PATRICK TUTTLE, CO-GROUP CHIEF EXECUTIVE

NONBANK IN FOCUS: *PEPPER GROUP*

The **Pepper Group** (Pepper) business started in Australian nonconforming mortgages but has spread to a range of global locations and product types. Pepper's Sydney-based co-group chief executive, **Patrick Tuttle**, talks international strategy.

How does Pepper deploy its strategy globally?

■ When we go into a new market we try to secure what we regard as the best local management we can find in each jurisdiction, with depth of experience in the consumer asset classes in which we choose to be active. We overlay our own credit intellectual property in product design, tailored to local regulations and funding requirements.

The structure involves having local executive committees that run the business in each jurisdiction. Our global executive committee – chaired by our co-group chief executives, myself and Mike Culhane – sits above the local operations. This committee, which meets monthly and at least twice a year on a face-to-face basis, includes all our country heads and group executives like the chief financial officer and chief risk officer. This is not a formality – it is about sharing culture, best practice in funding, product design and credit approach.

Pepper's approach varies depending on location. Is there a specific strategic focus on deploying certain skill sets globally?

■ The original motivation for seeking growth outside Australia was to leverage our servicing capabilities in Europe's most distressed markets. We targeted, in no particular order, the UK, Ireland, Spain and Italy – looking to manage nonperforming loan portfolios on behalf of third-party investors.

In the longer term, we aimed to learn from the mistakes we saw in the loans for which we had taken over the servicing – the factors that made them not perform. This gave us the knowledge base to go back and start originating in our own right. By being a servicer first we have learned about things like regulatory nuance, product features and cultural differences in a range of markets.

The Asian strategy has been slightly different. Asia didn't suffer as badly during the financial crisis, so we have been led more by lending than servicing. Buying a savings bank in South Korea that could quickly start originating consumer-finance products was a deliberate strategy. It's the same with our investment in the PrimeCredit business in Hong Kong.

The business has clearly stepped up its goals in other lending sectors, including outside the mortgage market entirely. What is the goal?

■ One of the benefits of acquiring the businesses and management teams we've added in recent years is expertise in sectors other than our core market of nonconforming mortgages.

The personal-loans capability we have in our Spanish, South Korean and Hong Kong businesses, for instance, is second to none globally. We believe we can deliver an exceptional personal-loan offering in Australia by acquiring this sort of intellectual property and deploying our credit-underwriting skills.

It's the same in auto loans, where we are adding an exceptional local management team in Australia to product experience from our Irish, Spanish and South Korean businesses.

We have a clear strategy of diversifying Pepper into a more broad-based consumer-finance company. The model is all about leveraging our core credit-underwriting expertise while bouncing ideas between six or seven jurisdictions globally, to create products and design features that may not previously have existed in every region.

Pepper is listed and growing. Why not become an authorised deposit-taking institution (ADI)?

■ There is a regulatory barrier in Australia relating to our shareholding structure – having a major shareholder with around 30 per cent of the stock prevents us from becoming an ADI without an exemption from the federal treasurer.

We also don't feel being an ADI would give us a real competitive edge in Australia. The increasing capital requirements banks are dealing with would severely limit our ability to offer the range of products we have on the market, especially in the near-prime and nonconforming mortgage sectors. The risk-weighted-asset requirements of those portfolios would be crippling if we were an ADI.

The logic of being a bank versus a nonbank varies by market, so it is very much horses for courses in our business. For example, in South Korea it is much more efficient for us to be a licensed mutual-savings bank because local tier-one capital requirements are much more efficient. We hold 8-9 per cent tier-one capital in South Korea, which allows for very appealing return on equity given our consumer-loan-origination yield. •

PEPPER GROUP PROFILE

SIZE OF LOAN BOOK	A$6.5BN
MAKEUP OF LOAN BOOK	• PRIME RESIDENTIAL MORTGAGES: 30% • NONCONFORMING RESIDENTIAL MORTGAGES: 43% • PERSONAL LOANS, ASSET FINANCE AND OTHER: ND
GEOGRAPHIC DISTRIBUTION OF LOAN BOOK	• AUSTRALIA: 80% • OFFSHORE (IRELAND, SPAIN, SOUTH KOREA, UK): 20%
OUTSTANDING DEBT ISSUANCE	• SECURITISATION: A$2.7BN • SECURITISED WAREHOUSE FACILITIES: A$2.8BN • CORPORATE DEBT FACILITY: ND

About Pepper Group

Pepper Group (Pepper) is a specialist residential-mortgage and consumer lender and loan servicer, operating in targeted market segments in Australia and internationally, many of which are underserviced by traditional bank and other prime lenders. Pepper was established in 2000 and commenced lending as a specialist residential-mortgage lender in the Australian market in March 2001.

Pepper offers a broad range of lending products including residential mortgages, auto and equipment finance, point-of-sale finance and personal loans. Pepper also provides loan servicing for its own products as well as for third parties across residential mortgages, unsecured and secured consumer loans and commercial-real-estate-backed loans. Pepper has become a specialist-lending and loan-servicing group through a combination of organic growth and targeted global acquisitions.

At 30 June 2016, Pepper had A$53 billion of assets under management.

Ownership and capital structure

Pepper is listed on the Australian Securities Exchange and its capital structure consists of fully paid ordinary shares.

Funding strategy

Pepper finances its lending businesses through a mixture of warehouse facilities provided by commercial banks, term-securitisation issues, whole-loan sales, co-investment with global investment firms and deposits. Its day-to-day operations are funded through internally generated cash flow and a prudent combination of debt and equity.

The primary funding model for Pepper's lending business is based on long-term, limited-recourse loan-funding strategies. In order to achieve this, loans will typically first be originated into shorter-term warehouse facilities until they can be pooled into transactions that will fund the assets for their full term.

The warehouse facilities are provided by the three major Australian banks, many international banks and other financial institutions. Pepper has numerous warehouse facilities that have 12-36 month maturities and are repaid with term securitisations or other loan-sale transactions. The primary form of term funding is public and private securitisations in the global debt capital markets. The business has been a regular issuer into the debt capital markets since 2003, and its PRS and Pepper Prime programmes have maintained market-leading performance over this entire period. Since the commencement of the programmes, Pepper has issued more than A$6.6 billion of nonconforming and prime residential mortgage-backed securities notes.

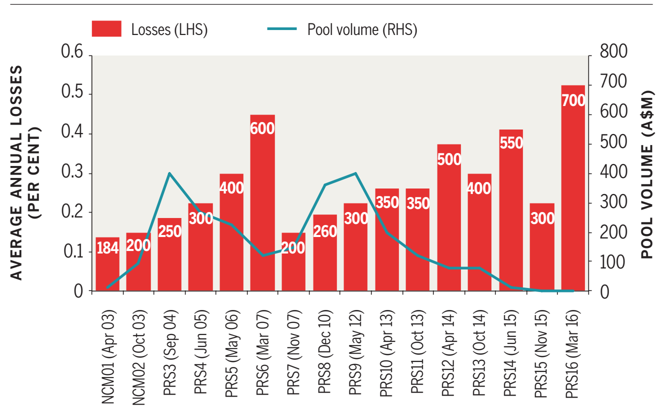
In addition to term securitisation, Pepper sells pools of loans at a premium to their par value. In the last two years, Pepper has executed a number of whole-loan sales of both prime and nonconforming mortgages which the firm continues to service on behalf of the buyer.

In South Korea, where Pepper owns a banking institution, loan originations are funded through a combination of deposits and whole-loan sales.

Corporate operations

Pepper primarily uses its own internally generated cash flow from the asset-servicing and lending businesses to fund corporate operations. In addition to this, Pepper retains a revolving corporate debt facility, which is used for working capital and investment in lending and other related businesses. Pepper maintains a disciplined ratio of corporate debt to the total equity of the business.

PEPPER GROUP ANNUALISED CUMULATIVE LOSSES ACROSS RMBS PORTFOLIOS



SOURCE: PEPPER GROUP JUNE 30 2016

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