

Judo Bank Pty Ltd

9 October 2023

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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 AUD1.04bn as of 9 October 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 AUD8.9bn (as of 30 June 2023), of which approximately 76% 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 (30 Jun) | 2023 |
| Net Interest Income | 347.6 |
| Credit loss provisions | (54.6) |
| Pro forma NPAT | 73.4 |
| Gross Loans and advances | 8,907.8 |
| Customer deposits | 5,954.4 |
| Gross Debt | 4,507.4 |
| Underlying NIM (%) | 3.53 |
| Credit losses (%) | 0.61 |
| Nonperforming loans (%) | 1.09 |
| CET1 Ratio (%) | 16.7 |

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 |

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

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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 around 45% 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 less than 2% 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 nearly 4% 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 FY23 at AUD8.9bn). 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:** 90% of the loan portfolio (as at 30 June 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 RBA 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 FY23. 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 16.7% as of 30 June 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 30 June 2023, it stood at 54.1%. 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.

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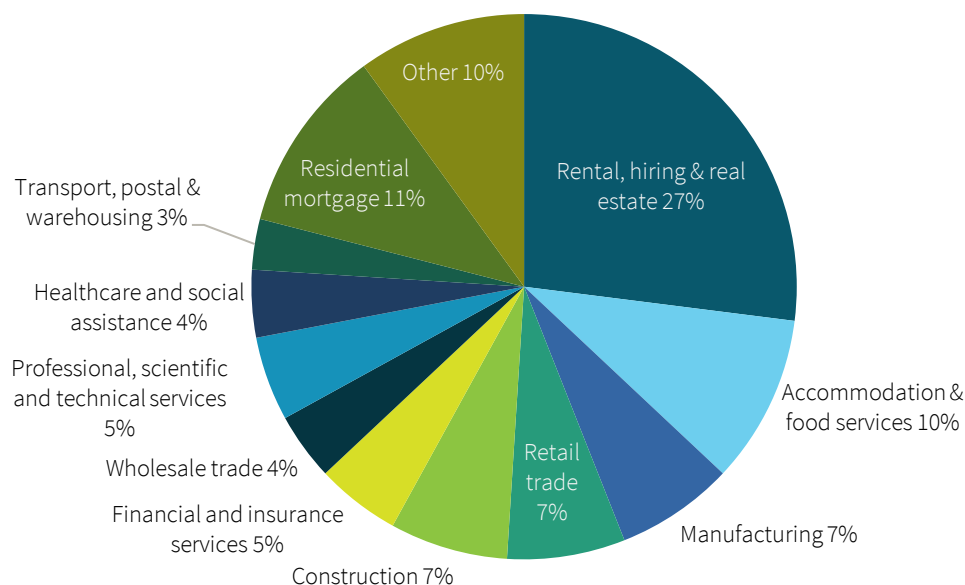
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- Strong management:** There is heightened operational risk for Judo Bank relative to established peers, as the bank is growing rapidly with systems and process that have not yet been tested at scale. Offsetting this is the management team's significant 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 1.09% 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, FY23



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 FY23 it has reported net profit after tax of AUD73.4m, compared to AUD15.6m for 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 AUD107.5m (with the majority being

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collective rather than specific provisions), which was up 95% on the prior year. 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 30 June 2023, Judo 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.

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