

## Re-orienting to fundamentals

We initiate coverage on Karnataka Bank (KBL), with a Buy rating and TP of Rs170. This franchise, contrary to market perception, merits consideration for its inherent strengths as evident in its business ratios. We expect the bank's efforts to further enrich these ratios, which will push up RoA / RoE to 1.0% / 14.4% by end-FY19, best ever since FY09. Banks with improved earnings quality, higher credit growth and efficient capital consumption tend to graduate into higher valuation multiples and we see a similar kind of re-rating due for KBL. BUY.

- The inherent strengths of the business model:** Regional banks are characterised by a) their lower CASA franchise, b) weak employee productivity and c) limited contribution from non-interest income. Compared to its peer banks, KBL has fared well with a superior CASA franchise (26% in FY16), better employee productivity, efficient cost management (cost/assets at 183bps in FY16), steady non-interest income, and adequate capital consumption. While the bank's margin (NIM) has improved in the recent past, it still remains low when compared to peers' – an outcome of inefficient balance sheet management. This, in addition to asset-quality headwinds and provisioning thereon, curtailed RoAs to 0.8% levels in FY16.
- Steps directed at addressing the limitations:** KBL's lower margin profile is an outcome of its lower loan to deposit ratio (LDR) and limited reduction in deposit rates. However, with the continued approach towards addressing this inefficiency which led to improvement over FY13-16, we expect the bank's NIM trajectory inch further up to 2.9% by end-FY19 (from 2.6% in FY16). Based on our calculations, the following factors would contribute to NIM expansion, a) further reduction in the Rural Infrastructure Development Fund (RIDF) exposure (positive 8bps impact), b) increase in LDR (positive 8bps impact), and c) further enhancement in the overall CASA proportion (8bps positive impact). Our assumptions on margin could be further revised upwards in the event of higher-than-expected credit growth and lower interest reversals following reduction in fresh delinquencies. The baggage of stressed loans (including 5:25/ SDR and S4A) remains at 12% of loans, and we have factored in 300bps/ 90bps of slippages/ credit cost over FY16-19E (vs. 270bps / 80bps for FY13-16).
- See RoA scale to 1% levels by end-FY19; best ever since FY09:** We expect NIM to improve over FY16-19E, given the bank's concentrated efforts towards increasing loan growth and curtailing interest costs. The share of non-interest income is also set to rise; on cost-efficiency, we see cost/ income reducing to ~51% by end-FY19 from ~54% at FY16. Even as we build in accelerated slippages and provisioning, we draw comfort from the bank's ability towards recovery / upgradation. We thus see the overall trend in asset quality stabilising. We expect these efforts to translate into RoA/ RoE of 1.0% /14.4% by end-FY19E (vs. 0.8% RoA / 11.7% RoE in FY16).
- Valuation, view and key risks:** Banks with an improving performance trajectory tend to trade at higher multiples as investors draw comfort in the quality of earnings and growth. We see a similar kind of re-rating due for KBL. We value the bank at 1.2x FY19E ABV leading to TP of Rs170 (21.5% upside). Initiate with a Buy rating. M&A activities in the old generation banking arena could be another trigger for multiple re-ratings. Key risks: a prolonged period of lower growth or margins; high delinquencies from the corporate portfolio.

Target Price	Rs170	Key Data	
CMP*	Rs140	Bloomberg Code	KBL IN
Upside	21.5%	Curr Shares O/S (mn)	282.6
Price Performance (%)*	1M 6M 1Yr	Diluted Shares O/S(mn)	282.6
		Mkt Cap (Rsbn/USDmn)	39.5/608
KBL IN	1.4 19.5 71.9	52 Wk H / L (Rs)	143.4/80.2
NIFTY	2.7 6.2 20.1	5 Year H / L (Rs)	161.9/51.7
		Daily Vol. (3M NSE Avg.)	374572

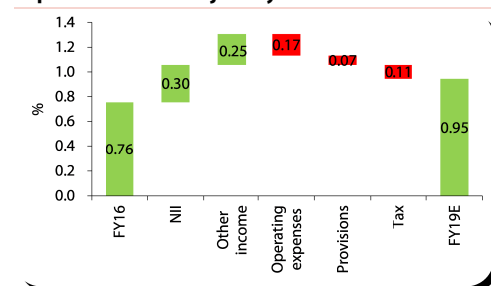
\*as on 28 March 2017; Source: Bloomberg, Centrum Research

### Shareholding pattern (%)\*

	Dec-16	Sep-16	Jun-16	Mar-16
Promoter	0.0	0.0	0.0	0.0
FIIIs	20.2	23.1	19.6	19.0
DIIIs	8.5	8.8	9.8	10.7
Others	71.4	68.1	70.6	70.4

Source: BSE,\*as on 28 March 2017

### Expansion in RoA trajectory



Source: Company, Centrum Research Estimates

### Centrum vs. Bloomberg Consensus\*

Particulars (Rs mn)	FY18E			FY19E		
	Centrum	BBG	Var (%)	Centrum	BBG	Var (%)
NII + Oth. Inc	25,223	24,366	3.5	29,447	27,360	7.6
PPoP	12,280	10,606	15.8	14,530	11,576	25.5
PAT	5,490	5,564	(1.3)	7,114	6,563	8.4

Bloomberg Consensus*				Centrum Target Price (Rs)	Variance (%)
BUY	SELL	HOLD	Target Price (Rs)	Target Price (Rs)	
3	1	0	138	170	23.2

\*as on 28 March 2017; Source: Bloomberg, Centrum Research Estimates

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Y/E Mar (Rs mn)	Net Income#	PPOP	Rep. PAT	YoY (%)	EPS (Rs)	P/E (x)	Adj BV (Rs)	P/Adj BV (x)	RoA (%)	RoE (%)
FY15	16,758	7,734	4,516	45.1	24.0	4.5	146.7	0.7	0.9	14.0
FY16	18,457	8,546	4,157	(8.0)	22.0	4.5	153.6	0.6	0.8	11.7
FY17E	21,841	9,438	4,283	3.1	15.1	7.6	129.0	0.9	0.7	10.3
FY18E	25,223	12,280	5,490	28.2	19.4	7.2	136.1	1.0	0.8	11.6
FY19E	29,447	14,530	7,114	29.6	25.2	5.6	144.9	1.0	1.0	14.4

Source: Company, Centrum Research Estimates #net income denotes NII + other income. FY15-17E have been valued on average market cap basis.

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## Karnataka Bank – Re-orienting to fundamentals

Karnataka Bank, a 92-year old franchise, with an extensive presence in south India, especially its home-state Karnataka, is in a phase of re-orienting itself to its key strengths. A respectable market share in its home-state, a well-drawn strategy towards increasing its footprint without affecting the cost-ratios, as evident in cost/ assets at 183bps in FY16, a steady rise in its CASA franchise, and adequate capital consumption have been its key strengths.

However, the bank's ROA has remained low due to its weak margin profile (compared to peers). We believe with efforts directed towards shoring its NIM profile and containing asset quality with adequate provisioning thereon, RoAs are set to inch upwards. We expect the bank's RoAs to inch towards 1.0% levels by end-FY19E, best ever since FY09. We see RoEs at 14.4% in FY19E from 11.7% in FY16.

### Exhibit 1: Areas of focus and the targeted outcome

Area of focus	Current state of affairs	Resultant outcome
Asset growth	<ul style="list-style-type: none"> <li>○ Loan growth moderated to 9% YoY in Dec'16 from a CAGR 18% over FY10-14.</li> <li>○ Share of corporate loans stood at 35% in Dec'16 (vs. 39% in FY14).</li> </ul>	<ul style="list-style-type: none"> <li>○ Pace of growth set to accelerate; share of retail-SME nature of the portfolio to further increase; direct corporate exposure towards select sectors.</li> <li>○ Share of exposure to internally rated investment grade portfolio on the rise.</li> <li>○ We are factoring in 14.6% CAGR in loans over FY16-19E as compared to 10.4% CAGR during FY13-16.</li> </ul>
Deposit franchise	<ul style="list-style-type: none"> <li>○ CASA proportion at 26%, superior to other regional players.</li> <li>○ Retail nature of deposits provides added comfort.</li> </ul>	<ul style="list-style-type: none"> <li>○ GoI's demonetisation drive in Q3'17 helped increase KBL's CASA proportion by 400bps QoQ to 30%. Efforts to retain the same are underway.</li> <li>○ The recent reduction in the bank's deposit rates (lowest amongst peers) coupled with its increasing CASA proportion will further reduce its cost of deposits and in-turn cushion spreads.</li> <li>○ We are factoring in CASA at 29% levels by end-FY19E.</li> </ul>
Margin (NIM)	<ul style="list-style-type: none"> <li>○ NIM at 2.6% is low when compared to peers even as the CASA proportion remains healthy.</li> </ul>	<ul style="list-style-type: none"> <li>○ Continued efforts towards accelerated growth in the retail-SME loan segments</li> <li>○ Reducing exposure under RIDF.</li> <li>○ Lowering of deposit rates and gradual expansion in LDR.</li> <li>○ We expect NIM to inch towards 2.85% levels by end-FY19E vs. 2.57% in FY16.</li> </ul>
Asset-quality	<ul style="list-style-type: none"> <li>○ Slippages have been rising due to excessive exposure to stressed sectors in the past.</li> <li>○ Slippages averaged 300bps over FY14-16 vs. 194bps over FY11-13.</li> <li>○ Problem loans (GNPA + restructuring + accounts under RBI's alternate window) stood at 12% of loans.</li> </ul>	<ul style="list-style-type: none"> <li>○ The bank initiated measures at containing bad loan accretion, including a) setting up a credit-monitoring team, b) efforts towards resolution of bad loans, including resorting to asset sale to ARCs and c) centralization of the credit process.</li> <li>○ We also draw comfort from the bank's ability towards recovery and upgradation. GNPA in retail/ SME portfolio remain low.</li> <li>○ We are factoring in slippages/ credit cost at 300bps/90bps over FY16-19E respectively.</li> </ul>
Return ratio	<ul style="list-style-type: none"> <li>○ FY16 RoA/ RoE stood at 0.8%/ 11.7% (vs. 0.9% / 12.8% in FY13).</li> </ul>	<ul style="list-style-type: none"> <li>○ Concentrated efforts towards each of the above parameters could push up RoA / RoE towards 1.0% / 14.4% levels by end-FY19E.</li> </ul>

Source: Company, Centrum Research

## Growth to accelerate; factoring 15% CAGR in loans over FY16-19E

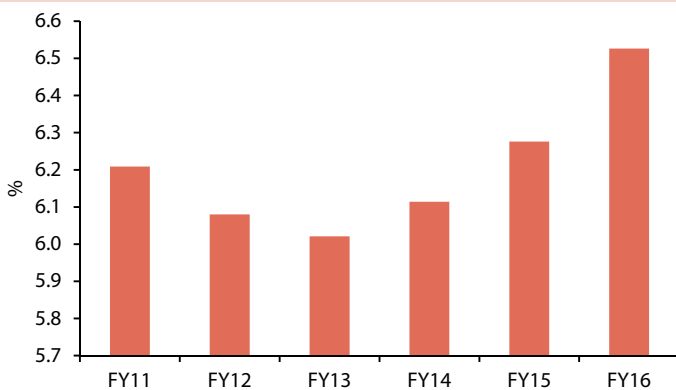
- The bank is directing its efforts towards increasing the pace of loan growth with a focus on the higher yielding SME and retail segments; it has also limited its corporate exposure to select sectors.
- Analysis of state-wise credit market share suggests that there exists a huge loan growth opportunity for KBL. We expect the bank's growth rate to accelerate to 14.6% CAGR over FY16-19E (vs. 10.4% CAGR in loans over FY13-16).

The state of Karnataka has witnessed a 14.0% CAGR in loans over FY12-16, higher than the 12.0% CAGR in overall banking credit pan-India. This increased Karnataka's share in the country's overall banking credit to 6.5% in FY16 vs. 6.1% in FY12. The reason for the higher credit growth in Karnataka was due to its strong net-state domestic product (NSDP). According to the Central Statistical Organisation (CSO), Karnataka's NSDP increased at a 5.8% CAGR over FY12-16 as compared to pan-India NSDP growth at 5.1% CAGR. Karnataka's NSDP growth is even higher than that of Tamil Nadu (5.4% CAGR) and Kerala (5.7%) over the same period.

While Karnataka's overall credit increased at a 14% CAGR over FY12-16, KBL's overall loans grew at a 13.1% CAGR over the same time. The lower credit growth, especially in the recent past, is an outcome of the management's cautious stance towards growth.

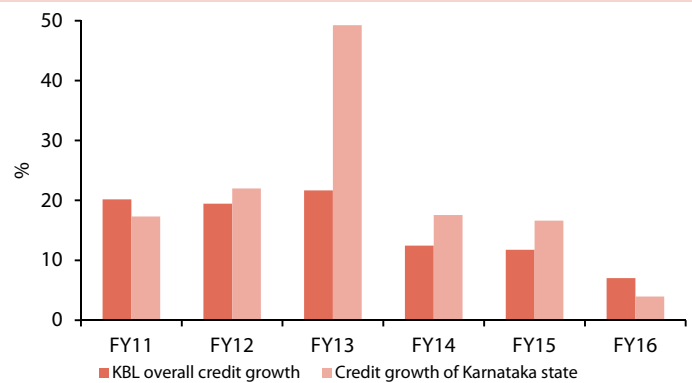
While KBL's overall loan growth has remained low, we draw comfort from KBL's extensive presence in its home-state and its growth therein. Over FY12-16, the bank's home-state portfolio increased at a 20.8% CAGR indicating its ability to penetrate deeper and scale its loan portfolio in its key markets.

**Exhibit 2: Increase in Karnataka's market share in overall banking credit**



Source: RBI, Centrum Research

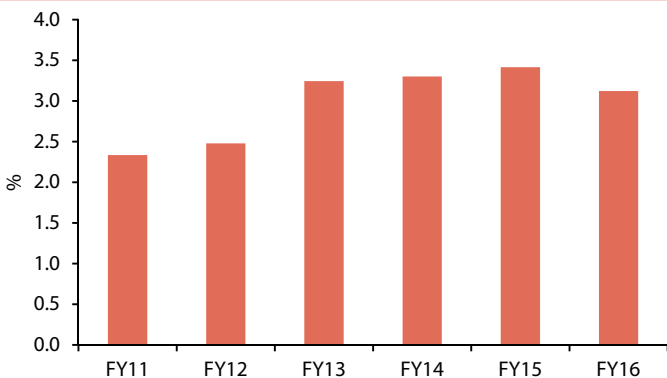
**Exhibit 3: KBL posted strong growth in its home-state vs. its overall credit growth**



Source: Company, Centrum Research

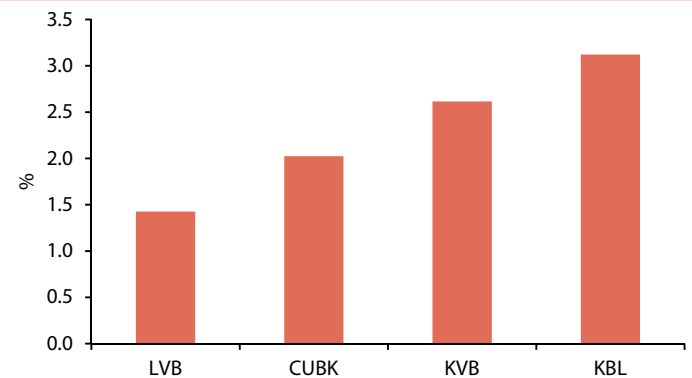
As KBL's credit growth increased in Karnataka, its market share in the overall state credit rose to 3.1% in FY16 from 2.3% in FY11. KBL also scores well when compared to other regional players in terms of market share in their respective home-state. In FY16, KBL's market share in its home-state stood at 3.1% as compared to Karur Vysya Bank (2.6%), City Union Bank (2.0%) and Lakshmi Vilas Bank (1.4%) in their home-state i.e. Tamil Nadu.

**Exhibit 4: KBL's market share in home state has been on the rise...**



Source: RBI, Company, Centrum Research

**Exhibit 5: ...and compares well to its peers in their respective home-states (FY16)**

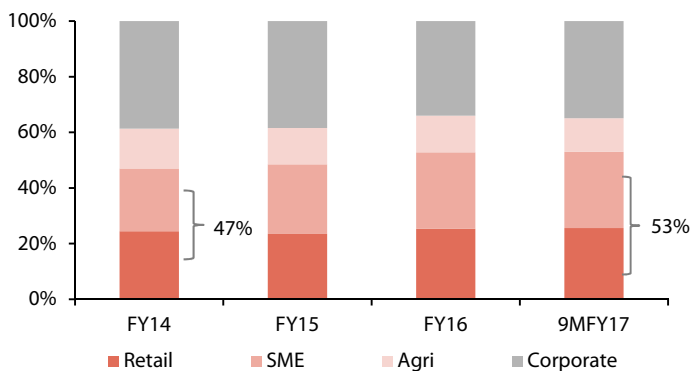


Source: RBI, Companies, Centrum Research

**Share of retail – SME segment on the rise**

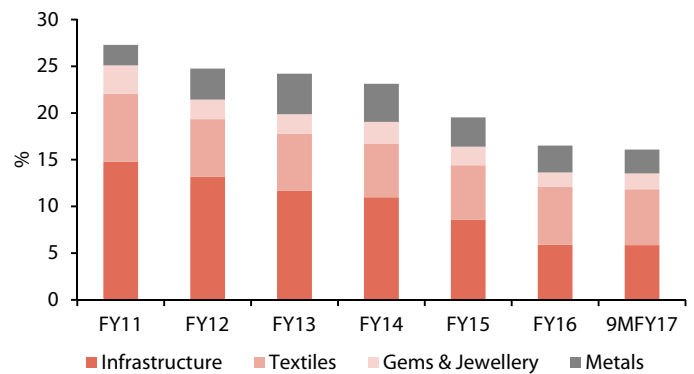
- While the bank loaned a higher proportion of credit to the corporate segment over FY10-12, beginning FY13, it considerably increased its exposure towards the higher yielding retail – SME segments. The change in stance towards shoring the retail – SME portfolio was due to concerns over asset quality and the considerable slow-down in credit from large corporates.
- Thus, over FY14-9MFY17, the share of retail + SME loans increased to 52.9% from 47.0% in FY14. The reduced focus on corporate exposure also enabled the bank to lower its exposure towards stressed sectors. While credit to stressed sectors grew at a 15.3% CAGR over FY10-13; in the subsequent period, the said portfolio witnessed de-growth of 2.8%. The bank's share of the total stressed sector exposure to total credit reduced to 16.1% in 9MFY17 vs. 27.2% in FY11.
- The increasing reliance on the SME portfolio is a result of client-specific product offerings in its key markets namely Karnataka, Tamil Nadu, Northern India and Maharashtra, and in particular sectors – warehousing receipt, auto-industry, textile and garment. On the retail front, the bank's home-loans and other personal loan portfolios have increased steadily.

**Exhibit 6: Reduction in corporate exposure...**



Source: Company, Centrum Research

**Exhibit 7: ...post reduction in stressed sector exposure**



Source: Company, Centrum Research

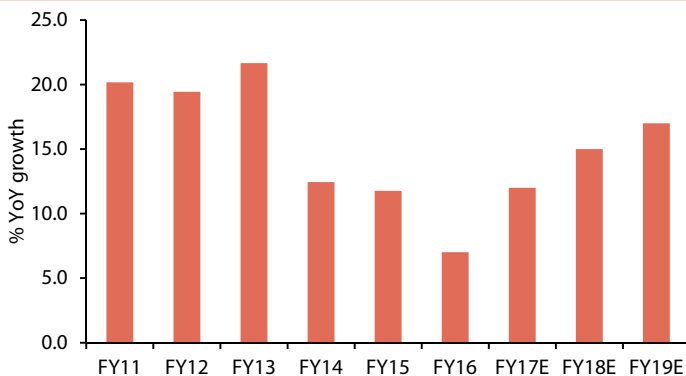
**Exhibit 8: Regional banks tend to place greater focus at retail-SME portfolio (9MFY17)**

% of loans	Corporate	SME	Retail	Agriculture
CUBK	31.5	34.0	18.3	16.2
DCB	16.0	11.0	56.0	17.0
FB	39.1	22.4		38.5
KBL	34.9	27.4	25.6	12.1
KVB	33.5	33.8	15.8	16.8
SIB	39.8	26.3	20.2	13.8

Source: Companies, Centrum Research. For Federal Bank retail includes agriculture exposure.

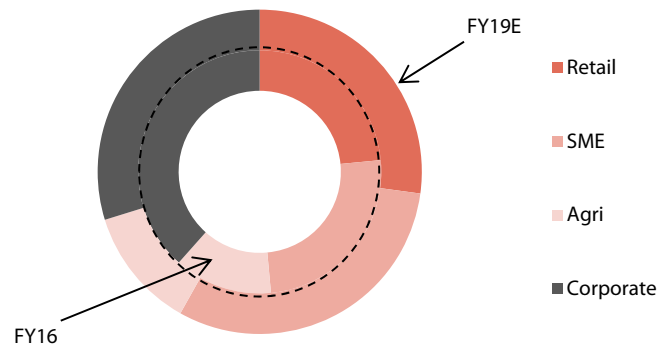
While the bank has maintained a cautious stance towards growth in the past, we believe that with a well-drawn-out growth strategy and by increasing its retail-SME portfolio, its pace of growth will accelerate. We thus are factoring in 14.6% CAGR in loans over FY16-19E (vs. 10.4% CAGR over FY13-16). We see the bank's share of retail-SME exposure inch up to 58% by end-FY19E vs. 53% in FY16.

**Exhibit 9: Factoring in 15% CAGR in loans over FY16-19E...**



Source: Company, Centrum Research Estimates.

**Exhibit 10: ...led by continued traction in retail-SME loans**



Source: Company, Centrum Research Estimates.

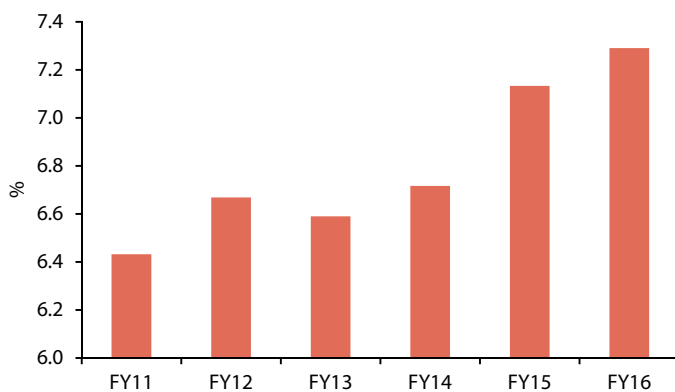
## Draw comfort from CASA franchise; especially in the home-state

### Deposit growth led by increasing share of CASA deposits

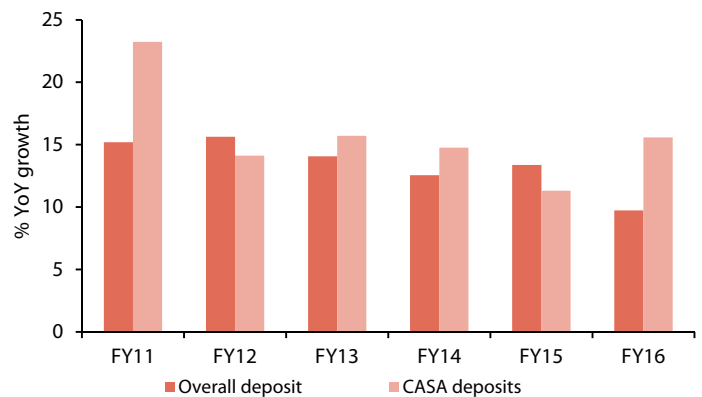
Contrary to the trajectory of Karnataka State's market share in overall credit and growth therein, the trend in the state's deposit growth and market share in overall systemic deposits has remained higher. Over FY12-16, while the systemic deposits increased at a 12% CAGR, the growth in deposits for Karnataka state was higher at 14.4%. Consequently, the share of the state's deposits in the country's overall deposits remains higher at 7.3% in FY16 (vs. 6.4% in FY11).

KBL's deposit growth at 12.4% CAGR over FY12-16 was lower than Karnataka state's deposit growth over the same timeframe. We however take comfort in the bank's deposit growth, as a) its deposit profile largely leans towards retail deposits, ensuring stickiness, and b) CAGR in CASA deposits was higher at 14.3% over FY12-FY16 (vs. 12.4% CAGR in overall deposit growth for KBL). Consequently, the proportion of CASA deposits to total deposits increased to 26.3% in FY16 from 24.6% in FY12.

**Exhibit 11: Increase in Karnataka's share in overall systemic deposits**      **Exhibit 12: KBL's CASA deposits outgrow overall deposits...**



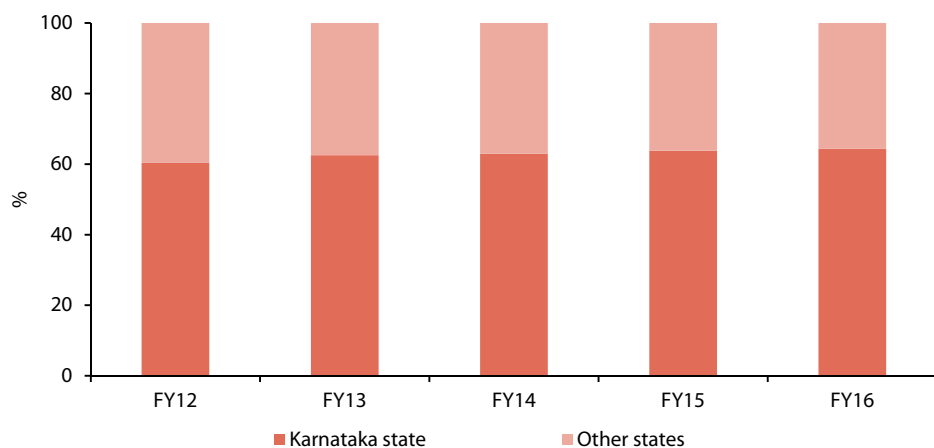
Source: RBI, Centrum Research



Source: Company, Centrum Research

We also draw comfort from the increase in the share of CASA deposits from the bank's home-state as compared to its total CASA deposits, indicating a strong franchise in Karnataka.

**Exhibit 13: ...led by strong traction in CASA deposits from home-state**

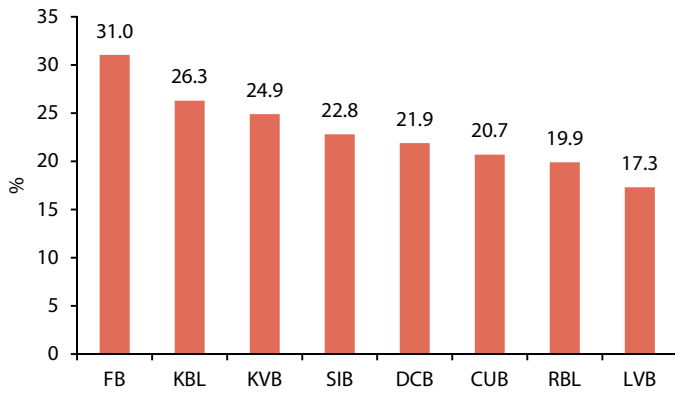


Source: Company, Centrum Research

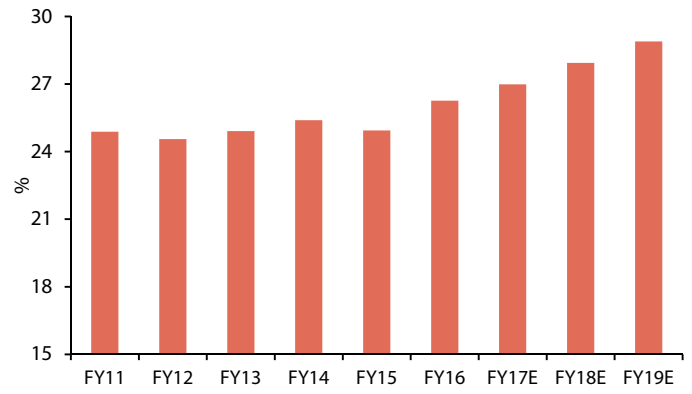
KBL's CASA proportion at 26.2% is higher than that of many other regional players and is an outcome of having strengthened its retail liability franchise. Management plans to continue to enhance the CASA franchise further.

In Q3'17 the proportion of CASA increased 400bps QoQ to 30%, an outcome of Gols move towards demonetisation. The bank has been able to retain a substantial part of the deposits on its balance sheet in Q4'17. We thus expect the trend in CASA accretion to remain intact and are factoring in CASA deposits inching up to 29% by end-FY19E vs. 26.3% in Q2'17.

**Exhibit 14: KBL's CASA proportion higher than peers' Exhibit 15: CASA ratio to inch up to 29% by end-FY19E (FY16).**



Source: Companies, Centrum Research



Source: Company, Centrum Research Estimates

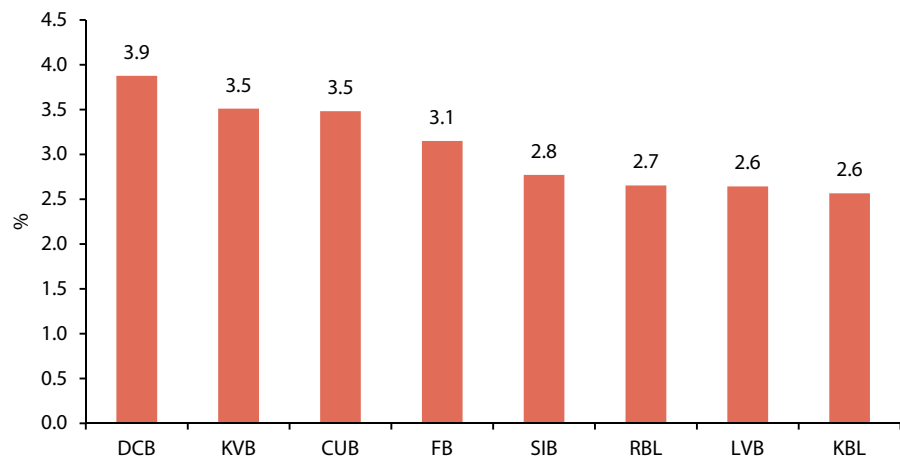
Increasing reliance on CASA deposits has enabled KBL to reduce its overall cost of deposits to 7.4% in FY16 from 8.1% in FY13. With a steady rise in CASA deposits and an aggressive cut in deposit rates in the recent past, we expect the cost of deposits to decline further and in turn aid spread and margin improvement.

## Lower margins, though improving; uptrend expected to continue

- Inefficient balance sheet management has seen NIM remain lower when compared to peers.
- The bank is taking measured steps towards scaling margins. We see NIM inch up to 2.9% by end-FY19, best ever in the recent past.
- Further upside to NIM cannot be ruled out in the event of higher-than-expected credit growth or a lower accretion of fresh delinquencies.

While KBL's margins have increased 19bps to 2.6% over FY13-16, they still remain lower to peers'. The lower margin profile, despite relatively higher CASA deposits, increasing share of retail-SME loans and reducing RIDF exposure, is due to inefficient balance sheet management particularly in the nature of low loan-to-deposit (LDR) ratio and limited reduction in deposit rates, resulting in higher cost of deposits when compared to peers.

### Exhibit 16: KBL's NIM remains lower than peers' (FY16)



Source: Companies, Centrum Research

We have analysed the bank's NIM profile over FY13-16 and factors that would have contributed to changes therein. Over FY13-16 KBL's LDR declined 276bps to 67.2%. Keeping other factors constant, the reduction in LDR had a negative impact of 8bps on NIM. On the positive side, reduction in RIDF investment to 9.5% of total investments (vs. 20.4% in FY13) and 135bps expansion in CASA to 26.3%, positively impacted the NIM by 19bps and 5bps respectively. We have discussed each of these aspects hereunder:

### Exhibit 17: Factors that contributed to NIM improvement over FY13-16

Particulars	
NIM as at end FY13	2.38%
Reduction in RIDF portfolio	19bps
Loan-to-deposit ratio	(8)bps
CASA proportion	5bps
Others*	3bps
NIM at the end FY16	2.57%

Source: Company, Centrum Research; \*mainly the combined effect of yield on advances and cost of deposits

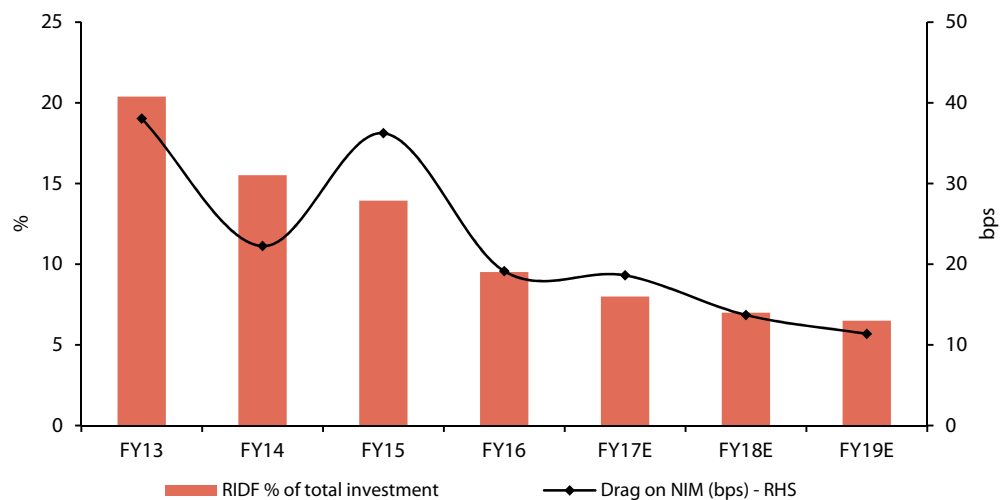
**Reducing RIDF exposure; positively impacting NIM**

One of the factors that dragged the NIM down was investment in RIDF. RIDF investments stood at 20.4% of the total investments in FY13 and their negative impact on margins (based on our calculations) was around 38bps.

However, since the beginning of FY13, the exposure under the RIDF instruments has been declining. In FY16, RIDF investments stood at 9.5% of the total investments. The reduction in the proportion of RIDF investments has resulted in augmenting margins by 19bps over FY13-16.

We expect the proportion of RIDF exposure to further reduce over FY16-19E leading to a positive ~8bps impact on margins.

**Exhibit 18: RIDF exposure as a proportion of total investment has reduced since FY13, thus aiding in NIM expansion. We expect this trajectory to continue and positively impact NIM over FY16-19E.**



Source: Company, Centrum Research Estimates

**Lower loan-to-deposit ratio impacted margins; trajectory to reverse**

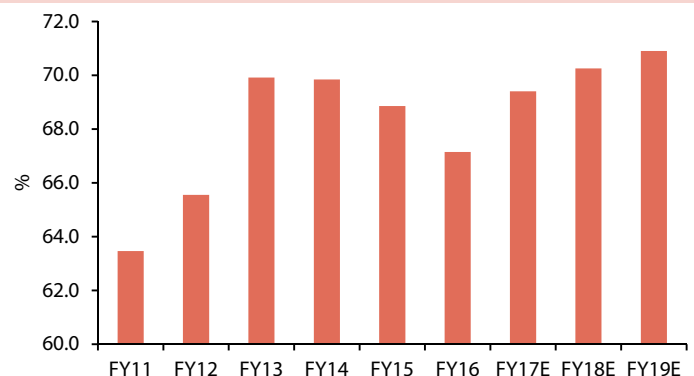
While the pace of loan growth moderated over the recent past, deposit growth was higher. One of the possible reasons for higher deposit growth could be the elevated deposit rates as compared to peers. KBL witnessed 12% CAGR in deposits vis-a-vis 10% CAGR in loans over FY13-16. Thus KBL's loan-to-deposit ratio, declined by 276bps to 67.2% in FY16, impacting margins negatively by 8bps (based on our calculations).

KBL's LDR has remained low, even as compared to its regional peers. However, with a well-drawn out strategy towards loan growth and the ability to contain deposit growth (following reduction in deposit rates), we believe that the bank's LDR is set to inch upwards towards 71% by end-FY19. Our estimates suggest an 8bps positive impact on margins following expansion in LDR over the same time frame.

**Exhibit 19: KBL's LDR has remained lesser than peers' (FY16)**      **Exhibit 20: Following efficient balance sheet management, we expect LDR to inch up to 71% by end-FY19**



Source: Companies, Centrum Research

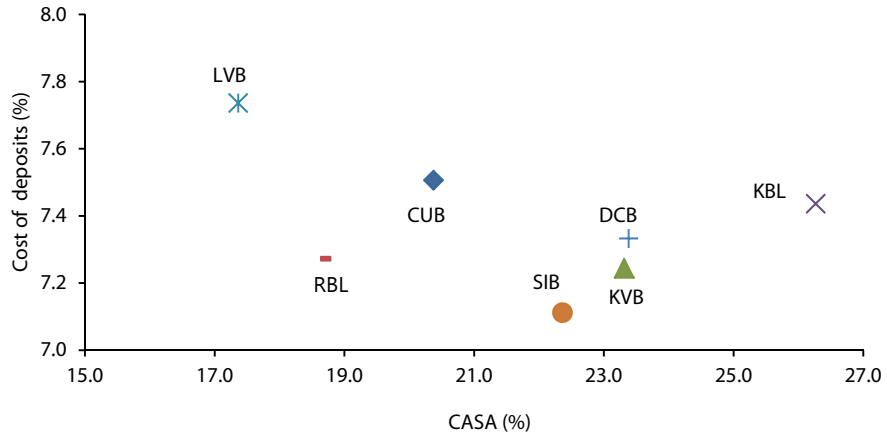


Source: Company, Centrum Research Estimates

**Margins to expand following recent deposit rate cuts**

While KBL’s CASA ratio has increased and fairs well as compared to its regional peers, its cost of deposits has remained higher, thus impacting margins. Elevated deposit rates had impacted cost of funds and thus margins in the past.

**Exhibit 21: KBL’s cost of deposits remains high, even as CASA proportion remains healthy (FY16)**



Source: Companies, Centrum Research.

As excessive deposit growth in the past depressed LDRs, KBL has resorted to reducing its deposit rates in the recent past. Its deposit rate at 6.75% for term deposits in the 1-3 year bucket is the lowest among peers. KBL has 46% of its deposits in the 1-3 year bucket and runs a tight ALM portfolio with average duration of ~2-years for both deposits and loans.

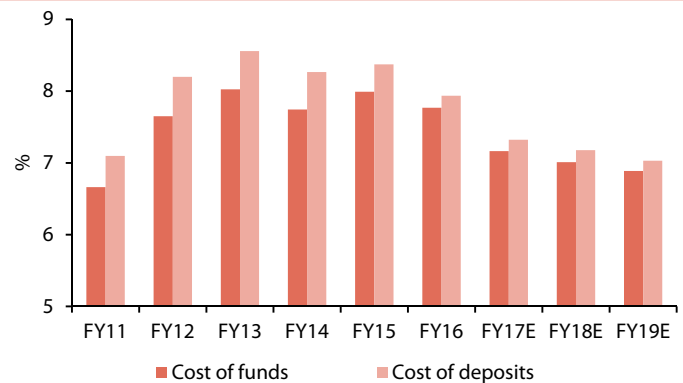
We believe that with the increasing proportion of CASA deposits and adequate headroom to mobilise funds under an alternate window i.e. AT-I bonds/ tier-II bonds, the overall cost of funds is set to decline over FY16-19 which in-turn will aid in margin expansion.

**Exhibit 22: Currently KBL’s term deposit rate (1-3yr bucket) is the lowest among peers**



Source: Companies, Centrum Research

**Exhibit 23: Improved liability franchise will lead to decline in the cost of deposits and cost of funds over FY16-19E**

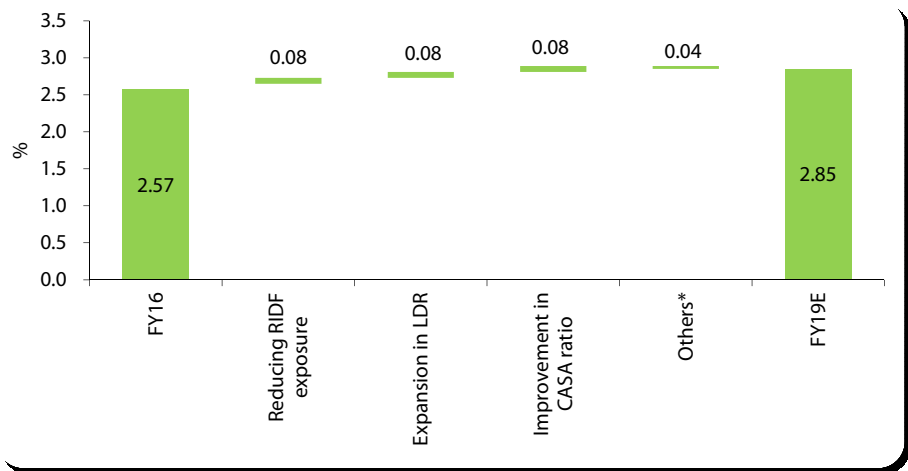


Source: Company, Centrum Research Estimates

Our calculations suggest 5bps positive impact on NIM following 135bps increase in CASA ratio over FY13-16. We estimate an additional 8bps positive impact on NIM over FY16-19, driven by continued traction in building the retail liability franchise, especially in the nature of CASA deposits. Our calculation for NIM expansion is based on CASA increasing by 263bps to 28.9% by end-FY19E.

We believe that a) reduction in deposit rates and the increasing share of CASA deposits b) focus on the retail-SME nature of loan franchise c) rising loan-deposit ratio and d) further decline in RIDF exposure will aid in margin expansion. Our interaction with the management and a closer look into factors that impact NIM makes us believe that NIM will improve by 28bps to 2.9% over FY16-19E.

**Exhibit 24: Factors contributing to margin expansion over FY16-19E**



Source: Centrum Research Estimates

**Lower slippages or higher-than-anticipated credit growth:** We have assumed a higher slippage ratio of 300bps (average over FY16E-19E) which stood at an average 270bps over FY13-16. Going forward, If the slippage ratio further improves on account of fewer fresh delinquencies, then there will be further tailwinds to the net spread and NIM on account of lower-than-expected interest reversals. NIM could increase further in the event of higher-than-expected credit growth.

We however have not factored these assumptions into our NIM calculations. We firmly believe that drivers that can lead to NIM improvement are at a low base and hence we see limited downside risk to our estimates.

## Cost-ratios intact; steps to shore non-interest income initiated

- **Employee productivity is near best among its peers; well-contained costs have led to the cost-assets ratio remain intact at 183bps (FY16) which is competitive to its peer set.**
- **Efforts underway at shoring up the non-interest income franchise which will lead to an uptrend in its share to total assets.**

KBL's cost/assets ratio at 183bps (FY16), is the best among its peers and is an outcome of its well-drawn strategy towards branch addition and the ability to quickly turn-around the same. This is even as the employee base continues to be driven by the IBA board and the need for provisioning towards pension and wage-revision has seen employee cost remain higher compared to regional peers.

One of the reasons for KBL's cost-efficiency is its ability to quickly turnaround branches. 62% of its branches are in its home-state; ~78% of its branches are in south India. On the loan side, the contribution of home-state is 45%. Regional banks which tend to have a high concentration of business and branches in their home-states have shown ability to quickly break-even.

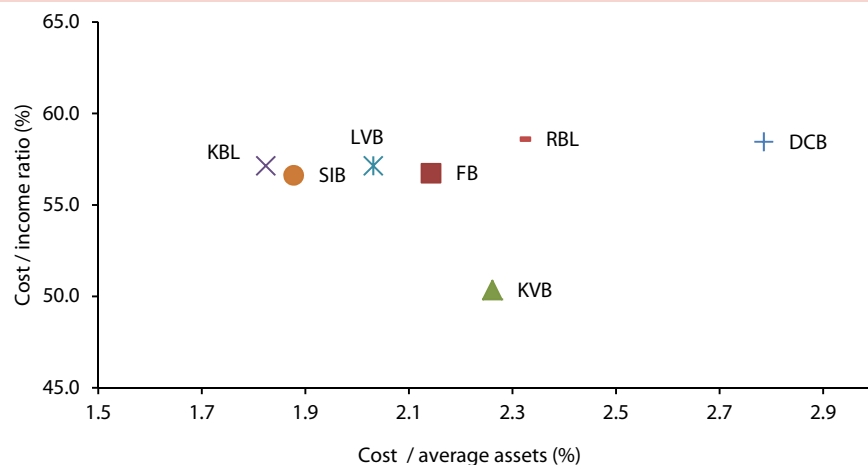
### Exhibit 25: Regional banks have a larger proportion of branches in their home-states

Bank	Total branches	% of branches in home-state
City Union Bank	528	68.6
Federal Bank	1,252	47.9
Karur Vysya Bank	706	53.1
Karnataka Bank	738	62.1
Lakshmi Vilas Bank	460	55.9
South Indian Bank	840	54.2

Source: Companies, Centrum Research.

While KBL's cost-assets ratio has traditionally remained low, its elevated cost-income ratio (average of 54.5% over FY14-16) is due to its weak income profile, especially due to its lower margin profile and lower credit off-take over FY14-16.

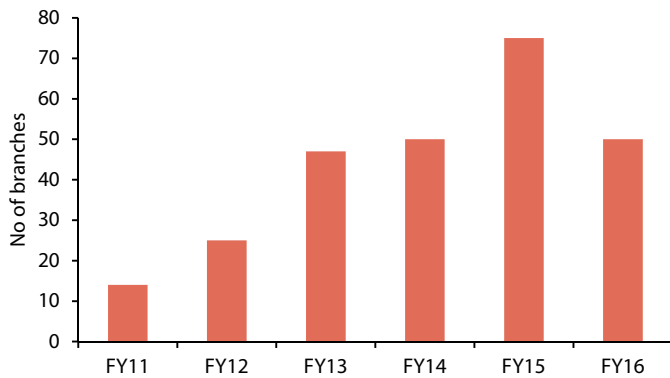
### Exhibit 26: KBL enjoys superior operating efficiency; cost-income ratio however remains high following a weak income trajectory (FY16)



Source: Companies, Centrum Research.

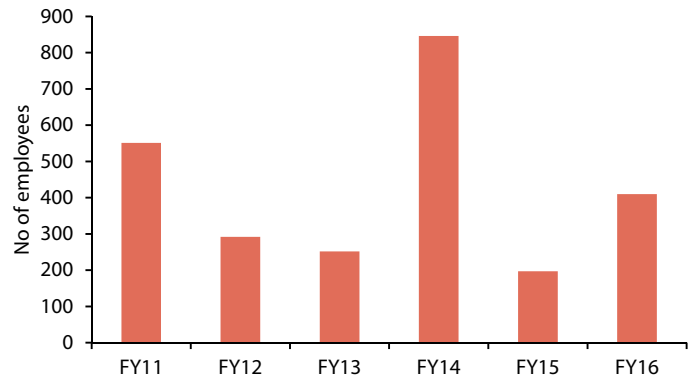
- While over FY11-FY16, KBL's cost-asset ratio has averaged 181bps, FY11 (1.87%) and FY14 (1.97%) saw a sharp rise in this ratio, primarily due to sizeable employee addition and provisioning towards wages and pension. In FY11 the bank added 551 employees; in FY14 the ratio escalated as it added 50 branches and 846 employees.
- Going forward, the bank management has guided at adding 40-50 branches per annum over FY16-19. Of these, 25% of the branches will be in the home state (the bank will fulfil the PSL requirements through these branches) and the remaining will be in states other than Karnataka.
- On the cost front, KBL already has a strong IT infrastructure platform in place. As for employee costs the bank has made provisions towards wage-related expenses in FY17. We thus are building in a higher cost/assets ratio at 200bps (average) over FY16-19E as we believe retail – SME and CASA will be the main drivers of the balance sheet growth going forward.

**Exhibit 27: Trend in branch additions**



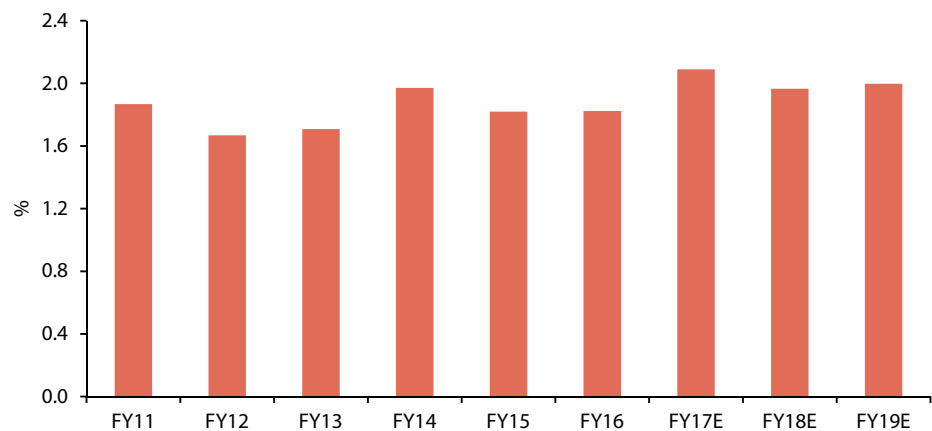
Source: Company, Centrum Research

**Exhibit 28: Trend in employee additions**



Source: Company, Centrum Research

**Exhibit 29: KBL's cost/ average assets ratio is expected to remain intact**



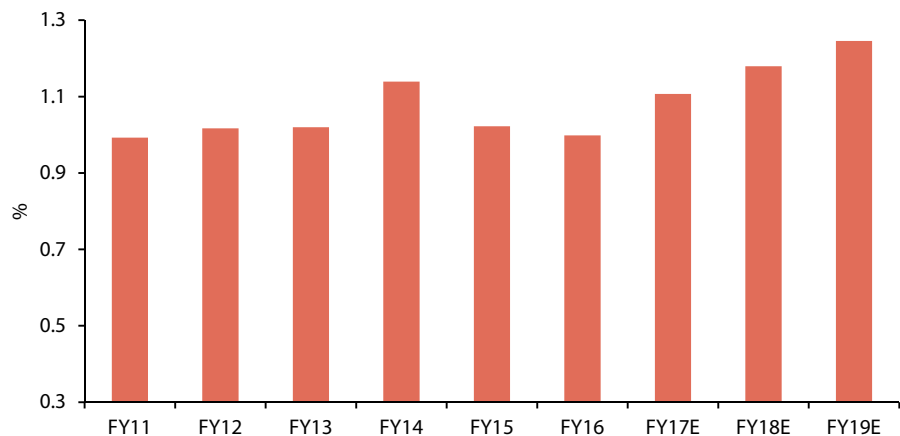
Source: Company, Centrum Research Estimates

**Non-interest income: See share rise over FY16-19E**

Historically KBL's non-interest income to total asset ratio has stood at ~1%.

- However, given the pick-up in the fee income stream owing to a) superior asset-liability mix driven by retail and SME on the asset side and CASA ratio improvement on the liability side b) higher credit growth leading to higher loan processing fees, and c) increase in third party and distribution fees following a tie-up with LIC on the life insurance side and Bajaj Alliance on the General Insurance side and 3-4 mutual funds for mutual fund distribution, we expect non-interest income to trend upwards.

**Exhibit 30: Other income/ total average assets is expected to witness an increasing trend**



Source: Company, Centrum Research Estimates

## Asset quality trend to stabilise; building in provisioning buffers

- Consortium nature of lending towards stressed sectors impacted the bank’s asset quality trend. Slippage run-rate inched up to 300bps (over FY14-16) vs. 190bps (over FY11-13).
- The bank’s problem loans stood at Rs42.6bn in Dec’16 (12% of loans); efforts towards asset quality resolution are underway.
- Factoring in 300bps of slippages / 90bps of credit cost over FY16-19E. Draw comfort in ability towards recovery/upgradation, also witnessed in the earlier cycle.

In a bid to grow rapidly the bank adopted an aggressive stance towards growth over FY11-13. Consequently, over this period, the bank’s exposure to stressed sectors transcended 20%. KBL’s slippages remained higher over FY14-16 due to its consortium based nature of lending especially towards stressed sectors. Slippage run-rate inched up to an average 300bps over FY14-FY16 from 190bps in the earlier cycle of FY11-13.

The bank’s problem loan portfolio stood at Rs42.6bn in Dec’16 and comprised - GNPA (Rs15.6bn), restructured portfolio (Rs 13.3bn), 5:25 Rs4bn (entirely standard), SDR (Rs4.5bn) and S4A at Rs5.2bn (entirely standard). The bank’s SMA-2 portfolio stood at Rs15.9bn.

- In a bid to contain the pace of bad loan addition, management has initiated various measures which includes a) separation of credit appraisal from branches to regional offices / central processing units b) setting up of a credit-monitoring team beginning FY16 and c) resorting to asset sale to ARCs
- Also, while the trend on bad loan accretion has been higher on the industrial exposure front, we draw comfort from the GNPA in retail/ SME portfolio. In FY16, personal loan GNPA stood at 1.6% (vs. 1.8% in FY15); SME GNPA stood at 3.5% (vs. 3.8% in FY15). With incremental growth targeted at the non-corporate portfolio i.e. retail-SME and agriculture, we don’t expect a sharp spurt in slippages.

### Exhibit 31: Trend in GNPA

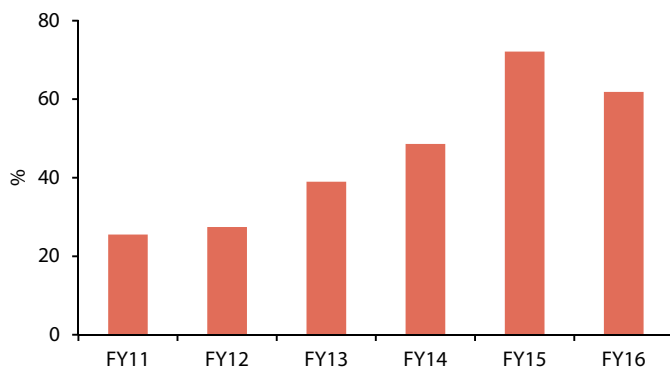
% of loans	FY15	FY16
Agriculture & allied activities	2.0	2.3
Industry	3.4	4.6
Services	3.8	3.5
Personal Loans	1.8	1.6

Source: Company, Centrum Research

- Our assumption about the stability in asset quality is also based on the premise of material reduction in exposure towards stressed sectors. In Dec’16, the bank’s cumulative exposure to infrastructure, textile, gems and jewellery and iron and steel sector had declined to 16.1% from 23.3% in FY14. We are also reassured by the bank’s increasing proportion of credit to higher rated corporates (see exhibit 43).

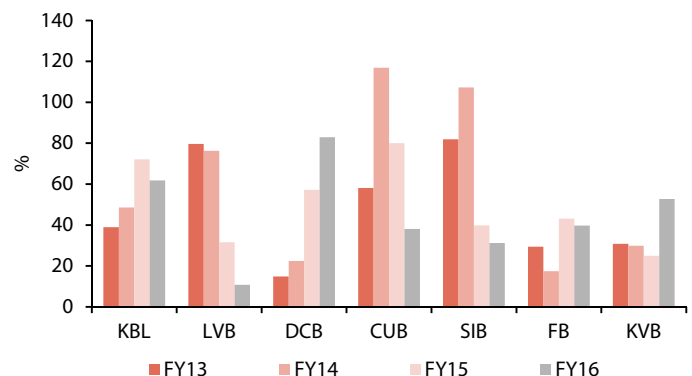
We also draw comfort from KBL’s ability towards recovery/upgradation. This is evident from the fact that despite the challenging environment, recovery/upgradation as a proportion of GNPA has inched up to 62% in FY16 from 26% in FY11. This ratio is better than some of its regional peers’.

Exhibit 32: KBL’s recovery-upgradation on the rise...



Source: Company, Centrum Research

Exhibit 33: ... also when compared to its regional peers



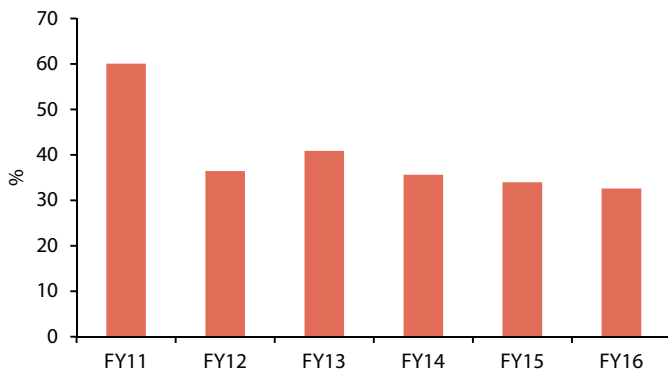
Source: Companies, Centrum Research

While we expect the trend in slippages to normalise as highlighted above, we remain conservative due to its large stressed asset portfolio and are modelling in slippages at 300bps over FY16-19E. Our assumptions on slippages factor in a certain degree of slippages from the SMA-2 portfolio and a haircut on the standard portfolio which is parked under restructured and other alternate windows i.e. 5:25 / SDR and S4A.

However, due to the bank's ability to reduce non-performing loans through recovery upgradation, and a pro-active stance towards asset sales to ARCs and w/offers, we expect GNPA's to decline to 3.3% by end-FY19E (vs. 4.3% as at Dec'16).

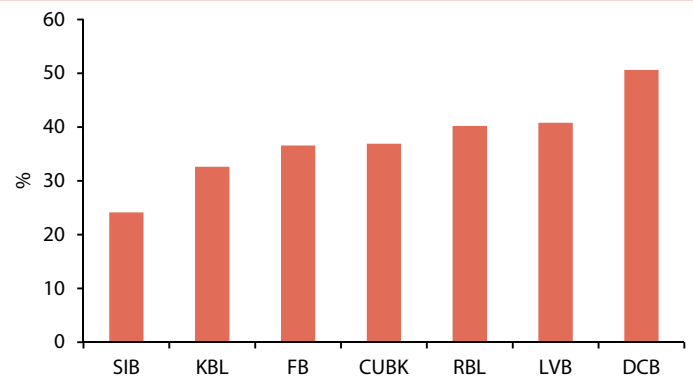
While we see asset quality normalising, we continue to factor in higher provisioning following a) the increasing proportion of bad loans in the D1/ D2 category and, b) the need for increasing the overall provisioning coverage ratio (PCR). The bank's PCR (calc) at 32.6% in FY16 is one of the lowest among its regional peers. Including technical write-offs, the same stood at 48%.

**Exhibit 34: The bank's PCR (calc). has remained low...**



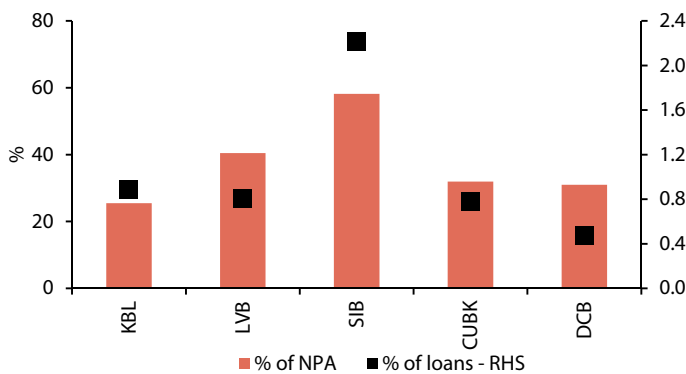
Source: Company, Centrum Research

**Exhibit 35: ...also when compared to its regional peers (FY16)**



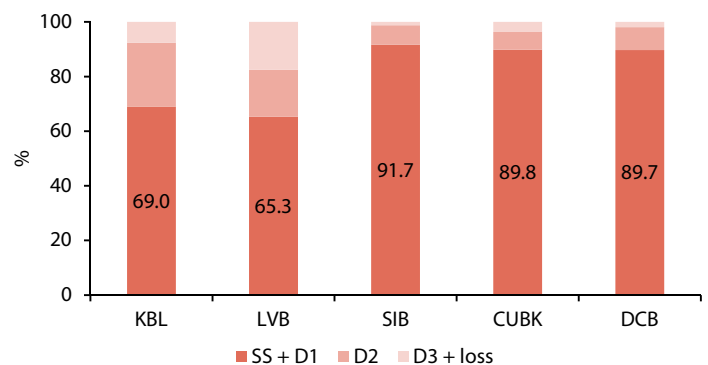
Source: Companies, Centrum Research

**Exhibit 36: Top-4 NPA accounts... Concentration risk remains low....(FY16)**



Source: Companies, Centrum Research

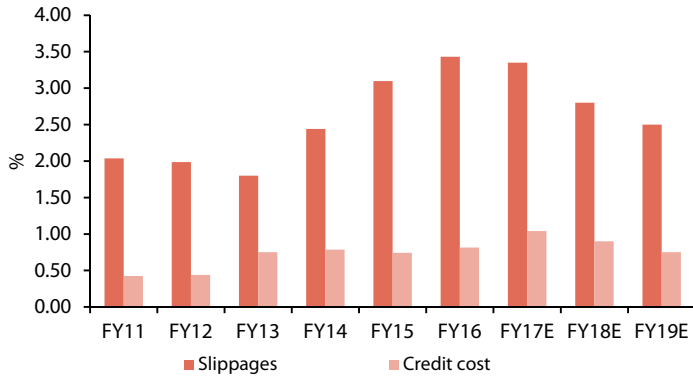
**Exhibit 37: ...due to a larger proportion of bad loans in doubtful segments, provisioning remains high (FY16)**



Source: Companies, Centrum Research

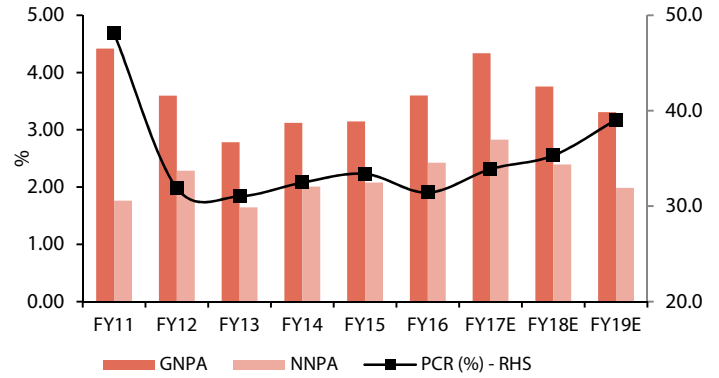
We thus are building in slippages/ credit cost at 300bps/ 90bps over FY16-19E for KBL. We expect PCR to gradually inch up towards 40% by FY19E. Including the technical write-offs, we see the same inch up to 55% levels.

**Exhibit 38: Building in 300bps / 90bps of slippages / credit cost for FY16-19E...**



Source: Company, Centrum Research Estimates

**Exhibit 39: ...led by better recovery/upgradation and provisioning, we see GNPA / NNPA moderate.**



Source: Company, Centrum Research Estimates

**Exhibit 40: GNPA + restructuring across peer set banks (FY16)**

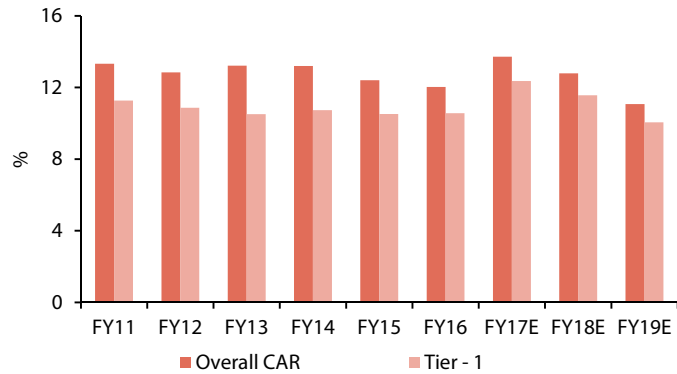
% of loans	Restructured portfolio	% Slippage to restructured from NPA	GNPA + restructuring
CUB	1.0	32.6	3.4
LVB	3.8	21.6	5.8
SIB	2.4	23.5	6.2
KBL	4.6	14.5	8.0
RBL	0.4	75.5	1.4

Source: Companies, Centrum Research

## Capital position strong; exposure to higher rated loans on the rise

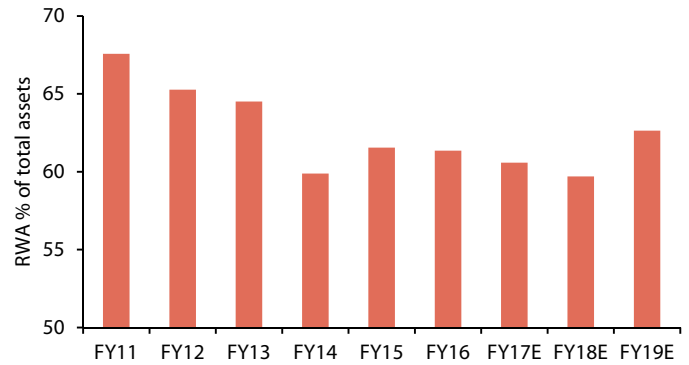
The bank's capital consumption has traditionally remained healthy, as evident from its risk-weighted assets/total assets ratio. KBL recently raised Rs6.6bn via right issues. Post the same, its overall CAR has inched up further to 13%+ levels including tier-I at 11%+.

**Exhibit 41: Capital position remains healthy...**



Source: Company, Centrum Research Estimates

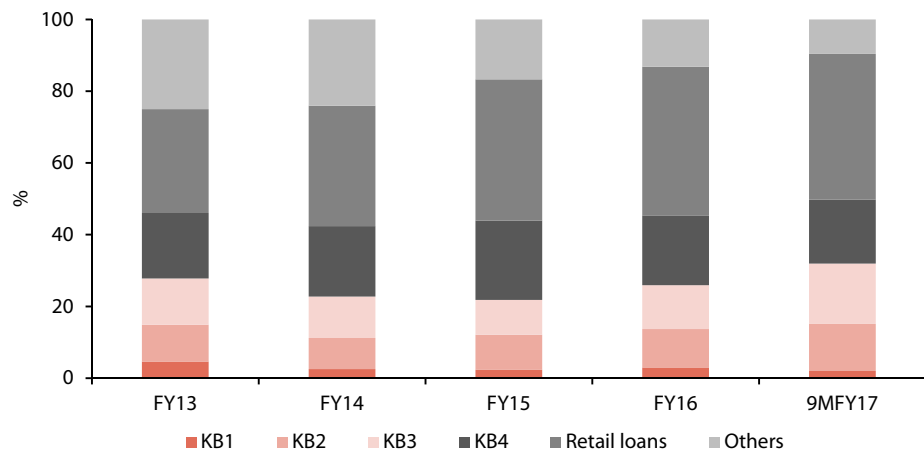
**Exhibit 42: ...an outcome of effective capital consumption. Ratio of RWA/total assets has remained at ~60% levels.**



Source: Company, Centrum Research Estimates

The reason behind the bank's efficient capital management is its increasing proportion of exposure to internally higher rated loans. From 75% of loans (including retail loans) internally rated KB4 and above in FY13, the same had increased to 90% in 9MFY17.

**Exhibit 43: Exposure to internally higher rated (including retail) exposure has been on the rise**



Source: Company, Centrum Research. Others indicate exposure between KB 5 to KB 8 and unrated loans.

### What is the desired outcome?

The bank's concentrated efforts towards asset growth with a focused approach at curtailing overall interest cost will see NIM improve over FY16-19E. We expect the share of non-interest income to improve further; in addition, we expect cost/ income to decline and moderate at ~51% levels by end-FY19E. Even as we build in accelerated slippages, drawing a reference from the bank's ability towards recovery/upgradation, we see the overall trend in asset quality stabilising.

We expect the outcome of these efforts translating into a RoA/RoE of 1.0% /14.4% by end-FY19E. Starting with a low NIM base, we do not see any major risk to our estimates. Also, our estimates factor in potential risk to slippages in the event of a slower pace of revival in stressed exposure.

We thus are building in 15% CAGR in loans over FY16-19E (vs. 10% CAGR in loans over FY13-16). This will translate into 16%/ 20% CAGR in NII /PAT over FY16-19E.

### Exhibit 44: DuPont analysis

(% of avg assets)	FY15	FY16	FY17E	FY18E	FY19E
<i>Interest income</i>	9.5	9.2	8.8	8.8	8.7
<i>Interest expenses</i>	7.1	6.8	6.2	6.1	6.0
<b>Net interest income</b>	<b>2.4</b>	<b>2.4</b>	<b>2.6</b>	<b>2.7</b>	<b>2.7</b>
<i>Other income</i>	1.0	1.0	1.1	1.2	1.2
<b>Total income</b>	<b>3.4</b>	<b>3.4</b>	<b>3.7</b>	<b>3.8</b>	<b>3.9</b>
<i>Operating expenses</i>	1.8	1.8	2.1	2.0	2.0
<b>pre-provisioning profit</b>	<b>1.6</b>	<b>1.6</b>	<b>1.6</b>	<b>1.9</b>	<b>1.9</b>
<i>Provisions</i>	0.4	0.6	0.8	0.8	0.7
<b>Profit Before Tax</b>	<b>9.5</b>	<b>9.2</b>	<b>8.8</b>	<b>8.8</b>	<b>8.7</b>
<i>Tax</i>	0.2	0.2	0.0	0.3	0.3
<b>Return on assets</b>	<b>0.9</b>	<b>0.8</b>	<b>0.7</b>	<b>0.8</b>	<b>1.0</b>
<i>Leverage (x)</i>	15.4	15.4	13.3	14.4	15.8
<b>Return on Equity</b>	<b>14.0</b>	<b>11.7</b>	<b>10.3</b>	<b>11.6</b>	<b>14.4</b>

Source: Company, Centrum Research Estimates

**Exhibit 45: KBL and its regional peers - ... key financial parameters**

FY16 – Rs mn	Karnataka Bank	Lakshmi Vilas Bank	City Union Bank	DCB Bank	RBL Bank	Federal Bank	Karur Vysya Bank	South Indian Bank
<b>Balance sheet</b>								
<b>Equity</b>	<b>36,906</b>	<b>17,636</b>	<b>30,520</b>	<b>17,922</b>	<b>29,893</b>	<b>80,912</b>	<b>45,730</b>	<b>38,456</b>
<b>Deposits</b>	<b>5,04,882</b>	<b>2,54,310</b>	<b>2,71,581</b>	<b>1,49,260</b>	<b>2,43,487</b>	<b>7,91,717</b>	<b>5,00,789</b>	<b>5,19,125</b>
- CASA	1,32,607	44,155	55,326	34,899	45,379	2,60,526	1,16,745	1,24,590
- CASA ratio(%)	26.3	17.4	20.4	23.4	18.6	32.9	23.3	24.0
- Term deposit ratio (%)	73.7	82.6	79.6	76.6	81.4	67.1	76.7	76.0
<b>Loans</b>	<b>3,39,027</b>	<b>1,96,437</b>	<b>2,10,569</b>	<b>1,29,214</b>	<b>2,12,291</b>	<b>5,80,901</b>	<b>3,90,844</b>	<b>4,10,857</b>
- Working capital (%)	40.2	63.3	66.2	22.2	28.8	58.2	78.8	50.8
- Term loan (%)	59.8	36.7	33.8	77.8	71.2	41.8	21.2	49.2
<b>Total assets</b>	<b>5,65,003</b>	<b>2,87,322</b>	<b>3,12,520</b>	<b>1,91,185</b>	<b>3,91,611</b>	<b>9,14,300</b>	<b>5,76,637</b>	<b>6,31,749</b>
<b>Stressed sector exposure</b>								
Infrastructure (%)	5.9	7.7	0.5	1.4	4.6	8.4	8.6	10.2
Metal (%)	2.9	4.7	5.7	2.2	1.8	3.3	3.1	4.7
Textiles (%)	6.2	5.4	11.1	2.8	2.6	2.3	9.0	4.0
<b>Du-pont analysis (%)</b>								
Interest earned	9.2	9.6	10.0	9.6	8.3	8.9	9.8	9.1
Interest expended	6.8	7.2	6.6	6.1	5.8	6.0	6.6	6.6
<b>Net interest income</b>	<b>2.4</b>	<b>2.4</b>	<b>3.3</b>	<b>3.5</b>	<b>2.5</b>	<b>2.9</b>	<b>3.2</b>	<b>2.5</b>
Other income	1.0	1.1	1.4	1.3	1.5	0.9	1.3	0.8
<b>Total income</b>	<b>3.4</b>	<b>3.6</b>	<b>4.7</b>	<b>4.8</b>	<b>4.0</b>	<b>3.8</b>	<b>4.5</b>	<b>3.3</b>
Operating expenses	1.8	2.0	1.9	2.8	2.3	2.1	2.3	1.9
<b>Pre-prov. profit</b>	<b>1.6</b>	<b>1.5</b>	<b>2.8</b>	<b>2.0</b>	<b>1.6</b>	<b>1.6</b>	<b>2.2</b>	<b>1.4</b>
Provisions	0.6	0.7	0.8	0.5	0.3	0.8	0.6	0.6
Tax	0.2	0.2	0.5	0.4	0.4	0.3	0.6	0.3
<b>RoAA</b>	<b>0.8</b>	<b>0.7</b>	<b>1.5</b>	<b>1.1</b>	<b>0.9</b>	<b>0.5</b>	<b>1.0</b>	<b>0.5</b>
<b>RoAE</b>	<b>11.7</b>	<b>10.9</b>	<b>15.5</b>	<b>11.5</b>	<b>11.2</b>	<b>5.9</b>	<b>12.9</b>	<b>9.0</b>
<b>Productivity ratios</b>								
Profit / employee (Rs mn)	0.53	0.51	0.98	0.46	0.76	0.41	0.79	0.43
Employee / Branch (no).	10.7	7.8	8.6	21.5	19.7	9.4	10.8	9.3
Oper. cost / employee (Rs mn)	1.27	1.52	1.23	1.16	1.98	1.59	1.74	1.48
<b>Asset quality</b>								
GNPA	11,804	3,913	5,120	1,974	2,081	16,678	5,112	15,624
NNPA	7,955	2,316	3,232	975	1,244	10,577	2,162	11,853
GNPA (%)	3.44	1.97	2.41	1.51	0.98	2.84	1.30	3.77
NNPA (%)	2.35	1.18	1.53	0.75	0.59	1.64	0.55	2.89
PCR (%) - calc	32.6	40.8	36.9	50.6	40.2	36.6	57.7	24.1
<b>Capital Adequacy</b>								
Tier – 1 Capital	36,752	15,685	30,294	17,182	29,715	77,918	40,644	36,569
Tier – 2 Capital	5,101	3,569	1,026	1,769	4,915	3,336	3,295	7,438
Risk-weighted assets (Rs mn)	3,47,873	1,80,457	2,00,824	1,34,299	2,67,610	5,83,301	3,60,990	3,71,993
CAR (%)	12.0	10.7	15.6	14.1	12.9	13.9	12.2	11.8
Tier-1 (%)	10.6	8.7	15.1	12.8	11.1	13.4	11.3	9.8
Tier-2 (%)	1.5	2.0	0.5	1.3	1.8	0.6	0.9	2.0
<b>Corporate governance</b>								
Board of Directors	12	12	10	13	12	10	11	10
Independent Director	9	6	6	10	6	8	4	7
<b>Valuation</b>								
Market cap (Rs mn)	25,820	29,064	86,140	44,358	1,49,343	1,46,712	60,719	27,546
P/E (x)	6.1	16.1	19.4	22.8	51.1	30.8	10.7	8.3
P/ABV (x)	0.9	1.9	3.1	2.6	5.2	2.1	1.4	1.0

Source: Companies, Centrum Research.

## Valuation, view and key risks

We initiate coverage on KBL, with a Buy rating and TP of Rs170. Superior CASA franchise (26% as at FY16); better employee productivity and efficient cost management (cost/assets at 183bps in FY16), steady non-interest income and adequate capital consumption, have been the bank's key strengths.

On the flip-side, led by inefficient balance sheet management, margins have remained low, even as compared to peers'. This in addition to asset-quality headwinds, especially in the recent past and the need for provisioning thereon has curtailed RoAs to 0.8% levels.

We believe that the steps directed at addressing the near-term challenges i.e. NIM and asset quality are in the right direction and any material improvement therein will translate into a considerable increase in RoAs. We see RoA/ RoE inch up to 1.0% /14.4% by end-FY19E, best ever since FY09.

Banks with a consistent improvement in key performance indicators tend to graduate to higher multiples. We see a similar kind of re-rating due in case of KBL. We value the bank at 1.2x FY19E ABV leading to a TP of Rs170 (21.5% upside). Initiate with a BUY.

**Key risks:** Lower than expected credit growth in retail-SME portfolio; higher delinquencies from the corporate portfolio or slow pace of traction on NIM front.

### Can be a sought-after franchise when spruced up

Until recently, before Kotak Bank acquired ING Vysya Bank in CY15, M&A activities in the Indian banking space were largely confined to the acquisition of weak banks or managements looking for an exit. One of the key parameters to evaluate the potential value was the number of branches the acquirer gained. Valuation multiples ascribed to each transaction were unique and entirely dependent on franchise value and how much the merged entity would gain post acquisition.

#### Exhibit 46: M&A activity in the banking space

Year	Name of the acquire bank	Branches (nos)	Acquirer Bank	Consideration paid (Rs mn)	Implied P/B (x)	Per branch (Rs mn)	
						Advances	Deposits
2000	Times Bank	39	HDFC bank	2,186	1.3	336	772
2001	Bank of Madura	355	ICICI Bank	3,426	2.6	99	33
2002	Vysya Bank	380	ING N.V	3,408	2.5	116	212
2006	Lord Krishna	112	Centurion Bank of Punjab	3,376	1.8	203	127
2006	Sangli Bank	198	ICICI Bank	3,004	12	101	45
2008	Centurion Bank of Punjab	394	HDFC Bank	112,671	5.4	377	285
2010	Bank of Rajasthan	463	ICICI Bank	24,737	2.4	325	180
2015	ING Vysya Bank	560	Kotak Bank	150,000	2.1	649	736

Source: Companies, Media, Centrum Research

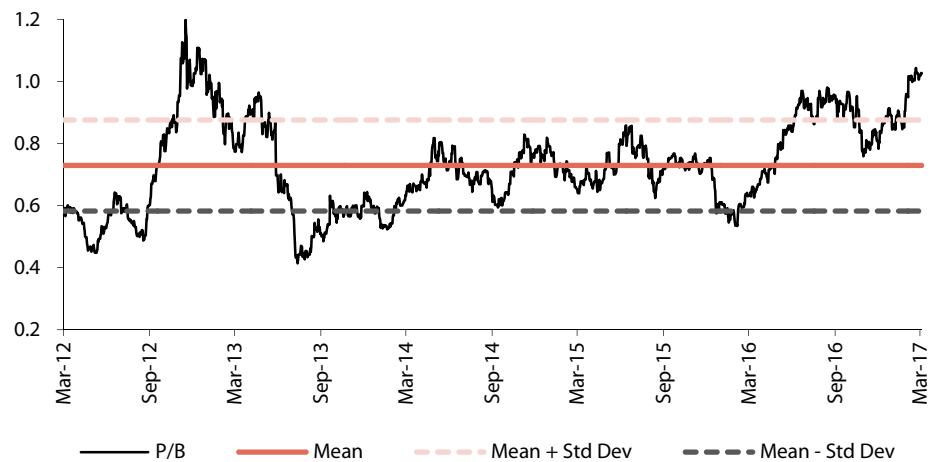
## Sensitivity analysis and peer comparison

**Exhibit 47: Sensitivity Analysis – impact of change in NIM and credit cost on FY18PBT**

%	Credit cost				
	+ 10bps	+ 20bps	' Current levels	- 10bps	- 20bps
- 5bps	(9.8)	(15.4)	(4.2)	1.3	6.9
- 10bps	(14.0)	(19.6)	(8.5)	(2.9)	2.7
<b>NIM</b>					
Current levels	(5.6)	(11.2)	-	5.6	11.2
+ 5bps	(1.3)	(6.9)	4.2	9.8	15.4
+ 10bps	2.9	(2.7)	8.5	14.0	14.0

Source: Centrum Research Estimates

**Exhibit 48: Rolling forward P/B chart**



Source: Bloomberg, Company, Centrum Research Estimates

**Exhibit 49: Comparative Valuations**

Company Name	Mkt Cap (Rs mn)	CAGR (FY16-FY18E) %			PE (x)			RoA (%)			RoE (%)			P/BVPS (x)			Div Yield (%)		
		NII + Oth inc	PPOP	PAT	FY16	FY17E	FY18E	FY16	FY17E	FY18E	FY16	FY17E	FY18E	FY16	FY17E	FY18E	FY16	FY17E	FY18E
KBL*	39,550	15.8	19.9	14.9	4.5	7.6	7.2	0.8	0.7	0.8	11.7	10.3	11.6	0.5	0.7	0.8	5.0	3.5	3.0
CUBK*	85,712	14.4	14.2	22.0	13.6	14.6	14.2	1.4	1.6	1.6	14.1	16.1	16.2	1.8	2.2	2.2	1.7	1.1	1.1
DCBB*	48,805	18.5	14.4	12.4	15.5	16.5	14.1	1.1	0.9	0.9	11.9	10.8	11.9	1.7	1.7	1.6	0.0	0.0	0.0
FB	1,55,920	37.0	80.0	49.7	21.8	14.6	14.5	0.5	0.9	1.0	5.9	11.8	13.4	1.3	1.3	1.6	1.2	1.5	1.1
KVB	65,477	29.7	23.7	8.3	9.8	10.7	10.1	1.0	0.9	1.1	12.9	12.6	14.5	1.2	1.2	1.2	3.1	3.0	2.6
RBL	1,79,949	74.2	64.1	47.2		30.3	29.0	1.0	1.1	1.2	12.5	13.8	16.1		3.3	3.7	0.4	0.5	0.4
SIB	30,197	32.1	58.7	22.1	8.6	7.5	6.8	0.5	0.6	0.7	9.0	11.0	11.9	0.7	0.8	0.8	2.3	2.6	2.5

Source: Bloomberg consensus, \*Centrum Research Estimates

## Quarterly financials

### Exhibit 50: Quarterly Financials

(Rs mn)	Q4FY15	Q1FY16	Q2FY16	Q3FY16	Q4FY16	Q1FY17	Q2FY17	Q3FY17
<b>Income statement</b>								
Interest earned	11,964	12,291	12,485	12,371	12,777	12,606	13,064	13,239
Interest expended	9,050	8,977	9,415	9,322	9,179	8,959	9,091	9,474
<b>Net interest income</b>	<b>2,913</b>	<b>3,313</b>	<b>3,070</b>	<b>3,049</b>	<b>3,597</b>	<b>3,647</b>	<b>3,973</b>	<b>3,765</b>
Non-interest income	1,117	1,191	1,210	1,327	1,700	1,744	1,897	1,336
<b>Total income</b>	<b>4,030</b>	<b>4,504</b>	<b>4,280</b>	<b>4,377</b>	<b>5,297</b>	<b>5,391</b>	<b>5,870</b>	<b>5,101</b>
Operating expenses	2,137	2,114	2,585	2,460	2,754	2,771	3,542	3,382
<b>PPOP</b>	<b>1,894</b>	<b>2,390</b>	<b>1,695</b>	<b>1,917</b>	<b>2,544</b>	<b>2,619</b>	<b>2,328</b>	<b>1,719</b>
Provisions	(45)	1,159	351	631	1,125	1,363	1,306	1,006
<b>PBT</b>	<b>1,938</b>	<b>1,232</b>	<b>1,344</b>	<b>1,286</b>	<b>1,419</b>	<b>1,256</b>	<b>1,022</b>	<b>713</b>
Tax	594	138	322	317	351	41	(216)	27
<b>Reported PAT</b>	<b>1,344</b>	<b>1,093</b>	<b>1,022</b>	<b>969</b>	<b>1,068</b>	<b>1,215</b>	<b>1,238</b>	<b>685</b>
<b>Ratios</b>								
<b>Growth YoY (%)</b>								
<i>NII</i>	16.6	19.1	3.3	1.0	23.5	10.1	29.4	23.5
<i>Non-interest income</i>	(2.0)	(26.8)	17.7	(18.5)	52.2	46.4	56.8	0.7
<i>Opex</i>	(22.2)	(3.8)	8.9	(12.7)	28.9	31.1	37.0	37.5
<i>PPOP</i>	112.4	8.1	4.2	4.6	34.3	9.6	37.3	(10.3)
<i>Reported PAT</i>	65.5	(10.1)	15.5	(9.4)	(20.6)	11.2	21.2	(29.3)
<i>Loans</i>	11.8	8.7	9.2	8.5	7.0	11.5	12.8	8.7
<i>Deposits</i>	13.4	9.3	10.6	10.9	9.7	10.1	8.6	15.6
<b>Margins (%)</b>								
<i>Yield on total assets</i>	12.2	12.4	12.4	12.1	15.3	14.6	11.8	11.9
<i>Cost of funds</i>	7.5	7.3	7.4	6.9	7.1	7.0	6.6	6.5
<i>Spread</i>	4.4	4.8	4.7	4.6	8.0	7.6	4.9	5.1
<i>NIM</i>	4.2	4.5	4.2	4.4	8.2	7.6	4.5	4.7
<b>Key drivers (%)</b>								
<i>Cost-income</i>	53.0	46.9	60.4	56.2	52.0	51.4	60.3	66.3
<i>GNPA</i>	3.0	3.3	3.2	3.6	3.4	3.9	3.6	4.3
<i>NNPA</i>	2.0	2.1	2.0	2.4	2.4	2.6	2.6	3.0
<i>Provision coverage</i>	34.0	38.2	39.1	33.4	32.6	34.4	28.5	31.7
<i>Tier I CAR</i>	10.5	10.3	10.1	10.0	10.6	10.3	0.0	11.9
<i>Tier II CAR</i>	1.9	1.8	1.7	1.7	1.5	1.4	0.0	1.3
<i>RoA</i>	1.3	1.1	0.9	0.9	1.3	1.4	1.1	0.6
<i>RoE</i>	31.7	25.8	22.7	10.6	23.1	-	25.2	13.0

Source: Company, Centrum Research

**Analysis of Q3FY17 results:** NII de-grew by 5.2% QoQ but grew 23.5% YoY. Due to demonetisation, the bank witnessed credit de-growth of 2.3% QoQ and 8.7% growth YoY. As a result, due to weak credit off-take and interest reversals on account of higher slippages, the bank's NIM declined by 8bps QoQ to 2.54%. Cost to income at 66.3% looks elevated on three accounts 1) higher employee expenses on account of higher pension provisioning, 2) higher operating expenses on account demonetisation and 3) depressed total income due to lower NII and other income. Reported GNPA and NNPA came in at 4.3% and 3.0% respectively, worsening QoQ by 66bps and 36bps respectively. While GNPA look optically higher on account of tepid credit growth, NNPA worsened on account of lower PCR. Consequently, PAT declined 44.5% YoY.

### Exhibit 51: Shareholding pattern (%)

	Q3FY17	Q2FY17	Q1FY17	Q4FY16
Promoter	0.0	0.0	0.0	0.0
FII	20.2	23.1	19.6	19.0
DII	8.5	8.8	9.8	10.7
Others	71.4	68.1	70.6	70.4

Source: BSE

### Company Background

Karnataka Bank, with an asset base of US\$5bn, is one of the old-generation private sector banks in India. It currently operates through 738 branches and 1,334 ATMs spread across the country. The bank enjoys a respectable 3%+ market share in home-state credit. It has 62% of branches in its home-state and originates ~45% of loans from the said region. In terms of its rating profile, KBL's tier-2 bonds are rated CARE A and ICRA A. Certificate of deposits are rated ICRA A1+.

KBL, a leading 'A' Class Scheduled Commercial Bank in India, was incorporated on February 18th, 1924 at Mangalore, a coastal town of Dakshina Kannada district in Karnataka State. With over 9 decades of experience at the forefront of providing professional banking services and quality customer service, the bank now has a national presence with a network of 738 branches spread across 21 states and 2 Union Territories. The bank has over 7,669 employees, 1,22,000 shareholders and over 9.2 million customers.

### Exhibit 52: Key management personnel

Name	Position	Profile
Mr. P. Jayarama Bhat	MD & CEO	Mr. P. Jayarama Bhat has been associated with the bank for the past 44-years. He is a Certified Associate of Indian Institute of Bankers (CAIIB). His banking experience spans four decades. He joined KBL as an officer in 1973 and over a period of time got promoted to various positions. In the year 2005, he was promoted as the Chief General Manager of the bank and has been entrusted with the responsibilities of overall supervision of operational areas of the bank. He was appointed as Managing Director & CEO of the bank on 14th July 2009. On completion of his 2nd term he was re-appointed for a third consecutive term of three years w.e.f. 14.07.2015.
Mr. Ashok. Haranahalli	Director	Mr Ashok Haranahalli, has been on the Board since 14.09.2012. He has a Bachelor's degree in Law. He has rich experience in the field of Law and also agriculture.
Mr. Mahabaleswara Bhat	Chief General Manager	A post graduate in agricultural sciences, he has over 29 years of banking experience both at operational and administrative levels. He started his career as a researcher and teacher at the University of Agricultural Sciences, Bangalore and joined the bank as an agricultural field officer in 1984. On his promotion as chief manager and later on as assistant general manager he served at the credit department and planning and development department at its head office. He has good experience in administration of agricultural and rural credit, retail, MSME and corporate finance, forex business, and so on.

Source: Company

## Financials (historical)

### Exhibit 53: Income Statement

Y/E March (Rs mn)	FY10	FY11	FY12	FY13	FY14
Interest Income	19,760	23,709	31,010	37,643	41,888
Interest Expense	17,078	17,584	23,689	28,606	31,328
<b>Net Interest Income</b>	<b>2,682</b>	<b>6,125</b>	<b>7,321</b>	<b>9,037</b>	<b>10,561</b>
<b>Non-Interest Income</b>	<b>3,787</b>	<b>2,918</b>	<b>3,463</b>	<b>3,977</b>	<b>5,056</b>
- Fee & Other Income	1,263	1,623	1,741	1,872	2,137
-Gains / (Losses) on Securities	1,822	443	502	531	1,017
<b>Total Net Income</b>	<b>6,469</b>	<b>9,042</b>	<b>10,784</b>	<b>13,014</b>	<b>15,617</b>
<b>Total Operating Expenses</b>	<b>3,861</b>	<b>5,490</b>	<b>5,682</b>	<b>6,660</b>	<b>8,746</b>
Employee Expenses	2,068	3,451	3,250	3,751	5,254
Other Operating Expenses	1,793	2,039	2,432	2,910	3,492
<b>Pre-provision Profit</b>	<b>2,608</b>	<b>3,553</b>	<b>5,102</b>	<b>6,353</b>	<b>6,871</b>
<b>Provisions &amp; Contingencies</b>	<b>703</b>	<b>1,204</b>	<b>2,216</b>	<b>1,712</b>	<b>2,784</b>
NPA Provisions	810	675	838	1,723	2,105
Other Provisions	(107)	529	1,379	(12)	679
<b>Profit Before Tax</b>	<b>1,905</b>	<b>2,349</b>	<b>2,886</b>	<b>4,642</b>	<b>4,087</b>
Taxes	226	303	425	1,161	976
<b>Profit after tax</b>	<b>1,671</b>	<b>2,046</b>	<b>2,461</b>	<b>3,481</b>	<b>3,110</b>
Exceptional items	2	6	25	(13)	13
<b>Adj Net Profit</b>	<b>1,669</b>	<b>2,040</b>	<b>2,436</b>	<b>3,494</b>	<b>3,097</b>

Source: Company, Centrum Research

### Exhibit 54: Balance sheet

Y/E March (Rs mn)	FY10	FY11	FY12	FY13	FY14
Cash and balance with RBI	17,431	19,398	17,048	17,180	21,527
Inter-bank borrowings	625	463	1,608	2,358	1,847
Loans & Advances	1,44,357	1,73,481	2,07,207	2,52,077	2,83,455
Investments	91,827	1,08,156	1,18,986	1,24,581	1,38,602
<b>Total Int Earning Assets</b>	<b>2,36,808</b>	<b>2,82,099</b>	<b>3,27,802</b>	<b>3,79,016</b>	<b>4,23,904</b>
Fixed Assets	1,481	1,455	1,522	1,670	1,975
Other Assets	6,869	7,451	7,978	8,405	10,616
<b>Total Assets</b>	<b>2,70,682</b>	<b>3,17,311</b>	<b>3,63,775</b>	<b>4,16,014</b>	<b>4,71,688</b>
Deposits	2,37,307	2,73,365	3,16,083	3,60,562	4,05,828
Current	17,065	18,561	21,015	24,624	27,488
Savings	38,137	49,465	56,614	65,200	75,588
Term	1,82,105	2,05,338	2,38,454	2,70,739	3,02,753
Other Int Bearing Liabilities	6,916	10,863	11,471	15,798	19,152
<b>Interest Bearing Liabilities</b>	<b>2,44,223</b>	<b>2,84,228</b>	<b>3,27,554</b>	<b>3,76,360</b>	<b>4,24,980</b>
Other non int bearing Liab	8,132	8,792	10,239	11,084	16,186
Total Liabilities	2,52,355	2,93,020	3,37,793	3,87,444	4,41,166
Equity	18,328	24,291	25,982	28,571	30,522
<b>Total Liabilities</b>	<b>2,70,682</b>	<b>3,17,311</b>	<b>3,63,775</b>	<b>4,16,014</b>	<b>4,71,688</b>

Source: Company, Centrum Research

### Exhibit 55: DuPont analysis

(% of avg assets)	FY10	FY11	FY12	FY13	FY14
Interest income	7.9	8.1	9.1	9.7	9.4
Interest expenses	6.8	6.0	7.0	7.3	7.1
<b>NII</b>	<b>1.1</b>	<b>2.1</b>	<b>2.1</b>	<b>2.3</b>	<b>2.4</b>
Other income	1.5	1.0	1.0	1.0	1.1
<b>Total income</b>	<b>2.6</b>	<b>3.1</b>	<b>3.2</b>	<b>3.3</b>	<b>3.5</b>
Operating expenses	1.5	1.9	1.7	1.7	2.0
<b>PPOP</b>	<b>1.0</b>	<b>1.2</b>	<b>1.5</b>	<b>1.6</b>	<b>1.5</b>
Provisions	0.3	0.4	0.7	0.4	0.6
<b>PBT</b>	<b>0.8</b>	<b>0.8</b>	<b>0.8</b>	<b>1.2</b>	<b>0.9</b>
Tax	0.1	0.1	0.1	0.3	0.2
<b>RoA</b>	<b>0.7</b>	<b>0.7</b>	<b>0.7</b>	<b>0.9</b>	<b>0.7</b>
Leverage	14.8	13.1	14.0	14.6	15.5
<b>RoE</b>	<b>9.8</b>	<b>9.6</b>	<b>9.8</b>	<b>12.8</b>	<b>10.5</b>

Source: Company, Centrum Research

### Exhibit 56: Financial ratios

Y/E March	FY10	FY11	FY12	FY13	FY14
<b>B/S Structure Ratios (%)</b>					
CD Ratio	60.8	63.5	65.6	69.9	69.8
Incremental CD Ratio	77.3	80.8	78.9	100.9	69.3
CASA Ratio	23.3	24.9	24.6	24.9	25.4
<b>Growth Ratios (%)</b>					
Loans	22.2	20.2	19.4	21.7	12.4
Deposits	16.7	15.2	15.6	14.1	12.6
NII	(46.9)	128.4	19.5	23.4	16.9
Opex	11.4	42.2	3.5	17.2	31.3
PPOP	(45.7)	36.2	43.6	24.5	8.1
Provisions	(12.5)	71.1	84.1	(22.8)	62.6
PAT	(37.3)	22.4	20.3	41.5	(10.6)
<b>Operating Ratios (%)</b>					
Yield on funds	8.2	8.3	9.4	9.9	9.7
Cost of funds	7.0	6.2	7.1	7.5	7.2
NIM	1.1	2.1	2.2	2.4	2.4
Non-int inc/ Total income	1.5	1.0	1.0	1.0	1.1
Fee to avg assets	0.5	0.6	0.5	0.5	0.5
Cost/Income	59.7	60.7	52.7	51.2	56.0
Opex/ Avg assets	1.5	1.9	1.7	1.7	2.0
Provisioning cost	0.6	0.4	0.4	0.8	0.8
Effective tax rate	11.9	12.9	14.7	25.0	23.9
RoA	0.7	0.7	0.7	0.9	0.7
RoE	9.8	9.6	9.8	12.8	10.5
<b>Credit Quality Ratios (%)</b>					
Gross NPA	4.2	4.4	3.6	2.8	3.1
Net NPA	1.4	1.8	2.3	1.6	2.0
Slippage rate to op advances	2.3	2.0	2.0	1.8	2.4
NPA coverage ratio	65.7	60.1	36.4	40.9	35.6
<b>Capital Adequacy Ratios (%)</b>					
Total CAR	11.9	13.3	12.8	13.2	13.2
Tier I	9.6	11.3	10.9	10.5	10.7
Tier II	2.3	2.1	2.0	2.7	2.5
<b>Dividend details</b>					
DPS (Rs)	4.0	3.0	3.5	4.0	4.0
Dividend Pay-out (%)	32.1	27.7	27.1	21.6	24.3
<b>Per Share (Rs)</b>					
BVPS	136.8	129.1	138.0	151.7	162.0
Adjusted BVPS	122.7	114.2	114.9	131.6	133.4
EPS - wt avg	12.5	10.9	13.1	18.5	16.5
<b>Valuations Ratios</b>					
Price/BV (x)	0.7	0.9	0.6	0.6	0.5
Price/Adj. BV (x)	0.8	1.0	0.7	0.7	0.7
P/E (x)	7.6	10.9	6.2	5.2	5.4
Dividend Yield (%)	4.2	2.5	4.4	4.1	4.5

Source: Company, Centrum Research. FY10-14 has been valued on average market cap basis.

## Financials

### Exhibit 57: Income Statement

Y/E March (Rs mn)	FY15	FY16	FY17E	FY18E	FY19E
Interest Income	46,984	49,922	52,373	57,687	65,163
Interest Expense	35,296	36,894	37,103	40,229	45,022
<b>Net Interest Income</b>	<b>11,688</b>	<b>13,029</b>	<b>15,270</b>	<b>17,458</b>	<b>20,140</b>
<b>Non-Interest Income</b>	<b>5,070</b>	<b>5,429</b>	<b>6,571</b>	<b>7,765</b>	<b>9,306</b>
Fee & Other Income	2,240	2,380	2,874	3,264	3,779
Gains / (Losses) on Securities	1,127	624	687	756	831
<b>Total Net Income</b>	<b>16,758</b>	<b>18,457</b>	<b>21,841</b>	<b>25,223</b>	<b>29,447</b>
<b>Total Operating Expenses</b>	<b>9,025</b>	<b>9,912</b>	<b>12,403</b>	<b>12,943</b>	<b>14,917</b>
Employee Expenses	5,247	4,430	5,903	6,192	7,137
Other Operating Expenses	3,778	5,482	6,500	6,751	7,780
<b>Pre-provision Profit</b>	<b>7,734</b>	<b>8,546</b>	<b>9,438</b>	<b>12,280</b>	<b>14,530</b>
<b>Provisions &amp; Contingencies</b>	<b>2,140</b>	<b>3,265</b>	<b>4,873</b>	<b>4,961</b>	<b>5,044</b>
NPA Provisions	2,231	2,672	3,737	3,674	3,553
Other Provisions	(91)	594	1,135	1,287	1,490
<b>Profit Before Tax</b>	<b>5,594</b>	<b>5,280</b>	<b>4,566</b>	<b>7,319</b>	<b>9,486</b>
Taxes	1,080	1,127	283	1,830	2,371
<b>Profit after tax</b>	<b>4,514</b>	<b>4,153</b>	<b>4,283</b>	<b>5,490</b>	<b>7,114</b>

Source: Company, Centrum Research Estimates

### Exhibit 58: Balance Sheet

Y/E March (Rs mn)	FY15	FY16	FY17E	FY18E	FY19E
Cash and balance with RBI	24,885	26,456	30,365	34,497	39,990
Inter-bank borrowings	1,257	3,993	4,377	4,973	5,764
Loans & Advances	3,16,800	3,39,024	3,79,707	4,36,663	5,10,896
Investments	1,26,905	1,42,179	1,46,895	1,60,165	1,79,643
<b>Total Int Earning Assets</b>	<b>4,44,962</b>	<b>4,85,197</b>	<b>5,30,978</b>	<b>6,01,800</b>	<b>6,96,304</b>
Fixed Assets	2,919	3,066	6,688	7,888	9,088
Other Assets	34,081	31,898	31,898	31,898	31,898
<b>Total Assets</b>	<b>5,20,257</b>	<b>5,67,005</b>	<b>6,20,317</b>	<b>6,96,471</b>	<b>7,97,667</b>
Deposits	4,60,086	5,04,882	5,47,120	6,21,566	7,20,542
Current	28,714	32,435	35,285	40,397	47,190
Savings	86,019	1,00,172	1,12,382	1,33,268	1,60,974
Term	3,45,353	3,72,275	3,99,453	4,47,901	5,12,378
Other Int Bearing Liabilities	10,378	10,515	10,515	10,515	10,515
<b>Interest Bearing Liabilities</b>	<b>4,70,464</b>	<b>5,15,397</b>	<b>5,57,635</b>	<b>6,32,081</b>	<b>7,31,057</b>
Other non int bearing Liabilities	15,903	14,702	16,063	16,148	16,233
Total Liabilities	4,86,367	5,30,099	5,73,698	6,48,230	7,47,290
Equity	33,891	36,906	46,618	48,241	50,377
<b>Total Liabilities</b>	<b>5,20,258</b>	<b>5,67,005</b>	<b>6,20,317</b>	<b>6,96,471</b>	<b>7,97,667</b>

Source: Company, Centrum Research Estimates

### Exhibit 59: DuPont analysis

(% of avg assets)	FY15	FY16	FY17E	FY18E	FY19E
Interest income	9.5	9.2	8.8	8.8	8.7
Interest expenses	7.1	6.8	6.2	6.1	6.0
<b>NII</b>	<b>2.4</b>	<b>2.4</b>	<b>2.6</b>	<b>2.7</b>	<b>2.7</b>
Other income	1.0	1.0	1.1	1.2	1.2
<b>Total income</b>	<b>3.4</b>	<b>3.4</b>	<b>3.7</b>	<b>3.8</b>	<b>3.9</b>
Operating expenses	1.8	1.8	2.1	2.0	2.0
<b>PPOP</b>	<b>1.6</b>	<b>1.6</b>	<b>1.6</b>	<b>1.9</b>	<b>1.9</b>
Provisions	0.4	0.6	0.8	0.8	0.7
<b>PBT</b>	<b>1.1</b>	<b>1.0</b>	<b>0.8</b>	<b>1.1</b>	<b>1.3</b>
Tax	0.2	0.2	0.0	0.3	0.3
<b>RoA</b>	<b>0.9</b>	<b>0.8</b>	<b>0.7</b>	<b>0.8</b>	<b>1.0</b>
Leverage	15.4	15.4	13.3	14.4	15.8
<b>RoE</b>	<b>14.0</b>	<b>11.7</b>	<b>10.3</b>	<b>11.6</b>	<b>14.4</b>

Source: Company, Centrum Research Estimates

### Exhibit 60: Key Ratios

Y/E March	FY15	FY16	FY17E	FY18E	FY19E
<b>B/S Structure Ratios (%)</b>					
CD Ratio	68.9	67.1	69.4	70.3	70.9
Incremental CD Ratio	61.5	49.6	96.3	76.5	75.0
CASA Ratio	24.9	26.3	27.0	27.9	28.9
<b>Growth Ratios (%)</b>					
Loans	11.8	7.0	12.0	15.0	17.0
Deposits	13.4	9.7	8.4	13.6	15.9
NII	10.7	11.5	17.2	14.3	15.4
Opex	3.2	9.8	25.1	4.4	15.3
PPOP	12.6	10.5	10.4	30.1	18.3
Provisions	(23.1)	52.6	49.2	1.8	1.7
PAT	45.1	(8.0)	3.1	28.2	29.6
<b>Operating Ratios (%)</b>					
Yield on funds	10.0	9.8	9.4	9.3	9.2
Cost of funds	7.5	7.3	6.7	6.5	6.4
NIM	2.5	2.6	2.7	2.8	2.8
Non-int inc / Total income	1.0	1.0	1.1	1.2	1.2
Fee to avg assets	0.5	0.4	0.5	0.5	0.5
Cost/Income	53.9	53.7	56.8	51.3	50.7
Opex/ Avg assets	1.8	1.8	2.1	2.0	2.0
Provisioning cost	0.7	0.8	1.0	0.9	0.8
Effective tax rate	19.3	21.3	6.2	25.0	25.0
RoA	0.9	0.8	0.7	0.8	1.0
RoE	14.0	11.7	10.3	11.6	14.4
<b>Credit Quality Ratios (%)</b>					
Gross NPA	3.1	3.6	4.3	3.8	3.3
Net NPA	2.1	2.4	2.8	2.4	2.0
Slippage rate to op advances	3.1	3.4	3.4	2.8	2.5
NPA coverage ratio	34.0	32.6	34.8	36.2	39.9
<b>Capital Adequacy Ratios (%)</b>					
Total CAR	12.4	12.0	13.7	12.8	11.1
Tier I	10.5	10.6	12.4	11.6	10.1
Tier II	1.9	1.5	1.4	1.2	1.0
<b>Dividend details</b>					
DPS (Rs)	5.0	5.0	4.0	4.3	4.5
Dividend Pay-out (%)	20.9	22.7	26.4	21.9	17.9
<b>Per Share (Rs)</b>					
BVPS	179.8	195.8	164.9	170.6	178.2
Adjusted BVPS	146.7	153.6	129.0	136.1	144.9
EPS - basic	24.0	22.0	15.1	19.4	25.2
<b>Valuations Ratios</b>					
Price/BV (x)	0.6	0.5	0.7	0.8	0.8
Price/Adj. BV (x)	0.7	0.6	0.9	1.0	1.0
P/E (x)	4.5	4.5	7.6	7.2	5.6
Dividend Yield (%)	4.6	5.0	3.5	3.0	3.2

Source: Company, Centrum Research Estimates. FY15-17E has been valued on average market cap basis.

## Appendix A

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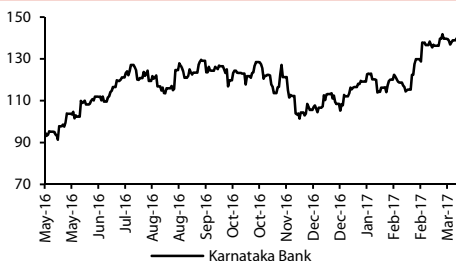
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### Karnataka Bank price chart



Source: Bloomberg, Centrum Research

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