MOODY'S
INVESTORS SERVICE

# Credit Opinion: Capitec Bank Limited

Global Credit Research - 28 Apr 2011

*Stellenbosch, South Africa*

## Ratings

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

## Contacts



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## Key Indicators

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

| | [2]**2-11** | [2]**2-10** | [2]**2-09** | [2]**2-08** | [3]**2-07** | **Avg.** |
|---|---|---|---|---|---|---|
| Total Assets (ZAR million) | **14,498.1** | **9,506.8** | **4,959.1** | **2,937.5** | **2,212.9** | [4]**60.0** |
| Total Assets (USD million) | **2,089.3** | **1,240.4** | **493.7** | **390.2** | **304.3** | [4]**61.9** |
| Tangible Common Equity (ZAR million) | **3,121.5** | **1,533.2** | **1,324.0** | **1,093.7** | **969.1** | [4]**34.0** |
| Tangible Common Equity (USD million) | **449.8** | **200.0** | **131.8** | **145.3** | **133.2** | [4]**35.6** |
| PPI / Avg RWA (%) | **21.1** | **24.7** | **28.9** | **15.9** | **--** | [5]**22.6** |
| Net Income / Avg RWA (%) | **5.9** | **8.2** | **10.0** | **6.1** | **--** | [5]**7.6** |
| (Market Funds - Liquid Assets) / Total Assets (%) | **-0.5** | **6.7** | **-17.0** | **-15.2** | **-43.7** | [6]**-13.9** |
| Core Deposits / Average Gross Loans (%) | **94.0** | **111.3** | **101.9** | **95.0** | **122.7** | [6]**105.0** |
| Tier 1 Ratio (%) | **29.8** | **28.2** | **41.5** | **34.5** | **--** | [5]**33.5** |
| Tangible Common Equity / RWA (%) | **29.8** | **28.6** | **41.6** | **33.6** | **--** | [5]**33.4** |
| Cost / Income Ratio (%) | **55.3** | **58.7** | **52.9** | **60.6** | **64.8** | [6]**58.5** |
| Problem Loans / Gross Loans (%) | **5.7** | **6.2** | **10.1** | **11.2** | **16.3** | [6]**9.9** |
| Problem Loans / (Equity + Loan Loss Reserves) (%) | **15.6** | **18.2** | **20.5** | **18.9** | **13.2** | [6]**17.3** |

Source: Moody's

[1] All ratios are adjusted using Moody's standard adjustments [2] Basel II; IFRS [3] Basel I; IFRS [4] Compound Annual Growth Rate based on IFRS reporting periods [5] Basel II & IFRS reporting periods have been used for average calculation [6] IFRS reporting periods have been used for average calculation

## Opinion

### SUMMARY RATING RATIONALE

Moody's assigns national-scale issuer ratings of A2.za/P-1.za to Capitec Bank Limited. The ratings reflect Capitec Bank's niche in the South African unsecured lending industry with approximately 2.8 million active customers, and a paperless technology-driven business model that enables it to provide a low-cost and efficient service. The bank has also successfully broadened its banking product range - and specifically its transactional banking services and savings products - which provides funding and revenue diversification and helps strengthen its position as a retail bank offering affordable banking to the South African public.

The bank's financial fundamentals have remained strong, displaying resilient profitability (bottom-line return on risk-weighted assets of 6.0% for the year-ended February 2011), a solid capital cushion (with a Tier 1 ratio of 29.8%), adequate control of asset quality (with loans outstanding more than 90 days fully provisioned and written-off), and successful efforts in building its retail deposit base (retail deposits account for approximately 60% of total funding, against a sector average of under 25%). The ratings also incorporate the potential for systemic support in case of need. In our view, Capitec Bank's involvement in a market sector that is nurtured by the government to support the low-income population of South Africa could qualify it for systemic support, if such assistance was ever required.

Capitec's ratings also reflect the risks relating to (i) its strong balance-sheet growth -- with a 2006-2011 CAGR of 60% -- which will test its credit, capital and liquidity/funding management capabilities; (ii) the bank's narrow market focus and sub-optimal size; (iii) high (though reducing) concentrations in its funding base; (iv) the lengthening of the maturity profile of its loan book, reducing its flexibility to make adjustments when borrower behaviour changes (successfully followed for shorter-term loans); and (v) the high systemic credit risk inherent in the demographic credit characteristics of its client base, also exacerbated by high consumer indebtedness.

**Rating Drivers**

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

- Successful penetration of transactional banking and retail deposit products

- The rapid growth in terms of balance sheet and infrastructure (as well as the lengthening of the maturity profile of its loan book) could hide credit risks

- Capitalisation and historical earnings-generating capabilities are solid

- The bank operates in a high-risk segment providing unsecured loans to lower-income earners

- Despite the successful tapping of the retail deposit base, funding concentrations remain high

- There is the potential for systemic support, in case of need

**Rating Outlook**

The bank's long-term national-scale issuer rating carries a positive outlook, reflecting both its strong financial performance and strengthening franchise.

**What Could Change the Rating - UP**

Capitec Bank's ratings could benefit from its ability to (i) maintain current sound financial fundamentals on an ongoing basis; (ii) consolidate and potentially further grow its market share gains; and (iii) further broaden and diversify both its funding base and revenue sources (primarily its transactional banking fee income).

**What Could Change the Rating - DOWN**

Capitec Bank's rating could be downgraded if (i) its business model and aggressive balance-sheet growth gives rise to credit and liquidity management problems; or (ii) high consumer indebtedness and potential rises in unemployment, inflation and interest rates adversely affect the bank's asset quality, capital position and earnings power.

**Recent Results and Developments**

For the year-ended February 2011, bottom-line profits rose 34% to ZAR473 million, with net interest income increasing by 62% and net fee income by 31%. However, net impairment charges rose by 81%, and operating expenses by 38%. As of February 2011, total assets stood at ZAR14.5 billion (up 53% from a year ago), with net loans up by 93% to ZAR10.1 billion and deposits (including market funding) up 42% to ZAR10.4 billion. Shareholders' equity (including ZAR259 million of preference shares) was ZAR3.2 billion.

**DETAILED RATING CONSIDERATIONS**

Our detailed considerations for Capitec Bank's currently assigned ratings are as follows.

Franchise Value

Capitec Bank provides basic, affordable banking through unsecured lending, savings options and transactional banking services that cater for daily money management. The bank has approximately 2.8 million active clients and its distribution network includes 455 branches and approximately 1,660 ATMs (including partnership ATMs) country-wide, and management plans further expansion.

The bank has implemented a customised banking platform that includes a paperless application process, biometric authorisation, online completion of all processes, and centralised back-office operations. The use of magnetic strip and electronic smart cards (that have access to all other banks and ATMs) allows the bank to operate a simple, low-cost, technology-based business model, with rapid application processes for savings accounts and personal loans. In its continued efforts to broaden its scope of operations, Capitec Bank aims to attract more `banking' (rather than `credit only') customers, thus expanding its depositor/funding base and its transactional, fee-based income sources which management aims to contribute to 40% of operating expenses. To this end, management continues to invest heavily on employee training, and has introduced an `above-line' advertising campaign that focuses on fee and pricing transparency. Over time, we also expect Capitec to increase its share of the middle-income market and further lengthen its loan tenors (currently ranging between 1 and 60 months) and loan amounts (up to ZAR120,000).

The bank's franchise value is, however, constrained by (i) its narrow market focus, at a time when we expect more fierce competition from the `big-four' South African banks, some of which are committed to growing their presence in the high-growth unsecured lending market; (ii) challenging operating conditions with more than one million job losses over the past year-and-a-half and sustained high consumer indebtedness; and (iii) its continued status as a `young' institution that will need a few years to grow its business volumes to fully utilise its infrastructure.

Risk Positioning

The bank's risk positioning is adversely affected by its high-risk product range - unsecured personal loans to lower and middle-income earners - and its strong balance-sheet growth. The ten-fold increase in loans and advances over the period 2006-2010 will test the bank's credit and liquidity/funding risk-management capabilities. Capitec Bank's recent track record does, however, show that it is successfully navigating through the recent credit crunch and macroeconomic slowdown. This is attributed to its (i) prudent liquidity management; (ii) low market-risk appetite; (iii) good credit management and information systems to manage risks; and (iv) conservative investment strategy with regards to its surplus liquidity, primarily deposited with National Treasury, the big local banks and money market funds.

Credit risk within its loan portfolio is the bank's most material risk. Capitec has therefore implemented prudent risk-management practices. Its credit assessment process is based on (i) the client's historic credit behaviour, with information obtained from the credit bureaus (for newly acquired clients) and Capitec's own behavioural score for its existing loan clients; (ii) an affordability assessment, which takes into account the client's income, living expenses and current obligations, and determines the "client available installment"; and (iii) Capitec's employer grading system which is indicative of the employer stability and hence the client's financial stability. Government employees - considered to have a stable job - account for a considerable proportion of Capitec's clientele.

Further risk mitigants include third-party credit life and retrenchment insurance, and conservative provisioning (see Asset Quality section below). An example of the latter would be the (year-end February 2011) significant provisions made against the new 60-month loan product despite excellent performance of that book in the three months to year-end.

Over the last couple of years, the bank has extended the maturity profile of its loan book, with nearly 80% of its loan book having a maturity of over 24 months. This lengthening of loan maturities, limits management ability to make adjustments to its underwriting criteria when borrower behaviour changes. However, this risk is mitigated by the fact that only a portion of the bank's existing clients would qualify for the longer-term products: 17% for the 48-month product and 8% of clients for the 60-month product.

Profitability

The bank has historically maintained sound earnings power despite the financial crisis and macro-economic slowdown. For the year-ending February 2011, bottom-line profits increased 34% to ZAR473 million. Earnings would have been much higher, had it not been for the (ZAR255 million pre-tax) impact of share price increases on the cash-settlement of employee share options (against an equity-settlement at Group - Capitec Bank Holdings Ltd - level). The bank's February 2011 profitability implied a bottom-line profitability as a percentage of risk-weight assets of 6.0%, with pre-provision profitability at 16.0%.

Despite declining net interest margins (to 17.0% according to Moody's calculations), operating income increased by 46% during the year ending February 2011, due to strong balance-sheet growth - with total assets increasing from ZAR9.5 billion in February 2010 to ZAR14.5 billion in 2011 - and an 80% growth of net transaction fee income, which absorbed 26% of operating expenses (2010: 20%). The strong growth in operating income enables the bank to absorb the increased operating expenses (of 38% in 2011) as well as the 81% increase in provision charges.

Going forward, we expect demand for Capitec Bank's products to remain strong and support its revenue growth and bottom-line profitability, with downside risks centred around higher-than-anticipated provision charges and pricing pressure stemming from increased competition.

Liquidity

The bank maintains robust liquidity buffers, with liquid assets (cash, cash equivalents, and investments) accounting for approximately 26% of total assets in February 2011. Capitec Bank manages its liquidity cautiously; its funding base is diverse and since 2009 has successfully introduced new retail products. This has meant that retail call deposits have increased to ZAR3.9 billion and retail fixed savings to ZAR2.3 billion. The bank is also an active issuer in the local capital market - via its ZAR4 billion domestic medium-term note (DMTN) Programme - and other bilateral loans. However, the bank maintains relatively high funding concentrations, with the top 20 deposits/funding accounting for approximately 35% of the total as of February 2011, although this number has fallen from 50% a year earlier.

Over the past couple of years, and as the bank extended its product range to include 36 month, 48 month and 60 month products, the maturity profile of its loan portfolio has increased to approximately 30 months and we expect that it will increase further. Nonetheless, the bank maintains no major maturity mismatches in its asset/liability profile, primarily given its ability to source term funding and maintain a high capital cushion.

Capital Adequacy

With ratio of shareholders' funds to total assets at 22% as of February 2011 and a capital adequacy ratio of 35.1% (Tier 1 of 28.8%), the bank is well capitalised. Capitalisation ratios are supported by (i) Capitec Bank's high earnings-generating capabilities; (ii) relatively conservative dividend payout ratios, targeting a dividend cover of 2.6x at Group level; and (iii) an ZAR1.27 billion ordinary share capital injection.

Capital ratios were also increased from a ZAR104 million preference shares issue and ZAR200 million of subordinated debt issuance, which boosted the bank's Tier 2 capital. The higher risk nature of Capitec Bank's business profile and target market does, however, warrant a higher capitalisation cushion compared with commercial banks. The South African Reserve Bank has recognised this issue and has set the minimum capital adequacy requirement at 25% for Capitec Bank.

Going forward, and as the bank maintains its aggressive growth trajectory, the bank may require additional capital raising initiatives. According to management, the Group's shareholders remain committed to supporting the bank's long-term growth strategy.

Efficiency

As of February 2011 the bank's cost-to-income stood at 55%, with non-interest expenses as a percentage of average assets at 17.2%. The latter is well-above the average for the banking sector (of under 3%), but reflects the high costs associated with its business model and the high turnover of short-term higher-yielding assets. Specifically, we note that for the year-ended February 2011, the bank advanced 5.5 million loans, while also continuing to make large investments in developing and expanding its retail banking infrastructure. Over the past two years, costs were also adversely affected by increased charges relating to the cash-settlement of employee share options, a portion of which maybe considered as non-recurring. For the year-ended February 2011, the charge was ZAR255 million.

Despite the above, we believe that Capitec runs its business efficiently and aims to streamline/improve branch processes. As such, in our view, it is a cost-conscious organisation. According to management, Capitec's branch set-up costs are estimated at a fraction (under 20%) of the industry average, while its developed infrastructure should also allow it to absorb higher business volumes, specifically relating to transactional banking services and attracting retail deposits. This, in turn, should help to further improve the bank's efficiency indicators over the medium term.

Asset Quality

Capitec provides unsecured lending to low/medium income earners, and hence its loan portfolio displays a higher proportion of impaired loans compared with conventional banks. This is evident from the high level of impairment expenses, which accounted for 9.1% of gross loans in

2011 (February 2010: 9.8%), against around 1.5% for the conventional banks.

Against this high-risk target market, Capitec follows tight risk-management practices and aims to `correctly' price for the risk undertaken, but also follows conservative provisioning policies. These include (i) full provisioning and subsequent write-off of all loans with three missed installments; (ii) subsequent recoveries of written off loans are recognized on a cash received basis; and (iii) the bank takes a `general' or `incurred but not reported' provision of up to 5% on its performing book.

As of February 2011, loans past due stood at ZAR625 million, which accounted for 5.7% of gross loans, compared with 6.2% in February 2010. In addition to these however, ZAR626 million of fully provisioned loans were written-off during the year (2010: ZAR494 million). Against these past due loans, the bank maintains a specific provision of ZAR332 million, which implies a coverage ratio of 53%. The bank also maintains a ZAR512 million provision on its performing book which translates to a 5.0% `general' provision. We consider such provisioning levels as adequate.

Latest vintage data show a small improvement in asset quality, with the exception of the 18 and 24 month loan products. The bank's management has informed us that this represents qualifying clients (those of better credit quality) migrating to the new longer-term and better-priced products, thus diluting the asset quality of the 18 and 24 month products. Similarly, there was a deterioration in the default rates of government employees during Q1 2011, when contract teachers and medical staff were not paid. Over the next year, we would expect asset quality trends to remain at broadly similar levels to present levels.

**ABOUT MOODY'S BANK RATINGS**

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 August 2010 entitled "Mapping Moody's National Scale Ratings to Global Scale Ratings."