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Credit Opinion: Capitec Bank Limited

Global Credit Research - 18 Aug 2014

Stellenbosch, South Africa

Ratings

Category	Moody's Rating
Outlook	Rating(s) Under Review
Bank Deposits	*Ba2/NP
Bank Financial Strength	**D
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

* Rating(s) within this class was/were placed on review on August 15, 2014

** Placed under review for possible downgrade on August 15, 2014

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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)	9,496.1	8,102.9	4,716.3	3,121.5	1,533.2	[4]57.8
Tangible Common Equity (USD million)	884.0	903.1	633.0	449.8	200.0	[4]45.0
Net Interest Margin (%)	—	16.9	17.0	16.9	17.6	[5]17.1
PPI / Average RWA (%)	22.7	21.8	23.1	21.6	23.5	[6]22.7
Net Income / Average RWA (%)	6.7	6.9	7.5	6.1	7.8	[6]6.7
(Market Funds - Liquid Assets) / Total Assets (%)	-12.9	-4.7	-6.9	-7.2	-13.8	[5]-9.1
Core Deposits / Average Gross Loans (%)	—	88.5	93.2	94.0	111.5	[5]96.8
Tier 1 Ratio (%)	30.6	28.5	27.8	32.1	26.2	[6]30.6
Tangible Common Equity / RWA (%)	31.9	28.8	29.3	32.1	26.5	[6]31.9
Cost / Income Ratio (%)	32.7	39.2	47.1	55.3	58.7	[5]46.6
Problem Loans / Gross Loans (%)	6.5	5.8	5.1	5.7	6.2	[5]5.9
Problem Loans / (Equity + Loan Loss Reserves) (%)	16.2	16.2	14.7	15.6	18.2	[5]16.2

Source: Moody's

[1] All figures and ratios are adjusted using Moody's standard adjustments [2] Basel III - 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 - transitional phase-in & IFRS reporting periods have been used for average calculation

Opinion

SUMMARY RATING RATIONALE

Capitec Bank's global scale deposit ratings of Ba2/Not-Prime (on review for downgrade) reflect the bank's overall standalone credit strength, which is captured by the ba2 baseline credit assessment (BCA). In August 2014, we removed the one notch of systemic support uplift that was previously incorporated in the bank's ratings. This decision reflects our view of the materially reduced probability of systemic support for South African banks, including Capitec, to fully protect senior creditors and depositors if needed, following the decision of the South African Reserve Bank (SARB) on 10 August to include a bail-in of senior unsecured bondholders and wholesale depositors as part of the restructuring plan for African Bank Limited.

Capitec's ba2 BCA (derived from the D standalone bank financial strength rating [BFSR]) captures the bank's small scale and narrow focus on the unsecured lending market, which generates high inherent risks. Amid weaker economic growth and reduced consumer affordability, we also note that the challenging operating conditions are leading to higher loan arrears and loan loss provisioning requirements.

At the same time, the ratings also reflect Capitec's niche unsecured lending franchise and increasing transactional banking customer base, which has supported a growing retail deposit base that has in turn reduced funding concentrations and broadened its funding profile. Moreover, the ratings also take into account Capitec's strong loss-absorption capacity, which is demonstrated by its robust pre-provision profitability, high capitalisation levels, and comprehensive provisioning policy.

The review for downgrade reflects our concerns that the challenging operating environment in South Africa's unsecured lending market may further weigh on Capitec's financial performance. The review for downgrade will focus on a forward-looking assessment of the shock absorption capacity afforded by Capitec's high capital and liquidity buffers against risks stemming from the on-going challenging operating conditions in South Africa's unsecured lending market, which are likely to dampen the bank's financial metrics, and the risk of a deterioration of the funding conditions for unsecured lenders in South Africa.

Rating Drivers

- Operating conditions remain challenging
- Capitec maintains sound provisioning and underwriting policies, and high capital buffers
- A growing retail-funded profile and high liquidity, although funding risks for unsecured lenders are elevated
- A successful niche franchise in South Africa, albeit with a narrow and undiversified focus on unsecured lending

Rating Outlook

All ratings are currently on review for downgrade, with the exception of the short-term Not Prime ratings.

What Could Change the Rating - Up

The rating review for downgrade indicates that there is limited upside potential for Capitec's ratings over the near-term.

What Could Change the Rating - Down

The review could be concluded with a downgrade of Capitec's ratings if (1) its business model and loan growth generates elevated credit and liquidity-management risks; or (2) Moody's considers that the current challenging operating conditions will materially affect its asset quality, capital base and earnings power.

DETAILED RATING CONSIDERATIONS

OPERATING CONDITIONS REMAIN CHALLENGING

Despite the gradual diversification of Capitec's revenue base, amid its expanding transactional banking business, the bulk of the bank's loan book is in unsecured consumer lending, which exhibits high inherent credit risks and is faced with challenging operating conditions. In particular, we consider that South Africa's slowing economy (quarter-on-quarter GDP growth contracted by 0.6% in Q1 2014), labour unrest, higher inflation (6.6% in June 2014) and a rising cost of living, will continue to weigh on consumers' loan affordability.

While we acknowledge Capitec's sound provisioning and underwriting policies, we believe that the challenging operating conditions will continue to weigh on Capitec's asset quality and profitability metrics. The bank's historically high credit costs (in line with its high-risk market focus) have increased further during the fiscal year ended February 2014 (FYE2014) amid the challenging operating conditions and as loan growth is curtailed following tighter underwriting criteria implemented by the bank. Loan loss provisioning expenses increased to 12.4% of average gross loans, compared to 10.8% during FYE2013 and around 1.1% for conventional banks in South Africa. Loans in arrears (by between 1 and 89 days) accounted for 6.5% of gross loans as of February 2014, compared with 5.8% as of February 2013.

Higher credit costs and lower business volumes are also pressuring Capitec's profitability, with net impairment charges absorbing 59% of pre-provision profits during FYE2014 (FYE2013: 55%), a ratio that is expected to remain high and potentially increase going forward. This should put pressure on the bank's currently strong profitability metrics (net income to average assets stood at 4.7% during FYE2014), despite high pre-provision profitability (pre-provision income (PPI)-to-average assets ratio of 16.0%) that are supported by high transaction fee income, high margins earned in the high-risk/high-return unsecured lending market, and its good operational efficiency.

CAPITEC MAINTAINS SOUND PROVISIONING AND UNDERWRITING POLICIES, AND HIGH CAPITAL BUFFERS

We believe that Capitec's comprehensive provisioning policy and risk management practices mitigate some of its asset-quality risks. In order to capture a degree of future unforeseeable event risk or economic uncertainty, the bank (1) fully provides for and subsequently writes off all loans over 90 days past due; and (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. As a consequence, Capitec maintains relatively high general provisions, with loan loss reserves accounting for 10.8% of gross loans as of February 2014, equivalent to 167% of all loans in arrears. We also recognise Capitec's good centralised collections capabilities and risk management practices, which have been calibrated to deal with the current challenging operating environment. Other factors mitigating Capitec's risks include third-party credit life insurance and retrenchment insurance.

We also acknowledge that Capitec's capital buffers allow the bank to absorb higher than expected credit costs. As of February 2014, the bank reported a shareholder 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%. As a point of reference, 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.

A GROWING RETAIL-FUNDED PROFILE AND HIGH LIQUIDITY, ALTHOUGH FUNDING RISKS FOR UNSECURED LENDERS ARE ELEVATED

While we acknowledge Capitec's growing retail-funded profile (two thirds of funding is now in the form of household deposits) and strong liquidity buffers, the bank still maintains a reliance on wholesale funding and we note the risk that recent events related to African Bank Limited could signal potentially tougher funding conditions for unsecured lenders in South Africa. In particular, recent developments could negatively impact Capitec's wholesale and retail deposit funded profile as well as its related cost, particularly in the context of pressure on financial fundamentals from the challenging domestic operating conditions.

As of February 2014, retail deposits accounted for ZAR23.6 billion (or around two thirds 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 June 2014, the bank had a 4.5% market share of household deposits, while over the past 12 months it has been gaining (on average) over ZAR500 million of new deposits per month (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 reduced (as of February 2014, top 20 depositors and funders accounted for 22% of the total, down from 50% as at FYE2010).

We also recognise that Capitec 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.

A SUCCESSFUL NICHE FRANCHISE IN SOUTH AFRICA, BUT WITH A NARROW AND UNDIVERSIFIED FOCUS ON UNSECURED LENDING

Capitec's franchise value continues to be constrained by its narrow, undiversified focus on the unsecured lending market, and its small size in terms of total assets (1.4% of total banking system assets as of June 2014, based on bank BA900 disclosures).

Capitec has, however, built 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 June 2014, from 9.7% in June 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, thus rendering earnings less dependent on unsecured credit trends. Net transactional, fee-based income covered around 59% of operating expenses during FYE2014. 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.

Global Local Currency Deposit Rating (Joint Default Analysis)

We assign a global local-currency (GLC) deposit rating of Ba2 to Capitec, which is in line with its ba2 BCA. In August 2014, we removed the one notch of uplift for external support previously incorporated in the bank's ratings. This decision reflects our view of the materially reduced probability of systemic support for Capitec (if needed) to fully protect senior creditors and depositors, as implied by SARB's recent approach in resolving a similarly sized bank.

In particular, SARB'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. In this recent case of a peer institution, senior bondholders and wholesale depositors sustained losses of 10%, with subordinated bondholders incurring significantly heavier losses.

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 19 December 2013.

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
Qualitative Factors (70%)						C+	
Factor: Franchise Value						C	Weakening
Market share and sustainability				x			
Geographical diversification				x			
Earnings stability	x						
Earnings Diversification [2]							
Factor: Risk Positioning						C-	Weakening
Corporate Governance [2]							
- Ownership and Organizational Complexity							
- Key Man Risk							
- Insider and Related-Party Risks							
Controls and Risk Management			x				
- Risk Management				x			
- Controls		x					
Financial Reporting Transparency			x				
- Global Comparability	x						
- Frequency and Timeliness				x			
- Quality of Financial Information				x			
Credit Risk Concentration			x				
- Borrower Concentration			x				
- Industry Concentration		x					
Liquidity Management			x				
Market Risk Appetite		x					
Factor: Operating Environment						C+	
Economic Stability		x					
Integrity and Corruption				x			
Legal System		x					
Financial Factors (30%)						B	
Factor: Profitability						A	Weakening
PPI % Average RWA (Basel III - transitional phase-in)	22.71%						
Net Income % Average RWA (Basel III - transitional phase-in)	6.73%						
Factor: Liquidity						C+	Weakening
(Market Funds - Liquid Assets) % Total Assets		-8.15%					
Liquidity Management			x				
Factor: Capital Adequacy						A	Neutral
Tier 1 Ratio (%) (Basel III - transitional phase-in)	30.60%						
Tangible Common Equity % RWA (Basel III - transitional phase-in)	31.90%						
Factor: Efficiency						A	Neutral
Cost / Income Ratio	39.64%						

Factor: Asset Quality						C	Weakening
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						ba2	

[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.

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's.com> for the most updated credit rating action information and rating history.



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