

Arun Finance Limited

ICRA Nepal assigns [ICRANP] IPO Grade 5 to the proposed Equity Shares (Rights Issue) of Arun Finance Limited

Facility/Instrument	Issue Size	Grading Action (June 2017)
Rights Share Issue	NPR 150 million	[ICRANP] IPO Grade 5 (Assigned)

ICRA Nepal has assigned “[ICRANP] IPO Grade 5”, indicating poor fundamentals to the proposed rights issue amounting NPR 150 million of Arun Finance Limited (Arun). 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. Arun is proposing to come out with 1:1 rights issue of 1,500,000 numbers of equity shares of face value NPR 100/- each, to be issued to its existing shareholders at par. The proposed issue is being made to augment the capital base and is a step towards ensuring revised (higher) paid up capital requirement set by Nepal Rastra Bank (NRB), the banking sector regulator.

The lowest IPO grade reflects Arun’s poor financial profile caused by weak assets quality (gross NPLs¹ of 91% on mid-April 2017). The grading also remains constrained by losses accumulated over the years leading to erosion of net worth² (accumulated loss of NPR 185 million on mid-April 2017). The business of Arun was subjected to multiple restrictions after being classified as “problematic institution” by NRB between January 2015 and February 2016. Because of the restrictions³, the credit and deposit portfolio declined leading to high customer concentration risks (97% of deposit among top 20 depositors and 54% of total credit among top 20 borrower accounts as on mid-April 2017). The recoveries from NPLs and Non-banking assets (NBA) remains weak so far. The grading also factors in weak competitive positioning of the company emanating from limited franchise (2 branches) leading to geographical concentration and dilution of company’s reputation over the years. Although short term liquidity and capitalization profile has been comforted by the equity injection by new promoters⁴ as calls in advance against the proposed rights issue into the company; the company is short of minimum regulatory paid up capital of NPR 800 million to be maintained by mid-July 2017 (vs NPR 150 million as of now). Even upon completion of this right issue the company will not meet minimum capital requirements. The company plans to go into another round of rights issue to ensure the minimum paid up capital. Ensuring the same within the deadline remains a major challenge for the company, which otherwise will continue to impact the operations of the company.

The credit portfolio of Arun de-grew with compounded annual rate (CAGR) ~22% from mid-Jul-12 to mid-April-17 while the deposit base de-grew with CAGR 31% over the same period. As on mid-Apr-17, Arun’s credit portfolio stood at NPR 58 million on a total deposit base of NPR 30 million, resulting in credit to deposit (CD) ratio of ~200%. ICRA Nepal takes note that the company has been released from problematic category ending the restriction in business growth. However, achieving business growth in the competitive banking industry will be a major challenge for the company going forward.

Arun’s profitability profile remains weak because of high NPLs and reduced scale of operations at present. The losses sustained over these years has eroded net worth base of the company (Net worth per share ~NPR 47⁵ as of mid-Apr-17 compared to face value of NPR 100). Profitability profile over medium term will be largely determined by the ability of the management to recover from existing NPLs and maintain the quality of incremental credit portfolio.

Arun breached the minimum regulatory capital requirement during FY12 to FY15 because of additional credit provisioning required on incremental slippages led to a negative net worth affecting the tier I capital (between FY12 and FY15 NPLs rose from 41% to 93%). Most of the NPLs resulted from aggressive lending in speculative real estate transactions signifying weak underwriting norms. Moreover, after being declared problematic, business of Arun witnessed de-growth, further affecting the business and limiting

¹ Non-performing loans

² Net worth per share of ~NPR 47 (including calls in advance of ~NPR 73 million) against face value of NPR 100.

³ Including non-renewal of deposits and loans, restriction in accepting new deposits and underwriting new loans.

⁴ New promoters own ~60% stake at present, comprising of almost entire promoter shareholding in the company.

⁵ Including calls in advance of NPR 73 million. Excluding the calls in advance net worth per share is (-) NPR 2 per share.

the prospects of business revival. Current capitalization profile of the company remains adequate vis-à-vis minimum regulatory requirement of 11% (CRAR of 24% in mid-April 2017) after equity injection (~NPR 73 million) by the promoters in the form of calls in advance during 9mFY17. Given the management plans to raise additional equity to ensure NPR 800 million paid up capital by mid-July 2017, incremental capitalization level of Arun is likely to remain well above the required minimum over the medium term. However, the ability of the company to raise relatively large capital within limited time span remains to be seen. Liquidity position of Arun also remains comfortable at present due to the equity injection by new promoters.

Company Profile

Arun Finance Limited (Arun) is a national level class C finance company operating since August 1997. Despite being a national level company, its operation is limited to 3 districts through its head office and two branches. The company accounts for 0.1% share in deposit base and 0.02% share in credit portfolio of finance company industry as on mid-Apr-17. Arun has 60:40 promoter public shareholding at present. Individual promoters affiliated to Hathway Investment Nepal Limited⁶ have acquired almost entire promoter stake from erstwhile promoters in FY16. Major shareholders of Arun as on mid-April 2017 includes Ms Sudha Aryal (~13%), Ms. Jeewan Kumari Aryal (~13%), Mr. Nawa Dutta Kafle (~10%), Mr. Jaya Ram Nepal (~9%), Mr. Kumar Paudel (~6%), among others.

Arun was declared problematic by NRB in January 2015 due to weak governance, internal control and deteriorating financial health. The company has been released from problematic status in February 2017. The company is short of the minimum paid up capital to be maintained by National Level Finance Company (paid up capital of NPR 150 million vs. minimum requirement of NPR 800 million by mid-July 2017). The company is planning to meet the revised paid up capital by raising fresh equity through rights issue.

Arun reported a net profit of NPR 31 million during FY16 over an asset base of NPR 145 million as on mid July 2016 as against net loss of NPR 6.30 million for FY15 over an asset base of NPR 98 million as on mid July 2015. During 9mFY17, the company has reported net profit of NPR 1 million over an asset base of NPR 112 million as on mid-April 2017. Arun's CRAR stands at 24.08% and reported gross NPLs were 91% as on mid-Apr-2017. As on mid-April 2017, the company has an accumulated loss balance of ~NPR 185 million.

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⁶ Hathway Investment is privately held company that deals in primary and secondary market investments of listed companies as well as in private equity.