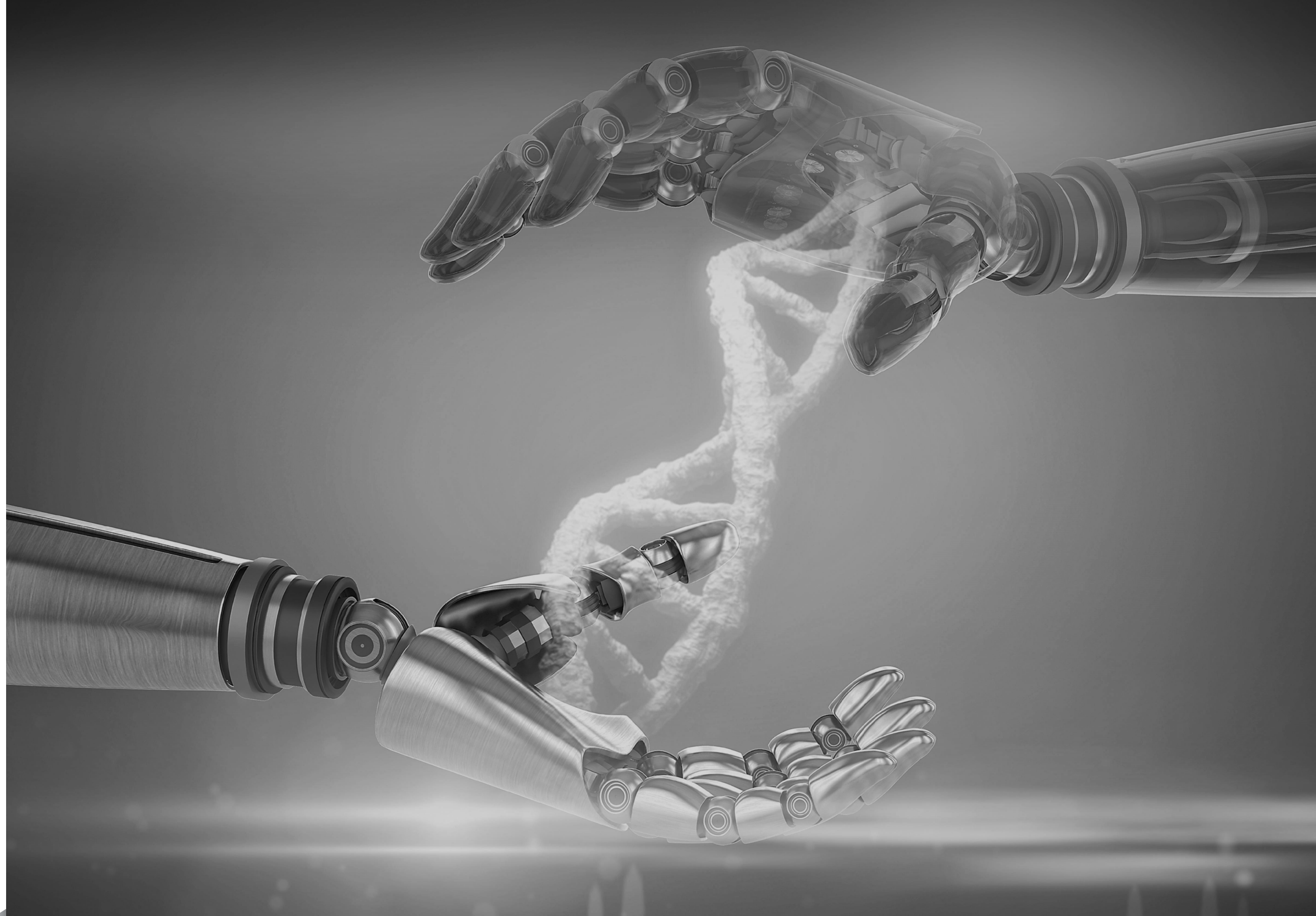
13 SEP 2022

Emerging Stocks Down Under

"Good banking is produced not by good laws, but by good bankers."

- Hartley Withers (1867-1950), The Economist editor (1916-1921)



JUDO CAPITAL

Serving a neglected market

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Stocks Down Under rating: ★★★★

ASX: JDO
Market cap: A$1.3BN

52-week range: A$1.09 / A$2.55
Share price: A$1.16

The aftermath of the events leading to the Banking & Financial Services Royal Commission, as well as the Commission itself, led to a number of so-called 'neobanks' rising out of nowhere and gaining the attention of the media and private equity investors. While many, such as Xinja, failed, Judo survived and last year became the first IPO of a licensed bank in over two decades since Macquarie debuted in 1996. Unlike Macquarie, though, Judo's share price has disappointed as investors fear higher inflation and interest rates will cripple Judo's customers and, therefore, Judo itself. Are these fears legitimate?

Share price chart

Source: Tradingview

Building its book

Judo began in 2016 and has been led by David Horney and Joseph Healy – two former NAB bankers – ever since. Over the course of several private funding rounds, it has attracted several high-profile investors and advisors. Notable investors include Bain Capital Credit, Abu Dhabi Capital Group, Ironbridge and Canadian pension fund manager OPTrust. Former Treasury Secretary John Fraser was the most notable advisor (and board member). The bank has some products for retail consumers, but its main focus has been on small to medium enterprises. It wants 3% of the SME banking market over the next 5-10 years.

At the IPO last year, Judo raised $650m at $2.10 a share, which valued it at 1.7x Price to Book (P/B). For the sake of our readers who haven't heard this before, P/B compares a company's market cap to its book value (difference between assets and liabilities, i.e. net equity). This is a favoured metric to value banks (but not many other firms), because banks have to periodically market their assets to market. This means that metrics such as EBITDA are not relevant in measuring banks' performance because depreciation and amortization of tangible assets is not relevant, while interest income is core to a bank's business. Although any P/BV above 1x is a premium, it is normal for banks that stick to handling customers and don't do activities such as trading (which can be risky), to be valued higher than those that do.

At the time Judo listed, the IPO market was starting to lose steam, but the stock didn't perform too badly given it was profitable and had recorded impressive loan book growth, roughly tripling in two years. Judo's lending book stood at $6.1bn per 30 June 2022 and the company is targeting $9bn by the end of next year, plus $20bn by 2026. It is also growing deposits quickly, currently holding $4.6bn and growing. The company has credited its growth to its superior customer experience, through its superior technology and specialisation of SMEs compared to the Big Four banks.

A falling share price despite solid growth and results

In FY22, Judo exceeded all of its prospectus forecasts, recording a $15.6m pre-tax profit (up from a forecasted $7.4m), $169.8m in Net Interest Income (up from $160.5m in its prospectus) and a Net Interest Margin (NIM) of 2.79%. For FY23, it has issued guidance of >$9bn in gross loans and advances, a >3% NIM, a cost-to-income ratio of <60% and a return on equity in the low to mid-single digits.

Consensus analyst estimates for revenue are $322.4m for FY23 and $411.1m for FY24, marking 94% and 24% growth from the preceding years. EPS was 1c for FY22 but is estimated at 6c for FY23 and 9c for FY24. Judo's P/E multiple for FY23 is a reasonable 20x and its PEG multiple is just 0.2x, suggesting it is undervalued relative to its growth. On a PEG basis, Judo trails all of the Big Four, but on a P/E basis, it is ahead of all the Big Four – even CBA is 'only' at 17x.

Ultimately, Judo's share price has performed poorly. Why? Obviously, Judo is heavily exposed to small businesses and their owners, which have typically less armour to see themselves through inflationary pressures not seen in 3 decades. Even the company has admitted that confidence in its longer-term outlook is now waning. And bear in mind that Judo has built 80% of its loan book during the pandemic when interest rates have been at record lows.

Can Judo weather the current environment?

To be clear, when we ask the above question, we're not suggesting we think Judo could go the way of Xinja. But will it continue to grow in the current environment and thereby reach its short term and long-term targets?

In Judo's favour are four things. First, it has extra 2% buffers in place to assess customer capacity. Essentially this means the company models if would-be customers can repay if interest rates are 2% higher than they actually are today and deny the application if the customers can't. Second, it avoided lending to certain cyclical sectors, such as to construction workers and to commercial property generally. It has also tried to increase exposure to non-cyclical sectors, such as health and agriculture. Third, its funding costs are anchored by the RBA's fixed rate Term Funding Facility. And fourth, as goes without saying, if customers do pay higher interest, Judo's own interest income rises.

But be all those as they may, there could be less new business coming in which would slow the growth that Judo has seen during the pandemic. And we still don't know when the rate hiking cycle will be over, how high rates will go and how the SME sector will fare. Inflation appears to be plateauing, but it is not declining and the RBA wants inflation back in the 2-3% target range. Further, it is no guarantee that the once RBA is done hiking rates, it will cut them again, at least as fast as they have hiked them.

Ultimately, while Judo would be a safer investment if there was clarity on those questions above, we think Judo is four stars assuming it can reach consensus estimates. We think the four factors listed above will put it in good stead to weather the current environment and eventually, investors will take notice of its growth once again.

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