DF CAPITAL
BANKS

21 April 2021

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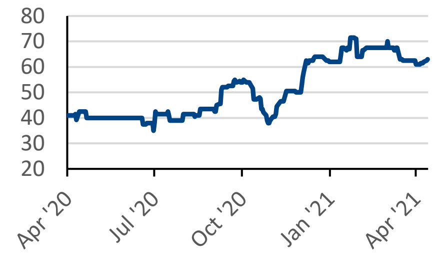
63p

Market Cap: £113m

SHARE PRICE (p)



12m high/low	72p/35p

Source: LSE Data

KEY DATA

Net (Debt)/Cash	£21.2m *(at 31/12/20)*
Enterprise value	£91.8m
Index/market	AIM
Next news	Trading update, Jul '21
Shares in Issue (m)	179.4
Chairman	John Baines
Chief Executive	Carl D'Ammassa
Finance Director	Gavin Morris

COMPANY DESCRIPTION

Specialist commercial lending and personal savings bank

www.dfcapital.co.uk

DF CAPITAL IS A RESEARCH CLIENT OF PROGRESSIVE

ANALYSTS

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Good momentum as FY 2021E starts strongly

Transformational FY 2020 provides solid platform

DF Capital's (DFC) FY 2020 results came from a challenging period, but also one of major progress, and were predominantly in line with our expectations - albeit that the pre-tax loss was a touch better than our estimate. Following the fundraising in January 2021, DFC is well-positioned for growth and has started FY 2021E strongly. Our unchanged estimates reflect the potential which the business has to grow its loan book substantially over the next three years, taking advantage of the underserved small business lending market in the UK. We note management's positive outlook comments and expect to see the Group achieve its target of a profitable monthly run rate in Q4 of this year as its funding costs continue to benefit from a favourable deposit-taking market environment. We continue to assume that operating expenses and the cost of risk remain well controlled and look forward to further positive updates.

- Following receipt of its banking licence in September 2020, DFC resumed growing its lending book, reaching £113m by the end of 2020 (from the October low point of £83m). Its deposit base reached £145m. Subsequent to the year-end, the loan book has grown strongly to over £193m as at 31 March 2021.
- DFC exited FY 2020 with no COVID-related legacy credit issues in its loan book. The cost of risk improved to 0.86% in FY 2020 from 0.99% in the prior year with arrears levels continuing to reflect good control of credit quality. The arrears trend from the end of FY 2020 (0.2% of the loan book) continued throughout Q1 2021E.
- DFC continues to see a good pipeline of potential facilities for its current working capital product (£900m by the end of March 2021) and management has reiterated its intention to consider the introduction of new products once it has reached monthly run-rate profitability in Q4 2021E. In our initiation note *Positioned for efficient growth* we outlined the added impetus that could come from an additional lending product – a 12% enhancement of our FY 2023E adjusted diluted EPS estimate under our scenario analysis.
- The Group has made a good start to FY 2021E with further solid lending growth in prospect which is expected to reflect a balance between seasonal sectors such as leisure and other commercial sectors with more consistent demand traits.

FYE DEC (£M)	2019	2020	2021E	2022E	2023E
Net interest income	4.0	2.1	12.9	26.4	39.0
Pre-impairment op. inc.	4.4	2.2	13.3	26.9	39.5
Profit before tax	-13.5	-13.6	-4.9	4.1	13.0
Adj. Diluted EPS (p)	-15.1	-12.8	-2.9	2.3	6.8
Price/NTAV	1.1x	1.3x	1.3x	1.3x	1.1x
Post-tax ROTE	-22.7%	-23.6%	-7.2%	4.7%	12.5%
PER (x)	-4.2x	-4.9x	-21.5x	27.5x	9.3x

Source: Company Information and Progressive Equity Research estimates.

On the move again after a challenging FY 2020

FY 2020 was obviously affected by COVID-19 with borrowers more reticent for a while and the wholesale funding markets, on which DFC was reliant for three-quarters of the year, less favourable. Although it was clearly a challenging year for DFC, it was also a transformational one during which it received full authorisation from the Prudential Regulation Authority.

Following receipt of its banking licence in September 2020, DFC resumed growing its lending book, no longer constrained by hesitant wholesale funders. As it has previously announced, the loan book grew to £113m by the end of 2020 (from the October low point of £83m) and its deposit base reached £145m. With deposit funding, DFC's net interest margin has moved from less than 2% to around 6% over our estimate horizon. The announcement notes the launch of new 15 and 18 month fixed rate savings products, in addition to a 2 year fixed rate product.

Subsequent to the year-end, the loan book has grown strongly to over £193m as at 31 March 2021. Pleasingly, credit quality remains well controlled with a continuation of the arrears trend from the end of FY 2020 (0.2% of the loan book) throughout Q1 2021E. DFC exited FY 2020 with no COVID-related legacy credit issues in its loan book.

Having completed a £40m fundraise in February 2021, the Group has enough regulatory capital to support growth in the loan book to around £550m. We note management's positive comments on the pent-up demand across its target lending market but also its recognition of the uncertainties which surround the economic environment.

Pipeline supports positive outlook

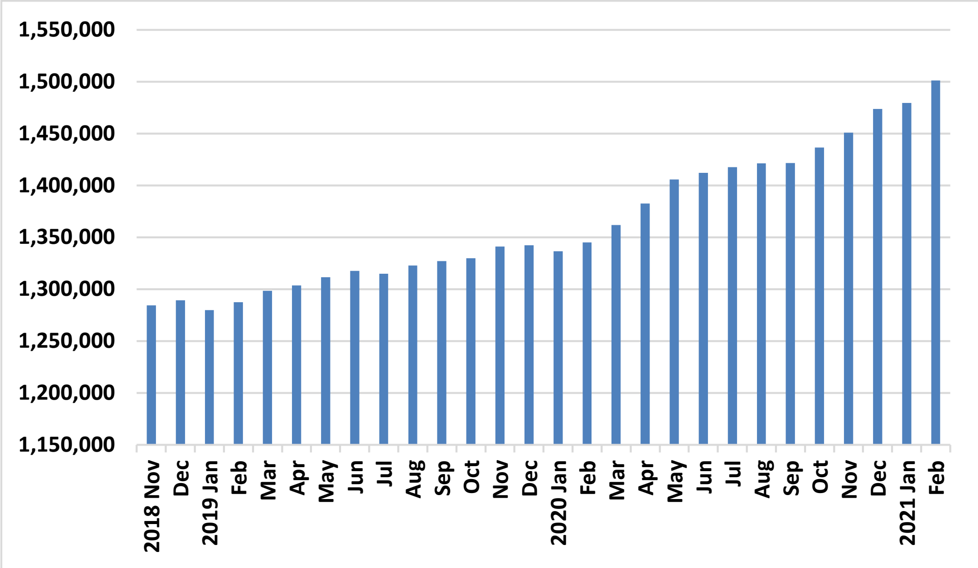
The £850m pipeline of potential facilities which DFC had previously identified had increased to £900m by the end of March 2021, representing clear demand for its working capital lending product.

As at 30 June 2020, DFC had 77 active agreements with manufacturers and 779 dealer customers. Following the advent of the pandemic, the Group carried out a review of its entire dealer network as part of its focus on credit quality. At the end of 2020 those numbers had reduced to 65 and 623 respectively. The 65 manufacturers give DFC access to over 1,700 dealers, providing a significant opportunity to increase market share of its inventory finance product. Management reiterates DFC's intention to diversify into adjacent products such as short-term working capital, invoice discounting, asset finance and leasing. Acquisitions reman a possible route to accelerate growth.

Deposit taking in FY 2020

With authorisation in place, DFC raised deposits of over £145m in the 12 weeks to 31 December 2020 with £130m of that raised within six weeks of the launch of its savings products in mid-October 2020. The Group repaid all of its previous, more costly, funding. Its highly digitised online account opening process has received strong positive feedback and brought a good customer satisfaction score of 4.3 out of 5. The demand for savings products has continued to grow despite the low rates available. The Bank of England data in this chart reflects that trend.

Financial institutions' deposits from UK residents (£m)

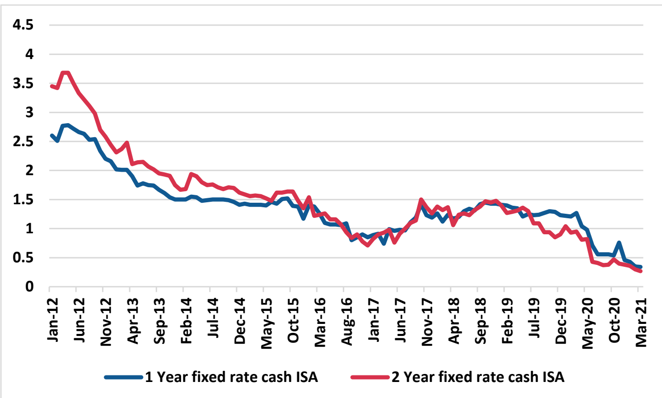


Source: Bank of England

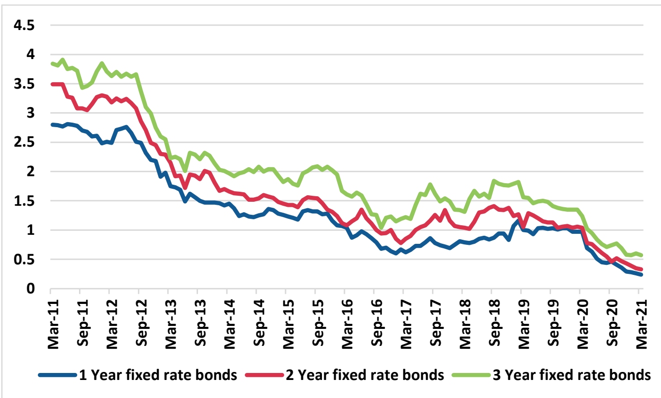
DFC launched several deposit products over the period from 14 October to the end of 2020 to achieve a total of £145m as at 31 December 2020. It now has 90 day, 1 year fixed, 15 month fixed, 18 month fixed and 2 year fixed products. The Group has postponed any participation in the British Business Bank's Enable Funding Scheme until it has reached greater scale but has not ruled out participating in Bank of England schemes once it has the required infrastructure in place. And, as we note earlier, it is to launch further savings products shortly.

As the chart below shows, market deposit rates for fixed rate bonds and cash ISAs have fallen significantly. This means that, on our estimates, DFC's current average funding cost is below 1.2%. That compares to around 6% for the wholesale funding available to the Group prior to the granting of its banking licence.

Deposit rates for cash ISAs (%)



Deposit rates for fixed rate bonds (%)

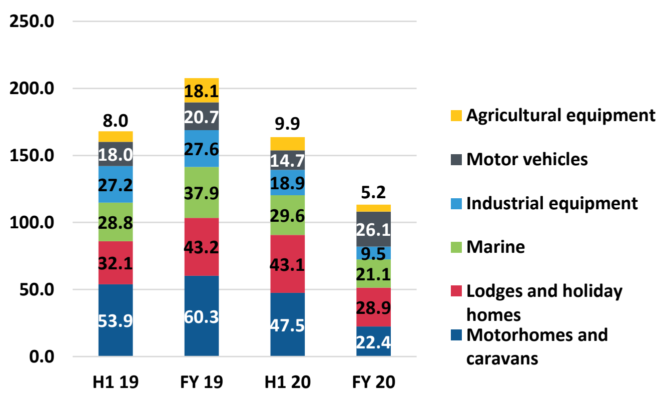


Source: Bank of England

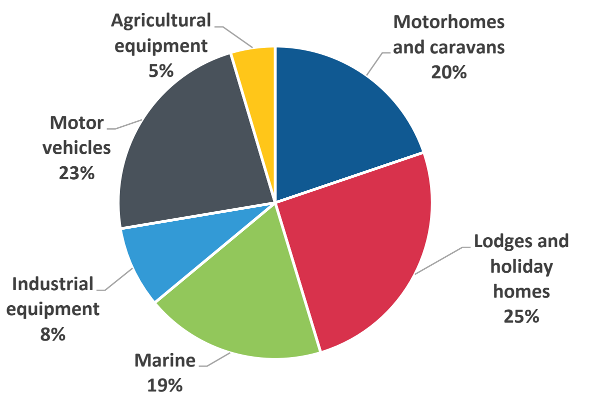
Lending in FY 2020…

Restrictions on DFC's wholesale funding lines and minimal availability of new stock to finance meant that its loan book reach a low-point of £83m in mid-October 2020. It restarted lending on 4 November 2020, with the loan book reaching £113m at 31 December 2020 and over £193m by 31 March 2021.

Concentration of credit risk (£m) – last four reports



Percentage concentration as at 31 December 2020



Source: Company information, Progressive Equity Research

The trend for staycations during 2020 produced an increased demand for leisure assets, resulting in strong sales by dealers with some initial constraint from the availability of replenishment assets. With that now resolved, DFC notes that many dealers forecast similar levels of demand through 2021 – although it remains a seasonal sector in terms of loan demand. It also highlights strong sales of motorcycles and electric bikes and expects strong demand for lending as dealers replenish their forecourts. DFC's commercial or non-leisure sectors are expected to experience a more consistent performance during FY 2021. Transport is seen as a growth sector. It is worth noting DFC's view that initial problems stemming from post-Brexit import processes have already 'eased significantly' for some manufacturers.

…and into FY 2021E

The announcement states that the rate of growth in Q1 remains consistent with its expected plan for FY 2021E of reaching monthly profitability during Q4 2021 as the loan book exceeds £270m. Our estimate for the loan book at the end of FY 2021E is currently £310m.

FY 2020 numbers

Loss in line with expectations

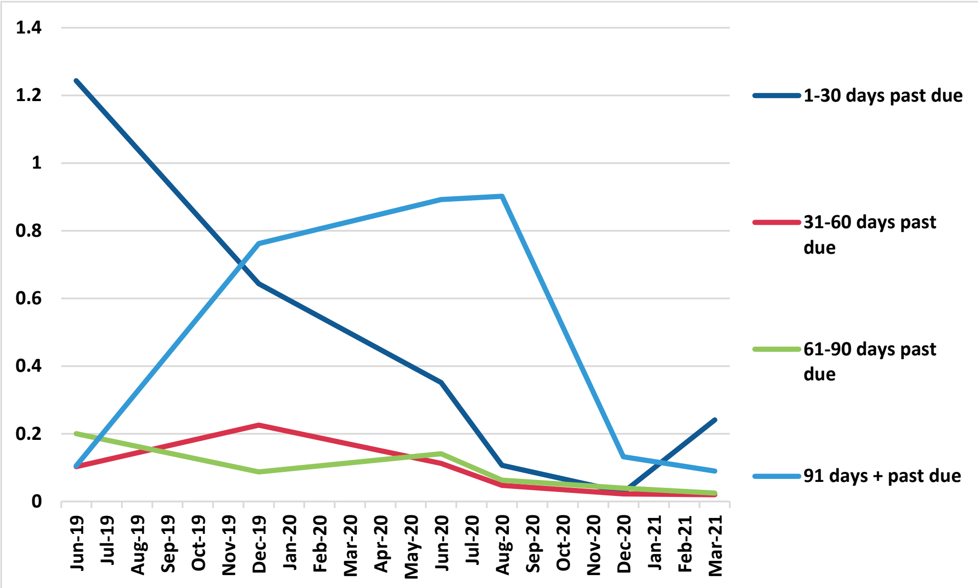
Given the impact of the pandemic on both DFC's lending and funding markets, it remained loss-making. The statutory loss of £13.6m for FY 2020 was a little better than we had estimated from a period in which the Group waived facility fees for all customers from March 2020 to December 2020 to support its customers. Consistent loan pricing during the year produced a stable gross yield at 7.7% compared to 7.8% in FY 2019. With the average loan book below that of 2019, gross revenues fell by 9% to £11.5m.

Higher wholesale funding costs in FY 2020 further squeezed the Net Income Margin to around 1.5% (FY 2019: 2.8%). Net Income of £2.3m compared to £4.4m in the prior year. The ability to take deposits has obviously transformed the economics for DFC and we expect to see overall funding costs to reduce to around 1.25% in FY 2021 from around 6% in FY 2020 with the Net Income Margin increasing to at least 6%.

Credit quality

Arrears as a percentage of the loan book fell to 0.2% as at 31 December 2020 from 0.8% a year earlier. The chart below shows the breakdown by value, by past due days.

Arrears (£m)



Source: Company information, Progressive Equity Research

DFC only provided forbearance to dealers representing less than 2% of the loan book by value during FY 2020 with 'minimal' forbearance requests reported since the first lockdown ended. Impairment charges and provisions for the period reached £1.3m in FY 2020 compared to £1.6m in FY 2019. Clearly, the loan book reduced in size during the year but the Group's loss rate for FY 2020 was also lower at 0.86% of average gross receivables compared to 0.99% in FY 2019. The impairment allowance at 31 December 2020 as a percentage of gross receivables stood at 1.14% compared to 0.67% a year earlier, reflecting the Group's cautious risk assessments given the economic uncertainties related to COVID.

The loan to wholesale value ratio of the loan book was 80% as at 31 December 2020 compared to 84% a year earlier. It is worth remembering that retail prices currently reflect a mark-up of approximately 20% on the wholesale invoice price. DFC also holds additional security in the form of debentures, personal and directors' guarantees as well as having manufacturer repurchase or redistribution agreements in place across c50% of its loan book.

Expenses

Expenses during FY 2020 reflect DFC's readiness to operate as bank ahead of receiving full authorisation in September. Until that point, therefore, the cost base was not in synchronisation with the net income generating capacity of the business for the majority of the financial year.

During FY 2020, DFC furloughed a small number of staff during the first lockdown but those roles were subsequently subject to redundancy. The Group has repaid the support which it has received from the government's Job Retention Scheme.

As we note above, there was some reduction in headcount with staff numbers down to 74 from 90 at the end of FY 2019. Operating expenses increased to £15.1m in FY 2020 (FY 2019: £14.1m) which reflected the full year cost of the preparations for attaining full operating capability.

Estimates

We leave our three years of estimates unchanged given the consistent view from management over its growth opportunities and the outlook for the lending and funding markets. We continue to expect the business to exhibit good growth in the loan book while controlling credit quality and operating expenses.

Selected financial estimates

Income Statement (£m)	**2020**	**2021E**	**2022E**	**2023E**
Net interest income	2.1	12.9	26.4	39.0
Other operating income	0.2	0.4	0.5	0.5
Pre-impairment operating income	2.2	13.3	26.9	39.5
Impairments	-1.3	-2.1	-4.0	-6.3
Expenses	-14.6	-16.1	-18.7	-20.2
Operating income	-13.6	-4.9	4.1	13.0
Profit before tax	**-13.6**	**-4.9**	**4.1**	**13.0**
Tax	0.0	0.0	0.0	0.0
Profit after tax	**-13.6**	**-4.9**	**4.1**	**13.0**
Per share data (p)				
Basic EPS	-12.8	-2.9	2.3	6.8
Diluted EPS	-12.8	-2.9	2.3	6.8
Adj. Diluted EPS before exc. Items	-12.8	-2.9	2.3	6.8
NAV/share	47.7	48.0	50.3	57.9
NTAV/share	47.0	47.4	49.7	57.4
Balance Sheet				
Customer loans (£m)	113.3	310.0	540.0	725.0
RWAs (£m)	96.4	264.5	461.2	620.2
Core tier 1 capital ratio (%)	**49.6%**	**32.1%**	**19.3%**	**18.9%**

Source: Progressive Equity Research estimates

Our estimates are consistent with comments from management on meeting a profitable monthly run-rate during the fourth quarter of DFC's current financial year. The numbers only reflect growth related to DFC's current pay-as-sold product and include an assumed aggregate raise of £15m of new capital during FY 2023E to keep our CET 1 ratio estimates, conservatively, above 18% over our forecast horizon.

As management reiterates in the announcement, it is the intention of the business to expand its product range to operate in additional sectors and further up and down the value chain. Once it has achieved a breakeven monthly run-rate we would expect DFC to consider the launch of those additional products which we mention earlier. In our initiation note *Positioned for efficient growth* we outlined the boost to earnings that could come from an additional lending product. The central case of our scenario analysis suggested that launching a new product in FY 2022E could, conservatively, improve our FY 2023E adjusted diluted EPS estimate by 12%.

Financial Summary: DF Capital

Year end: December (£m unless shown)

PROFIT & LOSS	**2019**	**2020**	**2021E**	**2022E**	**2023E**
Net interest income	4.0	2.1	12.9	26.4	39.0
Other operating income	0.4	0.2	0.4	0.5	0.5
Pre-impairment operating income	4.4	2.2	13.3	26.9	39.5
Impairments	(1.6)	(1.3)	(2.1)	(4.0)	(6.3)
Expenses	(14.2)	(14.6)	(16.1)	(18.7)	(20.2)
Operating income	(11.4)	(13.6)	(4.9)	4.1	13.0
Profit before tax	(13.5)	(13.6)	(4.9)	4.1	13.0
Tax	0.0	0.0	0.0	0.0	0.0
Profit after tax	(13.5)	(13.6)	(4.9)	4.1	13.0

PER SHARE ITEMS	**2019**	**2020**	**2021E**	**2022E**	**2023E**
No of shares (million)					
Undiluted, period-end	106.6	106.6	179.4	179.4	204.4
Undiluted, average	75.6	106.6	167.2	179.4	191.9
Fully diluted, average	75.6	106.6	167.2	179.4	191.9
Earnings per share (p)					
Basic EPS	(17.9)	(12.8)	(2.9)	2.3	6.8
Diluted EPS (p)	(17.9)	(12.8)	(2.9)	2.3	6.8
Adj. Diluted EPS before exc. items (p)	(15.1)	(12.8)	(2.9)	2.3	6.8

NAV	**2019**	**2020**	**2021E**	**2022E**	**2023E**
Net asset value	64.6	50.9	86.1	90.3	118.3
NAV/share (p)	60.5	47.7	48.0	50.3	57.9
Net Tangible Asset Value	63.7	50.1	85.1	89.2	117.3
NTAV/share (p)	59.7	47.0	47.4	49.7	57.4
Average equity	59.6	57.7	68.4	88.0	104.1

BALANCE SHEET	**2019**	**2020**	**2021E**	**2022E**	**2023E**
Customer loans	207.6	113.3	310.0	540.0	725.0
Customer deposits	0.0	(146.0)	(295.9)	(505.0)	(695.0)
Wholesale funding	(164.7)	(0.1)	0.0	0.0	0.0
Loan:deposit ratio	1.3	0.8	1.0	1.1	1.0
RWAs		96.4	264.5	461.2	620.2
Core tier 1 capital ratio (%)		49.6%	32.1%	19.3%	18.9%

VALUATION	**2019**	**2020**	**2021E**	**2022E**	**2023E**
Price/NTAV	1.1x	1.3x	1.3x	1.3x	1.1x
Post-tax ROTE	(22.7%)	(23.6%)	(7.2%)	4.7%	12.5%
PER (x)	-4.2x	-4.9x	-21.5x	27.5x	9.3x
Dividend yield	0.0%	0.0%	0.0%	0.0%	0.0%

Source: Company information and Progressive Equity Research estimates

21 April 2021

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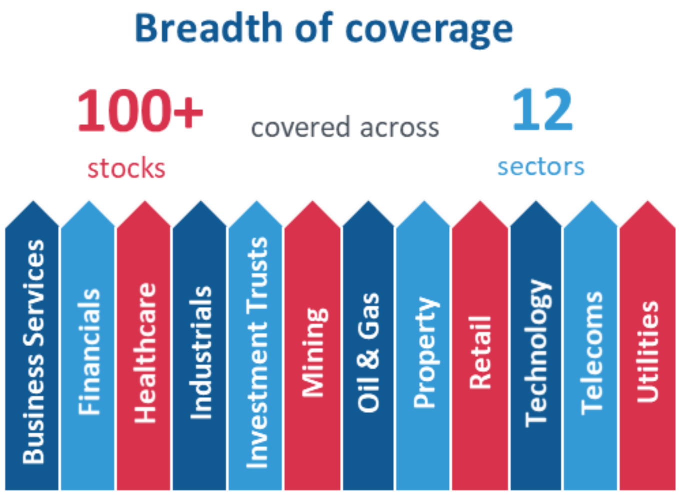

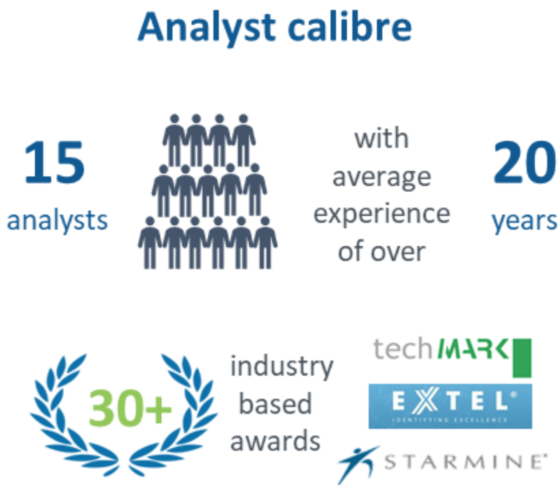

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