Quarterly Investment Insight – July 2022

Judo Capital – ready to put the majors on the mat

Small and medium-sized enterprises (SMEs) are an integral part of the Australian economy, responsible for 40% of private sector employment, and 35% of sales and service income. They are also a crucial source of innovation by virtue of them having to compete against large and multinational corporations, with access to significantly more resources. As such, it is important that these businesses have access to efficient and effective finance, whether it be for working capital or for funding capital expansion. Despite their size and relevance to the economy, SMEs have become increasingly underserviced by the Australian banking sector, with market research by East & Partners in 2020 finding that the gap between SME (turnover between $1m and $50m) funding needs and funding provision was a deficit of some $119b.

Over the last few decades, Australian banks have shifted their focus away from business lending towards household mortgage lending. Housing loans now make up the majority of the Big 4 Banks' total assets. This has been partly driven by capital adequacy regulations requiring banks to hold more capital against unsecured loans than home loans. As SME owners and entrepreneurs are less inclined to risk their family home on a business venture, the regulatory classification of these loans makes them less attractive than a mortgage.

Share of bank lending issued to each sector (excluding government), 1990 to 2020[a]

a. Shares do not add to 100 per cent as other personal lending and commercial lending to financial intermediaries are not depicted.

Figure 1, Source: Australian Government Productivity Commission

In a market where each SME is unique, a strong understanding of their industry, business proposition, cash flow characteristics and overall financial situation is critical in being able to appropriately evaluate the credit risk and price a loan. Due to the rise of automated credit decisioning models, the major banks lack the flexibility to assess business loans that do not fit their strict lending criteria, leaving many SMEs unable to obtain loan approval. Judo Capital ('Judo') has a high SME banker interaction to enhance knowledge and responsiveness. There is also something to be said for long-term, personal relationships with actual human business bankers. Be it lockdown-induced business shutdown or navigating an inflationary and rising rate environment, immediate and face-to-face assistance can provide invaluable peace of mind for small business owners.

Recognising this market shortcoming, Judo was launched in 2018 as a purpose-built, SME challenger bank, with the goal of becoming the most trusted SME business bank in Australia. Judo's value proposition resides in their relationship-centric lending model which focuses on increasing the time their customer-facing relationship bankers spend with SMEs to offer them a tailored lending solution.

Although Judo has a short history, it is led by a highly experienced Board and management team, with CEO Joseph Healy (former CEO of NAB's Business Banking division) and Deputy CEO & CFO Chris Bayliss (former General Manager of NAB Retail Banking) also being co-founders of the business. The Board is Chaired by Peter Hodgson, an experienced global banker who has held senior roles at Bank of America, Barclays and ANZ Bank.

Judo's investment case relies on its ability to achieve scale in total assets that allow key operational performance metrics to be achieved. Management expect that with a lending portfolio of some $20b, they will achieve the following targets:

- a net interest margin (NIM) above 3%;
- a cost-to-income ratio approaching 30%;
- a cost of risk of approximately 0.5% pa; and
- a return on equity in the low to mid-teens (implying >$200m in annual profit).

DBM Consultants estimate the total addressable SME lending market to be over $600b, inferring Judo's at-scale lending portfolio assumption of $20b implies a modest market share of only 3%. Currently at $6.1b, Judo's loan book is in line with the FY22 prospectus forecast with further near-term growth underpinned by a pipeline of approved and accepted loans of over $1.1b.

Building the business from scratch has allowed management to be unconstrained by outdated technology and banking architecture. This has created an agile and streamlined business lending operation built atop a scalable, cost-effective, cloud-native platform. Judo's relationship bankers can therefore spend more time with customers; an appealing prospect for career bankers who are tired of wrestling with legacy systems and bureaucracy. As such, Judo's network of relationship bankers has grown to 110, while average loans per banker has grown from $19m in 2019 to $53m in 2021, a testament to the high-quality talent Judo has attracted. Given the estimated total industry pool of bankers with more than 5 years of experience is over 2,600, there is plenty of scope for Judo to continue growing their banker network. A big focus of recruitment relates to cultural alignment and an ability to assess credit risk, with Judo bankers having on average 15 years of experience.

Management of credit and liquidity risk is of paramount importance to any financial institution. As an Authorised Deposit-taking Institution (ADI), Judo is regulated by the same prudential framework as all banks including the majors. APRA enforces adherence to well-defined capital governance and risk management requirements. Judo is currently well-capitalised with a CET1 ratio of 23% (compared to the majors' 11-12%), much higher than the other listed Australian ADIs and the 4.5% internationally agreed minimum under the international Basel III framework. This deep prudential capital base is vital for Judo as it allows significant capacity for the loan book to continue to grow. Some challenger peers have not been as well capitalised, and this has impacted their ability to reach scale without further equity raises. Management have forecast Judo will continue to remain self funding and therefore will require no external capital to support its loan growth.

One of the attractive characteristics of the Australian business lending market has been the historically low loss profile, as shown in the below graph. Judo's IPO prospectus at 30 June 2021, indicates that only 0.08% of Judo's loan book were at 90+ days impairment, although we need to be mindful that this has been supported by strong fiscal and monetary stimulus in response to the Covid-19 pandemic. Management remain confident that Judo's superior customer knowledge and customer experience will allow for better credit risk management, although it will be difficult to have evidence of this until we have seen a full credit cycle.

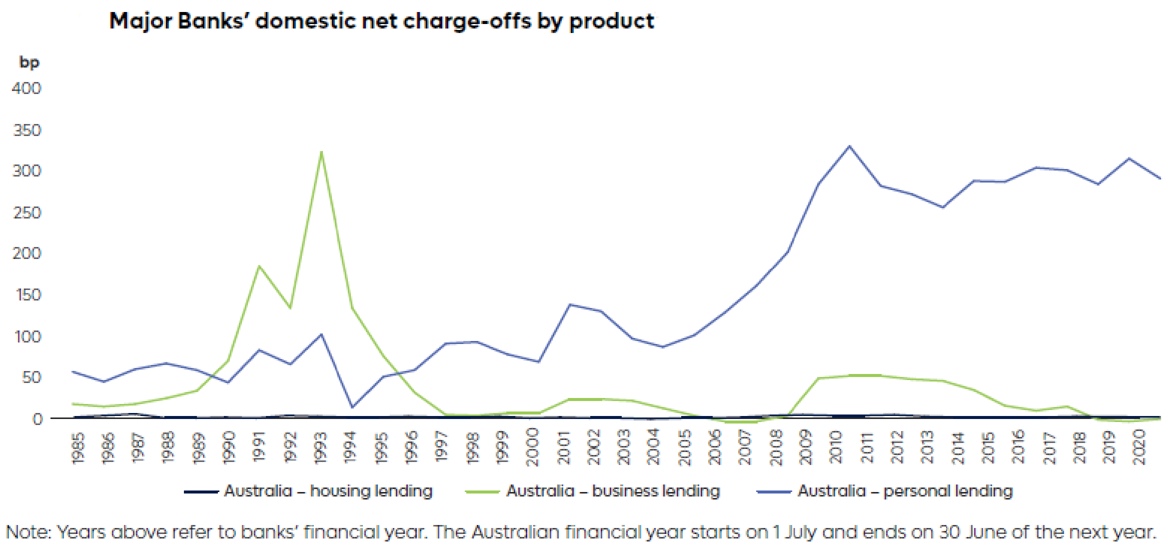

Figure 2, Source: Judo Bank 2021 Prospectus

Within their addressable market, Judo targets loans of up to $25m to high-quality SMEs with annual turnover up to $100m, located less than 200km from Australian capital cities and regional centres. Judo is well-diversified across most industries as seen in the chart below. Originations are also diversified across the direct channel and accredited third-party broker channels, however, regardless of how the loan is originated, Judo relationship bankers maintain a direct relationship with the SME customer.

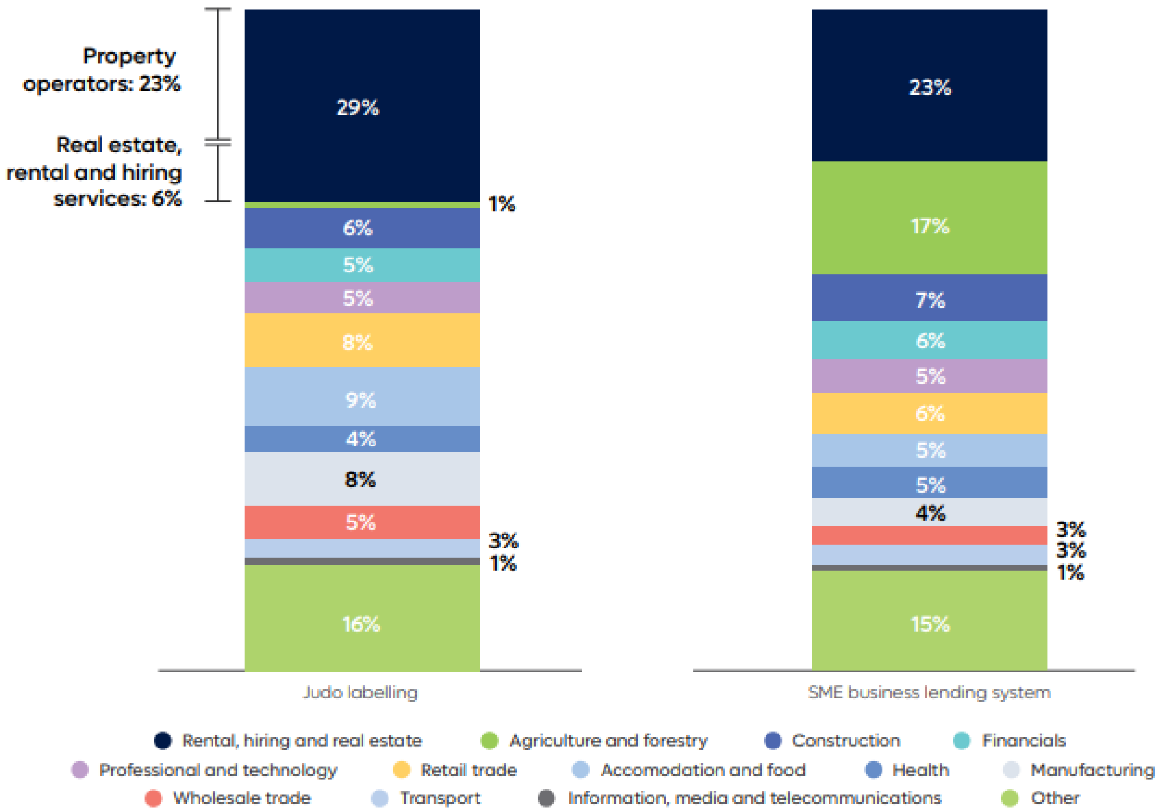

Figure 3, Source: Judo Bank 2021 Prospectus

On top of regulatory capital, Judo's funding stack comprises customer term deposits, warehouse facilities and the RBA's Term Funding Facility (TFF). As a response to the Covid-19 pandemic, the RBA introduced the TFF which provided ADIs with access to low-cost, three-year funding. Judo's exposure to SME lending entitled them to draw down $2.9b worth of funding under the program at a fixed rate of 0.10%. The TFF provides a significant medium-term funding and margin tailwind that will, however, need to be refinanced at market rates at maturation in 2024. Upon repayment of the TFF, Judo aims to be 70-75% funded via customer deposits. With a predominately fixed funding base matched to a predominately floating asset base, Judo is positively leveraged to rising interest rates, with NIM seeing an immediate 25bps uplift for every 50bps rate rise.

We at Celeste believe the shortcomings of the current SME lending market create a considerable opportunity for a well-funded, purpose-built challenger bank to penetrate what is a sizeable addressable market. We are equally attracted to Judo's experienced and founder-led management team and believe they will continue to execute on their business proposition and growth path. Having only recently achieved their FY22 prospectus guidance, Judo appears on track to reach their scale targets at which point it should be generating significant profitability and consistent, long-term durable cash flows.

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