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Ratings

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FE Investments Ltd.

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FE Investments Ltd.

Major Rating Factors

Issuer Credit Rating
B/Negative/B

Strengths:	Weaknesses:
• Well-capitalized on a risk-adjusted basis • Healthy growth potential	• Capital and liquidity susceptible to rise in loan impairment • Concentrated lending book by counterparty • Key-person risk

Outlook

The negative outlook on FE Investments Ltd. (FEI) reflects our view that there is a one-in-three chance that the consolidated FEI group will fail to return and maintain its risk-adjusted capital (RAC) ratio above the 15% threshold for the current rating.

Downside Scenario

We expect to lower our long-term rating on FEI to 'B-' if we came to the view that the finance company is unlikely to raise and sustainably maintain its RAC ratio above 15% in the next one year. We are likely to form this view if there is a significant delay or shortfall in the quantum of capital injections into the group, or if there is a noticeable delay in FEI's planned amortization in its property development portfolio, without commensurate additional capital injections. A sharp rise in nonperforming loans would also exert downside

pressure on the rating.

Upside scenario

We expect to revise the outlook back to stable if FEI's RAC ratio moves back above 15% and we believe it will remain above 15% on a sustainable basis. A revision in the outlook back to stable is almost entirely dependent on FEI successfully reducing its property development portfolio as scheduled, and attracting additional capital to support its broader balance sheet growth objectives.

Rationale

Our rating on FEI reflects our expectation that the finance company will maintain its very strong capitalization levels, benefitting from a reduction in property development loans as they mature, and continued capital injections to support its lending growth. We forecast the RAC ratio for the consolidated FEI group to increase to between 16.0% and 17.0% by March 31, 2019, from a static ratio of 10.4% as of Sept. 30, 2017. The pro forma capital ratio is lower than we had previously forecast, owing to a slower than anticipated amortization in the finance company's property development portfolio. We understand that FEI has delayed the exit to respond to the changes in operating environment, which has also created some business opportunities in this sector.

Our forecasted increase in the FEI group's RAC ratio stems from our expectation that the finance company will progressively reduce its property development-lending portfolio as a proportion of its total lending, and through significant capital injections. FEI has a sound track record of supporting its growth through additional capital; we see the recent public listing as broadening the potential for new sources of new capital, although raising capital as a listed company has yet to be fully tested, particularly in times of stress. In addition, given FEI's property development, lending is concentrated in a very small number of developments--which are risk weighted at close to 300% in our analysis--our forecast remains highly sensitive to a successful wind down.

In our opinion, FEI has a relatively small lending book, which highlights the finance company's business and credit risk concentration and its susceptibility to one-off, material losses. This is particularly the case with respect to the finance company's property development loans, which accounted for around 25% of total loans, and more than 150% of the main operating entity's capital base at Sept. 30, 2017. Performance across FEI's companywide lending book is currently sound, with credit losses relatively low at around 70 basis points (bps). Reserve cover remains sound, in our view, at around 30% of nonperforming loans (which almost entirely comprises a single loan; unchanged in recent years). We see limited change in the asset quality of FEIs lending book in the near term, although we expect it to remain highly susceptible to large, idiosyncratic impairments for the foreseeable future.

We expect to see a modest de-risking in FEI's lending book over the next few years as it pursues a greater mix of small and midsize enterprise (SME) term (working capital) lending and SME cash flow lending (discounting of rental or subscription contracts), which should see business and credit risk concentrations reduce noticeably. In June 2017, FEI completed its merger with the ASX-listed Wolfstrike Rental Group (WSG). The merged group now trades as FE Investments Group Ltd. (FEIG). Following the merger, FEIG has renewed its focus on SME term and cash flow lending, and added WSG as a channel for technology equipment leasing to its business-suite. We understand the finance company is likely to retain an interest in lending for property development, although no more than 15% of loans outstanding beyond March 2019.

Our ratings on FEI also take into account key-person risk, although it has reduced following the appointment of Philip Harkness (ex-Bank of New Zealand; BNZ; AA-/Negative/A-1+) as general manager. We also see FEI benefiting from Mr. Harkness' extended experience at BNZ, particularly in matters such as internal corporate governance.

We believe FEI has sufficient balance sheet flexibility to cover funding needs over a 12-month forecasted period, although like capital, it is likely to remain susceptible to large impairments for the foreseeable future. FEI's reliance on short-term funding sources within a reasonably concentrated yet well-defined niche offsets some of the benefits derived from a retail-like-funding model as reflected in the finance company's strong stable funding ratio (SFR, for detailed definition of SFR see Quantitative Metrics For Rating Banks globally: Methodology And Assumptions, July 17, 2013), at 136% at September 2017. We estimate FEI's SFR will drift lower and consistent with a longer-term range of between 105% and 110% as it reduces surplus liquidity.

We assess FEI's stand-alone credit profile (SACP) as 'b'.

Anchor: Weaker regulatory oversight and institutional framework and higher competitive risk than banks in New Zealand

Given FEI's status as a finance company operating in New Zealand, our assessment of FEI's SACP incorporates our assessment of the macro environment in which it operates. Our 'bb' anchor for finance companies in New Zealand is the standard three notches below the bank anchor, derived from our Banking Industry Country Risk Assessment. The three notches reflect our view of the incremental industry risk of finance companies in New Zealand relative to banks because of the finance companies' weaker regulatory oversight and institutional framework, higher competitive risk, and typically less-stable revenue through economic cycles. Funding risk for finance companies is higher than banks, in our view, because they typically lack central bank access.

Similar to other financial institutions operating in New Zealand, finance companies benefit from New Zealand's open, resilient, and well-developed economy, augmented by high-income levels and a creditor-friendly legal framework. Offsetting these positives is New Zealand's material dependence on external borrowings, persistent current account deficit, and rising house prices in some of the larger cities.

Business position: Very small yet well-defined niche as a specialized finance provider primarily to SMEs in New Zealand

FEI's very small and concentrated business base as a specialized finance provider to a well-defined niche of SMEs, mainly in the New Zealand city of Auckland, exposes the finance company to a relatively high degree of business risk, in our opinion.

We believe FEI has developed a well-defined niche as a term and cash flow lender to the SME sector. We understand that competition from the larger commercial banks is limited, partly due to the specialized and relationship-intensive nature of the lending (particularly with respect to the cash flow lending business). Following FEI's merger with WSG, FEIG's business mix has now incorporated WSG's channel for leasing of technology equipment.

We expect the bulk of FEI's business to come from New Zealand in the near term, with incremental growth to emerge from within Australia over the coming years. Given the low base, we see little change in the geographic diversity within FEI's lending book during this period. Historically, a small number of property development borrowers, term loans and cash-flow originators underpinned FEI's business base--highlighting the finance company's material business concentration. We see business concentration remaining a feature of FEI's identity for the foreseeable future. However, the merger with WSG--effectively a vertical integration--and renewed focus on SME lending has seen this concentration reduce somewhat.

SME lending--term, working capital, cash flow and leasing (primarily of technology equipment)--make up close to two-thirds of all receivables, with SME property development and residential mortgages making up the residual. We see the former, SME lending (ex-property development), increasing proportionally in the near term, which should help to further reduce FEI's business concentration and improve the predictability of cash flow for the finance company. Quality of earnings is otherwise sound, with the finance company deriving close to 80% of operating revenues from net interest income (forecast to remain unchanged over the next year).

FEI's exposure to SME property developers (mezzanine finance) remains high, at around 26% of their receivables portfolio (September 2017), and largely unchanged year on year, with most properties located in Auckland. Despite material single name concentrations and a high proportion of loans capitalizing in nature (that is, the finance company is not deriving regular interest repayments), which can result in uneven cash inflows, we believe the finance company has effectively capitalized on the strong pipeline of construction activity forecast for Auckland, tempering the risk to earnings stability. Until FEI exits some of their property positions, however, we believe the company's growth is somewhat constrained by their ability to bring in new capital as property development lending carries a high risk-weight under regulatory capital requirements.

Reliance on key persons--namely FEI's two cofounders--has been a risk for FEI's business continuity for some time. We believe the appointment of Philip Harkness, ex-BNZ, is a positive development for FEI, as it reduces the reliance on FEI's two cofounding executive directors. The directors have historically assumed a key role in loan and funding origination and approval, as well as capital providers to support growth ambitions in their capacity as shareholders. We also see FEI benefiting from Philip's extended experience at BNZ, particularly in matters such as internal corporate governance.

We consider FEI's high level of single-name concentration and small business base a higher risk relative to higher-rated peers including Avanti Finance Ltd. (Avanti; BB/Stable/B) and UDC Finance Ltd. (UDC; BBB/Stable/A-2). Both Avanti and UDC benefit from greater business and customer diversity and typically target a lower risk business mix. We believe the stability and diversity of FEI's business mix is broadly comparable to that of its nearest rated peer, Asset Finance Ltd. (AFL; B/Stable/B). Both FEI and AFL focus on a customer base that mainstream banks do not actively service. As with FEI, we believe AFL's high degree of single-name concentration within its business loan portfolio tempers the greater level of diversity within its personal loan portfolio.

Table 1

FE Investments Ltd.--Business Position

		--Year-ended March 31--			
(000s NZ$)	**2018***	**2017**	**2016**	**2015**	**2014**
Total assets	64,040	55,332	37,210	23,280	14,859
Gross receivables	45,591	42,162	28,687	19,767	13,398
Operating revenues	2,411	4,938	3,144	1,963	1,396
Net income after extraordinaries	(655)	1,213	2,143	620	335
% Change in operating revenue	(2.45)	57.05	60.18	40.60	238.49
Net interest margin (%)	8.49	9.45	7.26	7.05	7.59

*Data as of Sept. 30, 2017.

Capital and earnings: Well-capitalized on a risk-adjusted basis

We expect the RAC for the consolidated FEI group to increase to between 16.0% and 17.0% by March 31, 2019, from a static ratio of 10.4% as of Sept. 30, 2017. Our forecasted increase in FEI's RAC ratio stems from FEI's planned amortization in its property development portfolio, and further capital injections. FEI's property development loans are risk weighted at close to 300%, compared with closer to 100% for its SME loans.

Given the high degree of single-entity concentration within FEI's lending book, we believe the company's earnings, and as such capital, are susceptible to a material rise in credit losses--although this does not represent our base case.

We forecast lending and operating revenue growth for the main operating entity, FEI, to remain strong, with double-digit growth expected for both. Some margin pressure is likely as FEI shifts the mix of its balance sheet, although this should be offset somewhat as the finance company lowers its liquidity levels. We also expect new loan loss provisions to remain low on the back of very low interest rates and economic tailwinds in Auckland, but trend higher as a result of IFRS 9.

However, we expect noninterest expenses to remain elevated as the consolidated group continues to emerge as a single entity following the merger of FEI and Wolfstrike. We therefore see earnings for the consolidated group remaining modest in the near term. As such, our capital forecasts remain highly sensitive to further capital coming into the group to support the finance company's growth objectives (and our capital assessment). FEI has a sound track record of supporting its growth through additional capital; we see the recent public listing as broadening the potential for new sources of new capital, although raising capital as a listed company has yet to be fully tested.

Table 2

FE Investments Ltd.--Capital, Leverage And Earnings					
		--Year-ended March 31--			
	2018*	2017	2016	2015	2014
Debt/equity (x)	5.32	4.22	4.20	4.71	4.07
Debt/ATE (x)	5.29	4.20	4.89	4.71	4.07
Total managed assets/adjusted common equity (x)	6.37	5.28	6.18	5.80	5.25
Adjusted common equity/total adjusted capital (%)	100.00	100.00	100.00	100.00	100.00
Deferred Tax Assets	8	615	1,102	107	107
Deferred tax assets / TAC (%)	0.08	5.87	18.29	2.67	3.78
Deferred tax assets included in TAC / TAC (%)	0.08	5.87	1.77	2.67	3.78
Noninterest expenses/operating revenues (%)	71.46	61.08	62.55	68.41	79.87
Net interest income/operating revenues (%)	77.23	67.76	55.91	59.53	57.62
Fee income/operating revenues (%)	21.28	33.39	43.21	42.39	35.02
Market sensitive income/operating revenues (%)	1.49	(1.15)	0.88	(1.92)	7.35
New loan loss provisions/operating revenues (%)	6.47	4.50	0.92	0.00	(9.55)
Return on average assets (%)	(2.19)	2.62	7.09	3.25	2.71
Return on average equity (%)	(12.76)	13.87	38.86	18.13	14.12
Return on operating revenues (%)	(27.17)	24.56	68.17	31.59	24.00
Core earnings/average managed assets (%)	(0.25)	2.62	7.09	3.25	2.71
Core earnings/average adjusted assets (%)	(0.25)	2.62	7.09	3.25	2.71

*Data as of Sept. 30, 2017.

Risk position: Higher risk tolerance as measured by strong growth and high level of single-entity exposures, although we expect loan performance to remain sound in the near term

We see FEI remaining vulnerable to sizeable, one-off impairments in the near term. FEI is exposed to a high degree of single-entity concentration within its lending book, with its property development loans accounting for more than 150% of tangible equity.

Property development accounts for around 26% of the finance company's loan portfolio (as of September 2017), largely unchanged year on year. We estimate a similarly high proportion of FEI's outstanding loans are likely to be capitalizing in nature (that is, the finance company is not deriving regular interest repayments). We see the tail risk of these exposures as material, particularly against the backdrop of a small capital base. Loan performance is currently good, however, with a supportive economic backdrop--healthy economic and tourism activity in Auckland, and a deficiency in new dwelling supply--expected to persist in the near term.

We expect to see a modest de-risking in FEI's lending book over the next few years as it pursues a greater mix of SME term (working capital) lending and SME cash flow lending (discounting of rental or subscription contracts). FEI mitigates counterparty risk concentration in its cash flow lending by lending no more than 80%-85% of underlying discounted contract values, and holding recourse to the SMEs providing the product or service in addition to the end users of the product or service. We believe due diligence of the underlying contracts is robust, and, in our opinion, they are unlikely to represent a material tail risk.

We note that FEI's key asset quality metrics remain stronger than the higher-rated finance company, Avanti. We believe Avanti will benefit "through the cycle" from limited single-name concentration--a feature that we consider structural for both FEI and its nearest peer, AFL, for the foreseeable future. We expect credit losses for FEI to remain reasonably low at less than 100 bps over the next 12 months--from around 70 bps currently. A higher level of credit losses is possible, however, as the finance company transitions to IFRS 9. Reserve cover remains sound, in our view, at around 30% of nonperforming loans (which almost entirely comprises a single loan; unchanged in recent years). At the other end of the peer spectrum, we believe UDC exhibits a lower-risk profile (and, as such, stronger asset quality metrics), stemming from its primary focus on higher quality credit exposures and more homogenous customer segments, as well as limited single-name concentration.

Table 3

FE Investments Ltd.--Risk Position					
		--Year-ended March 31--			
	2018*	2017	2016	2015	2014
Growth in gross receivables (%) (YoY)	22.29	46.97	45.13	47.54	71.95
Nonperforming assets	1,208	1,137	1,083	773	1,570
Nonperforming assets/receivables + other real estate owned (%)	2.65	2.70	3.77	3.91	11.72
Net charge-offs	432	0.00	0.28	0.00	138
Net charge-offs/average gross receivables (%)	1.97	0.00	0.00	0.00	1.30
New loan loss provisions/average gross receivables (%)	0.71	0.63	0.12	0.00	(1.26)
Loan loss reserves/gross receivables (%)	0.83	0.53	1.33	1.93	2.85
Loan loss reserves/gross nonperforming assets (%)	31.28	19.53	35.26	49.40	24.33

Table 3

FE Investments Ltd.--Risk Position (cont.)					
		--Year-ended March 31--			
	2018*	2017	2016	2015	2014
% Change in assets (YoY)	53.49	48.70	59.84	56.67	50.48

*Data as of Sept. 30, 2017.

Funding and liquidity: Fully funded by short-term retail debentures; sufficient balance sheet flexibility to cover liquidity needs

We believe FEI's reliance on short-term funding sources within a reasonably concentrated yet well-defined niche offsets some of the benefits derived from a retail-funding model, as reflected in the finance company's strong stable funding ratio of 136% as of Sept. 30, 2017. Fully funded by retail debentures, we expect FEI's funding base to exhibit a reasonable degree of stability, in part the result of an intensive relationship-based model and high debenture offer rates. We believe these factors mitigate funding and liquidity risks faced by FEI, particularly as more than three-quarters of its funding matures within 12 months. Reinvestment rates have dropped to around 50% recently, down from between 70% and 80% in recent years, although we understand this is a deliberate approach to work down surplus funding liquidity. As such, we expect the finance company's SFR to revert to a range consistent with recent years at between 105% and 110% in the next 12 months.

FEI has sufficient balance sheet flexibility to cover funding needs over a 12-month forecasted period, in our view. We note that FEI has a record of stemming outflows (new lending) when the finance company has dealt with a significant level of nonperforming loans--as they lead to uncertainty around inflows, particular as some loans are relatively large. We expect this to remain an option for FEI to manage liquidity, despite the public listing. We also believe FEI's primary focus on SME lending injects an element of recurring income, smoothing out of some the inherent lumpiness in other parts of its lending book (especially property finance). FEI's reliance on household debentures provides some consistency and predictability to cash inflows and outflows on a monthly basis. Reinvestment rates have been high in recent years--at between 70% and 80%--although we believe they are explained, in part, by high debenture offer rates. After dipping lower to around 50% earlier this year (a deliberate approach in response to the high levels of liquidity), we expect reinvestment rates to trend toward 70% in the near term.

Table 4

FE Investments Ltd.--Funding And Liquidity					
		--Year-ended March 31--			
	2018*	2017	2016	2015	2014
Stable funding ratio (%)	135.88	126.55	121.85	113.08	103.84
Secured debt/debt + deposits (%)	100.00	100.00	100.00	100.00	100.00

*Data as of Sept. 30, 2017.

Additional rating factors: Comparable ratings adjustment

We believe elements of FEI's credit strength are insufficiently captured in our SACP analysis, particularly when compared with FEI's nearest rated peer, AFL. Although we view AFL's funding structure to be stronger than that of FEI's (a reflection of AFL's longer-tenured funding mix), we believe FEI's business profile and its risk profile are marginally stronger than those of AFL. In particular, we note FEI's loss experience (including arrears) in recent years has been far superior to that of AFL, while indicators of business stability--such as the level of earnings with recurring characteristics--continues to strengthen for FEI. However, we do not reflect this relative strength within our rating construct. As a result, we have applied a one-notch positive adjustment to recognize this relative strength.

Table 5

FE Investments Group Ltd.--Risk-Adjusted Capital Framework

(NZ$ mil.)	EAD (1)	Basel III RWA (2)	Average Basel III RW (%)	S&P Global RWA	Average S&P Global RW (%)
Government and central banks	0.0	0.0	0.0	0.0	3.6
Institutions and CCPs	17.3	0.0	0.0	5.8	33.4
Corporate	13.1	0.0	0.0	37.6	287.3
Retail	32.7	0.0	0.0	30.8	94.2
Of which mortgage	4.8	0.0	0.0	2.2	46.9
Securitization (3)	0.0	0.0	0.0	0.0	0.0
Other assets (4)	1.0	0.0	0.0	1.5	155.4
Of which deferred tax assets	0.0	--	--	0.0	375.0
Of which amount of over (-) or under (+) capitalization of insurance subsidiaries	0.0	--	--	0.0	0.0
Total credit risk	64.1	0.0	0.0	75.7	118.1
Total credit valuation adjustment	--	0.0	--	0.0	--
Equity in the banking book	0.0	0.0	0.0	0.0	0.0
Trading book market risk	--	0.0	--	0.0	--
Total market risk	--	0.0	--	0.0	--
Total operational risk	--	0.0	--	9.3	--
RWA before diversification	--	0.0	--	85.0	100.0
Total Diversification/Concentration Adjustments	--	--	--	68.5	80.7
RWA after diversification	--	0.0	--	153.5	180.7
		Tier 1 capital	**Tier 1 ratio (%)**	**Total adjusted capital**	**S&P Global RAC ratio (%)**
Capital Ratio before adjustments		0.0	0.0	8.9	10.4
Capital Ratio after adjustments (5)		0.0	0.0	8.9	5.8

Footnotes: (1) EAD: Exposure At Default (2) RWA: Risk-Weighted Assets (3) Securitisation Exposure includes the securitisation tranches deducted from capital in the regulatory framework (4) Other assets inlcudes Deferred Tax Assets (DTAs) not deducted from ACE (5) For Tier 1 ratio, adjustments are additional regulatory requirements (e.g. transitional floor or Pillar 2 add-ons). Total adjusted capital includes A$1 million in common equity received on Dec. 18 , 2017. Table data calculated using disclosure reported as of Sept. 30, 2017.

Rating Score Snapshot:

Issuer Credit Rating: B/Negative/B

SACP: b

Anchor: bb

Business Position: Weak (-2)

Capital, Leverage, and Earnings: Very Strong (+2)

Risk Position: Very Weak (-3)

Funding and Liquidity: Moderate (-1)

Comparable Ratings Adjustment: +1

External Influence: 0

Government Influence: 0

Group Influence: 0

Guarantees: 0

Other External Influence: 0

Rating Above The Sovereign: 0

Related Criteria

- Criteria - Financial Institutions - General: Risk-Adjusted Capital Framework Methodology, July 20, 2017
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings, April 7, 2017
- Criteria - Financial Institutions - General: Nonbank Financial Institutions Rating Methodology, Dec. 9, 2014
- General Criteria: Group Rating Methodology, Nov. 19, 2013
- 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, Nov. 9, 2011
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Ratings Detail (As Of March 29, 2018)	
FE Investments Ltd.	
Issuer Credit Rating	B/Negative/B
Issuer Credit Ratings History	
22-Mar-2018	B/Negative/B
02-Jun-2016	B/Stable/B
20-Apr-2016	B/Watch Neg/B

Ratings Detail (As Of March 29, 2018) (cont.)	
21-Mar-2014	B/Stable/B
Sovereign Rating	
New Zealand	
Foreign Currency	AA/Stable/A-1+
Local Currency	AA+/Stable/A-1+

*Unless otherwise noted, all ratings in this report are global scale ratings. S&P Global Ratings' credit ratings on the global scale are comparable across countries. S&P Global Ratings' credit ratings on a national scale are relative to obligors or obligations within that specific country. Issue and debt ratings could include debt guaranteed by another entity, and rated debt that an entity guarantees.