

## Equitable Mortgages Ltd.

### Rationale

The counterparty credit ratings on Equitable Mortgages Ltd. (EML) reflect the combined strength of the New Zealand Equitable (Equitable) group. EML is considered core to the Equitable group. Equitable is a New Zealand non-bank finance group demonstrating long-standing expertise in commercial-property lending. The ratings are supported by the group's focus on first-mortgage lending and its supportive principal shareholder. These strengths are offset by Equitable's mediocre asset quality, significant concentration in large counterparty borrowers and in commercial property assets; and lean management structure.

Equitable's creditworthiness is enhanced by its position as a first-mortgage non-bank property lender in a sector dominated by second-mortgage financiers. Equitable's average level loan-to-value ratio (LVR), at around 65% of its lending book, reasonably positions the group to withstand a moderate decline in underlying security values before material credit losses eventuate. The average LVR across the portfolio has increased, however, from 57% in November 2007, due to a decline in underlying asset values.

Equitable's rating benefits from being ultimately owned by interests associated with the Spencer family. Tangible support is provided by Equitable General Insurance Co. Ltd (EGIC) (wholly owned by the Spencer family, Not Rated) which provides protection against higher lending losses in the form of credit insurance to Equitable. EGIC is able to absorb up to NZ\$10 million of lending losses—a level well in excess of those anticipated to materialize in the short term. More generally, Equitable is believed to have access to additional support, including capital and liquidity support, from its principal shareholder above that recently provided to Equitable.

Equitable's creditworthiness is adversely affected by its weak asset quality. The group's arrears as a proportion of total loans are very high, having increased substantially over the last couple of years as New Zealand's economy entered recession. Moreover, the downturn in the New Zealand commercial property market, lack of third-market financing alternatives, and poor property investor confidence has contributed to significant slippage in

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BB/Negative/B

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Equitable's realization of security in its portfolio of loans in arrears. As a consequence, a material proportion of loans are more than 90 days in arrears.

With only about 20 staff managing a loan book of about NZ\$180 million, Equitable is considered to have a very lean personnel structure that emphasizes key-person risk. Furthermore, the group is considered complex with a variety of legal structures evident across its companies.

Equitable has significant counterparty credit exposure with the top-six such exposures accounting for close to 60% of Equitable's loan book at May 31, 2009. While a concentration of large exposures creates additional credit risks, these are mitigated, to an extent, by generally manageable loan-to-value exposures and by normally having security over separate assets for loans by each counterparty.

#### *Short-term credit factors*

The short-term rating on EML is 'B'. Liquidity and access to funding lines are adequate, noting that Equitable is set to reduce its liquidity facilities to NZ\$30 million, from NZ\$125 million, which will afford it less liquidity capacity in the event of need. The Equitable group also enjoys a good duration and maturity profile of its retail funds across its three issuers.

### **Outlook**

The negative outlook reflects the pressure on Equitable's financial profile given that unfavorable economic conditions may further increase arrears and delay realization of poor quality assets. If support mechanisms (for example from EGIC or the shareholder) to absorb loan losses are not working or proved inadequate, the long-term ratings will likely be lowered, potentially by two or more notches. A significant operation loss would also put downward pressure on the rating as would a large and unexpected credit loss from the group's "core" portfolio. Moreover, if earnings were to substantially deteriorate, a ratings downgrade would be considered. Given the challenging operating conditions, a ratings upgrade is extremely unlikely in the short-to-medium term in the absence of a material shareholder injection of support.

Following the securing of the New Zealand Crown guarantee for debentures issued by Equitable Mortgages Ltd. on Dec. 4, 2008, Equitable's debenture reinvestment rates and new funds received have markedly improved. While this short-term improvement supports credit quality, Standard & Poor's will continue to monitor any indicators of investor confidence—such as reinvestment rates and new investment trends—as well as the continuing support and confidence of bankers and other stakeholders, including Equitable's principal shareholder.

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