Kathmandu Finance Limited

ICRA Nepal assigns [ICRANP] IPO Grade 5 to the proposed Rights Issue of Kathmandu Finance Limited

Facility/Instrument	Amount (NPR million)	Rating Action (June 2015)
Rights Share Issue	183.7763	[ICRANP] IPO 5 (Assigned)

ICRA Nepal has assigned an "**[ICRANP] IPO Grade 5**", indicating poor fundamentals to the proposed rights issue amounting NPR 183.7763 million of Kathmandu Finance Limited (KFL). 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. KFL is proposing to come out with a rights issue of 1,837,763 numbers of equity shares of face value NPR 100 each, to be issued to its existing shareholders.

The grading is constrained by significant stress expected on KFL's capitalisation profile on account of proposed merger with one problematic bank, Gorkha Development Bank, which has reported negative net worth of NRs 539 million as on mid-Jan-15 vs. KFL's net worth of NRs 258 million as on mid-Apr-15. Despite the proposed fresh capital raising (through right issue), net worth of combined entity (post-merger) is likely to be negative. The grading is also constrained by KFL's moderate track record, small base of operation with lack of franchise network leading to geographical concentration, low profitability (PAT/Net worth ~6% over past 5 years), lack of diversity in earnings, high credit concentration to share base loan (29% of total credit portfolio comprised of margin lending[1]) with high concentration among top borrowers (top-20 borrowers accounted for 32% of loan book as on Jan-15) , high deposit concentration (top 20 depositors accounted for ~45% of total deposits on Apr-15) and low exposure of promoter & management in banking industry.

Assets quality of KFL (Gross NPLs of 1.54% on Apr-15 and 4.66% in July-14) fares better than finance company industry average; however, the same is benefitted from the regulatory forbearance[2] accorded to class C finance companies in NPL recognition. KFL's inferior deposits profile as reflected in higher concentration and high deposit cost (~10.5% in FY14 and 8.22% in 9MFY15) is a negative from liquidity perspective as well as competitive positioning vis-à-vis other players in the industry. ICRA Nepal expects deterioration in the financial profile of KFL post-earthquake, considering the geographical concentration of business and relatively weaker borrower profile. KFLs ability to achieve sustainable growth and generate return on to the shareholders under current situation remains low. The grading is also constrained by uncertain operating environment that Nepalese Banks and financial institutions are currently facing.

The credit portfolio of KFL grew by CAGR 3% over past 3 years (ending FY14) amid uncertainty surrounding the stability of board and management. Following the agreement introducing new shareholders and management into KFL, the credit growth spiked to 83% (albeit on a low base) over 9MFY15. Most of the growth was contributed by share based loans and demand loan to traders which led to the concentration of KFL's portfolio towards a these segment (share based loans accounted for ~29% and demand loan 33% of total loans on Apr-15). The gross NPL as on Apr-15

[1] loan against shares for the purpose of share trading .
[2] Class C companies can classify overdue instalments as NPA as opposed to the entire outstanding term loans for a period of 1 year from the date of instalments overdue.

stood at 1.54% compared to 4.66% as on July-14; the decline brought about primarily by increase in credit portfolio in the interim. Moreover, sizeable portion of the credit book of KFL remains unseasoned, considering recent high growth; thereby benefitting the assets quality position. Assets quality of KFL is further benefitted from regulatory forbearance accorded to class C finance companies regarding NPL recognition criteria; therefore the actual NPL level remains higher than reported.

Although a National Level Finance Company, KFL at present operates only through its registered office. This localized operation has imposed constraints in deposit mobilization, created risk of geographical concentration of credit and competition from other financial institutions with larger scale of operations. As on Apr-15, KFL's credit portfolio stood at NPR 837 million with total deposit base of NPR 876 million. KFL's credit portfolio comprised mainly of working capital loan (33%), Share loans (29%), Housing loans (16%), real estate loans (9%) and hire purchase (4%) among others. Exposure towards share loans also remains vulnerable to any untoward movement in the stock market; considering the marginal profile of borrowers and general lack of secondary collateral or income source.

As for funding profile, the cost of deposits remains on higher side due to higher interest offered in deposit product as a consequence of weak image of C class finance company among other financial institution. At the same time, significant concentration of deposits among the top depositors (40% of total deposits among top 20 depositors) also poses risk to the stability of deposit and liquidity position. Going forward, the ability of KFL to increase its presence across different geographies thereby increasing the depositor base will remain vital to funding profile as well as competitive positioning vis-à-vis other players.

KFL has not been able to adequately deploy its funds as evidenced by low CD ratio (last 5 years' average of 62% compared to 80% permitted by the regulations). Falling yield on advances, large proportion of idle funds yielding nominal return on investments coupled with high cost of deposits has resulted in lower gross interest spread affecting overall profitability. KFL's Net Interest Margin (NIMs) has remained low (~2-3%) over past 2 years, driven by falling yield on advances without corresponding fall in cost of deposits and low CD ratio. Falling NIMs and higher operating cost ratio (due to small scale of operation) led to KFL reporting modest profits of NPR 15.31 million in FY14 (corresponding to PAT/Net worth of 6.73% and PAT/ATA of 2.13%) and NPR 2.16 million in 6MFY15 (corresponding to PAT/Net worth 1.70% and PAT/ATA 0.48%). KFL's earnings profile going forward will largely depend on the ability of the company to expand its franchise and scale of operations, control further NPA growth and regularize existing NPA thereby maintaining the quality of incremental credit portfolio.

The shareholding of the company is diversified across over 102 individual promoters with no institutional promoter support. Present shareholding structure comprises 55% promoter holding with 45% holding by general public. KFL has a 5 member- Board of Directors having limited experience across Financial Institutions and no independent/professional director at present. The top management has moderate experience across Financial Institutions. As on Apr-15, capital adequacy ratio (CRAR) of KFL stood at 26.58% as compared to 39% as on July-14. Assuming full subscription of proposed rights issue and probability of low credit growth over short run, KFL' capitalization levels are expected to remain high (~20-25%) over next 2-3 years.

KFL has recently signed a memorandum of understanding with Gorkha Development Bank Limited (an ailing class B development bank) for merger; with the initiation of Central Bank of Nepal. The agreement provides for the merged entity to be a Class B Development Bank. Although the process has not reached conclusion, the immediate financial prospect of merged entity remains weak with likely hood of negative net worth post-merger requiring infusion of incremental capital in the merged entity.

Company Profile

Registered in November, 1994 Kathmandu Finance Limited (KFL) started its commercial operation on November 1994. The finance company was promoted by 102 individual persons involved in different professions. Share capital of the bank is distributed among promoter & public in the ratio of 55:45. Mr. Raj Kumar Rai is the Chief Executive Officer of the bank. The bank's equity share is listed in Nepal stock exchange.

KFL franchise is currently limited to its head office in Kathmandu despite having license to operate in any area within Nepal. KFL has market share of about 0.045% in terms of deposit base and 0.05% in terms of credit portfolio of overall banking industry as on mid Jan-15. KFL reported a net profit of NRs 15.31 million during 2013-14 over an asset base of NRs 815.43 million as of mid Jul-14 as against net profit of NRs 5.29 million during 2012-13 over an asset base of NRs 625.24 million as of mid Jul-13. As of 9MFY15, Bank has reported a profit after tax of NRs 8.13 million over an asset base of NRs 1,177.43 million. KFL's CRAR was 26.58% and gross NPLs were 1.54% as on mid-Apr-2015. In terms of technology platform, KFL has implemented "Bank Plus" as its software and is in process of updating to "Web Based Bank Pro".

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