

LH FINANCIAL GROUP PLC

No. 61/2019
26 April 2019

FINANCIAL INSTITUTIONS

| | |
|------------------------|--------|
| Company Rating: | BBB+ |
| Issue Rating: | |
| Senior unsecured | BBB+ |
| Outlook: | Stable |

Last Review Date: 13/07/18

Company Rating History:

| Date | Rating | Outlook/Alert |
|----------|--------|---------------|
| 09/05/18 | BBB+ | Positive |

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RATIONALE

TRIS Rating affirms the company rating on LH Financial Group PLC (LHFG) and the rating on LHFG's senior unsecured debentures at "BBB+". At the same time, TRIS Rating revises the rating outlook of LHFG to "stable" from "positive". The outlook reflects a lengthened period of time beyond our initial expectation that LHFG will be able to leverage its strategic alliance with CTBC Bank Co., Ltd. (CTBC Bank) from Taiwan. Benefits include expanding its client base, raising the contribution from fees and service income, and/or lowering its credit concentration.

The ratings reflect LHFG's creditworthiness as a non-operating holding company of LH Financial Group. The main operating asset of LHFG is Land and Houses Bank PLC (LH BANK), in which LHFG holds a 99.99% equity stake. The ratings are based on the stable stream of dividends it receives from LH BANK. The ratings also take into consideration the strong capital and good asset quality of LH BANK. On the contrary, the commercial bank's modest franchise, high concentration on corporate loans, and relatively high reliance on wholesale funding constrain LH BANK'S rating, which in turn impacts LHFG's ratings.

KEY RATING CONSIDERATIONS

A financial institution's non-operating holding company (NOHC)

TRIS Rating's assessment of LHFG reflects its status as a holding company of a financial service group. LHFG's company rating is one notch lower than that of its core bank subsidiary, LH BANK ("A-/Stable"). The one notch difference reflects several key factors, such as the structural subordination of LHFG's obligations to those of LH BANK, LHFG's dependence on dividends from LH BANK, and risk of a regulatory barrier surrounding payment of dividends from LH BANK.

LHFG's subsidiaries comprise LH BANK ("A-/Stable"), Land and Houses Fund Management Co., Ltd. (LH Fund), Land and Houses Securities Co., Ltd. (LH Securities), and Land and Houses Advisory Co., Ltd. (LH Advisory). LHFG's consolidated assets reached Bt246billion at the end of 2018. LHFG's financial position reflects almost entirely that of LH BANK since LH BANK's assets make up 98.8% of LHFG's assets. LH Bank's franchise remains modest. Market shares in loans and deposits were at 1.3% and 1.4% at the end of 2018, respectively. Total assets of the bank were Bt239 billion as of the end of 2018, ranking 11th among Thai commercial banks.

A new platform for growth

Despite slower progress than anticipated, we still expect LH Bank and other subsidiaries of LHFG to gradually expand the franchise and diversify sources of earnings from its new businesses. In longer term, we expect a gradual growth in net fee income as a percentage of total revenue from the 9.6% in 2018.

The group recently launched new products and services to serve business clients including trade finance, foreign-exchange, foreign-currency deposit, and payroll services. Meanwhile, LHFG is pursuing new strategies whilst building capacity in the existing areas of business banking, transaction banking, and wealth management. In transaction banking, for example, it seeks to tap potential synergies with its new partner, "QFPay", a Chinese-based mobile payment platform. The strategy is to bring a large number of Terminal 21

shopping mall tenants onto QFPay's platform and five-star Grande Centre Point hotels, both of which are owned and operated by LH Mall and Hotel Co., Ltd. (LHMH), a subsidiary of Land & Houses PLC (LH, rated "A+/Stable" by TRIS Rating), one of LHFG's parents. Terminal 21 malls and Grande Centre Point hotels are located in tourist spots. This could potentially create a massive volume of payment transactions, which bodes well for LH Bank's fee income generation in the future.

Another new strategy is integrating LHFG's securities brokerage and asset management services with LH Bank's mobile banking platforms to expand the Group's product and service offerings to the bank's wealth clients.

Capital to remain strong

We expect the Group to maintain its strong capital. We forecast LH Bank's core equity tier-1 (CET-1) ratio in the range of 17%-18% over the next three years, sufficient to support business expansion. We also assume the bank's loan growth of around 6% per year and a dividend pay-out ratio of 40% of net profit. CET-1 ratio accounted for 85% of the bank's total capital at the end of 2018, indicating a high quality of capital.

Strong banking asset quality but credit concentration remains a concern

LH BANK has a higher credit concentration, compared with other small- and mid-sized Thai banks rated by TRIS Rating. A small number of the bank's largest clients make up a substantial portion of the loan portfolio and deposit funding. Corporate loans made up 75% of total loans at the end of 2018. LH BANK also lacks a broad base of retail customers and does not have a wide range of funding sources.

LH Bank's asset quality has been strong. The reported gross non-performing loan (NPL) ratio was 2.2% at the end of 2018, compared with a commercial bank average of 3.1%, thanks to a focus on high quality corporate borrowers. The bank's loss experience is also better than the industry average. Credit cost was 0.4% in 2018, compared with a commercial bank average of 1.4%. Loan loss reserves to reported NPLs (NPL coverage) was at 108% in 2018. Although NPL coverage was higher than 80% in 2014 and 92% in 2015, it is still below the industry average of 147%.

Funding support from LH BANK

On the consolidated basis, LHFG's funding profile largely mirrors that of LH Bank's. LH BANK's funding is weaker and more concentrated than other banks rated by TRIS Rating. LH and Quality Houses PLC (QH)¹ are among the major depositors of LH Bank. Nonetheless, the bank has expanded its deposit base considerably. The loan-to-deposit ratio also fell to 95% at the end of 2018, from 107% in the previous year, due to strong deposit growth. Current account and savings account (CASA) to total deposits was 47% of total deposits at the end of 2018, below the industry average of around 60%. We also believe the Group's recent growth in terms of deposits reflects a move to comply with net stable funding ratio (NSFR) requirements made by the Bank of Thailand (BOT) and to secure its low funding costs. On a stand-alone basis, LHFG and LHFG's subsidiaries receive funding support from LH Bank in the form of credit facilities.

Adequate liquidity

On a consolidated basis, LHFG's liquidity is adequate, reflected by LH Bank's liquidity coverage ratio (LCR) which is above the regulatory requirements². However, the LCR is less than the average of 158% for smaller banks and 183% for all commercial banks, as reported by the BOT. Liquid asset to total assets ratio was at 36% in 2018 on a consolidated basis and 27% on a stand-alone basis.

BASE-CASE ASSUMPTIONS

The followings are our key assumptions for the performance of LHFG for 2019-2021:

- Loan growth at around 6%
- Credit cost at around 0.4%
- NPL ratio of 2.2%-2.4%
- CET-1 ratio (LH BANK) at 17%-18%
- Risk-adjusted net interest margin (NIM) of around 1.8%

¹ Land and Houses PLC (LH) and Quality Houses PLC (QH), respectively, holds 21.9% and 13.7% shares in LHFG.

² The regulatory requirement of a liquidity coverage ratio (LCR) is 90% in 2019 and 100% in 2020.

RATING OUTLOOK

The “stable” outlook of LHFG is in line with LH BANK’s rating outlook. The “stable” outlook reflects our expectation that its major banking subsidiary, LH Bank, will still benefit from CTBC Bank’s business and capital support. We expect this to be evidenced by gradual expansion of its banking franchise and client base as well as an increase in contributions from fees and service income. At the same time, we expect LH Bank’s credit concentration to be on a downward trend downward in the medium term.

RATING SENSITIVITIES

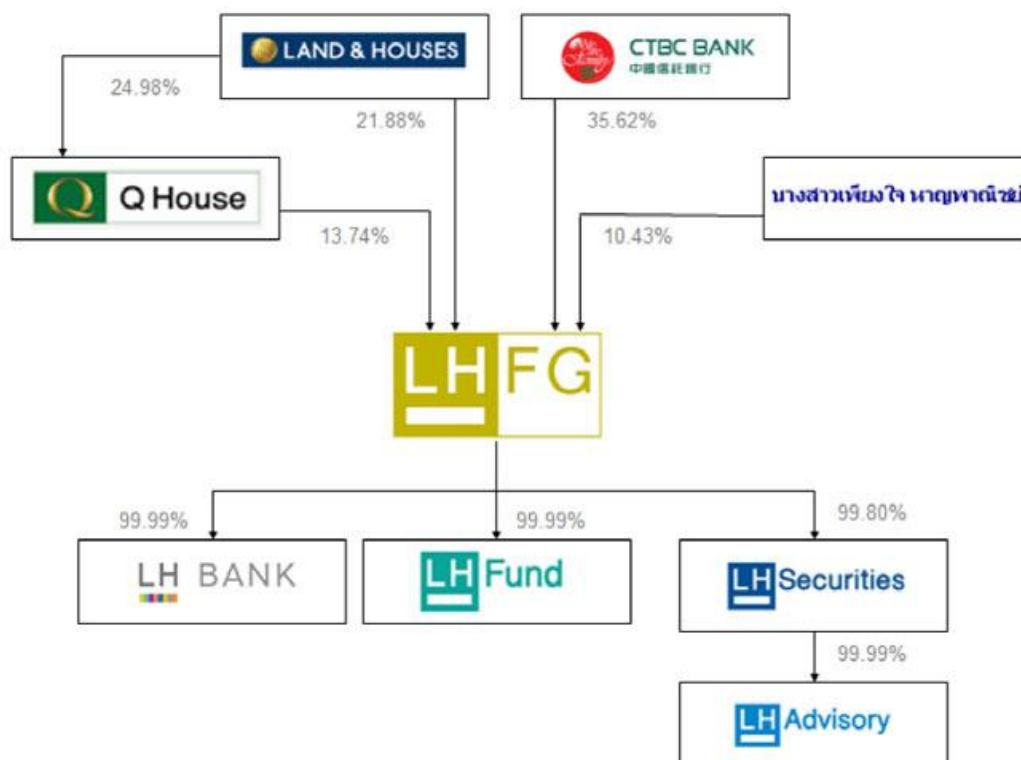
The rating upgrade hinges on the success of LH BANK’s effort to expand its franchise and revenue. We expect to see stronger evidence of improvements at LH Bank, including a more diversified customer base, stronger market share in loans and deposits, higher net fees and service income as a percentage of total revenue, and lower credit concentration. At the same time, the bank should maintain sound asset quality, capital base, and profitability. We could revise a rating downward if its capital weakens significantly and/or there is material deterioration in its asset quality or earnings capacity.

COMPANY OVERVIEW

LHFG was established on 22 April 2009 as a non-operating holding company under the Bank of Thailand’s consolidated supervision principle. LH BANK was set up as a subsidiary under the solo consolidation group, while LH Fund was a subsidiary outside the solo consolidation group. After a restructuring, the shareholders of LH BANK became the shareholders of LHFG, which holds 99.99% of paid-up shares of LH BANK. LHFG acquired a 99.80% stake in CIMB International (Thailand) PCL and a 99.99% stake in CIMB Advisory (Thailand) Co., Ltd. from CIMB International. The two companies were renamed Land and Houses Securities PCL (LH Securities) and Land and Houses Advisory Co., Ltd. (LH Advisory). On 1 March 2016, LHFG also acquired a 99.99% stake in LH Fund from LH BANK as part of a group restructuring. On 27 July 2017, CTBC Bank, a banking subsidiary of CTBC Financial Holding Co., Ltd. (CTBC FHC) in Taiwan, acquired 35.6% of LHFG. The combined shareholding of Land and Houses PLC (LH) and Quality Houses PLC (QH) in LHFG, therefore, was reduced to 35.6%. Other key subsidiaries under CTBC FHC include life insurance, securities, venture capital, and asset management. CTBC Bank is well-positioned in wealth management and credit card services, and is well-established in corporate banking, offering products like trade finance, treasury services, transaction banking, and offshore finances. CTBC Bank is rated “A/Stable” by S&P Global Ratings and “A2/Stable” by Moody’s Investors Service (Moody’s).

A strategic partnership formed with CTBC Bank has changed the board and management structure of LHFG. The Group welcomed three new members to its board and a new management team appointed by CTBC Bank. New business units are: 1) the Strategic Business Development unit, in charge of new product development such as trade finance and cash management, and Taiwan Business Development, and 2) the Wealth Management Business Planning unit.

Table 1: LHFG Group Structure



Source: LHFG's company website

FINANCIAL STATISTICS AND KEY FINANCIAL RATIOS¹

Unit: Bt million

| | Year Ended 31 December | | | | |
|---|------------------------|---------|---------|---------|---------|
| | 2018 | 2017 | 2016 | 2015 | 2014 |
| Total assets | 245,933 | 233,111 | 212,147 | 199,667 | 164,970 |
| Average assets | 239,522 | 222,629 | 205,907 | 182,318 | 157,035 |
| Investment in securities | 67,360 | 59,623 | 52,676 | 47,203 | 33,728 |
| Loans and receivables | 159,541 | 153,946 | 141,301 | 133,322 | 115,874 |
| Allowance for doubtful accounts | 3,801 | 3,422 | 3,102 | 2,564 | 2,145 |
| Deposits | 168,164 | 143,731 | 149,097 | 137,064 | 122,632 |
| Borrowings ² | 35,434 | 48,242 | 40,337 | 42,303 | 24,171 |
| Shareholders' equities | 39,709 | 38,555 | 20,316 | 17,951 | 16,286 |
| Average equities | 39,132 | 29,435 | 19,133 | 17,119 | 15,654 |
| Net interest income | 4,805 | 4,979 | 4,839 | 4,366 | 3,382 |
| Non-interest income ³ | 2,255 | 1,514 | 2,128 | 1,177 | 865 |
| Total revenue | 7,060 | 6,493 | 6,967 | 5,543 | 4,247 |
| Operating expenses ⁴ | 2,768 | 2,721 | 2,601 | 2,400 | 2,045 |
| Pre-provision operating profit (PPOP) | 4,291 | 3,773 | 4,366 | 3,144 | 2,202 |
| Impairment losses on loans and securities | 570 | 617 | 1,025 | 1,090 | 710 |
| Net income | 3,108 | 2,603 | 2,697 | 1,652 | 1,201 |
| Net fee and service income | 681 | 654 | 511 | 349 | 216 |
| Gains on investments | 342 | 241 | 1,188 | 673 | 491 |

1 Consolidated financial statements
 2 Including interbank and money market
 3 Net of fees and service expense
 4 Excluding fees and service expense

Unit: %

| | ----- Year Ended 31 December ----- | | | | |
|--|------------------------------------|--------|--------|-------|-------|
| | 2018 | 2017 | 2016 | 2015 | 2014 |
| Earnings | | | | | |
| Return on average assets | 1.30 | 1.17 | 1.31 | 0.91 | 0.77 |
| Interest spread | 1.66 | 1.94 | 2.10 | 2.11 | 1.83 |
| Net interest margins | 1.99 | 2.22 | 2.34 | 2.39 | 2.15 |
| Net interest income/average assets | 2.01 | 2.24 | 2.35 | 2.39 | 2.15 |
| Non-interest income ⁵ /average assets | 0.94 | 0.68 | 1.03 | 0.65 | 0.55 |
| Net fee and service income/total revenue | 9.65 | 10.07 | 7.33 | 6.30 | 5.09 |
| Cost-to-income | 39.21 | 41.90 | 37.33 | 43.29 | 48.16 |
| Capitalisation | | | | | |
| CET-1 ratio ⁶ | 17.50 | 19.30 | 10.54 | 10.61 | 12.16 |
| Tier-1 ratio ⁶ | 17.50 | 19.30 | 10.54 | 10.61 | 12.16 |
| BIS ratio ⁶ | 20.24 | 22.37 | 13.90 | 14.29 | 13.24 |
| CET-1/BIS ratio ⁶ | 86.47 | 86.31 | 75.83 | 74.25 | 91.84 |
| Asset Quality | | | | | |
| Credit costs | 0.36 | 0.42 | 0.75 | 0.87 | 0.65 |
| Non-performing loans/total loans ⁷ | 1.93 | 1.88 | 1.76 | 1.89 | 1.98 |
| Non-performing assets/total assets | 3.04 | 3.20 | 3.06 | 3.09 | 3.49 |
| Allowance for loan losses /non-performing loans | 107.65 | 104.41 | 111.58 | 90.78 | 82.11 |
| Funding & Liquidity | | | | | |
| CASA/total deposits ⁸ | 44.38 | 44.10 | 42.68 | 37.01 | 44.21 |
| Loan/total deposits ⁸ | 87.44 | 89.12 | 86.60 | 86.08 | 93.72 |
| Deposits ⁸ /total liabilities | 88.48 | 88.79 | 85.05 | 85.23 | 83.15 |
| Liquid assets/total deposits ⁹ | 46.01 | 42.91 | 39.37 | 38.24 | 33.62 |
| Liquid assets/short-term liabilities ¹⁰ | 47.49 | 45.51 | 40.83 | 41.61 | 36.02 |

5 Net of fee and service expenses

6 Consolidated basis

7 Based on reported NPL

8 Including bills of exchange

9 Including bills of exchange and interbank borrowing

10 Financial liabilities with maturity less than one year

RELATED CRITERIA

- Commercial Banks, 30 March 2017
- Group Rating Methodology, 10 July 2015

LH Financial Group PLC (LHFG)

| | |
|--|--------|
| Company Rating: | BBB+ |
| Issue Rating: | |
| LHFG207A: Bt2,000 million senior unsecured debentures due 2020 | BBB+ |
| Rating Outlook: | Stable |

TRIS Rating Co., Ltd.

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