THE ANALYST

NMB CAPITAL LIMITED

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MARKET UPDATE

- The benchmark index rallied 210 points (i.e. 18.49%) higher during the review period (Mid-November to Mid-February) to close at 1,345.97. The index has been gaining points since the beginning of December, 2019. All sub-indices gained points with Trading sub-index being the best performer followed by Microfinance and Life Insurance sub-indices whereas "Manu. & Pro." sub-index was the worst performer as shown in Table 1. Price of 160 companies advanced while 22 companies declined out of 182 companies traded. Average daily turnover volume surged by 192.2% to NPR 819 million compared to NPR 280 million in the previous review period.
- Commercial Banks posted a YoY growth of 6.9% in their net profit till Q2 FY 19/20 compared to 30.2% in corresponding period of previous FY. The fall in the growth rate of profitability can be attributable to slower credit growth and reduction in interest rate spread. Pressure on net interest margin shall remain as Commercial Banks need to reduce their interest rate spread to 4.4%[1] whereas average spread amongst the Commercial Banks is still 5.1%. Till Q2 FY 19/20, outstanding loans and advances of BFIs increased by 8.6% while deposits at BFIs expanded by 6.1% both figures being the lowest since FY 15/16. The credit to deposit (CD) ratio of Commercial Banks stood at 89.3% at Q2 FY 19/20 while Credit-to-Core Capital and Deposit (CCD) ratio stood at 77.5% compared to a regulatory threshold of 80%[2]. CCD ratio eased marginally due to central bank's newly enacted policy that would allow refinanced loans to be deducted while calculating CCD[3]. Compared to Commercial Banks, Development Banks, Finance Companies, Microfinance Companies and Non-Life Insurance Companies posted a higher YoY growth in their net profit as 21.9%, 39.1%, 40.3% and 22.6% respectively[4]. The overall market traded at a Price to Earnings (PE) ratio of 16.4x compared to 14.5x in previous review period. PE ratio of Commercial Banks, Development Banks, Finance Companies, Microfinance Companies and Non-Life Insurances stands at 13.7x, 11.4x, 11.9x, 23.9x and 26.5x respectively. The PE ratio of Commercial Banks and Finance Companies are below their one-year average PE while the same ratio of Development Banks, Microfinance Companies and Non-Life Insurances are above their one-year average PE.[5]
- Current Account and Balance of Payment improved to a deficit of NPR 84.71 billion and a surplus of NPR 26.65 billion at the end of Q2 FY 19/20 compared to a deficit in both the accounts of NPR 152.16 billion and NPR 63.68 billion respectively last year. Decline in trade deficit and increased remittance inflow has contributed to improvement in these accounts. During the same, export increased by 26.1% and import declined by 4.0%. Increase in export of palm oil resulted in rise of exports while decline in import of MS Billet, Petroleum product and Gold were major contributor to falling imports.[6]

Table 1: Changes in sub-indices during the quarter

Sub-Index	16th November 2019	12th February 2019	Change
Banking	1,042.04	1,153.71	10.72%▲
Dev. Bank	1,544.46	1,828.29	18.38%▲
Finance	565.23	671.13	18.74%▲
Hotels	1,775.48	1,948.98	9.77%▲
Hydro Power	944.36	1,010.68	7.02%▲
Life Insurance	5,015.19	7,534.46	50.23%▲
Manu. & Pro.	2,450.97	2,577.52	5.16%▲
Microfinance	1,492.74	2,322.58	55.59%▲
Non-Life Insurance	4,158.85	6,144.37	47.74%▲
Others	634.43	704.75	11.08%▲
Trading	365.46	808.22	121.15%▲

NMBCL UPDATES

- Promoter Share Auction, of **United Insurance Co. (Nepal) Ltd (UIC).** *Issue Open date: December 19, 2019 – December 26, 2019.*
- Renewal of RTS Agreement, of **Kalika Laghubitta Bittiya Sanstha Ltd (KMCDB)** on *January 13, 2020*.
- Renewal of RTS Agreement, of **Prudential Insurance Company Ltd. (PICL)** on *January 15, 2020*.
- Renewal of RTS Agreement, of **Naya Nepal Laghubitta Bittiya Sanstha Ltd. (NNLB)** on *January 20, 2020.*
- Renewal of RTS Agreement, of **Nagbeli Laghubitta Bittiya Sanstha Ltd. (NBBL)** on *February 9, 2020*.

[1] Nepal Rastra Bank. (2019). *Monetary policy for 2019/20*. Retrieved from https://www.nrb.org.np/ofg/monetary_policy/Monetary_Policy_(in_English)--2019-20_(Full_Text)-new.pdf
[2] Nepal Rastra Bank. (2020). *Banking & Financial Statistics*. Retrieved From https://www.nrb.org.np/bfr/statistics/cms_pdf/Monthly%20Statistics%20_%202076_09%20(Jan%202020).pdf
[3] Nepal Rastra Bank. (2020). *Circular 11-DTI CCD related*. Retrieved from https://www.nrb.org.np/bfr/circular/2076-77/2076_77_For_A_,_B_&_C_Class--Circular_11-DTI_CCD_related-new.pdf
[4] As per unaudited financials published till the end of the review period. The profit figures include data of listed entities only except for commercial banks which include both listed and unlisted institutions.
[5] as per compiled figures by NMBCL
[6] Nepal Rastra Bank (2020). *Current macroeconomic and financial situation of Nepal: Based on six months' data of 2019/20*. Retrieved from https://www.nrb.org.np/ofg/current_macroeconomic/CMEs%20Six%20Months%20Final%20Compilation%20-%20English%202076-77.pdf

INTEREST RATES

During the review period, interbank rate remained below the lower band of interest rate corridor for majority of the period; the interbank rate dropped to as low as 0.42%. The rate however came into upward pressure following the end of the second quarter (Mid-Jan) when sizable deposits went into the state coffers due to tax payment. Interbank rate peak at 5.38% during Mid-Jan which later settled at 4.06% at the end of the review period. During this period, central bank through open market operations mopped up NPR 28 billion worth of liquidity in the first half of the review period whereas NPR 70.2 billion of liquidity were injected through repo (NPR 50.0 billion), overnight repo (NPR 1.2 billion) and SLF (NPR 19.0 billion) in the later half of the review period. Interbank transaction among commercial banks amounted to NPR 415.5 billion.

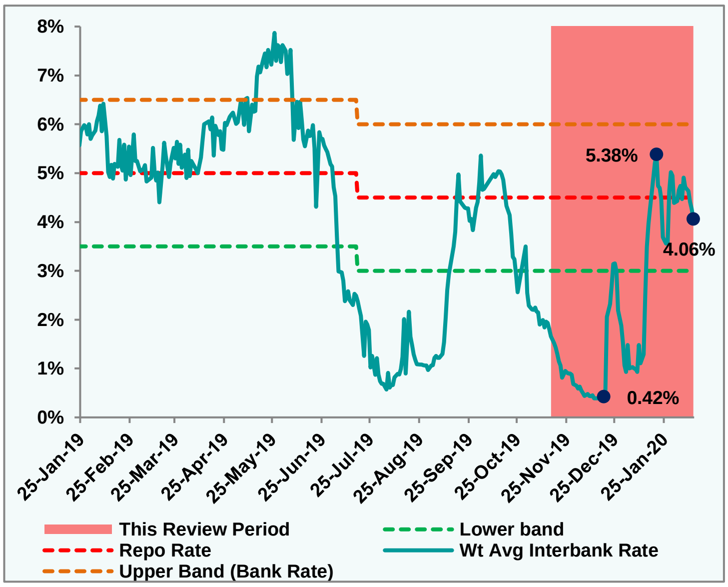

Figure 1: Weighted average interbank rate (Source: NRB)

NRB renewed NPR 52.0 billion worth of treasury bills during the review period meanwhile no fresh issues were issued. Discount rates on treasury bills of 28 days, 91 days, 182 days and 364 days stood at 4.3278%, 3.98%, 4.5730% and 3.9209% as compared to 4.3278%, 3.2014%, 4.1602% and 4.3942% respectively in Mid-November. Government of Nepal (GoN) has planned to raise NPR 195.0 billion through domestic borrowing with issuance of treasury bills and government bonds throughout the FY 19/20[7]. GoN hasn't yet published issuance calender for government bonds and treasury bills for the current FY; in the previous year such issuance was held in the fourth quarter. Such issuance will likely put pressure on discount rate of treasury bills. The discount rate and the interbank rate followed a similar trend during the review period.

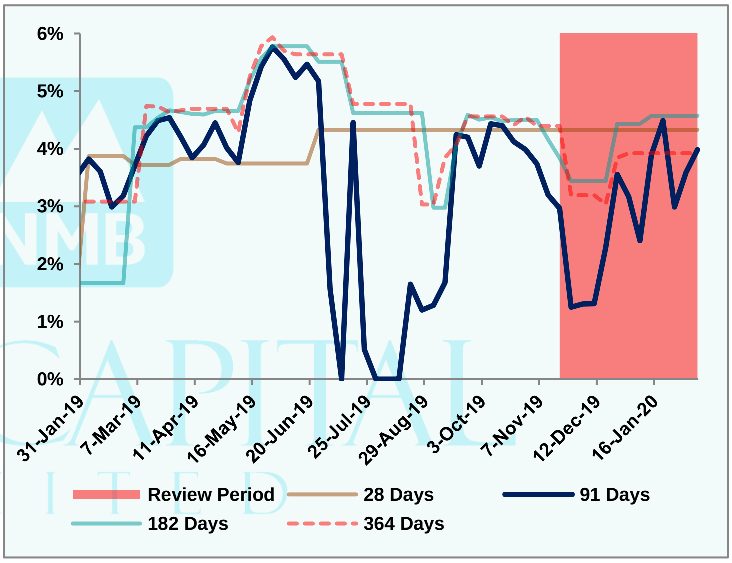

Figure 2: Discount rates of treasury bills (Source: NRB)

Figure 3, below displays average interest rates offered by Commercial Banks on fixed deposits for individual depositors for different tenures at the end of the review period. The dotted line shows average fixed deposit interest rates for respective tenure during Mid-November 2019. Interest rates has remained more or less same due to the ongoing understanding on fixing interest rate among commercial banks.

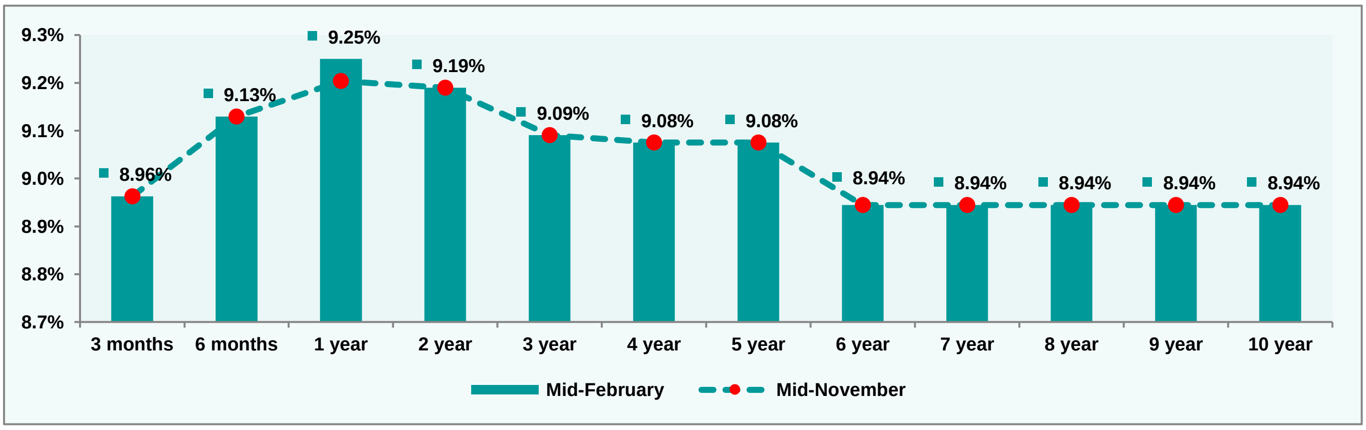

Figure 3: Average interest rates offered by commercial banks in fixed deposits for different tenure

[7] Ministry of Finance. (2019). *Budget speech of fiscal year 2019/20*. Retrieved from https://mof.gov.np/uploads/document/file/budget_speech_website_20190619052055.pdf

NEPSE – TECHNICAL ANALYSIS

Figure 4: Daily chart of NEPSE

The review period experienced a surge in market participants and a significant gain in overall market index. NEPSE Index *(1,345.97, ▲14.49%)* closed 210.02 points higher than the previous review period's close. Though market fell during the earlier days of the review period, the market quickly bounced back following the support at previous low of 1,100 and a bullish divergence in RSI propelled the index as shown in Figure 5. And during this rally, the index was able to break the long reigning long term bearish trend line in Mid-January 2020 with higher transaction volume as shown in Figure 4. Following the breakout, the index has been testing the 2019's high of 1,348. After two unsuccessful attempts, the index is giving it a go for the third time till the end of the review period.

As index rallied from 1,100, moving averages too have rallied; with shorter-term moving averages beating their longer-term counterparts. Moving averages looks bullish as of now. Relative Strength Index[8] (RSI) which settled near the oversold level marched as high as 88 in the overbought level at the peak of the recent rally. While index struggled to break past the 2019's high, RSI fell to 66 as the review period came to an end. Moving Average Convergence and Divergence[9] (MACD) has experienced multiple crossovers with signal line. The Bollinger Band[10] squeeze at the end of the previous review period followed a sudden widening of the band due to the increased volatility.

Figure 5: Daily chart of NEPSE with indicators

The formation of double bottom reversal pattern is clearly visible with two bottoms around 1,100 level and neckline at current level. NEPSE Index closing above this level shall indicate a completion of the double bottom pattern and that too with significant large transaction volume which shall set a target approx. 250 points higher than current level. Also, a close above this level would also mark a high higher than 2019's high which may lay the foundation for a bullish trend given that the market is no longer in a longer-term bearish trend as supported by the aforementioned trendline breakout. A triangle pattern can also be seen forming during the end of the review period. Its breakout shall also decide the index's move in coming days. In case, index shies away from the current level and falls below the 1,270 level, this shall complete the double top pattern with tops at 1,350s level and neckline at 1,270 and set a target of approx. 75 points lower of the neckline.

[8] No. of periods = 14
[9] Periods of 12, 26, 9 is taken for Fast average, Slow average and Signal Average respectively
[10] No. of periods = 20, Width = 4 times the Standard Deviation

SECURITIZATION

Securitization is the process of converting an asset or a pool of assets into securities which can be easily traded in the market. The process of securitization gives asset owner the ability to generate cash by selling the securities hence created through securitization. Securitization started as a source of funding for corporations. For instance, a corporation that has a pool of receivables can convert these receivables into securities through securitization and raise funds through the sale of these securities. Assets used in securitization can be of different nature like housing loans, corporate debts, auto loans, SME loans etc. Securitization differs from secured lending where the assets (the receivables in this case) is pledged at lender to receive funding. In secured lending the fund raised is in the form of debt, whereas in securitization the fund raised is the proceeds from the sale of these securities.

Securitization Process

Consider a Bank as a hypothetical firm that issues loans to its clients. Suppose the bank has outstanding housing loan worth NPR 50 billion and it wants to raise another NPR 10 billion to fund new housing loans. Rather than issuing corporate bonds or raising deposits, the bank can raise this fund through securitization. For this purpose, the bank sets up a legal entity referred to as Special Purpose Vehicle (SPV). The bank sells a pool of housing loans worth NPR 10 billion to this SPV and receives NPR 10 billion in cash. The bank is commonly termed as Originator. The SPV raises this cash from the investors by selling its securities usually as bonds. The bond holders receive interest and principal from the cash flow SPV receives from the pool of housing loans bought from the bank. Since the cash flow for these bonds issued are backed by the assets held by the SPV (housing loans in this case), these bonds are commonly termed as Asset Backed Securities (ABS). These bonds can either be of one class or multiple classes on the basis of seniority of their claims over the cash flow of SPV creating bonds with different risk-return structures. While SPV holds the housing loans, the responsibility of collecting payments from customers, notifying possible delinquent customers and recovering and disposing of the collateral if customer defaults etc. is assigned to an institution called servicer which in most cases is the bank (the institution who has issued the underlying loans) itself.

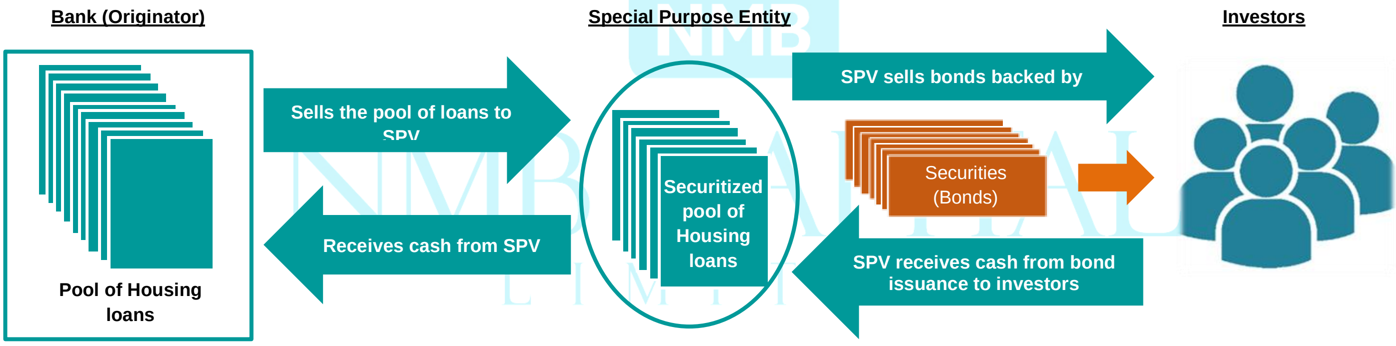

Figure 6: Securitization process

Scope of Securitization

Globally, securitization has important role to play in the economy. While in principle, securitization converts the illiquid assets into securities that can be readily traded in the market, it has lot more to offer. Securitization not only provides corporation a source of funding, it has the potential to reduce the funding cost as well. Let's assume that the aforementioned bank has a credit rating of "B" which is often referred to as rating with a higher risk of default. Thus, if the bank were to issue bond, investor shall seek higher interest rate to commensurate for the lower credit rating. However, bank can raise required fund in lower rates by selling its pool of loans to SPV and then issuing bonds with ratings higher than the bank. The bank is able to do this because of the creation of SPV. Since SPV is a separate legal entity, the credit rating of the bonds issued by it is not affected by the credit worthiness of the bank. Also, since the housing loans are sold to the SPV who later sells them as bonds to the investors, the bank's creditors in case of bank failure has no claim over these housing loans held by the SPV. This gives SPV the ability to issue bonds with credit ratings different from credit rating of the bank. SPV can in fact get the rating it desires in its bonds through enough credit enhancement as suggested by the rating agencies. Credit enhancement is a way to improve credit risk of an entity. There are basically three of credit enhancement techniques. There is originator sponsored credit enhancements such as excess spread (issuing bonds with average rate of 10% while average rate on housing loan is 12% creating excess spread of 2% which is used to cushion the losses protecting the investors), overcollateralization (selling NPR 10.5 billion worth of housing loans to SPV to back NPR 10 billion worth of bond issued such that investors are protected for a loss up to NPR 0.5 billion). These type of credit enhancements are very popular in India. Second, third party credit enhancements where the credit risk is borne by the third party for a fee. And the third is the structural credit enhancement where the risk is redistributed among the different classes of bonds. When one class of bond has senior priority over the cash flow over the another, the bond with senior claim automatically has better credit ratings.

Securitization also plays an important tool in managing corporate risks. The credit risk and the interest rate risk associated with the pool of assets once securitized is no longer faced by the originators. Whether one has sectoral concentration or one want to increase exposure to certain sectors in the portfolio, one can optimize these exposures through the process of securitization. Securitization comes really handy when there is legal requirement to maintain certain exposure to stipulated sectors. Financial institutions can use securitization to optimize the regulatory capital adequacy ratios. BFIs can free up capital by offloading certain portion of their portfolio through securitization which otherwise would have remained in their portfolio in order to meet their capital adequacy ratios. The BFIs with use of securitization can convert these capital-intensive assets (loans) into less capital-intensive source of income such as serving fees.

Securitization in context of Nepal

Although securitization has no footprint in country's financial markets, it sure has reached the discussion table. As a developing country, the need for asset creation is immense while the source for creating these assets are limited. In such scenario, securitization allows banks to offload the loans to free up capital which banks can use to fund other part of the economy. The potential buyers of these bonds may be insurance companies, pension funds, retirement funds, mutual Funds, investment companies, and general public as well. Highest rating bonds can be sold to risk-averse investors like insurance companies, pension funds and retirement funds while other lower rating bonds can be sold to investors with higher risk appetite. Since securitization converts illiquid loan assets into tradable securities, it has the potential to at least lessen the recurring liquidity unease. During the time of such unease, banks can offload some of its loan portfolio from its balance sheet through securitization and free up liquidity and capital creating stability in the financial system. This not only provides banks the flexibility in managing bank's capital adequacy ratios but also in management of asset liability. In the contemporary situation where the central bank is reducing the interest rate spread, securitization can create a source of income through servicing fees of the securitized pool of assets. Further, securitization can attract foreign investors willing to take advantage of the country's economic growth. This provides an easy way to gain exposure to a growing economy for foreign investors than the traditional way that too through securities with desired risk reward structure.

A case for securitization

Nepalese banks work on the "Create and Retain" model (banks issue loans and hold them till maturity), the amount of credit flow to the economy is thus constrained by the ability of the banks to raise the deposit. Therefore, there is always an ongoing debate on whether to direct these credits to infrastructure projects or to the consumer loans like hire purchase loans or housing loans and for a country like Nepal which needs significant investment in infrastructure sector it is always a difficult choice. Against this backdrop, there are retirement funds, pension funds and insurance companies which are perpetually cash heavy but due to unavailability of investment vehicles, mostly rely only on banks deposits (though regulation has allowed insurance companies to invest in infrastructure projects, they have no presence in such investments[11]). Securitization can ease out this predicament by not only creating low risk investment products for these companies but also by freeing funds in banks which can be directed to other infrastructure projects. The total amount of bank deposits of insurance companies, pension funds and retirement funds amounted to NPR 425 billion as of Mid-January 2020[12]. If even 20% of their fixed deposits portfolio can be shifted to the highest-grade longer-term bonds created through securitization, about NPR 85 billion of capital can be freed in the banking system which can be used to fund other projects by the banks. These institutions are better off as they have diversified exposure in their portfolio that too with ratings better than the ratings of the bank they park their deposit at. At the time where banks are having difficulty to find a long-term source of deposits to fund these long-term infrastructure loans, securitization can match these long-term assets to long term liabilities of these insurance companies, pension funds and retirement funds, facilitating both giver and receiver (banks and its counterpart) to better manage their Assets and Liability profile.

Concerns with Securitization

Despite the many benefits of securitization, there are some major concerns with securitization. Since banks can simply create and distribute the loans issued through securitization, it may weaken central bank's control over the

[11] Beema Samiti (2019). *Investment directive for insurer 2075*. Retrieved from http://nib.gov.np/wp-content/uploads/2019/03/Investment-Directive-for-Insurer-2075.pdf

[12] Nepal Rastra Bank (2020). *Current macroeconomic and financial situation: Tables (based on six month data of 2019/20)*. Retrieved from https://www.nrb.org.np/ofg/current_macroeconomic/CMEs%20Six%20Months%20final%20compilation%20-Tables%202076-77.xlsx

flow of credit in the economy. In addition, because securitization allows banks to lend beyond the constraints of capital base, there is an incentive for banks to maintain less capital base which would adversely impact the financial stability of the country. Another concern is that when banks run in the “Create and Distribute” model instead of traditional “Create and Retain” model, the banks may get motivated to enhance the loans’ quantity rather than the quality. When the banks disburse loans, it is likely that they might loan out on the underlying assumption that they can sell these loans through securitization rather than the assumption that the borrower can service these loans in future. These practices can lead to over lending to these sectors ultimately raising asset prices. For instances, excessive securitization of housing loans can unnaturally inflate housing prices. Such practice can contribute to creation of poor securities post securitization. US subprime crises of 2008 and its global impacts are good lesson to learn for enhancing the merits of securitization products.

Conclusion

Since securitization is new to the Nepalese market, establishment of legal, regulatory and accounting framework is necessary. On top of that, addressing the aforementioned concerns of securitization and the inherent nature of Nepalese financial system can help to reap more out of securitization. For instance, Nepalese banking system follows a floating interest rate regime which are linked with the base rate of the bank issuing the loans, the volatility in the cash flow for the securitized pool of loans has to be dealt with as investors seek fixed interest rate on bond issued. It may help to address this issue by either bringing in a third party who guarantees the fixed payment for a fee or by renegotiating with the borrower of the loans to securitized for a fixed interest rate. Or, bonds can also be issued with floating rates that are benchmarked with inflation rate (or interbank rate or T-Bill rates) where the government may facilitate to close the differences between interest rates on the securitized loans and bond’s coupon rate. Also, while allowing foreign investors to invest in these bonds, a lock in period can be introduced to prevent the capital shock during their exits for a small economy like Nepal. To deal with the risk of deteriorating quality of asset created, regulators can make banks to hold these loans on their books for a certain period before securitizing them. For instance, loans issued to infrastructure sector can only be allowed to securitized when they surpass a minimum repayment history after the commercial date of operation. Central bank can stipulate both the nature of the loans and the size of the loans each bank can securitize. This can help central bank to allocate more credit to its priority sectors while reducing the risk uncontrolled credit flow to undesired sectors. For a country like Nepal that is suffering from capital constraints, securitization can help in effective use of the available capital.

CHART OF THE QUARTER

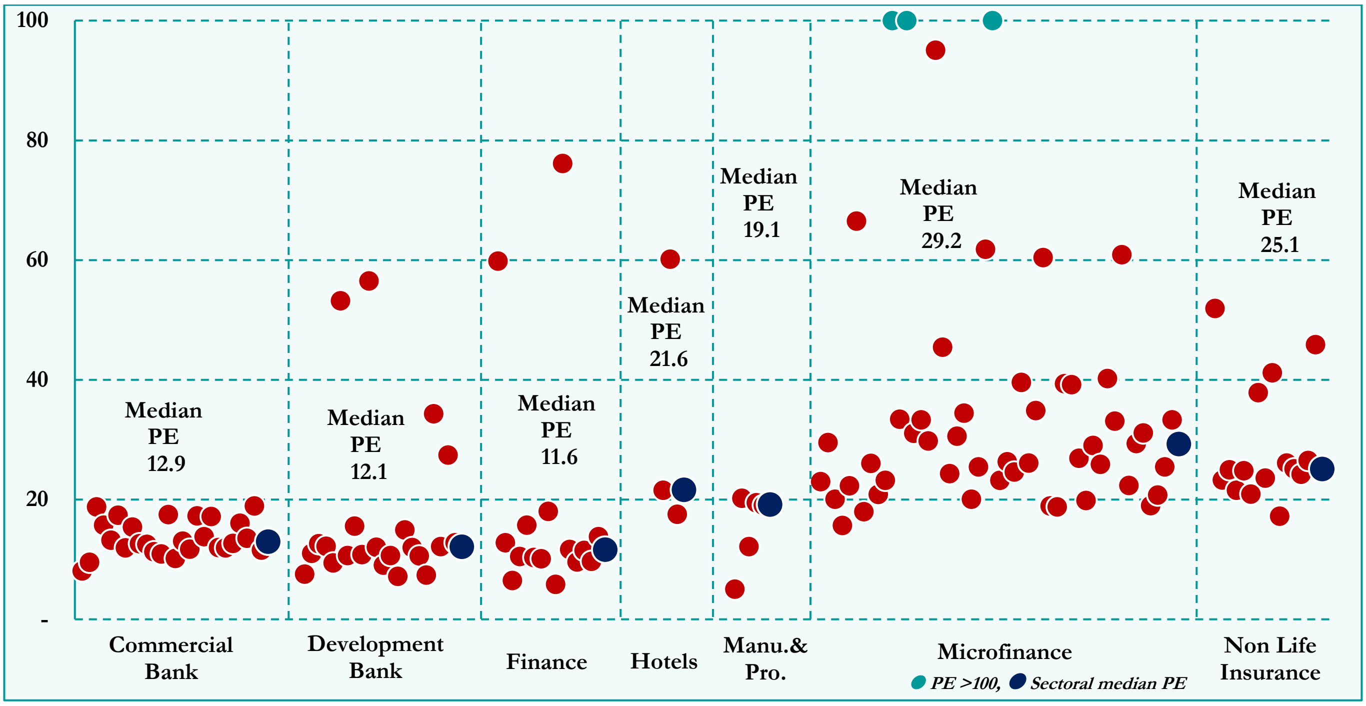

Figure 7: Price to Earnings Ratios as of 12nd February 2020. (Compiled by NMBCL, EPS was calculated using earnings from trailing 4 quarters)

Price to Earnings (PE) ratio of listed companies from different sectors are plotted in the graph shown above. PE ratio of all the listed companies of the aforementioned sectors ranges from 5.1x of Bottlers Nepal (Balaju) Limited (BNL) to 312.3x of Gurans Laghubitta Bittiya Sanstha Limited (GLBSL) at the end of the review period. While PE ratio of the commerical banks seems to cluster around a narrow band, PE ratio of Microfinance seems to scatter around a widest band among the above mentioned sectors. The median PE ratio for each sectors stands at 12.9x, 12.1x, 21.6x,19.1x,29.2x and 25.1x respectively.

NMB Capital Limited

RTS List

S. No	Symbol	Company	Sector
1	BPCL	Butwal Power Company Limited	Hydropower
2	CBBL	Chhimek Laghubitta Bikas Bank Limited	Microfinance
3	CFCL	Central Finance Co. Ltd	Finance
4	EIC	Everest Insurance Co. Ltd.	Non-Life Insurance
5	GLICL	Gurans Life Insurance Company Ltd.	Life Insurance
6	HGI	Himalayan General Insurance Co. Ltd	Non-Life Insurance
7	KMCDB	Kalika Laghubitta Bittiya Sanstha Ltd.	Microfinance
8	NBBL	Nagbeli Laghubitta Bikas Bank Ltd.	Microfinance
9	NNLB	Naya Nepal Laghubitta Bikas Bank Ltd.	Microfinance
10	NHDL	Nepal Hydro Developer Ltd.	Hydropower
11	NMB	NMB Bank Limited	Commercial Bank
12	NMBMF	NMB Microfinance Bittiya Sanstha Ltd.	Microfinance
13	PICL	Prudential Insurance Co. Ltd.	Non-Life Insurance
14	SAPDBL	Saptakoshi Development Bank Ltd.	Development Bank
15	SIL	Siddhartha Insurance Ltd.	Non-Life Insurance
16	SLBBL	Swarojgar Laghubitta Bikas Bank Ltd.	Microfinance
17	NSEWA	Nepal Seva Laghubitta Bittiya Sanstha Ltd.	Microfinance
18	NTC	Nepal Doorsanchar Company Limited[13]	Others
19	NMB50	NMB 50	Mutual Fund Scheme
20	NMBHF1	NMB HYBRID Fund L - I	Mutual Fund Scheme
21	SLBSL	Samudayik Laghubitta Bittiya Sanstha Limited	Microfinance
22	UIC	United Insurance Co. (Nepal) Ltd.	Non-Life Insurance
23	NMBD2085	10% NMB Debenture 2085	Corporate Debenture

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[13] *Cash Dividend Distribution Only*