BENGUELA GLOBAL
FUND MANAGERS

Benguela Global Fund Managers
**The Avenues North**
6 Mellis Road
Rivonia
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South Africa

19th January 2018

*Via Electronic Mail*

For Attention: Mr. Andre Pierre du Plessis
**Capitec Bank Holdings Limited**
Chief Financial Officer
1 Quantum Street,
Techno Park,
Stellenbosch
7600

Dear AP du Plessis (CFO)
cc: Gerhardus Metselaar Fourie (CEO)
cc: Riaan Stassen (Chairman of the Board)

**RE: BENGUELA GLOBAL FUND MANAGERS CONCERNS AROUND CAPITEC'S RESCHEDULING OF ARREARS LOAN BOOK**

Benguela Global Fund Managers (Pty) Ltd (Hereon referred to as "Bengeula") is a boutique worldwide investment management firm managing investment assets for institutional and retail clients. We invest clients capital in South African and Global markets.

We write to raise our concerns regarding Capitec Bank Holdings Ltd. ("Capitec") aggressive applied practice of rescheduling arrear loans and advances. While loans rescheduled from up-to-date accounts are not necessarily a good indication of the financial health of the underlying client, it may be a sensible thing to do for the business to ensure that good clients do not end up defaulting on their accounts. Our concerns revolve around the rescheduling of arrears and the impact these have had on reported financial performance of the business. We believe this practice has distorted the true performance of your business and warrants some review. Thus, we provide a summary of our concerns below and further provide a more detailed analysis in the Appendix A.

## 1. Financial concerns

1.1. **Aggressive arrears loan book rescheduling (six months)**: Rescheduled Arrear Loans and Advances are reported on a six monthly basis. Based on what is reported, an equivalent of 36% of the FY2017 pre-rescheduling arrears were in fact rescheduled between 31 August 2016 and 28 February 2017. The rescheduled arrears were therefore equivalent to 55% of reported arrears as at 28 February 2017. While loan rescheduling is a common practice in banking, Capitec's rescheduling of arrear loans appears to be quite aggressive.

1.2. **Aggressive arrears loan book rescheduling (twelve months)**: According to Capitec's annual reports, loans are unlikely to be rescheduled twice within one year. It can therefore be deduced that arrears that were reported as rescheduled arrears in the preceding six months are unlikely to be rescheduled in the subsequent six months. As a result, on a continuous 12 month basis to 31 August 2017 as an example, the rescheduled arrears amounted to 77% of the pre-rescheduling arrears for the 12 month period to 31 August 2017. It is notable that this is a cause for alarm for all stakeholders. To say that this is aggressive is a complete understatement. This observation is supported by the fact that in FY2017, Arrears and Rescheduled Arrears amounted to 9.8% of Gross Loans and Advances versus 7.8% in 2013. Bad debts written off have grown from 5.7% of gross loan book in 2013 to 12.1% in 2017.

While the operating environment has somewhat deteriorated since 2013, the scale of the increase in bad debts highlights the significant role played by prior years rescheduling practices –as an example in FY2017 bad debts written off grew 19% while the gross loan book grew only 10%. In other words, higher profits were taken in previous years through lower provisioning in rescheduled arrears and now the actual adverse effects are raised to the surface through bad debts.

1.3. **Contribution to gross loan book growth and revenues**: Without the rescheduling of arrears, it would appear that Capitec's gross loan and advances book would have been stagnant for the past 4 years to 2017. From a revenue and profit perspective, the contribution made by arrear rescheduling is even more pronounced when origination fees are taken into account.

1.4. **Provisioning impact**: Our analysis shows that Capitec's aggressive rescheduling practice enables it to achieve substantially lower impairment provision rate than it could have had if these arrears were left in the pre-rescheduling arrears loan book. The effect of this artificially lower provisioning rate is inflated profits and book value.

1.5. **Impact on reported performance:** From our perspective the excessive rescheduling of arrears materially distorts the reported financial performance of the business. We estimate that since 2013, the arrear rescheduling has contributed 10% p.a. to reported annual profits or a total contribution of R1.3 billion to from 2013 to 2017. The cumulative contribution of our estimated arrear rescheduling on profits is equivalent to 38% of FY2017 reported headline earnings.

We estimate that since 2013, arrear rescheduling has contributed to about 50% of reported growth in Headline Earnings Per Share (HEPS). Strictly speaking, half the compound growth reported by Capitec since 2013 was derived from rescheduling of arrears. Whether those rescheduled arrears could subsequently be converted into cash profits or not, remains open to question. It is noteworthy to state that the current price of Capitec on the Johannesburg Stock Exchange (JSE) may be distorted, and flattering in as far as it relates to arrears loans that have been rescheduled. In light of the above This should be a major concern for the Board and Executive team.

1.6. **We call the Board to action:**

1.6.1. We question the fact that this is overlooked as a major risk factor by the Risk Committee, the Executive and the entire Board?

1.6.2. We believe that the rescheduling of arrears would partially explain the heightened levels of bad debt write-off in 2016 and 2017 at R4 billion and R5.5 billion respectively. Bad debts almost immediately doubled as soon as the rescheduling practice was extended into arrears (2013: 5.7% vs. 2014: 10.4%).

1.6.3. The rescheduling appears to be authorised through robotic means. In the 2017 annual report, it is reported that: "**All forms** of rescheduling are **governed by a centrally controlled rules engine.**" We are all well aware that automated processes have certain limitations, particularly the lack human intuition. As a result, the automated rescheduling process while efficient, may have contributed to higher bad debts and thus putting Capitec's shareholders' capital at risk.

1.6.4. We believe that unless the Board puts an end to the **excessive** rescheduling practice, Capitec is running the risk of going the same route as African Bank and Blue Financial Services which caused investors substantial losses in the end.

2. **Social concerns**

 2.1. **Reckless lending:** Providing 77% of clients in arrears with a rescheduled loan could potentially be seen as reckless and poses a real risk of attracting a hefty fine from the National Credit Regulator. Shareholders and not management would suffer, should such consequences materialise.

 2.2. **Profiteering on struggling clients:** According to its own statement and policies, Capitec charges origination fees on each successful loan application. It follows from here then that a successful application for rescheduling would attract a loan origination fee which in turn puts struggling clients deeper into indebtedness than prior to rescheduling. This may be seen as profiteering on clients miseries which should be condemned for being morally repugnant.

3. **Governance concerns:**

 3.1. **Impact on Executive remuneration:** We are concerned that the rescheduling process has helped shore up the reported performance of the Executive. Given the above analysis, we believe that some of the Executive incentives were earned through morally repugnant means and excessive risk to shareholders capital.

In consideration of the significance of the abovementioned concerns, we would appreciate your urgent response as we need to communicate our position to our clients by the 5th of February 2017.

**Sincere regards**

**Zwelakhe Mnguni** / Chief Investment Officer

zwelakhe@benguelaglobal.com

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## APPENDIX A: DETAILED ANALYSIS OF BENGUELA'S CONCERNS ON CAPITEC'S RESCHEDULING PRACTICE

### 1. Rescheduling of Arrear Loans and Advances to Clients

1.1. In its 2014 annual report (for 28 Feb 2014), Capitec provided a first detailed report on its newly adopted practice of rescheduling loans. On page 45 of the 2014 annual report, Capitec explained its arrear rescheduling practice and the related impairment provisioning as follows:

*"Rescheduling (otherwise known as restructuring or forbearance) refers to arranging a* ***new payment plan for clients who are experiencing difficulty in making their repayments.*** *This is a normal practice of most credit providers with longer-term loans. All our rescheduled loans are managed as a separate group with appropriate subsegmentation to ensure accurate provisioning calculations.* ***When an arrears loan is rescheduled, a new contract is concluded and the client starts afresh as up-to-date in line with their status as reflected on the credit bureaux. Clients may only ever be rescheduled twice, and then only in certain circumstances****. Rescheduling is done in terms of a centralised credit policy and monitored by the credit committee. As concluding a new contract does not necessarily remove the risk, we have always carried a higher provision on current rescheduled loans than the rest of the current book. During 2014, we increased the provisioning for what we regard as higher-risk rescheduled clients, that is those clients who were in arrears but who were rescheduled in the last six months. The six month period is based on statistical data that indicates that if a client is up-to-date six months after being rescheduled they are more likely to be rehabilitated."*

1.2. In the credit risk section of risk management report of 2017 (pp. 63 of the 2017 Capitec Annual Report), Capitec describes its approach to rescheduling:

*"Rescheduling refers to changing the original terms of the loan contract, as formally agreed by both the client and Capitec.*

*Rescheduling is used as a* ***rehabilitation mechanism for arrears clients who are contacted successfully by centralised collections****. It is also used as a proactive mechanism to assist non-arrears clients who contact Capitec.*

*Rescheduling is customised to address clients' circumstances. It is applied for administrative reasons (e.g. pay frequency or employer changes) and where clients may be experiencing a temporary cash flow problem or a more permanent change in their circumstances that requires relief.*

*Various forms of rescheduling are available in order to offer suitable treatments. These include frequency, pay-date, payment break, variable instalment and term extension rescheduling.*

*The objective of our approach to rescheduling is to offer a solution to our clients that is mutually beneficial, as it addresses the needs of clients and mitigates the risk of credit losses.*

*All forms of rescheduling are* ***governed by a centrally controlled rules en****gine. The rules engine determines whether clients are eligible for rescheduling as well as the maximum term by which a loan term can be extended. Rescheduling performance is continuously monitored on a segmented approach to ensure that it remains within the risk appetite of the bank; rules and provisioning are reviewed accordingly. Validation of the rescheduling policy is performed by credit book and decision support, business intelligence, financial management (provisioning) and the legal department (compliance) and agreed at the credit committee."*

1.3. **2017 Reported Amounts:** As of 31 Aug 2017 (1H2018), Capitec reported that it had rescheduled R1.4 billion (1H2017: R1.6 billion) worth of loans in arrears and R1 billion (R1.5 billion) in up-to-date loans. For instance, a total of R2.4 billion worth of loans were rescheduled. The number reported in 2017 was substantially lower than the peak rescheduled amounts of R2.9 billion for rescheduled arrears and R2.1 billion for rescheduled up-to-date accounts. For further details, please see the attached schedule. The huge reduction in rescheduled loans can be succinctly captured by referring to page 27 of the 2017 Annual Report, where it states:

*"Part of the increase in arrears is due to the more stringent rule changes applied to the rescheduling policy during the current year. The size of the total non-rehabilitated rescheduled book relative to gross loans and advances decreased to 6% from 8% in 2016. These changes include preventing certain low risk clients from rescheduling out of a current state, as well as to prevent arrears clients from rescheduling for a second or third time if their related risk is too high….."*

The reduction in the quantum of loan rescheduling is a positive step but it warrants a thorough historic review to understand the effects on the interpretation of your financial statements.

## 1.4. BENGUELA'S CONCERNS ON CAPITEC'S ARREAR LOAN RESCHEDULING PRACTICE:

While loans rescheduled from up-to-date accounts are not necessarily a good indication of the financial health of the underlying client, it may be a sensible thing to do for the business to ensure that good clients do not end up defaulting on their accounts. Our concerns revolve around the rescheduling of arrears and the impact these have had on reported financial performance of the business.

## 1.5. Financial Concerns

### 1.5.1. Excessive amount of Rescheduled Loan within Aggregate Arrears:

Since inception, Capitec held a high reputation of being a prudent, cautious and a conservative participant in the unsecured loan market. It is this discipline that enabled Capitec to prosper when competitors like African Bank and Blue Financial Services floundered as a result of their ill-discipline.

Having had a look at the recently (2H2013) introduced practice of **arrear** loan rescheduling we are concerned that Capitec could be following in the steps of its failed peers. Figure 1 illustrates the extent to which arrears where rescheduled in the past.

1.5.2. We define "ACTUAL Total Arrears" as Reported Arrears + Rescheduled Arrears. As can be seen below, the arrears are increasingly being rescheduled, particularly in the past 12 months.

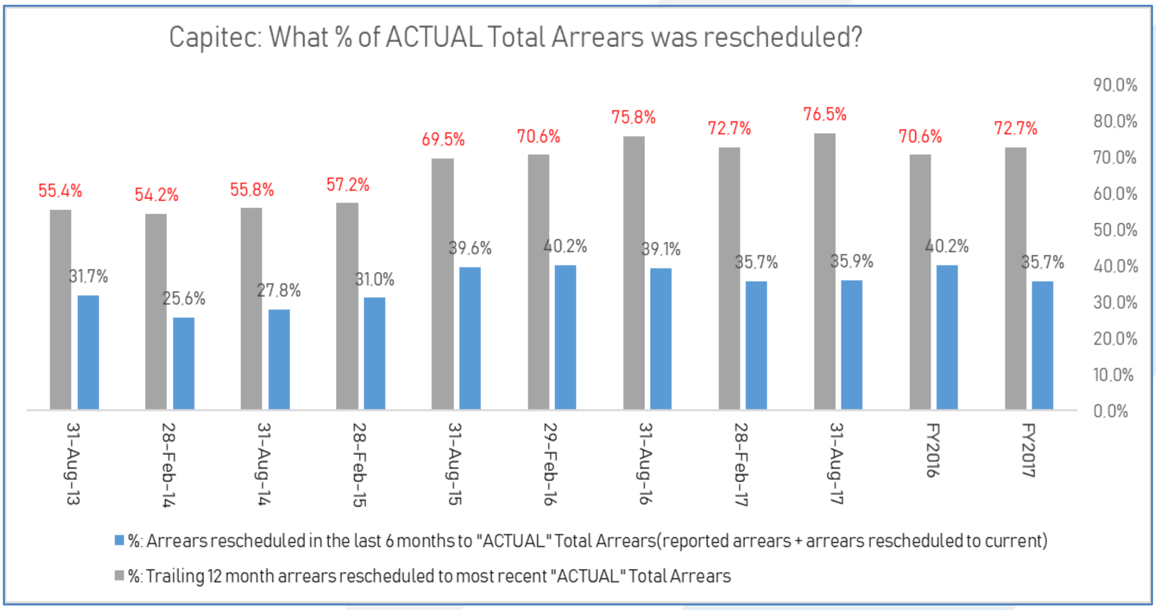


**Figure 1**
*Source: Capitec Annual Reports, Benguela Global Research Calculations*

1.5.3. **Trailing 6 month basis:** Based on reported numbers for arrear loans rescheduled in the past 6 months, between 2013 and 2015, Capitec has been rescheduling between 26% and 40% of its arrears loan book in any given 6 month period (34% on average since August 2013). This is appears to be extremely excessive. As can be seen from Figure 1 above, the practice of rescheduling arrears has actually increased over time, despite management frequently commenting on the tough economic environment in the annual reports. We would like to understand why the business was conducted in this manner and what the Board's reaction was to such an aggressive business practice.

1.5.4. **Trailing 12 month basis:** On a rolling twelve months basis, the rescheduled arrears amount to a striking 76% (1H2018) of "ACTUAL"total arrears. We do not believe that this demonstrates the reported conservative business ethos in Capitec's lending practices. It is downright aggressive to reschedule 76% of arrears.

1.5.5. As can be seen in Figure 2 below, it is also concerning to note that while the Capitec has been categorising increasingly more loans as "high risk", the difference between the provisioning in arrears versus rescheduled arrears has been widening. This demonstrates once again how aggressive the Group has been in its provisioning policy around rescheduled arrears. Once again, this is a hardly conservative lending practice.

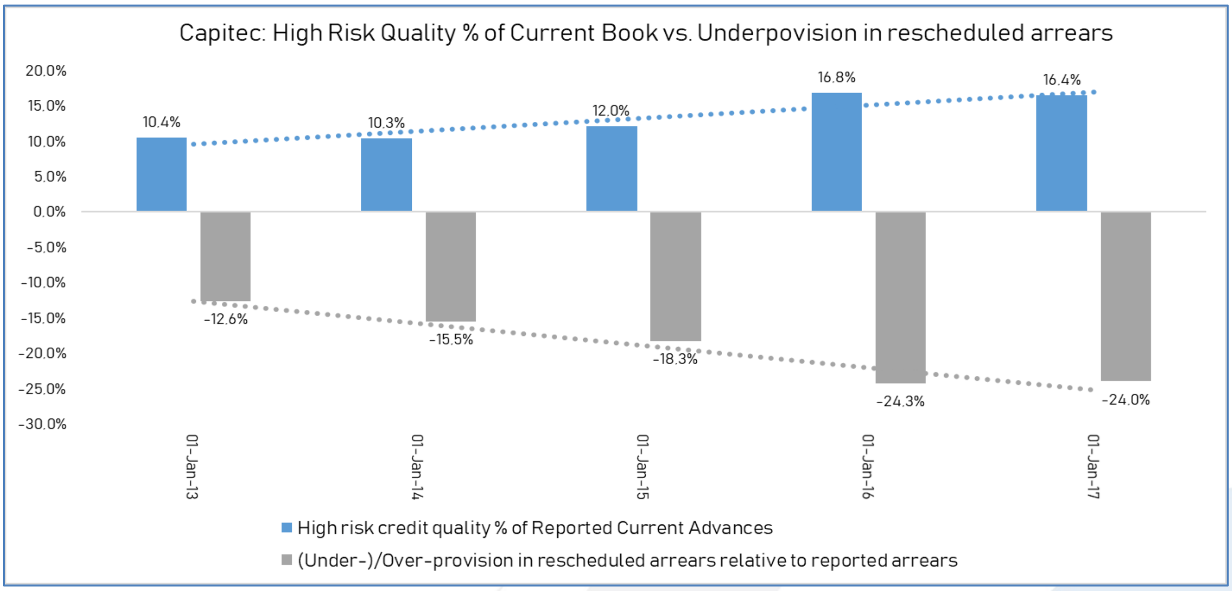


**Figure 2**
*Source: Capitec Annual Reports, Benguela Global Research Calculations*

1.5.6. We would like to understand how such an aggressive rescheduling practice by the Executive Team could have been allowed by the Board? In particular the fact that the trend of rescheduling has been rising. Does this suggest that objectivity and accountability are being impaired within the Board?

1.5.7. Figure 3 below demonstrates that rescheduling has contributed materially to the reported new "sales". The trailing twelve month rescheduled loans now contribute over 16% to new sales and by extension Lending and Interest Income (more on this later). In the past four years, an average of 98% of Gross Loan Book growth came from rescheduled arrears. It is undisputable that **without rescheduling** the arrears, Capitec's reported **Loan Book and revenues would have been stagnant for the past 4 years**. This is material to a large degree.

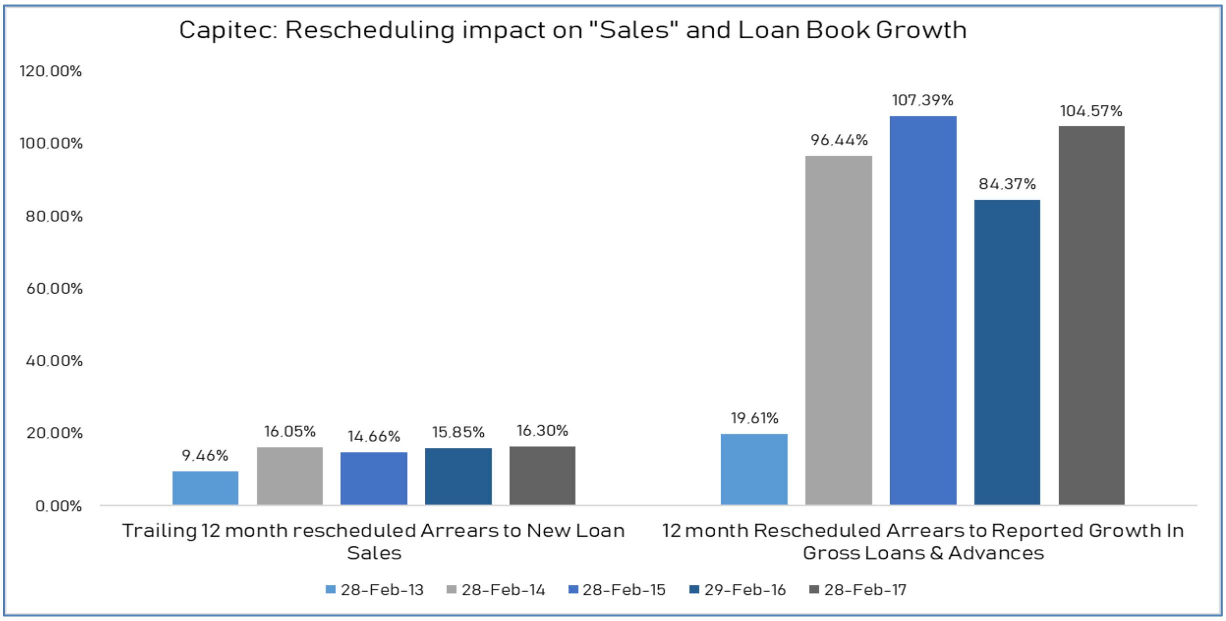


**Figure 3**

*Source: Capitec Annual Reports, Benguela Global Research Calculations*

1.5.8. We would like to enquire about whether the Board is aware of how material the rescheduling practice has been in the reported growth of the loan book, revenues and profits? In addition we are curious to know what has the Board done about this aggressive level of rescheduling?

1.5.9. Figure 4 below displays that if it was not for the rescheduling of arrears, the reported arrears would be 8.4% for 1H2018 as opposed to the reported arrears of 5.4%. It is unsettling to realise that in 2017 (28 Feb 2017), as much as 9.8% of Capitec's loan book was, in actual fact, in arrears (6 month basis). However only 6.3% was reported as the rest of the arrears were rescheduled.

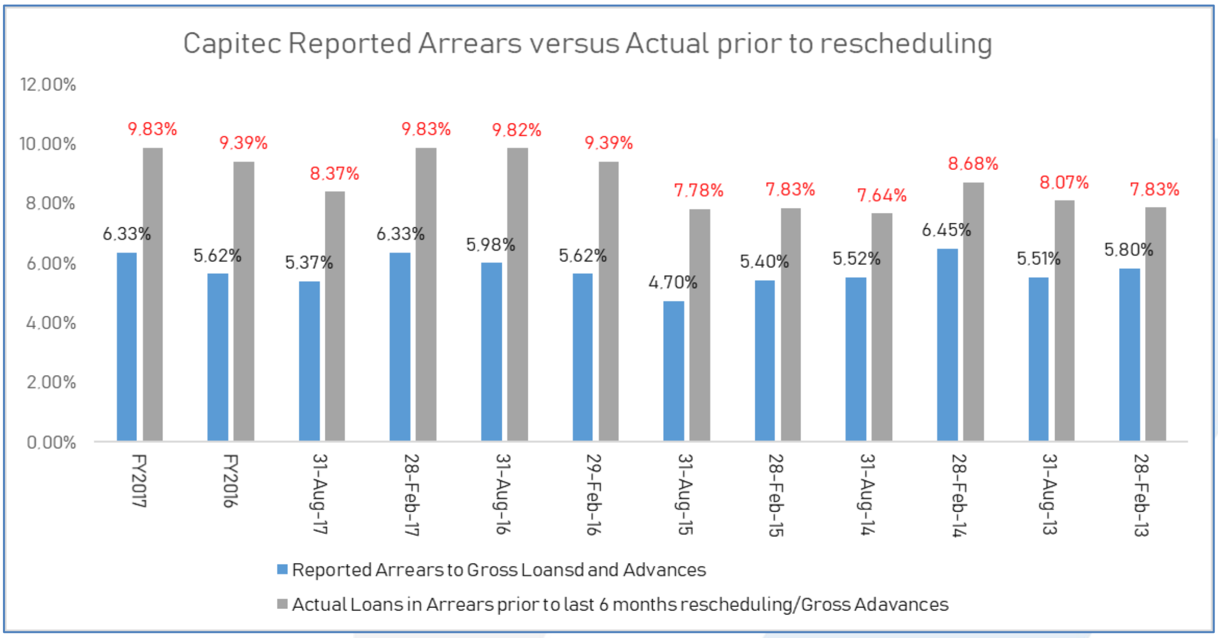


**Figure 4**

*Source: Capitec Annual Reports, Benguela Global Research Calculations*

## 2. IMPLICATIONS OF ARREAR RESCHEDULING FOR PROVISION FOR IMPAIRMENT AND IMPAIRMENT EXPENSE:

2.1. **Income Statement:** In the 2017 financial year, Capitec reported a gross loan impairment expense of R6.2 billion (2016: R5.3 billion) on page 14 of the Capitec 2017 Annual Report.

2.2. **Balance Sheet:** Capitec recognised a 67.2% impairment provision on reported arrears in 2017 (R1.9 billion) in comparison to 60.4% in 2016 (R1.4 billion). However the impairment provision on unrehabilitated rescheduled arrears of R1.6 billion was 51.9% in 2017 (R821 million) and 49.2% for 2016 (R758 million). We also noted that the Impairment provision of loans and advances to clients is a key audit matter (pp. 117 of the 2017 Capitec annual report).

2.3. Provisioning rate: On page 14 of the 2017 Annual Report, Capitec reports on its impairment provision policy:

*"The total provisions compared to gross loans and advances increased to 13.1% at the end of the 2017 financial year (February 2016: 12.5%).* ***<u>We provide 8% on current loans, 43% on loans one instalment behind, 81% for two instalments and 92% for three instalments, all statistically calculated</u>****. We provide on average 52% on clients that rescheduled any of their loans whilst in arrears within the last 6 months even though they are current in terms of their new agreement. For clients who rescheduled any of their loans whilst current we provide 15%. All provisions are based on the probability of default. All outstanding balances of clients who are 90 days in arrears on any loan are substantially provided for or written off. "*

*The gross loan impairment expense increased by 19% to R6.2 billion (February 2016: R5.3 billion).*

2.4. **Arrear Book Spread:** Based on:

2.4.1. the 2017 reported arrear impairment provision of 67.2%,

2.4.2. The provisioning policy stated above and

2.4.3. The age analysis of the gross arrears on page 141 of the 2017 Capitec annual report (2017: R2.8 billion in gross arrears made up of R490 million that are 60 – 90 days and R2.4 billion with less than 60 days in arrears)

2.4.4. We estimate the 2017 arrears book to be spread as follows:

2.4.4.1. 65%: up to 30 days,

2.4.4.2. 18%: 30 -60 days and

2.4.4.3. 17% : 60 – 90 days

2.4.4.4. with a portfolio provision is R252 million or 8.8% of the 2017 Gross Arrears.

2.5. Unless the rescheduled arrear mix is significantly different from our estimated spread above, it is apparent from Figure 5 below that rescheduled arrears attract a significantly lower impairment provision than the arrears that were not rescheduled.

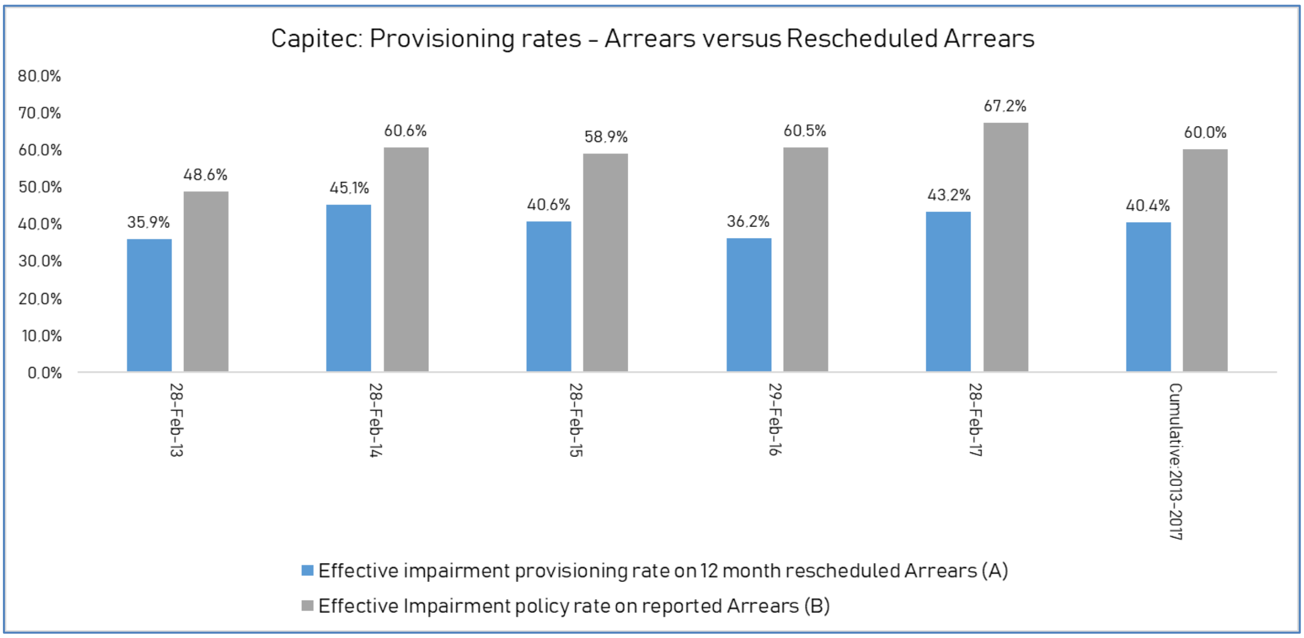


**Figure 5**

*Source: Capitec Annual Reports, Benguela Global Research Calculations*

## 3. IMPACT OF ARREAR RESCHEDULING ON BAD DEBTS

3.1. **SIGNIFICANT RISE IN BAD DEBTS SINCE THE INTRODUCTION OF ARREAR RESCHEDULING:** When Capitec introduced arrear rescheduling, promptly after 2013, bad debts picked up materially as demonstrated in Figure 6 below. In addition, Arrears and Rescheduled Arrears increased materially in the post 2013 period. We believe that this is a symptom of the aggressive rescheduling of arrears

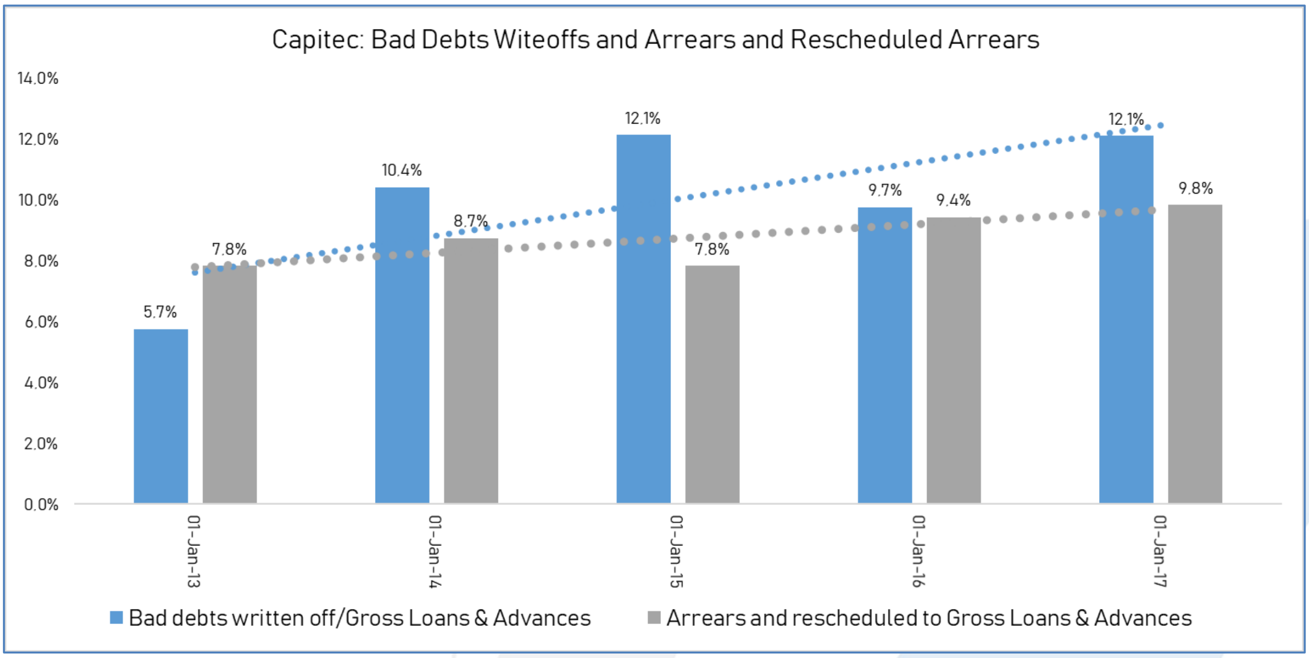


**Figure 6**

*Source: Capitec Annual Reports, Benguela Global Research Calculations*

## 4. IMPACT OF ARREAR RESCHEDULING ON ORIGINATION FEES

4.1. On page 45 of the 2014 annual report Capitec reported that:

*"When an arrears loan is rescheduled, **a new contract is concluded** and the client starts afresh as up-to-date in line with their status as reflected on the credit bureaux. Clients may only ever be rescheduled twice, and then only in certain circumstances."*

4.2. On page 25 of the 2017 annual report Capitec reported that:

*"The costs incurred for every loan application is calculated and recovered through an initiation fee charged to a client which has been successful in his/her application. In terms of common practice, we charge the entire cost related to the loan application upfront when incurred, but in terms of our accounting policy and prudency, t**he fee to recover this cost is deferred and amortised over the term of the loan on an effective interest rate basis**. This loan origination fee was always recognised, presented and disclosed as part of loan fee income in the past."*

4.3. The point made in 1.2.2.2. above is re-emphasised in the revenue recognition note 2.14.1. in the 2017 Annual report (pp.135):

*"Loan origination fees that relate to the creation of a financial asset are amortised over the term of the loan on an effective interest rate basis."*

4.4. It can be inferred from the above annual report extracts that Capitec earns origination fees on each successful loan application **including arrear loans that are rescheduled**. The **deferred portion of origination fees** is included in the balance sheet reported net loans and advances to clients.

4.5. Given the above extracts of policy and practice on origination fees, the average loan term of 38 months in 2017 (2016: 40 months), average loan size of R7 761 (2016: R6 577) and origination fees of R1 197 for loans above R5 000 (published on the on Capitec website, accessed on 16 Jan 2018, refer to Appendix A) we estimate the annualized revenue from origination fees to be ±4.9% of loan amount (2016: ±4.5%).

4.6. We kept the estimated 2016 origination fees constant for all the years prior, given that standalone income statement figure for origination fees was not published prior to 2016. Based on the above, we estimate that origination fees from rescheduled arrear loans contributed on average about 5% per annum to Capitec's **profits before tax:**

| Capitec Bank Holdings Limited | 28-Feb-13 | 28-Feb-14 | 28-Feb-15 | 29-Feb-16 | 28-Feb-17 | Cumulative:2013-2017 |
|---|---|---|---|---|---|---|
| Impact of Loan origination | R'million | R'million | R'million | R'million | R'million | |
| Rescheduled Arrear Loans | 2402 | 2924 | 2847 | 3 839,00 | 4 438,00 | 16 450,00 |
| Estimated annualised initiation fee | 6,92% | 6,30% | 5,49% | 4,54% | 4,87% | 5,45% |
| Estimated origination fee (income statement) related to rescheduled arrears | 166,14 | 184,11 | 156,30 | 174,35 | 216,15 | 897,05 |
| | | | | | | |
| Profit before tax | 2 277,00 | 2 834,00 | 3 560,00 | 4 473,00 | 5 240,61 | 18 384,61 |
| Rescheduled Arrears estimated contribution to C Pre-tax profits | 7,30% | 6,50% | 4,39% | 3,90% | 4,12% | 4,88% |
| | | | | | | |
| | 28-Feb-13 | 28-Feb-14 | 28-Feb-15 | 29-Feb-16 | 28-Feb-17 | Cumulative:2013-2017 |
| | R'million | R'million | R'million | R'million | R'million | |
| Growth in Pre-tax Profits | 252,00 | 557,00 | 726,00 | 913,00 | 767,61 | 3 215,61 |
| Rescheduled Arrears estimated contribution to Pre-tax profits Growth | 65,93% | 33,05% | 21,53% | 19,10% | 28,16% | 27,90% |

**Table 1**

*Source: Capitec Annual Reports, Benguela Global Research Calculations*

5. **Total Impact on Reported Earnings:** The combined effect of rescheduled arrears on earnings as result of lower impairments, new origination fees is summarized as follows:

| **Capitec Bank Holdings Ltd** | **28-Feb-13** | **28-Feb-14** | **28-Feb-15** | **29-Feb-16** | **28-Feb-17** | **Cumulative:2013-2017** |
|---|---|---|---|---|---|---|
| Effective impairment provisioning rate on 12 month rescheduled Arrears (A) | 35,9% | 45,1% | 40,6% | 36,2% | 43,2% | 40,4% |
| Effective Impairment policy rate on reported Arrears (B) | 48,6% | 60,6% | 58,9% | 60,5% | 67,2% | 60,0% |
| **(Under)/Over-provision on rescheduled arrears versus reported arrears C = (A) - (B)** | **-12,6%** | **-15,5%** | **-18,3%** | **-24,3%** | **-24,0%** | |
| | | | | | | |
| **Estimated loan origination fees effective interest rate (income statement)** | **-6,9%** | **-6,3%** | **-5,5%** | **-4,5%** | **-4,9%** | **-5,5%** |
| | | | | | | |
| | R'million | R'million | R'million | R'million | R'million | R'million |
| **Arrears rescheduled over trailing 12 months** | **2 402,00** | **2 924,00** | **2 847,00** | **3 839,00** | **4 438,00** | **16 450,00** |
| | | | | | | |
| Impairment provision recognised on rescheduled arrears | 863,49 | 1317,67 | 1156,311 | 1388,615 | 1918,508 | 6644,594 |
| Impairment Provion that would be recognised save for rescheduling | 1 167,19 | 1 772,25 | 1 676,18 | 2 320,81 | 2 982,26 | 9 918,68 |
| Rand Impact of Lower Provisioning (Balance sheet net loans and advances adjustment) | **- 303,70** | **- 454,58** | **- 519,87** | **- 932,19** | **- 1 063,75** | **- 3 274,09** |
| | | | | | | |
| | R'million | R'million | R'million | R'million | R'million | R'million |
| | **28-Feb-13** | **28-Feb-14** | **28-Feb-15** | **29-Feb-16** | **28-Feb-17** | **Cumulative:2013-2017** |
| | | | | | | |
| Annual movement in impairment provision (income statement adjustment) | - 303,70 | - 150,87 | - 65,29 | - 412,32 | - 131,56 | - 1 063,75 |
| Esitmated recoveries on additional impairments at 21% (2017) | 63,78 | 31,68 | 13,71 | 86,59 | 27,63 | 223,39 |
| New orgination fees on rescheduled arrears | - 166,14 | - 184,11 | - 156,30 | - 174,35 | - 216,15 | - 897,05 |
| **Total Pre-tax Impact of Loan Rescheduling (excluding interest)** | **- 406,07** | **- 303,30** | **- 207,88** | **- 500,08** | **- 320,08** | **- 1 737,41** |
| Tax effect at 28% | 113,70 | 84,92 | 58,21 | 140,02 | 89,62 | 486,47 |
| **Estimated net profit reduction without arrear rescheduling (excluding interest)** | **- 292,37** | **- 218,38** | **- 149,67** | **- 360,06** | **- 230,46** | **- 1 250,94** |
| | | | | | | |
| Shares in issue ('000) | 115,3 | 115,3 | 115,6 | 115,6 | 115,6 | 115,6 |
| | | | | | | |
| **Estimated on EPS and HEPS if arrear rescheduling is stripped off (cents per share)** | **- 253,6** | **- 189,4** | **- 129,4** | **- 311,4** | **- 199,3** | **- 1 081,9** |
| **Reported HEPS (cents)** | **1 498,00** | **1 740,00** | **2 206,00** | **2 781,00** | **3 270,00** | **11 495,00** |
| **Estimated revised HEPS without Arrear rescheduling (cents per share)** | **1 244,42** | **1 550,60** | **2 076,55** | **2 469,60** | **3 070,69** | **10 411,87** |
| | | | | | | |
| Difference between reported adjusted earnings | -20,4% | -12,2% | -6,2% | -12,6% | -6,5% | -10,4% |
| Estimated contribution of arrear rescheduling to reported growth in earnings | 63,6% | 78,3% | 27,8% | 54,2% | 40,8% | 49,8% |

**Table 2**

*Source: Capitec Annual Reports, Benguela Global Research Calculations*

## 6. SOCIAL & GOVERNANCE ISSUES

### 6.1. Rescheduling impact on executive remuneration

6.1.1. It is of grave concern that the rescheduling has contributed materially to two key Executive Incentive Key Performance Indicators (KPIs): HEPS growth and Return on equity (ROE).

6.1.2. The rescheduling is therefore a hugely conflicted and material contributor to performance incentives. Given that the losses on rescheduled loans are not disclosed, it is difficult for shareholders to understand the role played by rescheduling on bad debts in the past.

6.1.3. We believe that the Board has to urgently close this loophole and at the extreme clawback the performance incentives that were achieved through rescheduling of loans and advances.

### 6.2. Possible Reckless Lending?

6.2.1. Clients in arrears are already struggling to repay their Capitec loans, it would appear that they are being issued new loan contracts to start afresh despite their impaired ability to honour their existing obligations. We believe that it is near impossible for 77% of the clients in arrears to successfully apply for rescheduling especially when it was reported that more stringent rule changes applied to the rescheduling policy: As a result, it does appear to be reasonable conclusion that some form of reckless lending may be taking place within Capitec's arrears loan book.

### 6.3. Profiteering from Loan Origination Fees as a result of rescheduling?

6.3.1. According to its own statements, when Capitec reschedules a loan, it signs a new agreement with a client. It follows from this practice that additional origination fees may provide Capitec with an incentive to reschedule loans as this increases reported revenues and earnings growth. This has a direct and material impact on the reported revenues and profits.

6.3.2. There is a real risk of a social backlash under the impression that Capitec is profiteering from the miseries of their struggling clients. This may bring political and regulatory scrutiny to the business.

# APPENDIX B: CAPITEC FEE SCHEDULE

## Rates and fees

| You want | | | | | |
|---|---|---|---|---|---|
| Loan amount (R) | 5 000 | 25 000 | 50 000 | 100 000 | 250 000 |
| Term (months) | 1 (Credit facility) | 12 | 24 | 48 | 84 |
| You pay | | | | | |
| Interest rate (%) | 20.75 | 12.90 – 27.75 | 12.90 – 27.75 | 16.30 – 27.45 | 17.90 – 21.65 |
| Credit life insurance R/1000 per month | n/a | 2.35 – 4.50 | 2.35 – 4.50 | 2.35 – 4.50 | 2.35 – 4.50 |
| Once-off initiation fee (R) | R0 – R644.10 | 1 197 | 1 197 | 1 197 | 1 197 |
| Monthly service fee (R) | 35 – 68.40 | 68.40 | 68.40 | 68.40 | 68.40 |
| Your repayment | | | | | |
| Monthly repayment (R) | 5 155 – 5 810 | 2 442 – 2 663 | 2 568 – 3 015 | 3 101 – 3 882 | 5 756 – 6 760 |
| Total repayment (R) | 5 155 – 5 810 | 29 302 – 31 956 | 61 640 – 72 351 | 148 829 – 186 323 | 483 499 – 567 799 |

Please note that these are examples only. You can choose any term for your loan (up to 84 months) to make your monthly repayments more affordable. Your actual credit amount and credit interest rate will be based on your individual credit profile and affordability.

## Credit card rates and fees

- Initiation fee: R100
- Monthly fee: R35
- Interest rate: 14.75% - 20.75% (based on your credit profile)

## Credit facility 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)

**Source: https://www.capitecbank.co.za/global-one/credit/rates-and-fees** , accessed 16/01/2017

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### *2.4. IMPAIRMENT OF ADVANCES*

Loans and advances are stated at amortised cost net of identified impairments and incurred but unidentified impairments.

Loans and advances are considered impaired if, and only if, there is objective evidence of impairment as a result of events that occurred after initial asset recognition (known as loss events) and these loss events have an adverse impact
on the assets' estimated future cash flows that can be measured reliably.
Objective evidence that loans and advances may be impaired includes the following observable data:

(a) A breach of contract, such as a default or delinquency in interest or principal payments. In this regard, instalments past due date are considered a breach of contract.

(b) Historical loss experience of groups of financial assets with similar repayment terms.

(c) Data indicating that there is a measurable decrease in the estimated future cash flows from a group of financial assets since the initial recognition of those assets, although the decrease cannot yet be identified with the individual financial assets in the group including:

- adverse changes in the payment status of borrowers in the group; or

- national or local economic conditions that correlate with defaults on the assets in the group.

In determining whether a loss event has occurred, loans and advances are subjected to regular evaluations of the overall client risk profile and payments record.

The historical loss experience is adjusted on the basis of observable data to reflect the effects of current conditions that did not affect the period on which the historical loss experience is based and to remove the effects of conditions in the historical period that do not currently exist.

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On a collective basis, the group assesses whether objective evidence of impairment exists for groups of financial assets with similar repayment terms. If there is objective evidence that an impairment loss on loans and advances has been incurred, the amount of the loss is measured as the difference between the assets' carrying amounts and the present value of estimated future cash flows (excluding future credit losses that have not yet been incurred) discounted at the respective financial assets' original effective interest rates (the recoverable amount).
The methodology and assumptions used for estimating future cash flows are reviewed regularly to reduce differences between loss estimates and actual loss experience.

All impaired loans and advances are reviewed on a monthly basis and any changes to the amount and timing of the expected future cash flows compared to previous estimates will result in a change to the charges for impairment of loans and advances in the income statement.

***2.4.1. Identified impairment***
Loans and advances within the group comprise a large number of small, homogenous assets. Statistical techniques are used to calculate impairment allowances collectively, based on historical default and recovery rates. These statistical analyses use as primary inputs the extent to which accounts in the portfolio are in arrears and historical loss experience on the eventual losses encountered from similar delinquent portfolios.

These statistics feed discounted cash flow models, which have been developed for each of the loan products

offered by the group. The models are updated periodically in order to reflect appropriate changes in inputs.

Models contain both judgemental and non-judgemental inputs. The extent of judgement utilised in models developed for new loan products is greater than that for older products, given the limited historical experience available for the new products.

In outline, the statistical analyses are performed on a portfolio basis as follows:
▪ Loans and advances are monitored on a product basis, with each month's advances being treated as a discrete portfolio, on which an analysis of the run-off of recoveries, in period buckets and stratified between default statistics, is performed in order to develop a historical base for statistics on probability of default (PD).

▪ These derived statistics, based on actual experience, are used in plotting default values on a model curve that reflects the risk profile of the portfolio.

▪ Clients in arrears by more than 90 days are handed over for collection and written off. The estimated recoveries on term loans discounted at the contractual rates are recognised in gross loans and advances.

▪ Upon write-off, the accrual of interest income on the original term of the advance is discontinued.

▪ The expected amount outstanding when default occurs that is not subsequently recovered, or the loss given default (LGD), is taken into account in calculating the impairment allowance.

Loans and advances with outstanding balances that would otherwise have been reflected as past due are included in loans and advances not past due, due to renegotiated payment terms. The renegotiated loans are subject to continuous individual or collective impairment assessment. Loans that were past due and have been renegotiated within the past six months are separately disclosed and are subject to stricter impairment assessment than loans renegotiated more than six months ago. Past due renegotiated loans cease to be disclosed separately if they are up-to-date six months after being rescheduled. If a rescheduled loan goes into arrears, it forms part of the loans in arrears classification.

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***2.4.2. Incurred but unidentified impairment***

In addition to the impairment estimated for assets with recognised objective evidence of impairment, an estimate is made for impairments associated with those assets in the statement of financial position that are impaired, but for which objective evidence is not yet available.

- The impairment calculation utilises the results of the statistical analyses referred to above to estimate the proportion of assets in each portfolio that are likely to display objective evidence of impairment over the emergence period. The emergence period is defined as the experience of the length of time that it takes for objective evidence to become apparent after the asset has become impaired.
- In considering the occurrence of a loss event over the life of a loan, it is assumed that there is a constant risk of the loss event occurring at any point in the life of the loan.
- For a portfolio of loans in a particular month most of the provision is recognised in the early stages of the contractual period, as the outstanding loan balances are larger.

Loans and advances impaired on this basis are reflected as loans not past due.

***2.4.3. Loan write-offs***

Clients (and the related impairment allowance accounts) are written off at the earliest of when they are in arrears for 90 days or more or legal hand-over occurs. The estimated recoveries on term loans discounted at the contractual rates are recognised in gross loans and advances.