Laxmi Laghubitta Bittiya Sanstha Limited

ICRA Nepal assigns [ICRANP] IPO Grade 4 to the proposed Equity Shares (Rights Issue) of Laxmi Laghubitta Bittiya Sanstha Limited

Facility/Instrument	Issue Size	Grading Action (August 2016)
Rights Share Issue	NPR 110 Million	[ICRANP] IPO Grade 4 (Assigned)

ICRA Nepal has assigned an "**[ICRANP] IPO Grade 4**", indicating below-average fundamentals to the proposed rights issue amounting to NPR 110 million of Laxmi Laghubitta Bittiya Sanstha Limited (LLBS). 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. LLBS is proposing to come out with 1:1 rights issue of 1,100,000 numbers of equity shares of face value NPR 100/- each, to be issued to its existing shareholders at par. The proposed issue is being made to augment the capital base to support the future growth plans of the management.

The grading factors in the regulatory uncertainty for MFIs as introduced by Monetary Policy of FY16/17, with cap on interest rate spread at 7% (currently unregulated) and requirement for commercial banks to directly lend to deprived sector (2% of the total deprived sector lending requirements of 5%, rest 3% could be through intermediaries); which could significantly impact profitability and growth of LLBS and microfinance sector. The grading is also constrained by LLBS's limited track record (operating since June 2012), small scale of operations (asset size of NPR 1,543 million as of Jul-16[1]) with significant exposure to earthquake affected districts (~31% portfolio as of Jul-16), higher operating cost (~8% of AMA[2]), weak funding mix with borrowings solely from promoter bank, and competition from established peers undertaking microcredit activities through larger franchise.

The grading however factors in LLBS's promoter profile[3], ability to achieve high portfolio growth (CAGR[4] ~160% over last three years, albeit on a small base) largely through expansion in client base (68% CAGR) while the growth in average portfolio per member has been around 29%. LLBS's asset quality remains comfortable (0+ delinquencies of 0.36% as on mid July 2016, improving from 0.92% as on mid Apr-2016 and profitability profile remains healthy (RoNW and RoA[5] of ~42% and ~5% respectively for FY16 vs. ~2% and ~0.7% respectively for FY14). With regulation proposing cap on interest spreads LLBS's profitability could be severely impacted. Growth opportunities for LLBS remain adequate given LLBS's experienced management team, wide geographical reach[6] , access to low cost funds benefited from deprived sector regulation, adequate capitalization profile (CRAR[7] 12.77% as on Jul-16 vs. regulatory minimum 8%) and large below poverty line population in Nepal that act as target group for MFIs8. In ICRA's opinion, ability of the company to manage growth and asset quality while expanding into newer districts as well as increasing share of high ticket collateralized loans and maintaining prudent leveraging levels would be critical.

As for LLBS's monitoring mechanisms, the branches are audited once a year and MIS limitations in generating specific reports (asset quality, portfolio cuts at consolidation level) although LLBS has integrated all the branch in online system. In ICRA Nepal's opinion, the company's internal audit processes could be further strengthened (frequency and coverage). ICRA Nepal also takes note of the

[1] Mid-Jul-2016 data are unaudited; all calculations are based on management provided data
[2] Average managed advances
[3] Promoted by Laxmi Bank (rated at [ICRANP-IR]BBB by ICRA Nepal) with 70% holding
[4] Compounded Annual Growth Rate
[5] Return on Net Worth and Return on Assets
[6] 40 branches spread across 33 districts
[7] Capital to Risk (Weighted) Assets Ratio
[8] Micro-Finance Institutions

high growth rate of LLBS and increasing ticket sizes (from NPR 1lakhs to NPR 3 lakhs for 1st cycle loans and maximum from NPR 3 lakhs to NPR 5 lakhs by Monetary policy 2016/17), both of which could impact discipline and hence asset quality. MFIs would have to develop strong credit appraisal systems and carefully assess the cash flows and debt repayment capacity of the borrowers for sustainable growth.

The grading is further constrained by vulnerable asset class of LLBS mainly due to marginal borrower profile and unsecured lending business (~91% of portfolio as of Jul-16), further accentuated by low seasoning of LLBS's credit book. Overleveraging concerns also exist for LLBS considering the company's policy to offer large ticket size loans to borrowers in the first cycle (up to NPR 100 thousand), and absence of centralized credit bureau in microfinance segment. Going forward, LLBS's ability to maintain adequate profitability profile and improve internal controls to maintain its asset quality indicators would have a bearing on the overall financial profile.

LLBS follows group lending model, wherein 5-8 individuals take mutual responsibility for loan repayment for all the members. In addition, LLBS also extends Individual loans (secured loans) up to NPR 700 thousand to finance micro enterprise. LLBS offers NPR 1 lakh for the first cycle loans, however the average ticket size remains ~NPR 55,000 as of Jul-16, relatively higher than peers. LLBS's credit portfolio of NPR 1,401 million as of Jul-16 is dominated by unsecured group guarantee backed loans (~91%, comprising of Income Generation Loan ~86% and seasonal loans ~5%), rest being secured loans. As of Jul-16, majority of the loans were provided to agriculture sector (~58%), followed by service sector (~36%) and others (~6%). LLBS asset quality indicators remain healthy so far with 0+days delinquencies of 0.36% as of Jul-16 including NPLs of 0.30%.

As per regulation, Banks and Financial Institutions[9] (BFIs) are required to extend 4-5% of their total loans towards deprived sector[10], either directly or through microfinance companies. However, Monetary Policy of FY16/17 has mandated commercial banks to directly lend 2%, out of their total deprived sector lending requirements of 5%. This is likely to impact the funds available for growth of microfinance sector to a large extent and thus any further moderation/withdrawal in this regulation could have significant impact on funding profile of microfinance entities. Currently, LLBS is dependent upon bank borrowings (~70% of total funds; entirely from promoter bank). The savings collected from members also comprise ~30% overall funding profile which remains comparable to the industry despite limited track record of LLBS. LLBS's liquidity position remains comfortable due to availability of revolving lines of credit from funder, short tenure of loans extended (generally one year) and higher proportion of stable, non-withdrawable deposits from member.

LLBS has reported healthy improvement in profitability profile over last two years with ROA of 0.70% and RoNW of 2.30% in FY14 improving to 5.24% and 41.73% respectively in FY16, aided mainly by lending spreads of 13.58% during FY16. Going forward, profitability could be significantly impacted as 7% cap on interest rate spread has been introduced by Monetary Policy of FY17. The company's profitability is supported by healthy non-interest income (~2.6% of ATA for FY16, primarily on account of loan processing fees) and low credit costs (0.8% of ATA), however the operating expenses remain high at ~7% of ATA. Thus, ability of LLBS to achieve sustainable growth in business in order to ensure efficient utilisation of the enhanced capital whilst maintaining asset quality would have key bearing over future profitability of LLBS.

LLBS's CRAR of 12.77% as on Jul-16, though remains moderate compared to other banking counterparts and considering the vulnerable asset class, remains comfortable and higher to regulatory minimum of 8%. Owing to high debt funded growth since its inception, LLBS's gearing remains high at 7.37 as on Jul-16 (compared to 5.95 as on Jul-15), however moderate among peers. LLBS's capital would increase to NPR 220 million after proposed issue (against regulatory minimum of NPR 100 million as of now) and is likely to support the company's growth plans.

[9] Class A, B & C financial institutions.

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

Company Profile

Incorporated in November 2010, Laxmi Laghubitta Bittiya Sanstha Limited (LLBS) received its banking license as a national level Class D microfinance institution in March 2012 from NRB (the central bank) and started its microfinance operation from June 2012. It is 18th class D institution licensed by NRB to carry out microcredit activities out of 42 such institutions as of Jul-16. The registered office of LLBS is in Maharajgunj, Kathmandu. LLBS is 70% subsidiary of Laxmi Bank (Class A Commercial Bank, rated at [ICRANP-IR] BBB by ICRA Nepal for Issuer Rating) while rest of the shares are held by public shareholders. The shares of the company are listed on the Nepal Stock Exchange. Mr. Prakash Raj Sharma is the Chief Executive Officer of the company.

LLBS currently operates across 33 districts of Nepal through 40 branches. The company reported a profit after tax (PAT) of NPR 62 million during FY16, over an asset base of NPR 1,543 million as on Jul-16 as against PAT of NPR 16 million during FY15 over an asset base of NPR 840 million as on mid Jul-15. Its net worth as on mid-July 2016 was NPR 190 million and total loan portfolio was NPR 1,401 million. As on mid-Jul-16, LLBS reported gross NPLs of 0.30% and CRAR of 12.77%. In terms of technology platform, LLBS has implemented "Empower", with all its branches being interconnected.

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