Prabhu Bank Limited

Ratings

Facilities	Amount (Rs. Million)	Rating[1]	Rating Action
Subordinated Debenture (Prabhu Bank Debenture 2084)	**2,000.00**	**CARE-NP BBB [Triple B] (Credit watch with negative implications)**	**Reaffirmed and placed on credit watch with negative implications**
Subordinated Debenture (Century Bank Debenture 2088)*	**2,200.00**	**CARE-NP BBB [Triple B] (Credit watch with negative implications)**	**Reaffirmed and placed on credit watch with negative implications**

**Rating coverage for the debenture issued by erstwhile Century Commercial Bank Limited (CCBL) will be provided under Prabhu Bank Limited (PBL) going forward following the acquisition of CCBL by PBL in January 2023.*

CARE Ratings Nepal Limited (CRNL) has reaffirmed and placed on credit watch with negative implications the rating of 'CARE-NP BBB' assigned to the subordinated debentures issued by PBL. The earlier credit watch with developing implications has been removed after completion of the acquisition of CCBL by PBL. The instrument with this rating are considered to have moderate degree of safety regarding timely servicing of financial obligations, in Nepal. Such instruments carry moderate credit risk.

Detailed Rationale & Key Rating Drivers

The ratings assigned to the subordinated debentures of PBL have been placed on credit watch with negative implications factoring in the possibility of continued stress in the asset quality of the bank resulting from a sustained increase in total delinquent loans, which could adversely impact its overall credit risk profile over the near term. The banking industry in Nepal has seen a sharp rise in Gross Non-Performing Loans (GNPL) ratio as on mid-January 2023. High growth in loans & advances amid challenging market scenario during waves of Covid19, facilitated to some extent by various relaxations by the Nepal Rastra Bank (NRB), had led to an increased proportion of unseasoned credit of banks over FY20 and FY21 (FY refers to the twelve-month period ending mid-July). Following a contractionary monetary policy leading to the credit crunch in the banking sector by mid-FY22, most BFIs have seen increasing stress in their asset quality owing to declining repayment ability of the borrowers who, in turn, have been impacted by the tight liquidity, rising funding cost and slower than expected pace of economic growth in the country over FY22-H1FY23 (H1 refers to the six-months period ending mid-January). More slippages in asset quality over the near term remains a key concern for the banking sector, particularly in light of the restrictive Working Capital Loan Guideline introduced by NRB in September 2023 with more stringent NPL recognition norms. Hence, amid near-term headwinds for the banking sector, stress on PBL's asset quality is likely to sustain, leading to added pressure on the bank's earnings and distributable profits, which remains a key constraint from credit perspective.

The ratings continue to derive strengths from the bank's long track record of operations along with experienced directors and management team, widespread geographical coverage through branches, relatively better proportion of low-cost Current Accounts Savings Account (CASA) deposits, and diversified investment portfolio. The rating also takes cognizance of the bank's successful acquisition of CCBL in January 2023, although benefits from increased scale and market reach post-acquisition is likely to accrue over medium term and remains to be seen. The rating, also factors in certain relaxations provided by NRB to banks that have completed mergers and acquisitions in FY23, which could provide some relief to the bank's financial performance in the current fiscal year. The rating, however, is constrained by PBL's moderate capitalization levels, Downward pressure on capital adequacy ratios (CAR) from elevating trend in NPLs could, however, have a bearing on the bank's growth prospects and its ability to absorb further slippages in its assets over the near term.

Going forward, the ability of the bank to improve its asset quality while managing growth in operations would be critical for the bank's earning profile. The bank's ability to stabilize its operations post-consolidation and improve capital adequacy indicators

[1]Complete definition of the ratings assigned are available at www.careratingsnepal.com and other CARE publications

with comfortable cushion over minimum regulatory requirement levels, and manage the impact of any other regulatory changes by NRB would be the key rating sensitivities.

Detailed Description of the Key Rating Drivers

Key Rating Strengths

Long track record, experienced promoters and management team

Established in the year 2001, PBL has over two decades of operational history and an established market presence in Nepal. PBL is a professionally managed bank under the overall guidance of the bank's Board of Directors (BoD) which includes professionals with wide experience in the banking industry. Mr. Lila Prakash Sitaula is the Chairman of the bank, who has more than three decades of experience in banking industry. The senior management team is highly experienced in their respective field of operations and is headed by Mr. Ashok Sherchan (Chief Executive Officer), who has more than 25 years of experience in the banking industry.

Substantial increase in scale of operations and market reach post-acquisition of CCBL

PBL acquired CCBL and started the joint transactions from January 10, 2023. The overall business of the bank, indicated by advances and loans portfolio and deposit base, has increased by over 50% after the acquisition. Similarly, post consolidation of the branches, market penetration and reach of the bank has substantially increased with 365 branches (earlier 217 branches). The branches are spread over all 7 Provinces and cover all 77 districts in Nepal (vs 59 districts pre-acquisition). A larger scale with increased network could provide the bank with better business opportunities by increasing its reach as well as make it more competitive with other larger player than before. The bank's ability to drive in synergy post-acquisition remains to seen and crucial for the bank for its growth prospective.

Decent CASA ratio and relatively lower cost of funds

PBL continues to have relatively lower cost of funds of 8.60% during H1FY23 (Industry average 8.54%, ranked 10th among Class A banks). This is likely to be a competitive advantage for the bank, especially in the "base rate plus lending rate" regime. However, CASA mix declined from 50.76% at the end of FY21 (Industry average: 43.94%), to 45.23% during FY22 (Industry average: 37.74%). CASA ratio further declined to 33.95% (Industry Average: 34.80%) at the end of H1FY23 post consolidation. CASA ratio was lower in the industry in FY22 and H1FY23 amid industrywide liquidity stress and upward pressure in CD ratio. The bank's ability to support overall profitability through managing low-cost funds could be a challenge amid a declining CASA mix.

Diversified Investment Portfolio

PBL has investments of Rs. 49,825 Mn (FY21: Rs. 33,881 Mn) at the end of FY22. The investment portfolio of the bank has increased by 47.06% in FY22 over FY21 mainly due to additional investments made in treasury bills/ bonds of Nepal Government. PBL earned Rs. 2,038 Mn as interest income from bonds/ treasury bills (FY21: Rs. 1,205 Mn) and Rs. 96 Mn (FY21: Rs. 29 Mn) received as dividend income from shares of corporate sectors during FY22.

Moderate financial profile with below average returns

During FY22, the bank's total income increased by 28.17% y-o-y to Rs. 18,914 Mn from Rs. 14,757 Mn during FY21 backed by an increase in overall interest income by 32.02%. The increment in interest income was mainly due to higher interest income collected by bank attributable to increased yield on advances to 9.94% in FY22 (FY21: 9.24%). Consequently, net interest income increased by 14.32% to Rs. 5,743 Mn during FY22 from Rs. 5,023 in FY21. Despite moderation in Net Interest Margin (NIM) to 2.57% in FY22 from 2.63% in FY21 mainly due to increased cost of funds, the bank's PAT increased by 10.53% year-on-year to Rs. 1,902 Mn in FY22 (FY21: Rs. 1,721 Mn). However, the bank's PAT declined by 4.91% y-o-y to Rs. 1,200 Mn in H1FY23 amid increasing loan loss provisioning. Despite a slight revival in FY22, the bank's overall financial profile remains below average compared to peers reflected also by a modest Return on Total Assets (RoTA) of 0.85% during FY22 which had slightly declined from 0.90% during FY21. With acquisition of CCBL now completed, it is expected that the bank's earnings could benefit from increased scale and market reach over the medium term. Considering the expected synergy to be achieved post acquisition with much larger scale of operations with increased network coupled with relaxations in CD ratio (up to 2%) and interest rate spread (additional 1%) allowed by NRB, financial performance of the bank is expected to benefit over the near term.

Key Rating Weaknesses

Declining trend in asset quality, likely to remain under stress over near-term

As on mid-January 2023, PBL's total delinquent loans (0+ days past due) had surged to 16.17% from around 9.70% as on mid-July 2022. Particularly, the bank's loans in the watch list category (overdue between 31-90 days) has spiked to 11.89% of total loans & advances compared to 4.72% in mid-July 2022. Although PBL's GNPL ratio had deteriorated relatively less at 1.98% as on mid-January 2023 from 1.86% as on mid-January 2023, the substantially elevated delinquent loans in the 'up to 90 days overdue' bucket is a concern, as this heightens an increased possibility of more slippages over the near-term, continuing on the trend seen in H1FY23. These slippages can be attributed to the lingering impact of the covid19 pandemic with more slippages occurring after the relaxations by NRB ending 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. Further slippages in asset profile is a distinct possibility in the Nepalese banking sector over the near term as the macro-economic indicators remain muted, particularly amid lower government spending emanating mainly from lesser revenue collection. Furthermore, PBL's asset profile has been relatively weak vis-à-vis other industry peers in the past and any major slippages going forward could materially impact its earnings and its overall credit risk profile. PBL's ability to improve its asset quality via efficient recovery mechanisms will be a key monitorable aspect.

Moderate capitalization levels

As on mid-January 2023, PBL's overall Capital Adequacy Ratio (CAR) stood moderate at 12.84%, with Core Equity Tier-1 (CET-1) of 8.90% (mid-July 2022: 12.86% and 8.53%, respectively). The capitalization levels have broadly remained steady after consolidation with CCBL in H1FY23 and the bank currently has adequate buffer over the regulatory requirements with a cushion of 1.90% in Tier I and 1.84% in overall CAR as on mid-January 2023. However, downward pressure on capitalization levels remain over the near term, given the likelihood of increased provisioning requirements amid higher delinquent loans. A decline in 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 macroeconomic 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.

High growth in loans & advances amid uncertain market scenario, offset somewhat by consistent growth in deposits

Over FY19-FY22, PBL had achieved substantial growth in the loans & advances and deposits. Total loans and advances at the end of FY22 stood at Rs. 150,406 Mn, recording a three-year CAGR of 18.55% (industry average: 18.71%). The growth in the bank's loans & advances portfolio during the period was also accompanied by a similar growth in its deposits, which grew at a three-year CAGR of 17.46% (industry average: 16.43%) to Rs. 182,141 Mn in FY22. Such 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.

Concentrated advances portfolio

PBL's advances portfolio is concentrated towards corporate advances with 56.03% of total loans and advances as on mid-January 2023 (mid-July 2022: 56.36%), albeit in a declining trend as compared to 65.06% as on mid-July 2021. 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 retail sector combined with SME sector accounted for 38.66% as on mid-January 2023, increased from 24.06% as on mid-July 2021.

Concentration of top twenty group borrowers on total loans and advances stood at 21.41% and 16.93% respectively at the end of FY22 and H1FY23 respectively. Also, concentration of top twenty single borrowers on total loans and advances stood at 14.90% and 11.20% respectively at the end of FY22 and H1FY23 respectively. Although beneficial over the longer term, 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 tend to decline sharply amid a stressful macroeconomic scenario, resulting in increased possibility of bulk slippages.

Intense Competition

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). PBL had 366 branches along with head office as on same date. Industry (Class A Commercial Banks) had achieved net interest income of Rs. 87.72 Bn during H1FY23, where PBL's share on net interest income was 3.87% (FY22: 1.19%). 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. 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. 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 NRB 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 restrictive 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, construction, and even consumer goods to some extent. 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 PBL, given the ongoing trend of sharp rise in NPL levels.

About the Company

Prabhu Bank Limited (PBL) is "A" Class Licensed Institutions from Nepal Rastra Bank (NRB). It was incorporated on July 21, 1998 as Kist Merchant Banking and Finance Ltd. and renamed as Kist Bank Ltd. dt. June 19, 2001. Later it was merged with three other bank and financial institutions (BFIs) namely Prabhu Bikash Bank Ltd., Zenith Finance Ltd. and Gaurishankar Development Bank Ltd. as on September 15, 2014 and the name of the bank was changed to Prabhu Bank Ltd. As on July 16, 2022, 51% of the total shares of PBL were held by the promoter whereas remaining 49% is held by the general public.

Prabhu Bank Limited has acquired Century Commercial Bank Limited (CCBL) and the joint transaction started from January 10, 2023 onwards.

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