FLOW & EBB

THE FLOOD OF LIQUIDITY THAT HAS FLOWED TO FINANCE COMPANIES OVER THE LAST DECADE HAS EBBED. SOME HAVE NOT SURVIVED. WHAT ARE THE IMPLICATIONS FOR THOSE THAT REMAIN?

NEW ZEALAND FINANCE COMPANIES REPORT 2007

FOR EVERY BORROWER THERE IS AN INVESTOR. THIS REPORT PROVIDES THE ESSENTIAL TOOLS TO ASSIST INVESTORS IN CHOOSING A QUALITY FINANCE COMPANY.

McDOUALL STUART

NZX

November 2007

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New Zealand

Finance Companies

Sector

Research

Where to from here?

Much of the New Zealand finance company sector faces a crisis of confidence. The collapse of 12 companies in eighteen months has delivered a series of body blows to the sector's credibility and stability.

A tarred brush is having a significant impact on investment flows. For the worst prepared companies, the resulting ebb in sector liquidity has delivered their collapse in a matter of days.

But despite the apparent gloom, most of the sector remains, on paper, in good health. Profitability has been strong, liquidity has improved and the quality of loan books remains generally sound.

As most of the failures have demonstrated however, past performance is no guarantee of future success. Debenture flows have declined markedly since the start of most 2007/08 financial years, particularly for smaller companies. With over three-quarters of sector funding traditionally sourced from the public, companies will need to continue to adapt rapidly.

The singular and collective challenge for all companies is to reinforce to the investor, the sector, and the wider economy, the vital importance of finance companies in New Zealand's funding mix. This will take time, and with the likelihood that further companies will fail along the way, the battle to restore confidence will be hard-fought.

In the meantime, the focus for all companies will fall increasingly on asset and liability management. Funding line diversity is already proving important for those that have it. Non-debenture financing is set to become a more prominent feature on finance company balance sheets, but only for those companies able to secure it.

For companies starting on the back foot with weaker loan books, unbalanced maturity profiles and tighter funding lines, the road ahead may prove too much. For companies starting from relative positions of strength, there will be both challenges and opportunities.

All companies, regardless of size, are likely to be considering consolidation options over the next 12-24 months. Some will be beneficiaries, most will not.

This report provides an update to our March 2006 report on the sector. As well as addressing these issues, it discusses the impact of global events since then on the domestic finance sector. The report includes an analysis of the major company failures to identify common risk markers. It also presents an applied analysis of the impact of drying debenture flows on finance company loan books, the results of which give reason for both concern and optimism.

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McDOUALL STUART

Executive Summary

This report summarises McDouall Stuart's assessment of the health of the New Zealand finance company sector. As well as providing a commentary on major events affecting the industry over the 18 months since our last report, it poses a number of fundamental issues for the industry and investors to consider.

In our last two reports, we highlighted a golden run for finance companies. A benign lending environment, marked by strong economic growth, low interest rates and an insatiable appetite for debt, had seen finance companies prosper for most of the last decade.

We also warned of an increasingly challenging outlook. At the core of this assessment was unsustainable growth in the residential sector. With much of this growth debt funded, we expected rising interest rates and higher debt servicing to bring increased pressure to the quality of existing debt stock, and the ability of the sector to support growth in new debt issuance. Finance companies, which operate lending models with above-average risk profiles, were likely to feel the effects of a momentum shift before the rest of the finance sector.

We take no pleasure in seeing our predictions unfold. Dubious lending practices and poor balance sheet management have been exposed to claim a dozen finance companies, affecting over 50,000 debenture holders and $1.3b in debenture deposits.

There is real concern among investors, the industry, and the wider economy about where the sector is headed.

Key Themes

Three themes summarise the key issues facing the sector:

Hindsight – Benign Market Conditions

- Financial deregulation has boosted scale and credit flexibility
- Strong economic growth, low unemployment and cyclically low interest rates have delivered wealth to both corporates and households
- Householders have leveraged this wealth, inspired by rapidly appreciating house prices, cheap securitised debt and an accommodating retail banking sector.

Foresight – Focus on Fundamentals

- Capacity utilisations continue to point to a stretched economy, driving the Reserve Bank to maintain high interest rates to curb inflationary pressures
- Higher debt servicing will bring increasing pressure to existing debt holders, constraining debt market growth.
- Strategic and operational focus to shift increasingly to cost structures and to the liability side of the balance sheet. From this refocus, further industry consolidation will flow.
- Price competition to intensify as investors become more demanding and sophisticated.
- Diversity of funding lines to become increasingly important to manage liquidity.

For Investors – Quality, Diversity

- More than ever, investors should be aware of the risks and rewards involved with fixed interest returns. Advisors particularly so.
- Take a portfolio approach, favouring quality issuers that offer history, scale and transparency.
- Take a similar approach to selecting a financial advisor. Seek reputation, competence and integrity.
- Increase awareness of credit risk and rating issues, including the effect of non-traditional funding instruments on creditor access to company assets.

18 Months (and Counting) of Turmoil

2006/07 has been a poor vintage for the finance company sector:

- An undermining of investor confidence, brought about by the failure or default of 12 companies since May 2006, with an uneasy feel that a 'slow march' of failures may now emerge
- A global credit squeeze, with investors across the world shifting their tolerance for risk downwards
- Greater pressure on borrowers, brought about by an economic slowdown, rising inflation and higher interest rates
- A heightened regulatory environment, marked by stronger Trustee and regulator oversight.

But we should not forget that 2006/07 has also provided some positives:

- Across many companies, record profit results
- Generally stronger finance companies, measured by improved liquidity, stronger balance sheets, and with no material deterioration in bad debt positions;
- The start of industry consolidation, with several transactions during 2006/07, suggesting greater maturity.

The 2007 Global Market Shakedown

In investment terms, 2007 might be remembered as the year that international financial markets woke up to themselves. Market turmoil during the later part of the year, sparked by the US subprime meltdown, marked a long-overdue pricing correction to global markets across all asset classes.

While there remains a strong suspicion that subprime outcomes are still yet to fully unfold, what is clear is that the investing world has significantly reined-in its tolerance for risk.

New Zealand: Plenty of Parallels

The New Zealand context bares a number of similarities to what has unfolded in the US:

- A housing boom, driven by rising incomes, low interest rates and easy access to credit, delivering impressive paper wealth to the residential sector. Householders have leveraged this wealth to buy more and better houses, creating a demand-led pricing spiral.
- Deregulation of the finance industry opening the way for a wide range of new credit options, creating intense retail competition between lenders
- Responding to competitive pressure to place money, lenders progressively relaxing their lending criteria, resulting in higher loan-to-value ratios (LVRs) and lending exposures.

However, some key differences have served to insulate the local market from a heavier impact. In particular, lower comparative LVRs, the requiring of mortgage protection insurance of most subprime residential borrowers and lower levels of securitisation have served to minimise the direct local impact.

Indirectly, however, subprime sentiment has compounded with existing weaknesses in the New Zealand finance company sector to result in heightened investor concern over issues of risk. In a sector where 80% of funding is secured from the public, this sentiment has created significant continuity issues for a number of operators.

Finance Companies Taking the Pain

In our last report, just 18 months ago, we covered 38 companies with receivable books greater than $35m. This year, the number against the same threshold is 29:

- Six companies have failed (Western Bay, Provincial, Propertyfinance, Nathans, Five Star and Bridgecorp);
- Four companies have been acquired (Prime, Pacific Retail, North South and Nationwide);
- PGG and Wrightson have merged; and
- One company (MFS Boston) has grown to cross the $35m threshold.

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As Geneva Finance (at time of print) continues to operate as a (constrained) going concern, we continue to include coverage of it.

Poor Asset and Liability Management Mostly to Blame

Most of the failed companies have come unstuck for one or both of two reasons, either:

- their asset and liability timings were poorly matched; and/or
- the quality of their loan book deteriorated to the point where money coming back from loans did not cover money due out to investor maturities.

Either way, stress has primarily been balance sheet, rather than profitability-related.

Investment flow is what's causing finance companies the greatest current pressure. Public fund raising (mostly via the issue of retail debentures) accounts for the great majority of sector funding. The events of the last 18 months have severely dented investor confidence in the sector ("Minimise the risk" was Bridgecorp's pitch) and resulted in a substantial fall in debenture rollovers and new issues. Some companies with poorly structured maturity profiles have failed quickly as a result.

This pressure is likely to intensify as companies prepare for the arrival of a new regulatory regime from (probably) 2010.

Greater Oversight to Become Part of Life for Finance Companies

The government had no choice – it had to respond. With around 400,000 debenture holders in the sector, of which over 50,000 have been affected by the failures to date, its mandate couldn't have been much stronger. More importantly, the existing disclosure and monitoring regime failed to give sufficient protection to the investing public. The government's solution has been to introduce a series of new oversight measures intended to deliver better disclosure, stability, governance and transparency in finance companies.

Most industry stakeholders have acknowledged the need for greater sector oversight for some time. It is important however not to regulate away the risk, but instead to strike a balance between meeting investors' need for more complete and reliable information (the provision of which has been lacking) against the right to choose their own risk/reward profile. Success and failure are both necessary features of markets, facilitating the emergence of stronger more vibrant companies.

In that context, we consider the proposed programme to be pitched about right. The collective steps do not appear to cross the line and, we think, represent a fair balance of compliance cost to the sector against the delivered benefit of improved disclosure to the investing public. This is not to say that compliance costs will be minor – they are likely to be significant, particularly for those companies that need to make substantial changes to their business practices and capital structures to meet the new requirements.

In our view, the area of greatest challenge lies with the implementation of compulsory credit ratings. There is clearly a big gap in the current financial literacy of the investing public. Retail investors' knowledge of the intent and meaning of credit ratings is weak. Given the potential gravity of the impact to the sector, there is a major education task ahead for the industry, rating agencies and government.

More Work to be done at the Advisory Level

Damage to sector credibility has stretched to the financial advisory network. Advisors that have disingenuously put clients into failed companies have suffered from one or both of a lack of integrity and/or competency.

There has been no shortage of horror stories from clients caught up in some of the failures, Bridgecorp in particular. Such stories have served to reinforce:

- the importance of the advisory sector in facilitating informed investment decisions;
- the need for greater oversight in the advisory sector

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- the need for improved disclosure by advisors, particularly regarding fees and other potential conflicts of interest
- that advisors must have the necessary experience, accountability and incentives to competently and adequately match the public with appropriate investment products.

It is clear that many advisors have responded to the failures by retreating from recommending all except the 'safest' finance companies. While understandable, it is indicative of the broader need for greater investor and advisor understanding of risk and reward. Taking such a narrow approach is not without cost – the 'safest' companies offer among the lowest yields, sometimes no better than what can be earned from a bank. Understanding individual client wants and needs is paramount.

Focus on Balance Sheet

Our modelling, summarised in this report, indicates that even a modest easing in debenture rollovers and new investment rates can have a substantial impact on balance sheet positions, particularly if the downturn extends beyond the short-term. Assuming a typical maturity profile and capital structure, a nominal $100 opening loan book will be approximately maintained over a 12 month period if debenture rollovers of between 70 and 80% and new investment rates of between 10 and 15% are achieved. These figures approximate our reading of historical (pre-2006/07) sector averages.

However, we estimate that over the last few months, industry average rollovers and new investments have at least halved from their longer-term levels (although with wide variation across companies). Generic modelling suggests that, at these levels, for companies solely reliant on retail funding, a $100 opening book could decline to around $65 over a 12 month period. For companies with weaker maturity profiles, the decline could be considerably steeper.

However, at an aggregate industry level, the situation is likely to look considerably better. Rollover rates for the strongest companies have been substantially higher. With the biggest 10 companies accounting for 75% of the total value of all loan books in this report, there is good reason to conclude that, on a value basis, sector flows are in considerably better shape than many give credit for. Recent figures reported by the Reserve Bank lend support to this view.

Companies with access to alternative funding lines are much better placed to manage the downturn. Our assessment is that the biggest companies, with stronger equity positions and in-place headroom from non-debenture funding lines, are well-placed to emerge with a relatively steady loan book, albeit one with a considerably different funding profile.

Such comfort, however, will not be enjoyed by most finance companies. Situations will depend heavily on individual funding and maturity profiles.

Smoothing the Ripples

Assuming that loan book quality is not a major issue (for most companies, it does not appear to be), funding channels will be the most important and immediate challenge.

Most finance companies have traditionally used two or, depending on their credit quality, three core funding lines: equity, public debenture raising and third-party debt. As at the most recent balance dates for the 29 companies covered in this report, public debentures accounted for 80% of all company funding. 18 of the 29 companies had credit lines in place as at their most recent balance dates, although the relative capacities and headroom varied widely. Eight companies had NZDX-listed instruments on issue.

Debenture and wholesale funding currently face similar constraints – securing either is difficult. Some companies are already close to their draw limits on existing bank or wholesale credit lines. Except for the strongest companies, or those willing to issue a prior charge, we do not expect bank funding to emerge as a viable option for those that don't already have it.

For those that either already have, or are able to put funding facilities in place, we expect to see increasing reliance on them.

We also expect stronger companies to increasingly consider on-market capital-raising. As well as offering investors the liquidity and transparency benefits that come with listed instruments, a major upside for companies is that NZDX money is generally long-dated. Again, however, this option will only be realistic for a precious few companies, and even for them, the current investment climate will prove challenging. Pricing would need to be sharp.

Small- to mid-sized companies that are solely reliant on debenture flows to fund lending, have an unfavourable maturity profile, and which do not have sufficient balance sheet flexibility to meaningfully respond to rollover downturn will be the ones feeling the greatest pain. The viability of the business models of companies operating in this space is under threat.

For those unlikely to gain access to debt facilities, to maintain stability and liquidity, and to meet new regulatory minimums, company shareholders will increasingly be faced with the prospect of injecting further equity. For some, the question of whether further contributions would only be delaying the inevitable will be valid.

Two important consequences of the pending requirement for all >$10m finance companies to eventually secure an independent credit rating are that:

- pricing will progressively normalise around an industry risk/return frontier
- non-debenture funding will increasingly emerge as an important risk mitigant.

We would consider each of these outcomes as a positive, both from an investor and company perspective. The average 60 basis point difference (gross – on a net basis the spread would be considerably lower) between debenture and bank funding is likely to reduce over time as debenture rates rise to reflect underlying risk, making bank debt increasingly economic.

For those that are able, the result will be a new funding model, where prime bank and listed debt substitutes (rather than complements) debenture flow. The key, of course, is to secure investor support – not an easy challenge in the current environment. Credit ratings will help (credit providers and markets are likely to be considerably more receptive to big-3 rated companies). Ratings will also play an important role in the pricing of wholesale and listed funding lines and, therefore, retail debenture rates.

Securitisation

We also expect debt securitisation (the parcelling of loans for resale to institutional investors) to become increasingly popular as a means of providing additional financial flexibility. This will again depend on the appetite of institutions for securitised instruments, which remains uncertain after subprime.

From what we can tell, currently only five companies have gone down the securitisation route: Marac ($300m), MFS Pacific ($186m), Speirs ($123m), Capital+Merchant ($30m) and Instant Finance (also $30m). All except the Speirs arrangement have been initiated in the 18 months since our last report.

While clearly a viable source of cheaper funding and a means of adding balance sheet surety, securitisation programmes are complex and can carry implications for debenture holders.

Debenture holders retain a first-ranking charge over the non-securitised component of the loan book, ie, 'what's left'. If the securitised parcel was wrapped through a random loan selection process, there is no issue. However, there is an issue if the selection process is targeted, thereby risking the cherry-picking of better quality loans. For debenture holders on the periphery of such transactions, there is cause to be interested, if not concerned at the detail of these arrangements.

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Investment statements currently offer little detail to those interested in company securitisations. This is an area worthy of closer scrutiny by Trustees and investors. At a minimum, companies should be full and frank in disclosing the material aspects of securitisations, including how parcelled loans were selected, the parcel's value and the book value of the loans at time of sale.

Such issues bring increasing uncertainty to the term 'first-ranking secured debentures'. The first report by the Receiver of Propertyfinance Securities, one of the failed companies which securitised most of its loan book, is testament to the complex implications that securitisation arrangements can bring to debenture holders.

Economic Fundamentals Remain Strong

With most macroeconomic fundamentals showing ongoing resilience, and constrained credit access ensuring that debt markets remain tight, we do not expect a major demand-side downturn. However, easing property values, higher interest rates and persistent inflation lead us to conclude that pressure is likely to be felt most by property lenders.

A specific risk that we see over the next 12-24 months is rising pressure on companies with significant land bank holdings. Easing land values, rising interest costs and tighter sector liquidity are factors likely to bring greater pressure to the pre-development end of the market. This is particularly so for companies with significant levels of capitalising loans, where interest and principal are rolled over. Such arrangements tend to conceal potential borrower stress, as arrears do not become evident until the loan becomes due for repayment. Greater cash flow pressure may result for companies exposed to this dynamic.

Pricing Pressure to Intensify

These types of uncertainties highlight the need for investors to be adequately rewarded for their investment. As the industry moves towards compulsory credit ratings, our view is that debenture yield spreads will increasingly normalise to assessed credit risk. There is evidence that this is already occurring for 'big-3' rated companies.

There is already a strong basis to conclude that finance companies will face greater competition from alternative deposit products. Recent debt issues in the fixed interest space are representative of this, with a number of investment grade-rated issuers offering attractive retail yields. This demonstrates the pricing challenge ahead for finance companies. It also reinforces the increasing importance of multiple funding lines to broaden channels and costs.

For companies not currently rated, our analysis suggests that there is some way to travel before pricing reflects a return that could be regarded as commensurate with finance company risk profiles.

Opportunity in Adversity

Change requires a level head and maturity to effectively plan for and manage and there is good evidence to suggest that some of the better-placed companies have been preparing for some time. Stronger companies are benefiting from a wider range of lending opportunities, and are selectively funding the best of them. Lending margins are rising, reflecting simple scarcity of capital. Although a nice place to be for those placed to benefit, unfortunately the victims are likely to be smaller companies that face tighter funding constraints.

With business activity easing, focus will fall increasingly towards fixed costs. There is already clear evidence that some players are taking active and, in some cases, severe steps to address cost structures. Geneva is one, having decided to close its national branch network, turning its business model on its head in the process.

While disruptive, such change is part of the correction process. Companies will emerge as stronger and better operators for it.

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Consolidation Inevitable

There have already been a small number of amalgamations across the sector which, combined with the failures, have resulted in at least a dozen fewer companies than at the time of our last report. Although unnerving, this is a healthy sign of a maturing market.

In our view, however, there is plenty more consolidation yet to come. New Zealand still has around 100 finance companies – too many for a country of its size. As smaller companies struggle to manage reduced debenture flows and to meet new regulatory requirements, many will find the challenge too much.

Some companies may fail. Others may wind down as their receivable books mature. Doing so before the arrival of the new regulatory regime in 2009/10 is likely to emerge as an increasingly popular option.

Untraditional methods to managing business continuity are likely to emerge over the next 1-2 years. The Geneva, Propertyfinance and Beneficial solutions are representative of what will likely be a number of similar future arrangements to emerge. The onus will be on companies, Trustees and regulators to ensure that such proposals proceed equitably with the benefit of full and current information. To date, with the Geneva case at least, this has not been the case.

A buyers market is likely to emerge. Whereas even just a year ago acquirers were paying significant goodwill premiums, in the next 12-24 months, transactions are more likely to reflect underlying asset values. Buyers in this market (and there are potentially many) can afford to wait, although for higher quality assets, they will still need to jockey.

That said, M&A activity has been largely absent to date in 2007. We consider this reflects three main factors:

- that potential buyers are first consolidating their own positions before considering strategic acquisition options
- that buyers are waiting until the sector bottoms out (buying a loan book that is declining at 3% a month may not appeal to many, regardless of price).
- that some bidders may be struggling to access capital to fund acquisitions.

Behind the scenes, boardroom activity is likely to be anything but quiet, with strategic options (entry, exit and amalgamation) likely to feature regularly on Board meeting agendas.

Once the dust has settled, we do expect to see renewed transaction vigour. This may include acquisition interest from players currently operating at the fringes, and particularly those for which access to capital is not an issue. We expect the list of interested parties to include international players. We also expect to see some merger activity, particularly in the mid-range ($100m to $1b book) where partners are looking to increase scale without major outlay.

For Investors: Fly to Quality

Times of market uncertainty provide both motive and opportunity for investors to reassess their portfolios. In the current environment, we encourage fixed interest investors to be cautious. Our assessment is that most of the larger companies remain in good shape, particularly tier-1 companies. Beyond the first tier, we advise increasing care. Returns must justify the additional risk.

In this report, we analyse the major finance company defaults. This assessment highlights a number of risk factors which we consider should form the framework for selecting finance company investments:

- History: companies that can demonstrate histories and management track records that stretch across economic cycles are favoured
- Funding: companies that have access to multiple funding lines are better positioned than those that are solely debenture-reliant. Companies that can demonstrate strength in receivable and payable maturity profiles are strongly preferred.

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- **Scale**: bigger companies tend to have greater financial flexibility which allows them to adjust more quickly and effectively to changes in the investment environment
- **Governance**: we strongly favour companies that can demonstrate transparent governance and ownership structures. We tend to favour companies or parents that are stock exchange listed as a result.
- **Book quality**: tracking impaired asset and bad debt levels relative to past periods, others in the sector, and to acceptable industry benchmarks.
- **Credit rating**: preference for companies that can demonstrate a credit rating from one of the big three global rating firms.

Our view is that the key success factor to how effectively individual finance companies can weather the next 12-24 months, is scale. Size brings with it many benefits, but in the current environment, it is the generally superior flexibility that comes with scale that we consider to be the most important.

Of the companies covered in this report, it is the larger ones that tend to have the greatest funding optionality, are more transparent, have more balance in their lending practices and, as a result, have the better quality loan books.

This is not to imply, however, that all at-scale finance companies are of equal quality, nor is to imply that smaller companies are not worthy of investment consideration. Again, risk and return must show balance.

Those towards the very top end are more likely to be beneficiaries than victims of the downturn in sector funding. The dominance of the biggest companies therefore gives cause for some optimism that, in value terms, the downturn is not as serious as many are suggesting. However, this will come as little comfort to those further down the line.

The Bigger Picture

In the turbulence that has marked the last 18 months, some have forgotten the vital space that finance companies fill in New Zealand's funding mix. No other providers offer the at-the-margin property, motor vehicle, retail and consumer finance that the banks are not willing to lend against. This is the space that finance companies have made their own over the past decade or so, and that is unlikely to change.

The sell-side of the sector remains strong, with ongoing strength in the demand for financing. It will take time, but the buy-side will stabilise. When it does, the finance company sector will be leaner, more efficient and better-funded, and one that the banks will likely find more in their face than has been the case in the past.