Karnali Development Bank Limited

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

Facility/Instrument	Issue Size	Grading Action (October 2015)
Rights Share Issue	NPR 40 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 NPR 40 million of Karnali Development Bank Limited (hereinafter referred to as KRBL). 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. KRBL is proposing to come out with 50% rights issue of 400,000 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 in order to augment the capital base to support the future growth plans of the management.

The grading is constrained by KRBL's small scale of operations (asset size of NPR 1,645 million as of mid-Jul-15[1]) with weak asset quality indicators (NPLs[2] of 3.46% on Jul-15 vs. 2.70% in Jul-14) despite its long track record (started operations in February 2004), geographical concentration risks (operations spread across 3 districts in mid-west region), sub optimal utilization of available funds (CCD[3] ratio ~54% over last 6 years vs. regulatory maximum 80%), subdued and inconsistent profitability profile (PAT/ATA[4] of 0.87% and PAT/Net-worth of 9.10% for FY15), inferior borrower profile compared to commercial banks, lack of diversity in earnings and stiff competition from commercial banks offering products at more competitive interest rates. The grading is also constrained by small capital base compared to revised regulatory capital (NPR 120[5] million as on Jul-15 vs. NPR 500 million to be met by FY17), lack of Institutional promoters, moderate experience of the management team and weak recovery profile as on mid-Jul-15 which could be further deteriorated on account of political turmoil causing elongated strike in terai region. Nonetheless, the grading factors in KRBL's adequate franchise (11 branches spread over 3 districts), healthy mix of low cost deposits (~64% as of Jul-15 vs. ~53% for industry), competitive cost of deposits among peers (5.22% as of Jul-15), moderate credit concentration, low deposit concentration, comfortable capitalization profile (CRAR[6] 14.08% as of Jul-15 against regulatory minimum of 11%) and regulatory arbitrage available with 'Schedule B' Development Banks compared to 'Schedule A' commercial banks in the form of lower absolute capital requirements and lower CRR/SLR[7] requirements. ICRA Nepal also notes the limited impact of April-2015 earthquake in the area of operations of KRBL. Going forward, KRBL's ability to scale up its operations ensuring efficient utilization of existing as well as additional capital, improve its profitability and assets quality indicators would have a bearing on the overall financial profile.

The credit portfolio of KRBL has grown at a CAGR[8] of ~14% over past 5 years; much lower than the development bank industry credit growth CAGR of ~24%, with a small portfolio of NPR 788 million as of

[1] All calculations for Jul-15 are based on unaudited Management provided data
[2] Non-Performing Loans
[3] Credit to Core Capital and Deposits Ratio
[4] Profit after Taxes/ Average Total Assets
[5] including NPR 20 million calls in advance from promoters for proposed issue
[6] Capital to Risk Adjusted Assets Ratio
[7] Cash Reserve Ratio/ Statutory Liquidity Ratio
[8] Compounded Annual Growth Rate

Jul-15. Bank has witnessed sub optimal utilisation of available funds as reflected by very low levels of CCD ratio over the years (~49% as of Jul-15 vs. 80% as allowed by regulations and a maximum of 58% over last six years). Bank's yield on advances remain higher among peers at ~17% as of Jul-15 on account of higher interest charged on loan product. Major business of the bank is concentrated in Banke district (~58% of overall portfolio). The credit portfolio as of Jul-15 was mainly composed of Personal Loans (39%), Business Loans (24%), Hire purchase loans (13%), Agricultural loans (11%) and Housing loan (10%) among others. Due to limited economic activities in the region, most of KRBL's loans are small ticket loans towards meeting domestic needs in addition to few small and medium enterprises. As a result, KRBL's credit concentration remains moderate (~17% among top 20 borrowers as of Jul-15); better compared to most of the new generation development banks.

KRBL's assets quality has remained weak compared to peers; however better than development bank industry NPLs so far. With some deterioration in FY15, Gross NPLs were 3.46% on Jul-15 as against 2.70% on Jul-14 (Vs. 3.58% and 4.16% for industry respectively) and therefore remains a concern given high portfolio vulnerability on account of inferior borrower profile vs. commercial banks and assessed income based lending. With moderate provision cover (~63% as of Jul-15), Net NPLs were 1.34% for Jul-15 reflecting into solvency indicator[9] of ~7%. Further, around 65% credit portfolio of the bank is of revolving nature where the repayment capacity of the borrower remains to be tested. In addition, KRBL's area of operation is currently facing political turmoil causing elongated strike, impacting business profile and repayment ability of borrowers. This could impact KRBL's asset quality profile going forward and has been factored in while assigning the grading.

As for funding profile, KRBL's cost of funds 5.22% vs. 6.04% industry average as of Jul-15 remains competitive among peers, supported by healthy CASA[10] proportion of ~64% as of Jul-15 (vs. 53% for industry) which adds to its competitive strength. However, bank's ability to capitalise upon the same has remained low as evidenced by very low CCD ratio of the bank over last six years. Additionally, deposits of KRBL remain granular reflecting into a much lower deposit concentration among peers (~7% of total deposits on Jul-15 among top 20 depositors). Going forward, KRBL's ability to maintain healthy CASA proportion and granularity in deposits will have a bearing on the stability of the deposit profile and overall competitive positioning.

KRBL reported profit after tax (PAT) of NPR 13 million in FY15 (corresponding to return on net worth of 9.10% and return on assets of 0.87%) and NPR 17 million during FY14 (corresponding to a return on net worth of 12.87% and return on assets of 1.34%). The profitability profile remains inconsistent over the years and fares weaker among peers. Despite high yields, NIMs at ~4% as of Jul-15 remains lower than peers resulting into subdued profitability primarily on account of lower CCD ratio, higher provisioning due to weak assets quality, lower fee based income (0.88% of ATA) and high operating expenses (~3.5% of ATA). Going forward, profitability profile of the bank will depend on its ability to enhance its scalability; the same however remains a challenge given competition among the BFIs amidst relatively lower credit appetite in the region. The incremental asset quality and related credit provisioning will remain critical for future profitability.

KRBL's capitalization profile remains comfortable with CRAR 14.08% on Jul-15 as against minimum regulatory requirement of 11% for class B banks; with tier I capital of 13.06%. The proposed rights issue along with the internal accruals would further increase capitalization. However, monetary policy of FY 2015-16 has announced that development banks operating up to 3 districts are required to increase their paid-up capital to NPR 500 million within FY17. KRBL has a capital of NPR 120 million as of mid-Jul-15 (including NPR 20 million calls in advance from promoters for proposed issue) and same is expected to

[9] Net NPA/Net Worth
[10] Current and Savings Accounts

increase to NPR 140 million after proposed right issues (assuming full subscription), thus the bank likely to issue fresh capital or opt for merger to meet the regulatory minimum capital. Further, if the bank finds adequate sources to increase the capital to meet the revised regulatory norms, attaining adequate growth to ensure efficient utilization of the same would remain a key challenge for the bank.

Company Profile

Established in February 2004, Karnali Development Bank Ltd (KRBL) was the first regional development bank starting its operations in Mid-western region of Nepal. The bank is currently operating as a three district level development bank with operations in Banke, Bardiya and Dang districts. Its registered office is located in Surkhetroad Nepalgunj, Banke. The bank is promoted by 75 individual persons involved in different professions with maximum shareholding by one individual at 15% of total capital. Share capital of the company is distributed among promoter & public in the ratio of 51:49. Mr. Rajendra Bir Raya is the Chief Executive Officer of the bank. The bank's equity shares are listed in the Nepal Stock Exchange.

KRBL has a network of 11 branches and 5 ATMs spread over its working area of 3 districts. KRBL has market share of about 0.62% in terms of deposit base and 0.39% in terms of credit portfolio of Development banks as on mid Jul-15. KRBL reported a net profit of NPR 13 million during 2014-15 over an asset base of NPR 1,645 million as on mid Jul-15 as against net profit of NPR 17 million during 2013-14 over an asset base of NPR 1,422 million as on mid Jul-14. KRBL's CRAR was 14.08% and gross NPLs were 3.46% as on mid-Jul-2015. In terms of technology platform, KRBL has implemented Pumori-IV in its branches.

October 2015

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