MOODY'S INVESTORS SERVICE

Credit Opinion: Infrastructure Finance Corp. Ltd

Global Credit Research - 21 Jun 2011

Johannesburg, South Africa

Ratings

Category	Moody's Rating
Outlook	Negative
NSR Issuer Rating -Dom Curr	Baa2.za
NSR ST Issuer Rating -Dom Curr	P-2.za

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Key Indicators

Infrastructure Finance Corp. Ltd

	[1]2010	2009	2008	2007	2006	[2]Avg/CAGR
Total Assets (Rand mn)	5,037.89	6,630.25	6,519.74	7,084.00	6,627.55	(10.05)
Total Capital (Rand mn)	517.15	459.73	528.45	502.26	490.52	8.74
Recurring Earning Power % [3]	0.83	1.05	0.66	0.74	0.16	0.69
Return on Average Assets %	1.23	-0.83	0.77	0.52	2.29	0.80
Net Interest Margin %	1.37	1.46	1.27	1.35	0.73	1.24
Cost / Income Ratio % [4]	38.54	32.46	45.85	42.72	77.39	47.39
Problem Loans % Gross Loans	1.35	1.40	0.98	0.70	0.41	0.97
Shareholders' Equity % Assets	10.27	6.93	8.11	7.09	7.40	7.96

[1] As of June 30. [2] Compound Annual Growth Rate for total assets and capital. [3] Preprovision Income % Average Assets. [4] Non-Interest Expense % Operating Income

Opinion

Recent Developments

The Board of Directors (BoD) of Infrastructure Finance Corp Ltd (INCA) has taken the strategic decision to carefully manage down the company's portfolio rather than pursuing further growth. As a result of this decision, INCA has been deleveraging the balance sheet by not extending new advances, selling assets to increase liquidity, and repaying borrowed funds. INCA's senior management has also launched a new (independent) company - INCA Portfolio Managers - and has signed a three-year contract to continue to manage INCA.

SUMMARY RATING RATIONALE

The Baa2.za/P-2.za national scale issuer ratings assigned to INCA reflect its damaged business model - which focused on financing the municipal sector in South Africa - and funding profile. Specifically, the financial crisis and economic recession has compromised INCA's ability to raise funding at competitive/profitable rates and has also led to declining earnings power against the background of higher funding costs, tight margins, immaterial non-interest income and increasing competition.

Over the past several months, 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 with a face value of ZAR1.6 billion and used proceeds to build up its liquidity buffer and buy-back a portion of its INO3 bond, due at end-June 2011. As of May 2011, the INO3 liability declined to ZAR1.0 billion from ZAR1.95 billion in June 2009. While INCA has now matched the maturity profile of its assets and liabilities, management is still committed to sell an additional portion of its loan book if this is deemed necessary. We consider this a positive and necessary move, as it would partly shield INCA from the effects of possible asset quality deterioration that would otherwise have a follow-on effect on its own ability to meet its liabilities.

On a more positive note, the deleveraging of INCA's portfolio has led to an increased capitalisation buffer - with equity to assets of 12.8% as of December 2010, while additional comfort is derived from the historically low level of reported delinquencies (non-performing loans - NPLs - at 2.4% of gross loans as of March 2011). The ratings also impute a moderate probability of (indirect) parental support, specifically from FirstRand Bank Ltd. Shareholders have actively demonstrated their commitment to buy INCA assets and help address its funding/liquidity issues. In fact,

existing shareholders have been bidding for almost all assets sold by INCA, with FirstRand Bank acquiring approximately 59% of these assets.

Rating Drivers

- Decision to run down the portfolio against the background of an unsustainable business model

- Maturity profile of assets and liabilities have been matched, but still depend on INCA's clients repaying maturing loans on a timely basis

- Good asset quality with low NPLs, although high credit concentrations and the subdued pace of economic recovery remain important risk areas

- Increased capital cushion

- Likelihood of indirect parental support enhances overall creditworthiness

Rating Outlook

INCA's ratings carry a negative outlook, reflecting its reduced margin for error: an asset quality deterioration, and inability on the part of INCA's clients to make timely repayment of maturing loans, could affect the company's ability to repay its liabilities given its limited access to new funding.

What Could Change the Rating - Up

Following the BoD's decision to run down the portfolio, as well as INCA's limited access to funding, we see limited scope for a rating upgrade.

What Could Change the Rating - Down

Ratings could be downgraded if INCA's asset quality indicators were to deteriorate further. The inability of INCA's customers to repay their loans on a timely basis, could have a direct impact on INCA's own ability to repay its debt.

Recent Results

For the six months to December 2010, INCA reported bottom-line profits of ZAR37.4 million (December 2009: ZAR38.0 million). Results were boosted by realised and unrealised fair value gains of ZAR43.3 million, against ZAR21.7 million gains in December 2009 (INCA `fair values' all of its advances portfolio and all of its borrowed funds). During the period, net interest income fell 45% to ZAR24.5 million, and operating expenses increased 20% to ZAR15.2 million, with impairment charges remaining low at ZAR3.4 million. INCA's total assets were down 15% to ZAR4.3 billion since the June 2010 year-end, with advances down 21% to ZAR2.7 billion, and shareholders' equity at ZAR549 million.

DETAILED RATING CONSIDERATIONS

Detailed considerations for INCA's currently assigned ratings are as follows:

Franchise Value

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, its business model has been facing problems, including high levels of competitiveness in terms of price (primarily from the Development Bank of Southern Africa) and the improved financial position of municipalities coupled with their reduced capacity to implement projects. As a result of this, but also of increased funding costs following the global financial crisis and the increasingly limited access to the capital markets, the BoD decided to run down the company's portfolio; this has permanently marginalised INCA's franchise value.

Risk Positioning

We believe that INCA has good credit risk management systems, which are characterised by a low level of historic losses and NPLs, low market risk appetite as well as good internal systems and information management capabilities. However, its risk positioning is adversely affected by its high credit concentrations, with the 20 largest loan exposures accounting for approximately 80% of total advances and 400% of equity. This represents a high level of portfolio concentration to a few borrowers, although the bigger exposures are primarily to metropolitan municipalities that represent a large proportion of the country's economic activity.

More importantly, the financial crisis has led to a deterioration of INCA's funding profile, given its dependence on market funding; INCA's increased funding costs combined with still tight spreads on its loan portfolio, has been one of the main reasons for the company's decision to effectively seize operations and run down the portfolio.

Profitability

The company displays weak core profitability indicators, with recurring earning power (pre-provision, pre-fair value adjustment profits as a percentage of average total assets) of 1.2% as at FYE June 2010 (December 2010: 0.6%). INCA relies on interest margins to generate revenue, with non-interest income comprising an immaterial proportion (1-2%) of total income excluding fair value adjustments. At the same time, thin net interest margins (of 1.4% according to Moody's calculations) leave little room to absorb unexpected adverse events. For the year-ending June 2010, the company reported profits of ZAR71.7 million, including fair value adjustment gains of ZAR56.5 million. Going forward, we expect a decline in core profitability as the balance sheet shrinks, while bottom-line will continue to show volatility depending on the fair value adjustment gains/losses. For the six months to December 2010, INCA reported bottom line profits of ZAR37.4 million, including unrealized fair value adjustment gains of ZAR41.9 million.

Funding & Liquidity

Following the BoD's recent 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. INCA has now successfully addressed the sizeable funding gap relating to the bullet payment redemption of its INO3 bond in June 2011. Management has addressed this issue by selling assets/loans of ZAR1.6 billion since the

start of 2010, and then used the proceeds to build its liquid assets and partly redeem the INO3 notes. The face value of these bonds were reduced from ZAR1.95 billion in June 2009 to ZAR1.0 billion in May 2011. As a result, INCA now has a positive cash flow and should be in a position to repay all maturing liabilities over the next several years. This, however, assumes that there will be no asset quality deterioration, with INCA's clients making timely repayments of maturing liabilities, as inability to do so will have a follow-on impact on its ability to repay its own liabilities. To mitigate this risk, management is ready to sell additional loans/assets if required.

The company no longer has access to the capital markets, while a committed liquidity line of ZAR110 million (unused) expires in September 2011.

Capital Adequacy

As of end-December 2010, shareholders' funds accounted for 12.8% of total assets, with the ratio of borrowed funds to equity amounting to 6.4x (down from 11.2x in 2009). The improvement is due to the substantial deleveraging of INCA's balance sheet, with net loans down 40% to ZAR2.7 billion since December 2009. Management has also (unofficially, since INCA is not a bank) applied the Basel II framework, and estimates Tier 1 capital at 31%. The improvement in the company's capitalisation metrics has relieved some of the negative pressure on the ratings.

Efficiency

Management's cost-focused strategies over the past couple of years have resulted in a drop in non-interest expenses from around ZAR41.2 million in June 2005 to ZAR30.4 million at FYE 2010. The bulk of INCA's operating costs are now fixed under the three-year management agreement with the newly formed INCA Portfolio Managers. For the six months to December 2010, the company's cost-to-income ratio stood at 23% (64% excluding the unrealized fair value adjustment gains).

Asset Quality

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 of state-owned enterprises, which account for approximately 68% of INCA's loan book (even though this percentage has dropped from 78% in 2009, following the sale of assets). These institutions have historically demonstrated a low bad-debt experience, with less than 1% of total advances in default, partly because of government support and partly reflecting the prudent initial lending process and closely monitored follow-up procedures. As of end-June 2010, NPLs (loans outstanding more than 90 days) stood at 1.4% of gross loans, and have increased to 2.4% in March 2011. The subdued pace of economic recovery could lead to higher levels of NPLs going forward.

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