Nerude Laghubitta Bikas Bank Limited

ICRA Nepal assigns [ICRANP] IPO Grade 4 to the proposed Equity Shares (Rights Issue) of Nerude Laghubitta Bikas Bank Limited

Facility/Instrument	Issue Size	Grading Action (December 2016)
Rights Share Issue	NPR 90 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 90 million of Nerude Laghubitta Bikas Bank Limited (NLBBL). 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. NLBBL has proposed to come out with 50% rights issue of 900,000 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 takes into account NLBBL's moderate track record (operating since June 2007) and franchise strength (55 branches across 21 districts as of mid-Oct-2016); translating into fair credit portfolio growth (CAGR 31% during FY 2013-16). The grading also factors in diversified funding profile (with credit lines from more than 10 class A commercial banks), strong member's deposit base and fair profitability (return on net worth (RoNW) of ~28% during FY 2015-16). However, incremental profitability is likely to be impacted due to change in the operating environment through monetary policy 2016-17, if implemented. Growth opportunities for NLBBL remains adequate given the recently acquired national level MFI status (in FY2014-15), comfortable capitalization level (CRAR ~13%[1] in mid-Oct-2016 vs regulatory minimum of 8%), access to low cost fund benefitted from deprived sector regulations and large below-poverty-line population in Nepal that acts as target group for MFI players. However, scalability could remain a challenge due to promoter's reputation being limited to local arena. In ICRA Nepal's opinion, ability of the company to improve portfolio growth & generate scale economies through geographical expansion and maintain commensurate risk mitigation practices would be critical going forward.

The grading is however constrained by recent increase in delinquency levels (0+ days delinquency of 2.33% as on mid-Oct-2016[2] including gross NPA 0.93%) mainly due to six months long political turmoil[3] in the Terai region. The impact of political turmoil was heightened due to concentration of NLBBL's business in Eastern Terai region of Nepal, where it faces strong competition from regional as well as established national level MFI players. The grading also factors small scale of operations (assets size of NPR 2,782 million on mid-Oct-2016), relatively high cost of member deposits (~11% in FY16) and high expense ratio (7.84% of ATA in FY16); which might impact incremental returns assuming implementation of spread cap envisaged in the monetary policy. Further, the grading is also constrained by weak financial profile[4] of one of the major promoters of NLBBL- Nepal Rural Development Service Centre- an NGO; raising concerns about its ability to inject equity into the company in future. The grading factors in the regulatory uncertainty for MFIs as introduced by Monetary Policy of FY2016-17, with cap on interest rate spread at 7% (hitherto unregulated) and requirement for commercial banks to directly lend to deprived sector (2% of the total deprived sector lending requirements of 5%, rest 3%

[1] The company has publish capital-to-risk assets ratio (CRAR) of 11.84% in its quarterly report. However, as per the data available to us CRAR for mid-Oct-16 comes around 13%.

[2] Mid-Oct-16 data are unaudited and all the calculations are based on the information provided by management of NLBBL.

[3] The political turmoil including customs blockade that started from September 2015 and lasted till February 2016 had major impact on the southern plains of the country.

[4] NRDSC should inject NPR 22.5 million towards the proposed rights issue. Total assets base of NRDSC stood at NPR 23.97 million including bank balance of NPR 7.92 million as on mid-July-2016 per the audited financials.

could be through intermediaries). These changes could significantly impact profitability and growth of NLBBL and the microfinance sector

The grading further takes into account NLBBL's presence in relatively riskier product segment owing to marginal borrower profile and unsecured lending business (~82% of portfolio as of mid-Oct-2016). Moreover, absence of centralized credit bureau in microfinance segment remains a major concern, limiting MFI's ability to check multiple lending. However, adequate seasoning of credit books of NLBBL and low average tickets size (~NPR 39 thousand as on mid-Oct-2016) provides some comfort. Going forward, NLBBL's ability to develop commensurate control measures in line with business expansion and portfolio growth is likely to have a bearing on the overall financial profile.

NLBBL follows group lending model, wherein members related to a group (5 individuals) and a centre (5-7 groups) take mutual responsibility for loan repayment for all the members in the group and centre. In addition, NLBBL also extends individual loans (secured loans) up to NPR 700 thousand to finance micro enterprise. NLBBL offers credit up to NPR 40 thousand[5] for the first cycle loans; however the average ticket size remains ~NPR 39 thousand as of mid-Oct-2016, lower to most of the industry peers. NLBBL's credit portfolio of NPR 2,451 million as of mid-Oct-2016 is dominated by unsecured group guarantee backed loans (~82%), rest being secured loans. NLBBL's asset quality indicators remain fair, despite recent deterioration, with 0+days delinquencies of 2.33% as of mid-Oct-2016 including NPLs of 0.93%.

As per 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 FY 2016/17 has mandated class A commercial banks to maintain direct deprived sector lending of 2%, out of their total deprived sector lending requirements of 5%. This is likely to have significant impact the funds available for growth of microfinance sector and therefore, on the funding profile of microfinance entities. Currently, NLBBL is dependent upon bank borrowings (~58% of total funds; diversified across more than ten class A commercial banks as on mid-Oct-2016). The savings collected from members comprise ~42% of overall funding profile, higher than MFI industry average. The cost of deposits remains on higher side (~11% in FY2015-16), offsetting the advantage of low cost bank borrowings (~3.5%) and leading to high cost of funds (~7%). NLBBL's liquidity position remains comfortable due to availability of revolving lines of credit from lender BFIs, short tenure of loans extended (generally one to two years) and relatively stable nature of deposits from member.

NLBBL's profit level remains fair with return on assets (ROA) of 3.72% and RoNW of ~28% in FY2015-16; primarily aided by high lending spreads of ~12%. Going forward, profitability could be significantly impacted as 7% cap on interest rate spread has been introduced by Monetary Policy of FY17. Operating expense ratio of NLBBL remains on higher side (~8% of ATA in FY2015-16), largely offsetting healthy NIMs of the company (~11% of ATA[8]). Nonetheless, profitability remains supported by healthy non-interest income (~2% of ATA, primarily in the form of loan processing fees). The profitability profile going forward will be determined by the ability of NLBBL to scale up its business to ensure efficient utilisation of enhanced capital and counter the impact of spread rate cap through scale economies; while at the same time maintaining asset quality.

NLBBL's CRAR of ~13% as on mid-Oct-2016 remains adequate, considering the vulnerable asset class. Nonetheless, it remains much higher to regulatory minimum CRAR of 8% for MFIs. Despite high gearing level permitted by regulation (up to 30 times), NLBBL has been operating at low gearing levels (~5 times in mid-Oct-2016).

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[5] Increased with effect from mid-July-2016. Prior to the revision, initial ticket size was NPR 25 thousand

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

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

[8] Average total assets

Company Profile

Nerude Laghubitta Bikas Bank Limited (NLBBL) licensed as class D microfinance institution by NRB, has been operating since June 2007 in the eastern region of Nepal. NLBBL was originally licensed as regional MFI before being upgraded to a national level MFI in FY2014-15. NLBBL is promoted by two institutional promoters viz. Nepal Rural Development Service Centre (NRDSC)- an NGO and Birat Laxmi Bikas Bank Limited- a class B regional development bank with 25% and 17.50% shareholding respectively. Overall shareholding pattern of the bank constitutes of Promoters holding at 51% and public group by 49%. The shares of the Bank are listed in Nepal Stock Exchange. The registered and corporate Office of the bank is in Biratnagar, Nepal.

As at end of FY2015-16, NLBBL's presence is spread across 21 districts of Nepal through its 55 branches. NLBBL reported a profit after tax of NPR 81 million in FY2015-16 over an asset base of NPR 2,426 million as of mid-July-2016 as compared to net profit of NPR 78 million in FY2014-15 over an asset base of NPR 1,932 million as of mid-July-2015. During Q1FY17, NLBBL has reported profit of NPR 14.20 million over an asset base of NPR 2,782 million as of mid-Oct-2016. NLBBL's gross NPLs stood at 0.93% and CRAR at ~13% as on mid-Oct-2016. On information technology front, NLBBL uses M-Fin software.

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