

Global Credit Research - 09 Feb 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
Constantinos Kypreos/Limassol	357.25.586.586
Artemis Vrahimis/Limassol	
Yves Lemay/London	44.20.7772.5454

Key Indicators

Finbond Group Limited (Consolidated Financials)[1]

	[1]2010	2009	2008	[2]Avg/CAGR
Total Assets (Rand mn)	482.8	415.2	441.3	4.6
Total Capital (Rand mn)	252.6	213.9	293.2	-7.2
Recurring Earning Power % [3]	19.0	8.8	N/A	13.9
Return on Average Assets %	13.0	-13.5	N/A	-0.3
Net Interest Margin %	23.5	19.6	N/A	21.6
Cost / Income Ratio % [4]	68.9	74.7	47.3	63.7
Problem Loans % Gross Loans	17.1	35.6	34.8	29.2
Shareholder's Equity % Total Assets	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 190 branches in South Africa and has one branch in Botswana and one 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.

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 robust 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, in Moody's view 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 Events

For the six months ending August 2010, Finbond reported bottom line losses of ZAR4.9 million (H1 2009: profits of ZAR31.8 million). The H1 2009 results included fair-value adjustments of ZAR70.0 million (H1 2010: zero). Operating income was up 13% to ZAR79.6 million, operating expenses were down 24% to ZAR71.5 million and impairment charges on loans were up 26% to ZAR14.1 million. Total assets were ZAR468 million, down 3% from the year-end February 2010 figure, while net loans were down by 12% to ZAR85 million. The drop in loans partly reflects the shift towards shorter-term loans of one-to-three months and away from six months loans.

DETAILED RATING CONSIDERATIONS

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

Franchise Value

With gross loans of just ZAR97 million and 45,000 active customers as of August 2010 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, and is exposed to moderate market risk (including no foreign-exchange risks and moderate interest-rate risks). Finbond 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 benign inflation (3.6% in November 2010) 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 12 months, but these take at least six to twelve months to break even. For the year-ending February 2010, Finbond reported bottom-line profits of ZAR58.2 million, including revaluation gains on Investment Properties of ZAR138.8 million. Excluding these revaluation gains, the company was loss-making, even on a pre-provision basis. This situation has improved in the current financial year, primarily following Finbond's cost cutting initiatives and implementation of 'Project RISE' (which focuses on Revenues, Impairments, Short-term product focus, and Expenses). For the six months to August 2010, operating expenses dropped 24% and - despite zero fair-value adjustment gains - Finbond reported pre-provision profits of ZAR8.1 million.

For the year-ending February 2011, we expect Finbond to remain loss-making, affected by sustained high provisions and increased funding costs in the absence of any property-related revaluation gains.

Funding and Liquidity

Finbond generally maintains adequate liquid assets. As of end-August 2010, these assets were ZAR51.5 million, equivalent to 11% of total assets and approximately 29% of its debt. With these, Finbond can meet its maturing liabilities over the next 12 months. Additional liquidity may be sourced from a ZAR15 million and ZAR10 million overdraft facility from ABSA Bank and Standard Chartered, respectively. In addition, Finbond is in negotiations with World Business Capital for an additional US\$10 million loan.

Given the short maturity of its loan portfolio - mostly comprising of micro-loans that fall due within six 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 ZAR249 million as of August 2010 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 (but management maintains that the property investments are conservatively valued). Although current debt levels are adequately covered by assets, the debt-to-EBITDA ratio for the year-ending February 2011 is an estimated 4.6x, 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 substantially 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. Net loan-loss provision charges increased to ZAR14.1 million for the six months to August 2010, which translates to (an annualised) 29% of gross loans. Loans 90+ days outstanding increased to 11.4% in August 2010 from 3.9% in February 2010, with the provision coverage dropping to 89% 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.

National Scale Ratings

Moody's National Scale Ratings (NSRs) are intended as relative measures of creditworthiness among debt issues and issuers within a country, enabling market participants to better differentiate relative risks. NSRs differ from Moody's global scale ratings in that they are not globally comparable with the full universe of Moody's rated entities, but only with NSRs for other rated debt issues and issuers within the same country. NSRs are designated by a ".nn" country modifier signifying the relevant country, as in ".za" for South Africa. For further information on Moody's approach to national scale ratings, please refer to Moody's Rating Implementation Guidance published in August 2010 entitled "Mapping Moody's National Scale Ratings to Global Scale Ratings".



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