Letshego Holdings Namibia
Initiation Report
SEPTEMBER 2017

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Initiation Report

Target Price (c)	497
Current Price (c)	380

Year End 31 December	2015	2016	F2017	F2018	F2019
Net interest income (N$ million)	286	331	391	443	504
Non-interest income (N$ million)	194	230	265	302	341
Profit After Tax (N$'000)	272	330	356	405	459
HEPS (c)	54	66	71	81	92
DPS (c)	-	-	23	20	23
DY (%)	-	-	6.1	5.3	6.1
P/E	7.0	5.8	5.4	4.7	4.1
P/B	1.6	1.3	1.1	0.9	0.8

Recommendation	BUY
NSX Code	LHN
Market Cap (N$m)	1,900
Shares in Issue (m)	500.0
Free float (%)	20
52 week high (c)	n/a
52 week low (c)	n/a
Expected Total Return	30.9%

Source: LHN, IJG

Letshego Holdings Namibia (LHN) listed on the Namibian Stock Exchange (NSX) on the 28th of September 2017 following an initial public offer at a price of 380 cps, where 100 million shares were made available to the public.

LHN has two wholly owned subsidiaries, Letshego Bank (Namibia) Limited (LBN) and Letshego Micro Financial Services (Namibia) (Pty) Limited (LMFSN). LBN and LMFSN has a network of two branches and 14 customer access points across Namibia offering the provision of short to medium-term unsecured consumer loans to salaried employees of the public and private sectors.

With the attainment of a banking licence and new ownership structure, LBN has transferred 52% of its loan book to LMFSN, which will enable LBN to focus on providing retail banking solutions, while LMFSN will continue with their microlending activities. The retail banking products and services will include a range of simple and affordable transactional and savings solutions and services that will predominantly target the lower to middle income segments of the working population.

The Letshego loan book currently consists mainly of government employees and makes use of a deduction at source model. A government deduction code, which allows the holder to collect instalments directly off the government centralised payroll system, has been instrumental in limiting the credit risk of Letshego's lending activities. In conjunction with the use of credit management processes, which include credit insurance, LHN has kept their non-performing loans below 1% of total loans and advances.

Over the last three years Letshego Namibia has shown strong growth in profitability, as profit after tax has grown by 23% compounded annually. According to the prospectus, this has been achieved through good growth in assets and effective credit management processes. The net interest margin on average loans and advances is also much higher than a conventional retail bank, averaging 13.9% over the last three years. This is due to the high interest rates that are charged on uncollateralised loans. LBN lending rates are currently capped at 1.6x the Prime Interest Rate, whilst LMFSN maximum lending rate is capped at 2x the Prime Interest Rate as per the Usury Act.

Letshego also boasts an impressive cost to income ratio, which averaged 25.3% over the last three years. This is largely due to the operational efficiency of the business model, which relies heavily on strategic partnerships and mobile network operators to provide the infrastructure, technology and channels to market and enable Letshego to provide services to its customers.

Return on equity has averaged 20.5% over the last three years, while return on assets has been impressively high at 13.3%. The financial leverage of the business is thus quite low, with total assets to total equity at 1.52x at the end of FY16. This implies that ROEs could be materially higher if the company decides to tilt their capital structure to more deposit and debt financing as the company continues to grow.

However, the company does face some noteworthy business risks. Firstly, the cap on interest rates charged could be lowered which would have an immediate effect on the net interest margin of the lender. The Ministry of Finance has already issued guidelines to introduce regulations for reduced interest rate caps that will apply to the businesses of LBN and LMFSN as payroll deduction code holders.

Dividends

The company does not expect to declare any further dividends for the FY17 year.

Analyst

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Disclosures

IJG Securities (Pty) Ltd, a subsidiary of IJG Holdings is the sponsoring broker to the Letshego IPO.

IJG Advisory Services (Pty) Ltd, a subsidiary of IJG Holdings acted as Advisor to the Letshego IPO.

The author of this report holds a long position in the security.

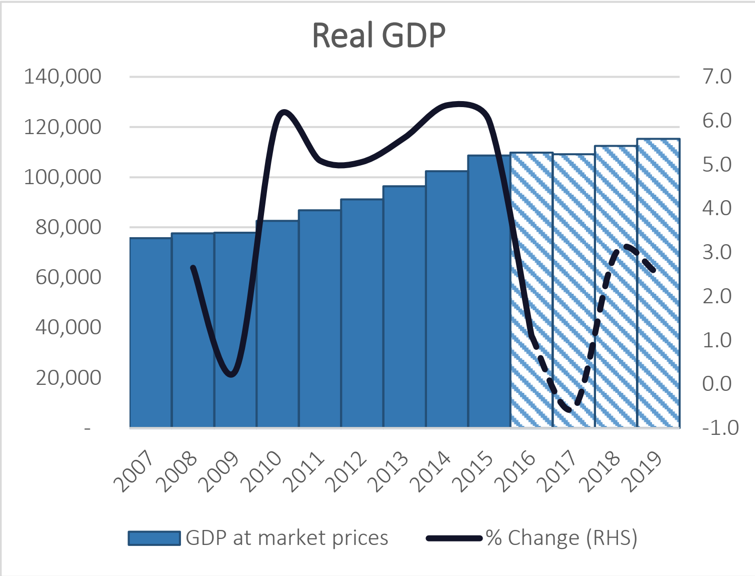
Secondly, both LBN and LMFSN are currently reliant on Government Deduction Codes for their collections. These codes have been issued for a five-year term after which they need to be renewed. If the facility is not renewed in 2022 the business might face increased credit risk and much higher non-performing loans.

Lastly, due to the historical business model of offering payroll loans to government employees, LMFSN has high credit concentration risk, with 99.6% of the loans concentrated in the Government sector.

We make use of a justified price to book multiple to value this company. We establish a cost of equity of 16.5%, which consists of a risk-free rate of 9.9% (based on the Namibian 10-year government bond), an equity risk premium of 4.6% and a unsystematic risk premium of 2.0%. Based on this cost of equity, a conservative long-term growth rate for the company of 8.0% and a long term sustainable Return on Equity of 20.0%, we believe a Price to Book multiple of 1.41x can be justified. Given expected book value per share of 353c in FY17, we derive a target price of N$c497 per share or an expected return of 30.9%. As a result of the apparent discount to fair value, we initiate our coverage on LHN with a **BUY** recommendation. Please see disclosures in the adjacent box.

Macro Backdrop

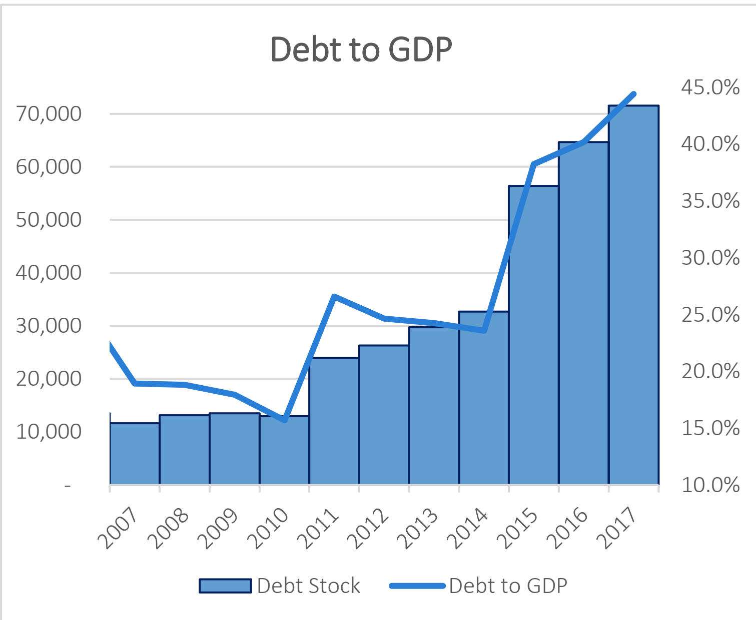
Growth Environment



The 2016/17 financial year was a particularly difficult year for the Namibian Economy. After many years of expansionary fiscal and monetary policy, the Namibian economy currently finds itself in a recession with limited policy tools available with which to kick-start growth.

Final National Accounts data shows real GDP growth figures for 2016 significantly depressed at 1.1% from 6.0% in 2015, while second quarter GDP indicates that both quarters of 2017 have declined by 1.7% on an annualised basis

The slowdown in growth stems from a slowdown in foreign direct investment and completion of construction on various mining projects, coupled with a slump in commodity prices and slowdown in government revenue growth. The construction sector was hardest hit by slowing government spending, posting a real contraction of 26.5% y/y in 2016.



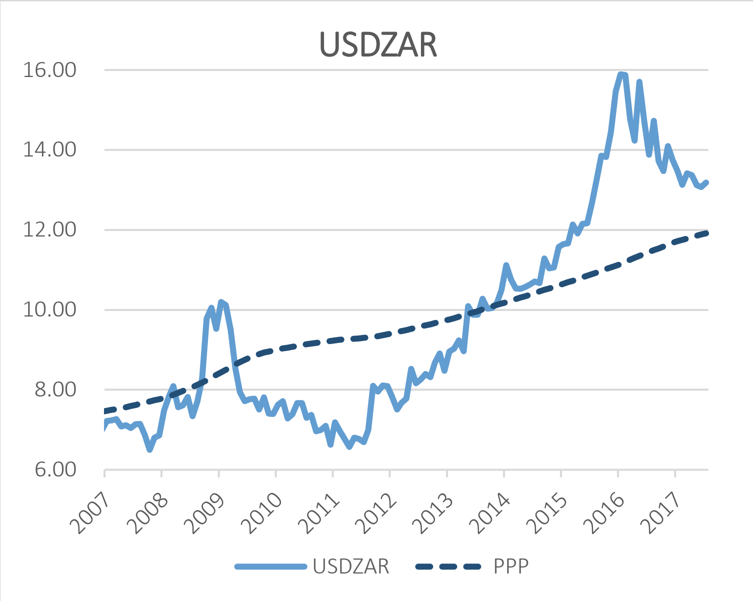
Elevated levels of government expenditure coupled with the slowdown in government revenue led to a large increase in public debt during 2015 and 2016, as growing budget deficits had to be financed. As a result, Debt to GDP rose from 23.6% in 2014 to its current level of around 44.4%. The rapid accumulation of government debt caused a crowing out effect where government securities drained liquidity for the market and caused funding costs for the banks to rise dramatically.

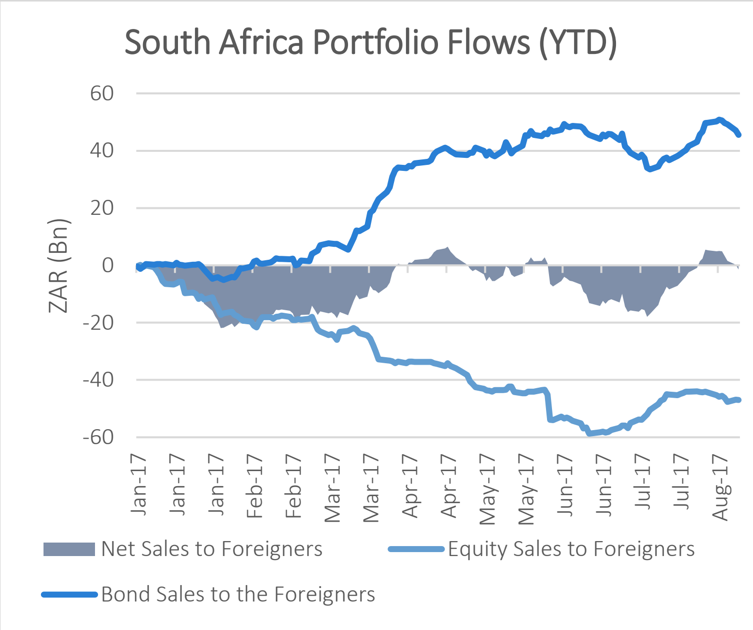
Although fiscal consolidation efforts have been implemented since the midterm budget review in October 2016, high debt to GDP levels as well as delayed or non-payment of private sector invoices were contributing factors to a Moody's downgrade of Namibia's foreign currency denominated debt to sub-investment grade. Although the downgrade had little immediate impact, this will increase our borrowing costs for foreign denominated debt in the future.

Luckily the region has showed some signs of improved growth prospects. After two consecutive quarters of decline, the South African economy lifted out of recession in the second quarter of 2017. Positive contributions to higher economic activity was experienced across most industries. Agriculture, finance and mining lifted South African GDP by 2.5% in the second quarter on an annualised basis. Agriculture continued to show strong recovery from South Africa's recent drought, increasing production by 33.6% driven mostly by maize and wheat production.

Namibia is also expected to recover from the current economic slowdown, but this is likely to take some time. Pro-cyclical fiscal policy, which contributed to the overheating of the economy, may now result in the economy remaining in a low growth environment for an extended period. Balancing structural reforms while undertaking fiscal consolidation will be challenging, but very necessary.

Exchange Rate

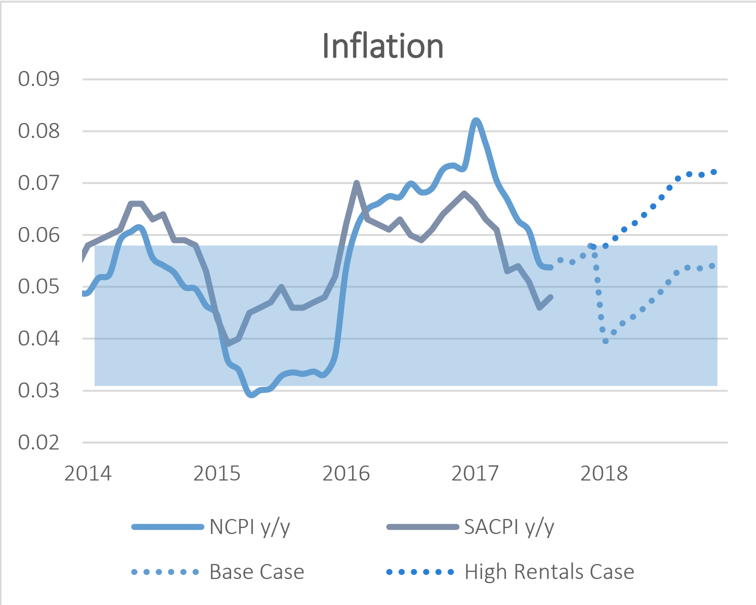




The rand has been steadily appreciating against the USD following the rapid depreciation witnessed in 2015. The currency also strengthened on a trade weighted basis by 23.9% since the start of 2016. However, the rand is still relatively far away from its purchasing power parity (PPP) value, which we estimate at around ZAR 11.90/USD.

Despite previous concerns, the risk of a local currency downgrade in South Africa, which would result in the country falling out of global bond indices, has not had any negative effect on sales of bonds to foreigners. Instead, foreign portfolio investment into bonds has been quite strong as carry traders have become enticed by higher yields, balancing out equity outflows to bring net portfolio flows close to nil. This likely provided some support for the rand.

Inflation

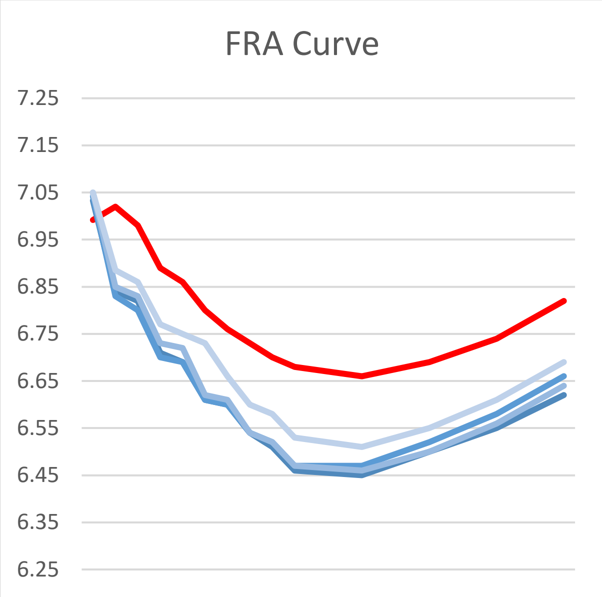


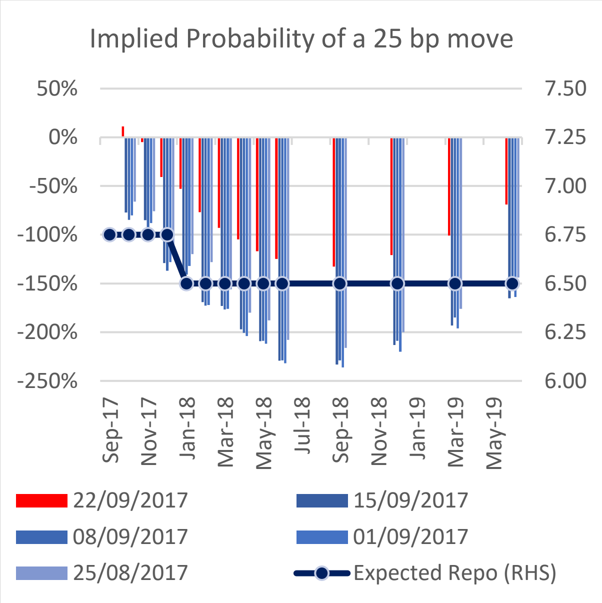
The Namibian inflation rate has returned to the 3-6% target range, as the most recent readings have surprised to the downside. Namibian inflation remained above 6% for the first half of the year, and has dropped to 5.4% in August.

South African inflation displayed a similar trend, and stood at 4.8% at the end of August. Inflation moderated more rapidly than expected due to quickly decelerating food price inflation as the effects of the drought in the Southern African region ceased. The South African reserve bank expects SACPI to average around 4.8% over the next twelve months.

Our NCPI inflation forecast is heavily dependent on rental payments for dwelling sub-category, which makes up 23.3% of the overall inflation basket. If rental increases revert to their mean, as implied by our autoregressive model, then inflation should average around 4.9% in 2018. However, if rentals display the same 9.8% increase seen in January 2017, this will underpin a much high level of in 2018, averaging around 6.7% for the 2018 calendar year.

Interest Rates





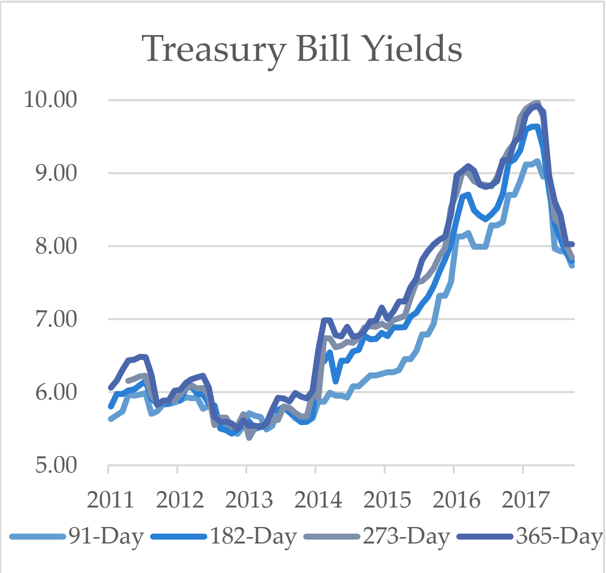
Interest rate expectations have changed substantially over the last six months. After the downgrade of the South African foreign denominated currency debt rating expectations were pointing to increases in the South African repo rate.

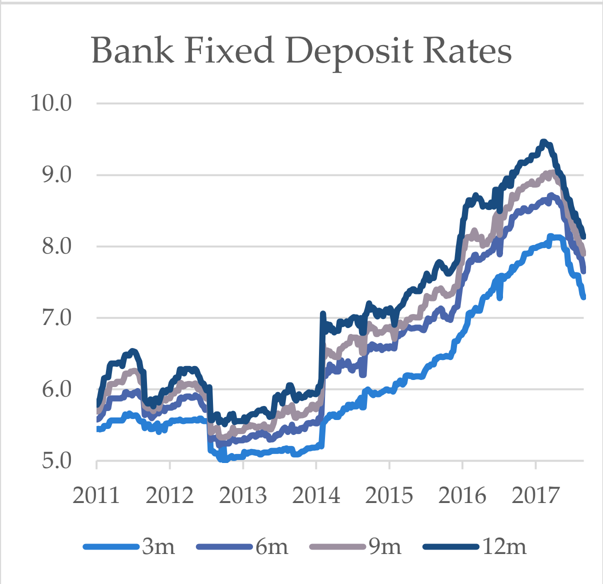
However, following a decline in GDP growth expectations and a rapid deceleration in inflation, the July South African Reserve Bank (SARB) monetary policy committee (MPC) meeting saw an unexpected 25 basis point cut in the South African repo rate. Additionally, the September MPC meeting also delivered a surprise, as the anticipated 25 basis point interest rate cut did not materialise, and the central bank elected to hold the repo rate at 6.75%.

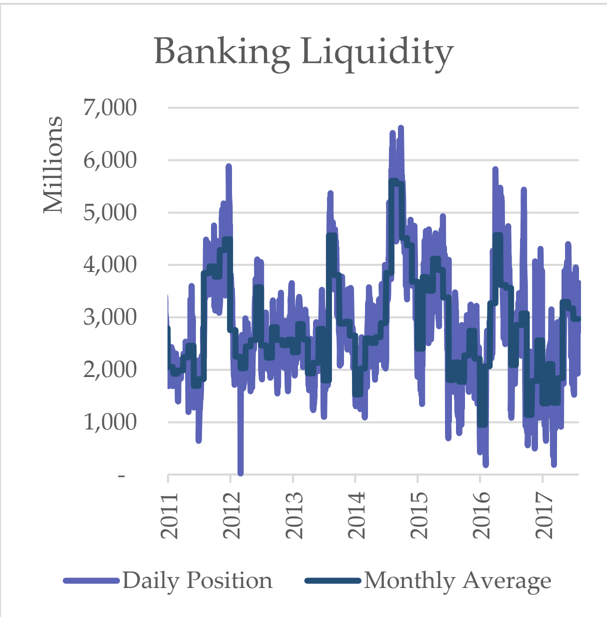
The latest FRA curve continues to point to a rate cutting cycle in South Africa, although only one 25 basis point move is expected in 2018. The bank of Namibia is likely to follow the SARB quite closely, as it has in the past.

The risk to this base case scenario is that the political environment in South Africa leads to further credit ratings downgrades. Should South Africa lose its local currency investment grade rating, large fund flows out of South African bonds could take place. This will lead to currency depreciation and an uptick in inflation as a result. In our downgrade scenario, the SARB may be forced to defend the currency by raising interest rates by at least 50 basis points.

Funding Costs







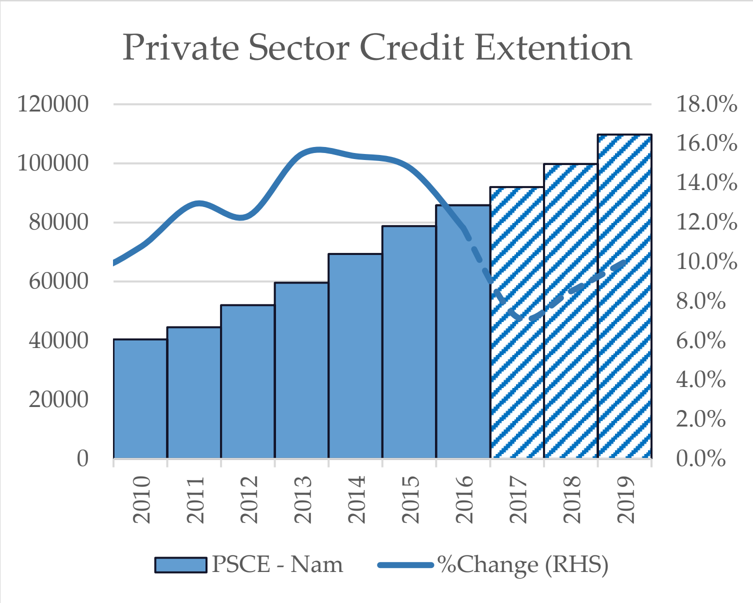
Funding costs were a major thorn in commercial banks' side in the last financial year. Following the rapid accumulation of government debt to finance large budget deficits, treasury bill yields increased to compensate for the increased credit risk as well as the decreased demand.

The large issuances in the short-term government securities combined drained liquidity from the market and directly competed with the banks' institutional funding. As a result, deposit rates increased dramatically, squeezing banks' net interest margins.

However, since April 2017 rates have been falling steadily. Liquidity conditions improved considerably as government found alternative sources of funding, which included a bridge loan from the African development bank to the tune of N$10 billion over the next two budget years.

Funding costs are expected to decrease slightly further from current levels as it seems demand has returned for government treasury auctions and bank deposit rates have also not found their floor.

Credit Demand and Supply



Private sector credit has continued to slow in the last six months, largely due to the abovementioned factors of low liquidity, high funding costs and slower economic growth.

PSCE growth declined to 6.8% in July driven largely by a slowdown in corporate credit which increased by only 5.0% y/y in July, while credit extended to individuals grew by 8.4%.

Instalment credit was the hardest hit by the economic slowdown. This was likely a combination of the direct effect of lower government spending as well as lower disposable income and lower demand for capital goods. Vehicle sales, the main contributor to instalment finance, have slowed by 24.4% on a twelve-month cumulative basis.

Mortgage loans have also slowed considerably, growing at 8.3% y/y in July 2017 compared to 11.1% in July of 2016. However, overdraft loans, which grew by 17.7% y/y in July has been the one category which has displayed strong growth, which may be indicative of the stretched financial position of many individuals and corporates at the moment.

Seeing as liquidity has improved somewhat, demand for credit will remain an obstacle for credit growth going forward. Credit extension will be tied to recovering economic growth and improving disposable incomes, which will likely not pick up rapidly in the short term. We expect this demand to pick up slowly over the next three years. We expect private sector credit extension to decline to 7.2% in the current financial year before ticking back up to 10.0% in 2019.

Company Structure and Background

Letshego Holdings Namibia (LHN) was incorporated on 24 February 2016 as a financial sector investment holding company to hold the controlling interest in two subsidiaries, namely: Letshego Bank Namibia (LBN) and Letshego Micro Financial Services Namibia (LMFSN). LHN is majority owned by Letshego Holdings Limited (LHL), incorporated in the Republic of Botswana.

Letshego Bank Namibia was incorporated in Namibia on 16 October 1997 and was initially called Edu-Loan. It was acquired by Letshego Holdings in 2008 and changed its name to Letshego Financial Services Namibia in 2009. The Bank of Namibia granted the institution a banking licence in 2016 and it was converted to a public company to comply with the requirements of the Banking Institutions Act. Its name was then changed to Letshego Bank Namibia Limited.

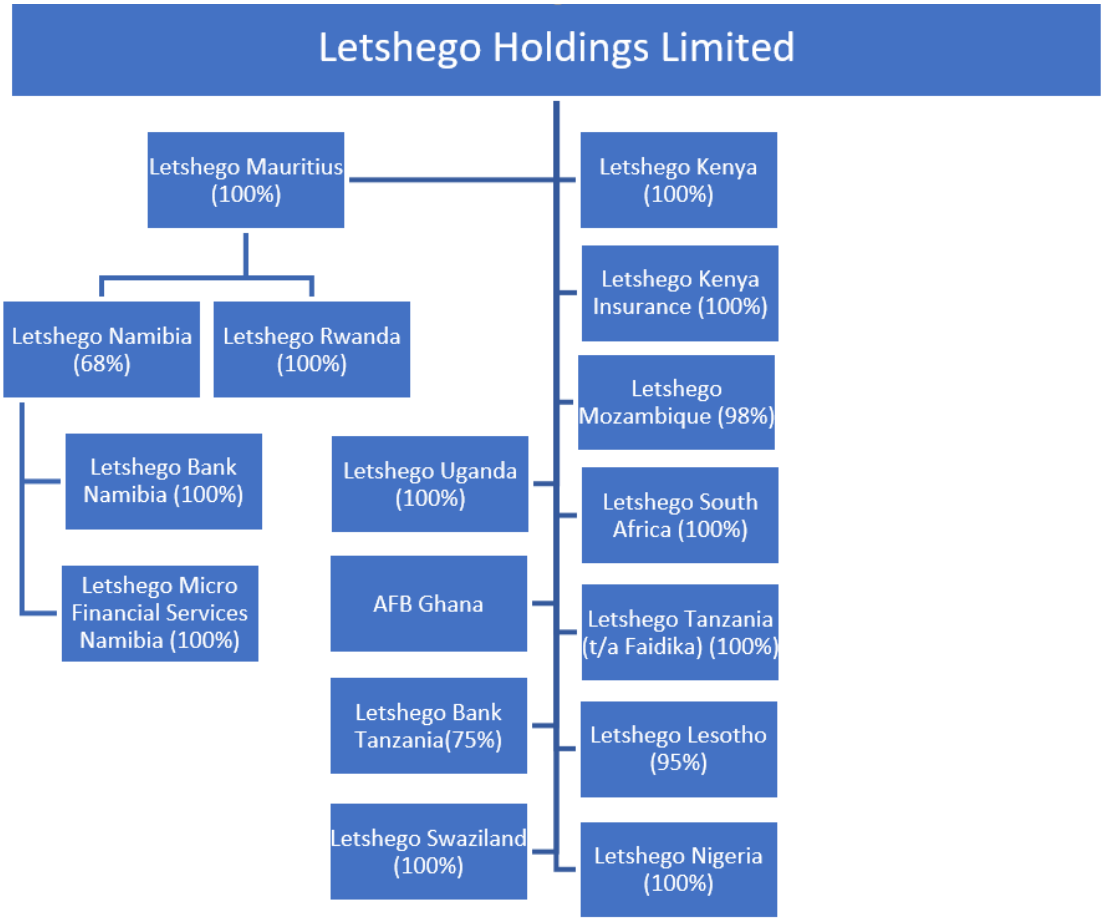
LBN and LMFS have a network of two branches and 14 customer access points across Namibia offering the provision of short to medium-term unsecured consumer loans to salaried employees of the public and private sectors. Instalments are deducted at source to minimise credit risk. With the attainment of a banking licence and new ownership structure, LBN has transferred 52% of its loan book to LMFSN, which will enable LBN to focus on providing retail banking solutions, while LMFSN will continue with microlending activities.

The retail banking products and services will include a range of simple and affordable transactional and savings solutions and services that will predominantly target the lower to middle income segments of the working population. The company’s offering consists of four main product lines:

- LetsPay: Transactional payment and remittance accounts.
- LetsBorrow: Loans up to the value of N$50,000, over loan tenures ranging from 6 months to a maximum of 5 years.
- LetsSave: Call and term savings deposits.
- LetsLive: Loyalty program to encourage diligent repayment with benefits which vest as cash rebates.

Following the listing, LHL (the ultimate parent) plans to move the holdings of LHN (and eventually all other African subsidiaries) to Letshego Holdings Mauritius as this will reduce the effective tax rate of the holding company.

The company structure of LHL, following the restructuring, will be as follows:



Following the IPO the ownership structure of LHN is (assuming a full subscription):

- -Letshogo Holdings Limited 68%
- -Kumwe Investment Holdings 12%
- -Public Shareholders 20%

It is important to note, however, that the Bank of Namibia have made LBN's banking licence contingent on a minimum of 45% local ownership before July 2020. Additionally, the Ministry of Finance's deduction code guidelines require financial institutions to be 51% owned by Namibians and that at least 30% should be previously disadvantaged persons (PDN). These codes are up for renewal in 2022.

After the IPO the combined shareholding of public shareholders and of Kumwe (the Namibian partners), which will comprise the total free float on the NSX, amount to a maximum of 32%. This means that Letshego Holdings Mauritius Limited will either have to sell an additional 13% on the exchange or alternatively LHN will have to go through a rights issue within the next five years. Thus, there is a risk of shareholder dilution through a rights issue.

Deduction at Source

A government deduction code, which allows the holder to collect instalments directly off the Government centralised payroll system, has been instrumental in limiting the credit risk of Letshego's lending activities. The government deduction code is issued by the Permanent Secretary of the Ministry of Finance, and a deduction code has currently been issued for a period of five years, expiring 2022, after which it must be renewed.

The deduction code comes with certain lending rules. The affordability rules of the deduction code stipulate that a client should take home 35% of their gross salary or N$750 whichever is the higher amount. However, LHN applies a more conservative rule of 35% of gross salary or N$1,200, whichever is higher.

Additionally, the Ministry of Finance deduction code guidelines require that financial institutions be 51% owned by Namibians and that at least 30% should be PDN persons, a target that should be reached before the next renewal and one of the reasons for the IPO.

For accounts which are not on the centralised government payroll, deduction mandates are obtained from customers in their loan contracts. Deductions are then made from their primary bank account (where the customer's salary is deposited). If collection is unsuccessful, the loan is considered to be in arears and will be followed up accordingly. The strategy going forward is to encourage customers to deposit their salaries into Letshego accounts. This way customers become depositors while simultaneously allowing the bank access to deduct their loan instalments.

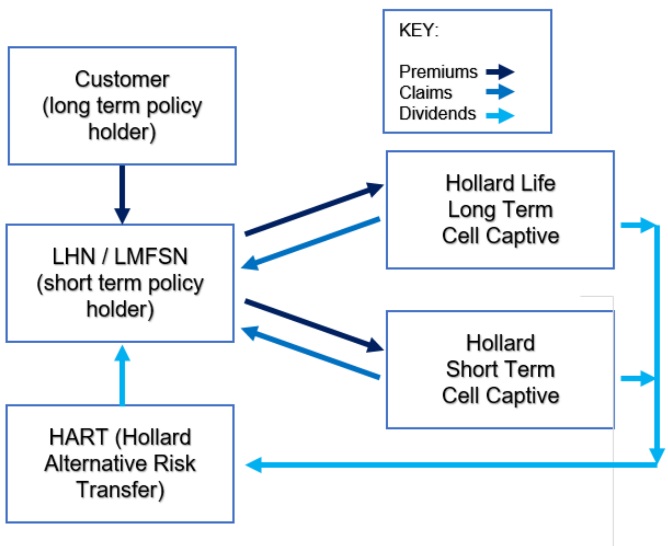
Insurance Arrangement

Insurance makes up a large part of LHN's business model, which serves to reduce credit impairment losses and provides a source of non-interest revenue. This consists of both a credit life insurance policy, where the customer is the policy holder and pledges the contract as collateral to Letshego as well as a credit insurance policy issued to one of the subsidiaries which covers the risk of default.

Using credit insurance LHN has managed to contain impairments to under 1% of the total loans and advances over the last three years. However, according to management this would have been materially higher, 2% in 2015 and 4% in 2016, in the absence of these contracts. No allowance for impairment losses is made for advances which are covered by the Cell Captive arrangement, which applies to the LMFSN advances portfolio.

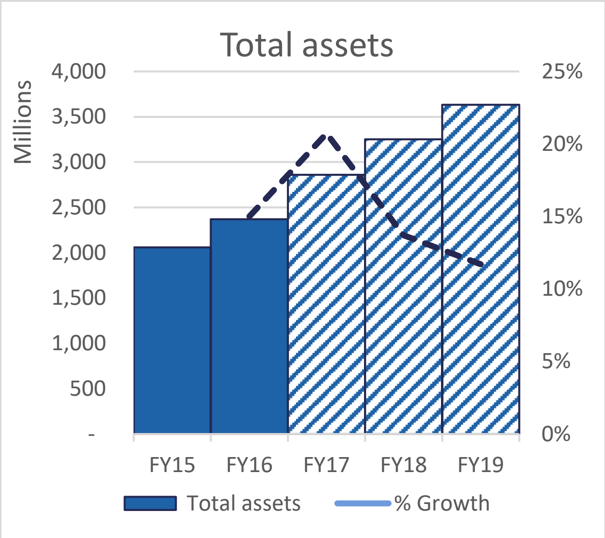
LMFSN and LHN conducts insurance business under a Master Credit Policy, where the underwriter is Hollard Life Namibia Limited and Hollard Insurance Company of Namibia Limited, both affiliates of Hollard Alternative Risk Transfer (Pty) Ltd (HART). Hollard administers two cell captives on behalf of LMFSN and LHN, one for long term and one for short term insurance.

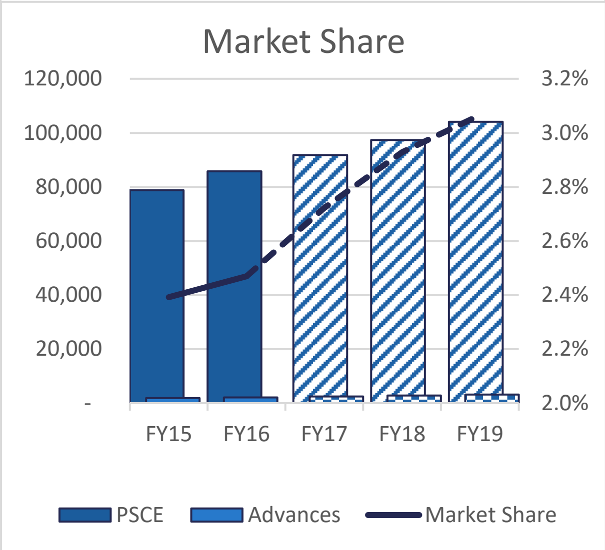
Premiums are paid by the customer (long term) and Letshego (short term) to the cell captives and claims are paid to the respective policyholders. The arrangement provides that all claims arising from insurance contracts written by cell are paid out of cell's assets, with any profits after deduction of the insurer's fees, and allocation taxes, and other costs payable to the corporate entity. Once a year, dividends are declared from Hollard back to LHN / LMFSN based on available reserves in the respective captives.



Asset Base

Growth





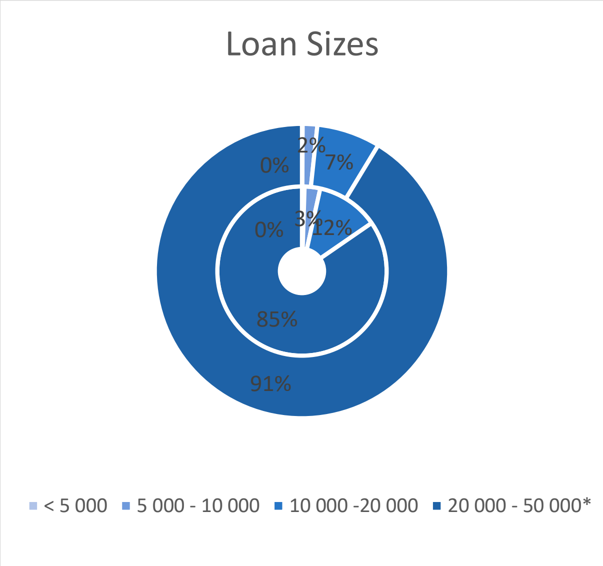
Letshego Namibia is still very small in comparison to the commercial banks, with total assets of N$2.36 billion at the end of 2016. Total assets grew by 15.0% in FY16 and is expected to continue growing at 15.3% compounded annually over the next three years.

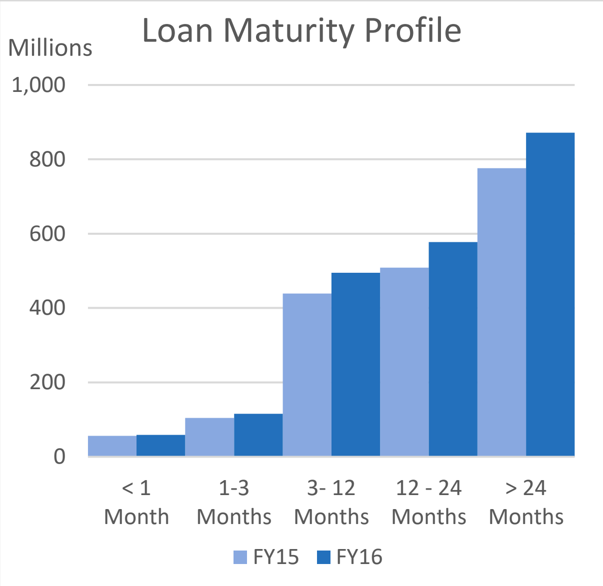
Currently the bulk of assets comprise mostly of advances to customers, which makes up 89.5% of total assets. The rest of the assets are made of other receivables, which consist largely of income receivable from the cell captive arrangement with Hollard.

Letshego has a small market share compared to the commercial banks, amounting to 2.5% of private sector credit extension at the end of FY16. This is due to the current narrow product offering and small portfolio of government employees.

However, plans are for the loan book to expand and diversify into private sector employees and advances are expected to grow by a 14.6% compounded annual growth rate, a target management are confident they will reach.

Advances Breakdown





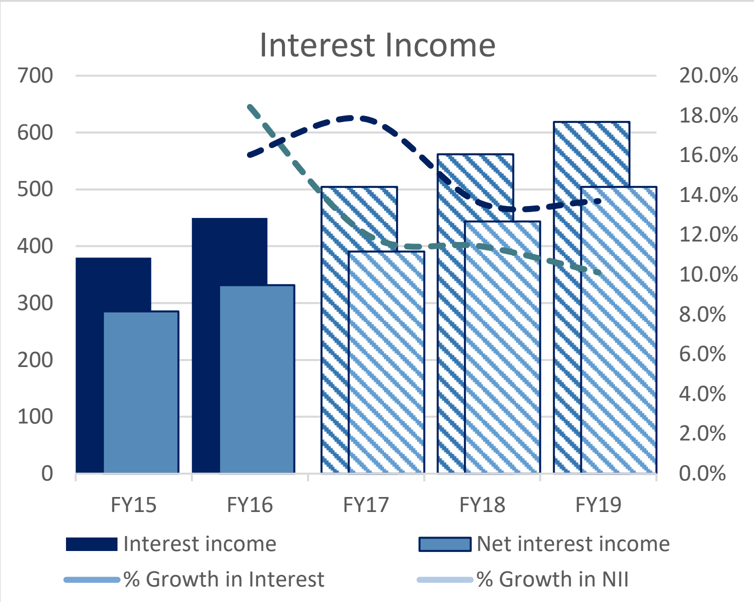
The advances portfolio is made up entirely of short term unsecured loans. Most loans are in the N$20,000 to N$50,000 brackets, which made up 91.3% of total advances at the end of FY16. The average loan size is around N$28,700.

The loan book is heavily concentrated in public sector employees. 99.6% of advances are to public sector employees, while the remainder is issued to private sector individuals. The strategy is to diversify this portfolio into salaried private sector employees to reduce the credit concentration risk of government.

Most loan maturities are longer than one year as 68.4% of loans outstanding at the end of FY16 had a maturity of 12 months and longer. It is expected that the average size and maturity profile of the bank will remain largely unchanged and only the makeup of customers will change significantly going forward.

Net Interest income

Interest Income



Income from lending activities are made up of interest income on advances and collection fees. These are split roughly in a 90:10 proportion.

LBN lending rates are currently capped at 1.6x the Prime Interest Rate, whilst LMFSN maximum lending rate is capped at 2x the Prime Interest Rate as per the Usury Act.

The average interest rate charged on loans amounted to 20.0% in FY16 or 1.9x average prime, while collection fees amounted to 2.4% of average advances, bringing the effective interest on loans to just under 22.5%.

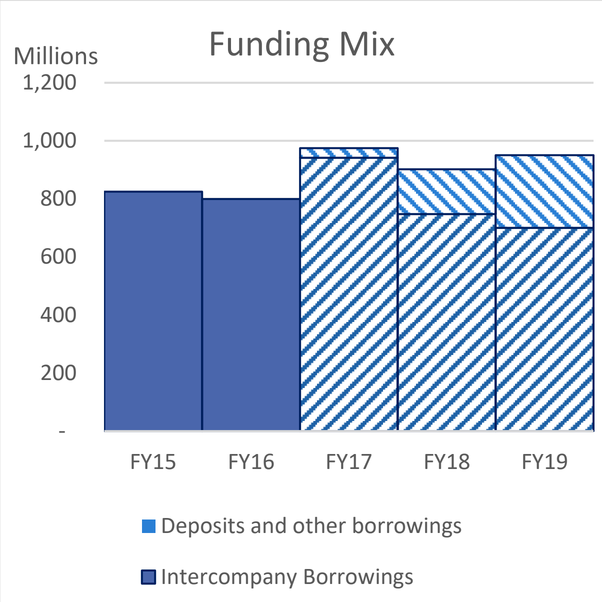
Over time, as the loan book matures and new loans are issued, we expect the interest rate to normalise to 1.8x prime, assuming the LBN and LMFSN portfolios remain in roughly the same proportion.

The Ministry of Finance has issued guidelines to introduce regulations for reduced interest rate caps that will apply to the businesses of deduction code holders. This is a big risk to the company as it will directly influence the net interest margin.

Management have indicated that they are pro-actively engaging with the Ministry to manage any potential changes and the impact thereof. The impact of reduced interest rate caps on our target price is presented in the table below.

Multiple of prime	1.50x	1.60x	1.70x
Interest rate on Advances (FY18)	15.8%	16.8%	17.9%
Target Price (cps)	413	437	462

Interest expense and funding mix

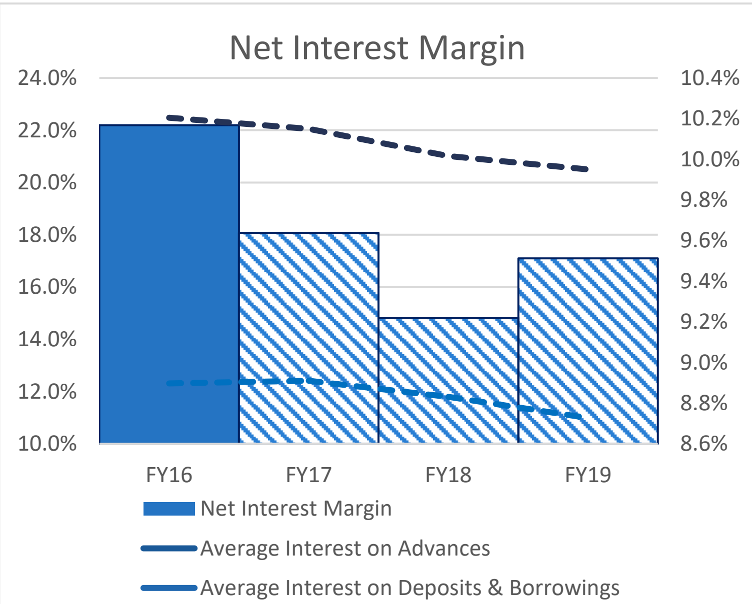


LHN is funded largely by intercompany borrowings, at an average interest rate of 12.3% (as at the end of FY16). By diversifying into other funding pools, the company will be able to rapidly lower their average cost of funding.

As the bank progresses to a fully-fledged banking institution, they plan to grow retail deposits. These retail deposits can be very attractively priced to appeal to retail depositors and compete with the commercial banks.

Similarly, the company also has access to institutional funding in the form of negotiable certificates of deposits as well as floating rate notes, which will have the same effect of reducing the effective funding cost. Additionally, LHN has expressed their interest in launching a Medium-Term Funding programme post the listing, which will further diversify their funding sources and would likely also be less expensive than the current intercompany loan. No details have yet been disclosed regarding the size and timing of such a programme.

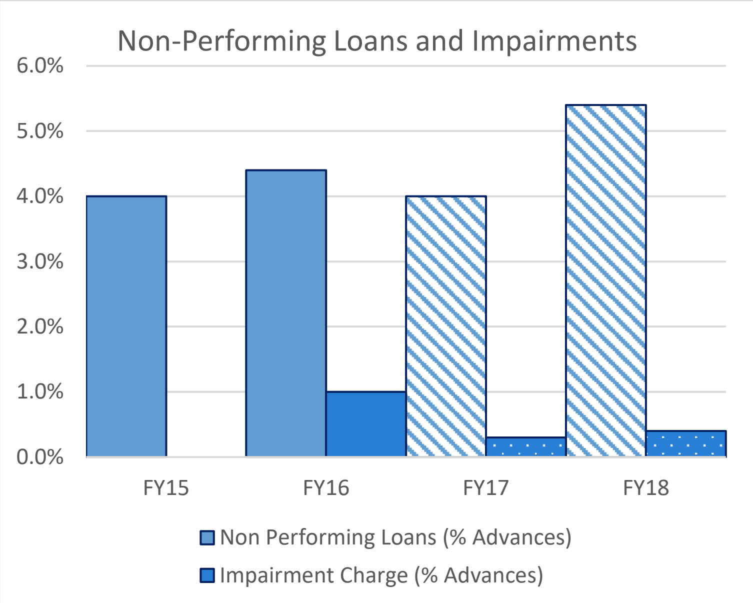
Net Interest Margin



As alluded to in the previous two sections, the average interest rate on loans is expected to decline to the 1.8x average multiple of prime as old loans mature and new loans are issued. Similarly, funding costs are expected to decrease over time as the sources of funding are diversified into lower cost alternatives.

The net effect of the two will likely be a decrease in the current net interest margin from 10.2% to 9.6% in FY17 and improve over time as the interest rate paid on funding decreases as deposits and other borrowings grow.

Non-Performing Loans and Impairments



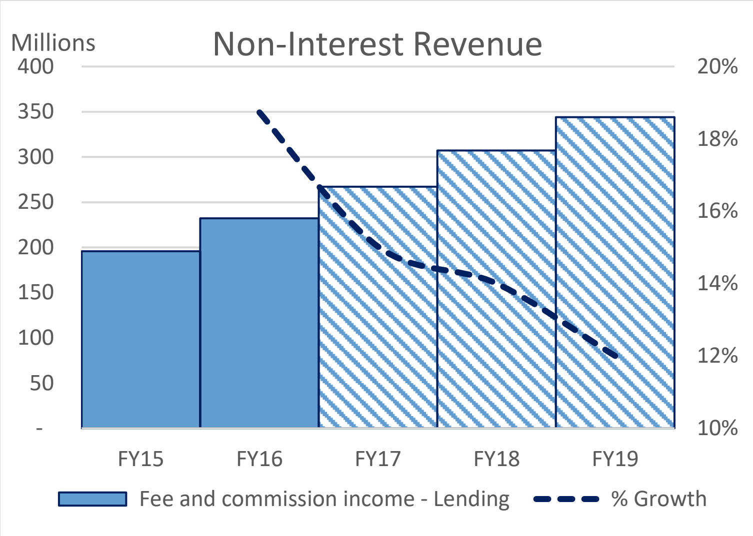
Non-performing loans (NPLs) are well above levels reported by a commercial bank, as would be expected from an unsecured lender. At the end of FY16, NPLs stood at 93.4m or 4.4% of advances.

Impairments are recognised on a seven-category classification system based on collectability status (CS). The first two tranches (CS01 – CS02) are not in good standing and makes use of an "incurred but not reported" provision.

CS03 -CS04 are one-to-three months in arrears and are provided for on a portfolio specific basis. Loans in the CS05 -CS06 category are more than three months in arrears and will be specifically impaired, while anything more than a year outstanding is fully impaired. No allowance for impairment losses is made for advances which are covered by the Cell Captive arrangement, which applies to the LMFSN advances portfolio, which has allowed LHN to keep impairments quite low.

LHN has not yet assessed the impact of IFRS9 on their impairments. However, given the backstop that any loan which is more than 30 days outstanding will have to be impaired based on lifetime expected losses, it follows that impairments should increase substantially. The FY16 impairment charge was substantially higher than FY15, at 1% of total advances or N$22.1 million. According to the prospectus, however, this movement was due to the initial implementation of the regulatory requirement on provisioning of the loan book in LBN as required by BID 2, when the banking license was obtained in 2016. Management have indicated this increase in provisioning should minimise the effect of IFRS 9 implementation. Expected impairment charges for the next two years amount to N$8.2 million and N$10.0 million or 0.3% and 0.4% of total advances.

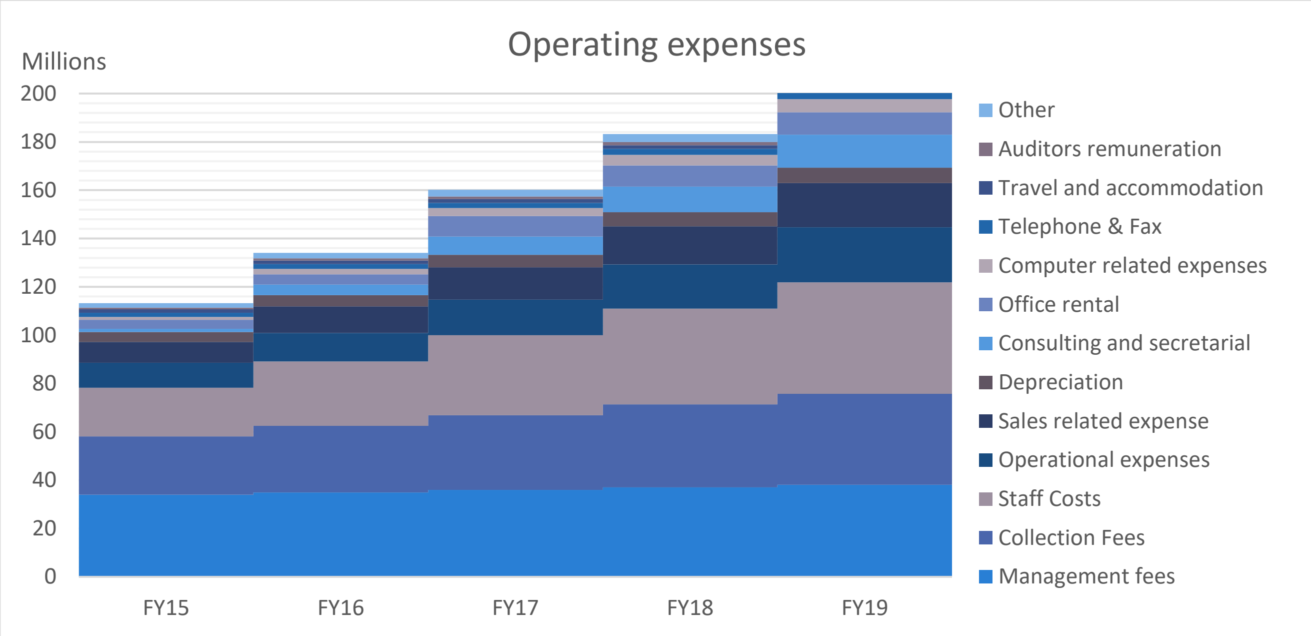
Non-Interest Revenue



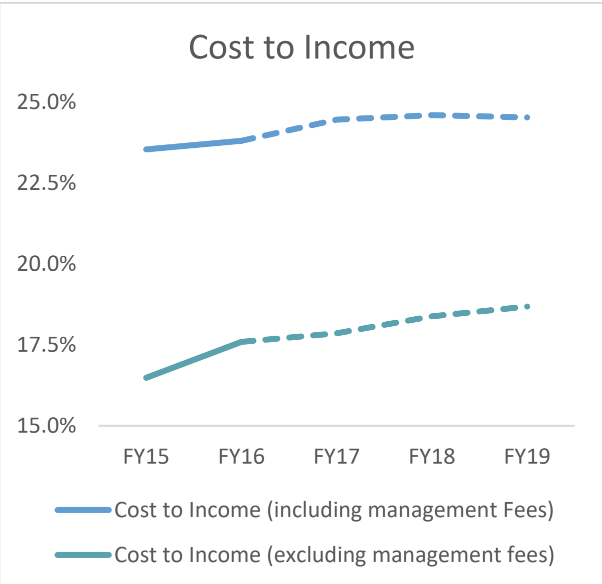
Non-interest revenue is made up primarily from dividends received from the cell captive. The dividends represent the excess reserves of the two cell captives administered by Hollard. Non-interest income thus currently is made up entirely of insurance profits. The insurance arrangement has been described in detail earlier in this report.

As the company transitions into the transactional banking space, transaction fees are expected to contribute to non- interest revenue. However, it is yet to be seen how much traction the company can get in the transactional banking space.

Operating Expenses



Management fees make up the largest single operating expense for LHN. The Administration and Management Services Agreement between LHL and LHN gives LHN access to intercompany loan facility arrangements, guarantees on external funding arrangements, trademarks and licencing and a host of management services, including but not limited to: IT systems and support, risk management services, HR services and internal audits.



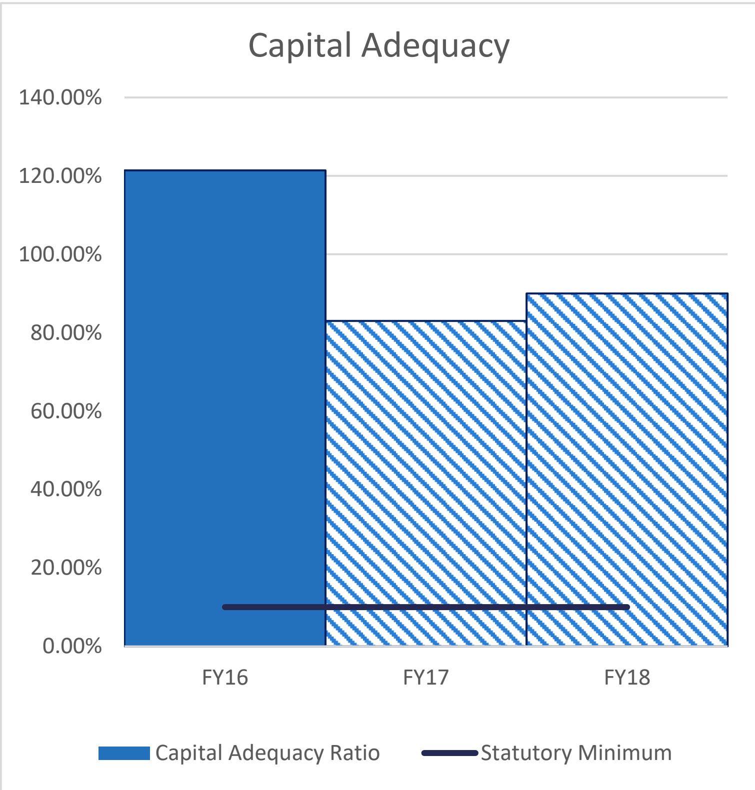
This arrangement is extremely beneficial to LHN as they can rely on the holding company's head office to provide many of the services and systems which they need to operate and can make use of the trademarks and licencing of Letshego. They also have a shareholder of reference for which the terms of intercompany financing have already been set out.

The management fee is calculated as 10% of the aggregate of:

- LHL head office costs directly attributable to LHN and;
- a proportion (based on LHN advances relative to total LHL advances) of fixed overheads of the LHL head office.

The business model of LHN, which is very streamlined and aimed at minimising physical branches in favour of digital channels have allowed them to have a very low cost to income ratio. However, operating expenses are expected to grow rapidly over the next three years as the business transitions into a fully-fledged banking operation. LBN will have to implement new systems and effectively manage compliance risks arising from increased regulatory requirements from Bank of Namibia. Furthermore, LBN needs to budget for increased operational costs associated with upgrading banking infrastructure for the deposit-taking branches. As such, operational expenses are expected to grow by 17.8% compounded annually over the next three years. However, LHN will have to work very hard to contain their operating expenses to their budget.

Capital Adequacy



The capital adequacy ratio is significantly higher than banking regulation requirements due to the historic accumulated Tier 1 capital that was built up prior to listing.

The forecast reduction from FY16 to FY17 onwards is due to dividends which were declared during the restructuring of the business prior to the IPO.

Seeing as the company has very low gearing and an abundance of equity capital, it should remain well capitalised for the foreseeable future.

Outlook

The outlook for Letshego is slightly uncertain, however, we believe the company has good growth prospects in the Namibian market and can still grow their portfolio of government employees, in which they have roughly a 50% penetration at present. This growth will not be without some key risks highlighted in this report, which include the renewal of the government deduction code, potential interest rate caps and the transformational risk of the company from a microlending entity to a bank.

If the transition continues as planned the company will be able to unlock cheaper funding through customer deposits which will improve their net interest margin as well as open up a stream of transactional income. Given the wealth of experience in the management team, they seem well equipped to handle this task. The backing, resources, and expertise of the LHL head office should serve as a strong foundation off of which to transition into a fully-fledged banking operation.

Valuation

As with the other financial institutions we make use of a justified price to book multiple to value this company. Firstly, we establish a cost of equity of 16.5%, which consist of a risk-free rate of 9.9% (based on the Namibian 10-year government bond), an equity risk premium of 4.6% and a unsystematic risk premium of 2.0%. Based on this cost of equity, a conservative long-term growth rate for the company of 8.0%, and a long term sustainable Return on Equity of 20.0%, we believe a Price to Book multiple of 1.41x can be justified on this share. Given expected book value per share of N$c353 in FY17, we derive a target price of N$c497 per share or an expected return of 30.9%. As a result of the apparent discount to fair value, we initiate our coverage on LHN with a **BUY** recommendation.

Sensitivity to our assumptions is presented below:

Target Price		LT Sustainable ROE				
		19.0%	19.5%	20.0%	20.5%	21.0%
Long-term growth rate	7.0%	4.45	4.64	4.82	5.01	5.19
	7.5%	4.50	4.70	4.89	5.09	5.29
	8.0%	4.56	4.77	**4.97**	5.18	5.39
	8.5%	4.62	4.84	5.06	5.28	5.50
	9.0%	4.70	4.93	5.17	5.40	5.64

Expected Return		LT Sustainable ROE				
		19.0%	19.5%	20.0%	20.5%	21.0%
Long-term growth rate	7.0%	17.1%	22.0%	26.9%	31.8%	36.7%
	7.5%	18.5%	23.6%	28.8%	33.9%	39.1%
	8.0%	20.0%	25.4%	**30.9%**	36.3%	41.8%
	8.5%	21.7%	27.5%	33.3%	39.1%	44.9%
	9.0%	23.6%	29.8%	36.0%	42.1%	48.3%

Pro forma statements

Statement of Comprehensive Income

	Actual		Forecast		
in N$ 000s	**2015**	**2016**	**2017**	**2018**	**2019**
Interest and similar income	381,868	431,407	501,957	556,316	610,373
Interest and similar expense	(96,172)	(99,943)	(111,433)	(112,839)	(106,155)
Net interest income	**285,696**	**331,464**	**390,524**	**443,477**	**504,218**
%Growth		16.0%	17.8%	13.6%	13.7%
Impairment losses	200	22,083	8,224	9,957	11,691
Non-Interest Income	**195,578**	**232,213**	**264,810**	**301,883**	**341,128**
Operating expenses	(113,243)	(134,123)	(160,217)	(183,266)	(207,252)
Operating profit	**368,031**	**429,554**	**495,117**	**562,094**	**638,095**
%Growth		16.7%	15.3%	13.5%	13.5%
Profit before tax	**368,031**	**429,554**	**495,117**	**562,094**	**638,095**
Income tax expense	(95,960)	(99,602)	(138,633)	(157,386)	(178,667)
Profit for the year	**272,071**	**329,952**	**356,484**	**404,708**	**459,428**
%Growth		21.3%	8.0%	13.5%	13.5%
Headline Earnings	**272,071**	**329,952**	**356,484**	**404,708**	**459,428**
%Growth		21.3%	8.0%	13.5%	13.5%
HEPS (c)	**54**	**66**	**71**	**81**	**92**
Dividends declared per share (c)	**-**	**-**	**23**	**20**	**23**

Statement of Financial Position

	Actual		*Forecast*		
in N$ 000s	**2015**	**2016**	**2017**	**2018**	**2019**
ASSETS					
Cash and cash equivalents	52,191	159,626	182,020	73,897	122,708
Advances to customers - net	1,885,399	2,118,679	2,500,042	2,850,047	3,192,053
Other receivables	106,525	68,163	87,344	77,753	82,548
Property, Plant and equipment	12,170	10,501	8,832	7,163	5,495
Deferred taxation asset	1,379	6,622	4,001	5,311	4,656
Total assets	**2,057,664**	**2,363,591**	**2,782,239**	**3,014,173**	**3,407,460**
LIABILITIES					
Trade Payables	44,113	42,446	43,279	42,863	43,071
Deposits	-	-	33,480	155,300	250,000
Taxation payable	537	2,022	-	-	-
Intercompany Borrowings	824,270	799,420	941,192	747,192	700,000
Total liabilities	**868,921**	**843,888**	**1,017,951**	**945,355**	**993,071**
EQUITY					
Share capital	0	100	100	100	100
Preference Shares	215,085	215,085	215,085	215,085	215,085
Capital reorganisation reserve	701,124	701,124	701,124	701,124	701,124
Long term incentive plan	463	1,432	2,432	3,432	4,432
Retained income	272,071	602,062	845,546	1,149,077	1,493,648
Total shareholders' equity	**1,188,743**	**1,519,803**	**1,764,287**	**2,068,818**	**2,414,389**

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