December 2019

Grading Rationale
NIC Asia Laghubitta Bittiya Sanstha Limited

Grading

Facility	Amount (Rs. In Million)	Grading	Rating Action
Initial Public Offer	475.50	CARE-NP IPO Grade 4+ [IPO Grade Four Plus]	Assigned

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

CARE Ratings Nepal Ltd. (CRNL) has assigned grading of 'CARE-NP IPO Grade 4+' to the proposed Initial Public Offer (IPO) of NIC Asia Laghubitta Bittiya Sanstha Ltd. (NALB). '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 use modifier {"+" (plus)} with the grading symbols 2, 3 and 4 and the same reflect comparative standing within the category. 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. NALB proposes to issue 4.755 Million shares of face value of Rs.100 each at par aggregating Rs. 475.50 Million.

Detailed Rationale & Key Grading Drivers

The grading assigned to NALB is constrained by concentrated resource profile with high dependence on Banks & Financial Institutions (BFIs) borrowings, short track record of operation including moderate market share in terms of deposit and loan portfolio, competition from other Micro Finance Institutions (MFIs) and Co-operatives, and inherent risk involved in the microfinance industry. The grading is also constrained by exposure to regulatory risks related to microfinance industry. The grading, however, derives strength from backup of strong institutional promoter, experienced board members and management team, geographical diversification of business, and comfortable capitalization level. The rating also factors in considerable growth in business over short period of time, comfortable liquidity profile, good assets quality being initial year of operation and low seasoning of the loan portfolio, improved financial performance over the period and diversified sector wise credit portfolio distribution.

Detailed Description of the Key Grading Drivers

Key Grading Weaknesses

Concentrated resource profile with high dependence on Banks & Financial Institutions (BFIs) borrowings

NALB's major source of fund consists of borrowing from BFIs. The percentage of borrowing from BFIs to total resource was high however, decreased to 62.64% in Q1FY20 (refers to 3 months' period ended October 17, 2019) from 65.14% in FY19 (refers to 12 months' period ended July 16, 2019), (84.32% in FY18). As on July 16, 2019, its funding is tied up with 8 BFIs where the average cost of borrowing was 11.52% in FY19 which is substantially higher than its cost of deposit of 7.37%. Due to use of large portion of debt, its cost of fund was high (i.e. 10.94% in FY19) which impacts its profitability. As on Mid July, 2019, out of total outstanding loan, 46.86% contributed by promoter bank.

Short track record of operation including moderate market share in term of deposit and loan portfolio

NALB has short track record (~2 years only) as it is operating since November 28, 2017. Although, company has grown substantially during the short period, its ability to continue growth momentum and maintain good asset quality remains to be seen. Further, it has 0.67% and 1.91% market share in terms of deposit base and loan portfolio respectively of microfinance industry in FY19, based on monthly data published by NRB.

Competition from other MFIs and Co-operatives

As on Mid-July 2019, there were 90 MFIs in operation with total 3,629 branches all over Nepal. NALB has 61 branches as on Mid July, 2019. Micro Finance Industry earned Rs. 31,647 Mn interest income, Rs 14,625 Mn net interest income and Rs 6,223 Mn Net profit during FY19. NALB has 1.77% (Rs. 561 Mn) share on interest income, 2.12% (Rs. 310 Mn) share on net interest income and 1.77% (Rs. 110 Mn) share on net profit for the same period in the industry. Further, large number of cooperatives are operating all over Nepal which provides loans and other financial services to their members with or without collateral. Due to presence of large number of micro finance and co-operatives, NALB is facing competition to tap the new customer and to retain the existing good consumer.

Inherent risk involved in the microfinance industry

MFIs are prone to credit risk which is directly related to the portfolio of the organization and is one of the most significant risks from MFI's perspective. Credit risk assumed by a MFI is typically higher compared to other BFIs given the weak borrower profile. Further, MFIs provide unsecured loan i.e. loan without any collateral. In case any borrower defaults, the MFI does not have any assets backed as collateral to meet its loss, which makes the credit even riskier. As borrowing from MFIs do not require collateral and in absence of credit report from Credit Information Bureau (CIB), clients tends to borrow from multiple MFIs resulting to a problem of loan duplication. However, monetary policy of 2018-19 required MFIs to send credit information to CIB continuously and failing to comply the same will result in 2% additional Loan Loss Provision (LLP). Further, as per NRB norms, MFIs are allowed to lend against collateral upto 33.33% of total lending. NALB's percentage of collateral loan to total loan was 26.93% in Q1FY20 which increased from 22.78% in FY19 (0.92% in FY18) as company focused on providing collateral loan within allowable limit to minimize risk.

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. Earlier, 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 A, B & C class financial institutions to lend 5% of their total loan to deprived sector. This regulation change is expected to impact the incremental fund availability, cost of fund, credit growth and profitability of the MFIs.

Earlier MFIs were allowed to determine interest rate on their lending by adding up to 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. However, reduction in spread rate by 1% and maximum allowable administrative expenses by 1% in determining interest rate might restrict interest earning capacity. Further, NRB required MFIs to classify overdue loan for more than one month to three months as watch list loan and required to make 5% loan loss provision thereon, which will impact MFIs profitability.

Key Grading Strengths

Strong institutional promoter

NALB is promoted by institutional promoter, NIC Asia Bank Ltd. with 100% holding in share capital. NIC Asia Bank Ltd. [CARE-NP A (Is)] is “A” Class (Commercial) Bank of Nepal operating since 1998 which has injected Rs 1,005 Mn capital and provided Rs 1,500 Mn loan to NALB at the end of Q1FY20 to support NALB business.

Experienced board members and management team

NALB has 5 members on its board, all are senior management level staff of NIC Asia Bank Ltd. and has more than decade of overall banking experience. The company’s management team is led by CEO, Mr. Laxmi Prasad Sharma, deputed by NIC Asia Bank Ltd., who has more than 16 years of experience in banking and microfinance sector. He has worked as head of deprive sector lending department for ~5 years in different banks including NIC ASIA Bank Ltd. Besides this, he has over ~9 years of working experience in microfinance sector. He is supported by other experienced management team.

Geographical diversification of business

It is operating in 18 districts and 5 provinces with 61 branches as on October 17, 2019 during the short period of operation (~2 years). The company has plans to open additional 50 branches during FY20 mainly in eastern part of Nepal. Further expansion of branches as well as area of operation will lead to growth of business, diversification of operation in new geographical areas including economies of scale.

Comfortable capitalization level

NALB’s overall Capital Adequacy Ratio (CAR) stood at 23.84% in FY19 (8.46% in FY18) which is comfortable in comparison to the minimum regulatory requirement of 8% for microfinance institutions (MFIs). CAR increased significantly in FY19 as compared to FY18 due to substantial increase in capital fund (by injection of Rs 935 Mn equity capital during FY19 and accretion of profit during FY19 to reserve and surplus) as compared to increase in risk weighted assets (RWA). Further, CAR increased to 24.5% in Q1FY20 due to increase in capital fund by accretion of profit during Q1FY20 to reserve and surplus is higher than increase in RWA. CAR is expected to increase further after issue of proposed IPO, which will help in further expansion of business. In Q1FY20, it has paid up capital of Rs 1,005 Mn (regulatory minimum requirement of Rs 100 Mn for national level microfinance).

Considerable growth in business over short period of time however, slight decrease in loan and advance at the end of Q1FY20

NALB's credit portfolio grew substantially to Rs 4,496 Mn in FY19 from Rs 828 Mn in FY18 due to low amount of credit portfolio in base year, aggressive lending strategy, substantial increase in member base by increase in geographical reach through branch expansion. However, the credit portfolio decreased marginally by 2.11% to Rs 4,401 Mn in Q1FY20, due to company not disbursing additional group guarantee loan to increase the proportion of collateral backed loans, and to focus on documentation and internal control procedures. Similarly, its deposit grew substantially to Rs 572 Mn in FY19 from Rs.69 Mn in FY18 due to low amount of deposit in base year and increase in client base through branch expansion. Further, the deposit grew by 10.40% during Q1FY20 to Rs 631 Mn.

Comfortable Liquidity Profile

NALB has comfortable liquidity profile with positive cumulative mismatch over one year as on October 17, 2019 due to well match tenure of assets and liabilities. It has maintained compulsory reserve ratio (CRR) and liquid assets of 0.54% and 19.18% in Q1FY20 (0.53% and 4.05% in FY19).

Good asset quality being initial year of operation and low seasoning of the loan portfolio

NALB's Non Performing Loan (NPL) level was at zero percent at the end of Q1FY20, FY19 and FY18 mainly due to initial year of operation, long repayment period resulting in low installment amount, and strict credit policy. It's ability to maintain zero level of NPL in long term is challenging as loan duplication problem is major issue in microfinance industry and aggressive lending strategy of the company. To ensure timely repayment and to control NPL, NALB is planning to educate, motivate and conduct various awareness program to its members.

Improved financial performance over the period

NALB's financial performance improved substantially during FY19 over FY18. It has reported net profit of Rs.110 Mn during FY19 against net loss of Rs 6 Mn during FY18 on back of substantial increase in total income as compared to increase in interest expenses and other non-interest expenses. Total income increased to Rs. 655 Mn during FY19 from Rs 11 Mn during FY18. Net interest income increased to Rs 310 Mn during FY19 from Rs 1 Mn during FY18 due to increase in interest income was higher than interest expenses on back of decline in proportion of interest bearing loans in total source of fund (76.78% in FY19 from 92.04% in FY18) by injection of additional share capital.

Further, its net profit increased substantially to Rs 55 Mn during Q1FY20 from Rs 20 Mn during Q1FY19, despite substantial decrease in non-interest income, mainly due to substantial increase in net interest income (by 260.78%) and decrease in provision for possible losses. Similarly, return on Total Assets (ROTA) increased to 4.46% in Q1FY20 from 3.80% in FY19 and Return on Net Worth (RONW) to 19.97% in Q1FY20 from 18.84% in FY19.

Diversified sector wise credit portfolio distribution

In Q1FY20, NALB's has lent 54.70% (55.65% in FY19) towards service industry (which includes 21.23% to wholesale and retail business, 4.29% to hotel and restaurants and 29.18% to other services) followed by 40.38% (39.40% in FY19) towards agriculture sector (which includes 16.88% to animal husbandry, 7.91% to poultry farming, 3.82% to vegetable) and 2.87% (2.65% in FY19) towards small and cottage industry.

About the Company

NALB is a "D" class National Level microfinance institution incorporated on July 25, 2017, licensed by Nepal Rastra Bank on November 24, 2017 and commenced operation on November 28, 2017. It is 100% subsidiary company of NIC Asia Bank Ltd. and primarily engaged in providing microfinance loan based on Joint Liability Group (JLG) model with each group consisting of minimum five members. As on October 17, 2019, it has Rs 1,005 Mn paid up share capital which held by promoter shareholder. After issue of proposed IPO, the share capital of the company is expected to be Rs 1,480 Mn which will be held by promoter and public shareholders in 67.87:32.13 ratio.

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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.