

ClearDebt



ClearDebt

CLEA 25-06-07

Share Price (as of close 22-06-07) 2.1p
Market Cap £6m

Company Description: ClearDebt offers debt resolution services to insolvent individuals, using a state-of-the-art web-based system for initial contact and individual supervision of all the later stages in the process, resulting in a higher success rate and lower overall costs than its competitors.

ACQUISITION OF ABACUS

ClearDebt has agreed (subject to approval at an EGM) to acquire Abacus (Financial Consultants) Ltd ("Abacus"), a company specialising in Debt Management Plans for individuals who are still solvent but for whom debt is an excessive or intolerable burden.

The initial consideration is £1.2m, of which £0.3m will be met out of a share placing and the balance, plus working capital needs, out of an unsecured loan of £1.6m from David Mond, ClearDebt's CEO. The deferred consideration is up to 222.222m shares, worth £5m at today's price, contingent on the achievement of earn-out targets that look fairly challenging unless the anticipated synergies are actually achieved (in which case the shares may well be worth quite a bit more than £5m, but the existing shareholders are unlikely to object).

The EGM should proceed smoothly since David Mond and other shareholders who between them own 44% of the shares have pledged themselves to vote in favour. AIM rules classify it as a reverse acquisition since the maximum possible value of the consideration exceeds the current market value of ClearDebt, although if Abacus makes enough profit to trigger the maximum pay-out of deferred consideration, the group should be worth rather more than twice that.

This is one of the relatively rare occasions where there is **genuine synergy** resulting from a business combination rather than just the elimination of competition or the strengthening of negotiating positions when dealing with suppliers.

The largest synergy will be from the sharing of responses to each advertising campaign; smaller ones will come from the benefits to Abacus from ClearDebt's superior administration and back-office systems and to ClearDebt from Abacus' strong cash-flow since the latter's income is front-end-loaded while ClearDebt's expenses are, more heavily, front-end-loaded and it collects most of its income from supervision fees (so that it makes its profit from successful IVAs and does not, unlike at least one rival, make a profit from those that fail).

Client acquisition costs (largely advertising and fees paid to third parties for finding potential clients) are the second-largest cost after staff for most IVA producers, and also for Abacus. For ClearDebt, with more efficient operating systems and no call centre, it is the largest cost. Earlier expectations that the advertising cost per case would rapidly shrink have been frustrated by the rush of other companies into the IVA market after it doubled in size and they saw how much profit Debt Free Direct ("DFD") could make.

Equity Development contact

Andy Edmond

020 7405 7777

andy@equitydevelopment.co.uk

The number of IVAs registered in 2006 was **more than twice** the number in 2005 which itself was nearly twice the number in 2004. This has attracted a minor swarm of competitors, and although the number of registered insolvency practitioners is strictly limited by the onerous conditions for qualifying the sums available to spend on advertising are not.

ClearDebt and Abacus operate in adjacent segments of the debt resolution market so each is frequently approached by an individual who is subsequently found to be more suitable for the other. Although these are, naturally, a minority, they are sufficiently numerous to make a substantial difference to group profitability if they are redirected.

One in five of the people who contact ClearDebt are categorised as potential IVA candidates by the initial fact-find, but only 7-8% eventually complete an IVA; many more are suitable for one of the other forms of debt resolution. DFD and Accuma, which only achieve a 4% conversion rate, have already moved to acquire providers of alternative solutions. Abacus provides Debt Management Plans ("DMPs") and earns commissions by referring cases that are more suitable for IVAs, remortgages, debt consolidation or occasionally, new loans, to other companies providing those services.

The formal documents state that Abacus will, in future, refer those requiring IVAs to ClearDebt: we think that the number of cases referred by ClearDebt to Abacus will be much more numerous, although they may be less valuable.

Until recently Abacus was effectively just a marketing organisation as it delegated the actual management of the DMPs to an unrelated company, Harrington Brooks (one of the leaders on the DMP market); as from mid-April 2007 it has taken management in-house. This might be cause for concern, but if there are any teething troubles then ClearDebt's expertise in supervising IVAs should provide solutions: it stated last year that it could compete in the DMP market but was initially concentrating on IVAs.

The agreement between Abacus and Harrington Brooks involved the latter carrying out all the administration of the DMPs in exchange for half the income.

The number of cases that Abacus has been referring to other IVA producers is not that much less than the number that ClearDebt is currently processing and since ClearDebt has the capacity to handle all of these with no increase in staff numbers, this, combined with the flow of cases from The Money Helper (see below), could more than double ClearDebt Ltd's turnover at little extra cost.

The price being paid looks good value – if the maximum earn-out is achieved the total paid will equate to just less than **three times 2009-10 earnings**. Obviously the PER multiple will be higher if they fall short of that target, but the maximum price is less than nine times Abacus' pre-tax profit in 2006-7, which was depressed by a couple of one-off factors that are not expected to recur (and, to a lesser extent, inflated by not paying any salaries to the two executive directors).

One factor is that management was preoccupied with corporate affairs so performance and sales declined in the last quarter; another, less significant, is that in the latter part of 2005-6 and first quarter of 2006-7 it had received **no commission** for its IVA referrals, averaging 20 a month.

We believe that these should not affect Abacus **post-acquisition**. Also ClearDebt has provided the software enabling Abacus to manage DMPs as the software that it previously used belonged to HB.

A potentially continuing problem is that advertising became less cost-effective in 2006-7 compared to the two previous years when it had generated turnover of around 6 times. As IVA producers increased their spending, costs increased and returns decreased so that the ratio of turnover to advertising plus commission for referrals from third parties declined from 4:1 to 3:1 with a consequent halving of gross profit margins.

Cross-referrals will make advertising significantly more cost-effective, going a long way towards restoring Abacus' gross margins.

In 2005-6 and again in 2006-7 Abacus sold to Harrington Brooks the right to future commission from its client list, cashing-in the discounted present value of future income, less whatever additional profit margin HB required from the deal. As Abacus had sold its then list in 2005-6, the profit realised in 2006-7 arose wholly from sales that year.

In future Abacus will manage the DMPs itself and continue to collect commission over the life of the plans. Even allowing for higher monthly management costs, as Abacus will not enjoy the same economies of scale as Harrington Brooks, we expect it to earn higher profits over the life of the plans since Accuma claim their costs relating to supervision fees are only around two-thirds of HB's share of the average monthly fees on DMPs introduced by Abacus and Accuma should have additional costs in complying with IVA regulations.

It will take some five years for Abacus to build up its portfolio of DMPs to the steady state where maturing DMPs match commencing ones. By that time, if the conditions in 2006-7 (apart from the two one-off problems referred to above) still apply, Abacus should be producing more than £3.5m pa before tax and directors' emoluments. In 2007-8, however, reported profits could be less than £0.5m as they will exclude margins on future fees on DMPs set up during the year.

Abacus has recently moved into new premises in Timperley, Cheshire, less than ten miles from the office in Central Manchester that ClearDebt currently uses. ClearDebt will move into the new Abacus office after the merger.

This will not produce any direct savings since ClearDebt has been using office space in a building owned by its CEO, but should be more efficient than trying to work in two separate locations.

In March 2007 ClearDebt signed an agreement with "The Money Helper" providing for the latter to introduce to ClearDebt IFAs who will subsequently refer clients in need of an IVA to ClearDebt. The reward to "The Money Helper" will be entirely performance-related and in the form of warrants to subscribe for shares in ClearDebt at **3p per share**. The IFA will be rewarded with 30% of the fees generated by each case it refers. Any forecasts of the effect of this agreement must be speculative, but since the payment to the principals of "The Money Helper" depends on the agreement generating several hundred, or a few thousand, completed IVAs, it may be significant.

On the face of it either of the two deals should lift ClearDebt's volume above the break-even threshold in 2007-8, and the combination should result in it earning substantial profits.

The impact of the rise in mortgage and other interest rates on over-indebted consumers must surely result in a further rise in the numbers needing IVAs and other forms of debt resolution help in the coming year.

It is too much to hope that the next Prime Minister will choose a Chancellor who will adopt sound fiscal and monetary policies leading to a positive balance of payments and positive real after-tax returns on savings, but his successor may do so. Until then lenders will continue to encourage consumers to spend money that they have not earned and the Debt Resolution sector will be a significant part of the UK economy. ClearDebt should be a growing and profitable part of it.

I certify that this report represents my own opinions
John Borgars, Senior Analyst
0207 405 7777
john@equitydevelopment.co.uk

This document has been provided to you solely for your information and may not be reproduced or redistributed, in whole or in part to any other person. The information contained in this document has not been approved for the purposes of Section 21(2) of the Financial Services & Markets Act 2000 of the United Kingdom (FSMA). As such this document is being distributed only to and is directed only at persons falling within the categories of exempt person described in the Financial Services and Markets Act 2000 (Financial Promotion) Order 2001 as amended, (the Order) or pursuant to any applicable exemption under FSMA (together 'relevant persons'). Any person who is not a relevant person should not act or rely on this document or any of its contents.

This report is intended for intermediate clients, market makers, Self-certified High Net Worth or Self-certified sophisticated investors only. Self certification can be completed free of charge at www.fisma.org

This document may not be distributed in or into, directly or indirectly to any persons with addresses in Australia, Canada, Japan, The Republic of Ireland, The Republic of South Africa or the United States (or any of its territories or possessions).

This report is being provided to relevant persons by Equity Development Limited ("ED") to provide background information about the corporate client. ED are regulated by the Financial Services Authority, and are retained to act as financial adviser for various clients, some or all of whom may now or in the future have an interest in the contents of this document and/or in the Company,

In the preparation of this report, ED has had access to publicly available information, the Company's management and other sources believed to be reliable. Whilst all reasonable care has been taken to ensure that the facts stated herein are accurate and that the forecasts opinions and expectations contained herein are fair and reasonable, neither the author nor ED has verified the information contained herein and accordingly none of the author, ED nor any of their respective directors, officers or employees makes any representation or warranty, express or implied as to the accuracy or completeness of the information or opinions contained herein and shall not be in any way responsible or liable for the contents hereof and no reliance should be placed on the accuracy, fairness or completeness of the information contained in this document. No person accepts any liability whatsoever for any loss howsoever arising from any use of this document or its contents or otherwise arising in connection therewith. Nothing in this paragraph shall exclude liability for any representations or warranties made fraudulently.

Any opinions, forecasts or estimates herein constitute a judgment as at the date of this report. There can be no assurance that future results or events will be consistent with any such opinions, forecasts or estimates. This information is subject to change without notice. It may be incomplete or condensed and it may not contain all material information concerning the Company.

This document does not constitute or form part of and should not be construed as any offer for sale or purchase of (or solicitation of or invitation to make any offer to buy or sell) any securities nor shall it or any part of it form the basis of or be relied on in connection with any contract or commitment whatsoever.

ED may In the future or may have in the past have provided investment banking services to the Company.

ED or its directors or officers may in the future or in the past have had a material investment in the Company.

© Copyright Equity Development Limited. All rights reserved.