EQUITY RESEARCH

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FEI

Shadowplay – Upgrade to BUY

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KEY POINTS

- After a protracted period in suspension, non-bank lender FEI reported a messy H1-19 result, which masked what is a strong underlying growth story.
- Management have improved transparency within the business, reduced the property development exposure and delivered stronger than expected growth in other parts of the lending book. We adjust H1-19 for non-recurring items, derived underlying EBITDA of -$0.1m with total income up +10% on PCP; core lending grew +25% on PCP. We increase our price target from 10.5 cents to **18.4 cents, and 86% upside.**

SPECULATIVE BUY

Risk Rating	High
Current Share Price (cents)	9.9
Price Target (cents)	18.4
Dividend Yield	0%
Total Return (Capital + Yield)	86%
Market capitalisation ($m)	16.1
CEO & Exec. Director	TK Shim
Liquidity (ADV)	67,940

Overview

- FEI has run-off its property development book to 15% of the total loan book and is aggressively recycling this expensive capital (on a risk-weighted asset basis) to target SME residential and Vendor Finance loans; these segments collectively grew by 25% over the period.
- Announced the expected approval of an AFSL to operate in Australia by end FY18 with growth plans in place – management expect the cost of funds to be lower in the Australian market and the opportunity to grow the book demonstrably larger.
- Management have always talked a good story about growing the book to $100m but this has been obscured by the property development book being run-off, and fees from this book back-ended towards completion. By FY20 (March year end) the income story becomes a lot simpler: loans x margin less COGS for any finance leases or operating leases written through the distribution network. We factor a current lending run-rate of $3m a month.
- We increase our loan growth forecasts and keep our NIM assumptions relatively unchanged – management called out a more favaourable cost of funds in Australia so there could be more margin upside on the table.
- Capital adequacy sits at 9.5%, and cash on B/S is $8.3m, sufficiently above liquidity requirements of approx ~$6m (10% of liabilities). Whilst we have not factored in a capital injection to our numbers we note that FEI are entering the larger Australian market, and have a strong demand profile ahead - which will need some market making and investment.

RISKS

- We model bad-debts to a max of 1.2% of Book in line with company historicals and management comments.

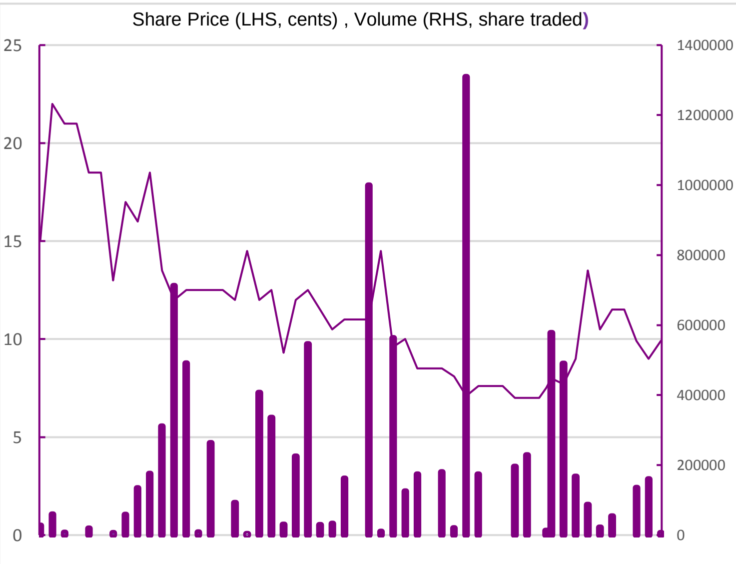
VALUATION

- 3 year EPS CAGR is 33%, apply a 16x FY20 multiple to reflect a growth premum vs market, offset by liquidity risk. Our price target of 18.4 cents **offers 86% upside** and a **BUY rating**.

Financials and Metrics (NZ $m)

	FY' 17A	FY' 18A	FY' 19F	FY' 20F
Revenue	4	13	16	23
EBITDA ($m)	-2.1	-0.5	-0.1	3.8
EBIT ($m)	-2.2	-0.6	-0.2	3.6
EBITDA margin	-48.0%	-3.5%	-0.6%	16.1%
NPAT ($m)	-2.2	-0.4	-0.2	2.5
EPS ($) (fully diluted)	0.01	-0.1	-0.001	0.014
DPS	0.00	0.00	0.00	0.00
POR	0%	0%	0%	0%
Dividend Yield	n/m	n/m	n/m	n/m
net debt/equity	n/m	n/m	n/m	n/m
P/E Ratio	9.9	-1.0	-78.0	7.0
EV EBITDA	-6.6	-32.0	-158.3	3.7

Share Price Performance



H1-19 Review

It has been some time since we reviewed FEI and this has been part due to finding a period of company stability from which to rebase our forecasts coupled with a change in analyst – the recent extended suspension from the exchange and the late publishing of the H1-19 accounts meant we were unable to move forward with some clarity.

We upgrade to a BUY call based on three key points:

1. We think the macro for non-bank /shadow bank lenders is becoming increasingly favourable in the wake of the Royal Commission, and as evidenced by comments made at peer (ASX:RMC) Homeloans recent AGM.

   "While definitive statistics about the size of the Australian home lending market are hard to obtain, we estimate that Home-loans currently originates about 1% of new business in the Australian market and hope to increase our originations to over 2% of the Australian market over the next 3-5 years".

   HOMELOANS currently have $8.6 billion in funded loans so this statement implies ~20-30% annual growth on a 3 or 5 year view – with FEI only having $52m of lending we think the base is low enough to grow at a similar or faster rate – particularly as FEI are at the early stages of entering Australia.

2. As we touch on later, the H1-19 result provides some resolution to a number of issues that created quality perceptions for investors, management have dealt with some issues around the trust deed, and generally cleaned house.

3. We change our valuation approach to reflect a P/E REL multiple that captures the 3 year expected CAGR growth relative to the market and move away from a book value approach which we see as discounting the growth unfairly.

With three months left to end of FY19, cleaned up and ready for FY20…

Management have been very active in addressing a number of issues, key highlights in H1-19:

- Property Development book now running off at pace.

- Very strong growth being achieved in SME and Finance leases (+25% on PCP).

- Cleaning up the business – adoption of a new risk-management framework that provides greater transparency loans.

- Remedial actions have taken place to address breaches in constitution

- Cleaned up and now ready to grow and enter the Australian market

- NZ Macro getting better, recent commentary from the RBNZ who will ease residential mortgage restrictions from 1 January as foreshadowed in recent commentary, providing small lift to housing going into summer season. The RBNZ also says "Risks to New Zealand's financial system have eased over the past six months, but vulnerabilities persist." and "If banks' lending standards are maintained we expect to further ease LVR restrictions over the next few years."

- Conducting a private placement to bolster the capital position.

business at a positive turning point in lending growth…

Understanding the H1-19 result…

- While a messy result, the trajectory of the business is heading in a positive direction with total group income up **~10% on H1-18 to $7.8m**, with finance lease income up 115%, from $1.8m to $3.8m, offset by lower fee-income: $2.5m to just over a $1m.
- Whilst fee income is lower this reflects the transition the business is making from property development loans to finance leases/SME lending; as flagged in previous announcements the company is growing its lease/SME book strongly, conservatively we estimate a gross amount of $2-3m a month whilst at the same time managing the run-off of the property (which has a higher capital RWA base).
- The company reported EBITDA -$1.2m in H1-19, which backing out our adjustments (to get to a normalised base number) would see the business deliver EBITDA of -$0.1m on an underlying basis.

A number of one-offs in OPEX that can be backed out…

We expect FY19 to deliver a +ve operating result on an underlying basis…

Understanding underlying H1-19 results…looking at key items in the P&L.

P &L	H1-18	H1-19	Change	Comments
Total Group Income	7.10	7.81	10%	Reflects the run-off of the property book which is now only 15% of total lending; the SME and finance lease book need to play catch-up as this growth is relatively new.
Interest expense	1.62	1.69	4%	
COGS	1.20	3.20	167%	Reflects the growth in the non-property business as business loans to SMEs and finance leases via Lease-tech and its distribution partners grew by 55% over the sequential 6-month period.
Employment Expense	0.76	0.92	21%	
OPEX	3.44	2.94	17%	See adjustments below
Impaired	0.16	0.32	100%	
D&A	0.25	0.07	-72%	
Transaction Costs	0.15	0	-100%	
EBITDA	**0.27**	**-1.21**	**-752%**	
PAC **Adjustments to OPEX to get to Underlying**				
- professional consulting fees		0.3		Special audit, one-off
- Fees Paid to FES		0.5		As the property book goes to zero then these fees will be greatly diminished.
- Marketing		-0.2		Marketing not reflective of entering Australia post completion of AFSL expected end 2018
- other expenses		0.1		Analyst adjustments
- Directors Rem		0.4		Discharge of loan to Director – one-off
- transaction costs	0.15	0		
Underlying EBITDA	**0.42**	**-0.10**		

Lending, Capital and Liquidity

At the September 30th balance date FEI reported a loan book of $52m which is broadly flat over the sequential period and reflects the aggressive run-down of property development loans. Management have done a good job on capital with deposit funding growing: both in actual balance and increasing tenure; whilst we expect FEI to remain competitive in the TD market, we see competition lessening as credit growth slows in property– this takes some of the pressure of discounting to chase front-book growth.

Deposit Summary	Sep17	Sep18	%
Total Deposits Balance	$49.19m	$50.95m	3.56%
Deposit Amount (avg.)	$44,641	$45,775	2.54%
Tenure (avg.)	9 Months	11 Months	23.86%
Deposit Rate (avg.)	6.55%	5.96%	(0.59%)

Source: FEI Investor presentation (H1-19)

Management growing deposit tenure to match liability profile…

Key Metrics		
	SEP17	SEP18
Loans / Deposit Ratio	0.85	1.02
Capital Adequacy Ratio	9.59%	9.30%
RBNZ CAR Required	8.00%	8.00%

Source: FEI Investor presentation (H1-19)

With FEI having a deposit reinvestment rate of 75% (rollover rate) the company is well-placed to smooth fluctuations in their interest expense, particularly if the business can reach the nirvana of matching deposit tenure with their liabilities.

- From a **liquidity perspective** management work on a cash base of 10% of liabilities which equates to around $6m, but some detective work is required to understand the capital position, as FEI do not publish their Risk Weighted Asset base by asset class but we understand from the RBNZ[1] that property development loans require approx. double the capital required than FEI's SME/Vendor Finance Book. Disclosed in the financial statements, an amendment to FEI's Trust Deed increased its minimum capital adequacy ratio from 8% of 9% from 1 April 2018 and from 9% to 9.5% from 1 October 2018. Based on Net-Assets minus intangibles and goodwill we get qualifying capital base of $8.0m which divided by 9.5% drives RWA of approx. $80m, property loans make up 15% of the $52m loan book, and attract twice the capital required for FEI's sweet spot in new lending – this implies an additional ~$7.5m in lending can be written from the same capital base.

- FEI have made some significant progress in providing transparency of the book, and these include a risk management framework for managing the impairment of financial assets. The outcome for FEI has been a classification system for performing (Stage1, Grades 1-3) and underperforming loans (Stage 2, 3) and we note that current exposure in Stage-3 sit at $2.8m which we see as impaired. Management have previously stated that they expect recognised loss ratios to be typically no more than 1.25% (which we understand to be net of recoveries e.g. what they can sell the equipment for).

- Post the balance date FEI announced a capital raise of $2.1m via a private placement at an issue price of 10 cents, in addition, the company will also be seeking shareholder approval for the issuance of fully paid ordinary shares to

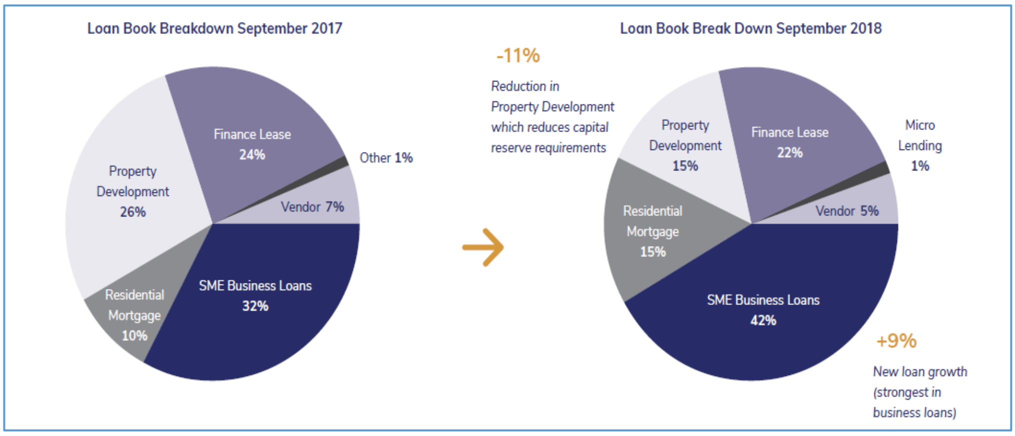
[1] http://www.legislation.govt.nz/regulation/public/2010/0167/latest/DLM3032713.html

parties related to some of the Directors for a value of $1.01m in consideration of repayment of certain redeemable preference shares previously issued by FE Investments Limited. The issuance will be made at the same issue price as the private placement above – we factor this dilution into our forecasts.

Time to consider future funding…

FUNDING GROWTH

Management are toward the end of their capital recycling unwind from their property development loans and need to reset their capital to address the strong growth profile ahead – this business is a growth business and while we see TD's as a mechanism to match assets, to address broader opportunities ahead Management will need to lay-out how the opportunities will be funded.



Source: FEI Investor presentation (H1-19)

To support the strong lending growth profile…

1. Total new Business Loan Book has grown by 25% over the past 12 months: SME lending and Residential Mortgages +61%, Lease-Tech equipment financing & other leasing (+17%); key sectors include Retail Franchise Expansion, Technology/IT Suppliers. Whilst the capital base is manageable a downstream capital injection cannot be ruled out If management decide to push the balance-sheet hard to service the strong demand.

Input Assumptions	FY18A	FY19F	FY20F	FY21F	FY22F	FY23F	FY24F
Average Interest Earning Assets –End Year	53	67	80	95	115	125	140
Mid-point	50	60	74	88	108	123	140
Average Interest Earning Assets -Beg Year	47	53	67	80	100	120	140

Projected asset growth – source PAC estimates

2. Working capital, for the launch in Australia once the AFSL has been approved; some setup will be required to get the Australian opportunity up and running, along with ongoing compliance.

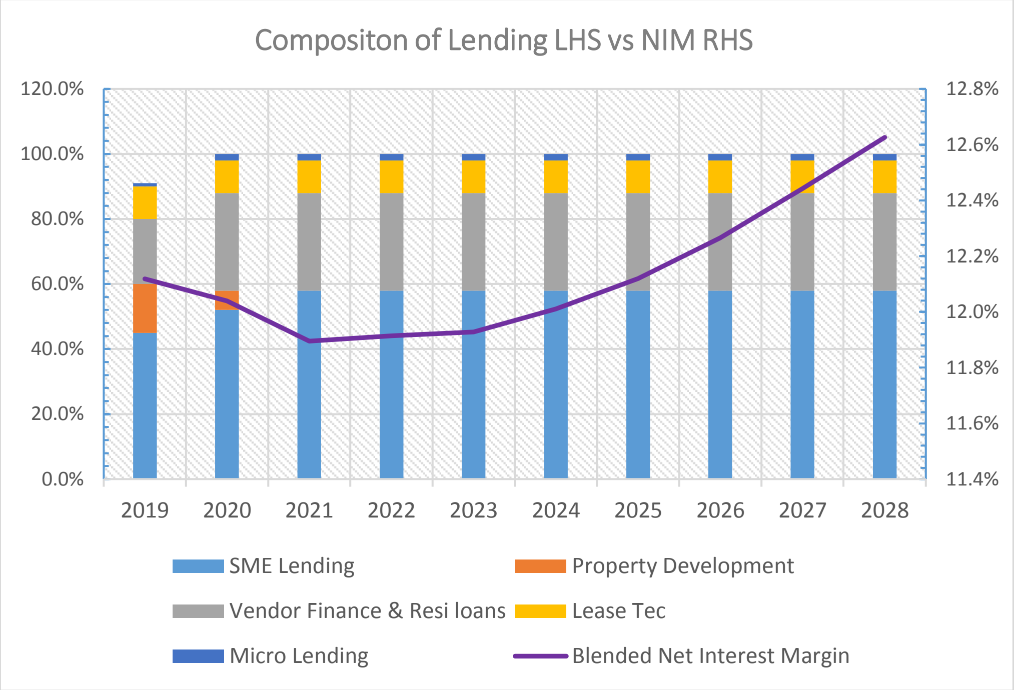
3. Further development and enhancement of the digital loan origination platform for Australia.

Forecasts

Lending profile in FY19 and FY20 show property run-off before growth kicks in from the other asset classes…

Projected asset growth by asset class – source PAC estimates

NIM improves as the book builds, capture a slowly rising interest rate environment, and funding profile starts to match liabilities…



Projected asset class growth vs NIM – source PAC estimates

Valuation

With just over two months left until FEI's end of year we roll forward our valuation to FY20 and discount back using the growth premium model described below.

	FY' 17A	FY' 18A	FY' 19F	FY' 20F	FY' 21F	FY' 22F	FY' 23F	FY' 24F
Revenue	5	13	16	23	28	34	39	44
EBITDA	-2.1	-0.5	-0.1	3.8	5.1	7.1	8.6	10.5
EBIT	-2.2	-0.6	-0.2	3.6	5.0	7.0	8.5	10.3
EBITDA margin	-46.8%	-3.6%	-1.2%	16.1%	18.5%	20.8%	22.3%	23.6%
NPAT	-2.2	-14.6	-0.2	2.5	3.5	4.9	6.0	7.2
EPS (fully diluted)	-0.080	-0.100	-0.002	0.014	0.019	0.027	0.033	0.040

CAGR FY20->FY23F eps growth is 33% versus small industrials ~9% and we discount the valuation back to today at a WACC of 13.6% and convert to AUD; this **derives a valuation of 18.4 cents and 86% upside.**

Table 1 - Growth Premium Inputs	
PE	
- Forecast 3Yr EPS CAGR - Company	33%
- Forecast 3Yr EPS CAGR – Small Industrials	9.0%
- Beta - company	1.6
- Beta - Market	1
- Implied Company PE	24
- Implied Market PE	15.8
- Calculated premium	152%
- Analyst Adjustment	-50%
- Adjusted premium	102%
- Implied fundamental Company PE	**16.1x**
- Valuation – PE ($NZ)	0.23
- Plus: PV of tax credits per share	0.0
- Valuation	0.23
AUD:NZD	1.05
- AUD valuation	0.22

Table 2 - Growth Premium Outputs	
Security Code	FEI-AU
Type	Multiples
EPS	0.014
EPS Fiscal Year	FY20
Market Multiples	Small Industrials
Calculated Premium/Discount	102%
FV	0.2155
PV	**0.184**
Currency	AUD
Today's Date	7/01/2019
Year End	31/03/2019
Discount Factor	0.23
Discount Factor to FY20	1.23

Financial Projections (NZ$)

Profit and Loss	**FY '17 A**	**FY '18A**	**FY '19F**	**FY '20F**	**FY '21F**	**FY '22F**	**FY '23F**	**FY '24F**	**FY '25F**
Portfolio Income	7.48	13.1	16.0	23.4	27.8	34.0	38.8	44.4	49.2
Net Income	5.0	5.6	6.5	8.9	10.5	12.8	14.6	16.7	18.6
Operating Expenses	-3.3	-6.0	-6.6	-5.1	-5.4	-5.7	-6.0	-6.2	-6.5
EBITDA	1.7	-0.5	-0.1	3.8	5.1	7.1	8.6	10.5	12.1
D&A	0.0	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1
EBIT	1.7	-0.6	-0.2	3.6	5.0	7.0	8.5	10.3	12.0
Net Interest	0	0	0	0	0	0	0	0	0
PBT	1.7	-0.6	-0.2	3.6	5.0	7.0	8.5	10.3	12.0
Tax	0.5	-0.2	0.0	1.1	1.5	2.1	2.6	3.1	3.6
NPAT	**1.2**	**-0.4**	**-0.2**	**2.5**	**3.5**	**4.9**	**6.0**	**7.2**	**8.4**
Statutory									
Goodwill Impairment	0	-14.1	0	0	0	0	0	0	0
NPAT Reported	1.7	-14.5	-0.2	2.5	3.5	4.9	6.0	7.2	8.4
NPAT Statutory	**1.7**	**-14.5**	**-0.2**	**2.5**	**3.5**	**4.9**	**6.0**	**7.2**	**8.4**

Balance Sheet	**FY '17 A**	**FY '18A**	**FY '19F**	**FY '20F**	**FY '21F**	**FY '22F**	**FY '23F**	**FY '24F**	**FY '25F**
Assets									
-Cash	12	13	14	18	23	30	37	46	55
-Finance receivable and lease	42	52	67	80	95	115	125	140	150
DTA	1	0	0	0	0	0	0	0	0
PPE	0	0	0	1	1	1	1	1	1
Goodwill	0	1	1	1	1	1	1	1	1
Other Intangible	0	2	2	2	2	2	2	2	2
Other Assets	0	0	0	0	0	1	0	0	0
Total Assets	**55**	**69**	**85**	**102**	**122**	**150**	**166**	**191**	**210**
Liabilities									
First Rank TDs	44	55	67	80	96	115	124	139	149
Payables	0.64	0.8	2.0	2.3	2.0	1.0	1.0	2.0	2.0
Interest Bearing Borrowings	0	0.8	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Provisions	0.011	0.1	0.6	0.7	0.9	1.1	1.2	1.4	1.6
DTL	0	0.6	0.6	1.6	3.0	3.6	4.6	5.6	6.6
Total Liabilities	**44.9**	**57.7**	**70.2**	**84.6**	**101.4**	**120.4**	**130.7**	**147.9**	**159.0**
Net Assets	10.5	11.3	14.6	17.6	20.8	29.6	35.5	42.8	51.2
Equity									
Ordinary Share Capital	11.03	25.8	30.15	30.15	30.15	30.15	30.15	30.15	30.15
Preference Shares	0.5	1.2	0	0	0	0	0	0	0
Reserves	0.00	-0.04	-0.04	-0.04	-0.04	-0.04	-0.04	-0.04	-0.04
Other Reserves	0.00	0.00	0.60	0.00	-1.80	0.00	0.00	0.00	0.00
Accumulated Losses	-1.06	-15.7	-16.1	-12.5	-7.5	-0.5	5.4	12.7	21.0
Total Equity	**10.5**	**11.3**	**14.6**	**17.6**	**20.8**	**29.6**	**35.5**	**42.8**	**51.2**

Cash Flow	**FY '17 A**	**FY '18A**	**FY '19F**	**FY '20F**	**FY '21F**	**FY '22F**	**FY '23F**	**FY '24F**	**FY '25F**
Operating Cash Flow									
EBITDA	1.7	-0.5	-0.1	3.8	5.1	7.1	8.6	10.5	12.1
W/C	1	-1.3	-0.7	-0.4	-0.2	2.0	1.2	2.2	1.2
Interest Expense	0	0	0	0	0	0	0	0	0
Tax	-0.5	0.0	0.0	0.0	0.0	-2.1	-2.6	-3.1	-3.6

Other	0.5	0.0	-0.1	0.0	0.0	0.0	-0.4	-0.2	-0.3
Operating Cash Flow	**2.7**	**-1.8**	**-0.9**	**3.4**	**4.9**	**7.0**	**6.8**	**9.3**	**9.4**
Investing Cash Flow									
PPE	-0.11	-0.10	-0.12	-0.12	-0.12	-0.12	-0.12	-0.12	-0.12
Acquisition of intangibles	0	0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Cash Used in Investing	-0.11	-0.099	-0.12	-0.12	-0.12	-0.12	-0.12	-0.12	-0.12
Financing Cash Flow									
Issue of Shares	2.2	1.8	3.1	0	0	0	0	0	0
Issue of redeemable prefs	0	0.2	-1.1	0	0	0	0	0	0
Other	0	1.1	0	0	0	0	0	0	0
Net cash from financing	**2.2**	**3.1**	**2**	**0**	**0**	**0**	**0**	**0**	**0**
Cash At Beg	7.26	12.1	13.4	14.4	17.7	22.7	29.7	36.5	45.9
Change in cash	4.8	1.2	1.0	3.4	4.9	7.0	6.8	9.3	9.4
Cash At End	12.1	13.4	14.4	17.7	22.7	29.7	36.5	45.9	55.2

Profitability Ratios	**FY' 17A**	**FY' 18A**	**FY' 19F**	**FY' 20F**	**FY' 21F**	**FY' 22F**	**FY' 23F**	**FY' 24F**	**FY' 25F**
Sales Growth	266%	194%	22%	46%	19%	22%	14%	14%	11%
EBITDA Margin	-48.0%	-3.5%	-0.7%	16.1%	18.5%	20.8%	22.3%	23.6%	24.6%
EBIT Margin	-48.7%	-4.6%	-2.1%	15.5%	18.0%	20.4%	21.9%	23.3%	24.3%
Tax Rate	30%	30%	30%	30%	30%	30%	30%	30%	30%
NPAT Margin	-47.5%	-111.6%	-7.8%	15.6%	18.4%	21.5%	22.3%	17.2%	17.7%

Trading Multiples	FY' 17A	FY' 18A	FY' 19F	FY' 20F	FY' 21F	FY' 22F	FY' 23F	FY' 24F	FY' 25F
EV/EBITDA	-6.6	-32.0	-158.3	3.7	2.2	1.2	0.4	0.0	-0.4
EV/EBIT	-6.5	-24.6	-47.3	3.9	2.3	1.3	0.5	0.0	-0.4
EV/FCFF	-5.9	-1.3	-5.3	8.1	4.4	1.9	0.7	0.0	-0.5
P/E	9.9	-1.0	-78.0	7.0	5.1	3.7	3.0	2.5	2.1
P/NTA	1.5	1.4	1.5	1.1	1.1	0.9	0.8	0.5	0.5

Valuation Ratios	FY' 17A	FY' 18A	FY' 19F	FY' 20F	FY' 21F	FY' 22F	FY' 23F	FY' 24F	FY' 25F
ROIC	-13.2%	-1.5%	-0.8%	8.4%	11.6%	16.1%	19.7%	24.0%	27.8%
EPS (cents)	-0.080	-0.100	-0.002	0.014	0.019	0.027	0.033	0.040	0.046
DPS (cents)	-	-	-	-	-	-	-	-	-
NTA	10.5	11.3	11.1	14.1	14.6	17.6	20.8	29.6	35.5

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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%

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