EQUITY RESEARCH

PAC PARTNERS

FE Investments Group (FEI)

SME Lender: Proven Model, Strong Growth

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KEY POINTS

- FEI is a founder-led licensed deposit-taking institution (DTI) that provides SME lending and microfinancing. FEI is one of a few remaining DTIs in New Zealand.
- FEI has a 13 year track record. They have created a successful franchise in New Zealand which they aim to replicate in Australia in the next 12 months. They have a big opportunity to work with SMEs underserved by banks, with an estimated addressable market of $20 billion.
- We initiate coverage on FEI with a buy recommendation and a 12 month price target of $0.18 based on 27x FY19 earnings. We believe loan growth and net interest margin expansion will drive strong earnings upside.

RECOMMENDATION — Buy

Initiating Coverage	
Risk Rating	High
Current Share Price	$0.11
12 Month Price Target	$0.18
Price Target Methodology	Earnings Multiples
Total Return (Capital + Yield)	62.7%
DCF Valuation	
Market capitalisation	$16m
Liquidity – Daily Value	$0.1m

Initiation of Coverage

- FEI has a large addressable market in Australian SME lending which is estimated to be a $20b opportunity. We believe FEI will have strong demand for their services and will leverage technology to significantly scale their lending activities.
- We believe FEI will have strong loan growth, a reduction in cost of funds to increase net interest margins, and a scalable platform to grow their business.
- Receivables: FEI can accelerate growth in its receivables book by extending their product range, cross-selling additional solutions to clients, and ultimately expanding their services to Australian SMEs. SME lending has become less of a focus for Australian banks.
- Margins: we calculate net margin between the receivables book (~14.5%) and their cost of funds (~6%) to be roughly 8.5%. FEI are reducing their cost of funds by adjusting their term deposit rates. As older, higher rate deposits roll off, we see FEI to further increase their margins.
- Deposits: FEI has grown their deposits at a strong pace. In the past 3 years, deposits increased by a CAGR of 45% due mostly to loyal and wide-spread Asian depositors. Management believes that FEI can continue to grow its NZ deposits at 20% p.a. to be able to match the growth in loans. FEI provides no 'at-call' deposits (only term deposits) in a number of currencies, enabling them to confidently manage liquidity.
- Scalable: As a private company, FEI's capital growth was restricted. As a listed entity, they can take advantage of the leverage inherent in a banking model and meet the sustained demand for their services – $1 of equity capital enables $4 of deposits, to generate $5 of total assets. Fixed costs provide strong operating leverage. FEI has attractive economics. We estimate a return on incremental equity of 28% if costs are held constant.

Financial Forecasts & Valuation Metrics

Y/e Jun ($m)	2018A	2019F	2020F	2021F
Revenue	12	13	16	19
NPAT	-1.2	1.0	1.8	2.8
EPS (cps)	-0.8	0.7	1.2	1.9
EPS Growth	-181%	181%	83%	56%
DPS (c)	0.0	0.0	0.0	0.0
PER (x)	-13.5	16.6	9.1	5.8
Dividend Yield	0.0%	0.0%	0.0%	0.0%
Gearing	-111%	-103%	-107%	-110%
Interest Cover (x)	na	na	na	na

Source: PAC Partners estimates

Investment View

- We initiate coverage on FEI with a Buy recommendation and a 12-month price target of $0.18 based on 27x FY19 PE and 4-year NPAT CAGR of 27%. FEI has roughly $12m in net cash.
- We believe FEI will have solid loan growth of 20% CAGR and net interest margin expansion of 50-100 bps over the next 3 year years, which would translate into strong earnings growth.
- In the last 12 months, FEI was in transition to integrate the merger with Wolfstrike group. FY18 was filled with one-offs: merger costs, revalued finance leases, more conservative provisions and a write-off of goodwill.
- FEI now has a clear path to grow profitability by increasing their receivables portfolio by 20% for the following years. We believe FEI has strong demand in SME lending. FEI are also looking at initiatives and are investing in technology to streamline the loan approval process.
- With an increased cost base, FEI is ready to scale. We see incremental gross profits to flow through to the bottom line.

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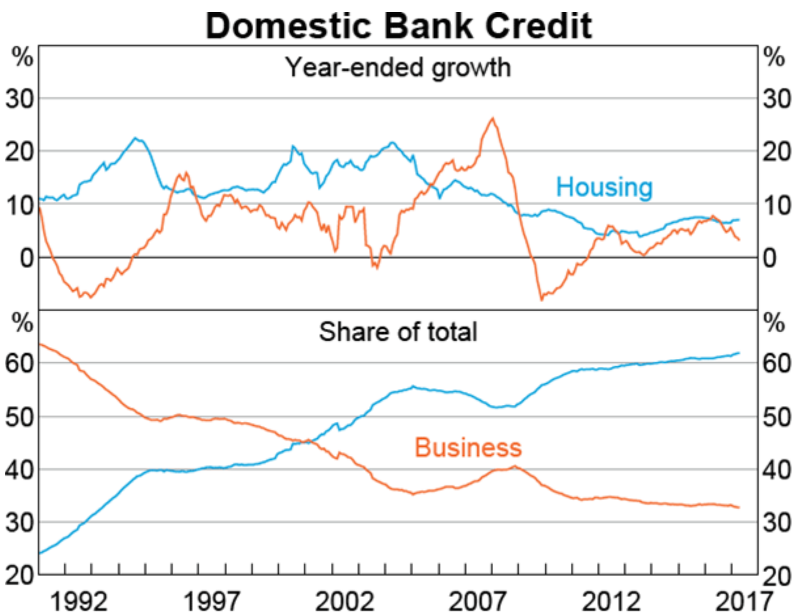
The Opportunity – SME lending

Post the financial crisis in 2008, banking regulators around the world have been mainly focussed on managing risk and liquidity in the sector. This has led regulators to require more capital buffers from banks to be able to withstand future shocks in the financial system. In Australia, capital standards have been set so that Australian banks have capital ratios to be 'unquestionably strong'.

Higher capital ratio requirements have initially led to more capital raisings from banks to be able to increase their resilience, but at the cost of reduced returns on equity. In other words, we have seen a deleveraging from banks post the crisis. To be able to maintain higher returns, banks have been encouraged to shift their practices more towards residential lending and scale back on capital-intensive and lower-return lending (for the amount of capital required) because of how riskiness of assets are weighted. Below is a chart from the RBA showing the increasing share of bank credit towards housing and a decrease in lending towards businesses. In roughly two and a half decades, we have seen the share of business loans halved from more than 60% to around 30% of domestic bank credit.

Due to regulatory changes, banks are incentivised to focus on residential lending because they are required to hold less capital on loans



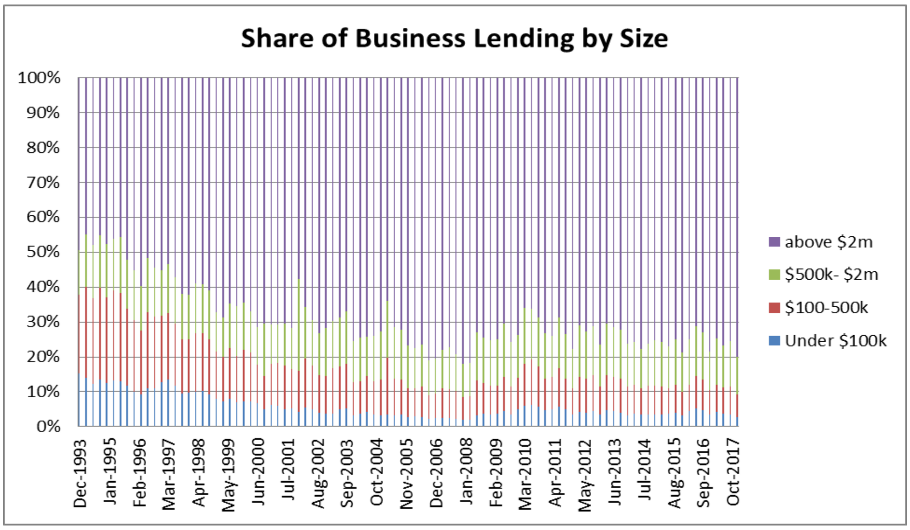
Source: RBA Bulletin June 2017

Aside from banking regulation, the RBA notes that other factors that drive this long-term trend include financial deregulation and competition in lending markets, and an increase in the cost of housing relative to business assets over time.

Due to banks' increasing focus on residential lending, SME lending is an underpenetrated market by financial institutions. Many estimates exist of how much the current SME lending market is and they range from $20b to $60b p.a. The RBA further notes that they have found that even high quality SMEs are finding it tough to access financing because banks typically require property security to be pledged to qualify for a loan. Hence, every SME that does not have property as collateral probably has issues borrowing from a bank, may they be profitable or not. As banks scale back on lending to businesses, other players take advantage. Among ASX listed companies, we have seen significant growth from players exposed to the same SME financing theme, namely Axsesstoday (AXL:AU) and Scottish Pacific Group (SCO:AU). We see FE Investments riding the same growth thematic.

Of the roughly 30% of domestic bank credit which is allocated to business loans, around 3% of the funds are lent under $100k which we believe is a good representation of SME loans. The share of lending under $100k has been relatively flat for a decade.

Only 3% of total business loans are allocated to loans that are less than $100k



Data as of Dec 2017 Source: APRA, RBA stats, analyst estimates

Loans and leasing growth

FEI's loan book growth is generated by high demand. FEI bundles multiple products such as POS systems, payment terminals, security alarms and IT equipment, etc. These rental contracts are for periods of 12 to 48 months and secured predominately by first ranking securities. Bundling makes their offering much stickier to their customers and easier to cross sell additional services. Over the medium term, we see FEI to offer leasing to other industries. They have recently launched SME lending towards hospitality companies to provide credit to mobile business and fast food outlets.

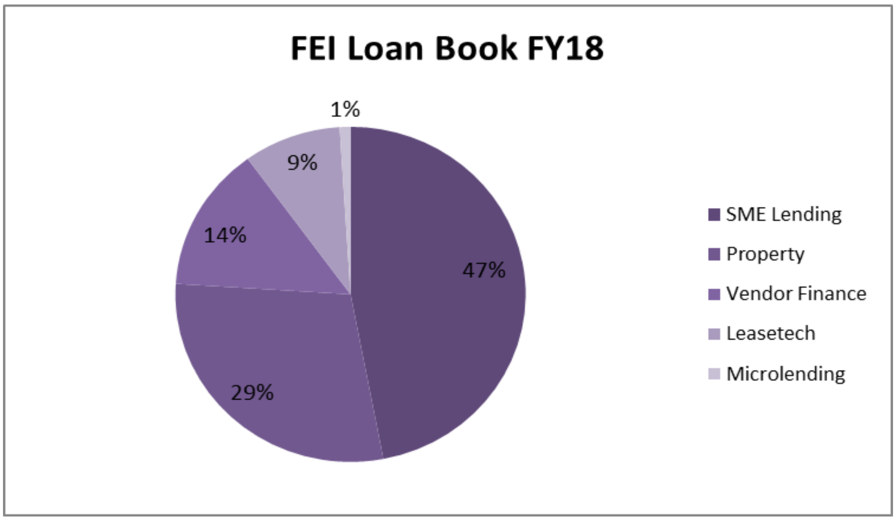
FEI recently introduced their micro lending platform and has seen strong demand

FEI Offering	Product	Security	Size/Term	Typical Offering/Product Suite
SME Business Lending	» Business Loans » Working Capital Cash	» Business/Personal Security	» Up to $600k » 1-4 Years	
LeaseTech	Equipment Leasing: » Commercial & Industrial Equipment » Auto Equipment » IT Equipment » Medical Equipment	» Equipment Security	» Up to $1m » 1-4 Years	
Vendor Finance	» Financing of Rental Contracts » Invoice/Receivables Financing	» Contract Security	» Up to $80k » 1-4 Years	
Micro Lending	» Fast Cash (<$50k)	» Unsecured	» Up to $50k » 1 Year	
Property Finance	» Commercial Developments » Hotel Developments » Business Expansion	» Business/Personal/ Land Security	» On Application	

Source: FEI Presentation

Also, FEI launched their B2B micro-lending products based on a credit scoring matrix and the ability to apply for applications online. They have noted that significant customer interest has been generated by this program. Below is a snapshot of their latest loan book allocation:

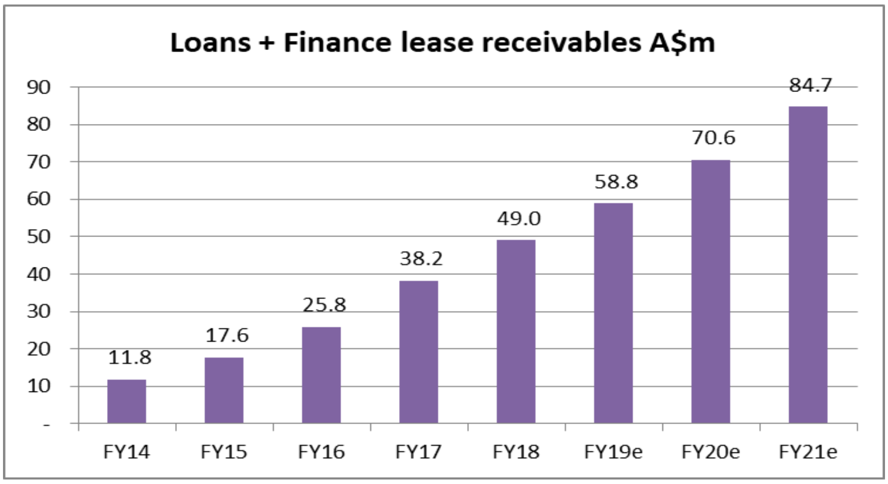
FEI is currently unwinding their property loans to reinvest in more capital -efficient lending categories



Source: FEI presentations

We forecast FEI to grow their combined loans and receivables book by 20% until FY20. We decided to group loans and leases together because roughly $9m of FEI's loans were to Wolfstrike, which is now part of FEI and moved to the leasing category.

FEI's loan write offs are below the industry average at less than 2% given their stringent credit process. The average loan amount is $8.5k to over 5k customers providing diversity to reduce concentration risk.



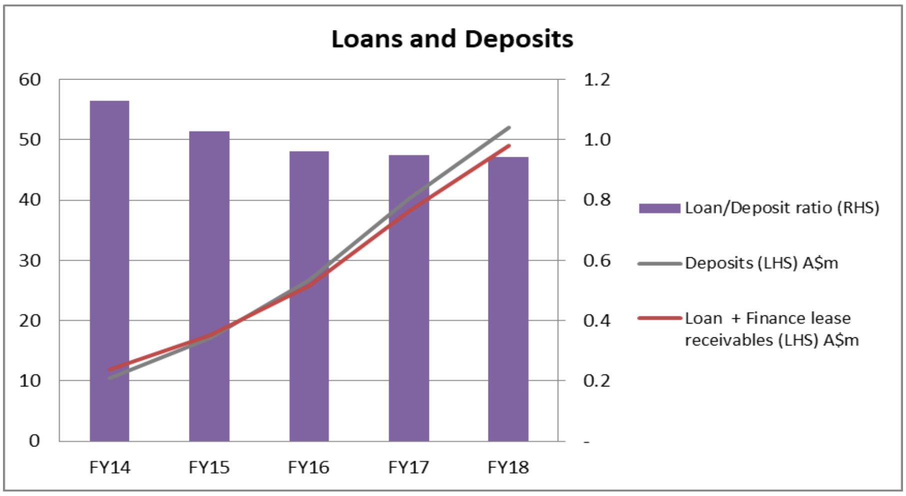
Source: FEI reports, analyst estimates

FEI has been able to grow its loan book from roughly $12m in FY14 to $49m in FY18 (March year-end), a 4-year CAGR of 42%.

Deposits and loans

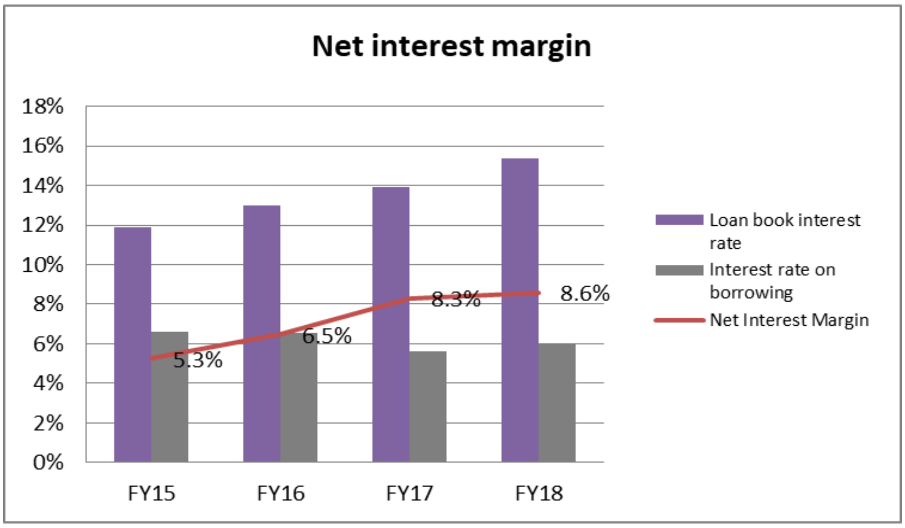
FEI is one of the few remaining non-bank deposit takers licensed by the Reserve Bank of New Zealand. FEI is well known to capture a large market of Asian loyal depositors, as well as Australian and New Zealand residents. Being able to accept retail deposits in multiple currencies (AUD, USD, GBP, NZD and Yen) enables FEI to fund the strong demand for SME lending and leasing. Below is a chart of FEI's deposit and loans for the previous 4 years. We can see that their loan to deposit ratio has been tracking above or close to 1 for the past 4 years due to strong growth in loans. FEI has a scalable business model because of the ability to obtain funding through locked-in (no 'at-call') term deposits.

FEI is currently unwinding their property development loans (roughly 29% as of FY18) to a self-imposed target of 10-15%. In the unwinding of property development loans, FEI would be able to redeploy capital to SME lending with lower risk weightings. Also, as property development loans have a higher risk weighting relative to SME loans, unwinding loans from this area would mean that FEI would be able to increase its total assets from the capital released from the property development loans. The same capital previously deployed in property development loans can support a higher level of SME loans. $1 of equity capital can move from currently $5 up to $6 of assets.



Source: FEI presentations, analyst estimates

Prior to the merger with Wolfstrike, FEI has enjoyed an increasing net interest margin while growing their receivables book. Once the higher cost of funds from Wolfstrike rolls over, we see FEI to expand their net interest margins.

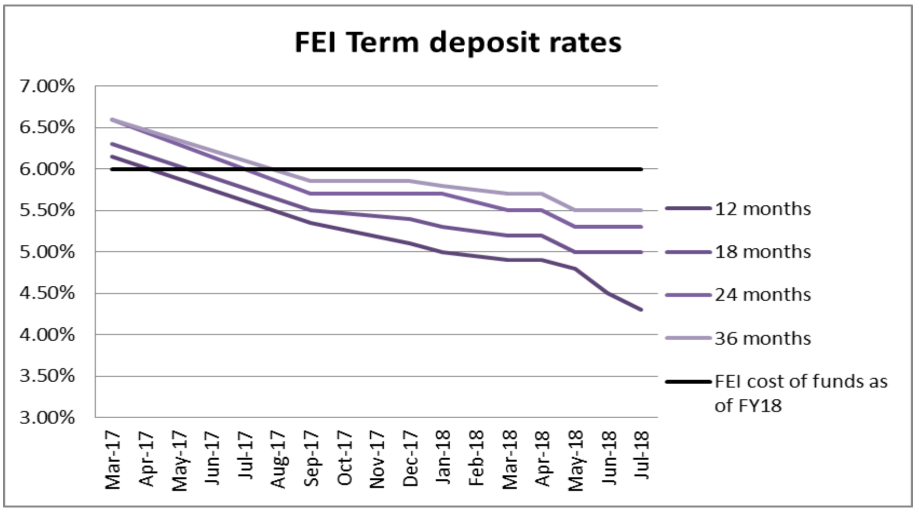


Source: FEI presentations, analyst estimates

Margins can expand more

Prior to the merger, FEI's average cost of funding was 5.61% for FY17. FY18's cost of funding was around 6.0% due to the higher cost of Wolfstrike funds. However, in the longer term, we see all loans and receivables to be funded at a lower cost, as these longer term costs of funding are renewed. We note that deposit rate offerings for FEI are now all below the current average cost of funds. Below are our findings of FEI's deposit rates since March 2017:

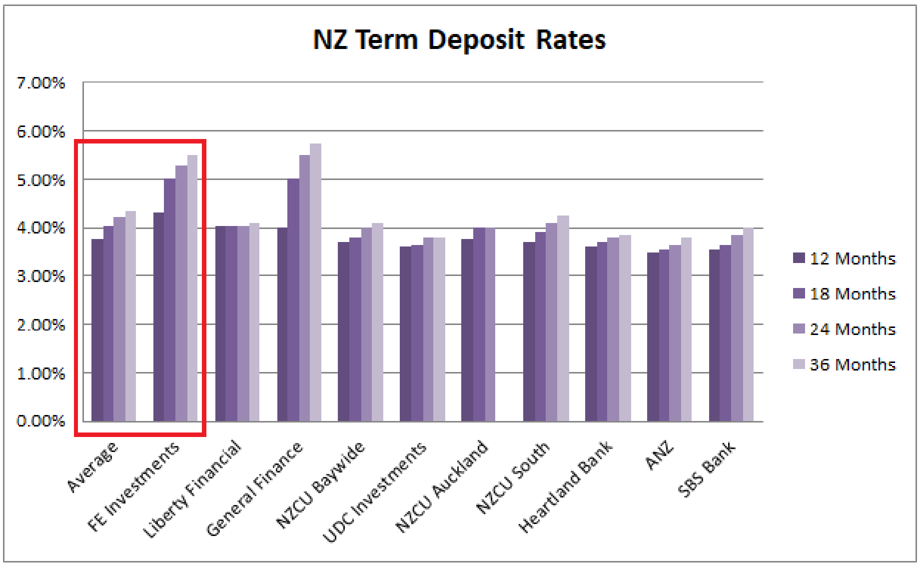
We see cost of funds to decrease further.



Data as of 2/7/18 Source: FE Investments website, analyst estimates

We believe that there is more room for FEI to decrease their cost of funding based on how much competitors offer. As of July 2018, FEI still offers one of the highest TD rates in New Zealand. General Finance competes closely with them in the 18, 24 and 36 month terms but FEI has the highest 12 month rate. Aside from FEI and General Finance, the next competitor and top 10's average are roughly 50-100 bps below. We believe that FEI may have around 50 bps to reduce on their TD rates and still be competitive.

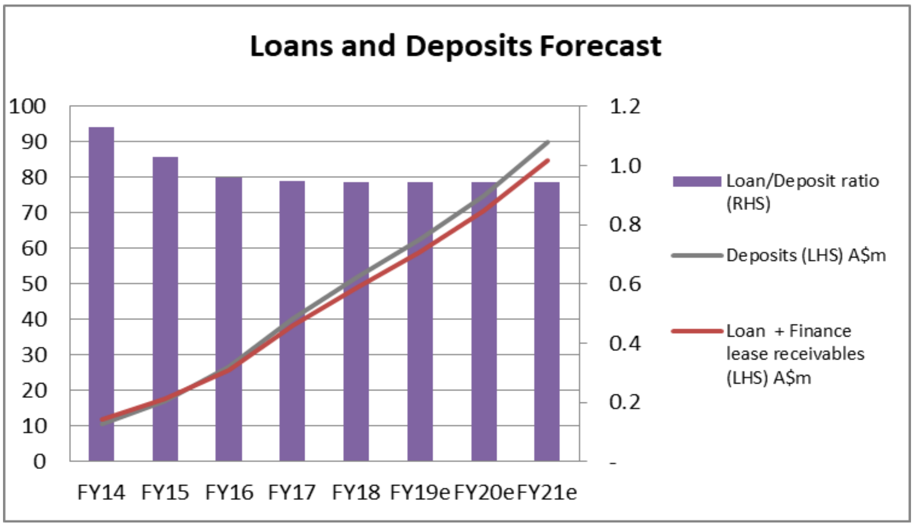
FEI still offers competitive term deposit rates despite decreasing their interest rates. There is more room for their deposit rates to decrease.



Data as of 2/7/18 Source: depositrates.co.nz, analyst estimates

Forecasts

There is a large market opportunity. We forecast FEI to grow their book by 20% until given this is the first time the company now has access to capital having raised $3m in FY18 to support forecast growth given lending opportunities were being turn away prior. We have assumed deposits would grow in lockstep with loans and a loan to deposit ratio of 0.95.



Source: FEI presentations, analyst estimates

There were substantial merger related costs arising from the Wolfstrike merger. These costs included on-off merger costs of $719k as well as other embedded duplication of operating costs and redeployment of staffing resources which would take the next 12 months to extract efficiencies. This FY18, we believe that they would be slightly below breakeven on a normalised NPAT basis. We see FEI has enough resources to scale up without significantly adding to their fixed costs once the cost rationalisation process is complete. FEI has averaged an ROE of 17% for the past 3 years and we should expect that FEI's ROE would converge to its historical average over time.

PROFIT & LOSS (m)

Y/end June	FY2017A	FY2018A	FY2019F	FY2020F	FY2021F
Revenue	**6.8**	**12.3**	**13.5**	**16.1**	**19.4**
Cost of funds/goods sold	-2.3	-7.0	-7.2	-8.6	-10.2
Net Interest	**4.5**	**5.3**	**6.2**	**7.5**	**9.1**
Operating Costs	-3.0	-6.1	-4.7	-4.8	-5.0
Depreciation & Amortisation	0.0	-0.1	-0.1	-0.1	-0.1
NPBT	**1.5**	**-0.9**	**1.4**	**2.6**	**4.0**
Income Tax Expense	-0.5	-0.3	-0.4	-0.8	-1.2
normalised NPAT	**1.1**	**-1.2**	**1.0**	**1.8**	**2.8**

Source:analyst estimates

If FEI is able to manage their costs, we estimate the return on incremental equity to be 28%. Due to the leverage inherent in a banking model, we see every additional $1 of funding in FEI to translate to an after tax return on $0.28. Below are our estimates including if NIMs expand:

Incremental Equity	$1.00		
Deposits	$4.00		
Loans	$5.00		
NIM on loans	7.5%	8%	8.50%
GP on loans	$0.38	$0.40	$0.43
After tax (30%)	$0.26	$0.28	$0.30
Return on incremental equity	26.3%	28.0%	29.8%

Note that the relationship between equity and loans can increase from 5x to 6x, once property development loans are unwound and are allocated to more capital efficient categories. 6x would imply a 20% increase on our estimated return on incremental equity.

Valuation and Risks

We recommend FEI with a buy recommendation and a 12-month price target of $0.18 per share. Conservatively, we believe that FEI would be able to grow by their loan book by at least 20% p.a. in the short to medium term. We value FEI at 27x FY19 earnings, based on a 4-year NPAT CAGR from FY17-21. Our target price implies a market capitalisation of $27m. FEI has roughly $12m in net cash.

RISKS

Key risks to our positive investment view of FEI include:

- Client risk – rising bad debts from poor performance from loans and leases
- Regulatory risk – as we have highlighted, regulators have played a key part in shaping the banking industry in how it is today. We think the SME lending opportunity is present mainly due to regulations, hence can also be affected by regulation.
- Competition – heightened competition may impact margins
- Compliance breaches -Deposit taking is a tightly regulated activity by banking and financial authorities. Breaches of compliance including failure to maintain satisfactory capital ratio, anti-money laundering offences and trust deed covenant non-compliance
- Reputational risk – As with all financial institutions, any negative customer experience may cause a less than favourable perception of FEI and its activities. This risk is mitigated by the fact that FEI is not involved in the provision of financial or investment advice to its customers
- FX volatility – because FEI accepts deposits and makes loans in different currencies, volatility in foreign exchange movements may affect their financial performance

FE Investments

		Price	**$ 0.11**
NFPOS	**150 m**	**Market Cap**	**$16 m**

PROFIT & LOSS (m)

Y/end June	FY2017A	FY2018A	FY2019F	FY2020F	FY2021F
Revenue	**6.8**	**12.3**	**13.5**	**16.1**	**19.4**
Cost of funds/goods sold	-2.3	-7.0	-7.2	-8.6	-10.2
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Operating Costs	-3.0	-6.1	-4.7	-4.8	-5.0
Depreciation & Amortisation	0.0	-0.1	-0.1	-0.1	-0.1
NPBT	**1.5**	**-0.9**	**1.4**	**2.6**	**4.0**
Income Tax Expense	-0.5	-0.3	-0.4	-0.8	-1.2
normalised NPAT	**1.1**	**-1.2**	**1.0**	**1.8**	**2.8**

BALANCE SHEET (m)

Y/end June	FY2017A	FY2018A	FY2019F	FY2020F	FY2021F
Cash	**11.2**	**12.5**	**12.6**	**15.0**	**18.6**
PP&E	-	0.1	0.3	0.4	0.5
Debtors & Inventory	39.1	49.0	59.8	71.7	86.1
Intangibles	-	2.7	2.5	2.4	2.4
Other assets	0.7	0.5	0.5	0.5	0.5
Total Assets	**50.9**	**64.8**	**75.7**	**90.1**	**108.0**
Borrowings	-	0.8	0.8	0.8	0.8
Trade Creditors	40.9	52.9	62.8	75.3	90.4
Other Liabilities	0.4	0.6	0.6	0.6	0.6
Total Liabilities	**41.3**	**54.3**	**64.1**	**76.7**	**91.8**
NET ASSETS	**9.6**	**10.6**	**11.6**	**13.4**	**16.2**
OEI and Pref Shares	-	-	-	-	-
Shareholder Equity	**9.6**	**10.6**	**11.6**	**13.4**	**16.2**

FE Investments

Date: 05-Jul-18

Model Updated: 05-Jul-18

KEY RATIOS

Y/end June	FY2017A	FY2018A	FY2019F	FY2020F	FY2021F
NPAT Margin (%)	15.9%	-9.9%	7.4%	11.2%	14.6%
ROE (%) y/e	11.2%	-11.5%	8.6%	13.6%	17.4%
ROTE (%) y/e	11.2%	-15.4%	10.9%	16.6%	20.4%
NTA per share ($/share)	0.09	0.05	0.06	0.07	0.09
Eff Tax Rate (%)	30.0%	-30.1%	30.0%	30.0%	30.0%

VALUATION PARAMETERS

Y/end June	FY2017A	FY2018A	FY2019F	FY2020F	FY2021F
EPS (cps)	0.7	-0.8	0.7	1.2	1.9
PE (x)	**15.2**	**-13.5**	**16.6**	**9.1**	**5.8**
Enterprise Value	5.3	4.7	4.6	2.2	-1.3
Price / NTA	1.2	2.1	1.8	1.5	1.2
DPS (cps)	0.0	0.0	0.0	0.0	0.0
Dividend Yield (%)	0.0%	0.0%	0.0%	0.0%	0.0%
Franking (%)	0%	0%	0%	0%	0%

VALUATION

($m)	
FY19 NPAT ($m)	1.0
P/E multiple based on 4 year CAGR FY17-21	27x
P/E valuation	**27**
Shares (m)	150
Equity value per share	**$ 0.18**

Operations

Y/end June		FY2017A	FY2018A	FY2019F	FY2020F	FY2021F
Deposits	$m	40	52	62	75	90
Receivables	$m	38	49	59	71	85
Net Interest margin		8.3%	8.6%	8.8%	8.9%	9.0%

GROWTH PROFILE (YoY)

Y/end June	FY2017A	FY2018A	FY2019F	FY2020F	FY2021F
Deposits	50%	29%	20%	20%	20%
Receivables	48%	28%	20%	20%	20%
NPAT		-213%	-181%	83%	56%
EPS (cps)		-213%	-181%	83%	56%
DPS (cps)		0%	0%	0%	0%

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RECOMMENDATION CRITERIA

Investment View

PAC Partners Investment View is based on an absolute 1-year total return equal to capital appreciation plus yield.

A Speculative recommendation is when a company has limited experience from which to derive a fundamental investment view.

Buy	Hold	Sell
>20%	20% – 5%	<5%

Risk Rating

PAC Partners has a four tier Risk Rating System consisting of: Very High, High, Medium and Low. The Risk Rating is a subjective rating based on: Management Track Record, Forecasting Risk, Industry Risk and Financial Risk including cash flow analysis.

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