Swarojgar Laghubitta Bittiya Sanstha Limited

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

Facility/Instrument	Issue Size	Grading Action (April 2018)
Rights Share Issue	NPR 122.49976 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 122.49976 million of Swarojgar Laghubitta Bittiya Sanstha Limited (SLBBL). 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. SLBBL is proposing to come out with 100% rights issue of 1,224,997.6 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 assigned grading is constrained by the regulatory cap on lending rates for Micro Finance Institutions (MFIs) at 18%, limiting the ability to pass on the spike in cost of funds to borrowers, hence pressurizing NIMs (Net Interest Margins) and profitability of MFIs. SLBBL's cost of funds has been increased sharply over last one year resulting in low NIMs among peers which could create challenges in adequate return generation going forward. Grading concerns also emanate from lack of strong institutional promoter support, company's small scale and moderate track record of operations with high competition from larger/established peers as well as new age MFIs. Moreover, presence of large number of players (including cooperatives operating microfinance activities), increased ticket size by regulations and absence of centralized credit information for MFIs raises concerns of overleveraging.

Nonetheless, the grading factors in SLBBL's healthy asset quality indicators, ability to attain healthy credit portfolio growth maintaining moderate average ticket size and also the ability to report good profitability indicators so far. Though the return indicators are expected to remain diluted over medium term amid squeezing NIMs and increasing capital, growth opportunities for SLBBL remain adequate given the rapid expansion plans over new geographies after recent upgradation to national level status. The growth is expected to be supported by comfortable capitalization profile (~11% as on Jan-18 vs. regulatory minimum of 8%) along with incoming capital from proposed issue. Going forward, ability of the company to maintain sustainable growth through geographical expansion & generate scale economies while strengthening commensurate risk mitigation practices would remain critical.

SLBBL's credit portfolio has grown at a healthy rate of 64% (albeit on a small base) over last three years ending Jul-17 vs. ~47% growth for retail MFI industry. Credit growth was exceptionally high at 123% in FY17 (further 62% annualized growth till H1FY18) mainly due to branch expansion in new geographies. SLBBL's credit portfolio of NPR 1,687 million as of Jan-18 is dominated by unsecured group guarantee backed loans (~79%), rest being secured loans. The company follows group-based lending model of microfinance for unsecured loans in addition to providing collateralized loans up to NPR 7 lakhs to finance micro enterprise in line with regulatory limit. SLBBL offers NPR 50,000 for the first cycle of unsecured loans (vs. 3 lakhs allowed by regulations) which can be increased to maximum of NPR 2 lakhs in successive cycles (vs. 5 lakhs allowed by regulations). Owing to this, the average ticket size remains relatively lower at ~NPR 50,000 as of Jan-2018. As of Jan-2018, majority of the loans were provided to agriculture sector (~64%), followed by service sector (~36%). So far, large below poverty line population in Nepal acts as target group for MFIs. Hence, incremental credit growth plans of management (~49% growth plans over medium term) is likely to remain supported by increase in member base with geographical expansion as well as incremental loan to existing members.

After witnessing stress in asset quality in initial years of operation, non-performing loans (NPLs) of SLBBL have gradually declined through recovery as well as dilution effect of portfolio growth. As of now, asset quality indicators of SLBBL remains healthy with 0+ day's delinquencies of 0.90% as of mid-Jan-18 of which 0.23% were NPLs (vs. NPLs of 1.69% on Jul-13). Over last three years, delinquencies have consistently remained below 1%. However, SLBBL's sizeable exposure in high ticket secured loans to marginal borrower profile (~21% as of Jan-18) with relatively inferior collateral along with further plans to increase such exposure up to regulatory ceiling (1/3rd of portfolio) remains an area of concern in terms of incremental asset quality. Contrary to many peers, SLBBL has not opted for loan/borrower insurance mechanism so far; instead it has been charging 1-2% of loans for borrower protection fund and bears the risks on its own, which also remains a concern. Overleveraging concerns also exist for SLBBL considering the absence of centralized credit information in microfinance segment so far limiting MFI's ability to check multiple lending. Going forward, ability of the company to improve internal controls while operating on diverse geographies and hence the ability to maintain the asset quality indicators would have a bearing on its overall financial profile.

As for SLBBL's monitoring mechanisms, separate monitoring & supervision department is in place in addition to outsourced internal audit function. Efficient monitoring system would remain critical given the growth targets set over wider geography. Though the frequency of in-house monitoring remains adequate at current scale of operations, the coverage of the same could be increased in ICRA Nepal's opinion. SLBBL would have to develop strong credit appraisal system including cash flow and debt repayment capacity analysis, robust credit monitoring and supervision for sustainable growth.

As per regulation, Banks and Financial Institutions (BFIs) are required to extend 4-5% of their total loans towards deprived sector, either directly or through microfinance companies. Any moderation or withdrawal to this regulation could have significant impact on funding profile of MFIs. Additionally, funds available to MFIs could be lowered if BFIs shift towards direct lending given the increased ticket size that qualify as deprived sector as well as expanding franchise at local/rural levels. Currently, SLBBL is highly dependent upon bank borrowings (~61% of total funds as of Jan-18) which has witnessed sharp spike in cost in recent periods (10.43% for H1FY18 vs. 6.73% for FY17) owing to low lendable funds across banking sector along with the implementation of "base rate plus[1]" lending regime. Savings from members comprises ~39% of overall funding profile (~43% for industry); however ~63% of the same was in form of high cost long term recurring deposits and hence cost of deposits also remains higher (10.39% for H1FY18), hence pushing overall cost of funds to 10.42% for H1FY18 (7.93% for FY17). Share of term loans in bank borrowings have sharply increased to 41% as of Jan-18 (vs. ~4% a year ago) and hence this could pressurize liquidity profile of the company. However, short tenure of loans extended (generally one year) and higher proportion of stable, non-withdrawable deposits from members could provide requisite support. Lack of diversity in funding sources would however remain major challenge for the MFI sector going forward.

SLBBL has reported healthy profitability indicators over increasing capital base (Return on net worth -RoNW of ~25% and return on assets of 2.67% for FY17; average RoNW of ~35% in last three years vs. ~39% for industry). Return indicators could witness major decline over medium term given the proposed 100% rights and cap on lending rates resulting in lower NIMs among peers (~7% for H1FY18 vs. ~9% for FY17 reflecting in RoNW of ~22%). In line with the interest rate cap on MFIs, average yield of SLBBL remains ~18% for H1FY18 (~18% for FY17 as well) while cost of funds increased sharply from ~8% for FY17 to ~10.4% for H1FY18 remaining high among peers. Additionally, operating cost of SLBBL at 6.48% of ATA for H1FY18 also remains high among peers. Nonetheless, improved fee-based income (2.37% of average total assets-ATA for H1FY18 vs. 1.71% for FY17) aided by healthy portfolio growth, low credit cost (0.54% of ATA for H1FY18) so far and the scale expansion

[1] Adds up operating costs, return on assets and cost of CRR/SLR to cost of funds. Earlier lending by banks was based only on cost of funds. With changed regulations, bank would now be lending at base rate plus premium.

plans could support profit going forward. Ability of SLBBL to achieve sustainable growth in business ensuring efficient utilization of enhanced capital whilst maintaining its asset quality would have key bearing over its future profitability profile.

SLBBL's capitalization (CRAR) as of mid-Jan-18 at 10.75% remained comfortable against regulatory minimum requirement of 8%. Full retention of profits in last three years and injection of external equity (100% rights issue in FY15 and 50% rights in FY17) have supported the capitalization over the years despite high business growth (albeit on a small base). SLBBL's gearing ratio has gradually increased to 9.03 times as at mid-Jan 2018 remaining higher among peers but much lower against regulatory maximum of 30 times. Incoming capital from proposed issue would support the business growth plans of the company.

Company Profile

Established as a 3-district level retail MFI on Dec-2009, SLBBL gradually scaled up its area of operations and recently upgraded as a National level retail MFI opening avenues for expanding operations nationwide. Currently, the operations is over 15 districts (out of 77) with 42 branches. SLBBL is promoted by diverse range of individuals with maximum shareholding by one individual at 2.87% of total paid-up capital as on mid-Jul-2017. Share capital of the company is distributed among promoter & public in the ratio of 51:49 (diluted from earlier 70:30). Mr. Udaya Raj Khatiwada is the Chief Executive Officer of the company. Company's shares are listed in Nepal Stock Exchange. The registered and corporate office of SLBBL is located at Banepa, Kavrepalanchowk, Nepal.

SLBBL reported a profit after tax of ~NPR 28 million during FY17, over an asset base of ~NPR 1,426 million as of mid-Jul-17 as against a net profit of ~NPR 25 million during FY16, over an asset base of NPR 702 million as of mid-Jul-16. Till H1FY18, SLBBL has earned a profit after tax of ~NPR 17 million over an asset base of 1,800 million as of mid-Jan-2018. SLBBL's gross NPLs stands at 0.23% and CRAR at 10.75% as of mid-Jan 2018. On technology front, SLBBL uses M-FIN software which is centralised across all branches.

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For further details please contact:

Analyst Contacts:

Mr. Kishor Prasad Bimali, (Tel No. +977-1-4419910/20)
kishor@icranepal.com

Mr. Rajib Maharjan, (Tel No. +977-1-4419910/20)
rajib@icranepal.com