PCF Group (incl. PCF Bank)

Cautious lending, steady progress

8 April 2021

When we initiated coverage in Dec 20, comparing PCF to peers was difficult as most lenders have a 31 Dec year-end. It turns out that PCF is in an elite group that were able to maintain growth during FY20 and stay profitable.

Moreover, its recent trading update, five months into the financial year, has shown a continuing improvement in the loan repayment environment, although originations have been slowed by the introduction of a third lockdown and underwriting caution.

The share price has lagged peers, falling 30% from 1 Jan 20 (peer median -23%) and its recovery from the stock-market lows one year ago is far below the peer group's top performers. There looks to be significant catch-up potential.

PCF has, quite correctly in our view, concentrated on writing high-quality, low-risk business with 93% of loan originations in FY21 being in the top four credit grades (100% in Feb), compared to 85% in FY20. **The portfolio in forbearance has dropped from 38% in June 20 to below 5%, a good indicator of the portfolio's quality.**

YTD, originations total £104m (£270m for the full FY20), with the portfolio increasing to £440m from £434m on 30 Sep 20. While behind FY20 on run-rate, bear in mind that comparing the first 5 months of FY20 and FY21 is essentially a pre-pandemic to lockdown comparison. **Seasonal factors and the UK's continuing progress out of the pandemic should result in originations accelerating in H2.**

Consumer loans are expected to bounce back strongly. Caravans and motorhomes (a niche market for PCF) should enjoy a particularly strong spring and summer as 'local' holidays replace international travel. H2 is also typically stronger for consumer car finance as H1 includes a Christmas lull. Lockdown easing should accelerate bridging property finance's already strong growth trend. Short-term prospects for SME asset finance and Azule (broadcast and media equipment) are more muted.

That said, with PCF reporting £104m of originations for the first five months, it isn't hard to multiply that up for the twelve-month period (even with a seasonal boost) and see they are unlikely to hit our FY21 origination forecast of £330m. On this basis they are also likely to fall short of our loan portfolio forecast of £553m. When we initiated back in December a third lockdown was not even on the cards. This has put the brakes on over a quarter of the year's trading period.

Additionally, while loan repayment indicators such as forbearance levels improve, PCF's accounting impairment charge will be subject to a degree of volatility at the moment. This charge is, in part, determined by financial models which use inputs such as forecast unemployment rate, CPI, and GDP- which are themselves volatile and subject to a high degree of uncertainty in the current environment.

With PCF taking a sensibly cautious approach to underwriting, and the continuing uncertainty around the pandemic and economic environments, we intend to update forecasts and our valuation when greater clarity emerges at the interim results in June.

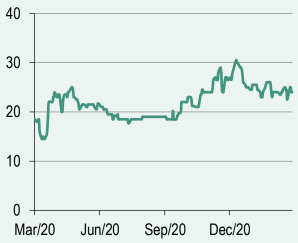
Outlook remains favourable

Despite this uncertainty, our medium and long-term term outlook remains bullish. The business has positioned itself well for an exit from the pandemic, and recent high calibre appointments (Caroline Richardson, CFO and Garry Stran, COO) strengthen the team to deliver the growth plan of building a £1bn lending book.

Company Data

EPIC	PCF
Price (last close)	24p
52 weeks Hi/Lo	30p/13p
Market cap	£60m
Net assets	£59m
Avg. daily volume	210k

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.

Paul Bryant (Analyst)
0207 065 2690
paul.bryant@equitydevelopment.co.uk

Hannah Crowe
0207 065 2692
hannah@equitydevelopment.co.uk

Financials

Results and key ratios				
y/e Sep 30	**FY17A**	**FY18A**	**FY19A**	**FY20A**
Loan originations, £m	84	148	276	270
Loan portfolio, £m	143	219	339	434
Net interest income, £m	11.1	15.0	21.6	26.6
Net interest margin	8.3%	8.3%	7.8%	6.9%
Cost to income ratio	59.3%	57.1%	55.6%	55.6%
Impairment charge	0.5%	0.5%	0.8%	2.0%
PBT, £m	3.6	5.2	8.0	1.4*
EPS basic & diluted, p	1.9	2.0	2.7	0.3*
RoE after tax	11.5%	10.3%	12.6%	1.4%*
Div, p	0.2	0.3	0.4	-
Yield	0.8%	1.3%	1.7%	0.0%
Price earnings ratio	12.6	12.0	8.9	80.0
Price to book ratio	1.6	1.4	1.0	0.9
Net assets, £m	38.7	42.6	58.8	58.8*
CET1 ratio (min 9%)	26.3%	19.4%	18.6%	17.7%*

Source: Company Historic Data, ED estimates. PER, Price to Book and Yield based on share price of 24p
**Estimates, subject to final results restatement (see RNS dated 11 March 2021)*

Consumer Finance

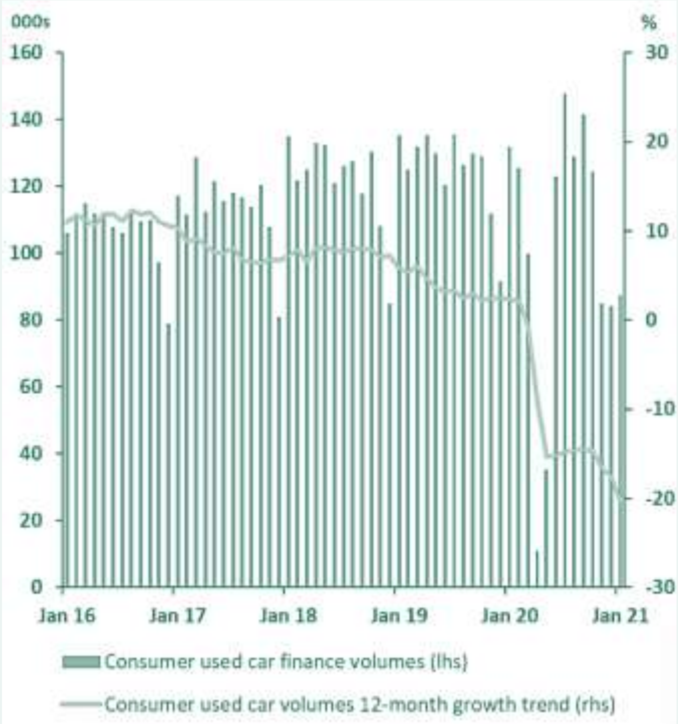
This division lends via hire purchase and conditional sale agreements to retail customers for the purchase of used cars (which have typically suffered their initial depreciation and make good loan collateral) and leisure vehicles such as motor homes, caravans and horse boxes.

Originations for the first five months of the year totalled £35m (£34m in the same period of FY20). **We think this division can meet or exceed our originations forecast for FY21 of £110m (**FY20 actual £93m)**.**

There is a heavy seasonality element to this market, particularly in leisure vehicles such as caravans and motorhomes (> 40% of the consumer finance division book). With the busiest summer months ahead, and with local travel likely to be boosted by the strong vaccine rollout, coupled with restricted international travel, we expect originations to accelerate in the coming months.

In the used-car segment of this division's business (just under 50% of the book), the Christmas period (within the period of the 5-month update) always sees a seasonal slump in used car sales, with 2020/2021 being no different (see chart). We would therefore also expect to see originations pick up as the financial year progresses.

FLA used car finance new business trends

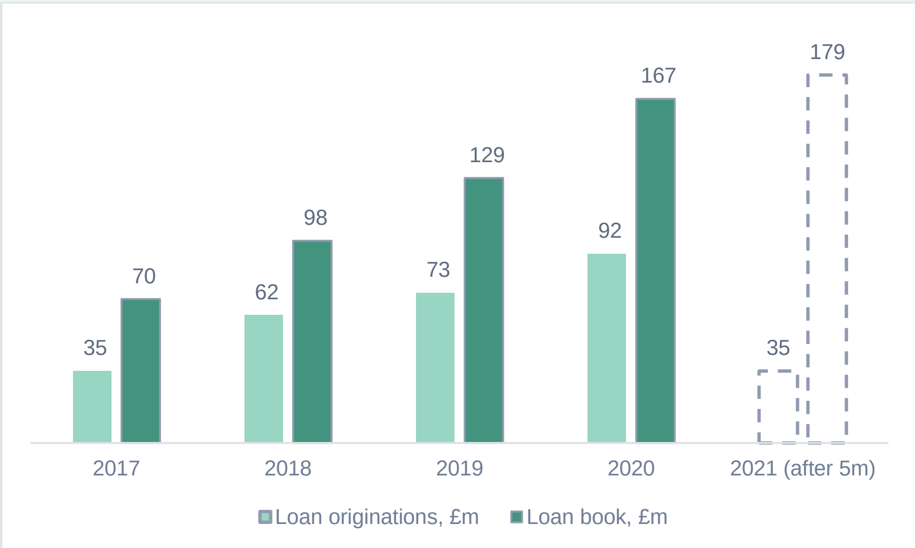


Source: Finance and Leasing Association (FLA)

Given the relatively strong growth of this division in comparison to the business finance division, it is now the largest proportion of the PCF book (41%). On 28 Feb 21 the portfolio had reached £179m, compared with £143m on 28 Feb 20 and £168m on 30 Sep 20.

The trend of forbearance levels continuing to drop was also encouraging. On 28 Feb 21, this stood at £3.9m or 2.2% of the portfolio.

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



Source: Company reports

Business Finance

PCF's business finance division lends money to UK SMEs to purchase business assets via hire purchase or finance lease agreements. The assets financed include motor cars, light commercial vehicles, heavy commercial vehicles, buses, and contractors' plant and equipment.

Originations for the first five months of the year were depressed for two main reasons. First, SMEs have continued to hold back on new investment more generally which has depressed the overall loan market in which PCF competes. Second, they have tended to use the government's Coronavirus Business Interruption Loan Scheme (CBILS) for their working capital and asset finance requirements, which has temporarily introduced a more attractive alternative to PCF's business loan products (e.g., in many cases no personal guarantees are required by the borrower).

Originations totalled £21m (£56m in the same period of FY20). We do expect some acceleration in business lending activity as the economy opens up and recovers, and as the CBILS lending scheme expires (on 31 March 2021), but the lending demand and lending quality environment looks uncertain and at the moment, it looks unlikely that our full year forecast of £90m will be reached.

On 28 Feb 21 the portfolio had reached £173m, compared with £204m on 28 Feb 20 and £184m on 30 Sep 20.

Given the financial damage many SME businesses have incurred during the pandemic, we believe PCF's particularly selective underwriting approach in this division (99% of new business originations were written in the top four credit grades) is the correct one, even if it does slow the division's growth somewhat.

Encouragingly, levels of forbearance continue to reduce. On 28 Feb 21 these totalled £11.1 million, or 6.4% of the portfolio. However certain segments (e.g., coach and bus, hospitality and retail) continue to show signs of strain.

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

Source: Company reports

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. The division uses a hybrid model which involves placing some business onto PCF's balance sheet (own-book), while placing some of the book with other loan providers (brokered) - for risk, pricing and concentration of exposure reasons.

Being heavily dependent on the TV, film, sports and live events sectors, Azule's business suffered a severe slowdown in FY20 (originations of £39m, down 43% y-o-y, split £26m brokered/£13m own-book).

Activity is starting to pick up slowly. Originations for the first five months of FY21 totalled £21m, compared with £19m for the first five months of FY20. However, the usual summer volumes of business (e.g., from festivals and events) will not be seen in FY21 due to continuing pandemic restrictions. **Our FY21 forecast for originations of £39m was very conservative and could still be met or exceeded.**

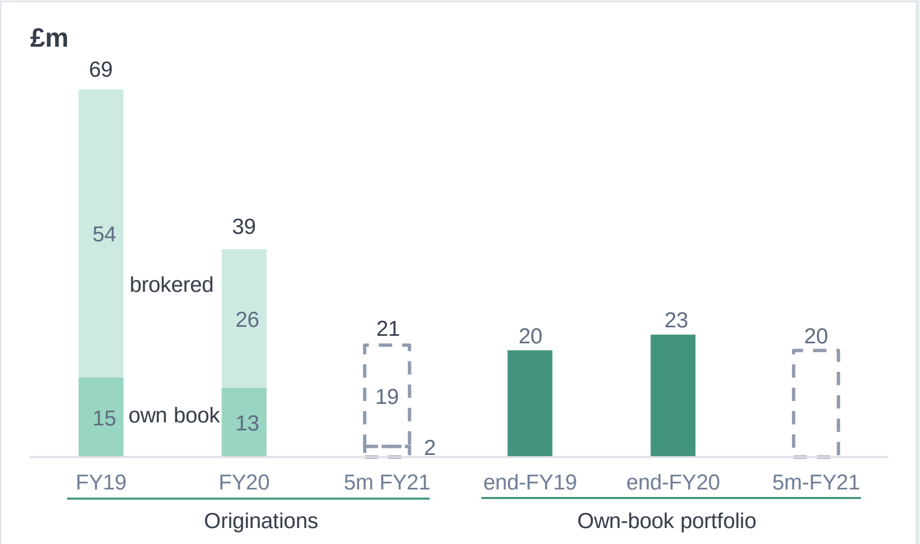
Given its conservative underwriting approach with 82% of business written in the top four credit grades, most originations (£19m) were brokered-on with £2m written to own-book.

On 28 Feb 21 the portfolio had reached £20m, compared with £24m on 28 Feb 20 and £22m on 30 Sep 20.

We maintain our view that longer-term, Azule's prospects look attractive. In our Dec 20 initiation note we pointed to streaming services such as Netflix and Amazon Prime soon being likely to resume demand for services and studio space across the UK, and that Netflix and Disney had made long-term commitments to the UK by signing leases for studios at Pinewood and Shepperton.

Indeed, **in late December 2020, Azule completed its largest ever transaction**, placing a £6.9 million LED video wall for an existing customer operating in the Disney studio at Pinewood. Importantly, a further growth market for Azule is the trend towards installing LED screens in retail space, public spaces, corporate offices and in education venues.

Azule: Loan originations and FY-end size of loan book



Source: Company reports

Bridging Property Finance

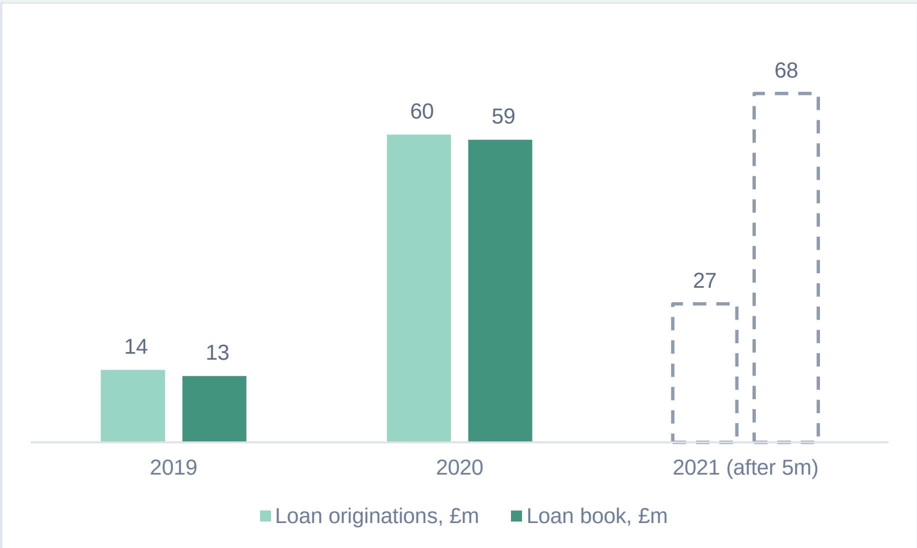
This division lends money (unregulated finance, not regulated mortgages) to UK-based property investors and developers. Funds are used to 'bridge' the period between when the property is first purchased and when it is sold or financed by traditional mortgages, for example: during a refurbishment and 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. The division was started in 2019 when PCF recruited a small team with a wealth of experience in this sector.

The division has continued on its strong growth trajectory. Originations for the first five months of the year totalled £27m (£18m in the same period of FY20). This is a little behind the run-rate required to reach our full year forecast of £90m, and even though we expect activity levels to pick up as the economy unlocks in mid-late 2021, it is unlikely that our forecast will be reached. Covid restrictions have stunted sector growth as in-person activities like valuations and refurbishments are less efficient, with the latter meaning that project lead times are longer.

On 28 Feb 21 the portfolio had reached £68m, compared with £21m on 28 Feb 20 and £60m on 30 Sep 20. In the trading update, PCF stated that demand for this division's products remains strong and that the pipeline is healthy.

There are no cases of forbearance in this division, and it has not realised any losses to date.

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



Source: Company reports

Management

Over the last few months, **two key executive appointments** have been made. Supporting Scott Maybury, a founder of the business who has been Chief Executive for the last 11 years (who successfully steered PCF through the Global Financial Crisis before leading it through the banking licence application process), will be:

Caroline Richardson, Chief Financial Officer. Caroline has significant experience as a finance director, most recently as Chief Financial Officer and Board Member at White Oak UK, where she was responsible for finance and treasury and helped develop their response to the pandemic. Additionally, Caroline has a strong knowledge and understanding of PCF's reporting requirements both as a listed entity and bank, having previously served as Group Finance and Transformation Director at Arrow Global PLC and led the Co-operative Bank's financial reporting for two years as Chief Accounting Officer. Whilst at the Co-Operative Bank, she was one of their key contacts with the PRA.

Caroline has more than 25 years' experience in finance and banking, including twelve years at Deutsche Bank, latterly as UK Finance Director, working within the UK regulatory environment. Caroline qualified as an accountant at PricewaterhouseCoopers and has a First-Class Honours Degree in Economics from the University of Hull.

and,

Garry Stran, Chief Operating Officer. Garry is a financial services professional having had a variety of roles in listed, owner managed, state and private equity controlled businesses. He has extensive experience across financial services with a focus on credit risk management, operation transformation and M&A. Garry's early career was with Nationwide Building Society where he was a senior executive and a member of Retail Credit Committee. Since then, he has worked extensively in private equity as both a founder, CEO, NED and Chairman. Garry was a non-executive director of Computershare Loan Services Ltd for six years including chairing the Audit and Compliance Committee for part of that time.

He has joined PCF from a leading fintech lender where he played a key role in supporting their rapid growth plans. Garry is a Member of the Institute of Credit Management (MICM) and holds the Finance and Leasing Diploma.

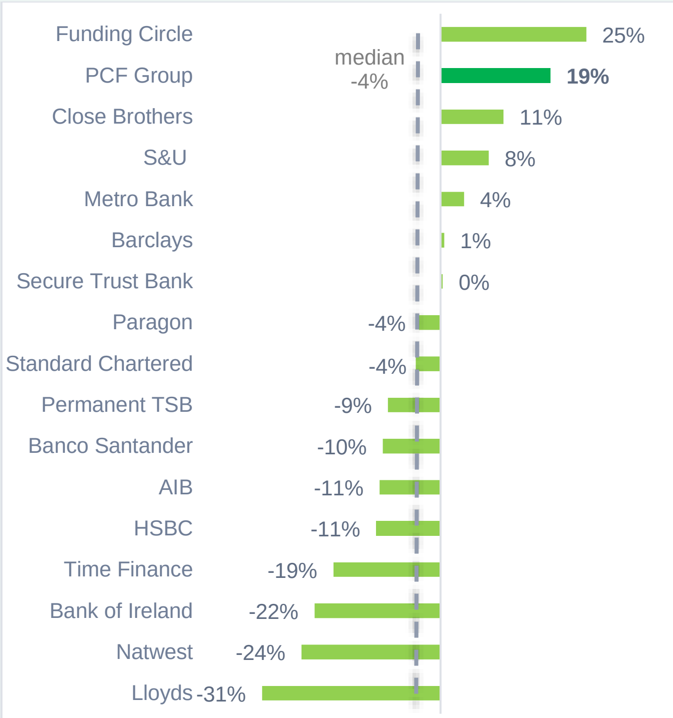
Share price recovery lags peers

When we initiated coverage of PCF in Dec 20, most UK lenders had not reported full year results that incorporated the initial impact of the pandemic (many have a 31 Dec year-end). Now that these results are available, comparisons are more meaningful.

Although many in this peer group are not perfect comparatives to PCF – some are substantially different in size, some are non-bank lenders, and not all compete in the same lending market segments - the peer analysis does offer insights into the impact of the pandemic on the UK lending sector more generally, and PCF's performance within it.

PCF is one of very few lenders which maintained strong revenue growth for FY20. It recorded the second highest growth rate (19%) out of a 17-strong peer group which showed a median revenue decline of 4%.

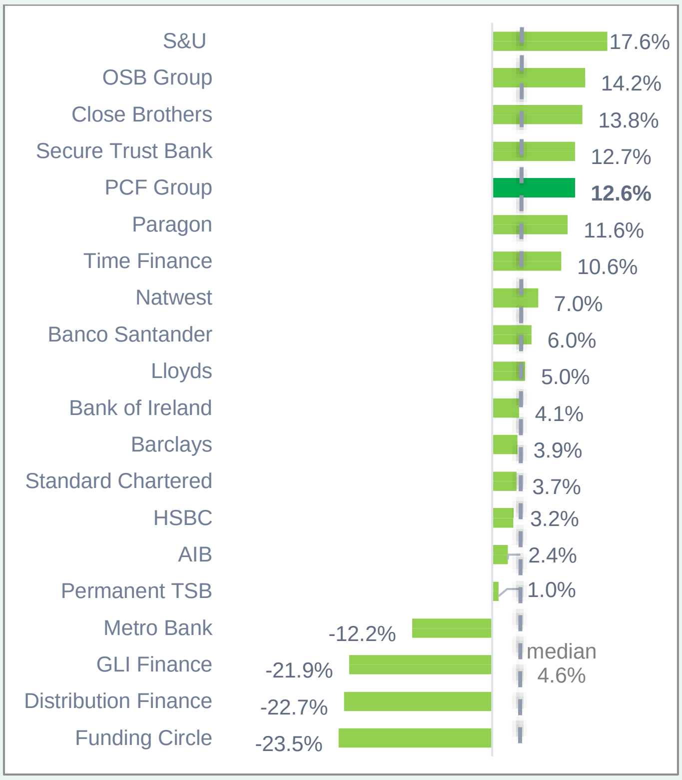
UK lenders FY20 revenue growth/decline



Source: Company reports, ED Analysis
All companies for the 12m period ending 31 Dec 20 except PCF Group & Paragon (30 Sep 20), Time Finance (30 Nov 20), and *Close Brothers and S&U (31 Jan 21)*

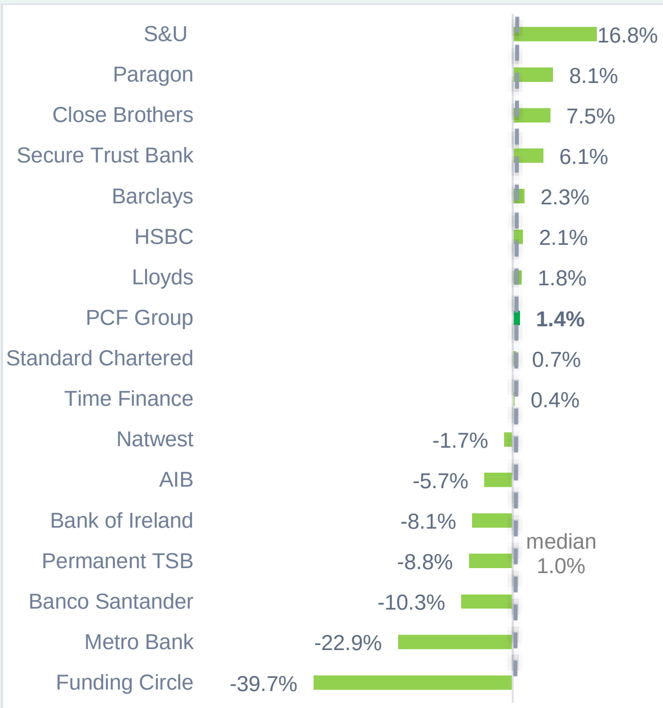
Additionally, it outperforms most peers when it comes to profitability, putting it in the rare position (compared to UK lenders' recent results) of achieving strong growth with positive RoE. Pre-pandemic (FY19), it achieved a top quartile RoE, and a top half RoE for FY20.

UK lenders FY19 RoE (pre-pandemic)



Source: Company reports, ED Analysis
All companies for the 12m period ending 31 Dec 19 except PCF Group & Paragon (30 Sep 19), Time Finance (30 Nov 19), and *Close Brothers and S&U (31 Jan 20)*

UK lenders FY20 RoE (including pandemic)

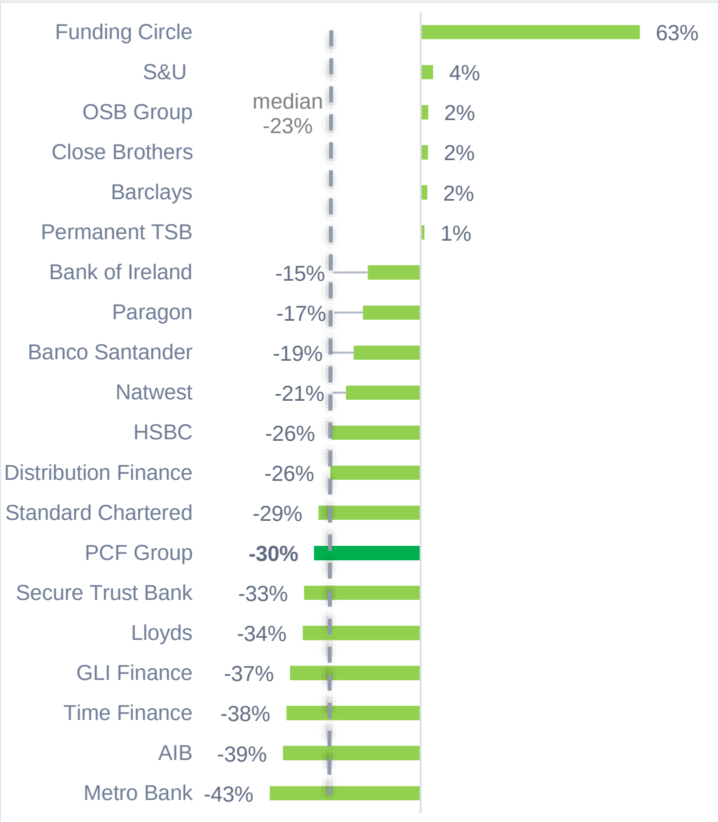


Source: Company reports, ED Analysis
All companies for the 12m period ending 31 Dec 20 except PCF Group & Paragon (30 Sep 20), Time Finance (30 Nov 20), and *Close Brothers and S&U (31 Jan 21). Latest results for OSB Group, GLI Finance and Distribution Finance (included in pre-pandemic chart) not available at time of analysis.*

It is therefore surprising that the PCF share price has been particularly hard hit since the start of the pandemic (-30% from 1 Jan 20 to 18 Mar 21) and hasn't recovered in line with many lenders (median peer group share price drop of -23%) who, on a fundamental basis, have fared worse than PCF.

We think PCF's relative fundamental performance compared to peers is not adequately recognised in the relative share price performance.

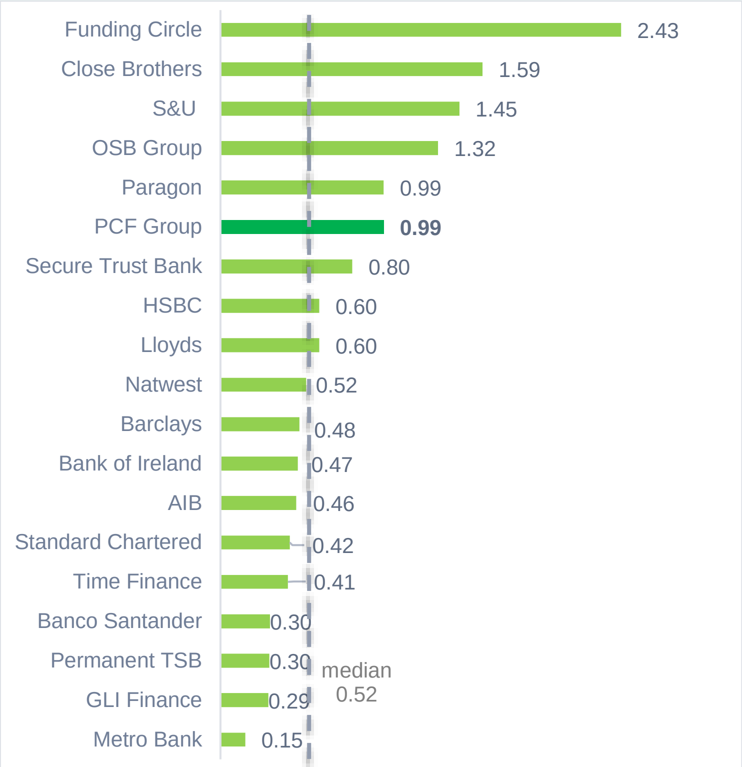
Share price moves 1 Jan 20 – 18 Mar 21



Source: ADVFN, ED analysis

We also note that PCF's price-to-book valuation ratio of 0.99 has fallen behind the most comparable peers: growing and profitable small-to-mid-cap lenders.

Price to book valuation ratios, UK Lenders



Source: Company reports, ED Analysis
As at 25 March 2021

We see significant upside potential for the share price on a rerating if PCF results start to recover quickly from the pandemic-induced growth and profitability setbacks.

We intend to update forecasts and our fundamental valuation after seeing the interim results in June.

Contacts

Andy Edmond
Direct: 020 7065 2691
Tel: 020 7065 2690
andy@equitydevelopment.co.uk

Hannah Crowe
Direct: 0207 065 2692
Tel: 0207 065 2690
hannah@equitydevelopment.co.uk

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More information is available on our website www.equitydevelopment.co.uk

Equity Development, 15 Eldon Street, London, EC2M 7LD

Contact: info@equitydevelopment.co.uk | 020 7065 2690