

ClearDebt

27 September 2011

Looking through the numbers

ClearDebt offers debt resolution services, principally IVAs and DMPs but also PTDs in Scotland, 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.

ClearDebt's core IVA division achieved strong organic growth in 2010-11, doubling to 1,601 the number of new IVAs passed in a declining market: hence more than doubling its market share. The group supplemented organic growth with three acquisitions of "back books" of DMPs and IVAs.

However the group's profitability is masked by accounting conventions, not just on amortisation of intangibles but also the notional interest on convertible loan notes, the notional charge for share-based payment, the write-off of Goodwill on an acquisition made two years earlier and of £75k of deferred tax credit so the profit reported under IFRS halved to £0.23m and reported eps fell 79% to 0.02p. **I calculate Headline Earnings eps to be 0.10p, more than four times the 0.02p reported under IFRS.**

Those who had not read the small print attached to the broker's forecast – an estimate of £1.5m *before tax and amortisation of intangibles* – were disappointed by the published figure of £0.23m pre-tax under IFRS: and, although the group marginally beat that forecast, the share price fell 11% last Friday. A thorough analysis suggests that this reaction was misplaced:

- Profits are stated conservatively and, even so, on a Headline earnings basis are more than double those reported under IFRS
- As a low-cost IVA provider it is flourishing in the tough environment
- It has more than doubled numbers of IVAs passed and market share – twice in three years (see chart on p3)
- Organic growth continues strongly in the current year and can be supplemented by acquisition of more "back books"
- Operating cash flow was £1.05m
- There is no credit for the refund, of up to £0.85m, of VAT due from HMRC

Company Details

EPIC	CLEA
Share price p	2.1
52 week High/Low p	3.4 / 1.6
Market cap £m	6.6

Share Price, p



Source: ADVFN

All our research is available at www.equitydevelopment.co.uk

Forecasts

Year to 30 June	2009A	2010A	2011A	2012E	2013E
Headline Pre-tax, £000s	338	599	466	1,250	1,920
EPS, p	0.09	0.14	0.10	0.30	0.48
PER	23.3	15.0	21.0	7.0	4.4
Div, p	0	0	0	0	0

Source: Company historic, ED estimates

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Valuation

Our forecast for 2011/2 on a Headline Earnings basis (far better than IFRS at representing ongoing profits as well as intellectually superior) is for pre-tax profits of £1.25m and eps of 0.3p (IFRS £1.2-1.75m and eps 0.3-0.45p). Offsetting the "small companies" discount against its "growth company" premium we estimate a fair price per share in the short term to be 3p, with a medium-term target of 4.25p.

Results

Preliminary results for the year to June 2011			
Year to end-June	2010	2011	Change
	£000	£000	%
Insolvency revenue	3,408	4,844	42.1%
Debt Management revenue	3,226	2,933	-9.1%
Total revenue	6,634	7,776	17.2%
Cost of sales	(3,333)	(3,812)	14.4%
Gross profit	3,301	3,964	20.1%
Amortisation of intangibles	(994)	(1,333)	34.1%
Operating expenses	(1,396)	(1,737)	24.4%
Operating profit	910	894	-1.8%
Net interest received/(paid)	(159)	(291)	82.5%
Notional finance cost	(46)	(238)	414.8%
Profit before abnormal items	705	365	-48.2%
Abnormal items	(239)	(138)	-42.4%
IFRS Profit before tax	466	227	-51.2%
IFRS Tax	(123)	(156)	26.5%
IFRS Profit after tax	342	71	-79.2%
IFRS earnings per share (p)	0.11	0.02	-79.2%
Headline earnings eps (p)	0.14	0.10	-26.4%
No of IVAs passed	799	1,601	100.4%

Source: Company

The growth in Insolvency revenues arises from doubling in new IVAs passed and the dramatic increase in the number under supervision following the purchase of Relax's "back book" in December 2009 part-way through 2009/10. However the smaller average value of the new cases taken on this year results in revenue growing at a lesser rate than the number of IVAs or the cost of managing them. Debt Management revenues declined as the attrition of DMPs, from successful completion having paid off debts, failure or conversion to an IVA, outweighed new clients signed up and the acquisition of two smaller "back books".

Numbers of the ClearCash pre-paid MasterCard are growing strongly, more than trebling year-on-year, since the group launched a new version without a monthly fee; ClearCash is not yet covering its costs but is justified because it helps clients manage their finances and is expected to become a minor profit centre in future.

Cost of sales for IVAs rose 55% and that for DMPs fell 20% while the number of new plans fell by one-third, reflecting the staff cost of processing leads, whereas marketing costs in the debt resolution market are largely independent of sales generated. Consequently gross profit grew modestly faster than revenue.

Amortisation of intangibles, which is the third largest cost item, includes amortisation of software development costs but that is relatively minor (less than 5% in 2009/10): nearly all relates to "back books" purchased. As these are wasting assets it is right to amortise the purchase price over time but standard straight-line amortisation, coupled with falling interest costs as cash flow reduces the debt taken on to pay for the assets, "front-end loads" costs; this gives a very conservative view of profits in the first couple of years.

The view taken of the quality and effective life of the acquired assets can easily double or halve reported profits under IFRS: if ClearDebt had used the same amortisation rate for purchased assets as one of its larger competitors, that would have more than trebled pre-tax profits reported under IFRS.

Operating expenses rose faster (53%) than revenue (42%) in the Insolvency division but it would be fairer to say that Insolvency revenue grew more slowly than cost so reducing operating margins. Debt Management expenses excluding reorganisation costs fell 10%, slightly more than revenue, so improving margins.

Net interest paid has inevitably increased as 2010/1 bears a full year's charge of £0.23m for interest on the convertible loan.

The notional finance cost is required under IFRS as a provision for the redemption premium that would be payable on the convertible loan stock if the holders should choose to redeem it rather than converting into shares at a conversion price of 1.8p. The share price has not been as low as 1.8p at any time this year. Stripping this out would slightly more than double reported profits.

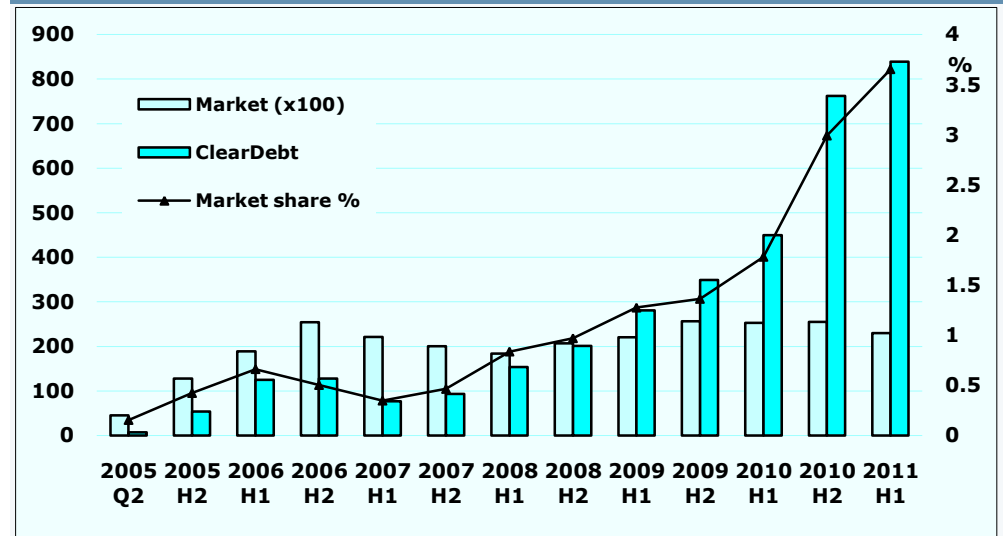
Abnormal items (other than the notional finance cost) are the write-off of goodwill on the purchase of the "Debt Advice Portal" in 2008/9, almost exactly offset by "negative goodwill" aka "gain on bargain purchases" on the purchase of "back books" during the year, and the reorganisation/relocation costs of moving the remnants of the Relax DMP operations and staff from Staveley to Timperley.

After these pre-tax profit reported under IFRS halved to £227k, in contrast to operating cash flow of £1.05m; the tax charge was inflated by a provision against £75k of deferred tax assets as they may not be realised for years, leaving IFRS earnings as 0.02p per share. No-one yet knows how much VAT HMRC will refund but excluding the impact of VAT in 2010/1 could have doubled its IFRS eps.

We have calculated Headline earnings (using ClearDebt's conservative amortisation policy and treatment of VAT) to be 0.10p per share.

The new financial year has started well for ClearDebt with 362 IVAs passed in two months, an increase of nearly two-thirds from July-August 2010, continuing the growth illustrated in the next chart:

ClearDebt IVAs compared to the overall market



Source: Company. The Insolvency Service, ED calculation

My habitual chart highlights ClearDebt's rapid growth since the new IVA protocol was agreed, linking fees to the level of repayments to creditors: only those, like ClearDebt, with low costs can profitably handle smaller cases, although Fairpoint with its massive economies of scale can still earn profits from the declining number of larger cases. We expect growth to continue strongly in the current year, but not that numbers will double again.

Growth in the overall IVA market has paused in 2011; a consequence of the decline in consumer debt in 2008-10 due to the "credit crunch" in 2008, but renewed growth in consumer debt over the last fifteen months presages a rise in demand for IVAs when the BoE eventually increases interest rates.

Although supervisory fees are smaller than nominee fees the margins over cost are higher so Insolvency profits, before amortisation, should grow in line with the number of IVAs under supervision: this growth is now mainly organic but those acquired from Invocas in June equal about half a year's organic growth. The profit they generate this year will be reduced by the cost of transferring the Invocas cases to Staveley and onto ClearDebt's system.

The improved guidance to the debt resolution industry from government bodies on practices is leading some smaller operators to leave the sector rather than take on heavier compliance burdens; this provides opportunities for larger companies to acquire "back books" of DMPs at a discount to "fair value". We think it likely that ClearDebt will buy more "back books" in 2011/2 but our profits forecast excludes negative goodwill, so most of the rise in Abacus' profits comes from the fall in amortisation charges as the Relax assets are fully written down.

In the absence of any further acquisitions the group amortisation charge should be £0.1m lower this year and reduce by a further £0.6m in 2012/3, resulting in a significant increase in reported profits, bringing them closer to cash flow.

The group has filed a claim for refund of VAT, amounting to £0.85m, incorrectly paid to HMRC over the past four years. Some of this is due to the creditors and there will be a corporation tax liability on the balance, but it should provide a welcome addition to the group's cash balances available for acquisitions or to reduce its debts.

Our forecast for 2011/2 on a Headline earnings basis excludes negative goodwill, the notional finance charge, and the VAT refund, as that relates to prior years: using ClearDebt's conservative amortisation policy we expect pre-tax profits of £1.25m, leading to eps of 0.3p. Those reported under IFRS will be distorted by all three so are less predictable but will probably fall in the range £1.2m to £1.75m and 0.3p to 0.45p. Any forecast for 2012/3 must be tentative as results will be significantly influenced by future acquisitions and the wider economic environment: our initial forecast is £1.92m pre-tax leading to eps of 0.48p.

Conclusion

At the current share price the PFER is 7.0x for 2011/2 and 4.4x for 2012/3. We still view ClearDebt as a long-term growth company and consider this undervalues them: our short-term share price target is 3p, with 4.25p for the medium term.

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