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20 YEARS

Initiating Coverage

Karnataka Bank Ltd.

16-October-2020

RETAIL RESEARCH

Karnataka Bank Ltd.

Industry	LTP	Recommendation	Base Case Fair Value	Bull Case Fair Value	Time Horizon
BFSI – Old Pvt. Bank	Rs 42.35	Buy at LTP and add on dips to Rs 38.50	Rs 47	Rs 50	2 quarters

HDFC Scrip Code	KARBAN
BSE Code	532652
NSE Code	KTKBANK
Bloomberg	KBL IN
CMP Oct 15, 2020	42.4
Equity Capital (cr)	310.9
Face Value (Rs)	10
Eq- Share O/S(cr)	31.1
Market Cap (Rscr)	1316.6
Adj. Book Value (Rs)	120.5
Avg.52 Wk Volume	20,59,000
52 Week High	75.0
52 Week Low	34.2

Share holding Pattern % (Sep, 2020)	
Promoters	0.00
Institutions	13.97
Non Institutions	86.03
Total	100.0

Fundamental Research Analyst

Atul Karwa

atul.karwa@hdfcsec.com

Our Take:

Karnataka Bank (KBL) is almost a century old scheduled commercial bank with presence predominantly in South India. In over view, though FY21 is likely to witness a muted loan growth due to reduced economic activity, we expect double digit growth in FY22 as the bank looks to shift its business mix towards higher yielding retail and MSME loans. Focus on increasing CASA ratio and improving credit-deposit ratio would result in expansion of NIMs and improvement in return ratios. KBL has taken big strides towards digitalization in its aim to reduce turnaround time (TAT) and enhance customer experience. We expect slippages to be higher and credit costs to remain elevated in FY21 despite higher provisioning taken in Q1FY21. Loan book under moratorium stood at 51% at the end of Q1FY21. KBL might have to raise additional capital on account of higher delinquencies post moratorium. It already has shareholder approval to raise Rs 1500cr through QIP valid till Mar-2021.

The management intends to maintain CAR at 1% above the regulatory requirement. It is also looking to reduce opex by ~Rs 100cr in FY21. We expect credit costs to moderate in FY22 onwards resulting in strong growth in PAT and return ratios.

Valuations & Recommendation:

We feel the base case fair value of the stock is Rs 47 (0.33x FY22E ABV) and bull case fair value is Rs 50 (0.35x FY22E ABV). Investors can buy the stock at the LTP and add further on declines to Rs 38.50 (0.27x FY22E EPS). At the LTP of Rs.42.35, it quotes at 0.30xFY22E ABV.

Financial Summary

Particulars (Rs cr)	Q2FY21	Q2FY20	YoY-%	Q1FY21	QoQ-%	FY19	FY20	FY21E	FY22E
NII	575	499	*15.3*	535	*7.4*	1905	2030	2113	2334
PPoP	500	413	*21.0*	677	*-26.1*	1450	1657	1880	1947
PAT	119	106	*12.8*	196	*-39.2*	477	432	199	606
EPS (Rs)	3.8	3.7	*2.5*	6.3	*-39.2*	16.9	13.9	6.4	19.5
P/E (x)						2.5	3.0	6.6	2.2
P/ABV (x)						0.3	0.4	0.4	0.3
RoAA (%)						0.6	0.5	0.2	0.7

(Source: Company, HDFC sec)

Recent Triggers

Q2FY21 financials

KBL posted strong numbers for Q2FY21 driven by contraction in cost of deposits. Net interest income increased by 15.3% yoy to Rs 575cr despite a muted growth in loan book. Yield on advances contracted by 14bps to 9.36% whereas cost of deposit declined by 53bps to 5.54%. As a result interest spread improved to 3.82% from 3.43%. Advances grew by 1.2% yoy to Rs 54,099cr driven by robust growth in retail/mid-corporate advances of 8.0%/15.9% while corporate advances contracted by ~28%. NIMs expanded by 26bps to 3.08%. Operating profit grew by 21% yoy to Rs 500cr on account of higher treasury gains of Rs 494cr. Fee Income fell 25.2% yoy to Rs.174.6 cr due to subdued Corporate advance activity. CASA rose to 29.2% of total deposits.

The bank used the treasury profit of Rs 355cr in Q1FY21 for current as well as future provision requirements which were generally one off in nature. Consequently provisions declined qoq 37% to Rs 322cr in Q2FY21 although they increased 28% yoy. GNPA/NNPA contracted by 65/80 bps sequentially to 3.97%/2.21% as fresh slippages were negligible. The provision coverage ratio reached an all-time high of 75.44% (incl. technical write-off) on account of accelerated prudent provisioning. Accounts under moratorium fell from 37.2% in Q1FY21 to 5.9% in Q2FY21 while in value terms it has declined from 51.2% to 11.4%.

Operating cost reduction

KBL is aiming to reduce its operating expenses by ~Rs 100cr in FY21 by renegotiating rent expenses, cutting down on travel expenses, conducting meetings online, and reduction in manpower. The Board of Directors also have opted to take a take a cut of around 29% in their Board sitting fee and the committee meetings by 20%.

Capital adequacy at comfortable levels

Capital adequacy ratio also has seen a significant improvement to 13.08% consisting of 11.08% Tier-1 and 2% Tier-2. This was at 12.64% about a year back and 12.66% as of March 2020.

Long term Triggers

Shift in focus towards retail and mid-corporate advances

Over the last 3 quarters KBL has been focusing on retail and mid-corporate portfolio rather than corporate advances. Consequently the share of corporate advances which was at 25.2% about a year back has now come down to 18.0%. Similarly the mid corporate advances

(Rs 5-100cr) has improved to 32.5% from 28.4% and the retail advances (< Rs 5cr) increased from 46.4% about a year back to 49.5% of the total loan book. Corporate advances have been facing a lot of stress in recent time due to the slowdown in economic activity, Covid-19 pandemic, GST related disruptions, etc. Focus towards retail assets would make the loan book more granular. NIMs are also expected to expand as retail loans fetch higher yields as compared to corporate loans.

Increasing share of Retail and Mid corporate advances

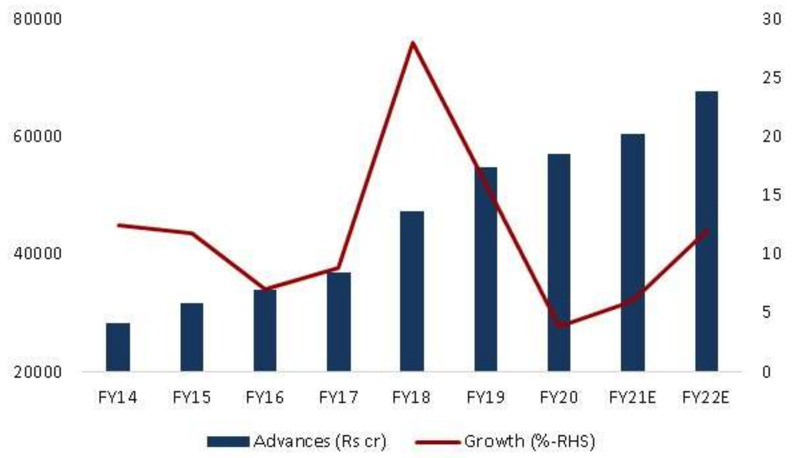
(Source: Company, HDFC sec)

Over FY18-FY20 retail advances have grown at a CAGR of 10.3%, mid-corporate advances have grown 11.9% and corporate advances at 6.7%.

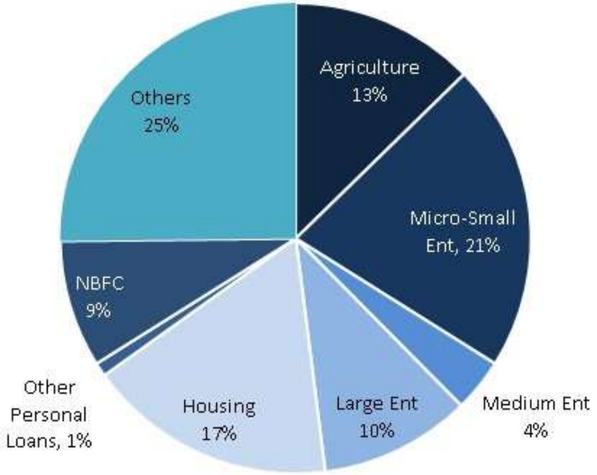
Loan growth expected to pick up in FY22

Growth in advances which had dipped from ~22% in FY13 to ~7% in FY16 had picked up again to 16% in FY19. However, the prolonged economic slowdown and the Covid-19 pandemic led to contraction in advances growth to 3.9% in FY20. The extensions of lockdowns and the rising coronavirus cases resulted lower economic activity and the advances growth further slipped to 1.2% in Q2FY21. However with the Government relaxing the lockdown over the past couple of months and also providing incentives to MSMEs lending activity of the bank is expected to increase. Advances growth could be in high single digit for FY21 while it is likely to return to double digit growth in FY22.

Growth in Advances



Advances Mix (Q2FY21)

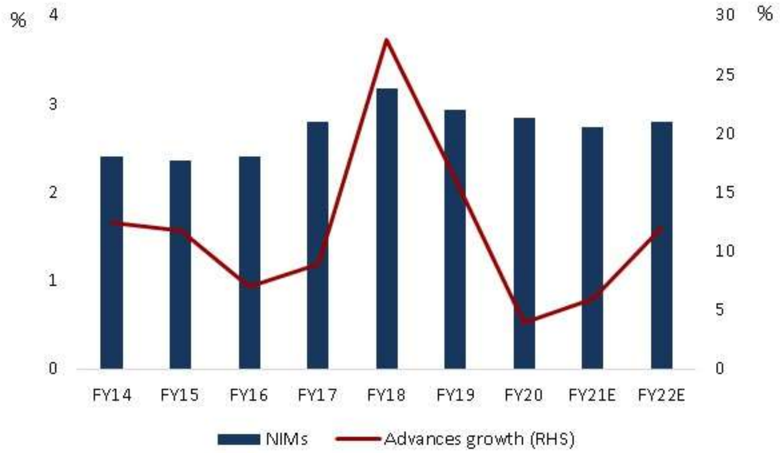


(Source: Company, HDFC sec)

NIMs to remain stable

NIMs of KBL had improved gradually to over 3% in FY18. However, due to higher NPAs and reversal of interest it contracted to 2.78% in FY20. We expect the benefit of higher lending to retail and mid-corporates to be offset by elevated NPAs and consequently interest reversals in the near term. NIMs are likely to remain stable in 2.7-2.8% range though they touched 3.08% in Q2FY21.

NIMs likely to stabilize



(Source: Company, HDFC sec)

Asset quality pressure to remain

Asset quality of KBL has deteriorated over the last few years due to higher stress in its corporate loan book. Slippage ratio increased to 3.5% in FY20 from 2.6% in FY19. Due to moratorium offered to its customers according to the guidelines prescribed by RBI, slippages were lower in Q1FY21 to 0.45% and negligible in Q2FY21. As of Q2FY21, KBL had ~11.4% of its loan book under moratorium. We expect the stress on its loan book to increase in H2FY21 after the moratorium is lifted.

The bank has made additional provision of ~Rs 74cr in Q1FY21 towards Covid-19 and ~Rs.62cr of accelerated provision for a few NPA accounts. It is carrying ~Rs 98cr of provision for Covid related stress. However, given the weak economic environment and ~11% of the bank’s current book under moratorium, we expect higher delinquencies going forward. Advances rated BBB and below amounted to Rs 4223cr out of the accounting for 7.66% of the gross bank credit.

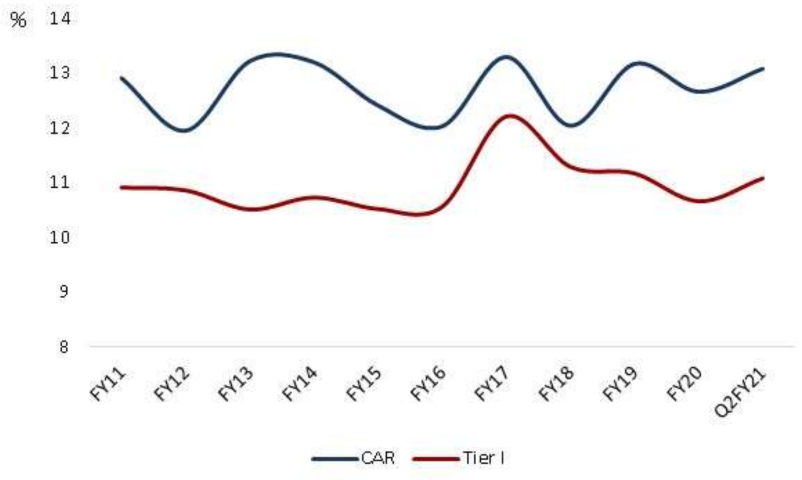
Asset quality trend

(Source: Company, HDFC sec)

Comfortable capital adequacy ratio

KBL is comfortably placed in terms of capitalisation with total capital adequacy ratio of 13.1% and tier-1 of 11.1%. The management has said it would ideally like to maintain CAR at 1% over regulatory requirements. The bank had taken board approval to raise Rs 1500cr in Jan-2020 through a QIP. KBL would take a call on raising capital after assessing the requirement post the moratorium. This will pave the way for further expansion of business and will allow the bank to grow at its targeted pace without any capital constraints over next couple of years. Increasing share of secured loan portfolio (retail and mid-corporate) would slow down the rate of capital consumption.

Comfortable CAR



(Source: Company, HDFC sec)

Transformation project to meet growth aspirations

KBL has initiated a transformation project namely – 'Project Vikaas' in 2017 to meet the growth aspirations by focusing on people and driven by technology. The bank would be mainly focusing on (a) growth with improved sales productivity and designing new products (b) cost optimization with process automation and digitization as well as NPA management (c) profitability boosters with pricing optimization and focus on fee income and (d) shareholder value enhancement through investor engagement, communication and corporate branding. KBL has partnered with Boston Consultancy Group (BCG) and formed an internal core team to drive and monitor the progress of the transformation milestones. Project Vikaas is a long term plan and expected to play a major role coinciding with the celebration of centenary year of the Bank in 2024.

KBL has set up a Digital Centre of Excellence (DCoE) in Bengaluru for developing innovative end-to-end digital solutions for deepening customer engagement and enhancing experiential customer touch points and delivery channels. With this initiative it has been able to significantly upgrade its underwriting capabilities with significant improvement in TAT. It has launched an innovative range of digital products and digital tools which has resulted in 83.5% of the bank's transactions happening through digital channels in FY20. The bank has provided handheld devices to its officers who will go to the customer doorstep to accept applications for loans and provide in-principle sanction within 20 minutes in majority of the cases. It has also decided to expand its network of digital branches. The bank's digital branches will have bare minimum staff presence while providing majority of banking services to customers. Presently, the bank has started one such branch at Basavanagudi in Bengaluru and plans to open another 10 such branches in metro cities in FY21. This would help in reducing operating expenses going forward and improve cost-income ratio and profitability of the bank.

Appointment of new directors to be value addition to the board

KBL has appointed Justice AV Chandrashekar and Pradeep Kumar Panja as Additional Directors in Aug-20. Mr Chandrashekar is a former Judge of Karnataka High Court and also a former Judicial Member of Karnataka State Administrative Tribunal. Mr Panja retired as Managing Director (Corporate Banking) of State Bank of India (SBI) in Oct-2015. During his long association of 39 years with SBI, he gained rich experience in various areas of banking. KBL is looking to benefit from their experience and guidance in field of law and banking. With the induction of these two directors, 72% of the board consists of independent directors, as against the minimum requirement of 33.33%.

What could go wrong

Bank has reported fraud of Rs 285cr

KBL has reported to the RBI in Jun-2020 that it has been defrauded of more than Rs 285cr (DHFL, Religare Finvest, Fedders Electric, LEEL Electricals) consequent to loans to four entities gone bad. The bank would have to make provision for these loans going forward. Overall KBL has an exposure of Rs 1413r to the NCLT accounts against which it is carrying provisions of Rs 1313cr.

High geographic concentration

KBL derives more than half of its business from ~63% of its branches located in the state of Karnataka. Any change in the socio-political scenario or a natural calamity could impact its borrowers and worsen the asset quality.

Adverse climatic conditions

Agriculture comprised of ~13% of Karnataka Bank Q1FY21 advances. Any extreme adverse climatic conditions like floods, drought or any natural catastrophe can have a direct impact on the agri lending space.

Competitive intensity in its retail foray

Due to higher stress in corporate loans most banks are looking at retail and MSME segments for growth. KBL is likely to face greater competitive intensity as it looks to expand its retail footprint and this might impact its fee income.

Deterioration in asset quality

NPA of the bank have increased significantly in the past 2 years. Any further deterioration in asset quality due to prolonged economic slowdown can result in higher provisioning requirements leading to lower profitability. Moratorium value and value of BBB and below accounts amount to ~Rs 10,400cr or 19%, part of which can go bad going forward.

Absence of promoter group

The bank does not have a clearly identified promoter group or a large shareholder, which results in lower financial flexibility, lower drive and a relatively low likelihood of bail out support in case of any unforeseen distress.

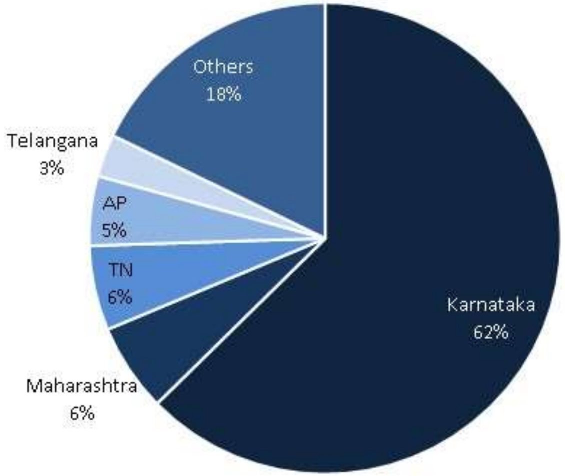
About the company

Established in 1924 at Mangalore, Karnataka Bank (KBL) is a leading 'A' Class Scheduled Commercial Bank in India. The bank took shape in the aftermath of patriotic zeal that engulfed the nation during the freedom movement of 20th Century India. Over the years the Bank grew with the merger of Sringeri Sharada Bank Ltd., Chitradurga Bank Ltd. and Bank of Karnataka. In 96 years of its presence KBL has built a network of 858 branches spread across 22 states and 2 Union Territories. It has forayed into General Insurance business as a JV partner in Universal Sompo General Insurance with a 15% stake with Allahabad Bank, Universal Sompo, Indian Overseas Bank and Dabur group being the other stakeholders.

As a premier bank, it has developed comprehensive range of customized products & services suitable for every kind of market, trade or perceived need - Business or Personal. These include, borrowing facilities, deposits, providing optimum returns on surplus funds or helping with overseas transactions. It is transforming itself into a technologically advanced bank looking at the needs of the future.

Over the last 5 years from FY15-FY20 total business of the bank has grown at a CAGR of 10.5% to ~Rs 1.29 lakh crore with advances growing at 12.5% to ~Rs 0.57 lakh crore and deposits growing at 9% to ~Rs 0.72 lakh crore. As on Jun-2020 almost 62% of the bank’s branches were in Karnataka with South India accounting for 78%. The bank has added 12 branches in FY20 and 10 in Q1FY21 to take the total network to 858 branches.

About 62% of the branches are in Karnataka



Business has grown at CAGR of 10.5% over FY15-20

(Source: Company, HDFC sec)

Peer Comparison

FY20	CMP (Rs)	Mcap (Rs cr)	NII (Rs cr)	PAT (Rs cr)	EPS (Rs)	ABV (Rs)	P/E (x)	P/ABV (x)	RoA (%)	NNPA (%)
Karur Vysya Bank	29.9	2386	2348.0	235.0	2.9	59.9	10.2	0.5	0.3	3.92
Federal Bank	51.8	10322	4648.9	1542.8	7.7	64.7	6.7	0.8	0.9	1.31
Karnataka Bank	42.4	1317	2030.4	431.8	13.9	120.5	3.0	0.4	0.5	3.08
South Ind.Bank	6.8	1222	2317.5	104.6	0.6	16.6	11.7	0.4	0.1	3.34
DCB Bank	76.5	2374	1264.9	337.9	10.9	93.1	7.0	0.8	0.9	1.16

Karnataka Bank Ltd.

Financials

Income Statement

(Rs cr)	FY18	FY19	FY20	FY21E	FY22E
Interest Income	5424	5906	6475	6654	7141
Interest Expenses	3566	4001	4444	4541	4807
Net Interest Income	**1858**	**1905**	**2030**	**2113**	**2334**
Non interest income	954	1002	1396	1408	1472
Operating Income	**2812**	**2907**	**3426**	**3521**	**3806**
Operating Expenses	1339	1457	1770	1642	1859
PPoP	1473	1450	1657	1880	1947
Prov & Cont	1163	842	1135	1631	1137
Profit Before Tax	310	608	522	249	810
Tax	-15	131	90	50	204
PAT	**326**	**477**	**432**	**199**	**606**

BALANCE SHEET

(Rs cr)	FY18	FY19	FY20	FY21E	FY22E
Share Capital	283	283	311	311	311
Reserves & Surplus	5128	5503	5660	5859	6340
Shareholder funds	**5410**	**5785**	**5970**	**6169**	**6651**
Deposits	62871	68452	71785	75839	82487
Borrowings	816	3326	4065	3925	4058
Other Liab & Prov.	1386	1608	1662	2187	2751
SOURCES OF FUNDS	**70483**	**79171**	**83483**	**88120**	**95947**
Cash & Bank Balance	3601	3610	2919	3200	3415
Investment	15444	16185	17545	19020	19612
Advances	47252	54828	56964	60382	67628
Fixed Assets	762	775	826	813	822
Other Assets	3425	3773	5228	4705	4470
TOTAL ASSETS	**70483**	**79171**	**83483**	**88120**	**95947**

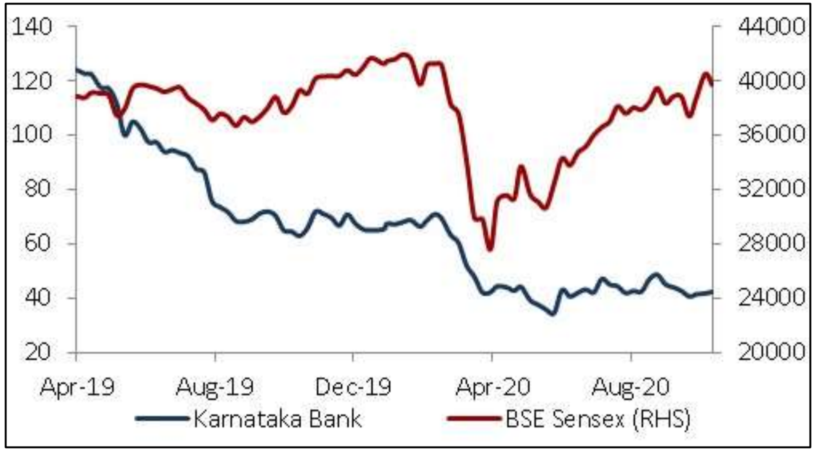
Balance Sheet

As at March (Rs cr)	FY18	FY19	FY20	FY21E	FY22E
Return Ratios (%)					
Calc. Yield on adv	9.7	9.2	9.2	9.1	9.0
Calc. Cost of funds	5.9	5.9	6.0	5.8	5.8
NIM	3.1	2.8	2.8	2.7	2.8
RoAE	6.2	8.5	7.3	3.3	9.5
RoAA	0.5	0.6	0.5	0.2	0.7
Asset Quality Ratios (%)					
GNPA	5.0	4.5	4.9	6.4	4.2
NNPA	3.0	2.9	3.1	3.8	2.6
PCR	41.1	34.2	37.3	40.6	38.0
Growth Ratios (%)					
Advances	28.0	16.0	3.9	6.0	12.0
Borrowings	-2.0	307.6	22.2	-3.5	3.4
NII	24.6	2.6	6.6	4.1	10.4
PPoP	47.9	-1.6	14.3	13.4	3.6
PAT	-28.0	46.6	-9.5	-53.9	204.5
Valuation Ratios (x)					
EPS (Rs)	11.5	16.9	13.9	6.4	19.5
P/E (x)	3.7	2.5	3.0	6.6	2.2
Adj. BVPS (Rs)	127.1	132.9	120.5	110.0	142.2
P/ABV (x)	0.3	0.3	0.4	0.4	0.3
Dividend per share (Rs)	3.0	3.5	0.0	0.0	4.0
Dividend Yield (%)	7.1	8.3	0.0	0.0	9.4
Other Ratios (%)					
Cost-Income	47.6	50.1	51.6	46.6	48.8
Credit-Deposit	75.2	80.1	79.4	79.6	82.0

(Source: Company, HDFC sec Research)

Karnataka Bank Ltd.

Price Chart



RETAIL RESEARCH

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HDFC securities Limited, I Think Techno Campus, Building - B, "Alpha", Office Floor 8, Near Kanjurmarg Station, Opp. Crompton Greaves, Kanjurmarg (East), Mumbai 400 042 Phone: (022) 3075 3400 Fax: (022) 2496 5066

Compliance Officer: Binkle R. Oza Email: complianceofficer@hdfcsec.com Phone: (022) 3045 3600

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