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Credit Opinion: Letshego Holdings Limited

Global Credit Research - 02 Dec 2014

Gaborone, Botswana

Ratings

Category	Moody's Rating
Outlook	Stable
Issuer Rating	Ba3
ST Issuer Rating	NP

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Key Indicators

Letshego Holdings Limited

	[1]2013	2012	2011	2010	2009	2008
Total Managed Assets (BWP Million)	4,970.2	4,279.2	3,212.7	2,430.2	1,915.4	1,401.0
Total Managed Assets (USD Million)	540.5	538.6	404.4	305.9	241.1	176.3
Pretax Preprovision profits / Average Managed Assets	20.06%	23.40%	26.77%	30.64%	33.49%	22.71%
Net Income/ Average Managed Assets	14.13%	17.61%	20.48%	21.78%	22.92%	15.64%
ROE (NPATBUI / Avg. Equity) [2]	20.31%	26.15%	28.74%	30.57%	37.73%	32.84%
Short Term Debt / Total Debt % [3]	--	18.17%	38.60%	24.04%	31.98%	56.74%
Tangible Common Equity / Tangible Managed Assets % [4]	68.17%	64.33%	70.40%	71.67%	69.94%	46.61%
Problem Loans/Gross Loans	--	4.73%	5.28%	1.42%	3.00%	2.15%
Problem Loans/(Shareholder Equity+ Loan Loss Reserve)	--	5.70%	7.07%	1.87%	3.75%	4.25%
Net Charge-offs / Average Gross Loans & Leases	--	1.04%	1.96%	1.60%	2.77%	1.44%

[1] For the fiscal year ending January 31, 2014 [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/Not Prime issuer ratings assigned to Letshego Holdings Limited (Letshego) captures the company's strong, albeit declining, profitability (the net income-to-average assets ratio stood at 14.1% during the first six months of the fiscal year ending December 2014 - hereafter 1H FYE2014) and solid capitalisation (the tangible common equity-to-tangible managed assets ratio was 66%). These metrics provide the company with a solid buffer to absorb the negative effect of any adverse changes either in the competitive environment or in its current business model.

The ratings balance these strengths against Letshego's narrow business model, with a high reliance on payroll deductions for loan repayment collections, which exposes the company to potential regulatory and legal changes.

Although the company has also diversified and broadened its funding profile over the past few years, it remains dependent on market-sensitive wholesale funding. The company is also highly exposed to foreign exchange risk, although actions are being taken to reduce this by the end of the year.

Letshego aims to gradually increase its geographical footprint and reduce its overall dependence on payroll-based lending, by broadening its customer segments and products, and build broader financial services operations with deposit mobilisation capabilities. Although we acknowledge that the company's strategy to diversify its business model is credit positive over the long-term rating horizon, Letshego will need to adequately manage any new and increasing risks that materialise over the next 12-24 months.

The Ba3 issuer rating assigned to Letshego reflects its standalone credit profile. No external support has been imputed in Letshego's ratings given its limited importance to Botswana's payment system resulting from its small scale, and given that it does not have any material customer deposits.

Rating Drivers

- Established niche, but narrow franchise

- Although asset quality is currently sound, Letshego remains exposed to potential adverse regulatory and legal changes that would lead to higher credit and operating costs

- Reliance on wholesale market funding; although the company has diversified and broadened its funding profile

- Good profitability and solid capitalisation that provide a good buffer for the company to meet any adverse changes to its current business model

- High exposure to foreign exchange risk

Rating Outlook

The company's ratings carry a stable outlook.

What Could Change the Rating - Up

An upgrade on the company's ratings would depend on Letshego successfully developing broader African financial services operations, while maintaining strong financial performance (profitability, asset quality and capitalisation). We expect these operations to help (1) diversify its funding profile; (2) strengthen its overall franchise; and (3) enhance the regulatory and supervisory framework.

What Could Change the Rating - Down

Negative rating pressure could be exerted on Letshego's ratings if regional authorities in the company's main operating markets impose restrictions on the deduction (at source) of loans and other repayments from the wages of public-sector employees, leading to a sharp rise in bad debts and impairment costs. In addition, negative pressure could be exerted on the ratings if (1) Letshego's expansion in other sub-Saharan markets, client segments and products, results in any material weakening of asset quality and profitability metrics; or (2) Letshego's current sound capitalisation metrics were to materially weaken.

DETAILED RATING CONSIDERATIONS

ESTABLISHED NICHE, BUT NARROW FRANCHISE

Letshego is a successful niche consumer finance company operating in 10 sub-Saharan African countries (including Botswana, Namibia, Mozambique, Tanzania). Although the company is becoming increasingly diversified across geographies, it remains highly reliant on a narrow payroll-based lending product offering and payroll deduction model, whereby it grants unsecured loans primarily to government and quasi-government employees. The company has a strong niche franchise within Botswana (where it offers payroll loans to around 21% of all government employees) and Namibia (where it offers payroll loans to around 51% of all government employees), benefiting from a quick and efficient loan-approval and disbursement process. As of January 2014, operations in Botswana contributed 36% of revenue, Namibia 20%, Tanzania 14% (where Letshego offers payroll loans to around 8% of all government employees) and Mozambique 11% (where it offers payroll loans to around 12% of all government employees). None of the remaining markets contribute more than 5% of revenue, and Letshego generally exhibits a lower franchise sustainability given weaker brand name and market recognition compared to its more established markets like Botswana and Namibia.

Although we acknowledge that the company's strategy to diversify its business model is a long-term credit positive, the company will need to adequately manage any new and increasing risks that materialise over the next 12-24 months. Letshego's strategy is to become a pan-African broad-based financial institution, facilitated by recent acquisitions (i.e., Micro Africa Limited (renamed Letshego Kenya Limited) - a financial group based in Kenya specialising in small, medium-sized and micro enterprises and unsecured consumer lending, with regional operations in Rwanda, South Sudan and Uganda) and the gradual acquisition of banking licenses in several territories (it has a deposit-taking license in Mozambique and Rwanda and received a preliminary banking license in Namibia). This expansion will gradually reduce its overall dependence on payroll lending (by broadening customer segments and products) and support its deposit mobilisation capabilities. In the short term, however, the company needs to address the conditions which may lead to elevated credit losses - such as (1) higher country risks; and (2) its relative inexperience in these newer markets and product offerings.

ALTHOUGH ASSET QUALITY IS CURRENTLY SOUND, LETSHEGO REMAINS EXPOSED TO POTENTIAL ADVERSE REGULATORY AND LEGAL CHANGES THAT WOULD LEAD TO HIGHER CREDIT AND OPERATING COSTS

The majority of Letshego's loans are granted through its payroll deduction model, whereby loan repayments are taken directly from the employer (mainly the government) prior to the monthly salary being paid to employees. This process is facilitated through a Central Registry, which combines all deductions from the government and checks that loan companies adhere to regulatory loan affordability requirements. In addition to Letshego's policy of ensuring that borrowers (wherever possible) have credit insurance, this business model supports asset quality metrics, reduces collection costs and improves collection statistics. As a result, credit costs have historically been maintained at fairly low levels of 1%-3% per annum, with the loan impairment charges-to-average loan book ratio at 1.7% for 1H-FYE2014. On evidence of impairment (e.g., when a debtor becomes unemployed), the company writes-off the loan, resulting in a low level of impaired loans as a proportion of total loans. A Central Registry, however, is not in place in some of its important markets like Mozambique and Tanzania, while Letshego Kenya Limited's micro lending operations are characterised by higher credit costs (albeit compensated by higher margins).

Our central scenario does not envisage governments in Letshego's main operating markets unexpectedly ceasing to facilitate these payroll deductions. However, under such a stress scenario, Letshego will be faced with an onerous change in its operating model, a sudden and substantial rise in bad debts and impairment costs (to over 10% of gross loans) and materially higher operating expenses. In response to such changes, Letshego would need to implement new collection mechanisms (the company maintains direct debit agreements with all customers). Although we acknowledge Letshego's currently sound affordability criteria and the gradual strengthening of its risk management capabilities, the company has limited experience in developing underwriting models and implementing measures that will enable it to manage the higher potential credit costs of alternative deduction models. Letshego is also exposed to other regulatory risks such as a potential lower cap on the effective interest rate it can charge on loans, which will lead to lower earnings generation.

RELIANCE ON WHOLESALE MARKET FUNDING, ALTHOUGH THE COMPANY HAS DIVERSIFIED AND BROADENED ITS FUNDING PROFILE

While we acknowledge Letshego's funding improvements, the company continues to rely primarily on wholesale funding to support its activities, which remains a rating constraint given that this type of funding is inherently confidence-sensitive and vulnerable to disruption.

We note positively that over the past two years Letshego has diversified and lengthened its funding structure, and improved its liquidity and asset and liability maturity profile through (1) a Johannesburg Stock Exchange listed senior secured bond - denominated in South African rand (amounting to ZAR700 million: Botswana pula equivalent: BWP647 million) , and (2) senior unsecured bonds amounting to BWP350 million (listed on the Botswana Stock Exchange), out of which BWP300 million had maturities of at least 10 years. In addition, Letshego continues to broaden its funding profile by tapping an increasing number of local institutional investors and financial institutions, as well as development finance institutions. As mentioned above, the company also aims to gradually tap customer deposits, which has commenced in Mozambique and Rwanda.

SOLID PROFITABILITY AND CAPITALISATION BUFFERS

Letshego's profitability and capitalisation levels continue to underpin the current ratings, as they provide the company with a solid buffer to face any adverse changes both to the competitive environment and to its current business model. The company is well capitalised, as reflected in its tangible common equity-to-total assets ratio of 65% at 1H-FYE2014. As the company acquires more debt in order to finance its loan growth, we expect its capital levels to drop slightly; however, we believe that Letshego should continue to maintain a capitalisation level that is higher than industry norms, given its narrow product offering. A material drop in the capitalisation ratio could weigh on its current ratings.

We expect that profitability will also remain sound despite declining trends with lower, albeit still strong, loan yields, owing to lower interest rates and increasing competition, and a higher cost base as a consequence of the company's broader banking offering in certain markets. The pre-provision income-to-average assets ratio was 21% during 1H-FYE2014 and the net income-to-average assets ratio was 14%. The net interest margin was 25%, broadly stable over the past 18 months, but lower compared with 30% during FYE2012. Despite ongoing investment, the cost-to-income ratio remains strong at 28% during 1H-FYE2014.

HIGH EXPOSURE TO FOREIGN EXCHANGE RISK

Letshego has substantial currency risk exposure as a result of its regional operations, and we estimate that a severe stress scenario of a 40% appreciation in the Botswana pula would result in a decrease of its net foreign-currency assets, with around a 90% impact on last year's profitability or 21% of tangible common equity. We note positively that Letshego is taking steps to reduce its net foreign-currency position, which should lead to a lower exposure by the end of the year.

Letshego also has a moderate exposure to interest-rate risk because a portion of funding is floating rate, whereas all loans are fixed rate, although the large margins allow some room for interest-rate fluctuation.

SOURCE OF FACTS AND FIGURES CITED IN THIS REPORT

Unless noted otherwise, we have sourced data relating to system-wide trends and market shares from the central bank. Bank specific figures originate from banks' reports and Moody's Banking Financial Metrics. All figures are based on our own chart of account and may be adjusted for analytical purposes. Please refer to Moody's cross-sector rating methodology: "Financial Statement Adjustments in the Analysis of Financial Institutions", published on 19 December 2013.

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. Letshego's assigned rating is in line with the outcome of the Finance Company scorecard - as per the aforementioned methodology.

Rating Factors

Letshego Holdings Limited

Rating Factors	Aa/A	Baa	Ba	B	Caa	Historical View		Forward View
Non-Financial Factors						**B**		**B**
Factor: Franchise Positioning						**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						Baa		Baa
Factor: Profitability						Aa/A		Aa/A
- PPI / AMA	26.94%							
- Net Income / AMA	19.96%							
- Pre-tax Income Coefficient of Variation		35.39%						
Factor: Liquidity						Baa		Baa
- 24 Month Coverage Ratio		95.06%						
- Secured Debt / Gross Tangible Assets		18.15%						
Factor: Capital Adequacy						Aa/A		Aa/A
Capital Bucket: Traditional Finance Company								
- TCE / TMA	64.33%							
Factor: Asset Quality						Ba		Ba
- Problem Loans / Gross Loans			3.81%					
- Problem Loans / (Shareholders Equity + LLR)	4.88%							
Scorecard estimated stand-alone credit assessment:						Ba3		Ba3
Assigned Rating:							Ba3	

[1] Capped at B; The operating environment score will not exceed the weighted average of scores assigned to a firm's other non-financial factors.

This publication does not announce a credit rating action. For any credit ratings referenced in this publication, please see the ratings tab on the issuer/entity page on http://www.moodys.com for the most updated credit rating action information and rating history.

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