Marlin Business Services Is A Buyout Target, But New Products Should Drive Growth

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Summary

Shares of MRLN have been clipped significantly in the last couple of years due to lower ROE and top management turnover.

There is increasing demand for these kinds of specialty financings as small businesses would rather not commit large amounts of upfront capital.

We think the firm will eventually be acquired by a larger bank that can utilize their large capital base and grow originations while lowering the cost of capital.

Shares of Marlin Business Services (NASDAQ:MRLN) have fallen by 37% over the last two years and 21% in the last year. Some of this is due to the announcement of the retirement of the founder of the company, CEO Dan Dyer. This comes on the heels of the CFO retiring back in May and who was replaced in August by Taylor Kamp. We think the valuation is extremely attractive with low-double-digit returns on equity and accelerating growth driven by both its core leasing business and its new ventures, coupled with the share decline.

The shares have waned despite the operating performance growing markedly the last few years with a revenue growth CAGR of 12.5% but operating income growing at just over 30% per year. We think the new ventures are likely to drive earnings to close to $2.00 per share over the next few years. In the interim, the company is overcapitalized, which we think will allow for another special dividend, similar to the $2 per share special paid a few months ago.

Secular Growth Story In Equipment Financing Market

The business holds a diversified portfolio across many markets. It has the largest exposure to copiers at 30.2% of equipment mix with medical and retail customers being the largest industry segments served. As copiers subside in need over the next five to ten years due to the shift to paperless work environments, the company has ample other avenues of equipment leasing to pursue. To be clear, management does not foresee a slowdown in copier leasing; in fact just the opposite as businesses shift to leasing over purchasing with the high upfront costs associated with it.

New Business Ventures Will Drive Revenue

In March, the company launched Funding Stream through its Marlin Business Bank. This innovative loan program is aimed exclusively at small businesses for loans of up to $100,000 to help grow their companies and satisfy capital needs. Funding Stream gives true business loans from as little as $5,000 with flexible six to 24-month terms. The process is meant to be fast and hassle free with an application process of as little as 10 minutes or less. Funds are received in as little as two days.

This new short-term funding mechanism is meant to provide working capital needs to small businesses that otherwise do not have much choice. Management noted that it believes it can leverage the product through cross-selling opportunities and credit data from its existing customer base to ramp the product quickly and profitably. Although the company noted it is taking a prudent approach in rolling it out, there is a real gap in the market for this type of loan offering which isn't typically offered by its local bank.

Management has guided to $50 million of business loan originations in 2016 compared to just $1 million in the first two quarters of 2015. Expectations call for 60% of the originations to be from cross-selling, and the company expects an increase in marketing to drive volume. Average loan size should be around $30K with a 12-15 month term with an average yield of 35% and loss rates as high as 10%. This compares to its core leasing business which carries implicit yields of about 11% and loss rates of 1.7%. We are being mindful of the credit quality and loss rates but would note that the company's disciplined underwriting and long track record mitigate some of this risk.

In early November, the company launched a new transportation finance unit that will provide financing to manufacturers and dealers of commercial trucks, trailers, and specialty vehicles. This is a new dealer-based model where the new sales force will leverage its regional truck dealer contacts. it is attempting to move into an area of the market just below the big players like GE (NYSE:GE). These larger firms do floor planning and they're looking for multi-unit, multi-truck opportunities in the $250K to $2 million range, above what Marlin will be targeting.

Lastly, the company announced it was expanding its insurance offerings on a broker basis with a partnership with The Hartford in order to offer a one-stop shop to meet the financial needs of small business owners. It generates insurance premium revenue from insuring the equipment it leases out to small businesses. Marlin is expanding its agency capabilities for business owner policies by leveraging its existing 36K customer base. If it can penetrate its entire base of customers, it would generate approximately $7 million in incremental, high-margin revenue with no capital requirements.

Return On Equity Set To Increase

In the latest quarter, return on equity was approximately 11.7% when adjusting for the one-time charge. This is below its stated 13% to 15% target range as the company remains significantly overcapitalized despite the special dividend. Given the large surplus of capital, the company could nearly double its lease and loan portfolio on the current amount of capital. Current ROE was depressed by this large capital base but also because of these growth initiatives and spending to build out its sales force.

We think the company is set to increase its share repurchase program. In the most recent quarter, it bought back ~200K shares or approximately 1% of the outstanding. It also increased the dividend payout to 37% of third-quarter earnings at $0.14 per share. These efforts have reduced the capital ratio to 19.1%, down from 23.1% at the end of the prior quarter. Management has stated that it has a 17.5% requirement level for its capital ratio. But as it reduces the ratio and sees the benefits from its recent growth investments, ROE should rise towards its objective range and the share price should respond favorably.

Valuation

The shares are likely depressed due to net interest and fee margin compression over the last two years. But we think that may be changing as the company launches these new higher-yielding products and they ramp up in relevance. The cost of funds remains very low around 90 bps, up 7 bps from the year before as management pushed out the duration of its CDs by an additional six to 12 months. That coupled with interest and fee yield declining by 68 bps from a year earlier and 5 bps sequentially to 12.85%, driven by the run-off from its higher-yielding assets and some product mix shift, has compressed margins a bit.

The shares trade at 1.3x book value which reflects the $2 special dividend payment a few months ago. The multiple is at a discount to the specialty finance peer group average which is close to 2.0x book despite having better operating performance metrics. We think the discount is there because of the ongoing transition of the top tier of management. The company has hired an executive search firm to find a new CEO, but there are obviously risks surrounding that change. Additionally, as we noted, there was a recent change at the CFO position and it will take time for investors to gain acceptance of the new hire.

The company should earn between $1.60 and $1.65 next year and around $1.90 in fiscal 2017. We think with MRLN's new product launches, it may be able to surpass those estimates if it gains a solid and early traction over the first half of 2016. We also think the growth rate should be in the low teens along with its return on equity. If we use a 13x multiple (equating to ROE and EPS growth) on those EPS estimates, we think the shares are worth $20.80-21.45 today and nearly $25 one year from today for strong upside potential. We think some of that potential will be realized once the company hires the new CEO.

Given the strength of its origination business and many large banks with deep pockets and little in the way of loans to give, we think the company would be an excellent acquisition target. A large acquirer could shed significant SG&A costs and boost originations to reduce that surplus capital position and increase returns on equity. The company has no deposit base which is why its cost of funding is near 1% while most large banks have excess deposits costing 25-50 bps. This advantage would mean significant accretion in an acquisition from this vantage point alone. The company has two large investment managers in the shares with Broad Run owning 9.3% and Red Mountain Capital at nearly 24%. We think these entities will be looking for an exit opportunity through the sale of the business.

Conclusion

Shares of Marlin appear like a decent value to us as the company continues to benefit from its niche business model generating strong leasing fee revenue. We think 2016 will be an upside year as the company launched its new loan businesses while expanding its insurance offering. We believe the additional fee revenue and lower capital base from the special dividend payout, increased dividend, and share repurchases will increase returns on equity towards 13-14%. But we think the business is likely to be sold in the next 12 to 24 months especially since the founder and CEO has retired from the company.