Credit Rating Report
Xceda Finance Limited

NZBN: 9429039261922

Credit Rating Report

Date: 7 May 2024

Prepared for: Xceda Finance Limited

Report prepared by: Equifax Australasia Credit Ratings Pty Ltd (“Equifax”)

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Currency used in this report:

This report is presented in New Zealand Dollars unless otherwise noted

1 Contents

2 Executive Summary

Xceda Finance Limited ('XFL' or 'the Company')

XFL (formerly known as Asset Finance Ltd) is a New Zealand based Non-Bank Deposit Taking ('NBDT') institution licensed by the Reserve Bank of New Zealand ('RBNZ') to accept deposits and underwrite loans to public. Equifax Credit Ratings Australasia Pty Ltd ('Equifax') has assigned XFL a credit rating of 'B+' at Mar24, which is a sub-prime classification with a moderate level of risk.

The rating has been upgraded to 'B+' at Mar24 from 'B' at Mar23 due to the Company's increased scale, healthy profitability and capital injection of $0.9m as part of a ~$2.0m capital raise programme to partially offset the recent deterioration in XFL's asset quality and support its near-term growth.

XFL's credit rating is supported by its incumbent market position in the New Zealand NBDT industry, healthy liquidity profile commensurate with its size, focus on secured lending and additional capital injection scheduled for FY25. The risks to the XFL's credit rating arise from the recent deterioration in its asset quality, macroeconomic headwinds and the Company's relatively small scale.

Strengths

- XFL's competitive profile benefits from its niche offerings in the secured consumer lending market, thereby enabling the Company to repeatedly attract customers in a segment underserved by traditional banks and profitably manage that customer portfolio. Further, XFL's ability to maintain a high yield on loans enables it to continually raise consumer deposits by offering attractive returns, which is evidenced by a 43.4% increase in XFL's retail funding over FY24.

- The Company's scale has steadily increased over the period under review, evidenced by a four-year (Mar20-Mar24) compound annual growth rate ('CAGR') of 36.4% for a gross loan book and 47.1% for its retail funding base. Together with a healthy level of profitability maintained over the assessed period, this has supported an improvement in the Company's overall credit profile and the credit rating upgrade.

- The Company remains suitably poised to grow its loan book over the near term. Most of the Company's loans are secured by first mortgages with LVR <= 70.0%, which translate into reduced risk weighting and probability of loss on default. Further, the Company is expected to raise ~$2.0m of equity over FY25 (including $0.9m raised in May 2024), which is expected to offset the impact of potential losses from the recent increase in impaired and underperforming loans. Hence, XFL's current capital ratio of 14.4% at Mar24 has healthy headroom to support the expected growth in the Company's loan book to $150.0m by Mar25, in our view.

- XFL's liquidity position is deemed adequate, supported by healthy retail deposits reinvestment rates and liquid assets to liabilities ratio of 31.0% at Mar24. Together they suitably position the Company to withstand liquidity shocks and partially offset risks associated with a high proportion of non-amortising loans (97.5% of the loan book at Mar24).

- Deposit Takers Act ('DTA'), which received Royal Assent on 6 July 2023, aims to place all deposit takers under one framework and introduce a depositor compensation scheme, ultimately promoting public confidence in the sector and improving attractiveness of NBDTs deposits, in our view.

Constraints

- The quality of the Company's loan book has materially declined in recent periods. The amount of impaired loans increased to 8.4% of XFL's gross portfolio at Mar24 (Mar23: 6.2%; Mar22: 0.7%) driven by fresh slippages in underperforming loans (a $1.4m loan for 180 days past due, $0.7m for 120 days past due, $0.6m for 90 days past due, etc) in addition to the $3.9m legacy account which has remained unresolved for more than 12 months notwithstanding its healthy LVR profile and multiple recovery prospects. We also note that the market price for one of the collateral assets is close to the impaired loan amount secured, which further highlights the potential idiosyncratic liquidity and valuation risks dormant in the healthy LVRs of Xceda's non-amortising secured loans portfolio.

- The NBDT sector players including XFL face significant macroeconomic headwinds (recessionary environment) characterised by persistent inflation, high interest rates, weakening economic growth and a slowing housing market. This challenging environment may continue to exert pressure on XFL similar to the moderation in the Company's loan book growth observed between Aug23 and Mar24, deterioration in its asset quality detailed above and potential shrinking of existing and/or future LVRs due to weakening of the property market.

- The Company's negative duration gap, characterised by longer terms of deposits compared to loans, which benefited XFL during the recent increase in interest rates, may pressure its net interest margin once interest rates start to decrease. Positively, RBNZ, similar to other foreign central banks, expects interest rates to remain elevated in the near term due to macroeconomic headwinds, and XFL is currently launching long-term loan products that are expected to reduce the duration gap going forward.

- XFL's rating is constrained by its small size and franchise, its focus on the upper quadrants of the risk-reward matrix and its retail deposit funding base. With a high proportion of interest only loans, its borrowers' debt serviceability is likely to be more susceptible and sensitive to the macroeconomic environment than that of traditional banks' borrowers.

The rating may be revised upward with sustained improvement in scale and asset quality, while maintaining healthy profitability. There may be downward pressure on the rating if the Company's asset quality, capital ratio or profitability materially deteriorate, on an individual or a collective basis.

Risk Rating

B+

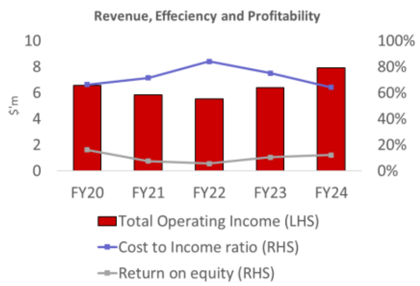
Stable

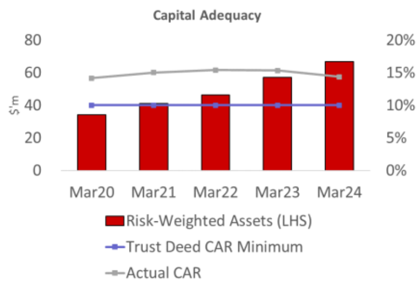
Public, Under ongoing monitoring

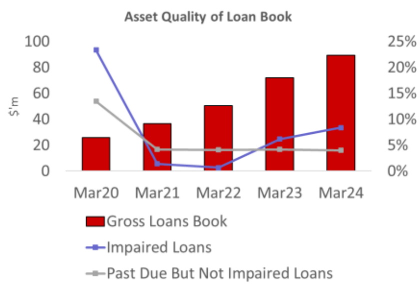
Industry Percentiles

Scale:	
Total Assets	47%
Gross loans	53%
Profitability:	
NIM	60%
ROE	73%
ROA	73%
Efficiency Ratio	53%
Capitalisation:	
Leverage (Gross Loans to Equity)	13%
Capital Ratio	40%
Capital to Total Assets	7%
Funding and Liquidity:	
Deposits to Loan Ratio	73%
Liquid Assets to Total Assets	80%
Asset Quality:	
Net Charge-offs	13%
Impaired Loans	7%
Provision for Loan Losses	33%

Key Trends







3 Scope of Report

The report provides an overview of the credit rating and associated rationale of Xceda Finance Limited ('XFL' or 'the Company').

We have complied with our rating services guidelines in order to derive the credit rating on Xceda 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	**07 May 2024**
Request Type	**Issuer**
Assessment Type	**Under ongoing monitoring**
Rating Initiation	**Issuer based (solicited)**
Rating Distribution	**Public Rating**
Report Distribution	**Unrestricted**
Purchased by	**Xceda Finance Limited**
Report Fee	**Fixed Price**
Ancillary fees	**Nil**
Subject First Time Rated	**No**
Issuer Name	**Xceda Finance Limited**
Issue Name	**Not Applicable**
Issue First Time Rated	**Not Applicable**
Financial Scope	**Consolidated Entity**
Structure	**Limited Company**
Industry	**Financial Services**
Sector	**NZ Non-Bank Deposit Takers (Peer Group included on page 24)**

This report should be read within the context of Equifax's Rating Services Guide. 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 Xceda Finance Limited, publicly available information and from our own enquiries. We have derived a credit rating on the Company based on the understanding that Xceda 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	**Audited Financial Statements for the years ended 31 March 2023, 2021 and 2020.** **Management Accounts for the year ended 31 March 2024.**
Name of auditor	**Grant Thornton New Zealand Audit Limited**
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**
Subject participation	**Full**
Material financial adjustments	**None**
Limitations of assessment	**None noted**
Outsourced rating activities	**No**
Confidentiality agreement	**No**
Material client	**No**
Rating amended post issuer disclosure	**Yes**
Potential conflict of interest	**No**
Rating methodology	**Financial Institution Rating Criteria**

Though the assigned rating remains the same as outlined in the initial discussion, the rating upgrade was under the assumption of (hence conditional on) a $0.9m capital raise. As that capital raise has now been completed in May24, the rating upgrade has been made unconditional.

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

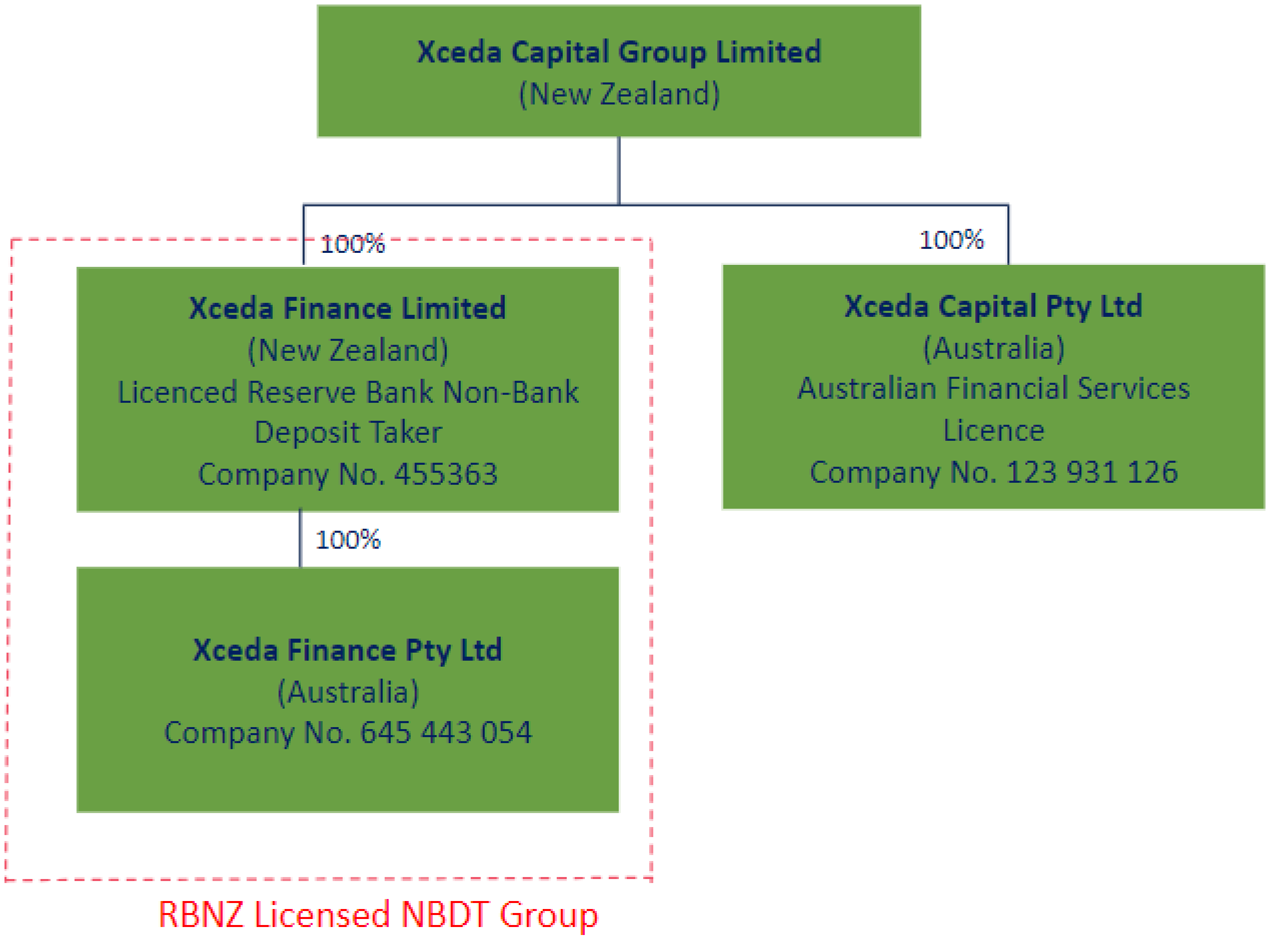
4 General Background of the Subject

4.1 Subject Overview

Subject Name	Xceda Finance Limited
Previous Name	Asset Finance Limited
Type of Entity	Licensed Non-Bank Deposit Taker ('NBDT')
Head Office Address	7 Windsor Street, Parnell Auckland NZ 1052
Date of Incorporation	15 December 1989
Principal Activities	XFL is licensed by the Reserve Bank of New Zealand to operate as a non-bank deposit taker and raise money from and issue securities to the public. XFL raises funds from the public by offering debt securities (fixed term deposits) and provides property (residential and commercial) and business loans to qualified borrowers.
History	Since 1997, the Company has been undertaking the business of lending money to generate yield in investor funds. In March 2015, the Company obtained a licence from the Reserve Bank of New Zealand to operate as a Non-Bank Deposit Taker. In September 2018, the majority ownership of the Company was acquired by Clare Investments NZ Limited (formerly named Blackstar Finance Limited), a company jointly controlled by Daniel McGrath (the current Chief Executive Officer of the Company). The RBNZ gave consent for the restructure on 17th December 2019 and Covenant Trustee Services Ltd (appointed Supervisor) also gave its consent on 17th February 2020. Further, on 25th April 2020, the Company underwent a reorganisation whereby the major shareholders (Clare Investments NZ Limited and other shareholders holding 98.98% of the total shares) transferred their shareholdings to a new holding company, Xceda Capital Group Limited (Refer 3.2 – Corporate Structure for ownership tree). Pursuant to the restructure, on 11th May 2020, the largest shareholder Clare Investments NZ Limited was wholly acquired by Clare Investment

	Management Pty Ltd, an Australian private company controlled by the current CEO Daniel McGrath. In Oct21, the Company changed its trading name and style to Xceda Finance Limited.

4.2 Corporate Structure



4.3 Management

Board Member	Position	Date Appointed
Ian Hankins	Independent Board Chairman	8 Dec 2022
Daniel McGrath	CEO	16 Aug 2018
Ross Verry	Independent Board Director	8 Dec 2022

Ian Hankins

Independent Board Chairman

Ian has a 28-year career in retail banking, investment banking and wealth management gained across NZ, Australia and the UK. Over the last 10 years Ian held a number of senior management and internal director roles at Westpac NZ including CFO, Chief Transformation Officer and GM Consumer Bank. In 2022, he joined Forsyth Barr and currently leads their Wealth management division. Ian has a Bachelor of Commerce and Administration majoring in Money and Finance from Victoria University and in 2020 was awarded a Fellow membership of CPA Australia.

Daniel McGrath (BA/LLB,MA)

CEO

Daniel has extensive experience in senior management positions, having worked as a solicitor for major international law firms - Freshfields Bruckhaus Deringer LLP and Shearman & Sterling LLP, representing banks, private equity firms and global corporations. Daniel was also Senior Legal Counsel for ASX-listed Challenger Financial Services Group Ltd, advising on acquisitions and divestments for the Challenger's funds management group. Daniel holds a BA/LLB from Queensland University of Technology and an MA from Cambridge University.

Ross Verry

Independent Board Director

Ross is the Chief Executive of Syndex, a private markets investment management and trading platform. Ross's previous role was General Manager, Agriculture for ANZ where he had responsibility for the development and implementation of the bank's Agri business strategy. Prior to that, Ross held several senior Commercial Banking roles, including General Manager Corporate Banking and General Manager Specialist Businesses. Ross is a member of the New Zealand Institute of Directors and a former Chartered Accountant. He is currently also Chair of TH Enterprises, a large scale, family-owned dairy farming business and a Director of Gold Creek Farm Management and the NZ Cricket Players Association.

4.4 Governance and Controls

Internal

XFL's risk management system uses principles and definitions included in AS/NZS ISO 31000:2009. The four key components of the Company's risks management system include the risk management program overview, the risk register, policy documents and operation manuals. The above documents serve as primer for its core risk management processes and are reviewed periodically. Changes, if any, to the processes mentioned in the above documents require the trustee's approval.

The Board of Directors is responsible for the overall risk oversight and approving the reporting requirements, policies, procedures and controls for XFL, monitoring XFL's risk exposure to ensure that it is consistent with established risk tolerances and ensuring that any exposures to, and transactions with, related parties are on arm's length terms and conditions. The CEO is responsible for risk oversight including conduct of the risk management process periodically, review of the risk management control results in the context of identified risks, determination of broad plans for action and reporting to the Board of Directors. The management team is responsible for development and implementation of corporate risk management policies, controls and action plans; and the conduct and operation of risk management processes periodically for its area/s of responsibility. The team leaders are responsible for supporting the managing director and management team in carrying out their risk management role, identifying risk incidents/events that have or may occur and reporting them to the management team; and performance of periodic reviews of the risk management process as it pertains to their area of operation.

The components of the Company core's risks management process are to identify, analyse, respond, monitor and report. Using the above core processes as template the Company has developed detailed and comprehensive policies and processes to manage credit risk, liquidity risk, operational risk, market risk and anti-money laundering and countering financing of terrorism risk.

<u>Credit Risk Policy</u>

Identification and analysis of credit risk is particularly relevant during the origination, evaluation, approval and documentation & settlement phases of the credit process cycle. The identification is undertaken at the portfolio level as part of the annual strategic planning process and at an individual borrower level at origination of a loan and periodically thereafter as an integral part of account monitoring, both for performing and non-performing loans. The outcome of the above process is a written strategy document to be approved by the Board. Once approved, the above document serves as the primer for identification of acceptable and unacceptable level of risk exposures and development and implementation of risk management policies. The polices once formulated are reviewed quarterly and changes if any are ratified by the board prior to submitting to the Trustee for approval. As part of ongoing monitoring, various reports as detailed below are produced and are kept on file for a period of twelve months.

Report Name	Freq.	Description	Report to
Management Accounts	Monthly	Financial accounts – Profit and Loss and Balance Sheet, shows bad debts written off.	**Management, Board**
Management Reporting to Directors	Monthly	Show loan book breakdown by impairment status, product type, payment type, geographical region, primary collateral type, top exposures, etc	**Management, Board, Trustee**
Account Collection Review Report	As required	Shows details about significant loans that are in default, so decisions can be made on future collection action.	**Management**
Trust deed reporting	Per Trustee Requirements	The monthly trustee reporting has information on loan quality and write offs.	**Board, Trustee**
Reserve bank spreadsheet	Per RBNZ requirements	The monthly template for the Reserve Bank that is submitted to the trustee contains loan quality and asset concentration information under the "Assets" heading.	**Board, Trustee, RBNZ *(via the trustee)***
Annual Report and Half Year Financial Accounts	6 Monthly	The asset quality note shows information on loan overdue and impairment status	**Public, Shareholders, Investors, Trustee**

Breaches of the policies are reported to CEO and the Board of Directors, who may or may not ratify the breach in accordance with the Company's risks management policy. A risk register is also maintained to document adherence to above policies and is updated regularly.

<u>Operation Risk Policy</u>

The operational risks are reviewed on an ongoing basis and the Risk Register is updated accordingly. The Risk Register and Obligations Register are the primary means of monitoring / tracking operational risk exposures and regulatory compliance. The trigger for the identification and analysis of new or emerging operational risks can be any combination of management, board or staff meetings and discussion. The Company has policies in place to reduce the likelihood of fraudulent loans, money laundering, mistakes and business disruptions. To ensure compliance with relevant regulatory requirements, the Company has also sought legal advice while devising policies and processes to manage operational risks. Like its credit policy, various reports are produced to monitor compliance, operational risk policies and procedures and any incident involving internal fraud, workplace safety, action by a regulator, damage to physical assets and significant business disruption is reported to the Board at the next meeting. The CEO is required to report to the Board of Directors on all matters which the board determines requires a reporting. The CEO shall report at each Board meeting on all instances of risk exposures identified as being outside of Company tolerances and shall advise the Board that no such instances exist where that is the case. These reporting requirements may be altered, as the board sees fit.

The Company's liquidity, market and AML-CFT policies are also developed on similar lines detailed above and include additional policies and procedure to manage special aspects associated with each of the above risks.

In our view, the Company's risk management system prima facies appear to be in line with widely accepted risks management practises and is deemed to be adequate in our view in absence of any information to suggest otherwise.

External

The Trust deed and the prudential norms prescribed by RBNZ are key source of external governance measures which XFL must comply with. The details of the RBNZ's prudential requirements are detailed in section 7 and the table below summarise the XFL's compliance with select requirements of the trust deed and RBNZ's prudential norms.

Ratio	Calculation	Mar24	Mar23	Mar22	Mar21	Mar20	Trust deed	Regulatory
Risk weighted capital ratio	Tier 1 capital as a percentage of risk weighted assets	14.4%	15.4%	15.4%	15.0%	14.2%	10.0% or more	8% or more if rated. 10% or more if unrated.
Related party ratio	Aggregate credit exposures to all the related parties as a percentage of tier 1 capital	3.7%	0.0%	0.0%	0.0%	0.0%	<5.0%	<15%

5 Financial Overview

5.1 Summary Financial Data

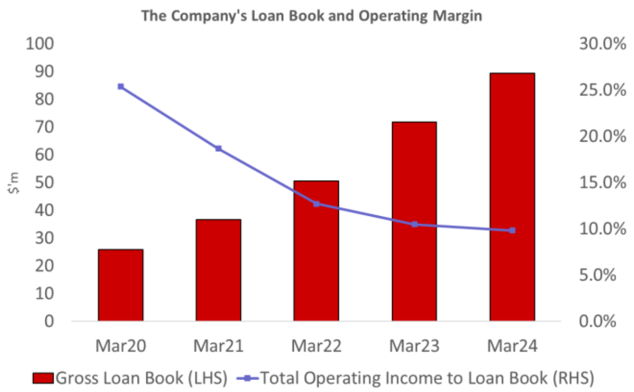
Xceda Finance Limited					
$'000s	Trend				
Income Statement		FY21	FY22	FY23	FY24
Net Interest Income		3,510	3,146	4,024	5,466
Non Interest Income		2,321	2,390	2,386	2,459
Operating Income		5,831	5,536	6,410	7,925
Operating Expense		4,174	4,662	4,820	5,090
Pre Provision Operating Profit		1,639	889	1,574	2,835
Credit Impairment Charge / (Reversal)		934	278	303	1,177
Operating Profit Before Tax		705	611	1,271	1,658
Other non Operating Income / (Expense)		- 18	15	- 16	-
Net Profit		503	435	902	1,190
Financial Position		Mar21	Mar22	Mar23	Mar24
Total Assets		46,744	59,074	89,454	126,486
Customer Deposits		38,659	50,170	79,258	113,668
Gross Loans		36,587	50,503	71,819	89,434
Liquid Assets		8,736	7,165	16,381	36,074
Ratios					
Profit Before Tax to Operating Income Margin (%)		12.1%	11.0%	19.8%	20.9%
Net Interest Margin (%)		9.0%	6.1%	5.5%	5.1%
Cost to Income (%)		71.6%	84.2%	75.2%	64.2%
Return on Asset (%)		1.2%	0.8%	1.2%	1.1%
Return on Equity (%)		7.6%	5.7%	10.5%	12.3%
Capital Ratio (%)		15.0%	15.4%	15.4%	14.4%
Capital to Total Asset Ratio (%)		15.4%	13.6%	10.2%	8.0%
Leverage Ratio - (Gross Loans / Equity) (x)		5.1	6.3	7.8	8.8
Charges-offs / Gross Loans (%)		2.6%	0.6%	0.4%	1.3%
Neither Impaired or Past Due to Gross Loans (%)		92.3%	94.5%	89.4%	87.4%
Non-Performing Loans to Gross Loans (%)*		2.4%	1.2%	6.4%	8.4%
Loan Loss Provision / Gross Loans (%)		0.9%	0.4%	0.5%	1.5%
Deposits to Gross Loans (%)		106%	99%	110%	127%
Liquid Assets to Total Assets (%)		18.7%	12.1%	18.3%	28.5%

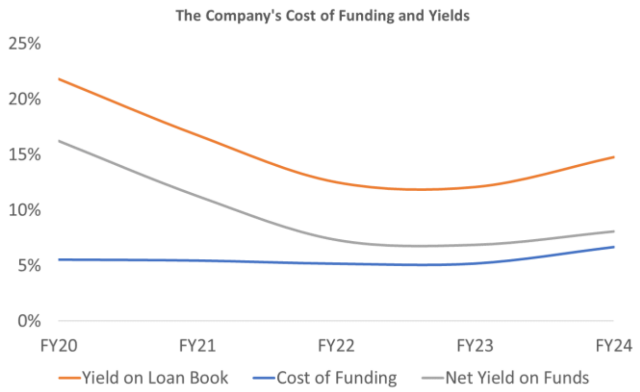
*Non-performing Loans = Impaired loans + Loans past due for more than 90 days,

5.2 Revenue and profitability

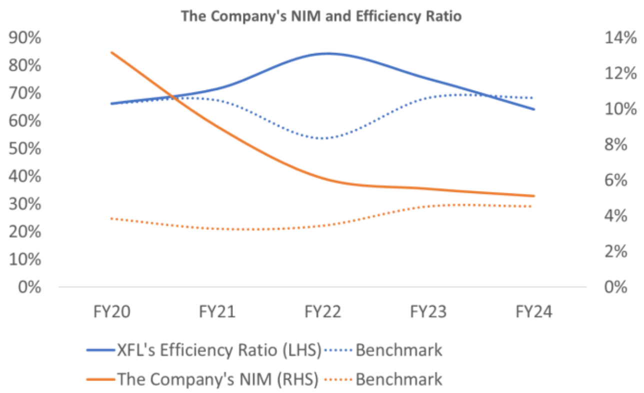
For the year ended Mar24, the Company's operating income increased by 23.6% (FY24: $7.9m; FY23: $6.4m; FY22: $5.5m), which translated to an operating margin (operating income to gross loan book ratio) of 9.8% (FY23: 10.5%; FY22: 12.7%). This increase in operating income was driven by the following factors:

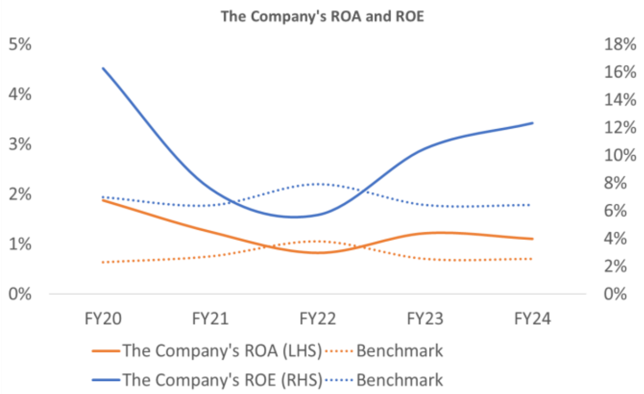
- increased gross loan book (Mar24: $89.4m; Mar23: $71.8m; Mar22: $50.5m), with an estimated effect of +$1.3m of additional operating income for FY24;
- increased net yield on funds, defined as a difference between yield on loan book and cost of funding (FY24: 8.1%; FY23: 6.9%; FY22: 7.3%), with an estimated effect of +$1.0m of additional operating income for FY24;
- increased amount of liquid assets (Mar24: $36.1m; Mar23: $16.4m; Mar22: $7.2m), which has partially offset the effects the above two factors by -$0.9m of operating income for FY24;
- effect of non-interest income was minimal, as it remained broadly stable over the period under review (FY24: $2.5m; FY23: $2.4m; FY22: $2.4m).





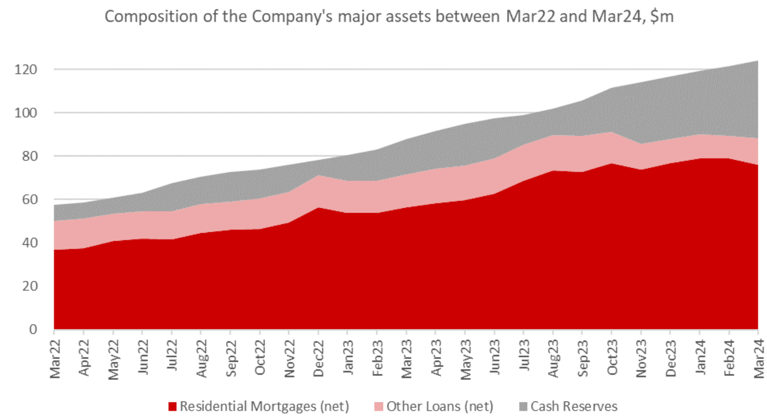
The Company's efficiency measured by its cost-to-income ratio is broadly in line with the sector average with material deviation observed for FY22 only (refer to the left-hand-side graph below). Similarly, XFL's net interest margin gradually converges to the sector average. Nevertheless, the Company's return on assets (ROA) and return on equity (ROE) largely remain better than the sector average.





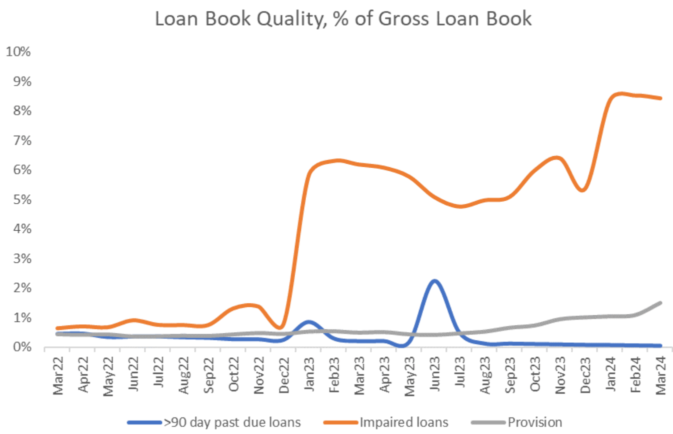
5.3 Asset Quality

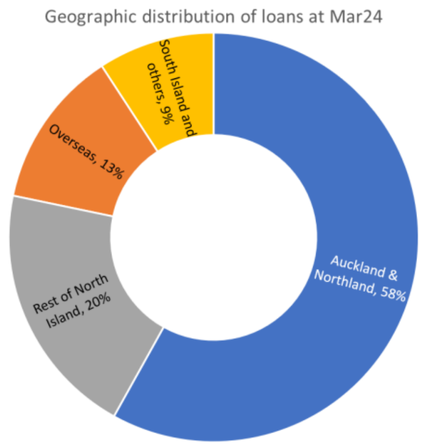
In recent years, XFL has focused on extending short-term bridge loans secured by residential properties to non-CCCFA clients (companies, trusts and individuals for business related purposes) for 3-24 months. This is reflected in a steady growth in the share of loans backed by residential properties in the Company's net loan book (Mar24: 86.3%; Mar23: 79.1%; Mar22: 73.1%), most of which have LVR <= 70.0%, accounting for 89.3% of net loan book at Mar24 (Mar23: 92.1%; Mar22: 61.8%). We note that these short-term loans put pressure on the Company to secure a constant flow of new deals to maintain / grow its scale. While the Company aims to increase its loan book to ~$150.0m by Mar25, its size has been stagnant for the most recent eight consecutive months (Aug23-Mar24), which has led to an accumulation of a relatively large amount of liquidity.



We note that long term loans (> one year) represent a relatively small portion of XFL' loan book net of non-performing loans (Mar24: 15.3%; Mar23: 22.4%; Mar22: 14.8%). In order to increase the duration of its assets, the Company has recently developed several new lending products with terms of up to 10 years.

The Company's loan book quality has steadily deteriorated over the period under review, which is evidenced by the increased amount of impaired loans, now representing >8.0% of the gross value of the entire loan portfolio, as well as a steady increase in provisions for impairment losses, as depicted in the graph below.

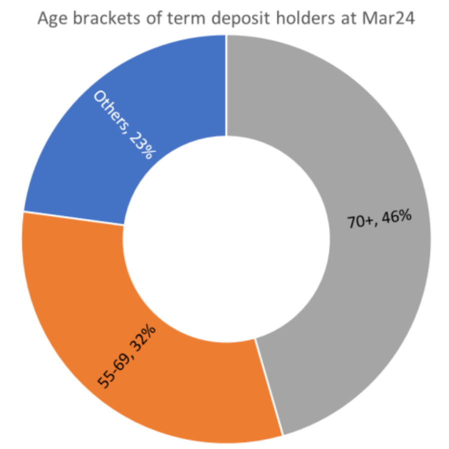


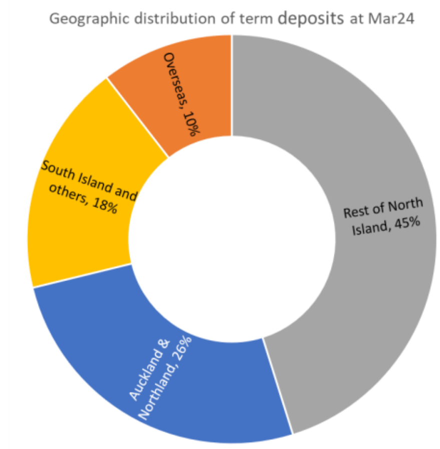


Due to the Company's relatively small scale, performance of its portfolio is susceptible to concentration risks; as of Mar24, 10 largest loans accounted for 29.1% of total loan book, and most of the Company's loans are associated with the Auckland and Northland regions.

5.4 Funding sources

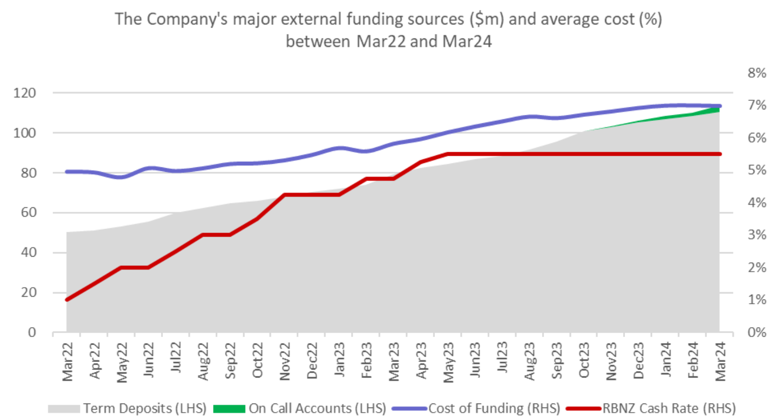
Term deposits remain the main source of funding for the Company, being equivalent to 87.2% of total assets at Mar24 (Mar23: 88.6%; Mar22: 84.9%; Mar21: 82.7%). Most of the funds on term deposits are allocated by people older than 70, followed by the age group within 55-69 age bracket. Both age groups are characterised by longer deposit terms compared to younger clients, which supports the stability of the Company's funding base. We also note that the Company's funding is better diversified compared to its loan book, with top 10 depositors accounting for 15.1% of the Company's deposit book, and geographic distribution closer aligned to the population spread across NZ.





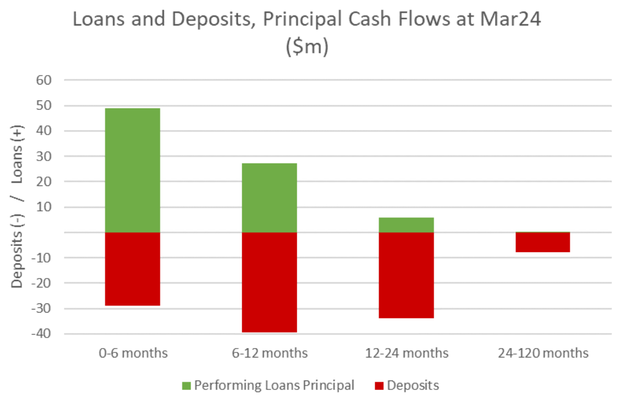
As of Mar24, 31.3% of term deposits had more than 12 months to maturity (Mar23: 42.6%; Mar22: 54.5%). However, the Company is currently targeting short-term deposits to reduce the duration of its deposit book, which has a weighted average term of 22.1 months and weighted months to maturity of 17.1 months, while average term of its loan book was 10 months at Mar24.

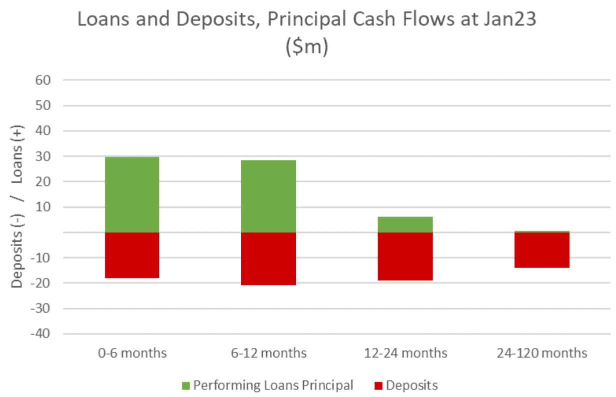
In addition to term deposits, the Company has recently introduced on-call accounts that have been steadily growing since Sep23 and were equivalent to 2.6% of total assets at Mar24. These accounts represent one of the cheapest sources of funding for the Company and reduce its exposure to market risks.



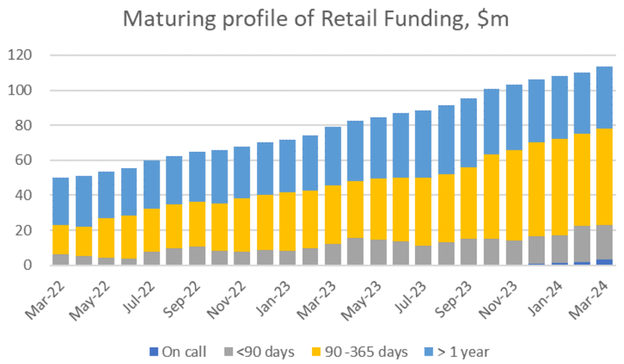
5.5 Duration and Liquidity

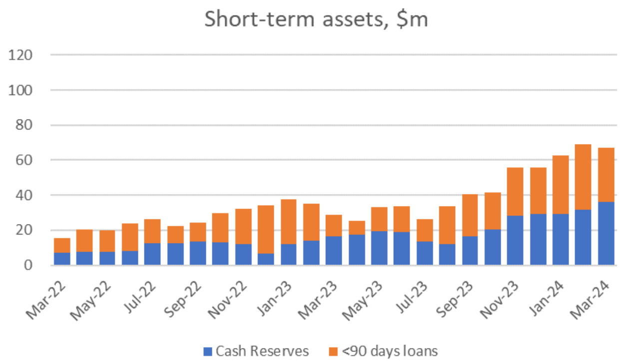
As alluded before, the Company's balance sheet has a negative duration gap, resulting from the longer average terms of its liabilities compared to assets. As of Mar24, the Macaulay Duration ('MD') of the Company's deposit book (10.8 months, assuming cost of funding of 7.1% and discount rate of 5.5%) was ~2.0x longer than the MD of its performing loan book (5.5 months, assuming interest yield of 13.5% and discount rate of 5.5%). We also note that compared to Jan23, this duration has reduced in absolute terms, as the MD for loan book was 7.1 months (assuming interest yield of 15.6% and discount rate of 4.25%), while the MD of deposit book was 14.3 months (assuming cost of funding 5.7% and discount rate of 4.25%) more than a year ago. While the Company's net interest margin benefitted from this mismatch during the interest rate rising phase, this is likely to expose XFL's performance once the interest rates decrease. To reduce this interest rate risk, the Company is introducing new loans with terms up to 10 years and targeting the younger market segment of depositors to attract more short-term deposits along with more on-call accounts.





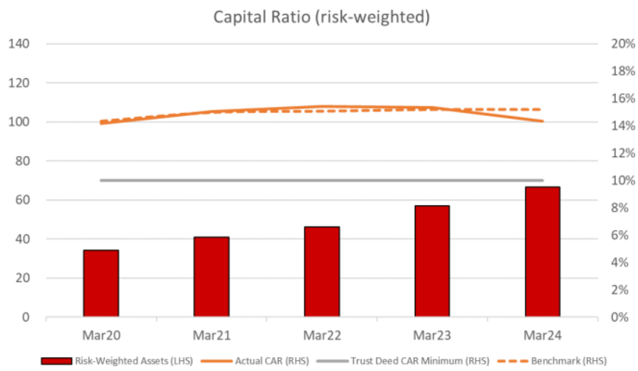
As the Company's deposit base continued to increase while its loan book remained stagnant for the most recent eight consecutive months (Aug23-Mar24), XFL's liquidity profile steadily strengthened. As evidenced by the graphs below, XFL's short-term assets (cash reserves and loan maturing within 90 days) were ~3.0x higher than its short-term liabilities (on-call accounts and deposits maturing within 90 days), compared to 1.6x at Apr23 (the lowest level observed over the past 24 months). We note that the Company allocates its cash reserves into saving accounts (mostly ANZ, accruing 5.6%) and short-term treasury bills (yield of 5.5%).

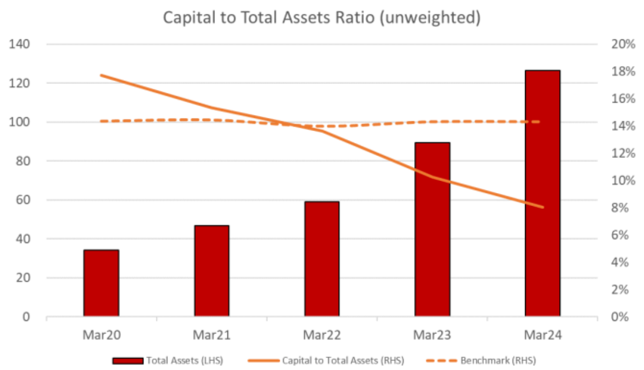




5.6 Capital Adequacy

As the Company has stopped new lending in the personal loans segments, and management has made a strategic decision to focus on residential mortgages with LVR <= 70.0%, which have relatively low risk weight, it managed to maintain a relatively stable capital ratio at >14.0% over the period under review. At the same time, as XFL's total assets grew with a compound annual growth rate ('CAGR') of 38.7% between Mar20 and Mar24, which exceeded its equity's CAGR of 13.9% over the same period.





We note that the Company's equity is under pressure due to the increasing amount of impaired loans, which were equivalent to 73.5% of net assets at Mar24. XFL's potential inability to minimise losses on its non-performing loans may severely impact its capitalisation. Positively, we note that the four largest loans in arrears are secured by first mortgages:

- Loan 1 with net amount of $3.0m and a reported LVR 57.4%; recovery of this loan is largely dependent on a successful sale of a collateral asset either by the borrower or the Company;
- Loan 2 with net amount of $1.4m and a reported LVR 64.7%; recovery of this amount is dependent on the borrower's ability to refinance the loan or a successful sale of a collateral asset (we note that anticipated sale value appears to be close to the loan amount and therefore actual LVR is likely to be higher and closer to 100.0%, which increases possibility of losses for XFL);
- Loan 3 with net amount of $0.7m and a reported LVR ~73.0%; recovery of this loan is also dependent on a successful sale of a collateral asset;
- Loan 4 with net amount of $0.6m and a reported LVR ~64.4%; repayment of this loan is expected at the end of May24.

The Company expects ~$2.0m of additional capital injections over the next 12 months: $0.9m in May 2024 and ~$1.0m throughout the year in order to support growth in total assets to $175.0m, as the Company aims to maintain its capital ratio within a 14.5%-15.5% range.

6 Economic Implications

Inflation

As in many other countries, headline inflation in New Zealand has fallen slightly more quickly than anticipated. Annual CPI inflation declined from 5.6% to 4.7% in the December 2023 quarter, below the 5.0% expected by the RBNZ. However, the larger decline in headline inflation relative to the projection was entirely accounted for by lower tradables inflation, which measures price changes for goods and services that are more exposed to international competition. Tradables inflation declined to 3.0% in the December quarter on an annual basis and was negative (-0.2%) on a quarterly basis.

Non-tradables inflation – which measures price changes for goods and services less exposed to international competition – declined in the December 2023 quarter, but by marginally less than expected by the RBNZ. Non-tradables inflation declined from 6.3% to 5.9% on an annual basis, and from 1.7% to 1.1% on a quarterly basis.

Headline inflation is assumed to continue to decline over the medium term. Easing capacity pressures and declining inflation expectations are expected to reduce non-tradables inflation, albeit at a slightly slower pace than assumed before. This is slightly more than offset by a much lower starting point and weaker outlook for tradables inflation, reflecting declining global prices for NZ imports. Annual headline CPI inflation is assumed to return to within the 1.0% to 3.0% target band by the September 2024 quarter and to the 2.0% midpoint by the end of 2025.

Financial Conditions

Mortgage rates have dipped slightly at most terms and term deposit rates have fallen at terms of more than six months. Wholesale interest rates, such as swap rates, have been volatile in recent months. Overall, wholesale interest rates at terms of up to two years have increased when compared to pre-November 2023, while rates at terms of longer than two years have decreased.

Market participants' near-term expectations for the Official Cash Rate (OCR) decreased in mid-December 2023, following the release of weaker-than-expected New Zealand GDP data and the US Federal Reserve commenting on the possibility of policy easing in 2024. Currently, market expects that OCR cuts to begin by November 2024.

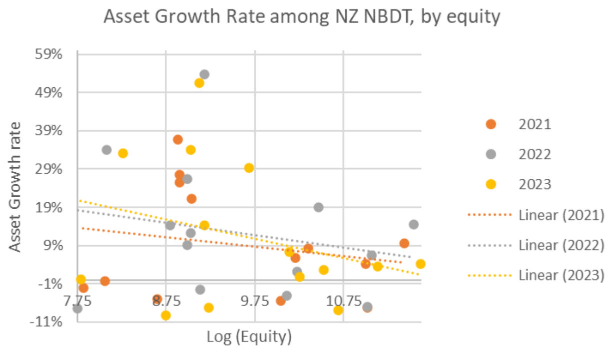
Mortgage rates have decreased slightly over the past couple of months. Increases in shorter-term wholesale rates mean that the spread between mortgage rates and wholesale rates has decreased. Despite this, the broad upward trend in spreads since the end of 2022 is likely to continue over the next few years. This is because increases in banks' cost of funding will likely continue to place upward pressure on mortgage rates in the years ahead, even in an environment of falling swap rates.

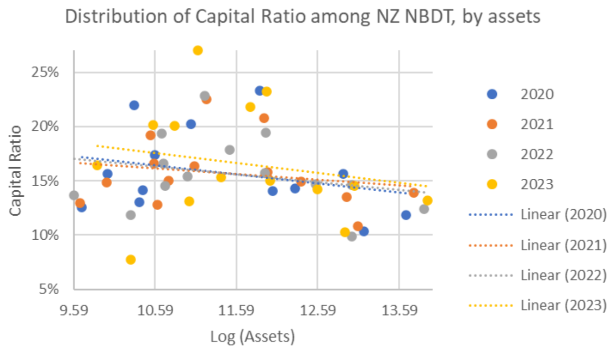
Interest rates on term deposits, which make up a large share of banks' core funding, have increased slightly at the 6-month term but decreased at longer terms. The recent upward trend in the spread between term deposit rates and wholesale rates has stalled, as wholesale rates at shorter tenors have moved higher. This spread remains significantly lower than pre-pandemic averages, holding down the cost of bank funding. A higher-than-normal share of customer deposits remain in day-to-day or transaction accounts that pay very low interest rates, further holding down bank funding costs. Bank funding costs are likely to increase further over the medium term, with banks expected to compete more aggressively for customer deposits as accommodative funding conditions for banks continue to fade.

Source: Monetary Policy Statement, RBNZ, February 2024

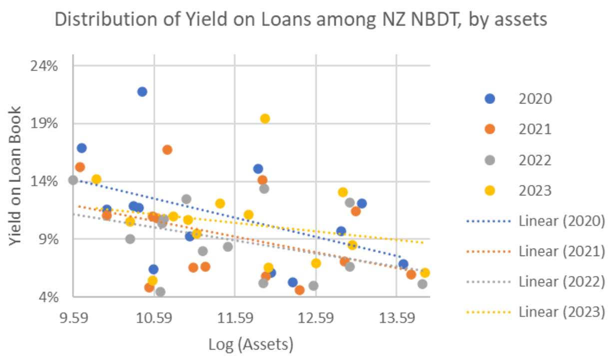
7 Market Overview

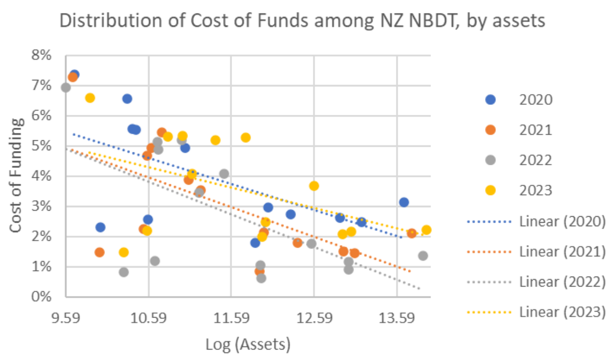
There are 15 NBDTs operating in New Zealand, which include building societies, credit unions, and deposit-taking finance companies, and this number is expected to reduce to 14 in June 2024, when NZCU Auckland intends to merge with First Credit Union. These entities have diverse business models, asset sizes, geographic concentration and product mixes. Total lending by NBDTs is around $2.20bn, compared to $542.00bn in lending by banks. While small, parts of the NBDT sector help to serve some customers who may be unable to access the products they need from banks. NBDT capital levels have been generally stable in the past year. Aggregate capital ratios are above their regulatory minimums. Asset quality is deteriorating, evidenced by increased non-performing loans from their low point in 2022, reflecting the slowing economy.





NBDTs are diverse in terms of asset size however the lack of economies of scale continues to weigh on profitability for many. This has been a long-standing challenge in parts of the sector, with 10 of the 15 current NBDTs having total lending of less than $100.0m. Operating costs tend to be high relative to income, and the capacity to raise capital is limited. The business models of individual lenders tend not to be well diversified in terms of geographic exposure and products. These factors contribute to lower resilience in the NBDT sector compared to the banking sector. The sector has consolidated in recent years, particularly for credit unions and further consolidation and/or changes to the business model may happen.





7.1 Prudential Framework

The Reserve Bank regulates non-bank deposit takers (NBDTs) in New Zealand for the purposes of promoting the maintenance of a sound and efficient financial system and avoiding significant damage to the financial system that could result from the failure of an NBDT. NBDTs are entities that make an NBDT regulated offer (as defined in section 5 of the Non-bank Deposit Takers Act 2013) and carry on the business of borrowing and lending money, or providing financial services, or both. The prudential regulation of NBDTs is provided under the Non-bank Deposit Takers Act 2013 and associated regulations. Trustee companies also have obligations under the Act. These include ensuring certain prudential content is included in licensed NBDTs' trust deeds. Trustees must report to the Bank any non-compliance with the Act and regulations by the licensed NBDT. Trustees are licensed by the Financial Markets Authority under the Financial Markets Supervisors Act 2011. The table summarises certain key prudential requirements for NBDTs currently in force.

Credit Rating	Licensed NBDTs are required to have a local currency (New Zealand dollar), long-term, issuer rating given by approved rating agencies.
Governance	Licensed NBDTs that are companies or building societies must have a chairperson who is not an employee of either the licensed NBDT or a related party and must have at least two independent directors. Licensed NBDTs that are subsidiaries of another person are prohibited from including provisions in their constitutions that would allow directors to act otherwise than in the best interests of the NBDT.
Risk Management	Licensed NBDTs are required to have a risk management programme that outlines how the licensed NBDT identifies and manages its credit, liquidity, market and operational risks. This programme is to be submitted to, and approved by, the licensed NBDT's trustee.
Capital Ratio	A minimum capital ratio (the level of capital in relation to the credit exposures and other risks of the NBDT or its borrowing group) is required to be included in licensed NBDTs' trust deeds. This ratio must be at least 8% for licensed NBDTs with a credit rating from an approved credit rating agency. For licensed NBDTs without a credit rating from an approved rating agency, the minimum capital ratio specified in the trust deed must be at least 10%.
Related party exposure limits	The exposures to related party, as defined in the Act, shall not exceed a maximum limit of 15% of capital.
Liquidity	Liquidity regulations require every licensed NBDT and its trustee to ensure that the licensed NBDT's trust deed include one or more quantitative liquidity requirements that are appropriate to the characteristics of the licensed NBDT's business, and that take into account the liquidity of the licensed NBDT and the liquidity of any borrowing group.
Suitability assessment of certain directors and senior officers	Licensed NBDTs must notify the Reserve Bank when one of its directors or senior officers (or a person who is proposed to be appointed as a director or senior officer) raises a "suitability concern".
Change in ownership	An application must be made to the Reserve Bank to approve a transaction that will result in a person: 1. having the direct or indirect ability to appoint 25% or more of a licensed NBDT's governing body; or 2. having a qualifying interest in 20% or more of the voting securities issued by the licensed NBDT.

Further changes to the regulatory framework are expected in the near future, as the RBNZ continues to strengthen its supervisory requirements. The Bank is launching consultation on prudential standards under the Deposit Takers Act, which will set out the key requirements for deposit takers, replacing the existing banking handbook, most conditions of registration, Orders in Council that currently create disclosure standards for banks and the equivalent instruments that set the current non-bank deposit taker regime. All standards will apply to both new and existing deposit takers when they come into force (which is planned for July 2028), and firms will be expected to comply with them from that point. However, prior to this date, decisions will be made about licensing existing deposit takers based on the four standards to be consulted on in May 2024 (capital, liquidity, disclosure and the depositor compensation scheme).

Source: Financial Stability Report, RBNZ, May 2024

7.2 Financial Benchmarks

Description	Percentile	Liberty Financial Limited	General Finance Limited	Mutual Credit Finance Limited	GoldBand Finance Limited	Finance Direct Limited	Nelson Building Society	Unity Credit Union	First Credit Union Incorporated	Christian Savings Limited	Wairarapa Building Society	Police and Families Credit Union	Hertaunga Building Society	Credit Union Auckland	Xceda Finance Limited
Financial Year		2023	2023	2023	2023	2023	2023	2023	2023	2023	2023	2023	2023	2023	2024
Scale:															
Operating income ($ 000s)	73%	2,859	7,555	3,954	3,281	3,492	33,322	37,054	27,276	7,069	6,634	3,912	453	2,882	7,925
Total Assets ($ 000s)	47%	67,546	128,462	60,192	50,303	19,518	1,138,268	412,215	460,964	293,294	164,135	156,775	38,918	29,563	126,486
Gross loans ($ 000s)	53%	52,542	109,611	57,621	44,275	17,311	894,577	259,058	332,326	249,047	148,429	34,404	25,360	23,234	89,434
Profitability:															
Net Interest Margin (%)	60%	4.1%	4.7%	5.9%	5.6%	7.9%	2.9%	7.4%	4.3%	2.4%	3.8%	2.7%	1.9%	6.8%	5.1%
Non Interest Income to total operating income (%)	73%	0.0%	29.1%	23.1%	20.2%	64.1%	5.3%	18.2%	31.9%	4.9%	13.2%	1.8%	-52.5%	33.3%	31.0%
ROE (%)	73%	9.5%	25.2%	18.7%	15.7%	-0.4%	9.3%	-27.1%	3.5%	9.9%	3.1%	2.0%	-4.3%	-28.5%	12.3%
Return on assets (%)	73%	1.3%	2.8%	2.8%	3.0%	-0.1%	0.9%	-3.3%	0.5%	1.2%	0.5%	0.4%	-0.7%	-2.7%	1.9%
Cost to Income (%)	53%	25.6%	35.1%	45.3%	36.9%	99.7%	50.4%	107.8%	87.9%	50.9%	60.9%	101.3%	146.2%	119.1%	64.2%
Capitalisation:															
Leverage (Gross loans to Equity) (x)	13%	5.1	6.9	6.9	4.5	4.5	8.1	5.9	4.9	6.7	5.9	1.2	4.0	9.6	8.8
Capital ratio - risk adjusted (%)	40%	27.0%	21.8%	13.1%	20.1%	16.5%	13.2%	10.3%	14.6%	14.2%	15.0%	23.3%	20.1%	7.8%	14.4%
Capital to total assets ratio (%)	7%	15.1%	12.4%	13.9%	19.4%	19.9%	9.7%	10.7%	14.8%	12.7%	15.4%	18.0%	16.2%	8.1%	8.0%
Funding and Liquidity:															
Gross loans as a % of total assets (%)	27%	77.8%	85.3%	95.7%	88.0%	88.7%	78.6%	62.8%	72.1%	84.9%	90.4%	21.9%	65.2%	78.6%	70.7%
Deposits to gross loans (%)	73%	105.9%	100.3%	86.8%	84.9%	83.8%	113.6%	135.1%	116.3%	101.4%	91.0%	372.1%	127.3%	112.8%	127.1%
Liquid assets to total assets (%)	80%	21.3%	14.3%	2.5%	11.7%	4.8%	20.4%	32.8%	22.2%	13.1%	5.5%	71.8%	25.0%	16.9%	28.5%
Asset Quality:															
Write-offs to gross loans (%)	13%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	4.3%	0.0%	0.1%	0.0%	0.0%	0.0%	1.1%	1.3%
Impaired loans to gross loans (%)	7%	2.4%	0.0%	1.3%	0.0%	2.0%	1.2%	2.3%	1.4%	0.0%	1.1%	0.0%	0.0%	0.0%	8.4%
Impairment provision to gross loans (%)	33%	2.2%	0.7%	0.6%	0.0%	2.1%	0.6%	4.4%	0.6%	0.1%	0.5%	0.4%	0.0%	1.6%	1.5%

8 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

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

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

Additional indicators used are computed as follows:

Operating Income	Net Interest Income + Non-interest income from operations
Operating profit	Operating income – operating expenses – provisions
Non-performing Loans	Impaired loans + Loans past due for more than 90 days

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 (version 6, 2019).

https://www.corporatescorecard.com.au/docs/RatingMethodologyFinancial.pdf

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