KIATNAKIN BANK PLC

No. 57/2019
26 April 2019

FINANCIAL INSTITUTIONS

Company Rating:	A
Issue Ratings:	
Senior unsecured	A
Basel III Subordinated	BBB+
Outlook:	Stable

Last Review Date: 25/04/18

Company Rating History:

Date	Rating	Outlook/Alert
25/04/18	A-	Positive
31/03/15	A-	Stable
31/03/11	A-	Positive
30/11/04	A-	Stable
12/07/04	BBB+	Positive
21/05/02	BBB+	-
21/06/00	BBB	-
06/03/00	BBB	Alert Negative
25/11/99	BBB	-

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RATIONALE

TRIS Rating upgrades the company rating on Kiatnakin Bank PLC (KK) to “A” from “A-”, the ratings of KK’s senior unsecured debentures to “A” from “A-”, and the ratings on KK’s Basel III Tier 2 subordinated debt to “BBB+” from “BBB” with a “stable” outlook. The ratings reflect KK’s improved asset quality and strengthened business platform following increased integration of its capital market and commercial banking operations. The ratings take into account KK’s diverse sources of revenue, particularly from its non-credit businesses, and adequate capital. The ratings are, however, constrained by KK’s relatively modest commercial bank franchise, and a relatively high reliance on wholesale funding.

KEY RATING CONSIDERATIONS

Diverse revenue sources

The financial performance of KK and its subsidiaries under Phatra Capital PLC (together known as Kiatnakin Phatra Financial Group – KKP) reflects its diverse sources of revenue, which include stable banking business, solid investment bank and securities brokerage, and a fast-growing private banking business.

Net interest income and non-interest income contributed 60% and 40%, respectively, of total revenue in 2018. These levels are broadly in line with other Thai commercial banks. Fees and service income made up 24% of total revenue, also a healthy figure.

We expect KK’s lending business to remain the largest contributor to revenue and earnings over the next three years, despite its modest franchise. As of the end of 2018, KKP ranked 9th among 11 listed Thai commercial banks based on consolidated asset size. KKP’s market share in loans was 1.9% and market share in deposits was 1.5%. In 2018, contributions from commercial banking were 78% of revenues and 72% of net income, while capital market business accounted for majority of the remainder.

We also expect intra-group synergies from integrated product offerings, service channels, and operating platforms to increase contributions from non-lending segments over time, albeit with exposure to volatility in the capital markets.

Diversifying more into non-auto sectors

KKP has been diversifying more towards lending to corporates, investment banking clients, and larger-scale real estate developers. In 2018, loans grew 18.5% year-on-year (y-o-y), with growth across all segments, driven mainly by small- and medium-enterprises (SMEs) and large corporates which expanded by 26% and 51%, respectively. Conversely, hire purchase (HP) lending expanded by a lesser degree at 4.1% y-o-y after a contraction in 2017. The slower growth led to HP loans declining to 47% of total loans at the end of 2018, down from 54% in the previous year.

At the same time, corporate loans rose to 10% of total loans at the end of 2018, from 8% a year earlier. Commercial loans also rose to 24% of total loans from 23%. These include loans to real estate developers, and SMEs.

Sufficient capital

We forecast KK's Basel-III compliant core equity tier-1 (CET-1) ratio in a range of 13%-14% over the next three years, which should be sufficient to support its business expansion. However, its CET-1 ratio at the end of 2018 declined to 13.56% from 14.61% at the end of 2017. This was due mainly to a strong loan growth of 18.5% and high dividend payouts of 70% in 2018. The rating upgrade is based on our expectation that the strong credit growth and high dividend pay-out is likely to be temporary. Our forecasts assume a normalised dividend payout of 60%[1] and loan growth expectation of 6-8% over the next three years. Meanwhile, CET-1 made up 79% of total capital at the end of 2018, indicating an average quality of capital.

Healthy profitability supports capital accretion

Strong profitability has been supporting KKP's capital accretion. The return on average asset (ROAA) was 2.1% in 2018, among the highest in the industry. Risk-adjusted net interest margin (NIM) was 3.8% in 2018, also well above industry standards of 2.1% and as has been the case for the past few years.[2] We project risk-adjusted NIM to remain relatively stable in a range of 3.5%-3.6% over the next three years, given our assumption that the higher NIM from SMEs could offset the narrow margin on corporate lending and that credit cost does not increase significantly. We believe that given its diverse sources of earnings, the bank's earnings capacity should be able to withstand the volatility of earnings across credit cycles.

Progress in addressing asset quality issues

In TRIS Rating's opinion, KKP continues to make progress in addressing asset quality of its past legacies. This echoes the Group's unified efforts to raise risk management standards over the past few years. The bank continues to actively resolve legacy non-performing loans (NPLs), notably from real-estate developers. At the same time, it has shifted focus to lend to developers with higher creditworthiness. A more diversified loan portfolio comprising corporate and broader retail segments should also help contain future credit risk.

Overall credit cost[3] was 1.04% in 2018, below the average over recent years but close to that of most Thai commercial banks. NPLs as a percentage of total loans, excluding the Special Asset Management (SAM) unit and interbank lending, continue a downward trend. The figure reached 3.9% at the end of 2018, down from 4.7% in 2017, approaching the Thai commercial bank average of 3.6%. The NPL ratio to real-estate developers dropped to 13.6% at the end of 2018, from 21.4% a year earlier, with absolute NPLs of these developers also declining. These troubled loans comprise a few large secured loans.

High reliance on wholesale funding

KK's funding profile matches that of smaller Thai banks: a narrow base of retail deposits and a higher reliance on wholesale funding. Current account and savings account (CASA) funding as a percentage of deposits, an indicator of sticky funding remains at 38% at the end of 2018, below peers' average of about 60%. Borrowings made up 20% of total funding, well above the peers' average of 5%. The loans-to-deposits ratio, was also high at 125%. However, we notice a recent growth in term deposits away from whole-sale funding recently. We believe this move was largely to comply with net stable funding ratio (NSFR) requirements and to lock in long-term funding costs.

Nonetheless, the bank is gradually building up a retail CASA base to help improve its funding profile. For instance, the bank offers settlement deposit accounts to its wealth clients (KKPSS), and corporate CASA products and cash management solutions to its corporate clients.

[1] Based on an estimate by TRIS Rating.
[2] Risk-adjusted NIM = Net interest income less credit cost divided by average earnings assets.
[3] Including loss on sale of repossessed cars.

Adequate liquidity

KK's liquidity coverage ratio (LCR) is above the regulatory requirement[4], but weaker than the 158% average for smaller banks and 184% for commercial banks at the end of 2018, as reported by the Bank of Thailand (BOT). The ratio of liquid assets to total deposits (including B/Es) and interbank borrowing was 30.4% at the end of 2018. This value is in line with the industry average.

Basel III-Compliant Tier 2 Securities Rating

The "BBB+" rating for KKP's Basel III Tier 2 capital securities (KK25DA) reflects the subordination of the securities and the non-payment risk of the securities, as defined by the non-viability loss absorption clause in the bond indenture. The features of the securities comply with Basel III guidelines, and the securities are qualified as Tier 2 capital under the BOT's criteria. The securities are subordinated, unsecured, non-deferrable, and non-convertible. The securities are also callable by KK prior to the maturity date, if the call date is at least five years after issuance and as long as the bank gets approval from the BOT. The holders of the securities are subordinated to KK's depositors and holders of KK's senior unsecured debentures. The principal of the securities can be written down in the event that the regulator deems the bank to be non-viable and decides to provide financial support to the bank, in accordance with the non-viability clause.

BASE-CASE ASSUMPTIONS

The followings are our base-case assumptions for 2019-2021F

- Loan growth: 6%-8%
- Credit cost: 1.1%-1.2%
- NPL ratio: 3.0%-3.8%
- CET-1 ratio: 13.7%-14.0%
- Risk-adjusted NIM: 3.7%-3.8%

RATING OUTLOOK

The "stable" outlook reflects our expectation that KK will continue strengthening its capital, improving its asset quality, and further cultivating synergies with its capital market and wealth management units to further improve its financial performance and credit profile.

RATING SENSITIVITIES

A rating upgrade will depend on KK's ability to expand its commercial bank franchise and/or improve its funding. We could revise a rating downward if over the next few years capital weakens steadily and/or earnings capacity weakens materially due to deterioration in asset quality or unexpected large losses from capital market-related business.

COMPANY OVERVIEW

KK, formerly known as Kiatnakin Finance and Securities Co., Ltd., was established by the Wattanavekin family in 1971. KK was listed on the Stock Exchange of Thailand (SET) in 1988 and became a public company in 1993. In August 1997, KK was one of 57 financial institutions with operations suspended due to the Asian financial crisis. After submitting and receiving regulatory approval for a rehabilitation plan, KK resumed operations in April 1998. In July 1999, KK's finance and securities business was split into two separate companies: Kiatnakin Finance PLC, operating the finance business, and Kiatnakin Securities Co., Ltd., operating the securities business.

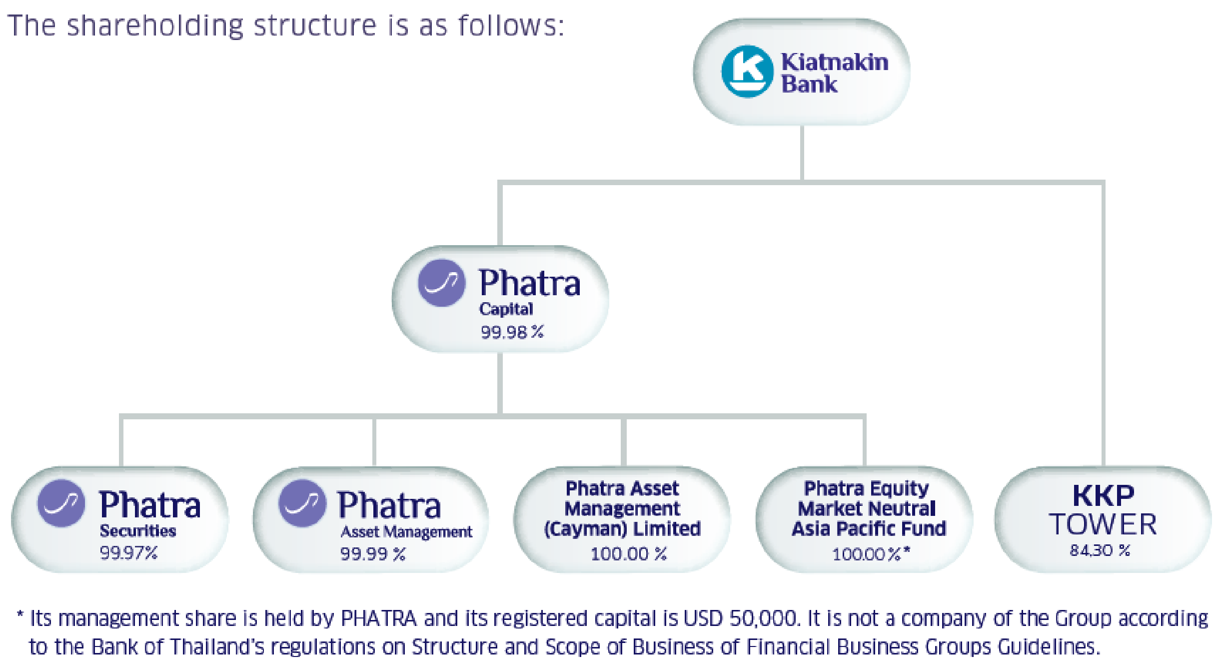
Following the financial crisis, KK began a new business, distressed asset management, by purchasing portfolios of troubled loans from the Financial Sector Restructuring Authority and other financial institutions. In 2000, KK started to expand by offering residential property development project loans to SME real estate developers.

In December 2004, the Ministry of Finance (MOF) granted KK a commercial banking license. KK commenced universal banking operations in October 2005, and later changed its name to "Kiatnakin Bank PLC". In order to expand the scope of its business to include fund management, KK purchased 60% of the shares of Phatra Asset Management Co., Ltd. (PHATRA

[4] *90% in 2019 and 100% in 2020.*

ASSET, formerly named Siam City Asset Management Co., Ltd.) in July 2011, and acquired the remaining 40% stake in September 2012.

Table 1: KKP Group's Structure



Source: KKP's annual report (2018)

As a part of its growth strategy, KK merged with Phatra Capital Co., Ltd. (PHATRA CAPITAL) in September 2012, and later created a new brand name for the Group: "Kiatnakin Phatra Financial Group" (KKP). KK's shareholding structure changed after the merger. KK and its subsidiaries reorganised their businesses based on three strategic focuses – (i) Credit Business, (ii) Private Banking, and (iii) Investment Banking.

To streamline its business operations, PHATRA later sold all its shares in KKTRADE, which operated securities business for retail clients to Yuanta Securities (Thailand) Co., Ltd. in July 2016. Also in 2016, KK established Phatra Asset Management (Cayman) Limited to support the Group's overseas securities investment business.

As of December 2018, KK held 99.9% shares of PHATRA CAPITAL, while PHATRA CAPITAL held shares of Phatra Securities PLC (PHATRA), PHATRA ASSET (PASSET) and Phatra Asset Management (Cayman) Limited, which are asset management companies, and Phatra Equity Market Neutral Asia Pacific Fund, which is an investment management of overseas securities company. KKP Tower, another subsidiary company of KK, operates the office rental and property management business for the Bank and subsidiary companies.

FINANCIAL STATISTICS AND KEY FINANCIAL RATIOS[1]

Unit: Bt million

	Year Ended 31 December				
	2018	2017	2016	2015	2014
Total assets	306,329	259,335	233,777	236,144	241,153
Average Assets	282,832	246,556	234,961	238,648	245,131
Investment in securities	29,781	34,048	28,365	20,290	29,289
Loans and receivables	229,066	193,087	177,277	178,902	185,778
Allowance for doubtful accounts	10,760	10,576	10,966	9,546	8,321
Deposits	181,694	132,878	109,923	104,327	132,297
Borrowings[2]	63,358	64,947	64,414	70,294	52,567
Shareholders' Equities	42,341	41,548	40,517	38,156	36,911
Average Equities	41,944	41,032	39,336	37,534	36,028
Net interest income	11,262	10,628	10,433	9,449	8,913
Non-interest income[3]	7,544	6,173	6,911	6,452	5,767
Total revenue[4]	18,806	16,802	17,345	15,901	14,680
Operating expenses[5]	9,232	8,369	7,897	7,441	6,271
Pre-provision operating profit (PPOP)	9,574	8,432	9,447	8,460	8,409
Impairment losses on loans and securities[6]	2,186	1,476	2,957	4,433	5,246
Net income	6,044	5,766	5,611	3,426	2,779
Net fee and service income	4,579	4,055	3,707	3,471	3,452
Gains on investments	390	178	203	336	261

1 *Consolidated financial statements*
2 *Including interbank and money market*
3 *Net of fees and service expense; including gains from sales of foreclosed assets*
4 *Including gains from sales of foreclosed assets*
5 *Excluding fees and service expense*
6 *Including losses from sales of repossessed cars*

Unit: %

	Year Ended 31 December				
	2018	2017	2016	2015	2014
Earnings					
Return on average assets	2.14	2.34	2.39	1.44	1.13
Interest spread	3.89	4.21	4.40	3.85	3.33
Net interest margins	4.26	4.64	4.87	4.36	3.93
Net interest income/average assets	3.98	4.31	4.44	3.96	3.64
Non-interest income[7]/average assets	2.67	2.50	2.94	2.70	2.35
Net fee and service income/total revenue	24.35	24.14	21.37	21.83	23.52
Cost-to-income	49.09	49.81	45.53	46.80	42.72
Capitalisation					
CET-1 ratio[8]	13.56	14.61	15.59	14.71	14.82
Tier-1 ratio[8]	13.56	14.61	15.59	14.71	14.82
BIS ratio[8]	17.26	17.69	18.96	16.58	15.19
CET-1/BIS ratio[8]	78.53	82.59	82.23	88.72	97.56
Asset Quality					
Credit costs	1.04	0.80	1.66	2.43	2.78
Non-performing loans/total loans[9]	4.13	5.02	5.65	5.85	5.61
Non-performing assets/total assets	4.29	5.30	5.89	6.63	5.82
Allowance for loan losses /non-performing loans	114.42	109.60	110.00	91.66	80.28
Funding & Liquidity					
CASA/total deposits[10]	38.26	40.55	53.65	50.56	47.60
Loan/total deposits[10]	125.73	145.31	161.14	171.06	140.15
Deposits[10]/total liabilities	69.01	61.01	56.93	52.82	64.90
Liquid assets/total deposits[11]	30.36	33.28	34.65	27.35	26.41
Liquid assets/short-term liabilities[12]	27.07	26.84	25.90	21.03	23.78

7 Net of fee and service expenses; including gains from sales of foreclosed assets
8 Consolidated basis
9 Based on reported NPL
10 Including bills of exchange
11 Including bills of exchange and interbank borrowing
12 Financial liabilities with maturity less than one year

RELATED CRITERIA

- Commercial Banks, 30 March 2017

Kiatnakin Bank PLC (KK)

Company Rating:	A
Issue Ratings:	
KK202A: Bt3,000 million senior unsecured debentures due 2020	A
KK203A: Bt3,000 million senior unsecured debentures due 2020	A
KK25DA: Bt3,000 million Basel III Tier 2 capital securities due 2025	BBB+
Rating Outlook:	Stable

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