Capital Network

PCF GROUP PLC (PCF.L)

FINANCIAL SERVICES

26/07/2017

Raising Retail Deposits will be Game Changer

SHARE PRICE	52 WEEK LOW
23.98p	21.55p
MARKET CAP	**52 WEEK HIGH**
£50.9m	32.50p
NAV	**NET DEBT**
£23.9m	£106m

EXECUTIVE SUMMARY

Substantial growth in new business forecasted by management; the current customer portfolio stands at £128m which management expect to grow to £350m in 3 years and to £750m in 5 years across both Consumer and Business Finance divisions. The returns guidance is very positive with ROAA (Return on Average Assets) targeted at 2.5% and ROE (Return on Equity) targeted at 12.5%, with both metrics improving further in the 3-5 year horizon. Combined with the reduction in credit risk as the Group focuses on the Prime and Super-prime markets (low and lowest credit risk), the potential returns look attractive.

An exciting opportunity for the Group (PCF.LON) and new PCF Bank Ltd; the positives of operating a bank include the opportunity to diversify treasury operations and fund directly from the savings markets. Matching the funding to risk appropriate customer loans should be straightforward, managing the regulation and bank oversight less so as this is more complex, but the rewards could be significant.

An authorised UK bank with access to retail deposit funding; following bank authorisation PCF (PCF.LON) is now raising retail deposits. The group has historically relied upon more expensive wholesale market funding, but following the change to a diversified treasury strategy to include deposits, the fall in overall cost of funding will enable the Group to offer more competitive finance rates to customers in higher credit areas of the asset finance market.

Granular, asset-backed customer lending portfolio with appropriate risk provision; PCF (PCF.LON) lends on LTV (Loan to Value) instalment credit or finance lease to consumers and businesses. The widely criticised PCP (Personal Contract Purchases) are not offered nor form part of the back book. The gross value of the customer portfolio is £154m of collateral secured lending on equipment and vehicles.

Dividend policy; PCF remains in growth mode and income distributions are likely to be modest in the short term. In 2016, the final dividend was 0.1p per share. We advise investors to expect modest increase in the short term and to focus on the capital appreciation as the company grows. Following on from this we anticipate a much larger dividend payout.

Forecasts; we see stable and consistent growth in customer loan volume up to year 2020 funded by the new diversified treasury strategy. Financial and economic returns follow from the scale, operational gearing and the lower credit risk pursued by the Group. EPS is forecasted at 3.8p per share in 2020 and net assets of £61m. We therefore believe the shares could be worth 50p.

MAJOR SHAREHOLDERS

1) Bermuda Commercial Bank – 54.47%
2) Somers Limited – 10.93%
3) Miton Asset Management – 4.20

Shares in Issue	211.58m
Avg Volume	148.35k
Primary index	AIM
EPIC	PCF.L
Next Key Announcement	-
Sector	Financial Services

SHARE PRICE CHART

Important: All disclaimer information can be found on the last page of this document. Please note that this publication has been commissioned by the company to which this publication relates and therefore it cannot be considered independent.

BUSINESS DESCRIPTION AND ACTIVITIES

PCF Group plc (formerly Private & Commercial Finance Group plc) is a UK-specialist vehicle and asset finance Group with a subsidiary PCF Bank that serves UK consumer and SME (Small Medium Enterprises) asset finance markets for vehicles, plant and equipment. PCF has a proven business model for lending to both individuals and SMEs with the respective consumer finance and business finance divisions providing performance diversification whilst also offering shared infrastructure and balancing of risk. Each business market provides growth opportunities at different points in the economic cycle and a business platform that is efficient and scalable but currently underutilised due to market share.

Company Information

Address: Pinners Hall, 105-108 Old Broad Street, London, EC2N 1ER

Analyst Details

James Dolman
james.dolman@capitalnetwork.com
+44 (0)20 7264 3921

For the interim financial period to March 2017, PCF had total assets of £133.6m, outstanding net loan book of £127.6m, and equity of £27.4m. Following the interim results, the Group completed a successful placing and open offer in early April raising an additional £10.5m of equity for liquidity and regulatory planning purposes as well as support future growth plans. The Group listed on the London AIM market (Alternative Investment Market) in 1998 and in December 2016 received authorisation as a UK bank.

Over the last 20 years, PCF has served over 60,000 customers in the UK financing vehicles and plant and equipment through both hire purchase contracts and finance leases from offices in London. Underwriters use experience and expertise to evaluate customer credit applications on a case by case basis, rather than using credit scorecards, in order to better understand customer risk. The Group employs a total of 58 staff with 7 years average employment experience.

The business strategy is to be able to attract customers requiring finance through comprehensive offerings and high level of service. To deliver this offer, PCF expects, in the future to be able to receive funds through a diversified treasury strategy enabling the Group to borrow in deep and liquid markets that will provide cost and trade volume benefits that can be passed through to customers. The customer portfolio built by the Group is expected to offer a diversified, high quality, credit risk appropriate, customer base from which the Group can sustainably earn net interest income, the difference between the return on its assets (lending) and the cost of the liabilities (funding).

PCF received regulatory authorisation to operate a UK bank in December 2016 following a two-year application process. The group announced on 19 July that it has commenced operation as a bank. This will enable the Group to diversify future funding away from wholesale market funding, a single source of more costly funding that PCF has historically relied upon.

The recent history of the Group begins with the Global Credit Crisis (GCC) in 2008 in which PCF experienced shrinking credit lines and bank debt maturities as lenders pulled back from lending which in turn placed restrictions on the Group's ability to lend to customers. Group management, having ensured significant portfolio diversification, were negatively affected by the dependency on bank funding from relatively few sources which had sought to shorten lending length to the Group to no longer than 12 months.

In response to the contraction in bank lending, management subsequently looked to strengthen the capital structure of the Group seeking to attract significant additional investment in the then form of £10m of convertible loans notes issued in November 2012 and September 2013, maturing in September 2016. This capital injection was supported by Bermuda Commercial Bank, the now majority shareholder.

Having issued unsecured convertible notes and strengthened the equity base of the business sufficiently for the banks' lending requirements, new bank debt in the form of committed term facilities was provided with maturities ranging from 12 to 60 months ensuring sufficient visibility for an implementable and workable business plan. Subsequently, a more stable and predictable diversified treasury strategy was sought by management which led to the decision to seek bank authorisation and to be able to directly raise retail deposits.

Below in figure 1 we show the historical development of both gross and net lending portfolio growth over the last 10 years. As can be seen the portfolio was growing prior to the GCC but from 2009 for a period of c.4 years contracted in gross and net lending terms. Issuance of the convertible note and the subsequent refinancing with longer maturity debt enabled the Group to restart lending. Finally, the establishment of PCF as a bank commences from 2017.

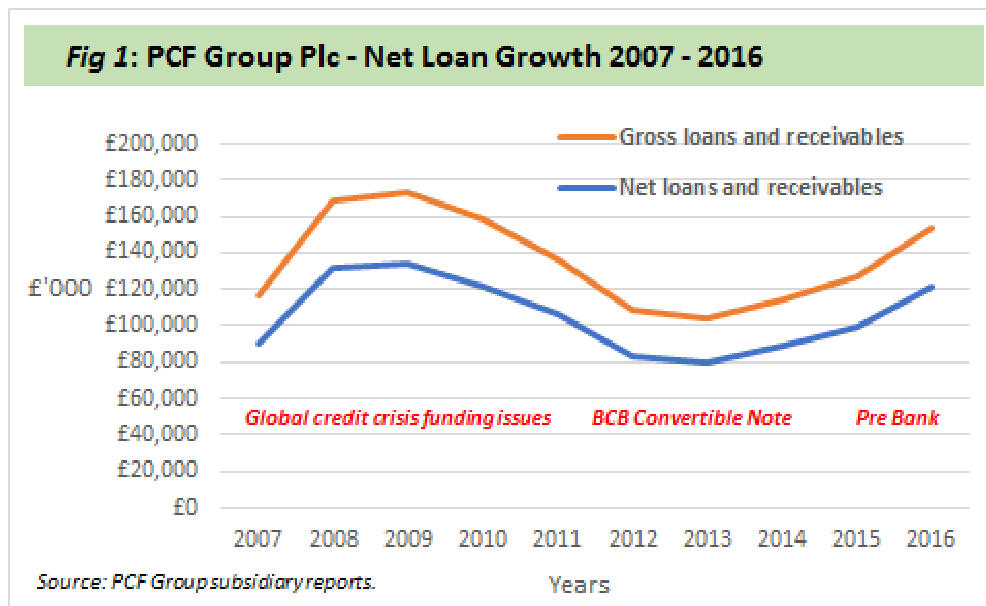


Fig 1: PCF Group Plc - Net Loan Growth 2007 - 2016

Source: PCF Group subsidiary reports.

OPERATIONS AND CATEGORY EXPOSURES

Asset finance, in the traditional sense, is the provision of credit (hire purchase and lease) to customers wanting to use finance to acquire depreciable assets such as motor vehicles and equipment. The finance is collateralised by the asset which acts as security in the case of non-repayment. Asset finance can also be considered as short-term cash loans secured against existing assets.

PCF is active in leasing (20%), and hire purchase (80%). Whilst asset finance can cover a myriad of assets and receivables, from large capital equipment to short term corporate IOUs, PCF only operates in the asset backed asset finance and motor vehicle finance markets, a subset of the overall UK market.

(a) Assets and Lending Portfolio.

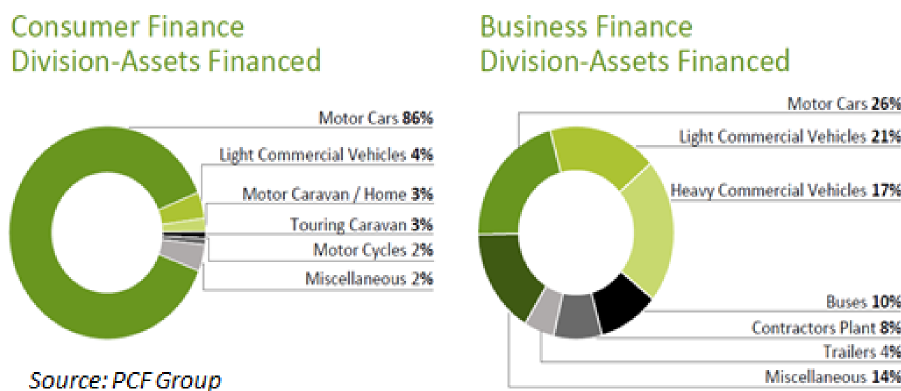
PCF serves customers in both the consumer and SME UK market through consumer and business finance divisions catering for these respective markets. In terms of asset allocation, 52% of total assets are consumer market and 48% are business finance division market.

(1) Consumer Finance Division (CFD) is responsible for providing asset backed finance to UK retail customers for the acquisition of motor vehicles including specialisms in classic cars, motorhomes and horse boxes. Average per transaction financing is c.£12,500 provided for terms up to 60 months. Repayment is made through instalments. The Group currently transacts with over 8,400 customers through a national network of c.50 brokers served by PCF's own internet based proposal system, eQuote. PCF does not offer PCP (Personal Contract Purchase) agreements for motor vehicle finance which defers significant capital repayment and residual risk. In this sense, these are 'bullet' style repayment plans whereas PCF only offers agreements with proportional capital paydown throughout the term down to zero.

(2) Business Finance Division (BFD) is responsible for providing secure asset backed finance for hire purchases and lease finance contracts to business customers in need of vehicles, plant and equipment that includes motor cars, light and heavy commercial vehicles, coaches, buses, and industrial and construction equipment. Average per transaction lending is c.£30,000 for terms up to 60 months. The Group currently transacts with c.3,000 customers through its national network of c.75 brokers.

Within the Group, category exposures are broadly diversified and granular, but within individual divisions there is a significant exposure concentration in Consumer Finance to motor cars (86%), especially used vehicles, whereas business finance has no overall concentration and thus good diversification. Category exposures per division are shown below in figure 1.

***Fig 2*: PCF Group - Divisional Asset Finance Categories**



The Group currently serves c.12,000 customers across both divisions. The largest customer exposure is c.0.55% of loans and receivables or c.£700,000 and 8 out of the top 10 customers have a £750k borrowing cap equal to 0.6% of lent assets. PCF has no global geographic diversification; activity is conducted and delivered in the UK only.

(b) Asset Credit Grades and Liability Funding.

For the interim period ended March 2017, the credit grade distribution in the customer lending book was 29.6% 'A' grade Prime, 27.9% 'B+' grade near Prime, 33.4% 'B' grade near Prime, and 9.2% 'C' grade non-Prime. At the same time, and while Group's current funding model is reliant on wholesale funding, the relatively higher interest expense precludes higher-grade customers (Prime and Super-Prime). In order to increase Prime and Super-Prime credit grade business, the Group's own funding cost would need to be lowered, thus the Group's funding cost is a major determinant of the overall credit grade business that can be profitably undertaken. The current cost of wholesale funding is therefore too high for a significant increase in trade of more Prime and Super-Prime credit grade business. Clearly the targeted diversification of funding with lower cost retail deposits seeks to address this.

Looking at the latest 2016 financial year results, the Group's. interest expense and similar charges totalled £7.5m which equates to an underlying explicit interest expense rate of c.5.75% . Interest income and similar income, was £22.4m which equates to an underlying explicit interest income rate of c.13.5%. From these two values we can derive the Group's NIM (Net Interest Margin) of c.8.0%, or as reported for the interim results to March 2017 8.2% (March 2016 8.8%). As can be seen with the current funding structure and with the current NIM target of 8.0%, targeted weighted average interest income of in excess of 13.5% needs to be achieved in order to be in budget which requires the group to look at the right area of the yield curve that matches with their credit quality criteria and with the right level of income. The consequence of this is that the Group currently cannot achieve the exposure to the higher credit grade (lower yielding) business that it would like because of the funding costs.

The Group in recent years, in order to mitigate some of the risks in the customer lending portfolio has improved the credit quality with the effect of achieving a slightly lower yielding portfolio (adding Prime and Super-Prime), together with a slightly compressed NIM (c.100 bps), and crucially lower loan loss provisioning charges directly due to the lower credit risks.

UK ASSET FINANCE MARKETS

In 2016 the UK finance market (source: Finance and Leasing Association membership, an industry body) provided £118bn of new finance to UK businesses and households. This comprised £41bn provided to UK consumers and businesses to support purchases of both new and used cars (including 86% of new car registrations), £88bn provided in general consumer credit accounting for over one third of total new consumer credit written during the year and £30bn of asset finance provided to businesses and the public sector to support investment into new equipment (FLA).

Looking at the short-term performance and the latest released figures for April 2017, *asset finance (business finance)* monthly new business lease and hire purchase grew 5% to £2.68bn. For the 3 months to April new business had grown 6% to £8.36bn, and over 12 months growth was 6% to £30.95bn. The UK asset finance market covers loans for plant and machinery, commercial vehicles, IT equipment, business equipment, automotive, and aircraft ships and rolling stock (figure 3), the most significant markets are the car finance, plant and machinery and commercial vehicle finance segments, all in which PCF has representation.

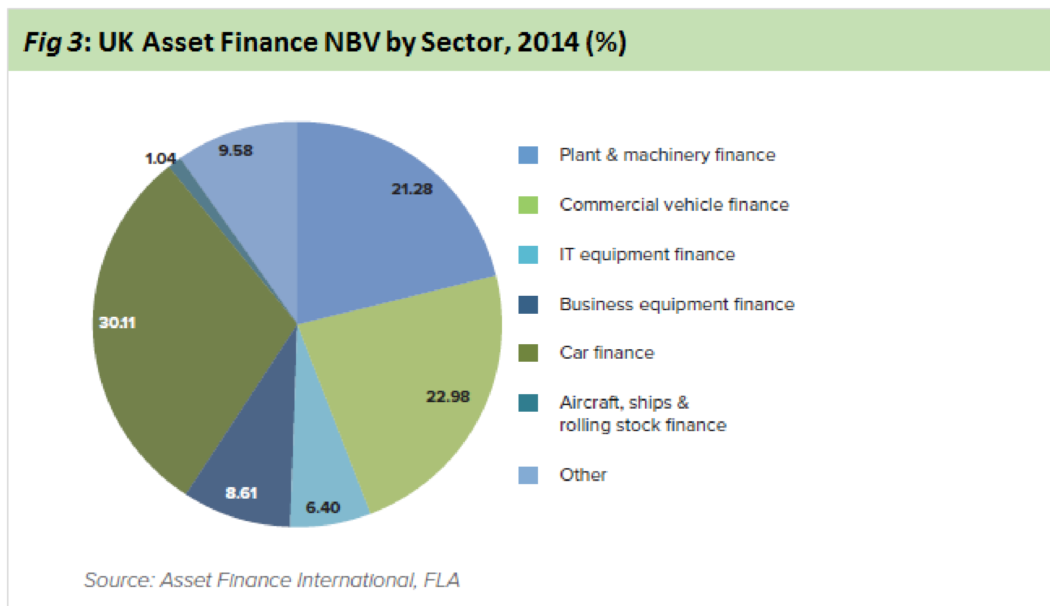


***Fig 3*: UK Asset Finance NBV by Sector, 2014 (%)**

Source: Asset Finance International, FLA

Looking across the 12-month performance horizon only, which excludes month-to-month seasonality associated with asset purchases, the most dynamic markets were aircraft, ships and rolling stock (52%) and business equipment (18%). Less lumpy industrial and cyclical markets performed well but did not record the double-digit growth rates seen in the capital equipment markets over this time scale.

In terms of comparable market performance to PCF, the broker-introduced asset finance market recorded performance of 14% over the 12 months to April 2017 to £5.44bn and the separately categorised lease and hire purchase market recorded 8% growth to £16.08bn over the same time period.

Looking at the separately produced *consumer motor finance* data, we see that data recorded for March 2017 showed significant double-digit growth across new and used car finance over 1, 3, and 12 months. Both the value of advances and the total number of cars financed showed considerable growth in both categories with the 12-month result recording +9% in new car advances and +11% in used car advances. We quantify this near term comparable UK market data below in figure 4.

Fig 4 **: Private and Commercial Finance Group Plc, UK Market Statistics**

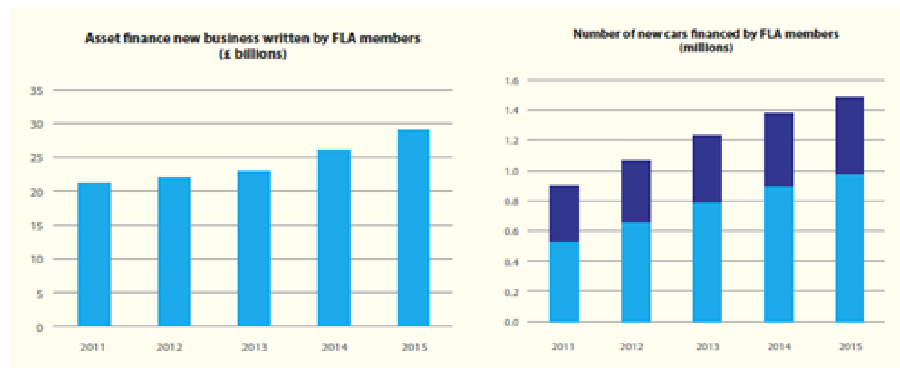
	April 2017	% chg. yoy	3 months to April 2017	% chg. yoy	12 months to April 2017	% chg. yoy
Asset Finance, £m						
Total FLA asset finance	**2677**	+ 5	**8359**	+ 6	**30952**	+ 6
Asset finance category:						
Plant and machinery	511	+ 9	1734	+ 13	6161	+ 6
Commercial vehicle	577	- 6	1962	+ 4	7437	+ 6
IT equipment	122	- 12	483	- 8	2222	- 3
Business equipment	177	- 10	619	+ 4	2472	+ 18
Automotive	974	+ 8	2696	+ 7	9485	+ 4
Aircraft ships and rolling stock	174	+ 192	310	+ 243	662	+ 52
Other	142		555		2513	
	2677		**8359**		**30952**	
Route to market:						
Direct	1329	- 4	4055	+ 6	15107	+ 5
Broker-introduced	431	0	1473	+ 17	5440	+ 14
Sales	726	- 2	2478	+ 2	9077	+ 1
Other	191		353		1328	
	2677		**8359**		**30952**	
Product:						
Finance leasing	297	- 7	943	- 4	3986	- 1
Operating leasing	707	+ 23	2047	+ 17	6923	+ 6
Lease/Hire purchase	1410	+ 2	4395	+ 9	16084	+ 8
Other	263	- 8	974	- 14	3959	+ 7
	2677		**8359**		**30952**	

		March 2017	% chg. yoy	3 months to March 2017	% chg. yoy	12 months to March 2017	% chg. yoy
Cars Bought on Finance by Consumers							
a *New cars:*							
	Value of advances, £m	3623	+ 13	5516	+ 10	18601	+ 9
	Number of cars	194348	+ 5	305406	+ 3	1054802	+ 4
b *Used cars:*							
	Value of advances, £m	1408	+ 17	3866	+ 12	13965	+ 11
	Number of cars	125179	+ 11	348059	+ 6	1274553	+ 8
	Total advances, £m	**5031**	+ 14	**9382**	+ 11	**32566**	+ 10
	Total number of cars	**319527**	+ 7	**653465**	+ 5	**2329355**	+ 6

Source: FLA research

In terms of longer term performance of UK financing, new business in UK asset finance written by FLA members has grown from c.£21bn in 2011 to £30.9bn in 2016 (figure 6), an average annual growth rate of c.8% over the period. Similar performance has been recorded in motor finance (figure 6) with both business and consumer new car purchases supported by finance increasing over the period from c.0.9m in 2011 to c.1.55m in 2016, an average annual growth rate of c.11.5% (Source: FLA annual review 2016).

Fig 5 **: UK Asset and Motor Vehicle Finance Market Performance.**



Source: FLA annual review 2016. Right chart: Consumer new cars; blue, Business new cars; purple.

The performance of the UK asset finance market is affected by firm scale effects, bank and non-bank finance effects, and by other interrelated forces of influence.

According to the Open University report into asset finance and SMEs (OU Business School, March 2009) firm scale effects are noticeable in the distribution of demand amongst firms for asset finance. Asset finance is a major source of funding for firms with 5 to 20 employees where the concentration is 48% of all asset finance sourcing. As firms get bigger or smaller, as judged by the number of employees, asset finance is less likely to be a source of funding with just 18% of firms with 1 to 4 employees sourcing asset finance and only 45% of firms with 20 plus (and into the thousands) employees.

This is corroborated by the turnover data which concludes that firms with a turnover size of less than £100k source asset finance at 6% on average. Between £100k and £500k of turnover asset finance is sourced 14% on average, between £500k and £1m it is 28%, and over £1m (and into the multi £m) this falls to 20% of financing requirements.

Turning to the drivers of demand for asset finance, by far the greatest relative demand compared with other sources of finance is the use of asset finance to fund investment in equipment (55% of respondents). Whilst other drivers of relative demand for asset finance exist across business expenditures and investment, equipment financing is the most prominent. Where asset finance is least likely to be used compared to other sources of funding is in managing cashflow or bad debts where just 37% of respondents use asset finance compared to the majority of respondents, 48%, who use other forms of financing.

A considerable driver of demand for asset finance also comes from UK corporation tax capital allowances where 43% of respondents indicate that this is very important feature compared to just 26% of other loans or external funding. Strictly leasing does not apply here as ownership title of plant and machinery is never transferred, but HP (Hire purchase) would fall within the capital allowances available.

Finally, looking at performance issues with firms that use asset finance compared to other forms of finance, asset finance is more likely to be associated with firm problems caused by economic climate or customer demand with 68% of respondents compared with 60% for other finance firms. Further, another performance distinction is looking at those respondents sourcing asset finance and reporting a particular customer debit/credit balance. 61% of respondents that replied that used asset finance also experienced debtor issues with their customers owing more, compared to just 49% of respondents that funded using other external sources.

So, in conclusion, we argue that firms that use asset finance are relatively more likely to;

1. Be the larger of smaller companies, or mid-sized companies.
2. Consider taxation benefits.
3. Not to use asset finance to manage general cashflow.
4. Worry about the economy.
5. Worry about customers not paying.

Comparing the data to the latest customer KPIs from PCF, the KPIs reported by PCF matches the SME statistics. The asset backed loans match the asset rather than general cashflow, and the loan characteristics through prudent LTV match the economic concerns expressed by this customer segment.

GROUP DEVELOPMENT AND GROWTH

(1) Banking licence and Variations of Permissions application

The Group received bank authorisation following approval from the UK regulator in December 2016, and commenced retail deposit operations on 19 July. The formation of a bank (PCF Bank Limited) permits PCF to structure operations such that it can take direct advantage in the future of new opportunities to grow, manage, and crucially fund commercial activity.

The new retail deposit capability, will change the funding structure and operations of the group such that it can expand to a greater percentage of the asset finance market, and in particular the Prime and Super-Prime markets.

(2) Retail deposits

A significant opportunity for the group is to access lower cost of funds through retail deposits and diversify the current wholesale market funding structure of £104m of borrowings owed to banks as of March 2017. The UK retail savings market is c.£800bn in size, within which PCF has estimated that its target term savings market is c.£154bn of middle to older age savers that read broadsheet newspapers, and review the online best-buy tables for deposits. Average retail savings are expected to be c.£40,000 and below the FSCS insurance cap.

In entering the UK retail deposit market, the Group is treading carefully; it is not seeking a retail presence on the high street or looking to compete on a product-by-product basis with high street banks, nor is it expected to compete unnecessarily in the UK deposit market. The Group will look to become a UK specialist bank with certain product lines aimed to attract retail deposits from an online or subscription service offering 100-day notice, and 1, 2, 3, 4, and 5-year fixed term deposit products. This spread of products will enable PCF Bank to target funding of c.3 years and duration match the effective maturity of the lending portfolio, hopefully mirroring both the sensitivities, as well lowering the cost of funds to the benefit of Group trade volumes in the Prime market. We look at the likely impact of the introduction of retail deposits into the funding mix later in this report, suffice to say at this point that the group is anticipating a significant improvement in bottom-line financial returns.

(3) Lending portfolio growth and profitability.

The Group has confirmed ambitious lending targets in its interim (March) 2017 report that would propel the Group into a much larger asset finance position in the UK. Stated lending portfolio targets would see the portfolio rise in value from £127m in March 2017 to £350m in 3 years, and £750m in in 5 years. Looking at the relative cost difference of funding using PCF disclosures for the financial year 2016 and values reported for interim financial performance, we can see that interest expense was equal to 5.75% across a mixture of fixed and floating facilities based on LIBOR plus premium.

Gauging the relative cost of this funding, 12 month UK GBP LIBOR (London Interbank Offer Rate) at the end of 2016 was 0.776% having been as high as 1.069% and with an average of 0.891% during the year. This suggests that the weighted average equates to a spread of 475 bps or so representing the gross mark-up enjoyed by the wholesale market banks financing PCF. Needless to say, some of this can be clawed back through a diversified funding mix of retail and wholesale. Company guidance suggests that expected funding cost will fall to around 3.0%. This seems high, however reason behind this is that the group operates as a bank and will have banking operational expenses which will add to the cost base. Company guidance here is for actual retail funding costs to be c.1.9%, or 90bps over historical LIBOR, a saving of 385 bps.

The fall in funding costs due to the diversified treasury strategy would be by itself enough to boost PCF profitability, however the fall in funding cost is not considered the direct benefit as PCF intends to pass through the fall in funding costs to customers. The indirect benefit is crucial, the fall in borrowing costs will enable the group to achieve greater scale in trade volumes in higher credit grade asset finance thus boosting profitability through market share and reduced credit risk as a result of higher quality lending.

In figure 3 we present the change in asset yields, the change in funding cost, and the effect on NIM. As can be seen, the net effect of lower asset yields and lower funding costs is negligible with NIM remaining the same.

Fig 6 : PCF Current and Guidance Asset Returns and Funding Cost

	Current*	Guidance*
Interest income range, rate %	8% - 18%	5.5% - 18%
Interest income average, rate %	13.5%	11.0%
Interest expense, rate %	5.75%	3.0%
Net Interest Margin (NIM), rate %	8.0%	8.0%

**Underlying rates, approximate, rounded values where applicable.*

Source: PCF, Capital Networks estimates.

PERFORMANCE, PROVISIONING, AND KPIs

The group reported solid interim results and KPIs for the 6 months to March 2017. New business trade volumes were up 13% to £35m, the customer lending portfolio grew 14% to £127.6m, and net interest income grew 6% to £5.2m. PBT, before banking project costs, grew 16% to £2.3m.

The overall financial performance, after tax, was affected in the period due to the increased costs of the banking project which raised total expenses by £0.5m to £3.0m and total intangibles by £1.3m to £2.1m for investment in computer and IT systems. Total banking project related cost over the two-year period has so far amounted to £1.1m with a total envisaged expense of £1.3m, and capitalised costs of £2.1m with a total envisaged capitalised cost of £2.5m, as shown in figure 6 below.

***Fig* 7: PCF Banking Project Costs.**

Period end date	Mar-15	Mar-16	Sep-16	Mar-17		
Months reported	6	6	18	6		
Reporting	1H15	1H16	2016	1H17	Total	Expected total
Banking project expenses	0	197	506	553	1059	1300
Banking project intangible costs			806	1294	2100	2500

RED: estimate

Source: PCF reports, Capital Network estimates

Once the banking project concludes (estimated by 2017) the set up costs will cease producing an immediate positive effect to profit and cash flow. On the other hand, the Group will have to contend with ongoing bank related costs such as increased governance, finance function and IT maintenance. The Group estimates these ongoing costs at £1.5m per annum.

The performance of the loan book has been positively controlled by Group management through the origination of additional lower yield opportunities in higher credit markets with the result that 57% of new business origination is now in the top two credit grades. This control of risk is key to the future growth plans of the business but also supports risk appetite towards the credit cycle and economic environment.

The risk focus has had the effect of reducing the impairment charge by 46% to 0.5% of portfolio assets. The impaired loan portfolio of £9.3m is 35% covered by the loss provision with the balance secured by court judgements, charging orders, and payment arrangements. Loss provisioning and risk control remains central to financial success, the Group always looks to the asset and the borrower (whichever recovers the loss soonest) and will proceed with a legal claim to recover arrears through the courts, where economically feasible to do so. Where the Group is successful in restarting payments, or accepting capital sums from borrowers in default, the loan remains part of the impaired loan book until fully repaid or otherwise written off.

In financial year 2016 the value of impaired loans fell from £10.5m to £9.3m as lending standards tightened in both instalment credit and finance leases. The additional provision created in the year was £1.5m, similar to the addition in 2015 and consistent with policy identifying problem areas, especially in past due but not impaired loans. We see these as positive risk developments, not only in terms of the evolution of the customer book towards lower credit risk but also in terms of prudent current risk assessment.

Economic returns and economic returns guidance has also been a positive area for the group with calculated results indicating that return on equity (ROE) has been as high as 16.0% in 2016 on an adjusted basis, and return on average assets (ROAA) as high as 4.0% (reported 3.1%). For the interim period to March 2017 both of these measures on an annualised basis were reported with ROE at 10.5% and ROAA at 2.8%.

Management guidance is for ROE of 12.5% and ROAA of 2.5% in the near term. This may seem low by historical standards or expectations, but these returns should be seen in context of the investment in the bank and the additional capital injected. These metrics are expected to move towards 17.5% and 3% in the 3 – 5 year horizon.

FORECASTS

(1) Funding (Assumes inclusion of the £10.5m raised in April 2017)

The Group at the current time has drawn wholesale debt facilities of £104m and current headroom of £36m. The drawn facility matures on a number of horizons over 5 years. We estimate, using the maturity profile of the Group's drawn facility and shareholder's equity, including the additional £10.5m raised recently, that the group will need to find an additional £1.5m of funding in financial year 2017 to match the portfolio growth aspiration from either the undrawn facilities or from new retail deposits. We expect the Group will use cheaper retail deposits over wholesale debt.

In between years 2017 and year 2020, the year that the Group estimates that the customer portfolio will rise to £350m, we estimate that the funding gap will increase from £1.5m to c.£215m. Again, this excludes current undrawn facilities and new retail deposits but this time we estimate that the equity will rise during this period similar to management guidance of c.12.5% per annum, or ROE. We assume little growth in dividends during these years. Our resultant funding deficit of £215m is corroborated by management who believe that by financial year 2020 funding will have developed and expanded to include a retail deposit book valued at c.£200m, therefore closing our estimated deficit and ensuring a fully funded customer portfolio.

(2) Returns and EPS

Combining the returns guidance on the customer portfolio to estimate future interest income, and combining the estimate from the funding data for future interest cost, we estimate that net interest income in 2020 will be £28.03m, and a net interest margin of 8.01% on an end of period measure. We make some small negative adjustments for fee and commission income for broker costs, and adjust for a small FV loss impact from financial instruments held on the balance sheet.

We assume that underlying administrative costs excluding both the costs of the banking project and the loan loss provision charge, remain a constant percentage of the customer portfolio. This may overestimate the actual administrative costs as this is before scale benefits and optimimisation, both of which we expect management to pursue. Administration costs are therefore estimated at £14.01m in 2020. Banking project costs are assumed to have ceased following completion by 2017.

The loan loss provision charge, is conservatively maintained at the at the higher rate of c.100 basis points in 2020, or £3.5m. This is higher than the currently reported 0.5% as we allow for countervailing forces of better credit risk new business offset by cyclical trends in customer arrears as prime credit grades at the lower end of the score are prone to financial leverage and thus quicker deterioration. We leave the effective forward rate of taxation at 20% despite UK government taxation policy proposing under certain circumstances to lower taxation rates. Our forecasts are summarised in the following figure 8.

Fig 8 : PCF Profit Forecast Summary

	2015	1H16	2016	1H17	Guidance	2020e
Total assets		114770	130702	133645		
Net loan book	99828	112270	121959	127590	*£350m by 2020*	350000
Average assets employed		*110341*	*112705*	*125659*		*350000*
Net assets		22923	24707	27352		61000
PBT statutory		1767	5127	1716		10184
PBT before banking project costs		1964	5633	2269		10184
PAT statutory	1614	1414	4021	1369		8147
PAT Excluding interest on loan notes		1501	4466	1369		8147
ROAA - calculated*		2.92%	3.97%	2.89%	*2.50%*	2.33%
ROAA - reported		3.10%	3.10%	2.80%		
ROE - calculated*		12.3%	16.3%	10.0%	*12.50%*	13.00%
ROE - reported		12.7%		10.5%		
EPS - Basic		**0.92**	**3.24**	**0.80**		**3.84**
EPS - Diluted		**0.88**	**2.62**	**0.80**		**3.84**
Shares in issue - Basic		*154163*	*124289*	*170124*		*212219*
Shares in issue - Diluted		*170378*	*170378*	*170124*		*212219*

Source: PCF reports, Capital Network estimates

VALUATION

Our forecasted profit estimate that per annum growth (CAGR – Compound Annual Growth Rate) in EPS (Earnings per Share) between 2017 and 2020 is c.25% driven by the growth in the loan book and the completion of the banking project with the termination of associated one –off costs. Between 2020 and 2022 PCF management's guidance for the rate of growth in the customer loan portfolio, accelerates from c.34% pa to c.46% per annum, which all being equal, must mean that the growth in EPS between 2020 and 2022 must accelerate proportionally. However, in estimating EPS five years from the present time, in-line with management's customer portfolio targets, we are facing a reliability issue due to the temporal uncertainty involved in a 5-year projection. We therefore moderate the maximum rate of EPS growth to 25% throughout the guidance period to 2022. Further, we estimate that beyond 2022 the rate growth in EPS is much reduced to just 5% growth, still a significant number in terms of today's low rate of return environment, but more reliable in terms of what could be achieved long-term.

Our valuation measures include discounted dividends and multiples of NAV. For the former we assume that the very low dividend pay out to shareholders continues until 2022 wherefrom policy is set at a 40% distribution. Our cost of equity capital is set at 8.5%, lower than could be presumed as we suggest that the lower credit risk portfolio at that point in time translates into a lower equity premium.

Our estimates and valuation are shown below in figure 9.

Fig 8 : PCF Valuation Summary

Year	Eps	Dps (40%)	Notes	Factor	PV	NAV, £m	Mkt Cap, £m	P/NAV
2020	3.84	0.00	*g = 25%*	0.783	0.00	61.0	49.87	0.82
2021	4.80	0.00	*g = 25%*	0.722	0.00			
2022	6.00	2.40	*g = 5%*	0.665	1.60			
2022	6.30	2.52	*Tv*	N/a	37.24			
				Total	38.84 p			

(a) Company beta: Equal weighted industry [Specialty Finance (0.83)] Capitalisation weighted industry [Specialty Finance (1.12)] Value = 0.97

(b) CAPM = Adjusted Rf, Re, and company beta. Value = 8.5%

(c) Payout ratio = 40%

Source: Morses Club, Capital Network estimates, London Stock Exchange, London Business School RMS Vol. 36 no.4 April - June 2014.

Our strict discounted dividend target price is 38.84p and our P/NAV based on the current share price of 23.5p (Market capitalisation of £49.8m) is 0.82x. We suggest that based on the significantly low dividend that we presume for years 2017 through to 2022, that this retained value is worth additional share value to shareholders such that the Group may have distributable additional reserves. We discount substantially these retained sums to the present and estimate that on a per share basis they are worth a further 10p. We believe the shares could be worth 50p.

Important – Please read this information: This report has been commissioned by PCF Group Plc and prepared and issued by Capital Network for publication globally. All information used in the publication of this report has been compiled from publicly available sources that are believed to be reliable, however, we do not guarantee the accuracy or completeness of this report. Opinions contained in this report represent those of the research department of Capital Network at the time of publication. The securities described in the Investment Research may not be eligible for sale in all jurisdictions or to certain categories of investors. Capital Network does not offer or provide personalised advice. We publish information about companies in which we believe our readers may be interested and this information reflects our sincere opinions. The information that we provide or that is derived from our website is not intended to be, and should not be construed in any manner whatsoever as, personalised advice. Also, our website and the information provided by us should not be construed by any subscriber or prospective subscriber as Capital Network's solicitation to effect, or attempt to effect, any transaction in a security. This document is not a solicitation or inducement to buy, sell, subscribe, or underwrite any securities mentioned or in the topic of this document. This document is provided for information purposes only and should not be construed as an offer or solicitation for investment in any securities mentioned or in the topic of this document. A marketing communication under FCA Rules, this document has not been prepared in accordance with the legal requirements designed to promote the independence of investment research and is not subject to any prohibition on dealing ahead of the dissemination of investment research. Capital Network has a restrictive policy relating to personal dealing. Capital Network does not conduct any investment business and, accordingly, does not itself hold any positions in the securities mentioned in this report. However, the respective directors, officers, employees and contractors of Capital Network may have a position in any or related securities mentioned in this report. Capital Network or its affiliates may perform services or solicit business from any of the companies mentioned in this report. The value of securities mentioned in this report can fall as well as rise and are subject to large and sudden swings. In addition it may be difficult or not possible to buy, sell or obtain accurate information about the value of securities mentioned in this report. Past performance is not necessarily a guide to future performance. Forward-looking information or statements in this report contain information that is based on assumptions, forecasts of future results, estimates of amounts not yet determinable, and therefore involve known and unknown risks, uncertainties and other factors which may cause the actual results, performance or achievements of their subject matter to be materially different from current expectations. For the purpose of the FAA, the content of this report is of a general nature, is intended as a source of general information only and is not intended to constitute a recommendation or opinion in relation to acquiring or disposing (including refraining from acquiring or disposing) of securities. The distribution of this document is not a "personalised service" and, to the extent that it contains any financial advice, is intended only as a "class service" provided by Capital Network within the meaning of the FAA (ie without taking into account the particular financial situation or goals of any person). As such, it should not be relied upon in making an investment decision. To the maximum extent permitted by law, Capital Network, its affiliates and contractors, and their respective directors, officers and employees will not be liable for any loss or damage arising as a result of reliance being placed on any of the information contained in this report and do not guarantee the returns on investments in the products discussed in this publication.