MOODY'S INVESTORS SERVICE

Credit Opinion: Capitec Bank Limited

Global Credit Research - 11 Nov 2014

Stellenbosch, South Africa

Ratings

Category	Moody's Rating
Outlook	Stable
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

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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 (%)	--	--	17.0	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 / 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 (%)	--	--	93.2	94.0	111.5	[5]99.6
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 reflect the bank's overall standalone credit strength, which is captured by the ba2 baseline credit assessment (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 depositors if needed.

Capitec's ba2 BCA (derived from the D standalone bank financial strength rating [BFSR]) balances Capitec's strong loss-absorption capacity and comprehensive underwriting and provisioning policies, against the high asset-quality pressure stemming from the on-going challenging operating conditions in South Africa's unsecured lending market.

Capitec faces high inherent credit risks and challenging operating conditions as the bulk of the bank's loan book comprises unsecured lending. Amid weaker economic growth and reduced consumer affordability, we expect that the challenging operating conditions will lead to higher loan arrears and loan loss provisioning requirements, which will likely continue to weigh on Capitec's asset quality and profitability.

At the same time, the ratings and stable outlook reflects our view that these risks are balanced by Capitec's sound underwriting policies and strong loss-absorption capacity, which is demonstrated by its robust pre-provision profitability, high capitalisation levels, and comprehensive provisioning policy. In addition, Capitec's profitability metrics and franchise-growth potential should remain sound as they are supported by an expanding transactional banking customer base that has enabled Capitec to diversify revenue and operations, but also leads to a growing retail deposit base reducing funding concentrations and broadening its funding profile. A growing deposit base in addition to solid liquidity levels should help the bank maintain a sound funding and liquidity profile despite potentially higher funding costs, amid tougher funding conditions.

Rating Drivers

- Capitec has a successful niche franchise in South Africa

- South Africa's challenging operating environment, which continues to weigh on asset quality and profitability

- Sound underwriting and provisioning policies and a strong loss-absorption capacity, underpinned by solid capitalization and resilient profitability

- Despite increased 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 could develop if risks within the operating environment subside and the bank is able to (1) consolidate and further expand its transactional banking franchise; (2) further broaden and diversify its revenue sources; and (3) maintain its sound financial fundamentals.

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 HAS A SUCCESSFUL NICHE FRANCHISE IN SOUTH AFRICA

Capitec has a successful niche franchise in South Africa's unsecured lending market. We estimate that its market share of unsecured personal loans (including cards and overdrafts) increased to around 11.8% as of August 2014, from 10.5% in August 2012 (based on bank BA900 disclosures). Its market share stands at 19.1% as of August 2014, if we exclude cards and overdrafts, which Capitec currently does not offer. 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. In addition, Capitec Bank has been more recently increasing its distribution network into malls and higher end-shopping centers.

Capitec's growth and revenue diversification has been supported by an expanding transactional banking customer base which has allowed Capitec to attract higher income individuals and more directly compete with the larger South Africa banks. We view positively Capitec's increasing customer base (over 5.8 million active clients as of August 2014, a 16% increase compared to August 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 over 60% of operating expenses during the first half of its fiscal year ending February 2015 (FYE2015). The bank can also potentially leverage on its increasing transactional banking customers to grow its franchise and earnings by cross-selling complementary products and services. As of August 2014, 2.4 million customers used Capitec as their primary bank to deposit salaries and make payments, a 26% increase from August 2013.

While improving, Capitec's franchise value remains constrained by its narrow, undiversified lending focus on the unsecured 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).

SOUTH AFRICA'S CHALLENGING OPERATING ENVIRONMENT, WHICH CONTINUES TO WEIGH ON ASSET QUALITY AND PROFITABILITY

Despite the gradual diversification of Capitec's revenue base, Capitec faces high inherent credit risks and challenging operating conditions as the bulk of the bank's loan book comprises unsecured lending. 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. In particular, South Africa's subdued economic growth rates (Moody's expects GDP to expand by 1.4% in 2014) and a rapidly rising cost of living (inflation stood at 5.9% in September 2014), will continue to weigh on consumers' loan affordability, thereby raising the likelihood of further asset quality pressure in the unsecured lending market.

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 during 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 1.0% 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. The first half of its fiscal year is seasonally better than the full year, and Capitec reported loans in arrears at 5.5% of gross loans as of August 2014 unchanged from August 2013, while loan loss provisions increased to 10.7% of gross loans (August 2013: 9.8%).

SOUND UNDERWRITING AND PROVISIONING POLICIES AND A STRONG LOSS-ABSORPTION CAPACITY, UNDERPINNED BY SOLID CAPITALIZATION AND RESILIENT PROFITABILITY

However we expect any potential asset quality deterioration to remain manageable. Capitec has a good centralised collections capabilities and risk management practices, which 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.

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 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 a relatively high general provision with loan loss reserves at 10.7% of gross loans as of August 2014, equivalent to 194% of all loans in arrears (between 1-90 days).

Based on the results of our scenario analysis, we also conclude that Capitec has solid capitalisation metrics. As of August 2014, the Capitec Bank Holdings Limited (the bank's holding company) reported a shareholders' funds-to-total assets ratio of 20.9%, a common equity Tier 1 ratio of 29.9%, a Tier 1 ratio of 30.5% and an overall capital adequacy ratio of 37.8%. While we adjust capital levels by using an 100% risk-weight for government securities, Capitec's capital levels remain high, although the higher-risk nature of Capitec's business profile and target market, warrant a more ample capital cushion than other commercial banks.

While we note the profitability pressure stemming from a slowdown in business growth, higher cost of funding and higher provisioning expenses, we expect Capitec to maintain its historically strong overall profitability thanks to the strong growth in transactional banking income, the high margins earned in the high-risk, high-return unsecured lending market, and strong potential to further grow its customers and product offering. We expect the bank to sustain its good efficiency metrics as it leverages on its existing infrastructure, while Capitec has publicly stated its commitment to run its business efficiently, remain cost conscious, and streamline and improve its branch processes. The holding company's net income-to-average assets ratio stood at 4.9% during the first half of FYE2015, its pre-provision income (PPI)-to-average assets ratio stood at 14.7% and the cost-to-income ratio stood at a strong 34%.

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

Finally, although Moody's expects Capitec to face potentially higher funding costs, amid tougher funding conditions, Capitec's funding profile will likely remain sound supported by growing retail customer deposits, limited reliance on short-term maturity wholesale funding, and a solid liquidity profile.

Capitec bank's funding base has become increasingly diverse aided by growth in its retail deposit base. As of August 2014, retail deposits accounted for ZAR26.6 billion (or 69% non-equity funding, one of the highest levels in South Africa), listed senior bonds accounted for around ZAR5.0 billion (or 13% of funding), subordinated debt for ZAR2.9 billion (or 8% of funding), with local and international bilateral loans accounting for the remainder. As of August 2014, the bank had a 4.4% market share of household deposits, while Capitec continues to grow its market share in household deposits gaining (on average) around ZAR500 million of new deposits per month during the last 12 months (an 8% 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 (top 20 depositors and funders accounted for around 20% of the total, down from 50% as at FYE2010).

In addition, Capitec has a limited reliance on wholesale funding that matures in the short-term, with wholesale maturities reasonably spread out over the next four calendar years. As a consequence, Capitec already complies with the Basel III liquidity ratios, while liquid assets (at around 34% of total assets as of August 2014) 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.

While the bank does have some maturity mismatches in its asset and liability profile, these 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.

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. 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 depositors if needed. In our view, 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.

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	Neutral
Market share and sustainability				x			
Geographical diversification				x			
Earnings stability	x						
Earnings Diversification [2]							
Factor: Risk Positioning						C-	Neutral
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	Neutral
PPI % Average RWA (Basel III - transitional phase-in)	22.71%						
Net Income % Average RWA (Basel III - transitional phase-in)	6.73%						
Factor: Liquidity						C+	Neutral
(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	Neutral
Problem Loans % Gross Loans				5.77%			
Problem Loans % (Equity + LLR)		15.72%					
Lowest Combined Financial Factor Score (9%)						C	
Economic Insolvency Override						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.moodys.com for the most updated credit rating action information and rating history.

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