Jeremy Grime's Weekly Commentary

Exclusively for SharePad & ShareScope subscribers

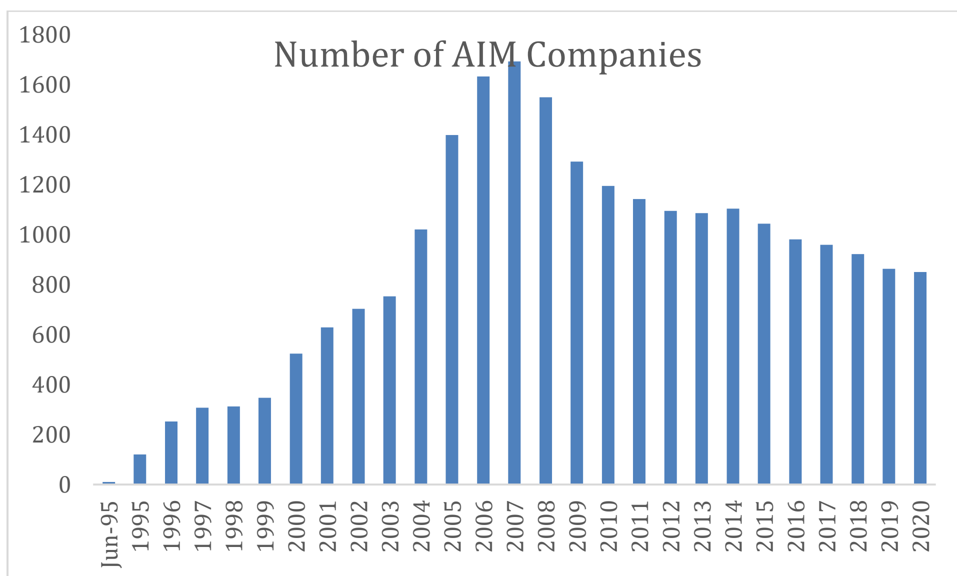
Barbell Portfolio

24 February 2020

Both technology companies and private equity have a huge advantage over us poor equity investors. For technology company research and development costs receive a tax credit which enables companies such as Amazon to benefit by paying little tax, while for private equity firms the use of debt finance, the interest on which is allowable against tax bills, enables them to benefit from lower cost of capital than equity funding.

The effect is that technology companies trade at premium valuations while private equity can afford to pay a higher price for businesses than an equity investor could justify. As a result, our stock market continues to shrink at an alarming rate. At the end of 2019 the number of AIM listed companies reached a 17-year low. While last week Share Plc was acquired by the JC Flowers backed Interactive Investor and the perennial memories of hours changing oil filters while trying not to spill the oil on the manual were taken away by the TowerBrook backed Info-Pro Digital bid for Haynes. By this mechanism the cheap companies are removed from the market resulting in an upwards revaluation of the average quoted company. Warburg Pincus meanwhile is said to be running the slide rule over Quilter Plc - and so the process continues.

Research and Development tax credits started in 2000 which fuelled AIM but with the arrival of quantitative easing, when debt became cheaply available, the advantage was handed to private equity.



Source: LSE

This article is for educational purposes only. It is not a recommendation to buy or sell shares or other investments. Do your own research before buying or selling any investment or seek professional financial advice.

Until the tax treatment of interest payments or for research and development changes, or alternatively the availability of debt changes there is no reason to imagine this trend will change. With shrinking markets we are now finding some extreme valuations at both ends of the scale. Unwanted companies become more unloved and high growth companies become more crowded. All stock market behaviours start to become exaggerated as the investment pool for equity investors dwindles.

Growth vs Durability

Part of the stock market behaviour is to naturally over value growth while undervaluing durability. With growth being very apparent in companies market updates accompanied by well drilled PR companies purposed to highlight companies growth attractions growth is easy to evidence. Laws of supply and demand for shares result in a squash in the doorway marked "growth" ensuring that growth companies become overvalued. However, this isn't altogether a bad thing because of the existence of the eighth wonder of the world, which is the law of compounding. Over paying for a growth company is a forgivable sin, as in the long run the impact of the growth will far outweigh the impact of overpaying. Terry Smith makes this point as elegantly as he always does in a medirect talk in March last year where he illustrated the impact of valuation over a 40-year time horizon. The link is here: https://www.youtube.com/watch?v=YZM9dhiDbzI. He then estimates that 80% of the return on stocks over time comes from the growth using a time period from 1917 to 1999.

S&P 500	1917	1999	Annualised CAGR	% of return
Return from P/E growth	5.3x	34.0x	2.3%	*20%*
Return from EPS and EPS growth			9.3%	*80%*
S&P 500 Total return			**11.6%**	

So, the message is clear, that with sustainable high return growth stocks we shouldn't get too hung up on valuation.

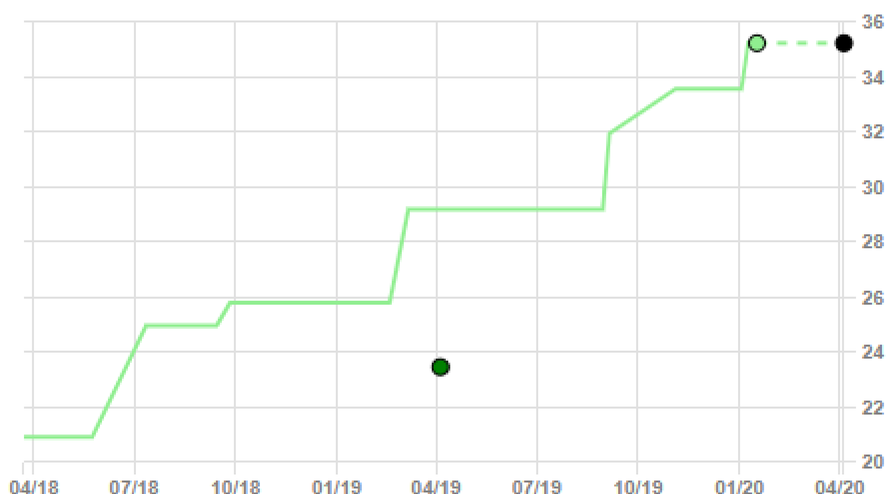
But "durable stocks are different. We don't recall seeing the words "durable" in a company's results statement. Words such as recurring income appear, but that is different to durable as it generally refers to fees that are likely to recur until the customer changes their mind. Haynes Publishing, for example, had durable revenues, as well as c.60% recurring revenue. It is the brand that makes the business durable in the long run. And the market's tendency to ignore durable in favour of growth stocks led it to be bid for by a private equity backed company. Couple the market tendency to undervalue durability with the liquidity aversion in small cap land post Woodford and we have a number of potential gifts for the retail investor.

This article is for educational purposes only. It is not a recommendation to buy or sell shares or other investments. Do your own research before buying or selling any investment or seek professional financial advice.

Portfolio Implications

This looks like the environment for a barbell portfolio. Small cheap income stocks with durable businesses are undervalued while high growth stocks are also likely to do well. We all have our favourite growth stocks. Mine is AlphaFX, trading on a lofty 41X PER which may well be overvalued. But having grown their earnings 53% in 2018 and with the current 39% anticipated EPS growth in 2019 it shouldn't take too long to grow into the valuation. Couple that with a likelihood of upgrades which have come at regular intervals over the last 12 months and it may grow into the valuation quicker than expected.

Alpha FX forecast history



Source: SharePad

Cheap durable stocks

This is more difficult in an environment when we are experiencing a global slow down on the back of a China shut down, a cyclical slowdown and tariffs. The dollar also reached new highs last week which is likely to severely impede global growth. The first two cheap durable businesses I come across have had profit warnings recently. M&C Saatchi reported a sharp slow down in December (as well as accounting issues) while Renold, the distributor of industrial chains reported on the improved efficiency at its China factory in November. Both China exposure and advertising slow down could get worse yet so I worry about catching falling knives. There is no doubt in my mind that both of these durable businesses will recover but being too early can be very painful. So, I will pass over these at the moment for more UK centric plays.

100% of Non-Standard's Finance's revenues are from the UK. The area of high cost lending is less cyclical as their customer tend to borrow for necessary spending, such as school uniforms, car services etc, as opposed to discretionary spending and the businesses are durable over time with one of their businesses having been trading since 1880.

This article is for educational purposes only. It is not a recommendation to buy or sell shares or other investments. Do your own research before buying or selling any investment or seek professional financial advice.

Non-Standard Finance Plc

Share Price 31p
Mkt Cap £96m

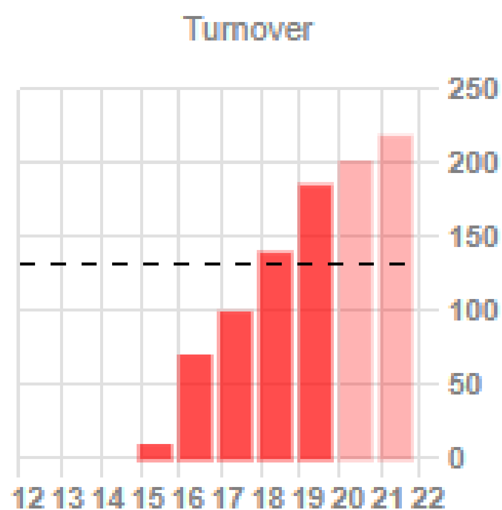
Source: SharePad

This chart is indicating something has changed. The Woodford stock overhang was placed out in December and January which has enabled the shares to recover from the selling pressure. Meanwhile after a disastrous growth strategy over the 4 years since it floated the company has now changed it strategy from growth in the loan book to growth in profits. One of the strange things about markets is that when a company changes strategy share prices take a long time to adjust, and usually when the profit growth is actually delivered the shares respond very positively. We need to be confident that profit growth will be delivered and that the shares are cheap.

This article is for educational purposes only. It is not a recommendation to buy or sell shares or other investments. Do your own research before buying or selling any investment or seek professional financial advice.

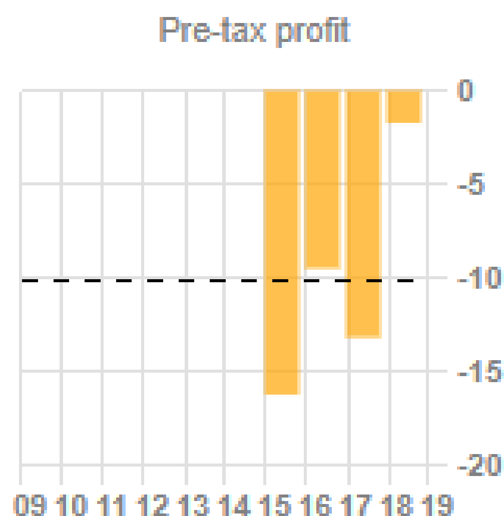
Business

The company was seeded back in 2015 at £1/share by Neil Woodford and Mark Barnet who backed the former CEO of Provident Financial to acquire alternative lending businesses and grow fast in an area where banks and other lenders had withdrawn. Having overpaid for businesses the growth strategy resulted in impairments blowing out and destroying shareholder value such that today the shares stand at 31p. The company has certainly succeeded in growing the book



Source: SharePad

But the company has made losses on the journey:



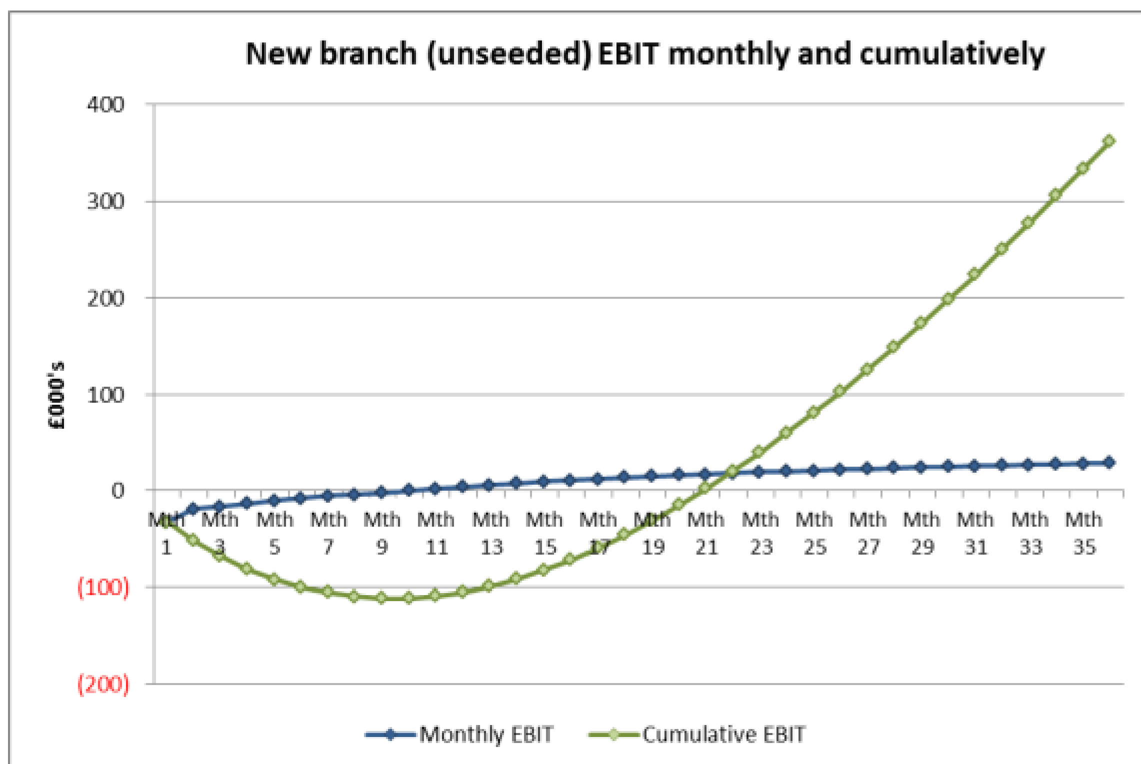
Source: SharePad

This article is for educational purposes only. It is not a recommendation to buy or sell shares or other investments. Do your own research before buying or selling any investment or seek professional financial advice.

Why will it make growing profits?

In short profits will grow because growth is slowing. In all 3 divisions.

1. **Everyday Loans**, the branch-based lending business typically take 12 months for a branch to break even. Thus, a branch roll-out will drag on profits while it can take up to 5 years for a branch to reach maturity.



Source: Non-Standard Finance

With 73 branches today the company now targets 100 branches over the next few years. Consequently, after 4 years of operation, the first branches are now reaching maturity, while the rate of roll out of branches is slowing down and thus the profits will start to come through.

2. **Home Collected Credit** This division is a very durable business, having been started in 1880. It is a high return business but is hard to grow for two reasons. Firstly, a new customer is always riskier than a customer who has an established relationship. Secondly, to grow a loan book generally lengthening the duration of the loan book is an effective means of doing this. But longer duration loans carry higher impairments as customers experience more changes in circumstances over time. And longer duration loans also tie up capital so deliver a lower return for the lender. With shorter term loans the company can recycle the capital faster achieving a higher annualised interest rate. As a result the most profitable book will be a stable short duration loan book which doesn't grow. This is the strategy that Non-Standard Finance announced in January when they reduced their

This article is for educational purposes only. It is not a recommendation to buy or sell shares or other investments. Do your own research before buying or selling any investment or seek professional financial advice.

growth guidance for all divisions. So, while the loans book will grow less the profits will grow more, a factor which seems to have passed by the majority of investors.

Non-Standard Finance January Guidance

	Loan book growth		Impairment as % of revenue		Return on asset[1]	
	Previous	New	Previous	New	Previous	New
Branch-based lending	20%	10% - 15%	20% - 22%	22% - 24%	20%	20%
Guarantor loans	30%	15% - 20%	20% - 22%	22% - 24%	20%	20%
Home credit	2-5%	(5%) - 5%	33% - 37%	30% - 33%	20%	20%

[1] *Normalised operating profit as a percentage of average net receivables*

Source: Non-Standard Finance

3. **Guarantor Loans** This is lending to credit impaired individuals which is guaranteed by a friend or family member enabling individuals to repair their credit score. The new strategy is around improving efficiency, slowing growth and as the company's capital markets day presentation clearly states:

Concentration on profitability alongside our revised medium-term growth target

Growth

It would seem a reasonable assumption that while the stock market is focussed on declining top line growth the reality is that profit growth is set to accelerate.

Valuation

A PE of 7.6X and a yield of 9.8% appears cheap if the profits and dividend is sustainable. The 2019 results expected in March are expected to show £15.6m PBT which is represents c 10.6% growth on the prior year. Going forward the PBT growth is set to accelerate to 35% delivering £18.4m. With a pipeline of maturing branches over the next 5 years this profit growth will be set to accelerate for some time. On 2020 forecasts the PE reduces to 5.6X. This represents EPS of 5.6p from which a well covered 3.4p dividend is expected to be paid. Rather than having sustainable profits it seems the earnings are likely to accelerate. This is a time not be blinkered by a rear-view mirror.

This article is for educational purposes only. It is not a recommendation to buy or sell shares or other investments. Do your own research before buying or selling any investment or seek professional financial advice.

FORECASTS						£ millions unless stated
Year	2019		2020		2021	
Turnover	185.0		200.9	+8.6%	218.2	+8.7%
EBITDA	43.2		52.1	+20.5%	60.8	+16.8%
EBIT	42.6		50.8	+19.3%	58.1	+14.5%
Pre-tax profit	15.6		21.3	+36.5%	26.1	+22.4%
Post-tax profit	12.8	+10.6%	18.4	+43.7%	22.6	+22.8%
EPS (p)	4.0	+8.1%	5.6	+40.0%	6.9	+23.2%
Dividend (p)	3.0	+15.4%	3.4	+13.3%	3.9	+14.7%
Capex	7.0	+15.1%	4.5	-35.7%	4.5	0.0%
Free cash flow	11.7		13.3	+13.6%	15.0	+12.8%
Net borrowing	302.9	+20.0%	328.0	+8.3%	369.3	+12.6%
NAV	51.6	-75.5%	59.1	+14.5%	70.4	+19.1%
Like for like sales growth %	-		-		-	

It is rare to find a stock growing its earnings in a low risk manner from UK customers at 36% trading on a PE of 5.6X and yielding in excess of 10%. However, no lender valuation is complete without a look at the balance sheet. A year from now the market could value this stock at 12X 2021 earnings which would give a share price of 83p, some 160% higher than the current 31p share price.

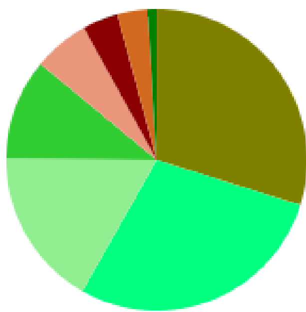
Balance Sheet

The January trading update confirmed the loan book stood at £366m which was financed by net debt of £309m. at December 2018, which is the most recent set of accounts, the net debt was £272m of which £235m was provided by a term loan from institutions with a six year term and the balance was provided by The Royal Bank of Scotland under a 5 year facility. The equity is shown as £211m, but as a result of overpaying for acquisitions the net tangible equity is negative. The gearing is perhaps high but the January trading statement stated that the company had signed an agreed term sheet finalising a new £150-200m securitisation facility that would provide a meaningful reduction in funding costs, adding further potential profit uplifts.

Bid potential

Generally regulated companies have a smaller pool of private equity buyers, but there are some. And the type of private equity buyer that is appropriate for this type of business is evidenced on the shareholder list. Woodford is now out of the stock and has been replaced by Alchemy who invest in special situations, which this certainly is.

This article is for educational purposes only. It is not a recommendation to buy or sell shares or other investments. Do your own research before buying or selling any investment or seek professional financial advice.



Key	Shareholder	Role	Date	Holding	+/-	%	%Chg
	Alchemy Special Opportunities ...		18/12/19	93.6m	+33.5m	29.9465	+10.7221
	Invesco Asset Management Ltd.		22/3/18			28.4800	
	Aberforth Partners LLP		22/10/19	53.1m		17.0005	
	Marathon Asset Management Ltd		17/12/19	33.9m	-2.12m	10.8483	-0.6776
	Neil Alan Utley		22/1/20	18.8m	+18.8m	6.0025	+6.0025
	Tosca Fund Asset Management…		1/5/19	12.0m		3.8408	
	Basswood Capital Management…		14/1/20	10.1m	+10.1m	3.2460	+3.2460
	John Philip de Blocq van Kuffeler	CEO/Dir…	8/3/19	2.11m		0.6768	
	Niall Booker	Non-ex	8/3/19	427k		0.1366	
	Charles Henry Gregson	Chairma…	3/1/20	410k	+37.6k	0.1313	+0.0120
	Heather John McGregor	Non-ex	25/6/19	133k		0.0425	
	Nicholas John Teunon	CFO/Dir…	12/12/19	128k	+20.0k	0.0410	+0.0064
	Total Shares in issue			**312m**	**+551**		**+0.0002**

Change over three months of +/- absolute number of shares held and %chg in percentage of company held

Source: SharePad

Conclusion

This has all the hallmarks of one of those overlooked resilient cheap businesses that institutional investors are embarrassed to own. Non-Standard lending is a durable and old business which is unlikely to go away and this company is at a stage of development where risks are reducing and returns increasing while stock markets can sometimes be backward looking rather than forward looking. There looks to be money to be made for investors who can look forward.

Summary

With the tax advantages that technology companies and private equity enjoy this is a time to take a barbell portfolio approach. We all have our favourite growth stocks (mine is Alpha FX) but durable companies that can improve profits and are cheap need more care. Particularly in an environment where global growth is slowing, China trade is vapourising and tariffs are on the increase. Non-Standard Finance looks to be a UK resilient company with a troubled past where the profits are set to increase, risks are set to reduce and the rating is extreme. If it doesn't get re-rated from its PE of 5.6X and yield above 10% perhaps Alchemy may decide to own all of it. And while we wait, we can enjoy the dividend.

Forthcoming Events

Neither company has yet confirmed the date for their December 2019 results. Alpha FX growth is forecast to slow to 18.5% in 2020 from 38% in 2019 so we may hope for forecast upgrades on Alpha results. Which the rating of 34X 2020 PE is perhaps anticipating, while delivering the numbers for NSF may highlight that 5.5X PE and 11% yield merits a re-rating.

Company	Date	Event
Alpha FX	Mar-20	FY Results
Non Standard Finance	Mar-20	FY Results

Source: SharePad estimates