INDIA

BUY

# Karnataka Bank

CENTRUM

Financials

Initiating Coverage — 29 March 2017

## Re-orienting to fundamentals

**We initiate coverage on Karnataka Bank (KBL), with a Buy rating and TP of Rs170. This franchise, contrary to market perception, merits consideration for its inherent strengths as evident in its business ratios. We expect the bank's efforts to further enrich these ratios, which will push up RoA / RoE to 1.0% / 14.4% by end-FY19, best ever since FY09. Banks with improved earnings quality, higher credit growth and efficient capital consumption tend to graduate into higher valuation multiples and we see a similar kind of re-rating due for KBL. BUY.**

- **The inherent strengths of the business model:** Regional banks are characterised by a) their lower CASA franchise, b) weak employee productivity and c) limited contribution from non-interest income. Compared to its peer banks, KBL has fared well with a superior CASA franchise (26% in FY16), better employee productivity, efficient cost management (cost/assets at 183bps in FY16), steady non-interest income, and adequate capital consumption. While the bank's margin (NIM) has improved in the recent past, it still remains low when compared to peers' – an outcome of inefficient balance sheet management. This, in addition to asset-quality headwinds and provisioning thereon, curtailed RoAs to 0.8% levels in FY16.
- **Steps directed at addressing the limitations:** KBL's lower margin profile is an outcome of its lower loan to deposit ratio (LDR) and limited reduction in deposit rates. However, with the continued approach towards addressing this inefficiency which led to improvement over FY13-16, we expect the bank's NIM trajectory inch further up to 2.9% by end-FY19 (from 2.6% in FY16). Based on our calculations, the following factors would contribute to NIM expansion, a) further reduction in the Rural Infrastructure Development Fund (RIDF) exposure (positive 8bps impact), b) increase in LDR (positive 8bps impact), and c) further enhancement in the overall CASA proportion (8bps positive impact). Our assumptions on margin could be further revised upwards in the event of higher-than-expected credit growth and lower interest reversals following reduction in fresh delinquencies. The baggage of stressed loans (including 5:25/ SDR and S4A) remains at 12% of loans, and we have factored in 300bps/ 90bps of slippages/ credit cost over FY16-19E (vs. 270bps / 80bps for FY13-16).
- **See RoA scale to 1% levels by end-FY19; best ever since FY09:** We expect NIM to improve over FY16-19E, given the bank's concentrated efforts towards increasing loan growth and curtailing interest costs. The share of non-interest income is also set to rise; on cost-efficiency, we see cost/ income reducing to ~51% by end-FY19 from ~54%% at FY16. Even as we build in accelerated slippages and provisioning, we draw comfort from the bank's ability towards recovery / upgradation. We thus see the overall trend in asset quality stabilising. We expect these efforts to translate into RoA/ RoE of 1.0% /14.4% by end-FY19E (vs. 0.8% RoA / 11.7% RoE in FY16).
- **Valuation, view and key risks:** Banks with an improving performance trajectory tend to trade at higher multiples as investors draw comfort in the quality of earnings and growth. We see a similar kind of re-rating due for KBL. We value the bank at 1.2x FY19E ABV leading to TP of Rs170 (21.5% upside). Initiate with a Buy rating. M&A activities in the old generation banking arena could be another trigger for multiple re-ratings. Key risks: a prolonged period of lower growth or margins; high delinquencies from the corporate portfolio.

| Target Price | | | Rs170 |
|---|---|---|---|
| CMP* | | | Rs140 |
| Upside | | | 21.5% |
| *Price Performance (%)** | | | |
| | 1M | 6M | 1Yr |
| KBL IN | 1.4 | 19.5 | 71.9 |
| NIFTY | 2.7 | 6.2 | 20.1 |

| Key Data | |
|---|---|
| Bloomberg Code | KBL IN |
| Curr Shares O/S (mn) | 282.6 |
| Diluted Shares O/S(mn) | 282.6 |
| Mkt Cap (Rsbn/USDmn) | 39.5/608 |
| 52 Wk H / L (Rs) | 143.4/80.2 |
| 5 Year H / L (Rs) | 161.9/51.7 |
| Daily Vol. (3M NSE Avg.) | 374572 |

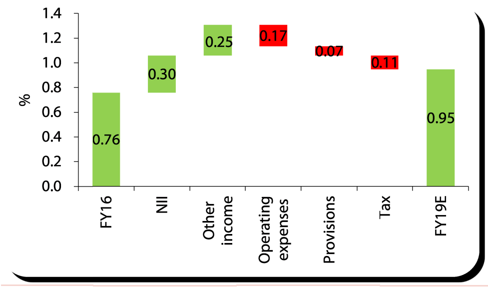
*as on 28 March 2017; Source: Bloomberg, Centrum Research*

### Shareholding pattern (%)*

| | Dec-16 | Sep-16 | Jun-16 | Mar-16 |
|---|---|---|---|---|
| Promoter | 0.0 | 0.0 | 0.0 | 0.0 |
| FIIs | 20.2 | 23.1 | 19.6 | 19.0 |
| DIIs | 8.5 | 8.8 | 9.8 | 10.7 |
| Others | 71.4 | 68.1 | 70.6 | 70.4 |

*Source: BSE,*as on 28 March 2017*

### Expansion in RoA trajectory




*Source: Company, Centrum Research Estimates*

### Centrum vs. Bloomberg Consensus*

| Particulars (Rs mn) | FY18E | | | FY19E | | |
|---|---|---|---|---|---|---|
| | Centrum | BBG | Var (%) | Centrum | BBG | Var (%) |
| NII + Oth. Inc | 25,223 | 24,366 | 3.5 | 29,447 | 27,360 | 7.6 |
| PPoP | 12,280 | 10,606 | 15.8 | 14,530 | 11,576 | 25.5 |
| PAT | 5,490 | 5,564 | (1.3) | 7,114 | 6,563 | 8.4 |

| Bloomberg Consensus* | | | | Centrum Target Price (Rs) | Variance (%) |
|---|---|---|---|---|---|
| BUY | SELL | HOLD | Target Price (Rs) | | |
| 3 | 1 | 0 | 138 | 170 | 23.2 |

*as on 28 March 2017; Source: Bloomberg, Centrum Research Estimates*


**Aalok Shah**, aalok.shah@centrum.co.in; 91 22 4215 9075
**Gaurav Jani**, Gaurav.jani@centrum.co.in; 91 22 4215 9110


| 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 (%) |
|---|---|---|---|---|---|---|---|---|---|---|
| FY15 | 16,758 | 7,734 | 4,516 | 45.1 | 24.0 | 4.5 | 146.7 | 0.7 | 0.9 | 14.0 |
| FY16 | 18,457 | 8,546 | 4,157 | (8.0) | 22.0 | 4.5 | 153.6 | 0.6 | 0.8 | 11.7 |
| FY17E | 21,841 | 9,438 | 4,283 | 3.1 | 15.1 | 7.6 | 129.0 | 0.9 | 0.7 | 10.3 |
| FY18E | 25,223 | 12,280 | 5,490 | 28.2 | 19.4 | 7.2 | 136.1 | 1.0 | 0.8 | 11.6 |
| FY19E | 29,447 | 14,530 | 7,114 | 29.6 | 25.2 | 5.6 | 144.9 | 1.0 | 1.0 | 14.4 |

*Source: Company, Centrum Research Estimates #net income denotes NII + other income. FY15-17E have been valued on average market cap basis.*

## Table of contents

## Karnataka Bank – Re-orienting to fundamentals

Karnataka Bank, a 92-year old franchise, with an extensive presence in south India, especially its home-state Karnataka, is in a phase of re-orienting itself to its key strengths. A respectable market share in its home-state, a well-drawn strategy towards increasing its footprint without affecting the cost-ratios, as evident in cost/ assets at 183bps in FY16, a steady rise in its CASA franchise, and adequate capital consumption have been its key strengths.

However, the bank's ROA has remained low due to its weak margin profile (compared to peers). We believe with efforts directed towards shoring its NIM profile and containing asset quality with adequate provisioning thereon, RoAs are set to inch upwards. We expect the bank's RoAs to inch towards 1.0% levels by end-FY19E, best ever since FY09. We see RoEs at 14.4% in FY19E from 11.7% in FY16.

**Exhibit 1: Areas of focus and the targeted outcome**

| Area of focus | Current state of affairs | Resultant outcome |
|---|---|---|
| Asset growth | ❍ Loan growth moderated to 9% YoY in Dec'16 from a CAGR 18% over FY10-14.<br>❍ Share of corporate loans stood at 35% in Dec'16 (vs. 39% in FY14). | ❍ Pace of growth set to accelerate; share of retail-SME nature of the portfolio to further increase; direct corporate exposure towards select sectors.<br>❍ Share of exposure to internally rated investment grade portfolio on the rise.<br>❍ We are factoring in 14.6% CAGR in loans over FY16-19E as compared to 10.4% CAGR during FY13-16. |
| Deposit franchise | ❍ CASA proportion at 26%, superior to other regional players.<br>❍ Retail nature of deposits provides added comfort. | ❍ GoI's demonetisation drive in Q3'17 helped increase KBL's CASA proportion by 400bps QoQ to 30%. Efforts to retain the same are underway.<br>❍ The recent reduction in the bank's deposit rates (lowest amongst peers) coupled with its increasing CASA proportion will further reduce its cost of deposits and in-turn cushion spreads.<br>❍ We are factoring in CASA at 29% levels by end-FY19E. |
| Margin (NIM) | ❍ NIM at 2.6% is low when compared to peers even as the CASA proportion remains healthy. | ❍ Continued efforts towards accelerated growth in the retail-SME loan segments<br>❍ Reducing exposure under RIDF.<br>❍ Lowering of deposit rates and gradual expansion in LDR.<br>❍ We expect NIM to inch towards 2.85% levels by end-FY19E vs. 2.57% in FY16. |
| Asset-quality | ❍ Slippages have been rising due to excessive exposure to stressed sectors in the past.<br>❍ Slippages averaged 300bps over FY14-16 vs. 194bps over FY11-13.<br>❍ Problem loans (GNPA + restructuring + accounts under RBI's alternate window) stood at 12% of loans. | ❍ The bank initiated measures at containing bad loan accretion, including a) setting up a credit-monitoring team, b) efforts towards resolution of bad loans, including resorting to asset sale to ARCs and c) centralization of the credit process.<br>❍ We also draw comfort from the bank's ability towards recovery and upgradation. GNPA in retail/ SME portfolio remain low.<br>❍ We are factoring in slippages/ credit cost at 300bps/90bps over FY16-19E respectively. |
| Return ratio | ❍ FY16 RoA/ RoE stood at 0.8%/ 11.7% (vs. 0.9% / 12.8% in FY13). | ❍ Concentrated efforts towards each of the above parameters could push up RoA / RoE towards 1.0% / 14.4% levels by end-FY19E. |

*Source: Company, Centrum Research*

## Growth to accelerate; factoring 15% CAGR in loans over FY16-19E

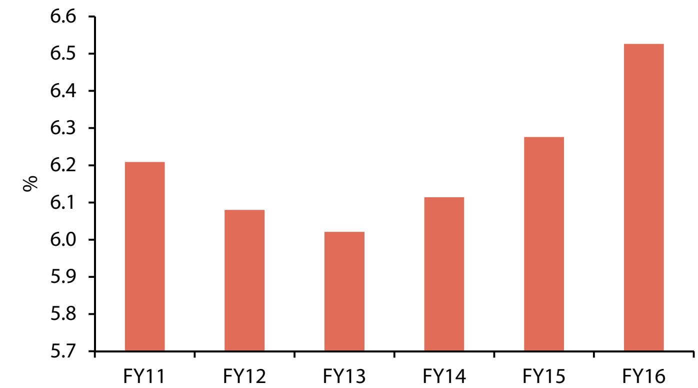
- **The bank is directing its efforts towards increasing the pace of loan growth with a focus on the higher yielding SME and retail segments; it has also limited its corporate exposure to select sectors.**
- **Analysis of state-wise credit market share suggests that there exists a huge loan growth opportunity for KBL. We expect the bank's growth rate to accelerate to 14.6% CAGR over FY16-19E (vs. 10.4% CAGR in loans over FY13-16).**

The state of Karnataka has witnessed a 14.0% CAGR in loans over FY12-16, higher than the 12.0% CAGR in overall banking credit pan-India. This increased Karnataka's share in the country's overall banking credit to 6.5% in FY16 vs. 6.1% in FY12. The reason for the higher credit growth in Karnataka was due to its strong net-state domestic product (NSDP). According to the Central Statistical Organisation (CSO), Karnataka's NSDP increased at a 5.8% CAGR over FY12-16 as compared to pan-India NSDP growth at 5.1% CAGR. Karnataka's NSDP growth is even higher than that of Tamil Nadu (5.4% CAGR) and Kerala (5.7%) over the same period.

While Karnataka's overall credit increased at a 14% CAGR over FY12-16, KBL's overall loans grew at a 13.1% CAGR over the same time. The lower credit growth, especially in the recent past, is an outcome of the management's cautious stance towards growth.

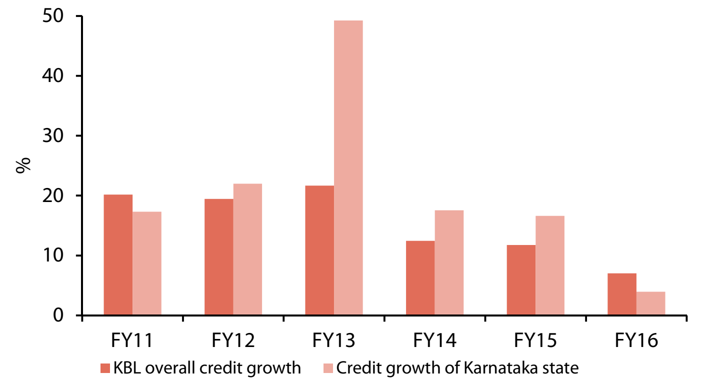
While KBL's overall loan growth has remained low, we draw comfort from KBL's extensive presence in its home-state and its growth therein. Over FY12-16, the bank's home-state portfolio increased at a 20.8% CAGR indicating its ability to penetrate deeper and scale its loan portfolio in its key markets.

**Exhibit 2: Increase in Karnataka's market share in overall banking credit**




*Source: RBI, Centrum Research*

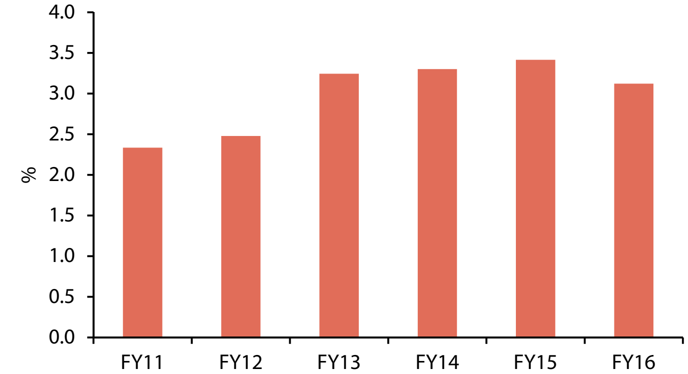
**Exhibit 3: KBL posted strong growth in its home-state vs. its overall credit growth**




*Source: Company, Centrum Research*

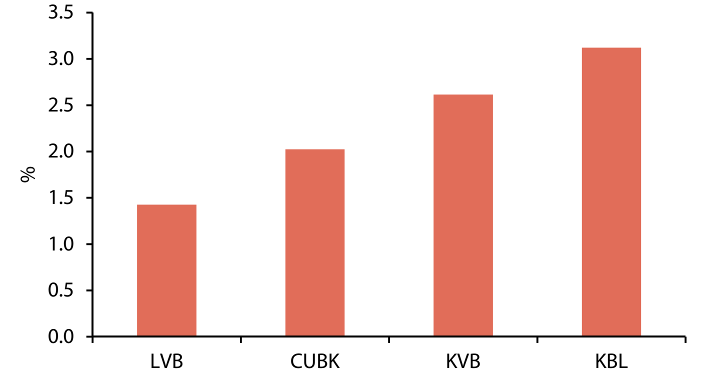
As KBL's credit growth increased in Karnataka, its market share in the overall state credit rose to 3.1% in FY16 from 2.3% in FY11. KBL also scores well when compared to other regional players in terms of market share in their respective home-state. In FY16, KBL's market share in its home-state stood at 3.1% as compared to Karur Vysya Bank (2.6%), City Union Bank (2.0%) and Lakshmi Vilas Bank (1.4%) in their home-state i.e. Tamil Nadu.

**Exhibit 4: KBL's market share in home state has been on the rise…**




*Source: RBI, Company, Centrum Research*

**Exhibit 5: …and compares well to its peers in their respective home-states (FY16)**

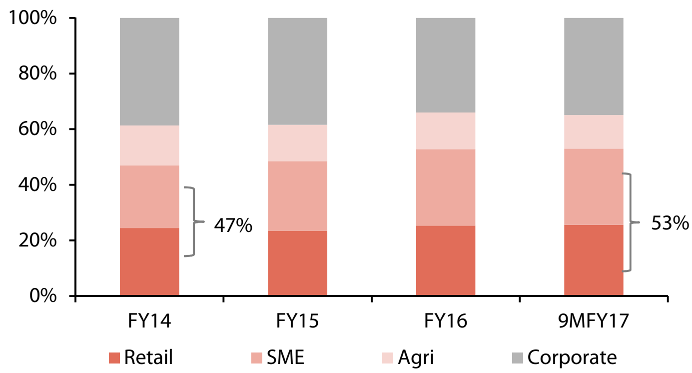



*Source: RBI, Companies, Centrum Research*

### Share of retail – SME segment on the rise

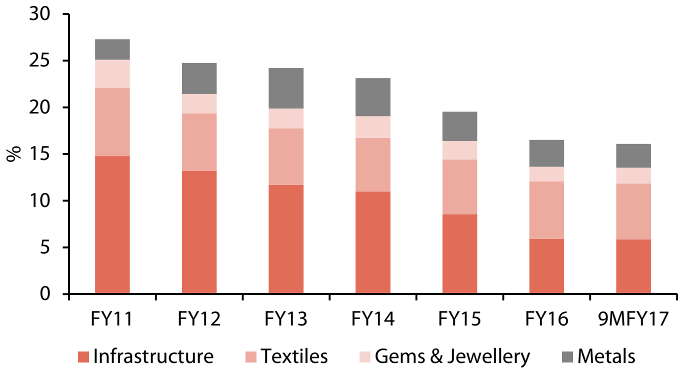
- While the bank loaned a higher proportion of credit to the corporate segment over FY10-12, beginning FY13, it considerably increased its exposure towards the higher yielding retail – SME segments. The change in stance towards shoring the retail – SME portfolio was due to concerns over asset quality and the considerable slow-down in credit from large corporates.
- Thus, over FY14-9MFY17, the share of retail + SME loans increased to 52.9% from 47.0% in FY14. The reduced focus on corporate exposure also enabled the bank to lower its exposure towards stressed sectors. While credit to stressed sectors grew at a 15.3% CAGR over FY10-13; in the subsequent period, the said portfolio witnessed de-growth of 2.8%. The bank's share of the total stressed sector exposure to total credit reduced to 16.1% in 9MFY17 vs. 27.2% in FY11.
- The increasing reliance on the SME portfolio is a result of client-specific product offerings in its key markets namely Karnataka, Tamil Nadu, Northern India and Maharashtra, and in particular sectors – warehousing receipt, auto-industry, textile and garment. On the retail front, the bank's home-loans and other personal loan portfolios have increased steadily.

**Exhibit 6: Reduction in corporate exposure…**




*Source: Company, Centrum Research*

**Exhibit 7: …post reduction in stressed sector exposure**




*Source: Company, Centrum Research*

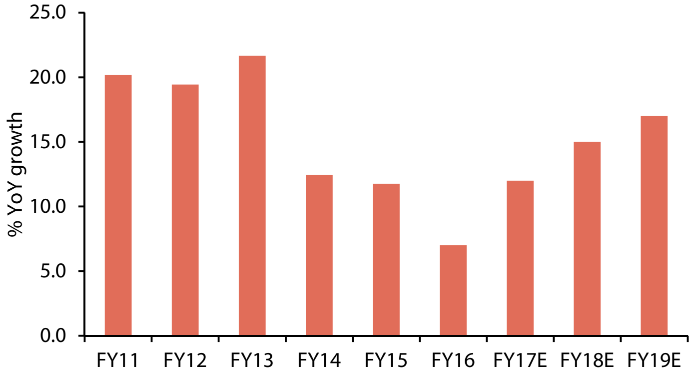
**Exhibit 8: Regional banks tend to place greater focus at retail-SME portfolio (9MFY17)**

| *% of loans* | Corporate | SME | Retail | Agriculture |
|---|---|---|---|---|
| *CUBK* | *31.5* | *34.0* | *18.3* | *16.2* |
| *DCB* | *16.0* | *11.0* | *56.0* | *17.0* |
| *FB* | *39.1* | *22.4* | | *38.5* |
| *KBL* | *34.9* | *27.4* | *25.6* | *12.1* |
| *KVB* | *33.5* | *33.8* | *15.8* | *16.8* |
| *SIB* | *39.8* | *26.3* | *20.2* | *13.8* |

*Source: Companies, Centrum Research. For Federal Bank retail includes agriculture exposure.*

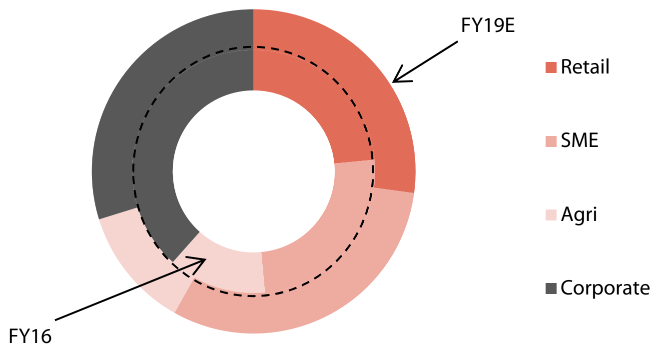
While the bank has maintained a cautious stance towards growth in the past, we believe that with a well-drawn-out growth strategy and by increasing its retail-SME portfolio, its pace of growth will accelerate. We thus are factoring in 14.6% CAGR in loans over FY16-19E (vs. 10.4% CAGR over FY13-16). We see the bank's share of retail-SME exposure inch up to 58% by end-FY19E vs. 53% in FY16.

**Exhibit 9: Factoring in 15% CAGR in loans over FY16-19E…**




*Source: Company, Centrum Research Estimates.*

**Exhibit 10: …led by continued traction in retail-SME loans**




*Source: Company, Centrum Research Estimates.*

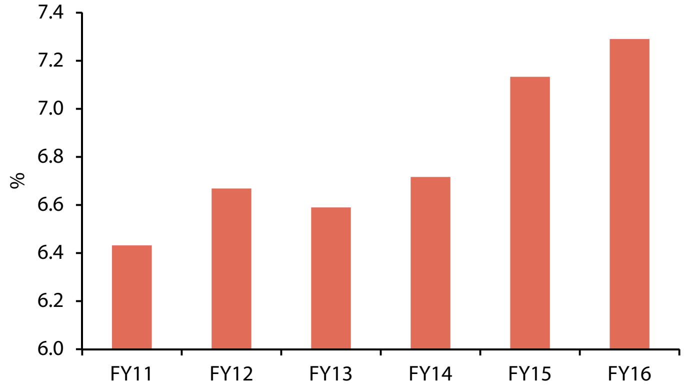
## Draw comfort from CASA franchise; especially in the home-state

### Deposit growth led by increasing share of CASA deposits

Contrary to the trajectory of Karnataka State's market share in overall credit and growth therein, the trend in the state's deposit growth and market share in overall systemic deposits has remained higher. Over FY12-16, while the systemic deposits increased at a 12% CAGR, the growth in deposits for Karnataka state was higher at 14.4%. Consequently, the share of the state's deposits in the country's overall deposits remains higher at 7.3% in FY16 (vs. 6.4% in FY11).

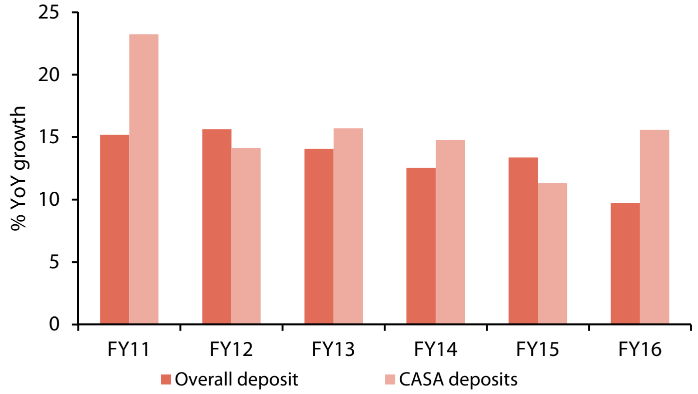
KBL's deposit growth at 12.4% CAGR over FY12-16 was lower than Karnataka state's deposit growth over the same timeframe. We however take comfort in the bank's deposit growth, as a) its deposit profile largely leans towards retail deposits, ensuring stickiness, and b) CAGR in CASA deposits was higher at 14.3% over FY12-FY16 (vs. 12.4% CAGR in overall deposit growth for KBL). Consequently, the proportion of CASA deposits to total deposits increased to 26.3% in FY16 from 24.6% in FY12.

**Exhibit 11: Increase in Karnataka's share in overall systemic deposits**




*Source: RBI, Centrum Research*

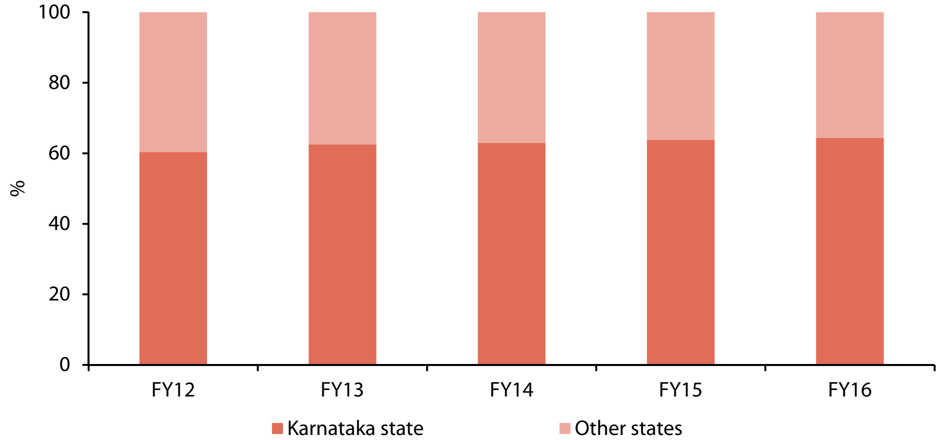
**Exhibit 12: KBL's CASA deposits outgrow overall deposits…**




*Source: Company, Centrum Research*

We also draw comfort from the increase in the share of CASA deposits from the bank's home-state as compared to its total CASA deposits, indicating a strong franchise in Karnataka.

**Exhibit 13: …led by strong traction in CASA deposits from home-state**

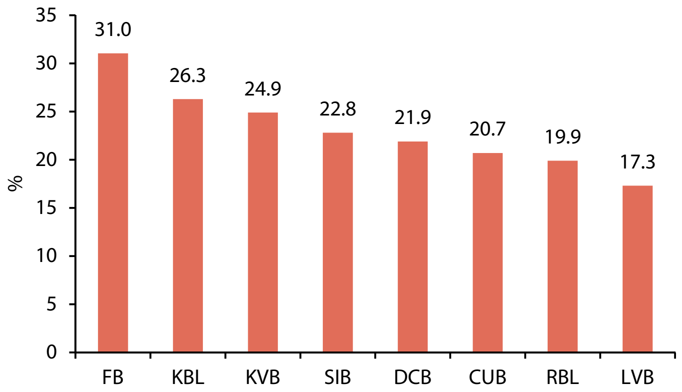



*Source: Company, Centrum Research*

KBL's CASA proportion at 26.2% is higher than that of many other regional players and is an outcome of having strengthened its retail liability franchise. Management plans to continue to enhance the CASA franchise further.

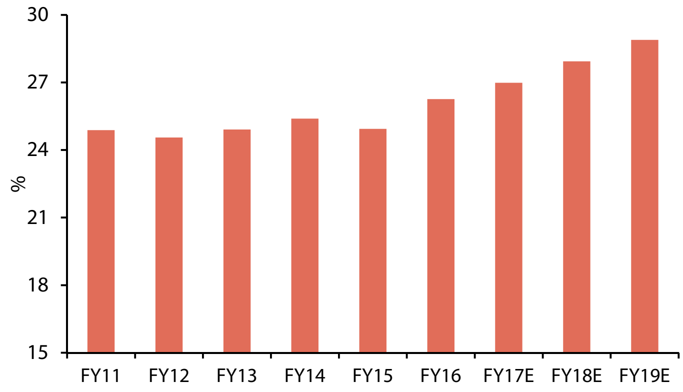
In Q3'17 the proportion of CASA increased 400bps QoQ to 30%, an outcome of GoIs move towards demonetisation. The bank has been able to retain a substantial part of the deposits on its balance sheet in Q4'17. We thus expect the trend in CASA accretion to remain intact and are factoring in CASA deposits inching up to 29% by end-FY19E vs. 26.3% in Q2'17.

**Exhibit 14: KBL's CASA proportion higher than peers' (FY16).**




*Source: Companies, Centrum Research*

**Exhibit 15: CASA ratio to inch up to 29% by end-FY19E**




*Source: Company, Centrum Research Estimates*

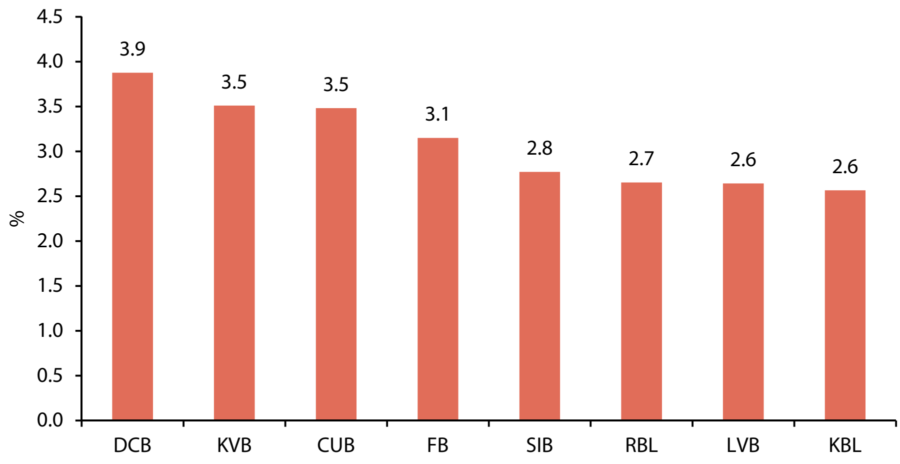
Increasing reliance on CASA deposits has enabled KBL to reduce its overall cost of deposits to 7.4% in FY16 from 8.1% in FY13. With a steady rise in CASA deposits and an aggressive cut in deposit rates in the recent past, we expect the cost of deposits to decline further and in turn aid spread and margin improvement.

## Lower margins, though improving; uptrend expected to continue

- **Inefficient balance sheet management has seen NIM remain lower when compared to peers.**
- **The bank is taking measured steps towards scaling margins. We see NIM inch up to 2.9% by end-FY19, best ever in the recent past.**
- **Further upside to NIM cannot be ruled out in the event of higher-than-expected credit growth or a lower accretion of fresh delinquencies.**

While KBL's margins have increased 19bps to 2.6% over FY13-16, they still remain lower to peers'. The lower margin profile, despite relatively higher CASA deposits, increasing share of retail-SME loans and reducing RIDF exposure, is due to inefficient balance sheet management particularly in the nature of low loan-to-deposit (LDR) ratio and limited reduction in deposit rates, resulting in higher cost of deposits when compared to peers.

**Exhibit 16: KBL's NIM remains lower than peers' (FY16)**




*Source: Companies, Centrum Research*

We have analysed the bank's NIM profile over FY13-16 and factors that would have contributed to changes therein. Over FY13-16 KBL's LDR declined 276bps to 67.2%. Keeping other factors constant, the reduction in LDR had a negative impact of 8bps on NIM. On the positive side, reduction in RIDF investment to 9.5% of total investments (vs. 20.4% in FY13) and 135bps expansion in CASA to 26.3%, positively impacted the NIM by 19bps and 5bps respectively. We have discussed each of these aspects hereunder:

**Exhibit 17: Factors that contributed to NIM improvement over FY13-16**

| **Particulars** | |
|---|---|
| NIM as at end FY13 | *2.38%* |
| Reduction in RIDF portfolio | *19bps* |
| Loan-to-deposit ratio | *(8)bps* |
| CASA proportion | *5bps* |
| Others* | *3bps* |
| NIM at the end FY16 | *2.57%* |

*Source: Company, Centrum Research; *mainly the combined effect of yield on advances and cost of deposits*

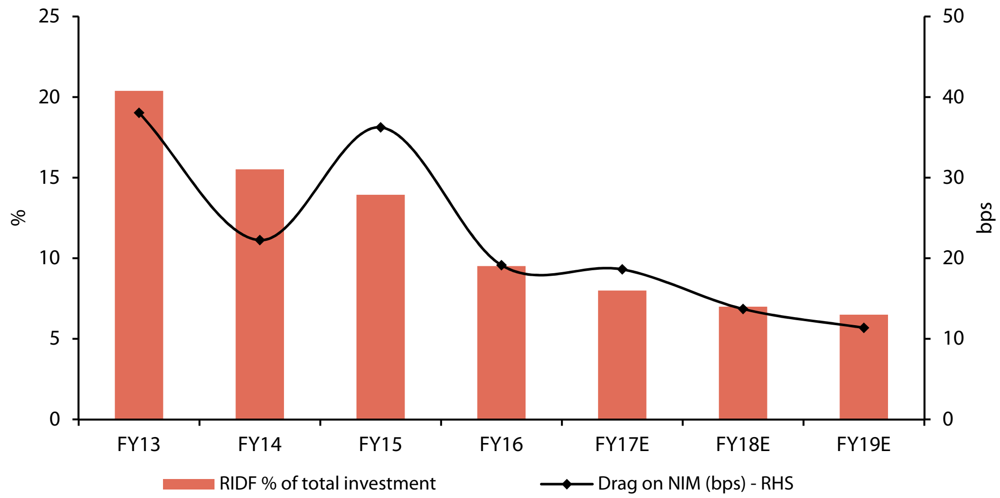
### Reducing RIDF exposure; positively impacting NIM

One of the factors that dragged the NIM down was investment in RIDF. RIDF investments stood at 20.4% of the total investments in FY13 and their negative impact on margins (based on our calculations) was around 38bps.

However, since the beginning of FY13, the exposure under the RIDF instruments has been declining. In FY16, RIDF investments stood at 9.5% of the total investments. The reduction in the proportion of RIDF investments has resulted in augmenting margins by 19bps over FY13-16.

We expect the proportion of RIDF exposure to further reduce over FY16-19E leading to a positive ~8bps impact on margins.

**Exhibit 18: RIDF exposure as a proportion of total investment has reduced since FY13, thus aiding in NIM expansion. We expect this trajectory to continue and positively impact NIM over FY16-19E.**



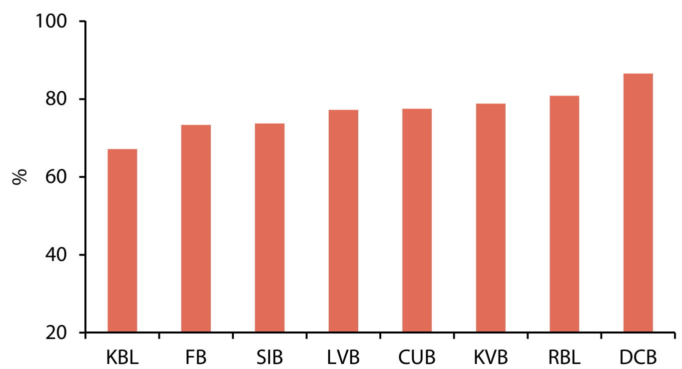

*Source: Company, Centrum Research Estimates*

### Lower loan-to-deposit ratio impacted margins; trajectory to reverse

While the pace of loan growth moderated over the recent past, deposit growth was higher. One of the possible reasons for higher deposit growth could be the elevated deposit rates as compared to peers. KBL witnessed 12% CAGR in deposits vis-a-vis 10% CAGR in loans over FY13-16. Thus KBL's loan-to-deposit ratio, declined by 276bps to 67.2% in FY16, impacting margins negatively by 8bps (based on our calculations).

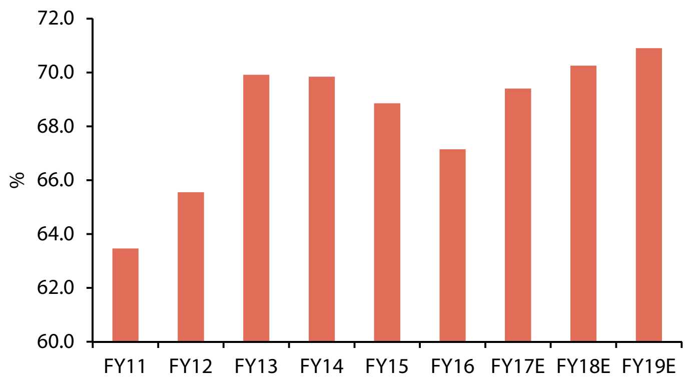
KBL's LDR has remained low, even as compared to its regional peers. However, with a well-drawn out strategy towards loan growth and the ability to contain deposit growth (following reduction in deposit rates), we believe that the bank's LDR is set to inch upwards towards 71% by end-FY19. Our estimates suggest an 8bps positive impact on margins following expansion in LDR over the same time frame.

**Exhibit 19: KBL's LDR has remained lesser than peers' (FY16)**




*Source: Companies, Centrum Research*

**Exhibit 20: Following efficient balance sheet management, we expect LDR to inch up to 71% by end-FY19**

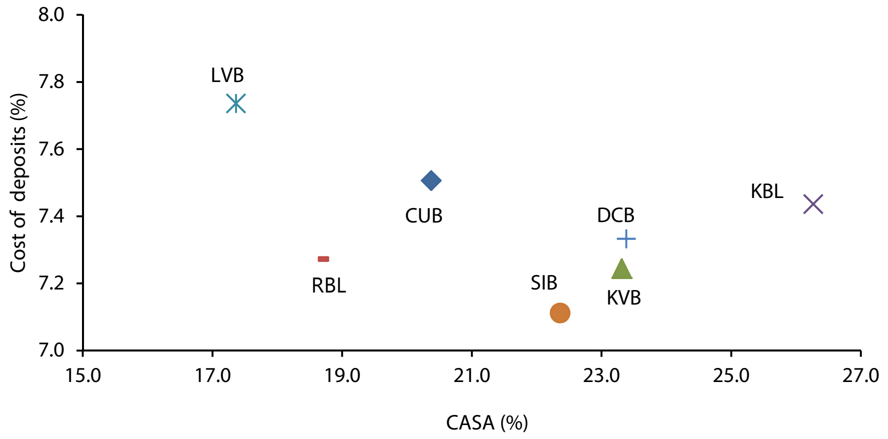



*Source: Company, Centrum Research Estimates*

## Margins to expand following recent deposit rate cuts

While KBL's CASA ratio has increased and fairs well as compared to its regional peers, its cost of deposits has remained higher, thus impacting margins. Elevated deposit rates had impacted cost of funds and thus margins in the past.

**Exhibit 21: KBL's cost of deposits remains high, even as CASA proportion remains healthy (FY16)**

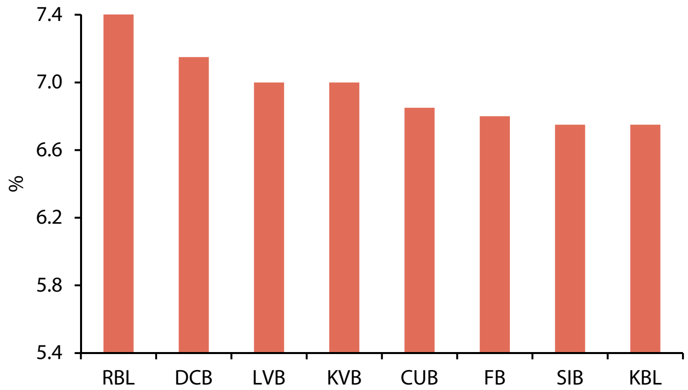



*Source: Companies, Centrum Research.*

As excessive deposit growth in the past depressed LDRs, KBL has resorted to reducing its deposit rates in the recent past. Its deposit rate at 6.75% for term deposits in the 1-3 year bucket is the lowest among peers. KBL has 46% of its deposits in the 1-3 year bucket and runs a tight ALM portfolio with average duration of ~2-years for both deposits and loans.

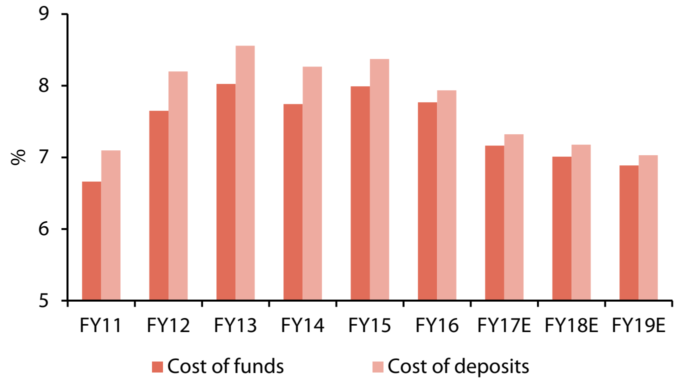
We believe that with the increasing proportion of CASA deposits and adequate headroom to mobilise funds under an alternate window i.e. AT-I bonds/ tier-II bonds, the overall cost of funds is set to decline over FY16-19 which in-turn will aid in margin expansion.

**Exhibit 22: Currently KBL's term deposit rate (1-3yr bucket) is the lowest among peers**




*Source: Companies, Centrum Research*

**Exhibit 23: Improved liability franchise will lead to decline in the cost of deposits and cost of funds over FY16-19E**

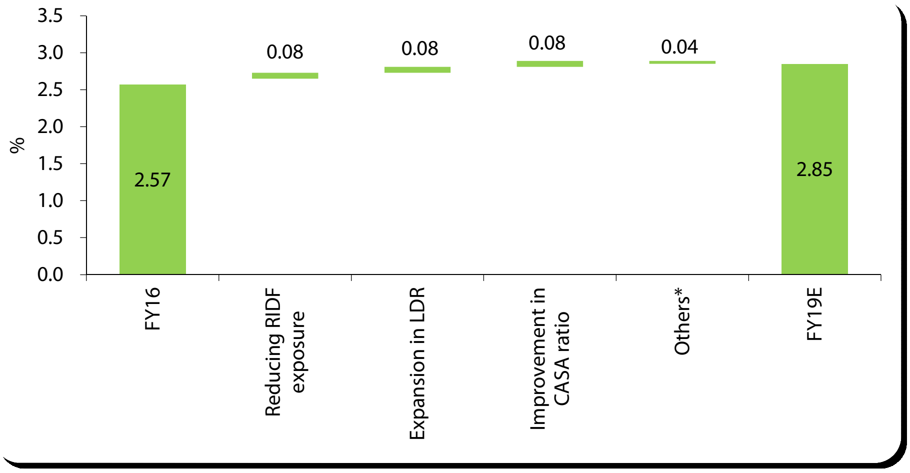



*Source: Company, Centrum Research Estimates*

Our calculations suggest 5bps positive impact on NIM following 135bps increase in CASA ratio over FY13-16. We estimate an additional 8bps positive impact on NIM over FY16-19, driven by continued traction in building the retail liability franchise, especially in the nature of CASA deposits. Our calculation for NIM expansion is based on CASA increasing by 263bps to 28.9% by end-FY19E.

We believe that a) reduction in deposit rates and the increasing share of CASA deposits b) focus on the retail-SME nature of loan franchise c) rising loan-deposit ratio and d) further decline in RIDF exposure will aid in margin expansion. Our interaction with the management and a closer look into factors that impact NIM makes us believe that NIM will improve by 28bps to 2.9% over FY16-19E.

**Exhibit 24: Factors contributing to margin expansion over FY16-19E**




*Source: Centrum Research Estimates*

**Lower slippages or higher-than-anticipated credit growth:** We have assumed a higher slippage ratio of 300bps (average over FY16E-19E) which stood at an average 270bps over FY13-16. Going forward, If the slippage ratio further improves on account of fewer fresh delinquencies, then there will be further tailwinds to the net spread and NIM on account of lower-than-expected interest reversals. NIM could increase further in the event of higher-than-expected credit growth.

We however have not factored these assumptions into our NIM calculations. We firmly believe that drivers that can lead to NIM improvement are at a low base and hence we see limited downside risk to our estimates.

## Cost-ratios intact; steps to shore non-interest income initiated

- **Employee productivity is near best among its peers; well-contained costs have led to the cost-assets ratio remain intact at 183bps (FY16) which is competitive to its peer set.**
- **Efforts underway at shoring up the non-interest income franchise which will lead to an uptrend in its share to total assets.**

KBL's cost/assets ratio at 183bps (FY16), is the best among its peers and is an outcome of its well-drawn strategy towards branch addition and the ability to quickly turn-around the same. This is even as the employee base continues to be driven by the IBA board and the need for provisioning towards pension and wage-revision has seen employee cost remain higher compared to regional peers.

One of the reasons for KBL's cost-efficiency is its ability to quickly turnaround branches. 62% of its branches are in its home-state; ~78% of its branches are in south India. On the loan side, the contribution of home-state is 45%. Regional banks which tend to have a high concentration of business and branches in their home-states have shown ability to quickly break-even.

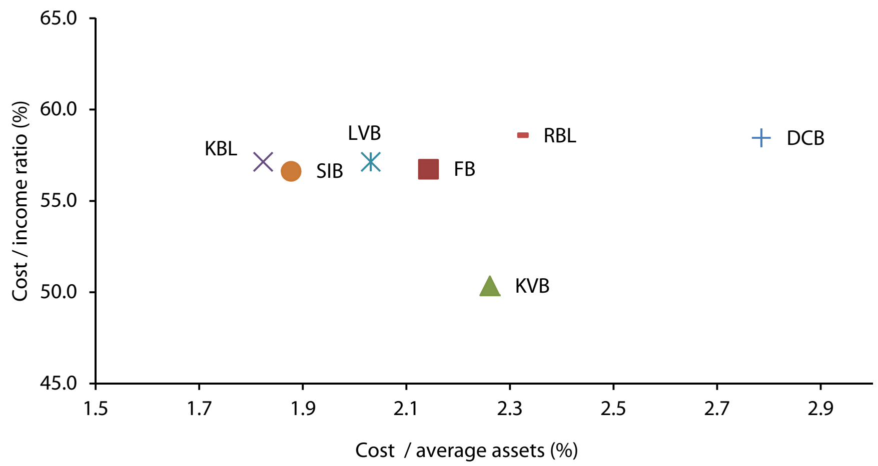
**Exhibit 25: Regional banks have a larger proportion of branches in their home-states**

| Bank | Total branches | % of branches in home-state |
|---|---|---|
| City Union Bank | 528 | *68.6* |
| Federal Bank | 1,252 | *47.9* |
| Karur Vysya Bank | 706 | *53.1* |
| Karnataka Bank | 738 | *62.1* |
| Lakshmi Vilas Bank | 460 | *55.9* |
| South Indian Bank | 840 | *54.2* |

*Source: Companies, Centrum Research.*

While KBL's cost-assets ratio has traditionally remained low, its elevated cost-income ratio (average of 54.5% over FY14-16) is due to its weak income profile, especially due to its lower margin profile and lower credit off-take over FY14-16.

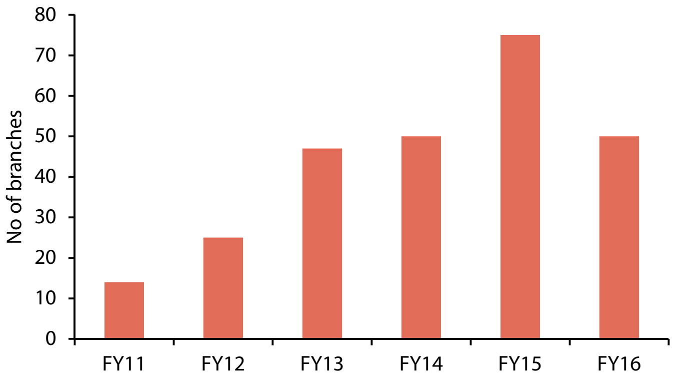
**Exhibit 26: KBL enjoys superior operating efficiency; cost-income ratio however remains high following a weak income trajectory (FY16)**




*Source: Companies, Centrum Research.*

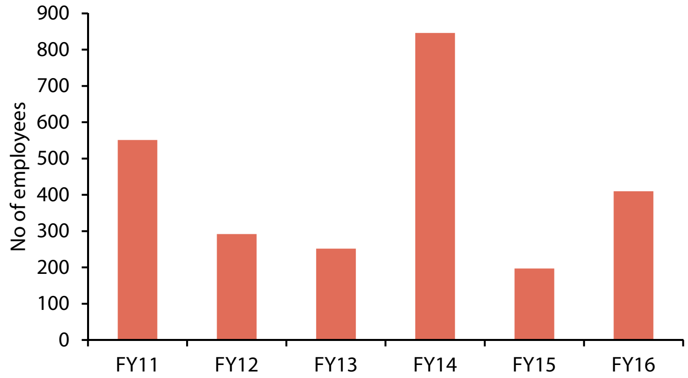
- While over FY11-FY16, KBL's cost-asset ratio has averaged 181bps, FY11 (1.87%) and FY14 (1.97%) saw a sharp rise in this ratio, primarily due to sizeable employee addition and provisioning towards wages and pension. In FY11 the bank added 551 employees; in FY14 the ratio escalated as it added 50 branches and 846 employees.
- Going forward, the bank management has guided at adding 40-50 branches per annum over FY16-19. Of these, 25% of the branches will be in the home state (the bank will fulfil the PSL requirements through these branches) and the remaining will be in states other than Karnataka.
- On the cost front, KBL already has a strong IT infrastructure platform in place. As for employee costs the bank has made provisions towards wage-related expenses in FY17. We thus are building in a higher cost/assets ratio at 200bps (average) over FY16-19E as we believe retail – SME and CASA will be the main drivers of the balance sheet growth going forward.

**Exhibit 27: Trend in branch additions**



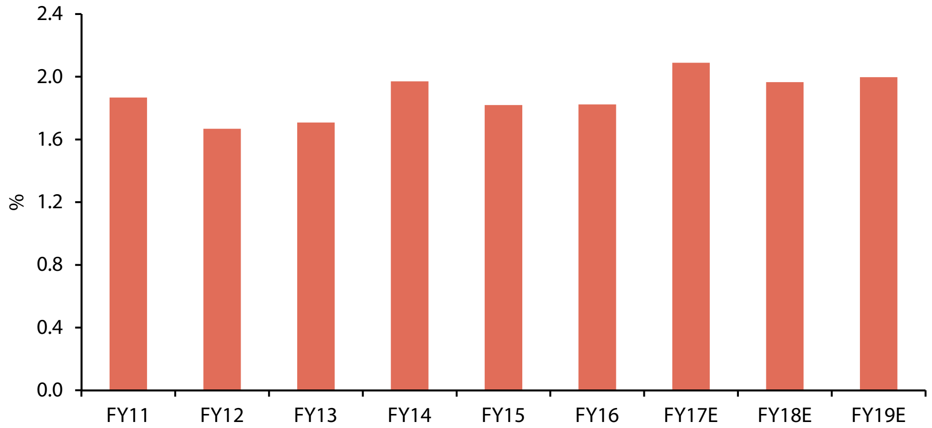

*Source: Company, Centrum Research*

**Exhibit 28: Trend in employee additions**




*Source: Company, Centrum Research*

**Exhibit 29: KBL's cost/ average assets ratio is expected to remain intact**



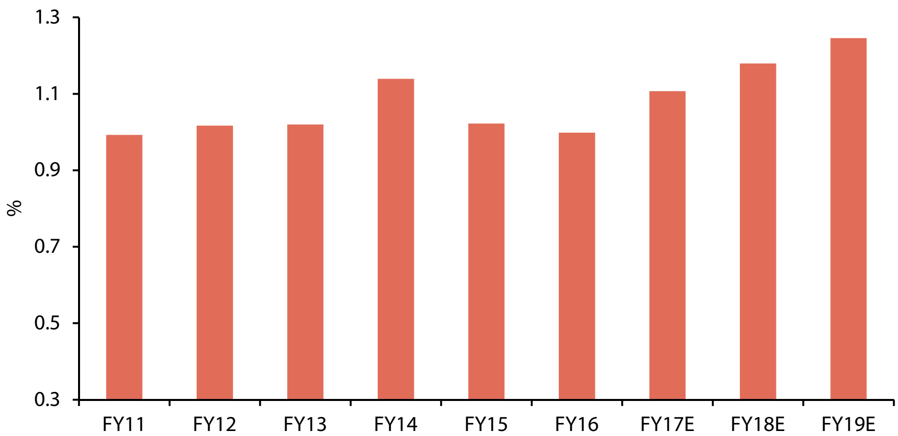

*Source: Company, Centrum Research Estimates*

## Non-interest income: See share rise over FY16-19E

Historically KBL's non-interest income to total asset ratio has stood at ~1%.

- However, given the pick-up in the fee income stream owing to a) superior asset-liability mix driven by retail and SME on the asset side and CASA ratio improvement on the liability side b) higher credit growth leading to higher loan processing fees, and c) increase in third party and distribution fees following a tie-up with LIC on the life insurance side and Bajaj Alliance on the General Insurance side and 3-4 mutual funds for mutual fund distribution, we expect non-interest income to trend upwards.

**Exhibit 30: Other income/ total average assets is expected to witness an increasing trend**




*Source: Company, Centrum Research Estimates*

## Asset quality trend to stabilise; building in provisioning buffers

- **Consortium nature of lending towards stressed sectors impacted the bank's asset quality trend. Slippage run-rate inched up to 300bps (over FY14-16) vs. 190bps (over FY11-13).**
- **The bank's problem loans stood at Rs42.6bn in Dec'16 (12% of loans); efforts towards asset quality resolution are underway.**
- **Factoring in 300bps of slippages / 90bps of credit cost over FY16-19E. Draw comfort in ability towards recovery/upgradation, also witnessed in the earlier cycle.**

In a bid to grow rapidly the bank adopted an aggressive stance towards growth over FY11-13. Consequently, over this period, the bank's exposure to stressed sectors transcended 20%. KBL's slippages remained higher over FY14-16 due to its consortium based nature of lending especially towards stressed sectors. Slippage run-rate inched up to an average 300bps over FY14-FY16 from 190bps in the earlier cycle of FY11-13.

The bank's problem loan portfolio stood at Rs42.6bn in Dec'16 and comprised - GNPAs (Rs15.6bn), restructured portfolio (Rs 13.3bn), 5:25 Rs4bn (entirely standard), SDR (Rs4.5bn) and S4A at Rs5.2bn (entirely standard). The bank's SMA-2 portfolio stood at Rs15.9bn.

- In a bid to contain the pace of bad loan addition, management has initiated various measures which includes a) separation of credit appraisal from branches to regional offices / central processing units b) setting up of a credit-monitoring team beginning FY16 and c) resorting to asset sale to ARCs
- Also, while the trend on bad loan accretion has been higher on the industrial exposure front, we draw comfort from the GNPA in retail/ SME portfolio. In FY16, personal loan GNPAs stood at 1.6% (vs. 1.8% in FY15); SME GNPAs stood at 3.5% (vs. 3.8%in FY15). With incremental growth targeted at the non-corporate portfolio i.e. retail-SME and agriculture, we don't expect a sharp spurt in slippages.

**Exhibit 31: Trend in GNPA**

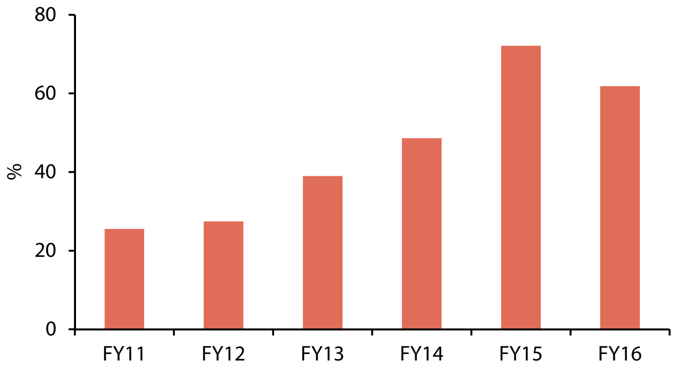
| % of loans | FY15 | FY16 |
|---|---|---|
| *Agriculture & allied activities* | *2.0* | *2.3* |
| *Industry* | *3.4* | *4.6* |
| *Services* | *3.8* | *3.5* |
| *Personal Loans* | *1.8* | *1.6* |

*Source: Company, Centrum Research*

- Our assumption about the stability in asset quality is also based on the premise of material reduction in exposure towards stressed sectors. In Dec'16, the bank's cumulative exposure to infrastructure, textile, gems and jewellery and iron and steel sector had declined to 16.1% from 23.3% in FY14. We are also reassured by the bank's increasing proportion of credit to higher rated corporates (see exhibit 43).

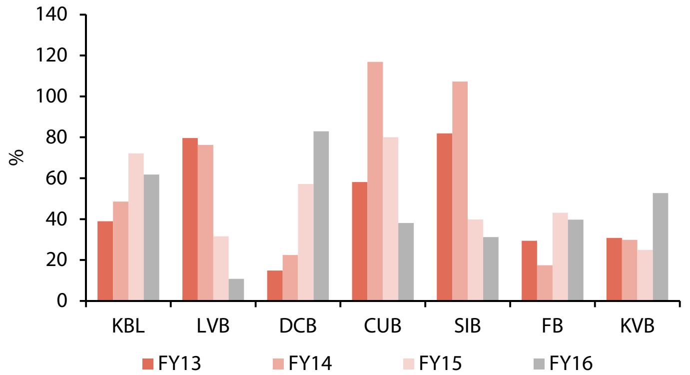
We also draw comfort from KBL's ability towards recovery/upgradation. This is evident from the fact that despite the challenging environment, recovery/upgradation as a proportion of GNPAs has inched up to 62% in FY16 from 26% in FY11. This ratio is better than some of its regional peers'.

**Exhibit 32: KBL's recovery-upgradation on the rise…**




*Source: Company, Centrum Research*

**Exhibit 33: … also when compared to its regional peers**



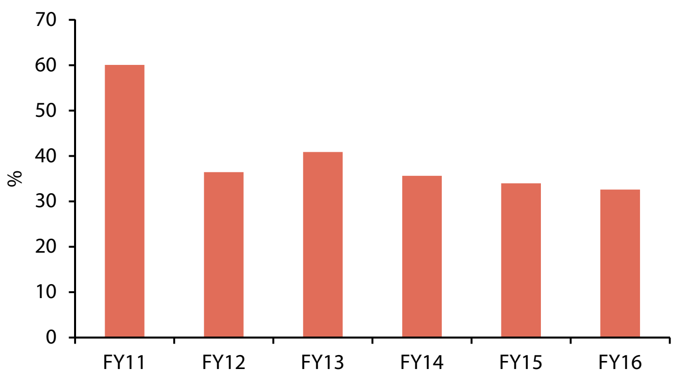

*Source: Companies, Centrum Research*

While we expect the trend in slippages to normalise as highlighted above, we remain conservative due to its large stressed asset portfolio and are modelling in slippages at 300bps over FY16-19E. Our assumptions on slippages factor in a certain degree of slippages from the SMA-2 portfolio and a hair-cut on the standard portfolio which is parked under restructured and other alternate windows i.e. 5:25 / SDR and S4A.

However, due to the bank's ability to reduce non-performing loans through recovery upgradation, and a pro-active stance towards asset sales to ARCs and w/offs, we expect GNPAs to decline to 3.3% by end-FY19E (vs. 4.3% as at Dec'16).

While we see asset quality normalising, we continue to factor in higher provisioning following a) the increasing proportion of bad loans in the D1/ D2 category and, b) the need for increasing the overall provisioning coverage ratio (PCR). The bank's PCR (calc) at 32.6% in FY16 is one of the lowest among its regional peers. Including technical write-offs, the same stood at 48%.

**Exhibit 34: The bank's PCR (calc). has remained low…**

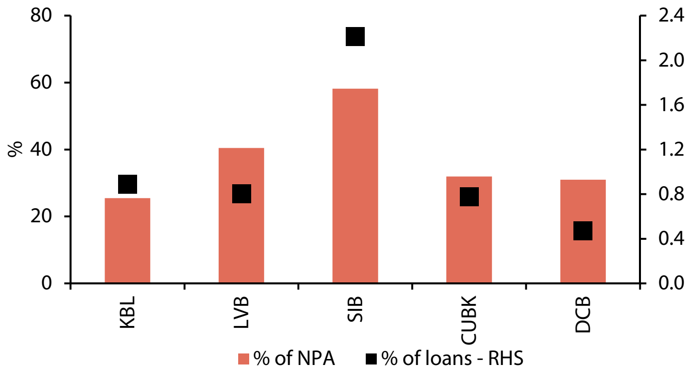



*Source: Company, Centrum Research*

**Exhibit 35: …also when compared to its regional peers (FY16)**

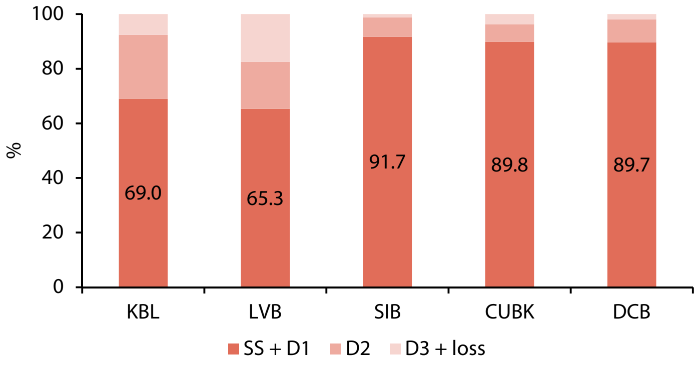

*Source: Companies, Centrum Research*

**Exhibit 36: Top-4 NPA accounts… Concentration risk remains low….(FY16)**




*Source: Companies, Centrum Research*

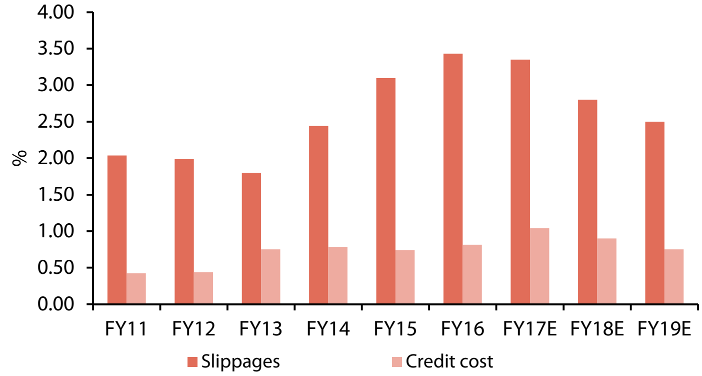
**Exhibit 37: …due to a larger proportion of bad loans in doubtful segments, provisioning remains high (FY16)**




*Source: Companies, Centrum Research*

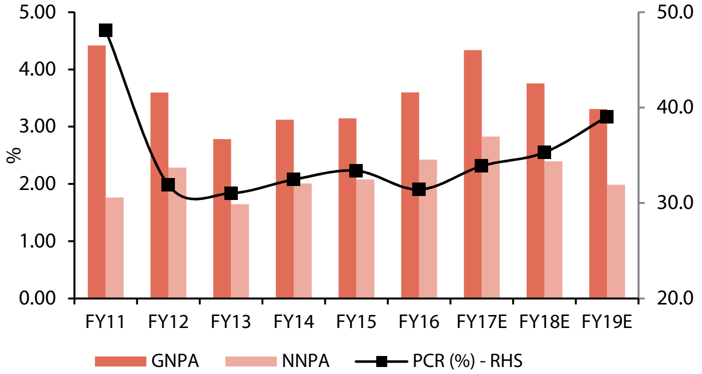
We thus are building in slippages/ credit cost at 300bps/ 90bps over FY16-19E for KBL. We expect PCR to gradually inch up towards 40% by FY19E. Including the technical write-offs, we see the same inch up to 55% levels.

**Exhibit 38: Building in 300bps / 90bps of slippages / credit cost for FY16-19E…**




*Source: Company, Centrum Research Estimates*

**Exhibit 39: …led by better recovery/upgradation and provisioning, we see GNPA / NNPA moderate.**




*Source: Company, Centrum Research Estimates*

**Exhibit 40: GNPA + restructuring across peer set banks (FY16)**

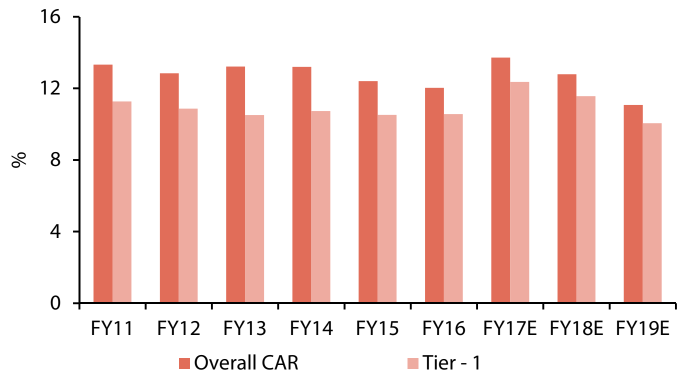
| % of loans | *Restructured portfolio* | *% Slippage to restructured from NPA* | *GNPA + restructuring* |
|---|---|---|---|
| CUB | *1.0* | *32.6* | *3.4* |
| LVB | *3.8* | *21.6* | *5.8* |
| SIB | *2.4* | *23.5* | *6.2* |
| KBL | *4.6* | *14.5* | *8.0* |
| RBL | *0.4* | *75.5* | *1.4* |

*Source: Companies, Centrum Research*

## Capital position strong; exposure to higher rated loans on the rise

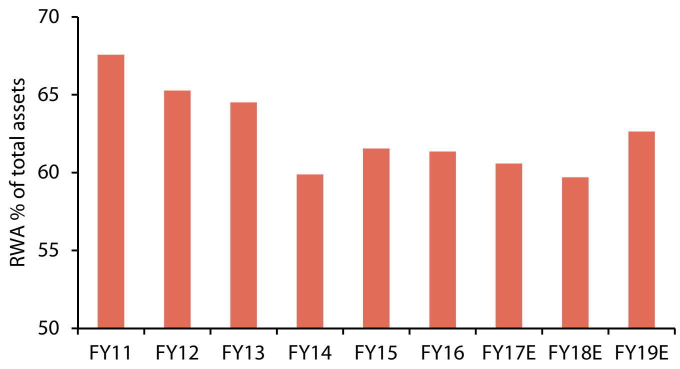
The bank's capital consumption has traditionally remained healthy, as evident from its risk-weighted assets/total assets ratio. KBL recently raised Rs6.6bn via right issues. Post the same, its overall CAR has inched up further to 13%+ levels including tier-I at 11%+.

**Exhibit 41: Capital position remains healthy…**




*Source: Company, Centrum Research Estimates*

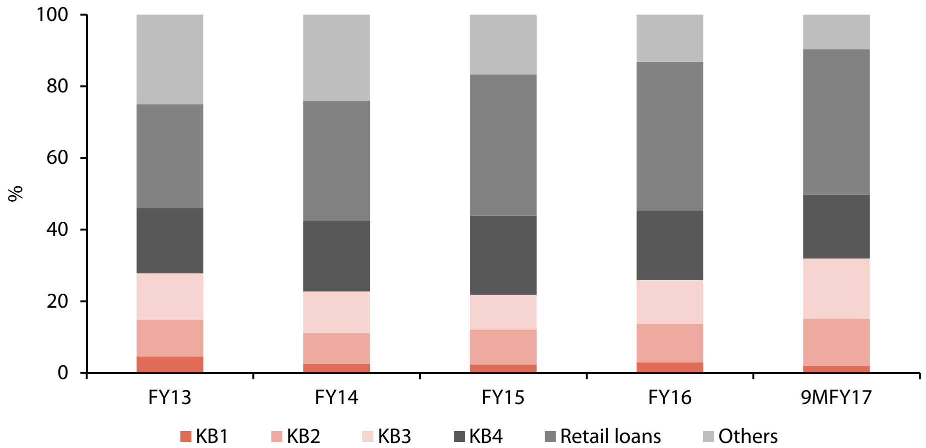
**Exhibit 42: …an outcome of effective capital consumption. Ratio of RWA/total assets has remained at ~60% levels.**




*Source: Company, Centrum Research Estimates*

The reason behind the bank's efficient capital management is its increasing proportion of exposure to internally higher rated loans. From 75% of loans (including retail loans) internally rated KB4 and above in FY13, the same had increased to 90% in 9MFY17.

**Exhibit 43: Exposure to internally higher rated (including retail) exposure has been on the rise**




*Source: Company, Centrum Research. Others indicate exposure between KB 5 to KB 8 and unrated loans.*

### What is the desired outcome?

The bank's concentrated efforts towards asset growth with a focused approach at curtailing overall interest cost will see NIM improve over FY16-19E. We expect the share of non-interest income to improve further; in addition, we expect cost/ income to decline and moderate at ~51% levels by end-FY19E. Even as we build in accelerated slippages, drawing a reference from the bank's ability towards recovery/upgradation, we see the overall trend in asset quality stabilising.

We expect the outcome of these efforts translating into a RoA/RoE of 1.0% /14.4% by end-FY19E. Starting with a low NIM base, we do not see any major risk to our estimates. Also, our estimates factor in potential risk to slippages in the event of a slower pace of revival in stressed exposure.

We thus are building in 15% CAGR in loans over FY16-19E (vs. 10% CAGR in loans over FY13-16). This will translate into 16%/ 20% CAGR in NII /PAT over FY16-19E.

**Exhibit 44: DuPont analysis**

| (% of avg assets) | FY15 | FY16 | FY17E | FY18E | FY19E |
|---|---|---|---|---|---|
| *Interest income* | *9.5* | *9.2* | *8.8* | *8.8* | *8.7* |
| *Interest expenses* | *7.1* | *6.8* | *6.2* | *6.1* | *6.0* |
| ***Net interest income*** | ***2.4*** | ***2.4*** | ***2.6*** | ***2.7*** | ***2.7*** |
| *Other income* | *1.0* | *1.0* | *1.1* | *1.2* | *1.2* |
| ***Total income*** | ***3.4*** | ***3.4*** | ***3.7*** | ***3.8*** | ***3.9*** |
| *Operating expenses* | *1.8* | *1.8* | *2.1* | *2.0* | *2.0* |
| ***pre-provisioning profit*** | ***1.6*** | ***1.6*** | ***1.6*** | ***1.9*** | ***1.9*** |
| *Provisions* | *0.4* | *0.6* | *0.8* | *0.8* | *0.7* |
| ***Profit Before Tax*** | *9.5* | *9.2* | *8.8* | *8.8* | *8.7* |
| *Tax* | *0.2* | *0.2* | *0.0* | *0.3* | *0.3* |
| ***Return on assets*** | ***0.9*** | ***0.8*** | ***0.7*** | ***0.8*** | ***1.0*** |
| *Leverage (x)* | *15.4* | *15.4* | *13.3* | *14.4* | *15.8* |
| ***Return on Equity*** | ***14.0*** | ***11.7*** | ***10.3*** | ***11.6*** | ***14.4*** |

*Source: Company, Centrum Research Estimates*

**Exhibit 45: KBL and its regional peers - … key financial parameters**

| FY16 – Rs mn | Karnataka Bank | Lakshmi Vilas Bank | City Union Bank | DCB Bank | RBL Bank | Federal Bank | Karur Vysya Bank | South Indian Bank |
|---|---|---|---|---|---|---|---|---|
| **Balance sheet** | | | | | | | | |
| **Equity** | **36,906** | **17,636** | **30,520** | **17,922** | **29,893** | **80,912** | **45,730** | **38,456** |
| **Deposits** | **5,04,882** | **2,54,310** | **2,71,581** | **1,49,260** | **2,43,487** | **7,91,717** | **5,00,789** | **5,19,125** |
| - CASA | 1,32,607 | 44,155 | 55,326 | 34,899 | 45,379 | 2,60,526 | 1,16,745 | 1,24,590 |
| *- CASA ratio(%)* | *26.3* | *17.4* | *20.4* | *23.4* | *18.6* | *32.9* | *23.3* | *24.0* |
| *- Term deposit ratio (%)* | *73.7* | *82.6* | *79.6* | *76.6* | *81.4* | *67.1* | *76.7* | *76.0* |
| **Loans** | **3,39,027** | **1,96,437** | **2,10,569** | **1,29,214** | **2,12,291** | **5,80,901** | **3,90,844** | **4,10,857** |
| *- Working capital (%)* | *40.2* | *63.3* | *66.2* | *22.2* | *28.8* | *58.2* | *78.8* | *50.8* |
| *- Term loan (%)* | *59.8* | *36.7* | *33.8* | *77.8* | *71.2* | *41.8* | *21.2* | *49.2* |
| **Total assets** | **5,65,003** | **2,87,322** | **3,12,520** | **1,91,185** | **3,91,611** | **9,14,300** | **5,76,637** | **6,31,749** |
| ***Stressed sector exposure*** | | | | | | | | |
| *Infrastructure (%)* | *5.9* | *7.7* | *0.5* | *1.4* | *4.6* | *8.4* | *8.6* | *10.2* |
| *Metal (%)* | *2.9* | *4.7* | *5.7* | *2.2* | *1.8* | *3.3* | *3.1* | *4.7* |
| *Textiles (%)* | *6.2* | *5.4* | *11.1* | *2.8* | *2.6* | *2.3* | *9.0* | *4.0* |
| **Du-pont analysis (%)** | | | | | | | | |
| *Interest earned* | *9.2* | *9.6* | *10.0* | *9.6* | *8.3* | *8.9* | *9.8* | *9.1* |
| *Interest expended* | *6.8* | *7.2* | *6.6* | *6.1* | *5.8* | *6.0* | *6.6* | *6.6* |
| ***Net interest income*** | ***2.4*** | ***2.4*** | ***3.3*** | ***3.5*** | ***2.5*** | ***2.9*** | ***3.2*** | ***2.5*** |
| *Other income* | *1.0* | *1.1* | *1.4* | *1.3* | *1.5* | *0.9* | *1.3* | *0.8* |
| ***Total income*** | ***3.4*** | ***3.6*** | ***4.7*** | ***4.8*** | ***4.0*** | ***3.8*** | ***4.5*** | ***3.3*** |
| *Operating expenses* | *1.8* | *2.0* | *1.9* | *2.8* | *2.3* | *2.1* | *2.3* | *1.9* |
| ***Pre-prov. profit*** | ***1.6*** | ***1.5*** | ***2.8*** | ***2.0*** | ***1.6*** | ***1.6*** | ***2.2*** | ***1.4*** |
| *Provisions* | *0.6* | *0.7* | *0.8* | *0.5* | *0.3* | *0.8* | *0.6* | *0.6* |
| *Tax* | *0.2* | *0.2* | *0.5* | *0.4* | *0.4* | *0.3* | *0.6* | *0.3* |
| ***RoAA*** | ***0.8*** | ***0.7*** | ***1.5*** | ***1.1*** | ***0.9*** | ***0.5*** | ***1.0*** | ***0.5*** |
| ***RoAE*** | ***11.7*** | ***10.9*** | ***15.5*** | ***11.5*** | ***11.2*** | ***5.9*** | ***12.9*** | ***9.0*** |
| **Productivity ratios** | | | | | | | | |
| Profit / employee (Rs mn) | 0.53 | 0.51 | 0.98 | 0.46 | 0.76 | 0.41 | 0.79 | 0.43 |
| Employee / Branch (no). | 10.7 | 7.8 | 8.6 | 21.5 | 19.7 | 9.4 | 10.8 | 9.3 |
| Oper. cost / employee (Rs mn) | 1.27 | 1.52 | 1.23 | 1.16 | 1.98 | 1.59 | 1.74 | 1.48 |
| **Asset quality** | | | | | | | | |
| GNPA | 11,804 | 3,913 | 5,120 | 1,974 | 2,081 | 16,678 | 5,112 | 15,624 |
| NNPA | 7,955 | 2,316 | 3,232 | 975 | 1,244 | 10,577 | 2,162 | 11,853 |
| *GNPA (%)* | *3.44* | *1.97* | *2.41* | *1.51* | *0.98* | *2.84* | *1.30* | *3.77* |
| *NNPA (%)* | *2.35* | *1.18* | *1.53* | *0.75* | *0.59* | *1.64* | *0.55* | *2.89* |
| *PCR (%) - calc* | *32.6* | *40.8* | *36.9* | *50.6* | *40.2* | *36.6* | *57.7* | *24.1* |
| **Capital Adequacy** | | | | | | | | |
| Tier – 1 Capital | 36,752 | 15,685 | 30,294 | 17,182 | 29,715 | 77,918 | 40,644 | 36,569 |
| Tier – 2 Capital | 5,101 | 3,569 | 1,026 | 1,769 | 4,915 | 3,336 | 3,295 | 7,438 |
| Risk-weighted assets (Rs mn) | 3,47,873 | 1,80,457 | 2,00,824 | 1,34,299 | 2,67,610 | 5,83,301 | 3,60,990 | 3,71,993 |
| *CAR (%)* | 12.0 | *10.7* | *15.6* | *14.1* | *12.9* | *13.9* | *12.2* | *11.8* |
| *Tier-1 (%)* | 10.6 | *8.7* | *15.1* | *12.8* | *11.1* | *13.4* | *11.3* | *9.8* |
| *Tier-2 (%)* | 1.5 | *2.0* | *0.5* | *1.3* | *1.8* | *0.6* | *0.9* | *2.0* |
| **Corporate governance** | | | | | | | | |
| Board of Directors | 12 | 12 | 10 | 13 | 12 | 10 | 11 | 10 |
| Independent Director | 9 | 6 | 6 | 10 | 6 | 8 | 4 | 7 |
| **Valuation** | | | | | | | | |
| Market cap (Rs mn) | 25,820 | 29,064 | 86,140 | 44,358 | 1,49,343 | 1,46,712 | 60,719 | 27,546 |
| P/E (x) | 6.1 | 16.1 | 19.4 | 22.8 | 51.1 | 30.8 | 10.7 | 8.3 |
| P/ABV (x) | 0.9 | 1.9 | 3.1 | 2.6 | 5.2 | 2.1 | 1.4 | 1.0 |

*Source: Companies, Centrum Research.*

## Valuation, view and key risks

We initiate coverage on KBL, with a Buy rating and TP of Rs170. Superior CASA franchise (26% as at FY16); better employee productivity and efficient cost management (cost/assets at 183bps in FY16), steady non-interest income and adequate capital consumption, have been the bank's key strengths.

On the flip-side, led by inefficient balance sheet management, margins have remained low, even as compared to peers'. This in addition to asset-quality headwinds, especially in the recent past and the need for provisioning thereon has curtailed RoAs to 0.8% levels.

We believe that the steps directed at addressing the near-term challenges i.e. NIM and asset quality are in the right direction and any material improvement therein will translate into a considerable increase in RoAs. We see RoA/ RoE inch up to 1.0% /14.4% by end-FY19E, best ever since FY09.

Banks with a consistent improvement in key performance indicators tend to graduate to higher multiples. We see a similar kind of re-rating due in case of KBL. We value the bank at 1.2x FY19E ABV leading to a TP of Rs170 (21.5% upside). Initiate with a BUY.

**Key risks:** Lower than expected credit growth in retail-SME portfolio; higher delinquencies from the corporate portfolio or slow pace of traction on NIM front.

### Can be a sought-after franchise when spruced up

Until recently, before Kotak Bank acquired ING Vysya Bank in CY15, M&A activities in the Indian banking space were largely confined to the acquisition of weak banks or managements looking for an exit. One of the key parameters to evaluate the potential value was the number of branches the acquirer gained. Valuation multiples ascribed to each transaction were unique and entirely dependent on franchise value and how much the merged entity would gain post acquisition.

**Exhibit 46: M&A activity in the banking space**

| Year | Name of the acquire bank | Branches (nos) | Acquirer Bank | Consideration paid (Rs mn) | Implied P/B (x) | Per branch (Rs mn) | |
|---|---|---|---|---|---|---|---|
| | | | | | | Advances | Deposits |
| 2000 | Times Bank | 39 | HDFC bank | 2,186 | 1.3 | 336 | 772 |
| 2001 | Bank of Madura | 355 | ICICI Bank | 3,426 | 2.6 | 99 | 33 |
| 2002 | Vysya Bank | 380 | ING N.V | 3,408 | 2.5 | 116 | 212 |
| 2006 | Lord Krishna | 112 | Centurion Bank of Punjab | 3,376 | 1.8 | 203 | 127 |
| 2006 | Sangli Bank | 198 | ICICI Bank | 3,004 | 12 | 101 | 45 |
| 2008 | Centurion Bank of Punjab | 394 | HDFC Bank | 112,671 | 5.4 | 377 | 285 |
| 2010 | Bank of Rajasthan | 463 | ICICI Bank | 24,737 | 2.4 | 325 | 180 |
| 2015 | ING Vysya Bank | 560 | Kotak Bank | 150,000 | 2.1 | 649 | 736 |

*Source: Companies, Media, Centrum Research*

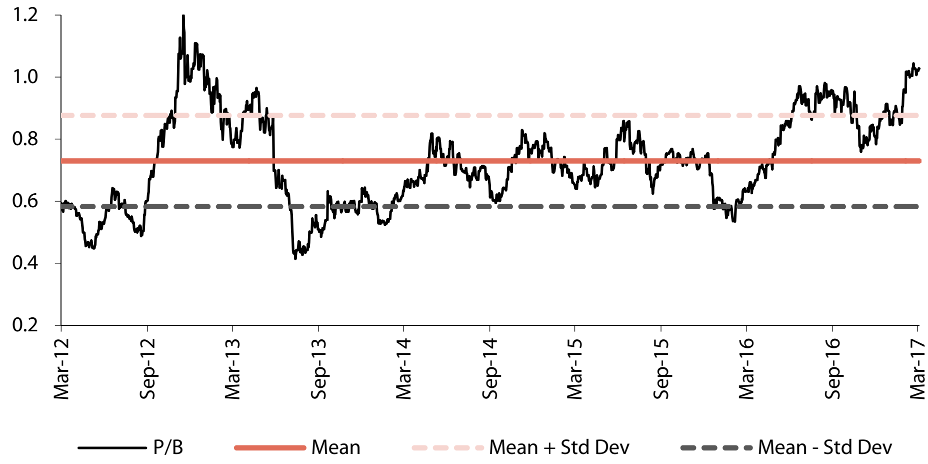
## Sensitivity analysis and peer comparison

### Exhibit 47: Sensitivity Analysis – impact of change in NIM and credit cost on FY18PBT

| % | | Credit cost | | | | |
|---|---|---|---|---|---|---|
| | | + 10bps | + 20bps | ' Current levels | - 10bps | - 20bps |
| NIM | - 5bps | *(9.8)* | *(15.4)* | *(4.2)* | *1.3* | *6.9* |
| | - 10bps | *(14.0)* | *(19.6)* | *(8.5)* | *(2.9)* | *2.7* |
| | Current levels | *(5.6)* | *(11.2)* | - | *5.6* | *11.2* |
| | + 5bps | *(1.3)* | *(6.9)* | *4.2* | *9.8* | *15.4* |
| | + 10bps | *2.9* | *(2.7)* | *8.5* | *14.0* | *14.0* |

*Source: Centrum Research Estimates*

### Exhibit 48: Rolling forward P/B chart




*Source: Bloomberg, Company, Centrum Research Estimates*

### Exhibit 49: Comparative Valuations

| Company Name | Mkt Cap (Rs mn) | *CAGR (FY16-FY18E) %* | | | PE (x) | | | *RoA (%)* | | | *RoE (%)* | | | P/BVPS (x) | | | *Div Yield (%)* | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | *NII + Oth inc* | *PPOP* | *PAT* | FY16 | FY17E | FY18E | *FY16* | *FY17E* | *FY18E* | *FY16* | *FY17E* | *FY18E* | FY16 | FY17E | FY18E | *FY16* | *FY17E* | *FY18E* |
| **KBL*** | **39,550** | ***15.8*** | ***19.9*** | ***14.9*** | **4.5** | **7.6** | **7.2** | ***0.8*** | ***0.7*** | ***0.8*** | ***11.7*** | ***10.3*** | ***11.6*** | **0.5** | **0.7** | **0.8** | ***5.0*** | ***3.5*** | ***3.0*** |
| CUBK* | 85,712 | *14.4* | *14.2* | *22.0* | 13.6 | 14.6 | 14.2 | *1.4* | *1.6* | *1.6* | *14.1* | *16.1* | *16.2* | 1.8 | 2.2 | 2.2 | *1.7* | *1.1* | *1.1* |
| DCBB* | 48,805 | *18.5* | *14.4* | *12.4* | 15.5 | 16.5 | 14.1 | *1.1* | *0.9* | *0.9* | *11.9* | *10.8* | *11.9* | 1.7 | 1.7 | 1.6 | *0.0* | *0.0* | *0.0* |
| FB | 1,55,920 | *37.0* | *80.0* | *49.7* | 21.8 | 14.6 | 14.5 | *0.5* | *0.9* | *1.0* | *5.9* | *11.8* | *13.4* | 1.3 | 1.3 | 1.6 | *1.2* | *1.5* | *1.1* |
| KVB | 65,477 | *29.7* | *23.7* | *8.3* | 9.8 | 10.7 | 10.1 | *1.0* | *0.9* | *1.1* | *12.9* | *12.6* | *14.5* | 1.2 | 1.2 | 1.2 | *3.1* | *3.0* | *2.6* |
| RBL | 1,79,949 | *74.2* | *64.1* | *47.2* | | 30.3 | 29.0 | *1.0* | *1.1* | *1.2* | *12.5* | *13.8* | *16.1* | | 3.3 | 3.7 | *0.4* | *0.5* | *0.4* |
| SIB | 30,197 | *32.1* | *58.7* | *22.1* | 8.6 | 7.5 | 6.8 | *0.5* | *0.6* | *0.7* | *9.0* | *11.0* | *11.9* | 0.7 | 0.8 | 0.8 | *2.3* | *2.6* | *2.5* |

*Source: Bloomberg consensus, *Centrum Research Estimates*

## Quarterly financials

### Exhibit 50: Quarterly Financials

| (Rs mn) | Q4FY15 | Q1FY16 | Q2FY16 | Q3FY16 | Q4FY16 | Q1FY17 | Q2FY17 | Q3FY17 |
|---|---|---|---|---|---|---|---|---|
| **Income statement** | | | | | | | | |
| Interest earned | 11,964 | 12,291 | 12,485 | 12,371 | 12,777 | 12,606 | 13,064 | 13,239 |
| Interest expended | 9,050 | 8,977 | 9,415 | 9,322 | 9,179 | 8,959 | 9,091 | 9,474 |
| **Net interest income** | **2,913** | **3,313** | **3,070** | **3,049** | **3,597** | **3,647** | **3,973** | **3,765** |
| Non-interest income | 1,117 | 1,191 | 1,210 | 1,327 | 1,700 | 1,744 | 1,897 | 1,336 |
| **Total income** | **4,030** | **4,504** | **4,280** | **4,377** | **5,297** | **5,391** | **5,870** | **5,101** |
| Operating expenses | 2,137 | 2,114 | 2,585 | 2,460 | 2,754 | 2,771 | 3,542 | 3,382 |
| **PPOP** | **1,894** | **2,390** | **1,695** | **1,917** | **2,544** | **2,619** | **2,328** | **1,719** |
| Provisions | (45) | 1,159 | 351 | 631 | 1,125 | 1,363 | 1,306 | 1,006 |
| **PBT** | **1,938** | **1,232** | **1,344** | **1,286** | **1,419** | **1,256** | **osses 713** | **713** |
| Tax | 594 | 138 | 322 | 317 | 351 | 41 | (216) | 27 |
| **Reported PAT** | **1,344** | **1,093** | **1,022** | **969** | **1,068** | **1,215** | **1,238** | **685** |
| **Ratios** | | | | | | | | |
| **Growth YoY (%)** | | | | | | | | |
| *NII* | *16.6* | *19.1* | *3.3* | *1.0* | *23.5* | *10.1* | *29.4* | *23.5* |
| *Non-interest income* | *(2.0)* | *(26.8)* | *17.7* | *(18.5)* | *52.2* | *46.4* | *56.8* | *0.7* |
| *Opex* | *(22.2)* | *(3.8)* | *8.9* | *(12.7)* | *28.9* | *31.1* | *37.0* | *37.5* |
| *PPOP* | *112.4* | *8.1* | *4.2* | *4.6* | *34.3* | *9.6* | *37.3* | *(10.3)* |
| *Reported PAT* | *65.5* | *(10.1)* | *15.5* | *(9.4)* | *(20.6)* | *11.2* | *21.2* | *(29.3)* |
| *Loans* | *11.8* | *8.7* | *9.2* | *8.5* | *7.0* | *11.5* | *12.8* | *8.7* |
| *Deposits* | *13.4* | *9.3* | *10.6* | *10.9* | *9.7* | *10.1* | *8.6* | *15.6* |
| **Margins (%)** | | | | | | | | |
| *Yield on total assets* | *12.2* | *12.4* | *12.4* | *12.1* | *15.3* | *14.6* | *11.8* | *11.9* |
| *Cost of funds* | *7.5* | *7.3* | *7.4* | *6.9* | *7.1* | *7.0* | *6.6* | *6.5* |
| *Spread* | *4.4* | *4.8* | *4.7* | *4.6* | *8.0* | *7.6* | *4.9* | *5.1* |
| *NIM* | *4.2* | *4.5* | *4.2* | *4.4* | *8.2* | *7.6* | *4.5* | *4.7* |
| **Key drivers (%)** | | | | | | | | |
| *Cost-income* | *53.0* | *46.9* | *60.4* | *56.2* | *52.0* | *51.4* | *60.3* | *66.3* |
| *GNPA* | *3.0* | *3.3* | *3.2* | *3.6* | *3.4* | *3.9* | *3.6* | *4.3* |
| *NNPA* | *2.0* | *2.1* | *2.0* | *2.4* | *2.4* | *2.6* | *2.6* | *3.0* |
| *Provision coverage* | *34.0* | *38.2* | *39.1* | *33.4* | *32.6* | *34.4* | *28.5* | *31.7* |
| *Tier I CAR* | *10.5* | *10.3* | *10.1* | *10.0* | *10.6* | *10.3* | *0.0* | *11.9* |
| *Tier II CAR* | *1.9* | *1.8* | *1.7* | *1.7* | *1.5* | *1.4* | *0.0* | *1.3* |
| *RoA* | *1.3* | *1.1* | *0.9* | *0.9* | *1.3* | *1.4* | *1.1* | *0.6* |
| *RoE* | *31.7* | *25.8* | *22.7* | *10.6* | *23.1* | *-* | *25.2* | *13.0* |

*Source: Company, Centrum Research*

**Analysis of Q3FY17 results:** NII de-grew by 5.2% QoQ but grew 23.5% YoY. Due to demonetisation, the bank witnessed credit de-growth of 2.3% QoQ and 8.7% growth YoY. As a result, due to weak credit off-take and interest reversals on account of higher slippages, the bank's NIM declined by 8bps QoQ to 2.54%. Cost to income at 66.3% looks elevated on three accounts 1) higher employee expenses on account of higher pension provisioning, 2) higher operating expenses on account demonetisation and 3) depressed total income due to lower NII and other income. Reported GNPAs and NNPAs came in at 4.3% and 3.0% respectively, worsening QoQ by 66bps and 36bps respectively. While GNPAs look optically higher on account of tepid credit growth, NNPAs worsened on account of lower PCR. Consequently, PAT declined 44.5% YoY.

**Exhibit 51: Shareholding pattern (%)**

| | Q3FY17 | Q2FY17 | Q1FY17 | Q4FY16 |
|---|---|---|---|---|
| *Promoter* | *0.0* | *0.0* | *0.0* | *0.0* |
| *FII* | *20.2* | *23.1* | *19.6* | *19.0* |
| *DII* | *8.5* | *8.8* | *9.8* | *10.7* |
| *Others* | *71.4* | *68.1* | *70.6* | *70.4* |

*Source: BSE*

## Company Background

Karnataka Bank, with an asset base of US$5bn, is one of the old-generation private sector banks in India. It currently operates through 738 branches and 1,334 ATMs spread across the country. The bank enjoys a respectable 3%+ market share in home-state credit. It has 62% of branches in its home-state and originates ~45% of loans from the said region. In terms of its rating profile, KBL's tier-2 bonds are rated CARE A and ICRA A. Certificate of deposits are rated ICRA A1+.

KBL, a leading 'A' Class Scheduled Commercial Bank in India, was incorporated on February 18th, 1924 at Mangalore, a coastal town of Dakshina Kannada district in Karnataka State. With over 9 decades of experience at the forefront of providing professional banking services and quality customer service, the bank now has a national presence with a network of 738 branches spread across 21 states and 2 Union Territories. The bank has over 7,669 employees, 1,22,000 shareholders and over 9.2 million customers.

**Exhibit 52: Key management personnel**

| Name | Position | Profile |
|---|---|---|
| Mr. P. Jayarama Bhat | MD & CEO | Mr. P. Jayarama Bhat has been associated with the bank for the past 44-years. He is a Certified Associate of Indian Institute of Bankers (CAIIB). His banking experience spans four decades. He joined KBL as an officer in 1973 and over a period of time got promoted to various positions. In the year 2005, he was promoted as the Chief General Manager of the bank and has been entrusted with the responsibilities of overall supervision of operational areas of the bank. He was appointed as Managing Director & CEO of the bank on 14th July 2009. On completion of his 2nd term he was re-appointed for a third consecutive term of three years w.e.f. 14.07.2015. |
| Mr.Ashok. Haranahalli | Director | Mr Ashok Haranahalli, has been on the Board since 14.09.2012. He has a Bachelor's degree in Law. He has rich experience in the field of Law and also agriculture. |
| Mr. Mahabaleswara Bhat | Chief General Manager | A post graduate in agricultural sciences, he has over 29 years of banking experience both at operational and administrative levels. He started his career as a researcher and teacher at the University of Agricultural Sciences, Bangalore and joined the bank as an agricultural field officer in 1984. On his promotion as chief manager and later on as assistant general manager he served at the credit department and planning and development department at its head office. He has good experience in administration of agricultural and rural credit', retail, MSME and corporate finance, forex business, and so on. |

*Source: Company*

# Financials (historical)

## Exhibit 53: Income Statement

| Y/E March (Rs mn) | FY10 | FY11 | FY12 | FY13 | FY14 |
|---|---|---|---|---|---|
| Interest Income | 19,760 | 23,709 | 31,010 | 37,643 | 41,888 |
| Interest Expense | 17,078 | 17,584 | 23,689 | 28,606 | 31,328 |
| **Net Interest Income** | **2,682** | **6,125** | **7,321** | **9,037** | **10,561** |
| **Non-Interest Income** | 3,787 | 2,918 | 3,463 | 3,977 | 5,056 |
| - Fee & Other Income | 1,263 | 1,623 | 1,741 | 1,872 | 2,137 |
| -Gains / (Losses) on Securities | 1,822 | 443 | 502 | 531 | 1,017 |
| **Total Net Income** | **6,469** | **9,042** | **10,784** | **13,014** | **15,617** |
| **Total Operating Expenses** | **3,861** | **5,490** | **5,682** | **6,660** | **8,746** |
| Employee Expenses | 2,068 | 3,451 | 3,250 | 3,751 | 5,254 |
| Other Operating Expenses | 1,793 | 2,039 | 2,432 | 2,910 | 3,492 |
| **Pre-provision Profit** | **2,608** | **3,553** | **5,102** | **6,353** | **6,871** |
| **Provisions & Contingencies** | **703** | **1,204** | **2,216** | **1,712** | **2,784** |
| NPA Provisions | 810 | 675 | 838 | 1,723 | 2,105 |
| Other Provisions | (107) | 529 | 1,379 | (12) | 679 |
| **Profit Before Tax** | **1,905** | **2,349** | **2,886** | **4,642** | **4,087** |
| Taxes | 226 | 303 | 425 | 1,161 | 976 |
| **Profit after tax** | **1,671** | **2,046** | **2,461** | **3,481** | **3,110** |
| Exceptional items | 2 | 6 | 25 | (13) | 13 |
| **Adj Net Profit** | **1,669** | **2,040** | **2,436** | **3,494** | **3,097** |

*Source: Company, Centrum Research*

## Exhibit 54: Balance sheet

| Y/E March (Rs mn) | FY10 | FY11 | FY12 | FY13 | FY14 |
|---|---|---|---|---|---|
| Cash and balance with RBI | 17,431 | 19,398 | 17,048 | 17,180 | 21,527 |
| Inter-bank borrowings | 625 | 463 | 1,608 | 2,358 | 1,847 |
| Loans & Advances | 1,44,357 | 1,73,481 | 2,07,207 | 2,52,077 | 2,83,455 |
| Investments | 91,827 | 1,08,156 | 1,18,986 | 1,24,581 | 1,38,602 |
| **Total Int Earning Assets** | **2,36,808** | **2,82,099** | **3,27,802** | **3,79,016** | **4,23,904** |
| Fixed Assets | 1,481 | 1,455 | 1,522 | 1,670 | 1,975 |
| Other Assets | 6,869 | 7,451 | 7,978 | 8,405 | 10,616 |
| **Total Assets** | **2,70,682** | **3,17,311** | **3,63,775** | **4,16,014** | **4,71,688** |
| Deposits | 2,37,307 | 2,73,365 | 3,16,083 | 3,60,562 | 4,05,828 |
| Current | 17,065 | 18,561 | 21,015 | 24,624 | 27,488 |
| Savings | 38,137 | 49,465 | 56,614 | 65,200 | 75,588 |
| Term | 1,82,105 | 2,05,338 | 2,38,454 | 2,70,739 | 3,02,753 |
| Other Int Bearing Liabilities | 6,916 | 10,863 | 11,471 | 15,798 | 19,152 |
| **Interest Bearing Liabilities** | **2,44,223** | **2,84,228** | **3,27,554** | **3,76,360** | **4,24,980** |
| Other non int bearing Liab | 8,132 | 8,792 | 10,239 | 11,084 | 16,186 |
| Total Liabilities | 2,52,355 | 2,93,020 | 3,37,793 | 3,87,444 | 4,41,166 |
| Equity | 18,328 | 24,291 | 25,982 | 28,571 | 30,522 |
| **Total Liabilities** | **2,70,682** | **3,17,311** | **3,63,775** | **4,16,014** | **4,71,688** |

*Source: Company, Centrum Research*

## Exhibit 55: DuPont analysis

| *(% of avg assets)* | *FY10* | *FY11* | *FY12* | *FY13* | *FY14* |
|---|---|---|---|---|---|
| *Interest income* | 7.9 | 8.1 | 9.1 | 9.7 | 9.4 |
| *Interest expenses* | 6.8 | 6.0 | 7.0 | 7.3 | 7.1 |
| ***NII*** | **1.1** | **2.1** | **2.1** | **2.3** | **2.4** |
| *Other income* | 1.5 | 1.0 | 1.0 | 1.0 | 1.1 |
| ***Total income*** | **2.6** | **3.1** | **3.2** | **3.3** | **3.5** |
| *Operating expenses* | 1.5 | 1.9 | 1.7 | 1.7 | 2.0 |
| ***PPOP*** | **1.0** | **1.2** | **1.5** | **1.6** | **1.5** |
| *Provisions* | 0.3 | 0.4 | 0.7 | 0.4 | 0.6 |
| ***PBT*** | **0.8** | **0.8** | **0.8** | **1.2** | **0.9** |
| *Tax* | 0.1 | 0.1 | 0.1 | 0.3 | 0.2 |
| ***RoA*** | **0.7** | **0.7** | **0.7** | **0.9** | **0.7** |
| *Leverage* | 14.8 | 13.1 | 14.0 | 14.6 | 15.5 |
| ***RoE*** | **9.8** | **9.6** | **9.8** | **12.8** | **10.5** |

*Source: Company, Centrum Research*

## Exhibit 56: Financial ratios

| Y/E March | FY10 | FY11 | FY12 | FY13 | FY14 |
|---|---|---|---|---|---|
| **B/S Structure Ratios (%)** | | | | | |
| *CD Ratio* | 60.8 | 63.5 | 65.6 | 69.9 | 69.8 |
| *Incremental CD Ratio* | 77.3 | 80.8 | 78.9 | 100.9 | 69.3 |
| *CASA Ratio* | 23.3 | 24.9 | 24.6 | 24.9 | 25.4 |
| **Growth Ratios (%)** | | | | | |
| *Loans* | 22.2 | 20.2 | 19.4 | 21.7 | 12.4 |
| *Deposits* | 16.7 | 15.2 | 15.6 | 14.1 | 12.6 |
| *NII* | (46.9) | 128.4 | 19.5 | 23.4 | 16.9 |
| *Opex* | 11.4 | 42.2 | 3.5 | 17.2 | 31.3 |
| *PPOP* | (45.7) | 36.2 | 43.6 | 24.5 | 8.1 |
| *Provisions* | (12.5) | 71.1 | 84.1 | (22.8) | 62.6 |
| *PAT* | (37.3) | 22.4 | 20.3 | 41.5 | (10.6) |
| **Operating Ratios (%)** | | | | | |
| *Yield on funds* | 8.2 | 8.3 | 9.4 | 9.9 | 9.7 |
| *Cost of funds* | 7.0 | 6.2 | 7.1 | 7.5 | 7.2 |
| *NIM* | 1.1 | 2.1 | 2.2 | 2.4 | 2.4 |
| *Non-int inc / Total income* | 1.5 | 1.0 | 1.0 | 1.0 | 1.1 |
| *Fee to avg assets* | 0.5 | 0.6 | 0.5 | 0.5 | 0.5 |
| *Cost/Income* | 59.7 | 60.7 | 52.7 | 51.2 | 56.0 |
| *Opex/ Avg assets* | 1.5 | 1.9 | 1.7 | 1.7 | 2.0 |
| *Provisioning cost* | 0.6 | 0.4 | 0.4 | 0.8 | 0.8 |
| *Effective tax rate* | 11.9 | 12.9 | 14.7 | 25.0 | 23.9 |
| *RoA* | 0.7 | 0.7 | 0.7 | 0.9 | 0.7 |
| *RoE* | 9.8 | 9.6 | 9.8 | 12.8 | 10.5 |
| **Credit Quality Ratios (%)** | | | | | |
| *Gross NPA* | 4.2 | 4.4 | 3.6 | 2.8 | 3.1 |
| *Net NPA* | 1.4 | 1.8 | 2.3 | 1.6 | 2.0 |
| *Slippage rate to op advances* | 2.3 | 2.0 | 2.0 | 1.8 | 2.4 |
| *NPA coverage ratio* | 65.7 | 60.1 | 36.4 | 40.9 | 35.6 |
| **Capital Adequacy Ratios (%)** | | | | | |
| Total CAR | 11.9 | 13.3 | 12.8 | 13.2 | 13.2 |
| Tier I | 9.6 | 11.3 | 10.9 | 10.5 | 10.7 |
| Tier II | 2.3 | 2.1 | 2.0 | 2.7 | 2.5 |
| **Dividend details** | | | | | |
| DPS (Rs) | 4.0 | 3.0 | 3.5 | 4.0 | 4.0 |
| *Dividend Pay-out (%)* | 32.1 | 27.7 | 27.1 | 21.6 | 24.3 |
| **Per Share (Rs)** | | | | | |
| BVPS | 136.8 | 129.1 | 138.0 | 151.7 | 162.0 |
| Adjusted BVPS | 122.7 | 114.2 | 114.9 | 131.6 | 133.4 |
| EPS - wt avg | 12.5 | 10.9 | 13.1 | 18.5 | 16.5 |
| **Valuations Ratios** | | | | | |
| Price/BV (x) | 0.7 | 0.9 | 0.6 | 0.6 | 0.5 |
| Price/Adj. BV (x) | 0.8 | 1.0 | 0.7 | 0.7 | 0.7 |
| P/E (x) | 7.6 | 10.9 | 6.2 | 5.2 | 5.4 |
| *Dividend Yield (%)* | 4.2 | 2.5 | 4.4 | 4.1 | 4.5 |

*Source: Company, Centrum Research. FY10-14 has been valued on average market cap basis.*

# Financials

### Exhibit 57: Income Statement

| Y/E March (Rs mn) | FY15 | FY16 | FY17E | FY18E | FY19E |
|---|---|---|---|---|---|
| Interest Income | 46,984 | 49,922 | 52,373 | 57,687 | 65,163 |
| Interest Expense | 35,296 | 36,894 | 37,103 | 40,229 | 45,022 |
| **Net Interest Income** | **11,688** | **13,029** | **15,270** | **17,458** | **20,140** |
| **Non-Interest Income** | 5,070 | 5,429 | 6,571 | 7,765 | 9,306 |
| Fee & Other Income | 2,240 | 2,380 | 2,874 | 3,264 | 3,779 |
| Gains / (Losses) on Securities | 1,127 | 624 | 687 | 756 | 831 |
| **Total Net Income** | **16,758** | **18,457** | **21,841** | **25,223** | **29,447** |
| **Total Operating Expenses** | **9,025** | **9,912** | **12,403** | **12,943** | **14,917** |
| Employee Expenses | 5,247 | 4,430 | 5,903 | 6,192 | 7,137 |
| Other Operating Expenses | 3,778 | 5,482 | 6,500 | 6,751 | 7,780 |
| **Pre-provision Profit** | **7,734** | **8,546** | **9,438** | **12,280** | **14,530** |
| **Provisions & Contingencies** | **2,140** | **3,265** | **4,873** | **4,961** | **5,044** |
| NPA Provisions | 2,231 | 2,672 | 3,737 | 3,674 | 3,553 |
| Other Provisions | (91) | 594 | 1,135 | 1,287 | 1,490 |
| **Profit Before Tax** | **5,594** | **5,280** | **4,566** | **7,319** | **9,486** |
| Taxes | 1,080 | 1,127 | 283 | 1,830 | 2,371 |
| **Profit after tax** | **4,514** | **4,153** | **4,283** | **5,490** | **7,114** |

*Source: Company, Centrum Research Estimates*

### Exhibit 58: Balance Sheet

| Y/E March (Rs mn) | FY15 | FY16 | FY17E | FY18E | FY19E |
|---|---|---|---|---|---|
| Cash and balance with RBI | 24,885 | 26,456 | 30,365 | 34,497 | 39,990 |
| Inter-bank borrowings | 1,257 | 3,993 | 4,377 | 4,973 | 5,764 |
| Loans & Advances | 3,16,800 | 3,39,024 | 3,79,707 | 4,36,663 | 5,10,896 |
| Investments | 1,26,905 | 1,42,179 | 1,46,895 | 1,60,165 | 1,79,643 |
| **Total Int Earning Assets** | **4,44,962** | **4,85,197** | **5,30,978** | **6,01,800** | **6,96,304** |
| Fixed Assets | 2,919 | 3,066 | 6,688 | 7,888 | 9,088 |
| Other Assets | 34,081 | 31,898 | 31,898 | 31,898 | 31,898 |
| **Total Assets** | **5,20,257** | **5,67,005** | **6,20,317** | **6,96,471** | **7,97,667** |
| Deposits | 4,60,086 | 5,04,882 | 5,47,120 | 6,21,566 | 7,20,542 |
| Current | 28,714 | 32,435 | 35,285 | 40,397 | 47,190 |
| Savings | 86,019 | 1,00,172 | 1,12,382 | 1,33,268 | 1,60,974 |
| Term | 3,45,353 | 3,72,275 | 3,99,453 | 4,47,901 | 5,12,378 |
| Other Int Bearing Liabilities | 10,378 | 10,515 | 10,515 | 10,515 | 10,515 |
| **Interest Bearing Liabilities** | **4,70,464** | **5,15,397** | **5,57,635** | **6,32,081** | **7,31,057** |
| Other non int bearing Liabilities | 15,903 | 14,702 | 16,063 | 16,148 | 16,233 |
| Total Liabilities | 4,86,367 | 5,30,099 | 5,73,698 | 6,48,230 | 7,47,290 |
| Equity | 33,891 | 36,906 | 46,618 | 48,241 | 50,377 |
| **Total Liabilities** | **5,20,258** | **5,67,005** | **6,20,317** | **6,96,471** | **7,97,667** |

*Source: Company, Centrum Research Estimates*

### Exhibit 59: DuPont analysis

| (% of avg assets) | FY15 | FY16 | FY17E | FY18E | FY19E |
|---|---|---|---|---|---|
| *Interest income* | *9.5* | *9.2* | *8.8* | *8.8* | *8.7* |
| *Interest expenses* | *7.1* | *6.8* | *6.2* | *6.1* | *6.0* |
| ***NII*** | ***2.4*** | ***2.4*** | ***2.6*** | ***2.7*** | ***2.7*** |
| *Other income* | *1.0* | *1.0* | *1.1* | *1.2* | *1.2* |
| ***Total income*** | ***3.4*** | ***3.4*** | ***3.7*** | ***3.8*** | ***3.9*** |
| *Operating expenses* | *1.8* | *1.8* | *2.1* | *2.0* | *2.0* |
| ***PPOP*** | ***1.6*** | ***1.6*** | ***1.6*** | ***1.9*** | ***1.9*** |
| *Provisions* | *0.4* | *0.6* | *0.8* | *0.8* | *0.7* |
| ***PBT*** | ***1.1*** | ***1.0*** | ***0.8*** | ***1.1*** | ***1.3*** |
| *Tax* | *0.2* | *0.2* | *0.0* | *0.3* | *0.3* |
| ***RoA*** | ***0.9*** | ***0.8*** | ***0.7*** | ***0.8*** | ***1.0*** |
| *Leverage* | *15.4* | *15.4* | *13.3* | *14.4* | *15.8* |
| ***RoE*** | ***14.0*** | ***11.7*** | ***10.3*** | ***11.6*** | ***14.4*** |

*Source: Company, Centrum Research Estimates*

### Exhibit 60: Key Ratios

| Y/E March | FY15 | FY16 | FY17E | FY18E | FY19E |
|---|---|---|---|---|---|
| **B/S Structure Ratios (%)** | | | | | |
| *CD Ratio* | *68.9* | *67.1* | *69.4* | *70.3* | *70.9* |
| *Incremental CD Ratio* | *61.5* | *49.6* | *96.3* | *76.5* | *75.0* |
| *CASA Ratio* | *24.9* | *26.3* | *27.0* | *27.9* | *28.9* |
| **Growth Ratios (%)** | | | | | |
| *Loans* | *11.8* | *7.0* | *12.0* | *15.0* | *17.0* |
| *Deposits* | *13.4* | *9.7* | *8.4* | *13.6* | *15.9* |
| *NII* | *10.7* | *11.5* | *17.2* | *14.3* | *15.4* |
| *Opex* | *3.2* | *9.8* | *25.1* | *4.4* | *15.3* |
| *PPOP* | *12.6* | *10.5* | *10.4* | *30.1* | *18.3* |
| *Provisions* | *(23.1)* | *52.6* | *49.2* | *1.8* | *1.7* |
| *PAT* | *45.1* | *(8.0)* | *3.1* | *28.2* | *29.6* |
| **Operating Ratios (%)** | | | | | |
| *Yield on funds* | *10.0* | *9.8* | *9.4* | *9.3* | *9.2* |
| *Cost of funds* | *7.5* | *7.3* | *6.7* | *6.5* | *6.4* |
| *NIM* | *2.5* | *2.6* | *2.7* | *2.8* | *2.8* |
| *Non-int inc / Total income* | *1.0* | *1.0* | *1.1* | *1.2* | *1.2* |
| *Fee to avg assets* | *0.5* | *0.4* | *0.5* | *0.5* | *0.5* |
| *Cost/Income* | *53.9* | *53.7* | *56.8* | *51.3* | *50.7* |
| *Opex/ Avg assets* | *1.8* | *1.8* | *2.1* | *2.0* | *2.0* |
| *Provisioning cost* | *0.7* | *0.8* | *1.0* | *0.9* | *0.8* |
| *Effective tax rate* | *19.3* | *21.3* | *6.2* | *25.0* | *25.0* |
| *RoA* | *0.9* | *0.8* | *0.7* | *0.8* | *1.0* |
| *RoE* | *14.0* | *11.7* | *10.3* | *11.6* | *14.4* |
| **Credit Quality Ratios (%)** | | | | | |
| *Gross NPA* | *3.1* | *3.6* | *4.3* | *3.8* | *3.3* |
| *Net NPA* | *2.1* | *2.4* | *2.8* | *2.4* | *2.0* |
| *Slippage rate to op advances* | *3.1* | *3.4* | *3.4* | *2.8* | *2.5* |
| *NPA coverage ratio* | *34.0* | *32.6* | *34.8* | *36.2* | *39.9* |
| **Capital Adequacy Ratios (%)** | | | | | |
| Total CAR | *12.4* | *12.0* | *13.7* | *12.8* | *11.1* |
| Tier I | *10.5* | *10.6* | *12.4* | *11.6* | *10.1* |
| Tier II | *1.9* | *1.5* | *1.4* | *1.2* | *1.0* |
| **Dividend details** | | | | | |
| DPS (Rs) | 5.0 | 5.0 | 4.0 | 4.3 | 4.5 |
| *Dividend Pay-out (%)* | *20.9* | *22.7* | *26.4* | *21.9* | *17.9* |
| **Per Share (Rs)** | | | | | |
| BVPS | 179.8 | 195.8 | 164.9 | 170.6 | 178.2 |
| Adjusted BVPS | 146.7 | 153.6 | 129.0 | 136.1 | 144.9 |
| EPS - basic | 24.0 | 22.0 | 15.1 | 19.4 | 25.2 |
| **Valuations Ratios** | | | | | |
| Price/BV (x) | 0.6 | 0.5 | 0.7 | 0.8 | 0.8 |
| Price/Adj. BV (x) | 0.7 | 0.6 | 0.9 | 1.0 | 1.0 |
| P/E (x) | 4.5 | 4.5 | 7.6 | 7.2 | 5.6 |
| *Dividend Yield (%)* | *4.6* | *5.0* | *3.5* | *3.0* | *3.2* |

*Source: Company, Centrum Research Estimates. FY15-17E has been valued on average market cap basis.*

# Appendix A

**Disclaimer**

Centrum Broking Limited ("Centrum") is a full-service, Stock Broking Company and a member of The Stock Exchange, Mumbai (BSE) and National Stock Exchange of India Ltd. (NSE). Our holding company, Centrum Capital Ltd, is an investment banker and an underwriter of securities. As a group Centrum has Investment Banking, Advisory and other business relationships with a significant percentage of the companies covered by our Research Group. Our research professionals provide important inputs into the Group's Investment Banking and other business selection processes.

Recipients of this report should assume that our Group is seeking or may seek or will seek Investment Banking, advisory, project finance or other businesses and may receive commission, brokerage, fees or other compensation from the company or companies that are the subject of this material/report. Our Company and Group companies and their officers, directors and employees, including the analysts and others involved in the preparation or issuance of this material and their dependants, may on the date of this report or from, time to time have "long" or "short" positions in, act as principal in, and buy or sell the securities or derivatives thereof of companies mentioned herein. Centrum or its affiliates do not own 1% or more in the equity of this company Our sales people, dealers, traders and other professionals may provide oral or written market commentary or trading strategies to our clients that reflect opinions that are contrary to the opinions expressed herein, and our proprietary trading and investing businesses may make investment decisions that are inconsistent with the recommendations expressed herein. We may have earlier issued or may issue in future reports on the companies covered herein with recommendations/ information inconsistent or different those made in this report. In reviewing this document, you should be aware that any or all of the foregoing, among other things, may give rise to or potential conflicts of interest. We and our Group may rely on information barriers, such as "Chinese Walls" to control the flow of information contained in one or more areas within us, or other areas, units, groups or affiliates of Centrum. Centrum or its affiliates do not make a market in the security of the company for which this report or any report was written. Further, Centrum or its affiliates did not make a market in the subject company's securities at the time that the research report was published.

This report is for information purposes only and this document/material should not be construed as an offer to sell or the solicitation of an offer to buy, purchase or subscribe to any securities, and neither this document nor anything contained herein shall form the basis of or be relied upon in connection with any contract or commitment whatsoever. This document does not solicit any action based on the material contained herein. It is for the general information of the clients of Centrum. Though disseminated to clients simultaneously, not all clients may receive this report at the same time. Centrum will not treat recipients as clients by virtue of their receiving this report. It does not constitute a personal recommendation or take into account the particular investment objectives, financial situations, or needs of individual clients. Similarly, this document does not have regard to the specific investment objectives, financial situation/circumstances and the particular needs of any specific person who may receive this document. The securities discussed in this report may not be suitable for all investors. The securities described herein may not be eligible for sale in all jurisdictions or to all categories of investors. The countries in which the companies mentioned in this report are organized may have restrictions on investments, voting rights or dealings in securities by nationals of other countries. The appropriateness of a particular investment or strategy will depend on an investor's individual circumstances and objectives. Persons who may receive this document should consider and independently evaluate whether it is suitable for his/ her/their particular circumstances and, if necessary, seek professional/financial advice. Any such person shall be responsible for conducting his/her/their own investigation and analysis of the information contained or referred to in this document and of evaluating the merits and risks involved in the securities forming the subject matter of this document.

The projections and forecasts described in this report were based upon a number of estimates and assumptions and are inherently subject to significant uncertainties and contingencies. Projections and forecasts are necessarily speculative in nature, and it can be expected that one or more of the estimates on which the projections and forecasts were based will not materialize or will vary significantly from actual results, and such variances will likely increase over time. All projections and forecasts described in this report have been prepared solely by the authors of this report independently of the Company. These projections and forecasts were not prepared with a view toward compliance with published guidelines or generally accepted accounting principles. No independent accountants have expressed an opinion or any other form of assurance on these projections or forecasts. You should not regard the inclusion of the projections and forecasts described herein as a representation or warranty by or on behalf of the Company, Centrum, the authors of this report or any other person that these projections or forecasts or their underlying assumptions will be achieved. For these reasons, you should only consider the projections and forecasts described in this report after carefully evaluating all of the information in this report, including the assumptions underlying such projections and forecasts.

The price and value of the investments referred to in this document/material and the income from them may go down as well as up, and investors may realize losses on any investments. Past performance is not a guide for future performance. Future returns are not guaranteed and a loss of original capital may occur. Actual results may differ materially from those set forth in projections. Forward-looking statements are not predictions and may be subject to change without notice. Centrum does not provide tax advice to its clients, and all investors are strongly advised to consult regarding any potential investment. Centrum and its affiliates accept no liabilities for any loss or damage of any kind arising out of the use of this report. Foreign currencies denominated securities are subject to fluctuations in exchange rates that could have an adverse effect on the value or price of or income derived from the investment. In addition, investors in securities such as ADRs, the value of which are influenced by foreign currencies effectively assume currency risk. Certain transactions including those involving futures, options, and other derivatives as well as non-investment-grade securities give rise to substantial risk and are not suitable for all investors. Please ensure that you have read and understood the current risk disclosure documents before entering into any derivative transactions.

This report/document has been prepared by Centrum, based upon information available to the public and sources, believed to be reliable. No representation or warranty, express or implied is made that it is accurate or complete. Centrum has reviewed the report and, in so far as it includes current or historical information, it is believed to be reliable, although its accuracy and completeness cannot be guaranteed. The opinions expressed in this document/material are subject to change without notice and have no obligation to tell you when opinions or information in this report change.

This report or recommendations or information contained herein do/does not constitute or purport to constitute investment advice in publicly accessible media and should not be reproduced, transmitted or published by the recipient. The report is for the use and consumption of the recipient only. This publication may not be distributed to the public used by the public media without the express written consent of Centrum. This report or any portion hereof may not be printed, sold or distributed without the written consent of Centrum.

The distribution of this document in other jurisdictions may be restricted by law, and persons into whose possession this document comes should inform themselves about, and observe, any such restrictions. Neither Centrum nor its directors, employees, agents or representatives shall be liable for any damages whether direct or indirect, incidental, special or consequential including lost revenue or lost profits that may arise from or in connection with the use of the information.

This document does not constitute an offer or invitation to subscribe for or purchase or deal in any securities and neither this document nor anything contained herein shall form the basis of any contract or commitment whatsoever. This document is strictly confidential and is being furnished to you solely for your information, may not be distributed to the press or other media and may not be reproduced or redistributed to any other person. The distribution of this report in other jurisdictions may be restricted by law and persons into whose possession this report comes should inform themselves about, and observe any such restrictions. By accepting this report, you agree to be bound by the fore going limitations. No representation is made that this report is accurate or complete.

The opinions and projections expressed herein are entirely those of the author and are given as part of the normal research activity of Centrum Broking and are given as of this date and are subject to change without notice. Any opinion estimate or projection herein constitutes a view as of the date of this report and there can be no assurance that future results or events will be consistent with any such opinions, estimate or projection.

This document has not been prepared by or in conjunction with or on behalf of or at the instigation of, or by arrangement with the company or any of its directors or any other person. Information in this document must not be relied upon as having been authorized or approved by the company or its directors or any other person. Any opinions and projections contained herein are entirely those of the authors. None of the company or its directors or any other person accepts any liability whatsoever for any loss arising from any use of this document or its contents or otherwise arising in connection therewith.

Centrum and its affiliates have not managed or co-managed a public offering for the subject company in the preceding twelve months. Centrum and affiliates have not received compensation from the companies mentioned in the report during the period preceding twelve months from the date of this report for service in respect of public offerings, corporate finance, debt restructuring, investment banking or other advisory services in a merger/acquisition or some other sort of specific transaction.

As per the declarations given by them, Mr. Aalok Shah & Mr. Gaurav Jani, research analyst and and/or any of his family members do not serve as an officer, director or any way connected to the company/companies mentioned in this report. Further, as declared by him, he has not received any compensation from the above companies in the preceding twelve months. He does not hold any shares by him or through his relatives or in case if holds the shares then will not to do any transactions in the said scrip for 30 days from the date of release such report. Our entire research professionals are our employees and are paid a salary. They do not have any other material conflict of interest of the research analyst or member of which the research analyst knows of has reason to know at the time of publication of the research report or at the time of the public appearance.

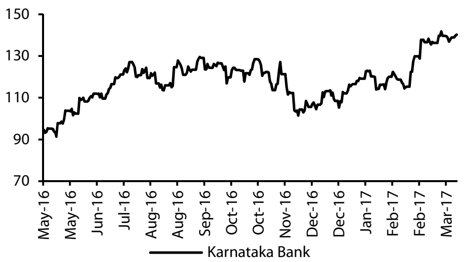
While we would endeavour to update the information herein on a reasonable basis, Centrum, its associated companies, their directors and employees are under no obligation to update or keep the information current. Also, there may be regulatory, compliance or other reasons that may prevent Centrum from doing so.

Non-rated securities indicate that rating on a particular security has been suspended temporarily and such suspension is in compliance with applicable regulations and/or Centrum policies, in circumstances where Centrum is acting in an advisory capacity to this company, or any certain other circumstances.

This report is not directed to, or intended for distribution to or use by, any person or entity who is a citizen or resident of or located in any locality, state, country or other jurisdiction where such distribution, publication, availability or use would be contrary to law or regulation or which would subject Centrum Broking Limited or its group companies to any registration or licensing requirement within such jurisdiction. Specifically, this document does not constitute an offer to or solicitation to any U.S. person for the purchase or sale of any financial instrument or as an official confirmation of any transaction to any U.S. person unless otherwise stated, this message should not be construed as official confirmation of any transaction. No part of this document may be distributed in Canada or used by private customers in United Kingdom.

The information contained herein is not intended for publication or distribution or circulation in any manner whatsoever and any unauthorized reading, dissemination, distribution or copying of this communication is prohibited unless otherwise expressly authorized. Please ensure that you have read "Risk Disclosure Document for Capital Market and Derivatives Segments" as prescribed by Securities and Exchange Board of India before investing in Indian Securities Market.

**Karnataka Bank price chart**




*Source: Bloomberg, Centrum Research*

| Disclosure of Interest Statement | | |
|---|---|---|
| 1 | Business activities of Centrum Broking Limited (CBL) | Centrum Broking Limited (hereinafter referred to as "CBL") is a registered member of NSE (Cash, F&O and Currency Derivatives Segments), MCX-SX (Currency Derivatives Segment) and BSE (Cash segment), Depository Participant of CDSL and a SEBI registered Portfolio Manager. |
| 2 | Details of Disciplinary History of CBL | CBL has not been debarred/ suspended by SEBI or any other regulatory authority from accessing /dealing in securities market. |
| 3 | Registration status of CBL: | CBL is registered with SEBI as a Research Analyst (SEBI Registration No. INH000001469) |

| | | Karnataka Bank | City Union Bank | DCB Bank |
|---|---|---|---|---|
| 4 | Whether Research analyst's or relatives' have any financial interest in the subject company and nature of such financial interest | No | No | No |
| 5 | Whether Research analyst or relatives have actual / beneficial ownership of 1% or more in securities of the subject company at the end of the month immediately preceding the date of publication of the document. | No | No | No |
| 6 | Whether the research analyst or his relatives has any other material conflict of interest | No | No | No |
| 7 | Whether research analyst has received any compensation from the subject company in the past 12 months and nature of products / services for which such compensation is received | No | No | No |
| 8 | Whether the Research Analyst has received any compensation or any other benefits from the subject company or third party in connection with the research report | No | No | No |
| 9 | Whether Research Analysts has served as an officer, director or employee of the subject company | No | No | No |
| 10 | Whether the Research Analyst has been engaged in market making activity of the subject company. | No | No | No |

*Rating Criteria*

| Rating | Market cap < Rs20bn | Market cap > Rs20bn but < 100bn | Market cap > Rs100bn |
|---|---|---|---|
| **Buy** | Upside > 20% | Upside > 15% | Upside > 10% |
| **Hold** | Upside between -20% to +20% | Upside between -15% to +15% | Upside between -10% to +10% |
| **Sell** | Downside > 20% | Downside > 15% | Downside > 10% |

**Member (NSE and BSE)**

**Regn No.:**
CAPITAL MARKET SEBI REGN. NO.: BSE: INB011454239
CAPITAL MARKET SEBI REGN. NO.: NSE: INB231454233
DERIVATIVES SEBI REGN. NO.: NSE: INF231454233
(TRADING & CLEARING MEMBER)
CURRENCY DERIVATIVES: MCX-SX INE261454230
CURRENCY DERIVATIVES:NSE (TM & SCM) – NSE 231454233

**Depository Participant (DP)**
CDSL DP ID: 120 – 12200
SEBI REGD NO. : CDSL : IN-DP-CDSL-661-2012

PORTFOLIO MANAGER

SEBI REGN NO.: INP000004383

**Website:** www.centrum.co.in
**Investor Grievance Email ID:** investor.grievances@centrum.co.in

**Compliance Officer Details**:
Kavita Ravichandran
(022) 4215 9842; Email ID: Compliance@centrum.co.in

| Centrum Broking Ltd. (CIN :U67120MH1994PLC078125) | |
|---|---|
| **Registered Office Address**<br>Bombay Mutual Building ,<br>2nd Floor,<br>Dr. D. N. Road,<br>Fort, Mumbai - 400 001 | **Corporate Office & Correspondence Address**<br>Centrum House<br>6th Floor, CST Road, Near Vidya Nagari Marg, Kalina,<br>Santacruz (E), Mumbai 400 098.<br>Tel: (022) 4215 9000 |

# Karnataka Bank Ltd

| Industry | CMP | Recommendation | Add on Dips to band | Sequential Targets | Time Horizon |
|---|---|---|---|---|---|
| BFSI | Rs. 136 | Buy at CMP and add on declines | Rs. 124-128 | Rs. 154 & Rs. 168 | 2-3 quarters |

| | |
|---|---|
| HDFC Scrip Code | KARBANEQNR |
| BSE Code | 532652 |
| NSE Code | KTKBANK |
| Bloomberg | KBL IN |
| CMP as on 10 Mar 17 | 135.85 |
| Eq. Capital (Rs cr) | 282.7 |
| Face Value (Rs) | 10 |
| Equity Sh. Outs (Cr) | 28.27 |
| Market Cap (Rs cr) | 3839.20 |
| Book Value (Rs) | 164.98 |
| Avg. 52 Week Vol | 28,58,000 |
| 52 Week High | 143.35 |
| 52 Week Low | 75.30 |

| Shareholding Pattern-% (Dec-2016) | |
|---|---|
| Promoters | 0.00 |
| Institutions | 28.73 |
| Non Institutions | 71.27 |
| Total | 100.0 |

**Research Analyst: Atul Karwa**
atul.karwa@hdfcsec.com

Established in 1924 at Mangalore, Karnataka Bank (KBL) is a leading Scheduled Commercial Bank in India. The bank took shape in the aftermath of patriotic zeal that engulfed the nation during the freedom movement of 20th Century India. Over the years the Bank grew with the merger of Sringeri Sharada Bank Ltd., Chitradurga Bank Ltd. and Bank of Karnataka. In 9 decades of its presence KBL has built a network of 738 branches spread across 21 states and 2 Union Territories. It has forayed into General Insurance business as a JV partner in Universal Sompo General Insurance with a 15% stake

## Investment Rationale:

- Accelerated branch addition
- Increasing share of CASA deposits
- Retail portfolio and MSE segment to drive growth
- NIMs should expand gradually from current levels
- Asset quality likely to improve

## Concerns:

- High geographic concentration
- Competitive intensity in its retail foray
- Deterioration asset quality
- Lower C/D ratios pulling down RoA
- High treasury profits seen in 9MFY17 may not continue

## Financial Summary

| (Rs Cr) | Q3FY17 | Q3FY16 | YoY (%) | Q2FY17 | QoQ (%) | FY16 | FY17E | FY18E | FY19E |
|---|---|---|---|---|---|---|---|---|---|
| NII | 377 | 305 | *23.5* | 397 | *-5.2* | 1303 | 1545 | 1787 | 2029 |
| PPP | 172 | 192 | *-10.3* | 233 | *-26.2* | 855 | 915 | 1061 | 1154 |
| PAT | 69 | 97 | *-29.3* | 124 | *-44.7* | 415 | 423 | 476 | 538 |
| EPS (Rs) | 2.4 | 5.1 | *-52.8* | 6.6 | *-63.1* | 22.0 | 15.0 | 16.8 | 19.0 |
| P/E (x) | | | | | | 6.2 | 9.1 | 8.1 | 7.1 |
| P/ABV (x) | | | | | | 0.9 | 1.1 | 1.0 | 1.0 |
| RoAA (%) | | | | | | 0.8 | 0.7 | 0.7 | 0.7 |

*(Source: Company, HDFC sec)*

## View and Valuation

The management is targeting to more than double the bank's business to Rs 180,000 cr by FY20 and to become a Preferred Banker to at least 1% of India's population. It expects to increase its touch points to 3,500 with 1,000 branches and 2,500 ATMs. Emphasis on technology to increase Digital Banking by increasing the digital touch points would result in cost reduction. Focus on increasing CASA ratio, improving credit-deposit ratio and shifting of business mix towards higher yielding retail and MSME loans would result in expansion of NIMs and improvement in return ratios. Better monitoring of asset quality will bring down NPA levels and lower the provisioning requirements. It is now critical for the bank to grow its advances without impacting its asset quality and liquidity profile, considering the subdued operating environment and expected withdrawals from the deposits made during November-December 2016.

On relative valuations the stock seems cheap, while possibilities of stake acquisition by other Banks/financial institutions or by institutional players could lead to a rerating of the stock. We feel investors could buy the stock at the CMP and add on declines to Rs. 124-128 band (0.9x FY19E ABV) for sequential targets of Rs. 154 (1.1x FY19E ABV) and Rs. 168 (1.2x FY19E ABV) in 2-3 quarters.

## Company Overview

Established in 1924 at Mangalore, Karnataka Bank (KBL) is a leading 'A' Class Scheduled Commercial Bank in India. The bank took shape in the aftermath of patriotic zeal that engulfed the nation during the freedom movement of 20th Century India. Over the years the Bank grew with the merger of Sringeri Sharada Bank Ltd., Chitradurga Bank Ltd. and Bank of Karnataka. In 9 decades of its presence KBL has built a network of 738 branches spread across 21 states and 2 Union Territories and 8 million customers. It has forayed into General Insurance business as a JV partner in Universal Sompo General Insurance with a 15% stake with Allahabad Bank, Universal Sompo, Indian Overseas Bank and Dabur group being the other stakeholders.

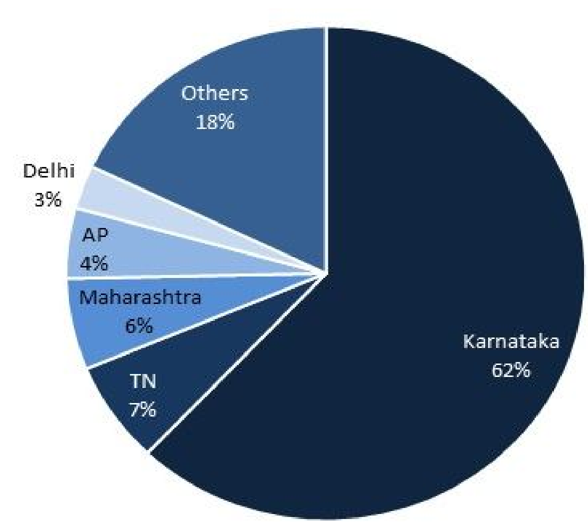
As a premier bank, it has developed comprehensive range of customized products & services suitable for every kind of market, trade or perceived need - Business or Personal. These include, borrowing facilities, deposits, providing optimum returns on surplus funds or helping with overseas transactions. It is transforming itself into a technologically advanced bank looking at the needs of the future. In recognition of its achievements under technology initiatives, social banking, export performance etc. the bank has won many awards like:

- IBA Banking Technology Award 2014-15, Runner up in the category of Best Risk and Fraud Management Initiative, amongst Small Banks.
- ASSOCHAM Social Banking Excellence Awards 2015, under the following categories:
    - Winner - Urban Banking [Small Bank] Category.
    - Winner-Agricultural Banking [Small Bank] Category
    - Runner Up - Participation in government schemes [Small Bank] category
    - Runner Up - Overall Best Social Bank[ Small Bank] category
- MSME Banking Excellence Awards 2015 [Runner Up] for Eco -Technology "Emerging Banks", instituted by CIMSME [Chamber of Indian Micro Small & Medium Enterprises].

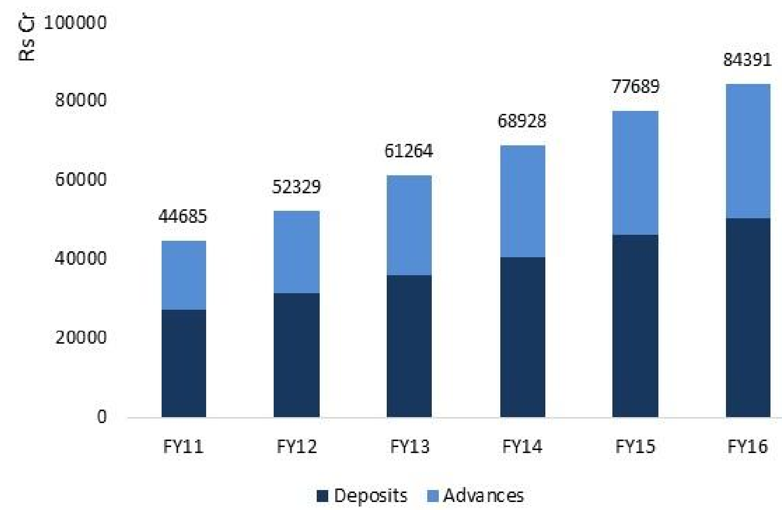
- Banking Technology Excellence Award - "Best Bank for Evangelising Technology Adoption" among Small Banks for the year 2014-15, instituted by IDRBT.
- "Export Excellence award for MSME" by the Federation of Indian Export Organisations - Western Region.
- "STP AWARD" from Bank of New York, Mellon in recognition to the improved payment formatting and straight - Through Processing success rate.
- "Outstanding Performance in MSME Funding" by the Federation of Industry, Trade and Services (FITS).

Over the last 4 years from FY12-FY16 total business of the bank has grown at a CAGR of 12.7% to ~Rs 84400 cr with advances growing at 13.1% to ~Rs 33900 cr and deposits growing at 12.4% to ~Rs 50500. As on Dec-2016 almost 62% of the bank's 738 branches were in Karnataka with South India accounting for 78%. The bank has added 50 branches in FY16 and 13 in 9MFY17 to take the total network to 738 branches.

*About 62% of the branches are in Karnataka*




*Business has grown at CAGR of 12.7% over FY12-16*




*(Source: Company, HDFC sec)*

**Key company milestones**

| Year | Milestone |
|---|---|
| **1924** | Incorporated at Mangalore |
| **1960-66** | Took over assets and liabilities of Sringeri Sharada Bank Ltd, Chitaldurg Bank & Bank of Karnataka, Hubli |
| **1977** | Became an authorised dealer of foreign exchange |
| **1995** | Public issue of 45 lakh equity shares in October 1995 for Rs.160 cr |

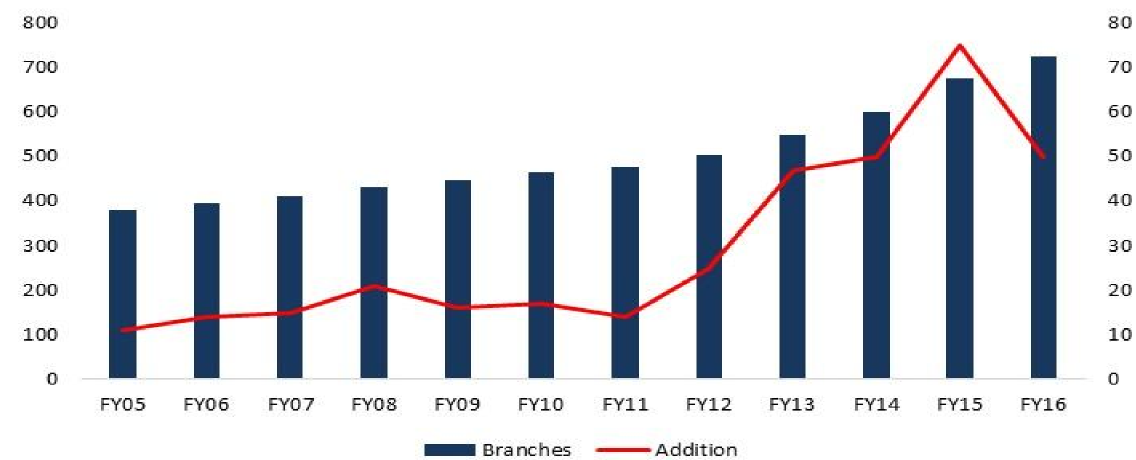
| | |
|---|---|
| **2000** | Implementation of "Finacle" CBS |
| **2002** | Bancassurance tie-up with MetLife |
| **2006** | Floated general insurance JV along with Allahabad Bank, Indian Overseas Bank, Dabur Investments and Sompo Japan Insurance. Launched CDSL-DP services at select branches |
| **2007** | Completed 100% implementation of CBS |
| **2011** | Launched online trading facility |
| **2012** | Business turnover crossed Rs 50000 cr. No. of branches crossed 500 |
| **2014** | Business turnover crossed Rs 75000 cr |
| **2015** | Unveiled KBL –VISION 2020 & adopted Vision Statement. No. of ATMs crossed 1,000 |

## Investment Rationale

**Accelerated branch additions**

Over the past 4 years the pace of branch additions at KBL has increased sharply. The bank has added ~65 branches annually on an average in the last four years taking the branch network from 503 in FY11 to 725 at the end of FY16. ATMs have increased from 352 in FY12 to 1275 in FY16. Prior to that KBL had added only 72 branches in the 4 year period from FY09-FY12 at an average of 18 branches per annum. Under the Vision 2020 document adopted by the bank, it is aiming to achieve 1000 branches and 2500 ATMs by 2020 which would envisage a branch addition run rate of ~70 branches per annum over FY16-FY20. Although the target of 1000 branches seems a bit over ambitious, we expect annual branch additions to remain at elevated levels nevertheless.

*Pace of branch additions has increased sharply*

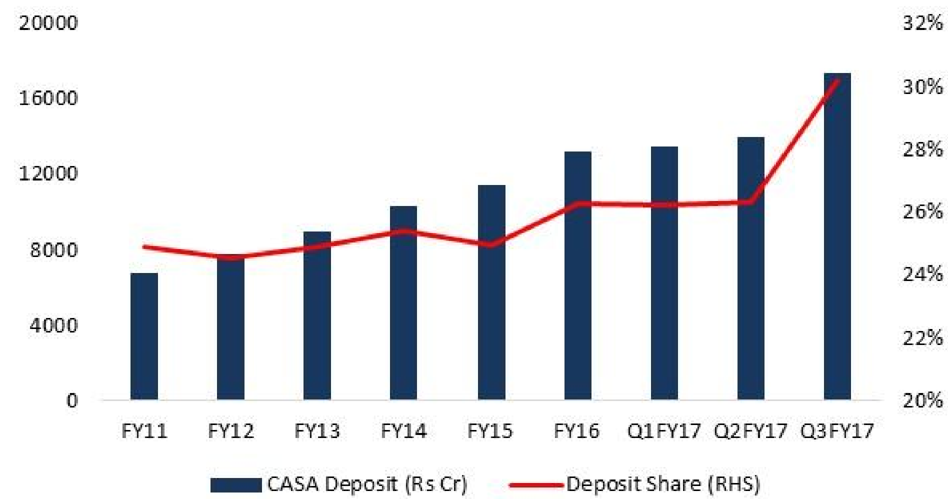



*(Source: Company, HDFC sec)*

**Increasing share of CASA deposits**

Increasing the share of CASA deposits has been one of the key business strategies of the bank. KBL has introduced new Savings Bank and Current account schemes tailored to suit the various market segments and undertakes periodical overhauling of the schemes with necessary sophistication/upgradation. It also carries out marketing through a focused marketing vertical to have the maximum effect on potential customers. The bank keeps holding CASA campaigns to reach out to new clients. All these measures are expected to boost the CASA share in total deposits and bring down cost of deposit for the bank. CASA ratio of KBL improved from 24.9% in FY11 to 26.3% in FY16. It jumped to over 30% at the end of Q3FY17 due to huge deposits on account of demonetization. The continued focus of the bank is likely to result in higher CASA ratio in the coming years. The market share of the Bank in deposits was 0.527 percent as of March 2016.

*CASA ratio has been increasing gradually*

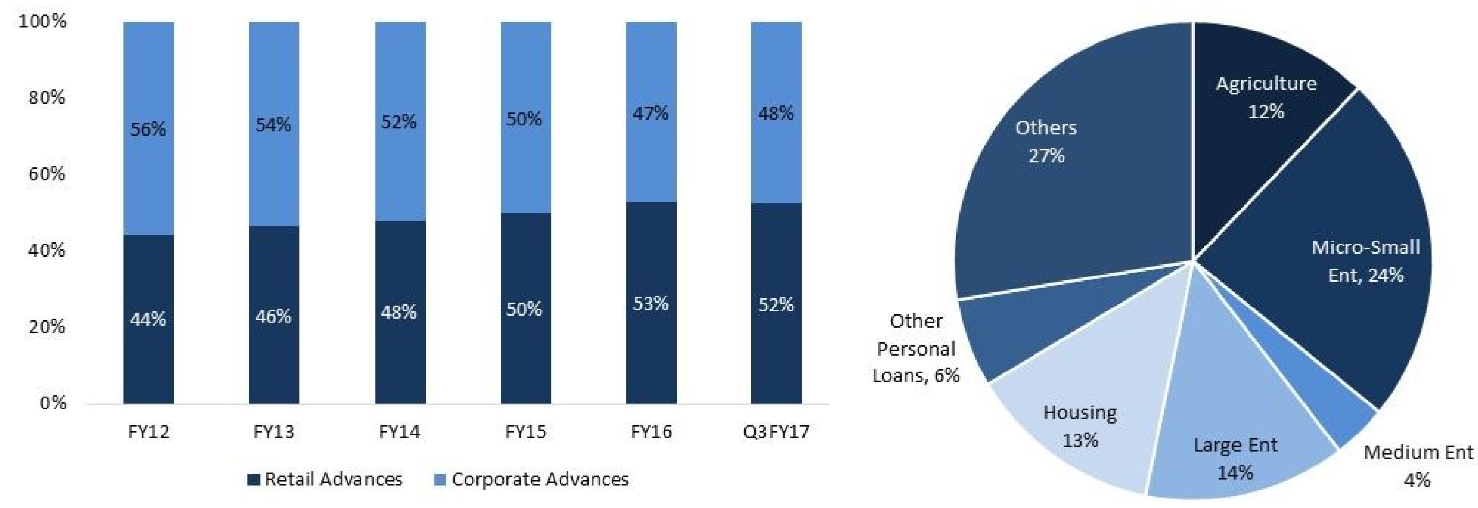



*(Source: Company, HDFC sec)*

**Retail portfolio and MSE segment to drive growth**

KBL has made retail loans as its focus area and is targeting a retail loan share of 55% of its total advances. Share of retail advances in total advances have grown from 44.3% in FY12 to 52.4% at the end of Q3FY17. KBL classifies any loan above Rs 5 cr as corporate and below Rs 5 cr as retail. KBL has a bouquet of products in the retail space like Housing Loans, Mortgages, Vehicle Loans, Gold Loans, Education Loans, etc. with multiple loan products. Due to its high presence in the state of Karnataka majority of the demand for retail products comes from within the state. Retail loans over the last 4 years (FY12-FY16) have grown at CAGR of 7.9% while corporate loans de-grew by 1% CAGR over the same period.

*Retail loans have been gaining share of total advances*




*(Source: Company, HDFC sec)*

Among the retail products housing loans have seen the maximum growth. Housing segment which consists of products like Apna Ghar, Home Comfort and Mortgages grew by 18.6% in FY14-FY16 with its share increasing from 10.7% to 12.6% during the same period. In 9MFY17 its share of advances has further increased to 13.2%.

<u>Thrust on MSE segment</u>

Among the corporate loans segment KBL is concentrating on Micro-Small Enterprises (MSE) loans. It has taken several initiatives to drive credit to this segment which include

- Focused attention through 210 specialized MSME branches to ensure hassle free flow of credit to the sector.
- Holding MSME cluster meets at various centres in association with stakeholders like DIC, ASSOCHAM, DSIA, etc.
- Simplified systems & procedures, attractive rates of interest & collateral free loans upto Rs 10 lakh.
- Extending differential rate of interest to MSE loans covered under CGTMSE.
- Entered into a MOU with Reliance Capital Ltd. for financing of MSMEs through co-financing arrangement.
- Entered into a MOU with Credit Analysis & Research Ltd (CARE), for providing Credit Rating & Due Diligence Services to the MSME clients of the Bank.
- Entered into a MOU with M/s Ashok Leyland, Tata Motors, BEML, TVS Motors and recently with Daimler for purchase of vehicles by MSEs.

These initiatives have helped the bank to grow its MSE portfolio which now accounts for 23.7% of its advances at the end of Q3FY17 as compared to 16.9% in FY14. The MSE segment has grown at CAGR of 28.8% over FY14-FY16.

**NIMs should expand gradually from current levels**

KBL has reported higher NIMs in 9MFY17 after two years of flattish NIM growth. NIMs have improved by 20bps yoy in 9MFY17 to 2.54%. With the bank's thrust on growing its retail and MSE loan books which have higher yields, improvement in CD ratio and increasing CASA ratio we expect NIMs to see further expansion going forward.

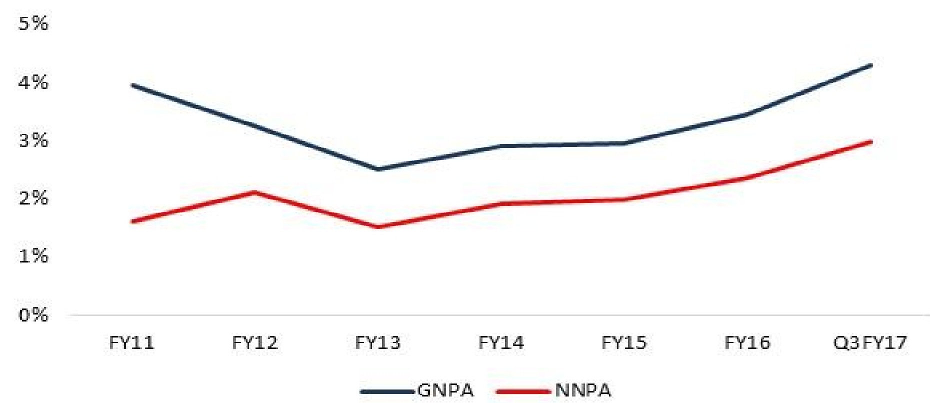
*NIMs likely to trend higher*


*(Source: Company, HDFC sec)*

**Asset quality likely to improve**

Asset quality of KBL had deteriorated sharply over the past couple of years on account of drought situation in Karnataka and economic slowdown faced by the companies in India. Demonetization in Q3FY17 further aggravated the situation as GNPA increased to 4.3% in Q3FY17 as against 3.6% in Q2FY17 led by lower recoveries and up-gradations along with higher slippages. However management has guided for better quarter ahead with sales/recoveries of of ~Rs. 450 cr in Q4FY17.

*Asset quality trend*



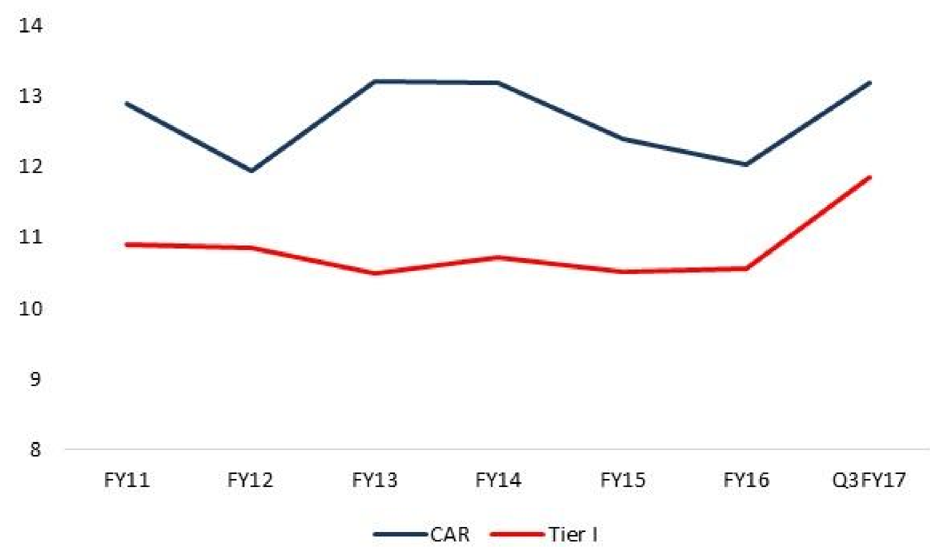

*(Source: Company, HDFC sec)*

Slippages have also decline from Rs 379 cr in Q3FY16 to Rs 233 cr in Q3FY17 and expected to trend lower going forward. KBL has formed a separate Credit Monitoring Department at its Head Office and Credit Monitoring Teams at Regional offices for better monitoring of the advance portfolio, specially stressed assets portfolio. The Provision Coverage Ratio (PCR) computed in accordance with the RBI guidelines works out to 48.4% in FY16 (Previous year 50.5%). The gross impaired ratio (including restructured loans) was 8.9% as of Dec 2016 while the net impaired ratio was 7.5%.

**Improved capital adequacy ratio**

KBL raised capital through a rights issue in Dec-16 offering 1 share for every 2 shares held. The issue received overwhelming response from shareholders and investors with an overall subscription reaching 186%. The bank issued 9.42 cr shares at a price of Rs 70 and augmented its capital funds to the extent of Rs 660 cr. Consequently capital adequacy ratio has improved to 13.2% in Q3FY17 from 11.2% in Q2FY17. This has paved the way for further expansion of business and will allow the bank to grow at its targeted pace without any capital constraints over next couple of years.

*Higher capital adequacy to ensure growth for next couple of years*

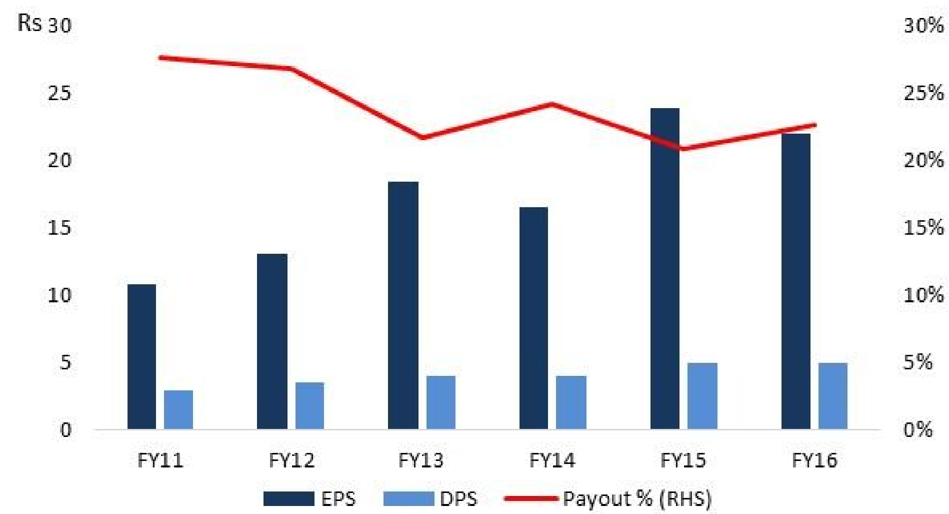



*(Source: Company, HDFC sec)*

**Dividend yield attractive**

KBL has a dividend payout ratio in excess of 20%. In FY16 the bank declared a dividend of Rs 5 per shares which translates to a dividend yield of ~3.7% on current market price. We expect higher dividends to continue in the coming years.

*Dividend payout has remained above 20%*




*(Source: Company, HDFC sec)*

## Concerns

**High geographic concentration**

KBL derives more than half of its business from ~62% of its branches located in the state of Karnataka. Any change in the socio-political scenario or a natural calamity could impact its borrowers and worsen the asset quality.

**Competitive intensity in its retail foray**

Due to higher stress in corporate loans most banks are looking at retail and MSME segments for growth. KBL is likely to face greater competitive intensity as it looks to expand its retail footprint and might impact its fee income.

**Deterioration asset quality**

NPA of the bank have increased significantly in the past 2 years. Any further deterioration in asset quality could result in higher provisioning requirements leading to lower profitability.

**Absence of promoter group**

The bank does not have a clearly identified promoter group or a large shareholder, which results in lower financial flexibility and a relatively low likelihood of bail out support in case of any unforeseen distress.

**Lower C/D ratios pulling down RoA**

KBL has historically been conservative in lending resulting in low credit-deposit ratio as compared to its peers ensuing lower NIMs. Lower NIMs coupled with higher cost-income ratio as compared to larger peers is pulling down RoA of the bank.

*Credit-Deposit trend*


*(Source: Company, HDFC sec)*

**High treasury profits seen in 9MFY17 may not continue**

In the current falling interest rate scenario treasury profits of KBL increased significantly considering excess investments. However, this may not continue as interest rates have likely bottomed out.

**Q3FY17 Result Review**

Karnataka Bank's (KBL) net profits declined by 29% yoy (45% qoq) to Rs 69 cr mainly on account of demonetization which resulted in higher operating expenses as well as lower recoveries and upgradations. Loan book grew by ~9% yoy to Rs 35,786 cr led by ~10% yoy growth in retail loans as against 7% yoy growth in corporate loans. Management has guided for a loan growth of 14-15% in FY17 as the bank is flush with deposits post demonetization and is focusing back on credit growth. NIMs for 9MFY17 improved by 20 bps yoy to 2.54% on back of higher interest spreads as cost of deposit declined faster than yield on advances.

GNPA increased to 4.3% as compared to 3.6% in Q2FY17 led by lower recoveries and up-gradations along with higher slippages. This was largely due to one chunky EPC account of Rs 65 cr slipping into NPA. Recovery efforts were impacted due to demonetization and recoveries dipped to Rs 52 cr as compared to Rs 250-260 cr earlier. Also asset sales could not take place as planned. Net NPAs increased from 2.6% to 3%. Management has guided for sales/recoveries of ~Rs 450 cr in Q4FY17 which could bring down NPA levels.

The bank reported an additional Rs 70 cr slippages which were not included adhering to the RBI dispensation of giving 60 days leeway to small accounts. The bank reported SMA2 of Rs 1589 cr down 26% yoy from Rs 2169 cr in Q3FY16. Restructured book has also declined by 30.8% yoy to Rs 1616 cr of which Rs 286 cr has slipped into NPA. It has Rs 451 cr in SDR accounts and around Rs 47 cr under S4A.

| Particulars | Q3FY17 | Q3FY16 | YoY (%) | Q2FY17 | QoQ (%) |
|---|---|---|---|---|---|
| Interest Income | 1324 | 1237 | *7.0* | 1306 | *1.3* |
| Interest Expenses | 947 | 932 | *1.6* | 909 | *4.2* |
| **Net Interest Income** | 377 | 305 | *23.5* | 397 | *-5.2* |
| Non interest income | 134 | 133 | *0.7* | 190 | *-29.6* |
| **Total Income** | 510 | 438 | *16.6* | 587 | *-13.1* |
| Operating Expenses | 338 | 246 | *37.5* | 354 | *-4.5* |
| PPP | 172 | 192 | *-10.3* | 233 | *-26.2* |
| Prov & Cont | 101 | 63 | *59.4* | 131 | *-22.9* |
| Profit Before Tax | 71 | 129 | *-44.6* | 102 | *-30.3* |
| Tax | 3 | 32 | *-91.3* | -22 | *-112.7* |
| **PAT** | 69 | 97 | *-29.3* | 124 | *-44.7* |
| **EPS** | 2.4 | 5.1 | *-52.8* | 6.6 | *-63.1* |

*(Source: Company, HDFC sec)*

## View and Valuation

The management is targeting to more than double the bank's business to Rs 180,000 cr by FY20 and to become a Preferred Banker to at least 1% of India's population. It expects to increase its touch points to 3,500 with 1,000 branches and 2,500 ATMs. Emphasis on technology to increase Digital Banking by increasing the digital touch points would result in cost reduction. Focus on increasing CASA ratio, improving credit-deposit ratio and shifting of business mix towards higher yielding retail and MSME loans would result in expansion of NIMs and improvement in return ratios. Better monitoring of asset quality will bring down NPA levels and lower the provisioning requirements. It is now critical for the bank to grow its advances without impacting its asset quality and liquidity profile, considering the subdued operating environment and expected withdrawals from the deposits made during November-December 2016.

On relative valuations the stock seems cheap, while possibilities of stake acquisition by other Banks/financial institutions or by institutional players could lead to a rerating of the stock. We feel investors could buy the stock at the CMP and add on declines to Rs. 124-128 band (0.9x FY19E ABV) for sequential targets of Rs. 154 (1.1x FY19E ABV) and Rs. 168 (1.2x FY19E ABV) in 2-3 quarters.

# Financial Statements

## Income Statement

| Particulars | FY15 | FY16 | FY17E | FY18E | FY19E |
|---|---|---|---|---|---|
| Interest Income | 4698 | 4992 | 5355 | 5866 | 6743 |
| Interest Expenses | 3530 | 3689 | 3810 | 4078 | 4714 |
| **Net Interest Income** | **1169** | **1303** | **1545** | **1787** | **2029** |
| Non interest income | 507 | 543 | 647 | 730 | 788 |
| **Operating Income** | **1676** | **1846** | **2191** | **2517** | **2817** |
| Operating Expenses | 902 | 991 | 1277 | 1456 | 1663 |
| PPP | 773 | 855 | 915 | 1061 | 1154 |
| Prov & Cont | 214 | 327 | 449 | 466 | 463 |
| Profit Before Tax | 559 | 528 | 466 | 595 | 690 |
| Tax | 108 | 113 | 43 | 119 | 152 |
| **PAT** | **451** | **415** | **423** | **476** | **538** |

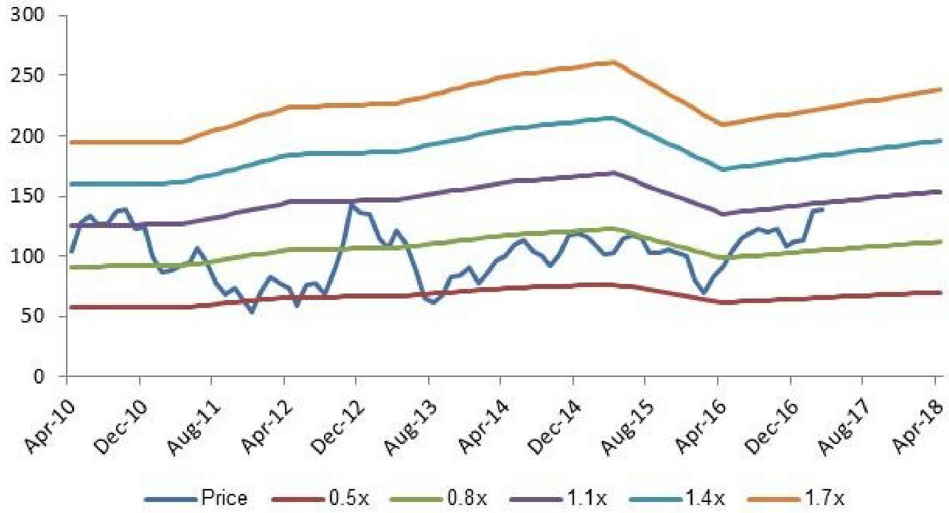
## Balance Sheet

| Particulars | FY15 | FY16 | FY17E | FY18E | FY19E |
|---|---|---|---|---|---|
| Share Capital | 188 | 188 | 283 | 283 | 283 |
| Reserves & Surplus | 3201 | 3502 | 4354 | 4694 | 5062 |
| **Shareholder funds** | **3389** | **3691** | **4637** | **4977** | **5345** |
| Deposits | 46009 | 50488 | 54960 | 61381 | 69706 |
| Borrowings | 1038 | 1051 | 1139 | 1250 | 1388 |
| Other Liab & Prov. | 1590 | 1470 | 1671 | 1853 | 2082 |
| **SOURCES OF FUNDS** | **52026** | **56701** | **62406** | **69461** | **78520** |
| Cash & Bank Balance | 2614 | 3045 | 3197 | 3512 | 3899 |
| Investment | 14032 | 16257 | 17587 | 19028 | 21051 |
| Advances | 31680 | 33902 | 37971 | 43097 | 49561 |
| Fixed Assets | 292 | 307 | 302 | 307 | 316 |
| Other Assets | 3408 | 3190 | 3349 | 3517 | 3693 |
| **TOTAL ASSETS** | **52026** | **56700** | **62407** | **69461** | **78520** |

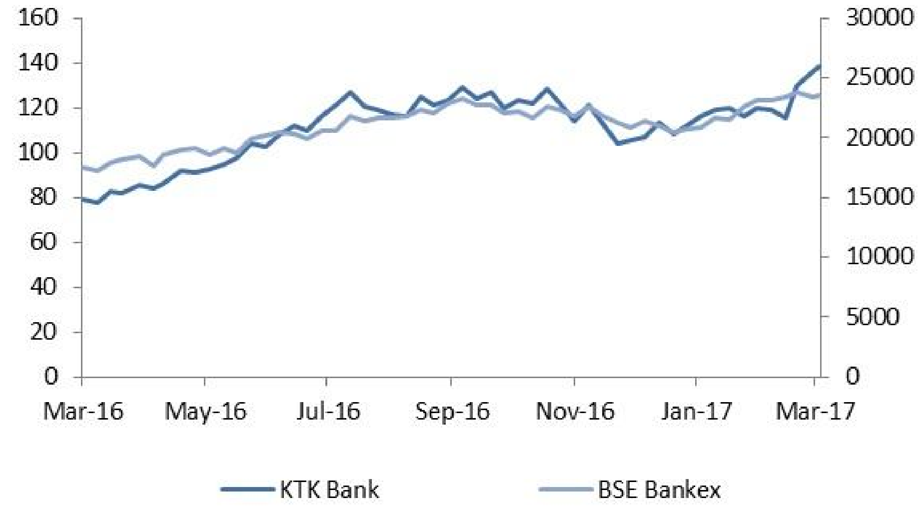
## Ratio Analysis

| Particulars | FY15 | FY16 | FY17E | FY18E | FY19E |
|---|---|---|---|---|---|
| **Return Ratios** | | | | | |
| Calc. Yield on adv | 11.7% | 11.3% | 11.1% | 10.9% | 11.0% |
| Calc. Cost of borr | 7.9% | 7.5% | 7.1% | 6.9% | 7.1% |
| NIM | 2.6% | 2.7% | 2.9% | 3.0% | 3.0% |
| RoAE | 14.0% | 11.7% | 10.2% | 9.9% | 10.4% |
| RoAA | 0.9% | 0.8% | 0.7% | 0.7% | 0.7% |
| **Asset Quality Ratios** | | | | | |
| GNPA | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% |
| NNPA | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% |
| **Growth Ratios** | | | | | |
| Advances | 11.8% | 7.0% | 12.0% | 13.5% | 15.0% |
| Borrowings | 13.4% | 9.7% | 8.9% | 11.7% | 13.6% |
| NII | 10.7% | 11.5% | 18.6% | 15.7% | 13.5% |
| PPP | 12.6% | 10.5% | 7.1% | 16.0% | 8.7% |
| PAT | 45.1% | -8.0% | 1.8% | 12.6% | 13.1% |
| **Valuation Ratios** | | | | | |
| EPS | 24.0 | 22.0 | 15.0 | 16.8 | 19.0 |
| P/E | 5.7 | 6.2 | 9.1 | 8.1 | 7.1 |
| Adj. BVPS | 146.7 | 153.6 | 123.0 | 131.8 | 140.0 |
| P/ABV | 0.8 | 0.7 | 0.8 | 0.8 | 0.7 |
| Dividend per share | 5.0 | 5.0 | 4.0 | 4.0 | 5.0 |
| Dividend Yield (%) | 3.7 | 3.7 | 2.9 | 2.9 | 3.7 |
| **Other Ratios** | | | | | |
| Cost-Income | 53.9 | 53.7 | 58.3 | 57.8 | 59.0 |
| Credit-Deposit | 69.8 | 68.9 | 67.1 | 69.1 | 70.2 |

## One year Forward PABV




## One year Price chart



**Fundamental Research Analyst: Atul Karwa, atul.karwa@hdfcsec.com**

**RETAIL RESEARCH Tel: (022) 3075 3400 Fax: (022) 2496 5066 Corporate Office**

**HDFC securities Limited, I Think Techno Campus, Building - B, "Alpha", Office Floor 8, Near Kanjurmarg Station, Opp. Crompton Greaves, Kanjurmarg (East), Mumbai 400 042 Phone: (022) 3075 3400 Fax: (022) 2496 5066**
**Website: www.hdfcsec.com Email: hdfcsecretailresearch@hdfcsec.com.**

***"HDFC Securities Ltd. is a SEBI Registered Research Analyst having registration no. INH000002475."***

**Disclosure:**
I **Atul Karwa, MMS** authors and the names subscribed to this report, hereby certify that all of the views expressed in this research report accurately reflect our views about the subject issuer(s) or securities. We also certify that no part of our compensation was, is, or will be directly or indirectly related to the specific recommendation(s) or view(s) in this report.
Research Analyst or his/her relative or HDFC Securities Ltd. **does not have** any financial interest in the subject company. Also Research Analyst or his relative or HDFC Securities Ltd. or its Associate may have beneficial ownership of 1% or more in the subject company at the end of the month immediately preceding the date of publication of the Research Report. Further Research Analyst or his relative or HDFC Securities Ltd. or its associate **does not have** any material conflict of interest.

**Any holding in stock – No**

**Disclaimer:**

This report has been prepared by HDFC Securities Ltd and is meant for sole use by the recipient and not for circulation. The information and opinions contained herein have been compiled or arrived at, based upon information obtained in good faith from sources believed to be reliable. Such information has not been independently verified and no guaranty, representation of warranty, express or implied, is made as to its accuracy, completeness or correctness. All such information and opinions are subject to change without notice. This document is for information purposes only. Descriptions of any company or companies or their securities mentioned herein are not intended to be complete and this document is not, and should not be construed as an offer or solicitation of an offer, to buy or sell any securities or other financial instruments.

This report is not directed to, or intended for display, downloading, printing, reproducing or for distribution to or use by, any person or entity who is a citizen or resident or located in any locality, state, country or other jurisdiction where such distribution, publication, reproduction, availability or use would be contrary to law or regulation or what would subject HDFC Securities Ltd or its affiliates to any registration or licensing requirement within such jurisdiction.

If this report is inadvertently send or has reached any individual in such country, especially, USA, the same may be ignored and brought to the attention of the sender. This document may not be reproduced, distributed or published for any purposes without prior written approval of HDFC Securities Ltd.

Foreign currencies denominated securities, wherever mentioned, are subject to exchange rate fluctuations, which could have an adverse effect on their value or price, or the income derived from them. In addition, investors in securities such as ADRs, the values of which are influenced by foreign currencies effectively assume currency risk.

It should not be considered to be taken as an offer to sell or a solicitation to buy any security. HDFC Securities Ltd may from time to time solicit from, or perform broking, or other services for, any company mentioned in this mail and/or its attachments.

HDFC Securities and its affiliated company(ies), their directors and employees may; (a) from time to time, have a long or short position in, and buy or sell the securities of the company(ies) mentioned herein or (b) be engaged in any other transaction involving such securities and earn brokerage or other compensation or act as a market maker in the financial instruments of the company(ies) discussed herein or act as an advisor or lender/borrower to such company(ies) or may have any other potential conflict of interests with respect to any recommendation and other related information and opinions.

HDFC Securities Ltd, its directors, analysts or employees do not take any responsibility, financial or otherwise, of the losses or the damages sustained due to the investments made or any action taken on basis of this report, including but not restricted to, fluctuation in the prices of shares and bonds, changes in the currency rates, diminution in the NAVs, reduction in the dividend or income, etc.

HDFC Securities Ltd and other group companies, its directors, associates, employees may have various positions in any of the stocks, securities and financial instruments dealt in the report, or may make sell or purchase or other deals in these securities from time to time or may deal in other securities of the companies / organizations described in this report.

HDFC Securities or its associates might have managed or co-managed public offering of securities for the subject company or might have been mandated by the subject company for any other assignment in the past twelve months.
HDFC Securities or its associates might have received any compensation from the companies mentioned in the report during the period preceding twelve months from the date of this report for services in respect of managing or co-managing public offerings, corporate finance, investment banking or merchant banking, brokerage services or other advisory service in a merger or specific transaction in the normal course of business.
HDFC Securities or its analysts did not receive any compensation or other benefits from the companies mentioned in the report or third party in connection with preparation of the research report. Accordingly, neither HDFC Securities nor Research Analysts have any material conflict of interest at the time of publication of this report. Compensation of our Research Analysts is not based on any specific merchant banking, investment banking or brokerage service transactions. HDFC Securities may have issued other reports that are inconsistent with and reach different conclusion from the information presented in this report.
Research entity has not been engaged in market making activity for the subject company. Research analyst has not served as an officer, director or employee of the subject company. We have not received any compensation/benefits from the Subject Company or third party in connection with the Research Report.

# KARNATAKA BANK Ltd.

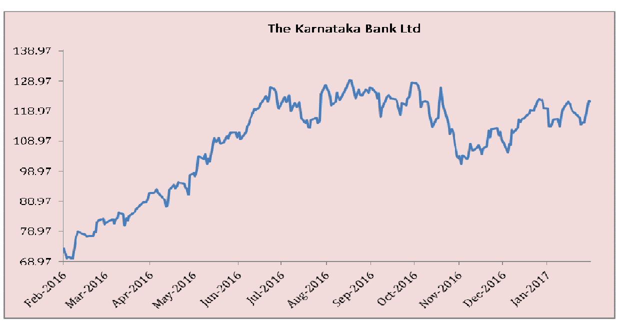
***March 31st, 2017***

| THE KARNATAKA BANK Ltd.(KTK) | |
|---|---|
| INDUSTRY | Bank - Private |
| No. of Shares (Crs) | 28.26 |
| Face value (Rs) | 10.00 |
| Mkt. Cap (Rs. Crore) | 3969.20 |
| Price (30/03/2017) | 140.45 |
| Book Value (Rs) | 145.03 |
| P/BV | 0.97 |
| BSE Code | 532652 |
| NSE Code | KTK BANK |
| Bloomberg | KBL IN |
| Reuters | KBNK.BO |
| Avg. Weekly Volume | 398790 |
| 52 W H/L (Rs) | 143.35/80.23 |

***Further to our Research report dated Feb 3rd 2016, wherein we had recommended a BUY at the then price of Rs. 95/- cum-dividend (dividend declared for the year ended March 2016 – 50%), the share price had spurted to Rs. 162 pre rights issue. There after the share price has stabilized at the current levels of Rs. 140 (ex-rights), notwithstanding the volatile stock market, Brexit, demonetization etc. The bank's plans to diversify its business activities in new sectors like Insurance, and expand its network and vision 2020 etc will see a re-rating for the stock in the near future. At the current market price of 140/- per share, ACCUMULATION is recommended with a medium to long term view.***

**Recommendation**

ACCUMULATE




## Company Background

Karnataka Bank Ltd (KTK), incorporated in 1924 at Mangalore is one of the oldest private sector Banks in India having more than nine decades of experience in the banking business. It offers wide variety of corporate and retail banking products and services to around 8 million customers. The Bank forayed into General Insurance sector as a JV partner with Universal Sompo General Insurance Company Ltd. As on December 31, 2016 the Bank had 2075 service outlets with 738 branches, 1334 ATMs in 486 centres across India. Out of 738 branches 78% of them are in South India.

## Investment Rationale

- Post Demonetization, CASA ratio improved to 30.22% in December 2016 from 25.23% in December 2015 and 26.33% in September 2016. The SB (savings bank) growth was robust during the quarter at 46.23%.
- The Bank has recently concluded right issue of 1:2 to raise Rs 658.96 crores which has improved the CAR from 12.03% in March 2016 to 13.19% in December 2016 (excluding profit for nine months) which could be ~14% by the end of FY17. The increased capital of the Bank would support its ambitious growth plan going ahead.
- KTK has reported strong growth in its business. Over the period of FY12-16, its loan book and total deposits grew at a CAGR of ~13% and ~12% YoY to ~Rs.33902 crores and ~Rs.50488 crores respectively. Consequently, its total business grew at a CAGR of ~12.69% to ~Rs.84391 crores over the same period.
- The Bank's strong growth in its business has helped it to improve its earnings. Over the period of FY12-16, its Net Interest Income (NII) and profitability grew at a CAGR of ~15% and ~14% respectively.
- The total business during 9mFY17 crossed Rs.90000 crore mark and the Bank targets a total business of Rs.180000 crores by March 2020. As a part of this growth strategy, the bank is targeting a CAGR of 22% credit growth by March 2020.
- The Bank targets to bring down its cost to income ratio from 59.26% in 9mFY17 to 50% in next two years.
- The NIM has improved to 2.54% in 9mFY17 from 2.40% a year ago.
- At the CMP of Rs 140, the stock trades at a P/ABV of 0.9 x FY18E adjusted BV & at a P/E multiple of 6.6 x FY18E earnings. We recommend a "ACCUMULATE" on the stock with a price target of Rs.167, an upside of 19.3%, over a period of 12 month.

| Particulars (Rs. Crs.) | 9mFY17 | 9mFY16 | Variance | FY14 | FY15 | FY16 | FY17e | FY18e |
|---|---|---|---|---|---|---|---|---|
| Net Interest Income | 1138.45 | 943.14 | 20.71% | 1056.07 | 1168.85 | 1302.87 | 5276.77 | 6003.52 |
| Total Income | 1636.10 | 1315.99 | 24.32% | 1561.65 | 1675.84 | 1845.73 | 2153.38 | 2649.85 |
| Operating Profit (OP) | 666.53 | 600.16 | 11.06% | 687.05 | 773.37 | 854.53 | 925.95 | 1165.93 |
| Profit After Tax (PAT) | 313.88 | 308.50 | 1.74% | 311.04 | 451.45 | 415.29 | 442.05 | 595.79 |
| EPS | 11.11 | 16.37 | -32.15% | 16.51 | 23.96 | 22.04 | 15.64 | 21.08 |
| BVPS | 145.03 | 195.67 | -15.72% | 161.82 | 179.68 | 195.67 | 164.77 | 180.47 |
| Equity (Rs Crores) | 282.61 | 188.47 | 49.94% | 188.42 | 188.46 | 188.47 | 282.61 | 282.61 |



Source: Company, AUM Research

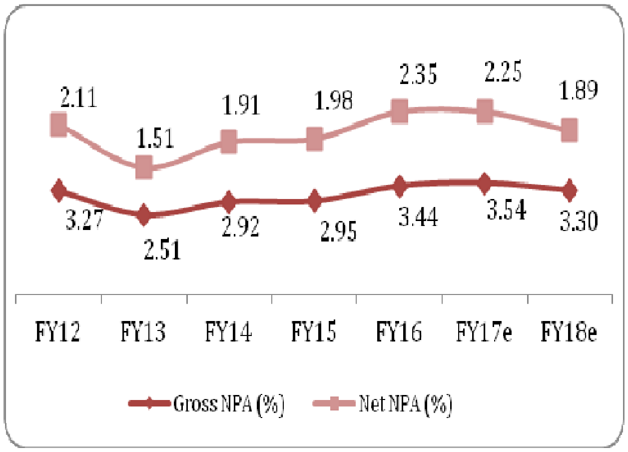
## Investment Rationale

### Adequate Capitalization to support rapid growth of the bank

The bank has recently concluded right issue of one share for every two shares at Rs.70 per share and augmented its capital funds to the extent of Rs.658.96 crores. As on December 30, 2016, KTK's capital adequacy ratio under the Basel III Capital Regulations was 13.19%, with a Tier I capital adequacy ratio of 11.86%, a Tier II capital adequacy ratio of 1.33% and CET I capital adequacy ratio of 11.86%. This capital adequacy ratio is without nine months profit, if added could be 14% of risk weighted assets of Rs.38120 crores in 9mFY17. The new capital will help bank to sustain credit growth.

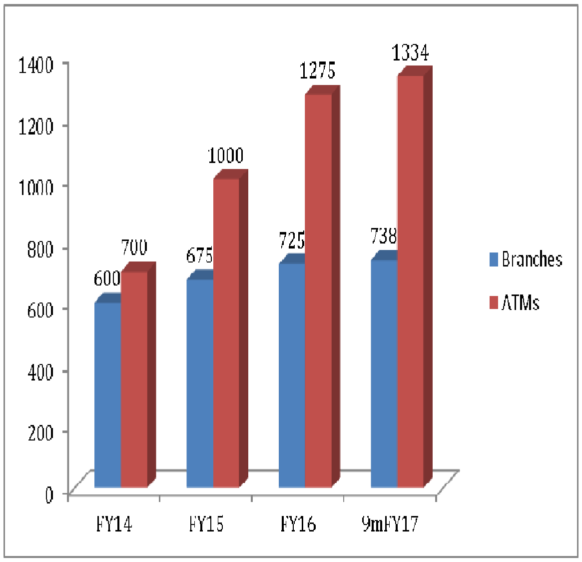
### Sound Asset Quality

KTK is focusing on containing the non-performing assets through better credit monitoring as well as intensified effort to recover the impaired asset. The bank's GNPA as on December 2016 increased to Rs.1560 crores from Rs.1180 crores in March 2016. From 3.44 % in 2015-16, gross non-performing assets stood at 4.30 % of loans as on December 2016 .The NNPA stood at Rs.1066 crores in December 2016 as against Rs.795 crores in March 2016. From 2.35 % in 2015-16, net non-performing assets stood at 2.99 % of loans as on December 2016. The Provision Coverage Ratio (PCR) computed in accordance with the RBI guidelines works out to 48.39 % as on March 2016 as against 50.54% in March 2015. However, better risk management policies and stable or reducing numbers in slippages may lead to improved asset quality.



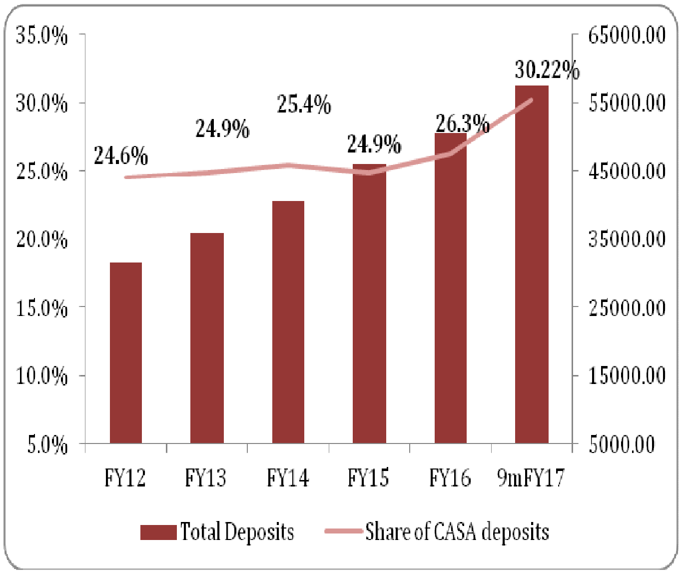

### The Bank intends to have national presence

The state of Karnataka continues to remain the bank's major business area. With the total asset base close to Rs 565 billion, the bank is serving close to 8.0 million valued customers across India. KTK Bank has around 738 branches (almost 78% of total network) in Southern region. It has a total of 2075 outlets which comprise of 3 Extension Counters, 738 branches & 1334 ATMs. Further the bank plans to extend its total number of business units to 3500 (1000 branches + 2500 ATMs), and has plans of extending its branch network in the Northern region. This will help the bank diversify its customer base and size of business and avoid exposure to regional risks.



## Increasing the share of CASA deposits

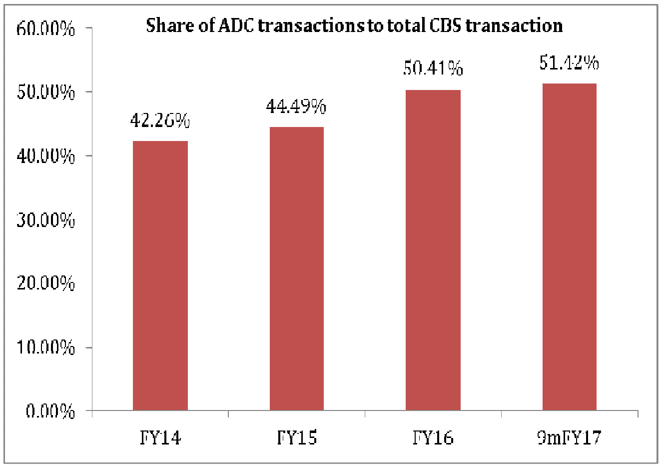
The bank's focus on garnering a higher share of low-cost CASA deposits has also led to steady margins. Over the last six years, the bank's share of CASA deposits in total deposits has been inching up gradually from 24.6% in FY12 levels to 26 % in FY16 and 30.22% in 9mFY17. The fall in cost of deposits during this period, has aided margins.




The total deposits of the bank grew by strong 13.76% in 9mFY17 to Rs.57435.00 crores backed by 30.91% growth in CASA deposits and CASA ratio jumped to 30.22% due to demonitization. Higher CASA ratio will ensure lower cost of funds and would protect the NIM in falling yield on advances scenario.

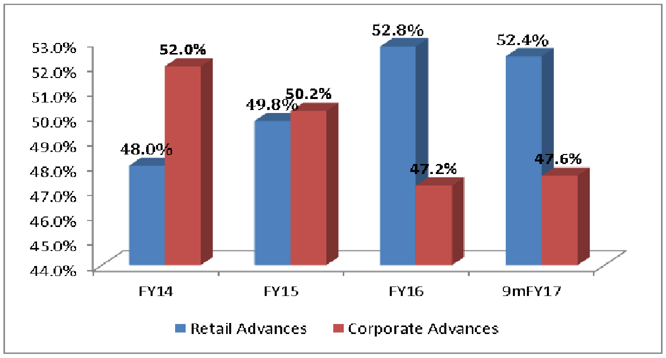
## Leveraging on Technology

The Bank migrated quickly to a centralised core banking system (CBS) in 2007 to process customer transaction. The bank also offers services to its customers through Alternative delivery channels (ADC) like internet banking, mobile banking, and many other technology products. Recently the bank launched Mobile Apps, viz., "KBL – ApnaApp" & "KBL-mPassBook" for enabling customers to carry on a host of banking activities through their mobile phone. Bank has also introduced online platform to apply for loan by MSME and other retail loans through banks website. With these technological developments bank would further increase customer power and support future growth.

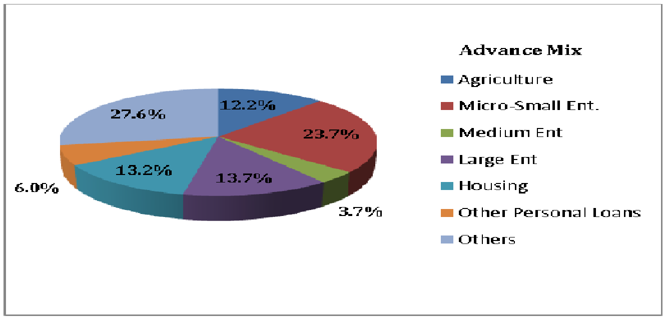


## Well diversified loan book

The Bank's loan book grew at a CAGR of 9.36% during FY14 -FY16 to Rs 33902.45 crores. Retail advances increased from 48% of the total loan book in FY14 to 52.40% in 9mFY17, Whereas Corporate advances decreased from 52.0% in FY14 to 47.6% in December 9mFY17. This justifies management's efforts to bring retail /corporate segments' composition in loan book to 50%/50% in FY15 and to 60%/40% in FY18. The bank is increasingly focusing on Retail advances growth which is gaining share for the last three years of total advances and the yield is high in this segment.

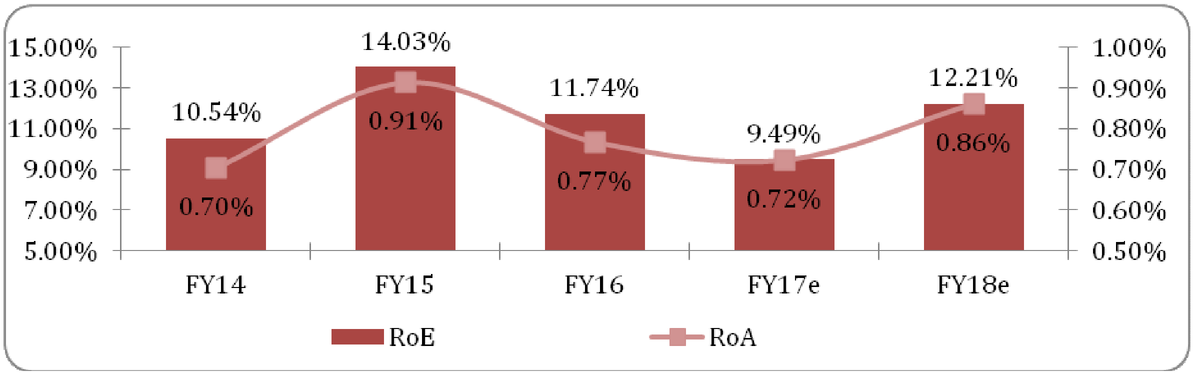



The segment wise distribution of advances to risky sectors likes Agriculture registered a fall from 13.27% in FY16 to 12.15% in 9mFY17 .The decline indicates scope for better asset quality. Also the bank's loan book is diversified and hence it is exposed to lower risk.



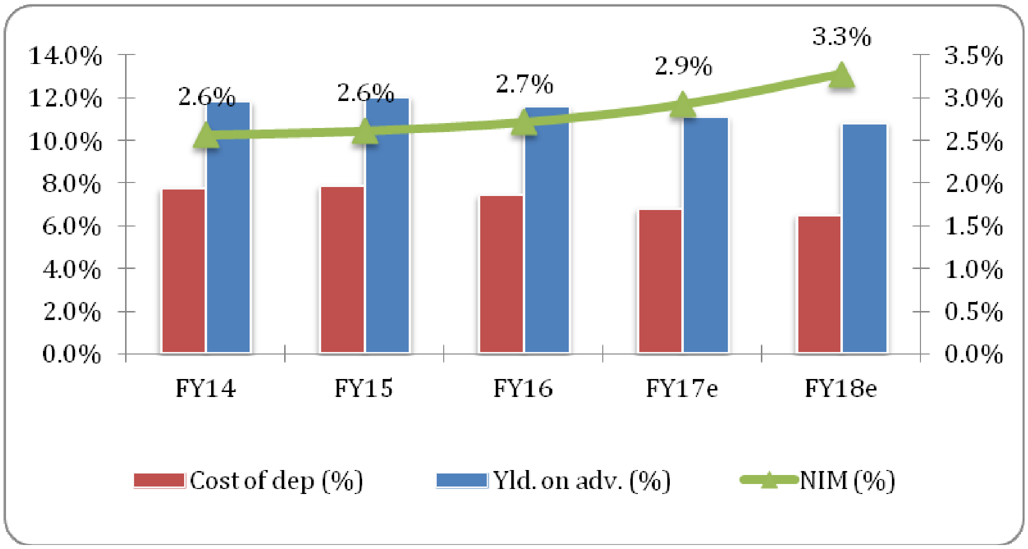

## Return ratios to strengthen

The Return on Equity ratio of the bank used to be in range of 18-19% till FY09. However due to lower profit it has fallen to 11.7% in FY16. Going forward we expect the ratio to be maintained in double digits of around 10%-12% in next two years. The RoA of the bank to increase from 0.77% in FY16 to 0.88% in FY18 on back of strong credit growth.



## Margins Trajectory

Yield on advances headed south to 11.6% in FY16 after registering 12.0% in FY15. However rising CASA base provided cushion to the bank due to fall in cost of deposits to 7.4% in FY16 as against 7.9% in FY15. Net interest margin improved to 2.7% in FY16 after being flat at 2.6% in FY15. The NIM has improved to 2.54% in 9mFY17 from 2.40% a year ago. We expect NIM to improve further due to strong CASA growth reported during Q3FY17 and also to be supported by loan growth due to expansion in branch network by the bank.




## Risk & Concerns

- ⇒ Deterioration in economic environment will result in lower than expected credit growth, which will hamper growth prospects of the bank.
- ⇒ The deterioration in the asset quality will impose a negative impact on banks profitability.
- ⇒ Any delay in the opening of branches within the stipulated time period can affect the CASA ratio of the bank, which would in turn affect its profitability.
- ⇒ Higher credit costs could lead to earnings growth being lower than estimated.
- ⇒ Volatility in interest rates could impact the financial performance.

| Income Statement (Figures in Rs. Crores) | | | | | |
|---|---|---|---|---|---|
| **Year ended 31st March** | **FY14** | **FY15** | **FY16** | **FY17e** | **FY18e** |
| **Interest income** | 4188.83 | 4698.42 | 4992.21 | 5276.77 | 6003.52 |
| Interest Expended | 3132.76 | 3529.57 | 3689.34 | 3720.39 | 4022.31 |
| Net interest income | 1056.07 | 1168.85 | 1302.87 | 1556.38 | 1981.21 |
| **Growth (%)** | 16.86% | 10.68% | 11.47% | 19.46% | 27.30% |
| Other Income | 505.58 | 507.00 | 542.86 | 597.00 | 668.64 |
| Total Income | 1561.65 | 1675.84 | 1845.73 | 2153.38 | 2649.85 |
| **Operating Expenditure** | 874.60 | 902.47 | 991.20 | 1227.42 | 1483.92 |
| Operating Income | 687.05 | 773.37 | 854.53 | 925.95 | 1165.93 |
| Provisions & Contingencies | 278.39 | 213.97 | 326.53 | 351.86 | 314.80 |
| **PBT** | 408.66 | 559.40 | 528.00 | 574.09 | 851.13 |
| Tax | 97.62 | 107.95 | 112.71 | 132.04 | 255.34 |
| Reported PAT | 311.04 | 451.45 | 415.29 | 442.05 | 595.79 |
| **EPS (Rs.)** | 16.51 | 23.96 | 22.04 | 15.64 | 21.08 |

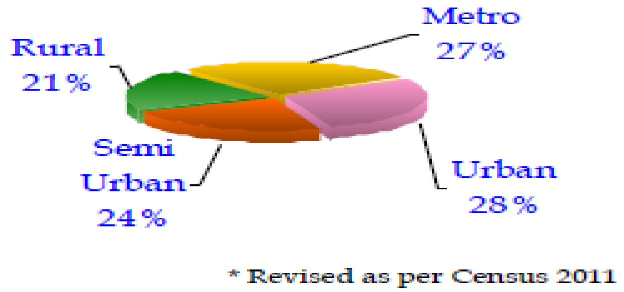
| Balance Sheet ( Figures in Rs. Crores) | | | | | |
|---|---|---|---|---|---|
| **Year ended 31st March** | **FY14** | **FY15** | **FY16** | **FY17e** | **FY18e** |
| **SOURCES OF FUNDS** | | | | | |
| **Share Capital** | 188.42 | 188.46 | 188.47 | 282.62 | 282.62 |
| Share Warrants & Outstanding | 3.31 | 3.01 | 2.92 | 0.00 | 0.00 |
| Reserves | 2860.46 | 3197.60 | 3499.20 | 4374.07 | 4817.86 |
| **Total Shareholders Funds** | **3048.88** | **3386.06** | **3687.67** | **4656.69** | **5100.48** |
| Total Deposits | 40582.83 | 46008.61 | 50488.21 | 58935.00 | 64828.50 |
| Borrowings | 1915.19 | 1037.76 | 1051.48 | 1038.00 | 1046.00 |
| Other Liabilities & Provisions | 1478.58 | 1401.18 | 1270.06 | 1336.00 | 1361.00 |
| **Total Liabilities** | **47028.80** | **51836.61** | **56500.34** | **65965.69** | **72335.98** |
| **APPLICATION OF FUNDS** | | | | | |
| Current Assets | 2337.40 | 2614.15 | 3044.92 | 6383.74 | 4297.07 |
| Investments | 15226.78 | 14031.67 | 16256.65 | 19162.56 | 21906.64 |
| Advances | 28345.49 | 31679.99 | 33902.45 | 37123.18 | 42691.66 |
| Fixed Assets | 197.48 | 291.85 | 306.64 | 356.21 | 390.61 |
| Other Assets | 921.65 | 3218.93 | 2989.67 | 2940.00 | 3050.00 |
| Lease Adjustments | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 |
| **Total Assets** | **47028.80** | **51836.61** | **56500.34** | **65965.69** | **72335.98** |

| Key Financial Ratios | | | | | |
|---|---|---|---|---|---|
| **Year ended 31st March** | **FY14** | **FY15** | **FY16** | **FY17e** | **FY18e** |
| **Growth Ratios** | | | | | |
| Int Inco (%) | 11.3% | 12.2% | 6.3% | 5.7% | 13.8% |
| NII (%) | 16.9% | 10.7% | 11.5% | 19.5% | 27.3% |
| Yield on advances (%) | 12.4% | 11.8% | 7.0% | 9.5% | 15.0% |
| Deposits (%) | 12.6% | 13.4% | 9.7% | 16.7% | 10.0% |
| EPS (%) | -10.7% | 45.1% | -8.0% | -29.0% | 34.8% |
| **Yield measurement measures** | | | | | |
| Yield on advances | 11.8% | 12.0% | 11.60% | 11.1% | 10.9% |
| Cost of deposits | 7.8% | 7.9% | 7.4% | 6.8% | 6.5% |
| Spread | 4.1% | 4.2% | 4.2% | 4.3% | 4.4% |
| Net interest margin | 2.6% | 2.6% | 2.7% | 2.9% | 3.3% |
| **Balance Sheet Ratios** | | | | | |
| Credit/Deposit Ratio | 69.8% | 68.9% | 67.1% | 63.0% | 65.9% |
| Investment/Deposit Ratio | 37.5% | 30.5% | 32.2% | 32.5% | 33.8% |
| CASA Ratio | 25.4% | 24.9% | 26.3% | 31.3% | 30.5% |
| Capital Adequacy Ratio (CAR) (%) | 13.2 | 12.4 | 12.0 | 13.27 | 12.74 |
| *Tier I* | 10.7 | 10.5 | 10.6 | 11.99 | 11.61 |
| **Aseet Quality Ratios** | | | | | |
| Gross NPA (%) | 2.92 | 2.95 | 3.44 | 3.54 | 3.30 |
| Net NPA (%) | 1.91 | 1.98 | 2.35 | 2.25 | 1.89 |
| **Profitability Ratios** | | | | | |
| RoA | 0.70% | 0.91% | 0.77% | 0.72% | 0.86% |
| RoE | 10.5% | 14.0% | 11.70% | 10.60% | 12.21% |
| **Efficiency Ratios** | | | | | |
| Cost to Income Ratio | 56.0% | 53.9% | 53.7% | 57.0% | 56.0% |
| **Productivity Ratio** | | | | | |
| Business per Employee (in Rs Cr.) | 9.59 | 10.52 | 10.83 | 11.94 | 12.97 |
| Profit per Employee (in Rs Cr) | 0.04 | 0.06 | 0.05 | 0.05 | 0.07 |
| **Valuation Ratios** | | | | | |
| PE (x) | 7.1 | 5.2 | 4.6 | 8.8 | 6.6 |
| P/BV (x) | 0.7 | 0.7 | 0.5 | 0.8 | 0.8 |
| Dividend Yield (%) | 3.4 | 4.0 | 4.9 | 2.9 | 3.6 |

## Shareholding Pattern

| Shareholding Pattern | % |
|---|---|
| Promoters | 0.00 |
| DIIs | 8.54 |
| FIIs | 20.19 |
| Body Corporate | 10.21 |
| Total Public | 61.06 |
| **Total** | **100.00** |
| **( As on December 31, 2016)** | |

**Area wise distribution of branches (Dec, 16)**




## Outlook and valuation

With recovering global economies and improving market conditions the outlook for the banking sector appears to be bright. The pickup in credit demand has already begun and the Reserve Bank of India has started phasing out its accommodative monetary policies. With both these taking place the interest margins for the industry is expected to improve, hence providing good investment prospects.

At the CMP of Rs 140, the stock trades at a P/ABV of 0.9 x FY18E adjusted BV & at a P/E multiple of 6.6 x FY18E earnings. We recommend a "ACCUMULATE" on the stock with a price target of Rs 167, an upside of 19.3%, over a period of 12 month.

## Aum Capital RESEARCH DESK


| | | |
|---|---|---|
| Rajesh Agarwal – Head of Research | 033 –30588405 | rajesh.agarwal@aumcap.com |
| Sanjeev Jain – Sr. Research Analyst | 033 –30588405 | sanjeev.jain@aumcap.com |
| Tanya Kothary - Sr. Research Analyst | 033 –30588405 | tanya.kothary@aumcap.com |




AUM Capital Market Private Limited
Registered Office: 5, Lower Rawdon Street, Akashdeep building 1st Floor, Kolkata – 700020; Phone: +91(33) 24861040/43; Fax: +91(33) 24760191
Website: www.aumcap.com; Email: aumresearch@aumcap.com