EXOTIX PARTNERS

LETSHEGO

17 November 2016

MICROLENDING

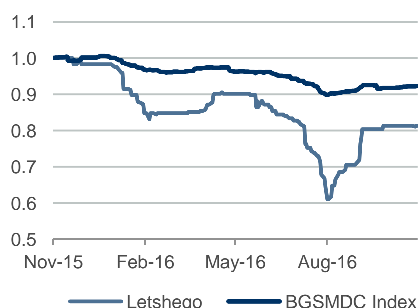
Recommendation: **HOLD**

Price	2.4
Target price	**2.50**
Expected share price return	4.2%
Expected dividend yield	7.6%
Expected total return	**11.8%**
Market cap (mn)	5,123
Market cap (US$mn)	473
Avg. daily volume (US$mn)	356

Market performance in US$

YTD return (%)	(11.0)
3-month return (%)	25.1
1-yr return (%)	(12.8)

Share price performance



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Failing to leverage up to expectations; down to Hold

- **Model update.** We downgrade our recommendation on Letshego to Hold (previously Buy) based on a target price of BWP2.5 (previously BWP4.5), giving an expected total return of 11.8% at the current market price. Our target price is 1.5x FY16f BVPS and 6.8x FY16f EPS.
- **New vs old.** We have reduced our FY16 and FY19 EPS estimates by 16.9% and 57.8% respectively and our ROE estimates by 1.6ppt and 5.7ppt respectively. The primary driver for the reduced estimates is lower than expected loans growth (forecast loan book of BWP10.9bn in FY19 vs BWP14.8bn previously) as the lender faces significant macro-economic headwinds across many of its subsidiaries (Mozambique, Botswana, Nigeria).
- **ROA remains under pressure.** Letshego's ROA has been on a steady downward trend over the last few years, declining from 21.0% in FY11 to 10.3% in FY15. We forecast it to decline further to 6.2% by FY20 as a) NIM declines from 21.6% in FY15 to 18.1% in FY20 driven by increasing competition from banks; 2) cost to income ratio surges to 44.1% by FY19f from 30.2% in FY15 as the lender consolidates new subsidiaries and continues to invest in deposit-taking capabilities; 3) cost of risk increases from 2.3% in FY15 to 3.2% in FY20 as it grows its higher risk portfolio; and 4) lending growth moderates in the short term due to increasing competition in Botswana and macroeconomic headwinds across some of its subsidiaries (Mozambique, Nigeria, Kenya).
- **Balance sheet leverage increasing but not significantly enough to mitigate decline in ROE.** The lender's debt to equity ratio increased to 72.5% in FY15 (from 49.3% in FY14) driven by a high payout ratio, significant increase in its long-term borrowings and strong balance sheet growth. We think the debt to equity ratio could increase to 117% by FY18 as it sustains the high payout ratio, buys back up to 10% of issued shares and incurs significant FX losses across some of its subsidiaries. Inability to further significantly increase leverage (as a debt to equity ratio of more than 100% would be considered high risk by potential lenders) means Letshego will probably have to reduce its payout ratio to 25% by FY20 to sustain growth momentum. Based on our assumptions, we estimate total borrowings will increase to BWP5,990mn by FY20 from BWP,2768mn in FY15 and the overall equity to assets ratio will decline from 54.0% to 38.5% within the same period.
- **Our recommendation explained.** We estimate the decline in ROA will more than offset the increase in leverage, resulting in the overall ROE declining to 16.1% by FY20 from 17.9% in FY15. Based on an average ROE of 17.1%, we estimate a justified P/BVPS of 1.3x which is moderately lower than its FY16 P/BVPS of 1.4x, thus supporting our HOLD recommendation on the counter.

Year to 31 Dec	2014*	2015	2016f	2017f	2018f
Net Income (mn)	675	713	733	647	597
EPS	0.34	0.33	0.37	0.32	0.30
EPS (Old)	0.34	0.33	0.51	0.59	0.69
P/E (x)	9.2	8.2	6.5	7.4	8.0
P/TBVPS (x)	1.71	1.46	1.51	1.49	1.36
DPS	0.16	0.17	0.18	0.16	0.12
Dividend yield (%)	5.3%	6.3%	7.6%	6.8%	5.0%
TROE (%)	20.0%	17.9%	19.7%	18.8%	16.5%
ROA (%)	13.0%	10.3%	10.0%	8.6%	7.0%

The company changed its financial year end from January to December in 2014, thus FY14 is for an 11 month period

Recommendations and opinions in this report, unless otherwise stated, are based on a combination of discounted cash flow analysis, ratio analysis, industry knowledge, logical extrapolations, peer group analysis and company specific and market technical elements (events affecting both the financial and operational profile of the company). Forecasting of company sales and earnings are based on segmented top-bottom models using subjective views of relevant future market developments. In addition, company guidance and financial guidance is taken into account where applicable. This report is on a stock under "active coverage". All prices provided within this research report are taken from the close of business on the day prior to the issue date unless explicitly stated.
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Investment theme

Growth momentum to remain modest in the short term

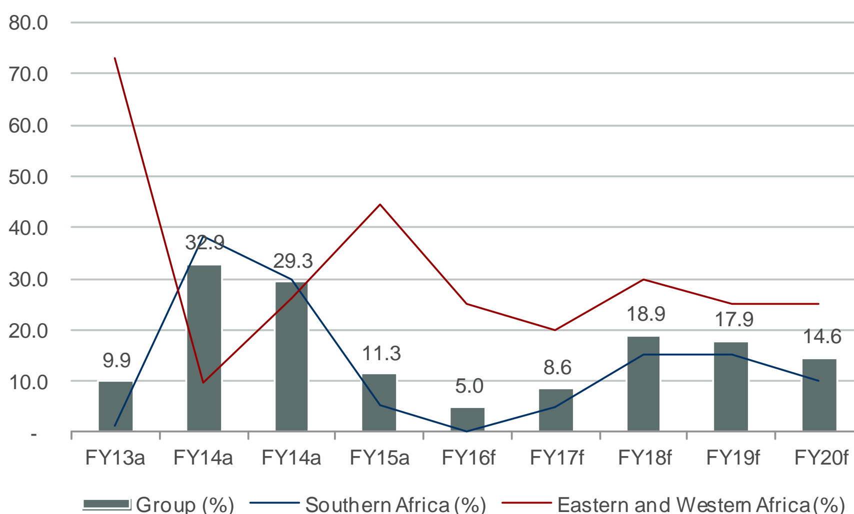
In the six-month period ending 30 June 2016, the micro-finance institution's loan book increased by a modest 6.7% yoy and actually declined by 1.7% on a YTD basis to BWP6,203mn. The slowdown can be attributed to 1) declining growth across its three major subsidiaries which combined account for almost 75% of the total loan book (the Botswana loan book was flat in LC terms while the Mozambique and Namibia loan books increased by 16% and 13% respectively), and 2) the depreciation of regional currencies against the Pula (according to management, the Pula appreciation reduced growth from 22% yoy in local currency terms to 9% yoy in Pula terms.

While growth at some of its other subsidiaries was very strong (Kenya +71%, Lesotho +44% yoy, Rwanda +42% yoy, Tanzania +19% yoy and Uganda +19% yoy), this was off a low base and therefore did not contribute significantly to overall group growth.

We believe Letshego's growth could remain muted in the short term due to 1) continued significant devaluation of currencies in many of the countries in which the group operates (Mozambique, Nigeria); 2) the weak and uncertain operating environment of some of the countries in which it operates (Botswana - decline in diamond prices, Mozambique - uncertainty about government fiscal balances, Kenya - Presidential elections and Nigeria – deep economic recession); and 3) increasing competition from banks within the salary-backed loans segment. Overall, we forecast a CAGR in group loans of 6.8% per annum in FY16 and FY17 driven by 2.5% per annum growth in Southern Africa and 22.5% per annum growth in East and West Africa.

We expect a potential improvement in macro-economic fundamentals and currency stability will accelerate growth to 17.1% per annum from FY18 onwards.

Figure 1: Loan growth estimates (%)



Source: Company annual reports, Exotix estimates

Diversification of loans and funds should mitigate significant margin decline

The MFI's NIM has declined steadily from 31.9% in FY11 to 21.6% in FY15, driven primarily by increasing competition within its salary-backed loans portfolio which has reduced the average lending rate from 36.0% to 31.8%. Margins have also been negatively impacted by increasing reliance on debt funding (the debt to equity ratio has increased from 28.9% to 72.5% within that period), the costs of which have increased from 5.3% to 11.3%.

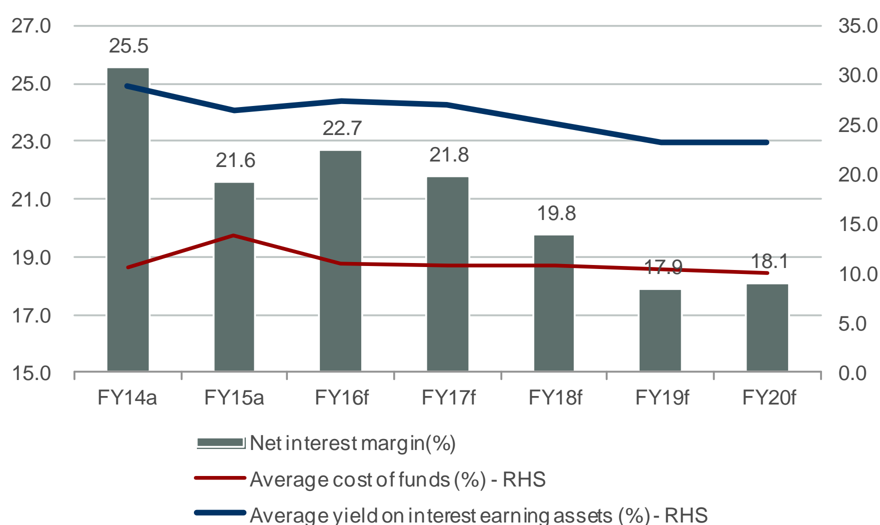
We believe that Letshego's margins will remain under pressure as a result of

increasing competition from banks. Nonetheless, we think the group's efforts to diversify away from its traditional portfolio of salary-backed lending to government employees to low-income private sector employees and micro and small enterprises, which is less competitive, should mitigate a further significant decline in lending rates. To this end, we note that as at H1 16, c.11% of the bank's loans were to the latter segment with most of the growth coming from Letshego's East and West African subsidiaries. As discussed above, we expect most of the growth to come from that region (see discussion above – we forecast contribution from the region to increase to 33.3% by FY20 from 20.0% in FY15) and this should enable Letshego to sustain relatively high lending rates compared to its peers in the banking sector.

We also believe Letshego's funding costs should gradually reduce as the bank continues to grow its deposit base. Following the granting of a deposit-taking licence in Namibia and acquisition of deposit-taking franchises in Nigeria and Tanzania, it now has deposit-taking capability across five different subsidiaries (including Rwanda and Mozambique). Total deposits at the end of FY15 stood at BWP154.5mn (5.6% of total borrowings) and we expect that to increase almost five-fold to BWP750mn by FY20 (12.5% of estimated borrowings). On that basis, we estimate Letshego's funding costs could potentially decline to 9.0% by FY20 from 11.3% in FY15.

Based on our assumptions, we estimate NIM could decline from 21.6% in FY15 to 18.1% in FY20.

Figure 2: Letshego NIM (%)



Source: Company annual reports, Exotix estimates

Capacity building and slowing revenue growth should reduce cost efficiency

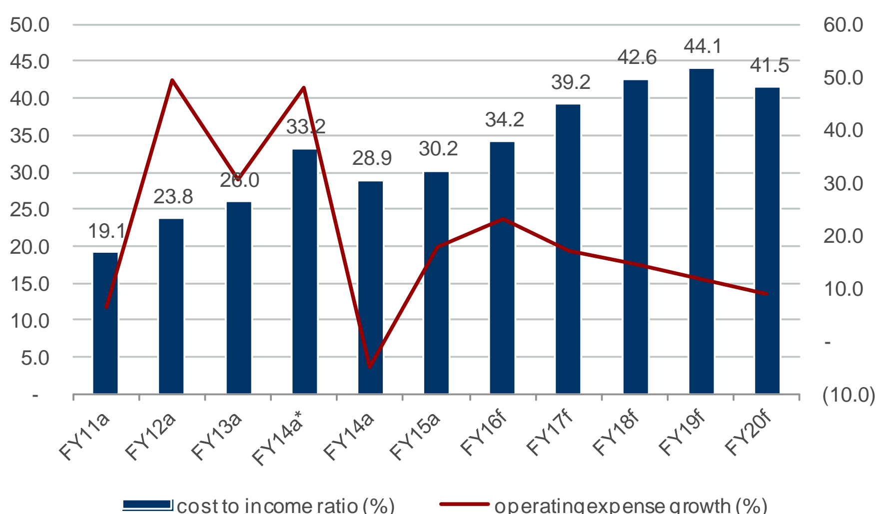
Letshego's operating expenses have increased at a cumulative rate of 26.5% per annum over the last five years as the company embarked on expanding its reach, both in terms of locations (it has aggressively expanded into East and West Africa) and product offering (it has built deposit-taking capabilities in three of its subsidiaries). The aggressive growth in costs has increased its cost to income ratio from 19.1% in FY11 to 30.2% in FY15.

We forecast cost growth to remain strong in the short term as it consolidates the operations of the new subsidiaries (Nigeria and Tanzania were acquired towards the end of 2015) and continues to build its deposit-taking platform. We therefore estimate opex growth of 23.2% yoy and 17.2% yoy in FY16 and FY17, respectively, before moderating to a CAGR of 11.8% per annum from FY18 onwards.

The continued strong opex growth combined with moderating revenue growth (due to declining loan growth and shrinking margins) should see Letshego's cost to income

ratio climb from 30.2% in FY15 to 44.1% in FY19f before moderating to 41.5% by FY20f, on our forecasts.

Figure 3: Letshego cost to income ratio estimates (%)



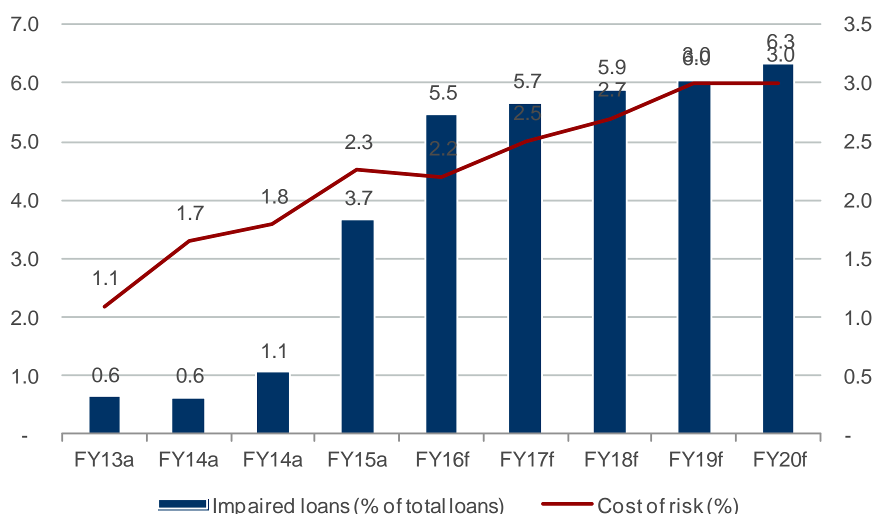
Source: Company annual reports, Exotix estimates

High return, high risk

The MFI's NPL ratio increased to 3.7% in FY15 from 1.1% in FY14. This was attributed by management largely to a change in loan loss provisioning policy: in the past Letshego would aggressively write-off non-performing loans, unlike most other financial institutions which would make provisions for the same and then make some recovery efforts before writing them off completely. The aggressive write-off policy therefore kept the overall NPL ratio fairly low. In line with other financial institutions, Letshego has started making provisions for its bad debts rather than writing them off (amounts written off as a percentage of gross loans declined to 1.1% in FY15 from a historical average of 3.2%), which therefore resulted in the NPL ratio increasing significantly on a yoy basis in FY15. Despite the decline in written-off NPLs, we note the MFI's overall cost of risk of 2.3% in FY15 was only 20bp above the historical average of 2.1%.

Nonetheless, we expect Letshego's asset quality ratios to deteriorate gradually as it diversifies away from its traditional salary-backed loans segment and towards more MSME lending. Being concentrated among civil servants, the former segment had a very low risk profile as the loan repayment would be deducted at source and thus the probability of default would arise only in case of dismissal (civil servants rarely get laid off) or death. We think the risk profile for MSME lending is likely to be higher as the income source is likely to be more volatile. We therefore assume Letshego's NPL ratio will gradually increase from 3.7% in FY15 to 6.3% in FY20 and similarly the cost of risk will rise from 2.3% to 3.0% over the same period.

Figure 4: Letshego asset quality ratios (%)



Source: Company annual reports, Exotix estimates

Balance sheet leverage increasing, but lack of cheap funding will limit further significant increase

Letshego's long-term borrowings jumped 43% in FY15 to BWP2,768mn. This increase, combined with a continued high dividend payout ratio, increased its debt to equity ratio to 72.5% from 49.3% in FY14. We forecast the bank's balance sheet leverage to continue increasing due to:

1) **Potential share buy-back of up to 10% of issued shares**: in May 2016 the MFI renewed its intention to buy-back up to 218.5mn shares (c. 10% of FY15 issued shares) for a total consideration of BWP561.5mn. To this effect the company had bought back a total of 52mn shares (c. 24% of the programme). In our forecasts we have assumed it will acquire the additional 152.4mn shares as approved at the AGM. The buy-back programme could therefore reduce Letshego's equity by up to BWP561.5mn.
2) **Unrealised FX losses**. The company's shareholder equity was negatively impacted by an FX loss of BWP283.2mn in FY15 and a further BWP298mn in H1 16 related to its net open positions in subsidiaries whose host currencies have depreciated sharply in the past 12 months (primarily from Mozambique and Nigeria). Given the continued devaluation across many of the countries in which it operates, we forecast FX losses could remain significant in the short term – we forecast FX losses of c. BWP450mn in FY16 and a further BWP250mn in FY17.
3) **High dividend payout ratio**. In order to increase its financial leverage, the company has been paying on average 52.6% of its earnings as dividends over the last two financial years compared to an historical average of 18.9%. Our discussions with management indicate they remain committed to sustaining a high payout ratio in order to achieve the 100% debt to equity ratio target. We therefore assume a dividend payout ratio of 50% in FY16 and FY17.

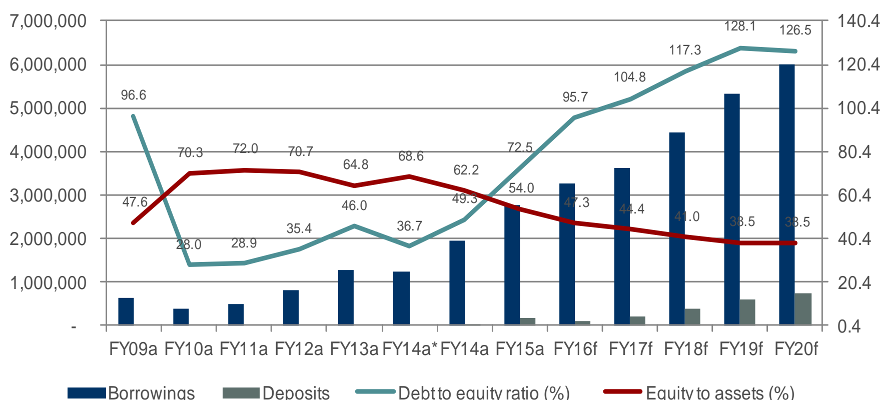
Based on our assumptions, we estimate Letshego's debt to equity ratio will increase to 95.7% in FY16 and 104.8% in FY17. In order to achieve the same, we estimate total group borrowings will increase from BWP2,768mn in FY15 to BWP3,627mn in FY17. Inability to raise the extra borrowings or refinance the maturing obligations (47% of which was scheduled to mature before the end of 2016) is therefore a key risk to our growth and dividend payout assumptions.

From FY18 onwards, barring a further significant increase in leverage (which we think would be highly risky), we believe the company may be forced to significantly reduce

its dividend payout ratio in order to continue funding its growth. Consequently, we assume the payout ratio declines to 40% in FY18 and 20% by FY20.

Even on those assumptions, we estimate the company's debt to equity ratio could climb to 126.5% by FY20, requiring the MFI raises an additional BWP2,364mn in borrowings to fund the assumed loan growth. Inability to raise the same is therefore a big risk to our loan growth and/or dividend payout assumptions.

Figure 5: Letshego balance sheet leverage assumptions

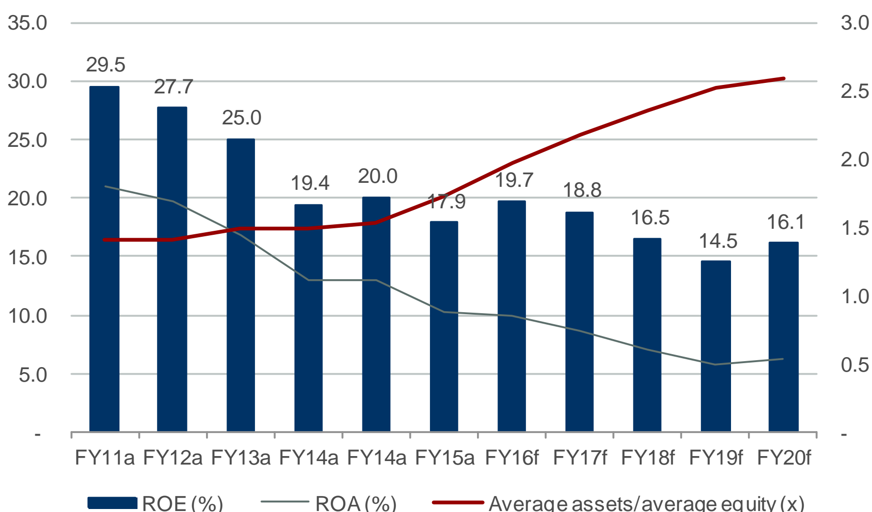


Source: Company annual reports, Exotix estimates

Increasing leverage not sufficient to offset declining ROA

We assume Letshego's ROA will decline from 10.3% in FY15 to 6.2% in FY20 and conversely the balance sheet leverage will increase from 1.7x to 2.6x over the same period. Overall, we estimate the decline in ROA will have a greater impact on profitability and therefore estimate the ROE will decline from 17.9% in FY15 to 16.1% in FY20.

Figure 6: Letshego ROE assumptions



Source: Company annual reports, Exotix estimates

In our view, the company's inability to source significant low cost funds significantly hampers overall group profitability. In this regard, stronger than expected growth in deposits remains a key upside risk to our estimates, as it not only reduces the MFI's borrowing costs but it would also boost its financial leverage.

Conversely and as highlighted above, continued dependence on long-term borrowings is a key risk for the group's growth and dividend outlook.

Key financials and ratios

Table 1: Income statement

Income statement (BWPmn)	FY14	FY15	% ch	FY16f	% ch	FY17f	% ch	FY18f	% ch
Interest income	1,455	1,754	20.5%	1,906	8.7%	1,918	0.7%	2,031	5.9%
Interest expense	(168)	(327)	94.9%	(330)	1.0%	(368)	11.7%	(433)	17.5%
Net interest income	**1,287**	**1,427**	10.8%	**1,576**	10.4%	**1,550**	-1.6%	**1,598**	3.1%
Other operating income	207	258	24.8%	261	1.1%	326	24.9%	385	18.0%
Total income	1,494	1,685	12.8%	1,837	9.0%	1,876	2.1%	1,983	5.7%
Less operating expenses	(433)	(510)	17.8%	(628)	23.2%	(736)	17.2%	(844)	14.7%
Operating profit	1,062	1,175	10.7%	1,209	2.8%	1,140	-5.7%	1,139	-0.1%
Impairment charge	(91)	(139)	51.8%	(148)	6.7%	(183)	23.4%	(235)	28.5%
Pre-tax income	**970**	**1,036**	6.8%	**1,061**	2.3%	**957**	-9.8%	**904**	-5.6%
Less tax	(248)	(269)	8.3%	(265)	-1.3%	(239)	-9.8%	(226)	-5.6%
Net income	722	768	6.4%	795	3.6%	718	-9.8%	678	-5.6%
Attributable income	**675**	**713**	5.6%	**733**	2.9%	**647**	-11.8%	**597**	-7.7%
EPS (BWP)	**0.34**	**0.33**	**-3.6%**	**0.37**	**12.5%**	**0.32**	**-11.8%**	**0.30**	**-7.7%**
DPS (BWP)	**0.17**	**0.17**	**2.6%**	**0.18**	**8.4%**	**0.16**	**-11.8%**	**0.12**	**-26.1%**
NAV (BWP)	**1.8**	**1.8**	**2.0%**	**1.7**	**-7.5%**	**1.7**	**1.5%**	**1.9**	**9.1%**

Source: Company annual reports, Exotix estimates

Table 2: Balance sheet

Balance sheet (BWPmn)	FY14	FY15	% ch	FY16f	% ch	FY17f	% ch	FY18f	% ch
Cash and cash equivalent	321	526	64.2%	285	-45.9%	308	8.3%	366	18.6%
Advances to customers	**5,687**	**6,312**	**11.0%**	**6,326**	**0.2%**	**6,853**	**8.3%**	**8,129**	**18.6%**
Other receivables	151	221	46.1%	221	0.3%	240	8.3%	285	18.6%
Property, plant and equipment	52	76	46.9%	70	-7.5%	88	25.0%	110	25.0%
Intangibles assets	46	61	34.5%	100	63.1%	110	10.0%	120	9.1%
Goodwill	55	171	209.3%	135	-21.0%	135	0.0%	135	0.0%
Deferred Taxation	26	68	162.9%	68	0.0%	68	0.0%	68	0.0%
Total assets	**6,337**	**7,462**	**17.8%**	**7,206**	**-3.4%**	**7,802**	**8.3%**	**9,212**	**18.1%**
Total shareholders' equity	**3,940**	**4,033**	**2.4%**	**3,409**	**-15.5%**	**3,461**	**1.5%**	**3,777**	**9.1%**
Minority interest	154	149	-3.7%	211	41.9%	282	33.5%	362	28.5%
Trade and other payables	210	175	-16.2%	184	5.0%	193	5.0%	203	5.0%
Income tax	49	60	21.8%	39	-35.4%	39	0.0%	39	0.0%
Borrowings	**1,938**	**2,768**	**42.9%**	**3,263**	**17.9%**	**3,627**	**11.2%**	**4,431**	**22.2%**
Deposits	4	154	3767.2%	100	-35.3%	200	100.0%	400	100.0%
Total liabilities	2,242	3,280	46.3%	3,586	9.3%	4,059	13.2%	5,073	25.0%
Total equity and liabilities	**6,337**	**7,462**	**17.8%**	**7,206**	**-3.4%**	**7,802**	**8.3%**	**9,212**	**18.1%**

Source: Company annual reports, Exotix estimates

Table 3: Key ratios

	FY14	FY15	FY16f	FY17f	FY18f
Margins					
Net interest margin (%)	25.5	21.6	22.7	21.8	19.8
Cost to income ratio (%)	28.9	30.2	34.2	39.2	42.6
Cost of risk (%)	1.8	2.3	2.2	2.6	2.9
Growth					
Gross loans (%)	29.3	11.3	5.0	8.6	18.9
Borrowing (%)	55.0	42.9	17.9	11.2	22.2
Total assets (%)	27.5	17.8	(3.4)	8.3	18.1
Asset allocation					
Net loans to total assets (%)	89.7	84.6	87.8	87.8	88.2
Cash to total assets (%)	5.1	7.1	4.0	4.0	4.0
Asset quality					
NPL ratio	1.1	3.7	5.5	5.7	5.9
NPL cover (%)	123.9	107.2	111.2	111.1	110.9
Funding					
Equity to assets ratio (%)	62.2	54.0	47.3	44.4	41.0
Debt to assets ratio	49.3	72.5	95.7	104.8	117.3
Deposits to assets ratio	0.2	5.6	3.1	5.5	9.0
Dividend payout ratio (%)	53.2	51.9	50.0	50.0	40.0
Profitability					
Return on average equity (%)	20.0	17.9	19.7	18.8	16.5
Return on average assets (%)	13.0	10.3	10.0	8.6	7.0

Source: Company annual reports, Exotix estimates

Valuation

Our fair value estimate and target price for Letshego is BWP2.5/share.

Methodology

To calculate our fair value estimate for Letshego we applied a two-stage dividend discount model:
Stage 1 - between FY16 and FY20 we estimated the present value of dividends using the profitability drivers we discuss above.
Stage 2 – we determine the terminal value as the perpetual growth rate in the bank's book value based on its average ROE between FY16 and FY20 and a terminal growth rate assumption of 8.0%.
We also include in the total intrinsic value the present value of the remaining potential share buyback (assuming it takes place before year end).
We assume a cost of equity (CoE) of 15%, using a risk-free rate of 10%, an equity risk premium of 5% and a beta of 1.0x. As our valuation is Botswana Pula-based, we have applied an 8% terminal growth rate.
In the table below, we provide our assumptions used to calculate our fair value estimate of the bank.

Table 4: Valuation summary

(BWPmn)	2016f	2017f	2018f	2019f	2020f
Aggregate Dividend	366.6	323.5	239.0	144.1	143.6
PV	359.5	275.9	177.2	92.9	80.5
Total PV	986.0				
Terminal Value					
RoAE					17.1%
CoE					15.0%
Growth					8.0%
Book value in 2020					4,736.2
Terminal value					6,185.1
PV of Terminal Value	3,988.2				
PV of share buy back	432.7				
Total PV	**5,406.9**				
Shares in issue (mn)	2,132.1				
Per share value	**2.5**				

Source: Company annual reports, Exotix estimates

Risks

In our opinion, the following are key risks to our forecasts and target price:

- **Execution risk:** as discussed above, management are in the process of diversifying away from their historical business model by becoming a deposit-taking institution and lending to MSMEs. Poor execution of the new strategy could reduce shareholder returns by significantly reducing operating efficiency and/or reducing the asset quality of the asset portfolio.
- **Funding risk:** as discussed above, we forecast the bank's debt to equity ratio to increase substantially over the next few years. This is driven by the assumption that Letshego can raise the necessary funding. Thus, inability to do so could lead to lower than expected balance sheet leverage and therefore profitability.
- **Margin risk.** As discussed above, we believe the decline in Letshego's margins will moderate as the bank diversifies into less competitive segments and raises cheap (relative to its historical funding base) deposits. A further significant decline in margins is therefore a key downside risk to our estimates.

DISCLOSURES

Analyst Certification

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- Buy recommendation means – an upside of 15% or more within a trading range of 180 days.
- Sell recommendation means – a downside of 10% or more within a trading range of 180 days.
- Hold recommendation means – an upside or downside of less than the above within a trading range of 180 days.

The recommendations are based on data generally available in the market and reflect the prices, volatility, corporate information and general economic data available at the time of publication together with historical information in respect of the security(ies) or issuer(s). Further information in respect of the basis of any valuation is available from the analyst on request.

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Trading recommendations as at 30 September 2016:

Buy	48	Sell	31	Hold	49

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