

HATTHA KAKSEKAR LIMITED

No. 65/2020
30 April 2020

FINANCIAL INSTITUTIONS

Company Rating: BBB+
Outlook: Stable

Last Review Date: 19/04/19

Company Rating History:

Date	Rating	Outlook/Alert
07/05/18	BBB+	Stable

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RATIONALE

TRIS Rating affirms the company rating on Hattha Kaksekar Limited (HKL) at “BBB+” with a “stable” outlook. The rating incorporates a rating enhancement from HKL’s stand-alone rating to reflect the company’s status as a strategically important subsidiary of Bank of Ayudhya PLC (BAY, rated “AAA/Stable” by TRIS Rating). HKL has received strong business and financial support from BAY. We believe the support is likely to continue as HKL is one of the companies within the solo consolidation group of BAY. The stand-alone rating reflects HKL’s strong market position as Cambodia’s top-three microfinance deposit-taking institution (MDI), strengthened capital, and prudent risk management. However, the country risk of the Kingdom of Cambodia, and the industry risk facing the MDI industry constrain the rating.

KEY RATING CONSIDERATIONS

A strategically important subsidiary of BAY

As a wholly-owned subsidiary of BAY since 2016, HKL represents BAY’s strategic microfinance business arm in Cambodia. BAY closely supervises and monitors HKL’s operations through its five senior executives who represent BAY on HKL’s board. HKL also receives business support, including know how on lending and deposit products. HKL’s risk management and information technology (IT) system are fully integrated with BAY’s platform.

We expect HKL to have adequate liquidity and the financial flexibility it needs to fund its growth plans. Under the solo consolidated supervision guidelines established by the Bank of Thailand (BOT), BAY is able to provide unlimited lending support to HKL. This includes large credit facilities and capital injection.

On 7 October 2019, the National Bank of Cambodia (NBC) approved BAY’s additional capital injection of US\$40 million into HKL. This will bring total paid-up capital of KHL to US\$115 million in 2020 financial statements. BAY previously injected US\$45 million capital into HKL in 2018, raising its total paid-up to US\$75 million.

Strict regulatory oversight

TRIS Rating views that the gap in terms of regulatory oversight between commercial banks and MDIs in Cambodia is minimal. As an MDI, HKL is regulated by NBC, which also regulates and oversees many other financial institutions including commercial banks, microfinance institutions (MFIs), specialized banks, leasing companies, and representative offices. The same requirements for capital adequacy ratio (CAR), liquidity coverage ratio (LCR), and credit risk grading and provisioning had been applied to both commercial banks and MDIs.

Cambodia country and financial sector risk

HKL’s company rating incorporates the country risk of the Kingdom of Cambodia and the sector risk related to MDI’s operation. HKL is directly exposed to these risks since the company only operates in Cambodia. In our opinion, Cambodian economy and financial institutions could face significant challenges from the economic impacts of COVID-19 pandemic and the European Union’s (EU) suspension of Everything-But-Arms (EBA) trade scheme.

We hold the view that Cambodia's relatively low income level and weak external balances could potentially constrain its economic resiliency. Its high-dollarisation economy also limits the effectiveness of the NBC's monetary policies. We also think there are certain degrees of economic imbalances, with the economic growth primarily driven by manufacturing exports (mainly textile to the EU) and real-estate construction. The fast-growing private-sector credit, reaching 100% of GDP at end-2018, has also caused much concern as it has been increasingly funded by short-term foreign funding. On a positive note, the country has maintained political stability, a risk factor in our assessment of country risk.

The banks and MFIs in Cambodia operate in an environment where the regulatory frameworks are still catching up with international standards, moderate profitability from fierce competition, and rising asset quality risks. System-wide funding is relatively stable, in our opinion, with customer deposits over 80% of total system funding at-end 2018. However, the deposit protection scheme in Cambodia has yet to be finalised, implying that the risk of deposit runs in a crisis still remains. Financial institutions also have limited funding options, given the development of local debt capital market being at an early stage.

A leading MDI

Our business assessment of HKL reflects its strong franchise as an MDI. As at end-2019, HKL market shares in loans and deposits became the second-largest among seven MDIs, up from the third rank in the previous year. Market shares for loans and deposits were at 17% and 16%¹, respectively. Loans to household sector accounted for around half of total loan portfolio. The remaining were primarily commercial loans to small- and medium-sized enterprises (SMEs). Lending is the primary revenue source, with net interest income (NII) accounting for around 94% of total revenue in 2019. Most of non-NII were loan-related fees, which will likely remain modest in the longer term. Going forward, HKL seeks to expand into high-yielding retail lending, whilst gradually growing its commercial client base.

Prudent risk management helps contain asset quality risks

In our opinion, prudent risk management at HKL should help contain asset quality risks. Similar to other MDIs, we expect HKL to face rising asset quality pressure over the next two years from the economic impacts of COVID-19 and EBA trade scheme suspension. Based on our conservative scenario, we forecast a non-performing loan (NPL) ratio of 0.8%-1.0%, and credit cost of around 1.0% for 2020 and 2021. That said, we do not expect the forecast NPL and credit cost to have significant impact on HKL's earnings. HKL has been able to maintain relatively low credit cost and decent loan loss coverage, relative to other MDIs over the past few years.

HKL has improved its asset quality over the past few years. NPL ratio dropped to a low of 0.3% at end-2019, from 0.7% at end-2018, from write-offs and strong loan growth. HKL's credit cost fell to -0.01% in 2019 due to NPL write-offs, from 0.55% in 2018. NPL coverage ratio was at a healthy 150%-160% level from 2017 to 2019.

Strengthened capital and moderate profitability

Our capital and earnings assessment of HKL reflects strengthened capital from the latest round of equity injection from BAY and the company's gradually improving profitability. An additional US\$40 million of paid-up capital should strengthen HKL's capital adequacy ratio (CAR) above 21.53% level at end-2019². This level is well above the minimum regulatory requirement of 15%. We forecast HKL's debt-to-equity (D/E) ratio to fall below 5 times, a strong figure relative to other MDIs, over the next two years.

HKL's profitability is growing but remains moderate, as it earns relatively low net interest margins (NIM) among MDIs. Return on average asset (ROAA) was 2.3% in 2018, trailing other key competitors. The spike in ROAA to 3.0% in 2019 from its normal 2.3%-2.4% level should be temporary, as it was attributed to the year's exceptionally low credit cost.

Liquidity mismatch is manageable

HKL's major funding source is deposit. Over the past five years, its deposit growth continued to be in line with loan growth. Loan-to-deposit ratio has been comparable with its peers. HKL's loan-to-deposit ratio of 151% at end-2018 was close to peers' average of 164%. We expect HKL's sticky deposit funding base to gradually expand, driven by its flexible high-yielding savings accounts (HYSA) introduced in 2018. This partly explains the growth in savings account, which accounted for 24% of total deposits at end-2019, up from 19% at end-2018.

We expect the duration mismatch of HKL to be manageable. Although around 90% of HKL's deposits are short-term, these are generally revolving. The credit lines from BAY should also help mitigate liquidity risk.

¹ Based on company's information.

² Based on company's information.

BASE-CASE ASSUMPTIONS IN 2020-2022

- Loan growth: 15%-20% per year.
- Loan yield: 14%-15%.
- NPL ratio: 0.8%-1.0%.
- Credit cost: around 1.0%.
- D/E ratio: below 5 times.

RATING OUTLOOK

The “stable” outlook is based on TRIS Rating’s expectation that HKL’s operation will continue to be closely aligned with BAY’s strategy. The outlook also reflects our expectation that HKL will continue to receive support from its parent bank. We also expect HKL to manage loan quality at an acceptable level, with its profitability and capital base to stay strong to serve as twin cushions against downside risks in the microfinance industry.

RATING SENSITIVITIES

The rating and/or outlook upside case would arise if HKL improves its market position while continues to deliver strong financial performance and maintains sound asset quality. The rating and/or outlook could be revised downward if HKL’s capital and/or asset quality materially deteriorate, or should there be any change in TRIS Rating’s view of the strategic importance of HKL to BAY.

COMPANY OVERVIEW

HKL was originally established in Cambodia in 1994 as a food security project by OCSF/OXFAM–Quebec, a Canadian organization. The project provided micro loans to Cambodian rural people. Two years later, the food security project was registered with the Ministry of Interior of Cambodia as a non-governmental organization (NGO) called Hattha Kaksekar (HK). In Khmer, "Hattha Kaksekar" means "Farmer's Hand" or "A Helping Hand for Farmers".

In 2001, HK was registered with the Ministry of Commerce of Cambodia and was transformed into a private limited company with a new name, Hattha Kaksekar Limited (HKL). The company was granted a three-year license by the NBC to offer microfinance services across Cambodia. HKL was then offered a permanent microfinance license in 2007. In 2010, the NBC offered HKL an MDI or "micro-finance deposit taking institution" license, permitting HKL to officially mobilize deposit from the public.

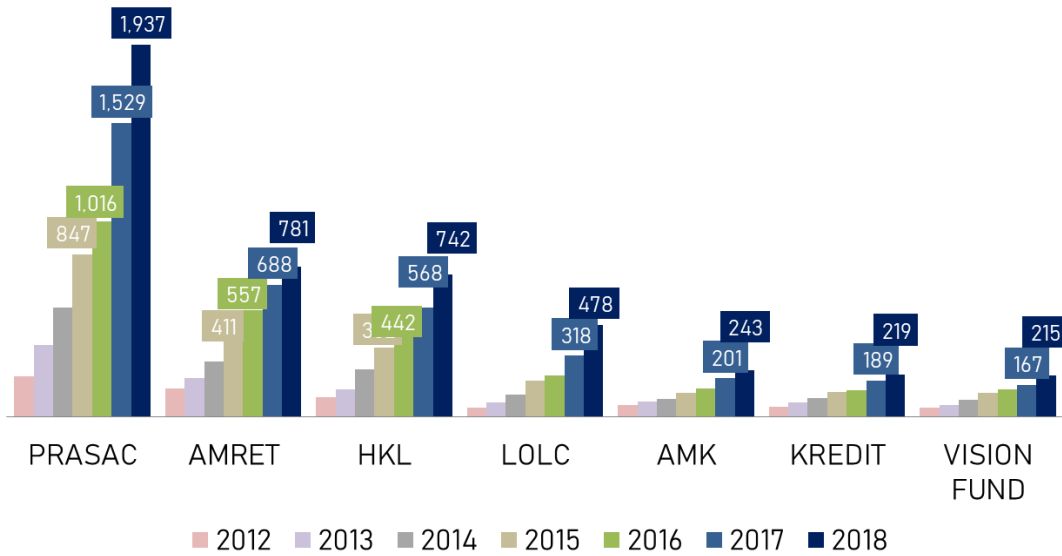
In 2016, HKL was acquired by BAY, a member of Mitsubishi UFJ Financial Group (MUFG), and became BAY’s solo consolidated wholly-owned subsidiary. In 2017, HKL received an equity injection of US\$23 million from its parent bank. Paid-up capital rose to US\$30 million. In 2018, HKL received additional equity injection of US\$45 million from its parent bank. Its paid-up capital rose to US\$75 million. On 7 October 2019, NBC approved BAY’s additional capital injection of US\$40 million into HKL. This will bring total paid-up capital of KHL to US\$115 million in 2020 financial statements.

Currently, HKL offers microfinance loans, savings and deposit accounts, local money transfers, automated teller machines (ATM), mobile banking services, and payroll services. As of 31 December 2019, the number of branches was 177 nationwide, plus the headquarters in Phnom Penh. Customers use loans from HKL for a number of different purposes, such as agricultural loans, loans for the trade and commerce sector, the construction sector, and personal (household) loans.

KEY OPERATING PERFORMANCE

Chart 1: Net Outstanding Loans

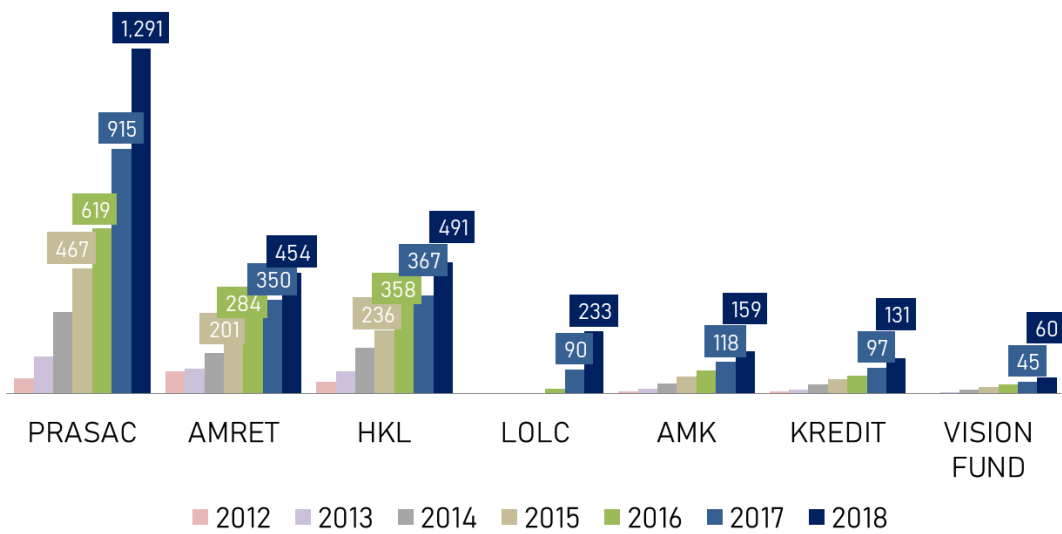
Unit: US\$ million



Source: National Bank of Cambodia (NBC)

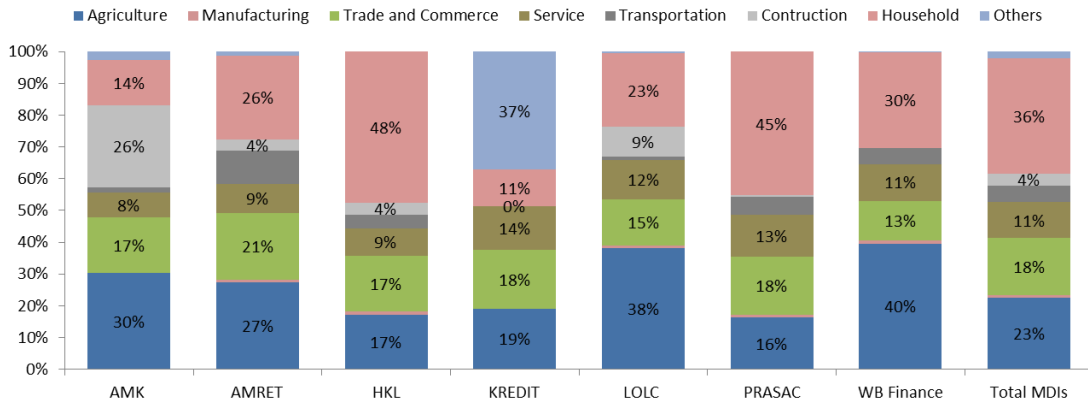
Chart 2: Deposit

Unit: US\$ million



Source: NBC

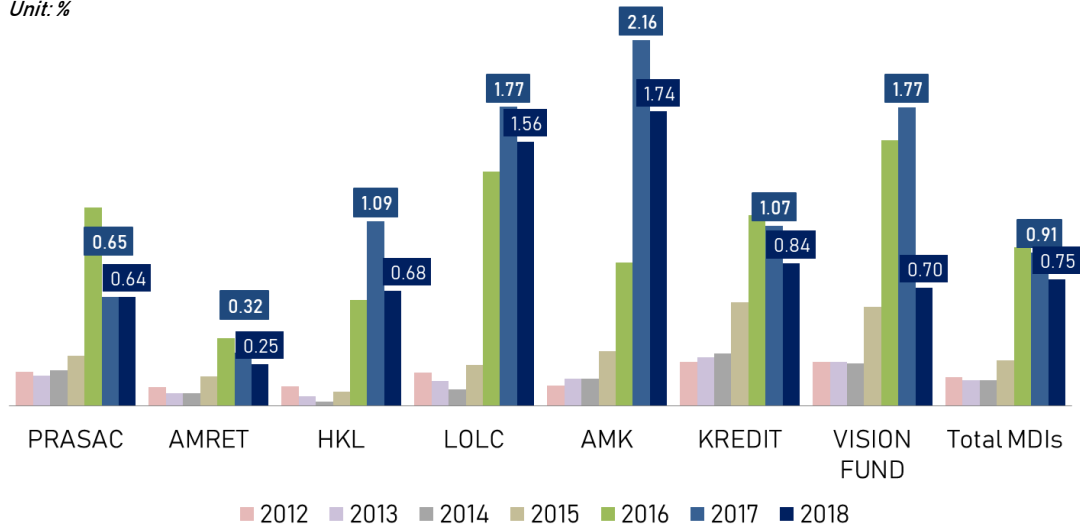
Chart 3: Year-end 2018 Loan Breakdown



Source: NBC

Chart 4: Net non-performing Loan (NPL) Ratio – NPL/Net loans

Unit: %



Source: NBC (discrepancy due to HKL using total loans and NBC's data using net loans)

FINANCIAL STATISTICS AND KEY FINANCIAL RATIOS
Unit: US\$ million

	-----Year Ended 31 December -----				
	2019	2018 ¹	2017	2016	2015
Total assets	1,227	925	691	587	446
Total loans	1,041	750	577	445	364
Allowance for doubtful accounts	5	8	9	3	2
Deposits	610	491	367	358	236
Borrowings	353	244	181	141	104
Shareholders' equity	198	166	105	67	58
Net interest income	82	64	56	46	39
Bad debts and doubtful accounts	(0)	4	7	2	1
Non-interest income	5	3	1	1	0
Operating expenses	52	39	31	29	25
Net income	32	19	15	13	11

1 Restated
Unit: %

	----- Year Ended 31 December -----				
	2019	2018 ¹	2017	2016	2015
Profitability					
Net-interest income/average assets	7.66	7.88	8.84	8.92	10.35
Net-interest income/total income	56.06	55.86	58.61	55.87	61.14
Operating expenses/total income	35.02	34.33	32.58	35.17	38.04
Operating profit/average assets	3.29	3.38	4.13	3.48	4.00
Return on average assets	2.98	2.33	2.40	2.48	2.91
Return on average equity	17.62	13.88	17.83	20.59	23.05
Asset Quality					
Non-performing loans/total loans	0.32	0.72	1.07	0.62	0.08
Bad debts and doubtful accounts/average loans	(0.01)	0.55	1.35	0.42	0.41
Allowance for doubtful accounts/total loans	0.50	1.10	1.62	0.67	0.46
Allowance for doubtful accounts/non-performing loans	155.43	153.46	150.78	107.32	571.30
Capitalization					
Shareholders' equity/total assets	16.17	17.97	15.25	11.40	12.93
Shareholders' equity/total loans	19.05	22.16	18.27	15.01	15.87
Debt to equity (times)	5.18	4.56	5.56	7.77	6.74
Funding & Liquidity					
Loans/deposits	170.70	152.66	157.01	124.45	153.76

1 Restated
RELATED CRITERIA

- Nonbank Financial Institutions Rating Methodology, 17 February 2020
- Group Rating Methodology, 10 July 2015

Hattha Kaksekar Limited (HKL)

Company Rating:	BBB+
Rating Outlook:	Stable

TRIS Rating Co., Ltd.

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