

MOODY'S

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Credit Opinion: Capitec Bank Limited

Global Credit Research - 01 Apr 2015

Stellenbosch, South Africa

Ratings

Category	Moody's Rating
Outlook	Stable
Bank Deposits	Ba2/NP
Baseline Credit Assessment	ba2
Adjusted Baseline Credit Assessment	ba2
NSR Issuer Rating -Dom Curr	Baa1.za
NSR ST Issuer Rating -Dom Curr	P-2.za

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Key Indicators

Capitec Bank Limited (Consolidated Financials)[1]

	[2]2-14	[3]2-13	[3]2-12	[3]2-11	[3]2-10	Avg.
Total Assets (ZAR million)	46,188.5	38,338.2	23,583.1	14,498.1	9,506.8	[4]48.5
Total Assets (USD million)	4,299.9	4,272.8	3,165.4	2,089.3	1,240.4	[4]36.5
Tangible Common Equity (ZAR million)	9,301.8	7,908.7	4,522.1	2,927.3	1,417.3	[4]60.1
Tangible Common Equity (USD million)	866.0	881.4	607.0	421.9	184.9	[4]47.1
Problem Loans / Gross Loans (%)	6.5	5.8	5.1	5.7	6.2	[5]5.9
Tangible Common Equity / Risk Weighted Assets (%)	31.2	28.1	28.1	30.1	24.5	[6]31.2
Problem Loans / (Tangible Common Equity + Loan Loss Reserve) (%)	16.8	16.7	15.3	16.6	19.4	[5]17.0
Net Interest Margin (%)	-	-	-	16.9	17.6	[5]17.2
PPI / Average RWA (%)	22.7	21.8	23.1	21.6	23.5	[6]22.7
Net Income / Tangible Assets (%)	4.4	4.0	4.1	3.2	3.7	[5]3.9
Cost / Income Ratio (%)	32.7	39.2	47.1	55.3	58.7	[5]46.6
Market Funds / Tangible Banking Assets (%)	12.4	11.5	12.6	15.6	23.7	[5]15.2
Liquid Banking Assets / Tangible Banking Assets (%)	31.4	24.0	24.4	26.4	40.6	[5]29.4
Gross Loans / Total Deposits (%)	125.5	141.2	134.7	140.6	113.9	[5]131.2

Source: Moody's

[1] All figures and ratios are adjusted using Moody's standard adjustments [2] Basel III - fully-loaded or transitional phase-in; IFRS [3] Basel II; IFRS [4] Compound Annual Growth Rate based on IFRS reporting periods [5] IFRS reporting periods have been used for average calculation [6] Basel III - fully-loaded or transitional phase-in & IFRS reporting periods have been used for average calculation

Opinion

SUMMARY RATING RATIONALE

Capitec Bank's deposit ratings of Ba2/Not-Prime are based on the bank's ba2 baseline credit assessment (BCA), which balances its credit strengths, among which are its growing deposit base and solid liquidity levels, strong loss-absorption capacity and relatively prudent underwriting and provisioning policies, against the credit challenges posed by a challenging domestic operating environment and credit concentration to the unsecured lending market.

The ratings do not incorporate any assumptions of systemic support, reflecting our view that there is a low probability authorities will fully protect senior creditors and depositors, if needed.

CAPITEC'S RATINGS INCORPORATE SOUTH AFRICA'S MODERATE MACRO PROFILE

Despite the cyclical downturn in the unsecured lending market, banks in South Africa (including Capitec) benefit from operating in a well developed financial system with a deep domestic capital market, a fairly large economy (\$350 billion), with abundant natural resources and a coherent macroeconomic policy formation. The country's economic strength however, is moderated by relatively low average incomes attributable to wide income disparities. Susceptibility to event risk also stems from the domestic political situation and from high levels of unemployment. Additionally, the banking system has a high funding dependence on short-term wholesale deposits and has to contend with a highly-leveraged household base.

Rating Drivers

- Capitec's ratings incorporate South Africa's Moderate macro profile
- Capitec remains exposed to challenges in South Africa's unsecured lending market, although sound underwriting supports its asset quality
- A strong loss-absorption capacity, underpinned by solid capitalization and comprehensive provisioning
- Resilient profitability, supported by a successful niche franchise and growing customer base
- Despite elevated wholesale funding challenges, we expect Capitec to continue growing its retail-funded profile and maintain a prudent liquidity management

Rating Outlook

All ratings carry a stable outlook.

What Could Change the Rating - Up

Upward pressure on the bank's ratings outlook could develop if risks within the operating environment subside and the bank is able to maintain its sound financial fundamentals. A further diversification of its revenue sources, including through continued expansion of its transactional banking franchise, as well as a broadening of its asset mix would also add positive momentum to the ratings.

What Could Change the Rating - Down

Downward pressure on Capitec's ratings could develop if asset-quality pressures adversely affect the bank's capital base and earnings power, or if its funding profile weakens.

DETAILED RATING CONSIDERATIONS

CAPITEC REMAINS EXPOSED TO CHALLENGES IN SOUTH AFRICA'S UNSECURED LENDING MARKET, ALTHOUGH SOUND UNDERWRITING SUPPORTS ITS ASSET QUALITY

Despite the gradual diversification of Capitec's revenue base, its credit profile remains constrained by the bank's narrow, undiversified lending focus on the unsecured market (which makes up the bulk of its loan book). This concentration leads to high inherent credit risks (a derivative of the high-risk product range of unsecured personal loans to lower- and middle-income earners), which in addition to South Africa's challenging economic conditions, continue to lead to elevated asset quality risks.

Nevertheless, we expect potential asset quality pressure to remain manageable. Capitec's adequate centralised collections capabilities and risk management practices have been calibrated to deal with the current challenging operating environment. Its credit assessment process is based on a regression model that includes (1) client historic credit behaviour; (2) an affordability assessment; (3) recent cash flow trend analysis; (4) an employer

grading system as an indication of employment stability; and (5) a forecast of clients with an unrestrained credit appetite. Other factors mitigating credit risks include third-party credit life and retrenchment insurance. We finally note that around 50% of Capitec's portfolio is granted to government employees, which have historically shown lower arrears.

As a consequence, the bank's asset quality metrics have improved during the fiscal year ended February 2015 (FYE2015). Loan loss provisioning expenses declined to 11.5% of average gross loans (or 54% of pre-provision income), compared to 12.4% during FYE2014, although they are high compared to around 1.0% for conventional banks in South Africa. We consider this metric as a better indicator of Capitec's high inherent credit risk. While we also monitor problem loans, they do not capture the true loss content of unsecured loans due to the bank's aggressive write off policy, whereby problem loans are written off after 90 days. Capitec's problem loans (loans in arrears by more than 1 day) improved to 5.4% of gross loans as of FYE2015, compared with 6.5% as of FYE2014, while problem loans, including rescheduled loans, also improved to 7.8% as of FYE2015, from 8.7% as of FYE2014.

A STRONG LOSS-ABSORPTION CAPACITY, UNDERPINNED BY SOLID CAPITALIZATION AND COMPREHENSIVE PROVISIONING

At the same time, the ratings capture Capitec's strong loss-absorption capacity, demonstrated by its high capitalisation levels and comprehensive provisioning policy.

While Capitec's capital levels have declined during FYE2015, they remain high and our scenario analysis suggests that capitalisation remains a fundamental strength of the bank. As of FYE2015, Capitec Bank reported a common equity Tier 1 ratio of 29.1%, down from 29.9% as of FYE2014. Nevertheless, we caution that the higher-risk nature of Capitec's business profile and target market warrant an ample capital cushion, and we expect the bank to maintain higher capital compared to the larger, more diversified, South African banks. This means that the bank's excess capital buffer is actually less than what would have been the case for other commercial banks.

We also believe that Capitec's comprehensive provisioning policy supports its strong loss-absorption capacity. In order to capture a degree of future unforeseeable event risk or economic uncertainty, the bank (1) fully provides for all loans over 90 days past due (which are written-off, as mentioned above); (2) actively applies conservative provisioning policies both for unseasoned longer-term loans (to account for the lack of any reliable historical loss rates) and for rescheduled loans; and (3) has supplemented the model generated provision with overlays of ZAR 264 million. As a consequence, Capitec maintains a relatively high general provision and the total loan loss reserves accounted for 10.6% of gross loans as of FYE2015, equivalent to 196% of all loans in arrears (between 1-90 days).

RESILIENT PROFITABILITY, SUPPORTED BY A SUCCESSFUL NICHE FRANCHISE AND GROWING CUSTOMER BASE

We expect Capitec to maintain its historically strong overall profitability, amid a successful niche franchise, the high margins earned in its high-risk, high-return, market segment, and a strong growth in transactional banking income, with the potential to further grow its customers and product offering. This is in spite of potential pressure on profitability stemming from caps on interbank and merchant fees. However, we also note that investor profitability expectations are high for unsecured lenders which requires Capitec to maintain a stronger profitability than other commercial banks.

During FYE 2015, the bank's net income-to-average assets ratio stood at 4.9% (up from 4.7% as of FYE2014), its pre-provision income (PPI)-to-average assets ratio stood at 14.9% (down from 15.9% as of FYE2014), the cost-to-income ratio stood at 36% (up from 32% as of FYE2014), while net transactional, fee-based income covered over 65% of operating expenses. We expect the bank to sustain efficiency metrics close to current levels as it remains cost conscious.

Capitec's successful niche franchise is underpinned by a simplified, low-cost, single-banking solution which has been gaining appeal with South Africa's consumers, while its paperless, straightforward, technology-driven business model enables it to provide a low-cost and efficient service, with rapid application processes and an improved service level. We estimate its unsecured personal loan market share (including cards and overdrafts) at around 11.9% as of January 2015, slightly up from 11.2% in January 2013 (based on bank BA900 disclosures). Its market share stands at 19.7% as of January 2015, if we exclude cards and overdrafts, which Capitec currently does not offer.

At the same time, Capitec's growth and revenue diversification remains supported by an expanding transactional

banking customer base and an increasing distribution network in malls and higher end-shopping centers, which has allowed the bank to attract higher income individuals and more directly compete with the larger South Africa banks. As of February 2015, Capitec had over 6.2 million active clients, a 16% increase from February 2014, out of which 2.8 million used Capitec as their primary bank to deposit salaries and make payments, a 26% increase from last year. The bank can potentially leverage on its increasing transactional banking customers to further grow its franchise and earnings by cross-selling complementary products and services, thereby further diversifying revenue and operations.

DESPITE ELEVATED WHOLESALE FUNDING CHALLENGES, WE EXPECT CAPITEC TO CONTINUE GROWING ITS RETAIL-FUNDED PROFILE AND MAINTAIN A PRUDENT LIQUIDITY MANAGEMENT

An increasing transactional customer base, which leads to an increasing retail deposit base, has also allowed Capitec to reduce funding concentrations and strengthen its retail funding profile. As of February 2015, retail deposits accounted for ZAR30.0 billion (or 73% non-equity funding, the highest level amongst rated South African banks), listed senior bonds accounted for around ZAR4.9 billion, subordinated debt for ZAR2.9 billion, with local and international bilateral loans accounting for the remainder. The bank had a 4.5% market share of household deposits as of January 2015 and it continues to grow its market share in household deposits. As a consequence, funding concentrations have been gradually reduced (top 20 depositors and funders accounted for less than 20% of total, down from 50% as at FYE2010).

As such, although wholesale funding conditions remain tough, amid higher spreads and a lower availability, Capitec's funding profile will likely remain sound. Its profile is further supported by no reliance on short-term maturity wholesale funding, with wholesale maturities reasonably spread out over the next four calendar years, and a solid liquidity profile. Although we adjust its funding profile to include institutional deposits as part of market funding, its total reliance on market funding remains moderate at 15% of tangible banking assets as of February 2015. Capitec already complies with the Basel III liquidity ratios, while liquid assets (at around 37% of total assets as of February 2015) should remain high owing to (1) muted retail loan growth; (2) continued retail deposit growth; and (3) the bank's prudent internal liquidity management policy.

Notching Considerations

GOVERNMENT SUPPORT

We assign global deposit ratings of Ba2/Not-Prime to Capitec, in line with its ba2 BCA. The ratings do not incorporate any assumptions of systemic support, reflecting our assessment of a low probability of systemic support to fully protect senior creditors and wholesale depositors, if needed. In our view, the South African Reserve Bank's willingness to proceed with a burden-sharing restructuring plan for African Bank Limited, involving debt holders and wholesale depositors, is a clear indication of a reduction in the likelihood of systemic support in a manner that would fully protect creditors. We also note the bank's small size in terms of total assets (1.4% of total banking system assets as of January 2015, based on bank BA900 disclosures).

NATIONAL SCALE RATING

Capitec's Baa1.za/P-2.za national scale ratings reflect the bank's relative creditworthiness within the South African credit environment.

SOURCE OF FACTS AND FIGURES CITED IN THIS REPORT

Unless noted otherwise, we have sourced data relating to system-wide trends and market shares from the central bank. Bank specific figures originate from banks' reports and Moody's Banking Financial Metrics. All figures are based on our own chart of account and may be adjusted for analytical purposes. Please refer to the document "Financial Statement Adjustments in the Analysis of Financial Institutions" published on 16 March 2015.

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Our Scorecard is designed to capture, express and explain in summary form our Rating Committee's judgment. When read in conjunction with our research, a fulsome presentation of our judgment is expressed. As a result, the output of our Scorecard may materially differ from that suggested by raw data alone (though it has been calibrated to avoid the frequent need for strong divergence). The Scorecard output and the individual scores are discussed in rating committees and may be adjusted up or down to reflect conditions specific to each rated entity.

Rating Factors

Capitec Bank Limited

Macro Factors	
Weighted Macro Profile	Moderate

Financial Profile						
Factor	Historic Ratio	Macro Adjusted Score	Credit Trend	Assigned Score	Key driver #1	Key driver #2
Solvency						
Asset Risk						
<i>Problem Loans / Gross Loans</i>	-	-	← →	b2	Long-run loss performance	
Capital						
<i>TCE / RWA</i>	31.2%	a2	← →	baa2	Stress capital resilience	
Profitability						
<i>Net Income / Tangible Assets</i>	-	-	← →	baa2	Earnings quality	
Combined Solvency Score		-		ba1		
Liquidity						
Funding Structure						
<i>Market Funds / Tangible Banking Assets</i>	12.4%	baa2	↓	ba2	Deposit quality	
Liquid Resources						
<i>Liquid Banking Assets / Tangible Banking Assets</i>	31.4%	baa2	← →	baa2	Stock of liquid assets	
Combined Liquidity Score		baa2		ba1		

Financial Profile	ba1
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Qualitative Adjustments	Adjustment
Business Diversification	-1
Opacity and Complexity	0
Corporate Behavior	0
Total Qualitative Adjustments	-1

Sovereign or Affiliate constraint	Baa2
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Scorecard Calculated BCA range	ba1 - ba3
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Assigned BCA	Private
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Affiliate Support notching	0
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Adjusted BCA	Private
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Instrument Class	Loss Given Failure notching	Additional notching	Preliminary Rating Assessment	Government Support notching	Local Currency rating	Foreign Currency rating

Deposits	0	0	ba2	0	Ba2	Ba2
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This publication does not announce a credit rating action. For any credit ratings referenced in this publication, please see the ratings tab on the issuer/entity page on <http://www.moody.com> for the most updated credit rating action information and rating history.



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