ICRA NEPAL

Summit Micro Finance Development Bank Limited

ICRA Nepal assigns [ICRANP] IPO Grade 4+ to the proposed Equity Shares (Rights Issue) of Summit Micro Finance Development Bank Limited

Facility/Instrument	Issue Size	Grading Action (March 2017)
Rights Share Issue	NPR 72.50 Million	[ICRANP] IPO Grade 4+ (Assigned)

ICRA Nepal has assigned an "**[ICRANP] IPO Grade 4+**", indicating below-average fundamentals to the proposed rights issue amounting to NPR 72.50 million of Summit Micro Finance Development Bank Limited (SMFDB). 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. SMFDB is proposing to come out with 100% rights issue of 725,000 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 to support the future growth plans of the management.

The grading factors in SMFDB's ability to achieve good portfolio growth (CAGR[1] ~52% during mid-Jul-14 to mid-Apr-17, albeit on a small base) largely through expansion in client base (~20% CAGR) whilst maintaining low average portfolio per member (~NPR 51,000 as of mid-Apr-17[2]). SMFDB's asset quality remains comfortable (0+ day past due delinquencies of 0.53% as on mid-Apr-17 with marginal deterioration from 0.52% as on mid-Jul-16) and profitability profile remains healthy (RoNW and RoA[3] of ~41% and ~5% respectively for FY16 vs. ~27% and ~3% respectively for FY13). Growth opportunities for SMFDB remain adequate given the adequate capitalization profile (CRAR[4] 15.37% as on Apr-17 vs. regulatory minimum 8%), experienced management team, adequate geographical reach in its area of operations[5] with plans of gradual expansion over new geographies, access to funds benefited from deprived sector regulation, and large below poverty line population in Nepal that act as target group for MFIs[6]. The grading also positively takes note of the recent regulatory relaxation of allowing addition of up to 4% operating costs to cost of funds in maintaining the 7% lending spreads as introduced by Monetary Policy of FY17. Going forward, ability of the company to maintain sustainable growth & generate scale economies through geographical expansion while maintaining commensurate risk mitigation practices would be critical.

Nonetheless, the grading is constrained by the recent regulatory constriction for MFIs capping lending rates at 18% which is expected to impact profitability of the sector going forward. Additionally, Monetary Policy of FY17 also required commercial banks to directly lend 2% to deprived sector (rest 3% of deprived sector lending requirements could be through intermediaries). Any further changes in regulations and banking sector's preference to route deprived sector lending through MFIs could significantly impact funding support for the sector and hence its growth and profitability prospects of SMFDB. The grading is also constrained by SMFDB's limited track record (operating since May 2009), small scale of operations (asset size of NPR 1,138 million as of Apr-17) with relatively higher operating cost (~6.92% of AMA[7]). The grading also takes into account SMFDB's promoter base being diversified across limited individuals, increasing cost of funds (~7% for 9MFY17) mainly due to tightening liquidity scenario and competition from established peers undertaking microcredit activities through larger franchise. Moreover, absence of centralized credit bureau in microfinance segment remains a major concern, limiting MFI's ability to check multiple lending, hence raising concerns of overleveraging.

[1] Compounded Annual Growth Rate
[2] Mid-Apr-2017 data are unaudited; all calculations are based on management provided data
[3] Return on Net Worth and Return on Assets
[4] Capital to Risk (Weighted) Assets Ratio
[5] 34 branches spread across 10 districts working area as of mid-Apr-17
[6] Micro-Finance Institutions
[7] Average managed advances

As for SMFDB's monitoring mechanisms, field monitoring of branches is done by respective branch manager which thereafter is reviewed by internal auditor during audit, branches are audited twice in a year by in-house internal audit department so far. In ICRA Nepal's opinion, the company's monitoring and supervision remains moderate and ability of the company to maintain similar frequency and coverage would remain critical given recent rapid expansion in branches and targeted growth. ICRA Nepal also takes note of the regulatory increase in maximum permissible ticket sizes (from NPR 1 lakh to NPR 3 lakhs for 1st cycle loans and maximum from NPR 3 lakhs to NPR 5 lakhs by Monetary policy of FY17), both of which could impact discipline and hence asset quality. MFIs would have to develop strong credit appraisal systems and carefully assess cash flows and debt repayment capacity of the borrowers for sustainable growth.

SMFDB follows group lending model, wherein 5 individuals take mutual responsibility for loan repayment for all the members. In addition, SMFDB also extends secured loans up to NPR 7 lakhs to finance micro business against regulatory limit of NPR 10 lakhs. SMFDB offers NPR 30,000 for the first cycle loans (maximum limit allowed in successive cycles is NPR 3 lakhs vs. 5 lakhs allowed by regulations) owing to this, the average ticket size remains relatively lower at ~NPR 51,000 as of Apr-17. SMFDB's credit portfolio of NPR 1,049 million as of Apr-17 is dominated by unsecured group guarantee backed loans (~87%, comprising of Business, General and discipline loans), rest being secured loans. As of Apr-17, majority of the loans were provided to service sector (~89%). SMFDB's asset quality indicators remain healthy so far with 0+days delinquencies of 0.53% as of Apr-17 including NPLs of 0.36%.

The grading is further constrained by risker asset mix of SMFDB mainly due to marginal borrower profile and unsecured lending business further accentuated by low seasoning of major portion of SMFDB's credit book. Though SMFDB's share of collateral based loans is moderate at ~13% (where collateral quality remains inferior compared to other banking counterparts while the ticket size remains high) also remains a concern. Though ticket sizes offered are lower compared to regulatory permissible limit, overleveraging concerns exist for SMFDB considering the absence of centralized credit bureau in microfinance segment. Going forward, SMFDB's ability to maintain adequate profitability profile and improve internal controls to maintain its asset quality indicators would have a bearing on the overall financial profile.

As per regulation, Banks and Financial Institutions[8] (BFIs) are required to extend 4-5% of their total loans towards deprived sector[9], either directly or through microfinance companies. However, Monetary Policy of FY16/17 has mandated commercial banks to directly lend 2%, out of their total deprived sector lending requirements of 5% (this is to be fully complied from Jul-18 onwards). This is likely to impact the funds available for growth of microfinance sector to a large extent and thus any further moderation/withdrawal in this regulation could have significant impact on funding profile of microfinance entities. Currently, SMFDB is dependent upon bank borrowings (~53% of total funds availed across diverse BFIs including six commercial banks). Despite limited track record of SMFDB, savings collected from members also comprise ~47% of overall funding profile which remains higher to industry average of ~32%. SMFDB's liquidity position remains comfortable due to higher proportion of stable, non-withdrawable deposits from member though these generally carry higher costs and availability of revolving lines of credit from funder and short tenure of loans extended (generally one year).

SMFDB has reported healthy profitability indicators over last two years with ROA of ~5% and RoNW of ~41% in FY16, aided mainly by lending spreads of 12.19% during FY16. The change in the spread rate as per regulations going forward (spreads are to be maintained maximum at 11% including maximum 4% operating costs) is expected to impact profitability to an extent. Additionally, 18% cap on lending rates could impact on profitability incase cost of funds were to go up in a tight liquidity scenario. With addition of 10 new branches in 9MFY17, operating expenses have increased by ~46 bps to 7.23% which has impacted the interim profitability (RoA of ~4.96% and RoNW of ~36.92%). Profitability, going forward, is expected to be supported by these branches achieving higher efficiency along with healthy non-interest income (~2.63% of ATA for 9MFY17, primarily on account of loan processing fees being

[8] Class A, B & C financial institutions.

[9] As defined by the central bank (NRB) covering marginal sections of the society

charged at flat rate of 1.5% on all loans) and low credit costs (~0.14%[10] of ATA). Thus, ability of SMFDB to achieve sustainable growth in business in order to ensure efficient utilisation of enhanced capital whilst maintaining asset quality would have key bearing over future profitability of SMFDB.

SMFDB's CRAR of 15.37% as on Apr-17 remains adequate considering the vulnerable asset class, though remains comfortable and higher to regulatory minimum of 8%. Despite high debt funded growth since its inception, SMFDB's gearing remains moderate among peers at 5.35 as on Apr-17 on account of healthy profitability leading good internal accruals strengthening net-worth base of the bank (compared to 6.90 as on Jul-16). Bank's promoter base is diversified across individuals only which is in contrast to most of the retail MFI players whereby BFI promoters hold major stake in most of the peers. SMFDB's capital would increase to ~NPR 145 million after proposed issue (against regulatory minimum of NPR 60 million for level MFI) and hence SMFDB has plans to upgrade into regional level status in order to support the company's growth plans.

Company Profile

Incorporated in December 2008, Summit Micro Finance Development Bank Limited (SMFDB) started its commercial operation as 10 district level Class D microfinance institution in May 2009. Overall shareholding pattern of the bank constitutes of Promoters holding of 70% and public group by 30%. The shares of the Bank are listed in Nepal Stock Exchange and being actively traded in with current market capitalization of ~NPR 1,053 million as on 5th July 2017. The registered and Corporate Office of the bank is located at Birtamode, Jhapa, Nepal. Mr. Debendra Bahadur Basnet is the Chief Executive Officer of the bank.

SMFDB has presence across 10 districts of Nepal through its 34 branches. SMFDB reported a profit after tax of ~NPR 37 million during FY16, over an asset base of NPR 910 million as of Jul-16 as against as against net profit of ~NPR 28 million during FY15 over an asset base of NPR 685 million as of mid-Jul-15. Bank reported profit after tax of ~NPR 38 million in 9MFY17 over an asset base of 1,138 million as of mid-Apr-17. As on mid-Apr-17, SMFDB's gross NPLs stood at 0.36% and CRAR at 15.37%. On technology front, SMFDB uses "M-FIN" software across all branches which however is not centralized on real time basis.

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[10] SMFDB insures all its credit book and regulator requires to make only 25% of the normal credit provision in case of insured loans resulting lower credit cost.