Kumari Bank Limited

ICRA Nepal assigns [ICRANP] IPO Grade 4+ to the proposed rights issue (equity shares) of Kumari Bank Limited

Facility/Instrument	Issue Size	Grading Action (January 2018)
Rights issue (Equity)	NPR 1,193.90 million	[ICRANP] IPO Grade 4+ (Assigned)

ICRA Nepal has assigned "**[ICRANP] IPO Grade 4+**", indicating below-average fundamentals to the proposed rights issue amounting to ~NPR 1,193.90 million of Kumari Bank Limited (KBL). ICRA Nepal assigns IPO grading[1] on a scale of IPO Grade 1 through IPO Grade 5, with Grade 1 indicating strong fundamentals and Grade 5 indicating poor fundamentals. For the grading categories 2, 3 and 4, the sign of + (plus) appended to the grading symbols indicate their relative position within the grading categories concerned. Thus, the grading of 2+, 3+ and 4+ are one notch higher than 2, 3, and 4, respectively. KBL is proposing to come out with 20% rights issue of 11,938,991.65 equity shares of face value NPR 100, each to be issued to existing shareholders at par. The issue is being made to comply with the increased paid up capital requirement[2] set by Nepal Rastra Bank (NRB), the banking sector regulator in Nepal.

The assigned grading factors in KBL's adequate track record (since 2001), comfortable capitalization profile, adequate franchise and experienced management team which is expected to support the incremental growth prospects of the bank. Additionally, rapid network expansion plans targeting a balanced mix of corporate and retail/SME portfolio also remains positive in terms of sustainable growth prospects going forward. ICRA Nepal also considers the scale advantages that the bank could garner following the acquisition of four relatively smaller BFIs[3] in June 2017 that contributed to ~30% growth in overall asset base of the bank. The grading also factors in the moderate credit concentration risk (~18% of total loans on mid-Oct 2017 among top 20 borrower groups) which partly comforts the asset quality concerns of the bank given the deterioration post the recent acquisition.

However, the grading remains constrained by bank's track record of lower than industry average growth rate in the past leading to reduced market share and smaller business volume among similar aged peers; credit portfolio grew by ~14%[4] over last five years (ending Jul-17) compared to ~23% growth in the industry. Lower pace of growth and stress in asset quality in the past has led to profitability indicators remaining below the industry average over the years. The grading also remains constrained by the recent spike in delinquency and NPA levels following the acquisition of BFIs with relatively stressed asset quality which could pressurize the return prospects over increased capital base going forward. The grading further remains constrained by inferior funding profile of the bank vis-à-vis the industry in terms of current and savings account (CASA) deposit proportion (32% in mid-Oct 2017 vs. ~43% for industry) and deposit concentration (~30% of total deposits from top 20 depositors as on mid-Oct 2017). Resulting low granularity exposes KBL to liquidity and/or pricing risk, as reflected in higher cost of deposits among peers (7.95% for Q1FY18 vs. 6.20% for industry). High cost of deposits and low non-interest income results in higher cost to income ratio for bank and weaker profitability for bank in relation to peers. High cost of deposits could also weaken the competitive positioning of the bank vis-à-vis peers with finer deposit profile/cost, especially in the recently introduced "base rate plus" lending rate regime. The grading is also constrained by absence of strong institutional promoter support, volatile liquidity scenario with low deposit vs. credit growth in the industry and uncertain operating environment that the banks in Nepal are currently facing.

KBL has registered a relatively lower credit growth of CAGR 14% during past 5 years ending Jul-17 (vs. commercial bank average of 23%). Low growth has resulted in bank's industry positioning at 23rd position in assets base among the 28-player industry, despite being the 15th commercial bank to come in operation. As on mid-October 2017, KBL's credit portfolio of NPR 47.47 billion comprised mainly of corporate loans (38%), followed by retail loans (33%) and SME loans (29%). The proportion of retail and SME loans have increased (50% on Jul-16) after the acquisition of BFIs which had relatively stronger

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[1] Includes rights and further public issues of equity shares

[2] NPR 8 billion for class A commercial bank.

[3] Kasthamandap Development Bank (National Level Class B Dev. Bank; graded IPO 4 by ICRA Nepal), Mahakali Bikas Bank (3-district level Class B Dev. Bank; graded IPO 4 by ICRA Nepal), Kakre Bihar Bikas Bank (1-district level Class B Dev. Bank) and Paschimanchal Finance Company Limited (National Level Class C Finance Company)

[4] All the indicators are reported on a consolidated basis, including acquired entities.

retail/SME base. Owing to largely balanced credit portfolio mix, credit concentration of KBL remains moderate at ~18% among top 20 borrower groups, which is a positive from assets quality perspective. Over next 12-18 months, incremental credit growth is likely to be driven by increased geographic coverage and penetration plans of management through aggressive branch expansion. On the long run, bank's credit growth will depend on its ability to offer finer lending rates, which in turn will depend on its funding profile.

Assets quality indicators of KBL had witnessed stress in the past owing to stress in the real estate sector that created similar pressure for most of the banks. With moderate growth and gradual recovery over the years, NPLs of the bank had come down from ~4% as of Jul-14 to ~1% as of Jul-16, remaining below the industry average of ~2% as of Jul-16. However, following the acquisition of entities with relatively stressed asset quality[5], NPLs spiked to 1.86% in Jul-17 and further to 1.97% as of mid-Oct-17 (1.79% for industry). Overall 0+ days delinquencies also increased to ~23% as of Jul-17 (vs. 8-10% earlier periods; ~26% as of Oct-17). Rising delinquency and NPA level remains a concern, especially considering the low seasoning of significant chunk of bank's credit book, ~45% of credit portfolio as of Oct-17 were booked after Jul-13 during relatively comfortable liquidity period and hence could come under stress in the current rising interest rate scenario. Stress over assets quality could be further accentuated given the relatively inferior borrower profile of the ~20% portfolio emanating from acquired entities. Nonetheless, major portion of the delinquencies as on mid-Oct 2017 are short term (overdue for <30 days) and are likely to be regularised in later part of the financial year which provides some comfort. Despite increased NPLs, credit provisioning cover remains adequate at ~68% as of Oct-17 (~71% as of Jul-17) resulting in moderate solvency indicator (net NPA/ net worth) at ~4% in mid-Oct 2017 (~3% in mid-July 2017).

In terms of deposit profile, KBL fares weaker to the industry average. As on mid-Oct 2017, KBL's deposit base of NPR 54.65 billion comprised of ~32% CASA (lower than industry average of ~43%), increasing from ~30% in mid-July 2017. At the same time, deposit concentration among top accounts remains on higher side (~30% among top 20 depositors). During past ~12 months, Nepalese banking industry has witnessed shortage of lendable deposits pushing up the cost of deposits. Low granularity and reliance on price sensitive corporate deposits has resulted in >70% increase in average cost of deposits of KBL between FY2016 and Q1FY2018. This is likely to adversely affect the bank's competitive positioning in the "base rate plus" lending rate regime; KBL's base rate was 11.15% as of mid-Oct-17 comparable to new age commercial banks. This is also likely to affect KBL's profitability (by affecting the net interest margin) as the bank's ability to pass on the increased cost to the borrower is dictated by industry competition. During past 3 years ending Jul-17, the rate of credit growth has outpaced the rate of deposit growth (~15% vs. ~13%) pushing up the CCD[6] ratio (~78% as on mid-Jul 2017 vs. 74-75% earlier vis-à-vis regulatory ceiling of 80%; ~77% as of mid-Jan-2018).

As for profitability, KBL's return on net worth (RoNW) has remained lower to industry-average in past five years (~12% vs. ~19% for industry); impacted mainly by low pace of growth and stress in asset quality. Over next 12-18 months, RoNW is likely to remain diluted due to sizeable equity injection made into the company through series of rights offering (50% in FY17 and 20% proposed issue). Because of rising cost of deposits, KBL's NIMs moderated from 3.20% for FY2016 to 3.00% for FY2017 and further to 2.27% for Q1FY2018. Triggered by sharp decline in NIMs, return indicators of KBL has moderated (RoNW of ~6% in Q1FY2018 and ~11.5% for H1FY18 vs ~10% in FY2017 and ~21% in FY2016). Moderation in NIMs, despite increased CCD ratio remains a concern to incremental profitability profile of the bank. Non-interest income of KBL also remains weaker among peers (0.86% of Average Total Assets-ATA for FY17 vs. 1.30% for industry) resulting in high cost to income ratio for the bank (~47% for FY17 vs. 43% for industry) and raising concerns over the diversity of earnings profile. Nonetheless, the profitability indicators remain supported to an extent by relatively lower operating expense ratio (1.83% of ATA for FY17 vs. 2.02% for industry) and low credit cost (0.10% of ATA for FY17; 0.34% for Q1FY18). The incremental profitability is likely to be determined by the bank's ability to boost the net interest margins (NIMs), explore non-interest income sources and improve the assets quality.

KBL has maintained adequate capital cushion over the regulatory minimum (11% for class A banks under prevailing Basel III norms) in the past. Bank's capitalisation level improved after the capitalisation

[5] Paschimanchal Finance had NPLs of ~14% prior to acquisition, ~5% for Kakrebihar, ~2% for Mahakali and ~1.5% for Kasthamandap.

[6] Credit to Core capital and Deposits ratio

of 50% rights issue in FY2017 and would be further strengthened after the proposed rights issue. However, KBL's capital would still remain lower by ~NPR 0.84 billion compared to minimum regulatory requirement of NPR 8 billion even after the proposed rights, hence bank would need to be capitalise retained earnings[7] and reserve created from acquisition to meet regulatory minimum capital. As on mid-Oct 2017, KBL's CRAR stood at 15.25%, comfortable vis-à-vis regulatory minimum of 11% (under Basel III norms). KBL's tier I capital of 14.21% also remains well above 8% (to be maintained by mid-July 2018 and 8.50% by mid-July 2019). Comfortable capitalisation profile of KBL is likely to support the incremental growth plans of the management. However, given the pressure on NIMs, ability of the bank to maintain adequate returns on increased capital remains a challenge. With the bank resorting to capital retention as well as sizeable injection of fresh equity in recent years, gearing level of KBL has declined from ~9 times on mid-July 2016 to ~7 times on mid-Oct 2017.

Bank Profile

Kumari Bank Limited (KBL), the 15th Class 'A' Commercial Bank to be licensed by NRB, has been in operation since April 2001. In June 2017, KBL acquired four various classes of banking and financial institutions in a bid to raise the minimum paid up capital as required by NRB. The acquisition increased the capital fund and assets base of KBL in addition to increasing its footprint across the country. The corporate office of the bank is located at Durbarmarg, Kathmandu. The bank is promoted by wide range of promoters with maximum shareholding by one promoter at 5.64% of total capital (as on mid-July 2017). Share capital of the company is distributed among promoter & public in the ratio of 51:49. The shares of KBL are registered and traded in Nepal Stock Exchange (NEPSE). Mr. Surender Bhandari is the Chief Executive Officer of the bank.

KBL has presence throughout the country through its 74 branches and 57 ATMs as of mid-Oct-17. The bank has market share of 2.22% in terms of deposit base and 2.28% of total advances of Nepalese Banking Industry as on mid-Oct 2017 (2.53% and 2.62% share among the commercial banks). On a consolidated basis including all acquired entities, KBL reported a profit after tax of NPR 709 million during FY 2016-17 over an asset base of NPR 60,994 million as at mid-Jul-17 against profit after tax of NPR 1,091 million during FY 2015-16 over an asset base of NPR 56,474 million as of mid-Jul-16. For H1FY2017-18[8], KBL has reported a net profit of NPR 480 million over an asset base of NPR 67,408 million. As of mid-Jan-18, KBL's CRAR was 14.48% and gross NPLs were 1.61%. In terms of technology platform, KBL has implemented Temenos T24 across all its branches.

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[7] As per unaudited data of FY17, retained earnings is NPR 0.62 billion
[8] As per recently published unaudited financial highlights