MOODY'S
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Credit Opinion: Infrastructure Finance Corp. Ltd

Global Credit Research - 02 Apr 2014

Johannesburg, South Africa

Ratings

Category	Moody's Rating
Outlook	Negative
NSR Issuer Rating -Dom Curr	Ba2.za
NSR ST Issuer Rating -Dom Curr	NP.za

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Key Indicators

Infrastructure Finance Corp. Ltd (Consolidated Financials)[1]

	[2]6-13	[2]6-12	[2]6-11	[2]6-10	[2]6-09	Avg.
Total managed assets (ZAR thousand)	1,480,977.0	2,399,453.0	2,703,096.0	5,037,888.0	6,630,249.0	[3]-31.3
Total managed assets (USD thousand)	149,183.8	293,385.5	398,745.5	657,190.1	858,562.5	[3]-35.4
Pretax Preprovision profits / Average Managed Assets (%)	0.7	-1.0	-1.1	1.8	-1.3	[4]-0.2
Net Income / Average Managed Assets (%)	0.6	-1.3	-0.9	1.2	-0.8	[4]-0.2
ROE (%)	3.0	-7.6	-7.1	14.7	-11.0	[4]-1.6
Tangible Common Equity (Finance) / Tangible Managed Assets (%)	28.2	17.3	16.9	10.3	6.9	[4]15.9
Effective Leverage	2.2	4.3	--	--	--	[4]3.3
Problem Loans / Gross Loans (Finance) (%)	3.5	4.1	4.6	2.0	1.4	[4]3.1
Problem Loans / (Shareholders' Equity + Loan Loss Reserve) (Finance) (%)	9.2	13.5	16.1	12.7	13.6	[4]13.0

Source: Moody's

[1] All figures and ratios are adjusted using Moody's standard adjustments [2] IFRS [3] Compound Annual Growth Rate based on IFRS reporting periods [4] IFRS reporting periods have been used for average calculation

Opinion

SUMMARY RATING RATIONALE

The Ba2.za/NP.za national scale issuer ratings assigned to Infrastructure Finance Corporation Limited (INCA) reflect its damaged business model - which focused on financing the municipal sector in South Africa - and funding profile. Specifically, increasing competitive pressures have compromised INCA's ability to raise funding at profitable rates and has also led to declining earnings power against a background of higher funding costs, tight margins and immaterial non-interest income. As a result, the company's board of directors has taken the strategic decision to cease extending new loans and manage down the portfolio.

Over the past several quarters, management has taken a number of actions to match the maturity profile of its assets to that of its liabilities. To this end, it has sold loans/advances and used proceeds to repay maturing liabilities and build up its liquidity buffers, while also buying back some of INCA's bonds outstanding. While INCA has now broadly matched the maturity profile of its assets and liabilities, management is still committed to sell an additional portion of its loan book. We consider this a credit positive move, as it partly shields INCA from the effects of possible asset quality deterioration that would otherwise have a follow-on effect on its own ability to meet liabilities. In fact, INCA's asset quality has been deteriorating, as reflected by the increase in the proportion of its loans that are classified in the non-investment-grade category on the national-scale (rated Ba1.za or lower) to 24.5% in December and June 2013, up from 17% in June 2012 and 14% in June 2011.

The deleveraging of INCA's portfolio (20% year-on-year decline in the loans & advances portfolio as of December 2013) has led to an increased capitalisation buffer, with equity to assets of 35.8% in December 2013 from 20.8% in December 2012. The ratings also impute a moderate probability of (indirect) parental support, as shareholders (including FirstRand Bank Ltd that owns 17.7% of INCA, and we rate at C- for bank financial strength rating equivalent to a baseline credit assessment of baa1) have actively demonstrated their commitment to buy INCA assets and help address its funding/liquidity issues.

Rating Drivers

- Tight liquidity positioning, albeit proactively managed

- Asset quality pressures from increasingly concentrated loan book

- Good loss absorption capacity as capital levels remain high

- Earnings exposed to volatility from fair value adjustments

- Franchise impairment as a result of unsustainable business model

Rating Outlook

INCA's ratings carry a negative outlook, reflecting the company's reduced financial flexibility as asset quality deterioration or inability on the part of INCA's clients to make timely repayment of maturing loans, would impair its ability to repay liabilities given its limited access to new funding.

What Could Change the Rating - Up

Following the board's decision to run down the portfolio, as well as INCA's limited access to funding, we see limited to no scope for a rating upgrade.

What Could Change the Rating - Down

The ratings could be downgraded if INCA's asset quality indicators were to deteriorate further, or if a significant liquidity mismatch were to develop in the company's cash-flow projections. Additionally, a lower willingness on behalf of its shareholders, specifically FirstRand Bank, to support the company's possible liquidity shortage could also exert negative rating pressure.

DETAILED RATING CONSIDERATIONS

Note: Unless noted otherwise, data related to system-wide trends is sourced from the South African Reserve Bank (SARB). Company-specific figures originate from company reports 2010-13, unaudited interim December 2013 financials and Moody's Banking Financial Metrics.

TIGHT LIQUIDITY POSITIONING, ALBEIT PROACTIVELY MANAGED

Following the board's decision to run down INCA's balance sheet, the focus has almost exclusively shifted toward the company's ability to meet its liabilities/maturing bonds as these fall due. During the six months ending December 2013 the bank sold advances of around ZAR51 million and repaid borrowings of around ZAR291 million bringing outstanding borrowings down to ZAR625 million as of December 2013 (33% year-on-year decrease). During the same period, investments decreased by ZAR94 million and the proceeds were used to settle liabilities. Moreover, during the 12 months ending June 2013, INCA managed to repay a total of ZAR832.6 million of borrowed funds. That included normal repayment maturities and early repayments on the subordinated bond issued. Consequently the group's unencumbered liquidity reserve declined to ZAR117.9 million in June 2013 compared with ZAR392.5 million in June 2012.

We also understand that the company is likely to sell two more significant loans this month (comprise around 28.6% of total loans) in order to enhance its core liquidity and resources available to repay its debt obligations, following a year-on-year reduction in its loan book by 20% as of December 2013. At the same time, we note INCA's liquidity maturity analysis as of December 2013, indicating a positive cumulative net cash flow throughout the period until January 2020, despite the negative net cash flow during 2015 due to high redemptions of its senior bonds. However, the liquidity risk is mitigated by INCA's unencumbered liquidity reserve that more than covers the shortfall within 2015.

The company no longer has access to the capital markets, and our working assumption is that INCA is not in a position to raise new funding, which raises the company's liquidity risk and makes it vulnerable to any possible material loan defaults in its books. However, we believe that shareholders will be willing to provide additional liquidity to INCA by purchasing assets from its portfolio for meeting its obligations in case of need.

ASSET QUALITY PRESSURES FROM INCREASINGLY CONCENTRATED LOAN BOOK

INCA has historically maintained strong asset quality, with low levels of delinquencies and a good average internal credit rating. The company has developed a good knowledge of the municipal sector and state-owned enterprises, which account for the bulk of INCA's loan book. These institutions have historically demonstrated a low bad-debt experience, partly because of government support and partly reflecting the prudent initial lending process and closely monitored follow-up procedures. The currently deteriorating asset quality (with 24.5% of gross loans rated non-investment grade on the national scale as of December 2013) is primarily the result of INCA's largest exposure of ZAR203 million to a telecoms entity (Neotel (pty) Ltd majority owned by the Indian-owned Tata Group) that was restructured, although the loan is still performing.

According to our estimates, as of end-June 2013 NPLs (loans outstanding more than 90 days) stood at 3.5% of gross loans (June 2012: 4.1%), which is higher than the average of 1.5% recorded during June 2008-June 2010. The provisioning coverage on the rental and lease book was 82.4% as of June 2013, while term loans are reported at fair value after considering their recoverability levels. The subdued pace of economic growth in South Africa has led to higher levels of NPLs and could deteriorate INCA's loan book even more. In addition, the company has very high concentrations as its loan exposure is only to a few entities, while its top 10 exposures comprised a high 80.9% of total loans as of December 2013. Although most loans are highly rated municipal-related exposures, this level of concentration raises the event risk for INCA and makes it vulnerable to any significant loan default.

GOOD LOSS ABSORPTION CAPACITY AS CAPITAL LEVELS REMAIN HIGH

As of end-December 2013, shareholders' funds accounted for 35.8% of total assets (factoring in a net dividend of ZAR9 million that was distributed to shareholders), with the ratio of borrowed funds-to-equity improving to 1.5x. The improvement in capitalisation is the result of substantial deleveraging of INCA's balance sheet in the past few years, with gross loans down to ZAR996 million in December 2013 from their peak of ZAR4.7 billion in June 2009. This improvement in the company's capitalisation metrics is credit positive as it enhances INCA's loss absorption capacity from possible loan losses.

According to INCA's estimates, its Tier 1 ratio stood at a high 84% as of December 2013, from 44% as of December 2012. The increase in the company's capital levels has been significant in the past few years, considering its CAR of 14.9% in June 2010 when INCA Portfolio Managers (Pty) Ltd were appointed with a mandate to manage down the company's assets and liabilities portfolio.

EARNINGS EXPOSED TO VOLATILITY FROM FAIR VALUE ADJUSTMENTS

INCA reported a profit after tax for the six months ended-December 2013 of ZAR8.3 million, compared with a loss of ZAR7.6 million during the same period in December 2012. Net interest income for the six months increased substantially by 44%year-on-year to nearly ZAR20 million, while the company took no further impairments and declared no interim dividend. Earnings are exposed to higher volatility as a result of large swings in realised and unrealised fair value adjustments, especially with respect to the company's investment and derivatives portfolio. Moreover, the company remains exposed to credit spreads movements in its metropolitan municipalities advances as it does not hedge for credit spread movements.

We expect that the company's core profitability will remain under pressure as its balance sheet shrinks, while bottom-line will continue to show volatility depending on the fair value adjustment gains/losses that are mainly related to INCA's derivative financial instruments (interest rate swaps for hedging).

The bulk of INCA's operating costs are now fixed under a three-year management agreement (which has been recently extended until September 2015) with INCA Portfolio Managers (Pty) Ltd that manages INCA's portfolio and debt repayment schedule. Operating expenditure reduced by 49% year-on-year and as a percentage of core income (net interest income plus fees) comprised 26% for the six months ended-December 2013 from 73% during the same period in 2012.

FRANCHISE IMPAIRMENT AS A RESULT OF UNSUSTAINABLE BUSINESS MODEL

INCA has historically developed specialised skills in financing the municipal sector in South Africa, where it had maintained a significant market share (of approximately 10%). In recent years however, the company's business model has been facing problems, due to high levels of competitiveness in terms of price (primarily from the Development Bank of Southern Africa - DBSA, Baa1 negative) and the municipalities' reduced capacity to implement projects. As a result of this, compounded by increased funding costs and no access to the capital markets, the board of directors decided to run down the company's portfolio. This has permanently marginalised INCA's franchise value as its business model was no longer sustainable.

This strategic direction has inevitably and irreversibly impaired INCA's franchise, limiting its earnings capacity and tightening its liquidity positioning. We consider these developments to be credit negative for INCA, exerting downward pressure on its rating.

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 entitled "Mapping Moody's National Scale Ratings to Global Scale Ratings".

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