internet functionality and speed of response), but without the aggressive practices of rollover charges and late payment fees. With little initial investment required (it is leveraging off the underwriting, account management and collections platforms of HCC and Vanquis), this could be profitable in the next year and could grow at a rapid rate thereafter. Online platforms like this can grow extremely fast if marketed well. Wonga, for example, grew from a marginally loss-making division in 2009 to a PBT of ~£80m in 2012. There will also be a natural flow of customer leads from i) Vanquis rejections; and ii) HCC customers sourced through the website.

*4) Impact on competition from Regulation*

Provident Financial has ~60% of the market share of home credit. Now that this business falls under the scope of the FCA, the levels of regulatory oversight will become much more stringent and thus force a number of the smaller players (the remaining market is highly fragmented, consisting of several hundred local businesses) out of the market. Thus, there are opportunities to pick up incremental new agents and customers as the industry consolidates.

*5) Relative and absolute valuation*

PFG is trading on a forward P/E multiple of 11.5x, which is as cheap as the shares have traded since mid 2012 and towards the bottom end of the range for PFG's UK specialist lender peers (11x-14x).

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# Special Situations (cont)

## Technicals:

Technically, the stock looks attractive. The RSI recently moved below 30, a traditionally oversold signal. With the shares having fallen 12% in recent weeks, dipping below its upward-sloping 200-day moving average, we feel this represents an opportune moment to buy a stock that is rising with momentum.

## Summary:

Provident Financial is a rare financial company that offers double-digit earnings growth (EPS CAGR of 15%), resulting in 25% potential upside to our price target of 1970p, coupled with a high and growing dividend yield of 5.4%.

Recent investor concern that PFG's major shareholder may be looking to sell part of its significant 25% holding appears overblown and we believe that the recent share price weakness provides an ideal entry point for investors looking for both capital growth and income.

## Chart Legend:

| | | |
|---|---|---|
| (red dashed line) | 20 day moving average | (signifies the short-term direction of the security. prices tend to gyrate around their 20 day m/a) |
| (red line) | 50 day moving average | (signifies the medium-term direction of the security) |
| (thick red line) | 200 day moving average | (signifies the long-term direction of the security - whether it is in a bull or bear market) |
| (green line) | 400 day moving average | (signifies the long-term direction of the security - whether it is in a bull or bear market) |
| (blue line) | bollinger bands | (an indicator that measures 2 standard deviations away from the 20 day m/a) |

## Technical Analysis Guide:

RSI (relative strength index) - indicates whether a security is overbought (above 70) or oversold (below 30). Also when the RSI moves above 50 that is considered bullish (or vice versa).

ADX (average directional index) - indicates whether a security is in a trend (above 20) or not in a trend (below 20). For trending markets moving averages work best when considering lines of support/resistance. For non-trending markets Bollinger Bands work best (sell at upper band, buy at lower band).

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