

Heartland Group

A Cautious Tale of Opportunities and Risks

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UNDERPERFORM

Heartland Group Holding's (HGH) 1H21 result was broadly in line with our expectations, with lower than anticipated impairment expenses offset by subdued receivable loan growth. This was predominantly due to the impact of the comprehensive COVID-19 fiscal stimulus packages provided by both the New Zealand Government and Reserve Bank of New Zealand during 1H21, driving early loan repayments and a slowdown in demand for financing. While we welcome HGH's longer term strategy of focussing on divisions exhibiting a higher return on equity, such as the motor and reverse mortgage books, we remain unconvinced by the company's investment into 'digital' and the long term potential of its Open4Business platform. We retain our UNDERPERFORM rating given HGH's sub-scale, high-risk profile compared to its international peers, an elevated cost to income ratio and slowing receivable growth expected to continue into 2H21.

NZX Code	HGH	Financials: Jun/	20A	21E	22E	23E	Valuation (x)	20A	21E	22E	23E
Share price	NZ\$1.89	NPAT* (NZ\$m)	69.9	82.2	83.5	89.4	PE	15.6	13.5	13.5	12.9
Target price	NZ\$1.72	EPS* (NZc)	12.1	14.0	14.0	14.7	EV/EBIT	n/a	n/a	n/a	n/a
Risk rating	High	EPS growth* (%)	-4.8	15.5	0.1	4.9	EV/EBITDA	n/a	n/a	n/a	n/a
Issued shares	576.7m	DPS (NZc)	7.0	5.0	8.5	8.5	Price / NTA	1.7	1.6	1.4	1.2
Market cap	NZ\$1,090m	Imputation (%)	100	100	100	100	Cash div yld (%)	3.7	2.6	4.5	4.5
Avg daily turnover	628.3k (NZ\$825k)	*Based on normalised profits					Gross div yld (%)	5.1	3.7	6.2	6.2

What's changed?

- **Earnings:** FY21 NPAT increased from NZ\$77.2m to NZ\$82.2m (+6.5%)
- **Target price:** Increased from NZ\$1.61 to NZ\$1.72 (+11c)

Rural division presents competitive opportunity

For a business to sustain a return on equity in excess of its cost of capital it needs to exploit and maintain a clear competitive advantage. HGH's scope for generating competitive advantage is limited given its lack of scale (1% of New Zealand banking assets) and inability to compete on cost of funding and resulting yield. As a result, we believe HGH's greatest opportunity lies in the rural sector given 1) its legacy network of relationship managers, 2) strong rural brand, and 3) reduced competition. However, in recent years HGH has reduced loan receivables in the division, while we await the impact of its new digital livestock platform.

Softer impairments offset by lower loan receivables

HGH's improved impairment expense ratio of 0.19% in 1H21 (0.40% at 1H20) was driven indirectly by supportive fiscal stimulus rather than an obvious improvement in the underlying quality of HGH's loan book. This benefit was offset by lower receivable loans during the period, which due to early repayments and lower demand for financing saw total receivables grow just 1.3% from FY20.

Valuation

We make changes to our risk free rate (from 1.3% to 2.3%) and market risk premium (from 6.0% to 5.5%), consistent with our strategy report, *Still a One Way Bet? – Updated WACC Assumptions*, published 12 February 2021. Our WACC increases from 8.9% to 9.3%. We raise our forecast FY21 return on equity (ROE) from 9.2% to 10.5%, which more than offsets the increased cost of capital and lifts our target price from NZ\$1.61 to NZ\$1.83. On current prices, our 12 month forward ROE driven target price implies a lower P/BV multiple than HGH is currently trading on.

Heartland Group Holdings (HGH)

Priced as at 22 Feb 2021 (NZ\$)

1.89

12-month target price (NZ\$)*

1.72

Expected share price return

-9.0%

Net dividend yield

3.9%

Estimated 12-month return

-5.1%

Spot valuations (NZ\$)

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

1.62

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	358.1	373.2	394.5
Net interest income	194.3	216.7	222.8	229.1	241.2
Other income	11.7	16.6	17.3	18.0	18.7
Net operating income	206.1	233.2	240.0	247.2	259.9
Operating and other expenses	80.0	97.6	102.1	105.3	108.6
Impairment expenses	20.7	29.4	13.3	14.4	14.9
Depreciation and Amortisation	5.8	9.2	10.5	11.5	12.3
Tax	27.9	27.2	32.0	32.5	34.7
Normalised NPAT	71.7	69.9	82.2	83.5	89.4
Abnormals/other	1.9	2.1	0.8	0	0
Reported NPAT	73.6	72.0	83.1	83.5	89.4
Normalised EPS (cps)	12.7	12.1	14.0	14.0	14.7
DPS (cps)	10.0	7.0	5.0	8.5	8.5

Growth Rates	2019A	2020A	2021E	2022E	2023E
Net interest income (%)	6.7	5.1	3.3	4.2	5.7
Net operating income (%)	4.7	13.2	2.9	3.0	5.2
Normalised NPAT (%)	6.2	-2.5	17.7	1.6	7.0
Normalised EPS (%)	1.5	-4.8	15.5	0.1	4.9
Ordinary DPS (%)	11.1	-30.0	-28.6	70.0	0.0

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	154.4	155.9	157.5
Receivables	4,349.8	4,583.8	4,670.7	4,993.1	5,318.7
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	572.8	585.1	596.6
Total funds employed	4,929.0	5,318.1	5,488.8	5,823.9	6,160.8
Deposits	3,153.7	3,264.2	3,296.8	3,428.7	3,531.6
Other borrowings	0	0	0	0	0
Other liabilities	1,099.7	1,354.0	1,412.2	1,503.1	1,601.7
Shareholder's funds	675.7	700.0	779.8	892.1	1,027.5
Minority interests	0	0	0	0	0
Total funding sources	4,929.0	5,318.1	5,488.8	5,823.9	6,160.8

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)	14.9	15.6	13.5	13.5	12.9
Price/NTA (x)	1.8	1.7	1.6	1.4	1.2
Free cash flow yield (%)	n/a	n/a	n/a	n/a	n/a
Net dividend yield (%)	5.3	3.7	2.6	4.5	4.5
Gross dividend yield (%)	7.3	5.1	3.7	6.2	6.2

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 (%)	2.9	2.6	3.0	2.9	2.9
Return on equity (%)	10.6	10.0	10.5	9.4	8.7
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	36	61	58

Capital	2019A	2020A	2021E	2022E	2023E
Tier 1 Capital (NZ\$m)	529	531	597	649	700
Total Capital (NZ\$m)	529	531	597	649	700
RWA (NZ\$m)	3921	4191	4001	4114	4306
CET1 Ratio	13.5%	12.7%	14.9%	15.8%	16.3%
Total Capital Ratio	13.5%	12.7%	14.9%	15.8%	16.3%

Key indicators	2019A	2020A	2021E	2022E	2023E
Net Interest Margin	4.2%	4.4%	4.2%	4.2%	4.1%
Cost to Income Ratio	41.6%	45.8%	46.9%	47.2%	46.5%
Impairment Expense Ratio	0.47%	0.64%	0.28%	0.29%	0.28%

Divisional NII (NZ\$m)	2019A	2020A	2021E	2022E	2023E
Motor	54.7	57.0	64.1	70.9	77.2
NZ Reverse Mortgages	20.7	20.1	20.7	21.9	23.1
Australia Reverse Mortgages	22.3	30.1	33.8	38.2	41.4
Personal Consumer	14.6	18.4	12.7	8.4	8.4
Business	52.9	58.0	61.0	61.6	62.8
Rural	30.4	29.7	28.5	26.9	26.9

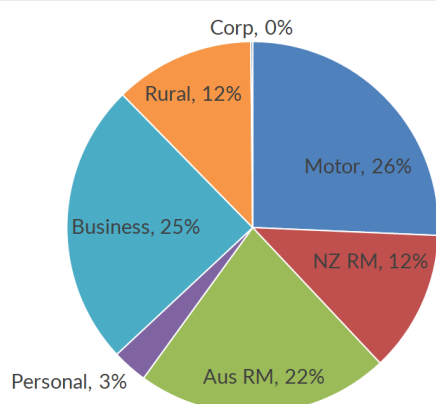
* Forsyth Barr target prices reflect valuation rolled forward at cost of equity less the next 12-months dividend

Results summary

HGH reported a 1H21 result broadly in line with expectations with underlying 1H21 NPAT of NZ\$43m marginally ahead our forecast of NZ\$41m, primarily due to impairment expenses reported at 0.19% against our forecast 0.21%. Total receivables were marginally lower than our forecast (NZ\$4.7bn against our forecast NZ\$4.8bn).

- **NIM in line with forecasts:** HGH reported a net interest margin of 4.28%, in line with our forecast 4.29%.
- **Slowing receivable growth a key theme:** One prominent theme in HGH's 1H21 result was the slowing of receivable growth. Key factors impacting this were elevated prepayments of loans in consumer segments given mortgage holidays and support from wage subsidies.
- **Guidance range reaffirmed:** HGH has stated its FY21 NPAT guidance to be at the upper end of the previously guided range NZ\$83–85m. This guidance does not assume any reversal of its NZ\$9.6m COVID-19 overlay, which to date has not been utilised.
- **One off items:** HGH has reported one-off gains of NZ\$5.2m more than offsetting one off expenses of NZ\$4.3m. The fair value gain was driven by a gain on equity investments in Harmony, while the one off expense was driven by increased amortisation of intangible assets following a review of software assets held on the balance sheet.
- **Motor finance exposed to growing demand for vehicle financing:** HGH's Motor Finance division performed relatively well in the period, with receivables growing +7% with increased dealer relationships and market share growth more than offsetting elevated prepayment levels and a shrinking Holden contribution.
- **No comment on resignation of Risk Officer:** On 19 February, HGH announced the resignation of its Chief Risk Officer, Grant Kemble. No further detail was provided at the result on 22 February.

Figure 1. Loan receivable split by division 1H21



Source: Forsyth Barr analysis

Figure 2. Key metrics 1H21 vs forecasts

(NZ\$m)	1H20	1H21E	1H21A	% change
Total receivables	4,585	4,804	4,685	-2.5%
Net interest income	105.2	113.3	113.2	-0.1%
NIM	4.31%	4.29%	4.28%	-0.01%
NPAT	39.9	40.7	43.2	6.1%
Divisional receivables				
Motor	1,124	1,225	1,203	-1.8%
NZ RM	536	594	577	-2.9%
Aus RM	887	1,043	1,031	-1.2%
Personal	234	207	144	-30.5%
Business	1,167	1,116	1,153	3.3%
Rural	621	605	571	-5.7%
Corp	16	14	8	-46.5%

Source: Forsyth Barr analysis

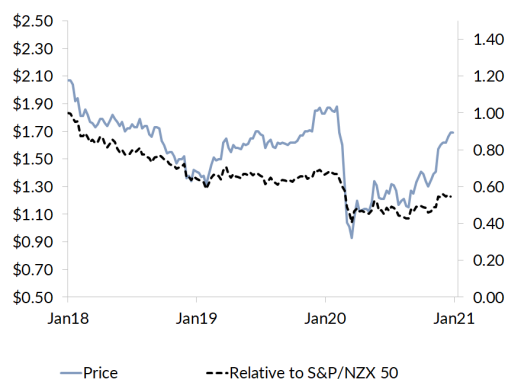
Changes to forecasts

Given the higher repayment of loans reducing loan receivables in 1H21, we reduce our receivable loan growth across the portfolio and expect to see a continued focus away from personal, business and rural lending. We also decrease our forecast impairment expense ratio in later years, given the use of the Heartland extend scheme.

Figure 3. Changes to forecasts FY21E to FY23E

(NZ\$m)	FY21E			FY22E			FY23E		
	Old	New	Chg	Old	New	Chg	Old	New	Chg
Net interest income	224.7	222.8	-0.8%	235.7	229.1	-2.8%	246.8	241.2	-2.3%
NIM	4.2%	4.2%	0.0%	4.2%	4.2%	0.0%	4.1%	4.1%	0.0%
PBT	106.3	114.2	7.4%	108.4	116.0	7.0%	116.8	124.1	6.2%
NPAT	77.2	82.2	6.5%	78.7	83.5	6.1%	84.8	89.4	5.4%
EPS (cent)	0.13	0.14	7.6%	0.13	0.14	6.1%	0.14	0.15	5.4%
DPS (cent)	0.05	0.05	0.0%	0.09	0.09	0.0%	0.09	0.09	0.0%

Source: Forsyth Barr analysis

Figure 4. Price performance


Source: Forsyth Barr analysis

Figure 5. Substantial shareholders

Shareholder	Latest Holding
Harrogate Trustee	9.8%

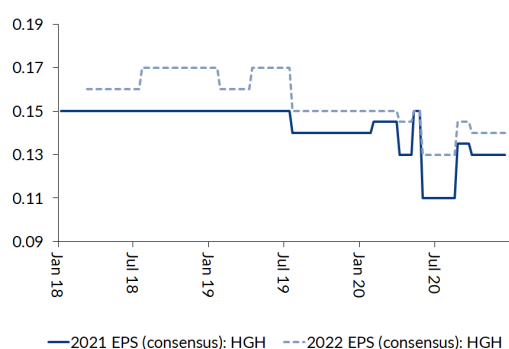
Source: NZX, Forsyth Barr analysis, NOTE: based on SPH notices only

Figure 6. International valuation comparisons

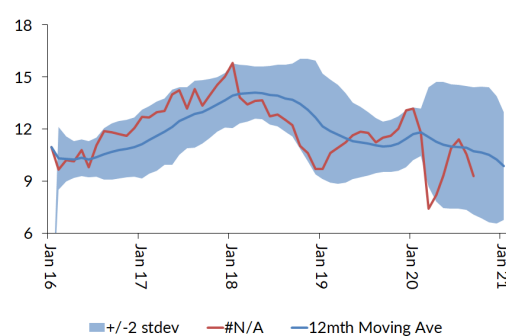
Company	Code	Price	Mkt Cap (m)	PE 2021E 2022E	EV/EBITDA 2021E 2022E	EV/EBIT 2021E 2022E	Cash Yld 2022E
(metrics re-weighted to reflect HGH's balance date - June)							
Heartland Group Holdings	HGH NZ	NZ\$1.89	NZ\$1,090	13.5x 13.5x	n/a n/a	n/a n/a	4.5%
AUST AND NZ BANKING GROUP	ANZ AT	A\$26.55	A\$75,549	15.3x 13.3x	n/a n/a	n/a n/a	5.2%
BENDIGO AND ADELAIDE BANK	BEN AT	A\$10.35	A\$5,507	14.5x 13.9x	n/a n/a	n/a n/a	4.8%
BANK OF QUEENSLAND	BOQ AT	A\$8.41	A\$3,831	18.5x 14.5x	n/a n/a	n/a n/a	4.5%
COMMONWEALTH BANK OF AUSTRAL	CBA AT	A\$83.62	A\$148,350	19.1x 17.7x	n/a n/a	n/a n/a	4.5%
NATIONAL AUSTRALIA BANK	NAB AT	A\$25.53	A\$84,176	19.8x 15.1x	n/a n/a	n/a n/a	4.8%
WESTPAC BANKING CORP	WBC AT	A\$24.37	A\$89,404	20.8x 14.9x	n/a n/a	n/a n/a	4.8%
Compco Average:				18.0x 14.9x	n/a n/a	n/a n/a	4.8%
HGH Relative:				-25% -9%	n/a n/a	n/a n/a	-5%

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 7. Consensus EPS momentum (NZ\$)


Source: Forsyth Barr analysis

Figure 8. One year forward PE (x)


Source: Forsyth Barr analysis

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