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Credit Opinion: Real People Investment Holdings (Pty) Ltd

Global Credit Research - 11 Sep 2014

Johannesburg, South Africa

Ratings

Category	Moody's Rating
Outlook	Rating(s) Under Review
NSR Issuer Rating -Dom Curr	*Ba3.za
NSR ST Issuer Rating -Dom Curr	NP.za

* Placed under review for possible downgrade on September 8, 2014

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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 (on review for downgrade) of Real People Investment Holdings Limited (Real People) reflect (1) our expectation of further asset quality pressures; (2) the company's weakened profitability; and (3) the increasingly challenging domestic funding conditions. All of these rating drivers continue to be pressured by the challenging operating conditions in South Africa's unsecured lending market. The aforementioned constraints are partially offset by Real People's planned capital increase (which will boost its capital buffers), 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.

The review for further downgrade will focus primarily on the extent to which Real People is successful in implementing its capital raising exercise and easing funding pressures.

Rating Drivers

- The challenging operating environment continues to pose further asset quality risks

- Weaker profitability reduces buffers with which to absorb credit losses

- The planned rights issue will potentially support capital levels

- Wholesale funding concentrations remain high, with the company facing increasingly challenging funding conditions

- Despite a small and narrow franchise, the company's credit management expertise leads to a successful niche

Rating Outlook

The outlook on the Ba3.za long-term national scale issuer rating has been placed on review for downgrade.

What Could Change the Rating - Up

Given the review for downgrade and the challenging operating conditions in South Africa's unsecured lending market, there is currently limited upside pressure on Real People's ratings. The rating may be affirmed at its current levels if the company increases its capital levels by the planned ZAR110 million and maintains sufficient access to market funding.

What Could Change the Rating - Down

Real People's ratings could be downgraded if the company fails to restore capital buffers to a level adequate to absorb expected losses and/or faces increased risk of a loss of market funding access.

DETAILED RATING CONSIDERATIONS

THE CHALLENGING OPERATING ENVIRONMENT CONTINUES TO POSE ASSET QUALITY RISKS

We expect continued asset quality pressure as a consequence of the challenging operating conditions in South Africa's unsecured lending market. South Africa's weaker economic growth (annualised quarter-on-quarter GDP growth of 0.6% in Q2 2014 compared to 1.9% in 2013) and higher unemployment - coupled with the highly leveraged consumers (household debt to disposable income of a high 74.5% in Q1 2014) and higher inflation (6.3% in July 2014) - will continue to weigh on consumers' loan affordability and lead to elevated loan loss provisioning expenses.

Real People's legacy general lending portfolio, in particular, has continued to underperform the company's own expectations, with weaker-than-expected asset quality performance. This loan book accounted for around ZAR850.2 million ($80 million) or 23% of net advances (including acquired assets) as of June 2014. In addition, the company has a fairly low specific impairment coverage ratio - at 56% of the NPL book - and a general impairment coverage of the performing book of 4.9%. While management has taken actions to address the declining asset quality trend, we consider it likely that the company will need additional provisions in the range of ZAR100-150 million against this portfolio which will weaken capital and profitability levels.

While asset quality performance for the remaining portfolio is more in line with the company's expectations, loan loss provisioning expenses remain elevated and the provisioning coverage of NPLs remains weak. While we recognise Real People's loan collections capability, the company is therefore highly exposed to any material deterioration in loan recoveries which will potentially have a significant impact on the company's profitability, capital buffers and overall credit profile. 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, and its net NPLs (NPLs minus loan loss provisions) stood at ZAR360 million or 49% of shareholder's equity (non-performing loans stood at 38% of gross loans and had a fairly low provisioning coverage of 68%).

WEAKER PROFITABILITY REDUCES BUFFERS TO ABSORB CREDIT LOSSES

Real People reported a profit from continuing operations of ZAR11.2 million or a relatively low 1.0% of average assets during the first quarter ending June 2014. We expect asset quality pressure to continue to lead to elevated provisioning costs which will pressure net income, although to a lesser degree than that reported in the fiscal year ended March 2014 (FYE2014), when the company suffered a ZAR204 million loss. Last year's results were adversely affected by a worse-than-expected deterioration in asset quality (both in terms of new NPL formation and collections on existing NPLs) that led to significantly increased loan loss impairments including an one-off impairment loss of ZAR281 million.

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 and a higher cost of funding. For the three months ended June 2014, pre-provision profitability from continuing operations stood at ZAR130 million or an annualised 11.9% of average assets from continuing operations, compared to 18.1% during FYE2014. Provisioning expenses therefore represented an elevated 91% of pre-provision income during the first quarter 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.

THE PLANNED RIGHTS ISSUE WILL POTENTIALLY SUPPORT CAPITAL LEVELS

Real People's capital levels remain weaker than in the past following the losses recorded during FYE2014. The tangible common equity (TCE)-to-total assets ratio stood at 15.2% as of June 2014 (March 2014: 15.5%, March 2013: 23.3%), while its Tier 1 capital ratio stood at 21.8% as of June 2014 (March 2014: 22.7%, March 2013: 29.9%).

The review for further downgrade will focus on an assessment of Real People's ability to conclude its planned of ZAR110 million capital raising exercise, which the company expects to complete within the next two months. Although the capital increase seems to be in advanced stages, during the review period we will assess the impact of any further delays on the company's funding/liquidity profile and solvency position.

The company is also in the early stages of raising an additional ZAR200-300 million of equity before the end of 2014, which may potentially further increase its capital adequacy ratio to over 36%, in line with its internal capital target (from 31.3% as of June 2014). Real People has adopted the Basel II framework, albeit self-imposed. 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]), and is contracted to maintain a minimum capital adequacy ratio of 30% (the company's internal target is 36%).

WHOLESALE FUNDING CONCENTRATIONS REMAIN HIGH, WITH INCREASINGLY CHALLENGING FUNDING CONDITIONS

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: 23% of total borrowings or 13% 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.

Real People is also faced with increasingly challenging funding conditions for South African unsecured lenders. Accordingly, we believe that the company's funding profile remains vulnerable in the context of the challenging domestic operating conditions and the company's weakened financial fundamentals. While we recognise that Real People may potentially access funding from international development financial institutions, delays in the company's ZAR110 million capital raising exercise have weakened its funding profile.

In a statement accompanying results in the three months to end-June 2014, Real People's management acknowledged that funding remains under pressure, which negatively affects new asset origination volumes. We estimate that lack of access to the wholesale market could affect around half of the company's new lending which will depress its revenues or lead to a shrinkage of its asset size, ultimately harming its franchise. Although we acknowledge Real People's relatively good liquidity profile and prudent liquidity management policy, we also note that the company's capital-raising exercise (for the additional ZAR200-300 million), if successful, will be an important factor in restoring funding conditions and sustaining asset growth over the next 12 months.

DESPITE A SMALL AND NARROW FRANCHISE, THE COMPANY'S CREDIT MANAGEMENT EXPERTISE LEADS TO 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 has recently refined its strategy to enable it to focus its resources 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). The company's refined strategy entails a gradual exit of the general-purpose unsecured credit market (as the loan book matures) with the sale of its 58 branches, and the exit/transfer of the smaller cellular phone products and the retail education businesses.

In order to successfully operate in South Africa's unsecured lending market, we believe that Real People can - despite its small franchise - leverage its niche experience and expertise in credit management, specifically in risk pricing and loan collections. Real People's business model is 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. We view Real People's expertise in distressed debt collections as a competitive advantage (with collections exceeding the market average).

Although Real People has been the dominant player in the acquisition of unsecured debt portfolios over the past few years, more recently competitive pressures have led to a reduction in its acquired debt volumes. 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 debt-collection expertise to provide outsourced collections services to other credit providers in the banking, retail and cellular phone industries; it is also in the process of developing the capability to collect municipal debt.

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.

ABOUT MOODY'S BANK RATINGS

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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