NIBL Ace Capital Limited: Rating upgraded to [ICRANP] AMC Quality 3+

February 8, 2021

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

Rating action

ICRA Nepal has upgraded the fund management quality rating (FMQR) of NIBL Ace Capital Limited (NIBL Ace) to [ICRANP] AMC Quality 3+ (AMC 3+; pronounced ICRA NP asset management company quality three plus) from [ICRANP] AMC Quality 3 (AMC 3; pronounced ICRA NP asset management company quality three). The rating indicates adequate assurance on management quality.

Rationale

The rating upgrade factors in the company's increasing track record in mutual fund (MF) management (first scheme operational since January 2015) with it currently managing three MF schemes, including the first open-ended MF scheme under the current regulatory framework. NIBL Ace has also been able to improve the returns of the schemes in recent periods, all of which have reported fair annualised returns, relative to the respective time of their launch. In the recent years, the secondary market has become increasingly conducive for active market participants like MF schemes, mainly with the rising number of individual/institutional investors (including the recent entry of a large stock dealer company), rising number of listed companies from the non-financial sector and increasing access to online trading. This also remains a rating positive in terms of expected improvements in market depth and liquidity. The rating action also considers the company's adequately established organisational structure and the satisfactory investor service practices/processes followed by it, while adhering to the regulatory guidelines and investment policies. The rating further draws comfort from the full ownership and continued technical support of Nepal Investment Bank Limited (NIBL), a Class 'A' commercial bank in Nepal (rated [ICRANP-IR] A). Its experienced fund supervisors and senior board/management team, involved in the supervision and management of the schemes, also provide comfort.

Nonetheless, the rating is constrained by the evolving nature of the MF industry itself, along with the evolving economic impact of the Covid-19 pandemic and the recent political turmoil. These factors could impact the economic growth pattern and hence, the market's assessment of these events would have a bearing on the funds' performance. Though the market index (Nepal Stock Exchange - NEPSE) has been on an improving trend in the recent months, the sustainability of the same remains to be seen. The Monetary Policy and policies of the Securities Board of Nepal (SEBON) for FY2021 have provided some impetus for market stability/growth. The ability of asset management companies (AMCs) to maintain portfolio diversification is also limited as the benchmark index is still 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 schemes' performance. Further, the debt market is still shallow, thereby limiting 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 continuously make prudent investment decisions through sound corporate governance practices and maintain a healthy growth in the net assets value (NAV) would remain a key rating sensitivity.

Key rating drivers

Strengths

Strong ownership profile – NIBL Ace is a wholly-owned subsidiary of NIBL (the sponsor). ICRA Nepal takes comfort from the sponsor's commitment to its subsidiary AMC, as demonstrated by the sharing of its strong brand name with the subsidiary along with the seed investment (~14–28%) in its MF schemes. The sponsor's extensive track record and experienced management reflect positively on the AMC's operations. NIBL Ace benefits from the sponsor in the form of technical/legal assistance and oversight-related functions. Apart from other experienced independent board members, the company's board includes three senior officials from the bank, which adds strength to its board profile.

Fair track record in fund management – NIBL Ace has been managing two close-ended MF schemes and an open-ended scheme so far with another close-ended MF scheme in the pipeline. Its first scheme (NIBL Samriddhi Fund) was issued in January 2015 with a tenure of seven years. This scheme was able to report modest annualised growth in its NAV till mid-January 2021 (NAV of NPR 13.87 against a face value of NPR 10, after having distributed a total of ~64% dividends till date; annualised growth of ~17%). The second scheme, NIBL Pragati Fund, a highly equity-oriented scheme, was issued in January 2017 with a seven-year tenure. This scheme had been impacted by market downturns since its launch, until the recent market uptick in the last few months (NAV was NPR 14.32 as of mid-January 2021 with no dividends so far; annualised growth of ~11%). The third scheme, i.e. NIBL Sahabhagita Fund, an open-ended scheme, was launched in June 2019 and reported NAV of NPR 13.95 as of mid-January 2021 (annualised growth of ~29%, although performance over a longer time frame and in the scenario of elongated market downturn remains to be seen). Since the market has already witnessed substantial increase, the timeline of further equity investments (~30–50% invested in equity as of mid-January 2021 against the target of 75–95%) would remain crucial for the NAV growth trend going forward.

Experienced fund supervisors and management team – The company has a set of experienced fund supervisors for its MF schemes. The supervisors have vast experience 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. However, the experienced and stable senior management team provides comfort. The fund manager has continuously focused on selection of fundamentally sound scrips through thorough research, which also remains a positive.

Regulatory support for development of MF industry and financial markets – Some of the provisions in the monetary policy for FY2021 and SEBON's annual plans for the year has benefitted the market. A major change in monetary policy includes provisions that have increased the banking sector's liquidity and have resulted in sharp reduction in interest rates as of now. Additionally, restructuring/refinancing facilities have been provided for the pandemic-impacted borrowers. This would lower the asset quality and profitability impact on BFIs, which comprise ~55% of the market capitalisation. This, along with flexibility in margin lending norms, has induced recent sharp improvements in the market (NEPSE has reported ~68% growth in the last six months). However, the market levels at the time of entry of the proposed scheme NIBL Samriddhi Fund–II would remain crucial in determining its NAV growth trend in the initial periods.

SEBON's plans of initiating fully automated trading, promoting liquidity of debentures as well as Government treasury bills/bonds, and issue licences to stock dealers, etc. are also likely to boost the market. Further, the policy stipulates allowing the book-building method for the initial public offering (IPO), come up with new trade instruments, including index fund, equity derivatives, municipal bonds etc., promote open-ended schemes as well as initiate 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. 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) has benefited the NAV of the MF schemes.

Challenges

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 stock price performances. Contrary to general expectations, the capital market has been improving since re-opening from June 29, 2020, after the prolonged Covid-19-induced trading halts. However, the sustainability of the same remains to be seen. Additionally, the recent unanticipated political turmoil (dissolution of the Parliament) and the ensuing political uncertainty could impact the stock market and the overall operating environment for MFs. NIBL Ace would be facing challenges in making prudent investment decisions amid the uncertain economic outlook. However, the banking sector's liquidity is prone to reduction as the economy returns to normalcy and the demand for credit picks up. Any sharp reduction in liquidity could lead to near-term market corrections, and hence, provide good reinvestment opportunities for the operational schemes, all of which are currently cash heavy.

Sectoral-concentration risks – After the recent exits from profitable sectors/scrips, the equity investments of the close-ended schemes are slightly concentrated in the hydropower, microfinance and insurance sectors. The total share of these sectors was ~40–45% for both close-ended schemes (in terms of cost price) as of mid-January 2021 against ~30% share in market capitalisation. These sectors still have higher price-to-earnings (P/E) and price-to-book (P/B) multiples and are hence, more susceptible to market volatility, thereby increasing the portfolio risk. Prudent scrip selection will remain imperative, going forward, for incremental fund performance.

MF industry itself in developing stage – 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 benefitted from the index uptick during their tenure. Based on the operational 18 schemes, the overall industry's assets under management (AUM) stood at ~NPR 25 billion as of mid-January 2021 (average NAV of NPR 14.27 per unit). The secondary market is also evolving and is yet to stabilise with adequate depth and diverse 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 fees for AMCs, 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 still dominated by the financial sector, with ~70–75% share in market capitalisation in the recent times. The schemes launched till now mostly make equity investments through the primary and secondary markets, predominantly in banks and financial institutions. Given the lack of depth in Nepalese equity markets, the ability of the schemes to liquidate the portfolio closer to their valuation could also be a challenge. Further, there is limited scope for investment and risk diversification (both industry-wise and instrument-wise), as it is a nascent market for bonds and other fixed income securities. Given this concern, the AMC's ability to protect the NAV could remain a challenge. The company's ability to maintain prudent asset allocation (i.e., a mix of equities, fixed income investments and cash), in line with the anticipated market movements, would drive the schemes' performance.

Low attraction of MF schemes among investors, albeit improving in recent periods – 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. This constrains the ability of the schemes to build a diversified and granular investor base, which could provide a sustainable growth to the industry. Most of the recent MF offerings have witnessed a marginal oversubscription trend; these schemes are usually traded at a discount at NEPSE compared to their NAV while the trading volume remains low. Hence, the company's ability to increase investor participation in its open-ended scheme (issued size can go up to the approved limit of NPR 500 million against NPR 200 million issued initially) and to maintain adequate liquidity levels to cater to large exits, if any, remains to be seen. However, the AMC has been able to increase this scheme's size to ~NPR 300 million through additions to investor base since its launch. Nonetheless, given the limited scale of the industry's AUM, the industry's ability to attract quality human resources remains average compared to the banking industry, as the investment banking industry is still in 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 MF schemes or of volatility in the returns.

Links to applicable criteria:
Fund Management Quality Rating Methodology

About the company

NIBL Capital Markets Limited was incorporated in 2011 as a wholly-owned merchant banking subsidiary of Nepal Investment Bank Limited. The company's name was changed to NIBL Ace Capital Limited post the merger with Ace Capital Limited in February 2018. It is licensed by the Securities Board of Nepal (SEBON) to work as an investment banker (including services as mutual fund, private placement, portfolio management) and as a merchant banker (including services as issue management, depository participant, registrar to share (RTS) and underwriting services). NIBL Ace has obtained a depository participant's licence in addition to a fund manager's licence from SEBON and is currently acting in both capacities for its three MF schemes. The company reported a net profit of ~NPR 63 million in FY2020 (~2% YoY growth) on an asset base of NPR 1,139 million as of mid-July 2020.

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