ICRA NEPAL

Janasewi Laghubitta Bittiya Sanstha Limited

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

Facility/Instrument	Issue Size	Grading Action (January 2019)
IPO (equity) Grading	NPR 46.33 Million[1]	[ICRANP] IPO Grade 4 (Assigned in August 2018; reaffirmed for enhanced IPO size in January 2019)

ICRA Nepal has assigned an "**[ICRANP] IPO Grade 4**", indicating below-average fundamentals to the proposed Initial Public Offering (IPO) of Janasewi Laghubitta Bittiya Sanstha Limited (JLB). 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. JLB is proposing to come out with an IPO of 463,300 numbers of equity shares of face value NPR 100 each at par.

The assigned grading factors in JLB's ability to maintain high credit growth so far, aided by rapid branch expansion and growth in client base, while maintaining moderate average ticket size (~NPR 66,000 as of mid-October 2018). Growth opportunities for JLB remain adequate given branch expansion plans encompassing new geographies (expansion in additional five districts planned shortly, subject to regulatory approval) and large below poverty line population in Nepal, the target group for microfinance institutions (MFIs). Current capitalisation of JLB (~22% as of mid-October 2018) remains high against the regulatory minimum of 8%, which along with capital from proposed issue could support growth plans of the management. The grading also takes comfort from the recent regulatory change removing 18% lending rate cap for MFIs, which provides them the flexibility to pass on the increased cost of funds to borrowers.

Nonetheless, the grading is constrained by the recent deterioration in asset quality of JLB, despite low seasoning of portfolio; non-performing loans (NPLs) have increased to 1.23% as of mid-October 2018 from 0.29% as of mid-July 2017. The grading further remains constrained by subdued return indicators of JLB so far despite the recent marginal improvement (RoNW and RoA[2] of ~8% and 1.57% for Q1 FY2019 as against ~5% and 1.05%, respectively, for FY2018). JLB's profitability indicators would be further impacted by capitalisation of proposed IPO and hence company's ability to improve profitability over a longer time frame remains to be seen. The grading also takes into account the frequent changes in regulation, impacting the spreads and funding sources for the MFI sector. After recently removing the interest rate cap of 18%, the spread for MFIs has been reduced to 6% (earlier 7%) which is considered over cost of fund plus operating costs up to 3% (earlier 4%). Contrary to earlier unregulated spreads, this could restrain MFIs from reporting better profitability indicators even if the current high interest rate regime moderates. The grading is also constrained by JLB's limited track record (operating since September 2015), small scale of operations (assets base of NPR 569 million as of mid-October 2018) with relatively higher operating expenses (~8% of Average Total Assets or ATA) and competition from larger/established peers. Moreover, increased ticket size by regulations, presence of a large number of players in the industry (including cooperatives), and absence of centralised credit information for MFIs raises concerns of overleveraging for the sector. Going forward, JLB's ability to increase its scale of operations while maintaining healthy asset quality indicators, by enhancing its credit appraisal capabilities and improving internal controls, would have a bearing on its overall financial profile.

JLB follows the group lending model, wherein five individuals take mutual responsibility for loan repayment for all members. JLB offers up to NPR 60,000 for the first cycle of general loans, where the maximum limit allowed in successive cycles is NPR 0.3 million as against NPR 0.5 million allowed by regulations. Owing to this, the average ticket size remains relatively moderate at ~NPR 66,000 as of mid-October 2018. In addition, JLB also extends secured loans up to NPR 0.7 million to finance micro enterprises as allowed by regulations. JLB's credit portfolio of NPR 487 million as of mid-October 2018 is dominated by unsecured group guarantee backed loans (~91%), the rest being secured loans. Credit

[1] *IPO size of the company has been enhanced to NPR 46.33 million from earlier graded size of NPR 42 million*

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

portfolio has reported high growth at a CAGR[3] of ~164% over two years ending mid-July 2018, albeit on a very small starting base of ~NPR 60 million. Over the medium term, the management plans to maintain high credit growth with increment in share of collateral-based loans up to regulatory ceiling (a third of portfolio). However, planned increase in high ticket collateral loans to marginal borrower profile (who could impair their repayment capability) with relatively inferior collateral remains an area of concern in terms of incremental asset quality profile.

As for JLB's monitoring mechanisms, field branches are monitored by respective branch managers along with sample-based review by an internal auditor. The internal audit department, however, is handled by a single individual so far, hence limiting the scope. In addition, JLB is yet to establish a separate monitoring department. In ICRA Nepal's opinion, the company's monitoring and supervision could be strengthened; frequency and coverage of monitoring would remain critical given the high growth being targeted. ICRA Nepal also notes the increased regulatory maximum permissible ticket sizes (from NPR 0.1 million to NPR 0.3 million for first cycle loans and maximum from NPR 0.3 million to NPR 0.5 million from FY2017 onwards), both of which could impact discipline and hence asset quality. JLB would have to develop strong credit appraisal systems and carefully assess cash flows and debt repayment capacity of the borrowers for sustainable growth.

As per regulation, Banks and Financial Institutions[4] (BFIs) are required to extend 5%[5] of their total loans towards deprived sector[6], either directly or through MFIs. Nonetheless, BFIs could gradually shift towards direct lending given the increased ticket size that qualify as deprived sector lending as well as expanding franchise at local/rural levels. 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). This could impact the funds available for growth of the microfinance sector to a large extent. Any further moderation/withdrawal in the existing regulation could have significant impact on funding profile of microfinance entities. Currently, JLB is primarily dependent upon bank borrowings (~70% of total funds availed across 10 BFIs) which has witnessed increased cost in recent periods (~12% for Q1 FY2019 as against ~7% for FY2017). Moreover, the "base rate plus" lending regime would keep cost of borrowings higher compared to earlier when MFIs could borrow at subsidised rates from banks. Despite limited track record, the company has been able to raise sizeable savings from members, which comprised ~30% of overall funding profile as of mid-October 2018. The cost of funds for this source is currently lower than bank borrowings (~7% for Q1 FY2019). Hence, the same lowered the overall cost of funds at 10.24% for Q1 FY2019 (~7% for FY2017). JLB's ability to diversify funding sources at competitive rates would remain a major challenge, going forward.

On the profitability front, JLB's indicators have remain subdued so far despite gradual improvements. Amid rising cost of funds and the then cap on lending rates at 18%, the profitability was supported mainly by strong fee-based income (4.16% of ATA for FY2018 over 3.15% for FY2017) while NIMs remained low at 7.14% for FY2018. High operating expenses among peers at 8.34% for FY2018 and increased credit cost (from 1.14% of ATA for FY2017 to 1.47% for FY2018) remained a drag to profitability. Nonetheless, JLB's overall profitability indicators improved in FY2018 with RoNW and ROA increasing from ~3% and ~0.6% for FY2017 to ~5% and ~1% for FY2018, respectively. Profitability, going forward, is expected to be supported by existing branches achieving higher efficiency, incremental portfolio from new branches that are planned to be set up and control over asset quality. Thus, JLB's ability to achieve sustainable growth in business ensuring efficient utilisation of enhanced capital while maintaining healthy asset quality would have a key bearing over its future profitability profile.

Capitalisation (CRAR) of the company at 22.04%, as of mid-October 2018, was much higher compared to the regulatory minimum of 8%. JLB's gearing remains low among its peers at 4.32 times as on the same date. JLB's capital would increase to NPR 144.33 million after the proposed IPO compared to the regulatory minimum of NPR 100 million for national level MFIs. Hence, JLB has plans to upgrade into national level status over the medium term to support the company's growth plans.

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[3] *Compounded annual growth rate*

[4] *Class A, B & C financial institutions*

[5] *This was 5%, 4.5% and 4%, respectively, for class-A, B and C BFIs, respectively, till mid-July 2018*

[6] *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

Company Profile
Janasewi Laghubitta Bittiya Sanstha Limited (JLB) started its commercial operation from September 29, 2015, upon receiving licence to operate as 10 districts-level Class D MFI. As of mid-October 2018, JLB had operations through 21 branches over its 10 licensed districts. JLB is promoted by 120 individual promoters engaged in different professions. The promoter's holding is expected to dilute to 67.90% after the proposed IPO, assuming full subscription. Mr. Kamal Bahadur Khatri is the Chief Executive Officer of the company. The registered and corporate office of JLB is located at Kushma, Parbat, Nepal.

JLB reported a profit after tax (PAT) of ~NPR 4 million for FY2018 (~NPR 1 million for FY2017) over an asset base of NPR 485 million as of mid-July 2018. For Q1 FY2019, JLB has reported PAT of ~NPR 2 million over an asset base of NPR 569 million as of mid-October 2018. JLB's gross NPLs stood at 1.23% and CRAR at 22.04% as of mid-October 2018. On the technology front, JLB uses "MFin" software, which is centralised across all of its branches.

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About ICRA Nepal Limited:
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