Ellerines bad debts hurting African Bank

By Maarten Mittner

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The decision to radically restructure African Bank Investments Limited (Abil) and put the Ellerines furniture business on the block, follows a significant deterioration in the financial position of Ellerines in the first half of this year.

After Abil saw its earnings fall for the interims to March, and its share price diving 60% over the past 12 months, corrective actions were taken in the hope it could stage a turnaround. These included writing off more bad debt, focusing on lower risk customers and curtailing advances. But that has proven not to be enough, with Ellerines continuing to be a drag on the group.

First highlighted by ratings agency Moody's last month, it has become clearer to Abil management that the group would have to face another financial shock and potentially more severe deterioration in the company's asset values in the September annual results if it continued on the present path.

Although the Ellerines lending portfolio accounted for only 16% of the gross loan book, signs of stress were already evident in the six months to March. The provisioning ratio to loss-making loans at Ellerines increased to 20.3% from 14.7% in the same period in 2012, materially higher than the overall 12.1% provisions on average gross loans by the group.

Capital being depleted

What further complicated matters was that after March, African Bank also started to experience strain as it curtailed advances. Growing bad debt put African Bank's profits under renewed pressure. This raised serious questions over whether the group would have been able to carry the Ellerines losses for the rest for the year.

With capital already depleted by the 60% drop in the share price, as well as relatively higher interest rates payable on yields on corporate bonds issued after March, Moody's emphasised there was limited potential for the group over the next 12 to 18 months.

Although the group's capital was theoretically sound, Abil's relatively low provisioning coverage of 60% for non-performing loans, added a new problem, as bad debt at Ellerines was expected to climb further. The present level of non-performing loans already means one-in-three loans ends up as bad debt.

With Ellerines showing headline earnings of R257m or 9% of the group's end-March earnings, Abil's low coverage of non-performing loans stood out against the 153% specific and general provisioning at Capitec and a comparable 75% and 80% at Standard Bank and FirstRand respectively.

Abil should have increased non-performing loans coverage as a loss was expected for Ellerines in the full 2013 year. Its coverage is significantly lower than the 70% and 69% for 2008 and 2009 respectively.

Strong growth waned

The original takeover of Ellerines in 2009 for R9.1bn by African Bank seemed like a good idea at the time.

African Bank had seen strong growth in the boom years between 2004 and 2008. However, with the intended implementation of the National Credit Act (NCA), African Bank had to prepare itself for lower interest income emanating from the capping requirements stipulated in the act.

At the time, taking over a retail franchise could open new doors for Abil with loans extended to customers entering Ellerines stores to buy furniture. It was even speculated at the time earnings from Ellerines could surpass those of African Bank itself.

The problem was that founder Eric Ellerine did not intend to sell cheaply. And before the transaction was concluded Ellerines embarked on a lending spree of its own, saddling African Bank with a renewed bout of bad debt, only later uncovered by chief executive Leon Kirkinis and his team.

"It was a lesson in humility for us," Kirkinis conceded earlier this year.

Over the past five years many steps were taken to turn Ellerines around, among others closing stores and axing more than 2,000 jobs. A huge new distribution warehouse was built near Boksburg, with state-of-the-art technology. The eventual lack of demand from indebted consumers for furniture made this venture hopelessly unprofitable, symbolising the futile efforts of Kirkinis and his team to make Ellerines a large profit contributor to the group.