Adhikhola Laghubitta Bittiya Sanstha Limited

ICRA Nepal assigns [ICRANP] IPO Grade 4 to the proposed Initial Public Offering (IPO) of Adhikhola Laghubitta Bittiya Sanstha Limited

Facility/Instrument	Issue Size	Grading Action (March 2019)
IPO (equity) Grading	NPR 40 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 Adhikhola Laghubitta Bittiya Sanstha Limited (ALB). 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. ALB is proposing to come out with an IPO of 400,000 equity shares with a face value NPR 100 each, at par. The proposed issue is being made to fulfil the regulatory provision requiring banks and financial institutions (BFIs) to float IPO within three years of coming into operation.

The assigned grading factors in ALB's ability to scale-up the business in its initial years of operations, aided by rapid branch expansion and growth in client base, while maintaining moderate average credit ticket size (~NPR 71,000 as of mid-January 2019[1]). Growth opportunities for ALB are expected to remain adequate given the large below poverty line population in Nepal who are outside the reach of mainstream banking and act as target group for microfinance institution (MFIs). Current capitalisation of ALB (~11 % as of mid-January 2019) remains comfortable vs. 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 regulatory change removing 18% interest 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 ALB despite low seasoning of portfolio; non-performing loans (NPLs) have increased to 1.43% as of mid-January 2019 from 0% as of mid-July 2018 while 0+ days delinquencies have increased to ~6% from ~2% over the same period. The grading further remains constrained by subdued return indicators of ALB so far despite some recent improvement (RoNW and RoA[2] of ~17% and ~1.7% for H1 FY2019 against loss reported earlier). ALB's profitability indicators would further be 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 note of the frequent changes in regulation impacting the spreads and funding sources for MFI sector. After recently removing the interest rate cap of 18%, 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 ALB's limited track record (operating since February 2017), small scale of operations (assets base of NPR 635 million as of mid-January 2019) and competition from larger/established peers. 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. Additionally, recent regulatory change has restricted further branch expansion before upgradation to national level status and hence the resultant uncertainty in company's growth momentum remains a concern. Going forward, ALB'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.

ALB follows group lending model, wherein five individuals take mutual responsibility for loan repayment for all members. ALB offers up to NPR 0.1 million for first cycle of general loans; maximum limit allowed in successive cycles is NPR 0.3 million against. NPR 0.5 million allowed by regulations. Owing to this, the average ticket size remains relatively moderate at ~NPR 71,000 as of mid-January 2019. In addition,

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[1] *Mid-January 2019 data are unaudited; all calculations are based on management provided data*

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

ALB also extends secured loans up to NPR 0.7 million to finance micro enterprise against maximum NPR 1 million as allowed by regulations. ALB's credit portfolio of NPR 537 million as of mid-January 2019 is dominated by unsecured group guarantee backed loans (~88%), rest being secured loans. Credit grew by ~8 folds to NPR 537 million over last 18 months ending mid-January 2019, albeit on a very small starting base of ~NPR 71 million. Over the medium term, growth is targeted to be facilitated by increment in share of collateral-based loans to ~20-30% (regulatory ceiling of 1/3rd of portfolio) within current geographies. However, planned increase in high ticket collateral loans to marginal borrower profile (which could impair their repayment capability) with relatively inferior collateral remains an area of concern in terms of incremental asset quality profile.

As for ALB's monitoring mechanisms, field monitoring of branches is done by respective branch manager along with sample-based review by internal audit department. However, this department is handled by single individual so far, hence limiting the scope. In addition, ALB is yet to establish separate monitoring department. In ICRA Nepal's opinion, company's monitoring and supervision could be strengthened; frequency and coverage of monitoring would remain critical in an increasing portfolio base. ICRA Nepal also takes note of the high regulatory permissible ticket sizes (NPR 0.3 million for 1st cycle of general loans and maximum NPR 0.5 million in successive cycles), both of which could impact discipline and hence asset quality. ALB 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, BFIs[3] are required to extend 5%[4] of their total loans towards deprived sector[5], 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, ALB is primarily dependent upon bank borrowings (~71% of total funds availed across 16 BFIs) with relatively higher cost (~13% for FY2018). Moreover, the "base rate plus" lending regime would keep cost of borrowings higher compared to earlier when MFIs could borrow at subsidized rates from banks. Despite limited track record, the company has been able to raise sizeable savings from members (~29% of overall funding profile). The cost of funds for this source is currently lower than bank borrowings (~6% for FY2018), hence lowering the overall cost of funds at ~11% for FY2018 (~10% for H1 FY2019). ALB's ability to diversify funding sources at competitive rates would remain a major challenge, going forward.

In the profitability front, ALB'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 (3.22% of average total assets-ATA for FY2018 and 4.49% for H1 FY2019), At the same time, relatively lower net interest margins (NIMs) at ~4% for FY2018 and ~5% for H1 FY2019 and remained a drag to better profitability. ALB has been able to report profit only from H1 FY2019 (RoNW of ~17% and RoA of 1.7%) despite increased credit cost (to 1.68% of ATA for H1 FY2019 from 1.02% for FY2018). Over the medium term, profitability is expected to be supported by existing branches achieving higher efficiency and hence further moderation in operating expenses (5.46% of ATA for H1 FY 2019) while controlling asset quality. Ability of ALB to achieve sustainable growth in business ensuring efficient utilisation of enhanced capital while maintaining healthy asset quality would have key bearing over its future profitability profile.

Capitalisation (CRAR) of the company at 11.13% as of mid-January 2019, was comfortable against the regulatory minimum of 8%. ALB's gearing remains moderate among peers at 9.78x as on mid-January 2019. The company's capital would increase to NPR 100 million after proposed IPO which is the regulatory minimum capital for national level MFI. However, the recent change in regulations has mandated MFIs to either consolidate their operations to a single province or to upgrade into national level status. The company's current operations are almost evenly distributed in two provinces i.e. Gandaki Province and Province five. ALB is yet to meet all the stipulated conditions for upgradation to

[3] *Class A, B & C financial institutions.*
[4] *This was 5%, 4.5% and 4% respectively for class-A, B and C respectively till mid-July 2018.*
[5] *As defined by the central bank (NRB) covering marginal sections of the society*

national status. Hence, the company has to constrict its business to one of these two provinces or seek suitable merger option for upgrade, both within mid-July 2020. This creates uncertainty over the company's ability to attain sustainable growth within limited geographies and hence remains a major concern.

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 August 26, 2016, Adhikhola Laghubitta Bittiya Sanstha Limited (ALB) started its commercial operation from February 12, 2017, upon receiving licence to operate as 10 districts-level class D MFI. As of mid-January 2019, ALB had operations through 19 branches over its 10 licensed districts. ALB is promoted by 38 individual promoters engaged in different professions. Mr. Dolraj K.C is the chief executive officer of the company. The registered and corporate office of ALB is located at Veerkot-1, Syangja district of Gandaki Province in Western Nepal.

ALB reported a net loss of ~NPR 2 million for FY2018, over an asset base of ~NPR 437 million as of mid-July 2018 as against a net loss of ~NPR 6 million during FY2017 over an asset base of ~NPR 108 million as of mid-July 2017. For H1 FY2019, ALB has reported profit after tax of ~NPR 5 million over an asset base of ~NPR 635 million as of mid-January 2019. ALB's gross NPLs stood at 1.43% and CRAR at 11.13% as of mid-January 2019. On the technology front, ALB uses "Synergy" software which is centralised across all of its branches.

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About ICRA Nepal Limited:
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