

Rating Rationale

Mithila Laghubitta Bittiya Sanstha Limited

Grading

Facility/Instrument	Amount (Rs. In Million)	Rating/Grading	Rating Action
Right Share issue	32.98897	CARE-NP IPO Grade 4 [IPO Grade Four]	Assigned

The explanatory notes regarding the Rating/Grading symbols of CARE Ratings Nepal Limited (CRNL) are attached as Annexure 1

CRNL has assigned grading of ‘CARE-NP IPO Grade 4’ to the proposed Right Share Issue of Mithila Laghubitta Bittiya Sanstha Limited (MLBSL). ‘CARE-NP IPO Grade 4’ indicates Below Average Fundamentals. CRNL assigns IPO grades on a scale of Grade 1 to Grade 5, with Grade 1 indicating strong fundamentals and Grade 5 indicating poor fundamentals. CRNL’s IPO grading is an opinion on the fundamentals of the issuer. The grade assigned to any individual issue represents a relative assessment of the ‘fundamentals’ of the issuer. MLBSL propose 50% right share issue of 329889 number of equity shares of face value of Rs.100 each at par aggregating Rs. 32.98897 million.

Detailed Rationale & Key Grading Drivers

The grading assigned to the right share issue of MLBSL is constrained by its small scale of operations, volatile net profit, declining interest spread & Net Interest Margin (NIM), high dependence on borrowing from Banks and Financial institutions (BFIs), high Gross Non Performing loan (GNPL) to total loan ratio, exposure to regulatory risks related to microfinance industry, inherent risk involved in microfinance industry and competition from other Micro Finance Institutions (MFIs) and Co-operatives. The grading, however, derives strength from increasing scale of operations (albeit on lower base), comfortable Capital Adequacy Ratio (CAR), moderate geographical diversification in its area of operation, comfortable liquidity position, ability of the company to continue its growth momentum without compromising on asset quality and maintaining the CAR and ability to manage the impact of any regulatory changes by NRB are the key grading sensitivities.

Detailed Description of the Key Grading Drivers

Key Grading Weakness

Volatile net profit, declining interest spread and Net Interest Margin (NIM)

Net profit of MLBSL declined to Rs 8.64Mn in FY17 (refers to period ended July 15, 2017) from Rs 9.00Mn in FY16, however, the same increased to Rs 9.59Mn in FY18(UA). Net profit of the company grew at lower rate of 11% in FY18 as compared to the growth of 37% in the total income due to low growth in net interest income, increase in employee cost, other operating expenses, and provision &

written off. During FY18 (UA), the interest income of the company increased by 32.02%, even though total Loan Portfolio increased by 39.15% due to decline in yield on advance to 17.59% in FY18 from 19.28% in FY17. During FY18, the interest expenses increased by 76.69% due to increase in total debt by 43.94% and increase in cost of borrowing by 304 bps to 11.47% over FY17 on back of high interest rates due to liquidity crunch in the Banking industry. Further, the company's interest spread narrowed to 7.12% in FY18 from 10.17% in FY17 and the NIM of the company dropped to 7.99% in FY18 from 10.94% in FY17 on back of lower increase in net interest income in comparison to the increase in total assets.

High dependence on borrowing from Banks and Financial institutions (BFIs)

Major source of funding for MLBSL is borrowing from BFIs and the percentage of bank borrowing to total resources increased to 59.05% in FY18 from 58.13% in FY17. As on July 16, 2018, MLBSL has funding tie up with eight BFIs, where interest rate ranges from 12.25% to 13% depending upon the financial institution. MLBSL cost of borrowing from BFI's is higher than its cost of deposit which indicates MLBSL has obtained costly debt due to high interest rates prevailing in the market on back of shortage of liquidity in Banking sector.

High Gross Non Performing Loan (GNPL) to total loan ratio

MLBSL's GNPL to the total loans ratio increased to 3.42% in FY18 from 3.20% in FY17 and was high as compared to peers. GNPL to total loan increased mainly due to lower realization of the harvest of the agricultural crops leading to delay/default in the repayments in agriculture related loans and also due to loan duplication. However, MLBSL is taking steps for the recovery of GNPL through education, motivation and various awareness program for timely repayment of loans.

Exposure to regulatory risks related to microfinance industry

The microfinance industry in Nepal is exposed to changes in the various regulatory measures issued by NRB from time to time. As per the earlier regulations, A, B & C class financial institutions were required to extend 5%, 4.5% and 4% respectively of their total loans towards deprived sector. However, Monetary Policy of 2018-19 changed the guidelines and instructed all A, B & C class financial institutions to lend 5% of their total loan to deprived sector.

Earlier MFIs were allowed to determine interest rate on their lending by adding upto 4% administrative expenses above cost of fund plus maximum of 7% spread with the interest rate ceiling of 18%. However, monetary policy of 2018-19 changed this provision where MFIs are now allowed to determine interest rate on loan by adding upto 3% administrative expenses above cost of fund plus maximum of 6% spread and the interest rate ceiling (i.e.18% earlier) is eliminated. As a result of changed NRB provision, MFIs can now pass increased cost of fund to the borrower which will improve their interest earning capacity.

Inherent risk involved in the microfinance industry

MFIs are prone to credit risk given the borrower profile and higher proportion of unsecured lending portfolio. MFIs provides unsecured loan i.e. loan without any collateral, which makes the credit riskier. As borrowing from MFIs do not require collateral, clients tends to borrow from multiple MFIs resulting to problem of loan duplication. Absence of credit report from Credit Information Bureau (CIB) is also one of the reasons for loan duplication which increases credit risk. However, monetary policy of 2018-19 required MFIs to send credit information to CIB continuously and 2% additional loan loss provision have to be maintained on such loan if MFIs fail to send credit information to CIB. Apart from these risks, the sector is also prone to socio political risks. And as per NRB norms, MFIs are allowed to lend against collateral upto 33.33% of total lending. MLBSL percentage of collateral loan to total loan was at 29.77% in FY18.

Competition from other MFIs and Co-operatives

As on Mid-April 2018, there are 62 MFIs in operation with total 2,275 branches all over Nepal. MLBSL has 21 branch along with head office. Micro Finance Industry earned Rs. 15,629 Mn total interest income, Rs 7,270Mn net interest income and Rs 2718Mn Net profit on April 13, 2018; however, MLBSL has 0.41% share in interest income, 0.45% share in net interest income and 0.29% share in net profit for the same period in the industry. Further, large number of cooperatives are operating all over Nepal which provides loan and other financial services to their members with or without collateral. Due to presence of large number of micro finance and co-operatives, MLBSL is facing competition to tap the new customer and to retain the existing good consumer.

Key Grading Strengths***Increasing scale of operation (albeit on lower base)***

The total loan portfolio of the company grew by compounded annual growth rate (CAGR) of 37.18% (albeit on lower base) over last 3 years ending July 16, 2018 mainly on back of increase in number of branches, borrowers and amount of loan taken by the members. The total loan portfolio of the company grew on Y-o-Y basis by 39.15% in FY18 to Rs 618Mn. The number of borrowers increased to 11,196 in FY18 from 9,902 in FY17. Similarly, its deposit grew by CAGR of 91.09% over last 3 years ending July 16, 2018. The deposit of the company grew on Y-o-Y basis by 50.43% in FY18 to Rs 174Mn due to opening of 5 new of branches during FY17.

Although loan and deposit grow substantially over the period, its market share in terms of Loan Portfolio and deposit is still low in the Microfinance Industry. Its market share in terms of loan portfolio was at 0.40% and for deposit was at 0.35% as on April 13, 2018.

Comfortable Capital Adequacy ratio (CAR)

MLBSL overall capital adequacy ratio stood at 13.93% as on July 16, 2018 (16.89% as on July 15, 2017) which is comfortable in comparison to the minimum regulatory requirement of 8% for MFIs. MLBSL CAR decreased during FY18 due to risk weighted assets (mainly Loan Portfolio) increased at rate higher than increase in capital fund. However, the CAR of the company is expected to improve after the issue of purpose right shares issue.

Moderate geographical diversification in its area of operation

MLBSL is operating since April 29, 2009 in 3 states covering 10 districts out of 7 states and 77 districts of Nepal through 21 branches as on July 16, 2018. Further, the company got approval for operation in 5 new district in June 2018 from NRB and plan for gradual expansion of 10 new branches which may lead to growth of loan portfolio and diversification of operation in new geographical areas. As on July 16, 2018 the loan concentration in any one branch is not more than 12.5% of total loan portfolio.

Comfortable Liquidity Profile

As per NRB directive, MFIs not taking deposit from general public has to maintain 0.5% cash reserve ratio (CRR). MLBSL has maintained CRR 0.52% in FY18 and 0.53% in FY17 which is in compliance with NRB norms. Further it has maintained liquid assets of 27.8% in FY18 and 6.73% in FY17 which is in compliance with minimum regulatory requirement of 2.5% of deposit for MFIs not collecting deposit from general public.

About the Company

MLBSL is “D” class 15 district Microfinance Institution licensed by Nepal Rastra Bank with its registered office in Dhalkewar, Dhanusha. MLBSL is incorporated on November 23, 2008 and commenced its operation from April 29, 2009 under Bank and Financial Institution Act 2006. It is primarily engaged in providing microfinance loans based on the Joint Liability Group (JLG) model with each group consisting of minimum five members. MLBSL achieved Rs 9.58Mn net profit during FY18 (UA) on loan portfolio of Rs.618 Mn. The share capital of the company is distributed among promoters and public in the ratio of 70:30. The board of the MLBSL led by Mr. Shiv Prasad Sah (Chairman) and the day to day operations are managed by Mr. Satyadeo Raut (CEO).

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Annexure 1

CARE Ratings Nepal – IPO Grading Scale

CARE IPO grade	Definition
CARE-NP IPO Grade 1	Strong fundamentals
CARE-NP IPO Grade 2	Above average fundamentals
CARE-NP IPO Grade 3	Average fundamentals
CARE-NP IPO Grade 4	Below average fundamentals
CARE-NP IPO Grade 5	Poor fundamentals

Note:

Modifiers {"+" (plus)} can be used with the grading symbols 2, 3 and 4. The modifiers reflect the comparative standing within the category.