

## Bank of Kathmandu Limited

### ICRA Nepal upgrades subordinated bonds rating of Bank of Kathmandu Limited from LBBB to LBBB+

Facility/Instrument	Amount	Rating Action (June 2017)
Subordinated Bond Program "7.5% BOK Bond 2078"	NPR 600 Million	[ICRANP] LBBB+ rating (upgraded)

ICRA Nepal has upgraded the rating of subordinated bonds (7.5% BOK Bond 2078) of NPR 600 million of Bank of Kathmandu Limited (BOK) from **[ICRANP] LBBB** (pronounced ICRA NP L triple B) to **[ICRANP] LBBB+** (pronounced ICRA NP L triple B plus). Subordinated bond rating BBB+ is one notch higher than BBB. Instruments with this rating are considered to have moderate degree of safety regarding timely servicing of financial obligations. Such instruments carry moderate credit risk.

While upgrading the ratings for BOK, ICRA Nepal takes into consideration of addition of institutional promoters<sup>1</sup> in BOK post-merger, cautious growth in current adverse interest rate scenario and improvement in return indicators of BOK in past 12-18 months following two-year period of modest profitability due to increased credit cost towards erstwhile off-balance-sheet exposure. Further, the bank's financial indicators continue to remain stable in the aftermath of earthquake and blockade which was not clear while assigning earlier rating. ICRA Nepal also takes into consideration scale up of operations because of merger with erstwhile Lumbini Bank Limited (LuBL)<sup>2</sup> during FY2015-16 leading to improvement in franchisee and customer base. Increase in franchise and customer base has helped increase the granularity of the credit portfolio (top 20 borrower groups accounted for ~15% of total credit on mid-Jan 2017). Improved market positioning post-merger along with BOK's established track record (operating since 1995) and experienced management team is likely to have positive impact on the future prospect of the bank; which has been also factored into the rating action.

However, the rating remains constrained by deterioration in the assets quality indicators of BOK (gross NPA of 3.08% on mid-April 2017) mainly caused by one of its large off-balance-sheet exposures (counter guarantee exposure). The off-balance-sheet exposure, now reported as non-performing asset (NPA), accounted for ~44% of the reported gross NPAs as on mid-April 2017. However, with adequate credit provisioning against the NPAs (including 100% provisioning towards the counter guarantee exposure), solvency profile of BOK remains comfortable (net NPAs/ net worth of ~5% on mid-April 2017). The rating also remains constrained by weaker deposit profile vis-à-vis commercial bank industry average (CASA<sup>3</sup> deposits of ~35% as on mid-April 2017 vs. ~43% for commercial bank industry). This has led to high cost of deposits (4.30% as of mid-April 2017), weakening its competitive positioning to some extent with similar age peers. At the same time, concentration of deposits among top accounts also remains on higher side (top 20 depositors comprised ~30% of deposits as on mid-Jan 2017). Moreover, successful integration of resources from merging entities remains a challenge. The rating is also constrained by uncertain operating environment that the banks in Nepal are currently facing.

BOK's credit portfolio has grown at a healthy pace of CAGR ~27% over past 5 years ending FY16, aided by merger in FY16 (81% credit growth during FY16), albeit on a low base. Apart from aiding the portfolio growth, the merger has also increased BOK's footprint across the country which is likely to aid the incremental credit growth. As on mid-Jan 2017, BOK's credit portfolio primarily comprises of Small & Medium Enterprise (SME) Loan (43%), followed by large corporate loans (~40%), retail loans (13%) and ~4% among others. Due to recent growth along retail & SME segment and recent uptick in the interest rate environment, average yield on advances has improved to 9.06% during 9MFY17 from 8.68% during FY16. Going forward, the management intends to leverage the strength of newly acquired branches (through merger) to achieve future credit growth with focus on retail/SME segment.

<sup>1</sup> ~9% stake between Employees Provident Fund, Nepal & Citizen Investment Trust, Nepal-both Government of Nepal Undertaking.

<sup>2</sup> LuBL was a class A Commercial Bank in operation since 1998

<sup>3</sup> Current and Savings Accounts

BOK's asset quality has deteriorated since FY15 end, when it reported the off-balance sheet exposure as NPA after failing to recover the amount from foreign counterparty bank<sup>4</sup>. Gross NPA of BOK increased to 3.47% in mid-July 2015 before moderating to 2.84% in mid-July 2016 on a larger credit base post-merger. As on mid-April 2017, gross NPA of BOK stood at 3.08%, 44% of which is accounted for by the aforementioned exposure. Excluding the same, gross NPA of BOK remains below the commercial bank industry average. The bank's overall delinquencies (zero+ days past due) has moderated to 7.60% as on mid-Jan 2017 from ~17% in mid-July 2015 and ~11% in mid-Jan 2016 as the event related stress emanating from earthquake and blockade has subsided. With Net NPAs of 0.72% as on mid-April 2017, BOK has maintained adequate credit provisions against the reported NPA leading to a comfortable solvency profile.

Due to lower CASA mix of LuBL, BOK's CASA deposit proportion has declined post-merger. As on mid-April 2017, it stood at ~35% vs. commercial bank industry average of ~43%. Like most of the players in the industry, BOK's CASA deposit proportion has further declined in past 12-18 months as they focussed on term deposits to counter the deposit crunch situation and stabilize the funding profile. Preventing deposit flight amid tight liquidity scenario and relatively higher deposit concentration among top deposit account remains a challenge for liquidity of bank. Moreover, due to inferior CASA proportion, cost of deposits of BOK remains higher than commercial banks' average, affecting the competitive positioning of the bank to some extent.

As for profitability, BOK's return indicators has shown improvement during past 12-18 months, following modest profit levels in FY14 and FY15 caused by higher credit provisioning expense towards the off-balance-sheet exposure. After reporting single digit return on net worth during FY14 and FY15, BOK's return on net worth improved to ~15% during FY16 and ~14.5% during 9mFY17 though, it still remains below the commercial bank industry average return on net worth. Post-merger improvement in profit levels is contributed by improvement in NIMs, primarily on account of higher yield on advances, optimum utilization of fund (CD ratio ~80%) and decline in credit provisioning expense. However, moderation in non-interest income (~1% of ATA) and higher operating expense ratio (despite improvement post-merger) remains a drag to incremental profitability. Going forward, bank's ability to ensure efficient utilisation of incremental capital through promoter FPO, maintain adequate NIMs, diversify earning sources and manage asset quality would have strong bearing on its profitability profile.

BOK's capitalisation level remains comfortable with CRAR of 13.33% and Common Equity Tier I (CET-I) of 11.16% as of mid-Apr-2017 (both under Basel III norms) against minimum regulatory requirement of 11% and 7.50% (both including capital conservation buffer-CCB) respectively. Total Tier I capital is required to increase to 8.5% by mid-Jul '19 (including capital conservation buffer) although the requirement for total capital would be at 11% (incl. CCB). BOK plans to increase paid-up capital to NPR 8 billion (vs. ~NPR 5.63 billion as of now) by FY17 (as required by changed regulations) through FPO and internal accruals. Accordingly, capitalization levels are expected to remain adequate to support BOK's growth plans over the medium term. The banks' ability to raise planned capital in a timely manner would have a bearing on its ability to meet the revised guidelines and support growth plans.

### **Bank Profile**

Bank of Kathmandu Limited (BOK), is a class A commercial bank, operating since March 1995. The bank is promoted by individual promoters related to business and industrial houses and is managed by a team of experienced bankers and professionals. Mr. Ajay Shrestha is the Chief Executive Officer of the bank. The bank's equity share is listed in Nepal stock exchange and its market capitalization was ~NPR 24 billion as of mid-March-2017.

BOK merged with Lumbini Bank (LuBL)<sup>5</sup> with effect from 14th July 2016. LuBL, a class A bank, was operating since July 1998, before merging with BOK. After the merger, the merged entity ran briefly

<sup>4</sup> The exposure is backed by counter-guarantee from China Construction Bank (CCB) of People's republic of China (long term credit rating of A1 by Moody's Investors Service). The case is currently under consideration at China District Court.

<sup>5</sup> Lumbini Bank Limited, class A bank, was operating since July 1998.



under the brand name of “Bank of Kathmandu-Lumbini (BOKL)”, before the name was changed back to Bank of Kathmandu Limited (BOK) by the FY16 Annual General Meeting of the merged entity.

As on mid-Apr 2017, BOK has presence across 34 districts of the country through its 74 branches including Head office in Kathmandu and six regional offices across the country. BOK is a medium size bank with 3.7% and 3.9% share in commercial banking deposit and credit portfolio respectively (mid-Apr-2017). BOK reported a profit after tax of NPR 1,015 million<sup>6</sup> during 2015-16 over an asset base of NPR 79,648 million as on Jul-16 as against profit after tax of NPR 678 million during 2014-15 over an asset base of NPR 68,417 million as on Jul-15. During 9mFY17, BOK has reported PAT of NPR 887 million. BOK’s CRAR was 13.33% and gross NPLs were 3.08% as on mid-Apr-17.

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*For further details please contact:*

*Analyst Contacts:*

**Mr. Kishor Prasad Bimali**, (Tel No. +977-1-4419910/20)

[kishor@icranepal.com](mailto:kishor@icranepal.com)

**Mr. Sailesh Subedi**, (Tel No. +977-1-4419910/20)

[sailesh@icranepal.com](mailto:sailesh@icranepal.com)

*Relationship Contacts:*

**Mr. Deepak Raj Kafle**, (Tel. No. +977-1-4419910/20)

[drkafle@icranepal.com](mailto:drkafle@icranepal.com)

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<sup>6</sup> Combined result of BOK and Lumbini. BOK reported standalone performance in the annual report adjusting Lumbini Bank’s financial in balance sheet only. Reported profit is NPR 655 million in FY 2015-16.