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Credit Opinion: Finbond Group Limited

Global Credit Research - 01 Jul 2011

South Africa

Ratings

Category	Moody's Rating
Outlook	Stable
NSR Issuer Rating -Dom Curr	Ba3.za
NSR ST Issuer Rating -Dom Curr	NP.za

Contacts

Analyst	Phone
George Chrysaphinis/Limassol	357.25.586.586
Nondas Nicolaides/Limassol	
Yves Lemay/London	44.20.7772.5454
Artemis Vrahimis/Limassol	

Key Indicators

Finbond Group Limited

	[1]**2011**	**2010**	**2009**	**2008**	[2]**Avg/CAGR**
Total Assets (Rand mn)	**439.4**	**482.8**	**415.2**	**441.3**	-0.3
Total Capital (Rand mn)	**235**	**252.6**	**213.9**	**293.2**	-15.3
Recurring Earning Power % [3]	**3.5**	**19.0**	**8.8**	**N/A**	10.4
Return on Average Assets %	**-4.4**	**13.0**	**-13.5**	**N/A**	-1.6
Net Interest Margin %	**27.3**	**23.5**	**19.6**	**N/A**	23.5
Cost / Income Ratio % [4]	**89.9**	**68.9**	**74.7**	**47.3**	70.2
Problem Loans % Gross Loans	**22.8**	**17.1**	**35.6**	**34.8**	27.6
Shareholder's Equity % Total Assets	**53.6**	**52.3**	**46.6**	**62.6**	53.8

[1] As of February 28. [2] Compound Annual Growth Rate for total assets and capital. [3] Preprovision Income % Average Assets. [4] Non-Interest Expense % Operating Income

Opinion

Business Profile

Finbond Group Limited (Finbond) is a micro-finance institution (MFI), operating under the "Finbond Micro Finance" brand - having exited the mortgage origination market, which was its main business line until 2007. The company operates a low-cost countrywide distribution network of 189 branches in South Africa and has one branch in Namibia. Its product range includes short-term personal cash loans, salary advances, credit-life insurance products, funeral insurance, cell-phone airtime and pre-paid electricity. Its target market is South Africa's under-banked - but formally employed - population, those individuals who fall within category 1 to 7 of the Living Standard Measurement (LSM) income categories. Finbond has a client base of 330,000, with 45,000 active customers.

Finbond applied for a Mutual Banking license from the South African Reserve Bank in late 2010, and is currently awaiting final approval.

SUMMARY RATING RATIONALE

Finbond's Ba3.za/NP.za national-scale issuer ratings reflect (i) its small size and narrow franchise; (ii) its focus on a high-risk business segment and resultant high level of impaired loans; (iii) its low earnings generating capabilities; and (iv) narrow funding base. Finbond also maintains a high proportion of secured debt in its funding structure, leading to structural subordination issues, as the senior unsecured creditors would be legally subordinated to the claims of secured creditors.

The ratings also reflect Finbond's adequate capitalisation and the favourable growth prospects of South Africa's microfinance industry. We believe Finbond has a "scale-able" franchise given its nationwide branch network and potential to develop into a banking institution serving the lower income brackets (subject to the relevant regulatory approvals). No external support has been imputed into Finbond's ratings.

Rating Drivers

- Finbond is a small institution with a narrow franchise at an early stage of development

- Its capital base is adequate

- Earnings generating capability is low

- Finbond has a high level of impaired loans, while operating in a high-risk segment, providing unsecured lending to lower-income earners

- Despite currently adequate liquid assets, Finbond needs to further broaden and diversify its funding sources

Rating Outlook

All Finbond's ratings carry a stable outlook.

What Could Change the Rating - Up

An upgrade of the national-scale issuer ratings would require Finbond to (i) improve its earnings generating capabilities, becoming profitable on a recurring basis; (ii) broaden its funding base; (iii) reverse deteriorating asset-quality indicators; and (iv) demonstrate its ability to materially grow its business franchise.

What Could Change the Rating - Down

The ratings could be downgraded if Finbond's profitability and asset quality were to weaken materially, putting its solvency at risk, or if it were to suffer a loss in market confidence. This, in turn, could hamper its ability to raise new funding or refinance its existing funding.

Recent Results

For the year ending February 2011, Finbond reported bottom line losses of ZAR20.0 million (February 2010: profits of ZAR58.2 million, but these included an one-off property revaluation gain of ZAR138.8 million). Operating income (excluding revaluation gains) was up 19% to ZAR161.7 million, operating expenses were down 23% to ZAR145.3 million and impairment charges on loans were down 15% to ZAR23.5 million. Total assets were ZAR439.4 million, down 9% from the year-end February 2010 figure, while net loans were flat at ZAR95.7 million; shareholders' equity stood at ZAR235.5 million. The value of loans advanced were up 7.8% to ZAR417 million.

DETAILED RATING CONSIDERATIONS

Our detailed considerations for Finbond's currently assigned ratings are as follows.

Franchise Value

With gross loans of just ZAR106 million and 45,000 active customers as of February 2011 and its limited product range - primarily short-term micro-finance loans - Finbond has a small and narrow franchise and is at an early stage of development. Its franchise value is also constrained by potential earnings and asset volatility, stemming from the high credit-risk profile of its target market, increased commoditisation of micro-finance products and increased competition from both bank and non-bank financial institutions.

Nonetheless, unsecured lending to low-income earners is perceived as one of the high-growth areas within South Africa's banking market. This, combined with Finbond's sizeable and nationwide branch network - and potential to develop into a banking institution serving the lower income brackets (subject to the relevant regulatory approvals) - imply that Finbond's franchise is "scale-able". It also implies that under certain circumstances, Finbond would have the opportunity to broaden its product range and revenue streams.

Risk Positioning

The Group's risk positioning is adversely affected by the nature of its operations, which effectively comprises unsecured lending to low-income earners that are potentially sensitive to the macro-economic environment. Finbond's target client market falls in the LSM 1 to 7 bands, with approximately 50% of lending falling within LSM 1 to 3 bands (individuals typically earning less than ZAR4,000 per month). Funding and liquidity management is also an area of concern, primarily because Finbond depends on a small number of banks and development finance institutions (currently four or five) to finance its operations. As a cash-based business, the company is also faced with higher fraud and theft-related operational risks.

Finbond's management does, however, continuously develop, refine and improve its credit scoring criteria, processes, pay-date management and collection strategies. During the year, Finbond introduced a new up front Credit Scoring system on all new loan products, as well as biometric identification and verification of clients at all branches. Finbond is exposed to moderate market risk (including no foreign-exchange risks) and moderate interest-rate risks, has no major concentrations in its loan book, while maintaining adequate financial reporting transparency. Financial statements are prepared under IFRS, audited by one of the Big-four accountancy firms; Finbond also reports (unaudited) half-year results. No major corporate governance issues were noted, but as Finbond grows its size and range of activities, ongoing improvements would be warranted.

Regulatory Environment

Finbond does not take deposits nor is it a registered bank. It is therefore not regulated by the SARB. We consider this to be negative rating driver, as supervision by the SARB would impose additional discipline in the form of compliance with prudential requirements as well as on-site visits by SARB examiners.

However, Finbond is registered with the National Credit Regulator (NCR), which was established as the regulator under the National Credit Act (NCA). The NCA aims to protect consumers taking credit and also regulates all institutions that provide consumer credit, including banks and micro-lenders. The NCA requires MFIs to perform a full assessment of (i) the applicant's credit and debt repayment history; and (ii) an affordability assessment. This has been instrumental in ensuring that the industry has not provided excessive credit to the consumer market since June 2007, when the NCA came into force. As a result, the NCA has been instrumental in ensuring that MFIs have successfully navigated through the current crisis.

Operating Environment

After going through its first recession in 17 years, the SA economy is recovering, growing by around 2.8% in 2010. Reduced interest rates, with cumulative repo rate cuts of 650 basis points (bps) since December 2008 and moderate inflation (4.6% in May 2011) are helping reduce debt-servicing costs and boost consumer affordability. However, the pace of economic recovery is subdued, consumer indebtedness remains high and substantial job losses recorded over the past two years imply that finance companies are faced with high credit risks.

Profitability and Efficiency

Finbond's profitability indicators remain weak, partly due to its early stage of development and high infrastructure spending. More than 80 new branches were opened over the past eighteen months, but these take at least six to eighteen months to break even. For the year-ending February 2011, Finbond reported bottom-line losses of ZAR20.0 million but these included one-off impairment of goodwill and intangibles of ZAR19.4 million. During the year, operating income (excluding one-off property revaluations) was up 19% to ZAR161.7 million, with operating expenses down 23% to ZAR145.3 million following Finbond's cost cutting initiatives and implementation of `Project RISE' (which focuses on Revenues, Impairments, Short-term product focus, and Expenses). Net impairment charges were down 15% to ZAR23.5 million, but these still account for a high 22% of gross loan (mainly because Finbond's loan portfolio exclusively comprises loans that mature between one and six months with an average tenure of 2.5 months -- the net impairment charge as a percentage of installments due were much lower, at around 5%).

For the year-ending February 2012, we expect Finbond to report further improvement in its earnings generating capabilities, primarily driven by further improvements in its credit quality (following the installation of the new credit scoring and loan management systems) and renewed growth in credit granting.

Funding and Liquidity

Finbond generally maintains adequate liquid assets. As of end-February 2011, these assets were ZAR36.9 million, equivalent to 8% of total assets and approximately 21% of its debt. Additional liquidity may be sourced from a ZAR14 million overdraft facility from ABSA Bank, while Finbond is in the process of raising funding from the local debt capital markets. Nonetheless, broadening and diversifying its funding base should remain a key objective for the company going forward.

Given the short maturity of its loan portfolio - mostly comprising of micro-loans that fall due within 2.5 months - Finbond does not face any major asset/liability maturity mismatches. However, almost all of its liabilities are secured against company assets; the high proportion of secured debt in its funding structure therefore leads to structural subordination issues, as the senior unsecured creditors would be legally subordinated to the claims of secured creditors.

Capital

With shareholders' equity of ZAR235.5 million as of February 2011 and equity-to-assets of 46% (adjusted for goodwill), we consider Finbond as adequately capitalised. Existing financial covenants require it to maintain a tangible net-worth ratio of >25%. However, equity includes unrealised property revaluation gains of ZAR138 million, which could reverse if property prices drop (management maintains that the property investments are conservatively valued, based on two independent valuations that are obtained annually). Although current debt levels are adequately covered by assets, the debt-to-EBITDA ratio for the year-ending February 2011 is an estimated 4.2x, which indicates a relatively weak cash flow generation, from which Finbond can run down its debt. We do not expect any dividends to be paid for the foreseeable future.

Asset Quality

Finbond's asset-quality indicators weakened during 2010, partly as a result of poor underwriting during H2 2009, but also as a result of the challenging operating environment during that period. Loans 90+ days outstanding increased to 8.9% in February 2011 from 3.9% in February 2010, with total arrears (delinquent by one day) accounting for 19% of gross loans. The provision coverage on loans 90+ days outstanding dropped to 94% from 134% over the same period. Asset quality therefore remains a negative rating driver, even though Finbond's management has been reducing its exposure to the six-month loan product - which was the main cause of asset deterioration - in favour of loan products with shorter terms. Finbond typically writes-off loans after 150 days, while rehabilitated loans are treated as negative bad debts written-off in the income statement.

Going forward, we expect a gradual improvement in Finbond's asset quality indicators, to reflect both the implementation of the new credit systems and management's tilting of the loan portfolio towards (better quality) shorter-term loans.

National Scale Ratings

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