Company In-Depth

SMALL & MID CAP

17 August 2006 | 45 pages

Provident Financial (PFG.L)

An Evolving Credit Story

- Initiating coverage — We initiate coverage with a Buy/High Risk (1H) rating and set a £7.50 target price, which implies a total expected return of ~36%. The stock's key attractions are its strong UK free cash flow generation, its premium dividend yield, and the growth potential offered by its international activities.
- Attractive valuation — The shares currently trade on a 2006E free cash flow yield of 7.8%, which rises to 10.9% by 2008E and supports a 6.3% prospective dividend yield. Despite the earnings drag of substantial new business start-up costs, Provident trades on 11.3x 2006E and 9.4x 2007E earnings, which seems inexpensive given the longer-term growth potential.
- International growth — Launched in 1997, the international credit activities accounted for 25% of group pre-exceptional profits in 2005, and we forecast this will rise to 45% by 2010E as a result of 20% pa profits growth over the next five years.
- UK cash and capital generation — The UK Home Credit and Motor Insurance businesses are relatively mature but highly cash generative. We forecast free cash flows totaling £115m from these businesses alone in 2006E, which more than covers our forecast for the group's annual dividend payment.
- De-merger to release value — The planned de-merger of the international division during 1H07 should allow these businesses to invest more heavily in rolling out the geographic platform and highlight the cash generative attraction of the UK businesses.

Buy/High Risk	1H
Price (16 Aug 06)	£5.82
Target price	£7.50
Expected share price return	28.9%
Expected dividend yield	6.3%
Expected total return	**35.1%**
Market Cap	£1,487M
	US$2,820M

Price Performance (RIC: PFG.L, BB: PFG LN)

See page 42 for Analyst Certification and important disclosures.

Provident Financial (GBP)

Year to 31 Dec	2004A	2005A	2006E	2007E	2008E
Net Income (£M)	144.4	157.8	132.0	158.0	178.7
Diluted EPS (p)	56.7	61.8	51.7	61.8	70.0
PE (x)	10.3	9.4	11.3	9.4	8.3
P/BV (x)	3.6	4.7	4.1	3.5	2.9
DPS (p)	34.4	35.4	36.5	37.6	38.7
Net Div Yield (%)	5.9	6.1	6.3	6.5	6.7
ROE (%)	37.5	0.0	39.0	40.4	38.6

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Fiscal year end 31-Dec	2004	2005	2006E	2007E	2008E
Valuation Ratios					
P/E (adjusted) (x)	10.3	9.4	11.3	9.4	8.3
P/E (reported) (x)	10.3	na	11.3	9.4	8.3
P/BV (x)	3.6	4.7	4.1	3.5	2.9
P/Adjusted BV (x)	3.6	4.7	4.1	3.5	2.9
Dividend yield (%)	5.9	6.1	6.3	6.5	6.7
Per Share Data (p)					
EPS (adjusted)	56.7	61.8	51.7	61.8	70.0
EPS (reported)	56.7	0.0	51.7	61.8	70.0
BVPS	162.6	124.3	140.5	165.5	197.4
Tangible BVPS	120.7	112.3	128.5	153.5	185.4
Adjusted BVPS	162.6	124.3	140.5	165.5	197.4
DPS	34.4	35.4	36.5	37.6	38.7
Profit & Loss (£M)					
Net interest income	1,108	1,183	1,069	1,120	1,183
Fees and commissions	0	0	0	0	0
Other operating Income	165	155	153	156	159
Total operating income	**1,272**	**1,338**	**1,222**	**1,276**	**1,342**
Total operating expenses	-782	-803	-664	-677	-700
Oper. profit bef. provisions	**491**	**535**	**558**	**599**	**642**
Bad debt provisions	-285	-353	-369	-374	-387
Non-operating/exceptionals	0	-141	0	0	0
Pre-tax profit	**206**	**40**	**189**	**226**	**255**
Tax	-61	-40	-57	-68	-77
Extraord./Min. Int./Pref. Div.	0	0	0	0	0
Attributable profit	**144**	**0**	**132**	**158**	**179**
Reported net income	**144**	**0**	**132**	**158**	**179**
Adjusted earnings	144	158	132	158	179
Growth Rates (%)					
EPS (adjusted)	na	8.9	-16.4	19.7	13.1
Oper. profit bef. prov.	na	9.0	4.3	7.4	7.1
Balance Sheet (£M)					
Total assets	**2,063**	**1,979**	**1,828**	**1,895**	**1,978**
Avg interest earning assets	1,192	1,237	1,198	1,156	1,231
Customer loans	1,200	1,274	1,122	1,190	1,273
Gross NPLs	0	0	0	0	0
Liab. & shar. funds	**2,063**	**1,979**	**1,828**	**1,895**	**1,978**
Total customer deposits	0	0	0	0	0
Reserve for loan losses	0	0	0	0	0
Shareholders' equity	415	317	359	423	504
Profitability/Solvency Ratios (%)					
ROE (adjusted)	37.5	43.1	39.0	40.4	38.6
Net interest margin	92.92	95.61	89.23	96.86	96.07
Cost/income ratio	61.4	60.0	54.3	53.0	52.2
Cash cost/average assets	40.16	39.72	34.89	36.35	36.16
NPLs/customer loans	0.00	0.00	0.00	0.00	0.00
Reserve for loan losses/NPLs	na	na	na	na	na
Bad debt prov./avg. cust. loans	23.92	28.57	30.84	32.32	31.41
Loans/deposit ratio	na	na	na	na	na
Tier 1 capital ratio	24.2	18.4	22.5	28.8	33.7
Total capital ratio	na	na	na	na	na

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Investment Thesis

Provident Financial offers a combination of (i) high free cash flows from its UK home credit and insurance divisions, and (ii) potentially significant earnings growth from its international home credit franchise and credit card platform. The key risks are regulatory risk in the UK, low earnings visibility in Mexico and Central Europe, and the performance of the Yes Car Credit book in run-off. We initiate coverage with a Buy/High Risk (1H) rating and a 750p target price.

Our fundamental price-to-book, sum-of the parts and de-merger-scenario valuations indicate end-December 2006 fair values within a 730p to 790p per share range, underpinned by a 721p per share estimate based on peer group relative analysis. Our LBO analysis of the UK home credit business suggests this unit could be worth around 400p per share on its own to private equity investors — around two-thirds of the current share price — which lends further support to our target price. The stock's key investment attractions include:

Attractive valuation

Figure 1. Key Valuation Metrics

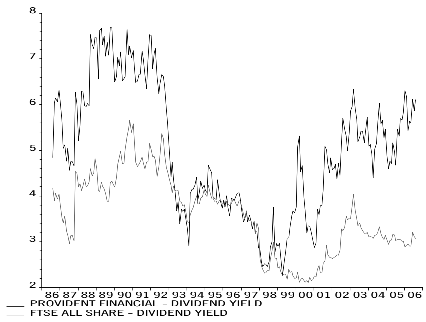
Year to December (£m)	**2006E**	**2007E**	**2008E**	**2009E**	**2010E**	**2006E-10E**
Net profit	132.0	158.0	178.7	197.7	215.3	881.6
Receivables growth	83.7	67.2	83.3	98.1	126.8	459.3
Working capital	-16.7	-13.4	-16.7	-19.6	-25.4	-91.9
Equity free cash flow	**115.2**	**144.5**	**162.1**	**178.0**	**189.9**	**789.8**
Dividends	-90.5	-94.3	-97.1	-100.0	-103.0	-484.9
Surplus capital generation	**24.7**	**50.2**	**65.0**	**78.0**	**86.9**	**304.8**
Market value	1,483					
Free cash flow yield	7.8%	9.7%	10.9%	12.0%	12.8%	53.3%
Dividend yield	6.3%	6.5%	6.6%	6.8%	7.1%	
P/E ratio	11.3	9.4	8.3	7.5	6.9	

Source: Citigroup Investment Research

High dividend and free cash flow yields

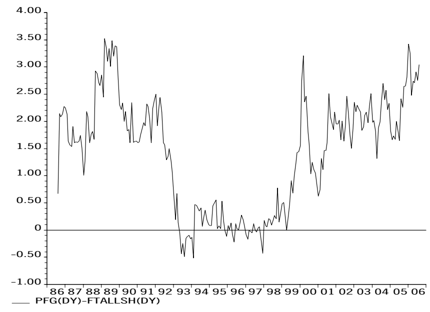
The shares are currently trading at close to their 20-year yield premium high relative to the FTSE All Share Index; the shares have traded at a market yield, between 1993 and 1999, when the group reported consistent earnings growth.

Figure 2. Provident Yield v FTSE All Share Index



Source: Datastream

Figure 3. Provident Yield Premium



Source: Datastream

- After funding loan growth at 20%, we estimate Provident will generate free cash flows of almost £115m in 2006E, a free cash flow yield of 7.8%.
- Looking further ahead, the group's free cash flow yield rises to almost 11% by 2008E and to almost 13% by 2010E. In aggregate, we estimate Provident will generate free cash flows totaling £790m in the five years to 2010E, some 53% of the group's current market value.
- These cash flows support a substantial dividend: we forecast dividends of £90m in 2006E, growing at 3% pa to just over £100m by 2010E. At current prices, this translates to a prospective dividend yield in excess of 6%, as compared with a peer group average of around 4%.

Inexpensive earnings multiples

- Although one or two year-ahead earnings estimates are a poor reflection of Provident's underlying earnings power due to the near-term drag of new business start-up losses, the shares look inexpensive on a relative PER basis.
- According to our forecasts, the shares trade on 11.3x 2006E earnings and 9.4x 2007E. This compares with averages of around 11.7x 2006E and 10.4x 2007E for a broad basket of UK-quoted commercial and consumer credit peers, putting Provident on a 2007E PER discount of ~10%.
- Applying peer group consensus PE ratios for 2006E to our Provident EPS estimate for 2007E suggests an end-December 2006 fair value of 721p.

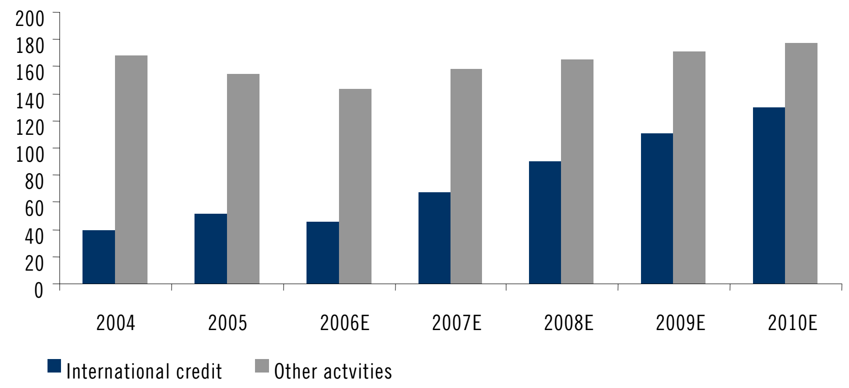
Discount to intrinsic value

- We have estimated Provident's intrinsic value using fundamental price to book and discounted sum-of-the-parts approaches.
- These methodologies indicate end-2006 fair values of 788p and 730p respectively, suggesting a year-end fair value of around 750p per share, 28% higher than the current share price. At 750p, the shares would trade on a 2007E PE multiple of 12.1x and yield a prospective 5.0%.

Strong international earnings momentum

- The international credit activities have grown rapidly: gross lending (credit issued) and customer numbers have grown at compounded annual rates of 63% and 51% respectively.
- The division's £60m increase in profit before tax between 1999 and 2005 accounted for all of the growth in the group's PBT over the period (and before YCC operating and exceptional losses).
- The division generated PBT of £51.1m in 2005, which accounted for 25% of the group's operating profits.
- We forecast International profits will grow at a compounded 20% per annum over the five years to 2010E, based on customer numbers up 15% pa and credit issued up 11% pa, by which time the division's contribution will have risen to an estimated 45% of the group total.

Figure 4. International Credit –Forecast PBT Growth (£m)



Source: Company reports and Citigroup Investment Research

Figure 5. International Credit – Forecast Summary

Year to December (£m)	**2005**	**2006E**	**2007E**	**2008E**	**2009E**	**2010E**	**2005-10E**
Turnover	358.6	436.5	474.3	522.6	583.1	661.5	13.0%
Interest	-19.3	-23.4	-26.0	-29.7	-34.6	-41.1	16.3%
Administrative expenses	-145.6	-180.8	-193.9	-210.7	-235.0	-267.0	12.9%
Pre-impairment profit	**193.7**	**232.3**	**254.5**	**282.2**	**313.5**	**353.4**	**12.8%**
Impairment charge	-132.4	-161.6	-167.8	-175.8	-185.3	-206.2	9.3%
Profit before tax & central	**61.3**	**70.8**	**86.7**	**106.4**	**128.2**	**147.2**	**19.2%**
Central overheads/interest	-10.2	-10.6	-11.0	-11.5	-11.9	-12.4	4.0%
Start-up losses		-15.0	-8.0	-5.0	-5.0	-5.0	
Profit before taxl	**51.1**	**45.1**	**67.7**	**89.9**	**111.3**	**129.8**	**20.5%**
Credit issued	**544.9**	**592.6**	**644.4**	**713.6**	**791.9**	**901.0**	**10.6%**
Closing receivables	328.7	355.9	384.3	421.0	462.3	519.3	9.6%
Average receivables	280.4	342.3	370.1	402.7	441.7	490.8	11.8%
Customer numbers (000s)	**1,777**	**1,958**	**2,199**	**2,553**	**2,960**	**3,544**	**14.8%**

Source: Citigroup Investment Research and company reports

Management's targets are more aggressive than our forecasts. In particular, management has targeted:

- A £60m PBT contribution from Poland, with £15m from each of the Czech Republic and Hungary, and £5m from Slovakia.
- Excluding Romania (still in pilot), management is therefore targeting total profits from Central Europe of ~£95m (versus £64.2m in 2005).
- A £90m PBT contribution from Mexico, following full roll-out, based on a total of 3 million customers generating a profit of £30 pa each.
- In total, management's long-term targets are for 4.6m international credit customers (excluding Romania and future new countries) as compared to our 2010E forecast of 3.5m customers.

Figure 6. International Credit – Management Targets

Country Targets	Poland	Czech Republic	Hungary	Slovakia	Romania	Central Europe	Mexico
Rollout year	1997	1998	2001	2001	2006		2003
Customer numbers ('000)	1,000	250	250	125	?	1,625	3,000
Market share	50%	50%	50%	50%	?	50%	
Credit per customer (£)	400	400	400	270	?	390	
Credit issued (£m)	400	100	100	34	?	634	
Profit per customer (£)	60	60	60	40	?	58	30
PBT (£m)	60	15	15	5	?	95	90

Source: Company Reports

Cash and capital generative UK businesses

The UK Home Credit and Motor Insurance businesses are relatively mature but significantly cash generative. We estimate that these businesses will generate free cash flows totaling £120m in 2006E, which more than covers the group's annual dividend (we forecast ~£90m this year).

Whereas in recent years some of this cash flow has been required to finance International growth, the latter is now self funding.

- In 2005, the UK Home Credit and Motor Insurance activities generated free cash flows totaling £127.5m. Deducting central costs, the UK activities generated net cash flows of £113m last year, which covered the group dividend 1.3x.
- The International Credit businesses have become increasingly cash positive, despite ongoing investment costs in Mexico and, in 2006, Romania. The division is capable of funding its investment and development spend and the marginal capital requirements of its loan book growth, ie it is now self-funding.
- Vanquis Bank, the group's credit card platform, is currently cash consumptive, and is expected to remain so in 2006. We forecast Vanquis will be profitable in 2007 and cash generative by 2008.

Figure 7. Cash Generation by Division

Year to December (£m)	2004	2005
-UK Home Credit	111.1	101.3
-Insurance	30.7	26.2
-Central	-12.9	-14.5
UK Businesses	**128.9**	**113.0**
Dividend	-84.9	-88.6
Net UK surplus	**44.0**	**24.4**
-International Home Credit	11.3	29.0
-Vanquis Bank	-10.6	-18.2
International Businesses	**0.7**	**10.8**
Pre-exceptional surplus	**44.7**	**35.2**
Yes Car Credit	-15.5	-36.4
Net surplus	**29.2**	**-1.2**

Source: Company Reports

The group is also capital generative, since we forecast internal capital generation (retained earnings as a percentage of regulatory capital) in excess of loan growth, which leads to an accumulation of surplus capital that should be available for reinvestment and/or distribution.

Strong capital ratios

As shown below, the group's total capital ratio at end-December 2005 was 21.3%, while its Tier 1 ratio was 14.8%. Although writing-off ~£90m of goodwill following the closure of Yes Car Credit increased the group's borrowings/equity leverage from 2.1x in 2004 to 3.1x in 2005, the key rating agency measure of leverage, the ratio of consumer credit tangible equity to consumer credit receivables — essentially a consumer credit Tier 1 ratio — fell only marginally, from ~20% in 2004 to ~19% in 2005.

Figure 8. Regulatory Capital Ratios

As at end-December (£m)	2004	2005
Receivables	1,200	1,274
Other RWAs	194	268
Risk weighted assets	1,394	1,542
Tier 1 capital	289	228
Tier 2 capital		100
Total capital	289	328
Tier 1 ratio	20.7%	14.8%
Total capital ratio	20.7%	21.3%

Source: Company Reports

Figure 9. Consumer Credit Leverage

As at December (£m)	2004	2005
Consumer credit receivables	1200	1274
Net consumer credit borrowings	858	983
Consumer credit tangible equity	236	239
Consumer credit goodwill	88	3
Consumer credit equity	324	242
Insurance equity	91	75
Group equity	415	317
Group leverage	2.1x	3.1x
Consumer credit NTAV/receivables	19.7%	18.8%

Source: Company Reports

According to the credit rating agencies, the core leverage ratio at Provident is the ratio of debt (including the group's pension fund deficit) to consumer credit tangible equity. So although additional pension fund contributions and the goodwill impact of closing Yes Car Credit (see Leaner & Fitter below) have increased headline leverage ratios, this has had little impact on core capital adequacy.

Leaner & fitter

A year ago, uncertainty over the outlook for Yes Car Credit (YCC) and the group's £130m-plus pension fund deficit were two significant investment negatives. Following the closure of YCC in December last year, and the elimination of the end-June 2005 pension fund deficit following a £133m funding transfer, these risks have been substantially reduced.

(1) YCC closure has improved earnings quality

In its pre-close trading statement on 14 December 2005, management announced that operating losses at Yes Car Credit (YCC) would amount to around £24m, and that YCC was to be closed forthwith, incurring additional exceptional losses amounting to approximately £141m. We believe the decision to close YCC was the correct one, despite the high costs involved, for the following reasons:

- At its core, YCC was a car dealer with additional consumer credit and insurance broking business lines. Its income sources — car dealing spread, broking commissions and net interest income — were never separately disclosed, and its credit provisions/impairments absorbed three-quarters of its pre-provision profit. The business brought the additional risks of forecourt management and stock control. YCC reduced the visibility and quality of Provident's earnings and weighed heavily on the stock's rating, in our view.

- Although YCC used up £36m of its capital as a result of trading losses and closure costs, management expects the run-off of the closed YCC book will release some £40m of capital over the next 3-4 years.

- The closure has freed up the substantial amount of management time that had been allocated to rescuing and/or selling YCC.

(2) Funding the pension scheme

Last December's pre-close statement included the announcement that Provident will make two special contributions totaling £133m to its final salary pension schemes: approximately £31m in December 2005 and the £102m in the first half of 2006. This will remove the IAS 19 deficit as at end-June 2005 (£133.2m). According to management, the interest cost of the cost of funding the deficit will be broadly offset by a reduction in the IAS 19 pension charge to the P&L.

New management

The last 12 months have seen some significant management changes at Provident, including the addition of two new members to the senior management team.

- Chris Johnstone, previously Managing Director of UK Consumer Credit division (which combined Home Credit, Yes Car Credit and Vanquis Bank), resigned from Provident's board effective 31 December 2005. Effectively, Johnstone has shouldered responsibility for the Yes Car Credit misadventure.
- Peter Crook, who joined Provident in September 2005 as Managing Director, UK Home Credit, has effectively replaced Johnstone as head of the UK credit activities. Crook, previously Managing Director of UK Consumer Credit at Barclays, was appointed to Provident's board in March 2006.
- Andrew Fisher, previously Finance Director at Premier Farnell for 11 years, was appointed Finance Director in January 2006, succeeding John Harnett, who is to take up new responsibilities as Managing Director of the International Division (David Swann, previously Managing Director of International, retired at the group's AGM in May). Harnett will continue to have responsibility for Vanquis Bank.

De-merger opportunity

As part of the 2005 final results release in March, management announced it was considering a separate listing for the group's international businesses, arguing that a de-merger would bring both business and valuation benefits. On 4 July, it was announced that following consultation with major shareholders, management expected the de-merger to take place in spring 2007 following the announcement of the 2006 results (a further update will be provided with the interim results on 13 September with full details of the de-merger to be published in March 2007.

Compelling industrial logic

With YCC closed and its loan book in run-off, with the removal of the group's June 2005 pension fund deficit, and with the international division now profitable and mature enough to be self funding, the separation of the UK and International activities is now workable.

The industrial logic for de-merging the UK and International activities is compelling, in our view:

- Excused from “dividend duty”, the international businesses would be free to invest more heavily in its longer-term growth prospects (ie incur higher near-term start-up and investment losses).

- A separate quote for the international businesses might also attract a growth-oriented investor base that is more likely to value the division’s longer-term earnings potential, tolerate near-term start-up losses/investment spend and pay less interest in dividend income.

- On the other hand, a relatively mature but highly cash generative UK entity would be likely to attract income seekers. With its lower growth trajectory, the UK business unit should be able to distribute a substantial proportion of its earnings in dividends.

- The re-alignment of investors along growth and income lines could result in an overall re-rating.

- The de-merged units are more likely to attract the attentions of potential acquirers: the International businesses would be ring-fenced from UK regulatory risk and the residual risks associated with the Yes Car Credit loan book in run-off; the free cash flows generated by the UK Home Credit businesses could appeal to private equity investors.

Business combinations

In our view, the natural business combinations would be:

- UK cash generators. The relatively low growth prospects and minimal marginal capital requirements of the UK Home Credit and Motor Insurance businesses would be able to support the group’s current central costs and fund a substantial dividend payment.

- International growth businesses. International Credit and Vanquis would make a good fit in that the latter’s banking license would permit credit/debit card direct repayment and variable rate alternatives to the existing home collected product offering.

Acquisition target

It could be argued that Provident Financial presents an attractive acquisition opportunity to a larger financial group as it stands now, with its undemanding valuation, international growth potential, cash/capital generation, and potential for funding and other synergies. We argue that the de-merged businesses would be even more attractive:

- Separated from the mature UK credit and cyclical UK motor insurance activities, the international credit businesses could attract the interest of international banks looking to quickly expand their non-prime consumer credit franchises.

- The UK home credit business appears to have characteristics that could appeal to private equity investors: substantial free cash flows to support and pay-down a leveraged capital structure, and the potential to be re-floated or sold following the implementation of new product, distribution and cost efficiency initiatives that should feed through to profitability in 2008 and beyond (we consider the group’s UK home credit strategy later in this note).

Risk factors

We rate Provident Financial High Risk. The risk rating on the stock is derived after the consideration of a number of industry-specific risks, financial risk and management risk. In addition, we consider historical share price volatility, based on the input of the Citigroup Investment Research quantitative research team, as a possible indicator of future stock-specific risk. We highlight in particular the following risk factors:

- Our near-term concerns are the Competition Commission enquiry into UK Home Credit, rising UK impairment provisions and the potential for further losses from the Yes Car Credit loan book in run-off.
- Longer term, the key risks relate to international credit: the impact of rate capping in Poland, slower growth from the Central European activities, and the relatively low earnings visibility of new regions such as Mexico and Romania.

Additional risks include bond market concerns over the impact of the proposed de-merger of the international businesses on debt funding capacity, and the potential for missed earnings due to higher than currently forecast international and credit card start-up losses.

Competition Commission Enquiry into UK Home Credit

On 20 December 2004, the Office of Fair Trading (OFT) announced that it was referring the UK home credit sector to the Competition Commission (CC) for inquiry. This resulted from the super-complaint launched by the National Consumer Council (NCC) in June 2004. The CC has indicated that the inquiry is now likely to be concluded by the autumn of 2006 (and in any case before the statutory deadline of 19 December).

The super-complaint highlighted six features of the home credit market that adversely affects its customers: little evidence of switching by customers, high switching costs, information asymmetries, high market concentration, high prices and high barriers to market entry. Also highlighted was the psychology of home-based transactions, especially the nature of the agent/borrower relationship and the prevalence of roll-over loans, locking-in customers.

The CC published its Provisional Findings and Possible Remedies report on 28 April. Potential remedies identified were: increased data sharing, better price information, provision of regular statements, the provision of comparable products, relaxation of the rules on canvassing new customers, and increasing the amount of the early settlement rebate.

The publication of the Provisional Findings and Possible Remedies report has brought with it the following complications:

- The timetable for the final report, including proposed remedial action, has now been delayed until the Autumn, which might be interpreted as being any time between September and November 2006, although we expect an announcement in October.

- The tone of the Provisional Findings was more aggressive that anticipated, even if its list of potential remedies was broadly as expected. On balance, we conclude that the final report and remedies recommended are likely to be more damaging to Provident's UK Home Credit profitability than previously.

- Although it seems unlikely that the final report will recommend rate ceilings, it is likely to recommend data-sharing, more regular statements, and a higher early redemption rebate. All of these would reduce profitability due to higher administration costs and potentially reduced lending margins.

- Reduced visibility of UK Home Credit earnings, cash flows and hence dividend payment capacity (or debt servicing capacity in a leveraged buy-out scenario) ahead of the final report would seem to rule out a de-merger this year.

Low international visibility

Investors have had to rely upon management guidance as to the likely financial performance of the international credit and credit card activities, particularly when they are in start-up mode. As far as we are aware, current market expectations for the Central European and Mexican businesses are based upon or around management's targets for these businesses. For Mexico, management is targeting profits of around £90m — last year it incurred losses of ~£3m. For Central Europe, management targets profits of around £95m, as compared with last year's ~£64m.

We argue that International earnings visibility is relatively low, for the following reason:

Rate ceilings in Poland

A new law establishing a maximum interest rate at four times the Lombard rate was introduced in Poland in August 2005, applicable for loans issued from 20 February 2006. On 7 February, Provident launched a revised product designed to meet the requirements of the new law, while aiming to broadly maintain the overall return on Polish loan assets.

The new product essentially separates the original bundled "service charge" into four separate charges: a preparatory fee, credit insurance, interest charged in accordance with the new law, and an optional home-collection charge. For the customer who selects all options, the aggregate return to Provident is similar to the old product. The customer who opts out of the home-collection charge has to make his or her payments directly to Provident via a bank or post office. The table below provides an example of how the new product works for a hypothetical 1,000 Zloty loan repaid weekly over 52 weeks.

Figure 10. Polish Rate Compliant Product

	Basic version Zloty	Home service Zloty
Face value of loan	1,000	1,000
Preparatory fee	56	56
Creditor insurance	120	120
Contractual loan value	1,176	1,176
Fixed interest	123.42	123.42
Home service fee	0	468.58
Total charge	299.42	768.00
Weekly charge	24.99	34.00
Basic annual fee rate	29.9%	29.9%
Home service fee rate		46.9%
Total annual fee rate	29.9%	76.8%

Source: Company Reports

- The interest element of the charge amounts to just over 12% of the face value of the loan, well within the 4xLombard Rate ceiling (currently 5.5% x 4 = 22%), which provides scope for a substantially lower Lombard rate without the need to reprice the product.

- The preparatory fee and creditor insurance fees add a further 18% to the overall charge, taking the annual "rate" on the basic product to ~30% pa.

- The optional fee for the home service adds a further 47% to the annual fee, taking this to an all-in ~77% pa.

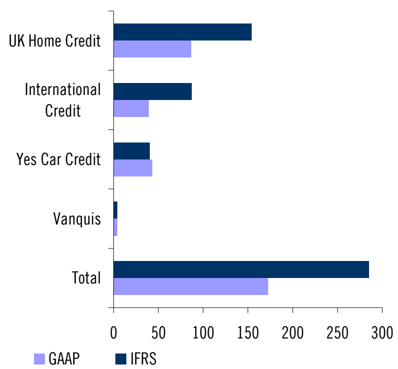
The risks associated with the new product are (i) gross margins could fall precipitously if a significant proportion of the customer base ultimately chooses not to pay for the home service; and (ii) credit quality could deteriorate as a result of reduced agent/borrower contact, effectively the first stage of the underwriting process. Since the new product was rolled-out in February, it is too early to assess the financial impact.

Reduced International disclosure

Provident had, until the final 2005 results, provided a full country-by-country breakdown of its Central European credit activities. The 2005 finals included only the total for Central Europe — Poland is now bundled with the Czech Republic, Hungary, Slovakia (and ultimately Romania) — and for Mexico. We suspect this is to avoid disclosing financial details that may arouse unwanted regulatory scrutiny (particularly in Poland, post the rate cap), but also to avoid presenting any adverse effects of the rate cap on profitability in Poland.

Accounting and impairment charging

Figure 11. Loan Loss Provisions – IFRS vs GAAP



Source: Company Reports

The issue of impairment charging for high APR unsecured lending businesses has been well discussed, discounting the value of an impaired loan using the effective interest rate (EIR) — essentially the loan's APR — has resulted in a sharp increase in impairment charges relative to the equivalent provision for loan loss charges under UK GAAP. As shown in the chart opposite, Provident's 2004 loan loss impairment charges rose from £173m under UK GAAP to £285m under IFRS.

While it is true to say that there is a grossing-up factor involved here — a proportion of the increase in the loan loss charge is counterbalanced by an increase in revenues — it is also fair to say that reported profitability at Provident's UK and International credit businesses have been negatively affected by the IFRS prescriptive approach to impairment charging.

Although managements of companies involved in high APR unsecured lending state that underlying cash flows and growth strategies are unchanged by the new accounting methodology, we would argue that there has indeed been an effect.

- Since it is now difficult to aggressively grow a high APR unsecured book without having to report substantially higher impairments, and hence lower earnings, we have detected increased caution from quoted companies when it comes to loan growth.

We suspect Provident's decision to reduce new lending volumes in Poland in order to stabilise credit quality and loan losses had one eye on the impact of new accounting standards.

We also suspect IFRS to have played some part in the decision to de-merge the International Division: a shift in ownership towards investors interested in the creation of long-term value, rather than the short-term costs of building it, might allow for a faster geographic roll-out.

Near-Term Earnings Outlook

The group's pre-close briefing of 4 July had the hallmarks of a near-term profit warning:

- UK home credit impairment costs "continue to increase reflecting growth in receivables of 7% together with continued pressure on customers' disposable income".
- UK home credit "first half marketing costs are running some £5m ahead of the corresponding period in 2005".
- At Vanquis Bank, "slower growth in revenues …coupled with the recent increase in marketing activity, will increase 2006 start-up losses to approximately £15m…these start-up losses will be heavily weighted to the first half."
- At International, "2006 has seen a significant step-up in start-up losses…will be approximately £15m, up from £4m in 2005".

Taken together, we expect this guidance to result in a fairly lackluster first half earnings performance, pretty much across the board, which in turn could lead to pressure on full year consensus earnings estimates.

Bond market concerns

Following the interim pre-close trading update on 4 July 2006, Fitch Ratings announced it was to keep Provident's Issuer Default rating of BBB+ and the Long-term BBB rating of its subordinated bond on Rating Watch Negative (RWN). This followed Provident's confirmation that it is proceeding with plans to de-merge its international operations in early 2007.

Fitch's main concerns are:

- The remaining uncertainty surrounding the final outcome of the Competition Commission enquiry;
- The likely legal structure of the de-merged UK entity, its leverage, and as a result, whether there will be any impact from having to renegotiate funding terms.

More positively, the Fitch report noted the highly cash generative nature of the UK home credit business that will be at the core of what is expected to remain within the existing Provident Financial corporate entity (where the subordinated bond will remain) following de-merger. The report also highlights the fact that, given its low growth and incremental funding needs, the UK home credit business is also highly capital generative, and that this should give management flexibility in the management of its leverage profile, even though dividend payout expectations are likely to be high.

Figure 12. YCC Closure Costs

Year to December (£m)	2005
Goodwill impairment	91.0
Property provisions	14.9
Receivables impairment	14.4
Employee costs	10.1
Fixed asset impairment	4.6
Stock write-downs	2.0
Other	4.0
Total closure costs	**141.0**
Receivables	235.3
Impairment % receivables	6.1%

Source: Company Reports

Yes Car Credit book in run-off

As at end-June 2005, the YCC loan book amounted to £269.6m; as at end-December, following the closure of the business, this had been reduced to £235.5m. As shown in the table opposite, this reduction in receivables included a £14.4m impairment charge, equal to around 6% of year-end receivables.

Management has indicated that it expects to run-off the closed YCC book at break-even, with net interest income being offset by loan losses and the administrative costs of run-off. It also expects the capital supporting this book — using the group-wide 20% equity:assets ratio as a guide we estimate around £50m — to be released as the book is wound down.

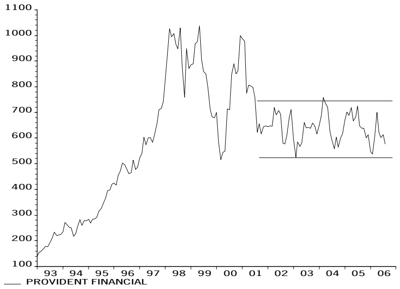
So far, the run down has progressed well — at the 2006 first-half trading update on 4 July, it was reported that £70m of receivables had been collected (~30% of the end-December 2005 total). However, this still leaves some £165m of YCC receivables outstanding, and a worse-than-expected future collections performance could result in additional losses not reflected in our base-case group earnings and dividend forecasts.

If the impact of these risk factors is greater than we currently anticipate, then the share price might reach our target price.

Price Performance

Range-bound since 2001

Figure 13. Price Performance 1993-2006



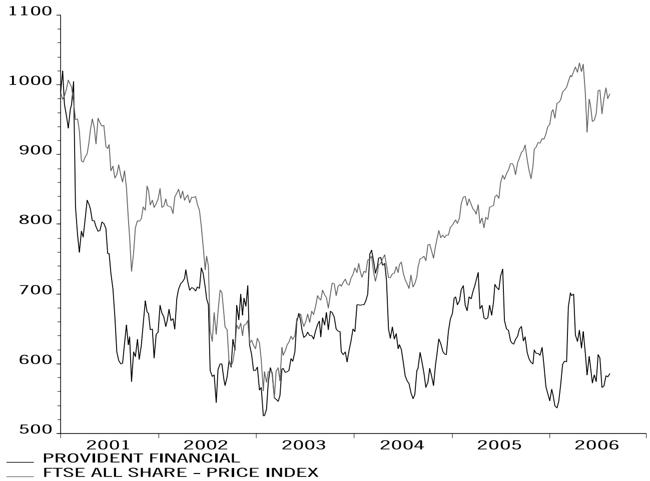
Source: Datastream

Provident's shares have traded within a 550p-750p price range since mid-2001, following a period of high price volatility dating back to early 1999, and very strong performance during the mid-1990's.

- Strong performance from 1993-1998 followed the appointment of current Non-Executive Chairman John van Kuffeler as group Chief Executive in 1991. Under van Kuffeler's leadership, the group exited credit-related merchandising, refocused on its core cash product, and substantially reduced its branch infrastructure. This improved returns and generated cash and capital in excess of loan book growth requirements. This allowed for substantial capital distribution via higher annual dividends, special dividends and share repurchases.
- Poor price performance from 1998-2000 followed a sharp increase in the UK home credit bad debt charge — UK GAAP bad debts had increased from 5.1% of credit issued in 1995 to 8.4% in 1999 — and management acknowledged for the first time that the UK home credit business was mature and that it was proving difficult to grow customer numbers profitably.
- The catalyst for strong price performance in 2000 was the announcement the international division had moved into profit after two years of start-up losses, while the stock's range-bound performance since mid-2001 has reflected a number of factors: the purchase and subsequent closure of Yes Car Credit, the impact on profits due to the shift to International Financial Reporting Standards, and uncertainty associated with the UK Competition Commission's inquiry into UK home credit.

Relative performance

Figure 14. PFG versus the FTSE All Share Index



Source: Datastream

Figure 15. PFG versus the FTSE General Financials Index

Source: Datastream

Valuation

Our fundamental analysis suggests end-December 2006 fair values within a 730p to 790p per share range, which is underpinned by a 721p per share estimate based on peer-group relative multiples. We set our 12-month target price in the middle of this range at 750p per share, at which the shares would trade on a 2007E PE of 12.1x and yield a prospective 5.0%.

Valuation issues

Basic price/earnings comparisons with quoted peers would undervalue Provident's International and credit card activities since near-term profitability within these units is dampened by start-up losses and investment spend.

Our preferred valuation methodology is the fundamental price to book approach used by the Citigroup UK Banks team. This is based on underlying profitability and sustainable returns in 2010E, by which time earnings estimates reflect the benefits of current investment expenditure. We also value Provident in relation to a wide range of UK General Financial company peers.

Fundamental price to book valuation

Our preferred valuation approach is summarised in the table below, alongside our earnings and loan growth projections to 2010E. Our objective is to estimate a fundamental fair value for the shares as at end-December 2006.

Figure 16. Fundamental Price to Book Valuation

Year to December (£m)	2006E	2007E	2008E	2009E	2010E
Receivables	1122.3	1189.6	1272.9	1371.1	1497.9
Memo: receivables growth	8%	6%	7%	8%	9%
NAV/receivables ratio - normalised	20.0%	20.0%	20.0%	20.0%	20.0%
Normalised NAV	289.5	302.9	319.6	339.2	364.6
NAV	358.9	422.6	504.2	601.8	714.1
Surplus capital	69.4	119.7	184.6	262.6	349.5
Attributable profit	132.0	158.0	178.7	197.7	215.3
Return on surplus capital	-3.5	-6.0	-9.2	-13.1	-17.5
Normalised return	128.5	152.0	169.5	184.5	197.8
Normalised return on NAV	44.4%	50.2%	53.0%	54.4%	54.3%
Dividends	90.5	94.3	97.1	100.0	103.0
Discount factor		1.105	1.221	1.349	1.491
PV dividends		85.3	79.5	74.1	69.1
Sustainable return on NAV	53.0%				
Long-term growth	2.0%				
Cost of equity	10.5%				
Fair value P/NAV	6.0				
2010 terminal value	2187.4				
2010 surplus capital	349.5				
NPV terminal value	1467.2				
NPV dividends	308.1				
NPV surplus capital	234.4				
Fair value	**2009.7**				
Shares in issue	255				
Fair value per share (p)	**788**				

Source: Citigroup Investment Research

There are three parts to this estimate:

- First, we calculate a terminal value for the business at end-2010E. Based on attributable profit, we calculate annual returns on normalised equity (normalised to reflect a 20% equity:loan assets ratio). We use these returns to estimate a sustainable RoE for the fair value price to book formula: P/BV = (RoE - g) / (CoE - g). This terminal value is discounted to NPV at end-December 2006E using an estimate of cost of equity as the discount rate.

- Next, we calculate the NPV of unallocated capital: our forecast for end-December 2010E net assets includes a "surplus" that in theory could be distributed without altering the operating outlook.

- Finally, we calculate the NPV of our dividend forecasts for 2007E-2010E.

The sum of these three items produces our estimate of a fair end-2006E market value for the group of £2,010m, which equates to £7.88 per share.

Sum-of-the-parts valuation (SOTP)

As an alternative to the price to book approach, we adapt the methodology to incorporate a sum-of-the-parts valuation based on forecast profit mix, also in 2010E, replacing the 2010E terminal value from the price to book methodology with a sum-of-the-parts estimate.

Figure 17. Sum-of-the-Parts Valuation – Based on 2010E Estimates

£m					2010E	Sustainable long-term						
Year to December 2010E	**PBT**	**Tax**	**PAT**	**NAV**	**ROE**	**ROE**	**Growth**	**COE**	**P/NAV**	**PER**	**£m**	**p**
UK Home Credit	145.6	-43.7	101.9	130.0	78%	66%	0.0%	9.5%	6.9	8.9	903.2	354
International Home Credit	129.8	-38.9	90.9	103.9	87%	60%	3.5%	10.5%	8.1	9.2	838.3	328
Vanquis Bank	19.2	-5.8	13.4	51.4	26%	20%	3.5%	10.5%	2.4	9.0	121.2	47
Insurance	34.1	-10.2	23.9	65.0	37%	35%	0.0%	9.5%	3.7	10.0	239.5	94
Central	-21.2	6.4	-14.9	363.8	-4%					10.0	-148.7	-58
Group	**307.5**	**-92.3**	**215.3**	**714.1**	**30%**				**2.7**	**9.1**	**1953.4**	**765**

Source: Citigroup Investment Research

The result of substituting the above SOTP-based terminal value and surplus capital estimates into the price to book methodology are set out below.

Figure 18. Fundamental Sum-of-the-Parts Valuation

Year to December (£m)	**2006E**	**2007E**	**2008E**	**2009E**	**2010E**
Terminal value*					1,953
Surplus capital					364
Dividends		94	97	100	103
Discount factor		1.105	1.221	1.349	1.491
PV dividends		85	80	74	69
Discount rate	10.5%				
PV terminal value	1,310				
PV surplus capital	244				
PV dividends	308				
Fair value	**1,862**				
Shares in issue	255				
Fair value per share (p)	**730**				

Source: Citigroup Investment Research. *2010E sum-of-the-parts.

The SOTP approach results in an end-2006E fair value estimate of £7.30, 7% lower than that derived from the fundamental price to book approach.

Peer group relatives

We have used a broad range of consumer and commercial credit companies within the U.K. Speciality & Other Finance Sector for the following comparative analysis.

Figure 19. Peer Group P/E Ratios and Yields

		Mkt Val		PER		Yield	
	Price*	**(£m)**	**Year-end**	**2006E**	**2007E**	**2006E**	**2007E**
Cattles*	334	1,098	Dec	12.3	11.1	5.2%	5.7%
Close Brothers*	892	1,313	Jul	12.3	11.0	3.5%	3.9%
Davenham Group	298	76	Jun	10.2	8.9	3.0%	4.9%
Intermediate Capital Group	1314	877	Jan	12.4	11.5	4.5%	4.9%
Kensington Group*	888	459	Nov	9.5	7.8	3.4%	4.2%
London Scottish Bank	116	1635	Oct	14.0	12.3	5.0%	5.3%
Paragon Group	613	741	Sep	10.5	10.5	2.7%	3.5
Total/average		**4,664**		**11.7**	**10.4**	**3.9%**	**4.6%**
Provident Financial*	583	1,488	Dec	11.3	9.4	6.3	6.5

Source: Citigroup Investment Research. *Prices at close 16 August 2006.

Figure 20. Relative fair value estimate

Peer group 2006E PER	11.7
PFG 2007E EPS	61.8p
12 month fair value	**721**

Source: Citigroup Investment Research

End-2006 relative fair value estimate

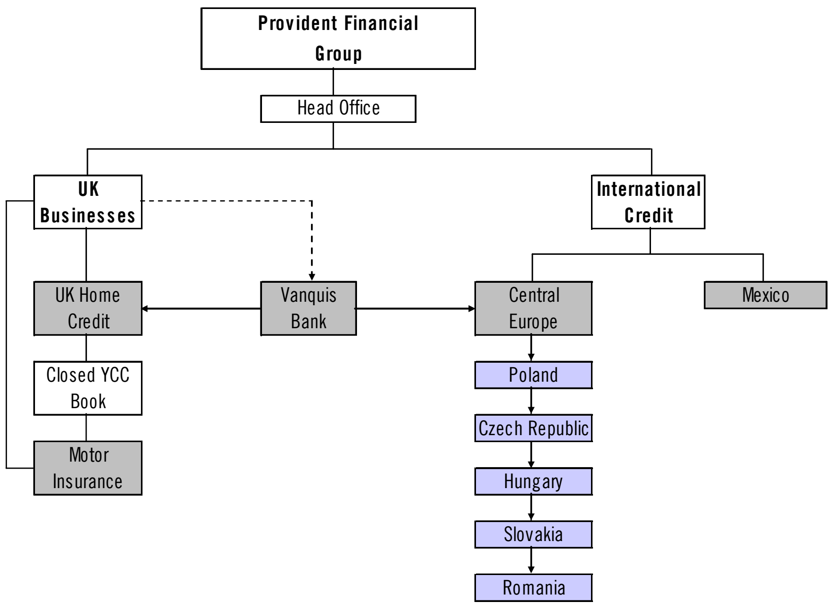
In estimating an end-2006E fair value, we have applied the peer group consensus PE ratio for 2006E to our Provident EPS estimate for 2007. This suggests a fair value of 721per share. This is around 4%lower than the average of the fair value estimates generated by our primary price to book and sum-of-the-parts methodologies, but nevertheless still substantially above current market levels.

Company Snapshot

Divisional structure

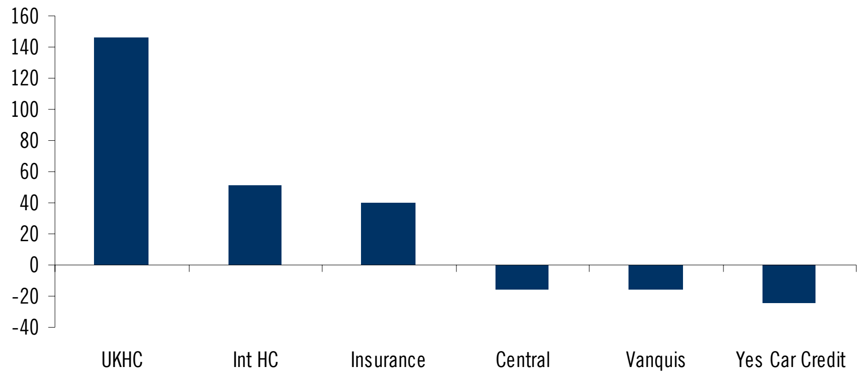
Provident Financial is a UK and International consumer credit company with additional UK motor insurance activities. The UK Home Credit business is cash generative but mature. The international credit unit spans Central Europe and Mexico, and combines established and profitable operations with more recent start-ups.

Figure 21. Corporate Structure



Source: Company Reports and Citigroup Investment Research

Figure 22. 2005 Profit Contributions by Division (£m)



Source: Company Reports

Financial snapshot

Figure 23. Divisional Structure – 2005 Key Financials by Segment

Year to December (£m)	UK Home Credit	International Credit	Vanquis Bank	Ongoing Consumer Credit	Yes Car Credit	Total Consumer Credit	Motor Insurance	Central Costs	GROUP TOTAL
Revenue	**578.9**	**358.6**	**17.8**	**955.3**	**227.5**	**1182.8**	**154.7**		**1337.5**
Operating expenses	-260.8	-175.1	-21.3	-457.2	-215.3	-672.5	-114.7	-15.5	-802.7
Trading profit	**318.1**	**183.5**	**-3.5**	**498.1**	**12.2**	**510.3**	**40.0**		**550.3**
Impairment charge	-171.8	-132.4	-12.4	-316.6	-36.8	-353.4			-353.4
Operating profit	**146.3**	**51.1**	**-15.9**	**181.5**	**-24.6**	**156.9**	**40.0**	**-15.5**	**181.4**
NOPAT @ 30% tax	102.4	35.8	-11.1	127.05	-17.2	109.83	28.0	-10.9	127.0
Receivables	649.9	328.7	60.0	1038.6	235.3	1273.9			1273.9
NAV	130.0	65.7	12.0	207.7	34.7	242.4	75.0		317.4
Equity:assets	20%	20%	20%	20%	15%	19%			25%
RoA	16%	11%	-19%	12%	-7%	9%			10%
RoE	79%	54%	-93%	61%	-50%	45%	37%		40%

Source: Company Reports and Citigroup Investment Research

UK and International credit

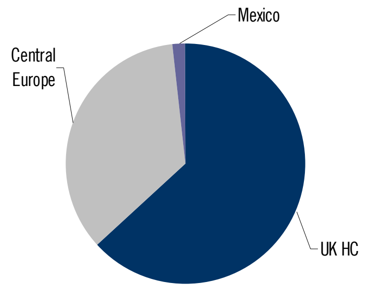
Figure 24. UK & International Home Credit Analysis

Year to December 2005 (£m)	UK HC	Central Europe	Mexico	Central Costs	Internat Credit	UK & Int Total
Customer numbers ('000)	1,490	1,646	131		1,777	3,267
Credit issued	927	522	23		545	1,471
Average receivables	559	275	6		280	839
Revenues	**578.9**	**347.9**	**10.7**		**358.6**	**937.5**
Interest	-13.2	-18.3	-1.0	-0.7	-20.0	-33.2
Costs	-247.6	-136.6	-9.0	-9.5	-155.1	-402.7
Trading profit	**318.1**	**193.0**	**0.7**		**183.5**	**501.6**
Impairment charge	-171.8	-128.8	-3.6		-132.4	-304.2
Operating profit	**146.3**	**64.2**	**-2.9**	**-10.2**	**51.1**	**197.4**
Impairment/credit issued	-19%	-25%	-16%		-24%	-21%
Impairment/avg receivables	-31%	-47%	-64%		-47%	-36%
Impairment/trading profit	-54%	-67%	-514%		-72%	-61%

Source: Company Reports and Citigroup Investment Research

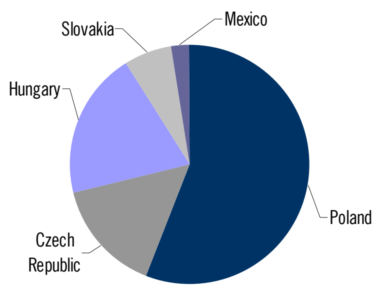
Consumer credit receivables

Figure 25. End-2005 Home Credit Receivables



Source: Company Reports

Figure 26. June 2004 International Receivables



Source: Company Reports

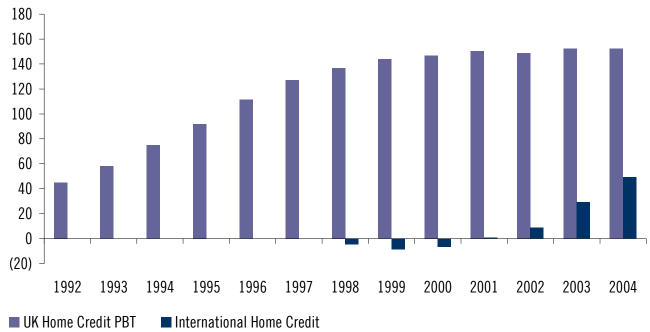
Long-term record

Figure 27. Long-Term Profit Record: 1992-2005

Year to December (£m)	**1992**	**1993**	**1994**	**1995**	**1996**	**1997**	**1998**	**1999**	**2000**	**2001**	**2002**	**2003**	**2004**	**2004***	**2005***	**CAGR**
UK Home Credit	44.9	58.1	74.7	91.9	111.4	127.2	136.9	143.9	147.0	150.4	148.8	152.6	152.3	154.0	146.3	10%
International Home Credit							-4.7	-8.4	-6.7	0.8	8.6	29.3	49.2	39.8	51.1	
Insurance	5.4	10.8	11.1	13.3	10.6	13.7	19.6	25.4	30.5	36.6	35.8	28.6	34.6	34.6	40.0	17%
Yes Car Credit											0.2	11.2	4.4	-2.7	-24.6	
Vanquis Bank											-1.1	-6.7	-8.7	-9.0	-15.9	
Operating profit	**50.3**	**68.9**	**85.8**	**105.3**	**122.0**	**140.9**	**151.8**	**160.9**	**170.8**	**187.7**	**192.3**	**215.0**	**231.8**	**216.7**	**196.9**	**11%**
Central costs	-7.6	-6.4	-4.6	-4.1	-3.5	-4.4	-5.9	-5.8	-10.6	-13.1	-10.9	-8.8	-11.1	-11.2	-15.5	
Pre-exceptional PBT	**42.8**	**62.5**	**81.1**	**101.1**	**118.5**	**136.5**	**145.9**	**155.0**	**160.2**	**174.7**	**181.4**	**206.2**	**220.7**	**205.5**	**181.4**	**12%**

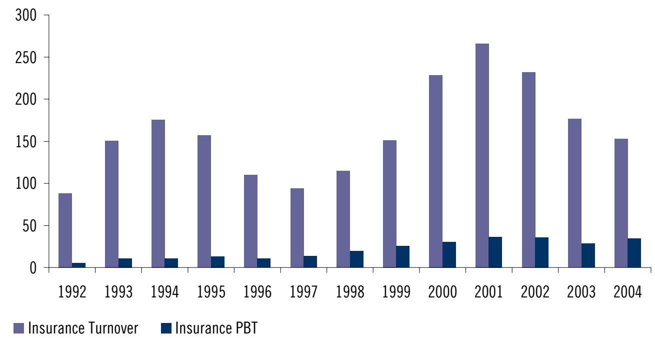
Source: Company Reports. *IFRS basis, otherwise UK GAAP.

Figure 28. UK & International Credit PBT (£m)



Source: Company Reports

Figure 29. Motor Insurance Turnover & PBT (£m)



Source: Company Reports

Senior management

John van Kuffeler, Non-Executive Chairman. Joined Provident Financial in 1991 as Chief Executive and appointed Executive Chairman in 1997, van Kuffeler became non-executive Chairman in 2002. He was formerly Chief Executive of Brown Shipley Holdings, and is currently Chairman of Huveaux PLC.

Robin Ashton, Chief Executive. Joined the group in 1983 as Finance Director of Provident Insurance, and went on to become Deputy Managing Director of HT Greenwood and Managing Director of Provident Investments. Ashton became group Treasurer in 1989 and was appointed to the board as Finance Director in 1993. In 1999 Ashton was appointed Deputy Chief Executive and Chief Executive in 2001.

Andrew Fisher. Finance Director. Joined in May 2006 from Premier Farnell, where he was Finance Director for 11 years. Fischer succeeded John Harnett, who is now Managing Director of the International Division. (Harnett continues to have responsibility for Vanquis Bank and public affairs.)

Peter Crook, Managing Director UK Home Credit. Joined Provident in September 2005 from Barclays where he was UK Managing Director of Barclaycard and latterly Managing Director of UK Consumer Finance. Crook was appointed to the board in March 2006.

Core Consumer Credit Activities

UK Home Credit

Products and customers

The UK home credit division currently services approximately 1.5m UK adults through two consumer credit brands — Provident Personal Credit and Greenwood Personal Credit. The division employs just over 2,700, and advances and collects loans via a network of some 11,700 self-employed agents.

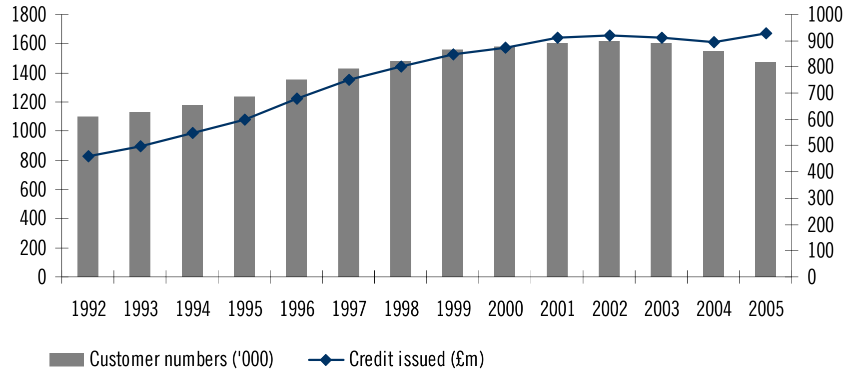
- The core products are cash loans and shopping vouchers. The key cash loan is an advance of £100 repayable at £3 per week over 55 weeks (total repayable £165); the key voucher loan is for £100 repayable at £5 per week over 25 weeks (total repayable £125). There are no extra, administrative charges associated with these products and there is no additional interest charged on late payment or default.
- Approximately 70% of UK home credit customers are female, and from the C1/C2, D and E socio-economic/demographic segments. Some 23% of customers own their own homes.

A maturing market

UK home credit began to go ex-growth during the latter half of the 1990's as competition from other unsecured credit providers — mainly banks and credit card companies — put pressure on customers' disposable incomes and hence repayment capacity. As a result, Provident found it difficult to grow the division profitably — new customer recruitment initiatives brought rising bad debts, and the division's UK GAAP bad debt charge increased from 5.1% of credit issued in 1995 to 8.4% by 1999.

Although rising income levels, low interest rates and stable unemployment have helped stabilise credit quality since then, competition from remote lenders and greater access to alternative credit products has put pressure on home-collected credit. Provident's UK home credit customer numbers peaked in 2002 at over 1.6m, but have declined in every year since then, ending 2005 at 1.49m.

Figure 30. UK Home Credit - Customers and Credit Issued



Source: Company Reports

Despite a 2.7% reduction in customer numbers to 1.49m in 2005, credit issued increased by 3.7% to £927m. Management was quick to point out that the growth in credit issued was largely due to the success of the larger, longer-term product, and that without underlying customer growth, credit issued growth was not sustainable.

More recently, however, the macro trends that put pressure on home credit during recent years have reversed somewhat: unemployment and interest rates are rising, remote lenders and credit card operators are suffering as a result of deteriorating credit quality, and as a result, there has been some early evidence of resurgence in the popularity of home credit.

In its pre-close trading update on 4 July, Provident reported increasing UK home credit customer numbers, with year-on-year customer growth being recorded in June after 3 years of decline, and continued growth in credit issued, up 1% during the first 5 months of 2006.

Innovations to drive future growth

Recent and planned innovations designed to recruit and retain new customers include:

- Product innovation: Larger loans (~£1500) repaid over longer periods, eg 18 or 24 months.
- Product innovation: An Argos card and a pilot Visa card — ready-loaded credit cards used like a debit card.
- New distribution channels: Greater use of direct mail and internet marketing to new and existing customers.
- New technology. Provident is currently testing new hand-held personal computers for its agents and field employees to improve administrative efficiency.
- Streamlining costs. Provident is combining the field management and administration of its home credit brands — Provident Personal Credit and Greenwood Personal Credit — while retaining these brands.

International Credit

Provident began researching opportunities overseas in the mid-1990s as part of its strategy of developing new sources of growth. From its first launch in Poland in 1997, the international division has grown rapidly, and now services more customers than the UK home credit business. In 2005, international credit contributed some 25% of the group's operating profit from continuing businesses.

The tables below demonstrate the division's growth over the past 9 years, detailing the addition of new countries in Central Europe (the Czech Republic in 1998, Hungary and Slovakia in 2001) and in Mexico.

A new pilot programme in Romania is being conducted this year, and management is currently researching potential additional operations in Russia, Brazil, Ukraine and India.

Figure 31. International Credit Division*

Year to December (£m)	UK GAAP 1999	2000	2001	2002	2003	2004	IFRS 1H05E
Poland							
Turnover	4.8	26.0	74.1	102.2	127.9	138.6	100.4
Interest	-0.7	-3.7	-10.6	-13.9	-13.3	-10.3	-5.3
Administrative expenses	-6.1	-22.2	-45.0	-53.5	-57.2	-58.6	-33.2
Pre-impairment profit	**-2.0**	**0.1**	**18.5**	**34.8**	**57.4**	**69.7**	**61.9**
Impairment charge	-0.6	-2.9	-11.8	-18.1	-24.3	-25.3	-47.6
Profit before tax	**-2.6**	**-2.8**	**6.7**	**16.7**	**33.1**	**44.4**	**14.3**
Credit issued	15.2	74.3	140.0	184.9	217.1	241.1	138.0
Customer numbers (000s)	72	305	504	660	813	941	950
Impairment/credit issued	4%	4%	8%	10%	11%	10%	34%
Average advance (£)	210	243	381	280	267	256	145
Czech Republic							
Turnover	3.6	14.2	24.9	33.6	39.4	41.2	26.1
Interest	-0.4	-1.1	-2.0	-2.3	-2.5	-2.2	-1.0
Administrative expenses	-5.5	-11.4	-14.4	-18.5	-19.9	-21.5	-11.1
Pre-impairment profit	**-2.3**	**1.7**	**8.5**	**12.8**	**17.0**	**17.5**	**14.0**
Impairment charge	-0.4	-1.6	-6.0	-7.7	-8.2	-7.5	-7.3
Profit before tax	**-2.7**	**0.1**	**2.5**	**5.1**	**8.8**	**10.0**	**6.7**
Credit issued	16.0	53.0	62.0	72.9	73.0	77.4	37.7
Customer numbers (000s)	66	161	189	218	223	230	229
Impairment/credit issued	3%	3%	10%	11%	11%	10%	19%
Average advance (£)	197	262	300	320	333	337	165
Hungary							
Turnover			0.4	4.9	18.3	42.7	33.0
Interest			-0.1	-0.5	-1.6	-3.7	-2.4
Administrative expenses			-2.5	-6.4	-15.0	-28.7	-14.7
Pre-impairment profit			**-2.2**	**-2.0**	**1.7**	**10.3**	**15.9**
Impairment charge			-0.1	-1.1	-3.6	-3.9	-10.8
Profit before tax			**-2.3**	**-3.1**	**-1.9**	**6.4**	**5.1**
Credit issued			1.9	14.3	45.6	87.2	49.3
Customer numbers (000s)			10	55	143	251	274
Impairment/credit issued			5%	8%	8%	4%	22%
Average advance (£)			190	260	319	347	180
Slovakia							
Turnover			0.2	1.7	5.8	11.0	9.0
Interest			0.0	-0.3	-0.6	-1.0	-0.7
Administrative expenses			-1.4	-3.0	-5.6	-8.1	-4.4
Pre-impairment profit			**-1.2**	**-1.6**	**-0.4**	**1.9**	**3.9**
Impairment charge			-0.1	-0.4	-1.2	-2.4	-5.0
Profit before tax			**-1.3**	**-2.0**	**-1.6**	**-0.5**	**-1.1**
Credit issued			0.8	5.7	14.8	27.2	15.6
Customer numbers (000s)			5	27	62	102	110
Impairment/credit issued			13%	7%	8%	9%	32%
Average advance (£)			160	211	239	267	142
Mexico							
Turnover					0.1	1.5	3.0
Interest					0.0	-0.2	-0.3
Administrative expenses					-1.3	-3.4	-3.2
Pre-impairment profit					**-1.2**	**-2.1**	**-0.5**
Impairment charge					0.0	-0.1	-1.0
Profit before tax					**-1.2**	**-2.2**	**-1.5**
Credit issued					0.2	3.9	6.2
Customer numbers (000s)					3	35	63
Impairment/credit issued					0%	3%	16%
Average advance (£)					67	111	98

Source: Company Reports. *Excludes South African pilot, 1999-2001

Figure 32. International Credit Division*

Year to December (£m)	UK GAAP 1999	2000	2001	2002	2003	2004	IFRS 2005
Turnover	8.8	41.9	101.6	142.4	191.5	235.0	358.6
Interest	-1.2	-5.0	-12.7	-17.0	-18.0	-17.4	-19.3
Administrative expenses	-12.5	-35.6	-63.3	-81.4	-99.0	-120.3	-145.6
Pre-impairment profit	**-4.9**	**1.3**	**25.6**	**44.0**	**74.5**	**97.3**	**193.7**
Impairment charge	-1.1	-4.8	-18.0	-27.3	-37.3	-39.2	-132.4
Profit before tax & central	**-6.0**	**-3.5**	**7.6**	**16.7**	**37.2**	**58.1**	**61.3**
Central overheads/interest	-2.4	-3.2	-4.9	-8.1	-7.9	-8.9	-10.2
Profit before tax	**-8.4**	**-6.7**	**2.7**	**8.6**	**29.3**	**49.2**	**51.1**
Credit issued	29.4	121.5	202.0	277.8	350.5	432.9	544.9
Customer numbers (000s)	149	500	693	960	1,241	1,524	1,777
Impairment/credit issued	4%	4%	9%	10%	11%	9%	24%
Average advance (£)	197	243	292	289	282	284	307

Source: Company reports. *Includes South African pilot, 1999-2001

International growth strategy

In Central Europe, the aim is to maximise returns from the established businesses:

- Through growth in customer numbers, growth in credit issued per customer and through cost efficiencies, growth in profit per customer.
- Through extending the product range to include larger and longer-term loans, and also monthly collected sub-prime and near-prime products.

In Mexico, the strategy revolves around expanding into new regions beyond Puebla and Guadalajara-Leon. Management is researching the potential for launching new operations in Monterrey, the Northern Territories and Mexico City during 2007-2009.

Management has set aggressive targets for the International Division (see Figure 33). In aggregate, these targets imply profit before international central costs of £185m although the timescale for the achievements of these targets is not precise. We highlight that this includes nothing from Romania or from additional new countries.

Figure 33. International Credit – Management Targets

Country Targets	Poland	Czech Republic	Hungary	Slovakia	Romania	Central Europe	Mexico
Rollout year	1997	1998	2001	2001	2006		2003
Customer numbers ('000)	1,000	250	250	125	?	1,625	3,000
Market share	50%	50%	50%	50%	?	50%	
Credit per customer (£)	400	400	400	270	?	390	
Credit issued (£m)	400	100	100	34	?	634	
Profit per customer (£)	60	60	60	40	?	58	30
PBT (£m)	60	15	15	5	?	95	90

Source: Company Reports

Figure 34. International Credit – Forecast Summary

Year to December (£m)	2004	2005	2006E	2007E	2008E	2009E	2010E
Central Europe							
Turnover	269.4	347.9	408.3	425.0	436.2	445.7	455.3
Interest	-18.8	-18.3	-21.0	-21.9	-22.5	-23.2	-23.9
Administrative expenses	-111.5	-136.6	-163.3	-165.7	-165.8	-164.9	-163.9
Pre-impairment profit	**139.1**	**193.0**	**224.0**	**237.4**	**248.0**	**257.6**	**267.5**
Impairment charge	-86.5	-128.8	-154.9	-155.3	-154.0	-152.6	-157.1
Profit before tax	**52.6**	**64.2**	**69.1**	**82.1**	**93.9**	**105.0**	**110.4**
Credit issued	432.9	522.3	553.1	575.2	592.4	610.2	628.5
Closing receivables	282.9	317.3	336.0	349.4	359.9	370.7	381.8
Average receivables	211.3	274.8	326.6	342.7	354.7	365.3	376.3
Customer numbers (000s)	1,524	1,646	1,728	1,797	1,851	1,907	1,964
Average advance (£)	284	317	320	320	320	320	320
Mexico							
Turnover	1.8	10.7	28.2	49.4	86.4	137.5	206.2
Interest	-0.2	-1.0	-2.4	-4.1	-7.2	-11.5	-17.2
Administrative expenses	-3.3	-9.0	-17.5	-28.1	-44.9	-70.1	-103.1
Pre-impairment profit	**-1.7**	**0.7**	**8.4**	**17.1**	**34.3**	**55.9**	**85.9**
Impairment charge	-0.5	-3.6	-6.7	-12.5	-21.8	-32.7	-49.1
Profit before tax	**-2.2**	**-2.9**	**1.6**	**4.7**	**12.5**	**23.2**	**36.9**
Credit issued	3.9	22.6	39.6	69.2	121.1	181.7	272.5
Closing receivables	2.2	11.4	20.0	34.9	61.1	91.6	137.5
Average receivables	0.9	5.6	15.7	27.4	48.0	76.4	114.6
Customer numbers (000s)	35	131	229	401	702	1053	1580
Average advance (£)	111	173	173	173	173	173	173
International							
Turnover	271.2	358.6	436.5	474.3	522.6	583.1	661.5
Interest	-19.0	-19.3	-23.4	-26.0	-29.7	-34.6	-41.1
Administrative expenses	-114.8	-145.6	-180.8	-193.9	-210.7	-235.0	-267.0
Pre-impairment profit	**137.4**	**193.7**	**232.3**	**254.5**	**282.2**	**313.5**	**353.4**
Impairment charge	-87.0	-132.4	-161.6	-167.8	-175.8	-185.3	-206.2
Profit before tax & central	**50.4**	**61.3**	**70.8**	**86.7**	**106.4**	**128.2**	**147.2**
Central overheads/interest	-10.6	-10.2	-10.6	-11.0	-11.5	-11.9	-12.4
Start-up losses			-15.0	-8.0	-5.0	-5.0	-5.0
Profit before tax	**39.8**	**51.1**	**45.1**	**67.7**	**89.9**	**111.3**	**129.8**
Credit issued	436.8	544.9	592.6	644.4	713.6	791.9	901.0
Closing receivables	285.1	328.7	355.9	384.3	421.0	462.3	519.3
Average receivables	212.2	280.4	342.3	370.1	402.7	441.7	490.8
Customer numbers (000s)	1,559	1,777	1,958	2,199	2,553	2,960	3,544
Average advance (£)	280	307	303	293	279	268	254

Source: Company reports and Citigroup Investment Research

Vanquis Bank

Vanquis Bank was established as a pilot in 2003 to test the demand for credit cards tailored to the needs of customers on average and below average incomes. After a period of market testing a full product launch in the UK began in January 2005. Over the course of 2005 customer numbers increased by 84,000 to 160,000 and customer receivables by £34m to £60m.

There are no agents involved with Vanquis, and all customer contact is carried out remotely. Provident has recruited a team of credit card specialists to develop the range of products on offer and to research opportunities to expand the product range outside the UK. Vanquis incurred a loss before tax of £15.9m in 2005, up from £9.0m in 2004, reflecting continued investment in infrastructure, customer acquisition costs and impairment charges. Management has guided the market to expect a broadly similar loss in 2006 before breakeven in 2007.

De-Merger Analysis

A separating listing for "International"

Alongside the 2005 final results on 8 March, management announced it was considering a separate listing for its "international business", arguing that a de-merger would bring both business and valuation benefits. In its half-year pre-close trading update on 4 July, management reported that following consultation with major shareholders work was underway to implement the separation and that it expected the de-merger to take place in spring 2007, following the announcement of the 2006 results. A further update will be provided with the interim results on 13 September.

A de-merger scenario

In tables below we have partitioned Provident's divisions into UK and International segments. We have allocated Central to the UK segment (the head office is currently situated in Bradford) and Vanquis to International (looking forward, the Vanquis banking license will be instrumental in the development of variable rate and remote lending products in Central Europe).

The UK Businesses

The table below sets out aggregated profit and loss account forecasts for UK Home Credit, Motor Insurance and Central Costs (the head office). We have applied a 30% tax charge and allocate notional equity to the segment equal to 20% of net customer receivables.

We have charged a working capital requirement to attributable profit equal to 20% of loan book growth in deriving segmental free cash flows (available for reinvestment and/or dividends).

Figure 35. UK Businesses (UK Home Credit + Motor Insurance + Central Costs)

Year to December (£m)	2005	2006E	2007E	2008E	2009E	2010E
Turnover	**733.6**	**760.5**	**768.7**	**777.0**	**792.5**	**808.4**
Operating expenses	-391.0	-411.0	-420.3	-426.3	-435.7	-445.3
Pre-provision profit	**342.6**	**349.5**	**348.4**	**350.7**	**356.9**	**363.1**
Provisions	-171.8	-191.1	-194.9	-196.7	-200.6	-204.6
Operating profit	**170.8**	**158.4**	**153.5**	**154.1**	**156.3**	**158.5**
Taxation @ 30%	-51.2	-47.5	-46.1	-46.2	-46.9	-47.6
Net profit	**119.6**	**110.9**	**107.5**	**107.8**	**109.4**	**111.0**
Receivables	649.9	682.4	696.0	710.0	724.2	738.6
Notional equity	205.0	201.5	204.2	207.0	209.8	212.7
RoE	57%	55%	53%	52%	52%	53%
Net profit	119.6	110.9	107.5	107.8	109.4	111.0
20% marginal funding	-7.3	-6.5	-2.7	-2.8	-2.8	-2.9
Free cash flow	112.3	104.4	104.7	105.1	106.6	108.1

Source: Citigroup Investment Research and company reports

Despite bearing Central Costs, our UK aggregation generated free cash flows sufficient to comfortably cover the group's dividend in 2005 (free cash flows of £112m versus a 2005 full year dividend of ~£90m).

The International Businesses

The table below presents profit and loss data for a combined International Credit and Vanquis Bank entity. As with the UK segment, we have applied a 30% tax charge and allocated notional equity equal to 20%

Figure 36. International Businesses (International Credit + Vanquis Bank)

Year to December (£m)	2005	2006E	2007E	2008E	2009E	2010E
Turnover	**358.6**	**436.5**	**474.3**	**522.6**	**583.1**	**661.5**
Operating expenses	-196.4	-253.2	-256.2	-273.9	-308.7	-354.3
Pre-provision profit	**180.0**	**208.5**	**250.8**	**291.3**	**329.8**	**379.2**
Provisions	-144.8	-178.4	-178.7	-190.0	-203.7	-230.2
Operating profit	**35.2**	**30.1**	**72.2**	**101.3**	**126.1**	**149.0**
Taxation @ 30%	-10.6	-7.5	-18.0	-25.3	-31.5	-37.3
Net profit	**24.6**	**22.6**	**54.1**	**76.0**	**94.5**	**111.8**
Receivables	388.7	439.9	493.5	563.0	646.9	759.2
Notional equity	77.7	88.0	98.7	112.6	129.4	151.8
RoE	35%	27%	58%	72%	78%	79%
Net profit	24.6	22.6	54.1	76.0	94.5	111.8
20% marginal funding	-15.5	-10.2	-10.7	-13.9	-16.8	-22.5
Free cash flow	9.1	12.3	43.4	62.1	77.8	89.3

Source: Citigroup Investment Research and company reports

Our International aggregation was also cash generative (ie self-funding) in 2005, despite including start-up losses in Mexico and at Vanquis.

Valuation

In the following analysis, we apply broadly the same fundamental price to book valuation methodology we use for the group (see the Valuation section of this note) to value our de-merged UK and International business units. We have made the following additional key assumptions:

- That the UK segment pays out 70% of its free cash flows in dividends, and that the International segment pays out 40% of its free cash flows. (These payments in aggregate broadly tally with our central case, group dividend forecasts.)

- We have assumed zero long-term growth from the UK businesses, which reflects our low near-term loan growth forecasts and the cyclicality of Motor Insurance. We discount UK cash flows at 9.5% to reflect low growth but relatively high visibility. For International we assume 3.5% long-term growth and discount cash flows at 11.5% to reflect the lower visibility/higher risk profile of these activities.

These valuations are summarised in the tables below, and expressed as implied 2007E P/E ratios and dividend yields.

Figure 37. De-Merger Scenario Valuation – Implied 2007E PE Ratios and Dividend Yields

	Value	07 Net	PER	07 Div	Yield	Value (p)	%
UK Business	1,017	107.5	9.5	73.3	7.2%	398	51%
International Business	959	54.1	17.7	17.4	1.8%	375	48%
YCC capital released	32					13	2%
	2,008	**161.6**	**12.4**	**90.7**	**4.5%**	**786**	**100%**

Source: Citigroup Investment Research

- We tentatively value the UK businesses, as defined, at just over £1bn, which based on our forecasts implies a 2007E PER of 9.5x. Assuming a 70% free cash flow payout ratio, this supports a 2007E dividend yield of 7.2%.
- We value International at ~£960m, which represents a 2007E PER of 17.7x, and assuming a 40% payout of free cash flows, a 2007E yield of 1.8%.
- In addition, we include £32m of value for YCC, this being an estimate of the NPV of capital released as the YCC loan book is run off.
- We have not attempted to value free cash flows not distributed as dividend, assuming these are required for maintenance capital expenditure in the UK and for new country investment expenditure in International.

Figure 38. UK Businesses – Fundamental Price to Book Valuation

Year to December (£m)	2006E	2007E	2008E	2009E	2010E
UK net profit	110.9	107.5	107.8	109.4	111.0
Equity	201.5	204.2	207.0	209.8	212.7
RoE	54.6%	53.0%	52.5%	52.5%	52.5%
Dividends		73.3	73.5	74.6	75.6
Discount factor	1.00	1.10	1.20	1.31	1.44
PV Dividends		67.0	61.3	56.8	52.6
Sustainable RoE	50.0%				
Long-term growth	0.0%				
Cost of equity	9.5%				
Fair value P/BV	5.3				
2010 terminal value	1120				
NPV Dividends	238				
NPV terminal value	779				
Fair value	**1017**				
Shares in issue	256				
Fair value per share (p)	**398**				

Source: Citigroup Investment Research

Figure 39. International Businesses – Fundamental Price to Book Valuation

Year to December (£m)	2006E	2007E	2008E	2009E	2010E
International net profit	22.6	54.1	76.0	94.5	111.8
Equity	88.0	98.7	112.6	129.4	151.8
RoE	27.3%	58.0%	71.9%	78.1%	79.5%
Dividends		17.4	24.8	31.1	35.7
Discount factor	1.00	1.12	1.24	1.39	1.55
PV Dividends		15.6	20.0	22.4	23.1
Sustainable RoE	75.0%				
Long-term growth	3.5%				
Cost of equity	11.5%				
Fair value P/BV	8.9				
2010 terminal value	1357				
NPV Dividends	81				
NPV terminal value	878				
Fair value	**959**				
Shares in issue	256				
Fair value per share (p)	**375**				

Source: Citigroup Investment Research

Potential taxation benefits

We assumed both units would be taxed at 30%, despite management comments that a stand-alone International division might be able to sustain a lower tax charge. Running the above analysis with International taxed at 25% rather than 30% added a further £71m or 27p per share, an increase of 3.5%.

Financials

Forecast summary

The table below summarises our financial forecasts out to 2010E.

Figure 40. Forecast Summary

	UK GAAP		IFRS						
Year to December (£m)	**2003**	**2004**	**2004**	**2005**	**2006E**	**2007E**	**2008E**	**2009E**	**2010E**
Income & Expenses:									
Credit turnover	957.5	1014.0	1107.6	1182.8	1069.0	1119.6	1182.9	1268.5	1376.1
Insurance turnover	176.7	152.7	164.8	154.7	153.2	156.2	159.3	162.5	165.8
Total turnover	**1134.2**	**1166.7**	**1272.4**	**1337.5**	**1222.2**	**1275.8**	**1342.2**	**1431.1**	**1541.9**
Operating costs	-788.1	-773.5	-781.8	-802.7	-664.2	-676.6	-700.2	-744.4	-799.5
Pre-provision profit	**346.1**	**393.2**	**490.6**	**534.8**	**558.0**	**599.3**	**642.0**	**686.7**	**742.3**
Provisions	-139.9	-172.5	-285.1	-353.4	-369.4	-373.6	-386.7	-404.3	-434.8
Pre-exceptional PBT	**206.2**	**220.7**	**205.5**	**181.4**	**188.5**	**225.7**	**255.3**	**282.4**	**307.5**
Exceptional items	0.0	0.0		-141.0					
Goodwill amortisation	-4.3	-4.6							
Profit before tax	**201.9**	**216.1**	**205.5**	**40.4**	**188.5**	**225.7**	**255.3**	**282.4**	**307.5**
Tax	-60.8	-64.7	-61.1	-40.4	-56.6	-67.7	-76.6	-84.7	-92.3
Attributable profit	**141.1**	**151.4**	**144.4**	**0.0**	**132.0**	**158.0**	**178.7**	**197.7**	**215.3**
Dividends	-83.4	-87.3	-84.9	-88.8	-90.5	-94.3	-97.1	-100.0	-103.0
Retained profit	57.7	64.1	59.5	-88.8	41.5	63.7	81.6	97.6	112.2
Balance Sheet:									
Average net receivables	**1036.2**	**1190.9**	**1192.0**	**1237.1**	**1198.1**	**1156.0**	**1231.3**	**1322.0**	**1434.5**
Gross receivables	1756.4	1992.2	1200.2	1273.9	1122.3	1189.6	1272.9	1371.1	1497.9
Less provision for bad debts	-143.8	-158.2	0.0						
Receivables after provisions	1612.6	1834.0	1200.2	1273.9	1122.3	1189.6	1272.9	1371.1	1497.9
Deferred revenues	-503.2	-561.7							
Net receivables	1109.4	1272.3	1200.2	1273.9	1122.3	1189.6	1272.9	1371.1	1497.9
Of which:-									
-UK Home Credit	642.5	984.2	613.5	649.9	682.4	696.0	710.0	724.2	738.6
-International	207.1	521.4	285.1	328.7	355.9	384.3	421.0	462.3	519.3
-Yes Car Credit	252.4	457.6	275.6	235.3					
-Vanquis Bank	7.4	29.0	26.0	60.0	84.0	109.2	142.0	184.5	239.9
Net assets	**449.0**	**525.5**	**414.7**	**317.4**	**358.9**	**422.6**	**504.2**	**601.8**	**714.1**
Net borrowings	-799.8	-855.1	-822.4	-930.0	-866.4	-870.0	-871.7	-872.2	-886.8
Per Share Data:									
Avg shares	252.7	254.6	254.6	255.5	255.5	255.5	255.5	255.5	255.5
End-period shares	254.3	254.6	255.1	255.4	255.4	255.4	255.4	255.4	255.4
Adj EPS (p)	**57.5**	**61.3**	**56.7**	**61.8**	**51.7**	**61.8**	**70.0**	**77.4**	**84.3**
Net div (p)	33.0	34.4	34.4	35.4	36.5	37.6	38.7	39.9	41.1
NAV/share (p)	176.6	206.4	162.6	124.3	140.5	165.5	197.4	235.6	279.6
Divisions (Cont. ops.):									
UK Home Credit	152.6	152.3	154.0	146.3	139.9	138.9	140.0	142.8	145.6
International Home Credit	29.3	49.2	39.8	51.1	45.1	67.7	89.9	111.3	129.8
Yes Car Credit	11.2	4.4	-2.7	-24.6					
Vanquis Bank	-6.7	-8.7	-9.0	-15.9	-15.0	4.5	11.4	14.8	19.2
Insurance	28.6	34.6	34.6	40.0	35.0	32.2	32.8	33.5	34.1
Central	-8.8	-11.1	-11.2	-15.5	-16.5	-17.6	-18.7	-19.9	-21.2
	206.2	**220.7**	**205.5**	**181.4**	**188.5**	**225.7**	**255.3**	**282.4**	**307.5**

Source: Company reports and Citigroup Investment Research

Divisional summary

The table below summarises our forecasts at the divisional level.

Figure 41. Divisions (Continuing Activities)

	UK GAAP		IFRS						
Year to December (£m)	**2003**	**2004**	**2004**	**2005**	**2006E**	**2007E**	**2008E**	**2009E**	**2010E**
UK HOME CREDIT									
Turnover	**495.6**	**490.5**	**558.4**	**578.9**	**607.3**	**612.5**	**617.7**	**630.0**	**642.6**
Operating expenses	-255.0	-251.8	-250.4	-260.8	-276.3	-278.7	-281.0	-286.7	-292.4
Pre-provision profit	**240.6**	**238.7**	**308.0**	**318.1**	**331.0**	**333.8**	**336.6**	**343.4**	**350.2**
Provisions	-88.0	-86.4	-154.0	-171.8	-191.1	-194.9	-196.7	-200.6	-204.6
Operating profit	**152.6**	**152.3**	**154.0**	**146.3**	**139.9**	**138.9**	**140.0**	**142.8**	**145.6**
Net receivables	642.5	642.2	613.5	649.9	682.4	696.0	710.0	724.2	738.6
Turnover/gross receivables	50.3%	49.8%	91.0%	89.1%	89.0%	88.0%	87.0%	87.0%	87.0%
Provisions/gross receivables	-8.9%	-8.8%	-25.1%	-26.4%	-28.0%	-28.0%	-27.7%	-27.7%	-27.7%
Expense ratio	-51%	-51%	-44.8%	-45.1%	-45.5%	-45.5%	-45.5%	-45.5%	-45.5%
Provisions/pre-prov profit	-37%	-36%	-50.0%	-54.0%	-57.7%	-58.4%	-58.4%	-58.4%	-58.4%
INTERNATIONAL HOME CREDIT									
Turnover	**191.4**	**235.0**	**271.2**	**358.6**	**436.5**	**474.3**	**522.6**	**583.1**	**661.5**
Operating expenses	-124.9	-146.6	-144.4	-175.1	-229.8	-238.9	-256.9	-286.6	-325.5
Pre-provision profit	**66.5**	**88.4**	**126.8**	**183.5**	**206.7**	**235.4**	**265.8**	**296.6**	**336.0**
Provisions	-37.2	-39.2	-87.0	-132.4	-161.6	-167.8	-175.8	-185.3	-206.2
Operating profit	**29.3**	**49.2**	**39.8**	**51.1**	**45.1**	**67.7**	**89.9**	**111.3**	**129.8**
Net receivables	207.1	310.0	285.1	328.7	355.9	384.3	421.0	462.3	519.3
Turnover/gross receivables	56.0%	45.1%	95.1%	109.1%	109.0%	109.0%	109.0%	109.0%	109.0%
Provisions/gross receivables	-10.9%	-7.5%	-30.5%	-40.3%	-42.0%	-41.0%	-40.0%	-39.0%	-38.0%
Expense ratio	-65%	-62%	-53.2%	-48.8%	-50.0%	-49.0%	-48.5%	-48.0%	-47.5%
Provisions/pre-prov profit	-56%	-44%	-68.6%	-72.2%	-78.2%	-71.2%	-66.2%	-62.5%	-61.4%
VANQUIS BANK									
Turnover	**1.3**	**6.7**	**5.9**	**17.8**	**25.2**	**32.8**	**42.6**	**55.4**	**72.0**
Operating expenses	-7.3	-11.4	-10.9	-21.3	-23.4	-17.4	-17.0	-22.1	-28.8
Pre-provision profit	**-6.0**	**-4.7**	**-5.0**	**-3.5**	**1.8**	**15.4**	**25.6**	**33.2**	**43.2**
Provisions	-0.7	-4.0	-4.0	-12.4	-16.8	-10.9	-14.2	-18.5	-24.0
Operating profit	**-6.7**	**-8.7**	**-9.0**	**-15.9**	**-15.0**	**4.5**	**11.4**	**14.8**	**19.2**
Net receivables	7.4	26.1	26.0	60.0	84.0	109.2	142.0	184.5	239.9
Turnover/gross receivables	15.9%	23.1%	22.7%	29.7%	30.0%	30.0%	30.0%	30.0%	30.0%
Provisions/gross receivables	-8.5%	-13.8%	-15.4%	-20.7%	-20.0%	-10.0%	-10.0%	-10.0%	-10.0%
Expense ratio	-562%	-170%	-185%	-120%	-93.0%	-53.0%	-40.0%	-40.0%	-40.0%
Provisions/pre-prov profit	12%	85%	80%	354%	-952.4%	-70.9%	-55.6%	-55.6%	-55.6%
MOTOR INSURANCE									
Turnover	**176.7**	152.7	164.8	154.7	153.2	156.2	159.3	162.5	165.8
Operating expenses	-148.1	-118.1	-130.2	-114.7	-118.1	-124.0	-126.5	-129.1	-131.6
Pre-provision profit	**28.6**	**34.6**	**34.6**	**40.0**	**35.0**	**32.2**	**32.8**	**33.5**	**34.1**
Provisions	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Operating profit	**28.6**	**34.6**	**34.6**	**40.0**	**35.0**	**32.2**	**32.8**	**33.5**	**34.1**
CENTRAL/HEAD OFFIDE									
Operating expenses	-8.8	-11.1	-11.2	-15.5	-16.5	-17.6	-18.7	-19.9	-21.2

Source: Company reports and Citigroup Investment Research

Key forecast assumptions

The key assumptions underlying our financial forecasts are as follows:

- UK Home Credit. Despite a recent slowdown in the reduction in customer numbers, and some modest growth in credit issued, we are forecasting a 4% fall in UK Home Credit profit in 2006, reflecting higher new business acquisition costs and general expenses, and a further increase in impairment charges.

- International Credit. We forecast a fall in profits in 2006 from last year's £51.1m to ~£45m reflecting (i) start up costs in Mexico and Romania and (ii) the decision to reduce new lending volumes in Poland due to rising arrears.

- Vanquis Bank losses in 2006 are likely to be somewhat higher than previous guidance (at around £15m only marginally down from losses of £16m in 2005), bringing expected start-up losses at Vanquis in the years 2002-2006 to more than £45m.

- Motor Insurance. We forecast Insurance of £35m in 2006, down from £40m in 2005, based primarily on management guidance that 2005 could mark the peak in the division's profit cycle.

- Yes Car Credit. At the pre-close trading update in July, it was reported that the run-off of the Yes Car Credit book was progressing well, with total collections of £70m, £3m ahead of plan and representing 30% of end-2005 receivables of £235m.

- Our forecasts assume that net interest income from the YCC book is matched by costs and loan losses, and hence is profit neutral. We expect the release of some £50m of capital supporting this loan book as it is run off over the next 2-3 years.

- We continue to forecast 3% pa dividend growth out to 2010E. In conjunction with our earnings forecasts, this results in a rebuilding of the group's dividend cover to 1.8x by 2008E and 2.0x by 2010E, broadly in line with management's guidance.

Appendix 1 – 2005 Results Analysis

Group results

Figure 42. 2005 Results Summary

Year to December (£m)	2004	2005	Ch £m	Ch %
Revenue				
UK home credit	558.4	578.9	20.5	3.7%
Vanquis Bank	5.9	17.8	11.9	201.7%
International	271.2	358.6	87.4	32.2%
Motor insurance	164.8	154.7	-10.1	-6.1%
Total ongoing operations	**1,000.3**	**1,110.0**	**109.7**	**11.0%**
Yes Car Credit	272.1	227.5	-44.6	-16.4%
Total group revenue	**1,272.4**	**1,337.5**	**65.1**	**5.1%**
Profit before tax				
UK home credit	154.0	146.3	-7.7	-5.0%
Vanquis Bank	-9.0	-15.9	-6.9	76.7%
International	39.8	51.1	11.3	28.4%
Motor insurance	34.6	40.0	5.4	15.6%
Central	-11.2	-15.5	-4.3	38.4%
Total ongoing operations	**208.2**	**206.0**	**-2.2**	**-1.1%**
Yes Car Credit	-2.7	-24.6	-21.9	811.1%
Pre-exceptional PBT	**205.5**	**181.4**	**-24.1**	**-11.7%**

Source: Company reports and Citigroup Investment Research

Figure 43. Balance Sheet Summary

Year to December (£m)	2004	2005	Ch £m	Ch %
Goodwill	87.8	3.1	-84.7	-96.5%
Other non-current assets	127.8	134.8	7.0	5.5%
Customer receivables	1,200.2	1,273.9	73.7	6.1%
Ivestments & cash	469.6	404.5	-65.1	-13.9%
Insurance assets	90.2	65.4	-24.8	-27.5%
Other current assets	87.1	97.6	10.5	12.1%
Net borrowings	-857.7	-982.9	-125.2	14.6%
Pension deficit	-129.8	-105.6	24.2	-18.6%
Insurance accruals	-424.9	-359.2	65.7	-15.5%
Other liabilities	-235.6	-214.2	21.4	-9.1%
Net assets	**414.7**	**317.4**	**-97.3**	**-23.5%**

Source: Company reports and Citigroup Investment Research

Divisional results

Figure 44. UK Home Credit

Year to December (£m)	**2004**	**2005**	**Ch £m**	**Ch %**
Revenue	558.4	578.9	20.5	3.7%
Costs	-233.7	-247.6	-13.9	5.9%
Interest charge	-16.7	-13.2	3.5	-21.0%
Operating profit	**308.0**	**318.1**	**10.1**	**3.3%**
Impairment charge	-154.0	-171.8	-17.8	11.6%
Profit before tax	**154.0**	**146.3**	**-7.7**	**-5.0%**
Closing receivables	613.5	649.9	36.4	5.9%
Average receivables	537.5	559.0	21.5	4.0%
Credit issued	893.8	926.5	32.7	3.7%
Customer numbers (000s)	1,529	1,488	-41	-2.7%
Agent numbers	11,865	11,755	-110	-0.9%

Source: Company Reports

Figure 45. Vanquis Bank

Year to December (£m)	**2004**	**2005**	**Ch £m**	**Ch %**
Revenue	5.9	17.8	11.9	201.7%
Costs	-10.9	-21.3	-10.4	95.4%
Operating profit	**-5.0**	**-3.5**	**1.5**	**-30.0%**
Impairment charge	4.0	12.4	8.4	210.0%
Profit before tax	**-9.0**	**-15.9**	**-6.9**	**76.7%**
Closing receivables	26.0	60.0	34.0	130.8%
Average receivables	14.3	42.5	28.2	197.2%
Number of accounts ('000s)	76	160	84	110.5%

Source: Company Reports

Figure 46. Motor Insurance

Year to December (£m)	**2004**	**2005**	**Ch £m**	**Ch %**
Gross earned premiums	168.9	160.9	-8.0	-4.7%
Gross written premiums	164.8	154.7	-10.1	-6.1%
Administrative expenses	-153.5	-136.3	17.2	-11.2%
Underwriting profit	**11.3**	**18.4**	**7.1**	**62.8%**
Investment income	23.3	21.6	-1.7	-7.3%
Profit before tax	**34.6**	**40.0**	**5.4**	**15.6%**
Policyholders	501.0	473.0	-28.0	-5.6%
Average investment fund	442.0	427.0	-15.0	-3.4%
Investment yield (%)	0.1	0.1	0.0	-5.7%
Combined ratio (%)	0.9	0.9	-0.1	-5.4%

Source: Company Reports

Figure 47. Yes Car Credit

Year to December (£m)	2004	2005	Ch £m	Ch %
Revenue	272.1	227.5	-44.6	-16.4%
Cost of goods sold	-143.4	-125.2	18.2	-12.7%
Gross profit	**128.7**	**102.3**	**-26.4**	**-20.5%**
Costs	-79.3	-75.6	3.7	-4.7%
Interest charge	-12.0	-14.5	-2.5	20.8%
Operating profit	**37.4**	**12.2**	**-25.2**	**-67.4%**
Impairment charge	-40.1	-36.8	3.3	-8.2%
Pre-exceptional PBT	**-2.7**	**-24.6**	**-21.9**	**811.1%**
Closing receivables	275.6	235.3	-40.3	-14.6%
Vehicles sold and financed	37,319	27,021	-10,298	-27.6%

Source: Company Reports

Figure 48. Central Europe

Year to December (£m)	2004	2005	Ch £m	Ch %
Revenue	269.4	347.9	78.5	29.1%
Costs	-111.5	-136.6	-25.1	22.5%
Net interest charge	-18.8	-18.3	0.5	-2.7%
Operating profit	**139.1**	**193.0**	**53.9**	**38.7%**
Impairment charge	-86.5	-128.8	-42.3	48.9%
Profit before tax	**52.6**	**64.2**	**11.6**	**22.1%**
Closing receivables	282.9	317.3	34.4	12.2%
Average receivables	211.3	274.8	63.5	30.1%
Credit issued	432.9	522.3	89.4	20.7%
Customer numbers (000s)	1,524	1,646	122	8.0%
Agent numbers	19,367	21,595	2,228	11.5%

Source: Company Reports

Figure 49. Mexico

Year to December (£m)	2004	2005	Ch £m	Ch %
Revenue	1.8	10.7	8.9	494.4%
Costs	-3.3	-9.0	-5.7	172.7%
Net interest charge	-0.2	-1.0	-0.8	400.0%
Operating profit	**-1.7**	**0.7**	2.4	-141.2%
Impairment charge	-0.5	-3.6	-3.1	620.0%
Profit before tax	**-2.2**	**-2.9**	**-0.7**	**31.8%**
Closing receivables	2.2	11.4	9.2	418.2%
Average receivables	0.9	5.6	4.7	522.2%
Credit issued	3.9	22.6	18.7	479.5%
Customer numbers (000s)	35	131	96	274.3%
Agent numbers	624	2,245	1,621	259.8%

Source: Company Reports

Figure 50. Central Europe + Mexico

Year to December (£m)	**2004**	**2005**	**Ch £m**	**Ch %**
Revenue	271.2	358.6	87.4	32.2%
Costs	-114.8	-145.6	-30.8	26.8%
Net interest charge	-19.0	-19.3	-0.3	1.6%
Operating profit	**137.4**	**193.7**	56.3	41.0%
Impairment charge	-87.0	-132.4	-45.4	52.2%
Profit before tax	**50.4**	**61.3**	**10.9**	**21.6%**
Closing receivables	285.1	328.7	43.6	15.3%
Average receivables	212.2	280.4	68.2	32.1%
Credit issued	436.8	544.9	108.1	24.7%
Customer numbers (000s)	1,559	1,777	218	14.0%
Agent numbers	19,991	23,840	3,849	19.3%

Source: Company Reports

Figure 51. International Central Costs

Year to December (£m)	**2004**	**2005**	**Ch £m**	**Ch %**
Admin expenses	-10.1	-9.5	0.6	-5.9%
Interest charge	-0.5	-0.7	-0.2	40.0%
Total costs	**-10.6**	**-10.2**	**0.4**	**-3.8%**

Source: Company Reports

Figure 52. International Division

Year to December (£m)	**2004**	**2005**	**Ch £m**	**Ch %**
Revenue	271.2	358.6	87.4	32.2%
Costs	-124.9	-155.1	-30.2	24.2%
Net interest charge	-19.5	-20.0	-0.5	2.6%
Operating profit	**126.8**	**183.5**	**56.7**	**44.7%**
Impairment charge	-87.0	-132.4	-45.4	52.2%
Profit before tax	**39.8**	**51.1**	**11.3**	**28.4%**
Closing receivables	285.1	328.7	43.6	15.3%
Average receivables	212.2	280.4	68.2	32.1%
Credit issued	436.8	544.9	108.1	24.7%
Customer numbers (000s)	1,559	1,777	218	14.0%
Agent numbers	19,991	23,840	3,849	19.3%

Source: Company Reports

Appendix 2 – LBO Scenario for UK Home Credit:

Attracting private equity interest

In the Investment Thesis section of this note we highlighted increased speculative interest as one of the potential benefits of de-merging the UK and international activities. In particular we noted that the cash and capital generative attributes of the UK activities could prove attractive to private equity interest.

In the following analysis we consider a notional transaction in which Provident's UK home credit business is acquired by a leveraged buy-out vehicle. This crude analysis indicates that, in theory, a leveraged acquisition vehicle could fund a take-out valuation of more than £1.5bn for the UK home credit franchise and its receivables book, which implies a valuation of the business (equity plus goodwill) of £1bn — some two-thirds of the group's current market value. Moreover, given what appear to be reasonable timescales and exit valuations, we believe such a transaction could deliver attractive internal rates of return (we estimate 20%-30% pa over 4-years).

The transaction

We consider the acquisition of the UK home credit activities only (we exclude motor insurance) and assume the buy-out is valued at £1,546m - £1bn for the business (10.2x estimated 2006E UK home credit profit after tax) and £546m for the debt funded element of the receivables book. To this we have added advisory fees of 1%, which increases the total value of the transaction to £1,561m (8.7x EBITDA) including leverage of £937m (5.2x EBITDA).

Figure 53. EBITDA Estimate

Year to December (£m)	2006E
Receivables	682.4
Equity	136.5
Finance	545.9
Profit before tax	139.9
Depreciation	3.0
Finance costs	36.6
EBITDA	**179.5**

Source: Citigroup Investment Research

Figure 54. LBO Capital Structure

	% EV
Senior debt	10%
Subordinated debt	50%
Total debt	**60%**
Equity	**40%**
-O/w shareholder loan	24%
-O/w cash equity	16%

Source: Citigroup Investment Research

Figure 55. Source and Uses of Funds

	£m
Acquisition price	**1,000.0**
Loan book funding	545.9
Fees	15.5
Use of funds	**1,561.4**
Senior debt	156.1
Subordinated debt	780.7
Debt	**936.8**
Shareholder loan	374.7
Cash equity	249.8
Source of funds	**1,561.4**

Source: Citigroup Investment Research

Figure 56. Debt Servicing Costs

	Rate	Cost
Senior debt	7.0%	10.9
Subordinated debt	10.0%	78.1
Debt	**9.5%**	**89.0**
Shareholder loan	12.0%	45.0
Debt + Shareholder loan	**10.2%**	**134.0**

Source: Citigroup Investment Research

Figure 57. LBO Proforma Income & Expenses

Year to December (£m)	2006E
EBITDA	179.5
Debt service	-89.0
Shareholder loan	-45.0
Depreciation	-3.0
PBT	**42.5**
Tax	-12.8
PAT	**29.8**

Source: Citigroup Investment Research

The analysis also assumes:

- UK home credit receivables total £682.4m end-December 2006E, funded with £136.5m of equity (an equity:loan assets ratio of 20%) and £545.9m of debt.
- Debt funding costs of £37m, which equates to an interest rate of 6.7% on debt funding (group-wide average funding costs, including hedging costs, were 6.65% in 2005).
- Adding back estimated funding costs and depreciation to estimated 2006E PBT, we estimate UK home credit EBITDA at £179.5m. This estimate is net of our forecast for loan loss impairment charges of £191.1m (28% of estimated receivables under IFRS).
- We have assumed an LBO capital structure made up as to 60% debt and 40% equity, with 60% of the equity component in the form of a shareholder loan.

Provident Financial

Company description

Provident Financial is a UK and International consumer credit company with additional UK motor insurance activities. The UK Home Credit business is cash generative but mature. The international credit unit spans Central Europe and Mexico, and combines established and profitable operations with more recent start-ups.

Investment thesis

We rate Provident Financial Buy/ High Risk (1H). Provident Financial offers a combination of (i) high free cash flows from its UK home credit and insurance divisions, and (ii) potentially significant earnings growth from its international home credit franchise and credit card platform. The key risks are regulatory risk in the UK, low earnings visibility in Mexico and Central Europe, and the performance of the Yes Car Credit book in run-off.

The UK generates free cash flows which more than cover the group's annual dividend, and although UK surplus cash flow has in the past been required to finance international growth, the latter is now self funding. We forecast international profits will grow at 20% per annum over the next five years and account for 45% of total profits by 2010.

Valuation

One or two year-ahead earnings estimates are a poor reflection of Provident's underlying earnings power due to the near-term drag of start-up losses incurred in rolling out the international credit platform in new countries and regions (such as Mexico and Romania). We estimate intrinsic value using fundamental price to book and discounted sum-of-the-parts approaches, which suggest end-December 2006E fair values within a 730p to 790p per share range, which is underpinned by a 721p per share estimate based on peer group relative multiples. We set our 12-month target price in the middle of this range at 750p per share, at which the shares would trade on a 2007E PE of 12.1x and yield a prospective 5.0%.

Risk

We rate Provident Financial High Risk. The risk rating on the stock is derived after the consideration of a number of industry-specific risks, financial risk and management risk. In addition, we consider historical share price volatility, based on the input of the Citigroup Investment Research quantitative research team, as a possible indicator of future stock-specific risk. Our near-term concerns are the Competition Commission enquiry into UK Home Credit, rising UK impairment provisions and the potential for further losses from the Yes Car Credit loan book in run-off. Longer term, the key risks relate to international credit: the impact of rate capping in Poland, slower growth from the Central European activities, and the relatively low earnings visibility of new regions such as Mexico and Romania. These risks could impede the share price from reaching our target price.

Analyst Certification Appendix A-1

I, Tony Cummings, research analyst and the author of this report, hereby certify that all of the views expressed in this research report accurately reflect my personal views about any and all of the subject issuer(s) or securities. I also certify that no part of my compensation was, is, or will be directly or indirectly related to the specific recommendation(s) or view(s) in this report.

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