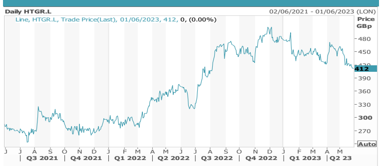
1 June 2023

HARDMAN & CO.

Finance and credit services



Source: Refinitiv

Market data

EPIC/TKR	**HAT**
Price (p)	**412.0**
12m high (p)	510.0
12m low (p)	311.0
Shares (m)	43.99
Mkt cap (£m)	181.2
EV 2022 (£m)	177.9
Free float*	86.3%
Country of listing	UK
Currency of listing	GBP
Market	AIM

**As defined by AIM Rule 26*

Description

H&T's products include pawnbroking, jewellery retail, cheque cashing, Western Union money transfer and Foreign Exchange, offered through 274 stores and online. 63% of 2022 gross profits were generated from pawnbroking and 17% from retail.

Company information

CEO	Chris Gillespie
CFO	Diane Giddy
Chair	Simon Walker
NEDs	James Thornton,
	, Toni Wood

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Key shareholders (26 May'23)

Octopus Investments	11.54%
Fidelity	9.94%
Close Bros	8.80%
Canaccord Gen WM	5.63%
Artemis	4.72%
Stichting Value	4.27%
Premier Miton	3.28%
JP Morgan AM	3.27%

Diary

Jul'23	Trading update

Analyst

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H&T

Pawnbroking's current appeal

In our 15 March initiation, *Pawnbroking royalty, with strong, profitable growth*, we highlighted that H&T's core is pawnbroking and related retail services operations. As other small-sum, short-term lenders have withdrawn at a time of heightened demand, H&T's well-capitalised, low-risk proposition has unique growth opportunities, which are expected to fuel strong earnings growth (2024E EPS 4.2x 2021 levels). We also note that the dividend is progressive (2024E yield 5.3%). H&T's *AGM trading statement* on 10 May confirmed our positive expectations. In this note, we focus on the reduction in competition at a time of heightened demand and the low-risk nature of H&T's pawnbroking business.

- **Strong growth:** The pawnbroking pledge book saw strong growth, rising to ca.£106.5m at the end of April, from £100.7m at 31 December 2022), despite recent above-normal redemptions (expected to have short-term impact), as some customers wanted their jewellery for Coronation events. Despite this drag, the growth is in line with our full-year forecast.
- **Other businesses:** Retail sales (to end-April) were up 13% YoY. Margins have continued to moderate, as expected, primarily because of mix. Forex revenues are up 10% YoY. Gold purchase volumes have been in line with forecasts. Scrap margins continue to benefit from a strong gold price.
- **Valuation:** We use a range of valuation approaches, including a Gordon Growth Model (GGM), a Discounted Dividend Model (DDM) and a Discounted Cashflow Model (DCF). On the assumptions we detailed in the initiation, the average indicative valuation is 606p. As H&T is a growing business, there is upside potential moving forward the base year.
- **Risks:** H&T's customers are cash-constrained. Its money laundering, stolen goods risk and other regulatory controls are appropriate to pawnbroking. We believe sentiment to the industry is a specific risk, which needs careful communication to overcome. Inflation risk to the cost base is also a specific short-term consideration.
- **Investment summary:** H&T is focused on delivering the opportunity in its core pawnbroking and related retail businesses. Having gained pawnbroking market share, and with the collapse of most other competitors, its strong balance sheet means it is structurally well-positioned to finance demand for small-sum, short-term credit. This generates a strategic, long-term competitive advantage from which to grow earnings. For 2023, there is growing customer demand from the cost-of-living crisis, with few alternative, regulated competitors.

Financial summary and valuation

Year-end Dec (£000)	2020	2021	2022	2023E	2024E	2025E
Revenue	129,115	121,995	173,941	198,007	221,400	236,770
Gross profit	82,799	76,355	101,916	125,589	140,470	151,183
Total expenses	(65,915)	(65,155)	(69,607)	(77,937)	(84,007)	(89,240)
Pre-tax profit	15,632	7,862	19,005	30,205	37,962	43,574
EPS (p)	32.11	15.43	37.15	52.69	64.93	74.53
DPS (p)	8.5	12.0	15.0	18.8	22.0	25.0
Receivables	55,751	72,449	104,046	117,500	127,500	137,500
Inventories	27,564	28,421	35,469	36,229	38,764	40,703
Cash	34,453	17,638	12,229	11,959	12,633	12,297
Shareholders' funds	134,549	136,618	164,119	179,979	199,778	222,471
P/E ratio (x)	12.8	26.7	11.1	7.8	6.3	5.5
Dividend yield	2.1%	2.9%	3.6%	4.6%	5.3%	6.1%

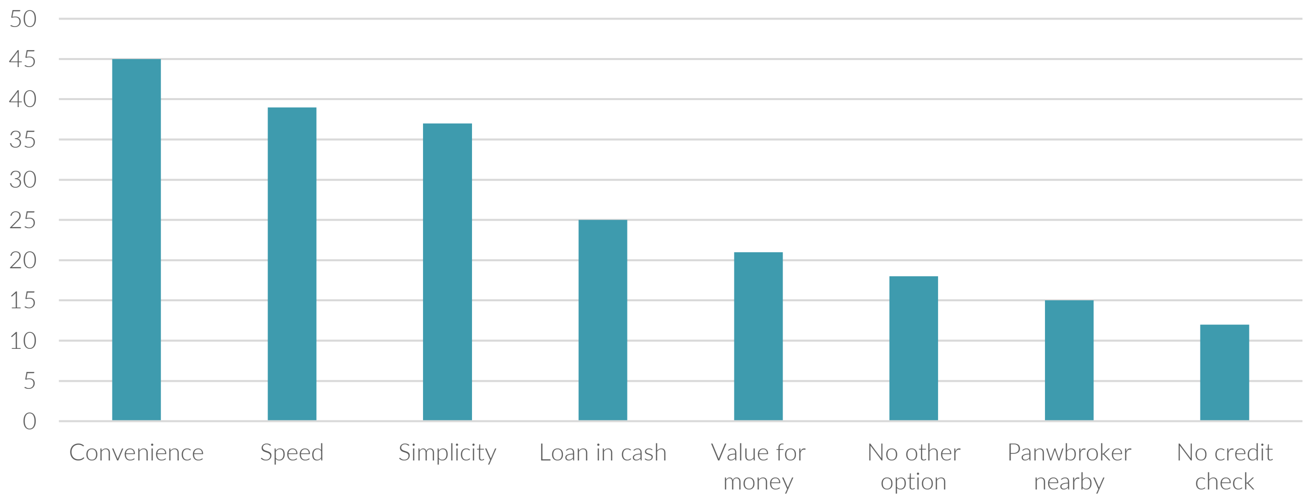
Source: H&T, Hardman & Co Research

A brief recap of what pawnbroking is

Three key features of pawnbroker: i) secured against an asset a customer has already bought; ii) interest charged only for days of borrowing; iii) no credit checks/impact on credit records

A pawnbroking loan offered by H&T is a secured loan with a contractual term of six months, with simple daily interest and with no penalties for early repayment. H&T lends to customers against the assessed value of the item they wish to pledge, which is typically pre-owned jewellery or watches. Interest rates are determined by the size of the loan within a range of just below 2%-9% p.m., with larger loans attracting the lower interest rates. Similarly, there are no set amounts of borrowing. They conclude a consumer credit agreement with the customer, charging a daily interest, allowing customers to repay their loan at a timing of their choice, and they pay interest only for the period for which they use the loan. The customers borrow only what they need, and incur interest only on that amount. Unlike other forms of credit, credit is assessed on the value of the item, not the creditworthiness of the customer, and so customers are normally not credit-checked.

Reasons for using a pawnbroker (%)



Source: The Personal Finance Research Centre, Pawnbroking customers in 2020, Hardman & Co Research

Relationships and trust further key elements

A further key aspect of any pawnbroking business is the relationship that it builds with the customer and the community that it serves. The pledged asset is more than just a store of value, and often has a real emotional attachment for the customer, frequently representing a link with a loved one. For some, it may be the only thing of value that they own. Giving this to a third party is not easily done, and transacting face-to-face with a person they trust is important. In 2022, only 13% of loans were to new borrowers, with new customer volumes up 40% YoY. In our view, remote-only franchises are unlikely to be successful. Pawnbroking is a community-based business, and H&T celebrated its 125-year anniversary in 2022 – so it is a well-established brand.

Long-term growth drivers

Less active competition…

In looking at the competition, it is critical to understand the amount and term of the loan. On average, the mean is under £400 (median, as reported in the March trading statement, remains under £200), and the average life of the borrowing is just under four months (contractual term is six months). In our initiation report, we detailed why most regulated providers, who, in the past, provided similar facilities, have significantly withdrawn and why those issues do not apply to H&T. In summary:

HCCs killed by CMCs

- Claims Management Companies (CMCs) have recently been active against home collect companies (HCCs). We detail the nature of the risk and why it does not apply to H&T in the section in our initiation. This has resulted in NSF and PFG closing their HCC business. Morses Club issued profit warnings, delisted and put in place a scheme of arrangements, which means customers will receive 40%-55% of the compensation due. New lending in this space, which was a natural provider to small-amount, short-term, living-expense-related finance, appears minimal.

Credit unions moved to larger lending – smallest loans well-above H&T's average

- Credit Unions have moved to larger loans, and are using customer credit scores, which may or may not be appropriate for the borrower. Typically, they want borrowers to have saved for a period before they can borrow, and they are not competing directly with H&T's target customers.

Branch-based lenders closed after GFC and, again, looking to lend larger amounts

- Most branch-based lenders closed after the GFC, leaving Everyday Loans as effectively the "last man standing". Its minimum loan, at £1,000, is well-above H&T's average, and it is a term facility offering the customer much less flexibility. Again, there is the customer credit score issue, and there are only 76 branches listed on the website, giving a distribution network of just over a third of the size of H&T.

…and strong current customer demand…

Lower-income deciles face specific pressure, because higher proportion of their income spent on energy and food costs

In understanding the near-term growth, it is important also to understand that customers often use pawnbroking for their immediate day-to-day living needs. H&T's customer base is being particularly hard-hit by inflationary pressure. In the UK, an average 10.8% of household spend went on food in 2019/20, while, for the lowest 20% of households by equivalised income, it was higher, at 14.7%.[1] With basic necessities costing more, we believe that more and more customers will turn to pawnbrokers for small-sum, short-term finance. The level of demand is already evident in the 2022 results and the recent trading statement, and will, we believe, rise further into 2023-24.

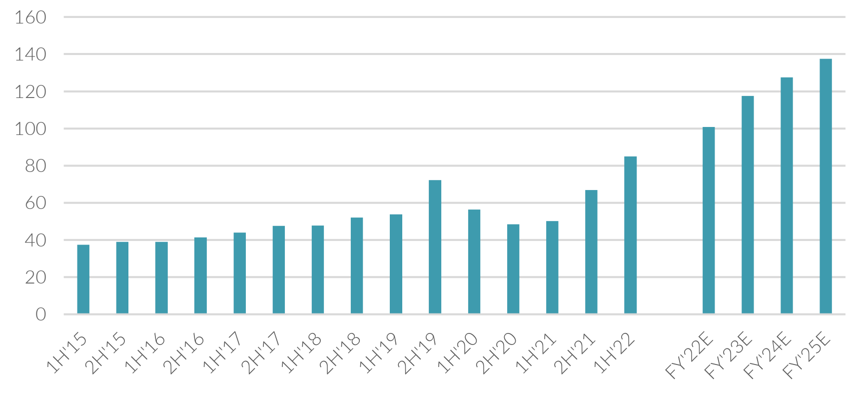
…leading to record pledge book growth

H&T seeing record monthly new lending

The trading statement noted that January and March were both record months, after the 2022 pledge book being up 51% on 2021. This is despite the IFRS9 drag, which depresses the book by ca.8% (see section, *Some important business nuances*, in our initiation). The reported 6% growth in the four months to end-April is in line with our 17% annual forecast, noting i) end-April saw above-normal redemptions, as some customers wanted their jewellery for Coronation events (but this is expected to have a short-term impact only), and ii) customer cashflows are likely to continue to face strains, with food price inflation being more persistent than expected.

[1] https://www.gov.uk/government/statistics/family-food-201920/family-food-201920

H&T's net pledge book – includes accrued income and impairment (£m)



Source: H&T, Hardman & Co Research

H&T's model of pawnbroking is low-risk

Pawnbroking is a low-risk form of financing

Risk reduced by i) low LTVs, ii) control over assets, iii) marketable assets, iv) short-term exposure, v) proven affordability

Compared with other forms of financing, pawnbroking risk is lower because:

- It has relatively low loans-to-value (LTVs – 65% in H&T's case). The valuation price is conservative, being based on a rate per gramme (for gold), and these prices are constantly reviewed, along with output prices from scrappage and retail. H&T's quoted LTV does not reflect the retail value of the item, which is likely to be considerably higher.
- The assets are directly under H&T's control at all times. H&T does not suffer the risk of the asset being allowed to deteriorate from poor maintenance or theft.
- The assets are readily marketable, with the jewellery having a gold-backed inherent value, based off its scrap value.
- Advances are short-term debt, meaning that risk is limited.
- The customers being able to afford the loan has already been proven by the fact that they own the asset in the first place. H&T is not exposed to the customer being able to afford the loan, as it is lending against the asset.

H&T's incremental financing risk reduction

Focused assets financed

99% of H&T's pawnbroking loans are secured against jewellery, gold and watches, with the remaining 1%, by exception, against, say, a car or luxury handbag. There is no lending at all against electronic assets, as H&T is focused on items that have inherent underlying intrinsic value, in which it has expertise and a long experience. It has prudent valuations, as the assets are not generally depreciating in value. The strength of the teams is their ability to appropriately identify and value items such as jewellery and watches, not iPads or computers.

Robust processes

In our view, any lending business requires very close control – so processes and management information are hugely important.

- Before a lending decision is made, i) the in-store team tests the item to identify the intrinsic value, and ii) if an item is more unusual, say a bespoke item of jewellery or a watch, the valuation of the item is referred to the valuations team. This team can assess/value the item through specific photographs taken, or by physically inspecting the item to provide a valuation.
- After the decision has been made, H&T has comprehensive, store-level, daily management information. Its anti-money laundering (AML) transaction monitoring should identify trends or triggers if transactions are not in line with group policies and procedures. Those situations are investigated immediately, and the root cause analysed and addressed promptly.
- Fraud, including staff collusion, is another aspect that can lead to material credit losses, although we understand that this is not the case for H&T. It comments that its internal audit team visits all the stores to conduct a set of agreed-upon procedures. The outcome of the store audit will affect the required period between the next store audits; and, again, the automated AML monitoring procedures are designed to identify and provide alerts to any in-store suspicious activity.

Industry "*not a priority area in terms of potential risk or harm to consumers*" for FCA

No recourse to customer a key issue

Other risks also low

The FCA commented, in its 2018 review of the industry, that the pawnbroking industry was "*not a priority area in terms of potential risk or harm to consumers*". We believe one critical issue for the regulator is the fact that there is no recourse to the customer, but only to the asset, in the event that repayments are not made. In pawnbroking, the customer already owns the asset being pledged, which is of greater value than the loan being sought. H&T's only claim is to that asset, and not to the customer, if repayments are not made, and this is a critical consideration in whether the customer is being treated fairly. It is also probable that the regulator takes cognisance of the strong customer satisfaction, and recognises that the alternative providers may well be unregulated and charge significantly higher rates of interest than regulated pawnbrokers.

CMCs a major issue across financial industry

We reviewed CMC risk in detail in our initiation. In summary, i) it is uneconomic for CMCs, because the financing is small, ii) H&T does not face the same rollover issues as HCCs, iii) H&T, unlike payday, has no recourse to the customer, which makes it challenging for the CMC to justify a claim, iv) this is probably reinforced by the regulator explicitly stating that the area is not a priority area in terms of potential risk or harm to consumers, and v) H&T will vigorously challenge spurious claims, limiting administration costs. We do not believe that any lender with capital resources can be immune to some CMC risk in the current market, but the risk to H&T would appear very modest, in our view.

H&T does not incur same accounting risk as most lenders

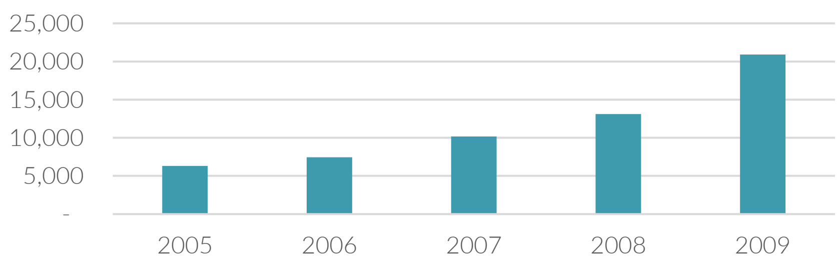
It is important to appreciate the type of lending market in which H&T operates. It is not the same risk of loss that, say, a bank would face, in that capital losses are very rare. Indeed, H&T's IFRS9 accounting models assess the impact of future lost revenue, using a forward-looking model. When making lending decisions, most banks would look at the customer cashflow, because their redress is the customer. H&T's redress is the pledged asset; so, the lending decision is not based off the customer cashflow, nor an assessment of it, which is why there is no requirement for a customer's credit score.

H&T profitable through COVID-19, GFC and early 1990s' recession, giving investors counter-cyclical protection

Proof it is a low-risk model

The proof of the pudding is profitability through downturns. At the depths of the early 1990s' recession, H&T was still profitable (1992 pre-tax £1.9m). Through the GFC, H&T was again profitable (2007 pre-tax £10.2m, 2008, £13.1m), as it was through COVID-19 (2020 pre-tax £6.3m). The profit trends below give investors returns that are counter-cyclical. Compared with today, there are business mix differences (e.g., in the GFC, a greater sensitivity to gold prices), and the accounting policies are different, but we believe the key business message is the trend of profits at the time. This shows resilience to downturns.

H&T profits through the GFC (£000)



Source: H&T, Hardman & Co Research

Financials

Our forecasts are unchanged on the March initiation, which provided a more detailed breakdown of the underlying assumptions.

Profit & loss (£000)									
Year-end Dec	**2017**	**2018**	**2019**	**2020**	**2021**	**2022**	**2023E**	**2024E**	**2025E**
Total revenue	124,697	143,025	160,213	129,115	121,995	173,941	198,007	221,400	236,770
Costs of sales	(46,567)	(54,781)	(58,852)	(46,316)	(45,640)	(72,025)	(72,418)	(80,931)	(85,587)
Gross profit	**78,130**	**88,244**	**101,361**	**82,799**	**76,355**	**101,916**	**125,589**	**140,470**	**151,183**
Other direct expenses - impairments	(20,846)	(25,881)	(20,798)	(6,438)	(6,012)	(11,756)	(15,601)	(16,754)	(16,947)
Other direct expenses	(32,594)	(32,855)	(40,044)	(43,750)	(40,239)	(47,779)	(53,926)	(57,596)	(60,187)
Total other direct expenses	**(53,440)**	**(58,736)**	**(60,842)**	**(50,188)**	**(46,251)**	**(59,535)**	**(69,527)**	**(74,349)**	**(77,134)**
Admin. expenses	(12,234)	(13,272)	(18,031)	(15,727)	(18,904)	(21,828)	(24,011)	(26,412)	(29,053)
Recurring operating profit	12,456	16,236	22,488	16,884	11,200	20,553	32,052	39,709	44,996
Non-recurring expenses				-	(2,099)	-			
Operating profit	**12,456**	**16,236**	**22,488**	**16,884**	**9,101**	**20,553**	**32,052**	**39,709**	**44,996**
Investment revenues	-	3	-	5	8	-	-	-	-
Finance costs	(567)	(2,468)	(2,405)	(1,257)	(1,247)	(1,548)	(1,847)	(1,747)	(1,422)
Profit before tax	**11,889**	**13,771**	**20,083**	**15,632**	**7,862**	**19,005**	**30,205**	**37,962**	**43,574**
Tax	(2,396)	(2,818)	(3,393)	(3,070)	(1,818)	(4,093)	(7,098)	(9,490)	(10,894)
Attributable underlying profit	9,493	10,953	16,690	12,562	6,044	14,912	23,106	28,471	32,681
Diluted EPS (p)	25.91	29.59	43.80	32.11	15.43	37.15	52.69	64.93	74.53
DPS (p)	10.5	11.0	4.7	8.5	12.0	15.0	18.8	22.0	25.0
Dividend cover (x)	2.5	2.7	9.3	3.8	1.3	2.5	2.8	3.0	3.0

Source: H&T Report and Accounts, Hardman & Co Research

Balance sheet (£000)									
@ 31 Dec	**2017**	**2018**	**2019**	**2020**	**2021**	**2022**	**2023E**	**2024E**	**2025E**
Goodwill	17,643	17,643	19,580	19,330	19,330	20,969	20,969	20,969	20,969
Other intangibles	331	343	3,889	2,729	1,892	6,368	7,782	9,196	10,610
Property, plant and equipment	6,381	6,032	7,739	8,635	11,101	13,045	13,545	13,545	13,045
Right of use assets	23,073	20,159	21,147	18,337	17,400	18,991	19,667	20,343	21,019
Deferred tax assets	1,988	1,683	2,180	2,822	1,726	251	251	251	251
Total non-current assets	**49,416**	**45,860**	**54,535**	**51,853**	**51,449**	**59,624**	**62,214**	**64,304**	**65,894**
Inventories	34,102	29,262	29,157	27,564	28,421	35,469	36,229	38,764	40,703
Trade and other receivables	63,089	73,379	90,891	55,751	72,449	104,046	117,500	127,500	137,500
Other current assets	665	877	714	1	0	0	0	0	0
Cash and cash equivalents	8,676	11,414	12,003	34,453	17,638	12,229	11,959	12,633	12,297
Total current assets	106,532	114,932	132,765	117,769	118,508	151,744	165,688	178,897	190,500
Assets held for sale									
Total assets	**155,948**	**160,792**	**187,300**	**169,622**	**169,957**	**211,368**	**227,902**	**243,201**	**256,394**
Trade and other payables	(8,362)	(6,015)	(10,578)	(10,807)	(10,154)	(9,097)	(9,097)	(9,097)	(9,097)
Lease liabilities	(237)	(249)	(4,890)	(3,568)	(3,191)	(3,743)	(4,243)	(4,743)	(5,243)
Tax payable	(1,033)	(842)	(2,066)	(1,972)	(375)	(937)	(937)	(937)	(937)
Total current liabilities	**(9,632)**	**(7,106)**	**(17,534)**	**(16,347)**	**(13,720)**	**(13,777)**	**(14,277)**	**(14,777)**	**(15,277)**
Borrowings	(21,810)	(24,888)	(26,000)	-	-	(15,000)	(15,000)	(10,000)	-
Lease liability	(26,789)	(23,724)	(19,670)	(17,077)	(15,792)	(16,326)	(17,000)	(17,500)	(18,000)
Long-term provisions, incl. retirement	(1,313)	(1,253)	(1,490)	(1,649)	(3,827)	(2,146)	(1,646)	(1,146)	(646)
Total non-current liabilities	**(49,912)**	**(49,865)**	**(47,160)**	**(18,726)**	**(19,619)**	**(33,472)**	**(33,646)**	**(28,646)**	**(18,646)**
Share capital	1,872	1,883	1,987	1,993	1,993	2,193	2,193	2,193	2,193
Share premium	26,641	27,152	33,179	33,486	33,486	49,423	50,398	51,373	52,348
Retained earnings	67,926	74,821	87,475	99,105	101,174	112,537	127,422	146,246	167,964
EBT share reserve	(35)	(35)	(35)	(35)	(35)	(34)	(34)	(34)	(34)
Total equity	**96,404**	**103,821**	**122,606**	**134,549**	**136,618**	**164,119**	**179,979**	**199,778**	**222,471**
No. of shares at year-end	37.4	37.7	39.7	39.9	39.9	43.9	43.9	43.9	43.9
NAV per share (p)	257.5	275.7	308.5	337.5	342.7	374.3	410.4	455.6	507.3

Source: H&T Report and Accounts, Hardman & Co Research

Valuation

Summary

Range of valuation approaches, including GGM, DCF and DDM

Average of all is 606p

We apply a range of different valuation approaches, as shown below, and give some of the key sensitivities to our assumptions. Our Gordon Growth Model (GGM) indicates a fair value of 628p, the dividend discount model (DDM) 472.7p and the discounted cashflow (DCF) model 717.5p. We believe the differences in strategy and business model make comparisons with the closest listed peer, Ramsdens, of limited value.

GGM

GGM valuation, at 628p, captures value added and growth

Looking at H&T, the assumptions were outlined in the initiation, and we show them in the table below.

GGM and key sensitivities

	Base	+1% RoE	+1% CoE	+0.5% G
RoE	13%	14%	13%	13%
CoE, post-tax	10%	10%	11%	10%
G	5%	5%	5%	55%
P/BV (x)	1.3	1.4	1.2	1.3
Disc./prem. re near-term performance	10%	10%	10%	10%
P/BV (x)	1.4	1.5	1.3	1.4
BV Dec'23E (p/sh)	439	439	439	439
Valuation (p/sh)	628	676	570	635
Variance (p/sh)		48	(57)	8

Source: Hardman & Co Research

DDM

DDM valuation 472.7p

Using the assumptions detailed in our initiation, the implied valuation on the DDM is 472.7p. The terminal value accounts for 34% of the total value. In terms of sensitivity to assumptions, an 11% CoE, the value would be 449p.

DCF

DCF valuation 717.5p

A DCF analysis is complicated by H&T, as is the case for any lender, needing to use cash as its working capital, and, again, the assumptions were outlined in our initiation. The terminal value accounts for 36% of the value (pre-balance sheet allocation). In terms of sensitivity to assumptions, an 11% CoE, the value would be 573p.

"Peer" companies

The only listed "peer" is Ramsdens (RFX). However, in making comparisons, there are some very important business model, size and strategy differences, which means that any comparison needs to be treated with caution. RFX is currently trading on a 12-month forward consensus P/E of 10.0x, against H&T's 6.8x. RFX's current dividend yield is 3.9%, against H&T's 3.6%, and RFX's forward yield is 4.7%, vs. consensus's 5.4% for H&T.[2] There is no consistency in these relative ratings.

[2] All sourced from Refinitiv, as at 1 June 2023

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