NMB Laghubitta Bittiya Sanstha Limited

ICRA Nepal assigns [ICRANP] IPO Grade 4 to the proposed rights issue of NMB Laghubitta Bittiya Sanstha Limited

Instrument/Facility	Issue Size	Grading Action (August 2019)
Rights Share Issue (equity) Grading	NPR 243.01 Million	[ICRANP] IPO Grade 4 (Assigned)

ICRA Nepal has assigned **[ICRANP] IPO Grade 4**, indicating below average fundamentals to the proposed rights issue of NMB Laghubitta Bittiya Sanstha Limited (NMBMF). 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 better position within the grading categories concerned. NMBMF plans to come out with 150% rights issue of 2,430,093.75 equity shares with a face value of NPR 100 each, at par for its existing shareholders.

The assigned grading factors in the presence of a strong institutional promoter in NMBMF with 51% stake held by NMB Bank (rated at [ICRANP-IR] A- by ICRA Nepal). The bank has deputed three senior personnel to the company's board, strengthening its board profile. This augurs well for the governance and oversight aspects, apart from supporting the funding profile of the company. The grading also factors in the lower average ticket size so far (~NPR 58,000 as of mid-Apr-2019) reflecting high portfolio granularity. Additionally, a large below-the-poverty-line population in Nepal, the target group for microfinance institutions (MFIs) along with a further branch expansion plan encompassing new geographies also spell positives from the growth perspective. The current capitalisation of NMBMF (~10% as of mid-July 2019) remains comfortable against the regulatory minimum of 8%. This, along with the proposed capital injection, could support the company's growth plans. The grading additionally takes comfort from the regulatory changes, removing the 18% cap on lending rates for the MFIs, which provides them the flexibility to pass on the increased cost of funds to borrowers.

Nonetheless, the grading is constrained by the increased stress on NMBMF's asset quality, whereby non-performing loans (NPLs) went up to 2.02% as of mid-July 2019 as against 0.98% as of mid-July 2017. The grading is also constrained by the declining profitability in the recent years (RoNW and RoA[1] of ~22% and 1.98% for FY2019 against ~38% and 3.38% respectively for FY2016) on account of the relatively low interest spreads, high operating expenses and rising credit costs. It also takes note of the company's aggressive growth plans to compensate for lower-than-industry growth in recent periods (~29% growth from mid-July 2017 to mid-April 2019 compared to industry growth of 36%). The increasing share of high-ticket collateral-based loans to marginal borrower profile (~23% as of mid-April 2019 against ~6% in mid-July 2016), along with plans for a further increment in such loans also remains a concern. Funding sources for the MFIs may also witness some constriction, going forward as the banking sector is comfortably above its deprived sector lending target (6.65% as of mid-April 2019 against 5% target). The grading also remains constrained due to the frequent regulatory changes impacting the spreads and funding sources for the MFI sector. Moreover, the high ticket sizes permitted by regulations, the presence of a large number of players in the industry (including cooperatives), and the absence of a centralised credit information for the MFIs, raises concerns of overleveraging for the sector. Going forward, NMBMF's ability to improve asset quality indicators, enhancing its credit appraisal capabilities and generating economies of scale will have a bearing on its overall financial profile.

NMBMF follows the group lending model, wherein five individuals take mutual responsibility for loan repayment for all members. It offers up to NPR 0.2 million for the first cycle of general loans with the maximum limit allowed in the successive cycles being NPR 0.3 million, as against 0.5 million as stated in the regulations. Hence, the average ticket size remains relatively low at ~NPR 58,000 as of mid-April 2019. In addition, NMBMF also extends secured loans of up to NPR 1 million to finance the micro enterprise, as specified by regulations. NMBMF's credit portfolio of NPR 2,869 million as of mid-April 2019 is dominated by unsecured group guarantee-backed loans (~77%), the rest being secured loans. The share of the collateral loans has increased substantially in recent years (~6% of the portfolio till mid-

[1] *Return on net worth and return on assets*

July 2016) with further plans to increase it towards the regulatory ceiling of one-third of the portfolio. High ticket collateral loans to marginal borrower profile could impair their repayment capability and hence remain an area of concern in terms of incremental asset quality profile. The company's credit portfolio has reported moderate growth in recent periods with a CAGR[2] of ~30% in the last two years ending mid-July 2019.

As for the monitoring mechanisms, NMBMF has dedicated a team of nine monitoring officers who conduct monitoring and supervision of the branches at least once in every two months. Similarly, the in-house internal audit department also plans to cover all branches at least twice a year. However, the deterioration in the asset quality, despite tighter monitoring, remains an area of concern (NPLs increased to 2.02% as of mid-July 2019 from 0.98% as of mid-July 2017; 0+ days delinquencies increased to 2.50% from 1.79% over the same period). ICRA Nepal also takes note of the increased regulatory maximum permissible ticket sizes (from NPR 0.1 million to NPR 0.3 million for the first cycle loans and maximum from NPR 0.3 million to NPR 0.5 million from FY2017 onwards). Both of these could impact the borrower's repayment capacity and hence the asset quality. NMBMF would need to strengthen the credit appraisal system and carefully assess the cash flows and the borrower's repayment capacity for sustainable growth.

As per the regulation, banks and financial institutions (BFIs)[3] are required to extend 5%[4] of their total loans towards the deprived sector[5], either directly or through microfinance companies. Nonetheless, the BFIs could gradually shift towards direct lending, given the increased ticket size, which qualifies as deprived sector lending as well as expanding franchise at local/rural levels. This could impact the funds available for the growth of the microfinance sector to a large extent and thus any further moderation/withdrawal in this regulation could have a significant impact on the funding profile of microfinance entities. Currently, NMBMF is primarily dependent on bank borrowings (~66% of total funds, availed from 17 BFIs) which witnessed increased cost in recent periods (10.55% for 9M FY2019 compared to 4.67% for FY2016), in line with the trend in the banking sector. Nonetheless, the overall cost of funds remains competitive at 9.81% for 9M FY2019, given the increased share of deposits in the funding mix (~34% as of mid-April 2019 from ~18% as of mid-July 2016), which now is relatively less costly (8.24%). NMBMF's ability to further diversify funding sources at competitive rates would remain a major challenge going forward.

On the profitability front, NMBMF's profitability indicators have reported a decline in recent periods (RoNW of ~22% for FY2019 compared to ~38% for FY2016). Decline in net interest margins (6.74% for FY2019 against 9.40% for FY2016), amid increasing cost of funds and cap on lending rates at 18% (for the last two years) along with rising credit and operational costs have impacted the profitability indicators. The lending rate cap has now been removed but the cap on interest rate spread has been brought down to 6% from 7% earlier. The spread is to be considered over the cost of funds plus operating costs of up to 3% (earlier 4%). This provides the MFIs with the flexibility to pass on any further increase in the cost of funds to the borrowers, notwithstanding the competitive intensity. Given its limited track record (since 2013) and small scale of operations, NMBMF's operating costs are still high among the peers (6.62% of average total assets-ATA for FY2019). Going forward, a strong fee-based income (3.08% of ATA for FY2019), along with an expected moderation in operating expenses with scale economies, could support profitability to an extent. NMBMF's ability to achieve sustainable business growth ensuring efficient utilisation of enhanced capital whilst maintaining a healthy asset quality would have a key bearing over its future profitability profile.

The capitalisation ratio of the company at 9.63% as of mid-July 2019, remains comfortable compared to the regulatory minimum of 8%. This, along with the proposed capital enhancement, could support the targeted growth plans. NMBMF's gearing remains moderate among the peers at 9.97 times as of mid-July 2019.

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[2] Compounded annual growth rate
[3] Class A, B & C financial institutions.
[4] This was 5%, 4.5% and 4% respectively for class-A, B and C respectively till mid-July 2018.
[5] As defined by the central bank (NRB) covering marginal sections of the society

Analytical approach: For arriving at the ratings, ICRA Nepal has applied its rating methodology as indicated below.

Links to applicable criteria:
IPO Grading Methodology
Bank Rating Methodology

About the company
Established in May 2012, NMB Laghubitta Bittiya Sanstha Limited (NMBMF) started its operations as a 10-district level class D retail microfinance institution from March 2013. Initially, the company was promoted by Clean Energy Development Bank (Class-B Bank) with ~73% shareholding; rest held by individual promoters. After the merger of the promoter bank with NMB Bank in October 2015, NMB Bank now holds the majority stake in NMBMF at 51%; 19% shares are held by individual promoters and rest by general public. The registered office of NMBMF is in Pokhara, Kaski. The company's shares are listed in the Nepal Stock Exchange.

As of mid-July 2019, NMBMF is operating through 100 branches spread over 54 districts of Nepal. NMBMF reported a profit after tax of ~NPR 61 million in FY2019 (YoY increase of 83%), over an asset base of NPR 3,483 million as of mid-July 2019. Its gross NPLs stood at 2.02% and CRAR stood at 9.63% as of mid-July 2019. On the technology front, the company uses "Uranus-Tech" software that is centralised across all its branches.

August 2019

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