

# Karnataka Bank

16 October 2019

Reuters: KBNK.NS; Bloomberg: KBL IN

## Turnaround could be around the corner

Karnataka Bank (KBL) reported 2QFY20 results with the key pointers being: (1) Gross slippages were somewhat elevated at Rs 5.03bn due to a large exports sector account and Sintex Industries slipping. However, management guided for improved asset quality outlook (2) Period-end loan growth was muted at 7% YoY due to IBPC sales and de-focusing of large corporate business (3) Margin commentary, fee income outlook and operating expenses control were all encouraging. (See comprehensive conference call takeaways on page 2 for *significant incremental colour*.) Per se, on the key P&L items, KBL posted 7% NII growth YoY at Rs4,987mn, PPOP growth of 16% YoY at Rs4,134mn and PAT decline of 5% YoY at Rs1,059mn. We have revised our estimates for FY20/FY21/FY22 and retained Buy rating on KBL, revising our target price on it to Rs83 (from Rs84 earlier) and valuing the stock at 0.4x H1FY22E P/BV.

**Gross slippages were somewhat elevated at Rs 5.03bn due to a large exports sector account and Sintex Industries slipping. However, management guided for improved asset quality outlook:** Slippage from large corporates amounted to Rs 2.05bn, of which Rs 1.01bn was an Exports sector account and Rs 0.95bn was Sintex Industries. The Rs 1.01bn exports sector account may get upgraded during the current quarter. Exposure to DHFL and Religare is Rs 1.68bn and Rs 0.68bn, respectively. These accounts are currently SMA2 and are also part of the ICA book. Owing to higher provisions, PCR has improved to 59.2%. PCR should be above 60% by year end. In the D-rated book which is standard, there are no bulky accounts as such other than Reliance Home Finance exposure of Rs 0.2bn. The restructured book stands at Rs 4.85bn and has a PCR of 18.56%. Security receipts book is Rs 4.01bn and carries a provision of Rs 0.47bn.

**Period-end loan growth was muted at 7% YoY due to IBPC sales and de-focusing of large corporate business:** Sales of IBPC at the end of the quarter amounted to Rs 45bn. The average advances growth was better at 12% YoY. Management described the de-focusing of large corporate book as a mid-course correction implying improved growth outlook going forward. Management is targeting a share of 20%, 30% and 50% for large corporate, mid-corporate and retail book, respectively by FY21.

**Margin commentary, fee income outlook and operating expenses control were all encouraging:** Cost of deposits rise has a one-off since there was a campaign to push a 451-day deposits offering at 7.5%. Cost of deposits should moderate going forward which, combined with the already up-trending yield on advances, should result in improved margin. Fee income growth has been robust at 38% YoY. Management is confident of 20% plus fee income growth going forward. Digitalisation of Bengaluru and Hyderabad branches has been implemented and the same will be replicated on a pan-India basis. Sales officers will be equipped with tab banking. Share of branches in transaction has declined to 18%, which is a positive trend from an opex control perspective.

**Valuation and outlook:** We have revised our NII estimates by -1.3%/-3.4%/-6.1%, PPOP estimates by -1.8%/-4.5%/-7.8% and PAT estimates by -1.1%/-4.1%/-6.8% for FY20/FY21, respectively. We have retained Buy rating on KBL, revising our target price to Rs83 (from Rs84 earlier), valuing the stock at 0.4x H1FY22E P/BV.

## BUY

**Sector:** Banking

**CMP:** Rs69

**Target Price:** Rs83

**Upside:** 21%

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### Key Data

Current Shares O/S (mn)	282.6
Mkt Cap (Rsbn/US\$m)	19.4/271.6
52 Wk H / L (Rs)	141/68
Daily Vol. (3M NSE Avg.)	1,074,018

### Price Performance (%)

	1 M	6 M	1 Yr
Karnataka Bank	(12.1)	(49.9)	(30.8)
Nifty Index	3.8	(3.1)	8.0

Source: Bloomberg

Y/E Mar (Rsmn)	Q2FY20	Q2FY19	Q1FY20	YoY (%)	QoQ (%)
Interest Income	16,296	14,526	15,844	12.2	2.9
Interest Expenses	11,309	9,849	10,898	14.8	3.8
<b>Net Interest Income</b>	<b>4,987</b>	<b>4,677</b>	<b>4,946</b>	6.6	0.8
<b>NIM (%)</b>	<b>2.82</b>	<b>2.91</b>	<b>2.81</b>	-9 bps	1 bps
Non Interest Income	3,088	2,012	2,448	53.5	26.1
<b>Operating Income</b>	<b>8,075</b>	<b>6,689</b>	<b>7,394</b>	20.7	9.2
Staff Cost	1,632	1,109	1,769	47.2	(7.8)
Other Op Exp	2,309	2,017	2,124	14.5	8.7
Total Operating Expenses	3,941	3,126	3,894	26.1	1.2
Cost to Income (%)	48.8	46.7	52.7	207 bps	-386 bps
<b>Pre-provisioning operating Profit</b>	<b>4,134</b>	<b>3,563</b>	<b>3,500</b>	16.0	18.1
Provisions	2,624	1,932	2,011	35.8	30.5
<b>PBT</b>	<b>1,510</b>	<b>1,631</b>	<b>1,489</b>	(7.4)	1.5
Tax	451	513	-266	(12.0)	NA
-effective tax rate	29.9	31.4	-17.8	-155 bps	NA
<b>PAT</b>	<b>1,059</b>	<b>1,119</b>	<b>1,754</b>	(5.3)	(39.6)
EPS (Rs)	3.7	4.0	6.2	(5.3)	(39.6)
BV (Rs)	210.4	197.5	210.9	6.5	(0.2)
Deposits	701,897	638,847	685,207	9.9	2.4
Advances	534,684	499,696	528,188	7.0	1.2

Source: Company, Nirmal Bang Institutional Equities Research

## Comprehensive Analyst Meet Takeaways

### Asset quality

- Gross slippage for the quarter was Rs 5.3bn. NPA reductions amounted to Rs 3.72bn, of which technical write-offs were Rs 2.28bn.
- Gross slippage in the same quarter last year was Rs 3.68bn.
- Slippage from large corporate amounted to Rs 2.05bn, of which Rs 1.01bn was an Exports sector account and Rs 0.95bn was Sintex Industries.
- Slippage from mid corporate book was Rs 1.35bn and from Agri book was Rs 1.28bn.
- Relatively large slippages from the mid corporate book includes a Rs 0.55bn textile sector account, Rs 0.26bn steel sector account and a Rs 0.21bn rice sector account.
- The Rs 1.01bn exports sector account may get upgraded during the current quarter. Property collateral is being disposed off in this regard.
- Exposure to DHFL and Religare is Rs 1.68bn and Rs 0.68bn, respectively. These accounts are currently SMA2 and are also part of the ICA book.
- Owing to higher provisions, PCR has improved to 59.2%. PCR should be above 60% by year end.
- In the D-rated book which is standard, there are no bulky accounts as such other than Reliance Home Finance exposure of Rs 0.2bn. The internal rating is better for some of these accounts. There are some smaller accounts such as Grandhi and Kannagiri Spinning in this book.
- Infrastructure exposure is Rs 28.28bn, which has declined 24% YoY and comprises 5.2% of loan book. Of this, about Rs 1.31bn is NPA or 4.63% of infra book.
- There are 5 accounts in the ICA book – DHFL, Religare, Reliance Home Finance, Reliance Commercial Finance and Sintex. Of these, Reliance Commercial Finance and Sintex are NPA.
- SMA2 is Rs 5.88bn.
- The resolution plan for Religare is under active examination and the Oversight Committee will soon provide its view.
- There is no other exposure to ADAG other than Reliance Home Finance and Reliance Commercial Finance.
- The exposure to IL&FS is Rs 0.75bn.
- Breakup of provisions is Rs 5.19bn of specific provisions, Rs 2.52bn of general provisions and rest is others.
- Investment provision outstanding is Rs 1.42bn.
- While there has been significant growth in CRE book, most of its LRD. Collateral is 150% plus.
- The restructured book stands at Rs 4.85bn and has a PCR of 18.56%.
- Security receipts book is Rs 4.01bn and carries a provision of Rs 0.47bn.

### Loan and business growth

- While period-end advances growth was tepid at 7% YoY, this was on account of sale of IBCC book worth Rs 45bn at the end of the quarter.
- The average advances growth was better at 12% YoY.
- Slower growth was also on account of de-focusing the large corporate book.
- The intention is to reduce the share of large corporate to 20% of total book.
- The share of retail and mid corporate targeted would be 50% and 30% of total book respectively. This is achievable by FY21.

- Growth for housing (including CRE) has been strong at 33% YoY.
- Gold agri book has also grown well at 10.76% YoY.
- Personal loans have grown at 31% YoY.
- Amalgamation of PSU Banks is being viewed as an opportunity.

### **Margin, Liabilities and Liquidity**

- Yield on advances has been on a rising trend.
- Cost of deposits rise has a one off since there was a campaign to push a 451-day deposits offering at 7.5%, under which the bank mobilized deposits worth Rs. 35 bn. Cost of deposits should moderate going forward.
- Healthy growth in CASA is expected.
- NIM expansion is expected going forward.

### **Fee and Other Income**

- Fee income growth has been robust at 38% YoY.
- There was 82% YoY growth in processing fees.
- Management is confident of 20% plus fee income growth going forward.

### **Operating Expenses**

- Digitalisation of Bengaluru and Hyderabad branches has been implemented and the same will be replicated on a pan-India basis.
- Sales officers will be equipped with tab banking.
- Share of branches in transaction has declined to 18%.

### **Capital Adequacy**

- If 1HFY20 net profit is included, Capital Adequacy Ratio would improve to 13.2%.
- The RWA as of September 2018 was Rs 47.62bn. It is Rs 50.28bn as of September 2019.

## Exhibit 1: Financial summary

Y/E March (Rsmn)	FY18	FY19	FY20E	FY21E	FY22E
Net interest income	18,577	19,051	20,929	24,380	28,893
Pre-provisioning operating profit	14,732	14,498	15,109	17,660	20,621
PAT	3,511	4,997	5,351	6,616	8,028
EPS (Rs)	12.4	17.7	17.2	21.3	25.8
BV (Rs)	191.4	204.7	209.5	227.0	249.0
P/E (x)	5.5	3.9	4.0	3.2	2.7
P/BV (x)	0.4	0.3	0.3	0.3	0.3
Gross NPAs (%)	4.9	4.4	4.2	4.3	4.1
Net NPAs (%)	3.0	3.0	2.4	1.9	1.1
RoA (%)	0.5	0.7	0.6	0.7	0.7
RoE (%)	6.7	8.9	8.7	9.8	10.9

Source: Company, Nirmal Bang Institutional Equities Research

## Exhibit 2: Actual performance versus our estimates

(Rsmn)	Q2FY20	Q2FY19	Q1FY20	YoY (%)	QoQ (%)	Q2FY20E	Devi. (%)
Net interest income	4,987	4,677	4,946	6.6	0.8	5,316	(6.2)
Pre-provisioning operating profit	4,134	3,563	3,500	16.0	18.1	3,895	6.1
PAT	1,059	1,119	1,754	(5.3)	(39.6)	1,391	(23.8)

Source: Company, Nirmal Bang Institutional Equities Research

## Exhibit 3: Change in our estimates

	Revised estimate			Earlier estimate			% Revision		
	FY20E	FY21E	FY22E	FY20E	FY21E	FY22E	FY20E	FY21E	FY22E
Net Interest Income (Rs mn)	20,929	24,380	28,893	21,196	25,240	30,770	(1.3)	(3.4)	(6.1)
NIMs (%)	2.7	2.8	2.9	2.7	2.8	2.8	<b>0 bps</b>	<b>1 bps</b>	<b>2 bps</b>
Operating Profit (Rs mn)	15,109	17,660	20,621	15,379	18,494	22,373	(1.8)	(4.5)	(7.8)
Profit after tax (Rs mn)	5,351	6,616	8,028	5,409	6,897	8,611	(1.1)	(4.1)	(6.8)

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)	FY18	FY19	FY20E	FY21E	FY22E
Interest income	54,238	59,060	66,866	76,635	87,698
Interest expenses	35,661	40,008	45,937	52,255	58,806
<b>Net interest income</b>	<b>18,577</b>	<b>19,051</b>	<b>20,929</b>	<b>24,380</b>	<b>28,893</b>
Fees	3,644	4,305	5,231	5,941	6,832
Other income	5,900	5,715	4,632	5,355	5,998
Net revenues	28,120	29,071	30,791	35,677	41,723
Operating expenses	13,388	14,573	15,683	18,017	21,102
-Employee expenses	5,248	6,056	6,965	7,455	8,196
-Other expenses	8,140	8,517	8,718	10,562	12,906
<b>Pre-provisioning operating profit</b>	<b>14,732</b>	<b>14,498</b>	<b>15,109</b>	<b>17,660</b>	<b>20,621</b>
Provisions	11,376	8,195	8,420	9,389	10,586
-Loan loss provision	10,549	7,922	8,389	9,300	10,483
-Provisions for investment	977	282	32	89	103
-Other provisions	(151)	(8)	0	0	0
PBT	3,356	6,303	6,688	8,270	10,035
Tax	(155)	1,306	1,338	1,654	2,007
<b>PAT</b>	<b>3,511</b>	<b>4,997</b>	<b>5,351</b>	<b>6,616</b>	<b>8,028</b>

Source: Company, Nirmal Bang Institutional Equities Research

### Exhibit 7: Balance sheet

Y/E March (Rsmn)	FY18	FY19	FY20E	FY21E	FY22E
Equity capital	2,826	2,826	3,109	3,109	3,109
Reserves & surplus	51,275	55,026	62,017	67,447	74,289
<b>Shareholder's funds</b>	<b>54,102</b>	<b>57,852</b>	<b>65,126</b>	<b>70,556</b>	<b>77,398</b>
<b>Deposits</b>	<b>628,713</b>	<b>684,521</b>	<b>756,894</b>	<b>849,006</b>	<b>954,934</b>
Borrowings	8,160	33,255	56,050	67,459	80,496
Other liabilities	12,763	14,829	28,378	44,022	61,219
<b>Total liabilities</b>	<b>703,737</b>	<b>790,458</b>	<b>906,448</b>	<b>1,031,042</b>	<b>1,174,047</b>
Cash/equivalent	36,010	36,097	52,196	60,026	69,030
Advances	472,518	548,282	614,076	706,187	812,115
Investments	154,444	161,850	194,443	217,500	243,876
Fixed assets	7,616	7,750	8,525	9,377	10,315
Other assets	33,149	36,478	37,208	37,952	38,711
<b>Total assets</b>	<b>703,737</b>	<b>790,458</b>	<b>906,448</b>	<b>1,031,042</b>	<b>1,174,047</b>

Source: Company, Nirmal Bang Institutional Equities Research

### Exhibit 6: Key ratios

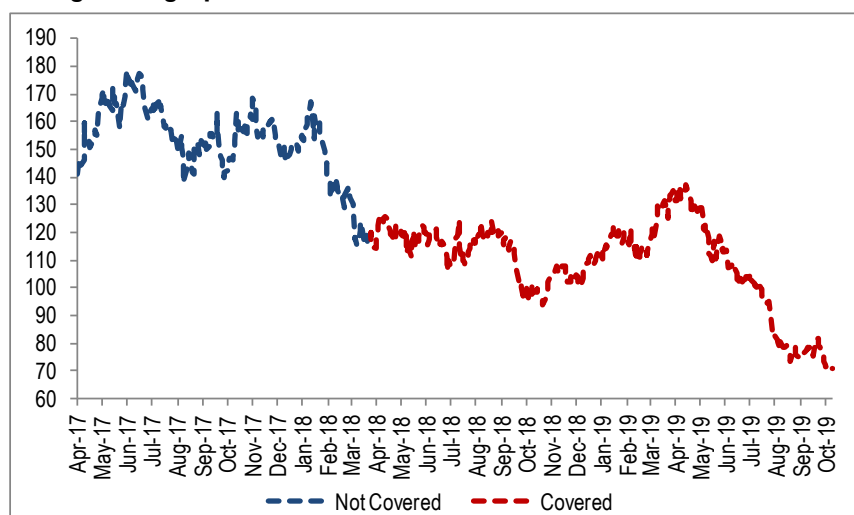
Y/E March	FY18	FY19	FY20E	FY21E	FY22E
<b>Growth (%)</b>					
NII growth	24.6	2.6	9.9	16.5	18.5
Pre-provision profit growth	47.9	(1.6)	4.2	16.9	16.8
PAT growth	(18.3)	42.4	7.1	23.7	21.3
<b>Business (%)</b>					
Deposit growth	10.8	8.9	10.6	12.2	12.5
Advance growth	28.0	16.0	12.0	15.0	15.0
Business growth	17.6	11.9	11.2	13.4	13.6
CD	75.2	80.1	81.1	83.2	85.0
CASA	28.0	28.1	28.3	29.0	29.9
<b>Operating efficiency (%)</b>					
Cost-to-income	47.6	50.1	50.9	50.5	50.6
Cost-to-assets	2.0	2.0	1.8	1.9	1.9
<b>Productivity (Rsmn)</b>					
Business per branch	1,376.5	1,474.6	1,594.2	1,767.3	1,963.4
Business per employee	134.5	149.0	151.2	168.3	182.6
Profit per branch	4.4	6.0	6.2	7.5	8.9
Profit per employee	0.4	0.6	0.6	0.7	0.8
<b>Spread (%)</b>					
Yield on advances	9.7	9.2	9.2	9.2	9.2
Yield on investments	6.5	7.0	7.0	7.0	7.0
Cost of deposits	5.8	5.8	5.8	5.8	5.8
Yield on assets	8.9	8.8	8.7	8.7	8.7
Cost of funds	5.9	5.9	6.0	6.0	6.0
NIMs	3.1	2.8	2.7	2.8	2.9
<b>Capital adequacy (%)</b>					
Tier I	11.3	11.2	12.2	11.5	11.0
Tier II	0.8	2.0	1.0	0.9	0.9
Total CAR	12.0	13.2	13.2	12.4	11.8
<b>Asset quality (%)</b>					
Gross NPAs	4.9	4.4	4.2	4.3	4.1
Net NPAs	3.0	3.0	2.4	1.9	1.1
Specific provision coverage	39.8	33.0	44.7	57.2	73.5
Slippage	5.0	2.8	2.3	2.3	2.0
Credit cost	2.6	1.5	1.3	1.3	1.3
<b>Return (%)</b>					
RoE	6.7	8.9	8.7	9.8	10.9
RoA	0.5	0.7	0.6	0.7	0.7
RoRWA	0.8	1.1	1.1	1.2	1.2
<b>Per share</b>					
EPS	12.4	17.7	17.2	21.3	25.8
BV	191.4	204.7	209.5	227.0	249.0
ABV	140.8	146.5	162.2	184.5	219.5
<b>Valuation (x)</b>					
P/E	5.5	3.9	4.0	3.2	2.7
P/BV	0.4	0.3	0.3	0.3	0.3
P/ABV	0.5	0.5	0.4	0.4	0.3

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
7 October 2019	Buy	72	84
16 October 2019	Buy	69	83

## Rating track graph



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BUY > 15%

ACCUMULATE -5% to 15%

SELL < -5%

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