

HATTHA KAKSEKAR LIMITED

No. 59/2018

7 May 2018

FINANCIAL INSTITUTIONS

Company Rating:
Outlook:BBB+
Stable

RATIONALE

TRIS Rating assigns the company rating of Hattha Kaksekar Limited (HKL) at “BBB+”. The rating is enhanced 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). We believe HKL will receive strong business and financial support as a wholly-owned subsidiary of BAY. The stand-alone rating reflects HKL’s strong market position and nationwide branch network in Cambodia, diverse customer base, and good risk management systems. However, the country risk of the Kingdom of Cambodia, regulatory risk, and high competition in the microfinance segment constrain the rating. HKL’s target customers are highly susceptible to changes in economic conditions. The deterioration in asset quality in recent years is a concerning trend.

KEY RATING CONSIDERATIONS

A strategically important subsidiary of BAY

HKL is BAY’s microfinance business arm in Cambodia. HKL became a wholly-owned subsidiary, with effective control by BAY, in September 2016. TRIS Rating views HKL as a strategically important subsidiary of BAY, based on the strong operation and financial support from BAY. TRIS Rating believes HKL would receive adequate financial and liquidity support from BAY should it encounter a period of financial distress.

Under the consolidated supervision guidelines established by the Bank of Thailand (BOT), HKL is closely supervised and monitored by BAY. HKL’s board of directors consists of five senior executives from BAY, three independent directors, and the chief executive officer (CEO). BAY is allowed to provide full funding support to solo-consolidated subsidiaries, including HKL. TRIS Rating expects HKL to have adequate liquidity and the financial flexibility it needs to fund its growth plans.

HKL receives other benefits from the strong ties with BAY, including know-hows on business operation, integrated risk management and information technology (IT) systems. These benefits have enhanced HKL’s competitive position and operating efficiency.

Regulated microfinance deposit taking financial institution

HKL is regulated by the National Bank of Cambodia (NBC) as a microfinance deposit taking financial institution (MDFI). HKL obtained its MDFI license in 2010. The license permits HKL to take deposits, a low-cost source of funds, from the public.

An MDFI, according to the regulations established by the NBC, is required to maintain a minimum amount of registered capital of KHR120 billion, or approximately US\$30 million. The NBC also requires that microfinance institutions (MFIs) must cap interest rates at 18% per annum for loans signed after 1 April 2017. Because of the cap, the interest yields on loans held by MFIs and MDFIs are expected to decline steadily. The falling yields will squeeze the profitability of MFIs’ for the next few years.

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Cambodia's country risk

HKL operates only in Cambodia. HKL's company rating partly reflects the country risk of the Kingdom of Cambodia. As a low income, high growth developing economy, Cambodia's gross domestic product (GDP) has grown by approximately 7% annually, on average, from 2011 through 2017. High dollarization and potential bubbles in the property sectors are some of the key risks identified for the Cambodian economy. The effectiveness of rule-of-law and political stability are other key risk factors taken into consideration in assessing the country risk.

Financial performance improves as business grows

HKL's loan portfolio has grown continuously. The size of the loan portfolio rose to US\$577 million in 2017, from US\$146 million in 2013. This translates to a compound annual growth rate (CAGR) of about 41%. Similarly, net income has risen steadily, climbing to US\$15 million in 2017, from US\$4 million in 2013. However, return on average assets (ROAA) has dropped steadily since 2013. ROAA was 2.4% in 2017, down from 4.7% in 2013. This drop was a result of a constant decline in the interest yield on the loan portfolio.

Deteriorating asset quality

Non-performing loans (NPLs) have risen rapidly during the past two years. The ratio of NPLs to total loans (NPL ratio) leaped to 0.6% in 2016 and 1.1% in 2017, from 0.1% in 2015. The ratio was below 0.1% in 2013 and 2014.

Despite the recent rise, TRIS Rating views that HKL's NPL ratio is currently at an acceptable level given the high risk profile of its customer base. The ratio of allowance for loan losses to NPLs was about 150%, as of ending 2017, which is considered more than adequate to cover the current level of NPLs. In the future, TRIS Rating expects HKL to control its asset quality at an acceptable level.

Adequate capital and financial liquidity

HKL's main source of funds is short-term deposits. Shareholders' equity made up 15.3% of total funding as of the end of 2017. There is a significant duration mismatch between its loan assets and short-term deposits funding. Liquidity risk is mitigated by the credit lines made available by BAY.

The ratio of debt to equity (D/E) improved to 5.6 times in 2017, from 7.8 times in 2016. A recent recapitalization increased HKL's paid-up capital to US\$30 million at the end of 2017 from US\$6.8 million at the end of 2016. The recapitalization is needed in order to comply with regulatory requirements.

RATING OUTLOOK

The "stable" outlook is based on the expectation that HKL's operation will continue to be closely aligned with BAY's strategy. The outlook reflects the assumption that HKL will continue to receive a high level of support from its parent bank. Loan quality is expected to be controlled at an acceptable level. TRIS Rating also assumes HKL's profitability and capital base will stay strong to serve as twin cushions against downside risks in the microfinance industry in Cambodia.

RATING SENSITIVITIES

The rating and/or outlook upside case would arise if HKL improves its market position, delivers strong financial performance continuously, and controls credit cost at an acceptable level. The rating and/or outlook could be revised downward if HKL's competitive position or asset quality deteriorates significantly. In addition, should there be any change in TRIS Rating's view of the strategic importance of HKL to BAY, the rating and/or outlook may change.

COMPANY OVERVIEW

HKL was originally established in 1994 as a food security project by OCSO/OXFAM-Quebec, a Canadian organization. The project provided micro loans to 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".

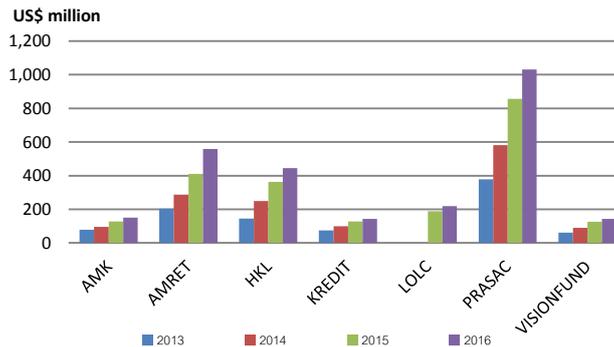
In 2001, Hattha Kaksekar NGO was registered with the Ministry of Commerce and transformed into a private limited company with a new name, Hattha Kaksekar Limited. (HKL). The company was granted a three-year license by the NBC to offer microfinance services across Cambodia. HKL was then offered a permanent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

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 March 2018, the number of branches reached 173 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.

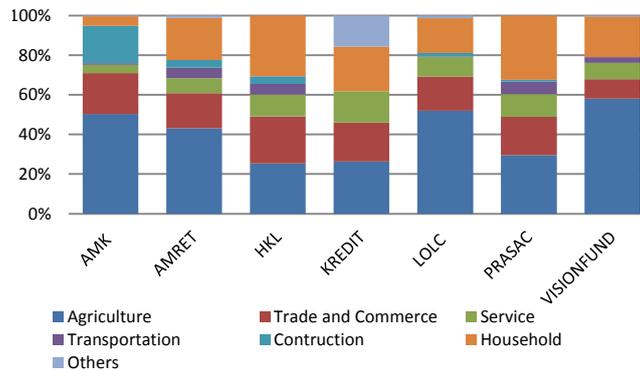
KEY OPERATING PERFORMANCE

Chart 1: Outstanding Loans



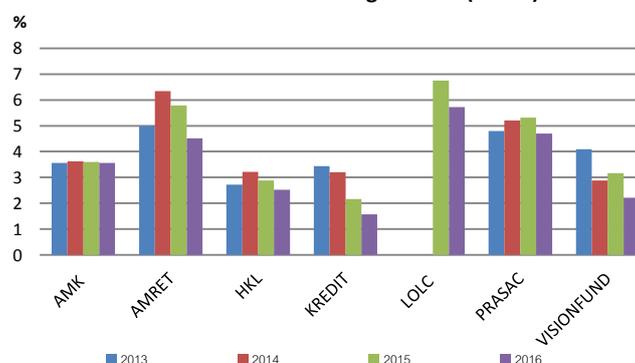
Source: National Bank of Cambodia (NBC)

Chart 2: Year-end 2016 Loan Breakdown

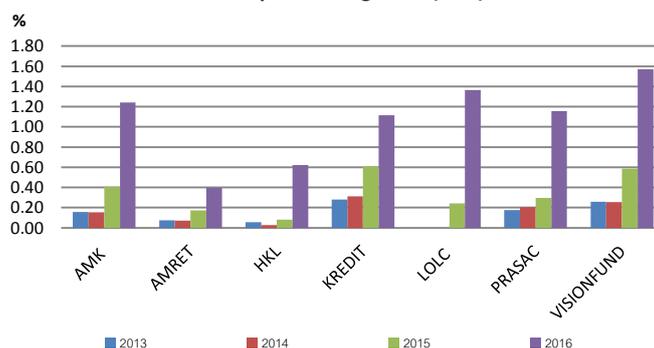


Source: NBC

Chart 3: Return on Average Assets (ROAA)



Source: NBC

Chart 4: Non-performing Loan (NPL) Ratio


Source: NBC

FINANCIAL STATISTICS AND KEY FINANCIAL RATIOS*

Unit: US\$ million

	Year Ended 31 December				
	2017	2016	2015	2014	2013
Total assets	691	587	446	316	180
Total loans	577	445	364	250	146
Allowance for doubtful accounts	9	3	2	1	1
Deposits	367	358	236	172	82
Borrowings	200	142	137	96	67
Shareholders' equity	105	67	58	39	25
Net interest income	56	46	39	29	20
Bad debts and doubtful accounts	7	2	1	(1)	1
Non-interest income	1	1	0	0	0
Operating expenses	31	29	25	20	15
Net income	15	13	11	8	4

* Consolidated financial statements

Unit: %

	Year Ended 31 December				
	2017	2016	2015	2014	2013
Profitability					
Net-interest income/average assets	8.84	8.92	10.35	11.54	13.54
Net-interest income/total income	58.61	55.87	61.14	62.51	67.11
Operating expenses/total income	32.58	35.17	38.04	42.83	49.46
Operating profit/average assets	2.95	3.11	3.66	4.11	3.52
Return on average assets	2.40	2.48	2.91	3.28	2.82
Return on average equity	17.83	20.59	23.05	25.38	18.07
Asset Quality					
Non-performing loans/total loans	1.07	0.62	0.08	0.03	0.06
Bad debts and doubtful accounts/average loans	1.35	0.42	0.41	(0.46)	0.41
Allowance for doubtful accounts/total loans	1.62	0.67	0.46	0.20	1.01
Allowance for doubtful accounts/non-performing loans	150.78	107.32	571.30	798.57	1,826.51
Capitalization					
Shareholders' equity/total assets	15.25	11.40	12.93	12.25	14.07
Shareholders' equity/total loans	18.27	15.01	15.87	15.49	17.34
Debt to equity (times)	5.56	7.77	6.74	7.17	6.11
Funding & Liquidity					
Loans/deposits	157.01	124.45	153.76	145.18	176.62
Stable funding sources/stable funding needs	116.68	127.16	118.72	122.58	119.72

* Consolidated financial statements

Hattha Kaksekar Limited (HKL)

Company Rating:	BBB+
Rating Outlook:	Stable

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