Saptakoshi Development Bank Limited

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

Facility/Instrument	Issue Size	Grading Action (April 2017)
Rights Share Issue	NPR 274.30 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 to NPR 274.30 million of Saptakoshi Development Bank Limited (SKDBL). ICRA Nepal assigns IPO/Rights issue 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. SKDBL is proposing to come out with 130% rights issue of 2,743,000 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 to augment the capital base to meet the elevated regulatory capital requirements and to support the bank's growth plans.

The grading is constrained by high geographical concentration risks (>70% of business is concentrated within one district), small scale of operations with limited franchise (asset base of ~NPR 994 million and eight branches as on mid Jan-17[1]), limited track record with recent growth in scale of operations resulting in limited seasoning of credit book (operating from October 2012), higher portfolio vulnerability due to relatively inferior borrower profile vs. commercial banks and high proportion of loans with assessed income based appraisal which could lead to higher volatility in asset quality indicators. While assigning the grading, ICRA Nepal also notices the conflict seen in board of directors in the recent past resulting impact in business growth in the interim period; which seems to be subside after regulator intervention coupled with nomination of directors from public. The grading is also constrained by increased NPLs[2] and delinquencies in Jan-17 (Gross NPLs increased from 0.55% as on Jul-16 to 1.38% as of Jan-17[3] with 30+ DPD[4] of ~5%). The grading is further constrained by bank's high cost of operations (~4% of ATA[5] for FY16), lack of diversity in earnings, lack of Institutional promoters, stiff competition with commercial banks offering products at finer lending rates and uncertain operating environment that financial institutions in Nepal are currently facing.

The grading however factors in the bank's ability to achieve adequate business growth over last two years (credit portfolio grew by CAGR[6] of ~69%; albeit on a lower base) which has supported gradual improvement in profitability profile. Bank's profitability profile also remains supported by healthy NIMs[7] (6.65% for H1FY17) reflecting into RoA and RoNW[8] of ~2% and ~16% which however would be significantly diluted over medium term arising from higher incoming capital vs. the targeted business growth requirements. Nonetheless, comfortable capitalization profile (CRAR[9] of 15.65% as on mid-Jan-17) and management experience along with reputation/knowledge of promoters in its area of operations are

[1] Mid-Jan-17 data are unaudited
[2] Non-Performing Loans
[3] This has declined to 0.79% as of Apr-17 as per recently published 9MFY17 highlights
[4] DPD: Days Past Due; SKDBL could not provide data for 1-30 days' delinquencies due to limitation in its system.
[5] Average Total Assets
[6] Compounded Annual Growth Rate
[7] Net Interest Margins
[8] Return on Assets and Return on Net Worth
[9] Capital to Risk-weighted Assets Ratio

expected to provide SKDBL with adequate growth opportunities over the medium term. The grading also takes into account bank's moderate CASA[10] deposit profile (~48% as on mid-Jan-17 against industry average of ~51%) and regulatory arbitrage available with 'Schedule B' Development Banks compared to 'Schedule A' commercial bank in the form of lower absolute capital requirements and lower CRR/SLR[11] requirements. Going forward, SKDBL's ability to scale up its operations ensuring efficient utilization of existing as well as additional capital, improve its profitability profile whilst maintaining healthy assets quality indicators would have a bearing on the overall financial profile.

SKDBL has been able to grow its portfolio at high pace (CAGR of ~69% achieved over last two years ending Jul-16, vs. industry average CAGR of ~19%) although portfolio size still remains small (credit portfolio of NPR 712 million as of mid-Jan-2017). As on mid-Jan-2017, SKDBL's credit portfolio primarily composed of business loans (37%), agriculture loans (28%), personal loans (19%), deprived sector loans (8%), housing loans (4%), hire purchase (2%) and balance being other loans. The credit expansion has been supported by gradual increment in franchise (eight branches as of mid-Jan-2017) with major concentration (>70%) in Morang district from where it started its operations. Bank's credit portfolio remains moderately concentrated among top 20 borrowers at ~17% of portfolio as of mid-Jan 2017. Being a three-district development bank, SKDBL is allowed to operate in limited geographical area and at the same time it faces competition from commercial banks with wider product suits and finer lending rates. However, SKDBL's promoter and management's reputation/knowledge of the local market and its focussed approach and reach in its area of operations along with plans to venture into group based microfinance lending and gold loans, could help achieve adequate growth. Over longer term, scalability of business would remain a challenge given promoters' knowledge/reputation limited to local market.

Bank's asset quality witnessed increased stress in Jan-17 despite limited seasoning of the credit portfolio so far. Delinquencies (30+ DPD) increased from 2.43% as of mid-Jul-16 to 4.94% as of Jan-17 while reported NPLs increased from Nil as on mid-Jul-2015 to 1.38% as of Jan-17. Overall, SKDBL's portfolio vulnerability remain high vs. commercial banks due to inferior borrower profile, limited capability for borrower's credit assessment system and assessed income based lending, which could lead to volatility in asset quality indicators. Management's ability to control on asset quality indicators with targeted portfolio growth would be critical for improvement in its profitability indicators.

As for funding profile, with gradual improvement over the years, SKDBL's proportion of low cost CASA deposits has improved to ~48% as on mid-Jan-17 (vs. ~37% on Jul-13) vs. ~51% for industry resulting in modest cost of funds among peers (5.85% for FY16). Despite some improvement in terms of granularity of deposits profile, top 20 depositors still account for a high proportion of deposits at ~33% as of mid-Jan 2017. Going forward, management's focus on achieving granular deposit growth through expansion of franchise and depositors' base could improve deposits profile. Bank's ability to manage its deposit cost would have a strong bearing on overall competitive positioning in the future.

Bank's profitability profile remains gradually progressive with RoNW of ~16% and ~9% for H1FY17 and FY16 respectively and RoA of ~2% and ~1.4% respectively. Improvement in profitability has been supported by healthy NIMs (6.65% for H1FY17) while high cost of operations (~4% of ATA for FY16) and lack of diversity in earnings act as a drag on profitability. Nonetheless, the profitability would remain diluted over medium term owing to higher incremental capital. Going forward, bank's ability to maintain healthy NIMs would have a key bearing on profitability profile amidst scenario of upward movement of interest rates as recently seen in banking channel owing to tightening liquidity and regulatory change requiring similar interest rates to call and savings deposits.

[10] Current and Savings Accounts
[11] Cash Reserve Ratio/ Statutory Liquidity Ratio

SKDBL's CRAR was 15.65% (tier I capital of 14.70%) as of mid-Jan-2017, significantly higher than the regulatory minimum of 11%. The proposed issue is likely to further maintain capital at higher levels over the medium term. Monetary policy of FY 2015-16 had announced that three district level development banks are required to increase their paid-up capital to NPR 500 million within Jul-17. SKDBL has a capital of NPR 211 million as of mid-Apr-17 and the same is expected to increase to ~NPR 485 million after proposed rights issue (assuming full subscription). Bank is planning to meet the shortfall capital from internal generations of FY17. However, maintaining adequate returns over increased capital base would remain a key challenge for the bank over the medium term.

Company Profile

Established in April 2012, Saptakoshi Development Bank Ltd (SKDBL) started its commercial operation as three district development bank from October 2012. SKDBL is licenced to operate in the territory of three districts viz. Morang, Panchthar and Ilam. The registered and corporate office of the bank is in Morang district. Share capital of the bank is distributed among promoter & public in the ratio of 60:40 with maximum shareholding by one individual at 7.80% of total capital. The shares of the company are listed on the Nepal Stock Exchange. Mr. Navin Subedi is the Chief Executive Officer of the bank.

SKDBL has a network of eight branches (all operating on core banking - Pumori IV System) spread across its working area. The bank has a market share of around 0.30% in terms of deposit base and 0.29% in terms of credit portfolio (both among Development Banks) as on mid-Jan-17. SKDBL reported a net profit of ~NPR 10 million during 2015-16 over an asset base of NPR 867 million as of mid-Jul-16 as against net profit of ~NPR 2 million during 2014-15 over an asset base of NPR 549 million as on mid Jul-15. Bank reported profit after tax of ~NPR 9 million for H1FY17 over an asset base of NPR 994 million as of mid-Jan-17. SKDBL's CRAR was 15.65% and gross NPLs were 1.38% as on mid-Jan-2017.

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