Credit Ratings & Research

Mutual Credit Finance Limited

NZBN: 9429031969055

Credit Rating Synopsis

Date: 09 February 2024

Prepared for: Mutual Credit Finance Limited

Report prepared by: Equifax Australasia Credit Ratings Pty Limited ("Equifax")

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Currency used in this report: This report is presented in New Zealand Dollars unless otherwise noted

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1. Executive Summary

Mutual Credit Finance Limited ("MCF" or "the Company")

MCF is a Non-Bank Deposit Taking (NBDT) organisation licensed and regulated by the Reserve Bank and primarily caters to customer segments relatively underserved by traditional banks.

Equifax Credit Ratings Australasia Pty Ltd ('Equifax') has affirmed MCFs credit rating of 'B' at Sep23, which is a sub-prime classification with a moderate level of risk. The outlook for the rating is 'Stable'. MCF's credit rating reflects its long operating history, profitable operations, consistently positive net interest margins, adequate liquidity position and potential net positive impacts of proposed regulatory reforms. The rating is constrained by the current macroeconomic environment, competitive pressures faced in attracting deposits and scaling the loan book, increasing exposure to the property development sector, as well as exposure to non-amortising loans and second mortgages in the loan mix and, geographic concentration risks.

Strengths

- MCF's competitive position benefits from its operating history dating back to 1956, and the profile of its management team. A majority of Directors and Executive management (CEO and Finance Manager) are chartered accountants and have extensive industry experience in leadership roles. Further, the Company's loan book has grown by ~70% since Mar20 whereby MCF has been able to capitalise on the market's healthy appetite for its offerings. This growth has been supported by a corresponding ~80% growth in deposits while maintaining healthy net interest margins, reflecting an efficient business and operating strategy, in our view.

- The Company maintained profitability during 1HFY24, evidenced by strong Return on Equity (ROE) metrics (1HFY24 :19.4% ,FY23: 18.7%, FY22: 16.8%, FY21: 13.8%), underpinned by healthy net margins (1HFY24: 5.4% in FY23: 5.9%), a considerable increase in (annualised) non-interest income and, prudent cost control. In addition, the adequate retention of profits (38.1% dividend payout during the review period) has helped the Company maintain its capital ratios in recent periods (Sep23: 12.5%, Mar23: 13.1%, Mar22: 14.5%) and aided in extinguishing past accumulated losses incurred during the 2007-2010 period.

- MCF's liquidity position remain at adequate levels. At Sep23, the liquidity ratio (excluding finance facilities) increased to 13.1% (Mar23: 2.9%) driven by repayment of loans, however, will likely revert to lower levels once repaid loans are recycled. Management advised that a finance facility with ASB bank increased to $3.25m (from $2.5m previously) reinforcing the Company's financial flexibility and its ability to meet minimum liquidity levels stipulated in its Trust Deed. The Company's liquidity position is also supported by its favourable asset-liability maturity profile with loans worth $44.3m due within one year compared to $27.7m for maturity of deposits for the same period. In addition, MCF has resumed lending to the gaming industry following a hiatus during the Covid period which will likely increase the proportion of amortising loans in the overall loan mix.

- The Deposit Takers Act, which received Royal Assent on 6 July 2023, aims to place deposit takers under one framework and introduce a depositor compensation scheme. Notwithstanding potential increase in costs/compliances, more stringent regulatory oversight of NBDTs is likely to promote further public confidence in the sector, and in turn, may assist MCF's initiatives to attract new depositors and expand its deposit base.

Constraints

- The NBDT sector players including MCF face the potential of significant macroeconomic headwinds such as a recessionary or stagflationary environment characterised by persistent inflation, high interest rates, weakening economic growth, and a slowing housing market. While MCF's asset quality has remained stable thus far, evidenced by low NPLs and credit loss ratios, it may come under pressure as persistent economic headwinds underpin concurrent risks of adverse property price movements eroding collateral coverage and a deterioration in borrowers' repayment capacity.

- The Company's high proportion of non-amortising loans (91.7% of the loan-book at Sep23), increasing exposure to the property sector (91.9%) including property development and presence of second mortgages (8.8% of the loan book) in the overall loan mix may aggravate the impact of the above risks on the Company's asset quality and liquidity profile. Positively, the bulk of the loans are due within one year and the average Loan to Value of the loan book is 67.3%, thereby partially mitigating some of these risks.

- In our view, the Company's ability to sustainably grow its loan book and the deposit base are key factors in achieving stable operating performance. Competitive pressures and challenging market conditions have meant that there has been a decrease in the loan book to $49.6m at Sep23 (Mar23: $57.6m) and a decline in the deposit base to $46.3m (Mar23: $50.0m). Furthermore, the weighted average risk of the loan book appears to have increased marginally, despite a decline in the loan book, due to higher exposure to property development - evidenced by a decline in Capital Adequacy Ratio (CAR) to 12.5% at Sep23 (Mar23: 13.1%). Positively, the cost of deposits appears to have peaked with no further increase in rates offered on 12-month term deposits since May23. This together with higher interest rates on loans may lead to some improvement in net interest margins going forward, in our view.

- MCF's operations have significant geographic concentration risks as most of its business is generated in the Canterbury region of New Zealand. In our view, this makes MCF's business and earnings highly susceptible to region-specific shocks. However, we acknowledge that operating in a specific region may allow the Company to better serve its customers' specific financial needs while maintaining close ties to its local community.

- MCF's limited offerings and relatively small scale also constrain its overall business and competitive profile. MCF, similar to a majority of its other NDBT peers, does not provide full suite of banking services thereby limiting its ability to compete with larger peers and traditional banks to retain and grow its depositor base. Furthermore, increased competition from innovative new financial products and FinTech's may impact the Company's ability to generate healthy returns on its loan assets.

A rating upgrade would require a sustainable improvement in scale and diversification of operations, while maintaining profitability and asset quality. There may be downward pressure on the rating if the Company's asset quality, capital ratio or liquidity positions materially deteriorate, on an individual or a collective basis.

Risk Rating

B

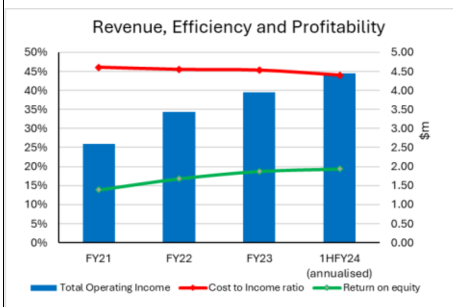
Outlook: Stable

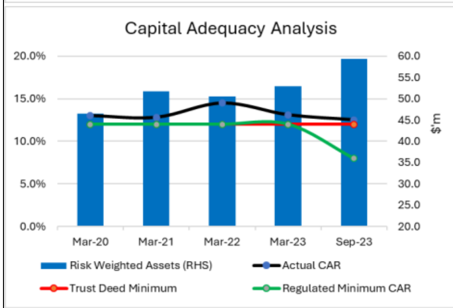
Type: Public, Monitored

Industry Percentiles

Scale:	
Total Assets	33%
Gross loans	40%
Profitability:	
NIM	60%
ROE	87%
ROA	80%
Efficiency Ratio	27%
Capitalisation:	
Leverage (Gross Loans to Equity)	53%
Capital Ratio	20%
Capital to Total Assets	67%
Funding and Liquidity:	
Deposits to Loan Ratio	27%
Liquid Assets to Total Assets	20%
Asset Quality:	
Net Charge-offs	93%
Impaired Loans	67%
Provision for Loan Losses	33%

Key Trends





2. Scope of Report

The purpose of this report is to provide a Credit Rating Synopsis on Mutual Credit Finance Limited.

We have complied with our rating services guidelines in order to derive the credit rating on Mutual Credit Finance Limited. The credit ratings and observations contained herein are solely statements of opinion and not statements of fact or recommendations to purchase, hold, or sell any securities or make any other investment decisions. The details pertaining to this report are outlined below:

Report Details	
Date of Report	**09 February 2024**
Request Type	**Issuer (Self-assessment)**
Assessment Type	**Under ongoing monitoring**
Rating Initiation	**Issuer based (solicited)**
Rating Distribution	**Public**
Report Distribution	**Unrestricted**
Purchased by	**Mutual Credit Finance Limited**
Report Fee	**Fixed Price**
Ancillary fees	**Nil**
Issuer Name	**Mutual Credit Finance Limited**
Issuer First Time Rated	**No**
Issue Name	**Not Applicable**
Issue First Time Rated	**Not Applicable**
Financial Scope	**Standalone Entity**
Entity Structure	**Limited Company**
Issuer Industry	**Financial Services**
Issuer Sector	**Non-Bank Deposit Takers**

This Report should be taken as a whole and cannot be abridged or excerpted for any reason.

We have conducted this assessment on the basis of the information provided to us by Mutual Credit Finance Limited, publicly available information and from our own enquiries. We have derived a credit rating on the Company based on the understanding that Mutual Credit Finance Limited has no contingent liabilities, cross guarantees or other liabilities to any other entity other than as disclosed to us or as detailed in the financial statements. Our duty does not include auditing the financial statements.

Information Sources	
Financial Statements	**- Statutory Financial Statements of Mutual Credit Finance Limited for the six-month interim period ended 30 September 2023.** **- Audited Financial Statements of Mutual Credit Finance Limited for the years ended 31 March 2023, 2022 and 2021.**
Name of Auditor	**PricewaterhouseCoopers (PwC)**
Other Information Sources	**The Company's response to our Request for Information, the Company website, industry and regulatory websites, management interviews, media articles, adverse searches and internet searches.**
Issuer Participation	**Full**
Material Financial Adjustments	**None**
Limitations of Assessment	**None noted**
Outsourced Assessment Activities	**No**
Confidentiality Agreement	**No**
Material Client	**No**
Rating Amended Post Issuer Disclosure	**No**
Potential Conflict of Interest	**None noted**
Rating Methodology	**Financial Institution Rating Criteria**

This report should be read within the context of Equifax's Ratings Services Guide.

APPENDICES

1. Explanation of the Equifax's credit rating

1.1 What is a rating?

Credit ratings provide an Agency's opinion as to the capacity, viability and willingness of an entity, issuer, or counterparty to meet their respective financial commitments. As such, Equifax assigns ratings based on the credit worthiness of an entity, commitment, or product, and provides probabilistic assessments of default over the short, medium, and long-term.

Credit ratings are a critical measure used extensively in commercial, financial, and capital markets to support key business decisions. Equifax's credit ratings are used to support debt and bonding decisions, loan origination and recovery, insurance and warranty, funds management, portfolio management, tendering and procurement, counterparty risk assessments and other commercial contracts.

Equifax provides credit ratings on government and commercial agencies, international conglomerates, infrastructure consortia, financial institutions, publicly listed entities, private corporations, and small-to-medium sized enterprises across a range of industry sectors both domestically and internationally. As such, Equifax is also able to provide detailed industry intelligence, benchmarking reports, and analysis across a wide range of sectors.

1.2 Equifax's credit rating

Equifax and other credit rating agencies all attempt to measure the probability of an entity being able to honour its financial commitments as and when they fall due. The most recognised credit rating is that based on Bond Rating Equivalents (BRE) used over the past eighty years to determine the proximity of an entity's securities to default (non-payment of interest or principal). The accuracy of this method has been extensively tested and is accepted worldwide.

The Equifax's database contains more than 100,000 financial years of information spanning more than twenty-five years. As such Equifax is in a unique position, having developed a large and empirical data source on entities across various industry sectors with long data histories covering a range of economic conditions and one or more complete business cycles. Equifax has therefore been able to use a variety of quantitative validation tools and comparisons using this information to adequately verify the stability, accuracy, and consistency of its rating models.

Equifax's rating models have been designed to assess the proximity of an entity to defaulting on its financial commitments and obligations. Proprietary risk analytics are used to evaluate the multivariate interrelationship of key risk indicators using scientifically based and empirically derived risk metrics. These models evaluate the financial performance, position, and profile of an entity in the context of its industry, size, and structure. They have been validated on Australian and international data with the assistance of Professor Edward Altman, an internationally recognised leader in the field of credit risk analysis and bankruptcy prediction.

Equifax uses its comprehensive benchmarking database to evaluate the financial position, performance and credit quality of an agency, institution, corporation, or entity relative to an industry and its peers. This enables the identification of key sensitivities, trends, cautionary alerts, and exception reports based on identified anomalies and/or outliers across key credit indicators of a select benchmarking group.

While there is no single method to discriminate unambiguously between firms that will default and those that will not, Equifax can make probabilistic assessments of default. This requires a large database of actual defaults to enable an assessment of default probabilities and actual default rates from empirical evidence. The Australasian market has a comparatively small number of corporate bond issues and a relatively benign credit climate over recent decades, and as such empirical data on Australian default rates is limited. Therefore, Equifax considers it is more appropriate to apply default probabilities using empirical data from international markets over several economic cycles.

Equifax's default statistics have been derived from nearly twenty years' experience analysing mainly US non-financial, non-utility corporate bond issuers. The analysis covered a relatively large number of companies (approximately 1,000 rated each year) and follows the well-established static pool approach used by Credit Rating Agencies to report their default experience. Static pools were created for bond issuers each year by both notch and grade, and the history of these bond issuers was then analysed over the period. The pools were then combined so that long-term average default experience by duration could be calculated, and both annual and cumulative default experience was calculated from the pools.

Equifax's risk analytics enable analysts to evaluate the most critical and sensitive financial and risk items through the Risk Assessment Platform by analysing key indicators to derive a definitive credit risk score and Bond Rating Equivalent (BRE), providing Probabilities of Default (PoD) over the short-, medium- and long-term horizon.

1.3 Rating Definitions

Credit ratings provide an Agency's opinion as to the capacity, viability, and willingness of an entity to meet their respective financial and contractual commitments. As such credit ratings are assigned in accordance with the entity, commitment, or product's proximity to default. Equifax adheres to internationally recognised grades and are similar to other agency classifications, providing ratings across twenty-two credit notches from ‘D’ (in default) to ‘AAA’ (extremely strong).

Moody’s	Fitch	S&P	Rating	Default rates (5 years)	Classification	Risk Level
Aaa	AAA	AAA	AAA	0.17	High Grade	Negligible
Aa1	AA+	AA+	AA+	0.31		
Aa2	AA	AA	AA	0.44		
Aa3	AA-	AA-	AA-	0.55		
A1	A+	A+	A+	0.76	Investment Grade	Very Low
A2	A	A	A	0.81		
A3	A-	A-	A-	1.47		
Baa1	BBB+	BBB+	BBB+	2.08		Low
Baa2	BBB	BBB	BBB	3.19		
Baa3	BBB-	BBB-	BBB-	4.37		
Ba1	BB+	BB+	BB+	7.13	Near Prime	Low to Moderate
Ba2	BB	BB	BB	7.49		
Ba3	BB-	BB-	BB-	10.52		
B1	B+	B+	B+	16.34	Sub Prime	Moderate
B2	B	B	B	22.21		
B3	B-	B-	B-	24.16		High
Caa1	CCC	CCC+	CCC+	28.16	Credit Watch	Very High
Caa2		CCC	CCC	29.90		
Caa3		CCC-	CCC-	39.16		
Ca		CC	CC	52.87	Distressed	Extremely High
		C	C	55.00		
C	D	D	D	100.00		

Equifax assigns ratings based on the credit worthiness of an entity or a specific financial commitment, and provides probabilistic assessments of default over the short, medium, and long-term. Every entity or commitment has some probability of default over a period of time, even those assigned with the strongest of ratings. An Investment Grade classification is attributed to credits that exhibit a lower probability of default, while a Sub-Prime classification has a greater expectancy of default.

An Equifax's credit rating may also be assigned additional clarification markers (symbols) to qualify the credit risk assessment. These may include:

Conditional Rating (#)

A Conditional Rating is used where Equifax has rated an entity on the basis of significant risk factors and/or report qualifications, with recommendations providing one or more conditions precedent and/or mitigation action(s) to reduce identified uncertainty and risk.

Provisional Rating (*)

A Provisional Rating is used when the most recent financial figures are based on draft management accounts or are deemed out-of-date. Entities with a provisional rating should be re-evaluated as soon as finalised financial statements become available.

Indicative Rating (^)

An Indicative Rating is used where Equifax is engaged to conduct preliminary analysis only, and as such an official rating assignment would require a more detailed and comprehensive investigation and due diligence assessment prior to the provision of our professional opinion.

1.4 Rating Outlooks

Equifax's forward estimates help ascertain the trajectory of ratings as well as the risks to ratings. Ratings with a positive trajectory are assigned 'Positive Outlooks'. Ratings with a negative trajectory are assigned 'Negative Outlooks'. Where Ratings are expected to remain unchanged, a 'Stable Outlook' assigned.

Rating trajectories are closely related to the outlook for the corporate's earnings. Earnings growth that is within sustainable growth parameters together with an attenuation of earnings volatility provide upward rating pressure and so may warrant the assignment of a Positive Outlook.

Credit Concepts measured

The main credit concepts measured against Australian and New Zealand Standard Industry Classifications (ANZSIC) and specific Peer Groups based on entity size are available in Corporate Scorecard's Rating methodology, which can be found at the below-mentioned links

http://www.corporatescorecard.co.nz/services_credit_ratings.php

https://www.corporatescorecard.co.nz/docs/RatingMethodologyFinancial.pdf

2. Regulatory Disclosures and Disclaimer

Equifax Australasia Credit Ratings Pty Ltd (Equifax Credit Ratings) is a credit rating agency regulated by the Reserve Bank of New Zealand. The licensing regime addresses a range of matters including the quality and integrity of the ratings process, independence and avoidance of conflict of interest, and responsibilities to the public, clients and assessed entities. The regime also covers confidentiality, communication and disclosure, professional development, document management, and a range of governance related matters. Financial, operational and compliance audits are conducted by external, independent auditors each year.

Equifax Credit Ratings also holds an Australian Financial Services License (AFS License no. 341391) which licenses it to provide credit ratings to wholesale clients in Australia.

The credit rating issued by Equifax Credit Ratings reflects our current opinion of the relative credit risk of the institution. This opinion has been formed in accordance with Equifax's published credit ratings methodology - financial institution rating criteria (Issue 8, November 2022).

https://www.corporatescorecard.co.nz/docs/RatingMethodologyFinancial.pdf

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