Pokhara Finance Limited

ICRA Nepal assigns [ICRANP] IPO Grade 4 to the proposed Further Public Offer (equity shares) of Pokhara Finance Limited

Facility/Instrument	Issue Size	Grading Action (January 2017)
Further Public Offer (Equity)	NPR 216.41 Million	[ICRANP] IPO Grade 4 (Assigned)

ICRA Nepal has assigned an "**[ICRANP] IPO Grade 4**", indicating below-average fundamentals to the proposed Further Public Offering (FPO) of Pokhara Finance Limited (PFL) amounting NPR 216.41 million. ICRA Nepal assigns IPO grading[1] 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. PFL is proposing to come out with FPO of 983,682 equity shares of face value NPR 100 each, to be issued to public at NPR 220 each including premium of NPR 120 per share *(subject to approval of regulatory authorities)*. The proposed FPO is being issued to augment the company's capital base to meet the elevated regulatory capital requirements and would be diluting the promoter holding to 51% (i.e. the regulatory minimum) vs. 60% as of now.

The grading factors in PFL's long track record (operating since 1997), ability to maintain moderate portfolio growth (CAGR[2] of ~16% and ~19% in terms of credit and deposits respectively over last five years ending FY16) and healthy asset quality indicators (NPLs[3] were 2.15% as of mid-Oct-16 against 15.27% for the industry; 0+ days delinquencies were ~10% of portfolio as of mid-Jul-16 which has however moved up to ~20% as of mid-Oct-16). The grading also takes into account PFL's adequate CASA[4] profile (~55% as of mid-Oct-16 vs. ~53% for industry) supported by higher interest rates on saving accounts and hence moderately higher cost of funds (6.27% for FY16) than industry average. Comfortable capitalization profile (CRAR[5] of 21.25% as of mid-Oct-16), experienced management team and plans of expansion in uncovered regions are expected to provide PFL with adequate growth opportunities going forward.

While PFL has granular portfolio profile (~16% and ~14% among top 20 borrowers and depositors respectively as of mid-Oct-16), however PFL's small base of operations with limited franchise[6] among national level players results in geographical concentration (>80% of portfolio in Kaski district) thereby constraining the grading. The grading remains further constrained by higher exposure to personal loan segment (~39% of total credit portfolio as of mid-Oct-16) which might be more vulnerable compared to other segments. Lack of diversity in earnings (fee base income <1% in average) for PFL constrains the overall profitability (RoNW[7] ~12% on an average over last five years vs. ~14% for industry), though PFL has been able to maintain healthy NIMs[8] (4.08% for FY16). ICRA Nepal has also factored in PFL's capital base being much lower to revised regulatory capital framework to be complied by Jul-17[9] and relatively marginal borrower profile compared to commercial and development banks.

Moreover, the grading is also constrained by lack of institutional promoters, high competition from other BFIs[10] who have ability to offer finer lending rates coupled with uncertain political and

[1] Includes rights and further public issue of equity shares
[2] Compounded Annual Growth rate
[3] Non-Performing Loans
[4] Current And Saving Accounts.
[5] Capital to Risk-weighted Assets Ratio
[6] Asset base of NPR 3,909 million and franchise of seven branches in three out of 75 districts of Nepal as on mid-Oct-16.
[7] Return on Net-worth
[8] Net Interest Margins as a % of Average Total Assets
[9] Regulator may impose restrictions in PFL operations if it fails to comply the capital requirements.
[10] Bank and Financial Institutions

operating environment that can impact the asset quality of Nepalese BFIs. Going forward, attaining requisite credit and deposit growth to ensure deployment of existing and incoming capital for generating adequate returns and also adequately diversifying its portfolio towards various sectors/geographies would remain key challenges for PFL.

PFL's credit portfolio has grown moderately at a CAGR ~16% over last five years and stood at NPR 2,804 million as of mid-Oct-16 despite long track record of ~20 years. Credit portfolio remains concentrated towards personal loans (39%), followed by business loans (26%), housing loans (16%), hire purchase loans (9%), deprived sector loans (4%), among others. Compared to peers, PFL's credit portfolio is granular wherein top 20 borrowers accounted for ~16% of portfolio as of mid-Oct-16.

Similar to the trends in the sector, asset quality of PFL witnessed major stress in FY12 with NPLs rising from ~5% to ~11% due to slump in real estate market owing to tight liquidity and regulatory changes in lending to real estate. Thereafter, with decline in interest rates and hence reduction in debt servicing burden of borrower, PFL has gradually brought down NPLs to 2.15% as of mid-Oct-16 (1.67% as of mid-Jul-16), which is much better than finance company industry average of ~15%; but closer to similar sized peers. Disregarding the regulatory forbearance towards NPL recognition for term loans accorded to class C finance companies[11], PFL's NPLs would be 3.73% as of mid-Oct-16. 0+ days delinquencies for PFL were ~10% of portfolio as of mid-Jul-16 which has however moved up to ~20% as of mid-Oct-16 amidst festive seasons, remaining in line with the trend across the industry. Portfolio vulnerability remains high for PFL due to high share of assessed income based lending (especially personal loans) and also due to marginal profile of borrowers compared to higher class BFIs.

As for funding profile, PFL has fair CASA proportion (~55% as of mid-Oct-16) compared to industry average of ~53% resulting into modest cost of deposits being slightly higher among peers (6.27%% for FY16 and 5.42% for Q1FY17) as it offers slightly higher saving rates. Further, concentration to top 20 depositors remains lower at ~14% as of mid-Oct-16. Going forward, the ability of PFL to increase its presence across different geographies thereby increasing the depositor base will remain vital to future cost of deposits as well as portfolio growth while achieving diversification and overall financial profile.

Despite slightly higher cost of deposits, supported by higher mix of personal loans in asset mix and consequently higher yields on advances; PFL has been able to maintain healthy NIMs (~4.1% for FY16), which have supported the profitability despite lower fee income. Profitability has been impacted during Q1FY17 due to increase in credit costs (0.65% of ATA for Q1FY17 vs. -0.01% for FY16). The profitability indicators declined during Q1FY17 (RoE and RoA of ~10% and 1.71% for Q1FY17 vs. ~14% and 2.44% for FY16). PFL's earnings profile going forward will largely depend on the ability to maintain NIMs, improve its scale of operations and control its assets quality.

As on mid-Oct-16, capital adequacy ratio (CRAR) of PFL was comfortable at 21.25% (22.66% as on mid-Jul-16) as compared to regulatory minimum of 11%, but is comparable to similar sized peers. Monetary policy of FY 2015-16 requires national level finance companies to increase their paid-up capital to NPR 800 million within mid-Jul-17, failure to comply the same may constrain growth. PFL has capital of ~NPR 557 million as of mid-Oct-16 and the same is expected to reach to ~NPR 656 million after proposed FPO (assuming full subscription). PFL plans to meet the shortfall in meeting the elevated capital requirements through 15% rights thereafter and retention of future profits.PFL' ability to raise planned capital in a timely manner would also have critical bearing on its ability to absorb any deterioration in asset quality and maintain comfortable solvency profile. However, attaining adequate quality growth to ensure adequate returns to shareholders would remain key challenge for the company.

[11] Only overdue installment up to 1 year can be reported as NPLs.

Company Profile

In operation since March 1997, Pokhara Finance Limited (PFL) is a National Level Class C Finance Company. PFL is promoted by a group of individual promoters from diverse backgrounds with maximum shareholding by largest? shareholder at ~6% of total capital (As on mid-Oct 2016). Its Corporate Office is located at Newroad, Pokhara. Share capital of the company is distributed among promoter & public in the ratio of 60:40 which is proposed to be diluted to 51:49 post proposed FPO. The shares of the company are listed on the Nepal Stock Exchange. Mr. Raj Kumar Gurung is the Chief Executive Officer of the company.

PFL has presence in three districts of Nepal through its seven branches. PFL has market share of 5.52% in terms of deposit base and 5.45% in terms of credit portfolio of Finance Companies' Industry as on mid-Oct-16. PFL reported a net profit of NPR 88 million during 2015-16 over an asset base of NPR 3,805 million as on mid-Jul-16 as against net profit of NPR 156 million during 2014-15 over an asset base of NPR 3,398 million as on mid-Jul-15. During Q1FY17, company has reported net profit of NPR 16 million over an asset base of NPR 3,909 million. PFL's CRAR stood at 21.25% and reported gross NPLs were 2.15% as on mid-Oct-2016. In terms of technology platform, PFL has implemented Pumori Plus IV System which is centralized throughout its branches.

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