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20
YEARS

Initiating Coverage City Union Bank Ltd.

14-December-2020





Industry	LTP	Recommendation	Base Case Fair Value	Bull Case Fair Value	Time Horizon
Private Bank	Rs. 176.9	Buy on dips to Rs.162-165 band and add more on dips to Rs.146-150 band	Rs. 187	Rs.206	2 quarters

HDFC Scrip Code	CITUNI
BSE Code	532210
NSE Code	CUB
Bloomberg	CUBK IN
CMP Dec 11, 2020	176.9
Equity Capital (Rscr)	73.8
Face Value (Rs)	1
Eq- Share O/S (cr)	73.8
Market Cap (Rscrs)	13058.6
Book Value (Rs)	71.8
Avg. 52Wk Volumes	1907122
52 Week High	249.3
52 Week Low	110.0

Share holding Pattern % (Sept, 2020)	
Promoters	-
Institutions	46.2
Non Institutions	53.8
Total	100.0

Fundamental Research Analyst

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Our Take:

City Union Bank Limited (CUBK) is a mid-sized private sector bank focused largely on working capital finance to small manufacturers and traders. City Union Bank has established retail franchise, granular asset and liability base, 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. The bank has healthy profitability indicators with return ratios above the private banks' average. CUBK's niche lending to small and medium businesses is building high pressure on growth and asset quality and can keep financial performance sub-optimal over next few quarters. The bank's niche positioning, strong SME relationships, better customer acquisition through referrals and regional focus would help the bank to post loan growth of over 12-14% in FY22-23.

CUBK has all the right ingredients, which include conservative management, unparalleled lending franchise, stable margins, superior return ratios across cycles and a well-capitalized balance sheet to deliver steady performance over the years. Although the net profitability has moderated in the last couple of quarters, given the provisions of Rs. 317cr or 0.91% of net advances as on September 30, 2020 for Covid-19 induced asset quality stress; its NIMs are likely to remain stable given its focus on high yielding MSME segment. CUBK's granular deposit base, reliance on retail term deposits and a low proportion of corporate deposits helps it maintain stable funding cost.

Valuations & Recommendation:

City Union Bank has delivered steady performance on account of its conservative management, tight control on asset quality and superior return ratios across cycles. Focus on small-ticket sole banker business model, expertise in southern India's niche business segments, viz MSME, traders and agri loans, and weak health of regional PSBs will drive higher loan growth. The asset quality pressures are expected to remain high for the bank in the near term, given the vulnerability of the target borrower segment MSME and traders (~51% of loan book). 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. Comfortable capital position would provide cushion to weakening asset quality metrics. Improving loan growth, diversified revenue profile, controlled C-I and lower credit costs should aid RoAA of 1.4-1.5% over FY22-23E. We believe that there is an ample opportunity for the bank to expand its presence across the country in the years to come.

City Union Bank's key strength lies in robust assets side of the business and the bank's ability to gain credit market share with stable credit quality. Though we remain optimistic on its retail focus and the segment it caters to; we are cautious on growth stance because of likely higher delinquency rates and credit costs in MSME segment. We like CUBK due to its high yield SME book focused on working capital (close to two thirds), high collateral cover (barely 1% unsecured) & sticky retail-funded liability base with largely matched ALM resulting in superior NIMs. We think the base case fair value of the stock is Rs.187 (2.4x FY22E ABV) and the bull case fair value is Rs.206 (2.65x FY22E ABV) over the next two quarters. Investors can buy the stock on dips to Rs.162-165 band (2.10x FY22E ABV) and add more on dips to Rs.146-150 band (1.90x FY22E ABV). At the LTP of Rs.176.9 it quotes at 2.28x FY22E ABV.

Financial Summary:

Particulars (Rs cr)	Q2FY21	Q2FY20	YoY-%	Q1FY21	QoQ-%	FY18	FY19	FY20	FY21E	FY22E
NII	475.1	411.5	15.5	437.0	8.7	1,430	1,611	1,675	1,776	1,975
PPoP	384.7	346.5	11.0	356.0	8.0	1,208	1,240	1,341	1,426	1,567
PAT	157.7	193.5	-18.5	154.0	2.4	592	683	476	535	761
EPS (Rs)	2.1	2.6	-19.0	2.1	2.2	8.0	10.5	10.9	10.0	12.4
RoAE (%)						15.3	15.2	9.4	9.6	12.3
RoAA (%)						1.6	1.6	1.0	1.0	1.4
Adj. BVPS (Rs)						55.5	57.9	61.3	65.7	77.7
P/E (x)						19.9	19.0	27.4	24.4	17.1
P/ABV (x)						3.2	3.1	2.9	2.7	2.3

(Source: Company, HDFC sec)

Q2FY21 Result Review

City Union Bank posted better than expected results supported by healthy operating performance as NIMs expanded 21bps YoY/14bps QoQ to 4.12% in Q2FY21, led by reduction in Cost of deposits 71bps YoY/35bps QoQ. With operating cost under control (flat YoY), the bank posted 11% growth YoY in its pre-provision profits. Non-tax provisions remain elevated at Rs 177cr as CUBK continued to provide for the potential impact of COVID-19 (Rs 115cr in Q2FY21); which resulted in fall of 18.5% YoY in net profit. Bank enhanced its COVID-19 related provisions by Rs 1.1bn, taking cumulative provisions to Rs 3.2bn (0.9% of loans).



GNPAs dipped 9.3% QoQ to Rs 1,220cr at 3.4% aided by nil slippages on account of SC order and slightly higher write-offs. PCR improved to 48.3%. Collection data of the bank was heartening, given the higher exposure to SME segment. For the month of Sep 2020, the bank collected 90% of demand raised (with term loan accounts saw repayments of 86% and working capital accounts saw repayments of 94%) and also disclosed that in last seven month, 4% of customers by value has not paid any instalment till Sep-20 as compared to 12.5% in June-20. Although the trend in collection efficiency is encouraging, the management expects around 5-6% of book to get restructured (including 1.5% of loans already restructured).

Loan growth moderated to 6% YoY led by contraction in traders (-6.7% YoY), agricultural loans (-14.5% YoY). MSME loan book grew 11% YoY propelled by disbursements under the credit guarantee scheme. Gold loans and loans for commercial real estate gather pace in the second quarter of FY21. Deposits growth moderated to 2% YoY as bank calibrated its liabilities in-line with loan growth. The management guides for high single-digit loan book growth in FY21E. We build in loan growth of 11.2% over FY21-23E. Higher credit costs combined with a weaker operating performance (attributed to slower business growth) could keep the earnings weak in FY21.

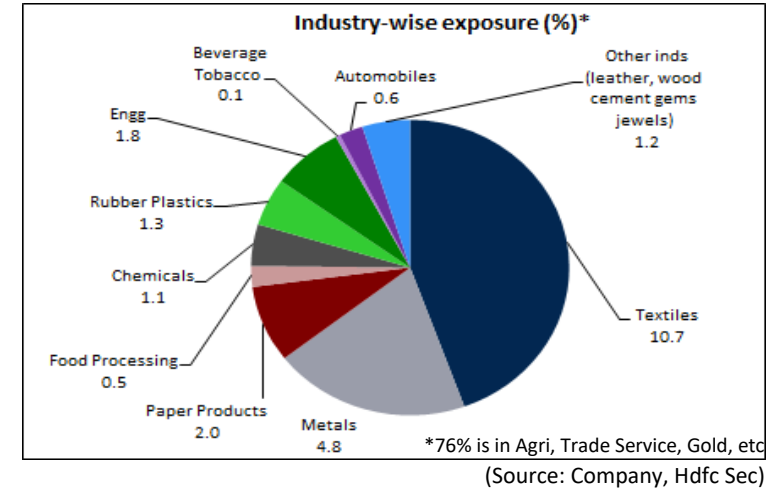
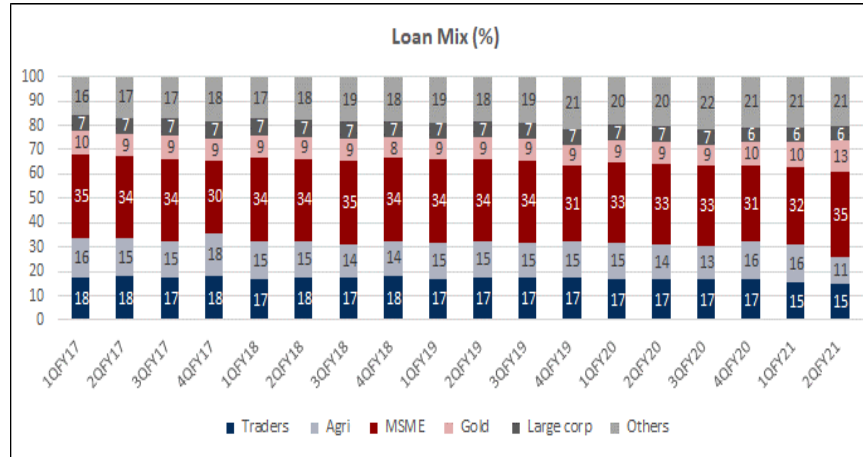
Triggers

Diversified Loan with MSME financing and regional focus:

CUBK's lending focus remains on trading and MSME loans (51% of its loan book) where it likes to operate in high-yielding, small ticket sizes of Rs 1-2cr. The bank focuses more on working capital loans and avoids risky products. Predominantly single banker relationships with minimal exposure to consortium / multiple banking arrangements / infrastructure lending and adequate collaterals mainly backed by residential property helps in keeping a tab on NPAs in high yielding MSME segment.

CUBK with expertise in MSME financing and strong understanding of local markets (ie Tamil Nadu) has taken an advantage of growing MSME sector. Superior client servicing leading to client retention and low business acquisition costs has helped its MSME loan book to grow at ~15% in FY18-20. Its strong regional presence (more than two-third branches in Tamil Nadu) and existence for more than 110 years has helped it gain immense knowledge and understanding on the way businesses are run locally. Being witness to a number of business cycles during the course of its existence along its granular loan book; the bank has managed asset quality risks effectively while taking advantage of higher yields. Top 20 borrowers account for just 5.4% of total advances as on March 31, 2020.

MSME sector constitute ~35%, while traders constitute 15% of the loan book as on Sep 30, 2020. Agricultural loan comprises of 11% followed by loans for commercial real estate at ~7.7%. In Q2, the Bank slowed down its advances growth and focused on ECLGS scheme (Emergency Credit Line Guarantee Scheme). For the current year, growth would be supported to some extent by the MSME credit guarantee scheme and recapitalization of interest accumulated during the six-month moratorium ending in August 2020. Loan growth outlook remains cautious, we have factored in a loan CAGR of 11.2% over FY20-23E.



Stable Liability franchise with focus on retail deposits:

CUBK 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. CUBK has a granular deposit base as bank's top 20 deposits constitutes less than 8.5% and ~91% of the total deposits are with ticket size of less than Rs 2cr as on Sep 30, 2020. CUBK's share of retail deposits (retail term deposits + CASA) has been comfortably between 75-85% during the past few years, indicating stability to the bank's resources profile. Although share of CASA has increased to 25.7% as on Sep 30, 2020 as against 25% as on March 31, 2020, it still remains lower compared to industry average. The management's focus is maintaining healthy and stable resource profile through its retail deposits (term deposits & CASA). The cost of deposit

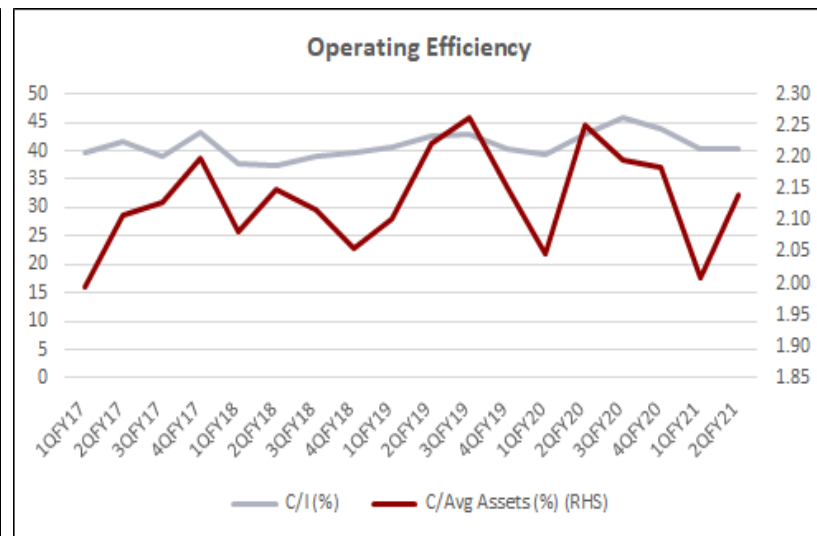
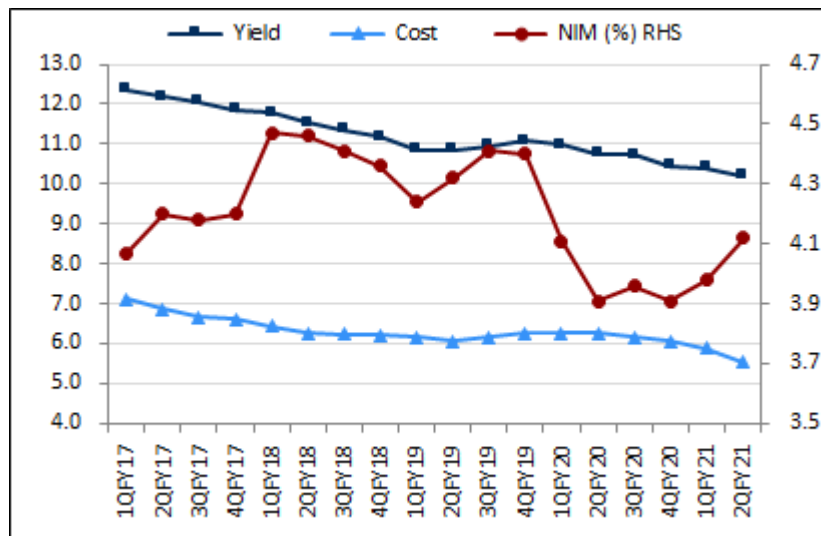


has fallen in line with industry from 6.07% in Q4FY20 to 5.54% in Sep quarter. Low dependence on borrowing and bulk deposits and superior asset liability management employed by the bank has kept its cost of funds on the lower side. The bank has a healthy asset liability management with 67% of deposits and 51% of advances having a maturity period of one to three years in FY20.

Healthy NIMs on the back of SME focused lending, 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). The nature and tenure of its term deposits as well as the improvement in CASA has helped the bank reduce its cost of funds faster than the rate of falling yields, leading to meaningful improvement in margins in the past two fiscals; although its cost of fund remains higher in relation to its peers. The bank's focus on higher-yielding working capital loans to MSME and traders segments supported healthy margin expansion. CUBK's rich experience in understanding the ins and outs of its target MSME segment helps to command higher yields in this niche segment without much impact on asset quality. Also, re-pricing is possible given large proportion of advances in form of working capital loan (59%) and reducing interest rate risk. Operating costs as a percentage of average total assets lower than its peers by 10-15bps support the bank's earnings.

The bank has reported moderation in its profitability given rise in credit cost and additional provisions due to covid-19 related stress. In fiscal 2020, the bank has reported return on assets (RoAA) of 1.0%, contrary to over 1.4% maintained over the last decade. While the pre-provisioning operating profit (PPoP) has remained steady over the quarters at 2.8-3.0% (PPoP to average total assets), overall profitability has moderated due to increase in credit cost. The bank carried ad hoc provisions of Rs. 317cr or 0.91% of net advances for Covid-19 stress as on September 30, 2020. Return on Equity was at 11.50% in Q2FY21 as compared to 15.18% in Q2FY20. The returns of Assets (RoAA) also declined for the Sep-quarter and was at 1.23% as against 1.62% for the same period of last year. NIM was also impacted due to interest reversal of Rs 25cr on SMA account balances over the seven-month period from March to September 2020. Excluding this, NIM would have been at ~4.3%. With cost and asset quality pressures, the profitability is likely to moderate in the near term, however, these are likely to remain healthy with RoAA above 1% in FY21.



(Source: Company, HDFC Sec)

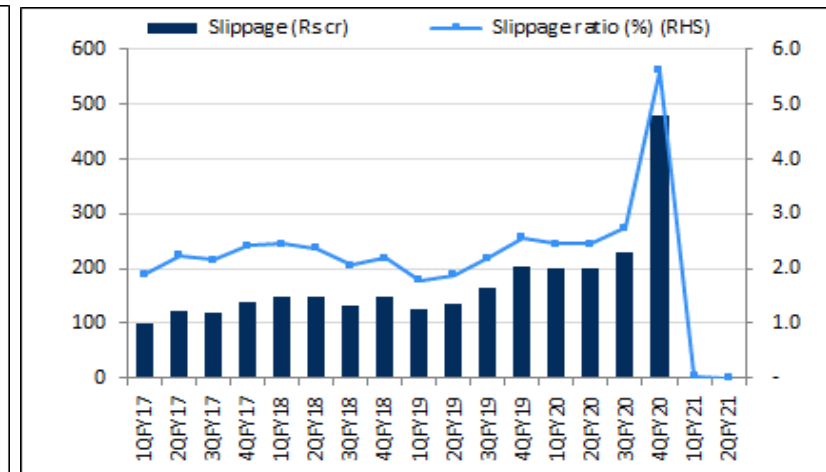
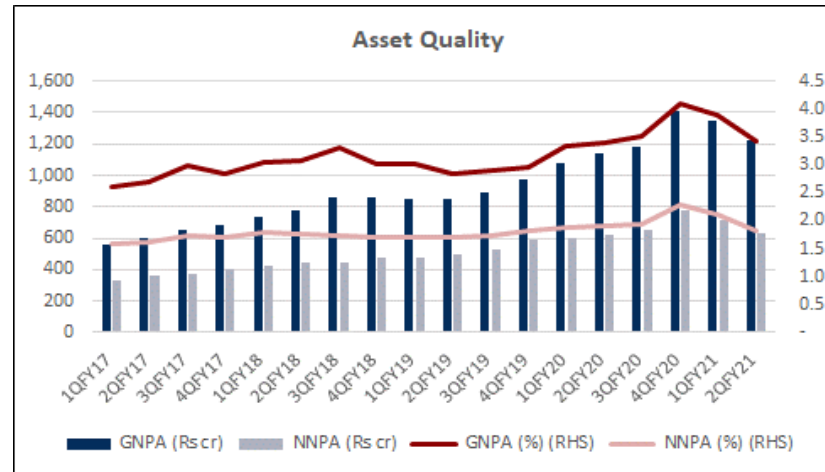
Operating Efficiency – Low Cost/Income Ratio:

CUBK is one of the best in terms of its operating efficiency; its core C/I ratio stood at 46% in FY20 compared to 50-55% of its peers. A contained, focused branch expansion strategy and increased share in non-branch channels (~90%) in transactions helped in capping its cost. Out of 50 branches opened during FY20, the bank had opened 30 Branches in Tamil Nadu, 6 in Andhra Pradesh, 2 in Telangana and the rest in other states. Branch expansion still focused in South India where the turnaround time is quick compare to its presence in other regions which helps in charting favourable opex ratio. We expect medium term C-I ratio to remain in the range bound of 43-45% barring impact from fluctuation in other income.

Robust Asset Quality; expect some short-term weakness:

The management's strategy of disbursing granular loan has aided the bank in maintaining its asset quality, despite witnessing higher slippages in last two years. The Gross NPA as at March 31, 2020 increased to Rs 1,413.4cr (4.09%) as against Rs 977.05cr (2.95%) in FY2019.

The Net NPA stands increased at 2.29% in FY2020 as against 1.81% in previous year. The reported Provision Coverage was 65% as at March 31, 2020 (vs 63% in previous year). As per the Reserve Bank of India guidelines, banks are required to make a provision of 10% (5% in Q4FY20 and 5% in Q1FY21) for accounts where the asset classification benefit was extended. Accordingly, as a prudent measure, the bank already holds a provision of Rs.225cr for Covid-19 as on June 30, 2020 and during Q2FY21 the bank has made an additional provision of Rs.115cr to meet any future contingency arising out of Covid pandemic. As economic activity has improved in past couple of months and customer transactions at 80-85% of pre-covid levels as per management commentary is quite heartening. CUBK has demonstrated its prudent underwriting in the past and asset quality remains in check. Secured lending (99% of advances), lower exposure to stressed sectors and strong relationship with borrowers will support the bank in improving its asset quality. Low ticket lending backed by high level of collaterals coupled with greater exposure to working capital loans (59% of advances) would keep slippages at acceptable level. Although there is risk of elevated slippages, we expect minimum risk as 99% of total lending are secured in nature which helps in easy recovery. The management guides for slippages of ~3.5% in FY21E, and expects to restructure 4.5-5% of loans (mostly from the moratorium book). However, we expect GNPA/ NNPA at 5.2/2.6% in FY21 and 4.2/1.9% in FY22. A high level of slippages and restructuring guidance points towards asset quality pressure in the near term and remains a key monitorable.



(Source: Company, HDFC Sec)



Comfortable Capital Position:

Capital adequacy remains comfortable in relation to scale and nature of operations, reflected in a common equity Tier I (CET I) capital and overall capital adequacy ratio (CAR) of 16.3% and 17.4%, respectively, as on Sep 30, 2020. The bank has also demonstrated a track record of raising equity capital through rights or preferential issue as and when required. Reported networth stood at Rs 5,571cr and networth coverage of NNPA was adequate at 8.8 times on Sep 30, 2020. Bank has a strong track record of maintaining capital adequacy ratio higher than minimum regulatory requirements, supported by healthy internal capital generation with an average return on equity of ~12.4% in FY2018 - FY2020. 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. 600cr. We believe that the current capitalisation levels are adequate to absorb any potential stress in the earnings profile due to higher credit cost.

Strong Liquidity Position:

Liquidity position is strong, supported by access to systemic liquidity. Liquidity position has been adequate with LCR of 292% as of Sep 30, 2020. The bank has positive cumulative mismatches across buckets over the next 12 months. 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, CUBK's ability to expand its deposit base and maintain high renewals will remain the key for liquidity while achieving the desired growth

Concerns

- **Geographical Concentration:** The Bank has a major presence in the State of Tamil Nadu and expanded its presence in other states by identifying potential centers. 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. Such concentration exposes the bank's asset and liability to local socio-economic and political risks. Any major change in the state policies or swing in regional growth environment could impact their earnings. Bank's operations to remain regionally concentrated and are unlikely to improve in the medium term as the management foresees its further potential to open branches in Tamil Nadu till it reaches 700 – 800 branches from the present level of 485. Its understanding of local businesses, relationships and knowledge of the niche business segments in southern India could support loan book growth.

State	No. of Branches	% of Deposits	% of Advances	% of Business
Tamil Nadu	485	80	64	72
Karnataka	41	6	6	6
Andhrapradesh	45	3	8	5
Telengana	33	2	5	4
Maharashtra	20	2	3	3
Kerala	18	2	2	2
Gujarat	14	1	4	2
Others	44	4	8	6
Total	700	100	100	100

(Data as on Sep 30, 2020; Source: Company, HDFC Sec)

- Likely rise in slippages in short term – COVID impact:** The Covid-19-led pandemic has disrupted cash flows of several borrowers, especially small businesses. The bank has extended a moratorium to all the eligible borrowers in line with relief measures provided by Reserve Bank of India. As on Sep 30, 2020, the bank received payments for accounts covering 70% of total exposure for six months during the moratorium period. For the month of Sep 2020, the bank collected 90% of demand raised (with term loan accounts saw repayments of 86% and working capital accounts saw repayments of 94%) and also disclosed that in last seven month, 4% of customers by value has not paid any instalment till Sep-20 as compared to 12.5% in June-20. CUBK being 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 will help to ride out expected asset quality shocks. ECLGS scheme (Emergency Credit Line Guarantee Scheme) could help in recoveries.

Company Profile:

City Union Bank (CUBK) was established in 1904 as Kumbakonam Bank Ltd in Tamil Nadu and is amongst India's oldest private sector banks. It has evolved into a strong regional player with major presence in South India (90% of total branches), with 700 branches out of which 485 are in Tamil Nadu as of Sep 30, 2020. About 57% of the branches are in semi-urban and rural areas. CUBK's decades of experience in a single geographical region has helped it gain immense knowledge and understanding on the way local businesses are run; and is focussed largely on providing working capital finance to small manufacturers and traders. This higher-yielding trade and MSME loans segment accounts for

~50% of advances and has registered compounded growth of 12% over FY15-FY20. Its lending philosophy is founded on the principle of providing small-ticket secured loans on strict collateralisation norms which helps it to control asset quality.

CUBK's net advances grew at a CAGR of 12.5% during FY2017 – FY2020. A higher advances growth compared to the system resulted in a marginal rise in CUBK's market share to 0.37%. The bank has an established retail franchise with more than 100 years of operations in South India and is one of the very few banks, which has reported consistent returns (RoA & RoE above 1.5% & 15% for the past decade). The returns were supported by stable margins (NIM above 3%) and better operating efficiency (C/I ratio below 45%). The bank reported a capital adequacy ratio of 17.36% (Tier I: 16.29%) and gross and net NPAs of 3.4% and 1.8%, respectively as of September 2020.

INCOME STATEMENT

(Rs cr)	FY18	FY19	FY20	FY21E	FY22E
Interest Income	3,402	3,767	4,169	4,359	4,721
Interest Expenses	1,972	2,156	2,493	2,583	2,747
Net Interest Income	1,430	1,611	1,675	1,776	1,975
Non-interest income	532	514	680	680	721
Operating Income	1,962	2,126	2,355	2,457	2,696
Operating Expenses	755	886	1,014	1,030	1,129
PPoP	1,208	1,240	1,341	1,426	1,567
Prov & Cont	418	315	755	736	585
Profit Before Tax	790	925	586	690	982
Tax	198	242	110	155	221
PAT	592	683	476	535	761

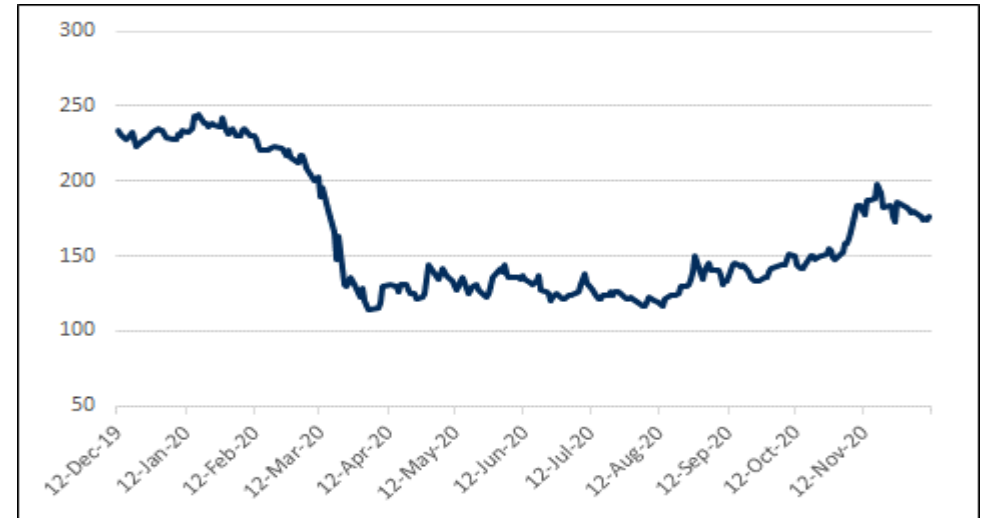
BALANCE SHEET

(Rs cr)	FY18	FY19	FY20	FY21E	FY22E
SOURCES OF FUNDS					
Share capital	66	73	74	74	74
Reserves and surplus	4,097	4,767	5,222	5,728	6,447
Shareholders' funds	4,163	4,841	5,296	5,801	6,520
Total Deposits	32,853	38,448	40,832	43,590	47,762
CASA	7,957	9,698	10,197	11,027	11,932
Total Borrowings	1,736	481	2,032	1,728	1,482
Other Liabilities, provisions	1,186	1,489	1,573	1,730	1,903
Total	39,937	45,259	49,734	52,849	57,667
APPLICATION OF FUNDS					
Cash & Bank Balance	2,636	2,963	4,722	4,028	3,331
Investments	7,879	7,712	9,117	10,445	11,357
Advances	27,853	32,673	33,927	36,267	40,717
Fixed Assets	223	250	245	257	270
Other Assets	1,346	1,660	1,722	1,852	1,991
Total	39,937	45,259	49,734	52,849	57,667

RATIO ANALYSIS

As at March (Rs cr)	FY18	FY19	FY20	FY21E	FY22E
VALUATION RATIOS					
EPS	8.9	9.3	6.5	7.3	10.3
Earnings Growth (%)	17.7	15.3	-30.2	12.3	42.3
BV	62.6	65.9	71.8	78.7	88.4
ABV	55.5	57.9	61.3	65.7	77.7
RoAA (%)	1.6	1.6	1.0	1.0	1.4
ROAE (%)	15.3	15.2	9.4	9.6	12.3
P/E (x)	19.9	19.0	27.4	24.4	17.1
P/ABV (x)	3.2	3.1	2.9	2.7	2.3
PROFITABILITY					
Yield on Advances (%)	11.0	10.5	10.5	10.3	10.1
Yield on Investment (%)	7.0	7.1	7.2	6.9	6.9
Cost of Funds (%)	6.0	5.9	6.1	5.9	5.8
Cost of Deposits (%)	6.1	5.9	6.1	5.9	5.9
Core Spread (%)	4.9	4.6	4.4	4.4	4.3
NIM (%)	4.2	4.1	3.8	3.8	3.8
OPERATING EFFICIENCY					
Cost/Avg. Asset Ratio	2.0	2.1	2.1	2.0	2.0
Core Cost-Income Ratio (%)	40.4	42.3	46.2	45.7	44.4
BALANCE SHEET STRUCTURE RATIOS					
Loan Growth (%)	16.9	17.3	3.8	6.9	12.3
Deposit Growth (%)	9.1	17.0	6.2	6.8	9.6
C/D Ratio (%)	84.8	85.0	83.1	83.2	85.3
CASA (%)	24.2	25.2	25.0	25.3	25.0
Total Capital Adequacy Ratio (CAR)	16.2	15.6	16.8	15.9	15.6
Tier I CAR	15.8	15.0	15.8	15.0	14.9
ASSET QUALITY					
Gross NPLs (Rs cr)	856.5	977.0	1,413.3	1,939.6	1,747.6
Net NPLs (Rs cr)	474.8	591.5	778.5	958.0	792.6
Gross NPLs (%)	3.0	3.0	4.1	5.2	4.2
Net NPLs (%)	1.7	1.8	2.3	2.6	1.9
Coverage Ratio (%)	44.6	39.5	44.9	50.6	54.6
Provision/Avg. Loans (%)	1.2	0.9	1.9	2.1	1.5

One Year Stock Price Chart



(Source: Company, HDFC sec)

Disclosure:

I, **Hemanshu Parmar, (ACA)**, authors and the names subscribed to this report, hereby certify that all of the views expressed in this research report accurately reflect our views about the subject issuer(s) or securities. HSL has no material adverse disciplinary history as on the date of publication of this report. We also certify that no part of our compensation was, is, or will be directly or indirectly related to the specific recommendation(s) or view(s) in this report.

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