Shangri-la Development Bank Limited

ICRA Nepal assigns [ICRANP] IPO Grade 3 to the proposed Rights Issue of Shangri-la Development Bank Limited

Instrument/Facility	Issue Size	Grading Action (October 2017)
Rights Issue (Equity shares)	NPR 1,086.78 million	[ICRANP] IPO Grade 3 (Assigned)

ICRA Nepal has assigned "**[ICRANP] IPO Grade 3**", indicating average fundamentals to the proposed rights issue amounting NPR 1,086.78 million of Shangri-la Development Bank Limited (SADBL). 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. SADBL proposes to come up with 80% rights issue of 10,867,798.50 numbers of equity shares, each with face value of NPR 100, to be issued to existing shareholders at par. The proposed capital injection is targeted towards ensuring regulatory minimum paid up capital of NPR 2,500 million for national level class B Development Banks.

The average fundamental grading factors in the SADBL's demonstrated ability to achieve scale growth (CAGR[1] ~31% over last three years vs. ~21% for banking industry) while maintaining healthy asset quality (NPLs 0.60% and overall delinquencies of ~5% as of mid-Jul-17) and adequate profitability levels. Comfortable capitalization, experienced management team, diversified franchise (35 branches across 17 districts) with rapid branch expansion plans of management remain positive for incremental growth prospect of SADBL. The grading also takes into consideration the fair granularity of SADBL's portfolio resulting in low concentration risks (~10% of total credit portfolio and ~12% of total deposits among top 20 customers). The grading also factors in the bank's adequate track record in banking (operating since 2006) with fair deposits profile that supports competitive cost of funds (5.58% for FY17) among peers.

However, the grading remains constrained by relatively weak competitive positioning of SADBL vis-à-vis large class A commercial banks with finer lending rates; especially in the "base rate plus" lending rate regime recently introduced by Nepal Rastra Bank (NRB). Limited avenue for fee based income[2] for class B banks is also likely to affect the income diversity and profitability prospect of SADBL, while operating on a large scale. The grading is also constrained by marginal borrower profile vis-à-vis commercial banks and relatively high proportion of loans with assessed income based appraisal, especially personal loans (~35%). The grading also factors in the lack of institutional promoters and uncertain operating environment that the banks in Nepal are currently facing. Dilution effect of significant capital increment on return indicators along with expected impact on asset quality post the recent hardening of interest rates also remains a concern. Going forward, SADBL's ability to scale up its operations ensuring efficient utilization of incremental capital, improve its risk management framework commensurate to growth plans, maintain its profitability profile and asset quality would have key bearing on the bank's overall financial profile.

SADBL's merger with Bageshwori Development bank in July 2014 aided significant scale enhancement (~68% growth in asset base) and upgradation to national level status. The upgradation aided the merged entity in registering healthy growth at CAGR of 31% in credit and 29% in deposits during last three years ending Jul-17 (vs. 21% and 17% for the banking industry respectively). The healthy credit growth has been supported by the bank's competitive cost of funds allowing it to offer lending at competitive rates as evident from bank's lower yield on advances among peers at ~12.5% for FY17. SADBL's credit portfolio of NPR 11,667 million as of mid-Jul-17 comprised mainly of Personal loans (~35% of total loans), Business loans (~29%), Hire purchase loans (~14%), Housing loans (~11%), Deprived sector loans (~7%) and Miscellaneous (~4%). Minimal chunk of the portfolio growth (NPR 604 million i.e. ~5% of

[1] Compounded annual growth rate

[2] Class B banks are not permitted to deal in foreign trade financing operations by regulations. Moreover, Class B banks hold small share in guarantee business vis-à-vis class A banks.

SADBL's combined portfolio as of mid-Jul-17) was aided by acquisition of Cosmos Development Bank in Jul-17.

On assets quality front, SADBL remains comfortable with gross NPLs of 0.60% (1.36% for Class-B industry) and solvency ratio (Net NPL/ net worth) of 2.18% as on mid-Jul-17. The improvement in NPLs from 1.49% as of Jul-13 has been aided by lower gross NPL generation rate (0.50% on an average for last three years), healthy recovery (~50% for last three years) and partly due to dilution effect of portfolio growth. Delinquencies also stands moderate at 5.23% as of mid-Jul-17 (3.07% on Jul-16). However, high growth in low interest rate regime over last 2-3 years along with high exposure to vulnerable real estate loans at ~13% as of Jul-17 (vs. ~8% for industry) remains a concern for incremental asset quality prospects. Going forward, ability of the bank to maintain healthy assets quality would remain dependent upon strengthening of underwriting practices and risk management framework in line with scale enhancement plans of management.

As for funding profile, SADBL's deposit profile witnessed similar decline in terms of current and savings account (CASA) proportion compared to development bank industry average and the same currently remains comparable to industry at ~42% as of mid-Jul-17. Despite similar CASA mix, cost of deposits for SADBL has remained competitive to peers and the industry average (5.58% for FY17 vs. 5.91% for industry), mainly due to different interest rate across the industry for similar product. The cost of funds is nonetheless poised to rise over medium term owing to swift increment in high cost deposits towards latter half of FY17 and hence this could impact the competitive positioning of SADBL, especially in the recently introduced "base rate plus" lending rate regime. Nonetheless, granular deposit base of SADBL cushions the bank from liquidity risk as well as offers scope for quicker repricing of the deposits in future.

SADBL's profitability profile has remained healthy (return on net-worth of ~18-20% and return on assets ~2% over last 3-4 years), driven by good Net Interest Margin (NIMs) on increasing scale of operations. NIMs of 5.05% for FY17 remain supported by healthy yield generated on high-yield-retail-advances, though slightly lower to peers. SADBL reported profit after tax (PAT) of ~NPR 344 million in FY17[3] (corresponding to return on net worth of ~21% and return on assets of 2.44%). Low credit cost and gradual moderation in operating expense ratio also supports the profitability level. However, low proportion of fee based income (0.68% of Average Total Assets for FY17) remains a drag to the profitability. Incremental profitability of the bank will depend on the management's ability to achieve healthy portfolio growth ensuring efficient utilisation of large incoming capital while maintaining the NIMs and increase diversification of the earning profile. Ability of the bank to maintain its assets quality will also have a bearing on the profitability prospect of the bank.

As on mid-Jul-17, CRAR of SADBL stood comfortable at 14.44% against regulatory minimum of 11% for class B banks. The proposed rights offering would help bank in meeting the elevated capital requirements of NPR 2,500 million (as applicable to national level development banks) comfortably. Incremental capital infusion would strengthen the capitalization profile further and support the targeted credit growth plans of management. Healthy rate of internal capital generation is also likely to support the capital requirement for future growth of the bank. However, over next 2-3 years, achieving adequate business growth and maintaining returns on increased capital base would remain key challenges for the management.

Company Profile

Established in December 2006 as a regional development bank, Shangri-la Development Bank Limited (SADBL) underwent merger with another regional development bank viz. "Bageshwori Development Bank" on 13th July 2014 and upgraded itself to a national level development bank. The merged operations were continued under the name of Shangri-la Development Bank and the corporate office of the merged entity was relocated to Baluwatar, Kathmandu. The bank recently acquired "Cosmos Development Bank", a small one district level development bank on 14th July 2017. The bank is promoted by 406 individual promoters from diverse backgrounds with maximum shareholding by one individual at 1.95% of total capital (as on mid-July 2017). Share capital of the company is distributed

[3] FY17/Jul-17 numbers are based on unaudited data as provided by the management

among promoter & public in the ratio of 70:30. The bank's equity shares are listed in Nepal stock exchange. Mr. Rajendra Prasad Poudel is the Chief Executive Officer of the bank.

SADBL has presence across 17 districts of Nepal through its 35 branches, 1 extension counter, 6 microfinance units and 14 ATMs as of mid-July 2017. SADBL has market share of 5.79% in terms of deposit base and 5.49% in terms of credit portfolio of Development banking industry as on mid-Jul-17. SADBL reported net profit of ~NPR 344 million during 2016-17 over an asset base of NPR 16,265 million as of mid-Jul-17 as against net profit of ~NPR 215 million during 2015-16 over an asset base of NPR 11,959 million as of mid Jul-16. SADBL's CRAR was at 14.44% and gross NPLs were 0.60% as on mid-Jul-2017. In terms of technology platform, SADBL has implemented Pumori-IV system which is centralised throughout all its branches.

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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