

Heartland Group

In the Heart of the Storm

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UNDERPERFORM

We initiate coverage of Heartland Group Holdings (HGH) with an UNDERPERFORM rating and target price of NZ\$1.35. HGH faces Net Interest Margin (NIM) pressure, slowing receivable loan growth, an increasing cost to income ratio and elevated impairment expenses, in our opinion. We also believe there are number of regulatory, competitive and economic headwinds ahead. This is corroborated by discussions with reverse mortgage brokers, car finance companies, competitors and industry experts. Currently HGH holds just 1% of total bank assets in New Zealand, while in comparison the four largest Australian banks hold a combined 89% of the New Zealand market. HGH has a higher funding cost than peers and focusses on providing nicher, higher risk products with higher yields. This is evidenced by generating the highest NIM across banks operating in New Zealand. Our ROE driven target price implies a lower P/BV multiple than HGH is currently trading on.

NZX Code	HGH	Financials: Jun/	20A	21E	22E	23E	Valuation (x)	20A	21E	22E	23E
Share price	NZ\$1.41	NPAT* (NZ\$m)	69.9	61.9	70.0	80.9	PE	11.6	13.4	12.0	10.6
Target price	NZ\$1.35	EPS* (NZc)	12.1	10.5	11.7	13.3	EV/EBIT	n/a	n/a	n/a	n/a
Risk rating	High	EPS growth* (%)	-4.8	-13.1	11.5	13.3	EV/EBITDA	n/a	n/a	n/a	n/a
Issued shares	576.7m	DPS (NZc)	7.0	5.0	8.0	8.5	Price / NTA	0.0	0.0	0.0	0.0
Market cap	NZ\$813m	Imputation (%)	100	100	100	100	Cash div yld (%)	5.0	3.5	5.7	6.0
Avg daily turnover	529.6k (NZ\$687k)	*Based on normalised profits					Gross div yld (%)	6.9	4.9	7.9	8.4

Downward NIM pressure driven by yield compression and securitisation funding...

We believe that competition will put downward pressure on HGH's ability to maintain yields in divisions that are currently exhibiting high returns on equity (ROE). The Australian reverse mortgage market has been subject to increasing competitive pressures evidenced by the entry of Legal & General. This followed exits by the largest Australian banks given the reputation risk associated with mis-selling the product. Additionally, we estimate HGH's recent securitisation to cost 3.5%–4.0% applying further NIM pressure. However, this could be partially offset by the RBNZ Funding for Lending program, which if mirroring the RBA's Term Lending Facility in Australia, would provide 5% of funding for banks in NZ. Accordingly, the RBNZ would be taking on additional credit risk in the form of collateral, which may mean funding is limited for HGH given its product mix and elevated risk profile.

ROE suppressed by increasing cost to income ratio and elevated impairment expense ratio

HGH has invested heavily in a digital strategy in recent years, raising its cost to income ratio and lowering ROE. While this should theoretically lower HGH's cost base, we believe earnings accretion to be highly uncertain. We believe HGH would experience a significant increase in non-performing loans in the event of a further downside economic scenario. This is partly due to HGH's relationship with Harmony, where HGH absorb any credit losses incurred through Harmony yet hold no direct control over the business. Given the risk profile of Harmony (loans charged up to 40% interest) we see this as an oversight by HGH.

Tightening regulatory frameworks a manageable headwind for HGH

While implementation of the RBNZ's capital adequacy requirements has been delayed, we do not expect HGH to struggle to meet capital targets. However, regulatory risks remain if the RBNZ up-weights the risk weighting of reverse mortgages. We see additional regulatory risk around high-interest personal lending.

Heartland Group Holdings (HGH)

Priced as at 16 Oct 2020 (NZ\$)

1.41

12-month target price (NZ\$)*

1.35

Expected share price return

-4.3%

Net dividend yield

4.3%

Estimated 12-month return

0.0%

Spot valuations (NZ\$)

1. R-g/C-g vs P/BV

1.29

2. n/a

n/a

3. n/a

n/a

Key WACC assumptions

Risk free rate

n/a

Equity beta

n/a

WACC

n/a

Terminal growth

n/a

DCF valuation summary (NZ\$m)

Total firm value

n/a

(Net debt)/cash

n/a

Less: Capitalised operating leases

n/a

Value of equity

n/a

Profit and Loss Account (NZ\$m)	2019A	2020A	2021E	2022E	2023E
Interest income	330.0	346.8	364.5	388.0	414.4
Net interest income	194.3	216.7	222.7	236.5	253.3
Other income	11.7	16.6	17.5	18.3	19.0
Net operating income	206.1	233.2	240.2	254.8	272.3
Operating and other expenses	80.0	97.6	109.9	114.0	118.3
Impairment expenses	20.7	29.4	35.2	33.5	30.9
Depreciation and Amortisation	5.8	9.2	9.9	10.8	11.6
Tax	27.9	27.2	23.3	26.4	30.5
Normalised NPAT	71.7	69.9	61.9	70.0	80.9
Abnormals/other	1.9	2.1	0	0	0
Reported NPAT	73.6	72.0	61.9	70.0	80.9
Normalised EPS (cps)	12.7	12.1	10.5	11.7	13.3
DPS (cps)	10.0	7.0	5.0	8.0	8.5

Growth Rates	2019A	2020A	2021E	2022E	2023E
Net interest income (%)	6.7	5.1	5.1	6.5	6.8
Net operating income (%)	4.7	13.2	3.0	6.1	6.9
Normalised NPAT (%)	6.2	-2.5	-11.5	13.2	15.5
Normalised EPS (%)	1.5	-4.8	-13.1	11.5	13.3
Ordinary DPS (%)	11.1	-30.0	-28.6	60.0	6.3

Cash Flow (NZ\$m)	2019A	2020A	2021E	2022E	2023E
EBITDA	n/a	n/a	n/a	n/a	n/a
Working capital change	n/a	n/a	n/a	n/a	n/a
Interest & tax paid	n/a	n/a	n/a	n/a	n/a
Other	n/a	n/a	n/a	n/a	n/a
Operating cash flow	n/a	n/a	n/a	n/a	n/a
Capital expenditure	n/a	n/a	n/a	n/a	n/a
(Acquisitions)/divestments	n/a	n/a	n/a	n/a	n/a
Other	n/a	n/a	n/a	n/a	n/a
Funding available/(required)	n/a	n/a	n/a	n/a	n/a
Dividends paid	n/a	n/a	n/a	n/a	n/a
Equity raised/(returned)	n/a	n/a	n/a	n/a	n/a
(Increase)/decrease in net debt	n/a	n/a	n/a	n/a	n/a

Balance Sheet (NZ\$m)	2019A	2020A	2021E	2022E	2023E
Cash & cash equivalents	74.5	147.2	147.7	148.2	148.7
Receivables	4,349.8	4,583.8	4,850.2	5,245.7	5,659.1
Intangibles	71.9	72.8	74.7	75.5	75.4
Right of use asset	0	18.4	16.2	14.3	12.6
Other assets	432.8	496.0	513.0	529.4	545.1
Total funds employed	4,929.0	5,318.1	5,601.8	6,013.0	6,440.9
Deposits	3,153.7	3,264.2	3,395.4	3,559.7	3,733.6
Other borrowings	0	0	0	0	0
Other liabilities	1,099.7	1,354.0	1,465.9	1,597.5	1,734.0
Shareholder's funds	675.7	700.0	740.5	855.9	973.3
Minority interests	0	0	0	0	0
Total funding sources	4,929.0	5,318.1	5,601.8	6,013.0	6,440.9

* Forsyth Barr target prices reflect valuation rolled forward at cost of equity less the next 12-months dividend

Valuation Ratios	2019A	2020A	2021E	2022E	2023E
EV/EBITDA (x)	n/a	n/a	n/a	n/a	n/a
EV/EBIT (x)	n/a	n/a	n/a	n/a	n/a
PE (x)	11.1	11.6	13.4	12.0	10.6
Price/NTA (x)	0.0	0.0	0.0	0.0	0.0
Free cash flow yield (%)	n/a	n/a	n/a	n/a	n/a
Net dividend yield (%)	7.1	5.0	3.5	5.7	6.0
Gross dividend yield (%)	9.9	6.9	4.9	7.9	8.4

Capital Structure	2019A	2020A	2021E	2022E	2023E
Interest cover EBIT (x)	n/a	n/a	n/a	n/a	n/a
Interest cover EBITDA (x)	n/a	n/a	n/a	n/a	n/a
Net debt/ND+E (%)	n/a	n/a	n/a	n/a	n/a
Net debt/EBITDA (x)	n/a	n/a	n/a	n/a	n/a

Key Ratios	2019A	2020A	2021E	2022E	2023E
Return on assets (%)	3.0	2.7	2.2	2.3	2.5
Return on equity (%)	11.0	10.5	8.6	8.8	8.8
Return on funds employed (%)	n/a	n/a	n/a	n/a	n/a
EBITDA margin (%)	n/a	n/a	n/a	n/a	n/a
EBIT margin (%)	n/a	n/a	n/a	n/a	n/a
Capex to sales (%)	n/a	n/a	n/a	n/a	n/a
Capex to depreciation (%)	n/a	n/a	n/a	n/a	n/a
Imputation (%)	100	100	100	100	100
Pay-out ratio (%)	79	58	48	68	64

Capital	2019A	2020A	2021E	2022E	2023E
Tier 1 Capital (NZ\$m)	529	531	568	609	654
Total Capital (NZ\$m)	529	531	568	609	654
RWA (NZ\$m)	3921	4191	4335	4555	4791
CET1 Ratio	13.5%	12.7%	13.1%	13.4%	13.6%
Total Capital Ratio	13.5%	12.7%	13.1%	13.4%	13.6%

Key indicators	2019A	2020A	2021E	2022E	2023E
Net Interest Margin	4.2%	4.4%	4.2%	4.2%	4.2%
Cost to Income Ratio	41.6%	45.8%	49.9%	49.0%	47.7%
Impairment Expense Ratio	0.47%	0.64%	0.72%	0.63%	0.54%

Divisional NII (NZ\$m)	2019A	2020A	2021E	2022E	2023E
Motor	54.7	57.0	58.2	60.3	63.9
NZ Reverse Mortgages	20.7	20.1	21.8	23.9	26.3
Australia Reverse Mortgages	22.3	30.1	33.4	39.0	44.9
Personal Consumer	14.6	18.4	18.8	19.8	20.7
Business	52.9	58.0	59.2	62.8	66.6
Rural	30.4	29.7	27.8	27.1	27.1

Executive Summary

We initiate coverage of HGH with an UNDERPERFORM rating and a target price of NZ\$1.35. Key drivers of the investment case include 1) yield compression of HGH's reverse mortgage product, 2) slowdown of receivable loan growth in the motor division, 3) an increasing cost to income ratio reducing ROE and 4) elevated impairment expenses given HGH's risk profile and current loan exposure. However, there are opportunities in the rural sector as increased capital requirements push out larger competitors.

Investment Thesis

Occupying just 1% of total bank assets in New Zealand, HGH has historically and will continue to struggle to compete on yield against the four Australian banks (holding 89% of assets) given its higher cost of funding. To grow its net interest margin (NIM), mainstream assets such as residential mortgages are unprofitable for HGH and so the company focusses on products with greater yield, but in smaller, less competitive and more niche markets. These are typically higher risk loans with higher regulatory capital charges. This is in contrast to the larger banks which focus predominantly on residential mortgages which incur lower capital charges. HGH funds its receivable loan assets through retail deposits (predominantly fixed term deposits), unsubordinated notes and securitisations.

Banks create value by generating a higher Return on Equity (ROE) than Cost of Equity (COE). This is closely related in valuation terms to their price to book value (P/BV) ratio, which reflect what investors are willing to pay for the bank's equity. For HGH to sustain ROE above its COE, in our view it needs to scale its reverse mortgage divisions, motor division and rural division, given the higher ROE generated in these businesses. In contrast, the personal lending and the business divisions (weighed down by Open4Business) generate an ROE lower than HGH's COE on our estimates.

Key questions for HGH

In order to value HGH materially ahead of its current share price one needs to conclude that HGH can widen its spread between ROE and COE. The key questions for HGH are currently:

- 1. Can HGH sustain yields in divisions exhibiting higher ROE?** Within the reverse mortgage business, competition has increased with the entry of large scale reverse mortgage provider Legal & General and the Australian Federal government. The New Zealand reverse mortgage business has already seen yield compression over the last 18 months and as such we would expect to see some downward pressure for the Australian business. Additionally, HGH's recent 30 year securitisation transaction which we estimate to be between 3.5% and 4.0% is likely to negatively impact NIM and ROE. This however maybe partially offset by the RBNZ's Funding for Lending program depending on funding criteria and size, which would see the RBNZ taking on additional credit risk in the form of collateral.
- 2. Are we likely to see increased ROE from decreased operating and impairment expenses?** With the current product mix we expect to see a continued increase to HGH's cost to income ratio predominantly driven by digital and core banking infrastructure investment. In addition, an elevated impairment expense ratio is underpinned by HGH's absorption of Harmony's credit losses and exposure to higher risk loans.
- 3. What is the impact of a changing regulatory environment on HGH?** Whilst HGH is relatively well positioned to meet the RBNZ's recent banking capital adequacy requirements published in December 2019, we see risk to changes in reverse mortgage risk weights requiring increased capital charges and a tightening of regulation surrounding short term, high interest loan caps.

High risk rating

We assign HGH a high risk rating and outline key risks as follows:

- **Reputation risk:** Some of HGH's products are unattractive to larger banks due to the reputational risk attached. We highlight reverse mortgages and high-interest consumer lending as we believe the risks are elevated.
- **Sensitivity to the economic cycle:** Banks are highly cyclical, and in our view HGH is likely to exhibit stress in a further downside scenario. The macroeconomic impacts of COVID-19 remain unknown, with consensus forecasts suggesting risk to the downside.
- **Execution risks as it progresses with digital strategy:** HGH has invested significantly in its digital strategy, which should theoretically lower cost to serve. There is a risk that investors do not see benefit in the form of earnings accretion.
- **Slowdown of the Australian reverse mortgage market:** The Australian reverse mortgage market is unlike the New Zealand market, characterised by higher competition and lower barriers to entry. There is a risk that HGH's entry into this market is less lucrative than expected. Key market risks include fall in the property market, new entrants to the market, change to the Australian pension scheme, increased regulation risk or disruption risk from the unknown.

What is HGH?

Heartland Group Holdings (HGH) is the parent holding company to subsidiaries Heartland Bank and Heartland Seniors Finance. Heartland Bank operates in New Zealand and provides a range of banking services which includes household loans, business loans and rural financing. Heartland Seniors provides a reverse mortgage product to the Australian market. Heartland Bank listed on the NZX in 2012 before a corporate restructure which saw HGH dual list on the ASX in 2018.

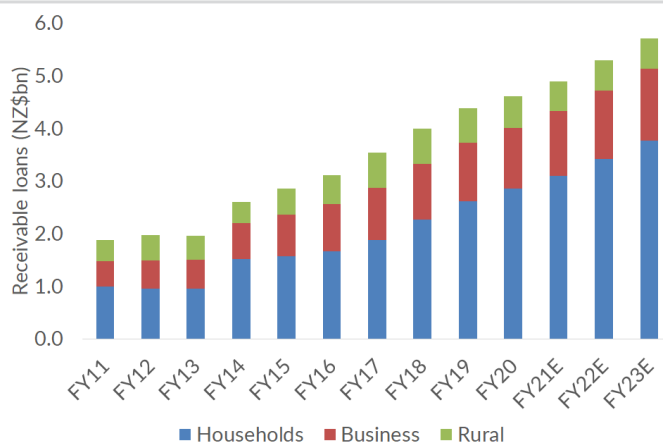
A brief history of the group

- In 2011 building societies Southern Cross and CBC Canterbury merged with MARAC car finance to become Heartland New Zealand before acquiring rural lender PGG Wrightson Finance
- The group was granted a bank registration in 2012 by the Reserve Bank of New Zealand (RBNZ) before listing on the NZX in 2012
- In 2014, the renamed Heartland Bank acquired reverse mortgage provider Australian Seniors Finance
- In the same year, the company acquired a 15% stake in peer to peer lending platform Harmoney
- In 2018 the company restructured and HGH became the holding company, subsequently dual listing on the ASX

Household remains HGH's dominant product segment

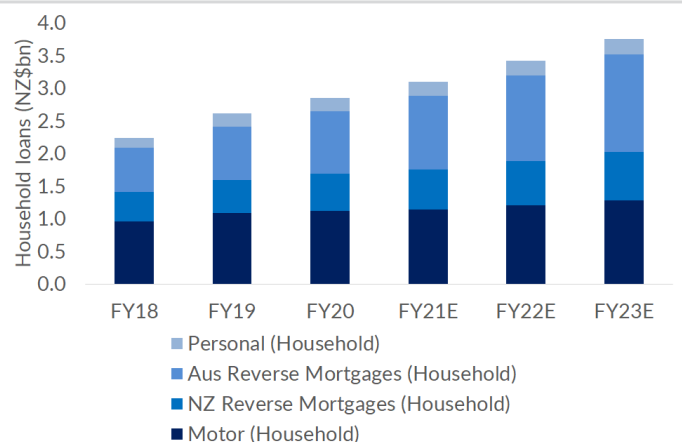
Heartland Bank is split into household, business and rural financing with household divided into personal, motor and reverse mortgage products. Household loans contributed 57% of the group loan receivables in FY20 and we forecast this to rise to 63% by FY23.

Figure 1. Group receivable FY11–FY23 (NZ\$bn)



Source: Forsyth Barr analysis, HGH

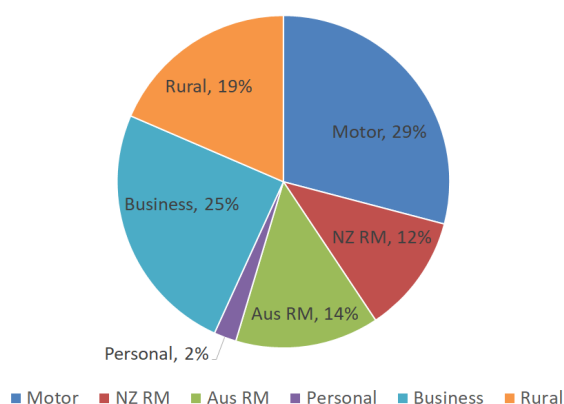
Figure 2. Household receivable FY11–FY23E (NZ\$bn)



Source: Forsyth Barr analysis, HGH

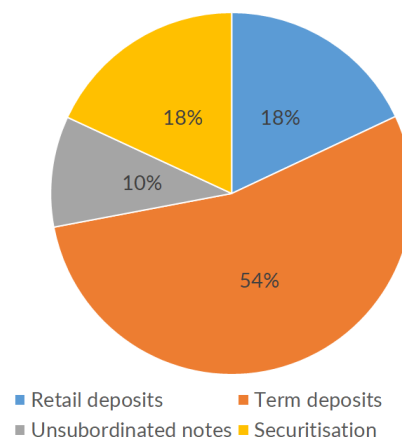
Within household products, motor loans remain the largest loan receivable contributor to the group (29% at FY20) having seen a seven year CAGR of 10%. Going forward, we forecast Australian reverse mortgages to be the fastest growing product, increasing its contribution from 14% of the group at FY20 to 19% by FY23E.

Figure 3. PBT divisional split FY20 % of group



Source: Forsyth Barr analysis, HGH. (RM= Reverse Mortgage)

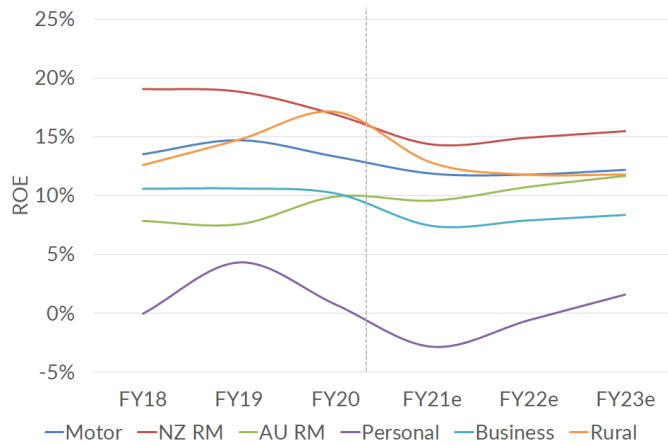
Figure 4. HGH funding split % FY20



Source: Forsyth Barr analysis, HGH

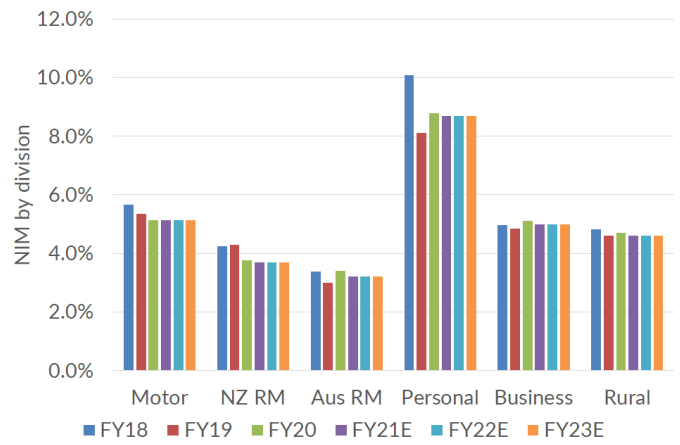
Our thesis in pictures

Figure 5. ROE by division FY18-FY23E



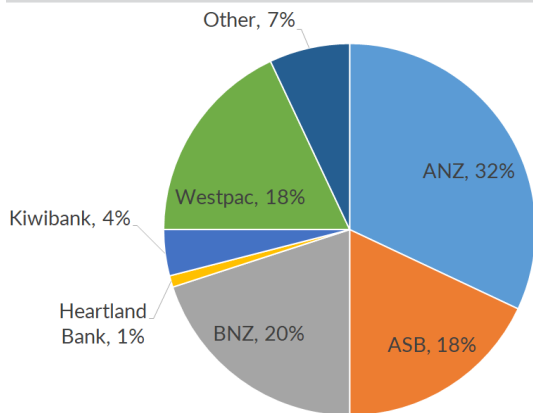
Source: Forsyth Barr analysis, Company reports

Figure 6. NIM an indicator as to divisional risk profile



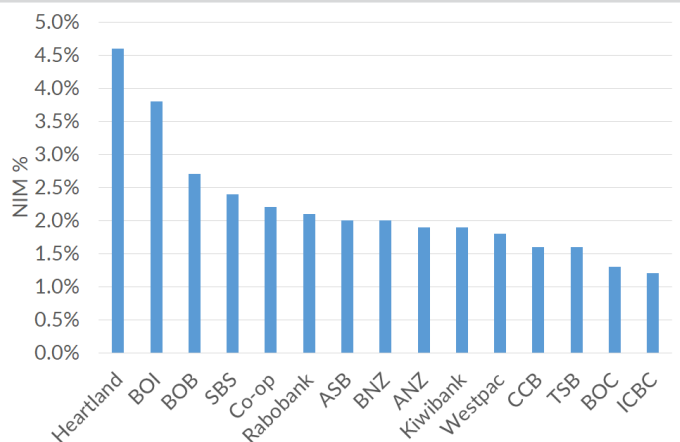
Source: Forsyth Barr analysis, Company reports

Figure 7. HGH makes up 1% of NZ bank assets



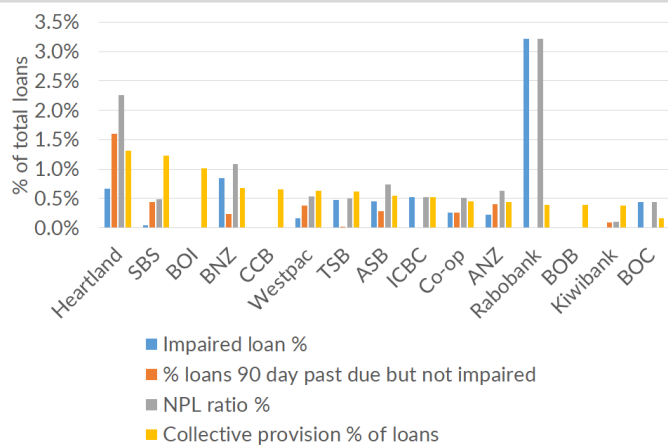
Source: Forsyth Barr analysis, RBNZ

Figure 8. HGH has the highest NIM & risk profile vs all NZ banks



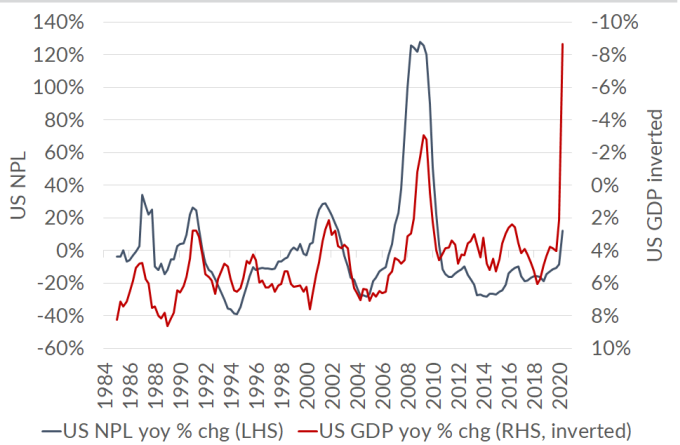
Source: Forsyth Barr analysis, RBNZ

Figure 9. RBNZ dashboard asset quality comparison



Source: Forsyth Barr analysis, RBNZ

Figure 10. GDP growth and NPL % strongly correlated



Source: Forsyth Barr analysis, FRED

Valuation

We value HGH using a variant of the Gordon Growth Model. We compare the price/book value multiple against HGH's profitability (ROE) to its cost of equity capital (COE) adjusted for the growth rate, using the Net Asset Value approach.

Calculating our cost of equity to be 8.5% and an ROE for FY21 at 8.6% we derive a valuation of NZ\$1.29, rolled forward at the cost of equity to imply a target price of NZ\$1.35. As such with the shares trading at NZ\$1.41 we initiate with an UNDERPERFORM rating.

For a bank's price to book value to rise this needs to be reflected by an increasing spread between ROE and COE, thus creating value. Pre COVID-19 HGH's ROE declined considerably, reflected in a declining share price. Coupled with an increasing cost to income ratio, an elevated impairment expense ratio, NIM pressure and a high risk loan book exposed to an uncertain macroeconomic backdrop, we are unconvinced in the short term that HGH's ROE can reach previous levels seen between FY17-FY19.

Figure 11. Gordon Growth Model variant calculation

Price	1.41
BV	1.26
P/BV	1.12
ROE	8.6%
COE	8.5%
G	5.0%
ROE-g/COE-g	1.03
Return	-8%
Valuation	1.29

Source: Forsyth Barr analysis

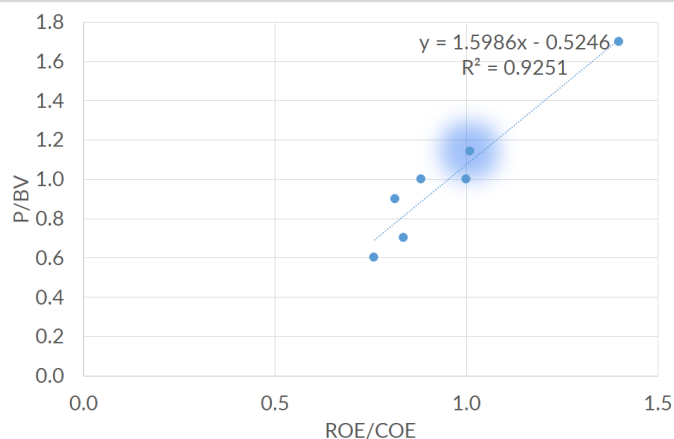
Figure 12. Cost of equity & Target Price calculation

Rf	1.30%
Beta	1.2
MRP	6.0%
Coe	8.5%
Target Price	
Valuation	1.29
Rolled forward at cost of equity	1.40
Less dividends	0.05
Target Price	1.35

Source: Forsyth Barr analysis

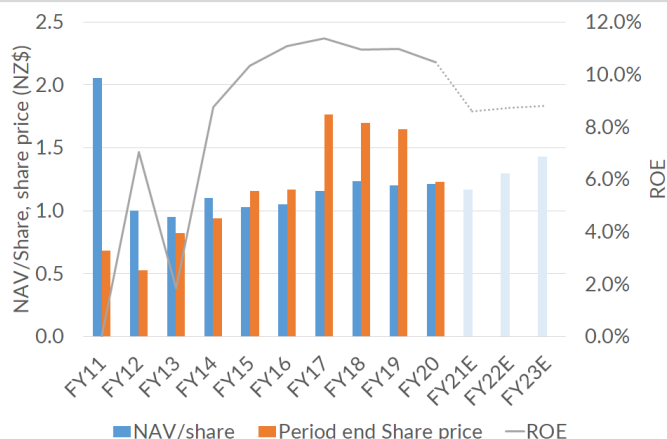
Australasian banks have a correlation of 93% between P/BV and ROE/COE and as illustrated below HGH appears relatively expensive against peers. We assume a growth of 0% in the table below for comparable purposes.

Figure 13. HGH & peer banks ROE/COE vs P/BV



Source: Forsyth Barr analysis

Figure 14. HGH NAV/share vs period end share price vs ROE



Source: Forsyth Barr analysis

Figure 15. ROE/COE vs P/BV, HGH vs Australasian peer group

Company	Code	Price	Mkt Cap	COE	ROE	ROE/COE	P/BV
Heartland Group Holdings	HGH	NZ\$1.41	NZ\$813	8.5%	8.6%	1.01	1.12
Common Wealth Bank of Australia	CBA	A\$69.24	A\$123,047	6.8%	9.5%	1.4	1.7
National Australia Bank	NAB	A\$19.22	A\$63,343	8.4%	7.4%	0.9	1.0
Westpac Banking Corp	WEBC	A\$18.66	A\$67,508	7.5%	7.5%	1.0	1.0
Australia and New Zealand Banking Group	ANZ	A\$19.31	A\$54,941	8.3%	6.7%	0.8	0.9
Bendigo and Adelaide Bank	BEN	A\$6.86	A\$3,642	6.3%	4.8%	0.8	0.6
Bank of Queensland	BOQ	A\$6.91	A\$3,145	5.9%	4.9%	0.8	0.7

Source: Forsyth Barr analysis, Bloomberg

Note: We assume a g of 0% and apply a historic Bloomberg beta for each peer in conjunction with NZ calculated MRP and Rf for comparative purposes

Forecasts & Sensitivity

Our current FY21 NPAT forecast of NZ\$62m is below current guidance of NZ\$83-85m. This is explained by our net interest income and impairment expense ratio forecasts.

Net interest income is driven by receivable loan growth, which we forecast to be +6.3% vs +0.8% for 2H20 (which also only saw three months of COVID-19 impact). We expect HGH to experience NIM pressure from both yield compression and the new 30 year securitisation transaction, which we assume to cost between 3.5% and 4.0%. However this maybe partially offset by the RBNZ's Funding for Lending program.

Using the current RBNZ banking dashboard HGH has a Net Interest Margin of 4.6%, vs ASB and BNZ both at 2.0% while ANZ and Westpac are at 1.9% and 1.8% respectively. A NIM of more than double its peers suggests that HGH has a considerably higher risk profile of loans and as such one would expect this to translate into higher impairment expenses. It is worth noting that Westpac reported an impairment expense ratio of 0.31% at its interim result, which when annualised we would translate to around 0.62%.

Figure 16. Forbar forecasts vs guidance & consensus FY21

Metric	HGH Guidance (NZ\$)	Consensus (NZ\$)	Forbar (NZ\$)	Assumptions
Net Interest Income	Implied 243m		223m	1. Loan receivable growth of +6.3% vs 2H20 of 0.8% (only 3 months of COVID-19) 2. NIM pressure from yield compression and new securitisation
Impairment ratio	Implied 0.64%		0.72%	HGH's NIM is double peers & impairments should reflect. HGH FY11 impairment 2.33%
NPAT	83-85m	73m	62m	

Source: Forsyth Barr analysis

Historic impairment expense ratio over time

During times of recession recovery, HGH has historically reported an impairment ratio well above peers. In recent years which have exhibited low economic stress, HGH has remained ahead of peers but at a reduced level. For the foreseeable future, we expect HGH's impairment expense ratio to be significantly in advance of peers given its considerable risk profile and current consensus economic forecasts.

Subsequently, we provide impairment ratio sensitivity for HGH's FY21 forecasts. On our forecasts an impairment expense ratio of 1.0% would reduce NPAT to NZ\$51m and lower ROE to 7.1%.

Figure 17. HGH impairment expense ratio vs peers 2006-19

	WPC	ANZ	CBA	NAB	HGH
2006	0.22%	0.27%	0.13%	0.37%	
2007	0.20%	0.27%	0.14%	0.34%	
2008	0.37%	0.55%	0.19%	0.62%	
2009	0.81%	1.48%	0.89%	1.32%	
2010	0.95%	1.73%	1.02%	1.17%	
2011	0.92%	1.17%	1.02%	1.14%	2.33%
2012	0.85%	1.02%	0.83%	1.13%	0.55%
2013	0.67%	0.80%	0.76%	1.22%	1.44%
2014	0.40%	0.51%	0.55%	0.77%	0.35%
2015	0.30%	0.43%	0.44%	0.39%	0.61%
2016	0.32%	0.41%	0.44%	0.48%	0.45%
2017	0.22%	0.38%	0.43%	0.31%	0.43%
2018	0.20%	0.30%	0.42%	0.26%	0.56%
2019	0.25%	0.31%	0.36%	0.33%	0.47%

Source: Forsyth Barr analysis, company reports

Figure 18. Impairment sensitivity on NPAT and ROE FY21

Impairment expense ratio	NPAT (NZ\$m)	ROE
2.5%	-3	-0.5%
2.0%	15	2.1%
1.5%	33	4.6%
1.0%	51	7.1%
0.7%	62	8.6%
0.5%	69	9.6%

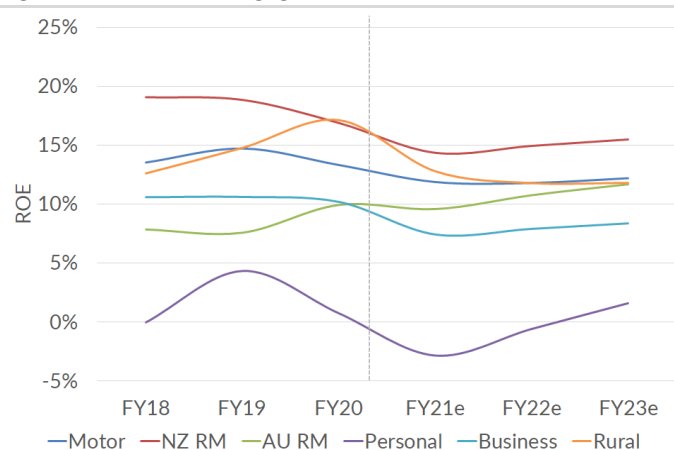
Source: Forsyth Barr analysis

Q1. Can HGH sustain yields in divisions exhibiting higher ROE?

Competition has increased in the Australian reverse mortgage market, with UK reverse mortgage provider Legal & General taking a 20% stake in Household Capital. We expect HGH's Australian business to experience yield compression particularly as the New Zealand reverse mortgage product has seen compression over the past 18 months. We view yields in the motor business to be more sticky, given high rates of car ownership supporting future demand, and see the rural sector as an opportunity to grow receivables and expand NIM as large banks exit the sector in light of increased capital charges.

We use the term 'yield' as the rate by which the consumer is charged per annum in return for borrowing a particular product (such as a reverse mortgage). HGH achieves a higher NIM than peers due to lending assets to higher risk consumers and charging a higher yield. Given the size of the organisation, HGH is unable to compete on funding cost against peers. It focusses on higher yielding products and higher risk consumers which help offset the higher cost of funding.

Figure 19. Reverse mortgages, motor, rural ROE above HGH COE



Source: Forsyth Barr analysis, HGH

Figure 20. Reverse mortgage, motor, rural ROE & forecast ROE

	FY18	FY19	FY20	FY21E	FY22E	FY23E
Australia Reverse Mortgages	7.8%	7.6%	9.9%	9.6%	10.7%	11.7%
New Zealand Reverse Mortgages	19.1%	18.8%	16.9%	14.4%	15.0%	15.5%
Motor	13.5%	14.7%	13.3%	11.9%	11.8%	12.2%
Rural	12.6%	14.8%	17.2%	12.8%	11.8%	11.8%

Source: Forsyth Barr analysis, HGH

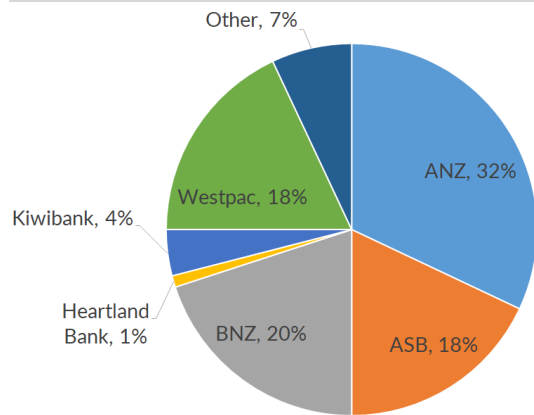
Reverse mortgages: product likely to face yield compression

HGH believes reverse mortgage yields in the Australian market are reasonably sticky with risk to the upside. We believe this is optimistic given the increasing competitive pressures, slowdown of receivable growth resulting from COVID-19 and the product's current premium yield compared against residential mortgage yields.

HGH has found a niche product in reverse mortgages, exposed to a number of growth drivers

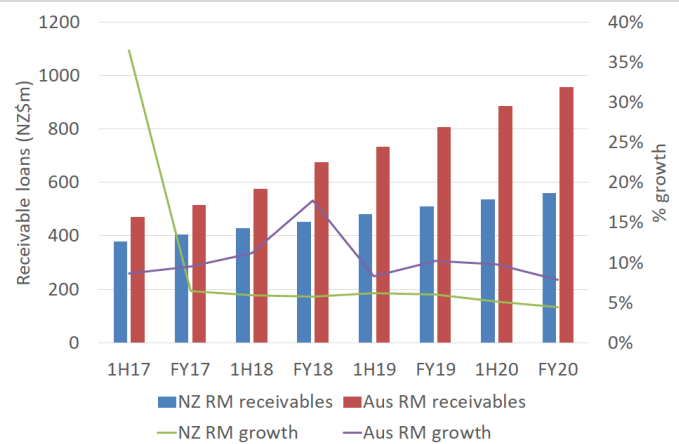
HGH moved into the reverse mortgage product in 2014 by way of differentiation, acquiring reverse mortgage providers Sentinel in New Zealand and Australian Seniors Finance. The product has seen three year receivables growth CAGR of +11% and +23% in New Zealand and Australia respectively, benefitting from a number of tailwinds that include ageing demographics, soaring house prices and sustained low interest rates.

Figure 21. NZ total bank asset split by provider



Source: Forsyth Barr analysis, RBNZ

Figure 22. HGH reverse mortgage book growth 1H17-FY20

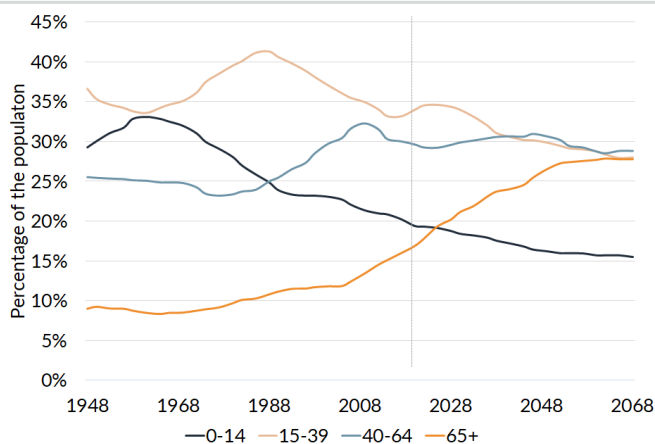


Source: Forsyth Barr analysis, HGH

Drivers include an increasingly older demographic....

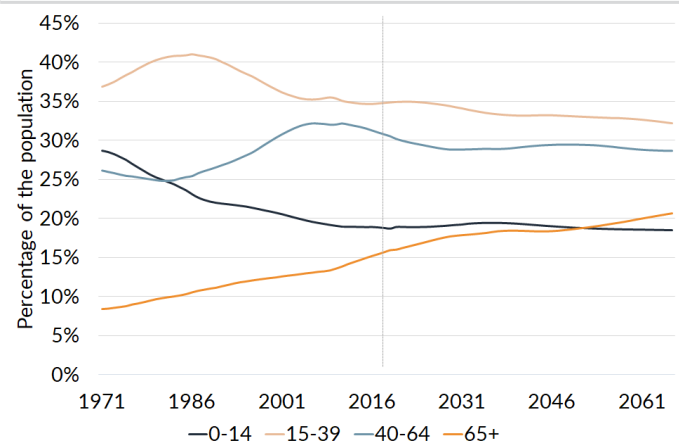
The over 65 age category currently makes up 17% of the population in New Zealand. This has risen from 8% in 1969 and is estimated to reach 28% by 2062. In Australia over 65s make up 16% of the population and this figure is expected to reach 20% by 2062. On speaking to a number of mortgage brokers, the main drivers behind growth of the reverse mortgage product are a dilution of partners amongst retirees combined with those on limited income paying rising household bills.

Figure 23. NZ population: age distribution and forecast



Source: Forsyth Barr analysis, Stats NZ

Figure 24. Australian population: age distribution and forecast

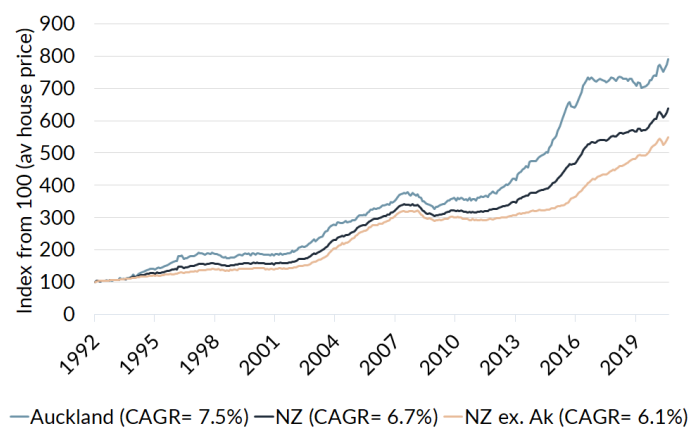


Source: Forsyth Barr analysis, ABS

...while house prices in New Zealand and Australia have boomed over the last 30 years

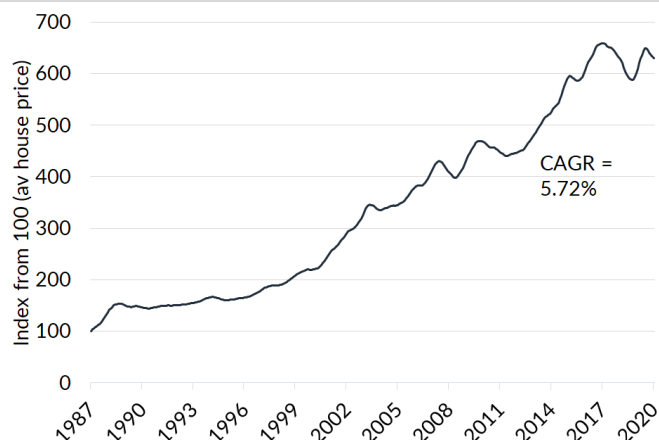
Since 1992 New Zealand house prices have grown at a CAGR of +6.7% (Auckland +7.5%) while in Australia, since 1987, average house prices have grown at a CAGR of +5.7%. We expect a protracted period of ultra low interest rates to further bolster house price growth going forward.

Figure 25. NZ Indexed house price growth 1992–2020



Source: Forsyth Barr analysis, REINZ

Figure 26. Australia Indexed house price growth 1992–2020



Source: Forsyth Barr analysis, CoreLogic

Structural tailwinds attracting competition back into the Australian reverse mortgage market

- In 2017 Westpac and Macquarie exited the Australian reverse mortgage market ahead of CBA in 2018. This followed criticism of the product by the Australian Securities and Investments Commission (ASIC) following a story by Australian Broadcasting Corporation (ABC) which questioned whether CBA had lent irresponsibly to a customer with dementia. Following the news story, ASIC commented that 'reverse mortgages should be treated with caution' while borrowers 'had a poor understanding of the risks' and stating to lenders that 'the borrowers long term needs were not adequately documented'.
- This left a few, small providers in the market, and in 2019 the Australian Federal Government entered the market, introducing the Pension Loans scheme after an expansion of eligibility criteria.
- In March 2020 Legal & General acquired a 20% stake in Australian reverse mortgage provider Household Capital (which launched home equity products in 2017) with the goal of growing the business 'in a market with lots of potential'.
- Although there is no data to provide a market share split between providers, HGH estimates it has grown its market share from 21% to 26% at FY20, implying a total addressable market of NZ\$3.7bn (AU\$3.4bn).

Applying downward pressure to HGH's yield...

Legal & General has substantial experience in the reverse mortgage market, currently providing 30% of reverse mortgages in the UK. Household capital (of which Legal & General has taken a 20% stake), currently offer reverse mortgages at a yield of 5.15% against HGH's current yield of 5.8%. In comparison, the Australian Federal Government's Pension Loan Scheme has a yield of 4.5%. Yield compression has already seen HGH's New Zealand reverse mortgage product rate drop from 6.9% to 6.2% over the past 18 months. Given increased competition and HGH's uncompetitive yield (the highest yield in the Australian market currently), we expect some yield compression for HGH.

...highlighting the disconnect between yield and credit risk when comparing residential mortgages with reverse mortgages...

Additionally on comparing HGH's small book of residential mortgages yielding 1.99% we do not believe a reverse mortgage yield of 5.8% is sustainable (premium of c.4%) given the higher credit risk associated with residential mortgages.

...with NIM already under pressure from increased cost of reverse mortgage funding...

Funding the reverse mortgage book has been a long term priority for HGH and in September 2020 the company secured a 30 year securitisation transaction. Given the duration of the securitisation (30 years) we assume the interest cost to be between 3.5% and 4.0%, thus increasing average cost of funding for the group and applying pressure to the Australian reverse mortgage Net Interest Margin (NIM). If HGH was to increase its Australia reverse mortgage yield to sustain its NIM, we would expect a reduction in market share and a significant slowdown of loan receivable growth. However given the possibility of the RBNZ's Funding for Lending program, NIM pressure maybe partially alleviated depending on criteria and scale of funding.

Figure 27. Reverse mortgage providers Australia (October 2020)

Provider	Yield
HGH	5.80%
Household Capital	5.15%
G&C mutual Bank	5.22%
P&N Bank	5.40%
IMB Bank	5.57%
Australian federal government	4.50%

Source: Forsyth Barr analysis

Figure 28. SBS customers reverse mortgage uses

How are SBS members using REM?

- 50%** Home improvements.
- 41%** Additional money for day-to-day expenses.
- 29%** Travel and holidays.
- 23%** A new car or appliances.
- 20%** Repay other debts.
- 15%** Healthcare.
- 13%** Helping family.

Source: Forsyth Barr analysis, SBS

...and slowdown of receivable growth due to COVID-19

Travel and holiday expenditure is also a large driver for reverse mortgage growth. SBS estimates that 29% of its customers use reverse mortgages for travel while HGH has stated previously that a 'high' number of customers use the product for travel. In light of current COVID-19 uncertainty and the resulting impact on travel we would expect reverse mortgage loan growth to slow in the short term, particularly given the risks for older demographics (its target market). We also expect propensity to travel to be subdued after borders are reopened given 1) ongoing restrictions, and 2) sustained apathy to travel among certain demographics. However, some of this decrease may be offset by an increased number of retirees looking to release equity in order to invest in home renovations.

Rural financing: more attractive as competitors raise rates to compensate for capital increases

In recent years HGH has reduced its rural loan receivable assets. This was due to the high concentration risk of individual loans and the inability to compete on yield with larger banks. With the RBNZ applying an increased capital charge to rural assets, larger banks which have historically had large exposures have now either reduced rural loan assets or increased yields in order to maintain ROE. With HGH previously unable to compete on yield due to funding costs, we see rural financing as an emerging opportunity where HGH would be able to leverage its legacy assets, brand and rural network.

The amount of capital charge required for rural assets now unappealing for large banks

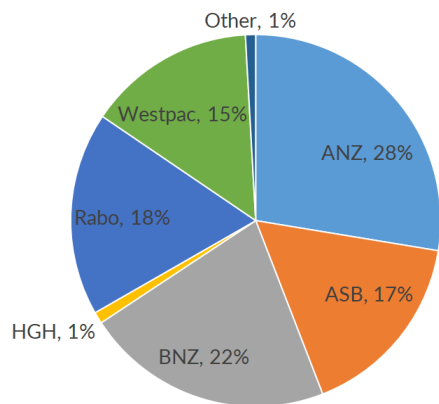
In what has historically been a highly competitive sector, in December 2019 the RBNZ prescribed a 100% risk weight for rural loan assets, having highlighted concerns over the growth of agri-business debt and the effect of volatile commodity prices within rural banking. This doubles the amount of capital that HGH is required to hold for regulatory purposes against a risk weight of 50%.

As a comparison, residential mortgages were prescribed a risk weight of between 35% and 100% (depending on loan to value ratio), with the majority of residential mortgages written around 50%. This has seen appetite for rural loans falling across the larger New Zealand banks and the resulting slowdown in rural loan growth. Exacerbating this was the APRA ruling that large Australian banks are only able to allocate half of their capital to foreign subsidiaries. However, due to pressure from the New Zealand Government and trade unions (such as First Union) the larger banks remain reasonably exposed to rural assets in order to support the New Zealand economy, but do not see this as an attractive area. Federated Farmers have estimated these capital changes and resulting yield impact will cost farmers an additional NZ\$800m in interest payments annually.

Withdrawal from larger banks leaves specialist rural lender Rabobank as main competitor...

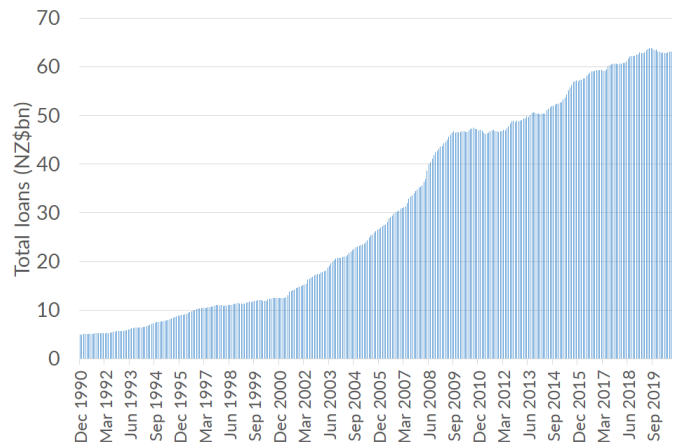
Specialist agri-lender Rabobank, the subsidiary of Dutch Rabobank, has been established in the New Zealand rural sector since 1994. It currently has an 18% market share of the rural lending market in New Zealand, with agricultural assets making up 96% of its total asset portfolio.

Figure 29. Market share rural assets (HGH 1% vs big 4 80%)



Source: Forsyth Barr analysis, RBNZ

Figure 30. Total rural loan growth December 1990–August 2020



Source: Forsyth Barr analysis, RBNZ

...presenting a timely opportunity for HGH to leverage legacy assets and branding through PGG Wrightson

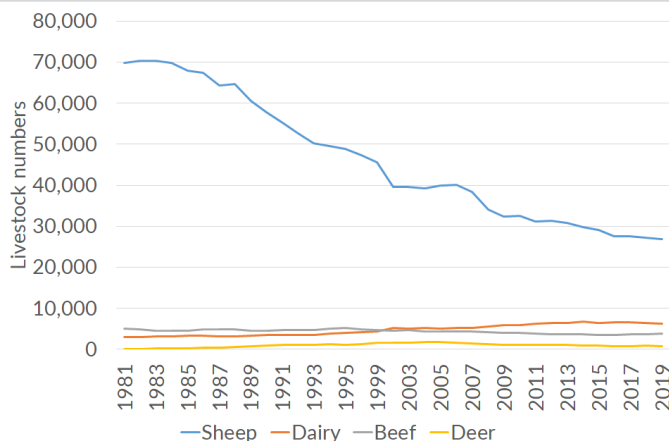
HGH already has a number of legacy rural assets originating from PGG Wrightson Finance, a well established rural company with roots tracing back to 1861. Given that the RBNZ prescribed a 100% risk weight to the rest of HGH's receivable assets (other than New Zealand reverse mortgages which are slightly over 50%) and Australian reverse mortgages (not under RBNZ capital requirements), the rural division currently looks attractive compared to other divisions. This is because it is able to generate a higher ROE than the business and personal divisions through a lower cost to income ratio and lower impairment expense ratios whilst operating in a less competitive environment.

Some signs of longer term structural decline but plenty up for grabs in the short term

The current RBNZ dashboard reports total rural loan assets to be worth NZ\$61.6bn in New Zealand, with HGH currently holding NZ\$626m (1%). Although rural financing in New Zealand clearly remains a relatively large market for HGH given the current size of its current book, we expect the impact of the recent Essential Freshwater government proposals to slow growth in the industry, as agricultural capacity is now more limited, which may in turn reduce rural borrowing.

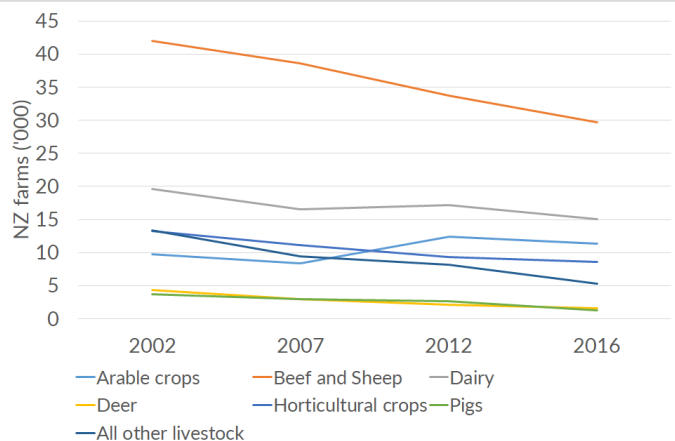
There are also signs of falling livestock numbers with a large decrease in the number of sheep in NZ more than offsetting the growth of dairy cattle while beef stock remains broadly flat. In aggregate, Stats NZ estimate total cattle to have experienced a 28 year CAGR decline of -0.5%. NZ stats also estimate the numbers of NZ farms to have fallen from 106,000 to 73,000 from 2002 to 2016.

Figure 31. NZ livestock numbers 1981–2019



Source: Forsyth Barr analysis, Stats NZ

Figure 32. Number of farms in NZ 2002–2016



Source: Forsyth Barr analysis, Stats NZ

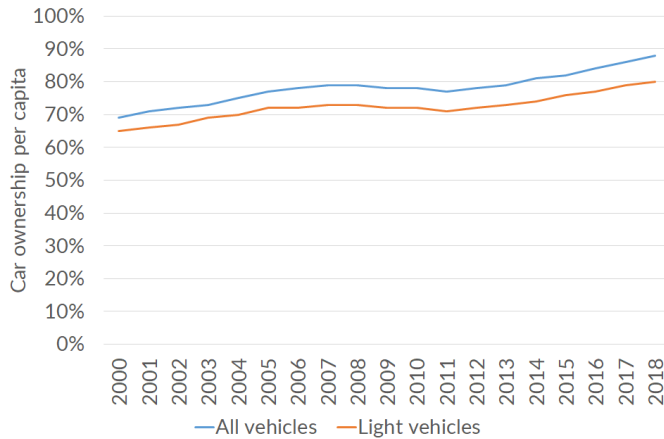
Motor: yields relatively sticky but receivable growth seeing signs of slowdown

New Zealand is widely recognised for its high car ownership per capita with several data sources suggesting that it currently ranks third on a global basis behind San Marino and Iceland. The Ministry of Transport suggests that car ownership per capita has increased from 65% in 2000 to over 80% in 2018. As a result strong demand has driven NZ motor financing at a steady pace in recent years, while in our view COVID-19 is unlikely to change working from home and commuting behaviours materially in the long term.

HGH has built a strong and defensive position in the New Zealand motor market

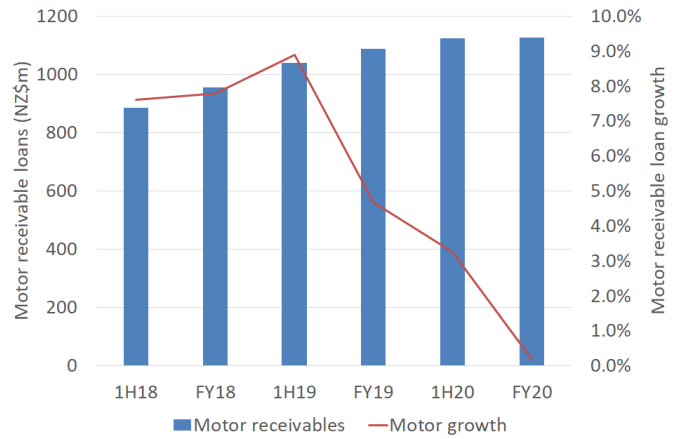
The motor business (MARAC) is well established, having been around since 1952. It includes car brands Jaguar, Land Rover, Kia, Volvo, Subaru and previously Holden. HGH estimates its current market share to be around 10% of the New Zealand market.

Figure 33. Car ownership rate in New Zealand 2000–2018



Source: Forsyth Barr analysis, transport.govt.nz

Figure 34. Motor receivables growth 1H18–FY20



Source: Forsyth Barr analysis, HGH

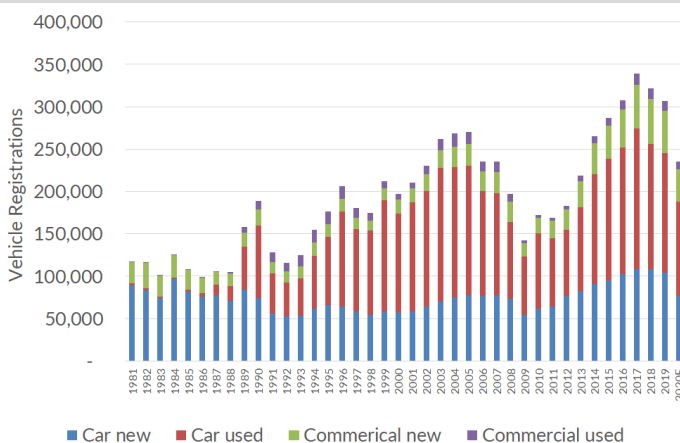
COVID-19 has seen some short term slowing of motor receivables growth...

Growth of motor loan receivables over the last three years has slowed from a peak of +8.9% in 1H19, falling to just +0.2% in FY20. Despite COVID-19 showing little long term impact on transport trends, light vehicle movement and working from home behaviours, car sales have clearly slowed. On talking to 12 car finance companies in New Zealand common feedback was that applications for car finance were down significantly due to consumers looking to decrease personal debt. Conversations with car dealers have suggested that up to 70% of cars are purchased on credit. A push towards green transport has also seen an uptake in cycling and walking to work.

...while new vehicle registrations may have already reached an inflection point in 2017

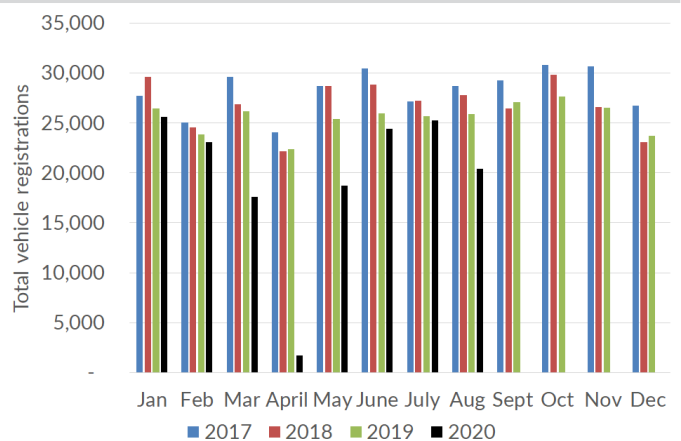
Motor Industry Association (MIA) data shows New Zealand vehicle registrations to have peaked in 2017 while vehicle registrations on a monthly basis slowed from previous years post lockdown. At this point in time we do not see an immediate catalyst for the growth rate to return to previous highs.

Figure 35. Annual vehicle registrations NZ 1981–2020E



Source: Forsyth Barr analysis, MIA

Figure 36. Monthly vehicle registrations NZ Jan-17–Aug-20

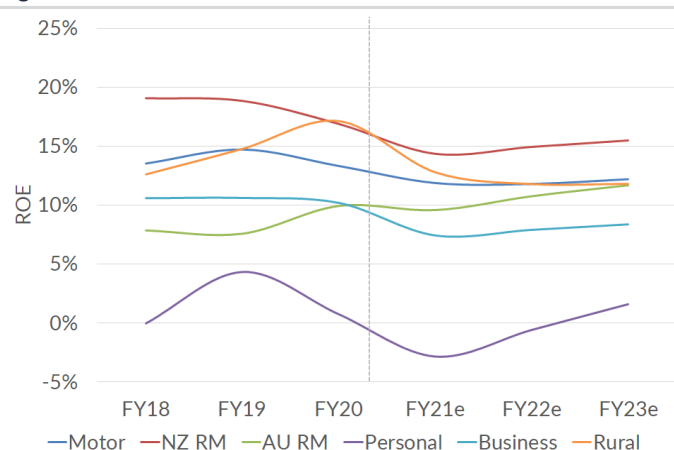


Source: Forsyth Barr analysis, MIA

Q2. Will ROE benefit from reduced operating and impairment expenses?

With its current product mix we expect to see a continued increase to HGH's cost to income ratio, driven by the sustained 'digital' investment and ongoing expenses related to core banking infrastructure. We also expect to see impairment expenses remain above pre COVID-19 levels given 1) HGH's lack of direct control over Harmony but absorption of Harmony's credit losses, 2) the high risk profile across HGH's loan book, and 3) the impact for HGH of economic headwinds. We also note the lag in falling impairment expenses after a recession. Our calculations estimate that both the personal and business division generate ROE below HGH's COE.

Figure 37. Business and Personal ROE below HGH COE FY21E



Source: Forsyth Barr analysis, HGH

Figure 38. Business and Personal ROE & forecast ROE

	FY18	FY19	FY20	FY21E	FY22E	FY23E
Business	10.6%	10.6%	10.2%	7.5%	7.9%	8.4%
Personal	0.0%	4.3%	0.7%	-2.9%	-0.6%	1.6%

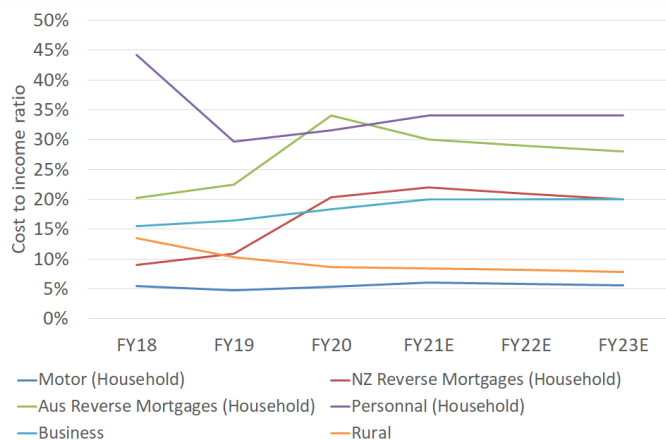
Source: Forsyth Barr analysis, HGH

Cost base inflated by high investment into 'digital' and technology

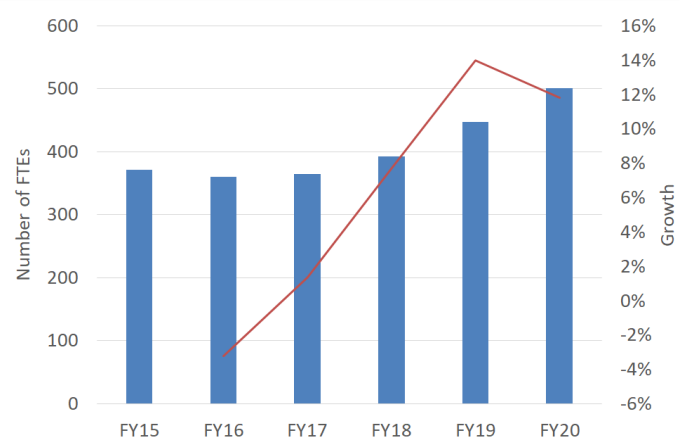
FY20 saw a sharp increase in HGH's cost to income ratio. A large proportion of this was driven by FTE growth (+12%), marketing spend, technology and 'digital' expenditure. HGH describes these additional costs as adding 'strategic initiatives'. However, group cost to income ratio increased from 42% to 46% and ROE decreased from 11.0% to 10.5%. We view the Open4Business and personal divisions as dilutive to earnings, given the elevated cost base and uncertain growth profiles going forward.

Operating expenses set to continue rising

The company has stated that it expects operating costs to continue growing for the foreseeable future. At a divisional level, the Australian reverse mortgage division reported the highest cost to income ratio in FY20. We believe investment into the highest growth area of the business is merited, particularly in light of the structural tailwinds supporting the business and expected long term growth profile. More concerning was the personal division, with its cost to income ratio reaching 31.6% (from 29.6%), while the business division continued its upward trajectory, increasing to 18.4% (from 16.4%). Rural was the only division to see its cost to income ratio decrease.

Figure 39. Divisional Cost:Income Ratio FY18–FY23E


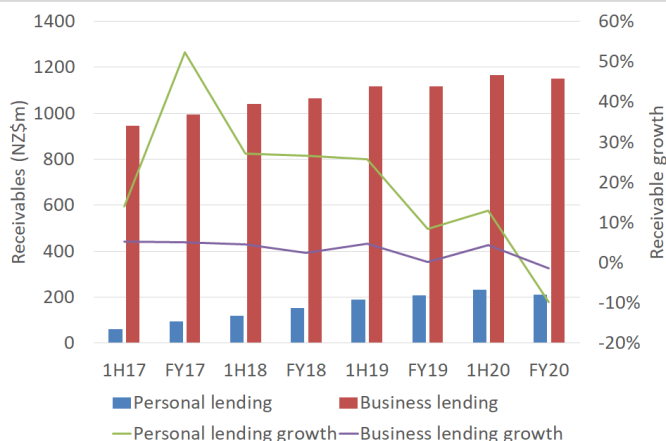
Source: Forsyth Barr analysis

Figure 40. FTE growth FY15–FY20


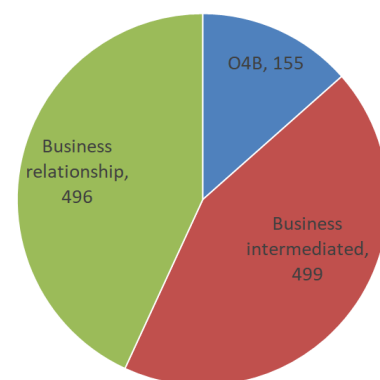
Source: Forsyth Barr analysis

Open4Business: An investment which has no obvious path to value creation

Open4Business (a platform/website designed to provide sole traders with unsecured working capital loans) contributes just 3% of group receivable loans, yet HGH stated that 'digital' FTEs make up 12% of the total group. As HGH has well documented, Open4Business has been a long term focus for high digital investment; however we remain unconvinced as to the growth potential of the project. At present we do not see it contributing positively to earnings, instead reducing ROE. In addition, unsecured loans targeted at sole traders significantly raises the credit risk of the group.

Figure 41. Growth of personal and business lending FY17–20


Source: Forsyth Barr analysis, HGH

Figure 42. FY20 business division lending split (NZ\$m)


Source: Forsyth Barr analysis, HGH

Business relationship and Business intermediated unlikely to inflate expenses materially

Business relationship (Corporate SME) lending in New Zealand is highly competitive with HGH reducing loan receivables by 4% in FY20. Historically, HGH's focus has been on smaller niche players compared to competitors.

Intermediate lending (trucks, trailers and products of the economy) is again a niche market, which in our view complements HGH's motor division well. Loan receivables grew +17% in FY20. In our view, neither intermediated lending or relationship lending are likely to heavily inflate HGH's cost base materially.

Core banking infrastructure a likely contributor to HGH's rising cost to income ratio

HGH uses Oracle Flexicube as its core banking platform. A number of high profile financial institutions have expressed frustration and difficulties on using Oracle in recent years, in particular due to its legacy technology. Issues include speed of implementation, poor functionality and continuous troubleshooting, with several banks moving away from using Oracle in recent years, mostly to Finastra. The National has even gone as far as to suggest it was the financial regulators that encouraged Citi to move away from Oracle in 2019. Suncorp has also widely documented its experiences of using Oracle and the significant cost outlays. Given our assumption that the increased technology expenses in FY20 includes the ongoing costs of using Oracle, we would view a migration to an alternative, superior provider as a better long term solution for HGH.

Impairment expense ratio set to remain elevated for HGH

HGH has little direct control over its investment in Harmoney yet absorbs all funded default losses incurred through the platform. HGH's loan receivables are heavily exposed to a further downside scenario given the risk profile (additionally illustrated by its divisional NIM). We expect to see this translate into prolonged and significant impairment expenses and a marked slowdown in receivable loan growth. The years after the GFC showed that financial institutions experienced high impairment ratios for a number of years subsequently.

What is Harmoney?

Harmoney began as a facilitator of peer to peer loans in New Zealand. This allowed private lenders to match with borrowers, choosing a profile to lend to, based on risk appetite, but assuming any credit losses. Risk was compensated by yield charged – in some cases up to 40%. Harmoney levied a fee for both borrowers and lenders to use the platform. However, in April 2020, Harmoney exited peer to peer lending, with loans now funded by HGH.

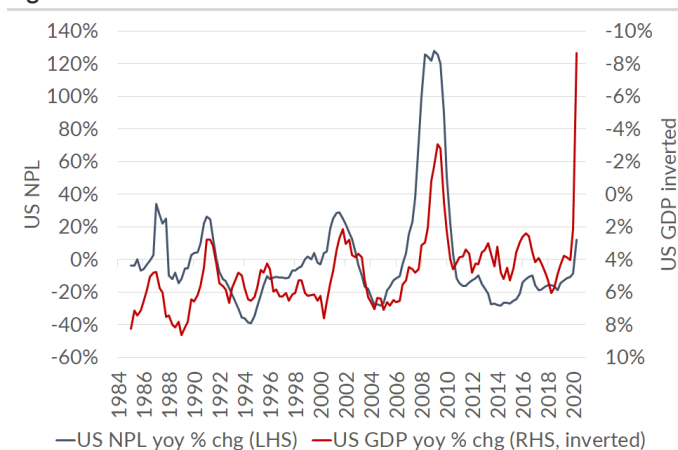
Loans of up to 40% on Harmoney's platform increase HGH's credit risk and risk company reputation

HGH currently owns a 12.2% stake in Harmoney (15% prior to a capital raise at October 2019). HGH has confirmed that it bears little to no control over the strategic direction of Harmoney, yet absorbs losses occurred through the platform. We see this as an oversight by HGH particularly in the current environment where impairment expenses are likely to be pronounced. In our view, there is also significant reputational damage from being associated with Harmoney – a company which charges consumers up to 40% interest on loans.

Impaired assets broadly correlate with inverted GDP

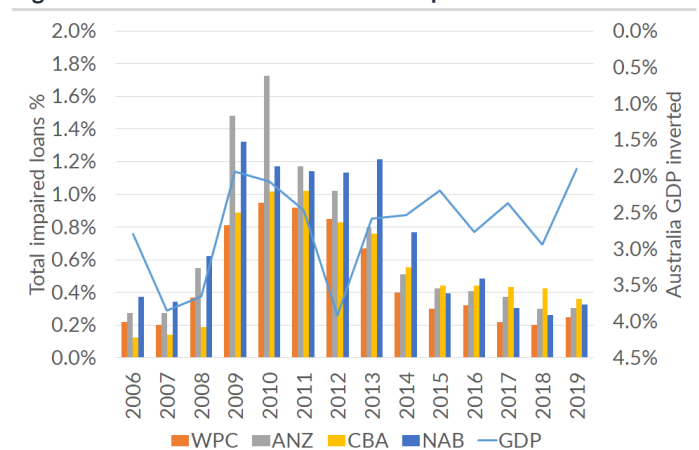
In the US there is a strong correlation between change in GDP (inverted) and bank NPL ratios. The correlation in Australia is less strong; however, using the four major Australian banks, the period around the GFC showed a clear relationship between inverted GDP growth and impairment expenses.

Figure 43. US inverted GDP vs NPLs 1984–2020



Source: Forsyth Barr analysis, FRED

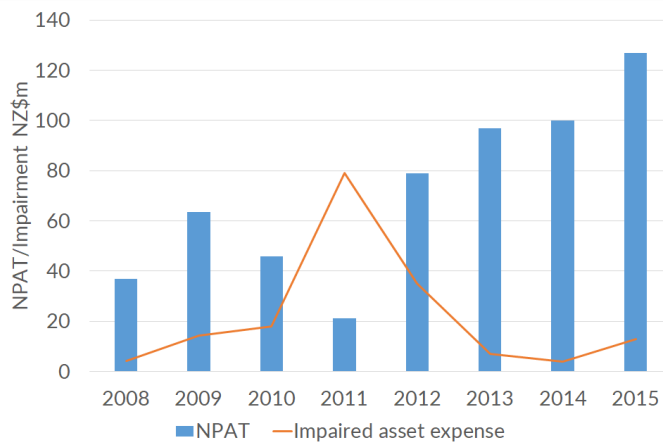
Figure 44. Australia inverted GDP vs impaired assets 2006–19



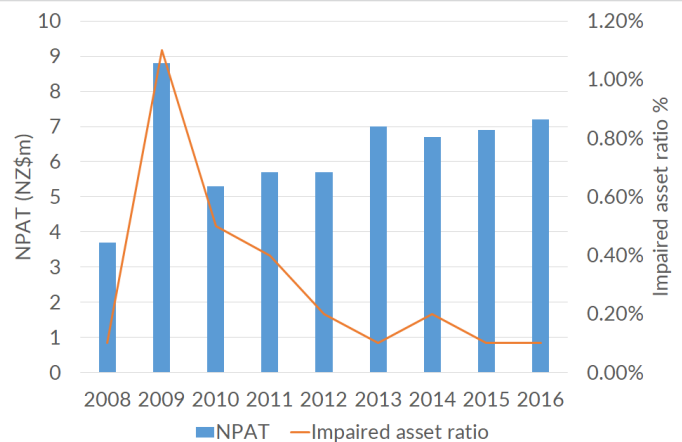
Source: Forsyth Barr analysis, World Bank, company reports

Small NZ finance companies took a number of years to recover impaired asset expense ratios

Whilst there is little data to make the comparison for New Zealand institutions and NPL ratios, we use Kiwibank and MTF as examples of where small NZ based lenders have taken a number of years to recover from recession. For example Kiwibank's impaired asset expense did not return to pre-GFC levels until 2013, with NPAT not recovering until 2012. MTF vehicle finance also did not see its impaired asset ratio return to normal levels until 2013.

Figure 45. Kiwibank impairment expenses 2008–2015


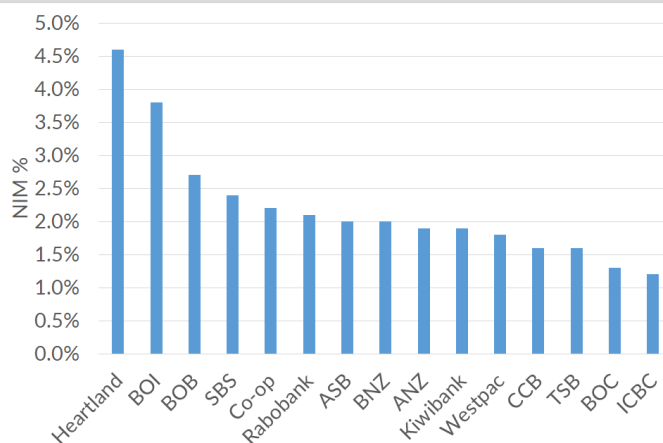
Source: Forsyth Barr analysis, Kiwibank

Figure 46. MTF finance impaired expense ratio 2008–2016


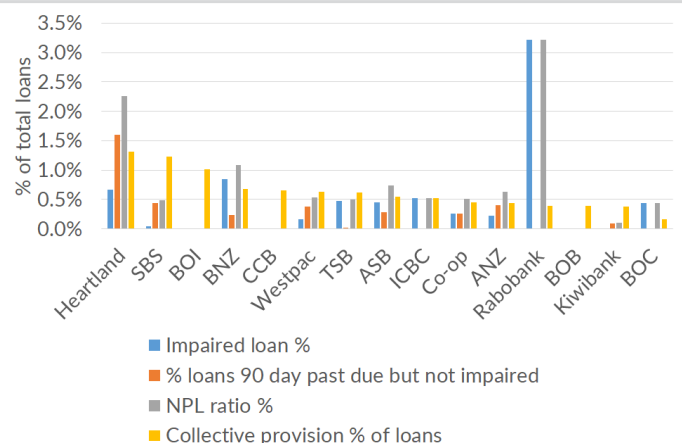
Source: Forsyth Barr analysis, MFT

HGH heavily exposed in further downside scenario

HGH has the highest Net Interest Margin (NIM) across all New Zealand banks. When considering its average cost of funding is higher than peers, this implies that its yields are significantly higher. As a result, an elevated risk profile means HGH remains more exposed to loan losses in an economic downturn. Additionally, using the RBNZ dashboard across all New Zealand banks, HGH has the second highest non-performing loan ratio, the highest 90 day past due but not impaired ratio and the highest collective provision ratio. Across the group personal lending has the highest NIM (8.8% at FY20) and highest impairment expense ratio at 5.3%.

Figure 47. NZ bank Net Interest Margin comparison


Source: Forsyth Barr analysis, RBNZ

Figure 48. RBNZ dashboard asset quality comparison


Source: Forsyth Barr analysis, RBNZ

FY20 increase in HGH's impairment expense ratio despite significant government intervention

HGH's impairment expense ratio increased from 0.47% to 0.64% in FY20 (NZ\$20m–NZ\$30m). Over the last six months, as a result of COVID-19, New Zealand's economy has seen stimulus in the form of 1) government wage subsidies, 2) mortgage holidays, and 3) Reserve Bank funding support. However, economic risks prevail in particular in the tourism sector. While HGH reports that it has little exposure to the tourism sector there could be a knock on effect for the rest of the economy and small business owners. It is our expectation that as government stimulus subsides, there will be a prolonged period of economic slowdown, illustrated by current consensus economic forecasts.

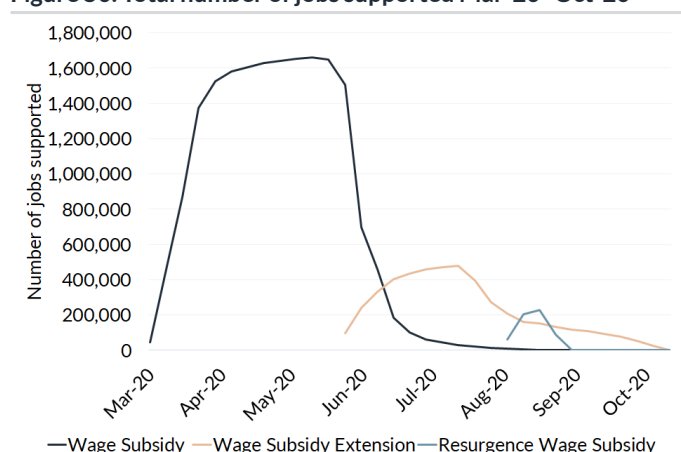
1) Wage subsidies

COVID-19 has seen the New Zealand Government provide a substantial degree of subsidies for both employers and employees. In our view, this has softened but prolonged the macroeconomic impact resulting from COVID-19. Applications for all three tranches of the wage subsidy scheme are now closed.

Figure 49. Government COVID-19 fiscal stimulus

Scheme	Dates	Applicable
Wage subsidy scheme	17/03-10/06	Employers revenue drop 30%
Wage subsidy extension payment	10/06-01/09	Employers revenue drop 40%
Resurgence Wage Subsidy payment	21/08-03/09	Employers revenue drop 40%
Covid-19 Income Relief Payment	01/03-30/10	Employees made redundant
Leave support scheme	Ongoing	Employees self isolating

Source: Forsyth Barr analysis, Ministry of Social Development

Figure 50. Total number of jobs supported Mar-20–Oct-20


Source: Forsyth Barr analysis, Ministry of Social Development

2) Mortgage holidays

On 24 March 2020, the government and the RBNZ announced a financial support package which included a six month principal and interest payment holiday for mortgage holders and SME customers whose incomes had been affected by COVID-19. This has since been extended for a further six months, although banks have some discretion in passing this extension on to customers. Loans on holiday will not be viewed as defaults and will not affect customer credit ratings, assuming customers were fully up to date with payments before COVID-19. Interest will continue to accrue while payments are deferred.

RBNZ data suggests that since the outbreak of COVID-19, there have been almost 90,000 requests for mortgage deferrals and almost 80,000 mortgages restructured to interest only. However, it is unclear how many customers remain on these mortgage holidays, and how many will have to resume full payments when the mortgage holiday ends on 31 March 2021.

3) RBNZ funding support

Since the outbreak of COVID-19 the RBNZ has also taken a number of reactive measures. In addition to announcing a -75bp cut to the OCR to 0.25%, the RBNZ subsequently introduced a number of funding support mechanisms in addition to relaxing the requirements around lending restrictions. This intervention has partially offset initial deposit pressures, with HGH reporting a 3Q20 deposit withdrawal of NZ\$70m before recovering in 4Q20 with cash inflow of NZ\$100m.

Figure 51. RBNZ funding support

Scheme	Date	Description
Term lending facility	Apr 20 - Feb 21	Ensures access to funding for banks for up to 5 years duration under Government Business Finance Guarantee scheme
Term auction facility	Mar 20 - Mar 21	Provides collateralised loans out to 12 months
Removal of LVR restrictions	May 20 - May 21	Reduces impact on borrowers and lenders
LSAP (QE) programme	Mar 20 - Jun 23	\$700m a week in on-market transactions (up to NZ\$100bn)

Source: Forsyth Barr analysis, RBNZ

A negative OCR and Funding for Lending scheme a likely outcome

We expect the RBNZ's next monetary policy announcement to express a preference for lowering the OCR into negative territory and provide a Funding for Lending program in an effort to avoid deflation. A Funding for Lending program would likely mirror the RBA's Term Funding Facility (TFF), providing bank funding for 3–5 years at a fixed rate of 0.25%. We would also expect there to be a deposit floor cap (for example as applied by the Bank of England). However, we believe the impact for HGH would be small given:

- Australia's TFF was originally capped at 3%, before increasing to 5% of total bank lending. The RBNZ may use a similar approach – thus accounting for a very small proportion of NZ banks overall funding.
- Another possibility could see the funding cap determined by risk tolerance (as the RBNZ would be taking on credit risk in the form of collateral) as seen by the UK and EU. This would likely limit funds for HGH given its elevated risk profile.
- There is also the possibility that the program would be provided for business and SME loan books only.

A negative OCR would mean banks would be charged for holding settlement account balances by the RBNZ rather than paid interest. As a result the banks would have an increased incentive to lend out money given that retail rates would remain above zero.

Q3. How does a tightening regulatory environment impact HGH?

Following the GFC, banks globally have come under increased scrutiny, leading to a tightened regulatory environment. The three key issues that we most expect to impact HGH are 1) a likely change to the permitted maximum interest charged on short term loans in New Zealand, 2) a risk that risk weights for reverse mortgages may increase, requiring a higher regulatory capital charges and 3) the December 2019 RBNZ banking capital adequacy requirements, which we see as a manageable headwind for HGH.

1) Regulation around high interest, short term loans set to increase

With Harmony charging up to 40% interest on loans, we see risk to HGH if regulators lower the cap on short term interest charges. Although the regulatory framework was visited as recently as 2019, we take a longer term view, with any further legislative reviews contingent on political attitudes post the upcoming New Zealand election. Over time we expect New Zealand to reach parity with international peers.

- Current regulation in **New Zealand** was updated in December 2019 by the Credit Contracts Legislation Amendment Bill, capping total interest and fees charged at 100% of the principal amount, or 0.8% a day.
- **In the USA** the interest rate cap is 36%, implemented on a state by state basis. The past year has seen a wave of new regulation tightening short term, high interest lending. For example, the California State Legislature passed the Fair Access to Credit Act in 2019 banning interest over 36% (lower than Harmony's 40%) for loans of up to US\$10k.
- **The UK** currently has the same cap as New Zealand at 100% of principal, and no higher than 0.8% a day. However, there are signs that tightening of legislation is imminent. The FCA recently stated that 'there have been talks over the last year between lenders and the FCA to make changes that protect customers'. The FCA has also recently implemented a one to three month payment freeze and encouraged pay day lenders to suspend, reduce, waiver or cancel interest rate charges for those having difficulty in making payments due to a loss or reduction of their income.
- **In Australia**, interest charged is capped at 48%, determined by the National Consumer Credit Protection Act of 2009. Currently loans of under NZ\$2,000 with a repayment schedule of under 15 days are banned.

2) Increased reverse mortgage risk weights would increase capital charges & lower ROE

A significant regulation risk for HGH's reverse mortgage business is a potential change to the reverse mortgage risk weight used to calculate credit risk of risk-weighted assets (RWA). Currently HGH's reverse mortgage risk weights are ~52%, with the rest of HGH's products weighted at 100%.

APRA recently put forward proposals to increase risk weights to 100% for reverse mortgages, but after consultation decided in 2019: *'In relation to reverse mortgages, APRA is proposing to retain the current approach under APS 112 which allows for a lower risk weight to apply to those mortgages with an LVR of less than 60 per cent. IRB ADIs would also be required to apply the standardised approach to their reverse mortgage exposures. Loans to SMSFs and shared equity mortgages would be treated as non-standard under both the standardised and IRB approaches'*.

As a result reverse mortgages for Australian banks remain weighted at 50% (unless with an LRV of over 60%) but the risk for HGH would be if the RBNZ also decide to look at changing the risk weights for reverse mortgages applying to New Zealand banks. If HGH's New Zealand reverse mortgage book was weighted at 100% instead of 50%, it would double the required capital to fund asset growth, which, in conjunction with the recent capital adequacy requirements, would mean additional capital would need to be raised or pressure applied to HGH's RWA growth rate.

Figure 52. Impact on FY20 NZ RM ROE by changed risk weight

	52% RW	100% RW
Adjusted NPAT (NZ\$m)	8	8
Total RWA (NZ\$m)	354	641
Capital charge (NZ\$m)	45	81
ROE	16.9%	9.3%
Increase in capital charged (NZ\$m)		36

Source: Forsyth Barr analysis, RBNZ, HGH

Figure 53. RBNZ Capital adequacy requirements timetable

Year	Capital requirement change timetable
2017	March – RBNZ fundamental review of bank capital requirements
2018	December – RBNZ proposal to increase bank capital requirements
2019	December – RBNZ final decisions from consultation in 'Capital Review'
2020	July – proposed start of new capital regime (delayed by COVID-19)
2021	July – current proposed start date of increased capital requirements
2028	7 years before banks are expected to comply to new requirements

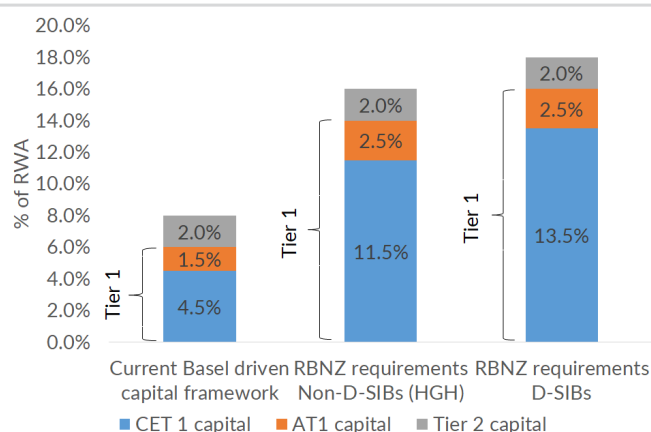
Source: Forsyth Barr analysis, RBNZ

3) A postponement to capital requirement implementation provides New Zealand banks with additional breathing room

In light of the economic uncertainty surrounding COVID-19, the Reserve Bank of New Zealand (RBNZ) took the decision to delay the implementation of its capital adequacy requirements by one year. This means New Zealand banks now have until July 2028 to meet total capital and Tier 1 capital requirements with initial implementation at July 2021.

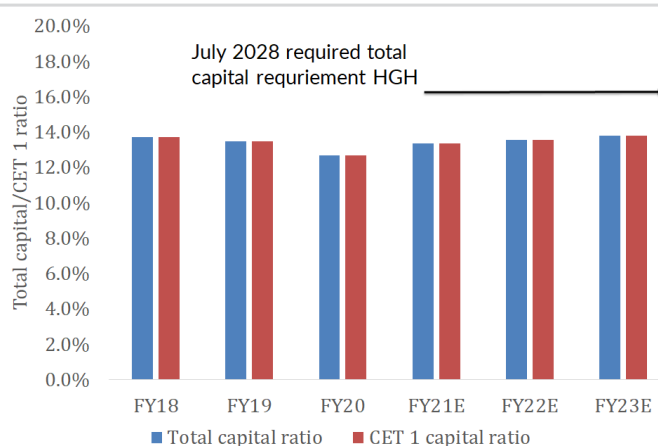
Heartland Bank is under no immediate capital pressure and we would expect the company to come close to the required 16% total capital requirements through retained earnings and the dividend reinvestment plan (DRP) alone. We expect all New Zealand banks to hold a buffer in excess of required ratios, with Heartland Bank also able to use AT1 or Tier 2 capital. The company has stated it is able to use funding from the group to provide capital for Heartland Bank if needed.

Figure 54. RBNZ New Zealand bank capital requirements



Source: Forsyth Barr analysis, RBNZ

Figure 55. Heartland Bank capital ratios vs requirement



Source: Forsyth Barr analysis, HGH

How did the RBNZ's December 2019 capital adequacy ruling impact HGH?

At December 2019 the RBNZ made its final decision on capital adequacy requirements for New Zealand banks. As a non domestic systemically important bank (Non-D-SIB) HGH is required to hold 14% Tier 1 Capital of total RWA, and a total capital ratio of 16%. Currently HGH has a total capital ratio of 12.7% down from 13.5% at FY19. We expect HGH's total capital ratio at FY21 to be around 13.3%.

At the time of the RBNZ publishing its conclusions in December 2019, implementation of the capital adequacy regime was set to take place starting 1 July 2020, with banks given seven years (July 2027) to comply. We are also aware of additional capital milestone targets set within the seven years, however, we do not attempt to address the implications for HGH in this report given that RBNZ requirements are currently on hold in the wake of COVID-19.

Figure 56. Capital terminology

AT1 Capital	Additional Tier 1 capital. AT1 capital, which includes perpetual preference shares, is the second highest quality of capital behind CET1.
Capital	Part of a bank's funding that allows it to absorb financial losses while remaining solvent. Includes the investment of the bank's shareholders (e.g. ordinary shares and retained earnings).
Capital Ratio	A bank's capital divided by its RWA. A capital ratio is a key indicator of the financial strength of a bank, measuring the losses it can withstand relative to the risk of its business.
CET1	Common Equity Tier 1 capital. CET1 is the highest quality of capital as it is permanently available to absorb a bank's financial losses. CET1 includes shareholders' investments (ordinary shares) and the bank's retained earnings.
Non-performing loans	Generally speaking, non-performing loans are loans that are at risk of not being fully repaid, or where interest on the loan may not be fully paid by the borrower.
Risk-weighted assets (RWA)	Risk-weighted assets (RWA) is an adjusted picture of a bank's financial position (e.g. its loan portfolios and other investments, and its operational and market trading activities) that takes into account the risk profile of that financial position.
Tier 1 capital	Tier 1 capital consists of CET1 capital and Additional Tier 1 (AT1) capital.
Tier 2 capital	Tier 2 capital, which includes some subordinated debt, is capital that can generally only absorb losses once a bank has already entered into financial difficulty. It is, therefore, considered of lower quality than Tier 1.

Source: Forsyth Barr analysis

Appendixes

Appendix 1: Divisional Overview

Subsidiary Heartland Bank provides business, rural, personal motor and household products to the New Zealand market while Heartland Senior Finances offer reverse mortgages to Australia.

Motor (Household)

The motor division originates from the acquisition of MARAC in 2011 and includes both wholesale and retail dealership loans across a range of vehicles including cars, motorbikes, jetskis, boats and caravans. We estimate wholesale to represent under 10% of the division. Dealerships currently include Land Rover, Jaguar and Kia, and previously Holden, while the duration of loans is typically one to five years. HGH estimates it has roughly 10% market share of the New Zealand motor market.

Personal (Household)

In 2014 HGH acquired a 15% stake in the peer to peer lending platform Harmoney, reducing to 12.25% following a capital raise more recently. Interest rates on Harmoney's personal lending platform range from 8% to 40%.

Reverse Mortgages (Household)

A reverse mortgage allows equity to be released against property owned which is repaid at the time of having incurred annual interest over the duration of the loan. Available for individuals over 60, the product is targeted at retirees asset rich with limited income or disposable cash. HGH has a reverse mortgages business in both Australia and New Zealand and the company assumes a current 26% and 85% market share respectively. The proportion of property value borrowed ranges from 15% to 40% depending on age and life expectancy.

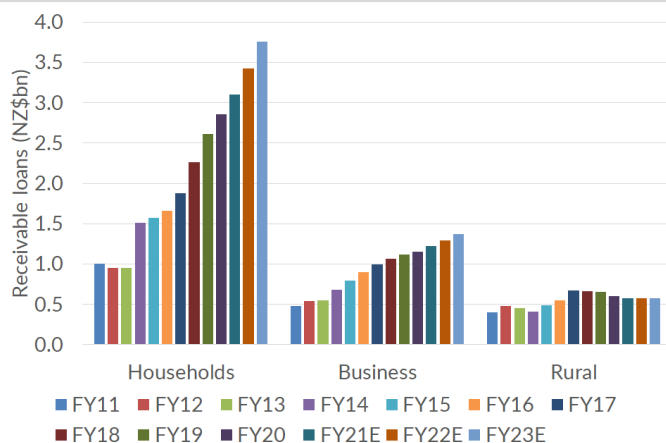
Business

The business division is split into Open For Business (O4B), relationship lending and intermediated lending. O4B is a digital solution aimed to provide sole traders with working capital quickly. Relationship lending provides lower margin larger loans to businesses across New Zealand (corporate banking), while intermediated lending provides financing for trucks, trailers and products of the economy. HGH estimate the addressable market for business relationship lending to be NZ\$40bn, and NZ\$10bn for intermediated.

Rural

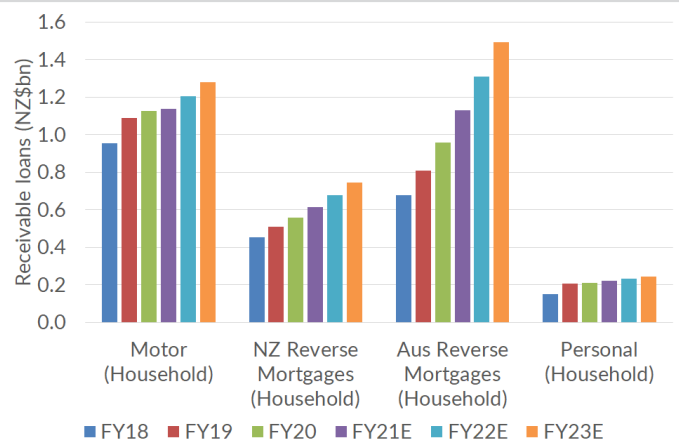
HGH's rural division is a split into livestock and relationship finance, originating from the acquisition of PGG Wrightson Finance in 2011. Livestock financing is secured against the stock with no repayments made until the stock is sold. It is used predominantly for trading and fishing stock. Relationship finance includes term loans for land purchase, agricultural development and equipment purchases with terms typically of up to 25 years. Seasonal financing also provides funding for seasonal mismatches between income and expenditure while farm transition loans allows borrowing against property to carry out deferred maintenance and improvements before sale or transition.

Figure 57. Divisional receivable growth FY11–FY23E (NZ\$m)



Source: Forsyth Barr analysis, HGH

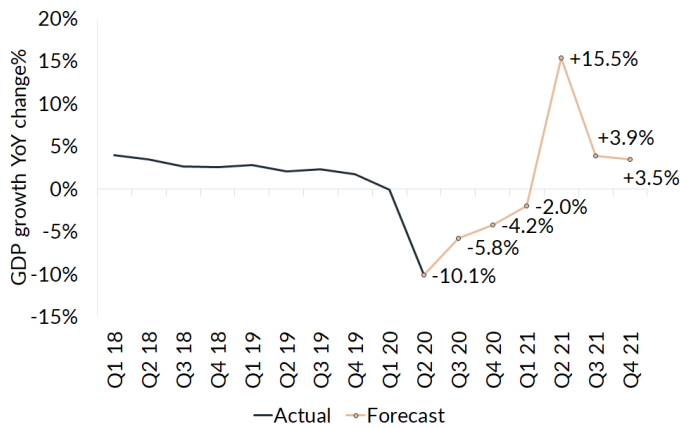
Figure 58. Household receivable growth FY11–FY23E (NZ\$bn)



Source: Forsyth Barr analysis, HGH

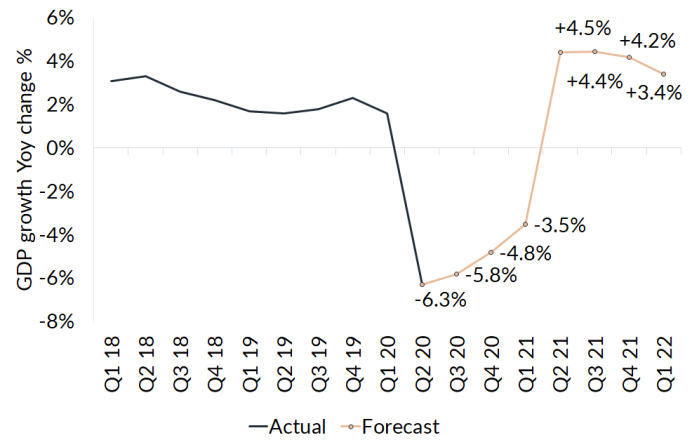
Appendix 2: Macro economic forecasts

Figure 59. New Zealand GDP YoY change 1Q18-4Q21



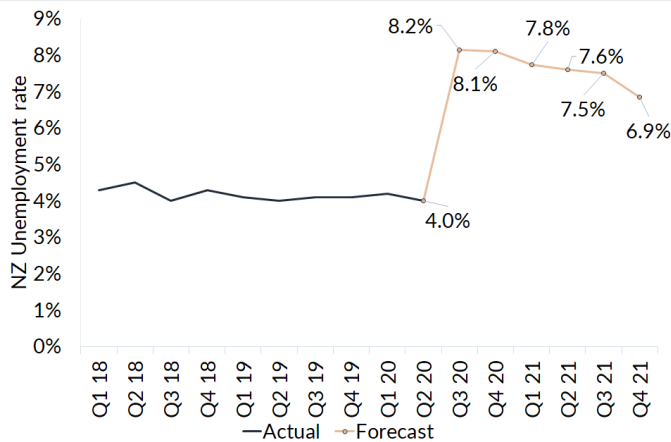
Source: Forsyth Barr analysis, Bloomberg

Figure 60. Australian GDP YoY change 1Q18-4Q21



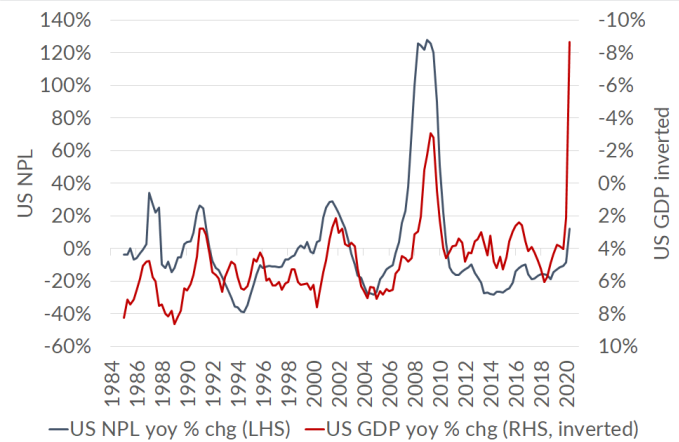
Source: Forsyth Barr analysis, Bloomberg

Figure 61. New Zealand unemployment 1Q18-4Q21



Source: Forsyth Barr analysis, Bloomberg

Figure 62. US inverted GDP vs NPL's 1984-2020



Source: Forsyth Barr analysis, FRED

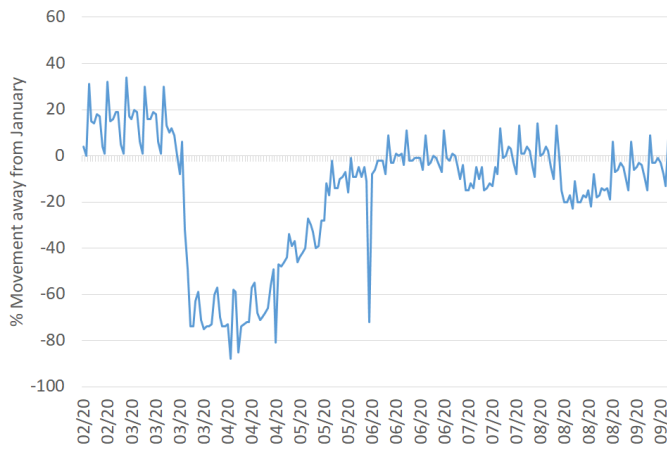
Appendix 3: Miscellaneous

Figure 63. Car finance company feedback vehicle applications

	Rate range	Access to \$	Loan Duration	Loan Amount	Established COVID comments
AA	8.50%-15.95%	1 hour	6m-5 yr	3k-100k	7 months AKL applications are up, rest of country quiet
Avanti Finance	9.95%-24.95%	1 hour	1yr-5yr	3k-450k	20 years
CFS Finance	11.00%-15.00%	A few hours	1yr-5yr	3k-30k	15 years Not busy — COVID impact
Finance Direct	8.00%-15.00%	1 hour	6m-5yr	3k-25k	10 years Very quiet — major COVID impact
Finance Now	9.95%-20.95%	24 hours	6m-5yr	3k-20k	20 years Considerable COVID slow down, people v cautious
Gem	9.99%-19.99%	2-3 days	6m-7yr	2k-70k	10+ years Quiet at the moment, ebs and flows
Geneva Finance	8.95%-19.95%	1 hour	6m-5yr	3k-40k	20+ years Short staffed, COVID impact, less applications
MARAC	8.95%-15.95%	1 hour	1yr-5yr	5k-10m	70 years
MFT	8.50%-20.00%	24 hours	1yr-5yr	2k-99k	50 years
NZ Vehicle Finance	9.95%-12.95%	24 hours	1yr-5yr	3k-50k	30 years Lockdown hard hitting, customers financial distress, less applications
Stadium Finance	9.95%-19.95%	24 hours	1yr-5yr	3k-100k	8 years Really quiet — unemployment impact
UDC	8.95%-15.95%	24 hours	1yr-5yr	10k-500k	80+ years No impact, still super busy, machinery loans high

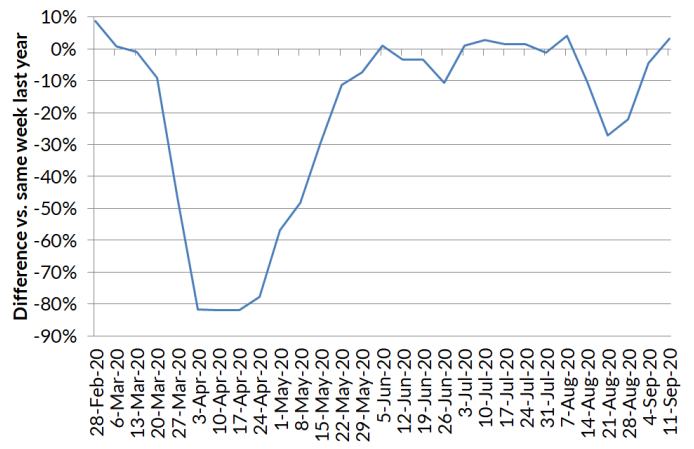
Source: Forsyth Barr analysis

Figure 64. Work place visitation January vs rest of year NZ



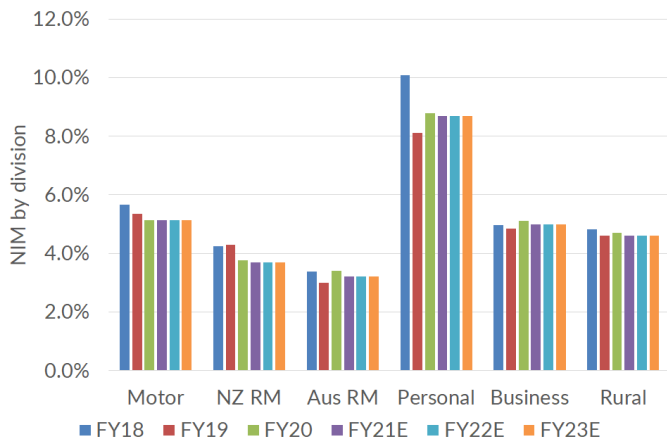
Source: Forsyth Barr analysis, Google

Figure 65. Light vehicle movements vs prior year



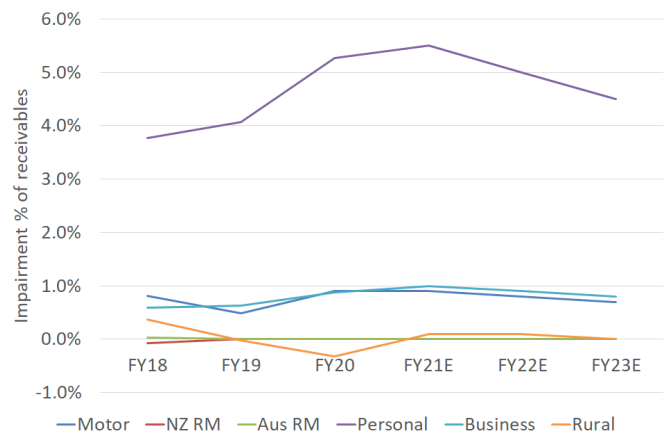
Source: Forsyth Barr analysis, NZTA

Figure 66. Net Interest Margin (NIM) by division FY18-FY23E



Source: Forsyth Barr analysis

Figure 67. Impairment ratio by division FY18-FY23E



Source: Forsyth Barr analysis

Figure 68. Price performance


Source: Forsyth Barr analysis

Figure 69. Substantial shareholders

Shareholder	Latest Holding
Harrogate Trustee	9.8%

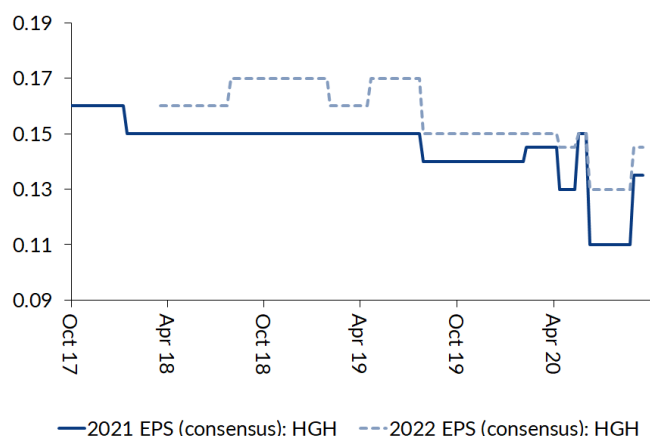
Source: NZX, Forsyth Barr analysis, NOTE: based on SPH notices only

Figure 70. International valuation comparisons

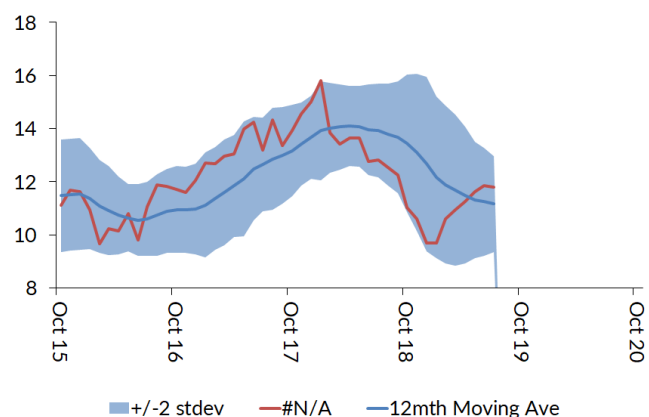
Company	Code	Price	Mkt Cap (m)	PE 2021E 2022E	EV/EBITDA 2021E 2022E	EV/EBIT 2021E 2022E	Cash Yld 2022E
(metrics re-weighted to reflect HGH's balance date - June)							
Heartland Group Holdings	HGH NZ	NZ\$1.41	NZ\$813	13.4x 12.0x	n/a n/a	n/a n/a	5.7%
AUST AND NZ BANKING GROUP	ANZ AT	A\$18.76	A\$53,285	12.7x 10.7x	n/a n/a	n/a n/a	5.8%
BENDIGO AND ADELAIDE BANK	BEN AT	A\$6.59	A\$3,498	13.0x 10.4x	n/a n/a	n/a n/a	5.8%
BANK OF QUEENSLAND	BOQ AT	A\$6.25	A\$2,840	13.8x 11.7x	n/a n/a	n/a n/a	5.6%
COMMONWEALTH BANK OF AUSTRAL	CBA AT	A\$67.95	A\$120,550	17.4x 15.4x	n/a n/a	n/a n/a	4.6%
NATIONAL AUSTRALIA BANK	NAB AT	A\$18.73	A\$61,623	13.8x 11.8x	n/a n/a	n/a n/a	5.5%
WESTPAC BANKING CORP	WBC AT	A\$18.27	A\$65,985	14.2x 11.0x	n/a n/a	n/a n/a	5.6%
Compco Average:				14.1x 11.8x	n/a n/a	n/a n/a	5.5%
HGH Relative:				-5% 1%	n/a n/a	n/a n/a	4%

EV = Current Market Cap + Actual Net Debt

Source: *Forsyth Barr analysis, Bloomberg Consensus, Compco metrics re-weighted to reflect headline (HGH) companies fiscal year end

Figure 71. Consensus EPS momentum (NZ\$)


Source: Forsyth Barr analysis

Figure 72. One year forward PE (x)


Source: Forsyth Barr analysis

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