Siddhartha Capital Limited: Rating reaffirmed

October 09, 2023

Summary of rating action:

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) to Siddhartha Capital Limited (SCL or the company). The rating indicates adequate assurance on management quality.

Rationale

The rating reaffirmation factors in the company's relatively long track record in mutual fund (MF) management, along with the presence of experienced fund supervisors and board/management team. The rating also continues to draw comfort from the majority ownership and continued technical support of Siddhartha Bank Limited (rated at [ICRANP-IR] BBB+). This, along with the sharply corrected market levels and funds availability to diversify further for the company's recently launched scheme/ its growing open-ended scheme, are expected to help SCL in reporting improved investment performance over the medium term. Further, the relatively long tenure for currently operational close ended schemes could help offset short term impact of market downturn. In recent years, the secondary market is also becoming increasingly conducive for active market participants like MF schemes, mainly with the growing number of individual/institutional investors and the rising number of listed companies from the non-financial sector (albeit mostly from the hydropower sector). The recent/planned improvement measures in the capital market and the regulatory framework remain the long-term positives for market development and hence the fund returns.

Nonetheless, the rating remains constrained by the relatively modest investment performance of the company's MF schemes (despite slight improvement since last rating), primarily due to the largely stagnant benchmark index (NEPSE). While the schemes' performance remains largely comparable to the trends in NEPSE, continuation of a volatile operating environment with tight banking sector liquidity, rising fiscal deficit, volatile regulatory/political outlook etc. remain the incremental challenges. Additionally, periodic non-fundamental upswings in certain volatile segments impedes the fund managers' ability to report better growth compared to the benchmark, while investing in fundamentally sound scrips. These concerns are accentuated by weakening asset quality and profitability outlook for the banks and financial institutions (BFIs), which are among the largest sectors in NEPSE and accordingly SCL's schemes also have sizeable exposures therein. As of now, there are limited portfolio diversification avenues amid the shallow debt market and the continued dominance of the financial sector, which limits the fund manager's ability to manage the evolving risks in fund management. Going forward, the company's ability to timely identify the market trends and accordingly maintain a prudent investment mix while continuing the requisite corporate governance practices and maintaining healthy growth in the net assets value (NAV) for its existing/proposed schemes, would remain the key rating sensitivities.

Key rating drivers

Rating strengths

Relatively long track record in fund management – SCL was the first company to issue an MF scheme in 2012 after the Mutual Fund Regulation, 2010 was rolled out. The company has launched six MF schemes so far (two of these already matured), SCL's ability to gradually increase its assets under management (AUM) remains a positive for maintaining adequately experienced resources for managing the multiple schemes with varied investment objectives.

Ownership profile and experienced fund supervisors/management team – The company is a 51% subsidiary of Siddhartha Bank Limited (sponsor), and the sponsor's commitment to its subsidiary AMC is demonstrated by the shared brand name and the seed investment (15% or more) in its MF schemes. The long track record and experienced management of the sponsor continues to reflect positively on the AMC's operations in the form of technical/legal assistance and oversight-related functions. SCL also has a seasoned team of fund supervisors and experienced management team to oversee its MF schemes, which remains a positive.

Regulatory support for development of MF industry and financial markets – The regulatory changes/reform measures in recent years have led to increased investor participation in the market. Further, the regulations promoting the entry of non-financial sector companies in the secondary market is likely to help increase the diversification avenues over the long run (multiple IPOs in pipeline from various sectors to issue IPO at premium and some companies also opting for the book building method). The Securities Board of Nepal (SEBON) and NEPSE have plans of promoting the liquidity of debentures/government treasury bills/bonds and issuing licences to stock dealers, initiating entry of non-resident Nepali to capital market etc. Also, new trade instruments (including index funds, equity derivatives, municipal bonds, etc) as well as short selling practices are likely to be initiated. Additionally, factors like the recent addition of brokers, increasing access to online trading, etc. could also remain the positives in terms of improving market depth and liquidity/stability. The mandatory regulatory allocation to MFs in IPOs (mostly at par so far) along with tax exemption on their income has also benefited the NAV of the MF schemes to an extent. Hence, any moderation in such regulatory support would impact incremental fund performance.

Rating challenges

Moderate investment performance – As of now, SCL is operating four equity-oriented MF schemes including three close-ended MF schemes, viz. Siddhartha Equity Fund (SEF), Siddhartha Investment Growth Scheme2I (SIGS-2), and Siddhartha Investment Growth Scheme-3 (SIGS-3), in addition to a one open-ended MF scheme, viz. Siddhartha Systematic Investment Scheme (SSIS). Amid the backdrop of major correction in NEPSE (~36% drop till mid-August 2023 from its peak of ~3,200 points in August 2021), SEF and SIGS-2 have reported annualized growth (including dividends) at ~9% and ~12% respectively since their launch till mid-August 2023 (~10% and 14%, when last rated) as against ~6% and ~13% growth in the benchmark. While SSIS has been able to report lower de-growth compared to NEPSE (~5% annualized degrowth till mid-August 2023 against ~17% degrowth in NEPSE), SIGS-3 was able to report lower growth vis-à-vis the NEPSE since its launch till mid-August 2023 (~10% vs. ~34%). Accordingly, the company's schemes' performance remains moderate among peers. Nonetheless, the recently launched SIGS-3 still had ~38% of its corpus in free cash, which along with growing AUM for SSIS can be invested at the current corrected levels and hence could help SCL report better investment performance for these. However, prudent scrip selection and conducive timing of new scheme launches will remain imperative going forward.

Continuation of the volatile operating environment – Tight liquidity in banking, inflationary economic outlook and the ensuing demand slowdown across most sectors, along with the volatile political outlook and weakening in the public revenue/spending pattern, has been adding challenges to the operating environment of MFs. The rising non-performing loans (NPLs) for banks and microfinance companies is likely to continue impacting their sectoral performance in NEPSE The microfinance sector has also been facing acute profitability pressures amid the regulatory lending rate cap at 15%, which has been continued despite sharp spike in their borrowing rates. Further, the changes in tax regime introduced by the recent budget announcement (mainly with regards to taxation of equity offerings at premium, bargain gain on mergers/acquisitions, capital gain taxation etc.) could impact incremental market sentiments, thereby affecting the incremental fund performance. However, the consolidated exposure of company's schemes in the impacted sectors remains relatively largely comparable the industry average as well as the benchmark index, which provides some comfort. Nonetheless, the company's MF schemes still continue to have higher than benchmark exposure in volatile segments like insurance, hydropower and microfinance, despite marginal reduction from last rating, which remains a concern. Furthermore, unexpectedly large redemption pressure because of unforeseeable market events may pose liquidity challenges in SCL's open-ended scheme and could be a key risk to the fund performance as this may necessitate quick exits from equity at lower/corrected prices.

Developing stage of mutual fund industry with moderate attraction among investors – The MF industry in Nepal itself is in developing phase, with track record of just over a decade and ~1.4% share in the total market capitalization of NEPSE as of mid-August 2023. The early MF entrants (now matured), including SCL's two matured schemes, reported good return trends as their performances were benefitted by the index uptick during their tenure. However, the late entrants have been struggling to replicate similar performance as seen in the industry average NAV of 10.41 per unit for the operational MF schemes as of mid-August 2023 (industry AUM of ~NPR 44 billion). The secondary market is also evolving and is yet to stabilize with adequate depth and diverse participants. The subscription rate of MFs still remains much lower compared (mostly undersubscribed during the current correction phase) to the recent IPOs from sectors like microfinance, hotels and hydropower. Generally lower participation from retail investors constrains the ability of the schemes to build a diversified and granular investor base, which could provide sustainable growth to the industry.

Limited investment diversification avenues so far; expected to gradually improve – The Nepalese stock market continues to remain dominated by the financial sector, with~63% share in the market capitalization as of mid-August 2023. Though the capitalization of financial sector has been gradually declining in recent years, most new entrants have been from the hydropower sector wherein the price performance are largely speculative while the underlying fundamentals remain weak across most players. As a result, MFs still have to rely heavily on the financial sector and hence any changes in the regulatory framework impacting the banking sector liquidity impacts the market and thus the schemes' performances. 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. Overall, sectoral diversification is only expected to improve as companies from non-financial sector gradually go public under the current conducive regulations.

Link to previous detailed rating rationale:
Rationale_Siddhartha Capital_FMQR-Surveillance_Sept-2022

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. The rating is also not indicative of the liquidity of the MF schemes or the AMC's ability to timely liquidate its open-ended scheme.

Link to the 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 is largely held by individual shareholders associated as promoters of the parent 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 a 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 four MF schemes. SCL reported a profit of NPR 56 million for FY2022 (~47% YoY decline, amid sizeable mark to market losses as opposed to sizeable gains during FY2021) over an asset base of NPR 541 million as of mid-July 2022. As per provisional numbers of FY2023, SCL has reported profit of ~NPR 60 million over an asset base of NPR 523 million as of mid-July 2023.

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