Siddhartha Capital Limited: Rating reaffirmed

July 27, 2020

Facility	Rated Amount	Rating Action
Fund Management Quality Rating (FMQR)	NA	[ICRANP] AMC Quality 3+; reaffirmed

Rating action

ICRA Nepal has reaffirmed the Fund Management Quality Rating (FMQR) of **[ICRANP] AMC Quality 3+** (pronounced ICRA NP Asset Management Company Quality Three Plus) assigned to Siddhartha Capital Limited (SCL). The rating indicates adequate assurance on management quality.

Rationale

The rating reaffirmation factors in the company's relatively long track record (~8 years) in mutual fund (MF) management, and the adequately established organisational structure to manage the existing MF schemes. The rating action also considers its satisfactory investor service practices and the processes followed by it, while adhering to the regulatory guidelines and investment policies. This is reflected in the fair growth trend in NAV reported by its MF schemes so far. The rating further draws comfort from the majority ownership and continued technical support of Siddhartha Bank Limited, a Class 'A' commercial bank in Nepal. The company's experienced fund supervisors and senior management, involved in the supervision and management of the schemes, also provide comfort. Additionally, a stable Government, along with the various ongoing/proposed regulatory improvement measures in the capital market remain positives for market development and hence fund returns.

Nonetheless, the rating is constrained by the evolving nature of the MF industry, along with the challenges in reporting good return trend for its operational MFs, given the volatile market movements since the last few years. The general downward trend in the market index (NEPSE) since their launch has impacted their net asset value (NAV) growth momentum. The market volatility could be partly attributed to the tight liquidity in banking in the last few years, increase in listed shares, and lack of large institutional investors/market makers. The economic impact of the Covid-19 pandemic is still developing and hence the market's assessment of the same remains to be seen. However, the recently announced Monetary Policy and policies of the Security Exchange Board of Nepal (SEBON) for FY2021 could provide some impetus for market stability/growth. Given that the schemes launched so far are predominantly equity-oriented, the asset management companies' (AMCs) ability to maintain portfolio diversification is limited as the equity market is currently dominated by the financial sector. As a result, any changes in the regulatory framework or banking liquidity, that could impact the market, would have a bearing on the scheme's performance. Further, the debt market is still shallow, and, therefore, limits the fund manager's ability to diversify investments as a tool for hedging and managing the evolving risks in fund management. Hence, the company's ability to maintain prudent asset allocation (i.e. mix of equities, fixed income investments and cash), in line with the market movements, would drive the schemes' performance. The company's ability to make prudent investment decisions and maintain a healthy growth in the NAV over a longer timeframe would remain a key rating sensitivity.

Key rating drivers

Strengths

Strong ownership profile – SCL is a 51% subsidiary of Siddhartha Bank Limited, while the balance shares are also held by individual promoters associated with the Group. ICRA Nepal takes comfort from the sponsor's (Siddhartha Bank Limited) commitment to its subsidiary AMC as demonstrated by the sharing of its strong brand name, along with seed investment (15% or more) in its MF schemes. The long track record and experienced management of the sponsor reflects positively on the AMC's operations. SCL benefits from the sponsor in the form of technical/legal assistance and oversight-related functions.

Relatively long track record in fund management – SCL was the first company to issue MF scheme in 2012 after the Mutual Fund Regulation, 2010 was rolled out. The company has launched four MF schemes so far with its first two schemes having already matured. The first scheme i.e. Siddhartha Investment Growth Scheme- I (SIGS-I) reported good growth in NAV with ~48% annualised return over its five-year tenure. While the early MF entrants to the market (including SIGS-I) were benefitted by sizeable market upswings, later schemes could not replicate a similar performance, as a general trend across most AMCs. This is also evident from annualised return of ~14% reported by SCL's second scheme (Siddhartha Equity Oriented Scheme - SEOS).

As of current, SCL is operating two equity-oriented schemes with 10-year tenures each, as opposed to the earlier five-year schemes. Both Siddhartha Equity Fund (SEF) and Siddhartha Investment Growth Scheme (SIGS-II) have reported adequate performance, relative to the schemes launched around a similar time. As of mid-June 2020, SEF reported a NAV of NPR 10.26 and an annualised growth of ~5% (NEPSE recorded decline of ~7% over same period), while SIGS-II has reported a NAV of NPR 10.13 and an annualised growth of 2% (NEPSE declined by ~3%).

Experienced fund supervisors – The company currently has a set of experienced fund supervisors for its two operational MF schemes. The supervisors have long exposure in diverse sectors and the pooling of such expert resources remains a positive for sound fund management practices. However, the extent of involvement of the supervisors in managing the schemes is not clearly mandated through a legal framework and hence remains a rating concern.

Regulatory changes remain positives for the market – Some of the provisions in the recently announced Monetary Policy and announcements made by SEBON are expected to benefit the market. These include provisions increasing the banking sector's liquidity, which would result in lower interest rates over the medium term. This, along with flexibility in margin lending norms, could remain positives for the market. Additionally, restructuring/refinancing facilities have been proposed for the Covid-19 impacted borrowers which would lower the asset quality and profitability impact on banks, which comprise ~65% of the market capitalisation.

SEBON has also recently announced its plans to initiate provisions for fully automated trading, promote liquidity of debentures as well as Government treasury bills/bonds, and issue licences to stock dealers etc. Further, the policy also stipulates to allow the book-building method for the initial public offering (IPO), introducing new trade instruments, including index fund, equity derivatives, municipal bonds etc., promoting open-ended schemes as well as initiating short selling practices. All of these are likely to increase market depth and stability. Additionally, the earlier regulatory changes to promote the entry of non-financial sector companies in the secondary market could help increase the diversification avenues, going forward.

Challenges

Evolving impact of Covid-19 on the economy – The impact of Covid-19 on the economy and its facets are still uncertain and this could have a near term impact on the stock price performances. Contrary to the general expectations, the capital market improved after reopening from June 29, 2020, after elongated Covid-19-induced trading halts. However, the sustainability of the same remains to be seen. While both schemes have adequate investable cash to diversify further, challenges remain in making the prudent investment decisions amid the uncertain economic outlook.

Mutual fund industry itself in developing stage – The MF industry in Nepal is still developing with only 22 MF schemes (including one open-ended) being launched within a span of eight years. The performance of the earlier schemes was benefitted by the index up-stick with the market reaching historic high levels of 1,881 points during their tenure. Based on the operational 17 schemes, the overall industry's assets under management (AUM) were ~NPR 17 billion as of mid-June 2020 (average NAV of NPR 10.09 per unit). The secondary market is also evolving and is yet to be stabilised with adequate market depth and diverse market participants. The low depth of the NEPSE remains a concern in terms of realisable value of the NAV. The reduction in fund management and depository fee for the AMC, despite being a short-term challenge, is likely to encourage the AMCs to scale up their operations, a likely positive for the capital market in the longer term.

Limited investment diversification avenues so far – The Nepalese stock market is dominated by the financial sector so far with ~78% share in market capitalisation as of mid-June 2020. The schemes launched so far mostly make equity investments through the primary and the secondary market, predominantly in banks and financial institutions. Further, there is a limited scope for investment and risk diversification (both industry-wise and instrument-wise), being a nascent market for bonds and other fixed income securities. Given this concern, the AMCs ability to protect the NAV, amid the Covid-induced uncertainty remains a challenge.

Further, sustained higher investment concentration of SIGS-II in the microfinance sector, (~16% as of mid-June 2020 against market capitalisation of ~9%) remains an area of concern, given the higher P/E and P/B multiples for the sector. These are more susceptible to market volatility, thereby increasing the portfolio risk. SCL's stance on evaluating the sectoral risks periodically based on regulatory/operational changes and rebalancing the portfolio, as appropriate, would remain critical.

Low attraction of MF schemes among the investors – As of now, the MF schemes are mostly subscribed by institutional investors like banks, insurance companies, retirement funds, investment companies, etc, while the participation of retail investors has remained low so far. Most of the recent MF offerings have witnessed the undersubscription trend, including SIGS-II (~86% subscribed) and these schemes are usually being traded at a discount in NEPSE in comparison to their NAV. Additionally, the industry's ability to attract human resources as well as financial capital also remains average, compared to the banking industry as the investment banking industry is still at the initial stages of development. This also remains a rating concern.

Analytical approach: For arriving at the rating, ICRA Nepal has applied its rating methodology as indicated below. The rating should, however, not be construed as an indication of the prospective performance of the mutual fund schemes or of volatility in its returns.

Links to applicable criteria:
Fund Management Quality Rating Methodology

About the company

Established in 2012, Siddhartha Capital Limited (SCL) is a 51% subsidiary of Siddhartha Bank Limited; the balance being held largely by other individual shareholders associated as promoters of the bank. At present, SCL is involved in fund management, issue management, underwriting, share registration, private placement, financial advisory services, and depository participant. SCL has obtained an MF depository's licence in addition to a fund manager's licence from SEBON (as per the Mutual Fund Regulation, 2010) and is currently acting in both capacities for its two MF schemes i.e. Siddhartha Equity Fund (SEF) and Siddhartha Investment Growth Scheme (SIGS-II). SCL reported a profit of NPR 61 million for FY2019 (~36% YoY decline) over a capital of NPR 200 million. For 9M FY2020, the company reported a profit of NPR 40 million.

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About ICRA Nepal Limited

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Our parent company, ICRA Limited, was set up in 1991 by leading financial/investment institutions, commercial banks and financial services companies as an independent and professional investment information and credit rating agency. Today, ICRA and its subsidiaries together form the ICRA Group of Companies.

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