Prabhu Bank Limited

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

INSTRUMENT/FACILITY	Issue Size	Grading Action (September 2015)
Rights Issue Grading	NPR 641.78 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 641.78 Million of Prabhu Bank Limited (PrBL). 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. PrBL is proposing to come out with 20% rights issue of 6,417,770 numbers of equity shares of face value NPR 100/- each to be issued to existing shareholders at par.

The grading is constrained by weak asset quality indicator of PrBL (Gross NPLs[1] of 7.39% as of Jul-15) and a relatively high NPA generation rate post-merger (~4.7% for FY15[2]), expected deteriorations in asset quality indicators owing to effect of earthquake in its borrower profile, very low operating profitability (operating profit after provision 0.52% of ATA[3] as on Jul-15), low seasoning of significant portion of credit book achieved post-merger (~21%), higher operating expenses vs. peers, lack of diversity in earnings and limited track record of operation as commercial bank. The grading is also constrained by proposed acquisition of another problematic commercial bank (Grand Bank) which would further deteriorate assets quality of bank. Grand Bank reported gross and net NPAs of 36.20% and 8.44% respectively as on mid-Jul-15. In addition, the grading is constrained by lower capital of the bank compared to the minimum capital levels as revised by Monetary Policy of FY 2015/16 (NPR 3.21 bn vs. elevated requirement of NPR 8 bn to be achieved by FY17; though targeted acquisition would increase its capital to some extent), competition from other established commercial banks and uncertain political and operating environment that banks in Nepal are currently facing. Nonetheless, the grading factors in the bank being a class 'A' commercial bank with largest franchise among private sector commercial banks (116 outlets), healthy deposit profile (Low cost CASA[4] deposits ~61% as of Jul-15) compared to class 'A' banking industry systemic average, lower cost of deposits among peer banks (3.40% as of Jul-15), moderate credit concentration as of now. Going forward, PrBL's ability to improve its assets quality indicators, maintain deposits profile, increase its client base in order to attain sustainable operational profitability, and its ability to improve capitalisation would have a bearing on the overall financial profile.

On a combined basis of all pre-merger entities, gross NPAs were 15.36% as of Jul-14; subsequently post-merger bank has been able to recover its NPA accounts significantly (NPR 1268 mn recovered from NPA Accounts in FY 2014-15) and reduce NPAs to 7.39% as of Jul-15. Also, the bank has created sizeable provision for these NPAs resulting in net NPAs of 1.91% as on same date. Higher NPLs were due to the fact that the largest player in the merger i.e. Kist Bank had NPLs of ~24% as of Jul-14 while other merged counterparts had fair assets quality profile. PrBL has announced acquisition of another problematic bank (Grand Bank) which has reported gross and net NPAs of 36.20% and 8.44% respectively as on mid-Jul 15; post the acquisition, Prabhu Bank's gross NPAs and net NPAs are expected to increase. Despite adequate provision cover ~76%, impact on Solvency (Net NPA/Net-worth)

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[1] Non-Performing Loans
[2] Mid-Jul-15 data are unaudited and all the calculations are based on data provided by management.
[3] Average total Assets
[4] Current and Savings Accounts

as of Jul-15 also remains on higher side at ~15% vs. peers which is further expected to deplete post the acquisition (~31% based on Jul-15 published data). Further, fresh NPA generation still remains high post-merger (~4.7% for FY15) and significant chunk of credit originated post-merger (~21% of portfolio as of Jul-15) remains unseasoned and as such its assets quality remains to be further tested. Additionally, significant portion of loans (~55%) are revolving in nature where repayment ability of the borrowers has not been tested fully. Asset quality is expected to come under pressure going forward due to damage caused by earthquake, impacting borrowers' ability to make repayments in a timely manner.

As for impact of earthquake on PrBL's operations, bank branches' portfolio in the earthquake affected areas accounted for ~69% of the credit portfolio and ~66% of the deposits. However, several of these businesses (end users of loans) are situated outside the earthquake affected areas due to which exact quantum of affected exposures and extent of damage could be restricted to certain sectors/segments accounting for ~1/3rd of PrBL's loan book. Out of this, PrBL has higher exposure to tourism sector (~6%), which along with other sectors perceived to be highly affected by earthquake would reflect in a portfolio of ~14%. Apart from stress in affected geographies/segments, exposures in unaffected geographies/segments could also witness some stress due to overall moderation in economic activity as well as linkage among businesses/borrowers. Accordingly, ICRA Nepal expects moderate level of stress on PrBL's asset quality and profitability profile over next 2-3 years due to damage caused by the earthquake in April 2015 and aftershocks. The banks' ability to raise planned capital in a timely manner would have critical bearing on its ability to absorb damages arising out of earthquake and maintain comfortable solvency profile.

Since the merger in September 2014, the bank has grown its portfolio at rapid pace (by NPR 6.3 billion) till Jul-15, though portfolio size still remains moderate for a bank of its scale (credit portfolio was NPR 29,705 million as of mid-Jul 2015). However, the credit growth over next 1-2 years is likely to get stunted on account of lack of credit demand following recent earthquake and moderation in economic activity; however reconstruction drive would support credit growth to some extent. The bank's credit portfolio comprised Corporate Loan (ticket size > NR 50 million for one corporate client ~26%), SME loan (~44%) and Retail Loan (~30%). PrBL expects to maintain similar portfolio mix in future as well which could be challenging considering the competition in the segment, though adequate branch network provides some comfort in this regard. Also, credit concentration remains moderate so far (top 20 borrowers group accounted for ~15% of total credit portfolio as on Jul-15).

ICRA Nepal has also noted that earthquake has not caused significant stress on PrBL's deposits/liquidity profile. The bank's deposit profile remains healthy than compared to peers and Nepalese Commercial banking industry average; as reflected in fair proportion of low cost deposits around 61% of total deposits as of mid-Jul-15 as against industry average of ~47%. Owing to this, bank's cost of deposits remains better among peer banks (~3.4% as of Jul-15); however higher compared to larger banks. Also, deposit concentration of top 20 depositors was lower among peers at 11.81% of total deposit as on Jul-15, mainly due to withdrawal of deposit from large corporates after gross NPLs crossed 5% level; as bank's NPAs are not expected to decline to less than 5% in short term, bank's ability to attract deposits from large institutions will remain low.

Profitability indicators of the bank remained inferior over the years compared to industry average; remaining subdued especially over last two years due to the fact that the erstwhile Kist Bank reported massive losses in these years depleting half of its net worth. On a joint basis of all premerger entities, the bank reported a PAT/Net-worth of (23.05%) for FY13 and (4.81%) for FY14 corresponding to PAT/ATA of (1.91%) and (0.38%) respectively. However, post-merger, bank has reported improvement in these indicators reporting a net profit of NPR 1,036 Million corresponding to a PAT/Net-worth of 28.11% and PAT/ATA of 2.46% for FY15. Improvement in profitability was largely contributed by write back from large amount of NPLs (write back of NPR 1,821 million in FY15). Thus, the operating profitability in FY15 remains minimal; mainly affected by significant credit provisioning on account of fresh slippage (additional provision of NPR 677 million in FY15), lower non-interest income (0.83% of ATA as of Jul-15) and much higher operating expenses (2.79% of ATA as of Jul-15) vs. peers; despite healthy Net Interest Margins (3.75% for FY15). ICRA Nepal expects PrBL's profitability profile to remain under pressure over next 2-3 years due to impact of devastating earthquake in 2015. Over long term, ability of the bank to attain sustainable growth, improve operational profitability and improve assets quality indicators would shape the profitability profile of the bank.

As on mid-Jul-15, PrBL's capitalization levels remained moderate at 11.20% (Tier I: 10.37%) against minimum regulatory requirement of 10%. Erstwhile Kist Bank's CRAR dropped to less than 10% in Jul-13 and Jul-14 owing to larger NPLs which has been moderated post-merger. Capitalization level of the bank is largely dependent upon movement in NPL levels; existing as well as expected NPLs that would come in post-acquisition. Any significant unexpected slippages in either of the bank's credit portfolio might impact CRAR levels and might trigger regulator restrictions should the CRAR level go below the regulatory minimum. However, proposed rights and internal capital generation is expected to address concerns towards capitalisation to some extent. In scenario of lowering CRAR, Bank might be forced to moderate its portfolio growth till external capital sources are arranged, which in turn would impact profitability. Further, bank would need to raise its capital to NPR 8 bn by FY17 from existing capital of NPR 3.21 bn; accordingly finding adequate sources to fulfil this elevated regulatory requirement would also remain a key challenge for the bank.

Company Profile

Prabhu Bank Limited (PrBL), formerly known as Kist Bank incorporated in 2002 as a Finance Company and upgraded to Class A Commercial bank in May 2009, was renamed to its current name after the merger of four financial institutions on 15th September 2014. The institutions before the merger were Kist Bank Limited (Class A), Prabhu Bikas Bank Limited (Class B), Gaurishankar Development Bank Limited (Class B) and Zenith Finance Limited (Class C). PrBL is the largest private sector commercial bank of Nepal in terms of branch network and it currently has presence through 114 branches, 2 extension counters and 108 ATMs throughout Nepal. Shareholding pattern of the Bank constitutes of the promoters holding ~65% of the shares while ~35% is floated for the public. Among the promoter's holding, ~13% shares are held by 4 institutional promoters and remaining ~52% by 448 individual promoters. The registered office is in Babarmahal, Kathmandu which is also the Head Office of the Bank.

PrBL has market share of about 2.19% in terms of deposit base and 2.20% of total advances in Nepal as on mid-June-15. On a combined basis of all premerger entities, PrBL reported a net loss of NPR 134 million during 2013-14 over an asset base of NPR 36,402 million as on mid Jul-14 as against net loss of NPR 659 million during 2012-13 over an asset base of NPR 35,558 million as on mid Jul-13. For FY15, Bank has reported a net profit of NPR 1,036 million over an asset base of NPR 48,534 million, supported mainly by write back of provisions amounting to NPR 1,821 million (net write back NPR 1,144 million). As on mid Jul 2015, its CRAR was 11.20% and Gross NPAs was 7.39%. In terms of technology platform, PrBL has implemented Pumori in all of its branches.

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