



2016 ANNUAL MEETING

CHIEF EXECUTIVE OFFICER'S REPORT

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3. FINANCIAL PERFORMANCE

Net Profit After Tax was up 12% from last year. This was achieved through a combination of:

- maintaining the highest interest margin amongst our bank peers – at 4.53%
- growth across all our lending divisions – at 9%
- costs – as a percentage of income – reduced to 44% from 47%
- managing impairments – to below 0.5%

We therefore achieved this growth without compromising risk/return criteria and without needing to pay higher costs to generate it.

On the funding side, we grew our retail deposits by \$185m, or 9%. Deposits remain Heartland's primary source of funding and we do appreciate the support and confidence of our customer depositors.

Growth occurred across all of the Household, Business and Rural divisions. Within the Household division in particular, it was very pleasing to see continued growth in the high margin Consumer lending products, especially Motor Vehicle finance and in the strategically important Reverse Mortgage product.

The performance has driven strong shareholder returns – enabling Heartland to pay a total dividend for the year of 8.5c per share, representing a 13% increase from the previous year. Since our last annual meeting, the share price has increased by 16%.

At the AGM last year, we spoke to the fact that we were carrying capital in excess of prudential and internal management policy requirements and that if we could not utilise it we should return some of this excess to shareholders.

Many of you told us that you would prefer us to actually keep the capital. In the end, growth exceeded expectations – with \$252m of receivables growth during the 2016 financial year, and a further \$131m already in the first quarter of this financial year.

This higher than expected growth came from strong demand coming through in the Motor Vehicle book and the Harmony platform (Consumer confidence, high employment, low inflation) faster growth in Reverse Mortgages (especially in Australia) and the success of new digital offerings for Business and Personal loans.

Examples of growth by product type are:

- Motor vehicles – 10%
- Reverse Mortgages NZ – 8%
- Reverse Mortgages AU – 10%
- Business – 12%
- Livestock – 5%
- Rural – 15%

And in that growth in lending, we used our capital with more efficiency, increasing ROE to 11.1%. We are now moving towards the average ROE of the major Australian banks.

With respect to Capital Management our focus now shifts to optimising and indeed growing capital and in particular the potential to introduce hybrid equity.

We remain interested in acquisitions, and in particular UDC which would be an ideal fit, however that acquisition potential is currently unclear. At this stage, all we know is

that ANZ is reviewing its options for UDC and the market sentiment is that a decision is imminent. Obviously, if UDC is for sale, we would be an interested bidder, as we believe an acquisition complements our strategy and would provide a number of synergies.

Forecast and Performance

Performance in the first three months of the 2017 financial year has been strong. NPAT was \$14.3m, up 21% from the same period in the prior year. Net finance receivables have grown 4% for the quarter continuing the strong growth we experienced over the last two financial years. We expect strong growth in net finance receivables to continue.

On the other side of the balance sheet, we are seeing increasing competition for deposits due to the fact that after a sustained period in growth of NZ savings, credit growth is now outstripping Household deposit growth. Partially off-setting this has been a reduction in our wholesale cost of funds.

We are fortunate to be able to offer some attractive Call products, having what we believe is the best product in the market – both in terms of rate and flexibility.

A more competitive funding market may make deposits more expensive to obtain, and for the first time, we face the high quality problem of being able to be more selective as to where to lend to ensure we maintain margins while continuing to manage our impairment levels.

Generally speaking the industry is moving off historically low levels of impairments – we are no different. The general macro-economic environment for NZ is favourable, but internationally, markets are prone to event driven volatility. It is still necessary to be cautious and watchful in terms of exposure to global markets. In this regard we continue to support our dairy farmers and note the improving environment.

We remain confident in achieving our FY 2017 NPAT range of \$57-\$60m (not accounting for any capital management initiatives).

Strategy Update

Heartland's success to date has been based on identifying best or only products where we can gain a dominant position in a valuable niche. This has been especially successful in the Household sector with Motor Vehicle loans and Reverse Mortgages, and more recently, through online channels, such as Harmoney. This strategy accounts for our higher margin – giving customers what they want when they need it.

In the Business and Rural sectors, we have the potential to overlap with other banks and it is harder to compete by product alone. We have been successful with the livestock finance product, but, using the lessons gained in the Household markets, we now believe that there are new emerging opportunities to acquire Business and Rural customers through differentiated digital channels, in particular by being faster and more flexible than major banks.

An example of this is Open for Business – an online origination platform we launched in April. This targets the great majority of small businesses in New Zealand who are time poor due to their heavy personal commitment to the business. Typically, these small businesses are owner operated, and the major banks are often only interested in lending to them if they can take a mortgage over the family home. For these people, the home is important for their family security, and many feel it is not appropriate to mix business and personal matters.

Heartland is able to offer these loans on an unsecured basis because we can price to cover risk and employ credit tools which enable us to focus on the likelihood of default, back the owner and the business supported by a personal guarantee, not the real estate sitting behind.

Open for Business is capable of approving a customer's loan application of less than \$50k in under 3 minutes on a smart phone. This allows a busy business owner to apply for a loan on the way to quoting on a job.

The emerging technology for digital platforms is not only the fastest, it is the cheapest. We can make the process of applying straightforward, while utilising highly predictive credit tools and can legitimately aim at being the fastest at originating loans – also at the lowest cost.

New data analytics allows us to be more precise in our marketing, by analysing behaviours to indicate customers with appropriate needs and credit worthiness.

We see tremendous opportunities to expand our product range into the emerging 'Millennial market', which in its demographic sense comprises people in their late teens through to mid-thirties. They are also referred to as 'digital natives', not just because they grew up surrounded by digital technology and take it for granted, but also because digital has shaped their not-negotiable expectation for speed, ease and choice – ideally transacted via smartphone.

When they visit a commercial website, they know exactly what they want, and they want to find it fast. They do not want to be confronted by the traditional bank model of trying to cross-sell different products. This is confusing and self-serving to the banks.

We expect digital use to expand – the fastest growing demographics for social media use are people aged 55+. So we are also developing digital platforms offering 'speed and ease' for our Depositors and already have semi-digital access for Reverse Mortgage customers who are part of this demographic.

Within the next three months we aim to have in place the following online origination channels:

- Residential mortgages
- Livestock
- Deposits
- Distributor specific solutions (eg Holden / Isuzu)

It is important though to maintain a degree of channel agnosticism – we will not force customers into transacting in a particular way – so it is expected that we will maintain a multi- channel strategy:

1. **Relationship** – typically larger Rural and Business

2. **Intermediary or transition** – where we will offer both relationship management, typically personalised telephone-based service, as well as online origination
3. **Digital** – fully online origination

Over time, we expect customers to prefer to transact in a digital environment, but our response will be customer driven. We will, however, aim to be the leading digital bank for origination.

And it is important to note the distinction between digital origination and online banking.

Online Banking is used for payments – in most parts of the world payments are either an oligopoly dominated by a few providers or are commoditised. In New Zealand it is the former, we do not intend to be a leader in online banking in this sense. However, new technologies are emerging – especially in block chain technology – which have the potential to disrupt the big banks’ stranglehold on payments – and we would prefer to wait for the next generation of technologies. But we do intend to be a leader in the online origination of loans.

4. **SUMMING UP**

In the coming financial year, our focus is firmly on ensuring that we become the leading bank for digital origination. We will be busy developing and launching the new online platforms for mortgages, livestock, deposits, and continue to improve and refine our back office processes to support the origination power of these platforms.

Thank you, our shareholders and depositors for your continued support.