First Microfinance Development Bank Limited

ICRA Nepal assigns [ICRANP] IPO Grade 3 to the proposed Rights Issue (equity shares) of First Microfinance Development Bank Limited

Facility/Instrument	Issue Size	Grading Action (March 2017)
Rights Issue Grading	NPR 132.25 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 132.25 million of First Microfinance Development Bank 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 1:2 rights offering of 1,322,500 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 adequate growth opportunities for microfinance business in Nepal given the large below poverty line population. The grading is further supported by FMDB's adequate loan underwriting processes resulting in good assets quality indicators (Nil Gross NPLs[1] so far) along with adequate profitability profile (RoA and RoNW[2] of ~2% and ~20% respectively for FY16) supported by low cost of funds, low credit provisioning expense & low operating expense ratio. Gradual increase in deprived sector lending requirements for banking sector (increased from 3% in FY12 to 5% in FY16 for commercial banks) is expected to ensure adequate flow of funds at low cost. However recent change in regulation requiring commercial banks to directly lend 2% of their deprived sector lending target may constraints funding source for MFIs over the long term. Going forward, FMDB's ability to increase its client base/presence and commercial banks' strategy to provide funding to microfinance entities directly or routing through specialized agencies such as FMDB would have bearing on future portfolio growth.

Nonetheless, the grading is constrained by moderate track record of FMDB (operating since 2010), stiff competition with other wholesale lending MFIs[3] and commercial banks, higher portfolio vulnerability arising from large share of exposure to cooperatives (~41% of credit portfolio) which lacks on regulatory supervision. The grading is also constrained by low seasoning of FMDB's credit book (~54% of loan as of Jul-16 was disbursed in last two years), relatively high portfolio concentration (~41% of total loans among top-20 borrowers on mid-Jan-17), lack of diversity in earnings, lower representation of promoters in the board (two directors from promoter groups in five membered board, lack of independent board member 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 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[4] 51% in past 3 years (ending Jul-16), albeit on a low base. The growth was supported by increased capital base through rights injection in FY15 while the growth in number of partner MFIs remained minimal (140 institutions with operations in 45 districts as

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

on mid-Jan-17 compared to 119 partner MFIs in Jul-14) resulting in largely similar portfolio concentration. FMDB's credit portfolio stood at NPR 3,275 million as of Jan-17, comprising of two major products- MFI term loans (69%) and MFI working capital loans (31%). Despite portfolio vulnerability remaining high due to marginal profile of borrowers and unsecured lending model, FMDB's asset quality indicators remains good with Nil NPLs so far and occasional minimal delinquencies. Nonetheless, more than 3/4th of the partner organizations are Co-operative societies accounting for ~41% of credit portfolio as on Jan-17; thereby posing risk to the incremental assets quality of FMDB given poor regulatory framework and general lack of transparency associated with 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 year supported mainly by augmented capital base. Going forward, FMDB's ability to maintain its assets quality profile over enhanced scale of operations will have a bearing on its overall profitability profile.

FMDB has healthy resources profile composed of low cost borrowings from BFIs. Lending to microfinance sector is classified as deprived sector lending, under current Nepalese banking regulations; which ensure flow of banks' credit to microfinance sector at lower interest rates. FMDB's total borrowings as on Jan-17 stood at 3,342 million, with over 95% borrowings from Class A commercial banks. The average cost of borrowings for FMDB remained low at 3.52% for FY16, benefitted by current regulations favouring deprived sector lending and low interest rate regime prevailing over the period. With tightening in liquidity in banking sector post Jul-16, cost of funds have increased to 3.95% for H1FY17. Recent change in regulations requiring commercial banks to directly lend 40% of their deprived sector lending targets is expected to arrest higher growth in MFI sector, however given ~20% growth in banking sector, the residual funds is also expected to be adequate for growth of MFI sector. Any further change in the regulations could affect FMDB's funding profile negatively; however, the institutional promoters which include BFIs with 40% holding in FMDB provides some comfort regarding the funding profile under adverse conditions. As of now, banks prefer lending through these institutions mainly owing to their supervision strength; if banks shift the model to direct lending to MFIs that could have negative impact on growth prospects.

Despite increase in capital base over last two years, the profitability profile of FMDB has remained largely similar supported mainly by increase in scale of operations. FMDB has largely maintained gross interest spread of ~3% which coupled with low 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 three years; supported by stable NIMs 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 steady NIMs and operational efficiencies brought about by increasing scale of operations. However, FMDB's ability to maintain the assets quality indicators amid existing portfolio vulnerability and increased business size will remain a key parameter for future profitability.

FMDB's CRAR[5] was 11.04% as on Jan-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. However, FMDB plans to offer series of rights and bonus in order to meet the revised capital requirements (from NPR 100 million to NPR 600 million to be met by Jul-18; FMDB has capital of NPR 264.50 million as of Jan-17). Moreover, the rate of internal capital generation remains healthy and is also likely to support the expansion plans. In the long run, the 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.

[5] Capital to Risk adjusted Assets Ratio

Company Profile

First Microfinance Development Bank Limited (FMDB), a wholesale microfinance lender, started its operations from January 8, 2010. It is licensed as a class D microfinance institution, by the NRB. FMDB is engaged in the 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 financial intermediary NGOs. Apart from this, it provides institutional strengthening and capacity building supports to its partner MFIs with a view to promote and develop microfinance sector in the country. As of Jan-17, FMDB is running its operations in 45 districts of the country through 140 partner organisations.

FMDB has 40% institutional holding as on Jan-17, which includes two Class A commercial banks (30%) and Class B & Class C BFIs (collective holding of 10%). The promoter-public shareholding ratio stood at 51:49 as on Jan-17 post conversion of 19% promoter share to public (earlier promoter-public holding was 70:30). During the year ended mid-July, 2016, FMDB reported a net profit of ~NPR 55 million over an asset base of NPR 3,076 million as against a profit of ~NPR 36 million over an asset base of NPR 2,342 million in the previous year. For H1FY17, FMDB has reported profit of NPR 34 million over asset base of NPR 3,696 million. As of mid-Jan-17, its CRAR stood at 11.04% and NPLs were zero.

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