PANMURE GORDON & CO

Founded 1876

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Equity Research

BUY

Target Price: 38p

Share Price: 27p

Key Data

Market Cap	£46m
DS Total UK Market	5,398
Sector	General Financial
Stock Codes	PCF.L / PCF LN
Next Event	9 June 2017
Gearing	418%

Last Published Research: 8 December 2016

Absolute & Relative Performance

— *Absolute*

— *Relative to DS Total UK Market*

Source *Datastream*

This is a marketing communication

Private and Commercial Finance

Licenced to Grow

PCFG is embarking on an exciting journey as a bank which we believe is transformational, providing the group access to a wider part of the asset finance market, entry to which is currently restricted due to its higher cost of funding. We forecast an acceleration of growth higher up the credit spectrum which constitutes c80% of the broker business which PCFG cannot currently access. We estimate that PCFG may look to raise c£10m of equity this year to operate as a bank and fund growth which we have factored into our forecasts. We maintain our TP of 38p, implying a 2017E P/B of 2.1 which we think is fair for a bank in its infancy and in the medium term targeting RoE of 17.5% and loan growth of 35% CAGR.

- **Banking licence will be transformational** – Achieving the banking licence on 6th December 2016 meant that PCFG can diversify its funding and tap into the £700bn savings market, thereby significantly reducing its funding costs and enabling PCFG to lend to higher credit grade customers. With deposits costing c200bp we forecast PCFG's cost of funding to fall from 5.6% to 3.9% by FY2019E with deposits accounting for c70% of total funding.
- **Moving up to super prime** – The lower cost of funding will transform PCFG's proposition to its clients. While super prime yields are lower, the risk of default is greatly reduced which, along with strong portfolio growth, will result in higher RoE and even better quality earnings. Cheaper financing will also improve customer retention, enabling the group to increase further the number of customers that return to PCFG for finance. New Asset Finance lending in the UK topped £30bn in FY2016 and while PCFG's market share is only 0.23%, its new business grew at twice the rate of the market. Therefore, the opportunity will significantly increase for PCFG.
- **Possible raise of £10m of new capital** – Management are targeting £350m balances in FY2020E, a CAGR of 35%. To fund this growth and maintain adequate capital ratios to operate as a bank, we estimate that a £10m equity injection may be required to satisfy the regulators and provide buffers. Therefore, including a £10m capital raise, we forecast FY2017E CET1 ratio of 24.2% reducing to 16.5% in FY2020E.
- **Valuation** – Our TP of 38p is based on a 10% sector premium given the outstanding growth prospects in prime lending following the obtaining of a banking licence, coupled with the low risk secured lending proposition with a 23 year track record.

Year End	Revenue	Adj PBT	Adj EPS	P/E	DPS	Yield
Sep	£m		p	x	p	%
2016A	55.8	4.1	1.9 from: 1.8	14.4	0.1	0.4
2017E	64.3	4.3	1.8 from: 1.7	15.2	0.3	1.1
2018E	83.7	5.1	1.9 from: 2.2	14.2	0.4	1.5
2019E	103.5	8.0	3.0	9.1	0.5	1.9

Source Company Data, Panmure Gordon

INVESTMENT CASE

We believe achieving the banking licence will transform PCFG's business and create significantly more opportunities to participate in markets that PCFG cannot currently access due to the group's high cost of wholesale funding. Obtaining a banking licence means that the group can diversify its funding base to a much cheaper source, with interest costs continuing to fall following the availability of even cheaper (25bp) BoE funding for the larger banks which has significantly relieved the competition for deposits since the Eurozone crisis. We estimate that PCFG will need to raise c£10m to satisfy the capital requirements and support its loan growth aspirations of £350m by FY2020, a CAGR of 30%.

BANKING LICENCE WILL BE TRANSFORMATIONAL

On the 6th of December 2016 PCFG was granted approval for a banking licence, marking a major milestone on a journey that started in 2013. Long term guidance remains unchanged and the company aims to start taking deposits in the summer of 2017. The approval of a banking licence and subsequent initiation of a banking operation will not only facilitate balance sheet growth but also improve returns to shareholders via lower funding costs and operational gearing. Additionally, it will lower balance sheet risk by reducing the group's reliance on wholesale funding. By decreasing the cost of funding, the group can service higher credit quality customers. This increases the addressable market substantially.

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The table below summarises management's guidance for the banking operation over the next 3yrs and 5yrs respectively. PCFG intends to commence the retail banking business in the summer of 2017, offering a range of standard deposit accounts to UK customers.

Management Objectives for banking business

	FY2016	FY2020	FY2022
Net Loan Book	£122m	£350m	£750m
Retail Deposits	£0m	£250m	£500m
Return on Equity	*13.08%.*	*12.50%*	*17.50%*
Pre-tax Return on Average Assets	*3.10%*	*2.50%*	*3.50%*

Source *Company, Panmure Gordon*

Cost of funds set to fall

Over the next 5 years the company will move towards utilising retail deposits as the main source of funds. Management estimate that the company's overall cost of funds will be reduced by at least 200bps. Based on the trend in deposit costs we think the saving on funding costs could be even greater.

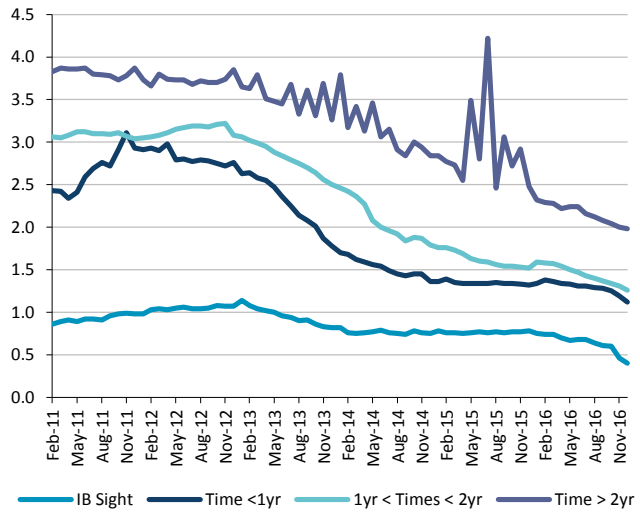
The UK Challenger banks are mostly deposit funded and have found it fairly easy to tap into the £700bn savings deposits outstanding to UK households. The company expects to target "UK domiciled middle to older age savers" with an estimated average savings deposits of £40k.

The savings market is highly commoditised due to the deposit protection scheme, so we do not believe that the company will have any difficulty raising deposits (especially as it is a UK domiciled business with a 23 year track record). In our view the main sensitivity is the pricing.

The charts below show that the cost of deposits has significantly fallen especially since the Bank of England introduced the Funding for Lending Scheme (FLS) in 2012 which helped to relieve pressure on deposit and wholesale funding costs at the height of the

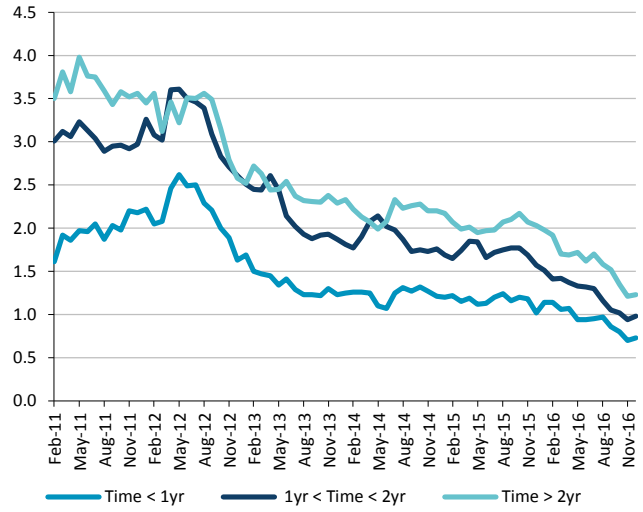
Eurozone crisis. In addition, with the large UK banks continuing to shrink their balance sheets, the cost of deposits continues to trend downwards.

UK Household Deposit Rates on Existing stock



Source Bank of England

UK Household Deposit Rates on New Business



Source Bank of England

However, new entrants to the market have had to offer enticing rates as competition, especially among the new banks has intensified. The table below shows the current best rates that are being paid on 1,3 and 4 year term deposits. If we assume that the company initially targets this duration of the savings market then the most they would have to pay is 1.75%. Therefore, the 250bp base case cost of deposits that management is using to plan its future business mix is very achievable.

1,3,4 year deposit rates Best Buy Tables

1 Year Fixed Rates			
Atom Bank	1.50%	1 Year Bond	£50
blme	1.50% expected rate See Details...	18 Month Bond	£25000
blme	1.45% expected rate See Details...	1 Year Bond	£25000
masthaven	1.42%	18 Month Bond	£500
Al Rayan Bank	1.41% expected rate See Details...	18 Month Bond	£1000
Harrods Bank Limited	1.40%	18 Month Bond	£20000
Charter Savings Bank	1.38%	1 Year Bond	£1000
IKANO Bank	1.35%	1 Year Bond	£1000
Milestone	1.32% expected rate See Details...	1 Year Bond	£10000
RCI Bank	1.31%	1 Year Bond	£1000

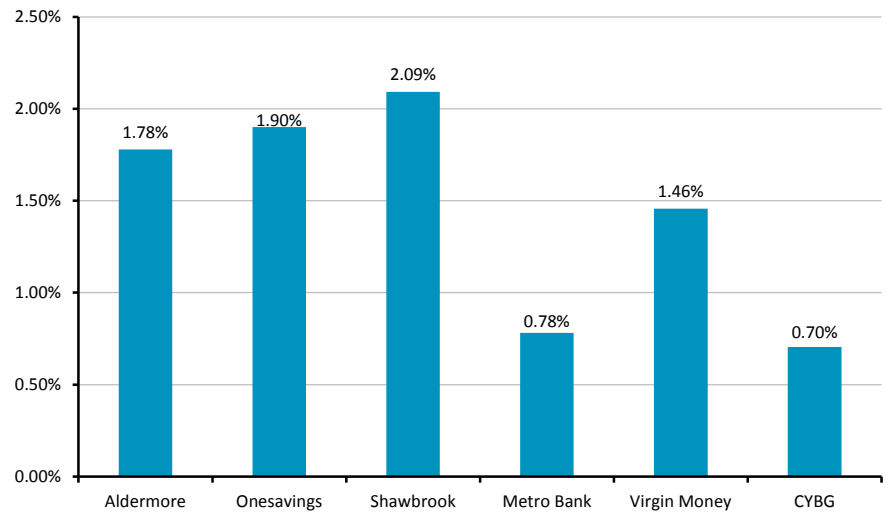
3 Year Fixed Rates			
Atom Bank	1.75%	3 Year Bond	£50
IKANO Bank	1.75%	3 Year Bond	£1000
blme	1.75% expected rate See Details...	3 Year Bond	£25000
masthaven	1.70%	3 Year Bond	£500
Union Bank of India (UK) Ltd	1.70%	3 Year Bond	£1000
RCI Bank	1.70%	3 Year Bond	£1000
Wesleyan Bank	1.67%	3 Year Bond	£1000
Charter Savings Bank	1.66%	3 Year Bond	£1000
Aldermore	1.65%	3 Year Bond	£1000
OakNorth Bank	1.62%	36 Month Bond	£1000

4 Year & Over Fixed Rates			
blme	2.25% expected rate See Details...	5 Year Bond	£25000
Secure Trust Bank	2.06%	10.03.22	£1000
Atom Bank	2.05%	5 Year Bond	£50
IKANO Bank	2.05%	5 Year Bond	£1000
paragon bank	2.05%	5 Year Bond	£1000
Vanquis Bank Savings	2.05%	5 Year Bond	£1000
Charter Savings Bank	2.01%	5 Year Bond	£1000
Skipton Building Society	2.00%	5 Year Bond	£500
Aldermore	2.00%	5 Year Bond	£1000
Milestone	2.00% expected rate See Details...	5 Year Bond	£10000

Source Moneyfacts

As a reference, the table below shows the implied cost of deposits for the listed challenger banks (Aldermore, Clydesdale, Metro, One Savings, Shawbrook and Virgin Money). All the banks have managed to gather deposits at much lower rates than the 250bp guided by management. Metro Bank and CYBG's cost of deposits is low as these banks have a branch network and are able to attract personal current accounts (PCA) and business current accounts (BCA) that are virtually a free source of funding.

Estimated Cost of Deposits for UK Challenger banks



Source *Company, Panmure Gordon*

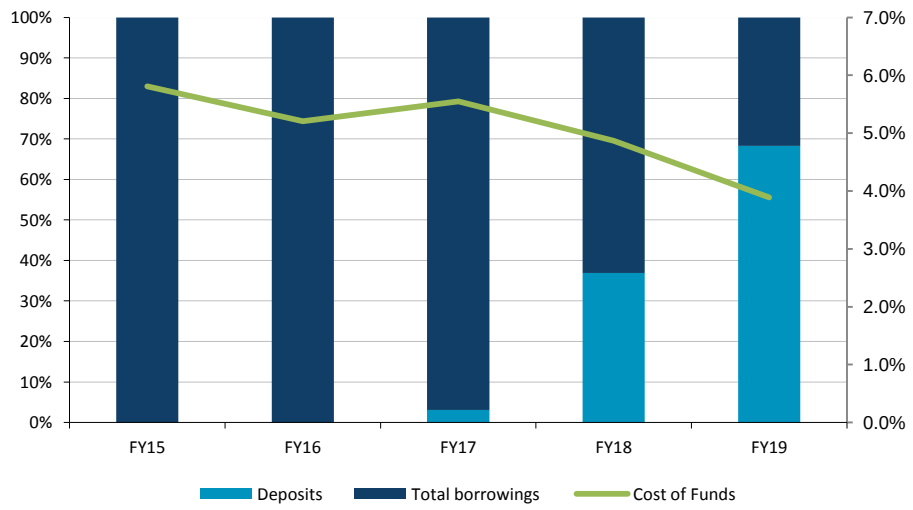
Change in funding mix

The cost of the deposits is expected to be c200bps and that additional overheads will cost 100-150bps. This implies greater than 200bps of saved costs on current all in costs of c5.6%.

Currently, PCFG pays an "all-in" rate of c5.6% on its wholesale funding facilities. The company has guided that they expect the cost of the deposits to be c200bps and that additional overheads will cost 100-150bps. This implies greater than 200bps of savings.

Given that deposit gathering will begin in the summer of 2017 with the group targeting £250m of deposits by the end of three years, we forecast a token amount in FY2017E rising to c£180m by FY2019E and assume a flat cost of 2.5%. As deposits replace wholesale funding, the average cost of funds falls from 5.5% in FY2017 to 3.9% in FY2019.

Estimated Mix and Cost of Funding



Source *Company Data, Panmure Gordon*

Balance sheet risk reduced

The group should also be able to access to the cheap BoE funding via the Term Funding Scheme (TFS) introduced in August 2016 in return for loans and other eligible collateral. Reduced cost is not the only benefit, as diversification of funding sources removes the company's reliance on wholesale funding.

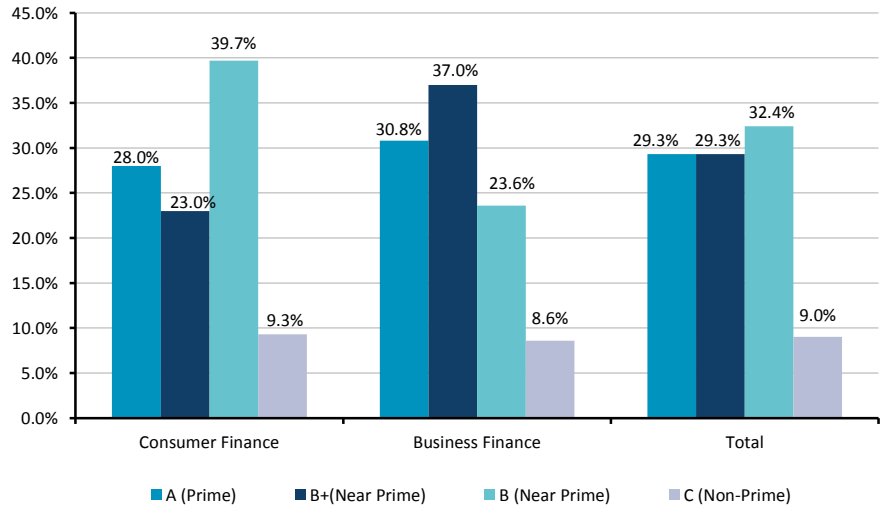
MOVING UP TO SUPER PRIME

We believe that the lower cost of funding will transform the business proposition offered by PCFG to its clients. Some of the key benefits are:

- **Improve profitability on its existing portfolio** – The company will continue to lend to the current range at the prevailing rates but the lower financing costs will improve the margins on these products.
- **Retain existing customers** who would otherwise be lost as their credit quality improves and are looking for better rates.
- **Move up the credit chain** – Increase the group's capacity to offer a wider range of prime financing solutions for individuals and small businesses.

While the majority of the lending is to prime and near prime (only 9% to non-prime), given the potential for the economic environment to deteriorate following Brexit and with current credit quality being very benign, management feel that taking on additional risk is not attractive. Therefore, although the net interest margin may trend downwards, this should be offset by lower credit costs, leading to sustained margin whilst reducing the risk profile.

Credit Grade Distribution



Source *Company Data, Panmure Gordon*

Consequently, PCFG is moving into super prime and expanding its credit rating bands from four shown above to eight below. The group has not previously been able to target the AAA and AA segments and the lower cost of funding will enable it to participate in a larger though more competitive market. Given that the credit spectrum is expanded into both consumer and business finance, we forecast broadly similar rates of lending growth for both the segments.

Competitors based on business and credit grade distribution

	AAA	AA	A	B+	B	B-	C	D
Motor Finance			**PCFG**	**PCFG**	**PCFG**	**PCFG**		
	Santander	Santander	Marsh Finance	Marsh Finance	Marsh Finance	S&U plc (Advantage)	S&U plc (Advantage)	S&U plc (Advantage)
	Barclays	MotoNovo	Close Brothers	Close Brothers	Close Brothers	PFG (Moneybarn)	PFG (Moneybarn)	PFG (Moneybarn)
	Lloyds Black Horse	Blue	Blue	Blue	S&U plc (Advantage)			
	C&C	Investec			PFG (Moneybarn)			
Business Finance			**PCFG**	**PCFG**	**PCFG**	**PCFG**	**PCFG**	
	Lloyds Black Horse	Hitachi	Aldermore	Close Brothers	Close Brothers		Catfoss	Catfoss
	Lombard	Aldermore	Shawbrook				Daveham	Daveham
	Hitachi	Shawbrook	Close Brothers				Ultimate	Ultimate
		Hampshire Trust	Paragon Bank					
		United Trust	United Trust					

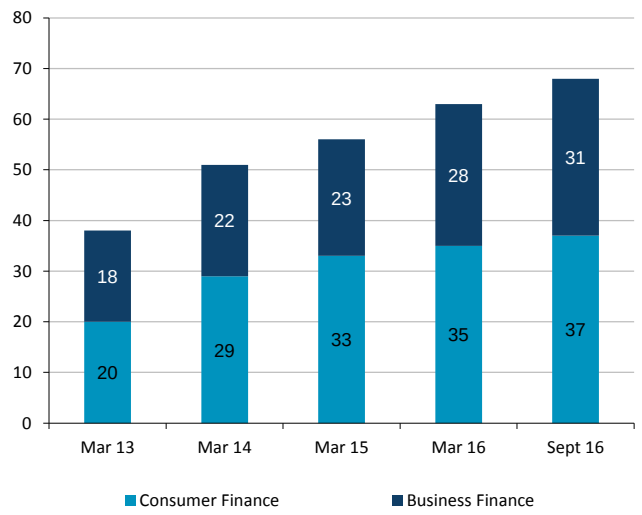
Source Company, Panmure Gordon

PCFG expected to grow market share

Market Size – Plenty of Opportunities

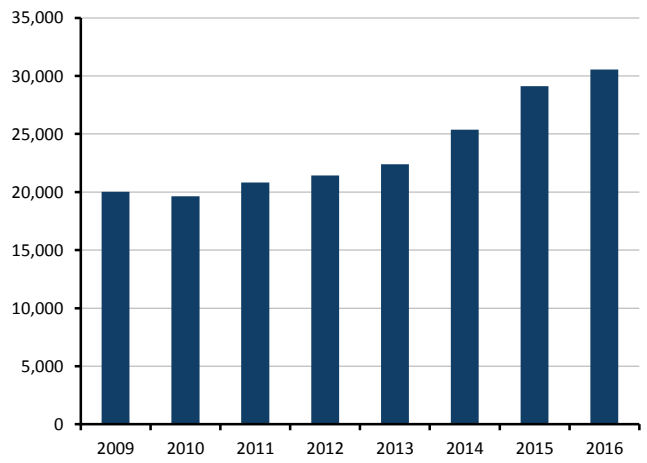
According to the Finance & Leasing Association ("FLA") the asset finance industry reported new business of £30bn for FY2016, implying a 0.23% market share for PCFG. The increase in overall market lending volumes in 2016 was 5%, whereas PCFG's new business growth to Sept 2016 was 11.5% YoY, implying market share gains, albeit from very low levels. In each individual class of asset finance we estimate that PCFG has less than a 0.5% market share in each segment.

PCFG New Business Volumes (£m)



Source Company, Panmure Gordon

Asset Finance New Business Volumes (£m)



Source FLA, Panmure Gordon

More prime business

As we expect PCFG to benefit from a lower cost of funding we think that PCFG has the potential to make more meaningful gains in market share once it begins to attract deposits. Currently around 80% of their brokers' business is inaccessible to PCFG as much of it is more prime and consequently customers expect to pay a lower rate than that currently offered by PCFG.

NEW CAPITAL FOR A NEW BANK

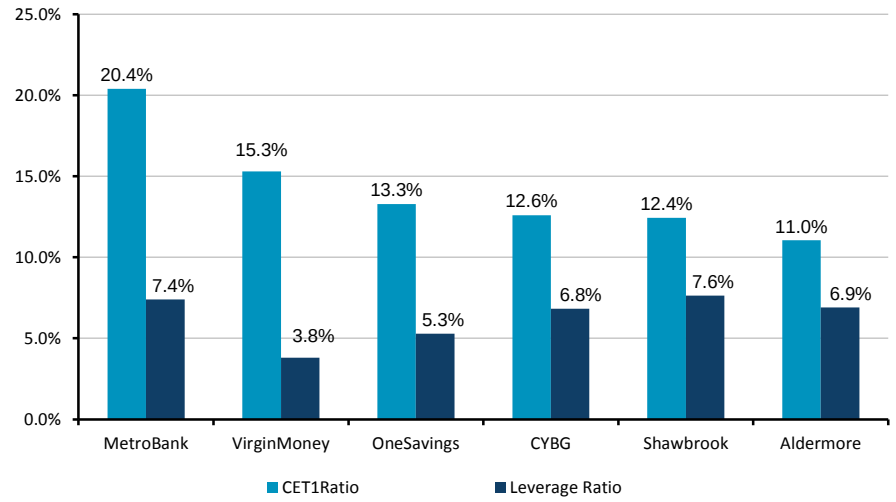
WE ESTIMATE £10M OF NEW CAPITAL MAY BE REQUIRED

As PCFG moves towards being a bank it will be required to meet capital requirements to support the deposit base. We estimate that the group's CET1 capital broadly equates to the tangible book value of c£24m. Despite the group generating aggregate net profits of £12.5m over the next three years, we estimate that additional capital may be required to support the loan growth targeted by management.

The lower end of management's CET1 ratio guidance is more in line with challenger banks solvency ratios.

Moreover, management has guided that they will target a 15%-20% CET1 ratio. This looks sensible with the bottom end of this range also appearing conservative in comparison to the current CET1 ratios of the challenger banks as can be seen in the chart below.

CET1 and Leverage ratios for UK Challenger banks, last reported



Source *Company Data, Panmure Gordon*

To ascertain what a CET1 ratio of 15-20% means for the minimum amount of tangible equity, we need to know what PCFG's loan book means in terms of risk weighted assets (RWA).

- **RWA Density** – Under the PRA handbook (BIPRU 3.4) standardised RWAs for SME and Retail exposures (of low credit rating) are 75% and 100% respectively.
- **Deferred Tax Assets (DTA)** – Under the Basel rules, adopted by the PRA, DTAs arising from timing differences should be risk weighted by 250% of their nominal amount. For DTAs arising due to tax loss carry forwards have to be fully deducted from capital calculations. PCFG's DTAs arise due to timing differences relating to its lease financing business and therefore the former capital treatment is applied.
- **RWAs calculated** – Based on the above calculations and our loan growth assumptions, we estimate that PCFG's RWAs of £141m in FY2017E rising to £275m in FY2019E.
- **Minimum Tangible Equity (TNAV)** – At the low end of management's CET1 ratio guidance of 15% we estimate that the group would need £21.1m of TNAV in FY2017E rising to £41.3m in FY2019E. The minimum leverage ratio requirement is 3% which is not a concern for PCFG, with the CET1 ratio being the constraining capital requirement.
- **Liquidity Requirements** – In addition to maintaining minimum capital requirements PCFG will also have to have sufficient liquid assets to satisfy the Liquidity Coverage Ratio (LCR) and the Net Stable Funding Ratio (NSFR). We believe this will also be factored into the minimum capital to be raised by management.

Estimating RWAs and minimum CET1 Capital (£m)

	FY2017E	FY2018E	FY2019E
Consumer Finance	87.5	126.9	171.3
Business Finance	65.0	94.3	127.2
Total Net Book	**152.5**	**221.1**	**298.5**
Risk Weightings			
Consumer Finance	*100%*	*100%*	*100%*
Business Finance	*75%*	*75%*	*75%*
Risk Weighted Assets			
Consumer Finance	87.5	126.9	171.3
Business Finance	48.8	70.7	95.4
Total Portfolio	**136.3**	**197.6**	**266.7**
RWA Density	89.3%	89.3%	89.3%
Deferred Tax Assets (DTA)	1.8	2.6	3.5
DTA Risk Weighting	250%	250%	250%
DTA RWA	4.5	6.5	8.7
Total RWA	**140.7**	**204.0**	**275.4**
Target CET1 Ratio	***15%***	***15%***	***15%***
Required CET1 Capital	**21.1**	**30.6**	**41.3**

Source Company, Panmure Gordon

Possible £10m capital injection should be sufficient to fund loan growth

While the current TNAV of £24.7m in FY2016 is sufficient to support the loan growth in FY2017, the net capital retention of £1.6m (net profit minus dividends) in FY2017E and £3.2m in FY2018E is not.

Given management's aspirations of net loans of £350m by FY2020E it is clear that the group would need additional capital from FY2017E onwards. As the Table below shows, a £10m capital injection would lead to a CET1 ratio of 16.5% which would provide sufficient buffer over the 15.0% minimum targeted for any unforeseen costs or credit quality.

We assume that PCFG may look to raise £10m of equity which would equate to 40m new shares in FY2107E based on a share price of 25p.

We therefore assume that PCFG may look to raise £10m of equity. Based on a share price of 25p this would lead to an issuance of 40m new shares in FY2017E.

CET1 Ratio Calculations (£m)

	FY2017E	FY2018E	FY2019E
Period Start - Shareholders Funds	24.7	38.1	41.6
Total Comprehensive Income	2.2	4.0	6.3
Intangible Assets	(2.3)	(1.8)	(1.3)
Pre-dividend, Pre-stock issuance CET1	24.7	40.4	46.6
Dividends Paid	(0.6)	(0.8)	(1.1)
New Share capital subscribed	**10**	**0**	**0**
Period End CET1	34.0	39.5	45.5
Other Capital	0	0	0
Total Capital	34.0	39.5	45.5
Total Leveraged Exposure	163.1	232.0	309.8
CET1 Ratio	***24.2%***	***19.4%***	***16.5%***
Total Capital Ratio	24.2%	19.4%	16.5%
Leverage Ratio	20.9%	17.0%	14.7%

Source Company, Panmure Gordon

SOLID UNDERLYING TRENDS

STRATEGY GEARED FOR GROWTH

PCFG is operating in growth markets. The consumer market is, we believe, driven by consumer confidence and the structural driver of technological changes in motor vehicles extending their lifespan, consequently expanding the used vehicle market relative to the new vehicle market. The business finance market is driven by the increasing acceptance of asset finance as an alternative to high street bank lending.

Moving up the credit quality spectrum

In FY2016 the loan book is growing at around 14% p.a. to £122m and adjusted pre-tax profits by 38% driven by reduced impairments of £0.3m YoY to £1.0m despite growth in loan book and scaling a stable overhead (adjusted cost income ratio improved from 45.5% to 42.0%).

The high quality loan portfolio of largely prime and near prime customers has experienced reducing impairments over recent years and the cost of risk (impairment charge-to-average loans) fell again from 1.3% to 0.9% in FY2016. The NPL ratio also improved to 6.0%, compared to 8.2% in the previous reporting period to March 2015, helped by most of the old loan book now having run-off.

All lending is secured

- **Consumer Finance** – New business originations were up 8% which is impressive given the market has slowed to a 5% growth in FY2016. Loans are originated through a national network of around 50 brokers which is served by an online portal eQuote. With the largest customer accounting for less than 0.2% of the portfolio and an average deal size below £11,500 this is a broadly spread low risk portfolio for secured loans. The loans are secured largely on motor vehicles.

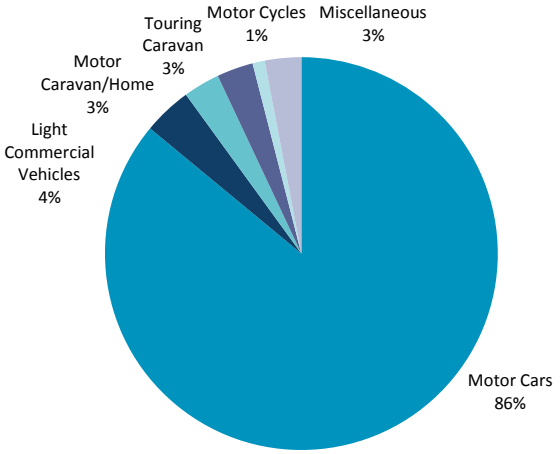
Diversified Portfolio

- **Business Finance** – New business originations have repeated their strong performance of 1H16 to be up 24% YoY to £31m illustrating the growing tendency for SME's to use asset based lending as an alternative to high street bank lending. Loans are introduced through a national network of around 75 brokers. The portfolio of loans is broadly spread with the largest customer accounting for less than 2% of the division's loan book. Average deal size is around £26,000 across some 2,250 customers. The portfolio is broadly spread among business assets with strong collateral characteristics.

PCFG has £148m of capacity for growing the business until summer of 2017 when the first deposits are planned

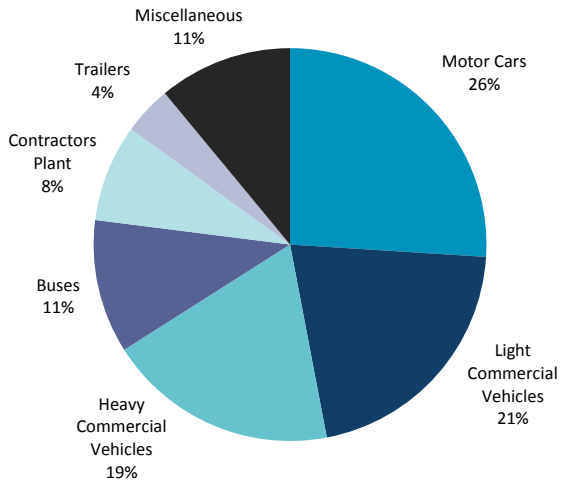
- **Ample Funding for growth in FY2017** – The group has £65m of undrawn committed debt facilities and during FY2016 PCFG entered in to an £83m facility with its major shareholder, Bermuda Commercial Bank. Therefore, the group has £148m of capacity for growing the business until summer of 2017 when the first deposits are planned.

Consumer Finance Division- Assets Financed



Source Company, Panmure Gordon

Business Finance Division – Assets Financed



Source Company, Panmure Gordon

ESTIMATE CHANGES AND ASSUMPTIONS

Changes to our estimates

The table below shows our changes to estimates. We had already factored in 40m new shares (based on a share price of 25p) given the granting of the banking licence was imminent at 1H16. We highlight the main changes below:

- **Gross margin** – While we have edged up our revenue yield given the strong 2H16 performance (FY2016 revenues of £55.8m vs. PG forecast of £55.0m), with the group expanding its offering to super prime we anticipate the costs to increase to support this growth. We forecast gross margins to reduce from 28.1% to 27.5% in FY2019E.
- **Admin Expenses** – Includes the banking set up costs. These were previously regarded as exceptional costs but from FY2018E when the bank will be fully operational, they will no longer be regarded as exceptional. For 2017E we have increased the banking costs to £1.5m from £1.0m with the run-rate after that of £1.8m (cf. £1.3m previously). Given the ramp up of the business, we expect other admin costs to rise by 10% pa over the next three years.
- **Loan loss charges** – Which are included in admin expenses, have been reduced from 1.1% to 1.0% of average loans as the group moves to better quality lending which should lead to lower loan losses.
- **Net interest expense** – We now assume that the replacement of wholesale funding for deposit will largely begin in 2018 rather than 2017. Therefore the benefits of lower deposit cost will be later than our previous expectations.
- **Loan growth** – We have edged up our loan growth forecast to 45% in FY2018E as it will be the first full year PCFG will operate as a bank, moderating to 35% in FY2019E, as loan balances increase towards £350m by FY2020E.

Changes to our estimates (£m)

	New				Old		
	FY2016	FY2017E	FY2018E	FY2019E	FY2016E	FY2017E	FY2018E
Total Revenue	55.8	64.3	83.7	103.5	55.0	64.1	78.4
Cost of sales	-40.1	-46.3	-60.7	-75.0	-39.1	-45.5	-55.7
Gross profit	15.7	18.0	23.0	28.5	16.0	18.6	22.7
Admin expenses	-7.1	-8.9	-10.4	-11.7	-7.5	-9.3	-9.8
Operating profit	8.6	9.1	12.7	16.7	8.5	9.3	12.9
Net Interest expense	-5.0	-6.3	-7.5	-8.7	-5.1	-5.8	-7.0
PBT	3.6	2.8	5.1	8.0	3.3	3.5	5.9
Tax	-0.8	-0.6	-1.1	-1.8	-0.7	-0.7	-1.2
PAT	2.8	2.2	4.0	6.3	2.6	2.8	4.8
Average No. of shares	170.1	190.1	210.1	210.1	170.4	195.4	220.4
EPS Diluted (p)	1.78	1.16	1.90	2.97	1.61	1.34	2.16
Adjusted							
PBT	**3.6**	**2.8**	**5.1**	**8.0**	**3.3**	**3.5**	**5.9**
Banking Costs	0.5	1.5	0.0	0.0	0.5	1.0	0.0
Adjusted PBT	**4.1**	**4.3**	**5.1**	**8.0**	**3.8**	**4.5**	**5.9**
Adjusted PAT	3.2	3.4	4.0	6.3	3.0	3.6	4.8
Adj.EPS Diluted (p)	1.88	1.78	1.90	2.97	1.84	1.73	2.16
Loans	122	153	221	299	120	150	210

Source *Company Data, Panmure Gordon*

Profitability

Investment following a period of beating targets

Management have updated their pre-tax RoAA and RoE targets, having beaten the previous targets materially. The new targets are set somewhat lower to account for the increased costs of setting up the bank, at 2.5% and 12.5% respectively. We estimate pre-tax RoAA falling to 2.1%, before returning to 3.1% in FY2019E.

Lower cost of funding to drive growth

We expect a pre-tax return of £4.3m in the year to Sept-17, and with the lower cost of funding we expect a large increase in reported PBT to £8.0m by FY2019E.

Fully diluted EPS will follow the same pattern, with FY2017E EPS of 1.8p rising to 3.0p in FY2019E.

Profitability Ratios

	FY2015	FY2016	FY2017E	FY2018E	FY2019E
Margins					
Gross Revenue Yield	*13.9%*	*13.7%*	*13.1%*	*12.3%*	*11.0%*
Net Interest Margin	*9.1%*	*9.3%*	*8.6%*	*8.3%*	*7.6%*
Gross Margin	*29.5%*	*28.1%*	*28.0%*	*27.5%*	*27.5%*
Adj PBT Margin	*5.9%*	*7.4%*	*6.7%*	*6.1%*	*7.7%*
Adjusted Net Profit Margin	*4.6%*	*5.7%*	*5.3%*	*4.8%*	*6.0%*
Costs					
Cost / income Reported	*46.0%*	*45.2%*	*49.5%*	*45.0%*	*41.2%*
Cost / Income Adjusted	*45.5%*	*42.0%*	*41.2%*	*37.1%*	*34.9%*
Interest Expense / Funding	*5.8%*	*5.2%*	*5.5%*	*4.9%*	*3.9%*
Provisions/loans	*1.3%*	*0.9%*	*0.9%*	*1.0%*	*1.0%*
Returns					
ROAA pre-tax	*2.7%*	*3.1%*	*2.1%*	*2.7%*	*3.1%*
ROAA post tax	*2.1%*	*2.4%*	*1.6%*	*2.1%*	*2.4%*
Adj. ROAE	*13.8%*	*14.1%*	*10.7%*	*10.0%*	*14.1%*
Adj. ROAE diluted	*16.4%*	*13.3%*	*10.7%*	*10.0%*	*14.1%*
RoATE	*10.9%*	*14.6%*	*11.3%*	*10.6%*	*14.6%*

Source *Company Data, Panmure Gordon*

VALUATION

Unchanged 38p target

We derive a price target of 38p per share or market cap of £64m taking into account 40m additional shares based on a share price of 25p. We continue to believe that the strong growth prospects from a low risk secured book in a business with significant barriers to entry arising from the specialist nature of the asset lending should trade at a premium to peers.

The table below identifies a peer group of niche quoted lenders. The average PER is 12.1 and the average P/B is 1.9. The new target of £750m loans in 5 years implies 35% CAGR loan growth which is the highest of its peers but understandable as the group seeks to expand its market presence. We therefore believe the shares should be valued at a 10% premium to the peer group being P/B of 2.1 on £38.1m (BVPS of 18.2p) at September 2017, which includes the £10m of additional equity that we estimate for capital ratios, leading to our target price of 38p.

Comparison Table (FY17E)

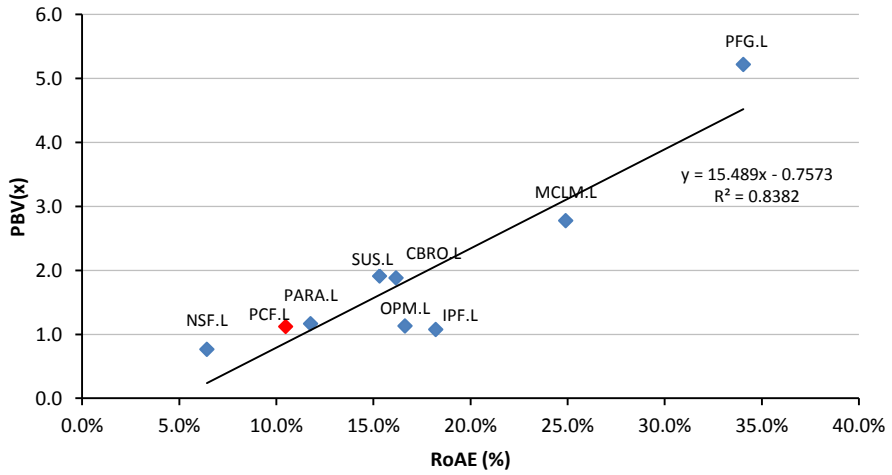
Company Name	Price (p)	Market Cap (£m)	*RoAA*	Leverage	*RoAE*	PE	PB	*DY*
S&U PLC	2,246	269	11.2%	1.45	15.3%	13.2	1.9	3.9%
International Personal Finance	185	413	6.2%	2.80	18.2%	6.3	1.1	6.7%
1pm	60	33	4.9%	2.45	16.6%	9.1	1.2	1.1%
Non-Standard Finance	60	190	4.3%	1.58	6.4%	17.0	0.8	1.6%
Close Brothers Group	,1480	2,222	2.1%	7.78	16.2%	12.5	1.9	3.9%
Paragon Group	425	1,174	0.9%	13.06	11.8%	10.3	1.2	3.3%
Provident Financial	2,832	4,185	9.7%	3.52	34.1%	16.2	5.3	4.7%
Private & Commercial Finance	27.00	46	**2.3%**	**4.28**	**10.7%**	**14.2**	**1.1**	**1.2%**
Morses Club	114.0	148	18.7%	1.33	24.9%	10.8	2.7	5.5%
Average			**6.7%**	**4.25**	**17.1%**	**12.2**	**1.9**	**3.6%**
Median			**4.9%**	**2.80**	**16.2%**	**12.5**	**1.2**	**3.9%**

Source *Company, Panmure Gordon, Bloomberg, Reuter*

Better growth prospects than peers

Below we have plotted forward ROE correlation to P/B for this basket of alternative lenders. The correlation is 84%. In the case of PCFG management expect RoE of 17.5% 5 years after it begins operating as a bank which we believe will be achieved. RoE will be under pressure short-term due to the upfront costs but we forecast 2019E RoE to improve to 14.1%. To achieve a P/B of 2.1 would, according to the correlation below, suggest an ROE of 18.4%. However this does not take account of the differing growth rates for the lenders. A higher growth attracts a higher valuation using the Gordon Growth model for valuing banks.

2017E P/BV vs. RoAE



Source *Company Data, Panmure Gordon*

RISKS

- **Credit Quality** – The level of impairments remains the main determinant of the volatility of profits at PCFG. The group lends to near prime and non-prime which are higher risk. However, the group is moving up the credit chain to super prime which should help to reduce fears about volatility in earnings.
- **Delays in mobilising the bank** – The group has opted for the mobilisation route to obtain a banking licence which means that certain requirements will need to be met before deposit gathering can commence. Any delays to this process could significantly impact the investment case in PCFG.
- **Lack of Growth** – Having obtained a Banking Licence, PCFG is investing significantly for the regulatory and other costs of running a bank. It is also moving in wider segments of the market that it has previously not participated in. This could prove difficult to break into although we believe that it currently is restricted from 80% of the lending due to its higher cost of funding.
- **Lack of deposit growth** – While new entrants have readily accessed the savings market, there is a risk that the level of deposit gathering could be slow initially, impacting the profitability of the group.
- **Increase in interest rates** – Would make deposits more expensive but we think that this will not occur in this decade.
- **Competition** – The new markets are large in size but competition is stiff including mainstream banks and other established lenders within the super prime space. It could lead to more margin pressure than our assumptions.

THE NUMBERS

Income Statement (£m)

September Year End	Sept-15 A	Sept-16 A	Sep-17 E	Sep-18 E	Sep-19 E
Total Revenue	48.4	55.8	64.3	83.7	103.5
Cost of Sales	(34.1)	(40.1)	(46.3)	(60.7)	(75.0)
Gross profit	14.3	15.7	18.0	23.0	28.5
Admin expenses	(5.3)	(6.1)	(7.7)	(8.6)	(9.2)
Loan loss provision	(1.3)	(1.0)	(1.3)	(1.8)	(2.5)
Operating profit	7.7	8.6	9.1	12.7	16.7
Interest expense	(4.9)	(5.0)	(6.3)	(7.5)	(8.7)
PBT	2.8	3.6	2.8	5.1	8.0
Tax	(0.6)	(0.8)	(0.6)	(1.1)	(1.8)
PAT	2.2	2.8	2.2	4.0	6.3
Adj Dil EPS (p)	1.3	1.9	1.8	1.9	3.0
DPS (p)		0.1	0.3	0.4	0.5
Payout Ratio	*0.0%*	*5.6%*	*25.8%*	*21.0%*	*16.8%*

Source *Company Data, Panmure Gordon*

Balance Sheet (£m)

September Year End	FY2015	FY2016	FY2017E	FY2018E	FY2019E
Non-Current Assets					
Goodwill	0.4	0.4	0.4	0.4	0.4
Other intangibles	0.5	0.4	1.87	1.37	0.87
PPE	0.1	0.1	0.1	0.1	0.1
Loans & receivables	69.1	81.0	100.7	145.9	197.0
Deferred tax	1.7	1.4	1.8	2.6	3.5
Total Non-current assets	71.8	83.3	104.8	150.4	201.9
Current assets					
Current assets -loans	38.4	41.0	51.9	75.2	101.5
Receivables	1.0	0.5	0.5	0.5	0.5
Corporation tax			0.0	0.0	0.0
Cash etc	0.5	5.9	5.9	5.9	5.9
Total Current assets	40.0	47.4	58.3	81.6	107.9
Total assets	**111.7**	**130.7**	**163.1**	**232.0**	**309.8**
Deposits			3.8	69.3	177.6
Derivatives	0.3	0.4	0.4	0.4	0.4
Borrowings	70.8	89.4	104.5	104.5	68.4
Total Noncurrent Liabilities	71.1	89.8	108.8	174.2	246.4
Current borrowings	17.0	13.9	13.9	13.9	13.9
Payables	1.3	1.9	1.9	1.9	1.9
Derivatives	0.0	0.1	0.1	0.1	0.1
Bank overdrafts	0.3	0.3	0.3	0.3	0.3
Corporation tax	0.5		0.0	0.0	0.0
Total Current liabilities	19.2	16.2	16.2	16.2	16.2
Total Liabilities	**90.3**	**106.0**	**125.0**	**190.4**	**262.6**
Equity					
Total Shareholders equity	**21.5**	**24.7**	**38.1**	**41.6**	**47.2**
Total liabilities And Equity	111.7	130.7	163.1	232.0	309.8

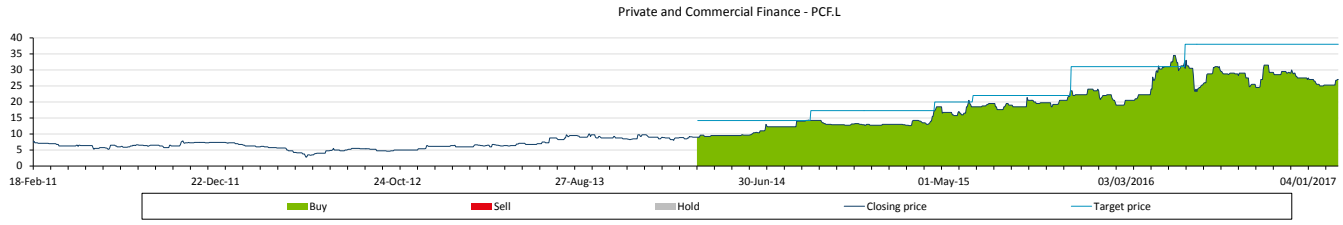
Source *Company Data, Panmure Gordon*

Ratios

Margins	FY2015	FY2016	FY2017E	FY2018E	FY2019E
Gross Revenue Yield [GP/Avg book]	*13.9%*	*13.7%*	*13.1%*	*12.3%*	*11.0%*
Net Interest Margin	*9.1%*	*9.3%*	*8.6%*	*8.3%*	*7.6%*
Gross Margin	*29.5%*	*28.1%*	*28.0%*	*27.5%*	*27.5%*
Adj PBT Margin	*5.9%*	*7.4%*	*6.7%*	*6.1%*	*7.7%*
Adjusted Net Profit Margin	*4.6%*	*5.7%*	*5.3%*	*4.8%*	*6.0%*
Costs					
Cost / income Reported	*46.0%*	*45.2%*	*49.5%*	*45.0%*	*41.2%*
Cost / Income Adjusted	*45.5%*	*42.0%*	*41.2%*	*37.1%*	*34.9%*
Interest Expense / Funding	*5.81%*	*5.21%*	*5.5%*	*4.9%*	*3.9%*
Returns					
ROAA pretax [ret. On recievables]	*2.7%*	*3.1%*	*2.1%*	*2.7%*	*3.1%*
ROAA post tax	*2.1%*	*2.4%*	*1.6%*	*2.1%*	*2.4%*
ROAE	*13.8%*	*13.8%*	*10.7%*	*10.0%*	*14.1%*
ROAE diluted	*16.4%*	*13.1%*	*10.7%*	*10.0%*	*14.1%*
RoATE	*10.9%*	*14.3%*	*11.3%*	*10.6%*	*14.6%*
Balance Sheet					
Gearing	4.1	4.2	*3.2*	*4.5*	*5.5*
Leverage [loans/equity]	5.0	4.9	*4.0*	*5.3*	*6.3*
Gross Leverage [Assets / Equity]	5.20	5.29	*4.28*	*5.58*	*6.56*
Impairments					
Provisions/Avg loans	*1.25%*	*0.86%*	*0.9%*	*1.0%*	*1.0%*
Provisions/Gross Profits	*9.0%*	*6.3%*	*7.0%*	*7.8%*	*8.7%*
DuPont					
Asset Turnover	*47.2%*	*48.6%*	*46.8%*	*44.8%*	*39.8%*
NPM	*4.5%*	*5.0%*	*3.4%*	*4.8%*	*6.0%*
RoA	*2.1%*	*2.6%*	*2.3%*	*2.0%*	*2.3%*
Leverage	*6.43*	*5.25*	*4.67*	*4.96*	*6.10*
RoE	*13.8%*	*13.8%*	*10.7%*	*10.0%*	*14.1%*

Source *Company Data, Panmure Gordon*

Distribution of investment ratings for equity research (as of 13 Feb 17)			Rating: GUIDELINE (return targets may be modified by risk or liquidity issues)	
Overall Global Distribution (Banking Client*)			**Buy**	Total return of >10% in next 12 months
Buy	**Hold**	**Sell**	**Hold**	Total return >-10% and <+10% in next 12 months
71% (45%)	17% (0%)	12% (0%)	**Sell**	Total return <-10% in next 12 months
* Indicates the percentage of each category in the overall distribution that were banking and/or corporate broking clients				



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