# Pepper Group Pty Limited
# (formerly Pepper Group Limited)

ABN 55 094 317 665

# Consolidated financial statements for the year ended 31 December 2019

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pepper

## Directors' report

The directors of Pepper Group Pty Limited (Pepper or the Company) and its controlled entities (the Group) submit the annual report of the Company and the entities it controlled at the end of, or during, the year ended 31 December 2019.

**Information about the directors**

The name and particulars of the directors of the company during or since the end of the financial year are:

Michael Culhane
Cameron Small
Mario Rehayem
Stuart Bleischke (Resigned 30 August 2019)

**Indemnification of officers and auditors**

During the period, the Group paid an insurance premium in respect of the Directors of the Group as named above, the company secretary and all executive officers of the company against a liability incurred as such a director, secretary or executive officer to the extent permitted by the Corporations Act 2001. The contract of insurance prohibits disclosure of the nature of the liability and the amount of the premium.

The Group has not otherwise, during or since the financial year, except to the extent permitted by law, indemnified or agreed to indemnify an officer or auditor of the Group against a liability incurred as such an officer or auditor.

**Operating and financial review**

The Board presents its 2019 operating and financial review. The review complements the financial report.

**Principal activities and review of operations**

Pepper is a specialist residential mortgage and consumer lender and loan servicer, operating in targeted market segments and asset classes in Australia and internationally.

Pepper has developed a strong specialist lending and loan servicing group through a combination of organic growth and targeted acquisitions across Australia, New Zealand, Ireland, the United Kingdom, Spain, Greece, Cyprus, South Korea, Hong Kong, China and Colombia.

Pepper offers a broad range of lending products across residential mortgages, commercial mortgages, commercial finance, auto and equipment finance, point of sale finance and personal loans, underpinned by a comprehensive risk based pricing methodology. Pepper also provides loan servicing for its own originated loans as well as for third party originated loans, including residential mortgages, consumer loans and commercial real estate loans.

Pepper's business model provides a diversified base of revenue generated at multiple points across the customer relationship and includes loan origination, lending, servicing and loan administration, performance fees and advisory revenue.

Pepper's unique operating model combines credit risk based underwriting expertise with highly developed specialist loan servicing and collection management capabilities which together deliver enhanced performance in both its lending and servicing businesses across multiple asset classes including: residential mortgages, auto loans, equipment finance, small balance commercial mortgages, small and medium sized enterprise loans and personal loans.

**Pepper's core capabilities include**

- Product manufacturing: Deep manufacturing expertise in residential mortgage and auto loans gives Pepper flexibility in providing a range of products with attractive risk-return profiles in Australia and New Zealand. Internationally, Pepper's management team has experience in specialist mortgage lending in the United Kingdom and South Korea and consumer finance in Spain, South Korea, Hong Kong and China. Pepper is able to apply its detailed knowledge of borrowers to develop new products that address unmet demand;
- Distribution: Pepper distributes loans in Australia through its relationships with accredited brokers and white-label partners, in addition to its direct-to-customer consumer channel. Strong long-term relationships with global loan portfolio acquirers help Pepper win and maintain servicing contracts across multiple jurisdictions. Overseas, Pepper distributes via intermediaries and direct to the public depending on the product type and location;
- Treasury and funding expertise: Pepper has strong long-term relationships with global funding partners and is a trusted issuer in the term securitisation markets;
- Risk management: Pepper operates with a holistic risk management and governance framework; and
- Collections management: Pepper's specialised collections processes are based on deep experience, expertise, analytical capabilities and a solution based approach to customer management.

**Operating and financial review (continued)**

**Funding**

Across each of its lending markets, Pepper maintains access to a diversified funding platform supported by established funding relationships and a Board approved funding policy.

The following funding channels are used to support Pepper's lending activities:

- Preference shares: issued by Pepper Savings Bank (PSB) in South Korea in September 2019 (qualify as regulatory capital for PSB but classified as borrowings by the Group);
- Warehouse facilities: Third-party funders provide limited-recourse financing to special purpose vehicles established by Pepper to originate or acquire loans;
- Term securitisations: Loans that are initially funded via a warehouse facility can be pooled together and refinanced by being sold to a new funding vehicle that issues limited-recourse asset-backed securities to public market investors;
- Corporate debt facilities: Utilised for working capital and business operations (which includes a revolving credit facility issued in Australia and a related party loan from Red Hot Australia Bidco Pty Limited (Bidco)). During 2018 Red Hot Australia Holdco Pty Ltd (ultimate parent entity - Holdco) issued a €230m, 4 year, fixed rate, subordinated bond (high yield bond). When Holdco received the funds, it invested the full amount into Bidco in exchange for ordinary shares. Bidco then entered an agreement to loan Pepper Group Pty Limited €230m on economically similar terms to the high yield bond, reported as a related party loan within corporate debt facilities.
- Whole loan sales: Pepper is able to create additional liquidity by selling specific pools of loans to release and recycle capital; and
- South Korea deposits: Pepper's lending business in South Korea holds a banking licence and the lending book is primarily funded by customer deposits.

**Principal risks**

The Group's key risks include, but are not limited to:

- Funding risk: Pepper's funding platform currently comprises a mix of warehouse facilities, term securitisations, corporate debt facilities, whole loan sales and customer deposits. Pepper depends on these sources to fund mortgage and consumer loan originations and therefore faces funding risks which could lead to the inability to access funding or to raise funding on less favourable terms;
- Capital and liquidity requirements: there is a risk that Pepper could be required to contribute additional "first loss" equity capital to support the credit position of senior ranking noteholders in Pepper warehouse facilities and term securitisations. Pepper could also be required to contribute additional capital to support the regulatory capital requirements or business needs of Pepper South Korea, which could impact Pepper's profitability, ability to grow and/or could force it to raise additional capital;
- Regulatory and licence compliance: Pepper is subject to extensive regulation in each of the jurisdictions in which it conducts its business. Changes in law or regulation in a market in which Pepper operates could materially impact the business. Pepper is licensed and/or registered to operate a number of its services across a range of jurisdictions. Changes to these licensing regimes, the revocation of existing licences, an inability to renew or receive necessary licences or the imposition of capital requirements could materially adversely affect Pepper's business, operating and financial performance; and
- Downturn in the global economy: Pepper is a global business operating in multiple jurisdictions. A material downturn in the economies in which Pepper operates, a sustained outbreak of higher inflation or shocks to the financial system could result in a material increase in unemployment, decreases in house prices, higher interest rates, general reduction in demand for credit and/or a reduction in a borrower's ability to service their debt.

**Operating and financial review (continued)**

**Financial performance review**

*Consolidated Income Statement (extract)*

| | **Year ended 31 December 2019 $'000** | Year ended 31 December 2018 $'000 |
|---|---|---|
| Total revenue | **876,211** | 678,881 |
| Profit from share of results of associates | **8,680** | 10,741 |
| Expenses | **(819,865)** | (665,060) |
| **Profit before tax** | **65,026** | 24,562 |

The Group recorded a statutory profit before tax for the year of $65.0m, an increase of 164.7% year on year (2018: $24.6m).

Total revenue increased by $197.3m (29.0%) to $876.2m, driven by an increase in net interest revenue in the Australian Mortgage and Asset Finance businesses, in South Korea due to organic growth, and in the UK reflecting the acquisition of Optimum Credit in December 2018.

Total statutory expenses increased by $154.8m (23.3%) to $819.9m, driven by a $52.8m increase in loan loss expenses commensurate with the Group's loan portfolio growth of 27%, a $30.2m increase in employee benefits costs (largely due to the acquisition of Optimum Credit), $18.0m increase in corporate interest costs collectively due to the Group's continued global expansion.

*Consolidated Balance Sheet (extract)*

| **Assets** | **As at 31 December 2019 $'000** | As at 31 December 2018 $'000 |
|---|---|---|
| Cash and cash equivalents | **1,807,658** | 1,200,367 |
| Investments in associates | **135,095** | 109,079 |
| Receivables | **130,672** | 118,884 |
| Loans and advances | **19,527,124** | 15,366,495 |
| Intangible assets (including Goodwill) | **137,066** | 128,550 |
| Other asset categories | **324,645** | 293,388 |
| **Total assets** | **22,062,260** | 17,216,763 |

The Group's loans and advances grew by $4,160.6m, reflecting 27.1% net portfolio growth. The portfolio growth demonstrates Pepper's global expansion, underpinning its core profitability.

This increase was driven by prime, near-prime and non-conforming mortgages and asset and equipment finance in the ANZ Division. The Asia Division also demonstrated strong growth throughout the year driven by increases in personal loans and residential mortgages in South Korea. The loan portfolio in the Europe Division continued to grow in line with forecast driven by increases in personal loans in Spain and residential mortgages in the UK.

**Operating and financial review (continued)**

**Financial performance review (continued)**

*Consolidated Balance Sheet (extract) (continued)*

| Liabilities | As at 31 December 2019 $'000 | As at 31 December 2018 $'000 |
|---|---|---|
| Deposits - South Korea | **3,664,431** | 2,826,343 |
| Borrowings | **17,067,638** | 13,452,986 |
| Other liability categories | **519,277** | 392,993 |
| **Total liabilities** | **21,251,346** | 16,672,322 |

The Group's asset growth was largely supported by increases in securitised funding facilities (borrowings) in Australia and customer deposits in South Korea.

**Changes in affairs**

Subsequent to the end of financial year, Pepper Group Limited changed its name to Pepper Group Pty Limited.

On the 27 May 2019 the Group completed the strategic sale of Pepper Property Group (PPG) to management and staff of PPG. PPG was rebranded to CapStra as a result of the management buyout.

There were no significant changes in the state of affairs of the Group during the year ended 31 December 2019.

**Events since the end of the financial year**

On 31 January 2020 Pepper entered into a binding agreement with Link Administration Holdings Limited (ASX:LNK) to sell its European Servicing business (Pepper European Servicing) for an upfront consideration of €165m (A$266m) and up to a further €35m (A$56m) if certain Assets Under Management thresholds and growth milestones are met.

Pepper Group Pty Limited, along with its immediate and ultimate parent, Red Hot Australia BidCo Pty Limited Red Hot Australia HoldCo Pty Limited (Holdco), and its subsidiaries (collectively, the "Pepper Group") are planning to undertake an internal corporate restructure ("Restructure") in 2020. As part of the Restructure, Red Hot HoldCo Pty Limited shareholders intend to create a foreign holding company structure for the Pepper Group with a new head corporate entity, Pepper Global Topco Limited ("TopCo"). After the restructure, the shareholders of TopCo will be substantially the same as the current HoldCo shareholders and the existing governance arrangements that apply to HoldCo will be substantially replicated at the TopCo level.

We are currently in the process of assessing the potential impact of the 2019-20 Coronavirus outbreak caused by SARS-CoV-2 (first identified in Wuhan, Hubei, China) on the Group.

No other matter or circumstance has arisen since 31 December 2019 that has significantly affected the Group's operations, results or state of affairs, or may do so in future years.

**Dividends**

No dividends were paid in 2019 (2018: $Nil).

**Auditor's independence declaration**

A copy of the auditor's independence declaration as required under section 307C of the *Corporations Act 2001* is set out on page 7.

**Rounding of amounts**

The Company is of a kind referred to in ASIC Legislative Instrument 2016/191, relating to the 'rounding off' of amounts in the directors' report. Amounts in the directors' report have been rounded off in accordance with the instrument to the nearest thousand dollars, or in certain cases, to the nearest dollar.

This report is made in accordance with a resolution of directors.

Michael Culhane
Group Chief Executive Officer and Director

Cameron Small
Group Chief Financial Officer and Director

## Directors' declaration

The directors of Pepper Group Pty Limited declare that, in the directors' opinion:

(a) the financial statements and notes set out on pages 11 to 62 are in accordance with the *Corporations Act 2001*, including:

  (i) compliance with Accounting Standards, the *Corporations Regulations 2001* and other mandatory professional reporting requirements, and

  (ii) giving a true and fair view of the consolidated entity's financial position as at 31 December 2019 and of its performance for the financial year ended on that date, and

(b) there are reasonable grounds to believe that the Company will be able to pay its debts as and when they become due and payable.

The attached financial statements are in accordance with the International Financial Reporting Standards as issues by the International Accounting Standards Board.

This declaration is made in accordance with a resolution of directors.

Michael Culhane
Director

Cameron Small
Director

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The Board of Directors
Pepper Group Pty Limited
Level 27, 177 Pacific Highway
North Sydney, NSW 2060

13 March 2020

Dear Board Members

**Auditor's Independence Declaration to Pepper Group Pty Limited (formerly Pepper Group Limited)**

In accordance with section 307C of the Corporations Act 2001, I am pleased to provide the following declaration of independence to the directors of Pepper Group Pty Limited.

As lead audit partner for the audit of the financial report of Pepper Group Pty Limited for the year ended 31 December 2019, I declare that to the best of my knowledge and belief, there have been no contraventions of:

(i) the auditor independence requirements of the Corporations Act 2001 in relation to the audit; and

(ii) any applicable code of professional conduct in relation to the audit.

Yours faithfully

Deloitte Touche Tohmatsu

DELOITTE TOUCHE TOHMATSU

Heather Baister

Heather Baister
Partner Chartered Accountants

Deloitte.

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# Independent Auditor's Report to the Members of Pepper Group Pty Limited (formerly Pepper Group Limited)

## Report on the Audit of the Financial Report

*Opinion*

We have audited the financial report of Pepper Group Pty Limited (formerly Pepper Group Limited) (the Company) and its controlled entities (the Group) which comprises the consolidated balance sheet as at 31 December 2019, consolidated income statement, the consolidated statement of comprehensive income, the consolidated statement of changes in equity and the consolidated statement of cash flows for the year then ended, and notes to the financial statements, including a summary of significant accounting policies, and the directors' declaration.

In our opinion, the accompanying financial report of the Group is in accordance with the *Corporations Act 2001*, including:

(i) giving a true and fair view of the Group's financial position as at 31 December 2019 and of its financial performance for the year then ended; and

(ii) complying with Australian Accounting Standards and the *Corporations Regulations 2001*.

*Basis for Opinion*

We conducted our audit in accordance with Australian Auditing Standards. Our responsibilities under those standards are further described in the *Auditor's Responsibilities for the Audit of the Financial Report* section of our report. We are independent of the Group in accordance with the auditor independence requirements of the *Corporations Act 2001* and the ethical requirements of the Accounting Professional and Ethical Standards Board's APES 110 *Code of Ethics for Professional Accountants* (the Code) that are relevant to our audit of the financial report in Australia. We have also fulfilled our other ethical responsibilities in accordance with the Code.

We confirm that the independence declaration required by the *Corporations Act 2001*, which has been given to the directors of the Company, would be in the same terms if given to the directors as at the time of this auditor's report.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

*Other Information*

The directors are responsible for the other information. The other information comprises the Directors' report for the year ended 31 December 2019, but does not include the financial report and our auditor's report thereon.

Our opinion on the financial report does not cover the other information and we do not express any form of assurance conclusion thereon.

In connection with our audit of the financial report, our responsibility is to read the other information identified above when it becomes available and, in doing so, consider whether the other information is materially inconsistent with the financial report or our knowledge obtained in the audit or otherwise appears to be materially misstated.

If, based on the work we have performed on the other information that we obtained prior to the date of this auditor's report, we conclude that there is a material misstatement of this other information, we are required to report that fact. We have nothing to report in this regard.

*Responsibilities of the Directors for the Financial Report*

The directors of the Company are responsible for the preparation of the financial report that gives a true and fair view in accordance with Australian Accounting Standards and the *Corporations Act 2001* and for such internal control as the directors determine is necessary to enable the preparation of the financial report that gives a true and fair view and is free from material misstatement, whether due to fraud or error.

In preparing the financial report, the directors are responsible for assessing the ability of the Group to continue as a going concern, disclosing, as applicable, matters related to going concern and using the going concern basis of accounting unless the directors either intend to liquidate the Group or to cease operations, or have no realistic alternative but to do so.

*Auditor's Responsibilities for the Audit of the Financial Report*

Our objectives are to obtain reasonable assurance about whether the financial report as a whole is free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with the Australian Auditing Standards will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of this financial report.

As part of an audit in accordance with the Australian Auditing Standards, we exercise professional judgement and maintain professional scepticism throughout the audit. We also:

- Identify and assess the risks of material misstatement of the financial report, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.

- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Group's internal control.

- Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by the directors.

- Conclude on the appropriateness of the directors' use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the Group's ability to continue as a going concern. If we conclude that a material uncertainty exists, we are required to draw attention in our auditor's report to the related disclosures in the financial report or, if such disclosures are inadequate, to modify our opinion. Our conclusions are based on the audit evidence obtained up to the date of our auditor's report. However, future events or conditions may cause the Group to cease to continue as a going concern.

- Evaluate the overall presentation, structure and content of the financial report, including the disclosures, and whether the financial report represents the underlying transactions and events in a manner that achieves fair presentation.

- Obtain sufficient appropriate audit evidence regarding the financial information of the entities or business activities within the Group to express an opinion on the financial report. We are responsible for the direction, supervision and performance of the Group's audit. We remain solely responsible for our audit opinion.

We communicate with the directors regarding, among other matters, the planned scope and timing of the audit and significant audit findings, including any significant deficiencies in internal control that we identify during our audit.

DELOITTE TOUCHE TOHMATSU

Heather Baister
Partner
Chartered Accountants
Sydney, 13 March 2020

## Consolidated income statement

| | Notes | Year ended 31 December 2019 $'000 | Year ended 31 December 2018 $'000 |
|---|---|---|---|
| Interest income | 4 | **1,165,696** | 851,763 |
| Interest expense | 4 | **(562,006)** | (426,488) |
| **Net interest income** | | **603,690** | 425,275 |
| Fee revenue | 4 | **226,913** | 199,103 |
| Other revenue | 4 | **45,608** | 54,503 |
| **Total revenue** | | **876,211** | 678,881 |
| Employee benefits expense | 4 | **(308,755)** | (278,528) |
| Depreciation and amortisation expense | 4 | **(35,327)** | (16,922) |
| Corporate debt facilities - borrowing costs | 4 | **(48,810)** | (30,787) |
| Loan loss expense | 4 | **(214,050)** | (161,256) |
| Other expenses from operations | 4 | **(212,923)** | (177,567) |
| **Total expenses** | | **(819,865)** | (665,060) |
| Share of net profit of results of associates | 9 | **8,680** | 10,741 |
| **Profit before tax** | | **65,026** | 24,562 |
| Income tax expense | 5 | **(15,176)** | (3,613) |
| **Profit after tax** | | **49,850** | 20,949 |
| **Profit is attributable to:** | | | |
| Owners of Pepper Group Pty Limited | | **49,908** | 20,513 |
| Non-controlling interests | | **(58)** | 436 |
| | | **49,850** | 20,949 |

*The above consolidated income statement should be read in conjunction with the accompanying notes.*

## Consolidated statement of comprehensive income

| | **Year ended 31 December 2019 $'000** | Year ended 31 December 2018 $'000 |
|---|---|---|
| **Profit after tax** | **49,850** | 20,949 |
| | | |
| **Other comprehensive income / (expense) that may be recycled to profit or loss** | | |
| **Currency translation reserve:** | | |
| Currency translation differences within associates | **(513)** | 604 |
| Currency translation differences relating to other Group entities | **(2,163)** | 16,325 |
| Tax | **1,938** | (517) |
| **Cash flow hedge reserve:** | | |
| (Loss) / gain from changes in fair value | **(30,196)** | (6,975) |
| Amounts transferred to the income statement | **590** | (613) |
| Tax | **6,879** | 2,141 |
| **Total other comprehensive (expense) / income that may be recycled to profit or loss** | **(23,465)** | 10,965 |
| | | |
| **Other comprehensive income not recycled to profit or loss (net of tax):** | | |
| Retirement benefit remeasurements | **(390)** | (275) |
| Tax | **139** | 61 |
| **Other comprehensive (expense) / income for the period** | **(23,716)** | 10,751 |
| | | |
| **Total comprehensive income for the period** | **26,134** | 31,700 |
| | | |
| **Comprehensive income attributed to:** | | |
| Owners of the company | **26,192** | 31,264 |
| Non-controlling interests | **(58)** | 436 |
| | **26,134** | 31,700 |

*The above consolidated statement of comprehensive income should be read in conjunction with the accompanying notes.*

## Consolidated balance sheet

| | Notes | **As at 31 December 2019 $'000** | As at 31 December 2018 $'000 |
|---|---|---|---|
| **Assets** | | | |
| Cash and cash equivalents | 21 | **1,807,658** | 1,200,367 |
| Derivative financial assets | 24 | **48,018** | 84,660 |
| Receivables | 6 | **130,672** | 118,884 |
| Current tax assets | | **2,298** | 9,813 |
| Other assets | | **43,643** | 34,356 |
| Loans and advances | 7 | **19,527,124** | 15,366,495 |
| Deferred tax assets | 5 | **47,286** | 34,750 |
| Investments | 8 | **64,974** | 108,157 |
| Investments in associates | 9 | **135,095** | 109,079 |
| Property, plant and equipment | 10 | **118,426** | 21,652 |
| Intangible assets | 11 | **76,745** | 67,726 |
| Goodwill | 11 | **60,321** | 60,824 |
| **Total assets** | | **22,062,260** | 17,216,763 |
| **Liabilities** | | | |
| Deposits | 13 | **3,664,431** | 2,826,343 |
| Derivative liabilities | 24 | **68,190** | 14,011 |
| Trade and other payables | | **76,650** | 61,083 |
| Current tax liabilities | | **3,462** | 4,977 |
| Borrowings | 14 | **17,067,638** | 13,452,986 |
| Other liabilities | 15 | **303,721** | 256,049 |
| Provisions | 16 | **60,308** | 55,671 |
| Deferred tax liabilities | 5 | **6,946** | 1,202 |
| **Total liabilities** | | **21,251,346** | 16,672,322 |
| **Total net assets** | | **810,914** | 544,441 |
| **Equity** | | | |
| Issued capital | 17 | **601,770** | 356,101 |
| Other equity | 18 | **(19,427)** | (19,176) |
| Other reserves | 18 | **1,374** | 24,836 |
| Retained earnings | | **226,093** | 181,698 |
| **Total equity attributable to owners of Pepper Group Pty Limited** | | **809,810** | 543,459 |
| Non-controlling interests | | **1,104** | 982 |
| **Total equity** | | **810,914** | 544,441 |

*The above consolidated balance sheet should be read in conjunction with the accompanying notes.*

## Consolidated statement of changes in equity

| | Issued capital $'000 | Other equity $'000 | Other reserves $'000 | Retained earnings $'000 | Attributable to owners of the parent $'000 | Non-controlling interests $'000 | Total equity $'000 |
|---|---|---|---|---|---|---|---|
| **Balance at 1 January 2018** | 306,101 | (9,029) | 13,820 | 191,017 | 501,909 | (436) | 501,473 |
| Impact of AASB 9 adoption | - | 1 | - | (51,801) | (51,800) | - | (51,800) |
| Impact of AASB 15 adoption | - | - | - | (2,501) | (2,501) | - | (2,501) |
| Profit for the period | - | - | - | 20,513 | 20,513 | 436 | 20,949 |
| Currency translation movements | - | - | 16,412 | - | 16,412 | - | 16,412 |
| Cash flow hedge movements | - | - | (5,447) | - | (5,447) | - | (5,447) |
| Retirement benefit remeasurements | - | (214) | - | - | (214) | - | (214) |
| **Total comprehensive income for the period** | - | (214) | 10,965 | 20,513 | 31,264 | 436 | 31,700 |
| Contributions of equity | 50,000 | - | - | - | 50,000 | 982 | 50,982 |
| Capital contribution | - | - | - | 14,535 | 14,535 | - | 14,535 |
| Transfer of settled equity share schemes | - | (9,935) | - | 9,935 | - | - | - |
| Other movements | - | 1 | 51 | - | 52 | - | 52 |
| **Balance at 31 December 2018** | **356,101** | **(19,176)** | **24,836** | **181,698** | **543,459** | **982** | **544,441** |
| **Impact of AASB 16 adoption** | **-** | **-** | **-** | **(4,028)** | **(4,028)** | **-** | **(4,028)** |
| **Profit for the period** | **-** | **-** | **-** | **49,908** | **49,908** | **(58)** | **49,850** |
| **Currency translation movements** | **-** | **-** | **(738)** | **-** | **(738)** | **-** | **(738)** |
| **Cash flow hedge movements** | **-** | **-** | **(22,727)** | **-** | **(22,727)** | **-** | **(22,727)** |
| **Retirement benefit remeasurements** | **-** | **(251)** | **-** | **-** | **(251)** | **-** | **(251)** |
| **Total comprehensive income for the period** | **-** | **(251)** | **(23,465)** | **49,908** | **26,192** | **(58)** | **26,134** |
| **Contributions of equity** | **245,669** | **-** | **-** | **-** | **245,669** | **-** | **245,669** |
| **Dividends paid** | **-** | **-** | **-** | **-** | **-** | **-** | **-** |
| **Capital contribution** | **-** | **-** | **-** | **5,285** | **5,285** | **180** | **5,465** |
| **Transfer of settled equity share schemes** | **-** | **-** | **-** | **(5,896)** | **(5,896)** | **-** | **(5,896)** |
| **Recognition of share based payments** | **-** | **-** | **-** | **-** | **-** | **-** | **-** |
| **Other movements** | **-** | **-** | **3** | **(874)** | **(871)** | **-** | **(871)** |
| **Balance at 31 December 2019** | **601,770** | **(19,427)** | **1,374** | **226,093** | **809,810** | **1,104** | **810,914** |

*The above consolidated statement of changes in equity should be read in conjunction with the accompanying notes.*

## Consolidated statement of cash flows

| | Notes | **Year ended 31 December 2019 $'000** | Year ended 31 December 2018 $'000 |
|---|---|---|---|
| **Cash flows from operating activities** | | | |
| Receipts from customers | | **299,793** | 326,008 |
| Payments to suppliers and employees | | **(547,532)** | (516,408) |
| Interest received | | **1,369,219** | 971,308 |
| Interest and other finance costs paid | | **(662,129)** | (479,747) |
| Income taxes paid | | **(4,372)** | (7,976) |
| **Net cash inflow from operating activities** | | **454,979** | 293,185 |
| **Cash flows from investing activities** | | | |
| Payments for property, plant and equipment | | **(60,459)** | (9,443) |
| Payments for intangibles and other assets | | **(45,427)** | (25,804) |
| Cash flows relating to investments | | **40,600** | (33,656) |
| Payments to related parties | | **(17,571)** | (5,555) |
| Payments for arrangement fees | | **(18,051)** | (18,750) |
| Net increase in loans and advances | | **(5,746,316)** | (6,285,505) |
| Net cash inflow / (outflow) from acquisition and disposal of businesses | | **(1,100)** | (12,248) |
| Cash flows relating to investments in associates | | **(25,692)** | 5,758 |
| Receipts from sale of loan portfolios | | **1,264,463** | 1,073,558 |
| **Net cash (outflow) from investing activities** | | **(4,609,553)** | (5,311,645) |
| **Cash flows from financing activities** | | | |
| Net proceeds from issuance of capital | | **245,646** | 50,000 |
| Net increase in borrowings | | **3,587,058** | 4,540,019 |
| Net increase in deposits | | **933,091** | 748,836 |
| **Net cash inflow from financing activities** | | **4,765,795** | 5,338,855 |
| Effects of exchange rate changes on cash and cash equivalents | | **(3,930)** | 25,783 |
| **Net increase in cash and cash equivalents** | | **607,291** | 346,178 |
| Cash and cash equivalents at the beginning of the financial year | | **1,200,367** | 854,189 |
| **Cash and cash equivalents at end of year** | 21 | **1,807,658** | 1,200,367 |

*The above consolidated statement of cash flows should be read in conjunction with the accompanying notes.*

## 1 About this report

The information presented in note 1 is considered relevant to an understanding of the financial statements.

### (a) General information

These consolidated financial statements are for the Consolidated Group (the Group), consisting of Pepper Group Pty Limited (the Company) and its controlled entities for the year ended 31 December 2019. These financial statements were approved and authorised for issue by the Board of Directors on the 13rd March 2020.

### (b) Basis of preparation

These general purpose financial statements have been prepared in accordance with Australian Accounting Standards and interpretations issued by the Australian Accounting Standards Board and the *Corporations Act 2001*. The Company is a for-profit entity for the purpose of preparing the financial statements.

*(i) Historical cost convention*

These financial statements have been prepared under the historical cost basis, except for the following:

- derivative financial instruments - measured at fair value.
- investment securities - measured at fair value.
- other investments - measured at fair value.

*(ii) Compliance with IFRS*

The consolidated financial statements of the Group also comply with International Financial Reporting Standards (IFRS) as issued by the International Accounting Standards Board (IASB).

*(iii) Rounding of amounts*

The amounts contained in this financial report are presented in Australian dollars (the Group's functional currency) and rounded to the nearest thousand dollar unless otherwise stated, under the option available under ASIC Legislative Instrument 2016/191.

*(iv) Basis of consolidation*

The consolidated financial statements incorporate the financial statements of the Company and all entities controlled by the Company. Control is achieved when the Company:

- has power over the investee;
- is exposed, or has rights, to variable returns from its involvement with the investee; and
- has the ability to use its power to affect its returns.

The Company reassesses whether or not it controls an investee if facts and circumstances indicate there are changes to one or more of the three elements of control listed above.

When the Company has less than a majority of the voting rights of an investee, it has power over the investee when the voting rights are sufficient to give it the practical ability to direct the relevant activities of the investee unilaterally. The Company considers all relevant facts and circumstances in assessing whether or not the Company's voting rights in an investee are sufficient to give it power, including:

- the size of the Company's holding of voting rights relative to the size and dispersion of holdings of the other vote holders.
- potential voting rights held by the Company, other vote holders or other parties.
- rights arising from other contractual arrangements.
- any additional facts and circumstances that indicate the Company has, or does not have, the current ability to direct the relevant activities at the time that decisions need to be made, including voting patterns at previous shareholders' meetings.

Consolidation of a subsidiary begins when the Company obtains control over the subsidiary and ceases when the Company loses control of the subsidiary. Specifically, income and expenses of a subsidiary acquired or disposed of during the year are included in the consolidated income statement and statement of other comprehensive income from the date the Company gains control until the date when the Company ceases to control the subsidiary.

Each component of comprehensive income is attributed to the owners of the Company and to the non-controlling interests. Total comprehensive income of subsidiaries is attributed to the owners of the Company and to the non-controlling interests even if this results in the non-controlling interests having a deficit balance.

**(b) Basis of preparation (continued)**

*(iv) Basis of consolidation (continued)*

All intragroup assets and liabilities, equity, income, expenses, changes in ownership interests and cash flows relating to transactions between members of the Group are eliminated in full on consolidation. When necessary, adjustments are made to the financial statements of subsidiaries to bring their accounting policies into line with the Group's accounting policies.

**(c) Foreign currency translation**

*(i) Functional and presentation currency*

Items included in the financial statements of each of the Group's entities are measured using the currency of the primary economic environment in which the entity operates ('the functional currency'). The consolidated financial statements are presented in Australian dollar ($), which is Pepper Group Pty Limited's functional and presentation currency.

*(ii) Transactions and balances*

Foreign currency transactions are translated into the relevant functional currency at the rates of exchange prevailing at the dates of the transactions. Exchange differences on monetary items are recognised in the income statement in the period in which they arise except for exchange differences on monetary items receivable from or payable to a foreign operation for which settlement is neither planned nor likely to occur (therefore forming part of the net investment in the foreign operation), or exchange differences on transactions entered into in order to hedge certain foreign currency risks.

At the end of each reporting period, balances are translated as follows:

- monetary items denominated in foreign currencies are retranslated at the rates prevailing at that date.
- non-monetary items carried at fair value that are denominated in foreign currencies are retranslated at the rates prevailing at the date when the fair value was measured.
- non-momentary items that are measured in terms of historical cost in the foreign currency are translated using the exchange rate at the date of the transaction.

*(iii) Group companies*

The results and financial position of foreign operations (none of which has the currency of a hyperinflationary economy) that have a functional currency different from the presentation currency are translated into the presentation currency as follows:

- assets and liabilities for each balance sheet presented are translated at the closing rate at the date of that balance sheet
- income and expenses for each statement of profit or loss and statement of comprehensive income are translated at average exchange rates (unless this is not a reasonable approximation of the cumulative effect of the rates prevailing on the transaction dates, in which case income and expenses are translated at the dates of the transactions), and
- all resulting exchange differences are recognised in other comprehensive income.

Goodwill and fair value adjustments, on identifiable assets and liabilities acquired. arising on the acquisition of a foreign operation are treated as assets and liabilities of the foreign operation and translated at the rate prevailing at the end of each reporting period. Exchange differences arising are recognised in other comprehensive income and accumulated in equity.

## 2 Application of new and revised accounting standards

### (a) New and amended standards adopted by the Group

New accounting standards have been adopted by the Group from 1 January 2019. The Group's assessment of the impact of these new standards is set out below.

*(i) AASB 16 Leases: effective for annual reporting periods beginning on or after 1 January 2019*

On 1 January 2019, the Group has adopted AASB 16 Leases, that introduces new or amended requirements with respect to lease accounting. It introduces significant changes to lessee accounting by removing the distinction between an operating and a finance lease and requires the recognition of a right-of-use asset and a lease liability at commencement of all leases, except for short-term leases and leases of low value assets.

Accordingly, applying AASB 16, for all leases entered as a lessee (except for short-term leases and low value assets), the Group:

- recognised lease liabilities in the consolidated statement of financial position, initially measured at the present value of future lease payments calculated using the regional incremental borrowing rate;
- recognised interest on lease liabilities in the consolidated statement of profit or loss;
- recognised right-of-use assets in the consolidated statement of financial position, initially measured at cost comprising the initial measurement of lease liability, any initial direct costs, restoration costs and any lease incentives received;
- recognised depreciation of right-of-use assets in the consolidated statement of profit or loss. Right-of-use assets are depreciated over the shorter of the asset's useful life and the lease term on a straight-line basis;
- separated the total amount of cash paid into a principal portion (presented within financing activities) and interest (presented within operating activities) in the consolidated statement of cash flows; and
- tested Right-of-use assets for impairment in accordance with AASB 136 Impairment of Assets.

Payments associated with short-term leases and all leases of low-value assets are recognised on a straight-line basis as an expense in profit or loss. Short-term leases are leases with a lease term of 12 months or less. Low-value assets comprise IT equipment and small items of office furniture.

The Group adopted AASB 16 using the modified retrospective method of adoption with the date of initial application of 1 January 2019, using the the incremental borrowing rate at the date of transition. Under this method, the standard is applied retrospectively with the cumulative effect of initially applying the standard recognised at the date of initial application, with no adjustments being made to the comparative figures, as outlined below:

**Balance sheet (extract)**

| | As at 1 January 2019 $'000 | AASB 16 adoption $'000 | As at 31 December 2018 $'000 |
|---|---|---|---|
| **Assets** | | | |
| Other assets | **32,539** | (1,817) | 34,356 |
| Deferred tax asset | **35,735** | 985 | 34,750 |
| Property, plant and equipment | **63,168** | 41,516 | 21,652 |
| **Total assets impacted** | | **40,684** | |
| **Liabilities** | | | |
| Trade and other payables | **59,218** | (1,865) | 61,083 |
| Other liabilities | **302,184** | 46,135 | 256,049 |
| Provisions | **56,256** | 585 | 55,671 |
| Deferred tax liabilities | **1,060** | (142) | 1,202 |
| **Total liabilities impacted** | | **44,712** | |
| **Total net assets** | | **(4,028)** | |
| **Equity** | | | |
| Retained earnings | **177,670** | (4,028) | 181,698 |
| **Total equity impacted** | | **(4,028)** | |

**(b) New standards and interpretations not yet adopted**

*(iii) IFRIC 23 Uncertainty over Income Tax Treatment: effective for annual reporting periods beginning on or after 1 Jan 2019*

The Group adopted IFRIC 23, Uncertainty over Income Tax Treatments, for the first time in the period commencing 1 January 2019. IFRIC 23 sets out how to determine the accounting tax position when there is uncertainty over income tax treatments.

The interpretation requires the Group to:

- determine whether uncertain tax positions are assessed separately or as a Group; and
- assess whether it is probable that a tax authority will accept an uncertain tax treatment used, or proposed to be used, by an entity in its income tax filings:
    - if yes, the Group should determine its accounting tax position consistently with the tax treatment used or planned to be used in its income tax filings.
    - if no, the Group should reflect the effect of uncertainty in determining its accounting tax position using either the most likely amount or the expected value method.

There have been no other new or amended accounting standards during the reporting period ended 31 December 2019 that have had or may have a significant impact on the financial results of the Group.

## 3 Critical estimates, judgements and errors

The preparation of financial statements requires the use of judgment, estimates and assumptions. Should different assumptions or estimates be applied, the resulting values may change, impacting the net assets and income of the Group. These estimates and assumptions are reviewed on an ongoing basis. The nature of significant estimates and judgements made are noted below.

**(a) Business model assessment**

Classification and measurement of financial assets depends on the results of the SPPI and the business model test (note 24). The Group determines the business model at a level that reflects how groups of financial assets are managed together to achieve a particular business objective. This assessment includes judgement reflecting all relevant evidence including how the performance of the assets is evaluated and their performance measured, the risks that affect the performance of the assets and how these are managed and how the managers of the assets are compensated.

The Group monitors financial assets measured at amortised cost or fair value through other comprehensive income that are derecognised prior to their maturity to understand the reason for their disposal and whether the reasons are consistent with the objective of the business for which the asset was held. Monitoring is part of the Group’s continuous assessment of whether the business model for which the remaining financial assets are held continues to be appropriate and if it is not appropriate whether there has been a change in business model and so a prospective change to the classification of those assets. No such changes were required during the periods presented.

**(b) Significant increase in credit risk and calculation of loss allowance**

Significant increase in credit risk: As explained in note 24 expected credit loss (ECL) are measured as an allowance equal to 12-month ECL for stage 1 assets, or lifetime ECL assets for stage 2 or stage 3 assets. An asset moves to stage 2 when its credit risk has increased significantly since initial recognition. AASB 9 does not define what constitutes a significant increase in credit risk. In assessing whether the credit risk of an asset has significantly increased the Group takes into account qualitative and quantitative reasonable and supportable forward-looking information.

Models and assumptions used: The Group uses various models and assumptions in measuring fair value of financial assets as well as in estimating ECL. Judgement is applied in identifying the most appropriate model for each type of asset, as well as for determining the assumptions used in these models, including assumptions that relate to key drivers of credit risk.

The following are key estimations that are expected to have the most significant effect on the amounts recognised in financial statements:

Probability of default: PD constitutes a key input in measuring ECL. PD is an estimate of the likelihood of default over a given time horizon, the calculation of which includes historical data, assumptions and expectations of future conditions.

Loss Given Default: LGD is an estimate of the loss arising on default. It is based on the difference between the contractual cash flows due and those that the lender would expect to receive, considering cash flows from collateral.

Establishing the number and relative weightings of forward-looking scenarios for each type of product/market and determining the forward-looking information relevant to each scenario. When measuring ECL the Group uses reasonable and supportable forward-looking information, which is based on assumptions for the future movement of different economic drivers and how these drivers will affect each other.

There is no ECL recognised on financial assets other than loans and advances as the Group has determined there is no material expected loss on these assets. The carrying value of loans and advances, as well as further information on the impairment provisions, is set out in note 7. Additionally, for further information on how the Group manages its credit risk please see note 24(b).

**(c) Goodwill and other intangible assets**

Determining whether goodwill or other intangible assets are impaired requires an estimation of the value in use of the cash generating units to which the intangible has been allocated. The value in use calculation requires management to estimate both the future cash flows expected to arise from the cash-generating unit and a suitable discount rate in order to calculate present value. Where the actual future cash flows are less than expected, an impairment loss may arise. In addition, determining the estimated useful lives of definite life intangible assets requires the use of judgement. For further information please see note 11.

**(d) Revenue recognition**

Measurement of financial instruments at amortised cost using the effective interest rate method requires calculations based on reliably estimated cash flows through the expected life of financial instruments incorporating behavioural modelling of prepayments. Any fee income accounted for using the effective interest rate method is assessed by management who apply judgement to ensure recognition in the most appropriate period.

AASB 15 requires the identification of performance obligations within a customer contract and a transaction price that is allocated to these obligations. Revenue is recognised upon satisfying these performance obligations. Key judgement is required to determine the timing and amount of variable consideration to be recognised in relation to performance fees, and the interrelated nature of obligations in the Group's servicing contracts. For further information please see note 4.

**(e) Share based payment valuation**

The value of employee services received (compensation expenses) in exchange for awards of equity instruments is recognised based upon the grant date fair value of share options, share rights and loans granted to employees. The grant date fair value of share options and share rights issued prior to 2018 are estimated using a Black-Scholes valuation model, a discounted cash flow model for loans granted to employees, and probability-weighted expected returns model for long term incentive plans issued after 2018. All models require the use of various assumptions and estimates involving management judgement. For further information please see note 22

## 4 Revenue and expenses

*Interest income*

Loans and advances are measured on an amortised cost basis in the balance sheet. Revenue is generally recognised over the life of the loan, taking into account all income and expenditure directly attributable to the loan. The rate at which revenue is recognised is referred to as the effective interest rate and is equivalent to the rate that effectively discounts estimated future cash flows throughout the estimated life to the net carrying value of the loan. The revenue stream includes interest revenue, mortgage risk fees received at loan settlement, loan premium revenue and early termination interest adjustments payable upon early redemption of a loan. Acquisition costs such as upfront broker commissions paid are also spread across the expected life of the loan. When a financial asset is classified in Stage 3 for impairment, subsequent interest income is recognised in profit or loss by applying the effective interest rate to the net carrying amount of the financial asset.

Interest expenses include: interest on customer deposits in South Korea, interest on securitised term funding facilities and interest on warehouse facilities (collectively referred to as asset funding). Interest expenses are recognised using the effective interest rate method.

*Fee revenue*

The key judgements in applying AASB 15 include the timing and amount of variable consideration (at a point in time or over time) to be recognised in relation to performance fees earned and determining whether multiple services provided in a single servicing contract are distinct.

*Servicing revenue*

Servicing fees are paid by portfolio owners to the Group for servicing portfolios of assets. Some contracts contain multiple performance obligations which are assessed separately for the nature and timing of their satisfaction. Except for performance fees, revenue is recognised over time as the servicing activities with the consideration being allocated to the performance obligations based on fair value.

Performance fees are recognised when the services have been provided and when it is considered highly probable that the performance will be met. The amount is estimated using either the expected value or most likely amount and recognised if, and only if, it is highly probably that the revenue will not subsequently reverse. Judgement is required to assess the likelihood and the potential amount of a revenue reversal from uncertain future events.

*Advisory fees*

Revenue is recognised upon completion of advisory services as the customer does not receive the benefits associated with the performance obligation until the services are complete.

*Other fee revenue*

The material components of other fee revenue include those fees that do not meet the criteria for recognition as part of the effective interest rate. Fees that relate to a provision of a specific transactional service are recognised when the service has been completed.

*Other revenue*

Other revenue includes gains on loan sales recognised upon de-recognition of loan portfolios by the Group.

**(a) Revenue recognition**

| | Year ended 31 December 2019 $'000 | Year ended 31 December 2018 $'000 |
|---|---|---|
| **Interest revenue:** | | |
| Interest from customers | **1,150,163** | 842,399 |
| Bank interest | **15,533** | 9,364 |
| **Total interest revenue** | **1,165,696** | 851,763 |
| **Interest expense:** | | |
| Interest - deposits | **(82,423)** | (59,797) |
| Interest - other asset funding | **(479,583)** | (366,691) |
| **Total interest expense** | **(562,006)** | (426,488) |
| **Total net interest revenue** | **603,690** | 425,275 |
| **Fee revenue:** | | |
| Servicing fees | **129,343** | 107,639 |
| Advisory fees | **15,443** | 21,790 |
| Other fee revenue | **82,127** | 69,674 |
| **Total fee revenue** | **226,913** | 199,103 |
| **Other revenue:** | | |
| Loan sale gains | **43,797** | 34,401 |
| Other revenue | **1,811** | 20,102 |
| Total other revenue | **45,608** | 54,503 |
| **Total revenue** | **876,211** | 678,881 |

Interest - other asset funding consists of funding costs paid on notes issued by securitised term funding facilities and warehouse facilities used to fund the Group's lending businesses. The Group's interest costs paid on corporate debt facilities and accrued on preference shares are disclosed at note 4(b).

Trial commissions payable in respect of the origination of loans and advances are expensed as an operational cost, and included in other expenses from operations (refer to note 4(b)). In prior years these expenses of $25.1m were deducted directly from interest from customers and therefore the 2018 comparatives have been restated accordingly. This restatement also impacted the Net interest income, Total revenue and Total expenses by the same amount. Profit before tax was not impacted.

**(b) Expense recognition policy**

*Employee benefits expense*

Employee benefits expenses are recorded for benefits to employees primarily in respect of wages and salaries, bonuses, share based payments, annual leave and long service leave and are recognised in respect of employees' services up to the end of the reporting period. See note 16 for further information on recognition and measurement of employee benefits.

*Depreciation of property, plant and equipment*

Depreciation of property, plant and equipment primarily includes depreciation of leasehold improvements, computer equipment and right of use lease assets arising from the implementation of AASB 16 on 1 January 2019, refer to notes 2 and 10 for additional information.

*Borrowing costs*

Borrowing costs include interest paid on corporate debt facilities, high yield bond and preference shares under the effective interest rate method. Refer to note 14 for further disclosures.

*Loan loss expenses*

Loan loss expenses include certain specific and collective provision movements for loan impairment and other direct loan write-offs recorded during the year.

| | **Year ended 31 December 2019 $'000** | Year ended 31 December 2018 $'000 |
|---|---|---|
| **(b) Expenses** | | |
| **Employee benefits expense** | **308,755** | 278,528 |
| | | |
| **Depreciation and amortisation** | | |
| Amortisation of intangibles | **12,324** | 8,149 |
| Depreciation of property, plant and equipment | **23,003** | 8,773 |
| | **35,327** | 16,922 |
| | | |
| **Borrowing costs** | | |
| Interest - corporate debt facilities | **46,431** | 30,787 |
| Interest expense - lease liability | **2,379** | - |
| | **48,810** | 30,787 |
| | | |
| **Loan loss expense** | **214,050** | 161,256 |
| | | |
| **Other expenses from operations** | | |
| Legal, consulting, audit, and other professional fees | **34,887** | 28,986 |
| Publications and advertising | **16,165** | 13,475 |
| Travel | **9,740** | 10,302 |
| Rent and other premises related expenses | **9,240** | 18,987 |
| Computer, internet, communication and information services | **34,840** | 25,002 |
| Insurance | **17,720** | 13,088 |
| GST input tax losses | **9,748** | 8,006 |
| Printing, stationery and postage | **4,911** | 3,792 |
| Trustee expenses, loan servicer fees, trail fees and loan enforcement expenses | **41,812** | 35,228 |
| Other expenses | **33,860** | 20,701 |
| **Total other expenses from operations** | **212,923** | 177,567 |

## 5 Taxation

Income tax expense comprises current and deferred tax. Income tax is recognised in the income statement, except when it relates to items that are recognised in other comprehensive income or directly in equity, in which case it follows the item to which it relates. Tax effects arising from the initial recognition of a business combination are included in the accounting for that business combination.

*(i) Australian tax consolidated group*

The Company and its wholly-owned Australian entities have formed a consolidated group for Australian income tax purposes. All entities within the tax consolidated group have entered into a tax sharing and funding agreement. The agreement is intended to limit joint and several liabilities for the applicable taxes.

*(ii) Current tax*

Current tax payable is based on taxable profit for the year and is calculated at the income tax rates applicable to group entities that have been enacted or substantively enacted in each jurisdiction at balance date.

*(iii) Deferred tax*

Deferred tax is accounted for using the balance sheet method, providing for temporary differences between the carrying amounts of assets and liabilities in the consolidated financial statements and the corresponding tax bases. Deferred tax assets and liabilities are not recognised in respect of the following temporary differences:

- those arising from the initial recognition of goodwill.
- those arising from the initial recognition of other assets and liabilities (other than in a business combination) that affects neither the taxable income nor the accounting profit.
- those related to investments in subsidiaries to the extent that it is probable that they will not reverse in the foreseeable future.

Deferred tax assets are recognised where it is probable that future taxable profits will be available against which the asset can be utilised.

Deferred tax is determined using the tax rates that are expected to apply in the period in which the liability will be settled or the asset realised, based on income tax rates (and tax laws) that have been enacted or substantively enacted at balance date.

Deferred tax assets and liabilities are offset when there is a legally enforceable right to set off current tax assets against current tax liabilities and the Group intends to settle them on a net basis.

| | **Year ended 31 December 2019 $'000** | Year ended 31 December 2018 $'000 |
|---|---|---|
| **(a) Income tax recognised in profit or loss** | | |
| *Current tax* | | |
| Current tax expense in respect to the current year | **11,718** | 7,667 |
| Adjustments recognised in the current year in relation to the current tax of prior years | **2,617** | (838) |
| **Total current tax expense** | **14,335** | 6,829 |
| *Deferred tax* | | |
| Deferred tax (benefit)/expense recognised in the current year | **3,229** | (2,344) |
| Adjustments recognised in the current year in relation to the deferred tax of prior years | **(2,388)** | (872) |
| **Total deferred tax (benefit) / expense** | **841** | (3,216) |
| **Total income tax expense recognised in the current year relating to continuing operations** | **15,176** | 3,613 |

| (b) The income tax expense for the year can be reconciled to the accounting profit as follows: | Year ended 31 December 2019 $'000 | Year ended 31 December 2018 $'000 |
|---|---|---|
| Profit from continuing operations before income tax expense | **65,026** | 24,562 |
| Tax at the Australian tax rate of 30.0% (2017: 30.0%) | **19,508** | 7,368 |
| Difference in overseas tax rates | **(5,213)** | (5,249) |
| Effect of expenses that are not deductible in determining taxable profit | **4,617** | 8,487 |
| Effect of income that is exempt from taxation | **(2,297)** | (4,451) |
| Previously unrecognised tax losses used to reduce deferred tax expense | **(2,580)** | (427) |
| Other | **911** | (405) |
| | **14,946** | 5,323 |
| Adjustments recognised in the current year in relation to the income tax of prior years | **230** | (1,710) |
| **Income tax expense** | **15,176** | 3,613 |

The tax rate used for the reconciliation above is the corporate tax rate of 30% payable by Australian corporate entities on the taxable profits under Australian tax law.

| (c) Deferred tax recognition | Year ended 31 December 2019 $'000 | Year ended 31 December 2018 $'000 |
|---|---|---|
| Deferred tax | **8,956** | 1,685 |
| **Total income tax recognised in other comprehensive income** | **8,956** | 1,685 |
| | | |
| Deferred tax | **1,127** | 17,140 |
| **Total income tax recognised in equity** | **1,127** | 17,140 |

| (d) Deferred tax balances | Year ended 31 December 2019 $'000 | Year ended 31 December 2018 $'000 |
|---|---|---|
| Opening balance | **33,548** | 11,435 |
| Impact from AASB 9 adoption | **-** | 16,784 |
| Impact from AASB 15 adoption | **-** | 356 |
| Impact from AASB 16 adoption | **1,127** | - |
| **Adjusted opening balance** | **34,675** | 28,575 |
| | | |
| Recognised in the income statement | **(841)** | 3,216 |
| Recognised in other comprehensive income | **8,956** | 1,685 |
| Others | **(2,450)** | 72 |
| **Closing balance** | **40,340** | 33,548 |

| (d) Deferred tax balances | Year ended 31 December 2019 $'000 | Year ended 31 December 2018 $'000 |
|---|---|---|
| **Breakdown of closing balance as follows:** | | |
| Employee benefits | **7,840** | 6,955 |
| Provisions | **4,996** | 548 |
| Loans and advances - deferred origination expense | **(15,264)** | (13,449) |
| Loan loss provisions and other doubtful debts | **18,792** | 23,002 |
| Deferred revenue | **2,826** | 1,909 |
| Other financial assets | **1,687** | 5,410 |
| Intangible assets | **838** | (694) |
| Reserves | **12,745** | 3,528 |
| Recognition of tax assets relating to tax losses | **5,244** | 6,940 |
| Other | **636** | (601) |
| | **40,340** | 33,548 |
| **Deferred tax balances are presented in the balance sheet as follows:** | | |
| Deferred tax assets | **47,286** | 34,750 |
| Deferred tax liabilities | **(6,946)** | (1,202) |
| | **40,340** | 33,548 |

*(iv) Unrecognised temporary differences*

There are unused tax losses in the Group, for which no deferred tax asset has been recognised as the measurement of any recognisable deferred tax asset is still highly uncertain and not reliably measurable.

## 6 Receivables

*(i) Trade receivables*

Trade receivables are amounts comprised primarily of servicing receivables earned in the ordinary course of business across the Group.

*(ii) Other debtors*

This balance comprises various other sundry balances which management do not consider core to the Group's business.

*(iii) Loans to related parties*

This balance predominantly represents loan assets held by Pepper Group Pty Limited with Red Hot Australia Bidco Pty Limited and with Executives and other employees associated with share based payments schemes.

Refer to note 24 for further Group accounting policy on receivables.

| | As at 31 December 2019 $'000 | As at 31 December 2018 $'000 |
|---|---|---|
| Trade receivables | **33,858** | 65,104 |
| Other debtors | **65,954** | 42,128 |
| Loans to related parties | **30,860** | 11,652 |
| **Total receivables** | **130,672** | 118,884 |

## 7 Loans and advances

Loans and advances are measured at amortised cost using the effective interest rate method.

*Deferred transaction costs*

Transaction costs include broker fees and commissions capitalised on the balance sheet as part of loans and advances. These costs are amortised to the income statement in line with the reduction in the underlying mortgage portfolio as part of the effective interest rate on the mortgage receivables.

*Impairment*

The Group recognises a loss allowance for expected credit losses on all loans and advances in accordance with AASB 9. Refer to note 24 for Group accounting policy.

| | **As at 31 December 2019 $'000** | As at 31 December 2018 $'000 |
|---|---|---|
| **Loans and advances by legal structure** | | |
| Loans and advances residing in securitised term trusts | **10,223,993** | 7,822,911 |
| Loans and advances residing in funding warehouses | **5,798,960** | 4,766,359 |
| Loans and advances residing in corporate entities | **3,504,171** | 2,777,225 |
| **Total loans and advances** | **19,527,124** | 15,366,495 |
| | | |
| **Loans and advances by product** | | |
| Residential mortgages | **14,012,974** | 10,920,450 |
| Auto and equipment finance | **2,502,642** | 1,938,239 |
| Personal loans | **1,787,784** | 1,555,725 |
| Commercial loans | **792,356** | 644,849 |
| Point-of-sale finance | **431,368** | 307,232 |
| **Total loans and advances** | **19,527,124** | 15,366,495 |

| | **As at 31 December 2019 $'000** | As at 31 December 2018 $'000 |
|---|---|---|
| **Impairment provisions** ***(included in the balances above):*** | | |
| Opening balance | **251,387** | 71,112 |
| Impact from adoption of AASB 9 | **-** | 62,689 |
| | **251,387** | 133,801 |
| | | |
| **Impairment provisions** ***(included in the balances above):*** | | |
| Provided for during the year | **214,098** | 161,439 |
| Loan assets written-off, sold or reversed, previously provided for | **(144,757)** | (52,598) |
| Effect of currency translation differences | **(5,608)** | 8,745 |
| **Total impairment provisions** | **315,120** | 251,387 |

## 8 Investments

*Debt Investments at FVTPL*

This balance is primarily comprised of a number of debt portfolio investments held by the Group at FVTPL.

*Equity investments at FVTPL*

This balance consists of shares held by the Group in various private companies in Australia, these are covered by the Group's AASB 9 accounting policies outlined in note 24.

*Corporate bonds at FVTPL*

Corporate bonds mainly comprise short term securities held at various times by the South Korean mutual savings bank as part of its liquidity management program. These may and will, fluctuate in size depending on the needs of the bank at any given point in time.

| | As at 31 December 2019 $'000 | As at 31 December 2018 $'000 |
|---|---|---|
| Equity investments at FVTPL | **10,212** | 20,149 |
| Corporate Bonds at FVTPL | **30,576** | 80,770 |
| Debt investments at FVTPL | **24,099** | 7,234 |
| Government bonds at FVTPL | **87** | 4 |
| **Total other investments** | **64,974** | 108,157 |

## 9 Investment in associates

*(i) General*

Associates are those entities over which the Group has significant influence but not control or joint control. Significant influence is the power to participate in the financial and operating policy decisions of the investee but is not control or joint control over those policies.

*(ii) Equity method*

Under the equity method of accounting, the investments are initially recognised at cost and adjusted thereafter to recognise the Group's share of the post-acquisition profits or losses of the investee in the income statement and the Group's share of movements in other comprehensive income of the investee in other comprehensive income. Dividends received or receivable from associates and joint ventures are recognised as a reduction in the carrying amount of the investment.

The carrying amount of equity-accounted investments are reviewed for impairment indicators at each reporting period and are tested for impairment when indicators of impairment exist.

*(iii) Details of associate investments*

Details of the Group's material investments in associates are outlined below:

| | | **As at** |
|---|---|---|
| | **31 December 2019 $'000** | 31 December 2018 $'000 |
| **Investments in associates** | | |
| Prime Credit Holdings Limited | **112,785** | 109,079 |
| Other investments in associates | **22,310** | - |
| | **135,095** | 109,079 |
| | | |
| **Group's share of profits** | | |
| Prime Credit Holdings Limited | **8,550** | 10,741 |
| Other investments in associates | **130** | - |
| | **8,680** | 10,741 |

*(iii) Details of associate investments (continued)*

Other associates primarily represent secured commercial real estate lending to customers in South Korea. The lending has been provided using Special Purpose Vehicles (SPVs) as the mechanism for lending on a syndicated basis. The Group is required to report the loans as investments in associates where it has provided greater than 20% but not more than 50% of the funding to each SPV. The collateral held by the SPVs largely consists of infrastructure and real estate assets. In aggregate the other associates recorded $15m of revenue and $0.4m of net profit after tax for the year ended 31 December 2019. At 31 December 2019 they collectively had $91m of total assets and $49m of equity.

*(iv) Prime Credit Holdings Limited*

The Group's only significant investment is in Prime Credit Holdings Limited, a consumer finance business in Hong Kong and China. This investment has been classified as an investment in an associate due to the Group's significant involvement in the financial and operating policy decisions, including Board representation of PCHL.

PCHL is incorporated in Hong Kong and the Group holds a 12% (2018: 12%) ownership interest and voting power.

| **Summarised statement of comprehensive income** | **Year ended 31 December 2019 $'000** | Year ended 31 December 2018 $'000 |
|---|---|---|
| Revenue | **380,299** | 351,527 |
| **Profit after tax** | **71,628** | 89,507 |
| Other comprehensive income | **2,522** | (4,972) |
| **Total comprehensive income** | **74,150** | 84,535 |

| **Summarised balance sheet** | **As at 31 December 2019 $'000** | As at 31 December 2018 $'000 |
|---|---|---|
| **Balance sheet** | | |
| Current assets | **266,834** | 200,028 |
| Non-current assets | **2,241,576** | 2,184,719 |
| **Total assets** | **2,508,410** | 2,384,747 |
| Current liabilities | **(1,205,826)** | (1,228,933) |
| Non-current liabilities | **(382,701)** | (266,772) |
| **Total liabilities** | **(1,588,527)** | (1,495,705) |
| **Net assets** | **919,883** | 889,042 |
| Group's share of net assets - 12% | **110,386** | 106,685 |
| Acquisition costs | **2,399** | 2,394 |
| **Total carrying amount of investment** | **112,785** | 109,079 |

The Group received a sum of $3.4m (2018: $5.7m) in dividends during the year from PCHL.

## 10 Property, plant and equipment

*(i) Property, plant and equipment*

Property, plant and equipment is measured at cost less accumulated depreciation and impairment losses.

Assets are depreciated on a straight-line basis over their estimated useful lives. Leasehold improvements are amortised over the shorter of the remaining period of the individual leases or the estimated useful life of the improvement. Useful lives are reassessed each period. Where parts of an item of property, plant and equipment have different useful lives, they are accounted for as separate assets. The expected useful lives are as follows:

Leasehold improvements - Not greater than the reasonable certain term of the lease of the premises

Office furniture and computer equipment - 1 to 5 years

*(ii) Right of use assets*

Right of use leases assets have arisen due to the implementation of AASB 16 on 1 January 2019. For related accounting policy and classification in comparative year please see note 2(a)(i).

| | **31 December 2019** | | | 31 December 2018 | | |
|---|---|---|---|---|---|---|
| | **Cost** | **Accumulated depreciation** | **Total** | Cost | Accumulated depreciation | Total |
| Land and buildings | **47,695** | **(97)** | **47,598** | - | - | - |
| Leasehold improvements | **28,418** | **(15,891)** | **12,527** | 20,595 | (8,613) | 11,982 |
| Office furniture | **7,408** | **(3,985)** | **3,423** | 14,730 | (9,733) | 4,997 |
| Computer equipment | **22,709** | **(16,635)** | **6,074** | 15,740 | (11,067) | 4,673 |
| Right of Use - Buildings | **65,559** | **(17,881)** | **47,678** | - | - | - |
| Right of Use - Other | **1,822** | **(696)** | **1,126** | - | - | - |
| | **173,611** | **(55,186)** | **118,426** | 51,065 | (29,413) | 21,652 |

## 11 Intangible assets & Goodwill

*(i) Nature of intangible assets*

- Goodwill - recognised as the consideration over and above the identifiable net assets on acquisition of the Oakwood business and the Optimum Credit business in the UK and the Avent IKE business in Greece.
- Mortgage servicing rights - the servicing rights relate to contracts acquired in the Oakwood business in the UK.
- South Korean mutual banking registration - the registration gives the South Korea savings bank the right to operate as a mutual savings bank in South Korea for an indefinite period of time.
- Licence fees and other information and technology costs recognised within the Group.

| | Licence fees and software $'000 | Mortgage servicing rights $'000 | South Korean mutual savings bank registration $'000 | Intangible assets (excluding Goodwill) $'000 | Goodwill $'000 | Total $'000 |
|---|---|---|---|---|---|---|
| Net book value at 31 December 2017 | 20,668 | 2,755 | 25,619 | 49,042 | 22,415 | 71,457 |
| Acquisitions | - | - | - | - | 45,101 | 45,101 |
| Additions | 26,419 | - | - | 26,419 | - | 26,419 |
| Disposal | (1,560) | - | - | (1,560) | - | (1,560) |
| Amortisation expense | (7,646) | (495) | - | (8,141) | - | (8,141) |
| Translation differences | 260 | 124 | 1,582 | 1,966 | 1,011 | 2,977 |
| Impairment | - | - | - | - | (7,703) | (7,703) |
| Net book value at 31 December 2018 | 38,141 | 2,384 | 27,201 | 67,726 | 60,824 | 128,550 |
| *Made up of:* | | | | | | |
| Gross carrying amount | 62,878 | 5,020 | 27,201 | 95,099 | 60,824 | 155,923 |
| Accumulated amortisation | (15,780) | (2,036) | - | (17,816) | - | (17,816) |
| Net book value at 31 December 2018 | 47,098 | 2,984 | 27,201 | 77,283 | 60,824 | 138,107 |
| **Acquisitions** | **-** | **-** | **-** | **-** | **-** | **-** |
| **Additions** | **22,286** | **-** | **-** | **22,286** | **-** | **22,286** |
| **Amortisation expense** | **(11,815)** | **(509)** | **-** | **(12,324)** | **-** | **(12,324)** |
| **Translation differences** | **(133)** | **86** | **(896)** | **(943)** | **(503)** | **(1,446)** |
| **Net book value at 31 December 2019** | **48,479** | **1,961** | **26,305** | **76,745** | **60,321** | **137,066** |
| ***Made up of:*** | | | | | | |
| **Gross carrying amount** | **81,986** | **5,226** | **26,305** | **113,517** | **60,321** | **173,838** |
| **Accumulated amortisation** | **(33,507)** | **(3,265)** | **-** | **(36,772)** | **-** | **(36,772)** |
| **Net book value at 31 December 2019** | **48,479** | **1,961** | **26,305** | **76,745** | **60,321** | **137,066** |

*(ii) Amortisation methods and useful lives*

The Group amortises intangible assets using the straight-line method over the following periods:

- Software costs and licence fee - over the expected life of the software - usually up to 3 years
- Mortgage servicing rights - over the average expected life of the rights
- South Korean mutual banking registration - indefinite life
- Goodwill - indefinite life

*(iii) Goodwill*

Goodwill arising on an acquisition of a business is carried at cost as established at the date of the acquisition of the business less accumulated impairment losses, if any.

Gains and losses on the disposal of an entity include the carrying amount of goodwill relating to the entity sold. For the purpose of impairment testing, goodwill is allocated to each of the Group's cash-generating units (or groups of cash generating units) that is expected to benefit from the synergies of the combination.

*(iv) Mortgage servicing rights & South Korean banking registration*

Both of these intangible assets have been acquired through business combinations and were initially recognised at their fair value on the acquisition date (which is regarded as their cost).

Subsequent to initial recognition, the servicing rights, which have a finite life, are carried at cost less accumulated amortisation and accumulated impairment losses. Amortisation is recognised on a straight-line basis over the estimated useful life. The estimated useful life and amortisation method are reviewed at the end of each reporting period, with the effect of any changes in estimate being accounted for on a prospective basis.

The South Korean mutual savings bank registration (KMBR) is considered to have an indefinite useful life as it is expected to contribute future economic benefits to the Group indefinitely through the right to operate as a savings bank established under the Mutual Savings Bank Act of the Republic of Korea. The KMBR, being an indefinite life intangible, is carried at cost less accumulated impairment losses. The carrying amount of the KMBR was allocated to the South Korean cash-generating unit for impairment testing purposes and collectively compared to the value in use of the South Korean cash generating unit.

*(v) Impairment tests for indefinite life intangible assets*

Goodwill and intangible assets that have an indefinite useful life are not subject to amortisation and are tested annually for impairment, or more frequently if events or changes in circumstances indicate they might be impaired. Other assets are tested for impairment whenever events or changes in circumstances indicate that the carrying amount may not be recoverable. An impairment loss is recognised for the amount by which the asset's carrying amount exceeds its recoverable amount. The recoverable amount is the higher of an asset's fair value less costs of disposal and value in use. For the purpose of assessing impairment, assets are grouped at the lowest levels for which there are separately identifiable cash inflows which are largely independent of the cash inflows from other assets or groups of assets (cash-generating units).

*(v) Impairment tests for indefinite life intangible assets (continued)*

| | **South Korea** | **Oakwood** | **Optimum Credit** | **Hellas** |
|---|---|---|---|---|
| Nature of intangible assets | Banking registration | Goodwill | Goodwill | Goodwill |
| Recoverable amount methodology used | Value in use | Value in use | Value in use | Value in use |
| **Period ended December 2019** | | | | |
| Carrying amount ($'000) | 26,305 | 15,951 | 38,814 | 5,556 |
| **Valuation assumptions used:** | | | | |
| Forecast period (years) | 3 | 3 | 3 | 3 |
| Revenue (% annual growth rate) | 21 | 10 | 37 | 57 |
| Long term growth rate (%) | 2.0 | 1.0 | 3.0 | 0.3 |
| Pre-tax discount rate (%) | 14.61 | 13.6 | 13.4 | 13.6 |
| **Period ended December 2018** | | | | |
| Carrying amount ($'000) | 27,201 | 15,321 | - | - |
| **Valuation assumptions used:** | | | | |
| Forecast period (years) | 3 | 3 | - | - |
| Revenue (% annual growth rate) | 30 | 14 | - | - |
| Long term growth rate (%) | 1.5 | 2.5 | - | - |
| Pre-tax discount rate (%) | 10.6 | 10.3 | - | - |

Optimum Credit and Hellas were acquired during 2018 and at the year end businesses are performing to plan and there were no indicators of impairment as at the 31 December 2018. An impairment was recognised in 2018 relating to the Pepper Property Group business that was disposed of in 2019.

*Approach followed to determine the value of assumptions used*

| **Assumption** | **Approach used to determine values** |
|---|---|
| Forecast period | The forecast period is the period over which management consider forecasting most reliable (and is consistent with the Group's approach to forecasting) plus a terminal value. |
| Average revenue growth rates | This is based on management's expectation of the cash generating unit's development in the market over the 3 year period when considering past performance. |
| Long-term growth rate | Regional inflation rates, consistent with external sources of data and economic conditions beyond 3 years. |
| Discount rate | Reflect specific risks relating to the relevant segments and the countries in which they operate. |

The Group performed sensitivity analysis and stress testing of the above assumptions for all cash generating units. As a result of the testing performed, Directors believe, as at 31 December 2019, any reasonable possible change in the key assumptions on which recoverable amount is based would not cause the aggregate carrying amount to exceed the aggregate recoverable amount of the cash-generating unit.

## 12 Business combination

### (a) Business combinations

The acquisition method of accounting is used to account for all business combinations, regardless of whether equity instruments or other assets are acquired. The consideration transferred for the acquisition of a subsidiary comprises the:

- fair values of the assets transferred,
- liabilities incurred to the former owners of the acquired business,
- equity interests issued by the Group,
- fair value of any asset or liability resulting from a contingent consideration arrangement, and
- fair value of any pre-existing equity interest in the subsidiary.

Identifiable assets acquired and liabilities and contingent liabilities assumed in a business combination are, with limited exceptions, measured initially at their fair values at the acquisition date. The Group recognises any non-controlling interest in the acquired entity on an acquisition-by-acquisition basis either at fair value or at the non-controlling interest's proportionate share of the acquired entity's net identifiable assets.

Acquisition-related costs are expensed as incurred.

The excess of the

- consideration transferred,
- amount of any non-controlling interest in the acquired entity, and
- acquisition-date fair value of any previous equity interest in the acquired entity

over the fair value of the net identifiable assets acquired is recorded as goodwill. If those amounts are less than the fair value of the net identifiable assets of the business acquired, the difference is recognised directly in profit or loss as a bargain purchase.

Where settlement of any part of cash consideration is deferred, the amounts payable in the future are discounted to their present value as at the date of exchange. The discount rate used is the entity's incremental borrowing rate, being the rate at which a similar borrowing could be obtained from an independent financier under comparable terms and conditions.

Contingent consideration is classified either as equity or a financial liability. Amounts classified as a financial liability are subsequently remeasured to fair value with changes in fair value recognised in profit or loss.

If the business combination is achieved in stages, the acquisition date carrying value of the acquirer's previously held equity interest in the acquiree is remeasured to fair value at the acquisition date. Any gains or losses arising from such remeasurement are recognised in profit or loss.

### (b) Summary of acquisition and disposals

On the 27 May 2019 the Group completed the strategic sale of Pepper Property Group (PPG) to management and staff of PPG. PPG was rebranded to CapStra as a result of the management buyout.

There were no acquisitions during 2019.

**2018 acquisitions**

On 13 December 2018 Pepper Money (Pepper) acquired 100% of the shares of Optimum Credit Ltd, a second charge mortgage business in the UK. Pepper acquired Optimum Credit's entire business, which includes a UK second charge loan portfolio of more than $950.7m residing in securitised term funding and warehouse funding vehicles.

On 14 May 2018 Pepper acquired 100% of the shares in Avent S.A. and its 100% owned subsidiary Avent IKE (together 'Hellas') a Greek real estate advisory business. Pepper paid $5.5m to acquire the shares resulting in the recognition of $5.5m of new net assets (including $5.2m goodwill).

**(b) Summary of acquisition and disposals (continued)**

| | Optimum Credit $'000 | Hellas $'000 | Total $'000 |
|---|---|---|---|
| **Total consideration** | 59,950 | 5,500 | 65,450 |
| **Assets** | | | |
| Cash and cash equivalents | 112,737 | 157 | 112,894 |
| Receivables | 1,162 | 423 | 1,585 |
| Other assets | 1,666 | 16 | 1,682 |
| Loans and advances | 950,675 | - | 950,675 |
| Property, plant and equipment | 711 | 80 | 791 |
| Intangible assets | - | 58 | 58 |
| **Total assets** | **1,066,951** | **734** | **1,067,685** |
| **Liabilities** | | | |
| Borrowings | (911,857) | - | (911,857) |
| Other liabilities | (134,605) | (385) | (134,990) |
| Provisions | (356) | - | (356) |
| Deferred tax liabilities | (133) | - | (133) |
| **Total liabilities** | (1,046,951) | (385) | (1,047,336) |
| **Net identifiable assets acquired** | 20,000 | 349 | 20,349 |
| **Goodwill acquired on acquisition** | **39,950** | **5,151** | **45,101** |

## 13 Deposits

Deposits are the primary source of funding for the South Korean Savings Bank. Subsequent to initial recognition, deposits are measured at amortised cost using the effective interest rate method.

| | **As at 31 December 2019 $'000** | As at 31 December 2018 $'000 |
|---|---|---|
| **Deposits from customers** | | |
| At call | **141,381** | 78,836 |
| Term deposits | **3,523,050** | 2,747,507 |
| **Total deposits** | **3,664,431** | 2,826,343 |

## 14 Borrowings

All borrowings are initially recognised at fair value of the consideration received less directly attributable transaction costs. After initial recognition, interest bearing borrowings are measured at amortised cost using the effective interest rate method. For further detail on the amortised cost basis of accounting see note 4 revenue and expenses.

| | **As at 31 December 2019 $'000** | As at 31 December 2018 $'000 |
|---|---|---|
| Securitised term funding facilities | **10,800,138** | 7,413,158 |
| Warehouse facilities - secured | **5,642,623** | 5,522,761 |
| Corporate debt facilities | **526,911** | 517,067 |
| Preference shares | **97,966** | - |
| **Total borrowings** | **17,067,638** | 13,452,986 |

The Group's borrowings consist of:

Securitised term funding facilities: loans initially funded via a warehouse facility are pooled together and refinanced by being sold to a new funding vehicle (term securitisation) that issues non-recourse asset-backed securities to investors. Term securitisation facilities are secured on the assets of each individual term securitisation entity;

Warehouse facilities - secured: third-party funders provide non-recourse financing to special purpose vehicles (warehouses) established by Pepper to originate or acquire loans. Warehouse facilities are secured by the loans and other cash collateral residing in the warehouses;

Corporate debt facilities: utilised for working capital and business operations which include a revolving credit facility issued in Australia, a related party loan from Bidco ($367m). Corporate debt facilities are secured on certain assets and shares held within the Group's global businesses; and

Preference shares: shares issued by Pepper Savings Bank (PSB) in South Korea in September 2019. The preference shares are classified equity (regulatory capital) in PSB but are classified as borrowings for Group, to support capital requirements in PSB.

## 15 Other liabilities

*(i) Settlement balances*

Settlement balances arising from the timing of funds collected by the Group yet to be passed onto customers. These balances are predominantly held within the Group's servicing and the South Korean banking businesses.

*(ii) Deferred consideration and other*

This balance is made up of deferred consideration payable to sellers of businesses acquired by the Group and a large number of individually immaterial amounts. Among the drivers of this balance are accruals built up within Pepper's servicing businesses which will be subsequently passed on to customers.

*(iii) Leasing activities*

The Group's leases primarily relate to the lease of buildings with lease terms generally between 2 and 10 years. Most lease contracts over 2 years contain clauses for annual market rental reviews or increases linked to annual inflation rates. The Group does not have an option to purchase the leased properties at the expiry of the lease periods. As outlined in note 2, $46.1m of lease liabilities were recognised from the adoption of AASB 16 on 2 January 2019.

| | **As at 31 December 2019 $'000** | As at 31 December 2018 $'000 |
|---|---|---|
| Settlement balances | **154,289** | 181,876 |
| Deferred consideration and other liabilities | **86,738** | 70,958 |
| Lease liabilities | **60,934** | 767 |
| Trail commissions payable to third parties | **1,760** | 2,448 |
| **Total other liabilities** | **303,721** | 256,049 |

## 16 Provisions

*(i) Accounting policy*

Provisions are recognised when the Group has a present obligation (legal or constructive) as a result of a past event, it is probable that the Group will be required to settle the obligation and a reliable estimate can be made of the amount of the obligation.

The amount recognised as a provision is the best estimate of the consideration required to settle the present obligation at the end of the reporting period, taking into account the risks and uncertainties surrounding the obligation. When a provision is measured using the cash flows estimated to settle the present obligation, its carrying amount is the present value of those cash flows (where the effect of the time value of money is material).

*(ii) Bonuses & other employee benefits*

Employee benefit liabilities are recognised for benefits accruing to employees predominantly in respect of wages and salaries, bonuses, annual leave and long service leave and are recognised in respect of employees' services up to the end of the reporting period. The measurement of such employee benefit liabilities is as follows:

• Short-term employee benefits (those expected to be settled within 12 months after the end of the reporting period) are measured at their nominal values using the remuneration rate expected to apply at the time of settlement.
• Long term employee benefits are measured as the present value of the estimated future cash outflows to be made by the Group in respect of services provided by employees up to the reporting date.

| | **Employee benefits $'000** |
|---|---|
| Balance at 31 December 2017 | 40,214 |
| Increase in provisions | 47,845 |
| Provision utilised | (33,656) |
| Exchange differences | 1,268 |
| Balance at 31 December 2018 | 55,671 |
| **Increase in provisions** | **58,953** |
| **Provision utilised** | **(54,399)** |
| **Exchange differences** | **84** |
| **Balance at 31 December 2019** | **60,309** |
| **Expected timing for utilisation of provisions:** | |
| Less than 12 months | 50,151 |
| Greater than 12 months | 5,520 |
| Balance at 31 December 2018 | 55,671 |
| **Less than 12 months** | **55,039** |
| **Greater than 12 months** | **5,270** |
| **Balance at 31 December 2019** | **60,309** |

## 17 Issued capital

| | Number of shares '000 | $'000 |
|---|---|---|
| As at 31 December 2017 | 184,369 | 306,101 |
| Shares issued | 13,723 | 50,000 |
| As at 31 December 2018 | 198,092 | 356,101 |
| Shares issued | 53,843 | 245,669 |
| **As at 31 December 2019** | **251,935** | **601,770** |

## 18 Other equity and other reserves

| **Equity/Reserve** | **Nature** |
|---|---|
| Common control reserve | The common control reserve arose as a result of a transaction between entities with common control. |
| Currency translation reserve | The currency translation reserve represents the cumulative gains and losses on the retranslation of the Group's net investment in foreign operations. |
| Cash flow hedge reserve | The cash flow hedge reserve represents the cumulative effective portion of gains or losses arising on changes in fair value of hedging instruments entered into for cash flow hedges. The cumulative gain or loss arising on changes in fair value of the hedging instruments that are recognised and accumulated in the cash flow hedge reserve will be reclassified to the income statement only when the hedged transaction affects the profit or loss. |

| | **As at 31 December 2019 $'000** | As at 31 December 2018 $'000 |
|---|---|---|
| Other equity | **(774)** | (523) |
| Common control reserve | **(18,653)** | (18,653) |
| **Total other equity** | **(19,427)** | (19,176) |
| Currency translation reserve | **29,897** | 30,633 |
| Cash flow hedges reserve | **(28,574)** | (5,848) |
| Other reserves | **51** | 51 |
| **Total other reserves** | **1,374** | 24,836 |

## 19 Structured entities

A structured entity is an entity that has been designed so that voting or similar rights are not the dominant factor in deciding who controls the entity and the relevant activities are directed by means of contractual arrangements. The Group considers all limited recourse entities in which it has interests to be structured entities.

*(i) Consolidated structured entities*

Pepper primarily utilises warehouse facilities and the securitisation markets to fund the origination of new loans (refer to Note 7).

Once loans are transferred into funding vehicles, they are funded by third-party senior and mezzanine debt, and equity, or other "first loss" capital, contributed by Pepper as part of a warehouse facility arrangement. The majority of warehouse facility funding is represented by the senior debt facilities, which are typically provided by highly-rated, regulated financial institutions and are available to Pepper on a revolving basis subject to eligibility criteria and other terms specific to each warehouse facility.

Periodically, warehouse facilities are refinanced through term securitisations involving the issuance of asset-backed securities which are long term match funding transactions placed by Pepper through the debt capital markets to a range of financial investors.

*(i) Consolidated structured entities (continued)*

In both warehouse facility and term securitisation structures, the third-party providers of the senior notes have first ranking priority over cash flows generated by the loans held by the funding vehicle and their contractual interest and principal repayments rank at the top (or near the top) of payment waterfalls (after certain expenses). Mezzanine funding providers' priority ranks below that of the senior funding providers. Pepper, as the provider of "first loss" capital and residual unitholder, receives its distributions only when the senior and mezzanine funders have received their contractual payments, and as the residual income unitholder, benefits from any additional incremental profits generated in the funding vehicle.

Pepper's limited-recourse financing structures transfer the risk of credit losses on mortgage portfolios to the capital providers to the funding vehicles. Pepper's exposure to losses is therefore limited to its rights to current and future residual income from its funding vehicles, along with the value of the equity notes that Pepper contributes as "first loss" capital to the funding vehicles.

Should a material increase in losses on Pepper's mortgages occur, the level of income available for distribution from the funding vehicles will decline, resulting in a reduction in equity note coupons and residual income paid to Pepper by the funding vehicles.

As losses increase beyond certain thresholds, the funding vehicles would cease distributing residual income and making distributions on Pepper's equity notes, and cash will instead be applied to repay the senior and mezzanine funding components of the funding vehicles; however, Pepper will have no legal obligation to contribute additional capital to offset the realised losses. In such a scenario, Pepper is able to increase the interest rate that it charges to its mortgage customers in order to offset the reduction in income due to credit losses.

Pepper is deemed to control these funding structures for accounting purposes due to the combination of Pepper's investment in each funding vehicle (exposure to variable interest) and Pepper's role as servicer (power to influence those variable returns). As a result, Pepper consolidates the assets and liabilities, income and expenses of most of these entities.

*(ii) Non-consolidated structured entities*

The Group's interests in non-consolidated structured entities can be categorised as follows:

- Investments in non-Pepper special purpose vehicles (SPVs). Each of the SPVs Pepper has an investment in, is designed to invest in and manage consumer, commercial or residential loan portfolios. The SPVs finance themselves by issuing note securities which entitle the holder to a specified stream of cash flows from the loan portfolios.
- Receivables earned in the course of servicing non-Pepper SPVs.

These SPVs are not consolidated as Pepper does not meet the definition of control.

The nature and extent of the Group's interests, as well as the Group's maximum exposure to loss, can be summarised as follows:

*(ii) Non-consolidated structured entities (continued)*

| | Commercial $'000 | Residential $'000 | Consumer $'000 | Total $'000 |
|---|---|---|---|---|
| **As at 31 December 2019** | | | | |
| **Balance Sheet** | | | | |
| **Assets** | | | | |
| Investments in non-consolidated SPVs | **1,642** | **2,144** | **-** | **3,786** |
| Receivables from non-consolidated SPVs | **-** | **486** | **448** | **934** |
| **Total assets** | **1,642** | **2,630** | **448** | **4,720** |
| **Maximum exposure to loss** | **1,642** | **2,630** | **448** | **4,720** |

| | Commercial $'000 | Residential $'000 | Consumer $'000 | Total $'000 |
|---|---|---|---|---|
| As at 31 December 2018 | | | | |
| Balance Sheet | | | | |
| Assets | | | | |
| Investments in non-consolidated SPVs | 10,802 | 2,586 | - | 13,388 |
| Receivables from non-consolidated SPVs | - | 453 | 586 | 1,039 |
| **Total assets** | **10,802** | **3,039** | **586** | **14,427** |
| **Maximum exposure to loss** | 10,802 | 3,039 | 586 | 14,427 |

The Group's maximum exposure to loss is limited to the carrying value of any investments in or receivables from the structured entities, as listed above. There are no additional off balance sheet arrangements with non-consolidated structured entities which would expose the Group to potential loss.

During the year the Group earned interest from its investments and servicing revenue from servicing contracts with a number of structured entities. Refer to note 4 for further information on revenues earned.

## 20 Related parties

### (a) Key management personnel compensation

| | Year ended 31 December 2019 $'000 | Year ended 31 December 2018 $'000 |
|---|---|---|
| **Key management personnel remuneration** | | |
| Short-term employee benefits | **5,768** | 5,454 |
| Post-employment benefits | **45** | 45 |
| Share-based payments | **2,053** | 5,146 |
| | **7,866** | 10,645 |

### (b) Transactions with other related parties

Balances and transactions between the Company and its subsidiaries, which are related parties of the Company, have been eliminated on consolidation and are not disclosed in this note. Details of transactions between the Group and other related parties are disclosed below.

During the year, group entities entered into the following transactions with related parties that are not members of the Group:

| | Year ended 31 December 2019 $'000 | Year ended 31 December 2018 $'000 |
|---|---|---|
| **Transactions with related parties (excluding employees)** | | |
| Fees and other revenue received from associates | **-** | 6,343 |
| Dividend received from associates | **3,423** | 5,758 |
| Interest received from related parties | **232** | 332 |
| Fees and other revenue received from other related parties | **1,095** | 1,521 |
| **Total revenue received** | **4,750** | 13,954 |
| | | |
| Interest paid to Red Hot Australia Bidco Pty Ltd and other related parties | **(27,971)** | (13,199) |
| Transaction costs paid on behalf of Red Hot Australia Holdco and Bidco Pty Ltd | **(91)** | (13,067) |
| **Total costs paid** | **(28,062)** | (26,266) |
| | | |
| **Balances held with related parties (excluding employees)** | | |
| Receivables due from Red Hot Australia Holdco Pty Ltd | **19,244** | - |
| Receivables due from Red Hot Australia Bidco Pty Ltd | **11,616** | 11,616 |
| Loan payable to Red Hot Australia Bidco Pty Ltd | **(366,693)** | 377,424 |
| **Total net receivables due from related parties** | **(335,833)** | 389,040 |

### (c) Parent entity and equity transactions

The ultimate parent entity of the Group is Red Hot Australia Holdco Pty Limited (Holdco), an entity incorporated in Australia. Holdco owns 100% of the shares in Red Hot Australia Bidco Pty Limited (Bidco) and Bidco owns 96.4% of the shares Pepper Group Pty Limited (and its controlled subsidiaries).

As outlined in note 22 the Group's employees are participants in share schemes in which Holdco is required to settle awards in the form of Holdco ordinary shares or cash. In accordance with AASB 2, as Holdco is required to settle the awards, the $5.3m of employee benefits received by the Group are presented in the statement of changes in equity as capital contributions from Holdco (2018: $14.5m).

The Group also receives capital injections from Bidco in exchange for ordinary shares, as outlined in note 17

## 21 Notes on the statement of cash flows

Cash and cash equivalents comprise cash on hand and demand deposits. Cash equivalents are short-term, highly liquid investments that are readily convertible to a known amount of cash, which are subject to an insignificant risk of changes in value and have a maturity of three months or less at the date of acquisition.

The Group's cash and cash equivalents include: balances held in corporate entities on behalf of servicing clients and balances held in limited recourse entities (collectively: cash and cash equivalents held on trust); balances held in Pepper Savings Bank in South Korea (subject to local regulations); and other balances held in Pepper's corporate entities.

| | **As at 31 December 2019 $'000** | 31 December 2018 $'000 |
|---|---|---|
| **(a) Reconciliation of cash and cash equivalents** | | |
| Held on trust | **1,132,408** | 851,200 |
| Pepper Savings Bank (South Korea) | **569,869** | 244,251 |
| Other corporate entities | **105,381** | 104,916 |
| | **1,807,658** | 1,200,367 |

| | **Year ended 31 December 2019 $'000** | Year ended 31 December 2018 $'000 |
|---|---|---|
| **(b) Reconciliation of profit for the year to net cash flows from operating activities** | | |
| **Profit for the period** | **49,850** | 20,949 |
| **Non-cash items:** | | |
| Depreciation and amortisation expenses | **35,327** | 16,927 |
| Loan loss expenses | **214,050** | 161,256 |
| Share of profits of associates | **(8,680)** | (10,741) |
| Share-based payment expense | **5,285** | 14,535 |
| Tax expense | **15,176** | 3,613 |
| **Cash movements in:** | | |
| Receivables | **(15,019)** | (3,497) |
| Other assets | **1,007** | (632) |
| Loans and advances | **35,107** | 18,782 |
| Trade payables | **58,880** | 4,904 |
| Borrowings | **40,607** | 26,665 |
| Other liabilities | **24,277** | 40,138 |
| Provisions | **2,968** | 1,993 |
| Other movements | **(3,856)** | (1,707) |
| **Total operating cash movements** | **454,979** | 293,185 |

| | **Issued Capital (Note 17) $m** | **Borrowings (Note 14) $m** | **Deposits (Note 13) $m** | **Total $m** |
|---|---|---|---|---|
| **As at 31 December 2017** | 306 | 8,192 | 1,919 | 10,417 |
| Financing cash flows | 50 | 4,540 | 749 | 5,339 |
| Acquisition/Disposals (Note 12) | - | 547 | - | 547 |
| Foreign exchange losses/(gains) and other movements | - | 174 | 158 | 332 |
| **As at 31 December 2018** | **356** | **13,453** | **2,826** | **16,635** |
| Financing cash flows | 246 | 3,587 | 933 | 4,766 |
| Acquisitions/Disposals (Note 12) | - | - | - | - |
| Foreign exchange losses/(gains) and other movements | - | 28 | (95) | (67) |
| **As at 31 December 2019** | **602** | **17,068** | **3,664** | **21,334** |

## 22 Share-based payments

*General*

The Group provides benefits to employees of the Group through share-based incentives. Employees are paid for their services or incentivised for their performance in part through shares or rights over shares.

*Equity-settled share-based payments*

During the year a limited number of equity settled share based payment plans have been in place. These transactions involve the Group receiving services and compensating the relevant parties via the provision of equity instruments of the Group or its parent entities.

*Measurement*

As part of the process of accounting for share based payments the Group is required to measure the fair value of the options granted because it is not possible to reliably measure the fair value of the employee services rendered. The LTI Scheme was valued using the Black Scholes option valuation model, interest free loans using a discounted cash flow model and the 2018 LTI Scheme was valued using a probability-weighted expected returns model. Where relevant, the expected life used in the model has been adjusted based on management's best estimate for the effects of non-transferability, exercise restrictions (including the probability of meeting market conditions attached to the option) and behavioural considerations.

*Recognition*

The fair value determined at the grant date is expensed on a straight-line basis over the vesting period, based on the Group's estimate of equity instruments that will eventually vest, with a corresponding increase in equity. At the end of each reporting period, the Group revises its estimate of the number of equity instruments expected to vest. The impact of the revision of the original estimates, if any, is recognised in the income statement such that the cumulative expense reflects the revised estimate, with a corresponding adjustment to the share based payment reserve.

*Description of schemes*

| Scheme | Description |
|---|---|
| **Long-term incentive (LTI) Scheme** | The Company established a LTI Scheme to assist in the motivation, retention and reward of senior management and to align the interests of executives and senior management with the interests of shareholders.<br>The LTI Scheme permits the grant of awards comprising of:<br>- Performance Rights; or<br>- Either Options or Loan Shares.<br>On 4 December 2017, all existing Pepper Group Pty Limited Loan Shares and Performance Rights held by an existing LTI Scheme participant were either: converted, exercised, amended, cancelled or exchanged for Holdco Loan Shares or Performance Rights.<br>Holdco Performance Rights are an entitlement to receive a Holdco Share for no consideration upon satisfaction of applicable vesting conditions.<br>Holdco Loan Shares are an entitlement to acquire a Share upon satisfaction of applicable vesting conditions and payment of an applicable exercise price.<br>Participants were provided with a loan for the sole purpose of subscribing for Holdco Shares to be held on trust for participants subject to satisfaction of applicable vesting conditions and subject to repayment of the loan and with recourse limited to the Holdco Shares. |

*Terms & Conditions for material schemes*

| Scheme | Terms & Conditions |
|---|---|
| **LTI Scheme** | The key management personnel and other senior management are eligible to participate in the LTI scheme. For the year ended 31 December 2018 the awards were delivered using a combination of Performance Rights and Loan Shares.<br><br>The LTI awards are divided into three equal tranches. The relevant performance periods for 2015 and 2016 are as follows:<br>- Tranche 1: 1 January 2016 to 31 December 2016<br>- Tranche 2: 1 January 2017 to 31 December 2017<br>- Tranche 3: 1 January 2018 to 31 December 2018<br><br>The relevant performance periods for 2017 are as follows:<br>- Tranche 1: 1 January 2017 to 31 December 2017<br>- Tranche 2: 1 January 2018 to 31 December 2018<br>- Tranche 3: 1 January 2019 to 31 December 2019<br><br>Each LTI award will vest based on the performance of the Group in each of the three consecutive financial years (the first tranche vested in 2017 in the case of the 2015 and 2016 LTI awards and in 2018 in the case of the 2017 LTI Award).<br><br>With the exception of the first tranche of each of the 2015 and 2016 LTI awards, the vesting conditions for the LTI awards were apportioned:<br>- 50%, to an adjusted net profit after tax (NPAT) growth performance condition, and<br>- 50%, to a return on equity (ROE) performance condition.<br><br>For the NPAT performance condition of the 2015 LTI awards, vesting occurred on achievement of a 25% increase, or greater, in NPAT for 2016 relative to 2015.<br><br>On 4 December 2017 all NPAT and ROE performance conditions were waived as part of the acquisition of Pepper Group Pty Limited by Bidco. |

| Scheme | Terms & Conditions |
|---|---|
| **2018 LTI Scheme** | The 2018 LTI Scheme provides an incentive to select management employees of Pepper Group companies and is structured to reward participants who contribute to the growth in value of the Pepper businesses they are involved with.<br><br>The 2018 LTI Scheme involves various classes of shares (tracker shares) being issued by Red Hot Australia Holdco Pty Limited. Each class of tracker shares entitles the holders to a share in the gain in value of a specific Pepper business unit (BU). The calculation considers:<br><br>- an initial BU starting value using a valuation as at 31 December 2017,<br>- the impact of capital flows into and from the BU since 31 December 2017,<br>- an allocation of group costs (including interest expense and tax reserves) since 31 December 2017; and<br>- the value achieved on realisation of the BU.<br><br>Participants will either be BU Participants or Group Participants. BU Participants will only hold tracker shares of a class relating to their BU whereas Group Participants will hold tracker shares of multiple classes relating to some or all the BU's. A small number of BU Participants will also hold tracker shares of multiple classes reflecting their involvement in Group activities as well as BU.<br><br>The LTI Scheme start date was 1 January 2018 for BU's in existence on 1 January 2018. The vesting period for participants is 3 years from the date the tracker shares are issued. The service conditions will be met for a tranche if a participant is engaged by a Group company as at the relevant anniversary of the start of their vesting period. |

| Scheme | Terms & Conditions |
|---|---|
| **Employee loans** | The Group and Holdco have provided interest free limited-recourse loans to Pepper Group Pty Limited's executives and senior employees enabling them to exercise previously issued options, to fund LTI related taxation payments, and to acquire Holdco tracker shares.<br><br>All loans are secured against Holdco shares and in accordance with AASB 2 the Group are treat these as share options and loans to related parties whilst Holdco treats the loans as Treasury Shares. |

*Quantitative data*

The only share-based payment arrangements were in existence within the Group as at 31 December 2019 was the 2018 LTI Scheme as all outstanding LTI Scheme awards fully vested. A total of 53,050,000 2018 LTI awards were granted by Holdco during the year. Holdco has the obligation to cash settle awards on realisation of a BU while the Group receives benefit from LTIP participants services. In accordance with AASB 2 the Group reported a $5.3m share based payment expense (and capital contribution) during the year (2018: $14.5m) to reflect the services received.

The following share-based payment arrangements were in existence within the Group as at 31 December 2018:

| Long term incentive schemes | Number | Grant date | Expiry date | Exercise price | Fair value at grant date |
|---|---|---|---|---|---|
| 2015 Long term incentive scheme - loan shares | 340,799 | August 2015 | August 2022 | $2.60 | $0.18 |
| 2015 Long term incentive scheme - rights | 330,571 | August 2015 | n/a | nil | $0.47 |
| 2016 Long term incentive scheme - loan shares | 437,294 | April 2016 | August 2023 | $2.42 | $0.16 |
| 2016 Long term incentive scheme - rights | 495,316 | April 2016 | n/a | nil | $0.41 |
| 2017 Long term incentive scheme - loan shares | 1,756,874 | April & August 2017 | August & April 2024 | $2.70 | $0.40 |
| 2017 Long term incentive scheme - rights | 2,168,518 | April & August 2017 | n/a | nil | $1.02 |

*Movements in share-based payment arrangements during the year*

The following reconciles the Group's share options and long-term incentive (LTI) schemes outstanding at the beginning and end of the year:

**(a) Movements in share-based payment arrangement during the year**

| | LTI schemes - loan shares | | LTI schemes - rights | |
|---|---|---|---|---|
| | **Number of units** | **Exercise price ($)** | **Number of units** | **Exercise price ($)** |
| At 31 December 2017 | 3,490,967 | - | 3,691,192 | - |
| Forfeited | (83,097) | 2.66 | (91,666) | - |
| Exercised during the year | (872,903) | 2.57 | (605,131) | - |
| At 31 December 2018 | **2,534,967** | **-** | **2,994,395** | **-** |
| | **-** | **-** | **-** | **-** |
| Exercised during the year | **(2,534,967)** | **2.62** | **(2,994,395)** | **-** |
| **At 31 December 2019** | **-** | | **-** | **-** |

## 23 Remuneration of auditors

During the year the following fees were paid or payable for services provided by the auditor of the parent entity, its related practices and non-related audit firms:

| | **Year ended 31 December 2019 $'000** | Year ended 31 December 2018 $'000 |
|---|---|---|
| Audit and review of financial statements - Deloitte Touche Tohmatsu | **3,740** | 2,173 |
| Audit and review of financial statements - Other firms | **584** | 585 |
| Advisory services | **605** | 1,143 |
| **Total auditor remuneration** | **4,929** | 3,901 |

The auditor of Pepper Group Pty Limited is Deloitte Touche Tohmatsu. It is the Group's policy to employ Deloitte Touche Tohmatsu on assignments additional to their statutory audit duties, in compliance with the Group's independence policies, where Deloitte Touche Tohmatsu's expertise and experience with the Group are important.

## 24 Financial assets and financial liabilities

*(i) Accounting policy*

Financial assets and financial liabilities are recognised in the Group's statement of financial position when the Group becomes a party to the contractual provisions of the instrument.

Financial assets and financial liabilities are initially measured at fair value. Transaction costs that are directly attributable to the acquisition or issue of financial assets and financial liabilities are added to or deducted from the fair value of the financial assets or financial liabilities, as appropriate, on initial recognition.

**Financial assets**

All recognised financial assets are measured subsequently in their entirety at either amortised cost or fair value, depending on the classification of the financial assets.

The three classification categories for financial assets are; amortised cost, fair value through other comprehensive income (FVOCI) and fair value through profit or loss (FVTPL).

*Amortised cost*

A financial asset is measured at amortised cost if both the following conditions are met:
(i) The financial asset is held within a business model whose objective is to hold financial assets in order to collect contractual cash flows: and

(ii) The contractual terms of the financial asset give rise on specified dates to cash flows that meet the solely represent the payment of principal and interest (SPPI) requirements.

*Financial value through other comprehensive income (FVOCI)*

A financial asset is measured at FVOCI if the following conditions are met:
(i) The financial asset is held within a business model whose objective is achieved by both collecting contractual cash flows and selling assets: and

(ii) The contractual terms of the financial asset give rise on specified dates to cash flow that meet the SPPI requirements.

Changes in the fair value of financial assets that are classified as FVOCI are recognised in OCI, except for the recognition of expected credit losses, interest revenue and foreign exchange gains and losses which are recognised in the income statement.

When debt financial assets at FVOCI are derecognised, the cumulative gain or loss previously recognised in OCI is reclassified from OCI to the income statement. At 31 December 2019 there were no asses held at FVOCI.

*Fair value through profit or loss (FVTPL)*

By default, all other financial assets are measured subsequently at fair value through profit or loss (FVTPL).

Changes in the fair value of financial assets that are classified as FVTPL are recognised in the income statement.

*(i) Accounting policy (continued)*

**Impairment**

The Group recognises a loss allowance for expected credit losses (ECL) on financial assets that are measured at amortised cost and FVOCI, lease receivables, loan commitments, certain letters of credit and financial guarantee contracts.

The ECL values are derived from internally developed statistical models and are adjusted to reflect probability-weighted forward-looking information. The Group's loan portfolios are segmented (at a minimum) by: product, region, and credit quality (arrears), to calculate ECL provisions.

The key inputs used for measuring ECL are:

• probability of default (PD);
• loss given default (LGD); and
• exposure at default (EAD).

PD is an estimate of the likelihood of default over a given time horizon. The Group's PDs are estimated considering the contractual maturities of exposures and estimated prepayment rates. The estimation is based on current conditions, adjusted to consider estimates of future conditions that will impact PD.

LGD is an estimate of the loss arising on default. The LGD models for secured assets consider forecasts of future collateral valuation considering sale discounts, time to realisation of collateral, cost of realisation of collateral and cure rates. LGD models for unsecured assets consider time of recovery, and recovery rates. The calculation is on a discounted cash flow basis, where the cash flows are discounted by the interest rate of the loan.

EAD is an estimate of the exposure at a future default date, considering expected changes in the exposure after the reporting date, including repayments of principal and interest. The Group's modelling approach for EAD reflects expected changes in the balance outstanding over the lifetime of the loan exposure that are permitted by the current contractual terms, including: amortisation profiles, early repayment or overpayment, changes in utilisation of undrawn commitments and credit mitigation actions taken before default. The Group uses EAD models that reflect the characteristics of the portfolios.

The Group uses forward-looking information that is available without undue cost or effort in its assessment of significant increase of credit risk as well as in its measurement of ECL. The Group uses external and internal information to generate a 'base case' scenario of future forecast of relevant economic variables along with a representative range of other possible forecast scenarios. The external information used includes economic data and forecasts published by governmental bodies and monetary authorities.

The Group has identified and documented key drivers of credit risk and credit losses for each loan portfolio and, using a statistical analysis of historical data, has estimated relationships between macro-economic variables and credit risk and credit losses. The principal macro-economic indicators included in the economic scenarios used at 31 December 2019 for the purposes of preparing ECL provisions include: unemployment rates and interest rates.

The Group has applied probabilities to the forecast scenarios identified in its measurement of ECL.

The Group's ECL is determined with reference to the following stages:

Stage 1: Performing loans (credit risk has not increased significantly since initial recognition): Predominantly loans less than 30 days past due - requires a loss provision equal to the expected loss over the next 12 months.

Stage 2: Significant increase in credit risk has occurred: All the Group's loans and advances not in stage 3 and 30+ days in arrears are within stage 2 - require a loss provision equal to the expected loss over the expected lifetime of the asset.

Stage 3: Impaired: As a minimum, all the Group's loans and advances 90+ days in arrears are within stage 3. Loans in stage 3 require a lifetime expected credit loss provision incorporating a 100% probability of default.

*(i) Accounting policy (continued)*

**Financial liabilities and Equity**

Debt and equity instruments are classified as either financial liabilities or as equity in accordance with the substance of the contractual arrangements and the definitions of a financial liability and an equity instrument.

Financial liabilities are classified as at FVTPL when the financial liability is
(i) contingent consideration of an acquirer in a business combination;
(ii) held for trading; or
(iii) it is designated as FVTPL

Financial liabilities at FVTPL are measured at fair value, with any gains or losses arising on changes in fair value recognised in profit or loss to the extent that they are not part of a designated hedging relationship (see Hedge accounting policy).

Financial liabilities that are not (i) contingent consideration of an acquirer in a business combination (ii) held for trading or (iii) designated as at FVTPL, are measured subsequently at amortised cost using the effective interest method.

**Derecognition**

*Derecognition of financial assets*

The Group derecognises a financial asset only when the contractual rights to the cash flows from the asset expire, or when it transfers the financial asset and substantially all the risks and rewards of ownership of the asset to another party. If the Group neither transfers nor retains substantially all the risks and rewards of ownership and continues to control the transferred asset, the Group recognises its retained interest in the asset and an associated liability for amounts it may have to pay. If the Group retains substantially all the risks and rewards of ownership of a transferred financial asset, the Group continues to recognise the financial asset and also recognises a borrowing for the proceeds received.

On derecognition of a financial asset measured at amortised cost, the difference between the asset's carrying amount and the sum of the consideration received and receivable is recognised in profit or loss.

On derecognition of a financial asset other than in its entirety the Group allocates the previous carrying amount of the financial asset between the part it continues to recognise under continuing involvement, and the part it no longer recognises on the basis of the relative fair values of those parts on the date of the transfer. The difference between the carrying amount allocated to the part that is no longer recognised and the sum of the consideration received for the part no longer recognised and any cumulative gain or loss allocated to it that had been recognised in other comprehensive income is recognised in the income statement. A cumulative gain or loss that had been recognised in other comprehensive income is allocated between the part that continues to be recognised and the part that is no longer recognised on the basis of the relative fair values of those parts.

*Derecognition of financial liabilities*

The Group derecognises financial liabilities when, and only when, the Group's obligations are discharged, cancelled or have expired. The difference between the carrying amount of the financial liability derecognised and the consideration paid and payable is recognised in profit or loss.

The Group accounts for substantial modification of terms of an existing liability or part of it as an extinguishment of the original financial liability and the recognition of a new liability. It is assumed that the terms are substantially different if the discounted present value of the cash flows under the new terms, including any fees paid net of any fees received and discounted using the original effective rate is at least 10 per cent different from the discounted present value of the remaining cash flows of the original financial liability. If the modification is not substantial, the difference between: (1) the carrying amount of the liability before the modification; and (2) the present value of the cash flows after modification should be recognised in profit or loss as the modification gain or loss within other gains and losses.

**Measurement categories of financial instruments**

| | Basis of measurement | **As at 31 December 2019 $'000** | As at 31 December 2018 $'000 |
|---|---|---|---|
| **Financial assets** | | | |
| Cash and cash equivalents | Amortised cost | **1,807,658** | 1,200,367 |
| Derivative financial assets | FVTPL | **48,018** | 84,660 |
| Receivables | Amortised cost | **130,672** | 118,884 |
| Equity investments | FVTPL | **10,212** | 20,149 |
| Debt investments | FVTPL | **24,099** | 7,234 |
| Corporate and government bonds | FVTPL | **30,663** | 80,774 |
| Loans and advances | Amortised cost | **19,527,124** | 15,366,495 |
| **Total financial assets** | | **21,578,446** | 16,878,563 |
| **Financial liabilities** | | | |
| Deposits | Amortised cost | **3,664,431** | 2,826,343 |
| Trade and other payables | Amortised cost | **76,650** | 61,083 |
| Derivative financial liabilities | FVTPL | **68,190** | 14,011 |
| Borrowings | Amortised cost | **17,067,638** | 13,452,986 |
| **Total financial liabilities** | | **20,876,909** | 16,354,423 |

**Fair value measurements and valuation processes**

The following assets and liabilities are measured at fair value by the Group for financial reporting purposes.

| **Financial instruments** | **Fair value hierarchy** | **Valuation technique(s) and key input(s)** | **As at 31 December 2019 $'000** | As at 31 December 2018 $'000 |
|---|---|---|---|---|
| Equity investments | Level 3 | Recent arm's length market transactions | **10,212** | 20,149 |
| Debt investment | Level 2 | Recent arm's length market transactions and Discounted cash flow, appropriate discount rates | **24,099** | 7,234 |
| Corporate and government bonds | Level 2 | Recent arm's length market transactions and Discounted cash flow, appropriate discount rates | **30,663** | 80,774 |
| Interest rate swaps | Level 2 | Discounted cash flow, forward interest rates, contract interest rates, appropriate discount rates | **(33,550)** | (7,471) |
| Foreign exchange contracts | Level 2 | Discounted cash flow, forward interest rates, contract interest rates, appropriate discount rates | **(299)** | 5,564 |
| Cross currency interest rate swaps | Level 2 | Discounted cash flow, forward interest rates, contract interest rates, appropriate discount rates | **13,676** | 72,556 |

In the year to 31 December 2019 there has been no change in the fair value hierarchy or the valuation techniques applied to any of the balances above.

*Fair value of assets and liabilities not measured at fair value*

The Group has considered all financial assets and liabilities not carried at fair value to determine whether the carrying value is an accurate reflection of fair value. For financial assets and liabilities whose carrying value does not accurately reflect the fair value, the Group performed a discounted cash flow valuation to determine fair value at the balance date.

The table below shows a comparison of the carrying amounts, as reported on the balance sheet and the fair values of those financial assets and liabilities that are measured at amortised cost where the carrying value recorded in the balance sheet does not approximate to fair value.

| | **As at 31 December 2019** | | As at 31 December 2018 | |
|---|---|---|---|---|
| | **Carrying value $'000** | **Fair value $'000** | Carrying value $'000 | Fair value $'000 |
| Loans and advances | **19,527,124** | **19,713,926** | 15,366,495 | 15,376,560 |

## 25 Financial risk management

This note explains the Group's exposure to financial risks and how these risks could affect the Group's future financial performance.

| **Risk** | **Exposure arising from** | **Measurement** | **Management** |
|---|---|---|---|
| Market risk - foreign exchange | Future commercial transactions, recognised foreign currency financial assets and liabilities. | Cash flow forecasting, Sensitivity analysis. | Forward foreign exchange contracts and cross currency interest rate swaps. |
| Market risk - interest rate | Mismatch in interest rates between assets and liabilities. | Sensitivity analysis. | Cross current interest rate swaps, Interest rate swaps. |
| Credit risk | Cash and cash equivalents, trade receivables, derivative financial instruments, loans and advances. | Credit risk analysis, Credit ratings. | Diversification, Strong collections/portfolio management. |
| Liquidity risk | Borrowings, deposits, derivative financial liabilities and other liabilities. | Rolling cash flow forecasts. | Availability of committed credit lines and borrowing facilities, Securitisation, Structuring terms of obligations. |

### (a) Derivatives and hedge accounting

The Group enters into a variety of derivative financial instruments to manage its exposure to interest rate and foreign exchange rate risks (detailed in tables below), including, cross currency interest rate swaps, interest rate swaps, foreign exchange forward contracts and foreign exchange options.

Derivatives are recognised initially at fair value at the date a derivative contract is entered into and are subsequently remeasured to their fair value at each reporting date. The resulting gain or loss is recognised in profit or loss immediately unless the derivative is designated and effective as a hedging instrument, in which event the timing of the recognition in profit or loss depends on the nature of the hedge relationship.

Derivatives are used for hedging financial risks as part of the Group's approach to risk management. They are not used for speculative purposes.

The Group designates certain derivatives as hedging instruments in respect of foreign currency risk and interest rate risk in fair value hedges, cash flow hedges, or hedges of net investments in foreign operations as appropriate. Hedges of foreign exchange risk on firm commitments are accounted for as cash flow hedges.

**(a) Derivatives and hedge accounting (continued)**

At the inception of the hedge relationship, the Group documents the relationship between the hedging instrument and the hedged item, along with its risk management objectives and its strategy for undertaking various hedge transactions. Furthermore, at the inception of the hedge and on an ongoing basis, the Group documents whether the hedging instrument is effective in offsetting changes in fair values or cash flows of the hedged item attributable to the hedged risk, which is when the hedging relationships meet all of the following hedge effectiveness requirements:

• there is an economic relationship between the hedged item and the hedging instrument;
• the effect of credit risk does not dominate the value changes that result from that economic relationship; and
• the hedge ratio of the hedging relationship is the same as that resulting from the quantity of the hedged item that the Group actually hedges and the quantity of the hedging instrument that the Group actually uses to hedge that quantity of hedged item.

Fair value hedges

Fair value hedges are accounted for as follows: the fair value gain or loss associated with the derivative is recognised in profit or loss, the fair value gain or loss associated with the hedged item is recognised in profit or loss.

During the year the fair value movement on the derivatives and the hedged item offset with no significant ineffectiveness.

Cash flow hedges

Cash flow hedges are accounted for as follows: the fair value gain or loss associated with the effective portion of the derivative is recognised initially in other comprehensive income (cash flow hedge reserve - CFHR) and then recycled to the income statement in the same periods the hedged item affects the income statement. Any ineffective portion of the gain or loss on the hedging instrument is recognised in the income statement immediately.

Hedges of net investments in foreign operations

The Group use net investment hedges to mitigate the foreign exchange risk arising from the Group's net investments in foreign operations. Net investment hedges are accounted for similarly to cash flow hedges. The details of the fair values of the derivative instruments used for hedging purposes and the movements in the reserves in equity are set out in the note below.

• The effective portion of the gain or loss on the hedging instrument shall be recognised in other comprehensive income (in the foreign currency translation reserve - FCTR); and
• The ineffective portion shall be recognised in profit or loss.

The cumulative gain or loss on the hedging instrument that has been accumulated in the foreign currency translation reserve shall be reclassified from equity to profit or loss as a reclassification adjustment on the disposal or partial disposal of the foreign operation.

**(a) Derivatives and hedge accounting (continued)**

*Interest rate risk management*

The Group is exposed to interest rate risk because entities in the Group borrowed and lent funds at both fixed and floating interest rates. The risk is managed by the Group by the use of interest rate swap contracts.

Interest rate swap contracts

Under interest rate swap contracts, the Group agrees to exchange the difference between fixed and floating rate interest amounts calculated on agreed notional principal amounts. Such contracts enable the Group to mitigate the cash flow exposures on interest rates and the fair value risk of changing interest rates.

The Group designates the interest rate swaps in cash flow hedges and fair value hedges.

Interest rate swap contracts - cash flow hedges

As the critical terms of the interest rate swap contracts and their corresponding hedged items are the same, the Group performs a qualitative assessment of effectiveness and it is expected that the value of the interest rate swap contracts and the value of the corresponding hedged items will systematically change in opposite direction in response to movements in the underlying interest rates.

Interest rate swap contracts - fair value hedges

The Group also entered into interest rate swap contracts to mitigate the fair value risk of changing interest rates.

The Group has applied the hedge ratio of 1:1 to all hedge relationships.

*Foreign currency risk management*

The Group is exposed to exchange rate fluctuations relating to non-Australian dollar borrowings as well as its investments in foreign operations.

The Group uses cross currency interest rate swap contracts to hedge fair value interest rate risk and foreign exchange risk.

The Group designates the cross currency interest rate swap contracts in:
• fair value hedges of changing interest rates on foreign currency fixed rate borrowings;
• cash flow hedges of foreign currency exposure on foreign currency borrowings;
• hedges of net investments in foreign operations.

The foreign currency basis spread of a cross currency interest rate swap is excluded from the designation of that financial instrument as the hedging instrument. Changes in fair value of the foreign currency basis spread of a financial instrument is accumulated in the cost of hedging reserve, and is amortised to profit or loss on a rational basis over the term of the hedging relationship.

As the critical terms of the cross currency interest rate swap contracts and their corresponding hedged items match, the Group performs a qualitative assessment of effectiveness. The main source of hedge ineffectiveness in these hedge relationships is the effect of the counterparty and the Group's own credit risk on the fair value of the cross currency interest rate swap contracts, which is not reflected in the fair value of the hedged item attributable to the change in interest rates. No other sources of ineffectiveness emerged from these hedging relationships.

The Group also designates related party EUR denominated debt as a net investment hedge of its net investment in EUR proportionally.

**(a) Derivatives and hedge accounting (continued)**

*Quantitative information*

The following table details the notional principal amounts and remaining terms of the cross currency interest rate swap, interest rate swap and foreign exchange contracts outstanding as at the end of the financial year. For the detail of derivative contract types, please refer above.

| | < 1 year | 1 - 2 years | 2 - 5 years | Over 5 years |
|---|---|---|---|---|
| **Interest rate risk - Interest rate swap contracts** | | | | |
| Average contracted fixed rate | 2.32% | 2.18% | 1.86% | 1.57% |
| Average notional Amount $'000 | 1,534,257 | 1,125,463 | 1,076,874 | 71,005 |
| **Foreign currency risk - Cross currency interest rate swap contracts** | | | | |
| Average contracted rate (AUD/USD) | 0.7175 | 0.7265 | 0.7207 | - |
| Average notional Amount $'000 | 1,455,147 | 299,323 | 252,923 | - |
| Average contracted rate (AUD/EUR) | 0.6276 | 0.6276 | 0.6276 | - |
| Average notional Amount $'000 | 189,682 | 98,952 | 252,155 | - |
| **Foreign currency risk - Cross currency interest rate swap contracts** | | | | |
| Average contracted rate (EUR/AUD) | - | - | 1.5936 | - |
| Average contracted rate (EUR/HKD)* | - | - | 9.2940 | - |
| Average contracted rate (EUR/KRW)* | - | - | 1,281.0 | - |
| Average contracted rate (EUR/GBP)* | | | 0.8872 | |
| Average notional Amount $'000 | - | - | 264,804 | - |
| **Foreign currency risk - Forward exchange contracts** | | | | |
| Average contracted rate (EUR/AUD) | 1.6161 | - | - | - |
| Average notional Amount $'000 | 35,554 | - | - | - |

*Note: These instruments are designated into cash flow hedge and net investment hedge to hedge the EUR debt and net investments in HKD, KRW and GBP. The average notional amount disclosed is based on the spot foreign exchange at designation date

**(a) Derivatives and hedge accounting (continued)**

*Quantitative information (continued)*

The following tables detail various information regarding interest rate swap contracts, cross currency interest rate swaps and foreign exchange forward contracts outstanding at the end of the reporting period and their related hedged items.

**Derivative financial assets / (liabilities):**

| | Current notional amount $'000 | Carrying amount of hedging instrument Assets $'000 | Carrying amount of hedging instrument Liabilities $'000 | Change in value of hedging instrument $'000 | Change in value of hedged item $'000 | CFHR opening balance before tax Dr/(Cr) $'000 | Movement in CFHR Dr/(Cr) $'000 | Transfer from CFHR to P&L Dr/(Cr) $'000 |
|---|---|---|---|---|---|---|---|---|
| **Cash flow hedges** | | | | | | | | |
| Interest rate swaps | 3,256,845 | - | (34,581) | (25,896) | 25,896 | 7,911 | 42,771 | (15,689) |
| Cross currency interest rate swap | 2,811,126 | 42,475 | (28,793) | (63,690) | 62,207 | 4,517 | 77,191 | (75,967) |
| Foreign currency forward contract | 35,554 | - | (299) | (5,863) | 5,863 | (4,073) | 9,955 | (5,863) |
| **Fair value hedges** | | | | | | | | |
| Interest rate swaps | 252,740 | 3,289 | - | 2,075 | (2,075) | - | - | - |
| **Net investment hedges** | | | | | | | | |
| Cross currency interest rate swap | 248,868 | 2,255 | (4,516) | 2,554 | (3,456) | - | - | - |
| **Total** | 6,605,133 | 48,018 | (68,190) | (90,820) | 89,337 | 8,355 | 129,917 | (97,519) |

**Non-derivative liabilities designated in net investment hedging relationship - natural hedge:**

| | Carrying amount of hedging instrument Liabilities $'000 | Change in value of hedging instrument $'000 | Change in value of hedged item $'000 |
|---|---|---|---|
| EUR denominated borrowing | (46,326) | 744 | (744) |

The cumulative deferred gain or loss on the hedging instrument is recognised in profit or loss only when the hedged transaction impacts the profit or loss, which is mainly due to the (gain) / loss from the hedged item spot rate revaluation and the foreign currency basis spread (FCBS) amortised to profit or loss on a rational basis over the term of the hedging relationship. The 2019 opening balance of the cash flow hedge reserve (CFHR) contained $9.5m FCBS (2018: $2.1m) that subsequently increased by $7.1m (2018: $8.8m) during the year due to changes in fair value, partially offset by $6.2m (2018: $1.4m) transferred to profit and loss. The 2019 movement in foreign currency translation reserve (FCTR) due to the change in value of hedging instrument in the net investment hedging relationship (included the natural hedge) was $3.3m (2018: $11.5m) which was effective and offset the FX movement of hedged item. Part of the FCTR movement on the hedging instrument included a ($1.7m) (2018: $7m) FCBS movement

There is no significant ineffectiveness in all hedges applied for both current and prior years.

**(b) Credit risk**

Credit risk arises from the financial assets outlined below, as well as credit exposures to customers, including outstanding receivables.

To manage credit risk, the Group has established strong risk management teams who bring together a wealth of knowledge and experience in loan origination, servicing and arrears management capabilities across the Group.

The Group's primary credit risk exposures relate to its lending activities in its mortgage, asset finance, and personal lending portfolios. The Group's primary lending activities are concentrated in the Australian, New Zealand, South Korea, UK and Spain markets. The underlying credit risk in the Group's lending activities is commensurate with a geographically diverse residential mortgage and asset finance portfolio, with no large concentration of single customers.

*Maximum exposure to credit risk*

The carrying amount of the Group's financial assets and undrawn customer facilities represents the maximum credit exposure. The Group's exposure to credit risk at the reporting date was:

| | **As at 31 December 2019 $'000** | As at 31 December 2018 $'000 |
|---|---|---|
| Cash and cash equivalents | **1,807,658** | 1,200,367 |
| Derivative financial instruments | **48,018** | 84,660 |
| Receivables | **130,672** | 118,884 |
| Debt investments at FVTPL | **24,099** | 7,234 |
| Corporate and government bonds | **30,663** | 80,774 |
| **Financial assets other than loans and advances** | **2,041,110** | 1,491,919 |
| Loans and advances at amortised cost - balance subject to credit risk | **19,749,955** | 15,423,937 |
| **Total potential exposure to credit risk** | **21,791,065** | 16,915,856 |

As at 31 December 2019, over 73% of the Group's cash and cash equivalents are held with banks or financial institutions with a credit rating of AA- or better (2018: over 66%).

In addition to the balances in the table above, the Group had $1,023m of undrawn customer facilities as at 31 December 2019 (2018: $873m).

*Distribution of financial assets - loan and advances and provisions by credit quality*

The tables below show analysis of loans and advances subject to requirements by stage at the reporting date.

| **Balance as at 31 December 2019** | **Maximum exposure to credit risk** | | | |
|---|---|---|---|---|
| **Gross loans and advances** | **Stage 1 $'000** | **Stage 2 $'000** | **Stage 3 $'000** | **Total $'000** |
| Residential mortgage | 13,506,098 | 263,104 | 177,726 | 13,946,929 |
| Auto and equipment finance | 2,512,338 | 38,865 | 54,890 | 2,606,093 |
| Point-of-sale finance | 370,005 | 4,763 | 641 | 375,408 |
| Personal loans | 1,571,693 | 93,171 | 135,523 | 1,800,386 |
| Commercial Loans | 852,933 | 87,692 | 80,514 | 1,021,139 |
| **As at 31 December 2019** | 18,813,067 | 487,594 | 449,293 | 19,749,955 |

**(b) Credit risk (continued)**

| Loan loss provision | Expected credit loss Stage 1 $'000 | Stage 2 $'000 | Stage 3 $'000 | Total $'000 |
|---|---|---|---|---|
| Residential mortgage | 11,144 | 2,451 | 9,351 | 22,926 |
| Auto and equipment finance | 42,826 | 2,363 | 29,579 | 74,838 |
| Point-of-sale finance | 3,554 | 1,346 | 641 | 5,542 |
| Personal loans | 51,074 | 13,088 | 74,000 | 138,161 |
| Commercial Loans | 17,082 | 7,827 | 48,857 | 73,766 |
| **As at 31 December 2019** | 125,749 | 27,075 | 162,428 | 315,253 |

**Balance as at 31 December 2018**

| Gross loans and advances | Maximum exposure to credit risk Stage 1 $'000 | Stage 2 $'000 | Stage 3 $'000 | Total $'000 |
|---|---|---|---|---|
| Residential mortgage | 10,494,296 | 253,930 | 145,685 | 10,893,910 |
| Auto and equipment finance | 1,850,868 | 25,842 | 25,292 | 1,902,002 |
| Point-of-sale finance | 308,352 | 3,985 | 10,328 | 322,665 |
| Personal loans | 1,413,896 | 73,549 | 136,692 | 1,624,136 |
| Commercial Loans | 570,035 | 55,460 | 55,729 | 681,224 |
| **As at 31 December 2018** | 14,637,447 | 412,765 | 373,726 | 15,423,937 |

| Loan loss provisions | Expected credit loss Stage 1 $'000 | Stage 2 $'000 | Stage 3 $'000 | Total $'000 |
|---|---|---|---|---|
| Residential mortgage | 15,729 | 1,199 | 7,128 | 24,055 |
| Auto and equipment finance | 28,323 | 3,239 | 19,877 | 51,439 |
| Point-of-sale finance | 2,991 | 2,114 | 10,328 | 7,623 |
| Personal loans | 44,840 | 10,611 | 68,821 | 124,272 |
| Commercial Loans | 12,528 | 5,189 | 26,271 | 43,988 |
| **As at 31 December 2018** | 104,303 | 22,352 | 124,731 | 251,387 |

**(b) Credit risk (continued)**

*Movement in gross carrying amount*

The following tables show movements in gross carrying amounts of loans and advances subject to impairment requirements.

| **Loans and advances at amortised cost** | **Stage 1 $'000** | **Stage 2 $'000** | **Stage 3 $'000** | **Total $'000** |
|---|---|---|---|---|
| As at 31 December 2018 | 14,637,447 | 412,765 | 373,726 | 15,423,937 |
| Transfer to stage 1 | 141,298 | (115,863) | (25,435) | - |
| Transfer to stage 2 | (297,728) | 306,906 | (9,178) | - |
| Transfer to stage 3 | (184,447) | (69,485) | (274,189) | - |
| Loan assets, written-off, sold or reversed. previously provided for | (2,539,838) | (47,837) | (274,189) | (2,861,865) |
| Originations | 7,911,896 | 138,806 | 56,266 | 8,106,968 |
| Adjustments | (854,360) | (3,610) | 17,191 | (903,082) |
| Translation differences | (1,200) | (134,087) | 56,979 | (16,004) |
| **Loans and advances at amortised cost - as at 31 December 2019** | 18,813,067 | 487,594 | 449,293 | 19,749,955 |

| **Loan loss provision** | **Stage 1 $'000** | **Stage 2 $'000** | **Stage 3 $'000** | **Total $'000** |
|---|---|---|---|---|
| As at 31 December 2018 | 104,303 | 22,352 | 124,731 | $251,387.00 |
| Transfer to stage 1 | 4,821 | (2,852) | (1,969) | - |
| Transfer to stage 2 | (2,716) | 3,976 | (1,260) | - |
| Transfer to stage 3 | (3,138) | (5,679) | 8,817 | - |
| Loan assets written-off,sold or reversed. previously provided for | (15,945) | (1,240) | (129,548) | (146,732) |
| Originations | 65,283 | 11,118 | 27,363 | 103,765 |
| Adjustments | (24,053) | 397 | 135,787 | 112,131 |
| Translation difference | (2,807) | (998) | (1,492) | (5,297) |
| **Loan loss provision - as at 31 December 2019** | 125,749 | 27,075 | 162,428 | 315,253 |

Provision balances above incorporate ECL provisions on undrawn customer commitments, and redraw balances (customer overpayment) and are not considered material to the Group. The loan loss provision increase is commensurate with the absolute increase in the number of loans originated.

The majority of the Group's exposure to loans and advances is limited, as they are legally owned by the special purpose entities (trusts) with no recourse to the Group. Losses on mortgage loans are therefore limited to the Group's investments in notes in these trusts and the cash collateral retained in the trust. The trusts' structures are designed such that losses are covered by excess spread generated from the assets within the trusts before the investment in notes is impacted.

As distinct from the above, Pepper South Korea's loan originations are funded on-balance sheet primarily through retail customer deposits and loan portfolio sales. There is a limited market for securitisation and warehouse funding in South Korea, unlike in Pepper's other core markets and the Group retains the associated credit risk with lending in South Korea.

**(c) Liquidity and capital risk**

Liquidity risk is the risk that the Group will not be able to meet its financial obligations as they fall due.

Pepper's funding platform currently comprises a mix of warehouse facilities, term securitisations, secured debt facilities, balance sheet cash and customer deposits in the case of South Korea.

The majority of the Group's liabilities represent bonds issued by special purpose trusts through warehouse facilities and term securitisation transactions. Under such arrangements, bondholder recourse is limited to the assets of the relevant special purpose vehicle to which the liability relates and the repayment profile of the bonds is matched to the repayments collected from the loan assets. Given the limited recourse nature of these borrowings, $16.4bn at 31 December 2019 (2018: $12.9bn), they have not all been included in the table below (which is prepared on an undiscounted basis).

The Group seeks to have sufficient liquidity to meet its liabilities when due, under both normal and stressed conditions, without incurring unacceptable losses or risking damage to the Group's reputation. The Group has cultivated valuable long term relationships with a range of domestic and global investment banks and professional mezzanine debt and fixed income investors. Refer to note 14 for more information on the Group's borrowings.

**(c) Liquidity and capital risk (continued)**

| At 31 December 2019 | Carrying amount $'000 | At call $'000 | 3 mnths or less $'000 | 3 to 12 mnths $'000 | 1 to 5 years $'000 | Over 5 years $'000 | Total contractual cash flows $'000 |
|---|---|---|---|---|---|---|---|
| **Financial liabilities** | | | | | | | |
| **Deposits** | **3,664,431** | **141,353** | **468,375** | **1,206,202** | **1,848,501** | **-** | **3,664,431** |
| **Payables** | **76,649** | **31,407** | **27,759** | **10,760** | **-** | **-** | **69,926** |
| **Lease liabilities** | **60,934** | **-** | **4,541** | **13,624** | **35,845** | **7,090** | **61,100** |
| **Borrowings** | **5,571,113** | **1,048** | **32,280** | **1,622,953** | **4,195,877** | **-** | **5,852,158** |
| **Derivative liabilities** | **68,190** | **-** | **2,970** | **17,877** | **46,126** | **2,304** | **69,277** |
| **Total** | **9,441,317** | **173,808** | **535,925** | **2,871,416** | **6,126,349** | **9,394** | **9,716,892** |
| **At 31 December 2018** | | | | | | | |
| **Financial liabilities** | | | | | | | |
| Deposits | 2,826,343 | 78,831 | 163,494 | 658,375 | 2,104,288 | - | 3,004,988 |
| Payables | 61,083 | 23,113 | 28,922 | 8,536 | 652 | - | 61,223 |
| Lease liabilities | 66,523 | - | 4,456 | 13,369 | 47,161 | 1,537 | 66,523 |
| Borrowings | 3,425,752 | 775 | 40,491 | 599,453 | 3,105,505 | - | 3,746,224 |
| Derivative liabilities | 14,011 | - | 733 | 1,906 | 11,372 | - | 14,011 |
| **Total** | 6,393,712 | 102,719 | 238,096 | 1,281,639 | 5,268,978 | 1,537 | 6,892,969 |

Pepper Savings Bank in South Korea (the Bank) is governed by the country's Mutual Savings Bank Act and is regulated by the Financial Supervisory Service and Financial Services Commission. The Bank must hold a portion of highly liquid assets on its balance sheet to meet regulatory liquidity requirements and hold regulatory capital against its assets in South Korea. The Bank is currently required to maintain a minimum South Korean regulatory Bank for International Settlements (BIS) capital ratio of 10%. As of 31 December 2019, the Group is compliant with the regulatory requirement.

**(d) Market risk**

Market risk is the risk of an adverse impact on the Group's earnings resulting from changes in market factors, such as interest rates and foreign exchange rates.

*(i) Cash flow and fair value interest rate risk*

Interest rate risk is the risk that the Group will experience deterioration in its financial position as interest rates change over time.

Interest rate exposure is created due to mismatches in interest rates between assets and liabilities (i.e. borrowing at floating interest rates and lending with fixed interest rates). Interest rate risk may be managed by entering into interest rate swaps subject to the Group's hedging and derivatives policies.

*Sensitivity*

As outlined above, the majority of the Group's liabilities are issued through warehouse facilities and term securitisations in special purpose entities. Under such arrangements, the repayment profile of the bonds is matched to the repayments collected from the loan assets.

For illustrative purposes the Group has calculated the impact of a potential increase or decrease in borrowing costs in limited recourse entities for the year in the event of a +/- 10bps change in interest rates as shown in the table below:

| 10 bps +/- | Year ended 31 December 2019 $'000 | Year ended 31 December 2018 $'000 |
|---|---|---|
| Borrowing costs in special purpose entities | **15,385** | 7,246 |

Any impact on funding costs in the special purpose entities as a result of changes to interest rates would be offset by a corresponding +/- impact on interest revenue proportionate to assets held.

**(d) Market risk (continued)**

*(i) Cash flow and fair value interest rate risk (continued)*

The remainder of the Group's loan portfolio and liabilities are held in corporate entities (predominantly Pepper South Korea). The impact of a potential +/- 10bps change in interest rates on interest revenue and borrowing costs on balances held by corporate entities for the year is set out in the table below:

| | **Year ended 31 December 2019 $'000** | Year ended 31 December 2018 $'000 |
|---|---|---|
| **10 bps +/-** | | |
| Corporate interest revenue | **3,222** | 2,724 |
| Corporate funding costs | **(2,623)** | (2,459) |
| **Total impact on corporate interest** | **599** | 265 |

*(ii) Foreign exchange risk*

The Group's financial reports are prepared in Australian dollars. The Group's revenues, expenses, cash flows, assets and liabilities in regions outside Australia are denominated in local currencies which include the Euro, South Korean Won, Pound Sterling, Hong Kong Dollar and United States Dollar. The Group manages its foreign exchange risk by matching the currency of loan receivables and funding and by monitoring the cash flow requirements of the business and regional operating subsidiaries on an ongoing basis.

The Group does not currently hedge its offshore earnings or the capital invested in the overseas operations, thereby accepting the foreign currency translation risk on invested capital and offshore earnings.

The figures in the table below indicate the potential increase or decrease in profit after tax for the year due to a +/- 10% variance in the exchange rates. Sensitivity analysis predominantly reflects the impact of exchange rate changes on profits earned in the Group's offshore businesses.

*Sensitivity*

| | **Year ended 31 December 2019 $'000** | Year ended 31 December 2018 $'000 |
|---|---|---|
| **10% variance +/-** | | |
| Change in AUD : EUR exchange rate | **2,598** | 2,633 |
| Change in AUD : KRW exchange rate | **2,251** | 1,548 |
| Change in AUD : GBP exchange rate | **444** | 1,476 |
| Change in AUD : HKD exchange rate | **718** | 1,354 |

## 26 Parent entity financial information

### (a) Summary financial information

The individual financial statements for the parent entity show the following aggregate amounts:

| | **Year ended 31 December 2019 $'000** | Year ended 31 December 2018 $'000 |
|---|---|---|
| **Income statement** | | |
| Revenue | **291,242** | 194,206 |
| Expenses | **(210,839)** | (194,191) |
| **Profit before tax** | **80,403** | 15 |
| | | |
| Income tax expense | **(7,891)** | (3,403) |
| **Profit/(Loss) after tax** | **72,512** | (3,388) |

| | **As at 31 December 2019 $'000** | As at 31 December 2018 $'000 |
|---|---|---|
| **Balance sheet** | | |
| Current assets | **917,711** | 656,176 |
| Non-current assets | **482,950** | 546,251 |
| **Total assets** | **1,400,661** | 1,202,427 |
| | | |
| Current liabilities | **9,105** | 4,584 |
| Non-current liabilities | **590,206** | 618,364 |
| **Total liabilities** | **599,311** | 622,948 |
| | | |
| **Total net assets** | **801,350** | 579,479 |
| | | |
| Issued capital | **601,748** | 356,101 |
| Other reserves | **(3,574)** | 2,147 |
| Retained earnings | **203,176** | 221,231 |
| **Total equity** | **801,350** | 579,479 |

### (b) Contingent liabilities of the parent entity

The Company has provided guarantees over funding facilities provided by several external parties to the Group. As at balance date the balance drawn on the guaranteed facilities was $568.5m (2018: $456.4m).

## 27 Events occurring after the reporting period

On 31 January 2020 Pepper entered into a binding agreement with Link Administration Holdings Limited (ASX:LNK) to sell its European Servicing business (Pepper European Servicing) for an upfront consideration of €165m (A$266m) and up to a further €35m (A$56m) if certain Assets Under Management thresholds and growth milestones are met.

Pepper Group Pty Limited, along with its immediate and ultimate parent, Red Hot Australia BidCo Pty Limited Red Hot Australia HoldCo Pty Limited (Holdco), and its subsidiaries (collectively, the “Pepper Group”) are planning to undertake an internal corporate restructure (“Restructure”) in 2020. As part of the Restructure, Red Hot HoldCo Pty Limited shareholders intend to create a foreign holding company structure for the Pepper Group with a new head corporate entity, Pepper Global Topco Limited (“TopCo”). After the restructure, the shareholders of TopCo will be substantially the same as the current HoldCo shareholders and the existing governance arrangements that apply to HoldCo will be substantially replicated at the TopCo level.

We are currently in the process of assessing the potential impact of the 2019-20 Coronavirus outbreak caused by SARS-CoV-2 (first identified in Wuhan, Hubei, China) on the Group.

No other matter or circumstance has arisen since 31 December 2019 that has significantly affected the Group's operations, results or state of affairs, or may do so in future years.