THE ANALYST

NMB CAPITAL LIMITED

SEPTEMBER, 2020
Vol. 3, Issue 2.

Market Update (Mid-May to Mid-August)

15.8% ↑
NEPSE: 1,391.46

NPR **1.1** Billion
Average daily turnover, 48.5% ↓

227 stocks traded
160 up ↑
49 down ↓

NEPSE Index gained 189.89 points to close at 1,391.46 after market reopened post lockdown.

Sectoral Performance

Best Performer:
29.7% ↑
Life Insurance

Worst Performer:
3.6% ↓
Hotels

NEPSE
PE: 21.8x ↑

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Macroeconomic Update (FY 19/20)

0.5% ↓
Remittance

15.6% ↓
Imports

0.6% ↑
Export

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Liquidity Indicator

7.6% ↓
1Y FD Rate

0.02% ↓
Interbank Rate

CCD Ratio (Credit to Core Capital cum Deposit): **69.6%** ↓

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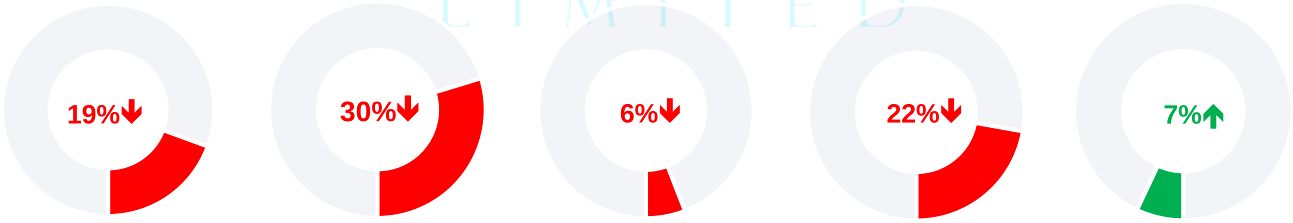
Major Sectoral Earnings (FY 19/20)



Commercial Bank (49.9 vs 61.8 bill) — 19% ↓

Development Bank (3.6 vs 5.2 bill) — 30% ↓

Finance Companies (1.3 vs 1.4 bill) — 6% ↓

Microfinance Companies (4.5 vs 5.8 bill) — 22% ↓

Non-Life Insurance (3.8 vs 3.6 bill) — 7% ↑

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> There's no such thing as a worry-free investment. The trick is to separate the valid worries from the idle worries, and then check the worries against the facts.
>
> \- Peter Lynch

Inside the newsletter

FUNDAMENTAL UPDATE

- During the review period (Mid-May to Mid-August), the market remained closed during the first half as SEBON closed down the market amid the nationwide lockdown. Once market reopened, the benchmark index gained 189.89 points (i.e. 15.8%) to close at 1,391.46. Apart from Hotels sub-index, all sub-indices advanced with Life Insurance sub index gaining the most (Table 1). Among the 227 scrips traded during the review period, prices for 160 scrips closed higher while prices of 49 scrips fell. The average daily turnover fell to NPR 1.1 billion as compared to NPR 2.3 billion during the previous review period - a drop of 48.5%.

Table 1: Changes in sub-indices during the review period

Sub-Indices	13-May-2020	16-Aug-2020	Change
Banking	1,041.50	1,182.37	13.53%▲
Dev. Bank	1,687.73	1,733.31	2.7%▲
Finance	629.23	656.08	4.27%▲
Hotels	1,556.69	1,500.85	3.59%▼
Hydro Power	899.67	949.62	5.55%▲
Life Insurance	6,509.45	8,439.69	29.65%▲
Manu. & Pro.	2,390.64	2,655.37	11.07%▲
Microfinance	2,008.29	2,348.39	16.93%▲
Mutual Fund	9.68	10.62	9.71%▲
Non-Life Insurance	5,142.25	6,603.36	28.41%▲
Others	641.76	808.31	25.95%▲
Trading	751.05	841.34	12.02%▲

- During the current FY, exports increased by 0.6%, import decreased by 15.6% and remittance decreased by 0.5%. Consequently, trade deficit narrowed down by 16.8% compared to expansion of 13.5% a year earlier. Current Account (CA) and BOP both improved compared to the same period previous year. CA deficit stood at NPR 32.1 billion and BOP surplus is at NPR 282.4 billion compared to a deficit of NPR 265.4 billion and NPR 67.4 billion respectively. This surplus of BOP is the largest surplus ever recorded. Gross foreign exchange reserve which had stagnated for more than three years has grown 23.3% compared to pre-lockdown levels[1].

- Nepalese banking system which had been grappling with shortage of loanable funds for more than three years witnessed a respite due to fall in credit demand amid the pandemic which subsequently lowered industry's CCD ratio. CCD ratio of overall BFIs and commercial banks dropped to 69.6% and 69.9% respectively at the end of the current FY.

- The pandemic has further weakened the already weak credit growth for the FY 19/20. Outstanding credit of BFIs grew by 12.4% as compared to an average growth of 21.1% in the past 5 years. Deposit growth however remained at par as compared to past figures - a growth of 17.3% for the FY year as compared to an average growth of 17.8% in the past 5 years.

- Majority of the listed companies saw their profit decline for the year. Commercial Banks, Development Banks and Finance Companies witnessed a YoY decline of 19.4%, 29.7% and 5.9% in their net profit as compared to a growth of 17.4%, 38.7% and 24.3% in the previous year respectively. Microfinance Companies also saw their net profit fall by 22.2% as compared to a growth of 49.7% last year. Net profit of Non-Life Insurance however increased by 7.0%[2]. The overall market's PE ratio has spiked to 21.8x as compared to 15.3x in previous review period due to rising NEPSE Index and falling earnings of listed companies (Figure 1).

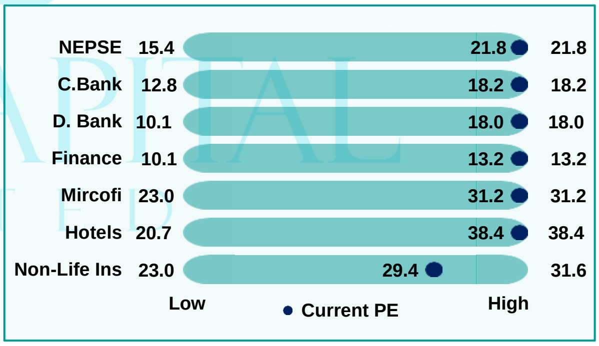

Figure 1: The bar diagram shows the highest PE and lowest PE recorded during the review period for each sector while the dot represents PE at the end of review period

- Major policy changes announced by the monetary policy for the FY 20/21 are as follows[3]:
  - moratorium period for COVID affected borrowers to be 6 - 12 months,
  - LTV ratio of margin nature loans revised from 65% to 70%,
  - limitations on cash dividend outlay to be set,
  - Upper limit on CCD ratio revised from 80% to 85%,
  - Maximum lending rate of MFIs set at 15%
  - Loan servicing fees of BFIs and MFIs be revised lower.

NMBCL UPDATES

- Right Share Issuance and Auction Issuance of **Prudential Insurance Company Ltd. (PICL).** *Issue Open date: Mar 1,2020 – Jul 3, 2020. Auction Issue open date: Jul 27,2020 – Aug 3, 2020.*
- Right Share Issuance of **Gurans Life Insurance Ltd. (GLICL)**. *Issue Open date: Jun 29, 2020. – Jul 19, 2020*
- RTS Agreement of **Forward Community Microfinance Bittiya Sanstha Ltd. (FOWAD)** on *Jul 10, 2020.*
- NMBCL appointed as issue manager for **SBL Debenture 2084** on *Jul 24, 2020*
- Renewal of RTS Agreement, of **Central Finance Co. Ltd. (CFCL)** and **Everest Insurance Co. Ltd. (EIC).**

[1] Nepal Rastra Bank (2020). *Current macroeconomic and financial situation of Nepal: Annual Data of 2019/20*. Retrieved from https://www.nrb.org.np/contents/uploads/2020/08/Current-Macroeconomic-and-Financial-Situation.-English.-Based-on-Annual-data-of-2019.20-1.pdf

[2] As per unaudited financials published till the end of the review period. The figures include data of listed entities only except for commercial banks which include both listed and unlisted institutions.

[3] Nepal Rastra Bank. (2020). *Monetary Policy for 2020/21.*

INTEREST RATES

During the review period, interbank rate plummeted to near zero. The interbank rate which was around 4.73% at Mid-May fell to 0.02% at the end of the review period. Due to low credit outflow and accumulation of liquidity in the banking system interbank rate fell near zero. NRB while injecting NPR 2.7 billion worth of liquidity through SLF, also mopped up NPR 80 billion in excess liquidity through four issues of 7-Day reverse repos during the period. NRB has lowered the repo rate and lower band of Interest Rate Corridor by 50 basis points to 3.0% and 1.0%.

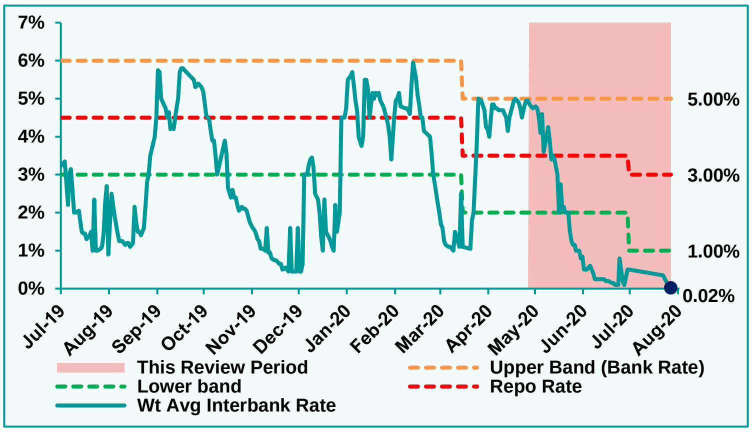

Figure 2: Weighted average interbank rate (Source: NRB)

NRB renewed NPR 67.9 billion and issued fresh NPR 48 billion worth of treasury bills during the review period. Discount rate on latest treasury bills of 28 days, 91 days, 182 days and 364 days stood at 0.0936%, 0.0966%, 1.4350% and 2.2574% compared to 4.3278%, 3.2648%, 4.8322% and 4.9533% respectively in Mid-May. The fall in these discount rates can be attributed to excess liquidity present in the banking system due to weak credit outflow amid the pandemic. Government of Nepal (GoN) has aimed to raise NPR 225 billion through domestic borrowing with issuance of treasury bills and government bonds throughout the FY 19/20.

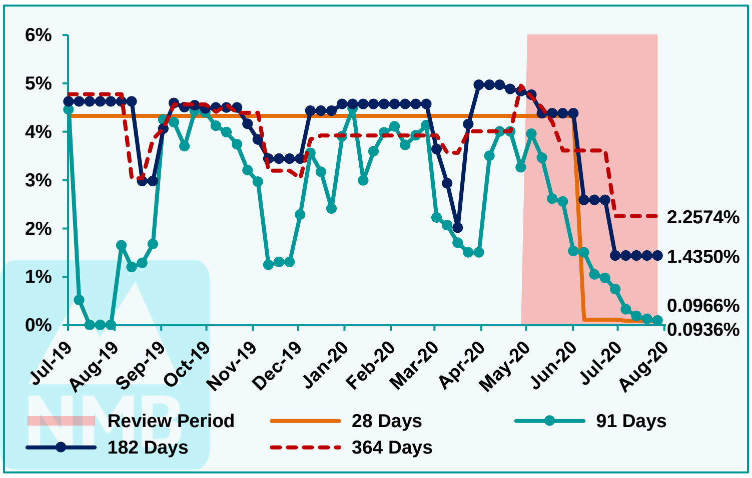

Figure 3: Discount rates of treasury bills (Source: NRB)

Figure 4, below displays average interest rates offered by commercial banks on fixed deposits for individual depositors for different tenures. Interest rates have declined over the review period for all maturities. Average interest rate on 1-year fixed deposit which stood at 8.3% in mid-May has dropped to 7.6% at the end of the review period. While the highest 1-year fixed deposit rate offered by a commercial bank is 8.75%, the lowest rate is 7.25%. Due to the ongoing pandemic, imports have declined significantly. Remittance inflow has remained steady as compared to the fall in imports and has subsequently resulted in rise in foreign exchange reserves. With persistent low demand for credit and accumulation of deposits in the banking system, CCD ratio in commercial banks dropped to 69.9%; 15% below the revised threshold of 85%. If the situation prolongs, interest rates are likely to fall lower in coming days.

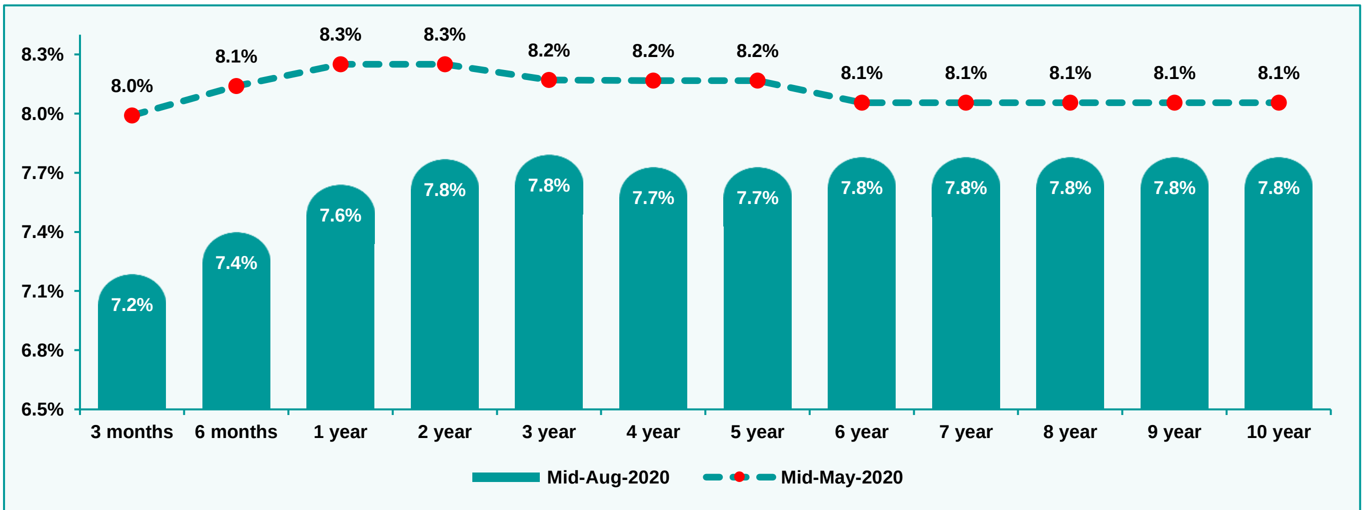

Figure 4: Average interest rates offered by commercial banks in fixed deposits for different tenure (as compiled by NMBCL)

NEPSE – TECHNICAL ANALYSIS

Figure 5: Daily chart of NEPSE

The only secondary market of the country remained closed for half of the review period due to precautionary measure taken by the regulatory body, SEBON. As the market resumed from 29th June, NEPSE Index (***1,391.46,▲15.80%***) rallied to gain some of the lost ground in the pre-lockdown sell-off of early March. The longer-term bearish trendline stood as support for the index nosediving below 1,200 as shown in figure 5. After finding its support, the index marched as high as 1,556 on 20th July breaking the resistance of 1,350s along the way. Since then, the index has been retracing this rally; briefly reaching the 50% Fibonacci retracement level at 1,350s.

Moving averages stayed bullish in the month of July. Shorter term moving average of 8 days (Colored: Green) had been hovering over the longer-term moving average of 20 days (Colored: Red) and 60 days moving average (Dotted blue line). However, at the end of review period, 8 Days moving average has fallen below 20 Days moving average pushing moving averages to the bearish territory. Moving Average Convergence and Divergence[4] (MACD) exhibited a bullish crossover in the negative territory in early July before the rally to 1,550s and exhibited a bullish crossover in positive territory in early August prior to the rally's retracement. Relative Strength Index[5] (RSI) which was in oversold level rose as the index peaked just below the overbought level at 66. From there, RSI gradually declined to settle at 48.23 in the neutral zone at the end of the review period. Transaction voulme is lower as compared to previous review period.

Figure 6: Daily chart of NEPSE with indicators

Technically the support provided by the longer term bearish trendline can be considered a significant development. This rebound of NEPSE from the trendline reaffirms January's breakout of the longer term bearish trendline. Thus, it is now more probable that the market has moved past the three and a half year long bearish trend. Going forward, market participants should be watchful of how the index will fare at 1,350s level. A fall below the level is more likely to head for the immediate support at 1,280s and 1,250s. While on the other hand, if index stays above 1,350s, 1450s can be the immediate target for the index. One can see early signs of a flag like pattern forming in the retracement, however if the pattern does get formed, market participant can use this pattern breakout to anticipate more probable targets for the index.

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4 Periods of 12, 26, 9 is taken for Fast average, Slow average and Signal Average respectively

5 No. of periods = 14

BANKING CONSOLIDATION: PROS AND CONS

Merger in the banking system has been one of the most discussed topics amongst policy makers, regulators and bankers. With various policy incentives, many of the financial institutions have merged. Since NRB introduced Merger by-laws, 196 BFIs including 25 commercial banks have gone through merger and acquisition to form 46 institutions as of 9M FY19/20[6]. Central bank has been offering merger subsidies for banks and financial institutions. In this monetary policy too, central bank has provided breaks on some regulatory thresholds to encourage merger and acquisitions. In addition, the central bank has also intended to commission BFIs controlled directly or indirectly by single family or business house to merge. It is safe to say that the central bank intends to consolidate the financial system so that there exist few but financially sound institutions.

How did we get there?

Though the liberalized economic policies of 1980s paved the way for growth in the financial industry, it was in the 1990s when financial sector really hit its stride. In the two decades between 1992 to 2011, number of BFIs (Class A, B and C) proliferated from 8 to 197[7]. At the end of these two decades, Nepalese banking experienced a liquidity crisis which shook the whole financial system. One of the major causes for the crisis was advocated to be the mushrooming of the BFIs that consequently spawned unhealthy competition in credit mobilization (Chandhan, 2011)[8] and (Bista, 2019)[9]. Many BFIs turned to the realty sector in that period which was booming due to influx of remittance and cheap credit, for quick returns. The crisis heightened in 2011 when Vibor Bikas Bank (now Lumbini Bikas Bank Ltd) knocked on the door of the central bank to provide relief as the lender of last resort. In the aftermath of the crisis, central bank stopped issuing new licenses of BFIs and started promoting mergers and acquisitions. The episode of credit crunch and interest rate volatility during 2016-2019 also rejuvenated central bank's effort to promote merger and acquisition.

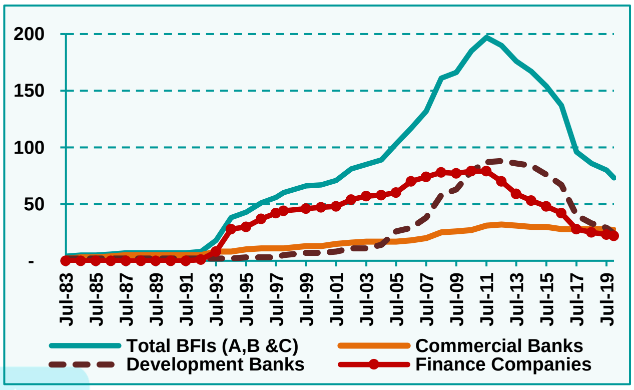

Figure 7: Number of BFIs over the year (Source: NRB)

Concentration Stability

The advocates of M&As in the banking system push forth the concentration stability hypothesis. The concentration stability hypothesis postulates that more concentrated banking system results into more stable financial system. Fewer number of BFIs can help to mitigate the extent of unhealthy competition that comes with large number of BFIs. Increased competition can sometime lead to what Howard Marks (a reputed investor) likes to call "the race to the bottom". Consider a hypothetical case of share auction; suppose, there was four bidders who applied for the auction at bid price of NPR 425, NPR 400, NPR 350 and NPR 300. The one who bid the highest i.e. NPR 425 would get the auctioned share. However, the winner of the auction i.e. one bidding the highest is the one who will be getting the lowest return among the bidders. With the same analogy, when there are large numbers of BFIs trying to make new loans, the loan will go to the bank that is willing to accept the least margin of error, or the lowest risk premium for the given risk. It certainly benefits the customers, competition encourages banks to be more efficient, innovative and provide better services.

Larger financial institutions are more immune to short term financial upheavals. Smaller financial institutions have lower risk-taking capacity and thus small events may cause existential crisis in these institutions. Also, smaller institutions' ability to diversify its Balance Sheet is lower as compared to larger institutions. Apart from financial stability, consolidation/merger of banks can enhance operational efficiency, specialize on bigger projects, replicate the success model on a larger spectrum, improve industry-wise risk culture, invest in advanced risk management frameworks and develop appetite to absorb risks. It also builds a seasoned team by educating others, helping through policy interventions and set an example for creating a stronger financial system.

Tradeoffs

Financial consolidation however is not without tradeoffs. Consolidation can lead to large financial institutions, the share of few large banks in the whole financial pie can get larger making these institutions systemically important or

[6] Nepal Rastra Bank. (2020). *Monetary Policy for 2020/21*
[7] Nepal Rastra Bank. (2020). *Quarterly economic bulletin: Mid-April 2020, 54*(3)
[8] Sapkota, C. (2011). Nepalese banking crisis explained. *Journal of Institute of chartered Accounts of Nepal*, *13*(4), 16-20.
[9] Bista, J.P. (2019). Big merger: Why now?. *The Himalayan Times*. Retrieved from https://thehimalayantimes.com/opinion/big-merger-why-now/

"Too Big To Fail (TBTF)" institution. These institutions are likely to get some kind of government's safety net or subsidies. The presence of these implicit public guarantees can create moral hazard problems that may incentivize these large financial institutions to involve in riskier investments which might increase systemic risk. As the central bank of England wrote in its website, "………However, during the financial crisis [2008], the biggest banks realized they would be bailed out…which made them take more risks……."[10]

In Nepal, the share of 10 largest BFIs in overall asset of BFIs has been decreasing until recently. The last two FYs witnessed mergers among large banks which elevated their share in the economy from 43% to 46%. If there are further merger amongst commercial banks, such share is likely to go up making the large merged institutions highly influential for the whole financial system - in other words making them systemically important institutions. When there are such large institutions which are TBTF, the role of supervision becomes difficult. These institutions can leverage their position to mold regulatory policies in their favor which can be a major deterrent for regulator to roll out macro prudential measures that may adversely affect the large bank's interest. If taken to the end of the spectrum that has only few large banks and an accommodative regulator, the regulatory role may faces challenges to protect the interest of the public at large. The former argument in favor of ease of supervision when there are few financial institutions can likely be disputable with such developments.

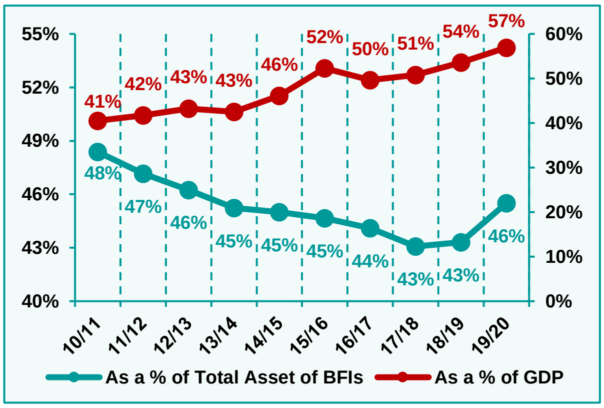

Figure 8: Contribution of 10 largest BFIs to the total asset of BFIs and GDP over the years (as compiled by NMBCL)

While excessive competition can lead to race to the bottom, it may also create risky assets in the banking system due to low margin of error. With competition cut down due to decreasing number of financial institutions, customers are the ones who will be limited to available choices. In a scenario where there are only few players, a monopolistic behavior of the banks cannot be ruled out. As an example, curbing the deposit interest rate to an upper band by all the banks has already been witnessed recently in the Nepalese market. Another tradeoff is that consolidated banking sector is likely to end up with small number of larger and more diversified firms. Many studies have advocated that diversification of risks in financial institutions, although beneficial on its own, can intensify similarities among themselves and expose them to the same risks consequently increasing systemic risk. This similarity among financial institutions can translate into joint survival or joint failure of banks which is beneficial for individual banks (due to implicit regulatory safety net) at the expense of increased systemic risk which is also known as systemic risk shifting.

Given the contagion nature, failure of one bank can put strain on other banks as well. Large number of financial institutions may also lead to difficulty in the supervision for regulators. The larger the number of financial institutions, harder it is for central banks to supervise an individual institution. Regulatory supervision has been recognized to have a significant role in maintaining financial stability; hence the prominent second pillar of BASEL III has been dedicated to this supervisory role of central banks.

Concluding Remarks

In the coming days, frequent and larger mergers and acquisitions are expected in the country's banking system than before. In such scenario, the spillover of any one institution's cries can have impacts in overall banking system and can cascade further towards the economy if impacts are large. History relates, the cost of imprudence by one shall have to be borne by the system. For instance, the failure of a small bank like 'Vibor' may have been managed, if any contemporary bigger bank fails it may demand much bigger costs from public coffers. To avoid possible systemic risk, discouraging excessive risk taking by way of prudential policy measures on capital charges and liquidity (ALM) management complying BASEL III can be a savior. Holistic policies regarding macro prudential measures like adequate liquidity, capital adequacy ratios, loss provisioning norms can help induce stability. Central bank as an independent body has the rightful authority to implement these policies. Hence, the higher independence of central bank is vouched for the better supervision by the key agencies like BASEL, IMF and the World Bank. Summing up, M&A accusation helps to build a better financial system if prudently managed. The role of central bank is going to be paramount in the days to come to deal with a bigger, better and a systematically important institution.

[10] https://www.bankofengland.co.uk/knowledgebank/why-is-competition-important-for-banks (Accessed 11th August 2020)

CHART OF THE QUARTER

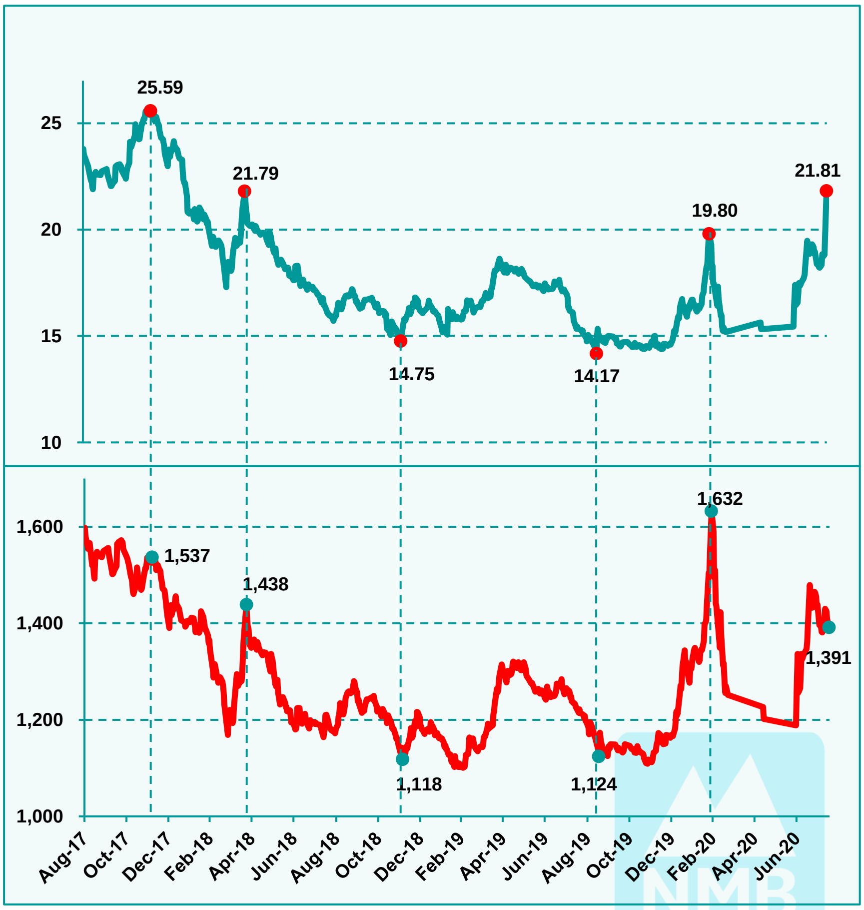

Figure 9: NEPSE Index and its Price to Earnings Ratio from 30th August 2017 to 16th August 2020 (as compiled by NMBCL)

The adjacent figure is the continuation of "Chart of the Quarter" published in "*The Analyst, June, 2019, Vol 2, Issue 1*". The earnings multiple or PE ratio for the NEPSE Index had been on decline since December 2017 to August 2019 because of the falling index and improved earnings of listed companies. The index traded at its lowest earnings multiple in August 2019, at 14.17x for the selected period shown in the figure 9. PE ratio spiked following the rally in index seen in early 2020. As earnings of listed companies have declined in 3Q and 4Q of FY 19/20 due to the ongoing pandemic and, PE of NEPSE Index has soared to 21.81x at the end of the review period.

PE is one of the simplest and oldest valuation multiples. One way to use PE in valuation is to compare current PE with historical PE. In the last 3 years, NEPSE has been trading at an average earnings multiple or PE of 17.90 (from 2017-08-30 to 2020-08-16).

NMB Capital Limited

RTS List

S. No	Symbol	Company	Sector
1	CBBL	Chhimek Laghubitta Bikas Bank Limited	Microfinance
2	CFCL	Central Finance Co. Ltd	Finance
3	EIC	Everest Insurance Co. Ltd.	Non-Life Insurance
4	FOWAD	Forward Community Microfinance Bittiya Sanstha Limited	Microfinance
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[11]	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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[11] Dividend Distribution only