Hong Leong Finance

Bloomberg: HLF SP | Reuters: HLSF.SI

Refer to important disclosures at the end of this report

5 Apr 2017

BUY (Initiating coverage)

Last Traded Price (4 Apr 2017): S$2.70 (**STI :** 3,179.06)
Price Target 12-mth : S$3.20 (19% upside)
Reason for Report : Initiating coverage
Potential Catalyst: New growth opportunities post regulatory relaxation; M&A
Where we differ: Only coverage in the market; first to initiate

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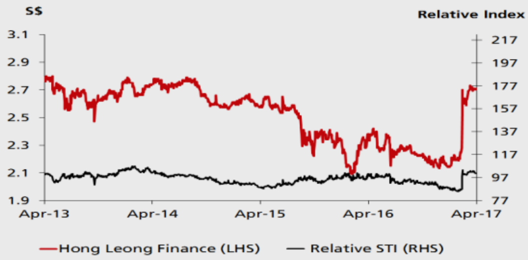
Price Relative



Forecasts and Valuation

FY Dec (S$m)	2015A	2016A	2017F	2018F
Pre-prov. Profit	83.1	65.1	93.6	97.1
Net Profit	72.9	53.1	76.7	79.7
Net Pft (Pre Ex.)	72.9	53.1	76.7	79.7
Net Pft Gth (Pre-ex) (%)	16.0	(27.2)	44.6	3.9
EPS (S cts)	16.4	12.0	17.3	17.9
EPS Pre Ex. (S cts)	16.4	12.0	17.3	17.9
EPS Gth Pre Ex (%)	16	(27)	44	4
Diluted EPS (S cts)	16.4	12.0	17.2	17.9
PE Pre Ex. (X)	16.4	22.6	15.6	15.1
Net DPS (S cts)	11.0	9.00	11.6	12.0
Div Yield (%)	4.1	3.3	4.3	4.4
ROAE Pre Ex. (%)	4.4	3.1	4.5	4.6
ROAE (%)	4.4	3.1	4.5	4.6
ROA (%)	0.6	0.4	0.6	0.6
BV Per Share (S cts)	380	382	387	392
P/Book Value (x)	0.7	0.7	0.7	0.7

ICB Industry : Financials
ICB Sector: General Financial
Principal Business: Hong Leong Finance Limited provides depository and financing services to its clients.

Source of all data on this page: Company, DBS Bank, Bloomberg Finance L.P.

Earnings recovery amidst M&A potential

- **Initiate coverage with BUY rating, S$3.20 TP; new opportunities abound, M&A a possibility**
- **Solid >50-year track record in property-related financing and SME lending; untapped and unbanked niche financier**
- **Expect 44% growth in NPAT in FY2017 due to NIM expansion**
- **Attractive M&A target for acquirers looking to expand reach in Singapore SME lending space**
- **Trading below book value and >30% discount to banks; TP of S$3.20 offers 18% upside; an additional minimum 43% upside in the event of an M&A over last close**

New opportunities abound; M&A potential. MAS' rule relaxation on finance companies (fincos) in mid-Feb 2017, which lifted the limits on uncollateralised loans as a percentage of capital funds (from 10% to 25% of capital funds) and liberalised its existing policy to now allow a foreign takeover of a finco (subject to certain conditions), opens new opportunities for Singapore fincos. Hong Leong Finance (HLF), the largest of the three fincos in Singapore, is poised to benefit, in our view.

Strong track record in property financing and SME lending. With over 50 years of lending experience with its SME expertise, HLF dominates the finco lending space, accounting for >75% of the fincos' total loans. HLF has the widest branch network among the three fincos with 28 branches and 10 Small-Medium Enterprise (SME) centres across Singapore. HLF's strength lies in property-related financing (78% of loans) and hire purchase and block financing (16% of total loans).

Expect >40% growth in NPAT. We estimate 44% growth in HLF's NPAT, from a multi-year low of S$53.0m in FY2016, riding on higher net interest margin (NIM) due to lower cost of funds. HLF faced higher cost of funds in FY2016 due to expensive deposits collected amidst fixed deposits competition towards end 2015.

Offers 18% share price upside; M&A could provide another 10-35% upside to last close. Our TP of S$3.20 offers 18% upside potential, based on HLF's competitive strengths and growth prospects vs its finco peers. This is derived from the Gordon Growth Model with 5.1% ROE, 1.5% long-term growth and 5.8% cost of equity, implying c.0.8x FY17F BV. Under an M&A scenario, we believe HLF should attract a min 1x BV as current shareholders are unlikely to sell out at lower valuations given the prospects of the business under this new regulatory regime, providing a minimum >43% upside over last close of S$2.70.

Key risks. Being a smaller financial institution and with exposure to riskier business lending, HLF may be more prone to asset-quality upsets should the economic cycle deteriorate.

At A Glance

Issued Capital (m shrs)	444
Mkt. Cap (Sm/USm)	1,199 / 857
Major Shareholders (%)	
Hong Leong Investment Holding	22.45
Hong Realty Pte Ltd	5.24
Free Float (%)	69.38
3m Avg. Daily Val (US$m)	0.41

INVESTMENT THESIS

Profile	Rationale
Hong Leong Finance, the financial services arm of Hong Leong Group Singapore, is Singapore's largest finance company with a distribution network of 28 branches and over 600 employees. HLF has more than 55 years of experience in Small and Medium-sized Enterprise (SME) lending, offering a wide range of products and services, including deposits and savings, consumer and corporate loans, government assistance programmes for SMEs, as well as corporate finance and advisory services.	Following the Monetary Authority of Singapore's (MAS) relaxation of rules on finance companies on selected business restrictions and shareholding policy liberalisation, we believe HLF has potential to re-rate on new prospects of M&A and growth. The regulatory changes are summarised in our previous note: Singapore Finance Companies: MAS relaxes rules on Finance Companies.
Valuation	**Risks**
Initiate with BUY; our TP of S$3.20 is based on the Gordon Growth Model with 5.1% ROE, 1.5% long-term growth and 5.8% cost of equity, implying 0.8x FY17F BV. We believe any takeover for fincos should be launched at above 1x P/BV, providing minimum >43% upside over last close of S$2.70 and an additional 21% upside over our TP of S$3.20.	Risk to asset quality. While HLF applies stringent credit underwriting procedures, unexpected deterioration in HLF's loan portfolio could pose downside risk to earnings. Deterioration in the loan portfolio could be caused by softening of the economic cycle and/or worsening business conditions limited to a specific sector.

Source: DBS Bank

SWOT Analysis

Strengths	Weakness
• Singapore's largest finance company with the widest distribution network: 28 branches and 10 SME centres island-wide • Reputable lender with over 55 years' experience serving SMEs with experienced management • Only finco that offers corporate finance and advisory services • Deep expertise in property-related loans • Established relationships with local enterprises and partners (e.g. car dealers) • Backed by strong parent, Hong Leong Investment Holdings Pte Ltd, which is the holding company (holdco) for Hong Leong Group, one of Asia's largest conglomerates with gross assets of over S$40bn	• Restrictions on foreign currency exposures and derivatives trading • May have less financial products and services compared to banks
Opportunities	**Threats**
• Opportunities of merger and/or acquisition • Increased limit on aggregate uncollateralised business loans from 10% to 25% of capital funds translates into opportunities for increased lending	• Competition from banks and other local finance companies • Changes in macroeconomic outlook which affect domestic loan growth

Source: DBS Bank

Company Background

Singapore's largest finance company established since 1961. Established since 1961, Hong Leong Finance (HLF), the financial services arm of Hong Leong Group Singapore, has since evolved to become Singapore's largest finance company with over 600 employees. Hong Leong Group Singapore is one of Asia's largest conglomerates with core businesses in property development, hotels, finance and trade and industry with gross assets of over S$40bn and 40,000 employees.

Widest distribution network in Singapore. Among the finance companies in Singapore, HLF has the widest distribution network with 28 branches and 10 Small and Medium-sized Enterprise (SME) centres island-wide. HLF's branches can be found mostly in shophouses near the town centres, as well as in shopping malls.

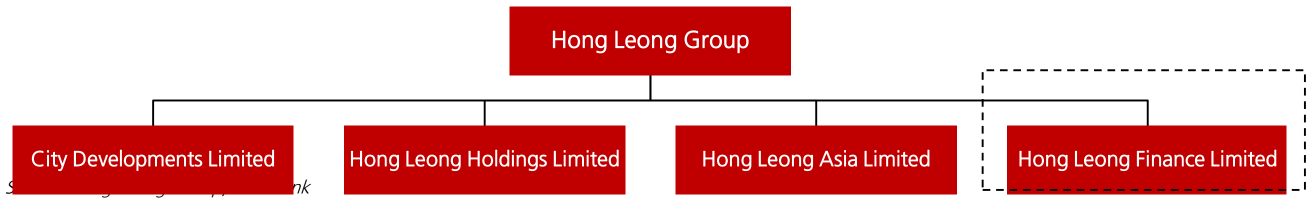
More than 55 years of experience in SME lending. HLF prides itself as a "SME specialist" with more than 55 years of experience serving SMEs locally. Besides providing financial support to SMEs, increasingly, HLF has shifted its focus to provide one-stop financial services to SMEs, for instance through the set-up of SME centres.

Large variety of products and services. HLF provides close to 20 types of SME financial products and services, ranging from commercial/industrial property loan, factoring, trade finance to micro loans. HLF is also one of the participating financial institutions under (1) Local Enterprise Finance Scheme (LEFS) administered by SPRING Singapore where SMEs may secure asset-based loans for factory, machinery, equipment purchase or lease/hire purchase; (2) Loan Insurance Scheme (LIS) administered by SPRING Singapore for companies who want to secure trade finance loans, and (3) Internationalisation Finance Scheme (LFS) administered by IE Singapore for companies looking to secure financing for overseas investments and/or projects.

HLF also provides deposits and savings, as well as personal loans such as car and housing loans for retail customers. In 2007, HLF was the first finance company in Singapore to offer to chequing account services for corporate loan customers.

HLF is also the only finance company in Singapore that is a Catalist Full Sponsor, hence offering various corporate finance services such as equity fund-raising and corporate advisory services to its SME customers.

Hong Leong Group: Group Structure



HLF's products and services

SME Loans

Commercial/ Industrial Property Loan
Development Loan
Equipment Financing
Equipment Refinancing
Factoring/ Accounts Receivable Financing
HDB Factory Loan
HDB Shop Loan
Hire Purchase
Internationalisation Finance Scheme Inventory Finance
JTC Factory Loan
Letters of Credit
Loans for Conservation Property
Loan Insurance Scheme
Local Enterprise Finance Scheme
Medical Asset Financing
Micro Loan Programme
Revolving Working Capital Finance
Suppliers' Invoice Financing
Trade Finance
Vessel Financing

Deposits and Personal Loans

Deposits:
Business Current Account
Fixed Deposits
Savings Accounts
Savers Plus

Personal Loans:
Car Loans (New & Used Cars)
HDB Home Loan
Private Housing Loan
Share Financing

Corporate Finance

Equity Fund Raising:
Initial Public Offering
Secondary Fund Raising
Underwriting of Shares

Corporate Advisory:
Financial Advisory
Mergers & Acquisitions
Restructuring
Independent Financial Advisory

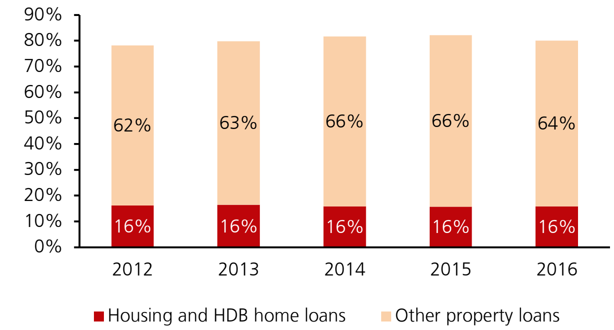
Source: Company, DBS Bank

The Business

Property loans, housing and HDB home loans account for close to 80% of loan base. When HLF together with property firm Hong Leong Holdings was set up in the 1960s, the intent was to develop private housing, and through HLF, enable property buyers to finance their property purchases. HLF has since created its niche in property-related lending, from financing residential developments, commercial properties, lending to private residential home owners and HDB home owners amongst others.

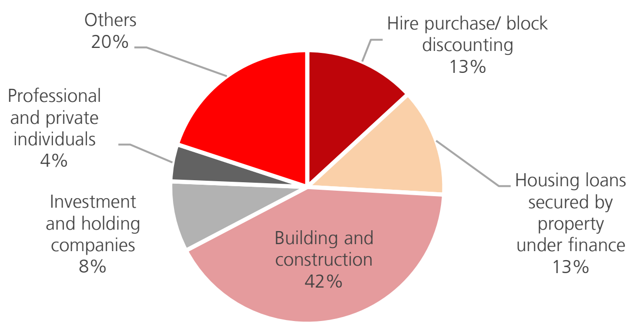
In FY2016, property related loans account for up to 80% of total loans. Housing and HDB home loans account for c.16% of HLF's total loans, of which 9% are HDB home loans, while other property loans account for c. 64% of total loans.

Property related loans as a % of total loans



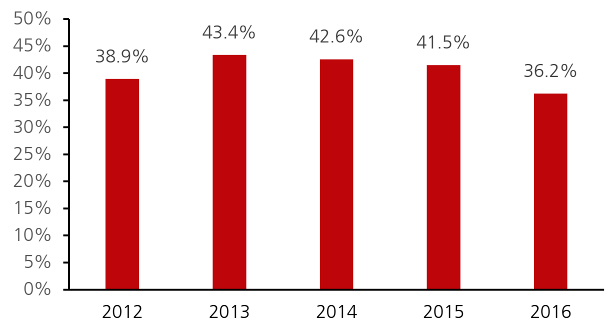
Source: Company, DBS Bank

Gross loans by industry breakdown (FY2016)



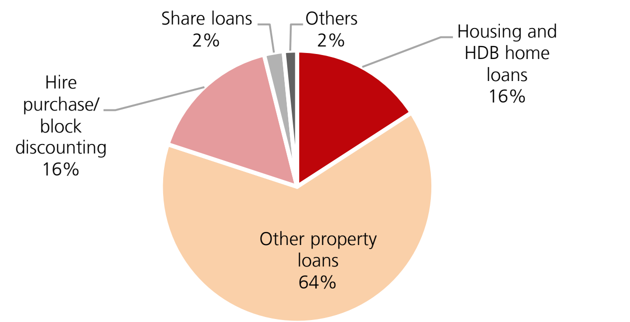
Source: Company, DBS Bank

Building and construction loans as a % of total loans



Source: Company, DBS Bank

Gross loans by product type (FY2016)

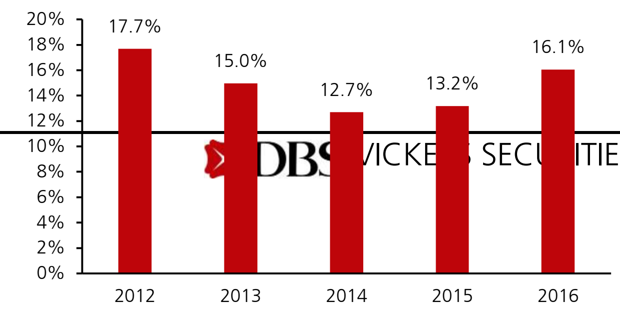


Source: Company, DBS Bank

Hire purchase and block discounting is second largest contributor to HLF's loan book. Hire purchase loans have fixed principals by nature, and monthly principal repayments, as well as prepayments, will reduce gross loan outstanding progressively. Hire purchase loans are typical for vehicle and machinery financing. HLF is also known to have strong partnerships with various car dealers, which ensure the continuous pipeline of new car loans.

Competition for car loan business is on the rise as new competitors such as credit companies have entered the market. However, compared to prior years where restrictive credit regulations translated into slow business, MAS has since eased car loan rules since mid-2016, increasing the borrowing limit from 50% to 70% and allowing longer loan tenures of seven years vs five years previously.

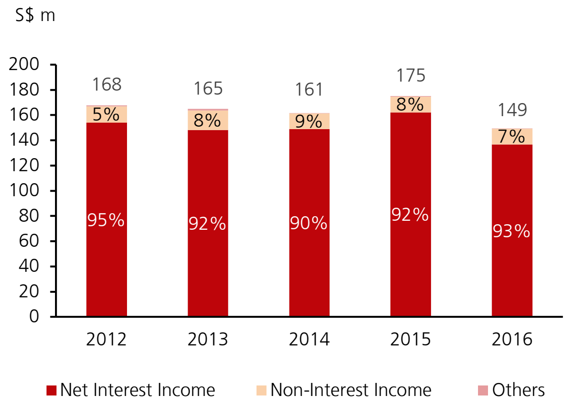
Hire purchase and block discounting as a % of total loans



Source: Company, DBS Bank

HLF derives most of its income from interest income. More than 90% of HLF's income is derived from net interest income on the loans made. Non-interest income is derived from fees and commissions related to the loans and other financing businesses, as well as from fees and commissions from HLF's non-lending business, including corporate advisory services as well as other trailer fees.

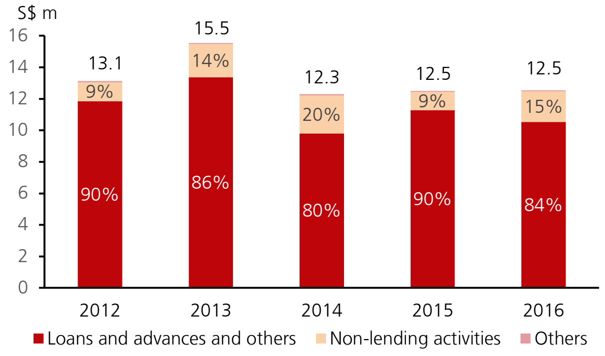
Net interest income vs non-interest income breakdown (S$)



Source: Company, DBS Bank

Fee and commission income is largest portion of non-interest income. In FY2016, fee and commission income contributed to 98.3% of non-interest income. Of the fee and commission income, the majority of income (84% of total fee and commission income) is derived from fee income from lending products, such as chequing account services to corporate loan customers.

Breakdown of fee and commission income (S$)



Source: Company, DBS Bank

Non-lending fee income from capital markets. In 2012, HLF achieved full sponsorship status for SGX Catalist Board, and has since been the only finance company locally to provide advisory and fund-raising services to SMEs looking to list on Catalist. In 2013, HLF entered the market with its first Catalist Initial Public Offering. Since then, HLF has acted as Full and Continuing Sponsor for several companies and engaged in roles such as Sub-Placement Agent, Rights Issue Manager and Independent Financial Advisor. The provision of such equity fund-raising and advisory services has helped to distinguish HLF from other finance companies in Singapore. As new listings decline due to broader environment factors, HLF continues to receive steady fee income by acting as Continuing Sponsor for several Catalist companies.

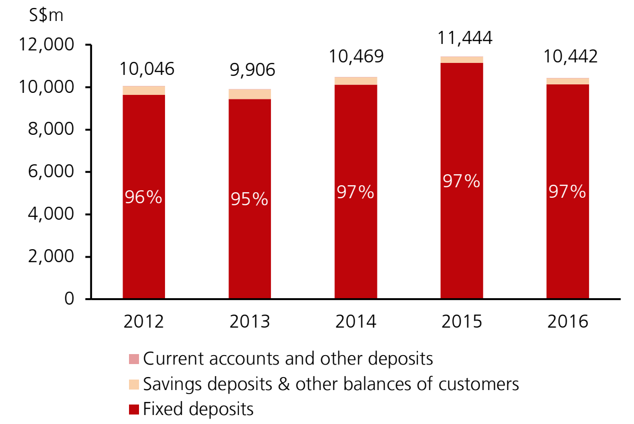
Selected past transactions in which HLF participated in (2013 – present)

Transactions	Gross Proceeds (S$ million)	HLF's Role
ISO Team Ltd IPO Listing	7.1	Sponsor
Global Investments Limited	48.7 (up to)	Rights issue manager
Asiatic Group (Holdings) Limited	12.1 (up to)	Rights issue manager
Talkmed IPO Listing	21.0	Sponsor
KOP Limited Reverse Takeover	N/A	Financial advisor, placement agent
SMJ International Holdings IPO Listing	3.9	Sponsor
mm2 Asia IPO Listing	7.8	Sponsor

Source: Company, DBS Bank

- **Customer deposits.** HLF funds its loans almost entirely through customer deposits and hence competes with other finance companies as well as banks for deposits base. Approx. 97% of HLF's customer deposits are fixed deposits, with the remaining are saving deposits and other balances of customers.

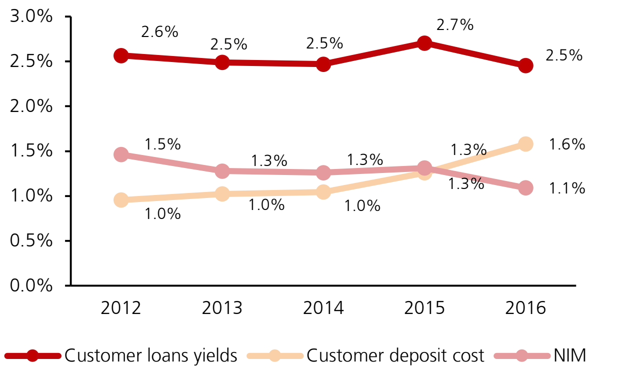
HLF's customer deposits (S$ m)



Source: Company, DBS Bank

NIM remains stable amid rising loan yields and increasing cost of funds. Customer loan yields have picked up in FY2016 to 2.5% amid rising cost of funds. HLF's deposits are mostly fixed deposits which are more expensive than Current Account Savings Account (CASA) deposits. Its cost of customer deposits increased from 1.3% in FY2015 to 1.6% in FY2016, compressing its NIM for the year.

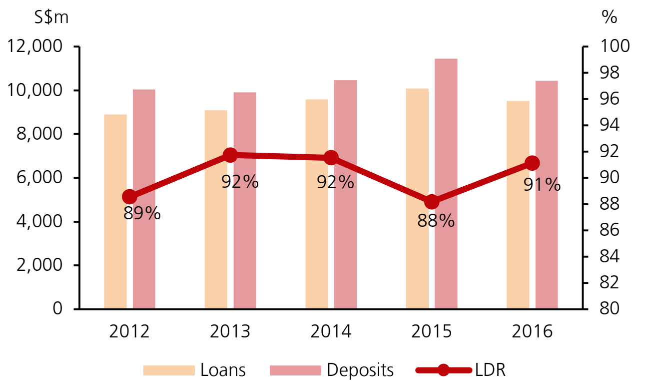
Customer loan yields vs deposit cost vs NIMs (%)



Source: Company, DBS Bank

Loan-to-deposit (LDR) ratio at 91%. With deposits growth exceeding loan growth, LDR ratio is now at 91%, which is comfortable and within the range of Singapore banks' S$ LDR ratio.

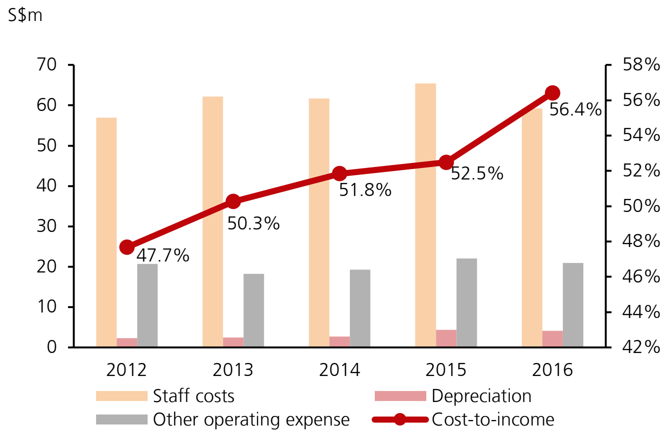
Loan-to-deposit ratio trend



Source: Company, DBS Bank

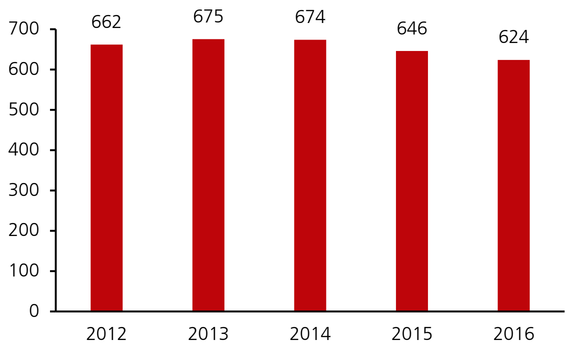
Cost-to-income ratio on upward trend. Its cost-to-income ratio has been on the uptrend, with FY2016's cost-to-income ratio at 56.4% due to a low base. The increase in expenses was due to the following: (1) higher staff cost, and (2) higher business promotion expenses and operating lease premises expenses. On top of that, higher depreciation was recorded in FY2016 due to the technology refresh of host computer systems being implemented. This represents HLF's efforts to continuously innovate and invest in infrastructure and technology so as to enhance internal systems' capabilities and capacities. It is envisaged that the system refresh would enable faster and more flexible processes.

Cost-to-income ratio trend



Source: Company, DBS Bank

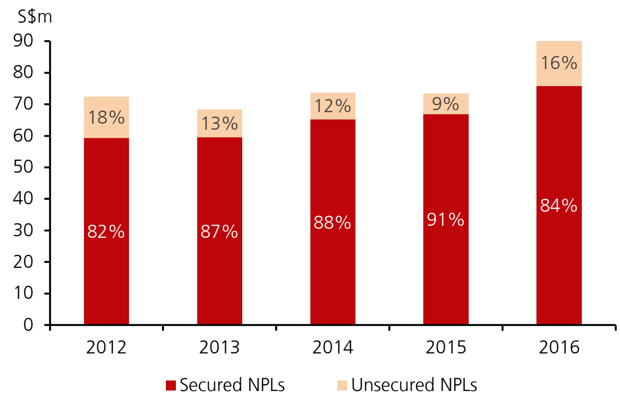
Staff strength



Source: Company, DBS Bank

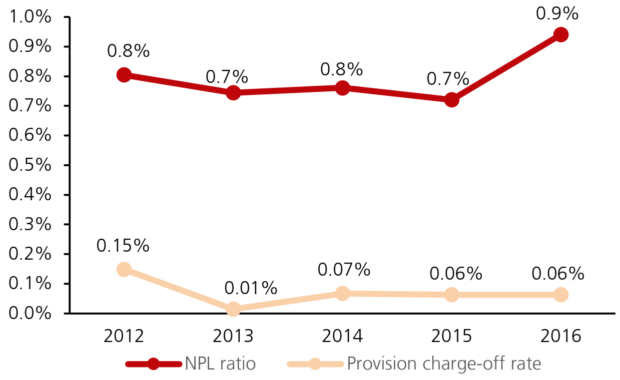
Asset quality is sound. HLF's non-performing loans (NPL) position is graded in line with industry standards. HLF's NPL ratio is the lowest amongst its peers, at 0.8% – comprising secured NPL of 0.7% and unsecured NPL of 0.1%. For secured NPLs, they are fully secured but classified as substandard loans where payments are not kept current for the last 90 days. For unsecured NPLs, they are classified as loss amounts, and are fully covered by specific allowances.

Secured vs unsecured NPLs (S$m)



Source: Company, DBS Bank

NPL ratio vs provision charge-off rate (%)



Source: Company, DBS Bank

Conservative allowances methodology. HLF sets aside general allowances on a portfolio basis, and provides for specific allowances for all NPLs where the collateral valuation does not cover the outstanding loan amount. As secured collaterals' valuation exceeds that of the secured NPLs, specific allowances are equal to the amount of unsecured NPLs.

Management & Strategy

Experienced management team. HLF is helmed by Mr Kwek Leng Beng, who is both the Executive Chairman of Hong Leong Investment Holdings Pte Ltd (HLIHPL) which has c.46% direct and deemed interest in HLF, as well as Board Chairman and Managing Director of HLF. Mr Kwek has helped to set up HLF in the 1960s and grow the original HLF which subsequently acquired and merged with Singapore Finance in 1970s. The merger has positioned HLF as a key finance company through the provision of various financial services to SMEs and consumers. Mr Kwek has been Managing Director of HLF since 1979, and Chairman since 1984.

Dividend policy. HLF has adopted a dividend policy which aims to pay dividends twice a year. Various factors of consideration such as HLF's operations results, retained earnings sufficiency, cash required for operations, capital adequacy and needs, capital expenditure and future investment plans will determine the actual payout. Between FY2013 and FY2016, the dividend payout ratio ranged from 60% to 76%. We believe this dividend payout range will likely be sustained going forward.

Historical dividend payout

	FY2013	FY2014	FY2015	FY2016
DPS (S cents)	12	10	11	9
Dividends declared	53.1	44.3	48.8	39.9
Dividend payout ratio	76%	71%	67%	67%

Source: Company, DBS Bank

Key management team

Key Management	Designation	Profile
Kwek Leng Beng	Board Chairman and Managing Director	Mr Kwek has been Managing Director of HLF since 1979, and Chairman since 1984. He is the Executive Chairman of Hong Leong Investment Holdings Pte Ltd, the immediate and ultimate holding company of HLF and City Developments Limited, one of Singapore's largest companies by market capitalisation. Mr Kwek is also non-executive Chairman of Millennium & Corpthorne Hotels plc, and Hong Leong Asia Ltd. Armed with more than 50 years of experience, Mr Kwek is also a veteran in real estate and hospitality industry, financials industry, as well as the trading manufacturing business.
Ang Tang Chor	President	Mr Ang Tang Chor joined HLF since 2003, and was appointed as President in 2016 after serving as its Deputy President since 2014. He has experience in the banking industry of more than 40 years, having worked in various positions in Tat Lee Bank Ltd/ Keppel Tatlee Bank Ltd (Tat Lee) for more than 27 years. Following Tat Lee's acquisition by OCBC Bank, Mr Ang was General Manager, International Banking Division in OCBC Bank.

Source: Company, DBS Bank

Industry Landscape and Regulatory Environment

A. Industry landscape

Here, we look at the industry landscape for finance companies, as well as highlight key differences between finance companies (fincos) and banks.

Foremost, fincos **derive most of their income through interest income**. This is unlike banks which increasingly derive the bulk of their revenue from non-interest income such as wealth management, trade-related, credit card, brokerage and investment banking fees, etc. OCBC and UOB's non-interest income contributed to ~40% of operating income in FY2016.

% of non-interest income of operating income

FY16	HLF	SIF	SF	DBS	OCBC	UOB
%	8.5%	11.8%	10.5%	36.4%	40.4%	38.0%

Source: Various companies' websites

Fincos typically provide **simpler products** such as car loans, property loans, hire purchase, block discounting, as well as various government-assisted schemes for SMEs. We broadly summarise the business offerings of the selected fincos in the following table:

Fincos' business offerings

	Hong Leong Finance (HLF)	Sing Investments & Finance (SIF)	Singapura Finance (SF)
Products - Personal	Fixed deposits & savings Car loans Property loans Share loans	Fixed deposits & savings Car loans Property loans Share loans	Fixed deposits & savings Property loans Share loans
Products – SME & Corporate	Deposits Working capital Property loans Equipment loans Medical loans Government assistance schemes Corporate finance Etc.	Block discounting Financing Floor stock financing Machinery financing Local enterprise Finance schemes Shipping loans Land & construction loans Etc.	Property loans HP equipment loans Vessel loans Etc.

Source: Various companies' websites

Secondly, fincos are typically **funded by retail fixed deposits,** compared to the local banks, whereby CASA forms more than half of the deposits base, and where funding is also gathered from corporate deposits, issuing debt instruments and various interbank lending. Most deposits accounts offered by fincos are eligible for deposit insurance coverage under the Deposit Insurance and Policy Owners' Protection Schemes Act 2011, up to the respective limits specified in the Act. Fincos **do not provide current account services** for retail customers and do not have a network of ATMs.

Finco vs Singapore banks: Deposits breakdown

% of total deposits	HLF FY16	SIF FY15	SF FY15
Fixed deposits	97%	97%	N/A
Others	3%	3%	N/A

% of total deposits FY16	DBS	OCBC	UOB
Fixed deposits	37%	44%	52%
CASA and others	63%	56%	48%

Source: Companies, DBS Bank

Thirdly, fincos tend to have to **pay higher interest rates** as compared to banks, as fixed deposits come with higher interest rates compared to CASA. Fincos like HLF typically run special campaigns from time to time to attract fixed deposits.

HLF's current fixed deposits promotions

3, 6, 12, 13 and 18 months Fixed Deposits

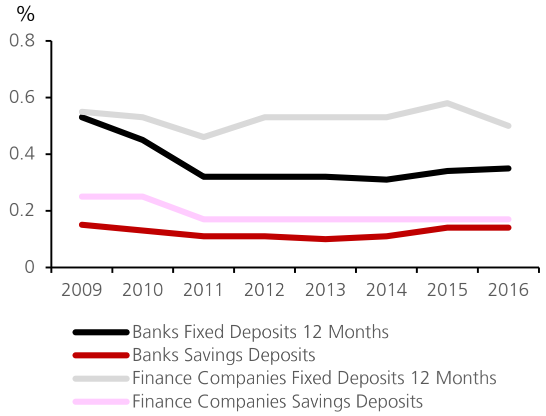
Enjoy attractive rates when you place a minimum of S$30,000.

Fixed Savings Account

Earn bonus interest of up to 1.70% p.a. on regular monthly savings.

Source: Company website, DBS Bank

Fincos vs local banks: Cost of deposits (%)



Source: Monetary Authority of Singapore (MAS), DBS Bank

Fincos vs Singapore banks: Cost of deposits (%)

FY16					
HLF	SIF	SF	DBS	OCBC	UOB
1.6%	1.6%	1.4%	0.65%	1.10%	1.14%

Source: Companies, DBS Bank

Fincos have been fulfilling their roles as a **niche player in SME financing,** at the same time complementing the banks' roles. Fincos have a different **customer base** within the SME lending space, and typically have a smaller **lending quantum.** Within the SME lending space, banks like UOB is known to be a strong SME lender with SME loans contributing to 20% of total loans. From our conversations with the fincos, fincos also serve SMEs with small funding needs, loans can range from half a million to S$1 million.

Lastly, fincos have **varying NIMs compared to Singapore banks, possibly due to nature of business and credit spreads charged.** However, fincos are largely viewed as taking on riskier assets compared to banks, as such non-performing loans (NPLs) are typically higher for finance companies, with the exception of HLF which operates pretty close to that of a bank. Unlike banks, fincos typically do **secured lending**. HLF was allowed to lend unsecured to SMEs before MAS relaxed its rules on unsecured lending, although secured lending forms the bulk of its loan book.

Fincos vs Singapore banks: NIM and NPL ratio (%)

NIM

FY16					
HLF	SIF	SF	DBS	OCBC	UOB
1.1%	1.5%	1.78%	1.80%	1.67%	1.71%

NPL Ratio

FY16					
HLF	SIF	SF	DBS	OCBC	UOB
0.8%	0.8%	3.0%	1.4%	1.3%	1.5%

Source: Companies, DBS Bank

B. Regulatory environment

Fincos are licensed under and governed by the Finance Companies Act. The spirit of the Finance Companies Act and other restrictions placed upon the fincos are to ensure that (1) fincos maintain their core focus on providing fixed and savings deposits and credit facilities to retail and business customers, especially the SME customers, and (2) there is a limit to fincos' business risks.

From an operational point of view, we summarise the key differences between requirements on fincos versus banks as stipulated by Finance Companies Act and Banking Act:

Differences between Finance Companies Act and Banking Act

	Fincos	Banks
Minimum capital requirements	Licence held before 18 Jan 1995, capital funds not less than S$50m Licence held after 18 Jan 1995, issued and paid-up capital, capital funds not less than S$50m	Bank incorporated in Singapore, paid-up capital, capital funds not less than S$1,500, Bank incorporated outside Singapore, head office capital funds not less than S$200m or equiv.
CAR ratio	Maintained at not less than 12%	Tier1, Additional Tier 1, Tier 2, Total CAR ratio prescribed by MAS637 according to Basel III transition rules
Branch opening restrictions	Application needs to be submitted for opening of new branches	Application needs to be submitted for opening of new branches

	Inspection may be applicable for assessment of application, up to five areas to be assessed	
Reserve fund	Reserve fund to be maintained net profits of each year needs to be transferred to reserve fund accordingly depending on size of reserve fund relative to paid-up capital	Repealed
Restrictions on trade	Shall not engage in wholesale or retail trade, including import or export trade, except for purpose of carrying on its financing business	Act is silent

Source: Finance Companies Act, Banking Act, DBS Bank

Several restrictions have been also applicable to fincos (unless otherwise approved by MAS) before MAS' relaxation of rules announced in 14 February 2017, including:

1) **Current account and chequing services.** Fincos may not offer current account and chequing services, i.e. deposit accounts which are repayable on demand by cheque, draft or order (we note that HLF has been granted approval to provide current account services for its business customers since 2007)
2) **Uncollateralised credit facilities.** Fincos may not grant uncollateralised credit facilities exceeding S$5,000 to a single borrower on an aggregated basis and outstanding at a single point in time
3) **Other transactions.** Fincos may not transact in foreign currencies (FX), gold or other precious metals, nor acquire FX-denominated stocks, shares or debt securities

On 14 February 2017, various regulatory changes have been announced in a bid to strength the resilience of fincos and enhance fincos' ability to provide SME financing. Relaxation of restrictions on current account and chequing services, as well as uncollateralised credit facilities (see (1) and (2) above) are as follow, while the restriction on other transactions (see (3) above) is retained:

1) **Lifting limit to uncollateralised loans as a percentage of capital funds.** The limit on a finco's aggregate uncollateralised business loans will be raised to 25% of its capital funds, from the current 10%. The limit on uncollateralised business loans to a single borrower will also be raised to 0.5% of capital funds, from the current S$5,000.
2) **Allowance to offer current account and chequing services.** Fincos will be allowed to offer current account and chequing services to their business customers. They will also be allowed to join electronic payment networks, including Inter-bank GIRO, Fast and Secure Transfers (FAST) and Electronic Funds Transfer at Point of Sale (EFTPOS). These changes will enable fincos to provide more comprehensive credit and deposit services to SMEs.

MAS will phase in the above regulatory changes starting this year.

C. **Liberalisation of shareholding policy.**

Allowing a foreign takeover. MAS will liberalise its existing policy of not allowing a foreign takeover of a finco. This will accord fincos greater flexibility to explore strategic partnerships and innovative business models that can strengthen their SME financing business.

Open to M&A/new strategic partners with a commitment to maintain SME financing as the finco's core business. Specifically, MAS is prepared to consider an application for a merger or acquisition if the prospective merger partner or acquirer commits to maintaining SME financing as a core business of the finco. In addition, the merger partner or acquirer must be able to demonstrate expertise in SME financing and present proposals to enhance the finco's SME lending activities with new technologies, methodologies or business models.

Better prospects for fincos post new rules. The ability for fincos to ramp up asset growth appears positive with the onset of these revised rules. In addition, fincos will now be able to gather current account deposits, which should also lower funding costs. These should see net interest margins (NIM) improve. The larger loan size with the increase in the single borrower limit should open doors to SMEs which were too large to borrow from a finco previously but too small in the eyes of the banks.

Competitive Strengths

Market leader of Singapore fincos with approx. 75% of fincos' market share. HLF has been a reputable finco for more than 55 years locally and is the market leader with approx. 75% of Singapore fincos' loan market share totalling c.S$12bn. With HLF's wide branch network across the neighbourhoods, we believe that HLF is well-positioned to serve its SMEs as well as garner retail deposits.

Strong niche and expertise in property loans. Property-related loans account for ~80% of total loans. The Hong Leong Group and HLF have deep expertise in the property sector and HLF has, through the years, amassed deep expertise in financing property developers. HLF stands out clearly from the other fincos as a well-regarded lender in the property sector and participates in syndicated lending with other banks for big property development projects.

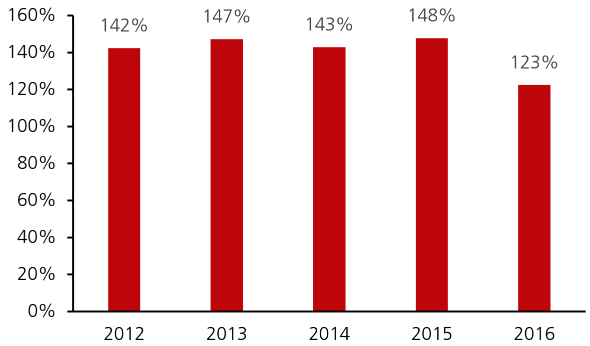
Strong SME relationships and comprehensive suite of SME products and services. HLF is known for its strong SME relationships, for instance, reaching out to SMEs in the HDB neighbourhoods, through its HDB SME loan which aims at helping HDB business owners. HLF is also the only finco to offer all three loan programmes administered by various government statutory boards: 1) Local Enterprise Finance Scheme (LEFS), (2) Loan Insurance Scheme (LIS), and (3) Internationalisation Finance Scheme (LFS), placing it in the "league" of local and foreign banks alike, in terms of product offerings. We believe this further helps to differentiate HLF from the other fincos. HLF has intention to participate in government-initiated programs such as "SMEs Go Digital" programme announced in Budget 2017, aimed at helping SMEs use digital technologies to build up their capabilities.

Deep relationships with partners, e.g. car dealers. HLF is also known to have deep and exclusive relationships with car dealers, which adds to its healthy pipeline of car and hire purchase loans. Notably, in 2012, HLF has appointed the first Porsche financial partner in Asia and has crafted various financial schemes for Porsche car owners.

Full sponsorship status for SGX Catalist Board. HLF is the only finance company locally to provide advisory and fund-raising services to SMEs looking to list on Catalist. The provision of such equity fund-raising and advisory services has helped to distinguish HLF from other finance companies in Singapore and adds to HLF's non-interest income continuously. HLF also piloted a SME Connector Programme to provide several SMEs with first-hand one-to-one corporate advisory services in 2016, aimed at increasing its corporate finance and advisory suite of services.

Sound asset quality with low NPL ratio and conservative provisioning. HLF has the lowest NPL ratio of 0.8% for FY2016, well below SIF and SF with NPL ratios of 1.7% and 2.4%, respectively, for FY2015. HLF has a conservative approach when it comes to general allowances provisioning and as a result, HLF's loan loss coverage is also the highest among the finco at over 120%, well above those of its peers as well as Singapore banks. We believe that HLF is well-positioned to absorb any sudden deterioration in asset quality.

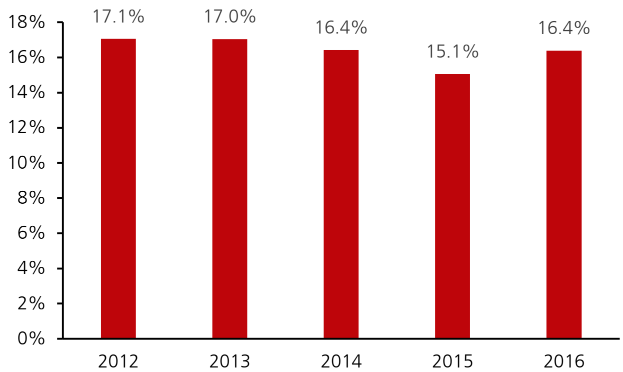
Loan loss coverage ratio trend (%)



Source: Company, DBS Bank

Strong capital position. HLF's total capital adequacy ratio (CAR) has been on the downtrend but its capital position remains strong at 16.4% for FY2016, well above the statutory requirements of 12%. This compares with SIF's CAR of 14.3% (FY2015) and SF's CAR of 24.8%.

Total CAR ratio trend (%)



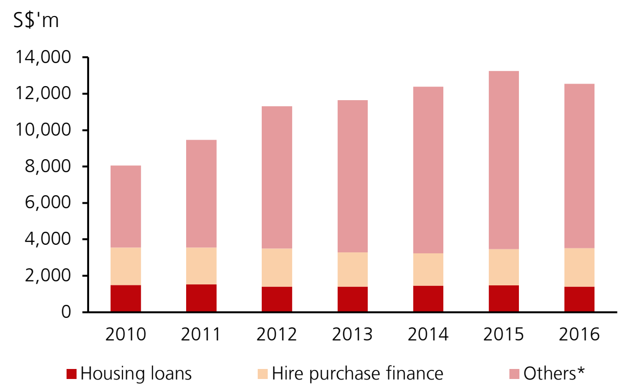
Source: Company, DBS Bank

Growth Strategies

Opportunities from MAS' rule relaxation. HLF was already the first finco to be allowed to offer business current accounts, subjected to various conditions prior to the MAS' rule relaxation. Going forward, positive catalysts could also come from cheaper funding if HLF is able to hold institutional deposits like the banks, thereby allowing HLF to act as the "go-to-bank" for various transactions for the SMEs. There could also be further opportunities in unsecured lending, however, we think caution should be exercised on unsecured lending to smaller-sized SMEs due to risk concerns. We note that the new MAS rules have not been implemented, and we look towards its full implementation and more clarify in 2Q2017.

Fincos may be allowed to further expand its role in providing SME financing. We believe fincos play an irreplaceable role in providing financing to niche customer segments, as demonstrated by the increasing amount of loans and advances provided by the fincos. Fincos may be further allowed to further expand its role in providing SME financing, for instance, increased risk-sharing from government-related entities in relation to unsecured lending. This would be in line with the government's objective of providing more support to the SMEs and local start-ups scene as reiterated in the recent Budget.

Singapore finco's total loans and advances

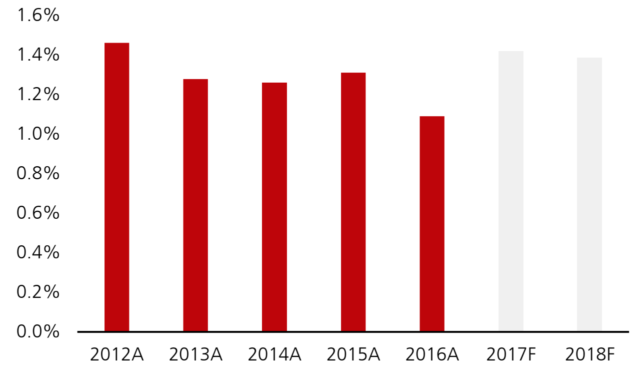


* including block discounting

Source: Monetary Authority of Singapore (MAS), DBS Bank

NIM set to recover after 2016's decline. FY2016's dip in NIM was caused by expensive fixed deposits taken in towards the end of 2015 due to competition for fixed deposits among banks alike, in lieu of the pending rate hike. HLF's cost of deposit was 1.6% for FY2016. According to our channel checks, fixed deposit rates have since fallen from the highs in end-2015 to beginning 2016 (some banks were offering as high as 1.8% - 1.9% for 12-month fixed deposits) to <1.3% currently. We believe that with expensive deposits now out of its system, HLF can focus on managing cost of funds going forward. There will also be a NIM uptick should Fed rate hikes translate into rising SIBOR yields in 2H2017. We estimate HLF's NIM for FY2017 to normalise to levels that are above FY2015's.

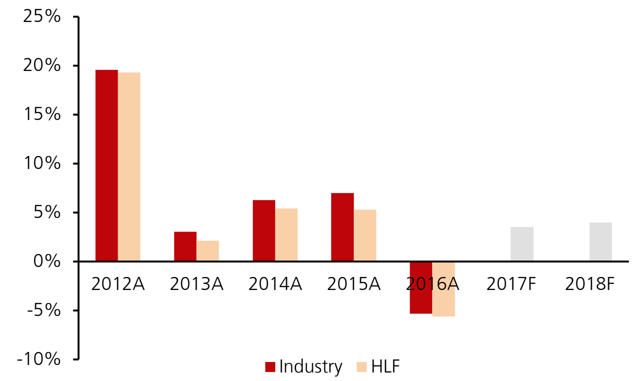
Net interest margin (%)



Source: Company, DBS Bank

Loan growth outlook. With the exception of FY2012 which saw expansion in balance sheet with loan growth of 19.3% and customer deposits growth of 29.4%, HLF's loan growth has been in the mid-single digit range between 2014 and 2015. 2016's loan book shrank due to lumpy development projects attaining Temporary Occupation Permit (TOP). We expect loan growth to be in the range of low single digits in FY17F due to the slower overall loan momentum in Singapore. HLF remains selective in writing loans for private residential properties due to the unattractive yield, and remains cautious about the commercial property market.

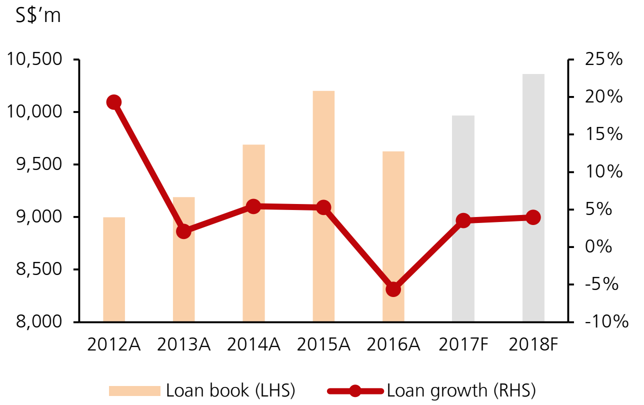
HLF vs industry loan growth (%)



Source: Company, DBS Bank

Highly selective key areas of growth. We remain optimistic about selected growth industries for HLF, such as medical and equipment financing, which continued to see high growth rates in the last few years. We also expect to see continued vehicle loan growth given the relaxation of rules on loan-to-value ratios and loan tenure, and unwavering interest in the luxury cars segment. HDB financing, in contrast to private residential properties, remains a key focus for HLF. The relaxation of unsecured lending limits could catalyse further lending.

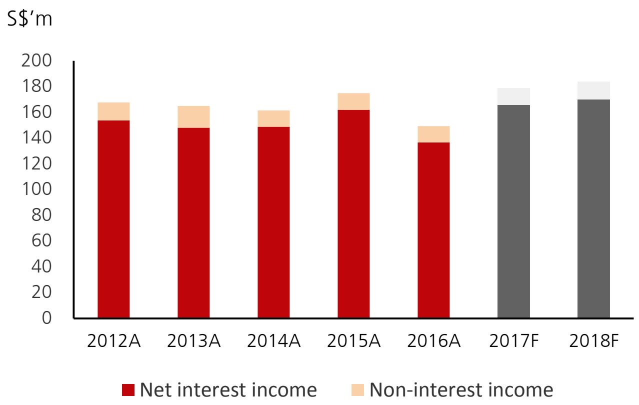
Loan book (S$ m) vs loan growth (%)



Source: Company, DBS Bank

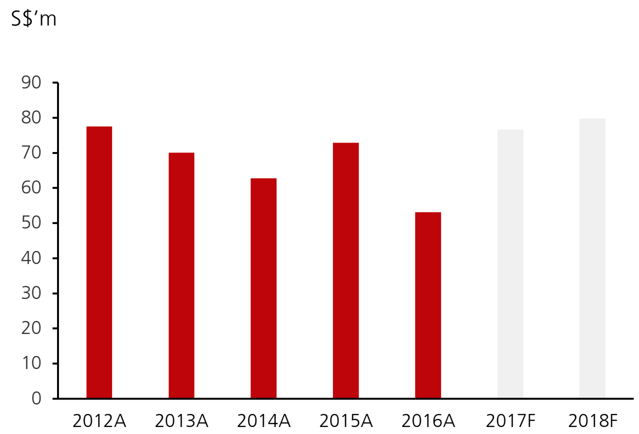
Earnings recovery in 2017. With loan growth returning back to positive territory, improved NIM, amid a recovering property outlook in Singapore for the coming years as signs are pointing to a bottoming out of the property cycle, as well as growth in non-interest income arising from corporate and advisory related services, we believe HLF will see stronger earnings in 2017.Our forecasts translates into > 40% increase in net profit, and accordingly, higher dividends per share to be declared.

Breakdown of HLF revenue (S$m)



Source: Company, DBS Bank

Net profit (S$m)



Source: Company, DBS Bank

Valuation

Initiate coverage with BUY and S$3.20 TP. Our TP of S$3.20 offers 18% upside potential, based purely on HLF's competitive strengths and growth prospects vs its finco peers. This is derived from the Gordon Growth Model with 5.1% ROE, 1.5% long-term growth and 5.8% cost of equity, implying approx. 0.8x FY17F BV.

Fincos are trading at c. 0.7x P/BV; potential re-rating on potential M&A newsflow. The share prices of the three fincos have surged by 10% to over 20% following the MAS announcement, and are currently trading at c.0.7x P/BV, with PEs of above 17x. From a P/BV perspective, these fincos are trading at a 30% discount to the banks. However, on a PE basis, it is considered lofty compared to banks given their sub-par ROEs.

HLF an attractive takeover target. We believe that HLF is an extremely attractive takeover target for foreign banks that are keen to expand their reach in the Singapore SME lending space, for the following reasons (1) its strong asset quality, (2) its niche lending expertise in property-related loans, (3) its extensive branch network.

Further 43% upside potential over last close on M&A possibility. We believe any takeover for fincos should be launched at above 1x P/BV, providing >43% upside over last close of S$2.70 and an additional 21% upside over our TP of S$3.20.

Key Risks

Asset-quality deterioration. There are still concerns over Singapore's sluggish economy outlook and that SME loans may turn sour, which could tilt HLF's asset-quality position. As most of HLF's loans are secured, together with HLF's conservative provisioning methodology and high loan loss allowance coverage, we believe that HLF is well-positioned to absorb any deterioration in asset quality.

Concentration in property-related loans. HLF has high exposure to the property sector. However, we are of the opinion that the worst is over for the Singapore property sector and we expect further government initiatives in the near term, which bode well for the sector and property developers at large.

Peer Comparison

	Price (S$)	Shares outstanding	Market Cap (S$m)	Bk Value/ share (S$)	P/B	P/E	ROE (%)	DPS (S$)	Div Yield (%)
Hong Leong Finance	2.70	444.7	1,200.8	3.82	0.71	22.6	3.14%	0.09	3.33%
Singapura Finance	1.09	158.7	172.2	1.58	0.69	87.7	0.79%	0.00	0.00%
Sing Investments & Finance	1.52	157.6	239.6	2.03	0.75	17.3	4.39%	0.05	3.29%
OCBC	9.72	4,183.6	40,664.6	8.64	1.12	11.7	9.94%	0.36	3.70%
UOB	22.05	1,636.2	36,077.3	18.82	1.17	11.7	10.21%	0.70	3.17%
DBS*	19.23	2,542.7	48,895.3	17.59	1.09	11.5	9.97%	0.60	3.12%

** Based on Bloomberg consensus*
Source: Bloomberg Finance L.P., DBS Bank

Share Performance Drivers -

Source: Bloomberg Finance L.P., DBS Bank

In our view, catalysts to HLF's share price going forward are:

(1) **HLF's competitive strength and growth prospects versus its finco peers.** Stronger loan growth, higher loan yields and lower cost of funds should contribute to higher net interest income and NIM for HLF. We observe that from 2010 to the beginning of 2012, HLF's share price was on a downward trend, in line with its full-year NIM. Between 2013 and mid-2015, HLF's share price was largely range bound due to flattish NIM of 1.3%. Thereafter, HLF's share price was on a downward trend due to lower full -year NIM. We believe our fair value of S$3.20 offers a 18% upside potential, based purely on HLF's competitive strengths and growth prospects vs its finco peers.

(2) **M&A newsflow.** We believe that HLF is an extremely attractive takeover target for foreign banks that are keen to expand their reach in the Singapore SME lending space. Any M&A-related newsflow would further catalyse HLF's share price. An M&A premium could further see HLF's share price run up by another 25%.

Key Assumptions

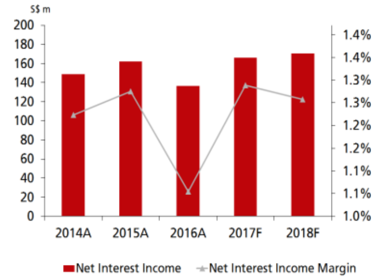
FY Dec	2014A	2015A	2016A	2017F	2018F
Gross Loans Growth	5.4	5.3	(5.7)	3.6	4.0
Customer Deposits Growth	5.7	9.3	(8.8)	5.0	7.0
Yld. On Earnings Assets	2.2	2.4	2.5	2.5	2.6
Avg Cost Of Funds	1.0	1.3	1.6	1.4	1.5

Income Statement (S$m)

FY Dec	2014A	2015A	2016A	2017F	2018F
Net Interest Income	149	162	137	166	170
Islamic Income	0.0	0.0	0.0	0.0	0.0
Non-Interest Income	12.5	12.9	12.8	13.2	13.6
Operating Income	**161**	**175**	**149**	**179**	**184**
Operating Expenses	(83.7)	(91.8)	(84.3)	(85.4)	(86.8)
Pre-provision Profit	**77.8**	**83.1**	**65.1**	**93.6**	**97.1**
Provisions	(2.0)	3.64	(1.1)	(1.2)	(1.0)
Associates	0.0	0.0	0.0	0.0	0.0
Exceptionals	0.0	0.0	0.0	0.0	0.0
Pre-tax Profit	**75.8**	**86.8**	**64.0**	**92.4**	**96.0**
Taxation	(13.0)	(13.9)	(11.0)	(15.7)	(16.3)
Minority Interests	0.0	0.0	0.0	0.0	0.0
Preference Dividend	0.0	0.0	0.0	0.0	0.0
Net Profit	**62.8**	**72.9**	**53.1**	**76.7**	**79.7**
Net Profit bef Except	62.8	72.9	53.1	76.7	79.7
Growth (%)					
Net Interest Income Gth	0.5	8.8	(15.7)	21.3	2.7
Net Profit Gth	(10.4)	16.0	(27.2)	44.6	3.9
Margins, Costs & Efficiency (%)					
Spread	1.1	1.1	0.9	1.1	1.1
Net Interest Margin	1.3	1.3	1.1	1.3	1.3
Cost-to-Income Ratio	51.8	52.5	56.4	47.7	47.2
Business Mix (%)					
Net Int. Inc / Opg Inc.	92.3	92.6	91.5	92.6	92.6
Non-Int. Inc / Opg inc.	7.7	7.4	8.5	7.4	7.4
Fee Inc / Opg Income	7.6	7.1	8.4	7.2	7.3
Oth Non-Int Inc/Opg Inc	0.1	0.2	0.1	0.1	0.1
Profitability (%)					
ROAE Pre Ex.	3.8	4.4	3.1	4.5	4.6
ROAE	3.8	4.4	3.1	4.5	4.6
ROA Pre Ex.	0.5	0.6	0.4	0.6	0.6
ROA	0.5	0.6	0.4	0.6	0.6

Source: Company, DBS Bank

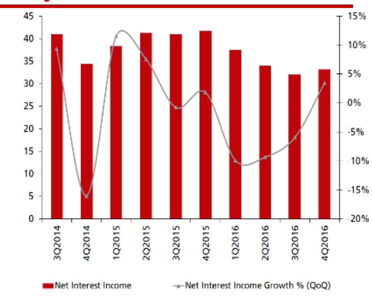
Margins Trend



Quarterly / Interim Income Statement (S$m)

FY Dec	4Q2015	1Q2016	2Q2016	3Q2016	4Q2016
Net Interest Income	41.7	37.5	34.0	32.0	33.1
Non-Interest Income	44.8	39.8	37.2	35.1	37.4
Operating Income	**44.8**	**39.8**	**37.2**	**35.1**	**37.4**
Operating Expenses	(21.0)	(23.1)	(21.9)	(20.4)	(18.9)
Pre-Provision Profit	**23.8**	**16.7**	**15.3**	**14.7**	**18.5**
Provisions	7.63	0.85	(1.9)	0.75	(0.8)
Associates	0.0	0.0	0.0	0.0	0.0
Exceptionals	0.0	0.0	0.0	0.0	0.0
Pretax Profit	**31.4**	**17.6**	**13.3**	**15.4**	**17.7**
Taxation	(4.9)	(3.0)	(2.3)	(2.7)	(3.0)
Minority Interests	0.0	0.0	0.0	0.0	0.0
Net Profit	**26.5**	**14.6**	**11.0**	**12.8**	**14.7**
Growth (%)					
Net Interest Income Gth	1.8	(9.9)	(9.3)	(5.9)	3.5
Net Profit Gth	57.5	(45.1)	(24.1)	15.8	15.0

Quarterly Net Profit & Growth

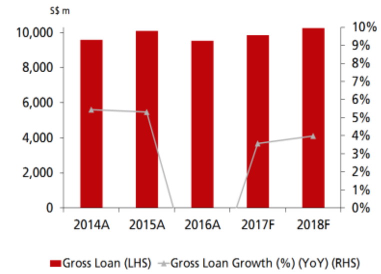


Balance Sheet (S$m)

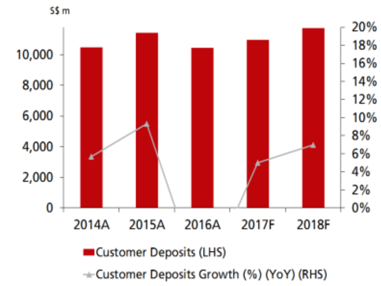
FY Dec	2014A	2015A	2016A	2017F	2018F
Cash/Bank Balance	1,365	1,796	1,485	1,645	1,994
Government Securities	1,259	1,333	1,258	1,271	1,296
Inter Bank Assets	0.0	0.0	0.0	0.0	0.0
Total Net Loans & Advs.	9,583	10,091	9,515	9,854	10,246
Investment	0.55	0.55	0.55	0.55	0.55
Associates	0.0	0.0	0.0	0.0	0.0
Fixed Assets	27.6	27.9	24.5	22.9	21.6
Goodwill	0.0	0.0	0.0	0.0	0.0
Other Assets	27.3	38.4	29.5	30.5	31.8
Total Assets	**12,262**	**13,287**	**12,313**	**12,823**	**13,591**
Customer Deposits	10,469	11,444	10,442	10,964	11,731
Inter Bank Deposits	0.0	0.0	0.0	0.0	0.0
Debts/Borrowings	0.0	0.0	0.0	0.0	0.0
Others	135	155	174	137	111
Minorities	0.0	0.0	0.0	0.0	0.0
Shareholders' Funds	1,659	1,688	1,697	1,722	1,749
Total Liab& S/H's Funds	**12,262**	**13,287**	**12,313**	**12,823**	**13,591**

Source: Company, DBS Bank

Gross Loan& Growth



Customer Deposit & Growth



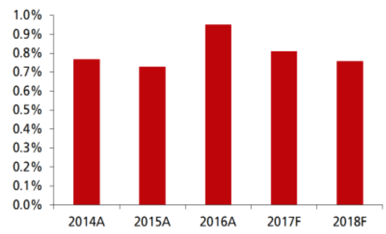
Financial Stability Measures (%)

FY Dec	2014A	2015A	2016A	2017F	2018F
Balance Sheet Structure					
Loan-to-Deposit Ratio	91.5	88.2	91.1	89.9	87.3
Net Loans / Total Assets	78.1	75.9	77.3	76.8	75.4
Investment / Total Assets	0.0	0.0	0.0	0.0	0.0
Cust . Dep./Int. Bear. Liab.	100.0	100.0	100.0	100.0	100.0
Interbank Dep / Int. Bear.	0.0	0.0	0.0	0.0	0.0
Asset Quality					
NPL / Total Gross Loans	0.8	0.7	1.0	0.8	0.8
NPL / Total Assets	0.6	0.6	0.7	0.6	0.6
Loan Loss Reserve Coverage	142.8	147.7	122.5	140.5	145.5
Provision Charge-Off Rate	0.0	0.0	0.0	0.0	0.0
Capital Strength					
Total CAR	16.4	15.1	16.4	N/A	N/A
Tier-1 CAR	0.0	0.0	0.0	0.0	0.0

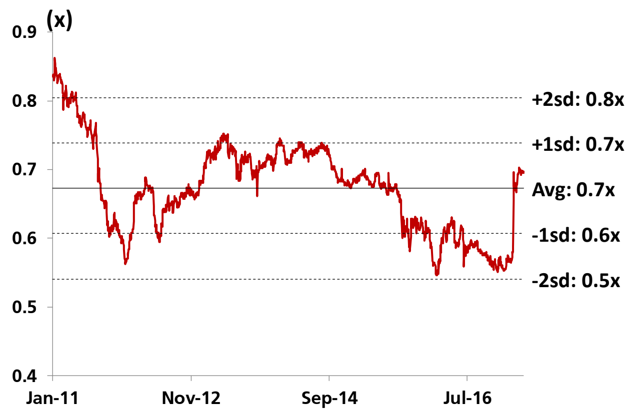
Lower NPL going forward

Source: Company, DBS Bank

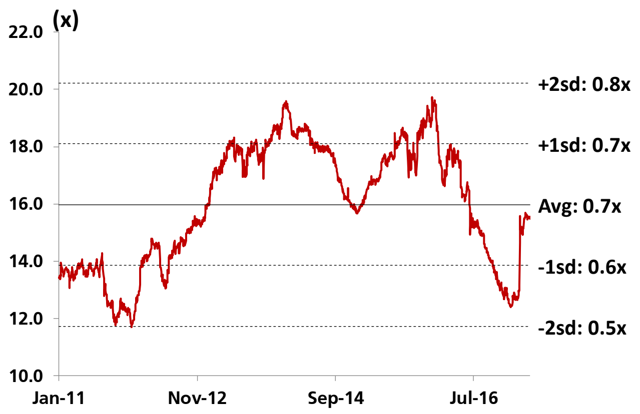
NPL / Total Gross Loans



Forward PB Band



Forward PE Band



Source: DBS Bank

Analyst: Singapore Research Team

Sue Lin LIM

DBS Bank recommendations are based an Absolute Total Return* Rating system, defined as follows:
STRONG BUY (>20% total return over the next 3 months, with identifiable share price catalysts within this time frame)
BUY (>15% total return over the next 12 months for small caps, >10% for large caps)
HOLD (-10% to +15% total return over the next 12 months for small caps, -10% to +10% for large caps)
FULLY VALUED (negative total return i.e. > -10% over the next 12 months)
SELL (negative total return of > -20% over the next 3 months, with identifiable catalysts within this time frame)

Share price appreciation + dividends

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