

Cementing its position

We retain Buy on Karnataka Bank (KBL) with TP unchanged at Rs180. Q1'19 results, albeit lower to our estimates on revenue front, were inline on both operational and profitability end. Slippages came in lower (2.3% of loans); provisions included accelerated coverage on NCLT cases (76% vs. 48% QoQ). Segments of MSME and corporate banking have shown signs of improvement; we expect traction therein to continue. Stressed asset pool has reduced to 3.8% of loans; we see loan loss provisions to remain contained at 120bps. We expect earnings growth to accelerate and see RoA / RoE scale to 0.9% / 12.6% by end-FY20E. Valuations at 0.7x FY20E ABV remain attractive.

- **Q1FY19 results – Low on revenue; high on earnings:** NII at Rs4.7bn (+10.4% YoY), tad lower to our estimates, was on back of healthy 24% YoY growth in loans and NIM (calc) at 2.7% - flat YoY. Non-interest income at Rs2.1bn declined 4% YoY; growth in fee income was healthy at 42%+ YoY. Operating profit grew 19.1% YoY; core-operating profit (ex-treasury) was up 54% YoY. Asset quality saw improvement with slippages at Rs2.7bn (2.3% of loans). The quarter saw recovery / upgrades to the tune of Rs802mn; w/off were at Rs2.7bn. Provisions for the quarter came in at Rs2.2bn and included Rs800mn of provisions towards NCLT cases. Adjusted for the same and provision on investment portfolio, PAT at Rs1.63bn grew +21.9% YoY.
- **Stressed pool reduces; so will the credit costs:** Q1'19 slippages at Rs2.7bn (lowest in the recent past) were in the form of slippages from agriculture – Rs750mn, MSME – Rs792mn, exports – Rs519mn and auto – Rs160mn, the remaining being granular in nature. Overall stressed pool (NNPA + various RBI dispensations) for the bank has reduced to 3.8% vs. 7.3% in Q1'18. The bank's NCLT exposure stands at Rs2.6bn; coverage ratio thereon has been increased to ~76% (vs. 48% QoQ). The shift in loan mix towards high rated corporate portfolio (35.4% of portfolio is externally rated; 25.5% is rated A and above), reduced stressed pool and improved recoveries, we expect pace of new NPA accretion to moderate. We are factoring in slippages at 240bps over FY19-20E (vs. 450bps for FY18). We are building in credit cost at 120bps over same time (230bps for FY18).
- **Earnings outlook:** The past three quarters (including Q1FY19) has seen pace of loan growth accelerate (24%+), strongest since FY13. We expect the momentum therein to continue given initiatives aimed at shoring retail and MSME segments. Also, while Q1'19 saw lower NII growth, the shift in loan portfolio (~Rs80bn) towards MCLR regime, overall increase in MCLR rates, non-recognition of income on certain MSME portfolio and limited cost pressures, we expect NII growth remain stable. Our estimates factors in 9% YoY / 19% YoY growth in NII / loans for FY19E. Traction in fee income remains healthy; operating expenses intact and credit cost pressures limited. We believe, all of the above factors will translate into improved revenue and earnings growth. We are factoring in 13% / 11% CAGR in NII / PPOP and 54% CAGR in net profit over FY18-20E. Capital position remains healthy with CAR / tier-I at 11.6% / 10.8% respectively.
- **Valuation, view and key risks:** Q1'19 results reiterate our positive stance on the bank and is evident from its improved operational performance. Trend in asset quality too has stabilised. We have left our estimates unchanged and see RoA / RoE to inch to 0.9% ~13% by end-FY20E. Valuations at 0.7x FY20E ABV remain attractive. Retain Buy with TP at Rs180 (valued at 1.1x FY20E ABV). Key risks - Higher than expected loan-loss provisions or lower growth could impact earnings.

Rs mn	Q1FY19	Q1FY18	% YoY	Q4FY18	% QoQ	Q1FY19E	% Var
Net interest income	4,686	4,244	10.4	5,422	(13.6)	4,936	(5.1)
Pre-provision profit	3,689	3,097	19.1	4,761	(22.5)	3,595	2.6
Net profit	1,632	1,339	21.9	117	1,292.8	1,517	7.6
GNPA	22,965	16,910	35.8	23,761	(3.3)	24,610	(6.7)
NNPA	13,960	12,300	13.5	14,005	(0.3)	12,634	10.5
PCR (%) (incl tech/woff)	57.2	52.0	519 bps	54.5	271 bps	-	-

Source: Company, Centrum Research

Y/E Mar (Rs mn)	Net Income#	PPOP	Rep. PAT	YoY (%)	EPS (Rs)	P/E (x)	Adj BV (Rs)	P/Adj BV (x)	RoA (%)	RoE (%)
FY16	18,457	8,546	4,157	(8.0)	22.0	6.8	153.6	1.0	0.8	11.7
FY17	23,000	9,958	4,523	8.9	16.0	7.2	132.1	0.9	0.7	10.2
FY18	28,120	14,732	3,256	(28.0)	11.5	13.3	127.6	1.2	0.5	6.2
FY19E	30,258	15,898	6,153	89.0	21.8	5.5	145.9	0.8	0.8	10.9
FY20E	34,709	18,078	7,682	24.8	27.2	4.3	166.5	0.7	0.9	12.6

Source: Company, Centrum Research Estimates #net income denotes NII + other income. Valuations are on average market cap basis for FY15-FY18EYTD.

In the interest of timeliness, this document is not edited

Centrum Equity Research is available on Bloomberg, Thomson Reuters and FactSet

Target Price	Rs180	Key Data	
CMP*	Rs114	Bloomberg Code	KBL IN
Upside	57.9%	Curr Shares O/S (mn)	282.6
Previous Target	Rs180	Diluted Shares O/S(mn)	282.6
Previous Rating	Buy	Mkt Cap (Rsbn/USDmn)	32.4/472.5
Price Performance (%)*		52 Wk H / L (Rs)	171.7/105
		5 Year H / L (Rs)	181.2/56.3
KBL IN	(4.8)	(31.5)	(30.7)
Daily Vol. (3M NSE Avg.)			2933829
NIFTY	1.5	3.2	11.4

*as on 13 July 2018; Source: Bloomberg, Centrum Research

Shareholding pattern (%)*

	Jun-18	Mar-18	Dec-17	Sep-17
Promoter	0.0	0.0	0.0	0.0
FIs	12.3	14.7	18.3	18.7
DIs	14.7	12.8	11.8	11.2
Others	73.0	72.5	69.9	70.1

Source: BSE, *as on 13 July 2018

Centrum vs. Bloomberg Consensus*

Particulars (Rs mn)	FY19E			FY20E		
	Centrum	BBG	Var (%)	Centrum	BBG	Var (%)
NII + Oth. Inc	30,258	41,564	(27.2)	34,709	48,813	(28.9)
PPoP	15,898	15,892	0.0	18,078	18,346	(1.5)
PAT	6,153	5,394	14.1	7,682	6,992	9.9

Bloomberg Consensus*				Centrum Target Price (Rs)	Variance (%)
BUY	SELL	HOLD	Target Price (Rs)		
7	0	1	162	180	11.1

*as on 13 July 2018; Source: Bloomberg, Centrum Research Estimates

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Conference call highlights

Balance Sheet and profitability

- Q1FY19 loan book grew 24.3% YoY and was led by strong traction in the segments of MSME (+29% YoY) and home loans (+17% YoY) and LAP (+42% YoY). Management has guided for 20%+ loan growth over FY19-20E.
- The bank has implemented its new delivery models for retail and MSME segment. The enhanced business model will aid in stronger growth and also their share in overall loans.
- Corporate portfolio (defined as >Rs50mn and above) accounts for 25-30% of overall loans.
- Portfolio quality for the bank is improving and an indicator of that is that ~35% of the bank credit is now externally rated as compared to ~25% a year back. Also, 25.5% of external rated credit portfolio is rated "A and above" and the compares with 14.4% in Q1'18 and 23.9% in Q4'18.
- The CD ratio of the bank stands at 76% and the bank has posted the highest CD ratio since 1948. The bank is targeting a business growth of 18% for FY19.
- Margins are expected to improve as lower yielding loans to the tune of Rs80bn will be replaced by higher yielding credit. The positive impact of this will be effected in two quarters. Also, NII is affected by non-recognition of income on its ~Rs3.2bn of SME portfolio.
- By Q4FY19, the bank is targeting yield on loans at 9.5% (currently at 9.29%) and cost of deposits of 6% (vs. 5.88% for Q1'19) resulting in gross spread of 3.5%.
- Deposits grew 11.6% YoY and this was mainly led by 14% YoY growth in term deposits. Share of CASA deposits stood at 27.4% (vs. 28.0% QoQ / 29.0% in YoY). The bank plans to garner more MSME customers so as to provide CA services. It is targeting CASA ratio at ~30% by FY20E.
- The pace of customer accretion too has been on a rise (FY18 saw ~1mn new client additions; Q1'19 saw ~0.17mn new customer accounts).

Asset Quality

- Q1'19 slippages came in at Rs2.7bn and the following segments were the main contributors: agriculture – Rs750mn, MSME – Rs792mn, exports – Rs519mn and auto – Rs160mn.
- Agriculture exposure is at Rs60bn; exposure in home-state is at Rs38bn. Crop loans are to the tune of Rs5.2bn. The total stress in the crop loans is to the tune of Rs1.8bn. The bank is awaiting clarity from state government following the loan waiver. According to management, large part of portfolio qualifies for loan waiver. The bank has created adequate provisions on these exposure and the same might reverse in the event of loan waiver.
- Power loan exposure stands at Rs27.2bn; stressed portion is Rs2.9bn. The management is not too concerned with the power portfolio as the major exposure is towards AAA rated PSUs.
- Commercial real estate stands at Rs29bn (5.95% of advances); NPA therein is at Rs783mn.
- MSME portfolio to the tune of Rs3.2bn qualifies for RBI dispensation. NII for the quarter is also impacted as the bank has not recognised income on the SME portfolio. Slippages for the quarter do not include slippages from the said portfolio. However the involved customers usually have cash flows and are just facing temporary cash crunch. The situation will be resolved going ahead.
- SMA 2 portfolio as at Q1'19 stands at Rs~7.2bn (vs. Rs4.2bn as at end-FY18). Additions were to the tune of Rs4.5bn; up-gradations Rs1.2bn, recoveries at Rs47.6mn and slippages to NPA at Rs330mn. The management has stated that historically 7-10% of the SMA-2 portfolio slips to NPA.
- SR portfolio stood at Rs4.4bn (vs. Rs4.5bn QoQ); provisioning towards these accounts is Rs690mn.

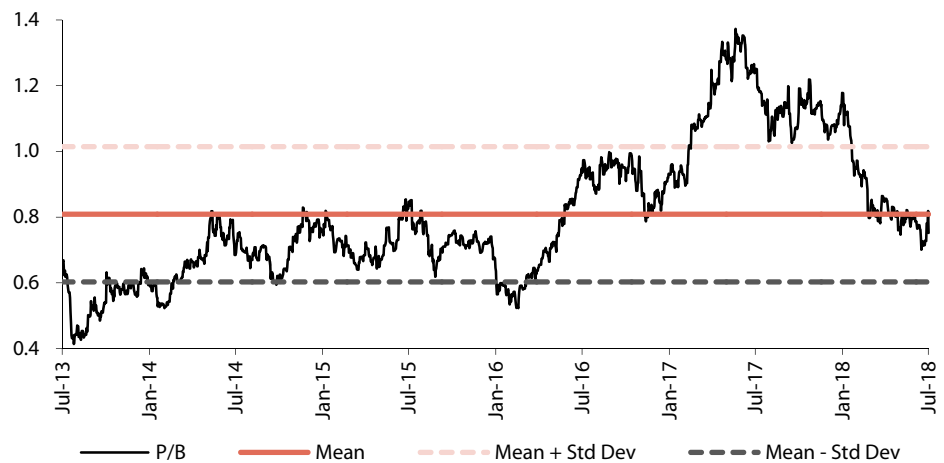
Sensitivity analysis & peer comparison

Exhibit 1: Sensitivity Analysis – impact of change in margins and credit cost on FY19PBT

%	Credit cost				
	+ 10bps	+ 20bps	' Current levels	+ 10bps	- 20bps
- 5bps	(11.2)	(18.0)	(4.4)	2.5	9.3
- 10bps	(15.5)	(22.4)	(8.7)	(1.9)	4.9
NIM Current levels	(6.8)	(13.7)	-	6.8	13.7
+ 5bps	(2.5)	(9.3)	4.4	11.2	18.0
+ 10bps	1.9	(4.9)	8.7	15.5	15.5

Source: Company, Centrum Research Estimates

Exhibit 2: Rolling forward P/ABV chart



Source: Company, Centrum Research Estimates

Exhibit 3: Comparative Valuations

Company Name	Mkt Cap (Rs mn)	CAGR (FY18-FY20E) %			PE (x)			RoA (%)			RoE (%)			P/BVPS (x)			Div Yield (%)		
		NII + Oth inc	PPOP	PAT	FY18	FY19E	FY20E	FY18	FY19E	FY20E	FY18	FY19E	FY20E	FY18	FY19E	FY20E	FY18	FY19E	FY20E
KBL*	32,148	11.1	10.8	53.6	13.3	5.4	4.3	0.5	0.8	0.9	6.4	11.0	12.6	0.9	0.6	0.6	2.0	4.2	5.7
CUBK*	1,28,812	9.5	6.7	16.9	16.7	17.7	15.9	1.6	1.6	1.6	15.3	15.4	15.5	2.4	2.5	2.3	0.2	0.2	0.2
DCB*	55,354	23.4	39.2	55.3	23.3	13.7	9.3	0.9	1.2	1.5	10.9	14.8	18.3	2.2	1.9	1.6	0.3	0.3	0.3
KVB	73,358	13.2	14.4	66.0	21.3	10.3	6.7	0.6	0.9	1.3	8.1	11.2	15.1	1.5	1.1	1.0	1.8	1.8	2.5
Federal Bk	1,54,063	17.9	20.2	25.3	19.8	13.6	9.5	0.8	0.9	0.9	9.8	10.2	11.6	1.7	1.3	1.1	1.6	1.6	1.4
SIB	39,085	15.6	14.4	48.5	15.1	8.1	5.3	0.4	0.7	0.8	7.2	10.3	12.9	1.1	0.8	0.7	2.4	2.4	2.4

Source: Bloomberg consensus, *Centrum Research Estimates. FY18 – FY19E have been valued on average market cap basis.

Quarterly financials

Exhibit 4: Quarterly Financials

(Rs mn)	Q2FY17	Q3FY17	Q4FY17	Q1FY18	Q2FY18	Q3FY18	Q4FY18	Q1FY19
Income statement								
Interest earned	13,064	13,239	12,945	13,305	13,179	13,322	14,438	14,076
Interest expended	9,091	9,474	9,423	9,061	8,777	8,808	9,015	9,391
Net interest income	3,973	3,765	3,522	4,244	4,402	4,515	5,422	4,686
Non-interest income	1,897	1,336	3,117	2,174	2,478	1,946	2,945	2,088
Total income	5,870	5,101	6,639	6,418	6,881	6,461	8,367	6,774
Operating expenses	3,542	3,382	3,346	3,321	3,218	3,242	3,607	3,085
PPOP	2,328	1,719	3,293	3,097	3,662	3,219	4,761	3,689
Provisions	1,306	1,006	1,604	1,989	2,260	1,964	5,418	2,221
PBT	1,022	713	1,689	1,108	1,403	1,255	(657)	1,468
Tax	(216)	27	305	(230)	469	381	(774)	(164)
Reported PAT	1,238	685	1,384	1,339	934	874	117	1,632
Ratios								
Growth YoY (%)								
<i>NII</i>	29.4	23.5	(2.1)	16.4	10.8	19.9	54.0	10.4
<i>Non-interest income</i>	56.8	0.7	83.3	24.7	30.6	45.7	(5.5)	(4.0)
<i>Opex</i>	37.0	37.5	21.5	19.8	(9.1)	(4.2)	7.8	(7.1)
<i>PPOP</i>	37.3	(10.3)	29.5	18.2	57.4	87.3	44.6	19.1
<i>Reported PAT</i>	21.2	(29.3)	29.6	10.1	(24.6)	27.5	(91.5)	21.9
<i>Loans</i>	12.8	8.7	9.1	10.1	12.3	24.1	27.7	24.0
<i>Deposits</i>	8.6	15.6	12.4	9.2	6.5	0.6	10.8	11.6
Margins (%)								
<i>Yield on total assets</i>	9.9	10.0	9.8	9.6	9.2	8.9	9.3	8.9
<i>Cost of funds</i>	6.2	6.3	6.0	5.7	5.5	5.4	5.3	5.3
<i>Spread</i>	3.1	3.2	3.2	3.3	3.0	2.9	3.4	3.0
<i>NIM</i>	2.7	2.5	2.2	2.7	2.8	2.7	3.1	2.7
Key drivers (%)								
<i>Cost-income</i>	60.3	66.3	50.4	51.7	46.8	50.2	43.1	45.5
<i>GNPA</i>	3.6	4.3	4.2	4.3	4.1	4.0	5.0	4.7
<i>NNPA</i>	2.6	3.0	2.6	3.2	3.0	2.9	3.0	2.9
<i>Provision coverage</i>	28.5	31.7	38.4	27.3	27.3	29.2	41.1	39.2
<i>Tier I CAR</i>	9.8	11.9	12.2	11.9	11.4	11.1	11.3	10.8
<i>Tier II CAR</i>	1.4	1.3	1.1	1.1	1.0	1.1	0.8	0.8
<i>RoA</i>	0.8	0.5	0.9	0.8	0.6	0.5	0.1	0.9
<i>RoE</i>	12.8	6.8	12.0	10.4	7.1	6.6	0.9	11.9

Source: Company, Centrum Research

Financials

Exhibit 5: Income Statement

Y/E March (Rs mn)	FY16	FY17	FY18	FY19E	FY20E
Interest Income	49,922	51,854	54,238	61,402	72,181
Interest Expense	36,894	36,948	35,661	41,111	48,616
Net Interest Income	13,029	14,906	18,576	20,291	23,565
Non-Interest Income	5,429	8,093	9,543	9,967	11,145
Total Net Income	18,457	23,000	28,120	30,258	34,709
Total Operating Expenses	9,912	13,042	13,388	14,360	16,631
Employee Expenses	4,430	6,010	5,248	6,071	7,107
Other Operating Expenses	5,482	7,031	8,140	8,289	9,524
Pre-provision Profit	8,546	9,958	14,732	15,898	18,078
Provisions & Contingencies	3,265	5,279	11,630	7,694	7,836
Profit Before Tax	5,280	4,679	3,101	8,204	10,242
Taxes	1,127	157	(155)	2,051	2,561
Profit after tax	4,153	4,523	3,256	6,153	7,682

Source: Company, Centrum Research Estimates

Exhibit 6: Balance Sheet

Y/E March (Rs mn)	FY16	FY17	FY18	FY19E	FY20E
Cash and balance with RBI	26,456	29,293	35,458	34,701	41,271
Inter-bank borrowings	3,993	3,448	552	5,803	6,901
Loans & Advances	3,39,024	3,70,037	4,72,518	5,60,049	6,66,781
Investments	1,62,567	2,02,197	1,54,444	1,64,939	1,91,718
Total Int Earning Assets	5,05,584	5,75,681	6,27,514	7,30,791	8,65,400
Fixed Assets	3,066	7,206	7,616	8,240	8,778
Other Assets	29,897	29,086	33,149	34,663	36,253
Total Assets	5,65,003	6,41,266	7,03,737	8,08,395	9,51,701
Deposits	5,04,882	5,67,331	6,28,713	7,25,322	8,62,648
Current	32,435	36,233	38,703	45,013	53,966
Savings	1,00,172	1,28,498	1,37,236	1,61,951	1,96,926
Term	3,72,275	4,02,600	4,52,774	5,18,358	6,11,755
Other Int Bearing Liabilities	10,515	8,326	8,160	10,160	10,160
Interest Bearing Liabilities	5,15,397	5,75,657	6,36,873	7,35,482	8,72,808
Other non int bearing Liabilities	12,701	14,182	12,763	14,463	14,974
Total Liabilities	5,28,098	5,89,840	6,49,635	7,49,945	8,87,781
Equity	36,906	51,426	54,102	58,450	63,920
Total Liabilities	5,65,003	6,41,266	7,03,737	8,08,395	9,51,701

Source: Company, Centrum Research Estimates

Exhibit 7: DuPont analysis

(% of avg assets)	FY16	FY17	FY18P	FY19E	FY20E
Interest income	9.2	8.6	8.1	8.1	8.2
Interest expenses	6.8	6.1	5.3	5.4	5.5
NII	2.4	2.5	2.8	2.7	2.7
Other income	1.0	1.3	1.4	1.3	1.3
Total income	3.4	3.8	4.2	4.0	3.9
Operating expenses	1.8	2.2	2.0	1.9	1.9
PPOP	1.6	1.7	2.2	2.1	2.1
Provisions	0.6	0.9	1.7	1.0	0.9
PBT	1.0	0.8	0.5	1.1	1.2
Tax	0.2	0.0	0.0	0.3	0.3
RoA	0.8	0.7	0.5	0.8	0.9
Leverage	15.3	12.5	13.0	13.8	14.9
RoE	11.7	10.2	6.2	10.9	12.6

Source: Company, Centrum Research Estimates

Exhibit 8: Key Ratios

Y/E March	FY16	FY17	FY18	FY19E	FY20E
B/S Structure Ratios (%)					
CD Ratio	67.1	65.2	75.2	77.2	77.3
Incremental CD Ratio	49.6	49.7	168.4	90.6	77.7
CASA Ratio	26.3	29.0	28.0	28.5	29.1
Growth Ratios (%)					
Loans	7.0	9.1	28.0	18.5	19.1
Deposits	9.7	12.4	10.8	15.4	18.9
NII	11.5	14.4	24.6	9.2	16.1
Opex	9.8	31.6	2.7	7.3	15.8
PPOP	10.5	16.5	47.9	7.9	13.7
Provisions	52.6	61.6	120.3	(33.8)	1.9
PAT	(8.0)	8.9	(28.0)	89.0	24.8
Operating Ratios (%)					
Yield on funds	9.8	9.1	8.6	8.6	8.6
Cost of funds	7.3	6.5	5.6	5.8	5.8
NIM	2.6	2.6	2.9	2.8	2.8
Non-int inc / Total income	1.0	1.3	1.4	1.3	1.3
Fee to avg assets	0.4	0.4	0.5	0.7	0.7
Cost/Income	53.7	56.7	47.6	47.5	47.9
Opex / Avg assets	1.8	2.2	2.0	1.9	1.9
Provisioning cost	0.8	1.6	2.57	1.40	1.20
Effective tax rate	21.3	3.4	(5.0)	25.0	25.0
RoA	0.8	0.7	0.48	0.81	0.87
RoE	11.7	10.2	6.2	10.9	12.6
Credit Quality Ratios (%)					
Gross NPA	3.6	4.5	5.0	4.5	3.9
Net NPA	2.4	2.8	3.0	2.3	1.9
Slippage rate to advances	3.4	3.8	4.5	2.6	2.2
NPA coverage ratio	32.6	37.7	41.1	47.9	50.3
Capital Adequacy Ratios (%)					
Total CAR	12.0	13.3	12.0	12.2	11.1
Tier I	10.6	12.2	11.3	11.6	10.6
Tier II	1.5	1.1	0.7	0.7	0.6
Dividend details					
DPS (Rs)	5.0	4.0	3.0	5.0	6.5
Dividend Pay-out (%)	22.7	25.0	26.0	23.0	23.9
Per Share (Rs)					
BVPS	195.8	167.0	176.7	192.5	211.8
Adjusted BVPS	153.6	132.1	127.1	145.9	166.5
EPS - basic	22.0	16.0	11.5	21.8	27.2
Valuations Ratios*					
Price/BV (x)	0.8	0.7	0.9	0.6	0.6
Price/Adj. BV (x)	1.0	0.9	1.2	0.8	0.7
P/E (x)	6.8	7.2	13.3	5.4	4.3
Dividend Yield (%)	3.3	3.5	2.0	4.2	5.6

Source: Company, Centrum Research Estimates. * has been valued on average market cap basis FY16-19EYTD.

Appendix A

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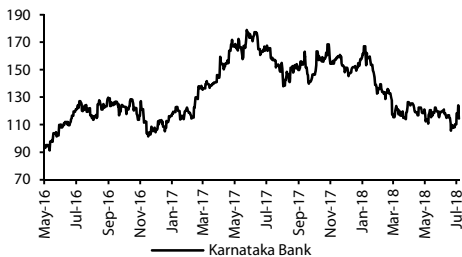
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Karnataka Bank price chart



Source: Bloomberg

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