PCF Group

EQUITY Development

Banks are back. PCF is positioned to capitalise.

11th December 2020

Founded in 1994, PCF first operated as a non-bank lender using wholesale debt as its main source of lending capital. In Dec'16 it obtained a banking license as part of an ambitious growth strategy, which allowed it to access retail deposits as its primary, and far cheaper, source of capital. PCF hasn't looked back. It used this advantage to not only grow rapidly, but also to improve credit quality. 'Prime' loan originations grew from 55% in FY16 to 85% in FY20.

Over the four financial years spent operating as a bank, customer deposits have grown from scratch to **£342m** on 30 Sep '20 and make up around 83% of non-equity capital. New business originations (asset-backed SME **finance**, used car and leisure vehicle consumer finance, and bridging property finance) have grown from £60m in FY16 to **£270m** in FY20; and the lending book has increased from £108m on 30 Sep '16 to **£434m** on 30 Sep '20, a compound annual growth rate (CAGR) of 42% - which includes a Covid-related slowdown in 2020. Impairments unsurprisingly jumped in FY20 from £2.2m, or 0.8% of average loan book in FY19, to £7.8m or 2.0%. Yet, this includes accounting (IFRS 9) provisions based on economic scenarios to cover 'potential' losses. The impairment outlook is improving, with forbearance levels falling from the May peak (38% of portfolio) to 6% in Nov.

Financial results have also been impressive during PCF's time as a bank. PBT increased from £3.6m in FY16 to £8.0m in FY19 (30% CAGR), before falling back to £2.1m in FY20, primarily due to the increased loan impairment charge and a £1.75m acquisition-related goodwill impairment. We see PBT recovering to £6.8m in FY21 and £9.4m in FY22. RoE had grown to 12.6% in FY19 before falling to 2.5% in FY20, but we also see this recovering quickly. 2020 has been a nasty pothole for the banking sector as a whole, but we do not think PCF has been knocked off its strategic path. The pre-Covid goal of building a loan book of £750m by FY22 might be pushed back into FY23**, but its medium-term goal of a £1bn loan book looks achievable by FY24 or FY25.** Currently there are economic headwinds to growth, but post-Covid we expect PCF to gain market share.

Given its growth prospects, we see PCF undervalued at 24p per share. Indeed, our fundamental valuation is 45p per share. If PCF delivers on its aspirations, we expect its FY21 PE ratio to move from 11x to well beyond the pre-pandemic banking sector median of 14-15x.

Key Financials

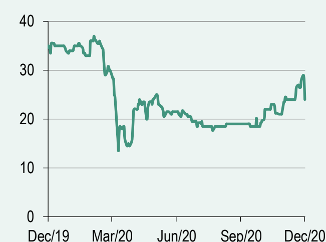
y/e Sep 30	FY17A	FY18A	FY19A	FY20A	FY21E	FY 22E
Loan originations, £m	84	148	276	270	330	446
Loan portfolio, £m	143	219	339	434	553	711
Net interest income, £m	11.1	15.0	21.6	26.6	30.4	34.5
Net interest margin	8.3%	8.3%	7.8%	6.9%	6.2%	5.5%
Cost to income ratio	59.3%	57.1%	55.6%	55.6%	56.0%	52.9%
Impairment charge	0.5%	0.5%	0.8%	2.0%	1.3%	1.0%
PBT, £m	3.6	5.2	8.0	2.1	6.8	9.4
EPS basic & diluted, p	1.9	2.0	2.7	0.6	2.2	3.1
RoE after tax	11.5%	10.3%	12.6%	2.5%	8.8%	11.2%
Div, p	0.2	0.3	0.4	-	0.3	0.5
Yield	0.8%	1.3%	1.7%	0.0%	1.4%	2.0%
Price earnings ratio	12.6	12.2	8.8	41.3	11.0	7.8
Price to book ratio	1.6	1.4	1.0	1.0	0.9	0.8
Net assets, £m	38.7	42.6	58.8	59.4	64.8	71.7
CET1 ratio (min 9%)	26.3%	19.4%	18.6%	17.7%	15.2%	13.1%

Source: Company Historic Data, ED estimates. PER, Price to Book and Yield based on share price of 24p

Company Data

EPIC	PCF
Price	24p
52 weeks Hi/Lo	37p/13p
Market cap	£60m
ED Fair Value/share	45p
Net assets	£59m
Avg. daily volume	215k

Share Price, p



Source: ADVFN

Description

PCF Group was established in 1994 and is the parent of PCF Bank, which provides retail savings products to individuals and offers loans in four UK market segments:

Business finance: asset-backed lending for SMEs to purchase motor vehicles, plant and equipment;

Consumer finance: for individuals to purchase nearly-new and used cars, and leisure vehicles such as motor-homes, horse-boxes and classic cars;

Bridging property finance: for property developers and investors to purchase or re-mortgage residential and commercial properties; and

Azule: asset-backed lending for businesses in the broadcast and media sectors.

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Please refer to the important disclosures shown on the back page and note that this information is **Non-independent** and categorised as **Marketing Material**

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PCF: in a nutshell

PCF Group plc is the AIM-listed parent company of PCF Bank limited. It has been listed on AIM since 1998. PCF is based in London and employs around 120 people.

The bank's primary source of lending capital comes from consumer savings. It offers notice accounts (minimum 100 days) and term deposits ranging from one to seven years. The most popular durations are 12 and 24 months, and the average savings balance is £42,500. The client base is mostly UK-domiciled, middle to older aged savers. Accounts are predominantly opened online (a 20-minute process) through PCF Bank's savings portal.

In addition to these retail deposits, the bank supplements its lending capital base through wholesale bank debt. This is borrowed directly from the Bank of England via its Term Funding Scheme (TFS) at base rate, or from commercial banks at commercial rates.

PCF lends money in three main market segments:

- **Business finance (48% of loan book) involves lending money via hire purchase or finance lease agreements to UK small businesses** for the purchase of physical assets such as motor cars, light commercial vehicles, heavy commercial vehicles, buses, and contractors' plant and equipment. The physical asset serves as collateral against the loan. The division predominantly uses broker intermediaries to source new business.

  PCF also has a specialist business finance unit (acquired in Nov 18), Azule, which provides finance for assets in the broadcast and media sector such as lighting and audio-visual equipment. Business is sourced in the UK and on continental Europe through direct end user relationships along with manufacturer, distributor and dealer introductions. It is partly brokered to other finance providers and partly placed onto PCF's own balance sheet.

- **Consumer finance (39% of loan book) involves lending money via hire purchase and conditional sale agreements to retail customers for the purchase of used cars** (which have typically suffered their initial depreciation and make good loan collateral) and leisure vehicles such as motor homes, caravans and horse boxes. The division also predominantly uses broker intermediaries as its route to market.

- **Bridging property finance (13% of loan book) is a relatively new division of PCF (started in 2019) and involves lending money to property developers and investors for a 'bridging' period, typically six to eighteen months.** Circumstances when these loans are taken out include when a property is bought for refurbishment or at an auction for later on-sale. A first charge against the property serves as loan collateral.

PCFs strategy is to grow mostly through organic means (growing existing business units or setting up new units such as Bridging property finance, where a team was recruited to start this business)**, supplemented by selective, strategic acquisitions**.

A primary consideration of any acquisition will be the diversification of its asset base and income streams. Azule is a good example which was the first acquisition since PCF became a bank (although several acquisitions were concluded prior to this). It diversified both the asset base (being focused on a specialist sector) and the income streams (bringing with it a higher proportion of brokered fee income spread across a wide geographic area).

The business is still founder-led, with the two most senior individuals (Scott Maybury, CEO and Robert Murray, MD) each having over 20 years' experience of managing PCF as an AIM-listed business.

FY20 results

The Covid-19 pandemic has been an extremely difficult period for banks and non-bank lenders. This has certainly been the case for PCF as well, but because of **its conservative lending portfolio and efficient management of operations** through the crisis, the negative impact on FY20 results has been relatively limited, given the dramatic impact on some of its clients and on the overall economy.

New loan originations of £270m were slightly down on the £276m of FY19 but the loan portfolio grew 28% from £339m to £434m.

Net interest income grew 23% from £21.6m to £26.6m with the net interest margin (NIM) dropping from 7.8% to 6.9% as the prime proportion of the portfolio (which attracts lower interest income because of its lower risk) continued to rise.

Impairments unsurprisingly jumped in FY20, from £2.2m in FY19 to £7.8m. Impairments as a proportion of average loan book (‘cost of risk’) increased from 0.8% to 2.0%. However, other operational costs were kept well in check with PCF’s cost-to-income ratio unchanged at 55.6%.

The large increase in loan impairment charge, coupled with a £1.75m impairment charge on the goodwill related to the acquisition of Azule, were primarily responsible for profit before tax declining from £8.0m to £2.1m, profit after tax declining from £6.4m to £1.5m, and EPS declining from 2.7p to 0.6p.

Although dividends of around 12.5% of PBT have been declared in the last few years (the FY19 dividend – a total of £1m or 0.4p per share – was paid as planned in Apr 2020), in light of continuing economic uncertainty and in the interests of prudent capital management, the board have deferred a decision on FY20 dividends until the FY21 interim results,

The balance sheet of the group continued to strengthen with net assets increasing from £58.8m to £59.4m. PCF remains very well capitalised with a CET1 ratio (core equity) of 17.7%. The liquidity coverage ratio (LCR) – high quality liquid assets divided by total net cash flows over a 30-day stress period – was 673%.

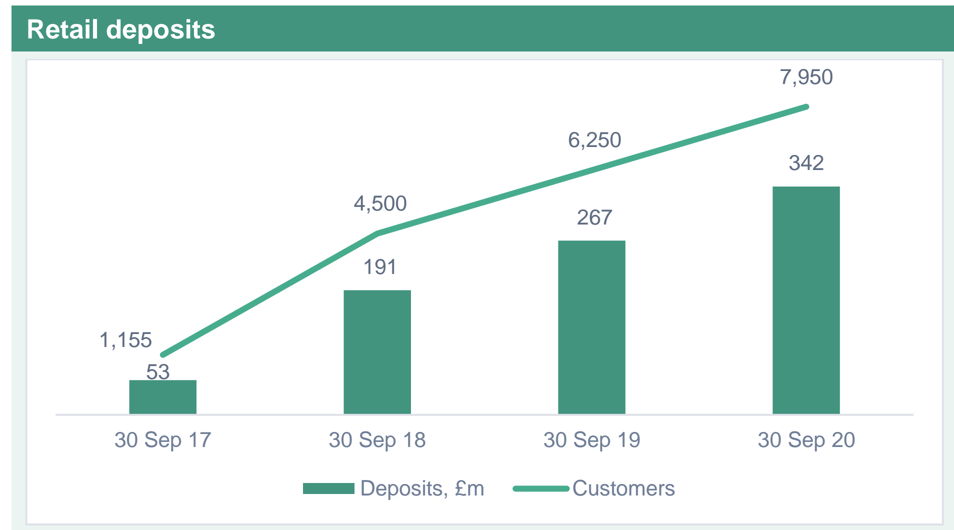
The funding mix did however change significantly during the year. Retail deposits (average cost 2.2%) increased 28% from £267m to £342m. Use of the Bank of England’s Term Funding Facility (cost 0.1%) increased from £25m to £63m. Borrowings from commercial banks (average cost ~5%) meanwhile, was eliminated, reducing from £19.4m at the end of FY19.

PCF also secured a £15m subordinated debt Tier 2 capital facility (fixed interest rate 8%) during FY20 to support growth. It drew £7m against this facility during the year.

Consumer Savings

Retail deposits, in the form of saving accounts for consumers, have grown rapidly over the last four years since becoming a bank – from zero at the start of 2017 to £342m on 30 Sep 20 (£267m on 30 Sep 19). The number of customers has also grown steadily to 7,950.

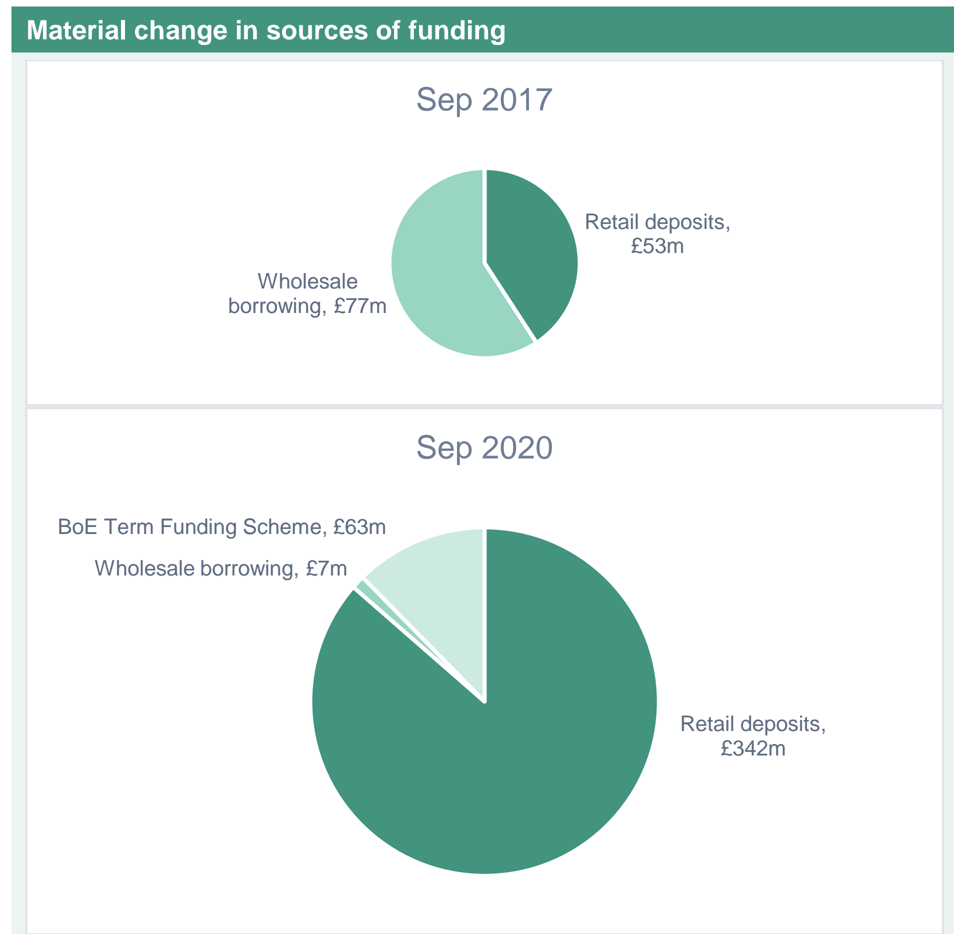
Retail deposits



Source: Company reports.

These deposits have also become the main source of PCFs lending capital, primarily because of their lower cost (around 2.2% in FY20 compared to the wholesale borrowing cost in FY20 of around 5%).

Material change in sources of funding



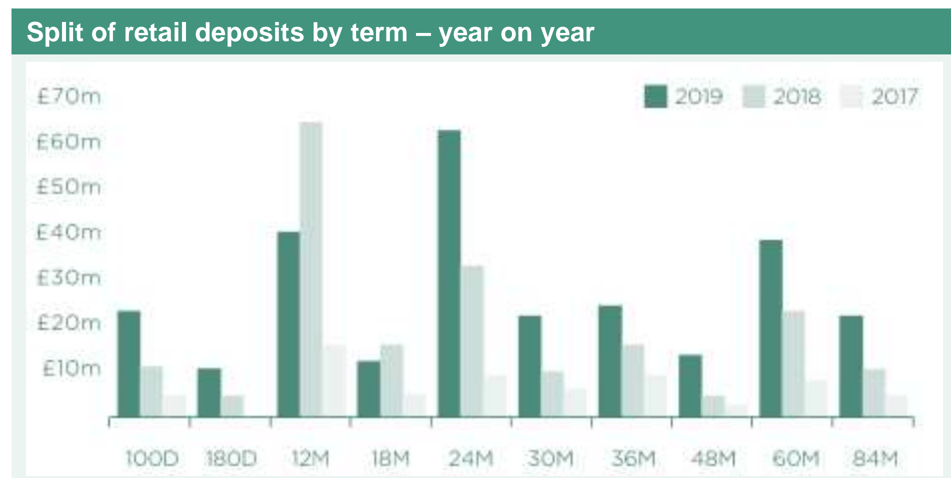
Source: Company reports

Consumer demand for savings products is strong: in H1, deposits grew 27% from £267m on 30 Sep 19 to £340m on 31 Mar 20. While PCF mostly stopped taking new deposits in H2 because it didn't need new lending capital (due to the slowdown in demand for loans and the availability of cheaper TFS funds), it did re-enter the market a number of times during the pandemic to make sure consumer demand was still there – with positive results. It added £2m of deposits in H2. This is evidence that retail deposits can be turned on and off to a degree as it suits PCF.

The duration-mix of deposits does, however, need to be carefully managed, so as not to create a large mismatch between average loan durations and average deposit durations.

As consumer and business loans can be up to five years (in some cases longer for leisure vehicles and specialist business equipment), the bank has been actively trying (and succeeding) to extend its average deposit duration by promoting longer-term deposits, even though it pays the consumer a slightly higher interest rate on these. Over the last years, there has been a marked decrease in 12-month deposits coupled with a marked increase in 24-84 months deposits. The average term of deposits is 2.9 years.

Split of retail deposits by term – year on year

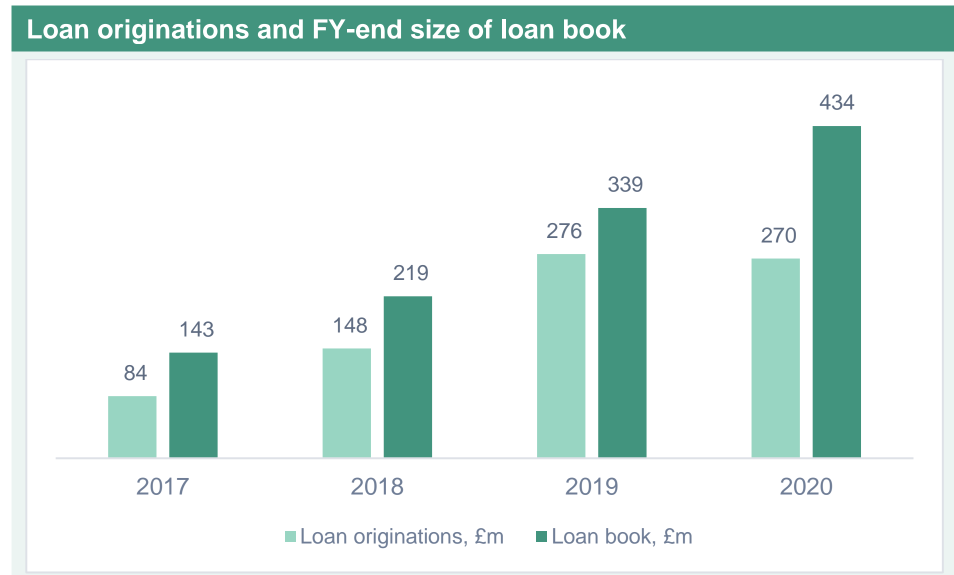


Source: Company

Loan portfolio

PCF's loan portfolio has been on a strong growth trajectory over the last four years, although the Covid-19 pandemic resulted in a rapid slowdown of loan growth (particularly business loans) in the last three quarters of FY20 (Jan–Sep 2020).

Loan originations and FY-end size of loan book

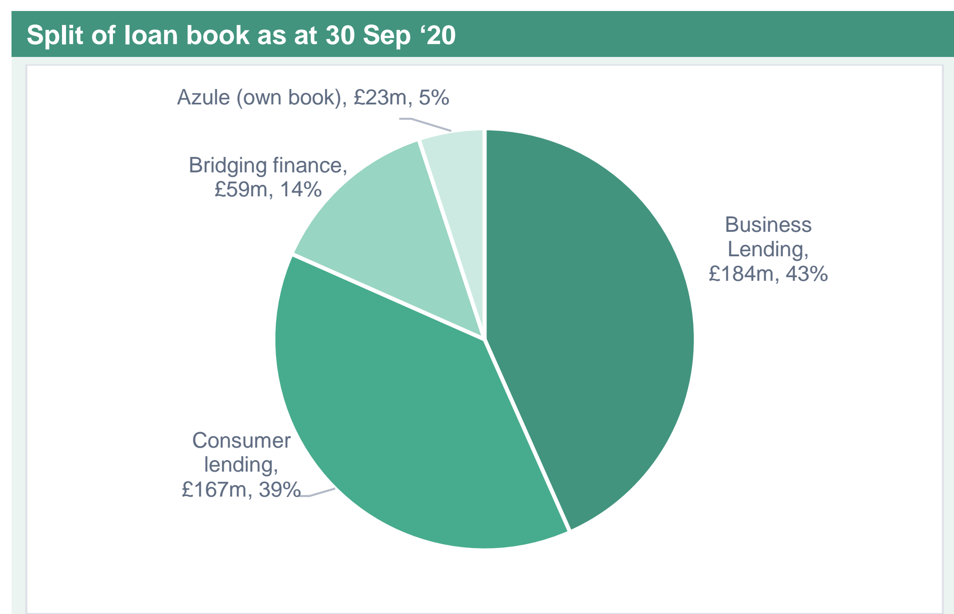


Source: Company reports

Business finance is currently the largest proportion of the loan book, but we forecast that because of the slowdown in business loans, and increasing demand for consumer loans, **consumer finance will become the largest proportion of the loan book in the next year or two**. We do not see this as a good or bad sign, it is simply the consequence of different market segments being impacted in different ways by economic conditions and highlights the flexibility and benefits of operating in different markets.

As the loan portfolio becomes even more diversified, there will naturally be swings in the proportions of each market segment (see further commentary in Business Finance; Consumer Finance; and Strategy, outlook and forecast sections of this note).

Split of loan book as at 30 Sep '20



Source: Company reports, ED analysis
Note: Azule (loans to media and broadcast sectors) excludes portfolio brokered to other loan providers

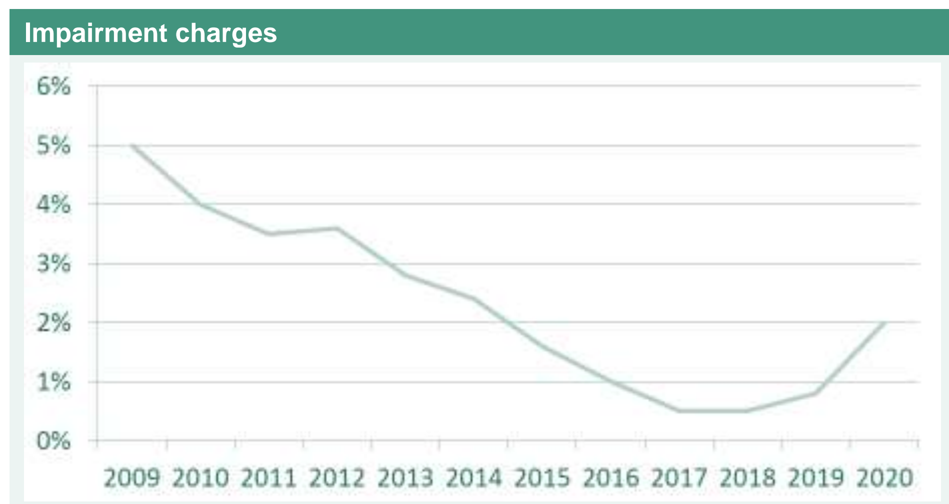
Over the last few years, PCF has also **shifted the credit-quality composition** of its loan book. Its overall risk philosophy is to finance assets which have strong collateral characteristics and readily identifiable re-sale markets; and where the bank understands customers' ability to service the loan.

Moreover, it has specifically been focusing on increasing the proportion of lending to lower-risk prime customers (top four credit grades where the customer has a clean credit profile and a low probability of default). PCF has only been able to target the top two of these credit grades since becoming a bank because the lower cost of funds allows it to target these lower-yielding, lower-risk products.

Two years ago, in FY18, 70% of new business originations were in the prime segment which made up 64.5% of the portfolio. In FY20, the prime segment made up 85% of new business originations and 79% of the portfolio (FY19 74% of originations and 69.4% of portfolio).

As the shift to prime progressed over the years, average loan impairment charges fell, although impairments have spiked in FY20 (to 2.0% of average loan balance) due to the economic impact of the pandemic.

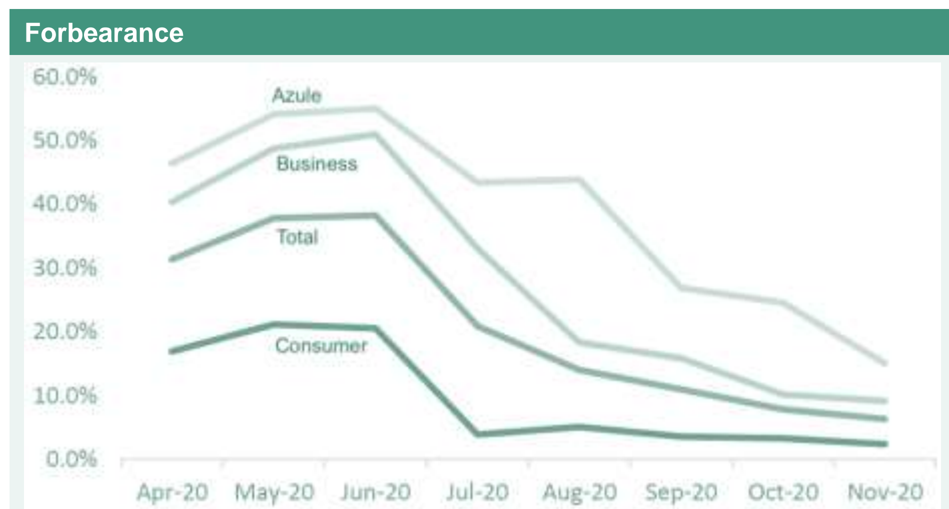
Impairment charges



Source: Company

While we expect impairments in FY21 to be higher than historic levels, we don't expect these to be as high as FY20. We forecast that the impairment charge will start reducing in FY21 (our forecast is 1.3%) and then reduce further to around 1% as we move out of the pandemic and the economy recovers. Early evidence of this recovery is provided by the rapid drop off in forbearance during 2020. Forbearance peaked in May at £139m (38% of the portfolio) but had dropped to £23m (6%) by 30 Nov.

Forbearance

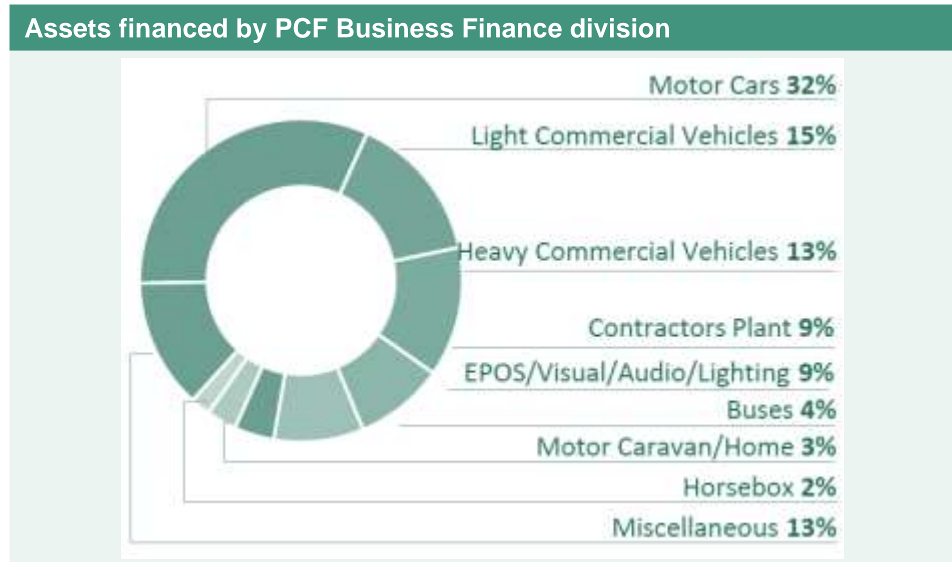


Source: Company

Business Finance

PCF's business finance division lends money to UK SMEs to purchase physical assets.

Assets financed by PCF Business Finance division



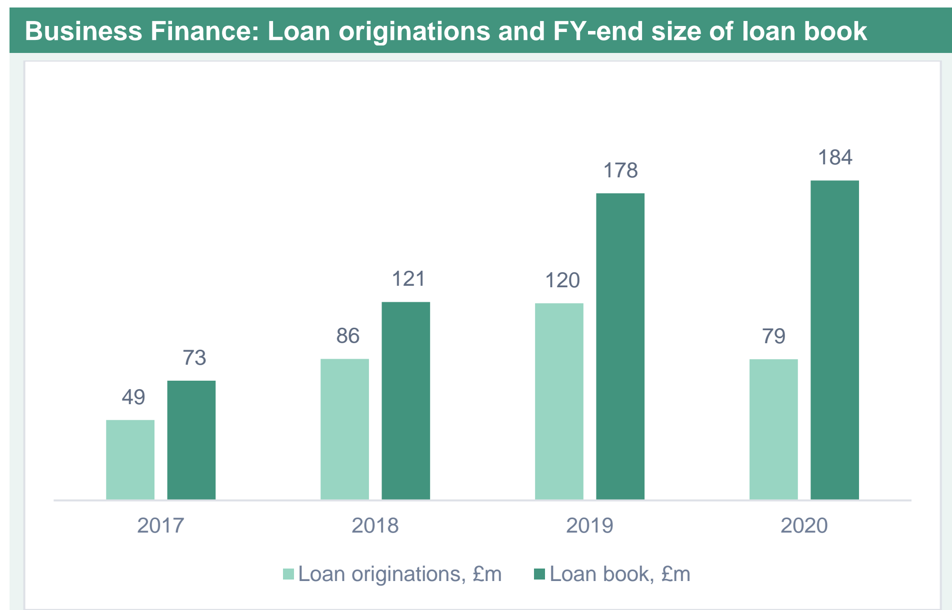
Source: Company

Lending is typically for up to five years with longer terms of up to ten years for specialist niche assets. Business is mostly sourced through broker intermediaries.

PCF has been increasingly focused on **prime customers** which now make up 78% of the portfolio (FY19 72%, FY18 74%). Average transaction size in FY20 was £47,000 which has been steadily increasing over the years (FY19 £45,300; FY18 £40,600; FY17 £32,800), mostly because of the increased focus on prime customers which tend to acquire newer and more expensive vehicles and equipment. PCF is not heavily exposed to any one customer with no aggregate customer exposure exceeding 1% of the portfolio, which is made up of over 5,800 individual agreements.

The division has been growing strongly in recent years but demand from SMEs was hard-hit by the Covid-19 pandemic. Originations in FY20 had been progressing well pre-pandemic (£66m in H1 to 31 Mar 20) but fell off dramatically in H2 (£13m).

Business Finance: Loan originations and FY-end size of loan book



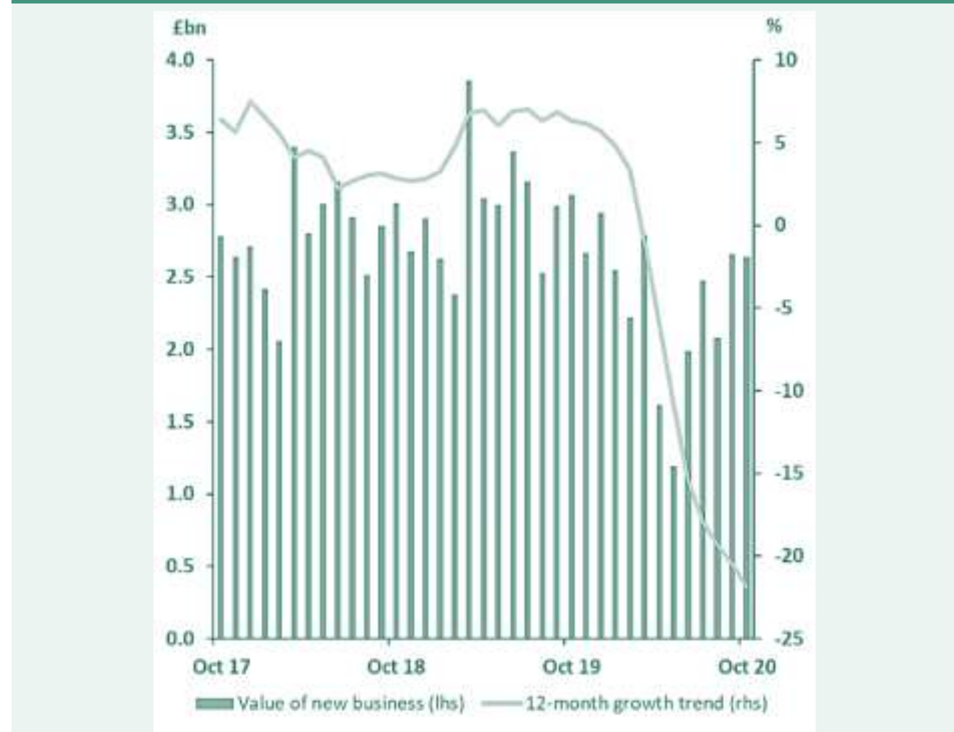
Source: Company reports

PCF's FY20 originations of £79m gives it just a 0.3% share of the total £28.2bn UK asset finance market (market originations in the 12m to Sep 20), as measured by the Finance and Leasing Association (FLA), **so it has plenty of room to grow**. Market originations fell 21% in the period from £35.8bn to £28.2bn.

In its area of the market, PCF's main competitors include Close Brothers, Paragon Bank, Aldermore, Hitachi Capital, Shawbrook Bank and United Trust Bank.

The UK asset finance market contracted sharply during the pandemic but there are early signs of recovery.

FLA asset finance new business trends



Source: Finance and Leasing Association (FLA)

Geraldine Kilkelly, Head of Research and Chief Economist at the FLA, commented on the figures to Sep 20: "*The asset finance market has gradually returned to more normal levels of new business, with the easing of the rate of contraction continuing in September.*" She did however sound a note of caution about short-term prospects because of the new round of lockdowns.

PCF is expecting a slow recovery of its new business volumes in FY21 and sees originations returning to FY19 levels in FY22.

Business Finance - Azule

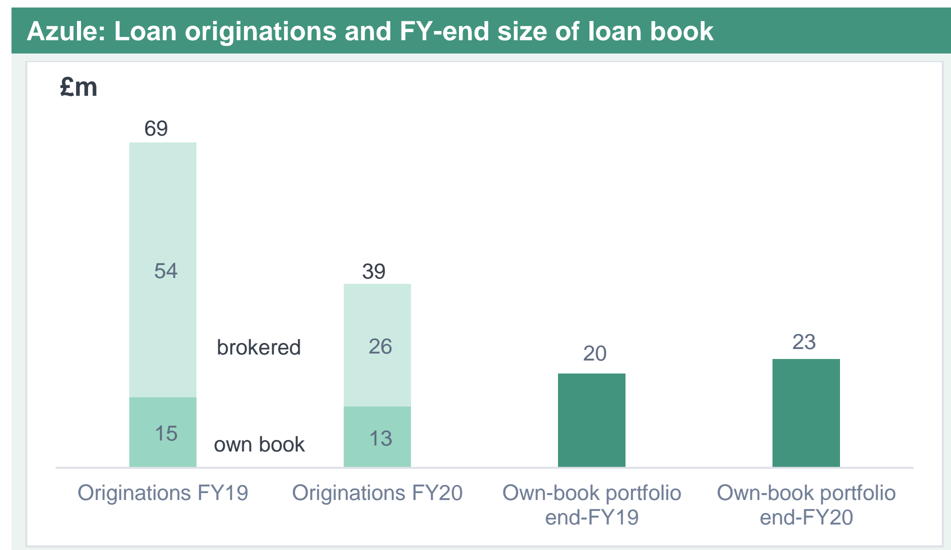
In Nov 18, PCF added to its business finance activities with the acquisition of Azule, which provides specialist asset finance for broadcast & media, sound, lighting and audio-visual equipment. Business is generated through direct end user relationships along with manufacturer, distributor and dealer introductions.

The acquisition provided PCF with the opportunity to diversify its lending book by both sector and geography (Azule operates in the UK and across most of continental Europe).

At the time of acquisition, Azule acted both as a lender and as a broker, placing loans with other lenders in consideration for an introductory commission. Part of the post-acquisition strategy was to selectively place a growing proportion of new business onto PCF's balance sheet, while still placing some of the book with other loan providers - for risk, pricing and concentration of exposure reasons.

The business had an excellent first year with PCF, writing over £69m of new business, its highest level of originations ever and up 26% year-on-year. £14m of this was placed on the PCF balance sheet, known as 'own-book' business. The average deal size was £45,000 with 76% of own- book originations coming from customers in PCFs top four credit grades. During FY19, Azule also generated £1m of fee income from the business it brokered, an increase of 33% year-on-year.

But, being heavily dependent on the TV, film, sports and live events sectors, Azule's business suffered a severe slowdown in FY20, with new originations totalling only £39m, down 43%. £13m of this was written to PCFs own-book with £26m brokered to other lenders.



Source: Company reports

PCF reports that activity levels did pick up in in September with some large studio productions back underway. It did however caution that a recovery to 2019 levels of activity was only likely in the spring of 2021.

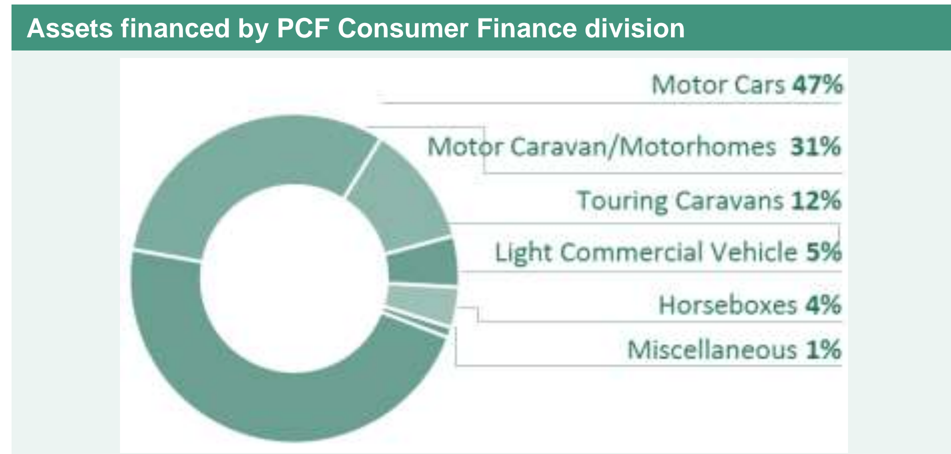
Longer-term, Azule's prospects still look attractive. Fast-growing streaming services such as Netflix and Amazon Prime are likely to resume demand for services and studio space across the UK. Netflix and Disney have made long-term commitments to the UK by signing leases for studios at Pinewood and Shepperton. The speed of recovery of the live entertainment market is more uncertain but as music festivals and artists' tours resume, so too will the demand for sound, lighting and audio-visual equipment.

A further growth market for Azule is the trend towards installing LED screens in retail space, public spaces, corporate offices and in education venues.

Consumer Finance

PCF's consumer finance division lends money to UK individuals to purchase used cars and leisure vehicles.

Assets financed by PCF Consumer Finance division



Source: Company

Lending terms for motor cars are up to five years. Terms for more specialist assets such as caravans, motorhomes and horseboxes can be up to ten years.

The Consumer Finance division has also been increasingly focused on prime customers in recent years which now make up 83% of the portfolio (FY19 66%, FY18 53%). Average transaction size in FY20 was £18,000, with the portfolio made up of over 12,700 individual agreements. Used vehicles tend to be good collateral against loans as they have already suffered much of their initial depreciation. Additionally, PCF does not offer a Personal Contract Purchase product which involves taking residual value risk as well as credit risk.

Like its Business Finance division, PCF sources most of its Consumer Finance business through brokers, but the underwriting process is more automated. This is necessary to compete effectively in the prime segment of the market. In 2019, PCF completed a project to improve and further automate its credit decision making processes, which involved working with a credit reference agency to develop a new scorecard modelled on over 320,000 recent PCF applications. This retrospective analysis of applications enabled the creation of a scorecard which reflects default risk more accurately and improves credit granting decision making.

The division has also been growing strongly in recent years and was far less affected by the Covid-19 pandemic when compared to the Business Finance division.

Originations grew 26% in FY20 to £92m (FY19 £73m). Particularly encouraging was the growth in originations in H2 (£49m) – which included a significant period of lockdown – over H1 (£43m). PCF reported an initial fall in demand at the start of lockdown in Mar and Apr 20.

In May, new business originations picked back up and increased again in June when dealerships re-opened. PCF also reported that the leisure market had a good summer in 2020 with the demand for motorhome finance, in particular, producing strong volumes.

Consumer Finance: Loan originations and FY-end size of loan book

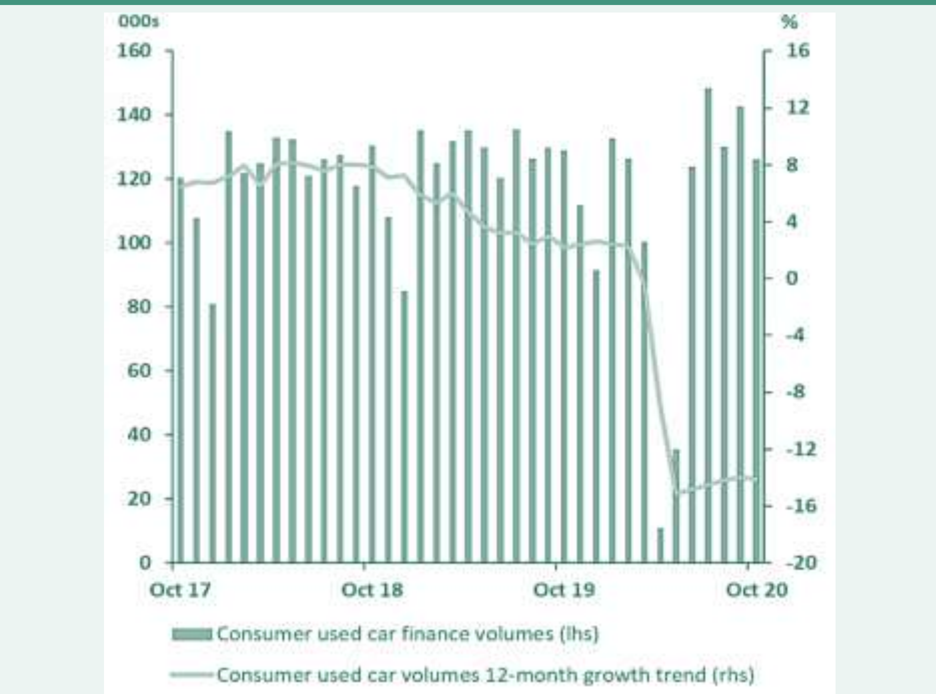
Source: Company reports

PCF's FY20 originations of £92m gives it a 0.5% share of the total £16.3bn UK consumer used-car finance market (market originations in the 12m to Sep 20 - cars bought on finance by consumers at the point of sale), as measured by the Finance and Leasing Association (FLA). Market originations fell 11% in the period from £18.3bn to £16.3bn.

In its area of the market, PCF's main competitors include Close Motor Finance, Barclays, Santander, MotoNovo Finance, Hitachi Capital, Oodle Finance and Blue Motor Finance.

Market statistics reflect a sharp fall and rapid recovery pattern: very much in line with PCF's commentary about its own experience of demand. PCF expects strong growth in originations in this market segment over the next few years.

FLA used car finance new business trends



Source: Finance and Leasing Association (FLA)

Property Bridging Finance

PCF's Property Bridging Finance division lends money (unregulated finance, not regulated mortgages) to UK-based property investors and developers. Funds are used to 'bridge' the period between when the property is first purchased and when it is sold or financed by traditional mortgages, for example: during a refurbishment and subsequent sale; a chain-break; or when properties are purchased at an auction for future re-sale. PCF clients are experienced property investors and can be sole traders, partnerships or limited companies.

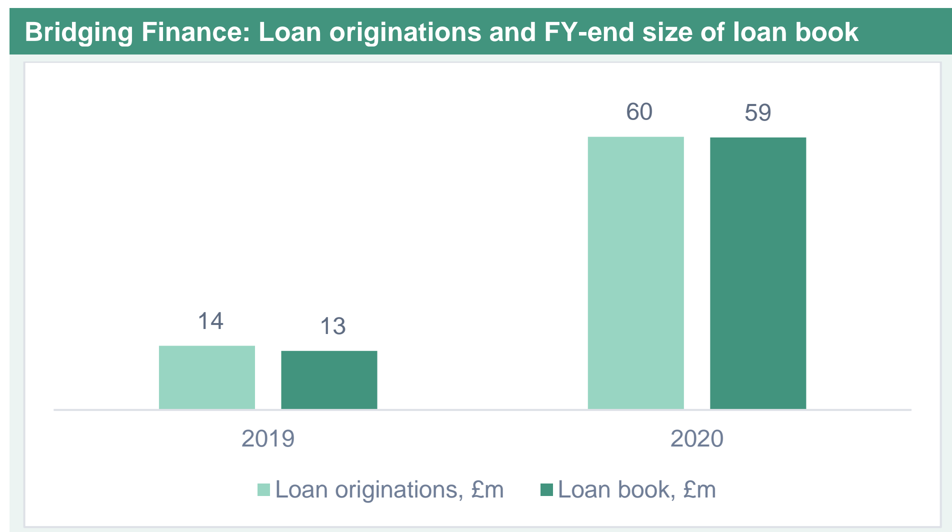
Lending terms are typically between six and eighteen months, the average deal size is approximately £600k, and security is by way of a first charge on the property. PCF applies a maximum loan to value of 75%, with the average loan to value being 60% in FY20.

The division was started in 2019 when PCF recruited a small team with a wealth of experience in this sector. Success in the bridging market holds a number of attractions that include: access to a new £4.3bn market[1]; diversification of the loan book because products have a shorter duration than PCF's existing businesses; and improved capital efficiency through a lower risk weighting (these loans require lower minimum regulatory capital levels than business or consumer loans).

The first two years of trading have been very successful. Originations and the overall portfolio have grown strongly and the impact from the Covid-19 pandemic has not been hugely significant. Originations in H2 20 (£42m) continued on their rapid upward trajectory (H1 20: £18m)

Moreover, PCF has benefited from a number of competitors withdrawing from this market due to liquidity issues.

Bridging Finance: Loan originations and FY-end size of loan book



Source: Company reports

PCF's main competitors in this market include Lendinvest, Octopus Bridging Loans, Together, United Trust Bank.

[1] EY: UK Bridging Market Study; April 2020

Management

PCF is still founder-led, and the two most senior individuals each have over 20 years' experience of managing an AIM-listed business. The key individuals are:

Scott Maybury, Chief Executive. Scott holds a degree in business studies and is a qualified accountant. He spent 6 years with BHP Billiton, Australia's largest multi-national corporation, and 5 years with McDonnell Douglas Bank. He is one of the founding directors of PCF Group plc and was previously Finance Director until October 2008.

He has been Chief Executive for the past 11 years, successfully steering PCF through the Global Financial Crisis before subsequently leading it through the banking licence application process and delivering its strategic plan as a bank.

Robert Murray, Managing Director. Robert holds the ACIB Banking Diploma and has over 40 years' banking and finance experience. He has extensive experience in lending to personal, corporate and International customers. He is also one of the founding directors of PCF Group plc.

Robert has spent his entire career in the financial services sector and has detailed knowledge of the business and, in particular, its lending activities, customers and introductory sources. He was instrumental in the acquisition of Azule in 2018 and the setting up of the bridging finance operation in 2019.

Nick Price, Interim Chief Financial Officer. Nick has a degree in Biochemistry and qualified as a chartered accountant with KPMG in 1990. He started his career in financial services with Goldman Sachs and worked in a number of senior finance roles in London and Asia. After spells at Deutsche Bank and Cantor Fitzgerald he joined UK merchant banking group Close Brothers in 2009 where he was Finance Director for the Commercial Division covering Asset and Invoice Finance. More recently he has completed interim CFO roles at OakNorth Bank and Raphaels Bank as well as being CFO for Independent Growth Finance (IGF), an independent asset-based lender.

The group is currently undertaking a search for a permanent CFO.

Shareholdings

The largest shareholder of PCF Group plc is Somers Limited (Somers), which owns 56.21% of the shares. Somers is a Bermuda Stock Exchange listed financial services investment holding company (www.somers.limited), with core investments in the banking, asset financing, and wealth management sectors. It was instrumental in supporting PCF in obtaining a banking license and has been a cornerstone in fund raising. It has also allowed itself to be diluted to improve share liquidity.

The next largest shareholders are Hof Hoorneman Bankiers (www.hofhoorneman.nl) with ~9% and Bermuda Commercial Bank Limited (www.bcb.bm with ~8.4%), the latter of which is owned by Somers, giving them a total beneficial interest of 64.61%

In total, management own around 1.6% of the group, with Scott Maybury (CEO) owning 0.7% and Robert Murray (MD) owning 0.4%. In addition, Scott Maybury owns share options over 1.0% of the equity and Murray 0.7%.

Strategy, outlook, and growth forecasts

As previously highlighted, PCF had set itself a shorter-term loan portfolio target of £750m by FY22 and a medium-term loan portfolio target of £1bn. It uses return on equity (RoE) as a primary profitability metric and had previously set itself **a target of 12.5% RoE.**

Prior to the Covid-19 pandemic, it was on track to meet its loan portfolio growth targets (possibly early), and it had already achieved its RoE target in FY19, which was 12.6% in that year.

The pandemic has obviously thwarted smooth progress towards these targets, but we don't believe the setback will be dramatic. We can see a path for PCF to achieve its £750m portfolio target by FY23 (one year later than originally forecast), and its £1bn target by either FY24 or FY25. We think RoE can recover quickly from the FY20 dip (2.5% statutory; 5.4% underlying - which removes the effect of the £1,75m Azule goodwill impairment) to its **previous target of 12.5% by FY23 and reach 15% in 4-5 years.**

These forecasts are based on successful execution of PCF's existing strategy. The primary growth strategy is to pursue organic growth, and to complement this with selectively targeted acquisitions. An additional overlay to this growth strategy (applicable to both organic and acquisitive growth) is to continue to diversify the lending portfolio (to reduce the correlations in impairments between different segments of the portfolio) and to diversify income streams (so growth is not overly dependent on one or two segments of the market).

The chances of successfully executing the organic growth strategy are **supported by PCF's structural advantage of being a bank.** While it competes with many non-bank lenders, these competitors are dependent on (relatively expensive) institutional debt for lending capital. Some have been severely weakened by the fallout from the pandemic and experienced liquidity problems. For them, access to capital might be difficult, or very expensive, going forward. **We expect PCF to gain market share.**

It is noteworthy that PCF is not alone in recognising and taking action to exploit this structural advantage, and others have subsequently followed a similar route. In 2020, Zopa (which offers personal loans), and DF Capital (which offers SME loans) are notable players to have obtained banking licences, having previously operated as non-bank lenders. We do not however expect a flood of non-bank lenders to apply for banking licences, as the barriers to entry are high.

Our outlook for each business unit is as follows:

We expect the Business Finance division to experience depressed demand for loans from SMEs in FY21, due to generally weak economic conditions (as a result of damage caused by the pandemic and the new post-Brexit trading environment), and because many SMEs have already increased their leverage substantially by taking on government-backed Corona Virus Business Interruption Scheme (CBILS) loans and Bounce Back Scheme loans. In 2021, SMEs will also be starting to feel the impact of the additional cash flow strain from these loans as initial 12m payment holidays come to an end. **We expect originations to grow 10-15% in FY21 (off a lower base – originations fell by 34% in FY20), and to recover more rapidly in FY22.**

The Consumer Finance division has stronger prospects in the shorter term, as the used car market does not appear to be too badly affected by the consequences of Covid-19. PCF's more automated procedures should serve it well to continue to grow the prime segment of its portfolio. Also, as economic conditions recover, PCF may start to grow the near-prime segment too. It has deep experience of this market segment but has pulled back from it recently because of the potential impact of a poor economic environment. **We expect new originations to grow by 20-30% over the next few years.**

In the Bridging Finance division (which is essentially an early-stage business), we see rapid growth continuing. While there may be short term headwinds in the property market, PCFs fortunes are more dependent on taking market share from competitors, and some competitors have struggled through the crisis (some, for example Together Financial, temporarily stopped lending altogether).

This has provided PCF with an opportunity to fill the void, do business with new brokers and intermediaries, and establish an even firmer footing for future growth. **We expect growth in originations to be in the order of 40-50% in the next two years.**

The speed of recovery in demand for Azule is uncertain, and we expect demand in FY21 to be weak. However, in FY22 and beyond, **we expect this to recover and for PCF to be placing a much higher proportion of new loans onto its own balance sheet.** This should result in originations growing by 30-40% on average in the next 3-4 years.

Another important consideration with regards to estimates is that **PCF has £69m of 'future earnings' already on its balance sheet which has not yet run through the income statement.** This arises from loans originated in prior years, with repayments extending for a few years into the future, for which the interest income has not yet been accounted for.

In addition to the above organic growth outlook, we wouldn't be surprised if **attractive acquisition opportunities present themselves in the next few years**. We have already pointed out that some non-bank lenders might struggle going forward. With access to relatively cheap capital, PCF might be in a position to exploit some of these opportunities and **accelerate growth beyond expectations through acquisitions.**

We would also expect PCF to demonstrate further operational leverage as it grows, spreads overhead costs over a larger loan portfolio and as further technology enhancements are made. It has announced an operational review to drive efficiency through automation and has also recruited a Chief Operating Officer (to start in January 2021). Its cost to income ratio has dropped steadily in recent years (from 59.3% in FY17 to 55.6% in FY20) and we expect it to drop below 50% by FY23 and to 45% longer-term.

Fundamental to the market strategy of any bank though is its underpinning by a sound capital management strategy. And PCFs capital management strategy going forward looks robust.

Its cheapest form of capital at the moment is the BoE Term Funding Scheme. PCF currently has £63m borrowed through this facility which it estimates will increase to £90m in FY21. These are four-year loans, so if the TFS remains as is, this source of capital will start reducing in FY24 and reduce to zero in FY25.

As it grows, PCF is likely to continue to take in more retail deposits as its next cheapest source of capital. Demand from consumers remains strong and we do not see this changing in the near-term. PCF could also open up its deposits to businesses if necessary.

Wholesale bank debt is unlikely to be a significant source of capital for PCF in the next few years, because of its high cost. However, there may be opportunities to use securitisation structures as a source of capital going forward (probably when TFS loans start to be repaid). These would involve packaging portfolios of PCF's loan book into financial instruments and selling them to investors.

Based on the above strategic outlook, we have compiled a five-year financial forecast which is summarised in the table below. This forms the basis of our fundamental valuation which is discussed in the next section.

Financials

5 years forecast						
Y/e 30 Sep	**2020 A**	**2021 E**	**2022 E**	**2023 E**	**2024 E**	**2025 E**
Loan originations, £m	270	330	446	536	590	649
Loan portfolio, £m	434	553	711	906	1,089	1,268
Net interest income, £m	26.6	30.4	34.5	42.6	53.2	62.1
Net interest margin	6.9%	6.2%	5.5%	5.3%	5.3%	5.3%
Operating income, £m	26.5	30.3	34.3	41.7	51.8	60.4
Op. expenses, £m (incl. impairments)	22.6	23.6	24.8	29.6	35.2	41.0
Cost to income ratio	55.6%	56.0%	52.9%	49.7%	46.6%	46.1%
Impairment charge	2.0%	1.3%	1.0%	1.0%	1.0%	1.0%
Operating margin	14.6%	22.3%	27.6%	29.0%	32.1%	32.2%
Profit before tax, £m	2.1	6.8	9.4	12.1	16.6	19.4
Profit after tax, £m	1.5	5.5	7.7	9.8	13.5	15.7
EPS basic & diluted, p	0.6	2.2	3.1	3.9	5.4	6.3
Assets, £m (mostly loans to customers & cash)	479	583	730	929	1,102	1,276
Liabilities, £m (deposits, TFS loans, bank debt, securitisation)	419	518	659	849	1,010	1,171
Net assets, £m	59	65	72	80	92	106
CET1 Capital Ratio	17.7%	15.2%	13.1%	11.5%	10.9%	10.7%
RoE after tax	6.1%	2.5%	8.8%	11.2%	12.9%	15.6%
Price Earnings Ratio	16.4	41.3	11.0	7.8	6.1	4.5
Price to Book Ratio	1.0	1.0	0.9	0.8	0.7	0.7

Source: Company Historic Data, ED estimates. PE & Price to Book ratio based on share price of 24p.

Valuation: Fundamental and peer-comparison

PCF's strategy is to target a period of high growth over the next five years (as per the table above), with the loan book forecast to grow to £1.2bn by FY25 (CAGR 20% - 25%). Growth is likely to slow after that period as the business matures. For our valuation, we have split our forecast into three distinct periods:

- An initial 5-year high growth period as above;
- A 'medium growth' period in years 5-10 where the loan portfolio grows at around 10% per annum and where PCF reaches its key target metrics – NIM 5.25%, Cost to Income ratio 46%, Cost of Risk 1%; and
- An ongoing period of steady growth thereafter, assumed to be 2.5% per annum, slightly higher than long term average UK GDP growth.

Because of this growth profile, we believe the most comprehensive method of valuing PCF is to calculate the present value of the forecast future free cash flows to equity holders (taking into account the regulatory capital demands of growth), by discounting them at the cost of equity. While banks are commonly valued using the Gordon Growth Model (which assumes a future series of dividends growing at a constant rate in perpetuity), because of PCF's forecast growth profile, we don't believe it is the best method in this case.

Our methodology involves:

- forecasting the future risk-weighted-assets (RWA) of PCF based on the above growth profile;
- applying minimum regulatory CET1 ratios to RWA to obtain minimum core equity levels;
- forecasting the actual core equity levels based on the starting core equity level and adding forecast net income;
- calculating the difference between actual core equity and minimum core equity to give free cash flow available to equity holders (which could also be thought of as surplus capital or the amount that COULD be used to pay dividends; or the additional capital required to fund the regulatory demands of growth when actual core equity falls below minimum core equity);
- calculating a terminal value following year ten (assuming 2.5% growth);
- discounting the above free cash flows at the cost of equity which we have calculated to be 9%, based on a risk-free rate of 0.3%, an equity market risk premium of 5.5%, and a beta of 1.65.

Core value of 45p / share

This methodology produces a per share fundamental value of 45p, substantially above the current share price of 24p, and around 20% higher than the late-2019 share price level of 37p.

We think it is worth comparing this valuation to a multiple-based valuation assuming PCF does recover as forecast**.** Based on FY21 PBT estimates of £6.8m and a 3-year banking sector PE of 14, the valuation is 37p.

We have also considered PCF's market valuation on a relative basis to peers. For two reasons though, there are relatively limited insights to be gleaned from this.

Firstly, the number of directly comparable publicly listed peers is extremely limited. Most companies which compete in PCFs market or in adjacent markets are non-bank lenders and therefore have a different risk profile and capital structure. Mortgage-focused banks such as OSB Group (OneSavings Bank) and Paragon Banking Group also make poor comparators because their large-portfolio low-NIM model is very different to PCF.

Secondly, most of these companies have a 31-Dec year-end and we are unable to compare the impact of events in 2020 on their financial results to the experience of PCF. For example, comparing the pre-Covid RoEs of peers to the most recent results of PCF is virtually meaningless.

What we are able to determine, though, is that **despite its heavy share-price fall in 2020, PCF does appear to enjoy a small valuation premium compared to small-cap peers**. This is shown in the table below. Data is at 30 Nov 2020, so company financial results do not include the impact of the pandemic (with the exception of some impact on 1pm with a 31 May year-end). In our opinion, this premium is fully justified, and probably too small a premium, given PCFs growth prospects, lower risk profile (particularly its prime-focused book and lower cost of capital compared to non-bank lenders), and its profitability.

Notably, four of the eight companies were making losses pre-pandemic, indicative of how impressive PCFs performance in 2020 has been.

Peer Comparison

Name	Financial year-end	Type	Market cap, £m	Share price 1 Jan 20 - 30 Nov 20	PE Ratio	Price to Book
PCF Group	***30-Sep***	***Bank***	***66***	***-24%***	***9.8***	***1.1***
Funding Circle	31-Dec	Non-bank	306	-1%	loss	1.0
S&U	31-Jan	Non-bank	221	-14%	7.6	1.2
Metro Bank	31-Dec	Bank	202	-43%	loss	0.1
Secure Trust Bank	31-Dec	Bank	173	-42%	5.5	0.7
Distribution Finance	31-Dec	Non-bank	54	-44%	loss	1.2
1pm	31-May	Non-bank	21	-33%	13.2	0.4
GLI Finance	31-Dec	Non-bank	7	-51%	loss	0.2
Median				**-37%**	**8.7**	**0.8**

Source: ADFVN. Company reports. All data as at 30 Nov 2020.

The above comparator list is however set to grow with the November 2020 announcement that City of London Group subsidiary, **Recognise**, has been granted a banking license.

What we believe is a more useful perspective for investors is to compare PCFs current valuation metrics to banking sector averages over the last few years. While many larger banks' operations differ significantly from PCF, this does give an indication of the valuation metrics investors are likely to assign over a longer timeframe.

Bearing in mind that most of the banks in this group are mature, low-growth businesses (unlike PCF with stronger growth prospects), **we would expect, over time, for PCF's FY21 PE ratio to move from its current 11x to well beyond the pre-pandemic banking sector median of 14-15x and towards its previous level of 20x. This, coupled with a potential strong recovery in profits, would result in a multiple-based valuation being aligned with our fundamental valuation.**

Looking at banking PERs:

Banks' PE ratios over time

Name	2017	2018	2019
PCF	**19.0**	**19.5**	**10.0**
AIB	13.8	9.4	25.8
Barclays	58.1	16.0	12.6
Bank of Ireland	12.1	8.4	13.5
Banco Santander	13.7	8.8	10.3
HSBC	21.3	13.1	26.0
Permanent TSB	35.2	N/A	26.3
Lloyds	15.4	9.4	17.9
Natwest	3.2	1.5	0.8
Standard Chartered	44.1	41.7	16.5
Secure Trust	16.6	7.8	9.5
Median in each year	**16.6**	**9.4**	**13.5**
3-year median		**13.8**	
3-year average		**17.4**	

Source: London Stock Exchange. Company reports.

Therefore, in relation to our fundamental valuation and in relation to longer-term average valuation multiples for banks, PCF is undervalued at its current per share price of 24p. If the recovery in its results starts to materialise as forecast, we see significant upside for the share price on a rerating.

Capital structure

As described above, an important point to bear in mind when it comes to valuing banks (and forecasting metrics such as return on equity), is that banks need to maintain a minimum level of shareholders' equity as a proportion of risk-weighted-assets, meaning that as the loan portfolio grows, there is a need for additional equity. As already shown, PCF has a substantial buffer above minimum equity levels (Actual FY20 CET1 ratio of 17.7% versus a regulatory minimum of 9.0%).

While this does provide room for growth, it should be noted that the high growth years of FY21-FY23 produce a negative free cash flow to equity holders i.e. the additional regulatory capital requirements of growth exceeds net income in these years. This is very common in medium to high growth banks. Therefore, in those years, CET1 ratios will decline more rapidly (as shown in the 5-year forecast above), or more likely, an equity raise will take place.

PCF management have shown a tendency to be conservative when it comes to minimum equity levels (correctly in our view). For example, it last raised £10.5m in 2017 which boosted its CET1 ratio at the end of that financial year to 26% (pre-raise CET1 ratio approximately 18%). Given its growth prospects, and using the current sources of capital, we would therefore probably expect that the next equity capital raise would be conducted in FY22, even though the CET1 ratio will still be well ahead of regulatory minimums at that time.

However, the opportunity for PCF to take an alternative approach to raising new common equity is a possibility. We think that PCF might pursue an 'off balance structure' such as securitising part of its loan portfolio as an alternative to raising additional shareholders equity. This would have the effect of removing the need for an equity raise in the short term, foregoing the net interest income associated with this portion of the portfolio (over the average term of the loan, say 4-5 years), but adding some fee income from this structure (as PCF would effectively be servicing a portfolio directly on behalf of investors) which would be earned over a shorter duration, if not upfront.

It is our understanding that these ‘capital-lite’ funding structures for banks, particularly for relatively high-yielding vanilla products such as motor car loans, are available in capital markets today at economic terms. They can be attractive investments to institutions such as pension funds, insurance companies, asset managers, hedge funds and some banks, and may be more attractive to PCF shareholders when compared to being diluted via an equity raise.

Because it is not clear which route PCF will take, we have not made assumptions about an equity raise (quantum, timing and pricing) or a capital-lite structure. Also, because PCF would still be above regulatory capital minimums in our models, we have left the current equity structure ‘as is’ for the duration of our five-year forecast. When it becomes clearer whether an equity raise or capital-lite structure will be pursued, we will update our forecasts and valuation accordingly, which will then also have more accurate assumptions around the terms of the selected transaction.

Investment case

In summary, investors in PCF will be backing:

- a fast-growing lender, with very small market shares in its target markets, which enjoys a structural advantage over many of its competitors, and has attractive organic and acquisitive growth prospects;
- which is conservatively run when it comes to loan-portfolio management, with a heavy focus on prime-customers and solid loan-security;
- with ample access to relatively cheap capital to fuel growth;
- that should be able to benefit from operational leverage as its portfolio grows and further technology enhancements are rolled out;
- has a strong management team with over 20 years of experience in the business, extending over several credit cycles;
- and appears undervalued, following a large share price drop in 2020.

Appendix – Historical and forecast financials

Consolidated Income Statement					
12 months to end Sep, £'000s	**2018A**	**2019A**	**2020A**	**2021E**	**2022E**
Interest and similar revenue	25,495	34,499	42,344	48,682	57,765
Interest and similar expense	(10,493)	(12,884)	(15,713)	(18,321)	(23,223)
Net interest Income	**15,002**	**21,615**	**26,631**	**30,362**	**34,542**
Fee and commission income	492	1,815	1,470	1,696	1,969
Fee and commission expense	(844)	(1,154)	(1,594)	(1,726)	(2,231)
Net fee and commission Income/(expense)	**(352)**	**661**	**(124)**	**(30)**	**(262)**
Net loss on financial instruments at fair value	-	(63)	(44)	-	-
Net operating income	**14,650**	**22,213**	**26,463**	**30,331**	**34,280**
Personnel expenses	(5,186)	(7,640)	(8,633)	(10,061)	(10,693)
Depreciation of office equipment, fixtures, fittings and vehicles	(84)	(137)	(685)	(273)	(353)
Amortisation of intangible assets	(385)	(416)	(550)	(654)	(832)
Other operating expenses	(2,907)	(3,827)	(4,933)	(6,003)	(6,384)
Impairment loss on financial instruments	(915)	(2,175)	(7,805)	(6,575)	(6,570)
Total operating expenses	**(9,477)**	**(14,195)**	**(22,605)**	**(23,566)**	**(24,834)**
Impairment loss on goodwill			(1,750)		
Profit before tax	**5,173**	**8,018**	**2,108**	**6,765**	**9,446**
Income tax charge	(981)	(1,624)	(655)	(1,285)	(1,795)
Profit after tax	**4,192**	**6,394**	**1,453**	**5,480**	**7,651**
EPS, basic and diluted	2.0	2.7	0.6	2.2	3.1
Fair value (loss)/gain on AFS financial instruments	18	-	-	-	-
Fair value loss on FVOI financial instruments	-	(10)	-	-	-
Deferred tax income/(expense)	(3)	2	-	-	-
Total comprehensive income, net of tax	**4,207**	**6,386**	**1,453**	**5,480**	**7,651**

Source: Company Historic Data, ED estimates

Consolidated Balance Sheet					
As at end Sep, £'000s	**2018A**	**2019A**	**2020A**	**2021E**	**2022E**
Assets					
Cash and balances at central banks	21,338	7,371	24,731	9,829	(416)
Debt instruments at FVOCI	39,902	19,638	9,095	9,095	9,095
Loans and advances to customers	219,322	338,503	433,694	552,854	710,599
Office equipment, fixtures, fittings and motor vehicles	224	579	2,605	2,832	2,979
Deferred tax assets	1,185	1,105	1,494	1,494	1,494
Other assets	1,542	4,932	2,794	2,794	2,794
Goodwill and other intangible assets	2,957	5,941	4,260	4,106	3,773
Total assets	**286,470**	**378,069**	**478,673**	**583,004**	**730,319**
Liabilities					
Due to banks	48,881	44,412	62,620	92,620	92,620
Due to customers	191,139	267,070	342,046	410,000	550,000
Subordinated debt	-	-	7,126	7,126	7,126
Derivative financial instruments	-	63	80	80	80
Current tax liabilities	414	1,521	388	1,285	1,795
Other liabilities	3,485	6,248	7,047	7,047	7,047
Total liabilities	**243,919**	**319,314**	**419,307**	**518,158**	**658,668**
Equity					
Issued capital	10,611	12,510	12,510	12,510	12,510
Share premium	8,527	17,619	17,619	17,619	17,619
Other reserves	15	7	48	48	48
Own shares	(355)	(355)	(355)	(355)	(355)
Retained earnings	23,753	28,974	29,544	35,024	41,830
Total equity	**42,551**	**58,755**	**59,366**	**64,846**	**71,652**
Total equity and liabilities	**286,470**	**378,069**	**478,673**	**583,004**	**730,319**

Source: Company Historic Data, ED estimates

Consolidated Statement of Cash Flows

12 months to end Mar, £'000s	2018A	2019A	2020E	2021E	2022E
Operating activities					
Profit before tax	**5,173**	**8,018**	**2,108**	**6,765**	**9,446**
Other non-cash items included in profit / (loss) before tax					
Depreciation of PPE	84	137	685	273	353
Amortisation of other intangible assets	385	416	550	654	832
Impairment loss on goodwill			1,750	-	-
Net change in FVOCI fin instruments	15	(8)	(7)	-	-
Share based payments	34	79	117	-	-
Impairment losses on financial assets	915	2,175	7,805	6,575	6,570
Income tax (paid) / due	(668)	(633)	(1,788)	(655)	(1,285)
Adjustment for change in op assets					
Net change in loans and advances	(74,519)	(106,348)	(102,996)	(125,735)	(164,316)
Net change in other assets	(502)	(2,231)	1,749	-	-
Change in operating liabilities	-	-	-	-	-
Net change in derivative fin instruments	-	63	-	-	-
Net change in amts due to customers	138,019	75,931	74,976	67,954	140,000
Net change in other liabilities	31	(1,492)	799	267	-
Net cash flows from / (used in) operating activities	**68,967**	**(23,893)**	**(14,252)**	**(43,902)**	**(8,399)**
Investing activities					
Cash paid for investment in subsidiary	-	(2,283)	-	-	-
Proceeds from financial instruments	(35,390)	-	-	-	-
Net sale of debt instruments at FVOCI	-	20,264	10,543	-	-
Purchase of office equipment, fixtures, fittings and motor vehicles	(36)	(384)	(2,711)	(500)	(500)
Purchase of intangible assets	(637)	(900)	(619)	(500)	(500)
Net change in derivative financial instruments			17	-	-
Net cash flows from / (used in) investing activities	**(36,063)**	**16,697**	**7,230**	**(1,000)**	**(1,000)**
Financing activities					
Proceeds from share issue	3	10,991	-	-	-
Purchase of own shares	-	-	-	-	-
Proceeds from subordinated debt loans	-	-	7,126	-	-
Net proceeds from borrowings	1,006	(17,012)	18,208	30,000	-
Repayments of borrowings	(29,190)	-	-	-	-
Dividends paid to equity holders	(403)	(750)	(993)	-	(846)
Changes to other reserve			41,000		
Net cash flows from / (used in) financing activities	**(28,584)**	**(6,771)**	**24,382**	**30,000**	**(846)**
Net incr/(decr) in cash & equivalents	**4,320**	**(13,967)**	**17,360**	**(14,902)**	**(10,245)**
Cash and equivalents b/f	17,018	21,338	7,371	24,731	9,829
Cash and equivalents c/f	**21,338**	**7,371**	**24,731**	**9,829**	**(416)**

Source: Company Historic Data, ED estimates
NOTE: 2020 based on ED estimates – full cash flow statement not provided in preliminary results

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