EXOTIX CAPITAL

LETSHEGO HOLDINGS

2 May 2018

SUB-SAHARAN CONSUMER FINANCE

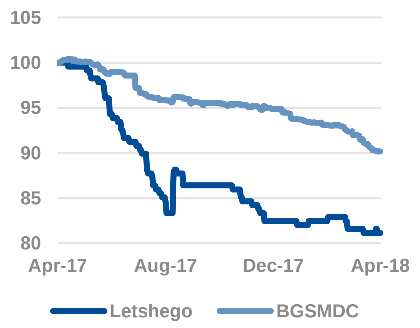
ISSUER-SPONSORED RESEARCH

Price (BWP)	1.85
Current valuation metrics	
2017 PE	5.6x
2017 PB	1.0x
2017 Dividend yield	11.4%
Market cap (BWPmn)	3,967
Market cap (US$mn)	404

Market performance in BWP

YTD return (%)	-1.6
3-month return (%)	-1.1
1-yr return (%)	-18.9

Share price performance



Well-executed diversification should support growth

- **We initiate coverage of Letshego Holdings.** Letshego provides consumer, microfinance and savings solutions to the financially under-served and has a broad geographical spread across Sub-Saharan Africa. At 1.0x 2017 BV and 5.6x 2017 PE, valuations do not appear challenging given our expectations for c20% average ROE over our forecast period.
- **Industry fundamentals are supportive of the volume growth story.** Sub-Saharan Africa continues to lag global financial inclusion trends, with only 43% account penetration versus 95% in high-income economies and 63% in developing economies. As growth in Letshego's core civil-servant lending portfolio stabilises in a competitive pricing environment, diversification to non-government lending should boost volumes. Improving accessibility provides clear opportunities for Letshego to grow its non-core loan portfolio of traditional microfinance lending (c10% of total) and informal short-term loans (1%) to 25% of the loan book.
- **Changing funding profile is medium-term positive.** A rapidly growing base of cheap and sticky deposits should support margins post-2019 as debt costs stabilise. On our forecasts, deposits will address c19% of funding needs in 2022 (from 3% as of 2017). Recent margin contraction has been the result of an increasingly expensive external debt load, partly obtained through acquisitions. However, 2018-19 could remain challenging as management switches the external debt profile from secured to senior unsecured funding.
- **Efficiency metrics should improve as recent acquisitions and technology investments drive fee growth.** As the group concludes a phase of heavy investment, we believe expense growth will slow from 26% pa in the five years preceding 2017 to 12% pa over the next five years. We expect management's focus on partnering with fintech and telecommunication companies will yield cost savings in the near to medium term. Combined with c14% pa average income growth, we see the cost/income ratio declining to c36% in 2022 from c40% in 2017.
- **Gearing could improve.** 2017 reported leverage of 93% remains below the 100% internal target. We assume Letshego will reach its target by raising additional debt (cBWP2.2bn) and buying back 1% of shares outstanding each year over our forecast horizon. Management has reiterated its commitment to share buybacks and will seek shareholder approval to extend the buyback program at the May 2018 AGM (2.4% and 1% repurchased in 2016 and 2017). Sustained buybacks will help propel ROE towards the 21% range, still beneath management's 25% target, and should translate to 10.9% effective dividend yield in 2018.
- **Deteriorating asset quality represents a downside risk.** Management has stated it will focus on augmenting its core portfolio of predominantly civil-servant-focused lending with more non-government and micro and small entrepreneurs (MSE) lending. Although the riskier borrower base should help prop up loan yields, it could also result in higher default rates and rising impairment costs. Our forecasts assume the cost of risk will rise to 4.5% in 2022 (from c3.0%).

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Contents

Investment case

We project 14% pa earnings growth through 2022 (see pages 18-20 for our full earnings forecasts). We identify the following three key factors that are likely to drive the investment case for Letshego: industry fundamentals, a more positive earnings outlook and improved gearing.

Three key factors drive the investment case for Letshego:

1) *Supportive industry fundamentals*
2) *A more positive earnings outlook*
3) *Improved gearing*

Microfinance opportunity in Sub-Saharan Africa

Sub-Saharan Africa continues to lag behind overall improvements in global financial inclusion, with a mere 43% account penetration versus 95% in high-income economies and 63% in developing economies overall. However, financial technology adoption has been most rapid in this region. 21% of adults in Sub-Saharan Africa now have mobile money accounts (nearly double the amount in 2014) and the highest of any region in the world. GDP growth of c4%pa through 2022 (IMF) and a young and underserved population are supportive of sustained credit growth to fund education, small-scale business opportunities and home ownership. The World Bank estimates 43% of the population is younger than 14, and 62% of the population lives in rural areas.

Against this backdrop of largely untapped potential in Sub-Saharan Africa, where all of Letshego's subsidiaries are domiciled, we see opportunities for the company to continue to grow its franchise by enabling financial inclusion.

A more positive earnings outlook

Broad geographical footprint and deposit-taking licenses should support volume growth. We forecast c12% average annual loan growth through 2022, which we expect to come from: 1) mobile loan offerings; 2) an expansion of agent networks; 3) customer acquisitions through partnerships and industry associations (such as cotton growers) and 4) short-tenor low-value high-volume credit.

Letshego's newly acquired deposit-taking licenses should facilitate 70% pa deposit growth through 2022, with potential upside from additional licenses in the five other locations (Botswana, Kenya, Lesotho, Swaziland, Uganda).

Further volume upside could come as some commercial banks and financial institutions cede unsecured lending volumes to consumer finance providers (like Letshego), as these institutions adopt Basel III and IFRS 9 requirements.

Margins should improve over the medium term on declining funding costs and higher loan yields. Lower funding costs from cheap deposit gathering will reduce blended borrowing costs to 10.8% in 2022 from 12.2% in 2017. We assume customer deposit costs will decline by 125bps to 4.75% in 2022 from 6.0% as inflation in locations with deposit-taking licenses falls. Further, we expect deposits to account for c19% of total funding needs by 2022 (from c3% in 2017). Combined with higher yields on low-value credit and growth in traditional microfinance lending, we forecast a c80bps increase in the net interest margin between 2017 and 2022. Margins in 2018 and 2019 could decline slightly as management switches the external debt profile from secured to senior unsecured funding, raising the near-term cost of debt funding.

Profitability should improve on improved operating efficiency. Following a period of cross-border investment in technology, customer acquisition, product enhancement, partnerships and agent expansion, we expect operating expense growth to moderate from c26% pa over the five years preceding 2017 to c12% over our forecast period. Combined with 14%pa income growth, this should cause the cost-to-income ratio to decline to 36.2% by 2022 from 39.6% in 2017.

Further acquisition activity could impact our forecasts. Although management's near-term focus is on integrating recent West African acquisitions and diversifying the portfolio mix, acquisitions remain a possibility. The group will assess acquisitions in a threefold manner: 1) to support or grow inorganically in markets where it currently operates; 2) to obtain additional deposit-taking licenses; and 3) as an entry into markets where Letshego does not currently exist. Any such activity would likely support stronger-than-forecast volume growth or a steeper ramp in deposit volumes, but potentially come at the expense of operating efficiency. Our model does not incorporate any future acquisitions.

MSE and non-government diversification could cause asset quality deterioration. As management augments the predominantly civil-servant-focused portfolio with increased lending to non-government sectors, including MSE lending, we expect asset quality to deteriorate, given the difficulty with enforcing the deduction-at-source model in such sectors. Although the riskier borrower base should help prop up loan yields, it could also result in higher default rates and rising impairment costs. We expect the cost of risk to rise to 4.6% in 2022 (from 2.9% in 2017), largely on a riskier loan mix, but also in part due to IFRS 9 implementation.

Gearing should improve

External funding is likely to remain a key component of liabilities over our forecast horizon as Letshego raises additional debt to reach its 100% internal-debt-to-equity target (93% reported in 2017). Our model assumes debt funding costs will rise to 13.5% by 2022 from an estimated 12.9% in 2017. Further initiatives to reach the 100% gearing target include: 1) share buybacks (2.4% and 1% of shares outstanding in 2016 and 2017 and a commitment to seek shareholder approval to extend the buyback program at the May 2018 AGM); 2) scope for special dividends; such as the BWP4.1/sh in 2017 from the proceeds of the Namibia IPO. Sustained buybacks over the period will further help propel ROE towards the 21% range (still beneath management's 25% target), and should translate into an effective dividend yield of 10.9% in 2018.

Valuation

At 1.0x 2017 BV and 5.6x 2017 PE, valuations do not appear challenging, given our expectations for 50% dividend payout and c20% average ROE over our forecast period.

On a dividend discount model basis, the current share price is equivalent to a medium-term ROTE of c15%. Relative to the peer group in FY 17, the shares trade at a 43% PE discount and a 50% PB discount. We believe the market is pricing in a sizeable conglomerate discount, and a potential cut to the 50% dividend payout ratio. We think that a 17% cost of equity and a 6% terminal growth rate is appropriate given the geographical mix of the business. Our mid-cycle ROTE estimate is 21.5%.

Key assumptions

To arrive at our 17% cost of equity, we weight long-term government bond yields by each country's estimated long-term loan book weight. We arrive at an 11% blended risk-free rate, to which we apply a 6% equity risk premium.

Sensitivity analysis

Below, we highlight possible upside/(downside) to our fair-value estimate under various mid-cycle ROTE and cost of equity scenarios.

Table 1: Letshego sensitivity analysis (BWP/share)

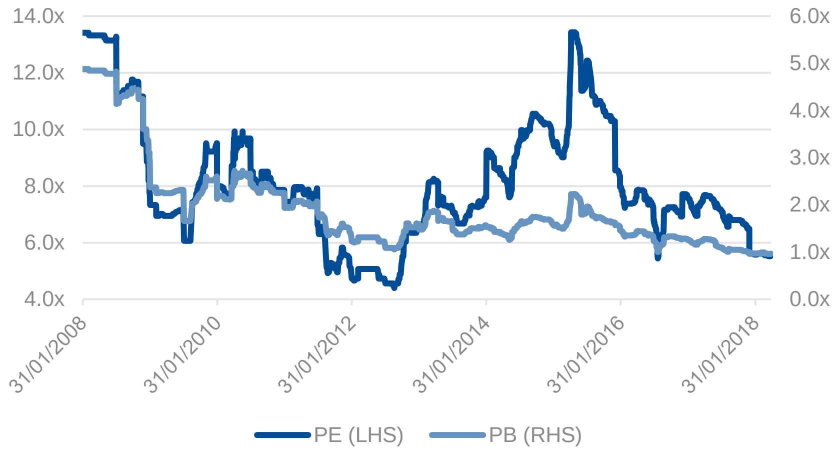
		Mid-cycle ROTE				
		19.5%	**20.5%**	**21.5%**	**22.5%**	**23.5%**
	15.0%	0.22	0.37	0.52	0.68	0.83
	16.0%	-0.03	0.11	0.23	0.37	0.51
Cost of equity	**17.0%**	-0.23	-0.11	0.00	0.12	0.24
	18.0%	-0.40	-0.30	-0.20	-0.09	0.02
	19.0%	-0.54	-0.45	-0.36	-0.26	-0.17

Source: Exotix Research

Historical trading ranges

Over the past 10 years, Letshego shares have traded at an average of 8.2x trailing PE and 1.9x trailing PB. The shares currently trade at 5.6x 2017 PE and 1.0x 2017 PB; i.e., a c40% discount to the historical range.

Figure 1: Historical valuation multiples



Source: Bloomberg

Peer multiples

In the table below, we compare trailing valuation multiples for Letshego Holdings with those of key global peers.

Table 2: Peer comparison

Company	Ticker	Country	Mkt cap (US$mn)	ADV (US$ 000s)	2017 PE	2017 PB	2017 ROE	2017 DY
Letshego Holdings	**Letshego BG**	**Botswana**	**404**	**na**	**5.6x**	**1.0x**	**16.7%**	**10.8%**
Exotix frontier peers								
Equity Group	EQBNK KN	Kenya	1,842	1,084	9.8x	2.0x	21.7%	4.1%
VPB Bank	VPB VN	Vietnam	3,501	6,310	11.7x	2.7x	26.9%	na
BRAC Bank	BRAC BD	Bangladesh	1,107	1437	18.6x	3.7x	22.0%	0.8%
Credit Agricole	CIEB EY	Egypt	802	404	7.3x	2.6x	41.8%	8.3%
Bank Alfalah	BAFL PA	Pakistan	734	756	9.9x	1.3x	13.4%	2.8%
Hatton National	HNB SL	Sri Lanka	722	331	7.0x	1.0x	15.0%	2.7%
Diamond Bank	DIAMONDB NL	Nigeria	125	154	7.9x	0.2x	2.5%	na
Exotix frontier comps median			**802**	**756**	**9.8x**	**2.0x**	**21.7%**	**2.8%**
Africa peers (not covered)								
Capitec Bank	CPI SJ	South Africa	8,111	16,979	22.6x	5.4x	25.7%	1.7%
Salafin	SLF MC	Morocco	270	86	18.0x	3.9x	21.8%	5.6%
Development Finance Company	DFCU UG	Uganda	157	na	4.1x	1.1x	27.3%	8.8%
Africa peers median			**270**	**8533**	**18.0x**	**2.5x**	**24.6%**	**7.2%**
Global consumer finance								
Bharat Financial Inclusion	BHAFIN IN	India	2,394	24,130	34.9x	5.3x	16.7%	na
Gentera	GENTERA* MM	Mexico	1,274	5,544	9.8x	1.4x	15.5%	na
International Personal Finance	IPF LN	Britain	759	940	7.3x	1.2x	7.9%	5.1%
Credito Real SAB	CREAL* MM	Mexico	561	997	6.3x	1.2x	18.3%	0.9%
Satin Creditcare	SATIN IN	India	295	934	57.1x	2.4x	5.2%	na
Quanzhou Huixin Microcredit	1577 HK	China	130	59	9.3x	0.8x	9.4%	4.2%
Global consumer finance peers median			**660**	**969**	**9.6x**	**1.3x**	**12.5%**	**4.2%**
All peers (median)			**747**	**940**	**18.0x**	**1.3x**	**16.1%**	**5.1%**

Source: Bloomberg, Exotix Research

Risk factors

Upside risks to our investment view

Upside risks include:

1) *Faster volume expansion*
2) *Robust fee income growth*
3) *Cheaper funding mix*

Faster-than-forecast volume expansion. Stronger loan growth than our 12% pa forecast could come from a rebound in economic activity in Namibia and Uganda, where economic growth has slowed in recent years. Government reforms in Tanzania could also boost medium-term credit growth. Deposits could rise faster than expected if additional banking licenses are acquired across the group.

Robust fee income growth from partnerships. Letshego is transforming its business model to include partnerships with mobile network operators and fintech/ telecommunications companies, which could help grow the customer base. Combined with a more diverse product platform, rapid customer acquisition could result in higher fee income growth. We forecast c34% pa growth in fees through 2022.

Cheaper funding mix. Management is focused on adding new funding sources to complement existing medium-term notes in Botswana, South Africa and Ghana, and bank funding. Successful debt restructuring could result in lower-than-forecast borrowing as it could lower costs in these three countries. Further upside could come from a decline in deposit costs across Ghana and Nigeria, where inflation has been decelerating steadily.

Alternative sources of interim financing could come from local African listings beyond Botswana, and a potential London placement.

Downside risks

Downside risks include:

1) *Funding risk*
2) *Margin declines*
3) *Political risk*

Execution risk. The challenge of effectively managing operations across 11 markets remains a key issue for Letshego. Cost overruns, implementation delays and/or an inability to properly integrate multinational operations could negatively impact the bottom line. Future expansion into new markets could further increase business complexity.

Funding risk. Failure to extend the debt maturity profile by refinancing existing loans could put pressure on the balance sheet and constrain asset growth. Higher inflation rates would also increase the cost of floating debt and, by extension, raise funding costs, given the sizeable reliance on wholesale funding. Lastly, muted deposit growth would necessitate a continued dependence on more expensive debt funding to grow the loan book.

Funding could also become more expensive if some of Letshego's existing commercial bank funders choose to stop or reduce lending to Letshego.

Margin declines in an increasingly competitive environment. Competitive pricing on the core civil-servant lending portfolio could force loan yield compression to sustain growth in the borrower base. This could pressure asset yields, dragging them below our 2022 forecast of 32.3%.

Political risk. Near term, lending to civil servants is likely to remain the largest component of Letshego's business. Accordingly, government changes that result in layoffs within the public sector or restrict payroll deductions could drive unexpected asset quality deterioration. A slowdown in economic activity following elections could also hamper credit growth. We note upcoming general elections in Botswana, Namibia, Mozambique and Nigeria in 2019.

Company profile

Letshego Holdings provides simple, appropriate and accessible consumer finance, microfinance and savings solutions to the financially under-served.

Letshego directly owns subsidiaries across 11 countries in Sub-Saharan Africa.

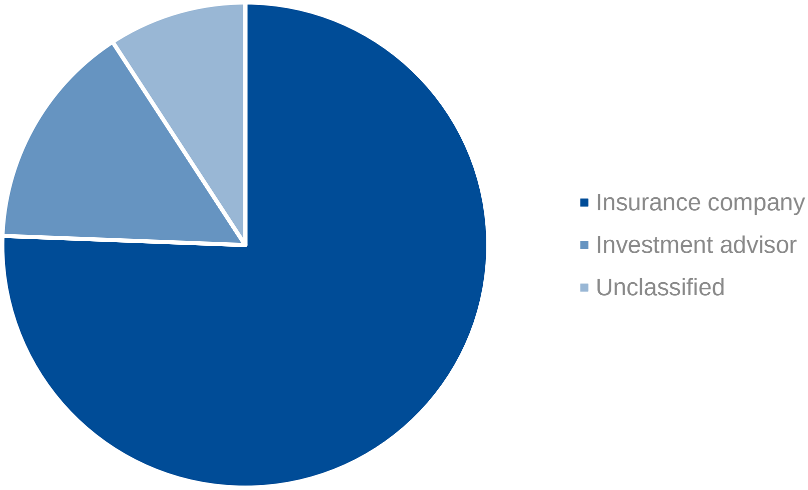
Background

Letshego was established in Botswana in 1998 and directly owns subsidiaries across 11 African countries. It employs 1,900 staff to serve 413,000 borrowers and 154,000 savers via 314 access points. Letshego Holdings is listed on the Botswana Stock Exchange and its Namibia subsidiary was recently listed on Namibia's Stock Exchange.

Shareholders

Key shareholders include Botswana Life Insurance Ltd (c26%) and Botswana Insurance Fund Management (c4%). Together, this mixture of international institutions and public-sector investors own c27% of shares outstanding. The free float stands at just over 73% of shares outstanding. As of 30 April 2018, the market capitalisation was US$404mn.

Figure 2: Ownership Structure



Source: Bloomberg

Board of Directors

The main Board of Directors consists of 12 members, 10 of whom are non-executive. As of 2016, 18 independent non-executive director appointments were also made across the 11 subsidiaries.

Enos Banda is a non-executive director of the bank, and was appointed Chairman in 2016. He has several years of governance and board level experience across the private and public sectors. Mr Banda previously worked with the South African Electricity Regulator and Municipal Infrastructure Investment Unit of the government.

CEO Christopher Low also sits on the Board.

Other Board members bring a mixture of experience from the banking, legal, education, telecommunications and insurance sectors.

Table 3: Board of Directors

Name	Role	Industry/affiliations
Enos Banda	Chairman and Independent Non-Executive Director	Legal, investment banking South African National Electricity Regulator Municipal Infrastructure Investment Unit of the SA government
A Christopher M Low	Executive Director	Financial Services Arthur Andersen & Co Goldman Sachs
Stephen Price	Independent Non-Executive Director	Accounting Ernst & Young AXYS Corporate Advisory
Robert Thornton	Independent Non-Executive Director	Strategy, risk marketing and HR management Citibank SSB Bank Ltd
Josias De Kock	Independent Non-Executive Director	Accounting Premier Foods Sanlam Group
Gloria Somolekae	Independent Non-Executive Director	Academia Botswana Parliament Kellogg Foundation
Gaffar Hassam	Non-Executive Director	Accounting Botswana Insurance Holdings Limited (BIHL) PricewaterhouseCoopers
Hannington R. Karuhanga	Independent Non-Executive Director	Business, commodities trade Uganda Coffee Marketing Board Ltd Stanbic Bank Uganda
Gerrit Lodewyk Van Heerde	Non-Executive Director	Actuary Sanlam Group Botswana Insurance Holdings Limited
Idris Mohammed	Non-Executive Director	Financial Services WPA Inc. Goldman Sachs
Christian Van Schalkwyk	Independent Non-Executive Director	Accounting, banking, legal Capitec Bank Jan S De Villiers
Colm Patterson	Executive Director	Accounting PricewaterhouseCoopers

Source: Company filings

Table 3: Management team

Name	Job title	Board Membership	Description
Christopher M Low	Chief Executive Officer	Yes	Mr Low joined the group as CEO in 2013, and was appointed to the board in the same year. His 30 years of experience in the banking sector span several countries, in multinational financial institutions including Standard Chartered Bank, National Bank of Kuwait and Goldman Sachs.
Caren Robb	Deputy Group MD	No	Appointed as Deputy Group MD in 2017. Prior to this, she was Commercial Director for afb Ghana Plc, where she was responsible for setting up subsidiaries across Kenya, Zambia and Tanzania.
Colm Patterson	Chief Financial Officer	Yes	Appointed to the role in 2007, following 10 years at Pricewaterhouse Coopers. He has prior experience from McQuillan Kelly & Co and Green Isaacson & Co in Ireland.
Frederick Mmelesi	Group Head of Consumer Lending	No	Mr Mmelesi joined Letshego in 1999 as a Financial Administration Manager, and led Letshego Botswana as its longest-serving CEO.
James Wainaina	Head of Customer Experience	No	Mr Wainaina joined Letshego in 2015. His 24 years of experience in the retail and corporate sectors have included stints at MasterCard and NIC Group.
Tom Kocsis	Group Head of Micro Finance Banking	No	Has held his current role since 2014. Previously, he served as CEO of FINCA, a regulated microfinance institution, both in the Democratic Republic of Congo and Tanzania.

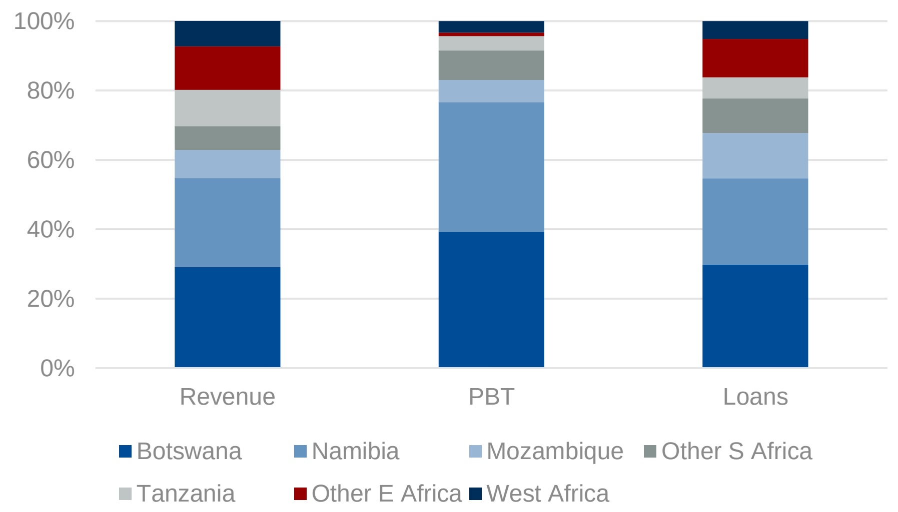
Source: Company filings

Business mix

Botswana and Namibia are the main contributors to group profit.

Despite accounting for 55% of total loans, Botswana and Namibia drove 75% of PBT in 2017 due to operating inefficiencies in the newer, smaller subsidiaries and disproportionately high, one-time impairment charges in Rwanda and Tanzania, where execution issues and political changes have negatively impacted the bottom line.

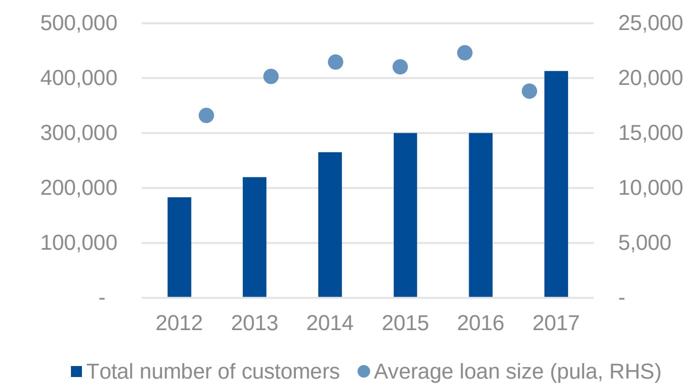
Figure 4: Operations mix (2017)



Source: Company filings, Exotix Research. Note: PBT split excludes negative contributions from the holding company.

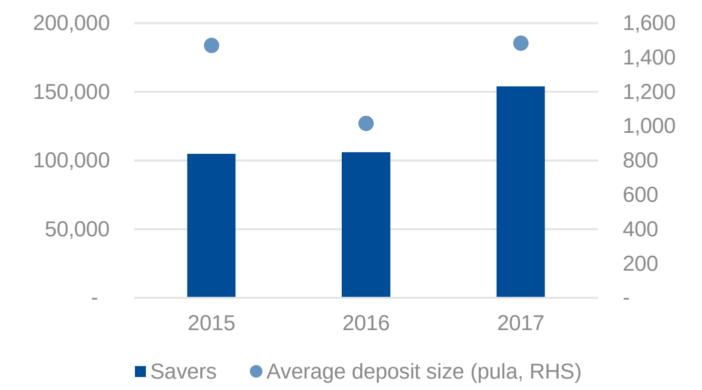
Average loan size declined in 2017, primarily due to inorganic customer acquisition in Ghana. Management has flagged it will pursue larger ticket loans, particularly in the formal and MSE sectors (schools, affordable housing). This could further drive expansion of the loan book.

Figure 5: Number of borrowers, average loan size (pula)



Source: Company filings, Exotix Research

Figure 6: Number of savers, average deposit size (pula)

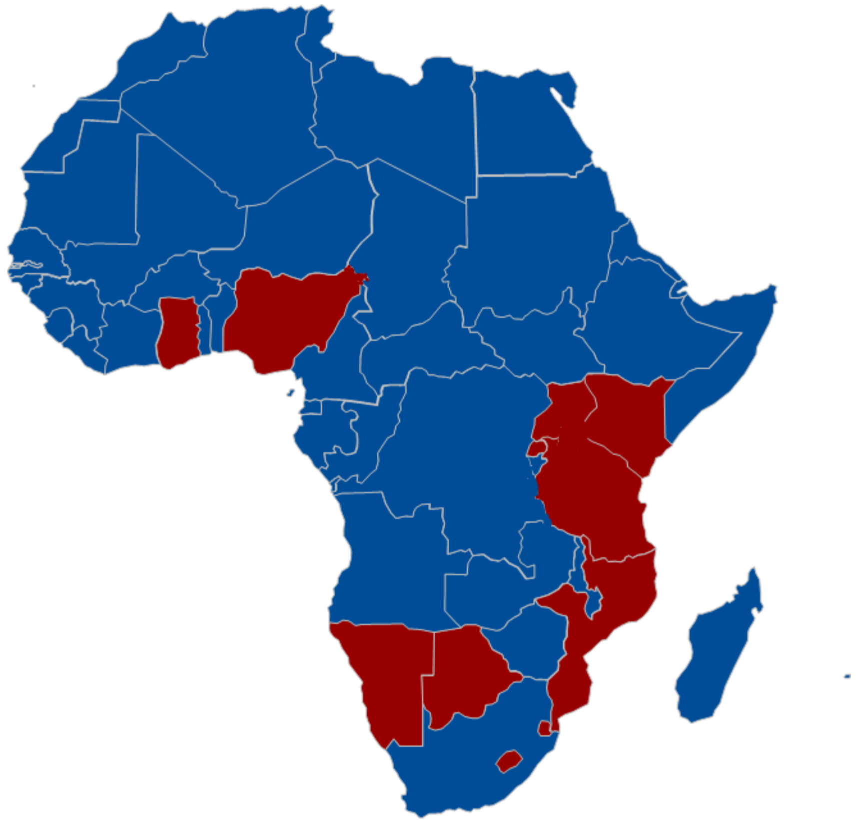


Source: Company filings, Exotix Research

Geographical mix

The group has subsidiaries across 11 African countries and has traditionally pursued greenfield expansion, with a few brownfield acquisitions to supplement growth. Most recently, Letshego acquired FBN Microfinance in Nigeria in 2016 and afb Ghana Plc in 2017. Management has stated there are no near-term plans to expand into additional markets but, medium term, will look to enter Zambia and Zimbabwe if attractive opportunities arise. Of its existing markets, management highlights Ghana, Nigeria and Kenya as the three biggest opportunities.

Figure 7: Sub-Saharan Africa geographical reach



Source: Company filings

Botswana

At 39% of group level PBT in December 2017, this subsidiary remains the key contributor to the bottom line (excluding negative contributions from the Holding Company). Botswana accounts for 30% of the total loan book. Intense competition from local banks within the country has pressured loan growth in the historically dominant government segment, leading the group to pursue expansion opportunities in non-government employee segments. The number of government-employed customers fell by 9% in 2017 and accounted for 71% of the total customer base at year-end (74% at end-2016).

Namibia

Letshego's second-largest subsidiary by loans (25% of the portfolio) generates 37% of group level PBT. Loan and deposit growth have been supported by aggressive sales efforts in recent years and the acquisition of a banking license in 2016. The subsidiary is one of six (including Ghana, Mozambique, Nigeria, Rwanda and Tanzania) with deposit-taking capabilities. In 2017, Letshego Namibia was listed on the stock exchange to partially satisfy Bank of Namibia licensing conditions. The group intends to fulfil the 45% local ownership target by 2020. Partial proceeds from the 2017 IPO were redistributed to shareholders as a special dividend.

Mozambique

The country accounts for 13% of total loans and has been a pilot location for LetsGo BlueBox, a technology-driven agency banking model. The number of agency channels grew by 495% in H2 17 to 131, driven by deployment of LetsGo BlueBox. Collections have also started to pick up as the government enforces automation of systems, which should aid deduction at source.

Tanzania

Tight liquidity conditions and political changes have generated declines in the loan book and operating income. Amid a challenging macroenvironment, management has switched focus in the country to cost savings, in order to support the bottom line. Tanzania accounts for 6% of the loan book and 4% of PBT.

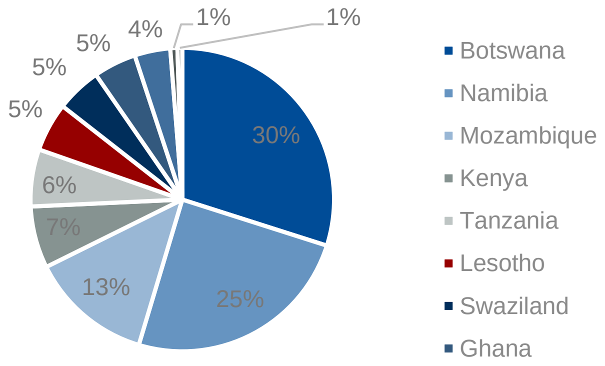
West Africa

Nigeria and Ghana (combined) currently make up c5% of the group's total loan portfolio and 3% of PBT, but management expects the two countries to become major contributors to the bottom line over time. Key growth drivers for Nigeria's balance sheet are agricultural, housing and education loans. For Ghana, technology offerings such as the SmartSave mobile wallet and a mobile loan joint venture with MTN Ghana should help drive growth. Subsidiaries within both countries are licensed to collect customer deposits.

Loan mix

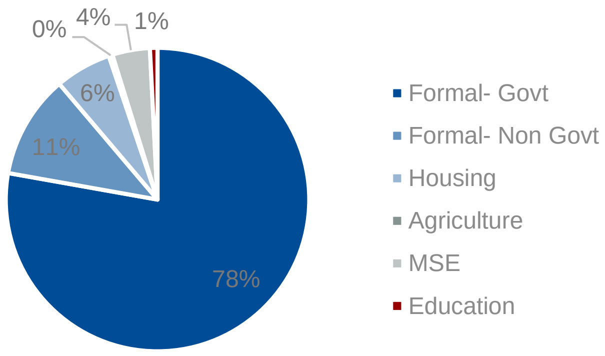
Lending has historically been concentrated in the formal government sector, which accounted for 78% of the loan portfolio in 2017. Management has stated it will focus on diversifying to non-government and MSEs in 2018 as government-lending growth decelerates across the group, with the intent to grow the weight of the loans from c11% to c25% of the portfolio over time.

Figure 8: Loan mix by country (2017)



Source: Company filings

Figure 9: Loan mix by type (2017)



Source: Company filings

Management strategy

Management's four key strategic pillars:

1) *Embrace financial inclusion*
2) *Grow the franchise*
3) *Enhance the customer experience*
4) *Embed future capability*

Management intends to leverage partnerships with several fintech and telecommunication companies (such as MobiCash and MTN) to broaden its domestic credit offerings across covered countries. Longer term, growth opportunities will come from potential acquisitions in neighbouring countries; a Zambia re-entry and opportunities in Zimbabwe were flagged as likely targets. Letshego envisions five markets becoming major contributors to earnings long term (Botswana, Namibia, Nigeria, Ghana and Mozambique).

Potential acquisitions will be evaluated as follows: 1) to support or grow inorganically in the markets where the group currently operates; 2) to obtain additional deposit-taking licenses; and 3) as entry into markets where Letshego is currently not present.

The four key pillars of Letshego's strategy are:

1) Embrace financial inclusion

Letshego seeks to promote financial inclusion by providing financing for agricultural, educational and affordable housing projects. The group also teaches financial literacy to customer segments in which it operates, to enhance productive use of funds and increase the probability of loan repayments.

2) Grow the franchise

Organic expansion (through partnerships and brand awareness) remains a key growth strategy for Letshego. Green and brownfield acquisitions since inception have also broadened the group's geographical reach across Sub-Saharan Africa. Most recently, the 2017 acquisition of afb Ghana Plc helped bring the group's total footprint to 11 African countries. Management has flagged Zambia and Zimbabwe as medium-term target countries for acquisitions.

3) Enhance the customer experience

Ease of access to customer offerings is ensured either physically, in the form of a wide range of access points, or through mobile offerings such as BlueBox, SmartSave and USSD financial services. Letshego also partners with mobile network operators (MNOs) and fintech companies, most recently MTN Ghana, to provide easily accessible products across a wide coverage.

4) Embedding future capability

The group invests heavily in technology and innovative solutions (third-party agency banking, mobile and internet banking) to increase product accessibility and customer satisfaction. Subsidiaries across the group have also been integrated into a standardised enterprise risk-management framework.

In our view, management has performed most strongly on the franchise growth and financial inclusion pillars, as evidenced by 18% pa average growth in the borrower base since 2010. Recent technology investments have also helped improve accessibility and the overall customer experience through additional access points and a broader agent base.

We believe that more could be done to improve customer integration across the numerous products that have been deployed, in order to drive revenue growth through cross-sales. Operating efficiency is another area that we think can be enhanced as management integrates new acquisitions.

Consumer finance industry overview

Letshego is well placed to benefit from the untapped potential in Sub-Saharan Africa by enabling financial inclusion through new technologies.

In its 2017 Global Findex database, the World Bank highlighted significant improvements in global financial inclusion trends, with a 7ppt increase (to 69%) in the share of adults owning an account since 2014. Sub-Saharan Africa continues to lag overall trends, with a mere 43% account penetration versus 95% in high-income economies and 63% in developing economies globally.

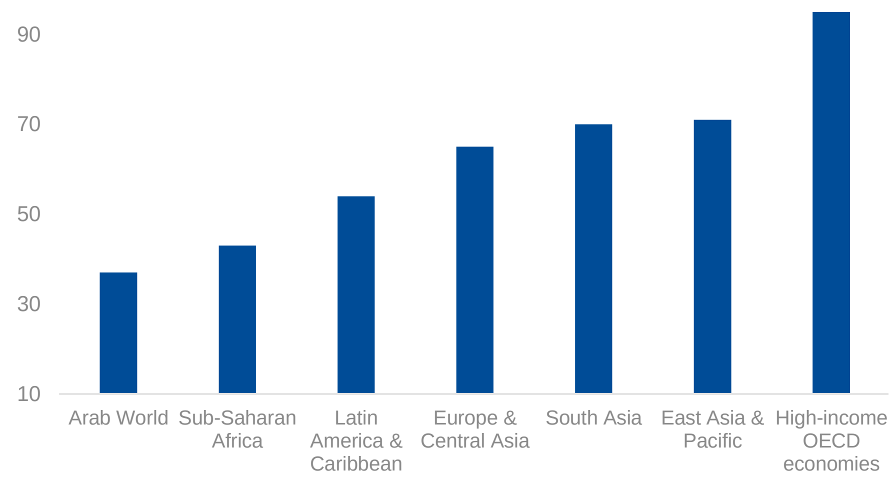
However, financial technology adoption has been most rapid in this region: 21% of adults in Sub-Saharan Africa now have mobile accounts (nearly double the level in 2014) and the highest of any region in the world.

Against this backdrop of largely untapped potential in Sub-Saharan Africa, we see opportunities for Letshego to continue to grow its franchise by enabling financial inclusion.

In contrast to other microfinance peers, Letshego has traditionally focused on deploying the deduction-at-source model to a predominantly government employee base. This model has helped keep credit quality strong, with the NPL ratio staying below 3%.

As management focuses on augmenting its government employee portfolio with non-government and MSE lending, the operating model could evolve, such that a growing portion of income comes from traditional microfinance lending.

Figure 10: Global bank account penetration (%)

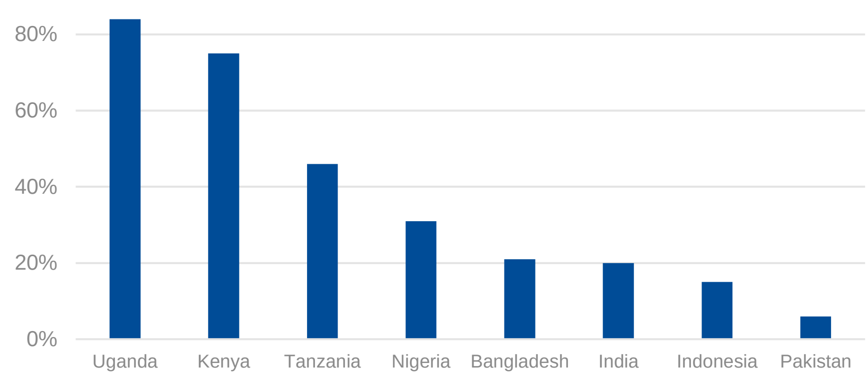


Source: CGAP, World Bank Findex 2017

Education remains a distinct barrier to rapid development in Sub-Saharan Africa, but the associated costs of funding often place a burden on low-income families. As an example, the Financial Diaries estimates the median amount of monthly income spent on education among rural households in Kenya at 18%, versus 11% for the broader population.

Notably, four of the countries in which Letshego has a presence (Uganda, Kenya, Tanzania and Nigeria; see Figure 11) have high proportions of their population that are unable to fund all or part of their schooling expenses. Providing funding for education is thus a key issue that Letshego can help resolve across its markets.

Figure 11: % of population that lacks funds to pay part or all of schooling costs



Source: CGAP

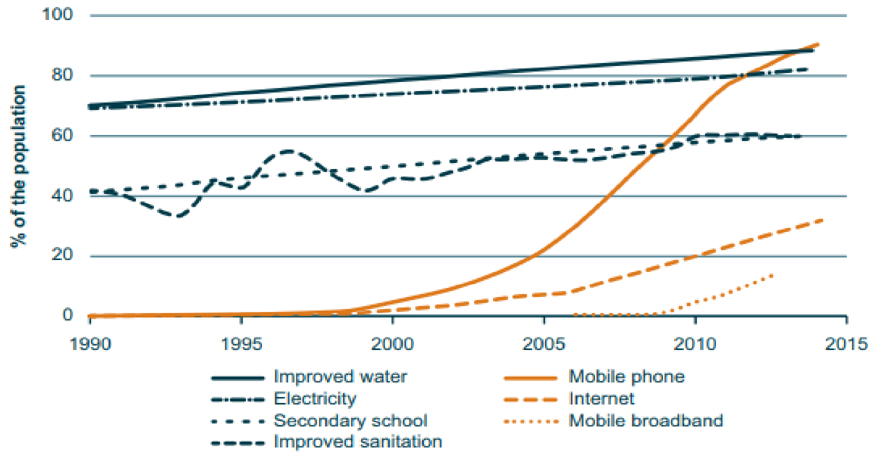
Mobile banking is the future

As mobile penetration has increased, technology-based transactions have cannibalised branch network usage. Recent CGAP research highlights the move from cash and other paper payments to card and electronic based payments within the industry, with 52% of adults globally (76% of account owners) having made or received at least one digital payment using their account in the past 12 months. In developing economies, 19% of adults (30% of account owners) utilised mobile money accounts, mobile phones or the internet for transactions in the past year.

Domestic remittances make up a significant portion of such financial transactions in Sub-Saharan Africa, with 45% of a sampled population reporting receipt or disbursement of such payments. Currently, the most commonly used modes of facilitating these transfers are through over-the-counter-services and mobile money operators. There is thus a sizeable market opportunity for consumer finance providers who can enable these remittances.

Letshego's push into technology-based transactions/remittances, coupled with its partnerships with MNOs and fintech companies, is clearly a step in the right direction, in our view.

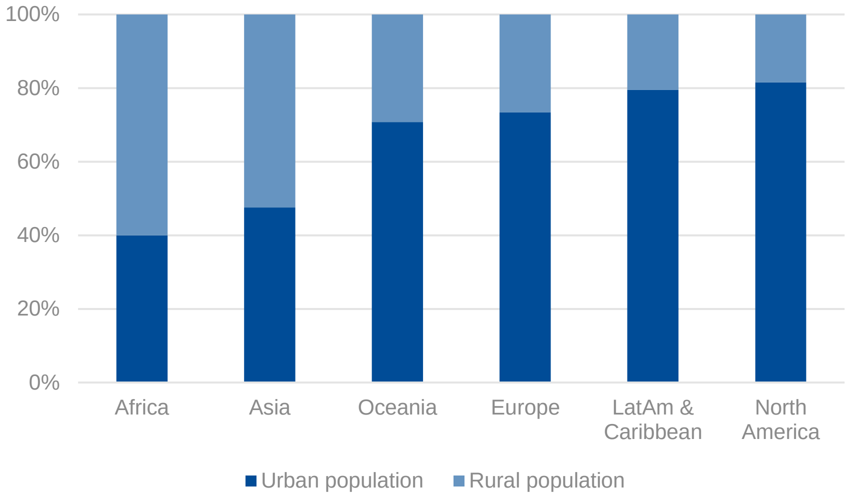
Figure 12: Percentage of the global population with access to select basic services (1990-2015)



Source: CGAP, World Bank 2016e

Lastly, Letshego's focus areas – agriculture, trade, education and affordable housing – clearly address urgent needs across rural Sub-Saharan Africa, where the bulk of the population lives.

Figure 13: Urban and rural population as a proportion of total population (1950-2050)



Source: CAP, UN 2014

Financial summary

Table 4: Letshego summary financials

BWPmn	2017f		2018f		2019f		2020f		2021f		2022f
Income statement											
Net interest income	1,782	14%	2,039	13%	2,312	15%	2,649	14%	3,012	12%	3,375
Other operating income	273	17%	320	16%	372	16%	431	15%	494	14%	563
Total operating income	2,055	15%	2,359	14%	2,684	15%	3,080	14%	3,506	12%	3,938
Operating expenses	814	13%	922	12%	1,037	12%	1,158	11%	1,285	11%	1,426
Pre-provision profit	1,241	16%	1,437	15%	1,648	17%	1,922	16%	2,221	13%	2,512
Loan loss provisions	237	23%	293	17%	342	34%	457	27%	580	16%	671
Net operating profit	1,004	14%	1,144	14%	1,306	12%	1,464	12%	1,641	12%	1,841
Pre-tax profit	1,004	14%	1,144	14%	1,306	12%	1,464	12%	1,641	12%	1,841
Net attributable income	638	18%	753	14%	862	13%	970	12%	1,091	13%	1,228
Balance sheet											
Net loans	7,769	15%	8,920	13%	10,119	13%	11,386	11%	12,604	10%	13,889
Interest-earning assets	7,822	15%	8,977	13%	10,178	12%	11,448	11%	12,669	10%	13,958
Total assets	8,961	14%	10,215	14%	11,594	13%	13,102	12%	14,674	12%	16,435
Total deposits	228	100%	457	75%	800	75%	1,399	50%	2,099	50%	3,148
Total interest-bearing liabilities	4,240	19%	5,037	18%	5,937	16%	6,910	16%	8,015	17%	9,349
Shareholders' funds	3,957	8%	4,293	9%	4,683	10%	5,128	10%	5,635	10%	6,211
Per share data											
EPS	0.292	20%	0.349	17%	0.408	14%	0.464	14%	0.527	14%	0.599
BVPS	1.807	12%	2.022	10%	2.229	11%	2.465	11%	2.736	11%	3.046
DPS	0.175	1%	0.176	16%	0.204	14%	0.232	14%	0.263	14%	0.300
Ratios											
Revenue generation											
Net interest margin	21.24%		21.26%		21.21%		21.46%		21.69%		21.70%
Revenues/assets	24.49%		24.60%		24.62%		24.94%		25.25%		25.32%
Gross asset yields	30.93%		31.15%		31.36%		31.68%		32.01%		32.34%
Gross funding costs	12.20%		12.53%		12.66%		12.14%		11.40%		10.76%
Operating efficiency											
Cost/income	39.6%		39.1%		38.6%		37.6%		36.7%		36.2%
Risk management											
Cost of risk	2.90%		3.10%		3.17%		3.74%		4.27%		4.46%
NPLs/gross loans	3.48%		4.01%		4.40%		4.93%		5.09%		5.46%
Loan provisions/NPLs	142%		139%		139%		139%		141%		140%
Profitability											
ROA	7.60%		7.85%		7.90%		7.85%		7.85%		7.89%
ROE	16.7%		18.3%		19.2%		19.8%		20.3%		20.7%
Effective tax rate	32%		30%		30%		30%		30%		30%
Dividend payout ratio	59%		50%		50%		50%		50%		50%
Effective payout (incl. buybacks)	65%		55%		55%		54%		54%		53%
Liquidity and solvency											
Debt/ equity	93%		98%		100%		98%		97%		92%
Shareholders' equity/assets	44%		42%		40%		39%		38%		38%

Source: Exotix Research

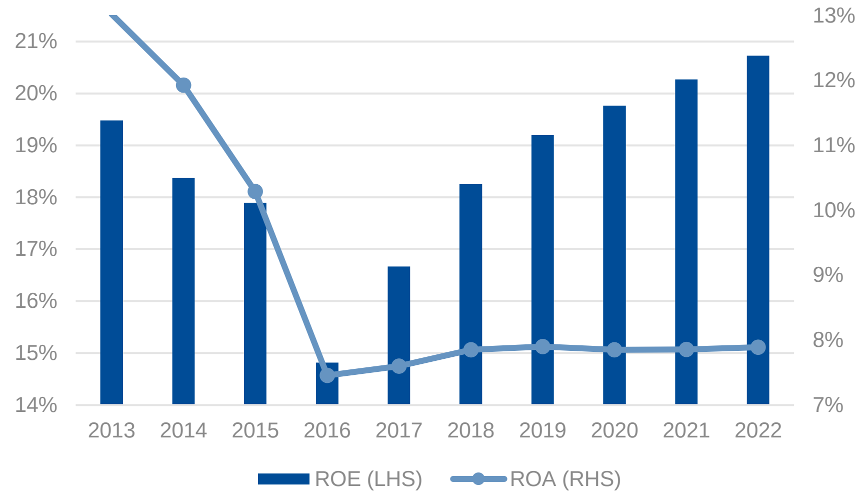
We expect stronger volumes, fee income and operating efficiency to be the primary drivers of earnings through 2022.

Outlook

Profitability

We expect ROE to increase to 20.6%, reflecting improved operating efficiency, stronger balance sheet volumes/fee income and share buybacks. ROA should remain at c7.8% over our forecast period.

Figure 14: Profitability metrics



Source: Exotix Research, Company data

Growth

Volumes

We forecast c12% average annual loan growth through 2022, which we expect to come from:

1. Mobile loan offerings;
2. Expansion of agent networks;
3. Customer acquisitions through partnerships and industry associations (such as cotton growers); and
4. Short-term low-value high-volume credit.

Average loan size declined in 2017, primarily due to inorganic customer acquisition in Ghana. Management has flagged it will pursue larger ticket loans, particularly in the formal and MSE sectors (schools, affordable housing). This could further drive expansion of the loan book.

Newly acquired deposit-taking licenses should facilitate 70% pa deposit growth through 2022, with potential upside from additional licenses.

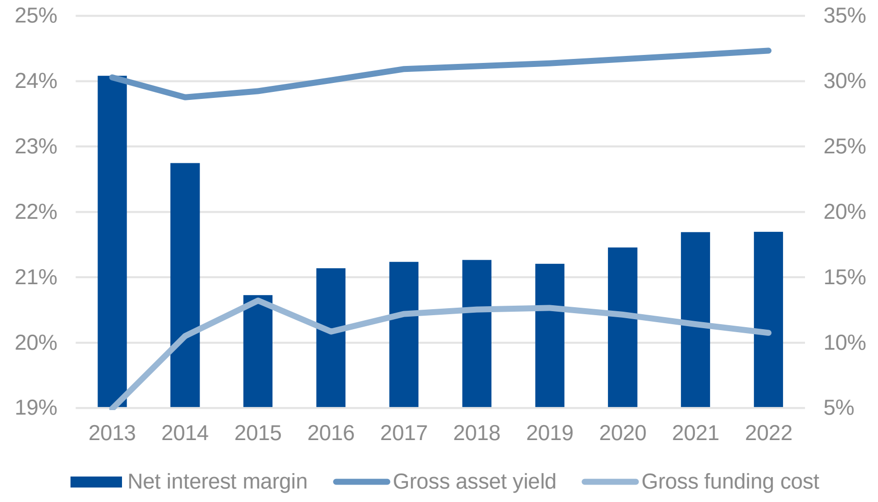
Margins

Lower funding costs from cheap deposit-gathering will reduce blended borrowing costs to 10.8% in 2022 from 12.2% in 2017. We assume customer deposit costs will decline by 125bps to 4.75% in 2022 from 6.0% as inflation in locations with deposit-taking licenses falls.

We expect deposits to account for c19% of total funding needs by 2022 (from c3% in 2017). Combined with higher yields on small-ticket credit and growth in traditional microfinance lending, we forecast a c80bps increase in the net interest margin by 2022.

Margins in 2018 and 2019 could decline slightly as management switches the external debt profile from secured to senior unsecured funding, raising the near-term cost of debt funding.

Figure 15: Margin drivers



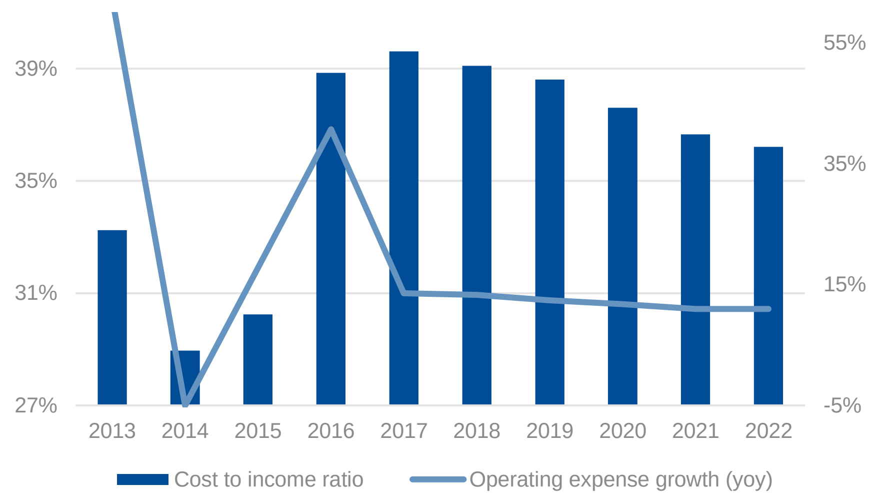
Source: Exotix Research, Company data

Operating efficiency

Following a period of cross-border investment in technology, customer acquisition, product enhancement, partnerships and agent expansion, we expect operating expense growth to moderate. Newly introduced products such as LetsGo BlueBox will help lower customer onboarding and transportation costs by enabling biometric authentication on tablet and SMART mobile phone-loaded software. In Ghana, mobile lending should cause agent-related expenses to decline, while partnerships with industry associations should support low-cost customer acquisition.

We expect operating expense growth to decline to c12% pa over our forecast period from c26% pa over the five years preceding 2017. Combined with 14% income growth, this should drive the cost-to-income ratio down to 36.2% by 2022 from 39.6% in 2017.

Figure 16: Operating expense trends

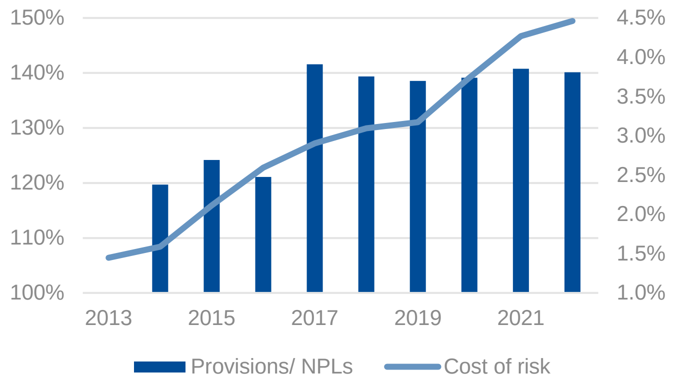


Source: Exotix Research

Asset quality

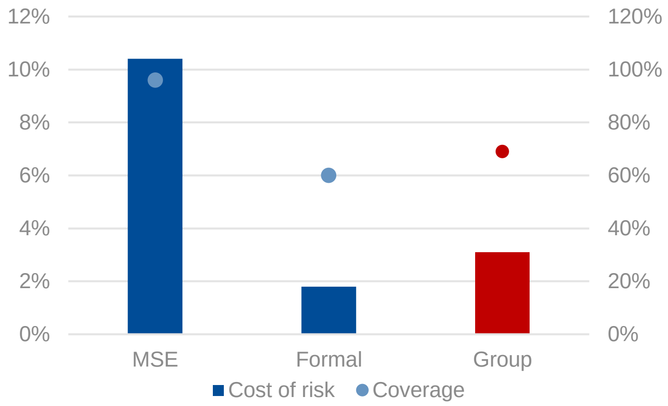
As management diversifies the portfolio composition away from predominantly civil-servant lending to non-government sectors including MSE lending, we expect asset quality to deteriorate given the difficulty with enforcing the deduction-at-source model in such sectors. Although the riskier borrower base might help prop up loan yields, it could also result in higher default rates and rising impairment costs. We expect the cost of risk to rise to 4.6% in 2022 (from 2.9% in 2017), largely on a riskier loan mix, but in part due to IFRS 9 implementation. Exotix loan provisions coverage of NPLs remains c140% over our forecast period.

Figure 17: Loans trends versus cost of risk



Source: Exotix Research, Company data

Figure 18: Asset quality by loan type (2017)



Source: Company filings

Taxes

Dividend distributions have served as a mechanism to manage capital across the group's broad country base. Accordingly, Letshego has set up a Mauritian holding company to leverage the double taxation treaty network that Mauritius has with several African countries in which Letshego is present. This entity will enhance tax efficiency by enabling a lower cost of withholding tax on dividends flows.

Capital structure

Less leveraged than peers, Letshego has room to increase its gearing.

Management is actively seeking to diversify its sources of funding.

External funding will remain a key component of liabilities over our forecast horizon as Letshego raises additional debt to reach its 100% internal debt-to-equity target. The group recently restructured its debt profile such that only c22% of debt is due before 2021, and we believe the extended maturity profile should allow the company to maintain a 50% dividend payout ratio and comfortably repay debt as it comes due.

Historically the bulk of funding came from local commercial banks, which would only undertake securities-backed lending. Letshego set up a security SPV to meet this requirement, allowing the banks to participate in the available securities at the time (receivables of Namibia (in part), Botswana and Swaziland). Going forward, management is actively working to complement secured debt with senior unsecured funding, which is likely to be more expensive near term.

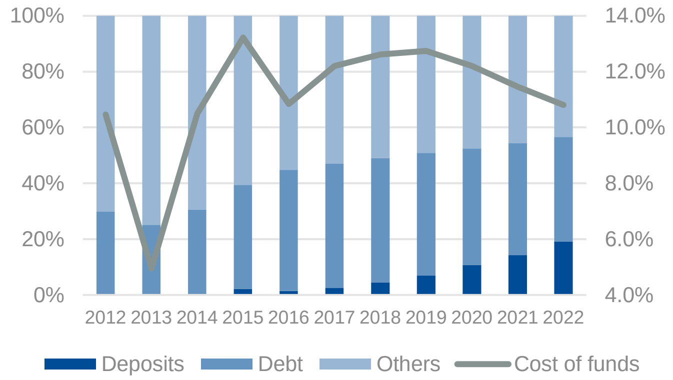
We assume external debt costs will rise to 13.65% by 2019 from 12.9% in 2017. However, as Letshego restructures its Ghana debt portfolio, we expect the cost of debt securities to decline by c20bps through 2022, in line with decelerating inflation and lower interest rates in Ghana.

Further efforts to reach the 100% gearing target include: 1) share buybacks (2.4% and 1% of shares outstanding in 2016 and 2017, respectively), and there is a commitment to seek shareholder approval to extend the buyback program at the May 2018 AGM; and 2) special dividends (such as the BWP4.1/sh in 2017 from proceeds of the Namibia IPO).

Our model assumes debt funding costs will rise to 13.5% by 2022 from an estimated 12.9% in 2017. New debt and a stronger deposit base will support c12% average annual loan growth over our forecast period; we believe management can generate enough cash to fund its 50% target dividend payout ratio, as well as 1% of share buybacks annually through 2022.

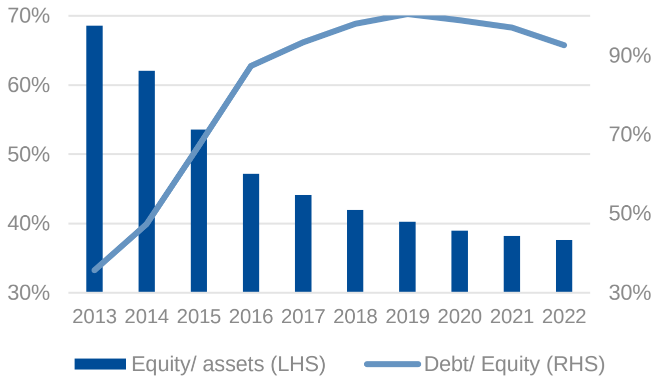
The buybacks over the period will further help propel ROE towards 21% (beneath management's 25% target) and should also translate into an effective dividend yield of 10.9% in 2018.

Figure 19: Funding sources (2013-22f)



Source: Company filings, Exotix Research. Note: "Others" includes shareholders' equity

Figure 20: Debt levels and leverage ratio (2013-22f)



Source: Exotix Research

Alternative sources of interim financing could come from local African listings beyond Botswana, and a potential London placement. Our model does not include proceeds from equity issuances, which could provide upside through reduced funding costs.

Appendix – Product definitions

LetsGo BlueBox. A technology-driven agency banking model, provided “in a blue box” for ease of use and transport by third-party agents appointed by Letshego Mozambique. The product runs off a rechargeable solar-powered battery and tablet-/smartphone-enabled software allows agents to biometrically authenticate customers for onboarding and account opening.

Smartsave. Mobile savings solution rolled out in Ghana in 2017. The platform had 1,500 customers as of end-2017.

Qwikloans. Mobile lending solution with c46,000 customers as of end-2017.

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