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Research Update:

FE Investments 'B' Ratings Affirmed, Off CreditWatch On Improved Credit Risk And Capital Sufficiency; Outlook Stable

Primary Credit Analyst:
Andrew Mayes, Melbourne (61) 3-9631-2078; andrew.mayes@spglobal.com

Secondary Contact:
Sharad Jain, Melbourne (61) 3-9631-2077; sharad.jain@spglobal.com

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Overview

- Previously heightened credit risk from one of New Zealand-based FEI's key debtors has lessened, in our view, and there is greater certainty that FEI will be able to maintain a very strong level of capitalization.
- We are affirming our long-term and short-term issuer credit ratings on FEI at 'B'. At the same time, we are removing the ratings from CreditWatch with negative implications.
- The outlook is stable reflecting our expectation that we are unlikely to change our rating on FEI in the next year.

Rating Action

On June 2, 2016, S&P Global Ratings affirmed its 'B' long-term and short-term issuer credit ratings on New Zealand-based FE Investments Ltd. (FEI). At the same time, we removed the ratings from CreditWatch, where we had placed them with negative implications on April 20, 2016. The outlook on the long-term rating is stable.

Rationale

The rating affirmation and removal from CreditWatch placement reflect our view that previously heightened credit risk from one of FEI's key debtors has lessened, which should help FEI maintain a very strong level of capitalization in the next two years. Our confidence in FEI's likelihood of maintaining a very strong capital level is also supported by the finance company's shareholders' plan to inject further capital—including within the next six-months—above that previously incorporated into our capital estimates. We expect that FEI will maintain a risk-adjusted capital (RAC) ratio above 15% in the next two years.

We believe previously heightened credit risk from one of FEI's key debtors, Australian-based Tomizone Ltd. (Tomizone; unrated), has moderated, at least in the short term, following a recent announcement that it had successfully raised new capital. As part of Tomizone's capital restructure, FEI has agreed to restructure its loan of about A$1.7 million to Tomizone, of which A$1.25 million will be refinanced into nonmandatory convertible notes (the residual represents personal loans to unnamed directors of Tomizone). We note that the loan restructure has, in some ways, strengthened FEI's rights as a creditor to Tomizone.

Despite the short-term improvement, we maintain our view that the credit risk faced by FEI in relation to its loans to Tomizone could expose FEI to a sizeable increase in loan impairments, given that FEI's loans to Tomizone (ex-loans to management of Tomizone) account for about 20% of the finance company's capital base. However, we believe the recent and expected capital injections from FEI's shareholders provide the finance company with very strong capital levels to absorb a reasonable increase in credit losses, stemming from any potential impairment in its exposure to Tomizone--or any other of its other large exposures for that matter. We note that FEI has a solid record of injecting additional capital into the finance company to fund new business growth and to maintain a buffer above its regulatory capital requirements.

We expect the RAC for FEI to remain very strong through to March 2018, remaining above 15%, compared with 15.1% as at Dec. 31, 2015. We expect the RAC ratio to strengthen due to continual capital injections from the finance company's shareholders, a slowdown in lending growth, and increased focus on lending toward lower-risk cash flow discounting and SME segments--that is, away from higher risk property development, which has been a strong source of growth for FEI over the last 12 months or so. We also expect a further strengthening in both operating revenues and underlying earnings, supported by reasonably low credit losses (new loan loss provisions).

Relatedly, we believe FEI has sufficient balance sheet flexibility to cover funding needs over a 12-month forecasted period. We believe FEI would curb new lending within a reasonably short period if either nonperforming loans rose sharply--as they lead to uncertainty around inflows, particular as some loans are relatively large--or if a loss in investor confidence triggered a sharp drain in on-balance sheet liquidity. We note that FEI has a record of cutting its new lending; a few years ago, the finance company dealt with a significant level of nonperforming loans. Supplementing our analysis, we believe FEI's reliance on household debentures provides some consistency and predictability to cash inflows and outflows on a monthly basis, particularly given the high reinvestment rates in recent periods--although we believe they are explained, in part, by high debenture offer rates.

Outlook

The stable outlook reflects our opinion that FEI's RAC ratio will remain above 15% through to fiscal 2018 (ending March 2018), which incorporates our expectation that strong lending growth forecasts will be sufficiently reinforced by improving retained earnings and further capital injections from the finance company's shareholders. The stable outlook also reflects our expectation that strengthening capital will be sufficient to offset a reasonable increase in credit losses (new loan loss provisions) equivalent to between 3.5% and 4.5% of average gross receivables, without placing our assessment of capital for FEI under pressure (all else being equal). Finally, rating stability factors in our expectation that any realistic and probable delay in loan receipts will have a manageable impact on FEI's short-term liquidity.

Downside scenario

Although we are unlikely to lower our rating on FEI in the next year, on balance we believe that the risks remain on the downside. We expect to lower the rating on FEI by one notch if our confidence moderates in FEI's ability to maintain its RAC ratio above 15% at all times, which is likely in the following scenarios:

- There are any delays in capital injections from FEI shareholders.
- FEI maintains very strong lending growth, including to the higher risk property development sector, without a commensurate and timely increase in capital injections.
- There is a substantial increase in credit losses (new loan loss provisions). We note that single-name concentrations such as FEI's exposure to Tomizone make FEI vulnerable to a sharp rise in credit losses.

Although liquidity stress is less likely to occur in our opinion, pressure on the rating would also emerge in such a case. Liquidity pressure could happen due to a loss in debenture investor confidence or delays in loan receipts. Such pressure would be reflected by a prolonged period of reinvestment rate at less than 50% under current loan growth expectations.

Upside scenario

We see limited prospects for upward rating momentum within the next 12 months. In our opinion, the upside to the rating on FEI is limited because we expect that the company's overall business position will remain small, its growth appetite will remain strong, and exposure to higher risk lending segments will remain a significant proportion of the business.

Related Criteria And Research

Related Criteria

- General Criteria: Understanding Standard & Poor's Rating Definitions - June 03, 2009
- Criteria - Financial Institutions - General: Nonbank Financial Institutions Rating Methodology - December 09, 2014
- Criteria - Financial Institutions - Banks: Quantitative Metrics For

Rating Banks Globally: Methodology And Assumptions - July 17, 2013
- Criteria - Financial Institutions - Banks: Banking Industry Country Risk Assessment Methodology And Assumptions - November 09, 2011
- Criteria - Financial Institutions - Banks: Bank Capital Methodology And Assumptions - December 06, 2010
- Criteria - Financial Institutions - Banks: Commercial Paper I: Banks - March 23, 2004
- General Criteria: Use Of CreditWatch And Outlooks - September 14, 2009

Related Research

- FE Investments Ltd. 'B' Ratings Placed On CreditWatch Negative On Potential Increase In Credit Risk, April 20, 2016
- FE Investments Ltd., March 30, 2016

Ratings List

Ratings Affirmed; CreditWatch/Outlook Action

	To	From
FE Investments Ltd.		
Counterparty Credit Rating	B/Stable/B	B/Watch Neg/B

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. Complete ratings information is available to subscribers of RatingsDirect at www.globalcreditportal.com and at www.spcapitaliq.com. All ratings affected by this rating action can be found on the S&P Global Ratings public website at www.standardandpoors.com. Use the Ratings search box located in the left column.