

March 17, 2020

Saurashtra Gramin Bank: [ICRA]A-(hyb)(Stable) assigned to perpetual bonds

Summary of rating action

| Instrument* | Current Rated Amount (Rs. crore) | Rating Action |
|--------------------------|----------------------------------|---------------------------------|
| Perpetual Debt Programme | 200.00 | [ICRA]A-(hyb)(Stable); Assigned |
| Total | 200.00 | |

*Instrument details are provided in Annexure-1

The rated Tier I Bonds have specific features, whereby the debt servicing is linked to the bank meeting the regulatory norms on capitalisation and reported profitability. As per the regulatory norms for these debt capital instruments, approval from the Reserve Bank of India (RBI) is required for debt servicing (including principal repayments) in case the bank reports a loss and is not liable to service the debt if it breaches the minimum regulatory capitalisation norms, i.e. CRAR of 9.0%. The coupon, if not paid, is non-cumulative.

Rationale

The assigned rating takes into account the parentage of Saurashtra Gramin Bank (SGB), held jointly by the Government of India (GoI; 50% holding), Government of Gujarat (GoG; 15%) and State Bank of India (SBI; 35%; rated [ICRA]AAA(Stable)). Further, SGB is incorporated under the Regional Rural Banks Act, 1976, under which dilution in the combined holding of the GoI and the sponsor bank (SBI) is limited to 51%, thereby ensuring sizeable direct or indirect sovereign ownership in SGB at all times. Moreover, regional rural banks (RRBs) remain strategically important to the GoI and state governments for meeting the credit demands of the agricultural sector.

The rating also factors in SGB's deposit profile, which remains inherently granular, given its predominantly rural presence as well as the high share of current account and savings account (CASA) in total deposits, which stood at 48% as on March 31, 2019 (RRB average of ~54% as on March 31, 2019). The high share of CASA and the highly granular term deposit base translated into a competitive cost of funds. This, coupled with the strong asset quality metrics, translated into strong operating profitability. ICRA, however, notes that the profitability was impacted in FY2019 by the provisioning of pension-related liabilities, resulting in the moderation of PAT/average total assets (ATA) to 0.49% in FY2019 from 1.25% in FY2018, despite low credit costs. The net NPA (NNPA) and unprovided pension liability, as a percentage of core equity (CET-I), remained limited at 18% and the bank has already provided for the same through internal accruals in 9M FY2020 and reported an annualised return on assets (RoA) of 0.70%.

While assigning the rating, ICRA notes that the operations remain focused on rural credit in a few districts of Gujarat, thereby limiting the overall scale and growth prospects while keeping the geographical and sectoral concentration of the loan book high. Further, given the high contribution of crop and agriculture loans to total gross advances (62% of gross advances as on March 31, 2019), SGB remains vulnerable to agro-climatic risks, which could severely impact collections and lead to the deterioration of the asset quality metrics. Moreover, given the focus on extending loans to farmers, SGB's product profile and avenues to scale up fee-based income (largely remains restricted to the sale of priority sector lending certificates [PSLCs]) remain limited.

SGB has maintained its capital metrics above the regulatory levels (CRAR of 9%) with the CRAR at 10.7% as on March 31, 2019 and 10.0% as on December 31, 2019. Though the overall cushion over the regulatory levels remains relatively moderate, the bank's current capital largely consists of CET-I, which stood at 9.0% as on December 31, 2019. Going

forward, ICRA estimates the bank will maintain a strong profitability profile with RoA of >0.7-1.0% and will maintain the capital ratio above the regulatory level (CRAR of 9.0%) with a cushion of >1.0-1.5% even without the proposed perpetual debt instrument (PDI) issuance. The capital cushions will improve further if SGB is able to raise capital from the proposed PDI issuance.

Key rating drivers and their description

Credit strengths

Strong parentage and constitution under RRB Act – SGB was incorporated under the Regional Rural Banks Act, 1976 and is jointly owned by the GoI (50%), GoG (15%) and SBI (35%). Legislative amendments introduced to the RRB Act in 2015 prevent a dilution in the combined holding of the GoI and the sponsor bank (SBI) below 51%, thereby ensuring sizeable direct or indirect sovereign ownership in SGB. Furthermore, under the Act, the GoI appoints the Chairman and two directors to the board, while the state government is represented by two nominee directors. SBI, on the other hand, is represented by two directors nominated by it. Additionally, the board has representatives from NABARD and the RBI as board members. SBI and NABARD closely monitor the operational and financial performance of RRBs and extend supervisory support on a periodic basis. However, ICRA notes that while SBI remains the sponsor bank for SGB, any change in the sponsor bank, under a scheme of amalgamation, will remain a monitorable going forward.

Deposit profile characterised by high share of CASA and granularity – As on March 31, 2019, SGB had over 260 branches in the rural and semi-urban regions in 11 districts of Gujarat. Despite the presence of three gramin banks in Gujarat, SGB remains the dominant RRB with a 43% share of the total deposits and advances in Gujarat. The rating also factors in SGB's deposit profile, which remains inherently granular (reflected by the top 20 depositors accounting for 2.2% of the total deposits as on March 31, 2019), given the rural presence of the bank as well as the high share of CASA (48% as on March 31, 2019; RRB average of ~54%). Accordingly, the cost of interest-bearing funds remained competitive and moderated to 5.01% in FY2019 from 5.79% in FY2017. The bank also narrowed the gap with the RRB average cost of funds, which stood at 5.01% in FY2019. This moderation was achieved on the back of a granular term deposit base, resulting in lower cost of funds.

Profitability to improve, although impacted by pension-related liabilities in FY2019 – With a competitive cost of funds and higher yields on assets that are supported by strong asset quality metrics (GNPA at 0.97% and NNPA at 0.00% as on March 31, 2019) and a higher credit-deposit ratio, SGB reported higher gross interest spreads of 3.65% in FY2019. Its credit-deposit ratio stood at 72.9% vis-à-vis the RRB average of 60.3% as on March 31, 2019, leading to better net interest margins (NIMs) in FY2019 (3.87% in FY2019 against 3.59% in FY2018). Accordingly, the bank's core operating profitability witnessed a steady improvement with the same increasing to 2.99% in FY2019 from 2.27% in FY2018. The credit costs (credit provision/ATA) were contained at 0.25% in FY2019 compared to 0.24% in FY2018. However, the pre-tax profitability was impacted in FY2019 by the provisioning of pension-related liabilities of ~Rs. 120 crore (out of the total pension liability of Rs. 177 crore), leading to a moderation in PBT/ATA to 0.63% from 1.86% in FY2018. Consequently, SGB reported a lower RoA of 0.49% during the year compared to 1.25% in the previous year. For 9M FY2020, the bank provided further for the balance pension liability of Rs. 57 crore and reported a net profit of ~Rs. 36 crore (annualised RoA of 0.70%). Going forward, SGB will maintain a strong profitability profile with RoA of >0.7-1.0%, subject to maintaining the asset quality.

Credit challenges

High geographical concentration and vulnerability to agro-climatic risks – RRBs were set up with a primary focus on meeting the credit demand of the agriculture sector, with a district-defined role for each RRB. As RRBs operate within a

limited number of districts, the overall scale and growth prospects remain limited, resulting in high geographical concentration of the loan book. Furthermore, SGB's loan book is concentrated towards agricultural advances (constituting 62% of the gross advances as on March 31, 2019). A high percentage of exposure to the agriculture sector, coupled with the marginal profile of the borrowers, exposes SGB to agro-climatic risks, which could severely impact collections and lead to the deterioration of its asset quality metrics. However, given these risks, SGB has been able to control slippages in its agriculture portfolio and the fresh NPA generation rate for the entire advances remained stable at 3.06% in FY2019 (3.32% in FY2018). Nevertheless, there have been slippages of some large ticket exposure accounts in the MSME segment (GNPA of 2.76% as on March 31, 2019 compared to 2.44% as on March 31, 2018), which resulted in an increase in the GNPA to 0.97% as on March 31, 2019 from 0.82% as on March 31, 2018. SGB has made 100% provision against these accounts (NNPA of 0% as on March 31, 2019).

Limited diversity in products and earnings – SGB's product profile primarily comprises agriculture loans and loans to MSMEs. The limited product profile and the absence of avenues to scale up the fee-based income restrict the scope for improvement in the bank's income profile. Nevertheless, the contribution of fee-based income for SGB stood at ~0.6-0.9% of ATA, which was higher than the RRB average. However, this was generated largely by PSLC fee income, adjusted for which, the fee-based income profile remains weak.

Satisfactory core equity capital, though overall capital cushions over regulatory levels remain thin – SGB has maintained its capital metrics above the regulatory level of 9%, with the CRAR at 10.7% as on March 31, 2019, and 10.0% as on December 31, 2019. Despite the capital cushion over the regulatory level of 1.0% as on December 31, 2019, the same remains thin, partly due to the low credit-to-deposit ratio. This is reflected by the net leverage (net advances/net worth), which remained high at ~12.36 times as on March 31, 2019 in comparison to the RRBs' average of ~8.15 times. Within the overall CRAR, the bank's core equity capital (CET-I) stood at 9.3% as on March 31, 2019 and at 9.0% as on December 31, 2019, while the balance comprised Tier II capital.

As per the capital adequacy norms for RRBs, they can raise PDIs for inclusion in Tier I capital. The RRBs need to maintain a minimum Tier I capital of 7.0%, and within the overall Tier I capital, the PDIs are restricted to 1.5%. If the bank meets the CET requirement of 5.5% and meets Tier I of 7.0% with PDIs, any additional PDI over 1.5% is eligible for the calculation of the overall CRAR. Further, RRBs are not allowed to issue Tier II instruments and the current Tier II capital consists of standard assets provisioning. Accordingly, even in a scenario where the RRBs are able to raise sizeable PDIs, their ability to meet the overall CRAR will continue to be driven by their ability to meet the minimum CET of 5.5%. Going forward, ICRA expects SGB to maintain the capital ratio above the regulatory level (CRAR of 9.0%) with a cushion of >1-1.5% even without the proposed PDIs (bonds). The capital cushions will improve further if the bank is able to raise capital from the proposed PDI issuance, subject to any significant worsening of its asset quality profile.

Liquidity position: Strong

SGB's advances mainly comprise crop loans (~60% of gross advances as of March 31, 2019) with a tenure of less than 12 months. This, along with the high share of CASA deposits, helps maintain a well-matched asset liability profile. As per the structural liquidity statement for December 31, 2019, the bank had positive cumulative mismatches across all buckets up to 1 year. Moreover, the statutory liquidity ratio (SLR) of ~19.93% of the net demand and time liabilities, as of December 2019, remained well above the regulatory requirement of 18.25%. The bank can also avail liquidity support from SBI in the form of overdraft facilities or refinance from NABARD or borrow from the RBI (through repo against excess SLR investments and the marginal standing facility scheme) in case of urgent liquidity needs.

Rating sensitivities

Positive triggers – Significant improvement in the scale of operations and an improvement in SGB’s business risk profile, which is vulnerable to asset quality risk given the high share of agricultural advances.

Negative triggers – Deterioration in the asset quality, leading to a decline in internal capital generation, and/or high credit growth without commensurate capital raising leading to the weakening of the capital cushions to less than 2.0% at the CET-I, Tier I or CRAR levels on a sustained basis.

Analytical approach

| Analytical Approach | Comments |
|---------------------------------|---|
| Applicable Rating Methodologies | ICRA Rating Methodology for Banks Impact of Parent or Group Support on an Issuer’s Credit Rating |
| Parent/Group Support | SGB was incorporated under the Regional Rural Banks Act, 1976 and is jointly owned by the GoI, GoG and SBI. RRBs remain strategically important to the GoI and state governments, with sizeable direct or indirect sovereign ownership ensured under the RRB Act, 1976 at all times. ICRA expects SGB to receive financial support from its co-owners, if required. |
| Consolidation/Standalone | To arrive at the rating, ICRA has considered the standalone financials of SGB |

About the company

Saurashtra Gramin Bank (SGB) came into existence on January 2, 2006 through the amalgamation of three erstwhile RRBs – Jamnagar Rajkot Gramin Bank, Surendranagar Bhavnagar Gramin Bank and Junagadh Amreil Gramin Bank. It operates in 11 districts in the Saurashtra region of Gujarat and has a network of 260 branches and 4 regional offices. The head office is in Rajkot.

SGB reported a profit after tax (PAT) of Rs. 31 crore in FY2019 (Rs. 68 crore in FY2018) on a total asset base of Rs. 6,677 crore as on March 31, 2019 (Rs. 5,700 crore as on March 31, 2018), translating into an RoA of 0.49% (1.25% as on March 31, 2018). For 9M FY2020, the bank reported a net profit of Rs. 36 crore on a total asset base of Rs. 6,914 crore as on December 31, 2019, translating into an RoA of 0.70%.

Key financial indicators (audited)

| | FY2018 | FY2019 | 9M FY2020* |
|---|--------|--------|------------|
| Net interest income | 195 | 240 | 185 |
| Profit before tax | 102 | 39 | 55 |
| Profit after tax | 68 | 31 | 36 |
| Net advances | 3,392 | 4,118 | 4,409 |
| Total assets | 5,700 | 6,677 | 6,914 |
| % CET I | 9.6% | 9.3% | 9.0% |
| % Tier I | 9.6% | 9.3% | 9.0% |
| % CRAR | 11.0% | 10.7% | 10.0% |
| % Net interest margin | 3.59% | 3.87% | 3.63% |
| % PAT / ATA | 1.25% | 0.49% | 0.70% |
| % Return on net worth | 22.51% | 9.17% | 12.86% |
| % Gross NPAs | 0.82% | 0.97% | 2.27% |
| % Net NPAs | 0% | 0% | 0% |
| % Provision coverage excl. technical write-offs | 100% | 100% | 100% |
| % Net NPA/ CET | 0% | 0% | 0% |

Note: Amount in Rs. crore; Net worth and total assets exclude revaluation reserves

Source: SGB, ICRA research

*9M FY2020 results are unaudited

All calculations are as per ICRA research

Status of non-cooperation with previous CRA: Not applicable

Any other information: None

Rating history for past three years

| Instrument | Type | Amount Rated | Amount O/S | Rating (FY2020) | Rating History for the Past 3 Years | | |
|--------------------------|------|--------------|------------|---------------------------------|-------------------------------------|--------|--------|
| | | | | Current Rating Mar-17-2020 | FY2019 | FY2018 | FY2017 |
| Perpetual Debt Programme | LT | 200.00 | 0.00 | [ICRA]A-(hyb)(Stable); Assigned | - | - | - |

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 |
|------|-----------------|-----------------------------|-------------|---------------|--------------------------|----------------------------|
| - | Perpetual Debt | - | - | - | 200.00 [#] | [ICRA]A-(hyb)(Stable) |

[#] Yet to be issued

Source: SGB

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