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22 June 2012

# Letshego Holding Limited (LETHEGO:BG): Maintain BUY on continued strong profitability

## Executive Summary

We maintain a BUY recommendation on Letshego based on a target price of BWP2.5 (previous BWP2.9), 65.3% above the current market price of BWP1.5. Despite developing headwinds, we estimate Letshego's profitability and earnings growth will continue to remain relatively strong – we estimate average ROE of 21.6% and 5-year CAGR in earnings of 12.2% between FY13 and FY17. However this will be a decline from Letshego's historical average ROE of 33.2% and CAGR of 39.2% between FY07 and FY12. We attribute the decline to two reasons:

1) Despite continued strong growth outside Botswana, we believe Letshego's loan portfolio in Botswana will decline by 2.5% in each of the next two financial years due to the Botswana government's decision to reduce 5% of the public sector workforce in each of the next three years. We estimate this will reduce the group's overall net loan growth to a CAGR of 14.2% from 47.8% between FY07 and FY12.
2) We believe Letshego's return on assets (19.7% in FY12) will continue to converge towards its Sub-Saharan African peer group range of 0-5% as the group makes a transition to a deposit taking institution. We believe competition amongst lenders should result in net interest margin continuing to decline while the cost-to-income ratio will increase as Letshego's investment spending (both on human and physical capital) remains elevated.

Nonetheless, despite the headwinds, profitability will continue to remain relatively strong and we therefore believe an upward rerating of Letshego's FY13 P/B of 1.1x is justified. Our target price of BWP2.5 (based on DDM) is 1.8x Letshego's FY13 NAV estimate of BWP1.4. We believe a multiple of 1.8x is fair for a company with an estimated average ROE of 21.6% (between FY13 and FY17) and cost of equity of 14%.

Moreover, we think Letshego's low balance sheet leverage (FY12 debt to equity ratio of 35.4%), strong internal capital generation (continued high ROE), steady funding pipeline and potential decline in loan growth could result in management increasing the dividend payout ratio in order to prevent cash building up on the balance sheet. We estimate management has to increase their payout ratio to 50% (from an average of 7.9% in the past three years) in order to maintain an optimum level of balance sheet leverage. Based on that, we estimate FY13 dividend yield of 10.8%.

We note that due to lack of sufficient information, we exclude Letshego's future expansion into new countries (such as Lesotho from this year and Rwanda, South Sudan and Kenya once the acquisition of Micro Africa is completed). Thus strong growth in any of the new countries may result in lower than estimated dividend payout ratio (as Letshego uses the profits to finance expansion). However the effect of lower dividend payout on our valuation will be offset by higher than forecast earnings growth (due to strong growth in new countries).

*The group is a Botswana based microfinance lender. It also has operations in a number of Sub-Saharan African countries viz Mozambique, Namibia, Swaziland, Tanzania, Uganda and Zambia and potentially Lesotho, Rwanda, Kenya and South Sudan by the end of the year. It's business focus is primarily lending to civil servants on a deduction at source model.*

*The company's financial results and presentations are available on www.letshego.com*

| **Exotix valuation as at 21 June 2012** | |
|---|---|
| **Recommendation** | **BUY** |
| **Target price (BWP)[1]** | **2.5** |
| **Forecast 2013 dividend yield (%)** | **10.8** |

### Key company information

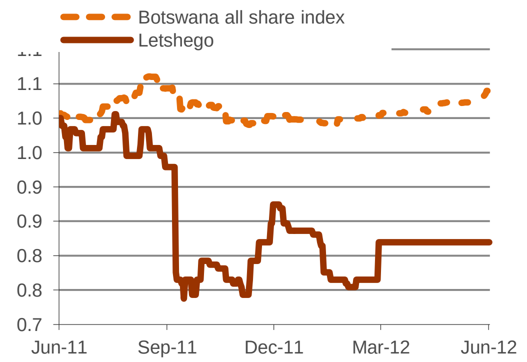
| | |
|---|---|
| **Country** | **Botswana** |
| **Market cap (US$mn)** | **386** |
| **Free float (%)** | **53.2** |
| **Share price as at 21 June 2012 (BWP)** | **1.5** |
| **Financial year end** | **January** |
| **Sector** | **Banking** |

### Market performance in BWP

| | |
|---|---|
| **YTD return (%)** | **(1.9)** |
| **3-month return (%)** | **0** |
| **1-yr return (%)** | **(18.0)** |
| **3M average trading volume, US$K** | **68** |

Source: Bloomberg, company filings,
from 3 stage dividend discount model

### Relative stock price and market performance




Source: Bloomberg

**Investment summary**

| BWPm/Jan year-end | FY12a | FY13f | FY14f |
|---|---|---|---|
| Net interest income | 835.1 | 1,020.5 | 1,156.2 |
| Operating expenses | (235.6) | (318.1) | (388.9) |
| Provisions | (44.1) | (65.1) | (73.8) |
| Profit before tax | 711.2 | 837.1 | 951.6 |
| EPS (BWP) | 0.28 | 0.30 | 0.31 |
| DPS (BWP) | 0.03 | 0.16 | 0.17 |
| PE ratio (x) | 5.2* | 4.9** | 4.6** |
| Price-to-book (x) | 1.3* | 1.1** | 0.9** |

Source: Company filings, Exotix estimates
* Based on year-end values, ** Based on current market prices

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.

## Is the dividend damn about to burst?

Being a non-deposit taking entity and entirely reliant on wholesale funding, Letshego has been very conservative since the onset of the global financial crisis in 2009; debt to equity ratio (D/E) has declined from 96.6% in FY09 (12 month period ending January 2009) to 28.9% in FY11 while cash dividend payout ratio dropped from 21.3% to zero within the same period (the company paid a scrip dividend in FY11 in order to crystallise a tax credit). The growth in lending portfolio over the period (up 71.2% to BWP3.0bn) has been mostly funded by shareholder funds (up 162% to BWP 1.7bn).

The most recent full year results indicate a reversal in the trend with debt to equity ratio increasing to 35.4% and the company resuming dividend payment (albeit at a very low payout ratio of 8.9%).

Our discussion with management indicates that it is confident of raising debt of between BWP400mn to BWP1,000mn in the next 12 to 18 months and would like to increase the company's D/E to the 50-60% range. In our base case scenario, we estimate the bank will struggle to significantly increase its leverage in the short term due to two reasons:

1) We assume Letshego's loan growth will slow down to a CAGR of 14.2% between FY13 and FY17 (from 47.8% between FY07 and FY12) due to potential disruption in its Botswana business – the government of Botswana has announced its intention to reduce the number of civil servants by 5% for each of the next three years. We therefore think Letshego's Botswana loan book will shrink in FY13 and FY14, level off in FY15 before starting to grow again from FY16 onwards. Therefore despite continued strong growth in its other subsidiaries, the group growth rate will decline as Botswana is the largest contributor to group loans (60% of total loans in FY12).
2) Strong equity accumulation in the short term: despite a potential decline in asset growth (in the short term – see above), we forecast Letshego's internal capital generation will remain strong due to continued high profitability (forecast average ROE of 21.6% between FY13 and FY17). Moreover, we think total equity capital in FY14 will be boosted by conversion of c.BWP250mn of debt (c.8.9% of Letshego's FY13f year total shareholder value) to equity.

The slowdown in asset growth leaves the management in a dilemma, in our opinion:

1) Should they remain conservative, not raise any new financing and continue to maintain a conservative D/E?
2) Or should they become more aggressive, continue to raise financing and increase balance sheet leverage?

Based on our assumptions, we believe Letshego's management will take a longer term view of Botswana. We therefore think management may increase dividend payout ratio in order to maintain a reasonable amount of balance sheet leverage – we assume they will increase their payout ratio to 50% throughout our forecast period. We acknowledge that a 50% payout ratio is very aggressive as historically the highest payout ratio it has ever paid was 25.4% (in FY08) and the average over the past three years 7.9%. Nonetheless, we justify our high payout ratio assumption due to the group's low current D/E and continued strong profitability despite potential decline in loan growth. If we are to assume a more moderate dividend payout ratio (say 25%) then based on our assumptions, we estimate Letshego will generate sufficient internal funds to repay most of its loans and D/E will decline to single digits. We think it is unlikely that management - having worked so hard to get the credit lines approved in the first place- will pay off the debt especially since growth outside Botswana remains strong and the disruption in Botswana is likely to be short term (maximum of three years).

Due to the uncertainty of the Botswana business (civil servant job cuts and potential removal of central registry) and the impact this could have on earnings growth and profitability (as it accounts for 60% of loan volumes), we provide a range of growth scenario's and the knock-on effect it could have on Letshego's leverage and dividend pay-out ratios. In each of the scenarios, we conclude that Letshego will have to increase its dividend payout ratio in order to maintain some of the credit lines and prevent cash building up on the balance sheet.

We review our profitability drivers in the sections below:

## Growth outside Botswana to remain strong

Loan growth in Letshego's subsidiaries outside Botswana continues to remain strong. Total portfolio size increased by 58.6% y/y in FY12 driven by continued strong growth in Namibia, a pickup of growth in Tanzania and strong performance by Mozambique in its maiden year.

Management expects growth in Namibia to remain strong as the company continues to gain market share from conservative commercial banks. Letshego expects the strong growth to sustain over the next two years before starting to normalise. We therefore forecast growth of 30% in FY13, declining gradually to 15% by FY17.

After two years of disappointing growth, Tanzania recorded growth of 59.8% in FY12. Management attributes the strong growth to two reasons: 1) the local regulator required Letshego to sign an agreement with each local district office before it can lend to public sector workers in that area. Letshego fulfilled this requirement in FY12, and 2) greater efficiency in collecting monthly payments resulted in improved cashflow and therefore increased confidence about disbursements. Thus management thinks FY12 was a "catch-up" year and going forward growth should remain fairly strong but not as strong as FY12. We therefore estimate loan growth of 30% in FY13, declining to 10% by FY17.

The performance of Mozambique in its first full year was above management expectation – gross loans increased from BWP79k in FY11 to BWP159.5mn, making it's the third largest subsidiary in the group (in terms of loan size) ahead of more established subsidiaries like Tanzania and Uganda. Management expects the strong growth to continue in FY13 due to a wider branch network – although the group had five operational branches by end of FY12, four of the branches were opened in December. Thus management expects growth to be driven by the four relatively new branches as well as five new branches it plans to open in FY13. We therefore estimate growth of 100% in FY13, declining gradually to 15% by FY17.

Management expects the consistent performance of its Uganda subsidiary to continue (loan book increased by 31.9% in FY12). We therefore estimate growth of 30% in FY13, declining to 15% by FY17.

Management remain conservative about the company's loan portfolio in Zambia and Swaziland. Over the past few years, Letshego's performance in Zambia has been hampered by local regulations limiting the term on Letshego's loans to two years while local commercial banks were able to provide five year loans, thus reducing Letshego's competitiveness. According to management, new regulations being introduced in Zambia (effective from 1 July 2012) should lift the limit on the tenor. However there is a possibility that the new regulations may limit the maximum lending rate on Letshego's loans. Thus management remain conservative about growth prospects in the country. In Swaziland, management remains concerned about the government's liquidity and therefore maintain a conservative stance. We therefore assume zero growth in each of the countries.

Overall, we forecast 5-year CAGR of loans outside Botswana of 23.7% and estimate they will contribute c.60% of total loan book by FY17 from c.40.0% in FY12 (based on our base case scenario for Botswana – see discussions below).

The table below summarises our growth assumptions outside Botswana.

| Loan book / BWP '000 | FY10a | FY11a | FY12a | FY13f | FY14f | FY15f | FY16f | FY17f |
|---|---|---|---|---|---|---|---|---|
| Swaziland | 148,974 | 172,269 | 148,091 | 148,091 | 148,091 | 148,091 | 148,091 | 148,091 |
| Tanzania | 144,402 | 149,691 | 239,265 | 311,045 | 388,806 | 466,567 | 536,552 | 590,207 |
| Uganda | 64,454 | 98,922 | 130,459 | 169,597 | 211,996 | 264,995 | 317,994 | 365,693 |
| Zambia | 37,034 | 11,587 | 9,355 | 9,355 | 9,355 | 9,355 | 9,355 | 9,355 |
| Namibia | 163,572 | 339,231 | 537,037 | 725,000 | 942,500 | 1,131,000 | 1,300,650 | 1,495,747 |
| Mozambique | 0 | 79 | 159,486 | 318,972 | 478,458 | 645,918 | 807,398 | 928,508 |

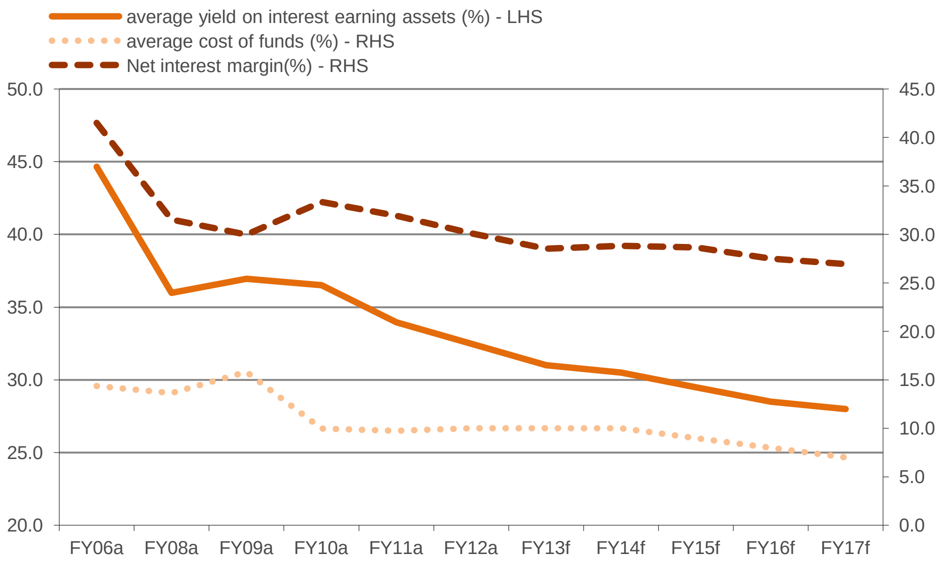
Source: Company annual reports, Exotix estimates

## Return on assets to continue declining as Letshego transitions to a deposit taking institution

Letshego's return on assets has continued to decline from a high of 27.6% in FY06 to 19.7% in FY12. Despite the sustained decline, Letshego's ROA remains far superior relative to its peers in Sub-Saharan Africa (ROA range for banks under our coverage is 0%-5%). As Letshego transitions into a deposit taking institution, we expect its ROA will continue trending down towards the peer group range - we forecast ROA to decline to 17% by FY17.

Letshego's net interest margin declined by 180bps y/y to 30.1% in FY12 due to a 150bps decline in average yield on assets to 32.5%. We forecast yield on assets to decline to 28.0% by FY17 due to increased competition from commercial banks. We assume, Letshego's average cost of funds will remain at 10% in FY13 and FY14 and thereafter gradually decline to 7.0% by FY17 as higher proportion of deposit funding reduces its funding costs. Based on our assumptions (and our base case scenario for Botswana), we estimate Letshego's NIM will decline to 28.5% in FY13 and 28.7% by FY15. Increased proportion of deposit funding from FY15 onwards, should mitigate further steep decline in NIM; we therefore estimate NIM of 27.5% in FY16 and 27.0% in FY17.

**Chart 1: Letshego net interest margin**

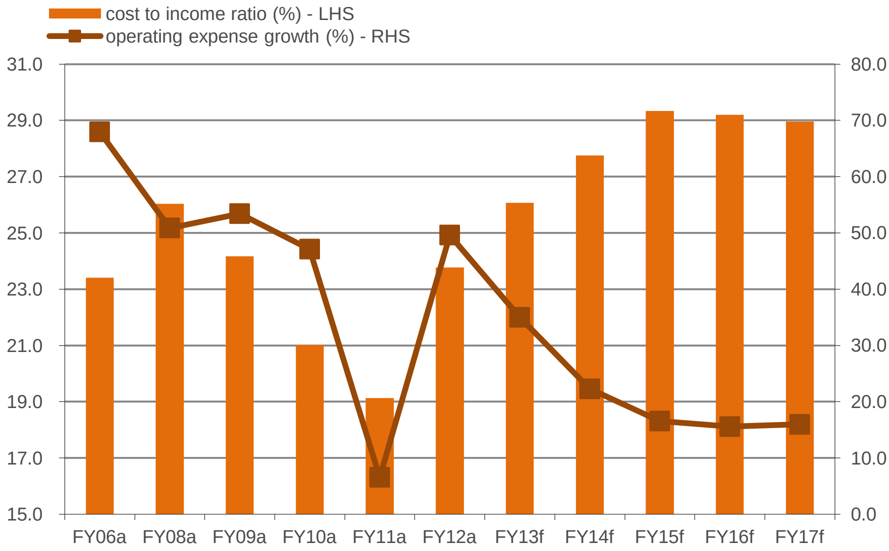



Source: Company annual reports, Exotix estimates

Similar to its NIM, Letshego's average cost to income ratio of 22.9% over the past six financial years is much lower than its Sub-Saharan Africa banking peers – range of CIR for banks under our coverage is 35%-80%. We attribute Letshego's superior efficiency to its business model – payroll lending to mostly government employees using wholesale funding. As a result, unlike banks, Letshego has been able to grow volumes by relying on fewer and cheaper locations – being non-deposit taking, it had a lower cost per branch and it did not require a large branch network to compete for deposits.

Letshego has a deposit taking license in Mozambique and has applied for deposit taking licenses in a few more countries in which it operates. Management expect to start collecting deposits in another twelve months – six months for regulatory approvals and a further six months to have the deposit taking infrastructure in place. We therefore expect operating expense growth will remain strong over the next two years due to increased investment by the company (both on human and physical capital) in order to become a deposit taking institution. Operating expense growth will also remain strong as the group continues to expand its branch network (especially in new subsidiaries like Mozambique). We therefore forecast operating expense growth of 35.0% and 22.3% in FY13 and FY14 respectively, normalising to an average of 16% from FY15 onwards. Based on our assumptions we forecast CIR will increase to 26.1% in FY13 and 28.9% by FY17.

**Chart 2: Letshego cost to income ratio**




Source: Company annual reports, Exotix estimates and forecasts

## Botswana remains key determinant of profitability

Given that it accounted for c.60% of the group's loan book in FY12, the performance of the Botswana subsidiary will be the key determinant of group profitability. According to management, the government of Botswana intends to reduce the civil servant workforce by 5.0% per annum in each of the next three years. We believe this will have a major impact on Letshego as 95% of its borrowers in Botswana are civil servants. As a result management has become very conservative in Botswana and does not expect the loan book to grow significantly (if at all). This will therefore affect Letshego's profitability in three different ways:

1) As mentioned above, Botswana remains the biggest contributor to group's loan book and a significant decline in loan growth (or outright decline) in Botswana will negatively impact overall group growth
2) Due to lack of redundancy insurance, Letshego's non-performing loans and cost of risk will be negatively impacted if any of its borrowers are made redundant
3) The growth in group's loans and profitability will be a key driver of balance sheet leverage, specifically it will determine whether management can achieve its target debt to equity ratio of 60%.

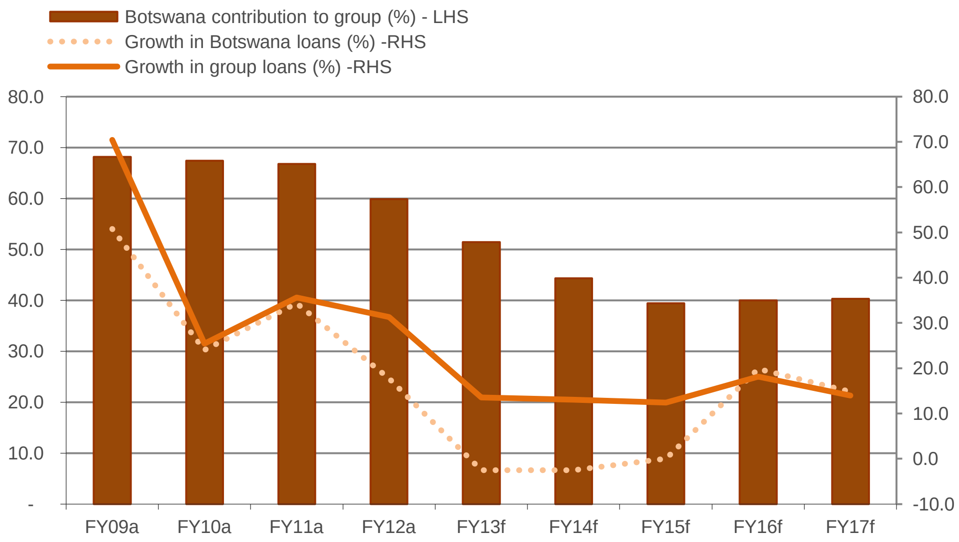
In the following sections, we present three different scenarios of loan growth in Botswana and the knock-on impact on group financing, profitability and investor payout.

### Scenario 1 (base case scenario): moderate decline in Botswana loan book in FY13 and FY14, management adopts an aggressive payout ratio to maintain a reasonable debt to equity ratio level

Our base case scenario is a marginal decline in Botswana loan book in FY13 and FY14 before a strong recovery in FY16 and FY17. Under this scenario, we estimate the 5-year CAGR in Botswana loan growth and overall group loan will decline to 5.5% and 14.2% from 31.1% and 39.7% respectively between FY08 and FY12. We believe the Botswana government's decision will have a negative impact on Letshego's business as 95% of its borrowers are civil servants. According to management, the loan book is concentrated amongst the core and vital civil servants like doctors, nurses, teachers, police and army. Management is optimistic that these civil servants will not be part of the job cuts but nonetheless would like to be more cautious until the government provides more clarity. We therefore think Letshego is unlikely to renew any maturing loans or disburse any new loans and therefore estimate the Botswana loan book will decline by 2.5% in each of the next two years. – we note that as at FY11, only 10% of Letshego's total assets had a maturity of less than 12 months while a further 20% had a maturity of between 1-3 years.

We believe the loan book will stabilise in FY15 and the pent up demand will result in strong growth in FY16 (estimate growth of 18.1%) and FY17 (estimate growth of +14.0%).

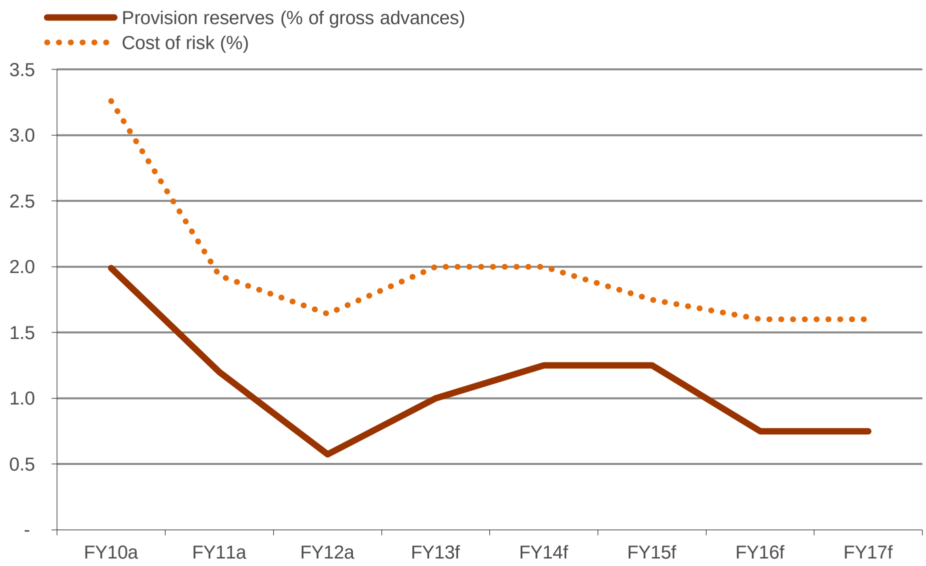
**Chart 3: Letshego Botswana growth assumptions**




Source: Company annual reports, Exotix estimates and forecasts

The government's move will also have a negative impact on Letshego's asset quality. Currently, Letshego's borrowers in Botswana do not have income protection insurance and therefore are likely to default if made redundant. We therefore believe Letshego's cost of risk and provision reserves will increase although increased management's conservatism should mitigate the rise. We therefore forecast cost of risk will increase to 2.0% in FY13 and FY14 (from 1.6% in FY12) before gradually declining to 1.6% by FY17. Similarly provision reserves (as a % of gross loans) will increase to 1% in FY13 (from 0.6% in FY12) and 1.3% in FY14 before gradually declining to 0.8% by FY17.

**Chart 4: Letshego group cost of risk and provision reserves**




Source: Company annual reports, Exotix estimates and forecasts

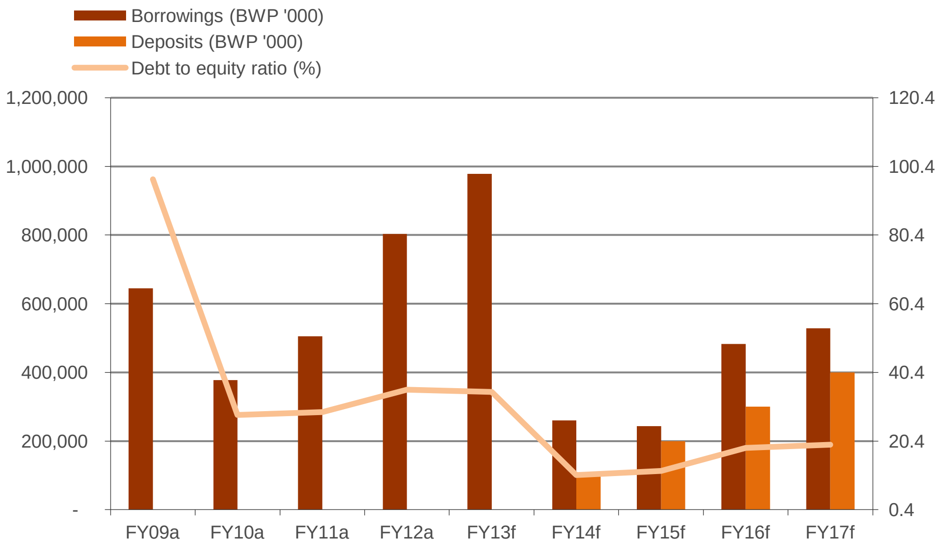
Lower asset growth combined with continued strong profitability will result in Letshego's balance sheet remaining underleveraged. As mentioned earlier, being entirely reliant on wholesale funding, Letshego became conservative after the global financial crisis by reducing the level of debt on its balance sheet and retaining a higher proportion of earnings – debt declined from BWP644.4mn in FY09 to BWP377.6mn in FY10 while dividend payout ratio declined to an average of 7.9% between FY10 and FY12 from 23.4% between FY08 and FY09. As a result, Letshego's D/E declined to 28.0% in FY10 from 96.6% in FY09.

The D/E rose to 28.9% in FY11 and 35.4% in FY12 as management became more confident about Letshego's funding sources. Our discussions with management indicate that it is confident it can raise additional funding of BWP400mn to BWP1,000mn in the next twelve months including a medium term note of BWP200-300mn on the Johannesburg Stock exchange. In addition, in the next twelve months, management expects to begin taking deposits in some of its subsidiaries. With the increased funding, management was intending to increase D/E to 60.0%.

Given our asset growth assumptions, we think management will be unable to reach its D/E target. Given the slowdown in Botswana we think management is unlikely to drawdown all the new credit lines. We estimate the aggregate debt level will increase in FY13 (to BWP978.6m) before declining in FY14 (to BWP259.9mn) and FY15 (BWP243.8mn). A significant drop in debt level in FY14 is driven by continued low asset growth as well the conversion of c.BWP250mn of debt to equity – we assume the sole private-equity bond holder will convert its stake to equity based on the conversion ratio of BWP 1.6/share and our NAV estimate of BWP1.6/share in FY14. Strong asset growth from FY15 onwards should result in aggregate debt level increasing to BWP482.7mn in FY16 and BWP528.4mn in FY17. In our funding assumptions, we also assume Letshego will raise deposits of BWP100mn in FY14, increasing by BWP100mn per annum thereafter.

Therefore, overall we estimate Letshego's D/E (including new deposit liabilities) will decline to 34.7% in FY13 and 10.5% by FY14 and thereafter increase to 19.4% by FY17.

**Chart 5: Letshego borrowing and D/E estimates**

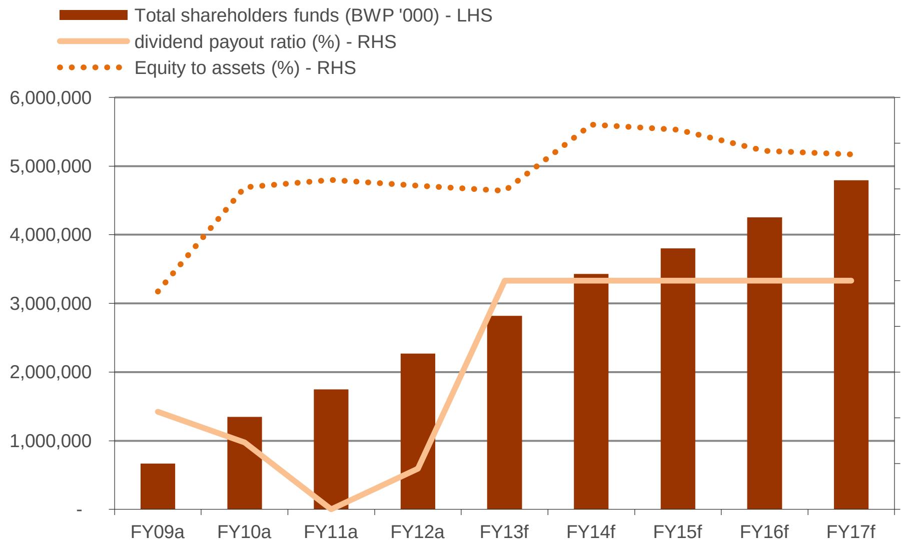



Source: Company annual reports, Exotix estimates and forecasts

Despite the slowdown in asset growth and decline in margins (lower NIM, higher CIR and higher cost of risk), we estimate Letshego's profitability will continue to remain strong (average ROE of 21.6% between FY13 and FY17). Therefore given the lower asset growth and continued strong internal capital generation as well as the potential debt conversion in FY14 (see discussion above), we believe Letshego will need to increase its dividend payout ratio in order to maintain a reasonable level of leverage on its balance sheet. In order to achieve the leverage assumed above, we estimate Letshego's payout ratio has to increase to 50.0%.

We acknowledge that the 50% assumption seems very aggressive relative to its historical maximum payout ratio of 25.4% in FY09 and average of 7.9% over the past three years. If we assume that the company continues to remain conservative and maintains a relatively low payout ratio (say 25%), based on our estimate of moderate loan growth combined and continued strong internal capital generation, we estimate the company will generate sufficient profits to pay off all its debt in the next three to four years. This will result in Letshego's D/E ratio declining to low single digits (assuming the company continues taking deposits as per our estimates above). We believe management is unlikely to pay off all the wholesale funding as it has worked very hard to get the credit lines approved. Moreover, we think management may take a longer term view of Botswana; we think it will want to maintain the existing credit lines with a view that loan growth in Botswana will eventually accelerate.

**Chart 6: Letshego dividend and shareholder equity estimates**




Source: Company annual reports, Exotix estimates and forecasts

Overall, based on our assumptions, we estimate five year earnings CAGR of 12.2% and ROE declining to 23.5% in FY13 (from 27.7% in FY12). We estimate the decline in ROE will continue in FY14 and FY15 (21.6% and 20.1% respectively) before recovering from FY16 onwards (20.9% and 21.9% respectively).

Based on our assumptions, we estimate a target price of BWP2.5 (including the debt conversion in FY14 we estimate a diluted target price BWP2.3).

### Scenario 2 (bull case scenario): continued strong growth in Botswana loan book and management adopts a very aggressive payout ratio, enabling it to achieve its debt to equity ratio target of 50-60%

In this case we assume Letshego's borrowers in Botswana are not affected by the job cuts and the group loan growth remains strong (see table below for our loan growth assumptions). In this scenario, we estimate 5-year group loan CAGR of 16.4%. Due to assumed "normal" loan growth in Botswana, we think the cost of risk would remain low. The strong loan growth would also allow management to increase D/E to the target range of 50-60%. In order to achieve this, we think management will have to increase the dividend payout ratio to 90% in the next two financial years before declining by ten percentage points per annum to 60% by FY17.

The table below summarises the key assumptions under this scenario:

| | FY11a | FY12a | FY13f | FY14f | FY15f | FY16f | FY17f |
|---|---|---|---|---|---|---|---|
| Botswana loan growth (%) | 34.4 | 17.7 | 10.6 | 10.9 | 10.0 | 9.9 | 9.9 |
| Group loan growth (%) | 35.6 | 31.3 | 21.4 | 19.4 | 16.1 | 13.6 | 11.8 |
| Cost of risk (%) | 1.9 | 1.6 | 1.5 | 1.5 | 1.5 | 1.5 | 1.5 |
| Provision reserves (% of gross advances) | 1.2 | 0.6 | 0.8 | 0.8 | 0.8 | 0.8 | 0.8 |
| Equity to assets ratio (%) | 72.0 | 70.7 | 65.9 | 70.6 | 63.1 | 59.3 | 58.6 |
| Debt to equity ratio (%) | 28.9 | 35.4 | 42.8 | 32.7 | 48.6 | 57.6 | 59.2 |
| Dividend payout ratio (%) | - | 8.9 | 90.0 | 90.0 | 80.0 | 70.0 | 60.0 |

Source: Company annual reports, Exotix estimates and forecasts

Under this scenario, our five year earnings CAGR improves to 13.8% while our average estimate ROE estimate increases to 25.8%. Also, our fair value estimate increases to BWP3.1 (diluted target price BWP2.9).

### Scenario 3 (bear case scenario): sharp fall in Botswana loan book and management maintains a conservative payout ratio, resulting in debt to equity ratio declining to single digits

Under this scenario, we assume a more drastic decline in Letshego's Botswana loan book – we assume it declines by 10% per annum for the next two financial years before stabilising in FY15 and growing strongly from FY16 onwards. This translates to five year CAGR in Letshego's

Botswana and group loan book of 1.1% and 12.4% respectively. We also assume, Letshego's cost of risk almost doubles to 3% in FY13 and FY14 before gradually declining to 1.5% by FY17.

Under this scenario, we assume management remains ultra conservative – it maintains a conservative dividend payout ratio and repays most of its wholesale debt. Under this scenario, we estimate the D/E ratio declines to 2.4 % by FY15 before gradually increasing to 4.0% by FY17.

The table below summarises the key assumptions under this scenario:

| | FY11a | FY12a | FY13f | FY14f | FY15f | FY16f | FY17f |
|---|---|---|---|---|---|---|---|
| Botswana loan growth (%) | 34.4 | 17.7 | -10.0 | -10.0 | -5.0 | 19.8 | 14.8 |
| Group loan growth (%) | 35.6 | 31.3 | 9.0 | 10.0 | 11.3 | 18.0 | 13.9 |
| Cost of risk (%) | 1.9 | 1.6 | 3.0 | 3.0 | 2.5 | 2.0 | 1.5 |
| Provision reserves (% of gross advances) | 1.2 | 0.6 | 1.3 | 1.5 | 1.3 | 1.0 | 0.8 |
| Equity to assets ratio (%) | 72.0 | 70.7 | 79.1 | 90.2 | 90.1 | 87.6 | 88.7 |
| Debt to equity ratio (%) | 28.9 | 35.4 | 17.3 | 2.4 | 2.4 | 5.3 | 4.0 |
| Dividend payout ratio (%) | - | 8.9 | 25.0 | 25.0 | 40.0 | 25.0 | 25.0 |

Source: Company annual reports, Exotix estimates and forecasts

We note that, despite the low loan growth estimates, our payout ratio assumption of 25% in FY13 and FY14 is higher than Letshego's payout ratio in FY11 and FY12. We explain this by the fact that despite the lower loan growth, Letshego internal capital generation remains relatively strong (ROE close to 20%). Thus a lower payout ratio would result in Letshego paying back most of its debt in the next two financial years and starting to accumulate unproductive cash on its balance sheet. We therefore think management would rather pay a higher dividend to shareholders than generate excess cash on its balance sheet.

Under this scenario, our 5-year earnings CAGR declines to 11.2% while our average ROE estimate declines to 19.2%. Our fair value under this scenario declines to BWP2.1 (diluted target price of BWP1.9)

## Investment conclusion

We note that even on our bear case scenario, the diluted valuation of BWP1.9 is 26.7% above the current market price of BWP1.5. Despite potential headwinds, we estimate the group's profitability (driven by high net interest margins and efficient operating cost structure) remains strong – even in our bear case scenario, the group's ROE declines to a low of 18.1% in FY15 before recovering to 19.6% by FY17. On the back of continued strong profitability, we believe the group's FY13 P/B of 1.1x (based on our base case scenario) looks attractive and an upward revaluation is justified. Our base case target price of BWP2.5 equates to 1.8x estimated FY12 book value – we think this valuation multiple is justified for a company with an estimated average ROE of 21.6% where the cost of equity is 14.0%. The revised price target is down from BWP2.94 previously primarily due to a change of methodology and earnings revisions.

# Valuation

## Methodology

We estimate the intrinsic value of the business by calculating the total present value of forecasted dividends, discounted at the cost of equity. Our model discounts dividends over a 10-year period ending 2022 (in two stages), and thereafter derives a value based on a perpetuity method under a long-term intrinsic growth assumption, as follows:

Stage 1 - between FY13 and FY17: dividends are estimated using our profitability drivers discussed in the previous sections.

Stage 2 - between FY18 and FY22: we assume earnings growth of 10.0% in FY17, declining by 0.5% per annum to 6.0% by FY22. We assume a payout ratio of 50% throughout the period.

Stage 3: - terminal growth rate of 5.0%.

## Other key valuation assumptions

- Risk free rate (%): 9.0
- Risk premium (%): 5.0
- Cost of equity (%): 14.0
- Beta: 1.0

The table below summarises our base case valuation for each bank:

| DDM Valuation (base case) | BWPmn |
|---|---|
| PV of dividends in Stage 1 | 1,402.2 |
| PV of dividends in Stage 2 | 1,164.8 |
| Terminal PV of dividends | 2,385.9 |
| **Total PV of dividends** | **4,952.9** |
| Shares in issues (m) | 1,998.6 |
| **Intrinsic value (BWP)** | **2.5** |
| Diluted shares in issue | 2,156.1 |
| Diluted intrinsic value (BWP) | 2.3 |

Source: Exotix estimates and calculations

## Key risks to our valuation

1) **Regulatory risk:** the biggest risk to our forecast is regulatory risk. Being a non-bank lending institution, Letshego does not come under the direct regulatory umbrella of central banks. However with the microfinance industry gradually growing across the region, there is a risk that local regulators could introduce new legislation that may disrupt Letshego's business model or make it less profitable. An example of this is the notice given by the government of Botswana in August 2011 to cease facilitating loan repayments by the central registry (a centralised payroll system used by the Botswana government to pay civil servants). This notice was put on hold in November 2011 pending a review process between the relevant stakeholders (government and civil servant unions who own the central registry). Given that Letshego relies on the central registry for 95% of its loan repayments, full implementation of the notice would have had a negative impact on its profitability – we think Letshego's operating costs would have increased as it would have to start reconciling collections from numerous direct debits rather than payments from one single source (the central registry). We believe Letshego's cost of risk would also have increased as financially constrained borrowers would be tempted to terminate their direct debit agreements and default on their repayments – they would be unable to do this when the repayments were deducted at source at the central registry. This would have reduced Letshego's profitability. Letshego's management believes the outcome of the review is unlikely to disrupt the central registry model – they believe the stakeholders may come to an amicable solution or government may form its own central registry.

2) **Execution risk:** as we mentioned above, we believe the next two financial years will be transition years for Letshego as it becomes a deposit taking institution. If managed well the transition will provide Letshego a more secure and cheaper source of funding which will enable the group to offer more competitive lending rates and mitigate the decline in NIM. At the same time poor execution could result in a significant increase in cost base without having a significant impact on their funding costs.

3) **Expansion:** Letshego continues to remain expansionary within the Sub-Saharan African region. Due to lack of information we do not include this in our forecasts. Most notably, we exclude the potential acquisition of Micro Africa Limited (MAL), a Kenyan company with operating subsidiaries in Uganda, South Sudan, Rwanda and an associated company in Tanzania. MAL provides secured and unsecured personal, SME and group loans. As at October 2011 MAL had a loan book of US$7.2mn (c. 1.8% of Letshego's FY12 loan book) and profit after tax for the 12 month period ending December 2010 was US$330k (c.0.5% of Letshego's FY11 attributable income). Thus the contribution of MAL to Letshego's assets or profits will be minimal. The purchase price was US$3.3mn for a 62.52% stake in MAL which had a net asset value of US$4.1mn as at June 2011 – we therefore estimate the purchase price to NAV ratio of 1.3x, slightly lower than Letshego's FY12 P/B of 1.4x (based on current prices). The acquisition will give Letshego access to three new markets – Rwanda, Kenya and South Sudan. Given the relatively high retail penetration rate in Kenya (relative to other SSA markets), we think management's main target with the MAL acquisition was South Sudan and Rwanda. Given the continued political turmoil in South Sudan, we think growth from that region will be moderate in the short term. Thus Rwanda is likely to be the main contributor to Letshego's asset growth in the short term. We therefore do not think that MAL will be a significant contributor to Letshego's growth or profits in the short term and do not include it in our forecasts.

   The company has also obtained regulatory approval to begin operations in Lesotho. Management expect to start lending in the country in the next 12 months. We are uncertain about the potential performance of Letshego - on the one hand it has a GDP of US$2.5bn (lowest amongst all the countries that Letshego operates in) and a population of 1.94mn (moderately higher than Swaziland and Botswana). On the other hand, Lesotho's per capita GDP of US$1,264 is higher than most of the East African countries as well as Mozambique (where Letshego has performed relatively well). Due to lack of further information, we do not include this in our forecasts.

   Overall, a strong performance in any of Letshego's new subsidiaries is an upside risk to our loan forecast. In which case, we think Letshego's dividend payout ratio could be lower than forecast (as management retain earnings to finance growth). However the lower payout ratio should be offset by higher than expected earnings performance.

# Botswana – country overview

## Politics

Botswana is one of Africa's most stable countries. Free and fair elections since independence in 1965 have helped confirm the stability and political maturity of Botswana. The Botswana Democratic Party (BDP) is the dominant party retaining its healthy majority in 2009 parliamentary elections. Significant power is also vested in the president, who is elected by parliament for a five-year term. Current President Ian Khama, the son of Botswana's first post-independence leader, Seretse Khama, is the country's fourth president. He took over the presidency in April 2008 (and served as an interim president until elections in October 2009), as the chosen successor to Festus Mogae, who stepped down at the end of his second term, after a decade in power. However, Ian Khama's succession has led critics to accuse the Khamas of creating a dynasty. Calls for the president to be directly elected by the people were rejected by parliament in 2008.

## Economics

Botswana is the world's largest producer of diamonds, which accounts for 70% of exports. Together with a track record of good governance, strong institutions and prudent macroeconomic and fiscal management, it has attained middle-income status. Real GDP growth has averaged 7% over the last thirty years with per capita income of nearly US$10k in 2011. Yet with ongoing uncertainty in the diamond industry, amid new supply and weaker global demand, the government is also making efforts to diversify the economy away from diamonds (for example, into coal and other metals). However, despite its impressive macro performance, Botswana still suffers from high levels of poverty and severe income inequality, with unemployment around 20%. Its HIV/Aids prevalence rates are amongst the highest in the world.

Botswana is recovering from the shock of the global financial crisis. This resulted in GDP contracting by 4.9% in 2009 as weak demand for diamonds, notably from India and China, negatively impacted the economy. The impact was somewhat mitigated however by the government's expansionary fiscal policy, interest rate reductions from the central bank and the running down of reserves in the pula fund (its SWF). The budget balance shifted into a deficit of 13% of GDP in 2009 from a 3% surplus in 2007 and the policy rate was cut by 550bps over 2008-09. The government also secured a US$1.5bn loan from the AFDB in June 2009 as the current account shifted into deficit. While GDP growth has returned, the country continues to run fiscal and external deficits. The government aims to eliminate the budget deficit in FY2012/2013 through expenditure restraint, while improving the efficiency of public spending. Government expenditure, above 30% of GDP, is high by international standards according to the IMF. However, we do not think there is a threat to debt sustainability, given public debt is below 20% of GDP.

The currency is fairly stable and inflation is under control. The pula is pegged to a basket of currencies under which it follows a gradual crawling band in order to achieve a stable real effective exchange rate. The pula was devalued by 12% in May 2005. The currency is supported by a healthy level of official reserves, amounting to US$8.1bn in March 2012 on central bank figures (equivalent to over a year of imports). Meanwhile, inflation eased to 7.5% yoy in April from 9.2% in November albeit still above the central bank's inflation target of 3-6%. As a result, the benchmark interest rate has been held at 9.5% since December 2010 as the authorities attempt to bring inflation down to the target. The IMF forecasts inflation to end 2012 at 6.7%.

**Botswana: Key macroeconomic data**

| | Average (2006-10) | 2009 | 2010 | 2011 | 2012f |
|---|---|---|---|---|---|
| Nominal GDP (US$ million) | n/a | 11,529 | 14,866 | 17,570 | 16,668 |
| Population (million) | n/a | 1.810 | 1.831 | 1.853 | 1.875 |
| Per capita income (US$) | 7,111 | 6,370 | 8,117 | 9,481 | 8,888 |
| Real GDP growth (%) | 3.0 | -4.9 | 7.2 | 4.6 | 3.3 |
| Inflation (%, eop) | 8.7 | 5.8 | 7.4 | 9.2 | 6.7 |
| Current account (% of GDP) | 5.6 | -5.8 | -5.2 | -6.8 | -4.1 |
| Fiscal balance (% of GDP) | -3.3 | -13.0 | -7.2 | -4.2 | 0.6 |
| Gross public debt (% of GDP) | 10.5 | 16.1 | 17.8 | 17.3 | 16.2 |

Source: IMF WEO, April 2012

## Key financials and ratios (January year-end)

| Key investment ratios | FY11a | FY12a | FY13f | FY14f | FY15f | FY16f | FY17f |
|---|---|---|---|---|---|---|---|
| **Margins** | | | | | | | |
| Net interest margin (%) | 31.9 | 30.1 | 28.5 | 28.8 | 28.7 | 27.5 | 27.0 |
| Cost to income ratio (%) | 19.1 | 23.8 | 26.1 | 27.5 | 29.1 | 29.2 | 28.9 |
| Cost of risk (%) | 1.9 | 1.6 | 2.0 | 2.0 | 1.8 | 1.6 | 1.6 |
| **Growth** | | | | | | | |
| Gross loans (%) | 35.6 | 31.3 | 13.5 | 13.1 | 12.4 | 18.1 | 14.0 |
| **Funding** | | | | | | | |
| Equity to assets ratio (%) | 72.0 | 70.7 | 69.6 | 84.0 | 82.9 | 78.3 | 77.6 |
| Debt to equity ratio | 28.9 | 35.4 | 34.7 | 10.5 | 11.7 | 18.4 | 19.4 |
| Dividend payout ratio (%) | - | 8.9 | 50.0 | 50.0 | 50.0 | 50.0 | 50.0 |
| Common shares issues (mn) | 1,841 | 1,985 | 1,998 | 2,156 | 2,156 | 2,156 | 2,156 |
| **Profitability** | | | | | | | |
| Return on average equity (%) | 29.5 | 27.7 | 23.5 | 21.6 | 20.1 | 20.9 | 21.9 |
| Return on average assets (%) | 21.0 | 19.7 | 16.5 | 16.6 | 16.8 | 16.8 | 17.0 |

Source: Company filings, Exotix estimates

| Income statement BWP '000 | FY11a | FY12a | FY13f | FY14f | FY15f | FY16f | FY17f |
|---|---|---|---|---|---|---|---|
| Interest income | 721,900 | 900,514 | 1,109,564 | 1,223,088 | 1,260,859 | 1,410,089 | 1,608,769 |
| Interest expense | 42,959 | 65,395 | 89,075 | 66,929 | 36,168 | 49,061 | 59,888 |
| **Net interest income** | **678,941** | **835,119** | **1,020,489** | **1,156,159** | **1,224,691** | **1,361,028** | **1,548,882** |
| *% growth* | *26.2* | *23.0* | *22.2* | *13.3* | *5.9* | *11.1* | *13.8* |
| Other operating income | 144,215 | 155,840 | 199,830 | 258,143 | 333,284 | 434,333 | 550,427 |
| Total income | 823,156 | 990,959 | 1,220,319 | 1,414,302 | 1,557,975 | 1,795,362 | 2,099,309 |
| *% growth* | *17.1* | *20.4* | *23.1* | *15.9* | *10.2* | *15.2* | *16.9* |
| **Less operating expenses** | **157,483** | **235,618** | **318,075** | **388,939** | **453,360** | **523,967** | **607,638** |
| Operating profit before impairment and taxation | 665,673 | 755,341 | 902,244 | 1,025,363 | 1,104,616 | 1,271,394 | 1,491,671 |
| **Impairment charge** | **38,957** | **44,109** | **65,128** | **73,782** | **72,778** | **76,822** | **89,016** |
| Pre-tax income | 626,716 | 711,232 | 837,116 | 951,581 | 1,031,837 | 1,194,572 | 1,402,655 |
| *% growth* | *24.1* | *13.5* | *17.7* | *13.7* | *8.4* | *15.8* | *17.4* |
| Less tax | 153,379 | 133,433 | 209,279 | 237,895 | 257,959 | 298,643 | 350,664 |
| Net income | 473,337 | 577,799 | 627,837 | 713,686 | 773,878 | 895,929 | 1,051,991 |
| *% growth* | *24.6* | *22.1* | *8.7* | *13.7* | *8.4* | *15.8* | *17.4* |
| **Attributable income** | **456,893** | **555,944** | **597,796** | **674,766** | **726,265** | **840,206** | **988,810** |
| Dividends | - | 49,625 | 313,918 | 356,843 | 386,939 | 447,965 | 525,996 |
| | | | | | | | |
| EPS (BWP) | 0.25 | 0.28 | 0.30 | 0.31 | 0.34 | 0.39 | 0.46 |
| DPS (BWP) | - | 0.03 | 0.16 | 0.17 | 0.18 | 0.21 | 0.24 |

Source: Company filings, Exotix estimates

| Balance sheet BWP '000 | FY11a | FY12a | FY13f | FY14f | FY15f | FY16f | FY17f |
|---|---|---|---|---|---|---|---|
| Cash and cash equivalent | 51,848 | 73,612 | 514,531 | 96,732 | 108,753 | 129,116 | 147,115 |
| **Advances to customers** | **2,298,880** | **3,034,639** | **3,430,208** | **3,869,287** | **4,350,136** | **5,164,634** | **5,884,605** |
| Other receivables | 31,752 | 54,037 | 51,453 | 58,039 | 65,252 | 77,470 | 88,269 |
| Property, plant and equipment | 7,045 | 9,513 | 12,843 | 16,053 | 16,856 | 17,699 | 18,584 |
| Intangibles assets | 306 | 3,291 | 3,500 | 3,500 | 3,500 | 3,500 | 3,500 |
| Goodwill | 27,824 | 27,824 | 27,824 | 27,824 | 27,824 | 27,824 | 27,824 |
| Deferred taxation | 12,575 | 9,809 | 9,809 | 9,809 | 9,809 | 9,809 | 9,809 |
| **Total assets** | **2,430,230** | **3,212,725** | **4,050,167** | **4,081,244** | **4,582,130** | **5,430,051** | **6,179,706** |
| | | | | | | | |
| **Total shareholders' equity** | **1,749,601** | **2,270,978** | **2,819,149** | **3,429,996** | **3,799,418** | **4,252,684** | **4,793,530** |
| Minority interest | 38,155 | 53,876 | 83,917 | 122,838 | 170,451 | 226,174 | 289,355 |
| Trade and other payables | 109,200 | 70,732 | 129,698 | 129,698 | 129,698 | 129,698 | 129,698 |
| Income tax | 28,100 | 14,275 | 38,769 | 38,769 | 38,769 | 38,769 | 38,769 |
| **Borrowed funds** | **505,174** | **802,864** | **978,635** | **259,944** | **243,795** | **482,726** | **528,354** |
| Deposits | - | - | - | 100,000 | 200,000 | 300,000 | 400,000 |
| Total liabilities | 642,474 | 887,871 | 1,147,102 | 528,411 | 612,262 | 951,193 | 1,096,821 |
| Total equity and liabilities | 2,430,230 | 3,212,725 | 4,050,167 | 4,081,244 | 4,582,130 | 5,430,051 | 6,179,706 |
| | | | | | | | |
| NAV per share (BWP) | 1.0 | 1.1 | 1.4 | 1.6 | 1.8 | 2.0 | 2.2 |

Source: Company filings, Exotix estimates and forecasts

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| | |
|---|---|
| Buy | 13 |
| Sell | 7 |
| Hold | 1 |

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**Change in target prices: Initiation of coverage**

*Company name*:

Letshego Holding Limited

| *Report date* | *Market price* | *Target price* |
|---|---|---|
| 28 April 2010 | BWP1.8 | BWP4.5 |
| 24 January 2011 | BWP 1.85 | BWP2.94 |

# Exotix Published Research*

| Date | Author | Category | Title |
|---|---|---|---|
| 21 June 2012 | Ronak Gadhia | Equity | Zenith Bank: maintain BUY, TP NGN16.5, 18.6% upside |
| 19 June 2012 | Stuart Culverhouse | Strategy | Exotix Bi-weekly Frontier Strategy: (1) Nigeria; (2) Kenya; (3) Ghana; (4) A'ayan Leasing |
| 18 June 2012 | Gabriel Sterne | Sovereign | Research snap: Greek election results. Not making a drachma out of a crisis (for now) |
| 8 June 2012 | Gabriel Sterne | Sovereign | Would there be singing in Greek baths post-drachmatisation? |
| 7 June 2012 | Stuart Culverhouse | Strategy | Exotix Bi-weekly Frontier Strategy: (1) Zambia; (2) Dominican Republic electric utilities |
| 31 May 2012 | Peter Lannigan | Credit | Dominican Republic: Electric utilities attractive versus sovereign debt |
| 30 May 2012 | Ronak Gadhia | Equity | Nigerian banking sector FY11 & 1Q12 results review |
| 28 May 2012 | Andy Gboka | Equity | Nigerian Breweries, downgraded from BUY to HOLD, TP increased from NGN101 to NGN105 |
| 25 May 2012 | Andy Gboka | Equity | Dangote Cement- Hold reiterated, TP Downgraded from NGN148.3 to NGN134.6 |
| 24 May 2012 | Binta Drave | Equity | Safaricom FY12 results |
| 23 May 2012 | Gabriel Sterne | Strategy | Exotix Bi-weekly Frontier Strategy: (1) Pakistan; (2) Tamweel |
| 21 May 2012 | Gabriel Sterne | Sovereign | Crisis Resolution Institutions and the Outlook for Europe |
| 10 May 2012 | Gus Chehayeb | Credit | Research Snap: Dana Gas - The battle lines are drawn; no bailout in sight |
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| 8 May 2012 | Peter Lannigan | Credit | Petrotrin Initiation – Close to 'BB' yield for 'BBB' credit risk |
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| 1 May 2012 | Binta Drave | Equity | Safaricom FY12 earnings preview |
| 26 April 2012 | Stuart Culverhouse | Strategy | Q2 2012 Frontier Outlook |
| 25 April 2012 | Ronak Gadhia | Equity | Access Bank Nigeria initiation of cover, TP NGN 11.9, 94.5% upside |
| 25 April 2012 | Gabriel Sterne | Sovereign | Euro crisis: some solution! And a focus on Portugal, Cyprus and Greece |
| 19 April 2012 | Andy Gboka | Equity | Nigerian cement sector, Initiation of coverage - Lafarge WAPCO (BUY, NGN49.8 TP), Ashaka Cement (BUY, NGN11.9 TP) and Dangote Cement (HOLD, NGN148.3 TP) |
| 19 April 2012 | Andy Gboka | Equity | Nigerian cement industry: 2012, the transitional year |
| 19 April 2012 | Andy Gboka | Equity | Dangote Cement– Pan-African expansion |
| 19 April 2012 | Gus Chehayeb | Credit | Research Snap: Dubai Inc's bank debt restructurings: some indigestion, but 2/3 complete |
| 13 April 2012 | Stuart Culverhouse | Sovereign | Research Snap: Bangladesh - IMF programme...at last |
| 11 April 2012 | Stuart Culverhouse | Strategy | Exotix Bi-weekly Frontier Strategy: (1) Gulf Finance House (GFH); (2) Nigeria T-bills |
| 5 April 2012 | Binta Drave | Equity | Nestle Nigeria: Quality comes at a price. Initiate - Hold |
| 4 April 2012 | Stuart Culverhouse | Sovereign | Research Snap: Kenya – CBK keeps rates on hold, as expected |
| 4 April 2012 | Ronak Gadhia | Equity | Equity Bank Kenya, downgrade to HOLD, TP KES 22.1, 15% upside |
| 29 March 2012 | Ronak Gadhia | Equity | Kenya Commercial Bank; maintain BUY, TP KES 36.9, 64% upside |
| 27 March 2012 | Stuart Culverhouse | Strategy | Exotix Bi-weekly Frontier Strategy: (1) Review of Q1; (2) St Kitts & Nevis; (3) MBPS |
| 22 March 2012 | Ronak Gadhia | Equity | Co-op Bank Kenya: Maintain Hold on lower profitability outlook |
| 21 March 2012 | Gus Chehayeb | Credit | MB Petroleum Services – The black sheep in MB Holding's flock |
| 20 March 2012 | Gabriel Sterne | Sovereign | Greece: a retrospective; and prospective opportunities |
| 13 March 2012 | Gabriel Sterne | Strategy | Exotix Bi-weekly Frontier Strategy: Room for a further fragile frontier rally |
| 13 March 2012 | Gus Chehayeb | Credit | Dar Al-Arkan – Heightened uncertainty; moving to the sidelines |
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| 6 March 2012 | Andy Gboka | Equity | Nigerian Breweries: FY11 earnings positive for the stock |
| 2 March 2012 | Ronak Gadhia | Equity | Research Snap: KCB FY11 results much better than expected |
| 27 February 2012 | Stuart Culverhouse | Strategy | Exotix Weekly Briefing: Venezuela oil warrants downgraded to Hold |
| 22 February 2012 | Binta Drave | Equity | Flour Mills Nigeria: Rights issue 101.6% subscribed, reiterate BUY |
| 22 February 2012 | Gabriel Sterne | Strategy | Exotix Weekly Briefing. Collateral damage - why the type of Greek default matters |

*All research available on request.

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