

CAPRICORN INVESTMENT GROUP
1H19 Results Review
April 2019

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Capricorn Investment Group Limited

1H19 Results Review

Target Price (c)	***1796***
Current Price (c)	1586

Year End 30 June	2017	2018	F2019	F2020	F2021
Net Interest Income (N$m)	1,649	1,819	2,072	2,296	2,533
Non-Interest Income (N$m)	998	1,225	1,332	1,450	1,581
Profit (N$m)	918	934	990	1,064	1,158
HEPS (c)	182	158	194	209	227
DPS (c)	68	60	64	69	75
DY (%)	3.8	3.5	4.0	4.4	4.7
P/E (x)	10.0	10.9	8.9	8.3	7.6
P/BV (x)	1.8	1.6	1.2	1.1	1.0

Recommendation	HOLD
NSX Code	CGP
Market Cap (N$m)	8,234
Shares in Issue (m)	519.2
Free float (%)	20.1
52 week high	1791
52 week low	1540
Expected Total Return (%)	17.3

Source: FNB, IJG, Bloomberg

Capricorn Investment Group (CGP) released interim results for the period ended 31 December 2018. Profit after tax for the period increased by 6.1% over the corresponding period last year. Basic earnings per ordinary share and fully diluted earnings per ordinary share increased by 9.6% and 9.8% respectively. A dividend of 30cps was declared for the period, in line with the interim dividend declared in 1H18.

Net loans and advances increased by 10.2% y/y to N$37.6 billion. The increase is mainly attributable to the inclusion of Entrepo, but strong growth in commercial loans from Bank Windhoek (increasing by 27.5% y/y) added roughly N$1.4 billion to total advances. Total investment securities made up mostly of treasury bills, government bonds and money market investments, increased by 29.0% y/y to N$6.82 billion. Total interest income increased by 12.5% y/y to N$2,373.1 million.

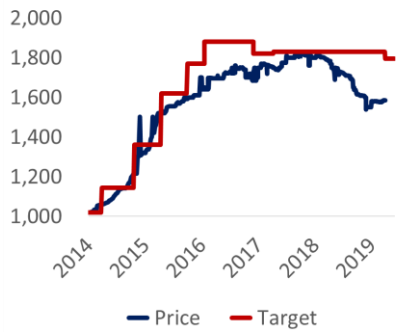
Deposits grew by 6.2% from N$32.8 billion to N$34.8 billion, which was mostly attributable to increases in wholesale funding in the form of NCDs and demand deposits. Debt securities increased by 11.2% from N$4,270.9 million to N$4,750.2 million while other borrowings increased by 20.8% from N$1,388.4 million to N$1,677.3 million. Interest expense grew by 5.9% y/y to N$1,089.2 million. CGPs loan-to-funding ratio deteriorated from 88.1% y/y to 90.1% as total funding increased by 8.5%, which was below the growth in gross advances of 12.2%.

Net interest income increased by 21.5% to N$1,089.2m. This was largely due to expanding net interest margins in the Namibian operations. The widening margins were as a result of both higher average interest rates charged and improved cost of funding. However, the net interest margins of the Botswana and Zambian operations contracted due to adverse liquidity conditions in those markets which increased funding costs. On group level the net interest margin improved from 4.0% to 4.2%.

Non-performing loans have increased by 60.0% from N$1.0 billion to N$1.6 billion. According to the announcement, the increase was due to five large, but "well secured" loans being classified as non-performing. The IFRS 9 day-one adjustment amounted to N$298.5 million which was accounted for as a direct transfer out of distributable reserves. However, impairment charges for the six months decreased by 3.3% to N$38.2 million.

Non-interest income increased by 8.3% to N$636.9m. the growth could be attributed to three main factors. Firstly, a sharp increase in forex trading income; Secondly, 18.8%

CGP Share Price vs Target Price



Dividends

Dividend (interim): 30c/share

Last day to trade: 8 March 2019

Ex-dividend date: 11 March 2019

Record date: 15 March 2019

Payment date: 27 March 2019

higher transaction-based income from electronic channels and; Lastly income from underwriting activities contributed by Entrepo.

Operating expenses grew by 20.6% y/y, from N$840.7m to N$1,051.1m. The bulk of the increase was due to staff costs which increased by 18.8% y/y. This is a combination of salary increases and capacity building in both Capricorn Private Wealth and the IT departments. Staff expenses contributed 10.1 percentage points of the 20.6% y/y increase in operational expenditure, while the inclusion of Entrepo contributed 2.4 percentage points and operational banking expenses accounted for 3.9 percentage points of the total growth figure. The cost to income ratio for the period increased to 60.1% compared to 58.2% in 1H18 as expenses grew at a faster pace than income.

Overall performance for the period was better than expected. However, as mentioned, it seems a large amount of the contribution has been due to the Entrepo acquisition. Deposit growth has been low, while organic advances growth has also been low. Non-performing loans have been increasing, as impairment charges are expected to going forward. Operating expenditure has not been contained well, as staff costs have continued to rise significantly. Although this can be seen as capacity building, the offsetting non-interest revenue has yet to materialise.

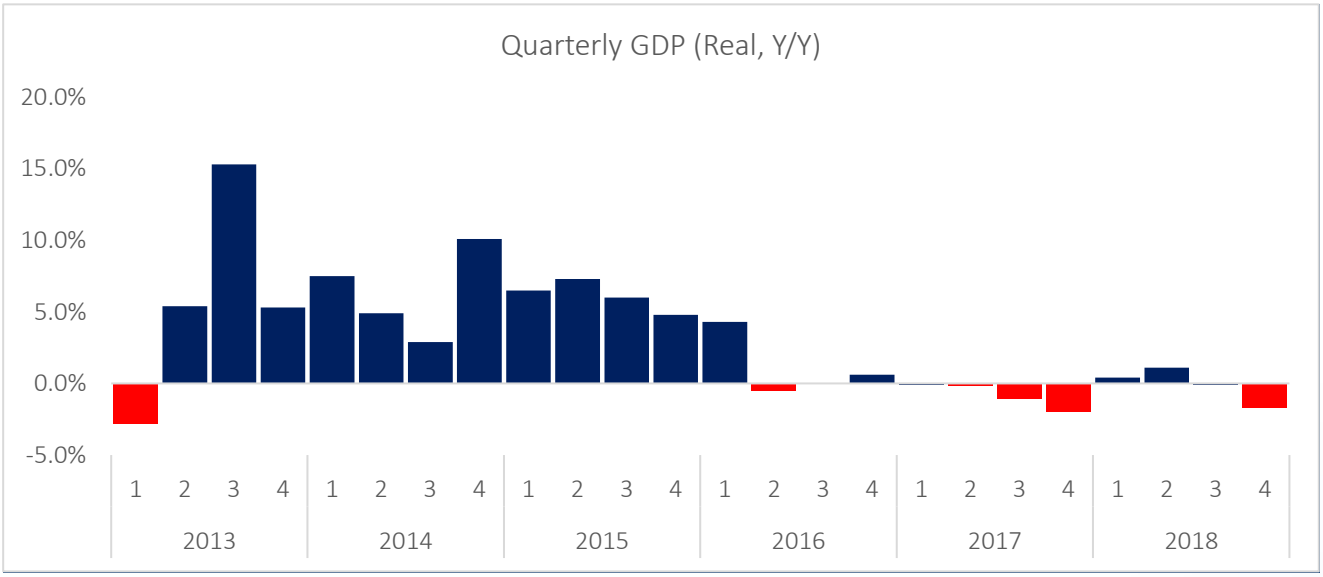
We have derived a **target price of N$c1796** per share. Coupled with dividends of 64 cps over the next 12 months, we expect a **total return of 17.3%.** Seeing as the share price of CGP has declined by roughly 11.5% over the last year, we believe that there is some value in the current price. However, due to continuing economic headwinds, possible regulatory changes in the microlending sector and expected increasing impairment charges, the risks to our target price are skewed to the downside, thus we maintain our **HOLD** recommendation on the Capricorn Group.

Banking Macro

Growth environment

The Namibian economy continues to find itself in a precarious position. Quarterly growth for the last three years has either been negative or marginally positive, meaning that the country's economy has been relatively stagnant since the beginning of 2016. Preliminary national accounts for 2018 showed some positive revisions to historical data, breaking the ten consecutive quarters of "depression" into three technical recessions. However it is framed, economic growth has not been doing well. The slowdown has been felt across all economic sectors. Lower disposable incomes, heightened unemployment and lower business activity has undeniably had a bearing on banking profitability.

Preliminary national accounts pointed to a year-to-date contraction in real GDP of 0.1% for 2018. However, as per our 2019 Outlook, growth for 2018 is expected to be revised to marginally positive. Contractions in agriculture and fishing, as well as manufacturing and a large proportion of tertiary industries are expected to be offset by growth in mining and quarrying. Uranium and diamond mining output rose significantly, contributing enough to counteract the decrease in consumer and business activity recorded in tertiary industries, pushing our expectations for growth in 2018 to 0.2%.



Source: IJG, NSA

The growth outlook for 2019 and beyond remains quite muted. Government is continuing with its pro-growth fiscal consolidation efforts, which was reiterated in this year's March budget speech. The budget revealed that fiscal controls have improved as the 2018/19 budget outturn is very close to the forecast from March 2018. This is a very positive development as improvement in fiscal controls and governance is critical to managing the fiscal position. However, government expenditure is expected to increase by 2.4% to N$66.55bn in the 2019/20 budget year, from N$65.02bn in 2018/19. This is an upward revision of 1.1% from the mid-term budget review last year, and the highest forecast expenditure ceiling for the year since the inclusion of 2019/20 in an MTEF period. Any slippage in the fiscal consolidation efforts will result in deteriorating debt metrics and will eventually have a negative impact on credit ratings.

Although expected to decline over time, government continues to run large fiscal deficits, and as a result government debt continues to rise. As per the latest budget forecasts, the funding requirements are roughly N$9.2 billion, N$8.6 billion and N$7.4 billion over each of the next three financial years. Should there be overruns in expenditure or shortfalls in revenues, pressure will return to fund the deficits by issuing sovereign paper locally, which has a negative effect on banking sector liquidity and cost of funding for banks.

Additionally, business and consumer confidence remain low as the lack of clarity surrounding investor unfriendly policies such as NEEEF and the Namibian Investment Promotion Act (NIPA) remain an overhang to the investment environment, acting as disincentives for both local and foreign direct investment.

Given the current circumstances, we expect real GDP growth of 0.9% in 2019. The growth being driven by a marginal rebound in tertiary sector activity as government ups operational expenditure and consumers start to find their feet. After which we expect real growth to stabilise around the 3.4% level in 2020 and 2021.

Interest Rates

Generally, 2018 was a year of monetary policy tightening in developed markets, especially as witnessed in the US. Following four policy rate increases of 25bps each in 2018, the first Federal Open Markets Committee ("FOMC") meetings of 2019 delivered a starkly dovish message. As a result, the FOMC have projected that the US federal funds rate is to remain unchanged all the way through to 2021. With political pressure on the Federal Reserve to "reverse their mistake" of increasing interest rates in 2018, markets are now pricing in a cut in the fed funds rate as the most likely outcome for 2019.

United States | Instrument: Futures: Fed Funds - Effective | Fed Effective Rate 2.41

1) Overview | 2) Future Implied Probability

Current Implied Probabilities | 3) Add/Remove Rates

Dates: Meeting / Calculation | Calculated 04/01/2019 | Based on rate 2.25-2.50

Meeting	Hike Prob	Cut Prob	1.25-1.5	1.5-1.75	1.75-2	2-2.25	2.25-2.5	Fwd Rate
05/01/2019	0.0%	4.7%	0.0%	0.0%	0.0%	4.7%	95.4%	2.39
06/19/2019	0.0%	18.9%	0.0%	0.0%	0.7%	18.2%	81.1%	2.35
07/31/2019	0.0%	24.5%	0.0%	0.0%	1.9%	22.5%	75.5%	2.34
09/18/2019	0.0%	46.1%	0.0%	0.6%	7.8%	37.7%	53.9%	2.27
10/30/2019	0.0%	51.2%	0.1%	1.3%	10.6%	39.2%	48.8%	2.24
12/11/2019	0.0%	64.3%	0.4%	3.8%	18.3%	41.8%	35.7%	2.18
01/29/2020	0.0%	69.7%	0.9%	6.0%	21.9%	40.9%	30.3%	2.14

Source: Bloomberg

Similarly, European markets are also not looking at much change in official policy rates. In the last ECB policy meeting, President Mario Draghi struck a more downbeat tone, acknowledging that "risks surrounding the euro area growth outlook have moved to the downside". This comes shortly after the ECB ended its massive asset-buying program in December. As a result, European interest rates are set to remain at present record-low levels.

Euro Zone | Instrument OIS: Eurozone OIS | Current Rate -0.40

1) Overview | 2) Future Implied Probability

Current Implied Probabilities | 3) Add/Remove Rates

Dates: Meeting / Calculation | Calculated 04/01/2019 | Based on rate -0.40

Meeting	Hike Prob	Cut Prob	-0.7	-0.6	-0.5	-0.4	-0.3	Fwd Rate
04/10/2019	0.3%	0.0%	0.0%	0.0%	0.0%	99.7%	0.3%	-0.36
06/06/2019	0.3%	1.8%	0.0%	0.0%	1.8%	97.9%	0.3%	-0.36
07/25/2019	0.3%	2.9%	0.0%	0.0%	2.9%	96.8%	0.3%	-0.37
09/12/2019	0.3%	8.0%	0.0%	0.2%	7.9%	91.6%	0.3%	-0.37
10/24/2019	0.3%	14.2%	0.0%	0.7%	13.5%	85.5%	0.3%	-0.38
12/12/2019	11.6%	12.4%	0.0%	0.6%	11.8%	75.9%	11.6%	-0.36

Source: Bloomberg

The United Kingdom economic outlook is clouded by immense uncertainty around the politics of Brexit and reactions to the eventual outcome. However, most market commentators agree that policy rates are currently low and should increase once Brexit is resolved. The market seems less sure and sees the current policy rates remaining unchanged for the 2019 calendar year and low chance of any increases on the horizon.

United Kingdom | Instrument OIS: United Kingdom OIS | Current Rate 0.75

1) Overview | 2) Future Implied Probability

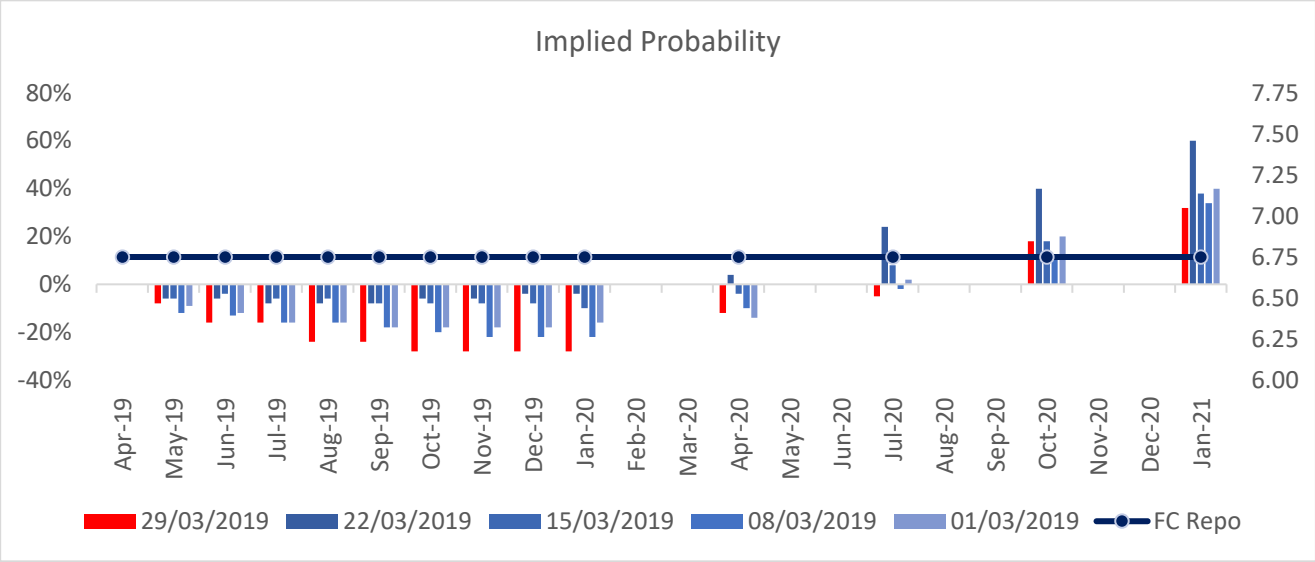
Current Implied Probabilities | 3) Add/Remove Rates

Dates: Meeting / Calculation | Calculated 04/01/2019 | Based on rate 0.75

Meeting	Hike Prob	Cut Prob	-0.25	0	0.25	0.5	0.75	Fwd Rate
05/02/2019	0.0%	3.9%	0.0%	0.0%	0.0%	3.9%	96.1%	0.70
06/20/2019	0.0%	5.4%	0.0%	0.0%	0.1%	5.3%	94.6%	0.69
08/01/2019	0.0%	6.5%	0.0%	0.0%	0.1%	6.4%	93.5%	0.69
09/19/2019	0.0%	10.3%	0.0%	0.0%	0.4%	9.9%	89.7%	0.68
11/07/2019	3.4%	10.0%	0.0%	0.0%	0.4%	9.6%	86.6%	0.69
12/19/2019	4.2%	9.9%	0.0%	0.0%	0.4%	9.5%	86.0%	0.69
01/30/2020	4.1%	10.4%	0.0%	0.0%	0.4%	10.0%	85.5%	0.69

Source: Bloomberg

Expectations of interest rate increases in South Africa have moderated since the beginning of 2019. Using the Forward Rate Agreement ("FRA") curve as a measure of market expectations, no change in the repo rate is expected for the next 18 months. IJG sees this scenario as unlikely as the risks to the South African Reserve Bank's ("SARB") inflation outlook remains skewed to the upside. Two of the most notable risk factors are increases in electricity tariffs, increased load shedding and a negative ratings assessment of SA's sovereign debt from Moody's which, to great surprise, was not updated in March. The next rating date in Moody's calendar date will be on November 1, after the medium-term budget speech. This gives South Africa a brief reprieve to get its fiscal house in order. As such, we maintain that one 25bp hike remains likely.



Source: Bloomberg, IJG

Namibia has not changed its policy rate since August 2017 as it remains very accommodative towards heavily indebted consumers. However, the Namibian repo rate is currently on par with the South African rate at 6.75%, following the SARB's 25bps rate hike in November 2018. The SARB's interest rate trajectory will have significant bearing on Bank of Namibia's (BoN) MPC decisions and we believe that the BoN may be proactive and increase the repo rate by 25bps during the year as a buffer, to potentially avoid a situation where the Namibian repo rate is below the South African rate which may lead to capital outflows.

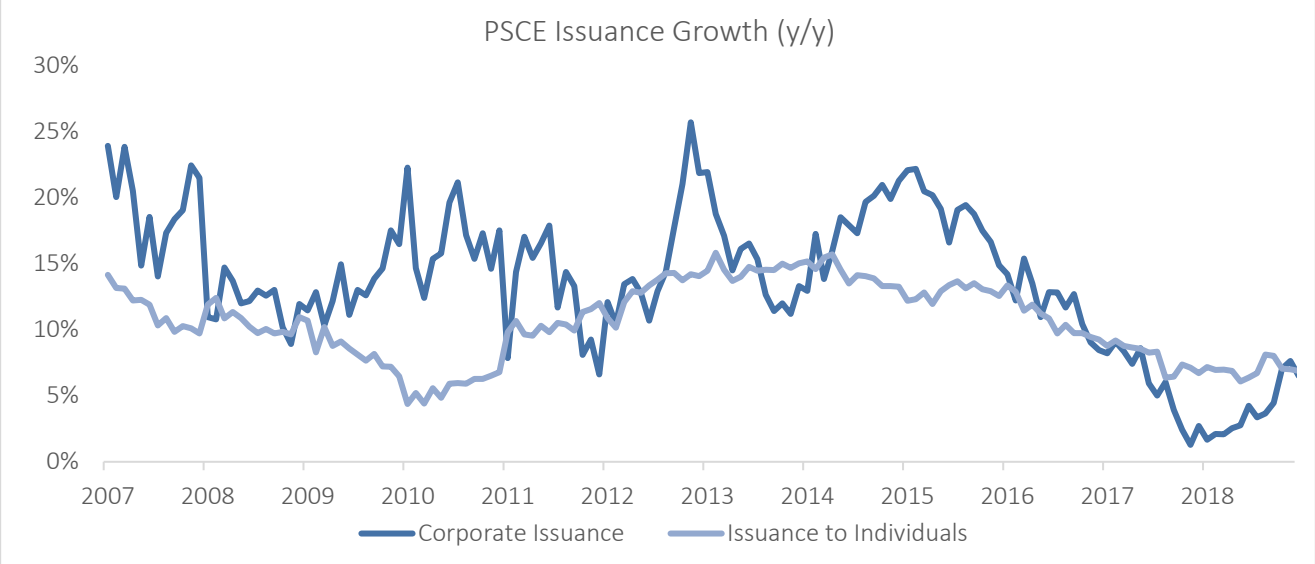
As a result, we have sketched three interest rate scenarios. The base case assumes BoN hikes rates once, in anticipation of South African rates rising. In the bull case scenario, South African inflation expectations moderate and we see no hike in either country. Finally, the bear case sees a negative ratings assessment from Moody's, a depreciation of the currency, higher inflation expectations and two interest rate hikes of 25bps. The three scenarios have little impact on the profitability of banks but will be marginally positive for the bottom line. This is due to the fact that lending rates adjust nearly immediately, while deposit rates take some time to adjust giving the banks some windfall net interest.

PSCE

Growth in private sector credit extension has been quite low over 2018, delivering growth of 7.4% y/y from December 2017 to December 2018. This is still an uptick from the 5.2% y/y growth witnessed in the previous calendar year. The acceleration has mostly been due to the recovery in growth of credit extended to corporates which was up by 6.5% y/y.

However, a significant part of this corporate credit resurgence has been in the form of overdrafts (+12.3% y/y) and other loans and advances[1] (+25.7% y/y), while instalment credit (-9.5% y/y) and leasing transactions (-11.7% y/y) continued its decline and corporate mortgage advances grew by only 2.6% y/y.

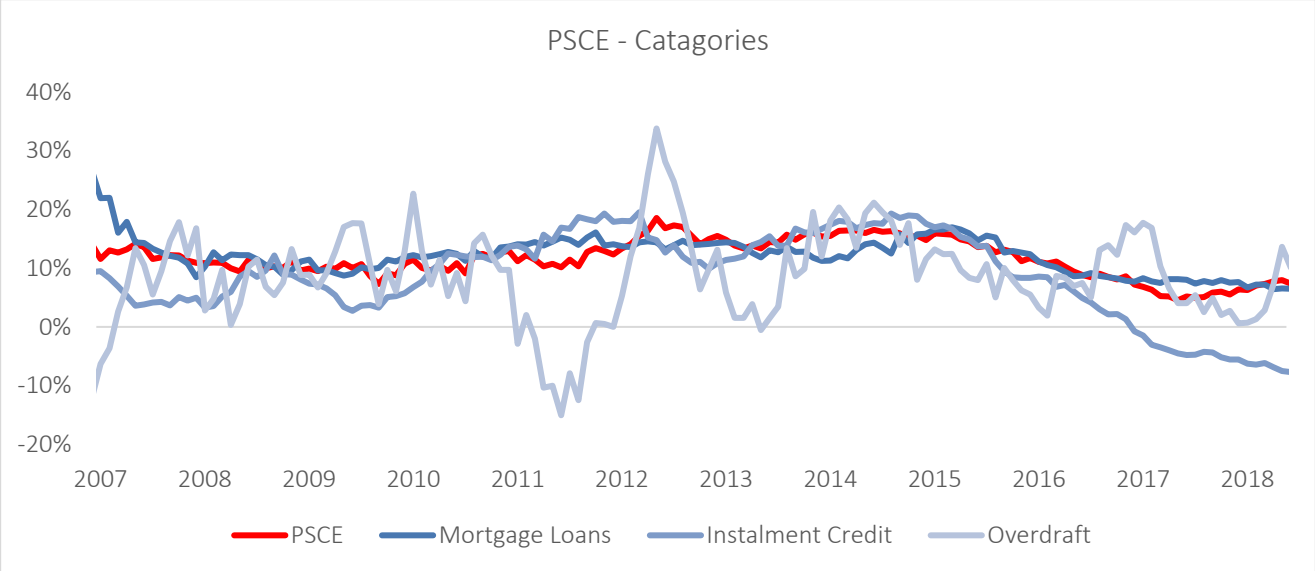
[1] Other loans and advances are made up of term loans, personal loans and credit cards.



Source: Bank of Namibia, IJG

Loans to individuals grew by 6.9% y/y in 2018, which was largely driven by decent growth in mortgages (+7.7% y/y) and other loans and advances (+17.7% y/y), while overdrafts grew marginally (+4.2% y/y). Instalment credit to individuals also posted a 6.5% y/y decline, while leasing transactions grew by 620% y/y from N$19.3 million to N$138.9 million.

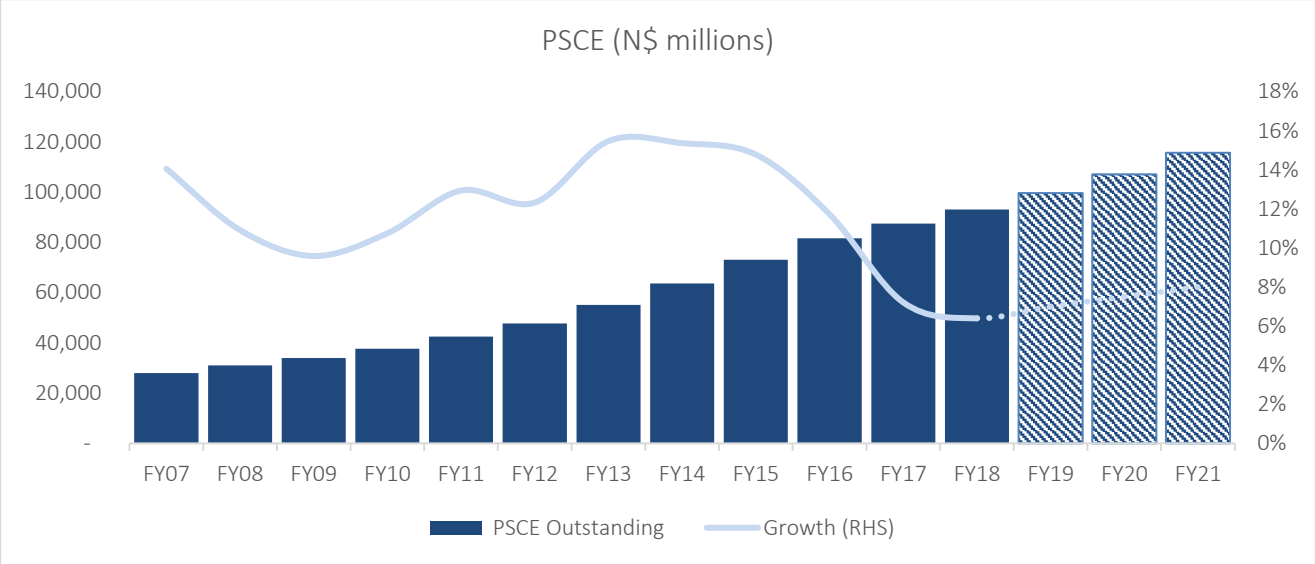
The rest of the 7.4% total credit growth figure was as a result of other financial corporations (+28.1% y/y) and the non-resident private sector (+120% y/y). According to the Bank of Namibia, the sharp increase to non-residents was as a result of a product launched by one of the commercial banks which caused a once off increase of N$720.0 million in March 2018.



Source: Bank of Namibia, IJG

Households remain indebted. Thus, increases in consumption will likely not be credit driven as it was in the past, but will rely on increasing disposable incomes. According to the Bank of Namibia's Financial Stability Report, the latest debt to disposable income ratio stands at around 83.3% (compared to 71.2% in South Africa). Although the uptick in credit extension has been a welcome development, the growth stemming from overdrafts and personal

loans may not be sustainable in the long term if being used for consumptive purposes and not being put to productive use. Generally, only consumption booms that are accompanied by an increase in investment tend to be sustainable.



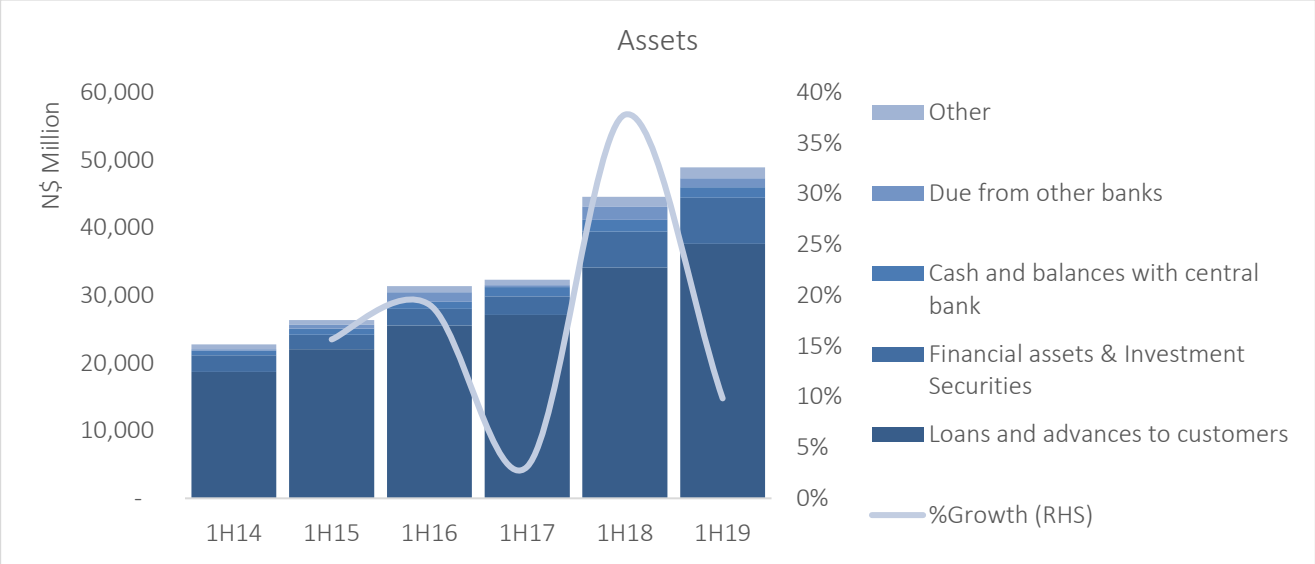
Source: Bank of Namibia, IJG

We expect to see some recovery in the rate of PSCE growth, on the back of modest economic growth and supported by an accommodative interest rate environment. We do not anticipate a return to double-digit growth as was seen in the first half of the decade but anticipate that credit extension will likely grow at roughly the same rate as nominal GDP. As a result, we have pencilled in a modest 7.0% y/y growth for FY19, 7.5% y/y for FY20 and 8.0% y/y growth for FY21.

Net Interest Income

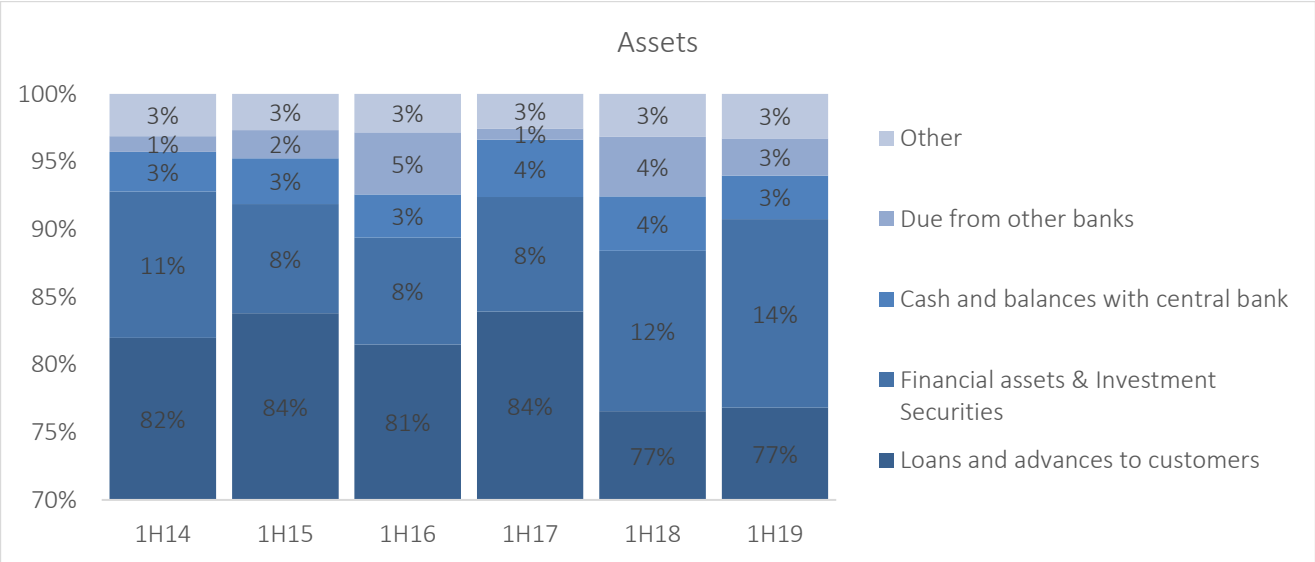
Asset Base

Total assets of the Capricorn Group grew by 9.8% y/y to N$48.92 billion. The relatively strong growth could be mainly attributed to strong growth in advances, which increased by 10.2% to N$37.58 billion. Not all this growth was organic, as the acquisition of Entrepo Finance Namibia added roughly N$1.0 billion of term loans to the total book.



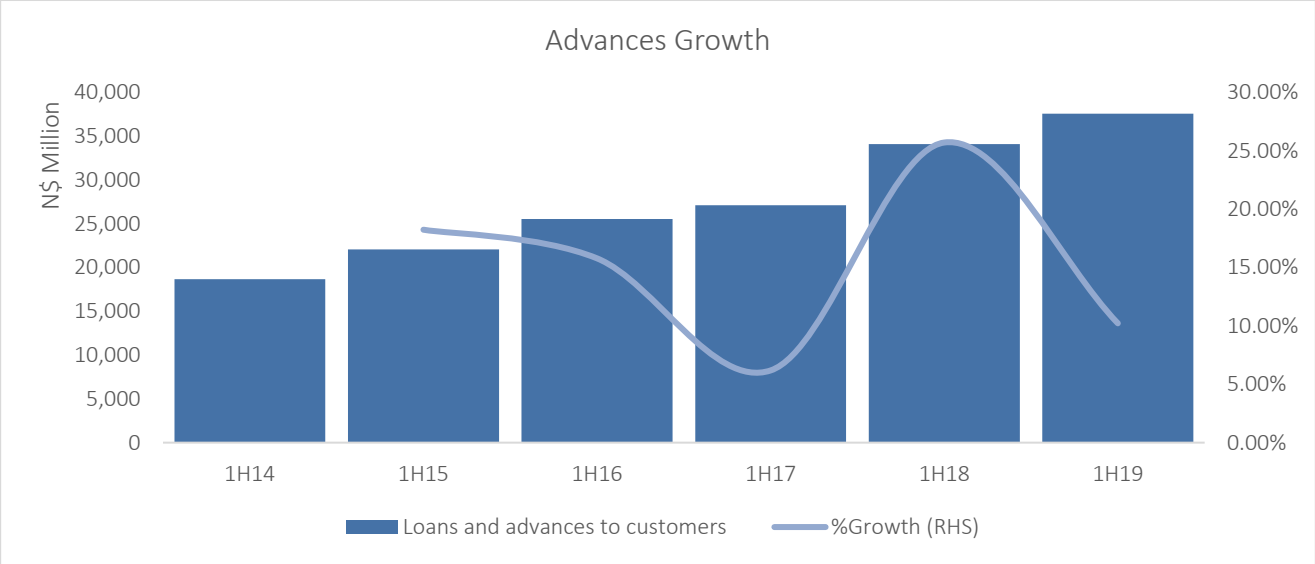
Source: CGP, IJG

Financial assets and investment securities grew by 29.0% y/y to a total of N$6.82 billion, made up largely of treasury bills, government bonds and money market investments. As has been the trend in the rest of the market, CGP has been stocking up on liquid assets. At the end of FY18 Capricorn group had N$3.47 billion worth of treasury bills, N$1.06 billion of government bonds and N$1.09 billion in money market investments. Included under investment securities are shares in Nimbus Infrastructure Ltd. In July 2018, the group increased their shareholding in Nimbus Infrastructure Ltd from 18.3% to 30.0% during a rights issue at a cost of N$54.3 million.



Source: CGP, IJG

As a result of the increases in liquid assets, the financial assets and investment securities categories have been steadily growing and now make up 14% of total assets, up from only 8% as at 31 December 2016. Conversely, advances have declined to 77% of total assets, down from 84% at 31 December 2016. The increase in liquid assets is a sign of prudent balance sheet management and allows the bank some liquidity buffers should liquidity shortages arise (as was the case in early 2017). Recently we have seen banking sector liquidity deteriorate from N$2.8 billion in December 2018 to N$261.1 million in January 2019, thus the increase in liquid assets is a comforting sign that Capricorn should be better able to insulate itself from rising funding costs.



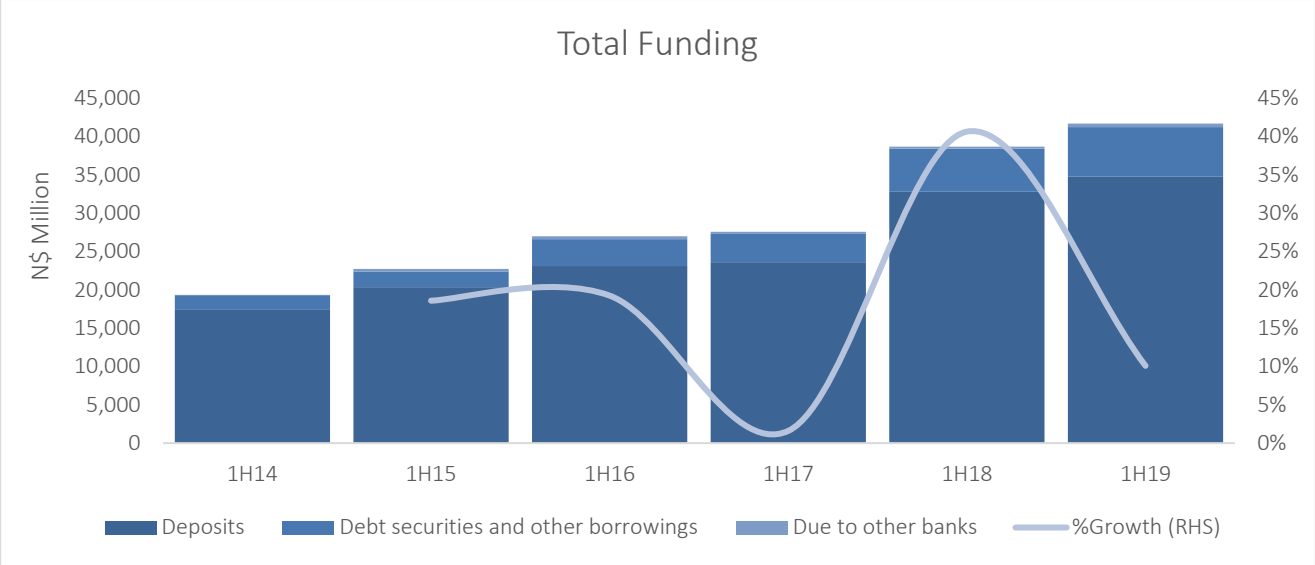
Source: FNB, IJG

Gross loans and advances increased by 12.6% to N$38.4 billion as at 31 December 2018. This was mainly due to the inclusion of Entrepo, although organic growth was achieved in the corporate loans segment. Loans to corporates increased by 27.5% or N$1.4 billion from 31 December 2017 to 31 December 2018. This compares favourably to PSCE which recorded 7.4% growth over the same timeframe. According to management, Capricorn continues to expect strong growth from Bank Windhoek's corporate department due to their quick turnaround times for credit applications and a strong dedication to building and maintaining client relationships.

Advances growth from Entrepo is expected to remain muted. According to management, Entrepo is following a strategy of contained growth to maintain a quality book. According to the Namibian Financial Stability report, microlending advances amounted to N$5.5 billion in 2017, which means Capricorn has a market share of roughly 18%, while Letshego is around 45% of the total microlending market. Both Entrepo and Letshego's loan books are heavily concentrated in government employees and it seems competition is heating up for these loans. Debt consolidation products, such as the one released by Nedbank is also targeted at government employees, offering up to N$200,000 loans for periods up to 5 years. This being said, management is open about the fact that Entrepo was purchased at an attractive price with a short-term view.

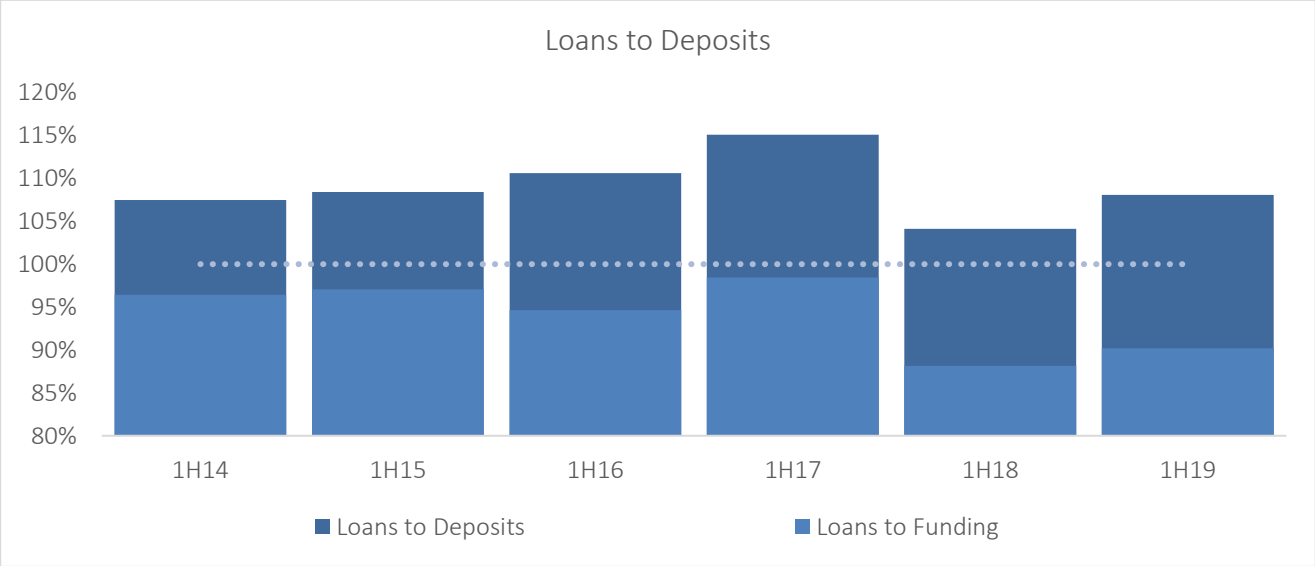
Funding

Total funding increased by 8.5% (or N$3.2 billion) to N$41.7 billion. The growth in funding is attributable mainly to growth in wholesale deposits and senior debt in Bank Windhoek. Wholesale funding was mainly obtained in the NCD market, and according to management there was a concentrated drive to reduce Namibian funding costs to open up net interest margins. Bank Windhoek issued two senior unsecured bonds in November 2018, one fixed (BWFk22) one floating (BWJk22), totalling N$400 million. The fixed rate bond was issued at a rate of 9.98% while the floating rate was issued at 3m Jibar + 187 bps.



Source: CGP, IJG

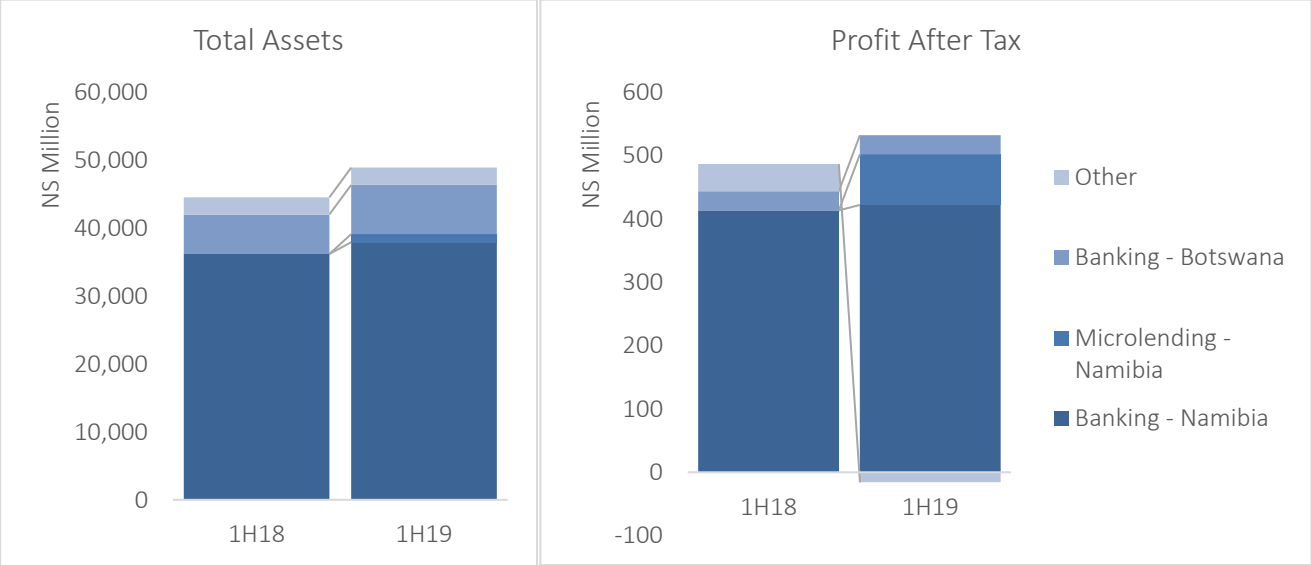
At the end of FY18 term deposits made up 36% of the total deposit book, while current accounts made up 22% and NCDs accounted for 17% of total deposits. Wholesale funding to retail funding stood at a 53:47 ratio. Loan to funding ratios have been on the increase, seeing as loans grew quicker than both deposits and total funding. The loan-to-funding ratio increased from 88.1% to 90.1%. Loan-to-deposits grew from 104.1% to 108.1%.



Source: CGP, IJG

Interest Income and Expenses

Net interest income increased by 21.5% to N$1.1 billion. Entrepo made a heathy contribution to the increase, adding roughly N$61.9 million of the N$192.5 million year-on-year increase in net interest income. Bank Windhoek also made a large contribution, adding N$96.8 million due to the increase of corporate lending and an increased net interest margin in the Namibian operations due to increased cost of funding.



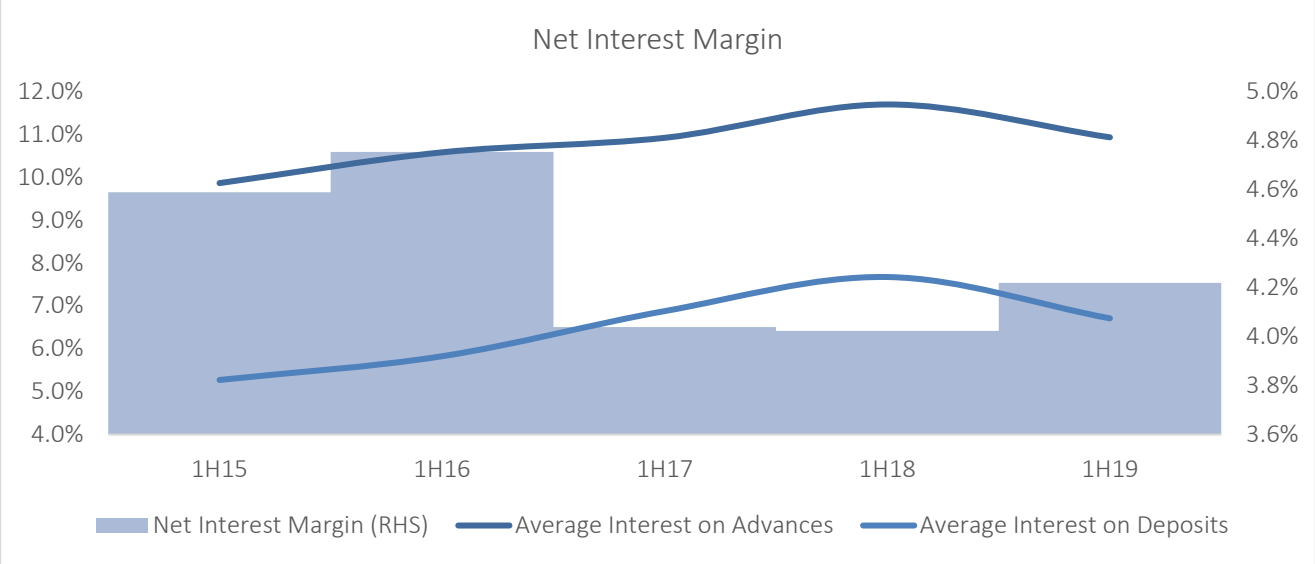
Source: FNB, IJG

In the FY18 results Capricorn claimed it expects Entrepo to contribute around 15% of the group's profit after tax in future. Although making up only 2.4% of total assets, Entrepo managed to contribute 15.5% or N$80.0 million of profit after tax in 1H19, exceeding management's guidance. This segment reported a 18.9% return on assets.

The *other* segment, which include property development, unit trust management, asset management and Zambian banking operations, made a loss of N$15.9 million. According to the interim report: "The Zambian operation has improved during the six months ended 31 December 2018 compared to the previous six months ended 30 June 2018."

However, Cavmont continues posting losses and will likely not break-even in FY19. According to management, drastic steps have been taken to make a turn-around in this segment. Capricorn management have changed most of the senior management of Cavmont and have taken a much more active role in the operations of the Zambian entity, citing increased focus as the strategy. Nearly half of the branches are to be closed and headcount is to be reduced by roughly 40% to reduce overheads. The turnaround strategy is however no quick fix and management expect at least 2 to 3 years before seeing tangible results of the restructuring exercise.

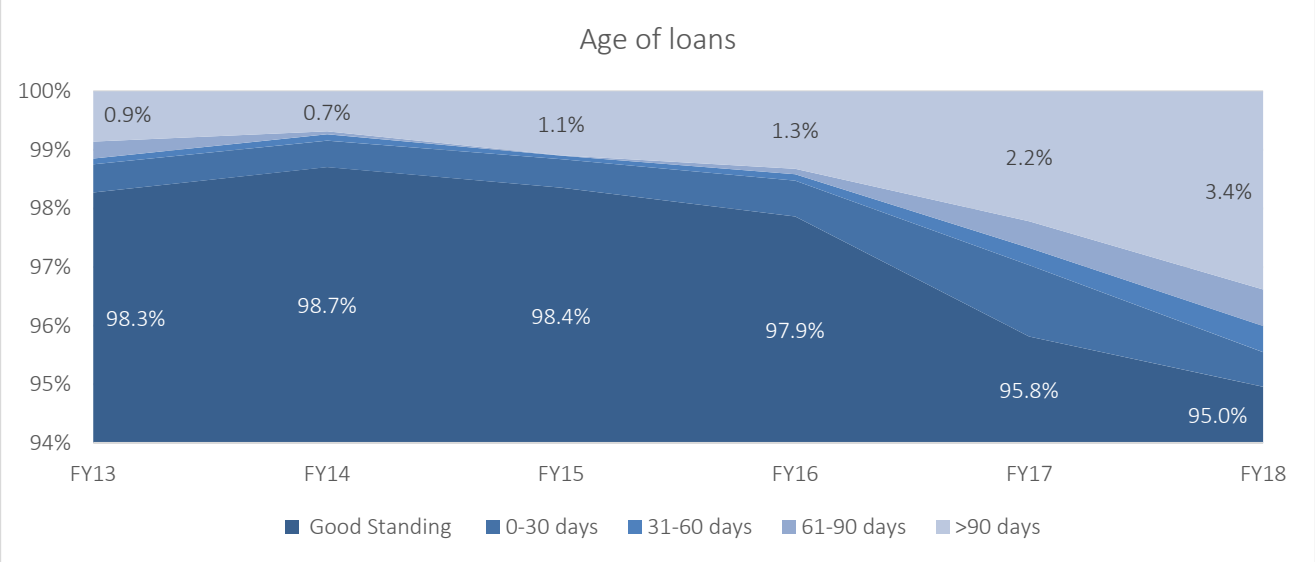
Botswana continues to perform well contributing positively to the bottom line. Management have indicated that they have learnt a few lessons, specifically with regards to the nuances of funding in the country which will contain funding costs going forward. Capricorn intends to roll out its digital offering, which includes online and mobile banking, to Botswana. Up until now this has been lacking in Bank Gaborone's offering.



Source: FNB, IJG

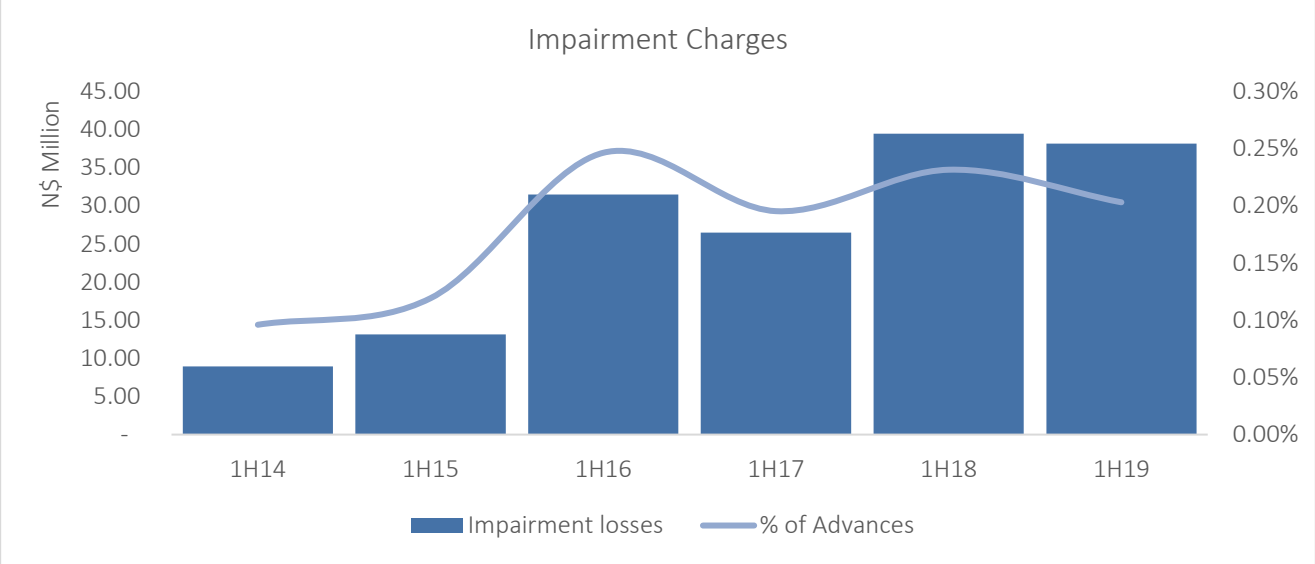
Although Namibian margins widened, Bank Gaborone and Cavmont Bank saw a reduction in their net interest margins as a result of increased cost of funding. According to our calculations, based on average advances and deposits, the consolidated net interest margin improved from 4.0% to 4.2%.

Impairments



Source: FNB, IJG

Non-performing loans increased from N$1.0 billion to N$1.6 billion. According to management the increase in NPLs is due to five (FY18: four) large, but well secured loans in Bank Windhoek. This is an increase from about 2.9% to 4.3% of NPLs to gross advances. This is a continuation of the trend of the deterioration of the age of the loan book. The age of the loan book as at financial year end is presented above.

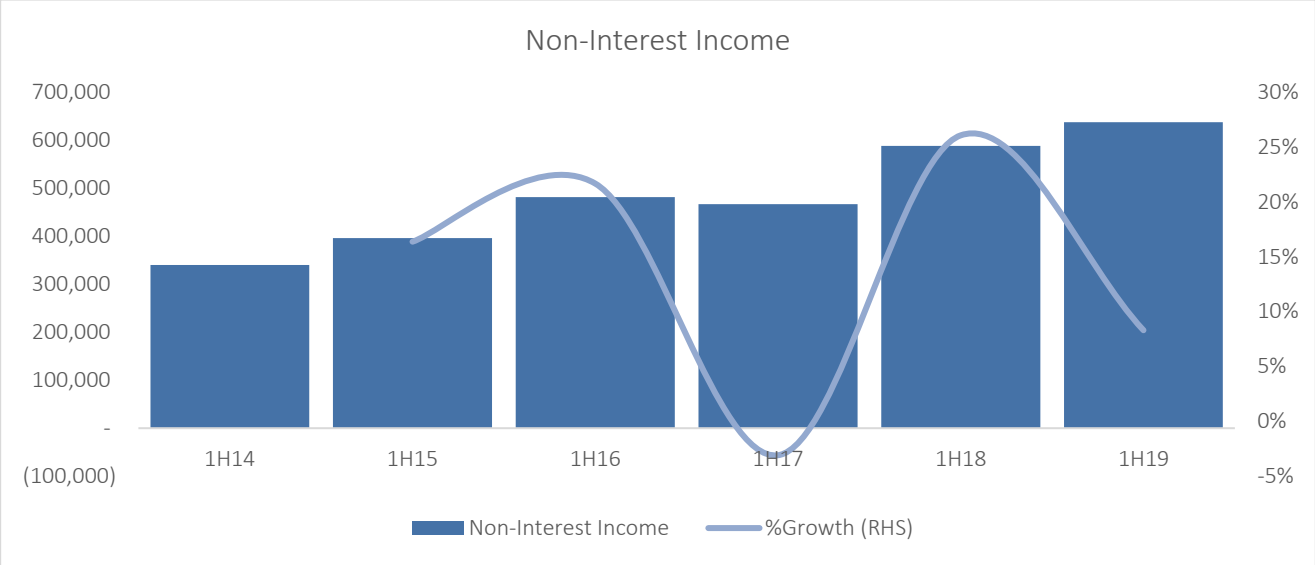


Source: FNB, IJG

The IFRS 9 day-one adjustment amounted to N$298.5 million, which was accounted for as a direct transfer out of distributable reserves. This was partially offset by a transfer of N$163.4 million from the credit risk reserve to retained earnings. Impairment charges decreased by 3.3% to N$38.2 million for the six months ended 31 December 2018 which translated to a credit impairment charge of just 0.20% of advances, which is low compared to the industry. We expect this to increase steadily over the next few years to 0.40% – 0.50%. Management have indicated that they are concerned about the volatility that IFRS 9 may introduce into the impairment line, but do not expect extremely large year-on-year increases for the next few years.

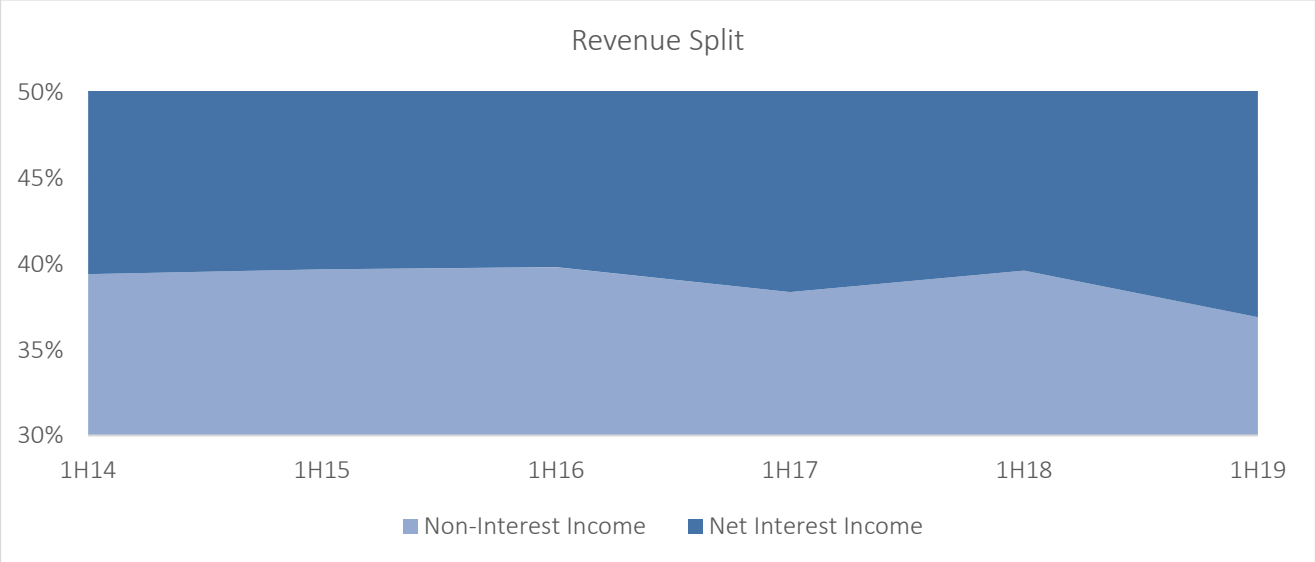
Non-Interest Revenue

Non-interest income increased by 8.3% to N$636.9 million for the half year ended 31 December 2018. However, the 8.3% growth was off a high base set by the sale of Visa Inc. listed securities in the prior period. According to the interim statements the growth was attributable to three main factors. Firstly, a sharp increase in forex trading income; econdly, 18.8% higher transaction-based income from electronic channels and; Lastly income from underwriting activities contributed by Entrepo.



Source: FNB, IJG

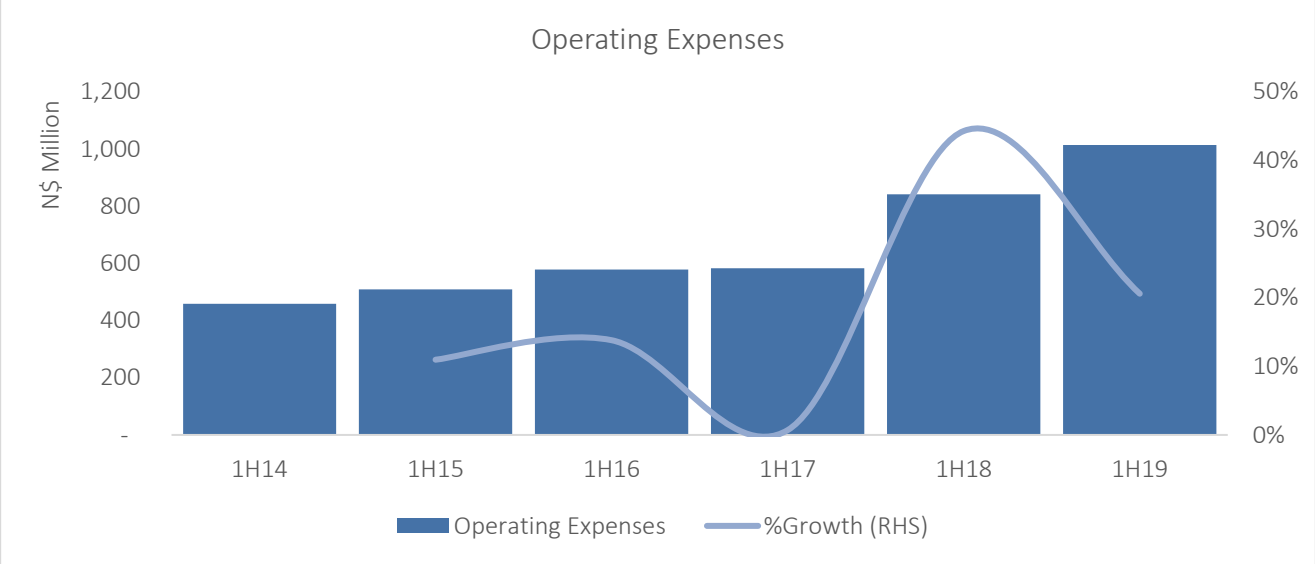
The underwriting income from Entrepo is worth further exploration. Entrepo Holdings Ltd is made up of two separate entities. Entrepo Finance (Pty) Ltd is a registered microlender and Entrepo Life Ltd is a registered long-term insurer. Entrepo Finance makes loans to clients while Entrepo life offers credit protection products which act as security against the loan. This combination of high interest loans combined with non-interest revenue from the sale of insurance products makes Entrepo extremely profitable.



Source: CGP, IJG

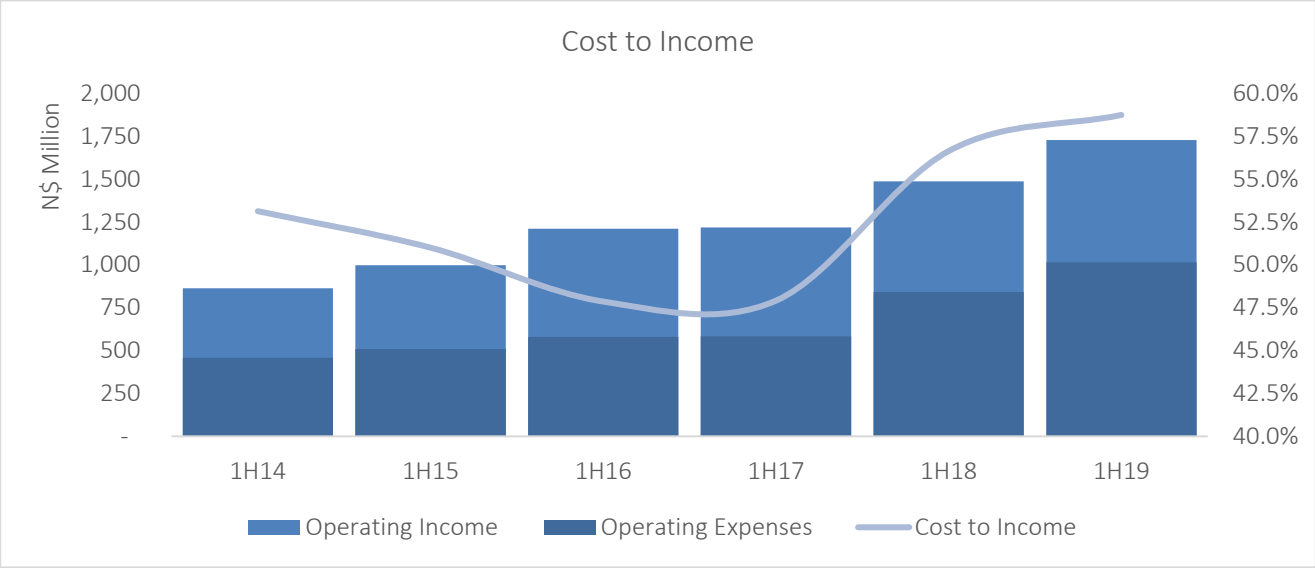
Non-interest revenue accounts for 37% of operating income, down from 40% in 1H18. However, the rough 60:40 split will likely remain the norm in the future.

Operating Costs



Source: CGP, IJG

Operating expenses increased 20.6% year-on-year from N$840.7 million to N$1.0 billion as at 31 December 2018. The increase was mainly due to an increase in staff expenses. According to the interim statements staff costs increased by 18.8% y/y which was mainly due to capacity was being built in the Capricorn Private Wealth suite and the IT department. Additionally, the filling of vacancies and increase in provision for performance remuneration also led to higher staff costs. According to management, compliance remains a large cost. Headcount in the risk department has quadrupled over the last 7 years as compliance and regulatory burdens continue to mount while systems implementation has also been costly.



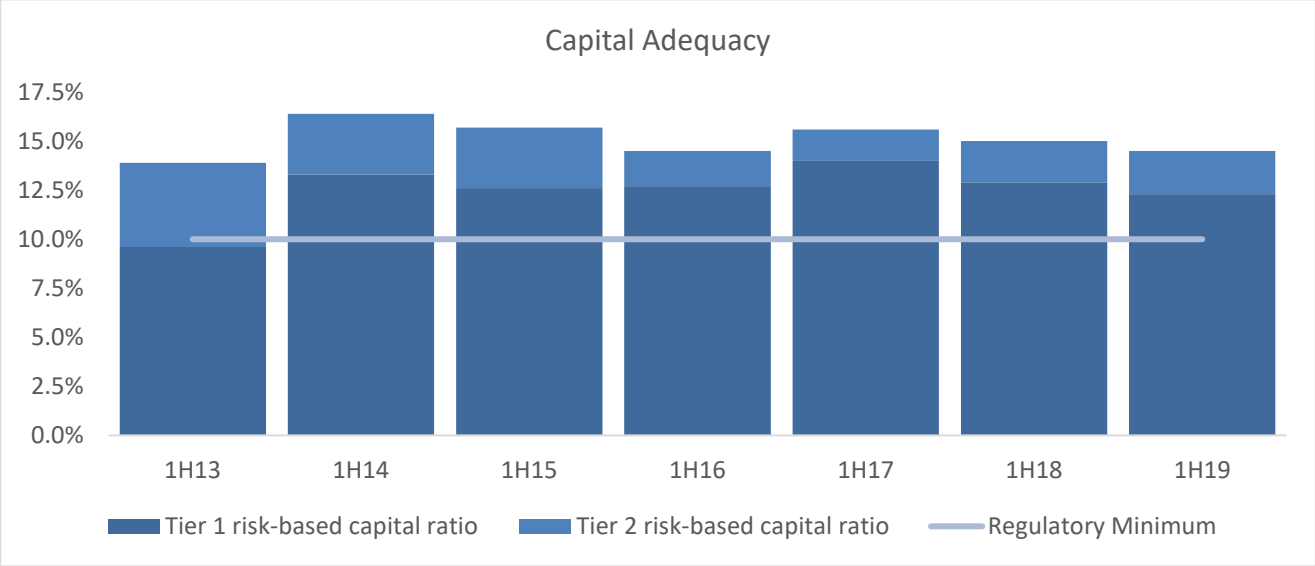
Source: CGP, IJG

The inclusion of Entrepo had also played a role, contributing 2.4 percentage points of the total 20.6% growth in operating expenditure. Finally, the strong growth in transactional volumes resulted in operational banking

expenses. Given the fact that expense growth continues to exceed income growth, the cost to income ratio has increased from 56.6% in 1H18 to 58.7% in 1H19.

According to management, the relatively high cost to income ratio is a result of a highly decentralised business model, which they have no intention of changing. By concentrating decision making powers in the hands of local branch managers, customers receive a better service and better turnaround times on credit applications. Management also affirmed that they are happy to pay good salaries to retain quality staff and skills, and that this is reflected in their staffing bill. This being said, the target is to reduce the cost to income ratio, so that it is closer to 50% than 60%, which will be possible once the Zambian operations improve.

Capital Adequacy



Source: CGP, IJG

The group remains well capitalised with its total risk-based capital adequacy ratio of 14.5%, down from the 15.0% recorded in 1H18. This is well above the minimum regulatory capital requirement of 10.0%, and currently being satisfied by Tier 1 funding only. In terms of credit quality, Global Credit Ratings Company affirmed the group's and Bank Windhoek Ltd's credit ratings of AA(NA) with a stable outlook during November 2018.

Outlook

The outlook for the banking sector is not overly optimistic. Although a modest recovery in GDP growth is expected over the next three years, the country faces a tough task to get back to the spectacular growth seen in the first half of this decade. The fiscal hangover will likely last another couple of years seeing as core issues, such as consumptive public spending, are not being addressed, while public development spending continues to be sacrificed to feed the beast which is consumptive spending.

Business and consumer confidence and investment are likely to remain depressed while policy uncertainty looms. NEEEF, NIPA and corporate tax increases are three of the largest worries. Consumers are certain to remain under pressure over the medium-term. Private sector credit growth is expected to recover slightly, but without business and consumer confidence and the investment it brings, long-term growth will remain difficult to achieve.

Capricorn has maintained some momentum by acquiring Entrepo. The acquisition of a highly profitable company has allowed Capricorn to keep earnings growing in the currently depressed economic environment. We expect Entrepo to continue to perform well over the next few years. Although the risk of regulatory changes in the microlending industry may impact profitability in the long run, the purchase price of this investment should be recuperated quite quickly.

The Capricorn group remains committed to growth, despite a challenging economic environment. Results from Namibia have been impressive as good growth in the corporate banking division and a push to drive down funding costs were evident in the results. The turnaround of Zambia continues to be a headache but is luckily a relatively small part of the overall business, while Botswana keeps on delivering satisfactory results. Although we do not expect fireworks for the next few financial years, the resilience of the financial results in trying times have been quite impressive and we expect this resilience and innovation to continue.

Valuation

To value the shares of Capricorn Investment Group, several valuation methods have been incorporated to reduce the overreliance on a single methodology. These methods include three discounted cash flow methodologies and two justified multiple approaches. The outputs of the different methodologies were equally weighed.

Two of the main valuation input assumptions are the cost of equity and long-term sustainable growth rate. The cost of equity was calculated using the capital asset pricing model (CAPM). The resultant cost of equity amounted to 14.60% based on a 10.08% yield on the IJG generic 10-year bond, an equity risk premium of 3.93% and a beta of 1.15. The sustainable growth rate was estimated to be 11.05% based on a long tern sustainable return on equity of 17.0% and an estimated pay-out ratio of 35.0%. Seeing as the valuation is very sensitive to these inputs, a sensitivity analysis can be found in the annexures to illustrate the effect of changes in these assumptions.

The output of our valuation model is presented below.

	Value (NS'000)	Price per Share	Price to Earnings	Forward PE	Price to Book	Forward PB	Dividend Yield	Forward DY	Weight
Free Cash Flow to Equity	9,282,616	18.22	10.1	9.4	1.66	1.42	3.29%	3.51%	20%
Residual Income	9,002,524	17.67	9.8	9.1	1.61	1.38	3.39%	3.62%	20%
Dividend Discount	9,086,204	17.84	9.9	9.2	1.62	1.39	3.36%	3.59%	20%
Justified Price to Earnings	9,032,545	17.73	9.8	9.1	1.61	1.38	3.38%	3.61%	20%
Justified Price to Book	9,344,133	18.34	10.2	9.4	1.67	1.43	3.27%	3.49%	20%
Weighted Average	**9,149,604**	**17.96**	**9.9**	**9.3**	**1.63**	**1.40**	**3.34%**	**3.56%**	**100%**

Source: IJG

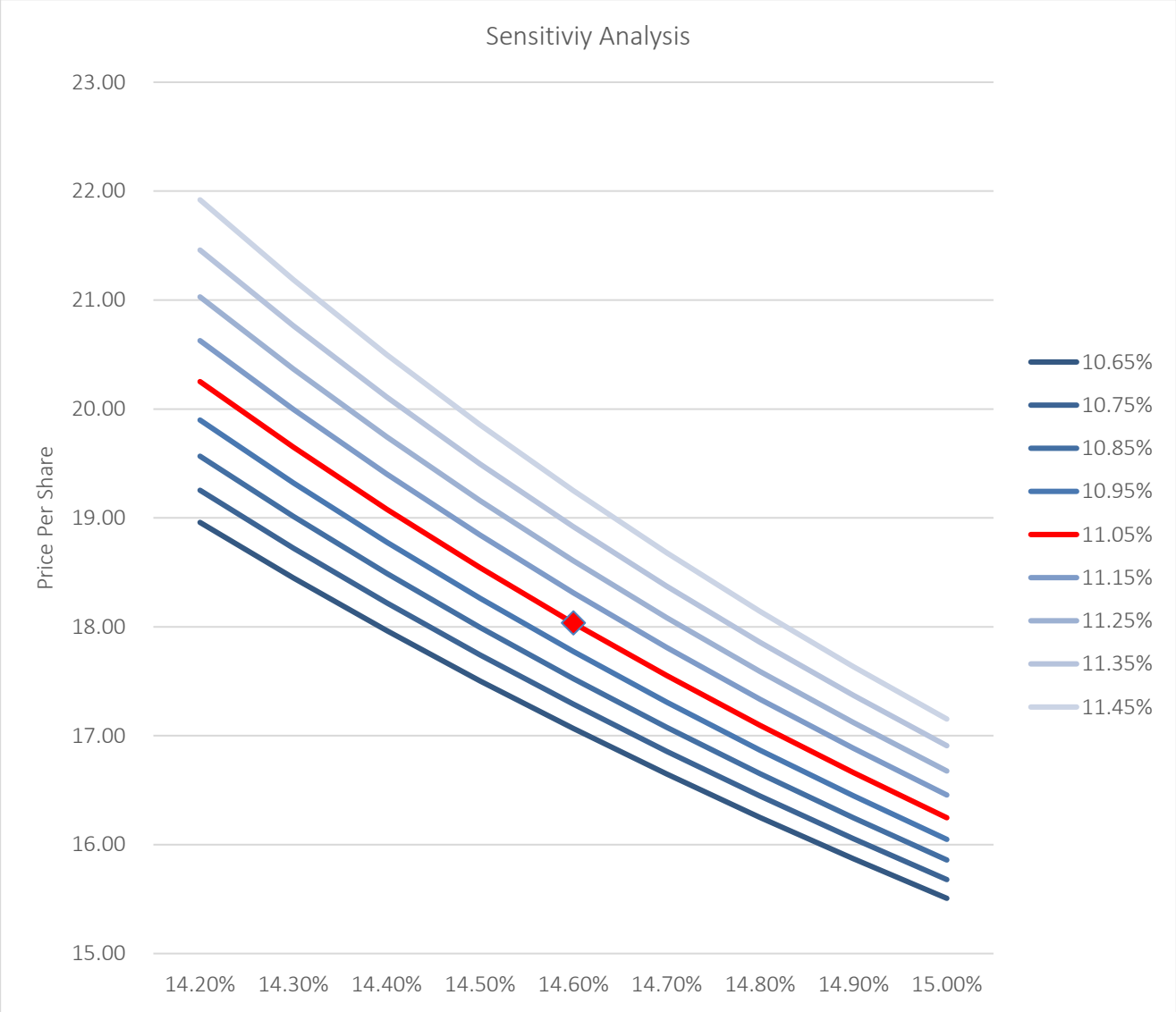
Based on the table above, we derive a **target price of N$c1796** per share. Coupled with expected dividends of 64cps over the next 12 months, we expect a **total return of 17.3%.** Seeing as this share price of CGP has declined by roughly 11.5% over the last year, we believe that there is some value in the current price. However, due to continuing economic headwinds, possible regulatory changes in the microlending sector and increasing impairment charges, the risks to our target price are skewed to the downside, thus we maintain our **HOLD** recommendation on the Capricorn Group.

Summary of Financial Statements

	Actual		Forecast		
in N$ 000s	2017	2018	2019	2020	2021
Interest and similar income	3,626,477	4,244,215	4,626,039	5,015,493	5,433,789
Interest and similar expense	(1,976,980)	(2,425,318)	(2,553,981)	(2,719,307)	(2,901,216)
Net interest income	**1,649,497**	**1,818,897**	**2,072,058**	**2,296,186**	**2,532,574**
%Growth	13.1%	10.3%	13.9%	10.8%	10.3%
Impairment losses	(57,998)	(80,840)	(96,567)	(124,105)	(155,695)
Non-Interest Income	**998,185**	**1,225,168**	**1,332,056**	**1,450,393**	**1,581,436**
Operating expenses	(1,395,005)	(1,795,108)	(1,980,285)	(2,185,545)	(2,389,730)
Operating profit	**1,194,679**	**1,168,117**	**1,327,262**	**1,436,930**	**1,568,585**
%Growth	2.0%	-2.2%	13.6%	8.3%	9.2%
Share of profit from joint ventures	1,094	1,148	1,216	1,153	1,172
Share of profit from associates	78,100	83,236	86,153	82,496	83,962
Profit before tax	**1,273,873**	**1,252,501**	**1,414,631**	**1,520,579**	**1,653,719**
Income tax expense	(356,252)	(318,066)	(424,389)	(456,174)	(496,116)
Profit for the year	**917,621**	**934,435**	**990,242**	**1,064,405**	**1,157,603**
%Growth	1.4%	1.8%	6.0%	7.5%	8.8%
Net gains on available -for - sale financial assets	**15,383**	**44,026**	**-**	**-**	**-**
Total comprehensive income	**931,055**	**986,240**	**990,242**	**1,064,405**	**1,157,603**
Headline Earnings	915,672	922,556	990,242	1,064,405	1,157,603
%Growth	-0.8%	5.9%	6.0%	7.5%	8.8%
EPS (c)	**178.3**	**180.6**	**194.2**	**208.7**	**227.0**
HEPS (c)	**181.6**	**157.9**	**194.2**	**208.7**	**227.0**
Dividends declared per share (c)	**68.0**	**60.0**	**64.0**	**69.0**	**75.0**

in N$ 000s	*Actual*		*Forecast*		
	2017	2018	2019	2020	2021
ASSETS					
Cash and balances with central bank	1,543,070	1,642,557	1,692,814	1,767,685	1,940,249
Financial assets designated at fair value	3,968,635	5,245,981	5,953,953	6,673,809	7,318,834
Investment securities	149,381	134,028	141,705	137,866	139,785
Derivative financial instruments	-	-	-	-	-
Due from other banks	2,198,596	1,773,529	2,000,000	2,100,000	2,200,000
Loans and advances to customers	33,433,922	36,234,418	38,626,967	41,368,173	44,484,367
Investment in associates	245,782	282,511	288,824	303,378	317,933
Other assets	1,081,841	1,246,410	1,152,069	1,173,222	1,152,947
Total assets	**42,920,914**	**47,433,686**	**50,730,582**	**54,398,386**	**58,428,368**
LIABILITIES					
Derivative financial instruments	-	-	-	-	-
Due to other banks	317,914	252,683	285,299	268,991	277,145
Other borrowings	1,165,064	1,313,433	1,313,433	1,313,433	1,313,433
Debt securities in issue	4,105,577	4,777,074	4,900,000	5,100,000	5,300,000
Deposits	31,571,561	33,948,091	36,426,203	39,154,914	42,156,474
Other liabilities	545,875	1,244,010	1,245,389	1,246,573	1,247,854
Total liabilities	**37,709,999**	**41,542,496**	**44,175,930**	**47,090,316**	**50,300,911**
EQUITY					
Share capital and premium	684,665	724,507	724,507	724,507	724,507
Non-distributable reserve	248,186	269,653	269,653	269,653	269,653
Distributable reserve	4,123,531	4,620,531	5,246,532	5,959,684	6,735,278
Non-controlling interest	154,533	276,499	313,960	354,226	398,018
Total shareholders' equity	**5,210,915**	**5,891,190**	**6,554,652**	**7,308,070**	**8,127,456**

Sensitivity Analysis



Sustainable Growth Rate \ Cost of Equity	14.20%	14.30%	14.40%	14.50%	14.60%	14.70%	14.80%	14.90%	15.00%
10.65%	**18.96**	18.45	17.96	17.50	17.07	16.65	16.25	15.87	15.51
10.75%	19.25	18.72	18.22	17.74	17.29	16.86	16.45	16.05	15.68
10.85%	19.57	19.01	18.49	17.99	17.52	17.08	16.65	16.25	15.86
10.95%	19.90	19.32	18.78	18.26	17.77	17.31	16.87	16.45	16.05
11.05%	20.25	19.65	19.08	18.54	**18.03**	17.55	17.10	16.66	16.25
11.15%	20.63	20.00	19.40	18.84	18.31	17.81	17.34	16.88	16.46
11.25%	21.03	20.37	19.74	19.16	18.61	18.08	17.59	17.12	16.68
11.35%	21.46	20.76	20.11	19.50	18.92	18.37	17.86	17.37	16.91
11.45%	21.92	21.19	20.50	19.85	19.25	18.68	18.14	17.63	17.15

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