Sabaiko Laghubitta Bittiya Sanstha Limited

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

Facility/Instrument	Issue Size	Grading Action (March 2019)
IPO (equity) Grading	NPR 53 Million	[ICRANP] IPO Grade 4 (Assigned)

ICRA Nepal has assigned an **[ICRANP] IPO Grade 4**, indicating below-average fundamentals to the proposed initial public offering (IPO) of Sabaiko Laghubitta Bittiya Sanstha Limited (SLBSL). 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 the grading of 2, 3, and 4, respectively. SLBSL is proposing to come out with an IPO of 530,000 equity shares of face value NPR 100 each at par. The proposed issue is being made to adhere the regulatory provision, that requires a microfinance institution (MFI) to issue an IPO within three years of coming into operation.

The assigned grading factors in SLBSL's ability to achieve healthy portfolio growth in its initial years of operation which has supported its profitability indicators. SLBSL's adequate network coverage of 33 branches across 22 districts along with the expansion plans over new geographies remain positive from a growth perspective. The grading also factors in company's adequate capitalization profile (CRAR[1] 11.31% as of mid-January 2019 against regulatory minimum of 8%), experienced management team and large below poverty population who are still outside the reach of mainstream banking. SLBSL's healthy asset quality indicators (non-performing loans (NPLs) of 0.03% and delinquencies of 0.39% as on Mid-January 2019) also provides comfort to the grading action. Going forward, SLBSL's ability to maintain sustainable growth and generate scale economies through geographical expansion while maintaining commensurate risk mitigation practices would remain critical for its overall financial profile.

Nonetheless, the grading is constrained by SLBSL's limited track record (operating since July 2017) and small scale of operations (assets base of NPR 1,279 million as of mid-January 2019) and competition from larger/established peers. Additionally, the company's relatively high cost of funds among peers at ~12% for H1 FY2019 could impact its lending spreads given the increasing competition in the sector. The grading is further constrained by the company's relatively higher loan ticket size (average unsecured loan of NPR 90,000 as of mid-January 2019). Additionally, the company has relatively high exposure to high-ticket collateral-based based loans (~23%) to inferior borrower profile, which also remains an area of concern. Moreover, increased ticket size by regulations, presence of large number of players in the industry (including cooperatives), and absence of centralised credit information for MFIs raises concerns of overleveraging for the sector. SLBSL's track record of profitability over a longer time frame also remains to be seen, especially given the expected dilution from capitalisation of proposed IPO. The grading also takes note of the frequent changes in regulation impacting the spreads and funding sources for MFI sector. Going forward, SLBSL's ability to increase its scale of operations while maintaining healthy asset quality indicators, by enhancing its credit appraisal capabilities and improving the internal controls, would have a bearing on its overall financial profile.

SLBSL follows group lending model, wherein at least five individuals take mutual responsibility for loan repayment for all the members. The company offers NPR 50,000 for the first cycle of unsecured loans (maximum limit allowed in successive cycles is NPR 0.20 million against NPR 0.50 million allowed by regulations). In addition, SLBSL also extends secured loans up to NPR 0.50 million to finance micro enterprise against regulatory limit of NPR 1 million. SLBSL's credit portfolio of NPR 1,157 million as of mid-January 2019 is dominated by unsecured group guarantee backed loans (~77%), rest being secured loans. As of mid-January 2019, majority of the loans were provided to agriculture sector (~56%), followed by service sector (~41%). The company's asset quality indicators remain healthy so far with 0+ days delinquencies of 0.39% as of mid-January 2019 including NPLs of 0.03%.

[1] *Capital to Risk (Weighted) Assets Ratio*

As for monitoring mechanisms, compliance and monitoring activities are performed by in house internal audit and risk management department of the company. In ICRA Nepal's opinion, the company's monitoring and supervision remains adequate for the current scale of operations. However, its ability to maintain similar control framework while targeting to maintain high growth trend (152% annualised portfolio growth till H1 FY2019), would remain critical for sustainable growth. ICRA Nepal also takes note of the high growth targets of SLBSL and high regulatory permissible ticket sizes (NPR 0.30 million for 1st cycle of general loans and maximum NPR 0.50 million in successive cycles), both of which could impact discipline and hence asset quality. MFIs would have to develop strong credit appraisal systems and carefully assess cash flows and debt repayment capacity of the borrowers for sustainable growth.

SLBSL's asset class remains relatively vulnerable mainly due to the marginal borrower profile and unsecured lending business further accentuated by low seasoning of major portion of its credit book. Additionally, SLBSL has substantial share of collateral based loans (~23%) wherein collateral quality remains inferior compared to other banking counterparts while the ticket size remains high. Though ticket sizes offered are lower compared to the regulatory permissible limit, overleveraging concerns exist for SLBSL considering the absence of centralized credit bureau in microfinance segment. Going forward, SLBSL's ability to maintain and improve internal controls to maintain its asset quality indicators would have a bearing on the overall financial profile.

As per regulation, banks and financial institutions[2] (BFIs) are required to extend 5% of their total loans towards deprived sector[3], either directly or through microfinance companies. 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. This could 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, SLBSL is dependent upon bank borrowings (~78% of total external funds) which is being availed across diverse BFIs (including 13 commercial banks). Despite limited track record, savings collected from members also comprise ~22% of its overall funding profile. SLBSL's liquidity position remains comfortable due to availability of revolving lines of credit from lender, short tenure of loans extended (generally one year) and growing proportion of stable, non-withdrawable deposits from members. The cost of funds for this source is currently lower (~6% for H1 FY2019) than bank borrowings (~13%), hence lowering the overall cost of funds at ~12% (~10% for FY2018). SLBSL's ability to diversify funding sources at competitive rates would remain a major challenge, going forward.

As regards profitability, the company has been able to report profit, albeit minimal, from initial years of operations. Though the return indicators have improved in H1 FY2019 with RoNW and ROA[4] of ~20% and ~2.5% respectively, profitability trend remains to be established. The interim profitability was mainly aided by moderate net interest margins of ~5.7%, with support from healthy non-interest income (~23% of the overall income). After recently removing the interest rate cap of 18%, regulatory 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. Thus, SLBSL's ability to achieve sustainable growth in business in order to ensure efficient utilisation of enhanced capital whilst maintaining asset quality would have key bearing over future profitability profile.

Capitalisation (CRAR) of the company at 11.31% as of mid-January 2019 remains comfortable against the regulatory minimum of 8%. SLBSL's gearing remains moderate among peers at 9.04x as on mid-January 2019. Given the company's high growth plans over medium term, the paid-up capital of NPR 165 million after proposed IPO might remain inadequate to support the growth targets and hence would need to be supported by fresh equity injection or retention of accruals.

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[2] *Class A, B & C financial institutions*.

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

[4] *Return on Net Worth and Return on Assets*

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

Incorporated in May 8 2017, SLBSL is one of the newer players in the retail MFI sector (53rd retail MFI out of 71 MFIs as of mid-January 2019). The company started commercial operation from July 14, 2017 as a national level class-D MFI. As of mid-January 2019, it is operating in 22 districts (out of 77) through its 33 branches. The company's registered office is in Dumre, Tanahun, Nepal. Mr. Keshav Kumar Poudel is the chief executive officer of the company.

For its first complete year of operations (FY2018), SLBSL reported a profit after tax (PAT) of ~NPR 1 million over an asset base of NPR 685 million as of mid-July 2018. For H1 FY2019, the PAT has improved to ~NPR 12 million over an asset base of NPR 1,279 million as of mid-January 2019. SLBSL's gross NPLs stood at 0.03% and capitalisation ratio stood at 11.31% as of mid-January 2019. On the technology front, SLBSL uses "Uranus" software that is centralised across all its branches.

March 2019

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