



**Karnataka Bank Ltd. (KBL)** posted mixed set of numbers for Q2FY19 reporting improvement on slippage front and muted performance on margin due to pressure on the yield on advances. NII grew by 6.2% YoY during Q2FY19 lower than the advances growth of 21.5% YoY as the yield reduced to 9.34% impacting NIM which reduced by 8bps QoQ and 2.91%. Meanwhile, the major portion of loan (~Rs100 bn) will re-price in coming quarters which in turn will provide support to NIM (guidance of NIM above 3% by FY19E). While slippage was reported at Rs3.7 bn (significantly lower than the avg. FY18 quarterly slippage of Rs5.3 bn), stressed assets (RS, SR an SMA2) reduced significantly to 1.9% of advances. Valuation has reached at historical level (past 3 years basis) and stock is currently trading at one year forward P/ABV multiple of 0.6(x) indicates limited downside from this level. Considering the building fundamental strength in business, we maintain our 'BUY' rating on stock with potential price at Rs167 valuing bank at 0.9(x) of FY20E Adj. BVPS at Rs191.6.

**Q2FY19 Result Analysis:** NII grew by modest pace of 6.2% YoY and (-)0.2% QoQ in Q2FY19 (10.4% YoY and -13.4% QoQ in Q1FY19) despite the strong growth in advances indicating pressure on yield which reduced to 9.34% from 10.15% in Q1FY18 and 9.29% in Q1FY19. Cost of deposits also increased 6bps to 5.9% amidst the rising interest rate scenario.

Thereby, NIM reduced by 9bps QoQ to 2.9% in Q2FY19 v/s 3.0% in Q1FY19. However the management has guided for over 3% NIM during the fiscal as the large chunk of loans will re-price at higher MCLR in the coming quarters (MCLR hike may go up to 70 bps). Other income reduced by (-)18.8% YoY in Q2FY19 mainly due to pressure on treasury income (-92% YoY to Rs70 mn) impacted by rise in the yield level in economy.

On the other hand, fee income continued to grow at higher pace (20% YoY to Rs1,940 mn) driven by increasing Mgt's focus to augment core fee income streams.

Despite muted performance on income front, C/I ratio remained under control at 46.7% (45.5% in Q1FY19 and 46.8% in Q2FY18) due to the contained opex. During Q2FY19, KBL reported 19.8% YoY growth in PAT at Rs1,118.6 mn also bolstered by P&C which reduced by (-)14.5% YoY.

**Balance Sheet Growth:** Business growth continue to remain strong with advances growing at 21.5% YoY and 4.7% QoQ in Q2FY19 (24.0% YoY and 1% QoQ in Q1FY19) and deposits by 13.0% YoY and 1.8% QoQ in Q2FY19 (11.6% YoY and -0.2% QoQ in Q1FY19). Advances growth was mainly driven by corporate credit and C/D ratio increased to 78.2% in line with mgt's target of 80% by FY19E. Business/branch increased by 10.4% to Rs1395.3 mn and CAR ratio stood at 12.5%

**Assets Quality Outlook:** Gross slippage was reported at Rs3,680 mn (slippage rate at 0.8% in Q2FY19 v/s 1.0% in Q2FY18) and after R&U and write-off, the net addition in gross NPAs was Rs750 to Rs23,716.2 mn. GNPA and NNPA was reported at 4.66% and 3.0% in Q2FY19 v/s 4.72% and 2.92% in Q1FY19 and coverage ratio stood at 36.8% (excl. write-off) in the month under review. Stressed assets reduced to 1.9% of advances as compared to 2.4% by Q4FY18. SMA2 watch list reduced to Rs3,467 mn (0.7% of advances) v/s Rs7,340 mn (1.5% of advances) in previous quarter due to higher portion of deletion/upgradation (Rs1,310 mn of the Rs6,021.6 was slipped into NPAs and balance was upgraded to SMA1 and SMA0 category).

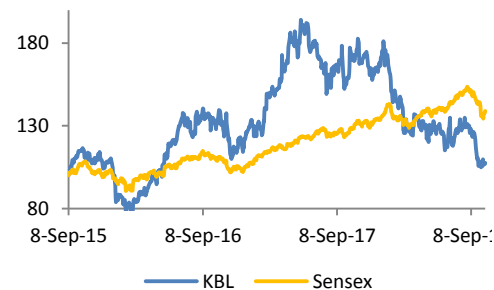
Management guided that only ~10% of SMA2 book could slip into the NPAs providing comfort on assets quality front. We expect GNPA to reduce to 4.1% by FY20E v/s 4.7% in Q2FY19.

**Rating Matrix**

CMP	Rs98
Rating	Buy
Potential Price	Rs167
Holding Period	18-24 Months
Upside Potential	70.0%
52 week H/L	Rs172/93.4
Face value	Rs10
Mar. Cap.	Rs27,653.2 mn
Category	Mid Cap
Sector	Banking

**Shareholding Pattern**

Particulars	Sep'18	Jun'18	Mar'18	Dec'17
Promoters	-	-	-	-
FPIs	12.6%	12.3%	14.7%	18.0%
Inst.	26.7%	27.0%	27.5%	29.8%
N. Insti.	73.3%	73.0%	72.5%	70.2%

**Relative Capital Market Strength****Key Financials (Rs bn)**

Particulars	FY16	FY17	FY18	FY19E	FY20E
NII	13.0	14.9	18.6	20.0	23.2
Gr. (%)	11.5%	14.4%	24.6%	7.6%	16.3%
NIM	2.6%	2.7%	3.0%	2.9%	3.0%
PPOP	8.5	10.0	14.7	15.5	18.8
A.PAT	4.2	4.5	3.3	5.7	7.0
Eq./As. (%)	6.5%	8.0%	7.7%	7.4%	7.1%
RoE (%)	11.7%	10.2%	6.2%	10.2%	11.4%
CASA(%)	26.3%	29.0%	28.0%	28.6%	29.2%
GNPA (%)	3.4%	4.2%	4.8%	4.4%	4.1%
P/ABV (x)			0.7	0.6	0.5

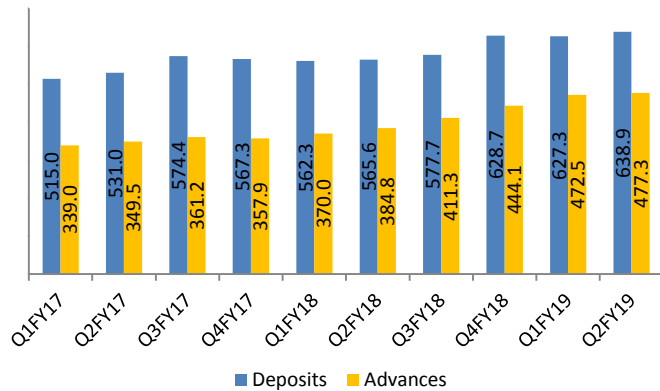


### Five Quarters at a Glance

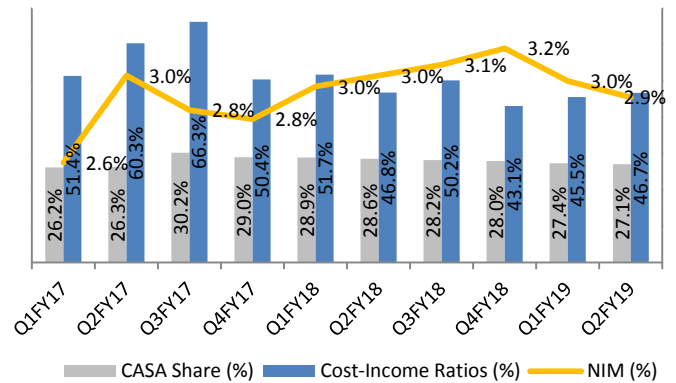
Particulars (Rs mn)	Q2FY18	Q3FY18	Q4FY18	Q1FY19	Q2FY19	YoY	QoQ
Interest Earned	13,179.3	13,322.4	14,430.4	14,076.4	14,526.1	10.2%	3.2%
Interest Expended	8,776.9	8,807.6	9,015.3	9,390.6	9,849.0	12.2%	4.9%
<b>NII</b>	<b>4,402.4</b>	<b>4,514.8</b>	<b>5,415.1</b>	<b>4,685.8</b>	<b>4,677.1</b>	6.2%	-0.2%
Other Income	2,478.2	1,946.2	2,945.1	2,088.0	2,012.0	-18.8%	-3.6%
Operating Expenditures	3,218.2	3,242.0	3,606.9	3,085.0	3,125.8	-2.9%	1.3%
<b>Pre- Prov Operating Profit</b>	<b>3,662.4</b>	<b>3,219.0</b>	<b>4,753.3</b>	<b>3,688.8</b>	<b>3,563.3</b>	-2.7%	-3.4%
P&C	2,259.8	1,964.0	5,417.5	2,220.6	1,932.2	-14.5%	-13.0%
PBT	1,402.6	1,255.0	-664.2	1,468.2	1,631.1	16.3%	11.1%
Tax	468.8	381.2	-774.2	-164.2	512.5	9.3%	-412.1%
<b>Net Profit</b>	<b>933.8</b>	<b>873.8</b>	<b>110.0</b>	<b>1,632.4</b>	<b>1,118.6</b>	19.8%	-31.5%
Outstanding Shares	282.6	282.8	282.6	282.6	282.6	0.0%	0.0%
Dil. EPS	3.3	3.1	0.4	5.8	4.0	19.8%	-31.5%
<b>Balance Sheet items/ratios</b>							
Deposits	565,580.0	577,710.0	628,712.9	627,250.0	638,850.0	13.0%	1.8%
CA Deposits	34,047.9	33,941.8	38,692.0	33,835.9	32,688.5	-4.0%	-3.4%
SB Deposits	127,594.8	129,118.2	137,248.0	137,744.1	140,291.5	10.0%	1.8%
CASA	161,642.8	163,060.0	175,940.0	171,580.0	172,980.0	7.0%	0.8%
Advances	411,270.0	444,110.0	472,517.5	477,310.0	499,700.0	21.5%	4.7%
CD Ratio (%)	72.7%	76.9%	75.2%	76.1%	78.2%		
<b>CASA Share (%)</b>	<b>28.6%</b>	<b>28.2%</b>	<b>28.0%</b>	<b>27.4%</b>	<b>27.1%</b>		
CAR(%)	12.5%	12.3%	12.0%	11.6%	12.5%		
Tier 1 (%)	11.4%	11.1%	11.3%	10.8%	11.4%		
<b>Operating ratios</b>							
Cost of deposits (%)	6.2%	6.2%	6.1%	5.9%	5.9%		
<b>NIM (%)</b>	<b>3.03%</b>	<b>3.09%</b>	<b>3.18%</b>	<b>3.00%</b>	<b>2.91%</b>		
Cost-Income Ratios (%)	46.8%	50.2%	43.1%	45.5%	46.7%		
Tax Rate (%)	33.4%	30.4%	116.6%	-11.2%	31.4%		
<b>Assets Quality</b>							
Gross NPA	17,157.0	17,843.1	23,760.7	22,965.3	23,716.2	38.2%	3.3%
Net NPA	12,648.1	12,629.6	14,005.1	13,959.7	14,976.8	18.4%	7.3%
Gross NPA (%)	4.13%	3.97%	4.93%	4.72%	4.66%		
<b>Net NPA (%)</b>	<b>3.08%</b>	<b>2.84%</b>	<b>2.96%</b>	<b>2.92%</b>	<b>3.00%</b>		
Coverage Ratio(%)	26.3%	29.2%	41.1%	39.2%	36.8%		
<b>Slippages</b>							
O/s Restructured book	10,280.0	9,703.8	10,460.0	10,460.0	8,190.0		
RA % of loan book	2.5%	2.2%	2.2%	2.2%	1.6%		
Gross slippages	3,740.0	2,100.0	10,380.0	2,700.0	3,680.0	-1.6%	36.3%
Reduction (Recoveries+ Up	3,490.0	1,420.0	4,450.0	3,490.0	2,930.0	-16.0%	-16.0%
Slippages (Net Addition to C	250.0	680.0	5,930.0	-790.0	750.0	200.0%	-194.9%
Slippages (%)	0.98%	0.52%	2.42%	0.60%	0.78%		
<b>Advances Break-Out</b>							
Total Advances	411,270.0	444,110.0	472,517.5	477,310.0	499,700.0	21.5%	4.7%
Retail Advances	204,812.5	208,287.6	213,105.4	214,789.5	220,867.4	7.8%	2.8%
Corporate Credit	46,679.1	53,470.8	53,583.5	59,043.2	64,511.3	38.2%	9.3%
MSME	102,365.1	105,653.8	109,198.8	110,592.7	117,079.7	14.4%	5.9%
Agriculture Advances	54,369.9	55,780.2	57,694.4	57,850.0	60,113.9	10.6%	3.9%
<b>Retail Advances Break-Out</b>							
Loans against deposits							
Manufacturing							
Other personal loans	24,923.0	25,447.5	26,272.0	26,204.3	29,032.6	16.5%	10.8%
Home Loans	52,930.4	54,803.2	52,733.0	57,754.5	61,463.1	16.1%	6.4%
Others	126,959.0	128,036.9	134,100.5	130,830.7	130,371.7	2.7%	-0.4%
<b>Network</b>							
ATMs	1,397	1,382	1,374	1,354	1,323	-5.3%	-2.3%
<b>Branches</b>	<b>773</b>	<b>781</b>	<b>800</b>	<b>807</b>	<b>816</b>	5.6%	1.1%
Business per branch (Rs mn)	1,263.7	1,308.3	1,376.5	1,368.7	1,395.3	10.4%	1.9%

CHANGE IN ESTIMATES (Rs mn)	FY19E		Change	FY20E		Change
	Old	New	Var. (%)	Old	New	Var. (%)
NII	19,410.3	19,980.6	2.9%	23,048.3	23,232.5	0.8%
OPEX	13,781.4	13,752.8	-0.2%	15,643.6	15,643.6	0.0%
P&C	8,885.8	8,534.2	-4.0%	9,722.0	9,722.0	0.0%
PAT	5,337.7	5,749.0	7.7%	6,844.7	6,986.5	2.1%
GNPA	4.6%	4.4%	-4.3%	4.4%	4.1%	-6.8%
Advances	551,104.2	551,104.2	0.0%	642,985.3	642,985.3	0.0%
Deposits	704,792.3	704,792.3	0.0%	793,751.0	793,751.0	0.0%

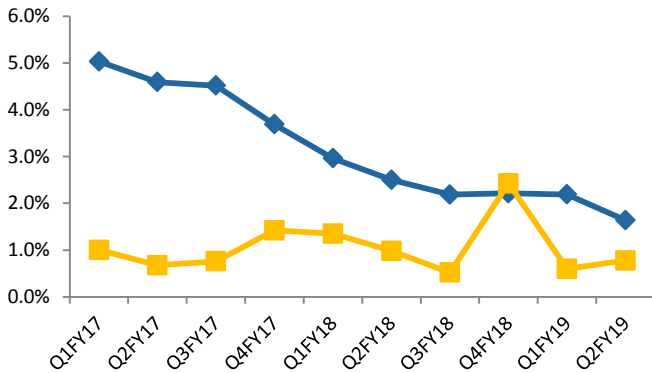
Trend in business growth (Rs bn)



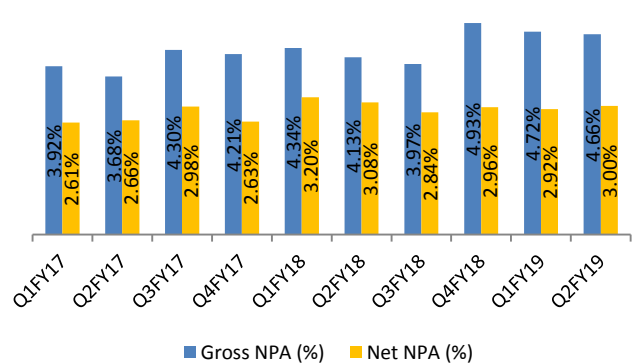
Trend in CASA, NIM and C/I ratios



RA % of loan book and Slippages (%)



Assets quality trend



Source: Choice Broking Research

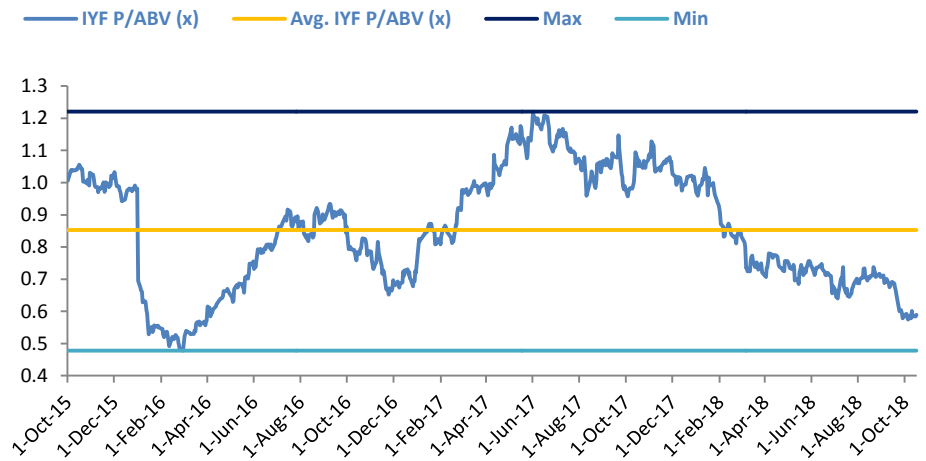
## Q2FY19 Con-call highlights:

- Key guidance for FY19; PCR: 60%, RoA : 1%, NIM: over 3%, CD ratio: 80%, GNPA: 4%.
- Slippage run rate of Rs1.5 bn-2 bn for the next two quarters
- KBL's exposure to IL&FS stood at Rs1,568 mn (0.3% of advances) which includes NBFC: Rs755 mn, transport: Rs308 mn and energy: Rs505 mn. All a/c are under the standard category with exposure towards transport arm is currently under SMA2 category. Further, the bank has Rs250 mn exposure to IL&FS debt securities.
- SR at Rs4,387.3 mn in Q2FY19 reduced from Rs4,412.3 mn in Q1FY19
- AAA rated a/c rose to 15% of advances in Q2FY19 v/s 6% in the year ago period
- Secured advances stood at ~88%
- MCLR rate could increase by up to 70 bps. Yield on advances would accelerate fast than cost of funds leading to NIM to improve over 3% by FY19
- Around 150 DSAs are on board, will help to boost retail advances especially housing and other small industrial loans
- The bank would augment capital base through issuing Tier 2 subordinate bonds. KBL could also raise Tier 1 capital without diluting equity base
- Depreciation in investment portfolio has been fully absorbed in the reporting quarter
- As per internal credit policy, exposure to NBFCs is capped at 18%. At present, the exposure to sector stands at 16%. All a/c under NBFCs (except IL&FS) are performing which are of short-term. The exposure is linked to MCLR and thereby these loans are getting re-priced higher.

## Valuation

At our recommended potential price of Rs167, the stock is available at P/ABV multiple of 0.9(x) of FY20E adjusted book value of Rs191.6 per share.

P/ABV Valuation	FY16	FY17	FY18	FY19E	FY20E
Adjusted BVPS (Rs)	153.6	147.5	141.9	164.3	191.6
<b>Valuation Parameters</b>					
P/ABV (x)	0.9				



On forward adj. book value basis

Source: Choice Broking Research

## Financial statements (Standalone, Rs mn)

### Profit And Loss Statement

Particulars	FY16	FY17	FY18	FY19E	FY20E
Interest Earned	49,922.1	51,854.0	54,237.5	63,154.1	77,244.4
Growth (%)	6.3%	3.9%	4.6%	16.4%	22.3%
Interest Expended	36,893.4	36,947.8	35,661.0	43,173.5	54,012.0
Growth (%)	4.5%	0.1%	-3.5%	21.1%	25.1%
<b>Net Interest Income</b>	<b>13,028.7</b>	<b>14,906.2</b>	<b>18,576.5</b>	<b>19,980.6</b>	<b>23,232.5</b>
Net Interest Margin	2.6%	2.7%	3.0%	2.9%	3.0%
Other Income	5,428.6	8,093.4	9,543.4	9,274.7	11,206.5
% of Interest Earned	10.9%	15.6%	17.6%	14.7%	14.5%
Total Income	18,457.3	22,999.6	28,119.9	29,255.3	34,439.0
Growth (%)	10.1%	24.6%	22.3%	4.0%	17.7%
Operating & Other expenses	9,912.0	13,041.6	13,388.2	13,752.8	15,643.6
Pre-Prov. Operating Profit	8,545.3	9,958.0	14,731.7	15,502.5	18,795.4
Provisions and contingencies (incl NPA)	3,265.3	5,278.6	11,630.1	8,534.2	9,722.0
P&C % of Advances	1.0%	1.4%	2.5%	1.5%	1.5%
Operating Profit before Tax	5,280.0	4,679.4	3,101.6	6,968.3	9,073.4
Growth (%)	-2.6%	-11.4%	-33.7%	124.7%	30.2%
Pre-tax Margin %	28.6%	20.3%	11.0%	23.8%	26.3%
Tax	1,127.1	156.9	-154.5	1,219.3	2,086.9
% of PBT	21.3%	3.4%	-5.0%	17.5%	23.0%
Reported PAT	4,152.9	4,522.5	3,256.1	5,749.0	6,986.5
Net Profit Margin %	22.5%	19.7%	11.6%	19.7%	20.3%
Extraordinary Income	0.0	0.0	0.0	0.0	0.0
<b>Adjusted PAT</b>	<b>4,152.9</b>	<b>4,522.5</b>	<b>3,256.1</b>	<b>5,749.0</b>	<b>6,986.5</b>
Growth (%)	-8.0%	8.9%	-28.0%	76.6%	21.5%

### Balance Sheet

Particulars	FY16	FY17	FY18	FY19E	FY20E
<b>ASSETS</b>					
Cash and balance with RBI and banks	30,449.2	32,740.3	36,010.1	52,210.7	50,510.5
Investments	162,566.5	202,197.3	154,444.5	150,707.6	158,041.0
Advances	339,024.5	370,036.5	472,517.5	551,104.2	642,985.3
Fixed assets	3,066.4	7,205.7	7,616.0	7,680.6	7,739.3
Other assets	29,896.7	29,085.7	33,148.6	32,418.1	34,077.1
<b>TOTAL ASSETS</b>	<b>565,003.3</b>	<b>641,265.5</b>	<b>703,736.7</b>	<b>794,121.2</b>	<b>893,353.3</b>
Capital	1,884.7	2,826.2	2,826.2	2,826.2	2,826.2
Reserves and Surplus	35,021.2	48,599.7	51,275.3	55,644.5	60,954.3
Deposits	504,882.1	567,331.1	628,712.9	704,792.3	793,751.0
Borrowings	10,514.8	8,326.2	8,159.7	12,559.0	14,367.4
Other liabilities and provisions	12,700.6	14,182.3	12,762.7	18,299.3	21,454.5
<b>TOTAL CAPITAL AND LIABILITIES.....</b>	<b>565,003.3</b>	<b>641,265.5</b>	<b>703,736.7</b>	<b>794,121.2</b>	<b>893,353.3</b>

### Financial Ratios

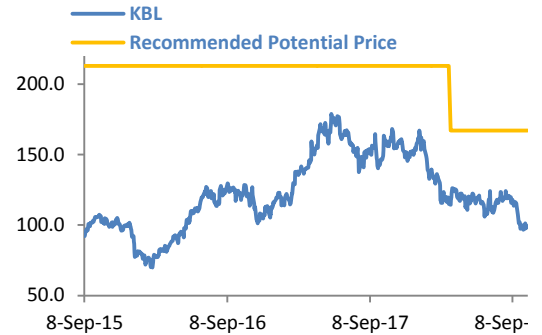
Particulars	FY16	FY17	FY18	FY19E	FY20E
<b>Return / Profitability Ratios (%)</b>					
Net interest margin	2.61%	2.72%	3.04%	2.92%	3.00%
Yield on advances	11.3%	10.7%	9.7%	10.6%	10.7%
Yield on investments	7.4%	7.1%	6.5%	7.6%	7.5%
EPS (Diluted) (Rs)	22.0	16.0	11.5	20.3	24.7
RoA	0.8%	0.7%	0.5%	0.8%	0.8%
RoE	11.7%	10.2%	6.2%	10.2%	11.4%
Avg. Cost of Deposits	7.4%	6.7%	5.8%	6.8%	7.0%
<b>Operating ratios (%)</b>					
Credit to Deposit	67.1%	65.2%	75.2%	78.2%	81.0%
Cost to income	53.7%	56.7%	47.6%	47.0%	45.4%
CASA	26.3%	29.0%	28.0%	28.6%	29.2%
Investment / Deposit	32.2%	35.6%	24.6%	21.4%	19.9%
Non interest income / Total income	29.4%	35.2%	33.9%	31.7%	32.5%
<b>Capitalization Ratios (%)</b>					
Equity / Assets	6.5%	8.0%	7.7%	7.4%	7.1%
Loans / Assets	60.0%	57.7%	67.1%	69.4%	72.0%
Investments / Assets	28.8%	31.5%	21.9%	19.0%	17.7%
Dividend payout	22.7%	25.0%	26.0%	20.0%	20.0%
<b>Capital adequacy (%)</b>					
Tier-1 capital adequacy ratio	10.6%	12.2%	11.3%	10.0%	9.6%
Tier-2 capital adequacy ratio	1.5%	1.1%	0.7%	1.3%	1.3%
Total capital adequacy ratio (Basel III)	12.0%	13.3%	12.0%	11.3%	10.9%
<b>Asset Quality ratios (%)</b>					
Gross NPA	3.4%	4.2%	4.8%	4.4%	4.1%
Net NPA	2.3%	2.6%	3.0%	2.2%	1.5%
Coverage Ratio	32.6%	38.4%	39.8%	52.8%	65.2%
Slippage Ratio	3.4%	3.8%	4.5%	3.3%	2.8%
<b>Per Share Data (Rs)</b>					
EPS (Diluted)	22.0	16.0	11.5	20.3	24.7
DPS	5.0	4.0	3.0	4.1	4.9
BVPS	195.8	182.0	191.4	206.9	225.7
Adjusted BVPS	153.6	147.5	141.9	164.3	191.6
<b>Valuation ratios (x)</b>					
P/E (x)	4.4	6.1	8.5	4.8	4.0
P/BV (x)	0.5	0.5	0.5	0.5	0.4
P/ABV (x)	0.6	0.7	0.7	0.6	0.5
<b>Growth ratios (%)</b>					
Advances	7.0%	9.1%	27.7%	16.6%	16.7%
Deposits	9.7%	12.4%	10.8%	12.1%	12.6%
Net interest income	11.5%	14.4%	24.6%	7.6%	16.3%
Interest income	6.3%	3.9%	4.6%	16.4%	22.3%
PAT	-8.0%	8.9%	-28.0%	76.6%	21.5%
<b>Business ratios</b>					
Profit per branch (Rs mn)	5.7	5.9	4.1	6.8	7.8
Business per branch (Rs mn)	1,164.0	1,225.3	1,376.5	1,477.5	1,596.4

Source: Choice Broking Research

### Choice's Rating Rationale

The price target for a large cap stock represents the value the analyst expects the stock to reach over next 12 months. For a stock to be classified as Outperform, the expected return must exceed the local risk free return by at least 5% over the next 12 months. For a stock to be classified as Underperform, the stock return must be below the local risk free return by at least 5% over the next 12 months. Stocks between these bands are classified as Neutral.

BUY	Absolute Return >15%
Accumulate	Absolute Return Between 10-15%
Hold	Absolute Return Between 0-10%
Reduce	Absolute Return 0 To Negative 10%
Sell	Absolute Return > Negative 10%



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POTENTIAL CONFLICT OF INTEREST DISCLOSURE (as on date of report) Disclosure of interest statement – • Analyst interest of the stock /Instrument(s): - No. • Firm interest of the stock / Instrument (s): - No.

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