Swastik Laghubitta Bittiya Sanstha Limited: [ICRANP-IR] B+ assigned and placed on Watch with Negative Implications

October 09, 2023

Summary of rating action:

Facility/Instrument	Rated Amount	Rating Action
Issuer Rating	NA	[ICRANP-IR] B+@*; **assigned and placed on Watch with Negative Implications**;

** The symbol '@' denotes Rating Watch with Negative Implications. Please refer here for further details on rating watch and its implications.*

Rating action

ICRA Nepal has assigned an issuer rating of [ICRANP-IR] B+ to Swastik Laghubitta Bittiya Sanstha Limited (SLBSL or the company) and placed the rating on Watch with Negative Implications. Issuers with this rating are at a high risk of default regarding the timely servicing of financial obligations. The rating is only an opinion on the general creditworthiness of the rated entity and is not specific to any debt instrument. The sign of + (plus) or – (minus) attributed to the rating symbol indicates their relative position within the concerned rating categories.

The rating has been placed on Watch with Negative Implications, considering the ongoing stress on the net interest margins and deterioration in the asset quality of SLBSL (albeit in line with the industry). The increased cost of borrowings along with the lending cap of 15% have put pressure on the interest margins of the company. Further, the challenging economic conditions and inflation impacted the marginal profile of the borrowers and diminished the repayment capacity, which led to the recent deterioration in the asset quality. The incremental regulatory changes or the ability of MFI players to cope with the ongoing stress will remain under focus.

Rationale

The rating remains constrained by the company's modest asset quality with gross non-performing loans (NPLs) of 3.49% as of mid-July 2023, despite having rescheduled/restructured ~25% of the portfolio in Q4 FY2023. The impact of the ongoing economic slowdown on the repayment capacity of the industry's marginal borrower profile accentuates the concern on asset quality, especially considering SLBSL's higher chunk of delinquencies in the 60-90 days bucket at ~6% as of mid-July 2023. The recent spike in slippage lowered SLBSL's provision cover and weakened its solvency ratio (Net NPA/net worth) to ~24% as of mid-July 2023. The rating action also factors in the sustained pressure on the company's interest margins due to the increased cost of funds, while the regulatory lending cap continues to be at 15% for the micro finance institutions (MFIs), thus leading to sharp moderation in profitability. The rating also remains constrained by the company's relatively smaller scale of operations, coupled with major portfolio degrowth during FY2023. In addition, its geographically concentrated business and the limited experience of the board members in the MFI sector, which is intensely fragmented/competitive, further constrain the rating. Moreover, the Central Bank's directive to the bank and financial institutions (BFI's) capping the risk premium on loans towards MFIs at 2%, is likely to discourage lending to MFIs, adding to the liquidity concerns for the industry.

Nonetheless, the rating factors in the positive impact of the recent portfolio degrowth on the company's capitalisation profile [capital to risk (weighted) assets ratio (CRAR) of 11.65% as of mid-July 2023, against the minimum regulatory requirement of 8%], which is expected to be further supported by the proposed initial public offer (IPO). SLBSL's relatively lower average ticket size and credit insurance of its entire loan portfolio also remain the rating positives. Going forward, SLBSL's ability to improve its asset quality indicators will remain a key rating sensitivity. Further, the company's ability to generate adequate operating profits amid the lending rate cap and high borrowing rates will remain among the key rating factors.

Key rating drivers

Credit strengths

Satisfactory capitalisation profile – The CRAR of the company stood at 11.65% as of mid-July 2023 (improved from 8.29% as of mid-July 2022, mainly on account of portfolio decline during the year) remains adequate against the regulatory minimum of 8%. This is expected to be further supported by the proposed IPO. The company's gearing also remained moderate at ~8 times as of mid-July 2023, against the regulatory maximum of 30 times. However, the moderate-to-weak profitability outlook for the sector would remain a near-term challenge.

Low average ticket size and insured portfolio – The company has been maintaining a relatively lower average ticket size of ~NPR 79,000 as of mid-July 2023 against the industry average of ~NPR 125,000, remaining well within the regulatory ceiling for the first-cycle borrowers. SLBSL has insured its entire portfolio with the deposit and credit guarantee fund (DCGF), which provides compensation at 75% of the outstanding balance in case of default. Further, the insured loans require provision only at 25% of the actual provision rate, decreasing the provision expenses and supporting its profitability profile to an extent.

Credit challenges

Deteriorated asset quality – SLBSL's asset quality deteriorated with gross NPLs of 3.49% as of mid-July 2023 as against 1.26% as of mid-July 2022. The NPLs had reached historically high levels of 12.71% as of mid-April 2023 and the improvements during Q4 FY2023 were mainly benefitted by restructuring of a sizeable chunk of loan book (~25%) after the relaxations introduced by the Central Bank. Though the 0+ days overdue portfolio remains controlled at ~10% as of mid-July 2023 (~21% as of mid-April-2023), a major chunk of these, i.e., ~60% remains close to the NPL bucket (i.e., 60-90 days), which raises major concern. The company's provision coverage remains low at ~22%, aided by the benefit of credit insured with DCGF. However, this results in a weak solvency ratio of ~24% as of mid-July 2023. Further, the recovery from DCGF remains limited/largely untested and could result in liquidity mismatches as the claim on overdue loans can only be filed after the completion of repayment tenure. SLBSL's ability to improve the asset quality remains to be seen amid the challenging economic outlook stressing the repayment capacity of borrowers.

Weak profitability amid declining interest margins and increased credit cost – The company remains heavily dependent on bank borrowings (~73%) for its operations, amid a low deposit base owing to the relatively low track record of operations. This exposes the company's margins to the increase in borrowing rates, given the 15% lending rate cap for MFI players. SLBSL's cost of funds increased to 10.54% in FY2023 (8.77% in FY2022) owing to the sharp increase in borrowing costs from BFIs. Thus, the company's net interest margins (NIMs) declined to 4.36% in FY2023 from 5.86% in FY2022. Pressure on NIMs, along with a decline in credit portfolio by ~27%, relatively higher operating expense ratio (4.99% for FY2023) and asset quality pressures, led to a decline in its return indicators with return on assets of 0.55% and return on net worth of 6.31% in FY2023 (1.02% and 14.05%, respectively in FY2022). The company's near-term profitability outlook also remains weak amid the continued margin pressure and the expected further deterioration in asset quality.

Limited track record, scale and branch network – SLBSL commenced its microfinance activities in March 2019 as a province-level class-D microfinance company licensed by Nepal Rastra Bank (NRB). The company has its operations concentrated in twelve branches across four districts (out of licensed eight districts in Madhesh Province). The relatively smaller scale of operation with a limited network base amid the regulatory action limiting branch expansion in the near term, exposes the company to stiff competition from multiple MFIs and BFIs operating in those districts. The lack of economies of scale could impact the company's operating profitability over the medium term. The limited experience of the board members in the microfinance sector also remains a major rating concern.

Exposed to regulatory risks – Regulatory risks remain high for the MFI sector, given its direct impact on funding sources and profit margins. The regulation capping the MFI's lending rate at 15% and fees at 1.5% strained the profitability of the entire industry, especially following the rise in bank borrowing rates in the last 12-18 months. The recent regulation restricting banks from charging more than a 2% premium over the base rate for wholesale lending to MFIs, discouraged BFIs from lending to MFIs beyond the regulatory minimum threshold, thereby affecting the easy availability of funds for MFI operations. Additionally, the relatively lower regulatory capital requirements (8%) despite lending to risky segments also remain a rating concern.

Moreover, a liberal ceiling for MFI lending by the NRB (unsecured loan of up to NPR 5 lakh for new borrowers that can increase to NPR 7 lakh after two years of good repayment record and secured loans of up to NPR 7 lakh for new borrowers), along with the absence of a centralised credit bureau for MFIs until recent past and high competition from new-age MFIs, led to aggressive growth in the industry in recent years. This resulted in major weakening of the industry's asset quality during unfavourable operating/economic conditions like the present. The recent directives restricting borrowings from multiple MFIs and enforcing single-loan limits, post the operation of the centralised credit information system for MFIs, could mitigate the asset quality concerns to an extent in the long term, which remain a positive.

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

Links to applicable criteria:
Issuer Rating Methodology
Credit Rating Methodologies for Non-banking Finance Companies

Company Profile

Incorporated in October 2018, Swastik Laghubitta Bittiya Sanstha Limited (SLBSL) initiated its commercial operations as a province-level (Madhesh province) class-D microfinance institution from March 2019. SLBSL is promoted by 25 individual shareholders. The registered and corporate office of SLBSL is in Lahan, Siraha, Nepal. SLBSL reported net profit of ~NPR 3.5 million for FY2023 (YoY decline of ~50%) over an asset base of NPR 535 million as of mid-July 2023. SLBSL's gross NPLs stood at 3.49% and CRAR at 11.65% during the same period.

Key financial indicators

Year ending on	Mid-July 2021 (Audited)	Mid-July 2022 (Audited)	Mid-July 2023 (Provisional)
Number of members	12,170	13,514	13,480
Credit portfolio (NPR million)	562	693	508
Number of borrowers	8,210	8,525	6,397
Average ticket size (NPR)	68,424	81,347	79,416

Year ending on	Mid-July 2021 (Audited)	Mid-July 2022 (Audited)	Mid-July 2023 (Provisional)
Number of branches	12	12	12
Deposits (NPR million)	109	190	125
Deposit to loan ratio	19%	27%	25%
Gross NPLs	0.78%	1.26%	3.49%
Operating ratios			
Yield on Average Loans	15.08%	15.09%	14.64%
Cost of Avg. Int. Bearing Funds	6.19%	8.77%	10.54%
Net Interest Margin / Average Total Assets	7.86%	5.86%	4.36%
Non-interest income/ Average Total Assets	3.15%	1.28%	1.81%
Operating expenses / Average Total Assets	6.20%	4.67%	4.99%
Credit Prov. & Write-offs / Average Total Assets	-0.22%	1.06%	0.40%
Profit After Tax / Average Total Assets	3.98%	1.02%	0.55%
Profit After Tax / Average Net worth	54.09%	14.05%	6.31%
Capitalisation ratios			
Capital adequacy ratio	8.05%	8.29%	11.65%
Gearing [(deposits+ borrowing)/ net-worth] times	12.14	12.60	7.88
Borrowing/ net worth (times)	9.82	8.99	5.72

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About ICRA Nepal Limited

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