Credit Opinion: Imperial Group Ltd

Global Credit Research - 31 Oct 2013

Johannesburg, South Africa

Ratings

<table>
<thead>
<tr>
<th>Category</th>
<th>Moody's Rating</th>
</tr>
</thead>
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<td>Outlook</td>
<td>Stable</td>
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<tr>
<td>Issuer Rating</td>
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<td>Bkd Senior Unsecured -Dom Curr</td>
<td>Baa3</td>
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Contacts

<table>
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<tr>
<th>Analyst</th>
<th>Phone</th>
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<tbody>
<tr>
<td>Carlos Winzer/Madrid</td>
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Key Indicators

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<tbody>
<tr>
<td>EBITA Margin %</td>
<td>7.5%</td>
<td>7.5%</td>
<td>7.7%</td>
<td>6.8%</td>
<td>5.9%</td>
</tr>
<tr>
<td>(FFO + Interest Expense) / Interest Expense</td>
<td>5.8x</td>
<td>6.5x</td>
<td>5.6x</td>
<td>3.6x</td>
<td>3.3x</td>
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<tr>
<td>FCF/Debt</td>
<td>1.0%</td>
<td>9.5%</td>
<td>14.0%</td>
<td>4.3%</td>
<td>10.9%</td>
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<tr>
<td>Debt/EBITDA</td>
<td>2.2x</td>
<td>2.1x</td>
<td>1.8x</td>
<td>2.4x</td>
<td>3.1x</td>
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<td>RCF/Net Debt</td>
<td>26.4%</td>
<td>35.5%</td>
<td>39.4%</td>
<td>21.3%</td>
<td>22.2%</td>
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Note: For definitions of Moody's most common ratio terms please see the accompanying User's Guide.

Opinion

Rating Drivers

- Strong brand and market presence in South Africa
- Diversified operations with concentration in South Africa
- Operating margins exposed to foreign exchange volatility, cost pressures and productivity disruptions
- Strong credit metrics incorporate financial flexibility to accommodate strategic initiatives including debt funded acquisitions

**Corporate Profile**

Imperial Holdings Limited ("Imperial" or "Group") is the largest private sector transport and mobility group in South Africa. Established in 1948, Imperial operates in Africa, the UK, Europe, USA and Australia.

Imperial's core activities include services relating to transportation and mobility. In their broader context these activities include logistics, car rental and tourism, motor vehicle dealerships and distributorships, as well as insurance. For financial year end (FYE) 30 June 2013, Imperial reported revenues of ZAR92.4 billion (USD10.5 billion) and Moody's-adjusted EBITDA of ZAR10.0 billion (USD1.1 billion).

**Rating Rationale**

Imperial's Baa3/A2.za issuer rating continues to be based on Moody's perception of the Group's business risk profile, combined with its level of debt protection ratios, and its diversified business structure, which mitigates its complex organization structure. The ratings also recognize Imperial's high concentration to South Africa contributing close to 70% of revenues and 79% of operating profit during FYE 2013. Imperial's long history and solid reputation in South Africa, its track record of growth, its strong market position and quality of management also support its Baa3/A2.za rating. Furthermore, the rating factors Imperial's ongoing conservative financial policies and its inherent exposure to currency volatility.

**DETAILED RATING CONSIDERATIONS**

**STRONG BRAND AND MARKET POSITION COMBINED WITH DIVERSIFIED AND INTEGRATED MIX OF RELATED BUSINESSES SUPPORT RATING**

Imperial is the largest private sector transport and mobility group in South Africa. Imperial holds sole or joint market leadership positions in South Africa in all of its core businesses, with the exception of its insurance operations although Regent (Imperial's insurance company) is the leading motor-related value-added insurance provider and it holds leading positions in Botswana and Lesotho for short-term and life insurance products. Imperial's two key business segments are logistics and distributions, which together accounted for approximately two thirds of revenues and operating profits in FYE 2013.

Although nearly 70% of Imperial's revenues were derived from South Africa in FYE 2013, it has decreased from approximately 74% in FYE 2012 as Imperial expanded its operations into Africa and the rest of the world. Contributions from Continental Europe have increased with the full consolidation of its Lehnkering Holdings GmbH acquisition and was the main driver behind the reduced revenues coming from South Africa. Africa (excluding South Africa) contributed 6.1% of revenue and 6.5% of operating income for FYE 2013 (5.8% and 5.3% respectively, for FYE 2012), while the rest of the world contributed 24.2% of revenue and 14.2% of operating profit for FYE 2013 (20.9% and 11.9% respectively for FYE 2012). Imperial's commercial interests in Europe, the UK, Australia, the United States of America and Africa create a geographically diversified business. The diversification renders Imperial's combination of activities relatively resilient to external factors such as global economic downturns and currency volatility, although it remains highly exposed to the South African economy and its political, social and economic environment.

Imperial is structured around three business pillars: (1) Logistics, which includes the African and International divisions; (2) Automotive and Industrial, which includes the Distribution, Retail and Allied Services, Automotive Retail divisions along with other segments such as Car Rental and Autoparts and; (3) Financial Services, which includes Insurance and other Financial Services. The business model comprises a mix of mostly related businesses operating in a common value chain around the transport and mobility sectors. Imperial's strategy is to extract the maximum value from identifying synergies and the cross-selling of different business solutions available across its value chain.

**OPERATING MARGINS AFFECTED BY FOREIGN EXCHANGE DEPRECIATION, PRODUCTIVITY DISRUPTIONS AND COST INFLATION IN SOUTH AFRICA**

Trading environment in South African continues to remain challenging with softer volume growth on new vehicle sales expected over the next 12 months. The weaker demand environment is expected to intensify competition and limit pricing power on new vehicles. However, Imperial's exposure to the used vehicle market and autoparts (benefits from approximately 10 million vehicles on the road) is likely to offset the weaker profit from new cars.
The risks to exchange rate volatility, industrial action and above inflationary wage increases are key challenges facing the Group in South Africa. While future exchange rate movements are unpredictable we note that the rand depreciation against major currencies experienced during first half of 2013 (17% to the US dollar and 15% to the Euro) placed negative pressure on the Group's margins in FYE 2013. In particular, it increased its costs of importing its major motor brands Kia and Hyundai which could not be fully passed on to the consumer. This was mitigated to some extent by hedging strategies employed but is unlikely to mitigate longer term Rand weakness without passing the cost increases onto the consumer, an element which will pressure Imperial's market share and value proposition. We note however that Imperial's foreign operational exposure does provide an element of protection against a weaker Rand as foreign cash flows benefit from translation gains.

The other key challenge facing Imperial is industrial action in South Africa and its negative ramifications being an ongoing challenge faced by many sectors in the country. Imperial’s Logistics division was negatively affected by industrial action which took place in the second quarter of FYE 2013. We expect this risk to reduce given Imperial has been successful in negotiating a two year wage agreement with its key unions at moderate above average inflation wage increases of 8% per annum.

We note that Imperial has embarked on a number of efficiency and cost saving initiatives which should help reduce the above cost pressure facing the Group.

RATING INCORPORATES BOLT ON ACQUISITIONS AND HIGHER LEVERAGE GOING FORWARD AND RECOGNISES MANAGEMENT’S PRUDENT FINANCIAL POLICIES

Imperial’s stated growth plans include a number of strategic acquisitions, similar to the Lehnkering logistics acquisition in Germany and the pharmaceutical logistics-related acquisition of Imperial Health Sciences (previously RTT Health Services) in Africa, as well as increased levels of capital expenditures as the Group invests in new capacity and replacement of its fleets. We view Imperial’s investment in the German company as favourable with Germany (Aaa/ Negative) being a stable mature market, and less exposed to economic instability compared to many of its European neighbours, although still affected by the slowdown in the European economy. Imperial’s growth plans are focused in the logistics industry and product distribution. Imperial’s strategy of following its customers into new geographies is viewed favourably, as the Group is entering new countries with a known demand for its products already.

Imperial aims to grow its operations in Africa through acquiring large, well-run, established family-owned businesses, which we view favourably as it protects the Group from the risks associated with greenfield projects in Africa. We note that although Africa is a volatile, challenging market to operate in, we acknowledge there is a lot of growth potential on the continent.

Moody’s current rating has a degree of flexibility to accommodate further strategic acquisitions that might increase its current leverage or pressure its key financial metrics. However, each acquisition would be evaluated on a case-by-case basis in order to determine the strategic fit of the potential acquisition, its cash flow and margin contributions, as well as any integration risks the Group may face. To the extent that further acquisitions are considered, it is our expectation that management will continue to follow its prudent financial policies and maintain a solid focus on cash flow generation, capital management and liquidity management at all times. Shareholder remuneration is expected to also be approached in a prudent manner.

Liquidity

Imperial’s liquidity position is sufficient to meet near term obligations, supported by the large availability under committed facilities of approximately ZAR4.4 billion, with sufficient covenant headroom, together with a substantial cash position (ZAR1.8 billion as of 30 June 2013) and cash generation capabilities. The company also has a large part of its ZAR13.5 billion domestic medium-term note programme available. The company’s debt maturity profile comprises a well staggered tenor of repayments.

Imperial funding profile is split 60% local currency (Rand) and 40% foreign currency (predominately Euro) as of FYE 2013. This compares to approximately 85% of EBITDA generated in South Africa and the balance from the rest of Africa and rest of the world. The mismatch between foreign currency debt and cash flows is not hedged exposing itself to foreign exchange risk should the Rand depreciate.

Structural Considerations

Imperial’s euro-denominated senior unsecured banking facility is issued from Imperial Mobility Finance B.V. and
Imperial’s euro-denominated senior unsecured banking facility is issued from Imperial Mobility Finance B.V. and guaranteed by both Imperial Mobility International B.V. (an offshore holding company - wholly owned by Imperial - established for its international operations) and Imperial Holdings Limited.

Compared to all other existing debt at the Imperial Group, the banking facility benefits from an additional upstream guarantee from Imperial Mobility International B.V., which in our view is not deemed to be a strong enough difference in terms of guarantee package to consider any notching implications.

Rating Outlook

The stable outlook on the ratings of Imperial Group Ltd and Imperial Mobility Finance B.V. reflects Moody’s expectation that Imperial’s credit profile will continue to be well positioned within the Baa3 rating category despite the group’s growth plans.

What Could Change the Rating - Up

Upward pressure could be exerted on the ratings or outlook of Imperial’s subsidiaries if Imperial were able to (1) maintain an Retained Cash Flow to Net Debt ratio above 25%, on a sustainable basis; (2) maintain stable and improving operating margins; and (3) achieve increased debt protection levels, such that Imperial's (Funds From Operations + Interest Expense)/Interest Expense were to exceed 4.0x on a sustainable basis. Moody’s notes that the current metrics were achieved in Imperial's latest financial year, ended 30 June 2013. However, the credit metrics incorporates flexibility to accommodate a range of strategic initiatives including debt funded acquisitions. Any debt funded acquisitions would nevertheless have to be assessed in terms of its impact on Imperial's business risk profile, overall capital structure and how it fits strategically in the group. All metrics are according to Moody’s standard adjustments and definitions.

What Could Change the Rating - Down

Negative pressure could be exerted on the ratings or outlook of Imperial's subsidiaries as a result of (1) weakness in Imperial's operating performance, resulting in lower debt protection measures, with (Funds From Operations + Interest Expense)/Interest Expense sustainably below 4.0x, or lower operating margins; (2) an average Retained Cash Flow/Net Debt ratio that trends below 20% on a prospective basis, considering past and expected future performance; (3) debt protection measures weakening, and a failure to adjust financial policies and cost structure such that Imperial generates positive free cash flow on a sustained basis through conservative capital expenditure and adjusted shareholder remuneration policies.

RATING METHODOLOGY

Given Imperial's broad product offering, there is no specific Moody’s Rating Methodology that can be applied to Imperial. As a result, Imperial does not have any direct peers. The Bidvest Group is used as the closest national peer but it is not seen as a direct peer as its operations are not directly comparable to Imperial's.
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