Sharekhan
by BNP PARIBAS

Powered by the Sharekhan 3R Research Philosophy





# City Union Bank

## Growth outlook weak, sustainable improvement in asset quality holds key

| Banks | Sharekhan code: CUB |
|---|---|
| **Reco/View: Hold** ⇔ | CMP: **Rs. 134** · Price Target: **Rs. 145** ⇔ |

↑ Upgrade ⇔ Maintain ↓ Downgrade

| 3R MATRIX | + | = | - |
|---|---|---|---|
| Right Sector (RS) | ✓ | | |
| Right Quality (RQ) | | ✓ | |
| Right Valuation (RV) | | ✓ | |

\+ Positive = Neutral – Negative

**What has changed in 3R MATRIX**

| | Old | | New |
|---|---|---|---|
| RS | + | ⇔ | + |
| RQ | = | ⇔ | = |
| RV | = | ⇔ | = |

**ESG Disclosure Score** NEW

ESG RISK RATING 27.63
Updated Aug 08, 2023

**Medium Risk**

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

Source: Morningstar

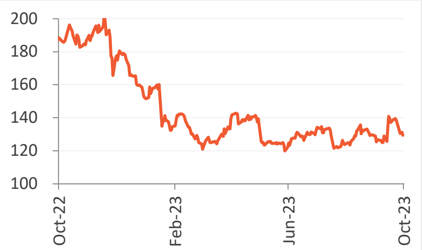
### Company details

| | |
|---|---|
| Market cap: | Rs. 9,885 cr |
| 52-week high/low: | Rs. 205/120 |
| NSE volume: (No of shares) | 44.9 lakh |
| BSE code: | 532210 |
| NSE code: | CUB |
| Free float: (No of shares) | 71.8 cr |

### Shareholding (%)

| | |
|---|---|
| Promoters | - |
| FII | 23.7 |
| DII | 33.2 |
| Others | 43.1 |

### Price chart




### Price performance

| (%) | 1m | 3m | 6m | 12m |
|---|---|---|---|---|
| Absolute | 3.9 | 0.0 | -4.3 | -28.7 |
| Relative to Sensex | 7.1 | 3.8 | -10.5 | -36.0 |

Sharekhan Research, Bloomberg


### Summary

- City Union Bank (CUB) reported a strong beat in earnings with PAT at Rs. 281 crore (versus estimate of Rs. 205 crore) mainly led by lower credit cost (53 bps annualised vs 143 bps q-o-q and 100 bps y-o-y) however, core PPoP declined by 20% y-o-y / 6% q-o-q. PPoP was 5% below our estimates.
- This was the first quarter since COVID-19 times where the bank saw asset quality trends normalise. Net slippages were negative to the tune of Rs. 13 crore led by substantial reduction in slippages (2.1% annualized vs 3.7% q-o-q) along with higher recoveries from NPAs.
- Credit growth (up 1% q-o-q) continued to remain muted and bank maintained its guidance for back-ended credit growth in FY2024E. The bank also cited that it is not in a hurry to accelerate growth pedals until asset quality trends are back to pre -COVID levels.
- We maintain a Hold rating on CUB with an unchanged PT of Rs. 145. We would watch out for sustainable improvement in asset quality going forward as stressed assets are still higher (~5% of advances) when compared to peers along with sub-optimal coverage (~55%) and also near term growth outlook is muted. The stock trades at 1.3x/1.1x its FY2024E/FY2025 ABV.


**City Union Bank (CUB) reported a mixed bag of numbers for Q2FY2024. Earnings were above estimates mainly led by lower credit costs, driven by strong improvement in asset quality trends. However, Core PPoP declined by 20% y-o-y / 6% q-o-q. PPoP was 5% below our estimates. Net interest income (NII) was down by 5% y-o-y but was higher by 3% q-o-q as NIMs were lower by 35 bps y-o-y but were higher by 7 bps q-o-q at 3.74%. Though cost of deposits increased by 15 bps q-o-q, cost of funds was higher by only 3 bps q-o-q. Increase in yields driven by higher rate transmission supported NIMs q-o-q. The bank guided that NIMs are expected to remain at 3.6-3.8% in coming quarters. Core fee income grew by 8% y-o-y/down 2% q-o-q. Treasury gains were reported at Rs. 27 crore versus Rs. 41 crore q-o-q and Rs. 46 crore y-o-y. Total operating expenses grew by 17% y-o-y/11% q-o-q led higher staff expenses (+20% q-o-q) as annual increments were rolled out and also other opex grew by 5% q-o-q led by investments in new products segment and tech. Thus, operating profit declined by 15% y-o-y/7% q-o-q. Provisions fell by 47% y-o-y/ 63% q-o-q. PBT declined by 6% y-o-y but was higher by 26% q-o-q led by lower credit costs. Net advances grew by 2% y-o-y/1% q-o-q. Deposits grew by 6% y-o-y/2% q-o-q, with CASA flat on y-o-y basis but down by 2% q-o-q. CASA ratio stood at ~29.6% versus 31.3% y-o-y. Slippages were lower at Rs. 225 crore (2.1% annualized, based on trailing 12-month advances) versus 3.7% q-o-q. GNPA/NNPA ratio fell by 25bps /17bps q-o-q to 4.66%/2.34% and PCR improved to ~51% versus 50% q-o-q. Net slippages were negative to the tune of Rs. 13 crore led by substantial reduction in slippages along with higher recoveries from NPA accounts. The restructured book stood at Rs. 1,103 crore (~2.6% versus 2.7% q-o-q of net advances).**

### Key positives

- Net slippages were negative to the tune of Rs. 13 crore as fresh NPA formation fell while there were also higher recoveries from NPA accounts.

### Key negatives

- Core PPoP declined by 20% y-o-y / 6% q-o-q.
- Loan growth remained below par.
- Weak CASA growth.

### Management Commentary

- The bank guided that the RBI inspection for FY23 has already been completed and there were no adverse outcomes.
- Credit cost is expected to be in declining trend led by lower slippages going forward gradually converging with pre-COVID levels. The bank is confident of improvement in asset quality trends.
- The bank expects net NPAs to fall to ~2% in FY24E and gradually to 1.0- 1.5% over the next few quarters. It is not in a hurry to accelerate growth pedals until asset quality trends are back to pre-COVID levels.

### Our Call

**Valuation – Maintain Hold rating with an unchanged PT of Rs. 145:** At CMP, CUB trades at 1.3x/1.1x its FY2024E/FY2025 ABV. We would watch out for sustainable improvement in asset quality going forward as stressed assets are still higher (~5% of advances) when compared to peers along with sub-optimal coverage (~55%) and also near term growth outlook is muted. The overall stressed book is higher than some of the lower tier PSU banks despite a benign credit cycle and muted growth in last two years.

### Key Risks

Stronger loan growth, higher-than-expected margins, lower slippages, and faster normalization of credit cost could lead to upside risk.

**Valuation (Standalone)** Rs cr

| Particulars | FY22 | FY23 | FY24E | FY25E |
|---|---|---|---|---|
| NII | 1,916 | 2,163 | 2,164 | 2,248 |
| PAT | 760 | 937 | 1,030 | 1,151 |
| EPS (Rs.) | 10.3 | 12.7 | 13.9 | 15.5 |
| P/E (x) | 13.0 | 10.6 | 9.6 | 8.6 |
| P/ABV (x) | 1.7 | 1.5 | 1.3 | 1.1 |
| RoE (%) | 12.2 | 13.4 | 12.9 | 12.7 |
| RoA (%) | 1.3 | 1.5 | 1.5 | 1.5 |

Source: Company; Sharekhan estimates

## Key Results Highlights

**NIMs outlook:** Net interest income (NII) was down by 5% y-o-y but was higher by 3% q-o-q as NIMs were lower by 35 bps y-o-y but were higher by 7 bps q-o-q at 3.74%. Despite the cost of deposits increased by 15 bps q-o-q, cost of funds was higher by only 3 bps q-o-q. Increase in yields driven by higher rate transmission supported NIMs q-o-q. The bank guided that NIMs are expected to remain at 3.6-3.8% in coming quarters.

**Guiding for lower credit cost:** Provisions fell by 47% y-o-y/ 63% q-o-q. Credit cost stood at 53 bps annualised vs 143 bps q-o-q and 100 bps y-o-y. The bank expects credit cost to be in declining trend led by lower slippages going forward gradually converging with pre-COVID levels. The bank is confident of improvement in asset quality trends.

**Credit growth muted:** Advances grew at a muted rate by 2% y-o-y/1% q-o-q, below system growth. The bank maintained its guidance for back-ended credit growth in FY2024E. The bank also cited that it is not in a hurry to accelerate growth pedals until asset quality trends are back to pre -covid levels.

**Weak CASA:** Total deposits grew by 6% y-o-y/ 2% q-o-q, with CASA flat on y-o-y basis / down 2% q-o-q. CASA ratio stood at 29.6% versus 31.3% y-o-y. Term deposits grew by 8% y-o-y/4% q-o-q. LD ratio stood at 81% vs 82% q-o-q.

**Asset quality outlook improving:** Slippages were lower at Rs. 225 crore (2.1% annualised based on past 12-month advances) versus 3.7% q-o-q. GNPA/NNPA ratio fell by 25bps /17bps q-o-q to 4.66%/2.34% and the provision coverage ratio (PCR) improved to ~51% versus 50% q-o-q. Net slippages were negative to the tune of Rs. 13 crore led by a substantial reduction in slippages along with higher recoveries from NPA accounts. The restructured book stood at Rs. 1,103 crore (~2.6% versus 2.7% q-o-q of net advances). The bank guided that the RBI inspection for FY23 has already been completed and there were no adverse outcomes. The bank expects NNPA to fall to ~2% in FY24E and gradually to 1.0- 1.5% over the next few quarters. It is not in a hurry to accelerate growth pedals until asset quality trends are back to pre-COVID levels.

**Others:** BCG is helping the bank in business re-engineering, including improvement in underwriting, modelling of portfolios, digital lending, sanction, and customer experience. The bank has recently launched instant digital loans, providing LAP, MSME loans of up to Rs. 3 crore and home loans.

**Results** Rs cr

| Particulars | Q2FY24 | Q1FY24 | Q2FY23 | y-o-y % | q-o-q % |
|---|---|---|---|---|---|
| Interest Income | 1,304 | 1,266 | 1,181 | 10% | 3% |
| Interest Expenses | 766 | 744 | 613 | 25% | 3% |
| **Net Interest Income** | **538** | **523** | **568** | **-5%** | **3%** |
| NIM (%) | 3.74 | 3.67 | 4.09 | | |
| Core fee income | 87 | 88 | 80 | 8% | -2% |
| Other Income | 95 | 103 | 94 | 2% | -7% |
| **Net Operating Revenue** | **720** | **714** | **741** | **-3%** | **1%** |
| Employee Expenses | 158 | 132 | 141 | 12% | 20% |
| Other Opex | 176 | 168 | 144 | 22% | 5% |
| **Total Opex** | **334** | **300** | **285** | **17%** | **11%** |
| **Cost to Income Ratio (%)** | **46.3%** | **42.0%** | **38.4%** | | |
| **Pre-Provision Profit** | **387** | **414** | **456** | **-15%** | **-7%** |
| Provisions & Contingencies - Total | 56 | 152 | 105 | -47% | -63% |
| **Profit Before Tax** | **331** | **262** | **351** | **-6%** | **26%** |
| Tax | 50 | 35 | 75 | -33% | 43% |
| Effective Tax Rate (%) | 15.1 | 13.3 | 21.3 | | |
| **Reported Profits** | **281** | **227** | **276** | **2%** | **23%** |
| Basic EPS (Rs.) | 3.8 | 3.1 | 3.7 | 1% | 23% |
| Diluted EPS (Rs.) | 3.8 | 3.1 | 3.7 | | |
| RoA (%) | 1.7 | 1.4 | 1.7 | | |
| Advances | 42,652 | 42,405 | 41,913 | 2% | 1% |
| Deposits | 52,714 | 51,655 | 49,878 | 6% | 2% |
| Gross NPA | 2,035 | 2,081 | 1,862 | 9% | -2% |
| Gross NPA Ratio (%) | 4.66 | 4.91 | 4.36 | | |
| PCR (%) | 50.9 | 50.1 | 39.4 | | |
| Net NPA | 999 | 1,039 | 1,129 | -12% | -4% |
| Net NPAs Ratio (%) | 2.34 | 2.51 | 2.69 | | |

Source: Company, Sharekhan Research

## Outlook and Valuation

### ■ Sector view - Deposit mobilisation to be in focus; banks with a superior liability franchise placed better

System-level credit offtake grew by ~20% y-o-y in the fortnight ending September 22, 2023, indicating loan growth has been sustaining, given distinct signs of an improving economy, revival of investments, and strong demand. On the other hand, deposits rose by ~13%. The gap between advances and deposits growth has again widened. We are seeing strong traction in loan growth and overall deposit growth is challenging and is mainly led by time deposits rather than CASA. Margins are expected to be lower as deposits get repriced at higher costs to fund growth. The overall asset-quality outlook is stable to positive for the sector. We believe banks with a robust capital base and strong retail deposit franchise are well-placed to capture growth opportunities.

### ■ Company outlook - Recovery expected to be gradual

Overall, the outlook remains challenging for the bank mainly due to higher stressed assets and sub-optimal coverage on stressed assets vs peers. In fact, the stressed book is higher than some of the lower tier PSU banks also. Although asset quality has started to normalise, but it expected to be slow and gradual. Additionally, business growth is expected to remain below par in the near term.

### ■ Valuation - Maintain Hold rating with an unchanged PT of Rs. 145

At CMP, CUB trades at 1.3x/1.1x its FY2024E/FY2025 ABV. We would watch out for sustainable improvement in asset quality going forward as stressed assets are still higher (~5% of advances) when compared to peers along with sub-optimal coverage (~55%) and also near term growth outlook is muted. The overall stressed book is higher than some of the lower tier PSU banks despite a benign credit cycle and muted growth in last two years.

**Peer Comparison**

| Companies | CMP (Rs/ Share) | MCAP (Rs Cr) | P/E (x) | | P/B (x) | | RoE (%) | | RoA (%) | |
|---|---|---|---|---|---|---|---|---|---|---|
| | | | FY24E | FY25E | FY24E | FY25E | FY24E | FY25E | FY24E | FY25E |
| City Union Bank | 134 | 9,885 | 9.6 | 8.6 | 1.3 | 1.1 | 12.9 | 12.7 | 1.5 | 1.5 |
| AU Small Finance Bank | 690 | 46,091 | 28.3 | 22.2 | 3.7 | 3.2 | 13.8 | 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 a 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 22.21%, of which Tier-1 constitutes 22.17%.

## Investment theme

The bank is focused on the niche segment of working capital financing to MSMEs and traders, which forms ~48% of its total loan book. Several smart business decisions of the management in the past such as staying away from consortium-based lending, infrastructure lending, and scaling back from segments where initial stress was seen have served well. However, the bank has not fully recovered from pandemic-related stress and its stressed book continues to remain higher than some of the PSU banks. Overall, the growth outlook continues to remain muted.

## Key Risks

Stronger loan growth, higher-than-expected margins, fewer slippages, and a subsequent drop in credit cost could lead to upside risk.

## Additional Data

**Key management personnel**

| | |
|---|---|
| Mr. M. Narayanan | Chairman |
| Dr. N. Kamakodi | MD and CEO |

Source: Company

**Top 10 shareholders**

| Sr. No. | Holder Name | Holding (%) |
|---|---|---|
| 1 | CAPITAL GROUP COS INC LTD. | 5.97 |
| 2 | FRANKLIN RESOURCES INC. | 5.15 |
| 3 | HDFC ASSET MANAGEMENT CO. LTD | 4.60 |
| 4 | SBI FUNDS MANAGEMENT LTD. | 4.38 |
| 5 | AXIS ASSET MANAGEMENT CO. LTD. | 2.41 |
| 6 | ICICI Prudential AMC LTD | 2.21 |
| 7 | HDFC Life Insurance Co. LTD | 2.04 |
| 8 | VAIDYANATHAN VILASINI | 2.04 |
| 9 | G Visalam | 1.95 |
| 10 | VANGUARD GROUP INC | 1.94 |

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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