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Idea Preview: Karur Vysya Bank

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The period from 2003 to 2008 saw some of the highest GDP growth rates for India and bank credit as a proportion of GDP doubled from 25% to 52% during the similar period, driven by the nationalized banks. With the advent of the global financial crisis, the GDP growth rate slowed down and consequently the growth in corporate profits started slackening from FY11 onwards. When the cycle turned, the nationalized banks were left holding the can and today accounts for ~68% of the gross non-performing assets of the system. At a time when the credit growth to the industrial sector has turned out to be a risky proposition for banks and is on a declining trajectory, it is the retail credit that is driving growth in the near future.

Karur Vysya Bank (KVB), a solid franchisee based in South India, is a regional bank which started its journey in 1916 in Karur, a textile town in Tamil Nadu. KVB primarily started as a Small & Medium Enterprise (SME) bank and continues to position itself as a comprehensive player to cater to the needs of SME customers. The bank has been focusing mainly on SMEs and retail financing in its 100 years of existence, which today constitutes ~68% of the total advances of the bank. KVB has an unmatched presence in the states of Tamil Nadu, Andhra Pradesh and Telangana, which constitutes ~75% of the branch network of the bank. The bank's majority presence in semi-urban and rural locations places it at the heart of SME financing.

The bank's core strength lies in SME financing, wherein bank and customer relations span 2 or 3 generations. KVB's model of working capital finance has always ensured lower leverage for the borrowing units. This has helped many units tide over the situation even in the face of poor cash flows as the servicing liabilities were lower. KVB's core philosophy of nurturing its customers through times, thick and thin, is what has earned it respect among customers and peers, through its 100 years of existence, resulting into a sticky customer base.

The seed of the bank's success was sown in 2009 when it embarked upon a seven-year transformational plan ending in the bank's centenary year – 2016. Over the past seven to eight years, the bank has substantially rebalanced its loan book with corporate book coming down from 43% to 33% and retail book increasing from 8% to 15%. The banks clear cut strategy is to granulize its portfolio by shunning large ticket corporate lending and focusing on low ticket SME, retail loans and corporate loans. The management believes that its 7.5 million customer base provides them an opportunity to grow the retail book without significant competition. Historically, the growth has been tepid in the retail segment and the management is restructuring its sales force, changing its processes, creating a digital environment and aims to double the retail book in 18 months time. This granulation strategy will also support recoveries in the future since the portfolio would be highly collateralized.

During the period from 2010 to 2018, the banks' Net Interest Margins (NIM's) has expanded from 2.95% to 3.7% driven by an increase in CASA ratio from 23% in March 2011 to 28% in

Dec 2017. The bank enjoys a very stable deposits portfolio with retail deposits constituting ~90% of the portfolio. KVB's CASA ratio out-performs its closest peer, City Union Bank, a Tamil Nadu focused bank having a CASA ratio of ~22%. One of the unique strength of KVB's business model is that 80% of its advances are working capital loans which enables it a quicker repricing of loans, protecting it from a rising interest rate environment. A stable retail deposit portfolio and high proportion of working capital advances is expected to help the bank to protect its NIM's in the future. An increase in the CASA ratio over the last few years will help the bank to tide over a rising interest rate environment better than during the last cycle from 2011 to 2015.

The bank has traditionally enjoyed a high average ROA profile of ~1.7% as observed between the years 1999 to 2013, which has currently shrunk to 0.6%. This is because the average credit cost which was ~0.3% between the years 1999 to 2014 has increased to an average of 1.7% between the FY15 to FY18 and is expected to increase to 2.7% by FY18. The credit cost is expected to decline from FY19 onwards because most of the chunky NPA's has already slipped and the required provisions on them has been addressed. The incremental slippage ratio is expected to come down and hence the incremental provisions are also expected to come down. With this tailwind in place and an incremental focus on granularization of the loan portfolio, the credit cost is expected to revert to its long term average of ~1% across all cycles.

There has been a recent management change in the bank with the hiring of Mr P Seshadri, a very competent CEO. Mr Seshadri, an alumnus of IIM, Bangalore, one of the best B-Schools in India, is a senior banker with over 25 years' experience and started his banking career with Citibank in early 1992. He has served in various capacities including Managing Director of Citi Financial Consumer Finance Ltd and Citi Financial Retail Services India Ltd till 2005. He moved to Singapore in 2005 as the Managing Director and regional head of the bank's retail banking and lending businesses for Asia Pacific region. Mr Seshadri's extensive experience in the retail lending sector is expected to aid the transformation of the bank's retail strategy. The company is in the process of transforming its management team and is currently looking at hiring a Chief Risk Officer. The change in management provides confidence in the ability of the bank to return back to its long term growth rate in advances in the range of 15-20% and simultaneously granulize the portfolio with an increase in share of retail loans.

The slippage ratio is expected to reduce going ahead because in a recent clean-up drive, Mr Seshadri increased the watch-list of stressed asset guidance from INR 650 cr to INR 1200 cr and as per the management, this is the tail-end of recognizing stressed assets. The current watch-list stands reduced to ~INR 650 cr after NPA recognition of 700 cr in Q3FY18. Mr Seshadri's aggressive clean-up drive and low slippages in the non-corporate portfolio provides certainty and confidence of a decline in incremental stress in the standard asset book in the near term.

KVB has historically traded at Price to Adjusted Book Value in the range of 1 to 2 times on 1-year forward basis and is currently trading at INR 100, implying a multiple of ~1.3 x, which implies an attractive risk-reward ratio of ~2.3 x. KVB also currently trades at Price to Normalized Earnings of 9 times, while in the past the average Price to Normalized Earnings band for the bank is ~8 to 15 times, which once more indicates an attractive risk-reward ratio. The retained earnings test for KVB suggests that whenever an investor buys KVB at close to 1.2 x Adjusted Book value, the bank has created roughly 2 times the market value of the cumulative retained earnings over a 5 year period. KVB has recently raised 760 cr through rights issue at a price of INR 76 per share and hence the Capital Adequacy ratio stands at 13.92% as of Dec 2017, with Tier-1 ratio of 13.36%. This gives the bank the ability

to grow at a high rate since the minimum Capital adequacy ratio requirement is 9%.

KVB’s faces the risk of high credit cost in the near to medium term, which will keep the profitability of the bank suppressed and will subsequently limit its ability to grow and snatch market share from government owned PSU banks. The bank also faces the risk of high cost to income ratio due to expansion in the number of branches, wage hike revisions, expensive management hiring and equity dilution due to ESOP’s. In the medium term, KVB faces the risk of increase in slippage from the non-corporate sector book in an increasing interest rate environment. KVB faces the risk of competition in near, medium and long term, which would be a threat to the NIM’s.