HEARTLAND GROUP

NZX/ASX Release

Heartland announces half year profit of $39.9 million

18 February 2020

Heartland Group Holdings Limited (**Heartland**) (NZX/ASX: **HGH**) achieved a net profit after tax (**NPAT**) of $39.9 million for the six months to 31 December 2019 (**1H2020**), an increase of 20.4% from the six months to 31 December 2018 (**1H2019**)[1].

Highlights for 1H2020[2]

- NPAT of $39.9 million, up 20.4% ($6.7 million).
- Gross finance receivables[3] (**Receivables**) of $4.6 billion, up $177 million (8% annualised growth)[4] since June 2019.
- Return on equity (**ROE**) of 11.7%, up 165 basis points (**bps**).
- Net interest margin (**NIM**)[5] of 4.72%, flat on the six months to 30 June 2019 (**2H2019**) and 5 bps down compared to 1H2019.
- Cost to income ratio (**CTI**) of 46.0%, up 3.5%. After allowing for changes in the accounting treatment and one-off impacts, the underlying CTI is 43.3%, up 4.3% as a result of significant investments.
- 32% ($4.3 million) lower impairment expense reflecting significant efforts to enhance collections processes and discipline.
- 2020 Interim Dividend of 4.5 cents per share (**cps**), an increase of 1.0 cps from 1H2019.
- Significant progress made on implementing Heartland's workplan to address improvements across conduct and culture.
- 47% of employees were aged 35 years and under.
- 35 interns joined Heartland Bank's Manawa Ako internship programme – 10 more interns than last year's intake.
- Heartland Bank awarded Canstar's 2019 Bank of the Year – Savings and Canstar's 5-Star Rating for Outstanding Value Savings Account for its Direct Call Account.
- Australian Reverse Mortgages awarded Money Magazine's Best Reverse Mortgage 2019.

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[1] This announcement is based on the 31 December 2019 unaudited interim consolidated financial statements of Heartland Group Holdings Limited (**Heartland**). Following a corporate restructure on 31 October 2018, Heartland Bank Limited (**Heartland Bank**) became a 100% controlled subsidiary of Heartland, and ownership of the Australian group of companies (comprising Heartland Australia Holdings Pty Limited and its subsidiaries) transferred from Heartland Bank to Heartland. As common control has remained the same both before and after the corporate restructure, management believes that the operations of Heartland from 1 November 2018 are directly comparable to those of Heartland Bank prior to 1 November 2018.

[2] All comparative results are based on 31 December 2018 unaudited interim consolidated financial statements of Heartland Bank and its subsidiaries up to 31 October 2018, and Heartland and its subsidiaries from 1 November 2018 to 31 December 2018 (financial performance), or 30 June 2019 audited full year consolidated financial statements of Heartland (financial position), unless otherwise noted.

[3] Gross finance receivables also includes Reverse Mortgages.

[4] Excluding the impact of changes in foreign currency exchange (**FX**) rates.

[5] NIM calculated based on average interest earning assets excluding liquid assets.

FINANCIAL POSITION

Receivables increased by $177 million (8% annualised growth)[6] mainly due to growth in Reverse Mortgages, Business Intermediated, Motor, Harmoney and Open for Business (**O4B**), offset by decreases in non-core lending, specifically Business and Rural Relationship.

Total assets increased by $263 million (11% annualised growth), primarily driven by the increase in net finance receivables. Liquid assets, comprising cash, cash equivalents and investments, increased $75 million (36% annualised growth) in line with business growth.

Total borrowings[7] increased by $235 million (11% annualised growth).

During the reporting period, net assets increased by $12 million to $687 million. Net tangible assets (**NTA**) increased by $12 million to $605 million, resulting in an NTA per share of $1.05 (30 June 2019: $1.04; 31 December 2018: $1.01).

FINANCIAL PERFORMANCE

Profitability

NPAT was $39.9 million for 1H2020, a $6.7 million (20.4%) increase on 1H2019.

ROE was 11.7%, up 165 bps from 1H2019.

Earnings per share (**EPS**) was 6.9 cps, up 1.0 cps from 1H2019 as a result of an increase in NPAT.

	1H2020	2H2019	1H2019
NOI[8]	118.6	103.7	102.1
NPAT	39.9	40.5	33.1
NIM	4.27%	4.29%	4.34%
NIM excl. liquid assets[9]	4.72%	4.72%	4.77%
ROE	11.7%	11.0%	10.0%

Income

Total net operating income (**NOI**) was $118.6 million, an increase of $16.5 million (16%) on 1H2019.

Fair value gains on equity investments and recent accounting standard change in respect of upfront reverse mortgage fees contributed $2.1 million and $4.4 million respectively to 1H2020 NOI (correspondingly, mentioned accounting standard change contributed $5.1 million to operating expenses in 1H2020). Adjusted for this, NOI increased by $10.3 million (10%) compared to 1H2019, largely due to a $7.2 million (7%) increase in underlying net interest income. Underlying other

[6] Excluding the impact of changes in FX rates.
[7] Total borrowings includes retail deposits and other borrowings.
[8] NOI includes fair value gains/losses on investments.
[9] NIM calculated based on average interest earning assets excluding liquid assets.

income increased by $3.1 million (83%) compared to 1H2019, primarily due to a stronger Treasury result.

Heartland’s NIM for 1H2020 was 4.27%, 7 bps down on 1H2019 and 2 bps down on 2H2019.

NIM was primarily impacted by the reduction in interest rates, lending and deposit portfolio mix changes, and the increased holding of lower yielding cash and investment assets necessary to support the business activity through the Christmas/New Year period – a period of traditionally lower deposit flows and volumes. Excluding liquid assets, NIM was 4.72%, 5 bps down on 1H2019 however unchanged from 2H2019.

Expenses

Operating expenses were $54.6 million, an increase of $11.2 million (26%) on 1H2019. The required accounting standard change in respect of upfront reverse mortgage costs contributed $5.1 million to 1H2020 operating expenses. Adjusted for this, the underlying operating expenses were $6.7 million (16%) higher compared to 1H2019.

Higher underlying operating expenses were primarily due to a $1.8 million increase in marketing investment. The marketing spend was driven by the additional activity across both markets to drive product and brand awareness. Higher underlying operating expenses were also due to a $4.3 million (19%) increase in staff expenses.

The latter they reflect Heartland’s significant investment in responding to regulatory and compliance commitments, including increasing the number of full-time equivalent (**FTE**) employees in relevant areas. Heartland has also invested in technical expertise in key areas (for example, in its digital and finance teams) to reduce the reliance on external service providers and enable Heartland to adopt a more agile delivery model, reflecting the growing maturity of the business and the need to respond to an increasingly complex operating environment.

As a result, the cost to income ratio increased to 46.0%, compared to 42.5% in 1H2019, while on an underlying basis this was 43.3% in the current period, compared to 39.0% in 1H2019.

Impairments

Impairment expense decreased by $4.3 million (32%) to $9 million. This reflects continued focus on improving the collections processes. Furthermore, the new provisioning methodology in accordance with IFRS9 was further refined following its initial adoption in 1H2019 thus benefiting impairment expense in the subsequent periods.

Impairment expense as a percentage of average receivables decreased from 0.64% in 1H2019 to 0.40% in 1H2020.

BUSINESS PERFORMANCE

New Zealand Reverse Mortgages

New Zealand Reverse Mortgages NOI was $13.0 million, an increase of $2.7 million (26%) compared to 1H2019.

New Zealand Reverse Mortgage Receivables increased $26 million (10% annualised growth) to $536 million, driven by an investment in marketing to increase brand awareness and digital channel enhancements.

Motor

Motor NOI was $30.1 million, an increase of $1.9 million (7%) compared to 1H2019.

Motor Receivables increased $35 million (6% annualised growth) to $1,124 million mainly due to an increase in the Motor dealer book (car dealerships, brokers and partnerships such as Holden, Kia and Jaguar/Land Rover).

Harmoney and other personal lending

Harmoney NOI was $8.4 million, an increase of $2.2 million (36%) compared to 1H2019.

Harmoney Receivables increased $30 million (31% annualised growth), with the New Zealand Harmoney portfolio increasing $7 million (10% annualised growth) to $159 million, while the Australia Harmoney portfolio increased $22 million (116% annualised growth) to $61 million.

Business

Business lending NOI was $21.9 million, a decrease of $1.4 million (6%) compared to 1H2019.

Business Receivables increased by $24 million (5% annualised growth) to $1,009 million. Heartland Bank's growth focus continues to be on Business Intermediated, with Receivables in this portfolio up $69 million (32% annualised growth) to $494 million. The Business Relationship portfolio, on the other hand, decreased by $44 million (16% annualised decrease) as a result of the strategic focus on reducing concentration risk in low margin exposures.

O4B

O4B NOI was $6.6 million, an increase of $2.3 million (54%) compared to 1H2019.

O4B Receivables increased $25 million (37% annualised growth) to $158 million. Ongoing investment in operational capacity, automation and marketing to increase product awareness are expected to fuel growth in future periods.

Rural

Rural lending NOI was $15.5 million, a decrease of $0.3 million (2%) compared to 1H2019.

Rural Receivables decreased by $36 million (11% annualised decrease) to $621 million. Rural Relationship Receivables reduced by $22 million (8% annualised decrease) as optimisation of non-core Rural Relationship lending to reduce low margin concentration continues. At the same time, Livestock Receivables decreased by $13 million (22% annualised decrease) to $108 million.

Australia

Australian operations NOI was $16.6 million, an increase of $4.9 million (42%) compared to 1H2019.

Australian Reverse Mortgage Receivables increased $79 million (20% annualised growth)[10] to $887 million. Strong growth in the portfolio, driven by investment in marketing, resulted in market share increasing to 26%[11], with a similar trend expected to continue in the future.

FUNDING AND LIQUIDITY

Heartland operates a diversified funding base that continues to grow with the business. The corporate restructure continues to enable new opportunities to expand and diversify funding across Heartland.

Heartland Bank increased borrowings by $125 million, primarily through deposits which increased by $80 million (3% growth) to $3.2 billion. Term deposits increased by $101 million (4%) reflecting Heartland Bank's competitive interest rates. A specific focus has been on extending the duration of the term deposits to support effective liquidity management for Heartland Bank. On average, Heartland Bank retains 88% of all maturing term deposits.

Heartland Bank utilises other funding sources in addition to deposits, including:

- 90-day registered certificate of deposits
- externally rated auto loan warehouse
- money market lines.

Heartland Bank held $429 million of liquid assets, up $47 million (12%) on 30 June 2019. This has positioned Heartland Bank well in excess of all liquidity ratio requirements imposed by the Reserve Bank of New Zealand (**RBNZ**). Liquidity was increased through the end of the December period to ensure sufficient liquidity over the Christmas/New Year period.

Heartland Australia increased borrowings by $235 million to support business growth. $145 million of new securitised borrowings, $100 million of which was from a new major bank provider, were drawn, together with a A$100 million medium-term (2.5-year) note issued in November 2019. This additional MTN issuance provides funding for growth in the Reverse Mortgage business and for O4B that was recently launched in Australia, and allowed for the repayment of intercompany funding. The extension of the duration of funding together with further diversification of funding programmes remains a strategic focus.

Heartland Group extended its corporate debt facility by 6 months, and reduced its limit from $50 million to $25 million. It remained undrawn at 31 December 2019.

REGULATORY UPDATE

The financial services sector has continued to see considerable regulatory activity and review, including the Financial Markets Authority (**FMA**) and RBNZ review of conduct and culture in New Zealand retail banks (**Culture and Conduct Review**), the Treasury's review of the Reserve Bank of New Zealand Act 1989 and the RBNZ's review of the capital adequacy framework for registered banks.

[10] Excluding the impact of changes in FX rates.
[11] Based on APRA ADI Property Exposure and Heartland Seniors Finance data as at 30 September 2019.

Heartland is committed to continuous improvement in all areas identified by the FMA and RBNZ in their Culture and Conduct Review, and has been working through the implementation of its workplan to address improvements across the organisation. This has contributed to the increase in operating expenses as Heartland invests in resources to deliver on regulatory and customer expectations.

Specifically, this has included the establishment of a Customer Care team focused on obtaining customer feedback and ensuring a good customer experience is delivered across Heartland's products and services.

Following a period of consultation, in December the RBNZ announced its final decision on the revised Capital Framework for Registered Banks in New Zealand (the **Framework**). The revised Framework requires Heartland Bank, as a standardised registered bank, to increase its Total Capital ratio to 16% over a seven-year transitional period commencing July 2020. The revised Framework is not expected to impact Heartland Bank's capital ratio requirements until 2022 when minimum regulatory capital requirements increase from 8% to 9%, therefore not having a material impact on Heartland Bank. Heartland Bank's Total Capital ratio was 12.9% as at 31 December 2019.

STRATEGIC PRIORITIES

Heartland's activity comprises three areas of strategic focus: New Zealand, Australia and Digital.

New Zealand

<u>Product optimisation and distribution</u>

Heartland Bank's focus remains on delivering best or only products to depositors and borrowers through continued growth in niche markets.

Heartland Group's corporate restructure, its investment in digital distribution capability and its increased emphasis on customer experience, also provide Heartland Bank with an opportunity to broaden its focus beyond providing 'best or only' products, and to challenge and disrupt banks and financial technology companies by finding ways to deliver banking products more cost effectively and with less friction for customers. For example:

- Heartland Bank differentiates its small business lending offering from others in the market by providing a fast and simple digital application process with decisioning
- development of Open for Commercial, Heartland Bank's online portal for Business Intermediated customers, enables intermediaries to complete plant and equipment loan applications online on behalf of their clients – this has since been launched
- the Heartland Mobile App allows Deposits customers greater self-service access to Heartland Bank's products and to managing their accounts
- the online calculator and application form for Heartland Bank's reverse mortgage product allows customers to determine how much they might be able to drawdown, before completing an application in their own time online.

Investment in marketing activity for New Zealand Reverse Mortgages took place in 1H2020 in order to raise product and brand awareness. There has been an increase in lead volumes during this time.

Results of the marketing activity, through a combination of digital and offline channels, will continue to be monitored and optimised. Investment in TV and radio marketing activity to promote this product and its benefits will continue in the second half of FY2020.

In July 2019, a new television campaign for O4B was launched to help achieve increased reach and awareness of the small business lending platform. Together with the increased marketing activity through other channels, this has resulted in a significant uplift in visits to the O4B website. There has been an uplift in application and drawdown volumes in 1H2020 (compared to 1H2019). Heartland will continue to monitor activity and refine its advertising placements, creatives and media to raise brand awareness, reach its targeted audience and appeal to that audience.

In FY2019, Heartland Bank recognised an opportunity in the millennial market to deliver a savings product with features that appeal to that particular generation. The YouChoose savings account (with an optional overdraft) was subsequently launched, and Heartland Bank has since been using digital channels to reach the millennial market and seek their feedback on the product to enable continued product optimisation and enhancements.

Partnerships

Heartland Bank successfully entered into a partnership with Kia Motors to provide motor vehicle finance. Kia customers now have access to vehicle finance under Heartland Bank's Kia Finance label.

Heartland Bank and Turners Automotive Group entered into a distribution agreement to provide insurance products under Turners Automotive Group's DPL Insurance 'Autosure' brand. Heartland Bank's insurance products were previously provided by MARAC Insurance Limited, a subsidiary of Heartland Bank. By partnering with Autosure, a specialist, market-leading insurance provider in New Zealand, Heartland Bank can maintain its focus on customer outcomes and be confident that customers have access to a broader range of consumer insurance policies to meet their needs. The agreement came into effect in January 2020 – existing MARAC Insurance customer policies are unaffected.

Customer outcomes

A dedicated Customer Care team was formed in Ashburton to support customers in both New Zealand and Australia, and a Customer Experience and Insights team created to support Heartland's products and services across the Group. Both teams have been established to ensure good customer experiences and outcomes are delivered across Heartland.

Australia

Reverse Mortgages

Heartland remains the primary originator of reverse mortgages in Australia. In addition, Heartland's market share continued to grow to 26%[12] in September 2019, up from 24%[13] in March 2019.

[12] Based on APRA ADI Property Exposure and Heartland Seniors Finance data as at 30 September 2019.
[13] Based on APRA ADI Property Exposure and Heartland Seniors Finance data as at 31 March 2019.

With a focus on product simplicity and increased importance placed on customer experience and continued improvement and ease of use for the website and application, Heartland expects to see continued growth in its Australian Reverse Mortgage business.

Heartland has seen Australian Reverse Mortgage leads increase in the past six months due to increased marketing activity, and expects to continue to see results from this activity through the remainder of FY2020.

O4B

The Heartland Group corporate restructure undertaken in 2018 has provided Heartland with the opportunity to launch existing products in other markets. Heartland's small business lending platform O4B is an example of this, which was launched in Australia in November. The launch was accompanied by light digital marketing activity while the platform is piloted to ensure the product was set up and operating well. Increased marketing activity will begin in the second half of FY2020 to raise awareness of the product and drive leads.

Funding

Heartland's Australian funding strategy is to source funding that provides:

- capacity – enabling continued growth in line with the business
- diversity – avoiding concentration risk from a range of sources and type
- longevity – is reliable, sustainable and matches duration of the assets being funded
- efficiency – minimises the use of, and enhances the return on capital deployed in the business.

Heartland continues to execute that strategy, having completed the following during the six months to 31 December 2019:

- a new A$250 million committed reverse mortgage funding facility with a major Australian financial institution, with A$100 million drawn to date
- a second issuance from its A$ medium-term note programme, A$100 million of 2.5-year notes to a key Australian institutional fixed income investor.

Work on diversification and new funding opportunities continues.

Digital

Digital services, platforms and processes remains a core focus of Heartland's overall strategy – particularly to achieve Heartland's key digital strategy objectives:

- to make products available to customers online or via an app, providing simple, frictionless and fast on-boarding and processing
- to achieve low cost reach to the broadest target market, through online and mobile access and highly automated processes
- to broaden the reach of products across other markets by using existing platforms and capabilities, a benefit that arises from the corporate restructure

- to enable customer self-service and flexibility to apply for and manage their Heartland products when they want
- to respond to and adapt Heartland's customer experience to meet the expectation of customers to be able to use any device
- to provide opportunities to challenge other banks and financial technology companies by identifying alternative ways to deliver banking products more cost effectively and with less friction for customers.

In 1H2020, digital achievements have been centred around customer facing developments, back office automation and efficiency features, improved staff engagement tools to contribute to culture and better customer outcomes, together with extending Heartland's best or only products to alternate markets.

Customer facing highlights

- Heartland Bank's O4B product was launched in Australia with a website and online application now available for Australians to access small business finance.
- Improvements to the Heartland Mobile App continue, including from customer feedback.
- Australian Reverse Mortgage customers can now apply for their reverse mortgage online and receive an indication of approval.
- New Zealand Reverse Mortgage customers can now calculate online how much they may be able to borrow, before they begin their reverse mortgage application.

Automation and efficiency highlights

- Robotics process automation has been rolled out across multiple processes, reducing manual interventions.
- The integration of DocuSign has automated the signing process for loan documents.
- Through the use of APIs, the time required to complete the fulfilment process of Australian Reverse Mortgage applications has reduced, improving customer experience.
- YouChoose customers can now make purchases online with the integration of Online EFTPOS.
- Development of an online platform to allow Business Intermediated customers to receive automated decisions for their online loan applications – this has since been launched.
- Document management tool rolled out internally to reduce paper usage.

INTERIM DIVIDEND

Heartland is pleased to declare a fully imputed 2020 interim dividend of 4.5 cps, an increase of 1.0 cps from 1H2019. The resulting gross dividend yield was 8.3%[14]. The dividend reflects the continued consistent performance of Heartland Bank and Heartland's Australian business.

[14] Total fully imputed dividends for 2H19 (**final**) and 1H20 (**interim**) divided by the closing share price as at 14 February 2020 of $1.84.

Heartland has a Dividend Reinvestment Plan (**DRP**), giving eligible shareholders the opportunity to reinvest some or all of their dividend payments into new ordinary shares. The DRP will apply to the interim dividend with a 2.0% discount[15].

The DRP offer document and participation form is available on our shareholder website at: https://shareholders.heartland.co.nz/shareholder-resources/dividends.

LOOKING FORWARD

Asset growth from Heartland's core lending activities is expected to continue in the second half of FY2020, particularly in Australia and New Zealand reverse mortgages and small business lending.

Investment will continue, specifically in marketing, to continue building awareness of reverse mortgages (in Australia and New Zealand) and O4B, as well as in new areas of opportunity. Some of these costs are anticipated to be one-off and will contribute to growth beyond FY2020.

Further diversification of funding is expected, particularly in Australia to support growth.

Looking ahead to the rest of FY2020, Heartland will continue its focus on evaluating its overall Environment, Social and Governance (**ESG**) strategy and the ways in which it can continue to reduce its environmental impact.

The underlying balance sheet growth supports a result in line with the original NPAT forecast in the range of $77 million to $80 million.

– Ends –

For further information, please contact:

Jeff Greenslade
Chief Executive Officer
M 021 563 593

Cherise Barrie
Chief Financial Officer
M 027 503 6119

For investor enquiries, please contact:
Andrew Dixson
Head of Corporate Finance
M 021 263 2666

For media enquiries, please contact:
Nicola Foley
Senior Communications Manager
M 027 345 6809

[15] That is, the strike price under the DRP will be 98.0% of the volume weighted average sale price of Heartland shares over the five trading days following the Record Date. For the full details of the DRP and the Strike Price calculation, refer to Heartland Group Holdings Limited DRP offer document dated 10 December 2018.