# Nepal Community Development Bank Limited

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

| Facility/Instrument | Issue Size | Grading Action (January 2016) |
|---|---|---|
| Rights Share Issue | NPR 100 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 100 million of Nepal Community Development Bank Limited (NCDBL). 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. NCDBL is proposing to come out with 1:1 rights issue[1] of 1,000,000 numbers of equity shares of face value NPR 100/- each to be issued to existing shareholders at par. The proposed issue is being made in order to increase the capital base as a step towards meeting revised regulatory minimum paid up capital[2] for BFIs[3] and to augment the capital base for further business growth.

The grading factors in NCDBL's experienced senior management team, local promoters knowledge of the geographies and healthy credit growth (CAGR of 34% during the past three years ending FY15) although on a small base.  Comfortable capitalization profile (CRAR of 13.39% as on mid Oct-15[4]) and low capital adjusted credit deposit ratio (69% on Oct-15) provides adequate room for the bank's near term growth.

The grading is however constrained by NCDBL's limited franchise (five branches and two extension counters across three districts on Oct-15), high geographical concentration risks (~70% of business is concentrated within one district), limited track record and weak competitive positioning (resulting from relatively higher cost of funds and stiff competition from established BFIs in the region). ICRA also takes note of buildup of delinquencies[5] during the last few months on account of uncertain operating environment created by ongoing political turmoil in the southern plains of the country impacting the overall economy and repayment capacity of the borrowers, weakening the financial profile during Q1FY15-16. NCDBL witnessed deterioration in earnings profile during Q1FY16 (RoA of 0.06% during Q1FY16 as compared to 1.47% during FY15) and the asset quality (Gross NPLs 0.77% as on mid-Oct-15 from 0.10% as on mid-Jul-15) which could be further impacted going forward. However, NCDBL's reported asset quality is supported by unseasoned credit books and high proportion of revolving loans. While assigning the grading ICRA Nepal has also factored in NCDBL's capital base being lower to revised regulatory capital framework, lack of Institutional promoters, and relatively weaker borrower profile compared to commercial banks.

Nonetheless, ICRA also considers the 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[6] requirements. Going forward, NCDBL's ability to scale up its operations ensuring efficient utilization of capital, achieve economies of scale, and manage the delinquency levels would have a bearing on the overall financial profile.

[1] On mid-Jul-15 capital of NPR 100 million.
[2] NPR 500 million for NCDBL (3-district development bank)
[3] Banks and financial institutions
[4] Mid-Oct-15 data are unaudited
[5] Delinquent loans (overdue between 1-90 days) on mid-Oct-15 accounted for ~24% of total loans vs. ~5% in mid-July-15.
[6] Cash Reserve Ratio/ Statutory Liquidity Ratio

NCDBL commenced operations in Nov-2010 with the credit portfolio growing to NPR 758 million as of mid Oct-2015. NCDBL is allowed to operate in limited geographical area (being a three district level development bank), where it faces stiff competition from commercial banks/established regional players with wider product suits and finer lending rates. The bank's competitive positioning is also adversely impacted due to high cost of funds. Although NCDBL's promoters' reputation/knowledge of the local market and focussed approach is likely to support credit growth over short term; long term credit growth of NCDBL will depend on the ability of the bank to improve its franchise and expand geographically. The credit portfolio as on mid Oct-15 was primarily composed of business loans (~41%), personal loans (31%), housing loans (12%), agriculture (7%), hire purchase loans (~4%), among others.

NCDBL's reported asset quality (gross NPLs of 0.77% as on mid Oct-15) is benefitted from limited seasoning of the credit book, and sizeable revolving loan portfolio (~65% on mid-Oct-15). However relatively higher credit concentration among top borrowers (top 20 borrowers accounting for ~21% of total loans on Oct-15) and relatively inferior borrower profile remains a challenge for the incremental asset quality. During Q1FY16, NCDBL has witnessed weak recoveries on account of elongated strikes in Terai region, resulting in build-up of delinquencies. The bank reported delinquencies (overdue up to 90 days) of ~24% as on mid Oct-15 (~5% as on mid Jul-15), which could impact NCDBL's asset quality profile going forward. The regulator has provided temporary relaxations in NPL recognition norms factoring in the strike; however the same is expected to defer the actual impact on asset quality towards the end of the year, should the current scenario extend for a longer period of time. Although NCDBL's portfolio was not impacted directly by the earthquake, the exposures in unaffected geographies/segments could witness some stress due to overall moderation in economic activity as well as linkage among businesses/borrowers. Going forward, management's ability to maintain the asset quality indicators along with targeted portfolio growth would be critical for improvement in its profitability indicators.

As for funding profile, NCDBL's deposit mix remains moderate with CASA[7] proportion at par with development bank industry average of 54% as on mid-Oct-15. However, the cost of deposits remains marginally higher than the development bank average (6.32% vs. average of 5.98% during Q1FY16) impacting the bank's competitive positioning. Granularity of deposit profile remains low with top-20 depositors accounting for ~27% of total deposits on mid-Oct-15. Adequate capitalisation level and low CD ratio (~13.39% & 69% respectively as of Oct-15), provides adequate room for credit growth provided the ongoing turmoil resolves soon and economic activity picks up. Going forward, the ability of NCDBL to improve the deposit cost and granularity will have a bearing on the stability of the deposit profile and overall competitive positioning.

NCDBL's profitability profile remains relatively weak, with the bank reporting modest profits in FY14 and FY15 (return on net worth of ~7% and 12% respectively). High operating expense ratio has impacted the profitability profile of NCDBL; despite fair NIMs (~5% in FY15) and lower credit provisioning expense so far. Profitability profile was further weakened during Q1FY16 on account of recent political turmoil with bank reporting negligible profit (NPR 0.15 million) despite availing regulatory relaxation[8] of lower provisioning in watch list accounts (2% instead of 2.5%). Incrementally, NCDBL's earnings profile will depend on the ability of the bank to improve its scale of operations thereby improving scale efficiencies and reduce its cost of funds thereby improving the NIMs and maintain the quality of its credit portfolio. However, it remains a challenge given the intense competition among the BFIs in the region and economic impact of elongated strikes on the repayment ability of borrowers.

NCDBL's capitalization profile remains moderate with CRAR[9] of 13.39% on mid-Oct-15 vs regulatory minimum of 11% for class B banks; which is likely to improve further post proposed rights issue. However, the central bank through monetary policy of FY 2015-16, has announced that development banks

[7] Current and Saving Accounts
[8] In absence of relaxation, the bank's financial performance wold have been impacted adversely
[9] Capital to Risk weighted Assets Ratio.

operating up to three districts are required to increase their paid-up capital to NPR 500 million within FY17 as compared to NCDBL's post rights issue capital of NPR 209.50 million (assuming full subscription). The bank is likely to issue fresh capital or opt for merger to meet the regulatory minimum capital. Going forward, successful execution of merger (if opted) or attaining adequate organic growth to ensure efficient utilization of fresh capital (in case of equity injection) thereby preventing dilution of returns; would remain key challenge for the bank.

**Company Profile**

Nepal Community Development Bank Ltd (NCDBL) started its commercial operation from November 2010, as three district-level development bank. Its Head Office is located in Butwal-8, Rupandehi. NCDBL is promoted by 386 individual promoters, with maximum shareholding by one individual of 2.5% of the total share capital. Share capital of the bank is distributed among promoter & public in the ratio of 70:30. Mr. Rajan Prasad Khanal is the CEO of the bank.

NCDBL has presence in three districts of Nepal through its five branches and two extension counters. NCDBL has market share of about 0.39% in terms of deposits and 0.37% in terms of advances of Development bank industry as on mid Oct-15 and about 0.05% in terms of deposits and advances of Nepalese banking industry on same date. NCDBL reported a net profit of NPR 13.54 million during 2014-15, over an asset base of NPR 1,103 million as on mid Jul-15 as against net profit of NPR 7.48 million during 2013-14 over an asset base of NPR 1,053 million as on mid Jul-14. During Q1FY15-16, NCDBL reported modest post tax profit of NPR 0.15 million. NCDBL's CRAR was 13.39% and gross NPLs of 0.77% as on mid-Oct-2015. In terms of technology platform, NCDBL has implemented Pumori IV System.

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