

# CFO's Report



## Introduction

This is the first annual report for the FNB Namibia Holdings Group (Group) that includes the results of the Swabou Group of Companies (Swabou) following the merger that became effective on 1 July 2003. The main components of the merger were Swabou Bank, Swabou Life Assurance Company (Swabou Life) and Swabou Insurance Company (Swabou Insurance). The financial results of the Group are therefore not directly comparable with the previous year.

The relative pre-tax contributions of the component companies are set out in the table below:

	2004		2003	
	N\$ million	%	N\$ million	%
Banking Operations	218.6	89.9	247.7	100
Life Insurance Operations	15.2	6.3		
Short term Insurance Operations	9.3	3.8		
<b>Net income before tax</b>	<b>243.1</b>	<b>100</b>	247.7	100

The Group's risk profile has significantly improved with the introduction of the insurance operations, resulting in a more diversified income stream. This is clearly evident from the table above. It illustrates the benefit gained from the insurance operation's income against the negative impact of the decline in interest margins. All merger costs are included under Banking Operations.

The net asset value (NAV) of the Group now exceeds N\$1 billion, reflecting a compound growth of 26% (16% excluding Swabou) over the past five years as shown in the adjacent graph :

## Overall review

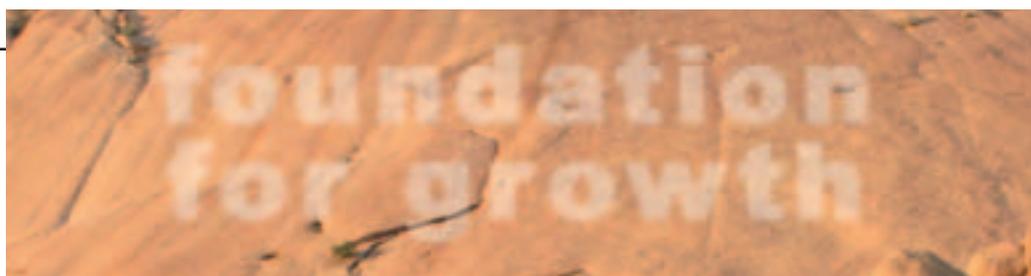
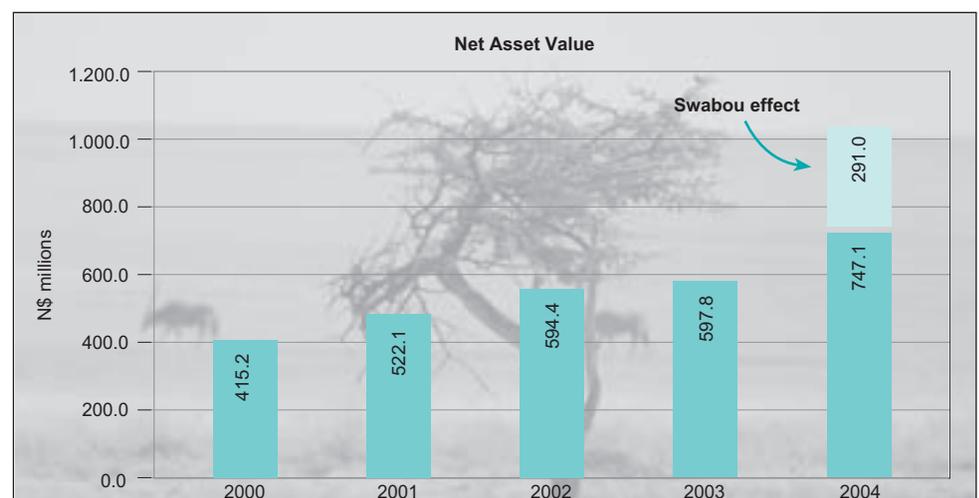
### Prior year restructuring

The Group was restructured to create a holding company housing the banking, life insurance and short term insurance operations in separately regulated legal entities. In terms of the Banking Institutions Act of 1998, the banking operation is not allowed to hold a direct interest in insurance operations.

The listed company, First National Bank of Namibia Limited, was renamed FNB Namibia Holdings Limited (FNBH) and the banking operation sold to a newly-formed company called First National Bank of Namibia Limited (FNB). FNBH handed

back its banking licence and a banking licence was issued to FNB on 1 June 2003.

The net asset value of the Group now exceeds N\$1 billion



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One result of this restructuring was the creation of a deferred taxation asset of N\$80 million arising from the sale of the FNB trademark to FNB. The value of this trademark eliminates on consolidation. As indicated in the trading update issued in July 2004, the 2003 annual report and December 2003 interim report, the benefit from the sale of the trademark resulted in higher after-tax profits for the 2003 financial year.

The once-off tax benefit was not adjusted in headline earnings in the previous year in conformity with GAAP. A core operational earnings figure was disclosed to give stakeholders a better indication of the sustainable profit base.

## Effect of the Swabou transaction

The effective date of the merger with Swabou was 1 July 2003, following the satisfaction of the conditions stipulated in the merger agreement. The migration of customer accounts was successfully completed by mid-October 2003.

The section 311 scheme of arrangement, with an effective date of 1 July 2003, was sanctioned by the High Court on 23 September 2003. The purpose of the scheme was to transfer the banking business, excluding home loans and immovable properties, from Swabou Investments (formerly Swabou Bank), to the newly formed FNB. The scheme of arrangement was also designed to identify all unknown creditors and liabilities on the effective date of the transaction. No

material additional liabilities were identified. Also refer to Directors' Report.

On 30 June 2004, an amount of N\$53.9 million was allocated from the preference share capital of N\$108.8 million to intangible assets. This amount represents an estimated value of the preference shares which will not convert at the end of the ring-fenced period (which cannot exceed five years from 1 July 2003).

The excess of the purchase price over the net asset value acquired was N\$153 million. The Swabou trademark was valued at N\$143 million. The above-mentioned estimated amount of N\$53.9 million was offset against the trademark value for accounting purposes in compliance with GAAP.

The effect of the estimated conversion of the preference shares to ordinary shares was taken into account in the calculation of diluted earnings per share.

## Compliance with accounting standards

The accounting policies of the Group have remained consistent with the prior year, except in one instance. The FNB Share Incentive Trust was consolidated for the first time this year. The effect was to reduce the equity figure by the shares held by the Trust (1.7 million shares issued at N\$4 per share). The dividend received by the Trust was also eliminated from dividends paid on Group level.

Significant portfolio provisions were created in the current year in terms of AC

133. These were calculated using statistical models representing the reduced expected future cash flow directly attributable to credit risk as a result of the current position in the interest rate cycle. A significant portion of the portfolio provision was created from general provisions already held in terms of Bank of Namibia requirements and provisions taken over from Swabou.

## Overall view of results for the year

Total Group assets have increased by 51% to N\$7.2 billion (2003: N\$4.7 billion). Some N\$2 billion arose from the merger with Swabou.

Group results for the year are in line with expectations of management and the industry, given the external and internal factors affecting the operating environment. Core operational earnings increased from N\$159 million to N\$174 million, representing a 9% increase over the prior year. The higher cost-to-income ratio in the current year is mainly attributable to a lower interest income (a result of the decrease of 500 basis points in the prime lending rate in the first half of the financial year). In addition, the repricing ability of a substantial portion of the Swabou deposit base was negatively impacted by its large exposure to fixed deposits.

The once-off costs of N\$10 million, directly attributable to the merger, were adjusted on a core operational earnings level to arrive at a sustainable income for the financial year.

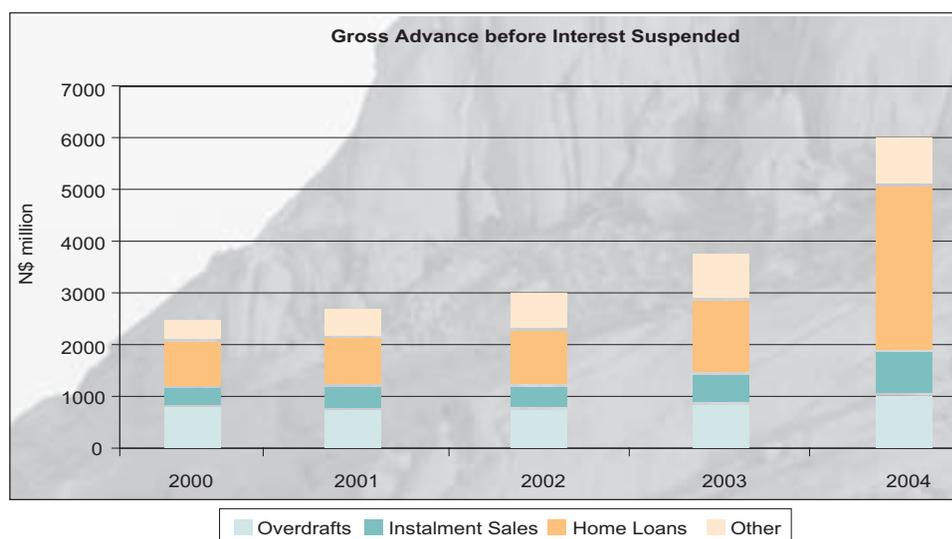
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## Banking operations

### Asset base

Growth in advances was accelerated in the closing months of the year as management was once again able to focus outwards after the successful completion of the merger. Net advances exceeded N\$5.8 billion, reflecting a year-on-year growth of 64%. Of this, 47% is attributable to structural changes (Swabou) and 17% reflects organic growth.

The compound growth in gross advances over the last five years is 25% (15% excluding Swabou). The adjacent graph illustrates the composition of advances for the current year compared to previous years.



### Impairment of advances and non-performing loans

The current year's specific impairment charge for advances of N\$11.7 million (2003: N\$7.2 million) has been maintained at a very low level of 0.2% of gross advances, reflecting the continued healthy profile and quality of the Bank's lending portfolio.

The full impact of the AC133 requirements in the prior and current year is illustrated in the adjacent table. Taking into account the unwinding of the discounted present value (PV) of the non-performing loans (NPL) and off-market loans (included in the net interest income total), the resultant income statement effect was a net decrease of N\$2 million in impairment and interest costs for the year.

<b>2004</b>			
	Net interest income	Impairment charge	Total
N\$'000			
Unwind of discounted PV on NPL's	8 574		8 574
Unwind of discounted PV on off-market loans	8 315		8 315
Increase in impairment of PV of NPL's		(3 853)	(3 853)
Increase in impairment on off-market loans		(7 407)	(7 407)
Net charge in specific bad debt impairment		(11 697)	(11 697)
<b>Net effect</b>	<b>16 889</b>	<b>(22 957)</b>	<b>(6 068)</b>
<b>2003</b>			
	Net interest income	Impairment charge	Total
N\$'000			
Unwind of discounted PV on NPL's	1 096		1 096
Unwind of discounted PV on off-market loans	2 440		2 440
Increase in impairment of PV of NPL's		(1 377)	(1 377)
Increase in impairment on off-market loans		(2 994)	(2 994)
Net charge in specific bad debt impairment		(7 226)	(7 226)
<b>Net effect</b>	<b>3 536</b>	<b>(11 597)</b>	<b>(8 061)</b>

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The Bank's policy on determining and classifying non-performing loans, as well as the suspension of interest on non-performing loans and the provision for bad and doubtful debts exceeds the minimum requirements of Determination 2 of the Banking Institutions Act.

The ratio of non-performing advances to gross advances, at 4.3%, is higher than the 2.7% of 2003, as illustrated in the graph below. This does not indicate deterioration in credit quality, but is directly related to the inclusion of the CSIB book, including its provisions as acquired. Once the CSIB book has been cleared, we expect the positive trend to continue.

The Bank's capital adequacy ratio is 21.2% compared to 19.9% at 30 June 2003. See detailed analysis on page 81.

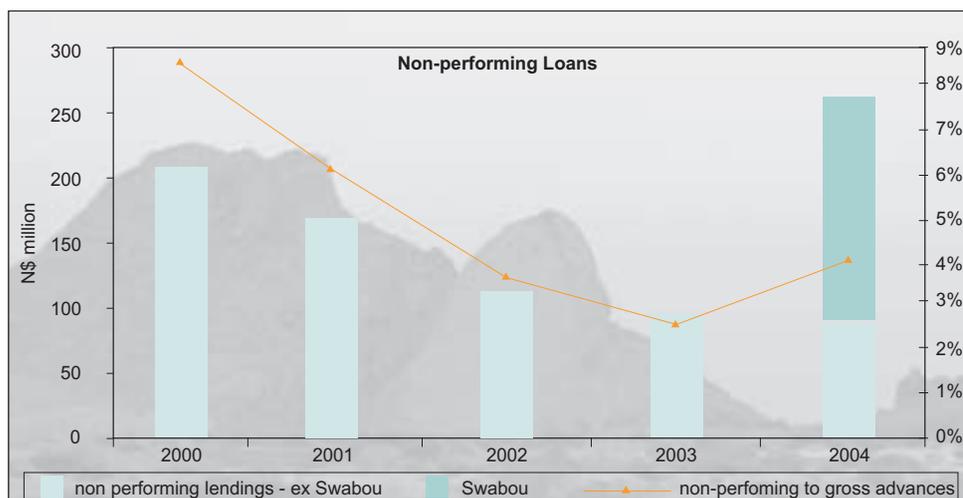
Capital of the Bank is currently not maintained at an optimal level mainly because Bank of Namibia regulations permit banks to appropriate profits to retained earnings only once a year or on completion of a full audit. Additional capital therefore needs to be maintained to accommodate balance sheet growth during the year.

### Operational efficiency

Non-interest income grew by 11.5% and, as a percentage of total income, non-

especially exports to Angola. Exchange earnings contributed 12% to non-interest income compared to 16% a year ago.

The year-on-year increase in operating expenses of 51% was significantly affected by expenses associated with the merger. In addition, the prior year is not comparable as it excludes Swabou and merger related expenses. When operating expenses are expressed as a percentage of total assets, the figures are 4.75% in the current year against 4.78% the previous year. The decision to reduce the useful life of computer and office equipment from five years to three resulted in an additional depreciation charge of N\$8.3 million in the current year.



### Capital adequacy

The prescribed capital determinations of Bank of Namibia, require banks to maintain a minimum Tier 1 ratio of 7% and a minimum total ratio of 10%, based on the risk-weighted assets and off balance sheet transactions.

interest income decreased from 37.5% to 34.5%. This decrease is in line with the change in structural mix of the balance sheet as home loans are not strong generators of transactional fees. Exchange earnings decreased by 20% as a result of weak international trade,

Certain expenses included under operational costs were incurred only because of the merger. One condition was that non-managerial staff would not be retrenched. This had an adverse effect on the salary costs. There were other indirect merger-related costs that will be properly synchronised with income generation in future years. An example is rental commitments of the old Swabou Group.

The squeeze on interest margins had the highest impact on the cost-to-income ratio – the 45.9% reported last year increasing to 56.5%. The high margins of the past are not expected to be achieved again.

The Swabou trademark was valued at N\$143 million. For accounting purposes this value was adjusted for goodwill

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created on consolidation and the effect of the portion of convertible preference share capital that will not convert. The adjusted accounting value is amortised to the income statement over 11 years.

## Insurance Operations

### Swabou Life Assurance Company

The free reserves of the Swabou Life Assurance Company were N\$20.5 million at acquisition and have increased to N\$33.7 million as at 30 June 2004. The capital adequacy requirement (CAR) of N\$12.9 million (2003: N\$15.3 million) was covered 2.6 times (2003: 1.3 times) by this excess.

The analysis of the main components of the company's embedded value is set out in the following table:

N\$'000	30 June 2004	30 June 2003	Increase
Shareholders' net assets	26 876	11 153	15 723
Value of in force business	85 071	66 211	18 860
<b>Embedded value</b>	<b>111 947</b>	<b>77 364</b>	<b>34 583</b>

The embedded value, as calculated, is an estimate of the potential value of the existing business of Swabou Life at the valuation date. The value is dependent on Swabou Life's actual experience with regard to expenses, mortality, investment yields, lapse rates and other assumptions.

Included in the N\$34.6 million increase in embedded value is an amount of N\$17.7 million that represents the value of new business.

### Swabou Insurance Company

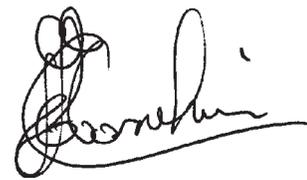
Gross premium income of N\$44.3 million (2003: N\$44.7 million) has left the company with an after-tax profit contribution of N\$6.7 million. Operational challenges included implementing a new system and losing personnel in key positions. The situation is receiving

attention from management and will be rectified as a matter of urgency.

Swabou Insurance Company has a strong retail banking division as its base for premium income. This will be a point of focus for future cross-selling.

## Concluding Remarks

The main aim this year was to lay the foundation for future growth by containing the risks associated with a merger of this magnitude. Because this was achieved, the Group is now better positioned to mitigate the risks attached to strong organic growth and to achieve sustainable earnings.



Gideon Cornelissen