Machhapuchchhre Bank Limited

Rating

Facility/Instrument	Amount (Rs. in Million)	Ratings[1]	Rating Action
Issuer Rating	**NA**	**CARE-NP A- (Is) [A Minus (Issuer)]**	**Assigned**

CARE Ratings Nepal Limited (CRNL) has assigned the issuer rating of 'CARE-NP A- (Is)' to Machhapuchchhre Bank Limited (MBL). Issuers with this rating are considered to have adequate degree of safety regarding timely servicing of financial obligations, in Nepal. Such issuers carry low credit risk.

Detailed Rationale & Key Rating Drivers

The rating assigned to MBL derives strengths from the bank's long track record of operations, experienced promoters and management team, and widespread diversified geographical coverage. The rating also factors in the resilient asset quality profile of the bank, which despite some deterioration in the recent quarters remains substantially better than the overall industry trend as high growth in loans & advances amid uncertain market scenario during waves of Covid19 led to an increased proportion of unseasoned credit, which along with the ongoing tight liquidity, upward trend in interest rates and slower than expected pace of economic growth in the country has led to stress in the asset profile of the overall banking sector as on mid-January 2023, wherein Gross Non Performing Loans of the banking sector more than doubled that as on mid-July 2022. The rating also takes note of relatively lower slippages in MBL's asset profile, also reflective in its relatively better gross and net NPL levels vis-à-vis majority of other industry peers. Additionally, the rating also takes comfort in the relatively lower exposure of the bank in the currently more stressed sectors such as construction and hospitality among others. Consequently, bulk slippages that could emanate from one of these more vulnerable sectors is less likely for MBL over the near term although some transient decline in NPL levels is expected over the next quarter or so. Furthermore, the rating also factors in the adequate cushion in the bank's overall capitalization levels vis-à-vis other peers, despite slight moderation as on mid-January 2023.

The rating, however, is constrained by MBL's moderate CASA mix leading to relatively higher cost of funds coupled with relatively small scale of operations which could impact its pricing power and profitability amid intense competition in the industry. The rating also factors in the bank's exposure to the regulatory risk. Decrease in regulatory cap in interest spread, and subdued scope for credit growth over the near-term coupled with increasing cost structure and elevated provisioning requirements in the current market dynamics are likely to add to the margin pressure of the bank over the near term. Furthermore, although core capitalization of the bank remains comparatively lower, expectations of relatively lesser slippages in assets given a historically proven risk management practice of the bank provides some comfort. A material negative deviation in the core capitalization level and asset profile than envisaged will be a key rating constraint.

Going forward, the ability of the bank to manage growth while maintaining profitability levels and without compromising on asset quality would be critical for the bank's earning profile. The bank's ability to improve capital adequacy indicators with comfortable cushion 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 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. Dr. Upendra Mahato, Chairman, is a well-known philanthropist and entrepreneur with business ventures in many European, African and Asian countries. He is the founding President of Non-Resident Nepali Association and is involved in different National and International Social and Business Associations. Mr. Santosh Koirala, CEO, has an experience of more than fourteen years in the banking sector of Nepal in various capacities. The bank's management is further supported by an experienced team across various functions.

Satisfactory asset quality profile, likely to remain largely resilient despite near-term moderation

MBL has historically maintained a relatively better asset quality profile vis-à-vis the industry reflective of the bank's more efficient risk management setup. MBL had Gross Non Performing Loans (GNPL) ratio of 1.41% as on mid-January 2023, compared to the industry average of ~2.49%. Although the GNPL level has deteriorated from historical levels of less than 1%, it still remained well below the industry average. Furthermore, the bank's net NPL ratio of 0.64% as on mid-January 2023 continues to remain one of lowest in the industry. The decline in asset quality of MBL and the overall banking industry in H1FY23 (H1 refers to the six-month period ending mid-January) can be attributed to industrywide slippages and recovery challenges amid lingering impact of COVID, with more slippages occurring after the relaxations by NRB ended after mid-July 2022. Increasingly stressed asset profile currently observed in the banking industry has exacerbated amid the liquidity crunch, high inflation and increasing interest rates impacting entire demand-supply dynamics for various sectors, resulting in higher delinquencies. Amid the stressed environment, however, some comfort is taken in MBL displaying a more resilient asset quality relative to peers. MBL's ability to maintain the asset quality indicators going forward would remain a key rating monitorable.

Moderate capitalization level

As on mid-January 2023, MBL's overall Capital Adequacy Ratio (CAR) stood at 13.20%, with Core Equity Tier-1 (CET-1) of 8.64% (mid-July 2022: 12.98% and 10.01%, respectively). Although the capitalization levels have deteriorated in H1FY23, the bank currently has adequate buffer over the regulatory requirements with a cushion of 1.64% in Tier I and 2.20% in overall CAR as on mid-January 2023. The decline in capitalization level was partly due to MBL's tier 1 capital affected by Rs. 340 Mn being transferred to Regulatory Reserve (adjustment for interest income for H1FY23 booked but not yet received) as on January 14, 2023, which was excluded from the bank's capital fund. Lower capitalization levels could limit the bank's ability to absorb losses, should they materialize, especially given the increasing uncertainty surrounding credit recovery. Post-pandemic recovery remains a concern amid the ongoing liquidity stress in the economy and macro headwinds leading to increased upward pressure on interest rates. 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.

Increasing scale of operations backed by consistent growth in deposits and advances in recent years

Over FY19-FY22 (FY refers to the twelve-month period ending mid-July), MBL has achieved a healthy growth in the loans & advances and deposits. Total loans and advances (Gross) stood at Rs. 129,555 Mn in FY22 recording a three-year CAGR of 18.59% (industry average: 19.10%) and year-on-year growth of 11.33% over FY21 (industry average: 12.33%). MBL held 3.10% of the industry advances (of Class A Commercial Banks) as on mid-July 2022 (mid-July 2021: 3.13%). However, this growth in the bank's loans & advances portfolio during the period was also accompanied by a similar level of growth in its deposits, which grew at a three-year CAGR of 18.50% (industry average: 16.47%) to Rs. 148,698 Mn at the end of FY22. Bank's share of total industry deposits (Class A commercial Banks) stood at 3.27% as on mid-July 2022 (mid-July 2021: 3.20%). Bank deposits in FY22 were impacted by the liquidity crunch faced by the country's economy amid lower remittance, increasing balance of payment deficit, and reduced government expenditure during the year. MBL, however, managed to outperform the industry recording 10.57% yoy growth in deposits at the end of FY22 (industry average: 8.09%). A substantial increase in loans & advances in a relatively short span would raise concerns regarding the asset quality as this kind of aggressive growth often lead to higher proportion of unseasoned credit in the bank's portfolio. In H1FY23, however, MBL has slowed down its pace of growth as the bank's loans and advances have declined by 1.49% while total deposits have increased by 2.28% after mid-July 2022, with CD ratio at 85.18% as on mid-January 2023.

Improving financial performance trend

Over FY19-FY22, MBL's total income has increased with a CAGR of 14.17%. The growth was on account of consistent increase in asset size over the period. In FY22, the bank's total income increased by 10.57% y-o-y to Rs. 15,296 Mn from Rs. 11,155 Mn in FY21. The increment is mainly due to higher interest revenue collected by banks attributable to improved yield on advances to 11.55% in FY22 (FY21: 8.92%). The increase is also backed by an increase in overall interest income by 37.12% and increase in other income by 5.79%, although operating expenses increased by 15.26% in FY22 to Rs 3,666 Mn. Consequently, overall PAT increased by 10.95% to Rs. 1,783 Mn in FY22 (FY21: 1,607 Mn). With increase in PAT, however, the bank's Net Interest Margin (NIM) declined to 2.93% in FY22 from 3.08% in FY21 due to increased cost of funds as the bank had focused more on increasing its deposits amid industrywide liquidity challenges. In H1FY23, MBL's net interest income grew 24.19% y-o-y over H1FY22 to Rs. Rs. 2,792 Mn, attributable to higher yield in advances due to further increase in interest rates in H1FY23. The bank reported PAT of Rs. 1,008 Mn in H1FY23, relatively stable as compared to Rs. 1,010 Mn in H1FY22. This was mainly due to increased interest cost on deposits due to upward pressure in interest rates amid stressed liquidity conditions, which was further exacerbated in H1FY23.

Key Rating Weaknesses

Moderate CASA mix leading to relatively higher cost of funds

MBL had moderate CASA mix of 31.32% in its total deposits at the end of H1FY22 (Industry average: 34.80%, which decreased from 34.28% at the end of FY22 (Industry average: 37.74%). As on mid-January 2023, CASA deposits in absolute amount also declined by 5.71% over the deposit base as on mid-July 2022. Amid industrywide liquidity stress and upward pressure in CD ratio, banks had shifted their focus towards high-cost fixed term deposits, especially after FY21. Although MBL's trend of CASA mix was comparable to that of the overall industry, lower CASA mix leads to higher cost of funds for MBL vis-à-vis peers and provides a disadvantage to MBL in the "base rate plus" lending rate regime. MBL's base rate during the last month of Q2FY23 was 11.23% which was one of the highest among all the commercial banks.

Intense competition in the industry

Currently there are 22 commercial banks (as on mid-January 2023), including three major state-owned banks, operating with total 5,029 branches all over Nepal (based on monthly statistics published by NRB for mid-January 2022). MBL had 165 branches along with head office as on same date. Industry (Class A Commercial Banks) achieved net interest income of Rs. 87.52 Bn during H1FY22, where MBL's share on net interest income was 3.19% (FY22: 3.13%). Intense competition in the banking industry results in a highly dynamic market with volatile market shares, especially considering the wave of mergers and acquisition in the industry. MBL's peers with comparable sizes have either undergone merger/acquisition or are in the process of doing so. Besides the synergy expected to be derived with much larger scale of operations with increased network, they are also enjoying relaxations in CD ratio (up to 2%) and interest rate spread (additional 1%) allowed by NRB for merged entities. MBL is likely to miss those benefits due to its relatively small size, and no major developments regarding decision to undergo merger/acquisition. Competition in the interest rates also remains a prominent challenge, especially amid liquidity challenges in the banking system.

Concentrated advances portfolio

MBL's advances portfolio is concentrated towards corporate advances with 42.61% and 44.11% of total loans and advances at the end of FY22 and Q1FY23, albeit in a declining trend as compared to 50.16% at the end of FY21. With a view of risk management, however, the bank has been shifting its portfolio concentration from corporate sector to retail and SME (Small and Medium Enterprises) sector, evident from the figures reported by the bank as on mid-July 2022 as well as mid-October 2022. Retail sector combined with SME sector accounted for approximately 50% of the total loans and advances at the end of both FY22 and Q1FY23, increasing from 44.13% at the end of FY21. Concentration of top twenty borrowers on total loans and advances stood at 12.05% and 12.51% respectively at the end of FY22 and Q1FY23 respectively. Having a higher concentration towards retail and SME portfolio could mean a more risk-prone borrower base given that the credit history/debt repaying ability of a lot of these borrowers amid the stressful macroeconomic scenario are largely unknown/unestablished.

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. NRB has changed to CD ratio mechanism from previous Credit to Core Capital plus Deposit (CCD) ratio measures, where CD ratio needs to be maintained below 90% by mid-July 2022 from earlier provision of 85% for CCD. Via the monetary policy for FY23, NRB increased the minimum requirement of liquid assets that the BFIs must hold, where Cash Reserve Ratio (CRR) was increased to 4% (previously 3%), while Statutory Liquidity Ratio (SLR) was kept at 12% of the total deposit base. Such increase in mandatory liquidity reserve to be maintained by BFIs is likely to increase cost for BFIs, and is likely to reduce the amount of loanable funds, thereby limiting liquidity in the economy. Bank rate and policy rate (repo rate) were increased to 8.5% and 7% (previously 7% and 5%). Furthermore, via the first quarter review of the Monetary Policy for FY23, NRB reduced the maximum interest rate spread to be maintained at the end of FY23 by commercial banks to 4% from 4.4%. Increased bank rates will likely put upward pressure on both lending and deposit interest rates of the bank over the near term, while decreased interest rate spread will likely put downward pressure on the bank's profitability. Ability of the bank to manage the impact of any other regulatory changes by Nepal Rastra Bank would be the key rating sensitivities.

Industry Outlook

Credit expansion in Nepal took off substantially during the pandemic era with loans & advances portfolio of BFIs growing by a compounded annual growth rate of 19.91% over FY20-FY22. Subsequently, NRB introduced a slew of contractionary policies such as limiting a bank's credit to deposit ratio at 90% to help check the surging pace of credit expansion by BFIs. This along with a sluggish deposit base amid muted national savings led to credit crunch in the banking sector, which has been exacerbated further after the introduction of the Working Capital Loan Guideline, 2079. Furthermore, with the country's economy yet to completely recover from the lingering impact of the pandemic, disruptions from global macroeconomic headwinds spilling into Nepal has led to a difficult road to recovery for domestic corporates. In the last twelve months, supply disruptions amid various geopolitical events have led to cost-push inflation globally, which Nepal imports given its excessively import heavy trade balance, resulting in elevated input prices. However, pass-through of the higher input cost is being checked amid sluggish demand scenario across sectors, particularly so for sectors like steel, cement, and even consumer goods to some extent. Hospitality sector recovery, although improving year-on-year, remains a far cry from the pre-pandemic levels. Construction sector is reeling from low government spending. Consequently, revenue momentum across various sectors has continually faded over FY22-H1FY23. In contrast, working capital needs remain elevated, as net operating cycle is getting elongated. With rising base rates and widening premiums of BFIs resulting in highly elevated corporate funding costs, cash flows have come under sustained pressure adding to the slippages observed in H1FY23. Tighter financing conditions on the back of prolonged liquidity stress, slower than expected pace of economic growth in the country, and persistent cost push inflation could add to the stress in corporate margins, leading to the possibility of a sharp credit deterioration and further slippages in asset profile of the BFIs over the next few quarters, which could add to the woes of the banking sector including MBL, given the ongoing trend of sharp rise in NPL levels.

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, 2023, the paid-up capital of the bank stood at Rs. 10,257 Mn with 51% of the total shares held by promoters and the remaining 49% by the general public.

Contact us

Analyst Contact
Mr. Prashiddha Sharma Gaire
Contact No.: +977 9802335865
Email: prashiddhas@careratingsnepal.com

Mr. Santosh Pudasaini
Contact No.: +977- 9802312855
Email: pudasaini.santosh@careratingsnepal.com

Relationship Contact
Mr. Achin Nirwani
Contact No.: +977 9818832909
Email: achin.nirwani@careratingsnepal.com

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