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# Credit Opinion: Real People Investment Holdings (Pty) Ltd

Global Credit Research - 26 Jan 2015

*Johannesburg, South Africa*

## Ratings

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

## Contacts



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## Key Indicators

**Real People Investment Holdings (Pty) Ltd**

| | [1]**2014** | **2013** | **2012** | **2011** | **2010** |
|---|---|---|---|---|---|
| Total Managed Assets (Rand Million) [2] | **4,559.5** | **4,305.8** | **4,278.7** | **3,611.8** | **2,517.7** |
| Pretax Preprovision profits / Average Managed Assets | **17.10%** | **23.53%** | **16.92%** | **11.87%** | **14.43%** |
| Net Income/ Average Managed Assets [3] | **-6.85%** | **2.53%** | **3.07%** | **3.96%** | **4.10%** |
| ROE (NPATBUI / Avg. Equity) [4] | **-23.37%** | **12.76%** | **9.39%** | **10.51%** | **10.94%** |
| Short Term Debt / Total Debt % [5] | **--** | **--** | **23.72%** | **16.81%** | **17.75%** |
| Tangible Common Equity / Tangible Managed Assets % [6] | **15.37%** | **23.32%** | **24.00%** | **27.12%** | **32.56%** |
| Problem Loans/Gross Loans [7] | **38.03%** | **30.78%** | **27.82%** | **25.75%** | **34.76%** |
| Problem Loans/(Shareholder Equity+ Loan Loss Reserve) | **75.02%** | **56.38%** | **43.92%** | **30.29%** | **36.61%** |
| Net Charge-offs / Gross Loans [7] | **26.88%** | **14.73%** | **5.32%** | **24.25%** | **28.53%** |

[1] For the fiscal year ending March 31, 2014 [2] The total assets include the disposal group and may differ from figures below where it is excluded [3] Net income includes income/ loss from the disposal group and may differ from figures below [4] NPATBUI refers to net profit (loss) after-tax before unusual items [5] Short term debt refers to the current liabilities reported by the company [6] Tangible managed assets are total assets less intangibles [7] Gross loans exclude the fair value of acquired debt, housing and education loans

## Opinion

### Rating Rationale

The Ba3.za/NP.za national scale issuer ratings (negative outlook) of Real People Investment Holdings Limited (Real People) reflect (1) the company's still weak, albeit recovering, profitability; and (2) the challenging domestic operating environment, that poses risks for asset quality and funding. The aforementioned constraints are partially offset by Real People's capital increase (which will strengthen its loan loss provisioning coverage), and by the company's niche expertise in the unsecured lending and credit management business in South Africa, with a particular strength in risk pricing and loan collections.

No external support has been imputed in Real People's ratings.

### Rating Drivers

- The challenging operating environment continues to pose asset quality risks, despite signs of a recovery

- The capital increase will be primarily used to strengthen provisioning levels

- Profitability continues to provide a weak buffer to absorb credit losses

- Wholesale funding concentrations remain high, although the company's capital increase will support its funding profile

- Despite a small and narrow franchise, the company maintains a successful niche

### Rating Outlook

The outlook on the Ba3.za long-term issuer rating is negative.

### What Could Change the Rating - Up

Given the negative outlook and the challenging operating conditions in South Africa's unsecured lending market, there is currently limited upside pressure on Real People's ratings. The outlook may be changed to stable if Real People further strengthens its provisioning and capital levels or Real People's profitability is strengthened.

### What Could Change the Rating - Down

Real People's ratings could be downgraded if the challenging operating environment leads to further material provisioning needs and/or the company faces increased risk of a loss of market funding access.

## DETAILED RATING CONSIDERATIONS

THE CHALLENGING OPERATING ENVIRONMENT CONTINUES TO POSE ASSET QUALITY RISKS, DESPITE SIGNS OF A RECOVERY

While we acknowledge Real People's experience and expertise in credit management (specifically in risk pricing and loan collections), management's actions to address the declining asset quality trend, and signs of a recovery in asset quality, we expect the challenging operating conditions in South Africa's unsecured lending market to continue to pose asset quality risks. Real People's credit loss ratio improved to 7.6% during the first half of the fiscal year ending September 2014, amid a material slowdown in new NPL formation.

However, South Africa's weak economic growth (annualised quarter-on-quarter GDP growth of 1.4% in Q3 2014 compared to 1.9% in 2013), high unemployment and still elevated inflation (5.8% in November 2014) - will likely continue to weigh on consumers' loan affordability and lead to elevated loan loss provisioning expenses. As such, any potential lower loan loss recoveries present a material downside risk for Real People given its high balance sheet exposure to problematic loans in general, and written off exposures in particular. As of March 2014, Real People's written-off loan book (held at a relatively high fair value of 18.1 cents to the South African rand by March 2014, according to the company) stood at ZAR439 million or 60% of shareholder's equity.

THE CAPITAL INCREASE WILL BE PRIMARILY USED TO STRENGTHEN PROVISIONING LEVELS

Positively, Real People's recent capital increase of ZAR278 million will be used to strengthen provisioning levels. We consider it likely that the company will need additional provisions in the range of ZAR180-270 million, against (1) Real People's legacy general lending portfolio is underperforming expectations, with weaker-than-expected asset quality performance, and (2) to strengthen its general impairment coverage of the performing book which as of September 2014 stood at 3.1%.

With most of the capital being used to strengthen Real People's provisioning, capital levels will likely remain broadly stable. The tangible common equity (TCE)-to-total assets ratio stood at 16.3% as of September 2014 (March 2014: 15.5%, March 2013: 23.3%), its Tier 1 capital ratio stood at 22.7% as of September 2014 (March 2014: 22.4%, March 2013: 29.9%), while its total capital adequacy ratio stood at 32.7% (March 2014: 31.7%). Real People is not a registered bank nor does it take deposits, and is therefore not regulated by the central bank (the South African Reserve Bank [SARB]). However, it's contracted to maintain a minimum capital adequacy ratio of 30% (the company's internal target is 36%).

## PROFITABILITY CONTINUES TO PROVIDE A WEAK BUFFER TO ABSORB CREDIT LOSSES

Real People reported a profit for the second quarter of the fiscal year ending March 2015 ( FYE2015), following losses during the past five quarters. The stronger financial performance can be attributed to lower impairments, cost rationalization measures and lower losses from its disposal units. The profit came in spite of higher funding costs, higher collections costs and continued weakness in the legacy general purpose lending book.

At the same time, the ability of Real People's recurring profitability to withstand any worse-than-anticipated asset quality deterioration will likely remain constrained, as we expect Real People's pre-provision profitability to remain weak amid lower volumes of loan sales (amid a cut-back due to recent funding pressure) and a higher cost of funding. For the six months ended September 2014, pre-provision profitability from continuing operations stood at ZAR255 million or an annualised 12% of average assets from continuing operations, compared to 18.1% during FYE2014. Provisioning expenses therefore represented an elevated 89% of pre-provision income during the first half of FYE2015.

Potential pressure on profitability may also stem from any change in the South African regulatory environment that limits credit to the company's client base (through changes to the affordability calculation) and/ or reduces the maximum allowable interest and fees that the company can charge.

## WHOLESALE FUNDING CONCENTRATIONS REMAIN HIGH

High wholesale funding concentrations remain a rating constraint for Real People, and we will closely monitor the company's ability to access market funding during the next few quarters. The company's top five funders accounted for a relatively high percentage of total funding (at over 50% as of the FYE2014), despite a gradual diversification over the past few years. As of June 2014, domestic listed and unlisted bonds accounted for 34% of total funding, bilateral loans for 23%, securitisation for 18%, Nordic bonds for 16%, and subordinated debt accounted for the remaining 9%.

The company has gradually reduced the proportion of secured debt in its funding structure (FYE2014: 20.5% of total borrowings or 12.3% of gross tangible assets, minus goodwill and adding back loan loss reserves); however, the company may increase the amount of securitisation in the next 12 months. Structural subordination could arise if the volume of secured funding exceeds one-third of total funding, thus weighing on the company's unsecured debt ratings.

## DESPITE A SMALL AND NARROW FRANCHISE, THE COMPANY MAINTAINS A SUCCESSFUL NICHE

Real People has a small and narrow franchise, with relatively low operational diversification as the company's two main business lines are interconnected; both are dependent on trends in the unsecured lending market - primarily in South Africa. The company's strategy focuses on areas of niche expertise, in particular (1) purpose-specific unsecured lending - primarily home improvement finance - through its cooperation with building material merchants, and education finance (accounting for 47% of total assets and 52% of net operating income as of FYE2014); and (2) the acquisition and servicing of non-performing unsecured debt portfolios (accounting for 36% of total assets and 41% of net operating income as of FYE2014).

Nevertheless, Real People maintains a successful niche franchise underpinned by its competitive advantage in credit management and distressed debt collections (with collections exceeding the market average). Its housing finance business model is also supported by its IT systems, with a branch origination platform incorporating customer risk scoring, product selections and pricing, and affordability calculations, all of which are linked directly with a centralised database. In terms of the acquisition of unsecured debt portfolios, recent competitive pressures have led to a reduction in acquired debt volumes, with Real People becoming less dominant in the sector. The company, however, expects the market to re-price over the next 12 to 18 months, which will enable the company to successfully defend its market position. While the market's growth potential is high, it remains relatively small and underdeveloped. Real People has also been leveraging its experience and expertise to provide outsourced collections services to other credit providers in the banking, retail and cellular phone industries; and is in the process of developing its municipal debt collection capabilities.

## SOURCE OF FACTS AND FIGURES CITED IN THIS REPORT

Unless noted otherwise, we have sourced data relating to system-wide trends and market shares from the central bank and the national credit regulator. Company specific figures originate from the company's reports and Moody's Banking Financial Metrics. All figures are based on our own chart of account and may be adjusted for analytical purposes. Please refer to the document "Financial Statement Adjustments in the Analysis of Financial Institutions", published on 19 December 2013.

RATING METHODOLOGY

The principal methodologies used in this rating were "Finance Company Global Rating Methodology", published in March 2012, and "Mapping Moody's National Scale Ratings to Global Scale Ratings", published in October 2012. Please see the Credit Policy page on www.moodys.com for a copy of these methodologies.

The assigned ratings are one notch below the scorecard outcome reflecting the asset quality risks posed by the challenging operating environment.

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 October 2012: "Mapping Moody's National Scale Ratings to Global Scale Ratings".

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