

Karnataka Bank

13 July 2018

Reuters: KBNK.NS; Bloomberg: KBL IN

Slippage Ratio Declines Encouragingly

Karnataka Bank (KBL) reported 1QFY19 results with the key strategic pointers being: (1) Slippage ratio declined to 0.59% compared with 2.88% in 4QFY18 (2) NII growth lagged loan growth owing to yield pressure (yield stood at 9.29% compared with 10.22% in 1QFY18) but management stated that loan rates are slated to reprice higher (3) Management guided for fee income growth of ~30% for FY19 (4) Opex control remains admirable even adjusted for beneficial one-off. (See conference-call highlights on page 2; [See Management Meet note](#); [See 4QFY18 results note](#); [see initiating coverage report here](#)). Per se, on the results front, KBL posted 10% NII growth YoY to Rs4,686mn, PPOP growth of 19% YoY to Rs3,689mn and PAT growth of 22% YoY to Rs1,632mn. We have revised our estimates for FY19/FY20 and retained Buy rating on KBL, revising our target price on it to Rs155 (from Rs150 earlier) and valuing the stock at 0.65x FY20E P/BV.

Slippage ratio declined to 0.59% compared with 2.88% in 4QFY18 indicating various restructuring dispensations that were standard have largely fallen into NPA category: As of 3QFY17, CDR/JLF, 5/25, SDR, S4A, SR book and watchlist (SMA2), taken together, were ~10.7% of loan book (not factoring in overlaps). By 4QFY18, this cumulative exposure had declined to 2.4% of loan book. The significantly lower stress pipeline has, now, in 1QFY19, led to the meaningfully lower slippage ratio. While there is a sub-investment grade book, which is 5.8% of gross bank credit, management points out that (1) many of these accounts are long-standing customers, which are not stressed (2) many are not from the large corporate category. SMA2 loans rose QoQ from Rs 4.30bn to Rs 7.26bn (1.5% of loans) but management has stated that only 7-10% of this pool could ultimately slip.

NIM compression impacted NII growth but this is a largely transient phenomenon: Yield on advances fell to 9.29% from 10.22% last year. Management has stated that yield on advances will move up on account of interest-rate resets that will kick in over the next 6 months and alleviate, to a material extent, the recent yield compression. Secondly, KBL has availed RBI dispensation on NPA recognition for MSMEs for a loan quantum of Rs3.19bn, on which interest income has not been recognized, which was an incremental reason that impacted yield adversely.

Fee income traction will remain robust and opex control was admirable: Fee income continued to grow at a pace greater than 40% YoY on the back of charges' revisions. Management guided that fee income would rise ~30% in FY19 and 20-25% on a steady state basis, going forward. Operating expenses de-grew YoY aided by a Rs 210mn superannuation benefits writeback. Even adjusted for this, opex would be flat YoY. Share of alternate digital channels in transaction value rose 216 bps QoQ to 67.50%. Provisions for new bi-partite employee settlement that would apply effective November 2017 have already been made.

Valuation and outlook: We have revised our NII estimates by -3%/-3.4%, our PPOP estimates by 7.9%/5.3% and PAT estimates by -0.7%/2.6% for FY19/FY20, respectively. We have retained Buy rating on KBL, revising our target price to Rs155 (from Rs150 earlier), valuing the stock at 0.65x FY20E P/BV.

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BUY

Sector: Banking

CMP: Rs115

Target Price: Rs155

Upside: 36%

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Key Data

Current Shares O/S (mn)	282.6
Mkt Cap (Rsbn/US\$m)	32.4/472.6
52 Wk H / L (Rs)	172/105
Daily Vol. (3M NSE Avg.)	2,933,829

Price Performance (%)

	1 M	6 M	1 Yr
Karnataka Bank	(4.8)	(31.5)	(30.7)
Nifty Index	1.5	3.2	11.4

Source: Bloomberg

Y/E March (Rsmn)	1QFY19	1QFY18	4QFY18	YoY (%)	QoQ (%)
Interest income	14,076	13,305	14,430	5.8	(2.5)
Interest expenses	9,391	9,061	9,015	3.6	4.2
Net interest income	4,686	4,244	5,415	10.4	(13.5)
NIM (%)	3.0	2.97	3.5	3 bps	(54) bps
Non-interest income	2,088	2,174	2,945	(4.0)	(29.1)
Operating income	6,774	6,418	8,360	5.5	(19.0)
Staff costs	1,105	1,374	1,418	(19.6)	(22.1)
Other operating expenses	1,980	1,947	2,189	1.7	(9.5)
Total operating expenses	3,085	3,321	3,607	(7.1)	(14.5)
Cost-to-income (%)	45.5	51.7	43.1	(620) bps	240 bps
Operating profit	3,689	3,097	4,753	19.1	(22.4)
Provisions	2,221	1,989	5,418	11.7	(59.0)
PBT	1,468	1,108	(664)	NA	NA
Tax	(164)	(230)	(774)	NA	NA
-effective tax rate	(11.2)	(20.8)	116.6	-	-
PAT	1,632	1,339	110	22.0	1,384.0
EPS (Rs)	5.8	4.7	0.4	22.0	1,384.0
BV (Rs)	197.2	183.1	191.4	7.7	3.0
Deposits	6,27,247	5,62,270	6,28,713	11.6	(0.2)
Advances	4,77,312	3,84,053	4,72,518	24.3	1.0

Source: Company, Nirmal Bang Institutional Equities Research

Please refer to the disclaimer towards the end of the document.

Key Conference Call Takeaways

- The bank showed improvement in asset quality metrics indicated by decline in slippage ratio from 2.88% to 0.59% QoQ, credit costs decline from 1.25% to 0.41% QoQ and PCR rise from 54% to 57% QoQ.
- The management stated that the key intervention areas for the bank were to revamp the entire collection mechanism of their total asset portfolio within the next 6 months. In this aspect, home loan delivery loan model has been rolled out and MSME delivery loan model is in the process of rolling out.
- The management stated that the reduction in employee cost from Rs.1374.1mn to Rs.1105mn QoQ was aided by writeback of super annuation benefits amounting to Rs 210mn.
- The management guided that advances would grow at ~20% in FY19. The bank is aiming to reduce GNPA to 4% and NNPA to 2% by the end of FY19.
- The management guided that the bank will be able to grow fee income by 30% in FY17 and sustain a 20-25% growth on a steady state basis.
- The bank has availed RBI dispensation provided to MSME borrowers to the extent of Rs 3190mn worth of MSME loans. Interest income on these loans was not reckoned which was an incremental reason impacting NIM negatively.
- Loan book growth YoY for certain segments has been as follows: MSME- 29.89%, housing- 16.62%, mortgage- ~40%, agriculture- ~15%.
- The management stated that around Rs.80000mn of the total loan book is still low yielding. The management guided that upward repricing of loan book will take place over the next 6 months.
- The management expects to register a spread of 3.5% for FY19.
- The bank has provided 76% on its NCLT List 1 and 2 exposures. Incremental provision on this book in 1QFY19 was Rs 800mn.
- The management stated that there has been no sale to ARC this quarter. Outstanding SR stood at Rs.4412.3mn down from ~Rs.4460mn QoQ. Outstanding Provision of Rs.690mn this quarter is held against SR book.
- Fraud Account in Gems and Jewellery sector has been technically written-off. Management is attempting to resolve this account.
- Consortium accounts numbered 74 and KBL is not a lead bank in these arrangements. No new consortium arrangement has been entered into this quarter.
- Mortgaged backed loans' ticket sizes generally ranged from Rs.50mn to Rs.500mn. The collateral in some of these mortgaged backed loans are commercial properties, malls.
- While SA accretion has been soft recently, the management is focusing on accelerating customer onboarding. Customers onboarded have moved up to 171585 from 161780 QoQ.
- Advances to commercial real estate sector stood at Rs.28960mn (5.95% of Total Loans). NPAs from this segment stood at Rs783mn (2.70% of CRE Loans).
- While there is a sub-investment grade book, which is 5.8% of gross bank credit, management points out that (1) many of these accounts are long-standing customers, which are not stressed (2) many are not from the large corporate category.
- The management states that the bank does not directly compete in a significant way with either PSU banks or modern private banks.
- The management has identified 10-12 states for expansion.
- The bipartite settlement i.e revised salary structure will be applicable from Nov 2017 and required provision has been made in this regard.
- Exposure to power sector (Rs.27240mn) stood at 5.6% of total loans, NPAs from this sector stood at Rs.2930mn. Most of the power sector exposure is to high rated PSUs.
- The management gave a credit cost guidance of 0.5% per quarter and PCR would hover around 55-57%.
- SMA2 loans rose QoQ from Rs 4.30bn to Rs 7.26bn (1.5% of loans) but management has stated that only 7-10% of this pool could ultimately slip.

- Of ~Rs.60000mn agricultural sector loan book, ~Rs.38000mn is loans in Karnataka. Crop loans in Karnataka stood at Rs.5134mn in which Rs.1782mn are stressed (NPA, Restructured, Overdue). It is this stressed book which will fall under the ambit of the Karnataka govt. for loan waiver.
- Current CAR of 11.60% doesn't consider the profits earned in this quarter.

Exhibit 1: Financial summary

Y/E March (Rsmn)	FY16	FY17	FY18	FY19E	FY20E
Net interest income	13,029	14,906	18,577	21,972	27,679
Pre-provision profit	8,545	9,958	14,732	18,865	22,987
PAT	4,153	4,298	3,511	6,632	9,055
EPS (Rs)	22.0	15.2	12.4	23.5	29.1
BV (Rs)	195.8	182.0	191.4	211.1	239.0
P/E (x)	5.2	7.5	9.2	4.9	3.9
P/BV (x)	0.6	0.6	0.6	0.5	0.5
Gross NPAs (%)	3.4	4.2	4.9	4.3	4.0
Net NPAs (%)	2.4	2.7	3.0	2.0	1.4
RoA (%)	0.8	0.7	0.5	0.9	1.0
RoE (%)	11.7	9.7	6.7	11.7	13.5

Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 2: Actual performance versus our estimates

(Rsmn)	1QFY19	1QFY18	4QFY18	YoY (%)	QoQ (%)	1QFY19E	Devi. (%)
Net interest income	4,686	4,244	5,415	10%	-13%	5,097	-8%
Pre-provision profit	3,689	3,097	4,753	19%	-22%	3,857	-4%
PAT	1,632	1,339	110	22	1384%	602	171%

Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 3: Change in our estimates

	Revised estimate		Earlier estimate		% Revision	
	FY19E	FY20E	FY19E	FY20E	FY19E	FY20E
Net interest income (Rsmn)	21,972	27,679	22,651	28,641	(3.0)	(3.4)
NIM (%)	3.2	3.4	3.2	3.3	(4) bps	2 bps
Operating profit (Rsmn)	18,865	22,987	17,484	21,825	7.9	5.3
Profit after tax (Rsmn)	6,632	9,055	6,680	8,829	(0.7)	2.6

Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 4: One-year forward P/BV



Source: Company, Nirmal Bang Institutional Equities Research

Financials

Exhibit 5: Income statement

Y/E March (Rsmn)	FY16	FY17	FY18	FY19E	FY20E
Interest income	49,922	51,854	54,238	63,843	76,735
Interest expenses	36,893	36,948	35,661	41,871	49,057
Net interest income	13,029	14,906	18,577	21,972	27,679
Fees	2,379	2,761	3,644	9,271	11,040
Other income	3,049	5,333	5,900	3,036	3,536
Net revenues	18,457	23,000	28,120	34,279	42,255
Operating expenses	9,912	13,042	13,388	15,414	19,268
-Employee expenses	4,430	6,010	5,248	6,143	7,001
-Other expenses	5,482	7,031	8,140	9,271	12,267
Pre-provision profit	8,545	9,958	14,732	18,865	22,987
Provisions	3,265	5,503	11,376	8,817	9,267
-Loan loss provision	2,857	5,358	10,549	8,782	9,233
-Provisions for investment	132	40	977	36	34
-Other provisions	276	106	(151)	0	0
PBT	5,280	4,455	3,356	10,048	13,720
Tax	1,127	157	(155)	3,416	4,665
PAT	4,153	4,298	3,511	6,632	9,055

Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 7: Balance sheet

Y/E March (Rsmn)	FY16	FY17	FY18	FY19E	FY20E
Equity capital	1,885	2,826	2,826	2,826	3,109
Reserves & surplus	35,021	48,600	51,275	56,829	71,198
Shareholder's funds	36,906	51,426	54,102	59,655	74,307
Deposits	5,04,882	5,67,331	6,28,713	7,13,766	8,25,280
Borrowings	10,515	8,326	8,160	33,772	42,455
Other liabilities	12,701	13,303	12,763	24,513	37,616
Total liabilities	5,65,003	6,40,386	7,03,737	8,31,706	9,79,658
Cash/equivalent	30,449	32,740	36,010	49,066	56,872
Advances	3,39,024	3,69,157	4,72,518	5,57,571	6,69,085
Investments	1,62,567	2,02,197	1,54,444	1,82,880	2,09,998
Fixed assets	3,066	7,206	7,616	8,378	9,215
Other assets	29,897	29,086	33,149	33,812	34,488
Total assets	5,65,003	6,40,386	7,03,737	8,31,706	9,79,658

Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 6: Key ratios

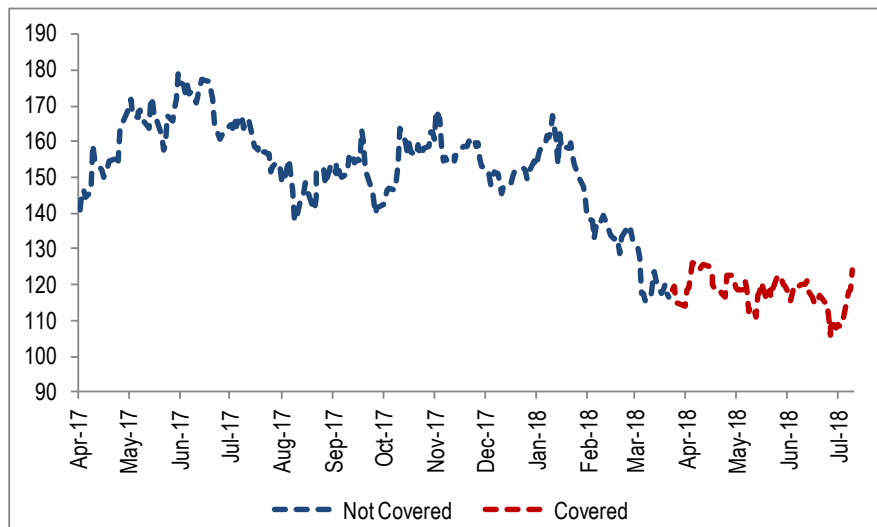
Y/E March	FY16	FY17	FY18	FY19E	FY20E
Growth (%)					
NII growth	11.5	14.4	24.6	18.3	26.0
Pre-provision profit growth	10.5	16.5	47.9	28.1	21.8
PAT growth	-8.0	3.5	-18.3	88.9	36.5
Business (%)					
Deposit growth	9.7	12.4	10.8	13.5	15.6
Advance growth	7.0	8.9	28.0	18.0	20.0
Business growth	8.6	11.0	17.6	15.4	17.5
CD	67.1	65.1	75.2	78.1	81.1
CASA	26.3	29.0	28.0	28.2	28.2
Operating efficiency (%)					
Cost-to-income	53.7	56.7	47.6	45.0	45.6
Cost-to-assets	1.8	2.2	2.0	2.0	2.1
Productivity (Rsmn)					
Business per branch	1,164.0	1,224.2	1,376.5	1,531.7	1,737.6
Business per employee	108.3	117.3	134.5	145.9	165.5
Profit per branch	5.7	5.6	4.4	8.0	10.5
Profit per employee	0.5	0.5	0.4	0.8	1.0
Spread (%)					
Yield on advances	11.3	10.7	9.7	9.9	10.0
Yield on investments	7.4	7.0	6.5	7.0	7.1
Cost of deposits	7.4	6.7	5.8	5.9	5.9
Yield on assets	10.0	9.5	8.9	9.2	9.3
Cost of funds	7.5	6.8	5.9	6.0	6.1
NIMs	2.6	2.7	3.1	3.2	3.4
Capital adequacy (%)					
Tier I	10.6	12.2	11.3	10.5	10.9
Tier II	1.5	1.1	0.8	0.8	0.9
Total CAR	12.0	13.3	12.0	11.3	11.8
Asset quality (%)					
Gross NPAs	3.4	4.2	4.9	4.3	4.0
Net NPAs	2.4	2.7	3.0	2.0	1.4
Specific Provision coverage	31.4	36.8	39.8	54.0	66.2
Slippage	3.4	3.8	5.0	2.5	2.3
Credit-cost	0.8	1.6	2.6	1.5	1.4
Return (%)					
RoE	11.7	9.7	6.7	11.7	13.5
RoA	0.8	0.7	0.5	0.9	1.0
RoRWA	-	2.2	0.8	1.3	1.4
Per share					
EPS	22.0	15.2	12.4	23.5	29.1
BV	195.8	182.0	191.4	211.1	239.0
ABV	152.9	146.6	140.8	170.7	209.1
Valuation (x)					
P/E	5.2	7.5	9.2	4.9	3.9
P/BV	0.6	0.6	0.6	0.5	0.5
P/ABV	0.7	0.8	0.8	0.7	0.5

Source: Company, Nirmal Bang Institutional Equities Research

Rating track

Date	Rating	Market price (Rs)	Target price (Rs)
26 March 2018	Buy	117	147
17 May 2018	Buy	116	150
13 July 2018	Buy	115	155

Rating track graph



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