

Company In-Depth

SMALL &
MID CAP

22 January 2007 | 12 pages

Provident Financial (PFG.L)

Shifting to break-up valuation

Rating change ☒
Target price change ☒
Estimate change ☐

- **Shifting to break-up valuation** — In advance of a detailed de-merger announcement on 7 March, and following last week's announcement that Provident Insurance is up for sale, we are shifting our valuation basis to a break-up, sum-of-the-parts approach. As a result, we raise our 12-month target price by 17%, from 710p to 830p per share.
- **De-merger to release value** — The de-merger should allow the international division, excused from dividend duties, to invest more heavily in rolling out the geographic platform and should also highlight the cash generative attraction of the UK businesses.
- **Risks reduced: changing rating from High to Medium** — The shares have been progressively and substantially de-risked, following the closure of Yes Car Credit and the completion of the Competition Commission enquiry in UK Home Credit. A reassuring pre-close update in December confirmed Provident had has traded in line with management's expectations.
- **Acquisition targets** — Separated from the UK activities, the international businesses could attract international banks looking to quickly expand their non-prime consumer credit franchises. The UK Home Credit business has characteristics that could appeal to private equity investors.
- **Inexpensive** — The shares are currently inexpensive, trading on 14.9x 2007E earnings and yielding 5.0%. We see upside potential to our estimated break-up value of 830p per share should further corporate interest emerge; hence, we continue to recommend buying ahead of the results on 7 March.

See page 10 for Analyst Certification and important disclosures.

Buy/Medium Risk	1M
<i>from Buy/High Risk</i>	
Price (19 Jan 07)	£7.50
Target price	£8.30
<i>from £7.10</i>	
Expected share price return	10.7%
Expected dividend yield	5.0%
Expected total return	15.7%
Market Cap	£1,921M
	US\$3,791M

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



Provident Financial (GBP)

Year to 31 Dec	2004A	2005A	2006E	2007E	2008E
Net Income (£M)	144.4	157.8	129.0	131.9	151.3
Diluted EPS (p)	56.7	61.8	50.5	51.6	59.2
Diluted EPS (Old) (p)	56.7	61.8	50.5	51.6	59.2
PE (x)	13.2	12.1	14.9	14.5	12.7
P/BV (x)	4.6	6.0	5.4	4.9	4.3
DPS (p)	34.4	35.4	36.5	37.6	38.7
Net Div Yield (%)	4.6	4.7	4.9	5.0	5.2
ROE (%)	37.5	0.0	38.4	35.3	36.1

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Fiscal year end 31-Dec	2004	2005	2006E	2007E	2008E
Valuation Ratios					
P/E adjusted (x)	13.2	12.1	14.9	14.5	12.7
P/E reported (x)	13.2	na	14.9	14.5	12.7
P/BV (x)	4.6	6.0	5.4	4.9	4.3
P/Adjusted BV diluted (x)	4.6	6.0	5.4	4.9	4.3
Dividend yield (%)	4.6	4.7	4.9	5.0	5.2
Per Share Data (p)					
EPS adjusted	56.7	61.8	50.5	51.6	59.2
EPS reported	56.7	0.0	50.5	51.6	59.2
BVPS	162.6	124.3	138.9	153.7	174.9
Tangible BVPS	120.7	112.3	127.0	141.7	162.9
Adjusted BVPS diluted	162.6	124.3	138.9	153.7	174.9
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	1,195
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	1,354
Total operating expenses	-782	-803	-674	-715	-748
Oper. profit bef. provisions	491	535	548	561	607
Bad debt provisions	-285	-353	-364	-373	-391
Non-operating/exceptionals	0	-141	0	0	0
Pre-tax profit	206	40	184	188	216
Tax	-61	-40	-55	-57	-65
Extraord./Min. Int./Pref. Div.	0	0	0	0	0
Attributable profit	144	0	129	132	151
Adjusted earnings	144	158	129	132	151
Growth Rates (%)					
EPS adjusted	na	8.9	-18.2	2.2	14.7
Oper. profit bef. prov.	na	9.0	2.5	2.4	8.1
Balance Sheet (£M)					
Total assets	2,063	1,979	1,828	1,895	1,992
Avg interest earning assets	1,192	1,237	1,198	1,156	1,238
Customer loans	1,200	1,274	1,122	1,190	1,287
Gross NPLs	0	0	0	0	0
Liab. & shar. funds	2,063	1,979	1,828	1,895	1,992
Total customer deposits	0	0	0	0	0
Reserve for loan losses	0	0	0	0	0
Shareholders' equity	415	317	355	392	447
Profitability/Solvency Ratios (%)					
ROE adjusted	37.5	43.1	38.4	35.3	36.1
Net interest margin	92.9	95.6	89.2	96.9	96.5
Cost/income ratio	61.4	60.0	55.1	56.0	55.2
Cash cost/average assets	40.2	39.7	35.4	38.4	38.5
NPLs/customer loans	0.0	0.0	0.0	0.0	0.0
Reserve for loan losses/NPLs	na	na	na	na	na
Bad debt prov./avg. cust. loans	23.9	28.6	30.4	32.3	31.5
Loans/deposit ratio	na	na	na	na	na
Tier 1 capital ratio	20.7	14.8	19.1	20.8	23.0
Total capital ratio	20.7	21.3	26.3	27.6	29.4

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Shifting to Break-Up Valuation

In advance of a detailed de-merger announcement on 7 March, and following December's reassuring pre-close trading update and last week's announcement that Provident Insurance is up for sale, we are shifting our valuation basis from the previous conglomerate price to book methodology to a break-up, sum-of-the-parts approach. As a result, we raise our 12-month target price by 17%, from 710p to 830p per share.

Investment case

- Provident Financial has become an event-driven special situation as we approach the 7 March date when it will disclose full details of the proposed de-merger of the group's UK and International businesses, progress in the sale of its UK motor insurance business, its potential plans for the use of proceeds from such a sale and the final results for the year to December 2006.
- The de-merger should allow the international division, excused from dividend duties, to invest more heavily in rolling out the geographic platform and should also highlight the cash generative attraction of the UK businesses. UK income seekers are likely to value the UK division in relation to its yield, whilst global growth investors are likely to value the international division in relation to its existing franchise and future growth potential.
- Separated from the UK credit and motor insurance activities, the international businesses could attract international banks looking to quickly expand their non-prime consumer credit franchises. The UK home credit business could appeal to private equity investors as it provides substantial free cash flows to support and pay down a leveraged capital structure.
- On 17 January Provident announced that, in response to third party approaches, it will be considering whether to sell its non-core motor insurance business, Provident Insurance. Further announcements on the progress of its discussions with potential buyers will be made at the time of the 2006 final results and at the de-merger announcement on 7 March.
- The shares have been progressively and substantially de-risked over the past 14 months, following the closure of Yes Car Credit and the completion of the Competition enquiry in UK home credit. The company issued a reassuring pre-close update in December, which stated Provident had traded in line with management's expectations in the 11 months to end-November.
- Robin Ashton stepped down as group CEO at the end of last year, although he will remain with the group until April. The reason given for Ashton's departure is that "new skills and leadership will enable our businesses to capture the next phase of growth". We expect further details will be provided with the de-merger announcement.
- Based on our estimates, the shares are currently inexpensive, trading on 14.9x 2007E earnings and yielding a prospective 5.0%. We see upside potential to our estimated break-up value of 830p per share should further corporate interest emerge; hence, we continue to recommend buying ahead of the results on 7 March.

Valuation

Based on estimated earnings in 2008, adjusted for investment costs, we derive a break-up valuation for Provident of 831p per share. Taking the group's current market value and subtracting stand-alone values for UK Home Credit and Motor Insurance, the International Credit and Vanquis Bank units look to be trading on an implied P/E multiple of only 11.3x estimated 2008 earnings and only 9.2x for 2009.

Adjusting for investment costs

The table below summarises our profit forecasts by division, highlighting new country and product investment costs in the International Credit unit and Yesinsurance.co.uk investment costs in the UK.

Figure 1. Forecast Summary

Year to December (£m)	2005	2006E	2007E	2008E	2009E	2010E	CAGR
-Central Europe	64.2	72.6	66.2	76.9	83.8	88.6	7%
-Mexico	-2.9	-0.6	0.7	3.0	9.5	16.2	
-New Countries/Products		-15.0	-8.0	-5.0	-5.0	-5.0	
-International Central	-10.2	-10.6	-11.0	-11.5	-11.9	-12.4	4%
International Credit	51.1	46.4	47.9	63.4	76.3	87.4	11%
Vanquis Bank	-15.9	-15.0	0.0	7.1	12.0	19.2	
UK Home Credit	146.3	134.5	130.0	136.4	141.9	147.5	0%
Insurance	40.0	38.0	30.0	29.0	32.2	35.3	-2%
Yesinsurance.co.uk		-3.0	-2.0	-1.0	0.0		
Central	-15.5	-16.5	-17.6	-18.7	-19.9	-21.2	6%
Group total	206.0	184.3	188.4	216.1	242.4	268.3	5%

Source: Company Reports and Citigroup Investment Research Estimates

The following table isolates the investment cost items and presents adjusted profits for what we label the "International Division" (International Credit plus Vanquis Bank) and the UK Division (UK Home Credit and Motor Insurance).

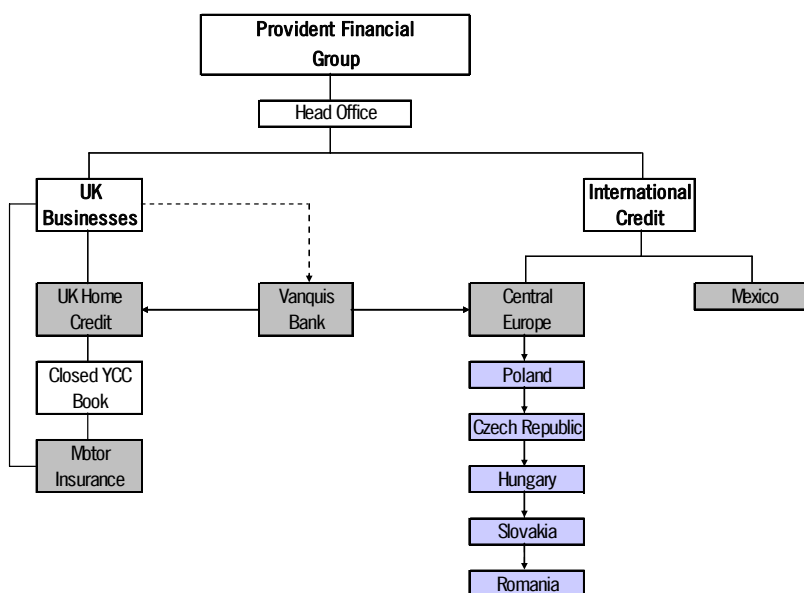
Figure 2. Forecasts Adjusted for Investment Costs

Year to December (£m)	2005	2006E	2007E	2008E	2009E	2010E	CAGR
International Credit Core	51.1	61.4	55.9	68.4	81.3	92.4	13%
Vanquis	-15.9	-15.0	0.0	7.1	12.0	19.2	
"International Division"	35.2	46.3	55.9	75.5	93.3	111.6	26%
UK Home Credit	146.3	134.5	130.0	136.4	141.9	147.5	0%
Insurance	40.0	38.0	30.0	29.0	32.2	35.3	-2%
Central Costs	-15.5	-16.5	-17.6	-18.7	-19.9	-21.2	
"UK Division"	170.8	156.0	142.5	146.6	154.1	161.6	-1%
New Countries/Products	0.0	-15.0	-8.0	-5.0	-5.0	-5.0	
Yesinsurance.co.uk	0.0	-3.0	-2.0	-1.0	0.0	0.0	
Group Total	206.0	184.3	188.4	216.1	242.4	268.3	5%

Source: Company Reports and Citigroup Investment Research Estimates

Although on one level Vanquis Bank is a UK sub-prime credit card business, we believe its banking license will be of more use in the de-merged international segment, since it will provide a platform for remotely collected credit products and also variable rate loans. As shown below, it can be viewed as servicing both UK and International businesses.

Figure 3. Existing Group Structure



Source: Company Reports

Break-up valuation

Our break-up valuation is based upon adjusted 2008 earnings estimates and is summarized below.

Figure 4. Sum-of-the-Parts / Break-Up Valuation

Year to Dec 2008 (£m)	PBT	Tax	PAT	Div	PER	Yield	Value £m	Value p
International Division	75.5	-18.9	56.6	11.3	15.0	1.3%	849	332
UK Insurance	29.0	-8.7	20.3	7.5	10.0	3.7%	203	79
UK HC less central	117.7	-35.3	82.4	78.3	11.9	8.0%	978	382
Divisional total	222.1	-62.9	159.3	97.1			2,030	793
Surplus capital							97.5	38
Group	222.1	-62.9	159.3	97.1	13.4	4.6%	2,128	831

Source: Citigroup Investment Research

The key assumptions are as follows:

- For the “International Division” we have assumed a lower, 25% tax rate based on previous management guidance to this effect. We have then applied a 15x P/E multiple to net profits to derive our fair value estimate. The 15x multiple assumption is derived from an (ROE-g)/(COE-g) price to book formula, which is in turn assumes a 50% return on notional equity (we assume an equity:loans ratio of 20% for both International Credit and Vanquis balances), a 10% cost of equity and a long-term equity growth rate of 4% pa.
- For UK Insurance, we have assumed a trade sale value of just over £200m. Although this equates to 10x our estimate of 2008 earnings, it is based on a multiple of tangible net assets (TNA). The most comparable quoted company to Provident Insurance is Highway Insurance, which currently trades on a multiple of TNA of around 2.2x. Applying this to Provident Insurance’s £75m of NTA would suggest a publicly traded valuation of around £165m. Taking the quality of Provident Insurance into account, and applying a 20% premium for control, suggests a trade sale value of around £200m.
- We have valued UK Home Credit in relation to its cash generation and its dividend paying capacity. The key assumptions are a 95% payout ratio and an 8.0% fair value yield, which suggests a fair value of £978m, or 11.9x estimated 2008 earnings. Although a 95% payout ratio in 2008 would leave estimated retentions of only ~£4m, with a 20% equity:loans ratio, this would be sufficient to fund growth the UKHC book of £20m, or ~3%, which is approximately the rate of growth our forecasts assume.
- Our estimate of surplus capital is based on the excess of our forecast for group equity in 2008 and “required equity” which we calculate as 20% of loan assets plus Motor Insurance capital.

Estimating an implied International Division P/E multiple

Using the group’s current market value, and our stand-alone valuations for UK Home Credit, Motor Insurance and surplus capital, we derive the following implied P/E multiples for our International Division.

Figure 5. Estimating an Implied International Division P/E Multiple

	£m			
Current market value	1921			
Less UK Home Credit	-978			
Less Insurance	-203			
Less surplus capital	-98			
Implied “International Division” EV	642			
Year to December (£m)	2007E	2008E	2009E	2010E
International Division NOPAT	41.9	56.6	70.0	83.7
International EV/NOPAT	15.3	11.3	9.2	7.7

Source: Citigroup Investment Research

2006 Pre-Close Trading Update

Provident issued a reassuring pre-close trading update on 18 December 2006. In aggregate, the company had traded broadly in-line with management's expectations in the 11 months to end-November, and that Motor Insurance has traded a little ahead of expectations.

Divisional Updates

UK Home Credit

UK Home Credit has performed in line with expectations, with end-November customer numbers up 0.5% yoy. This is despite an additional 40,000 customer rejections since the introduction of tighter credit underwriting criteria in May. Continuing pressure on UK disposable incomes has seen the division's impairment charges increase at a faster rate than revenue, which is consistent with the trend reported for the first half.

International

In total, the international home credit businesses have performed in line with expectations, with end-November customer numbers up 3% yoy. In Poland, management reports an improvement in the quality of the loan book which has significantly reduced the level of impairment charges and that the business is now investing in marketing and its field operations to restore profitable growth. In Hungary, new lending recommenced on 6 December, having been temporarily suspended on 17 October, a couple of weeks later than previously expected. In Mexico, customer numbers stood at ~250,000 at end-November, up from 184,000 at end-June.

Motor Insurance

Provident Insurance is trading ahead of expectations, with profits continuing to benefit from the favourable development of claims costs. Yesinsurance.co.uk, its internet-based distribution channel launched earlier this year, is trading well.

Vanquis Bank

Customer numbers continue to grow and were close to 250,000 at the end of November, close to management's target for the year-end. As indicated in the group's November trading update, Vanquis is expected to report a slightly higher 2006 start-up loss than indicated at the time of the interim results announcement in September. The business is still expected to breakeven in 2007.

Yes Car Credit

The run-off of the closed Yes Car Credit loan book has continued to progress well.

Forecast summary

Our financial forecasts out to 2008E are summarised in the table below.

Figure 6. Forecast Summary

Year to December (£m)	2004	2005	2006E*	2007E	2008E	06/05	07/06	08/07
Income & Expenses:								
Credit turnover	1107.6	1182.8	1069.0	1119.6	1195.0	-10%	5%	7%
Insurance turnover	164.8	154.7	153.2	156.2	159.3	-1%	2%	2%
Total turnover	1272.4	1337.5	1222.2	1275.8	1354.4	-9%	4%	6%
Operating costs	-781.8	-802.7	-674.0	-714.5	-747.7	-16%	6%	5%
Pre-provision profit	490.6	534.8	548.2	561.3	606.7	3%	2%	8%
Provisions	-285.1	-353.4	-363.9	-372.9	-390.5	3%	2%	5%
Pre-exceptional PBT	205.5	181.4	184.3	188.4	216.1	2%	2%	15%
Exceptional items		-141.0						
Profit before tax	205.5	40.4	184.3	188.4	216.1	356%	2%	15%
Tax	-61.1	-40.4	-55.3	-56.5	-64.8	37%	2%	15%
Attributable profit	144.4	0.0	129.0	131.9	151.3		2%	15%
Dividends	-84.9	-88.8	-91.6	-94.3	-97.1	3%	3%	3%
Retained profit	59.5	-88.8	37.4	37.6	54.2	-142%	0%	44%
Balance Sheet:								
Net receivables	1200.2	1273.9	1122.3	1189.6	1286.8	-12%	6%	8%
Of which:-								
-UK Home Credit	613.5	649.9	682.4	696.0	723.9	5%	2%	4%
-International	285.1	328.7	355.9	384.3	421.0	8%	8%	10%
-Yes Car Credit	275.6	235.3						
-Vanquis Bank	26.0	60.0	84.0	109.2	142.0	40%	30%	30%
Average net receivables	1192.0	1237.1	1198.1	1156.0	1238.2	-3%	-4%	7%
Net assets	414.7	317.4	354.8	392.4	446.6	12%	11%	14%
Net borrowings	-822.4	-930.0	-870.5	-900.2	-943.3	-6%	3%	5%
Ratios:								
Credit turnover/avg loans	92.9%	95.6%	89.2%	96.9%	96.5%			
Provisions/avg	-23.9%	-28.6%	-30.4%	-32.3%	-31.5%			
Expense ratio	-61.4%	-60.0%	-55.1%	-56.0%	-55.2%			
ROA	12.1%	11.4%	10.8%	11.4%	12.2%			
ROE	69.6%	33.5%	38.4%	35.3%	36.1%			
Effective tax rate	-29.7%	-22.3%	-30.0%	-30.0%	-30.0%			
Per Share Data:								
Adj EPS (p)	56.7	61.8	50.5	51.6	59.2	-18%	2%	15%
Net div (p)	34.4	35.4	36.5	37.6	38.7	3%	3%	3%
NAV/share (p)	162.6	124.3	138.9	153.7	174.9	12%	11%	14%
Divisions:								
UK Home Credit	154.0	146.3	134.5	130.0	136.4	-8%	-3%	5%
International Home Credit	39.8	51.1	46.4	47.9	63.4	-9%	3%	32%
Yes Car Credit	-2.7	-24.6						
Vanquis Bank	-9.0	-15.9	-15.0	0.0	7.1			
Insurance	34.6	40.0	35.0	28.0	28.0	-12%	-20%	0%
Central	-11.2	-15.5	-16.5	-17.6	-18.7	6%	6%	6%
	205.5	181.4	184.3	188.4	216.1	2%	2%	15%

Source: Company Reports and Citigroup Investment Research Estimates. *Continuing business 2006E-08E

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/ Medium Risk (1M). The proposed de-merger of the group's UK and International businesses will release value, in our view, in that it will allow the International businesses (excused from dividend duty) to invest more heavily in rolling out its geographic platform, and highlight the cash generative attraction of the UK businesses. UK income seekers attracted to the UK businesses are likely to value them on a yield basis, whilst global growth investors are likely to value the international division in relation to its existing franchise and future growth potential.

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 fair value using a sum-of-the-parts methodology based upon estimated earnings in 2008E. We value the International activities in relation to underlying earnings, UK Home Credit in relation to its free cash flow yield, and Motor Insurance on its estimated trade sale value. We estimate a fair break-up valuation of 831p per share and have set our target price with reference this. We therefore have a 12-month target price 830p per share, at which the Provident would trade on a 2008E PE of 14.0x and a 2008E yield of 4.7%.

Risk

We rate Provident Financial Medium 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. The key risks are rising UK impairment provisions and the potential for further losses from the Yes Car Credit loan book in run-off, the impact of increased regulation in Poland and Hungary, a slowdown in 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

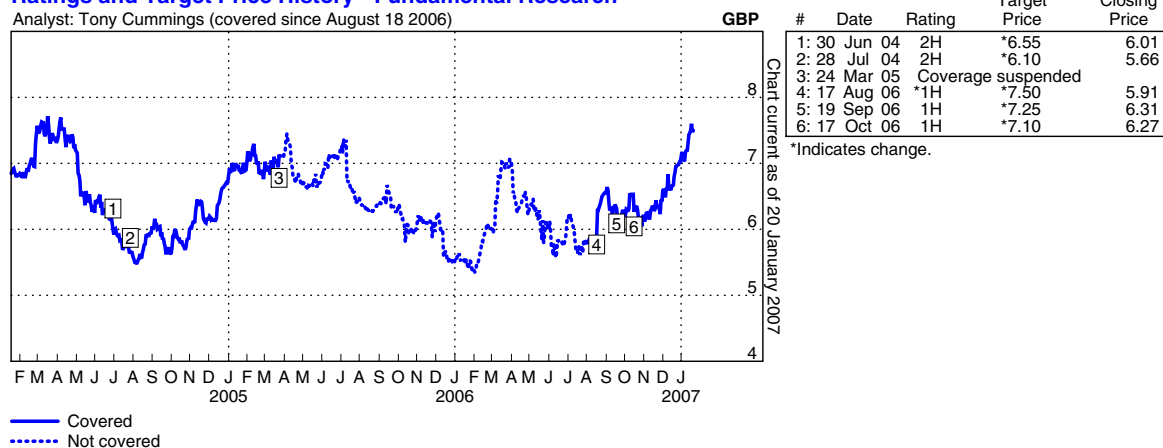
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IMPORTANT DISCLOSURES

Provident Financial (PFG.L)

Ratings and Target Price History - Fundamental Research

Analyst: Tony Cummings (covered since August 18 2006)



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Data current as of 31 December 2006

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% of companies in each rating category that are investment banking clients	11%	0%	0%

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