Kasthamandap Development Bank Limited

ICRA Nepal assigns [ICRANP] IPO Grade 4 to the proposed Equity Shares (Rights Issue) of Kasthamandap Development Bank Limited

Facility/Instrument	Issue Size	Grading Action (May 2016)
Rights Share Issue	NPR 169.9742 Million	[ICRANP] IPO Grade 4 (Assigned)

ICRA Nepal has assigned an "**[ICRANP] IPO Grade 4**", indicating below-average fundamentals to the proposed rights issue amounting to NPR 169.9742 million of Kasthamandap Development Bank Limited (KDBL). ICRA Nepal assigns IPO grading 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. KDBL is proposing to come out with 4:1 rights issue of 1,699,742 numbers of equity shares of face value NPR 100/- each to be issued to the existing shareholders at par. The proposed issue is being made to augment the capital base to meet the elevated regulatory capital requirements and to support the bank's growth plans as well.

The grading factors in bank's moderate track record (operating since FY08), and fair proportion of CASA[1] deposit (~52% as on mid-Apr-16[2] against industry average of ~56%) which supports KDBL's cost of funds (4.97% as on mid-Apr-16). Comfortable capitalization profile (CRAR[3] of 13.04% as on mid-Apr-16) and management expertise are expected to provide KDBL with adequate growth opportunities over the medium term. ICRA Nepal also takes note of the bank's ability to recover losses sustained in FY13 and FY14, primarily supported by write back of credit provisions due to healthy recoveries on earlier non-performing loans. KDBL's ability to further improve deposits profile and maintain healthy portfolio growth as evidenced in 9MFY16 (~33% growth in portfolio over 9MFY16 compared to CAGR[4] of ~16% over past five years ending FY15) would have a key bearing over the financial profile of the bank going forward.

The grading is however constrained by high geographical concentration risks (~63% of business is concentrated within Kathmandu valley) and modest scale of operations (asset base of ~NPR 7.5 billion as on mid Apr-16). Although the bank has been able to manage NPLs[5] level (gross NPLs 2.6% as on mid-Apr-16 vs. 7.95% as on mid-Jul-15), KDBL has restructured a number of loans (6.6% of credit) and continues to witness high delinquencies (0+ days ~28% including NPLs as on mid Apr-16[6]) on account of earthquake and elongated political turmoil[7] impacting the overall economy and repayment capacity of the borrowers. Hence the bank's asset quality could remain under pressure going forward, despite easing of event related stress on the borrowers with the strike ending recently.

The grading is further constrained by KDBL's moderate operating profitability indicators (lower NIMs[8] among peers at 3.66% during 9MFY16 with high operating expenses ratio). While assigning the grading, ICRA Nepal has also factored in KDBL's capital base being much lower to revised regulatory capital framework to be complied by FY17, lack of Institutional promoters, and relatively weaker borrower profile compared to commercial banks.

Nonetheless, the grading also factors in regulatory arbitrage available with 'Schedule B' Development Banks compared to 'Schedule A' commercial bank in the form of lower absolute capital requirements and

[1] Current and Savings Accounts
[2] Mid-Apr-16 data are unaudited
[3] Capital to Risk-weighted Assets Ratio
[4] Compounded Annual Growth Rate
[5] Non-performing loans
[6] Delinquent loans on mid-Apr-16 accounted for 27.99% of total loans vs. 31.49% in mid-July-15.
[7] Nepalese economy faced ~5 months long custom blockade and strikes in terai region in FY16 that ended recently.
[8] Net Interest Margins as a % of Average Total Assets

lower CRR/SLR[9] requirements. Going forward, KDBL's ability to scale up its operations ensuring efficient utilization of capital, improve its operational profitability and manage delinquent loans would have a bearing on the overall financial profile.

KDBL commenced operations in Oct-2007 and with low credit growth (CAGR of ~16% over past five years ending mid-Jul-15 vs. ~24% growth in industry), the credit portfolio was ~NPR 5.5 billion as of mid Apr-2016. The growth was partly supported by merger of a Class C Finance Company (Shikhar Finance) with KDBL in April 2012. However, KDBL has witnessed high growth of ~33% during 9MFY16, supported mainly by competitive rates offered for advances. The credit portfolio (as of Apr-16) primarily comprises business overdraft (30%), personal loans (21%), term loans (16%), home loans (16%), loan against shares (6%), hire purchase loans (5%), among others. KDBL's portfolio remains fairly concentrated, both geographically (~70% loans in Kathmandu Valley) and among top borrowers (~19% of portfolio on Apr-16 among top 20 borrowers).

Bank's asset quality witnessed high stress in FY13 (post-merger) with gross NPLs rising from 1.66% to 11.11% during the year. Though the NPLs gradually declined over the next two years, fresh NPL generation remained high (~5-6%). With increased recovery efforts and lower fresh generation (0.72% during 9MFY16), the NPLs have come down to 2.60% by mid-Apr-16 (vs. 7.95% as on mid-Jul-15), however still remains higher than industry average and peers. KDBL's delinquency levels also generally remain high at ~28% of total loans on mid-Apr-16 vs. ~32% on mid-July-15. Higher delinquencies, coupled with adverse impact on repayment capacity of borrowers (on account of earthquake and prolonged strike) resulting in rescheduling of ~7% of portfolio could impact bank's asset quality profile going forward. Overall, KDBL's portfolio vulnerability remain high vs. commercial banks due to inferior borrower profile, limited capability for borrower's credit assessment system and assessed income based lending, which could lead to volatility in asset quality indicators.

As for funding profile, despite deterioration in 9MFY16, KDBL has a fair proportion of low cost CASA deposits (~52% as on Apr-16 vs. ~56% for the industry) resulting in lower cost of funds (4.97% for 9MFY16) among peers. With larger reliance on term deposits to meet the high growth in advances during 9MFY16, the bank's CASA deposit has witnessed deterioration post Jul-15 (CASA deposits were ~60% as of Jul-15). Additionally, deposits remain moderately concentrated (top 20 depositors comprise ~16% of total deposits on Apr-16). Bank's ability to manage its deposit cost would have a strong bearing on overall competitive positioning in the future.

Owing to spike in NPLs, the bank incurred losses during FY13 and FY14 eroding ~23% of its net worth; which KDBL was able to recover during FY15 and 9MFY16 through improved profitability(return on net worth of ~11% and ~34% respectively and return on assets of 1.21% and 3.86% respectively). However, the profitability indicators were largely supported by write-back of provisions (reduction in NPLs) and gain on sale of NBA[10] (return on networth excluding recovery from NPLs was ~12% during 9MFY16). Further, lower fee based income (~0.9% of ATA) and high operating expenses ratio (~3% of ATA) also act as a drag on profitability. Going forward, the profitability profile of the bank will be primarily dependent on its ability to improve lending spreads and manage asset quality; which however remains a challenge given the expected impact of elongated strikes on the repayment ability of borrowers.

KDBL's CRAR stood at 13.04% as of mid-Apr-16 (13.60% on mid Jul-15) as against minimum regulatory requirement of 11% for class B banks; with tier I capital of 11.90%. Monetary policy of FY 2015-16 has announced that national level development banks are required to increase their paid-up capital to NPR 2,500 million within FY17. KDBL has a capital of ~NPR 680 million as of mid-Apr-16 and the same is expected to increase to ~NPR 850 million after proposed right issue (assuming full subscription). Bank is planning further rights offering and is also exploring merger options to meet the revised regulatory capital requirements. Finding adequate sources to meet the elevated regulatory requirement and maintaining adequate returns over increased capital base would also remain key challenges for the bank.

[9] Cash Reserve Ratio/ Statutory Liquidity Ratio
[10] Non-Banking Assets

Bank Profile

Operating since October 2007, Kasthamandap Development Bank Limited (KDBL) is a national level development bank promoted by a group of individual promoters from diverse backgrounds. Its corporate office is located at New Road, Kathmandu. A Class C institution (Shikhar Finance) was merged with KDBL in Apr-12, and the merged operations continued with KDBL's name. Share capital of the company is distributed among promoter & public in the ratio of 70:30 with maximum shareholding by one individual at 9.43% of total capital. The bank's equity shares are listed on the Nepal Stock Exchange. Mr. Umesh Singh Bhandari is the Chief Executive Officer of the bank.

KDBL has a network of 19 branches and eight ATMs in 11 districts of Nepal. The bank has a market share of around 2.37% in terms of deposit base and 2.42% in terms of credit portfolio (both among Development Banks) as on mid-Jan-16. KDBL reported a net profit of NPR 69 million during 2014-15 over an asset base of NPR 5,881 million as on mid Jul-15 as against net loss of NPR 61 million during 2013-14 over an asset base of NPR 5,518 million as on mid Jul-14. For 9MFY16, bank has reported net profit of NPR 193 million over an asset base of NPR 7,455 million. KDBL's CRAR was 13.04% and gross NPLs were 2.60% as on mid-Apr-2016. In terms of technology platform, KDBL has implemented Pumori Plus IV System which is centralized throughout its branches.

May 2016

For further details please contact:

Analyst Contacts:
Mr. Kishor Prasad Bimali, (Tel No. +977-1-4419910/20)
kishor@icranepal.com

Mr. Rajib Maharjan, (Tel No. +977-1-4419910/20)
rajib@icranepal.com

Relationship Contacts:
Mr. Deepak Raj Kafle, (Tel. No. +977-1-4419910/20)
drkafle@icranepal.com