Pepper Money Limited

1H 2023 Results Presentation

Script

Wednesday 23 August 2023

**slide number 2**

Good morning, everyone and welcome to Pepper Money Limited’s first half 2023 results presentation. My name is Gordon Livingstone - Investor Relations at Pepper Money.

I would like to begin by acknowledging the traditional custodians of the land on which we meet today, the Gadigal people of the Eora Nation. We pay our respects to each of their Elders, past, present, and emerging.

Following a business update from Pepper Money's CEO - Mario Rehayem – Pepper Money’s CFO - Therese McGrath - will walk us through the financials. After some closing remarks by Mario - there will be an opportunity to ask questions, which can be either via phone, or submitted via the portal.

I will now pass over to Pepper Money’s CEO – Mario Rehayem.

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Thanks Gordon.

On behalf of my team at Pepper Money, I would like to thank everyone who has joined us today.

Before stepping through the operational, business and financial performance for the first half of 2023, I think it is worthwhile just taking stock of Pepper Money’s journey.

Pepper Money’s mission has always been the same…. to “help people succeed”.

We have developed deep understanding of customer niches - typically underserved by banks. Our ability to act nimbly, to innovate, and to leverage our core competencies of - credit, funding, distribution, and technology – has seen the business grow from a specialist lender in 2000 to a leading non-bank lender in Mortgages and Asset Finance.

We have successfully managed through all cycles over the last 23 years. We know when to drive volume, when to flex to the margin, how to manage and allocate capital and how to price for risk.

Since our foundation in 2000, Pepper Money has grown to become one of the largest non-bank lenders in Mortgages and Asset Finance:

* We have an exemplary long track record in debt capital markets. We have a broad and deep investor base of both domestic and global debt investors that have, and continue to, support us over the past two decades. Since 2003 to June 2023, we have raised in excess of $36 billion across 58 transactions via our RMBS and ABS programs.
* We have helped nearly 410 thousand customers - into homes, cars, boats and caravans – many of these typically are not served by the major banks.
* Our pursuit of innovation to support underserved customer niches has seen Pepper Money expand from being a specialist lender in Australia in 2000 to now offering:
  + Prime, Near Prime and Specialist mortgages in Australia and New Zealand.
  + Self-Managed Super Fund mortgages and Small balance Commercial Real estate loans in Australia.
  + A complete suite of Asset Finance solutions – from Consumer to Commercial to Used Cars to Marine to Novated Leasing.
  + We were at the forefront of EV lending. In the first half of 2023 alone our EV lending was $184 million – up 272% on prior comparable period.
  + And all the above was built organically …. which has seen the business underwrite $54 billion in loans since 2000.

Pepper Money has $19 billion in Assets under Management.

As a business we have seen through all the cycles – from the GFC to the Greek crisis. We responded to COVID in a way that - helped not just our customers and employees through the uncertainty - but saw us accelerate our technology platform and business growth.

We have successfully managed through all the peaks and troughs of the property market over the last 20 years.

And during this time, we have remained focused, disciplined and nimble … we have leveraged what we are great at – data and customer insights, technology, funding, distribution, credit and underwriting … and how to balance risk and rewards.

This is why, since we started the business 23 years ago, we have – cumulatively - only written off 0.4% of total loans originated.

As you can see, at all points of every cycle Pepper has put in the groundwork to ensure we remain strong and have the ability to capitalise on opportunities as they emerge.

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The changing conditions seen over the second half of 2022 accelerated over the first six months of 2023 given further increases to interest rates, high inflation and volatile capital markets.

The performance of our Mortgage business was also impacted by the intense competitive environment – as banks fought to gain market share through price and cash back offers.

As I spoke about in February - when presenting our full year results – we were expecting the softening in Mortgage originations seen in the second half of 2022 to continue into 2023. And this has happened.

But we were prepared and responded - by accelerating the growth in Asset Finance, which has achieved – again – record results in the first half of 2023. This has helped counteract the current cyclical trend experienced in Mortgages.

So while Originations of $3.5 billion were (38)% lower than prior comparable period, Asset Finance Originations of $1.8 billion were the highest we have ever achieved in a half, and were up 19% on PCP.

Flexing to drive Asset Finance has ensured we have tightly managed AUM – which is a key driver of future profitability – and at $18.9 billion Total AUM is in line with 2022 close.

NIM compression over the last 18 months is starting to ease… and while NIM at 2.06% was down (23)bps on PCP …. it reduced only (5)bps on the second half of 2022. We have continued to implement back and front book price increases as the RBA raised official cash rates. This has helped to partially offset increased cost of funds. Likewise growing our Asset Finance business has helped maintain Total NIM given the positive mix impact.

We continue to be disciplined in credit risk management. Our 23 years of experience through multiple economic cycles, and the use of our proprietary data and analytics, sees 90+ arrears continue to trend below long-term averages. Loan Losses, as a percent of AUM, at 0.28% increased only (2) basis points on December 2022 – this was driven by the AUM growth in Asset Finance.

There is some noise in the cost base – given that the prior comparable period did not include the Stratton acquisition in the run rate.

Normalising for Stratton our core FTE costs are only up 3% on PCP, and all other expense lines, other thanCorporate Interest, have increased below inflation given our scaled processes and technology. Therese will run through expenses in more detail in the financials.

Pro-forma NPAT at $52 million is down (29)% on PCP… with the flow through of adverse market conditions in Mortgages, higher funding costs and increased provisioning for loan losses as Asset Finance AUM grows, all impacting profit flow through. On top of this – expenses have increased on PCP given we acquired Stratton 1 July 2022 - so have a full six months of costs now reflected over and above PCP.

But as we enter the second half I am encouraged by several trends – from easing inflation to stability returning to funding spreads. Likewise, we are starting to see demand in Mortgages pick up.

The Board has declared a fully franked interim dividend of 3 and a half cents per share, representing a 30% payout ratio and an annualised yield of 5.1%.

Pepper Money remains, as always, disciplined in respect to capital. We have been able to grow our Asset Finance business over 2023 as we have had the capacity to deploy capital to fund the growth opportunities.

Now to business performance.

**slide number 5**

Total Originations were $3.5 billion in the first half of 2023 – with Asset Finance exceeding Mortgages for the first time, delivering $1.8 billion, up 19% on PCP and 37% on the second half of 2022.

Given the breadth of our Mortgage product suite, as the RBA increased interest rates we were able to enhance our focus on the Non-Conforming Mortgage segment. Of the total $1.7 billion in Mortgages originated in the first half of the year, 65% were Non-Conforming

Lending AUM of $18.0 billion was (1)% lower than PCP … but with a clear mix shift:

* + While Mortgages AUM dropped by (12)% on PCP to $12.4 billion,
  + Asset Finance has now reached AUM of $5.6 billion – up 32% on PCP. This growth equates to 3 times system over the prior comparable period. We do believe we are now the largest non-bank asset financer in Australia.

Turning now to each of the business areas.

slide number 6

No doubt, the market has been tough for Mortgages. Equifax reported that total mortgage enquiry volumes were down over (10)% in the 12 months to June 2023. At the same time as demand was down, banks were competing to gain market share – and were offering very compelling rates as well as high levels of cash backs.

In balancing capital allocation, we decided to accelerate our growth in Asset Finance, while focusing on margin in Mortgages - given our strength in the Non Conforming segment.

This was a slow down in mortgage originations and mix skewed to Near Prime and Specialist.

Mortgage AUM dropped by (12)% on PCP to $12.4 billion. Other than the lower origination rate over the last 12 months, we have also seen heightened customer attrition across our Mortgage portfolio, as customers sought lower rates and capitalised on cash backs offered by the banks. 97% of customers who refinanced away from Pepper Money moved to a major bank.

We continue to maintain our strong track record of disciplined credit risk management – this has seen indexed LVRs protected, with 66% of loans sitting in LVR bands below 70%.

We moved our customer rates within two weeks of when the RBA announced an increased to the OCR. However given regualtory requirements to provide customers 20 days notice before their repayment amount can increase, this time lag has caused a NIM drag of about (1) basis point.

A detailed NIM walk will be covered in the Financial section, and likewise Therese will ta;k you through our Credit performance in detail. But before turning to the Asset Finance businsess I will call out that the credit performance of our Mortgage portfolio continues to track well.

* + Our customers are managing the 12 increases in interest rates experienced since May last year.
  + If we do believe a borrowers maybe facing financial stress we will actively engage with them and provide options – from lower repayments for a period - to loan restructuring.
  + We continue to manage Credit Risk tightly – as I have said in the past we will take risk on the customer but not on collateral.
  + Our 90+ days arrears – which is the best indicator of future hardships - for Mortgages are tracking well inside the long term average, and as at 30 June 2023 we only had 361 loans in 90+ arrears.

Now to Asset Finance:

slide number 7

Our Asset Finance business continues to outperform the market – growing 3 times system half one 2023 over half one 2022.

As we moved into 2023, we saw a clear opportunity to accelerate growth in Asset Finance – as the COVID generated supply issues which had been impacting car deliveries were starting to ease, and tax incentives presenting growth opportunities for us in Novated Leasing and electric vehicles.

We knew we could capitalise on the opportunity to fast-track volume growth as we had the capital needed to fund the credit enhancement – which is higher for Asset Finance vs Mortgages. This allowed us to bring forward planned ABS securitisations to support growth.

Our investment in systems and processes meant we could continue to drive scale and productivity.

And accelerating in Asset Finance would allow us to balance out for the lower run rate in our Mortgage business.

In the first half of 2023 we have grown Asset Finance Originations by 19% on PCP – with Novated Leasing being the fastest growing segment, all be it, from a low base.

Of the $400 million originated through Novated Leasing 81% was electric vehicles.

As always, we were disciplined with the type of risk we took on – 63% of originations in the first half of 2023 were Tier A – clean credit customers, and originations were up 24% versus PCP.

AUM for Asset Finance now stands at $5.6 billion – growing 32% on PCP and 19% on where we closed 2022. This growth is all organic, and I will cover off in the next slide how we have used processes and technology to deliver growth on reducing cost to serve.

Asset Finance Net Interest Income increased by 12% on PCP to $66.2 million, as record volume growth offset the adverse impact of rising swap rates and funding margins. We also partially protected income by price increases.

From a Net Interest Margin perspective - the combination of swap rate volatility and the strong growth in our Novated Leasing segment – which has lower rates but virtually no loan losses – drove some compression in NIMfor Asset Finance – with half one 2023 NIM of 2.62% (12) basis points below the second half of 2022 and (45) basis points below PCP.

The strong mix of our business – Tier A and Novated Leasing – coupled with our credit and underwriting know how – has seen us manage the credit quality of the portfolio:

* + Loan loss provision increased in line with AUM growth; and
  + 90+ day arrears for Asset Finance closed June at 0.19% - well inside the long-term average of around circa 0.24%.

Turning now to how we have been able to deliver scaled growth in Asset Finance.

slide number 8

I have spoken in the past about how our tech stack has been supporting both scale and productivity.

We have always made constant investment in our technology platform. Our approach is to ensure that the full potential is reached.

Using Asset Finance as an example: we have invested in our Solana platform at a run rate of $3 million per annum under the build phase to just shy of $2 million under the leverage phase. Leverage is important as it allows us to continually improve. It also has allowed us to support ever increasing loan application volumes.

And as application volumes have grown we have extended our API suite into more introducers driving double digit improvement in productivity per FTE.

We are now at a stage where 81% of Novated Leasing loans and 40% of Commercial are auto approved. As we continue to learn and invest, these auto approval rates will continue to grow. However, we will always make sure – for higher risk tier loans – that a human oversees final approval.

Our Solana platform has significantly improved the partner and customer experience. Simply put, it is about making it “easy to do business” with Pepper Money.

We conduct regular partner surveys – and quoting a particular partner directly from our most recent survey I think says it all:

* + *“…..Improvements to systems and tech have turned Pepper into an industry leader in technology, with a collaborative, relationship based approach, and introducers want Pepper to succeed.*
  + *In a rate-sensitive environment, Pepper can push forward in pricing or increasing consistency, speed, flexibility and growing appetite particularly in commercial deals where there is greatest strength*…”

To help our partners deliver the best experience to their customers – we launched Real Time Payments – at the end of 2022…. This now means that from the time a customer’s loan is approved to the time it settles, is between 2 and 4 hours. Our partners can deliver the best experience – from time to yes to time to cash, which improves their customer NPS.

And all this is driving real returns. Our average cost per application has reduced by a compound average of 22%. Cost to serve will continue to improve as we continue to scale.

And as Mortgages is designed in the same way, we will continue to reduce our cost to serve for our Mortgage portfolio as volume returns.

Now to funding.

slide number 9

Funding is at the core of our growth.

Over the first six months of 2023 we have raised, from the public markets, in excess of $3.1 billion – an incredible growth of 22% on PCP. To June, we completed four public securitisations and a further $734 millionwas added in Private term securitisation over the six months.

As I have said in the past, we have always taken the prudent approach to funding and maintained a minimum of 6 months of headroom. This is a part of our ongoing strategy that allows us to be prepared to manage any cycle whether it’s up or down.

Given our Mortgage volumes - we reduced Warehouse capacity limits by $600 million, bringing total Warehouse capacity at 30 June 2023 to $10.3 billion, down (6)% from 31 December 2022.

We have started strong as we entered the second half – and our second ABS for the year, SPARKZ 7 for $725 million – settles today.

I will now pass to Therese on the financials before coming back to talk about the outlook.

slide number 10

Thank you, Mario, and good morning, everyone.

Mario has covered off the volume trends experienced by the business over the last 6 months so I will now concentrate on NIM, credit quality and expense movements.

If we turn first to Net Interest Margin, on page 11

slide number 11

Mario noted earlier that NIM compression is starting to stabilise.

Total NIM for the first half of 2023 at 2.06% was only (5) basis points below second half 2022.

* as the RBA increased interest rates, we implemented both back and front book price increases across Mortgages;
* and when swap rate volatility was impacting Asset Finance we also repriced this portfolio.

However, there is always a delay between the date of notification of increase - and when it takes effect.

This lag, coupled with widening funding margins, saw NIM compression continue into 2023.

But clearly the downward pressure on NIM is starting to ease.

Looking at our Mortgage portfolio, which is the waterfall on the bottom left-hand side of the chart:

* as the RBA increased the Official Cash Rate, we increased prices on both our back and front books, which saw customer rates increase by 139 basis points half one 2023 when compared to second half of 2022; however
* continued volatility in BBSW, and further deterioration in external margins, were not fully covered by customer rate increases and product mix, and as such Mortgage NIM decreased (7) basis points half on half.

These conditions were the same in Asset Finance – which is the graph on the lower right-hand side:

* + the volatility in swap rates is clearly seen in our Asset Finance NIM. Over the first half of 2023 NIM contracted (61) basis points from rising swap rates.
  + As our Asset Finance products are fixed rate – we hedge the book almost every 2 days - which does allow for some protection. What we continue to experience was swap rates moving faster than even our hedging program.
  + And while we moved customer rates up, this was eroded by adverse cost of funds as well as business mix.
  + The Novated Leasing segment grew substantially over first half, making up 24% of Originations and now represents 12% of Asset Finance AUM. While Novated Leasing has a low NIM, as it is salary sacrificed, it has virtually no credit losses, so margin after losses is maintained.

These factors contributed to Asset Finance NIM reducing from 2.75% second half 2022 to 2.62% in the first half of 2023.

Now to credit

slide number 12

The credit performance of our portfolio continues to be strong.

Our customers are managing the 12 rates rises experienced since May last year.

Total Credit expense increased by $(5) million on second half 2022 and $(11) million on PCP.

Mortgage loss expense remains flat on the second half of 2022, in line with AUM.

Asset Finance loss expense increased on the second half given AUM growth.

* Specific losses for Asset Finance increased in the half to June as we saw a short-term uplift in insolvencies - as Government protections implemented under COVID-19 were removed at the start of the year. Insolvency trends have now reverted to pre-COVID averages.
* Versus PCP the increase in Asset Finance loan loss expense was further driven by the release in first half 2022 of COVID and other post model overlays.

At June close, we hold total provisions of $130.4 million - a coverage ratio of 0.72% of Assets under Management, up from 0.67% as at December 2022. This increase is due to strong growth in Asset Finance.

As the impact of macro-economic conditions, including high interest rates and ongoing inflationary pressures, are yet to be fully reflected in consumers disposable income, a total post model overlay of $15.8 million - $13.0 million of which relates to the Mortgage business - is being held in case of increased customer hardships.

At 30 June 2023, Loan Losses as a percent of AUM, excluding post model overlay, of 0.28% continued to be well inside the long term average. The marginal increase of (2) basis points on the second half of 2022 was due to the growth of Asset Finance as an overall percent of business mix.

We continue to monitor early indicators of potential future loss through the 90 plus days arrears – as per the chart on the bottom right-hand side. Please note that, as per industry standard, COVID hardships have been removed.

90 plus days arrears, for both our Mortgage and Asset Finance portfolios, are well inside the long-term average of about 1.45% for Mortgages and 0.24% for Asset Finance.

Again to note – we continue to be conservative and are holding $15.8 million in Post Model Overlays.

slide number 13

Turning to expense management.

The underlying picture is slightly muddied, when trying to compare to PCP, due to the consolidation of Stratton in the second half of 2022.

So to try and cut out the noise it is best to look at key ratios when comparing first half 2023 with first half 2022:

Underlying FTE – which is our lending FTE – declined 7% on PCP

Core FTE Salary and Wages only increased 3% on PCP. The increase of 9% in Manila reflects the substantially higher inflationary environment that the Philippines has been experiencing.

If we compare the expense run rate to the second half of 2022 – given Stratton was fully incorporated for those 6 months - controllable expenses continue to be tightly managed:

* + marketing and technology costs have decreased by 3% and 1% respectively on the second half – as synergies and efficiency gains are captured;
  + depreciation and amortisation increased (14)% due to “Right of Use” as we entered into a new leases for both our Head Office and Paramatta Service Centre;
  + underlying depreciation relating to the investment in our platforms is flat period on period given our consistent reinvestment rate.

And due to the movement in BBSY - Corporate Interest expense increased (36)% over the 2nd half of 2022 to $11.7 million.

slide number 14

For completeness I have provided our core metrics on page 14 which we have largely covered off already.

So turning to our Pro-forma Income Statement on page 15 of our Investor Presentation.

slide number 15

While the adverse market conditions in Mortgages were partially offset by record growth in Asset Finance:

* + ongoing NIM compression,
  + coupled with increased Loan Loss expense given Asset Finance AUM growth,
  + and the annualisation of Stratton operating expenses

All contributed to EBITDA at $94.7 million, contracting (21)% on PCP and (19)% on the second half of 2022.

When we add to EBITDA:

* + the increase in depreciation and amortisation which I have just covered;
  + and the adverse impact of movements in BBSY on Corporate Interest expense.

Our Pro forma NPAT of $52.0 million, contracted (29)% on PCP and (25)% on the second half of last year.

slide number 16

If we now turn to our balance sheet - the main movement, as you would expect, has been in Loans and Advances which, at $18.1 billion for 30 June 2023, have followed the movement in AUM net of loan loss provisions.

We originated $3.5 billion in new financial assets over the period. Asset growth was financed by the issuance of four Public Term securitisations of just over $3 billion, and a further $734 million in Private Term securitisation.

Given the soft Mortgage market we reduced warehouse capacity by (6)% from 31 December 2022 to $10.3 billion.

Net Assets at 30 June grew 4% on December 2022, with Cash and cash equivalents at the end of the first half of $1.1 billion.

And Retained earnings reflect the profit delivered by the business over the first half, net of dividend paid.

And as usual we continue to manage capital - balancing between holding sufficient levels to manage in uncertain markets and knowing when and where to invest.

Thank you and I will now hand back to Mario to close.

slide number 17

Thanks Therese

So yes – while it has been challenging for our Mortgage segment, our diversified business model, our ability to manage capital, plus our ongoing investment in our market leading technology - has allowed us to flex and focus on driving significant growth in Asset Finance.

As we start to move into the back half of the year, I am encouraged by some of the external trends we are seeing – most notably as reported by Equifax – mortgage enquires are again starting to trend upwards

Likewise, Asset Finance enquires remain steady.

slide number 18

So looking ahead … there are more encouraging signs:

* + inflation, at least on the demand side, is moderating;
  + the rate of interest rate rises has slowed, and while I am not confident to bet they have stopped, I believe we are getting closer to the terminal rate;
  + unemployment remains very low;
  + and immigration is returning – a great stimulus to housing demand.

And Pepper is prepared.

Over the 23 years we have been in business we have successfully managed through all cycles.

Our credit performance remains strong: we have managed our customers through 12 rates rises and we have maintained the quality of our portfolios. We are well provisioned.

As I detailed – our technology and processes are scaled: what we have achieved in Asset Finance will be replicated in Mortgages as volumes return.

We have not sat still in Mortgages, even when demand has been suppressed. We continue to launch new products – such as Self-Managed Super Fund mortgages - so that when market confidence returns and interest rates trend back to historical averages – we are best positioned to capitalise on the growth.

And we have the funding headroom to support the growth when it returns.

slide number 19

I started today by taking stock of the Pepper Money journey. We started over 23 years ago as a specialist mortgage non-bank lender in Australia.

Since then we have successful navigated the business through multiple economic cycles.

We have built a business with strong core competencies in credit and underwriting, distribution, funding, data and technology.

We are diversified, both in terms of the scale of our two-core lending businesses of Mortgages and Asset Finance, as well as the ever-expanding range of products we offer.

We have one of the strongest distribution footprints in the market.

We know how to innovate, we are nimble.

But we also disciplined: whether it be how we manage credit, expenses or capital. With $19 billion in Assets under Management today we remain strong and have the ability to capitalise on opportunities as they emerge.

Thank you and I will now hand back to the operator for questions

slide number 20

