Stockbrokers Botswana Ltd.

Letshego Holding Company Limited

Letshego results stoke the fire

BUY

P2.92 **USD 0.30**

April 29, 2015

Letshego released an impressive set of results for the period ended December 2014, on the back of strong performance particularly from its four largest markets, accelerated growth of the microfinance operations, and a growing and increasingly diversified franchise which has positioned the group well for future growth. The group's emphasis on geographic diversification is being realized, as we are seeing increased contribution and promising growth from some of the newer markets, while the more mature and larger markets continue to provide a solid base and good growth.

Growth tends to come with the number of customers, and the group's customer centric approach has seen the customer base rise 11% to 265,000 during the period. Customer access points across Letshego's footprint increased by 19% and now sit at 252, and distribution reach was enhanced with the addition of over 100 commission-based sales agents, bringing the Micro and Small Enterprise (MSE) compliment to 560.

Overall, advances to customers increased 28% to BWP5.7 billion (Jan14: BWP4.4 billion). The bulk of the growth is attributable to the Southern African region, as 75%, or BWP944 million of loan book growth is attributable to Botswana, Namibia and Mozambique. The microfinance operations in Kenya, Rwanda and Uganda are also reported to have produced strong results during the period. Combined, the three East African nations achieved growth of 117%, closing at BWP370 million, and this was driven by significant growth in the low income housing and MSE loan solutions. Payroll however remains core to the group, as the payroll portfolio increased 26%. This has aided in maintaining the quality of the loan book as the impairment charge was 2.0% of net advances.

The growth in advances has seen interest income up 25%* to BWP1.4 billion (Jan14: BWP1.2 billion). Interest expense was 193%* higher at BWP167.6 million (Jan14: BWP62.5 million) which translates to net interest income growth of 15%*. Margins however came under pressure as the net-interest margin for the period ended December 2014 declined to 21% (Jan14: 24%).

Fee and commission income increased 24%* during the period while other operating income grew 54%* to BWP188.0 million (Jan14: BWP122.0 million). During the period, the group dipped its toes into transactional banking, as deposit-taking commenced in Mozambique (February) and Rwanda (August), whilst Namibia has seen a provisional license granted in July.

Operating income during the period was BWP1.5 billion (Jan14: BWP1.4 billion), a 19%* increase, while employee costs increased 13%* and other operating expenses increased 5%* to BWP225.5 million (Jan14: BWP255.8 million). This produces a lower cost to income ratio of 29%.

Trading & Liquidity

Mkt cap (Pm)	5,681
Mkt cap (US$m)	575
DCI Mkt weight	12.3%
Shares in issue (m)	2,184
Free float	76.2%
Annual Liquidity	12.6%
12 month high	292
12 month low	198

Codes

BSE	LETSHEGO
Reuters	LETS.BT
Bloomberg	LETSHEGO.BG
ISIN No	BW 0322

Results

Last results	Finals- Dec 2014
Expected results	Interims - Jun 2015

Analysts

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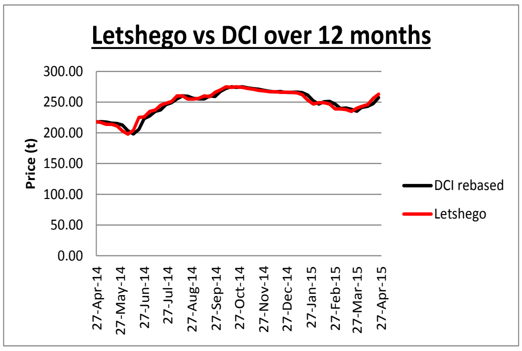


*** Note: where applicable, measures have been annualized in this commentary**

Letshego has embarked on a new strategy of financial inclusion, which optimizes its distribution channels by using agents and mobile telephony. Letshego intends to grow the franchise by taking its product offering to the masses. According to management, "The LHG of the future will offer simple, appropriate, and inclusive solutions; flexible and convenient access; responsive and ethical credit; and support for the MSE owner to build his or her business – and all at a very low cost." We view management's assertions as an indication as to where their focus lies and what their growth trajectory is going to be predicated on. The MSE sector and blue collar employees will continue to offer exciting opportunities as observed by the exponential growth achieved in Kenya, Uganda, and Rwanda where the businesses have a fledgling non-payroll lending component. This explosive growth comes against a backdrop of solid numbers from Namibia and Botswana where 70% – 80% of the growth is attributed to top-ups.

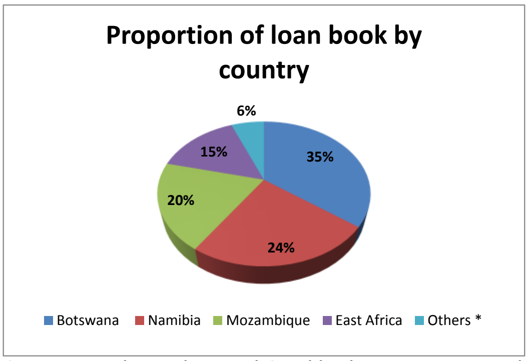
Competitive advantage lies in the group's ability to reach the masses

The Microfinance business likely to become a significant player in driving future growth

Explosive Loan Book

The lion's share of the growth in the loan book is attributable to Mozambique and Namibia, which continue to further the company's diversification efforts. Total loan book growth has achieved a CAGR of 20% between FY2011 and the period ended December 2014. The Namibia loan book registered 45% growth during the period ended December 2014 and Mozambique loan book registered 40% growth during the period. Letshego now has 12 branches in Mozambique. Armed with a deposit taking license, Letshego is well placed to secure further gains in that market. Kenya registered the fastest growth rate for the period ended December 2014, with 139%, albeit from a low base.

Total loan book growth at 20% CAGR between FY2011 and the period ended December 2014



Source: Letshego data and Stockbrokers Botswana calculations

Letshego continues to utilize its expertise in lending to government employees to expand into other markets. Payroll lending now accounts for 92% of the group's loan book. During the period under review however, the group concluded its disinvestment out of South Sudan due to the civil unrest in that country. We expect that the company will rationalize operations where regulation is not conducive to payroll lending. In Lesotho the government suspended the payroll deduction code. Subsequently it was re-instated but it has been observed that the costs of rescinding the payroll deduction in Lesotho out-weighed the benefits. As such, we no longer view a rescission in the payroll deduction code in Botswana as a risk, especially as civil servants in that country have recently been awarded an increment of 6% placating the increasingly acrimonious relationship between government and unions.

Payroll deduction remains core to the business at 90% of total loan book

	Market penetration	Government employees ('000)	Current loan book (BWP '000)	Payroll
Botswana	29%	150	2005	99%
Kenya	1%	450	201	13%
Mozambique	13%	400	1114	100%
Namibia	50%	100	1366	100%
Tanzania	9%	500	307	100%
Uganda	11%	275	249	68%
Swaziland	11%	50	151	100%
Rwanda	0%	130	103	100%
Lesotho	13%	45	190	93%

Source: Letshego data and Stockbrokers Botswana calculations

Average duration of 3.5 to 4 years in Botswana, Namibia and Mozambique

Advances in payroll markets have an average maturity profile of between 3.5 to 4 years – in Botswana, Namibia and Mozambique. In markets that are non-payroll in nature; Kenya, Uganda, and Rwanda, the duration of loans tends to be less than twelve months. Management has mentioned that they are considering increasing the tenure of household improvement loans as these are less risky assets that are secured by an underlying asset. We do not anticipate management will extend the term of unsecured loans as such an intrusion into the asset-backed lending category offers diminishing returns.

Financial Performance

	2011	2012	2013	Jan-14	Dec-14
Net interest margin	30%	28%	30%	25%	21%
Non-interest income growth	-7%	-20%	46%	1%	14%
Impairment as % of gross advances	2%	1%	1%	1%	2%
CIR	19%	14%	26%	33%	29%
ROE	30.0%	28.1%	25.4%	20.2%	20.7%
D/E	28%	35%	45%	36%	47%

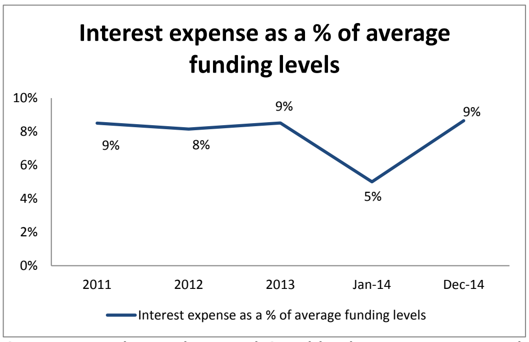
Source: Letshego data and Stockbrokers Botswana calculations

Asset quality stable at 2% impairments to gross advances

Letshego's NIMs remain firm at 21%, however, they have decreased significantly from 30% in FY 2011. Impairments as a percentage of gross advances for the period ended December 2014 came in at 2% (Jan 2014: 1%). Impairments have remained under wraps and below Letshego's internal threshold of 3% due to improved risk management. Letshego does not provide for impairments, as traditionally after two months of non-payment Letshego will write-off the entire loan. This gives the company the ability to manage impairments while allowing the company to reverse the charge to the income statement upon collection of outstanding payments. However, we anticipate an increase in the level of provisions as system changes in Letshego's core platform do not allow for the reversal of loans that have been written off. Such changes will be cosmetic in the income statement as the net effect on the bottom line will remain the same.

Non-interest income grew 14%* year-on-year for the period December 2014. Due to the pressure on margins, growing the non-interest portion of income will likely become a priority. We anticipate a significant increase in non-interest income, as transactional business gains traction. ROE's have been trending downwards however, as Letshego attempts to better manage its balance sheet, we expect a higher level of gearing to spur ROE gains. Management has a target of 100% debt to equity ratio. With the current level of cash reserves, Letshego is well placed to take advantage of acquisition opportunities. Letshego's interest expense as a percentage of funding levels averaged 9% between FY 2011 and the period ended December 2014. We note the sharp decline in interest expense for the period ended Jan 2014, as the interest expense included a significant foreign exchange gain of BWP50 million. However, this does not reflect the true cost of funds as the group uses a blended cost of funds.

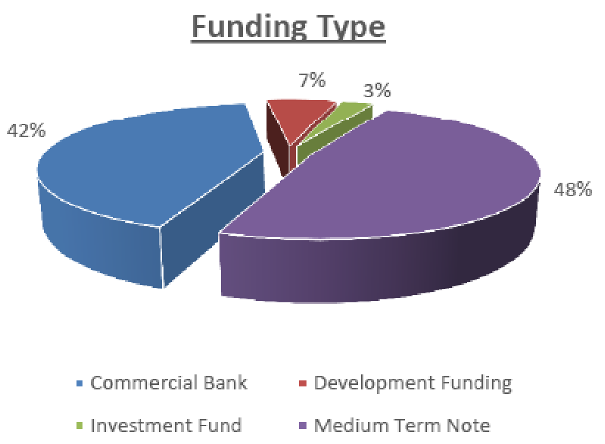
Increased levels of gearing should serve to enhance ROE



Source: Letshego data and Stockbrokers Botswana calculations

With the aim of achieving diversification in funding and revenue sources, Letshego has been reducing dependence on funding from financial institutions. Currently the group has ZAR700 million worth of notes outstanding under the dual currency note programme to bolster lending. Furthermore a first tranche of USD2 million has been issued under the DMTN programme in Mozambique.

Diversification of funding sources being achieved with local currency funding set to bolster lending



Source: Letshego

As Letshego gears up to become a deposit taking institution, we anticipate that funding from commercial banks will decrease. The mix should serve to lower the group's cost of funds. Currently, the group cost of funds lies at 11%. We estimate Letshego's weighted duration of debt outstanding is about 3.5 years. With a capital adequacy ratio of 67%, Letshego is well capitalized to weather any market disruptions.

Capital Adequacy Ratio at 67%

Core Banking Platform

Letshego has allocated a significant amount of its Capex to its new IT platform, TCS. The group's motivation to invest in the system change is in line with the broader strategy of the company, as TCS facilitates enhanced functionality that includes internet banking, mobile banking and deposit taking. As such, the system will allow the group to consolidate all their operations into one platform. TCS is an off the shelf system, which is similar to the system used by Capitec Bank. Management reports that BWP 100million has been spent on the system thus far, with an additional BWP50 million to complete the first stage of implementation, which will be funded by CAPEX and OPEX. Seven out of Letshego's nine markets have been changed over with Kenya and Rwanda to follow.

Investments in a new IT system to support the group's broader strategy of transactional banking

Catalysts

1. Deposit taking licenses have been secured in Rwanda and Mozambique, and a provisional license granted in Namibia. In Mozambique Letshego has commenced banking operations with fixed deposits being offered to customers.

2. Procurement of deposit taking licenses will enable Letshego to diversify revenue streams by boosting transactional revenue

3. Agreement between the government of Botswana and the unions on a 6% increment in wages will alleviate the high levels of indebtedness in that country.

Risks

1. Over dependence on payroll deductions; means Letshego has too much exposure to unsecured lending.

2. Levels of customer indebtedness is a cause for concern in some countries of operation.

3. Civil unrest in Kenya may hamper operations in the future if the recent spate of terrorist attacks is not addressed.

What we like

1. Letshego does not have exposure to loans with a tenure of longer than 5 years

2. Letshego has made significant strides towards diversifying revenue streams.

3. Letshego has an adequate funding mix from commercial banks, developmental institutions and the capital markets.

What we don’t like

1. High top-ups exposes Letshego to customers who may be caught up in a perpetual debt trap.

2. Letshego’s strategy of growth through acquisitions may not be the best strategy, as opportunities tend to arise during a downturn in the unsecured lending cycle.

Outlook

With margin compression plaguing most unsecured lenders, Letshego will need to roll-out new products to stem further declines in NIM's. On the upside, Letshego is well placed to do so, as they have sufficient cash reserves of USD 30million on deck. With the roll-out of the TCS system we expect the introduction of new products to gain traction. Furthermore, the roll-out of the new banking platform is expected to enhance disbursement of loans to between T+1 to T+3. As transactional income becomes a more important source of income to the unsecured lending giant, Letshego will be able to leverage its over 250,000 strong customer base to offer higher margin financial solutions. We envisage the use of agents as the next piece in the puzzle towards Letshego's transformation to a deposit taking institution. Although such developments might be several years in the pipeline, Letshego's attempt to procure deposit taking licenses in several countries underscores our predictions, especially as its banking licenses in Mozambique, Rwanda, and Namibia permit the business to offer debit card facilities to its deposit customers. Letshego's recently announced buy-back should further propel the stock to historic highs, as we expect a limited free-float to swing the investor pendulum in favour of investors with a longer investment horizon

Valuation

	P/E (x)	P/BV (x)	ROE (%)
Letshego	8.1	1.6	21
Capitec	26.0	5.8	25

On a relative valuation we derive a target price of BWP3.42

On a relative valuation of P/E and P/B multiples, Letshego is relatively cheaper than industry peer, Capitec. We value Letshego using a relative valuation of Price/Book value and target a P/B valuation of 1.8x, assuming Letshego trades at a 17.2% discount to Capitec when scaled against ROE. We derive a target price of **BWP3.42.**

We recommend a BUY on the counter.