Forward Community Microfinance Bittiya Sanstha Limited

ICRA Nepal assigns [ICRANP] IPO Grade 4+ to the proposed Initial Public Offering (IPO) of Forward Community Microfinance Bittiya Sanstha Limited

Facility/Instrument	Issue Size	Grading Action (August 2016)
IPO (Equity) Grading	NPR 60 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) of Forward Community Microfinance Bittiya Sanstha Limited (FCM). 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. FCM is proposing to come out with an IPO of 600,000 numbers of equity shares of face value NPR 100/- each, to be issued to general public at par. The issue is being made to meet the minimum public shareholding norms as prescribed by Nepal Rastra Bank (NRB) and also to augment the capital base to support the growth plans.

The grading factors in the regulatory uncertainty for MFIs[1] as introduced by Monetary Policy of FY16/17, with cap on interest rate spread at 7% (currently unregulated) and requirement for commercial banks to directly lend to deprived sector (2% of the total deprived sector lending requirements of 5%, rest 3% could be through intermediaries); which could significantly impact profitability and growth of FCM and the microfinance sector. Although FCM's funding mix remains adequate for current scale of operations, the company has large dependence on promoters (comprising 32% of the funding mix) as well as high cost deposits (~40% vs. ~30% for industry as of Apr-16) from members resulting high cost of funds (6.71% as of Apr-16). However, member deposits are a source of long term and stable funds. The grading is also constrained by FCM's high gearing levels (9.54 times as on mid-Apr-16), lack of fee based income, and increasing competition within the microcredit industry.

The grading however factors in FCM's promoter profile[2], company's track record of over a decade in microcredit activity (including that of Forward NGO, since December 2002) and FCM's status as the fifth largest retail MFI in Nepal with a portfolio of Rs. NPR 3,812 million as on mid-April 2016. ICRA Nepal also takes note of FCM's ability to maintain high portfolio growth (CAGR[3] ~52% over last three years) largely through expansion in client base (~80% CAGR) while the growth in average portfolio per member has been around 31%. FCM's asset quality indicators remain comfortable (0+ days past due of 0.33% as of Apr-16) and profitability profile remains healthy (RoNW and RoA[4] of ~46% and ~4.1% respectively for 9MFY16 vs. ~58% and ~4.3% respectively for FY15). With regulation proposing cap on interest spreads, FCM's profitability could be severely impacted. Growth opportunities for FCM remain adequate given company's experienced management team, wide geographical reach[5], access to low cost funds benefited from deprived sector regulation, adequate capitalization profile (CRAR 11.49% on Apr-16 vs. regulatory minimum 8%) and large below poverty line population in Nepal that act as target group for MFIs. In ICRA Nepal's opinion, ability of the company to manage growth and asset quality while expanding into newer districts as well as increasing share of high ticket collateralized loans and maintaining prudent leveraging levels would be critical.

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[1] Micro-Finance Institutions

[2] Forward-NGO, with experience in social mobilization and financial access programs, Everest Bank, (a Class A commercial Bank rated at LA- by ICRA Nepal) and RMDC (a wholesale microfinance graded at IPO 3+ by ICRA Nepal), jointly hold ~86% shares as of now.

[3] Compounded Annual Growth Rate

[4] Return on Net Worth and Return on Assets

[5] 75 branches and 10 area offices (for monitoring purposes only) spread across 32 districts of Nepal (out of 75).

All of FCM branches are computerized, however currently all the branches are not integrated (14 out of 75 branch integrated and balance are in process of integration). As for monitoring mechanisms, FCM has a dedicated team of ten area offices with internal audit being carried out every quarter. However, some slippages were witnessed in the frequency of the audit due to inadequate employee strength in the department. ICRA Nepal also takes note of the high growth rate of FCM and increasing ticket sizes (from NPR 1lakhs to NPR 3 lakhs for 1st cycle loans and maximum from NPR 3 lakhs to NPR 5 lakhs by Monetary policy 2016/17), both of which could impact discipline, and hence asset quality. FCM would have to develop strong credit appraisal systems and carefully assess the cash flows and debt repayment capacity of the borrowers for sustainable growth.

The grading is further constrained by vulnerable asset class of FCM primarily due to marginal borrower profile with unsecured lending business (~92% of portfolio as of Apr-16) and, further accentuated by low seasoning of significant portion of FCM's credit book (loan member growth CAGR 80% for last three years). Overleveraging concerns also exist for FCM considering the absence of centralized credit bureau in microfinance segment. Going forward, FCM's ability to maintain adequate profitability profile and improve internal controls to maintain its asset quality indicators would have a bearing on the overall financial profile.

FCM follows Grameen model, wherein five individuals take mutual responsibility for loan repayment for all the members. FCM offers loans up to NPR 50,000 for the first cycle borrowers, comparatively lower to most of the peers aiding lower average ticket size at ~NPR 37,000 as of Apr-16. FCM's healthy portfolio growth (CAGR ~52% over last three years) has been mainly supported by growth in number of borrowers (CAGR ~80% over same period) and network expansion. FCM's credit portfolio of NPR 3,812 million as of Apr-16 is entirely backed by group guarantee and is dominated by unsecured loans (~92% comprising of General Loan ~71%, Micro-enterprise Loan ~10%, Housing Loans ~5% and seasonal Loans ~4%), rest being secured loans. As of Apr-16, majority of the loans were provided to service sector (~56%), followed by agriculture sector (~40%) and others (~4%). FCM's asset quality indicators remain healthy so far with 0+days delinquencies of 0.33% as of Apr-16 including NPLs of 0.16%.

As per the regulation, Banks and Financial Institutions[6] (BFIs) are required to extend 4-5% of their total loans towards deprived sector[7], either directly or through microfinance companies. However, Monetary Policy of FY16/17 has mandated commercial banks to directly lend 2%, out of their total deprived sector lending requirements of 5%. 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 business profile of microfinance entities. FCM has banking relationship with 26 BFIs, accounting for 60% of the total borrowing profile, whereas the rest is from deposits availed from members. However, FCM's reliance on promoter entities - Everest and RMDC is significant, accounting for ~32% of overall borrowings as of mid Apr-16. The savings collected from members comprise ~40% of overall funding profile which remains higher to the industry average of ~30%. Though the member deposit is relatively at a higher cost, it provides certain level of security in case of credit default by borrowers. FCM's liquidity position remains comfortable due to availability of revolving lines of credit from funders, short tenure of loans extended (generally one year) and higher proportion of stable non-withdraw able deposits from members.

FCM reported healthy net interest margin / average total assets of 10.5-11% during the last 6-18 months, resulting in the company reporting healthy profitability indicators with ROA of 4.07% and RoNW of ~46% for 9MFY16. Going forward, profitability could be significantly impacted as 7% cap on interest rate spread has been introduced by Monetary Policy of FY17. The company's profitability is also supported by lower operating expenses and credit costs (~5% and ~0.4% of ATA respectively). FCM's dependence on interest income remain high as reflected by lack of diversity in earnings (non-interest income of ~0.3% of ATA for 9MFY16). Thus, ability of FCM to achieve sustainable growth in business and ensure efficient

[6] Class A, B and C financial Institutions
[7] As defined by the central bank (NRB) covering marginal sections of the society

utilisation of the enhanced capital whilst maintaining asset quality would have key bearing over future profitability of FCM.

FCM's CRAR of 11.49% as on Apr-16, though remains moderate compared to other banking counterparts and considering the vulnerable asset class, remains comfortable and higher to regulatory minimum of 8%. FCM's gearing remains higher among peers at 9.54 times as on Apr-16, notwithstanding the improvement from 11.21 times as on Jul-15 on account of capitalisation of profits. FCM's capital would increase to NPR 200 million after proposed IPO (against regulatory minimum of NPR 100 million as of now) and is likely to support the company's growth plans over medium term.

Company Profile

Incorporated in September 2012, Forward Community Microfinance Bittiya Sanstha Limited (FCM) received license as a national level Class D microfinance institution in March 2013 from NRB (the central bank). After its licensing, FCM took over the microfinance business being conducted by Forum for Rural Women Ardency Development (FORWARD), an NGO, established in May 1995 and operating as financial intermediary from December 2002. FCM is 24th class D institution licensed by NRB to carry out microcredit activities out of 42 such institutions as of Jul-16. The current shareholding structure of FCM consists of FORWARD NGO (~36%), Everest bank (~36%), RMDC (~14%) and rest being held by 54 individual promoters. The promoter holding is planned to be diluted to 70% post proposed IPO. Mr. Ash Narayan Chaudhary is the CEO of the company.

With its registered office in Duhabi (Sunsari district), FCM currently operates across 32 districts of Nepal through 75 branches. The company reported a profit after tax (PAT) of NPR 125 million during 9MFY16 over an asset base of NPR 4,731 million as against PAT of NPR 127 million during FY15, over an asset base of NPR 3,467 million as on Jul-15. Its net worth as on Apr-16 was NPR 439 million and loan portfolio was NPR 3,812 million. As on mid-Apr-16, FCM's gross NPLs stood at 0.16% and CRAR at 11.49%. On information technology front, FCM uses "Synergy" software on all its branches standalone basis for which integration process is in progress (14 out of 75 branches are integrated so far).

August 2016

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