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# Credit Opinion: Letshego Holdings Limited

Global Credit Research - 14 Aug 2012

*Gaborone, Botswana*

## Ratings

| Category | Moody's Rating |
|---|---|
| Outlook | Negative |
| Issuer Rating | Ba3 |
| ST Issuer Rating | NP |

## Contacts


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## Key Indicators

**Letshego Holdings Limited**

| | [1]2012 | 2011 | 2010 | 2009 |
|---|---|---|---|---|
| Total Managed Assets (BWP Million) | 3,212.7 | 2,430.2 | 1,915.4 | 1,401.0 |
| Total Managed Assets (USD Million) | 433.9 | 338.6 | 253.5 | 175.8 |
| Pretax Preprovision profits / Average Managed Assets | 26.77% | 30.64% | 33.49% | 22.71% |
| Net Income/ Average Managed Assets | 20.48% | 21.78% | 22.92% | 15.64% |
| ROE (NPATBUI / Avg. Equity) [2] | 28.74% | 30.57% | 37.73% | 32.84% |
| Short Term Debt / Total Debt % [3] | 38.60% | 24.04% | 33.13% | 56.74% |
| Tangible Common Equity / Tangible Managed Assets % [4] | 70.40% | 71.67% | 69.94% | 46.61% |
| Problem Loans/Gross Loans | 5.28% | 1.42% | 3.00% | 2.15% |
| Problem Loans/(Shareholder Equity+ Loan Loss Reserve) | 7.07% | 1.87% | 3.75% | 4.25% |
| Net Charge-offs / Average Gross Loans & Leases | 1.96% | 1.60% | 2.77% | 1.44% |

[1] For the fiscal year ending January 31, 2012 [2] NPATBUI refers to net profit (loss) after-tax before unusual items [3] Short term debt refers to short term borrowings as reported by the company [4] Tangible managed assets are assets including loan loss reserves, less intangible assets

## Opinion

### Rating Rationale

The Ba3 issuer ratings of Letshego Holdings Limited (Letshego) reflects its well established niche franchise (particularly in Botswana), although in our view this remains vulnerable to increased competition and changes in the regulatory and legal environment. With regards to the latter, we have a negative outlook on the ratings which reflects the ongoing risk that in Botswana the government may cease facilitating the payroll deduction model. Further, the company has a concentrated and narrow wholesale funding base, although the company's planned medium-term note program may help broaden and diversify its funding sources.

Positively, good profitability (net income-to-average assets stood at 20.5%, based on the issuer's FY2012 results, supported by high margins and good efficiency) and solid capitalisation buffers (tangible common equity-to-tangible managed assets of 70% based on the issuer's FY2012 results), provide the company a good buffer to face any adverse changes to the competitive environment and its current business model.

No external support has been imputed in Letshego's ratings and the Ba3 rating reflects the standalone credit profile of the company.

### Rating Drivers

- Established niche, but narrow and potentially vulnerable, franchise

- Concentrated and narrow funding base

- Regulatory and legal framework remains vulnerable to changes in Botswana and elsewhere, with potential higher credit and operating costs in Botswana as a result of any imposed change in its loan repayment collections model

- Good profitability (supported by high margins and good efficiency) and solid capitalisation buffers (with low overall leverage), that provide a good buffer for the company to meet any adverse changes to its current business model

### Rating Outlook

The outlook on the company's long-term issuer rating is negative which reflects the ongoing risk that in Botswana the government may cease facilitating Letshego's payroll deduction model.

### What Could Change the Rating - Up

There is currently limited upward pressure on Letshego's rating given the negative outlook.

An eventual upgrade on the company's ratings would depend on Letshego maintaining strong financial performance (profitability, asset quality and capitalisation), together with evidence that its funding profile has been considerably diversified while achieving significant growth in its size and franchise.

In the longer term, positive rating pressure could result if Letshego successfully develops banking operations as this will likely help (i) diversify its funding profile, (ii) strengthen its overall franchise, and (iii) enhance the regulatory and supervisory framework.

### What Could Change the Rating - Down

Negative rating pressure could result if the government decides to cease facilitating the deduction at source, of loans and other repayments from public sector employees' wages. This is expected to lead to a sudden rise in bad debts and impairment costs, and an onerous change in its operating model with operational challenges in implementing a new collections mechanism (the company maintains direct debit agreements with all customers). Letshego's ratings will likely be downgraded if some of the company's financial metrics -- profitability, asset quality and capitalisation -- were to deteriorate to levels below those of similarly rated peers, as a result.

Additionally, negative rating pressure would be exerted following evidence that its operational capacity has been limited by an inability to access wholesale funding. Such inability could be expressed by a reduction in asset size or increased funding costs.

## DETAILED RATING CONSIDERATIONS

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

Franchise Value

Letshego is a successful niche consumer finance company operating in sub-Saharan Africa (Botswana, Namibia, Tanzania, Mozambique, Swaziland, Uganda, Zambia and Kenya), offering short to medium-term, unsecured loans primarily to government and quasi government employees (over 98% of the company's clients). The company is a leading brand name in its niche within Botswana (accounting for two thirds of the loan book and of pre-tax profits). In Botswana it lends to around 30% of all government employees (based on the issuer's FY2012 annual report), benefiting from a quick and efficient loan-approval and disbursement process, whereby a loan can be disbursed within two days or less, a shorter period than banks. We expect the company's market shares to weaken slightly in Botswana, as part of a conscious decision by the company to reduce its exposure to government employees potentially more vulnerable to the government's announced intention to reduce public sector employees by 5% over the next three years.

Weighing on our assessment is our view that its franchise strength is potentially vulnerable to increased competition and regulatory changes due to the combination of (i) the monoline nature of its operations with a reliance on a single product offering and the payroll deduction model, (ii) the ongoing risk of changes to the regulatory and legal environment where the company operates in, (iii) the low barriers to entry to its main markets, and (iv) its small scale in absolute terms (with total assets of BWP 3,213 million ($434 million) and net profit BWP 578 million ($78 million) at based on the issuer's FY2012 results). While the current payroll deduction model in place -- facilitated via electronic collections through a Central Registry - mitigates potential repayment risk as it allows the Group to receive monthly loan repayments directly from the employer (mainly the government), the negative outlook on the ratings reflects the ongoing risk that in Botswana the government may cease facilitating these payroll deductions.

With short-term franchise growth opportunities within Botswana becoming limited and interest yields more competitive, the company is looking to strengthen its regional expansion. While its geographical diversification outside Botswana provides some operating diversification, the company needs to further strengthen its regional market position and franchise sustainability before we assign a higher benefit. At the moment, the company may be vulnerable to high unexpected losses in other Sub-Saharan markets due to (i) the potentially risky operating environment, (ii) the rapid growth within its regional loan portfolio (with a compounded annual growth rate of 49% over the past two years), and (iii) combined with its inexperience in some of the new markets.

Letshego will also be seeking to acquire banking licenses in the major markets where it operates in. Longer term this will allow the company to form banking relationships with its existing clients, acquiring retail deposits and having direct access to customer salaries. We believe that, in the longer term, this could help address some of our concerns above by strengthening its overall franchise, making it more defendable and less dependent on a single product offering and the source deduction code. It will also provide a cheaper and stable source of funding to further grow its regional franchises. At the moment, a key constraint to Letshego's growth and franchise development is the availability of affordable regional wholesale funding.

Funding and Liquidity

Funding and liquidity management is a key challenge for Letshego. The company has a concentrated and narrow wholesale funding base, although the company's planned medium-term note program may help broaden and diversify its funding sources. That said, at the moment non-equity funding accounts for a relatively small 25% of total assets given the company's strong capital position.

We believe that there is a need for further diversification of Letshego's funding base, strengthening its short term liquidity and lengthening of its duration to better match the duration of assets. Funding is generated from around ten institutions: (i) asset management and insurance companies, at 55% of total, (ii) banks, at 31% of total, and (iii) International Financial Institutions, at 14% of total. Funding by asset management and insurance companies is mostly unsecured with bank funding mostly secured. In total 26% of funding is secured, while secured funding accounts for a relatively low 6.6% of total assets.

Competition from banks has lead to a lengthening in the tenure of loans, which are longer relative to its international peers, at around 50 months; longer tenured loans also carry increased repayment risk. At the same time, the company holds a limited amount of short term cash accounting for a low 13.6%. Under a stress scenario where market funding is disrupted the company thus relies on monthly loan repayments to be able to repay all of its funding which we believe it can do within five to six months. Under this stress scenario we estimate that Letshego will need to cut back as much as 50% of new lending in order to refinance maturing obligations over the next 24 months, which means the company will not be able to grow its loan portfolio by more than 10%.

Risk Management and Asset Quality

Although the company extends credit with very high intrinsic risk, unsecured loans to low-income individuals, credit costs have historically been maintained at a relatively low 2%-3% of the total portfolio per annum, which can be partly attributed to its payroll deduction model. The company does not have any sophisticated underwriting standards, but approves loans to formally employed clients based on its own affordability criteria, as long as Letshego has negotiated a salary deduction code with the employer. The deduction at source is facilitated through a central register (CR), which combines all deductions from the government into one deduction code, and also checks that regulatory loan affordability requirements are adhered to. The existence of a CR reduces collections costs and improves collection statistics, although a CR is not currently in place in Mozambique, Tanzania, and Zambia.

The ratio of loan impairment charges-to-average loan book was 1.6% for fiscal year ended 2012, down from 1.9% in 2011 and 3.3% in 2010, based on the issuer's FY2011-12 results. The company maintains loan loss provisions by country based on historical performance which is on aggregate around 0.5% of gross loans. In cases where there is evidence of impairment (e.g., when the debtor loses his job), the company writes-off the loan. As such the company does not have any impaired loans. During FY2012, the company experienced a deterioration in the past due but not impaired loans which increased to 5.3% of gross loans at FYE2012, from 1.4% as at FYE2011, due to transient disruptions in the government payroll following the strikes that occurred last year.

A major potential risk for Letshego would be any regulation that would threaten the company's payroll-deduction model (as discussed above) or earnings generation through a cap on the effective interest rate at a low level. If Letshego's payroll deduction model is impaired in Botswana it will likely be faced with a sudden rise in bad debts and impairment costs, and an onerous change in operating model with operational challenges in implementing a new collections mechanism (the company maintains direct debit agreements with all customers) and higher operating expenses. Further, the company does not currently have any experience in developing underwriting standards that will allow it to manage the higher potential credit costs of alternative deduction models. We expect impairments to rise to over 10% of gross loans if its current payroll deduction model is impaired in Botswana. Such impairment levels are common in the unsecured lending market of South Africa, where no such payment mechanism is in place.

At the moment, the company is also exposed to high operational risk as accurate deductions need to be made for thousands of accounts under several different payroll systems. The company relies on its own systems and the systems of the CRs and local governments to accurately perform payroll deductions. Failure of these systems would lead to lower collection levels or incorrect deductions, which can lead to litigation against the company.

Letshego is also exposed to currency risk due to its operations in several countries. Letshego tries to use natural hedges, whenever possible, by borrowing in local currency for each country or rely on currency pegs where these exist. However, we estimate that a stress scenario of a 40% appreciation in the Botswana Pula would result in a decrease of its net foreign currency assets with more than a 50% impact on 2012 profitability or 17% of tangible common equity. Letshego has also a more modest exposure to interest-rate risk, as funding is floating whereas loans are fixed rate; although, the large margins allow for some room for interest-rate fluctuation.

Profitability and Capital Adequacy

Positively, good profitability and solid capitalisation buffers, provide the company a good buffer to face any adverse changes to the competitive environment and its current business model.

Letshego's historical profitability has been strong, supported by high margins and good efficiency. We expect profitability to remain at good levels, although interest yields will likely continue to trend downwards. Pre-provision income-to-average assets was 26.8% during FY2012 (FY2011: 30.6%) and net income-to-average assets was 20.5% (FY2011: 21.8%). The net interest margin was 30% (FY2011: 32%), with margins impacted by a lengthening in the tenure of loans with longer term loans having lower yields. The cost-to-income ratio stood at 24% during FY2012, from 19% during FY2012. Letshego benefits from a low cost structure, a result of most operations being centralised, and the fact that loan applications, approvals and disbursements are computerised.

With tangible common equity-to-total assets of 70% at FYE2012 (71% at FYE2011) the company is well capitalised. We expect however that capitalization will fall towards industry norms of around 30-40% as the company acquires more debt to finance its strong loan growth. Letshego has entered into a Pula denominated convertible loan agreement for $36 million with Development Partners International (DPI). DPI has the option to convert the loan into equity in April 2013, which if exercised will further support the company's equity base and growth.

Sources of Facts and Figures Cited in this Report

Annual Audited Financial Statements: 2010-2012; Annual Report: 2012; Moody's Investors Service estimates

Rating Methodology

The principal methodologies used in this rating were "Finance Company Global Rating Methodology" published in March 2012. Please see the Credit Policy page on www.moodys.com for a copy of these methodologies.

## Rating Factors

**Letshego Holdings Limited**

| Rating Factors | Aa/A | Baa | Ba | B | Caa | Historical View | | Forward View |
|---|---|---|---|---|---|---|---|---|
| **Non-Financial Factors** | | | | | | B | | B |
| **Factor: Franchise Value** | | | | | | B | | B |
| - Market Position and Sustainability | | | x | | | | | |
| - Operational Diversification | | | | x | | | | |
| **Factor: Risk Positioning** | | | | | | B | | B |
| - Potential Volatility of Assets/Cashflows | | | | x | | | | |
| - Governance and Management Quality | | | x | | | | | |
| - Risk Management | | | | x | | | | |
| - Key Relationship Concentrations | x | | | | | | | |
| - Liquidity Management | | | | x | | | | |
| **Factor: Operating Environment** [1] | | | | | | B | | B |
| - Economic Strength | | | x | | | | | |
| - Institutional Strength | | x | | | | | | |
| - Susceptibility to Event Risk | | x | | | | | | |
| **Financial Factors** | | | | | | Ba | | Ba |
| **Factor: Profitability** | | | | | | Aa/A | | Aa/A |
| - PPI / AMA | 30.30% | | | | | | | |
| - Net Income / AMA | 21.73% | | | | | | | |
| - Pre-tax Income Coefficient of Variation | | 20.74% | | | | | | |
| **Factor: Liquidity** | | | | | | B | | B |
| - 24 Month Coverage Ratio | | | | | 13.56% | | | |
| - Secured Debt / Gross Tangible Assets | 6.66% | | | | | | | |
| **Factor: Capital Adequacy** | | | | | | Aa/A | | Aa/A |
| Capital Bucket: Traditional Finance Company | | | | | | | | |
| - TCE / TMA | 69.72% | | | | | | | |
| **Factor: Asset Quality** | | | | | | Baa | | Ba |
| - Problem Loans / Gross Loans | | 1.78% | | | | | | |
| - Problem Loans / (Shareholders Equity + LLR) | 2.28% | | | | | | | |
| **Scorecard estimated stand-alone credit assessment:** | | | | | | Ba3 | | Ba3 |
| **Assigned stand-alone credit assessment:** | | | | | | | Ba3 | |

[1] Within the scorecard, the operating environment score will not exceed the weighted average of scores assigned to a firm's other non-financial factors.



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