Response of Wonga Group Limited to CC working paper on the profitability of payday lending companies

14 March 2014

1 EXECUTIVE SUMMARY

1.1.1 This submission sets out Wonga Group Limited's (**"Wonga"**) response to the Competition Commission's (**"CC"**) Profitability Working Paper (**"WP"**). Wonga has commissioned a report from its economic consultants, AlixPartners UK LLP (**"AP"**), which examines the profitability of Wonga and the industry, and which highlights certain measurement and interpretation issues relevant to the CC's analysis. The AP report is included as an annex to this response. In addition to the key messages highlighted below, Wonga raises a number of specific points in response to the Revenues and Costs, Returns and Benchmarks sections of the WP in the following sections of this response.

The payday industry is facing increasing competitive and regulatory pressures, leading to a collapse in returns

1.1.2 While the WP notes that some firms' level of profitability fell in 2012 compared with 2011, it appears to put little weight on this (noting that part of the reason may reflect management discretion in the level of retained earnings) (WP §102). In fact, a detailed assessment of actual returns for 2013 and forecasts for 2014 demonstrates that the sector is already experiencing, and will continue to face, significant changes. For example:

(a) The significant competitive pressures facing the sector are having a real and immediate impact on Wonga. The trend of significant revenue growth which had been experienced up to 2012 was reversed in 2013, and an even deeper fall is anticipated in 2014. This reflects increasing pricing pressure (**[CONFIDENTIAL]**);

(b) Wonga's market share is under pressure from competitive rival product offerings **[CONFIDENTIAL]**. Wonga has had to respond to this threat by **[CONFIDENTIAL]**); and

(c) Regulatory changes announced by the FCA (including limits to the use of Continuous Payment Authority ("CPA"), rollovers and the price cap due to be introduced from 2015) are also forecast to have significant cost and revenue implications.

1.1.3 Taking all of these factors into account, Wonga's EBIT for its UK payday lending business **[CONFIDENTIAL]** in 2012 to **[CONFIDENTIAL]** in 2013. It is forecast to **[CONFIDENTIAL]** in 2014. Economic return on capital is similarly **[CONFIDENTIAL]** rapidly, from **[CONFIDENTIAL]** in 2012 to **[CONFIDENTIAL]** in 2013 and **[CONFIDENTIAL]** in 2014. This is outlined in more detail in Section 3 of this response. Wonga considers that similar challenges are being faced by rivals in the sector, as illustrated by DFC's latest UK lending data showing a fall in revenue of 17.7% year on year for the three months to December 2013.[1]

1.1.4 Even if the CC finds evidence of excess profits based on its historic assessment, the significant changes in the sector already taking place are likely, therefore, to remove any such concerns. This trend is entirely consistent with a sector characterised by innovation and low barriers to entry: Wonga performed strongly in the growth phase, having developed an attractive proposition which served the needs of customers well (as is evidenced by Wonga's world class net promoter score). Other firms have since improved their performance and caught up, leading to increased focus on pricing and very significant downward pressure on returns.

The CC's WP overstates the returns earned by Wonga in 2012

1.1.5 The CC concludes that Wonga's 2012 return on capital employed basis ("ROCE") is likely to be somewhere between**[CONFIDENTIAL]** and **[CONFIDENTIAL]**. The range reflects **[CONFIDENTIAL]**. For the purpose of this submission, Wonga has allocated the costs (**[CONFIDENTIAL]**) attributable to **[CONFIDENTIAL]** and has identified that around **[CONFIDENTIAL]** of costs (in 2012), which the CC proposes to strip out from its analysis, should be retained in the calculation of accounting returns. At the same time, Wonga has taken account of other adjustments to reflect the underlying economics of the UK lending entity, including adjusting for **[CONFIDENTIAL]** which were undertaken to ensure that **[CONFIDENTIAL]**, but which relate to balances were in fact serving the ongoing working capital needs of the UK lending business.[2] The resulting 2012 accounting ROCE is estimated to be **[CONFIDENTIAL]**.

1.1.6 More fundamentally, the CC has not sought to examine the extent to which relevant economic adjustments should be made to accounting measures of profitability (even though it recognises that they may be potentially relevant) (WP §12). The AP report identifies a number of approaches to addressing this issue, including assessments of intangible assets such as customer acquisition costs, staff training costs, and other economic adjustments, which reflect the nature of the payday lending business. The total value of intangible assets under the preferred valuation approach is estimated to be **[CONFIDENTIAL]** in 2012, which compares to the average value of capital employed on an accounting basis of just over **[CONFIDENTIAL]** (i.e. the capital base is increased by a significant proportion in 2012 when a reasonable measure of intangible assets is incorporated.)

[1] CC Working Paper, Paragraph 27
[2] The revised P&L and Balance sheet information are summarised in Annex 1 and the changes are described in more detail in Section 2.

1.1.7 AP finds that the 2012 ROCE would **[CONFIDENTIAL]** (on a purely accounting basis with an adjustment to allocate costs within the service charge) to around **[CONFIDENTIAL]** once these adjustments are made.

In assessing historical profitability, it is essential that the CC takes account of the rapid development of the payday market

1.1.8 Wonga considers that the CC cannot draw any meaningful conclusions regarding the nature of competition in the payday market on the basis of findings that, historically, financial performance has been relatively strong through the period considered by the CC (2008 to 2012) where this reflects factors which are specific to a particular phase of industry development and which are not expected to continue. In particular: (i) financial performance for the period 2008 to 2012 provides no meaningful insight as to the current state of competition in the market; (ii) even where overall financial performance may be strong, variation between lenders is a strong indicator of vigorous competition; and (iii) in innovative markets which have emerged recently and are continually evolving, any strong performance by particular lenders must be assessed by reference to ex ante risks, and the need to reward superior innovation and efficiency. These points are considered in turn below.

1.1.9 The period 2008 to 2012 represented a period where leading operators developed a disruptive business model. The significant competitive and regulatory changes which have occurred since 2012 mean that financial performance over the period 2008 to 2012 provides no meaningful insight as to the current state of competition in the market. For example, Wonga's EBIT **[CONFIDENTIAL]** in 2013 compared with 2012, and is forecast to **[CONFIDENTIAL]** further in 2014.

1.1.10 Furthermore, as the CC itself acknowledges, there has been a wide range in the financial performance of payday operators. It notes that some firms have earned negative returns over the period in question. The AP report finds that, on average, the financial performance of the sector has been **[CONFIDENTIAL]** (when measured using ROCE) **[CONFIDENTIAL]**, and that there has been significant variation across firms. This variation in performance is consistent with a competitive sector in which firms must seek to develop attractive products, offer value for money, and ensure they are efficient and rigorous in their credit assessment if they are to achieve competitive success (and lend responsibly). The dispersion of financial performance is consistent with a market where firms are competing to develop the best business model to serve the customer.

1.1.11 Whereas many of the sectors investigated by the CC may be mature, the payday lending market has grown quickly from a very low base over the period examined by the CC. This makes any comparison of performance against a benchmark such as the weighted average cost of capital for consumer credit firms highly problematic. Wonga's business model was unproven, there was significant investment risks facing the company at establishment, and its success could not have been easily predicted at the time it was raising start-up capital.

1.1.12 It is also important to recognise that factors such as efficiency and innovation can lead to firms earning returns above the cost of capital for a period of time. Wonga considers that, from the outset, it has been a leading innovator in the sector, both in terms of its ability to develop an attractive proposition for customers – many of whom have access to alternative sources of short term credit and have consistently given Wonga world-class 'net promoter' ratings – but also in achieving industry-leading repayment rates reflecting the strong performance of its proprietary credit risk-assessment models.

1.1.13 While there is no doubt that Wonga has become a successful enterprise, the CC must ensure that it adjusts for the risk of 'survivorship bias' in its assessment of Wonga's performance. This can be done by looking at the returns that venture capitalists require on their successful investments so as to deliver overall returns for their portfolio consistent with the high risks they bear.

1.1.14 Moreover, the ROCE and return on equity ("ROE") measures relied on by the CC suffer from significant drawbacks when applied to the payday sector. Wonga's business model has relatively low capital intensity, such that even relatively modest changes in parameters such as rate of loan growth, default rates etc. can have significant effects on outturn returns. For example, had Wonga's loan loss rate been **[CONFIDENTIAL]** (still better than some firms in the sector have achieved) **[CONFIDENTIAL]**, this would have had a dramatic impact on historical EBIT. In 2012, for example, such a change in default rates could have reduced EBIT from around **[CONFIDENTIAL]** (post-service charge adjustment, on the basis of Wonga's internal assessment of EBIT for a stand-alone UK entity) to just **[CONFIDENTIAL]**. The sensitivity of Wonga's EBIT to the principal loss rate is illustrated in the figure below.

[CONFIDENTIAL]

[CONFIDENTIAL]
[CONFIDENTIAL].

The CC wrongly interprets relationships between principal loss rates and cumulative loans issued as leading to a prospective barrier to entry

1.1.15 The CC notes that an inverse relationship between principal loss rate and the cumulative number of loans issued exists. In the AIS the CC raises this in the context of its discussion of possible barriers to entry (AIS §99). Wonga disagrees with any suggestion that a higher principal loss rate for new entrants as compared to established lenders represents an insurmountable barrier (to entry or expansion). It is unsurprising that firms with fewer customers will have less experience and data to draw on when undertaking credit assessment.

1.1.16 However, to the extent that efficient entrants can anticipate improvements in this regard (and have some access to capital) they can nevertheless enter the market. In other words, higher default losses are treated like any other investment in future returns – they will be funded provided there is anticipation of sufficient future returns. Wonga's own experience shows this: it experienced high default rates in an early phase of development and earned **[CONFIDENTIAL]** prior to 2009 but as it gained experience and improved its credit assessment models, default rates began to fall.

1.1.17 Furthermore, access to relevant customer data, in particular, from CRAs has improved significantly thereby narrowing any advantage enjoyed by established lenders, with further expected developments (such as real-time credit reference data) narrowing any such advantage still further.

Conclusion

1.1.18 Wonga considers that the available evidence on industry profitability is consistent with a rapidly evolving and competitive sector. In addition, Wonga considers that the CC should carefully interpret profitability results to take into account the significance of economic adjustments to the capital base; the immature nature of the sector; the need to control for 'survivorship bias' and, above all, the major impact competitive developments and increased regulation have had, and will continue to have, on rates of return.

2 REVENUE AND COSTS

2.1.1 This section covers a number of Wonga's comments on the CC's treatment of its revenues and costs, in particular:

(a) **a like-for-like adjustment should be made for Wonga's service fee**. Wonga's service fee represents a **[CONFIDENTIAL]**, and its exclusion would therefore lead to a substantial over-statement of Wonga's rate of return for 2012 (and beyond). Accordingly, Wonga has produced like-for-like financial information from 2012 onwards that includes an **[CONFIDENTIAL]**, is set out below.

(b) **the CC's historical focus does not take account of the significant competitive and regulatory forces shaping the industry**. Trends in Wonga's forecasted revenues and costs, adjusted for the allocated service fee, are set out in more detail in this section.[3]

(c) **relationships between the principal loss rate and size or the share of repeat customers are not inconsistent with competition**. Wonga also has a number of more detailed points relating to the CC's calculations in this regard, in particular:

(i) the CC's approach to defining repeat customers, which includes new customers taking out top-ups; and

(ii) the CC's methodology for calculating Wonga's principal loss rate.

2.1.2 These comments are set out in more detail below.

2.2 A LIKE-FOR-LIKE ADJUSTMENT SHOULD BE MADE FOR WONGA'S SERVICE FEE

2.2.1 The CC sets out a discussion of Wonga's corporate restructuring in which it concludes that **[CONFIDENTIAL]**, may distort year on year comparisons for Wonga, and affect the CC's analysis of payday lending as a whole.[4] The CC presented analysis of costs and profitability which (at one end of its range) stripped out the entire service charge from the cost base of the UK entity.

2.2.2 Wonga has provided the CC with information on the basis of the service charge (which includes the **[CONFIDENTIAL]** In order to assist the CC in carrying out its profitability analysis, Wonga has undertaken an assessment of costs **[CONFIDENTIAL]**. Wonga notes that **[CONFIDENTIAL]**

[3] An analysis of 2014 returns is outlined in Section 3.
[4] CC profitability working paper, §49 onwards.

2.2.3 The service fee includes a **[CONFIDENTIAL]** Annex 2 sets out, for each cost item, **[CONFIDENTIAL]**. In particular:

(a) **[CONFIDENTIAL]**;

(b) **[CONFIDENTIAL]**;

(c) **[CONFIDENTIAL]**;

(d) **[CONFIDENTIAL]**; and

(e) **[CONFIDENTIAL]**.

2.2.4 In addition to the above adjustments, Wonga has made certain revisions to the financial template to better reflect the underlying economics of the UK lending entity over the period 2008 to 2014. These adjustments have been made to assist the CC in its analysis and are based on assumptions which, while deemed reasonable by management, have not been audited. In particular, the changes made are:

(a) **[CONFIDENTIAL]**;

(b) to make certain adjustments to revenue for the period 2008 to 2010 to better reflect IFRS principles;

(c) **[CONFIDENTIAL]**. The CC's financial template requested year-end values, and so the **[CONFIDENTIAL]**; and

(d) minor other adjustments (such as updating revenue in 2012 to reflect very minor differences between annual report and internal monthly management accounts – these are negligible and usually within 0.5% difference).

2.2.5 The overall impact of the allocation exercise is to increase the 2012 EBIT from **[CONFIDENTIAL]** (as reported in the financial template submitted to the CC) to **[CONFIDENTIAL]**. This compares to the upper value of **[CONFIDENTIAL]** included in the CC's range within the profitability working paper, **[CONFIDENTIAL]**.

2.2.6 Therefore, the effect of this adjustment on the CC's preliminary observations in its profitability working paper is as follows:

(a) in §59, the CC overstates the revised estimated operating profit growth at the industry level of 25% in 2012;[5]

(b) Table 5 should be updated for the year 2012, amending the service charge adjustment of **[CONFIDENTIAL]**;

(c) paragraphs 61 through 65 may need updating where the CC refers to industry level performance based on its adjustments;

(d) figure 7 should be revised; the revised Wonga operating margin (based on EBIT / revenues) is **[CONFIDENTIAL]** instead of **[CONFIDENTIAL]** in 2012;

(e) §86 identifies **[CONFIDENTIAL]** in total customer acquisition costs for 2012, where it is not clear how the CC has arrived at this number; and

(f) the CC's references to Wonga's ROCE (para 103 and Table 11) and ROE (paragraphs 98 and 106 and Table 10) in 2012 should be revised from **[CONFIDENTIAL]** to **[CONFIDENTIAL]** for ROCE, and from **[CONFIDENTIAL]** to **[CONFIDENTIAL]** for ROE. To be clear, Wonga considers that even these revised figures overstate profitability since they fail to take account of relevant economic adjustments which are discussed further below.

2.3 THE CC'S ANALYSIS DOES NOT TAKE ACCOUNT OF SIGNIFICANT COMPETITIVE AND REGULATORY FACTORS AFFECTING REVENUES AND COSTS

2.3.1 The CC's historical focus fails to take full account of the factors driving change in the payday sector. These are not merely 'hypothetical' or possible changes: **[CONFIDENTIAL]**.

2.3.2 The CC's working paper suggests a relatively wide range of views by operators on future market growth, for example with several operators anticipating the market to contract over the period to 2015 (§30), while some felt the market may continue to expand for a further 5-10 years (The Cash Store, Appendix 2, §1(h)). However, the CC notes that the forecasts were supplied before the FCA published its detailed proposals for the FCA regime for consumer credit, and that forecasts may therefore not be representative of current forecasts.

2.3.3 The FCA has now published its final proposals for consumer credit.[6] Amongst its proposals for the payday segment, the FCA has confirmed that it will implement its proposals to cap the use of CPA to

[5] Wonga cannot calculate the appropriate value due the redactions in the working paper.

two unsuccessful attempts, and that partial recoveries by CPA (without express consent of the customer) will not be permitted. Furthermore the FCA has confirmed it will limit the number of rollovers that a customer can take to two. The FCA has not yet formulated specific options in relation to its duty to impose a price cap on short term lending by January 2015, but expects to do so in summer 2014.

2.3.4 Changes including the trend for customers to switch to instalment loans and the regulatory changes described above are already having a significant impact (**[CONFIDENTIAL]**), and are forecast to have a further impact in 2014. In order to better understand the extent of the implications of these regulatory and competitive changes, **[CONFIDENTIAL]**.

2.3.5 The forecast produced for 2014 shows a **[CONFIDENTIAL]**. Figure 2 below shows the trend from 2009 to 2014 for each of these variables. These demonstrate the following points:

(a) principal lent and revenue had **[CONFIDENTIAL]** to 2012, **[CONFIDENTIAL]** in 2013; and

(b) the business is expected to **[CONFIDENTIAL]** in 2014, both in terms of principal lent and net revenue (both facing a **[CONFIDENTIAL]** as compared to 2013 forecasts), with **[CONFIDENTIAL]**.

[CONFIDENTIAL]

[CONFIDENTIAL]
[CONFIDENTIAL]

2.3.6 There are a number of market and regulatory developments which explain the movements above, which can be divided into revenue and cost trends.

Revenue trends

2.3.7 **Innovation and price competition from rivals** will continue to affect Wonga's revenue. This effect was apparent in 2013, with **[CONFIDENTIAL]**) as rivals such as Cash America made an early move into the instalment loan space and have been successfully exploiting this competitive advantage. **[CONFIDENTIAL]**.[7]

2.3.8 **[CONFIDENTIAL]** is expected from Wonga's **[CONFIDENTIAL]**. Wonga's development of this product was in response to both customer feedback (**[CONFIDENTIAL]**) and rival offerings. While

[6] http://www.fca.org.uk/static/documents/policy-statements/ps14-03.pdf
[7] See, e.g., Figure 8 in Wonga's response to the AIS, which shows **[CONFIDENTIAL]** quarterly net revenues for Wonga, Cash America and Dollar Financial UK in the last 12 months. Wonga expects this trend to continue, driven by increased competition, quality and innovation in the sector.

it is hoped that Wonga will benefit in the longer term through better customer retention, it is anticipated that some **[CONFIDENTIAL]**. This is evidence of a competitive market at work.[8]

2.3.9 **Competition increasingly focuses on price**, so that average prices are expected to fall over time. This includes, for example, the discounted interest rate offered to repeat customers of Sunny (depending on their trust status), and the overall pressure on prices arising from the development of instalment loans. Wonga is in the process of considering a number of pricing initiatives in response to these developments, **[CONFIDENTIAL]**). Details of these proposed changes were provided to the CC during the course of Wonga's hearing on 4 March.

2.3.10 While Wonga considers that any price cap is likely to reduce revenue yield over time, it anticipates that revenue yield will **[CONFIDENTIAL]**. While on the face of it this may appear to indicate a decrease in price pressure in the market, in fact this evidence is consistent with the increasing competitive pressures described above for two reasons:

(a) **[CONFIDENTIAL]**.

(b) **[CONFIDENTIAL]**.

Cost trends

2.3.11 Wonga's forecasts allow for two main effects associated with the FCA's proposals. Firstly, **[CONFIDENTIAL]**.

2.4 RELATIONSHIPS BETWEEN THE PRINCIPAL LOSS RATE AND CUMULATIVE LOANS ISSUED/REPEAT CUSTOMERS ARE NOT INCONSISTENT WITH COMPETITION

Higher principal loss rates for new customers do not necessarily represent a barrier to entry

2.4.1 The CC highlights in the profitability working paper that it finds 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*" (§80). It also notes, by contrast, that the relationship between the principal loss rate and time spent as a payday lender is less clear (§81).

2.4.2 While the CC does not draw any conclusions from this analysis in the WP, the annotated issues statement (AIS) comments that default costs "*make up nearly half of total industry operating costs,*

[8] It should also be noted that the **[CONFIDENTIAL]**.

suggesting that differences in lenders' ability to assess risk may have a significant impact on their ability to compete" (AIS §99).

2.4.3 Wonga refers the CC to its response to the AIS (§7.18 onwards) which addresses this issue. Wonga agrees that default rates for new customers tend to be higher than for customers with whom the lender has an established relationship and who have demonstrated an ability to repay. However, as set out in Wonga's AIS response, far from representing a barrier to entry, this merely reflects a path that all lenders (including Wonga itself, which has managed to reduce principal loss losses from **[CONFIDENTIAL]** in 2008 to **[CONFIDENTIAL]** in 2012) potentially have to traverse in order to be successful. New entrants can and have overcome this issue. Furthermore, improvements in the quality of credit reference agency data currently available (and to be made available in the near future) reduce the risks facing new and recent entrants in respect of higher default rates.

2.4.4 Wonga's more detailed comments on the CC's approach on this topic are set out below.

<u>The CC's approach to defining repeat customers</u>

2.4.5 Although no explicit mention is made of how the CC defines repeat customers in the WP, Wonga notes that elsewhere (e.g. AIS footnotes 30-31) the CC includes top-up loans in its definition of repeat lending.

2.4.6 In Wonga's case, many customers who may otherwise have taken out a larger principal (comprising the original principal and the top-up amount) may be choosing to use top-ups to manage their cashflow during the original loan period, avoiding interest on the top-up amount until the cash is required. For example, if a customer knew they required £150 now and £100 in two weeks' time, both to be repaid at the end of one month, they could avoid two-weeks' interest on a £100 top-up (or £14, less the top-up fee of £5.50), rather than incur interest from the beginning of the month on a total principal of £250. Accordingly, customers themselves may view top-ups as part of the same effective borrowing requirement as the original loan, albeit split into more than one transaction to save interest.

2.4.7 If this were the case, the CC's definition – by including these top-up amounts – could potentially overestimate the proportion of:

(a) customers who take at least one further loan with the same lender within a certain time of the previous loan (e.g. as the CC comments on in AIS §38); and

(b) revenues from repeat customers, and implicitly lenders' financial reliance on these customers.

The CC's approach to estimating Wonga's principal loss rate

2.4.8 Although Wonga agrees that the principal loss rate is a reasonable indicator of default risk, the CC's approach to calculating this does not appear to be the best method of doing so. Rather than calculating the rate as principal provided in the year divided by principal loaned in the year (i.e. Wonga's definition, which gives **[CONFIDENTIAL]** for 2012), it is calculated as cash collected in the year accounted for as principal collected divided by total new lending in the year.[9]

2.4.9 This approach gives rise to the following issues:

(a) this takes no account of cash collected on 2012 loans after the end of 2012, resulting in a potential over-statement of principal loss. Wonga notes that significant sums were received in 2013 (and even in 2014) relating to principal lent in 2012, through late customer payments, regular payments from customers (e.g. those in hardship) placed on repayment schedules, and from sales to Debt Collection Agencies. These receipts reduce the true principal loss rate.

(b) the measure of principal collected used in the numerator of the CC's calculation is not related to the same loans as measured for the denominator in the CC's calculation. Total new lending in the year (i.e. the denominator) is essentially the principal paid out to customers within a calendar year, but the repayments received from customers (i.e. the numerator) relates to loans issued over a longer period, namely October 2011 (if there were rollovers) to some loans in December 2012 (there will be some proportion of loans issues in the last quarter of 2012 that will not be collected until 2013). If the principal lent is changing year on year (e.g. as volumes shrink), the CC's approach (which does not ensure consistency between the principal lent and the repayments) will distort the principal loss rate.

[9] The CC reaches a figure of **[CONFIDENTIAL]** in 2012 for Wonga in Table 7, based on Wonga's financial template submission

3 RETURNS

3.1.1 In this section, Wonga provides its observations in relation to the CC's discussion of returns in the payday lending sector, namely:

(a) the use of ROCE and ROE to measure performance;

(b) evidence on intangible assets and economic returns;

(c) evidence on industry returns; and

(d) evidence on forward-looking returns.

3.2 THE USE OF RETURN ON CAPITAL EMPLOYED AND RETURN ON EQUITY TO MEASURE PERFORMANCE

The CC should be cautious in its use of ROCE and ROE when assessing the profitability of the payday loans sector

3.2.1 The CC presents returns using two measures: ROCE and ROE. The accounting results for capital employed (**[CONFIDENTIAL]**) are shown below in Table 3.1. Even on an accounting basis, it is clear that – **[CONFIDENTIAL]** (as set out above) – there has been a **[CONFIDENTIAL]**. Section 4 outlines some issues to be aware of when interpreting the profitability of the payday sector (or for Wonga itself) given the characteristics of the industry, its relative immaturity, and the changes which are occurring in the competitive environment.

Table 3.1: Wonga's accounting capital employed and ROCE, 2007-13

	2007	**2008**	**2009**	**2010**	**2011**	**2012**	**2013**
Capital Employe	**[CONFIDENTIAL]**	**[CONFIDENTIAL]**	**[CONFIDENTIAL]**	**[CONFIDENTIAL]**	**[CONFIDENTIAL]**	**[CONFIDENTIAL]**	**[CONFIDENTIAL]**
ROCE (%)	**[CONFIDENTIAL]**	**[CONFIDENTIAL]**	**[CONFIDENTIAL]**	**[CONFIDENTIAL]**	**[CONFIDENTIAL]**	**[CONFIDENTIAL]**	**[CONFIDENTIAL]**

Source: AP analysis of Wonga financial information

3.2.2 Wonga considers that particular caution should be taken when measuring returns using the ROE and ROCE methods, for a number of reasons:

(a) the relatively low equity and capital employed associated with the online payday lending business model leads to great sensitivity of returns to variables such as default rates. Although the CC considers the relative merits of ROE versus ROCE, it does not consider wider interpretation issues related to both. Wonga notes that its capital intensity (prior to adjusting for intangible assets) is far lower than was the case in many other CC market inquiries for financial services firms as is shown in the AP report;

(b) there are issues in identifying an appropriate benchmark against which ROCE and ROE may be compared which should ideally be based on suitable comparators in industries at a comparable point in the growth cycle. This is discussed in more detail in Section 4; and

(c) on a more detailed point, the CC comments that one of the advantages of the ROE over the ROCE measure is that a capital structure assumption is not required (§97). However, Wonga notes that some assumption on capital structure is still required when benchmarking against the cost of capital.

3.3 EVIDENCE ON INTANGIBLE ASSETS AND ECONOMIC RETURNS

Taking account of intangible assets has a significant impact on returns

3.3.1 Wonga considers that it is particularly important to take account of economic adjustments (such as the value of intangible assets not included in accounting measures of capital employed) in the payday lending sector. The relatively low level of fixed capital assets employed within the sector, particularly for online lenders such as Wonga, means that intangible assets may be proportionately greater than is the case in many other sectors.

3.3.2 The CC notes that it has typically accepted the merits of adjusting historical book values of capital employed to an economic base where there is clear evidence of a material distinction between historical and economic values (§12). The CC notes, however, that it has not received any substantial evidence (prior to publication of the working paper) in relation to intangible values.

3.3.3 Wonga has previously identified to the CC the intangible assets it considers it possesses but which are not recognised (at all or in full) on its balance sheet. These are set out in §2 of Appendix 3 of the WP and include, *inter alia*, knowledge of customer creditworthiness, staff training and customer acquisition costs. Wonga welcomes the CC’s expressed intention to review evidence on the significance of intangible assets, and refers the CC to the report it has commissioned from AP which addresses this issue in detail.

3.3.4 The AP report identifies several approaches to valuing intangible assets. AP's preferred approach consists of a bottom-up valuation of intangibles including those shown in Table 3.2 below, since these are based on identifiable and separable costs incurred by Wonga, in line with CC guidelines.[10] The total value of intangible assets identified using this approach for 2012 is **[CONFIDENTIAL]**.

Table 3.2: Wonga's economic capital employed, 2007-13

£000s	2007	2008	2009	2010	2011	2012	2013
Accounting capital employed	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]
Marketing and customer acquisition costs	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]
Knowledge of customer creditworthiness	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]
Pre-incorporation costs	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]
Staff training	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]
Recruitment	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]
Regulatory compliance and business continuity	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]
Total intangible assets	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]
Economic capital employed	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]

Source: AP analysis of Wonga financial information

3.3.5 Once adjusted for intangible assets, the economic ROCE is significantly **[CONFIDENTIAL]** the accounting ROCE, as shown in Table 3.3 below.

Table 3.3: Comparison of Accounting and Economic return on capital employed, 2007-13

	2007	2008	2009	2010	2011	2012	2013
Accounting ROCE	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]
Economic ROCE	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]

Source: AP analysis of Wonga financial information

3.3.6 The Working Paper refers to a range for Wonga's ROCE for 2012 of **[CONFIDENTIAL]**. Taking account of intangible assets leads to a **[CONFIDENTIAL]** in the 2012 ROCE for Wonga to **[CONFIDENTIAL]**.

[10] Competition Commission "*Guidelines for market investigations: Their role, procedures, assessment and remedies*" April 2013, §14, second bullet point.

3.4 EVIDENCE ON INDUSTRY RETURNS

Returns in the sector vary significantly and are [CONFIDENTIAL] than those of Wonga

3.4.1 Industry returns (adjusted for intangibles) are significantly **[CONFIDENTIAL]** those for Wonga and there is a wide dispersion of the performance of individual firms. This is consistent with a dynamic and competitive market.

3.4.2 The CC notes that ROCE has varied widely across the period from around minus 180% to above 100%[11]. The table below presents AP's estimate of accounting ROCE for the sector. Analysis of accounts for specific lenders by AP[12] demonstrates that returns on an accounting basis have ranged between lenders from **[CONFIDENTIAL]** for 2012 and from **-[CONFIDENTIAL]** over the overall period of analysis. While the results from this analysis are illustrative since they do not correct for different approaches to providing for bad debts, they support the analysis of the CC and demonstrate firstly that average accounting returns at the sectoral level are **[CONFIDENTIAL]** those of Wonga over the period considered by the CC, and furthermore demonstrate a wide range of performance. Table 3.4 provides the weighted average accounting ROCE across the firms in the AP sample, calculated as the ratio of total operating profits to total (year-average) industry capital employed. Note that public information on industry returns is only available to 2012.

Table 3.4: Industry annual accounting return on capital employed

ROCE (%)	2007	2008	2009	2010	2011	2012
Industry	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]

Source: AP analysis of public accounts for firms in the sector

3.4.3 Wonga notes that industry profitability appears to be substantially **[CONFIDENTIAL]** that of Wonga (see Table 3.1) highlighting the point made in Section 2 that single firm measures need to be interpreted carefully with due consideration to the possibility that a firm is unusually innovative, high performing or efficient etc.

3.4.4 Wonga notes that AP has applied its assessment of Wonga’s intangible assets (on a proportionate basis to accounting capital employed, i.e. by uplifting the accounting capital each year for the industry by the same proportion to that estimated in each year for Wonga) to the industry data it has compiled.. Table 3.5 below sets out AP's estimate of the resulting economic capital employed for the industry.

[11] CC Working Paper, paragraph 10.
[12] This analysis comprising data on 20 payday lending companies that report financial data to Companies House including Wonga)

Table 3.5: Industry economic capital employed, 2007-12

£m	**2007**	**2008**	**2009**	**2010**	**2011**	**2012**
Wonga	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]
Rest of payday industry	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]
Total	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]

Source: AP analysis of Wonga financial information and public accounts for firms in the sector

3.4.5 Assuming the economic adjustments relevant to Wonga are also appropriate to the industry, the table below reports AP's assessment of ROCE for the industry. Taking account of this adjustment the average over the period is **[CONFIDENTIAL]**.

Table 3.6: Industry annual economic return on capital employed

ROCE (%)	**2007**	**2008**	**2009**	**2010**	**2011**	**2012**
Industry	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]

Source: AP analysis of public accounts for firms in the sector

3.4.6 We note that, after economic adjustments, the calculated ROCEs are in a range of **[CONFIDENTIAL]** While these are **[CONFIDENTIAL]** the cost of capital that the CC provisionally estimates for the industry (of between 8 and 13%), taking account of the wider interpretation issues identified in this response, including in relation to the appropriate benchmark measure) they do not indicate any significant competitive concerns in the market.

3.5 EVIDENCE ON FORWARD-LOOKING RETURNS

Wonga anticipates that competitive and regulatory developments will have a significant impact on returns

3.5.1 For the reasons explained in Section 2 above, increased competition and regulation are likely to **[CONFIDENTIAL]** forward-looking profitability, continuing the trend already experienced in 2013. **[CONFIDENTIAL]**.[13] AP has also applied its economic adjustments based on the methodology outlined above to the 2014 forecasts. The results of this are set out in Table 3.7 below (with 2012 and 2013 included for comparison).

Table 3.7: Wonga's economic capital employed, 2012-14

[13] **[CONFIDENTIAL]**.

	2012	2013	2014
EBIT (£000s)	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]
Accounting capital employed (£000s)	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]
Economic capital employed (£000s)	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]
Accounting ROCE (%)	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]
Economic ROCE (%)	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]

Source: AP analysis of Wonga financial information

4 BENCHMARKS FOR PROFITABILITY

4.1.1 In this section, Wonga provides its observations in relation to the WP's assessment of potential benchmarks for profitability, namely:

(a) it is too soon to make an assessment of the reasonableness of profits given the relative immaturity and the dynamic nature of the sector;

(b) any assessment of profits should take account of factors such as efficiency and innovation which may enable firms to earn profits above the cost of capital for a period of time;

(c) the *ex ante* cost of capital is not an appropriate benchmark for outturn or *ex post* returns, particularly given the market is not in 'steady state'. If an assessment is going to be made, any interpretation of the reasonableness of profits should factor in the significant 'survivorship bias' that exists; and

(d) Wonga suggests that a wide range of benchmarks should be applied, including returns envisaged by VC investors under a 'successful scenario'. Wonga addresses the CC's use of evidence on the 2012 BCVA Performance Measurement Survey below.[14]

It is too soon to make an assessment of the reasonableness of profits given the relative immaturity and the dynamic nature of the market

4.1.2 Wonga notes that the industry is immature and is likely to be coming towards the end of a transitional growth phase.

4.1.3 Initial growth was rapid, reflecting successful innovation in customer service and access. The reference period used by the CC of 2008-12 therefore does not reflect a suitable period in relation to which any reasonable conclusions may be reached as to whether profitability is 'persistently' above the competitive benchmark.

4.1.4 As demonstrated by Wonga's forecasts above, lending, revenues and returns are expected to **[CONFIDENTIAL]** due to a combination of continuing and intensifying competition (**[CONFIDENTIAL]**), the forthcoming cap on the total cost of borrowing, and rising customer acquisition and collection costs. This also demonstrates the importance of examining trends in profitability and forward-looking profitability scenarios.

4.1.5 Taking account of the overall evidence, returns are consistent with what would be expected in a competitive market. The success of Wonga's innovative business model has attracted new entrants

[14] British Private Equity and Venture Capital Association.

and the development of new products, bringing pricing and other competitive factors under increased pressure.

Any assessment of profits should take account of factors such as efficiency and innovation which may enable firms to earn profits above the cost of capital for a period of time

4.1.6 The CC itself observes that "*differences between returns and the cost of capital may be explained by innovation and successful risk-taking by firms*" (WP §15). As set out in Wonga's AIS response,[15] the "*Competition in product innovation*" working paper refers to a very large volume of innovations implemented by numerous market participants, which is consistent with strong non-price competition. Significant innovations include not only greater repayment flexibility, facilities for drawing down further funds, **[CONFIDENTIAL]** and faster payment services as acknowledged in the working paper, but should also include mobile phone access and improvements to the loan approvals process. These innovations have contributed to consistently high customer satisfaction ratings for Wonga, as well as enabling it to become highly efficient (e.g. its innovative loans approval process has resulted in industry-leading repayment rates).

4.1.7 Wonga's returns must be interpreted in the context of such innovation and the continued need for innovation to ensure that Wonga remains competitive, continues to gain high customer satisfaction and is not "leapfrogged" by new products offered by rivals **[CONFIDENTIAL]**.[16] Investment in such innovation requires a reasonable return, and the resulting competitive advantage and/or superior efficiencies may enable the innovating firm to earn returns above its cost of capital over a period of time. Wonga notes that the CC acknowledges this point in §116 of the WP.

The *ex ante* cost of capital is not an appropriate benchmark for outturn or *ex post* returns and in particular for an immature and dynamic market

4.1.8 The CC identifies a range of WACC of 8-13% for consumer lending (paragraph 120) based on a pre-tax cost of equity in the range of 9%-13%; a cost of debt of 5%-11.5% and a gearing assumption of 32%. The wide range for the cost of debt reflects a debt premium of 2%-7.5% above the risk-free rate.

4.1.9 The CC has in many previous inquiries compared outturn or *ex post* profitability with the cost of capital to assess whether returns are 'persistently and substantially' above the cost of capital. However, the cost of capital is an *ex ante* concept of the required return of equity and debt investors.

4.1.10 As previously noted to the CC, in Wonga's view, a comparison of outcome returns with the cost of capital is particularly inappropriate for start-up companies or immature industries where outcome

[15] See, e.g., Section 5C of Wonga's AIS response.
[16] Wonga's response to Question 6 of the CC's Market Questionnaire contains a more detailed list of product innovations introduced by Wonga since 2008.

returns can differ from the cost of capital for a variety of reasons, or where the industry has been subject to significant change (as discussed in the AP report). In paragraph 13, the CC acknowledges that the cost of capital might not be the most appropriate benchmark.

4.1.11 This issue is particularly relevant to Wonga as a new start-up that introduced disruptive lending and loans approval technology into the existing short-term unsecured credit market, which required taking material investment and operational risk. Wonga faced high risk of failure (or underperformance relative to expectations) of the innovative online business model either because demand was insufficient or costs too high. The innovative nature of the product also required the business to suffer losses on initial customers/loans while it developed and enhanced its knowledge of the creditworthiness of customers.

4.1.12 The CC should consider the extent to which Wonga's, and the industry's returns and any gap with the cost of capital, may reflect potential 'survivor bias' in that companies that did not succeed are not in the CC's sample or have a lower weight in any industry average.

4.1.13 The CC has, in other market investigations, discussed the relationship between risk and profits, for example observing in *Movies on pay TV* that 'it was possible for a company to earn profits in excess of its cost of capital within a competitive market particularly where significant investment risks had been taken'.[17] Whereas the data requested by the CC reflects, in Wonga's case, a successful outcome scenario, other scenarios could have developed since incorporation. Arguably, the expected profitability at the time of the investment would be a better comparison to the cost of capital or, alternatively, different cash flow outcomes that might have materialised could be modelled to determine a risk-adjusted level of profitability.

Use of a wide range of benchmarks including expected VC returns

4.1.14 If an assessment of the reasonableness of profitability is to be undertaken, Wonga considers that a wide range of possible benchmarks are relevant. Such benchmarks could include returns expected by venture capital investors under a 'successful scenario'. The CC refers to evidence from returns achieved by private equity and venture capital managed funds as a potential benchmark, including from the 2012 BCVA performance measurement survey (WP §125).

4.1.15 Wonga agrees that returns achieved by the venture capital sector in particular provides a potential benchmark, but considers that the evidence on returns achieved by VC investors is more nuanced than the WP suggests. In particular, the dispersion within the potential VC benchmarks cited by the CC is consistent with the high risks and probability of failure associated with investing in start-ups

[17] Competition Commission (2012) '*Movies on pay TV market investigation*' Final Report, §5.114.

(**[CONFIDENTIAL]**) and in private equity. It also suggests that the CC's profitability assessment is highly sensitive to judgments about the appropriate range of benchmarks for individual companies. For example:

(a) the CC cites ten-year annual IRR for funds in the survey of 15%, which appear to be based on surviving funds in the survey as at December 2012. However, even within these funds the pooled average masks a wide inter-decile range of over 50%, where for example **the top-performing 10th percentile of post-1996 vintage funds earned annual IRR of 41.2%**.[18]

(b) the CC notes from the survey that the since-inception IRR is the most appropriate metric to use when looking at private equity and venture capital performance, and observes that returns were around 15 per cent. However, this does not account for varying vintages within this average, with **funds first drawn down in 1994 earning 34.3% annual IRR** and funds first drawn down **between 2001 and 2004 earning between 20.7% and 25.5% annually**. [19] This is likely to reflect wider economic cycle factors but also illustrates the potential effect of survivorship bias, as the surviving funds over the period are likely to have the largest influence on the average.

[18] 2012 BCVA survey, p.42.
[19] 2012 BCVA survey, p.6.