PAYDAY LENDING MARKET INVESTIGATION

Profitability of payday lending companies working paper

Introduction

1. This working paper sets out our preliminary assessment of profitability of payday lending companies. In gathering evidence from lenders, we sent questionnaires and obtained detailed financial and customer data from 11 major lenders, including both high street and online lenders, and including lenders that collectively provide a range of single repayment and instalment loans. The lenders included in this sample operate 16 separate companies in the UK and market loans under around 22 different brands. Collectively, we estimate that these lenders accounted for over 90 per cent of both loans issued and payday loan revenue in 2012.

2. Our analysis covers the period including financial years ending December 2008 to June 2013 inclusive.[1]

3. Our analysis is discussed under the three areas of:

   (a) revenue and costs;

   (b) returns; and

   (c) benchmarks for profitability.

Summary of preliminary observations

Revenue and costs

4. Sources of revenue for payday lenders include some or all of: interest income, fees/ charges, and 'other' revenue including sales to brokers. At company level the most significant associated non-payday activities include pawnbroking, buying and selling

[1] Aggregated data for 2012 is based on the last reported financial years ending July to December 2012 and January to June 2013.

gold, foreign exchange services and money transfer. Interest income was the main source of revenue for the major lenders, representing on average around 83 per cent of total revenue in 2012. Across the period 2008 to 2012 the proportion of revenue represented by interest has declined from around 90 per cent, with an offsetting increase in the participation from fees/charges including roll-over fees, late payment charges and funds transfer fees. Evidence submitted suggests that sales to brokers are a small part of revenue and are derived from selling on customer leads purchased from brokers/lead generators.

5. Growth in both revenue and the value of loans issued has been high over the period. Growth rates in the last reported year have been slower than previous years, but remain at a high level relative to growth of the overall unsecured lending market. The limited data available on the most recent trends suggests some further slowing in growth from around a 40 per cent increase for the major lenders in 2012.

6. The most significant operating costs faced by lenders are the doubtful debt expense and customer acquisition costs. We have made several estimates to adjust costs to make them more comparable between companies. These adjustments are described in the revenue and cost section below.

7. On the basis of our operating margin analysis, which adjusts for some cost timing and cost allocation issues, we estimate that the average adjusted operating margin for payday lending was around 20 per cent for the major lenders in 2012, compared with around 20 to 25 per cent in previous years.

8. Our work suggests a wide disparity in the cost structures of individual payday lending companies with the most cost-efficient lenders experiencing a default rate (as

determined by our preferred measure, the principal loss rate[2]) of less than 10 per cent. Financial information submitted suggests that the principal loss rate for [✂] has been higher at between 35 and 55 per cent. For online lenders, advertising and promotions costs combined with commissions paid to lead generators/brokers and affiliates ranged from less than £20 to around £120 per loan for loans issued to new customers.

Returns

9. Our analysis of return on equity (ROE)[3] shows that accounting profitability has varied considerably across the period. Some lenders have achieved returns of between 15 per cent and over 100 per cent; other major lenders are not profitable.

10. Our analysis of return on capital employed (ROCE)[4] indicates that profitability has varied widely across the period from around minus 180 per cent to over 100 per cent. ROCE for the largest three lenders has varied less. Two of the major lenders, [✂] and [✂], were not profitable during the period under review.

11. It is important to note that economic profitability can differ from accounting profitability due to historical cost reporting, different treatment of intangible assets and other adjustments. The basis of this analysis is audited statutory accounts, management accounts and data submitted by parties.

12. Several parties commented that profitability analysis should incorporate economic adjustments to include the intangible value of investments in the business, such as a skilled labour force, brand value, the customer base and IT systems. Typically the Competition Commission (CC) has accepted the merits of adjusting historical book

[2] The principal loss rate is defined as 1-(loan principal collected/loan principal issued) for a given financial year.
[3] ROE calculations are post-tax and based on the book value of equity submitted by the major lenders.
[4] ROCE calculations are pre-tax and based on the book value of capital employed submitted by the major lenders.

values of capital employed (equity or otherwise) to an economic base where there is clear evidence of a material distinction between historical and economic values. We have not, however, received any substantial evidence on the value of intangible assets. We will review any further submissions from companies in this area as the inquiry progresses.

Benchmarks for profitability

13. We have estimated a preliminary cost of capital for consumer lending which may provide an appropriate benchmark for considering the levels of profitability observed over the last five years. We are considering other benchmarks which may also be appropriate, or more appropriate, as relevant comparators for the levels of profitability observed.

14. There was a wide range of submissions from parties on the cost of capital. We also requested target rates of return from five venture capital companies which had provided start-up capital to [✄]. We received two replies, both of which indicated target returns of around [✄] invested capital under a successful scenario.

15. Differences between returns and the cost of capital may be explained by innovation and successful risk-taking by firms. Our Guidelines recognize that at particular points in time the profitability of some firms may exceed what might be termed the 'normal' level. There could be several reasons, including cyclical factors, transitory price or other marketing initiatives, and some firms earning higher profits as a result of past innovation, or superior efficiency.[5] We will consider how these factors affect our interpretation of any observed gap between returns and the cost of capital; and how they affect our interpretation of differences in profitability between firms. A key factor

[5] *Guidelines for market investigations: Their role, procedures, assessment and remedies (CC3)*, paragraph 117.

in this consideration will be the extent to which material investment risks have been taken and, where possible, our expectation of the future evolution of profitability.

16. Any profit gap observed between returns and an appropriate benchmark may be an indicator of competitive conditions in the market. We will consider the extent to which judgements on the relative maturity or immaturity of the payday lending market are relevant for the interpretation of our profitability analysis. Some of the major lenders are very new businesses; however, there are signs that the growth of revenue, operating profit and returns for more established lenders may be slowing.

17. Our preliminary estimate of the cost of capital for consumer lending is between 8 and 13 per cent. We will consider to what extent this cost of capital is an appropriate benchmark for payday lending activities as a subset of consumer lending.

18. Several parties told us that estimates of the cost of capital were not routinely made. Of the major lenders which provided figures for the cost of equity, estimates ranged from 12.7[6] to over 40[7] per cent, with some concentration around 18 to 19[8] per cent post-tax. Of the major lenders which provided figures for weighted average cost of capital (WACC), estimates ranged from 9.85 per cent pre-tax to 18 per cent post-tax.

19. We received little comment from parties on the approach to profitability analysis other than from Wonga which told us that comparing an ex ante concept of the cost of capital with an ex post measure of out-turn profitability was particularly inappropriate for start-up companies. [✂]

[6] [✂]
[7] [✂]
[8] [✂]

CC guidance on profitability assessment

20. The CC Guidelines[9] set out how consideration of the economic profitability of the business activity being investigated may be used as an indicator of competitive conditions in the market.

21. In practice a competitive market would be expected to generate significant variations in profit between firms and over time as supply and demand conditions change, but with an overall tendency towards levels commensurate with the cost of capital of the firms involved. Firms in a competitive market would generally earn no more than a 'normal' rate of profit where the rate of return on capital employed for a particular business activity would be equal to the opportunity cost of capital for that activity. In competitive markets, characterized by free entry and exit, companies are expected in the long run to make profits that equal the minimum returns required by investors (the opportunity cost of capital). Hence returns that are persistently in excess of the cost of capital can be an indication of market power or a lack of competition in the market.

Revenue and costs

22. Table 1 shows the major lenders included in this analysis. Based on the responses received from major lenders, revenue from payday lending was £982 million[10] in 2012.[11] The proportion of company turnover represented by payday lending for the major lenders ranged from 100 per cent for the pure online lenders to [✄] per cent of total revenue for [✄], which reflects the company's core business in pawnbroking.

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[9] *CC3*, paragraphs 114–120.

[10] In its reference, the OFT had estimated total turnover of payday lenders to be around £860 million in 2011/12 based on 190 respondents: www.oft.gov.uk/shared_oft/Credit/oft1481a.pdf.

[11] Aggregated data for 2012 is based on the last reported financial years ending July to December 2012 and January to June 2013.

TABLE 1 **Major lenders payday loan data 2012**

Parent company	*UK operations*	*Mix of payday within total revenue %*	*Payday revenue £m*
Axcess Financial	Cheque Centres high street	[✂]	[✂]
	Cheque Centres online—The Loan Store	[✂]	[✂]
Cash America	CashEuroNetUK—Quick Quid, Pounds to Pocket	[✂]	[✂]
CFO Lending	CFO, Paydayfirst	[✂]	[✂]
DFC Corp	Dollar online—MEM Consumer Finance Ltd (Pay Day UK)	[✂]	[✂]
	Dollar online, Express Finance Bromley (PaydayExpress)		
	Dollar high street—Instant Cash Loans—The Money Shop	[✂]	[✂]
EZCORP	Ariste Holding—Cash Genie	[✂]	[✂]
Global Analytics	Lending Stream, Zebit	[✂]	[✂]
H&T Group plc	H&T pawnbrokers	[✂]	[✂]
MYJAR	MYJAR	[✂]	[✂]
SRC Transatlantic	SRC—Speedy Cash	[✂]	[✂]
	WageDayAdvance	[✂]	[✂]
The Cash Store Financial Services Inc	The Cash Store	[✂]	[✂]
Wonga Group Ltd	WDFC UK Ltd	[✂]	[✂]
Major lenders		65	982

Source: Financial Questionnaire. Based on reported fiscal year ends July to December 2012 and January to June 2013.

23. The three largest lenders (Wonga, Dollar and CashEuroNetUK) are significantly larger than the other companies and in 2012 accounted for just under a 70[12] per cent share of our estimate of total revenue generated by payday lenders. The three largest lenders are also individually significantly larger than the next largest lenders, [✂] and [✂]. [✂] and [✂] each generated revenue of around £[✂] million in 2012, around [✂] of the revenue of [✂], the third largest lender, and around [✂] the level of the largest lender.

Revenue mix

24. Table 2 shows the mix of payday revenue for the major lenders during the period 2008 to 2012. Interest income was the major source of revenue, representing on average around 83 per cent of total revenue in 2012, down from 90 per cent at the start of the period.

[12] See 'The size and concentration of the payday lending sector working paper'.

25. Rollover fees were the next most important revenue source, representing on average around 7 per cent of total revenue, and these fees grew in importance over the period from around 3 per cent in 2008. The third most significant revenue source was transfer fees, accounting for 5 per cent of total revenue in 2012, up from around 1 per cent in 2008. The contribution of late fees to total revenue as reported by lenders has not changed across the period, although analysis of the detailed information submitted suggests that lenders may not have distinguished between late fees and rollover fees in a standard way when providing information.

TABLE 2 **Payday lending revenue mix, 2008 to 2012**

per cent

	2008	*2009*	*2010*	*2011*	*2012*
Interest	90	86	85	83	83
Transmission fees	1	2	3	4	5
Late fees and charges	5	6	4	5	4
Roll-over fees	3	6	7	8	7
Extension fees	0	0	0	1	1
Other fees	1	0	0	0	0
Total revenue from borrowers	100	100	100	100	100

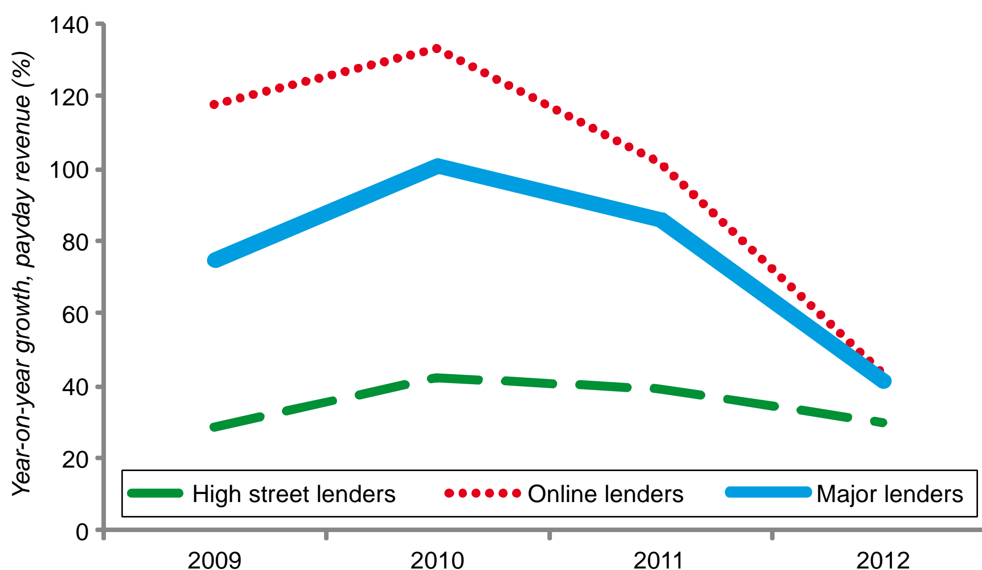
Source: CC analysis.

Revenue growth

26. Payday lending revenue growth for the period 2009 to 2012 is shown in Figure 1. Revenue growth for the major lenders has ranged from 40 to over 100 per cent a year during the period. After very strong growth in the early part of this period, the recent trend has slowed, although for 2012 remained at a high level compared with the overall unsecured lending market.

FIGURE 1

Payday revenue growth, 2009 to 2012



Source: CC analysis.

27. The limited data available on the most recent trend in revenue growth suggests some further slowing in growth. The moderating trend in historical revenue growth was mentioned by [✂], and a board paper supplied by [✂]. Elsewhere the most recently published lending data from DFC Corp, for Q2 2014,[13] showed a fall in revenue of 17.7 per cent year on year for UK lending for the three months to December 2013.

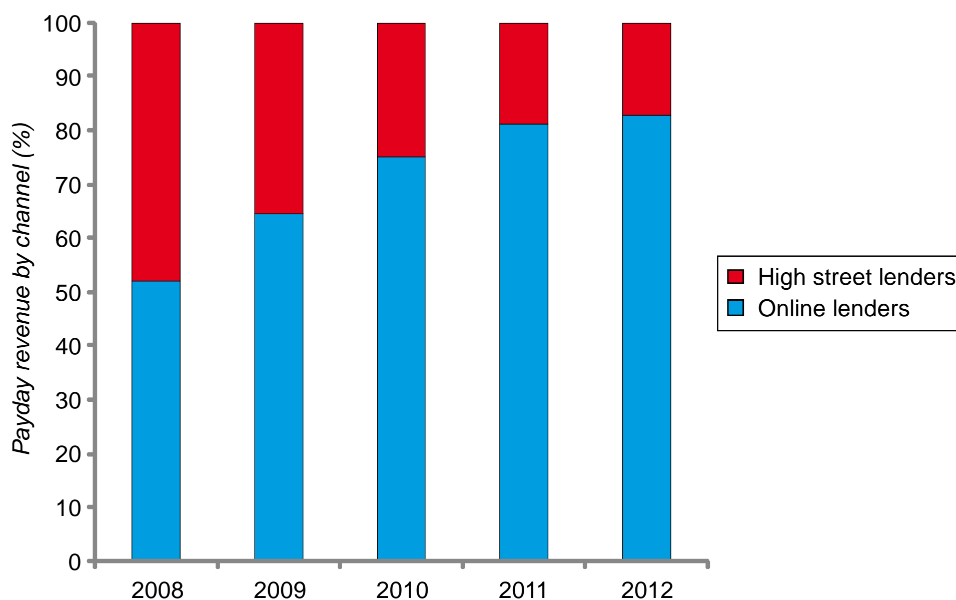
28. Growth rates for online lenders[14] and high street operators[15] have converged in the last year of our analysis after a period where online lenders grew significantly faster than high street lenders. Online lenders have seen revenue growth of between 40 and over 130 per cent a year between 2009 and 2012. Revenue growth rates for high street operators have been lower and less variable across the period at between 30 and 40 per cent a year.

[13] http://ir.dfcglobalcorp.com. All figures are shown in USD and percentages calculated based on USD amounts.
[14] Online lenders include: Wonga, MEM Consumer Finance & Express Finance (Dollar online); CashEuroNetUK; WageDayAdvance; Global Analytics; The Loan Store (Cheque Centres online); MYJAR; CFO Lending; and Ariste.
[15] High street lenders include: The Money Shop (Dollar); SRC; Cheque Centres; The Cash Store; and H&T.

29. In line with higher growth rates, the proportion of revenue accounted for by the online channel has steadily increased to more than 80 per cent of major lenders' revenue, up from around 50 per cent in 2007/08.

FIGURE 2

Payday revenue by channel, major lenders, 2008 to 2012



Source: CC analysis.

Revenue forecasts

30. We asked the major lenders for their view on future market growth, and to provide forecast growth data in the financial template. Where we received definitive responses on this subject, four lenders said that the payday loan market was immature, and three told us that the market was mature or likely to contract (in part due to changes in the regulatory regime). Where growth rates were predicted, estimates from major lenders ranged from 5 per cent[16] to 50 per cent[17] for 2013, and

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[16] [✂]
[17] [✂]

from –50 per cent[18] to 50 per cent[19] for 2014. Individual responses are detailed in Appendix 2.

31. It should be noted, however, that forecasts were supplied before the Financial Conduct Authority (FCA) published its detailed proposals for the FCA regime for consumer credit, which proposes restricting rollover and Continuous Payment Authority (CPA) use, and prior to the announcement of a future price cap requirement. Forecasts provided may therefore be unrepresentative of current company projections.

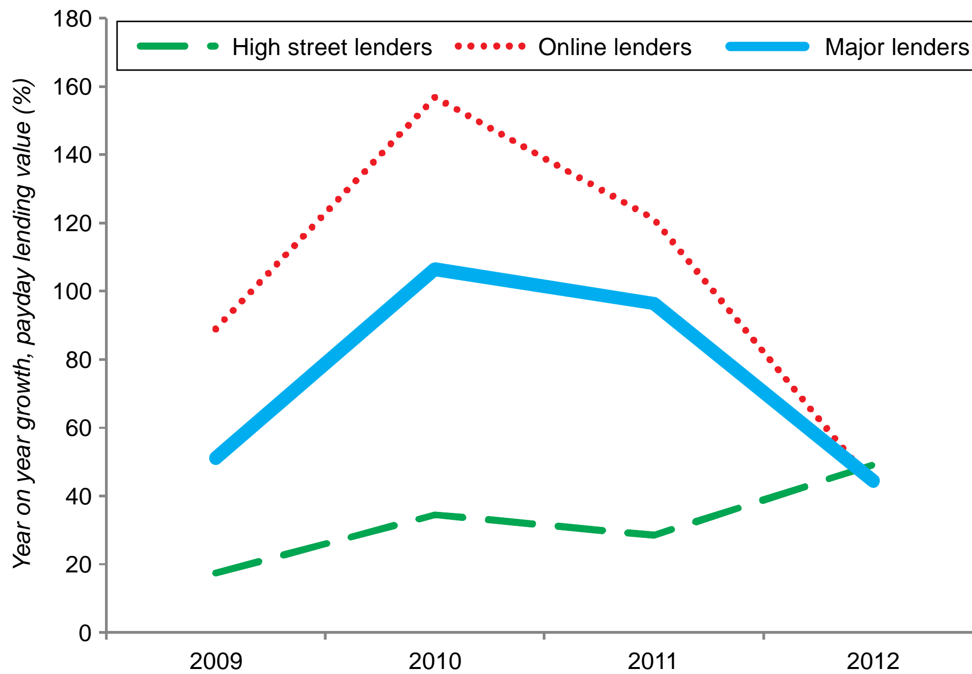
Growth in total value of loans issued

32. Our analysis of data on growth rates and channel participation for the value of loans issued shows similar trends to the revenue data discussed above, with the exception that growth rates of high street lenders at 49 per cent slightly exceeded the 43 per cent rate of growth for online lenders in 2012 for the first time in the period under review. Two lenders, [✂] and [✂], were unable to supply data on the value of loans issued, which may affect comparisons between trends shown in Figures 1 and 3.

[18] [✂]
[19] [✂]

FIGURE 3

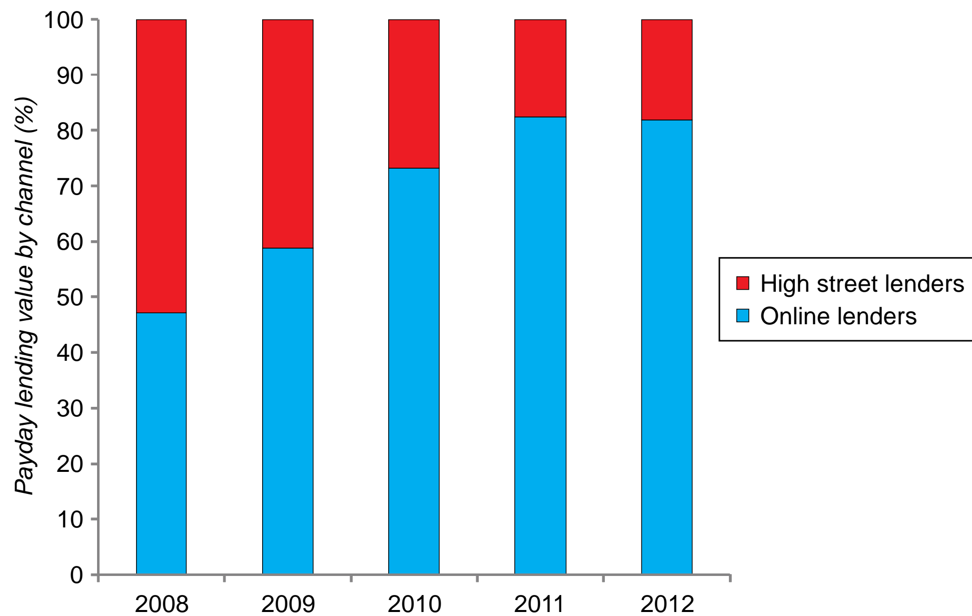
Payday lending value growth, 2009 to 2012



Source: CC analysis.

FIGURE 4

Payday lending value by channel, 2008 to 2012



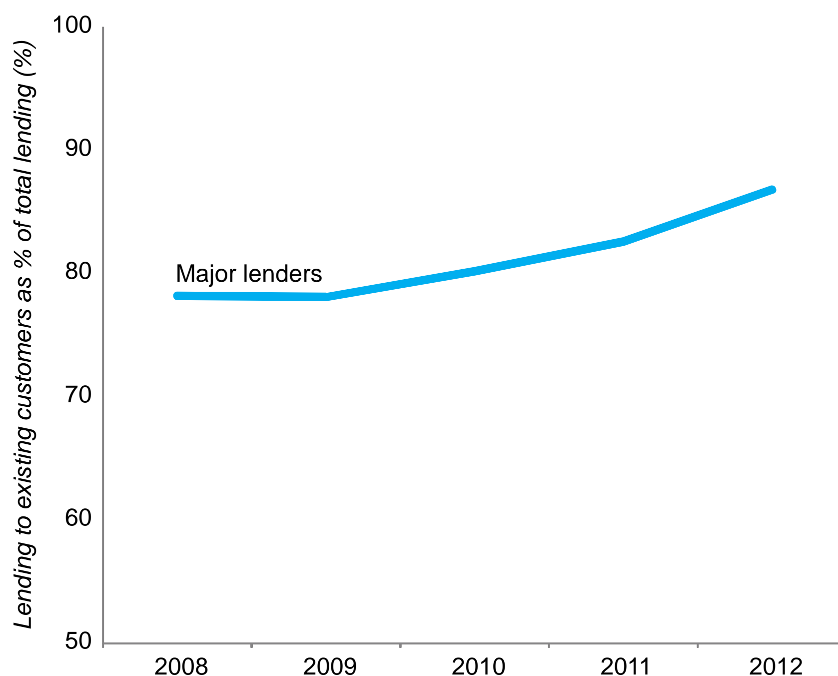
Source: CC analysis.

33. Examining lending data for new versus existing customers (see Figure 5) shows that the proportion of lending (loan principal) issued to existing customers has grown from

already high rates for the majority of lenders, and reached very significant levels in the last reported year. Data for individual major lenders for new customers as a proportion of total lending in 2012 varied from around 40 to over 90 per cent.

FIGURE 5

Lending to existing customers as a percentage of total lending, 2008 to 2012



Source: CC analysis.

Operating costs of payday lenders

Cost mix

34. Table 3 sets out the relative importance of the major operating cost categories for the major payday lenders.

35. The most significant cost faced by lenders is the doubtful debt expense,[20] which represented around 45 per cent of total costs for all lenders in both 2012 and 2011.

[20] The doubtful debt expense is an item in the Profit and Loss statement based on an accounting estimate of the portion of a debt that may not be recovered.

36. The doubtful debt expense is a particularly significant contributor to operating costs for online lenders, representing around 50 per cent of total operating costs against 24 per cent of total operating costs for high street lenders. The doubtful debt expense is a lower proportion of total costs for high street lenders because store costs apply to high street lenders only, which drives a lower participation of doubtful debt charges within the overall cost mix for the high street. The relative importance of this expense within the overall cost mix is also affected by the higher level of staff costs seen at high street lenders.

TABLE 3 **Operating cost breakdown**

per cent

	All		*Online*		*High street*	
	2011	*2012*	*2011*	*2012*	*2011*	*2012*
Doubtful debt expense	44	45	51	51	20	24
Customer acquisition—commissions	10	10	14	12	0	0
Customer acquisition—advertising and promotions	6	6	7	7	3	3
Credit checks, collection, bank charges	5	5	6	6	1	3
Technology	3	3	4	3	1	0.3
Store costs	4	4	0	0	15	16
Staff costs	16	13	9	8	37	33
Depreciation	2	2	1	1	5	5
Other	10	9	7	8	18	16
Total	100	97	100	97	100	100

Source: CC analysis.

Notes:
1. Excludes [✂] due to limited cost allocation.
2. [✂].

37. The second most important category of operating costs faced by the major lenders within the overall mix is customer acquisition costs comprising commissions paid to lead generators, brokers and affiliates, as well as advertising and promotions costs. Taken together these two categories of customer acquisition costs account for 16 per cent of total costs for all major lenders analysed, and are a prominent feature of the online lending business model at 19 per cent of total costs in 2012. High street lenders, by contrast, rely on the physical presence of stores to generate customer traffic and do not buy customer leads.[21] The cost information provided shows that

[21] Some high street lenders have recently introduced online loans so may now be paying for leads.

building brand awareness is relevant for both types of lenders, with advertising and promotions for high street operators representing 3 per cent of total costs and 7 per cent for online lenders.

38. Credit management costs including credit reference agency charges, the cost of depositing the loan principal into customers' bank accounts and collecting customer payments, along with associated bank charges, represented 5 per cent of total costs for the major lenders in 2012. Credit management costs are more significant for online lenders than high street lenders, as would be expected with loans available in cash from stores, and a higher proportion of credit checking done by staff in high street premises at the point of loan issuance.

39. Despite the critical importance of technology in online payday lending, technology costs are a relatively small part of reported operating costs. This may be due to several factors including: the exclusion of staff costs related to technology; the reliance of several lenders on technology developed and/or supplied by parent or other group companies; the availability of standard technology components to check bank account details and sort codes/point-of-sale payment processing systems from third parties; and the capitalization of information technology development spending on to the balance sheet, rather than expensing these technology charges as an operating cost.

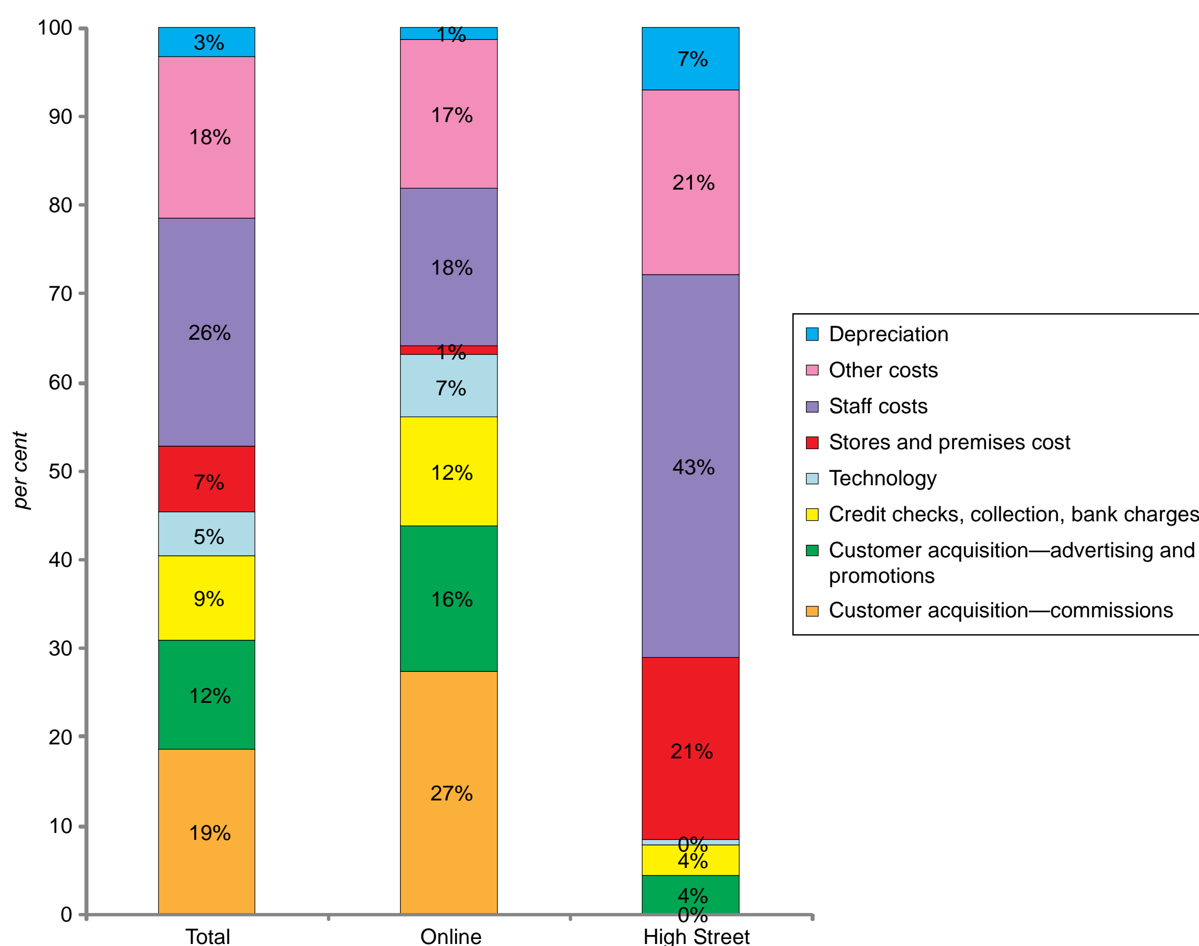
40. The relative importance of store costs reflects the different structures of the online versus high street lending model with store costs accounting for around 16 per cent of total costs for high street lenders only.

41. Staff costs, related to some degree to store costs, are also a notable contributor to the cost mix for high street lenders at over 30 per cent of total costs compared with around 8 per cent for online lenders.

42. Figure 6 shows the breakdown of costs excluding the doubtful debt expense and shows the relative importance of customer acquisition costs to online lenders and how staff and stores costs are relatively more significant for high street lenders.

FIGURE 6

Breakdown of costs excluding doubtful debt expense, 2012



Source: CC analysis.
Note: [✄]

Comparability of revenue and operating costs between lenders

43. The cost breakdown in Table 3 gives an indication of the relative importance of the different costs in payday lending within overall costs and as such is relatively straight-

forward. In examining the reliability and comparability of cost data, however, we observe two issues: first how costs are allocated to payday versus non-payday operations; and secondly how changes in inter-company management charges have affected reported profits.

Cost allocation between products and services

44. Some of the major lenders derive revenue from other sources as well as payday lending, including, for example, pawnbroking, gold buying and selling, foreign exchange and money transfer services. We have compared payday lending costs submitted by parties as a proportion of total costs, with payday revenue as a proportion of total revenue. Our comparison indicates that in general the ratios were similar; however, information for Dollar's high street operations [✄] in the year to June 2013.[22] Dollar told us for its high street operations that [✄].

45. Whilst this methodology may align with Dollar's operational approach to its business, for our purposes it is likely to [✄] the profitability of payday lending within the total. [✄] In our view it is counter-intuitive to argue that [✄]. We examine below the effect of an alternative cost allocation approach with payday costs allocated [✄] to payday revenues.

Inter-company management charges

46. We also explored the effect of inter-company management charges when examining costs of the following companies.

[22] CC analysis for financial year to June 2013. Total revenue includes non-payday activities such as pawnbroking, gold buying and selling, money transfer, and cheque cashing.

Dollar Online—EFL and MEM

47. [✂][23]

48. [✂] it is possible that this aspect of our analysis will require updating.

Wonga

49. Wonga restructured its operations in 2012. Wonga told us that 'a commercial hub was established in Geneva and this entity provides [✂] services to the international lending entities and the service fee charged [✂].[24]

50. [✂]

51. [✂] charged [✂] relating to the final quarter of 2012 and included this figure in the financial template under commissions to affiliates, lead generators and agents cost category. Wonga has indicated a service charge [✂].

TABLE 4 **Analysis of Wonga's service charge**

£'000

	2008	*2009*	*2010*	*2011*	*2012*	*2013*	*2014*	*2015*
[✂] service charge	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Revenue	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Service charge as % revenue	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Non-service-charge costs	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Non-service-charge % revenue	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Total costs % revenue	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]

Source: CC analysis.

52. [✂], indicating that an element of this charge may be incremental.

53. [✂] Basing analysis solely on reported profits post the full service charge may distort growth comparisons for Wonga year on year, and affect our analysis of payday lending as a whole given [✂].

[23] [✂]
[24] [✂]

54. This approach is supported by Wonga's submission that 'the reported financial results for the periods up to and including 2012 are difficult to compare directly with the forecasts for 2013 onwards'.

55. Furthermore, we regard the principle of examining the effect of an adjustment as reasonable given that [✂].

56. In our analysis we explore the effect of adjusting Wonga's figures for the full £[✂]. Our adjustment [✂][25] (see Tables 5, 10 and 11). We recognize that this adjustment is likely to overestimate adjusted profitability because some element of the service charge relates to costs which could be included in any comparative analysis. However, [✂].

Other

57. CashEuroNetUK's figures include [✂]. This fee [✂] is not relevant therefore in our analysis of growth rates. Our estimated adjusted returns figures do exclude this charge to be consistent with our estimates of adjusted returns for Wonga and Dollar online in Tables 10 and 11.

58. For [✂], whilst we have been able to verify total costs submitted for payday lending, the company does not allocate expenses other than the doubtful debt expense to the payday product. As we have no basis on which to make any cost allocation adjustments, we have not done so at this stage.

Proposed adjustments

59. Table 5 shows that if combined costs and revenues for payday lending submitted by the major lenders prior to any adjustment are simply aggregated, operating profits fell

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[25] Adjustment made to PAT for ROE calculations and to EBIT for ROCE calculations.

5 per cent in 2012 against 2011. Applying the proposed adjustments discussed above indicates revised estimated operating profit growth of 25 per cent in 2012.

TABLE 5 **Comparison of profits submitted by major lenders and CC adjustments, 2008 to 2012**

	2008	*2009*	*2010*	*2011*	*2012*
Operating profit per financial template (£'000)					
High street	[✂]	[✂]	[✂]	[✂]	[✂]
Online	[✂]	[✂]	[✂]	[✂]	[✂]
Major lenders	[✂]	[✂]	[✂]	[✂]	[✂]
Online share	[✂]	[✂]	[✂]	[✂]	[✂]
Operating profit adjustments (£'000)					
[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
[✂]					[✂]
[✂]					[✂]
Adjusted operating profit (£'000)					
High street	[✂]	[✂]	[✂]	[✂]	[✂]
High street [✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Online	[✂]	[✂]	[✂]	[✂]	[✂]
Major lenders	[✂]	[✂]	[✂]	[✂]	[✂]
Major lenders [✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Online share (%)	[✂]	[✂]	[✂]	[✂]	[✂]
Online share excluding [✂] (%)	[35–45]	[50–60]	[70–80]	[80–90]	[85–100]
Operating margin per financial template (% revenue)					
High street	[✂]	[✂]	[✂]	[✂]	[✂]
Online	[✂]	[✂]	[✂]	[✂]	[✂]
Major lenders	[✂]	[✂]	[✂]	[✂]	[✂]
Adjusted operating margin (%)					
High street	[✂]	[✂]	[✂]	[✂]	[✂]
High street excluding [✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Online	[✂]	[✂]	[✂]	[✂]	[✂]
Major lenders	[✂]	[✂]	[✂]	[✂]	[✂]
Major lenders excluding [✂]	25	22	25	24	21
Operating profit growth per financial template (%)					
High street		[✂]	[✂]	[✂]	[✂]
Online		[✂]	[✂]	[✂]	[✂]
Major lenders		555	250	97	–5
Adjusted operating profit growth (%)					
High street		[✂]	[✂]	[✂]	[✂]
High street excluding [✂]		[✂]	[✂]	[✂]	[✂]
Online		[✂]	[✂]	[✂]	[✂]
Major lenders		[✂]	[✂]	[✂]	[✂]
Major lenders excluding [✂]		53	133	81	25

Source: CC analysis.

60. The reduction in operating profit growth relative to prior years reflects both a slow-down in revenue growth as discussed above, and an increase in costs relative to revenue compared with prior periods. Both raw and adjusted growth rates for 2012 show a considerable reduction compared with historic growth rates.

61. Based on our analysis in 2012 we estimate:

(a) At least 85 per cent of adjusted operating profit was generated by online lending.

62. The adjusted operating margin was around 20 per cent for the major payday lenders with online lending substantially more profitable than high street lending. We estimate that the adjusted operating margin delivered by online lenders was [✂] per cent, with high street lenders achieving an adjusted operating margin of [✂] per cent including [✂] and [✂] per cent excluding [✂]. Cost information supplied by [✂] suggests that only the doubtful debt expense is tracked for this part of the business and the resulting operating margin is therefore overstated for our comparative purposes. Our analysis indicates a wide range of operating margins among the other high street lenders with [✂].

63. The estimated adjusted operating margin of [✂] per cent for online lenders compares with [✂] stated margin cap of 17 to 20 per cent. [✂] told us that 'any excess profit will go directly back to reducing costs for customers'.

64. Additional context for our margin analysis comes from [✂], which told us that it had a target margin of 20 per cent based on total turnover less credit losses and direct costs.

65. Figure 7 shows that there is considerable variability in the levels of operating margin generated by parties on payday lending. Data shown here is a combination of the operating margin for payday lending and the operating margin for the corporate entity. Although Dollar high street payday [✂], Dollar's high street operations as a whole achieved a [✂] per cent operating margin in 2012.

66. [✂] as an entity is loss-making. However, the figures submitted for revenue and operating costs for payday lending result in an operating margin on payday lending of

[✄] per cent. As noted above, limited cost allocation is distorting the reported margin for this lender.

FIGURE 7

Operating margins on payday lending, 2012

[✄]

Source: CC analysis.

67. [✄]

Cost drivers

68. Having looked at the cost mix, we now examine cost drivers for the two most significant cost categories: the doubtful debt expense and customer acquisition costs.

Doubtful debt expenses

69. The doubtful debt expense is an item in the profit and loss statement for the relevant financial year. For details on how this is expense is calculated, see Appendix 6.

Calculating the doubtful debt expense

70. In simple terms the expense is calculated by assessing the level of outstanding debt (loan principal and interest due) by repayment status and applying an assumption about the percentage of debt that will not be recovered. Typically the percentage of debt treated as doubtful increases as the loan becomes more overdue, as shown in the illustrative example in Table 6.

TABLE 6 **Illustrative example of method and assumptions used in the doubtful debt expense calculation**

Status of loans outstanding	*Percentage of loan outstanding included in provision* %
Current	15
Overdue by:	
1–15 days	60
16–30 days	70
31–60 days	80
60+ days	100

Source: CC illustrative example.

Anticipated versus actual default

71. The doubtful debt expense is therefore a cost item which *anticipates* default, and is dependent on assumptions about the future collection pattern of loan principal made to customers and interest charges due to be paid. The doubtful debt expense differs from *actual* default experienced by lenders and is an indication of the level of *anticipated* risk at a specific point in time rather than a measure of the *actual* default cost experienced by a lender as loans pass through the collection cycle.

72. We have looked in detail at the assumptions underlying the calculation of the doubtful debt expense to gauge the extent to which this cost is comparable between the major lenders.

73. To aid our comparison of the policies used by lenders to calculate this expense, we constructed a hypothetical loan book based on the combined loan books of the 11 major lenders at the end of the last reported financial year.[26] This is not a precise exercise as we can only model the range of impairment policies in broad terms given limited data on the aging mix of loans past due. However, we believe that this analysis provides a useful illustration of the extent to which costs may vary due to the

[26] The loan book at year end represents loans outstanding at year end including principal and interest and differs from new lending made during the year which is for the year as a whole and is principal only.

use of different *methods,* as distinct from differences which arise due to the use of different *assumptions,* within a similar method.

74. The reason for examining methods and assumptions separately is that we might wish to make adjustments in our cost analysis for significantly different *methods* between lenders in order to increase the comparability of data. However, we would be less inclined to adjust for differences in the *assumptions* used in cost calculations because assumptions are generally based on the actual historic collections experience of lenders (albeit that several of the major lenders do not have a long trading history on which to judge historic trends).

75. The requirement for judgement in calculating the doubtful debt expense can be illustrated with the example of the provision for doubtful debt at Express Finance (included in Dollar online), which rose in the year to June 2013, [✂]. Dollar told us that:

> Changes in [✂], following the adoption of the Code of Practice and OFT requirements, impacted both debt recovery during fiscal 2013 and our estimation of the future recovery of debt outstanding at the end of the fiscal year. In addition, increased competition in the market place [✂].

76. Our review of provisions policies indicates that in general terms the majority of lenders follow similar methodologies with the exception of:

(a) [✂], which takes a single percentage of lending and interest due;

(b) [✂], which do not include a provision for current debt; and

(c) [✂], which provides for loan principal only on [✂] revenue,[27] which means that, all else being equal, the doubtful debt expense will be understated relative to the rest of the sample.

77. The lenders listed above do not account for a significant portion of the cost base under review and we therefore do not propose to make adjustments to any cost analysis which is based on the doubtful debt expense.

Doubtful debt expense in context

78. Putting the doubtful debt expense into context, however, is not straightforward. It is common for management and industry analysts to evaluate this expense in relation to revenue, and the resulting percentages can appear high at around 40 per cent for established lenders.[28]

79. The doubtful debt expense is a cost which is subtracted from revenue in calculating accounting profits; however, this cost is based on loan principal and interest. Revenue is not based on principal repayment, therefore comparing a cost which includes loan principal against revenue, which does not, may be a useful management tool for monitoring business performance, but does not provide a full picture on the level of risk experienced by lenders.

Principal loss rate

80. We consider the principal loss rate to be a better indicator of default risk. The principal loss rate is a cash on cash measure calculated as:

= 1 – (loan principal collected / loan principal issued) for a given financial year

---

[27] [✂]
[28] [✂]

81. The principal loss rate has the advantage that it measures the actual cash loss to the business rather than an element of expected revenue forgone. It compares principal with principal and is not referenced to revenue levels which vary depending on the interest level charged by lenders. Furthermore, we find an inverse relationship between the principal loss rate for lenders and the number of loans issued over the last five years, and an inverse relationship between the principal loss rate and the level of lending to repeat customers as shown in Figures 8 and 10.

FIGURE 8

How default rates vary with the cumulative number of loans issued

[ ]

Source: CC analysis.

82. By contrast, the relationship between the principal loss rate and time spent as a payday lender is less clear.

FIGURE 9

How default rates vary with time in the market

[ ]

Source: CC analysis.

FIGURE 10

How default rates vary with lending to existing customers

Lending to existing customers, 2008–2012

Source: CC analysis.
Note: Axes adjusted.

83. The level of principal loan loss calculated for Wonga using this method is consistent with [✂].

84. Our analysis indicates that default costs, as measured by the principal loan loss rate, have fallen in 2012 on the prior year for most of the major lenders.

TABLE 7 **Principal loss rates for major lenders, 2011 and 2012**

	per cent	
	2011	*2012*
Ariste	[✄]	[✄]
CashEuroNetUK	[✄]	[✄]
Cheque Centres high street	[✄]	[✄]
Cheque Centres online	[✄]	[✄]
Dollar—EFL	[✄]	[✄]
Dollar—MEM	[✄]	[✄]
Dollar high street	[✄]	[✄]
Dollar online (combined)	[✄]	[✄]
Global Analytics	[✄]	[✄]
H&T	[✄]	[✄]
MYJAR	[✄]	[✄]
SRC	[✄]	[✄]
The Cash Store	[✄]	[✄]
WageDayAdvance	[✄]	[✄]
Wonga	[✄]	[✄]

Source: CC analysis.

85. We recognize that this analysis has some limitations in that it may overestimate the cost of default for loans which are rolled over and where default charges and/or roll-over fees may compensate the lender for loss of loan principal.

Customer acquisition costs

86. We asked the major lenders to provide cost information in three areas relevant to customer acquisition: advertising, commissions paid to brokers/lead generators/ affiliates and store costs.

87. For our analysis of customer acquisition costs, we have reviewed Wonga's supplier list and categorized payments based on our interpretation of supplier names and cost descriptions used by Wonga. This analysis suggests that total customer acquisition costs for [✄] were £[✄] million including advertising, branding, sponsorship, digital marketing, sponsorship and payments to lead generators and affiliates. [✄]

Growth in commission fees

88. Dollar told us that:

From the beginning of calendar year 2013 the market for new business became even more competitive [✂]. In addition, with the increased competition, [✂].

Dollar also noted that increased competition in the marketplace had resulted in [✂] both PPC (pay per click) advertising and lead generators, and told us that PaydayUK paid up to £[✂] and Payday Express up to £[✂] for an approved lead.

89. Table 8 indicates how reported commissions paid to brokers/lead generators vary by lender. These charges are an important part of the online lending model but there is significant variation in the proportion of customers sourced via this route and the implied levels of commission paid. As discussed Wonga included [✂]. Our review of Wonga's supplier list indicated that commissions to brokers/lead generators were [✂] is included in Table 8.

TABLE 8 **Customer acquisition costs**

Lender		*Proportion of new customers sourced from brokers/lead generators %*	*Commissions to brokers/lead generators as % revenue 2012*
Ariste	Online	[✂]	[✂]
CashEuroNetUK	Online	[✂]	[✂]
CFO Lending	Online	[✂]	[✂]
Cheque Centres	High street	[✂]	[✂]
Cheque Centres online	Online	[✂]	[✂]
Dollar—ICL	High street	[✂]	[✂]
Dollar—MEM	Online	[✂]	[✂]
Dollar—EFL	Online	[✂]	[✂]
Dollar—online (combined)	Online	[✂]	[✂]
Global Analytics	Online	[✂]	[✂]
H&T	Both	[✂]	[✂]
MYJAR	Online	[✂]	[✂]
SRC	High street	[✂]	[✂]
The Cash Store	High street	[✂]	[✂]
Wage Day Advance	Online	[✂]	[✂]
Wonga	Online	[✂]	[✂]

Source: CC analysis.

Note: Wonga figure adjusted using supplier list analysis.

90. In the absence of detailed information on prices paid for leads we note that:

(a) [✂] is almost entirely reliant on new customer acquisition from brokers and lead generators, yet commissions costs were [✂] per cent of revenue in 2012. [✂]

(b) Figures from CashEuroNetUK for commissions costs [✄].

(c) Transaction data indicates that [✄] acquired around 80 per cent of customers from brokers/lead generators in 2012,[29] whilst costs were only [✄] per cent of revenue.

Commissions and advertising combined

91. Taking commissions and advertising together and comparing these costs with the number of loans issued to new customers submitted by the major lenders indicates a customer acquisition cost of between less than £10 and around £120 per new loan in 2012 for all lenders, and between £20 and £120 for online lenders [✄]. Combined costs were generally lower in 2011, as shown in Figure 11.

92. We acknowledge that this analysis has several limitations, including the fact that at least some element of advertising costs are likely to be attributable to existing customers who are reassured and roll-over loans, or take subsequent loans with the same lender.

FIGURE 11

Combined advertising costs and commissions paid to brokers/lead generators/affiliates, per new customer loan, 2011 and 2012

[✄]

Source: CC analysis.

Returns

93. We have calculated two returns measures:

(a) ROE as profit after interest and tax (PAT) as a percentage of the equity capital employed (taken as the average of the financial year in which PAT was generated and the prior year post dividends[30] paid out to shareholders); and

[29] [✄]

[30] Dividends applicable to [✄].

(b) ROCE expressed as profit before interest and tax as a percentage of financial debt plus equity shareholders' funds.

94. In previous market investigations in the financial services sector, including PPI, Store Cards and banking services to SMEs,[31] the CC has considered an ROE approach to be most appropriate. ROE was chosen for SME banking, because customers' deposits and other customer accounts have a dual nature, being both a liability/ means of financing lending activities and a retail product in their own right, ie forming part of working capital. Accordingly the CC concluded that a cost of capital taking both equity and debt into consideration was not relevant for banks and the appropriate cost of capital was the cost of equity and the appropriate profitability calculation was ROE. There are also regulatory requirements for banks to hold minimum levels of equity. In many other market investigations, including Home Credit, the CC has assessed profitability using an ROCE approach.

95. There are several factors to evaluate if we are to choose one profitability measure over another and the relative importance placed on these factors requires judgement. We have therefore analysed rates of both ROE and ROCE based on the financial information supplied by parties.

96. Factors supportive of an ROE approach include: the pattern of equity funding in the payday industry from venture capital and individuals; submissions from parties which suggest that debt funding for payday lending is difficult to obtain; and evidence that debt funding at many of the major lenders has been provided by parent companies. Our review of financial information submitted shows that only two lenders, [✄] and [✄], have debt capital from external sources. We also found a wide variation in the

[31] The supply of banking services by clearing banks to small and medium-sized enterprises, March 2002.

applicable interest rates on debt provided from group sources with charges ranging from zero to 12 per cent.

97. Factors supportive of an ROCE approach include the fact that there is no regulatory requirement for payday lending companies to hold a particular level of equity and that payday lenders do not have access to internal equity funding from customer deposits for lending operations. An ROCE approach may be indicated by similarities between home credit products and payday lending products. The adjusted returns in our analysis to aid cost comparisons between lenders and between time periods are likely to be more robust for ROCE than ROE, because comprehensive adjustments to PAT would require estimates of adjusted tax and interest. Adjustments to ROCE do not require assumptions about tax and interest because the numerator is EBIT.

98. The importance of capital structure is also a factor in evaluating the relative benefits of ROE and ROCE analysis. Table 9 analyses the information submitted by parties on levels of debt and shows that debt levels at eight of the major lenders are appreciable. We are considering the level of inter-company funding within levels of reported debt and this may affect our analysis. Interest rates may not be based on the cost of borrowing for the lender and it is possible that with internal funding arrangements no cash is physically paid on capital provided by parent companies. If inter-company debt is, however, regarded as quasi equity, profitability based on ROCE rather than ROE may be more representative.

TABLE 9 **Debt as a percentage of capital employed**

per cent

	2008	*2009*	*2010*	*2011*	*2012*
Ariste	[✂]	[✂]	[✂]	[✂]	[✂]
CashEuroNetUK	[✂]	[✂]	[✂]	[✂]	[✂]
CFO Lending	[✂]	[✂]	[✂]	[✂]	[✂]
Cheque Centres	[✂]	[✂]	[✂]	[✂]	[✂]
Cheque Centres online	[✂]	[✂]	[✂]	[✂]	[✂]
Dollar high street	[✂]	[✂]	[✂]	[✂]	[✂]
Dollar online	[✂]	[✂]	[✂]	[✂]	[✂]
Global Analytics	[✂]	[✂]	[✂]	[✂]	[✂]
H&T	[✂]	[✂]	[✂]	[✂]	[✂]
MYJAR	[✂]	[✂]	[✂]	[✂]	[✂]
SRC	[✂]	[✂]	[✂]	[✂]	[✂]
The Cash Store	[✂]	[✂]	[✂]	[✂]	[✂]
WageDayAdvance	[✂]	[✂]	[✂]	[✂]	[✂]
Wonga	[✂]	[✂]	[✂]	[✂]	[✂]

Source: CC analysis.

Return on equity

99. Our analysis suggests that accounting returns based on the book value of equity have varied considerably across the period. Some lenders have achieved returns of between 15 and over 100 per cent. Returns appear to have been high for some of the major lenders, including the big three lenders at between [✂] and [✂] per cent on reported accounting basis across a significant part of the period. Returns for other major lenders have ranged from around –[✂] to around –[✂] per cent during the period under review.

TABLE 10 **Return on equity, 2009 to 2012**

per cent

	2009	*2010*	*2011*	*2012*
[✂]	[✂]	[✂]	[✂]	[✂]
[✂]	[✂]	[✂]	[✂]	[✂]
[✂]	[✂]	[✂]	[✂]	[✂]
[✂]	[✂]	[✂]	[✂]	[✂]
[✂]	[✂]	[✂]	[✂]	[✂]
[✂]	[✂]	[✂]	[✂]	[✂]
[✂]	[✂]	[✂]	[✂]	[✂]
[✂]	[✂]	[✂]	[✂]	[✂]
[✂]	[✂]	[✂]	[✂]	[✂]
[✂]	[✂]	[✂]	[✂]	[✂]
[✂]	[✂]	[✂]	[✂]	[✂]
[✂]	[✂]	[✂]	[✂]	[✂]
[✂]	[✂]	[✂]	[✂]	[✂]

Source: CC analysis.

100. It is not possible to calculate ROE for any year in the period for two lenders, [✂] and [✂], due to negative equity balances. [✂] reported [✂] in 2012 than in 2011. However, the significant reduction in ROE for [✂][32] in 2012 is heavily affected by charges relating to the prior year.

101. We have calculated both reported and adjusted returns for three lenders,[33] Wonga, Dollar online and CashEuroNetUK. Adjusted returns are based on the following estimates:

(a) Wonga PAT excludes [✂]. The adjusted return of [✂] per cent is likely to be an overestimate because [✂]. Wonga has not, however, provided a breakdown of this charge and the level of ROE representative of the business on a fully comparable basis prior to the introduction of this charge is, therefore, likely to lie somewhere between [✂].

(b) Dollar online excludes inter-company management charges.

(c) CashEuroNetUK excludes inter-company management charges.

(d) Our estimates of adjusted returns are indicative because we have not sought to model the effect of our cost adjustments on tax and interest.

102. Our comparison of returns indicates that levels of ROE generally fell in 2012 relative to the previous year. In 2012, of the nine major lenders for which we can calculate two years of ROE, eight lenders reported ROE levels below those of 2011; one lender saw a reduced rate of negative ROE at [✂] per cent in 2011. One lender, [✂], reported a significant drop in profitability in 2012[34] primarily due to timing differences relating to the recording of bad debts in 2012 which relate to the prior year.

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[32] [✂]
[33] [✂]
[34] [✂]

103. In analysing the recent trend in returns, we note that the drivers of year on year changes are not uniform for all lenders. Factors affecting returns in 2012 include both margin deterioration due to cost increases (which may be outside the control of management), as well as the dilution effect of retained earnings increasing the capital base of profitable companies (which may reflect management discretion).

Return on capital employed

104. Our analysis of ROCE differs from calculated levels of ROE due to tax and interest expenses and capital structure differences. We have calculated ROE post-tax and interest incorporating the full extent of reported profits and to facilitate comparisons with the post-tax cost of equity. Our analysis of ROCE follows the general approach for this measure and is based on profits which are pre-tax and interest, and a capital base which incorporates reported levels of financial debt; although it should be noted that all of the major lenders except [✄] and [✄] operate with inter-company borrowings and shareholder loans, the level of which may not be fully representative of the capital employed if these businesses were stand-alone operations.

TABLE 11 **ROCE, 2009 to 2012**

per cent

	2009	*2010*	*2011*	*2012*
[✄]	[✄]	[✄]	[✄]	[✄]
[✄]	[✄]	[✄]	[✄]	[✄]
[✄]	[✄]	[✄]	[✄]	[✄]
[✄]	[✄]	[✄]	[✄]	[✄]
[✄]	[✄]	[✄]	[✄]	[✄]
[✄]	[✄]	[✄]	[✄]	[✄]
[✄]	[✄]	[✄]	[✄]	[✄]
[✄]	[✄]	[✄]	[✄]	[✄]
[✄]	[✄]	[✄]	[✄]	[✄]
[✄]	[✄]	[✄]	[✄]	[✄]
[✄]	[✄]	[✄]	[✄]	[✄]
[✄]	[✄]	[✄]	[✄]	[✄]
[✄]	[✄]	[✄]	[✄]	[✄]

Source: CC analysis.

105. Table 11 shows ROCE for the major lenders based on the book value of equity and debt provided by parties. Our analysis indicates that ROCE has varied widely across the period from around –[✄] to over [✄] per cent. Profitability for the largest three

lenders has varied less at between [✂] and over [✂] per cent. Two of the major lenders, [✂] and [✂], were not profitable during the period under review. One lender, [✂], reported a significant drop in profitability in 2012[35] primarily due to timing differences relating to the recording of expenses in 2012 which relate to the prior year.

106. Our analysis indicates that levels of ROCE generally fell in 2012 relative to the previous year. In 2012, of the nine major lenders for which we can calculate two years of ROCE, seven lenders saw ROCE levels below those of 2011; one lender, [✂], improved ROCE and one lender, [✂], reduced levels of negative ROCE from [✂] to [✂] per cent.

107. We have calculated reported and adjusted ROCE for three lenders:[36] Wonga, Dollar online and CashEuroNetUK. Our adjusted returns are based on the following estimates:

    (a) Wonga EBIT excludes the full £[✂]. The adjusted [✂] is likely to be an overestimate because [✂]. Wonga has not, however, provided a breakdown of this charge and the level of ROCE representative of the business on a fully comparable basis prior to the introduction of this charge is, therefore, likely to lie somewhere between [✂] and [✂] per cent in [✂].

    (b) Dollar online excludes inter-company management charges.

    (c) CashEuroNetUK excludes inter-company management charges.

108. In analysing the recent trend in returns we note that the drivers of year on year changes are not uniform for all lenders. Factors affecting returns in 2012 include both margin deterioration due to cost increases (which may be outside the control of

[35] [✂]
[36] [✂]

management), as well as the dilution effect of retained earnings increasing the capital base of profitable companies (which may reflect management discretion).

Parties' views on the approach to profitability analysis

109. We sought views from the parties on the approach to profitability analysis. Several parties commented that profitability analysis should incorporate economic adjustments to include the intangible value of investments in the business such as a skilled labour force, brand value, the customer base and IT systems.

110. Wonga told us that it considered customer relationships and know-how to be assets with significant value. Wonga also told us that [✂].

111. CashEuroNetUK stated that it had not undertaken an economic analysis of profitability relevant within the context of a competition investigation. Such an analysis should, CashEuroNetUK noted, take into account a thorough valuation of the economic capital base which may include (but would not limited to) the intangible value of the business arising from skilled labour, brand, customer base, IT and other elements of the business it has invested in; sufficient working capital that reflects the uncertainties of the business; and assets which are stated in the statutory accounts.

112. The other major lenders did not make submissions on adjustments to capital values relating to intangible assets. For detailed comments from major lenders regarding the approach to profitability analysis, see Appendix 3.

113. Wonga also suggested other profitability analysis including expected probability-weighted risk-adjusted returns, returns made by other low capital-intensive industries and overseas payday lending. In the absence of any evidence submitted, we have not conducted any analysis in these areas.

114. Wonga told us that comparing an ex ante concept of the cost of capital with an ex post measure of out-turn profitability was particularly inappropriate for start-up companies. [✂]

Benchmarks for profitability

115. We typically use the return required by investors for the risk involved in having capital invested in the business (also expressed as the opportunity cost to investors of not being able to invest that capital elsewhere) as a benchmark for interpreting profitability analysis. We have estimated a preliminary cost of capital for consumer lending, which may provide an appropriate benchmark for considering the levels of profitability observed for the major lenders over the last five years. We are considering other benchmarks which may also be appropriate, or more appropriate, as relevant comparators for the levels of profitability observed.

116. Differences between returns and the cost of capital may be explained by innovation and successful risk taking by firms. Our guidelines recognize that at particular points in time the profitability of some firms may exceed what might be termed the 'normal' level. There could be several reasons, including cyclical factors, transitory price or other marketing initiatives, and some firms earning higher profits as a result of past innovation, or superior efficiency.[37] We will give further consideration to how these factors affect our interpretation of any observed gap between returns and the cost of capital; and how they affect our interpretation of differences in profitability between firms. A key factor in this consideration will be the extent to which material investment risks have been taken and, where possible, our expectation of the future evolution of profitability.

[37] *CC3*, paragraph 117.

117. Any profit gap observed between returns and an appropriate benchmark may be an indicator of competitive conditions in the market. We will consider the extent to which judgements on the relative maturity or immaturity of the payday lending market are relevant for the interpretation of our profitability analysis. Some of the major lenders are very new businesses; however, there are signs that the growth of revenue, operating profit and returns for more established lenders may be slowing.

Estimating the cost of capital

118. We have calculated a preliminary cost of capital for a consumer lending business using the Capital Asset Pricing Model (CAPM). The CC's guidelines[38] refer to CAPM as a widely understood technique with strong theoretical foundations.

119. In considering the appropriate costs of equity and debt for the major payday lenders, there are several factors which mean that our calculations cannot be made with complete accuracy:

(a) None of the high street payday lenders have the supply of payday lending as its only activity—non-payday products accounted for between 44 and 96 per cent of company revenue in 2012. The existence of these other activities means that the corporate entity's cost of capital may be different from that of its payday lending operations.

(b) Data on betas is limited because of the 11 major lenders only H&T is listed. The parent companies of Dollar, CashEuroNetUK, Ariste and The Cash Store are listed, but the share price performance of parent companies is likely to be affected by investors' perception of group profits, including prospects of the significant non-payday and non-UK operations of these parent companies.

(c) The cost of debt for a company is largely determined by its credit rating. A company with a higher credit rating can borrow more cheaply than one with a

[38] *CC3*, Annex A, paragraph 16.

lower rating. Credit ratings are only available for DFC, which is rated B[39] by S&P, and The Cash Store, which is rated Caa2[40] by Moody's and CCC[41] by S&P.[42] Coupon rates for recent debt issues by parent companies include a 3.25 per cent DFC convertible bond; a 5.75 per cent unsecured Cash America bond; and a private placing by The Cash Store in January 2012 at 11.5 per cent.

(d) Debt capital raised and provided by overseas parent companies to UK payday lending operations may be made available on more favourable terms or additional interest could be added to cover costs. These terms could have changed over the period under review. Parties told us that raising debt capital for payday lenders was difficult and we note that DFC postponed its proposed $650 million bond issue in November 2013.[43]

120. Our preliminary calculation of the average pre-tax nominal WACC for the period 2008 to 2012 is between 8 and 13 per cent. This is derived from an average pre-tax cost of equity of between 9 and 13 per cent, a pre-tax cost of debt from 5 to 11.5 per cent, and gearing of 32 per cent. Our preliminary estimate of the post-tax cost of equity is from 7 to 10 per cent. The detail of the calculations is set out in Appendix 4.

Parties' views on the cost of capital

121. We sought views from the parties on the cost of equity and the cost of capital. There was little similarity in the opinions of the major lenders on the cost of equity and several parties told us that estimates were not routinely made in this area.

[39] Obligations rated B rating by S&P are judged to be more vulnerable to adverse business, financial and economic conditions but currently having the capacity to meet financial commitments: www.standardandpoors.com/ratings/definitions-and-faqs/en/us.
[40] Obligations rated Caa by Moody's are judged to be speculative of poor standing and are subject to very high credit risk: www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_79004.
[41] Obligations rated CCC by S&P are judged to be currently vulnerable and dependent on favourable business, financial and economic conditions to meet financial commitments.
[42] Bloomberg.
[43] Bloomberg.

122. Of those major lenders which provided figures for the cost of equity, estimates ranged from 12.7[44] to over 40 per cent,[45] with some concentration around 18 to 19 per cent.[46] Of the major lenders which provided figures for WACC, estimates ranged from 9.85 per cent pre-tax to 18 per cent post-tax. For detailed views of parties, see Appendix 5.

123. We requested target rates of return from five venture capital companies which had provided start-up capital to [✄]. We received two replies, both of which indicated that target returns were [✄] initial invested capital under a successful scenario.

124. [✄]

125. Accel Partners invested £5.6 million in Wonga in June 2009, at which point Wonga had 2009 planned revenues of £11 million, and a small positive cash flow. Accel told us that in making investments in fledgling technology companies it targeted a return of at least [✄] invested capital and historically had to wait an average of [✄] before it saw any return from an investment. Accel provided additional capital of £14 million to Wonga and told us that it 'maintained a return expectation of [✄] aggregate invested capital in a scenario where the company executes well, but with potential for significant upside beyond that in a successful scenario, and still being hopeful for the targeted [✄]'.

126. We have also sought information on returns achieved by private equity and venture capital managed funds as a potential benchmark against which to consider the returns achieved by the major lenders. The BVCA[47] Private Equity and Venture

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[44] [✄]
[45] [✄]
[46] [✄]
[47] The BVCA—The British Private Equity and Venture Capital Association—is the industry body for the UK private equity and venture capital industry. The BVCA had membership of over 500 and stated that it represented the overwhelming majority of UK-based private equity and venture capital providers and advisers as well as fund investors.

Capital Performance Measurement Survey 2012,[48] produced in association with PwC and Capital Dynamics, contains information on 510 UK-managed funds. The survey shows that the ten-year annual internal rate of return (IRR) for the funds in the survey was 15 per cent. Five-year returns for UK private equity and venture capital funds were 6 per cent. The survey notes, however, that private equity and venture capital are long-term illiquid asset classes, and as such, the since-inception IRR is the most appropriate metric to use when looking at their performance. Returns on this basis were around 15 per cent, with a low of 13 per cent in 2004 and a high of 17.3 per cent in 2007. Returns for venture funds at least four years old for the 2002 to 2008 'post bubble' vintages showed a pooled average since inception IRR of –1.4 per cent, with the top decile funds returning 15.7 per cent a year.

[48] http://bvca.co.uk/Portals/0/library/Files/News/2013/PMS%202012%20full%20report.pdf.

APPENDIX 1

Companies list and scope of submissions

Lenders which sent financial questionnaire and template are as follows:

(a) Ariste Holding Limited;

(b) CashEuroNetUK;

(c) CFO Lending;

(d) Cheque Centres Limited;

(e) Dollar—MEM, EFL, ICL;

(f) Global Analytics;

(g) Harvey & Thompson Limited (H&T Pawnbrokers);

(h) MYJAR (formerly known as Txtloan);

(i) SRC Transatlantic Limited /WageDayAdvance Limited;

(j) The Cash Store Limited; and

(k) Wonga—WDFC UK.

Revenue forecasts

1. We asked the major lenders for their view on future market growth:

   (a) CashEuroNetUK said that it believed the short-term loan market had matured, [✂].

   (b) Dollar provided forecast data for 2015 and 2016 based on a high-level planning projection and noted that given the uncertainty of any possible outcomes from the CC review, as well as any outcomes of the FCA consultation, it it did not consider this data to be reliable. With regard to future growth of the market, Dollar said that it did not feel it had a good basis on which to provide an estimate of the growth of payday lending and lenders for the next three years. It said that market maturity was difficult to define and even more challenging to project and told us that it believed that some level of consolidation in the market was still to come.

   (c) Wonga noted that the industry was relatively immature, likely to be in a transitional growth phase, and that the period over which data had been requested by the CC (namely 2008 to 2012) was unlikely to be sufficient to allow the CC to reach a reasonable conclusion as to whether profitability was 'persistently' above the competitive benchmark.

   (d) Ariste provided forecast revenue growth of [✂] and said that it believed the demand for short-term loans would continue to remain high due to: *(a)* the banks would need a long time to repair their balance sheets; and *(b)* protracted inflation for many years. Ariste suggested that the industry was not mature as it had only been in operation for around six years.

   (e) Cheque Centres said that it expected the market to contract but did not have specific metrics available.

   (f) Global Analytics considered that the payday loan market in the UK was mature and estimated that for 2013 growth in lending and revenue would be [✂] per cent

for the industry, and a range of [✄] to [✄] per cent for 2014, followed by [✄] per cent for 2015 to 2016.

(g) MYJAR told us that when considering the size of addressable market for payday loans, it looked at overdrafts and viewed the market as very large and getting bigger. It forecast growth rates of [✄] per cent a year and expected that annual loan volumes of £2 billion currently would rise to £[✄] billion over the next few years.

(h) The Cash Store did not consider that the payday loan market was mature and anticipated that the market would become mature on a timescale of five to ten years.

Views from parties on the approach to profitability analysis

Wonga

1. Wonga said that a number of factors would be important to take into account when measuring profitability of the business, including:

   (a) *The life cycle of the business.* The CC should recognize that Wonga's business had been in a growth phase in recent years, having only been established in 2006. Therefore, estimates of profitability over a snapshot period of time (eg over the period 2008 to 2012 consistent with the requirements stipulated by the CC for the financial template) were unlikely to be a reliable indicator of future or average/ steady-state profitability.

   (b) *Profitability in the context of innovation markets.* Wonga had developed a business model which was successfully challenging established lending models (including those of the much larger mainstream banks). However, many aspects of the model were novel or unproven at the outset and the performance of the business could therefore have easily turned out very differently.

   (c) [✄]

   (d) *Impact of low capital intensity.* The short-term credit sector operated with lower capital intensity compared with some other consumer finance sectors. This implied that economic adjustments (such as valuing and including intangible assets in the asset base) may have a particularly material impact on profitability estimates.

2. In addition to the points above, Wonga told us that it considered adjustments to the capital base to be likely to be required to reflect intangible assets which had not been included in the statutory accounts but which nonetheless represented capital assets employed to support the development of future income. Wonga had not carried out a detailed assessment of intangible assets for the purpose of responding to the finan-

cial questionnaire. However, in order to assist the CC, Wonga noted that it had incurred each of the following costs in order to develop its future earning potential:

(a) staff training costs;

(b) recruitment costs;

(c) customer acquisition costs

(d) IT costs relating to development of software/hardware or 'know-how' not already capitalized;

(e) knowledge of customer creditworthiness;

(f) costs incurred before incorporation including foregone opportunities;

(g) start-up losses;

(h) regulatory compliance costs; and

(i) business continuity costs.

CashEuroNetUK

3. CashEuroNetUK stated that it had not undertaken an economic analysis of profitability relevant within the context of a competition investigation. Such an analysis should, CashEuroNetUK noted, take into account a thorough valuation of the economic capital base which may include (but would not limited to) the intangible value of the business arising from skilled labour, brand, customer base, IT and other elements the business it had invested in; sufficient working capital that reflected the uncertainties of the business; and assets which were stated in the statutory accounts. [✂]

4. Dollar said that over the last 24 months profitability had been negatively affected by regulatory and self-regulatory actions, marketing channel restrictions and payment

processor operating requirement changes, as well as general increases in operating costs. In response, the business had increased prices.[49]

[49] Dollar told us that one of the price increases by EFL was subsequently reversed and that Dollar companies had also run price promotions during the period. [✂]

Preliminary calculations of the cost of capital for UK payday lenders

1. This appendix sets out our preliminary estimate of the cost of capital for a consumer lending business in the UK using the CAPM. The CC's Guidelines[50] refer to CAPM as a widely understood technique with strong theoretical foundations.

2. The WACC is calculated using weights and costs of equity and debt in an appropriate capital structure. We calculate an estimate of pre-tax WACC on a nominal basis as this is the appropriate figure for comparison with historical ROCE. Historical ROCE is based on the accounting data of the major lenders, which has not been adjusted for the effects of inflation. We calculate the cost of equity on both a nominal post-tax basis because ROE is stated on a post-tax basis, and on a nominal pre-tax basis for inclusion in pre-tax WACC.

Estimating the cost of capital

3. Our preliminary calculation of the average pre-tax nominal WACC for the period 2008 to 2012 is between 8 and 13 per cent. This is derived from an average pre-tax cost of equity of between 9 and 13 per cent, a pre-tax cost of debt from 5 to 11.5 per cent and gearing of 32 per cent. Our preliminary estimate of the post-tax cost of equity is from 7 to 10 per cent. The detail of the calculations is set out below.

[50] CC3, Annex A, paragraph 16.

TABLE 1 **Estimates of WACC parameters**

	per cent	
	Low	*High*
RFR	3.0	4.0
ERP	4.0	5.0
Equity beta (number)	1.0	1.2
Cost of equity (post-tax)	7.0	10.0
Tax	25	25
Cost of equity (pre-tax)	9.3	13.3
Debt premium	2.0	7.5
Cost of debt (pre-tax)	5.0	11.5
Gearing	32	32
WACC	**7.9**	**12.7**

Source: CC calculations.

4. The pre-tax WACC is calculated from the following formula:

$$WACC = ((1 - g) \times Ke \times (1/(1 - t)) + (g \times Kd)$$

Where:

g is the gearing level (debt divided by the sum of debt and equity)

Ke is the cost of equity

Kd is the pre-tax cost of debt

t is the tax rate (weighted average for the major lenders)

5. Each of the elements of WACC is discussed below.

Gearing and capital structure

6. Our analysis of information submitted by the major lenders indicates that across the period the weighted average gearing of the major lenders was 32 per cent. We refer to gearing as the percentage (debt/debt + equity) based on the book values of debt and equity submitted by parties. We have not attempted to incorporate market values of debt or equity for the major lenders due to the difficulties of obtaining data relevant to analysis in this area.

7. Our analysis indicates that gearing for the selected consumer lending comparables included in Table 2 (where full data is available for the period 2008 to 2012) averaged 37 per cent based on historic book debt and historic market capitalization figures from Bloomberg. The current gearing of these companies is 39 per cent, based on the book value of debt and market value of equity as at 4 February 2013.

The cost of equity

8. We estimate the cost of equity following the CC's market investigation guidelines which state that we generally look to the CAPM when considering the cost of capital, but have regard to alternative models where appropriate[51]. There are limitations to the availability of data for this analysis and the nature of the payday lending industry suggests that a wide range of estimates is appropriate.

9. The CAPM postulates that the opportunity cost of equity (Ke) is equal to the risk-free rate (RFR) plus the equity risk premium (ERP) multiplied by beta, where beta measures the extent to which the price of a particular share fluctuates with the market (referred to as systematic risk or non-diversifiable risk, ie the sensitivity of returns to market returns).

ERP and RFR estimate

10. The ERP, calculated as the market return (Rm) less RFR, is the additional return that investors require to compensate them for the risk associated with investing in equities, rather than in risk-free assets.

11. The ERP is not directly observable from market data because the future payout from equities, unlike that on bonds held to maturity (other than in respect of default risk), is uncertain. In the past, the CC and sector regulators have used two methods to esti-

[51] CC3, Annex A, paragraph 16.

mate the ERP: historical data showing the difference between the realized return on equities over the RFR; and forward-looking data relating to investors' current expectations of the ERP.

12. The arithmetic average of historical market returns over the last 112 years suggests a real market return (Rm) of around 7 per cent; Fama and French's evidence suggests a long-run real market return of 5.5 per cent, with a short-run return (since 1950) of 4.5 per cent, although with less extensive statistical data. Forward-looking approaches suggest a market return of 5.5 to 6.5 per cent. Based on this evidence, it would seem reasonable to use a range for the real market return of between 5 and 7 per cent.

13. Using a range for real Rm of between 5 and 7 per cent results in a range for the ERP of 4 to 5 per cent, based on the low-end Rm of 5 per cent minus the low end of the range of real RFR of approximately 1 per cent and the high end of the estimate of Rm of 7 per cent less the high end of the real RFR of approximately 2 per cent.

14. We estimate the nominal RFR for use in our WACC calculation referencing UK gilt yields as they have negligible default risk and forecast CPI as a measure of expected inflation over the period. In previous investigations we have taken the view that long-dated index-linked gilt yields are in principle the most suitable basis for estimating the RFR as they match the long (indefinite) maturity nature of equities. We have, however, tended to use medium-term gilt yields rather than long-term yields, as long-dated index-linked gilts have been affected by distortions (associated with, for example, pension fund dynamics). Assuming that the market return is likely to be more stable than the ERP and taking Rm of 5 to 7 per cent indicates an RFR of 3 to 4 per cent.

Beta estimate

15. The beta of a share measures the exposure of the company to systematic risk. It is only this form of 'non-diversifiable' risk for which investors require compensation. Non-systematic risk ('company-specific risk') can be diversified by investors. Hence it is only systematic risk that is relevant to the cost of equity of a company.

16. Data on betas is limited because, of the 11 major lenders, only H&T is listed. Additionally, as noted above, none of the high street listed lenders have the supply of payday lending as its sole operation. This means that the beta for the UK payday lending business may differ from the company beta. We have therefore sought to use beta values for a variety of consumer lending businesses, shown in Table 2.

17. The observed beta range from Bloomberg for the period 1 January 2008 to 30 June 2013, taking account of weekly, daily and quarterly data, and examining both raw and adjusted betas, indicates a range for the median estimate of 1.0 to 1.2.

18. There are a variety of financial year ends included in our financial analysis. We have therefore also examined beta values for the period January 2008 to December 2012 (as the majority of lenders use a December year end) and July 2008 to June 2013 (Dollar uses a June year end). Bloomberg data indicates that average beta values for daily, weekly and quarterly time periods and for both raw and adjusted beta over these time periods ranged from 0.8 to 1.2, which is very similar to the range we include in our preliminary WACC calculation.

19. In its own calculations of WACC, Dollar used a beta of [✂] (relevered using a 34 per cent tax charge) for its UK operations (high street and online) for the financial year to June 2013, and [✂] and [✂] for 2012 and 2011 respectively which falls [✂] the

range of observed betas above. [✂] used a beta of [✂] based on a peer[52] average of [✂]. We note that Advance America is no longer listed, having been acquired by Grupo Elektra. H&T submitted a WACC calculation as at 7 October 2013 based on a comparable levered beta of [✂].

20. We are considering whether any other companies should be included in our comparator companies for any updated beta estimates. This will depend on our assessment of these companies' business models and the extent to which they are comparable to the major lenders. We will also assess trading volumes in judging whether our beta estimates should be updated to incorporate these companies as a valid proxy for the unquoted major lenders.

[52] [✂]

TABLE 2 **Comparable consumer lending metrics**

Name	*Weekly Beta adj*	*Daily Beta adj*	*Quarterly Beta adj*	*Weekly Beta raw*	*Daily Beta raw*	*Quarterly Beta raw*	*Beta relative index*	*Gearing 2008–2012 (%)*	*Debt (local) current*	*Market cap (local) current*	*Free float*	*PE Trailing LTM*
Cash America Intl Inc	1.1	1.0	1.2	1.2	1.0	1.3	SPX Index	31	739,989,000	1,014,193,312	97	9.2
DFC Global Corp	1.4	1.1	1.1	1.5	1.2	1.1	SPX Index	56	1,042,000,000	275,274,936	97	
Ezcorp Inc-Cl A	1.1	1.1	0.9	1.1	1.1	0.9	SPX Index		247,299,000	597,463,989	93	8.3
H&T Group Plc	0.4	0.4	0.7	0.1	0.1	0.5	UKX Index	26	34,000,000	58,913,843	92	5.4
Cash Store Financial, The	0.7	0.5	0.6	0.5	0.3	0.4	SPTSX Index		128,367,000	18,801,840	72	
Cash Converters Intl Ltd	0.7	0.7	1.3	0.6	0.6	1.5	AS51 Index	11	70,928,052	370,883,407	95	10.4
First Cash Finl Svcs Inc	0.9	0.9	0.5	0.8	0.9	0.2	SPX Index		190,352,000	1,400,202,067	93	17.0
Provident Financial Plc	0.7	0.7	0.5	0.6	0.5	0.2	UKX Index	42	1,201,400,000	2,267,613,027	99	14.7
Regional Management Corp	0.9	0.9	1.5	0.9	0.8	1.7	SPX Index		292,379,000	417,466,066	89	14.8
World Acceptance Corp	1.2	1.3	1.1	1.3	1.4	1.2	SPX Index	25	400,250,000	1,087,163,110	75	10.9
Capital One Financial Corp	1.7	1.6	1.7	2.0	1.8	2.0	SPX Index	62	39,739,000,000	39,441,849,000	99	9.1
American Express Co	1.4	1.4	1.6	1.5	1.5	1.8	SPX Index	57	60,000,000,000	88,163,040,000	100	16.8
High	1.7	1.6	1.7	2.0	1.8	2.0						
Low	0.4	0.4	0.5	0.1	0.1	0.2						
Median	1.0	1.0	1.1	1.0	1.0	1.2		37				
S&U Plc	0.4	0.4	0.7	0.2	0.4	0.7	UKX Index		20,574,000	212,936,986	25	17.7
QC Holdings Inc	0.9	0.7	0.9	0.8	0.7	0.9	SPX Index		28,154,000	37,659,497	24	7.8
MCB Finance Group Plc	0.3	0.3	0.4	0.0	0.3	0.4	UKX Index		28,915,284	6,987,553	40	
Albemarle & Bond Holdings	0.4	0.4	0.7	0.1	0.4	0.7	UKX Index		43,501,000	4,498,164	57	1.3

Source: Bloomberg and CC analysis.

21. Within a CAPM framework, changes in gearing affect equity betas.[53] All other things being equal, a higher level of gearing will increase risk to both debt and equity holders, causing them to demand a higher return in exchange for making capital available. Hence, it may be necessary to adjust for gearing differences in order to make comparisons between equity betas, for example by calculating the asset beta (ie the beta at zero gearing). As discussed in paragraph 6, our review of Bloomberg data indicates that gearing levels for the major lenders and the consumer lending comparables have not diverged significantly over the period. Our preliminary assessment of the appropriate beta is therefore based on the equity betas for the comparable companies in Table 2.

Cost of debt

22. The cost of debt can be calculated as the sum of the RFR and the debt premium; however, when assessing historical costs on a nominal basis it can also be observed using actual debt costs. Our review of information submitted by parties indicates a range of debt costs of zero to 13.6[54] per cent between 2011 and 2012/13. If we exclude interest-free inter-company loans at the bottom of the range and the top-end estimate (which includes capital leases and other obligations as well as senior secured debt) from our analysis, this indicates a range of around 2 to 12 per cent for the cost of debt submitted by parties.

23. In assessing the cost of external debt, we have looked at credit ratings and recent corporate bond issues. Credit ratings are only available for DFC, which is rated B by S&P and The Cash Store, which is rated Caa2 by Moody's and CCC by S&P.[55] Coupon rates for recent debt issues by parent companies include a 3.25 per cent

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[53] The theory behind adjusting betas for gearing differences is that a company's exposure to systematic risk increases for a given increase in fixed costs (eg interest payments on debt). As a result, the beta of a company increases as debt costs increase. This also applies to operating lease payments as they increase fixed costs, although they are not shown on the balance sheet.
[54] [✂]
[55] Bloomberg.

DFC convertible bond; a 5.75 per cent unsecured Cash America bond; and a private placing by The Cash Store in January 2012 at 11.5 per cent. Excluding data on the convertible bond,[56] we consider that a range of 5 to 11.5 per cent is a suitable reflection of the likely cost of debt for the period under review.

Tax

24. Our analysis of data submitted by parties indicates a weighted average tax rate of 25 per cent for the major lenders for the period 2008 to 2012.

[56] Coupon rates on convertible bonds may be lower given the expectation of equity issuance at maturity.

Parties' views on the cost of equity and cost of capital

1. We sought views from the parties on the cost of equity and the cost of capital:

   (a) Wonga told us that it did not routinely estimate its cost of equity or capital as part of any evaluation process. Wonga noted that:

   > the cost of capital is an ex ante concept of the required return of equity and debt investors whereas the profitability results the CC will 'presumably' calculate are likely to be based on outturn data or, in other words, be an ex post measure and that a comparison of out-come returns with the cost of capital is particularly inappropriate for start-up companies or immature industries where outcome returns could differ from the cost of capital for a variety of reasons. For example, it could reflect superior innovation, efficiency or quality. The CC itself has recognised the fact that difference between profit-ability and the cost of capital do not necessarily reflect market power.

   (b) Dollar provided internal analysis calculating the cost of equity for 2013 as [✂] per cent post-tax and [✂] per cent post-tax for online and high street lending respectively and the cost of capital for 2013 as [✂] per cent post-tax and [✂] per cent post-tax for online and high street lending respectively.

   (c) CashEuroNetUK assessed its cost of equity for [✂] and WACC [✂].

   (d) Global Analytics (Lending Stream) said that, based on a shareholder base that favoured venture capital firms, its cost of equity could be between [✂] and [✂] per cent given return expectations over a five-year time horizon on a nominal pre-tax basis and estimated its cost of debt at [✂] per cent. The company told us that it was likely that the cost of equity had gone down over the past six years and suggested that a Series A/B investor might be looking for a [✂] return on

investment, while a Series C/B investor might be seeing a [✂] return. Global Analytics also said that its cost of debt capital had [✂].

(e) MYJAR said that, based on conversations with potential investors in the sector, it believed the cost of capital to be [✂] (pre-tax) and that private equity investors sought returns of [✂].

(f) The Cash Store told us that [✂] had determined a cost of [✂]. The company considered this to be a reasonable proxy for its UK operations [✂].

(g) H&T calculated its cost of debt at [✂] per cent post-tax and cost of equity at [✂] per cent post-tax (7 October 2013) and said that it did not believe that these costs had changed substantially over the last six years. It suggested that it might be appropriate to include a small company premium of around 1 to 2 per cent to the cost of equity for payday loan companies. It said that it was likely that new equity investment in the payday loans market would bear a substantial cost, certainly [✂] per cent net a year.

(h) Some of the parties provided coupon rates for loans from banks and parent companies, including [✂] which told us that it had a £50 million facility at a margin of between 1.25 and 2.25 per cent over LIBOR, and [✂].

Accounting issues and process of data collection for profitability analysis

1. This appendix identifies the key accounting issues considered and the approach taken in performing our preliminary profitability analysis (see process of data collection at Annex A). Our detailed review has focused on financial information for the prior two financial years.

2. Where significant differences between accounting policies have been identified, and an adjustment considered necessary, this has been discussed in the profitability analysis above.

Naming conventions

3. Throughout this paper a combination of company and trading names are used, particularly where two brands operate under one company. To clarify:
   - 'Wonga' refers to the UK operation (WDCF UK) unless stated.
   - The Cheque Centres Group Limited refers to both Cheque Centre (high street) and Cheque Centre (online). These have also been split out where necessary.
   - Global Analytics, the parent of Lending Stream and Zebit, is only referred to as Global Analytics.
   - SRC Transatlantic is split between SRC and WageDayAdvance and is not referred to as one company.
   - This appendix has been prepared for the 2011 and 2012 financial years. For Dollar Financial companies, '2012' refers to the financial year ended 30 June 2013 and '2011' to 30 June 2012.

Accounting standards

4. The first difference to be recognized between companies is the set of accounting standards each use. These are based on where the company is physically registered and whether they are listed on a stock exchange. Of the 11 companies included in the profitability analysis, three different sets of accounting standards are used:

   (a) UK Generally Accepted Accounting Practice (UK GAAP): this applies to UK-registered companies only. Although these will be very similar to US GAAP and IFRS, these rules were designed for smaller companies and therefore have less disclosure and reporting requirements.

   (b) International Financial Reporting Standards (IFRS): any company listed on the London Stock Exchange or Alternative Investment Market (AIM) must comply with IFRS. These are accounting rules set by an international body and used around the world to prepare financial statements. They are designed for larger businesses therefore non-listed UK companies can choose to apply UK GAAP or IFRS.

   (c) United States Generally Accepted Accounting Practice (US GAAP): This set of accounting rules only applies to companies registered within the USA. Listed companies must also comply with the Sarbanes-Oxley Act (SOX) and Security and Exchange Commission (SEC) rules.

5. The above sets of accounting rules are very similar and all have the same major requirements such as the use of accrual accounting and similar revenue recognition policies. Differences do remain, however, including how items are capitalized, the disclosures required and how calculations, such as the doubtful debts provision, are made.

TABLE 1 **Accounting standards by company**

Company	*UK GAAP*	*IFRS*	*US GAAP*
Ariste	✓		
CashEuroNet			✓
CFO Lending	✓		
Cheque Centres Group Limited	✓		
Dollar	✓		
Global Analytics			✓
H&T		✓	
MYJAR	✓		
SRC	✓		
The Cash Store			✓
WageDayAdvance	✓		
Wonga		✓	

Source: CC analysis of data provided by parties.

Accruals versus cash accounting

6. The accruals basis is an accounting method whereby income and expense items are recognized and entered into the books as they are earned or incurred, even though they may not have been received or actually paid in cash. The accruals basis aims to match income with expenses.

7. The other main accounting method, the cash basis, only recognizes transactions when cash is received from customers or paid to suppliers. The primary difference between these methods is timing—both record the same transaction for the same amount, but they may be recorded in different accounting periods.

8. Under the accruals basis, interest revenue from a loan is generally recognized over the life of the loan, rather than at the beginning or end of the lending period. In practice, this means that interest revenue can be spread across multiple accounting periods. For example, where an accounting period is one 30-day month and the loan period is 45 days, interest revenue for the first 30 days will be recorded in the first

month, and interest revenue for the remaining 15 days recorded in the second month.

9. Under the cash basis, interest revenue would only be recorded when cash was received. If interest and principal were to be repaid together at the end of the lending period, no interest revenue would be recognized until this point. Using the example above, the total interest income on a 45-day loan would only be recorded in month 2, when cash is received. It would not be recorded across both months.

Recognizing interest revenue

10. There are two accrual accounting revenue recognition methods used by the payday lending companies reviewed in this investigation:

    (a) Accrued Interest method. Interest income is recognized as revenue as it is earned over the life of the loan. The corresponding amount is added to the customer's outstanding balance, increasing the total loan receivable asset.

    (b) Deferred Income method. Under this method, the expected interest receivable on a loan is recognized/recorded at the same time as the principal, ie before it has been earned. The corresponding amount can be recorded as a liability, taken directly to revenue, or recorded as a reduction of the asset:

    (i) Deferred income liability: the corresponding amount to the interest receivable asset is recorded as a liability on the balance sheet, creating a nil effect. As interest is earned over the life of the loan, the revenue is recognized in the profit and loss statement (P&L) and the liability decreased until all revenue is recognized and the liability is nil.

    (ii) Revenue: the interest receivable is recorded as revenue in the P&L although it has yet to be earned. At the end of the accounting period an adjustment is made to the balance sheet and P&L for any unearned revenue. This is very

similar to the above method except the adjustment is only made at period end, rather than when interest is incurred.

11. For an illustrative example of how interest revenue would be recorded under each method, and how this would affect the balance sheet and P&L, see Annex B.

TABLE 2 **Interest revenue recognition methods by company**

Company	*Accrue interest*	*Defer income*
Ariste	✓	
CashEuroNet		✓
CFO Lending		
Cheque Centres Group Limited		
Dollar		✓
Global Analytics	✓	
H&T	✓	
MYJAR	✓	
SRC		✓
The Cash Store	✓	
WageDayAdvance	✓	
Wonga	✓	

Source: CC analysis of data provided by parties.

Note: [✂].

Other revenue

12. As well as interest, payday lenders also charge a variety of fees such as loan origination, late fees and non-sufficient funds fees. The latter fees are usually grouped into 'default fees and interest' and can be treated differently from origination fees:

(a) Loan origination fees: In line with the interest revenue policies above, we noted that companies recorded these in two ways: allocated over the expected life of the loan, or recognized immediately.

(b) Default fees and interest: these can also be recognized differently but are primarily recognized as revenue only when it is likely that the amount will be recovered.

TABLE 3 **Loan origination fees and default fees and interest recognition policies by company**

Company	*Loan origination*			*Default fees and interest*		
	Accrue/defer with interest income	*Immediate recognition*	*When received*	*When expected to be recovered*	*Immediate recognition*	*When received*
Ariste	✓			✓		
CashEuroNet	✓			N/A		
CFO Lending		✓		N/A		
Cheque Centres Group Limited		✓			✓	
Dollar		✓				✓
Global Analytics			✓			✓
H&T	✓			N/A		
MYJAR		✓			✓	
SRC		✓		N/A		
The Cash Store	✓				✓	
WageDayAdvance	✓					✓
Wonga	✓			✓		

Source: CC analysis of data provided by parties.

Notes:
1. For H&T this table applies to the payday loan products only. Interest and fee revenue for the instalment loan (KwikLoan) is only recognized when cash is received. [✂]
2. N/A = information not supplied.

Provisions for doubtful debt (expense item charged to the profit and loss account)

13. The provision for doubtful debt is an accounting estimate of the portion of a debt that may not be collected, and is taken to recognize credit risk and ensure that assets are not overstated. The provision is recorded against the loan book in the balance sheet with the year-on-year movement an expense in the P&L. Although all sets of accounting standards require this provision, neither include a specific accounting standard on how it must be calculated. This is left to management's judgement, with the provision usually based on historical collection patterns. It is the largest expense in the P&L, and therefore has a significant impact on net profit.

14. Payday loans are not individually significant enough for impairment provisions to be assessed on a case-by-case basis, therefore they are usually grouped. This can be done in any number of ways but is usually on similar credit risk characteristics, such as number of days in arrears, loan size or month in which the loan was made.

15. Given that each payday loan company is different, they will have their own unique provisioning policy based on assumptions and rates relevant to their own loan book. This makes comparing the doubtful debt expense between companies difficult as the percentages used to create the provision, and how the loan book is assessed, differs across lenders.

16. For further clarification on how the provision for doubtful debts is calculated, and its impact on the P&L and balance sheet, see Annex C for an illustrative example.

17. On reviewing the doubtful debt provisions, we found that there were two distinct groups when providing for doubtful debts:

    (a) Provide for both principal and accrued interest. Evidence submitted showed that this can be presented as one provision or as two separate provisions, depending on whether companies can separate their loan book between accrued interest and principal.

    (b) No doubtful debt provision is calculated. Several companies do not prepare a calculation for doubtful debts at period end. Instead, they have a strict write-off policy where any overdue debt, both principal and interest, is immediately written off to the doubtful debts provision. Therefore the doubtful debts expense in the P&L will be 100 per cent overdue debt, less any funds subsequently recovered.

TABLE 4 **Method of providing for doubtful debts, by company**

Company	Provide for doubtful debts?	Method: Principal and interest	Method: Overdue debts only
Ariste	[✂]	[✂]	[✂]
CashEuroNet	[✂]	[✂]	[✂]
CFO Lending	[✂]	[✂]	[✂]
Cheque Centres Group Limited	[✂]	[✂]	[✂]
Dollar	[✂]	[✂]	[✂]
Global Analytics	[✂]	[✂]	[✂]
H&T	[✂]	[✂]	[✂]
MYJAR	[✂]	[✂]	[✂]
SRC	[✂]	[✂]	[✂]
The Cash Store	[✂]	[✂]	[✂]
WageDayAdvance	[✂]	[✂]	[✂]
Wonga	[✂]	[✂]	[✂]

Source: CC analysis of data provided by parties.

Note: H&T only provides for principal on KwikLoan products. Cheque Centres Group Limited charges a flat fee on its loans rather than interest. For analysis purposes, we have included this fee as interest income.

TABLE 5 **How provisioning and loan information was presented to the CC in the financial template**

	Expense		*Balance sheet provision*		*Gross loan book*	
Company	*Separate expense for interest, separate expense for principal*	*Expense recorded together*	*Principal and interest together*	*Separate provision for interest, separate provision for principal*	*Principal only*	*Principal and interest*
Ariste	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
CashEuroNet	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
CFO Lending	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Cheque Centres Group Limited	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Dollar	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Global Analytics	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
H&T	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
MYJAR	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
SRC	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
The Cash Store	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
WageDayAdvance	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Wonga	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]

Source: CC analysis of data provided by parties.

Note: Ariste has only provided for principal and interest since April 2012.

18. Given the above differences, any comparison of the doubtful debts provision and expense for each company must be considered carefully. The majority of provision-

ing policies are based on assumptions and rates relevant to each loan book, which is in turn influenced by company lending and collection policies.

19. The provision for doubtful debt calculations received from the companies varied greatly in detail. While some were able to provide full calculations, showing percentages applied to overdue debt by number of days, and a breakdown between accrued interest and principal, others provided an average percentage used across the loan book, with no explanation of how it differed by the age of the loan.

20. In order to illustrate the impact assumptions have on the provision for doubtful debts, we have taken the percentages applied to overdue debt for each company and applied these to a hypothetical loan book. As shown in Annex D, these assumptions lead to large variations in the doubtful debt provision required, and ultimately revenue.

21. Due to the importance of the loan book and doubtful debt provisions for our analysis, we requested that companies confirm that the total new lending and loan collection activity recorded in the financial template was for principal only. All companies confirmed that this was correct, except for [✂] and [✂], indicating that their figures for total new lending and loan collection activity also included accrued interest. No response was received from [✂].

22. Given the impact the provision expense has on profit, we also looked at how it affects tax calculations. Lenders are most likely to be covered by the HMRC's loan relationship rules, which cover 'money debt, arising from a transaction for the lending of money'.[57] These rules outline that debt write-offs can only be claimed as deductible expenses when the expense is from an impairment loss or the company has

[57] HMRC guidance: *CFM30140 – Loan relationships: a short guide: the meaning of 'loan relationships.*

released all or part of the debt. Any expense related to the revaluation of debt, ie the costs of a general doubtful debts provision, cannot be claimed.[58] This means that only debts the company is certain will not be paid, and has written off, can be included as an expense in its tax calculation. As has been shown, the majority of companies analysed in this paper do calculate a general provision. However, it will not affect taxable profit.

Write-offs

23. Unlike the provision for doubtful debts, a write-off, or bad debt, is an amount the company knows will not be collected. Each company will have its own criteria for when a loan is written to bad debts, which can include time spent in arrears or knowledge of the customer's circumstances, such as bankruptcy or death.

24. When loans are written off, this expense can be treated in two ways. A bad debt, an amount the company is certain will not be collected and has not provided for, will be recorded as an expense in the P&L. Other write-offs will not go through the P&L as they have already been provided for in the provision for doubtful debts expense. Rather, the provision for doubtful debts recorded in the balance sheet will decrease, as will the loan book.

25. It is possible for cash to be recovered even when a loan has been written off for accounting purposes. Indeed, many finance companies will 'write off' a loan for accounting purposes while actively trying to recover the debt. When this occurs, the cash received can either be recorded as revenue or as a reduction to the bad debt expense already incurred.

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[58] HMRC guidance: *CFM41040 – Deemed loan relationships: money debts other than discounts: trade debts: restrictions on write-down.*

TABLE 6 **Write-off policies by company**

Company	*Number of days after default that loan written off*
Ariste	[✄]
CashEuroNet	[✄]
CFO Lending	[✄]
Cheque Centres Group Limited	[✄]
Dollar: MEM	[✄]
Dollar: Express Finance	[✄]
Dollar: Instant Cash Loans	[✄]
Global Analytics	[✄]
H&T	[✄]
MYJAR	[✄]
SRC	[✄]
The Cash Store	[✄]
WageDayAdvance	[✄]
Wonga	[✄]

Source: CC analysis of data provided by parties.

26. Again, the difference between policies makes the provision for doubtful debts expense difficult to compare. Write-offs and recoveries will be much higher for a company writing off loans on default than one which waits 180 days.

Information technology systems and website assets

27. Given the importance of information in providing payday loans, many companies have spent considerable amounts building loan-writing software and websites. All three sets of reporting standards applied by the companies (UK GAAP, IFRS, US GAAP) allow expenses incurred in developing software, including websites, to be capitalized as an asset and depreciated over its economic useful life. It is also worth noting that companies using UK GAAP must record capitalized development costs as tangible (fixed) assets, while IFRS and US GAAP allow these as intangible assets. However, all three sets of standards state that any research costs must be expensed.

28. UK GAAP, US GAAP and IFRS all have a specific research and development accounting standard identifying when research ends and development begins. However, this is often more difficult to separate in practice and the standards are open to interpretation, therefore some companies have stricter capitalization policies

than others. For example, WageDayAdvance does not capitalize staff costs, often a significant proportion of development costs, while others do.

29. In addition to capitalization policy disparities, other differences relating to IT systems can affect cost comparisons between companies. Some companies do not own their software, using parent company systems or a third party provider. How parent company software is recorded differs between companies, as some are charged licensing fees while for others it is included in management charges. Where specific UK adjustments are made to the system, these can also be capitalized or expensed. Depreciation policies for capitalized assets will also impact total costs.

30. Table 7 shows which companies capitalize IT expenditure and where this is recorded on the balance sheet. Where possible, the amount capitalized and expensed in 2012 is also recorded.

TABLE 7 **Information technology systems and websites accounting policies by company**

Company	*IT systems held on balance sheet?*	*Tangible or intangible asset?*	*Amount capitalized 2012 £'000*	*Amount expensed 2012 £'000*
	[✂]	[✂]	[✂]	[✂]
Ariste	[✂]	[✂]	[✂]	[✂]
CashEuroNet	[✂]	[✂]	[✂]	[✂]
CFO Lending	[✂]	[✂]	[✂]	[✂]
Cheque Centre (high street)	[✂]	[✂]	[✂]	[✂]
Cheque Centre (online)	[✂]	[✂]	[✂]	[✂]
Dollar: MEM	[✂]	[✂]	[✂]	[✂]
Dollar: Express Finance	[✂]	[✂]	[✂]	[✂]
Dollar: Instant Cash Loans	[✂]	[✂]	[✂]	[✂]
Global Analytics	[✂]	[✂]	[✂]	[✂]
H&T	[✂]	[✂]	[✂]	[✂]
MYJAR	[✂]	[✂]	[✂]	[✂]
SRC	[✂]	[✂]	[✂]	[✂]
The Cash Store	[✂]	[✂]	[✂]	[✂]
WageDayAdvance	[✂]	[✂]	[✂]	[✂]
Wonga	[✂]	[✂]	[✂]	[✂]

Source: CC analysis of data provided by parties.

[✂]
Note: All companies will have expensed some portion of IT costs.

Inter-company management fees and charges

31. The largest payday lenders within the investigation are all subsidiaries of larger corporations. As such, they are charged management fees or other inter-company charges from the parent company, which can cover a variety of costs. Depending on what these charges relate to, including or excluding them from our analysis could be misleading and create distortions.

32. When reviewing the inter-company charges, we distinguished two categories:

    (a) *Direct costs.* Charge directly relates to providing payday loans. For example, some companies outsource customer service activities to another subsidiary within the group. Such charges are often calculated using a driver such as number of loans written and are therefore attributable to providing payday loans. Although these costs can be directly traced, they still need to be evaluated to ensure that the value is reflective of the activities involved, and the allocation method is comparable to prior periods.

    (b) *Indirect costs.* Charge indirectly relates to providing payday loans. Parent companies often allocate a portion of corporate overheads to other companies within the group, such as group director fees or internal audit. These are usually allocated on a pro-rata basis, like proportion of group revenue, and not directly related to individual activities. Including these inter-company charges could distort profitability if they are not a true reflection of the costs incurred in providing payday loans.

TABLE 8 **Inter-company management fees and charges by company**

Company	*Management fees charged?*	*2012 amount £'000*	*Allocation basis*	*From*	*For*
Ariste	[✂]	[✂]	[✂]	[✂]	[✂]
CashEuroNet	[✂]	[✂]	[✂]	[✂]	[✂]
CFO Lending	[✂]	[✂]	[✂]	[✂]	[✂]
Cheque Centre (high street)	[✂]	[✂]	[✂]	[✂]	[✂]
Cheque Centre (online)	[✂]	[✂]	[✂]	[✂]	[✂]
Dollar: MEM	[✂]	[✂]	[✂]	[✂]	[✂]
Dollar: Express Finance	[✂]	[✂]	[✂]	[✂]	[✂]
Dollar: Instant Cash Loans	[✂]	[✂]	[✂]	[✂]	[✂]
Global Analytics	[✂]	[✂]	[✂]	[✂]	[✂]
H&T	[✂]	[✂]	[✂]	[✂]	[✂]
MYJAR	[✂]	[✂]	[✂]	[✂]	[✂]
SRC	[✂]	[✂]	[✂]	[✂]	[✂]
The Cash Store	[✂]	[✂]	[✂]	[✂]	[✂]
WageDayAdvance	[✂]	[✂]	[✂]	[✂]	[✂]
Wonga[59]	[✂]	[✂]	[✂]	[✂]	[✂]

Source: CC analysis of data provided by parties.

33. Another issue raised by management fees and inter-company charges is the way in which they are allocated. For example, where the expense is based on personnel expenses, it is not known whether this is an appropriate indicator of activity. Management fees can also be a way of shifting costs to more profitable from less profitable businesses to take advantage of differing tax rates. This is where transfer pricing agreements are used.

34. Transfer pricing is primarily applied by multinational companies providing goods and services between subsidiaries in different tax jurisdictions. In order to stop profits being moved to countries with lower tax rates, transfer pricing ensures that prices charged between related parties are similar to those charged between unrelated parties.[60] Guidance on the principles of transfer pricing and accepted calculation methods are outlined in the OECD's Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, which is used internationally for tax

[59] [✂]
[60] HMRC guidance, *INTM412040 – Transfer pricing: legislation: rules: the arm's length principle*.

legislation.[61] HMRC frequently undertakes audits of transfer pricing and can recalculate the tax provisions if it believes that calculations are incorrect.[62]

Financing

35. As cash-intensive businesses, access to finance is extremely important to payday loan companies. During our review we identified two primary means of funding: inter-company borrowings and shareholder loans. This makes comparisons between the interest expense, and potentially profits, for each company more difficult. Interest rates and repayment terms between group companies ('internal funding') may not be based on the cost of borrowing for the lender. It could be more favourable to the borrowing company, or additional interest could be added to cover costs. It should also be noted that the parent companies of these groups operate in different countries, affecting their access to credit which in turn will affect the interest rate charged.

36. Of the 11 companies analysed, only two have external sources of finance. The majority of independent companies have raised cash through equity or debt issuance.

37. Inter-company funding may also have an impact on cash flows as it is possible that no physical payment of interest is made. It is common for subsidiary companies in any industry to accrue interest as it is incurred but add the amount owing to the total loan payable. No cash is physically paid to the lender. This is an important difference between those with external and internal funding, as companies with external sources of finance would be contractually obliged to pay.

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[61] ibid.
[62] ibid.

TABLE 9 **Financing arrangements by company for the financial year 2012**

Company	*Source of financing*	*Outstanding amount £'000*	*Interest rate*	*Interest expense £'000*	*Repayment terms*
Ariste	[✂]	[✂]	[✂]	[✂]	[✂]
CashEuroNet	[✂]	[✂]	[✂]	[✂]	[✂]
CFO Lending	[✂]	[✂]	[✂]	[✂]	[✂]
Cheque Centre (high street)	[✂]	[✂]	[✂]	[✂]	[✂]
Cheque Centre (online)	[✂]	[✂]	[✂]	[✂]	[✂]
Dollar: MEM	[✂]	[✂]	[✂]	[✂]	[✂]
Dollar: Express Finance	[✂]	[✂]	[✂]	[✂]	[✂]
Dollar: Instant Cash Loans	[✂]	[✂]	[✂]	[✂]	[✂]
Global Analytics	[✂]	[✂]	[✂]	[✂]	[✂]
H & T	[✂]	[✂]	[✂]	[✂]	[✂]
MYJAR	[✂]	[✂]	[✂]	[✂]	[✂]
SRC	[✂]	[✂]	[✂]	[✂]	[✂]
The Cash Store	[✂]	[✂]	[✂]	[✂]	[✂]
WageDayAdvance	[✂]	[✂]	[✂]	[✂]	[✂]
Wonga	[✂]	[✂]	[✂]	[✂]	[✂]

Source: CC analysis of data provided by parties.

[✂]

Allocation of expenses

38. In order to assess the financial performance of payday lenders, we need to consider the extent to which the revenue and costs analysed are related to payday loans rather than other products. This can be difficult to ascertain where companies offer more than one loan product. For example, many high street lenders will also offer other services such as pawnbroking or foreign currency. While revenue is often recorded by product, costs may be more difficult to attribute to products, and the total cost of running a store, such as rent and staff, would need to be allocated across the products offered.

39. Expenses are often allocated based on the revenue generated by a product, but it is also an area of judgement. We compared payday lending costs submitted by parties as a proportion of total costs with payday revenue as a proportion of total revenue. For these calculations we have excluded the provision for doubtful debts expense as this is a direct cost, and in most cases has already been verified with other documentation. We would expect the expense and revenue proportions to be similar.

TABLE 10 **Proportion of payday revenue and costs as a proportion of total revenue and costs excluding the doubtful debt expense as submitted by parties**

per cent

Company	*Payday expenses as a percentage of total expenses*	*Payday revenue as a percentage of total revenue*
Ariste	[✂]	[✂]
CashEuroNet	[✂]	[✂]
CFO Lending	[✂]	[✂]
Cheque Centre (high street)	[✂]	[✂]
Cheque Centre (online)	[✂]	[✂]
Dollar: MEM	[✂]	[✂]
Dollar: Express Finance	[✂]	[✂]
Dollar: Instant Cash Loans	[✂]	[✂]
Global Analytics	[✂]	[✂]
H&T	[✂]	[✂]
MYJAR	[✂]	[✂]
SRC	[✂]	[✂]
The Cash Store	[✂]	[✂]
WageDayAdvance	[✂]	[✂]
Wonga	[✂]	[✂]

Source: CC analysis of data provided by parties before adjustments outlined in the profitability paper.

Process of data collection

1. This annex summarizes the process we have followed to obtain financial information from the major payday lenders for use in our profitability analysis.

Stage 1: Design and issue of the financial questionnaire

2. We prepared a financial questionnaire and a financial template to gather financial information from 11 major payday lenders.

3. The Excel template contained one sheet comprising integrated summary financial statements—profit and loss, balance sheet and a simplified cash flow statement, and further detailed notes relating to various line items in the financial statements. The template requested financial information for five historical years and three forecast years.

4. The financial questionnaire included 54 questions on a variety of topics. These included company background, ownership structure, accounting principles, lending and collection processes, communication with customers, write-off and provision policies, cost allocation, cost of capital and growth predictions. Payday loans were defined to direct parties to the information required, and the CC specified that only UK operations were to be included.

5. The questionnaire and Excel template were issued as a draft on 5 September 2013 and we allowed parties four days to review and provide comments on the structure and content.

6. We updated the questionnaire and template to reflect parties' comments and incorporate other modifications that we felt appropriate, and issued a final version to the parties on 16 September 2013.

7. We allowed parties four weeks to respond and make submissions. During the response period we notified parties of minor modifications to the template.

Stage 2: Review and clarification

8. Between October and November we reviewed the submissions to our questionnaire and template. Where possible, we verified the information provided in the template for the last two financial years to management accounts provided by the entity, or publicly available financial statements from Companies House. We also reviewed the submitted information for any unusual relationships or movements to seek to identify if any input errors had been made.

9. As the financial template was being verified, we also noted the set of accounting standards used by each company, important accounting policies and any information on inter-company transactions, funding and intangible assets. The accounting policies considered important for our analysis were revenue recognition, provision for doubtful debts, bad debt write-offs and capitalization of intangible assets.

10. Each individual template was copied into one spreadsheet, the aggregation file. This made comparisons between companies easier and allowed for the calculation of totals and percentages. It also allowed for the standardizing of the latest financial year. Each company has a different financial year end, from February to December, although the majority are December. To ensure that information was comparable and no distortion would arise through timing differences, any year-end dates falling

between July 2012 and June 2013 were treated as '2012' for the purposes of our analysis.

11. On 28 November we issued further questions (supplementary questions) to parties. These primarily related to:

(a) information provided in the financial template which could not be verified from the management accounts or financial statements. We requested a reconciliation, explanation or updated information in order to complete the verification process;

(b) explanations for unusual movements between accounts, such as those between the doubtful debt expense and gross loan book;

(c) requests for the provision for doubtful debts calculation, in order to understand the method used to calculate the provision, including the percentages applied;

(d) information regarding accounting policies where this was not clear from the financial questionnaire or financial statements; and

(e) questions confirming where amounts disclosed in the financial template relating to the loan book and doubtful debts provision included principal and/or accrued interest.

Several companies were also asked to resubmit the template due to incomplete information or the exclusion of divisions required for our analysis.

12. The majority of replies to supplementary questions were returned the first week of December. Where additional financial information had been received, this was used to verify figures in the financial template. Any new or updated financial templates were verified again using the process outlined above and added to the aggregation template with a comment on the change. Further information on accounting policies, or explanations for unusual movements, were noted with the original information.

13. Doubtful debt provision calculations were reviewed to understand how they worked and whether accrued interest was included. We also agreed the loan book, total

provision calculated and any provision expense to the financial template. The findings from this review are included in our analysis on the provision for doubtful debts.

14. Following a review of the supplementary questions, further questions were issued to several companies. The majority of these were questions which had not been answered in the original financial questionnaire, template or supplementary questions. Explanations were also requested where new information had been provided which did not agree with the financial template. These questions were issued ad hoc as they arose but were primarily sent mid-December and received back in early January.

Illustrative comparison between accrued interest, deferred income and immediate recognition accounting methods

Loan amount: £100

Interest: 25% per month

Loan period: 2 months

For simplicity, no other fees are charged

P&L: Profit and loss

BS: Balance sheet

Step 1: Loan is provided to customer in cash, receivable accounts created

General Ledger account	*Accrued Interest method*	*Deferred income: deferred liability*	*Deferred income: revenue*
Loan receivable asset	↑£100 (BS)	↑£100 (BS)	↑£100 (BS)
Interest receivable asset	-	↑£50 (BS)	↑£50 (BS)
Deferred revenue liability	-	↑(£50) (BS)	-
Interest revenue	-	-	↑(£50) (P&L)
Cash on hand	↓£100 (BS)	↓£100 (BS)	↓£100 (BS)
	Only the loan principal is recognized as an asset because no interest income has been earned yet	The loan principal and expected interest from the loan are recognized immediately. However, as no interest revenue has actually been earned, it is also recorded as a liability	The loan principal and expected interest from the loan are recognized immediately. The interest revenue is recognized at the same time as the receivable
Summary: Loan provided			
Total loan and interest receivable	100	150	150
Total deferred revenue liability	-	(50)	-
Total revenue	-	-	(50)

Step 2: Interest revenue recognized at the end of month 1

General Ledger account	**Accrued Interest method**	**Deferred income: deferred liability**	**Deferred Income: Revenue**
Loan receivable asset	-	-	-
Interest receivable asset	↑£25 (BS)	-	-
Deferred revenue liability	-	↓£25 (BS)	↑(£25) (BS)
Interest revenue	↑(£25) (P&L)	↑(£25) (P&L)	↓(£25) (P&L)
	One month of interest revenue has been earned and recognised, creating an interest receivable account in the balance sheet	One month of interest revenue has been earned and can now be recognised. This increases interest revenue and decreases the liability	An adjustment is required at period end for any unearned revenue. As two months of revenue have been recorded but only one month has been earned, revenue for the second month is treated as a liability and removed from revenue for the period
Summary: End of month 1			
Total loan and interest receivable	125	150	150
Total deferred revenue liability	-	(25)	(25)
Total revenue	(25)	(25)	(25)

Step 3: Interest revenue recognized at the end of month 2

General Ledger account	*Accrued Interest method*	*Deferred income: deferred liability*	*Deferred income: revenue*
Loan receivable asset	-	-	-
Interest receivable asset	↑£25 (BS)	-	-
Deferred revenue liability	-	↓£25 (BS)	↓£25 (BS)
Interest revenue	↑(£25) (P&L)	↑(£25) (P&L)	↑(£25) (P&L)
	The second month of interest revenue is earned and recognized, increasing the interest receivable and interest revenue accounts	The second month of interest revenue is recognized, leaving the deferred revenue account at 0	The second month of interest revenue has now been earned, therefore the deferred revenue liability created in month one is reversed and revenue recognized
Summary: End of month 2			
Total loan and interest receivable	150	150	150
Total deferred revenue liability	-	-	-
Total revenue	(50)	(50)	(50)

Step 4: Repayment			
General Ledger account	*Accrued Interest method*	*Deferred income: deferred liability*	*Deferred income: revenue*
Loan receivable asset	↓£100 (BS)	↓£100 (BS)	↓£100 (BS)
Interest receivable asset	↓£50 (BS)	↓£50 (BS)	↓£50 (BS)
Deferred revenue liability	-	-	-
Interest revenue	-	-	-
Cash on hand	↑£150 (BS)	↑£150 (BS)	↑£150 (BS)
	The loan principal of £100 and interest expense of £50 is repaid in cash, decreasing the loan and interest receivable assets and increasing the bank account.		
Summary: After repayment			
Total loan and interest receivable	-	-	-
Total deferred revenue liability	-	-	-
Total revenue	(50)	(50)	(50)

Cash Flow effect			
	Accrued Interest method	*Deferred income: deferred liability*	*Deferred income: revenue*
End of month 1	Cash out £100	Cash out £100	Cash out £100
End of month 2	Cash in £150	Cash in £150	Cash in £150

Although the three revenue recognition methods outlined above record revenue and loan assets at different times, the period-end balances will be the same across all methods.

Illustrative example of relationship between the doubtful debt provision, balance sheet and profit and loss

This is to clarify how the doubtful debts provision is calculated, and its impact on the balance sheet and profit and loss statement.

Beginning of year 1

- Gross loan book: £200,000
- Year-end doubtful debts provision: £5,000

Step 1: Calculate the doubtful debts provision required for the year
Management believe that based on historical rates, 15% of the loan book will not be collected

Doubtful debts provision required: £30,000

Step 2: Calculate the additional doubtful debt provision expense for the year

Required doubtful debts provision:	£30,000
Current doubtful debts provision:	£5,000
Difference	£25,000

The additional £25,000 will be recorded in the P&L as the doubtful debts expense.

Effect on profit

Revenue	£400,000
Less doubtful debt expense	£25,000
Gross profit	£375,000

Step 3: The value of the loan book in the balance sheet will be shown net of the provision for doubtful debts

The loan book will be presented as £170,000:

Gross loan book	£200,000
Less provision for doubtful debts	£30,000
Net loan book	£170,000

During year 1

Gross loan book: £225,000
Doubtful debts provision: £30,000
Bad debts: £10,000

Step 1: Write-off the bad debts from the loan book
Loan book: ↓£10,000 to £215,000

Step 2: Deduct the bad debts from the doubtful debts provision
Doubtful debts provision: ↓£10,000 to £20,000

No additional expense is recorded in the P&L as these loans were already caught in the doubtful debts provision made at the beginning of the year.

The loan book will be presented as:

Gross loan book	£215,000
Less provision for doubtful debts	£20,000
Net loan book	£195,000

End of year 1

- Gross loan book: £250,000
- Doubtful debts provision: £20,000

Step 1: Calculate the doubtful debts provision for the year
Management have reviewed their assumptions and now believe that 10% of the loan book will not be collected

Doubtful debts provision required: £25,000

Step 2: Calculate the additional doubtful debt provision expense for the year

Required doubtful debts provision:	£25,000
Current doubtful debts provision:	£20,000
Difference	£5,000

The additional £5,000 will be recorded in the P&L as the doubtful debts expense.

Effect on profit

Revenue	£400,000
Less doubtful debt expense	£5,000
Gross profit	£395,000

Step 3: The value of the loan book in the balance sheet will be shown net of the provision for doubtful debts

The loan book will be presented as £225,000:

Gross loan book	£250,000
Less provision for doubtful debts	£25,000
Net loan book	£225,000

Illustration of the impact different assumptions used in the provision of doubtful debts calculation have on revenue and the net loan book

TABLE 11 **Hypothetical loan book**

Aging category	*Total loan book*	*Principal*	*Interest*
Current	[✂]	[✂]	[✂]
1–15 days	[✂]	[✂]	[✂]
16–30 days	[✂]	[✂]	[✂]
31–60 days	[✂]	[✂]	[✂]
61–90 days	[✂]	[✂]	[✂]
91–120 days	[✂]	[✂]	[✂]
121–150 days	[✂]	[✂]	[✂]
151–180 days	[✂]	[✂]	[✂]
	[✂]	[✂]	[✂]

[✂]

TABLE 12 **Results by company**

Company	*Provisioning method*	*Provision required (D)*	*Net loan book (A) – (D)*	*Provision expense (E) = (D) – (C)*	*Revenue post-provision charge (B) – (E)*	*Provision as % of loan book (D)/(A)*	*Expense as % of revenue (E)/(B)*
Ariste	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
CashEuroNet	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
CFO Lending	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Cheque Centres (high street)	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Cheque Centres (online)	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Dollar: MEM	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Dollar: Express Finance	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Dollar: Instant Cash Loans	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Global Analytics	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
H&T	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
MYJAR	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
SRC	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
The Cash Store	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
WageDayAdvance	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Wonga	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]