November 30, 2020

City Union Bank Limited: Ratings reaffirmed

Summary of rating action

Instrument*	Previous Rated Amount (Rs. crore)	Current Rated Amount (Rs. crore)	Rating Action
Issuer Rating^	-	-	[ICRA]AA-(Stable); reaffirmed
Certificates of Deposit Programme	25.00	25.00	[ICRA]A1+; reaffirmed
Total	**25.00**	**25.00**	

**Instrument details are provided in Annexure-1*
^Issuer rating is an opinion on the general creditworthiness of the rated issuer and is not specific to any particular debt instrument

Rationale

The rating reaffirmation considers City Union Bank Limited's (CUB) established retail franchise, resulting in a granular asset and liability base, its strong capitalisation (CET I ratio of 16.29% as on September 30, 2020) and strong liquidity profile with liquidity coverage ratio of ~292% as on September 30, 2020. Further, the rating takes into account the bank's healthy profitability indicators with return ratios above the private banks (PVBs) average. While the net profitability has moderated in the last couple of quarters, given the provisions of Rs. 317 crore or 0.91% of net advances as on September 30, 2020 for Covid-19 induced asset quality stress, ICRA expects the bank to maintain satisfactory profitability indicators, given its high interest margins along with its stable operating costs.

The asset quality pressures are expected to remain high for the bank in the near term, given the vulnerability of the target borrower segment[1] to economic disruptions. The management has provided a slippage and restructuring guidance of 3.0%- 3.5% and ~5% -6% of advances for FY2021, which is likely to exert pressure on the asset quality and net profitability in the near term. However, the bank's strong capital position provides cushion to absorb the guided asset quality shocks. The ratings also factor in CUB's average deposit profile, as reflected in the higher cost of interest-bearing funds compared to the PVBs average, largely due to its low share of current account and savings account (CASA) deposits (25.70% as on September 30, 2020) in total deposits. Further, the rating takes note of CUB's modest scale of operations and geographically concentrated operations with 64% of advances and 80% of deposits from Tamil Nadu (TN) as on September 30, 2020, which is likely to continue in the medium term and could pose asset and liability challenges in case of any local disruptions.

The stable outlook on the long-term rating reflects our expectations that the bank will continue to maintain a granular asset and liability profile, which will support its liquidity and it will be able to ride out the near-term asset quality stress while maintaining strong capital position and solvency.

[1] Micro, small and medium enterprise (MSME) and traders consisted of ~50% of the advances as on September 30, 2020

Key rating drivers and their description

Credit strengths

Established retail franchise resulting in granular asset and liability base – CUB has an established retail franchise with more than 100 years of operations in South India with 69% of total branches (700) in Tamil Nadu as on September 30, 2020. The bank has a strong retail deposits franchise with limited dependence on bulk deposits. The share of the top 20 deposits to total deposits remains at lower levels among its peers at 9.2% as on March 31, 2020. Given the focus on low ticket loans, ~91% of its deposits are with a ticket size of less than Rs. 2 crore as on September 30, 2020 compared to 89% as on March 31, 2020. Further, the bank has a granular asset profile with the top 20 exposures to total exposure of 5.2% or 40.6% of Tier I capital as on March 31, 2020 (5.4% and 43.1% as on March 31, 2019), which is also the lowest among its peers.

Healthy profitability indicators, though moderation is expected in the near term – The bank has been able to maintain its net interest margins (NIMs) through various interest rate cycles in the past and the NIMs remain strong at 3.64% in H1 FY2021 (3.54% in H1 FY2020), comparable to the PVBs average. Though CUB has a relatively higher funding cost in relation to the PVBs' average with cost of funds at 5.58% in H1 FY2021 compared to the PVBs average of 4.9% in the same period, its focus on the higher-yielding MSME and the traders segment drives margins while imparting granularity to loan book.

Because of the Covid-19-induced stress on asset quality and consequent increase in credit provisions on account of expected stress, the bank has recently reported moderation in profitability. The return on assets (RoA) and return on equity (RoE) declined to 1.24% and 11.47%, respectively in H1 FY2021 (1.00% and 8.99%, respectively in FY2020 and 1.60% and 14.11%, respectively during FY2019). Though the slippages were negligible in H1 FY2021, the credit provisions increased to 1.94% (annualised) of advances during H1 FY2021 and 1.89% during FY2020 compared to 0.89% in FY2019. The bank carried ad hoc provisions of Rs. 317 crore or 0.91% of net advances for Covid-19 stress as on September 30, 2020. The bank's profitability remains supported by its operating costs of 2.0-2.1% of average total assets (ATA) during FY2017-2020 compared to the PVBs' average of 2.2- 2.3% in the same period. Further, the management expects the employee cost could increase by ~15% in FY2022 due to the wage-revision negotiations under process, which could translate into a dip in the RoA and the RoE in FY2022 until the bank increase their business to absorb expenses. With cost and asset quality pressures, the profitability is likely to moderate in the near term, however, these are likely to remain healthy with an RoA of ~1%.

Strong capitalisation level – CUB continues to maintain a strong capitalisation profile with CET I of 16.29% (17.30% including H1 FY2021 profits as per ICRA's estimates) as on September 30, 2020, supported by healthy internal capital generation with an average return on equity of ~12.4% in the last three fiscals (FY2018 - FY2020). The bank raised an equity capital of Rs. 350 crore in FY2015 and since then, the internal capital generation has been adequate to meet the credit growth. The improvement in capital ratios was also driven by a reduction in the risk-weighted assets (-4.8% YTD) as on September 30, 2020 due to incremental disbursement under the Emergency Credit Line Guarantee Scheme (ECLGS) loans (which has 0% Risk weight) in H1 FY2021. The Tier II capital has increased to 1.07% as on September 30, 2020 from 0.52% as on March 31, 2019, mainly driven by the Covid-19 provisions of ~Rs. 340 crore. While the management stated that there is no capital requirement in the near term, however, given the uncertainty on asset quality, it has a board-approved equity capital-raising plan of Rs. 600 crore. Despite the near-term challenges on asset quality, we expect the bank to maintain a strong capitalisation profile with a Tier I capital >16.0% and solvency[2] of < 20%.

Credit challenges

Increased pressure on asset quality; strong capital position and healthy operating profitability likely to mitigate asset quality shocks – Given the standstill in asset classification as non-performing that resulted in almost negligible slippages in H1 FY2021, the gross NPA (GNPA%) and net NPA (NNPA%) declined to 3.44% and 1.81%, respectively as on September 30, 2020 compared to 4.09% and 2.29% as on March 31, 2020. CUB's asset quality remained moderate with a gross fresh slippage rate of ~2.5-3.5% of standard advances during the last few years. With a high share of loans to the MSMEs and traders, the asset quality remains vulnerable to asset quality shocks because of the economic slowdown. The restructured MSME loans rose to 3.7% of overall MSME loans as on September 30, 2020 from 0.9% as on September 30, 2019 and is expected to rise further.

During the moratorium period (March 2020 – August 2020), the bank witnessed ~10% of the term loan/ CC & OD accounts (in value terms) had skipped all six EMIs. Management provided slippage guidance of 3.0%- 3.5% and an additional 5% -6% of the loan book to be restructured in FY2021. A high level of slippages and restructuring guidance points towards asset quality pressure in the near term and remains a key monitorable.

The solvency profile remains strong at ~15.1% as on September 30, 2020, driven by high provisioning levels (70% including technical write-offs) and strong capital levels. ICRA also takes comfort from CUB as a sole lender for a large part of its portfolio, the granular nature of advances, high recovery levels from past NPAs given the secured nature of lending which are additional factors to ride out expected asset quality shocks.

Average deposit profile reflected by relatively higher cost of interest-bearing funds and geographical concentration – Though CUB has a granular liability profile, given the geographical concentration of its branches in South India (~90% of total branches) and 69% of the overall branches located in Tamil Nadu, results in a high geographical deposit concentration. Similar to other South-India based banks, the bank's CASA ratio remains lower - at 25.70% of its total deposits as on September 30, 2020, which is much lower than the PVBs' average of ~41%. A low CASA base results in a comparatively higher cost of interest-bearing funds of 5.58% compared to the PVBs' average of 4.9% in H1 FY2021. Although the differential between the cost of the interest-bearing funds between CUB and the PVBs' average have declined gradually to ~0.68% in H1 FY2021 from ~0.91% in FY2017, ICRA also takes note of the changing landscape with increasing competition from small finance banks, apart from other private sector banks in terms of deposit mobilisation. In this regard, the bank's ability to scale up the deposit base, improve the share of CASA deposits and reduce the cost of funds will remain enabling factors to compete in better borrower segments and to achieve the envisaged growth while maintaining a healthy earnings profile.

Modest scale and geographically concentrated operations; unlikely to improve in the medium term – CUB's net advances grew at a CAGR of 12.5% during FY2017 – FY2020 compared to PVBs CAGR of 16.4% and system CAGR of 7.4% during the same period. A higher advances growth compared to the system resulted in a marginal rise in CUB's market share to 0.37% as on September 30, 2020 from 0.31% as on March 31, 2017. Along with the modest scale of operations, the banks' operations remain geographically concentrated with ~90% of total branches (700) in South India (Tamil Nadu, Karnataka, Andhra Pradesh, Telengana and Kerala) and 69% located in Tamil Nadu as on September 30, 2020. This

[2] Net stressed assets (including net NPA, Net non-performing investments and net security receipts) / core capital

resulted in advance concentration with 64% of the advances from Tamil Nadu and 85% from South India. Also, the deposits remain concentrated with 80% of the deposits from Tamil Nadu and 93% from South India. Such concentration exposes the bank's asset and liability to local socio-economic and political risks. The management foresees its further potential to open branches in Tamil Nadu till it reaches 700 – 800 branches from the present level of 485. ICRA expects the bank's operations to remain regionally concentrated, and it is unlikely to improve in the medium term.

Liquidity position: Strong

CUB's liquidity profile remains strong with positive cumulative mismatches across all buckets in the less-than-one-year category as on September 30, 2020. This was supported by a high deposit rollover rate of ~90% but characterised by huge concentration of deposits in Tamil Nadu. Further, the bank increased its excess liquidity to Rs. 2,902 crore or 6.8% of net demand and time liabilities (NDTL) as on October 23, 2020 from 1.5% as on March 27, 2020. This, coupled with low level of non-operational/less stable deposits to total deposits, leads to low near-term outflows, resulting in a high liquidity coverage ratio of ~292% as on September 30, 2020 against the regulatory requirement[3] of 100% as on January 1, 2019. The excess SLR holding above the regulatory levels can be utilised to avail liquidity support from the RBI (through repo), apart from the marginal standing facility of the RBI in case of urgent liquidity needs. Going forward, CUB's ability to expand its deposit base and maintain high renewals will remain the key for liquidity while achieving the desired growth.

Rating sensitivities

Positive triggers – ICRA could revise the outlook to Positive or upgrade the ratings if the bank increases its geographical diversification of asset and liability base outside Tamil Nadu, while maintaining its asset quality and profitability.

Negative triggers – ICRA could revise the outlook to Negative or downgrade the ratings if there is a weakening in the solvency profile with net stressed assets / core capital increasing to more than 20-25% or if the cushion over the regulatory Tier I capital adequacy falls below 3% on a sustained basis. Further, the inability to internally generate growth capital (RoA below 1.0%) or a deterioration in the liability franchise will be the negative triggers.

Analytical approach

Analytical Approach	Comments
Applicable Rating Methodologies	ICRA Rating Methodology for Banks
Parent/Group Support	Not applicable
Consolidation/Standalone	For arriving at the ratings, ICRA has considered the standalone financials of CUB

About the company

Incorporated as The Kumbakonam Bank Limited in 1904, CUB is one of the oldest private sector banks, with its headquarters in Kumbakonam, Tamil Nadu. As on September 30, 2020, it had a network of 700 branches and 1,780 ATMs with about 90% of the total branches being in South India. About 57% of the branches are in semi-urban and rural areas. CUB reported a capital adequacy ratio of 17.36% (Tier I: 16.29%) and gross and net NPAs of 3.4% and 1.8%, respectively,

[3] On April 17, 2020, RBI revised the LCR requirement to ease the burden on bank's cash flows due to pandemic. As per the revised guidelines, the LCR requirement will be 80% from April 17, 2020 to September 30, 2020, 90% from October 1, 2020 to March 31, 2021 and 100% from April 1, 2021 onwards.

as of September 2020. In H1 FY2021, the bank reported a net profit of Rs. 312 crore on an asset base of Rs. 50,583 crore compared to a net profit of Rs. 379 crore on an asset base of Rs. 48,272 crore in H1 FY2020.

Key financial indicators (audited)

	FY2019	FY2020	H1 FY2020	H1 FY2021
Net Interest Income	1,611	1,675	828	912
Profit Before Tax	925	586	474	407
Profit After Tax	683	476	379	312
Net Advances	32,673	33,927	32,760	34,825
Total Assets	45,259	49,734	48,272	50,583
Tier I%	15.03%	15.80%	14.96%	16.29%
CRAR%	15.55%	16.76%	15.49%	17.36%
%Net interest margin / Average total assets	3.78%	3.53%	3.54%	3.64%
%Net profit / Average total assets	1.60%	1.00%	1.62%	1.24%
%Return on net worth	15.17%	9.40%	15.13%	11.47%
% Gross NPAs	2.96%	4.09%	3.41%	3.44%
% Net NPAs	1.81%	2.29%	1.90%	1.81%
% Provision coverage excl. technical write-offs	39.47%	44.92%	45.03%	48.27%
% Net NPA / Core capital	12.51%	16.83%	13.21%	12.54%

Amounts in Rs. crore

Half yearly results are unaudited while annual results are audited

Source: Bank, ICRA research

Status of non-cooperation with previous CRA: Not applicable

Any other information: None

Rating history for past three years

<table>
<tr><th rowspan="3"></th><th rowspan="3">Instrument</th><th colspan="4">Current Rating (FY2021)</th><th colspan="4">Rating History for the Past 3 Years</th></tr>
<tr><th rowspan="2">Type</th><th rowspan="2">Amount Rated</th><th rowspan="2">Amount Outstanding</th><th>Rating</th><th>FY2020</th><th colspan="2">FY2019</th><th>FY2018</th></tr>
<tr><th>Nov-30-2020</th><th>Oct-31-2019</th><th>Sep-11-2018</th><th>Aug-31-2018</th><th>-</th></tr>
<tr><td>1</td><td>Issuer Rating</td><td>Long Term</td><td>-</td><td>-</td><td>[ICRA]AA- (Stable)</td><td>[ICRA]AA- (Stable)</td><td>[ICRA]AA- (Stable)</td><td>-</td><td>-</td></tr>
<tr><td>2</td><td>Certificates of Deposit Programme</td><td>Short Term</td><td>25.0</td><td>25.0</td><td>[ICRA]A1+</td><td>[ICRA]A1+</td><td>[ICRA]A1+</td><td>[ICRA]A1+</td><td>-</td></tr>
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Amount in Rs. crore

Complexity level of the rated instrument

ICRA has classified various instruments based on their complexity as "Simple", "Complex" and "Highly Complex". The classification of instruments according to their complexity levels is available on the website www.icra.in

Annexure-1: Instrument details

ISIN	Instrument Name	Date of Issuance / Sanction	Coupon Rate	Maturity Date	Amount Rated (Rs. crore)	Current Rating and Outlook
NA	Issuer Rating	-	-	-	-	[ICRA]AA-(Stable)
NA	Certificates of Deposit Programme	-	-	-	25.00	[ICRA]A1+

Source: CUB

Annexure-2: List of entities considered for consolidated analysis

Company Name	Ownership	Consolidation Approach
NA	NA	NA

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