Chautari Laghubitta Bittiya Sanstha Limited

ICRA Nepal assigns [ICRANP] IPO Grade 4 to the proposed Initial Public Offering (IPO) of Chautari Laghubitta Bittiya Sanstha Limited

Facility/Instrument	Issue Size	Grading Action (July 2018)
IPO (equity) Grading	NPR 54 Million	[ICRANP] IPO Grade 4 (Assigned)

ICRA Nepal has assigned an "**[ICRANP] IPO Grade 4**", indicating below-average fundamentals to the proposed Initial Public Offering (IPO) amounting to NPR 54 million of Chautari Laghubitta Bittiya Sanstha Limited (CLB). 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. CLB is proposing to come out with an IPO of 540,000 numbers of equity shares of face value NPR 100 each at par. The proposed issue is being made to fulfill the regulatory provision requiring BFIs to float IPO within 3 years of coming into operation.

The grading factors in CLB's ability to scale up its operations through high credit growth which was aided by rapid branch expansion and growth in client base, whilst maintaining moderate average portfolio (average ~NPR 50,000 as of mid-Apr-18[1]). Growth opportunities for CLB remain adequate given the plans for further branch expansion over new geographies and large below poverty line population in Nepal that act as target group for MFIs. Current capitalization of CLB (~23 % as of Apr-18) remains high vs. regulatory minimum of 8%, which along with capital from proposed issue could support growth plans of the management. To this end, presence of banking sector promoters (~33% held by 7 BFIs currently) also remains a positive. The grading also considers CLB's ability to improve profitability indicators with RoNW and RoA[2] of ~8% and ~2% for FY17 (vs. loss reported in FY16) despite general challenges in the MFI industry. However, track record of profitability over longer time frame remains to be seen. Going forward, ability of the company to maintain sustainable growth through geographical expansion while strengthening commensurate risk mitigation practices would remain critical.

Nonetheless, the grading is constrained by regulatory cap on lending rates for MFIs at 18% and hence the inability to pass on the increased cost of funds to borrowers resulting in pressure over NIMs (Net interest margins). Any further changes in regulations and banking sector's preference to route deprived sector lending through MFIs could significantly impact funding support and accordingly the growth and profitability prospects for the sector. Despite of low seasoning of portfolio, recent deterioration in asset quality of CLB (NPLs of 0.91% as of Apr-18 vs. 0.14% on Jul-17 with overall 0+ days delinquencies increase to 1.14% as on mid-Apr-18 from 0.26% as on mid-Jul-17) remains a concern. The grading is also constrained by CLB's limited track record (operating since November 2015) with marginal borrower profile and unsecured lending, small scale of operations (assets base of NPR 681 million as of Apr-18) with relatively higher operating expenses (~8% of Average Total Assets - ATA) and competition from larger/established peers. Moreover, increased ticket size by regulations, presence of large number of players in the industry (including cooperatives), and absence of centralized credit information for MFI raises concerns of overleveraging for the sector as a whole. Going forward, CLB's ability to maintain asset quality indicators over a larger scale of operations by enhancing its credit appraisal capabilities and improving internal controls would have a bearing on its overall financial profile.

As for CLB's monitoring mechanisms, strengthening of the monitoring team is ongoing with plans to conduct field monitoring of branches once a month for terai based branches and once every two months for branches in hilly areas that witness relatively lower growth. The compliance and monitoring activities are also planned to be conducted annually by in house audit department (earlier outsourced). In ICRA Nepal's opinion, company's monitoring and supervision could be strengthened; frequency and coverage of monitoring would remain critical given the high growth being targeted. ICRA Nepal also takes note of

[1] Mid-Apr-2018 data are unaudited; all calculations are based on management provided data
[2] Return on net worth and Return on assets

the increased regulatory maximum permissible ticket sizes (from NPR 1 lakh to NPR 3 lakhs for 1st cycle loans and maximum from NPR 3 lakhs to NPR 5 lakhs from FY17 onwards), both of which could impact discipline and hence asset quality. CLB would have to develop strong credit appraisal systems and carefully assess cash flows and debt repayment capacity of the borrowers for sustainable growth.

CLB follows group lending model, wherein 5 individuals take mutual responsibility for loan repayment for all members. CLB offers up to NPR 60,000 for first cycle of general loans; maximum limit allowed in successive cycles is NPR 3 lakhs vs. 5 lakhs allowed by regulations. In addition, CLB also extends secured loans up to NPR 7 lakhs to finance micro enterprise as allowed by regulations; average ticket size remains relatively moderate at ~NPR 50,000 as of Apr-18. CLB's credit portfolio of NPR 615 million as of Apr-18 is dominated by unsecured group guarantee backed loans (~96%), rest being secured loans. Credit portfolio has reported high growth of ~224% for FY17, albeit over small base; the pace of growth has since moderated to ~79% for 9MFY18. Over medium term, management plans to maintain high credit growth with increment in share of collateral based loans to ~20%.

As per regulation, Banks and Financial Institutions[3] (BFIs) are required to extend 4-5% of their total loans towards deprived sector[4], either directly or through microfinance companies. Given the increase in ticket size that qualify as microfinance lending by regulator and expanding franchise of BFIs at local/rural levels, BFIs could gradually shift their portfolio towards direct lending. This is likely to impact the funds available for growth of microfinance sector to a large extent and thus any further moderation/withdrawal in this regulation could have significant impact on funding profile of microfinance entities. Currently, CLB is highly dependent upon bank borrowings (~66% of total funds availed across diverse range of 18 BFIs) which has witnessed increased cost in recent periods (~11% for. 9MFY18 vs. ~8% for FY17). Moreover, the "base rate plus" lending regime would keep cost of borrowings higher compared to earlier when MFIs could borrow at subsidized rates from banks. Despite limited track record, the company has been able to raise savings from members which comprised ~34% of overall funding profile and the cost of funds for this source is lower than bank borrowings (~6% for 9MFY18), hence lowering overall cost of funds at 9.08% for 9MFY18 (7.78% for FY17). Ability of CLB to diversify sources of funding at competitive rates would remain major challenge going forward.

Amid rising cost of funds and the cap on lending rates at 18%, NIMs of CLB has witnessed slight decline from 9.11% for FY17 to 8.26% for 9MFY18. The interim profitability was supported to an extent by increased fee-based income (2.75% of ATA vs. 2.24% for FY17) while the operating expenses have slightly increased to 7.68% (7.50% for FY17) mainly due to rapid branch expansion. Due to increase in NPLs, credit costs also witnessed increment from 0.99% of ATA for FY17 to 1.09% for 9MFY18. Hence, CLB's overall profitability indicators witnessed some moderation in 9MFY18 with RoNW and ROA coming down from ~8% and ~2% for FY17 to ~7% and ~1.6% for 9MFY18. Profitability, going forward, is expected to be supported by existing branches achieving higher efficiency, incremental portfolio from new branches that are planned to be set up and low credit costs. Thus, ability of CLB to achieve sustainable growth in business ensuring efficient utilisation of enhanced capital whilst maintaining healthy asset quality would have key bearing over its future profitability profile.

Capitalisation (CRAR) of the company at 22.71% as of Apr-18, was comfortable compared to regulatory minimum of 8%. CLB's gearing remains lowest among peers at 3.66 as on Apr-18. CLB's promoter base is largely diversified across institutional and individuals where by institutional BFI promoters hold ~33% stake. However, no single institution holds significant stake (maximum holding at 9.5%) which remains a concern. CLB's capital would increase to NPR 180 million after proposed IPO vs. regulatory minimum of NPR 100 million for national level MFI. Hence, CLB has plans to upgrade into national level status over medium term in order to support the company's growth plans.

Company Profile
Chautari Laghubitta Bittiya Sanstha Limited (CLB) was incorporated in 23rd March 2015 as 10 districts level class D microfinance institution. The company started its commercial operation from 25th November 2015. As of mid-Apr-18, CLB had operations through 34 branches over its 10 licensed districts. CLB has

---

[3] Class A, B & C financial institutions.

[4] As defined by the central bank (NRB) covering marginal sections of the society

recently been upgraded to 15 districts level status on 23rd May 2018. Shareholding pattern of the company constitutes institutional promoters' holding of ~33% (held by 7 BFIs including largest stake of Central Finance Limited at 9.52%) and individual promoters' holding of ~67%. The promoter holding is expected to be diluted to 70% post proposed IPO. Mr. Laxman Ghimire is the Chief Executive Officer of the company. The registered and corporate office of CLB is located at Butwal, Nepal.

CLB reported a profit after tax of ~NPR 6 million during FY17, over an asset base of ~NPR 428 million as of mid-Jul-17 as against a net loss of ~NPR 1 million during FY16 over an asset base of NPR 157 million as of mid-Jul-16. For 9MFY18, CLB has reported profit of ~NPR 7 million over an asset base of NPR 681 million as of mid-Apr-18. CLB's gross NPLs stood at 0.91% and CRAR at 22.71% as of mid-Apr-18. On technology front, CLB uses Uranus software which remains to be centralized in 2 branches (Thulabsei and Shantinagar) out of 34 branches as of mid-Apr-18.

July 2018

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