Saptakoshi Development Bank Limited

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

Facility/Instrument	Issue Size	Grading Action (September 2016)
Rights Share Issue	NPR 100 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 100 million of Saptakoshi Development Bank Limited (SKDBL). ICRA Nepal assigns IPO/Rights Issue 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. SKDBL is proposing to come out with 1:1 rights issue of 1,000,000 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.

The grading is constrained by high geographical concentration risks (~70% of business is concentrated within one district), small scale of operations with limited franchise (asset base of ~NPR 871 million and eight branches as on mid Jul-16), limited track record (operating from October 2012), limited seasoning of credit book, higher portfolio vulnerability due to relatively inferior borrower profile vs. commercial banks and high proportion of loans with assessed income based appraisal which could lead to higher volatility in asset quality indicators. The grading is further constrained by bank's high cost of operations (~4% of ATA for FY16), declining NIMs[1] (5.26% for FY16) and lack of diversity in earnings resulting in weak profitability profile among peers despite gradual improvement over the years (RoNW of ~5% for FY14 to ~9% for FY16). While assigning the grading, ICRA Nepal has also factored in SKDBL's capital base being much lower to revised regulatory capital framework to be complied by FY2017 and the dilution in return indicators over medium term arising from higher incoming capital vs. the targeted business growth requirements. The grading is also constrained by lack of Institutional promoters, stiff competition with commercial banks offering products at finer lending rates and uncertain operating environment that financial institutions in Nepal are currently facing.

The grading however factors in the bank's ability to achieve high business growth over last two years (credit portfolio grew by CAGR[2] of ~69%; albeit on a lower base) while maintaining fair assets quality indicators (gross NPL[3] were 0.55% as on mid-Jul 2016, benefited by low seasoning of credit book). Comfortable capitalization profile (CRAR[4] of 17.45% as on mid-Jul-16) and management expertise along with reputation/knowledge of promoters in its area of operations are expected to provide SKDBL with adequate growth opportunities over the medium term. The grading also takes into account bank's moderate CASA[5] deposit profile (~49% as on mid-Jul-16[6] against industry average of ~54%) and regulatory arbitrage available with 'Schedule B' Development Banks compared to 'Schedule A' commercial bank in the form of lower absolute capital requirements and lower CRR/SLR[7] requirements. Going forward, SKDBL's ability to scale up its operations ensuring efficient utilization of existing as well as additional capital, improve its profitability profile whilst maintaining its assets quality indicators would have a bearing on the overall financial profile.

---

[1] Net Interest Margins
[2] Compounded Annual Growth Rate
[3] Non-Performing Loans
[4] Capital to Risk-weighted Assets Ratio
[5] Current and Savings Accounts
[6] Mid-Apr-16 data are unaudited
[7] Cash Reserve Ratio/ Statutory Liquidity Ratio

SKDBL has been able to grow its portfolio at high pace (CAGR of ~69% achieved over last two years, vs. industry average CAGR of ~19%) although portfolio size still remains small (credit portfolio was NPR 601 million as of mid-Jul-2016). As on mid-Jul-2016, SKDBL's credit portfolio primarily composed of business loans (37%), agriculture loans (29%), personal loans (17%), deprived sector loans (7%), housing loans (5%), hire purchase (2%) and balance being other loans. The credit expansion has been supported by gradual increment in franchise (8 branches as of mid-Jul-2016) with major concentration (~70%) in Morang district from where it started its operations. Bank's credit portfolio remains moderately concentrated among top 20 borrowers at ~17% of portfolio as of mid-Jul 2016. Being a three-district development bank, SKDBL is allowed to operate in limited geographical area and at the same time it faces competition from commercial banks with wider product suits and finer lending rates. However, SKDBL's promoter and management's reputation/knowledge of the local market and its focussed approach and reach in its area of operations along with plans to venture into group based microfinance lending and gold loans, could help achieve adequate growth. Over longer term, scalability of business would remain a challenge given promoters' knowledge/reputation limited to local market.

Bank's asset quality witnessed increased stress till 9MFY16 arising from impact of elongated strikes in repayment capacity of its borrower profile. Delinquencies (30+ dpd)[8] increased from 1.66% as of mid-Jul-15 to 8.67% as of mid-Apr-16 and thereafter declined to 2.43% as of mid-Jul-16 owing to easing of event related stress on the borrowers with the end of strike. SKDBL's reported NPLs of 0.55% as of Jul-16 (increased from Nil as on mid-Jul-2015) are partly benefitted from limited seasoning of credit book wherein asset quality trend is yet to be established. Overall, SKDBL'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. Management's ability to control on asset quality indicators with targeted portfolio growth would be critical for improvement in its profitability indicators.

As for funding profile, with gradual improvement over the years, SKDBL's proportion of low cost CASA deposits has improved to~49% as on mid-Jul-16 vs. ~54% for industry, compared to CASA of ~37% as on Jul-13 resulting in modest cost of funds among peers (5.85% for FY16). Despite some improvement in terms of granularity of deposits profile, top 20 depositors still account for a high proportion of deposits at ~31% as of mid-Jul 2016. Going forward, management's focus on achieving granular deposit growth and expansion of depositors' base could improve deposits profile. Bank's ability to manage its deposit cost would have a strong bearing on overall competitive positioning in the future.

Bank's profitability profile remains subdued, notwithstanding the improvement over the last 2-3 years.. SKDBL reported return on net worth of 8.50% and 2.22% for FY16 and FY15 respectively and return on assets of 1.32% and 0.44% respectively. Profitability indicators of the bank has been witnessing gradual improvement over the years, with exception of FY15 where the indicators were impacted by capitalisation of its IPO along with related expenses. However, declining NIMs (5.26% for FY16), high cost of operations (~4% of ATA for FY16) and lack of diversity in earnings act as a drag on profitability. SKDBL's profitability is expected to remain low over the medium term owing to substantial capital enhancement plans in order to meet revised regulatory capital requirements.

SKDBL's CRAR was 17.45% (tier I capital of 16.58%) as of mid-Jul-2016, significantly higher than the regulatory minimum of 11%. The proposed issue is likely to further maintain capital at higher levels over the medium term. Monetary policy of FY 2015-16 has announced that three district level development banks are required to increase their paid-up capital to NPR 500 million within FY17. SKDBL has a capital of NPR 100 million as of mid-Jul-16 and the same is expected to increase to NPR 200 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 remain key challenges for the bank.

[8] Dpd: days past due; SKDBL could not provide data for 1-30 days delinquencies due to limitation in its system.

Company Profile

Established in April 2012, Saptakoshi Development Bank Ltd (SKDBL) started its commercial operation as three district development bank from October 2012. SKDBL is licenced to operate in the territory of three districts viz. Morang, Panchthar and Ilam. The registered and corporate office of the bank is in Morang district. Share capital of the bank is distributed among promoter & public in the ratio of 60:40 with maximum shareholding by one individual at 7.80% of total capital. The shares of the company are listed on the Nepal Stock Exchange. Mr. Navin Subedi is the Chief Executive Officer of the bank.

SKDBL has a network of eight branches (all operating on core banking - Pumori IV System) spread across its working area of three districts of Nepal. The bank has a market share of around 0.27% in terms of deposit base and 0.26% in terms of credit portfolio (both among Development Banks) as on mid-Jul-16. SKDBL reported a net profit of ~NPR 9 million during 2015-16 over an asset base of NPR 871 million as of mid-Jul-16 as against net profit of ~NPR 2 million during 2014-15 over an asset base of NPR 549 million as on mid Jul-15. SKDBL's CRAR was 17.45% and gross NPLs were 0.55% as on mid-Jul-2016.

September 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