FIIG | Factsheet

Judo Bank Pty Ltd

30 May 2023

Disclaimer

This bond or financial product has not been reviewed or recommended by FIIG research nor should this document be considered as credit research. This Factsheet is only a summary document, designed to assist Investors identify the key elements of the company bond or financial product referred to in this document and should be read in conjunction with the other offering documentation available in relation to the financial products. This Factsheet is not complete information concerning any financial product and should not be relied on as such.

Issuer Outline

Judo Bank Pty Ltd (Judo, Company) is the main operating company of the Judo Capital Holdings Limited group of companies. It is an Australian authorised deposit-taking institution (ADI) which primarily provides lending services to small and medium enterprises (SMEs) and, as a regulated entity, it is supervised by the Australian Prudential Regulation Authority (APRA). The Company was founded in 2015 and started operations in 2019. Judo Capital Holdings Limited is listed on the ASX with a market capitalisation of AUD1.27bn as of 30 May 2023.

Judo offers various services including business loans, lines of credit, equipment loans, and finance leases, with a focus on offering direct and focused relationships with clients relative to competitors. Judo also provides personal term deposit products to consumers (unlike other banks, it doesn't offer transaction banking or retail deposit services). Judo's core lending market are SMEs with annual turnover of up to AUD100m with group loan exposures of between AUD250k and AUD35m, which are located in Australian capital cities and major regional areas and are industry-agnostic.

The Company's loan book has grown to AUD8.0bn (as of 31 March 2023), of which approximately 77% are made up of business loans to SMEs, with the aim to reach a lending portfolio of AUD15-20bn over the next five years.

Sector: Financials
Sub-sector: Banks
Country: Australia
Ownership: Public

Key Financials (AUDm)

LTM (31 Dec)	2022
Net Interest Income	259.3
Credit loss provisions	(38.1)
Pro forma NPAT	44.5
Gross Loans and advances	7,485.3
Customer deposits	5,259.1
Gross Debt	3,989.4
Underlying NIM (%)	3.56
Credit losses (%)	0.51
Nonperforming loans (%)	1.04
CET1 Ratio (%)	17.3

Source: FIIG Securities, Company

Summary Bond Details

ISIN	Issue Amount	Ranking	Coupon	Coupon Frequency	First Call[1]	Maturity Date
AU3CB0292480	AUD 175m	Senior Unsecured	6.40%	Semi-Annual	N/A	26 Sep 2025
AU3FN0078754	AUD 65m	Sub. Unsec. T2	3M BBSW + 5.00%	Quarterly	6 Jun 2028	6 Jun 2033

[1]Excludes potential terms that may allow the issuer to redeem prior to the first call date.

FIIG The fixed income experts

Judo Bank Pty Ltd

Strengths

- Success in developing a niche position in SME lending: Judo's business model is based on delivering a relationship-focused service to its customers, which is the key driver of its competitive position and has additionally leveraged broker relationships to generate new business volumes. This is reflected in the bank's origination model, which prioritises the character of borrowers and their cash flow ahead of the heavily collateral-focused lending approach of many of its competitors such as the 'Big Four'. It has demonstrated a strong risk management approach, highlighted by c45% of new requests being rejected.

  Judo only lends to businesses within 200km of one of their offices, which enables the Judo relationship manager to physically meet the customer and business prior to extending a loan (and over the life of the lending relationship). This is underscored by the high application conversion rate of 89% through both broker and direct channels. SME customers greatly benefit from a relationship-focused business model because, unlike residential mortgage borrowers, they are not homogenous and require more frequent interaction with their bank.
- Long-term growth opportunities: Judo Bank has approximately a 1% of the total SME business lending market share in Australia. Judo has an even smaller position in mortgages, which are often used in association with a SME's business financing. Given its niche position, this provides significant long-term growth opportunities for the Company while maintaining a rigorous risk-focused approach. Judo has targets to grow its SME lending portfolio to AUD15-20bn over the next four to five years. Currently its loan book is growing at 3% per month, and if growth is maintained at similar rates over the next few years, this target is achievable and once reached it would stand as the 5th largest (depending on growth in the rest of the industry) SME lender in Australia (behind the major banks). Its IPO in late-2021 provided the Company with substantial equity to enable the next stage of growth and results have been significant so far (the loan book was AUD3.5bn prior to the IPO and ended FY22 at AUD6.1bn). Judo has indicated that it will become a regular issuer of bonds and term securitisations for funding purposes, while term deposits remain its primary source of funding (strong demand given higher interest rates). We note that aggressive growth can present some risks (as it might hide the underperformance of certain parts of the loan portfolio) but greater scale utilises operating leverage and we view the market gap as being large enough for Judo to fill in a responsible manner. To date, provisions have tracked the growth of total loans outstanding (mainly from collective rather than specific provisions).
- Leverage to rising interest rates: 91% of the loan portfolio (as at 31 March 2023) was priced off the 1-month BBSW (swap) rate. As such, upward movements in the RBA cash rate provide support to its net interest margin (NIM). The *direct* relationship with 1M BBSW (rather than the Reserve Bank of Australia cash rate, typically used for residential lending) means that both assets and liabilities are generally linked to the same index (rather than linked to two indices that are broadly correlated), with the benefit seen during 2H22. During the period, the 1M BBSW rate experienced significant volatility as the RBA lifted its cash rate, which negatively impacted NIM for many residential mortgage lenders by about 5 to 10 basis points, yet Judo positively benefited from these movements.
- Strong capitalisation: Judo Bank maintains capital levels above the minimum ratios set by the Australian Prudential Regulation Authority (APRA), with a Common Equity Tier 1 ratio of 19.0% as of 31 March 2023. Its high capital levels create room for the bank to grow over the next two years and absorb credit losses, despite limited internal capital generation to date. While we expect Judo Bank's strong loan growth to drive a decline in the bank's capital ratio, we forecast it will remain sustainably above 15% for the next two years (which is a target of the bank). Unlike many banks, Judo's current policy is not to pay dividends and instead re-invest profit back into the business, which will support this target.
- Legacy-free technology: As a new bank, Judo Bank benefits from up-to-date technology systems that can scale with the business and facilitate continued business growth. In time, Judo Bank's legacy-free systems will allow it to operate with a lower underlying cost base than peers operating on a mix of new and legacy platforms (as evidenced by Judo targeting a cost-to-income ratio approaching 30%, compared to peers at around 60%). As of 31 March 2023, it stood at 53.0%. The modular system architecture of modern banking platforms also allows continuous rollout of system updates, meaning Judo will be able to adopt new technologies, as they become available, more readily than many of its peers.

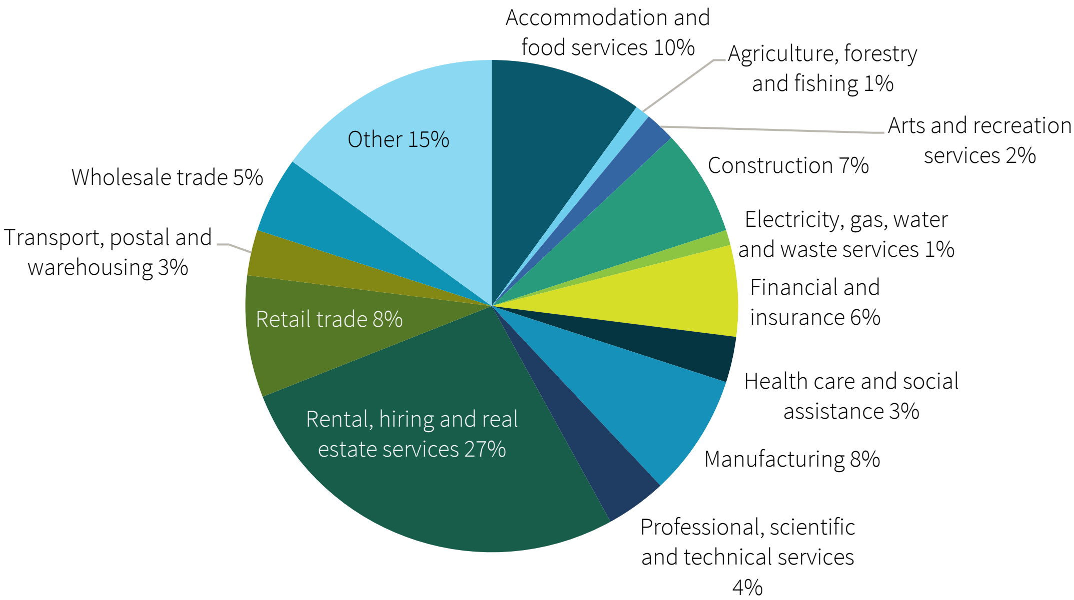
Judo Bank Pty Ltd

- Strong management: There is heightened operational risk for Judo Bank relative to established peers, as the bank is growing rapidly with systems and process that have not yet been tested at scale. Offsetting this is the management team's significant experience running large-scale business banking operations. We also believe Judo Bank's existing governance structures have capacity to accommodate its growth aspirations. There is an element of key person(s) risk within the bank, but this is mitigated by their substantial equity interest with directors and staff owning roughly 8% of Judo's equity.

Risks

- Business operation risks: There is ongoing uncertainty around Judo's credit losses, both as its portfolio seasons and in response to the impacts of rising inflation, higher interest rates and possible recession. SME lending is inherently riskier in nature (as evidenced by holding a greater level of capital compared to residential mortgage lending), given the greater sensitivity to economic fluctuations. Judo has recently entered into the agriculture and health sectors markets (which are deemed riskier) as a means to grow the lending book but represent very small parts of its overall book (1% and 3% respectively). We note that the bank's exposure is diversified across sectors (see Figure 1), which mitigates some risks associated with SME lending. In 2022, the bank undertook a credit quality assessment of its loan book in response to challenging macroeconomic conditions, and customers remain in good financial health (arrears of more than 90 days are currently 0.22% of the book). Additionally, Judo Bank is a relationship-led bank, meaning it is in a better position recognise problems early and hopefully resolve issues with clients that may be struggling.

Figure 1: Judo Bank SME lending exposure (%) by sector, 1H23



Source: Company

- Limited ability to absorb large credit losses: Since Judo is still in its early growth phase, it is arguable that it does not have an established earnings base to absorb very large credit losses. However, as the bank grows, we expect this risk to reduce considerably from a greater granularity of its loan portfolio. Judo has also generated increasingly larger profits; in the first nine-months of FY23 it has reported net profit after tax of AUD87m, compared to AUD15.6m for the entire FY22. To offset the risk from the impact of write-offs, Judo is in a provision building mode; it has current provisions on loans and advances of AUD77.5m (with the majority being collective rather than specific provisions), which was up 40% on the prior year (but broadly constant when expressed as a percentage of its gross loans and advances). Furthermore, the bank maintains very high levels of capital which provides a buffer against credit losses in the interim. Finally, we note that Judo benefits from several Government support schemes to the SME sector, including the SME Recovery Loan programme and retains an ASX listing which can be a valuable source of funding if/when required.

- Strong growth may mask asset-quality underperformance: Judo has grown rapidly since inception over various periods of economic conditions, both strong and challenging. It experienced very strong growth during the COVID-19 years, with approximately 70-75% of gross lending assets written during that time. The onset of COVID-19 saw the Australian and state governments and regulators rollout various support packages to promote economic recovery, and many banks, including Judo, benefited from strong growth in lending as a result. As loans generally season over the medium-term (three to five years), strong growth can mask potential asset quality issues (as growth in the denominator outpaces growth in the numerator, which typically lags the former). It remains to be seen if Judo can sustain its business growth and retain its clients through a full economic cycle or periods of more aggressive competitive pressures while continuing to improve its profitability.
- Susceptible to volatile and price-sensitive term deposit funding: To date, the bank has been successful in attracting term deposit funding (primary source of funding) in the previously low interest rate environment, where there is a segment of investors seeking higher returns from deposit products. In our view, this funding base is susceptible to volatile reinvestment rates and can be less stable than retail transaction deposits. Although Judo currently doesn't have any at-call or transactional deposits, as an ADI it is able to accept these in the future. Additionally, Judo aims to fund 70-75% of its business from deposits, which is possible given total deposits in Australia of approximately AUD850bn.
- Funding risk: The onset of COVID-19 led governments and regulators to support accommodative monetary policy measures, one of which was allowing banks access to a Term-Funding Facility (TFF), enabling Australian banks to access low-cost funding for three years. As of 31 March 2023, Judo Bank had AUD2.3bn of funding through the TFF, which has been and continues to be used to fund new loans, however final repayment of TFF is June 2024. Therefore, Judo Bank will progressively need to repay this exposure and replace it with alternative funding sources, which may include increased deposits, securitisations, and wholesale unsecured funding options and likely corresponding increasing cost of funding compared to the TFF, although we believe the impact on Judo's NIM will be manageable.

Judo Bank Pty Ltd

Certain statements contained in the information may be statements of future expectations and other forward-looking statements. These statements involve subjective judgement and analysis and may be based on third party sources and are subject to significant known and unknown uncertainties, risks and contingencies outside the control of the company which may cause actual results to vary materially from those expressed or implied by these forward looking statements. Forward-looking statements contained in the information regarding past trends or activities should not be taken as a representation that such trends or activities will continue in the future. You should not place undue reliance on forward-looking statements, which speak only as of the date of this report. Opinions expressed are present opinions only and are subject to change without further notice.

No representation or warranty is given as to the accuracy or completeness of the information contained herein. There is no obligation to update, modify or amend the information or to otherwise notify the recipient if information, opinion, projection, forward-looking statement, forecast or estimate set forth herein, changes or subsequently becomes inaccurate.

FIIG shall not have any liability, contingent or otherwise, to any user of the information or to third parties, or any responsibility whatsoever, for the correctness, quality, accuracy, timeliness, pricing, reliability, performance or completeness of the information. In no event will FIIG be liable for any special, indirect, incidental or consequential damages which may be incurred or experienced on account of the user using information even if it has been advised of the possibility of such damages.

FIIG provides general financial product advice only. As a result, this document, and any information or advice, has been provided by FIIG without taking account of your objectives, financial situation and needs. Because of this, you should, before acting on any advice from FIIG, consider the appropriateness of the advice, having regard to your objectives, financial situation and needs. If this document, or any advice, relates to the acquisition, or possible acquisition, of a particular financial product, you should obtain a product disclosure statement relating to the product and consider the statement before making any decision about whether to acquire the product. Neither FIIG, nor any of its directors, authorised representatives, employees, or agents, makes any representation or warranty as to the reliability, accuracy, or completeness, of this document or any advice. Nor do they accept any liability or responsibility arising in any way (including negligence) for errors in, or omissions from, this document or advice. Any reference to credit ratings of companies, entities or financial products must only be relied upon by a 'wholesale client' as that term is defined in section 761G of the Corporations Act 2001 (Cth). FIIG strongly recommends that you seek independent accounting, financial, taxation, and legal advice, tailored to your specific objectives, financial situation or needs, prior to making any investment decision. A copy of FIIG's current Financial Services Guide is available at www.fiig.com.au/fsg.

An investment in notes or corporate bonds should not be compared to a bank deposit. Notes and corporate bonds have a greater risk of loss of some or all of an investor's capital when compared to bank deposits. Past performance of any product described on any communication from FIIG is not a reliable indication of future performance. Forecasts contained in this document are predictive in character and based on assumptions such as a 2.5% p.a. assumed rate of inflation (unless otherwise stated), foreign exchange rates or forward interest rate curves generally available at the time and no reliance should be placed on the accuracy of any forecast information. The actual results may differ substantially from the forecasts and are subject to change without further notice. The information in this document is strictly confidential. If you are not the intended recipient of the information contained in this document, you may not disclose or use the information in any way. No liability is accepted for any unauthorised use of the information.