October 31, 2019

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 takes into account City Union Bank Limited's (CUB) established retail franchise, resulting in a granular asset and liability base, its strong capitalisation (CET I ratio of 15.2% in June 2019) and liquidity profile, and the above-average profitability indicators (return on assets stood at 1.6% for FY2019). The ratings, however, consider the moderate asset quality, with gross NPA at 3.3% as of June 2019 (3.0% as of March 2019), the relatively high share of SMA 2 (5.5% as of June 2019 compared to 4.0% as of March 2019) and the vulnerability of the target borrower segment to economic disruptions. About 50% of the bank's advances are towards the micro, small and medium enterprises (MSME) segment and traders. The ratings also factor in CUB's average deposit profile, as reflected in the higher cost of interest-bearing funds compared to the private banks' average, and the modest scale and geographically concentrated nature of operations (63% of advances and 79% of deposits were in Tamil Nadu as of June 2019).

ICRA notes that the bank may not require any external capital to achieve a compounded annual growth rate (CAGR) of 15-18% over the next three years (FY2020-2022) while maintaining sufficient cushion above the regulatory capital requirement[1]. Going forward, CUB's ability to strengthen its deposit profile through higher mobilisation of low-cost funds, thereby enabling it to compete in better borrower segments, while maintaining a tight control over the asset quality as the business grows would be a key rating driver.

Key rating drivers and their description

Credit strengths

Established retail franchise resulting in granular asset and liability base – CUB has more than 10 decades of operations with a strong retail franchise. The bank's focus on retail deposits is reflected in its granular liability profile with deposits below Rs. 5 crore constituting 88% of the overall term deposits as of March 2019 (91% as of March 2018). The top 20 depositors accounted for 9% of the total deposits as of March 2019 (8% as of March 2018). Further, the bank has a built a granular loan base with the top 20 exposures at 43% of the Tier I capital, which is relatively low compared to the private sector bank average. Over the past 10 years (FY2010-2019), the bank achieved a steady business growth (advances and deposits) of 17.7% (CAGR), backed by a stable senior management team headed by Dr. N. Kamakodi (Managing Director & Chief Executive Officer). Nevertheless, its operations remain concentrated with a sizeable presence in Tamil Nadu, which accounted for 70% of the branch network, while advances and deposits constituted 63% and 79% of the deposits, respectively, as of June 2019.

[1] Minimum Tier I capital requirement including capital conservation buffer (CCB) will be 9.5%, while total capital including CCB will be 11.5% from March 31, 2020

Likely to maintain above-average profitability, aided by high margins and stable operating efficiency – CUB's net interest margin (NIM), as a percentage of average total assets (ATA), remained healthy at 3.8% in FY2019 (3.8% in FY2018; 3.6% in FY2017) supported by the high yielding and granular nature of its exposures; the NIM stood at 3.7% in Q1 FY2020. This was despite the relatively high funding cost in relation to peers among the private sector banks. Given the granular nature of the advances profile (about three-fourth of the advances have a ticket size of less than Rs. 5 crore) and the nature of the target segment (MSME and traders constitute 50% of advances), the bank commands better pricing compared to larger corporates or prime retail exposures. Further, close to 65% of CUB's advances were in the form of working capital facilities, which enable the repricing of loans at regular intervals. Despite the granular loan book, the bank's operating costs have remained lower than peers as well as the private banks' average at 2.0-2.1% of ATA over the last three years (FY2017-2019). Its credit costs have also been lower in the range of 0.7-0.8% of ATA. CUB's non-interest income, though lower than the private banks' average, has remained comparable with peers and remained largely stable at about 1.1-1.2% over the last three years. It is driven mainly by recoveries from written-off accounts. Healthy NIMs along with stable operating and credit costs have helped the company maintain a stable RoA of 1.5-1.6% over the last three-year period, translating into above-average profitability.

Strong capitalisation levels – CUB's capital levels have remained strong, supported by good internal generation[2] (return on equity of 15% over the last three years). The bank raised equity capital of Rs. 350 crore in FY2015 and since then, the internal generation has been adequate to meet the credit growth. Its overall capital adequacy under Basel III was comfortable at 15.7% (CET I ratio at 15.2%) as of June 2019. CUB's current capital levels are likely to support its envisaged growth (15-18% per annum) over the next three years (FY2020-2022) without any sizeable capital requirement. Its solvency ratio (net NPAs/net worth) was comfortable at 11.9% as of June 2019 and was better than peers and the private sector banks' average.

Credit challenges

Relatively marginal borrower profile, which can get impacted by economic disruptions and translate into asset quality pressure for CUB – CUB's gross NPAs increased to 3.3% in June 2019 (3.0% in March 2019) from 2.4% in March 2016 because of the impact of the ongoing economic slowdown on the MSME sector, which is the target segment for CUB. The bank's fresh slippage rate remained in the range of 2.3-2.4% during FY2017-Q1 FY2020. ICRA also notes that CUB's overall SMA 2 remained high at 5.5% of advances in June 2019 compared to 4.0% in March 2019 (4.3% in March 2018). Further, the quantum of loans restructured under the MSME window[3] could increase to about 1% by March 2020 from 0.2% as of June 2019 as the MSME segment continues to face stress. ICRA expects the gross fresh slippages to remain at 2-2.2% in FY2020. Higher-than-expected slippages or the restructuring of loans, coupled with limited recoveries, would remain an overhang on the overall asset quality and the same would be a rating monitorable. CUB's unprovided security receipts (SRs) stood at about Rs. 200 crore (0.6% of advances) as of June 2019.

ICRA, however, takes comfort from the granular nature of the bank's advances, the sole banking arrangement for close to 95% (in June 2019) of its exposures and the secured nature of its loans, which are expected to partially offset the inherent credit risk of the target borrower segment. CUB's exposures are generally secured by fixed assets (residential/commercial) to the extent of 75-80% of the loan value. This is over and above the movable asset/book debt security of 125% on working capital loans. The bank, therefore, is able to undertake effective recoveries from the overdue or written-off accounts. Recoveries from technically written-off (TWO) accounts remained in the range of about 20-25% of the opening TWO accounts during FY2018-2019.

Average deposit profile, reflected in relatively higher cost of interest-bearing funds compared to sector average – CUB's deposits increased at a CAGR of 12% during FY2016-2019, which lagged the advances growth over the same period. This led to an increase in the credit-to-deposit (CD) ratio to 86% in March 2019 from 75% in March 2015. ICRA also notes that although the CASA base improved to 25.2% in March 2019 from 20.4% in March 2016, it remains low compared to the private bank'

---

[2] *PAT, less dividend, as a proportion of average net worth*

[3] *The forbearance window for restructuring MSME loans is available till March 2020*

average of ~39%. The lower share of CASA has resulted in a higher cost of interest-bearing funds compared to peers and the sector average, thereby inhibiting the bank's ability to pursue credit growth opportunities by targeting better credit profile customers. The cost of interest-bearing funds for the bank stood at 5.8% compared to the private banks' average of 5.5% in FY2019 (6.0% and 5.3%, respectively, in FY2018). 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 and maintain a good earnings profile.

Modest scale and geographically concentrated operations – CUB's advances and deposits stood at Rs. 32,229 crore and Rs. 39,077 crore, respectively, in June 2019 accounting for about 0.4% and 0.3%, respectively, of the banking sector's. CUB's advances and deposits grew at a CAGR of 15.7% and 12.3%, respectively, during April 2016-March 2019 compared to the private sector banks' growth of 18.2% and 17.9%, respectively (6.7% and 8.3%, respectively, for the overall banking sector) during this period. In line with its concentrated branch presence, about 63% of the advances and 79% of the deposits were from Tamil Nadu in June 2019. ICRA expects the bank's operations to remain regionally concentrated, going forward. ICRA also expects CUB's share in the banking sector to remain modest, notwithstanding the envisaged advances growth of about 15-18% over the near to medium term.

Liquidity position: Strong

The bank's liquidity coverage ratio (LCR) remained high at 198.5% in Q1 FY2020 against the regulatory requirement of 100% as on January 1, 2019. Apart from being driven by holdings in Government securities, the bank's LCR is driven by the relatively lower share of non-operational and less stable deposits, leading to lower near-term outflows even though inflows from advances remain lower than the averages for other banks.

As per the structural liquidity statement for June 30, 2019, the bank has positive mismatches (inflows higher than outflows) across all the buckets in the less than 1-year segment. The rollover rate of term deposits remained high at ~86-89% of retail deposits during FY2018-2019. Going forward, CUB's ability to expand its deposit base and maintain high renewals will remain key for liquidity while achieving the desired growth. On a fortnightly average basis, the bank maintained an excess SLR holding of 250 bps of the net demand and time liabilities during FY2019. 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.

Rating sensitivities

Positive triggers – ICRA could revise the outlook to Positive or upgrade the rating if the bank continues to improve its cost of interest-bearing funds while achieving growth, thereby bringing it closer to the sector average and enabling it to compete in better borrower segments. This, in ICRA's view, can be achieved by maintaining CASA deposits above 35%.

Negative triggers – ICRA could revise the outlook to Negative or downgrade the ratings if there is a weakening in the solvency profile with Net NPA / CET I 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 1.0-1.1%) or a deterioration in the liability franchise will be negative triggers.

Analytical approach

Analytical Approach	Comments
Applicable Rating Methodologies	[ICRA's Credit 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 June 30, 2019, it had a network of 650 branches and 1,711 ATMs with about 90% of the total branches being in South India. About 56% of the branches are in semi-urban and rural areas. CUB reported a capital adequacy ratio of 15.7% (Tier I: 15.2%) and gross and net NPAs of 3.3% and 1.9%, respectively, as of June 2019. In Q1 FY2020, the bank reported a net profit of Rs. 186 crore on an asset base of Rs. 46,123 crore compared to a net profit of Rs. 162 crore on an asset base of Rs. 39,870 crore in Q1 FY2019.

Key financial indicators (audited)

	FY2018 Audited	FY2019 Audited	Q1 FY2019 Unaudited	Q1 FY2020 Unaudited
Net interest income	1,430	1,612	375	417
Profit before tax	790	925	222	236
Profit after tax	592	683	162	186
Net advances	28,239	32,673	28,215	32,230
Total assets	39,937	45,259	39,870	46,123
% CET I	15.8%	15.0%	15.6%	15.2%
% Tier I	15.8%	15.0%	15.6%	15.2%
% CRAR	16.2%	15.6%	16.1%	15.7%
% Net interest margin / Average total assets	3.8%	3.8%	3.8%	3.7%
% Net profit / Average total assets	1.6%	1.6%	1.6%	1.6%
% Return on net worth	15.3%	15.2%	15.2%	15.0%
% Gross NPAs	3.0%	3.0%	3.0%	3.3%
% Net NPAs	1.7%	1.8%	1.7%	1.9%
% Provision coverage excl. technical write-offs	44.6%	39.4%	44.4%	44.2%
% Net NPA/ CET I	11.3%	12.5%	11.5%	12.7%

All ratios as per ICRA calculations Amount in Rs. crore

Source: Bank, ICRA research

Status of non-cooperation with previous CRA: Not applicable

Any other information: None

Rating history for past three years

	Instrument	Current Rating (FY2020)				Rating History for the Past 3 Years			
		Type	Amount Rated	Amount Outstanding	Rating	FY2019		FY2018	FY2017
					31-Oct-2019	11-Sep-2018	31-Aug-2018	-	-
1	Issuer Rating	Long Term	-	-	[ICRA]AA- (Stable)	[ICRA]AA- (Stable)	-	-	-
2	Certificates of Deposit Programme	Short Term	25.0	25.0	[ICRA]A1+	[ICRA]A1+	[ICRA]A1+	-	-

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

Not applicable

Analyst Contacts

Karthik Srinivasan
+91-22-61143444
karthiks@icraindia.com

Anil Gupta
+91-124-4545314
anilg@icraindia.com

Govindaraj Prabhu M
+91-44-4596 4306
govindaraj.m@icraindia.com

Shaik Abdul Saleem
+91-44-4596 4325
shaik.saleem@icraindia.com

Relationship Contact

Jayanta Chatterjee
+91 80 4332 6401
jayantac@icraindia.com

MEDIA AND PUBLIC RELATIONS CONTACT

Ms. Naznin Prodhani
Tel: +91 124 4545 860
communications@icraindia.com

Helpline for business queries:

+91-9354738909 (open Monday to Friday, from 9:30 am to 6 pm)

info@icraindia.com

About ICRA Limited:

ICRA Limited was set up in 1991 by leading financial/investment institutions, commercial banks and financial services companies as an independent and professional investment Information and Credit Rating Agency.

Today, ICRA and its subsidiaries together form the ICRA Group of Companies (Group ICRA). ICRA is a Public Limited Company, with its shares listed on the Bombay Stock Exchange and the National Stock Exchange. The international Credit Rating Agency Moody's Investors Service is ICRA's largest shareholder.

For more information, visit www.icra.in

ICRA Limited

Corporate Office
Building No. 8, 2nd Floor, Tower A; DLF Cyber City, Phase II; Gurgaon 122 002
Tel: +91 124 4545300
Email: info@icraindia.com
Website: www.icra.in

Registered Office
1105, Kailash Building, 11th Floor; 26 Kasturba Gandhi Marg; New Delhi 110001
Tel: +91 11 23357940-50

Branches

Mumbai	+ (91 22) 24331046/53/62/74/86/87
Chennai	+ (91 44) 2434 0043/9659/8080, 2433 0724/ 3293/3294,
Kolkata	+ (91 33) 2287 8839 /2287 6617/ 2283 1411/ 2280 0008,
Bangalore	+ (91 80) 2559 7401/4049
Ahmedabad	+ (91 79) 2658 4924/5049/2008
Hyderabad	+ (91 40) 2373 5061/7251
Pune	+ (91 20) 2556 0194/ 6606 9999

ICRA ratings should not be treated as recommendation to buy, sell or hold the rated debt instruments. ICRA ratings are subject to a process of surveillance, which may lead to revision in ratings. An ICRA rating is a symbolic indicator of ICRA's current opinion on the relative capability of the issuer concerned to timely service debts and obligations, with reference to the instrument rated. Please visit our website www.icra.in or contact any ICRA office for the latest information on ICRA ratings outstanding. All information contained herein has been obtained by ICRA from sources believed by it to be accurate and reliable, including the rated issuer. ICRA however has not conducted any audit of the rated issuer or of the information provided by it. While reasonable care has been taken to ensure that the information herein is true, such information is provided 'as is' without any warranty of any kind, and ICRA in particular, makes no representation or warranty, express or implied, as to the accuracy, timeliness or completeness of any such information. Also, ICRA or any of its group companies may have provided services other than rating to the issuer rated. All information contained herein must be construed solely as statements of opinion, and ICRA shall not be liable for any losses incurred by users from any use of this publication or its contents