NADEP Laghubitta Bittiya Sanstha Limited

ICRA Nepal assigns [ICRANP] IPO Grade 4+ to the proposed Initial Public Offer (equity shares) of NADEP Laghubitta Bittiya Sanstha Limited

Facility/Instrument	Issue Size	Grading Action (March 2018)
Initial Public Offer (Equity)	NPR 48 million	[ICRANP] IPO Grade 4+ (Assigned)

ICRA Nepal has assigned "**[ICRANP] IPO Grade 4+**", indicating below-average fundamentals to the proposed initial public offer (IPO) of equity shares amounting to NPR 48 million of NADEP Laghubitta Bittiya Sanstha Limited (NADEP). 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. The issue is being made to ensure a minimum public shareholding of 30% (currently nil) in the company as required by the regulation governing banks and financial institutions (BFIs).

The grading factors in NADEP's strong promoters profile (>60% institutional shareholding including Nabil Bank's[1] 25%, Deprosc NGO's[2] 25% and Lumbini Bikas Bank's[3] 10%) which augurs well on the governance as well as funding profile of NADEP. Although NADEP was incorporated recently, microfinance (MFI) operations of the company has track record of more than 10 years (previously under the aegis of Deprosc NGO), which has been factored into the grading. Most of the senior management team and field staff of NADEP are seasoned in MFI sector; which also provides comfort. The grading also factors in good credit growth rate (CAGR 33%) over past 2.5 years, backed by increase in network and member base. Incremental growth is likely to remain supported by increase in members base with geographical expansion as well as incremental loan to existing members as it remains well below than regulatory limit. The grading also factors in healthy profitability profile (with return on net worth of ~25% in H1FY18 and comfortable capitalization profile.

However, the grading is constrained by regulatory cap introduced in the lending rates for MFIs at 18% (hitherto unregulated) which limits the MFI's ability to pass on the increased cost to the borrowers. In the recently started regime of high borrowing rates, this is likely to have a direct impact on the interest margins and hence profitability of MFI players. Cost of borrowings has gone up for MFIs due to increase in interest rates across banking industry (caused by shortage of lendable deposits) and mandatory implementation of "base rate plus" lending model (hitherto recommendatory) in BFIs. Any further changes in regulations could significantly impact funding support for the sector and accordingly the growth and profitability prospects of NADEP.

The grading also remains constrained by moderate asset quality as reflected in gross NPLs of 2.69% as on mid-Jan 2018. However, most of these NPAs have been taken over from the promoter NGO and are completely provisioned against, resulting in low net NPA of 0.11% on Jan-18. Grading also remains constrained by increased competition from other MFI players as well as other BFIs who are aggressively expanding their reach to semi-urban and rural areas which were earlier the domain of MFI players. Concerns also arise from the marginal profile of MFI borrowers and absence of centralized credit bureau in microfinance segment increasing the risk of multiple lending and overleveraging. However, this is partly mitigated by average ticket size of lending (~NPR 59 thousand as on mid-Jan 2018). The grading is also constrained by weak management information system (MIS)[4] of NADEP which limits the extent of management oversight and control. The company's control and compliance mechanism are evolving, given its recent transformation from (relatively unregulated) NGO to a regulated MFI industry.

NADEP follows group-based lending model of microfinance for unsecured loans in addition to providing collateralized loans to its members. As on mid-Jan 2018, credit portfolio of NADEP stood at NPR ~2.4

[1] Class A commercial bank, rated AA- by ICRA Nepal
[2] NGO working in financial access programs since 1995.
[3] Class B bank, assigned IPO 4 for rights issue by ICRA Nepal.
[4] Due to lack of centralized accounting software and database

billion; 99% of which comprised of unsecured group-guarantee based loans while collateralized secured loans formed a small portion of its portfolio. In the past 2.5 years since its incorporation in May 2015, NADEP has registered healthy credit growth of CAGR 33%, albeit on low base. Going forward, management plans to increase NADEP's member base (from ~52,000 as on mid-Jan 2018) through geographical expansion. Out of the total 62 branches of the company as on mid-Jan 2018, 19 are recently established which will add to the business volume and member base in coming days. Moreover, management has planned further expansion in franchise network over next 12-18 months. Effective execution of the plan will have a bearing on future growth of NADEP. Average ticket size per borrower for NADEP has increased gradually during past 2 years to reach NPR 59 thousand as on mid-Jan 2018, marginally higher to the industry average but much lower than regulatory permissible limit. Incremental credit growth is also likely to remain supported by large below poverty line population in Nepal that act as target group for MFIs.

NADEP's funding profile comprises of external borrowings and member's deposits. As on mid-Jan 2018, 68% of the total external fund comprised of borrowings and remaining 32% comprised of members deposits. As on mid-Jan 2018, NADEP has borrowed from 22 BFIs (including 18 class A commercial banks); including 10% borrowing from promoter BFIs. Deposit to loan ratio of NADEP stood at ~31% as on mid-Jan 2018, marginally lower to the industry average of ~33%. As on mid-Jan 2018, ~80% of the deposits are of mandatory nature, subject to withdrawal restrictions providing stability to funding profile to some extent. Average cost of fund for NADEP has increased sharply during past 18 months from ~6% in FY16 to ~9.5% in H1FY18; backed by more than 100% growth in cost of borrowings in the interim. Being highly reliant on borrowings, NADEP's funding profile is vulnerable to any changes in DSL regulations. Incrementally, management plans to diversify its funding source by increasing the proportion of member deposits. Management ability to do so will have an impact on the stability and resilience of funding profile of NADEP.

With the implementation of interest rate cap on MFIs, average yield of NADEP has declined from ~19% in FY17 to ~18% in H1FY18. At the same time, cost of fund has increased from ~6% in FY16 to ~7.5% in FY17 and ~9.5% in H1FY18; due to sharp increase in the cost of bank borrowings. As a result, NIMs of NADEP has moderated from ~11% in FY17 to ~8% in H1FY18. Increase in non-interest income (mainly loan processing fee) from ~1.3% in FY16 to ~1.7% in FY17 and ~1.9% in H1FY18 has partly offset the impact of decline in NIMs and supported the profitability. Profitability also remains supported by low credit cost and moderation in operating expense (still higher at ~6.5% of ATA) in recent period. Due to pressure on interest margin, NADEP's return on assets declined from ~3.6% in FY17 to ~2.2% in H1FY18 while the return on networth moderated from ~39.7% in FY17 to ~24.8% in H1FY18 Going forward, NADEP's profitability will depend on the management's ability to scale up the business to generate economies and offset the impact of slimming margin.

So far, capitalisation indicators of NADEP remains adequate supported mainly by good internal capital generation. As on mid-Jan 2018, capital to risk assets ratio (CRAR) of NADEP stood at 11.25%, comfortable vis-à-vis regulatory minimum requirement of 8% for class D microfinance licensed by NRB. Gearing ratio of NADEP remains moderate (~8.6 times on mid-Jan 2018), and much lower to regulatory maximum of 30 times. The proposed issue is also likely to support the capitalisation profile of the company positively

Company Profile
NADEP Laghubitta Bittiya Sanstha (NADEP) was incorporated on 29th January 2014 as a national level microfinance institution. The company started commercial operation from 15th May 2015 after taking over the microfinance operation hitherto being carried by Deprosc Nepal (an NGO). The NGO is one of the major shareholders in NADEP, with 25% equity stake. The registered and Corporate Office of the bank is located at Gajuri, Dhading, Nepal.

As of mid-Jan-2018, NADEP's paid up capital is 100% promoter owned; which will dilute to 70% after proposed IPO. Major promoters of NADEP as on mid-Jan 2018 are Nabil Bank Limited 25%, Deprosc-Nepal (NGO) 25%, Lumbini Bikas Bank Limited 10%, etc.

As on mid-Jan 2018, NADEP has presence across 33 districts of Nepal through its 62 branches. NADEP reported a profit after tax of ~NPR 83 million during FY17 (NPR 34 million in FY16) over an asset base of NPR 2,344 million in July 2017 (NPR 1,853 million as of July 2016). Till H1FY18, NADEP has reported profit after tax of ~NPR 31 million over an asset base of NPR 2,894 million. As of mid-Jan-2018, NADEP's gross NPLs stood at 2.69% and CRAR at 11.21%. On technology front, NADEP uses MFIN Plus which is in the process of centralisation across all the branches.

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