Nagbeli Laghubitta Bittiya Sanstha Limited

ICRA Nepal assigns [ICRANP] IPO Grade 4 to the proposed Equity Shares (Rights Issue) of Nagbeli Laghubitta Bittiya Sanstha Limited

Facility/Instrument	Issue Size	Grading Action (April 2018)
Rights Share Issue	~NPR 76.64 Million	[ICRANP] IPO Grade 4 (Assigned)

ICRA Nepal has assigned an "**[ICRANP] IPO Grade 4**", indicating below-average fundamentals to the proposed rights issue amounting to ~NPR 76.64 million of Nagbeli Laghubitta Bittiya Sanstha Limited (NBBL). 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. NBBL is proposing to come out with 100% rights issue of 766,463.15 numbers of equity shares of face value NPR 100/- each, to be issued to its existing shareholders at par. The proposed issue is being made to augment the capital base to support the future growth plans of the management.

The grading is constrained by regulatory cap on lending rates for Micro Finance Institutions (MFIs) at 18%, limiting the ability to pass on increased cost of funds to borrowers hence pressurizing NIMs (Net Interest Margins) and profitability of MFIs. Grading concerns also emanate from NBBL's weak asset quality indicators, decentralized MIS, inadequate organization structure with weak promoter profile, small scale with moderate track record of operations and competition from larger/established peers. Moreover, presence of large number of players (including cooperatives operating microfinance activities), increased ticket size by regulations and absence of centralized credit information for MFIs raises concerns of overleveraging. The grading is also constrained by NBBL's high cost of funds and low NIMs among peers which along with inefficient fund mobilization seen in recent periods could create challenges in adequate return generation going forward.

Nonetheless, the grading factors in NBBL's ability to maintain decent credit portfolio growth (CAGR ~53% from Jul-13 to Jul-17 vs. ~49% for industry) and hence being able to report good profitability indicators (return on net worth - RoNW of ~36% for FY17 and average of ~41% in last five years). Though the return indicators are expected to remain diluted over medium term amid squeezing NIMs and increasing capital, growth opportunities for NBBL remain adequate given healthy capitalization profile (~18% as on Jan-18 vs. regulatory minimum of 8%), rapid expansion plan of NBBL in new geographies and the large below poverty line population in Nepal. The grading also derives comfort from the moderate average ticket sizes so far (~NPR 46,000) and the mechanism of insurance of loans. Going forward, ability of the company to maintain sustainable growth through geographical expansion while strengthening commensurate risk mitigation practices would be important from a risk perspective.

NBBL follows group-based lending model of microfinance for unsecured loans in addition to providing collateralized loans up to NPR 7 lakhs to finance micro enterprise in line with regulatory limit. Despite being a new age player, credit portfolio growth remained only slightly higher to industry at CAGR ~53% over last four years vs. ~49% for industry resulting in low portfolio base among similar aged peers. In H1FY18, NBBL's credit portfolio declined by ~4% to NPR 613 million and was dominated by unsecured group guarantee backed loans (~86%), rest being secured loans with plans to increase portion of secured loans over medium term. As of Jan-18, majority of loans were provided to agriculture sector (~63%), followed by service sector (~35%), rest being other sectors (~2%). NBBL offers NPR 50,000 for first cycle of general loans; maximum limit allowed in successive cycles is NPR 2 lakhs vs. 5 lakhs allowed by regulations. Hence, the average ticket size was ~NPR 46,000 as of Jan-18 much lower than regulatory permissible limit. Incremental credit growth plan (~37% CAGR over next five years) is likely to remain supported by increase in members base with geographical expansion as well as incremental loan to existing members.

NBBL's asset quality profile deteriorated in recent times (Non-Performing Loans -NPLs increased from 0.93% as of Jul-15 to 4.05%[1] as of Jan-18 with ~17% delinquencies) mainly due to inadequate credit appraisal and absence of separate monitoring and supervision department, further accentuated by the impact of last monsoon floods in its geographically concentrated operations. Management's plans to expand operations over new geographies is expected to lower future asset quality shocks arising out of such events. NBBL's sizeable exposure in high ticket collateralized loans to marginal borrower profile (~14% as of Jan-18 with higher delinquencies at ~21%) with relatively inferior collateral and further plans to increase such exposure up to regulatory ceiling (1/3rd of portfolio) also remains an area of concern in terms of incremental asset quality. Overleveraging concerns also exist for NBBL considering the absence of centralized credit information in microfinance segment so far limiting MFI's ability to check multiple lending. However, entire loan portfolio is insured against probable defaults (cost borne by borrower) assuring 75% recovery of due amount and hence providing some comfort. Going forward, NBBL's ability to improve internal controls and maintain healthy asset quality indicators would have a bearing on its overall financial profile.

As for NBBL's monitoring mechanisms, separate monitoring & supervision department is not in place and the inhouse internal audit function was also handled by single personnel so far (recently outsourced). In ICRA Nepal's opinion, frequency and coverage of monitoring would remain critical given the growth targets set over wider geography. NBBL would have to develop strong credit appraisal system including cash flow and debt repayment capacity analysis, robust credit monitoring and supervision of the borrowers for sustainable growth.

As per regulation, Banks and Financial Institutions[2] (BFIs) are required to extend 4-5% of their total loans towards deprived sector[3], either directly or through microfinance companies. Any moderation or withdrawal to this regulation could have significant impact on funding profile of MFIs. Additionally, funds available to MFIs could be lowered if BFIs shift towards direct lending given the increased ticket size that qualify as deprived sector as well as expanding franchise at local/rural levels. Currently, NBBL is highly dependent upon bank borrowings (~70% of total funds as of Jan-18) which has witnessed sharp spike in cost in recent periods (~12% for H1FY18 vs. ~7% for FY17) owing to low lendable funds across banking sector along with the implementation of "base rate plus" lending regime. Mismatch in deposits and borrowings growth (~40% and ~22% respectively) in the interim compared to ~4% decline in credit also remains a concern. Owing to limited track record, savings from members comprises ~30% of overall funding profile (~43% for industry) and this currently carries lower cost than bank borrowings (~8% for H1FY18), hence lowering overall cost of funds to 10.96% for H1FY18 (7.43% for FY17). NBBL's liquidity position remains comfortable due to availability of revolving lines of credit, short tenure of loans extended (generally one year) and higher proportion of stable, non-withdrawable deposits from members. Lack of diversity in funding sources would however remain major challenge for the MFI sector going forward.

NBBL has reported healthy profitability indicators over increasing capital base (Return on net worth - RoNW of ~36% and return on assets of 4.96% for FY17; average RoNW of ~41% in last five years). Return indicators could witness major decline over medium term given the proposed 100% rights and cap on lending rates resulting in lower NIMs (~6% for H1FY18 vs. ~11% for FY17 reflecting in RoNW of ~19%). With the implementation of interest rate cap on MFIs, average yield of NBBL has declined from ~20% in FY17 to ~19% in H1FY18 (fresh loans flown at 18% while old loans continue earlier high rates) while cost of funds increased sharply from ~7% for FY17 to ~11% for H1FY18. The interim profitability was further impacted by spike in delinquencies and gradual decline in fund utilization ratio (credit/ total available funds at ~76% in Jan-18 vs. ~98% in Jul-14). Nonetheless, improved fee-based income (1.94% of average total assets-ATA for H1FY18 vs. 1.71% for FY17), low operating cost among peers (4.60% of ATA for H1FY18) and scale expansion plans could support profit going forward. Ability of NBBL to achieve sustainable growth in business ensuring efficient utilisation of enhanced capital whilst improving its asset quality would have key bearing over its future profitability profile.

[1] Disregarding the regulatory forbearance that allows only instalment overdue to be recognised as NPLs (until overdues are within 1 year), NPLs would be 8.44% as of Jan-18.

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

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

So far, NBBL's capitalisation has remained comfortable with CRAR of 18.21% as on Jan-18 vs. regulatory minimum of 8%. This was supported by retention of most of the internal accruals so far and injection of external equity via 50% rights issue in FY17. Hence, NBBL's gearing remains lower among similar aged peers at 5.26 times as on Jan-18. NBBL's capital would increase to ~NPR 153 million after proposed issue vs. the regulatory minimum of NPR 100 million for national level MFI and hence could support the company's growth plans.

Company Profile

Incorporated in June 2009, Nagbeli Laghubitta Bittiya Sanstha Limited (NBBL) started its commercial operation from January 2010 as a 3-district level (Ilam, Morang, and Jhapa) Class D microfinance institution. NBBL has recently been upgraded to 10 districts level status from Oct-2017; branch expansion to new geographies planned shortly. Shareholding pattern of the company constitutes of promoter holding 70% and public group 30%. NBBL's shares are already listed in Nepal Stock Exchange. The registered and corporate office of NBBL is located at Birtamode, Jhapa, Nepal.

NBBL has presence across 3 districts of Nepal through its 18 branches as of mid-Jan-18. NBBL reported profit after tax (PAT) of ~NPR 34 million during FY17, over an asset base of NPR 751 million as of mid-Jul-17 as against as against PAT of ~NPR 27 million during FY16 over an asset base of NPR 606 million as of mid-Jul-16. For H1FY18, NBBL has reported PAT of ~NPR 12 million over an asset base of 867 million as of mid-Jan-18. NBBL's gross NPLs stood at 4.05% and CRAR at 18.21% as of mid-Jan-18. On technology front, NBBL uses M-Fin software which remains to be centralized across all branches.

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