Sharekhan by BNP PARIBAS

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City Union Bank

Downgrade to Hold

Bank	Sharekhan code: CUB	
Reco/View: Hold ↓	CMP: **Rs. 160**	Price Target: **Rs. 176** ↓

↑ Upgrade ↔ Maintain ↓ Downgrade

Summary

- We downgrade City Union Bank (CUB) to Hold from Buy with a revised TP of Rs. 176. Our downgrade factors in weak business outlook compared to peers despite strong sector tailwinds and recent lapses in internal controls. Key monitorables remain RBI's approval on the reappointment of existing MD and CEO (tenure ends in April 2023).
- We believe credit cost is expected to remain higher due to– a) Total stressed assets stand at 6.7% of loans with sub-optimal coverage of ~42%; b) The bank has guided that slippages in FY2024E are expected to remain higher (2-2.5%), above pre-Covid levels despite muted growth in the past two years and benign credit cycle, partly offset by recoveries and upgrades.
- CUB reported PAT of Rs. 218 crore (up 11% y-o-y/down 21% q-o-q), below consensus and our estimates, led by higher core credit cost reported at 2.5% annualised vs. 1% q-o-q and 0.9% in Q3FY2022. Loan growth for FY2023 is expected to be lower than the earlier guided range of 15-18%, citing lower risk appetite and muted deposit growth.
- Slippages were at Rs. 439 crore (4.6% annualised based on trailing 12-month advances) vs. 2.8% q-o-q and 3.1% in Q3FY2022. However, slippages of Rs. 185 crore were mainly attributed to divergence in GNPA reported for FY2022. GNPA and NNPA were reported at 4.62% (higher by 26 bps q-o-q) and 2.67% (stable q-o-q), respectively. CUB trades at 1.8x/1.6x/1.4x its FY2023E/FY2024E/FY2025 ABV, respectively.

City Union Bank (CUB) reported sub-optimal performance in Q3FY2023. Net interest income (NII) grew by 13% y-o-y/down 2% q-o-q. Net interest margin (NIM) declined by 21 bps q-o-q to 3.88%. The bank has guided that NIMs were negatively impacted by Rs. 32 crore lower interest income, led by non-recognition of interest subvention income on agri gold loans due to deficiency/lapses in documentation of loans. However, once the regulator is satisfied about the documentation and the bank receives the amount, the bank would account for it. Core fee income grew by 11% y-o-y/1% q-o-q. Treasury income was reported at Rs. 35 crore vs. Rs. 46 crore q-o-q and Rs. 41 crore in Q3FY2022. Total operating expenses grew by 1% y-o-y/down 1% q-o-q. There were no provisions made related to leave encashments during the quarter, thus opex growth was muted as provisions were sufficiently made in H1FY2023 to cover for 9MFY2023. Operating profit grew by 35% y-o-y/9% q-o-q due to muted opex growth. Provisions were up by 82% y-o-y/114% q-o-q. Core credit cost stood at 2.5% of average advances during the quarter versus 1% in the past quarter. PAT grew by 11% y-o-y/down 21% q-o-q. Advances grew by 12% y-o-y/3% q-o-q. Deposits grew by 7% y-o-y/flat q-o-q, with CASA growing at 5% y-o-y/down 6% q-o-q. Slippages were at Rs. 439 crore (4.6% annualised based on trailing 12-month advances) vs. 2.8% q-o-q and 3.1% in Q3FY2022. However, slippages of Rs. 185 crore were mainly attributed towards divergence in GNPA reported for FY2022. GNPA and NNPA reported were at 4.62% (higher by 26 bps q-o-q) and 2.67% (stable q-o-q), respectively. The restructured book stood at Rs. 1,730 crore (~4.0% of advances vs. 4.7% of advances sequentially).

Key positives

- PCR improved to ~43% from ~39% q-o-q.

Key negatives

- NIM declined by 21 bps q-o-q.
- Core credit was higher at 2.5% vs. 1.0% q-o-q.
- Loan growth and deposit growth were below system growth.
- CA and SA balance declined by 8% and 6% q-o-q.

Management Commentary

- Loan growth for FY2023 is expected to be lower than the earlier guided range of 15-18%, citing lower risk appetite, muted deposit growth, lower capacity utilisation, and lower capex intensity. NIMs are expected to remain stable.
- The bank expects slippages to be at ~2-2.5% in FY2024E and reach pre-COVID levels (i.e. below 2%) in FY2025E.

Revision in estimates – We have lowered our FY2023E/FY2024E earnings estimates, factoring in higher credit cost and lower loan growth. We have also added FY2025 estimates.

Our Call

Valuation – Downgrade to Hold with a revised PT of Rs. 176 - At the CMP, CUB trades at 1.8x/1.6x/1.4x its FY2023E/FY2024E/FY2025 ABV, respectively. Our downgrade factors in weak business outlook compared to peers despite strong sector tailwinds and recent lapses in internal controls. We believe credit cost is expected to remain higher due to subpar coverage on bad loans and slippages are expected to remain higher in FY2024E despite muted growth in the past two years and benign credit cycle. The restructured book is relatively higher than PSU banks also. Business momentum continues to remain below system growth. Key monitorable remains the RBI's approval on the reappointment of the existing MD and CEO (tenure ends in April 2023).

Key Risks

Higher loan growth, higher margins than anticipated, lower slippages, and, in turn, lower credit cost could lead to upside risk.

Valuation (Standalone) Rs cr

Particulars	FY22	FY23E	FY24E	FY25E
NII	1,916	2,189	2,355	2,568
PAT	760	939	982	1,078
EPS (Rs.)	10.3	12.7	13.3	14.6
P/E (x)	15.5	12.6	12.0	11.0
P/ABV (x)	2.1	1.8	1.6	1.4
RoE (%)	12.2	13.3	12.3	11.9
RoA (%)	1.3	1.5	1.4	1.4

Source: Company; Sharekhan estimates

3R MATRIX

	+	=	-
Right Sector (RS)	✓		
Right Quality (RQ)		✓	
Right Valuation (RV)		✓	

\+ Positive = Neutral – Negative

What has changed in 3R MATRIX

	Old		New
RS	Positive	↔	Positive
RQ	Positive	↓	Neutral
RV	Positive	↓	Neutral

ESG Disclosure Score NEW

ESG RISK RATING 35.21

Updated Oct 08, 2022

High Risk

NEGL	LOW	MED	HIGH	SEVERE
0-10	10-20	20-30	30-40	40+

Source: Morningstar

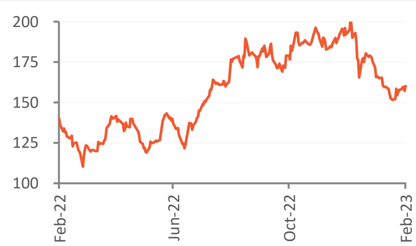
Company details

Market cap:	Rs. 11,842 cr
52-week high/low:	Rs. 205 / 109
NSE volume: (No of shares)	32.8 lakh
BSE code:	532210
NSE code:	CUB
Free float: (No of shares)	71.8 cr

Shareholding (%)

Promoters	-
FII	23.7
DII	37.7
Others	38.5

Price chart



Price performance

(%)	1m	3m	6m	12m
Absolute	-3.6	-17.1	-9.6	14.3
Relative to Sensex	-4.6	-15.3	-11.9	9.9

Sharekhan Research, Bloomberg

Stock Update

Result Update

Key Results Highlights

- **Margin outlook stable:** NII grew by 13% y-o-y/down 2% q-o-q. NIM declined by 21 bps q-o-q to 3.88%. The bank has guided that NIMs were negatively impacted by Rs. 32 crore lower interest income, led by non-recognition of interest subvention income on agri gold loans due to deficiency/lapses in documentation of loans. However, once the regulator is satisfied with the documentation and the bank receives the amount, the bank would account for it. The bank has passed on 120-150 bps in terms of rate hikes. The bank further plans to transmit 50-60 bps while increasing the rate of deposits also. Except gold loan book (25% of loans), rest book is floating rate book. NIMs are expected to remain stable.
- **Credit growth outlook lowered:** Advances grew by 12% y-o-y/3% q-o-q below system growth. Loan growth for FY2023 is expected to be lower than the earlier guided range of 15-18%, citing lower risk appetite, muted deposit growth, lower capacity utilisation, and lower capex intensity.
- **Weak deposit mobilisation:** Total deposits grew by 7% y-o-y/flat q-o-q below system growth, with CASA growing at 5% y-o-y/down 6% q-o-q. CA and SA balance declined by 8% and 6% q-o-q. Term deposits grew by 8% y-o-y/3% q-o-q. LD ratio stood at 86% vs. 84% in the last quarter.
- **Core credit cost and slippages were higher:** Provisions were up by 82% y-o-y/114% q-o-q. Core credit cost stood at 2.5% of average advances during the quarter versus 1% in the past quarter. Slippages were at Rs. 439 crore (4.6% annualised based on trailing 12-month advances) vs. 2.8% q-o-q and 3.1% in Q3FY2022. However, slippages of Rs. 185 crore were mainly attributed to divergence in GNPA reported for FY2022. The bank guided that majority of the NPA divergence for FY2022 were due to difference in interpretation and not based on 90 days lapse. In some cases, sanctions guidelines were not met and in some cases SMA 2 accounts (before pre-Covid) were restructured, thus leading to divergence in NPA. The bank also guided that it may require to make additional Rs. 200 crore provisions based on ECL models over a period of five years i.e., Rs. 40 crore each year if implemented. The bank expects ~2.5% slippages in Q4FY2023. The bank also expects slippages to be 2%-2.5% in FY2024E and reach pre-COVID levels (i.e., below 2%) in FY2025E. The current outstanding of Spice Jet is at Rs. 65.6 crore. In June 2023, the final installment will be received and the bank currently holds Rs. 75 crore provisions against the same account.
- **Asset quality:** GNPA ratio increased by 26 bps q-o-q to 4.62% and NNPA ratio stable at 2.67%. PCR increased to 43% vs 39% q-o-q. Restructured book stood at Rs. 1,730 crore (~4.0% of advances vs. 470% of advances sequentially). Gross slippages were at Rs. 439 crore vs. Rs. 262 crore q-o-q. Upgrades and recovery amounted to Rs. 173 crore vs. Rs. 189 crore q-o-q. Write-offs were at Rs. 139 crore vs. Rs. 114 crore in the past quarter.

Result table (Standalone) Rs cr

Particulars	Q3FY23	Q2FY23	Q3FY22	y-o-y	q-o-q
Interest Income	1,206	1,181	1,035	16%	2%
Interest Expenses	650	613	545	19%	6%
Net Interest Income	**556**	**568**	**490**	**13%**	**-2%**
NIM (%)	3.88	4.09	4.00		
Core fee income	80	80	72	11%	1%
Other Income	144	94	88	64%	54%
Net Operating Revenue	**780**	**741**	**650**	**20%**	**5%**
Employee Expenses	127	141	134	-5%	-10%
Other Opex	156	144	147	6%	8%
Total Opex	**283**	**285**	**280**	**1%**	**-1%**
Cost-to-Income Ratio (%)	**36.2%**	**38.4%**	**43.1%**		
Operating Profits	**497**	**456**	**370**	**35%**	**9%**
Provisions & Contingencies - Total	225	105	124	82%	114%
Profit Before Tax	**273**	**351**	**246**	**11%**	**-22%**
Tax	55	75	50	10%	-27%
Effective Tax Rate (%)	20.2	21.3	20.3		
Reported Profits	**218**	**276**	**196**	**11%**	**-21%**
Basic EPS (Rs.)	2.9	3.7	2.7	11%	-21%
Diluted EPS (Rs.)	2.9	3.7	2.6		
RoA (%)	1.3	1.7	1.4		
Advances	43,009	41,913	38,387	12%	3%
Deposits	49,997	49,878	46,722	7%	0%
Gross NPA	1,989	1,862	1,999	0%	7%
Gross NPA Ratio (%)	4.62	4.36	5.21		
PCR - (%)	43.5	39.4	35.2		
Net NPA	1,124	1,129	1,296	-13%	0%
Net NPAs Ratio (%)	2.67	2.69	3.44		

Source: Company, Sharekhan Research

Outlook and Valuation

■ Sector View – Deposit mobilisation to be in focus; Banks with strong deposit franchise placed better

System-level credit offtake grew by ~16.5% y-o-y in the fortnight ending January 13, 2022, indicating loan growth has been sustaining, given distinct signs of an improving economy and revival of investments and loan demand. On the other hand, deposits rose by ~10.6% but are trailing advances growth. We should see sustained acceleration in loan growth. Margins are likely to improve, but momentum is expected to moderate and margins are expected to peak out by H1FY2024. Asset quality is not a big issue on the corporate lending end, as only de-leveraging is observed. From the retail side, there could be some pressure, but nothing is significant. Asset quality is likely to remain stable in the medium term. Banks are in a sweet spot in terms of fundamentals. In the past few years, lenders have been cautious about lending to the 'BB and below' category, thus the general risk, which they are carrying on the corporate loan portfolio, is low. On the retail loans front, due to COVID-19, banks have already seen one downcycle. Most of the exposure has been taken into credit costs. In terms of the MSME book, we need to be watchful. At present, we believe the banking sector is likely to see higher risk-off behaviour, with tactical market share gains for well-placed players. We believe large banks with a strong capital base, strong deposit franchise, and asset quality (with high coverage and provision buffers) are well placed to capture growth opportunities.

■ Company Outlook – Weak business momentum despite strong sector tailwinds

We believe credit cost is expected to remain higher due to subpar coverage on bad loans and slippages are expected to remain higher in FY2024E despite muted growth in the past two years and benign credit cycle. The restructured book is relatively higher than PSU banks also. Business momentum continues to remain below system growth. Moreover, in recent times, there have been instances of lapses in internal control, which appear to be a red flag.

■ Valuation – Downgrade to Hold with a revised PT of Rs. 176

At the CMP, CUB trades at 1.8x/1.6x/1.4x its FY2023E/FY2024E/FY2025 ABV, respectively. Our downgrade factors in weak business outlook compared to peers despite strong sector tailwinds and recent lapses in internal controls. We believe credit cost is expected to remain higher due to subpar coverage on bad loans and slippages are expected to remain higher in FY2024E despite muted growth in the past two years and benign credit cycle. The restructured book is relatively higher than PSU banks also. Business momentum continues to remain below system growth. Key monitorable remains the RBI's approval on the reappointment of the existing MD and CEO (tenure ends in April 2023).

Peer valuation

Banks	CMP (Rs / Share)	MCAP (Rs Cr)	P/E (x)		P/B (x)		RoE (%)		RoA (%)	
			FY23E	FY24E	FY23E	FY24E	FY23E	FY24E	FY23E	FY24E
City Union Bank	160	11,842	12.6	12.0	1.8	1.6	13.3	12.3	1.5	1.4
AU Small Finance Bank	649	43,229	30.8	26.6	4.0	3.6	15.1	15.2	1.7	1.8

Source: Company, Sharekhan Research

About company

CUB was founded in October 1904 and is headquartered at Kumbakonam, Tamil Nadu, India. The bank mainly focuses on lending to MSME and retail/wholesale trade with granular asset profile, including providing short-term and long-term loans to the agricultural sector. The bank has 752 branches, of which ~88% are in South India with ~74% business coming from Tamil Nadu. The bank focuses on the niche segment of working capital financing to MSMEs and traders. The bank has a comfortable capital position with CRAR of 20.47%, of which Tier-1 constitutes 19.41%.

Investment theme

CUB is a private bank operating in Southern Indian, focused on the niche segment of working capital financing to MSMEs and traders, which forms ~50% of its total loan book. Several smart business decisions of the management such as staying away from consortium-based lending and scaling back segments, where initial stress was seen, have served it well. However, we believe the bank is citing for lower risk appetite, as the bank has not fully recovered from pandemic-related stress and its restructured book continues to remain higher than some of the PSU banks. Additionally, recent internal control lapses appear to be a red flag.

Key Risks

Higher loan growth, higher margins than anticipated, lower slippages and, in turn, lower credit cost could lead to upside risk.

Additional Data

Key management personnel

Mr. M. Narayanan	Chairman
Dr N. Kamakodi	MD & CEO
Mr. Sadagopan J	CFO

Source: Company Website

Top 10 shareholders

Sr. No.	Holder Name	Holding (%)
1	CAPITAL GROUP COS INC LTD.	5.91
2	SMALLCAP WORLD FUND INC.	4.95
3	AXIS ASSET MANAGEMENT CO. LTD.	4.91
4	HDFC ASSET MANAGEMENT CO. LTD.	4.47
5	CANARA ROBERO ASSET MANAGEMENT CO. LTD.	2.65
6	FRANKLIN RESOURCES LTD.	2.61
7	SBI FUNDS MANAGEMENT LTD.	2.49
8	LIFE INSURANCE CORP OF INDIA	2.34
9	L&T MUTUAL FUND TRUSTEE LTD.	2.18
10	VAIDYANATHAN VILASINI	2.04

Source: Bloomberg

Understanding the Sharekhan 3R Matrix

Right Sector	
Positive	Strong industry fundamentals (favorable demand-supply scenario, consistent industry growth), increasing investments, higher entry barrier, and favorable government policies
Neutral	Stagnancy in the industry growth due to macro factors and lower incremental investments by Government/private companies
Negative	Unable to recover from low in the stable economic environment, adverse government policies affecting the business fundamentals and global challenges (currency headwinds and unfavorable policies implemented by global industrial institutions) and any significant increase in commodity prices affecting profitability.
Right Quality	
Positive	Sector leader, Strong management bandwidth, Strong financial track-record, Healthy Balance sheet/cash flows, differentiated product/service portfolio and Good corporate governance.
Neutral	Macro slowdown affecting near term growth profile, Untoward events such as natural calamities resulting in near term uncertainty, Company specific events such as factory shutdown, lack of positive triggers/events in near term, raw material price movement turning unfavourable
Negative	Weakening growth trend led by led by external/internal factors, reshuffling of key management personal, questionable corporate governance, high commodity prices/weak realisation environment resulting in margin pressure and detoriating balance sheet
Right Valuation	
Positive	Strong earnings growth expectation and improving return ratios but valuations are trading at discount to industry leaders/historical average multiples, Expansion in valuation multiple due to expected outperformance amongst its peers and Industry up-cycle with conducive business environment.
Neutral	Trading at par to historical valuations and having limited scope of expansion in valuation multiples.
Negative	Trading at premium valuations but earnings outlook are weak; Emergence of roadblocks such as corporate governance issue, adverse government policies and bleak global macro environment etc warranting for lower than historical valuation multiple.

Source: Sharekhan Research

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by BNP PARIBAS

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