

Shangri-la Development Bank Limited: Issuer rating [ICRANP-IR] BB+ assigned

February 3, 2021

Summary of rated instruments

INSTRUMENT/FACILITY	ISSUE SIZE	RATING ACTION (FEBRUARY 2021)
Issuer Rating	NA	[ICRANP-IR] BB+; assigned

Rating Action

ICRA Nepal has assigned a rating of **[ICRANP-IR] BB+** (pronounced ICRA NP issuer rating double B plus) to Shangri-la Development Bank Limited (SADBL). Issuers with this rating are considered to have a moderate risk of default regarding timely servicing of financial obligations. The rating is only an opinion on the general creditworthiness of the rated entity and is not specific to any debt instrument. The sign of + (plus) or – (minus) appended to the rating symbol indicates their relative position within the rating categories concerned.

Rationale

The rating factors in SADBL's adequate track record of operation (operating since 2006) with strong presence across the country (92 branches as of mid-January 2021). An adequate branch network and experienced management team have helped the bank register healthy business growth in the last three to four years while maintaining portfolio granularity. Further, SADBL's fair deposit profile with above industry average current and saving accounts (CASA) proportion, competitive cost of funds and granular deposit profile have been factored into the rating action.

However, these positives are offset by the bank's moderate asset quality with gross NPLs of 2.4% and high 0+ days delinquency level of ~17% as of mid-January 2021. Modest capitalisation profile (CRAR of 11.98% as of mid-January 2021 against the minimum regulatory requirement of 11%) and resulting low capital cushion amid increased delinquencies and high growth raises rating concerns. The deterioration in the profitability indicators in the last 12–18 months because of elevated credit cost also remains a concern as it limits the bank's ability to generate internal capital to support its capitalisation profile. The ability of the bank to raise and capitalise the proposed tier-II debentures will also have a bearing on the bank's future capitalisation levels and will remain a key monitorable. Rating concerns also arise from the relatively weaker competitive positioning of SADBL vis-à-vis large and established commercial banks offering wider range of services with finer lending rates. The regulatory restrictions for class B banks in areas, such as loans against hypothecation of stocks and receivables and foreign currency-based transactions (such as import LCs) erodes their competitive positioning and earning potential vis-à-vis class A banks, which remains a long-term credit negative.

Going forward, SADBL's ability to improve its asset quality, given the difficult operating environment and high delinquency levels will remain a key monitorable. The ability to improve profitability and maintain adequate cushion in capitalisation front will also be important for its incremental financial profile.

Key rating drivers

Credit strengths

Adequate track record with diversified presence across country – Operating since 2006, SADBL has an adequate track record of operations in the Nepalese development banking arena. The bank also has adequate presence across the country through its 92 branches as of mid-January 2021, supporting the bank's portfolio growth along the retail and the SME segments.

Fair deposit profile with sound growth and granularity – SADBL's deposit growth remained healthy with CAGR of ~28% in the last three years ending in July 2020 against the banking industry average CAGR of ~18% over the same period. The deposit growth was aided by adequate franchise network across the country despite challenging liquidity scenario in the

last few years (the industry witnessed deposit crunch since January 2016 that lasted till April 2020), which resulted in increased share of term deposits for the industry. Hence, in line with the industry trend, SADBL's CASA declined to ~34% as of mid-July 2020 from ~42% as of mid-July 2017. SADBL's CASA of ~34% as of mid-October 2020 remained slightly better than the development bank industry average of ~30% on the same date. Despite high growth, the company's deposit remains granular, wherein the top 20 depositors comprise ~10% of the overall deposit as of mid-October 2020.

Granular credit portfolio despite healthy portfolio growth – SADBL has maintained portfolio granularity, wherein the top 20 customers accounted for ~13% of total credit portfolio as of mid-October 2020. This provides some comfort on credit-concentration risks and risks arising from relatively higher credit portfolio growth (CAGR ~27% over the last three years ending in mid-July 2020 against 18% for the banking industry¹).

Credit challenges

Modest capitalisation with thin cushion against regulatory minimum – SADBL has maintained a CRAR of 11.98% as of mid-January 2021, leaving a very thin margin against the regulatory (Nepal Rastra Bank; NRB) minimum of 11%. This, however, is expected to be comforted by the issuance of proposed tier-II debentures. Thin capital cushion amid high growth targets reduces the bank's ability to absorb probable credit shocks. Low capital cushion also remains a concern, given the high credit portfolio delinquency level of the bank in the post-pandemic era.

Relatively inferior asset quality with moderate NPLs and high delinquencies – Due to the Covid-19 impact, the bank's gross NPL levels have spiked to 2.4% as of mid-January 2021 (industry average NPLs of 1.67% as of mid-October 2020) from 1.1% as of mid-July 2020. Delinquencies of 0+ days also remain high at ~17% as of mid-January 2021, despite improvement over the mid-July 2020 delinquency level of ~30%. The asset quality indicators are likely to remain subdued over the medium term, given the difficult operating environment for SADBL's borrowers amid the pandemic.

Deteriorating profitability profile due to decline in NIMs² and high credit cost – SADBL's return indicators have witnessed steady erosion in the last three to four years (RoNW of ~6% for FY2020 from ~23% in FY2017 and RoA of 0.6% in FY2020 from 2.5% in FY2017). This was caused by pressure on NIMs arising from higher cost of deposits across the industry in FY2018 and FY2019 and implementation of interest spread cap of 5% after FY2019 (NIMs declined from 5.1% in FY2017 to 3.5% in FY2020). High operating expense ratio due to relatively small scale of operation and recent rise in credit cost also remains a drag to profitability. The lending yield and in turn profitability were further affected in FY2020 by the pandemic-related discounts and deferrals (in line with the Central Bank's directives)

Intense competition from larger commercial banks with wider range of services – As per the regulatory provisions, class B banks are restricted to undertake certain activities that are allowed for class A commercial banks, viz. credit secured only against hypothecation of stock and receivables, opening of foreign currency denominated letter of credit/guarantees, etc. These provisions erode the competitive positioning of the development banks (such as Shangri-la) vis-à-vis commercial banks with higher capital, stronger brand and branch network, larger customer base, wider range of services and finer lending rates. This remains a long-term negative for the development bank industry.

Company profile

Established in December 2006 as a regional development bank, Shangri-la Development Bank Limited (SADBL) underwent merger with another regional development bank (Bageshwori Development Bank) on July 13, 2014 to become a national level development bank. The merged operations were continued under the name of Shangri-la Development Bank. Later, the bank acquired Cosmos Development Bank, a one district level development bank on July 14, 2017. SADBL's corporate

¹ Industry data of development banks impacted by mergers of many peers with class A commercial banks and hence overall banking industry data taken for comparison.

² Net interest margins

office is located at Baluwatar-4, Kathmandu. The share capital of the company is held by the promoter and public shareholders in the ratio of 51:49. Mr. Suyog Shrestha is the bank's Chief Executive Officer.

SADBL has presence in 42 districts of Nepal through its 92 branches as of mid-January 2021. SADBL has a market share of ~8.6%, both in terms of deposit as well as credit portfolio base of development banks as on mid-October 2020. The bank reported net profit of ~NPR 189 million in FY2020 over an asset base of NPR 32,894 million as of mid-Jul 2020 against net profit of ~NPR 342 million in FY2019 over an asset base of NPR 26,284 million as of mid-July 2019. The bank reported net profit of ~NPR 165 million in H1 FY2021 over the asset base of ~NPR 40,141 million as of mid-January 2021. The capitalisation profile (CRAR) of SADBL was at 11.98% and gross NPLs were at 2.43% as on mid-January 2021. In terms of technology platform, SADBL has implemented centralised Pumori-IV system across all its branches.

Key financial indicators

KEY FINANCIAL RATIOS YEAR ENDED	Jul-18 (Audited)	Jul-19 (Audited)	Jul-20 (Provisional)	Jan-21 ³ (Provisional)
OPERATING RATIOS				
Net Interest Margin/Avg. Total Assets	4.24%	4.18%	3.54%	2.97%
Non-interest Income/Avg. Total Assets	0.74%	0.77%	0.59%	1.16%
Operating Expenses/Avg. Total Assets	2.10%	2.86%	2.35%	2.16%
Credit Provisions / Avg. Total Assets	0.76%	0.04%	0.86%	0.76%
PAT / Avg. Total Assets	1.48%	1.44%	0.64%	0.90%
PAT / Net Worth	11.82%	10.86%	5.70%	9.71%
Gross NPAs	1.62%	0.84%	1.13%	2.43%
CAPITALISATION RATIOS				
Capital Adequacy Ratio	19.02%	16.66%	13.98%	11.98%
Net NPAs/Net Worth	4.17%	2.82%	4.36%	13.05%
COVERAGE & LIQUIDITY RATIOS				
Total Liquid Assets/Total Liability	29.67%	23.98%	25.65%	22.32%
Total Advances/Total Deposits	82.41%	86.68%	81.79%	86.83%

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