ICRA NEPAL

Grameen Bikas Laghubitta Bittiya Sanstha Limited

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

Instrument/Facility	Issue Size	Grading Action (February 2019)
Rights Share Issue (equity) Grading	NPR 327.5 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 Grameen Bikas Laghubitta Bittiya Sanstha Limited (GBLBS) (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. GBLBS plans to come out with the 50% rights issue of 3,275,000 equity shares with a face value NPR 100 each, at par for its existing shareholders. The issue is being made in order to maintain the regulatory minimum capital adequacy ratio for microfinance institutions (MFIs).

The assigned grading factors in GBLBS's strong promoter profile (~30% holding by Government of Nepal (GoN), ~3% holding by Nepal Rastra Bank (NRB) and ~14% holding by NRB licensed Class A commercial banks), which augurs well for the governance as well as the funding profile of the company. The grading also factors in GBLBS's large scale of operation encompassing wide geography (188 branches across 57 districts of Nepal as on mid-Oct-2018) and customer base, which is expected to support incremental credit growth. Growth opportunities for GBLBS remain adequate, given its adequate presence across the country, future expansion plans and large below-poverty-line population in Nepal, the target group for MFIs. The grading additionally takes comfort from the recent regulatory change removing the 18% cap on lending rate for the MFIs, enabling them to pass on the increased cost of funds to ultimate borrowers.

Nonetheless, the grading is constrained by GBLBS's relatively weak asset quality indicators (non-performing loans-NPLs of 4.82% as of mid-October 2018). Weak capitalisation profile (capital to risk assets ratio- CRAR of 7.41% as of mid-Oct-2018 in breach of regulatory minimum of 8%[1]) also remains a concern, although it is likely to be mitigated after the proposed rights issue (assuming full subscription). The grading is also constrained by GBLBS's weak management information system (MIS[2]) which limits the extent of management oversight and control. The grading also remains suppressed by the frequent changes in the regulations affecting spreads and funding sources for the MFI sector. Despite the removal of the 18% cap on lending rates, MFI's lending spread has been capped at 6% (earlier 7%) and the maximum allowable operating cost has been capped at 3% (4% earlier) which can affect GBLBS' profitability. 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, GBLBS' ability to improve asset quality indicators and to enhance the operating efficiency would have a bearing on its overall financial profile.

GBLBS was formed after the merger of erstwhile five regional Grameen Bikas banks. These regional Grameen Bikas banks (established between 1993 and 1997) were promoted by the Nepal Government and Nepal Rastra Bank (NRB, the banking sector regulator) in collaboration with NRB licensed BFIs to replicate the Grameen model and increase financial access among the poorer sections of the community. Over the years of operation, most of these Grameen Bikas Banks faltered under rising NPLs and operational inefficiencies leading to large accumulated losses. As a measure to revive these ailing institutions, GoN and NRB initiated the process of merger among five regional Grameen Bikas Banks which was eventually concluded in August 2014. Although the asset quality of GBLBS (the merged entity) has improved in the post-merger era (from ~9% at the time of merger), the NPA levels remain on the higher side (gross NPAs of 4.82% as on mid-October 2018) and remains a grading concern.

[1] *GBLBS is permitted to carry on business despite low capitalization as per the merger terms approved by NRB.*
[2] *Out of 188 branches, 91 branches are operating in manual system (22 of them are in migration phase). Further, these systems are not integrated.*

GBLBS follows the group lending model, wherein the group members (typically five individuals) take mutual responsibility for loan repayment for all members. As per GBLBS's lending policy, it offers group-guarantee-based unsecured loans of up to NPR 60,000 for the first cycle (vis-à-vis permissible limit of NPR 0.3 million by regulations in the first cycle which can be extended in successive cycles up to NPR 0.5 million after 2 years). As on mid-October 2018, the average ticket size per borrower stands relatively lower at ~NPR 69,000. In addition, GBLBS also extends secured loans of up to NPR 0.7 million to finance the micro enterprise as allowed by the regulations. GBLBS's credit portfolio of NPR 9,094 million as of mid-October 2018 is dominated by unsecured group guarantee-backed loans (~89%), the rest being secured loans. The company's credit portfolio growth remained lower to the industry average growth over the past three years ending Jul-2018 (CAGR[3] of ~18% vs. ~42% for the industry), due to a sizeable credit portfolio base and greater focus on business consolidation. The pace of growth, however, has slightly increased in the recent period with an annualised growth of ~20% during Q1 FY2019. The MFI's credit growth could get affected by funding constraints since the banking sector has met its minimum lending target for the deprived sector (6.63% of banking sector portfolio as of mid-October 2018, as against a target of 5%). Moderation in the overall banking sector credit growth amid current liquidity shortage could also lower the quantum of fund available for the MFI sector.

As for monitoring mechanisms, compliance and monitoring activities are performed by the in-house internal audit department of the company. Internal audit is conducted two times a year, audit of the head office and regional offices conducted by the internal audit department of the head office and audit of the branch and area offices is conducted by the internal audit wing of the respective regional offices, which also takes support from the risk management department staff to carry out field visits. 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 the credit discipline and hence the asset quality of the MFIs. GBLBS 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 regulations, banks and financial institutions (BFIs)[4] are required to extend 5%[5] of their total loans towards the deprived sector[6], either directly or through microfinance companies. However, with a large number of branches of BFIs at local/rural levels and higher yield associated with direct lending; the BFIs could gradually shift towards direct lending. This could impact the funds available for the growth of the microfinance sector and thus any further moderation/withdrawal in mandatory deprived sector lending regulation could have a significant impact on the funding profile of microfinance entities. Currently, GBLBS is primarily dependent on bank borrowings (~62% of total funds availed from 33 lenders including NRB and Nepal Government) which witnessed increased cost in recent periods (~11% for Q1 FY2019 compared to ~5% for FY2016). Moreover, the 'Base Rate plus' lending regime would keep the cost of the borrowings higher compared to the earlier, when the MFIs used to borrow at subsidised rates from banks. Nonetheless, the increased share of deposit in the funding mix (~29% as of mid-July 2015 to ~38% as of mid-October 2018), which carries a relatively lower cost as of now (~6.29%), has slightly moderated the overall cost of funds to ~9.54% for Q1 FY2019. GBLBS's ability to further diversify funding sources at competitive rates would remain a major challenge going forward.

On the profitability front, GBLBS's profitability indicators, post-merger, remain healthy. The company reported a return on net worth (RoNW) of ~19% and return on asset (ROA) of 1.7% for FY2018 (vs. ~20% and 1.56% respectively in FY2017). Despite moderation, the net interest margins for GBLBS remain healthy (~9% in FY2018 vs. ~12% in FY2017). Removal of the lending rate cap is expected to support the interest margin and profitability of GBLBS going forward. However, higher credit cost and operating expense ratio of GLBLS (~8% in FY2018 vs. permissible 3% over and above lending spread cap of 6%) remains a drag to profitability. Nonetheless, profitability remains supported by improvement in

[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 respectively till mid-July 2018.*

[6] *As defined by the central bank (NRB) covering marginal sections of the society*

fee-based income (1.92% of ATA for FY2018 vs 1.41% in FY2017). Going forward, the company's ability to scale up its operation and achieve scale economies and check the asset quality will have an impact on the profitability profile of GBLBS.

As on mid-October 2018, GBLBS's CRAR stood at 7.41% in breach of regulatory minimum capital requirement of 8%. It was caused by merger between erstwhile Grameen Bikas Banks most of which had depleted capital fund on account operating losses accumulated over the years. Proposed equity injection and retention of incremental profit accruals[7] is likely to improve the capitalisation profile. Thin capitalisation and inherent risk of microfinance business increases the vulnerability of the company towards probable credit shocks. Despite thin capitalisation, GBLBS' gearing ratio is moderate (~8 times as on mid-October 2018, much lower to the regulatory maximum of 30 times). With the proposed capital injection plan and retention of future profits, the gearing level is expected to further improve.

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
GBLBS was incorporated in August 2014, after the merger of five regional level rural development banks viz; Purwanchal (Eastern), Madhyamanchal (Central), Paschimanchal (Western), Madhya-Paschimanchal (Mid-Western) and Sudur-Paschimanchal (Far western) Grameen Bikas Banks to operate as a national level class-D microfinance institution. The shares of the Bank are listed in Nepal Stock Exchange with current market capitalization of ~NPR 3,393 million as of mid-Oct 2018. The registered and corporate Office of the company is in Butwal, Rupandehi, Nepal.

As on mid-October 2018, GBLBS has presence across 57 districts of Nepal through its 188 branches, five regional offices and one head office. GBLBS reported a profit after tax of ~NPR 160 million during FY2018, over an asset base of NPR 9,981 million as on Jul-18 as against net profit of ~NPR 128 million during FY2017 over an asset base of NPR 8,828 million as of mid-Jul-17. Company reported profit after tax of ~NPR 29 million during Q1FY2019, over an asset base of NPR 11,159 million as on Oct-2018. As on mid-Oct-2018, GBLBS's gross NPLs stood at 4.82% and CRAR at 7.41%. On technology front, GBLBS uses Empower Software in some branches and Pumori Software in some branches, while company is operating on manual system in 69 branch/ area offices and 22 branches are on migration phase.

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[7] as the company cannot distribute dividends before recovering the accumulated losses

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