Lumbini Bikas Bank Limited

ICRA Nepal assigns [ICRANP] IPO Grade 4 to the proposed Rights Issue (equity shares) of Lumbini Bikas Bank Limited

Instrument/Facility	Issue Size	Grading Action (November 2017)
Rights Issue (Equity shares)	NPR 200.89 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 200.89 million of Lumbini Bikas Bank Limited (LBBL). 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. LBBL proposes to come up with 10% rights issue of 2,008,878.47 numbers of equity shares, each with face value of NPR 100, to be issued to existing shareholders at par. The proposed capital injection is a step towards ensuring regulatory minimum paid up capital of NPR 2,500 million for national level class B Development Banks.

The grading remains constrained by the weak track record of the pre-merger entities[1] in terms of assets quality and profitability profile, which despite improvement in recent years, continues to result in inferior overall profile of LBBL vs. peers and the industry average. ICRA Nepal expects incremental strain on asset quality and profitability post the recent hardening of interest rates which is evident to an extent through increased NPLs and delinquencies resulting in stress over NIMs in Q1FY2018 for LBBL as well as across the banking sector. Weaker deposits profile among peers resulting in high cost of funds (8.87% for Q1FY2018) and limited avenue for fee based income for class B banks could also affect the future profitability prospects of LBBL. Additionally, the bank may be exposed to further claims related to good for payment[2] surfaced in 2014 depending upon the verdict of Hon'ble Supreme Court, which if decided against bank, could deteriorate its current net worth by ~13% and hence set back return prospects to shareholders over the medium term. 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 and real estate loans (~17%). The grading also takes into consideration the uncertain operating environment that the banks in Nepal are currently facing and also the relatively weak competitive positioning of LBBL vis-à-vis large class A commercial banks with finer lending rates; especially in the "base rate plus" lending rate regime introduced by Nepal Rastra Bank.

Nonetheless, the grading factors in LBBL's ability to achieve moderate portfolio growth (~17% compounded growth over last four years on a consolidated basis vs. ~18% for banking industry). Comfortable reported capitalization, experienced management team and diversified franchise (56 branches across 21 districts) remain positive for incremental growth prospect of LBBL. The grading also takes into consideration the scale advantages the bank could garner going forward (LBBL is one of the largest development bank operating in Nepal) and moderate granularity of its portfolio (~16% of total credit and deposits among top 20 customers as of mid-Oct-17). Going forward, LBBL's ability to scale up its operations ensuring efficient utilization of existing and incremental capital, improve its risk management framework commensurate to growth plans, improve its profitability profile and asset quality would have key bearing on the bank's overall financial profile.

Mergers in FY2017 aided significant scale enhancement making LBBL one of the largest development bank operating in Nepal. On a consolidated basis for all pre-merger entities, credit portfolio registered

[1] LBBL was formed after merger of Vibor Society Dev. Bank (formed via. Merger of Vibor and Society Dev. Bank in Sep-2016) with Lumbini Finance in Jul-2017.

[2] Erstwhile Society Dev. Bank (name was H&B Dev. Bank back then) faced employee fraud in collusion with some traders, major portion of which was issuance of Good for Payment cheques without freezing account balance, having financial impact of ~NPR 1 bn; ~60% of which has been paid; rest agreed with claimants to be paid out of recovery from the scam culprits. Nepal Rastra Bank has instructed the bank to make provision for balance 40% also, which is not provided due to pending court case.

moderate growth at CAGR of ~18% during last four years ending Jul-17 (vs. 19% for the banking industry). Yield on advances at ~14% for FY2017 for LBBL remains slightly higher among peers which could impact its competitive positioning and the ability to maintain better borrower profile. LBBL's credit portfolio of NPR 15,900 million as of mid-Oct-17 comprised mainly of Business loans (~44% pf total loans), Personal loans (~12%), Housing loans (~11%), Hire purchase loans (~9%), Deprived sector loans (~6%), Loan against shares (~5%), Real estate loans (~5%) and Miscellaneous (~8%).

LBBL has witnessed significant improvement in asset quality over last few years (Gross NPLs came down from ~9% as of Jul-14 to 3.16% as of mid-Oct-17). Nonetheless, the NPLs stood much higher vs. peers and the industry average. Delinquencies continue to remain high for LBBL at ~15% as of mid-Jul-17 (~12% on Jul-16) which has increased significantly to ~28% as of mid-Oct-17 amidst festive seasons as well as declining repayment capability of borrowers to service loan facilities, given the recent increase in interest rates. Due to moderate provision cover of ~62% as of mid-Oct-17, solvency ratio (Net NPL/ net worth) for LBBL remains weaker because it is higher than peers at 6.73%. However, comfortable reported capitalisation levels along with incoming capital could help bank offset spike in solvency despite expectation of stress in asset quality over the medium term. High exposure to vulnerable personal and real estate loans also remains a concern for incremental asset quality prospects. Going forward, ability of the bank to improve its assets quality would remain a key driver for overall financial profile.

As for funding profile, LBBL's deposit profile was inferior to industry which further witnessed higher than industry average decline in with current and savings account (CASA) proportion declining to ~29% as of mid-Jul-17(~45% in Jul-16) vs. ~42% (~54% in Jul-16) for industry. Impacted by this, cost of deposits for LBBL remains high among peers and the industry average (7.91% for FY2017 vs. 5.91% for industry). The cost of funds is nonetheless poised to rise over medium term (8.87% for Q1FY2018) owing to swift increment in high cost deposits towards latter half of FY2017 and hence this could impact the competitive positioning, asset quality and profitability of LBBL, especially in the recently introduced "base rate plus" lending rate regime. Nonetheless, moderate granularity of LBBL's deposit cushions the bank from liquidity risk as well as offers scope for quicker repricing of the deposits in future.

LBBL's profitability profile has remained weak with major losses sustained in the past due to stress in asset quality as well as the impact of employee fraud. LBBL's average return on net-worth (RoNW) was ~5% in past five years (vs. ~14% for industry) impacted mainly by negative RoNW of ~16% for FY2013-FY2014. Despite improvement in return indicators in recent years, LBBL is yet to recover accumulated losses of ~NPR 39 million as of mid-Oct-17. Net Interest Margin (NIMs) of LBBL at 4.18% for FY2017[3] remains weaker among peers which has further come under pressure during Q1FY2018 (1.92%) amid spike in delinquencies. This has significantly impacted the return indicators of Q1FY2018; RoNW of ~2% vs. ~13% for FY2017 and return on assets of 0.29% (1.75% for FY2017). High operating expense ratio (2.72% of Average Total Assets-ATA for FY2017) and low proportion of fee based income (0.93% of ATA for FY2017) also remains a drag to the profitability. Incremental profitability will depend on the management's ability to improve asset quality, achieve healthy portfolio growth ensuring efficient utilisation of existing and incremental capital while improving the NIMs and diversification of the earning profile.

As on mid-Oct-17, CRAR of LBBL stood comfortable at 17.03% (as per Basel-II) against regulatory minimum of 11% for class B banks. The proposed rights offering would help bank towards meeting the elevated capital requirements of NPR 2,500 million (as applicable to national level development banks); rest planned to be met from capitalisation of reserves created from the last merger. Incremental capital infusion would strengthen the capitalization profile further and support the targeted credit growth plans of management. However, over next 2-3 years, achieving adequate business growth and generating healthy returns over increased capital base would remain key challenges for the management.

[3] FY2017/Q1FY2018 numbers are based on unaudited data; earlier number are consolidated for all pre-merger bank.

Company Profile

Lumbini Bikas Bank Limited (LBBL) is a national level development bank formed after the merger of Lumbini Finance & Leasing Company Limited and Vibor Society Development Bank on 9th July 2017. Erstwhile Vibor Society Development bank was also formed after merger of Vibor Bikas Bank Limited with Society Development Bank Limited in September 2016, with both of these banks having track record of earlier mergers/acquisitions on standalone basis as well. Corporate office of the bank is located at Dillibazar, Kathmandu. The bank is promoted by wide range of promoters with maximum shareholding by one promoter at 4.60% of total capital (as on mid-Oct 2017). Share capital of the company is distributed among promoter & public in the ratio of 51:49. The bank's equity shares are listed in Nepal stock exchange. Mr. Jhalak Prasad Khanal is the CEO of the bank.

LBBL has presence in 21 districts of Nepal through its 56 branches and 24 ATMs as of mid-Oct 2017. LBBL has market share of 7.49% in terms of deposit and 7.46% in terms of credit portfolio of Development banks as on mid Jul-17. LBBL reported net profit of ~NPR 377 million during FY2017 over an asset base of NPR 22,177 million as of mid-Jul-17 as against net profit of ~NPR 492 million during FY2016 (on a combined basis for all three pre-merger entities) over an asset base of NPR 19,157 million as of mid Jul-16. For Q1FY2018, the bank has reported net profit of NPR 16 million over an asset base of NPR 22,656 million as of mid-Oct-17. The capitalisation profile (CRAR) of LBBL was at 17.03% (as per BASEL-II) and gross NPLs was at 3.16% as on mid-Oct-2017. In technology front, LBBL has implemented centralised Pumori-IV system throughout all its branches.

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