Mega Bank Nepal Limited: [ICRANP-IR] BBB+ assigned

August 17, 2020

Summary of rated instruments

INSTRUMENT/FACILITY	RATED AMOUNT	RATING ACTION
Issuer Rating	NA	[ICRANP-IR] BBB+; assigned

Rating action

ICRA Nepal has assigned the issuer rating of [ICRANP-IR] BBB+ (pronounced ICRA NP issuer rating triple B plus) to Mega Bank Nepal Limited (Mega). Issuers with this rating are considered to have a moderate degree of safety regarding the timely servicing of financial obligations. Such issuers carry a moderate credit risk. The issuer rating is only an opinion on the general creditworthiness of the rated entity and not specific to a debt instrument. The sign of + (plus) or – (minus) appended to the rating symbols indicates their relative position within the rating categories concerned.

Rationale

The assigned rating factors in Mega's comfortable capitalisation profile (CRAR of ~12.6% with Tier I capital of ~11.7% as of mid-April 2020), which, along with the granularity in the credit portfolio remains a comfort against probable credit shocks. The rating also factors in Mega's good reported asset quality (gross non-performing assets (NPAs) of ~1.3% as of mid-April 2020) and solvency level (net NPA to net worth ratio of ~4% as of mid-April 2020 despite a mere 55% NPA provision cover), notwithstanding the Covid-19 induced rise in delinquencies (~25% as of mid-April 2020). NPA levels have also remained low partly because of the high growth in the credit portfolio in recent years. The rating also factors in Mega's diversified presence across the country (206 branches), resulting from its strategic acquisition of multiple development banks. Mega has grown into a mid-sized commercial bank within a short time span through these inorganic measures, resulting in business synergies and economies of scale. The assigned rating also derives comfort from Mega's good profitability profile, which remains supported by its strong net interest margin (NIM) of ~4% for 9mFY2020 and low credit cost despite the marginally higher operating expense ratio.

However, rating concerns emanate from the incremental asset quality concerns regarding Mega's largely unseasoned credit books and untested borrowers. The bank has added a large portion of its current day credit books over a short time span through organic and inorganic measures. A sizeable portion of Mega's credit books have come from development banks[1]. Given the relatively moderate underwriting quality of development banks and the current unfavourable economic condition created by the Covid-19 pandemic, Mega's asset quality is likely to be tested over the near term. The asset quality concerns are also exacerbated by the bank's relatively higher exposure to sectors deemed vulnerable[2] (~17% vs. ~11% as of mid-April 2020). Rating concerns also arise from the relatively weak competitive positioning of the bank, given its higher cost of deposits and consequently higher base rate, which could be a deterrent in attracting good quality borrowers. Mega's high cost of deposits stems from its lower current account and savings account (CASA) proportion. The bank also has a relatively concentrated deposit portfolio, which could make it vulnerable to liquidity risks during the volatile interest environment. Mega's ability to handle post-merger integration issues also remains a major concern. The extremely diversified ownership profile also remains a concern as it could limit the ability of the promoter groups to revive the bank in case of stress.

Going forward, Mega's asset quality amid the economic uncertainty and the capital cushion to withstand potential credit shocks will remain key rating sensitivities. The bank's ability to improve its deposit profile and lower the deposit concentration will also be a key rating sensitivity.

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[1] *Mega acquired four development banks during the 10-year period since its inception; the most recent acquisition was in July 2020*

[2] *Sectors such as real estate, hire purchase, margin loans and mining loans*

Key rating drivers

Credit strengths

Comfortable capitalisation level – Mega reported a comfortable CRAR of ~12.6% with a Tier I capital of ~11.7% as of mid-April 2020 (15.3% and 14.3%, respectively, as of mid-July 2019), despite the moderation caused by the dividend pay-out from FY2019 profits. The adequate cushion over the minimum regulatory requirement of 8.5% at the Tier I level remains a comfort against credit and liquidity shocks that could arise in future.

Good reported asset quality, notwithstanding recent deterioration – Mega's gross NPA level stood at ~1.3% as of mid-April 2020, rising marginally from ~1% as of mid-July 2019. The increase in the NPA level can be attributed to the Covid-19-induced stress in recent periods. Mega has a sound solvency profile (net NPA/net worth of ~4%) because of the relatively low NPA level and comfortable capitalisation profile. The delinquency level reported by the bank as of mid-April 2020 was low at ~2.5%. However, disregarding the forbearance, the delinquency level stood at ~25%, which could be an indicator of stress in the asset quality going forward.

Fairly diversified credit portfolio supported by wide branch network – Mega has an extensive branch network (206 branches as of mid-July 2020) across the country, aided by the recent acquisition of Gandaki Bikas Bank. This is a strong network for a mid-sized bank, which reflects positively in the portfolio granularity, especially the credit portfolio. The credit concentration of Mega among the top borrowers remains low (~18% of total credit among top 20 borrowers as of mid-April 2020) despite the sharp portfolio growth in recent years and the sizeable addition of corporate loans in the last 12 months.

Adequate profitability profile – Mega's profitability remains good supported by the healthy NIMs of ~4% in the last 1-2 years. This, in turn, stems from the sizeable proportion of high-yielding non-corporate loans, which offset the bank's relatively higher cost of deposits. NIMs also remained supported by the optimum utilisation of funds in recent years, as evidenced by the higher credit to capital adjusted deposit (CCD) ratio (~77% as of mid-April 2020). The profitability also remains supported by the low credit cost despite being dragged down by the relatively higher operating expenses. Mega's return on assets (RoA) and return on net worth (RoNW) stood at ~1.9% and ~14.2%, respectively, as of mid-April 2020, better than the commercial bank industry average of ~1.6% and ~13%, respectively, indicating a healthy profitability profile.

Credit challenges

Asset quality concerns amid pandemic-induced difficult economic condition – Mega's credit portfolio has increased at a high compound annual growth rate (CAGR) of ~38% over the three years ending July 2019, both organically and inorganically. As a result, a large portion of its mid-April 2020 credit books are unseasoned. The unseasoned credit books and untested borrowers could result in asset quality concerns amid the difficult economic condition created by the Covid-19 pandemic. The concerns are exacerbated by Mega's relatively higher exposures to vulnerable sectors like real estate (~10% of Mega's credit portfolio as of mid-April 2020) and the recent uptick in the NPA and delinquency levels (as of mid-April 2020, ~25% of the credit portfolio was delinquent although this was largely because of the regulatory forbearance accorded by the Central Bank).

Moderate funding profile with high cost and concentration among top depositors – Mega's CASA deposit proportion stood at ~31% as of mid-April 2020, lower than the industry average of ~40%. The lower proportion of CASA and higher proportion of term deposits led to a high cost of funds, leading to a higher base rate. This could be a competitive disadvantage in the 'base rate plus' lending model being practised in the industry and could limit the bank's ability to attract quality borrowers. Mega also has a relatively high concentration of deposits among the top depositors (~31% of the total deposits among the top 20 depositors as of mid-April 2020). This remains a challenge for the bank in terms of the stability of deposits and the incremental cost of funds. Although the recent decline in deposit rates across the industry has had a supressing effect on Mega's base rate, the sustainability of the same will depend on the bank's ability to improve its CASA mix and deposit portfolio granularity.

Company profile

Mega Bank Nepal Limited (Mega), a class A bank licensed by Nepal Rastra Bank (NRB – the Central Bank), commenced its operations on July 23, 2010. It is the youngest class A commercial bank in the fragmented banking industry of Nepal. In recent years, Mega has grown into a mid-sized commercial bank due to organic as well as inorganic growth.

Between FY2016 and FY2018, Mega merged with two development banks viz. Paschimanchal Development Bank (combined operations from April 2016) and Tourism Development Bank (combined operations from May 2018). Both banks were performing well in terms of asset quality and network, albeit on a small base. Mega also acquired Gandaki Bikas Bank (MoU signed in October 2019 (swap ratio of 1:1) and combined operations started from July 5, 2020). Multiple mergers and acquisitions with established regional players have helped Mega grow into a mid-sized commercial bank within a short time span.

As of mid-April 2020, Mega had a pan-Nepal presence through 206 branches (including branches added through the acquisition of Gandaki Bikas Bank), 31 extension counters, 142 ATMs and 89 branchless banking outlets. The promoter-public shareholding ratio stood at ~51:49. Mega's shares are listed and traded on the Nepal Stock Exchange and its market capitalisation was about NPR 22,672 million as of mid-April 2020. Its head office/registered office is in Kamaladi, Kathmandu.

Mega has a market share of ~2.4% in terms of the deposit base and ~2.5% in terms of the total advances in the Nepalese banking industry as of mid-April 2020 (2.8% and 2.9% share, respectively, in the commercial bank industry). It reported a profit after tax (PAT) of NPR 1,630 million in FY2019 (YoY growth of ~23%) on an asset base of NPR 97,792 million as of mid-July 2019. For 9M FY2020, Mega reported a profit of NPR 1,451 million on an asset base of NPR 109,960 million. Mega's reported CRAR was ~12.6% (Tier I capital of 11.7%) and the gross nonperforming loans (NPLs) were ~1.3% as of mid-April 2020. In terms of the technology platform, Mega is using Flexcube as a core banking software across all its branches.

Key financial indicators

KEY FINANCIAL RATIOS YEAR ENDED	Jul-17 (Audited)	Jul-18 (Audited)	Jul-19 (Audited)	Apr-20 (Provisional)
OPERATING RATIOS				
Net Interest Margin/Avg. Total Assets	4.01%	3.81%	4.30%	4.09%
Non-interest Income/Avg. Total Assets	0.88%	1.04%	0.96%	0.91%
Operating Expenses/Avg. Total Assets	1.96%	1.87%	2.15%	2.00%
Credit Provisions / Avg. Total Assets	0.28%	0.02%	0.48%	0.34%
PAT / Avg. Total Assets	1.86%	2.11%	1.85%	1.86%
PAT / Net Worth	15.69%	14.18%	12.47%	14.20%
Gross NPAs	1.36%	0.82%	0.98%	1.32%
CAPITALISATION RATIOS				
Capital Adequacy Ratio	14.80%	17.91%	15.29%	12.56%
Tier I capital	13.80%	16.97%	14.34%	11.70%
Net NPAs/Net Worth	4.25%	1.61%	1.74%	3.54%
COVERAGE & LIQUIDITY RATIOS				
Total Liquid Assets/Total Liability	21.56%	25.26%	23.85%	22.00%
Total Advances/Total Deposits	89.00%	89.95%	92.19%	92.00%

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About ICRA Nepal Limited

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