

## Bank of Kathmandu Limited

### ICRA Nepal reaffirms the LBBB+ ratings assigned to the subordinated bonds of Bank of Kathmandu Limited

Facility/Instrument	Amount	Rating Action (August 2018)
Subordinated Bond Program	NPR 600 Million	[ICRANP] LBBB+ (reaffirmed)

ICRA Nepal has reaffirmed the rating of existing subordinated bonds of NPR 600 million of Bank of Kathmandu Limited (BOK) at **[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.

The rating reaffirmation continues to draw support from the long track record of the bank (operating since 1995), its adequate geographical presence across the country (through 79 branches and 6 regional offices), cautious growth approach and established underwriting norms, despite being challenged by large one-off slippage in FY15. The rating action factors in adequate granularity of credit portfolio, as reflected in low credit concentration among top borrowers (top 20 borrowers accounted for 17% of total credit on mid-April 2018). The rating also factors in healthy capitalization profile of the bank (CRAR<sup>1</sup> of ~15% as on mid-April 2018), strengthened after recent promoter shares issuance. Comfortable capitalization, experienced management team and adequate franchise is expected to support future balanced growth and profitability of the bank. While reaffirming the rating, ICRA Nepal notes the increase in institutional shareholding of BOK after the recent promoter shares issuance (through auction). Employees' provident fund, Nepal (EPF) acquired almost entire shares floated under follow-on offer of promoter shares, increasing its stake in BOK from erstwhile ~5.5% to ~14.9% as of mid-April 2018. This is a positive from the governance perspective.

On the other hand, the rating remains constrained by high Non-performing Loans (NPLs) of BOK. The bank's NPL level continues to remain on higher side after the spike in FY15, caused by non-recovery from counterparty in an off-balance-sheet exposure (counter guarantee). As on mid-April 2018, BOK's gross NPL stood at 3.05% of which ~41% is accounted for by the single NPL arising from counter guarantee case. However, with adequate credit provisioning against the NPLs (75% overall provision & 100% provision against the counter guarantee exposure), solvency profile of BOK remains comfortable (net NPL/ net worth of ~4.5% on mid-April 2018). The bank has been witnessing relatively higher slippage rate post-merger with Lumbini bank Limited in FY16 (along with the rise in NPL levels), which remains a concern for incremental assets quality. Rating also remains constrained by relatively weaker deposit profile vis-à-vis industry average. CASA proportion of BOK as on mid-April 2018 stood at 37% vs. commercial bank average of 44%. As a result, cost of deposits of BOK (6.98% during 9mFY18) has remained ~80-100 bps higher than commercial bank average during past 12-18 months. This could be a limitation to the competitive positioning of the bank, in the prevailing "base rate plus" lending rate regime. Concentration of deposits among top depositors also remains on higher side (top 20 depositors accounted for ~28% as on mid-April 2018). Growth wise, BOK is yet to achieve post-merger synergy as evidenced by low credit growth during FY17 and 9mFY18 (~4% and ~10% respectively) much lower to industry average. Achieving post-merger synergy by integrating the resources of merging entities will have a bearing on incremental prospect of the bank.

BOK's credit growth has remained low after merger in FY16. During FY17 and 9mFY18, BOK's credit growth stood at ~4% and ~10% (annualized) vis-à-vis commercial bank average growth of ~25% and 20% respectively. The growth rate remained low due to focus on post-merger consolidation and has picked up in recent quarters. Post-merger synergy could support the incremental growth prospect, but it will depend successful integration of resources of merging entities. In terms of portfolio mix, BOK's reliance on corporate credit has gradually come down over the years. As on mid-April 2018, corporate loans accounted for 37% of total loans, SME loans accounted for 36% while retail segment accounted

<sup>1</sup> Capital to Risk-Weighted Assets Ratio

for 22% of total loans (vs. 37%, 43% and 15% respectively on mid-July 2017). Due to recent growth along retail & SME segment and recent uptick in the interest rate environment, average yield on advances has improved to ~12% during 9MFY18 from ~10% during FY17. Going forward, the management intends to leverage the increased franchise strength to focus on retail/SME credit growth. However, the bank's ability to achieve the growth targets along with commensurate control measures remains to be seen.

In terms of assets quality, BOK's gross NPL level remains higher than the industry average and similar aged peers, mainly due to single large slippage in FY15 involving an off-balance sheet exposure (guarantee to local party backed by counter guarantee from foreign bank<sup>2</sup>). As of mid-April 2018, gross NPL of BOK stood at 3.05%, of which ~41% was accounted for by NPL related to the off-balance sheet exposure. Moreover, gross NPL level of BOK has shown an increasing trend post FY16 merger which remains a concern. Nonetheless, despite high NPL level, BOK has maintained comfortable solvency profile (net NPL/ net worth of ~4.5%) because of adequate NPL provisioning cover (~75% on mid-April 2018). Moreover, 0+ days delinquency proportion (~6% as on mid-April 2018) has come down marginally in past 12-18 months which remains a comfort.

On deposits front, BOK's Current and Savings (CASA) deposit proportion continues to trail behind the commercial bank average. As on mid-April 2018, BOK's CASA deposit proportion stood at ~37% (vs. 39% in mid-Jan 2017) vs. commercial bank average of ~44%. Due to lower proportion of CASA deposit, cost of deposits of BOK has remained ~80-100 bps higher than commercial bank average during past 12-18 months. In the prevailing "base rate plus" lending regime in the banking industry, this could have a negative impact on competitive positioning of the bank. In terms of deposit concentration, BOK's has reported improvement over past 12-15 months. Concentration of deposits among top 20 depositors has declined from 30% in mid-Jan 2017 to ~28% in mid-April 2018, albeit continues to remain on higher side.

As for profitability, BOK's return indicators remains moderate in past 12-18 months amid pressure on net interest spreads from rising cost of fund. However, the Bank has been able to report relatively stable NIMs (~3.2% during past 12-18 months) by improving the credit to deposit ratio. Profitability profile of BOK remains constrained by low level of non-interest income (~0.85% of average total assets (ATA) in past 12-18 months) vs. commercial bank average of ~1.25% over the same period. Nonetheless, low credit cost and gradual moderation in operating expense ratio is expected to support the profitability profile to some extent. BOK's return on average assets (RoA) improved from 1.36% in FY16 to 1.61% in FY17 before moderating to 1.45% during 9mFY18 while the return on average net worth (RoNW) stood at ~13.9%, ~15.6% and ~12.1% in the corresponding period. Sharp dilution in RoNW during 9mFY18 is partly aided the proceeds collected from the issuance of further promoter shares. Going forward, bank's ability to ensure efficient utilisation of incremental capital, 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 15.02% and Common Equity Tier I (CET-I) of 13.13% as of mid-April 2018 (both under Basel III norms) against minimum regulatory requirement of 11% and 8% (both including capital conservation buffer-CCB) respectively. BOK's current CET-I level is comfortable vis-à-vis the CET I requirement of 8.5% to be maintained by mid-July 2019. Following the capitalization of proceeds collected from issuance of further promoter shares towards the end of 2017, BOK has ensured the regulatory minimum paid up capital level of NPR 8 billion for class A banks.

### **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. The bank's equity share is listed in Nepal stock exchange and its market capitalization was ~NPR 18 billion as of mid-June 2018.

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<sup>2</sup> BOK's gave performance guarantee to domestic employer company on behalf of a Chinese contractor company. BOK's guarantee was backed by counter-guarantee from China Construction Bank (CCB) of People's Republic of China. The case is currently under consideration at Chinese Court.

BOK merged with Lumbini Bank (LuBL)<sup>3</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 under the brand name of “Bank of Kathmandu-Lumbini (BOKL)”, before the name was changed back to Bank of Kathmandu Limited (BOK) by the Annual General Meeting of the merged entity for FY2016.

As of mid-April 2018, BOK has presence across 39 districts of the country through its 79 branches including Head office in Kathmandu and six regional offices across the country. As on mid-April 2018, BOK has market share of 2.91% in credit portfolio and 2.84% in deposit base of Nepalese banking industry (3.36% and 3.26% share respectively in commercial bank industry). BOK reported profit after tax of NPR 1,312 million during FY2017 over an asset base of NPR 83,601 million as of mid-July 2017 vis-à-vis profit after tax of NPR 1,015 million<sup>4</sup> during 2015-16 over an asset base of NPR 79,648 million as on Jul-16. During 9mFY2018, BOK has reported PAT of NPR 931 million. BOK’s CRAR was 15.02% and gross NPLs were 3.05% as on mid-April 2018.

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<sup>3</sup> Lumbini Bank Limited, class A bank, was operating since July 1998.

<sup>4</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.