Mero Microfinance Laghubitta Bittiya Sanstha Limited

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

Instrument/Facility	Issue Size	Grading Action (December 2018)
Rights Share Issue (equity) Grading	NPR 328.90 Million	[ICRANP] IPO Grade 4+ (Assigned)

ICRA Nepal has assigned an “**[ICRANP] IPO Grade 4+,**” indicating below average fundamentals to the proposed rights issue of Mero Microfinance Laghubitta Bittiya Sanstha Limited (Mero) (ICRA Nepal assigns an 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. Mero plans to come out with the 100% rights issue of 3,289,000 equity shares with a face value NPR 100 each, at par for its existing shareholders.

The assigned grading factors in Mero’s strong promoter profile (promoted solely by banking institutions[1]), which augurs well for the governance as well as the funding profile of the company. The grading also takes into consideration the company’s ability to maintain a healthy credit growth so far (albeit over small base) which was mainly aided by rapid branch expansion and growth in its client base. Growth opportunities for Mero remain adequate, given the further branch expansion plans encompassing new geographies and large below-poverty-line population in Nepal, the target group for microfinance institutions (MFIs). Current capitalisation of Mero (~11% as of mid-October 2018) remains comfortable against the regulatory minimum of 8%, which, along with the proposed capital injection, could support the management’s growth plans. The grading additionally takes comfort from the recent regulatory changes removing the 18% cap on lending rate 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 increasing stress on Mero’s asset quality (non-performing loans-NPLs increased from 1.32% as of mid-July 2017 to 2.36%[2] as of mid-October 2018) despite high portfolio growth. Funding sources for MFIs may also witness some constriction going forward as the banking sector is comfortably above its deprived sector lending target (6.63% as of mid-October 2018 against 5% target). The grading is also constrained by the declining profitability in the recent years (RoNW and RoA[3] of ~24% and 2.88% for FY2018 vs. ~31% and 4.20% respectively for FY2016). The grading also remains suppressed by the frequent changes in the regulations impacting the spreads and funding sources for the MFI sector. Despite the removal of the 18% cap on lending rates, the reduction in lending spreads for MFIs by 1% (to 6%) and a similar reduction in maximum allowable operating costs for this purpose (to 3%) could restrict improvement in profitability of MFIs. Moreover, the increased ticket size following the regulations, the presence of a large number of players in the industry (including cooperatives), and the absence of centralised credit information for MFI, raises concerns of overleveraging for the sector. Going forward, Mero’s ability to improve asset quality indicators while increasing the scale of operation by enhancing its credit appraisal capabilities and improving internal controls, would have a bearing on its overall financial profile.

Mero follows the group lending model, wherein five individuals take mutual responsibility for loan repayment for all members. Mero offers up to NPR 60,000 for the first cycle of general loans; maximum limit allowed in the successive cycles is NPR 0.3 million as against 0.5 million allowed by regulations. Hence, the average ticket size remains relatively moderate at ~NPR 68,000 as of mid-October 2018. In addition, Mero also extends secured loans up to NPR 0.7 million to finance the micro enterprise as allowed by the regulations. Mero’s credit portfolio of NPR 3,649 million as of mid-October 2018 is

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[1] *Promoted by 10 banks and financial institutions- 8 class-A and 2 class-B banks, who now hold ~69% stake.*

[2] *NPLs data based on principal at risk as on date for overdue loans more than three months. Published NPLs were 1.48% considering the regulatory forbearance on NPL recognition available for MFIs; regulation allows only overdue portion to be reported as NPLs until the overdue period crosses one year. Mero disregards this forbearance in annual accounts while utilizes the same in quarterly reports.*

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

dominated by unsecured group guarantee-backed loans (~79%), the rest being secured loans. The share of collateral loans has increased substantially in recent years (0.20% of portfolio till mid-July 2015) with further plans to increase it towards the regulatory ceiling of one-third of the portfolio. High ticket collateral loans to a 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 high growth at a CAGR[4] of ~69% in the last four years ending mid-July 2018, albeit on a small base. The pace of growth, however, has reported a moderation in the recent period with an annualised growth of ~31% during Q1 FY2019. Portfolio growth could witness a further moderation as the banking sector is already above the targeted deprived sector lending requirements (6.63% of portfolio as of mid-October 2018, as against target of 5%). This remains a concern in terms of funds availability to support targeted growth.

As for monitoring mechanisms, Mero has established ten area offices for close monitoring of the branches. Each of these cover six to nine branches in the vicinity and every branch is covered at least once a quarter. Similarly, the internal auditor (outsourced) also covers all branches at least once a year. However, the deterioration in the asset quality, despite tighter monitoring, remains an area of concern (NPLs increased from 1.32% as of mid-July 2017 to 2.36% as of mid-October 2018 and 0+ days delinquencies increasing from 2.37% to 5.30%). 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 could impact discipline and hence the asset quality. Mero would have to develop a strong credit appraisal system and carefully assess the cash flows and the debt repayment capacity of the borrowers for sustainable growth.

As per the regulation, bank and financial institutions (BFIs)[5] are required to extend 5%[6] of their total loans towards the deprived sector[7], 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, Mero is primarily dependent on bank borrowings (~76% of total funds availed from 20 BFIs) which witnessed increased cost in recent periods (~10% for Q1 FY2019 compared to ~4% for FY2016). Moreover, the "base rate plus" lending regime would keep the cost of the borrowings higher compared to earlier, when the MFIs could borrow at subsidised rates from banks. Nonetheless, the increased share of deposit in funding mix (~8% as of mid-July 2015 to ~24% as of mid-October 2018), which carries a relatively lower cost as of now (~7.2%), has slightly moderated the overall cost of funds to ~9.4% for Q1 FY2019. Mero's ability to further diversify funding sources at competitive rates would remain a major challenge going forward.

On the profitability front, Mero's profitability indicators remain healthy, despite some decline in recent periods (RoNW of ~31% for FY2015 to ~24% for FY2018). Decreasing net interest margins (9.54% for FY2016 to 7.28% for FY2018), amid increased cost of funds and cap on lending rates at 18% (for the last two years), has impacted the profitability indicators. The lending rate cap has now been removed but the cap on interest rate spread has been brought down from 7% to 6%. The spread is to be considered over the cost of funds plus operating costs of up to 3% (earlier 4%). Since Mero's operating costs are still high (6.25% of average total assts-ATA for FY2018), changed regulations are not expected to have an immediate impact on the company's profitability. However, this provides the MFIs with the flexibility to pass on a further increase in the cost of funds, if any, to borrowers. Going forward, a strong fee-based income (3.22% of ATA for FY2018), along with an expected moderation in operating expenses with scale economies, could support profitability to an extent. Mero'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.

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

The capitalisation ratio of the company at 11.37% as of Oct-2018, remains comfortable compared to the regulatory minimum of 8%. This, along with the proposed capital enhancement could support the targeted growth plans. Mero's gearing remains moderate among the peers at 8.13 times as of mid-October 2018.

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

Mero Microfinance Laghubitta Bittiya Sanstha Limited (Mero) started its commercial operations from July 2013, when it received the licence to operate as a national level class D microfinance institution. As of mid-October 2018, Mero had operations spread through 86 branches across Nepal. The company was promoted solely by the BFIs (eight commercial banks and two development banks) who now hold ~69% stake; the rest is held by the general public. Mr. Ram Hari Dahal is the Chief Executive Officer of the company. The registered and corporate office of the company is located at Bidur Municipality-4, Battar, Nuwakot, Nepal. The company's shares are listed in the Nepal Stock Exchange.

Mero reported a profit after tax (PAT) of ~NPR 95 million for FY2018, over an asset base of ~NPR 3,878 million as of mid-July 2018 as against a net profit of ~NPR 94 million for FY2017 over an asset base of NPR 2,687 million as of mid-July 2017. The company reported a PAT of ~NPR 27 million for Q1 FY2019 while gross NPLs stood at 1.48% and CRAR at 11.37% as of mid-October 2018. On the technology front, Mero uses the Empower software, which is centralised across all its branches.

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About ICRA Nepal Limited:

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