LETSHEGO HOLDINGS (NAMIBIA) LTD
1H22 Results Review
December 2022

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Letshego Holdings (Namibia) Ltd

1H22 Results Review

Target Price (c)	*301*
Current Price (c)	300

Year End 31 December	FY18A	FY19A	FY20A	FY21A	FY22E	FY23E	Recommendation	BUY
Net interest income (N$ million)	567	506	483	483	459	489	NSX Code	LHN
Non-interest income (N$ million)	255	230	149	214	203	205	Market Cap (N$ m)	1,325
Profit after tax (N$ million)	469	401	321	303	283	300	Shares in Issue (m)	500
HEPS (c)	76.2	80.2	64.2	61.7	56.6	60.1	Free float (%)	22
DPS (c)	23.5	22.5	22.5	45.5	42.4	45.0	52 Week high (c)	300
DY (%)	6.7	8.3	11.3	23.9	14.1	15.0	52 Week low (c)	150
P/E	4.6	3.4	2.3	3.1	5.3	5.0	Expected Total Return (%)	14.34%
P/B	0.8	0.6	0.4	0.3	0.5	0.5		

Source: LHN, IJG Securities

1H22 Results Review

Letshego Holdings (Namibia) Ltd (LHN) released interim results for the period ended 30 June 2022 (1H22). Earnings and headline earnings per share increased by 5.2% y/y from 31.93cps in 1H21 to 33.6cps in 1H22. Profit after tax also rose by 5.2% y/y from N$159.6 million in 1H21 to N$168.0 million in 1H22. Operating profit before tax however declined by 7.4% from N$207.0 million in 1H21 to N$191.7 million in 1H22 largely due to declining net interest income. LHN's ROE declined marginally from 12.6% in 1H21 to 12.1% in 1H22 while ROA dropped from 8.0% to 5.6%. LHN declared an interim dividend of 25.20cps, or 75% of its earnings after tax (1H21: 15.96cps).

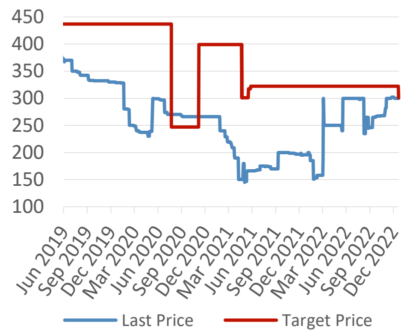
LHN continued to record robust growth in advances to customers, with the loan book growing by N$628.7 million or 16.3% y/y, although most of this increase was recorded in 2H21. Advances to customers grew by 5.1% or N$218.7 million since FY21 to reach N$4.50 billion. This is compared to growth in PSCE to individuals of 2.0% over the same period. The credit impairment charge for the period reported amounted to N$4.8 million (1H21: N$22.0 million), a marked decrease when compared to the prior period. The company also reported very strong growth in deposits of 45.1% y/y to N$437.3 million in 1H22.

Total income rose by 10.4% y/y to N$469.9 million in 1H22. The growth was primarily driven by a strong increase in cell captive dividend income, which rose by 47.1% y/y or N$46.7 million from a revised N$95.6 million in 1H21 to N$128.9 million in 1H22. Total interest income declined by 0.7% y/y over the same period. Growth in interest income from lending activities continues to lag loan book growth, decreasing by 4.4% y/y or N$14.4 million to N$309.9 million, despite the Bank of Namibia hiking interest rates by 100 bps over the same period. Other interest income jumped by 604% y/y to N$14.1 million. Interest received on bank deposits rose by N$5.4 million, while interest received on investments in government securities contributed N$6.7 million to the increase in other interest income.

Total operating expenses grew by 21.2% y/y to N$183.9 million. Employee benefits expenses, which have been the main driver of operating expenses growth over the past couple of years, were well contained, increasing by only 2.7% y/y in 1H22 to N$38.1 million (compared to inflation of 6.0% over the same period). Other operating expenditures however grew by 27.1% y/y, mainly attributable to an increase in insurance expenses on the microfinance lending book. Excluding insurance expenses sees other operating expenditures rise by only 0.1% y/y.

LHN's borrowings rose by 275.0% y/y from N$661.5 million in 1H21 to N$2.48 billion in 1H22, although most of the borrowing originated in 2H21. During the period, the company raised an additional N$200.0 million through its listed bond program, bringing the total amount outstanding on the bond programme to N$431.0 million. The new bond (LHN02) was issued at 3-month JIBAR plus 280bps and matures on 29 June 2025. LHN continued to increase its local borrowing base from commercial banks while reducing its reliance on intercompany financing. Borrowings from LHL declined by 72.8% y/y or N$454.0 million to N$169.6 million in 1H22. The sharp rise in debt levels also culminated in a significant rise in borrowing costs, which rose by 62.5% y/y to N$89.6 million in 1H22.

LHN Share Price vs Target Price (c)



Dividends

An interim dividend of 25.20 cents per ordinary share has been declared.

- Last Day to Trade: 14 October 2022
- Ex-Dividend Date: 17 October 2022
- Record Date: 21 October 2022
- Payment Date: 04 November 2022

LHN remains well capitalised, despite recording lower capital adequacy levels. Tier 1 capital fell from 65.4% in 1H21 to 42.9% in 1H22 while Tier 2 capital fell from 3.4% to 0.6%. Accordingly, the total capital adequacy ratio fell from 68.8% in 1H21 to 43.5% in 1H22, albeit well above the 10% minimum regulatory level.

The results release stated that LHN has added 39,000 active customers since the launch of the company's 'digital mall' (app) in December 2021, and that it opened another branch in Windhoek.

Valuation

Overall, LHN's 1H22 earnings came in below our forecasts largely due to the pandemic-induced low-interest rate cycle still playing out in LHN's lending interest rate numbers. On the upside, the relatively lower interest rates boosted advances growth above our expectations. Using a panel of standard valuation techniques, a cost of equity of 19.78% and a long-term sustainable return on equity of 17.0%, we derive a target price of 301c per share. Coupled with an expected dividend of 43.63cps, we derive a potential total return of 14.34%. While we anticipate a decline in earnings and relatively tepid advances growth for FY22, we are bullish on LHN's earnings growth potential over the coming years considering that LHN's net interest rate margin is expected to widen as we move deeper into the interest rate hiking cycle. We also anticipate LHN's operating costs to hold firm over the period. Overall, the current price of 300c per share is an attractive buying point in our view and, we therefore, maintain our **BUY** recommendation.

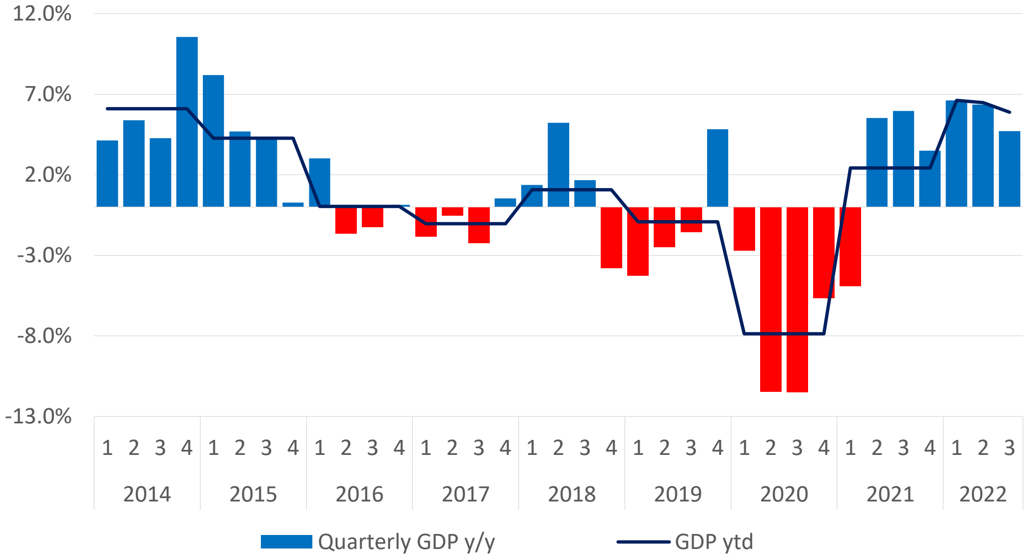
Macroeconomic Overview

Growth Environment

The Namibia Statistics Agency's Q3 GDP data shows that the Namibian economy grew by 4.3% y/y in real terms in Q3. Namibia has now experienced six consecutive quarters of growth on a year-on-year basis, with four of these quarters posting growth of over 5.0%. Encouragingly, the Q2 and Q3 annual growth figures are off a higher base than the first quarter, indicating that the recovery does have some momentum, and that it is not just due to base effects.

The growth in Q3 was primarily driven by the Mining and Quarrying sector which grew by 14.9% y/y, followed by Manufacturing which posted growth of 12.9% y/y. Five sectors, namely Agriculture, Financial Intermediation, Fishing, Construction and Public Administration, posted contractions on an annual basis.

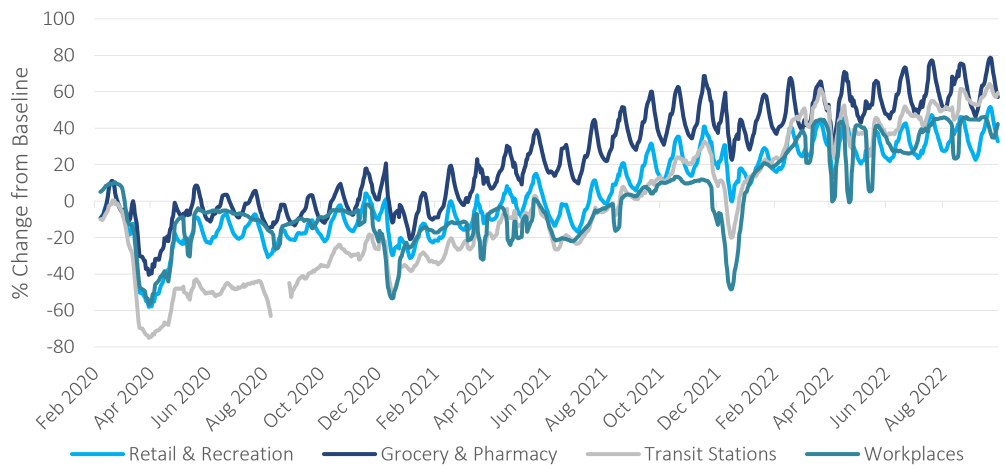
Namibian Quarterly GDP (Real, % y/y)



Source: NSA, IJG Securities

The graph below shows how visitors to the categorised places change compared to the baseline, which is the 5-week period from 3 January to 6 February 2020, before governments around the world started implementing lockdowns. Google's mobility trends data shows that movement/activity in Namibia has more or less settled in 2022 following the strong recovery during the second half of 2021, but that it remains well above the baseline period.

Google Mobility Trends – Namibia



Source: Google, IJG Securities

The increase in activity during 2H21 was further confirmed by the commercial banks who all noted that they saw a significant increase in transaction volumes towards the end of last year. It is furthermore interesting to see how movement (particularly retail and grocery store visits) consistently drops off around the 13th of every month, as people start to run out of money, before gradually climbing again after the 20th.

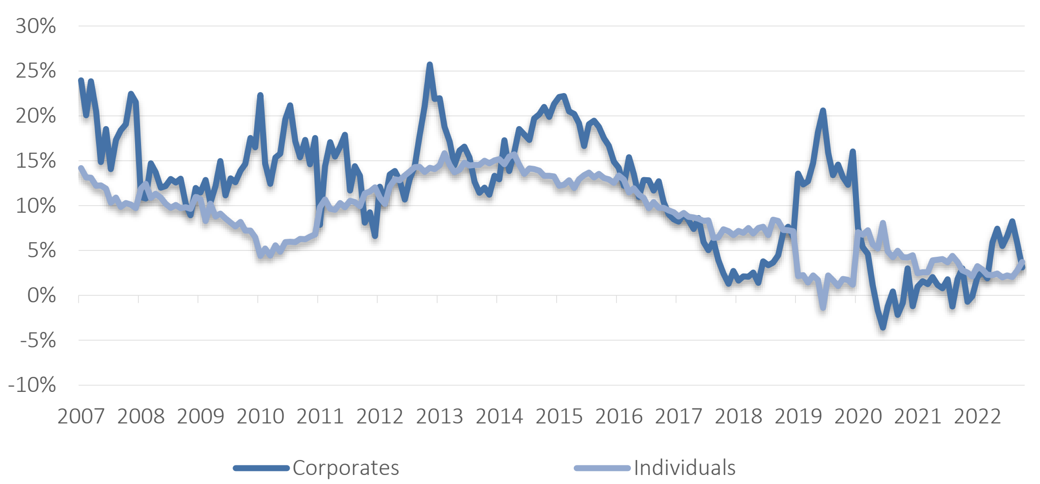
Economic growth for the year is forecast to come in at around 3.3% in 2022, accelerating from the lacklustre growth of 2021. Much of the growth is expected to come from the primary sectors, with diamond mining providing for a substantial portion of the expansion. Secondary industries, while expected to grow somewhat, are not expected to reach levels of output seen before the pandemic. Tertiary industries are exhibiting mixed performance with sectors such as tourism recovering from an extremely low base in prior years while wholesale and retail trade struggles to gain momentum as unemployment increases brought on by the pandemic are slow to reverse.

The Namibian economic recovery remains under threat and the fiscus has few tools with which to protect against economic shocks. The outlook is uncertain and warrants prudent management by fiscal and monetary authorities in the near term. The longer-term outlook is likely to be significantly better provided that the recent oil discoveries translate to oil extraction.

Private Sector Credit Extension

Private sector credit (PSCE) growth slowed to 3.0% y/y in October. Despite this growth rate being roughly double those witnessed between May 2020 and March 2021, PSCE growth remains well below the levels observed prior to the pandemic. Corporate credit demand has improved from last year and made up 77% of credit extended over the last 12 months, although much of this corporate issuance has been driven by short-term debt uptake in the form of 'Other Loans and Advances' (credit card debt and term loans), which is relatively more expensive, and typically used to cover day-to-day expenses, than to invest in larger capital projects.

PSCE Issuance Growth (y/y)



Source: Bank of Namibia, IJG Securities

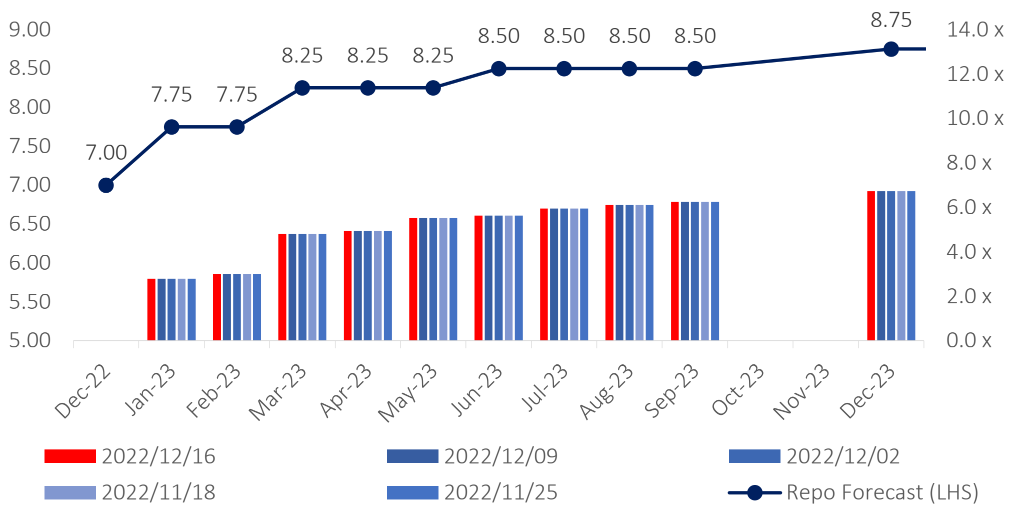
We expect PSCE growth to remain subdued over the short- to medium-term while the central bank continues its monetary tightening stance in line with other central banks across the world. While we should see commercial banks become more willing to extend credit in the rising interest environment, as they experience margin expansion, demand for credit would not necessarily follow suit. The private sector has endured a lot of financial hardship over the past couple of years and there are probably fewer households and corporate entities with the ability to take up new credit from commercial banks despite debt remaining relatively inexpensive by historic standards. The private sector may also be unwilling to commit to long-term expensive debt under the current lacklustre economic circumstances. We therefore expect demand for credit to remain low while the supply of credit is set to improve.

Interest Rates

Monetary Policy normalisation continues to be a key economic theme this year, with central banks around the world unleashing the most aggressive tightening of monetary policy in decades to combat the highest global inflation in forty years.

Inflation rates in South Africa and Namibia have also picked up and breached the SARB's target band of 3-6%, although the MPC has in recent years preferred to anchor inflation expectations closer to the midpoint of the range. SA's inflation rate is believed to have peaked in July at 7.8% and should return to the target band by mid-2023. The SARB's MPC has responded to rapidly rising inflation quicker than several of its global peers by raising the repo rate seven consecutive times by a total 350bps since November 2021. SARB governor Lesetja Kganyago has noted that the MPC's decisions are not correlated to those of the Fed or other major central banks, however we believe that the more aggressive hiking path in the US is bound to weigh on the committee.

Implied Probability of Rate Hikes Over Time (SARB)



**The columns indicate the number of 25bp hikes expected for a given month as at the date indicated in the legend (RHS).*
Source: Bloomberg, IJG Securities

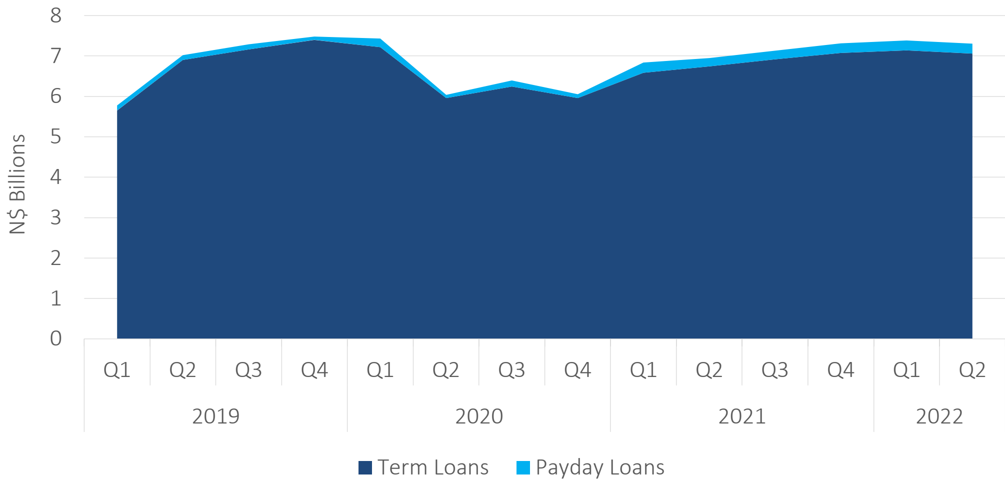
As the figure above indicates, the Forward Rate Agreement (FRA) curve is currently pointing toward another 175bp hike by the SARB before the end of next year, and for the South African repo rate to end 2023 at 8.75%. It is however worth pointing out that while the FRA curve is good at indicating the direction of future interest rates, it does tend to 'overshoot' on the way up (anticipating too much tightening) and tends to consider rate cuts only once a rate hiking cycle has ended.

As the BoN's mandate is to maintain the peg between the South African rand and the Namibia dollar, while keeping an eye on price stability, it has little choice but to follow the SARB in hiking rates further to deter the outflow of foreign reserves needed for purposes of upholding the peg as a consequence of offering a relative less attractive interest rate.

Microlending Sector Overview

According to the Namibia Financial Institutions Supervisory Authority ("NAMFISA"), Namibia had 379 microlenders registered under the Microlending Act at the end of Q2 2022. Competition in the sector is thus fierce with a few entities dominating the space.

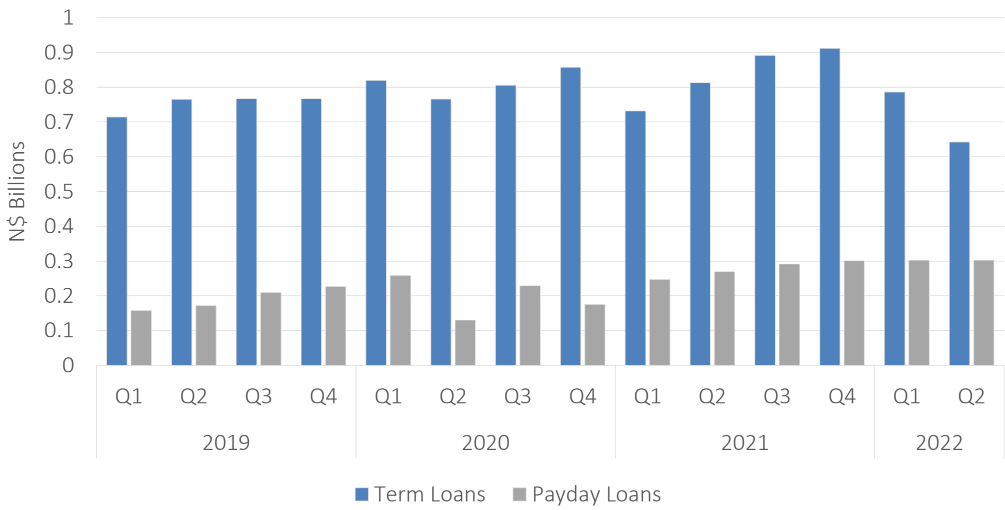
Total Microlending Sector Loan Book Value



Source: NAMFISA, IJG

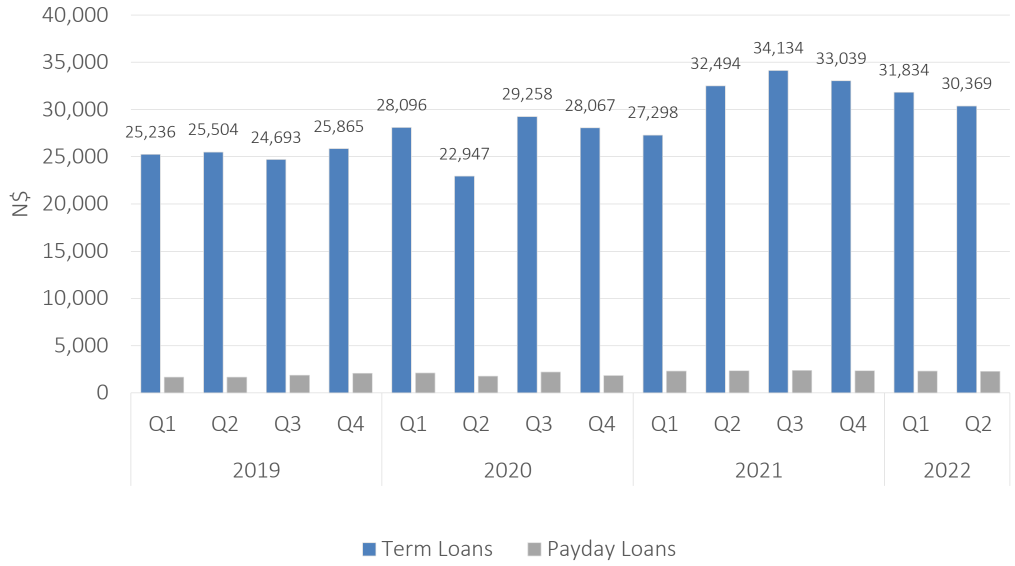
The industry's total advances grew by 5.0% y/y from N$6.95 billion in Q2 2021 to N$7.30bn in Q2 2022. The total industry loan book continues to be dominated by term loans which at N$7.06 bn accounts for 96.6% of total advances. The average term loan size has been growing at a CAGR of 8.1% since 2016 to N$30,369 in Q2 2022. The average payday loan size has been growing at a CAGR of 9.1% over the same period to N$2,273 in Q2 2022. During the 12-months ending Q2 2022, total loans worth N$4.43 billion were disbursed by microlenders, up 7.3% y/y from the N$4.13 billion distributed over the 12-month period a year ago. Term loans worth N$3.23 billion were disbursed over the 12-month period, increasing 0.8% y/y. Payday loans worth N$1.20 billion were distributed over the same period, jumping 29.9% y/y. The number of term lenders stood at 165,182 at the end of Q2 2022, while payday lenders stood at 78,120.

Quarterly New Disbursements



Source: NAMFISA, IJG

Quarterly Average
Size of Loan



Source: NAMFISA, IJG

We should continue to see growth opportunities for the sector. The recently announced increase in civil servant salaries should allow for some further advances growth for the microlenders offering loans to government employees. Furthermore, despite Namibian interest rates having remained historically low for a number of years now, PSCE growth has been lacklustre on the back of corporates choosing to de-lever their balance sheets due to the uncertainty brought by the Covid-19 pandemic, and domestic commercial banks being more prudent when extending credit to both individuals and corporates to protect the quality of their advances books.

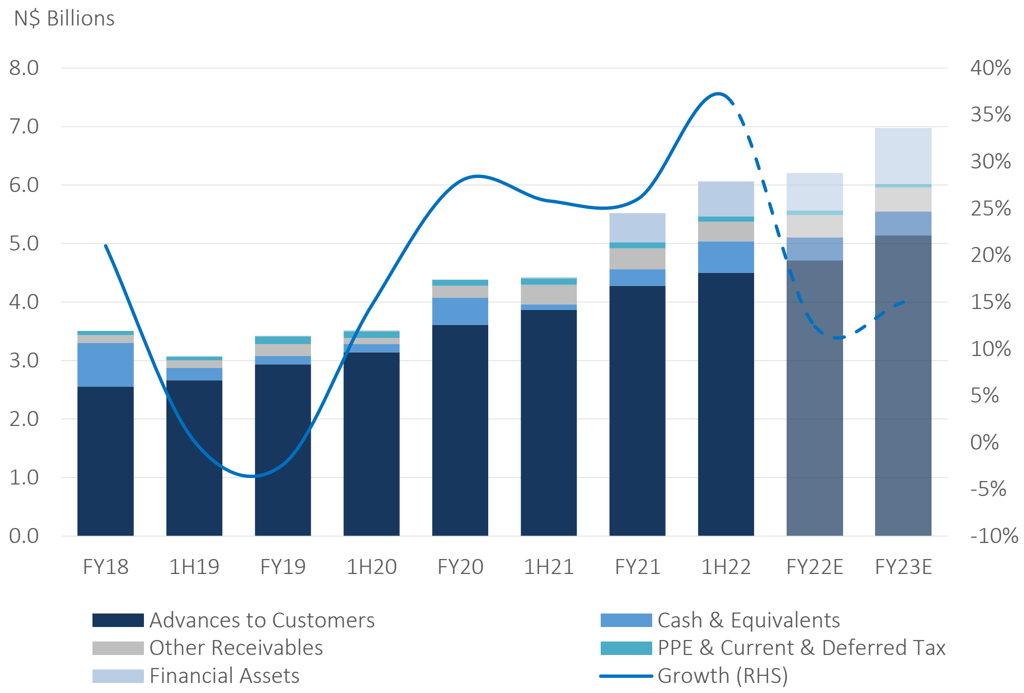
The reluctance to extend credit would have been one of the forces driving demand for microloans in the country. While we are amidst a rising interest rate environment, the non-performing loans of the commercial banks remain relatively high which should mean that banks will remain somewhat reluctant to extend credit to individuals they consider to be riskier, which in turn should continue to drive the demand for microloans in our view.

Company Overview

Asset Base

LHN's total assets grew by 37.0% y/y from N$4.42 billion in 1H21 to N$6.06 billion in 1H22. Most of the growth, however, was captured in 2H21. 1H22 saw total assets rise by 9.81% or N$541.9 million from the N$5.52 billion recorded in FY21.

Asset Breakdown



Source: LHN, IJG Securities

Advances to customers continue to make up the lion's share of LHN's total assets. LHN again recorded robust advances growth. The advances book grew by 16.3% y/y or N$628.7 million to N$4.5 billion in 1H22, although most of this growth was recorded in 2H21. The year-over-year growth in advances was largely spurred on by the relatively low interest rates resulting in customers taking on more debt. The advances book growth slowed in 1H22 however, growing by only 5.1%. Management expects advances growth to remain under pressure over the remainder of the year as we move deeper into the interest rate hiking cycle and the rising borrowing cost puts pressure on demand for credit. The salary increases to government employees (effective from October) may alleviate some of the pressure, but management does not expect significant growth to come from this.

LHN, through its subsidiary Letshego Bank Namibia Ltd (LBN), started rolling out its new affordable home loan offering in 1H22. Management noted that the roll-out was somewhat delayed by the issuance of a home loan deduction code facility which LBN only received in May. With the home loan deduction code now secured, management expects growth in the home loan advances book to pick up in the second half of FY22. LHN furthermore started expanding its loan offerings to the private sector. This includes corporate loans and personal loans to employees in the private sector and can be applied for through Letshego's digital mall. These are welcomed developments as it provides much needed diversification to LHN's advances book which remains arguably overly biased toward the government sector.

LHN's other financial assets increased significantly from N$19.6 million in 1H21 to N$595.7 million in 1H22. Most of the increase in other financial assets was in 2H21. During FY21, LBN purchased USD-denominated South African Government Bonds to the tune of N$480 million. The bonds were acquired as a currency hedge for the USD-denominated loan facility LHN procured from the International Finance Corporation (IFC) to shore up the affordable housing finance business. LBN intends to hold the bond to maturity which should mitigate the risk of the group incurring losses on the investment arising from adverse interest rate movements. Other financial assets also include treasury bills amounting to N$112.0 million, up N$95.7 million from the N$19.6 million recorded in 1H21

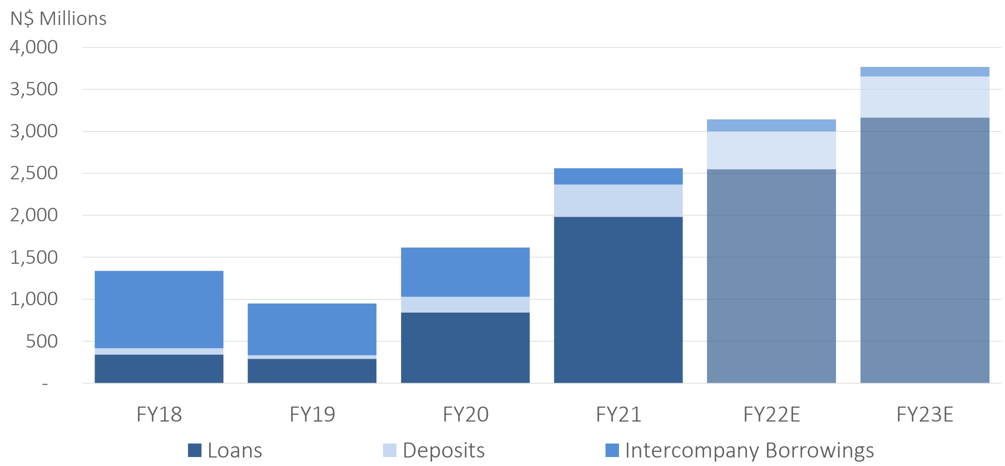
Other receivables rose marginally by 0.2% y/y to N$333.75 million in 1H22, slightly down from the N$352.3 million recorded at the end of FY22. Cash and Cash Equivalents on the other hand increased significantly by 498.7% y/y or N$451.8 million to N$542.4 million, albeit from a relatively low base in 1H21. In the last six months, cash balances are up by N$255.3 million from the N$287.0 million recorded at the end of FY22. The substantial increase in LHN's cash position is largely due to the N$200 million proceeds LHN received from the new bond (dubbed LHN02) it issued on 29 June 2022 as detailed further below. LHN intends to deploy the proceeds towards its lending activities and, as such, we anticipate limited cash drag on LHN's investment portfolio arising from the bond issuance capital raise.

Overall, LHN's asset growth came in strong on the back of rapid growth in customer advances. However, we expect total asset growth to slow in FY22 before picking up again in subsequent years, although marginally.

Funding

Since FY21 LHN's total funding rose by 17.1% or N$450.7 million from N$2.56 billion to N$3.09 billion in 1H22, bringing the total year-over-year change to 94.7% y/y or N$1.50 billion in 1H22.

Funding Mix



Source: LHN, IJG Securities

During the six-months period under review, LHN group continued to increase its local borrowing base and further scaled down its reliance on funding from Letshego Holdings Limited (LHL). LHN local borrowings rose by N$490.6 million in 1H22, while its intercompany borrowings fell by N$22.4 million over the period. As noted above, LHN raised N$200.0 million through its listed bond programme during 1H22, bringing its total debt outstanding under the bond programme to N$431.0 million. This was LHN's second issuance under the programme. Bond LHN02 was issued at 3-month JIBAR plus 280bps (at slightly more favourable rate than bond LHN01 which was issued at 3-month JIBAR plus 355bps) and matures on 29 June 2025.

The loan facility from the IFC rose slightly from N$479.3 million in FY21 to N$489.9 million in 1H22 after accounting for the appreciation of the US Dollar relative to the Namibian Dollar over the period. In USD terms, however, the loan amount received remained unchanged. As of 1H22, LBN received US$30 million (FY21: US$30 million) of the total US$50 million loan facility. LBN is entitled to a further US$20 million on the condition that it fully disburses the US$30 million by December this year according to LHN's most recent annual report. On inquiry on the progress in achieving the timelines agreed with the IFC to roll out the home loan product, management noted that the delay in issuance of the home loan deduction code slowed progress but still expect to achieve the target and receive the additional facility amount.

LHN recorded a 13.3% or N$51.3 million increase in deposits from customers from N$386.1 million in FY21 to N$437.3 million at 1H22. Term deposits rose by 4.0% from N$363.3 million in FY21 to N$377.9 million in 1H22, while current account deposits rose by 161.5% from N$22.7 million to N$59.4 million over the same period. On a year-over-year basis, LHN's customer deposits rose by 45.6% y/y or by N$137.05 million in 1H22. Growing Letshego Bank's retail deposits, a relatively inexpensive source of funding, by comparison, should remain a focus area for the bank's management to further improve the funding mix. While the move to reduce its reliance on relatively expensive intercompany funding assisted in this regard, the greater reliance on floating rate debt exposed LHN to rising borrowing costs and overall resulted in an increase in the group's average borrowing costs as noted in more detail below.

At the 2022 Annual General Meeting a special resolution was passed to amend LHN's Memorandum and Articles of Association allowing it to increase the company's borrowing limit from 10% to 30% and to limit the company's single-person and large exposure to 30%. The 30% limit is based on the total consolidated shareholders' equity of the LHN Group whereas the 10% limit was based on the total shareholders' equity of LHN at the company level only. This amendment paved the way for LHN to raise additional debt under its listed bond programme and potentially free up tools for LHN to be more flexible in terms of capital allocations, including dividend distributions considering that the listed bond debt is issued under LHN (at company level). We expect LHN's debts to continue to rise in support of its asset growth going forward.

Interest Income and Expenses

Interest income

LHN's interest income from lending activities fell 4.4% y/y in 1H22 to N$309.9 million compared to N$324.3 million in 1H21. This drop comes as somewhat of a surprise given the strong growth recorded in the advances book and considering that interest rates have risen by 100bps since the beginning of the year. Management explained that the decline in lending interest income comes as the pre-pandemic high yielding customer advances was rolled into the lower yielding customer advances made during the pandemic, causing the average yield on the advances book to drop (below the advances growth) and interest income to fall by extension.

LHN's advances mix has transformed considerably over the previous reporting periods with banking loan growth starting to outpace microlending loan growth. This in part comes on the back of LHN's loyalty product in terms of which customer advances from the microlending business are rolled into cheaper banking loans. As at FY21, microlending loans accounted for 57% of the loan book while banking loans accounted for 43% of the book. Banking loan disbursement, however, outpaced microlending loan disbursements by 2 percentage points in that year. Management expects the banking and microlending disbursements to reach parity at the end of the year with growth in banking advances outpacing microlending advances growth. Management further expects lending interest income growth to recover as the year progresses and new advances are rolled into the higher yielding loans.

While growing competition in the microlending segment coupled with weaker demand for higher priced loans under the current hard economic conditions may very likely slow LHN's advances growth, we should see lending interest income pick up over the remainder of the year and into next year as we go deeper into the interest rate hiking cycle and the (relatively) lower priced customer loans roll into higher yielding loans as a result. We expect the interest income to grow by double-digits over the short run before tapering off in the medium to long term in anticipation of slowing advances growth as market saturation intensifies.

Other interest income in contrast rose by 604.4% y/y to N$14.1 million in 1H22 from a low base of N$2.0 million in 1H21. Interest accruing on short-term bank deposits and money market instruments came in at N$7.4 million, representing a 269.5% y/y rise from the N$2.0 million recorded in 1H21. Interest income from the investment in government securities came in at N$6.7 million, up N$4.36 million from the N$2.34 million recorded in FY21.

Total interest income came in marginally lower in 1H22, falling by 0.7% y/y from N$326.3 million in 1H21 to N$324 million in 1H22. We expect a sizable uptick in LHN's total interest income for the remainder of the year and into next year before slowing by extension of our views on the lending activities.

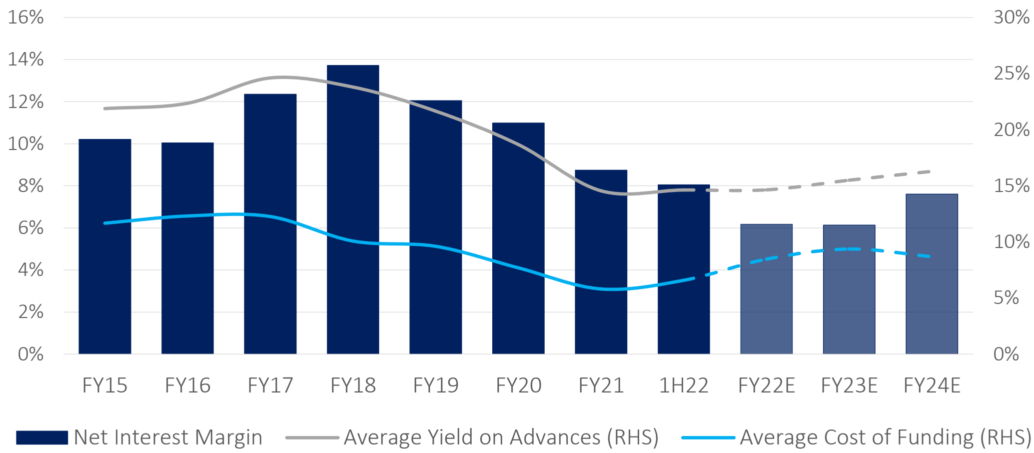
Interest expense

Interest expense rose by 62.5% y/y from N$55.1 million in 1H21 to N$89.6 million in 1H22, a reflection of both the increased debt LHN took on to finance its asset growth and rising interest rates over the period. LHN's average borrowing cost also shot up, from 5.81% in FY21 to 6.58% in 1H22. This is mainly the result of LHN's greater exposure to floating rate borrowings coupled with rising interest rates. Bar further improvements in the debt funding mix, we expect the average borrowing costs to rise further as more rate hikes are expected by the end of the year. Interest rates increased by 200 bps since 1H22 and another 175bps rate hike is on the cards by the end of next year as noted above.

Net Interest Margin

LHN's net interest margin deteriorated slightly in 1H22, from 8.7% in FY21 to 8.0% in 1H22. Swelling borrowing costs were the leading cause. The average yield on advances (before impairment allowance), on the other hand, was slightly better, improving from 14.55% in FY21 to 14.63% in 1H21 but remains between 7-10 percentage points below the highs achieved pre-pandemic. Since the net interest margin tends to grow when interest rates rise, we expect the margin to increase as we move further into the interest rate hike cycle, albeit marginally. We expect LHN's net interest rate margin to stabilise at around the 10.0% mark in the long run provided the anticipated improvements in LHN's funding mix materialise.

Net Interest Margin



Source: LHN, IJG Securities

Non-Performing Loans and Impairments

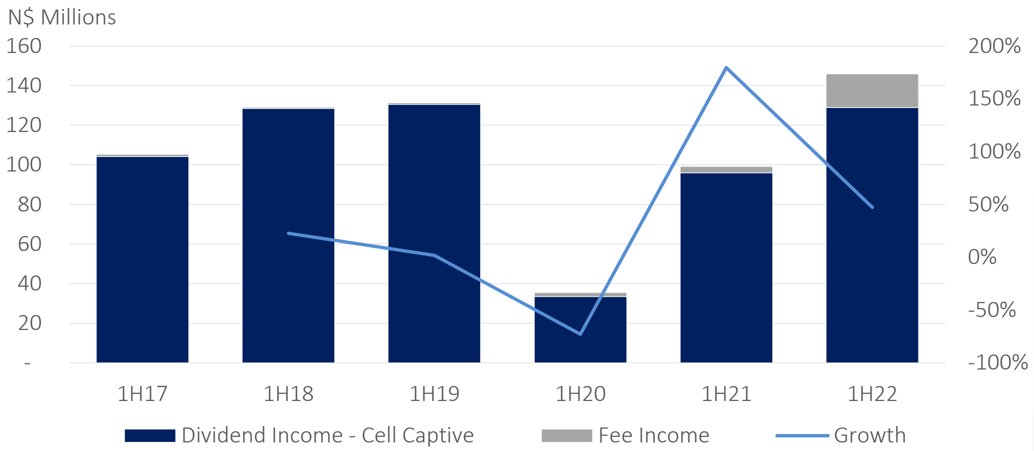
LHN recorded a credit impairment charge of N$4.8 million in 1H22, down by N$17.7 million from the N$22.0 million recorded over the same period last year. Impairments as a percentage of the gross advances book also decreased from 0.6% in 1H21 to 0.1% in 1H22 and remain marginally lower than those of the commercial banks. Management ascribed the decline in LHN's impairments to insuring the previously uninsured advances book. Only a small portion of the advances book remains uninsured.

With covid behind us, we expect LHN's non-performing loans to stay steady going forward. The lack of diversification in LHN's advances remains the biggest source of concern considering that civil servants have been stretched financially for a couple of years now. The recent statements from the government that they may withhold salary payments from civil servants that strike certainly put increased focus on LHN's concentration risk exposure as most of the group's advances (more than 90 cents for every N$1 advanced) are to the public sector. The planned private sector loan offerings, including the home loan product (to the extent that is advanced to private sector employees), will certainly alleviate some of the concentration risks over time. That said, the trade-off in diversifying away from the government sector may come in the form of potential increases in impairments from private sector loans as they carry relatively higher credit risk.

Non-Interest Revenue

Non-interest income increased by N$46.7 million or 47.1% y/y, from N$99.2 million in 1H21 to N$145.9 million in 1H22.

Non-Interest Revenue



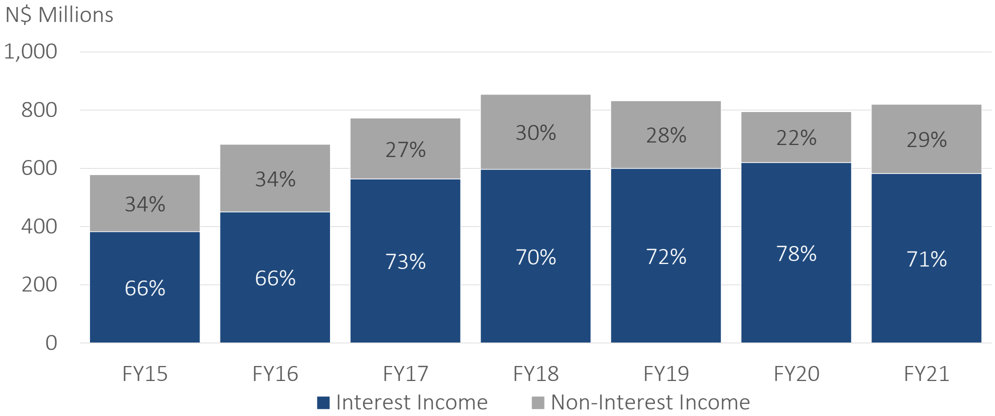
Source: LHN, IJG Securities

Dividend income from cell captives, which make up the bulk of the non-interest income, increased by 34.5% y/y or N$33.0 million from a revised N$95.9 million in 1H21 to N$128.9 million in 1H22. The dividend income for 1H21 was revised after it was discovered that the dividends were recorded gross of taxes paid and that LHN's dividend income as well as its tax expense initially recorded for the period was overstated by the tax amount as a result. The revision, however, had no impact on LHN's bottom line.

LHN also recorded strong growth in fee income, with fees and commissions earned rising by 418.0% y/y from N$3.3 million in 1H21 to N$17.0 million in 1H22. Postage fees rose by 9.5% y/y to N$69,000. Management ascribes the rise in fee income to an increase in transaction activity by LBN driven by its digital offerings, amongst others.

Overall, non-interest income continues to make up almost a third of LHN's total income with dividend income from the cell captive arrangement remaining a substantial component of the profitability of the group considering that it accounts for 27.4% of the group's total income in 1H22 (1H21: 22.5%), or roughly 64.0% (FY21: 53.0%) of the group's earnings (after adjusting for insurance costs related to the cell captive arrangement).

LHN's Income Breakdown



Source: LHN, IJG Securities

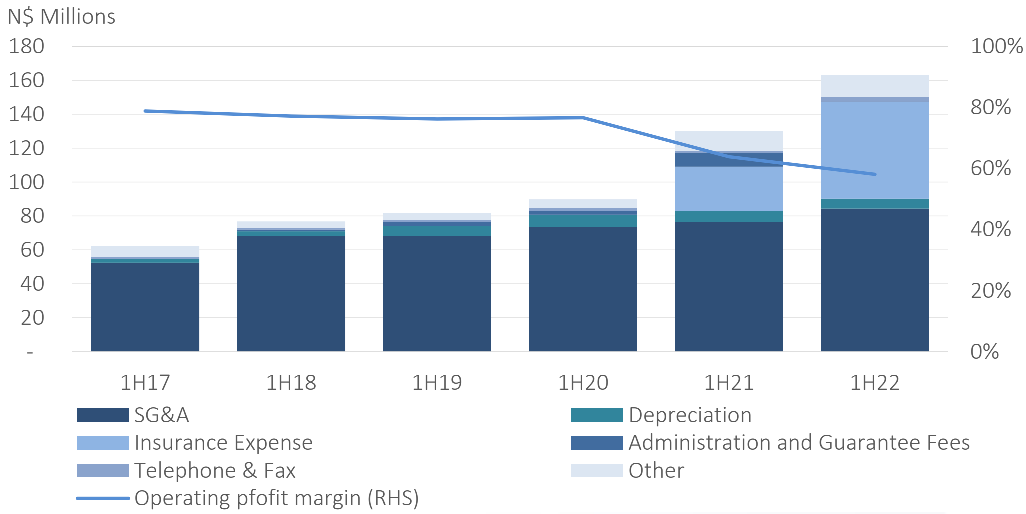
Operating Expenses

LHN's operating expenses continued to climb, rising by 21.2% y/y to N$183.9 million in 1H22. The steep rise in operating costs is attributable to rising credit default insurance costs on LHN's microlending book and if normalised, operating expenditure rose by only 0.74% y/y.

The rise in credit default insurance costs was expected following the classification of the charge as finance cost[1] which meant LHN could no longer capitalise the cost and had to subject the charge to the limits imposed under the Usury Act. Since LHN already charged the maximum allowed under the Usury Act, the insurance had to be expensed. Consequently, LHN's insurance costs shot up by 120.4% y/y, from N$25.9 million in 1H22 to N$57.2 million in 1H22.

While the insurance is a significant cost for the group, the benefits of maintaining the credit default insurance still outweigh the costs of the insurance, according to management. The cost of the insurance is about 3.5% while the potential costs from defaults is estimated at about 4.5%.

Operating Expenses



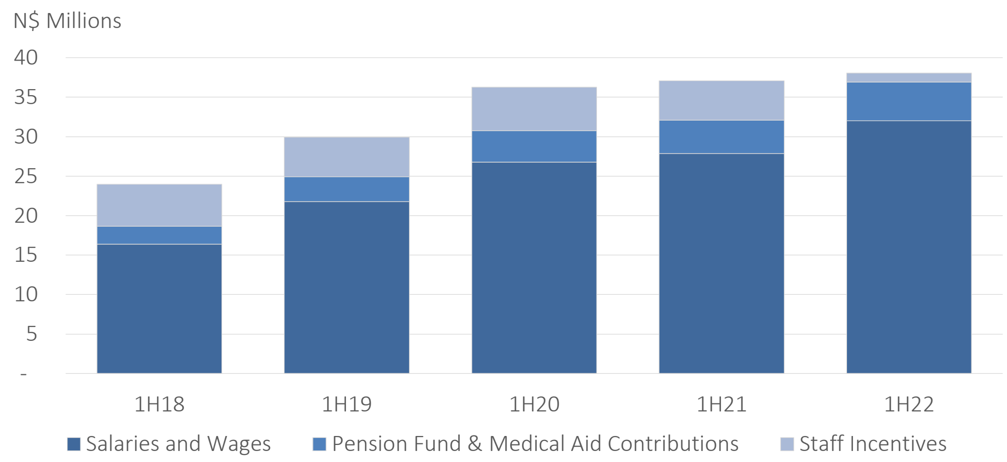
Source: LHN, IJG Securities

[1] In terms of the Microfinance Act.

Salary expenses and management fees also rose sharply. Salaries and wages increased by 14.98% y/y to N$32.0 million in 1H22, and management fees grew by 75.29% y/y to N$24.9 million. According to management, both cost items were incurred in relation to growth activities. The rise in salaries and wages was due to skill acquisitions, specifically in the banking business while the increase in management fees accounts for the larger cost allocation from the group in relation to the development and support of LHN's digital offerings. These two cost items together make up 39.1% of LHN's operating expense base, the largest contributors after insurance costs which accounted for 39.2% of the total operating expenses.

Total employee benefits (salary expenses included) rose by only 2.7% y/y to N$38.1 million in 1H22 as staff incentives were significantly reduced, falling by 76.5% y/y to N$1.17 million.

Employee Benefits

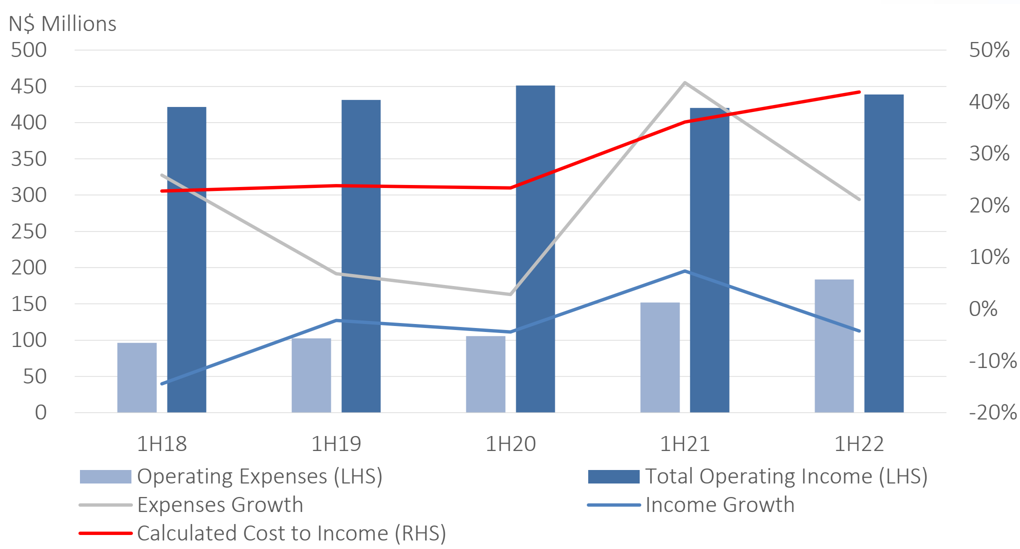


Source: LHN, IJG Securities

Guarantee fees saw the largest decline, falling by 99.8% y/y or N$7.85 million to N$16,000 in 1H22. This follows LHN's reduced reliance on intercompany debts on which it had to incur those fees. Consulting and Secretarial fees also dropped notably, falling by 30.2% y/y to N$5.8 million.

Overall, operating expenses continued outpacing total income in growth terms. Employee costs and management fees remain the driving forces behind LHN's growing cost base, apart from the rising insurance costs. LHN's cost-to-income ratio (CTI) rose from 36.1% in 1H21 to 41.9% in 1H22, although slightly better than the all-time high of 45.9% registered in FY21. We expect LHN's CTI ratio to remain elevated at around the 40% level with the insurance cost included.

Cost to Income



Source: LHN, IJG Securities

Outlook

All considered LHN delivered decent results in 1H21. LHN achieved solid growth in advances and delivered respectable profits and earnings growth despite interest income coming in below a year prior. The decline in interest income came as an initial surprise considering the strong growth in customer advances but we are of the view that the decline observed was the tail-end of the rate cutting cycle still playing out in LHN's advances book. We expect interest income growth to pick up this year and beyond as we move deeper into the interest rate hiking cycle. For the most part, LHN is on track to meet IJG's revised FY22 estimates with lower-than-estimated interest income as the most likely surprise outcome in our view.

On the funding side, we continue to see positive developments in terms of LHN opting for a more cost-effective debt funding mix. LHN further reduced its relatively expensive intercompany debts by increasing its local borrowing base. LHN furthermore managed to diversify its offerings to the market through the rollout of its digital mall and home loan product offerings. We expect LHN to reap benefits from these offerings predominantly through loan book diversification and increased bank transaction flows.

On the downside, the microlending sector is experiencing stiff competition and we expect growth in microlending advances and the margins on the microlending book to come under pressure as we move further into the interest rate hiking cycle and the cost of funding escalates. That said, we believe that there is still room for fair growth in this sector. The margin pressures are expected to push out the smaller players, leaving the established microlender to pick up that market share and alleviate some of the competition. Furthermore, LHN has yet to meet the 45% minimum Namibian shareholding requirement set by the Bank of Namibia. The current deadline for LHN to increase its Namibian shareholding is 31 December 2023. Management confirmed that they are actively working towards broadening the Namibian ownership in line with the target. We will continue to monitor the developments in this regard.

Valuation

Two of the main valuation input assumptions are the cost of equity and long-term sustainable growth rate. The cost of equity was calculated using the capital asset pricing model (CAPM). The resultant cost of equity amounted to 19.78%, based on an average 9.78% yield on the IJG generic 10-year bond over the past 10 years, an equity risk premium of 6.0%, an unsystematic risk premium of 2.0%, and an additional 2.0% risk premium related to the regulatory risk that LHN is exposed to. A long-term sustainable return on equity of 17.0%, a downward revised long-term sustainable growth rate of 4.0%, and an upward revised estimated long-term pay-out ratio of 50.0% have been used. The output of our valuation model is presented below:

	Value (N$ '000)	Price per Share	Price to Earnings	Forward PE	Price to Book	Forward PB	Dividend Yield	Forward DY	Weight
Residual Income	1,866,159	3.73	6.15	6.60	0.69	0.65	7.91%	11.36%	25%
Dividend Discount	1,286,723	2.57	4.24	4.55	0.47	0.45	11.47%	16.48%	25%
Justified Price to Earnings	895,929	1.79	2.95	3.17	0.33	0.31	16.47%	23.67%	25%
Justified Price to Book	1,963,551	3.93	6.48	6.94	0.72	0.69	7.52%	10.80%	25%
Weighted Average	**1,503,091**	**3.01**	**4.96**	**5.32**	**0.55**	**0.52**	**10.84%**	**15.58%**	**100%**

Source: IJG Securities

Based on the table above, we derive a target price of N$301c per share and coupled with an expected full-year dividend of 42.41cps, we derive an expected total return of 14.34%. Despite the downward revision in our target price, we maintain our **BUY** recommendation.

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