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Alpha shares analysis

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Times change and we must change with them

Investors are understandably nervous about businesses reliant on the well-being of the housing market. However, the dynamics of the mortgage market differ from the housing transaction market and it is possible for businesses ploughing new or different furrows to sustain growth even in seemingly difficult times.

- Mortgage Advice Bureau (MAB1) – a year ago we were concerned that MAB's outlook for physical expansion into an increasingly digital world of mortgage advice, and into a slowing housing market after the surge during Covid, could not support a 40x PE ratio (share price divided by earnings per share). A share price drop and a potentially transformational acquisition have, in effect, caused the shares to de-rate by c.60 per cent to a point where fresh potential feels overlooked and housing market risk is over-promoted. MAB has potential to see EPS rise by 70 per cent between 2022 and 2024 and all on just a 15x PE ratio. Throw in a more generous dividend and comfortably double digit total returns look to be on offer here.
- Paragon (PAG) – the mortgage market has become riskier, but Paragon's focus on the professional landlord market and rapid expansion of its higher-margin commercial loans business should ensure solid progress, assuming the housing market doesn't implode. We don't think it will, but some wind back after two surprisingly strong years does feel inevitable. The surge in house prices has materially de-risked the mortgage portfolio and overall it feels as if the market still attaches to Paragon something of the risk profile it had at the end of the global financial crisis: in reality it is a much stronger and better capitalised business. If RoTE (return on tangible equity) can be sustained the shares could be 25-30 per cent undervalued, but in turbulent markets investors seem happier to move ahead on proof rather than faith. However, with buybacks and a decent yield, there is scope to see double-digit total shareholder return (TSR).
- Morgan Advanced Materials (MGAM) – it can sometimes be confounding as to how a company can be growing well, hold leading market positions and be on the cusp of a new phase of acquisitive growth, but still the stock stands on a rock bottom rating. This is certainly the case with MGAM, but when looking at this stock one needs to be mindful of a troubled past that has left investors uninterested and dismissive of this business. While the shares look cheap, it is hard to see from where the catalyst to get investors re-engaged will come. In time, value is likely to show here, but one needs to buy with a relatively long time frame in mind.

Analyst: **Robin Hardy**

Mortgage Advice Bureau (MAB1) - a new beginning?

Source: FactSet

We wrote about MAB back in August last year in Alpha in an article entitled '[Beware of overpriced growth]' in which we concluded that while MAB had a decent model that it was executing well, at a PE of 40x the stock was simply too expensive and had run ahead of itself. Since then the share price has fallen sharply, so does MAB make a more enticing proposition today?

A quick sketch of MAB

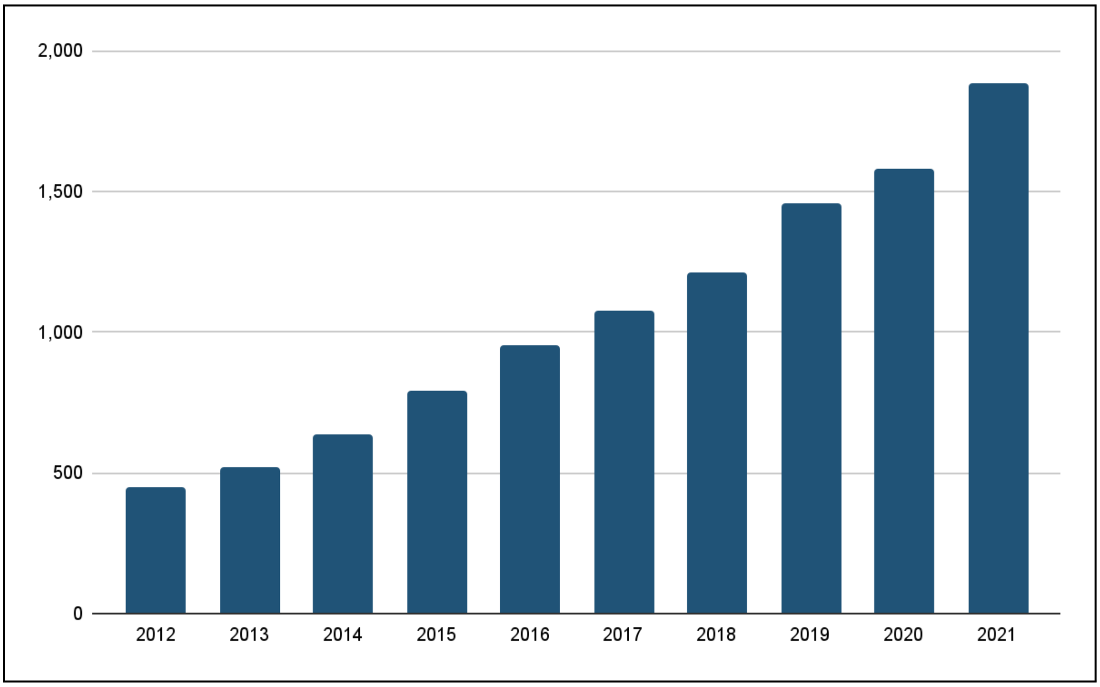
MAB is an ambitious, fast-growing and acquisitive mortgage origination business based in the UK. MAB has not historically been a broking business in the traditional sense (i.e. originating business directly from clients), but rather provided a range of services to brokers through its technology platform known as MIDAS Pro. This is a toolkit that allows independent mortgage brokers and advisers to offer applicable and compliant, licenced mortgage advice and avoid themselves having to undertake compliance procedures. MIDAS also offers administration, financial tools and customer questionnaires plus access to off-market mortgage deals not available in-branch or online direct from lenders.

Brokers using MIDAS share c. 25 per cent of any commission or 'procuration fee' paid out by the ultimate mortgage lender: this is typically a flat fee rather than a percentage of the mortgage sum. Historically, fees were paid only on newly written business and not product roll-overs or re-mortgages, but more recently reduced fees have begun to be paid on such transactions. Today, some 75 per cent of all new mortgage loans taken out in the UK come through an intermediary with lenders preferring to pay commissions to third parties to originate new business for them rather than sell mortgages directly themselves. These payments are a fairly modest flat fee (c.£1,000 – this is the least complex form of financial advice and has the lowest qualification standards so cannot command a large fee) and is not related to the mortgage size or house price.

Regional growth

MAB's growth historically has been through adding regional mortgage brokers to its network either on an arm's length basis or, as has been mostly the case recently, by purchasing a minority stake directly in mortgage and insurance broking businesses. At the end of 2021 MAB's network encompassed some 1,885 advisers, up 19 per cent (although some of this growth will have been catch-up from a Covid-impacted 2020).

Growth in advisers/consultants on the MIDAS network



Source: MAB

The mortgage advice market is still highly fragmented even after many years of consolidation and MAB is still the largest player (still with only a 6.5 per cent market share) but, for some time, management had been seeking a way to accelerate growth.

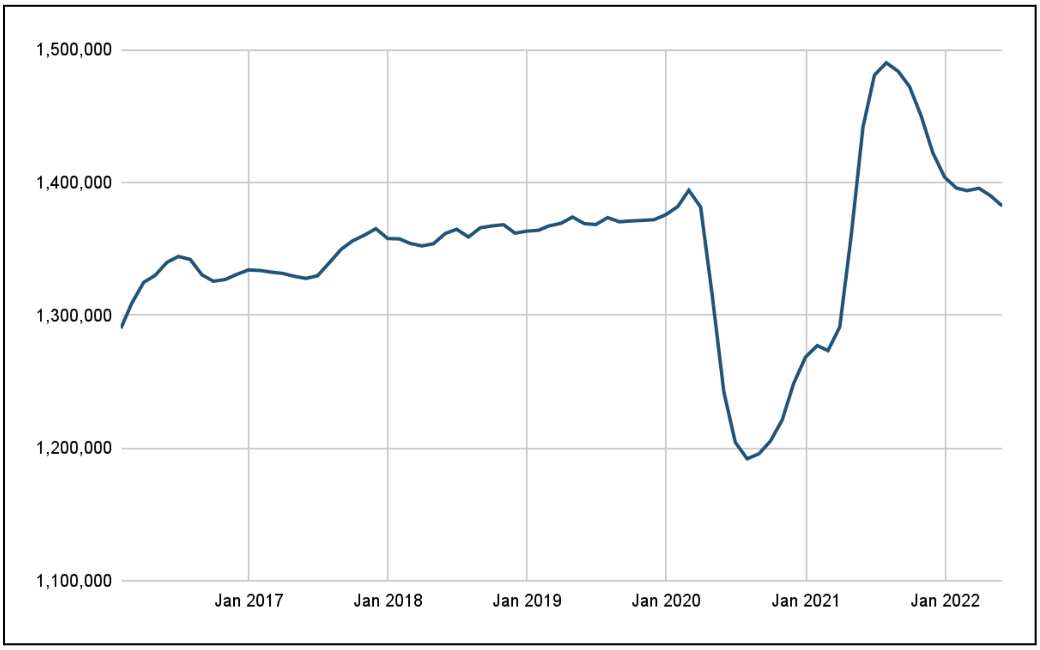
Hitherto, the group's network had been grown by adding smaller, local or regional businesses but this was relatively hard and slower work. The ambition was to bring in an alliance with one or more national networks of lead generators or mortgage originators and it had been expected that MAB would make a connection to one of the UK's major comparison sites. These now dominate simple lead generation (ie without advice or execution). This would inevitably have been on an arm's length basis and would have made MAB the junior party in any arrangements that were set up. While feeling lower quality, the scale of new leads would be substantial.

Time to shake it up

Such a step change in the business model was necessary because the rate of growth was beginning to mature as MAB pushed on towards its target of an involvement in around 10 per cent of the mortgage advisory market. Regional absorption of market share is a relatively slow approach, buying into smaller businesses risked becoming ever more expensive and rolling into 2022 and 2023, the overall climate in the mortgage market was likely to become much tougher.

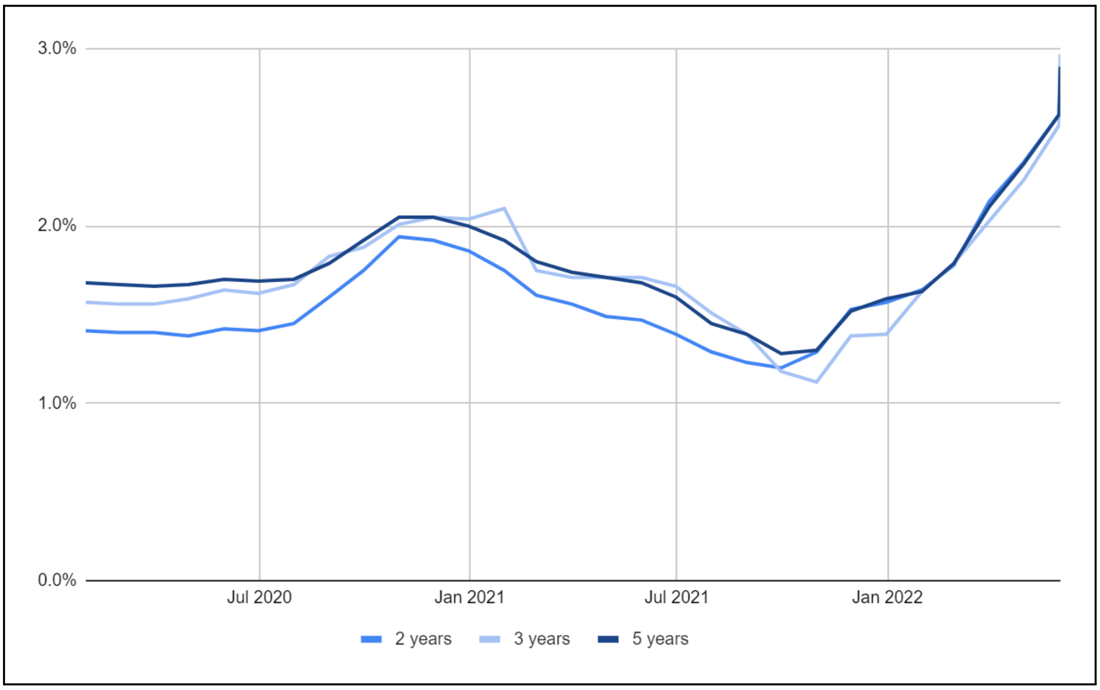
The unexpected momentum in 2020 and 2021 has now reversed and most recently mortgage market activity has dropped back, falling below the long term trend line as the market both normalises and hunkers down with affordability an issue for potential buyers. House prices have increased more than 20 per cent over two years and mortgage rates are rising, so the situation for would-be borrowers is becoming more strained.

Annual UK mortgage approvals - home movers and remortgaging



Source: BankStats

UK mortgage rates - fixed rates of 75 per cent LTV loans



Source: Bankstats

However, strained affordability can be a positive for mortgage brokers. Many homebuyers today are stretched in terms of affordability which is likely to narrow their choices for available mortgage products. When a customer's needs become more complex in this way, the value of using a broker increases and the chances of being able to secure a loan improve.

Changes in mortgage costs since start of Covid

	UK average house price *	Average mortgage rate **	Monthly repayments ***
Q4 2019	£215,925	1.4%	£626
Q2 2022	£270,452	2.9%	£954

Sources: Nationwide, BankStats, Investors' Chronicle | * Nationwide UK average; ** 2 year fixed 75% LTV; ***30 year repayment loan

While there may be more strain for new buyers, anyone who bought a house at the start of 2020 finds themselves in a much more favourable position. The c.25 per cent increase in the average house value since the start of the pandemic has provided useful de-risking for both the borrower and the lender. Even a high ratio borrower from 2020 with a long-maturity loan (say 30 or 35 years where capital reduction is low in the first five years) will have been dropped into a bracket of borrowers able to access far more generous terms.

A 90 per cent LTV (loan to value) loan from the start of 2020 will now have an LTV of just 64.5 per cent if borrowing over 30 years. This should be highly favourable for the remortgage market and could provide enough additional work for brokers to offset any drop in the numbers moving house.

One potential, longer-term threat to a positive remortgaging cycle is impetus to follow the US market model and have more ultra-long dated fixed-rate mortgages. While today there are almost no 30 year deals to be had, there are a growing number of 10 year packages to replace 2 or 5 year deals; wider adoption of such long-dated deals would naturally lower the 'churn' rate in the mortgage market. As interest rates appear set to rise (noting that mortgage rates are tied to long-term bond yields and thus inflation rate rather than central bank rates) demand for long-term certainty is likely to increase. A quick look around the market suggests that 10 year fixed rate terms carry much the same interest rate as 5-years deals and actually often cost less than a two-year fix. Early exit penalties are more onerous, however.

While MAB has managed to secure a place on the platforms of some national lead generators (like Moneysupermarket.com, the FinApp 'Boomin' , MoneyBox and Nottingham Building Society's Beehive App) these have not made a substantial change in the rate of growth across the group. These are naturally less solid lead generators than direct additions to MIDAS via alliances with or direct investment into established brokers. In order to accelerate the business, MAB instead went down a somewhat different path.

Fluent

MAB has acquired a 75 per cent stake (with potential to control 100 per cent in time) in a fast growing national broking business called Fluent Money. The deal was announced along with a share placing at the time of the full year results in late March 2022. The initial transaction totalled £75mn with MAB buying from private equity house Beech Tree.

Fluent brands itself as "The UK's favourite and fastest growing broker". This is a pure-play digital (telephone, app and website) mortgage advice and specialist lending lead generator for aggregators (those buying/building mortgage portfolios for securitisation) and other national providers of mortgages, secured loans, equity release, bridging loans and insurance. Fluent provides the 'engine' behind a number of other indirect finance providers. It is just another broker in reality but is wholly digital and brings more than 125 advisers onboard (growing the group's footprint by c.7 per cent) and broadening the product offering that MAB can farm out to all of its connected advisers, most effectively through those businesses it part/owns. In particular, equity release and secured personal loans look to be the key additions.

The claim to be 'fastest growing' is not just bombast: in the last five years revenue growth has averaged 34 per cent per annum. Growth appeared to be accelerating before MAB's purchase and should now be able to create some attractive marriage value with and through MAB's existing network of advisers.

In addition to fast growth, Fluent's average revenue generation per adviser is above £150,000 per annum compared with £114,000 across the existing network. Annual revenue is around £38mn historically and is likely to exceed £50mn in the current year: MAB's expected revenue this year prior to the acquisition was £270mn for context.

The historic profit figures at around £4mn of Ebitda (earnings before interest, tax, depreciation and amortisation) may not look that impressive, but this reflects the typical financial burden suffered by a business under private equity ownership (expensive debt instruments and excessive oversight management costs). Due to the addition of Fluent, consensus forecasts for MAB's group Ebitda have increased by around £14mn (or more than 35 per cent) for the first full year (2023) of ownership: this is seen to be more indicative of the quality of its trading.

At the EPS level (reflecting higher debt interest and the shares issued for the purchase), there is expected to be an improvement/enhancement of 20-25 per cent for 2023 and 2024. It is still very early days, and one cannot be sure how much bleeding across of new leads into the existing network will actually happen, but a mortgage broking business is not going to turn away a ready-made opportunity to generate additional revenue from new lines. Some analysts may be expecting the average revenue across all 2,000+ advisers to reach Fluent's £155k but while that feels optimistic, certainly we would expect to see a faster uplift in fees earned per head. There are likely also to be cost savings from elimination of duplicated functions, especially in IT.

Valuation etc

Without Fluent, it feels likely that MAB would have begun to see its growth rate flag somewhat as the climate in the UK housing market changes now and on into 2023. Numbers moving house feel almost certain to drop and data from the ONS (Office for National Statistics) already shows that in June the number of housing transactions dropped below what is widely seen as the market's 'steady state' of 100,000 seasonally adjusted house moves each month: there were just 95,000 in that month. Mortgage approvals for house moves are also edging down and it looks as if activity is around 10 per cent lower than in January this year: it is more than 35 per cent lower than the recent highpoint reached in November.

Remortgaging is likely to be more active in the next 18 months as mortgage holders seek to protect themselves from potentially sharp increases in costs. Also, those profiled earlier may find themselves unexpectedly with a sharply reduced LTV to take advantage of when remortgaging, but this market is far less predictable than mortgage demand driven by house moves. It is likely that more homeowners will opt for long-maturity loans when refinancing and this risks eliminating some portion of market activity after 2024; this would be a more acute problem if the government was able to push 30 year fixed rate loans on reasonable terms into the market.

Fluent appears, however, to be able to do much more than just offset the loss of momentum and confidence in the mortgage market and does appear capable of adding some new dynamism to MAB overall. The market did initially react favourably to this transaction with the share price rising by almost a quarter before falling back by more than one third, eventually to bottom out at over 200p below the 1,050p placing price. The positives from this deal are increasingly fighting against the weakening macroeconomic backdrop, growing concerns about the health of the housing market and worries about the risk appetite of lenders about the craziness of the last two years.

From pillar to post

A year ago we were concerned that growth here risked slowing and that, despite working hard to expand, on a PE of 40x the valuation was just too high. Overall, the group's prospects today are more positive even with housing market woes taking some of the sheen off the seemingly 2+2=5 purchase of Fluent. The share price is today 35 per cent lower than last August and EPS estimates for 2023 are 22 per cent higher. So overall, the shares have effectively derated by almost 60 per cent in a year. Is that too much? Almost certainly it is.

The year 2 PE is now just 15x and for year 3 it is just 12x and there is even a decent yield now in the mix: 4.9 per cent next year and potentially 5¾ per cent on the 2024 distribution. However, Fluent has first to deliver both on its own account and pull through the marriage value into the existing network AND the housing market must show only a mild wind back in activity and pricing rather than a collapse if forecasts are to be met. At this stage none of these is certain but the potential growth and the current rating do look out of alignment with too much of the risk and too little of the potential now reflected in the share price. Even taking a fairly cautious approach, a PE of 20x would not be unreasonable with scope to push that a little higher if the promise of Fluent is delivered and if the housing market turns out to be more robust - it has, after all, run contrary to expectations in the last two to three years.

So, the shares appear comfortably to support a price of 1,250-1,300p (970p at the time of writing), but there does need to be some more robust evidence of delivery first. That should come in quarterly updates, ideally starting the interim results on 27 September – it is too early for management to be able to say much or have seen much at Fluent as the deal only closed on 12 July and little was said in the 28 July update. Given the expected step up in the dividend and some further correction of the substantial de-rating made in the last year, investors at this level should feel fairly confident about seeing double-digit total return on a year's view.

Paragon Bank (PAG) – time to shake off old preconceptions

Source: FactSet

Paragon is one of the UK's 'challenger' banks that gathered much attention in the decade following the banking crisis. These are small, recently created retail banks that compete head-to-head with the major UK banks, often specialising in areas underserved by the industry leaders. This would tend to include what are seen as riskier areas of retail banking such as high ratio mortgages, lending to those with a chequered history or the likes to buy-to-let residential loans. As the lending is typically higher risk, borrowers will pay a higher rate of interest to reflect the higher (although in recent years small) risk of default.

Like new generation banks (the newest fintech-led are known as neo banks) such as Monzo, Starling or Revolut, Paragon does not offer customers day-to-day clearing bank services, but is instead focused on consumer and small business loans, with a bias towards mortgage lending and offer savings, usually in fixed-rate term packages.

Challenging the status quo

Paragon's history is in mortgages but slowly, this is evolving to present a slightly broader operating base and a more robust business in the face of a still cyclical housing market. Paragon has three operating divisions:

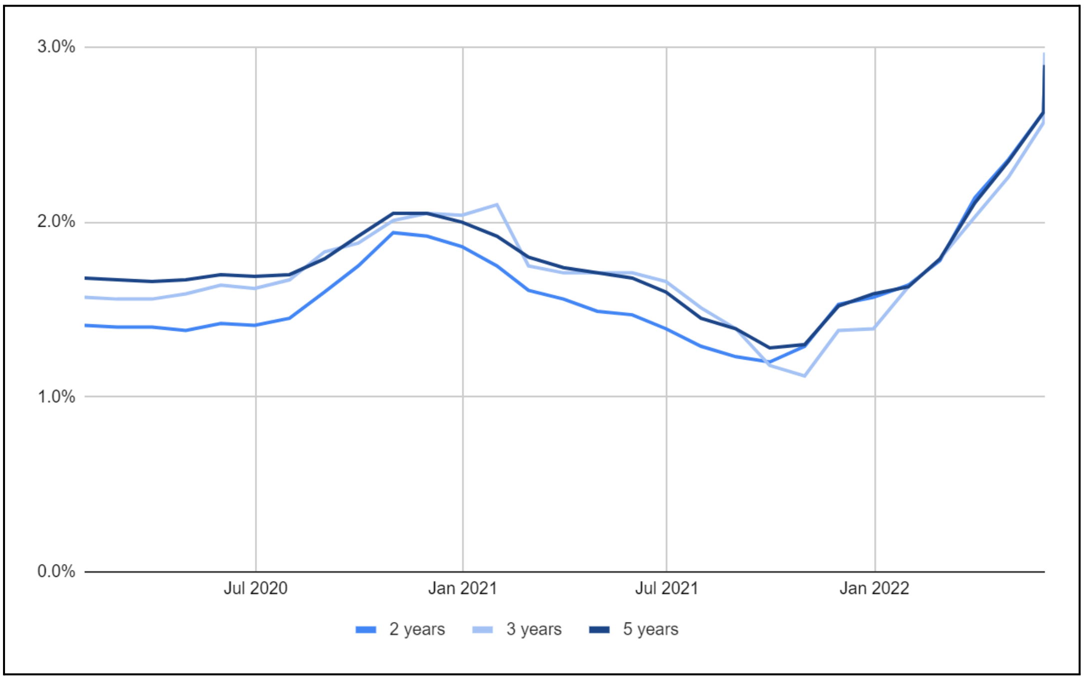
Mortgages – the largest part of the group, with around £12bn of the total £14bn of loans vested here. This contributes the largest slice of total profits, but the NIM or net interest margin (the key profitability measure) is just 2.07 per cent: this has, however, increased materially from 1.69 per cent back in 2019.

Mortgage lending is not an especially profitable business area. Mortgage rates today are rising and are rising faster than deposit rates so the NIM should increase. There is an inevitable lag in rising market mortgage rates flowing through the revenues because many (most) loans are on a fixed-rate term, fixed rate basis. Almost all of Paragon's loans are made into the buy-to-let (BTL) market segment.

Mortgage rates - fixed rate pricing, long run

Source: Bank of England Bankstats

Mortgage rates – fixed rate pricing since start of Covid

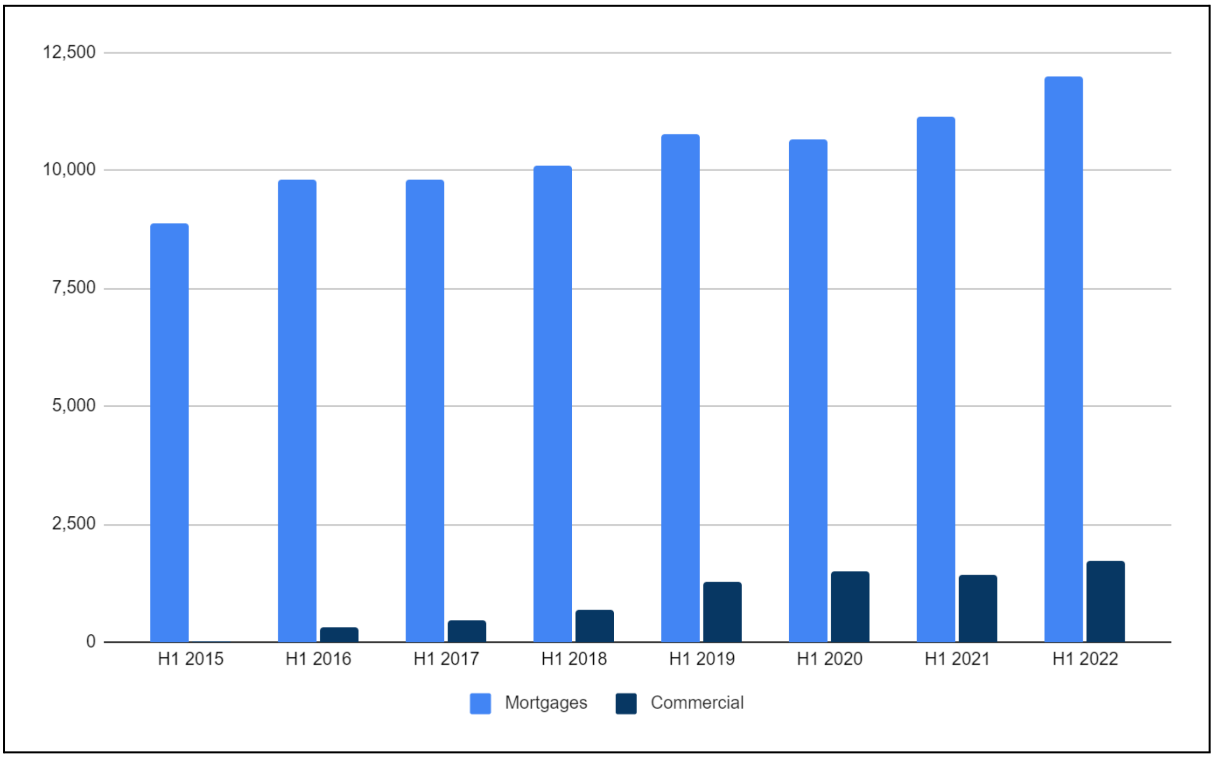


Source: Bank of England Bankstats

Commercial Loans – Paragon began making commercial loans back in 2015, just after it had become a bank. As shown in the chart below, this remains materially smaller than the mortgage arm (£630mn deployed versus £12bn) but it is growing more rapidly. Since 2019, mortgages have grown by 11 per cent while commercial loans have expanded by more than one-third. The largest footprint is in development finance for real estate (40 per cent) followed by around one third in general SME business loans, some 15 per cent is in motor finance and the remainder is structured finance (more complex financial instruments such as credit default swaps and collateralised loans).

This arm generates higher margins than mortgages with a NIM of 6 per cent. This means that despite being a fraction of the size, gross revenues (interest and fees) are close to half that from mortgages and net profits are around one third the level. This division is a key driver for the group's aim of improving overall NIM, looking to flatten the impact of housing market cycles and raising the perceived quality of earnings. As mentioned above mortgages do not deliver the higher quality of earnings. The strategy is to continue growing this division at a faster rate than residential loans.

Mortgage and commercial loan balances



Source: Paragon

Idem Capital – this was a major part of the business for the last decade or more, but is now largely historic and well into its run down. Idem Capital has been a riskier but highly profitable part of Paragon's operations since the end of the Global Financial Crisis (GCF) in 2009. This business purchased what other lenders had classed as bad debts for cents-on-the-dollar and then managed the loans to both their own and the borrower's benefit. Initially, these loans could be acquired very cheaply allowing well above average returns to be made but that very positive phase proved to be relatively short-lived.

Competition for the loan portfolios increased, pushing up the entry price and as both the economic climate and credit conditions improved there were fewer poorly performing or impaired loans available to acquire. As loans were paid off, the level of invested capital steadily declined and most recently Paragon has been selling off tranches of the remaining loan assets and now less than £100mn remain.

Back in 2017 Idem was contributing around half of group profits and contributed high margins as the interest cost it incurred on the loans was exceptionally low and the rates charged were high. By 2021, the contribution had dropped to only around 5 per cent.

This has been a great source of profits and cash flow for Paragon, but is not readily repeatable and its wind down has, to a material extent, masked the steady growth in the mortgage and commercial lending operations. Mortgage lending profits are close to double their level in 2017 and commercial loans profits have risen six-fold but group profits have only risen by around one third. However, the drag on overall is now largely eliminated.

Sources of capital

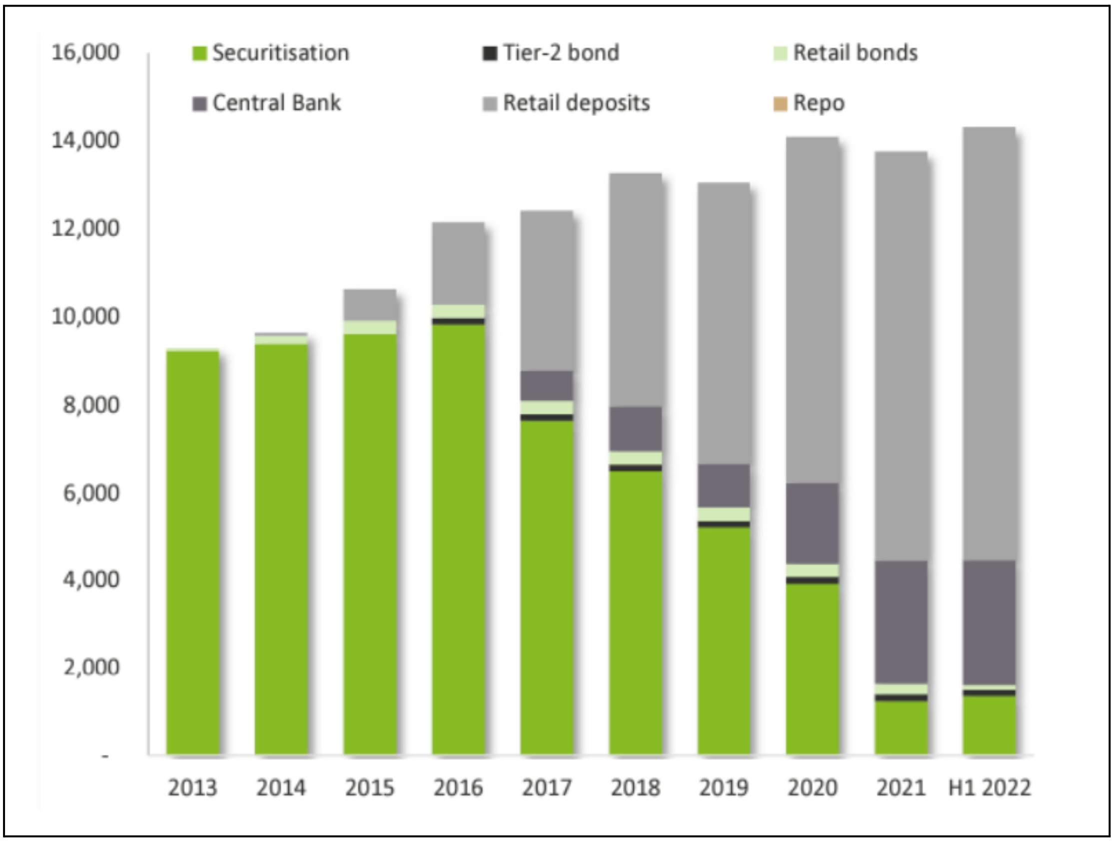
An inherent problem for a small bank is that it will only have a relatively small balance sheet and this will limit the amount of business it can write. Banks are tightly regulated and may only lend limited sums relative to their own capital base and must hold material amounts of capital in reserve against financial distress in the loan book (this is Common Tier 1 Equity or CET1 ratio).

Historically for Paragon this meant relying on the now somewhat discredited securitisation market (see below), but this has now changed significantly. Since becoming a bank and a deposit taker in 2014, the bulk of the funds available to lend today come from savers' deposits and as the chart below shows, securitisation is a rapidly declining legacy.

Paragon also has a sizable balance from Bank of England market support schemes (Central Bank in the chart) such as Funding for Lending and, predominantly, the Term Funding Scheme. Paragon cleverly repaid and then redrew its borrowings under the scheme (£2.75bn) as it closed at the end of 2021, but this balance will still need to be repaid and replaced before the end of 2025.

Arguably, it should be done sooner as the interest cost on the funds equals the BoE base rate, which has already risen from 10bps to 125bps (0.1 to 1.25 per cent) in the last six months. It could conceivably hit 3 per cent and begin to drag on the net interest margin. Although fixing this may be hard to pull off.

Paragon's changing sources of capital



Source: Paragon

Loan securitisation - One way that smaller banks historically overcame their modest balance sheets was to use what is called 'securitisation'. In effect, a collection of loans is bundled up and sold to external investors either using loans originated on their own balance sheet or using a bond pre-issued to investors and then loaned out to customers.

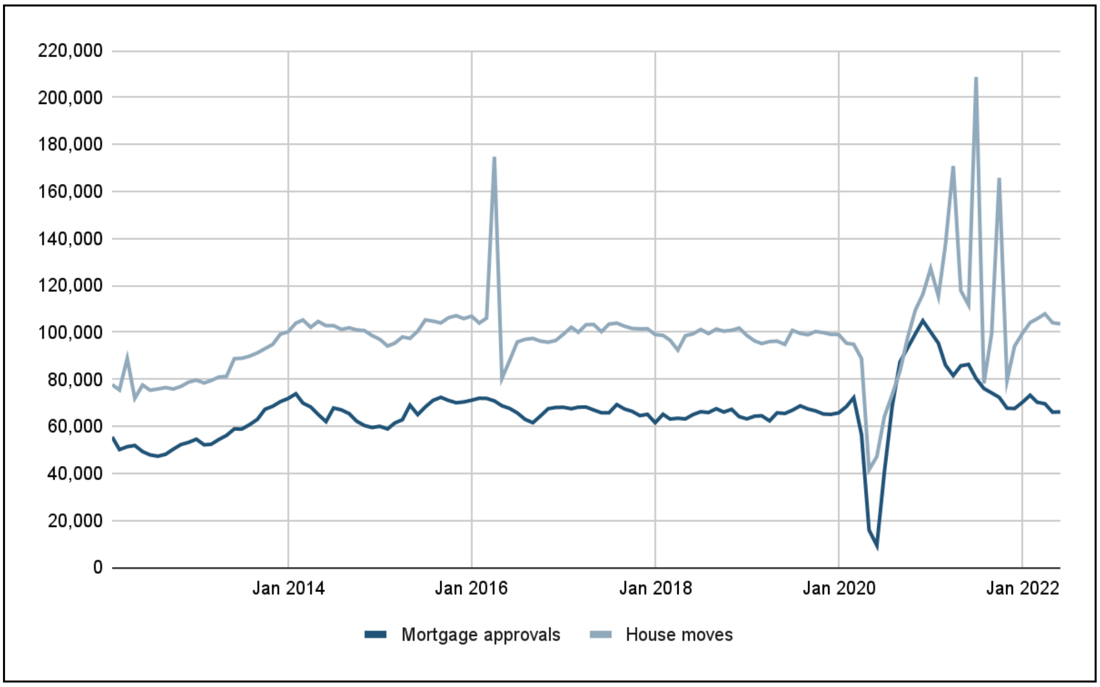
This allowed a smaller bank to generate substantially more business than its own core capital would allow, in theory granting it infinite capacity to originate incremental business. In practice, this is impossible to achieve as the larger and/or faster growing a loan portfolio using third party capital becomes, the lower the credit rating it would attract and the higher the interest rate. This would make it difficult to lend on a competitive basis.

This may all have a somewhat concerning ring to it as excessive and reckless securitisation was a key factor leading to the 2008/09 financial crisis. For Paragon this is really now a legacy issue but the history does continue to cast something of a shadow across the business.

Mortgage market heading into choppy waters

The UK mortgage market has enjoyed an unexpectedly bright couple of years with a number of factors pushing up demand for new residential mortgages. There was the Stamp Duty (SDLT) 'holiday; the urban exodus during Covid as people started to work more from home; and the greater savings generated by potential buyers not having to commute.

House moves and mortgage approvals – monthly, seasonally adjusted



Source: Bank of England BankStats, ONS

Mortgage interest rates also remained at exceptionally low/emergency levels for months after the Covid shock hit. Furthermore, the increased availability of very long maturity mortgages (i.e. 40 year loans) lowered monthly costs.

Also worth considering are the changes to the government's Help to Buy scheme. From 2021 it was only available to first time buyers and the scheme is mooted to end altogether from 2023. The rush to beat deadlines has possibly had the effect of compressing demand for homes in the past couple of years.

Another factor is continued transfer of intergenerational wealth, and people helping children and grandchildren on the property ladder. This has been boosted by the growth in equity release/lifetime mortgages and a spike in early retirement leading to more rapid growth in tax-free lump sums being harvested from pensions.

It's been something of a perfect storm but, while many of these key drivers are no longer present, the surge in pricing they caused remains.

So, what negative forces potentially face a mortgage lender?

- **Potentially lower demand** – tighter household finances will more likely affect private buyers than renters. In June some 62 per cent of landlords surveyed were still seeing higher rental demand and wished to deploy more capital so this is most likely not an area of concern.

- **Potentially tougher wholesale market** – external investors likely to be more cautious or to demand too high an interest rate. However, there is limited use today of securitised funding but, as outlined above, Paragon may need to replace the funds it has borrowed from the Bank of England. It is likely to be able to achieve this through increased saver deposits.

- **Potentially higher default risk** – an understandable concern, but much less of a problem after two years of double digit house price inflation leaving the average LTV across the mortgage portfolio at 57 per cent: this is materially lower than four years ago when it was c.66 per cent. Only 1.2 per cent of Paragon's loans are above 90 per cent LTV and only 1.6 per cent above 80 per cent: in 2008 these figures were 31 and 63 per cent, respectively, so the loan portfolio carries significantly lower risk than at the time of the global financial crisis. Also the default rate on loans is exceptionally low – in the last six months it was just 0.02 per cent.

Tighter mortgage market conditions are undoubtedly coming but this feels more likely to impact the retail, private buyer market than the professional market. The buy-to-let (BTL) sector is unlikely to survive unscathed and the strong asset underpinning Paragon enjoys is likely to weaken a little. However, the starting position in terms of LTVs is very robust and the balance sheet is still carrying unreleased provisions taken against Covid risks that are available to absorb any fresh distress.

Buy-to-let: "reports of my death are greatly exaggerated"

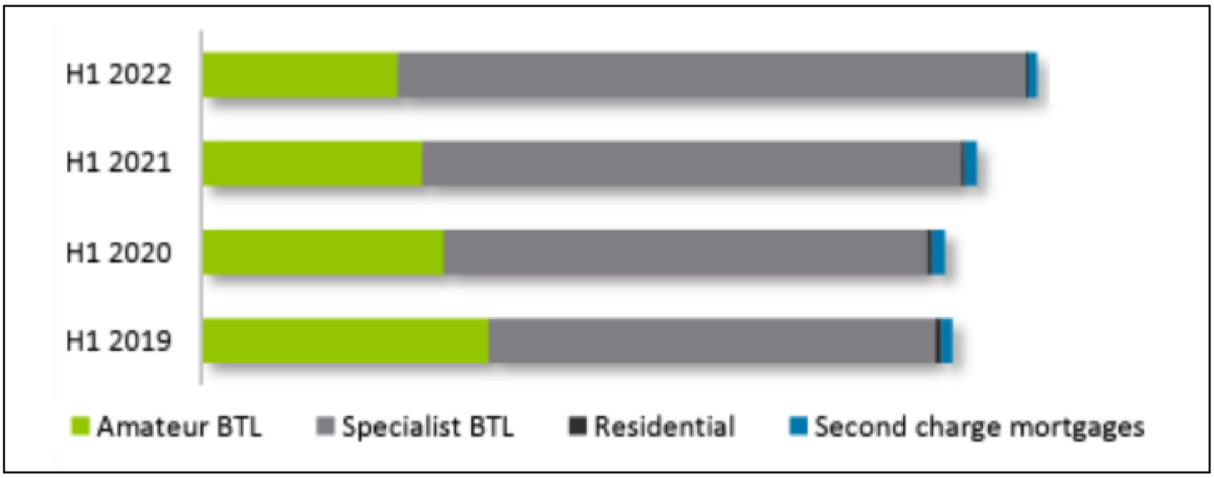
Numerous tax changes that started in 2017 have threatened to strangle off the popularity of BTL by stopping landlords operating under PAYE from deducting mortgage interest payments from rental income. Instead, all that is now available is a 20 per cent tax credit for the interest payments. This typically caused tax on rental incomes to more than double and for profits to fall to a small fraction of levels enjoyed before the completed phasing in of the new tax regime in 2020.

This meant that rental income was barely profitable, leaving the only profits from residential investment to come from capital gains. But running up to 2020, house price inflation looked to be heading towards zero, potentially even into negative territory. Many landlords were expected to quit. The surging prices in 2020 and 2021 injected fresh attraction into BTL and stopped landlords from selling up.

However, all of the negative factors mostly apply to the 'amateur' end of the lettings market where individuals own one or two homes to let out, are an 'accidental landlord' (someone who keeps a flat after moving to a large home or a couple each with a home moving into one and renting out the other). These people are typically taxed through PAYE and this is where the tax changes have hit.

These are largely not Paragon's customers. The group's mortgages are made typically to professional landlords who own more than five rental units and usually own them through a company (either long established or they have incorporated to avoid the tax changes) rather than properties owned as an individual. A company owning rental property is still allowed to offset loan interest fully as a corporate expense and as a small company, tax is only payable at 19 per cent. This compares with, in most cases, tax at a marginal rate of 43.25 per cent (higher rate PAYE plus 3.25 per cent national insurance), sometimes higher if the High Income Child Benefit Charge applies and/or if the personal allowance erosion kicks in for income above £100,000.

Paragon's mortgage lending profile



Source: Paragon

So the attraction of the buy-to-let market for smaller investors is now in doubt and, after what is likely to have been a stay of execution through the Covid surge, there are likely to be some smaller investors who exit the BTL sector. These units would be expected to end up either being taken on by first-time buyers for occupation or, and perhaps more likely, being absorbed by the larger, more professional landlords.

So, while the BTL market is at risk of shrinking, the scale of investment by Paragon's customers could actually increase or else the rental market shrinks, which ought to be a positive driver for rental levels. What might look to be a negative development through a private landlord's lens appears more of a positive for Paragon.

When the big aim small

Historically the UK's larger banks (here we mean the 'big 6') have tended only to service the 'bread and butter' mortgage market, that is personal home buyers with decent financial history. They have tended to avoid buy-to-let (they do operate here but sparingly), borrowers with bad credit histories (subprime borrowers), those with non-standard earnings (self-employed, actors, artists etc) and those looking to borrow on very high LTVs. However, the sands appear to be shifting here as recently evidenced by Barclays' purchase of Kensington Mortgages (from Blackstone and Sixth Street private equity houses) and HSBC's hints in recent analysts' meetings that it might be interested in getting more involved in the 'non-standard' market.

It is not hard to understand why they would be interested in getting into this space – Nationwide, the UK's largest mortgage lender, achieves a NIM of only 1.26 per cent, less than half that of Paragon and highlights the competitive (if not cut-throat) nature of mainstream mortgage lending. This could be a threat to margins in Paragon's segment, but it feels unlikely that these larger players will want to pull down returns – rather that they are looking to boost their margin mix. However, new, substantial well-capitalised competition is never welcome.

A long history of high capital returns: set to continue

Paragon has a long history of returning surplus capital to shareholders. The group has a robust CET 1 ratio (the ratio of core equity and risk weighted assets, in this case its loans) of 15.4 per cent which has been fairly stable for the last couple of years. This is well above the minimum level required under the Basel III regulations (6 per cent) and its own higher requirement (i.e. its assets are seen as being slightly riskier) of 9.5 per cent. This has allowed a steady capital return programme which has used what we see as the preferred method of share buy backs (as opposed to special dividends): buybacks create a permanent boost to returns and equity valuations whether working on an earnings/PE or economic value added basis (EVA), which is more typical for valuing banks.

Since 2015, Paragon has redeemed £335mn of its equity in addition to paying out a very similar amount in core dividends (£339mn), giving a total distribution ratio of 40 per cent of net profits. This is set to continue and for FY2022 the plan is to buy in £75mn and Gary Greenwood at Shore Capital expects another £50mn (at least) in each of the following two financial years. For comparison, the group's market capitalisation is just £1.25bn.

So, the buy back offers investors a boost to total returns of around 6 per cent this year and the core yield offers additional income of around 5¼ per cent. This makes it easy to see how Paragon has delivered a total return averaging 8¾ per cent across each of the last five years and how that can continue.

Valuation

The valuation basis for banks is fairly standard and is, essentially, an EVA (economic value added) model. This means that the extent to which a bank's return on tangible equity (RoTE) exceeds the market's estimate/calculation of its weighted average cost of capital (WACC) should be the extent to which the share price exceeds the net asset value (NAV).

Larger banks have in the last 10 or more years struggled to make returns above their WACC and have, therefore, tended to trade below NAV. The challenger banks have, in contrast, made much higher returns and have traded closer to NAV. They are also much more transparent businesses with all of the key data about capital costs, returns on loans and risk being more visible and easier to assess.

Paragon is currently making an RoTE of around 14½-15 per cent and the market estimate of its WACC is around 11 per cent, which suggests that the shares would be trading at around 1.35x NAV. However, they are trading at closer to 1x NAV which reflects a number of concerns that the market has about both this business, the challenger banks more broadly, and the underlying core housing market. Essentially:

- Worries that the current level of RoTE reflects a now ended benign wider economy and a flourishing, self de-risking housing market. Very long term returns for banks tend to be closer to 10 than 15 per cent
- That the cost of capital (WACC) is actually higher than 11 per cent – cost of funds, risk-free returns and tax rates are all rising.

- Fears that the major banks will invade their market, steal business and potentially dilute NIMs.
- That the housing market will not have a soft landing, house prices will fall and lower the perceived quality of the loan portfolio. Also that new business will dry up potentially to the extent that Paragon suffers net redemptions and a falling load portfolio.
- That the cost of wholesale finance will rise faster than mortgage rates and begin to drag on the NIM.

The macroeconomic outlook is now far less certain but banks in general and the challengers in particular are much less risky than back in 2007-09 and there is a danger that investors are mapping outdated concerns onto what are now much stronger businesses. Paragon is much better capitalised, has sharper accounting, regulation is tighter and technology & digitalisation enable better and faster understanding of customers allowing more rapid reactions to difficulties. Also, the quality of lending is much improved and the broadening into higher net margin operations makes that position stronger still.

In the current climate it feels unlikely that investors will allow the valuation to stretch to notional 1.35x book value (implying a share price of around 675p) in the near term, but that does still look like a destination as the NAV rises (through retained profits, provision adjustments and share buybacks) to around 650p by September 2024. That, taken with a 5+ per cent dividend yield should mean that investors can expect to see a moderate double digit annual return going forward.

If the housing market throws sharply into reverse, this would be harder/impossible to achieve, but it does not look as if there is a major housing slump coming. House prices look vulnerable to some measure of wind back in the next 12-18 months, but most likely only in the low single-digit percentage. Also we would not expect market conditions weak enough to undermine either asset backing here or cause large numbers of landlords to sell up. On balance, the investment case here looks positive.

If the story here sounds attractive, it is worth noting that many analysts who follow this company, while bullish on this stock, often believe that **OneSavings Bank (OSB)** is a better way to invest in this space.

Morgan Advanced Materials (MGAM) – "why must I be so misunderstood?"

Source: FactSet

MGAM is a diverse industrials sector business that operates globally (over 30 countries with the US by some margin the largest) and holds market leading positions in most of its fields of activity. Formerly known as Morgan Crucible, the name was changed in 2013 to reflect that the group had grown into something far broader than foundry products.

The business has had a somewhat chequered history with unfulfilled market hopes and profit warnings but since the arrival of current CEO Pete Raby in 2015, the group has been through some aggressive restructuring, streamlining and costing. This has yielded (by 2021 when all of the various moves had been fully enacted) a kicker to profits of £23mn, no small beer against baseline pre-tax profits of only a little over £100mn.

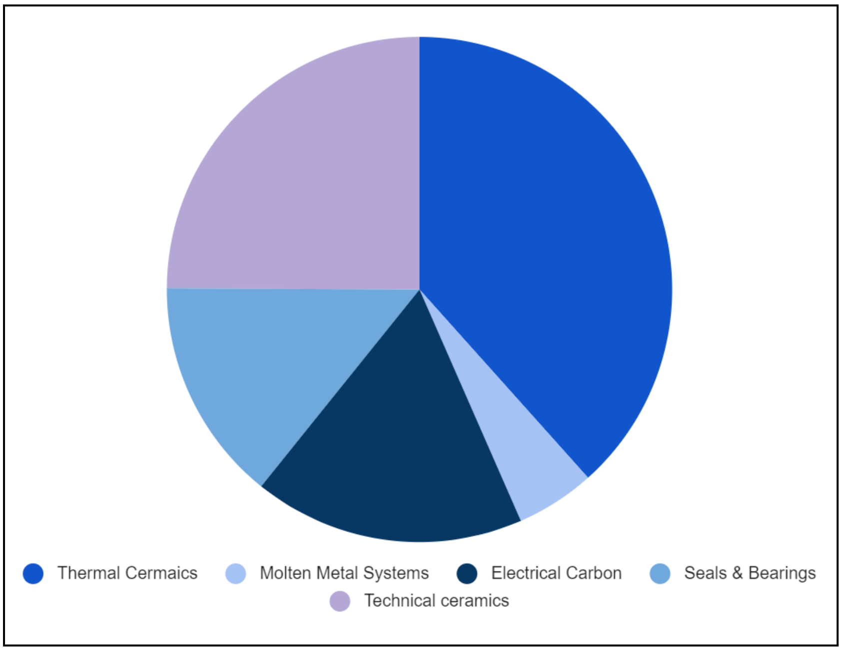
The business fared well through Covid with sales in 2020 dropping by 14 per cent but operating profit (EBIT) margins only fell from 14 to 12½ per cent and, in 2022, profit before tax (PBT) is likely to be back very close to 2019 levels. Analysts feel that the group of old would have been much harder hit and point to the far greater resilience that the group's operations now present.

MGAM today

MGAM operates across such a wide range of industries and end markets that it is hard to see any substantial swing in any one of these being likely to cause a material impact on the overall trading of the group. This is good for stability, especially in equity markets where slip-ups and mis-steps, even if they are industry issues, will typically lead to a large hit on the share price.

However, the converse is also true. In a market looking for readily identifiable, positive triggers (such a higher defence spending or a soaring copper price) this breadth of operations will tend to limit larger, positive reactions to macro events: no one business area appears large enough to materially alter EPS expectations at the group level. That said, potentially running into a recession, a multi-faceted business model might prove to be a better option for investors.

MGAM revenue split by business line



Source: Morgan Advanced Materials

Thermal Ceramics: this covers products and systems used in high temperature industrial processing of metals (production and end use), petrochemicals, cement, ceramics and glass, and by manufacturers of equipment for aerospace, automotive, marine, insulation fibres, refractory products, insulated fire bricks (ie kiln linings), microporous high temperature board/wrap insulation and heat shields for hot running automotive engines/emission systems and domestic appliances. Products and solutions are often bespoke for each customer, usefully creating a greater dependency on MGAM. This is the most diverse division in terms of end markets and products.

Molten Metal Systems (MMS): this division manufactures high-performance crucibles and foundry consumables for non-ferrous (primarily zinc, precious metals, aluminium, copper, brass and bronze) metal melting applications. End segments include foundries, die-casting, melting facilities, metal powder production, refining/recycling of precious metals and the production of pure aluminium for electronics applications. Dominant markets are automotive (aluminium), construction (copper for electrical and plumbing) and precious metals (jewellery, electronics and automotive). Again very broad/diverse.

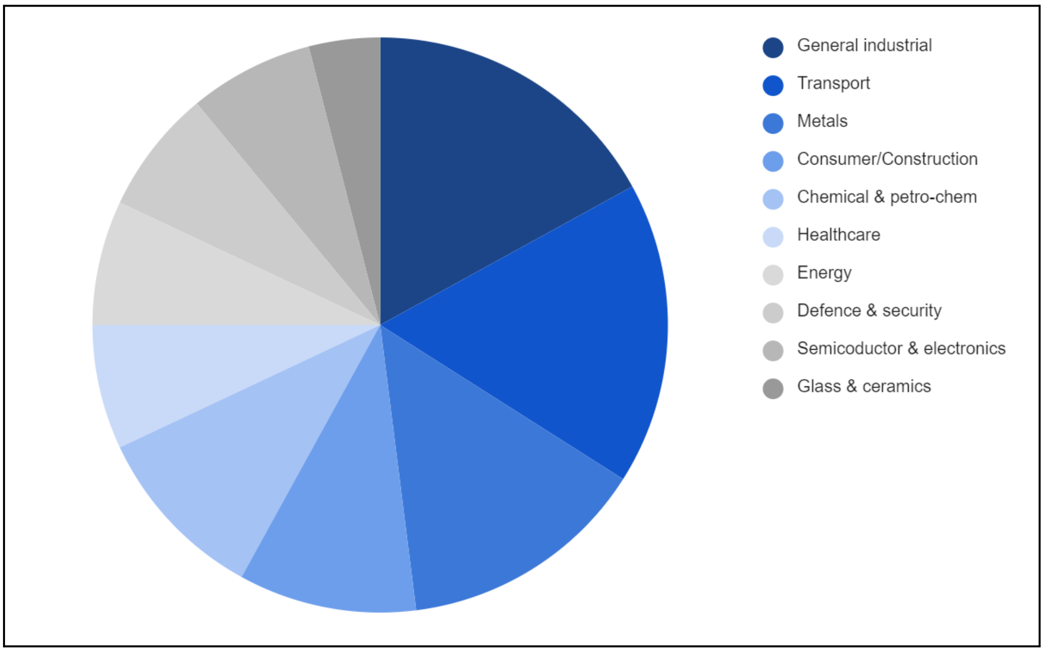
Electrical Carbon: here MGAM manufactures brushes and other core components for heavy electrical motors with most products bespoke and often required to work in extreme environments. The primary end markets are rail, industrial drives (motors for large machinery & industrial plant), power generation (thermal and wind), iron and steel (arc heating), and mining equipment. Once again, a very broad spectrum business.

Seals and Bearings: this covers the production of high-performance self-lubricating bearing and seal components, predominantly used in pumps in both industrial and domestic environments especially in extreme temperature, corrosive or hygienic locations. Using carbon/graphite, silicon carbide, alumina and zirconia lightweight, low-friction components overcome the issues caused by relying on lubricants, especially maintenance in hard-to-access locations. The main markets are petrochemical, industrial pumps of all sizes, aerospace, automotive and domestic appliances.

Technical Ceramics: in its second largest division, MGAM produces a very wide and diverse range of products for a large array of industries. Again, most products are bespoke to customers' own manufacturing needs in industries such as electronics, energy, healthcare, industrial, petrochemicals, security and transport. Essential products here replace cast metal where either weight, spark risk, electrical insulation, hygiene, cost or other factors make ceramics preferable to metals.

Continued below

End markets for MGAM



Source: Morgan Advanced Materials

Well positioned for inflationary times

In times of high input cost inflation, many businesses discover that they lack the market positioning and customer relationships they imagined they had and find it difficult to pass through their higher costs into product pricing. This does not appear to have been the case for MGAM with every expectation that its own costs will be almost fully passed through with higher prices put in place even faster than the typical three month lag (typically built into contracts as escalators).

This is made possible by: a) the large market share positions the group has in most markets (but typically in the 20 per cent range rather than being monopolistic) and; b) that MGAM's products are so vital to customers core manufacturing processes (and these customers understand that MGAM has a great deal of flexibility to which of its customers it will allocate its manufacturing resources).

This ability to pass through inflation has again been underscored in the recently published interim results (29th July).

We have already seen how strong capability to pass through higher costs can be beneficial with the recent update from foundry product manufacturer **Vesuvius (VSVS)**. In its case, higher product pricing was achieved far more quickly than consensus forecasts had expected, resulting in profits significantly higher than the market had expected. This has caused a major re-rating (shares up 15 per cent in month) in a stock in which investors had largely lost interest. MGAM has scope to go through this same cycle and the initial, positive reaction to its interims underscore this.

Pension casts a long shadow

Pension commitments to current and former employees can be a major drag for businesses, especially those that have been established for a very long time (MGAM was founded in 1839). If a pension scheme has members eligible for defined benefit or final salary payments in retirement and the pension fund is under-funded, this can weigh heavily on the company in terms of its equity valuation, it cash flow, its ability to pay dividends, potential problems in raising new equity and making it less attractive for potential takeover (although sometimes this last point can be a positive).

MGAM has been working hard over the last five years to reduce what had been a sizable pension funding shortfall: in 2016 the pension scheme was £270mn in deficit and this was larger than the group's net asset value (£164mn) at that date. The deficit has been reduced and in 2021 fell from £176mn to £103mn, but is still fairly substantial against the group's overall balance sheet value of £350mn.

This is not an ideal position to be in, but does little lasting harm to the business as the liability is unwound over the very long term and the pension trustees here appear largely aligned with management's interests and strategy (i.e. they are unlikely to start making major claims against and hampering the PLC). More concerning, however, is the drain on cash flow with the PLC having to pay in £20mn to the pension fund each year in a drive to put the fund back into balance. This is equal to around one third of last year's free cash flow and this is likely to starve the business of growth and investment potential.

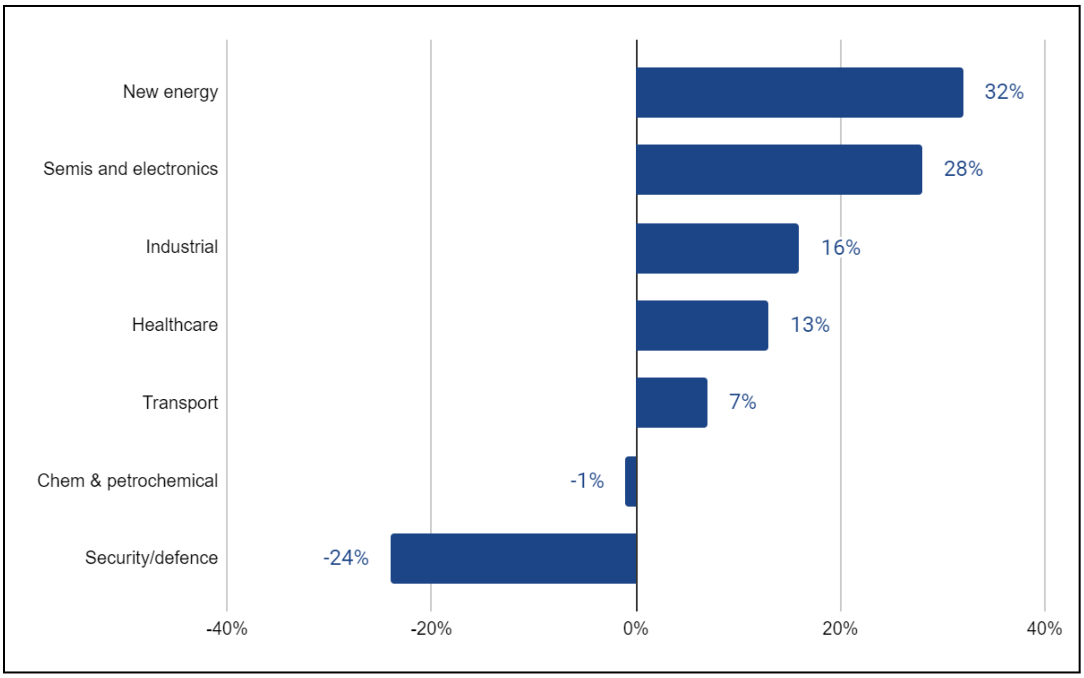
Stable core and dynamic 'new gen' businesses

MGAM is something of a two-speed business with the board now separating out the differential trading performance of what it calls 'core' and 'faster growing' market segments. This is a fairly new presentation of the group's performance (only started within the last year) and should have allowed investors to begin to apply a higher rating to business areas and end markets that are generally more in vogue, appear more 'green' and exhibit faster growth.

However, to date this has not really happened. The areas that the board has chosen to separate out are: clean energy (wind, solar and hydrogen), clean transportation (EVs and fuel cell systems), semiconductors (larger scale devices and third-party 'fab' processes) and healthcare (medical devices and body inserts such as hip joints).

These end markets now represent 20 per cent of group revenue and are exhibiting annual growth rates of 22 per cent; the remainder of the business (the 'core') is growing at a lower but still very respectable 7 per cent. Naturally this is likely to become a larger portion of the business (moving closer to 30 per cent by 2024) and could grow even faster as more of the group's capital investment is likely to be directed here. New energy has a kicker from the now even greater pressure to step away from fossil fuels, the semiconductor industry is growing fast despite serious industry shortages that should (slowly) begin to unwind after additional capacity investment and an ageing population should result in higher spending by global healthcare providers.

Change in group organic revenues in FY2021



Source: Morgan Advanced Materials

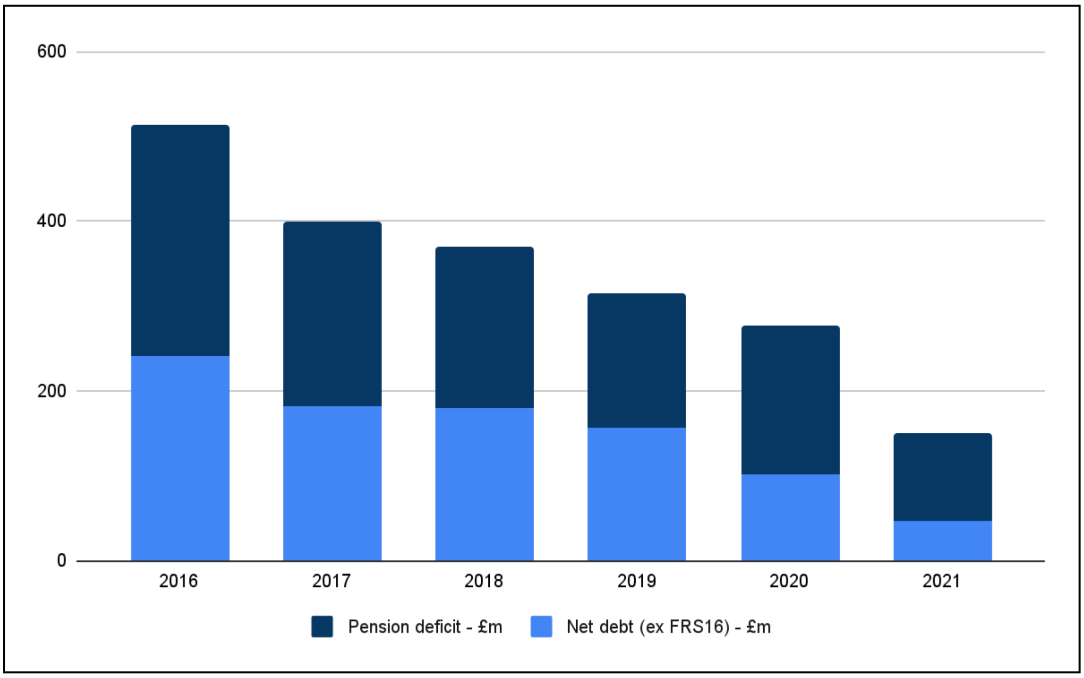
It may appear odd at a time when defence spending is widely expected to be rising that MGAM's revenues here should be falling. This is, however, something of a quirk as the division largely comprises a single military contract (for lightweight ceramic personnel and vehicle armour plate) that is: a) in wind down and; b) is 'call-off' in nature rather than steady supply meaning that it is naturally lumpy in terms of revenue contribution. Unless new contracts can be secured, it feels unlikely that MGAM will benefit from higher defence spending. That said, the climate is sharply more positive here and 'passive' military spending (i.e. not weaponry) is seen as a key area. So, it is possible that a fifth 'faster growing' business area might in time be added.

Ready for some corporate activity?

Now that debt has been substantially reduced and the pension fund is closer to being in balance, the board's thoughts might turn to engaging in some corporate activity. MGAM has been largely inactive on the acquisitions front and has actually been a net seller of surplus business assets for much of the last decade.

However, while MGAM might now have the financial capability to begin buying businesses, it is not immediately clear what it would be able to buy. Most of the businesses that would be able to improve its market positioning within existing spheres are unlikely to be available as they are divisions of larger businesses rather than standalones. Most are seen as trading well and are still wanted by their current owners. Also there would likely be competition regulation issues if a major competitor was added to the existing business portfolio.

MGAM's financial position



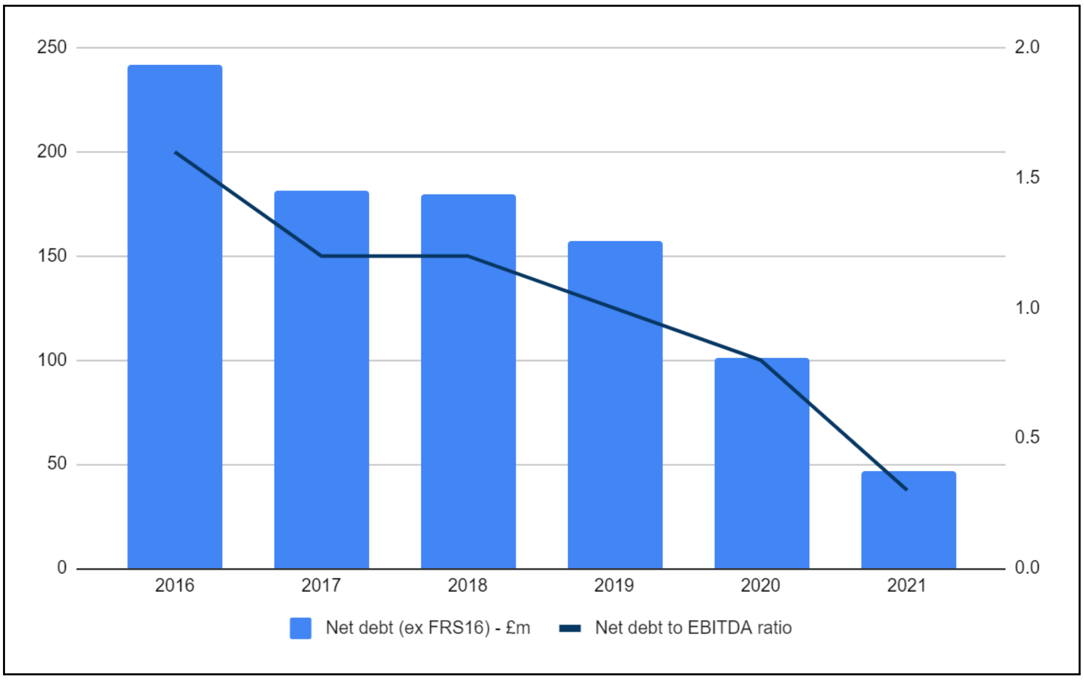
Source: Morgan Advanced Materials

Management could launch into new fields or end industries but for a business that already has fragile trust amongst its investors, that is likely to be seen as too risky and management is unlikely to want to bolt on a fledgling business with far less market share or market scale at this stage in the economic cycle. Overall, we probably have to conclude that a substantial acquisition that could materially alter the prospects of the business does not appear likely to be made in the foreseeable future. That said, the opportunity to act is the best it has been for a decade at MGAM.

There is, however, ample scope for share buy backs. While return on capital from business investment would likely be higher, the low rating the share trades on does make a buy-in of, say, £75mn (which is very affordable) appear very attractive.

Peel Hunt estimates that without any major new investments here, there will be a small net cash balance by the end of 2024. Using £75mn to reduce the group's invested capital could bump EPS up by around 10 per cent and still leave the group with a debt to Ebitda ratio of less than 0.5x and perhaps a more ambitious programme could be undertaken.

Net debt to Ebitda



Source: Morgan Advanced Materials

Low ratings do not always a value stock make

MGAM appears to be a cheap stock based on the key valuation ratios shown in the table below. Growth is decent, although not spectacular, with the consensus suggesting that EPS will show a compound annual growth rate (CAGR) of around 8.5 per cent between 2021 and 2024. However, this could prove to be too cautious an estimate given the presence of faster growing and typically more highly rated areas of activity, the benefits of cost cutting, potential for either EPS enhancing acquisitions and/or a material share buy-back programme.

Key valuation ratios for MGAM (price at 302p)

Year to Dec.	2022	2023	2024
EV/Sales	0.9x	0.9x	0.8x
EV/EBITDA	5.2x	4.9x	4.6x
PE ratio	10.1x	9.5x	8.8x

Source: FactSet

However, the shares have looked this cheap for a long time and investors have remained uninterested. Why so? It is primarily because of a long history of disappointments and failure to deliver/maximise potential, although much of this was in the era of previous management. Too many potential investors feel that while the story sounds positive, they have here 'seen it all before'.

Then there has been the issue with the pension under-funding, the arguably excessive diversity of operations (one might see this business as something of a jack of all trades), the unwillingness of the CEO to publish margin targets (analysts believe that 15 per cent EBIT margins versus today's 13 per cent are possible but management will not adopt this so forecasts are constrained), the smaller market value (a market cap. of £850mn which means fund managers can afford to ignore it) and, of course, wide issues such as potential recession, geopolitical instability and the cost-of-living crisis can easily allow investors to adopt a wait-and-see stance. Investors rarely see any urgency to get on board here.

Another issue is that MGAM has many competitors in the FTSE Industrials sector that are seen as being better players, more focused and are much larger – **Halma (HLMA)**, **Spirax-Sarco (SPX)** and **Megitt (MGGT)** have market caps 8-10x larger – these businesses are typically the focus of investment in this sector. At the smaller end of the sector, investors appear more likely to pick more dynamic businesses such as **DiscoverIE (DSCV)**, which has made significantly better total returns even after being dragged down by the technology sector de-rating.

Look forwards, not backwards

However, this is a great example of why investors need to look afresh at businesses that they think they know (and think they do/will not like).

MGAM does look a much better business than five to 10 years ago, the debt has been sorted out, so has the pension scheme (to some extent) and whereas the ability to make decent acquisitions or undertake major buybacks did look impossible, that is no longer the case. The current rating is way below the favoured stocks in the sector with Spirax and Halma both trading on a PE ratio of around 30 times, even though forecast EPS growth is fairly similar to MGAM's.

The rating here does appear to be carrying too much baggage with investors seeming deliberately to accentuate the negatives, arguably to excess. It feels as if the shares could still be viewed with a higher level of caution or reticence even with the rating bumped to be half that of the peer group rather than the current one third. That would suggest that a fairer price for the stock is closer to 450p, rather than the current 320p.

However, there is no obvious, immediate catalyst likely to kick off a re-rating, but it is possible to see where that could arise: management's willingness to nail margin targets to the mast, acknowledgment that an M&A programme was in hand, that a pension 'risk transfer' initiative was to be undertaken or that a buyback programme was in the offing. While there does not seem to be any immediate rush to buy the stock, this does look to be a good slow burner for longer-term investment.

Alternatively, as we have seen recently with Vesuvius, a short-term step re-rating is also possible just because investor interest is piqued. The very recent interim results were strong with EPS up 25 per cent and the dividend raised by two-thirds, most likely marking a change in distribution policy.

Upgrades are coming as management ups guidance to be towards the top end of the consensus – costs are being passed through well and growth in the hitherto more sedate 'core' has recently stepped up from 7 per cent to over 10 per cent. It does feel as if a re-rating is coming here and while previously we might have expected that to come more slowly, across an 18-24 month period, it may now happen sooner.

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