

NDB Bank: Anatomy of a Banking Puzzle

Over the past three years National Development Bank (NDB) has successfully merged its development banking and the retail banking operations whilst achieving commendable growth spurts. The Management of NDB should be further credited for their superior performance in asset quality with the continued decline in the ratio of non-performing loans being the

lowest in the sector. (This contrasts with the rise in NPL's amongst the industry participants including the undisputed leader in banking -- Commercial Bank -- COMB).

Bank	Gross NPL %	Cost/income %	EPS growth, 2007
NDB	2%	45%	49%
COMB	3%	49%	116%
NTB	4%	58%	56%
HNB	6%	59%	41%
DFCC	7%	47%*	25%*
SAMP	6%	62%	7%
SEYB	12%	77%	4%
<i>(*projected results)</i>			

They have also presided over a bank with the lowest cost to income ratio, which is indicative of managing overhead costs better than their peers. NDB is no slouch in terms of its earnings per share (EPS) either – being third after COMB and the much smaller (hence the smaller profit base) boutique bank NTB. In most performance matrices NDB Bank is the first or one of the leaders in the banking sector in Sri Lanka. For all intents and purposes it appears to be a model servant of that fickle master – the share market.

So what does the market think of the performance of NDB management?

Apparently not too kindly!

The attached table presents the market returns on NDB Bank compared to the other listed companies in the sector. NDB Bank is positively the worst performing bank from the perspective of market price with negative returns of 13% compared to the 57% of HNB -- and HNB although good, certainly performed less well than the NDB.

Why is this otherwise highly successful bank with smart management unable to translate superior performance to a superior share price?

The answer surprisingly lies in the exemplary and otherwise blameless balance sheet of the NDB Bank. With its copious asset base and over-capitalization, NDB Bank may be loading up on too much into a good thing. It appears to be an obese lumbering giant in a sea of slim, swift, muscular competitors. To get its market performance up NDB Bank may need to go through a diet of capital restructuring.

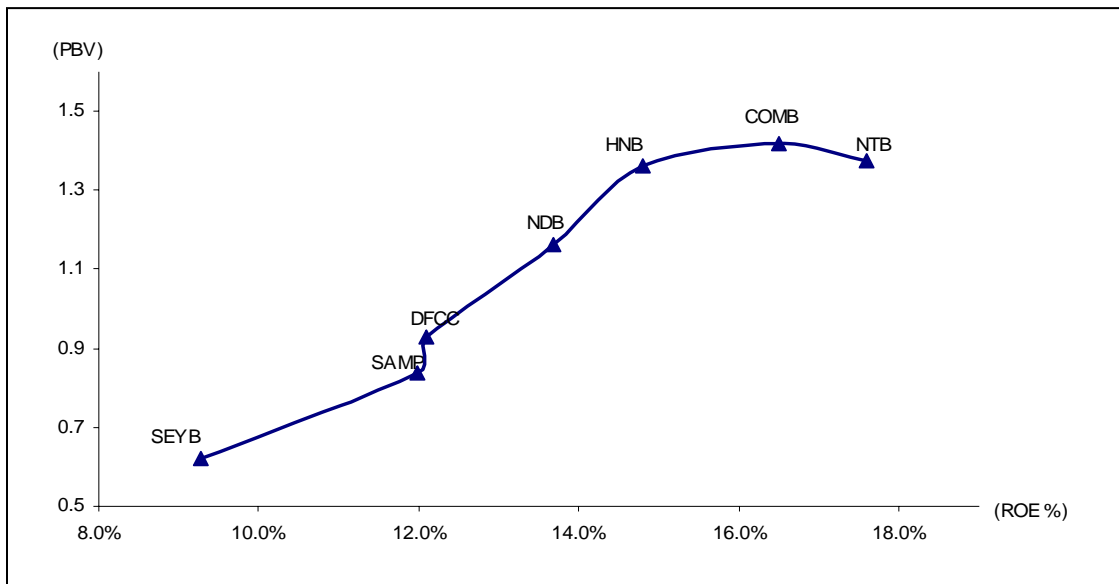
Bank	Adjusted share price*		Dividend return (based on 2007 receipts)	Share price appreciation (in 2007)	Total investor returns (in 2007)
	YE 2006	YE 2007			
HNB	77.5	122.0	0%	57%	57%
COMB	133.5	148.5	5%	11%	17%
SAMP	109.8	120.5	2%	10%	12%
NTB	28.3	29.8	4%	5%	9%
SEYB	35.0	32.0	4%	-9%	-4%
DFCC	142.6	127.0	2%	-11%	-8%
NDB	201.0	170.0	2%	-15%	-13%

(Share prices adjusted for bonus and rights issues)

Blood & Guts; Flesh & Bone

If NPL's, Cost to income, and Earnings Growth is the blood and guts of the banking business; then the asset base of a bank and the Return on Investment (ROI) is its flesh and bone. The perceptions of the market on how the assets are managed are reflected in how much of a premium it is willing to pay on the net asset value per share. When analysing the banking industry we identified a strong correlation of +95%, between return on shareholders equity (ROE) and price multiple on net asset value per share (PBV). This is not too difficult a concept. If I can make your money work harder for you, then you will be willing to pay me a higher amount than for someone who is not going to make your money work that hard.

COMB, currently enjoys the highest PBV of 1.42 (x) mainly due to its higher ROE of 16.5%. However Nations Trust Bank (NTB) despite having the highest ROE of 17.6%, enjoys a marginally lower price multiple to net asset value due to other factors such as size, growth rates, capital adequacy levels etc. influencing the price



multiples. Currently NDB has a ROE of 13.6%. If NDB achieves a ROE of over +15%, the market may nearly provide a 20% premium pushing up PBV towards +1.4(x). Therefore at 1.4(x) PBV from the current 1.17(x), NDB's share price could arguably increase from its current Rs.167 (at the point of writing) to over Rs.200.

With NDB's management being in par with COMB, having completed a successful merger, achieving commendable growth and having the best loan book in the industry with the lowest NPL ratio of 1.8%, and all this at a reasonable cost; we cannot identify any factor other than the lower ROE as the catalyst for its dismal

price performance. Amongst many positives (which the investors have correctly identified) NDB's only evil is the over capitalised balance sheet for which the shareholders are paying dearly.

See no Evil

So what is the right level of capitalization? This can be a debatable issue for many industries. Luckily for us, the Banking regulator has set out the minimum desired levels of capitalization for banks – being 10% of risk weighed assets for Tier 1 and Tier 2 capital. So how does NDB stack up in respect mandated minimum levels? The graph below depicts the capital adequacy levels of each of the listed banks in Sri Lanka. It clearly depicts how far off the field NDB capital adequacy ratio is – it is almost twice that of its highly respected and market leading competitor COMB, and two and one half times required by the Central Bank.

Despite superior performance of the Management, we remain critical of NDB's balance sheet management and the absolute lack of interest of the Management to address this glaring anomaly. We do not contest that there are occasions when excess capital is useful. First if the bank anticipates a massive growth in the loan book in the short-term requiring additional capital cover, then certainly it should retain its capital. Second it could be planning for strategic acquisition which in turn may require excess capital. However the loan book growth is unlikely to grow significantly faster than the rest of the market, and certainly not require the kind of fat-cushion provided by the current levels of excess capital. The NDB management has not spoken the management considering any new strategic acquisitions – and they have had plenty of time to do so – so we can assume quite rightly that they have no such plans.

Capital adequacy levels are a double edged sword in banking, where the market would penalise banks with lower capital adequacy levels whilst excess capital levels also would not be preferred. With the Central Bank stipulated total capital adequacy levels (CAR) at 10%, banks are expected to maintain capital levels above these rates. However excess capital does not dictate a premium since it signals capital idling which would drag down the ROE's. Therefore as presented in the graph below NTB enjoys the highest market price multiple since it maximises capital usage whilst creating strong growth. However we believe CAR of 14% to be the ideal situation with commendable capital utilisation and a fair capital cushion facilitating future organic growth. NDB share is suffering due to poor capital management and consequently destroying shareholder wealth.

What should the NDB Management do? First they should open their eyes. Second they should reduce the excess equity by returning the funds to the shareholders through an extra-ordinary dividend.

Where will they get the money from? Well for one thing they could dispose of the marketable securities. Again they could increase their borrowing either overseas (if they could manage exchange risk) or locally through debentures – much like the other peer banks COMB and HNB.

Goodness me, but borrowing in this climate is expensive?

That depends.

It is certainly more expensive for the Management who are currently sitting on zero cost money of pliant, obedient and non-complaining shareholders. From the perspective of the shareholders however it is significantly cheaper.

To understand this is quite simple. Put your-self in the shoes of the Shareholder. If the Shareholder were to receive the extra-ordinary dividend he/she has several options.

First, he could reinvest in equities. Equity returns in Colombo market runs on the average about 11%-13% above the risk free (Treasury bill) rate since early 1990's. He/she can reasonably expect a return of approximately 30% in today's climate if the past is any guide.

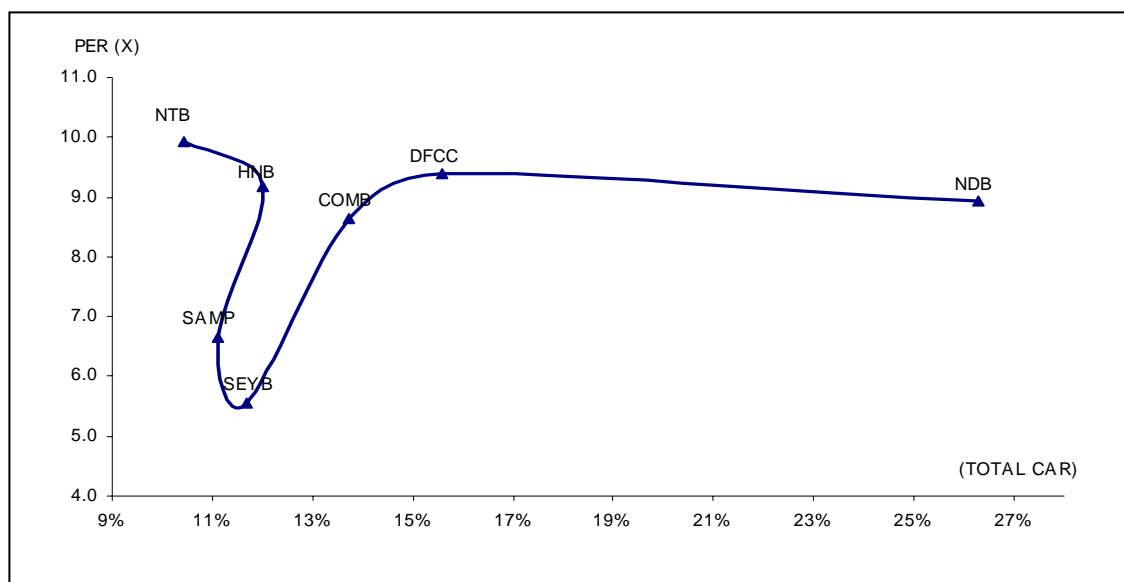
He/she can invest it in a risk-free investment such as Treasury Bills, and get a return of 18% (less taxation of 10%).

He could of course (if he is a small shareholder and under financial strain) just use it to settle the balance of his harmless looking credit card bills which currently costs him around 45% in interest costs.

In contrast if the money remains in the NDB, NDB is likely to get the 18%, but then pay taxes of around 40%, giving a notional yield to the shareholder of only 10.8%. Of course that is only notional you see – remember we are talking about NDB Bank here. And NDB Bank likes to sit on its cash!

See how shareholder value is destroyed?

Shredding the equity holding by way of an extraordinary dividend benefit would give an immediate benefit to the Shareholder in two ways. First he will get cash, and second it would also push up the ROE unlocking opportunities for share price upside. The Management would hopefully get a special bonus for looking after the well-being of the Shareholders and everybody would be happy.



A modest proposal to Cinderella

Therefore we developed the following exceptional dividend payout options whilst increasing the debt component to compensate the redemption of equity and evaluated the impact on 2007 BVPS and ROE. Currently NDB's cost of funds other than equity is a near 9.8% and we are confident that NDB could easily raise medium term debt at 18% (as recently done by Seylan Bank and HNB with much weaker balance sheets). Further we believe by leveraging on the foreign funding agencies (recently NDB obtained a Norwegian funded concessionary credit line for developing the mortgage business), expanding its deposit base and tapping

overseas markets with lower cost (whilst further benefiting from a strengthening local currency), the banks cost of borrowing for additional debt may be even below 18%.

Further we believe that NDB repaying excess shareholder capital through an extraordinary dividend would bring back retail interest into the share and trigger higher multiples. Therefore if NDB Management was to signal to the market their commitment to maximise shareholder wealth, it is likely to push up PBV multiples from current 1.17(x) to in excess of 1.4(x). Whilst having the best loan book and resolving the capital management issue would easily push NDB further up the PBV rankings, easily surpassing COMB.

The following analysis displays the impact an incremental improvement in PBV multiples would have in unlocking NDB share value. Taking the rational assumption of increases in PBV multiples would be directly correlated with rising dividend payment levels, we have assumed a SLR10 extraordinary dividend would push up PBV to 1.3(x) and there onwards have incremental increases of 0.1X (per every SLR10 dividend) till 1.6(x) when the dividend payment per share reaches SLR40. Further such a capital repayment strategy would safeguard and increase shareholder wealth providing the opportunity to obtain higher returns. Currently the risk free rate is a near 18% whilst we believe the market risk premium to be around 11% and at a beta of 0.9, NDB shareholders' required ROE would be 26%. Therefore by returning the equity NDB provides its shareholders the opportunity to invest the proceeds at risk free rate, rather than allowing the bank to generate a mediocre return of only around 11% after tax. The following table illustrates the increase in ROE in line with rising dividend payments and the impact on shareholder wealth.

	Scenario 1	Scenario 2	Scenario 3	Scenario 4	Scenario 5	Scenario 6	Scenario 7	Scenario 8
Dividend options per share	0	10	20	30	40	50	60	70
Closing BVPS	142.75	132.75	122.75	112.75	102.75	92.75	82.75	72.75
Core CAR	23.2%	21.7%	20.3%	18.8%	17.4%	15.9%	14.5%	13.0%
EPS	18.6	17.7	16.7	15.8	14.8	13.9	13.0	14.0
ROE based on closing equity	13.0%	13.3%	13.6%	14.0%	14.4%	15.0%	15.7%	19.2%
Price based on PBV rising 10%, on SLR10 dividend payout	167.00	172.57	171.85	169.12	164.40	157.67	148.95	130.95
Extraordinary dividend per share	0.00	10.00	20.00	30.00	40.00	50.00	60.00	70.00
Net dividend available for shareholders	0.00	9.00	18.00	27.00	36.00	45.00	54.00	63.00
Total shareholder value per share (assumed PBV multiple to rise by 0.1(x), each additional SLR10 dividend payout and peak at 1.8(x))	167.00	181.57	189.85	196.12	200.40	202.67	202.95	193.95

So here is a modest proposal to Cinderella. Pay an extra-ordinary dividend of Rs.50 and you never have to be worried about your carriage turning into a pumpkin again.

But what about liquidity

We analysed the practicality of the scenario whilst attempting to unearth any hidden limitations for a potential extraordinary dividend. One such concern is whether the bank would be liquid consequent to such a payout. Since the Central Bank stipulated minimum liquidity level of 20% requires the bank to have liquid assets (namely; cash, treasury bills and trade bills etc.) amounting to the total average liabilities.

Any fears of the mandatory liquidity ratios constraining capital repayment, appears to be just an illusion. The liquidity requirements would only influence liquidity management and not the capital management. Furthermore in the recent past NDB share has been targeted by adventurous strategic investors seeking larger share-holdings, thereby somewhat narrowing the shareholder base. NDB has gone to court to prevent registration of their shares and appears to be in the unenviable position of fighting their own shareholders. The

much required change in NDB's capital management policies and increase in share price will deter such adventurers and encourage the broadening of the shareholder base. The Management can then get back to the business of Managing the Bank, for which they have shown an exemplary aptitude.

Can this actually happen?

Yes it can. But only if the august Gentlemen sitting on the Board of the Bank were to decide that indeed Shareholders well being did indeed matter to them.

In 1999, the writer was instrumental in persuading Trans-Asia Hotels to pay-out a combined 200% or so (as I recall) dividend compared to the traditional 20%-30% dividend the shareholders were used to. That Company had no growth options and the funds were tied-up in Treasury Bills. In that instance we had a wise Board who listened to that advice and did something extraordinary.

The share-price hardly ever looked back. Through rain and shine, and war and (almost) peace, the combined ex-dividend price together with the total dividend pay-out far exceeded the pre-extra-ordinary dividend share price. As a side benefit, we also discouraged a hostile group attempting to buy-out a strategic block and force a restructuring to their sole benefit. Pre-emptive action by the Board ensured that all of the shareholders benefitted – not only some.

The second example is more recent. A few years ago, Lanka Lubricants (Caltex) which was sitting on a large stockpile of cash, decided to pay what I recall to be around an 800% dividend. The price post dividend today is higher than the price that was paid per share before the dividend. The shareholders have more than doubled the value of their share. Again a wise, far-thinking Board.

Perhaps the Board and the Management of NDB should look carefully at these two examples.

Otherwise NDB despite its stellar performance will always remain a wall-flower. We would never-ever discover the true beauty of Cinderella, despite the heart of gold