First Microfinance Laghu Bitta Bittiya Sanstha Limited

ICRA Nepal assigns [ICRANP] IPO Grade 3 to the proposed Rights Issue (equity shares) of First Microfinance Laghu Bitta Bittiya Sanstha Limited

Facility/Instrument	Issue Size	Grading Action (December 2017)
Rights Issue Grading	NPR 228.1313 million	[ICRANP] IPO Grade 3 (Assigned)

ICRA Nepal has assigned "**[ICRANP] IPO Grade 3**", indicating average fundamentals to the proposed rights issue amounting to NPR 228.1313 million of First Microfinance Laghu Bitta Bittiya Sanstha Limited (FMDB). 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. FMDB is proposing to come out with 50% rights offering of 2,281,313 numbers of equity shares of face value NPR 100 each to be issued to existing shareholders at par. The issue is being made to augment capital base and meet the revised (higher) paid up capital requirement set by Nepal Rastra Bank (NRB), the banking sector regulator in Nepal.

The average fundamental grading factors in the strength of institutional promoters (15% stake of Global IME Bank rated at A-@ by ICRA Nepal, among others), experienced management team and comfortable capitalisation profile (~15% as of Oct-17) which is expected to support FMDB in maintaining the healthy pace of growth reported so far (CAGR[1] ~46% over last four years ending Jul-17, albeit on a small base vs. ~38% for industry). Incremental growth opportunities for microfinance business in Nepal also remains good given the large below poverty line population. The grading is further supported by FMDB's adequate loan underwriting and monitoring processes resulting in good assets quality indicators (Nil Gross NPLs[2] so far) along with adequate profitability profile (RoA and RoNW[3] stable at ~2% and ~20% respectively over last four years ending Jul-17) supported by healthy NIMs (3.76% for FY2017), low credit provisioning expense & moderate operating expense ratio. The grading also factors in the mandatory deprived sector lending requirements for banking sector (5% for commercial bank, 4.5% for development bank and 4% for finance companies) and relaxation on regulation requiring 2% direct deprived sector lending by commercial banks, which is expected to ensure adequate flow of funds for future growth of microfinance sector.

Nonetheless, the grading is constrained by the regulatory risk in MFI[4] industry which along with stiff competition from other wholesale lending MFIs and commercial banks pursuing direct deprived sector lending might impact funding profile of FMDB that has remained solely dependent upon bank borrowings so far. While assigning the grading, ICRA Nepal also takes note of the lack of long term funding sources for FMDB (~84% loans are revolving in nature as of Oct-17) for floating ~64% scheduled nature loans which might create liquidity management issues. Nonetheless, FMDB's revolving borrowings have been mostly renewed so far, given the deprived sector lending targets to be met by the banking sector, which provides some comfort. The grading is also constrained by higher portfolio vulnerability arising from large share of exposure to cooperatives (~36% of credit portfolio on Oct-17, however lowered compared to 60% in Jul-14) which lacks regulatory supervision and relatively high portfolio concentration (~43% among top-20 borrowers on mid-Oct-17). The grading is further constrained by limited track record of FMDB (operating since 2010), lack of diversity in earnings, lower representation of institutional promoters in the board (one director out of six from institutional promoter despite ~38% shareholding) and uncertain operating environment that banks in Nepal are currently facing. Moreover, high portfolio vulnerability given unsecured nature of loans, high chances of overleveraging in the absence of credit bureau in MFI

[1] Compounded Annual Growth Rate
[2] Non-performing Loans
[3] Return on Assets and Return on Net worth
[4] Micro Finance Institutions

sector and marginal profile of borrowers also remains a constraint; although mitigated to some extent through guarantee from board and right of lien on the assets of borrowing units.

FMDB's credit portfolio has grown at a high rate of CAGR 46% in past four years (ending mid-Jul-17), albeit on a low base. Portfolio growth has been moderated to ~29% CAGR in last two years ending mid-Jul- 2017 mainly on account of frequent changes in regulations impacting MFIs, tight market liquidity and increase in its portfolio base. The growth was supported by increased capital base through series of rights and bonus issues while the growth in number of partner MFIs remained minimal (141 institutions with operations in 45 districts as on mid-Oct-17 compared to 119 partner MFIs in Jul-14) resulting in slight increment in portfolio concentration (43% in Oct-17 vs. 39% in Jul-14). FMDB's credit portfolio stood at NPR 3,733 million as of Oct-17, comprising of two major products- MFI term loans (64%) and MFI working capital loans (36%). Despite portfolio vulnerability remaining high due to marginal profile of borrowers and unsecured lending model, FMDB's asset quality indicators remain good with Nil NPLs so far and occasional minimal delinquencies. Nonetheless, co-operative societies accounting for ~36% of credit portfolio as on Oct-17; thereby posing risk to the incremental assets quality of FMDB given limited regulations for cooperative industry in Nepal. However, FMDB's sound underwriting approach, control mechanism, experienced management team; gradually declining portfolio share to Cooperatives (from ~60% of loans on Jul-14) coupled with standard assets provisioning provides some comfort. The credit growth of FMDB is likely to remain high over next 2-3 years supported mainly by augmented capital base, provided that liquidity remains comfortable in banking sector.

FMDB's funding profile is composed of bank borrowings so far as the lending to MFI is classified as deprived sector lending, under current Nepalese banking regulations ensuring flow of banks' credit to microfinance sector at relatively lower interest rates. FMDB's total borrowings as on Oct-17 stood at 3,525 million, with over 95% borrowings from Class A commercial banks. With tightening in liquidity in banking sector post Jul-16, average cost of borrowings for FMDB has increased to 6.17% for FY17 (3.52% for FY16) and further to 8.82% for Q1FY18. Though the regulations requiring commercial banks to directly lend 40% of their deprived sector lending targets has been made voluntary, some of the commercial banks have started to venture into direct deprived sector lending as well that could limit the funds available for growth of MFI sector. However, given the deprived sector targets to be met over ~20% annual growth in banking sector and the supervision strength of specialised institutions like FMDB, fund flow towards MFI is expected to be adequate for maintaining moderate growth. Any further change in the regulations could affect FMDB's funding profile negatively; however, the institutional promoters which include BFIs with ~38% holding in FMDB provides some comfort regarding the funding profile under adverse conditions.

FMDB's CRAR (Capital to Risk adjusted Assets Ratio) was 15.33% as on Oct-17 as against minimum regulatory requirement of 8%. While FMDB's capitalisation is adequate against minimum regulatory requirement, economic capital levels are moderate given the riskiness of loan book. Post the proposed issue, FMDB would be meeting the revised capital requirements (NPR 600 million to be met by Jul-18). Moreover, the rate of internal capital generation remains healthy and is also likely to support the expansion plans. In long run, ability of FMDB to raise additional capital from its existing/ external investors will have a strong bearing on the growth prospects and overall capitalization profile.

Despite increase in capital base over last two years, the profitability profile of FMDB has remained largely similar supported mainly by increased scale of operations. FMDB has largely maintained gross interest spread of ~3% which coupled with moderate operating cost ratio and low credit provisioning expense has helped FMDB maintain healthy profitability profile. FMDB's RoA and RoNW has remained ~2% and ~20% over last four years; supported by improving NIMs (3.34% for FY14 increasing to 3.76% for FY17) over increased asset base. Going forward, FMDB's profitability profile is likely to witness some decline following the proposed rights offering; however, management plans to gradually increase the indicators through largely steady NIMs and operational efficiencies brought about by increasing scale of operations. Going forward, FMDB's ability to maintain its asset quality profile over enhanced scale of operations will have a bearing on its overall profitability profile.

Company Profile

First Microfinance Laghu Bitta Bittiya Sanstha Limited (FMDB), a wholesale microfinance lender- was incorporated in 12th October 2009 and started its operations from January 8, 2010. It was earlier in operation as First Microfinance Development Bank Limited till 12th November 2017 after which it was renamed to its current name. It is licensed as a class D microfinance institution by NRB. FMDB is engaged in business of providing microfinance access to rural poor households, especially to women via. wholesale lending to partner organisations which include retail microfinance institutions, rural cooperatives and NGO financial intermediaries. Apart from this, it provides institutional strengthening and capacity building support to its partner MFIs with a view to promote and develop microfinance sector in the country. As of October-2017, FMDB is running its operations in 45 districts of the country through 141 partner organisations.

FMDB has 38.2% institutional promoter holding as on Jul-17, which includes two Class A commercial banks (30%) and Class B & Class C BFIs each holding 4.1%. The promoter-public shareholding ratio stood at 51:49 as on mid-Jul-17. During the year ended mid-Jul-17, FMDB reported net profit of ~NPR 80 million over an asset base of NPR 3,785 million as against profit of ~NPR 55 million in the previous year over an asset base of NPR 3,076 million. For Q1FY2018, FMDB has reported profit of NPR 24 million over asset base of NPR 4,143 million. As of mid-Oct-2017, its CRAR stood at 15.33% and NPLs were zero.

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