Chief Financial Officer's report

Tom O'Connell
Chief Financial Officer

LOCAL ECONOMIC SENTIMENT

A stronger currency and moderating inflation in an economy that may have fallen into a second recession in consecutive years gave the South African Reserve Bank scope to lower its key interest rate for the first time in more than a year, lowering borrowing costs by 25 basis points.

Household debt levels have been increasing as consumers under financial pressure took on more credit and debt servicing costs as a percentage of income increased. The lowered interest rate may offer some relief to financially strained consumers. However, with higher petrol prices and rising administered prices for basic utilities, meaningful household cash flow improvements remain likely to be delayed.

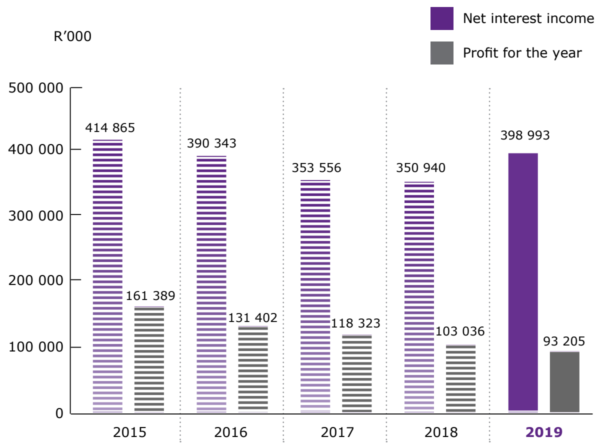
Domestic weaknesses in South Africa impacts the outlook. Broad structural problems in the labour market, education and network industries, coupled with fiscal slippage, high unemployment, low consumption and a slow reform agenda constrained growth.

MODERATE PERFORMANCE

Concerted efforts to improve performance continued, rendering results ahead of expectations which projected a decline, but with performance remaining below that of F2018.

Profit for the year decreased by 9,5% (2018: decrease of 12,9%) to R93,2m (2018: R103,0m).

Performance



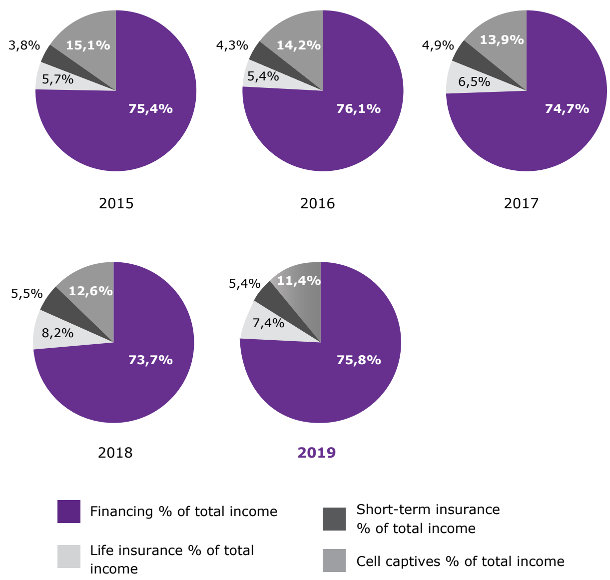
Financing, comprising mainly vehicle advances, pension-backed housing advances and unsecured advances, remains the largest contributor to the Group's income. Revenue from financing activities comprised interest received, administration fees and credit life insurance commission.

Interest income increased by 11,3% (2018: decrease of 0,7%) from R625,6m to R696,1m, due to an improvement in advances and the reallocation of initiation fees in terms of the effective interest rate adoption as required by IFRS 9. Non-interest income decreased on prior year levels at R240,2m (2018: R252,7m), representing 25,7% (2018: 28,8%) of total income.

Other direct advance-related income, such as fees and commission, increased by 5,7% (2018: decrease of 1,3%) to R53,9m (2018: R51,0m). The decrease in fees is mainly due to the impact of the final credit life insurance regulations, effective from August 2017, and the reallocation of initiation fees in terms of the IFRS 9 adoption.

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

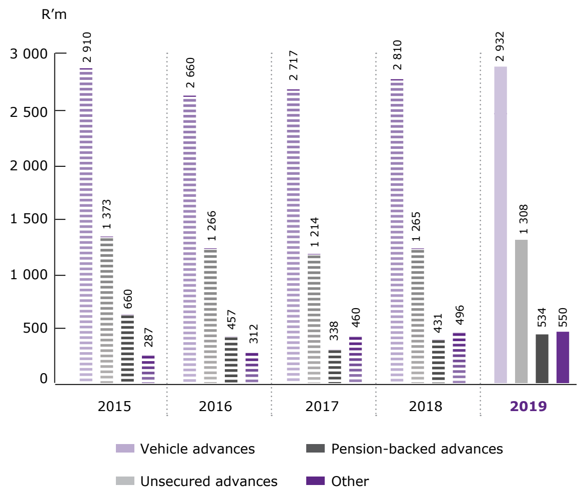
South African consumers remain under financial strain and it is important that they have access to financial products and services that are offered in a responsible manner during times when they need assistance.

The credit market is characterised by strong competition to attract members with good credit profiles, as debt levels are relatively high and a substantial number of consumers have defaults or judgements on their credit record. Iemas' focus has been on attracting members with healthy credit profiles and purposefully managing the quality and composition of its advances, resulting in the product mix of advances remaining well balanced.

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

- Vehicle advances increased by 4,3% (2018: 3,4%);
- Pension-backed advances increased by 3,4% (2018: 4,1%); and
- Unsecured and other advances increased by 17,0% (2018: 16,1%).

Advances per main product categories



Iemas' total net advances increased by 6,4% (2018: 5,6%) to R5 368,9m (2018: R5 047,8m). The growth is mainly attributable to Iemas implementing its diversification strategy through the onboarding of new employer groups in the knowledge economy. This started the process of reducing its large exposure to the mining and manufacturing industries, which still experienced uncertainty, low business confidence and low growth.

GROWTH IN ADVANCES

The National Association of Automobile Manufacturers (Naamsa), in August 2019, stated that new vehicle sales improved which has been prevalent through most of the year.

Iemas' vehicle advances, which constitute the largest portion of the total advances, increased by 4,3% (2018: 3,4%) to R2 931,7m (2018: R2 809,8m).

South African household debt is still above 70%. This means more than 70% of consumers' income goes to servicing their debt, making it more challenging to get quality debtors.

Iemas' pension-backed housing advances, that comprise loans utilised by members to either buy land or property or renovate their properties, increased by 3,4% (2018: 4,1%) to R1 307,9m (2018: R1 264,9m).

The increase of 17,0% (2018: 16,1%) in unsecured and other advances is mainly attributable to Iemas' strategy to focus on growth in the middle and middle-high income categories.

CREDIT LOSSES AMID PRUDENT CREDIT EXTENSION

In a weak and constrained economic environment, 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. Iemas will improve on its credit risk processes with the implementation of a credit scorecard as part of the IBM program. This will ensure consistency in credit assessment, increase the speed of processing applications and better risk profile management.

Although unsecured advances increased during F2019, the focus remained on advancing credit to creditworthy consumers rather than aggressively growing the book. This resulted in a shift in the applicants' risk profile.

Iemas is diligently managing the quality of both secured and unsecured advances. The loan impairment expense (bad debts plus provisions less recoveries) increased by 14,6% (2018: decreased by 14,5%) to R88,0m (2018: R76,8m). A significant number of members resigned during H2 F2019, which resulted in an increased arrears portfolio, as a portion of these members are unemployed due to retrenchments. The amount in arrears, classified conservatively, includes all arrears, regardless of the amount or reason, and incorporates technical arrears.

Arrears as a percentage of gross loans and advances increased from 1,3% to 1,4%. This includes all loans that are not up to date with contractual obligations.

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 R86,5m to R102,1m, representing 1,9% (2018: 1,7%) of total advances. Considering the total number of members under debt review, R0,36m (2018: R0,45m) was in arrears at year-end, which represented 0,3% (2018: 0,5%) of the total capital owed by these members. The increasing trend in members under debt review is being closely monitored.

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.

Iemas makes adequate provision for impairment of bad debts through meticulous analysis of historic trends and projections of future market conditions.

The impairment provision increased by R13,0m (2018: R5,0m) to R168,0m (2018: R155,0m), which represented 4,1% (2018: 4,1%) 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 impairment expenditure on vehicle advances decreased by R1,4m (2018: R0,5m) to R40,4m (2018: R41,8m), representing 1,4% (2018: 1,5%) of the total vehicle advances. The impairment expenditure on unsecured advances and other loans increased by R6,4m (2018: decrease of R9,9m) to R47,5m (2018: R41,1m), representing 4,4% (2018: 4,4%) of the total unsecured advances and other loans. Post write-off recoveries increased by 8,1% (2018: 5,9%) from R11,1m to R12,0m.

The impact of the adoption of *IFRS 9, financial instruments* is disclosed in note 1.16.

CONTRIBUTION FROM THE INSURANCE BUSINESS

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 R119,2m (2018: R120,5m) of which 42,3% (2018: 40,1%) was contributed by the short-term insurance division and 57,7% (2018: 59,9%) by the life division.

The short-term insurance business is subject to intense competition, price-sensitive consumers, increasing regulations, a high turnover and a shortage of human resources with the required skills and qualifications. Total income increased by 4,4% (2018: 10,2%) to R50,4m (2018: R48,3m), while the number of policies increased by 4,1% (2018: 5,9%).

The life division has agreements with the majority of large insurance companies in South Africa, including a recent partnership with Simply. Total income decreased by 4,7% (2018: increased by 23,9%) to R68,8m (2018: R72,2m) and expenditure increased by R8,4m (2018: R21,8m), resulting in a net income decrease of R11,8m (2018: R7,8m).

The strategy of the insurance business has been reviewed and updated to further align it to market needs and will be rolled out in F2020.

INCOME FROM CELL CAPTIVES

For F2019, the net premiums decreased by R3,8m (2018: R12,1m), 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 higher than expected. This was mainly due to retrenchment claims at large employers that materialised during the reporting period.

COST MANAGEMENT

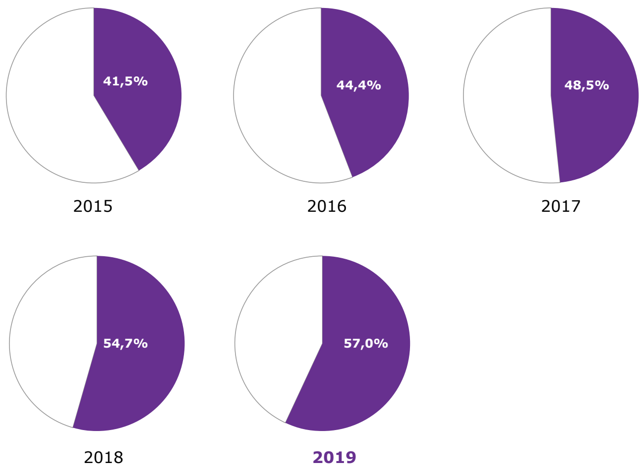
The increase in Co-operative's operating costs in excess of inflation is largely attributable to recruitment cost of key management and vehicle recovery fees, together with information technology costs in order to obtain system readiness.

Salary cost, the largest contributor to expenditure, increased by 8,4% (2018: 10,4%) to R203,3m (2018: R186,9m) and represents 53,8% (2018: 54,2%) of total operating cost. Iemas' total employee complement decreased with 39 employees (2018: 48 employees) to 563 (2018: 602). The lower employee complement relates mainly to the insurance business where there were some retrenchments.

The continued focus on the IBM program demanded an additional investment of R16,5m (2018: R13,8m) in information technology for F2019. The business modernisation program is nearing finalisation with implementation scheduled during the next financial year.

The cost-to-income ratio worsened from 54,7% to 57,0%. This was the result of an increase in net income of 4,6% (2018: increase of 0,5%), with expenditure increasing by 10,4% (2018: 10,8%).

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 R62,5m (2018: R61,9m), which represents 40,4% (2018: 37,7%) of net profit after tax before rewards.

The interest paid on members' deferred bonus payment funds amounted to R47,4m (2018: R47,4m), which represents a return of 6,25% (2018: 6,5%) on their funds. These returns compare favourably with savings products in the market. The total member rewards for 2019, which comprise the rewards allocated and the interest accrued on the members' deferred bonus payment funds, amounted to R109,9m (2018: R109,4m).

FUNDING FOR SUSTAINABLE GROWTH

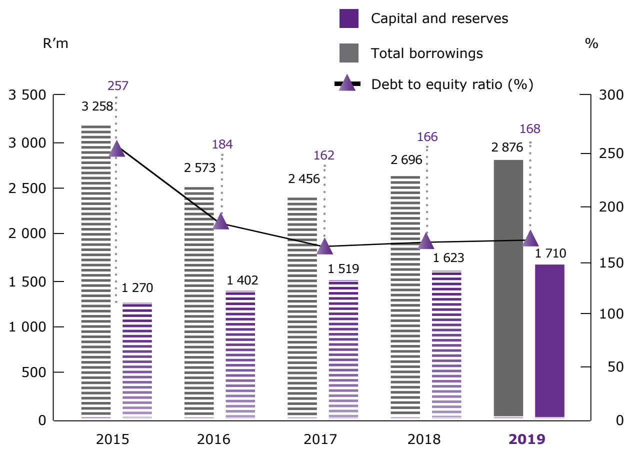
The Group's primary sources of funding are its retained reserves and members' deferred bonus payment funds as well as borrowings. For F2019, capital and reserves increased by 5,4% (2018: 6,8%) to R1 710,7m (2018: R1 623,1m) and members' funds increased to R848,3m (2018: R814,1m).

The retained reserves and members' funds are complemented with funding facilities from three South African banks, which represent 88,0% (2018: 87,2%) of the Group's total external funding. Funding via the securitisation structure, Torque Securitisation, represents 12% (2018: 12,8%) of the Group's external 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 (established in August 2012) to finance a portion of the vehicle advances in the capital markets. In May 2018, this revolving structure changed to an amortised 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 previous external noteholders were redeemed and replaced by one external investor, who does not require the notes to be listed or rated. Iemas re-issued notes to the value of R119,1m during F2019.

This has resulted in additional long-term funding at competitive rates, with the added benefit of a simplified and lower cost structure.

CONSERVATIVE PERFORMANCE EXPECTATIONS

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.

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 its 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.

Given the volatile current economic environment, diligent management of bad debts and arrears will be required 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, reliable payment and collection environment for both the creditor and debtor.

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