Pokhara Finance Limited

ICRA Nepal assigns [ICRANP] IPO Grade 4 to the proposed Rights Issue of Pokhara Finance Limited

Facility/Instrument	Issue Size	Grading Action (October 2017)
Rights Issue (Equity Shares)	NPR 98.37 Million	[ICRANP] IPO Grade 4 (Assigned)

ICRA Nepal has assigned "**[ICRANP] IPO Grade 4**", indicating below-average fundamentals to the proposed rights issue of Pokhara Finance Limited (PFL) amounting ~NPR 98.37 million. ICRA Nepal assigns IPO grading on a scale of IPO Grade 1 through IPO Grade 5, with Grade 1 indicating strong fundamentals and Grade 5 indicating poor fundamentals. For the grading categories 2, 3 and 4, the sign of + (plus) appended to the grading symbols indicate their relative position within the grading categories concerned. Thus, the grading of 2+, 3+ and 4+ are one notch higher than 2, 3, and 4, respectively. PFL proposes to come out with 15% rights issue of 983,682.74 numbers of equity shares, each with face value of NPR 100, to be issued to existing shareholders at par. The issue is being made to augment the company's capital base to meet the elevated regulatory capital requirements.

The grading factors in PFL's long track record (operating since 1997) along with the ability to maintain moderate portfolio growth (credit and deposits grew by CAGR[1] of ~19% and ~16% respectively over last five years ending Jul-17) and healthy asset quality indicators (NPLs[2] were 1.42% as of mid-Jul-17 vs. 13.37% for industry; delinquencies were ~11%). Comfortable capitalization levels, experienced management team and plans of expansion in uncovered regions are expected to provide PFL with adequate growth opportunities over the medium term. The grading also takes into account healthy share of scheduled loans (~59% of portfolio as of Jul-17) where repayment ability of borrower is tested regularly and also the relatively moderate exposure to perceived vulnerable sectors (mainly real estate and hire purchase loans) compared to industry (~25% vs. ~30% for industry as of Jul-17).

Nonetheless, the grading remains constrained by high decline in share of CASA[3] during FY17 (from 60% to 37%) which would be pushing up PFL's cost of funds over medium term, hence impacting its competitive positioning especially in the "base rate plus" lending rate regime recently introduced by Nepal Rastra Bank (NRB). PFL's operations also remains geographically concentrated (~86% of portfolio in Kaski district) which along with assessed income based appraisal and higher exposure to personal loan segment (~36% of portfolio as of mid-Jul-17) with no proper monitoring of end use of funds further constrains the grading. While assigning the grading, ICRA Nepal has also factored in PFL's relatively lower return indicators vs industry (Return on net worth of ~18% on an average over last four years vs. ~23% for industry primarily due to low gearing of PFL) which would be further diluted post spike in capital from earlier floated FPO[4] and the proposed issue. The grading is also constrained by marginal borrower profile compared to commercial and development banks, lack of institutional promoters, high competition from other BFIs[5] with finer lending rates and the uncertain political and operating environment in Nepal. Going forward, attaining requisite credit and deposit growth to ensure deployment of existing and incoming capital for generating adequate returns and also adequately diversifying its portfolio towards various sectors/geographies would remain key challenges for PFL.

PFL's credit portfolio has grown moderately at a CAGR ~19% over last five years (vs. ~20% for banking industry) and stood at NPR 3,320 million as of mid-Jul-17 despite long track record of ~20 years. Credit portfolio remains concentrated towards personal loans (36%), followed by business

---

[1] Compounded Annual Growth rate
[2] Non-Performing Loans
[3] current and savings accounts
[4] PFL issued FPO of 983,682 numbers of equity Shares of NPR 100 each at a premium of NPR 120 per share which was capitalized in September 2017. This diluted promoters' holding to 51% from earlier 60%.
[5] Bank and Financial Institutions

loans (26%), housing loans (16%), hire purchase loans (12%), deprived sector loans (4%), among others. PFL's credit portfolio is moderately granular wherein top 20 borrowers accounted for ~18% of portfolio as of mid-Jul-17.

In the asset quality front, PFL has been able to gradually bring down NPLs from ~11% as of Jul-12 to 1.42% as of mid-Jul-17 remaining much better than finance company industry average of ~13%; but still slightly higher vs. peers. The improvement in asset quality was also supported by comfortable liquidity and low lending rates over this period. Disregarding the regulatory forbearance towards NPL recognition for term loans accorded to class C finance companies[6], PFL's NPLs would be 2.50% as of mid-Jul-17. 0+ days delinquencies for PFL were ~11% of portfolio as of mid-Jul-17. Portfolio vulnerability remains high for PFL due to high share of assessed income based lending (especially personal loans) and also due to marginal profile of borrowers compared to higher class BFIs.

As for funding profile, PFL witnessed higher decline in CASA from 60% to 37% during FY17 compared to industry (52% to 36%) owing to liquidity turmoil faced by the industry during latter half of FY17. PFL's cost of funds (6.41% for FY17) remained higher to industry average (6.11% during FY17) over last four years and with the recent decline in CASA, cost of funds would remain higher over medium term impacting its competitive positioning among peers as well as among other larger banks. As regards growth, PFL was able to grow its deposits by ~16% over last five years compared to ~17% growth for the banking industry. Concentration to top 20 depositors also remains lower among peers at ~13% as of mid-Jul-17. Going forward, the ability of PFL to increase its presence across different geographies thereby increasing the depositor base will remain vital to future cost of deposits.

PFL's NIMs[7] (~4.5% of ATA for FY17) and fee based income (<1% of ATA in average) remains moderate among peers and hence overall profitability also remains moderate (Return on net worth of ~18% on an average over last four years vs. ~23% for industry and return on assets of ~2-2.5%). Dilution effect of significant capital increment on return indicators along with expected impact on asset quality post the recent hardening of interest rates across banking sector also remains a concern. PFL's earnings profile going forward will largely depend on the ability to maintain NIMs, improve its scale of operations and control its assets quality.

As on mid-Jul-17, capital adequacy ratio (CRAR) of PFL was much higher at 20.37% as compared to regulatory minimum of 11% despite capitalization of FPO still remaining pending till then. Higher capitalization levels have been impacting the return indicators and hence efficient utilization of existing and incremental capital (from FPO and rights) would remain key challenge for the management over the medium term. Nonetheless, the proposed issue would help PFL attain increased paid-up capital requirements of NPR 800 million for national level finance companies. PFL has capital of ~NPR 557 million as of mid-Jul-17 and the same is expected to reach ~NPR 754 million after proposed issue; shortfall is expected to be met from capitalization of internal accruals of FY17. Incremental capital would also have critical bearing on its ability to absorb any deterioration in asset quality and maintain comfortable solvency profile.

Company Profile

In operation since March 1997, Pokhara Finance Limited (PFL) is a National Level Class C Finance Company. PFL is promoted by a group of individual promoters from diverse backgrounds with maximum shareholding by largest shareholder at ~5% of total capital (As on mid Jul-17). Its Corporate Office is located at Newroad, Pokhara. Share capital of the company is distributed among promoter & public in the ratio of 51:49 post capitalization of FPO in September 2017. The shares of the company are listed on the Nepal Stock Exchange. Mr. Raj Kumar Gurung is the Chief Executive Officer of the company.

---

[6] Only overdue installment up to 1 year can be reported as NPLs.

[7] Net Interest Margins as a % of Average Total Assets (ATA)

PFL has presence in four districts of Nepal through its 10 branches. PFL has market share of 6.93% in terms of deposit base and 6.76% in terms of credit portfolio of Finance Companies' Industry as on mid Jul-17. PFL reported a net profit of NPR 88 million during 2016-17 over an asset base of NPR 4,638 million as on mid Jul-17 as against net profit of NPR 88 million during 2015-16 over an asset base of NPR 3,805 million as on mid Jul-16. PFL's CRAR was 20.37% and reported gross NPLs were 1.42% as on mid-Jul-2017. In terms of technology platform, PFL has implemented Pumori Plus IV System which is centralized throughout its branches.

October 2017

For further details please contact:

Analyst Contacts:
Mr. Kishor Prasad Bimali, (Tel No. +977-1-4419910/20)
kishor@icranepal.com

Mr. Rajib Maharjan, (Tel No. +977-1-4419910/20)
rajib@icranepal.com

Relationship Contacts:
Mr. Deepak Raj Kafle, (Tel. No. +977-1-4419910/20)
drkafle@icranepal.com