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Provident Financial PLC faces restructuring woes

By Liu Hanlei

Provident Financial PLC, UK's largest subprime lender, saw its share price plunging by 65% after issuing a second profit warning in three months, on 22 August, due to its botched restructuring plan of the consumer credit division, which lends to low-income households. Shortly after the share price plunge, Provident was removed from the FTSE 100, UK's index of blue-chip stocks, less than two years after it joined the index. Provident's consumer credit division, which accounts for 37% of the company's pretax income, was in the spotlight as its latest profit warning expects the division to post record losses for the full year.

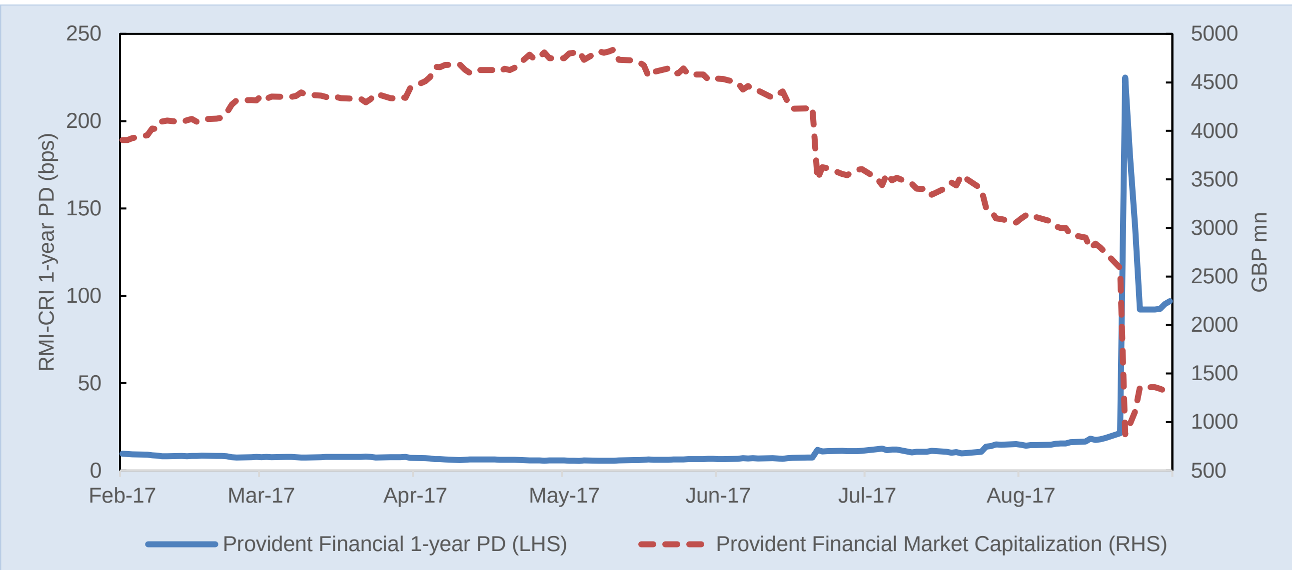

Figure 1: RMI-CRI 1-year PD (LHS) and market capitalization (RHS) for Provident Financial PLC *Source: RMI-CRI, Bloomberg*

Provident announced a restructuring of its consumer credit division in February 2017 by releasing its 4500 self-employed debt collection agents (who worked on a commission basis) and creating 2500 new dependent positions termed customer experience managers (CEMs) on the company's payroll. However, over the next few months, the payment collection rate fell from 90% to 57%, almost half of the payments owed to Provident were not collected as new staff turnover hits a new high.

The inexperienced new staff and a problematic IT system caused the restructuring woes. The scheduling and routing system failed to deploy CEMs accurately in meeting their customers and the data integrity was not well-maintained. Many of Provident's CEMs were too inexperienced and quit the business at a faster pace than management expected. Even worse, many agents that left went on to join rivals such as Morses Club and Non-Standard Finance who offered the agents the same or a better commission package. In fact, UK's second largest subprime lender, Morses Club, managed to report higher customer numbers and credit issued over the past six months as it grabbed market share from Provident. The decades-old face-to-face relationship-based business model that Provident had previously argued would help to achieve lower default rates had undergone a restructuring. Unfortunately, the results are not up to Provident's expectation yet. Its CEO, Peter Crook, quit as a result and Provident scrapped plans to pay an interim dividend in order to shore up its balance sheet.

The potential reason why Provident undertook a restructuring was in anticipation of stronger regulations in the high-cost credit sector. Reports found some lenders resort to intimidation to collect repayments. The Financial Conduct Authority (FCA) is also concerned about the growing risk with the increasing UK household debt. Unsecured consumer credit in the UK has been rising since 2014 and has grown by 10% to GBP 201bn in 2017 already by June. The last time that outstanding debt was above GBP 200bn was in December 2008. The FCA is targeting high-cost credit products, which may pose risks to potentially vulnerable customers. FCA also mentions that one in six people with debt on credit cards are in financial distress. In light of this trend, FCA may impose regulations to tackle the concerns just like what it has done in 2015 when it released a cap on the charges levied by lenders in 2015. The restructuring that Provident undertook was to anticipate stricter regulatory standards to have a better-centralized control over a distributed workforce and to prepare itself for a more regulated sector.

Due to its restructuring woes, Provident's shortfall in contribution from weaker collections adds up to GBP 40mn. Sales also detoriated as credit issued was GBP 37mn lower as compared to the previous year. Provident issued its first profit warning in June, with the consumer credit division's contribution in 2017 reduced to being GBP 60mn lower than 2016's GBP 115mn. On 22 August, Provident issued another profit warning and updated that its consumer credit division would instead report losses of between GBP 80mn and GBP 120mn for the full year. As seen in Table 1 below, net income and EBITDA-to-interest-expense multiple dropped sharply and analysts opined that this debacle would not only affect 2017's results but also have a negative impact for 2018 and 2019. As a result, the RMI-CRI 1-year Probability of Default (PD) for Provident went up, exhibiting a deteriorating credit profile. Consequently, Provident's bonds were hit as the yield on one of its bonds maturing in 2019 spiked above 17% from 1.9% after the profit warning.

	2H 2015	1H 2016	2H 2016	1H 2017
Net Income (GBP mn)	129.6	124.2	138.7	67
EBITDA/Interest Expense (x)	5.43	5.45	5.59	3.72

Table 1: Financial Data for Provident Financial PLC. *Source: Bloomberg*

The restructuring was not only driven by good intentions to tackle oncoming regulations faced by subprime lenders to better control its agents but also to follow up on leads and complaints efficiently. However, the restructuring was not well executed due to its problematic IT system and the mishandling of the debt collection staff. The restructuring may help in the long-run but in order to succeed, Provident needs to tackle short-term issues such as improving both the debt collection system and the motivation of the CEM workforce, perhaps better incentivize staff to collect repayments and conduct credit sales competently. However, time is not on Provident's side. Provident must rectify its temporary restructuring issues quickly before declining profits and strong competition harm its future on a permanent basis.

Credit News

Investors can't get enough of China's property developer bonds

Sep 4. Investors heavily subscribed to bonds of China's property developer as they are lured by the firms' improving financial performance and credit quality. The notes sold in July and August drew orders 6.3 times the issue size, with bond sales rising to USD 35.2bn this year. Generally, the revitalization of Chinese property bond market has helped drive Asian high-yield issuance to a peak of USD 39bn and expand the dollar bond market with a USD 193.6bn record of Asian sale (exclude Japan). However, the bonds from the property sector is still under risks of falling yields. For example, Greenland Holding Corp., China's fourth-biggest developer by property sales, has USD 69.5mn overdue loans at the end of June. Yields of non-investment grade dollar-bond in Asia has dropped about 20bps over the past month. (Bloomberg)

Looming debt ceiling deadline pushing some US fund managers to cash

Sep 2. A potential standoff over US federal debt ceiling is raising alarm bells among fund managers, who fear the 2011 event might repeat that resulted in a downgrade of US credit quality and a 15% slump in S&P 500. The failure to increase the debt ceiling might lead to a recession and a significant sell-off of the benchmark S&P 500. In order to reduce potential losses, US investors are raising cash and lowering the credit duration in their portfolio. Federal efforts to clean up the destruction caused by Hurricane Harvey may have decreased the probability of a shutdown to 35% but fund managers are not confident of a debt ceiling agreement passed as quickly as the market expects. (Reuters)

Rating agencies warn on failure to raise US debt limit

Sep 1. Credit rating agencies have stepped up their warnings about the consequences of a divided Washington failing to raise the debt ceiling in a timely fashion. Investors and economists expect that the Treasury will hit its debt limit in early to mid-October, and consequently, signs of anxiety have appeared in the USD 14tn Treasury market, with money managers demanding greater compensation to hold debts maturing on October 12 and 19. In the event of a failure to raise the debt limit, credit rating agencies warned that the triple-A rating of US debt would be reviewed with negative rating implications, and a financial catastrophe would result, pushing the US into a recession. (FT)

China Construction Bank profits lifted by economy, debt crackdown

Aug 31. China Construction Bank (CCB), one of the country's "big four" financial institutions, reported a slight increase in first-half profit growth and improving asset quality amidst government crackdown on bad debt. Its non-performing loans ratio was 1.51%, down from 1.52% in the second half of 2016. Other banks, which have reported flat performance in recent years, also benefited from 6.9% economic growth in the first half of the year, with a better growth rate of assets and more stable risk control. Although CCB commented that business environment is still grim, it expressed optimism for the future, expecting a stronger economy worldwide. (Business Times)

Rickmers completes winding up, bonds to be delisted

Aug 30. Rickmers Maritime completes its winding up process with outstanding bonds delisted from the Singapore bourse at 9am on August 30. Its unsecured creditors had received a final distribution, representing a recovery of about 12.1% on the bond. No further distributions or payments will be made to its unsecured creditors, including those holding the USD 100mn 8.45% notes due this year. The outstanding amount due on the notes had been paid to notes trustee, DB International Trust, which is currently arranging for the relevant distribution to individual bondholders. Bondholders had previously rejected Rickmers' appeal to swap the principal on the USD 100mn note due this May for USD 40mn due in November 2023 pegged to much lower coupon rates. (Straits Times)

Moody's raises China growth forecast but cuts US as it warns of geopolitical risks (Straits Times)

Russian agriculture thrives as sanctions close off imports (FT)

Challenges SMEs face in going cashless (Straits Times)

Regulatory Updates

European property companies want to attract more insurers

Sep 3. The European Public Real Estate Association (Epra) is lobbying the EU's insurance regulators, the European Insurance and Occupational Pensions Authority, to relax Solvency II rules that have curtailed real estate investment by insurers through requiring insurers to hold capital to guard against potential losses on their investments in property, equities and bonds. Epra is pushing the government to reduce the capital weighting on listed property investments from 39% to 25%, and such liberalization is expected to cause the FTSE Epra/NAREIT Europe index, an index that tracks Europe's biggest listed property companies, to double to close to EUR 500bn. Furthermore, the insurance industry is expected to benefit, as the industry is currently having difficulties covering its liabilities due to the low-yield environment in bond markets, and is looking for new investment opportunities. (FT)

68 small and medium-sized German banks fail national stress test

Aug 30. Nearly 5% of small and medium-sized German banks failed to meet the regulatory capital requirement in a stress test conducted by Germany's financial regulators. These 68 banks were not up to the mark even when contagion effects were left out in the stress test. German banks have suffered from low profitability in a fragmented market, which has been made worse by low or even negative interest rates.

Banks are expecting their profits before tax to slide by 9% over the next five years. However, German regulators remain relaxed given that they know the risk profile of these 68 banks. Regulators are putting extra attention on the real estate sector as there is insufficient granular mortgage data provided by the smaller banks to effectively assess their risk exposure. (Bloomberg)

UK challenger banks shy away from current accounts market (FT)

State-led companies back on top in China's outbound M&A rankings (FT)

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