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Credit Opinion: Letshego Holdings Limited

Global Credit Research - 12 Aug 2011

Botswana

Ratings

Category	Moody's Rating
Outlook	Stable
Issuer Rating	Ba3
ST Issuer Rating	NP

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Key Indicators

Letshego Holdings Limited

	[1]2011	2010	2009	2008	[2]2006	[3]Avg/CAGR
Total Assets (BWP thousand)	2,427,655	1,915,421	1,401,021	811,919	444,999	52.83
Total Capital (BWP thousand)	1,786,142	1,369,316	671,480	461,267	323,564	53.28
Recurring Earning Power % [4]	30.53	33.49	28.75	37.09	36.74	33.32
Return on Average Assets %	21.67	22.92	19.8	26.88	27.6	23.77
Net Interest Margin %	33.16	34.38	30.09	39.37	41.48	35.7
Cost / Income Ratio % [5]	19.64	21.02	24	25.84	23.41	22.78
Loan Loss Provision Expenses (%) Average Gross Loans	1.93	3.26	2.72	2.53	0.85	2.26
Shareholders' Equity % Total Assets	72.01	70.35	47.61	56.62	72.71	63.86

[1] As of January 31. [2] As of October 31. [3] Compound Annual Growth Rate for total assets and capital. [4] Preprovision Income % Average Assets. [5] Non-Interest Expense % Operating Income

Opinion

Rating Rationale

The Ba3/Not-Prime issuer ratings assigned to Letshego Holdings Limited (Letshego) reflect its (i) niche, but narrow franchise in Botswana and its growing presence in the sub-Saharan region; (ii) developing regulatory status; (iii) concentrated and vulnerable funding base; and (iv) rapid growth model in consumer lending to the formally employed. The ratings also reflect the company's historically strong net interest income generation, efficient operations, low leverage and good credit performance.

Rating Drivers

- Established niche, but narrow franchise in Botswana, with a growing presence in the sub-Saharan region; though competition is intensifying from other market participants

- Concentrated and narrow funding base

- Good profitability supported by high margins, low credit costs and good efficiency owing to a fast loan-approval process

- Regulatory and legal framework still developing in Botswana and other markets where Letshego operates

- Low leverage and adequate capitalisation buffers

- High-risks associated with unsecured business lending in Sub-Saharan Africa, though risks are partly mitigated by using the payroll-deduction model

Rating Outlook

The outlook on all of the company's ratings is stable.

What Could Change the Rating - Up

There would be positive pressure on the company's ratings if Letshego achieves significant growth in its size and franchise, while maintaining strong financial performance (profitability, asset quality and capitalisation) together with evidence that its funding profile has been considerably diversified. Any potential ratings upgrade would require a more developed and mature regulatory and supervisory framework in Botswana.

What Could Change the Rating - Down

Letshego's long-term issuer rating could be downgraded on evidence that its operational capacity has been limited by an inability to access wholesale funding. Such inability could be expressed by a reduction in asset size or increased funding costs leading to depressed profitability. A deterioration in asset quality that would adversely affect profitability would also put pressure on the rating.

Additionally, negative rating pressure would be exerted by potential changes to the regulatory or legal framework in any of Letshego's key markets, which would affect its operating model (i.e. disallowing the company's salary-deduction model or capping the maximum interest rate on loans to a level which would notably affect margins).

DETAILED RATING CONSIDERATIONS

Detailed considerations for Letshego's currently assigned ratings are as follows:

Franchise Value

Letshego is a successful niche consumer finance company in the sub-Saharan Africa region and particularly in its home market of Botswana. Nevertheless, the company is small in absolute size - total assets and net profit of US$354 million and US$71 million respectively at FY2011 - with a single product offering. The company's principal product is short to medium-term personal unsecured loans to formally employed individuals. The majority of the company's clients are government employees (over 98%).

Letshego was founded in 1998 in Botswana and has grown quite rapidly becoming active in six other sub-Saharan African countries: Namibia, Swaziland, Tanzania, Uganda, Zambia and most recently, Mozambique. The company continues to derive the majority of its income from its home country - Botswana accounts for two-thirds of the loan book and of pre-tax profits. Each country operates as a separate subsidiary with its own CEO and Board of Directors.

Growth opportunities within the company's home market are currently limited as Letshego has already achieved a high penetration in government employees while the government of Botswana is expected to tighten its fiscal position, decrease spending and limit new public employee hires.

Low credit penetration in sub-Saharan Africa and Letshego's experience in replicating its business model in multiple countries provide the company with the opportunities and tools to continue its expansionary strategy; Ghana, Lesotho, Nigeria and Zimbabwe are possible candidates for expansion while existing operations in some countries are underutilised. Even so, a key constraint to Letshego's growth and franchise development is the availability of affordable local wholesale funding; Letshego does not currently have a license to take deposits in any market except Mozambique.

Increasing competition from local banks is a threat to the company's franchise as banks have access to cheaper deposit funding and could potentially lead to a sustained reduction in interest yields. Letshego however benefits from an established brand in its niche market - with around a 30% market share in consumer lending to government employees in Botswana and Namibia - and a quick and efficient loan-approval and disbursement process, whereby a loan can be disbursed within two days or less, a shorter period than banks.

Although Letshego performs a careful due-diligence process before entering a new country, bureaucracy, public-sector inefficiencies, a lack of local legal frameworks and corruption in some African states expose the company to country risk, and could lead to unexpected losses or underperformance, negating any positive impact of geographical diversification.

Risk Positioning

Letshego is principally exposed to credit, operational as well as funding and liquidity risk, which are all inherent in its elected operational model. We believe that Letshego has been managing these and other risks adequately for its size and operations, although the recent (compound annual growth rate of 43% over the past three years) and sustained growth of the portfolio expected going forward puts strain on its systems and effective risk management.

Although the company extends credit with very high intrinsic risk, unsecured loans to low-income earning individuals, credit costs have historically been maintained at a relatively low 2%-3% of the total portfolio per annum. Letshego manages credit risk through the direct deduction of monthly loan instalments from the client's salary. It is a prerequisite, before extending a loan, that the client is employed and that Letshego has negotiated a salary deduction code with the employer, whereby the employer has agreed to make the loan repayment deduction directly from the salary before being paid into the employee's account. In cases where there is evidence of impairment (e.g. when the debtor loses his job), the company immediately writes-off the loan. The company also maintains a general portfolio provision by country based on historical performance.

The deduction at source is facilitated through a central register (CR) which combines all deductions from the government into one deduction code, and also checks that loan affordability requirements are adhered to. The existence of a CR reduces collections costs and improves collection statistics, although a CR is not currently in place in Mozambique, Tanzania, and Zambia.

Accurate deductions need to be made for thousands of accounts under several different payroll systems, which exposes the company to operational risk. The company relies on its own systems and the systems of the CRs and local governments to accurately perform the payroll deductions. Failure of these systems would lead to lower collection levels or incorrect deductions which can lead to litigation against the company. Letshego has limited capacity to perform collections using other mechanisms if automatic payroll deductions fail.

Funding and liquidity management is a key challenge for the company, as it borrows from the confidence-sensitive wholesale market. Funding is generated from around ten institutions: local banks, asset management and insurance firms and international financial institutions (IFIs). Leverage remains relatively low, debt-to-equity of 28.9% at FY2011 and borrowings funding 21.7% of the loan book, while monthly loan repayments would allow the company to repay all of its funding within five to six months. However, we believe that there is a need for further diversification of the company's funding base and lengthening of its duration to better match the duration of assets. Competition from banks has lead to a lengthening in the tenure of loans, which are longer relative to its international peers, at around 50 months - longer tenured loans also carry increased repayment risk.

Although the company operates in several countries, it has limited exposure to currency risk. Letshego tries to use natural hedges, whenever possible, by borrowing in local currency for each country or rely on currency pegs where these exist. Finally, the company is exposed to interest-rate risk, as funding is floating whereas loans are fixed rate; however, the large margins allow for some room for interest-rate fluctuation.

Regulatory Environment

Although Letshego is regulated by local central banks in certain jurisdictions (Swaziland, Zambia and Mozambique), in Botswana the company is regulated by the Non-Bank Financial Institutions Regulatory Authority (NBFIRA), a relatively new entity which assumed responsibility of regulating and supervising non-bank financial institutions in the second half of 2009.

The legal framework under which the NBFIRA is set to operate has not yet been approved by the respective Ministry. This together with the lack of a comprehensive regulatory framework for micro-lenders does not allow the NBFIRA to supervise effectively.

Overall, a strong and enforceable regulatory framework will be credit positive for Letshego, as it would allow for better supervision, improved governance and potentially lead to higher barriers for entry.

Letshego has to abide by loan-affordability requirements in the countries in which it operates in terms of the minimum take-home pay. There are also regulations in some countries with regards to the number of loans allowed per customer. The local central register plays a key supervisory role in this regard.

A major potential risk for Letshego would be any regulation that would threaten the company's payroll-deduction model or earnings generation through a cap on the effective interest rate at a low level. South Africa is currently the only sub-Saharan country which prohibits most types of payroll deduction; when the country disallowed payroll deduction in 1998, micro-lenders operating under this model suffered through an onerous change in operating model and a sudden rise in bad debts.

Financial Fundamentals

Letshego's historical profitability has been strong, supported by high margins and good efficiency. We expect profitability to remain at good levels, although interest yields will continue to be under pressure. Pre-provision income and net income-to-average assets were 30.5% and 21.7%, respectively at FY2011 (2010: 33.5% and 22.9%). The net interest margin was 33.2% (2010: 34.4%), since margins have been impacted by a lengthening in the tenure of loans as the longer term loans have lower yields.

The cost-to-income ratio was down to 19% from 22% in 2010. Letshego benefits from a low cost structure, with employee and other operating costs of BWP147 million against operating income of BWP823 million. This is the result of most operations being centralised, and the fact that loan applications, approvals and disbursements are computerised.

With shareholders' equity-to-total assets of 72% at FY2011 the company is well capitalised. The group did not pay a cash dividend for the FY2011 (cash dividend of 14% after-tax profit for 2010 was paid) which will support projected growth. Letshego had also entered into a Pula denominated convertible loan agreement for US$36 million with Development Partners International (DPI). DPI has the option to convert the loan into equity in April 2013 which if exercised will further support the company's equity base and growth.

The ratio of loan impairment charges-to-average loan book was 1.9% for FY2011, down from 3.3% in 2010. Higher credit costs during the financial year 2010 originated from the Zambian operations, as an upgrade in the local government's payroll system meant that the company could not get accurate collections. Letshego reduced its exposure in Zambia, while it has worked to improve collections. We expect credit costs to remain within the historical 2%-3% level.

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