Chief financial officer's report

Tom O'Connell

GLOBAL ECONOMIC GROWTH

Lest the past two months, the two preceding years exhibited improved global economic activity, with the world's economies growing in a synchronised manner, resulting in a broad-based recovery. However, growth divergences between the United States on one side, and Europe and Japan on the other, are widening. Growth is also becoming more uneven among emerging market and developing economies, amid rising oil prices, higher yields in the United States, escalating trade tensions, and market pressures on the currencies of economies with weaker fundamentals.

As a result of these developments, the global backdrop has changed from a positive outlook to a neutral to negative outlook, exacerbated by the risks of increased protectionism, supply concerns, a generally stronger dollar and lower demand from China. Global growth is projected to reach 3,9% in 2018 and 2019, in line with the forecast of the April 2018 World Economic Outlook (WEO), although the expansion is becoming less even.

LOCAL ECONOMIC SENTIMENT

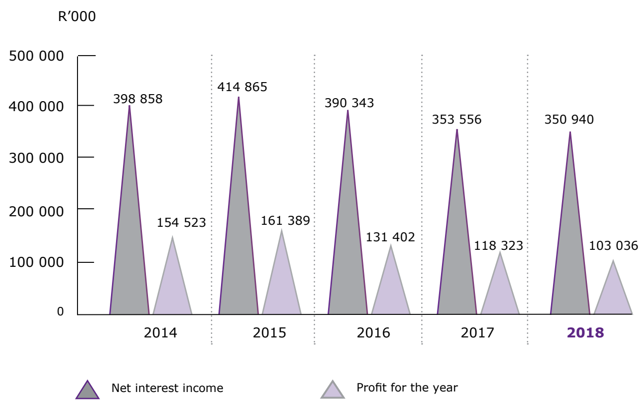
Against this backdrop, domestic weaknesses in South Africa also weigh on the outlook. Broad structural problems in the labour market, education and network industries, coupled with fiscal slippage, high unemployment, low consumption and a slow reform agenda constrained growth.

MODERATE PERFORMANCE

Concerted efforts to improve performance had a positive impact on the co-operative's performance for the year under review. The business stabilised during the first half and achieved moderate growth during the latter part of the year under review.

Profit for the year decreased by 12,9% (2017: decrease of 10,0%) to R103,0 million (2017: R118,3 million).

Performance



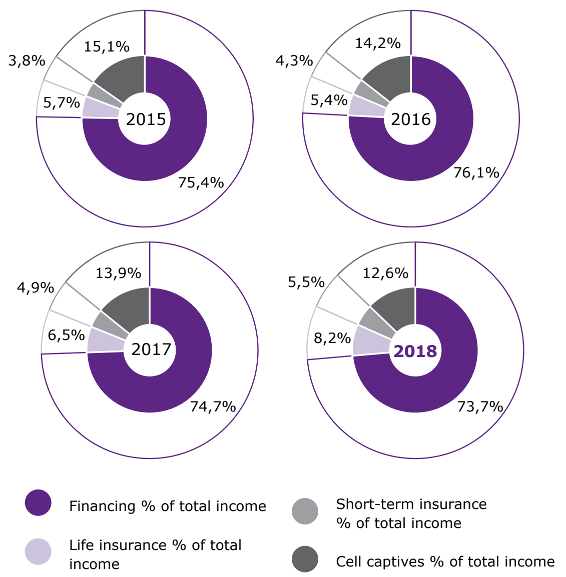
Financing, comprising mainly of vehicle advances, pension-backed housing advances and unsecured advances, remains the largest contributor to the group's income. Revenue from financing activities comprise interest received, administration fees and credit life insurance commission.

Interest income decreased by 0,7% (2017: 9,0%) from R629,8 million to R625,6 million, mainly due to the sluggish performance of the advances during previous years. Non-interest income decreased by 3,0% (2017: 5,2%) to R252,7 million (2017: R260,4 million), representing 28,8% (2017: 29,3%) of total income.

Other direct advance-related income, such as fees and commission, decreased by 1,3% (2017: 20,3%) to R51,0 million (2017: R51,7 million). The decrease in fees is mainly due to the impact of the final credit life insurance regulations, effective from August 2017, which impacted credit agreements concluded from this date under the National Credit Act.

The contributions to total income from financing, life insurance, short-term insurance and the cell captives are illustrated below.

Income contribution percentage per main product category



MAINTAINING A HEALTHY MIX OF ADVANCES

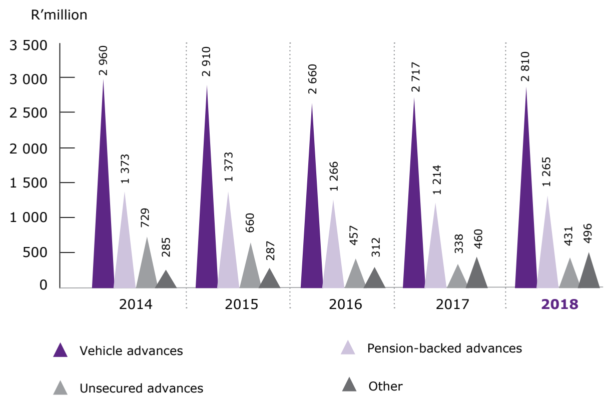
South African household debt decreased to 71.90% of gross income in 2017, from 74,40% in 2016. Since 2008, when household debt was 86,4%, there has been a downward trajectory and this metric of financial stress reached its lowest level in a decade in 2017. However, the debt level is still high when compared to other emerging countries. South African consumers remain under financial strain and it is therefore important that they have access to financial products and services that are offered in a responsible manner during times when they need assistance.

Because of the relatively high debt levels and a high number of consumers with defaults or judgements on their credit record, the credit market is characterised by strong competition to attract members with good credit profiles. In an effort to ensure the sustainability of the business, Iemas also focused on attracting members with healthy credit profiles and purposefully managed the quality and composition of its advances. As a result, the advances product mix remained well balanced.

The changes in advances per the main product categories were as follow:

» Vehicle advances increased by 3,4% (2017: 2,1%);
» Pension-backed advances increased by 4,1% (2017: decreased by 4,1%); and
» Unsecured and other advances increased by 16,1% (2017: 3,8%).

Advances per main product categories



Iemas' total net advances increased with 5,6% (2017: 0,6%) to R5 047,8 (2017: R4 779,5 million) which represented a noticeable improvement on the growth in net advances of R30,1 million recorded for the 2017 financial year. The moderate growth is mainly attributable to Iemas' large exposure to the mining and manufacturing industries which still experienced uncertainty, low business confidence and low growth.

Chief financial officer's report

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MODERATE GROWTH IN ADVANCES

The National Association of Automobile Manufacturers (Naamsa), in August 2018, stated that vehicle sales were expected to show modest improvement over the short to medium term and projected an improvement in domestic sales volumes of 2% – 3% in volume terms. Iemas' vehicle advances, which constitute the largest portion of the total advances, increased by 3,4% (2017: 2,1%) to R2 809,8 million (2017: R2 716,7 million).

Although South African household debt decreased, some cause for concern is the fact that the nature of the household debt has changed in that the portion utilised for mortgage advances decreased while the portion utilised for unsecured advances increased since 2006. However, Iemas' pension-backed housing advances, that comprise of loans utilised by members to either buy land or property or renovate their properties, increased by 4,1% (2017: decrease of 4,1%) to R1 264,9 million (2017: R1 214,5 million).

The increase of 16,1% (2017: 3,8%) in unsecured and other advances is mainly attributable to Iemas' strategy to focus on growth in the middle and middle-high income categories and a general improvement in credit market conditions.

LOW CREDIT LOSSES AMID PRUDENT CREDIT EXTENSION

There is often tension between members' financial needs and the moral and regulatory obligation on Iemas to be prudent on behalf of all members. Iemas' credit screening is done responsibly to protect members and to ensure that they do not find themselves in a situation they regret further down the road. Although unsecured advances increased during the year under review, the focus remained on advancing credit to creditworthy consumers rather than aggressively growing the book. This resulted in a shift in the risk profile of applicants.

Iemas is diligently managing the quality of both secured and unsecured advances. The loan impairment expense (bad debts plus provisions less recoveries) decreased by 14,5% (2017: 19,9%) to R76,8 million (2017: R89,8 million). In addition to sustained management, the decrease is attributable to a general stabilisation of business, both in Iemas and its participating employers and continuous improvement of credit control processes. The amount in arrears, classified conservatively, includes all arrears, regardless of the amount or reason and incorporates technical arrears.

The capital amount outstanding represents the total outstanding capital owed to Iemas for advances in arrears before taking into account any security, such as the value of the vehicle, a pledge on the member's pension fund credit or the member's available deferred bonus payment fund.

Capital outstanding of members under debt review increased from R76,7 million to R86,5 million, representing 1,7% (2017: 1,6%) of total advances. Considering the total number of members under debt review, R0,45 million (2017: R0,2 million) was in arrears at year-end, which represented 0,5% (2017: 0,3%) of the total capital owed by these members. The increasing trend in members under debt review is being monitored closely.

ADEQUATE PROVISION FOR IMPAIRMENT

Credit risk can be defined as the likelihood that a member will fail to meet their obligation in accordance with the agreed terms and conditions of a credit agreement. Exposure to credit risk continues to be a source of concern for financial institutions worldwide. Iemas makes adequate provision for impairment of bad debts through meticulous analysis of historic trends and projections of future market conditions. Strict adherence to credit policies and conservative credit evaluation criteria resulted in the decrease in non-performing loans and bad debts for the year under review.

The impairment provision increased by R5,0 million (2017: R8,0 million) to R155,0 million (2017: R150 million), which represented 4,1% (2017: 4,2%) of the total advances, excluding pension-backed housing advances. No provision was made for impairments on pension-backed housing advances as these advances are covered by a pledge of an equal amount of the member's pension fund credit. The positive variance is a result of both improved collection efforts and expected retrenchments at large employers which did not materialise during the year under review.

The impairment expenditure on vehicle advances increased by R0,5 million (2017: R3,4 million) to R41,8 million (2017: R41,3 million), representing 1,5% (2017: 1,5%) of the total vehicle advances. The impairment expenditure on unsecured advances decreased by

R9,9 million (2017: R16,0 million) to R41,1 million (2017: R51,0 million), representing 4,4% (2017: 6,4%) of the total unsecured advances, mainly due to the implementation of good credit practices. Post write-off recoveries increased by 5,9% (2017: decrease of 3,6%) from R10,5 million to R11,1 million.

The IFRS 9, 'financial instruments', is effective for annual periods beginning on or after 1 January 2018. Iemas will adopt IFRS 9 retrospectively in the next financial year.

CONTRIBUTION FROM THE INSURANCE BUSINESS

Iemas' primary business is financing which, as a natural value-adding process, leads to a broader value proposition that includes insurance and ancillary products offered to members. As detailed earlier in this report, Iemas Insurance Brokers was established as a wholly-owned subsidiary of the co-operative, operating with a new license as a separate legal entity, under the Iemas umbrella brand.

Iemas Insurance Brokers offers a diverse portfolio of life and non-life insurance products. The contribution to total income generated by the insurance business amounted to R120,5 million (2017: R102,0 million) of which 40,1% (2017: 42,9%) was contributed by the short-term insurance division and 59,9% (2017: 57,1%) by the life division.

The short-term insurance business is subject to intense competition, price-sensitive consumers, increasing regulations and a shortage of human resources with the required skills and qualifications. Total income increased by 10,2% (2017: 5,9%) to R48,3 million (2017: R43,8 million), while the number of policies increased by 5,9% (2017: decrease of 3,5%). Although fairly common in contact centres, high employee turnover added pressure to the business, contributing to lower-than-expected acquisition rates due to open seats in the outbound sales division.

The life division has agreements with the majority of large insurance companies in South Africa. Total income increased by 23,9% (2017: 11,2%) to R72,2 million (2017: R58,2 million) and expenditure increased by R21,8 million (2017: R6,0 million), resulting in a net income decrease of R7,8 million (2017: R0,2 million).

During the year, the business plan for the insurance business was reviewed and is expected to yield results in the next financial year, mainly through a larger and more effective sales team, repositioning of the value proposition and a complementary marketing strategy.

INCOME FROM CELL CAPTIVES

For the year ending 31 August 2018, the 'net premiums' decreased with R12,1 million (2017: R15,0 million), mainly due to the regulatory cap on credit life premiums on a portion of the unsecured advances as mentioned earlier in this review.

The 'net claims expense' was lower than expected. This was mainly due to projected retrenchment claims at large employers which did not materialise during the year.

SENSIBLE COST MANAGEMENT

There is cost associated with doing the right thing, doing things differently or doing nothing. The group's operating cost was contained well during the year and savings were realised mainly as a result of vacant positions, deferral of information technology cost owing to the inevitable postponement of the core systems' implementation date, amortisation of the loans system and the depreciation expense. The saving in the depreciation expense was realised due to a change in the accounting policy that increased the useful lives of computer equipment from 3 to 4 years, effective 1 September 2017.

Salary cost, the largest contributor to expenditure, increased by 10,4% (2017: 3,4%) to R186,9 million (2017: R169,3 million) and represents 54,2% (2017: 53,8%) of total operating cost. Iemas' total employee complement increased with 48 employees (2017: 51 employees) to 602 (2017: 554). The employee complement was strengthened mainly in the insurance business to support the product growth strategies and to ensure alignment of human resources capacity with the needs of the business.

The continued focus on the business modernisation project demanded an additional investment of R13,8 million (2017: R19,4 million) in information technology for the year under review. The business modernisation project is nearing finalisation with implementation scheduled for the next financial year.

The cost-to-income ratio increased from 48,5% to 54,7%. This was the result of an increase in net income of 0,5% (2017: decrease of 5,2%), with expenditure increasing by 10,8% (2017: 0,8%).

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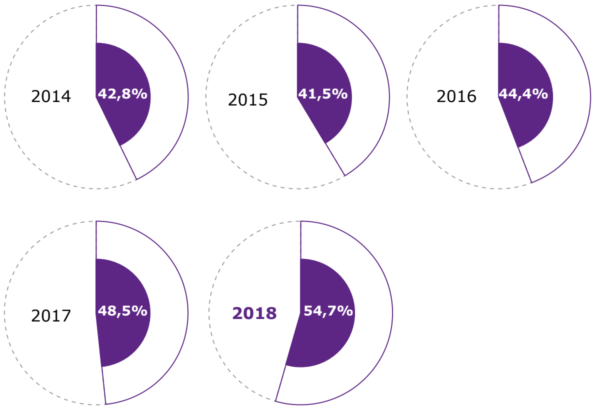
Cost-to-income ratio



MEMBERS SHARE IN THE PROFITS

The foundation of the co-operative model is that members share in the prosperity of the co-operative. Iemas' annual reward allocations to members illustrate its commitment to the co-operative principle. Total member rewards (excluding interest on the members' deferred bonus payment fund) amounted to R61,9 million (2017: R64,1 million), which represents 37,7% (2017: 35,4%) of net profit after tax before rewards.

The interest paid on members' deferred bonus payment funds amounted to R47,4 million (2017: R45,6 million), which represents a return of 6,5% (2017: 6,5%) on their funds. These returns compare favourably with savings products in the market. The total member rewards for 2018, which comprise the rewards allocated and the interest accrued on the members' deferred bonus payment funds, amounted to R109,4 million (2017: R109,7 million).

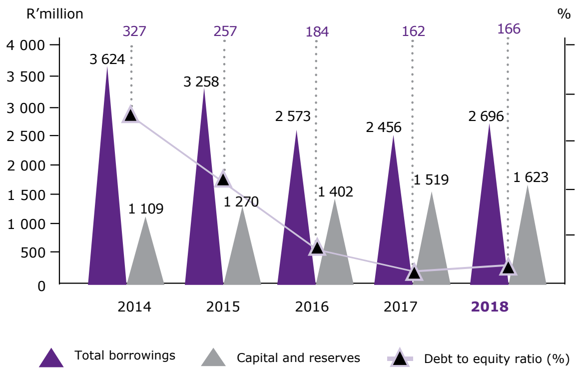
FUNDING FOR SUSTAINABLE GROWTH

The group's primary sources of funding are its retained reserves and members' deferred bonus payment funds. For the year under review, capital and reserves increased by 6,8% (2017: 8,5%) to R1 623,1 million (2017: R1 519,9 million) and members' funds increased to R814,1 million (2017: R786,5 million).

The retained reserves and members' funds are complemented with funding facilities from three South African banks, which represent 87,2% (2017: 92,7%) of the group's total external funding. Funding via the securitisation structure, Torque Securitisation, represents 12,8% (2017: 7,3%) of the group's funding and is discussed in more detail further in this review.

In an effort to secure continuous access to funding at competitive terms, performance was managed within the covenants agreed with the banks. Iemas is currently well within the limits of its covenants, mainly attributable to good cash- and arrears management. Regular, pro-active engagement with funders and timely, accurate reporting further established Iemas' credibility as a sound investment.

Debt to equity



TORQUE SECURITISATION (RF) LIMITED (TORQUE)

Torque Securitisation (RF) Limited is a special-purpose securitisation vehicle that Iemas established in August 2012 to finance a portion of the vehicle advances in the capital markets. Initially, the structure obligated Iemas to sell eligible participating vehicle assets to the revolving structure on a quarterly basis.

The structure was effective in the period during which the vehicle advances recorded continuous growth as it provided longer term funding for the group. However, low growth during the 2015 and 2016 financial years, negated the necessity for high levels of funding and consequently Torque's early amortisation commenced in May 2016.

During 2017 the vehicle advances increased with R57 million (2,1%). In view of the improved performance of the vehicle advances and the value that the structure adds to the group's funding composition, the feasibility of re-establishing Torque was evaluated.

An amortised structure was proposed versus the previous revolving structure. This entailed that Iemas would not be obliged to sell vehicle advances to the structure on a continuous bases as required by the previous revolving structure. The number, value and timing of vehicle advances sold to the structure would be at management's discretion based on Iemas' funding requirements from time to time. The structure also provides the flexibility for Iemas to approach additional investors should the need arise. The board approved a proposal to re-establish Torque in April 2017.

Subsequent to the approval by the board, the structure was re-established. The previous external noteholders were redeemed and replaced by one external investor who does not require the notes to be listed or rated. This has resulted in additional long-term funding at competitive rates, with the added benefit of a simplified structure.

CONSERVATIVE PERFORMANCE EXPECTATIONS

The change in South Africa's outlook to stable reflected the view of ratings agencies that South Africa's credit metrics will remain broadly unchanged and that political instability should abate, enabling government to focus on measures to improve economic growth. However, post the 2019 election cycle, ratings agencies will reconsider South Africa's growth rate.

According to S&P, the South African banking sector is showing signs of stability for the first time since 2013. In a recent report that tracks the performance of local finance groups, the rating firm assigned a positive outlook to domestic banks because of their continued robust financial performance.

The economic growth outlook remains weak with a slow recovery projected from the latter part of 2018. The weaker currency and rising oil prices are expected to exert upwards pressure on headline inflation. The Rand is also expected to remain volatile over the next 12 months.

Concomitantly, Iemas' performance expectations are conservative with a strong focus on growing both its advances and insurance business in market segments that comprise of quality debtors who have a propensity to repay their debt and premiums.

The focus on diversifying the industries in which Iemas operates will continue to include, in particular, the knowledge economy, with specific focus on members in the middle to middle-high income groups.

In view of conservative income projections, it is important to ensure responsible cost-containment and improvement of operational efficiency. As Iemas' growth rate slowly gains momentum, more resources will be allocated into those areas that have the most benefit for members. This calls for the balancing of the income with continued discipline around cost management and improvements in the efficiency of operations, processes and procedures. A number of operational improvements are expected to materialise in the months following the roll-out of the business modernisation program during the first half of the next financial year.

Diligent management of bad debts and arrears will continue to ensure that the initiatives envisaged to improve collections, have the desired results. A new payment and collection stream, DebiCheck, has been designed in response to the terms of reference supplied to the Payments Association of South Africa (PASA) by the South African Reserve Bank. The programme aims to provide a more efficient and reliable payment and collection environment for both the creditor and debtor. It is envisaged that the implementation of this will have an operational impact, including information technology changes. Iemas has commenced with preparations for implementation.

Iemas will continue to manage its funding responsibly to ensure sufficient capital for sustainable growth. The group acknowledges and embraces its accountability to its bankers, investors, employer groups and members and will continue to nurture these relationships.

It is expected that the next year will be challenging. However, sound financial management, good corporate governance and long-standing relationships with stakeholders form a strong foundation for Iemas to remain a caring partner.

Tom O'Connell
Chief financial officer