BPI Capital Africa

EQUITY RESEARCH

Letshego

SSA Banks

Shareholder Focus II

(YE17 PT of BWP3.10 vs YE16 PT of BWP2.95; Rec. upgraded from Hold to Buy)

Buy

High-Risk

30th September 2016

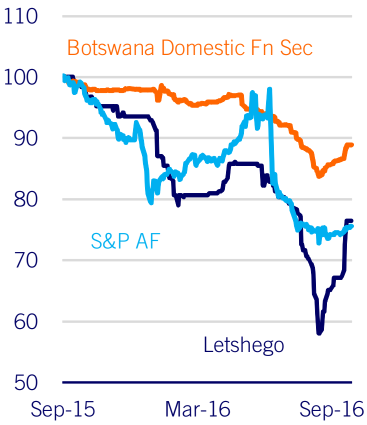
Botswana

- **Letshego recently commenced a capital reduction via a 10% share buyback.** We reiterate that this is a novelty in SSA (218mn shares will ultimately be cancelled). We have so far tracked the buyback and we believe that 2.5% of stock was cancelled. Assuming a maximum BWP2.57/share for the remainder, we believe the total cost of the buyback will be c. BWP545mn/USD52mn (11% of current market cap). In our opinion, the buyback is net/net positive for minorities, because: (1) management is signalling that the current valuation is attractive (17-18^F PER: 5.6x and P/BV: 1.15x); (2) this supports the stock price; (3) B/S efficiency improves, further driving stronger ROE; and importantly (4) the transaction is potentially EPS accretive. The key risk is that the stock is relatively illiquid (12M ADV: USD250k).

- **Performance review and outlook.** 1H16 PAT declined by 3.5% y/y, at BWP388mn (annualised: BWP776mn), remaining on track with our FY estimates. Key earnings drivers were: (1) further MZN/USD exchange rate volatility; (2 negative risk asset growth; (3) > 50% opex growth y/y, due to expansion and a one-off Rwandan VAT expense. Broadly, we continue to be conservative on our estimates, and further cut our 16-19^F earnings by an avg. 6%. As such, we estimate revised 6% PAT CAGR15-19^F, which implies avg. ROE16-19^F of 18%.

- **Valuation**. Recent price action (21% return in 1M) is testament to the positive impact of capital reduction. In addition, we maintain our investment case on Letshego: (1) strong SSA presence; (2) dominant payroll lender, (3) rising exposure to non-payroll, (4) low NPLs, (5) conservative management and (5) an attractive DPR. However, Mozambique is a key risk, while interest rate regulation in Kenya remains an uncertain issue for Letshego's local subsidiary. **All in all, we set a new YE17 PT of BWP3.10 and we think risk/reward is positive. Upgrade from Hold to Buy.**

Letshego vs. Domestic Financial Sector Index vs. S&P Africa Frontier



Source: Bloomberg.

Stock data

Price (BWP):	2.37	Price Target (BWP):	3.10
Adjusted Nº of shares (mn):	1 966	Reuters/Bloomberg:	LET.BT/LETSHEGO BG
Market Cap (BWPmn):	5 185	Market Cap (USDmn):	495
Avg. Daily Vol. (BWP '000):	2 626	Avg. Daily Vol. (USD '000):	252
Debt/Equity '17:	0.7	Free-float:	50%
EPS growth ('15-'19^F):	6%	ROE'17^F:	18%
Major shareholders:			Botswana Insurance Holdings (23%)

Estimates	2014	2015	2016^F	2017^F	2018^F	2019^F
Diluted EPS (BWP)	0.33	0.35	0.37	0.40	0.45	0.50
P/E (x)	7.1	6.7	6.5	6.0	5.2	4.8
Dividend yield	7.0%	7.6%	8.7%	9.5%	11.2%	12.4%
Adjusted P/BV (x)	1.29	1.30	1.32	1.21	1.10	1.00

Historical Recommendation

	Recommendation
14-May-14	Buy
21-Sep-15	Hold

Source: BPI Equity Research.

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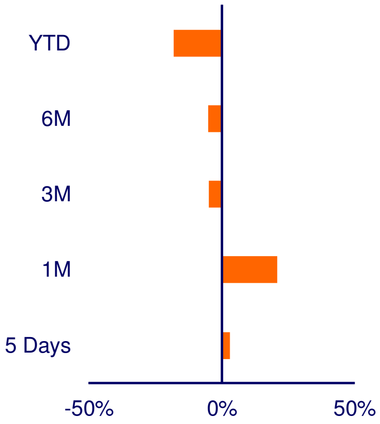
We update Lethsego following 1H16 results, as well as the on-going 10% capital reduction via share buy back programme. We also made further cuts to our earnings estimates, highlighting increased risk to the profit model due to local currency volatility. Notably, our valuation is adjusted for the capital reduction, and we set a new YE17 PT of BWP3.10/share. Our recommendation is upgraded from Hold to Buy.

HIGHLIGHTS OF THE ON-GOING CAPITAL REDUCTION

Following the publication of 1H16 results, Letshgo commenced a capital reduction via a 10% share buy back and cancellation programme (Letshego_300415). Thus far, about 2.5% of stock has already been purchased and cancelled, at a BWP2.28/share VWAP. In our opinion, the share buy back is net/net positive, because: (1) management is signalling that the current valuation is attractive (YE17-18[F] PER 5.6x and P/BV: 1.15x); (2) this will provide some support to the stock price: the stock is already up > 15% over the last 1M; (3) it enhances efforts to improve B/S efficiency, and ultimately drive stronger ROE in the ST and MT; (4) assuming the quantum of dividends remains unchanged (as highlighted in the initial share buy back circular), this would imply a potential increase in the dividend payout ratio; and importantly (5) it will most likely be EPS accretive, despite the transaction costs.

While we reiterate that the share buy back is a novelty in the SSA space (though common in SA and Europe), **a key risk is that stock liquidity remains low (12M ADV: USD250k)**. Post capital reduction, therefore, we would expect a further liquidity reduction, and do not rule out that this could have an impact on stock valuation in the MLT. In addition, management may reduce the amount of absolute dividend available for payout, in the event that the extent of capital depletion is considered significant.

Share Price Performance



Source: Bloomberg.

Capital reduction Tracker

Date	Shares	Price	% of stock	Cost
5-Sep-16	13 355	204	0.6%	27 243
21-Sep-16	3 000	230	0.1%	6 900
22-Sep-16	36 700	237	1.7%	86 979

Source: Bloomberg, BSE.

Sizing-up the cost of the capital reduction

Due to low stock liquidity, we believe that there will be further price action in the ST and MT, triggered by the capital reduction initiaitive. **The initial share buy back circular stipulated a maximum BWP2.57/share price, although there are additional parameters, such as a 5% cap on the 5-day historical trading price**. Assuming that 7.5% of total stock is yet to be purchased, this would imply an additional BWP425mn (USD41mn) spend, using the maximum price. **The total cost of the purchase would therefore be about BWP546mn (11% of current market cap).**

Impact on B/S: Increased gearing

We have assumed that Letshego will conclude the capital reduction in YE16, and that borrowings will continue to increase in the ST and MT (due to the current bond programme). As such, we have modelled YE16F debt/equity at 79% vs 66% at YE15. In contrast, assuming that there is no capital reduction, Letshego's YE16 debt/equity would be 75%.

Importantly, we highlight that we do not forsee the capital reduction to have any impact on our earnings estimates. Almost all of Letshego's interest income is derived from net loans to customers, while a marginal amount is contributed by a small portfolio of ST interbank placements. Since capital reduction would imply significant cash outflows (our estimate: BWP546mn), this would drive stronger gearing (even if debt levels are held constant).

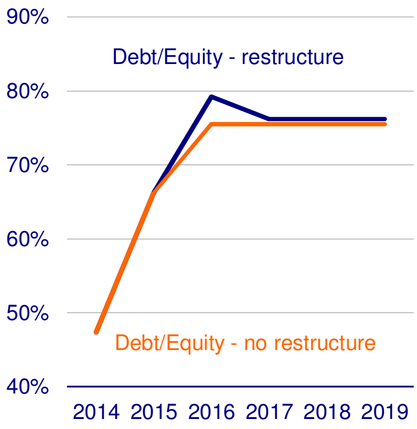
Gearing

	YE15	YE16F	YE17F	YE18F	YE19F	*Avg.
No reduction	66%	75%	75%	75%	75%	75%
Post reduction	**66%**	**79%**	**76%**	**76%**	**76%**	**77%**

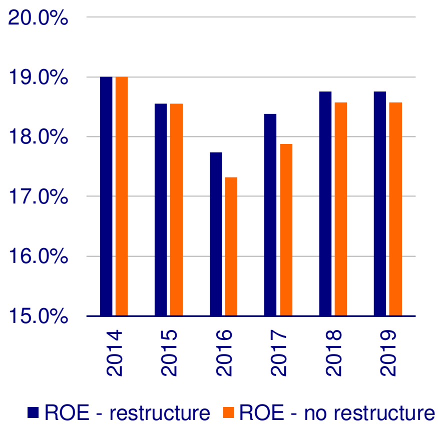
** Estimate period.*

Source: Company report, BPI Capital Africa.

Debt/Equity Analysis



ROE Analysis



Source: Company report; BPI Capital Africa.

Potential EPS Accretion

We estimate 11% avg. EPS accretion post capital reduction. Assuming that the the share buy back is concluded in YE16, with no bearing on our estimates, we estimate 4.4% y/y EPS growth, at BWP0.37 (although strictly not comparable). In addition, we highlight that EPS growth 16-19F will be about 9%.

EPS Accretion

	YE15	YE16F	YE17F	YE18F	YE19F	Avg.
No reduction	0.35	0.33	0.36	0.41	0.45	6.3%
Growth		-6%	8%	14%	10%	7%
Post reduction	**0.35**	**0.37**	**0.40**	**0.45**	**0.50**	
Growth		4%	8%	14%	10%	9%
EPS difference		**11%**	**11%**	**11%**	**11%**	**11%**

Source: Company report, BPI Capital Africa.

1H16 PERFORMANCE REVIEW

Letshego recently published 1H16 results for the period ending 30 June 2016. We were neutral on performance, as a 3.5% y/y PAT reduction, at BWP388mn was largely on track with our estimates (annualised PAT: BWP776mn vs BPI: BWP745mn). Broadly, key issues, which affected performance were: (1) additional MZN/USD exchange rate volatility (BWP298mn loss); (2) Negative risk asset growth, at 1.7% ytd to BWP6.2bn, with notable reductions in Botswana and Mozambique; (3) 51% y/y opex growth expansion, at BWP345mn. This was mostly attributed to current growth and expansion initiatives. However, management acknowledged that some inefficiencies persisted as underlying LfL opex growth was 21%; (4) 41% y/y PBT reduction in East Africa, at BWP27mn. This was largely due to a one-off adjustment for VAT in Rwanda: an issue that particularly remains unclear in the entire region; and lastly (5) a marginal increase in provisioning by 2.5% y/y, at BWP69mn. This was below expectations (annualised: BWP137mn vs BPI: BWP166mn).

Double-digit top line growth despite risks

Interest income increased by 11% y/y, at BWP952.3mn (annualised: BWP1.90bn vs BPI: BWP1.82bn). Notably, double-digit interest income growth was achieved despite net loans declining by 1.7% ytd, at BWP6.2bn, as well as the negative impact of exchange rate fluctuations on BWP reporting-MZN/USD volatility was of particular concern. However, the consolidation of Advans Bank Tanzania would have also contributed to revenue growth. Interest expense, on the other hand, increased at a slower rate of just 4.0% y/y, to BWP178.2mn (annualised: BWP356.3mn vs BPI: BWP355.2mn). Importantly, FX losses declined by 77% y/y, at BWP11.6mn, ultimately driving COF at 6.5% (annualised 12%-in line with BPI). Notably, borrowings were flat ytd, at BWP2.75bn. Loans to borrowings therefore remained relatively unchanged, at 2.8x. As such, net interest income increased by 13% y/y, at BWP774.1mn (annualised: BWP1.55bn vs BPI: BWP1.46bn).

NIR lagged on sundries reduction

Total unfunded income declined by 3.5% y/y, at BWP128.5mn (annualised: BWP257.0mn vs BPI: BWP317.4mn). This was mostly due to a 69% y/y sundries reduction, at BWP7.2mn. Fee income, on the other hand, more than doubled y/y, at BWP22.6mn. Hence, NIR contribution to total income was 14% vs 16% in the matching period. Total income therefore increased by 10% y/y, at BWP902.6mn (annualised: BWP1.81bn vs BPI: BWP1.78bn).

Operating efficiency disappoints as expansion distorts cost control

Opex grew by 51% y/y, at BWP345.0mn (annualised: BWP690.0mn vs BWP619.4mn). This was mostly due to the impact of expansion, as Letshego increased headcount and managed integration of new subsidiaries. However, management highlighted two key issues: (1) LfL opex was up by 21% y/y, indicating that there were some inefficiencies in cost control; and (2) there was a one-off charge related to retrospective VAT issues on fee income earned in Rwanda. In addition, management further cautioned that VAT legislation in East Africa remained largely unclear. CIR was therefore 38% (1H15: 27.8%), and in excess of management's 35% target. We estimated YE16 CIR of 35.0%. Importantly, higher than expected opex resulted in negative operating profit growth by 6.0% y/y, at BWP557.6mn (annualised: BWP1.12bn vs BPI: BWP1.16bn).

Marginal provisioning cut ultimately supported earnings
Letshego reduced provisioning by 2.5% y/y, at BWP68.6mn (annualised: BWP137.2mn vs BPI: BWP165.6mn). In our opinion, lower provisioning was a significant trigger in driving annualised earnings in line with our expectations. Nevertheless, CoR at 2.5% remains in line with management guidance (BPI YE16 estimate: 2.4%). As such, PBT declined by 6.4% y/y, at BWP489.1mn (annualised: BWP978.1mn vs BPI: BWP994.0mn). A lower tax rate, at 21% (1H15: 23.0%) resulted in a 16% y/y taxation reduction, at BWP101.1mn (annualised: BWP202.2mn vs BPI: BWP248.5mn). We estimated a YE16 tax rate of 25.0%.

Overall, PAT declined by 3.5% y/y, at BWP388.0mn (annualised: BWP775.9mn vs BPI: BWP745.5mn). Notably, annualised ROE at about 19% compared with our estimated 18%.

ESTIMATES REVISION: TAKING EXTRA CAUTION

We have further cut our YE16-17^F estimates by an avg. 6% taking into account the following: (1) further MZN volatility vs USD: we believe Mozambique will continue to increase forecast risk on our estimates in the ST and MT; and (2) a marginal cut to our interest expense, as we consider the impact of deposit-taking licences and improved debt pricing terms COF. **Notably, we have maintained our CoR at 2.5%. Overall, we estimate PAT CAGR16-19^F at 6%. This would imply avg. ROE16-19^F, at 18%.**

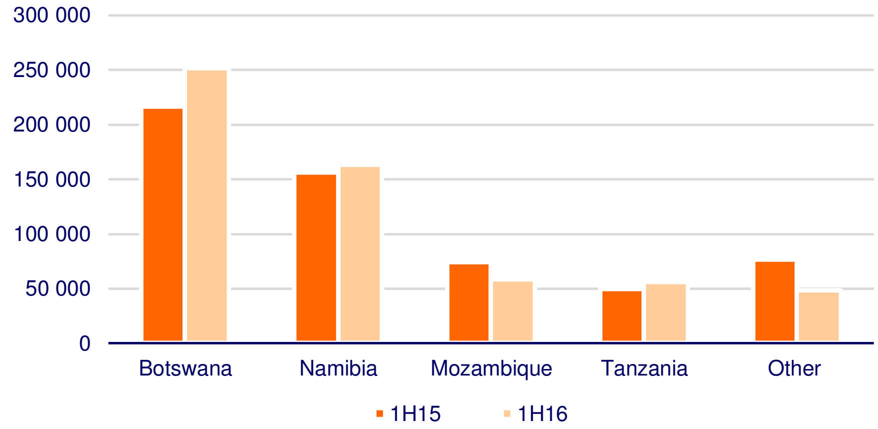
Earnings Revision

	Change				
	2016^F	2017^F	2018^F	2019^F	Avg.
Interest income	1%	-3%	-4%	-4%	-3%
Interest expense	-2%	-2%	-2%	-2%	-2%
Net interest income	**1%**	**-3%**	**-4%**	**-4%**	**-3%**
Fees and commission	-1%	-2%	-2%	-2%	-2%
Other operating income	-1%	-2%	-2%	-2%	-2%
Non-interest revenue	**-1%**	**-2%**	**-2%**	**-2%**	**-2%**
Total income	1%	-3%	-4%	-4%	-3%
Staff costs	-1%	-2%	-2%	-2%	-2%
Other operating costs	11%	-2%	-2%	-2%	1%
Total expenses	**5%**	**-2%**	**-2%**	**-2%**	**-1%**
Operating profit	-1%	-4%	-5%	-5%	-4%
Impairment allowance	**2%**	**0%**	**0%**	**0%**	**0%**
Profit before taxation	-2%	-4%	-6%	-6%	-4%
Taxation	2%	-1%	-2%	-2%	-1%
Net profit	**-3%**	**-6%**	**-7%**	**-7%**	**-6%**

Source: BPI Capital Africa.

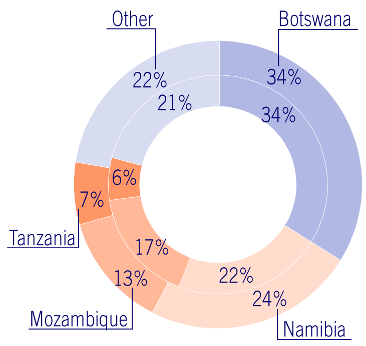
BPI

1H16 vs 1H15 PBT (BWP '000)



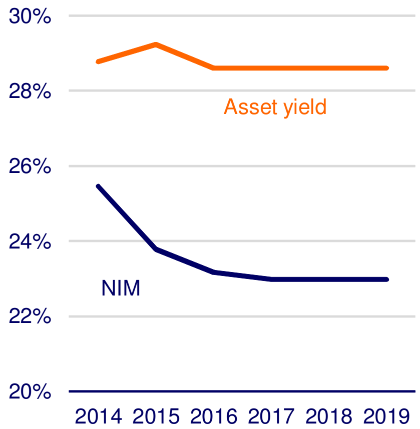
Source: Company report; BPI Capital Africa.

1H16 vs YE15 Loans

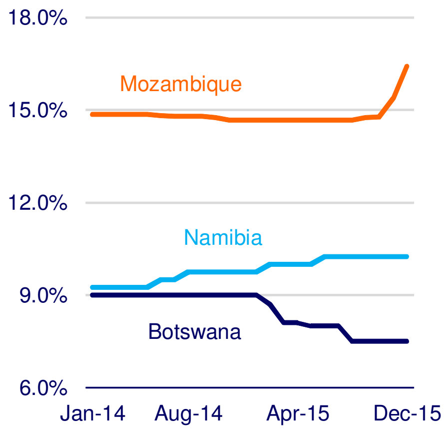


Source: Company report; BPI Capital Africa: Outer Ring =1H16.

Asset Yield and NIM Evolution

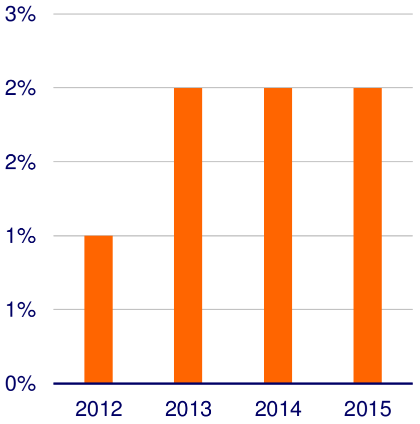


Sector Prime Lending Rates

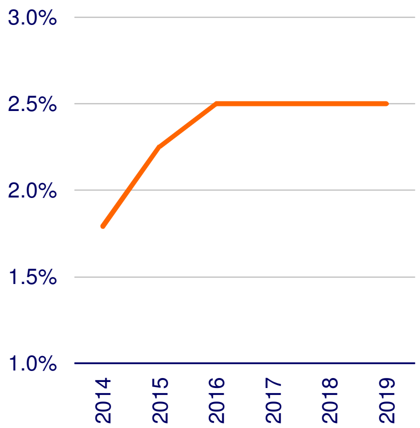


Source: Company report; BPI Capital Africa.

NPL Ratio Evolution

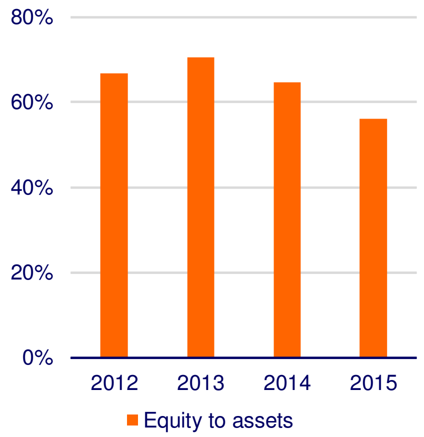


Cost of Risk Evolution

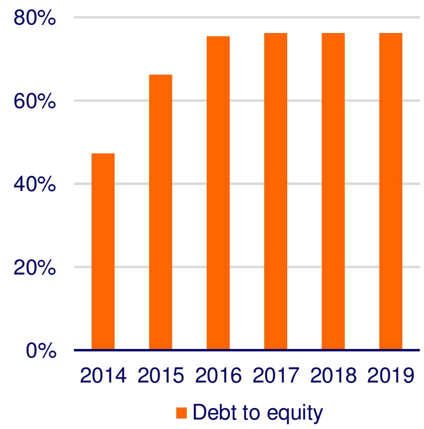


Source: Company report; BPI Capital Africa.

Equity/Assets Evolution

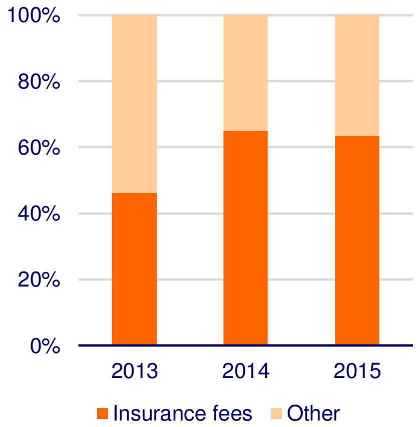


Leverage Analysis

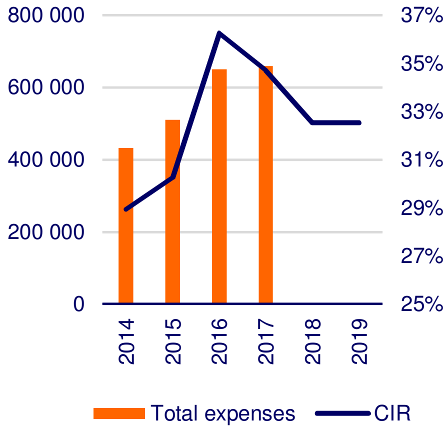


Source: Company report; BPI Capital Africa.

Insurance fees contribution to total NIR



Opex (BWP 000) and CIR Evolution



Source: Company report; BPI Capital Africa.

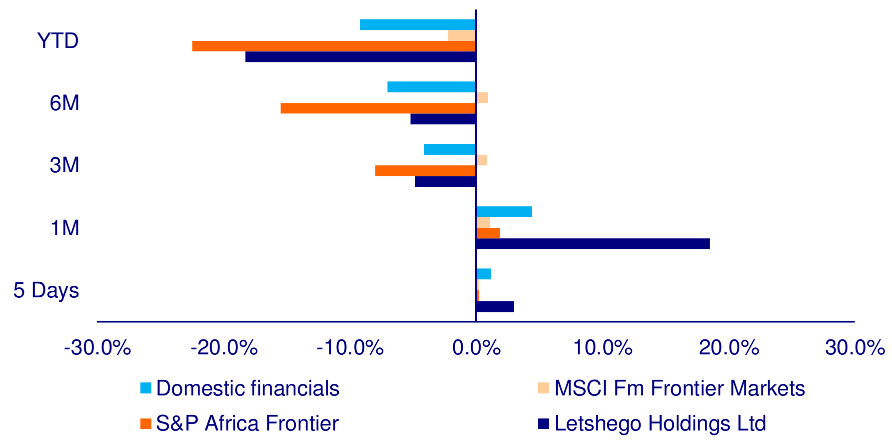
VALUATION

We continue to set our valuation for Letshego using equal-weighted dividend discount model and a PBV approach. **Following changes to our ST and MT assumptions, and importantly, after fully adjusting for the capital reduction, we have set a new YE17 PT of BWP3.10/share. We upgrade our recommendation from Hold to Buy.**

Valuation 1: Dividend Discount Model

Our DDM model uses a risk-free rate of 9.3%, derived from the weighted avg. of risk free rates in countries where Letshego has exposure. We adjusted our beta from 0.9 to 1.0, due to increased stock volatility vs the Botswana financials index. We maintained a risk premium of 6.0% (BPI house rule), and calculated COE at 15.3%. Our LT growth is 5.0% and lastly, we continue to apply a 50% dividend DPR.

Letshego stock vs Indices



Source: Bloomberg.

DDM Sensitivity Table (BWP/share)

		Growth rate				
		13%	14%	15%	16%	17%
	3%	3.37	3.04	2.77	2.54	2.34
	4%	3.56	3.19	2.88	2.63	2.41
Discount rate	5%	3.81	3.37	**3.05**	2.74	2.50
	6%	4.12	3.60	3.19	2.87	2.60
	7%	4.53	3.89	3.41	3.03	2.72

Source: BPI Capital Africa.

Valuation 2: P/B Comparative Valuation

We derived our PBV model using a revised sector YE17F P/BV of 1.6x, which we believe to represent a fair exit multiple for Letshego. We then applied the exit multiple to Letshego's YE17F T. NAV to derive a PT.

Price BWP/share

YE17 PT	3.10
Current price	2.37
Initiating coverage	2.14
31 Dec-15	2.90
12-month high	3.10
12-month low	1.80

Source: Bloomberg, BPI Capital Africa.

Valuation Summary

	BWP/share
YE17 DDM PT	3.05
YE17 P/BV PT	3.15
YE17 Price Target	3.10
Current price	2.37
12M return	25%

Source: BPI Capital Africa.

DDM parameters

Risk free rate	9.3%
Risk premium	6.0%
Beta	1.0
Cost of equity (Ke)	**15.3%**
Terminal growth (g)	5.0%
Dividend payout	50%

Source: BPI Capital Africa.

DDM Valuation (YE17)

Total dividends (BWP) 000)	5 945 807
*Shares in Issue (000)	1 966 412
YE17 PT (BWP)	3.05
Current value (BWP)	2.37
12M return	22%

** adjusted for capital reduction.*
Source: BPI Capital Africa.

PBV Valuation (YE17)

Sector exit P/B (x)	1.6
Discount to sector P/B	1.00
Exit multiple (x)	1.6
YE17 T. NAV (BWP)	1.96
YE17 PT (BWP)	**3.15**
Current value (BWP)	2.37
12M return	27%

Source: BPI Capital Africa.

Valuation Triggers

1. On-going share buyback and cancellation - price support
2. Improved macro fundamentals in Mozambique
3. Additional hedging of underlying USD positions vs local currency depreciation
4. Successful integration of recently acquired subsidiaries and cost optimisation
5. Achieving 35% CIR target
6. CoR within management target

Valuation Risks

1. Weaker performance of the Mozambique subsidiary increases forecast risk in the ST.
2. Additional VAT issues in East Africa that may impact opex
3. Potential increase of PAR as non-payroll exposures grow

HIGHLIGHTING STOCK VALUATION

Letshego's current multiples remain relatively undemanding, discounting 1yr avg. 12M fw PER and P/BV by 5%. However, Equity Bank and Diamond Bank currently offer more significant discounts-due to substantially higher forecast risk.

12M fw PER Multiples

	Letshego	Capitec	Equity	Diamond	Avg.
Current rating	6.4	17.5	5.2	1.6	7.7
1yr avg.	6.7	17.2	6.7	2.1	8.2
Premium/discount	-5%	2%	-22%	-25%	-12%
YTD lowest	4.9	14.0	4.3	1.3	6.1
3yr minimum	4.9	9.1	4.3	1.3	4.9
Premium/discount	0%	54%	0%	0%	13%

Source: Bloomberg.

12M fw P/BV Multiples

	Letshego	Capitec	Equity	Diamond	Avg.
Current rating	1.2	4.2	1.2	0.1	1.7
1yr avg.	1.3	4.1	1.6	0.2	1.8
Premium/discount	-5%	3%	-27%	-35%	-16%
YTD lowest	0.9	3.3	1.0	0.1	1.3
3yr minimum	0.9	1.8	1.0	0.1	1.0
Premium/discount	0%	76%	0%	0%	19%

Source: Bloomberg.

Income Statement

(BWP mn)	2014	2015	2016	2017F	2018F	2019F	CAGR 15-19F
Net interest income	**1 287**	**1 427**	**1 480**	**1 560**	**1 716**	**1 887**	**7%**
Dividends	-	-	-	-	-	-	
Commissions	23	29	46	49	54	60	20%
FX and trading	-	-	-	-	-	-	
Other	184	229	268	288	317	348	11%
Net operating revenue	**1 494**	**1 685**	**1 794**	**1 897**	**2 087**	**2 295**	**8%**
Personnel expenses	207	212	306	329	317	348	13%
Other admin exp	225	297	344	329	362	398	8%
Operating cash flow	1 062	1 175	1 143	1 239	1 408	1 549	7%
Depreciation	13	22	15	20	20	20	-2%
Cost-to-income (incl. dep.)	29%	30%	36%	35%	33%	33%	
Operating profit	**1 048**	**1 154**	**1 128**	**1 219**	**1 388**	**1 528**	**7%**
Loan loss impairments	91	139	168	185	204	224	13%
Other provisions	-	-	-	-	-	-	
Extraordinaries	-1	-	-	-	-	-	
Profit before taxes	**970**	**1 036**	**975**	**1 053**	**1 204**	**1 324**	**6%**
Taxes	248	269	254	274	313	344	6%
Minorities	-	-	-	-	-	-	
Net profit	**722**	**768**	**722**	**780**	**891**	**980**	**6%**

Balance Sheet

(BWP mn)	2014	2015	2016F	2017F	2018F	2019F	CAGR 15-19F
Cash	321	526	705	776	853	939	16%
Loans to customers	5 687	6 312	6 464	7 111	7 822	8 604	8%
Tangible & intangible	153	308	329	362	398	438	9%
Other assets	177	316	337	371	408	448	9%
Total assets	**6 337**	**7 462**	**7 836**	**8 619**	**9 481**	**10 429**	**9%**
Customer deposits	4	154	196	215	237	261	14%
Total borrowings	1 938	2 768	3 134	3 448	3 792	4 172	11%
Other liabilities	300	358	548	431	474	521	10%
Shareholders' equity	4 095	4 182	3 957	4 525	4 978	5 475	7%
Total liabilities & sh. Equity	**6 337**	**7 462**	**7 836**	**8 619**	**9 481**	**10 429**	**9%**

Source: Company report and BPI Capital Africa.

BPI Capital Africa

INVESTMENT RATINGS AND RISK CLASSIFICATION
(TOTAL RETURN IN 12-18 MONTHS):

	Low Risk	Medium Risk	High Risk
Buy	≥15%	≥20%	≥25%
Hold	≥0% and < 15%	≥0% and < 20%	≥0% and < 25%
Sell	<0%	<0%	<0%

These investment ratings are not strict and should be taken as a general rule.

INVESTMENT RATINGS STATISTICS

As of 31st August BPI Capital Africa Equity Research's investment ratings were distributed as follows:

Buy	40%
Hold	40%
Sell	20%
Total	100%

BPI

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BPI is also present in Africa through:

BFA in Angola (50.1% stake)

BCI in Mozambique (30% stake)