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Humm Group ('HUM') is a diversified Australian financial company listed on the ASX. Previously known as Flexigroup, it is a company that we have invested in the past. Founded by its major shareholder, Andrew Abercrombie ('AA'), as a leasing business, the company has undergone a range of acquisitions, divestments, and restructuring throughout its lifetime as a listed company. Many of these have occurred as a response to regulatory changes and to changes in broader market conditions.

Today, HUM comprises of two divisions: Hum Consumer Finance ('HCF') and its sector-leading commercial lending division.

Asset Sale

HUM has signed a binding agreement to sell HCF to Latitude Group Holdings ('LFS'), another listed financial, with the consideration being primarily in LFS scrip plus a small cash payment to shareholders. This sale is subject to shareholder approval as an ordinary resolution which only requires 50% of votes to be in favour.

We believe this is an attractive deal as it is essentially a merger of consumer finance businesses, in a sector that is experiencing strong headwinds and requires scale. We consider that the LFS team is well qualified to run a consumer business at a far greater scale given their professional background. Broadly, leveraged business models benefit from a greater scale which aids in optimising financing and cost structures.

The basis of any financing operation is the origination of loans that fit within the business' credit criteria to maintain a minimum level of receivables upon which an interest margin can be earned. There has been considerable press around the present negative and declining consumer sentiment, a larger organisation simply has more resources to compete for newly originated receivables when the market shrinks in absolute terms then shifting the industry structure to that of a zero-sum game.

BNPL was an innovation that provided largely non-recourse, small-scale instalment loans to a long tail of borrowers; for some time it held the promise of reducing the costs of origination for financiers. However, in retrospect, the growth of this business model was supercharged by the broad and perhaps overly generous fiscal and monetary stimulus throughout the covid-affected period from 2020. This dynamic has come to a screeching halt as losses from borrowers continue to mount for all participants in the space - with the discontinuance of the various stimulus programs. Ultimately, we can conclude that the creditworthiness of a portion of borrowers was enhanced by the provision of this stimulus; a position which is now unwound.

The impact on ASX-listed BNPL companies has been immense, with the second largest local player ZIP's share price falling around 85% when measured from the disclosure date of HUM's receipt of multiple proposals for its HCF business.

The nature of the consumer lending market and business has changed immensely over the past 6 months. The consumer finance industry has suddenly changed into a zero-sum game. The nature and structure of the BNPL sector mean it's a 'winner-take-all' market; despite an ostensibly longer-term trend towards commodification, which is validated by the fact that Apple has just entered the BNPL sector with ApplePay now providing instalment payments.

This dynamic appears to have been confirmed by HUM in their latest business update which states HCF has not been profitable in the 4 months till April 2022. This implies that credit losses may be higher than originally projected. Interestingly, ZIP trades at approximately 25% of its claimed net asset value. By the same measure, HUM may be worth $152 million or around 30c a share; however, this assumption is overly onerous given HUM's blend of assets and business lines. Assuming a market value of 50% of net asset value results in a rough market value of $300 million or around 60c per share (around 20% lower than HUM's share price at the time of writing); if the LFS asset sale offer was not on the table.

These aspects make the LFS offer look exceptionally attractive, especially given the higher relative valuation of ~13x 'cash' NPAT and 1.8x NTA. Should the transaction not be consummated - we believe the potential downside risk for HUM is considerable based on the performance of listed sector peers.

Offer

LFS's offer entails a consideration that will be paid largely in LFS shares plus a smaller cash component. HUM intends on distributing this scrip and cash received via an in-specie capital return to its shareholders. Accordingly, HUM shareholders have the option to retain their stock exposure to LFS or to sell to realise the cash value of the holding.

This optionality has value as it allows HUM shareholders to participate in any potential synergies and residual benefits that the combined entity may realise in time, in a tax-efficient manner. These residual benefits could include the combined entity trading at potentially a higher value due to inclusion within stock indices and other passive vehicles like ETFs.

This sale appears to be a rare win-win situation for both sets of LFS and HUM shareholders

Residual value

HUM's commercial business, which will remain, is an excellent base to consolidate within that sector given its dominance being the 2nd largest player in the ANZ region.

This business will likely experience strong positive tailwinds to new business openings post covid, inflationary pressures that increase the investment in labour-saving machines as well as anticipated high-interest rates which may increase margins over time. HUM's foundations are firmly rooted within the commercial space and it has managed to survive through periods of commercial distress that competitors have been unable to bear.

We believe that it is likely that a high quality, pure play commercial lending business is likely to trade at a higher multiple than the current blend of business divisions.

The approximate value to HUM shareholders at the time of writing equates to just over 57c a share versus a current HUM share price of 76c**. This implies a residual value of only around $95 million for HUM's commercial business, well under its net asset value of $268 million.**

This value differential is likely attributable to the uncertainty that exists at the board and shareholder level.

Governance

The role of independent, non-executive directors on a board, is to act on behalf of all shareholders, providing important protections for minority shareholders

The HUM board is comprised of 6 directors, 2 non-independent, and the balance independent. All directors are well-credentialed, well-known, and well-qualified individuals in their own right.

The transaction enjoys unanimous support from the entire board except for AA who is the sole dissident against the transaction at the board level.

Interestingly, given AA's incumbency on the board since inception, all the non-executive directors were appointed under his aegis. In particular, one director aside from AA has been a member of the board, since 2003 pre-listing. The rest of the non-executives have an average tenure of 3.5 years between them; so, prima facie, it appears that this board was functional up until the time of the LFS offer. Accordingly it’s safe to assume that the present schism is solely related to the HCF transaction itself.

LFS deal was structured via a non-binding heads of agreement. This allowed a mutual due diligence period and some exclusivity subject to a fiduciary carve-out. This bought time for any competing, perhaps improved offer from another counter-party to eventuate. This agreement was In place for over 40 days before a binding agreement was reached, so it's unlikely that an alternative appropriate offer was received. **In addition, we note that AA stepped down as board chair in December, which begets the question: was AA planning his own privatisation proposal for HCF, which has consequently failed to find financial backers?**

In a nutshell, this can be viewed as the major 20% shareholder opposed to the transaction; whereas the representatives of the other 80% of shareholders are in favour of the transaction.

HUM has advised that there is no competing offer. Shareholders are being asked to take it upon a single board member's word, that the business is undervalued. As part of the process, an independent expert report ('IER') has been undertaken and the proposed sale of HCF has been deemed fair and reasonable in the absence of a superior offer. **Notably, the IER provided a valuation range of $260-308 million before the disclosure of the headwinds being experienced by the business in the calendar year 2022. Despite this and the fall in LFS's share price, the offer remains within this valuation range presently around $275 million**. One can only imagine what a new IER would look like in the present, difficult conditions being experienced by HUM and its competitors.

Ultimately HUM is a business that is heavily correlated to the economic cycle. After listing in 2006, HUM's share price fell over 90% from its peak in the GFC. From this GFC low, it consequently rose 20 times into 2013 in a highly favourable macro environment for financials. However, from 2013 high to the present, the company's current share price is down around 85% despite some of the most benign conditions for lenders in living memory.

Questions that shareholders should ask themselves:
Can HCF prosper despite adverse macro headwinds in the consumer sector?

Does the HCF business have the capability to originate suitable receivables with acceptable credit metrics within a more competitive market environment?

Is it appropriate for the company to continue to risk capital within a sector where it has no clear competitive advantage and sub-par scale?

Does the potential downside risk justify the potential for greater value realisation over time? Is a bird in the hand worth more than two in the bush?

Does the unvalidated opinion of HUM's major shareholder trump the qualified opinion of the independent valuation expert?