



Moody's Investors Service

Credit Opinion: Capitec Bank Limited

Global Credit Research - 08 Sep 2009

Stellenbosch, South Africa

Ratings

Category	Moody's Rating
Outlook	Stable
NSR Issuer Rating -Dom Curr	A2.za
NSR ST Issuer Rating -Dom Curr	P-1.za

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Key Indicators

Capitec Bank Limited

	[1][2]2009	2008	2007	2006	2005	[3]Avg.
Total Assets (Rand mn)	4959.14	2937.53	2212.91	1265.83	817.90	[4]57.94
Shareholders' Equity (Rand mn)	1366.37	1169.95	1052.76	419.97	363.16	[4]31.71
Return on Average Assets	8.27	7.92	7.66	7.62	6.53	7.60
Recurring Earnings Power	23.70	19.95	20.66	20.00	16.59	20.18
Net Interest Margin	27.58	30.44	69.42	112.93	146.40	77.36
Cost/Income Ratio (%)	52.76	60.72	64.47	72.61	79.42	65.99
Problem Loans % Gross Loans	10.00	11.07	11.15	19.06	--	12.82
Shareholder's Equity % Total Assets	27.55	39.83	47.57	33.18	44.40	38.51

[1] As of February 28. [2] Statement period in which the bank switched to Basel II accounting framework. [3] The average calculations are based on Basel I and Basel II data where applicable. [4] Compound annual growth rate.

Opinion

SUMMARY RATING RATIONALE

Moody's assigns national scale issuer ratings of A2.za/P-1.za to Capitec Bank Limited. The ratings reflect Capitec Bank's niche in the South African unsecured lending industry with approximately 2.0 million active customers, and a paperless technology-driven business model that allows it to provide a low-cost and efficient service. The bank is also successfully broadening its banking product range - and specifically its transactional banking services and savings products - which provides funding and revenue diversification and helps strengthen its position as a retail bank offering affordable banking to the South African public. Despite the challenging operating conditions, the bank's financial fundamentals have remained strong, with an RoE and RoAA of 23.9% and 8.3% respectively, and Tier 1 ratio of 41.5% as at the fiscal year ended (FYE) February 2009, as well as good control of asset quality despite a challenging operating environment. The ratings also incorporate the potential for systemic support in case of need. In our view, Capitec Bank's involvement in a market sector that is nurtured by the government to support the low-income population of South Africa could qualify it for systemic support, if such assistance was ever required.

The ratings on Capitec Bank also reflect (i) aggressive balance sheet growth, which tests its credit and liquidity/funding risk management capabilities; (ii) the bank's 'monoline' status and small size (with total assets of ZAR5.0 billion (US\$497 million) as of February 2009); and (iii) the high systemic credit risk inherent in the demographic credit characteristics of its client base, also exacerbated by the deteriorating macro-economic environment and retrenchment levels. We do appreciate, however, that Capitec Bank has so far successfully navigated through the global credit crunch and macro economic slowdown.

Rating Drivers

- A niche player in South Africa's unsecured lending industry, with good prospects for growth given that this sector is under-served by the bigger commercial banks

- High capitalisation and strong historical earnings-generating capabilities
- The potential for systemic support in case of need
- Ability to (i) maintain its asset quality indicators and earnings-generating capabilities and (ii) to further grow, diversify and lengthen the maturity profile of its funding sources, under the current challenging operating conditions
- A young and small institution, experiencing rapid growth in balance sheet and infrastructure
- Operating in a high-risk segment providing unsecured loans to lower-income earners

Rating Outlook

The bank's national scale issuer ratings have a stable outlook.

What Could Change the Rating - UP

Capitec Bank's ratings could benefit from (i) a material growth in its business franchise; (ii) a stable funding base and continued good liquidity levels, especially in light of its strong balance sheet growth; and (iii) the bank's ability to maintain its sound financial fundamentals under the current operating conditions.

What Could Change the Rating - DOWN

Capitec Bank's rating could be downgraded if (i) its business model/growth either falters or gives rise to credit and liquidity risk management problems; or (ii) the slowdown in the macro-economic environment adversely affects the bank's financial fundamentals, specifically its asset quality, funding position and earnings power.

Recent Results and Developments

For FYE 2009, the bank reported a 60% rise in bottom-line profits to ZAR326 million. Performance has been driven by a strong (52%) increase in operating income which has offset the 102% growth in provision charges and 32% growth in expenses. Total assets rose 69% to ZAR4.959 billion since FYE 2008, with loans and advances up 48% to ZAR2.975 billion. In a trading statement, the bank announced that for the six months to August 2009, its bottom-line profits will be between 35-55% higher than same period of the previous year.

DETAILED RATING CONSIDERATIONS

Detailed considerations for Capitec Bank's currently assigned ratings are as follows:

Franchise Value

Capitec Bank provides basic, affordable banking primarily by way of unsecured lending, while also offering savings options and transactional banking services. The bank has approximately 2.0 million active customers and its distribution network includes more than 360 branches and ATMs (940 including partnership ATMs) all over South Africa, and management plans further expansion. It has implemented a customised banking platform with a paperless application process, biometric authorisation, online completion of all processes, and centralised back-office operations. The use of magnetic strip and electronic smart cards (that have access to all other banks and ATMs) allows the bank to operate a simple, low-cost, technology-based business model, with application processes for savings accounts and personal loans taking just minutes to complete. In its continued efforts to broaden its scope of operations, Capitec Bank aims to attract more 'banking' (rather than 'credit only') customers, thus expanding its depositor/funding base and its transactional, fee-based income sources. Over time, we also expect Capitec to continue to move towards the middle income market and further lengthen its loan tenors (currently ranging between one and 36 months).

The bank's franchise value is, however, constrained by (i) its 'monoline' status and narrow market; (ii) its lack of geographical diversification (based in South Africa only); (iii) challenging operating conditions; and (iv) its continued status as a small institution (with total assets of ZAR5.0 billion as of February 2009) that will need a few years to grow its business volumes to derive scale efficiencies and fully utilise its infrastructure.

Risk Positioning

The bank's risk positioning is adversely affected by its high-risk product range - unsecured personal loans to lower-income earners - and its aggressive balance sheet growth, including a fourteen-fold increase in loans and advances over the period 2006-2009, which will test the bank's credit and liquidity/funding risk management capabilities. Capitec Bank's recent track record does, however, show that it is successfully navigating through the recent credit crunch and macro economic slowdown. This is partly attributed to its prudent approach to liquidity (evidenced by the absence of any major mismatches in the maturity profile of its assets and liabilities), low market risk appetite, good information systems to manage risks, no concentrations in its loan books, and conservative investment strategy with regards to its surplus liquidity, primarily deposited with the big local banks.

Profitability

For the year ended February 2009 the bank has maintained an impressive earnings power despite the current tough market conditions, with bottom-line profits up 60% to ZAR326 million - implying an RoE of 23.9% and an RoAA of 8.3%. Despite declining net interest margins (to 27% according to Moody's calculations), operating income displayed 52% growth to ZAR1.981 billion on the back of strong balance sheet growth (of 69% for the year-end February 2009) and increased emphasis on transactional-type fee income. The strong growth in operating income enabled the bank to absorb the 32% increase in operating expenses (to ZAR1.048 billion) and the 102% increase in provision charges (to ZAR467 million). Going forward, we expect demand for Capitec Bank's products to remain strong and support its revenue growth and bottom-line profitability, with downside risks centred around higher-than-anticipated provision charges.

Liquidity

The bank has adequate liquidity, with liquid assets (cash, cash equivalents, and traded investments) accounting for approximately 33% of total assets in February 2009. Capitec Bank manages liquidity cautiously, also illustrated by the net positive gap in the maturity profile of its assets and liabilities. It has a diversified funding base, including retail and wholesale deposits, market funding (via its ZAR2 billion domestic medium term note (DMTN) Programme, under which ZAR812 million have already been issued), and other bilateral loans; during the year it has also successfully introduced a number of new products - including a retail fixed-term saving plan - which has helped minimise the impact of the global credit crunch. Retail deposits represent approximately 50% of its funding base.

Capital Adequacy

With shareholders funds to total assets at 27.6% as of February 2009 and a Group Tier 1 ratio of 41.5%, the bank is currently well capitalised. Capitalisation ratios are supported by Capitec Bank's high earnings-generating capabilities and relatively conservative dividend payout ratios (dividend cover on ordinary shares has remained at 2.6x). The higher risk nature of Capitec Bank's business profile and target market does, however, warrant a higher capitalisation cushion compared to commercial banks, an issue also recognised by the South African Reserve Bank, which has set higher minimum capital adequacy requirements. Over the medium-term we expect the bank's capital adequacy ratio to move towards management's minimum target of 25%.

Efficiency

The bank's cost-to-income ratio has been improving over the past four years, and by February 2009 it had dropped to 53%. The bank's non-interest expenses as a percentage of average assets has also dropped to 26.5% , but remains well above the level reported by commercial banks; this reflects the large investments made in developing a retail banking infrastructure and high operational costs, but also the costs associated with the high turnover of short-term higher yielding assets. Going forward, we expect further improvements in the bank's efficiency indicators, as Capitec Bank remains a cost-conscious organisation, and continuously aims to streamline/improve branch processes. Its developed infrastructure should also allow it to absorb higher business volumes, which should, in turn, help to further improve efficiency indicators over the medium term.

Asset Quality

Capitec Bank's asset quality ratios are acceptable when considering the typically high bad debt levels that accompany the micro-financing industry. Given that non-performing loan (NPL) ratios are difficult to interpret because a proportion of the loans have tenors of less than 12 months, the bank also measures loan impairment expense as a percentage of instalments due. According to this metric, the weighted average gross impairment expense increased from 5.9% at FYE 2008, to 7.9% at FYE 2009. We believe this reflects the more challenging operating conditions, but also the lengthening of the book tenure (loan loss provision as a percentage of instalments is higher for a new and growing loan book, although over time these revert to a normal distribution of arrears).

As of February 2009, NPLs stood at ZAR325 million (10% of gross loans), with provision reserves at 7.5% of gross loans; these have been steadily decreasing over the past few years, but appear adequate for the current level of delinquencies. Loan classification and provision standards are adequate, with loans going into arrears if a payment or part thereof is missed, while all 90-day plus past-due loans are written off and the account is transferred from the branch to the centre for centralised collection procedures and handed over to collection agents. During the year, an additional ZAR446 million of bad debts were written off.

Going forward, we believe that there are still risks of further deterioration in asset quality, partly as a result of the volatile market conditions. Nonetheless, management has implemented a retrenchment insurance cover to mitigate related risks, while it maintains that arrears are still within its risk appetite, and continuously adjusts vetting criteria to address changing market conditions; its November 2008 policy changes have already had a positive impact on vintages.

ABOUT MOODY'S BANK RATINGS

National Scale Ratings

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