NIC Asia Capital Limited: Rating reaffirmed

April 19, 2021

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

Rating action

ICRA Nepal has reaffirmed the FMQR of [ICRANP] AMC Quality 3 (AMC 3; pronounced ICRA NP Asset Management Company Quality Three) assigned to NIC Asia Capital Limited (NICAC). The rating indicates adequate assurance on management quality.

Rationale

The rating reaffirmation continues to draw comfort from the full ownership in NICAC by NIC Asia Bank[1] and the technical support that the former receives from the latter by virtue of a technical support service agreement. Its experienced fund supervisors and board members as well as a stable management team, involved in the supervision and management of the schemes, also provide comfort. In addition, the company's three operational schemes (two close-ended and one open-ended) have been able to register good growth trend in their net asset value (NAV) over the last few quarters, aided by the recent market upswings. Since the market has already reported sharp growth, the timeline of further investments would drive the fund performance trajectory over the near term. In the recent years, the secondary market has become increasingly conducive for active market participants like mutual fund (MF) schemes, mainly with the rising number of individual/institutional investors (including the recent entry of a large stock dealer company) as well as listed companies from the non-financial sector and increasing access to online trading. This also remains a rating positive in terms of the expected improvement in market depth and liquidity. Additionally, the ongoing/proposed improvements in the capital market and the regulatory framework remain positives for market development and hence, fund returns.

Nonetheless, the rating is constrained by the company's recent investment philosophies of having a higher chunk of investments in slightly risky/volatile sectors, including microfinance/insurance segments as well as fixed deposits/debentures in non-investment grade companies. The company has also been aggressive in terms of assets under management (AUM) growth by launching new schemes (proposes to launch its fourth scheme shortly) despite its limited track record in fund management (first fund launched in March 2018). The rating is also limited by the developing stage of the MF industry itself, along with the evolving economic impact of the Covid-19 pandemic and the ongoing 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 improving in the recent quarters, the sustainability of the same remains to be seen. 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 change 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, 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 NAV would remain a key rating sensitivity.

Key rating drivers

Strengths

Ownership profile – The company is a wholly-owned subsidiary of NIC Asia Bank Limited (NIC; the sponsor). ICRA Nepal takes some comfort from the sponsor's commitment to its subsidiary AMC as demonstrated by the sharing of its brand name with the subsidiary, along with seed investment (~14–15%) in its MF schemes. NICAC benefits from the sponsor in

[1] *A class A commercial bank rated IR-BBB+ for issuer rating by ICRA Nepal.*

the form of technical/legal assistance and oversight-related functions. Apart from the experienced independent board members, the company's board includes two senior officials from the bank, which adds strength to its board profile and provides assurance on corporate governance.

Healthy performance of operational MF schemes so far – The company is managing two close-ended and one open-ended MF schemes as of now with its first scheme, i.e. NIC Asia Growth Fund (NICGF), issued in March 2018 with a tenure of seven years. This scheme has reported a NAV of NPR 16.60 as on mid-March 2021 (against face value of NPR 10) reflecting into a healthy annualised growth of ~29% since its launch (including 22% cash dividend distributed so far). This return trend remains largely similar to the growth in NEPSE over the same period. NICAC's second MF scheme, i.e. NIC Asia Balanced Fund (NICBF), a 10-year tenured scheme, was issued in July 2019. With a NAV of NPR 15.56 as of mid-March 2021, its annualised NAV growth till that date was ~39%, while the benchmark NEPSE index grew by ~57% during the same period. NICAC's third MF scheme, i.e. NIC Asia Dynamic Debt Fund (open-ended), was launched in November 2020 and targets higher investment in bonds and debentures (up to 65%). The NAV of this scheme was NPR 10.86 as on mid-March 2021, with ~9% growth since its launch against ~25% growth in NEPSE during the same period.

Experienced fund supervisors and directors/management team – For its MF schemes, the company has a set of experienced fund supervisors, who have extensive experience in diverse sectors. Hence, the pooling of such expert resources remains a positive for sound fund management practices. Contrary to most peers, the AMC has segregated the investment and risk management functions, with the risk management being driven by a director-led committee remaining a rating positive. NICAC's experienced and stable management team also provide comfort.

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 have benefitted the market. Major changes in the Monetary Policy include provisions that have increased the banking sector's liquidity and have resulted in a sharp reduction in the interest rates as of now. This, along with the flexibility in margin lending norms, has induced the recent sharp improvement in the market (NEPSE has reported ~57% growth in the six months ending in mid-March 2021).

SEBON's plans of initiating fully automated trading, promoting the liquidity of debentures as well as Government treasury bills/bonds, and issuing licences to stock dealers, etc., are also likely to boost the market. Further, the book-building method has been allowed for initial public offerings (IPOs), with plans to come up with new trade instruments (including index funds, 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 promoting 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 the pipeline from various sectors, mainly through book-building method. The mandatory regulatory allocation to MFs in IPOs (which are mostly at par so far) has benefited the NAV of the MF schemes, especially for AMCs having lower number of operational schemes.

Challenges

Limited track record in fund management – NICAC is one of the new players in the Nepalese MF industry. Its first scheme became operational since March 2018 and the total AUM of all its three operational schemes is at ~NPR 3 billion as of mid-March 2021. The fund performance has remained good so far, mainly aided by the sharp market upswings since the launch of all its schemes. Hence, the AMC's ability to make prudent asset allocation (i.e. mix of equities, fixed income investment and cash), in line with market movements and maintain a healthy growth in NAV over a longer timeframe remains to be seen. Further, the market is already at historic high levels with irrational/largely non-fundamental growth in the last few quarters. Hence, the index levels at the time of entry of the proposed scheme, NIC Asia Select-30, would remain crucial for determining its NAV growth trend in the initial years.

High chunk of investments in volatile and risky segments – The company has maintained a high chunk of its investments along volatile sectors like insurance and microfinance sectors, across its most schemes. Compared to other sectors, these usually have high P/E, P/B multiples and have witnessed high price fluctuations in the past. The first two schemes had ~35–37% exposure in these segments as of mid-March 2021 against ~26% share in market capitalisation. The recent scheme, however, had ~75% of equity investments along this sector, albeit on a small equity investment base of NPR 61 million, at cost as of mid-March 2021 (in a total initial corpus of ~NPR 500 million). Rating concerns are further elevated by the fact that a sizeable chunk of the fixed deposit and debenture investments across most schemes, were along non-investment grade companies (as per their external ratings). The debt-focused third scheme had ~49% of its debenture investment book in such companies as of mid-March 2021. The current regulations do not restrict or prescribe a cap for such investments, which remains a rating concern. The exposure was also very high for the latest scheme on account of its small debenture investment book (NPR 57 million), the scheme's limited track record and non-availability of debentures in the secondary market, as per demand. Low liquidity of debentures also remains a concern as this open-ended scheme would be investing up to 65% of its corpus herein. Hence, the company's ability to manage the liquidity in case of redemption pressure, remains to be seen.

Volatile operating environment – The impact of Covid-19 on the economy and its facets are still uncertain with the country's economic growth rate sharply impacted by the initial phase of the pandemic. The rising second wave of the pandemic could further deter the economy and have a near-term impact on stock price performances. Despite this, the capital market has reported sharp improvement in the recent quarters. Hence, the sustainability of the same remains to be seen. Additionally, the ongoing political turmoil could impact the stock market and the overall operating environment for MFs. NICAC would be facing challenges in making prudent investment decisions amid the uncertain economic outlook. Further, the restructuring/refinancing facilities provided to pandemic-impacted borrowers have deferred the asset quality impact for the banks. Hence, it could pose future challenges on the profitability of the banking sector, which still comprises ~52% of the market capitalisation. Hence, market returns from the sector.

MF industry itself in developing stage – The MF industry in Nepal is still developing with only 27 MF schemes (including two open-ended) being launched within a span of around eight years (two of these being launched after mid-March 2021). The performance of the earlier schemes benefitted from the index uptick during their tenure. Based on the operational 20 schemes as of mid-March 2021, the overall industry's AUM stood at ~NPR 29.5 billion (industry average NAV of NPR 15.42 per unit). The secondary market is also evolving and is yet to stabilise with adequate depth and diverse participants. The low depth of 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, could encourage these to scale up operations, a likely positive for the capital market in the longer term.

Limited investment diversification avenues so far; expected to gradually improve – The Nepalese stock market is still dominated by the banking sector, with ~52% 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 these sectors. 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. Though some new large cap companies have been recently added to NEPSE, most of these are again from the financial sector. Under the current conducive regulations, the overall sectoral diversification is expected to improve as the companies from the non-financial sector gradually go public. 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, MF schemes are mostly subscribed by institutional investors like banks, insurance companies, retirement funds, investment companies, etc., while the participation of retail investors remains low. 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 are witnessing a marginal oversubscription trend. These schemes are usually traded at a ~20–25% discount on NEPSE compared to their NAV, while the trading volume usually remains low. The AMC would also have to add adequately experienced manpower to manage the upcoming scheme. Additionally, given the limited scale of its 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 mutual fund schemes or of volatility in its returns.

Links to applicable criteria
[Fund Management Quality Rating Methodology]

About the company

NIC Asia Capital Limited (NICAC) was incorporated in 2016 as a wholly-owned subsidiary of NIC Asia Bank Limited. The company is licensed by the Securities Board of Nepal 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 and underwriting services). NICAC has obtained a depository participant's license in addition to the fund manager's license from SEBON. As of mid-March 2021, NICAC is managing three mutual fund schemes, viz. NIC Asia Growth Fund with initial corpus of NPR 835 million (NAV of NPR 16.60), NIC Asia Balanced fund with initial corpus of NPR 755 million (NAV of NPR 15.56) and NIC Asia Dynamic Debt Fund (NAV of NPR 10.86). NICAC reported a net profit of ~NPR 43 million for FY2020 (~100% YoY growth) over an asset base of NPR 363 million as of mid-July 2020.

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About ICRA Nepal Limited

ICRA Nepal Limited, the first credit rating agency of Nepal, is a subsidiary of ICRA Limited (ICRA) of India. It was licensed by the Securities Board of Nepal (SEBON) on October 3, 2012. ICRA Nepal is supported by ICRA Limited through a technical support services agreement, which envisages ICRA helping ICRA Nepal in areas such as rating process and methodologies, analytical software, research, training, and technical and analytical skill augmentation.

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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