

Karnataka Bank

18 June 2018

Reuters: KBNK.NS; Bloomberg: KBL IN

Shaken And Stirred

We recently met the CEO and CFO of Karnataka Bank (KBL), Mr. Mahabaleshwara M. S. and Mr. Balachandra Y. V., respectively. The meeting helps us re-iterate, with confidence, that KBL is a bank that is making several key process improvements. (Also, see Detailed Management Meeting Takeways on page 2). Given its outlook and FY19E/20E RoE profile of 10%/12%, KBL is a prime re-rating candidate, currently trading at 0.5x FY20E P/BV. It may, also, be noted that, as of 4QFY18, KBL has recognized as NPA the lion's share of its stress pipeline ([See results note](#)). Also, see our [Initiating Coverage Report](#). We retain Buy rating on KBL with a target price to Rs150, valuing the stock at 0.7x FY20E P/BV.

- The **housing loan delivery model has been overhauled** in collaboration with marquee consulting firm BCG. This new system has been implemented on a pilot basis in Bangalore and Hyderabad. Housing loan **business in these specific branches has jumped 3x** compared with the same period last year. **Turnaround Time (TAT) has fallen** from ~30 days to less than 7 days. Following the successful pilot, this model is being replicated pan India.
- The same loan delivery model is being extended for **SME loans** as well.
- While loan account opening process had been centralised 3 years ago, **liability account opening** process has also been centralised now.
- The **Power sector stress** has largely been recognized by Karnataka Bank. Of the Rs 25.71bn Power sector exposure, about 84% is PSU exposure (not at risk of default). The Rs 2.93bn NPA in the Power sector book all comes from private sector Power exposure. These are 3 accounts of Rs 1.56bn, Rs 1.19bn and Rs 0.17bn, respectively.
- Of the Rs 44.57bn **Non Fund book**, Rs 38.26bn (86%) are Bank Guarantees (BG) and Rs 6.31bn (14%) are Letter of Credit. There is nil exposure to the discontinued **Letter of Undertaking / Letter of Comfort**.
- Management expects a slippage ratio of 1% and a **credit costs** of less than 100 bps in FY19. GNPA Ratio and NNPA Ratio are expected to move lower to 4% and 2%, respectively. PCR would hover between 55-60%.
- To **source home loans**, the bank has tied up with builders, tapped DSAs and market referral agents.
- The bank has also tied up with **Fin Tech** entities such as aggregators to source retail loans.
- The bank has also forayed into **pre-approved** retail loans.
- The bank has implemented a **Document Management System** that is having a multiplier effect across the organisation.
- Human resource management has been streamlined. The KRAs are now well-defined with a clear reward and recognition process in place. In this AGM, a **resolution to implement ESOPs** across the board has been passed. The management has also decided to implemented worthwhile training programs to employees.
- **Employee expenses** could rise by 10% in FY19. Salary negotiation is going on at the industry level and the rise in fixed salaries could be 10% at the most. The rise in salaries in FY20 over FY19 would only be due to increment/ dearness allowance, which is minimal.
- **Other opex** is expected to remain broadly at the level of FY18. In fact, branches have been given the specific instruction that if the Other Opex level of FY18 is to be breached, then head office approval would be required for the same.
- **Service and other charges** were revised in August 2017 and then in January 2018.
- **Cost to income ratio** will decline to 45%.
- The bank guides for FY20 **RoA and RoE** of 1% and 13%, respectively.
- **Net interest margin** will sustain at ~3.2% in FY19 despite rise in cost of funds.
- The bank added **1 million new customers** in FY18 and will add another 1.2 million in FY19.

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BUY

Sector: Banking

CMP: Rs118

Target Price: Rs150

Upside: 27%

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Key Data

Current Shares O/S (mn)	282.6
Mkt Cap (Rsbn/US\$mn)	33.1/486.2
52 Wk H / L (Rs)	180/107
Daily Vol. (3M NSE Avg.)	3,037,281

Price Performance (%)

	1 M	6 M	1 Yr
Karnataka Bank	(3.0)	(21.0)	(34.0)
Nifty Index	1.9	4.0	12.7

Source: Bloomberg

Detailed Management Meeting Takeaways

- The **housing loan delivery model has been overhauled** in collaboration with marquee consulting firm BCG. Earlier, the due diligence was carried out at the branch level but now, the lead is passed from the branch on to a centralised unit (Regional Loan Processing Center), which sends a person (Loan Disbursement Officer) to the potential customer's doorstep for due diligence. If approved, the customer is then asked to visit a branch of his convenience while keeping the relevant Branch Officer in the loop. Collection will also be carried out by a centralised team. This new system has been implemented on a pilot basis in Bangalore and Hyderabad. Housing loan **business in these specific branches has jumped 3x** compared with the same period last year. **Turnaround Time (TAT) has fallen** from ~30 days to less than 7 days. Following the successful pilot, this model is being replicated pan India.
- The same loan delivery model is being extended for **SME loans** as well.
- While loan account opening process had been centralised 3 years ago, **liability account opening** process has also been centralised now.
- The bank has carried out **significant stress recognition** over the course of FY18 with Non Priority Sector GNPA Ratio rising from 3.7% to 5.6%. Within this, Industry loan GNPA Ratio rose from 16.2% to 22.9% while Infra (including Power) GNPA Ratio moved from 1.6% to 9.2%.

Exhibit 1: Segment-wise evolution of GNPA Ratios over FY17-FY18

GNPA Ratios - Non Priority Sector Loans		
	FY17	FY18
Overall	3.72%	5.61%
Industry	16.22%	22.91%
Services	6.74%	4.91%
Personal	7.92%	1.69%
Other	0.77%	3.46%
CRE	4.03%	4.68%
Education	1.87%	2.01%
Housing	1.48%	1.31%
Infra(incl Power)	1.57%	9.22%

GNPA Ratios - Priority Sector Loans		
	FY17	FY18
Overall	4.41%	3.90%
Agri	4.59%	3.38%
Industry	6.51%	6.54%
Services	4.14%	3.93%
Personal	1.52%	1.32%

Source: Company, Nirmal Bang Institutional Equities Research

- The **Power sector stress** has largely been recognized by Karnataka Bank. Of the Rs 25.71bn Power sector exposure, about 84% is PSU exposure (not at risk of default). The Rs 2.93bn NPA in the Power sector book all comes from private sector Power exposure. These are 3 accounts of Rs 1.56bn, Rs 1.19bn and Rs 0.17bn, respectively.
- Of the Rs 44.57bn **Non Fund book**, Rs 38.26bn (86%) are Bank Guarantees (BG) and Rs 6.31bn (14%) are Letter of Credit. There is nil exposure to the discontinued Letter of Undertaking / Letter of Comfort. While BG used to be fraud prone at some point in the past, the implementation of Secured Financial Messaging System precludes the incidence of fraud. Letter of Credit issuance has also been centralised.
- Management expects a slippage ratio of 1% and a **credit costs** of less than 100 bps in FY19. GNPA Ratio and NNPA Ratio are expected to move lower to 4% and 2%, respectively. PCR would hover between 55-60%.
- To **source home loans**, the bank has tied up with builders, tapped DSAs and market referral agents.
- The bank has also tied up with **Fin Tech** entities such as aggregators to source retail loans.

- The bank has also forayed into **pre-approved** retail loans.
- The bank has implemented a **Document Management System** that is having a multiplier effect across the organisation.
- Human resource management has been streamlined. The KRAs are now well-defined with a clear reward and recognition process in place. In this AGM, a **resolution to implement ESOPs** across the board has been made. The management has also decided to implemented worthwhile training programs to employees.
- The bank is **targeting a loan mix** of 40% from Corporate loans (greater than Rs 150mn ticket size), 15% from Mid Corporate (Rs 50-150mn ticket size) and 45% from Retail (less than Rs 50 mn ticket size). A broad ticket size range of Rs 5mn to Rs 500mn is being targeted.
- Present status of **banks under PCA** is helpful for Karnataka Bank since, for a number of accounts, renewal business is becoming difficult to execute for such banks.
- Breakup of '**Others**' in **loan book pie chart** in Company Presentation: ~Rs 20bn is IBPC (Inter Bank Participation Certificate), Rs 6.39bn is Food Credit, Loans to NBFCs is Rs 70.89bn, Other Infra Loans is Rs 33.78bn, Other Vehicle Loans is Rs 10.97bn.
- Of the Rs 59.89bn of **Agri loan book**, 59% is in Karnataka state. Without farm loan waiver, Rs 1.06bn would turn NPA and hence, there is short-term gain from such a waiver. As regards, deterioration of credit culture, the bank does not any significant impact. The primary requirement of the farmer is price stability, which the government is increasingly willing to address. Crop insurance schemes are also helpful to alleviate farmer woes.
- While about 65% of transaction value is already through **alternate digital channels** (everything other than branches), the management wishes to increase this share to 80%.
- **Employee expenses** could rise by 10% in FY19. Salary negotiation is going on at the industry level and the rise in fixed salaries could be 10% at the most. The rise in salaries in FY20 over FY19 would only be due to increment/ dearness allowance, which is minimal.
- **Other opex** is expected to remain broadly at the level of FY18. In fact, branches have been given the specific instruction that if the Other Opex level of FY18 is to be breached, then head office approval would be required for the same.
- About 200 **employees** are going to be recruited per year for the foreseeable future.
- **Service and other charges** were revised in August 2017 and then in January 2018.

Exhibit 2: Detailed breakup of Other Income - FY17-FY18 – Rsmn

(Rsmn)	FY17	FY18
Locker Rent, Etc	328	345
Service Charges	780	967
Exchange Transactions	189	285
Forex Income	620	762
Incidental Charges w.r.t. Loans	226	435
Other Incidental charges	682	985
Recoveries from W/o ac	178	796
Insurance (Third Party)	295	326
ATM Fees	749	989
Other Miscellaneous	869	1,679
Treasury Income	3,042	1,970
Other	137	5.2
Total Other Income	8,093	9,543

Source: Company, Nirmal Bang Institutional Equities Research

- **Cost to income ratio** will decline to 45%.
- The bank guides for FY20 **RoA and RoE** of 1% and 13%, respectively.
- While the bank can grow at ~20% plus without **raising capital** in FY19, it could come to the market in 2HFY19. If not, it would definitely come to the market to raise equity capital in FY20.
- While there is no definitive number to share regarding **impact of IndAS**, there could be a negative impact of 100-150 bps on capital levels on proforma basis based on certain assumptions. The bank has engaged E&Y in the regard and the Working Group stands fully ready to implement IndAS before the deadline.
- **Net interest margin** will sustain at ~3.2% in FY19 despite rise in cost of funds.
- The bank added **1 million new customers** in FY18 and will add another 1.2 million in FY19.

Exhibit 3: One-year forward P/BV



Source: Company, Nirmal Bang Institutional Equities Research

Financials

Exhibit 4: Income statement

Y/E March (Rsmn)	FY16	FY17	FY18	FY19E	FY20E
Interest income	49,922	51,854	54,238	65,310	79,886
Interest expenses	36,893	36,948	35,661	42,662	51,251
Net interest income	13,029	14,906	18,577	22,648	28,635
Fees	2,379	2,711	7,570	7,343	8,063
Other income	3,049	5,383	1,970	3,076	3,646
Net revenues	18,457	23,000	28,117	33,067	40,343
Operating expenses	9,912	13,042	13,388	15,584	18,519
-Employee expenses	4,430	6,010	5,248	6,143	7,001
-Other expenses	5,482	7,031	8,140	9,441	11,518
Pre-provision profit	8,545	9,958	14,728	17,483	21,824
Provisions	3,265	5,279	10,436	9,130	9,817
-Loan loss provision	2,857	5,358	10,400	9,094	9,783
-Provisions for investment	132	40	36	36	34
-Other provisions	276	(119)	-	-	-
PBT	5,280	4,680	4,292	8,353	12,007
Tax	1,127	157	(155)	2,840	4,082
PAT	4,153	4,523	4,447	5,513	7,924

Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 6: Balance sheet

Y/E March (Rsmn)	FY16	FY17	FY18	FY19E	FY20E
Equity capital	1,885	2,826	2,826	2,826	3,109
Reserves & surplus	35,021	48,600	51,275	55,323	68,624
Shareholder funds	36,906	51,426	54,102	58,149	71,733
Deposits	504,882	567,331	628,713	732,667	859,490
Borrowings	10,515	8,326	8,160	38,679	50,640
Other liabilities	12,701	14,182	12,763	27,176	42,707
Total liabilities	565,003	641,265	703,737	856,671	1,024,570
Cash/equivalent	30,449	32,740	36,010	50,729	59,780
Advances	339,024	370,036	472,518	576,471	703,295
Investments	162,567	202,197	154,445	187,281	217,792
Fixed assets	3,066	7,206	7,616	8,378	9,215
Other assets	29,897	29,086	33,149	33,812	34,488
Total assets	565,003	641,265	703,737	856,671	1,024,570

Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 5: Key ratios

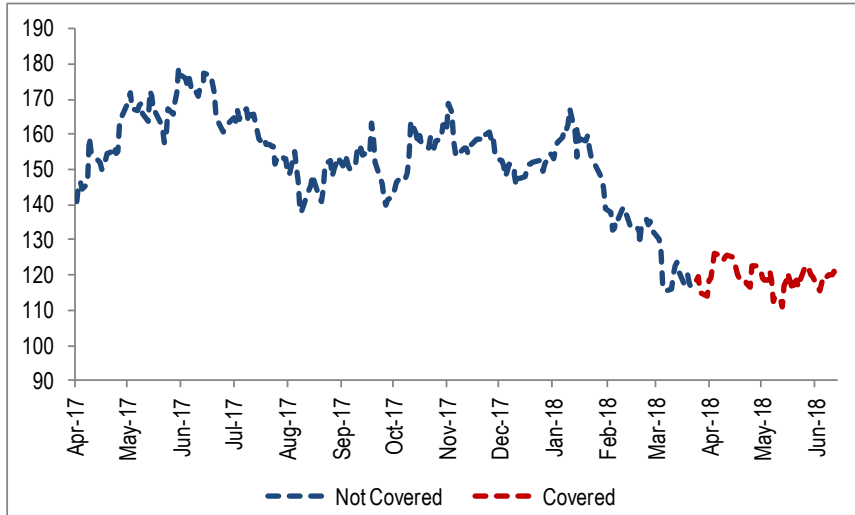
Y/E March	FY16	FY17	FY18	FY19E	FY20E
Growth (%)					
NII growth	11.5	14.4	24.6	21.9	26.4
Pre-provision profit growth	10.5	16.5	47.9	18.7	24.8
PAT growth	(8.0)	8.9	(1.7)	24.0	43.7
Business (%)					
Deposit growth	9.7	12.4	10.8	16.5	17.3
Advance growth	7.0	9.1	27.7	22.0	22.0
Business growth	8.6	11.1	17.5	18.9	19.4
CD	67.1	65.2	75.2	78.7	81.8
CASA	26.3	29.0	-	28.2	28.2
Operating efficiency (%)					
Cost-to-income	53.7	56.7	47.6	47.1	45.9
Cost-to-assets	1.8	2.2	2.0	2.0	2.0
Productivity (Rsmn)					
Business per branch	1,164.0	1,225.3	1,376.5	1,577.3	1,817.2
Business per employee	108.3	117.4	134.5	150.2	173.1
Profit per branch	5.7	5.9	5.6	6.6	9.2
Profit per employee	0.5	0.6	0.5	0.6	0.9
Spread (%)					
Yield on advances	11.3	10.7	9.7	10.0	10.0
Yield on investments	7.4	7.1	6.5	6.9	7.1
Cost of deposits	7.4	6.7	5.8	5.9	5.9
Yield on assets	10.0	9.5	8.9	9.2	9.3
Cost of funds	7.5	6.8	5.9	6.1	6.1
NIMs	2.6	2.7	3.1	3.2	3.3
Capital adequacy (%)					
Tier I	10.6	12.2	11.3	9.9	10.0
Tier II	1.5	1.1	0.8	0.8	0.8
Total CAR	12.0	13.3	12.0	10.7	10.8
Asset quality (%)					
Gross NPAs	3.4	4.2	4.9	4.8	4.7
Net NPAs	2.4	2.7	3.0	3.0	3.1
Provision coverage	31.4	36.8	41.0	38.2	35.5
Slippage	3.4	3.8	5.0	3.7	3.5
Credit-cost	0.8	1.6	2.3	1.6	1.4
Return (%)					
RoE	11.7	10.2	8.4	9.8	12.2
RoA	0.8	0.7	0.7	0.7	0.8
RoRWA		2.3	1.1	1.0	1.2
Per share					
EPS	22.0	16.0	15.7	19.5	25.5
BV	195.8	182.0	191.4	205.8	230.7
ABV	152.9	146.6	141.9	144.5	161.7
Valuation (x)					
P/E	5.4	7.4	7.5	6.1	4.6
P/BV	0.6	0.7	0.6	0.6	0.5
P/ABV	0.8	0.8	0.8	0.8	0.7

Source: Company, Nirmal Bang Institutional Equities Research

Rating track

Date	Rating	Market price (Rs)	Target price (Rs)
26 March 2018	Buy	117	147
17 May 2018	Buy	116	150
18 June 2018	Buy	118	150

Rating track graph



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BUY > 15%

ACCUMULATE -5% to 15%

SELL < -5%

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