

Prabhu Capital Limited (Revised)

Ratings

Facilities	Amount (Rs. Million)	Rating ¹	Rating Action
Issuer Rating	NA	CARE- NP BBB- (Is) (Triple B Minus (Issuer))	Assigned
Fund Management Quality Rating (FMQR)	NA	CARE-NP AMC Quality 3 (AMC 3)	Reaffirmed

**The issuer rating is subject to adjusted overall gearing² not exceeding 0.25x at the end of FY24 (FY refers to the twelve-month period ending mid-July)*

The explanatory notes regarding the scale and definitions for FMQR of CARE Ratings Nepal Limited (CRNL) are attached as Annexure 1.

CRNL has assigned issuer rating of "CARE-NP BBB- (Is)" to Prabhu Capital Limited (PCL). Issuers with this rating are considered to offer moderate degree of safety regarding timely servicing of financial obligations, in Nepal. Such issuers carry moderate credit risk.

Also, CRNL has reaffirmed the Fund Management Quality Rating of "CARE-NP AMC Quality 3 (AMC 3)" assigned to Prabhu Capital Limited (PCL). AMC 3 indicates adequate assurance on management quality of Asset Management Company (AMC).

Detailed Rationale & Key Rating Drivers

The ratings assigned to PCL derive strength from its adequate capitalization and comfortable leverage structures at the end of FY23 with satisfactory financial performance trend supported by rebound in investment income despite moderation in merchant banking income in FY23. The ratings also factor in experienced promoters and board of directors in financial sector with established track record of operations and professional fund supervisors. The ratings also take cognizance of moderate performance of PCL's two mutual fund schemes with better than industry average net asset values (NAV).

The ratings, however, is constrained by the relatively short track record of the company in fund management. The rating also factors in susceptibility of investment income to market risk, evolving nature of Mutual Fund Industry, limited market diversification in the industry so far and volatile trend of Nepal Stock Exchange (NEPSE) index.

Detailed Description of the Key Rating Drivers

Key Rating Strengths

Experienced promoters and management in financial sector and established track record in merchant banking

Prabhu Bank Limited (PBL; rated CARE-NP BB+) holds 56.79% stake in PCL as on mid-October 2023 and PCL is deriving benefits by availing regular technical and management support from its parent company. PCL is channeling the branch network of PBL to provide the various merchant banking services; thereby increasing the reach to its customers. PBL is also the fund sponsor for the existing mutual fund scheme being managed by PCL. PCL has been providing merchant banking services from last one decade by taking over the business of Growmore Merchant Banker Limited which commenced business operations in 2010.

PCL is managed under the overall guidance of Company's Board of Directors (BoD) who possesses wide experience in the banking and finance sector. There are six members in the PCL's BoD, chaired by Mr. L.P. Bhanu Sharma, who is a qualified Chartered Accountant and has wide experience working in the banking services for more than 16 years. The board is supported by experienced management team. PBL, on the capacity of Fund Sponsor, appointed five professionals as fund supervisors. Fund supervisors are well qualified professionals and have wide experience in their respective fields.

¹Complete definition of the ratings assigned are available at www.careratingsnepal.com and other CARE publications

²Total debt less loans against fixed deposits to tangible net worth

Adequate capitalization level and comfortable leverage structure

Following the acquisition of CCBL by PBL, PCL acquired Century Capital Markets Limited (CCML) and started its joint operations from May 15, 2023 onwards resulting into larger capital base of the company. PCL has healthy capitalization levels with paid up capital base of Rs. 1,200 Mn as on mid-July 2023 (Rs. 1,000 Mn before the merger) and currently has the largest capital base among the merchant bankers in Nepal. Larger capital base offers a competitive edge to PCL as it enables the company to undertake larger underwriting activities with size of underwriting a merchant banker can pursue being directly tied to multiples of its paid-up capital. This enhances its revenue prospects and market position compared to competitors with smaller capital bases. Also, capital structure of PCL remains comfortable with low overall gearing ratio of 0.15x as on mid-July, 2023 (0.02x as on mid-July, 2022). PCL's adjusted overall gearing ratio (excluding loans against fixed deposits) stood nil. Comfortable leverage structure provides financial flexibility to the company with lower susceptibility to volatile interest rates and lower likelihood of financial distress.

Moderate Financial profile

PCL reported total operating income of Rs. 246 Mn during FY23, improved from Rs. 11 Mn during FY22. Although income from merchant banking activity declined to Rs. 72 Mn in FY23 (FY22: Rs. 136 Mn) with moderation in income from issue management and income from Depositor Participant (DP) following regulatory cap on fees from FY23 onwards, investment income of the company increased in FY23 over FY22 levels. PCL reshuffled its portfolio with ~44% of its investment towards fixed deposits at the end of FY23 (FY22: ~24%) amid high interest rate environment and ~14% of its investment towards listed equity shares, which are highly volatile to market risk (FY22: ~41%). As a result, PCL reported net gain (realised and unrealised) on financial investments- Held for Trading during FY23 as compared to losses during FY22, on top of increment in its fixed interest income. Consequently, PCL reported operating profit of Rs. 119 Mn in FY23 (FY22: operating losses of Rs. 127 Mn). Gross cash accruals however remained steady at Rs. 69 Mn and Rs. 61 Mn during FY22 and FY23, although after adjusting unrealised losses on financial investments. Profitability and return indicators of the capital remain moderate with operating profit margins of ~48% and return on total assets (ROTA) of ~4.5% in FY23.

Moderate Fund Performance

PCL manages two mutual funds (Prabhu Select Fund and Prabhu Smart Fund) with total fund size of Rs. 2,250 Mn as on mid-January, 2024. Both of its mutual fund are equity-oriented schemes with sizeable investments of the schemes in equity instruments. Prabhu Select Fund (PSF) was issued only during FY21 which was allotted to public in May 2021. Since its launch, the fund performance has been moderate. The mutual fund has been introduced in May 2021 towards the end of last bullish cycle and the market has been bearish since then. PSF has reported NAV of Rs. 10.68 as on January 14, 2024 after distributing cash dividend of 9.50% during FY23. PSF's NAV growth reflects an alpha of 6% since the inception of mutual fund. Prabhu Smart Fund (PRSF) was recently launched on June 06, 2023 and reported NAV of 10.96 as on January 14, 2024. Diversifying investments and associated risk to ensure good returns, ploughing back of returns and enhancing NAV will be crucial from the analytical perspective.

Key Rating Weaknesses**Short track record as fund manager under Mutual Fund Regulations, 2010**

PCL and its management have nascent experience in handling the Mutual Fund Scheme earlier. PCL introduced its first mutual fund, Prabhu Select Fund in May 2021 and its second mutual fund, Prabhu Smart Fund in June, 2023. However, the management team consisting of wide experience in management of portfolio and merchant banking services along with banking services provide cognizance in AMC's ability to diversify its investment portfolio with anticipated market movements.

Evolving Mutual Fund Industry

Formal issuance of Mutual Fund Schemes started after the issuance of Mutual Fund Regulations, 2010 by SEBON. As on mid-January 2024, there are 36 close ended mutual funds with total AUM of Rs. 38,514 Mn. There are 7 open ended mutual funds as on mid-January, 2024. Further, seven mutual fund schemes are in the pipeline to be approved from SEBON with total AUM of Rs. 5,950 Mn. Despite the regulatory support including mandatory allocation of 5% of primary market shares to mutual funds which are mostly issued at par and tax exemption on income of mutual funds, the mutual fund industry is still in developing phase with moderate attraction among the retail investors. The preference for subscription of mutual funds is still lower compared to Initial Public Offerings (IPO) from other sectors.

Investment income susceptible to market risk

The investment portfolio of PCL was highly concentrated towards listed shares during previous two fiscal years with ~64% and ~41% of total investment in listed shares during FY21 and FY22 respectively which led to high volatility in investment income during these periods. It is indicated by Rs. 747 Mn net gain on investments (realized gain of Rs. 501 Mn) reported in FY21 and Rs. 213 Mn net losses on investments (unrealized losses of Rs. 188 Mn) reported in FY22. Although, PCL reduced its investment in listed shares to ~14% in FY23, given the overall business model of PCL to invest in secondary market by diversifying its portfolio mix, investment income of the capital is susceptible to market risk.

Limited market diversification and volatile trend of NEPSE index

The schemes managed by PCL are equity-oriented scheme, and majority of funds collected will be invested in the primary and secondary market of Nepal Stock Exchange Limited (NEPSE). There is limited scope for the diversification of investments both industry wise and instrument wise amid developing market for fixed income securities in the economy. The overall schemes launched so far in the market have their investments concentrated in banks, financial institutions, insurance and hydropower sectors. Thus, any changes in banking liquidations have adverse impact on the market and schemes performance and the banking sector in Nepal is currently faced by challenges centered around declining asset quality.

Also, NEPSE index has shown volatile trend over the period. Introduction of contractionary policies, muted GDP growth in the country and lower than expected government expenditures (4% y-o-y decline in 7MFY24 on a low base) has also impacted the overall operating environment of capital market. With some ups and down, NEPSE reached all time high of 3,198.60 as on August 18, 2021 (Previous all-time highest index was 1,888.36 as on July 27, 2016), which has remained at level of 2,097.55 and 2,120.62 as on July 16, 2023 and as on January 14, 2024 respectively. However, going forward increasing participation by the non-financial sectors meeting the capital and turnover requirements, as required by the Finance Act FY23, in the capital market is likely to enhance scope for investment and risk diversification of the schemes. Investment diversifications of scheme to minimize the risk of the volatile trend of NEPSE index and generate fair returns will remain key monitorable aspect.

About the Company

Prabhu Capital Limited (PCL) is a subsidiary of Prabhu Bank Limited, with Prabhu Bank holding around 57% of PCL's share capital. PCL has undertaken successful acquisitions and commenced joint transactions with Samriddhi Capital Limited on July 13, 2020, and Century Capital Markets Limited on May 15, 2023. The company holds Merchant Banking and Depository Services licenses obtained on September 9, 2010, and May 14, 2013, respectively. Furthermore, it acquired Fund Manager Licenses on December 28, 2020. As of mid-January 2024, PCL's paid-up capital stands at Rs. 1.2 billion.

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Annexure 1

CARE Ratings Nepal Limited – Fund Management Quality Rating Scale and Definitions

Symbols	Rating Definition
CARE-NP AMC Quality 1 (AMC1)	AMCs rated AMC 1 are adjudged to have the highest assurance on management quality of AMC.
CARE-NP AMC Quality 2 (AMC2)	AMCs rated AMC 2 are adjudged to have high assurance on management quality of AMC.
CARE-NP AMC Quality 3 (AMC3)	AMCs rated AMC 3 are adjudged to have adequate assurance on management quality of AMC.
CARE-NP AMC Quality 4 (AMC4)	AMCs rated AMC 4 are adjudged to have inadequate assurance on management quality of AMC.
CARE-NP AMC Quality 5 (AMC5)	AMCs rated AMC 5 are adjudged to have poor assurance on management quality of AMC.

Note:

- CARE Ratings Nepal's opinion as expressed by way of AMC quality ratings are not a comment on statutory compliance, financial performance or future performance of schemes managed by the Asset Management Company.
- For the quality rating categories 2, 3 and 4, the sign of + (plus) may be appended to the Rating symbol to indicate its relative better position within the Rating categories concerned.