Credit Opinion: Capitec Bank Limited

Global Credit Research - 12 Oct 2015

Stellenbosch, South Africa

Ratings

Category	**Moody's Rating**
Outlook	Stable
Bank Deposits	Ba2/NP
Baseline Credit Assessment	ba2
Adjusted Baseline Credit Assessment	ba2
Counterparty Risk Assessment	Ba1(cr)/NP(cr)
NSR Issuer Rating	Baa1.za
NSR ST Issuer Rating	P-2.za

Contacts

Analyst	**Phone**
Christos Theofilou, CFA/Limassol	357.25.586.586
Nondas Nicolaides/Limassol	
Sean Marion/London	44.20.7772.5454

Key Indicators

Capitec Bank Limited (Consolidated Financials)[1]

	[2]**2-15**	[2]**2-14**	[2]**2-13**	[3]**2-12**	[3]**2-11**	**Avg.**
Total Assets (ZAR million)	**53,912.5**	**46,188.5**	**38,338.2**	**23,583.1**	**14,498.1**	[4]**38.9**
Total Assets (USD million)	**4,626.5**	**4,299.9**	**4,272.8**	**3,165.4**	**2,089.3**	[4]**22.0**
Tangible Common Equity (ZAR million)	**11,026.7**	**9,301.8**	**7,908.7**	**4,522.1**	**2,927.3**	[4]**39.3**
Tangible Common Equity (USD million)	**946.3**	**866.0**	**881.4**	**607.0**	**421.9**	[4]**22.4**
Problem Loans / Gross Loans (%)	**5.4**	**6.5**	**5.8**	**5.1**	**5.7**	[5]**5.7**
Tangible Common Equity / Risk Weighted Assets (%)	**29.4**	**28.9**	**28.1**	**28.1**	**30.1**	[6]**28.8**
Problem Loans / (Tangible Common Equity + Loan Loss Reserve) (%)	**13.2**	**16.8**	**16.7**	**15.3**	**16.6**	[5]**15.7**
Net Interest Margin (%)	**--**	**--**	**--**	**--**	**16.8**	[5]**16.8**
PPI / Average RWA (%)	**21.3**	**21.0**	**21.7**	**23.0**	**21.4**	[6]**21.3**
Net Income / Tangible Assets (%)	**4.5**	**4.3**	**3.9**	**4.0**	**3.2**	[5]**4.0**
Cost / Income Ratio (%)	**36.1**	**32.7**	**39.3**	**47.2**	**55.5**	[5]**42.1**
Market Funds / Tangible Banking Assets (%)	**9.6**	**12.4**	**11.5**	**12.6**	**15.6**	[5]**12.3**
Liquid Banking Assets / Tangible Banking Assets (%)	**36.6**	**31.4**	**22.2**	**24.4**	**26.4**	[5]**28.2**
Gross Loans / Total Deposits (%)	**109.7**	**125.5**	**141.2**	**134.7**	**140.6**	[5]**130.4**

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 depositor 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. The loss given failure approach is not yet applicable to any bank in South Africa, although over the next 12 to 18 months, we understand that the local authorities will introduce a formal bank resolution framework. Any rating actions will depend on the liability structure of a bank's balance sheet, and the loss severity for each instrument class in the credit hierarchy, or waterfall.

Rating Drivers

- 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

- Capitec's growing retail-funded profile and prudent liquidity management counters elevated wholesale funding challenges

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 accounts for all of the bank's 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. We expect South Africa's economic growth to increase only marginally, reaching 1.7% in 2015 and 1.9% in 2016, as electricity supply disruptions, weak consumer spending, reduced commodity prices and low new investment take a toll.

Nevertheless, we expect potential asset quality pressure to remain manageable. Capitec's 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 42% of Capitec's portfolio is granted to government employees.

As a consequence, the bank's asset quality metrics remain in line with our expectations. Loan loss provisioning expenses increased to 11.2% of gross loans (or 51% of pre-provision income) during the first six months of the fiscal year ending February 2016 (H1 FYE2016), compared to 10.7% over the same period last year, reflecting higher provisions taken against clients dependent on the mining industry and due to the continued challenges in the domestic economy. Loan loss provisions are high compared to around 1.0% for conventional banks in South Africa, reflecting 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 4.7% of gross loans as of August 2015, compared with 5.5% a year ago. The improvement primarily reflects a higher percentage of rescheduled loans, a conscious effort by the bank to improve collections. Accordingly, problem loans, including rescheduled loans, deteriorated slightly to 7.8% as of August 2015, from 7.6% a year ago.

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 been coming down slightly, they remain high and our scenario analysis suggests that capitalisation remains a fundamental strength of the bank. As of August 2015, Capitec Bank's tangible common equity stood at 20.1% of total assets, slightly down from 20.5% as of February 2015, while its total capital adequacy ratio stood at 36% in August 2015, down from 36.3% in February 2015 and 38% in August 2014. Nevertheless, we caution that the higher-risk nature of Capitec's business profile and target market warrant an ample capital cushion and higher excess capital buffers compared to the larger, more diversified, South African 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 to capture the challenging operating conditions. As a consequence, Capitec maintains a relatively high general provision and the total loan loss reserves accounted for 239% of all loans in arrears (between 1-90 days) and 144% of loans in arrears, including rescheduled loans.

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

We expect Capitec to maintain its historically strong overall profitability, despite pressure from caps on interbank and merchant fees, given the bank's 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. We also expect the bank to sustain efficiency metrics close to current levels as it remains cost conscious, despite its ongoing infrastructure investments. 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.

The bank's profitability remained solid for the six months up to August 2015, despite a reduction of interbank fees which slightly weighed on pre-provision income and the cost-to-income ratio. During H1 FYE 2016, the bank's net income-to-average assets ratio stood at 5.1% (up from 4.8% over the same period last year), its pre-provision income (PPI)-to-average assets ratio stood at 14.6% (down from 15.0%), the cost-to-income ratio stood at 36.5% (up from 35.2%), while net transactional, fee-based income covered around 60% of operating expenses (down from 62%).

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 July 2015, up from 11.5% in July 2013 (based on bank BA900 disclosures). Its market share stands at 19.8% as of July 2015, if we only include personal loans and 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 August 2015, Capitec had over 6.7 million active clients, a 16% increase from August 2014, out of which 3.0 million used Capitec as their primary bank to deposit salaries and make payments, a 24% 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.

CAPITEC'S GROWING RETAIL-FUNDED PROFILE AND PRUDENT LIQUIDITY MANAGEMENT COUNTERS ELEVATED WHOLESALE FUNDING CHALLENGES

An increasing transactional customer and retail depositor base, has also allowed Capitec to reduce funding concentrations and strengthen its retail funding profile. 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). Retail deposits accounted for ZAR34.6 billion (or 77% non-equity funding, the highest level amongst rated South African banks), as of August 2015. The bank had a 5.0% market share of household deposits as of July 2015 and it continues to grow its market share in household deposits.

As such, although wholesale funding conditions remain tough, amid higher spreads, 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 32% of total assets as of August 2015) should remain high owing to (1) muted loan growth; (2) continued retail deposit growth; and (3) the bank's prudent internal liquidity management policy. In particular, we note that the bank places the bulk of its core savings deposits in liquid assets.

Notching Considerations

LOSS GIVEN FAILURE

The loss given failure approach is not yet applicable to any bank in South Africa. Over the next 12 to 18 months, we understand that the local authorities will introduce a formal bank resolution framework, known locally as Statutory Loss Absorption Regime (SLAR). The framework will introduce the bail-in concept on certain liabilities in the case of a bank insolvency. The South African Reserve Bank (SARB) and the National Treasury published a paper on 13 August 2015 outlining the framework for bank resolutions, which will incorporate trigger events at the point of non-viability, which is likely to be 5.875% for common equity Tier 1 capital ratio.

Once the resolution regime is operational with the approval of the special resolution bill, we will accordingly consider applying our loss-given-failure analysis to all rated South African banks as described in our bank rating methodology. Any rating actions will depend on the liability structure of a bank's balance sheet, and the loss severity for each instrument class in the credit hierarchy, or waterfall.

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 (1.5% of total banking system assets as of July 2015, based on bank BA900 disclosures).

COUNTERPARTY RISK ASSESSMENT

We assign a Counterparty Risk (CR) Assessment of Ba1(cr)/NP(cr) to Capitec Bank. CR Assessments are opinions of how counterparty obligations are likely to be treated if a bank fails, and are distinct from debt and deposit ratings in that they (1) consider only the risk of default rather than expected loss and (2) apply to counterparty obligations and contractual commitments rather than debt or deposit instruments. The CR Assessment is an opinion of the counterparty risk related to a bank's covered bonds, contractual performance obligations (servicing), derivatives (e.g., swaps), letters of credit, guarantees and liquidity facilities.

For South African banks, which are yet to be subject to an official operational resolution regime, the CR Assessment is positioned one notch above the adjusted BCA and therefore above senior unsecured and deposit ratings, reflecting our view that its probability of default is lower than that of senior unsecured debt and deposits. We believe that senior obligations represented by the CR Assessment will be more likely preserved in order to limit contagion, minimise losses and avoid disruption of critical functions. The CR Assessment does not benefit from any government support, in line with our support assumptions on deposits and senior unsecured debt.

NATIONAL SCALE RATING

Capitec's Baa1.za/P-2.za national scale ratings (NSRs) reflect the bank's relative creditworthiness within the South African credit environment. Moody's has recently published a Request For Comment (RFC) report titled "Mapping National Scale Ratings from Global Scale Ratings" that invites market participants to comment on a proposal to update Moody's existing methodology for mapping NSRs from global scale ratings (GSRs). If the updated methodology is adopted as proposed, there will be no impact on Capitec's NSRs.

Moody's 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."

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" (https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_182293) published on 15 June 2015.

ABOUT MOODY'S BANK SCORECARD

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						
Problem Loans / Gross Loans	-	-	←→	b2	Long-run loss performance	
Capital						
TCE / RWA	29.4%	a2	←→	baa2	Stress capital resilience	
Profitability						

Net Income / Tangible Assets	-	-	← →	baa2	Earnings quality	
Combined Solvency Score		-		ba1		
Liquidity						
Funding Structure						
Market Funds / Tangible Banking Assets	9.6%	baa1	↓ ↓	ba1	Deposit quality	
Liquid Resources						
Liquid Banking Assets / Tangible Banking Assets	36.6%	baa1	← →	baa1	Stock of liquid assets	
Combined Liquidity Score		baa1		baa3		

Financial Profile	**ba1**

Qualitative Adjustments	**Adjustment**
Business Diversification	-1
Opacity and Complexity	0
Corporate Behavior	0
Total Qualitative Adjustments	**-1**

Sovereign or Affiliate constraint	Baa2
Scorecard Calculated BCA range	**ba1 - ba3**
Assigned BCA	**ba2**
Affiliate Support notching	**0**
Adjusted BCA	**ba2**

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

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.

MOODY'S INVESTORS SERVICE