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)]**	**Reaffirmed**
Subordinated Debenture (8.75% Prime Debenture 2085) *	**2,447.96**	**[CARE-NP] A- [Single A Minus]**	**Reaffirmed**

CARE Ratings Nepal Limited (CRNL) has reaffirmed 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 reaffirmed 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 rating assigned to PCBL continues to derive strength from the bank's long track record of operations, experienced promoters and management team, and widespread geographical coverage. Although PCBL's asset quality declined substantially as on mid-January 2023, as seen in majority of the class A banks following a tightened regulatory supervision after covid19 related relaxations expired in mid-July 2022 coupled with declining repayment abilities of borrowers amid a sluggish economy, the rating continues to positively factor in the relatively comfortable core capitalization level of the bank. Hence, despite the declining asset quality reflected by rising GNPL levels, the rating takes cognizance of the adequate cushion in the bank's core capitalization levels to absorb losses, should they materialize. The rating also factors in the moderate financial profile of the bank with relatively better return on assets (ROTA) of the bank as compared to similar peers in the industry.

The rating, 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 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. Although current capitalization levels remain adequate, further slippages in asset quality leading GNPL levels significantly higher than envisaged will remain a key rating concern.

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.

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

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

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. Narayan Das Manandhar, who has 5-decade long experience in various financial institutions. He is aptly supported by an experienced management team.
PCBL has diversified presence in Nepal with 188 branches and 111 ATMs terminals as on mid-January 2023 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 continue to remain adequate, although marginal moderation was observed as on mid-January 2023 compared to previous periods. As on mid-January 2023, PCBL's overall Capital Adequacy Ratio (CAR) stood at 12.49%, with Core Equity Tier-1 (CET-1) of 11.27% (as on mid-July 2022: 13.12% and 11.87%, respectively). The decline in Tier-I capital in H1FY23 was majorly due to payment of cash dividend (4.95%) amounting to Rs. 923 Mn and transfer of Rs. 1,364 Mn to Regulatory Reserve (adjustment for interest income for H1FY23 booked but not yet received, which is excluded from the bank's capital fund) amid increased slippages in the asset profile as on January 14, 2023. Although the capitalization levels have deteriorated in H1FY23, the bank currently has adequate buffer over the regulatory requirements with a cushion of 4.27% in CET-I capitalization level as on mid-January 2023. 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, albeit declining trend in recent periods

During FY22, PCBL's total income grew 24.43% y-o-y to Rs. 19,920 Mn (FY21: 16,009) on account of 30.63% y-o-y increase in interest income. Growth in interest income was supported by increase in yield on advances by 131 bps. Amid increasing cost of funds, the bank's net interest income increased by only 4% y-o-y to Rs. 6,187 Mn during FY22 (FY21: Rs. 5,949 Mn) resulting in Net Interest Margin (NIM) of 3.09% in FY22 (FY21: 3.47%). During FY22, PCBL reported Rs. 1,240 Mn impairment charge on loans and advances to customers (FY21: Rs. 769 Mn), which remained relatively higher amid increasing Non-Performing Loans. Consequently, PCBL's PAT declined to Rs. 2,787 Mn in FY22 (FY21: Rs. 3,268 Mn). The operational performance remained subdued in H1FY23 owing to increase in impairment charge. PAT in H1FY23 declined 1.58% y-o-y to Rs. 1,652 Mn amid increasing loan loss provisioning. Despite muted earnings, the bank's returns remain relatively better compared to similar sized peers. Supported by low operational expense, the bank's annualized Return on Total Assets (RoTA) for H1FY23 was 1.52%, which was amongst the highest in the industry.

Diversified Investment Portfolio

The investment portfolio of the bank has increased by 11.90% y-o-y in FY22 to Rs. 31,548 Mn (FY21: Rs. 28,194 Mn) mainly due to additional investments made in Government of Nepal (GoN) and NRB securities which increased by 25.96% y-o-y during FY22 coupled with increase in investment in shares and other investments. 83.59% of the investments in FY22 (FY21: 74.26%) has been invested in treasury bills and bond instruments issued by GoN and NRB; 15.95% has been invested in equity securities of domestic corporate entities and other investments during FY22 (FY21: 6.65%). PCBL earned Rs. 1,063 Mn, up 42.68% y-o-y, as interest income from Securities/ Bonds in FY22 (FY21: Rs.745 Mn), Rs.30 Mn (FY21: Rs.67 Mn) received as interest on Interbank Placements and Rs. 82 Mn (FY21: Rs.19 Mn) received as dividend income from shares of corporate sectors during FY22.

Key Rating Weaknesses

Declining trend in asset quality following high growth in portfolio during the pandemic

As on mid-January 2023, PCBL's GNPL ratio stood at 2.81%, deteriorating from 1.77% at the end of FY22 (FY21: 0.99%). Similarly, total delinquent loans (0+ days past due) had surged to 18.48% as on mid-July 2022 from around 13.33% as on mid-July 2021, which has further increased to 19.15% as on mid-January 2023. These slippages can be attributed to the substantial growth in unseasoned credit of the bank over FY20-FY22, facilitated to some extent by the various relaxations/concessions provided by NRB amid the covid19 pandemic.

PCBL's total loans and advances grew at a three-year CAGR of 26.63% over FY19-FY22 (industry average: 18.71%) although this was also accompanied by a similar level of growth in its deposits, which grew at a three-year CAGR of 24.24% (industry average: 16.43%). However, 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. When the relaxations ended in mid-July 2022 and following introduction of the more stringent working capital loan guidelines in September 2023, the NPL levels of majority of banks, including PCBL, sharply increased as on mid-January 2023.

Stressed asset profile currently observed in the banking industry has been exacerbated by the liquidity crunch, high inflation and increasing interest rates impacting entire demand-supply dynamics for various sectors. Further slippages in asset profile are a distinct possibility in the Nepalese banking sector over the near term as the macro-economic indicators remain muted, particularly amid substantially lower government spending than budgeted. 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 volatile and lower levels of CASA deposits as compared to the industry average. PCBL had low CASA mix of 21.37% in its total deposits at the end of H1FY23 (Industry average: 34.80%), which decreased from 23.65% at the end of FY22 (Industry average: 37.74%). The bank continues to have higher proportion of institutional depositors. Lower CASA proportion resulted in higher cost of funds for PCBL of 9.25% during H1FY23 (one of the highest among all commercial banks) thus imposing competitive disadvantage for the bank against its peers in the "base rate plus" lending rate regime. However, base rate of the bank remains competitive, to some extent, owing to the lower operational expense of the bank.

High portfolio concentration among top depositors and borrower groups

Deposit concentration by top 20 institutional depositors was high at 33.91% of the total bank deposits (Rs.165,418 Mn) as on July 16, 2022. This has increased to 34.95% of the total bank deposits (Rs.168,072 Mn) as on January 14, 2023. The bank has moderately high concentration on loan portfolio as top 20 group borrowers accounted 20.99% of total loans & advances (Rs. 154,920 Mn) as on July 16, 2022. Similarly, top 20 corporate borrowers accounted for 19.68% of the total loans & advances as on July 16, 2022. This has however decreased to 14.90% of the total loans & advances (Rs. 156,850) as on January 14, 2023.

Intense competition in the industry

Currently there are 22 commercial banks, 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 2023). PCBL had 188 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 PCBL's share on net interest income was 4.03% (FY22: 3.92%). 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. PCBL'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. PCBL is likely to miss those benefits with 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.

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%, 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 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 PCBL, given the ongoing trend of sharp rise in NPL levels.

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 2023, the paid up capital of the bank is Rs. 18.66 Bn with 15% promoter holding and 49% held by general public.

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