

Credit Opinion: Infrastructure Finance Corp. Ltd

Infrastructure Finance Corp. Ltd

Johannesburg, South Africa

Ratings

Category	Moody's Rating
Outlook	Stable
NSR Issuer Rating -Dom Curr	A2.za
NSR ST Issuer Rating -Dom Curr	P-1.za

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Key Indicators

Infrastructure Finance Corp. Ltd

	[1]2008	2007	2006	2005	2004	[2]Avg/CAGR
Total Assets (US\$ mn)	818.60	1,001.13	1,059.45	1,286.31	1,118.09	-7.50
Total Capital (US\$ mn)	77.95	84.96	94.52	78.30	95.51	-4.95
Recurring Earning Power % [3]	0.66	0.74	0.16	0.27	0.30	0.46
Return on Average Assets %	0.77	0.52	2.29	0.91	0.97	1.12
Net Interest Margin %	1.27	1.35	0.73	0.83	1.13	1.05
Cost / Income Ratio % [4]	45.85	42.72	77.39	66.08	72.91	58.01
Problem Loans % Gross Loans	0.98	0.70	0.41	0.33	--	0.61
Shareholders' Equity % Assets	8.11	7.09	7.40	3.98	4.19	6.64

[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

SUMMARY RATING RATIONALE

The A2.za/P-1.za national scale issuer ratings assigned to Infrastructure Finance Corporation Limited (INCA) reflect the company's role as the only private-sector specialist financier to South Africa's politically important municipality sector, with a market share ranging between 10% and 20%. INCA therefore maintains a niche player status in this market, while its historically low level of reported delinquencies and strong collection capabilities demonstrate its good credit risk management and low risk appetite.

Over the past couple of years, however, INCA's niche status within the municipality sector has come under threat due to increasing competition (primarily from Development Bank of Southern Africa or DBSA), and municipalities' improved financial position but also due to their reduced capacity to implement projects. In response, INCA has broadened its mandate and now seeks to finance private-sector initiatives - specifically in the education and healthcare sectors, Public Private Partnerships, and provide rental and lease discount finance. Although this diversification may have positive medium-term implications, it does hide risks with regard to the asset quality of these projects as their loss content has not yet been established.

The company's ratings also reflect INCA's funding and liquidity risks - the company is wholly dependent on market funding, its low earnings-generating capabilities, and its high levels of credit concentration with the 20 largest exposures accounting for more than 70% of total advances. Given these concentrations, as well as the sizeable unrealised gains included in shareholders' equity, we consider the company to be sparsely capitalised. We believe

that the current market conditions - and specifically the global credit crunch, high interest rate environment and deteriorating macro conditions - could adversely affect INCA's earnings, capitalisation, asset quality and fund-raising capabilities, and hence place negative pressure on the ratings.

The ratings are enhanced by the likelihood of external support, both from its major shareholders (FirstRand Group and the Kagiso Group) and from the South African authorities. We believe the authorities would like to see INCA continuing to support the politically important municipalities sector, and would also be keen to avoid any disruption to the South African capital markets. However, we are less certain about the timeliness of such support, as INCA has no clearly identified means of external support, and the company does not come under the direct responsibility of any particular government or regulatory entity.

Credit Strengths

- Specialised financier to the politically important municipality sector
- Strong asset quality with good loan collection record, backed by close credit risk management and monitoring
- Low tolerance for market risk
- Likelihood of possible external support enhances overall creditworthiness

Credit Challenges

- Thin profit margins
- High credit concentrations and low capitalisation
- INCA's small size and management's attempts to broaden its franchise may hide risks
- Funding and liquidity risk challenges, given the company's dependence on market funding and challenging market conditions
- Neither regulated nor supervised by outside parties

Rating Outlook

INCA's ratings have a stable outlook. However, the current challenging operating/macroeconomic conditions combined with its low capitalisation and potential funding issues, imply that INCA is weakly placed in its rating category.

What Could Change the Rating - Up

INCA's ratings could be upgraded if its earnings power and capitalisation level were to improve considerably, credit concentrations reduced, and its franchise strengthened following the broadening of its mandate.

What Could Change the Rating - Down

The ratings could be downgraded if INCA's financial fundamentals were to further weaken, and, specifically, if its profit-generating capabilities, capital base and asset quality indicators were to deteriorate, or if the company were to face funding and liquidity issues.

Recent Results and Developments

For year-end June 2008, INCA reported bottom-line profits of ZAR52.4 million (2007: ZAR35.5 million). Despite the 9% drop in net interest income to ZAR80.0 million, results were positively affected by lower provision charges of ZAR1.9 million (2007: ZAR13.4 million) and fair value adjustment gains of ZAR18.9 million (2007: ZAR6.9 million). Total assets fell 8% to ZAR6.52 billion, in line with the 8% drop in advances to ZAR4.63 billion and long-term liabilities to ZAR5.57 billion. Shareholders' equity stood at ZAR528 million.

DETAILED RATING CONSIDERATIONS

Franchise Value

INCA has developed specialised skills in financing the municipalities sector in South Africa, and maintains business relations with over 100 municipalities acting as a provider of capital expenditure finance. The company

has a significant market share - of 10% in the current year, and expected to settle at 20% going forward - but in recent years its business model has been facing problems, including (i) high price competitiveness (especially from DBSA), (ii) the improved financial position of the municipalities and (iii) their reduced capacity to implement projects.

In response to these challenges, INCA has taken the decision to broaden its mandate, and is now looking to fund Public Private Partnerships and private-sector initiatives in local/regional developments, and to be more active in project and property finance, as well as in rental and lease discount financing. In these new initiatives, the company is also seeking the support and co-operation of its shareholders and partners. INCA's franchise value is, however, constrained by its small size and narrow focus, lack of geographical diversification, high earnings volatility, as well as the challenges/risks that the company could face in broadening its client base.

Risk Positioning

We believe that INCA has good credit risk management systems - with a low level of historic losses and non-performing loans, low market risk appetite, and good internal systems and information management capabilities. However, its risk positioning is adversely affected by high credit concentrations, with the 20 largest loan exposures accounting for more than 70% of total advances. This represents a high level of portfolio concentration to a few borrowers, even though exposures are primarily to metropolitan municipalities that represent a large proportion of the country's economic activity. Management of its liquidity and funding profile is also a major challenge, given INCA's dependence on market funding, low capitalisation, but also tough current market conditions.

Profitability

The company displays weak core profitability indicators - with the year-end June 2008 recurring earning power (pre-provision profits as a percentage of average total assets) of 0.66% - which we consider as a negative rating driver, despite a notable improvement from 2006 (0.16%). INCA relies solely on interest margins to generate revenue, with non-interest income comprising an immaterial proportion (less than 5%) of total income excluding fair value adjustments, although efforts are under way to strengthen these. At the same time, thin net interest margins (of 1.3% according to Moody's calculations) leave little room to absorb unexpected adverse events. Fair value adjustments (of ZAR18.9 million for the year-end June 2008) are generally non-cash and volatile items that we generally discard when estimating core profitability.

Liquidity

Given that INCA runs a highly leveraged balance sheet, we believe that liquidity and funding is one of the company's foremost risks. The company's dependence on market funding, coupled with the high concentrations in its advances portfolio and the sizeable bullet repayments on its bonds, also highlights INCA's liquidity challenges. Nonetheless, we believe that this risk is mitigated - to an extent - by the low likelihood of 'en masse' default by clients and by the liquidity buffer maintained by the company. As of June 2008, liquid assets were estimated at over ZAR1.2 billion (or 18% of total assets). INCA derives approximately 65% of its funding from domestic market bond issuances and borrowings, and the remainder from international sources including the European Investment Bank and Agence Française de Développement. The company's ability to raise new longer-term funding will be closely monitored, as failure to do so may place negative pressure on the ratings.

Capital Adequacy

As of June 2008, shareholders' funds accounted for 8.1% of total assets; however, we believe that - given sizeable fair value adjustments and unrealised gains being taken to capital (which account for approximately 30% of the total) - higher capitalisation ratios are warranted. The company maintains an additional 1.4% of total assets as subordinated capital, but the balance sheet remains highly geared, with the ratio of long-term debt to equity amounting to 10.5 times as at June 2008.

INCA is not required to adhere to any minimum capitalisation requirements (as it is not regulated by the South African Reserve Bank), but management has decided to implement a new method of calculating its capital adequacy, in line with Basel II. According to management, INCA's capital adequacy ratio as of June 2008 stood at 9.7%, but aims to raise this to 12%, partly via a capital injection and lower dividend payouts.

Efficiency

The company's efficiency indicators have historically been moderate, but substantially improved since 2006. Management's cost-focussed strategies over the past couple of years, has allowed non-interest expenses to drop from around ZAR41.2 million in June 2005 to ZAR38.0 million in 2008. As a result, the cost-to-income ratio - excluding fair value adjustments - has dropped to 46% in June 2008 from 77% in 2006, despite the fact that during 2008 the company witnessed a 6% drop in operating income. Overall INCA now has a lean cost structure, with non-interest expenses at 0.56% of average assets.

Asset Quality

INCA has historically maintained a strong asset quality, with low levels of delinquencies and a good average internal credit rating, while the quality of the advances book is enhanced by collateral comprising zero coupon bonds amounting to approximately 20% of the total advances. The company has developed a good knowledge of the municipalities sector and of state-owned enterprises, which account for approximately 79% of INCA's loan book. 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 close follow-up procedures. Going forward, given the company's broadened mandate as well as the current - more challenging - operating conditions, we believe that increased exposure to the private sector as well as to rentals and lease discount finance could lead to higher levels of non-performing loans.

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