FIIG | Factsheet

# Heritage Bank Limited

21 November 2021

**Sector:** Financials
**Sub-sector:** Banks
**Country:** Australia
**Ownership:** Mutual

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### Issuer Outline

Heritage Bank Limited (HBL) is one of Australia's largest member-owned mutual banks, focusing on the provision of retail lending and deposit-taking services across Australia. It was founded in 1875 and is headquartered in Toowoomba, Australia

HBL is predominately focused on providing retail banking services in the Central and South-East Queensland regions of Australia, with the broader state of Queensland accounting for approximately two-thirds of lending activities. Residential mortgages account for more than 95% of HBL's lending portfolio. HBL is primarily funded by customer deposits (85% of total funding).

### Key Financials (AUDm)

| LTM (30 June) | 2021 |
|---|---|
| Net interest income | 205.0 |
| Non-interest income | 30.5 |
| NI Margin (%) | 1.81 |
| NPAT | 44.8 |
| Gross loans | 8,923 |
| Customer deposits | 9,578 |
| Gross impairments (%) | 0.11 |
| Credit losses (%) | 0.03 |
| CET 1 ratio (% 30June 2021) | 12.79 |

*Source: FIIG Securities, Company Reports*

### Summary Bond Details

| ISIN | Issue Amount | Ranking | Coupon | Coupon Frequency | First Call[1] | Maturity Date |
|---|---|---|---|---|---|---|
| AU3FN0054771 | AUD 50m | Subordinated Unsecured Tier 2 | BBSW +3.50% | Quarterly | 24 Jun 2025 | 24 Jun 2030 |

*[1]Excludes potential terms that would allow the issuer to redeem prior to the maturity date through a make-whole call*
*[2]Resets on 8 March 2027 and every subsequent five years at a rate equal to five-year-swap rate + 3.703%*

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| Tier 2 Structure | |
|---|---|
| Interest Deferral/Cancellation | Interest is deferrable and cumulative if, prior to the payment of interest, the issuer is not solvent or would not be solvent after payment. |
| Non-Viability Trigger | Yes, standard Basel III compliant non-viability trigger. If APRA determines the issuer is at risk of becoming non-viable, the terms of the notes indicate that the primary method of loss absorption will be via write off, in-part or in full. |

### Strengths

- **Focus on lower-risk retail lending underpins strong asset quality**: HBL is primarily focused on residential mortgage lending in Australia, which account for more than 95% of total loans, with consumer and small business lending making up the residual. The underlying quality is also sound, ~85% of loans have a loan –to-value (LVR) of 80% or less. As a result, asset quality metrics are relatively strong, with non-performing loans (90-day past due and impaired loans) at 0.46%, with specific provisions providing cover for approximately 85% of impaired loans.
- **Sound capitalisation, underpinned by good earnings quality:** HBL is well-capitalised, with a regulatory Tier 1 Capital Ratio of 12.79% (Total Capital ratio of 14.28%) at 30 June 2021. This places the bank around the mid-point of peer averages (and at the upper-end of industry averages), offsetting to an extent the limited capital flexibility of HBL owing to its unlisted status (see Figure 1 below). The quality of HBL's capital is strong and largely comprising of common equity (retained earnings), supported by a high proportion of earnings with recurring characteristics (net interest income accounts for over 85% of operating revenues).

  Although HBL's minimum capital ratio is not disclosed (APRA will typically require smaller banks to hold additional capital above prescribed minimums), we estimate HBL has approximately 4.5 times its annual earnings in surplus common equity above minimum requirements.

  Figure 1: Bank Regulatory Tier 1 Capital Ratios (not exhaustive)


- **Solid funding structure:** HBL is primarily funded by customer deposits, which account for around 85% of total funding (inc. equity), up ~10 percentage points over the last five years, with a mix of short-term and long-term wholesale (including securitisation) making up much of the residual. HBL were also able to access the Reserve Bank of Australia (RBA) Term Funding Facility (TTF) to support financial institutions with low cost funding through the COVIC-19 pandemic. HBL's TFF funding represented ~5.8% of funding in FY21, and securitisation ~5%.
- **Sound macro environment and regulatory oversight**: Australian financials, benefit from operating in an economy characterised as having a very high degree of economic resilience with low susceptibility to event risk. The Australian

economy rebounded strongly after the initial wave of COVID-19 related lockdowns in 2020. Although there remains a significant level of uncertainty relating to the COVID-19 pandemic, regarding the duration of lockdowns, and severity of economic impacts institutional and governance frameworks compare well with overseas jurisdictions, providing an additional level of security.

Australian banks including HBL are overseen by a highly regarded prudential regulator, APRA, who oversees banking, insurance and superannuation, with the aim of maintaining the integrity, safety and soundness of financial institutions. In response to the COVID 19 pandemic APRA have provided regulatory relief for loans under deferral and the Reserve Bank of Australia has provided low cost funding through the Term Funding Facility (TFF) to enable Banks to support their customers during the period of economic uncertainty caused by COVID-19 (now closed for new drawdown).

### Risks

- **Small market share:** Although HBL is one of Australia's largest member-owned mutual banks, its market share within the Australian home loan market is insignificant at materially less than 1.0%. As a reflection of its size, the bank also has a relatively high cost base, with its cost to income at ~69.0%. These factors leave the bank and its business volumes susceptible to competitive and margin (profitability) pressures. The bank to-date has managed this reasonably well without a significant shift in its risk profile, highlighting a sound business base (see Figure 3 and 4 below).

Figure 2: Net interest margin

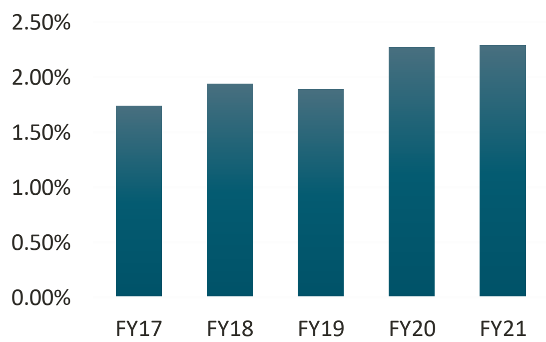
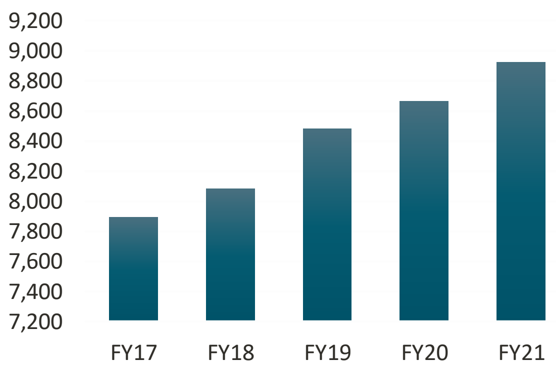



Figure 3: Gross Loan Book (AUDm)




- **Limited business line and geographic diversity:** Although the quality and composition of HBL's earnings are very good, with net interest income accounting for ~85% of operating revenues, HBL's lending portfolio is heavily-weighted toward its home state of Queensland, accounting for approximately two-thirds of its lending activities, with New South Wales and Victoria making up much of the residual. This, combined with a predominant exposure to residential mortgages, leaves the bank reliant on favourable residential property market dynamics (primarily house prices and employment), particularly in Queensland.
- **Liquidity risk within the bond:** A bond's liquidity reflects the ability to sell a bond at a reasonable price (i.e., without causing a significant change in its price) in a reasonable amount of time. Given the size of the issuance (and the issuer), bond liquidity is unlikely to be high within the secondary market.
- **Rating downgrades:** Ratings on both issuers and issues can be influenced by factors that do not necessarily reflect the financial strength or credit quality of a specific issuer. For example, in early-2020 both S&P and Moody's placed the ratings on a number of Australian financial institutions on negative outlook due to concerns about the economic outlook for Australia, which was revised back to stable in June 2021 as a result of the strong economic recovery after the initial contraction caused by the COVID-19 pandemic.

#### Risks relevant to Subordinated Unsecured Tier 2 instrument

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- Deeply subordinated ranking: Tier 2 instruments are unsecured and deeply subordinated instruments, ranking ahead only of ordinary shares and additional Tier 1 hybrids. Tier 2 instruments rank behind senior creditors, which includes depositors, senior unsecured and senior non-preferred creditors (mostly relevant for European banks, only).
- Optional call dependent on regulatory approval: Tier 2 include an early call feature where the face value of the notes may be repaid early in cash from a given date stated in the terms and conditions of the instrument. The optional redemption requires regulatory approval, which may not be provided.

  In general, regulators are unlikely to provide approval for a Tier 2 instrument to be called if it results in a reduction in the issuer's capitalisation; regulators are unlikely to provide approval for a redemption or resale unless the issuer has, or is expected to, issue an instrument of similar size to replace the instrument subject to that call. To the extent the optional call was expected not to be exercised, it is likely that the price of the notes will be negatively affected, with this negative price movement being potentially material.
- Write-down following a Non-Viability Trigger Event: A Non-Viability Trigger Event occurs when APRA determines write-off of some or all of an issuer's contingent capital securities is necessary to prevent that financial institution becoming non-viable. Whether a non-viability trigger event will occur is solely at the discretion of APRA. APRA does not define what constitutes a non-viability event and there are currently no precedents under Basel III to determine non-viability. If such event occurs, the issuer may be required to write-off the value of these notes. We note that it is expected that the write-off would be expected to be applied first to AT1 hybrids (if any) and only then to the Tier 2 if the AT1 write-off was not sufficient to restore the issuer to a viable position.
- No equity conversion: Unlike ASX-listed bank that can potentially offer an equity conversion as part of a Non-Viability Trigger Event (because such shares can be issued and traded, Heritage is unable to provide the same conversion mechanism, meaning that the only recourse for a Non-Viability Trigger Event is a write-off (either partial or total) of the notes.

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## Financials

The financial summary below represents the consolidated operations of HBL

| FYE June 30 (AUDm) | 2017 | 2018 | 2019 | 2020 | 2021 |
|---|---|---|---|---|---|
| Profit and Loss | | | | | |
| Net interest income | 155 | 183 | 185 | 197 | 205 |
| Non-interest income | 41 | 35 | 32 | 31 | 30 |
| **Total revenue** | **196** | **218** | **217** | **227** | **236** |
| Provision for loan losses (credit losses) | (3.4) | (2.8) | (2.2) | (12.3) | 2.0 |
| Non-interest expenses | (137) | (151) | (153) | (163) | (173) |
| **Net profit after tax** | **40** | **45** | **43** | **36** | **45** |
| Balance Sheet | | | | | |
| Cash and investment securities | 1,245 | 1,181 | 1,371 | 1,958 | 2,912 |
| Gross loans | 7,893 | 8,083 | 8,469 | 8,663 | 8,923 |
| Allowance for loan losses | (7.4) | (8.4) | (9.0) | (20.8) | (17.6) |
| Intangibles | 9 | 19 | 20 | 18 | 15 |
| **Total assets** | **9,379** | **9,524** | **10,085** | **10,739** | **11,943** |
| Deposits | 7,155 | 7,180 | 7,776 | 8,442 | 9,578 |
| Term debt (inc. securitisation) | 1,272 | 1,347 | 1,339 | 1,369 | 1,440 |
| **Total liabilities** | **8,891** | **8,991** | **9,509** | **10,128** | **11,286** |
| **Total equity** | **487** | **533** | **576** | **611** | **657** |
| Credit metrics | | | | | |
| Net interest margin | 1.74% | 1.94% | 1.89% | 1.89% | 1.81% |
| Bad debt expense (credit loss provisions) | 0.05% | 0.03% | 0.03% | 0.14% | (0.02)% |
| Non-performing loans^ | 0.53% | 0.62% | 0.61% | 0.60% | 0.45% |
| Impaired assets covered by specific provisions | 28.2% | 33.0% | 42.7% | 80.7% | 51.9% |
| Common Equity Tier 1 ratio | 12.0% | 12.7% | 13.0% | 13.1% | 12.8% |

*Source: Company, S&P Capital IQ, FIIG estimates. ^90-days past due and impaired.*

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