Credit Research
Financials

Liberty Financial Pty Ltd

1 November 2018

Liberty Financial Pty Ltd (Liberty) is one of Australia's largest non-bank finance companies. Liberty provides prime and nonconforming mortgage lending and other personal and commercial lending.

FY18 Results – strong growth; equity issuance to shore up capital levels

We revise our recommendation on the Liberty AUD300m 5.10% Jun 2020 to Market Perform, from Underperform. We initiate our coverage on the Liberty AUD225m 5.10% Apr 2021 with an Underperform recommendation. Our credit outlook is Stable.

Executive summary

- Liberty reported a consolidated statutory net profit after tax (NPAT) of AUD63.1m in FY18, up from AUD59.5m on the prior corresponding period (pcp).
- The increase in NPAT was supported by a significant increase in loans under management, which were up more than 30% in FY18 to around AUD9.3bn. Liberty remains one of the primary beneficiaries of the current restrictions on the value of interest-only loans commercial banks can underwrite, with compound annual growth of more than 30% since 2015.
- Liberty's net interest margins continue to trend lower as the finance company derives significant growth in prime residential mortgages. We estimate Liberty's net interest margin declined by around 30 basis points in FY18. Prime residential mortgages make up an estimated 80% of Liberty's AUD9.3bn in loans under management.
- Growth in prime mortgages should ultimately benefit Liberty's asset quality, although key indicators are likely to show some signs of deterioration (off a low base) when growth slows as mortgages generally season over the medium-term. Liberty's asset quality metrics remain broadly unchanged year-on-year, with credit losses at 0.24% and gross charge-offs at 0.15%.
- Liberty's capitalisation is a relative strength, although it declined on the back of strong lending growth. Liberty issued AUD150m in common equity in August and intends to issue a further amount in early 2019 to support its capitalisation.
- We also note that on October 29 2018, S&P Global Ratings affirmed the issuer ratings on Liberty, with a Stable outlook.
- Of the two, we prefer the Liberty AUD225m 5.10% Jun 2020 notes, as they offer an equivalent yield to worst and lower duration risk as a result of a shorter term to maturity of ten months.

Recommendation

Market Perform
AUD300m 5.10% Jun 2020
Underperform
AUD225m 5.10% Apr 2021

Credit Outlook
Stable

Credit Rating
BBB-/Stable (S&P)

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Key Financials (AUDm)

FYE (30 June)	16	17	18
Net Interest Income	128.5	162.5	195.8
Credit Loss Provisions	(4.1)	(12.6)	(19.2)
NPAT	61.1	59.5	63.1
Gross Loans	4,692	6,992	9,323
NI Margin (%)	N.A.	2.62	2.31
Credit Losses (%)	0.16	0.22	0.24
Gross Charge-Offs (%)	0.19	0.19	0.15

Source: Company Reports. N.A. Not Available.
Note: Financials are for the consolidated operations of Liberty.

Relative Value

Security	Ranking	Coupon Type	Size (AUDm)	Mid-Price	YTW (%)	YTW Date	Next Call Price	Next Call Date	Recommendations
Liberty 5.10% Jun 2020	Snr Unsec	Fixed 5.10%	300	100.68	4.65	1 June 2020	n/a	n/a	Market Perform
Liberty 5.10% Apr 2021	Snr Unsec	Fixed 5.10%	225	101.00	4.66	9 April 2021	n/a	n/a	Underperform

Note: Prices accurate as of 25 October 2018 but subject to change. Indicative only.
Source: FIIG Securities, Bloomberg

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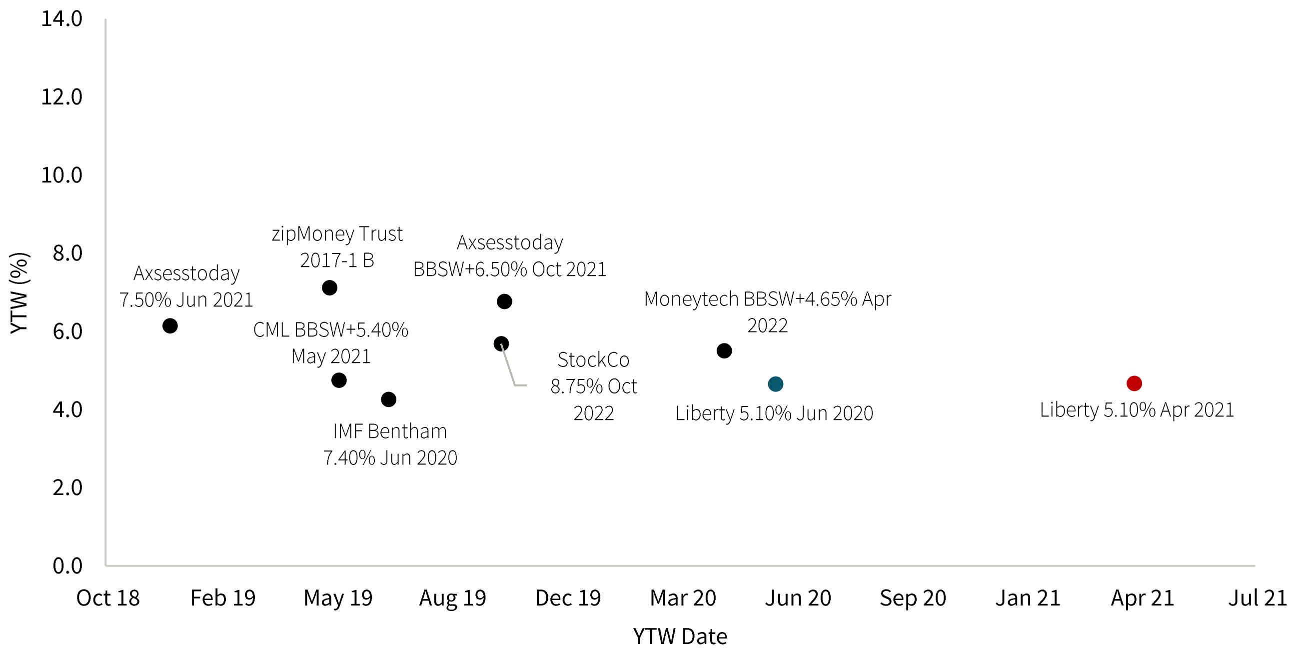
Relative Value

We have a Market Perform recommendation on the Liberty Financial Pty Ltd. (Liberty) 5.10% Jun 2020 notes (2020 Notes) at the current indicative mid-price of 100.68 and yield to worst of 4.65%, and an Underperform recommendation on the Liberty 5.10% Apr 2021 notes (2021 Notes) with an indicative mid-price of 101.00 and yield to worst of 4.66%. Of the two, we prefer the 2020 Notes, as they offer an equivalent yield to worst and lower duration risk (sensitivity to movements in interest rates) as a result of a shorter term to maturity of ten months. This is the primary rationale behind the Underperform recommendation for the 2021 Notes.

Both notes offer a relatively high yield to worst in a senior unsecured investment issued by an investment-grade finance company. Liberty is the only rated issuer amongst its finance company peers. Both notes also include a step-up provision that increases the margin by 100bps for a one-notch downgrade in the issuer rating on Liberty (and 50bps thereafter if downgraded by a further notch, limited to 100bps [two or more notches or if the rating is withdrawn]).

Figure 1: Relative Value



Source: FIIG Securities, Bloomberg

Note: Indicative prices as of 25 October 2018

Financial Analysis for the year ended 30 June 2018 (FY18)

Liberty reported a consolidated statutory net profit after tax (NPAT) of AUD63.1m in FY18, up from AUD59.5m on the prior corresponding period (pcp). The increase in NPAT was supported by a significant increase in loans under management, which were up more than 30% in FY18 to around AUD9.3bn.

Liberty remains one of the primary beneficiaries of the current restrictions on the value of interest-only loans commercial banks can underwrite, with compound annual growth of more than 30% since 2015. Liberty's lending mix and customer profile has shifted markedly in recent years following the introduction of certain lending restrictions placed on commercial banks in 2014, with a decline in the proportion of nonconforming loans offset by a significant increase in prime mortgages--particularly investor lending.

Liberty's net interest margins (net interest income to average earning assets) continue to trend lower as the finance company derives significant growth in lower-risk (but lower-yielding) prime residential mortgages. We estimate Liberty's net interest margin declined by

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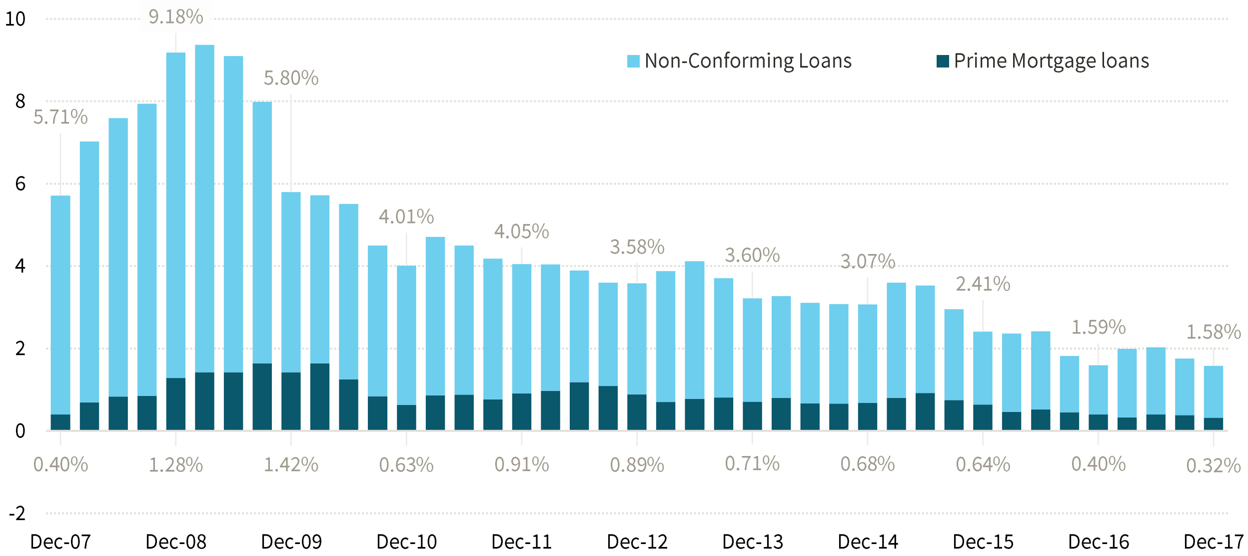
around 30 basis points in FY18. Prime residential mortgages make up an estimated 80% of Liberty's AUD9.3bn in loans under management, according to S&P Global Ratings (S&P), with the remainder comprising nonconforming mortgages, auto loans, and commercial loans.

Growth in prime mortgages should ultimately benefit Liberty's asset quality "through the cycle", although key indicators are likely to deteriorate somewhat when growth slows as mortgages generally season over the medium-term. Liberty's asset quality metrics remain broadly unchanged year-on-year and at a low level, with credit losses at 0.24% and gross charge-offs at 0.15%.

The level of loans in arrears continues to trend south, although this is more likely a function of the significant growth in loans in recent years, rather than a step change improvement in the underlying performance. Nevertheless, given a backdrop of benign economic conditions and accommodative interest rates, we believe arrears for Liberty are likely to remain relatively low in the near term.

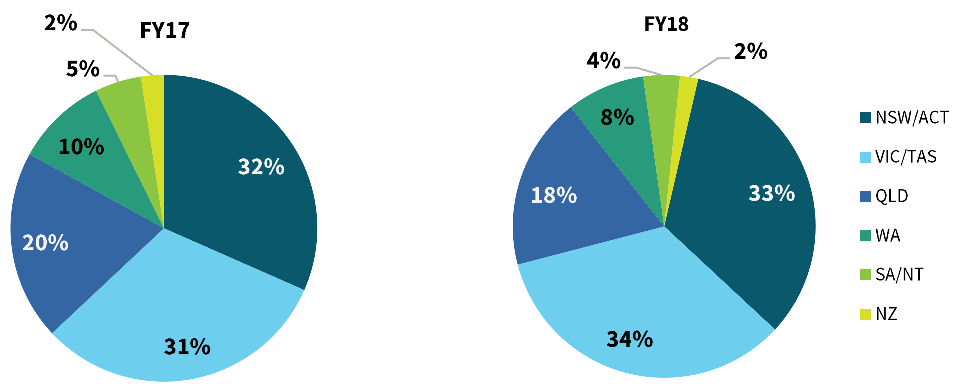
Figure 2: Liberty Consolidated 30+ Days in Arrears (%)



Source: Company, S&P Capital IQ

The geographic dispersion of Liberty's loan portfolio remains largely unchanged, year on year (see Figure 3):

Figure 3: Geographic Distribution of Loans



Source: Company

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Liberty is not prudentially regulated, and as such, is not obligated to maintain a prescribed level of risk-adjusted capitalisation as is the case for regulated financial institutions. Nevertheless, capitalisation for Liberty is a relative and absolute strength, as measured by the level of capital held by the finance company according to S&P's credit rating methodology.

On the back of significant lending growth in FY18, we estimate Liberty's capitalisation declined by between three-four percentage points during the year. Subsequent to this, Liberty issued AUD150m in common equity in August and according to S&P, the finance company intends to issue a further amount in early 2019 to support its capitalisation as the growth outlook remains very favourable.

Liberty's issuer credit rating remains susceptible to a weakening in capital. Accordingly, and given the step-up margin payable on both notes if the rating on Liberty is downgraded, we expect growth to be matched by a commensurate increase in capital in the foreseeable future. Privately-owned, Liberty has never paid its small ownership contingent a dividend.

Funding for Liberty is primarily through warehouse and securitisation. Reliance on unsecured term debt--short and long-term--remains limited, and as such, so does the refinance (liquidity) risk. Unutilised warehouse funding stands at around 50%, up from 33%, with the finance company benefiting from favourable funding conditions in FY18 that saw debt issuance increase by around AUD3bn. According to S&P, Liberty's warehouse funding is provided by five, highly rated bank counterparties with well-spaced maturities (largely unchanged in recent years). As such, we believe the finance company remains well-positioned to report strong growth in FY19.

Figure 4: Liberty Consolidated Financial Summary (FYE 30 June)

Profit & Loss (AUDm)	FY16	FY17	FY18
Net Interest Income	**128.5**	**162.5**	**195.8**
Interest Income	263.7	362.3	495.2
Interest Expense	(135.3)	(199.8)	(299.4)
Other Finance Income	53.1	61.7	115.7
Other Finance Expense	(46.2)	(66.5)	(131.3)
Other Income	2.9	2.5	11.1
Operating Revenues	**138.3**	**160.2**	**191.3**
Operating Expenses	(60.5)	(71.3)	(88.2)
Credit Loss Provisions	(4.1)	(12.6)	(19.2)
Profit Before Tax	**73.8**	**76.3**	**83.9**
Income Tax Expense	(12.6)	(16.8)	(20.8)
Profit After Tax	**61.1**	**59.5**	**63.1**

Asset Quality	FY16	FY17	FY18
Loan Loss Reserves/Loans	0.57%	0.44%	0.44%
Charge-Offs/Avg. Loans	0.19%	0.19%	0.15%
New Provisions/Avg. Loans	0.16%	0.22%	0.24%

Balance Sheet (AUDm)	FY16	FY17	FY18
Cash and Cash Equivalents	483.6	255.7	351.3
Trade Receivables	192.6	269.0	438.8
Gross Loans	4,691.6	6,992.4	9,322.6
Specific Provisions	(18.2)	(21.5)	(27.5)
Collective provision	(8.7)	(9.5)	(13.1)
Net Loans	**4,664.6**	**6,961.4**	**9,282.0**
Other Assets	61.4	60.8	122.8
Total Assets	5,402.3	7,546.9	10,194.8
Unsecured Term Debt	100.0	300.0	425.0
Securitised Term Debt	2,214.1	3,780.9	6,709.5
Warehouse Facilities	2,518.5	2,826.7	2,124.7
Other Liabilities	156.1	159.1	313.3
Total Liabilities	**4,988.7**	**7,066.8**	**9,572.5**
Contributed Equity	45.2	70.2	170.2
Reserves	(7.4)	(3.4)	(4.8)
Retained Profits	356.0	394.4	440.1
Non-Controlling Interests	19.7	18.9	16.7
Total Equity	**413.6**	**480.1**	**622.3**

Source: Company, S&P Capital IQ

Outlook

Our Stable credit outlook reflects our expectation that key asset quality metrics will remain broadly unchanged while the finance company continues to originate strong lending volumes in FY19. The broader economic backdrop remains largely favourable, despite recent declines in property prices across Australia. Economic conditions are otherwise benign, while interest rates appear set to remain unchanged throughout FY19, which should be supportive to loan serviceability.

As noted earlier, we believe the finance company has considerable incentives to maintain capital levels commensurate with its lending growth trajectory.

According to S&P, Liberty's long-term goal remains to further diversify its business, reducing its dependence on residential mortgages and increasing its exposure to commercial and auto loans. We believe this shift makes sense given the recent strong growth in mortgages in recent years. With system growth slowing and commercial banks well-below prudential restrictions on interest-only

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lending, competition is likely to remain intensive in the foreseeable future, with further margin pressure on front book (new) lending highly probable. Although commercial and auto segments may be the first to show signs of deterioration if the credit cycle turns sharply in the near term, the higher yield on offer should compensate for the heightened risk. We also note the finance company has a long-standing presence in commercial and auto segments.

Background

Operating since 1997, Liberty is a diversified finance company with operations across Australia and, in more recent years, New Zealand. Its products and services include specialty lending, finance and insurance brokering, receivables servicing, consumer insurance underwriting, and funds management. The company offers home, car, personal, and business loans. The company was one of the first in Australia to design and offer loans to the underserviced non-prime mortgage market, where borrowers do not have established credit history (so-called nonconforming loans).

Liberty is one of Australia's largest non-bank finance companies, with total loans under management of more than AUD10.0bn. Although privately owned, the three founding shareholders have retained their shareholding since 1997 providing stability to the company. Despite being a privately owned company Liberty has strong governance practices and has an independent board.

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