CASHEURONETUK, LLC:

RESPONSE TO THE PROFITABILITY OF PAYDAY LENDING COMPANIES WORKING PAPER ISSUED BY THE COMPETITION COMMISSION ON 24 FEBRUARY 2014

CashEuroNetUK, LLC (**CashEuroNet**) appreciates the opportunity to comment on the Competition Commission's (**CC**) Profitability of Payday Lending Companies Working Paper. These comments are set out below.

1 INTRODUCTION

1.1 CashEuroNet has a number of specific comments that it would like to make about the analysis of profitability described in the CC's working paper.

1.2 In particular, CashEuroNet would like to emphasise the importance of conducting a comprehensive economic analysis of profitability which considers the risk facing investors funding payday lending companies and the dynamics of a new and rapidly developing sector. We welcome the CC's recognition of the need to investigate how the development of the sector affects profitability and the higher risks inherent in start-up companies.[1]

1.3 CashEuroNet believes that it is important that the CC's assessment of profitability takes into account:

1.3.1 The need to consider profitability on an ex-ante basis, taking into account the wide range of possible outcomes that an investor could reasonably have expected;

1.3.2 The appropriate economic capital base (or capital employed) against which returns from payday lending should be compared; and

1.3.3 The appropriate cost of capital for this form of consumer lending.

1.4 We have set out below our observations regarding each of these elements.

1.5 In a new and rapidly developing sector, subject to fierce competition, one would expect to see both businesses failing and businesses making substantial profits. This is exactly what we observe in the CC data on payday lenders. It will be very difficult to draw any meaningful conclusions about the state of competition in such a market based on such a wide distribution of outcomes (over a relatively short period of time).

1.6 CashEuroNet believes that, after making the adjustments described in this note, the profitability of payday lending companies will not raise issues in relation to the competitive conditions in this market.

2 EX-ANTE PROFITABILITY ASSESSMENT

2.1 As we set out in our response to the Annotated Issues Statement, it is vital to consider profitability on an ex-ante basis, taking into account the wide range of possible outcomes that an investor could reasonably have expected.[2] Some lenders have been successful, whilst others have made losses, and in this rapidly changing market, no lender can assume their success will continue indefinitely.

[1] Competition Commission, "Payday Lending Market Investigation: Annotated Issues Statement", paragraph 51.
[2] Please see section 5 of CashEuroNet's response to the Annotated Issues Statement.

2.2 The CC acknowledges that an assessment of profitability needs to take into account 'innovation and successful risk-taking by firms'.[3] The wide variation in the profitability of different payday lenders, as observed by the CC,[4] has resulted in the profitability of some firms being well below any reasonable estimate for the cost of capital of consumer lending (making losses), whilst other firms' profits are likely to be above such an estimate. CashEuroNet believes that this variation indicates the material investment risks faced by payday lenders both in the past and also in the future.

2.3 Below we have set out our thinking on how the CC could approach the estimation of profitability on an ex-ante basis, taking account of:

2.3.1 The wide variation in default rates;

2.3.2 The potential impact of default rates on profitability;

2.3.3 The timeframe over which losses would likely be endured in an adverse scenario; and

2.3.4 The implications for expected ex-ante profitability relative to observed ex-post profitability.

Wide variation in default rates

2.4 The primary source of risk for a payday lender arises from customers defaulting and failing to pay back in full, which the CC measures using the principal loss rate. These vary considerably between different firms, as indicated by the CC in the working paper 'Customers and their loans'.[5] This shows that there is wide variation in both the proportion of new and repeat customers who fail to pay back in full.

2.5 CashEuroNet cautions against concluding that a high proportion of lending to repeat customers results in low loan losses and therefore high profitability. The inverse relationship that the CC presents in Figure 10, between the principal loss rate and the level of lending to repeat customers[6], is heavily driven by the three lenders with the highest rates of default.[7] Excluding these three observations results in a much less clear correlation, as presented in Figure 10, with a considerable degree of variation in the principal loss rate amongst lenders with fairly similar rates of lending to existing customers.

2.6 [**CONFIDENTIAL**]

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[3] Competition Commission, "Profitability of Payday Lending Companies", paragraph 15.
[4] Competition Commission, "Profitability of Payday Lending Companies", paragraph 10.
[5] Competition Commission "Customers and Their Loans – Presentation Based on Analysis of the Transaction Data", see slide 36 in particular.
[6] Competition Commission, "Profitability of Payday Lending Companies", see paragraph 81 and Figure 10 on page 27.
[7] CashEuroNet also notes that this analysis should take account of any variations in price, in order to more directly address the relationship between lending patterns and profitability. Some lenders may have lower prices and lower default rates, by competing for the lower risk customers (and vice-versa). This should be considered by the CC analysis, as we have noted in our response to the Annotated Issues Statement.

2.7 We also note that the variation in the default rate for new customers is only weakly correlated with the variation in the default rate for repeat customers, according to the CC data.[8] This is also particularly the case if the three lenders with the highest default rates are excluded from the sample of thirteen lenders. This suggests that a lender who is successful in picking new customers who are more likely to pay back, cannot be sure that this will translate into a low default rate among subsequent repeat customers.

2.8 Furthermore, as CashEuroNet noted in its response to the 'repeat customers' working paper, the majority of loans are to customers who started borrowing during the course of the current year. On an annual basis, most customers are 'new customers', as few existing customers have used a lender for more than a 12-18 month period. Therefore, lenders must continually recruit new customers to maintain the business.

2.9 This means that lenders not only faced considerable uncertainty regarding the likely default rate (and therefore profitability) when they entered the market, but also that they still face considerable uncertainty once established with a stock of existing customers. A stock of new customers with a low default rate does not ensure that the default rate will remain low in the future, even when some of those customers return to take out new loans.

2.10 For this reason, CashEuroNet believes that past success in identifying customers (in terms of the default rate) does not guarantee that default rates will be similarly low in the future. [**CONFIDENTIAL**].

Potential impact of default rates on profitability

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Table 1
Illustrative scenarios

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Timeframe over which losses would be endured

2.16 CashEuroNet believes that it is a highly innovative and flexible organisation that would attempt to respond to developing market conditions as quickly as possible. However, there is a limit to how quickly a response can be made to worse-than-expected default rates, due to sunk costs in terms of some elements of marketing spend and intellectual property, as well as uncertainty over the month-by-month fluctuations in default rates.

2.17 The losses that a payday lender would endure, in a scenario in which default rates were unprofitably high, would depend on how long they would continue lending, in the hope of turning the business around. [**CONFIDENTIAL**].

[8] See slide 36 of working paper 'Customers and their loans'.

Implications for ex-ante profitability

2.18 This analysis seeks to highlight that uncertainty over the default rate will have a very material impact on expected ex-ante profitability relative to observed ex-post profitability. The wide dispersion of outcomes for default rates (and consequently profitability) observed by the CC across the payday lending sector highlights that lenders face considerable risk going forward and hence will factor downside scenarios (of high default rates) when judging future profitability.

2.19 Furthermore, the level of uncertainty indicated by the past variation in default rates may under-estimate uncertainty regarding future profitability due to the ongoing and forthcoming changes to the regulatory environment.

3 ECONOMIC CAPITAL BASE

3.1 In our previous response to the CC's financial questionnaire, CashEuroNet expressed the importance of conducting a thorough examination of the economic capital base in order to assess profitability. Here, we provide our thinking on three specific elements of the economic capital base that we suggest the CC should consider:

3.1.1 Inter-company debt as quasi equity;

3.1.2 Working capital required due to the uncertainties of the business; and

3.1.3 Intangible value of the business.

Inter-company debt

3.2 As the CC acknowledges, it is important to recognise that many online payday lenders employ a significant extent of inter-company funding, rather than sourcing debt from the market.[9] CashEuroNet suggests that for the purposes of assessing profitability, the CC should consider this debt to be a form of equity.

3.3 This has implications for the cost of capital analysis, as discussed further in Section 4 below. Treating debt as being a form of equity suggests that the CC should use a Return On Capital Employed (**ROCE**) approach[10], as the total returns to the shareholder from inter-company debt plus equity should be considered.

Working capital

3.4 The cash reserves that CashEuroNet holds are required due to the nature of the business of payday lending, as we need to hold reserves to meet fluctuating demand and fluctuating rates of default and late payment. Cash on the balance sheet is therefore a necessary operational cash reserve or working capital, and does not reflect a cash surplus.

3.5 For this reason, CashEuroNet recommends that the estimate of capital employed is not adjusted for cash held. In other words, financial debt should not be estimated net of cash.

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[9] Competition Commission, "Profitability of Payday Lending Companies", paragraph 98.

[10] Competition Commission, "Profitability of Payday Lending Companies", as suggested by the CC in paragraph 98.

Intangible value of the business

3.6 It is important that the CC takes account of the intangible value of the business which the UK operations rely upon but were built up before operations in the UK began. [**CONFIDENTIAL**].

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3.7.1 [**CONFIDENTIAL**]; and

3.7.2 [**CONFIDENTIAL**].

3.8 These intangible assets were created by CashNetUSA, the original US lending company start-up founded in June 2004 and then sold to Cash America in September 2006 for approximately US$ [**CONFIDENTIAL**] million (the final total sale price was determined on an earnout based on a rolling EBITDA multiple for the two year period after the acquisition). At the time of the acquisition, CashNetUSA had recently begun online payday lending in the United States and [**CONFIDENTIAL**]. The company founded CashEuroNetUK and commenced UK operations 10 months later in July 2007.

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3.10 [**CONFIDENTIAL**].

3.11 [**CONFIDENTIAL**].

4 COST OF CAPITAL FOR CONSUMER LENDING

4.1 The CC describes benchmarks for profitability, and focuses in particular on the weighted average cost of capital (**WACC**) estimates. CashEuroNet wishes to emphasise the importance of conducting a rigorous analysis of the cost of capital, and has the following comments to make on the CC's analysis.

4.2 The first observation is that the WACC estimate is an ex-ante measure of the required rate of return, whilst observed profitability provides an ex-post measure of the achieved rate of return. On this basis, the comparison of profitability to the WACC is inconsistent. For example:

4.2.1 If a portfolio manager was looking for a benchmark for the actual rate of return achieved over the past five years, one would expect them to use a suitable market index for the past five years, in order to compare two ex-post measures of profitability. They would not typically use an estimate of the WACC.

4.2.2 A portfolio manager may use the WACC, however, to compare to a risk-adjusted forecast for future profitability, as long as it fairly reflected both upside and downside risk.

4.3 As noted above, CashEuroNet suggests that the CC should use a ROCE approach to assessing profitability, due to the prevalence of inter-company debt.

4.4 The CC has excluded Advance America from the cost of capital analysis on the basis that it is no longer listed. Advance America was only acquired by Grupo Elektra in February 2012, so it would not seem unreasonable to include its historic data up to that point. CashEuroNet recommends including this company in the analysis, as it will provide the only available equity beta estimate for a pure play online lender.

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5 CONCLUSION

5.1 CashEuroNet appreciates the detailed analysis undertaken by the CC in relation to the profitability of payday lending companies and would respectfully ask the CC to consider the points raised in this response during the next phase of this inquiry.