Karnataka Bank

16 July 2019

1QFY20 Result Update

Reuters: KBNK.NS; Bloomberg: KBL IN

Positive delta expected across RoA tree

Karnataka Bank (KBL) reported 4QFY19 results with the key pointers being: (1) Stock of GNPAs was contained; improving NPAs guidance retained with only 2 accounts majorly concerning (2) Multiple levers on the income front – improving yields, traction in TPP tie-ups and liability franchise build-up – could drive growth (3) Cost reduction measures, opening low-cost branches and digitalization are likely to support profitability from a cost perspective. (See comprehensive conference call takeaways on page 2 for *significant incremental colour.*) Per se, on the key P&L items, KBL posted 5.6% NII growth YoY at Rs4,946mn, PPOP decline of 5.1% YoY at Rs3,500mn and PAT growth of 7.5% YoY at Rs1,754mn. We have revised our estimates for FY20/FY21 and retained Buy rating on KBL, revising our target price on it to Rs118 (from Rs119 earlier) and valuing the stock at 0.5x FY21E P/BV.

Stock of GNPAs was contained; improving NPAs guidance retained with only 2 accounts majorly concerning: GNPAs at 4.55% (+14 bps QoQ) look optically higher largely due to the base effect. In absolute terms, stock of GNPAs came down sequentially by Rs 1.89 bn to Rs. 24.4 bn. Gross slippages during the quarter were Rs. 5.3 bn, of which one account was an NBFC under Reliance ADAG where exposure was Rs. 1.37 bn. Apart from this, MSME slippages were to the extent of Rs. 1.19 bn and agri slippages were Rs. 0.74 bn. There was also a toll operator infra account of Rs. 0.4 bn, categorized as 'rated D', which moved into NPA category during the quarter. Overall reductions were Rs. 5.45 bn, of which Rs. 1.54 bn was through recoveries while the remaining Rs. 3.90 bn was written off post 100% provisioning. The bank has assessed Sintex and Dewan Housing, where exposures are Rs. 0.95 bn and Rs. 1 bn, respectively, to be the key pain points. Apart from these two accounts, the bank, so far, does not envisage any major stress. For FY20, the bank has guided for <4% GNPAs, <3% NNPAs and absolute gross slippage run-rate of Rs. 3 bn per quarter. Included in this guidance is the impact of MSME dispensation ending in August 2019, which could be to the tune of Rs. 0.79 bn. The bank expects an additional impact of Rs. 0.30 bn from the MSME portfolio, outside of the dispensation stock. NNPAs for the quarter were 3.33% (+38 bps QoQ), security receipts were 4.08 bn and standard restructured advances stand at Rs. 3.62 bn.

Multiple levers on the income front – improving yields, traction in TPP tie-ups and liability franchise build-up – could drive growth: The Management has stated that it would be strategically focusing on Rs. 0.05–1 bn ticket size loans in the mid-corporate segment, where yields are reasonable and credit quality is high too. This, along with equally strong focus on the retail piece, is expected to drive yields higher. Additionally, the bank also shed corporate loans worth Rs. 25 bn during the quarter, which was highly rated and hence low yielding. The bank has reported yield on advances of 9.32% for the quarter (-1 bps QoQ). The bank's internal expectation is to deliver a NIM of 3% by March 2020. On the fee income front, the bank has 3 life-insurance tie-ups, namely LIC, PNB Metlife and Bharati AXA, which was recently added; 2 general insurance tie-up, namely Universal Sompo and Bajaj Allianz General Insurance; and, lastly, the bank has 7 mutual fund tie-ups, which are expected to improve fee income traction. On the liabilities front, the bank has launched a new product for the salaried class, CASA premium, focusing on employers and their employees, in order to garner low-cost CASA deposits. This is also expected to generate credit opportunities by way of cross-sell.

Cost reduction measures, opening low-cost branches and digitalization are likely to support profitability from a cost perspective: The bank currently has 839 branches and is expected to open 24 new branches during FY20. Regarding the existing branch network, the bank would be focusing on reducing premises area, while new branches are expected to have smaller carpet area of 800-1,000 sqft. New branches in the rural unbanked areas would be 500 sqft in area, manned with minimal manpower. On the digital front, the bank has started a digital centre of excellence (COE) focusing on digitalizing the customer's lending journey from end-to-end. As a result, the bank can now sanction a housing loan within 20 minutes versus a much longer time earlier. Further, the bank plans to launch MSME digital product by Nov '19. These measures are expected to improve bank's profitability from a cost perspective while becoming more sales-oriented by deploying 'feet-on-street' is expected to yield efficiencies. The bank has guided for a cost-to-income ratio of 50% (+/-2%).

Valuation and outlook: We have revised our NII estimates by 2.8%/-0.5%, PPOP estimates by -7.2%/-4.9% and PAT estimates by -9.9%/-8.0% for FY20/FY21, respectively. We have retained Buy rating on KBL, revising our target price to Rs118 (from Rs119 earlier), valuing the stock at 0.5x FY21E P/BV.

BUY

Sector: Banking

CMP: Rs102

Target Price: Rs118

Upside: 16%

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Key Data

Current Shares O/S (mn)	282.6
Mkt Cap (Rsbn/US$mn)	28.9/421.5
52 Wk H / L (Rs)	141/92
Daily Vol. (3M NSE Avg.)	244,432

Price Performance (%)

	1 M	6 M	1 Yr
Karnataka Bank	(4.1)	(14.2)	(7.8)
Nifty Index	(2.0)	6.4	6.0

Source: Bloomberg

Y/E Mar (Rsmn)	1QFY20	1QFY19	4QFY19	YoY (%)	QoQ (%)
Interest Income	15,844	14,076	15,313	12.6	3.5
Interest Expenses	10,898	9,391	10,504	16.1	3.7
Net Interest Income	**4,946**	**4,686**	**4,809**	5.6	2.9
NIM (%)	***2.81***	***3.00***	***2.87***	*-19 bps*	*-6 bps*
Non Interest Income	2,448	2,088	2,906	17.2	(15.8)
Operating Income	**7,394**	**6,774**	**7,715**	9.2	(4.2)
Staff Cost	1,769	1,105	2,035	60.1	(13.0)
Other Op Exp	2,124	1,980	2,438	7.3	(12.9)
Total Operating Expenses	3,894	3,085	4,472	26.2	(12.9)
Cost to Income (%)	*52.7*	*45.5*	*58.0*	*712 bps*	*-531 bps*
Pre-provisioning operating Profit	**3,500**	**3,689**	**3,242**	(5.1)	8.0
Provisions	2,011	2,221	2,177	(9.4)	(7.6)
PBT	**1,489**	**1,468**	**1,065**	1.4	39.8
Tax	(266)	(164)	448	61.7	(159.3)
-effective tax rate	*(17.8)*	*(11.2)*	*42.0*	*-665 bps*	*-5987 bps*
PAT	**1,754**	**1,632**	**617**	7.5	184.2
EPS (Rs)	6.2	5.8	2.2	7.5	184.2
BV (Rs)	210.9	197.2	204.7	6.9	3.0
Deposits	685,207	627,247	684,521	9.2	0.1
Advances	528,188	477,312	548,282	10.7	(3.7)

Source: Company, Nirmal Bang Institutional Equities Research

Comprehensive Analyst Meet Takeaways

Asset Quality

- Currently, the bank has two main stress accounts which it is monitoring. One is Sintex where exposure is Rs. 0.95 bn and the other account is Dewan Housing Finance, where exposure is Rs. 1 bn. The bank's exposure to Dewan Group has reduced since the sale of Aadhar Housing Finance, where the exposure is Rs. 0.56 bn and is being serviced regularly.
- The bank does not expect any major stress accounts apart from Sintex and Dewan Housing, ICA for both of which has already been signed.
- Total gross slippage during the quarter was Rs. 5.3 bn of which Rs. 1.37 bn is attributable to Reliance ADAG NBFC, Rs. 1.19 bn was from the MSME portfolio and Rs. 0.74 bn was from the agri portfolio.
- Exposure to ADAG is 0.3% of the total loan book and is provided for the extent of 15%.
- The bank has exposure to Religare Finvest (rated D) and Religare Housing. Religare total exposure is Rs. 0.6 bn and doesn't have any provisions except standard asset provisions.
- Indiabulls exposure pertains to Indiabulls Commercial Credit and Indiabulls Housing, both of which are standard assets and are categorized as 'rated AAA'.
- The bank does not have any stressful exposure to the real estate sector.
- The bank has guided for a PCR, including technical write-off, of ~60% for FY20.
- 57% of NPA Portfolio is sub-standard category which requires minimum 15% provisioning (as per IRAC).
- The breakup of provisioning during the quarter is as follows:
    - Provision for diminution in fair value on restructured advances : Rs -12mn
    - Provision for NPA: 2.3bn
    - Provision for Standard advances and investments: Rs -54.9mn
    - Provision for depreciation on investments/SRs: Rs-213.6mn
    - Provision for current and deferred tax and wealth tax: Rs -265.5mn
    - Other Provisions: Rs 8.7mn
- The bank has guided for a credit cost of ~1%.
- The write off of Rs. 3.9 bn was mainly pertains to advances given for infra facility in power generation sector which have been NPA for the last 3-4 years.
- Of Rs 3.9bn total write-offs, technical write-offs are Rs 2.7bn.
- The gross slippages run rate is expected to be Rs 3bn per quarter and a similar amount of recoveries and upgrades. For the full year, gross slippage ratio is expected to be less than 3%.
- The company has guided for GNPAs of <4% and NNPAs of <3% by year end.
- SMA2 stock as of Jun 2019 was Rs. 5.43bn and as of now is Rs 3.44bn. Five to six accounts took about 2-3 days extra to service interest due to which the number has come down now. SMA 2 was Rs 7.34bn as of Jun 2018 and Rs 1.69bn as of March 2019.
- The bank expects MSME slippages of Rs. 0.79 bn due to ending of MSME dispensation scheme in August 2019. Outside of the dispensation stock, the bank expects an additional impact of Rs. 0.30 bn.
- Reductions were Rs. 5.45 bn, of which Rs. 1.54 bn were through recoveries and remaining Rs. 3.9 bn were through write-offs.
- Stock of security receipts is Rs. 4.08 bn and provisioning cover is Rs. 0.9 bn.
- The bank has migrated to daily marking of NPAs.
- The bank has also revamped its collection process by setting up regional collections hub, which is expected to help reduce stress and manage NPAs better.
- Credit department is now divided into 3 functions namely, marketing, sanction and monitoring.

Business and Loan Growth

- The loan growth drivers during the quarter were housing (23.61%), equipment loans to contractors (42.55%), agri-ancilliary activities (24.03%) and car loans (8.80%). In addition to these sectors, the bank expects MSME growth to be in double digits.
- Company expects loan book growth of 17% during FY20.
- Retail and MSME combined may contribute ~75% of the loan book as the company is focusing on small ticket loans.
- The bank is targeting a total business of Rs. 1.44 trn, of which credit business is expected to be Rs. 645 bn.
- 79.7% of the transactions are through digital channel.
- The bank stated it has more than 10 mn customers and all of its branch staff are now lead generators. The bank has started data analytics which is being shared with field staff, so as to enable them to make appropriate sales efforts.
- As opposed to targeting only walk-in customers for sales earlier, the bank has become more aggressive by deploying 'feet-on-street' strategy.

Margin, Liabilities and Liquidity

- The company has guided for NIM of 3% and RoA of 1% by year end.
- The bank expects to take CASA to 29-30%, though it may not happen by March 2020.
- The bank has launched a new CASA product for the salaried class, CASA premium, which will target employers and employees.
- As part of its CASA strategy, company has launched new initiatives, including creating a 25 member all-India CASA team under a CASA national head which will approach employers and employees for new accounts. There is also a special CASA campaign being undertaken.
- During the quarter, the bank has exited high rated-low yielding corporate advances worth Rs 25bn. The company plans to focus on advances upto Rs 100 crore where yields are reasonable and credit quality is high too.

Fee and Other Income

- The bank has 3 life insurance tie-ups, namely, LIC, PNB Metlife, Bharati AXA which is a relatively new partner; 2 general insurance tie-ups, namely, Universal Sompo and Bajaj Allianz General Insurance; and, 7 mutual fund tie-ups. The bank expects good fee income traction from these tie-ups.

Operating Expenses

- The company has guided for a cost/income ratio of 50% (+/- 2%).
- The bank stated opex could grow by 10% over FY19.
- The bank has reported negative tax expense on account of provisioning and write-offs which are tax deductible under the income tax act. For FY20, the bank expects an effective tax rate of 20-25%.
- Establishment expenses were lower sequentially due to decrease in salary expenses (Rs 1.6bn in current quarter Vs Rs 1.8bn in previous quarter) and superannuation expenses(Rs 0.21bn in current quarter Vs Rs 0.37bn in previous quarter).
- Other Expenses were reported at Rs 2.1bn (Vs Rs 2.4bn in previous quarter).
- Company plans to open minimum 24 branches in the current year while simultaneously aiming to reduce the premises area of the branches. The new branches would be having carpet area of 800-1000 sqft thus lowering the need for CapEx.
- Branches in rural areas will be smaller (~500sq ft), manned by only 2 employees.

- The bank, as part of its transformation journey, has a developed a 'feet-on-street' strategy and analytics to push sales. Besides, the bank has also initiated a regional sales concept across India. The bank has also launched a digital tool for lead management and managing customers' loan journey end-to-end. As a result of its digital efforts, the bank can now sanction a housing loan within 20 minutes versus a much longer time earlier.
- As part of its digital strategy, the bank would be digitalizing its MSME loans. The product is expected to be launched in November 2019.
- The bank stated it would be undertaking rebranding of Karnataka Bank.

Others

- The bank has received in-principal approval from the RBI for starting a wholly owned NBFCs. The bank has also submitted the final application to the regulator post which the NBFC will be floated. The NBFC is expected to focus on activities which couldn't be done in the bank in a cost effective manner.

Exhibit 1: Financial summary

Y/E March (Rsmn)	FY17	FY18	FY19	FY20E	FY21E
Net interest income	14,906	18,577	19,051	21,747	26,806
Pre-provisioning operating profit	9,958	14,732	14,498	15,456	19,145
PAT	4,298	3,511	4,997	5,695	7,637
EPS (Rs)	15.2	12.4	17.7	18.3	24.6
BV (Rs)	182.0	191.4	204.7	222.4	243.2
P/E (x)	6.8	8.3	5.8	5.6	4.2
P/BV (x)	0.6	0.5	0.5	0.5	0.4
Gross NPAs (%)	*4.2*	*4.9*	*4.4*	*4.1*	*4.1*
Net NPAs (%)	*2.7*	*3.0*	*3.0*	*2.4*	*2.0*
RoA (%)	*0.7*	*0.5*	*0.7*	*0.7*	*0.7*
RoE (%)	*9.7*	*6.7*	*8.9*	*9.0*	*10.6*

Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 2: Actual performance versus our estimates

(Rsmn)	1QFY20	1QFY19	4QFY19	*YoY (%)*	*QoQ (%)*	1QFY20E	*Devi. (%)*
Net interest income	4,946	4,686	4,809	*5.6*	*2.9*	4,989	*(0.9)*
Pre-provisioning operating profit	3,500	3,689	3,242	*(5.1)*	*8.0*	3,925	*(10.8)*
PAT	1,754	1,632	617	*7.5*	*184.2*	1,394	*25.9*

Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 3: Change in our estimates

	Revised estimate		Earlier estimate		*% Revision*	
	FY20E	FY21E	FY20E	FY21E	*FY20E*	*FY21E*
Net Interest Income (Rs mn)	21,747	26,806	21,151	*26,937*	*2.8*	*(0.5)*
NIMs	*2.8*	*2.9*	*2.7*	*2.9*	***5 bps***	***-6 bps***
Operating Profit (Rs mn)	15,456	19,145	16,653	*20,132*	*(7.2)*	*(4.9)*
Profit after tax (Rs mn)	5,695	7,637	6,319	*8,300*	*(9.9)*	*(8.0)*

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)	FY17	FY18	FY19	FY20E	FY21E
Interest income	51,854	54,238	59,060	68,298	82,373
Interest expenses	36,948	35,661	40,008	46,551	55,567
Net interest income	**14,906**	**18,577**	**19,051**	**21,747**	**26,806**
Fees	2,761	3,644	4,305	5,651	6,704
Other income	5,333	5,900	5,715	4,718	4,873
Net revenues	23,000	28,120	29,071	32,116	38,383
Operating expenses	13,042	13,388	14,573	16,661	19,238
-Employee expenses	6,010	5,248	6,056	6,548	7,242
-Other expenses	7,031	8,140	8,517	10,113	11,996
Pre-provisioning operating profit	**9,958**	**14,732**	**14,498**	**15,456**	**19,145**
Provisions	5,503	11,376	8,195	8,154	9,354
-Loan loss provision	5,358	10,549	7,922	8,123	9,263
-Provisions for investment	40	977	282	32	91
-Other provisions	106	(151)	(8)	0	0
PBT	4,455	3,356	6,303	7,301	9,791
Tax	157	(155)	1,306	1,606	2,154
PAT	**4,298**	**3,511**	**4,997**	**5,695**	**7,637**

Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 7: Balance sheet

Y/E March (Rsmn)	FY17	FY18	FY19	FY20E	FY21E
Equity capital	2,826	2,826	2,826	3,109	3,109
Reserves & surplus	48,600	51,275	55,026	66,035	72,486
Shareholder's funds	**51,426**	**54,102**	**57,852**	**69,144**	**75,595**
Deposits	**567,331**	**628,713**	**684,521**	**787,050**	**915,348**
Borrowings	8,326	8,160	33,255	56,919	76,536
Other liabilities	13,303	12,763	14,829	29,713	47,166
Total liabilities	**640,386**	**703,737**	**790,458**	**942,826**	**1,114,644**
Cash/equivalent	32,740	36,010	36,097	54,527	65,432
Advances	369,157	472,518	548,282	641,490	769,788
Investments	202,197	154,444	161,850	201,077	232,095
Fixed assets	7,206	7,616	7,750	8,525	9,377
Other assets	29,086	33,149	36,478	37,208	37,952
Total assets	**640,386**	**703,737**	**790,458**	**942,826**	**1,114,644**

Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 6: Key ratios

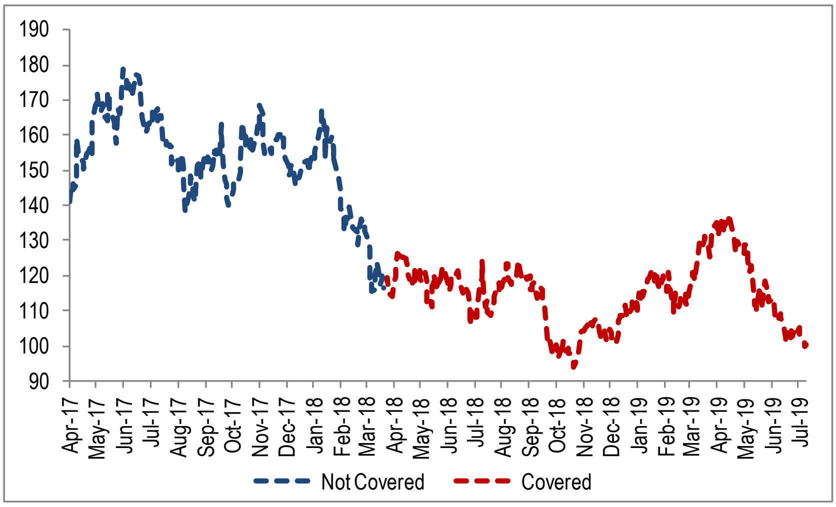
Y/E March	FY17	FY18	FY19	FY20E	FY21E
Growth (%)					
NII growth	14.4	24.6	2.6	14.1	23.3
Pre-provision profit growth	16.5	47.9	(1.6)	6.6	23.9
PAT growth	3.5	(18.3)	42.4	14.0	34.1
Business (%)					
Deposit growth	12.4	10.8	8.9	15.0	16.3
Advance growth	8.9	28.0	16.0	17.0	20.0
Business growth	11.0	17.6	11.9	15.9	18.0
CD	65.1	75.2	80.1	81.5	84.1
CASA	29.0	28.0	28.1	29.5	31.0
Operating efficiency (%)					
Cost-to-income	56.7	47.6	50.1	51.9	50.1
Cost-to-assets	2.2	2.0	2.0	1.9	1.9
Productivity (Rsmn)					
Business per branch	1,224.2	1,376.5	1,474.6	1,661.1	1,914.9
Business per employee	117.3	134.5	149.0	162.9	182.4
Profit per branch	5.6	4.4	6.0	6.6	8.7
Profit per employee	0.5	0.4	0.6	0.6	0.8
Spread (%)					
Yield on advances	10.7	9.7	9.2	9.2	9.3
Yield on investments	7.0	6.5	7.0	7.0	7.0
Cost of deposits	6.7	5.8	5.8	5.8	5.8
Yield on assets	9.5	8.9	8.8	8.7	8.8
Cost of funds	6.8	5.9	5.9	6.0	6.1
NIMs	2.7	3.1	2.8	2.8	2.9
Capital adequacy (%)					
Tier I	12.2	11.3	11.2	10.6	9.6
Tier II	1.1	0.8	2.0	0.8	0.8
Total CAR	13.3	12.0	13.2	11.4	10.4
Asset quality (%)					
Gross NPAs	4.2	4.9	4.4	4.1	4.1
Net NPAs	2.7	3.0	3.0	2.4	2.0
Specific provision coverage	36.8	39.8	33.0	42.6	52.8
Slippage	3.8	5.0	2.8	2.3	2.3
Credit cost	1.6	2.6	1.5	1.2	1.2
Return (%)					
RoE	9.7	6.7	8.9	9.0	10.6
RoA	0.7	0.5	0.7	0.7	0.7
RoRWA	2.2	0.8	1.1	1.0	1.0
Per share					
EPS	15.2	12.4	17.7	18.3	24.6
BV	182.0	191.4	204.7	222.4	243.2
ABV	146.6	140.8	146.5	172.8	194.5
Valuation (x)					
P/E	6.7	8.2	5.8	5.6	4.2
P/BV	0.6	0.5	0.5	0.5	0.4
P/ABV	0.7	0.7	0.7	0.6	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
9 October 2018	Buy	99	141
15 October 2018	Buy	98	149
14 January 2019	Buy	116	143
8 April 2019	Buy	137	160
16 May 2019	Buy	111	153
8 July 2019	Buy	103	119
16 July 2019	Buy	102	118

Rating track graph



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BUY > 15%

ACCUMULATE -5% to15%

SELL < -5%

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