Jammu Kashmir Bank

NSE Code: J&KBANK, BSE Code: 532209, ISIN Code: INE168A01041

3rd April 2018

CMP: 57.80

"Bank on unique advantages"

by

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Executive Summary

Idea being presented is a bank with the following unique characteristics:

- Oligopoly position with 60%+ market share in the state of Jammu & Kashmir (J&K).
- Translating into high NIM (Net Interest Margin) and high Return on Capital (RoA, RoE).
- Strong growth opportunity as state government looks to grow J&K economy.
- Suffering due to poor credit decisions of the past. However, most of the pain of poor asset quality and high provisions are already in the numbers.
- New CEO (started 1.5 years back) is keen to bring the bank to its past glory.
- Trading at .6x P/B and 1.1x P/Adj Book – excluding revaluation reserve – and presenting a good upside from here.

Oligopoly

Bank is unique among Indian banks in its dominance of geography:

- 63.1% of all deposit in J&K (Jammu & Kashmir state) is owned by Jammu Kashmir Bank (JKB).
- 64.8% of all credit in J&K is provided by JKB.

The above market share enables bank to:

- Reduce cost of deposit in J&K
- Enjoy good yield on advances in J&K
- Lower delinquency on advances in J&K

Business Model

Bank raises cheap deposits in J&K and provides advances to J&K. However, since there are limited avenues to give advances in J&K, bank also provides advances in the rest of India.

What went wrong?

Bank had poor underwriting in the rest of India. Rest of India book is primarily being lent to corporates and many of these corporates (in sectors like Metals, Textiles, Infrastructure) did very poorly.

In J&K book, bank was hit by natural and man-made calamity. This caused the restructured assets of the bank to rise and bank had to make high provisions.

Lastly, previous management didn't anticipate the problem and was slow to respond.

Where are we now?

Bank has taken a lot of provisions over the last 1.5 years. We think that most of the cost of poor underwriting is already in the numbers. Hence, we expect the provisions to start coming down next year.

Restructured assets in J&K should also come down as those advances come out of moratorium.

Lastly, at current price, there is a very good upside and very limited downside.

Basic Facts

Industry	Banking
Price (3rd Apr 2018)	**57.80 Rs/share**
Market Cap (INR/$ = 65)	**$495 MM**
Valuation (excluding revaluation reserve)	**Price/Book: 0.59x** **Price/Adjusted Book: 1.07x**
Capital Adequacy Ratio (CAR)	**Basel III: 10.9%** **Tier 1: 8.5%** **Tier 2: 2.4%**
Quality of Assets	**Gross NPA: 10.1%** **Net NPA: 4.3%** **Restructured Assets: 9.2%**
Ownership	**J&K State: 59.23%** **Foreign Portfolio Investor (FPI): 16.04%**
Management – CEO	**Government appointed** (Has been at JKB for 20 years)
Liquidity (Listed on NSE & BSE)	**$800K/day**

Stock Price (2018/04/03 – 3rd April 2018)

Recent price fall has made this stock an interesting candidate for the portfolio.

Company Background

Jammu & Kashmir Bank (JKB) was incorporated in 1938 to handle unique challenges of the state of Jammu and Kashmir (J&K). Today it functions as a universal bank in J&K and as a specialised bank in the rest of the country. It is also the only private sector bank designated as RBI's agent for banking business, and carries out the banking business of the Central Government, besides collecting central taxes for CBDT.

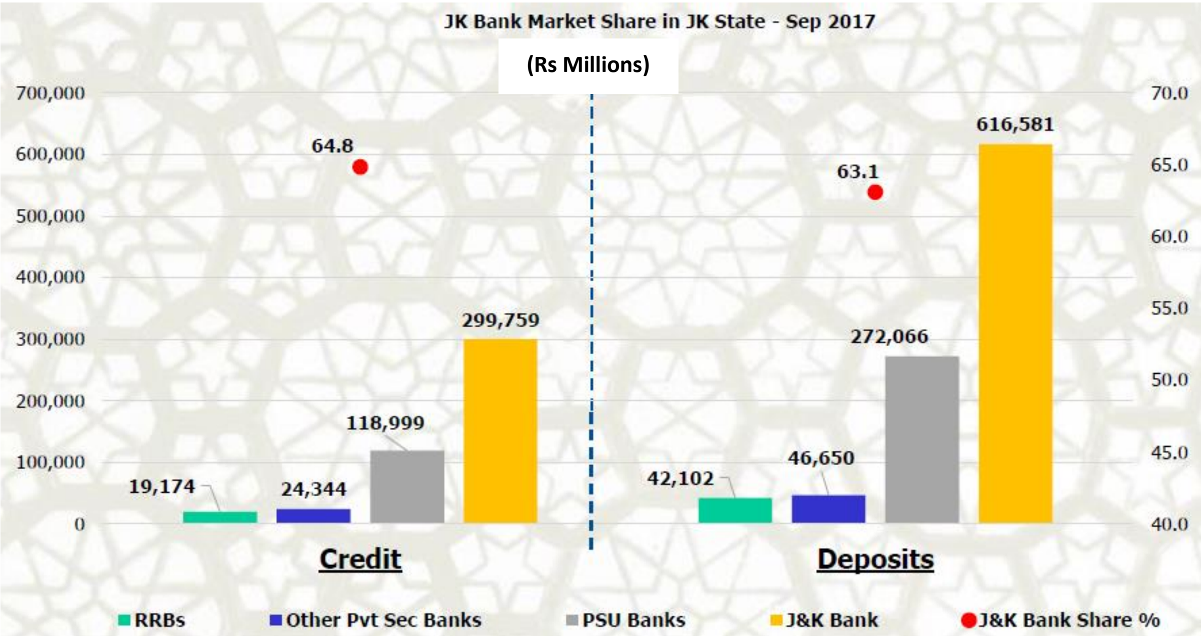
Business Model

JKB has a fairly simple business model:

- Raise cheap deposits in the state of J&K
- Extend credit in state of J&K. Credit that cannot be absorbed in J&K is lent out in Rest of India (RoI)

JKB has an oligopoly position in the state of J&K. JKB has attained this position in J&K because it has been closely tied to the growth of state economy for the last 80 years. The extent of its dominance in J&K can be gauged by the following facts:

- 63.1% of all bank deposit in J&K is owned by JKB
- 64.8% of all bank credit in J&K is given by JKB



This dominating market share of banking services in J&K provides bank a few unique advantages:

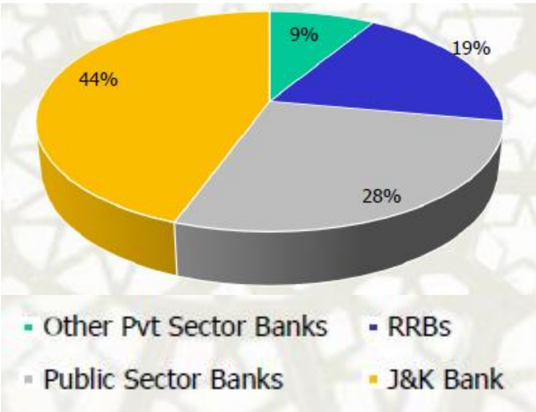
- Low cost of deposits in J&K
- Good yield on advances in J&K
- Lower delinquency on advances in J&K

Deposits

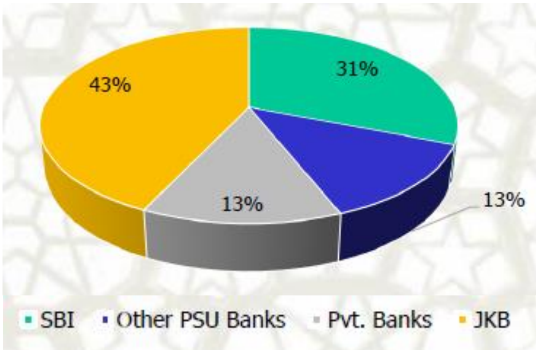
Bank enjoys low cost of deposits due to many reasons:

- **Sole banker to the state of J&K government**: All banking transactions for state government of J&K are done through JKB. Below examples explain why these lead to lower cost of deposits:
    - Monthly salaries of J&K government employees are given through bank accounts at JKB. Since these accounts will be used for day to day expenses, most account holders leave deposits in Current & Savings account thereby reducing the cost of deposits.
    - Any incentive and subsidy schemes are conducted through JKB producing similar impact on cost of deposits as above.
- **Extensive geographical presence in J&K**: JKB has the leading branch franchise in J&K. This enables customers to bank from anywhere in J&K. JKB takes full advantage of the networking effect from its dominating presence.

Branch Network in J&K state
(as of 30th Sept 2017)



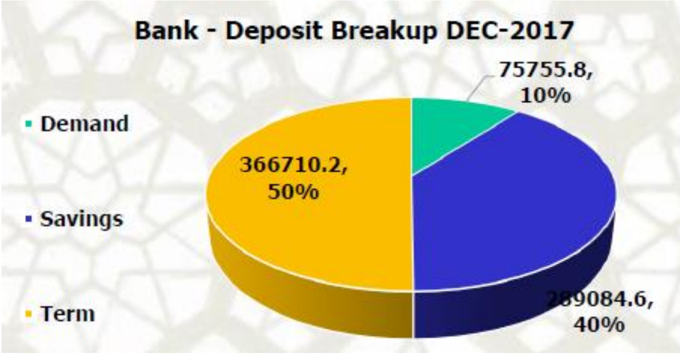
ATM Network in J&K state
(as of 30th Sept 2017)

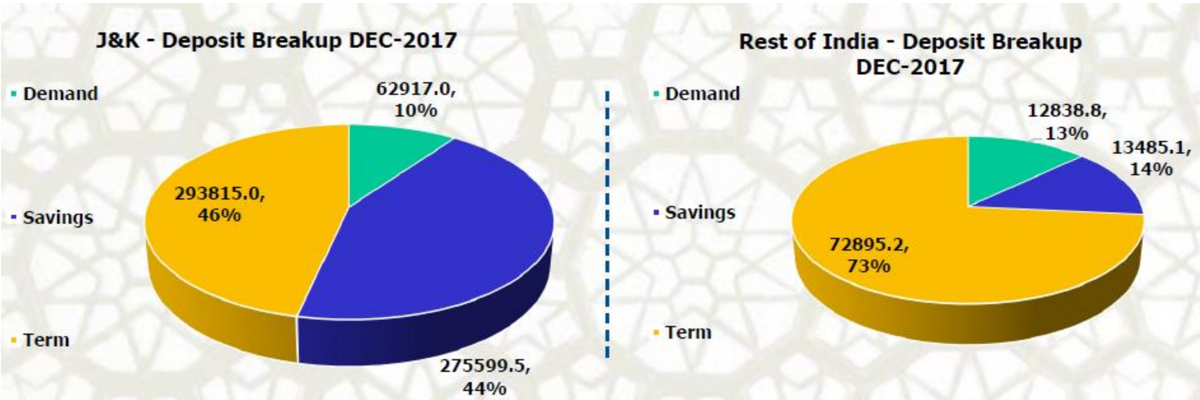


- **Bank is deeply embedded in the psyche of the society**: J&K populace has gone through a lot of turmoil over the last many decades. JKB is one of the few banks that have been with them through their trials and tribulations. This enables customers to have a strong emotional attachment with the bank. Hence, they want to do their banking at JKB.

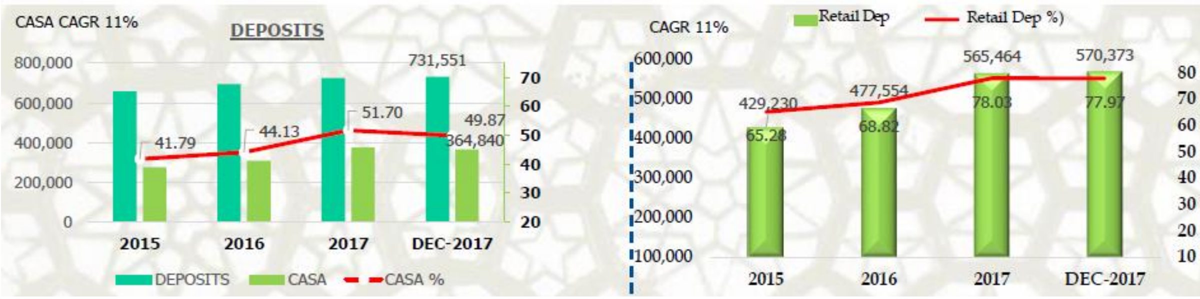
Distribution of Deposits

- 86% of all deposits of the bank are contributed by J&K state.
- J&K contributes 93% of overall CASA (Current Account and Savings Account) deposits of the Bank.
- Bank's CASA ratio is 50% thus enabling bank to reduce its cost of deposit.





- Bank's CASA ratio in J&K state is an impressive 54%.
- This offsets the 27% CASA ratio in the Rest of India.
- Bank has worked to improve its CASA ratio over the last few years.
- In addition it has continued to improve its Retail deposit as a % of total deposit.
- Both of the above factors have helped them reduce the cost of deposit.

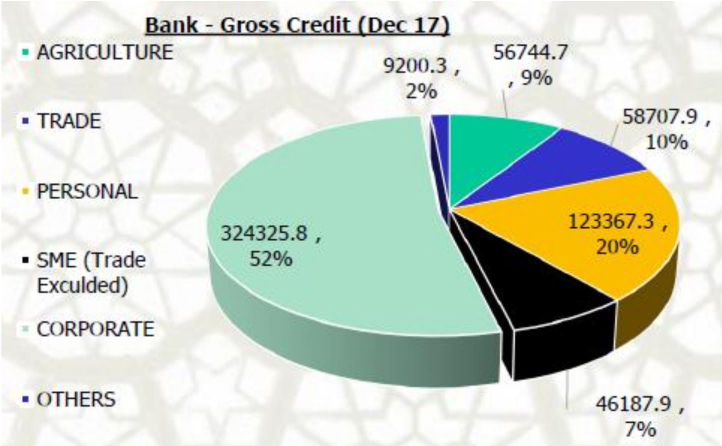


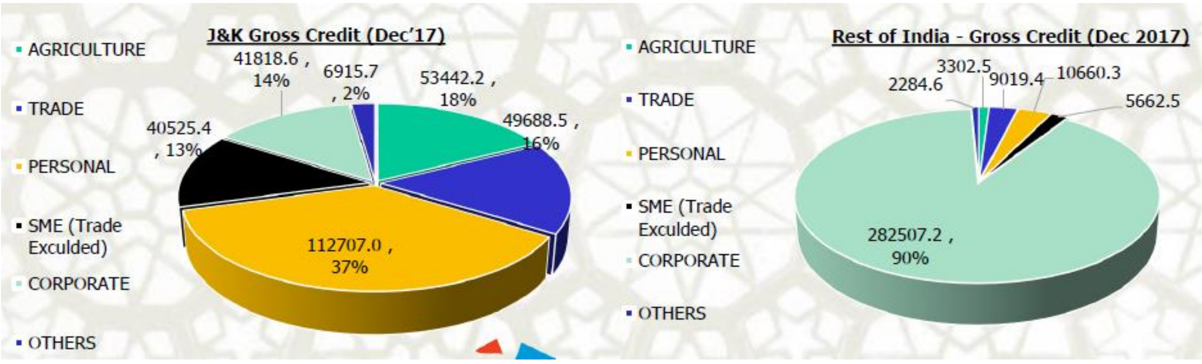
Advances

Bank endeavors to provide advances in J&K to the extent possible. As of Dec 2017, 48% of its advances are in J&K state and 52% in Rest of India. Bank has lower percentage of advances in J&K due to the following reasons:

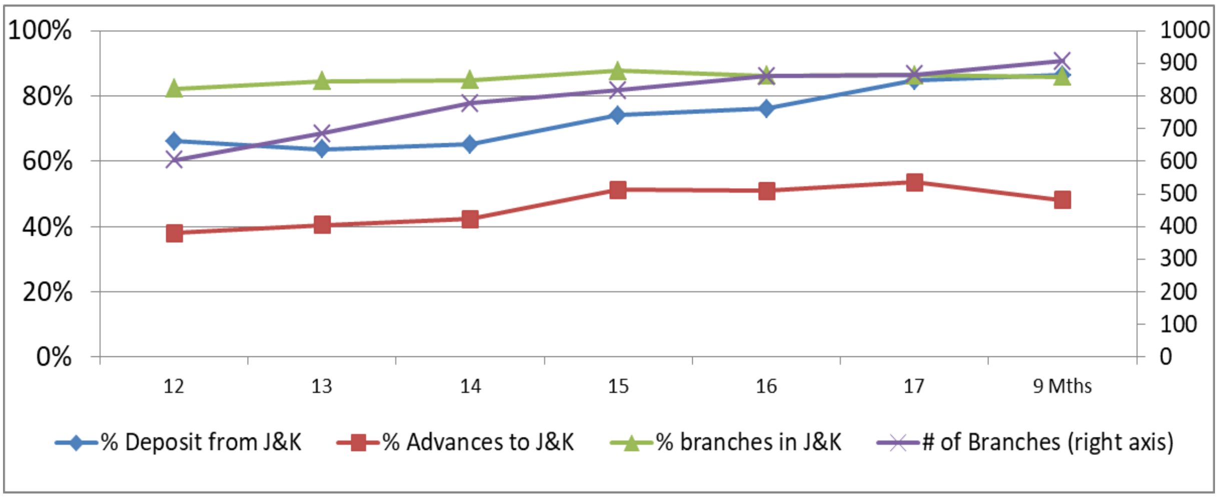
- J&K state has limited ability to absorb loan as economy is primarily service and agriculture oriented. These activities don't need too much of credit.

- While some corporates are setting up base in the state, the footprint of these corporates is quite small.



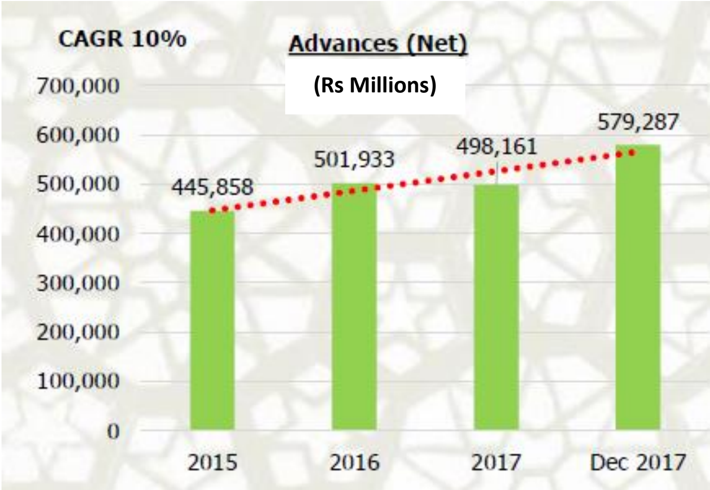


Bank's gives credit primarily to Agriculture, Trade, SME (Small & Medium Enterprises) and Personal sectors in J&K while in Rest of India it gives credit primarily to corporates. This is because bank has limited branch infrastructure in the Rest of India. The same can be seen through the below chart.



In the recent past, bank credit growth has been muted due to a few reasons:

- Slowdown in economic growth in J&K and Rest of India
- Bank ran into asset quality issues and focus was on resolving them



Slowdown in economic growth in J&K

J&K state was hurt by perfect storm in the last few years:

- State had massive floods in FY 15. Thus GSDP (Gross State Domestic Product) of J&K registered a growth rate of -0.96% in FY 15. In addition, a lot of assets were destroyed in these floods forcing JKB to restructure the loans given in the state.
- State had civilian unrest in FY 17. This again impacted most of the businesses in Kashmir region reducing the growth rate of the economy. Besides, many of the loans given by JKB also became unserviceable as the economy came to a standstill. Bank has since restructured these loans.

Slowdown in economic growth in Rest of India

In the Rest of India, certain sectors of the economy have been under pressure:

- Basic metals especially Iron & steel: These commodities were getting dumped into India earlier. Thus many players in these sectors were unable to service their obligations.
- Infrastructure: India has faced intermittent issues around land acquisition, collection of tolls, environmental clearances, etc. which has impacted many infra players.
- Power: India has been perennially a power deficit country. Government incentivized players to come in and setup power plants. Unfortunately, it was overdone and now many of these plants are not viable.

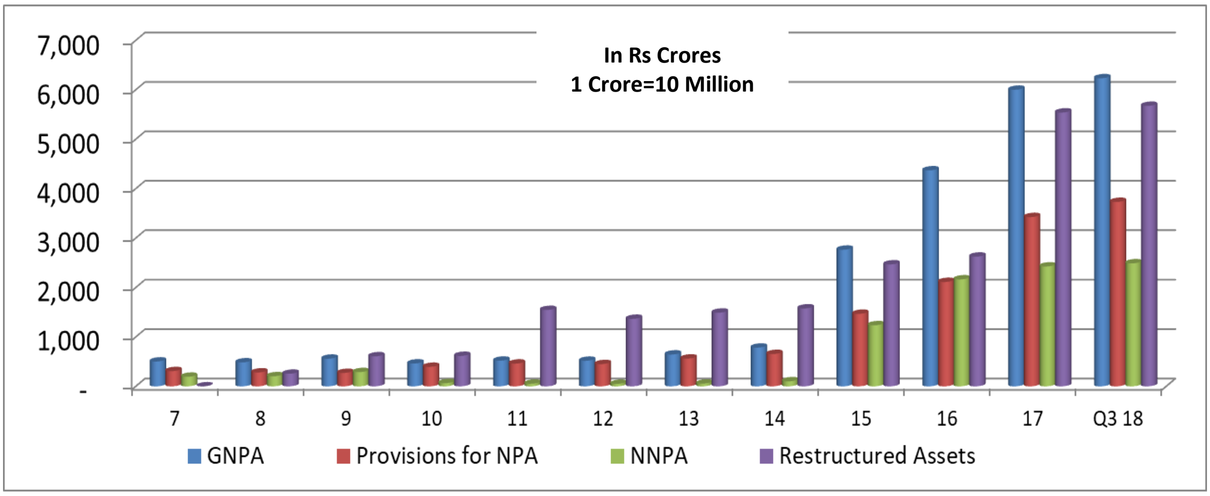
Apart from sector specific issues, India is going through a big transition. Many of the decade old rules are being replaced to improve governance and agility of the economy. Government is inducing economy to move to be more digitally oriented. These actions have hurt economy in the short-term though they should position economy to do very well over the long-term.

JKB was impacted far more because of the poor underwriting quality of its book in Rest of India.

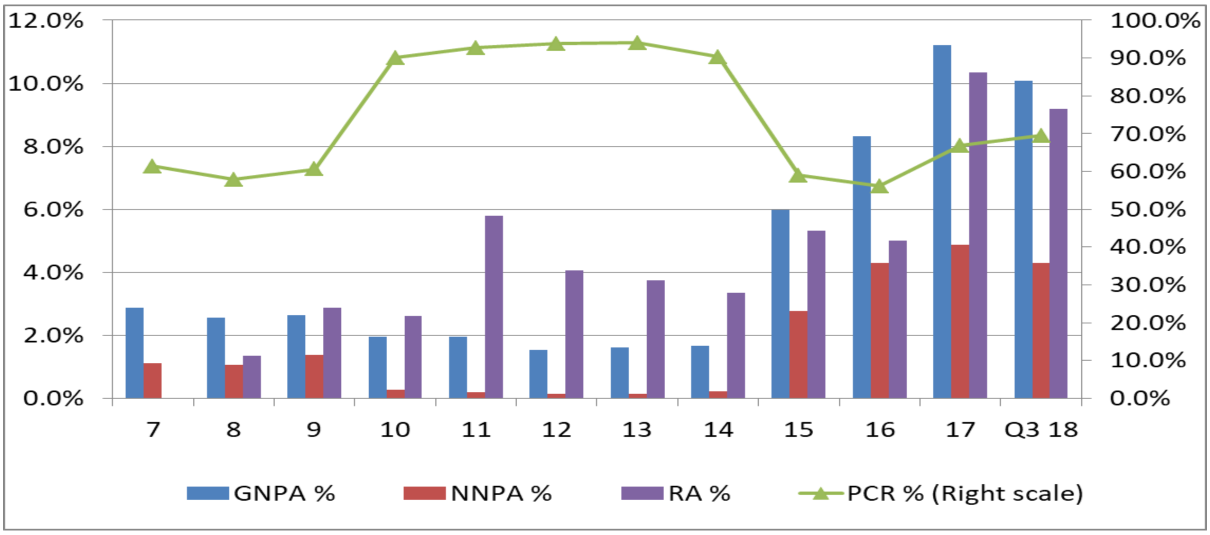
Asset Quality

Bank's asset quality suffered mightily as certain sections of the economy weakened and bank realized that its underwriting capability had not kept up with time. Result was:

- Gross NPA (GNPA) and Net NPA (NNPA) jumped sharply in the last few years due to stress in Rest of India book
- Restructured Assets (RA) jumped sharply due to stress in J&K book driven by floods in FY 15 and civilian unrest in FY 17.

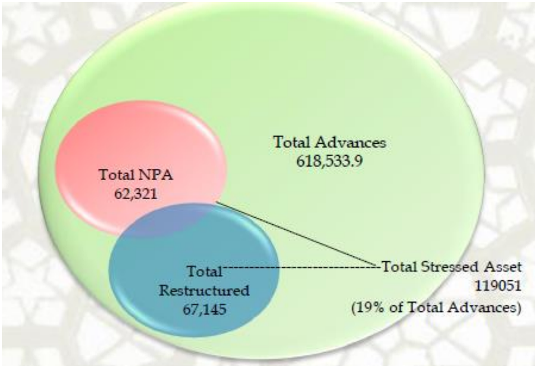


Looking at these stressed loans as a % of advances gives us a better sense of what % of the book is stressed.



- GNPA has increased from 1.7% in FY 14 to 10.1% as of Dec, 2017.
- NNPA has increased from 0.2% in FY 14 to 4.3% as of Dec, 2017.
- RA has increased from 3.3% in FY 14 to 9.2% as of Dec, 2017.

Since there is some overlap between GNPA and RA, total stressed assets is 19% of the advances.

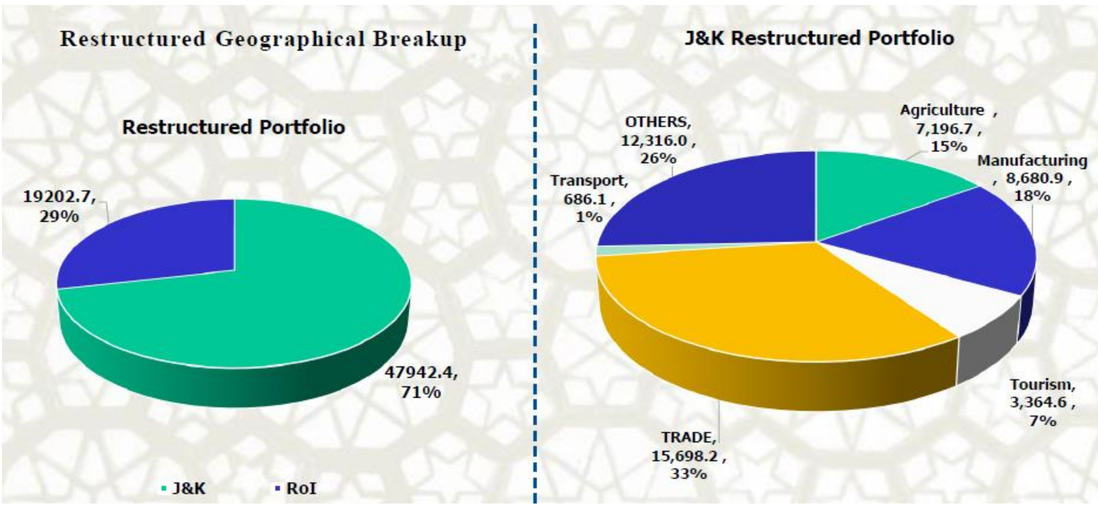


Non-Performing Assets

- Rest of India accounts for 85% of the total NPAs of the bank.
- Corporate book accounts for 88% of total NPAs.
- GNPA in J&K is 3.1% as against 16.8% in Rest of India.
- 57% of the banks' GNPA are currently going through the bankruptcy (NCLT) process.

Restructured Assets

- 71% of the RA of the bank is in J&K.
- Restructured assets in J&K are well diversified across different segments.
- As the moratorium period has ended, we expect the bulk of the RA from J&K will become standard over the next year.
- For RA in the Rest of India book, they are likely to experience deterioration and become NPA before becoming resolved. Our expectation is that bulk of these will get resolved in the next two years.



Financials

Balance Sheet

Year / Rs Crores	7	8	9	10	11	12	13	14	15	16	17	Q3 18
SOURCES OF FUNDS	28,645	32,755	37,688	42,541	50,498	60,264	71,734	78,612	76,064	80,253	82,012	85,065
Share Capital	48	48	48	48	48	48	48	48	48	48	52	56
Revaluation Reserve										-	635	635
Reserves & Surplus	1,960	2,260	2,574	2,962	3,431	4,045	4,816	5,674	6,060	6,372	4,986	5,431
Shareholder's Funds / Equity	2,008	2,308	2,622	3,010	3,479	4,093	4,864	5,722	6,108	6,420	5,673	6,122
Liabilities	26,637	30,447	35,066	39,531	47,019	56,171	66,870	72,890	69,956	73,833	76,339	78,943
Deposits	25,194	28,593	32,999	37,232	44,670	53,342	64,212	69,328	65,736	69,379	72,459	73,155
Demand Deposits	3,479	4,295	4,620	4,887	5,354	5,734	6,401	6,839	6,546	7,211	9,561	7,576
Saving Bank Deposits	5,849	6,903	7,953	10,261	12,727	15,981	18,789	20,243	20,930	23,408	27,898	28,908
Term Deposits	15,866	17,396	20,425	22,084	26,589	31,627	39,022	42,246	38,260	38,759	35,000	36,671
CASA%	37%	39%	38%	41%	40%	41%	39%	39%	42%	44%	52%	50%
Borrowings	620	752	997	1,100	1,100	1,241	1,075	1,765	2,340	2,240	1,276	4,005
Other Liability & Provisions	823	1,102	1,070	1,199	1,249	1,588	1,583	1,797	1,880	2,214	2,604	1,783
APPLICATION OF FUNDS	28,646	32,756	37,687	42,542	50,504	60,263	71,734	78,613	76,064	80,253	82,013	85,065
Non-Current Assets	560	678	751	919	1,070	1,113	1,399	1,827	4,984	6,522	5,533	5,321
Fixed Asset	183	192	199	204	394	420	457	535	689	764	1,544	1,587
Other Assets	377	486	552	715	676	693	942	1,292	4,295	5,758	3,989	3,734
Current Assets	28,086	32,078	36,936	41,623	49,434	59,150	70,335	76,786	71,080	73,731	76,480	79,744
Cash and Balance with RBI	1,855	3,220	2,303	2,745	2,975	2,784	2,695	3,046	2,373	3,127	3,591	3,090
Balance with Banks	1,759	1,217	2,972	1,870	574	1,670	2,709	1,170	1,362	77	1,802	229
Investments	7,392	8,758	10,731	13,951	19,691	21,619	25,731	26,185	22,759	20,334	21,271	18,496
Advances	17,080	18,883	20,930	23,057	26,194	33,077	39,200	46,385	44,586	50,193	49,816	57,929

Key observations from the balance sheet:

- Bank didn't dilute its capital Between FY 07 and FY 16. In this period, total assets of the bank almost tripled. Thus, the bank was able to self-fund its capital need through its profits.
- Bank has diluted its share capital by 15% since FY 16 given challenges with asset quality.
- CASA % of the bank went from 37% in FY 07 to 50% in FY 18. Higher CASA % will allow bank to reduce the cost of deposit.
- Total assets of the bank grew at 10.7% over the last 11 years and 2.1% in the last 4 years.
- Advances grew at 12% over the last 11 years and 6.1% in the last 4 years.

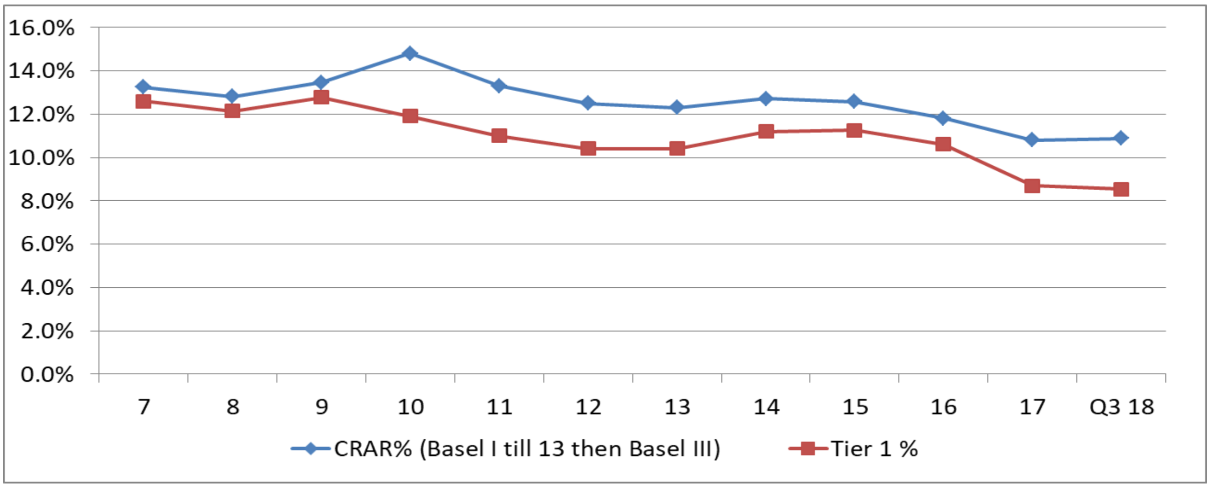
Profit & Loss

Year / Rs Crore	7	8	9	10	11	12	13	14	15	16	17	9 Mths
Total Income	2,059	2,679	3,233	3,473	4,078	5,171	6,622	7,160	7,660	7,353	7,183	5,352
Interest Earned	1,899	2,434	2,972	3,057	3,713	4,836	6,137	6,767	7,061	6,844	6,686	5,029
Other Income	160	245	261	416	365	335	485	393	599	509	497	323
Interest Expended	1,131	1,624	1,988	1,937	2,169	2,997	3,820	4,082	4,410	4,132	4,173	2,815
Net Interest Income	768	810	984	1,120	1,544	1,839	2,317	2,685	2,651	2,712	2,513	2,214
Optg Expense/NII	48%	50%	48%	52%	49%	44%	43%	44%	53%	57%	68%	64%
Operating Expenses	372	404	471	577	759	804	992	1,181	1,416	1,554	1,716	1,422
Employee Expenses	220	226	279	367	524	523	654	747	894	1,025	1,126	939
PPOP	556	651	774	959	1,150	1,370	1,810	1,897	1,834	1,667	1,294	1,115
PPOP % of Income	27%	24%	24%	28%	28%	26%	27%	26%	24%	23%	18%	21%
Provisions	141	76	145	166	215	169	285	147	1,015	976	2,800	1,009
PBT	415	575	629	793	935	1,201	1,525	1,750	819	691	(1,506)	106
Provision for Tax	140	216	220	280	319	398	471	570	312	276	126	(69)
Tax %	34%	38%	35%	35%	34%	33%	31%	33%	38%	40%	-8%	-65%
Profit After Tax	275	359	409	513	616	803	1,054	1,180	507	415	(1,632)	175
Diluted EPS (Rs)	5.7	7.4	8.4	10.6	12.7	16.6	21.7	24.3	10.5	8.6	(31.3)	3.1
DPS	1.2	1.6	1.7	2.2	2.6	3.4	5.0	5.0	2.1	1.8	-	-
ROE	14%	16%	16%	17%	18%	20%	22%	21%	8%	6%	-29%	3%
ROA	1.0%	1.1%	1.1%	1.2%	1.2%	1.3%	1.5%	1.5%	0.7%	0.5%	-3.3%	0.3%
BVPS	41.4	47.6	54.1	62.1	71.7	84.4	100.3	118.0	126.0	132.4	96.6	98.5
Adjusted BVPS	34.3	37.4	43.4	48.1	60.8	70.7	83.4	99.2	100.5	87.8	50.1	53.8

Key observations from Profit & Loss include:

- Total Income, Net Interest Income and PPOP (Pre-Provision Operating Profit) grew quite fast till FY 14. Since then all of these metrics have been range bound or fallen.
- Bank reduced its interest expense in FY 18. This has enabled it to produce better Net Interest Income in the 9 months of FY 18 as compared to 9 months in FY 17.
- Provision cost jumped quite a bit from FY 15 and has continued at a very high level since FY 15 to keep up with the provisioning required for worsening asset quality. Provision as a % of PPOP has also jumped up a lot.
- ROE and ROA used to trend between 15-20% and 1-1.5% respectively pre FY 14. These return on capital metrics have also fallen a lot.

Capital adequacy



A few salient points around Capital adequacy:

- Bank used to have good capital adequacy till FY 15. As asset quality worsened, capital adequacy has come down a lot.
- Bank raised capital of 532Cr in FY 17 and 18 from J&K state government in the following tranches:
    - 250Cr at 68.39/share in FY 17
    - 282Cr at 79.38/share in FY 18
- Even after raising capital from J&K state government, JKB's current capital adequacy is close to the minimum requirements laid out by RBI (Indian central bank).
- Bank is actively looking to raise additional equity capital through QIP or rights issue. In our valuation of the bank, we have assumed that bank will further dilute its existing shareholder by 25%. 25% dilution will allow bank to raise between 500-900Cr of Tier 1 Equity capital based on the price that they can get.
- Bank is likely to raise further capital through Tier 1 and Tier 2 bonds.
- We believe that above capital raise will provide sufficient capital to the bank for the next few years. Subsequently, increase in profitability should provide additional capital for growth.

Our Thesis

Our thesis rests on the following pillars:

- Bulk of the asset quality woes are already in the numbers. Asset quality starts improving from FY 19.
- Earnings of the bank come back strongly for the following reasons:
  - As asset quality improves, provision cost will come down.
  - As asset quality improves, more assets will be earning interest for the bank.
  - Bank is looking to better leverage its franchise in J&K.
- New CEO of JKB is a driven individual and eager to get bank back to its past glory.

Improvement in Asset Quality

Non-Performing Assets

- 57% of the banks' GNPA are currently going through the bankruptcy (NCLT) process. This process came into existence after India adopted new bankruptcy code (IBC) in FY 17.
- Bankruptcy is a time bound process. Either the stressed assets are bought out by interested parties in this time window, or these assets automatically go for liquidation. We expect clarity on these stressed assets in the next few quarters.
- Early indications are that some of the bigger stressed accounts of JKB (like Bhushan Steel and Essar Steel) are having many suitors (both international and domestic). Hence we expect very good recovery in both of these accounts as the bankruptcy process is completed.
- JKB has provided 47.8% on these NCLT accounts. Hence, only if recovery is below 52% in the aggregate, will bank have to provide additional provisions. We expect that on an aggregate basis current provisions should be sufficient.
- Lastly, and more importantly, there is a gradual change in the attitude of promoters towards loans from banks. In the past many promoters of the companies used bank loans as an option. If the company did well, promoter would get the upside. If the company didn't do well, it was the bank problem. However, with the new bankruptcy code, for the first time there is a fear in the mind of these promoters they may lose the company. Hence, they are being more diligent with their bank loans.

Restructured Assets

- 71% of the RA of the bank is in J&K. These RA were under moratorium (where neither loan nor the interest was collected) till Dec 2017.
- Bank is now starting to collect interest on these RA.
- J&K state government has incentivized the borrowers (to pay interest and return the loan) by shouldering 1/3rd of the interest cost.
- Given that JKB has a dominant presence in J&K state, most of the borrowers want to be in the good books of JKB. Hence, they will try their best to avoid defaulting.
- SARFAESI act has been implemented in J&K state (earlier it was only implemented in Rest of India but not J&K). This gives bank more power to collect their dues from the borrowers.

- J&K state economy is picking up in FY 18 and should enable the borrowers to have more income.
- With recent guidance by RBI, there is a risk that non J&K RA could become NPA sooner. We expect that provision cost for this stress will be met by the interest income from RA in J&K book.

Overall

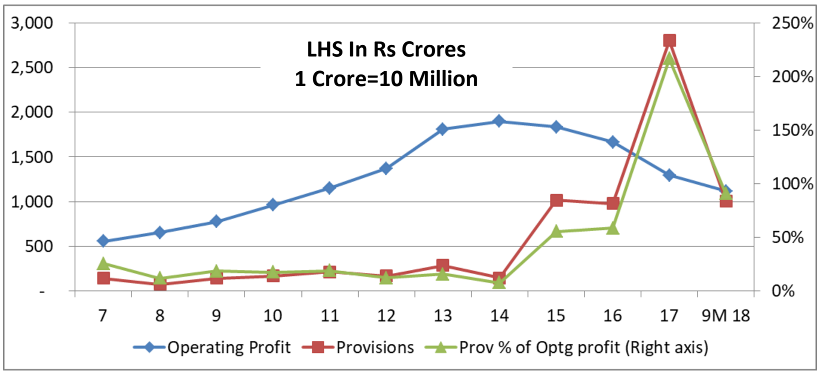
- We expect improvement in NPA as NCLT accounts goes through bankruptcy.
- High PCR (Provision Coverage Ratio) of 70% should give bank buffer from new stresses on asset quality.
- Interest income on RA should be able to offset any provision required for deterioration of these assets into NPA
- Bank focus on recovery, by creating a separate vertical, will keep stressed assets in check.
- New loans in Rest of India book are being made to PSU (Public Sector Unit) – owned by government – and high quality borrowers.

Improvement in Earnings

Lower Provision cost

Bank had to make a high amount of provisions to keep up with the asset quality issues in the last few years (as shown in the graph):

- Since FY 15 almost 100% of operating profits has gone to provisions. In FY 17, bank provided >200% of operating profits for provisions.
- Prior to FY 15, bank's provision cost was around 20% of operating profits.



As quality of asset improves, we expect provision cost will gradually come down to pre FY 15 level in the next few years. This will enable profitability to jump significantly.

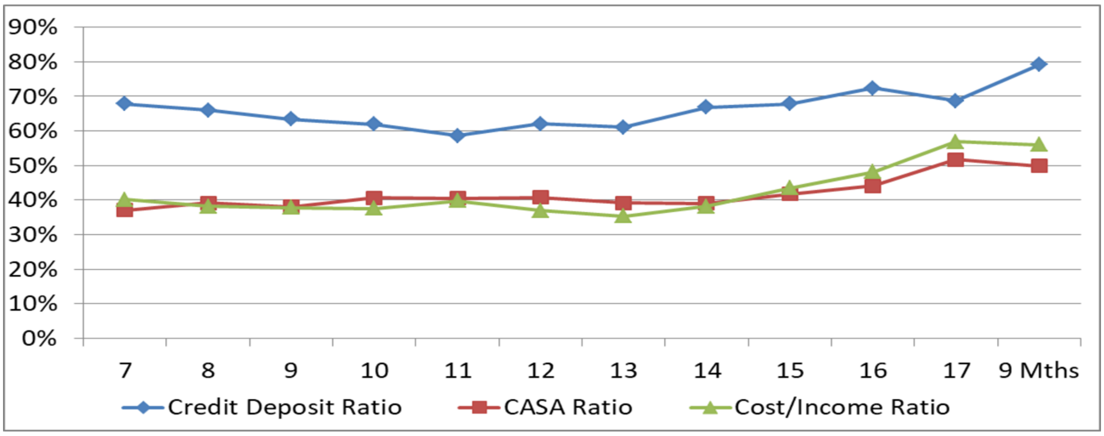
Higher Operating Profit

Previous graph also illustrates how the operating profit of the bank has fallen in the last few years. Operating profit has fallen because:

- More of the bank assets have become non-performing. Bank is not earning any interest on most of these non-performing assets.
- More of the bank assets have become restructured assets (RA). Bank had provided a moratorium on these RA which ended only recently.

We expect operating profit to start improving gradually as both NPA and RA come down and more of bank’s loan book becomes standard.

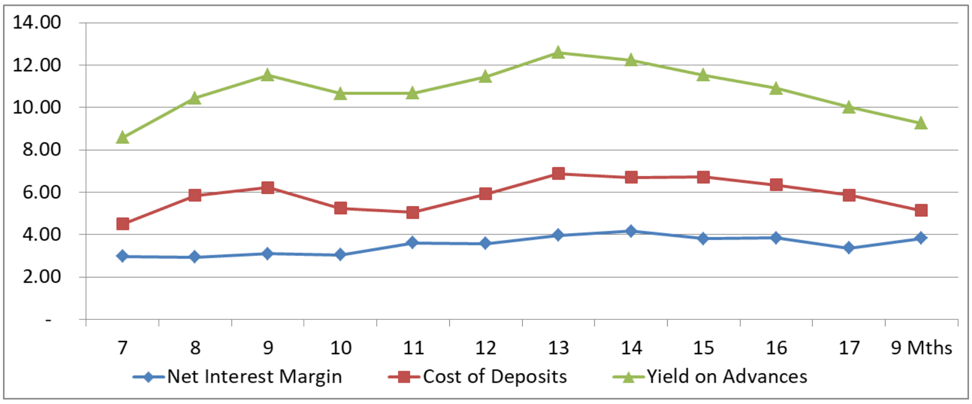
Lastly, bank is looking at ways to improve earnings by improving Credit-Deposit ratio, CASA ratio and Cost/Income ratio. It has shown good progress in some of these areas.



Leverage J&K franchise

As we discussed so far, bank has a unique franchise in J&K with very high market share. Bank is looking to build on its strength in J&K through:

- Increase the coverage of branches in J&K to unbanked areas.
- These branches tend to attract higher CASA deposits which are inherently low cost.
- Bank is also looking to lend more in J&K as it provides them better yield on advances.
- As bank executes on leveraging J&K more, we expect NIMs to continue to improve – NIM in J&K is around 6% vs 4% in aggregate.
- Higher NIMs will translate into higher returns on capital (ROA, ROE).
- We are starting to see early signs of how this strategy is working as NIMs come back in FY 18.



Valuation

Before we value the bank, it is important to list out our key assumptions

Assumptions

- Bank growth agenda will increasingly be driven by expansion in J&K state given the inherent advantages that it enjoys there:
    - Limited competition
    - Better NIMs
    - Better ROA/ROE
- Headwinds of high provisions will reduce:
    - Bank has made high provisions in FY 17 and FY 18. These provisions should give them adequate buffer.
    - As NPA go through NCLT, some of these stressed assets will get resolved. Thus, asset quality will improve.
    - As RA come out of moratorium, interest earnings from these assets will be more than sufficient to offset any deterioration in quality
- Dilution
    - Bank is looking to raise additional capital given it is close to regulatory minimum.
    - We estimate equity dilution of up to 25% should give them enough capital for the foreseeable future.
    - Earnings should provide additional capital for growth.
- Growth rates of total assets will remain muted and we have assumed lower growth rate than was achieved in the last decade. Main reason for this assumption is bank's continuous focus on recovery of stressed assets.
- Profitability (as measured by ROA) will improve but will not reach its peak of FY 13 and 14.
- Being conservative we value the bank at 10x earnings

Earnings Grid

Based on the assumptions mentioned above, we create a valuation grid with the following considerations:

- Asset Growth: This is the expected grow in assets between Dec 2017 and end of March 2021 (end of FY 2021). For our grid we assume that assets grow at the rate of 6%, 9% and 12%.
- ROA (Return on Assets): This is the expected return that bank can obtain on its assets in FY 2021. Being conservative, we assume ROA to be 0.5%, 0.9% and 1.3%.
- Based on the Asset Growth and ROA, we then derive the expected PAT of the bank in FY 21. Applying a PE multiple of 10x we then derive the market value.
- Lastly, we derive the expected CAGR (Compounded Annual Growth Rate) on this investment. For deriving CAGR, we take the current market value of the bank and assume that our equity will be diluted by 25%. We then derive what should be our expected CAGR that will give us the future expected value of the bank from the current market value.

Asset Growth → / ROA ↓	6%	9%	12%
0.5%	PAT=514Cr MV=5,140Cr CAGR=7.8%	PAT=563Cr MV=5,630Cr CAGR=10.9%	PAT=615Cr MV=6,150Cr CAGR=13.9%
0.9%	PAT=925Cr MV=9,250Cr CAGR=29.2%	**PAT=1,013Cr MV=10,130Cr CAGR=32.9%**	PAT=1,106Cr MV=11,060Cr CAGR=36.5%
1.3%	PAT=1,336Cr MV=13,360Cr CAGR=44.7%	PAT=1,463Cr MV=14,630Cr CAGR=48.8%	PAT=1,598Cr MV=15,980Cr CAGR=52.9%

Expected Returns

- Assuming that Asset Growth is 9% and ROA is 0.9%, we expect CAGR on our investments to be 31.1% between now and end of June 2021. This should take the value of the stock from the current 57.8/sh to 145/sh in the next 3.25 years.
- In our mind, Asset growth of 9% over the next 3.25 years is quite reasonable for the following reasons:
  - Asset growth was 10.6% in the last 10.75 years.
  - Asset growth was 15.5% between FY 07 and FY 14.
  - Asset growth was 2.1% between FY 14 and Q3 FY 18.

  We think that asset growth has been depressed in the recent past because bank was focused on resolving asset quality issues. As these asset quality issues are addressed, bank will be able to grow its assets. Besides, given the low growth in the recent past, there is a lot of pent up demand from the borrowers which the bank can tap into.

- In our mind, ROA of 0.9% over the next 3.25 years is quite reasonable because:
  - ROA was between 1 – 1.5% between FY 05 and FY 14.
  - ROA has fallen dramatically since FY 15 due to high cost of provisions.
  - We expect ROA will start coming back and should get close to 1% by FY 21.

Downside Protection

- Even in a case where bank grows assets at a much slower 6% and ROA is only 0.5%, we don't lose money. Instead we get a CAGR of 7.8%.
- We think that the downside we have laid out is quite conservative. Barring unexpected geopolitical risk like war/skirmishes with a neighboring country this downside shouldn't be breached. In the case of negative geopolitical situation we will have a lot more to worry about than just this investment!

Upside

- We do think that there is an upside to the expected return that we have laid out. However, we would rather be pleasantly surprised rather than think too much about it.

Alternative Valuation

- We can alternatively value the bank using the Book Value approach.
- Current Book Value of the bank (excluding revaluation reserve which is just an accounting entry) is 98.5 Rs/share.
- Book value of the bank grew at 19.3% between FY 07 and FY 14.
- Assuming book value grows at 14% between Q3 FY 18 and FY 21. This gives us a book value of 150.8 Rs/share in FY 21.
- However, the big unknown is the price at which bank will dilute 25% of the equity (what we have outlined in our assumption).
- Assuming that they dilute 25% of the equity at around 70 Rs/share (lower of the price at which they diluted to state government and a premium of 21% from the current share price), Book value of the bank will fall to 92.8 Rs/sh. Assuming a growth rate of 14% on this book value gives us an ending value of 142 Rs/share.
- Valuing the bank at 1x Price / Book Value gives us around 142 Rs/share.

Overall

Having looked at the valuation through both earnings and book value method, we feel quite comfortable that bank has a very decent upside from the current price. However, we expect that this upside will take a few years and there will be volatility along the way.

Variant View

In this section we outline some of the reasons why Mr. Market is underpricing this bank. We then provide our variant view of the same. This section has been put in the thesis to follow Charlie Munger's dictum, *"I never allow myself to have an opinion on anything that I don't know the other side's argument better than they do."*

While we don't claim that we know the other side of the argument better the next person, we sure as hell do try.

Mr Market View	Our Variant view
Bank has poor asset quality and its earnings in the recent past give little confidence.	Bank definitely has high GNPA, NNPA and RA. However, we expect that asset quality should start improving as we have discussed. These asset quality improvements are not in the numbers and hence bank trades at the price that it does. Earnings have been hurt as bank was trying to get to adequate amount of provisions. With sufficient provisions, we expect bank earnings should start improving and the value of the franchise will start becoming apparent.
Government owned banks (GOB) have poor risk management and hence very risky.	We agree that risk management and underwriting standards were lax at JKB. However, incremental lending from bank is of much higher quality. In the interim, bank is working to improve its credit processes. In addition, while JKB is owned by state government it is classified

	and works like a private sector bank (as reflected by its past results). Given that JKB is critical to J&K state, JKB should recover and do well over time.
Government owned banks (GOB) have destroyed a lot of shareholder value. It is unlikely to change.	This is a classic case of cause and effect being mixed up. Past destruction in value was caused due to high valuation of GOB relative to their private peers. Now no price is low enough for GOB. A good way to assess the antipathy of investors towards GOB is to ask them if they own any GOB. They will behave as if we have questioned their intelligence! Hence, this is the right time to start looking at GOB selectively! With 60%+ market share in J&K state, JKB is uniquely positioned.
There are too many unknowns. It is difficult to price the bank.	In the short-term the list of unknowns is long. We are not sure how quickly NCLT accounts get resolved, whether RA start paying interest and to what extent, at what price capital will be raised on and so on. However, as we extend our horizon a few years out, many of these unknowns become less important. Besides, bank has been priced as if there is no end in sight for these issues. We think that these issues will get resolved in the next 1-2 years and bank stock price will reflect the resolution. We take inspiration from Warren Buffett's quote, *"A second argument is made that there are just too many question marks about the near future; wouldn't it be better to wait until things clear up a bit? You know the prose: "Maintain buying reserves until current uncertainties are resolved," etc. Before reaching for that crutch, face up to two unpleasant facts: The future is never clear; you pay a very high price in the stock market for a cheery consensus. Uncertainty actually is the friend of the buyer of long-term values."*

Trade Feasibility / Idea Practicality

Bank's market capitalization is $495 Million. Bank is listed on both NSE (National Stock Exchange) and BSE (Bombay Stock Exchange). Additional details are provided in the table below:

Attribute	NSE	BSE
Average Daily Volume (Shares)	515,371 shares	67,039 shares
Average Daily Value Traded (in $ Thousands)	548.9	69.5

Given the liquidity, one should be able to build a few $Million position over a few weeks without disturbing the price. Our view is that best returns will come from this idea if investor is thinking long-term.

Risks with the thesis

Some of the key risks with the thesis include:

J&K State Economy

Our thesis is based on the fact that bank focuses more on J&K economy to grow its profitability and return on capital. However, if J&K economy were to worsen for any reason it can impact the growth prospect and quality of assets for the bank.

Government ownership

J&K state government owns 59% of the bank. In the past, state government has not interfered with the affairs of the bank. If this hands-off approach were to change it can impact the performance of the bank negatively.

Dilution

We assume that bank will dilute its equity by 25% to raise capital. If bank has to dilute more of its equity capital due to lower price, it will reduce the prospective returns for the shareholders.

Asset Quality

Our thesis is based on the premise that the worst of asset quality woes are behind it. However, if we find information to the contrary, it will negate the thesis.

Banking scam

A big government owned bank was recently caught in a banking scam worth $2 Billion. JKB has categorically denied any exposure to those accounts or any exposure to similar instruments (unfunded liabilities). Any exposure to these new sources of stress could damage the thesis.

Disclaimer / Disclosure

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