GCR GLOBAL CREDIT RATING CO.
Local Expertise • Global Presence

Finbond Group Limited

South Africa Bank Analysis | **October 2016**

Rating class	Rating scale	Rating	Rating outlook	Review date
Long-term Short-term	National National	BBB-$_{(ZA)}$ A3$_{(ZA)}$	Stable	October 2017
Long-term	International LC	BB-	Stable	October 2017

Financial data:

(USDm comparative)

	28/02/15	28/02/16
R/USD (avg.)	10.95	13.09
R/USD (close)	11.52	16.03
Total assets	117.1	89.3
Total capital	30.0	24.2
Total borrowings	81.3	59.8
Net advances	25.2	27.4
Liquid assets	49.5	23.0
Operating income	34.3	35.8
Profit after tax	4.6	4.4
Market cap.‡	R1,89bn/USD136m	

‡ Finbond's JSE listing on 26 October 2016 (R/USD 13.90).

Ratings history:

Initial rating (October 2011)
Long-term: BB$_{(ZA)}$
Rating outlook: Stable

Initial rating (October 2013)
Long-term (International LC): BB-
Rating outlook: Stable

Last rating (December 2015)
Long-term: BBB-$_{(ZA)}$
Short-term: A3$_{(ZA)}$
Rating outlook: Stable
Long-term (International LC): BB-
Rating outlook: Stable

Related methodologies/research:

Global Criteria for Rating Banks and Other Financial Institutions, updated March 2016
Finbond rating reports (2011-15)

GCR contacts:

Primary Analyst
Kurt Boere
Credit Analyst
boere@globalratings.net

Committee Chairperson
Jennifer Mwerenga
Senior Credit Analyst
jennifer@globalratings.net

Analyst location: Johannesburg, ZA
Tel: +27 11 784 – 1771
Website: http://globalratings.net

Summary rating rationale

- Finbond Group Limited ("Finbond", "the group"), through its underlying businesses, the most significant being Finbond Mutual Bank ("FMB", "the bank"), offers short- and medium-term unsecured loans, insurance and savings products, transactional banking, and mortgage finance products to individuals in South Africa. Post FYE16, Finbond raised a total of R1.08bn from shareholders and expanded its operations to the United States of America ("US") and Canada through the acquisition of 178 short-term lending branches operating in the Alternative Financial Services market.
- The ratings of Finbond, an operating holding company (through which the group's credit-linked insurance products are provided), reflect its growing local mutual banking and microfinance businesses, and international expansion. Evolving regulatory landscapes, characterised by amendments to existing regulations and the introduction of new requirements, as well as weak economic conditions (in South Africa especially) were also considered.
- Robust credit/risk management, stable asset quality/performance and comfortable capital/liquidity levels support the ratings, which exclude the prospect of state support, given its low likelihood. The rating outlooks consider the group's development and growth phase, within the context of challenging and uncertain economic and regulatory environments.
- The group maintains adequate capitalisation relative to its level of credit risk. Finbond's capital/assets ratio was 27.1% (FYE15: 25.6%), and FMB's capital adequacy ratio was 35.8% (FYE15: 35.1%) at FYE16.
- Fixed term deposits from customers, Finbond's main source of funding, decreased by 1.5% (compared to loan growth of 17.2% in F16) as management sought to reduce the cost of surplus funds. As a result, the loan/deposit ratio increased to 35.9% (FYE15: 31.0%) at FYE16, and liquid assets as a percentage of total assets was a lower 25.7% (FYE15: 42.3%) at FYE16.
- Finbond's conservative lending practices and strict upfront credit scoring, as well as write-offs of R94.4m (F15: R78.2m), reduced the gross impairment ratio to 12.4% (FYE15: 19.4%) at FYE16. Provision coverage of arrears increased to 49.1% (FYE15: 43.7%). In F16, collection and rejection rates remained high. While most metrics highlighted asset quality improvement, operating environment challenges make a reversal of this trend in F17 a possibility in GCR's opinion.
- In F16, operating income rose by 24.6% to R468.3m and net income by 12.6% to R57.3m. The majority of profit was derived from Finbond's small personal loans, microfinance initiation and service fees, and insurance commission revenue. Impairments increased by 18.6% (in line with loan growth), while the cost-to-income ratio remained unchanged at 64.5% in F16.

Factors that could trigger a rating action may include

Positive change: A sustained improvement in business profile (particularly scale and earnings diversification), as well as stable asset quality and capital metrics would be positively considered.

Negative change: A significant deterioration in Finbond's asset quality, earnings, capital, funding and/or liquidity profiles, could lead to negative rating action.

GLOBAL CREDIT RATING CO.

Organisational profile

Business overview

Finbond operates as a specialist consumer finance provider, offering credit, savings, insurance and transactional banking solutions in South Africa, as well as short-term lending in North America.

History and background

Finbond was established in 2003 as a debt consolidation, bridging finance and second-bond origination company, and listed on the AltX sector of the JSE in 2007[1]. Following the global sub-prime crisis in 2007/08, which heavily impacted the mortgage origination market in South Africa, Finbond diversified its business to microfinance (by acquiring various micro lenders). The group introduced micro insurance through its own insurance cell captives in 2009, and in 2012, Finbond established/registered FMB.

Recent developments

Post year-end (29 February 2016), Finbond initially acquired four North American short-term unsecured lending businesses with branches in the US and Canada. Subsequently, the group acquired two further short-term lending businesses in the US. The establishment of a business presence in the North American short-term unsecured lending market through acquisitions and subsequent organic growth is part of Finbond's earnings enhancing growth strategy. Management expects over half of Finbond's profits to be denominated in USD by FYE17, and 80-90% over the next three to five years.

Operations/products

Finbond primarily focuses on providing short-term personal cash loans (tenures of three months and less; average loan amounts of R1,700 and USD400), in South Africa and North America. The group also provides insurance, secured lending, savings/ investment and transactional banking products/ services in South Africa.

Short-term unsecured lending – Short-term micro credit products are offered to South Africa's underbanked but employed population. Clients in the lower-to-middle income brackets (Living Standards Measure ("LSM") bands 1-7) are targeted, and reached through Finbond's extensive branch network, growing employee base, and understandable product offering/loan repayment platform. Finbond's US clientele are generally middle income earners seeking short-term advances.

Savings and investments – Finbond offers fixed/ indefinite term savings/investment products to investors and pensioners at above average yields. Such products provide funding for the group's short-term unsecured lending products.

Insurance – To manage its exposure to credit risk, as well as attract clients, Finbond offers credit life, retrenchment cover and funeral insurance to its lending customer base.

Transactional banking – Finbond launched numerous transactional banking products during F16, including bank and savings accounts, mobile and internet banking, and a MasterCard debit card. However, uptake was modest in terms of management expectations. Transactional banking customers grew to 51,303 at FYE16.

Secured lending – The predominant focus of the home loan product range is consolidation mortgages, where a client already has an existing home loan, and would like to consolidate their debt by refinancing the existing loan using the equity in the property as collateral. Alternatively, Finbond provides bridging finance and home loans to first-time owners. The home loan product range consists of prime-linked mortgages with terms of 20 years.

Since 2007, Finbond has expanded its branch network in South Africa by opening and acquiring branches in all nine provinces. In F16, Finbond grew its local branch network to 344 branches (F15: 286) and at 31 August 2016, Finbond's footprint in South Africa increased to 379 branches. Finbond, through Finbond Group North America LLC, also operates across 172 branches in the US, located in the states of Alabama, California, Florida, Illinois, Indiana, Louisiana, Mississippi, Missouri, Nevada, New Mexico, Oklahoma, South Carolina, Utah, and Wisconsin, as well as six in Toronto, Canada (as at 31 October 2016). The group's head office is located in Pretoria, South Africa. Finbond's staff complement grew to 1,588 employees at 1H F17 (FYE16: 1,104; FYE15: 880).

Strategy

Finbond aspires to be recognised as a leading short-term unsecured lending and 30-day microfinance company in its target geographies. The group's 'hedgehog concept'[2] and strict compliance culture form the framework within which strategic objectives are expected to be achieved. In F16, Finbond embarked on the initial phase of its expansion strategy into North America, but also focused on growing its local unsecured lending business. In addition, the group launched transactional banking activities and grew its home loan product offering. The group is currently undergoing changes in executive management positions, in particular the recent appointment of a new Chief Financial Officer ("CFO"). There are also key changes underway in the risk department.

[1] Finbond transferred its listing to the main board of the JSE in 2014, following a sector reclassification from 'consumer finance' to 'banks'.

[2] Finbond will only launch new ancillary products if they do not shift the focus of management away from the group's core strength and profit driver, that is short-term cash generative unsecured lending (hedgehog concept).

Finbond's main strategic initiatives currently underway include:

- Growing its market share through increased sales of short- and medium-term loans (up to a maturity of 6 months);
- Refining, developing and improving information technology systems and processes;
- Converting its mutual banking license to a commercial banking license; and
- Expanding its South African and North American branch network through additional strategic acquisitions in the South African and North American short-term lending markets.

While many consumer finance providers are lending-only organisations, the FMB banking license enables the group to meet borrowing/saving/risk management (insurance) needs of clients, but remains primarily a short-term unsecured lender. Upon recommendation from the South African Reserve Bank ("SARB") Banking Supervision Department, Finbond is in the process of converting its Mutual Banking license to a Commercial Banking license. This conversion, which is only expected to take place in 2017, requires enhancements to the group's risk management systems, given the more onerous capital (adequacy), governance, risk management and regulatory reporting requirements under Basel III, compared to simpler requirements under the Mutual Banks Act.

Finbond's key strategic objectives for the next five years (up to 2021) are to:

- Grow its after-tax profitability to around R520 R600m through a combination of organic growth (inclusive of newly established product lines), strategic acquisitions in the short-term micro lending industry, and international expansion of the core business in North America and to Europe.
- Grow its South African branch network to approximately 450 branches nationwide, and its North American and European branch network to approximately 600 branches (mainly through the acquisition of small short-term unsecured lending groups with networks of between five and 40 branches).
- Increase its staff numbers to approximately 3,500, thereby creating a further 2,400 jobs.

Organisational structure

Ownership structure

Finbond's Chief Executive Officer, Dr Willie van Aardt, holds 24% of the issued shares in the group through Kings Reign Investments. The remaining shares in Finbond are held by various institutional shareholders, the most significant being Pershing LLC and Net 1 Finance Holdings (with a combined shareholding of 58.4%), as well as numerous private shareholders and other directors of the group.

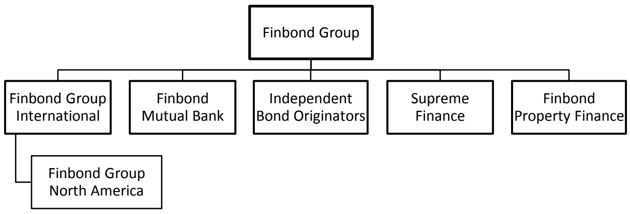
Table 1: Effective shareholding (%)	F16	1H F17
Pershing LLC	18.8	32.5
Net 1 Finance Holdings	25.9	25.9
Kings Reign Investments	33.7	24.0
Investec Bank Limited Private Placements	2.4	1.9
Midbrook Lane	1.9	1.9
Finbond Group Limited	2.3	1.9
Snowball Wealth	2.3	1.8
Constantia Insurance Company	1.2	1.4
Other (with less than 1% shareholding)	11.5	8.7

Source: Finbond.

Group structure

Finbond acts as a holding company (as well as the entity through which insurance products are provided), while its lending, savings and transactional banking operations are carried out by its wholly-owned operating subsidiaries, the most significant being FMB. The bank provides savings products, unsecured and home loan products, and transactional banking products/services through its SARB-regulated infrastructure. Home loan bridging finance is provided by Finbond Property Finance Pty Ltd. Malta based Finbond Group International Ltd, which owns 100% of the group's North America subsidiary (Finbond Group North America LLC), are independent of South African regulations.

Group structure (as at 30 September 2016)



All shareholdings in the ordinary share capital of the subsidiaries are 100%.
Source: Finbond Annual Report 2016.

Governance and control structures

The ultimate management, oversight and governance structures of the group are robust and led by Finbond's board ("the board"), which sets strategy, risk parameters and ethics/governance direction, approves financial results and budgets, and monitors performance. At FYE16, the board comprised seven non-executive directors (six being independent) and three executive directors. Finbond's new CFO was appointed to the board in July 2016. The board's composition reflects local business/governance requirements, and relevant bank statutes. The board exercises oversight through several board committees, including: audit, remuneration, social and ethics, risk, and investment committees, and the executive committee, which oversees a number of sub-committees where executive directors and senior management are members. Audit and compliance functions report directly to the audit committee and typically on a monthly basis to the SARB.

Legal/compliance matters

Finbond is a registered Financial Services Provider, and is regulated by the SARB and National Credit Regulator ("NCR"). The group is required to comply with the National Credit Act ("NCA"), Companies' Act and JSE listing requirements, amongst others.

On 10 June 2015, the NCR applied to the South African National Consumer Tribunal ("the Tribunal") to *inter alia* order Finbond to:

- Refund five consumers whom the NCR believes Finbond overcharged in respect of credit life insurance;
- Perform an audit to determine how many other customers have been charged more than the industry average since commencement of the credit life business, and to refund those customers; and
- Pay an administrative fine of R1m.

However, Finbond has investigated the allegations[3] and has sought legal advice, and believes the matter will be satisfactorily resolved in its favour through due legal process.

Reporting structure and access to information

The bank/group has extensive operational and reporting policies in place, which involve producing detailed management and risk reporting on a monthly basis. Investor communications are timely and disseminated by the group as appropriate.

Finbond's financial statements are prepared in accordance with IFRS and relevant local statutes. The annual and interim financial reports are detailed, transparent and timely. KPMG Inc., Finbond's external auditor, issued an unqualified audit report on the group/bank's F16 financial statements.

Operating environment – South Africa[4]

Finbond is directly exposed to lower-income customers through credit linked financial products provided. Consequently consumer confidence, employment rates, indebtedness levels, consumer lending trends and related considerations, impact potential business growth, asset quality and profitability.

Economic overview

In 2015 and 1H 2016, South Africa's macroeconomic environment has been broadly negative, characterised by moderating real GDP growth, partly linked to power supply constraints, lower productivity and rising inflationary pressures. The Rand's depreciation against major currencies over this period exacerbated inflationary pressures, prompting the SARB to raise the repo rate by a cumulative 50bps in 2015, and another 75bps to end-July 2016. Rand weakness was exacerbated by a December 2015 Finance Ministry re-shuffle. 1H 2016 has been characterised by Rand weakness and volatility.

Global economic malaise, low commodity prices, rising interest rates, volatile labour relations, drought, low investment/business confidence, and increasing polarisation of socio-political sentiment continue to weigh on South Africa's economic growth prospects. Downward pressure on disposable incomes is likely to persist, and SARB's real GDP growth projections for 2016 have been revised down to 0.5% (from 1.5% in September 2015). The country is also at risk of a sovereign rating downgrade to non-investment grade.
In 2015 and 1H 2016, corporate performance was muted, while consumer spending/household income growth has been slow (due to high unemployment levels, low consumer confidence, and modest lending growth). Debt affordability has stabilised somewhat, reflected high indebtedness (but below 2008 levels). Growth in households' financial liabilities combined with slower appreciation in the value of housing stock and equity holdings has moderated household net wealth. Nonetheless, there has been a notable acceleration in household deposit growth in 1H 2016.

Industry overview

The 2007 promulgation of the NCA began a process of structural change in the consumer lending industry's composition, while also providing statistics from non-bank credit providers, which have increased their share of consumer loan issuance from 16% (2007) to 22% (2015), per the NCR statistics. Concomitantly, secured lending has declined from 75% of loan issuance in 2008 to 57% at the height of the unsecured lending boom in 2012. Over the same period, unsecured credit rose from 12% to 24% of consumer credit issuance, with 'other loans' (comprising credit facilities and, to a lesser extent, short-term loans) retaining a fairly constant share. Developmental finance has been included in NCR statistics since 2012, and comprised 3-4% of consumer loan issuance in 2015.

Regulatory developments

In recent years, regulation has been aimed at curbing consumer over-indebtedness, while balancing financial inclusion objectives. Such regulation affects registered credit providers which lend to consumers or small/micro businesses, with much legislation implemented or promulgated since the beginning of

[3] The NCR alleges that Finbond's customers, when taking out a short-term unsecured loan, are required to pay unreasonable premiums for the provision of credit life insurance, in contravention of the NCA. In addition, the commission charged for this insurance is not properly disclosed to customers. Finbond is, however, confident that it at all times complied with all relevant laws and regulations, and that the NCR application does not have legal merit and will be dismissed. The insurance premium rates of the credit life insurance products that Finbond sells to consumers are risk based, product specific, value adding, fully justified and not unreasonable (nor at an unreasonable cost to the consumer) and Finbond intends to demonstrate this to the Tribunal. A ruling not in favour of Finbond could have damaging financial and reputational implications for the group.

[4] Given the nascent stage of Finbond's North American operations, the operating overview focuses on local factors only.

2015. A discussion of these developments directly or indirectly pertinent to Finbond follow.

In September 2015, The Department of Trade and Industry ("DTI") implemented affordability assessment regulations in an attempt to combat reckless lending and borrowing. These amendments tighten criteria for affordability assessments and require credit providers to ensure that the consumer has sufficient income available to finance the proposed credit instalments, taking cognisance of all existing debt and maintenance obligations. Finbond confirmed that its internal credit application policies regarding affordability were more stringent than the guidelines and thus the group did not adjusted its credit applications process as a result of the new regulations.

The DTI also published regulations for interest rate limits and fees for credit agreements (effective from 6 May 2016). Interest rate and fee caps affect most consumer credit to some extent. Profitability for lenders and pricing for borrowers will be most impacted in the unsecured (in particular, short-term) credit segment, where much of the lending is priced close to the regulatory upper limits. These regulations broadly include changes to the formula for calculating maximum prescribed interest rates, as well as initiation and servicing fees which may be charged on various types of consumer credit agreements. Contrary to stricter maximum interest rate limits on most credit categories, rate limits for developmental credit were raised.

Where Finbond's interest rates for unsecured credit transactions (loans with a term of more than six months) were above the limits, the group has had to adjust accordingly. Since the majority of loans originated by Finbond are of a term of six months or less, the impact on interest income is expected to be minimal. Rates for short-term credit transactions (1-6 month loans) remained at 5% per month on the first loan and 3% (down from 5%) per month on subsequent loans within a calendar year. Finbond anticipates there to be a much more significant impact on interest revenues given its focus on this loan type. However, this should not materially impact profitability overall as Finbond's initiation and service fees can be raised to account for the lower interest earned.

Furthermore, on 13 November 2015, the DTI released draft regulations regarding the capping of costs on credit life and retrenchment insurance. The credit life rates proposed for unsecured/short-term credit transactions of R4.50 per R1,000 of the deferred amount (excluding the cost of credit) may, if implemented, have some impact on the group's insurance revenues.

Although these regulations are intended to enhance financial stability, support consumer protection and make credit more affordable, as well as lowering NPL levels in consumer lending, they are also likely to have a negative influence on the supply of household credit in the economy.

A case[5] is currently awaiting judgement from the Constitutional Court on the use of emolument attachment orders ("EAOs"). An EAO is a court order that compels an employer to deduct money from an employee's salary every month for debt owed to a creditor that has obtained judgment against the employer. Finbond itself does not use EOAs, however, some of the collection agencies used by the group do. The potential impact on the group, should the order be upheld with prospective effect, is not expected to be material. In the event of the order being implemented retrospectively, the impact could potentially be materially negative for the group and most financial service providers, especially banks.

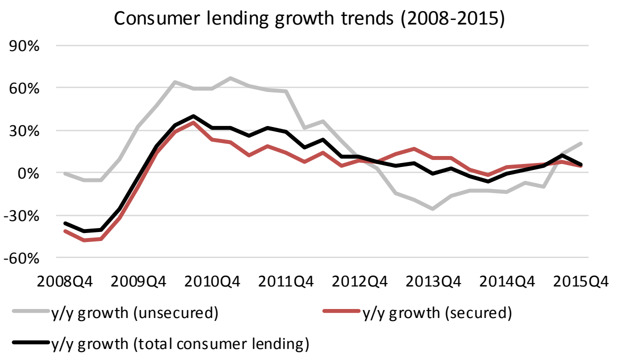
A major change for banks as a result of Basel III is the introduction of minimum liquidity and funding standards. The liquidity coverage ratio ("LCR") is designed to ensure that banks can withstand an acute stress scenario, requiring banks to hold stocks of high quality liquid assets to cover net outflows over a 30-day period. Banks are required to maintain a minimum LCR of 80% during 2016, increasing in 10% annual increments to reach 100% by 1 January 2019. Finbond's LCR was 271% at FYE16 (1H F17: 259%).

The net stable funding ratio ("NSFR"), which comes into effect (at a level of 100%) on 1 January 2018, requires banks to utilise a minimum quantum of stable sources of funding relative to the liquidity profile of assets and off-balance sheet commitments.
At FYE16 and 1H F17, Finbond's NSFR was 664% and 499% respectively.

Consumer lending trends

Challenging macroeconomic conditions and an evolving regulatory landscape have largely shaped trends in consumer credit supply/demand over the past few years. Lending to individuals is still subdued relative to 2011-13 levels. Higher delinquency on loans issued during this period has constrained credit supply, while a deterioration in consumer confidence, persistent labour market instability, and stagnant disposable income levels have had negative credit supply and demand implications.

[5] A class action law suit was brought to the Western Cape High Court by the University of Stellenbosch's Legal Aid Centre ("LAC") and 15 consumers. The LAC alleges among other things that in many instances EAOs had been obtained in Magistrate's Courts outside the area of jurisdiction relating to where the loans had been obtained. The LAC is also concerned that clerks of the court, instead of magistrates, have been issuing EAOs. The LAC also seeks to determine whether it is constitutionally permissible for an EAO to be issued without any form of judicial oversight. Further, when the EAO is issued, a magistrate should ensure a debtor has sufficient means to maintain himself and any dependents. The list of respondents in the matter include the Minister of Justice and Correctional Services, the Minister of Trade and Industry and the NCR as the action is intended to get the law on EAOs redrafted.



Source: NCR.

Since 2012, secured credit issuance (mainly instalment sales/mortgages) has shown moderate positive growth, while unsecured loan issuance growth has been broadly negative (with substitution from unsecured to secured credit categories evident), turning positive again in 2015.

Intensifying economic pressure is starting to dampen demand for vehicles and house purchases, feeding through into the credit markets, while tighter regulations are constricting supply. Credit application rejection rates have moderated slightly in the past few quarters, but are expected to increase again in the wake of recent regulatory changes, despite some recent signals that both credit quality and consumer indebtedness measures are improving. GCR views the outlook for consumer lending growth as neutral to negative, given the prevailing economic and regulatory environment. While this should ultimately have a positive impact on asset quality and consumer indebtedness levels, the social cost of a potential reduction in financial inclusion is harder to measure.

While these broad trends highlight the direct and/or indirect challenges market participants face, their specific areas of focus and lending practices continue to be the key determinants of each credit provider's actual experience. Consequently, while the industry overview provides historical and aggregate context, performances reflect companies' strategic choices and risk appetites rather than the products they offer or sector-wide trends. This is particularly relevant for monoline businesses which operate exclusively or primarily in selected segments, such as the unsecured, short-term and development finance credit markets (given their lack of diversification and operational complexity as a result of the volume-driven nature of these businesses, and relatively higher exposure to the impact of changing regulation).

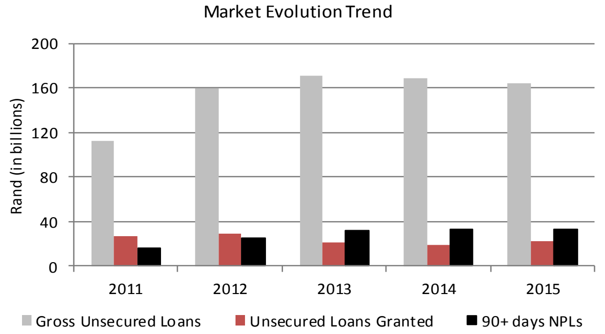
Specialist industry segments

Trends in unsecured credit

The unsecured lending boom was largely driven by improved access to credit for middle-income earners, a larger middle class, substitution of secured for unsecured credit in upper-middle income clients, longer/larger unsecured loans being made available, and a degree of reckless lending, including loans being granted to higher risk customers.

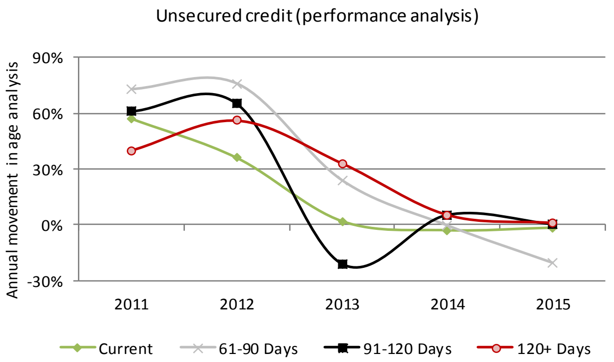
Credit risk and asset quality

After three years of constrained issuance, conservative underwriting and rising arrears, in 2015 the unsecured credit markets appear to be stabilising.



Source: NCR.

The abovementioned factors resulted in a de-risking of credit books, which are now starting to display some stability, characterised by slight prolongation of tenor, increasing average loan sizes and consistency in credit quality and ageing metrics over four successive quarters.



Source: NCR.

While market participants' de-risking of their books and increases in provisions and write-off rates should have largely mitigated the challenges of the past, the sector's outlook remains constrained by regulatory and macroeconomic challenges, compounded by the broadly negative consumer environment, which are likely to constrain credit growth.

Collections environment

The collections operating environment has continued to experience a number of challenges aligned to those impacting consumer lending. Macroeconomic factors, together with myriad regulatory changes[6], has increased the effort and cost of collection, but may encourage clients to increase servicer outsourcing, potentially boosting outsourced collection business

[6] The complexity, compliance requirements and attention to detail required in servicing operations continues to increase, potentially leading to a contraction in retail credit granting. A further significant (but currently unquantifiable) risk to the collections environment is the expected change from a non-authenticated debit order ("NAEDO") system currently in place, to customer authenticated collections ("AC"). While the switch from NAEDO to AC is expected to take place in September 2016, the details around how this process will be implemented, as well as its consequences for collection levels, remain unclear to most industry players.

volumes. Finbond's collection rates improved to 86% of anticipated receipts in F16 (F15: 83%).

Finbond's primary payment platform is in the form of a direct debit order. Finbond uses internal and external collection centres for early stage/remedial collections. Late stage/legal collections are handed over to specialist collection agents, who are responsible for tracing the debtors, facilitating payment arrangement and, if deemed necessary, take legal action (in the form of obtaining EAOs).

Competitive landscape/positioning

The South African microfinance market consists of a large number of players, from small unsophisticated 'mom and pop' shops to larger well-funded companies and banks.

Finbond's main competition in the short-term credit market remains independent cash lenders and Capitec Bank. As increasing regulation and unfavourable market conditions place strain on smaller loan providers, opportunities for Finbond to acquire existing branches/clients are often presented. Finbond added 58 branches to its network in F16, and a further 35 by 1H F17, primarily by acquiring several existing short-term lending businesses, making Finbond the largest South African unsecured short-term credit provider by branch footprint in South Africa.

Despite significantly increased competition in the short-term loan market over the past 12 months (that grew 1.9 times year on year as many unsecured lenders that previously focused on longer term loans changed their focus and now also target the short-term market), Finbond's market share of all 2- and 3-month loans in South Africa (in terms of rand value) increased to 32.1% at Q2 2016. When considering the number of loans written in the 2-3 month loan space, Finbond had a 43.2% market share at Q2 2016. Finbond has increased its total market share of the short-term unsecured loan market to 16.1%. Nevertheless, Finbond's share of the total unsecured lending market in South Africa remains insignificant.

Capitec Bank – which is used as a benchmark by Finbond with regards to growth and development in its journey from niche microlender to retail bank – has established itself as the new leader in the unsecured credit space, and at 31 August 2016 had 7.9m active clients, 751 branches and around 25% of the local unsecured credit market.

Financial profile

Likelihood of support

To date, shareholders have demonstrated support for the group through two successful capital raises post FYE16 and short-term loan facilities. Therefore, shareholder support, having been tested in the past, is seen as a viable emergency avenue. Given Finbond's lack of systemic importance, regulatory/government support cannot be relied upon.

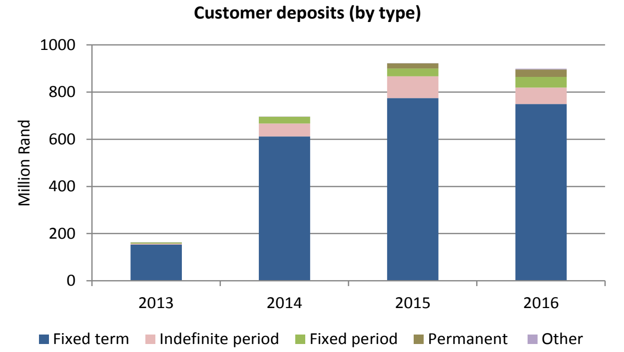
Funding structure

Table 2 sets out the Finbond's funding base, which at FYE16 comprised equity (28.8%) and liabilities (71.2%).

Table 2: Funding profile	F15		F16	
	Rm	%	Rm	%
Customer deposits	922.0	71.8	910.9	67.7
Fixed/notice deposits	*921.9*	*71.8*	*907.7*	*67.4*
Transactional deposits	*0.1*	*-*	*3.2*	*0.3*
Bank overdraft*	-	-	29.6	2.2
Shareholder loans	15.0	1.2	18.0	1.3
Equity	345.9	27.0	388.0	28.8
Total	**1 282.9**	**100.0**	**1 346.5**	**100.0**

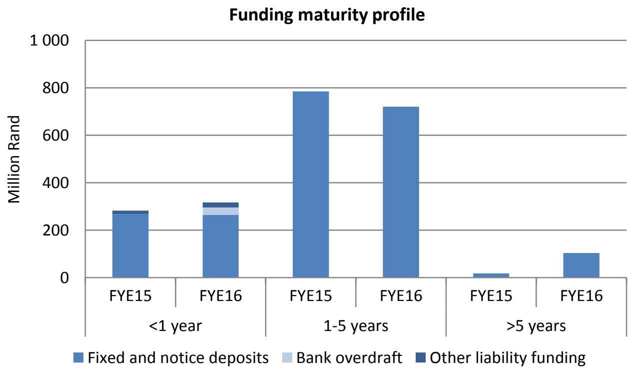
* R40m overdraft facility from Absa Bank for working capital purposes.
Source: Finbond Annual Report 2016.

Given Finbond's conservative credit risk appetite, and the risk of negative carry associated with excess interest-bearing liabilities, the group implemented measures to help curb deposit growth in F16, including adjusting deposit rates and scaling back marketing/advertising. As a result, fixed and notice deposits reduced by 1.5% to R907.7m at FYE16, but remain Finbond's main source of funding. Finbond is not exposed to volatile wholesale/call deposits since the group mainly accepts 6-72 month fixed and indefinite-term deposits.



Source: Finbond Annual Report.

Finbond's deposit base is granular (with over 2,600 active deposits), implying fairly low concentration risk. At 1H F17, the single and ten largest deposits accounted for 2.8% and 9.3% of deposits respectively. The majority of Finbond's deposits are taken up by retirees in the LSM 8-10 bracket, who are seeking low-risk, high yield investments.



Source: Finbond Annual Report 2016.

On average, depositors favoured larger, longer term and higher interest bearing deposits in F16. The deposit portfolio had an average interest rate of 9.6% (FYE15: 9.4%), an average term of 28.3 months (FYE15: 26.6 months) and an average deposit size of R352k (FYE15: R338k) at FYE16.

Liquidity

As Finbond's weighted average deposit term at FYE16 was 28.3 months, and weighted average loan term of its South African micro credit portfolio was 3.8 months, the contractual asset/liability mismatch is positive in the critical "0-6 month" bucket. Cash and liquid assets, including other financial assets of R232m[7], declined from R570m to R338m at FYE16, as Finbond reduced the intake of deposits. As a result, Finbond's ratio of cash, liquid funds and financial investments to total assets declined to 25.7% at FYE16 (FYE15: 42.3%). At FYE16, Finbond's LCR and NSFR were both well ahead of the requirements and South African bank averages.

Capital structure

Finbond

Finbond's eligible capital grew by 6.3% to R354.8m at FYE16, driven by earnings retention (despite a dividend of R20m) and additional SARB-approved Tier 2 capital. Overall, the group's capital to total unweighted assets ratio improved to 27.8%, which is considered adequate (despite the relatively high level of credit risk associated with unsecured lending).

Table 3: Capitalisation	F15 Rm	F16 Rm
Total reported capital	**381.5**	**418.7**
Paid up common shares	*239.7*	*239.7*
Retained earnings	*141.8*	*179.0*
Add: Qualifying reserves	2.6	5.7
Add: Approved Tier 2 capital	69.7	83.4
Less: Goodwill	(120.0)	(153.0)
Eligible capital	**333.8**	**354.8**
Total balance sheet assets (excl. goodwill)†	**1 229.2**	**1 278.5**
Selected ratios:		
Adjusted capital : Total assets	27.2%	27.8%

† Asset exposures not risk-weighted. Source: Finbond.

FMB

Finbond's capital is lower than that of FMB, as part of the group's capital is funded by an intercompany loan from FMB. FMB, the SARB-regulated entity in which regulatory capital is measured, has a higher capital base than the group (R450.7m vs. R388.0m at FYE16) and a CAR of 35.8% at FYE16 (1H F17: 36.1%). FMB's capitalisation is seen as adequate given current risk levels, management CAR targets, and the 25% regulatory minimum.

[7] Other financial assets include R57m invested in treasury bills (which qualify as regulatory Tier 2 capital), and R175m invested in a portfolio of money market and income funds (which are available immediately on call).

Operational profile

Risk management

Finbond is exposed to various financial and non-financial risks. Risk is managed holistically at executive management/board levels, supported by rigorous reporting and period review of processes.

Asset composition

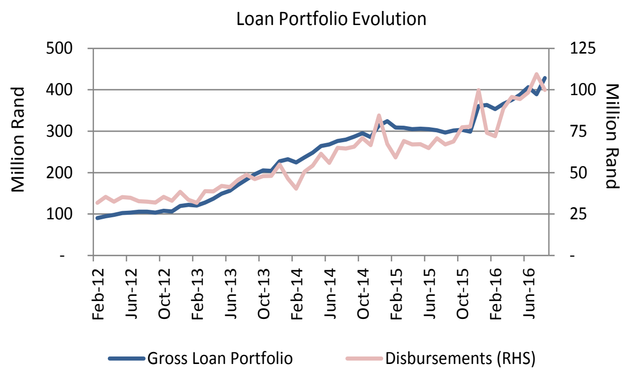
Finbond's total on-balance sheet assets grew by 6.1% (F15: 24.3%) to R1.4bn in F16, with a higher 30.6% (F15: 21.5%) of the group's balance sheet allocated to lending, 25.7% to liquidity management, and 18.8% to investment property, which are mainly legacy capital contributions. An additional R16.6m investment in property was made during F16, which is expected to further assist the group to realise commercial profits from this portfolio in the medium to long-term. An assessment of the lending business, and associated performance and risks, follows.

Credit risk

Finbond continued to apply strict upfront credit scoring and affordability criteria. The credit scores on the various products are monitored on a monthly basis and are continually adjusted to reduce credit risk and further improve the quality of assets held.

Micro lending portfolio – South Africa

The gross loan book (excluding unearned finance revenue) reflected another year of positive growth (17.2% to R372.2m) at FYE16. Growth in the portfolio was supported by an increase in new clients serviced (from 105,304 to 138,039) and 109,156 new contracts granted in F16. This is despite high rejection rates, which stood between 32% and 60% for the 3- to 6- month product range, and 79%-92% for the 12- to 24-month products at FYE16.



Source: Finbond.

Growth in loans advanced was most heavily concentrated in the mid-term products (loans of between 2 and 6 months in duration), and constituted 72.1% (FYE15: 67.5%) of gross loans and advances at FYE16. Finbond's average loan size was R1,515 (F15: R1,617) with an average tenure of 3.8 months (F15: 3.6 months) in F16, reflecting the group's appetite for more mid-term products). Finbond's loan portfolio is cash flow generative, as it turns over three times a year, and is a good source of internally generated liquidity.

Finbond's loan book is diversified (with over 160k active loans), and does not have significant exposure to any specific employer or industry. Finbond has a presence throughout the country, with a higher concentration of branches/clients in the main economic hubs/more populated areas.

Mortgage Finance
At FYE16, the mortgage finance portfolio comprised 139 loans with a total value of R94.8m, at an average LTV of 60%. Decline rates were between 70-90%.

North America loans
Finbond's branches in North America offer short-term unsecured loans (including payday loans) to customers. Payday loans are short-term unsecured cash loans based on the customer's personal check held for future deposit or on electronic access to customer's bank account. The average loan term is about two weeks and the loan is due on the customers next payday. At 1H F17, the loan book totalled R115m, with 50,852 loans at an average loan size of USD272.

Asset quality
Finbond's collections rates improved to 86% of anticipated receipts in F16 (F15: 83%), and together with conservative lending practices and rigorous credit vetting, contributed to a 5.8% decrease in arrears during F16. While overall credit quality metrics appear to be improving, the weak economic environment and the group's more vulnerable client base, is likely to place upward pressure on asset quality in the medium-term.

Table 4: Asset quality	F15 Rm	F16 Rm
Gross loans and advances	317.6	467.0
Not past due	*256.0*	*409.0*
Past due (>30 days)	*61.6*	*58.0*
Less: Provisions	(26.9)	(28.5)
Net loans and advances	**290.7**	**438.5**
Gross impairment ratio	19.4%	12.4%
Arrears coverage ratio	43.7%	49.1%
Net impairment ratio	11.9%	6.7%

Source: Finbond Annual Report 2016.

The outstanding balance is written off after 150 days (where no payment has been received for at least 90 days). Bad debts written off rose to R94.4m in F16 (F15: R78.2m), growth of 20.7% (compared to loan sales of 23%). In particular, longer term loan products continue to reflect higher write-offs. Nevertheless, Finbond's three longest unsecured term loans (ie, excluding mortgage loans), being the 12-, 18- and 24-month products, with by far the highest rejection rates, make up a relatively small portion of the overall loan portfolio, amounting to 13% thereof by value, and only 3% by volume of loans at FYE16. 27% of bad-debts written off in F16 were recovered (F15: 35%). Finbond did not reschedule any loans over the review period.

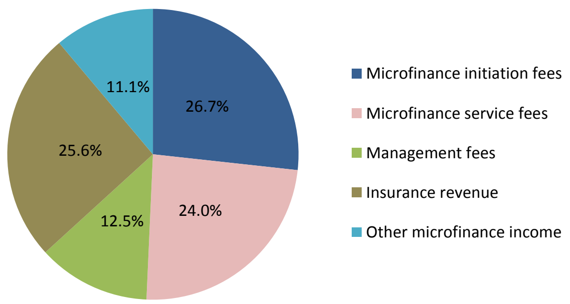
Financial performance and prospects

A five year financial synopsis is shown at the back of this report, supplemented by the commentary below.

Finbond posted an after tax profit of R57.3m in F16, up from R50.9m in F15, thereby maintaining its track record of improving returns over the past five years.

Net interest income grew 6.6% to R73.9m in F16, driven by gross loans and advances growth of 47.1% and improved collections rates (up 3%). The net interest margin contracted from 17.6% (F15) to 15.3% (F16) largely as a result of higher funding costs. Fee income (comprising initiation and service fees) increased by 22.3% to R208m as a result of new transactional banking products and services launched in F16, as well as growth in client numbers and loans granted of 31% and 23% respectively. Other significant non-interest income related to insurance commissions of R100.4m (F15: R21.5m). Total non-interest income increased by 28.6% to R394.4m, and contributed 84.2% (F15: 81.6%) of total operating income in F16, which grew by 24.6% to R468.3m.

Breakdown of non-interest income for F16*



* Excluding fair value adjustments. Source: Finbond Annual Report 2016.

In F16, impairments increased by 18.6% to R71.3m in line with the group's unsecured loan growth, while operating expenses increased by 24.6% to R302.1m, mainly due to IT infrastructure development costs and increased capacity (in branches and staffing). Nevertheless, the cost-to-income ratio remained unchanged at 64.5% in F16.

The group's revenue increased 2x to R540.3m at 1H F17. Finbond's South African operations contributed R347.2m (or 64.3%) while its North American branches contributed R193.1m (or 35.7%) of total revenue for the six-month period to 31 August 2016. In terms of net profit, 38.3% was earned in USD. Finbond anticipates that 60-70% of net profit will be denominated in USD by 1H F18, and 80-90% in three to five years' time. Despite issuing additional shares during the period, the group's return on equity remained stable at 15.5% in 1H F17, compared to 15.6% achieved in F16 (before the rights issue).

Finbond's commitment to risk management enhancement and rigour support the likelihood of comfortable capital and liquidity buffers being maintained, enabling the group to manage the current economic/regulatory challenges.

Finbond Group Limited

(South African Rands in millions except as noted)^

Year end: February	2012	2013	2014	2015	2016
Income Statement					
Interest income	47.4	51.2	93.0	145.5	161.4
Interest expense	(16.8)	(20.7)	(44.3)	(76.1)	(87.5)
Net interest income	**30.6**	**30.5**	**48.7**	**69.3**	**73.9**
Asset related gains†	22.4	3.1	5.0	1.8	3.0
Other income	126.0	142.2	182.4	304.8	391.4
Total operating income	**179.0**	**175.7**	**236.1**	**375.9**	**468.3**
Net impairment charge	(23.7)	(19.8)	(24.9)	(60.1)	(71.3)
Operating expenditure	(127.0)	(134.7)	(164.3)	(242.4)	(302.1)
Net profit before tax	**28.2**	**21.2**	**46.9**	**73.4**	**94.9**
Tax	(14.8)	(0.7)	(9.9)	(22.5)	(37.7)
Net profit after tax	**13.4**	**20.5**	**36.9**	**50.9**	**57.3**
Other after-tax income	0.1	0.3	-	-	-
Net attributable income	**13.6**	**20.7**	**36.9**	**50.9**	**57.3**
Balance Sheet					
Ordinary share capital and reserves	247.6	305.8	330.4	346.7	388.8
Minority interest	(0.6)	(0.8)	(0.8)	(0.8)	(0.8)
Total capital and reserves	**247.1**	**304.9**	**329.6**	**345.9**	**388.0**
Long-term borrowings	159.2	111.4	484.1	654.6	641.8
Short-term borrowings	35.2	76.1	211.8	282.4	316.8
Other liabilities	35.6	65.0	60.3	66.3	84.9
Total capital and liabilities	**477.1**	**557.5**	**1 085.8**	**1 349.3**	**1 431.4**
Cash and bank balances	53.2	63.0	86.8	197.5	136.0
Unsecured customer loans	89.5	122.3	211.0	290.7	343.7
Secured customer loans	0.1	0.1	-	-	94.8
Investments - Financial assets	8.6	24.8	413.7	372.8	231.9
Investments - Property	229.6	233.0	242.6	248.8	269.5
Other assets	96.1	114.2	131.8	239.4	355.4
Total assets	**477.1**	**557.5**	**1 085.8**	**1 349.3**	**1 431.4**
Contingencies	**26.6**	**31.2**	**32.8**	**49.0**	**79.1**
Key ratios (%)					
Financial management					
Interest expense / Average gross advances	16.3	15.3	19.2	24.0	18.7
Interest expense / Average funding liabilities	9.0	11.0	6.4	8.1	9.1
Interest bearing debt / Total capital (:1)	0.8	0.6	2.1	2.7	2.5
Total capital / Total assets	51.8	54.7	30.4	25.6	27.1
Internal capital generation	2.8	3.7	3.4	3.8	4.0
Loans / Deposits	46.0	65.2	30.3	31.0	35.9
Cash and liquid assets / Total assets	11.2	11.3	8.0	14.6	9.5
Cash, liquid funds and financial investments / Total assets	13.0	15.8	46.1	42.3	25.7
Asset quality					
Portfolio at risk‡ / Gross advances	24.2	24.4	21.3	19.4	12.4
Loan loss reserves / Average gross advances	10.4	11.3	10.5	9.8	7.3
Loan loss reserves / Portfolio at risk‡	44.4	40.2	39.1	43.6	48.7
Net impairment charge / Average gross advances	22.9	16.8	13.6	22.0	18.2
Net inpairment charge / Total operating income	13.3	11.3	10.6	16.0	15.2
Efficiency and Productivity					
Operating expenses / Average gross advances	122.9	99.3	71.4	76.3	64.7
Cost per loan (Rand value)	3.3	2.8	2.1	2.1	1.9
Operating expenses / Operating income	71.0	76.7	69.6	64.5	64.5
Profitability					
Net interest margin	22.2	18.6	20.2	17.6	15.3
Net interest income / Average gross advances	29.6	22.5	21.2	21.8	15.8
Non interest income / Total operating income	82.9	82.7	79.4	81.6	84.2
Net profit margin	15.8	12.0	19.8	19.5	20.3
Portfolio yield	0.2	0.2	0.2	0.2	0.1
ROaE	5.6	7.5	11.6	15.1	15.6
ROaA	2.9	4.0	4.5	4.2	4.1
Nominal growth indicators					
Total assets	7.4	16.8	94.8	24.3	6.1
Net customer loans	(6.4)	36.7	72.3	37.8	50.8
Shareholders equity	5.1	23.5	8.1	4.9	12.1
Attributable income	(167.7)	53.0	78.1	37.8	12.6

^ Differences may occur due to rounding.
† Relates to revaluations, recognition of goodwill, net profit on sale/purchase and impairment losses on intangibles.
‡ Refers to loans past due for more than 30 days.

GLOSSARY OF TERMS/ACRONYMS USED IN THIS DOCUMENT AS PER GCR'S FINANCIAL INSTITUTIONS GLOSSARY

Arrears	An overdue debt, liability or obligation. An account is said to be 'in arrears' if one or more payments have been missed in transactions where regular payments are contractually required.
Asset	A resource with economic value that a company owns or controls with the expectation that it will provide future benefit.
Asset Quality	Refers primarily to the credit quality of a bank's earning assets, the bulk of which comprises its loan portfolio, but will also include its investment portfolio as well as off balance sheet items. Quality in this context means the degree to which the loans that the bank has extended are performing (ie, being paid back in accordance with their terms) and the likelihood that they will continue to perform.
Basel	Basel Committee on Banking Supervision housed at the Bank for International Settlements.
Bond	A long-term debt instrument issued by either: a company, institution or the government to raise funds.
Capital	The sum of money that is invested to generate proceeds.
Capital Adequacy	A measure of the adequacy of an entity's capital resources in relation to its current liabilities and also in relation to the risks associated with its assets. An appropriate level of capital adequacy ensures that the entity has sufficient capital to support its activities and that its net worth is sufficient to absorb adverse changes in the value of its assets without becoming insolvent.
Cash	Funds that can be readily spent or used to meet current obligations.
Collateral	Asset provided to a creditor as security for a loan.
Credit Risk	The possibility that a bond issuer or any other borrowers (including debtors/creditors) will default and fail to pay the principal and/or interest when due.
Debt	An obligation to repay a sum of money. More specifically, it is funds passed from a creditor to a debtor in exchange for interest and a commitment to repay the principal in full on a specified date or over a specified period.
Default	Failure to meet the payment obligation of either interest or principal on a debt or bond. Technically, a borrower does not default, the initiative comes from the lender who declares that the borrower is in default.
Diversification	Spreading risk by constructing a portfolio that contains different investments, whose returns are relatively uncorrelated. The term also refers to companies which move into markets or products that bear little relation to ones they already operate in.
Dividend	The portion of a company's after-tax earnings that is distributed to shareholders.
Downgrade	The assignment of a lower credit rating to a company or sovereign borrower's debt by a credit rating agency. Opposite of upgrade.
Equity	Equity (or shareholders' funds) is the holding or stake that shareholders have in a company.
Exposure	Exposure is the amount of risk the holder of an asset or security is faced with as a consequence of holding the security or asset.
Fixed Deposit	Where funds are deposited in a savings account for a pre-determined period of time.
Gearing	With regard to corporate analysis, gearing (or leverage) refers to the extent to which a company is funded by debt.
Impairment	Reduction in the value of an asset because the asset is no longer expected to generate the same benefits (periodically assessed).
Interest Rate	The charge or the return on an asset or debt expressed as a percentage of the price or size of the asset or debt.
Interest Rate Risk	Interest rate risk in the banking book is the risk that earnings or economic value will decline as a result of changes in interest rates. The sources of interest rate risk in the banking book are repricing/mismatch, basis and yield curve risk.
International Scale Rating LC	International local currency (International LC) ratings measure the likelihood of repayment in the currency of the jurisdiction in which the issuer is domiciled. Therefore, the rating does not take into account the possibility that it will not be able to convert local currency into foreign currency or make transfers between sovereign jurisdictions.
Leverage	With regard to corporate analysis, leverage (or gearing) refers to the extent to which a company is funded by debt.
Liquid Assets	Assets, generally of a short-term, that can be converted into cash.
Liquidity Risk	The risk that a company may not be able to meet its financial obligations or other operational cash requirements due to an inability to timeously realise cash from its assets.
Long-Term	Not current; ordinarily more than one year.
Long-Term Rating	Reflects an issuer's ability to meet its financial obligations over the following three to five year period, including interest payments and debt redemptions. This encompasses an evaluation of the organisation's current financial position, as well as how the position may change in the future with regard to meeting longer term financial obligations.
Maturity	The length of time between the issue of a bond or other security and the date on which it becomes payable in full.
Net Interest Margin	Net interest income divided by average interest earning assets. Measures a bank's margin after paying funding sources and how successful a bank's interest-related operations are.
Off Balance Sheet	Off balance sheet items are assets or liabilities that are not shown on a company's balance sheet. They are usually referred to in the notes to a company's accounts.
Operational Risk	The risk of loss resulting from inadequate or failed internal processes, people or systems or from external events. This includes legal risk, but excludes strategic risk and reputational risk.
Portfolio	A collection of investments held by an individual investor or financial institution.
Prepayment	Any unscheduled or early repayment of the principal of a mortgage/loan.
Provision	The amount set aside or deducted from operating income to cover expected or identified loan losses.
Regulatory Capital	The total of primary, secondary and tertiary capital.
Risk	The chance of future uncertainty (ie, deviation from expected earnings/an expected outcome) that will have an impact on objectives.
Risk Management	Process of identifying and monitoring business risks in a manner that offers a risk/return relationship that is acceptable to an entity's operating philosophy.
Securitisation	A process of repackaging portfolios of cash-flow producing financial instruments into securities for sale to third parties.
Security	An asset deposited or pledged as a guarantee of the fulfilment of an undertaking/repayment of a loan, forfeited in case of default.
Settlement	Full repayment of an obligation.
Shareholder	An individual, entity or financial institution that holds shares or stock in an organisation or company.
Short-Term	Current; ordinarily less than one year.
Short-Term Rating	An opinion of an issuer's ability to meet all financial obligations over the upcoming 12 month period, including interest payments and debt redemptions.
Sovereign Debt	A bond issued by a government or a government-backed agency.
Stock Exchange	A market with a trading-floor or a screen-based system where members buy and sell securities.
Subordinated Debt	Debt that in the event of a default is repaid only after senior obligations have been repaid. It is higher risk than senior debt.
Tenor	The time from the value date until the expiry date of a financial instrument.
Tier 1 Capital	Primary capital consists of issued ordinary share capital, hybrid debt capital, perpetual preference share capital, retained earnings and reserves. This amount is reduced by the portion of capital that is allocated to trading activities and other regulatory deductions.
Tier 2 Capital	Secondary capital is mainly made up of subordinated debt, portfolio impairment and 50% of any revaluation reserves and other specified regulatory deductions.

For a detailed glossary of terms utilised in this report please click here

SALIENT FEATURES OF ACCORDED RATINGS

GCR affirms that a.) no part of the rating was influenced by any other business activities of the credit rating agency; b.) the rating was based solely on the merits of the rated entity, security or financial instrument being rated; c.) such rating was an independent evaluation of the risks and merits of the rated entity, security or financial instrument; and d.) the validity of the rating is for a maximum of 12 months, or earlier as indicated by the applicable credit rating document.

Finbond Group Limited participated in the rating process via face-to-face management meetings, teleconferences and other written correspondence. Furthermore, the quality of information received was considered adequate and has been independently verified where possible.

The credit ratings have been disclosed to Finbond Group Limited with no contestation of the rating.

The information received from Finbond Group Limited and other reliable third parties to accord the credit rating(s) included:

- Audited financial results of the bank at 29 February 2016 (plus four years of comparative numbers);
- Corporate governance and enterprise risk framework;
- Reserving methodologies and capital management policy;
- Industry comparative data and regulatory framework; and
- A breakdown of facilities available and related counterparties.

The ratings above were solicited by, or on behalf of, Finbond Group Limited, and GCR has been compensated for the provision of the ratings.