Capital Network

PCF GROUP PLC (LON:PCF)

FINANCIAL SERVICES

30/05/2018

SHARE PRICE	52 WEEK LOW
43.33p	22.00p
MARKET CAP	52 WEEK HIGH
£89.14m	44.00p
MARKET	CET1 ratio
AIM	21.6%

MAJOR SHAREHOLDERS

1) **Bermuda Commercial Bank Limited 54.5%.**
2) **Somers Limited – 10.93%**
3) **Hof Hoornemans Bankiers – 6.24%%**

Shares in issue	212.23m
Avg volume	184,534
Primary index	AIM
EPIC	LON:PCF
Next key announcement	May 2018
Sector	Financial Services

SHARE PRICE CHART

PCF Group Plc: Interim results to end of March '18

OVERVIEW OF RESULTS

The group announced interim results on the May 23, reporting significant progress across the business as it builds scale while at the same delivering credible financial and operational performance. These results were achieved despite the twin constraints of upfront capital investment and equity capital raised previously, nevertheless, PCF continues to grow according to its strategic plan.

The headline financial performance was held back by the investment made to date and by the dilution from new equity. Profit before tax for the first half of 2018 (1H18) was £2.1mln, an increase of 20% year-on-year (yoy), which was less than average asset growth, and profit after tax was £1.65mln, an increase of 20% also. Earnings per share, meanwhile, were affected by the effective increase in share capital and weighted average shares in issue (+24.7%) and were therefore largely unchanged at 0.8p. The group announces final dividends only.

In anticipation of becoming a bank, PCF invested upfront the equivalent of c.£2mln of annualised cost that affected these interim financial results by c.£1mln. We are not inclined to adjust for this cost to determine an adjusted earnings figure; rather we appreciate in our forecasts the future operational gearing that can be delivered from operating a significantly greater portfolio of loans from the same relative base. It is this gearing that gives us the assurance of better earnings to follow.

While the financial results were held back, the strategic performance was excellent. Portfolio assets increased 40% yoy, or 23% since the year-end. Retail deposits from a standing start have grown to £108mln in eight months. New business originations across both Consumer and Business loans nearly doubled to £69mln as the group grows into prime markets. These results are entirely consistent with what management set out to deliver and the group remains on target to grow portfolio assets to £350mln by 2020.

The priorities for the remainder of 2018 remain the same as before: (1) Increase lending into the prime market and expand the range of services; (2) Maintain high levels of customer and broker service at much higher volumes; (3) Further improve the efficiency of the banks treasury and savings structure; (4) maintain momentum towards the portfolio target of £350mln by 2020; (5) harness the power of scale and deliver the operationally geared benefits. We consider that these all remain on track. Our new price target is 55p per share.

CHANGES TO CAPITAL NETWORK FORECASTS

PCF Group Plc: Profit, Earnings, and Dividend Forecasts

	Portfolio Assets	Average assets	Pbt	Eps (p)	Dps (p)	Payout (%)
2017	145,718	133839	3633	1.46	0.19	13.0%
Old 2018	200,000	172500	4826	1.82	0.23	12.6%
New 2018	215,000	181000	4931	1.86	0.27	14.5%
Old 2019	280,000	240000	7466	2.81	0.25	8.9%
New 2019	280,000	240000	7466	2.81	0.31	11.0%
Old 2020	350,000	315000	10182	3.84	0.28	7.3%
New 2020	350,000	315000	10182	3.84	0.40	10.4%

Source: PCF reports, CN estimates. (£'000 except where indicated)

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Our old forecast considered portfolio assets reaching £200mln by 2018 year-end (Sept). The group has so far achieved retail funding roughly at the variable rate of £8 -13.5mln per month, depending on the binary nature of deciding for a greater or lesser competitive retail savings rate, which dictates volume. It seems that the retail market can be tapped, for the moment, for any reasonable amount when required.

Our new 2018 portfolio asset estimate is for £215mln, a 7.5% increase over the old. This leads our revised 2018 earnings forecast higher, albeit we have increased our administration expenses but lowered the impairment loss rate concurrently. In addition, we have raised DPS (dividend per share) for each year 2018 – 2020 reflecting the higher expected earnings in 2018, and a slightly higher pay-out ratio in subsequent years.

1) BALANCE SHEET HEALTH – LOANS, FUNDING AND CAPITAL

The PCF balance sheet enters the second half of the calendar year 2018 in a strong position. Portfolio asset growth was achieved organically through new business originations, which nearly doubled to £69mln. This was funded with the commencement of retail deposit operations in July 2017. The £108mln deposited now represents c.50% of total funded assets.

The gross portfolio of loans grew to £222mln, an increase of nearly 40%. £74.6mln, or 33% of the total, is repayable within one year, the lowest proportion for some time as the group extends loan maturity consistent with lower credit risk from prime customers.

New business originations were strongest in Business Finance, increasing 111%, driven by average loan sizes, which increased by over a third to £41,500 from prime customer demand. Business Finance is now the largest group segment at 54%, a reversal of relative size over the last few years. Consumer Finance, meanwhile, delivered an equally decent performance with new business increasing 81%.

Consistent with the increase in new business, unearned future income (the difference between what has been loaned and the total repayable) grew equally well to £38.5mln and allows the group some visibility into future income.

Net portfolio loans (after considering unearned future income and the loss provision) increased to £179.2mln, an increase of 40% yoy.

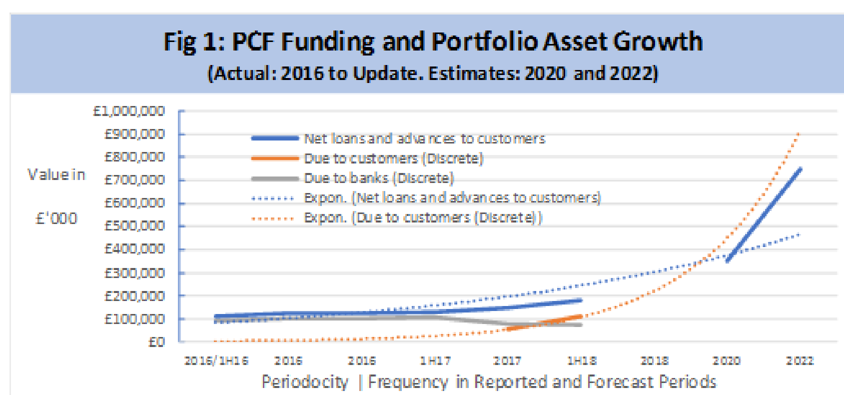
Also on the asset side, eligibility to participate in the Bank of England's TFS (Term Funding Scheme) has allowed the group to access £25mln of preferential borrowing with an all-in cost of 1.2/1.3%. The scheme ended at the end of February 2018 and is no longer accessible. The loan is for four years with repayment at maturity. While this was not flagged previously, as a bank, PCF is legitimately able to access this funding as others have done also; however, the contention from some investors may be that this line complicates funding given its small size. We would contend that the £25mln is earnings accretive to the tune of £175,000 a year once deployed, and from that perspective, we see this as a tactical funding opportunity well taken. At the current time, the £25mln TFS sits in UK gilts.

Cash held on deposit at central banks remains relatively consistent with the 2017 full year result, at c.£15mln.

Balance sheet funding since becoming a bank has been a tour-de-force for the group over the last eight months. Retail deposits have lowered the cost of funding (allowing competitive prime rates) and diversified the sources while retaining liquidity. The decision to launch small-to-medium enterprise (SME) deposits from the third quarter of 2018 will further the diversification and cost benefits.

Retail deposits cost the group a blended average rate of 2% for an average term of 2.5 years. The blended rate achieved compares favourably to the c.6% cost of wholesale debt previously relied upon and effectively obviated the need for the group to fully competing in lower credit risk, prime credit grades simply because with wholesale funding it would have been uneconomic to do so.

The remaining £72mln of wholesale funding, which includes the £25mln of TFS funding, is guided by the group to continue to fall in line with repayment dates and economic opportunities to cancel this funding. Prepayment penalties exist within this funding so to trigger immediate repayment would be costly. The expectation is that this will continue to decline by c.£15mln in the second half to c.£57mln by the year-end. Retail and corporate deposit funding will replace any lost wholesale capacity. Below, in figure 1, we show the development of the balance sheet. We show the historical development of net portfolio assets and the guidance for 2020 and 2022. We further show the rise in deposit funding and the decline in wholesale. For comparison, we show the exponential rates for both portfolio assets and retail deposit funding.



Consistent with the growth in assets and liabilities, group capital has developed into a strong position. While group profitability was subdued due to upfront costs, profits retained within the business increased capital and retained strong capital measures.

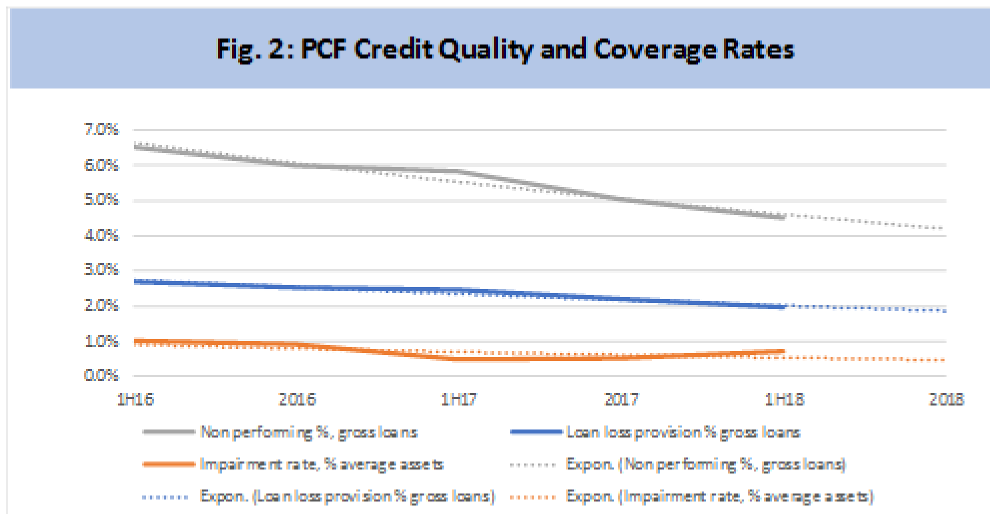
Total common equity increased to £40.3mln during the first six months of the year and tangible common equity increased to £37.3mln after deducting c.£3mln of goodwill and intangibles. Tangible equity capital leverage relative to gross portfolio assets of £222mln was 6x. The common equity tier 1 capital ratio was a healthy 21.6% equating to c.£172.5mln of estimated RWA or risk-weighted assets. The group has used this healthy capital position by deploying more capital to support lending; however, this has not materially altered the risk of the group especially when considering that the majority of growth has come from prime lending.

(2) CREDIT - QUALITY AND IMPAIRMENTS

PCF delivered new business expansion without unnecessary risk in the 1H18. Lending to the top four credit grades (the As and B+) continued to rise, to 70%, compared to 63% in 2017FY, and 57% in 1H17, following the group's return-for-risk policy, which benefits from the lower funding cost. The focus on quality has helped to ensure the performance of gross loans. Neither past due nor impaired remains high at 91.5% while non-performing loans, the lowest quality segment, is greater in absolute terms compared to 2017FY but remains much the same in relative terms.

The loan loss impairment taken during the first half of the year was £579,000 or an annualised rate of 0.72% of average assets, which raised the group's provision for bad debts to £4.4mln. This equates to 2% of gross portfolio loans and 44% of the currently non-performing book of c.£10mln comprising 50% legacy assets in recovery from the global financial crisis and 50% of bad debts realised since.

The group used just £186,000 of the provision during the first six months, which has meant that the provision has continued to rise since 1H16.



3)OUTLOOK – RETURNS AND VALUATION

PCF still expects to deliver ROE (return on equity) of 12.5% by 2020 (8.4% 1H18, annualised) and we still anticipate c.2.6% of ROAA (return on average assets) by the same date (2.6% 1H18, annualised). Our expectations-derived forecast for earnings per share (EPS) for the financial year 2020 using an impairment rate of 0.86% is for 3.84p per share.

Strategic expectations remain the same as before. The group will continue with balance sheet expansion as the primary means of building value, and operational gearing as the primary means of building returns. In time, our expectation is that the company will grow profits and earnings and therefore declare a more meaningful dividend; however, in the short term, additional capital may be required from the market to build scale between 2020 and 2022, to build, therefore, portfolio assets from £350mln to £750mln.

We have previously used dividends as a means of valuation but given the low pay-out ratio of dividends and no conclusive near-term guidance, we are tending back towards earnings at this stage in the group's development.

Based on an EPS multiple of 10x, our EPS forecast for the financial year 2020, 3.84p, is almost exactly in line with the current share price of 39p. Arguably for a group with a bank that is forecast to grow beyond that year, 10x forecast EPS is too low. A more justifiable multiple could be calculated thus: forecast ROAA 2.6%; retention rate of EPS 90%; forecast peak portfolio assets £750mln; tax rate 20%; 212.22mln shares in issue. This would equate to a notional peak EPS of 7.3p. If we assume from that point in time, 2022, that growth slows to 5% and our required rate of return was 10%, then a justifiable multiple would be 18x.

We will discount this scenario to produce the following new value per share based on our 2020 EPS.

Fig 3 **: PCF Valuation Summary**				
Year	Eps	Multiple	Value per share	Notes
2020	3.84p	14x	**55p**	*Growth continues, scaled back multiple from peak.*

Sources: CN estimates, PCF Group reports.

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