Kumari Capital Limited: Rating reaffirmed

March 27, 2024

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 of **[ICRANP] AMC Quality 3** (pronounced ICRA NP Asset Management Company Quality Three) to Kumari Capital Limited (KCL). The rating indicates adequate assurance on management quality.

Rationale

The rating reaffirmation factors in the satisfactory performance of the company's operational mutual fund (MF) schemes and its experienced fund supervisors/board of directors. The rating also derives comfort from the continued technical support by Kumari Bank Limited (KCL's sole promoter, recently downgraded to [ICRANP-IR] BBB-@), despite the moderation in financial profile of the bank. 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, the rising number of listed companies from the non-financial sector (albeit mostly from the hydropower sector) and increasing access to online trading. This also remains a rating positive in terms of improving market depth and liquidity, thereby supporting the company's ability to manage adequate liquidity in its open-ended scheme. The recent/planned regulatory measures also remain the long-term positives for market development and hence the fund returns.

Nonetheless, the rating remains constrained by the company's relatively moderate track record in MF management (since March 2021) and the operational challenges amid largely sustained corrected levels of benchmark index (NEPSE) in the last 12-18 months. Additionally, while the low-cap liquid stocks and sectors have registered secular upswing rallies, the participation of large-cap in the rallies have remained subdued which has affected the overall performance of institutional fund managers, impeding their performance vis-à-vis the market. Furthermore, most of KCL's schemes have been launched at lower market levels, thus benefiting their initial performance. Hence, the company's ability to protect the assets under management (AUM) in case of elongated market corrections remains to be seen. Additionally, a slightly higher redemption pressures in its open-ended scheme (vis-à-vis fresh subscriptions) also remains a concern amid largely untested liquidity management practices. Most of KCL's schemes have also invested slightly higher chunk in equity as against their prospectus targets, while ~10% of their corpus were invested in fixed income securities of non-investment grade companies, which also remain the rating concerns. As of now, the limited sectoral diversification avenues amid the shallow debt market and continued dominance of the financial sector in NEPSE limits the fund manager's ability to manage the evolving risks in fund management. Going forward, KCL's ability to maintain prudent asset allocation in line with anticipated market trends, along with the continuation of sound corporate governance practices and similar/better net assets value (NAV) trajectory would remain the key rating sensitivities.

Key rating drivers

Rating strengths

Satisfactory fund performance so far – The company currently manages three closed-ended MF schemes[1] and an open-ended scheme (viz. Kumari Sunaulo Lagani Yojana - KSLY, launched in April 2023). KEF, KDBY, and KSLY have been able to report annualised NAV growth (including dividends) of around 6%, 9% and 13% respectively since their launch till mid-February 2024 as compared to NEPSE's annualised growth of -6%, 5% and 11%, respectively over the same period. The recent portfolio shift from financial sectors (~41% as of mid-February 2024 against ~65% as of mid-January 2023) could

[1] *Kumari Equity Fund (KEF, launched in March 2021), Kumari Dhanabriddhi Yojana (KDBY, launched in June 2022), and Kumari Sabal Yojana (KSY, launched in February 2024).*

support NAV trajectory amid sustained asset quality, capitalisation and profitability pressures being faced by this sector. Prudent scrip selection will remain imperative for incremental fund performance.

Full ownership and continued support from the parent bank and experienced fund supervisors – KCL is a fully-owned subsidiary of Kumari Bank Limited (rated [ICRANP-IR] BBB-@). Despite the recent moderation in the bank's financial profile (leading to series of rating corrections), ICRA Nepal continues to take comfort from the sponsor's (parent bank's) commitment to its subsidiary asset management company (AMC), as demonstrated by the sharing of its brand name along with the seed investment (~15-19%) in its MF schemes. KCL benefits from the sponsor in the form of technical/legal assistance and oversight-related functions. The company's board of directors comprises of two independent directors and three senior officials from the bank, which adds strength to its board profile. Experienced management team and pooling of a set of experienced fund supervisors having long experience across diverse sectors remains a positive for sound investment practices.

Regulatory support for development of MF industry and financial markets – The regulatory changes and reform measures in recent years have led to increased investor participation in the market. Additionally, regulatory changes promoting the entry of non-financial sector companies in the secondary market have gradually increased diversification avenues (multiple IPOs in pipeline from various sectors and few companies also opting for the book building method). The Securities Board of Nepal (SEBON) and the NEPSE have plans to enhance the liquidity of debentures/ government treasury bills/bonds and initiate the 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 further. Furthermore, factors such as the recent addition of brokers/stock dealers, increasing access to online trading and others, could also contribute positively to improving market depth and liquidity/stability.

Rating challenges

Moderate track record in MF management – The company is among the new players in the Nepalese MF industry with its first scheme being operational since March 2021 and the total AUM of ~NPR 2.8 billion as of mid-February 2024. Though the fund performance has remained good so far, the company is yet to demonstrate similar performance in case of a major/sustained market downturn, while adhering to investment policies. While the asset management company's (AMC's) timing of schemes (mostly during corrected market levels) remains a positive, higher asset allocation in equity (vis-à-vis the targets in prospectus) also remains a concern. Further, the mandatory IPO allocation for MFs have also aided the investment performance. Amid the company's aggressive pace of new scheme launches, the company's initial schemes have reported gradually increasing investments in other MFs (mainly owing to cross subscription practices in the industry), which might impact their NAV as the MFs are usually traded at a discount.

Volatile operating environment could impact NAV trajectory – NEPSE index has largely remained rangebound between ~1,800-2,300 levels in the last 12-18 months following the sharp correction post the peak of ~3,200 points in August 2021. Sluggish economy/demand trends, along with volatile political/regulatory outlook and weakening in the public revenue/spending pattern, have been adding challenges to the operating environment of MFs. The rising asset quality/profitability pressures for banks and microfinance companies also remains a major concern. While, the timing would be favorable for making additional investments for KSY at the corrected market levels, challenges remain in making prudent investment decisions and protecting the NAV of other schemes in case of elongated market downfall. Nonetheless, increasing influx of remittance, with low fresh credit demand amidst economic stagnation, has resulted in built up of liquidity in the banking system, which could provide some support to the market trends.

Limited investment diversification avenues so far; expected to gradually improve – The Nepalese stock market is still dominated by financial sector companies, with ~65% share in market capitalization as of mid-February 2024. Though the capitalization of financial sector has been gradually declining in recent years, most new entrants have been from the hydropower sector (~16% of market cap as of mid-February 2024), wherein the price performance are mostly speculative while the underlying fundamentals remain weak across most players. As a result, MFs still have to rely heavily on financial sector and hence any changes in the regulatory framework impacting the banking sector liquidity/asset quality/profitability 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. Further, ~10% of the consolidated corpus of the operational schemes as of mid-February 2024 were invested in non-investment grade fixed income securities. Hence, the AMC's ability to protect the NAV remains a challenge.

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 as of mid-February 2024. The early MF entrants (now matured) 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 10.28 per unit for the operational 43 MF schemes as of mid-February 2024 (industry's AUM of ~NPR 47 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 (mostly undersubscribed during the current index correction phase) compared to the recent IPOs from sectors like manufacturing and hydropower. Generally lower participation from retail investors constrains the AMC's ability to build a diversified and granular investor base, which could provide sustainable growth to the industry. KCL's open-ended scheme also had relatively higher reliance on institutional investors, thus leading to relatively higher redemption trend. These schemes are also usually traded at a discount compared to their NAVs while the trading volume remains low. Additionally, the liquidity management practices for open-end scheme remains largely untested for bullish market (wherein there could be profit booking trend or redemption owing to relatively lower growth in MF sector), which also remains a rating concern.

Link to the previous rating rationale:
Rationale_Kumari-Capital-Limited_FMQR-Surveillance_March-2023

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. 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 2017, Kumari Capital Limited is a wholly owned subsidiary of Kumari Bank Limited. At present, KCL is involved in merchant banking, corporate advisory, mutual fund management, depository participant and asset management services. KCL has an MF depository license and a fund manager license from SEBON (as per the Mutual Fund Regulation, 2010) and is acting in both capacities for its operational open-ended and close-ended schemes. The company reported a net profit of ~NPR 69 million for FY2023 (~216% YoY growth) over an asset base of ~NPR 498 million as of mid-July 2023.

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