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Credit Opinion: Real People Investment Holdings (Pty) Ltd

Global Credit Research - 12 Jun 2014

Johannesburg, South Africa

Ratings

Category	Moody's Rating
Outlook	Negative
NSR Issuer Rating -Dom Curr	Ba1.za
NSR ST Issuer Rating -Dom Curr	NP.za

Contacts

Analyst	Phone
Christos Theofilou, CFA/Limassol	357.25.586.586
Nondas Nicolaides/Limassol	
Yves Lemay/London	44.20.7772.5454
George Korniliou, CFA/Limassol	357.25.586.586

Key Indicators

Real People Investment Holdings (Pty) Ltd

	[1]2013	2012	2011	2010	2009
Total Managed Assets (Rand Million) [2]	4305.8	4,278.7	3,611.8	2,517.7	2,271.5
Pretax Preprovision profits / Average Managed Assets	23.53%	16.92%	11.87%	14.43%	20.85%
Net Income/ Average Managed Assets [3]	2.53%	3.07%	3.96%	4.10%	5.96%
ROE (NPATBUI / Avg. Equity) [4]	12.76%	9.39%	10.51%	10.94%	21.39%
Short Term Debt / Total Debt % [5]	27.00%	23.72%	16.81%	17.75%	18.06%
Tangible Common Equity / Tangible Managed Assets % [6]	23.32%	24.00%	27.12%	32.56%	27.66%
Problem Loans/Gross Loans [7]	30.80%	27.82%	25.75%	34.76%	25.83%
Problem Loans/(Shareholder Equity+ Loan Loss Reserve) [7]	41.55%	34.44%	27.45%	34.39%	36.79%
Net Charge-offs / Gross Loans [7]	14.73%	5.32%	24.25%	28.53%	13.04%

[1] For the fiscal year ending March 31, 2013 [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 manged assets are assets including loan loss reserves, less intangible assets [7] Gross loans exclude the fair value of acquired debt, housing and education loans

Opinion

Rating Rationale

The Ba1.za/NP.za national scale issuer ratings (negative outlook) of Real People Investment Holdings Limited (Real People) reflects its standalone credit profile. The ratings remain constrained by the (1) continued weakness in the company's profitability metrics; (2) elevated levels of non-performing loans (NPLs) stemming from the challenging operating conditions in South Africa's unsecured lending market; (3) the company's high funding concentrations, despite a continued broadening and diversification of funding sources; and (4) the company's small and narrow business franchise.

The aforementioned constraints are partially offset by Real People's planned rights issue which we expect will raise its total capital adequacy ratio to over 36%, and 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

- Real People's persistently weak profitability has reduced buffers available to absorb credit losses

- The challenging operating environment will likely continue to pose further asset quality risks

- The planned rights issue will support capital levels

- Funding concentrations remain high, despite a progressive broadening and diversification of the company's funding base

- The company's franchise is small and narrow, although its credit management expertise leads to a successful niche

Rating Outlook

The outlook on the Ba1.za issuer rating is negative. The negative outlook captures our assessment of the risk of further asset quality deterioration, in a period when the company's profitability will likely remain weak and its funding profile confidence sensitive.

What Could Change the Rating - Up

Under the challenging operating conditions in South Africa's unsecured lending market, there is currently limited upside pressure on Real People's ratings. In the next 12-18 months, the outlook could be changed to stable if Real People improves its asset quality and profitability metrics and/or if we believe that there is a reduced risk of further asset quality deterioration.

What Could Change the Rating - Down

Real People's ratings could be downgraded if we believe that there is a risk of a further deterioration in asset quality metrics, as a consequence of the challenging operating conditions, leading to sustained pressure on profitability and/or reduced access to funding. Further negative rating pressure may result, if the company fails to raise additional capital.

DETAILED RATING CONSIDERATIONS

REAL PEOPLE'S WEAKER PROFITABILITY REDUCES BUFFERS TO ABSORB CREDIT LOSSES

We expect asset quality pressure to continue to lead to elevated provisioning costs, which will continue to pressure the company's net income, although these should decline from the levels reported during the fiscal year ended March 2014 (FYE2014). Real People reported a ZAR304 million ($29 million) loss for the FYE2014, compared to a ZAR109 million profit during FYE2013, primarily caused by a worse-than-expected deterioration in asset quality (both in terms of new NPL formation and collections on existing NPLs) that has led to significantly increased loan loss impairments on its continuing operations and a ZAR100 million loss for the company's discontinued operations (primarily the Cellular and Aspire Group).

In addition, we expect pre-provision profitability to remain depressed at similar levels, providing a weakened first line of defence against any potential credit losses. During FYE2014, Real People also reported weaker pre-provision profitability in its continuing operations (at ZAR758 million or 17.1% of average assets, 25% lower compared to the previous fiscal year), amid lower sales volumes, higher funding costs and operating expenses. The volume of loan sales are likely to remain weak, while potentially higher revenue from East African operations and staff cost rationalisation will likely be offset by higher costs related to funding, loan collection charges and new business initiatives.

While not our central scenario, potential pressure on profitability may also stem from any change in the 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 CHALLENGING OPERATING ENVIRONMENT POSES FURTHER ASSET QUALITY RISKS

Real People's asset-quality indicators reflect the typically high levels of bad debt that accompany the unsecured lending business. With higher-than-expected formation of NPLs and lower collections on existing NPLs, the company reported an increase in impairments to ZAR1,011 million for FYE2014 (for its continuing operations, based on its unaudited financial statements), up 26% over FYE2013.

We expect further asset quality pressure as the challenging operating conditions will likely continue to lead to elevated provisioning expenses amid high NPL formation and weak recoveries. According to our central scenario, South Africa's real GDP growth will likely remain below potential at under 3% in 2014-15, while there is a risk of further labour unrest, which, in addition to the deleveraging of consumers (following an aggressive build up of unsecured credit up to early 2013) and a rising cost of living, could continue to weigh on loan affordability.

While we recognise Real People's loan collections capability, tightening underwriting standards and the increase in loan loss provisioning coverage, we also note the company's high stock of net NPLs (NPLs minus loan loss reserves) and the fair valuing of its written off book, which accounted for a combined 115% of tangible common equity as of March 2014, which also renders the company's financial performance highly dependent on the success of future loan recoveries.

A material further deterioration in loan recoveries will therefore have a significant impact on the company's profitability, capital buffers and overall credit profile. The NPL ratio - defined as NPLs as a percentage of gross loans (excluding the fair value of acquired debt, written off loans and education loans) - was approximately 38%, based on the issuer's FYE2014 results, up from 30.8% as of FYE2013. While provisioning coverage increased to 67.8% (FYE2013: 62.1%), it remains modest in our view, despite being higher than historical loss rates. In addition, Real People carried its written-off portfolio (typically loans overdue by more than 12 months) at a fair value of 18.1 cents to the South African rand by March 2014, which is fairly high and may lead to future revaluation losses.

THE PLANNED RIGHTS ISSUE WILL SUPPORT CAPITAL LEVELS

As a consequence of Real People's loss for the FYE2014, its capital levels have weakened, with the tangible common equity (TCE)-to-total assets ratio falling to 15.5% as of March 2014, from 23.3% as of March 2013, while its Tier 1 ratio dropped to 22.7% as of March 2014, from 29.9% as of March 2013. The current rating level incorporates our view that the company is likely to raise capital of over ZAR100 million, which will boost its capital adequacy ratio to over 36%, in line with its internal capital target (from 32.1% as of March 2014 and 34.7% as of March 2013).

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 minimum is 36%).

FUNDING CONCENTRATIONS REMAIN HIGH, DESPITE A PROGRESSIVE BROADENING AND DIVERSIFICATION OF THE COMPANY'S FUNDING BASE

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). While borrowing from shareholders accounts for around 30% of total borrowings, its business franchise remains vulnerable to any potential disruption in market funding. 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.

The above-mentioned scenarios notwithstanding, we acknowledge a broadening and diversification in Real People's funding sources, with an increase in its funding counterparties, while the company has a reasonable ladder of debt maturities. Over the past few years, the company has also (1) issued subordinated debt, thereby easing structural subordination risks for senior unsecured debt holders; and (2) issued a foreign bond in the Nordic capital markets, which comprised five-year maturity Swedish krona and Norwegian krone tranches - together amounting to over ZAR600 million. While the company has also reduced the proportion of secured debt in its funding structure (FYE2014: 20% of total borrowings or 12% of gross tangible assets, adding back loan loss reserves), the company is seeking to increase the amount of securitisations. 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.

While we acknowledge Real People's relatively good liquidity profile and prudent liquidity management policy, the company's capital-raising exercise, if successful, will be an important factor in sustaining asset growth over the next six months. Real People generally adopts prudent internal short- and long-term liquidity targets and maturity mismatch limits, with its funding maturity profile currently longer than the average maturity of its loan book (which remains short term in nature), although the gap has been narrowing, amid lengthening loan tenors.

THE COMPANY'S FRANCHISE IS SMALL AND NARROW, ALTHOUGH ITS 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's refined strategy will enable management 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 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 education businesses.

Despite its small franchise, we believe that Real People can leverage its niche experience and expertise in credit management, specifically in risk pricing and loan collections, to successfully operate in South Africa's increasingly competitive, but also rapidly growing, unsecured lending market. 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. Real People's expertise in distressed debt collections is viewed 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 Real People 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 developing the capability to collect municipal debt.

SOURCES OF FACTS AND FIGURES CITED IN THE REPORT

Unless noted otherwise, data related to system-wide trends and market shares are sourced from 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 documents entitled "Moody's Approach to Global Standard Adjustments in the Analysis of the Financial Statements of Banks, Securities Firms and Finance Companies" and "Frequently Asked Questions: Moody's Approach to Global Standard Adjustments in the Analysis of the Financial Statements of Banks, Securities Firms and Finance Companies", both published on 19 July 2012.

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.

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

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