Kamana Sewa Bikas Bank Limited

ICRA Nepal assigns [ICRANP] IPO Grade 4+ to the proposed Rights Issue of Kamana Sewa Bikas Bank Limited

Instrument/Facility	Issue Size	Grading Action (December 2017)
Rights Issue (Equity shares)	NPR 309.42 million	[ICRANP] IPO Grade 4+ (Assigned)

ICRA Nepal has assigned "**[ICRANP] IPO Grade 4+**", indicating below average fundamentals to the proposed rights issue amounting NPR 309.42 million of Kamana Sewa Bikas Bank Limited (KSBBL). 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. KSBBL proposes to come up with 15% rights issue of 3,094,154.78 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 assigned grading takes into account KSBBL's adequate track record in banking (both pre-merger entities operating since 2007), demonstrated ability to achieve healthy growth (CAGR ~21%[1] over last four years vs. ~19% for banking industry) and the scale advantages the bank could reap going forward being a national level development bank. Comfortable capitalization profile, experienced management team, diversified franchise (40 branches and one head office across 14 districts) with rapid branch expansion plans of management remain positive for incremental growth prospects of KSBBL. The grading also considers the highly granular portfolio of KSBBL among peers (~7% of credit and ~8% of deposits among top 20 customers as of mid-Oct-17) reducing concentration risks. The grading also factors in the adequate profitability indicators reported by KSBBL in the past (average return on net worth remained ~18% in past five years vs. ~14% for industry), notwithstanding the stress seen in Q1FY2018 due to increased delinquencies.

However, the grading remains constrained by relatively weak competitive positioning of KSBBL 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). Higher decline in KSBBL's low cost CASA deposits compared to industry (from 54% on Jul-16 to 41% on Oct-17 vs. 54% and 44% for industry) and the resultant higher cost of funds among peers (8.68% for Q1FY2018) also remains a concern. The grading also remains constrained by the gradual deterioration in the asset quality profile of the bank over the years with Gross NPLs increasing from 0.34% as of Jul-15 to 2.11% as of Oct-17 along with swift spike in delinquencies in Oct-17[2] to ~35% from earlier 15-20% levels. ICRA Nepal expects incremental strain on asset quality and profitability post the recent hardening of interest rates for KSBBL as well as across the banking sector. Limited avenue for fee based income[3] for class B banks is also likely to affect the income diversity and profitability prospect of KSBBL, while operating on a large scale. The grading is also constrained by marginal borrower profile vis-à-vis commercial banks owing to assessed income based appraisal and lack of institutional promoters. Going forward, KSBBL's ability to scale up its operations ensuring efficient utilization of incremental capital, improve its risk management framework commensurate to growth plans, maintain adequate profitability profile and asset quality would have key bearing on the bank's overall financial profile.

[1] Compounded annual growth rate (CAGR) on a consolidated basis for all the pre-merger entities.
[2] FY17/Jul-17 numbers are based on unaudited data provided by management on combined basis for both pre-merger entities; Q1FY18/Oct-17 numbers are based on unaudited data provided by management for merged entity.
[3] 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.

KSBBL's scale of operations was significantly enhanced by merger of two largely similar sized development banks (erstwhile Kamana Bikas Bank and Sewa Bikas Bank) in Aug-17 creating a larger national level development bank. Kamana Bikas Bank had earlier undergone merger with Kaski Finance in June 2016. Consolidated portfolio growth for all the pre-merger entities over the years has remained healthy with CAGR ~21% over last four years ending Jul-17 (vs. 19% for banking industry), however lower growth was reported in FY17 compared to industry (~14% vs. 19% for industry) amidst tightening liquidity scenario. Bank's yields remain moderate among peers (~13% for FY17) which along with comfortable capitalization has supported the growth so far. KSBBL's credit portfolio of NPR 11,925 million as of mid-Oct -17 comprised mainly of overdraft (~32% of total loans), term loans (~27%), hire purchase loans (~12%), housing loans (~12%), real estate loans (~9%), deprived sector loans (~5%) and miscellaneous (~3%).

In asset quality front, bank has reported gradual deterioration over the years (gross NPLs increasing from 0.34% as of mid-Jul-15 to 2.11% on mid-Oct-17) while the delinquencies have also increased form ~15-20% levels to ~35% as of Oct-17. Increment in delinquencies can be partly attributed to recent hardening of interest rates across the banking sector. KSBBL reported high fresh slippage of 1.20% during Q1FY18 compared to 0.69% for last two years leading to increment in NPLs from 1.12% as of mid-Jul-17 to 2.11% as of mid-Oct-17. This has resulted in decline of provision cover to ~55% on Oct-17 (~73% on Jul-17) and increased solvency ratio to ~4% as of Oct-17 (~1.5% as of Jul-17). 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, KSBBL's low cost CASA deposits remained comparable to industry till Jul-16 (~54% for both). However, the mix has deteriorated at a higher pace than industry in recent periods resulting in lower CASA compared to industry and peers (~41% in Oct-17 vs. 44% for industry). With this, cost of funds of the bank has increased to 8.68% for Q1FY2018 compared to 6.11% for FY2017, impacting the bank's competitive positioning among peers. Nonetheless, granular deposit base of KSBBL (~8% among top 20 customers as of Oct-17) cushions the bank from liquidity risk as well as offers scope for quicker repricing of the deposits in future.

KSBBL's reported profitability profile has remained adequate (average return on net-worth of ~18% vs. industry average of ~14% and return on assets ~2% over last five years; ~18% and 2.43% for FY2017), supported by healthy NIMs among peers (5.35% for FY2017). Increased delinquencies coupled with higher increase in cost of deposits have pressurized NIMs in Q1FY2018 (2.45%) which along with dilution effect of capital increment would be impacting profitability indicators for FY2018. Downsizing the delinquencies levels and hence improve the poor profitability indicators reported for Q1FY2018 (return on assets of 0.07% and return on net worth of 0.31%) would remain major challenges for the bank going forward given the continued stress in liquidity across banking sector which could impair the ability of borrowers to serve the facility at higher rates. Additionally, low proportion of fee based income (0.65% and 0.55% of Average Total Assets for FY2017 and Q1FY2018 respectively) 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 increased capital along with ability to improve the asset quality profile, NIMs and diversification of the earning profile.

As on mid-Oct-17, capitalisation profile (CRAR) of KSBBL stood much higher at 25.25% (as per Basel-II) against regulatory minimum of 11% for class B banks. The proposed rights offering is hence targeted towards meeting the elevated capital requirements of NPR 2,500 million (as applicable to national level development banks, to be met by Jan-18). Post proposed issue, bank would have capital of ~NPR 2,368 million; rest planned to be met from capitalisation of last year's profits. The capital infusion would support the targeted credit growth plans of management and would also help in maintaining comfortable solvency profile in case of further incremental slippages.

Going forward, achieving adequate business growth and generating healthy returns over increased capital base would remain key challenges for the management.

Company Profile

Kamana Sewa Bikas Bank Limited (KSBBL) is a national level development bank formed after merger of Kamana Bikas Bank (National level development bank) and Sewa Bikas Bank (10 district level development bank) on 4th August 2017. Prior to this merger, erstwhile Kamana Bikas bank had also undergone merger with Kaski Finance on 20th June 2016. The corporate office of the bank is located at Pokhara, Kaski. The bank is promoted by wide range of promoters with maximum shareholding by one promoter at 1.93% of total capital (as on mid-Oct 2017). Share capital of the bank is distributed among promoter & public in the ratio of 51:49. Mr. Mahesh Prasad Kafle is the Chief Executive Officer of the bank.

KSBBL has presence in 14 districts of Nepal through its 41 branches and 16 ATMs as of mid-Oct 2017. KSBBL has market share of 5.26% in terms of deposit base and 5.49% in terms of credit portfolio of development banks as on mid Jul-17. On a consolidated basis for all pre-merger entities, KSBBL reported net profit of ~NPR 350 million during FY2017 over an asset base of NPR 15,298 million as of mid-Jul-17 as against net profit of ~NPR 213 million during FY2016 over an asset base of NPR 13,500 million as of mid Jul-16. For Q1FY2018, the bank has reported net profit of ~NPR 2 million over an asset base of NPR 16,259 million as of mid-Oct-17. KSBBL's CRAR was at 25.25% (as per BASEL-II) and gross NPLs was at 2.11% as on mid-Oct-2017. In terms of technology platform, KSBBL has implemented centralised Pumori-IV system throughout all its branches.

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