Malaysia **Trading Idea**

16 August 2019

Financial Services | Non-Bank Financials

RCE Capital (RCE MK)

Non Rated

Measured Growth, Undemanding Valuations

Fair value (Return)	MYR2
Price:	MYR1.59
Market Cap:	USD134.64m
Avg Daily Turnover (MYR/USD)	0.34m/0.08m

- **Fair value of MYR2 based on a GGM-derived P/BV of 1.1x against FY20F (Mar) ROE of 16%.** RCE Capital, a provider of general financing services for civil servants, is forecast to achieve sustained earnings growth of 6% pa in FY20F-21F on measured loan growth – this is as management focuses on asset quality. Current valuation multiples of 0.99x P/BV (March) and a mere 5.4x FY20F P/E are undemanding, while its yield of 6% is attractive.
- **Measured loan growth in challenging times.** RCE achieved healthy 3-year CAGR loan growth of 8.2% pa in FY17-19, helped by healthy consumption spending and expansion in its customer base: To 79,000 from 60,000 over the same period. Management sees opportunity to further increase its customer numbers, given RCE's small c.5% market share of Malaysia's 1.7m civil servants. That said, management is focused on asset quality in the current challenging economic environment and expects loan growth to track system growth over the near term. Still, we believe an increase in its loans should continue to outpace the system, albeit slightly.
- **Improved funding costs.** RCE established a new MYR2bn *sukuk murabahah* assets-backed securitisation programme with the first tranche issued in March. To date, the cumulative issuance stands at MYR373m, with a weighted average profit rate at 4.81% – 59bps lower than the previous MYR900m *sukuk* programme. This should help support NIMs, even as average loan yields trends lower. Although total borrowings increased to MYR1,605bn as at end-FY19, to support expansion in lending business, RCE's net gearing ratio remains healthy at 1.9x. We expect net gearing to be relatively stable at 1.7-1.8x.
- **NPLs stable, LLC comfortable.** RCE's GIL ratio has been stable at 7.1-7.4% in FY17-19 – improving from a high of 13.7% in FY13 – while NPL ratio ranged between 4.1% and 4.4% in FY16-19. The LLC of NPLs is comfortable at 172-178%. Given proactive management of asset quality, we expect the latter to remain solid. That said, we have conservatively pencilled in higher credit costs for FY20-21.
- **Earnings and dividend forecasts.** We expect RCE to deliver net profit growth of 5.8% in FY20 and 6.3% FY21. The slower growth compared to FY19's increase of 7.7% reflects expectations for a moderation in loan growth to 4.8% pa and higher impairment allowance, as economic growth softens. We expect the company to maintain the payout ratio at c.32% over the next two years, which would mean DPS of 9.5 sen for FY20F and 10 sen for FY21F.

Forecasts and Valuation	Mar-18	Mar-19	Mar-20F	Mar-21F	Mar-22F
Reported net profit (MYRm)	88.7	95.5	101.1	107.5	114.9
Net profit growth (%)	12.3	7.7	5.8	6.3	6.9
Recurring net profit (MYRm)	88.7	95.5	101.1	107.5	114.9
Recurring EPS (MYR)	0.26	0.28	0.29	0.31	0.33
BVPS (MYR)	1.46	1.61	1.82	2.05	2.31
DPS (MYR)	0.070	0.090	0.095	0.100	0.105
Recurring P/E (x)	6.1	5.7	5.4	5.1	4.8
P/B (x)	1.09	0.99	0.87	0.77	0.69
Dividend Yield (%)	4.4	5.7	6.0	6.3	6.6
Return on average equity (%)	18.5	17.3	16.2	15.2	14.4
Return on average assets (%)	4.98	4.68	4.18	3.95	3.95

Source: Company data, RHB

Analyst

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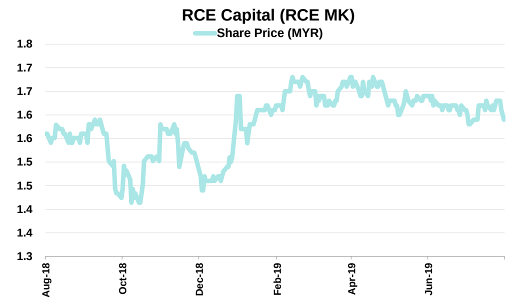
Share Performance (%)

	YTD	1m	3m	6m	12m
Absolute	8.2	-1.2	-1.9	-1.9	-3.6
Relative	10.3	0.0	-2.9	0.4	2.5
52-wk Price low/high (MYR)					1.38 – 1.72



Source: Bloomberg

Financial Exhibits

Asia
Malaysia
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RCE Capital
RCE MK

Valuation basis

We use Gordon Growth Methodology to derive the target P/BV multiple. Key assumptions:

i. COE of 13.9%;
ii. ROE of 15%;
iii. 3% long-term growth.

Key drivers

Our FY20 forecasts are most sensitive to changes in:

i. Financing margins;
ii. Impairment allowances;
iii. Growth in receivables.

Key risks

Downside risks include:

i. Higher credit costs;
ii. Weaker NIMs;
iii. Weaker growth in receivables.

Company Profile

RCE provides general financing services to civil servants with repayments via direct salary deductions through Biro Perkhidmatan Angkasa and the Accountant General's Department of Malaysia. Its wholly-owned EXP Payment unit offers payroll collection management services for government departments under the purview of the Accountant General.

Financial summary	Mar-18	Mar-19F	Mar-20F	Mar-21F	Mar-22F
EPS (MYR)	0.26	0.28	0.29	0.31	0.33
Core EPS (MYR)	0.26	0.28	0.29	0.31	0.33
DPS (MYR)	0.07	0.09	0.10	0.10	0.11
BVPS (MYR)	1.46	1.61	1.82	2.05	2.31

Valuation metrics	Mar-18	Mar-19F	Mar-20F	Mar-21F	Mar-22F
Recurring P/E (x)	6.1	5.7	5.4	5.1	4.8
P/B (x)	1.09	0.99	0.87	0.77	0.69
Dividend yield (%)	4.4	5.7	6.0	6.3	6.6

Balance sheet (MYRm)	Mar-18	Mar-19F	Mar-20F	Mar-21F	Mar-22F
Gross loans & advances	1,643	1,729	1,813	1,900	1,991
Loan impairment allowances	(119)	(130)	(144)	(157)	(164)
Net loans & advances	1,525	1,599	1,669	1,742	1,827
Total assets	1,859	2,226	2,608	2,837	2,976
Deposits from customers	1,298	1,605	1,904	2,051	2,101
Total liabilities	1,340	1,643	1,943	2,086	2,133
Shareholders' funds	519	584	665	751	843
Total equity	519	584	665	751	843

Income statement (MYRm)	Mar-18	Mar-19F	Mar-20F	Mar-21F	Mar-22F
Net interest income	144	156	174	186	191
Non-interest income	40	39	38	41	44
Operating income	184	195	211	226	235
Overhead expenses	(41)	(45)	(48)	(50)	(52)
Pre-provision operating profit	142	150	164	176	182
Loan impairment allowances	(25)	(18)	(25)	(29)	(27)
Other impairment allowances	0	0	0	0	0
Associates	0	0	0	0	0
Pretax profit	117	131	139	147	155
Reported net profit	89	96	101	108	115
Recurring net profit	89	96	101	108	115

Profitability	Mar-18	Mar-19F	Mar-20F	Mar-21F	Mar-22F
ROA (%)	4.98	4.68	4.18	3.95	3.95
ROE (%)	18.5	17.3	16.2	15.2	14.4
Yield on IEAs (%)	12.93	12.26	11.90	11.80	11.75
Cost of funds (%)	5.52	5.38	5.26	5.15	5.10
Net interest margin (%)	8.73	8.18	7.77	7.62	7.56
Non-II / Total income (%)	21.5	19.8	17.8	17.9	18.7
CIR (%)	22.5	23.2	22.5	22.1	22.4
Credit cost (bps)	158	110	139	157	138
PIOP growth (%)	15.2	5.0	9.3	7.9	3.2
Net profit growth (%)	12.3	7.7	5.8	6.3	6.9

Asset quality	Mar-18	Mar-19F	Mar-20F	Mar-21F	Mar-22F
Gross impaired loans/Gross loans (%)	7.10	7.40	7.93	8.28	8.24
Loan loss coverage ratio (%)	178.0	172.1	175.0	177.0	178.0
NPL formation (bps)	4	4	5	5	5

Liquidity	Mar-18	Mar-19F	Mar-20F	Mar-21F	Mar-22F
Loan growth (%)	8.0	5.2	4.8	4.8	4.8
Customer deposits growth (%)	7.0	23.6	18.6	7.7	2.4
LDR (%)	126.6	107.7	95.2	92.6	94.8
Net gearing (x)	2.1	1.9	1.8	1.7	1.6

Source: Company data, RHB

Investment Thesis

Loan growth that tracks system's growth

In the current challenging economic environment, there is no shortage of lending opportunities for RCE's consumer financing products, which cater to the lower-income earners segment. That said, management is focused on the quality of loans that gets added to its balance sheet, particularly in the current slowing economy. We view this measured approach to its lending business positively, as it should help preserve the quality of RCE's loans book.

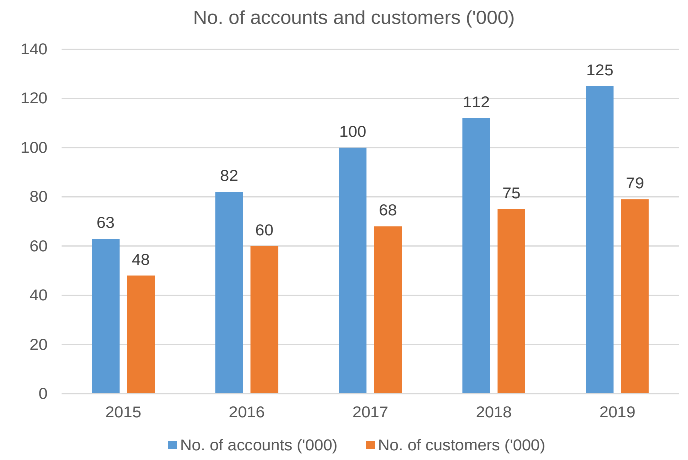
Management aims to track system loan growth in FY20. The company expanded its loan portfolio 5.2% in FY19, slightly ahead of banking system loan growth of 4.9% YoY in March. We have pencilled in loan growth of 4.8% pa for FY20 and FY21.

Expect sustained expansion in customer base

RCE's loan growth should be supported by sustained expansion in its customer base, namely the civil service. The company has approximately 79,000 customers as at end March, which is a mere 4.6% of the total 1.7m civil servants in the public sector. We see good opportunity for RCE to gradually enlarge its market share. This is evident by a CAGR growth of 13% pa in customer base and +18.7% pa in number of accounts between FY15 and FY19.

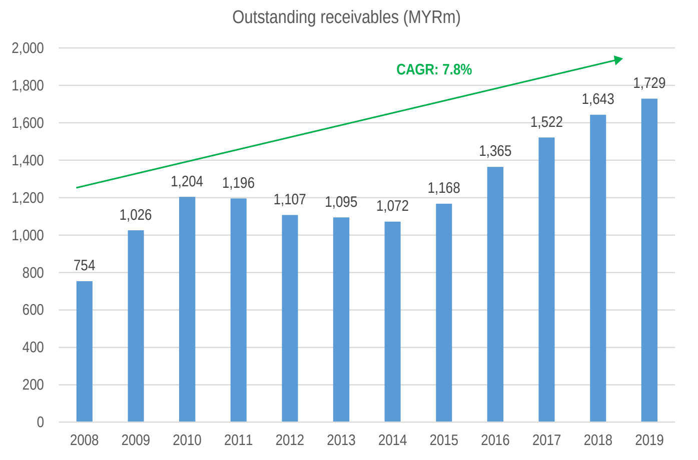
About 28% of RCE's customers have monthly salaries of between MYR3,000 and MYR5,000, while another 26% earn more than MYR5,000 per month. Average loan size: Approximately MYR16,000, with maximum tenure of 10 years and monthly repayments made through direct salary deductions. These loans are generally used for home renovation (c.22.5% of total receivables), medical, education, and other personal uses.

Figure 1: RCE's growth in customer base



Source: Company data, RHB

Figure 2: RCE's growth in outstanding receivables



Source: Company data, RHB

Less impacted by Overnight Policy Rate (OPR) cuts

Unlike banks, non-bank lenders like RCE are not required to revise their lending rates in response to changes in Bank Negara Malaysia's (BNM) OPR. Customers of non-bank lenders tend to be less sensitive to changes in interest rates, given their small loan size and limited access to unsecured personal financing from banking institutions.

That said, the company regularly tweaks its products to meet customer's needs and this would, at times, include adjustments to rates charged.

Lower funding costs with new *sukuk* programme

RCE established a new MYR2bn *sukuk murabahah* assets-backed securitisation programme with the first tranche issued in March. The first issuance of MYR265m was at a weighted average profit rate (WAPR) of 4.92% pa, which is much lower than the WAPR of 5.4% pa for the MYR900m *sukuk* programme that was fully-issued in Mar 2018. This has lowered average borrowing costs by approximately 10bps.

A second tranche of MYR108m was issued in July at a lower rate of 4.54%. Cumulative issuance stands at MYR373m, with WAPR at 4.81% – this is 59bps lower than the previous *sukuk* programme. We believe RCE's strong credit rating from Rating Agency Malaysia – AAA and AA2 – is a key factor for the lower profit rate.

The previous MYR900m *sukuk* programme was fully-issued in Mar 2018, with all-in costs at 5.51%. Management estimates the all-in cost of the MYR2bn programme to be 50bps lower, at 5%.

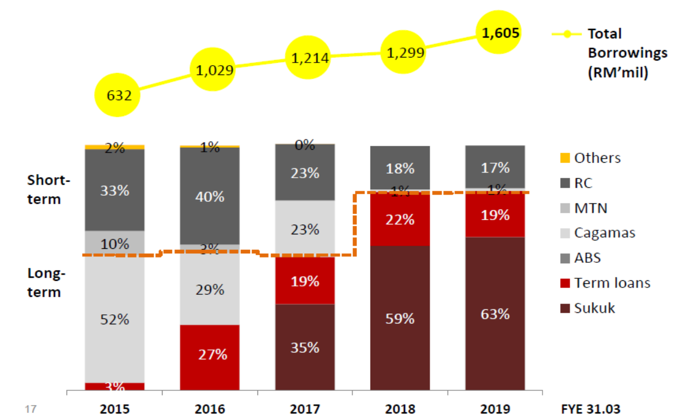
Net gearing to remain well-managed

RCE has to rely on borrowings and the debt capital market to support its lending business as it cannot accept customer deposits for funding. Management has made good process in efforts to improve the company's funding profile in the past few years. At end-FY19, long-term funding has increased to 82% of total debt funding vs 55% in FY15. This was achieved via the company's first *sukuk* programme in 2017. The increased level of long-term funding means greater stability in its overall funding structure.

Although total borrowings have increased to MYR1,605bn as at end-FY19 – to support expansion in the lending business – RCE's net gearing ratio remains healthy at 1.9x. This compares favourably against AEON Credit Service (M)'s (ACSM MK, NEUTRAL, TP: MYR15.80) 3.38x.

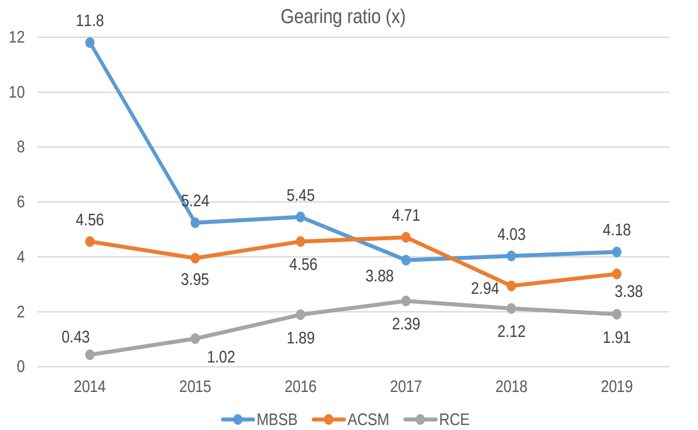
With the MYR2bn *sukuk* programme in place, we believe the net gearing ratio will remain relatively stable at 1.7-1.8x. Management does not see the need for a capital-raising exercise, unless the gearing threshold is breached, which is likely to be above 3x.

Figure 3: RCE's improved funding profile



Source: Company data, RHB

Figure 4: RCE's net gearing is well-managed



Source: Company data, RHB

Focus on asset quality

As RCE does not yet have access to the Central Credit Reference Information System, the company is unable to comprehensively assess a borrower's outstanding debt position with other domestic lenders. To safeguard the quality of its receivables, it deploys a robust credit scoring model to assess a customer's risk level, complemented by due diligence, and credit practices to safeguard asset quality. Products are priced and designed for specific risk levels, with higher priced products for riskier customers.

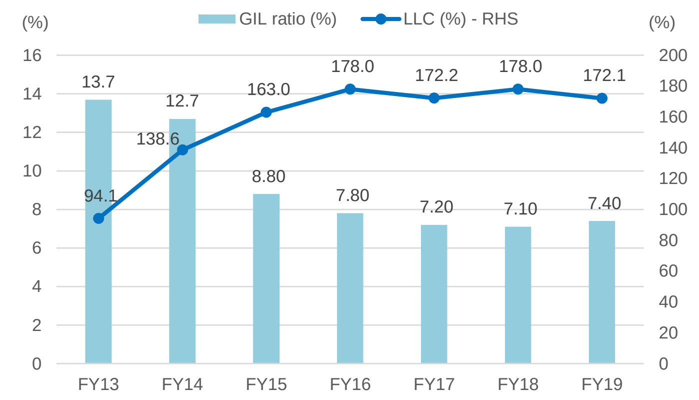
Management conducts regular review of products, and credit practices and scoring models to ensure that RCE remains relevant and competitive in the market place.

NPL ratios stable, LLC comfortable

In addition, RCE adopts a conservative debt service ratio of 60% maximum, after excluding housing loans, credit cards, and loans from financial institutions. Coupled with the direct salary deduction and small average loan size of c.MYR16,000, asset quality risk is well-contained.

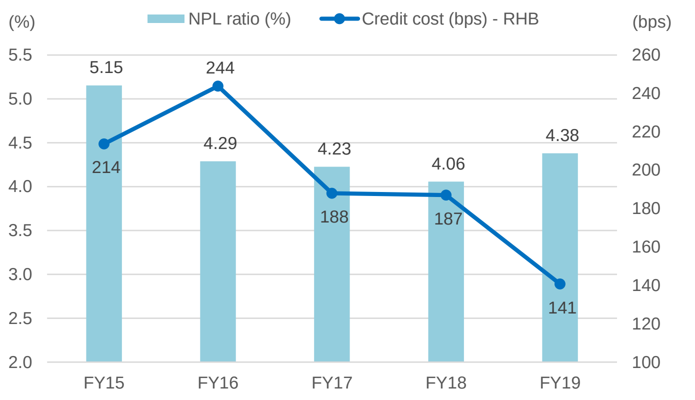
Reflecting this, RCE's GIL ratio has been stable at 7.1-7.4% in FY17-19, after having improved from a high of 13.7% in FY13. Meanwhile, its NPL ratio ranged between 4.1% and 4.4% in FY16-19. The LLC of NPLs is comfortable, at 172-178%.

Figure 5: RCE – GIL vs LLC ratios



Source: Company data, RHB

Figure 6: RCE – NPL ratio vs Credit cost



Source: Company data, RHB

Earnings Forecast

Net profit to grow c.6% p.a. in FY20F-21F. We expect RCE to deliver net profit growth of 5.8% in FY20 and 6.3% FY21. The slower growth – compared to FY19's increase of 7.7% – reflects expectations for a moderation in loan growth to 4.8% pa and higher impairment allowance, as economic growth softens.

Stable dividend payout. In FY19, RCE improved its dividend payout to 32.2% of net profit from 27% in FY18. We expect the company to maintain the payout ratio at c.32% over the next two years, which should mean DPS of 9.5 sen for FY20F and 10 sen for FY21F. With share price at MYR1.59, the dividend yield is attractive at 6%.

RCE does not have formal dividend policy. Management guides for dividend pay-outs of 20-40% of net profit.

Valuation

Undemanding valuations. At its current price, RCE is trading at 0.99x P/BV (March) and a mere 5.4x FY20F EPS of 29 sen. We believe its valuation multiples are undemanding, given the company's annualised ROEs of 15-16% for FY20F-21F. This is compared to AEON Credit's FY20 (Feb) P/BV of 2.35x against ROE of 21%.

Based on a GGM-derived P/BV of 1.10x, we believe the stock is worth MYR2.

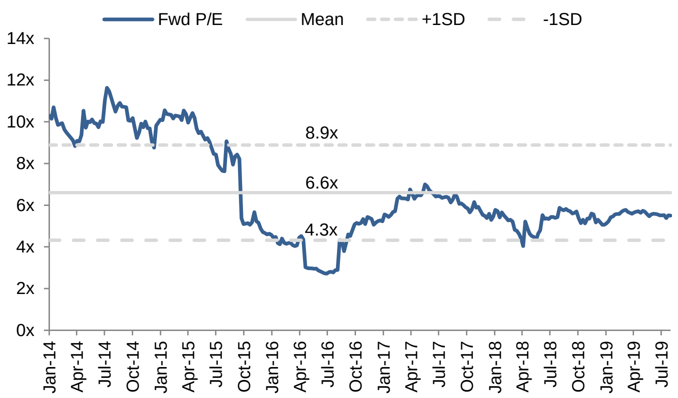
We believe our view on RCE's valuation is shared by management, which has been buying back the company's shares at prices ranging between MYR1.40 and MYR1.64 over the past 12 months.

Figure 7: RCE – GGM valuation

Cost of equity (COE) computation:		Sustainable ROE (%)	15.0
Risk free rate (%)	3.50	COE (%)	13.9
Equity premium (%)	10.38	Long-term growth (g)	3.0
Beta (x)	1.00	Implied P/BV (x)	1.10
Cost of equity - CAPM (%)	13.88	BVPS - FY19F	MYR1.82
		Target price	MYR2.01
		TP (rounded)	**MYR2**

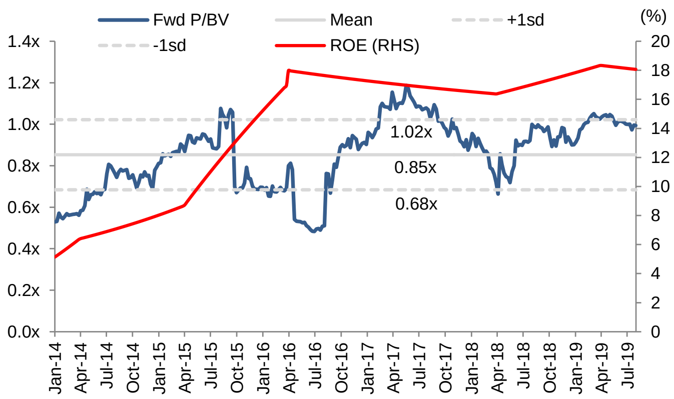
Source: Company data, RHB

Figure 8: RCE's 12-month forward consensus P/E



Source: Bloomberg, RHB

Figure 9: RCE's 12-month forward consensus P/BV



Source: Bloomberg, RHB

Risks

Key risks to our view are a sharper rise in loan impairment charges, sharper-than-expected NIM compression, and a sharper slowdown in loan growth.

Consumer Credit Act. BNM is working is working with a number of ministries to make the Consumer Credit Act law soon. The central bank expects to have it included in the legislative process next year. Enactment of the Act will promote a healthy consumer credit market across the board, by providing consumers equal treatment and protection irrespective of who they borrow from. Through the Act, the true annual percentage rates or effective interest rates for financing or purchase will be transparent, fair, and reasonable to consumers.

Currently, RCE does not fall under the direct purview of BNM. It holds a money lending license under the Moneylenders Act, 1951, granted by the Ministry of Housing & Local Government. Enactment of the Consumer Credit Act will likely mean greater regulation on loan pricing by non-bank lenders like RCE.

Company Background

Personal financing for civil servants is its core business

RCE was listed in the Main Market of Bursa Malaysia in Aug 2006. The company has a long history that dates back to Sep 1994 when it was first listed on Bursa Malaysia's Second Board as Rediffusion.

Back then, Rediffusion's principal activities were broadcasting and advertising & media. The company took on its current name in Oct 2003 following the venture into personal financing of electrical home appliances and other consumer durables under hire purchase terms in Jun 2003. The broadcasting business was sold in Jan 2003 to Star Media, while the advertising & media operations was disposed to Rekaweb.Com in Jul 2004.

Today, RCE's core business is in the provision of consumer financing under RCE Marketing (RCEM). RCEM enters into agreements with cooperatives and/or foundations to provide unsecured Islamic financing products to civil servants. Repayments are received in the form of monthly instalments via direct salary deductions through Biro Perkhidmatan Angkasa and the Accountant General's Department (Figure 10). RCEM is the main contributor to RCE's earnings.

RCE Factoring, a commercial financing business that provides confirming and factoring services, was acquired in Jan 2007 to complement RCE's existing business. Contributions from this segment is marginal.

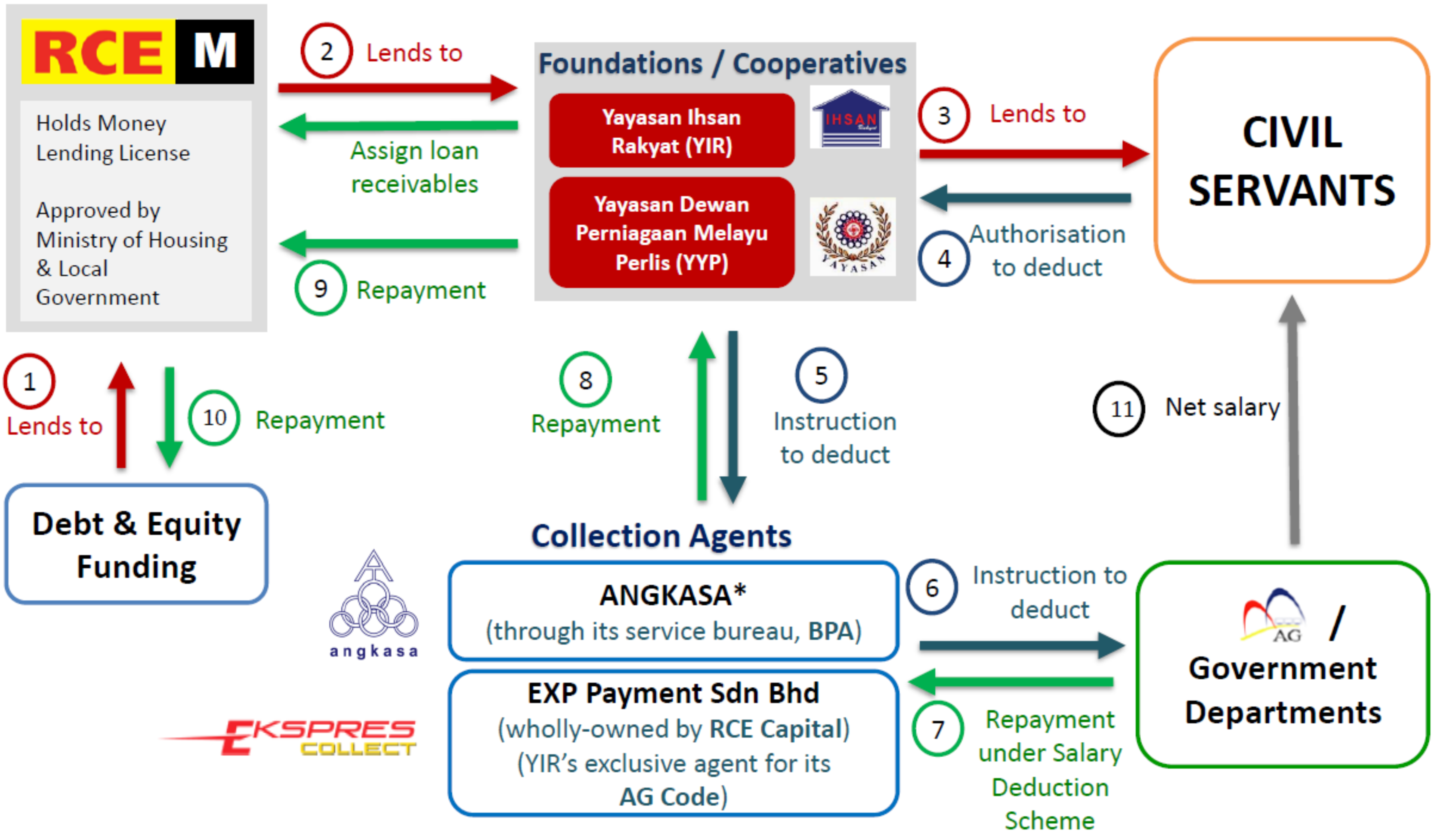
In Oct 2014, the company venture into payroll collections management through EXP Payment (EXP). EXP's collection service, which provides an alternative to existing market players, attends to deductions in payroll systems of government departments under the purview of the Accountant General's Department (Figure 11). EXP has invested in a collection management system that provides enhanced convenience and speed to clients. RCE has 100% equity interests in all three firms.

Management

Amcorp Group, which is wholly-owned by Tan Sri Azman Hashim, has an effective 60.78% stake in RCE. Shahman Azman has been the non-independent non-executive chairman since 1 Apr 2015, while Shalina Azman has been a non-independent non-executive director since 6 Jan 2000. Shahman and Shalina are Tan Sri Azman's children.

RCE is managed by professionals: Chief executive officer Loh Kam Chuin was appointed to this post on 1 Mar 2010, while chief financial officer – Johnson Yap Choon Seng – has been with the company since Feb 2005. Chief business officer Oon Hooi Khee joined RCE in Sep 2006.

Figure 10: RCEM's business model

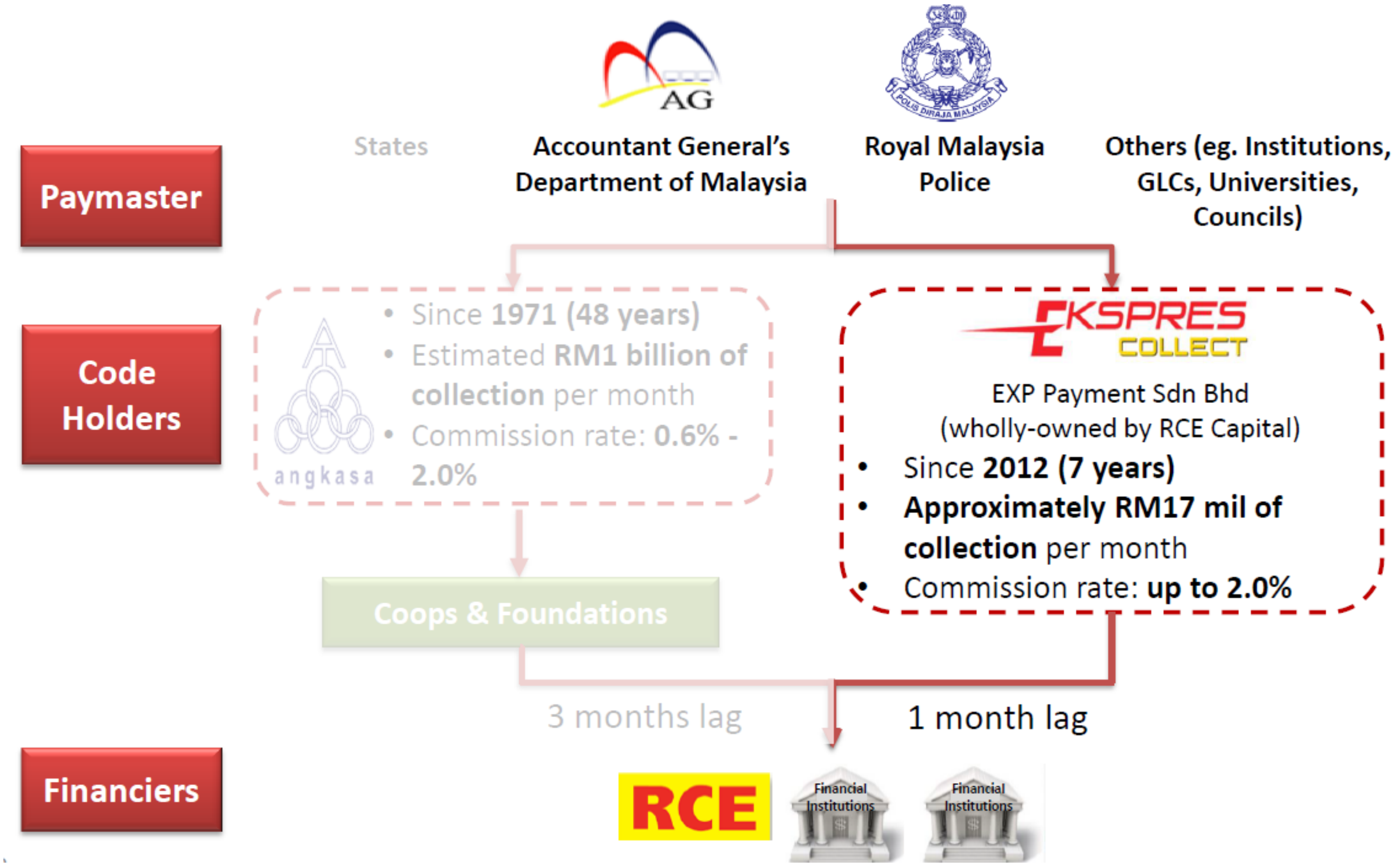


Note: *ANGKASA is incorporated to unite all the cooperatives in Malaysia under on federation for cooperatives. It plays the role of the apex of cooperatives for the Malaysian cooperative movement.

AG – Accountant General's Department of Malaysia
BPA – Biro Perkhidmatan Angkasa

Source: Company, RHB

Figure 11: EXP Payment's Ekspres Collect



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Source: Company, RHB

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Trading Buy:	Share price may exceed 15% over the next 3 months, however longer-term outlook remains uncertain
Neutral:	Share price may fall within the range of +/- 10% over the next 12 months
Take Profit:	Target price has been attained. Look to accumulate at lower levels
Sell:	Share price may fall by more than 10% over the next 12 months
Not Rated:	Stock is not within regular research coverage

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