Machhapuchchhre Bank Limited

Rating

Facility/Instrument	Amount (Rs. in Million)	Ratings[1]	Rating Action
Issuer Rating	**NA**	**CARE-NP BBB+ (Is) [Triple B Plus (Issuer)] (Credit Watch with negative implications)**	**Revised from CARE-NP A- (Is) and placed on credit watch with negative implications**

CARE Ratings Nepal Limited (CRNL) has revised the issuer rating assigned to Machhapuchchhre Bank Limited (MBL) to 'CARE-NP BBB+ (Is)' from 'CARE-NP A- (Is)' and has placed the rating on credit watch with negative implications. Issuers with this rating are considered to offer moderate degree of safety regarding timely servicing of financial obligations, in Nepal. Such issuers carry moderate credit risk.

Detailed Rationale & Key Rating Drivers

The rating assigned to MBL has been revised and placed on credit watch with negative implications factoring in thin cushion in its Tier 1 capital adequacy ratio (CAR) as on mid-January 2024 with likelihood of sustained downward pressure over the near term amid declining asset quality trend. MBL reported uptick in its Non-Performing Loans (NPL) in FY23 (FY refers to the twelve-month period ending mid-July), with continued declining trend in H1FY24 (Unaudited, H1 refers to the six-month period ending mid-January) amid economic slowdown. Besides, subdued profitability in H1FY24 on account of moderation in growth of loans and advances coupled with regulatory cap on interest rate spread and higher transfer to regulatory reserve (interest accrued but not yet received and short loan loss provision in Non-Banking Assets) resulted in lower qualified capital and decline in capitalization level at the end of H1FY24. Furthermore, Nepal Rastra Bank's (NRB) implementation of adding 0.5% countercyclical buffer to the regulatory capital from mid-July 2024 for Class A commercial banks (minimum Tier-1 CAR to be maintained at 9% from FY24 end) is expected to make it even more challenging for the bank to uphold the minimum regulatory Tier 1 capitalization levels by mid-July 2024. The bank's ability to successfully carry out its capital plans to improve its capitalization levels to meet the regulatory requirements by mid-July 2024, particularly given the stress in its asset quality and the overall industry headwinds in the Nepalese banking sector remains to be seen.

The rating, however, continues to derive strengths from the bank's long track record of operations along with experienced directors and management team, widespread geographical coverage through branches, moderate financial profile of the bank despite moderation in H1FY24 and moderate CASA mix with decent cost of funds in recent quarters. The ratings also factor in concentration of the loan portfolio of the banks towards corporate advances, relatively small scale of operation of the bank amid intense competition and exposure to regulatory risk related to industry.

Going forward, the ability of the bank to maintain its capitalization levels with adequate cushion over minimum regulatory requirement levels, and manage the impact of any other regulatory changes by NRB would be the key rating sensitivities. The bank's ability to improve its asset quality and delinquent loans would be critical for the bank's earning profile.

[1]Complete definitions of the ratings assigned are available at www.careratingsnepal.com and in other CRNL publications.

Detailed Description of the Key Rating Drivers

Key Rating Strengths

Long track record of operations along with experienced promoters and management team

With operational track record of over two decades, MBL is a professionally managed bank under the overall guidance of its Board of Directors (BoD) which includes eminent businessmen/industrialists with wide experience. Mr. Roshan K.C, the bank's chairman, is a well-known entrepreneur with multiple business ventures. Mr. K.C had also previously served as the Chairman of MBL from April 27, 2017 till January 4, 2019. Besides Mr. K.C is involved in multiple business ventures with K.C group of companies. Mr. Santosh Koirala, CEO, has an experience of more than a decade in the banking sector of Nepal in various capacities. The bank's management is further supported by an experienced team across various functions.

Moderate financial performance trend in FY23-H1FY24, despite slight moderation in profitability indicators amid interest rate cap and rising credit cost

During FY23, MBL's total income increased by ~24% y-o-y to Rs. 21,041 Mn (FY22: Rs. 16,933 Mn) mainly on account of increase in interest income by ~27% over FY22 level backed by increased yield on advances despite slight degrowth in loans and advances (gross). The bank's net interest income (NII) grew by ~10% y-o-y during FY23, growth in interest income counterbalanced by increase in overall deposit base which grew by ~6% y-o-y at the end of FY23 coupled with increase in overall cost of funds. Net interest margin (NIM) increased to 2.94% in FY23 (FY22: 2.90%). Furthermore, the bank maintained its operating costs level and reported a ~19% y-o-y growth in pre-provision operating profit (PPOP), which increased to Rs 3,484 Mn in FY23 (FY22: Rs.2,928 Mn). Credit cost increased to 0.63% in FY23 (FY22: 0.30%) with substantial increase in impairment charges which doubled in FY23 to Rs. 1,148 Mn (FY22: Rs.501 Mn) amid rising NPL levels. This resulted into moderation in bank's return on total assets (ROTA) which remained subdued at 0.89% in FY23 (FY22: 1%).

The regulatory cap on interest spread, set at 4% from the end of FY23, led to a decline in MBL's total income during H1FY24 by approximately 6% y-o-y to Rs. 8,948 Mn (compared to Rs. 9,617 Mn in H1FY23). This decline had a subsequent impact on MBL's Net Interest Income (NII) and pre-provision operating profit (PPOP). Consequently, the bank's performance and return indicators were subdued in H1FY24, with a net profit of Rs. 805 Mn (down from Rs. 1,025 Mn in H1FY23) and a Return on Total Assets (ROTA) of 0.85%.

Moderate CASA mix

MBL has a moderate CASA mix in its total deposit with 35.34% CASA deposits at the end of H1FY24, which improved from 33.99% at the end of FY23 (Industry average: 35.55%). CASA deposits in absolute amount have increased year-on-year by 5.55% to Rs. 53,795 Mn at the end of FY23, which further increased by 3.12% (over FY23 level) at the end of H1FY24. With increase in CASA mix of the company, the cost of funds improved to 7.26% in H1FY24 from 8.07% in FY23. Higher cost of funds vis-à-vis peers pose advantage to a bank in the "base rate plus" lending rate regime. Although, MBL's base rate has remained higher than the industry average at the end of FY22 and FY23, it has improved in recent quarters with the increase in CASA mix. The base rate of the company stood at 9.81% in Q1FY24 below the industry average of 9.98%.

Key Rating Weaknesses

Thin cushion in Tier I capitalization level

Although MBL's overall capitalization levels continue to remain adequate, the bank is expected to have near term capitalization pressure for upholding its minimum regulatory requirement for tier 1 Capital Adequacy ratio. Tier 1 CAR of the bank declined to 8.66% as on mid-January 2024 (as compared to 9.02% as on mid-July, 2023) with thin cushion of 0.16% over the regulatory requirement of 8.50%. It was on account of subdued profitability in H1FY24 (H1FY24: Rs. 805 Mn) with

higher transfer of Rs. 888 Mn (adjustment for interest income booked but not yet received and short loan loss provision on Non-Banking Assets) to regulatory reserves, which are not qualified as core capital of the bank. With already thin cushion in Tier 1 ratio over the regulatory requirement, NRB's directive to implement 0.5% countercyclical buffer from FY24 end on top of moderation in growth of loans and advances, reduced interest rate spread, possibility of further increase in provisioning requirements and rising interest receivables amid subdued economic indicators with reduced borrowers repayment ability in FY24 is likely to add further pressure on the bank to meet the required regulatory capital levels going forward. The overall CAR remain adequate with slight moderation to 13.06% as on mid-January, 2024 from 13.58% as on mid-July, 2023.
Maintaining CARs above the prescribed regulatory threshold is critical for a bank. Lower capital cushion is also likely to restrict MBL's ability to undertake additional business over the near-term. This could also limit the bank's ability to adequately absorb further losses, given the increasing trend in its GNPL levels over FY23-H1FY24 in the subdued economic scenario which remains a key concern for MBL. The bank's ability to successfully execute its capital plans leading to achieving capital adequacy ratios in line with the regulatory requirement levels by mid-July 2024 will remain key monitorable aspect.

Increasing trend in NPL levels amid industry headwinds although better than industry average

MBL's Gross Non-Performing Loans (GNPL) ratio stood at 1.04% as on mid-July 2022 which deteriorated to 2.26% as on mid-July, 2023 and the trend continued as on mid-January, 2024 with GNPL of 2.62% amid industry headwinds. Although GNPL ratio is lower as compared to the industry average of ~3.63%, GNPL level deteriorated from historical levels of less than 1%. It is also further emphasized by MBL's delinquent loans (0+ past day due) which stood at 20.74% as on mid-January 2024, although majority of these delinquencies i.e. 13.16% in pass loan category (0-30 days bucket) which provides comfort to an extent. Higher concentration on stressed sectors including wholesaler and retailers increases possibility of slippages in the asset quality over the near-term. Besides, the bank's solvency indicators also deteriorated with net NPL to net worth increased to ~11% and ~8% at the end of FY23 and H1FY24 from ~4% as on mid-July, 2022. Sustained slippages in MBL's asset quality could materially impact its overall credit risk profile and its requirement for increased provisioning, which is likely to subdue its profitability and capitalization indicators in FY24. MBL's ability to improve its asset quality via efficient recovery mechanisms will be critical from analytical perspective.

Concentrated advances portfolio

MBL's advances portfolio is concentrated towards corporate advances with 59.68% and 61.31% of total loans and advances at the end of FY23 and H1FY24. Deposit concentration of the top 20 institutional depositors at the end of FY23 and Q1FY24 were 17.31% and 16.64% respectively. Although, concentration on top twenty single borrowers on total loans and advances stood low at 13.79% and 13.49% respectively at the end of FY23 (FY22: 12.05%) and Q1FY24 respectively, the concentration on top 20 group borrowers remained higher at 20.86% as on mid-July, 2023.

Intense Competition

Currently there are 20 Commercial Banks (as on mid-January 2024), including three major state-owned banks, operating with total 5,019 branches all over Nepal (based on monthly statistics published by NRB for mid-January 2024). MBL had 165 branches along with head office as on same date. Industry (Class A Commercial Banks) had achieved net interest income of Rs. 49.45 Bn during Q1FY24, where MBL's share on net interest income was 2.86%. Intense competition in the banking industry results in a highly dynamic market with volatile market shares, especially considering the recently completed mergers and acquisition in the industry. MBL's peers with comparable sizes have undergone merger/acquisition with synergy expected to be derived with much larger scale of operations with increased network. MBL is likely to miss those benefits of increased scale of operations and improved market reach due to its relatively small size. Competition in the interest rates also remains a prominent challenge, especially amid liquidity challenges in the banking system.

Exposure to regulatory risk related to industry

The banking industry of Nepal is exposed to changes in the various regulatory measures issued by NRB from time to time. In recent times, NRB had changed to CD ratio mechanism from previous Credit to Core Capital plus Deposit (CCD) ratio measures, increased the minimum requirement of liquid assets that the BFIs must hold, and implemented working capital guidelines. Cumulatively these led to muted credit growth and tightened liquidity in the market in FY23. NRB capped interest rate spread of commercial banks at 4% from 4.4%, which has also added to the lower profitability of banks in FY23 and H1FY24 apart from increased impairment. Going forward, NRB has required Class A banks to maintain countercyclical buffer of 0.5% from FY24 end. Increase in regulatory requirement in capitalization levels in an industry with increasingly stressed asset profile is likely to subdue the growth prospects in loans and advances in near term. Subdued growth in loans and advances, reduced interest rate spread and increase in credit cost due to rising NPL levels and tightening of provisioning requirements by NRB will likely put downward pressure on the bank's profitability indicators.

Industry Outlook

The major challenges currently faced by the banking sector in Nepal is centered around declining asset quality. High and rising GNPLs are leading to stressed profitability and adding downward pressure on banks' capitalization. The regulator's directive to implement countercyclical buffer from FY24 end only adds to their near-term woes. CARs of Class A banks declined from 13.53% as on mid-July 2022 to 12.48% as on mid-January 2024 against the backdrop of deterioration in GNPL ratio from 1.20% to 3.63% over the same period. Credit expansion in Nepal took off substantially and in more aggressive manner during the pandemic era with loans & advances portfolio of Class A banks growing by a compounded annual growth rate of 19.91% over FY20-FY22, leading to a higher proportion of unseasoned credit in their books. Introduction of contractionary policies helped check credit growth in FY23. However, muted GDP growth in the country and lower than expected government expenditures (4% y-o-y decline in 7MFY24 on a low base) has led to prolonged the difficult road to recovery for various sectors including construction, steel, cement, automobiles, retail and SME sectors. Although the central bank has come up with prescriptions to provide reliefs to some stressed sectors, doing so would increase the provisioning requirements of banks, which could add further stress to their capitalization levels. As cash flows of corporates have come under sustained pressure, BFIs have been reporting higher slippages in asset quality over FY23 and H1FY24. While a revival in the tourism industry, sustained growth in remittances, augmenting forex reserves and controlled inflation so far in FY24 remain some positives, there are several headwinds that could offset the positive impact. Declining exports and moderation in government capital expenditure etc pose slowdown to the economic outlook leading to the possibility of sustained credit deterioration and further slippages in asset profile of the BFIs over the near term.

About the Bank

Machhapuchchhre Bank Limited (MBL) is a class A commercial bank incorporated on February 16, 1998. The bank started its banking operations since 2000. As on January 14, 2024, the paid-up capital of the bank stood at Rs. 11,621 Mn with 51% of the total shares held by promoters and the remaining 49% by the general public.

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Our parent company, CARE Ratings Limited commenced operations in April 1993 and over two decades, it has established itself as one of the leading credit rating agencies in India. CARE is registered with the Securities and Exchange Board of India (SEBI) and also recognized as an External Credit Assessment Institution (ECAI) by the Reserve Bank of India (RBI).