Capitec: A wolf in sheep's clothing

Based on our research and due diligence, we believe that Capitec is a loan shark with massively understated defaults masquerading as a community microfinance provider. **We believe that the South African Reserve Bank & Minister of Finance <u>should immediately place Capitec into curatorship</u>.**

Capitec Bank Holdings Limited (JSE: CPI) is a South Africa-focused microfinance provider to a **majority low-income demographic**, yet they out-earn all major commercial banks globally *including competing high-risk lenders*. **We don't buy this story.** Viceroy believes this is indicative of predatory finance which we have **corroborated with substantial on-the-ground discussions with Capitec ex-employees, former customers, and individuals familiar with the business.**

Viceroy's extensive due diligence and compiled evidence suggests that indicates Capitec **must take significant impairments to its loans** which will likely result in a net-liability position. We believe Capitec's concealed problems largely resemble those seen at African Bank Investments (JSE: AXL) prior to its collapse in 2014.

We think that it's only a matter of time before Capitec's financials and business unravel, with macro headwinds creating an exponential risk of default and bankruptcy.

This report will provide underlying information and analysis we believe supports the following conclusions:

- Reconciliation of loan book values, maturity profiles and cash outflows imply **Capitec is either fabricating new loans and collections, or re-financing ~ZAR 2.5bn – 3bn (US$200m-$240m) in *principal* per year by issuing new loans to defaulting clients.**
- Legal documents obtained by Viceroy **show Capitec advising and approving loans to delinquent customers in order to repay existing loans**. These documents also show Capitec engaging in reckless lending practices as defined by South Africa's National Credit Act. This corroborates Viceroy's loan book analysis.
- As a consequence of re-financing delinquent loans, Viceroy believes Capitec's loan book is massively overstated. **Viceroy's analysis against competitors suggests an impairment/write-off impact of ZAR 11bn will more accurately represent the delinquencies and risk in Capitec's portfolio.**
- Legal experts that we have spoken to believe that the outcome of an **upcoming reckless and predatory lending test case in March 2018 will be used to trigger a multi-party litigation refund (class action)**. We believe that, at a minimum, Capitec will be required to refund predatory origination fees primarily related to multi-loan facilities; an **estimated ZAR 12.7bn**.
- Viceroy's investigations suggest that **Capitec's prohibited and discontinued multi-loan facility lives on**, rebranded as a "Credit Facility". Former Capitec employees have corroborated this. Despite its perception as an affordable lender, Capitec's implied interest rates are significantly true of the maximum allowable rates in South Africa.
- South Africa's microfinancing sector has been the graveyard of numerous Capitec competitors who chased the same meteoric growth Capitec displays, largely due to low acceptance and mass delinquencies. **We see no operational difference between Capitec and its ill-fated predecessors, including African Bank.**
- **Former employees consider the business to still be an outright loan-shark operation**, where fees are key. Some former employees believe they **were fired for not deceiving borrowers and failing to meet rescheduling targets on impaired/defaulting loans.**
- **Jean Pierre Verster**, **chairman of Capitec's audit committee**, is/was indirectly short Capitec through Steinhoff. We believe this is an oversight, and understand Verster to be an excellent analyst on the short side. **We encourage Verster to raise the concerns within this report to company auditors and recognize Capitec's resemblance to his previous African Bank short.**

Given what we believe is a massive overstatement of financial assets and income, together with opaque reporting of loan cash flow and reckless lending practices, **we believe Capitec is simply uninvestable and accordingly have not assigned a target price.**

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Contents

1 Background

Capitec

Capitec was formed in 1999 by South African investment holding group PSG through the combination of several microfinance businesses, some PSG owned, including Smartfin, Finaid and PSG Anchor Finance. In 2000 PSG purchased The Business Bank and used its banking license to create the newly named Capitec from its component companies.

Capitec primarily operates unsecured lending and banking services aimed at low-income markets in South Africa. The company has become something of a stock market darling and has a reputation for disruptive practices and low operating costs.

History of microlending in South Africa

Political developments and legislative changes to lending regulations in the early 1990's created a surge in microcredit availability in South Africa[1]. Ideally, access to capital and a banking system would revitalise and empower the most disenfranchised communities.

After a rapid growth in microcredit supply, the first signs of individual over-indebtedness led to wavering government support for the industry in the early 2000's. Many of the loans were being used for consumption spending, and easier access to capital essentially crowded out already-successful businesses.

This culminated in the 2002 blow-ups of leading microfinance bank Saambou[2] and Absa's microfinance unit Unifer[3].

The industry returned to prominence in 2005 through the establishment of Mzansi accounts: low-cost accounts for low-income individuals designed to increase banking reach to lower-income communities. The scheme was largely a failure by 2012 with the majority of Mzansi accounts inactive or otherwise dormant leading to little-to-no fee income[4].

Out of this two microfinance-only names emerged: the now-infamous African Bank Investments[5] and Capitec. African Bank Investment's fate was sealed when it was placed into curatorship by the South African Reserve Bank (SARB). We believe Capitec will meet the same outcome.

South Africa is now in the grips of a household debt crisis exacerbated by easy access to microfinance. By 2012 as little as 6% of the total microcredit volume advanced was being used for conventional business purposes[6]. At one point the mining town of Rustenburg had one microfinance provider per 3000 people with many lenders literally operating on the mine site.

The growing crisis has gained prominence in the South African media with suggestions that microfinance lenders had instituted a form of debt slavery for low-income families. A popular TV series, "In Debt" features a "Debt Doctor" who attempts to restructure and refinance the show's contestants[7]. Several prominent newspapers have featured columns on refinancing and administration.

[1] http://ebha.org/public/C7:paper_file:147
[2] https://www.fanews.co.za/article/banking/35/general/1223/does-anyone-remember-saambou-bank/341
[3] https://www.iol.co.za/business-report/companies/absa-picks-up-pieces-after-last-years-banking-crisis-by-integrating-unifer-769680
[4] http://www.cgap.org/blog/beyond-mzansi-account-south-africa-%E2%80%93-targeting-usage
[5] https://www.fin24.com/Opinion/lest-we-forget-lessons-from-african-bank-20170927
[6] http://www.mondaq.com/southafrica/x/274240/Microfinance+And+Poverty+Alleviation+In+South+Africa
[7] http://www.ochre.tv/south-africans-are-drowning-in-debt-fact-hello-to-the-debt-doctor/

"Carefully concealed high interest rates, hidden administrative fees, unannounced penalties for nonrepayment or early redemption, garnishee orders that could tap into a client's income in order to repay a debt, and grossly exorbitant lawyer fees that were incurred for any trivial contract infraction"[8]

The Board

Capitec's board is largely and unsurprisingly made up of several executives from both PSG and Steinhoff. PSG is Capitec's largest shareholder and Steinhoff was, until recently, PSG's largest shareholder.

While this is not overly suspicious, we are cautious of incestuous management between these firms given Steinhoff's poor corporate governance.

- Markus Jooste, former Steinhoff CEO, served on the boards of both PSG and Capitec.
- Christo Wiese served on the board of PSG.
- Jannie Mouton, PSG's founder and chairman, has served on the board of Steinhoff.
- Piet Mouton, Jannie's son and now CEO of PSG, serves on the board of Capitec.
- Ben la Grange, Steinhoff CFO, has served on the board of PSG – Resigning from Steinhoff African Retail (STAR JSE) last week, Jan 25, 2018.

While large intra-company holdings exist, Viceroy are skeptical of any significant independence within Capitec management. To be clear – this report does not have an opinion on PSG's business model. In fact, the unwillingness of PSG to raise fresh equity as an investment group is a breath of fresh air.

We do have concerns with Capitec's business, which we will detail in this report, that we believe are not best dealt with by a management team that is so intertwined with its largest stakeholder. This presents a very real conflict of interest to minority shareholders.

Breakneck insider sales

Our sentiments regarding Capitec seem to be echoed by management who appear to be selling shares at an alarming pace. Most notable amongst the sales are those of Capitec CEO Gerrie Fourie and former CEO Riaan Stassen (2004 – 2013)[9].

[8] Seduced and Betrayed: Exposing the Contemporary Microfinance Phenomenon by Milford Bateman & Kate Maclean
[9] https://www.biznews.com/undictated/2017/12/22/capitec-ceo-sell-shares/

Jean-Paul Verster and Fairtree Capital

Ironically, we note that one of Capitec's independent directors and chairman of its audit committee, Jean Pierre Verster, may be too independent to the level of poor corporate governance. Jean Pierre Verster is concurrently the portfolio manager of Fairtree Capital and has publicly marketed his big short bet on Steinhoff, which at the time indirectly held ~7.5% of Capitec through PSG[10].

Jean Pierre Verster: Why I shorted Steinhoff

'There is a hole in the books, we just don't know how big.'

Warren Thompson / 6 December 2017 15:34 22 comments

Figure 1 Extract from moneyweb.co.za article "Jean Pierre Verster: Why I shorted Steinhoff"[11]

Legal opinion we have requested suggests that this is a major conflict of interest, regardless of the inherent flaws in Steinhoff.

Fairtree Capital also has extremely small holdings of ~75,000 shares in Capitec through three of its funds: Fairtree Equity Prescient Fund, Fairtree Flexible Balanced Prescient Fund and Fairtree Balanced Prescient Fund[12]. None of these funds are managed by Verster which we believe to be **a vote of no-confidence in Capitec's valuation and future performance.**

Table current as of January 24, 2018

Fund Name	Managers	AUM (ZAR m)	Capitec holding
Fairtree Equity Prescient Fund	Stephen Brown Cor Booysen	4,904.70	74,491 (1.43%)
Fairtree Balanced Prescient Fund	Stephen Brown Jacobus Lacock Bradley Anthony	44.4	243 (0.57%)
Fairtree Flexible Balanced Prescient Fund	Jacobus Lacock Bradley Anthony	38.4	223 (0.56%)

Figure 2 Fairtree funds invested in Capitec13,14,15

Despite limited audit experience, from what we can see from his profile, Jean Pierre Verster appears to be an excellent analyst having called the Steinhoff short and prior to that African Bank[16]. We hope Jean Pierre Verster sees the similarities between Capitec and African Bank after reading this report and prudently raises serious concerns regarding Capitec's reporting practices. He has also been positive about our report on Steinhoff and we appreciate his comments[17].

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10 https://www.moneyweb.co.za/news/companies-and-deals/jp-verster-why-i-shorted-steinhoff/
11 See reference 9
12 As of January 24, 2018
13 http://fairtree.com/wp-content/uploads/2015/08/Fairtree-Equity-Prescient-Fund-Minimum-Disclosure-Document-August-2017.pdf
14 http://fairtree.com/wp-content/uploads/2017/05/Fairtree-Balanced-Prescient-Fund-Minimum-Disclosure-Document-December-2017.pdf
15 http://fairtree.com/wp-content/uploads/2015/08/Fairtree-Flexible-Balanced-Prescient-Fund-Minimum-Disclosure-Document-December-2017.pdf
16 https://www.biznews.com/briefs/2014/08/13/hedge-fund-made-r100m-abil/
17 https://www.bloomberg.com/news/articles/2018-01-12/faceless-men-upend-south-africa-stocks-on-fears-of-steinhoff-2-0

2 Kicking the can – receivable or not receivable?

Viceroy believes analysts covering Capitec have placed significant emphasis on valuation of interest income streams without back-testing the viability of its loan book. This is an important test given Capitec's target market's steadily deteriorating ability to service debt per the market analysis in section 6 below.

Recall that Capitec's loan portfolio almost entirely consists of unsecured retail consumer loans: inherently risky and getting riskier.

Capitec's FY 2016 loan maturity profile indicated that ZAR 12.9bn of principal would become payable within 12 months (i.e. "current"). Capitec's ***bad debt*** (not impairment provisions, but full write-offs) for FY 2017 was over ZAR 5.4bn.

Bad debt impact equates to over 42% of Capitec's gross collectable principal per the loan book's maturity schedule.

Loan Maturity Profiles			
ZAR ('000s)	**2017**	**2016**	**2015**
Net Loans	**39,204,980**	**35,756,860**	**32,483,897**
Identified impairments	(4,011,869)	(3,742,990)	(2,701,059)
Unidentified impairments	(1,918,508)	(1,388,615)	(1,156,311)
Total impairments	**(5,930,377)**	**(5,131,605)**	**(3,857,370)**
Gross Loans	**45,135,357**	**40,888,465**	**36,341,267**
Demand - 1 mth	1,995,288	1,954,994	1,459,335
1 mth - 3 mths	2,636,689	2,186,002	1,728,706
3 mths - 1 yr	10,728,106	8,742,187	7,223,538
> 1 yr	30,494,018	28,586,451	26,260,041
Loan origination fees	(718,744)	(581,169)	(330,353)
Bad debt write-off	(5,447,481)	(3,980,854)	(4,395,602)
Previous year 'current' loan book (< 1 yr maturity)	12,883,183	10,411,579	9,210,599
Write-off % of collectable principal	**-42.3%**	**-38.2%**	**-47.7%**

Figure 3 Viceroy analysis of Capitec loan maturity profiles

We believe this is the tip of the iceberg. As the quality of Capitec's accounts continues to decline, further systemic vulnerabilities become increasingly material and expose Capitec to potential liquidity concerns.

Capitec's loan book income irreconcilable

Viceroy has back-tested Capitec's principal loan book balances and have found material discrepancies in working capital accounts. A back-testing of Capitec's loan book movements suggests that ~ZAR 2bn – 3bn is either:

1. Being repaid early;
2. Long term loans that are defaulting extremely early; or
3. Non-cash loans

Given Capitec's target market is the low-income demographic, we believe that early repayment of hand-to-mouth payday loans is unlikely. Capitec's loan vintage graphs suggest most long-term loans do not default at the start of their term.

Through our analysis below, we demonstrate that Capitec materially misrepresents the balance of its unpaid loans by consistently "rescheduling" these loans through the issuance of new loans.

Reconciliation of Capitec loan book (ZAR 000's)	2017	2016	2015
Opening Balance	**40,891,465**	**36,341,267**	**33,690,026**
Gross Expected Principal Received	*(12,886,183)*	*(10,411,579)*	*(9,210,599)*
Less: pro-rata debt portion	*1,480,091*	*1,040,947*	*1,188,729*
Net Expected Principal Received - opening balance	(11,406,092)	(9,370,632)	(8,021,870)
Gross intra year loan principal received	*(5,961,000)*	*(5,955,000)*	*(3,145,000)*
Less: pro-rata debt portion	*693,078*	*560,475*	*375,300*
Net Expected Principal Received - intra year loans	(5,267,922)	(5,394,525)	(2,769,700)
Total bad debt	*(5,447,481)*	*(3,980,854)*	*(4,395,602)*
Bad debt attributable to expected principal received	*1,480,091*	*1,040,947*	*1,188,729*
Bad debt attributable to intra-year loans	*693,078*	*560,475*	*375,300*
Applicable bad debt	(3,274,311)	(2,379,433)	(2,831,573)
Balance after repayments and write offs	**20,943,141**	**19,196,677**	**20,066,882**
Reported gross loans	45,135,357	40,891,465	36,341,267
Required new loans	**24,192,216**	**21,694,788**	**16,274,385**
Reported new loans	27,226,000	24,228,000	19,417,000
Difference	**(3,033,784)**	**(2,533,212)**	**(3,142,615)**
Difference USD 000's (current exchange rate)	(240,776)	(201,049)	(249,414)

Figure 4 Viceroy analysis of Capitec loan book reconciliation

Gross expected principal received

The "current" portion of a loan book (receivable within 12 months) is a reliable indicator of how much principal one would **expect** to receive from its borrowers by the following year, and thus not appear on the loan book the following year (we will refer to this as the **Gross Expected Principal Received**).

Gross intra-year loans

Capitec have recorded incremental intra-year loans despite management advice that it would shift focus towards longer term loans.

These loans have recently been re-classified by the company as credit facilities – essentially a working capital account repayable at the end of each month. The EOY balances for these credit facilities as a percentage of gross loans are almost immaterial. We have taken them into account as follows to estimate the principal sums returned:

Starting credit facility balance
Add: credit facilities issued
Less: ending gross credit facility balance
Intra-year credit facilities returned

Figure 5 Calculation of intra-year credit

We must consider the effect of part-principal repayments of loans issued in the current year. We have done so on an amortization table for each duration of new loans.

As interest on loans is typically paid out incrementally (i.e. principal portion of loan repayment increases over time), loans of more than 12 months had immaterial effect.

An example of 2017 calculations:

Back-testing total loans issued / collected

ZAR (m)	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Total	
Issued	1,961	1,961	1,961	1,961	1,961	1,961	1,961	1,961	1,961	1,961	1,961	1,961	23,526	*Total new loans issued 2017*
Mar	-	-	-	-	-	-	-	-	-	-	-	-	-	
Apr	52	-	-	-	-	-	-	-	-	-	-	-	***52***	
May	53	52	-	-	-	-	-	-	-	-	-	-	***105***	
Jun	54	53	52	-	-	-	-	-	-	-	-	-	***160***	
Jul	56	54	53	52	-	-	-	-	-	-	-	-	***215***	
Aug	57	56	54	53	52	-	-	-	-	-	-	-	***272***	
Sep	58	57	56	54	53	52	-	-	-	-	-	-	***330***	
Oct	39	58	57	56	54	53	52	-	-	-	-	-	***369***	
Nov	39	39	58	57	56	54	53	52	-	-	-	-	***408***	
Dec	40	39	39	58	57	56	54	53	52	-	-	-	***449***	
Jan	41	40	39	39	58	57	56	54	53	52	-	-	***490***	
Feb	42	41	40	39	39	58	57	56	54	53	52	-	***532***	
													3,382	*Principal collected from 2017 issued notes*

Figure 6 Intra-year distribution of principal collected

Intra-year credit facilities and intra-year personal loan recoveries are consolidated into gross intra year loan principal received.

Intra-year loans returned	+
Intra-year credit facilities returned	+
Gross intra-year loan principal received	

Figure 7 Calculation of intra-year loan principal received

We have assumed maximum interest rates charged on each loan period type, as this is still below a simple average of the interest charged on Capitec loan books (prior to intra-year consideration).

Opening Book Balance	40,891,465
Closing Book Balance	45,135,357
Average Book Balance	**43,013,411**
Interest charged on loans 2017	12,389,250
Simple interest rate	28.8%

Figure 8 Calculation of simple interest rate

Write-offs

Capitec's massive write-offs presumably partially contribute to these expected collectable principal figures, which slightly complicates the reconciliation of the end-of-year loan book and cash balances as we must now recognize an expense amongst asset class transfers. We have therefore adjusted for write-offs on a pro-rata basis. We believe this is conservative given loan vintages suggest loans are more likely to default at the end of their terms.

The pro-rata base is the sum of the Gross Loan Book Opening Balance and Gross Intra-Year Principal Received. We believe this is a fair estimate without a significantly complex equation and without a more detailed disclosure of write-off allocations.

Bad debt reversals

Bad debt reversals are not added back on the loan book as they appear to arise from the sale of defaulted loans[18]. A sale of loan book would not result in a receivable loan, but straight cash.

Recoveries

Recoveries increased by 32% year-on-year from R854 million in 2016 to R1 125 million in 2017. The increase resulted from operational debt recovery improvements, a larger handover book and debt sales.

Figure 9 Extract of Capitec 2017 Annual Report

Kicking the can - loans and advances to clients

Capitec claims to have achieved ZAR 27.2bn and ZAR 24.2bn of loan sales in FY 2017 and FY 2016 respectively[19], representing over 50% of Capitec's opening gross loan book each year. Our analysis suggests this figure should be ~ZAR 2.5bn – ZAR 3bn lower each year. Another way to represent this is to show the expected vs actual working capital adjustment year-on-year based on loans.

Reconciliation using reported new loans (ZAR 000's)	2017	2016	2015
Opening Balance	**40,891,465**	**36,341,267**	**33,690,026**
Loans issued	27,226,000	24,228,000	19,417,000
Estimated end loan book before repayments	**68,117,465**	**60,569,267**	**53,107,026**
Net Expected Principal Received - intra year loans	(5,267,922)	(5,394,525)	(2,769,700)
Net Expected Principal Received - opening balance	(11,406,092)	(9,370,632)	(8,021,870)
Remaining bad debt	(3,274,311)	(2,379,433)	(2,831,573)
Estimated end loan book	**48,169,141**	**43,424,677**	**39,483,882**
Reported end loan book	45,135,357	40,891,465	36,341,267
Difference	**(3,033,784)**	**(2,533,212)**	**(3,142,615)**
Difference USD 000's (current exchange rate)	(240,776)	(201,049)	(249,414)

Figure 10 Viceroy analysis of Capitec loan book – Estimated v Reported

Viceroy believes Capitec are rolling over existing unpaid loans by issuing new loans; all the while demonstrably collecting zero principal from these delinquencies, and capitalizing interest and massive fees.

[18] Capitec 2017 Annual Report – pg. 14
[19] Capitec 2017 Annual Report – pg. 24

Rescheduled loans

Capitec often reschedules loans which are in arrears. Given these loans are classified as rescheduled, they would not (or should not) be classified as “new loans”. Readers should note that the inclusion of these loans in our analysis would *increase* the inconsistency value.

The Damage

Viceroy believe between ZAR 2.5bn and ZAR 3bn of Capitec’s loan book balance at the end of FY 2017 was payable in 2017, and discretionally carried forward via the issue of new loans to repay delinquent loans. This activity would essentially conceal losses the size of Capitec’s earnings and elevate their loan metrics above their competitors.

By refinancing delinquencies, Capitec is also creating a false economy within its income statement, as it records interest and fees on delinquent loans which would otherwise be unpaid.

This type of loan renewal would be concerning at any commercial bank. However, Capitec being a retail microfinance lender, carrying forward small, unsecured retail loans represents much higher credit risk.

The Evidence

We believe Summit Financial Partners’ case against Capitec corroborates our analysis:

> In the case before the magistrate's court, Summit alleges that the plaintiff was asked three simple questions to access multiple loans electronically (via an ATM).
>
> None of the questions determined whether the plaintiff could afford to pay back the loans.
>
> The questions listed in the court papers, requires only a yes/no answer. They are:
>
> 1. Your income did not decrease?;
> 2. Your expenses did not increase?;
> 3. You are not in arrears at any credit provider?
>
> In a normal affordability assessment the financial institution, would among others, have to request current payslips to determine and confirm the applicant's gross and net income; recent bank statements to reflect payment of salary into a bank account; the applicant's loan obligations, credit history, any adverse listings (repossessions, loans written off, loans handed over to attorneys for collection, etc), against him/her; and the applicant's living expenses.
>
> **Summit: '10 000 Capitec loans were issued to Amplats employees during strike'**
>
> "We believe this is how it is possible that 10 000 Capitec loans were issued to Amplats employees during the strike period. How can this be responsible lending? In time, a mere 10 500 Amplats employees have accessed over 150 000 loans each attracting the 12% initiation fee. That is an average of 15 loans per employee, why not provide a term loan instead?" asked Gardner.
>
> Summit also alleges that Capitec charges a new initiation fee every time a consumer extends their multi loan, "just another term for 'pay-day' loans".

Figure 11 Extract from fin24.com article “Capitec taken to court over ‘reckless lending’”[20]

Viceroy has obtained affidavits of numerous Capitec victims who evidence Capitec issuing new loans to repay existing facilities.

[20] https://www.fin24.com/Companies/Financial-Services/capitec-taken-to-court-over-reckless-lending-20160504

Below are extracts from an affidavit of former Capitec customer, Mr. Thobejane:

7. On or about May 2014, I approached the Respondent for a loan. At the time, I already had an existing loan with the Respondent, in terms of which I was paying approximately R728.00 per month, with a total outstanding balance of approximately R69 692.94.

8. On 27 May 2014, the Respondent granted me two loans.

LOAN 1

9. The first loan was for R80 000.00, to be repaid over a period of 34 months in equal instalments of R3664.84 ("**LOAN 1**"). I attach hereto a copy of the pre-agreement quotation and signed loan agreement as Annexure "**MPT1**" and "**MPT2**" respectively.

12. **LOAN 1** was used to settle the existing loan. Thus, even though **LOAN 1** was for an advance of R80 000.00, I only received R10 307.06, as the pre-existing loan first had to be settled. A copy of the settlement letter is annexed hereto as Annexure "**MPT3**".

Figures 12 & 13 Extract from Thobejane v. Capitec Affidavit

Mr. Thobejane had an existing loan facility with Capitec to the value of ZAR 69,693. Upon approaching the bank for a further loan, the bank granted him two – one to *repay the existing facility*, and another multi-loan facility.

Below are extracts from another affidavit of former Capitec customer, Ms. Mthimkhulu:

6. The Respondent has granted me eight (8) loans over the course of fifteen (15) months.

10. On 14 October 2014 the Respondent granted me the first two (2) loans. I approached the Respondent in order to obtain a loan. A credit agreement for R35 000.00 was concluded (the **October 2014 loan**). I annex hereto a copy of the signed loan agreement marked as **Annexure "MTM1".** The Respondent presumably concluded an affordability assessment before granting me the **October 2014 loan**.

11. On the same day, the Respondent advised me on and granted me a multi loan product (the **October 2014 multi loan**). An apparent affordability assessment was concluded wherein the Respondent did not take into account all of my actual debt obligations at the time the loan was granted. I find it particularly perplexing that the instalment for **October 2014 loan** with the Respondent was not taken into account either.

30. Having utilized the **October 2014 multi loan** numerous time, causing me to fall into a debt spiral, I approached the Respondent again on 9 December 2014, two (2) months after the initial loans were granted.

31. I was advised by the Respondent that I should take out a bigger loan in order to cover my outstanding **October 2014 multi loan** instalment and the balance of the **October 2014 loan**. I was unable to repay the aforementioned loans due to their recklessness.

32. A further loan agreement for the amount of R87 102.06 was concluded (the **December 2014 loan**). The instalment on my financial obligations with the Respondent went from R1868.93 (plus optional Multi Loan repayment) to R4 476.03 (plus optional Multi Loan repayment) within two (2) months. I annex hereto a copy of the pre-agreement quotation and signed credit agreement of the **December 2014 loan** marked as **Annexure "MTM6"** and **"MTM7"** respectively.

APRIL 2015

36. On 8 April 2015 I returned to the Respondent in order to attain a solution to the spiralling financial situation I found myself in. Instead of aiding me by reducing the instalment, the Respondent opted to extend a further loan of R99 379.51 to me (the **April 2015 loan**). I annex hereto a copy of the pre-agreement quotation and signed credit agreement marked as **Annexure "MTM9" and "MTM10"** respectively.

37. It should be noted that my financial duress was evident, and the Respondent's eagerness to extend more credit than what was prudent, is crucial. My monthly obligation to the Respondent after the **April 2015 loan** was R3973.55 (plus multi loan instalment), while my indebtedness to the Respondent increased to approximately R100 000.00.

Figures 14, 15, 16 & 17 Extract from Mthinkhulu v. Capitec Affidavit

Ms. Mthimkhulu originated two loans with Capitec in October 2014, which she *could not afford*. This was a result of insubstantial affordability assessments by Capitec which did not take into account loan installments!

Instead of arranging remediation for the loans, Capitec issued Ms. Mthimkhulu more debt to repay her old debt, both in December 2014, and again in April 2015. In this period, Ms. Mthimkhulu's debt spiraled from an initial ZAR 35,000 to ~ZAR 100,000.

2013 credit crisis – Capitec history of loan re-financing

Capitec has a history of loan refinancing indicators, most notably their performance during the 2013/2014 South African credit crisis.

In 2013 as a result of a myriad of factors South Africa experienced something of a credit crunch. The ensuing fallout resulted in the eventual collapse of African Bank Investments Limited in 2014 when it was placed under curatorship. The comprehensive Myburgh report on the bank's collapse highlights the differences between African Bank and Capitec:

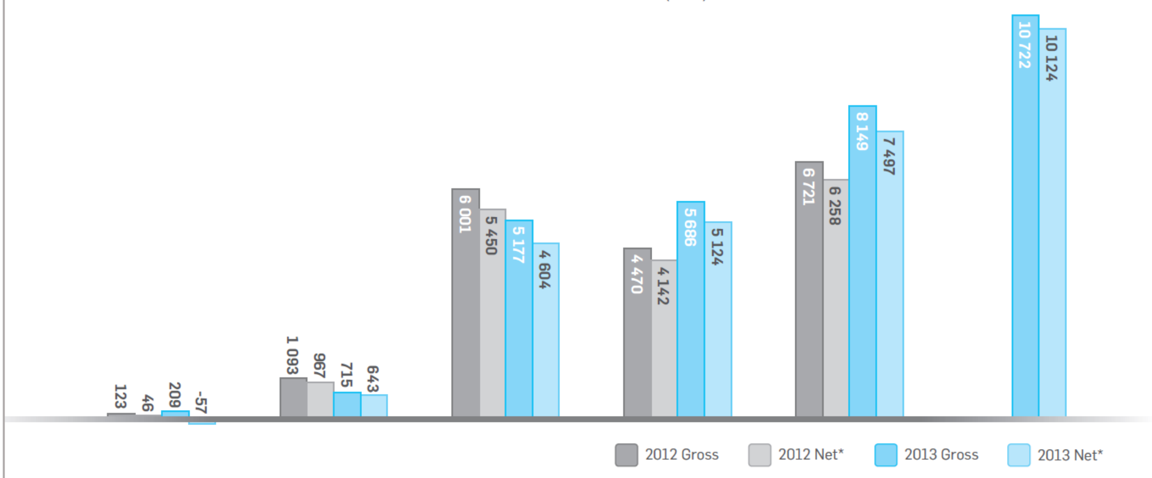
(i) Abil: the level of impaired advances to loans and advances ratio as at March 2013 was 29,39% (March 2012: 28,08%), while the coverage of specific impairments (coverage ratio) stood at a mere 49,36%. Despite the high balance sheet growth, the ratio of impaired advances to total advances increased further from 28,08% in March 2012 to 29,39% in March 2013.

(iv) Capitec Bank: the level of impaired advances to loans and advances ratio as at March 2013 was 5% (2012: 4%), while the coverage of specific impairments stood at 53,52%. Despite the high balance sheet growth rate of 63%, the ratio of impaired advances to total advances increased further from 4% in March 2012 to 5% in March 2013.

Figures 18 & 19 Extracts from Myburgh report on African Bank Limited[21]

Viceroy finds it literally unbelievable that a bank would be able to increase its balance sheet by more than half and only incur a 1 percentage point increase in its non-performing loans in that environment, much less an unsecured lender.

Incredibly and suspiciously, 2013 was the first year Capitec introduced its 84-month loans which instantly became its most popular loan product, accounting for a third of its loan book.

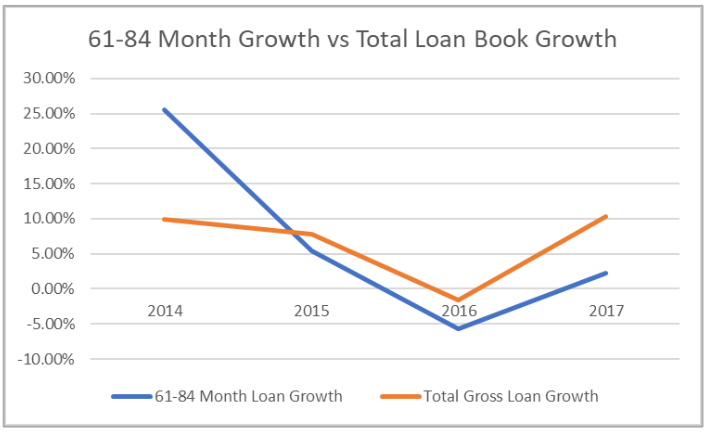


(Months)	Other	1-12	13-36	37-48	49-60	61-84	Total
2012 Gross	123	1 093	6 001	4 470	6 721	–	18 408
2012 Provision	(77)	(126)	(551)	(328)	(463)	–	(1 545)
2012 Net*	46	967	5 450	4 142	6 258	–	16 863
2013 Gross	209	715	5 177	5 686	8 149	10 722	30 658
2013 Provision	(266)	(72)	(573)	(562)	(652)	(598)	(2 723)
2013 Net*	(57)	643	4 604	5 124	7 497	10 124	27 935

Figure 20 Extract from Capitec Annual Report 2013

Given the sudden popularity of the 61-84 month loan product, it would be expected that these loans would become a larger part of the Capitec loan book over time. **This was not the case**.

[21] https://www.resbank.co.za/Publications/Detail-Item-View/Pages/Publications.aspx?sarbweb=3b6aa07d-92ab-441f-b7bf-bb7dfb1bedb4&sarblist=21b5222e-7125-4e55-bb65-56fd3333371e&sarbitem=7288



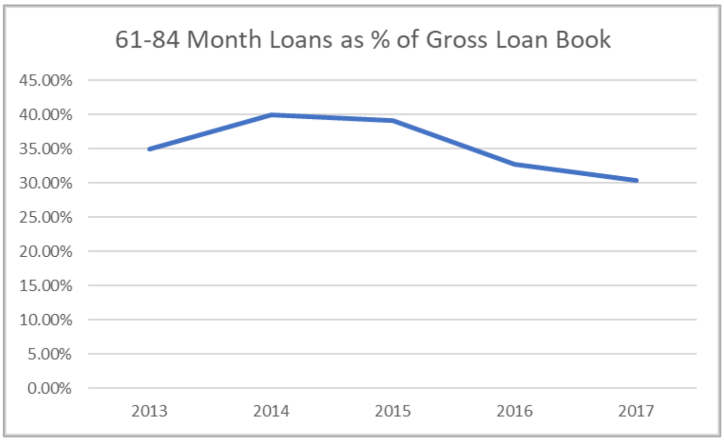


Figure 21 & 22 Viceroy analysis of 61-84 month loans

Taken together; the 63% balance sheet growth, sudden and unrepeated prominence of 61-84 month loans and disproportionately low increase in non-performing loans leads us to believe that Capitec “rescheduled” non-performing loans by issuing new loans to delinquent customers in 2013.

Since 2013, Capitec’s loan book has grown 47.22% yet non-performing loans only increased from 5.8% to 6.3% (8.6% increase).

Viceroy believes that Capitec is artificially maintaining low arrears by issuing new extended term loan agreements so clients could pay off existing loans.

3 Capitec credit facility's origination fee resembles loan shark tactics

Since 2016, consumer rights advocacy group and financial advisors Summit Financial Partners has taken Capitec to court on numerous occasions, some ongoing, on behalf of wronged clients. At the heart of each of Summit's cases against Capitec, is that the bank has engaged in predatory lending practices that amount to reckless lending in violation of the National Credit Act.

Prior to this, Summit Financial were consumer protection advisors to Capitec. Summit states the relationship was severed by "irreconcilable differences over Capitec's lending practices, their failure to accommodate consumers thrown into a debt spiral by their products and their refusal to provide documents to enable [Summit] to assess their clients' financial situation"[22].

The major issue Summit appears to have with Capitec was with the operation of its multi-loan facility:

How multi loans exploit desperate consumers

There are a number of legal and ethical problems with these month-to-month multi loans:

1. Their ease of access preys on desperate consumers. Cash from a multi loan is instantly accessible via an ATM or mobile app, making them hard to resist for consumers in a short-term financial bind.

2. Their month-to-month payment scheme traps consumers into a vicious debt cycle. This quickly makes them reliant on Capitec, with many consumers accessing as many as 14 – 21 multi loans in a 24 month period.

3. Although clearly designed to be a credit facility, they are disguised as a series of short-term payday loans. This means Capitec can play by different rules and charge extra fees.

4. By disguising multi loans as a series of short-term loans, Capitec charges a series of unjustified initiation fees which push up the total cost of credit to as much as 500% per year.

5. In many cases, they amount to reckless credit.

Figure 23 Extract from Summit Financial Partners blog article "Summit takes Capitec multi loans to court"[23]

Capitec has subsequently discontinued its "multi-loan" facility, but has introduced its "credit facility" product which, for all intents and purposes, is exactly the same thing. The facility:

1. Offers instantly accessible credit via ATMs
2. Has a month-to-month payment scheme that resembles payday loans
3. Is designed as a "unplanned expense" facility, but short terms and frequent full repayments resemble payday loans.
4. Charges a series of massive origination fees and monthly fees – even if you have *no balance owing.*

Our analysis suggests that ~87% of the number of loans issued by Capitec (not the value), are through Capitec's recently rebranded multi-loan facility: Capitec Credit Facility. Viceroy believes this facility is little more than a loan shark making it ultimately unsustainable and highly unethical.

Origination fees

Loan origination fees are a major boost to Capitec's returns every year and a significant reason Capitec's returns are so exemplary compared to its competitors. While competitors' origination fees are immaterial (<1% of earnings), Capitec's origination fees contributed ~21% of earnings in 2017.

[22] https://www.fin24.com/Companies/Financial-Services/capitec-taken-to-court-over-reckless-lending-20160504
[23] http://blog.6cents.co.za/summit-takes-capitec-to-court/

This is largely attributable to the high number of loans and low value of the average loan issued by Capitec, allowing them to charge origination fees more often.

Origination fee analysis		
		2017
No. loans issued	*000's*	3,508
Total origination fees	*ZAR 000's*	836,080
Origination fee per loan	***ZAR***	**238.34**
Initiation fee per loan facility	ZAR	1,050
Minimum initiation fee per credit facility	ZAR	113
Weighted avg assuming ZAR 644 over five ZAR 1,000 advances.		
Proportion of credit facilities	%	13%
Proportion of loans	%	87%

Figure 24 Viceroy analysis of Capitec loan book composition

While the accounting for these loans is slightly complex (fees are partially recognized upfront, partially amortized over life of loan), the relative stability of origination fees year-on-year and moderately flat number of new loans issued gives a relatively consistent gross origination fee income. Our analysis of origination fees suggests that **87% of total loans issued by Capitec are credit facilities**.

Our assumption is also based on a minimum initiation fee, calculated as a pro-rata amount of ZAR 113 (pre-VAT) per ZAR 1,000 advance, drawn and repaid every month.

The reality is that many advances are far below this ZAR 1,000 mark. For instance, we refer back to the affidavit of Ms. Mthimkhulu:

repayment consequences thereof. I annex hereto a copy of my bank statements for the month of November 2014 marked **Annexure "MTM4".** The withdrawals were made from my cell phone/an ATM on the following days for the following amounts:

15.1 8 November 2016 – R 500.00;

15.2 9 November 2016 – R 1 000.00;

15.3 10 November 2016 – R 500.00;

15.4 19 November 2016 – R 500.00; and

15.5 23 November 2016 – R 500.00.

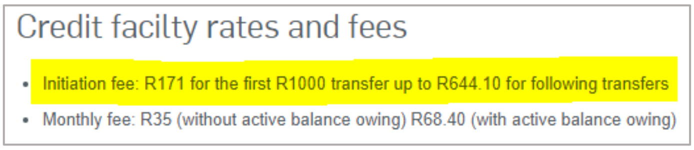
Figure 25 Extract of Mthimkhulu v. Capitec

Therefore, our 87% estimate of credit facility advances as a percentage of overall advances is a conservative estimate.

According to former employees, Capitec also had "a lot of new cash out on extending loans" referring to a policy by which the company targets well-performing loans and offers to increase the term (generally into a 36-month loan) and increases the cash-out amount. This allows Capitec to book further origination fee income.

Loan sharking

Capitec's multi-loan product was withdrawn in November 2015 as a result of new credit regulations which will be expanded upon in section 4 below. The multi-loan product is essentially still available, but rebranded as Capitec's new credit facility.



Credit facilty rates and fees

- Initiation fee: R171 for the first R1000 transfer up to R644.10 for following transfers
- Monthly fee: R35 (without active balance owing) R68.40 (with active balance owing)

Figure 26 Extract of Capitec's "Credit Facility" webpage[24]

Note that each monthly advance attracts a minimum of **12.9% in origination fees** including VAT. Given these facilities have the characteristics of payday loans, this fee is essentially incurred *monthly*.

Thus over one year drawing down the full ZAR 5,000 facility will incur customers an effective interest rate 155%. **Viceroy refers to these origination fees as interest because IFRS standards clearly classify these fees as interest.**

This origination 155% is paid *on top of* interest rates of 20.5% resulting in a combined annual interest 175.5% assuming customers can meet their payment obligations each month. Considering Capitec's history of burdening delinquent clients with new loans to repay their delinquent loans (see section 4), failure to pay the amount owed would substantially increase this interest rate.

The credit facility also attracts a monthly fee of ZAR 68.4 if in use. If the facility is *not* drawn down, customers are still charged a maintenance fee of ZAR 35 per month, presumably for the "convenience" of having the facility available.

Viceroy believes Capitec's Credit Facility charges excessive and illegal interest rates, disguised as initiation fees and monthly fees.

[24] https://www.capitecbank.co.za/global-one/credit/credit-facility

4 Legal Proceedings

Viceroy's investigation unearthed several cases in South Africa's justice system against Capitec for reckless lending claiming the bank:

1. Failed to conduct affordability and credit assessments and/or
2. Failed to ascertain whether the customer understood the cost and nature of their loans

The claims are largely related to Capitec's now-defunct multi-loan product through which customers could access 12 separate monthly loans. Each time the customer accessed one of the multi-loan advances an additional initiation fee was charged. We believe that these cases may trigger a class action suit (multi-party litigation) against Capitec that would at minimum require a refund of initiation fees associated with the multi-loan product. **This represents a liability of an estimated ZAR 12.7bn (US $1bn).**

While an initial affordability and credit assessment was conducted at the start of the multi-loan agreement, further access to the advances was available at ATMs after answering three questions:

1. "Your income did not decrease?";
2. "Your expenses did not increase?";
3. "You are not in arrears at any credit provider?"

Paradoxically, according to a web archive of Capitec's multi-loan website, the loans are principally marketed for "unplanned expense(s) or emergency situation(s)". We struggle to understand what "unplanned expense(s) or emergency situation(s)" would result in a respondent answer in the positive to the above questions.

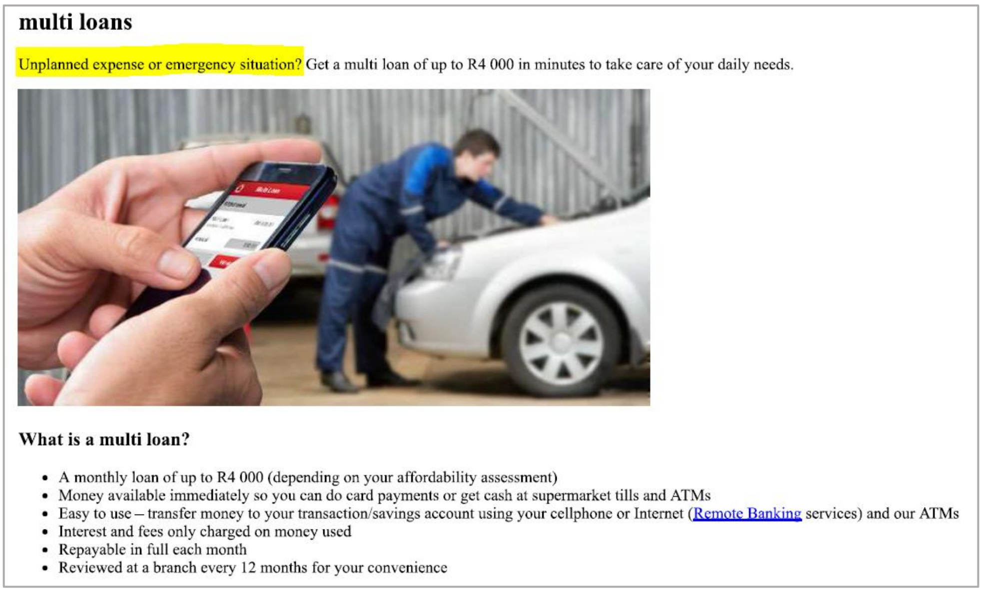


Figure 27 Extract of archived Capitec multi-loan webpage dated July 4, 2015[25]

Considering that each advance incurs an initiation fee this appears to be a credit facility or payday loan rather than a loan: thus a full affordability and credit assessment should have been administered for each advance.

As mentioned in section 2, one customer was issued an R80,000 loan to settle an existing R70,000 loan and was also granted an additional multi-loan facility **despite the fact the combined payments would leave him with a negative balance each month.**

[25] https://web.archive.org/web/20150604113035/https://www.capitecbank.co.za/global-one/credit/multi-loan?relatedFrom=/global-one/credit/apply

16. The *"FINANCIAL INFORMATION"* used and considered in respect of **LOAN 2**, did not include the instalment that I was now also required to pay in terms of **LOAN 1**.

17. After granting **LOAN 2**, my *"Household Financial Obligations"* would have increased to R8 792.84. In support of this contention, I attach hereto a copy of a rudimentary calculation of my ability to afford the credit as Annexure "**MPT6**". This calculation is based on the presumption that I would accept the full amount offered by the Respondent in the form of the Multi Loan.

18. According to Annexure "**MPT6**" I would be left with a negative balance of R2517.16 after I had paid my monthly financial obligations. Accordingly, any extension of credit would be reckless.

Figure 28 Extract of Thobejane v. Capitec

As highlighted above, **this would constitute reckless lending**. These claims were echoed by a separate affidavit claiming that Capitec advised a customer to take out a ZAR 87,102 loan to cover her outstanding balance on a multi-loan facility issued **just two months earlier.**

30. Having utilized the **October 2014 multi loan** numerous time, causing me to fall into a debt spiral, I approached the Respondent again on 9 December 2014, two (2) months after the initial loans were granted.

31. I was advised by the Respondent that I should take out a bigger loan in order to cover my outstanding **October 2014 multi loan** instalment and the balance of the **October 2014 loan**. I was unable to repay the aforementioned loans due to their recklessness.

32. A further loan agreement for the amount of R87 102.06 was concluded (the **December 2014 loan**). The instalment on my financial obligations with the

34. A rudimentary calculation was conducted to demonstrate the affordability of the **December 2014 loan** together with the **October 2014 multi loan.** I annex the rudimentary calculation hereto marked **Annexure "MTM8"**. The calculation uses the Respondent's amounts for other debt obligations and living expenses, together with the instalment on the **December 2014 loan** and the maximum instalment on the **October 2014 multi loan**. According to the Annexure I would be left with a negative balance of R2 885.29 after I paid my monthly financial obligations. Accordingly, any extension of the multi loan would be reckless.

Figures 29 & 30 Extract from Mthinkhulu v. Capitec

In total, Viceroy has obtained four affidavits against Capitec of this nature all of which recommend the court declare the credit agreements reckless in terms of section 80(1)(b)(ii) of the National Credit Act.

80. (1) A credit agreement is reckless if, at the time that the agreement was made, or at the time when the amount approved in terms of the agreement is increased, other than an increase in terms of section 119(4)—

(a) the credit provider failed to conduct an assessment as required by section 81(2), irrespective of what the outcome **of** such an assessment might have concluded at the time; or

(b) the credit provider, having conducted an assessment as required by section 81(2), entered into the credit agreement with the consumer despite the fact that the preponderance of information available to the credit provider indicated that—

(i) the consumer did not generally understand or appreciate the consumer's risks, costs or obligations under the proposed credit agreement; or

(ii) entering into that credit agreement would make the consumer over-indebted.

Figure 31 Extract from South African National Credit Act 2006

Further, the affidavits request the court sets aside their obligations under the relevant credit agreements and order:

19.1 The re-payment of all amounts paid by the Plaintiff to the Defendant in terms of the subsequent credit agreements; and/or

19.2 The re-payment of all interest and/or fees paid by the Plaintiff to the Defendant in terms of the subsequent credit agreements; alternatively

19.3 Any order which is deemed just and reasonable in the circumstances.

Figure 32 Extract from Van Zyl v. Capitec

The South African Legal Information Institute database shows 6 cases were due for hearing in February 2017 by debt mediation firm Accord Debt Solutions solely to obtain statements of their accounts despite two previous attempts.

BACKGROUND

7. The Applicant has a credit agreement with the Respondent under reference number [7...].

8. The Applicant requested Accord Debt Solutions to assist with resolving his financial difficulties.

9. The Applicant signed a power of attorney allowing Accord Debt Solutions to request a statement of his account on his behalf from his credit providers.

10. Accord Debt Solutions sent written requests to the Respondent to provide statements of the Applicant's account on at least two occasions, which had not been provided up to the date of the hearing.

Figure 33 Extract of Ntshangase v. Capitec[26]

Test case – March 2018

Legal experts that we have spoken to believe the outcome of a test case in March 2018 will be used to trigger a class action refund.

Prior to its prohibition in November 2015, Capitec issued millions of multi-loan advances a year. Capitec continue to issue quasi-multi-loans rebranded as credit facilities. We believe that these lending practices were verifiably reckless and that Capitec will – at minimum – need to refund initiation fees from its multi-loan product amounting to an **estimated ZAR 12.7bn (US $1bn)**. Viceroy have assumed 8% interest on these refunds, which is conservative given relatively high ZAR inflation over this period.

Origination fees repayment calcs (ZAR 000's)

	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	Total
Loan fee income	76,943	574,584	897,502	1,038,905	1,273,574	1,657,018	1,496,009	1,306,619	1,245,881	1,545,477	1,711,018	
Growth		646.77%	56.20%	15.76%	22.59%	30.11%	-9.72%	-12.66%	-4.65%	24.05%	10.71%	
Growth - origination				13.00%	18%							
Growth - mothly				22.00%								
Portion - orgination	69.33%	69.33%	69.33%	69.33%	69.33%	69.33%	69.33%	69.33%	69.33%	69.33%	48.9%	
Portion - monthly				30.67%								
Origination fees - estimate	53,347	398,378	622,268	-	883,011	1,148,866	1,037,233	905,923	863,811	-	-	
Origination fees - reported	-	-	-	720,307	-	-	-	-	-	903,635	836,080	
Plus interest 8%	**124,386**	**860,069**	**1,243,917**	**1,333,239**	**1,513,326**	**1,823,106**	**1,524,035**	**1,232,498**	**1,088,153**	**1,054,000**	**902,966**	**12,699,695**

**note - yellow cells are estimates derived from 2010 figures. Estimates are reasonably accurate when compared to 2016 reported figures.*
2017 portion heavily weighed down on large increase of monthly fees

Figure 34 Viceroy analysis of Capitec historical origination fees

Readers should note that the claimants are seeking recovery of all sums paid to Capitec, making our estimate fairly conservative.

[26] Ntshangase v. Capitec case number: NCT/71665/2016/114(1) NCA

5 Capitec's impossibly low arrears

Critics and supporters of Capitec have both failed thus far to explain why Capitec's loan performance is drastically better than its direct peers. In 2017 Capitec had 6.3% of loans past due (2016: 5.6%); extremely low for an unsecured lender to low-income customers.

As previously discussed Viceroy believes that to prevent accounts from falling into arrears, Capitec simply issues a new credit agreement with identical terms. This was corroborated by affidavits of Capitec customers:

> 12. **LOAN 1** was used to settle the existing loan. Thus, even though **LOAN 1** was for an advance of R80 000.00, I only received R10 307.06, as the pre-existing loan first had to be settled. A copy of the settlement letter is annexed hereto as Annexure "**MPT3**".

Figure 35 Extract of Thobejane v. Capitec

South Africa has been the graveyard of several unsecured lending operations due to high and unpredictably spiking delinquency rates. In this historically extremely risky environment Capitec has managed what we believe is an unrealistically low level of arrears with no clear reason why.

Comparison

To better assess the likelihood of Capitec's loan performance being genuine, we have compared Capitec's monthly loan payments to those of Bayport Financial Services South Africa, Standard Bank and African Bank Holdings Limited.

> **Who We Are**
>
> Bayport Financial Services was established in 2004 and has rapidly become one of the largest non-bank providers of unsecured credit and allied products in South Africa. Through our nationwide multifaceted distribution footprint we are able to effectively service the needs of our clients no matter how remote their location through our loans and insurance product offerings.

Figure 36 Extract from Bayport Financial Services South Africa's "About Us" webpage[27]

Given the overlap between Bayport, African Bank and Capitec's markets one would assume Bayport and African Bank Investments would have similar arrears rates however this is not the case:

Asset quality

Reported under IAS 39	% change MOM	Nov 17 R'000	Oct 17 R'000	Sep 17 R'000	Aug 17 R'000	July 17 R'000	June 17 R'000	May 17 R'000	Apr 17 R'000	Mar 17 R'000	Feb 17 R'000	Jan 17 R'000	Dec 16 R'000
Gross loans and advances	(1.8%)	**4 812 599**	4 899 636	4 963 315	5 061 607	5 027 697	4 638 274	4 757 328	4 769 409	4 740 745	4 803 447	4 831 485	4 815 297
Performing loans	(2.3%)	**3 451 207**	3 531 095	3 574 840	3 654 343	3 616 142	3 213 964	3 325 338	3 336 319	3 317 092	3 375 144	3 421 902	3 414 464
Non-performing loans	(0.5%)	**1 361 392**	1 368 541	1 388 475	1 407 264	1 411 555	1 424 310	1 431 990	1 433 090	1 423 653	1 428 303	1 409 583	1 400 833
Arrears Rate		**28.29%**	**27.93%**	**27.97%**	**27.80%**	**28.08%**	**30.71%**	**30.87%**	**30.05%**	**30.03%**	**29.73%**	**29.17%**	**29.09%**

Figure 37 Extract from Bayport Monthly Investor Report November 2017[28]

Bayport's arrears rate consistently runs at ~30% of gross advances over 2017.

[27] https://www.bayportsa.com/about-bayport/

[28] https://www.bayportfinance.com/wp-content/uploads/2013/10/Baysec-Investor-Report-November-2017.pdf (arrears calculations added)

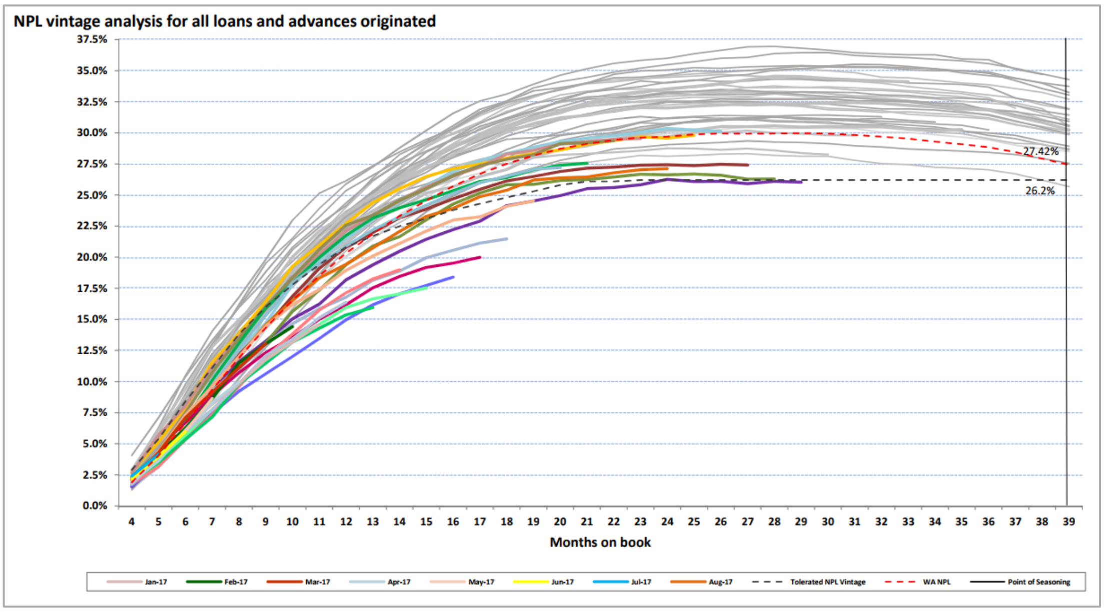


Figure 38 Vintage analysis from Bayport Investor Report November 2017[29]

This ~30% arrears rate is echoed with African Bank Holdings portfolio of unsecured personal loans.

26.1.1.2. Arrears analysis

Rmillion	Loan 2017	Credit card 2017	Total 2017	Loan 2016	Credit card 2016	Total 2016
Financial assets that are neither past due nor specifically impaired						
CD 0:	11 569	2 268	13 837	11 197	2 478	13 675
Past due and specifically impaired						
CD 1 to CD 3	1 535	1 594	3 129	1 391	1 477	2 868
CD 4 and higher	3 105	786	3 891	3 026	989	4 015
Total credit exposure	**16 209**	**4 648**	**20 857**	**15 614**	**4 944**	**20 558**
Arrears Rate	**28.63%**	**51.20%**	**33.66%**	**28.29%**	**49.88%**	**33.48%**

Figure 39 Extract from African Bank Annual Report 2017[30]

Note: Capitec's credit card product was only introduced in September 2016 and represented 1.3% of its loan book in 2017. As such the focus is on the loan arrears rate in the figure above. The figures above are post- African Bank Holdings' restructure, implying an optimized loan book in the target market.

How is Capitec's arrears rate more than 20 percentage points lower than companies providing essentially the same service to the same market?

There are really only two possible reasons:

1. Lower monthly payments making easier for customers to remain non-delinquent; or
2. Better policies regarding customer approval.

[29] https://www.africanbank.co.za/media/51630/3-african-bank-holdings-limited-2017-final.pdf
[30] https://www.africanbank.co.za/media/51630/3-african-bank-holdings-limited-2017-final.pdf (arrears calculations added)

Viceroy believes neither of these is the case. For the sake of completeness, we have included our findings below.

If Capitec were to accurately represent the health of its loan book, it would need to take a ~ZAR 11bn write-off and impairment. Together with any potential class action liabilities, this is likely to put Capitec on the brink of insolvency.

Better credit approval policies? No

As detailed in section 4 above of this report, Capitec's (possibly intentionally) loose methods of vetting potential customers are now the subject of a legal dispute.

Affidavits claim Capitec did not properly conduct affordability tests for its multi-loan product and in several cases issued the client new loans to pay off their existing Capitec loans for which they were in arrears. The customers were then issued multi-loan product **ignoring the fact that the combined repayments would place them in financial distress thus constituting an act of reckless lending.**

Lower monthly payments? No

Unsecured loans from Capitec garner a headline interest rate of anywhere from 13% to 28%. Due to the large number of fees on top of this the effective interest rate is closer to 20% to 40%. These include monthly services fees, initiation fees and "compulsory" monthly insurance, the latter of which we were informed is impossible to get a loan without.

For the sake of comparison of monthly payments, we have compared two loans: a ZAR 25,000 12-month loan and a ZAR 50,000 24-month loan between three banks: Capitec, Bayport and Standard Bank. The data below is valid as of January 27, 2018.

Capitec

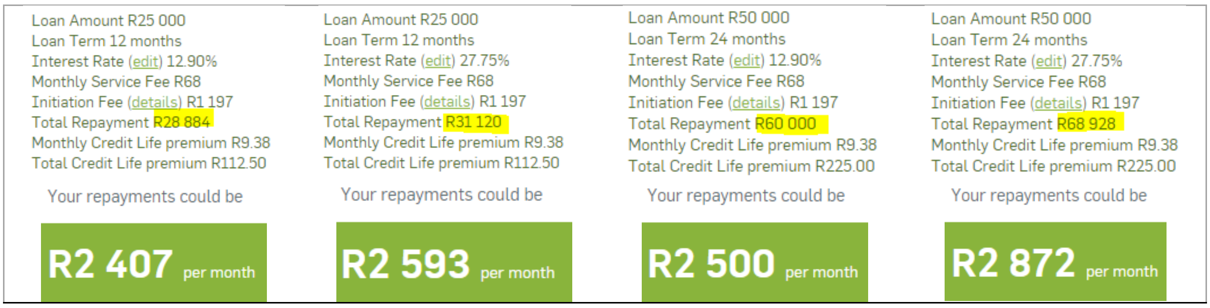
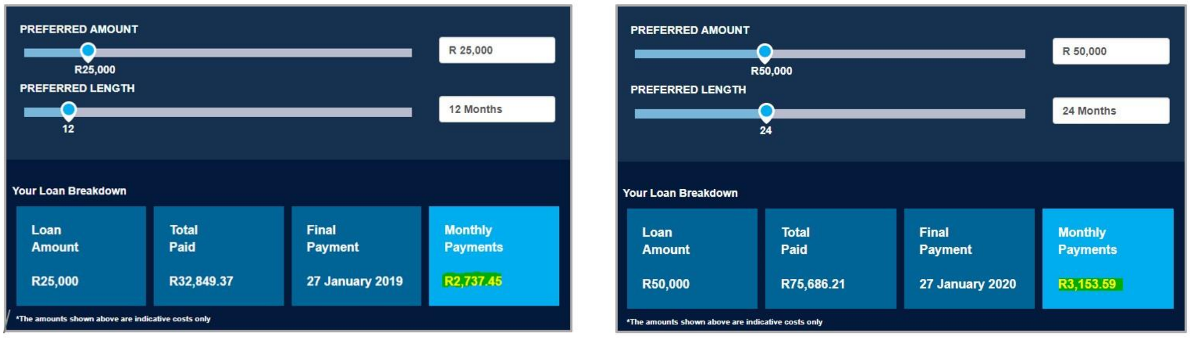


Figure 40 Low- and High-case Payment Calculations for a Capitec Loan[31]

As detailed in section 3 above roughly 87% of Capitec's loan book is comprised of the 12-month credit facilities. Accordingly, the cost of these facilities will be of greater importance than the ZAR 50,000 24-month loan in our analysis. We have presented the costs of both loans for the sake of thoroughness.

[31] https://www.capitecbank.co.za/tools/credit/Landing

Bayport

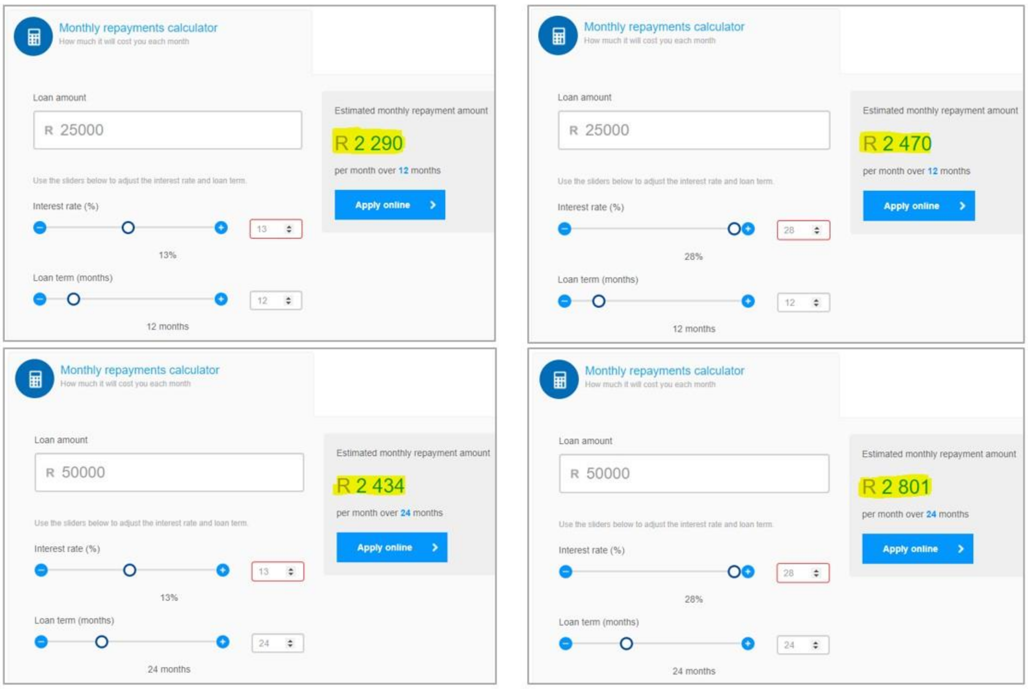


Figures 41 & 42 Extract of Monthly Payment Calculator for Bayport Financial Services[32]

Bayport		
	ZAR 25,000 12-month	**ZAR 50,000 24-month**
Monthly payment	2,737.45	3,153.59

Figure 43 Viceroy analysis of Bayport loan repayments

Standard Bank



Figures 44 & 45 Extract of Standard Bank Monthly repayments calculator[33]

Standard Bank				
	ZAR 25,000 12-month		**ZAR 50,000 24-month**	
	Low	**High**	**Low**	**High**
Monthly payment	2,290.00	2,470.00	2,434.00	2,801.00

Figure 46 Viceroy analysis of Standard Bank loan repayments

[32] https://www.bayportsa.com/faqs/budget-calculator/
[33] https://www.standardbank.co.za/standardbank/Personal/Borrowing/Personal-loans/Calculator

Comparison					
	ZAR 25,000 12-month				
	Capitec		Standard Bank		Bayport
	Low	High	Low	High	
Monthly payment	2407.00	2593.00	2,290.00	2,470.00	2,737.45
	ZAR 50,000 24-month				
	Capitec		Standard Bank		Bayport
	Low	High	Low	High	
Monthly payment	2,500.00	2,872.00	2,434.00	2,801.00	3,153.59

Figure 47 Viceroy analysis of comparative loan repayments

As can be seen from the table above, Standard Bank beats Capitec on monthly payments for both low- and high-case scenarios. This confirms our thesis that Capitec's delinquency rate is irregularly low and cannot be accounted for through lower fees than competitors.

Write-off implication

Tying our delinquency analysis with Capitec's loan book irregularities, we believe Capitec's loan book is subject to significant write-offs as delinquencies and risk are massively underrepresented.

Below is a comparison of Capitec's loan book against African Bank's pre-restructure loan book for reference:

Loan book comparative analysis	**Capitec**	**African Bank**
ZAR ('000s)	**2017**	**2017**
EOY gross Loans	**45,135,357**	**21,025,000**
Total impairments	(5,930,377)	(6,313,808)
% Gross loans	***-13.1%***	***-30.0%***
Bad debt write-off	(5,447,481)	(4,877,000)
% Gross loans	**-12.1%**	**-23.2%**
Comp-based adjustment		
Expected further impairment	(5,930,377)	
Expected further write off	(5,447,481)	
Total one-time impact	**(11,377,857)**	

Figure 48 Viceroy analysis of Capitec loan book delinquencies

It's noteworthy that African Bank has significantly culled its appetite to issue new high-risk loans, and still has a significantly higher impairment and write-off rate than Capitec.

Viceroy estimates that a write-off and impairment of ~ZAR 11bn will accurately represent the delinquency and risk in Capitec's loan book.

Together with any damages/refunds arising from imminent ligation, this would put Capitec in a net liability position, at which point it would be in breach of the minimum liquidity required, as a bank, to meet its depositor's demands.

Viceroy encourages the South African Reserve Bank and financial regulators to seriously investigate these issues and consider placing the bank under curatorship (appoint a Viceroy, as it may).

6 State of the market

Current financial stability assessment by the central bank

The recent meteoric growth in microfinancing in South Africa came at a price. Credit default ratios in retail sectors have only increased since 2014 especially in the retail revolving credit and “other” categories which includes credit cards.

It is to these sectors that Capitec is the most exposed. The general population’s ability to repay debt has not improved:

Figure 13 Credit default ratios for selected asset categories

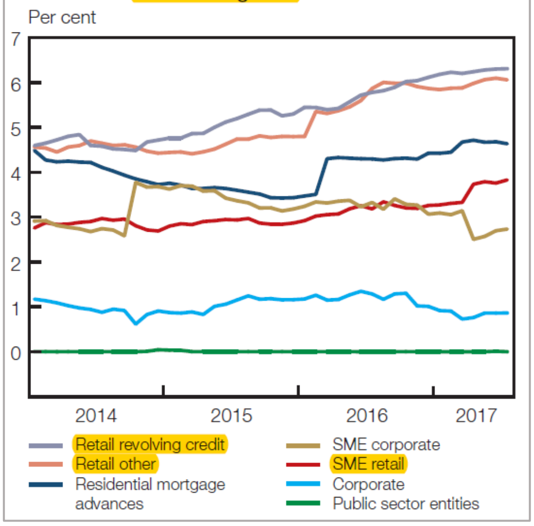


Table 6 Selected indicators for the household sector

Annual percentage change, unless indicated otherwise

	2016			2017	
	2nd qr	3rd qr	4th qr	1st qr	2nd qr
Disposable income	8.0	7.6	7.3	7.3	6.5
Financial assets	5.0	6.3	4.5	3.6	2.7
Total assets	5.6	6.4	4.8	4.2	3.4
Net wealth*	5.8	7.0	5.0	4.3	3.4
Consumption expenditure	0.9	0.8	1.0	0.7	1.6
Consumption expenditure to GDP	59.2	59.4	59.3	59.8	59.2
Capital gearing**	16.3	16.3	16.4	16.2	16.3
Credit extension	2.1	1.2	0.7	0.7	2.9
Mortgage advances extended to households	4.2	3.5	2.9	2.9	3.0
Mortgage debt as percentage of household disposable income	36.7	36.5	35.9	35.8	35.6
Savings as a percentage of disposable income	-0.2	-0.2	0.2	0.3	0.2
Debt as a percentage of disposable income	74.8	73.9	73.1	73.0	72.6
Debt as a percentage of GDP	44.2	43.8	43.4	43.8	43.1
Debt-service cost of household debt	13.1	10.4	8.1	4.5	3.3
Debt-service cost as a percentage of disposable income	9.7	9.6	9.4	9.4	9.4
Debt	4.4	3.6	3.4	3.9	3.4
FNB Household Debt-Service Risk Index	5.23	5.19	5.20	5.24	n/a

* Household net wealth is defined as total assets of households less total financial liabilities
** Capital gearing' refers to household debt as a percentage of total assets of households. Data are preliminary

Sources: SARB and FNB

Figures 49 & 50 Extract from SARB Financial Stability Review Second Edition 2017[34]

[34] https://www.resbank.co.za/Lists/News%20and%20Publications/Attachments/8073/Second%20Edition%20FSR%20Oct%202017.pdf

Throughout 2016 to mid-2017 we see a significant decline in disposable income and net wealth, and a flat debt-service cost as a percentage of disposable income.

While the National Credit Regulator data shows that the proportion of South Africans with impaired credit records is falling, the use of aggregate data is heavily weighted towards the smaller, wealthier demographic who are not Capitec's customer base.

While the wealthy have had success at meeting this debt, demographic specific indicators suggest low-income demographics have seen no improvement in credit crisis.

Experian's Consumer Credit Default Index, which tracks demographic credit defaults, shows low-income households' credit defaults remain extremely volatile, even post the 2013 credit crisis recovery:

Mosaic type A03 - Largest credit exposure	6,86	6,21	346,903,351
Mosaic type H33 - Lowest CDI	5,47	5,03	9,603,986
Mosaic type F25 - Highest CDI	11,52	8,68	107,358,523

A03 – Hard Working Money
Middle-aged educated families, with a mid to high income living in the suburbs around industrial and mining areas recorded an improved CDI of 2.91% in Aug 2017 compared to the 3.14% in Aug 2016.

A02 – Secured Affluence
Mature, well educated, wealthy couples living in free-standing high-value established homes in city suburbs recorded the lowest CDI of 1.92% in Aug 2017 which was an improvement on the 1.98% recorded in Aug 2016.

B07 – Would-be Wealth
Young aspirational families living in good homes in up-and-coming areas, and the first to have such opportunities and living spaces recorded the best year-on-year improvement in their CDI from 6.20% in Aug 2016 to 3.98% in Aug 2017.

F25 - Indigent Township Families
Very low income, mostly unemployed, young families living in small properties or in a room of shared-housing in densely populated areas remained the worst performing segment, recording the worst year-on-year deterioration with a CDI of 7.93% in Aug 2017 compared to the 6.81%recorded in Aug 2016.

Figures 51 & 52 Extracts from Experian Consumer Credit Default Index November 2017[35]

Note: Mosaic type H33 refers to "Senior Single Traditionalists".

New defaults were up year-on-year for low-income households, Capitec's target market for unsecured lending.

Not only is Capitec's market finding it harder to pay their existing loans on time, but they may not be able or willing to incur further loans in the future. Based on household economic indicators and other macro factors, Viceroy believes the projected appetite of the market for microfinance is drastically being overestimated.

Regulatory Environment Changes : Deposit Insurance Scheme

The South African Reserve Bank (SARB) has initiated a privately funded Deposit Insurance Scheme (DIS) which will demand contribution from banks. The scheme would aim to protect "less financially sophisticated depositors" in the event of a bank failure and operate as a subsidiary of SARB.

[35] http://www.experian.co.za/assets/consumer-information/experian_consumer_default_index_november_2017.pdf

SARB suggests a coverage limit of R100,000 per qualifying depositor per bank with a recommended target size of 5.0% of covered deposits. This placed Capitec at significant risk with a SBG Securities Analysis note suggesting the possibility of a 12% drop in Capitec's book value.

Capitec' s valuation may take a c6% hit if the proposed DIS goes ahead, in our view. The initial contribution could eliminate c12% of Capitec book value, however this may be offset by higher ROE, assuming this loss in capital does not hamper future return potential. Admittedly the impact could be closer to 12%, than the 6% we suggest above, given covered deposits are 249% of NAV.

Figure 53 SBG Securities Analysis – Deposit Insurance Schemes July 24, 2017

Capitec's deposits would be largely covered by the DIS placing them at great exposure:

Figure 4: Composition of potentially qualifying deposits

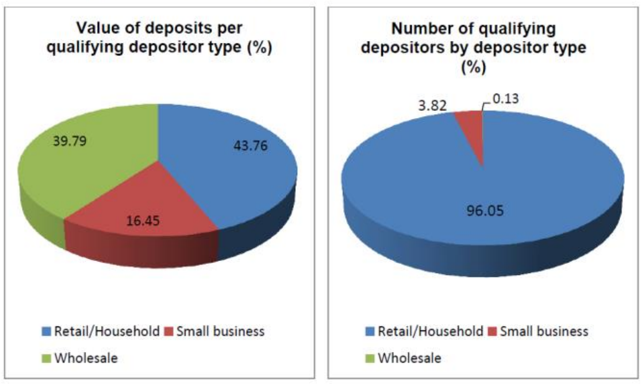
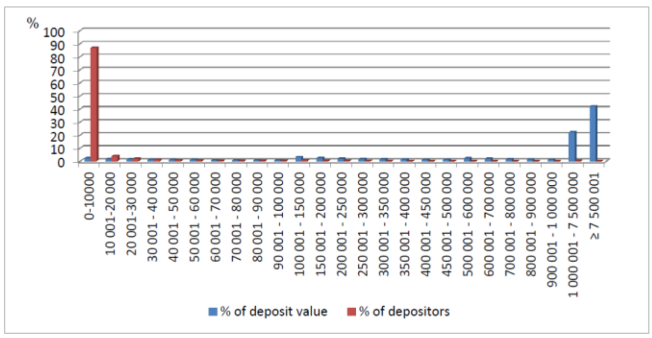


Figure 1: Number of qualifying depositors and value of deposits



Figures 54 & 55 Extracts from "SARB – Designing a deposit insurance scheme for SA"[36]

Viceroy believes the implementation of the DIS will have an adverse effect on Capitec's ability to lend as it has done to date by placing further strain on its cash reserves. Capitec's 2017 annual report shows ZAR 48,039m of retail deposits, implying a DIS funding obligation of ZAR 2,402m.

[36] https://www.resbank.co.za/Lists/News%20and%20Publications/Attachments/7818/DIS%20paper.pdf

8 Impossible cost structure

Staff

A pillar of Capitec's growth story is its incredibly low costs relative to other banks and lenders operating within the South African market, a factor Viceroy has been unable to account.

Table 5: South African banks costs structures

%

	FirstRand	Standard Bank	Barclays Africa	Nedbank	Investec	Capitec
Divisional Split:						
- Retail : South Africa	54%	49%	59%	65%	N/A	100%
- CIB	18%	33%	19%	20%	N/A	N/A
- WesBank	15%	N/A	N/A	N/A	N/A	N/A
- Central & Other	13%	17%	14%	5%	3%	N/A
- Specialist Bank	N/A	N/A	N/A	N/A	65%	N/A
- Wealth & Investment	N/A	N/A	8%	10%	11%	N/A
- Asset Management	N/A	N/A	N/A	N/A	21%	N/A
Cost -to- income:						
- Retail : South Africa	51%	55%	56%	63%	N/A	35%
- CIB	47%	53%	47%	39%	N/A	N/A
- WesBank	41%	N/A	N/A	N/A	N/A	N/A
- Central & Other	68%	68%	63%	95%	N/A	N/A
- Specialist Bank	N/A	N/A	N/A	N/A	47%	N/A
- Wealth & Investment	N/A	N/A	64%	62%	59%	N/A
- Asset Management	N/A	N/A	N/A	N/A	66%	N/A
Costs 3-year CAGR:						
- Retail : South Africa	14%	10%	10%	15%	N/A	30%
- CIB	23%	8%	10%	12%	N/A	N/A
- WesBank	17%	N/A	N/A	N/A	N/A	N/A
- Central & Other	18%	12%	6%	19%	N/A	N/A
- Specialist Bank	N/A	N/A	N/A	N/A	17%	N/A
- Wealth & Investment	N/A	N/A	12%	10%	26%	N/A
- Asset Management	N/A	N/A	N/A	N/A	13%	N/A
Retail Infrastructure:						
- SA Branches	723	641	774	695	0	796
- SA ATMs	6,629	5,564	8,885	4,634	0	4,024
- Customers (million)	7.48	11.72	11.79	6.50	75.3K	8.60
- Deposits [Retail]	206,621	401,497	176,952	272,274	303,470	55,582
- Loans [Retail]	449,660	571,468	387,027	298,789	227,552	39,205
Ratios:						
Cost/Branch (R'm)	31.54	43.42	30.30	26.52	NA	6.83
Cost/ATMs (R'm)	2.23	5.00	30.30	3.98	NA	1.35
Cost/Customer (R)	3,048	2,374	1,989	2,836	14,325	633

Source: Company reports and J.P. Morgan calculations and estimates. Investec cost/customer assumes that 30% of the South African Specialist bank's costs relate to Private Banking division

Figure 56 Extract from J.P.Morgan Report "South African Banks" dated June 23, 2017

Despite similar branch and ATM numbers, Capitec boasts a cost-to-income percentage of 35%, far below competitors FirstRand(51%), Standard Bank(55%), Barclays Africa(56%) and Nedbank(35%).

While sell-side analysts and management have been quick to claim this is due to Capitec's unique operational structure, the staff numbers show a different story:

Staff costs per employee ('000)*													
Barclays Africa (Absa)	200	224	260	299	341	388	382	425	464	510	536	7.0%	10.3%
Nedbank	253	267	256	292	319	359	397	428	454	457	479	3.8%	6.6%
Standard Bank	292	327	374	389	412	451	521	547	585	583	637	4.1%	8.1%
FirstRand	204	259	282	287	324	401	427	447	494	503	534	4.6%	10.1%
Capitec	132	159	169	194	223	176	181	171	201	211	212	3.3%	4.9%
Investec Bank SA	732	843	880	838	843	831	917	972	1,056	1,148	1,049	2.7%	3.7%

Figure 57 Extract from J.P.Morgan Report "South African Banks" dated June 23, 2017

Capitec's average staffing costs per employee are less than half those of any of its competitors.

In 2017, average salaries at Capitec outside of Senior Management level positions averaged ZAR 165k, or USD $13k.

Bank		Strategic management	Senior management	Other employees	Total
Employees	Number	12	101	12 956	13 069
Remuneration awards					
Fixed	R'000	53 063	145 105	2 134 975	2 333 143
Cash remuneration	R'000	53 063	145 105	2 134 975	2 333 143
Variable	R'000	324 041	100 856	123 250	548 147
Cash staff performance bonus	R'000	18 528	797	123 250	142 575
Cash bonus bank	R'000	–	61 317	–	61 317
Share options[(1)]	R'000	176 370	20 088	–	196 458
Share appreciation rights[(1)]	R'000	129 143	18 654	–	147 797

Figure 58 Extract Capitec Annual Report 2017

Being an almost pure-play retail bank does not appear to be sufficient justification for why Capitec employees are remunerated less, the theory being lower qualified positions do not demand higher remuneration.

Having less staff per branch is also inexplicable, as we are looking at cost on a per head basis. If anything, the fewer staff at Capitec branches should be paid *more* to ensure they get the best people.

A review of indeed.co.za reflects that Capitec staff members are being paid significantly less than they would in the same role at a competitor branch. For instance: here is the average salary of retail branch managers:

Bank	Role	Salary	Range
Capitec	**Branch Manager** 53 salaries reported	**R 13 219** per month	● Most Reported R 700 – R 30 000
Standard Bank	**Branch Manager** 6 salaries reported	**R 28 516** per month	R 600 – R 33 000
African Bank	**Branch Manager** 27 salaries reported	**R 16 646** per month	● Most Reported R 3 300 – R 41 000
Nedbank	**Branch Manager** 13 salaries reported	**R 20 125** per month	R 1 300 – R 23 000

Figure 59 indeed.co.za branch manager salaries dated January 28, 2017

Even African Bank appears to pay branch managers 25% more than Capitec.

We don't consider it viable that all local competitors appear to have significantly higher remuneration packages for staff than Capitec in similar roles.

9 Channel checks

Online reviews

Consumers' through to employees' online reviews commonly refer to Capitec as a loan shark. A telling employee review that stood out to us on Glassdoor, states that Capitec actually phones clients to **market loans**[37].

[37] https://www.glassdoor.com/Reviews/Employee-Review-Capitec-Bank-RVW4748557.htm

"Capitec is just a loan shark not a retail bank"

Former Employee - Service Consultant in Newcastle (South Africa)

Doesn't Recommend Negative Outlook

I worked at Capitec Bank full-time (More than a year)

Pros

Training is is excellent.
Branches are conveniently located.

Cons

You work long hours including public holidays.
Almost all advancement opportunities are in Cape Town.

No staff accounts.

No fringe benefits.

Consultants are required to phone clients to market capitec loans and to follow up on arrears.

If you made a mistake while performing your duties they call it a fraud.

Salaries for the same level employees in different branches are not the same.

Advice to Management

Hire call center agents and tellers instead of using service consultants to do that job without being compensated for,otherwise you will continue to lose good employees.

Figure 60 Glassdoor.com employee review of Capitec

Consumers appear to feel equally exploited by Capitec, raising issues regarding the non-performance of retrenchment insurance, Capitec debiting personal accounts to repay finances and incurring nonsensical fees, web checks showing Capitec took monies before they were due, where customers had to endure financial hardship as a result. Online reviews point towards a predatory lending operations where the consumer/client is locked into a lifetime of debt or use of expensive credit.

Former employee interviews

Former employees we interviewed raised serious issues. Viceroy believes these statements speak for themselves and require no interpretation:

"Borrowers "for sure" have 1 or more loan outstanding with other providers Wonga, RealPeople & Capfin."

"It was crisis management just getting them to pay anything. Capitec had a whole team that would just consolidate and defer loans, to avoid default. Not sure what you mean about impairments it was just getting them to repay anything. There was no way they'd ever repay some had multi loans with multiple providers."

"We would do 27% interest and let the client pay only one monthly fee and one life insurance fee, the real interest rate after fees was huge…a substantial portion of the book."

"It was like they were paying the call-center people do to the consultants' work. It was not a secret we were a loan shark. It was all about fees, initiation fee, origination fees, non-repayment penalties, outstanding loans, consolidation. People could not repay and it felt like you were taking food from their children's' mouths."

"When the [interest rate] cap came in [Capitec] had a problem. From memory they formed a separate insurance company, I think Capitec were the owners. Most of the loans did not have compulsory insurance. It was an "automatic" or optional product, but it was clear they wouldn't get the loan without the insurance."

"Capitec profited from insurance. There [was] always a delay in processing claims especially for retrenchment. The insurance was meant to activate immediately but more often we never got to processing for 4 months."

"Before leaving there was a big push on lending top up loans to good payers. We'd consolidate the balance of a loan into new loan at better rate. The targets were to raise the origination fees in exchange for reducing interest rate. Before leaving "no-payers" [defaulting accounts] were increasing."

10 Conclusion

- Viceroy's analysis and consumer affidavits show Capitec is inflating its loan book performance by issuing delinquent customers new loans.
- Capitec's origination fees for its credit facility and former multi-loan facility give it the characteristics of a loan shark operation.
- Ongoing legal action against Capitec is likely to result in a class refund of predatory multi-loan lending fees.
- Capitec's low arrears book cannot be explained any other way: the company **must be refinancing its own delinquencies.**
- Viceroy expects a write-off of ~ZAR 11bn to Capitec's balance sheet to accurately reflect real delinquencies and risk.

Viceroy believes the outcome of ongoing legal proceedings, massive loan book impairments and income statement impact will result in a loss-making, net-liability bank.

As a result of blatantly predatory lending practices, Capitec massively inflated its loan book which Viceroy believes will lead to major write-offs. Despite operating in a notoriously high default and impairment sector of microlending, Capitec's default and impairment rates are well below the industry standard.

Upon accurate accounting of Capitec's loan book and reserving for potential litigation, Capitec's own financial health seems to teeter on insolvency. The South African Reserve Bank and financial regulators cannot stand by silently in the face of these abuses. We implore the appropriate authorities to place Capitec under custodianship before further liquidity issues arise.

African Bank Investments were wiped out in 2012 when strikes in South Africa's platinum industry prevented its customers from repaying their loans. Recent volatility in the mining sector, the introduction of the new mining charter and a massive spike in unsecured credit defaults evidenced in the most recent National Credit Regulator's report of 2017 all raise alarms that Capitec is playing a very dangerous game.

Viceroy believes loopholes are being utilized to sustain unaffordable borrowing. This includes consolidating previous loans, restructuring/consolidation fees, initiation fees and service fees which all hide the true reality of a business struggling in a sector where historically, businesses have collapsed.

The National Credit Regulator December 2017 report evidences a defaults and arrears rate topping 100+ days. In the unsecured lending sector, there appears to be only one company unaffected: Capitec. This company openly admitted to employing inexperienced staff to reduce wages bills, but amazingly has the most success in "avoiding" defaults[38].

Capitec will certainly state they have vigorous controls in place to avoid the lessons of other bankrupt microlenders in South Africa and Japan. The reality is very different.

"While unsecured lending bore fantastic results for companies such as Steinhoff and [former] African Bank in the short term, it should be plainly apparent that this model is unsustainable and inevitably leads to collapse." Glen Jordan - Director, IMB Financial Services[39].

[38] https://www.moneyweb.co.za/news/companies-and-deals/banking-sector-union-takes-on-capitec/

[39] https://www.fin24.com/Economy/unsecured-lending-sa-sitting-on-another-steinhoff-bubble-expert-20180126