

Global Credit Research - 29 May 2014

Stellenbosch, South Africa

## Ratings

Category	Moody's Rating
Outlook	Stable
Bank Deposits	Baa3/P-3
Bank Financial Strength	D+
Baseline Credit Assessment	ba1
Adjusted Baseline Credit Assessment	ba1
NSR Issuer Rating -Dom Curr	A2.za
NSR ST Issuer Rating -Dom Curr	P-1.za

## Contacts

Analyst	Phone
Christos Theofilou, CFA/Limassol	357.25.586.586
Nondas Nicolaides/Limassol	
Yves Lemay/London	44.20.7772.5454
George Korniliou, CFA/Limassol	357.25.586.586

## Key Indicators

### Capitec Bank Limited (Consolidated Financials)[1]

	[2]2-14	[2]2-13	[2]2-12	[2]2-11	[2]2-10	Avg.
Total Assets (ZAR million)	46,188.5	38,338.2	23,583.1	14,498.1	9,506.8	[3]48.5
Total Assets (USD million)	4,299.9	4,272.8	3,165.4	2,089.3	1,240.4	[3]36.5
Tangible Common Equity (ZAR million)	9,496.1	8,102.9	4,716.3	3,121.5	1,533.2	[3]57.8
Tangible Common Equity (USD million)	884.0	903.1	633.0	449.8	200.0	[3]45.0
Net Interest Margin (%)	16.5	16.9	17.0	16.9	17.6	[4]17.0
PPI / Average RWA (%)	22.4	21.8	23.1	21.6	23.5	[5]22.5
Net Income / Average RWA (%)	6.7	6.9	7.5	6.1	7.8	[5]7.0
(Market Funds - Liquid Assets) / Total Assets (%)	-12.9	-4.7	-6.9	-7.2	-13.8	[4]-9.1
Core Deposits / Average Gross Loans (%)	83.4	88.5	93.2	94.0	111.5	[4]94.1
Tier 1 Ratio (%)	28.3	28.5	27.8	32.1	26.2	[5]28.6
Tangible Common Equity / RWA (%)	29.5	28.8	29.3	32.1	26.5	[5]29.3
Cost / Income Ratio (%)	32.7	39.2	47.1	55.3	58.7	[4]46.6
Problem Loans / Gross Loans (%)	6.5	5.8	5.1	5.7	6.2	[4]5.9
Problem Loans / (Equity + Loan Loss Reserves) (%)	16.2	16.2	14.7	15.6	18.2	[4]16.2

Source: Moody's

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

## Opinion

### SUMMARY RATING RATIONALE

Capitec Bank's global scale deposit ratings are Baa3/Prime-3. The ratings are underpinned by (1) the bank's overall standalone credit strength (reflected in a baseline credit assessment (BCA) of ba1); and (2) our view that the bank's depositors will likely benefit from government support if necessary, based on its involvement in a market sector that is encouraged by the government to support South Africa's low-income population, and its 4.3% market share of household deposits as of March 2014 (based on BA900 disclosures).

Capitec's ba1 BCA (derived from the D+ standalone bank financial strength rating [BFSR]) reflects its growing niche franchise in South Africa's unsecured lending market, supported by its increasing transactional banking customer base. As a consequence, the bank's retail deposit base has been growing, thus reducing funding concentrations and broadening its funding profile. The rating also reflects Capitec's strong loss-absorption capacity, which is demonstrated by its robust profitability, solid capitalisation levels, and comprehensive provisioning policy which has enabled the bank to counter the currently challenging operating conditions in South Africa's unsecured lending market.

At the same time, Capitec's ratings also capture its small scale and narrow focus on the unsecured lending market, where challenging operating conditions will likely continue to lead to higher loan arrears and provisioning requirements, which will, in turn, weigh on profitability metrics.

### **Rating Drivers**

- A successful niche franchise in South Africa
- A growing retail-funded profile and prudent liquidity management
- South Africa's challenging operating environment, which continues to weigh on asset quality, is only partly mitigated by Capitec's provisioning policy
- A strong loss-absorption capacity, underpinned by robust profitability and solid capitalisation

### **Rating Outlook**

All ratings carry a stable outlook.

### **What Could Change the Rating - Up**

We believe there is limited upside potential for Capitec's ratings within the next 12-18 months, given the challenging operating environment. However, over the next two to three years, the bank's ratings could be upgraded if it is able to (1) maintain its sound financial fundamentals; (2) consolidate and further grow its franchise position; and (3) further broaden and diversify its revenue sources (primarily its transactional banking fee income) and funding base.

### **What Could Change the Rating - Down**

Capitec's ratings could be downgraded if (1) its business model and recent balance sheet growth induces credit and liquidity management risks; or (2) its asset quality, capital base and earnings power are materially adversely affected by the country's current challenging operating conditions.

## **DETAILED RATING CONSIDERATIONS**

### **A SUCCESSFUL NICHE FRANCHISE IN SOUTH AFRICA**

Capitec has a successful niche franchise in South Africa's unsecured lending market, with growth and revenue diversification supported by its expanding transactional banking customer base. The bank's simplified, low-cost, single-banking solution 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 that its market share of unsecured personal loans (including cards and overdrafts) increased to around 11.5% as of March 2014, from 8.9% in March 2012 (based on bank BA900 disclosures).

We view positively Capitec's increasing customer base (over 5.4 million active clients as of February 2014, a 15% increase compared to February 2013) and its transactional banking offering, which have strengthened its franchise position, and have led to revenue diversification, rendering earnings less dependent on unsecured credit trends. Net transactional, fee-based income covered around 59% of operating expenses during the fiscal year ending

February 2014. The bank can also potentially leverage on its increasing transactional banking customers to grow its franchise and earnings by cross-selling complimentary products and services. As of February 2014, 2.2 million customers used Capitec as their primary bank to deposit salaries and make payments, a 24% increase from February 2013.

Nevertheless, Capitec's franchise value continues to be constrained by its (1) narrow, undiversified focus on the unsecured lending market amid challenging operating conditions; and (2) small scale in terms of total assets, despite significant growth over the past few years, with 1.4% of total banking system assets as of March 2014 (based on bank BA900 disclosures).

#### A GROWING RETAIL-FUNDED PROFILE AND PRUDENT LIQUIDITY MANAGEMENT

Capitec's funding base has become increasingly diverse aided by growth in its retail deposit base, while the bank also continues to make use of the domestic capital markets via its ZAR8 billion Domestic Medium-Term Note (DMTN) programme. As of February 2014, retail deposits accounted for ZAR23.6 billion (or 66% of non-equity funding, one of the highest levels in South Africa), listed senior bonds accounted for ZAR5.5 billion (or 15% of funding), subordinated debt for ZAR2.9 billion, or 8% of funding, with local and international bilateral loans accounting for the remainder.

As of March 2014, the bank had a 4.3% market share of household deposits, while over the past 12 months it has been gaining on average ZAR500 million new deposits per month which suggests an 11% market share in new household deposits (based on BA900 disclosures). As a consequence of its increasingly retail funded profile, funding concentrations have been gradually diminishing (as of February 2014, top 20 depositors and funders accounted for 22% of the total, down from 50% a few years ago).

Capitec adopts a prudent approach to liquidity management. It already complies with the Basel III liquidity ratios as it does not rely on short-term wholesale deposits thanks to the relatively high proportion of retail deposits and equity financing within its funding structure. The bank also maintains liquid assets (cash and fair value investments, primarily with South Africa's National Treasury, large local banks and money market funds) of around 32% of total assets as at February 2014, up from 24% as of February 2013.

While the bank does have some maturity mismatches in its asset and liability profile, these have come down over the past year (as indicated by the improving Basel III liquidity ratios). Mismatches remain manageable given (1) the still relatively short-term nature of Capitec's assets; (2) the bank's ability to source term funding; and (3) its ample capital cushion.

#### SOUTH AFRICA'S CHALLENGING OPERATING ENVIRONMENT, WHICH CONTINUES TO WEIGH ON ASSET QUALITY, IS ONLY PARTLY MITIGATED BY CAPITEC'S PROVISIONING POLICY

We expect that the challenging operating conditions in South Africa's unsecured lending market will continue to weigh on Capitec's asset quality and profitability metrics. South Africa's real GDP growth will likely remain below potential at under 3% in both 2014 and 2015, following a slowdown in 2013 to 1.9% when a series of protracted domestic labour strikes reduced mining and manufacturing output. The risk of further labour unrest remains, which in addition to the deleveraging of consumers (following the recent pull-back in credit) and rising consumer price inflation is weighing on the consumer's loan affordability and overall confidence.

The bank's historically high credit costs (in line with its high-risk product range of unsecured personal loans to lower- and middle-income earners) were higher the fiscal year ended February 2014 (FYE2014). The loan loss provisioning expenses accounted for 12.4% of average gross loans, compared to 10.8% during FYE2013 and around 1.5% for conventional banks in South Africa. Loans in arrears (by 1-89 days) accounted for 6.5% of gross loans as of February 2014, compared with 5.8% as of February 2013. This increase has occurred amid challenging operating conditions and as loan growth is curtailed as a consequence of tighter underwriting criteria implemented by the bank to address exposure to asset-quality risks.

At the same time, we believe that Capitec's comprehensive provisioning policy mitigates some of its asset-quality risks. The bank fully provides for and subsequently writes off all loans over 90 days past due (subsequent recoveries are recognised on a cash received basis) and actively applies conservative provisioning policies for unseasoned longer-term loans (to account for the lack of any reliable historical loss rates), rescheduled loans and to capture a degree of future unforeseeable event risk or economic uncertainty. As a consequence, Capitec maintains a relatively high general provision with loan loss reserves at 10.8% of gross loans as of February 2014, equivalent to 167% of all loans in arrears.

We also acknowledge Capitec's good centralised collections capabilities and adequate risk management practices. Its credit assessment process is based on a regression model that includes (1) the client's historic credit behaviour; (2) an affordability assessment; (3) an analysis of recent cash flow trends; (4) Capitec's employer grading system, which is indicative of employment stability and hence the client's financial stability; and (5) a forecast of which clients may have an unrestrained appetite for credit. Other factors mitigating Capitec's risks include third-party credit life insurance and retrenchment insurance.

#### **A STRONG LOSS-ABSORPTION CAPACITY, UNDERPINNED BY ROBUST PROFITABILITY AND SOLID CAPITALISATION**

While we note the profitability pressure stemming from a slowdown in business growth and higher provisioning expenses, we expect Capitec to maintain its historically strong overall profitability thanks to the high margins earned in the high-risk, high-return unsecured lending market, and its good operational efficiency. The bank's net income-to-average assets ratio stood at 4.7% during FYE2014 compared to 4.9% during FYE2013, as a result higher provisioning expenses. Capitec's pre-provision income (PPI)-to-average assets ratio stood at 16.0% during FYE2014 compared to 15.6% during FYE2013, as higher transaction fee income offset the deceleration in loan book growth.

Capitec has publicly stated its commitment to run its business efficiently, remain cost conscious, and streamline and improve its branch processes. We therefore expect the bank to sustain efficiency metrics close to current levels as it leverages on its existing infrastructure. During FYE2014, the bank's cost-to-income ratio improved to 33% from 39% in FYE2013. According to management, Capitec's branch network costs are estimated to be a fraction of the industry average, while its developed infrastructure should enable it to absorb higher business volumes, specifically in terms of transactional banking services and attracting retail deposits.

Based on the results of our scenario analysis, we conclude that Capitec has solid capitalisation metrics. As of February 2014, the bank reported a shareholders' funds-to-total assets ratio of 21.3%, a common equity Tier 1 ratio of 29.9%, a Tier 1 ratio of 30.6%, and an overall capital adequacy ratio of 39.5%. The higher-risk nature of Capitec's business profile and target market, and its potentially higher loan growth potential, warrant a more ample capital cushion than other commercial banks.

#### **SOURCE OF FACTS AND FIGURES CITED IN THIS REPORT**

Unless noted otherwise, data related to system-wide trends is sourced from South Africa's National Credit Regulator and the central bank. Bank-specific figures originate from the bank's reports, BA900 submissions, quarterly capital adequacy disclosures, 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 documents entitled "Moody's Approach to Global Standard Adjustments in the Analysis of the Financial Statements of Banks, Securities Firms and Finance Companies" and "Frequently Asked Questions: Moody's Approach to Global Standard Adjustments in the Analysis of the Financial Statements of Banks, Securities Firms and Finance Companies", both published on 19 July 2012.

#### **Global Local Currency Deposit Rating (Joint Default Analysis)**

We assign a global local-currency (GLC) deposit rating of Baa3 to Capitec, which is one-notch higher than its BCA of ba1. The uplift is based on (1) our assessment of a moderate probability of systemic support if necessary; and (2) the government's capacity to support the bank, reflected in South Africa's systemic support indicator of A3.

We believe there is a moderate probability that systemic (government) support will be extended to Capitec in the event of a stress scenario. This assessment is based on (1) Capitec's involvement in a market sector that is encouraged by the government to support the low-income population of South Africa; and (2) the bank's 4.3% market share in household deposits as of March 2014 (based on BA900 disclosures).

#### **National Scale Rating**

Capitec's A2.za/P-1.za national scale ratings reflect the bank's strong creditworthiness within the South African credit environment. These ratings also take into account the bank's intrinsic financial strength and our assessment of a moderate probability of systemic support if necessary.

#### **ABOUT MOODY'S BANK RATINGS**

Bank Financial Strength Rating

Moody's Bank Financial Strength Ratings (BFSRs) represent Moody's opinion of a bank's intrinsic safety and soundness and, as such, exclude certain external credit risks and credit support elements that are addressed by Moody's Bank Deposit Ratings. Bank Financial Strength Ratings do not take into account the probability that the bank will receive such external support, nor do they address risks arising from sovereign actions that may interfere with a bank's ability to honor its domestic or foreign currency obligations. Factors considered in the assignment of Bank Financial Strength Ratings include bank-specific elements such as financial fundamentals, franchise value, and business and asset diversification. Although Bank Financial Strength Ratings exclude the external factors specified above, they do take into account other risk factors in the bank's operating environment, including the strength and prospective performance of the economy, as well as the structure and relative fragility of the financial system, and the quality of banking regulation and supervision.

Moody's uses the Baseline Credit Assessment (BCA) to map BFSRs onto the 21-point aaa-c rating scale and like the BFSR, it reflects a bank stand-alone default risk. Each point on the aaa-c scale represents a specific probability of default and therefore allows Moody's to use the BCA as an input to Moody's Joint Default Analysis (JDA), described below. The baseline credit assessment reflects what the local currency deposit rating of the bank with the given BFSR would be without any assumed external support from a government or third party

#### Global Local Currency Deposit Rating

A deposit rating, as an opinion of relative credit risk, incorporates the Bank Financial Strength Rating as well as Moody's opinion of any external support. Specifically, Moody's Bank Deposit Ratings are opinions of a bank's ability to repay punctually its deposit obligations. As such, Moody's Bank Deposit Ratings are intended to incorporate those aspects of credit risk relevant to the prospective payment performance of rated banks with respect to deposit obligations, and includes: intrinsic financial strength, sovereign transfer risk (in the case of foreign currency deposit ratings), and both implicit and explicit external support elements. Moody's Bank Deposit Ratings do not take into account the benefit of deposit insurance schemes which make payments to depositors, but they do recognize the potential support from schemes that may provide assistance to banks directly.

According to Moody's joint default analysis (JDA) methodology, the global local currency deposit rating of a bank is determined by the incorporation of any external elements of support into the bank's Baseline Credit Assessment. In assigning the local currency deposit rating to a bank, the JDA methodology also factors in the rating of the various potential support providers (parent company, cooperative group, regional or national governments), as well as the degree of dependence that may exist between each one of them and the bank. Moody's assessment of the probability of systemic support (by a national government) is derived from the analysis of the capacity of a government and its central bank to provide support on a system-wide basis. The systemic support indicator is determined for a particular country and serves as an input for all bank ratings in that country. The support indicator can be set at, above or, in rare cases, below the government's local currency bond rating for that country.

#### National Scale Ratings

Moody's National Scale Ratings (NSRs) are intended as relative measures of creditworthiness among debt issues and issuers within a country, enabling market participants to better differentiate relative risks. NSRs differ from Moody's global scale ratings in that they are not globally comparable with the full universe of Moody's rated entities, but only with NSRs for other rated debt issues and issuers within the same country. NSRs are designated by a ".nn" country modifier signifying the relevant country, as in ".za" for South Africa. For further information on Moody's approach to national scale ratings, please refer to Moody's Rating Implementation Guidance published in October 2012 entitled "Mapping Moody's National Scale Ratings to Global Scale Ratings."

#### Foreign Currency Deposit Rating

Moody's ratings on foreign currency bank obligations derive from the bank's local currency rating for the same class of obligation. The implementation of JDA for banks can lead to high local currency ratings for certain banks, which could also produce high foreign currency ratings. Nevertheless, it should be noted that foreign currency deposit ratings are in all cases constrained by the country ceiling for foreign currency bank deposits. This may result in the assignment of a different, and typically lower, rating for the foreign currency deposits relative to the bank's rating for local currency obligations.

#### Foreign Currency Debt Rating

Foreign currency debt ratings are derived from the bank's local currency debt rating. In a similar way to foreign currency deposit ratings, foreign currency debt ratings may also be constrained by the country ceiling for foreign

currency bonds and notes; however, in some cases the ratings on foreign currency debt obligations may be allowed to pierce the foreign currency ceiling. A particular mix of rating factors are taken into consideration in order to assess whether a foreign currency bond rating pierces the country ceiling. They include the issuer's global local currency rating, the foreign currency government bond rating, the country ceiling for bonds and the debt's eligibility to pierce that ceiling.

About Moody's bank financial strength scorecard

Moody's bank financial strength model (see scorecard below) is a strategic input in the assessment of the financial strength of a bank, used as a key tool by Moody's analysts to ensure consistency of approach across banks and regions. The model 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

Rating Factors [1]	A	B	C	D	E	Total Score	Trend
<b>Qualitative Factors (70%)</b>						<b>C+</b>	
<b>Factor: Franchise Value</b>						<b>C</b>	
Market share and sustainability				x			
Geographical diversification				x			
Earnings stability	x						
Earnings Diversification [2]							
<b>Factor: Risk Positioning</b>						<b>C-</b>	
<b>Corporate Governance [2]</b>							
- Ownership and Organizational Complexity							
- Key Man Risk							
- Insider and Related-Party Risks							
<b>Controls and Risk Management</b>			x				
- Risk Management				x			
- Controls		x					
<b>Financial Reporting Transparency</b>			x				
- Global Comparability	x						
- Frequency and Timeliness				x			
- Quality of Financial Information				x			
<b>Credit Risk Concentration</b>			x				
- Borrower Concentration			x				
- Industry Concentration		x					
<b>Liquidity Management</b>			x				
<b>Market Risk Appetite</b>		x					
<b>Factor: Operating Environment</b>						<b>C+</b>	
<b>Economic Stability</b>		x					
<b>Integrity and Corruption</b>				x			
<b>Legal System</b>		x					
<b>Financial Factors (30%)</b>						<b>B</b>	
<b>Factor: Profitability</b>						<b>A</b>	
PPI % Average RWA (Basel II)	22.45%						
Net Income % Average RWA (Basel II)	7.00%						
<b>Factor: Liquidity</b>						<b>C+</b>	
(Market Funds - Liquid Assets) % Total Assets		-8.15%					
<b>Liquidity Management</b>			x				
<b>Factor: Capital Adequacy</b>						<b>A</b>	
Tier 1 Ratio (%) (Basel II)	28.21%						

Tangible Common Equity % RWA (Basel II)	29.21%						
Factor: Efficiency						A	
Cost / Income Ratio	39.64%						
Factor: Asset Quality						C	
Problem Loans % Gross Loans				5.77%			
Problem Loans % (Equity + LLR)		15.72%					
Lowest Combined Financial Factor Score (9%)						C	
<i>Economic Insolvency Override</i>						Neutral	
Aggregate BFSR Score						C+	
Aggregate BCA Score						a2	
Assigned BFSR						D+	
Assigned BCA						baa3	

[1] - Where dashes are shown for a particular factor (or sub-factor), the score is based on non-public information.  
[2] - A blank score under Earnings Diversification or Corporate Governance indicates the risk is neutral.



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