

Sadhana Laghubitta Bittiya Sanstha Limited: [ICRANP] IPO Grade 4+ assigned to proposed IPO

February 11, 2020

Summary of graded instruments:

| Instrument | Issue size (NPR Million) | Rating Action |
|--------------------------|--------------------------|---------------------------------|
| Initial Public Offerings | 70.78 | [ICRANP] IPO Grade 4+; assigned |

Grading action

ICRA Nepal has assigned a grading of **[ICRANP] IPO Grade 4+**, indicating below-average fundamentals, to the proposed initial public offering (IPO) of NPR 63 million of Sadhana Laghubitta Bittiya Sanstha Limited (SLB). ICRA Nepal assigns IPO¹ gradings on a scale of 1 through 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 indicates their relative positioning within the grading categories concerned. Thus, the grading of 2+, 3+ and 4+ are one notch higher than 2, 3, and 4, respectively. SLB is proposing to come out with an IPO of 707,800 equity shares with a face value of NPR 100 each, at par. The proposed issue is being made to fulfil the regulatory provision requiring banks and financial institutions (BFIs) to float IPO within three years of coming into operation.

Rationale

The assigned grading factors the presence of regulated institutional promoters; NCC Bank (rated BBB by ICRA Nepal) with one director representation in board and Shangri-la Development Bank Limited (Graded IPO 3 by ICRA Nepal in Oct 2017), each having ~14% shares. The grading also factors in SLB's ability to scale-up the business in initial years of operation, aided by rapid branch expansion, acquisition of 10 district level MFI (Arthik Sambriddhi Laghubitta Bittiya Sanstha Limited-ASLB) and growth in client base, while maintaining healthy asset quality profile (gross NPLs of 0.16% as of Jul-2019, 0.32% as of Oct-2019). Additionally, adequate network base for its scale of operation (44 branches in 14 districts as of mid-Oct 2019); along with a further branch expansion plan, encompassing new geographies; and a large below-the-poverty-line population in Nepal, the target group for microfinance institutions (MFIs) spell positives from the growth perspective. Further, adequate profitability, with reported PAT of NPR 15 million in FY2019 (RoNW of ~21%) supported by healthy fee-based income and lower credit costs, has also been considered while assigning the grading. The current capitalisation of SLB (~13% as of mid-Oct-2019) remains comfortable against the regulatory minimum of 8%. This, along with the proposed capital injection, could support the company's growth plans. The grading additionally takes comfort from the regulatory changes—the removal of the 18% cap on lending rates for the MFI; which provides them the flexibility to pass on the increased cost of funds to borrowers.

Nonetheless, the grading is constrained by the limited track record along with the higher average ticket size for initial cycles of lending among the peers, with ~NPR 64K (on outstanding loans). It also takes note of the low share of deposits in the funding mix (~24% as of mid- Oct-2019 vs. ~43% for the industry) and the recent regulatory restriction to collect recurring deposits. Funding sources for the MFIs may also witness some constriction, going forward, as the banking sector is comfortably above its deprived sector lending target (6.65% as of mid-April 2019 against 5% target). The company's increasing share of high-ticket collateral-based loans to marginal borrower profile (~19% as of mid-Oct 2019), along with plans for a further increment in such loans also remains a concern. The grading also remains constrained by the frequent regulatory changes that impact the spreads and funding sources for the MFI sector. Moreover, the high-ticket sizes permitted by regulations, the presence of a large numbers of players in the industry (including comparatively weak regulated cooperatives), starting phase of the credit information bureau with low penetration of credit information for the MFIs, raise concerns of overleveraging by borrowers. Going forward, SLB's ability to maintain asset quality indicators,

¹ Includes rights and further public issue of equity shares

ability to generate stable and adequate profitability over increasing capital base and generating economies of scale will have a bearing on its overall financial profile.

Grading strengths

Regulated institutional promoters– The company is promoted by two BFIs, each with stake of ~14%, namely BBB rated NCC Bank with one director representation and IPO 3 Graded Shangrila Development Bank and rest held by 90 individuals. Post the proposed IPO, the promoter holding will dilute to 70%. The company derived funding as well as operational support from the promoter BFIs. Also, adequate quality of management with experienced senior management remains comfort.

Healthy growth over small base; supported by rapid expansion in franchise along with acquisition of another MFI - SLB's portfolio registered ~3.5-fold growth in FY2019, building up its portfolio base to ~NPR 1,195 million as of Jul-2019. This was aided by rapid branch expansion, acquisition of 10 district level MFI- ASLB having portfolio base of ~NPR 269 million as of Jul-2019, and growth in client base. However, recent restriction by the regulator to not allow MFIs to extend both collateral and non-collateral loans to a same borrower might hinder the growth going forward. The company's ability to scale-up operation vis a vis maintaining healthy asset quality would remain critical.

Adequate presence in target geography - The company has presence in 14 districts with 44 branches. Adequate penetration in the target geography of the company has aided to gain operational efficiency.

Healthy capitalisation profile – The company is comfortable with CRAR of ~13% as of Oct-2019 vs. 8% regulatory minimum. Incoming capital from the proposed issue will further strengthen capitalisation profile. Also, the gearing of ~8% remains moderate among new age peers.

Fair asset quality – Portfolio quality remains healthy, with gross NPLs of 0.16% and delinquencies of 0.6% as of Jul-2019; with the acquisition of relatively weaker MFI, these have increased to 0.32% and 1.98% respectively as of Oct-2019. The company's ability to control fresh slippage and reduce the delinquencies would remain key monitorable.

Improvement in profitability profile; however, track record remains to be seen; profitability supported by decent fee-based income and lower credit cost – The company reported PAT of NPR 15 mn in FY2019, which is RoNW of ~21%. It was mainly supported by healthy fee-based income of ~5% and low credit costs (~1%), despite high operating costs (~8%). High fee-based income, though the regulator has capped fees to 2%, was mainly on account prepayment of loans prior to maturity date and disbursement of fresh loan to the same borrower by deducting fees @2%. The removal of lending rate cap by the regulator remains positive for the entire MFI sector. However, the interest rate spread cap of 9% remains there. With the removal of lending rate cap, the company can now increase its lending rate up to 19%, remaining within the regulated spread.

Grading Challenges

Limited track record of operation; acquisition of relatively weak MFI – The company has been in operation since November 2017 (licenced as 10 district level MFI) and later upgraded to the national level by acquiring the then ASLB in mid-July 2019. Acquisition of a relatively weak MFI might impact the future operating performance of the company.

Low penetration of credit bureau in Nepalese MFI sector – The presence of large number of MFI players and the micro lending by some of class-A and class-B banks as well as cooperatives in the same geography lead to high competition and risk of multiple loans availed by borrowers. To tackle this, the Centralized Credit Information Bureau for MFI has been established, but full-fledged operation of the same has not begun yet and the bureau coverage on the borrowers' profile is low. However, NRB has mandated all the MFIs to send credit information to bureau along with the mandatory assessment of loans from other institutions prior to loan disbursement. While this could reduce duplication and overleveraging risks going forward, there can be risks to asset quality during the transition period.

Low share of deposits in funding mix – Funding mix remains moderate, given the recent commencement of operations, with bank borrowing accounting for relatively high share (~76% in total interest-bearing liabilities) and the remaining 24% from member deposits (vs. ~43% for industry). Recent regulatory restriction to collect recurring deposits from members might also impact the growth of deposits going forward. The company has availed loans from 32 BFIs, including 14 class-A banks, with sound fund mobilisation ratio of credit/ total available fund of 98% as of Jul-2019.

Regulatory environment - Regulatory risks remain high for the sector as the frequent changes in regulation impact funding sources and interest spreads. Also, high loan ceiling for MFI lending by NRB (NPR 300K for new borrowers) might lead to aggressive growth and affect the industry’s asset quality. Low regulatory capital requirements (8%), despite lending to risky segment, remains a concern from the standpoint of the company’s ability to absorb credit shocks. Further, the marginal profile of borrowers, who are prone to income shocks and have limited ability to repay overdue amounts in case of missed instalments, and the high loss in case of default, given the unsecured nature of credit, are credit negatives.

Analytical approach: For arriving at the ratings, ICRA Nepal has applied its rating methodology as indicated below.

Links to applicable criteria:

[IPO Grading Methodology](#)

[Bank Rating Methodology](#)

Company Profile

Incorporated in June-2016, Sadhana Laghubitta Bittiya Sanstha Limited (SLB) started its commercial operation from November 2017 on receiving licence to operate 10 district institutions. It was later upgraded to national level class D microfinance institution after acquisition of Aarthik Samriddhi Laghubitta Bittiya Sanstha (10 district level), starting joint operation from mid-Jul-2019. As of mid-Oct-2019, SLB operated through 44 branches over its 14 districts. SLB is promoted by 92 promoters, including 2 BFIs (NCC- rated at BBB (~14%) and Shangrila Development Bank Ltd. (~14%) graded at 3 by ICRA Nepal among others) with share of ~27%, and by individuals (~73%). Mr. Resham Neupane is the Chief Executive Officer of the company. The registered and corporate office of SLB is located at Haramtari-6, Gorkha, Gandaki Province, Western Nepal.

SLB reported a net profit of ~NPR 15 million in FY2019, over an asset base of ~NPR 1,234 million as of mid-Jul-2019, as against a negligible net profit of ~NPR 0.04 million in FY2018, the first year of operation, over an asset base of ~NPR 376 million as of mid-Jul-2018. Further, it reported a profit after tax of ~NPR 8 million in Q1FY2020 over as asset base of ~NPR 1,581 million as of Oct-2019. SLB’s gross NPLs stood at 0.32% and CRAR at 13.05% as of mid-Oct-2019, while gross NPLs were 0.16% (overall delinquencies at ~1.98%) and CRAR were 8.08% as of mid-Jul-2019. On the technology front, SLB uses “Uranus” software, which is centralised across all its branches.

Key financial indicators

| Year Ended | FY 2018 (Audited) | FY 2019 (Audited) | Q1FY2020 (Provisional) |
|---------------------------------|-------------------|-------------------|------------------------|
| Credit portfolio (NPR mn) | 351 | 1,195 | 1,346 |
| No. of borrowers | 4,950 | 18,592 | 21,101 |
| Avg. ticket size (NPR) | 70,876 | 64,248 | 63,782 |
| No of branches | 20 | 40 | 44 |
| Deposits | 55 | 280 | 326 |
| Deposit to loan ratio | 16% | 23% | 24% |
| Operating ratios | | | |
| Yield on Average Loans | 10.24% | 18.31% | 17.95% |
| Cost of Avg. Int. Bearing Funds | 8.17% | 11.72% | 10.48% |
| Net Interest Margin/ATA | 2.61% | 6.97% | 6.99% |
| Non- interest income/ ATA | 6.56% | 4.81% | 3.49% |
| Operating expenses / ATA | 7.37% | 8.23% | 6.47% |

| Year Ended | FY 2018 (Audited) | FY 2019 (Audited) | Q1FY2020 (Provisional) |
|--|-------------------|-------------------|------------------------|
| Credit Prov. & Write-offs /ATA | 1.75% | 1.08% | 0.89% |
| PAT/ATA | 0.02% | 1.87% | 2.18% |
| PAT/Average Net worth | 0.12% | 20.74% | 22.23% |
| Capitalisation ratios | | | |
| Capital adequacy ratio | 14.52% | 8.08% | 13.05% |
| Gearing [(deposits+ borrowing)/ net-worth] | 6.59 | 11.76 | 7.59 |
| Borrowing/ net worth (times) | 5.46 | 8.84 | 5.78 |

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About ICRA Nepal Limited

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