ICRA NEPAL

RSDC Laghubitta Bittiya Sanstha Limited

ICRA Nepal assigns [ICRANP] IPO Grade 4 to the proposed rights issue (equity shares) of RSDC Laghubitta Bittiya Sanstha Limited

Facility/Instrument	Issue Size	Grading Action (March 2018)
Rights Issue (Equity)	NPR 215.96 million	[ICRANP] IPO Grade 4 (Assigned)

ICRA Nepal has assigned "**[ICRANP] IPO Grade 4**", indicating below-average fundamentals to the proposed rights issue of equity shares amounting NPR 215.96 million of RSDC Laghubitta Bittiya Sanstha Limited (RSDC). 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. RSDC has proposed 60% rights issue of 2,159,600 number of equity shares of face value NPR 100 each to be issued to the existing shareholders at par. The issue is being made to augment capital base in order to meet the revised (higher) paid up capital requirement[1] set by Nepal Rastra Bank (NRB), the banking sector regulator in Nepal.

The grading factors in the institutional promoter shareholding in RSDC (~15% stake is held by RSDC-NGO and 12% is held by Bank of Kathmandu Limited[2]) which augurs well on the governance of RSDC. The grading also factors in RSDC's demonstrated ability to grow (credit portfolio grew by CAGR 63% during FY14–H1FY18; albeit on a small base) driven by increase in number of partner co-operatives (from 62 in mid-Jul-14 to 169 on mid-Jan 2018). Incremental credit growth prospect remains supported by strong capitalisation profile (CRAR ~29% as on mid-Jan 2018 vs regulatory minimum 8%), fund raised through equity injections and potential for growth for MFIs in Nepal given large below poverty line population; which has been factored in while assigning the grading. The grading also takes into consideration RSDC's good asset quality maintained over the years, with gross NPLs of 0.04% as on mid-Jan 2018.

Nonetheless, the grading is constrained by limited track record, and low seasoning of credit book of RSDC coupled with more than 85% loan to relatively weak regulated cooperatives sectors. As per current regulations, being a wholesale MFI, RSDC relies entirely on bank borrowings to fund its operations. Recent uptick in the borrowing rates (given the rising interest rates across banking industry) and limitations in passing on the increased cost to the borrowers (due to competitive pressure and upper cap 18% on MFIs retail lending) has put pressure on the interest margin of RSDC as reflected in the moderation of return indicators in past 12-18 months. The grading is also constrained by lack of diversity in earning, increased competition from other MFIs as well as other BFIs that are aggressively expanding their reach to semi-urban/rural areas and uncertain operating environment that the financial institutions in Nepal are currently facing.

As a wholesale lender to MFIs, RSDC uses the network of existing co-operatives (separate legal entities) and NRB licensed retail MFIs[3], to reach the targeted population. As on mid-Jan 2018, RSDC's credit portfolio stood at NPR 1.26 billion, distributed among 169 partner organizations, mostly co-operatives. As on mid-Jan 2018, the borrower profile of RSDC comprises of savings and credit co-operatives (33% of credit portfolio), agriculture co-operatives (16%), Self-reliance co-operatives[4] (15%) and multipurpose co-operative (11%) among others. The credit growth in recent years was aided by growth in number of partner organizations as well as increase in individual ticket size of loans. Incrementally, management plans to consolidate the borrower base and grow by increasing the ticket size to seasoned borrowers. This is also reflected in the growth in average ticket size from ~NPR 5 million about 1 year back to ~NPR 7.5 million as on mid-Jan 2018. Accordingly, the concentration

[1] Minimum paid up capital of NPR 600 million for wholesale MFI, to be maintained by mid-July 2018.
[2] Rated BBB+ by ICRA Nepal for subordinated tier II bond
[3] In the past, the borrowers of RSDC were all co-operatives. Recently, RSDC has started to lend to NRB licensed MFIs.
[4] Co-operatives set up by RSDC-NGO (promoter of RSDC)-forerunner to RSDC, as a part of donor-funded programs.

among top 20 borrower organization has also increased to 40% of total credit portfolio as on mid-Jan 2018.

So far, RSDC has reported good asset quality with 0.04% Gross NPL as on mid-Jan 2018 vs. 0.01% as on mid-July 2017 (partly benefited by low seasoning of credit book). 0+ days delinquency level also remains low at ~1.23% as on mid-Jan 2018. However, given the unsecured lending and marginal profile of the ultimate borrower, overall risk in MFI sector remains high. This is further accentuated by lack of centralized credit bureau in MFI sector which increases the risk of overleveraging. At the same time, RSDC's ability to monitor its credit exposures also remains limited due to small staff strength (11 staffs as on mid-Jan 2018), which coupled with weak regulatory supervision over co-operative players (accounting for >85% of RSDC's loan as on mid-Jan 2018) could lead to some volatility in asset quality indicators.

Availability and pricing of funds of MFI like RSDC depends highly on the deprived sector lending (DSL) regulations[5]. Any change in the norms, therefore, has a corresponding impact on the funding profile of MFIs., RSDC's funding profile is entirely dependent on external borrowings. During past 12-18 months, interest rates across banking industry has gone up due to shortage of lendable deposits[6] in the system. As a result, the borrowing cost of RSDC has more than doubled in past 18 months from ~4% in FY16 to ~10% in H1FY18. As on mid-Jan 2018, RSDC's total borrowings as on mid-April 2017 stood at NPR 1.06 billion, sourced entirely from class A banks. ~17% of the total external borrowings was from BOK-the promoter bank, indicating promoter support. However, sizeable equity proceeds raised by RSDC in recent past and proceeds from proposed rights issue is likely to support the credit growth of RSDC over next 6-12 months. Presence of class A commercial bank as institutional promoter also adds to the funding strength of RSDC.

NIMs of RSDC has witnessed moderation in past 12-18 months due to increase in cost of borrowings. NIMs of the company declined from ~4.39% in FY16 to 4.32% in H1FY18 while the cost of fund rose from ~4% to ~10% over the same period. Improvement in lending yield and high growth in credit portfolio during H1FY18 (annualised growth of 81%) offset the impact of rising cost of fund and supported the NIMs of RSDC. Due to relatively small scale of operation, operating expense of RSDC continues to remain on higher side (2.12% in FY17 and 1.81% in H1FY18). However, profitability remains supported by low credit cost on account of good asset quality. Return on assets of RSDC moderated from 2.30% in FY16 to 2.03% in FY17 and 2.17% in H1FY18 amid pressure in interest margin. Return on net worth of RSDC dipped from ~20% in FY16 to ~15% in FY17 and ~10% in H1FY18 due to sizeable capital infusion made into the company. Amid declining NIMs and proposed equity infusion, return to shareholders is likely to remain diluted over next 1-2 years.

Following repeated equity infusions, capital to risk assets ratio (CRAR) of RSDC stood strong at ~29% on mid-Jan 2018 (against regulatory minimum of 8%). This is likely to increase further after proposed equity injection plan. As a result, RSDC is likely to maintain excess capital over next 1-2 years. This is likely to enhance the risk bearing capacity of the company although maintaining return on the incremental capital will remain a challenge. Due to adequate capitalization on a small scale of operations, gearing ratio of RSDC remains low (~3 times on mid-Jan 2018 vs. ~5.5 times on mid-July 2017; much lower to regulatory maximum of 30 times). With proposed capital injection plan, gearing level is also expected to come down considerably.

Company Profile

RSDC Laghubitta Bittiya Sanstha Limited (RSDC) is a class D wholesale microfinance institution licensed by NRB, operating since September 11, 2013. RSDC is involved in microfinance operation through its network of partner cooperatives. RSDC Laghubitta was incorporated to take over the business erstwhile being conducted by its NGO forerunner Rural Self Reliance Development Centre. As

[5] NRB regulation making it mandatory for BFIs to allocate 4-5% of total loans outstanding towards deprived sector.

[6] Most of the banks are operating very close to "credit to deposit" ratio ceiling. The demand for fresh deposits is high to support the incremental lending. This has pushed up the interest rates across banking sector.

on mid-Jan 2018, RSDC has 60:40 promoter public shareholding with major shareholdings from RSDC (NGO)-15.1%[7], Bank of Kathmandu Limited (12.0%), and Mr. Sumit Agrawal (MS Group, 11.7%). Head office of RSDC is in Butwal of Rupandehi District. Mr. Damodar Joshi is the chief executive officer of RSDC.

RSDC was set up to provide funding and technical support to the cooperatives set up by parent NGO and other cooperatives with similar nature; with an aim to strengthening them. During FY2016-17, RSDC reported a net profit of ~NPR 17 million on an asset base of NPR 924 million vs. net profit of ~NPR 15 million on an asset base of NPR ~765 million during FY2015-16. During H1 FY2017-18, RSDC has reported a profit of ~NPR 13 million over an asset base of NPR 1,446 million. As on mid-Jan 2018, RSDC's gross NPLs stood at 0.04% and CRAR at 28.72%. In information technology front, RSDC uses Pumori IV software.

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[7] RSDC (NGO) renounced its rights (1:2 rights issue) to a private investor; diluting its stake in RSDC from erstwhile ~25% to ~15% as on mid-Jan 2018. Most of the renounced stake was taken over by Mr. Sumit Agrawal (from MS group, a family run business house) who is now the third largest shareholder in the company with ~11.8% stake.