DCB Bank Limited

December 28, 2018

Summary of rating action

Instrument	Previous Rated Amount (Rs. crore)	Current Rated Amount (Rs. crore)	Rating Action
Basel III Compliant Tier II Bonds Programme	550.00	550.00	[ICRA]A+(hyb)(stable); reaffirmed
Short-term Fixed Deposit Programme	-	-	[ICRA]A1+; reaffirmed
Total	**550.00**	**550.00**	

Rationale

The ratings positively factor in DCB Bank Limited's granular loan book and its improving scale of operations, which shall result in better operating efficiencies and profitability and lead to sustainable growth. ICRA notes that despite its presence in the lower end of the retail borrower segment, including small and medium enterprises (SMEs), and various disruptions in the past few quarters like demonetisation, implementation of the Goods and Services Tax (GST), enforcement of Bharat Stage IV emission norms and implementation of the Real Estate (Regulation and Development) Act (RERA), DCB's asset quality has held up well. This was primarily supported by its focus on sufficiently collateralising the loans. The bank's limited presence in the corporate segment is also characterised by a well-diversified borrower profile with restricted ticket size.

With a capital infusion in April 2017, the bank's capital position currently remains comfortable. However, with high growth in advances and given its average profitability, the bank will need to raise capital over the next 12-18 months. Aggressive branch expansion during FY2016-18, the ongoing scaling up of operations, and a presence in low-medium ticket size lending led to high overheads and a below-average share of fee income, thereby resulting in a high cost-to-income ratio and average profitability. DCB's liability franchise also remains average, with the share of low-cost current account and savings account (CASA) deposits remaining below the sector average, but comparable with some of the peer rated banks. With strong growth in advances, the dependence on bulk deposits (> Rs. 1 crore) has been increasing. Given the tighter liquidity conditions during the last two quarters, this has resulted in increased cost of funds and moderation in core profitability. Further, because of the presence of long-tenure mortgage loans, the bank has negative mismatches. Ability to mobilise long-term deposits/refinance with longer-term liabilities and improve the asset-liability gaps will remain a key driver of liquidity.

Going forward, the bank's ability to improve its profitability will be driven by its ability to improve its scale of operations further by maintaining advances growth that will reduce its cost-income ratio. However, in ICRA's view, DCB's ability to improve its cost of funds vis-à-vis peers, reduce the asset-liability gaps in the near-term buckets and maintain the asset quality while pursuing growth will remain a key rating driver.

Outlook: Stable

The outlook remains Stable given the bank's comfortable financial risk profile characterised by adequate capitalisation, comfortable asset quality and improving scale of operations. The outlook may be revised to Positive if the bank improves its liability profile, reduces asset-liability mismatches and improves the scale of operations while maintaining a tight control over the asset quality, thereby leading to further improvement in profitability. However, the outlook may be revised to Negative if there is a significant deterioration in the asset quality and earnings profile, thereby weakening its ability to raise capital in future.

Key rating drivers

Credit strengths

Improving scale of operations with granular retail book – Supported by the recent expansion of its branch network, DCB has grown its advances at a healthy CAGR of 25% over a five-year period (FY2013-18), which is higher than the industry average, albeit on a modest loan book size. The bank grew its net advances by 29% in FY2018 to Rs. 20,337 crore as on March 31, 2018 from Rs. 15,818 crore as on March 31, 2017. Its growth rate was higher than the growth rate of 6% for the banking industry and 20% for private banks. The portfolio grew further to Rs. 22,069 crore as on September 30, 2018.

Despite the high growth, DCB continues to maintain granularity in its loan book with the mortgage, agri and inclusive banking (AIB) and SME/MSME segments constituting 40%, 19%, and 12%, respectively, of net advances as on September 30, 2018 against 42%, 17% and 12%, respectively, as on September 30, 2017. Including other retail products, the share of retail/MSME loans was 85% while that of corporate advances remained limited at 15% as on September 30, 2018 against 83% and 17%, respectively, as on September 30, 2017. The bank's presence in the corporate segment is also characterised by a well-diversified borrower profile with a median ticket size of Rs. 40 crore among the top 100 borrowers. As a result, DCB's advances are well-diversified with a relatively low exposure to sensitive sectors such as infrastructure, construction and commercial real estate. To improve its profitability as well as the utilisation of the expanded branch infrastructure and to reduce the cost-income ratio, the bank continues to target strong growth in advances (22-24% YoY), which will lead to the doubling of its asset base over the next 3-4 years.

Asset quality remains comfortable with improved provision cover – With a focus on retail and SME customers and despite the various disruptions in the past few quarters like demonetisation, GST and RERA implementation, and the enforcement of Bharat Stage IV emission norms, the asset quality of the bank has held up well. Fresh slippages in FY2018 and FY2017 stood at 2.21% and 2.04%, respectively. Supported by good recoveries and upgrades, the bank's asset quality remained comfortable with gross and net NPAs of 1.84% and 0.70%, respectively, as on September 30, 2018 (1.79% and 0.72%, respectively, as on March 31, 2018 and 1.59% and 0.79%, respectively, as on March 31, 2017), translating into a provision cover (without technical write-offs) of 62.12%, 60.24% and 51.06%, respectively.

Notwithstanding the improvement in the asset quality numbers, ICRA notes a slight increase in delinquent accounts during the last 15 months because of the various disruptions highlighted earlier. DCB's ability to reduce the delinquencies will be critical for future asset quality and remains a monitorable. With limited corporate exposure, the bank's gross standard restructured assets remained low at 0.3% of the total advances as on March 31, 2018 with SDR accounts of 0.1%. It does not have any CDR, S4A or 5/25 refinancing accounts. DCB's security receipts also stood low at 0.3% as on September 30, 2018. Overall, despite the weakening, the bank's asset quality remains comfortable.

Adequate capitalisation levels for proposed growth plans – The bank's capital ratios remain comfortable with Tier I and CRAR, as a percentage of risk-weighted assets (RWAs), of 12.02% and 15.57%, respectively, as on September 30, 2018 against 12.72% and 16.47%, respectively, as on March 31, 2018. Though the cushion over regulatory capital ratio levels currently remains comfortable, the same has been declining since the last capital infusion by the bank (Rs. 379 crore in April 2017) primarily because of growth being higher than the pace of internal accruals. In FY2018, DCB also raised Tier II capital of Rs. 450 crore, which resulted in an improvement in the CRAR as of March 2018. Given its medium-term growth targets, the bank will need to raise capital over the next 12-18 months. Maintaining a strong asset quality and earnings profile will remain critical for DCB's ability to raise equity capital in future. The solvency (net NPA/net worth) remained strong at 5.79% as on September 30, 2018 (5.74% as on March 31, 2018 and 6.39% as on March 31, 2017), and was better than the industry average.

Healthy interest margins supported by better asset quality – While the bank's cost of interest-bearing funds is higher than some its peers as well as the industry average, the net interest margins (NIMs) have remained healthy, primarily supported by better asset quality leading to higher income-earning assets. Supported by healthy CASA growth and surplus liquidity situation in the markets, DCB's NIMs (as a percentage of average total assets) were on an upward trend in FY2018. NIMs stood at 3.70% in FY2018 compared to 3.72% in FY2017 and 3.52% in FY2016. They were also above the industry average and the average for private sector banks. However, with tightening liquidity and the rising cost of deposits in H1 FY2019, NIMs moderated to 3.56%. To support its margins, the bank has increased its benchmark lending rate (marginal cost-based lending rate – MCLR) multiple times during January 2018-November 2018 by a total of ~100 bps (1-year MCLR). Going forward, DCB's ability to protect its yields, considering the competition from small finance banks and non-banking finance companies, as well as its ability to improve its cost of funds, supported by an improved branch network, and maintain stable asset quality indicators would remain determinants of its interest margins and would thus be monitorable.

Credit challenges

Average liability franchise – The share of CASA deposits in the bank's total deposits remained average at 24.3% as on September 30, 2018 compared to 25.9% as on September 30, 2017. It also remained below the share of many other peer private sector banks and the overall banking sector average. Further, because of the high growth in advances, the share of bulk deposits (over Rs. 1 crore) in term deposits (including interbank deposits) increased to 62% as on June 30, 2018 from ~50% as on March 31, 2016. The share of term deposits (> Rs. 10 crore), as a percentage of total deposits, also increased to ~44% as on June 30, 2018 from 32% as on March 31, 2016. With the bank doubling its branch network in three years to 328 as on September 30, 2018 from 160 as on September 30, 2015, ICRA expects the retail deposits to grow. However, the share of bulk deposits may remain high in the medium term till the bank continues to pursue high credit growth. The ability to offer differentiated products or value-added services can be a driver of growth in retail deposits. Also, in a tight liquidity scenario, the pricing of bulk deposits tends to be higher than that of retail deposits and can hence be a monitorable.

Moderate profitability levels with elevated operating expenses – DCB remains focused on the retail segment, which is more operationally intensive because of the low ticket size of loans. Also, the bank doubled its branch count during September 2015 to September 2018. As a result, its cost-to-income ratio and operating expenses remain on the higher side. The cost-to-income ratio and operating expenses, as a percentage of average total assets (ATA), were 60% and 2.72%, respectively, in H1 FY2019, higher than the average for private sector banks. ICRA expects the operating expenses to moderate as the new branches mature and become more profitable. Further, cross-sell opportunities are limited given the low share of the corporate loan book and the marginal profile of the borrowers. Thus, the non-interest income (0.99% of ATA in FY2018) is lower than the private bank average (1.45% in FY2018) and is expected to remain at similar levels in the medium term. Therefore, the bank's profitability indicator has remained subdued with a return on asset (RoA) and return on equity (RoE) of 0.91% and 10.89%, respectively, in FY2018 and 0.92% and 10.88%, respectively, in H1 FY2019.

Asset-liability mismatches – As per the structural liquidity statement (SLS) as of August 2018, the bank has a liquidity mismatch across most of the time buckets. This is because of the long tenure of its assets while most of the deposits are repayable within three years. Only 20% of the advances mature in the up to 1-year buckets compared to 47% of deposits, resulting in negative mismatches. However, the bank has been consistently investing around 2-4% of its net demand and time liabilities (NDTL) in SLR securities, over and above the regulatory requirement. The ability to mobilise longer-term deposits, increase the share of retail deposits and refinance through longer-term liabilities will determine the future asset-liability mismatches.

Marginal profile of borrowers – Around 85-90% of the borrowers in the mortgage and SME segments represent marginal self-employed borrowers with an average loan ticket size of Rs. 30-35 lakh. Further, loans under the AIB and CV segments and gold loans have an average ticket size of Rs. 1-3 lakh. Such borrowers are vulnerable to income shocks. Given the pace of growth and the relatively marginal borrower profile of the low and assessed income segments, the asset quality indicators can be subject to any macroeconomic event such as demonetisation or GST. While the bank has a strong credit appraisal and risk management mechanism in place, it remains exposed to the shock in asset quality given the risk associated with the target borrower segment.

Liquidity position

The bank has negative mismatches across most time buckets as per the SLS statements. While ICRA expects the retail deposits to grow at a healthy pace given the considerable branch expansion, the rollover of existing deposits and ability to mobilise fresh deposits at competitive costs to support growth will continue to be the key driver of DCB's liquidity.

Analytical approach

Analytical Approach	Comments
Applicable Rating Methodologies	ICRA Rating Methodology for Banks
Parent / Group Support	For arriving at the ratings, ICRA has not considered parent or Group support
Consolidation / Standalone	Standalone

About the company

Incorporated in 1995, DCB Bank was formed by the merger of Ismailia Co-operative Bank Limited and Masalawala Co-operative Bank. The Aga Khan Fund for Economic Development (AKFED) and Group companies are the largest shareholders in the bank with a combined stake of 14.94% as on September 30, 2018. DCB had a network of 328 branches and 541 ATMs as on September 30, 2018. It reported a profit after tax (PAT) of Rs. 245 crore with net interest income of Rs. 995 crore in FY2018 compared with PAT of Rs. 200 crore with net interest income of Rs. 797 crore in FY2017. The bank's total assets stood at Rs. 30,222 crore and its net worth was Rs. 2,556 crore as on March 31, 2018.

In H1 FY2019, DCB reported PAT of Rs. 143 crore and net interest income of Rs. 555 crore vis-à-vis PAT of Rs. 124 crore and net interest income of Rs. 481 crore in H1 FY2018.

Key financial indicators - (standalone)

For period ending Number of months	FY2017 12	FY2018 12	H1 FY2018 6	H1 FY2019 6
Net interest income	797	995	481	555
Profit before tax	307	386	195	222
Profit after tax	200	245	124	143
Net advances	15,818	20,337	17,395	22,069
Total assets excluding revaluation reserves	23,790	29,972	25,652	32,260
% CET	11.87%	12.72%	12.90%	12.02%
% Tier I	11.87%	12.72%	12.90%	12.02%
% CRAR	13.76%	16.47%	14.65%	15.57%
% Net interest margin / Average total assets^	3.72%	3.70%	3.89%	3.56%
% Net profit / Average total assets^	0.93%	0.91%	1.00%	0.92%
% Return on net worth^	10.82%	10.89%	11.28%	10.88%
% Gross NPAs	1.59%	1.79%	1.80%	1.84%
% Net NPAs	0.79%	0.72%	0.90%	0.70%
% Provision coverage excl. technical write-offs	51.06%	60.24%	50.28%	62.12%
% Net NPA / Net worth	6.39%	5.74%	6.46%	5.79%

Amount in Rs. crore; ^ Annualised; All ratios are as per ICRA calculations
Source: DCB, ICRA research

Status of non-cooperation with previous CRA: Not applicable

Any other information: None

Rating history for last three years

Sr. No.	Name of Instrument	Current Rating (FY2019)				Chronology of Rating History for the Past 3 Years		
		Type	Rated amount (Rs. crore)	Amount Outstanding (Rs. crore)	Dec-18	FY2018 Nov-17	FY2017 Nov-16	FY2016 Feb-16
1	Basel III Compliant Tier II Bonds Programme	Long Term	550.00	536.60^	[ICRA] A+(hyb) (stable)	[ICRA] A+(hyb) (stable)	[ICRA] A+(hyb) (stable)	[ICRA] A+(hyb) (stable)
2	Short Term Fixed Deposit Programme	Short Term	-	-	[ICRA] A1+	[ICRA]A1+	[ICRA] A1+	[ICRA] A1+

^ Balance amount yet to be placed

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 No	Instrument Name	Date of Issuance / Sanction	Coupon Rate	Maturity Date	Amount Rated (Rs. crore)	Current Rating
INE503A08010	Basel III Compliant Tier II Bonds	31-Mar-2016	10.25% p.a.	30-Apr-2026	86.60	[ICRA]A+(hyb) (stable)
INE503A08028	Basel III Compliant Tier II Bonds	18-Nov-2016	9.85% p.a.	18-Nov-2026	150.00	[ICRA]A+(hyb) (stable)
INE503A08036	Basel III Compliant Tier II Bonds	17-Nov-2017	9.85% p.a.	17-Nov-2027	300.00	[ICRA]A+(hyb) (stable)
Proposed	Basel III Compliant Tier II Bonds	NA	NA	NA	13.40	[ICRA]A+(hyb) (stable)
NA	Short Term Fixed Deposit Programme	NA	NA	NA	NA	[ICRA]A1+

Source: DCB

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About ICRA Limited:

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