

January 31, 2020

DCB Bank Limited: Ratings reaffirmed

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 rating reaffirmation positively factors in DCB Bank Limited's improving liability profile and the increasing granularity of its deposits base with the share of higher ticket value deposits (Rs. 10 crore and above) declining to ~30% as on September 30, 2019 from ~44% as on June 30, 2018. This, however, was driven by the high interest rate proposition of the bank for its deposits compared to other banks, which continues to keep the cost of interest-bearing funds high in comparison to private sector banks (PVBs). Because of the presence of long-tenure mortgage loans, DCB has asset-liability mismatches, particularly in the shorter maturity buckets. However, the increased share of longer-term retail deposits and refinancing through long-term borrowings have reduced these mismatches over the last one year.

Given its presence in the self-employed and lower end of the retail borrower segment (including small and medium enterprises; SMEs), the bank's asset quality metrics are susceptible to a slowdown in economic growth. Increasing delinquency trends in the softer buckets remain monitorable as they could have a bearing on the asset quality metrics. The annualised rate of fresh NPA generation remained higher at 2.92% (of standard advances) in 9M FY2020 against 2.08% in FY2019 due to high slippages across most segments, including the corporate segment.

Despite the high cost of funds, the net interest margins (NIMs)/average total assets (ATA) ratio remained strong at 3.42% in 9M FY2020, supported by higher yields on advances, although it moderated from 3.51% in FY2019. With slowing new branch addition and increasing scale of operations, the bank's cost metrics continue to improve with total operating expenses/ATA of 2.48% in 9M FY2020 against 2.60% in FY2019, even though this remains high given the granularity of the loan book. As a result of the improved cost metrics, the operating profitability improved to 1.97% of ATA in 9M FY2020 from 1.86% in FY2019. Rising slippages and credit costs, however, prevented a significant improvement in the pre-tax profitability with PBT/ATA at 1.45% in 9M FY2020 against 1.55% in FY2019. Nevertheless, lower corporate tax rates helped maintain the net profitability and return on assets at 0.98% in 9M FY2020 compared to 0.99% in FY2019.

The ratings continue to factor in the steady profit accretion that has helped maintain the bank's capital position at comfortable levels with Tier I at ~13.43%¹ (including profits for 9M FY2020) and CRAR at ~16.93% as on December 31, 2019 against 13.10% and 16.81%, respectively, as on March 31, 2019. With slowing credit growth from the banking sector and a ~10-15% credit growth for DCB, the bank is unlikely to require any capital over the next 1-2 years.

Going forward, the improving scale of operations will reduce DCB's cost metrics and support the operating profitability. However, in ICRA's view, DCB's ability to improve its cost of funds vis-à-vis its peers, further reduce the asset-liability

¹ ICRA's estimates

gaps in the near-term buckets and maintain the asset quality will remain a key rating driver. Amid the current economic environment and in a stressed scenario of higher slippages, ICRA expects the bank's capital position and solvency metrics to remain better than the negative rating thresholds.

Key rating drivers and their description

Credit strengths

Improvement in granularity of deposits – DCB added ~188 branches during FY2015-18 and ~15 branches in FY2019, which supported its deposit mobilisation efforts besides helping the advances grow at a healthy CAGR of 31% during FY2015-19. Because of the high growth in advances, the share of bulk deposits (over Rs. 1 crore) in term deposits (including interbank deposits) remained high at 62% as on June 30, 2018 while the percentage of total deposits above Rs. 10 crore stood at ~44% as on June 30, 2018. However, the efforts to granularise the deposit base during the last few quarters helped bring down the high ticket deposits (>Rs. 10 crore) to ~30% as on September 30, 2019, which remains a positive outcome of the comparatively higher interest rate offering of the bank. The share of DCB's top 20 depositors also reduced to 8.97% as on September 30, 2019 from 14.87% as on March 31, 2018 and the management has guided towards a further reduction.

Improving scale of operations with granular retail book – The bank grew its net advances by 11% in 9M FY2019 to Rs. 25,438 crore as on December 31, 2019 from Rs. 22,888 crore as on December 31, 2018. Its growth rate was higher than the growth rate of ~7% for the banking industry. Despite the high growth during the last few years, DCB continues to maintain granularity in its loan book with the mortgage (loan against property), agri and inclusive banking (AIB) and SME/MSME segments constituting 41%, 21%, and 12%, respectively, of net advances as on December 31, 2019 against 40%, 19% and 12%, respectively, as on December 31, 2018. Including other retail products, the share of retail/MSME loans was 88% while that of corporate advances remained limited at 12% as on December 31, 2019 against 85% and 15%, respectively, as on December 31, 2018. 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 by reducing the cost-income ratio, DCB continues to target strong growth in advances with the aim of doubling of its asset base over the next 3-4 years.

Comfortable capitalisation levels for growth requirements of next 1-2 years – The bank's capital ratios remain comfortable with Tier I and CRAR, as a percentage of risk-weighted assets (RWAs), of ~13.43%² and ~16.93%, respectively, as on December 31, 2019 against 13.10% and 16.81%, respectively, as on March 31, 2019. The bank had last raised capital of Rs. 379 crore in April 2017 and has followed a low capital consumption strategy by focusing on lower risk weight assets. DCB's RWA/total assets declined to 63% as on December 31, 2019 from 73% as on March 31, 2017. As a result, despite a growth of 56% in advances since June 30, 2017, its Tier I capital ratio has remained stable. Though the cushion over the regulatory capital ratio levels currently remains comfortable, growth is expected to slow down given the ongoing economic slowdown. ICRA expects the bank's capital to be sufficient for growth over the next 1-2 years. Maintaining a strong asset quality and earnings profile will remain critical for DCB's ability to raise equity capital in future, particularly given the economic environment, which may pose asset quality pressure. ICRA estimates that even in a scenario of elevated slippages, the solvency (net NPA/core equity) and the capital position are likely to remain strong and better than the negative rating triggers.

² ICRA's estimates including profit for 9M FY2020

Healthy interest margins despite high cost of borrowings – While the bank’s cost of interest-bearing funds is higher than some its peers as well as the industry average, the NIMs have remained healthy, primarily supported by higher-yielding assets and better asset quality. While the surplus liquidity environment and benign cost of funds helped the NIMs improve to 3.70% in FY2018 and 3.72% in FY2017, the same moderated to 3.51% in FY2019 due to increasing interest rates and the high cost of interest-bearing funds. Subsequently, with a focus on improving the granularity of the liability profile by offering better rates on term deposits amid a declining rate environment, the contraction in NIMs continued in 9M FY2020 with the same declining to 3.42%. Going forward, DCB’s ability to maintain NIMs by improving its cost of funds and maintain stable asset quality indicators would remain a determinant of its interest margins and would thus be a monitorable.

Credit challenges

High cost of funds amid increasing granularity of deposits – During the last few quarters, the bank has continued to focus on improving the granularity of its deposits by offering higher deposit rates. Though this strategy has improved the granularity of its liabilities as highlighted earlier, it has resulted in a limited decline in the cost of interest-bearing funds for the bank. The cost of funds stood at 7.05% in Q3 FY2020 and 7.03% in 9M FY2020 compared to 5.66% for PVBs in H1 FY2020. With the increased focus on term deposits, the share of low-cost current account and savings account (CASA) deposits in the bank’s total deposits remained at 23% as on December 31, 2019 compared to 24% as on December 31, 2018. It also remained below the share of many other peer PVBs and the overall banking sector average of ~40-42%. Going forward, the management has guided towards continued focus on improving the granularity of the deposit base. The ability to reduce the cost of funds while doing so will remain a driver of profitability.

Elevated operating expenses, though reducing with improving scale of operations – DCB also remains focused on the retail segment, which is operationally more intensive because of the low ticket size of the loans. Also, the bank doubled its branch count during September 2015 to September 2018 to 328, following which the pace of branch addition slowed down with only six branches added till December 31, 2019. With the improved scale of operations, the bank’s cost-to-income ratio and operating expenses have been declining but remain on the higher side. The cost-to-income ratio and operating expenses/ATA were 58% and 2.60%, respectively, in FY2019, higher than the average for PVBs. In 9M FY2020, the cost-to-income ratio and operating expenses/ATA witnessed some improvement to 56% and 2.48%, respectively. ICRA expects the operating expenses to moderate as the new branch additions moderate and the scale of operations improves. 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 (0.95% of ATA in FY2019 and 1.02% in 9M FY2020) is lower than the PVB average (1.42% in FY2019 and 1.48% in H1 FY2020) and is expected to remain at similar levels in the medium term. The bank’s return indicators have improved with a return on asset (RoA) and return on equity (RoE) of 0.99% and 11.99%, respectively, in FY2019 against 0.91% and 10.89% in FY2018. The increase in the credit costs and the narrowing of the gross lending spreads on the back of the higher cost of interest-bearing funds impacted the return indicators in 9M FY2020 with the same moderating to 0.98% and 11.94%, respectively, despite lower corporate tax rates.

Asset quality remains monitorable amid ongoing economic slowdown – 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 commercial vehicle (CV) segments and gold loans have an average ticket size of Rs. 1-3 lakh. Such borrowers are vulnerable to income shocks. However, despite the various disruptions in the past few quarters like demonetisation, GST and RERA implementation, and the enforcement of Bharat Stage IV emission norms, DCB’s asset quality has held up well. Accordingly, the pace of fresh NPA generation stood at 2.08% in FY2019 against 2.21% in FY2018. Furthermore, supported by good recoveries and upgrades, the bank’s asset quality remained comfortable with gross and net NPAs of 1.84% and 0.65%, respectively, as on March 31, 2019 (1.79% and 0.72%, respectively, as on March 31, 2018), translating into a provision cover (without technical write-offs) of 65.01% as on

March 31, 2019. Notwithstanding the strong asset quality numbers, ICRA notes that the prevailing economic conditions will pose challenges to the bank's asset quality. The annualised rate of fresh NPA formation in 9M FY2020 was 2.92% while it was significantly higher than past trends at 3.31% in Q3 FY2020. This, in turn, led to an increase in the GNPA and NNPA metrics to 2.15% and 1.03%, respectively, as on December 31, 2019. DCB's ability to contain the delinquencies will be critical for the future asset quality and remains a monitorable. ICRA expects slippages to increase and the pace of fresh NPA generation to remain elevated in FY2020, which could result in some weakening of the asset quality from the present levels, although it will remain stronger than the PVB average.

Asset-liability mismatches, though reduced over the last one year – As per the structural liquidity statement (SLS) as of September 2019, the bank has asset-liability mismatches 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. As on September 30, 2019, only 18% of the advances mature in the up to 1-year buckets compared to 46% of the deposits, resulting in negative mismatches. The ongoing focus on the increasing share of term deposits, availing long-term refinance and reducing interbank deposits by increasing the share of retail deposits will continue to support a reduction in the mismatches.

Liquidity position: Adequate

DCB has negative mismatches, particularly in the shorter maturities, including mismatches in the one-month and three-month buckets. Nonetheless, the cumulative gaps reduced to 13% of the total outflows in the one-year maturity bucket as on September 30, 2019 from ~18% as on August 31, 2019. Further, the bank's liquidity coverage ratio (LCR), which dipped below the regulatory level of 100% in Q3 FY2019 to 80.31% following directives from the Reserve Bank of India (RBI) to reclassify certain parts of the deposits in the higher outflow category, improved to 108% in Q3 FY2020. However, it was lower than other peer banks. Besides this, the excess SLR holding above the regulatory levels can be utilised to avail liquidity support from the RBI (through reverse repo) apart from the marginal standing facility of the RBI in case of urgent liquidity needs.

Rating sensitivities

Positive triggers – ICRA could revise the outlook to Positive/upgrade the rating if DCB's liability profile improves with steady improvement in CASA levels with lower cost of borrowed funds, thereby resulting in a reduction in the gap between the bank's cost of borrowed funds and the PVBs' average. This apart, maintaining the asset quality and profitability, while improving the ALM profile with no mismatches in the near-term buckets, will be positive triggers.

Negative triggers – ICRA could revise the outlook to Negative/downgrade the ratings if DCB's solvency metrics (NNPA/core equity) weaken beyond 25% or if the capital cushions reduce below 2% at the Tier I level on a sustained basis. This apart, weakening of the internal capital generation with RoA < 0.7-0.8% on a sustained basis or a deterioration in the deposits franchise will remain negative triggers.

Analytical approach

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

About the company

Incorporated in 1995, DCB Bank was formed by the merger of Ismailia Co-operative Bank Limited and Masalawala Cooperative Bank. The Aga Khan Fund for Economic Development (AKFED) and Group companies are the largest shareholders in the bank with a combined stake of 14.89% as on December 31, 2019. DCB had a network of 334 branches as on December 31, 2019. It reported a profit after tax (PAT) of Rs. 325 crore with net interest income of Rs. 1,149 crore in FY2019 compared with PAT of Rs. 245 crore with net interest income of Rs. 995 crore in FY2018. The bank's total assets stood at Rs. 35,547 crore and its net worth was Rs. 2,871 crore as on March 31, 2019. In 9M FY2020, DCB reported PAT of Rs. 269 crore and net interest income of Rs. 941 crore vis-à-vis PAT of Rs. 229 crore and net interest income of Rs. 848 crore in 9M FY2019.

Key financial indicators (standalone) – DCB Bank Limited

	FY2018 Audited	FY2019 Audited	9M FY2019 Unaudited	9M FY2020 Unaudited
Net interest income	995	1,149	848	941
Profit before tax	386	507	356	398
Profit after tax	245	325	229	269
Net advances	20,337	23,568	22,888	25,438
Total assets	29,970	35,547	34,131	37,846
% CET	12.72%	13.10%	11.93%^	12.30%^
% Tier I	12.72%	13.10%	11.93%^	12.30%^
% CRAR	16.47%	16.81%	15.45%^	15.80%^
% Net interest margin / Average total assets	3.70%	3.51%	3.53%	3.42%
% Net profit / Average total assets	0.91%	0.99%	0.95%	0.98%
% Return on net worth	10.89%	11.99%	11.47%	11.94%
% Gross NPAs	1.79%	1.84%	1.92%	2.15%
% Net NPAs	0.72%	0.65%	0.71%	1.03%
% Provision coverage excl. technical write-offs	60.24%	65.01%	63.28%	52.76%
% Net NPA/ CET	5.56%	5.29%	6.17%	8.97%

Amount in Rs. crore; ^ Excluding current year's profits

Source: DCB Bank Limited, ICRA research

All ratios are as per ICRA calculations

Status of non-cooperation with previous CRA: Not applicable

Any other information: None

Rating history for last three years

Sr. No.	Name of Instrument	Type	Current Rating (FY2020)			Chronology of Rating History for the Past 3 Years			
			Rated amount (Rs. crore)	Amount Outstanding (Rs. crore)	31-Jan-20	FY2019 28-Dec-18	FY2018 23-Nov-17	FY2017 16-Nov-17 11-Nov-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)	[ICRA] A+(hyb) (stable)
2	Short-term Fixed Deposit Programme	Short Term	-	-	[ICRA] A1+	[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	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 Bank Limited

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