

September 16, 2019

Karnataka Bank Limited: Ratings reaffirmed

Summary of rating action

Instrument*	Previous Rated Amount (Rs. crore)	Current Rated Amount (Rs. crore)	Rating Action
Lower Tier-II Bonds Programme	250.00	250.00	[ICRA]A (stable); Reaffirmed
Lower Tier-II Bonds Programme	200.00	0.00	[ICRA]A (stable)/ Withdrawn
Certificate of deposits	3,000.00	3,000.00	[ICRA]A1+/ Reaffirmed
Basel III Compliant Tier-II Bonds Programme	720.00	720.00	[ICRA]A(hyb) (stable)/ Reaffirmed
Basel III Compliant Tier-II Bonds Programme	80.00	0.00	[ICRA]A(hyb) (Stable); Withdrawn
Total	4,250.00	3,970.00	

*Instrument details are provided in Annexure-1

Rationale

The rating on the Rs. 200.00 crore Lower tier-II bond programme is withdrawn as the instrument has been fully redeemed and there is no amount outstanding against the rated instrument. The rating on the Rs.80.00 crore Basel-III compliant tier-II bond programme is withdrawn, at the request of the bank, as the instrument was not placed and there is no amount outstanding against the rated limit.

The rating re-affirmation continues to factor in KBL's established retail franchise in Southern India which provides access to core retail deposits with retail term deposits accounting for 72.2% of the total deposits and share of current accounts and savings accounts (CASA) of 27.4% as on June 30, 2019; its comfortable liquidity profile with liquidity coverage ratio of 241.1% as on June 30, 2019 and no negative cumulative mis-matches in its structural liquidity (in June 2019) across maturity buckets up to 1 year. Near term capital profile is adequate with Tier I capital of 10.7% as on June 30, 2019, however the bank would have to improve its capitalization for the envisioned growth in FY2020-FY2021 to maintain adequate buffer over regulatory capital requirement.

The rating, however, remains constrained due to persistently moderate asset quality numbers with GNPA% (gross non-performing asset / gross advances) and NNPA% (net non-performing asset / net advances) of 4.6% and 3.3% as on June 30, 2019, (4.9% and 3.0% respectively as on March 31, 2018). ICRA notes that the bank's provision coverage (cumulative provisions / GNPA) and solvency ratio (NNPA/Net-Worth) continues to remain subdued at 26.6% and 29.5% respectively (as on June 30, 2019). Stress in asset quality led to high credit provisions which resulted in subdued profitability (profit after tax / average total assets) of 0.6% for FY2019 and 0.5% for FY2018. Further, with high regional concentration in Karnataka (accounting for 43.4% of advances and 62% of branches as on March 31, 2019) the bank is susceptible to any regional event related risks. Going forward, the bank's ability to control incremental slippages, increase provision cover and making effective recoveries would be crucial.

Key rating drivers and their description

Credit strengths

Established regional franchise in Karnataka:

KBL has an established presence in Southern India of over 95 years. KBL's long standing regional franchise in Karnataka provides access to core retail deposits. Retail term deposits accounted for 72.2% of its total deposits as on June 30, 2019 and CASA ratio stood at 27.4% of total deposits in June 30, 2019. The bank's loan book grew by 16.0% YoY in FY2019 to Rs. 54,828 crore (as on March 31, 2019) and stood at Rs.52,819 crore as on June 30, 2019. While KBL's advances to the corporate segment have grown and accounted for 55.0% of total advances as on June 30, 2019 (55.0% as on March 31, 2018), ICRA takes note of incremental exposure were largely to 'A' and higher rated entities which contributed 59.0% (Rs.4,473.2 crores out of Rs.7,576.5 crore) of the total YOY increase in total advances of the bank in FY2019. The share of advances with external rating in 'A' category and above stood at 24.3% of gross bank credit and 44.8% of corporate advances as on June 30, 2019. Going forward, the bank is expected to leverage on its established retail franchise to enhance its retail and SME exposures.

Adequate near-term capitalization:

KBL had an adequate capitalization profile with Tier I and capital to risk weighted assets ratio (CRAR) of 10.7% and 12.7% respectively as on June 30, 2019. The bank's current capital profile is adequate for meeting near term growth requirements. As per ICRA's estimates, the bank would require incremental Tier I capital of Rs.1,500-1,800 crore during FY2020-FY2022 to support a 16% growth per annum in its RWA, while maintaining a comfortable buffer of about 2% over regulatory Tier-I (9.5%).

Credit challenges

Modest scale of operations with a regionally concentrated presence:

KBL's scale of operations remained moderate with the bank's market share in the overall deposits and being at about 0.6% and 0.6% respectively as on March 31, 2019. The bank's operations are highly concentrated in the region of Southern India which accounted for 60.2% (as on March 31, 2019) of total credit and 75.9% of its branches (as on June 30, 2019). ICRA expects the bank's operations to remain highly concentrated in Southern India over medium term.

Moderate asset quality and solvency:

The bank's asset quality remains moderate with GNPA and NNPA of 4.6% and 3.3% respectively as on June 30, 2019, as compared to 4.9% and 3.0% respectively as on March 31, 2018. The provision cover and solvency ratio weakened to 26.6% and 29.5% respectively as on June 30, 2019 from 41.0% and 25.9% as on March 31, 2018 respectively. With fresh NPA generation at 3.9% (annualized) for Q1FY2020 as compared to 3.2% (annualized) for Q4FY2020, it will be crucial for the bank to contain further slippages and undertake significant recoveries to contain credit costs and improve asset quality.

Subdued profitability indicators:

The bank reported operating profit / average total asset of 1.7% for FY2019 as compared to 1.9% for FY2018 which was due to increased share of A and above rated advances in FY2019 over FY2018 resulting in lower yields and consequent drop in net interest margins to 2.6% in FY2019 from 2.8% in FY2018. The bank's net profitability remains subdued at 0.6% for FY2019 (0.9% in Q1FY2020) as compared to 0.5% for FY2018. KBL's credit costs (credit provisions / average total assets) showed marginal improvement at 1.1% for FY2019 as compared to 1.7% for FY2018, however remains above average as compared to peers in similar rating category of the bank. The bank's return on net-worth remained moderate at 8.8% for FY2019. For healthy internal capital generation, ability to generate adequate net interest margin and keeping the asset quality under control would be crucial as the bank further increases its provision cover on NPAs going forward.

Liquidity position: Strong

Liquidity profile of the bank remains comfortable with no negative cumulative asset-liability management gap in the maturity bucket of up to one year (as on June 11, 2019). LCR stood comfortable at 241.1% as on June 30, 2019 against minimum regulatory requirement of 100% (since January 01, 2019). This has been supported by sizable share of retail term deposits which account for 72.3% of total deposits as on June 30, 2019.

Rating sensitivities

Positive Triggers: ICRA could upgrade the above long-term rating if the bank demonstrates a sustained improvement in its profitability and solvency ratios. Key metrics that could lead to an upgrade for the bank are (1) Return on average total assets of above 1.0% on sustained basis; (2) Net non-performing asset / CET-I below 20.0% on sustained basis.

Negative triggers: The bank's above-mentioned ratings could face downward pressure in case of continued subdued profitability, further deterioration in asset quality and delay in raising capital in timely manner. Key metrics that could lead to a downgrade for the bank is (1) Return on average total assets of less than 0.5%; (2) Net non-performing asset / CET-I crossing 35.0%.

Analytical approach

Analytical Approach	Comments
Applicable Rating Methodologies	Rating Methodology for Banks
Parent/Group Support	Not Applicable
Consolidation/Standalone	Not Applicable

About the company

KBL is one of the old private sector banks, having commenced its operations in 1924 in Mangalore (Karnataka). The bank reported an asset size of Rs. 78,949.4 crore as on June 30, 2019. KBL's shares were largely held by the public (61.8%) followed by foreign portfolio investors (15.3%), banks/mutual funds/insurance companies (12.7%) and others (10.1%) as on June 30, 2019. The bank had a network of 839 branches and 1,191 ATM outlets as on June 30, 2019 with about 62.0% of its total branches located in Karnataka.

For Q1 FY2020, the bank reported a net profit of Rs. 175.4 crore on a total asset base of Rs. 78,949.4 crore as on June 30, 2019 (compared to net profit of Rs. 163.2 crore for Q1 FY2019 on a total asset base of Rs. 70,603.2 crore as on June 30, 2018).

For the financial year FY2019, the bank reported a net profit of Rs. 477.2 crore on a total asset base of Rs. 78,633.6 crore as on March 31, 2019 (compared to Rs. 325.6 crore in FY2018 on a total asset base of Rs. 69,957.5 crore as on March 31, 2018).

Key financial indicators (audited)

	FY2018	FY2019	3M FY2019	3M FY2020
Net interest income	1,858	1,905	469	495
Profit before tax	310	608	147	149
Profit after tax	326	477	163	175
Net advances	47,252	54,828	47,731	52,819
Total assets (net of revaluation reserves)	69,958	78,634	70,603	78,949
% CET 1	11.3%	11.2%	10.8%	10.7%
% Tier 1	11.3%	11.2%	10.8%	10.7%
% CRAR	12.0%	13.2%	11.6%	12.7%
%Net interest margin/average total assets	2.8%	2.6%	2.7%	2.5%
%Net profit/average total assets	0.5%	0.6%	0.9%	0.9%
%Return on average net worth	6.4%	8.9%	11.9%	12.0%
% Gross NPAs	4.9%	4.4%	4.7%	4.6%
% Net NPAs	2.9%	3.0%	2.9%	3.3%
% Provision coverage excl. technical write offs	41.0%	34.2%	39.2%	27.8%
% Net NPA/net worth	25.9%	30.1%	25.0%	29.5%

Status of non-cooperation with previous CRA: Not applicable

Any other information: None

Rating history for past three years

	Instrument	Current Rating (FY2020)			Chronology of Rating History for the past 3 years					
		Type	Amount Rated	Amount Outstanding	FY2020	FY2019	FY2018			FY2017
					16-September 2019	24-September 2018	21-March 2018	16-February 2018	26-July 2017	18-January 2017
1	Lower Tier-II Bonds	Long term	250.00	250.00	[ICRA]A (Stable)	[ICRA]A (Stable)	[ICRA]A (Stable)	[ICRA]A (Stable)	[ICRA]A (Stable)	[ICRA]A (Stable)
2	Certificate of Deposits	Short term	3,000.00	3,000.00	[ICRA]A1+	[ICRA]A1+	[ICRA]A1+	[ICRA]A1+	[ICRA]A1+	[ICRA]A1+
3	Basel III Compliant Tier II Bonds	Long Term	720.00	720.00	[ICRA]A(Hyb) (Stable)	[ICRA]A(Hyb) (Stable)	-	-	-	-

Fig in Rs. Crore

Complexity level of the rated instrument

ICRA has classified various instruments based on their complexity as "Simple", "Complex" and "Highly Complex". The classification of instruments according to their complexity levels is available on the website [click here](#)

Annexure-1: Instrument details

ISIN No	Instrument Name	Date of Issuance / Sanction	Coupon Rate	Maturity Date	Amount Rated (Rs. crore)	Current Rating and Outlook
INE614B08013	Lower Tier-II Bonds	27-09-2008	11.25%	27-09-2018	200.00	[ICRA]A (Stable); withdrawn
INE614B08021	Lower Tier-II Bonds	17-11-2012	11.00%	17-11-2022	250.00	[ICRA]A (Stable)
-	Certificate of Deposit	NA	NA	7-365 days	3,000.00	[ICRA]A1+
INE614B08039	Basel III Compliant Tier II Bonds	16-11-2018	12%	16-11-2028	400.00	[ICRA]A(hyb) (Stable)
INE614B08047	Basel III Compliant Tier II Bonds	18-02-2019	12%	18-02-2029	320.00	[ICRA]A(hyb) (Stable)
-	Basel III Compliant Tier II Bonds	-	-	-	80.00	[ICRA]A(hyb) (Stable); withdrawn

Source: Karnataka Bank Limited

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