

RBB Merchant Banking Limited: Rating reaffirmed

March 27, 2024

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

Rationale

The rating reaffirmation factors in the company's strong parentage, being a 100% subsidiary of Rastriya Banijya Bank Limited (RBB, a state-owned commercial bank). By virtue of its parentage, four senior officials from the bank (including the Deputy Chief Executive Officer - DCEO) are present in the company's board, which augurs well for the governance aspects while managing its mutual fund (MF) schemes. The rating action also remains supported from the adequate controls in place for the investment process, as well as the company's experienced supervisors and management team. In recent years, the secondary market is 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 sectors and increasing access to online trading. Additionally, the proposed improvements in the capital market and regulatory framework remain long-term positives for market development and hence fund returns.

Nonetheless, the rating remains constrained by the company's low track record in the fund management (since July 2021), along with the increased operational challenges amid the largely sustained corrected levels of benchmark (NEPSE) over last 12-18 months. Further, the weakening asset quality/profitability outlook for the banking and microfinance sectors with the company's sizeable exposure herein, along with the volatile regulatory/political outlook, also remain the rating concerns. While the current corrected market levels could benefit the initial performance of the recently launched scheme, the company's first MF scheme's performance would largely depend upon the market trends and prudent deployment of remaining cash balance amid sizeable unrealized losses in its equity investments. As of now, the sectoral diversification avenues still remain limited, amid shallow debt market and continued dominance of the financial sector in NEPSE, thus impacting the fund manager's ability to diversify investments as a tool for hedging and managing 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 sound corporate governance practices and maintaining healthy growth in the net assets value (NAV), for its existing/proposed schemes would remain a key rating sensitivity.

Key rating drivers

Rating strengths

Strong ownership profile – RBBMBL is a fully-owned subsidiary of RBB which is almost 100% held by the Government of Nepal and is one of the largest commercial banks in the country. ICRA Nepal takes comfort from the sponsor's (parent bank) commitment to its subsidiary asset management company (AMC), as demonstrated by the sharing of its brand name and extending management support, as required. The sponsor's long track record (>50 years) and the experienced management reflect positively on the AMC's operations. RBBMBL benefits from the sponsor in the form of technical/legal assistance and oversight-related functions. The company's board of directors comprises two independent directors and four senior officials from the bank (including the DCEO), which adds strength to its board profile.

Experienced fund supervisors and management team – The company has a set of experienced fund supervisors who have long experience in diverse sectors (~2-3 decades), for providing guidance to its MF operations. Hence, the pooling of such expert resources along with the experienced management team remain the positives for sound fund management practices, notwithstanding the recent turnaround in the fund management team.

Regulatory support for development of the equity and financial markets – The regulatory changes and reform measures in recent years have led to increased investor participation in the market. Among others, 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, mainly through the book building method). The Securities Board of Nepal (SEBON) and NEPSE have plans of further stabilizing the automated trading system, promoting the liquidity of debentures as well as government treasury bills/bonds, 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 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 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. Hence, any moderation in such regulatory support would have a bearing over the incremental fund performance.

Rating challenges

Moderate fund performance so far – RBBMBL's first scheme viz. RBBMF1, was launched in July 2021 when the NEPSE was around 3,000 levels. Affected by the sharp market corrections shortly after its launch, this scheme reported a NAV of NPR 10.04 as of mid-February 2024 (with a face value of NPR 10), i.e. nominal growth in NAV against ~13% de-growth in NEPSE over the same period. With moderate fund performance, the scheme has not been able to distribute any dividend so far. However, the scheme had ~15% cash balance as of mid-February 2024, which could be invested further at currently corrected market levels. The company's second MF scheme viz. RBBMF2 (launched in May 2023) has reported slightly better fund performance with NAV of NPR 10.79 as of mid-February 2024 (i.e. ~11% annualised growth against ~10% growth in NEPSE), supported mainly by the timing of its launch at corrected market levels. This scheme also had sizeable free cash on same date, which could provide good investment opportunity in case of further corrections in market. Nonetheless, prudent scrip selection amid the uncertain economic outlook will remain crucial for enhancing fund performance.

Low track record in MF management – RBBMBL is one of the new players in the Nepalese MF industry with its first scheme being operational since July 2021 and the total assets under management (AUM) at ~NPR 2.2 billion as of mid-February 2024. The AMC's ability to make prudent asset allocation (i.e., mix of equities, fixed income investment and cash), in line with anticipated market movements, and maintain decent fund performance over a longer timeframe, remains to be seen. As compared to the benchmark index, the schemes had also maintained a high chunk of their investments in sectors like hydropower, insurance and microfinance. Compared to other sectors, these usually have high price-to-earnings (P/E) and price-to-book value (P/B) multiples and have witnessed high price fluctuations in the past. Hence, any major fluctuations in these sectors could impact the schemes' NAV trajectory.

Volatile operating environment could impact NAV trajectory – NEPSE's largest sector i.e. banking has been facing acute asset quality/profitability pressures in recent times after the end of all Covid related moratoriums/relaxations, slowdown in fresh credit growth after implementation of working capital guidelines, volatile interest rates, slowdown in demand across most segments (amid inflationary outlook). Another major sector of attraction for the MF industry i.e. the microfinance sector has also been facing similar pressures, which has been further exacerbated by the regulatory lending rate cap at 15%, which has been continued despite sharp spike in their borrowing rates during FY2023. These factors are likely to impact their sectoral performances within NEPSE and hence the fund performance. Additionally, the political outlook also remains volatile with the recent shift in coalition parties while the government's revenue collection trend has also moderated, leading to major slowdown in the public capital spending pattern. This has further affected the overall operating environment of MFs. Following these challenges, the NEPSE has continued to remain rangebound in highly corrected levels over the last one year (~33% correction from highest point ever, to ~2,101 levels as of mid-February 2024; volatile movements in between with occasional spikes and dips, mostly in segments like hydropower.

Moderate investor attraction in MF industry, albeit improving – 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, thus impacting investor attraction. The secondary market is also evolving and is yet to stabilize with adequate depth and diverse participants. 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. These schemes are also usually traded at a discount compared to their NAVs (~10-20%) while the trading volume remains nominal.

Limited investment diversification avenues so far; expected to gradually improve – The Nepalese stock market is still dominated by financial sector companies, with ~66% share in market capitalisation as of mid-February 2024. Though the capitalisation of financial sector has been gradually declining in recent years, most of the new entrants have been from the hydropower sector (~16% of market cap as of mid-February 2024), wherein the price performance is volatile while the underlying fundamentals remain weak across most players. As a result, most of the schemes still have to rely heavily on the financial sector companies and hence any changes in the regulatory framework or banking 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 remains a challenge, especially in the event of elongated market downturn. Overall, sectoral diversification is only expected to improve as companies from non-financial sector gradually go public under the current conducive regulations.

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.

Link to the applicable criteria:

[Fund Management Quality Rating Methodology](#)

Link to the previous rating rationale:

[RBB-Merchant-Banking-Limited FMQR-Surveillance March-2023](#)

About the company

Established in January 2016, RBB Merchant Banking Limited is a wholly owned subsidiary of Rastriya Banijya Bank Limited. At present, RBBMBL is involved in merchant banking, mutual fund, depository participant and asset management services etc. RBBMBL has obtained mutual fund depository's license in addition to fund manager's license from SEBON (as per the Mutual Fund Regulation, 2010). The company is currently acting in both capacities for its two operational close ended MF schemes i.e., "RBB Mutual Fund 1" and "RBB Mutual Fund 2". The company reported a net profit of ~NPR 29 million in FY2023 (YoY de-growth of ~10%) over an asset base of ~NPR 395 million as of mid-July 2023.

Analyst Contacts

Mr. Rajib Maharjan (Tel No. +977-1-4519910/20)

rajib@icranepal.com

Mr. Pranil Dahal (Tel No. +977-1-4519910/20)

pranil@icranepal.com

Relationship Contacts

Ms. Barsha Shrestha (Tel No. +977-1-4519910/20)

barsha@icranepal.com

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.

For more information, visit www.icranepal.com

ICRA Nepal Limited

Sunrise Bizz Park, 6th Floor, Dillibazar, Kathmandu, Nepal.

Phone: +977-1-4519910/20

Email: info@icranepal.com

Web: www.icranepal.com

All Rights Reserved.

Contents may be used freely with due acknowledgement to ICRA Nepal.

ICRA Nepal ratings should not be treated as recommendation to buy, sell or hold the rated debt instruments. The ICRA Nepal ratings are subject to a process of surveillance which may lead to a revision in ratings. Please visit our website (www.icranepal.com) or contact ICRA Nepal office for the latest information on ICRA Nepal ratings outstanding. All information contained herein has been obtained by ICRA Nepal from sources believed by it to be accurate and reliable. Although reasonable care has been taken to ensure that the information herein is true, such information is provided 'as is' without any warranty of any kind, and ICRA Nepal in particular, makes no representation or warranty, express or implied, as to the accuracy, timeliness or completeness of any such information. All information contained herein must be construed solely as statements of opinion and ICRA Nepal shall not be liable for any losses incurred by users from any use of this publication or its contents.