Prime Commercial Bank Limited

Ratings

Facility/Instrument	Amount (Rs. in Million)	Ratings[1]	Rating Action
Issuer Rating	**NA**	**[CARE-NP] A- (Is) [Single A Minus (Issuer)] (credit watch with negative implications)**	**Placed on credit watch with negative implications**
Subordinated Debenture (8.75% Prime Debenture 2085) *	**2,447.96**	**[CARE-NP] A- [Single A Minus] (credit watch with negative implications)**	**Placed on credit watch with negative implications**

CARE Ratings Nepal Limited (CRNL) has placed on credit watch with negative implications the issuer rating of "CARE-NP A- (Is) [Single A Minus (Issuer)] " assigned to Prime Commercial Bank Limited (PCBL). Issuers with this rating are considered to offer adequate degree of safety regarding timely servicing of financial obligations, in Nepal. Such issuers carry low credit risk.

CRNL has also placed on credit watch with negative implications the rating of "CARE-NP A- [Single A Minus]" assigned to the Subordinated Debenture (8.75% Prime Debenture 2085) issued by PCBL. The instruments with this rating are considered to have adequate degree of safety regarding timely servicing of financial obligations, in Nepal. Such instruments carry low credit risk.

Detailed Rationale & Key Rating Drivers

The ratings assigned to PCBL have been placed on credit watch with negative implications factoring in deterioration in its asset quality as reflected by substantial uptick in non-performing loans (NPL) as on mid-July, 2023. Although NPL levels has marginally declined in H1FY24 (Unaudited, H1 refers to the six-month period ending mid-January), NPL levels still remained higher than the industry average with substantial delinquent loans i.e. ~15% of total advances in watchlist category (31-90 days bucket) with the possibility of further slippages, which could adversely impact its overall credit risk profile over the near term. Although slightly better solvency profile of the bank as compared to other industry peers as indicated by its low net NPL to net worth ratio, which stood at ~6% as on mid-January, 2024 provides comfort to an extent, further stress in its asset quality amid the overall industry headwinds in the Nepalese banking sector with its subsequent impact on bank's earnings, distributable profits and capitalization will remain key monitorable.

The ratings assigned to PCBL continue to derive strength from the bank's long track record of operations, experienced promoters and management team, and widespread geographical coverage. Despite the declining asset quality reflected by rising GNPL levels, the ratings take cognizance of the adequate cushion in the bank's core capitalization levels to absorb losses, should they materialize. The ratings also factor in the moderate financial profile of the bank with relatively better Return On Total Assets (ROTA) of the bank in H1FY24 as compared to similar peers in the industry.

The ratings, however, is constrained by PCBL's lower levels of Current Account Savings Account (CASA) deposits leading to relatively higher cost of funds which could impact its pricing power and profitability amid intense competition in the industry. The ratings also factor in high portfolio concentration on top depositor and borrowers' group and bank's exposure to the regulatory risk.

Going forward, the ability of the bank to improve its asset quality while managing growth in operations, maintain adequate cushion in capital adequacy indicators from the minimum regulatory requirement levels, and manage the impact of any other regulatory changes by Nepal Rastra Bank would be the key rating sensitivities.

[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, experienced promoters and management team and diversified presence

Established in the year 2007, PCBL has almost 15 years of operational history and an established market presence in Nepal. PCBL is a professionally managed bank under the overall guidance of the bank's Board of Directors (BoD), which includes eminent businessmen and professionals with wide experience in financial services and other industries. Mr. Rajendra Das Shrestha is the Chairman of the bank, who has been engaged in manufacturing and trading industry for the last 27 years. The bank is led by Chief Executive Officer (CEO), Mr. Sanjeev Manandhar, who has twenty-six years of long experience in various financial institutions. He is aptly supported by an experienced management team.

PCBL has diversified presence in Nepal with 189 branches, 132 ATMs terminals and 3 extension counters as on mid-January 2024 across the country. The branches are spread over all 7 Provinces and cover 53 districts (out of total 77 districts) of Nepal.

Adequate core capitalization level

PCBL's capitalization levels, particularly its core capitalization, continue to remain adequate, despite moderation in FY23-H1FY24 as compared to previous periods. As on mid-January 2024, PCBL's overall Capital Adequacy Ratio (CAR) stood at 11.98%, with Tier-1 CAR of 10.59% (as on mid-July 2023: 12.10% and 10.80%, respectively). The decline in Tier-I capital in FY23 over 12.28% reported as on mid, July 2022 was majorly due to muted profitability during FY23 (FY refers to the twelve-month period ending mid-July) amid substantial increment in impairment charges, payment of cash dividend (4.95%) amounting to Rs. 923 Mn and transfer of higher amount to the tune of Rs. 1,555 Mn to regulatory reserves (interest income accrued but not received, short loan loss provision on non-banking assets) which does not qualify as core capital. Reduced borrower's repayment ability due to subdued economic indicators led to increase in interest receivables and overall NPL levels in FY23 and the impact has prolonged in H1FY24. Despite rebound in profitability during H1FY24, the distributable profit remained lower on account of Rs. 991 Mn transferred to regulatory reserves, which coupled with growth in loans and advances (gross) by ~12% over FY23 level in H1FY24 led to further moderation in capitalization level at the end of H1FY24. Nonetheless, the bank continues to have adequate buffer over the regulatory requirements with a cushion of 2.09% in Tier 1 capitalization level as on mid-January 2024 (current minimum regulatory requirement of 8.5%; 9.0% needed to be maintained from mid-July 2024 after implementation of additional 0.5% countercyclical buffer to Tier I capitalization levels). Adequate capitalization levels, particularly in core capital, helps a bank's ability to absorb losses, should they materialize, especially given the increasing uncertainty surrounding credit recovery. The bank's ability to maintain adequate cushion in the capital adequacy ratios will remain critical for its solvency and growth prospect, particularly following a period of around 3-4 years of high credit expansion in the industry.

Moderate financial profile

During FY23, PCBL's total income increased by ~24% y-o-y to Rs. 24,807 Mn (FY22: Rs. 19,902 Mn) on account of increase in interest income which grew by ~26% y-o-y in FY23. The increase in interest income was due to moderate pace of advances growth (~5%) along with increase in yield on advances. The increase in yields on advances was counterbalanced by increase in overall cost of funds with rise in Fixed Deposits (FD) proportion on overall deposit base. The bank's Net Interest Income (NII) grew by ~15% y-o-y during FY23 with improvement in Net Interest Margin (NIM) to 3.31% in FY23 (FY22: 3.09%). 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. 6,160 Mn in FY23 (FY22: Rs. 5,191 Mn). However, despite improvement in Pre-provision Operating Profit (PPOP), substantial increase in impairment charges which doubled to Rs.

8,585 Mn in FY23 (FY22: Rs. 4,470 Mn) impacted its profitability in FY23. Return on Total Assets (ROTA) remained subdued at 0.48% in FY23 (FY22: 1.39%). However, profitability and return indicators of the company rebounded during H1FY24 as indicated by annualised ROTA reported at 1.84% in H1FY24. The bank reported a ~15% y-o-y growth in Pre-provision Operating Profit t (PPOP) backed by year-on-year growth in total income, sustained net interest margin (NIM) and controlled operating expenses in H1FY24. Also, supported by lower incremental provisioning requirements during H1FY24 (H1FY23, H1FY24: Rs. 583 Mn and Rs. 281 Mn respectively) due to controlled NPL levels over FY23 levels with prudent provisioning in previous year, banks performance and return indicators improved in H1FY24.

Key Rating Weaknesses

Sustained decline in asset quality in FY23-H1FY24

PCBL's GNPL ratio had deteriorated substantially to 4.85% as on mid-July 2023 as compared to 2.81% as on mid-January 2023 (1.77% as on mid-July, 2022). Although, GNPL ratio slightly improved to 4.07% in H1FY24, the ratio still stood higher than the industry average of 3.63%. The sustained slippages over FY23-H1FY24 can be attributed to the slowdown in the country's economy (estimated GDP growth for FY23 of 1.9%) amid monetary tightening and effects of import restrictions. Although PCBL's total delinquent loans (0+ days past due) of 24.86% as on mid-January 2024 stood comparable vis-à-vis other peers, delinquent loans were particularly high in the watchlist category (overdue between 31-90 days) which were ~ 15% of total loans & advances. This heightens possibility of further slippages in the asset quality over the near-term. However, the bank's net NPL to net worth stood at ~6% at the end of H1FY24, which is lower as compared to other industry peers. Any major slippages going forward could impact the bank's earnings and its overall credit risk profile. PCBL's ability to improve its asset quality via efficient recovery mechanisms will be a key monitorable aspect.

Low CASA deposits leading to high cost of funds

PCBL continues to maintain relatively lower levels of CASA deposits as compared to the industry average. Furthermore, PCBL's CASA proportion is also in a volatile trend over the past few years. PCBL's mix of low-cost CASA deposits stood at 23.16% in FY23, much lower compared to industry average of 35.55%. This further declined in H1FY24 with the bank reporting CASA proportion of 19.40%. The bank continues to have higher proportion of institutional depositors who prefer fixed deposits. Lower CASA proportion resulted in higher cost of funds for PCBL thus imposing competitive disadvantage for the bank against its peers in the "base rate plus" lending rate regime. Base rate stood at 10.64% during Q11FY24 above the industry average of 9.98% and one of the highest among all commercial banks.

High portfolio concentration among top depositors and borrower groups

Deposit concentration by top 20 institutional depositors was high at 27.84% of the total bank deposits (Rs. 178,570 Mn) as on July 16, 2023. This has increased to 31.67% of the total bank deposits (Rs. 209,073 Mn) as on January 14, 2024. The bank has moderately high concentration on loan portfolio as top 20 corporate borrowers accounted 22.61% of total advances (Rs. 163,070 Mn) as on July 16, 2023 which also slightly increased to 23.83% of total advances (Rs. 183,008) as on January 14, 2024. Similarly, top 20 group borrowers accounted for 23.04% and 23.19% of total loans & advances in FY23 and H1FY24 respectively.

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). PCBL had 189 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 PCBL's share on net interest income was 4.04%. 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. PCBL's peers with comparable sizes have undergone merger/acquisition with synergy expected to be derived with much larger scale of operations with increased network. PCBL is likely to miss those benefits. 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 centred 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 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

PCBL, an "A" Class Licensed Institution from Nepal Rastra Bank (NRB) listed in Nepal Stock Exchange, is one of the mid-sized private sector banks in Nepal. It was incorporated on July 17, 2007 as the 21st commercial bank in Nepal and started commercial operation from September, 2007. As on mid-January 2024, the paid-up capital of the bank is Rs. 19.40 Bn with 51% promoter holding and 49% held by general public.

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About CARE Ratings Nepal Limited:

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