Equity Research

December 15, 2020
BSE Sensex: 46253

ICICI Securities Limited is the author and distributor of this report

Company update and reco change

Banking

Target price: Rs74

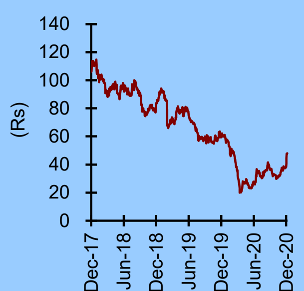
Target price revision
Rs74 from Rs33

Shareholding pattern

	Mar '20	Jun '20	Sep '20
Promoters	2.1	2.1	2.1
Institutional investors	44.4	43.2	41.7
MFs and others	17.3	16.9	16.6
Insurance Cos.	0.2	0.1	0.1
FIs and Banks	4.4	4.2	3.3
FIIs	22.5	22.0	21.7
Others	53.5	54.7	56.2

Source: BSE

Price chart



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INDIA

ICICI Securities

Karur Vysya Bank

BUY
Upgrade from Hold

Improving visibility on RoA recovery; upgrade to **BUY**

Rs48

We upgrade our rating on Karur Vysya Bank (KVB) to BUY on improving visibility on RoA recovery, continuity of strategic initiatives even after management change and favourable risk-reward. We see a retracement of valuation to 1x (~15% lower than 5yr average multiple) on likely ~60bps RoA improvement over FY21E-FY22E to 0.9%. Key rationale: a) overall collections at ~95% as on 29th Oct'20, with better collection in commercial segment than peers, speaks for KVB's superior customer profile (*chart 14*); b) calibrated growth during FY17-FY20 (5% loan CAGR) to ensure lower legacy stress and strong PCR at 64% would keep credit cost low; c) strong liability franchise (*charts 5/6/7*), adequate capital (tier-1 @ 16.4%) and completion of corporate book realignment will help revive credit growth quicker than peers; and d) revamped digital platform and business processes are likely to enable quality growth ahead.

- **Adequate capital (tier-1 @ 16.4%) and strong liability franchise to support loan growth revival.** During the past couple of years, KVB has been actively fine-tuning its portfolio mix by: a) reducing corporate exposure, b) building robust infrastructure to expand its retail portfolio, and c) setting up separate corporate and business banking units to sharpen the focus on both these segments. **KVB also launched 'NEO Banking' – 'phygital' alternate distribution channel with focus on acquiring new-to-bank customers in commercial and corporate segments.** Further, strong tier-1 at 16.4%, granular retail liability base and completion of corporate book realignment (*chart 10*) would help KVB shore up credit growth quicker than peers.
- **Better collections and strong PCR @ 64% to ensure credit cost moderation from FY22E onwards.** While we expect interim spike in slippages owing to Covid over H2FY21E, calibrated growth over past two years and recent collection trends suggest that incremental stressed asset formation would be within manageable limits and is unlikely to dent balance sheet quality meaningfully. Further, current PCR @ 64% is likely to restrict credit cost, only to incremental slippages and negligible legacy provisions. The same gives us comfort to lower our credit cost assumption for FY22E to 1.7% *vs* 2.2% in FY21E (still higher than the 10-year historical average of 1.4%).
- **Bringing the culture of 'ownership'.** KVB will roll out new performance-linked ESOP policy (starting Mar'21), covering ~90% of its workforce. ESOP vesting period will be 1-3 years depending upon retirement year and number of years serviced.
- **RoA to touch 0.9% in FY22E.** Historically, KVB demonstrated an average of ~1.5% RoA and ~20% RoE (FY07-FY12) on the back of robust asset quality (average NNPA >0.25%), strong pricing power and ability to control costs (average C/I ratio >42%). However, aggressive branch expansion between FY12-FY13 followed by muted growth and more recently elevated credit cost, impacted RoA that stands at 0.63% as at Sep'20. However, we believe the worst is behind and KVB is well placed to show steady improvement in RoA from FY22E onwards.

Market Cap	Rs38.3bn/US$521mn
Reuters/Bloomberg	KARU.BO/ KVB IN
Shares Outstanding (mn)	799.2
52-week Range (Rs)	62/20
Free Float (%)	97.9
FII (%)	21.7
Daily Volume (US$'000)	1,587
Absolute Return 3m (%)	29.6
Absolute Return 12m (%)	(21.2)
Sensex Return 3m (%)	19.6
Sensex Return 12m (%)	14.1

Year to Mar	FY19	FY20	FY21E	FY22E
NII (Rs bn)	23.6	23.5	23.7	26.8
Net Profit (Rs bn)	2.1	2.4	4.3	7.3
EPS (Rs)	2.8	2.9	5.3	9.1
% Chg YoY	-44.5	6.4	81.2	71.5
P/E (x)	17.0	16.0	8.8	5.1
P/BV (x)	0.6	0.6	0.5	0.5
Net NPA (%)	4.9	3.9	3.7	3.7
Dividend Yield (%)	5.7	2.7	0.0	2.7
RoA (%)	0.3	0.3	0.6	0.9
RoE (%)	3.3	3.7	6.3	10.0

Inherent strength in core business model

Till FY12, KVB and CUBK were the most profitable regional banks within our small private bank coverage universe. Strong pricing power, ability to operate efficiently (cost/income ratio >42%) and robust asset quality (NNPA >0.25%) were the key reasons behind their higher RoA than others.

Table 1: Return on assets – KVB and CUBK were the only small private banks having RoA >1.5%

	FY08	FY09	FY10	FY11	FY12	FY13	FY14	FY15	FY16	FY17	FY18	FY19	FY20
KVB	**1.6**	**1.5**	**1.7**	**1.7**	**1.5**	**1.3**	**0.9**	**0.9**	**1.0**	**1.0**	**0.5**	**0.3**	**0.3**
CUBK	**1.6**	**1.5**	**1.5**	**1.6**	**1.7**	**1.6**	**1.4**	**1.5**	**1.5**	**1.5**	**1.6**	**1.6**	**1.0**
FB	1.3	1.4	1.2	1.3	1.4	1.4	1.2	1.3	0.5	0.8	0.8	0.9	0.9
DCB	0.5	-1.3	-1.3	0.3	0.7	1.0	1.3	1.3	1.1	0.9	0.9	1.0	0.9

Source: Company data

Adequate capital (tier-1 @ 16.4%) and strong liability franchise to support loan growth revival

During the past couple of years, KVB has been actively fine-tuning its portfolio mix by: a) reducing corporate exposure, b) building robust infrastructure to expand its retail portfolio, and c) setting up separate corporate and business banking units to sharpen the focus on both these segments. **KVB also launched 'NEO Banking' – 'phygital' alternate distribution channel with focus on acquiring new-to-bank customers in commercial and corporate segments.** Further, strong tier-1 at 16.4%, granular retail liability base and completion of corporate book realignment (chart 10) would help KVB shore up credit growth quicker than peers.

Chart 1: Steady improvement in CASA ratio

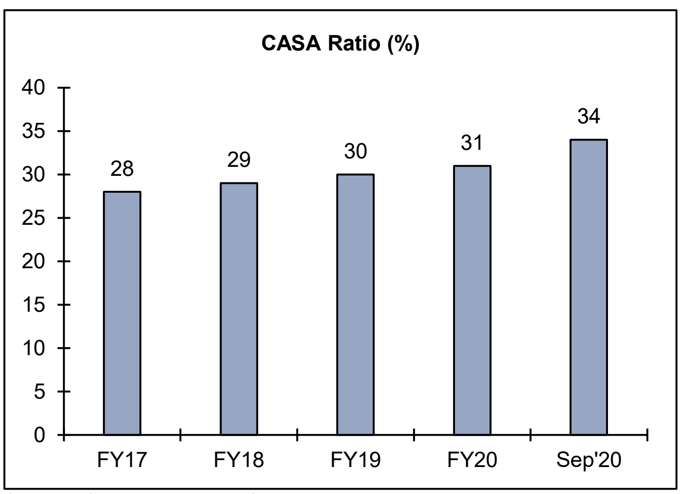
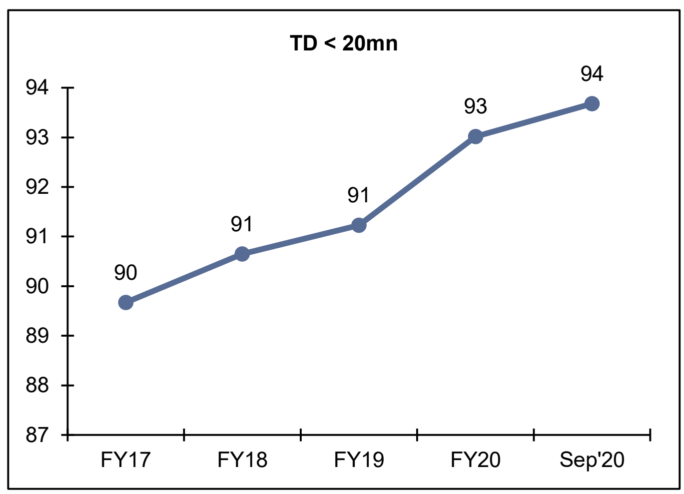
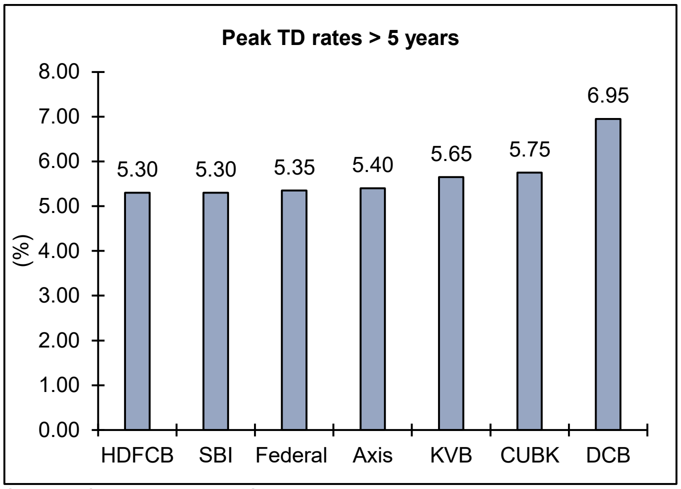


Chart 2: Increasing share of sticky retail deposits…



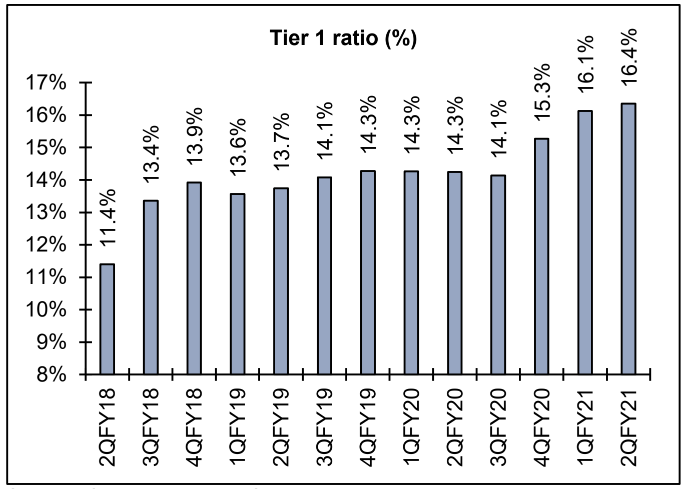
Source: Company data, I-Sec research

Chart 3: …without offering higher differentiated rates



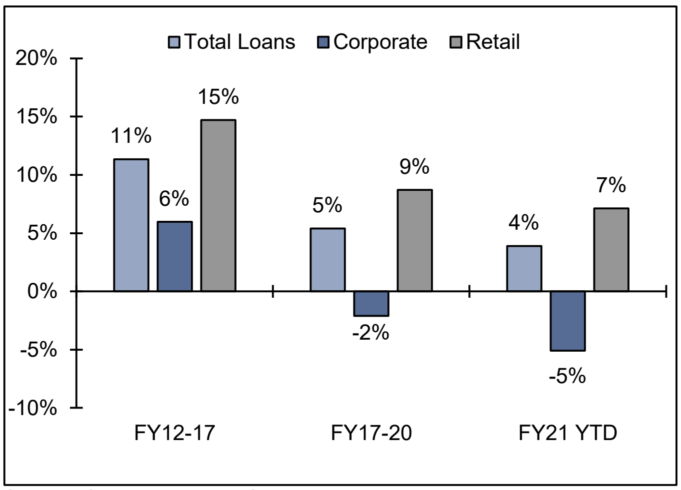
Source: Company data, I-Sec research

Chart 4: Adequate capital to ensure credit growth revival quicker than peers



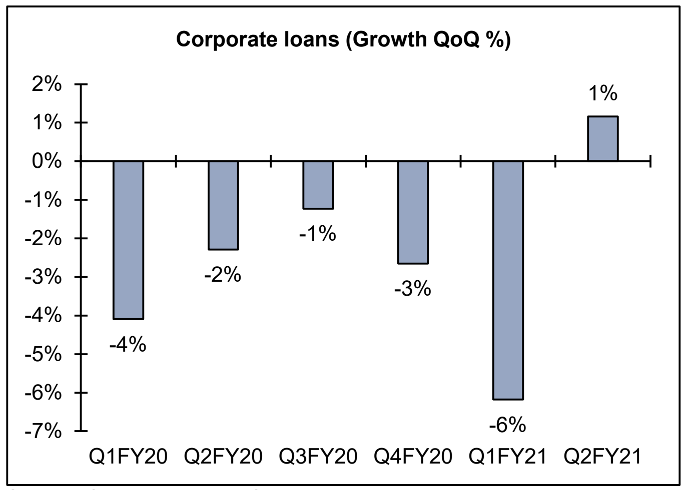
Source: Company data, I-Sec research

Chart 5: Consolidation in corporate segment is largely over…



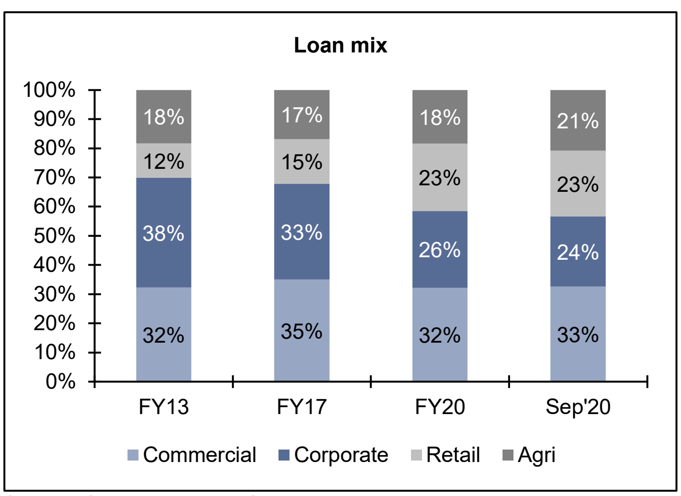
Source: Company data, I-Sec research

Chart 6:…as reflected in sequential segmental growth in Q2FY21



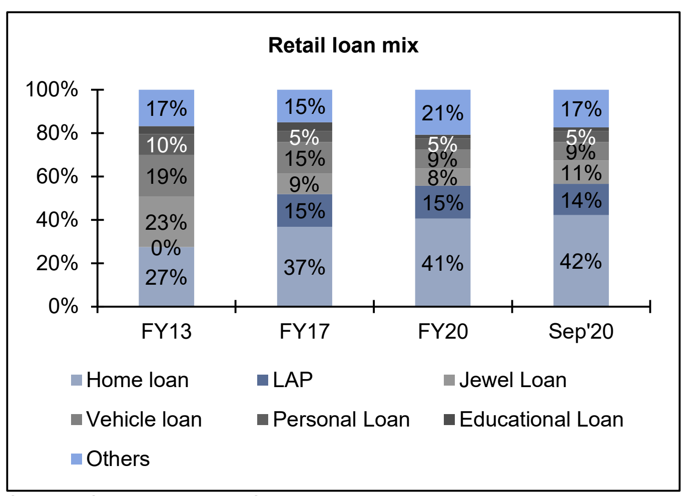
Source: Company data, I-Sec research

Chart 7: 'Retailization' to continue



Source: Company data, I-Sec research

Chart 8: Within retail, focus is more towards secured assets



Source: Company data, I-Sec research

Improving visibility on RoA improvement

We estimate 60bps improvement in RoA over FY20-FY22E driven by: a) 10bps improvement in margin, and b) ~100bps reduction in credit cost. Return on assets at 0.3% in FY20 was lowest since 2006, largely due to the highest-ever credit cost at 2.2% coupled with elevated cost ratio at 2.5% *vs* average 1.9% during the last decade. Operating leverage, if plays out, is an upside risk to our FY22E RoA estimate.

Table 2: RoA decomposition

Year ended	FY10	FY11	FY12	FY13	FY14	FY15	FY16	FY17	FY18	FY19	FY20	FY21	FY22
Interest income/Assets	9.0	8.8	9.9	10.1	10.4	10.3	9.8	9.4	8.9	8.5	8.7	8.0	8.2
Interest expenses/Assets	6.1	5.8	7.1	7.3	7.8	7.5	6.6	5.9	5.3	5.1	5.3	4.7	4.7
Net interest income/Assets	2.9	3.1	2.8	2.7	2.6	2.8	3.2	3.5	3.6	3.5	3.4	3.4	3.5
Other Inc. from operations/Assets	1.3	1.1	1.1	1.1	1.1	1.1	1.3	1.3	1.4	1.4	1.7	1.4	1.4
Total income/Assets	4.2	4.1	3.8	3.8	3.8	3.9	4.5	4.8	5.0	4.9	5.1	4.8	4.9
Employee expenses/Assets	0.8	0.9	0.8	0.8	1.1	1.0	1.0	1.0	1.0	1.1	1.2	1.3	1.2
Other operating expenses/Assets	1.0	0.8	0.8	1.0	1.0	1.1	1.2	1.1	1.2	1.3	1.3	1.2	1.2
Total Opex	1.8	1.7	1.6	1.8	2.1	2.1	2.1	2.2	2.2	2.4	2.5	2.5	2.4
Operating profit/Assets	2.4	2.4	2.2	2.0	1.7	1.8	2.4	2.6	2.8	2.5	2.6	2.3	2.4
Tax/Assets	0.5	0.6	0.4	0.4	(0.1)	0.0	0.6	0.5	0.2	0.2	0.1	0.2	0.3
Loan loss provisions/Assets	0.2	0.2	0.3	0.3	0.9	0.9	0.7	1.2	2.0	2.0	2.2	1.5	1.2
Net profit/Assets	1.7	1.7	1.5	1.3	0.9	0.9	1.0	1.0	0.5	0.3	0.3	0.6	0.9

Source: Company data

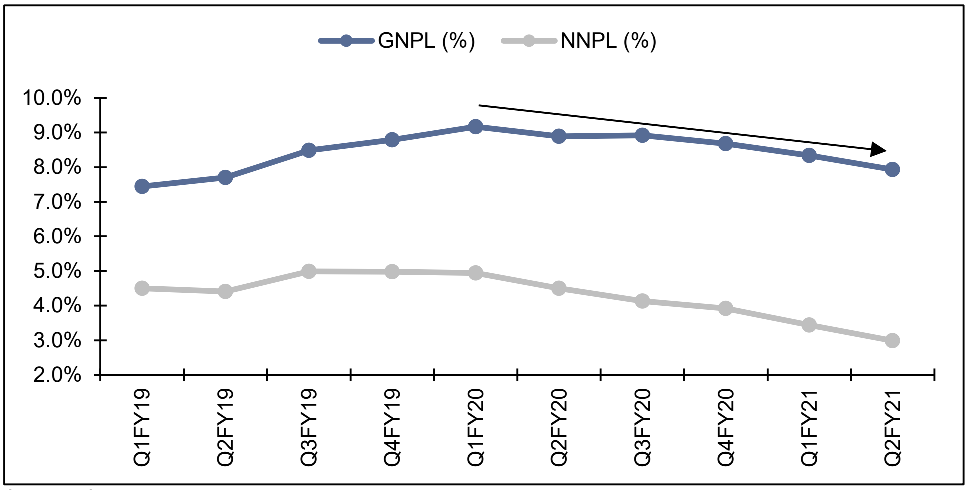
Credit cost to moderate from FY22E onwards

Management's intent to upfront all stressed accounts in FY20 and calibrated growth during FY17-FY20 would ensure lower legacy stress during the current pandemic. Further, management has utilised the strong operating performance to improve coverage ratio to as high as 64% as at Sep'20. Further, we expect fresh delinquencies (when environment normalises) to remain lower given: a) NPA recognition in corporate portfolio is close to completion, b) realigned lending norms, c) incremental lending in retail/SME portfolio over the past couple of years, d) end of 'judgment-based lending' with the rollout of a whole new digital banking platform, e) centralised collection system, and f) separate recovery team.

Under the new collection mechanism, immediately on default, central call centre starts chasing customers for repayment and then there is constant follow-up/reminder via messages. Separate tracking system and incentive structure have been created for faster recovery.

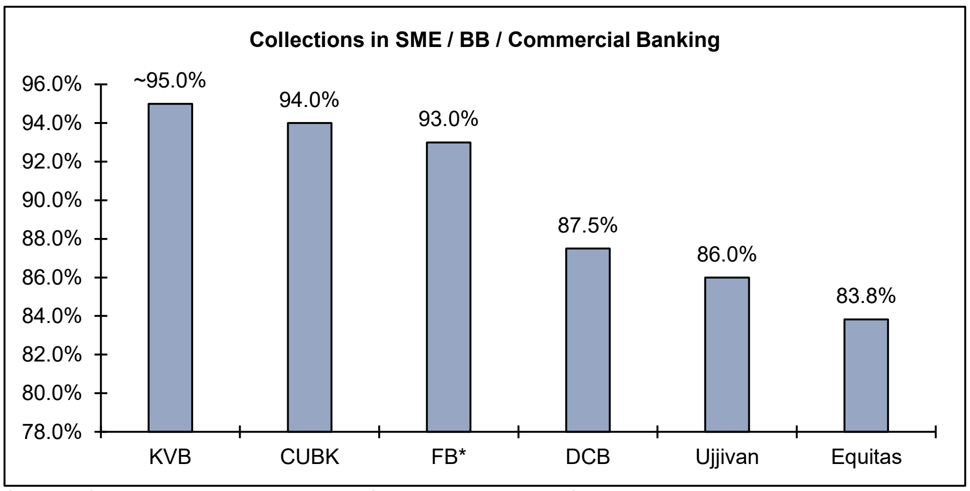
The bank estimates credit cost to range between 1.75-2% (max 2.5% in worst-case scenario) and has guided for a restructured book of 2.5% of loans. However, given its overall collections at ~95% and >99% in non-morat corporate & commercial book, we believe credit cost is likely to remain marginally higher than the upper end of guidance at ~2.25%. Strong PCR @ 64% and negligible legacy stress will help contain credit cost beyond FY21E.

Chart 9: GNPL ratio started moderating from Q1FY20 onwards; however, Covid-related stress could result in higher slippages



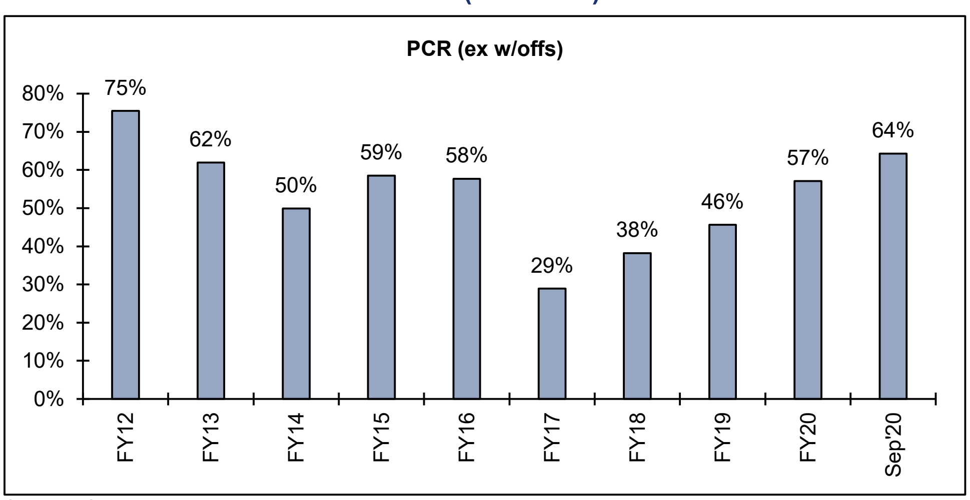
Source: Company data

Chart 10: Best-in-class collections in SME portfolio would ensure lower stress than peers



Source: Company data. For KVB, its I-Sec estimates. For DCB its LAP collections.

Chart 11: Trend in calculated PCR (ex w/offs)



Source: Company data
Note – PCR has been calculated as (GNPA-NNPA)/GNPA

Focus on cost rationalisation

Post FY12, KVB's decision to expand branch network aggressively and participate in consortium-based high-ticket lending resulted in elevated credit cost during FY17-FY20, which impacted return ratios significantly.

Notably, during the past couple of years, KVB focused on cost optimisation. Between FY17-FY20, it revamped its business processes and rolled out its end-to-end digitally enabled 'banking platform'.

Chart 12: Branch addition per year

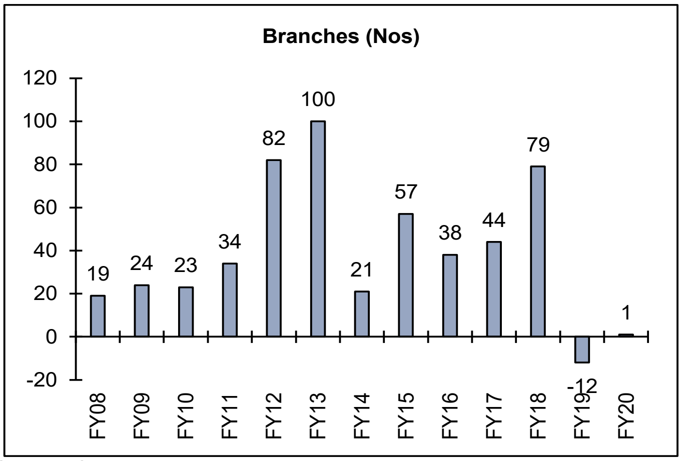
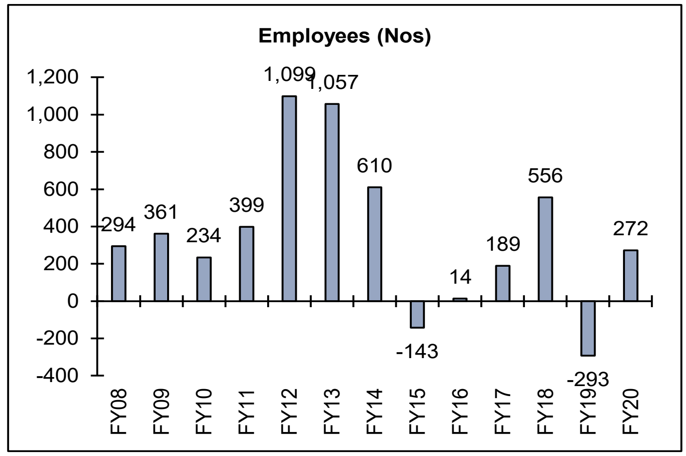


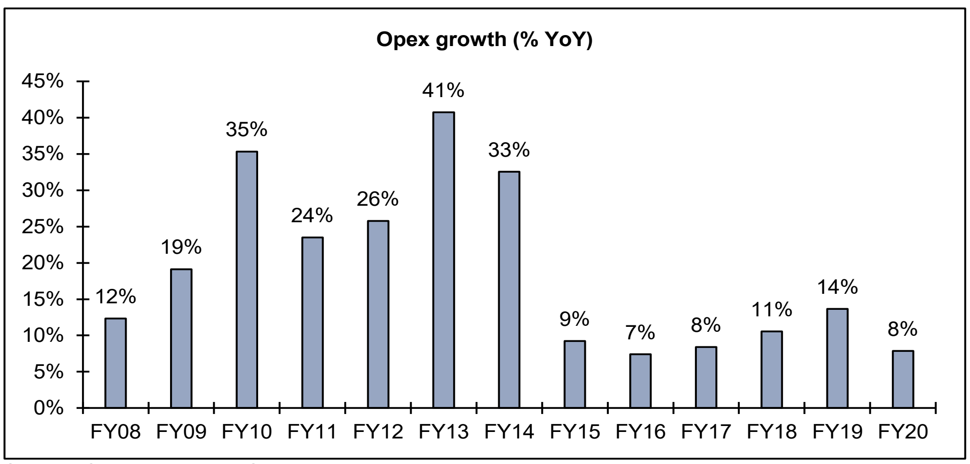
Chart 13: Employee addition per year



Source: Company data

Management sounded confident about maintaining opex growth lower than revenue growth going forward. Rollout of new digital banking platform and branch rationalisation is likely to drive branch/employee productivity going forward.

Chart 14: KVB focused on cost optimisation immediately after aggressive branch expansion as reflected in subdued opex growth between FY15-FY20



Source: Company data, I-Sec research

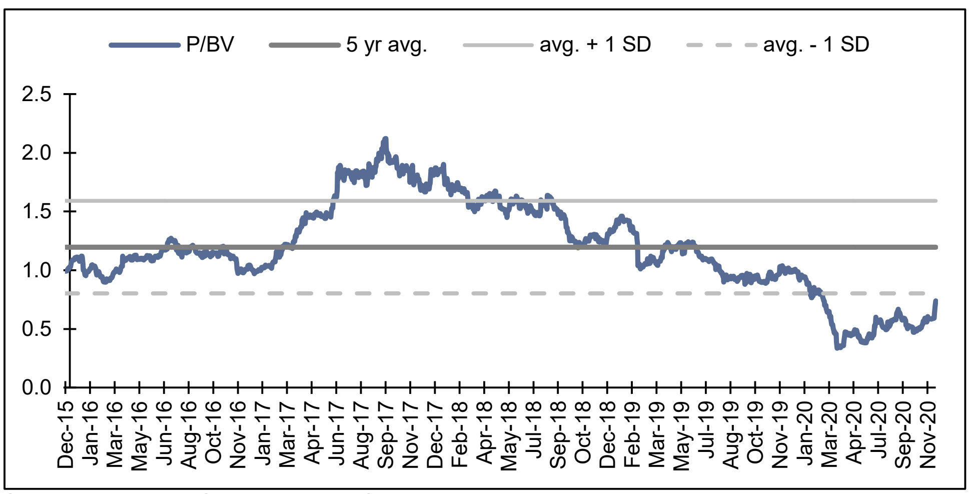
Attractive risk-reward profile

Karur Vysya Bank (KVB) stock currently trades at 0.8x/0.7x FY21E/FY22E P/BV, which is at a significant discount to its closest regional bank peers like City Union Bank. Increased delinquencies in KVB's corporate/commercial portfolio (thus higher GNPL ratios), muted credit growth owing to overall economic slowdown (particularly in Tamil Nadu) and depressed return ratios are the key reasons for the recent derating of the stock. However, we expect valuation multiples to rerate going forward considering the potential business growth backed by: 1) new digital platform, 2) manageable Covid-related stress, 3) adequate capital (no risk of dilution in the near term), and 4) better return ratios. Upgrade to **BUY (from Hold)** and a revised target price of Rs74/share (earlier: Rs33), valuing it at 1x FY22E P/ABV.

KVB's inherent strength in SME banking, focus on expanding its retail portfolio in coming years and fully digitalised 'banking platform' are likely to help revive loan growth and improve asset quality going forward. We estimate 60bps improvement in RoA over FY20-FY22E driven by: a) 10bps improvement in margin, and b) ~100bps reduction in credit cost. Return on assets at 0.3% in FY20 was lowest since 2006, largely due to the highest-ever credit cost at 2.2% coupled with elevated cost ratio at 2.5% *vs* average of 1.9% during the last decade. Operating leverage, if plays out, is an upside risk to our FY22E RoA estimate.

Historically, KVB has traded at an average ~1.1x P/BV (1-year forward) when it was generating RoE of ~18/20% and RoA of ~1.5% in FY11/FY12, respectively. However, post aggressive branch expansion in FY12/FY13, higher credit cost (in FY17-FY20) owing to corporate NPLs and lower-than-expected balance sheet growth (FY17-FY20) impacted return ratios. The stock reacted positively since the management change in Jul'20 and improving visibility on RoA recovery. We believe the current valuation, provides an opportunity to enter the stock and participate in a turnaround.

Chart 15: Trend in P/ABV



Source: Bloomberg, Company data, I-Sec research

Financial summary

Table 3: Profit and Loss statement

(Rs mn, year ending March 31)

	FY19	FY20	FY21E	FY22E
Interest Income	58,158	59,900	56,347	63,194
Interest Expense	34,530	36,420	32,580	36,387
Net Interest Income	**23,628**	**23,479**	**23,767**	**26,807**
% NII Growth	2.8	(0.6)	1.2	12.8
Treasury Income				
Non-interest income	**9,628**	**11,546**	**10,143**	**11,017**
Net Revenue	**33,256**	**35,026**	**33,910**	**37,824**
Employees Expenses	7,612	8,567	8,823	9,529
Other Op. Expenses	8,536	8,851	8,674	9,367
Operating Profit	**17,108**	**17,609**	**16,413**	**18,927**
% OP Growth	-3.7	2.9	-6.8	15.3
Tax	1,114	372	1,432	2,436
Total Provisions	13,886	14,887	10,685	9,184
Net Profit	**2,109**	**2,350**	**4,296**	**7,307**
% PAT Growth	(39.0)	11.5	82.8	70.1

Source: Company data, I-Sec research

Table 4: Balance sheet

(Rs mn, year ending March 31)

	FY19	FY20	FY21E	FY22E
Capital	1,599	1,599	1,599	1,599
Reserves and Surplus	62,629	64,404	68,313	74,421
Deposits	5,98,680	5,90,751	6,29,150	7,23,522
Borrowings	15,653	11,842	9,395	11,025
Other Liabilities & Provisions	14,840	14,186	9,993	17,850
Total liabilities	**6,93,402**	**6,82,782**	**7,18,450**	**8,28,416**
Cash & Balances with RBI	29,347	27,327	28,735	33,055
Bal. with banks/ call money	7,624	16,599	12,178	17,681
Investment	1,48,816	1,57,624	1,57,287	1,80,881
Loans and advances	4,85,808	4,60,981	4,97,860	5,72,539
Fixed Assets	5,830	5,866	6,280	6,861
Other Assets	15,977	14,384	16,110	17,399
Total assets	**6,93,401**	**6,82,782**	**7,18,450**	**8,28,416**
% TA Growth	4	(2)	5	15

Source: Company data, I-Sec research

Table 5: Key ratios

(Year ending March 31)

	FY19	FY20	FY21E	FY22E
Per Share Data				
Book value per share (INR)	80.3	82.6	87.5	95.1
Adj. BVPS (INR)	57.6	65.6	70.0	74.8
Price/Book value	**0.60**	**0.58**	**0.5**	**0.5**
Price/ Adj. Book value	**0.8**	**0.7**	**0.7**	**0.6**
EPS(INR)	**2.8**	**2.9**	**5.4**	**9.1**
P/E Ratio	**17.4**	**16.3**	**8.9**	**5.3**
DPS	2.8	1.3	-	1.3
Asset Quality				
Gross NPA (Rs mn)	44,498	42,128	41,766	41,951
Gross NPA (%)	8.79	8.68	8.39	7.33
Net NPA (Rs mn)	24,203	18,087	18,568	21,627
Net NPA (%)	4.98	3.92	3.73	3.78
% coverage of NPA	45.6	57.1	55.5	48.4
Delinquencies (%)	5.0	3.4	3.0	3.0
Capital Adequacy Ratios				
RWA (Rs mn)	4,37,325	4,14,976	4,48,174	5,15,400
Tier 1 (%)	**14.3**	**15.3**	**15.2**	**14.4**
Tier 2 (%)	1.7	1.9	1.8	1.5
Total CAR (%)	16.0	17.2	17.0	16.0
Business Ratios				
Credit / Deposit(%)	81.1	78.0	79.1	79.1
Investment / Deposit (%)	24.9	26.7	25.0	25.0
CASA (%)	**29.9**	**31.3**	**27.8**	**27.8**
RoaA (%)	**0.3**	**0.3**	**0.6**	**0.9**
Core RoE (%)	3.3	3.6	6.3	10.0
Dividend Yield (%)	5.7%	2.7%	0.0%	2.7%
Earnings Ratios				
Interest Inc. / Avg.assets (%)	8.5	8.7	8.0	8.2
Interest Exp./ Avg. assets (%)	5.1	5.3	4.7	4.7
NIM (%)	**3.5**	**3.4**	**3.4**	**3.5**
Int. exp/ Int earned (%)	59.4	60.8	57.8	57.6
Oth. Inc./ Tot. Inc. (%)	29.0	33.0	29.9	29.1
Staff exp/Total opt. exp (%)	47.1	49.2	50.4	50.4
Cost/ Income Ratio (%)	**48.6**	**49.7**	**51.6**	**50.0**
Prov./ Operating Profit (%)	81.2	84.5	65.1	48.5
Loan loss prov./Avg. loans (bps)	**297.4**	**314.5**	**222.9**	**171.6**

Source: Company data, I-Sec research

Table 6: RoA tree

(%, year ending March 31)

	FY19	FY20	FY21E	FY22E
Interest income/Assets	8.5	8.7	8.0	8.2
Interest expenses/Assets	5.1	5.3	4.7	4.7
Net interest income/Assets	**3.5**	**3.4**	**3.4**	**3.5**
Other Inc. from operations/Assets	1.4	1.7	1.4	1.4
Total income/Assets	4.9	5.1	4.8	4.9
Employee expenses/Assets	1.1	1.2	1.3	1.2
Other operating expenses/Assets	1.3	1.3	1.2	1.2
Total Opex	**2.4**	**2.5**	**2.5**	**2.4**
Operating profit/Assets	**2.5**	**2.6**	**2.3**	**2.4**
Tax/Assets	0.2	0.1	0.2	0.3
Loan loss provisions/Assets	2.0	2.2	1.5	1.2
Net profit/Assets	**0.3**	**0.3**	**0.6**	**0.9**

Source: Company data, I-Sec research

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