Kanchan Development Bank Limited

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

Facility/Instrument	Issue Size	Rating Action (August 2015)
Rights Share Issue	NPR 33 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 33 million of Kanchan Development Bank Limited (hereinafter referred to as KDBL). 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. KDBL is proposing to come out with 25% rights issue of 330,000 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 KDBL's moderate track record (started operations in September 2009), geographical concentration (spread across 3 districts in far west) with small scale of operations (asset size of NPR. 1,431 million as of mid-april-15), limited franchise (6 branches as on mid-april-15), lack of diversity in earning, deterioration in asset quality indicators (2.24% on April-15 vs. 1.91% in July-14), relatively weaker borrower profile which could lead to adverse impact on the asset quality indicators going forward 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 framework (NPR 132 million as on Apr-15 vs NPR 500 million to be met by FY17), lack of Institutional promoters, moderate experience of the management team and uncertain operating environment that financial institutions in Nepal are currently facing. Nonetheless the grading factors in KDBL's improved profitability indicators levels since FY14 (PAT/ATA of 2.70% and PAT/Networth of 20.72% during 9MFY15), healthy mix of low cost deposits (~74% CASA[1] deposits in April-15), low credit and deposit concentration, 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[2] requirements. ICRA Nepal also notes the limited impact of April-2015 earthquake in the area of operations of KDBL. Going forward, KDBL's ability to scale up its operations ensuring efficient utilization of existing as well as additional capital, improve its profitability profile while maintaining its assets quality indicators would have a bearing on the overall financial profile.

The credit portfolio of KDBL has grown at a CAGR of 33% during the past 3 years (albeit on a low base) however, the portfolio size still remains small at NPR 1,115 million as of April-15. The credit growth has been supported by KDBL's franchise of 6 branches; with major business concentration in Kanchanpur district (~70% of overall portfolio).The credit portfolio of NPR 1,115 million as on April-15 was mainly composed of Overdraft/ Working capital Loans (53%), Personal Loans (15%), Housing loan (13%), Hire purchase loans (5%) and Agricultural loans among others. Due to limited economic activities in the region, most of KDBL's loans are small ticket loans towards meeting domestic needs in addition to few small and medium enterprises. As a result, KDBL's credit concentration remains low (top 20 borrowers accounting for ~10% of total loans on April-15); better compared to most new generation development banks. KDBL's

[1] Although reported Current and saving account (CASA) deposit is ~82%, it includes ~8-10% deposit of organisation which needs to be classified as call or current deposit.
[2] Cash Reserve Ratio/ Statutory Liquidity Ratio

assets quality has deteriorated during 9MFY15 (Gross NPA of 2.24% on April-15 vs. 1.91% on July-14) and therefore remains a concern given high portfolio vulnerability vs. commercial banks on account of inferior borrower profile and assessed income based lending. Further around 70% credit portfolio of the bank is of working capital nature where the borrower has to pay interest portion only and principal get renewed over the years where the repayment capacity of the borrower remains to be tested.

Although KDBL's promoters' reputation/knowledge of the local market and it's focussed approach and reach in its geography of operations could help to achieve adequate growth in spite of geographical restrictions; competition from other regional players in addition to commercial banks with wider product suits and lower lending rates remains a challenge. The competition has further aggravated in recent years since commercial banks are also venturing into retail and SME sector which remains key segment for development banks. Moreover, the scalability of business in the long run also remains a challenge given promoters' knowledge/reputation limited to local market. Going forward, management's ability to scale up the operations and maintain control on asset quality indicators would be critical for improvement in its profitability indicators.

As for funding profile, though better than new generation development banks, KDBL's cost of funds (6.29% during 9MFY15) remains slightly higher than the industry average (6.01%) and established peers which impact its competitive positioning. The high cost of funds is on account of higher rates offered on deposit accounts during the initial years of operations. However, KDBL has been reducing the deposit rates and as a result the overall cost of deposits reduced to 6.29% during 9MFY15 from 6.32% during FY14 and 7.03% during FY13). KDBL has healthy proportion of low cost CASA deposits (74% as on April-15 as compared to industry average of 54%) along with relatively lower deposit concentration (~16% of total deposits on April-15 among top 20 depositors). Going forward, the ability of KDBL to improve the deposit cost and maintain granularity will have a bearing on the stability of the deposit profile and overall competitive positioning.

KDBL reported profit after tax (PAT) of NPR 30 million in FY14 (corresponding to return on net worth of 19.58% and return on assets of 2.50 [3]%) and NPR 28 million during 9MFY15 (corresponding to a return on net worth of 20.72% and return on assets of 2.70%). KDBL's profit during FY14 was primarily supported by account of gain on sale of its share investment portfolio. Although KDBL maintains healthy NIMs around 5% over past years, its profitability is impacted due to higher provisioning due to deteriorating asset quality and high operating expenses. Going forward, the profitability profile of the bank will depend on its ability to expand its scale of operations thereby achieving scale economies; the same however remains a challenge given competition among the BFIs in the region and relatively lower credit appetite in the region. The incremental asset quality and related credit provisioning will remain critical for future profitability.

KDBL's capitalization profile remains adequate with CRAR 14.10% on April-15 as against minimum regulatory requirement of 11% for class B banks; with tier I capital of 13.27%. The proposed rights issue along with the internal accruals is likely to support 20-25% CAGR growth plans over next 2 years. 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. KDBL has a capital of NPR 132 million as of mid-April-15 and same is expected to increase to NPR 190 million after capitalization of accrued profit till Apr-15 and proceeds from 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.

[3] 1.32% was on account of gain on sale of investment

Company Profile
Kanchan Development Bank Ltd (KDBL) started its commercial operation as three-district Development Bank from September 2009. Its registered office is located in Bhimdatta municipality of Kanchanpur District in Far western region of Nepal. Currently, KDBL has licence from NRB to operate in Kanchanpur, Kailali and Dadeldhura Districts of the far west. The bank is promoted by 76 individuals involved in different professions with maximum individual shareholding of 10%. The current shareholding is divided among the promoters and public shareholders in the ratio of 70:30. Mr. Suresh Bahadur Bam is the Chief Executive Officer of the bank. The bank's equity shares are listed in the Nepal Stock Exchange.

KDBL has its presence in all 3 licensed districts through its 6 branches. KDBL has market share of about 0.60% in terms of deposit base and credit portfolio of Class B Development banks while its share in the overall banking industry is ~0.08% as on mid-April-15. KDBL reported a net profit of NPR 30 million during 2013-14 over an asset base of NPR 1,324 million as on mid Jul-14 as against net profit of NPR 11 million during 2012-13 over an asset base of NPR 1,048 million as on mid-Jul-13. During 9MFY15, the Bank has reported a profit after tax of NPR 28 million. KDBL's CRAR was 14.10% and gross NPLs were 2.24% as on mid-April-15. In terms of technology platform, KDBL has implemented "Pumori IV" in all of its branches.

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For further details please contact:

Analyst Contacts:
Mr. Sailesh Subedi (Tel No. +977-1-4419910/4419920) **(for immediate contact 01-5551616)**
sailesh@icranepal.com

Relationship Contacts:
Mr. Deepak Raj Kafle, (Tel. No. +977-1-4419910/4419920) **(for immediate contact 01-5551616)**
drkafle@icranepal.com