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Letshego Holdings
Credit overview

- **Letshego Holdings (Moody's Ba3), a leading Sub-Saharan Africa (SSA) micro-finance company, released YE11 results in April.** In this note we review the company's consolidated numbers for the financial year ended 31 January 2012 (further referred to as YE11 or 2011 results). With a pre-tax RoE of 35%, an impressive 32% asset growth and continued low cost of risk (c. 1.5% of average gross loans), we believe Letshego is an emerging personal finance business in an expansion phase. However, Letshego is not a typical micro-finance institution, the company's main product is a relatively long-term, unsecured personal loan issued to civil servants under a payroll deduction scheme implemented by a participating (government) employer.

- **Letshego's 'deduction-at-source' model key to its financial performance, in our view.** In its current format and particularly in Botswana, Letshego's key market, the payroll deduction code almost guarantees low default rates. However, we believe the model is also implicitly vulnerable to policy risk as was demonstrated by the recent Botswana government decision (currently on hold) to eventually cease facilitating deduction-at-source from public sector employees' wages, followed by the temporary stoppage of lending in Botswana in September-October 2011 and Moody's downgrading its rating outlook on Letshego from stable to negative.

- **We believe regulatory changes could affect Letshego's ability to source loan repayments through the central registry in Botswana,** but that does not necessarily imply a spike in delinquencies. In fact, Letshego maintains direct debit agreements with its borrowers and in the case of disruption in central registry collections the company will still be able to collect repayments directly from the customer's bank account. Accordingly, we think Letshego will more likely be facing elevated operating costs rather than a sharp increase in non-performing loans (NPLs). Furthermore, Letshego management has acknowledged the importance of responsible lending practices, one of the principal areas for concern and the reason for the government's involvement. In fact, the central registries play a critical role in ensuring sufficient take-home funds for public employees, which is why we believe the government put on hold its decision to terminate the deduction-at-source scheme.

- **From a credit perspective, the company's relatively low leverage is of equal importance to us.** Letshego has been financed mainly by equity investors which to a significant extent mitigates refinancing risk, in our view. The company's debt/equity ratio was a relatively low 35% at YE11, with its share of short-term borrowings below 40% of total borrowings. Unusually for a micro-finance company, loans with maturities from three years and above comprise 62% of Letshego's portfolio, creating an obvious liquidity mismatch. However, we think it is unlikely to threaten the company's cash flows unless there is a dramatic disruption in collections since nearly all of the company's long-term assets were effectively covered by equity at YE11, while its short-term borrowings were covered by liquid assets after adjustment for the short-term portion of loans.

- **Capital raising is top of the agenda for Letshego.** The company has an ambitious growth plan for 2012, mainly aiming to diversify out of its core market in Botswana which currently represents only 60% of its total loans. Management expects more conservative lending expansion in Botswana but with extensive growth in other markets, particularly Mozambique, Namibia and Tanzania. We believe access to unsecured funding is the key to sustainable growth for Letshego and the Johannesburg Stock Exchange-listed MTN programme is part of the company's effort to strengthen its funding base. Letshego's borrowing mandate, which was approved by shareholders, allows borrowing up to twice the equity. In selected markets, Letshego has said it would pursue banking licences to attract customer deposits.

Figure 1: Letshego's key financial metrics, BWPmn

	2009	2010	2011
Total assets	1,915.40	2,430.20	3,212.70
Loans to customers, gross	1,712.90	2,323.10	3,050.10
Borrowings	377.6	505.2	802.9
Shareholders' equity	1,369.30	1,787.80	2,324.90
Net interest income	537.9	678.9	830.7
Operating income	703.2	823.2	986.5
Operating expenses	-147.8	-146.6	-213.7
Impairment of loans through P&L	-50.2	-39	-39.7
Net profit	380	473.3	577.8

Source: Company data, Renaissance Capital

Figure 2: Letshego's key ratios, %

	2009	2010	2011
Pre-tax RoAE	49.5%	39.7%	34.6%
After-tax RoAA	22.9%	21.8%	20.5%
Cost of risk*	3.3%	1.9%	1.5%
Effective interest rate on loans**	38.5%	36.0%	33.6%
Net interest margin**	33.3%	31.9%	30.0%
Cost/income***	21.0%	19.1%	23.9%
Borrowings/equity	27.6%	28.3%	34.5%
Equity/total assets	71.5%	73.6%	72.4%

* calculated as an impairment charge through P&L to average total loans
** excluding lending-related administration fees
*** including insurance-related costs

Source: Company data, Renaissance Capital

Business profile

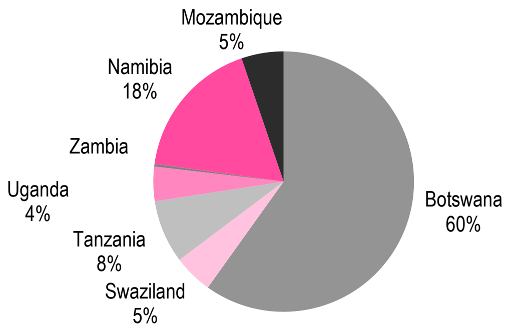
Established in 1998 as Micro Provident Botswana Limited, Letshego Holdings is a non-bank finance company with unsecured personal loans to formally employed individuals (almost exclusively public-sector workers) being its main product contributing c. 95% of total revenue. Typically for personal finance, loans are granular with the average amounts varying from BWP500-BWP200,000 in Botswana. However, loans are offered at terms of up to five years for repayment with monthly payments automatically deducted at source via the clearing systems of participating employers.

Botswana is Letshego's original core market, although its share of the Group's total revenue has declined significantly over recent years and constituted only c. 50% of total revenue in 2011. The 32% growth in loans was largely driven by Letshego's rapid expansion in Namibia (net loans up 59% YoY), Tanzania (+60% YoY) and Uganda (+32% YoY), albeit from a low base. Central registries similar to the payroll-deduction system in Botswana are in place in Namibia, Swaziland and Uganda. In December 2011, the Group submitted its first application for a banking licence to the Central Bank of Namibia.

In our view Letshego's business risk depends on the sustainability of the salary deduction scheme and, in general, on the economic environment and staff turnover in the public sector of each country. This model was tested during the industrial action undertaken by government employees in Botswana in April-June 2011. However, according to the company the action did not have any significant impact on Letshego's Botswana operations, even though it had to reschedule loans to those public officials that were temporarily unable to honour their loan repayments during the industrial action.

Letshego offers life insurance products to all its clients in Botswana, which covers the repayment of the loan in the event of death or permanent disability of the borrower. In certain countries, Letshego introduced a comprehensive 'cell-captive' insurance scheme to cover both credit and mortality risks.

Figure 3: Geographical breakdown of Letshego's loan book, YE11



Source: Company data, Renaissance Capital

Letshego Holdings is a Botswana Stock Exchange-listed company with a diversified shareholder structure. At YE11, the list of Letshego's largest shareholders included Botswana Life Insurance Ltd. (25.6%), Botswana Public Officers Pension Fund (BIFM – funds under management, 17.8%), Investec – funds under management (13.0%), Fleming – funds under management (10.8%), Ashmore Emerging Markets Fund (4.0%) and International Finance Corporation (4.0%).

YE11 results review[1]

Letshego's YE11 financial results were overall positive, in our view. Despite the controversy surrounding the salary deduction mechanism and industrial action by government employees in Botswana, the Group demonstrated a solid performance across its key segments and impressive growth in new markets, including the start-up in Mozambique. On a consolidated basis, strong profitability and capitalisation are the most important factors for Letshego's credit profile, while its high asset quality is effectively an implicit characteristic of the business model. Our key takeaways from the YE11 results are as follows:

- ***High margins:*** Letshego's total annualised return on its loan portfolio is c. 34% (36.5% if we include lending-related administration fees but before credit life insurance fees). On the funding side, the Group's relatively low leverage supports retention of its interest margin at the level of c. 30%, based on our estimates. We believe this is more than sufficient to withstand a moderate increase in borrowing costs - as Letshego experienced in 2011 (from 9.7% to 12.8%) – without a significant negative effect on its operating profit.
- ***A solid bottom-line:*** The Group reported consolidated net income of BWP578mn (22% growth YoY or c. 13% recalculated in dollar using the EoP currency rates). Strong operating margins, low impairment charges, and, finally, low operating expenses (a cost/income ratio below 25%) results in an after-tax RoAA of 20.5%.
- ***No material deterioration in asset quality:*** Letshego reported cost of risk at 1.5% of average total loans and balance sheet provisions at 0.5% of total loans at YE11. However, the decrease in the impairment level is partly due to the introduction of credit insurance in Namibia, Swaziland and Mozambique. Write-offs increased as a proportion of average total loans from 4.0% to 9.7% in 2011, but we think this was offset by Letshego's high recovery rates (>80%).
- ***Equity as a major source of funding:*** Letshego's balance sheet differs from that of commercial banks in that it has no deposit-taking function. The Group has financed its operations mainly with equity. Although the wholesale debt component increased in 2011 (the debt/equity ratio was up from 28% to 35%), shareholders' capital was still covered at 72% of total assets and, technically, this funded all of the Group's long-term exposure.
- ***Cash instalments are liquidity-supportive:*** Based on the negative cash flow from operations reported for 2011, we think the growth in lending has outpaced that of available financing. Nevertheless, we believe Letshego's lending practices, implying monthly cash instalments for all customers, should be naturally supportive of the company's cash position. We therefore consider the Group's operating cash flows as a source of short-term liquidity; the limited availability of funding could be a constraint on growth, in our view, but it is less of an issue from the refinancing risk standpoint.

[1] For simplicity, we refer to the financial report for the year ended 31 January 2012 as 'at YE11'.

Asset quality

The salary deduction model assumes Letshego obtains employer's authorisation (Salary Deduction Code) to enable deductions of instalments from the borrower's monthly salary. The underwriting process at Letshego is based on the following key inputs:

- The employer does not guarantee loans to its employees, but is obliged – through the central registry system – to deduct the instalment payable prior to the salary being paid into the employee's bank account. The deductions are subsequently paid directly to Letshego on a monthly basis.

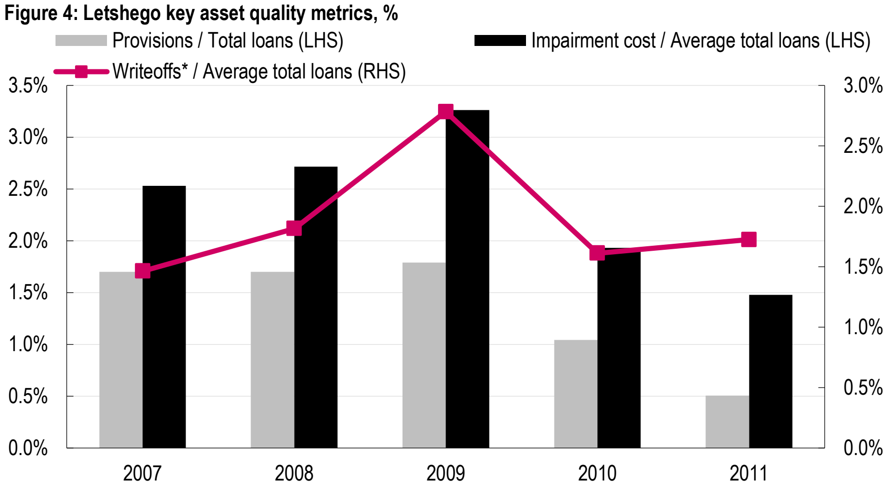
- Loans are only granted to employees who are able to present their past two months' original salary advice and have an active bank account. The individual limit is calculated as the maximum deduction amount plus take-home pay as prescribed by legislation or by the relevant employer.

- If the customer is no longer employed, the loan is written off and recovery procedures are initiated. If the customer has changed employment to an employer with no deduction code, Letshego is authorised to use a direct debit from the borrower's bank account to recover loan repayments. Group-wide recovery rates have exceeded 80%, which also explains why the increase in write-offs during 2011 was not followed by a respective increase in impairment cost.

- If a customer's salary is reduced during study or maternity leave, loan repayments are scheduled to recommence once the customer returns to full salary. Loans rescheduled on these grounds are typically classified as past due but not impaired.

- Letshego offers life insurance to all its clients in Botswana, covering the outstanding balances of the loan to Letshego in the event of death or permanent disability of the customer. In Namibia, Mozambique and Swaziland, Letshego's loan book default risk is also covered by comprehensive credit insurance that covers all aspects of default, which allows for the minimising of impairment expenses.

Figure 4: Letshego key asset quality metrics, %



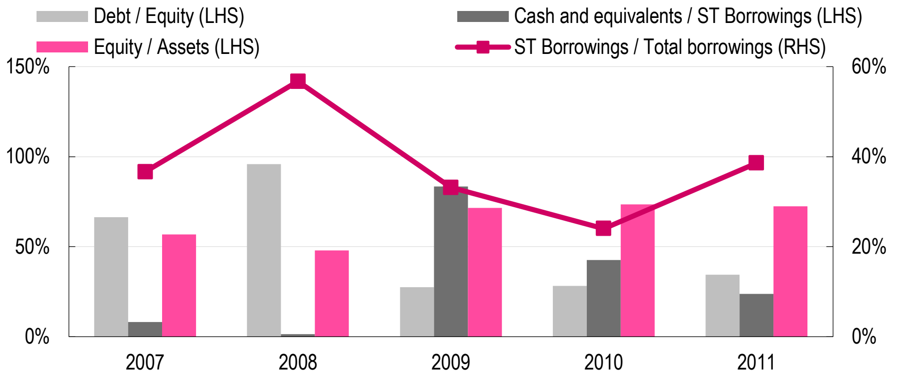
* Writeoffs adjusted for recoveries during the same period

Source: Company data, Renaissance Capital

Liquidity and leverage

With equity funding accounting for 72% of the Group's balance sheet, Letshego is not overly dependent on the availability of debt funding. In our view, monthly instalment payments represent a natural source of cash inflow, although this source is definitely not sufficient for sustainably high pa growth rates. Otherwise, Letshego does not have to maintain a material liquidity surplus in the form of cash and bank deposits and, to a significant extent, relies on bank loans for short-term refinancing.

Figure 5: Letshego's liquidity and leverage ratios, %



Source: Company data, Renaissance Capital

Letshego has a strong track record of servicing bilateral loans from local banks and institutional investors (quite often, related parties). At YE11, borrowings represented c. 90% of total liabilities, with long-term and short-term loans approximately in the proportion of 60/40. Based on this breakdown, we estimate Letshego's refinancing needs for 2012 at about BWP350mn (including trade payables). In the unlikely scenario of the complete unavailability of new funds in the market, we expect Letshego will still be able to cover about one-quarter of short-term debt with cash outstanding and the remainder from its operating cash inflow. This scenario implies a period of restricted growth rather than immediate refinancing risk, in our view.

Figure 6: Letshego's borrowing structure, 2009-2011, BWPmn

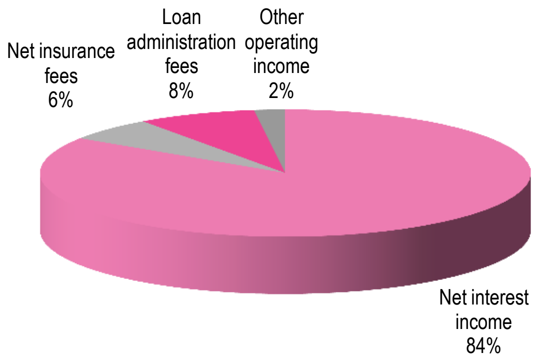
	2009	2010	2011
Borrowings, total	**377.6**	**505.2**	**802.9**
incl. long-term:	*252.5*	*383.7*	*493.0*
African Alliance Botswana Liquidity-Fund	15.0	25.0	55.0
Barclays Bank of Botswana Limited	39.5	0.0	0.0
IFC	112.4	92.2	64.4
Investec Asset Management Botswana (Prop)	55.0	55.0	55.0
FMO	30.6	13.5	0.0
ADP I Holdings 2	0.0	198.1	246.2
ZAR Private placement – Investec	0.0	0.0	72.4
incl. short-term:	*125.1*	*121.4*	*309.9*
Bank ABC (Botswana) Limited/Bank ABC (Tanzania) Limited	0.0	45.0	62.4
Barclays Bank of Botswana Limited	37.8	16.4	28.0
BIFM	45.0	0.0	100.0
Standard Chartered Bank of Botswana Limited	8.9	0.2	0.4
Standard Chartered Bank Tanzania Limited	3.0	16.7	41.5
Standard Chartered Bank Uganda Limited	30.3	43.2	62.9
FNB of Botswana	0.0	0.0	2.6
FNB of Mozambique	0.0	0.0	12.1
Average cost of borrowings	**10.0%**	**9.7%**	**12.8%**

Source: Company data, Renaissance Capital

Profitability

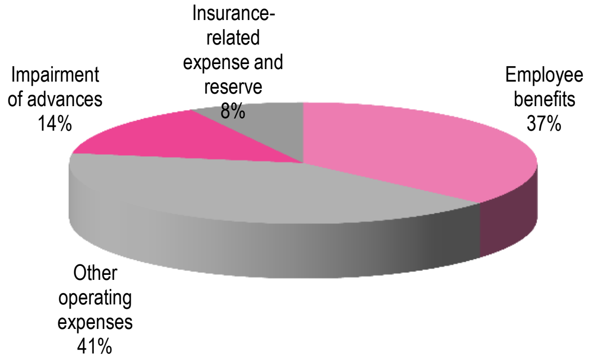
Letshego's key revenue source is its interest income, thereby suggesting to us relatively high (although not unusual in micro-finance) effective lending rates of above 30%. The business has also been efficient in terms of cost structure with the cost/income ratio below those typically reported by commercial banks. Letshego's operating cost structure is dominated by 'other' expenses which were largely driven by the launches of new subsidiaries in 2011 (particularly in Mozambique) as well as one-off legal expenses.

Figure 7: Operating revenue structure



Source: Company data, Renaissance Capital

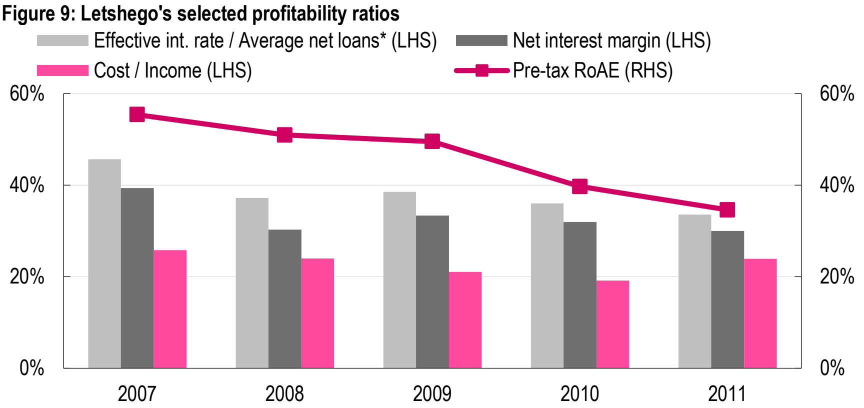
Figure 8: Operating expense structure



Source: Company data, Renaissance Capital

Profitability ratios remain very strong, allowing Letshego to pay dividends and thereby make an attractive investment case for portfolio investors. As long as lending growth continues and impairment remains low (including the increased use of credit insurance across the Group's geographies), we believe Letshego will be able to sustain a high return on capital. According to management, the Group will continue to focus on consumer finance as its core competence despite growing saturation in the market (particularly in Botswana) and the competition from commercial banks and micro-finance operators. At the same time, management is looking at options of acquiring banking licences, eventually transforming into a deposit-taking entity, i.e. a full-fledged retail banking group.

Figure 9: Letshego's selected profitability ratios



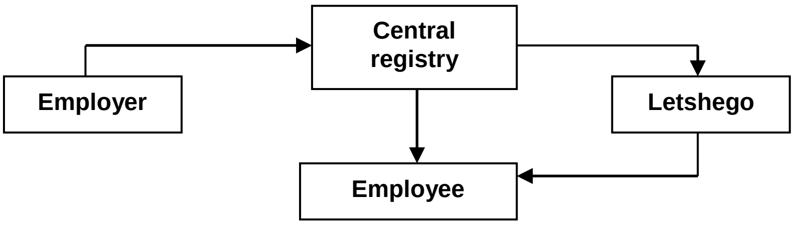
Source: Company data, Renaissance Capital
* excl. loan administration fees

Governmental issue

The central registry is only a fee-based intermediary between employers (most often, the government), lenders (i.e. micro-finance companies and telecom operators) and employees. Central registries are in place in Botswana, Namibia, Swaziland and Uganda and may also be introduced in Tanzania and Zambia. The government of Botswana has been concerned with the reckless lending practices used by certain micro-lenders, which led to the decision to discontinue central registry services for micro-finance operations in December 2011 (note this is currently on hold).

Letshego has a different viewpoint, arguing that the use of central registries is actually best-practice as a mechanism for confronting fraud and monitoring indebtedness of public sector employees. Most importantly, central registries are independent both from lenders and from borrowers. Letshego's management acknowledged the importance of responsible lending practices, one of the key areas of concern and the reason for the government's involvement in this situation. In fact, in our view central registries play a critical role in ensuring sufficient 'take-home' funds for public employees, which is the reason we think the Botswana government put on hold its decision to terminate the deduction-at-source scheme following a review with the stakeholders involved.

Figure 10: Payroll deduction model in Botswana, simplified



Source: Renaissance Capital

Letshego's operations in Botswana continues as normal and – according to the company's statement – collections remain "on historical levels" via the deduction at source basis. In Botswana, the Non Bank Financial Institutions Regulatory Authority (NBFIRA) published the regulations for the industry, effective 9 March 2012. According to management, Letshego Botswana will be in a position to comply with these new regulations and management does not anticipate any significant implications or changes to the business arising from these regulations.

We believe the governmental pressure in Botswana has demonstrated that Letshego's business model can be vulnerable to policy shocks, but we think it is also positive for the company in that it managed to clarify the situation with regard to payroll deduction without a significant negative impact on the Group's results. Although regulatory changes could affect Letshego's collection practices, in our opinion it will not necessarily lead to an immediate increase in overdue loans. As an alternative way of collecting payments, Letshego is entitled to direct-debit agreements with its borrowers and in the event of a disruption in central registry operations, the company could still be able to collect repayments directly from the customer's bank accounts. In our view, this will result in substantially lower growth and higher operating expenses, although the potential negative impact on delinquent loans is less certain.

Credit ratings

On the back of Letshego’s cautionary statement to investors regarding the potential termination of central registry services in September 2011, Moody’s lowered its rating outlook on Letshego from stable to negative without a change in the rating (long-term Ba3).

Below we include an excerpt from Moody's press release, dated 16 September 2011:

“The negative outlook is driven by the likelihood that, although the company maintains direct debit agreements with all customers and can, in theory, convert to receiving loan repayments directly from customer's bank accounts, Letshego may be faced with increased impairment costs and higher operating expenses relating to the new collections mechanism. Furthermore, performing direct debit collections for around 35,000 accounts could initially prove an operational challenge. Moody's notes the relatively longer term nature of Letshego's receivables, with around 70% of loans extended at five-year maturities. This limits the company's ability to quickly effect credit risk management changes in its portfolio. In addition, this development may compromise Letshego's future fund-raising capabilities, and will likely lead to a revision of the company's strategic plan and income growth targets in Botswana. However, in Moody's view, the company's growth potential will remain strong in its other regional operations in SSA.”

In our view, the logic behind the rating outlook change is almost entirely based on uncertainty regarding Letshego’s collection mechanism and its overall business outlook in Botswana. Moody’s was unable to quantify the potential costs of this uncertainty, but the rating agency did not mention any direct threats to Letshego’s rating level which is explained in the special section of the rating report on potential rating triggers:

“The Ba3 issuer rating remains supported by very high profitability -- pre-provision income to average managed assets of 30.5% for the year ending 31 January 2011 -- which allows the company some capacity to absorb elevated credit and operating costs. The rating could be downgraded if there were evidence that the company's financial metrics -- namely profitability and asset quality but also liquidity and capitalisation -- were deteriorating to levels below those of similarly rated peers.”

The company’s business model went through the first test for policy risk vulnerability and Letshego’s FY11 results confirmed the events of the past year did not significantly affect the Group’s financial performance, or at least there are no signs of a deterioration in our view of any of the critical parameters mentioned by Moody’s – profitability, asset quality, liquidity and capitalisation. We think Letshego’s results are credit-supportive and positive rating-wise.

Financial results and ratios

Figure 11: Letshego five-year balance sheet, BWPmn

	2007	2008	2009	2010	2011
Cash and cash equivalents	9.2	5.2	104.5	51.8	73.6
Advances to customers	787.9	1,342.6	1,682.3	2,298.9	3,034.6
Other receivables	3.1	8.5	74.5	9.2	18.7
Long-term receivables	0.0	0.0	8.4	10.0	11.1
Short-term investments	0.0	0.0	0.0	12.6	24.2
Plant and equipment	4.4	7.2	6.6	7.0	9.5
Intangible assets	1.0	0.6	0.6	0.3	3.3
Goodwill	0.0	25.8	25.8	27.8	27.8
Deferred taxation	6.4	11.3	12.9	12.6	9.8
Total assets	**811.9**	**1,401.0**	**1,915.4**	**2,430.2**	**3,212.7**
Trade and other payables	31.1	80.1	129.7	109.2	70.7
Income tax	12.8	5.0	38.8	28.1	14.3
Borrowings	306.7	644.4	377.6	505.2	802.9
Total liabilities	**350.7**	**729.5**	**546.1**	**642.5**	**887.9**
Stated capital	35.1	35.1	396.0	412.8	669.9
Foreign-currency translation reserve	-1.4	4.4	0.8	-9.8	-32.5
Share-based payment reserve	3.9	10.6	18.3	12.5	15.7
Retained earnings	422.1	616.9	932.4	1,334.0	1,618.0
Minority interest	1.6	4.4	21.8	38.2	53.9
Total shareholders' equity	**461.3**	**671.5**	**1,369.3**	**1,787.8**	**2,324.9**
Total liabilities and equity	**811.9**	**1,401.0**	**1,915.4**	**2,430.2**	**3,212.7**

Source: Company data, Renaissance Capital

Figure 12: Letshego five-year P&L accounts, BWPmn

	2007	2008	2009	2010	2011
Interest income	278.4	398.3	588.8	721.9	896.1
Interest expense	-34.5	-72.2	-50.9	-43.0	-65.4
Net interest income	**243.9**	**326.1**	**537.9**	**678.9**	**830.7**
Premium income	0.0	0.0	0.0	30.7	64.2
Insurance fees	0.0	0.0	0.0	-2.4	-5.7
Net interest and insurance income	0.0	0.0	537.9	707.3	889.2
Fee and commission income	64.8	87.8	118.4	109.6	87.2
Operating income	**314.3**	**418.6**	**703.2**	**823.2**	**986.5**
Employee benefits	-44.0	-54.5	-80.3	-73.1	-100.3
Other operating expenses	-37.2	-45.9	-67.5	-73.5	-113.4
Claims expense	0.0	0.0	0.0	-8.1	-0.7
Insurance claim mitigation reserve	0.0	0.0	0.0	-2.8	-21.3
Net income before impairment	233.1	318.1	555.4	665.7	750.9
Impairment of advances	-15.7	-29.4	-50.2	-39.0	-39.7
Profit before taxation	**217.4**	**288.7**	**505.2**	**626.7**	**711.2**
Income tax	-48.5	-69.6	-125.2	-153.4	-133.4
Profit for the year	**169.0**	**219.1**	**380.0**	**473.3**	**577.8**

Source: Company data, Renaissance Capital

Figure 13: Letshego key ratios

	2007	2008	2009	2010	2011
Profitability					
After-tax RoAA	26.9%	19.8%	22.9%	21.8%	20.5%
Pre-tax RoAE	55.4%	51.0%	49.5%	39.7%	34.6%
Net interest margin	39.4%	30.2%	33.3%	31.9%	30.0%
Effective interest rate	45.6%	37.2%	38.5%	36.0%	33.6%
Adj. effective interest rate*	52.4%	43.1%	44.7%	40.4%	36.5%
Leverage					
Cash/short-term borrowings	8.2%	1.4%	83.5%	42.7%	23.8%
Debt/equity	66.5%	96.0%	27.6%	28.3%	34.5%
Equity/assets	56.8%	47.9%	71.5%	73.6%	72.4%
Asset quality					
Cost of risk	2.5%	2.7%	3.3%	1.9%	1.5%
Write-offs during the period**	3.1%	3.0%	4.3%	4.0%	9.7%
Recoveries during the period***	53%	39%	35%	60%	82%
Impairment provision/total loans	1.7%	1.7%	1.8%	1.0%	0.5%

* - including lending-related administration fees
** - as a proportion of average total loans
*** - as a proportion of write-offs during the period

Source: Company data, Renaissance Capital

Disclosures appendix

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