RBB Merchant Banking Limited: [ICRANP] AMC Quality 3 assigned

December 28, 2020

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

Rating action

ICRA Nepal has assigned the fund management quality rating of **[ICRANP] AMC Quality 3** (pronounced ICRA NP Asset Management Company Quality Three) to RBB Merchant Banking Limited (RBBMBL). The rating indicates adequate assurance on management quality.

Rationale

The rating assignment factors in the company's strong parentage, being a 100% subsidiary of Rastriya Banijya Bank Limited (RBB; a Class 'A' commercial bank). Four senior officials from the bank (including the CEO and the DCEO) are present in the company's board, which could augur well for the controlled performance of its first proposed mutual fund (MF) scheme. The rating further draws comfort from the company's adequately established organisational structure to manage the proposed MF scheme. ICRA Nepal also considers the satisfactory investment policies and guidelines developed by RBBMBL, while adhering to the regulatory guidelines. While RBBMBL has no prior track record in MF management, the experienced background of the company's fund supervisors and senior management provides comfort. The monetary policy and the policies of the Securities Board of Nepal (SEBON) for FY2021 have provided some impetus for market stability/growth. Additionally, various ongoing/proposed regulatory improvement measures in the capital market remain positives for market development and in turn, 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 the MFs, given the evolving economic impact of the Covid-19 pandemic. These concerns are further aggravated by the recently developed political turmoil, which could impact the economic growth pattern. Hence the market's assessment of these events would have a bearing on the fund's performance. Though the market index (NEPSE) has been improving in the recent months, sustainability of the same remains to be seen. The increased supply of shares over last few years and the lack of large institutional investors/market makers also pose challenge for market depth and liquidity. The asset management companies' (AMCs') ability to maintain portfolio diversification is limited as the benchmark index is currently dominated by the financial sector. As a result, any changes in the regulatory framework or banking liquidity could impact the market and would have a bearing on the proposed scheme's performance. Further, the debt market is still shallow, which limits the fund manager's ability to diversify investments as a tool for hedging and managing the evolving risks in fund management. The company's ability to make prudent investment decisions through sound corporate governance practices and maintain a healthy growth in the net asset value (NAV) would remain a key rating sensitivity.

Key rating drivers

Credit strengths

Strong ownership profile – RBBMBL is a fully-owned subsidiary of RBB, which is almost 100% held by the Government of Nepal and is the largest commercial bank of the country. ICRA Nepal takes comfort from the sponsor's (parent bank) commitment to its subsidiary AMC, as demonstrated by the sharing of its brand name and extending management support, as required. The long track record (>50 years) and the experienced management of the sponsor are expected to reflect positively on the AMC's operations. RBBMBL benefits from the sponsor in the form of technical/legal assistance and oversight-related functions. The company's board of directors comprises two independent directors and four senior officials from the bank (including the CEO and DCEO, among others), which adds strength to its board profile.

Experienced fund supervisors and management team – The company has appointed a set of experienced fund supervisors for its proposed MF scheme. The supervisors have extensive experience in diverse sectors. Hence, the pooling of such expert resources, together with the experienced management team, is expected to remain a positive for sound fund management practices. However, the extent of involvement of the supervisors in managing the scheme is not clearly mandated through a legal framework and hence, remains a rating concern.

Improvement in banking sector liquidity and sharp market upswing – Some of the provisions in the monetary policy for FY2021 and SEBON's annual plans for the year have benefitted the market. Major changes in the monetary policy include provisions that increased the banking sector's liquidity and resulted in a sharp reduction in interest rates. Additionally, restructuring/refinancing facilities have been provided for the Covid-19 impacted borrowers. These provisions are likely to lower the asset quality and profitability impact on BFIs, which comprise >60% of the market capitalisation. Further, the flexibility in margin lending norms has induced the recent sharp improvements in the market (NEPSE has reported ~70% growth in the last six months). However, the market levels at the time of entry of the proposed scheme would remain crucial in determining its NAV growth trend in the initial periods.

SEBON has also 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 stipulates book-building method for the initial public offering (IPO), introduces trade instruments including index fund, equity derivatives, municipal bonds, etc., promote open-ended schemes as well as initiates short selling practices. All of these are likely to increase the 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. This is also evident from the multiple IPOs in pipeline from various sectors. The mandatory regulatory allocation to MFs in IPOs (which are mostly at par so far) is likely to benefit the NAV of the proposed scheme.

Credit challenges

Evolving economic impact of Covid-19 and volatile operating environment – 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 has been improving post reopening on June 29, 2020, after elongated Covid-19-induced trading halts. However, the sustainability of the same remains to be seen. Additionally, recent unanticipated political turmoil (dissolution of parliament) and the ensuing political uncertainty could also impact the stock market and overall operating environment for MFs. RBBMBL would face challenges in making prudent investment decisions amid the uncertain economic outlook.

No track record in MF management; proposed scheme details yet to be finalised – RBBMBL proposes to shortly launch its first close-ended MF scheme, which is currently in the planning stage. Detailed investment and sectoral diversification strategies are also yet to be finalised. Hence, the company's stance in maintaining a well-balanced, fundamentally strong portfolio, through sound investment and risk management practices, would remain a key monitorable. The earliest MF entrants to the market (now mostly matured) were partly benefitted by sizeable market upswings; later schemes have not yet been able to replicate a similar performance—a general trend across most AMCs. RBBMBL has limited experience in fund management as it has been managing only its own investments and providing portfolio management services to limited clients so far. The market levels at the entry time of the proposed MF scheme would also remain crucial in determining its initial NAV trajectory. Hence, the company's ability to maintain a good NAV growth trend for its first proposed MF scheme, while adhering to its investment policies and regulations, remains to be seen.

Developing stage of mutual fund industry – The MF industry in Nepal is still developing with only 23 MF schemes (including one open-ended) being launched within a span of eight years. The performance of the earlier schemes had benefitted by the index up-stick during their tenure. Based on the operational 18 schemes, the overall industry's assets under management (AUM) were ~NPR 21 billion as of mid-November 2020 (average NAV of NPR 11.91 per unit). The secondary market is also evolving and is yet to stabilise with adequate market depth and diverse market participants. The low depth of the NEPSE remains a concern in terms of the 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 – The Nepalese stock market is dominated by financial sector companies, which have ~70-75% share in market capitalisation in the recent times. The schemes launched so far mostly make equity investments through the primary and the secondary market, predominantly in banks and financial institutions. Given the lack of depth in the Nepalese equity markets, the ability of the schemes to liquidate the portfolio closer to their valuation could also be a challenge. Further, the scope for investment and risk diversification (both industry-wise and instrument-wise) is limited, as the market for bonds and other fixed income securities is nascent. Given this concern, the AMC's ability to protect the NAV could remain a challenge. Hence, the company's ability to maintain prudent asset allocation (i.e., a mix of equities, fixed income investments and cash), in line with the market movements, would drive the scheme's performance.

Low attraction of MF schemes among general investors – As of now, the MF schemes are mostly subscribed by institutional investors such as banks, insurance companies, retirement funds, and investment companies; while the participation of retail investors has remained low so far. This constrains the ability of the MF schemes to build a diversified and a granular investor base, which could provide a sustainable growth to the industry. Most of the recent MF offerings have also witnessed an undersubscription trend. In the secondary market (NEPSE), these MF schemes are usually traded at a discount in comparison to their NAV and the trading volume remain low. Additionally, given the limited scale of the AUM, the industry's ability to attract quality human resources 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 January 2016, RBB Merchant Banking Limited is a wholly-owned subsidiary of Rastriya Banijya Bank Limited. At present, RBBMBL is involved in issue management, underwriting, share registration services etc. The company proposes to provide fund management and depository services (as per the Mutual Fund Regulation, 2010) to its proposed close-ended MF scheme. The company reported a profit of ~NPR 11 million in FY2020 (~69% YoY growth) over an asset base of ~NPR 222 million as of mid-July 2020.

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