First Microfinance Development Bank Limited

ICRA Nepal assigns [ICRANP] IPO Grade 3 to the proposed Rights issue of First Microfinance Development Bank Limited

	ISSUE SIZE	RATING ACTION
Rights Issue Grading	NPR 100 million	[ICRANP] IPO Grade 3 (Assigned)

ICRA Nepal has assigned "**[ICRANP] IPO Grade 3**", indicating average fundamentals to the proposed rights issue amounting NPR 100 million of First Microfinance Development Bank Limited (hereinafter referred as FMDB). 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. FMDB is proposing to come out with rights issue of 1,000,000 numbers of equity shares of face value NRs 100/- each to be issued to the existing shareholders at par.

The average fundamental grading factors in the strength of institutional promoters and experienced BoD[1] & management team of FMDB, benefit arising from deprived sector regulation which ensure adequate flow of funds from banking system as well as lower funding cost, adequate growth opportunities, adequate loan underwriting and monitoring processes, good assets quality indicator (Nil Gross NPL[2]) and adequate profitability profile supported by low cost of funds, low credit provisioning expense & low operating expense ratio. However, the grading is constrained by limited track record of FMDB, stiff competition with other wholesale lending MFIs and commercial banks, higher portfolio vulnerability arising from large share of exposure to cooperative societies (around 60% of credit portfolio) which lacks on regulatory supervision and inferior borrower profile, low seasoning of credit book (around 67% loan was disbursed in last two years and higher portion of working capital loan (around 49%) where repayment capacity of the borrower have not been tested), relatively high portfolio concentration (39% of total loans on mid-july-14 to top-20 borrowers), lack of diversity in earnings, lack of independent member in BoD, and uncertain operating environment that banks in Nepal are currently facing. Moreover, high portfolio vulnerability given unsecured nature of loans, high chances of overleveraging in the absence of credit bureau in MFI sector and marginal profile of borrowers also remains a constraint; although mitigated to some extent through guarantee from BoD and right of lien on the assets of borrower MFIs. Nepal offers good growth potential for microfinance business given large below poverty line population. Going forward, FMDB's ability to increase its client base/ presence and commercial banks' strategy to provide funding to microfinance entities directly or routing through specialized agencies such as FMDB would have bearing on FMDB's portfolio growth.

FMDB's credit portfolio has grown at a high rate of CAGR 61% in past 3 years, albeit on a low base. The growth was supported by rapid increase in the number of partner MFIs (119 institutions with operations in 40 districts as on mid-July-14). FMDB's credit portfolio stood at NPR 1,212 million as of July-14, comprised of two major products- MFI term loans (51%) and MFI demand loan & Overdraft (49%). FMDB's assets quality indicators remains good with Nil NPL as on July-14, partly benefitted by low seasoning of credit books; although the portfolio vulnerability remains high due to marginal profile of borrowers and unsecured MFI lending. More than 3/4th of the partner organizations

[1] Board of Directors
[2] Non-performing Loans

accounting for ~60% of FMDB's credit portfolio as on July-14 are the Co-operative societies-industry; thereby posing risk to the incremental assets quality of FMDB given poor regulatory framework and general lack of transparency associated with cooperative industry in Nepal. However, FMDB sound underwriting approach, control mechanism, experienced management team; gradually improving portfolio granularity coupled with standard assets provisioning provides some comfort. The credit growth of FMDB is likely to remain high over next 2-3 year with further increase in business network and supported by augmented capital base. Going forward, FMDB's ability to maintain its assets quality profile over enhanced scale of operations will have a bearing on its overall profitability profile.

FMDB has healthy resources profile composed of low cost borrowings from Banks and Financial Institutions. Lending to microfinance sector is classified as deprived sector lending, under current Nepalese banking regulations; which ensure flow of banks' credit to microfinance sector at lower interest rates. FMDB's total borrowings as on July-14 stood at 1,432 million, with over 90% borrowings from Class A commercial banks. The average cost of borrowings for FMDB remained low at 3.37% for FY14, benefitted by current regulations favouring deprived sector lending. Any change in the regulations could affect FMDB's funding profile negatively; however the institutional promoters which include Banks and Financial Institutions with 40% holding in FMDB provides some comfort regarding the funding profile under adverse conditions. As of now banks are lending largely through these institutions if banks shift the model to direct lending to MFIs that could have negative impact on FMDB's growth prospects.

The profitability profile of FMDB has improved in past 2 year with the increase in scale of operations. FMDB has maintained gross interest spread of ~3% with improvement in recent years following expansion of credit portfolio. Improving spreads coupled with low operating cost ratio and low credit provisioning expense has helped FMDB maintain healthy profitability profile. Moreover, recent trend in portfolio growth supported by growing business network is likely to aid the profitability indicators. FMDB posted PAT/ATA of 1.86% and PAT/Networth of 23% in FY14 compared to 1.63% and 16% respectively in FY13; improvement brought about by marginal improvement in NIMs upon increased asset base. Going forward, FMDB is likely to maintain the profitability profile aided by steady NIMs and operational efficiencies brought about by increasing scale of operations. However, FMDB's ability to maintain the assets quality indicators amid existing portfolio vulnerability and increased business size will remain a key parameter for future profitability.

FMDB's CRAR was 9.98% as on Jul-14 as against minimum regulatory requirement of 8%. While FMDB's capitalisation is adequate against minimum regulatory requirement, economic capital levels are moderate given the riskiness of loan book. Further, FMDB is coming out with the rights issue in order to support the future growth plans. Moreover, the rate of internal capital generation remains healthy and is also likely to support the expansion plans. As per ICRA estimates, current level of capital[3] is likely to support the CAGR 40% growth plans of the management over next 2-3 years; maintaining overall capitalization in the range of around 8-10% with solvency indicators[4] expected to remain range bound at 2-5%. In the long run, the ability of FMDB to raise additional capital from its existing/ external investors will have a strong bearing on the growth prospects and overall capitalization profile.

Company Profile

First Microfinance Development Bank Limited (FMDB), a wholesale microfinance lender registered as a public company, started its operations from January 8, 2010. It is licensed as a class D microfinance institution, by the NRB. FMDB is engaged in the business of providing microfinance

[3] Including the proposed rights issue
[4] Unprovided NPL (Net NPL)/ Net worth

access to rural poor households through wholesale lending to partner organisations involved in retail microfinance activities. As of July-14, FMDB is running its operations in 40 districts of the country through 119 partner organisations. FMDB has 40% institutional promoter holding as on July-14, which includes Class A commercial banks (30%) and Class B & Class C BFIs (collective holding of 10%). The promoter-public shareholding ratio stood at 70:30 as on July-14.

During the year ended July 16, 2014 FMDB reported a net profit of NPR 25.9 million on an asset base of NPR 1,575 million as against a profit of NPR 17.1 million on an asset base of NPR 1,207 million in the previous year. FMDB reported net profit of NPR 6.6 million as on Mid-Oct-2014 over assets base of NPR 1,754 million.

December 2014

For further details please contact:

Analyst Contacts:
Mr. Kishor Prasad Bimali (Tel No. +977-1-4419910)
kishor@icranepal.com

Relationship Contacts:
Mr. Deepak Raj Kafle, (Tel. No. +977-1-4419910)
drkafle@icranepal.com