

Catch the CUB before it roars like a Lion....

Initiating Coverage

- **Business growth ahead of industry average; robust advances growth, rise in CD ratio and stable margins to boost Net Interest Income:** City Union Bank has outperformed its peers in terms of business and profitability growth when they were at similar stage of growth. City Union Bank's advances grew by 35% in FY11 ahead of industry average of 21%. The bank has already disbursed advances of ~Rs.9,500 crore (up 35% Y-o-Y) in Q1FY12 and we expect the bank to maintain loan book growth of 28% in FY12 above industry average of 20%. City Union Bank's Net Interest Income (NII) and return ratios are set to increase on the back of expansion in the CD ratio, stable margins and robust advances growth.
- **High deposit growth trajectory of 25% plus likely over FY11-13E on the back of attractive franchise concentrated in South India.** Historically, City Union Bank has remained strongly associated with the highly banked South Indian region as more than 75 % of its branches are located in south. City Union Bank has experienced healthy deposit CAGR of ~30% in the past five years and in FY11 as well deposit growth was strong at 25% Y-o-Y. The bank's low cost CASA deposit has remained stable at ~22% over FY08-11. We expect deposits to post 25% plus CAGR over FY11-13E.
- **Healthy asset quality, provision coverage in line with RBI norms; limited restructuring, strong operating efficiency:** City Union Bank's Gross NPA and Net NPA are one of the lowest in the small cap banks at 1.22% and 0.51% respectively. Total stressed assets (restructured advances + Gross NPA) are at comfortable levels of 3.96%. Provision coverage for the quarter Q1FY12 stood at 76% & was in line with stipulated RBI norms of 70%. City Union Bank has one of the lowest Cost to Income ratio of 37.5% as of March 2011, due to management's focus on improving productivity. We expect the assets quality to remain at comfortable levels going forward.
- **Attractive Valuations; one of the best return ratios and asset quality in the industry; initiate coverage with "BUY":** We believe City Union Bank is an attractively priced bank compared to its peers at 1.3x FY13E adjusted book and 5.9x FY13E earnings, delivering sustainable ROAE's of around +22% and ROA's of 1.5%. The comfortable capital adequacy ratio (CAR) of 12.75% (Basel II), provisioning coverage ratio (PCR) at 76% and Gross NPA's of 1.22% make a strong case for the stock to trade at premium valuations compare to peer group valuations. We value the bank at 1.7 x FY13E adjusted book value, arriving at a target of Rs.60. (Upside potential of 33%). We believe going forward continued strong performance will drive a re-rating in the stock.

November 01, 2011

Rating	BUY
Target Upside (%)	33.3
Sector	Banking
NSE Code	CUB
BSE Code	532210
EW Code	CITUNI
Bloomberg Code	CUBK IN

## MARKET DATA

52-week range (Rs.)	53.9 / 34.8
M Cap (Rs. Cr.)	1,840
Avg. Daily Vol.	2,67,064

## SHARE HOLDING PATTERN (%)

Promoters	0.00
Foreign Inst Investors	27.7
Domestic Institutions	6.9
Public	54.1
Corporate Bodies	11.2

Price Perf (%)	6 Mths	1 Year
City Union Bank	4.7	(9.4)
Bank Nifty	(13.6)	(19)
Nifty	(6.8)	(11.5)

Year to March	FY09	FY10	FY11	FY12E	FY13E
Net Int. Income (Rs. Cr)	243	278	420	519	616
Net profit after tax	122	152	215	258	306
Adjusted BV per share	17.7	18.7	22.7	27.6	35.2
Diluted EPS (Rs.)	3.8	3.8	5.3	6.4	7.6
Gross NPA Ratio (%)	1.8	1.4	1.2	1.2	1.3
Net NPA Ratio (%)	1.1	0.6	0.5	0.5	0.6
Price / Adj. Book Value (x)	2.5	2.4	2.0	1.6	1.3
Price/ Earnings (x)	11.8	11.8	8.5	7.0	5.9

## Company Background & Key Risks

### Company Background

Incorporated in 1904 as “The Kumbakonam Bank”, City Union Bank is a private sector bank headquartered in Tamil Nadu. It is one of the oldest banks in India and amongst the very few banks that remain profitable through out its operating history. City Union Bank is a leading bank in South India with widespread presence in Tamil Nadu, Andhra Pradesh and Karnataka. The bank’s staff strength is at over ~2830 and it has 259 branches and 280 ATM’s across India and all its branches are covered under Core Banking Solutions (CBS). Branches in south account for 88% of network and 89% of business.

The bank has plans to increase the number of branches to 500 over the next three years. In FY12, the bank has plans to grow its advances and deposits by 30%, respectively. Its balance sheet size is ~Rs. 146 bn as on Q1FY12 and it has market cap of Rs. 18 bn.

### Investment Theme:

Business growth ahead of industry average; robust advances growth, rise in CD ratio and stable margins to boost Net Interest Income.

High deposit growth trajectory of 25% plus likely over FY11-13E on the back of attractive franchise concentrated in South India.

Healthy asset quality, provision coverage in line with RBI norms; limited restructuring, strong operating efficiency.

Attractive Valuations; one of the best return ratios and asset quality in the industry.

### Key Risks:

#### Higher than expected Delinquencies:

Economic downturn may result in deterioration in asset quality and could adversely affect the profitability of the bank. We have built-in higher delinquencies for City Union Bank in our projections. Also, higher than expected slippages on restructured assets can risk asset quality.

#### Slowdown in Economy:

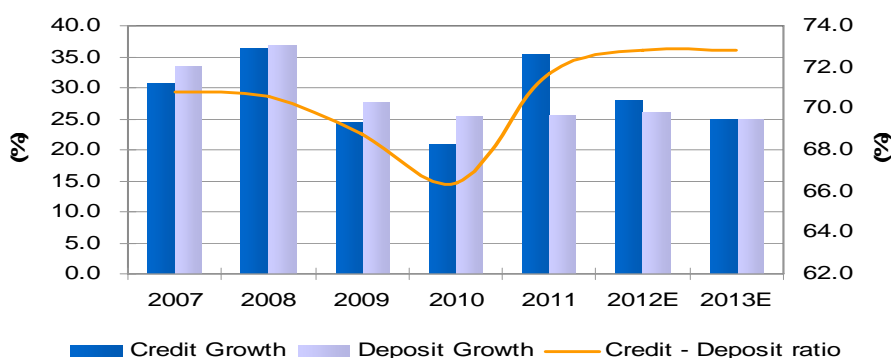
The future profitability and revenue growth of Indian banks is dependent on the country’s macro economic factors. Hence, any slowdown in the growth rate of the Indian economy or the major change in the economic factor may change our recommendations.

## Business growth ahead of industry average; robust advances growth, rise in CD ratio and stable margins to boost Net Interest Income

City Union Bank has experienced healthy business CAGR of ~29% in the past five years. Despite such a strong growth CITUNI continues to remain one of the smallest banks in terms of total assets the Indian banking space (~0.24% market share in advances & deposits). Therefore, we believe that there is massive growth opportunity for CITUNI compare to most other listed banks in India. Continued focus of management on niche SME working capital requirements (60% of advances) will help to drive its loan growth above 25% over FY11-13E.

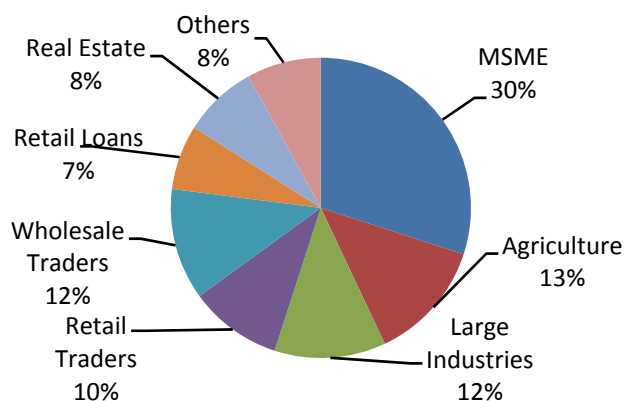
CITUNI has outperformed its peers in terms of business and profitability growth when they were at similar stage of growth. CITUNI's advances grew by 35% in FY11 ahead of industry average of 21%. The aggressive loan book growth strategy in FY10 helped the bank to maintain its net interest margins at around 3.0%. The bank has already disbursed advances of ~Rs. 9,500 crore (up 35% Y-o-Y) in Q1FY12 and we expect the bank to maintain loan book growth of 28% in FY12 above industry average of 20%. City Union Bank's Net Interest Income (NII) and return ratios are set to increase on the back of expansion in the CD ratio, stable margins and due to robust advances growth. Moreover, 80% of the loan book is on floating rate basis which will help the bank to maintain its NIMs at around 3.5% in FY11-12E. Consequently, NII will post a strong CAGR of ~28% over FY11-13E vis-à-vis balance sheet growth of 25%.

**Exhibit No. 1: Business growth to be ahead of industry**



Source: Company, Edelweiss Research

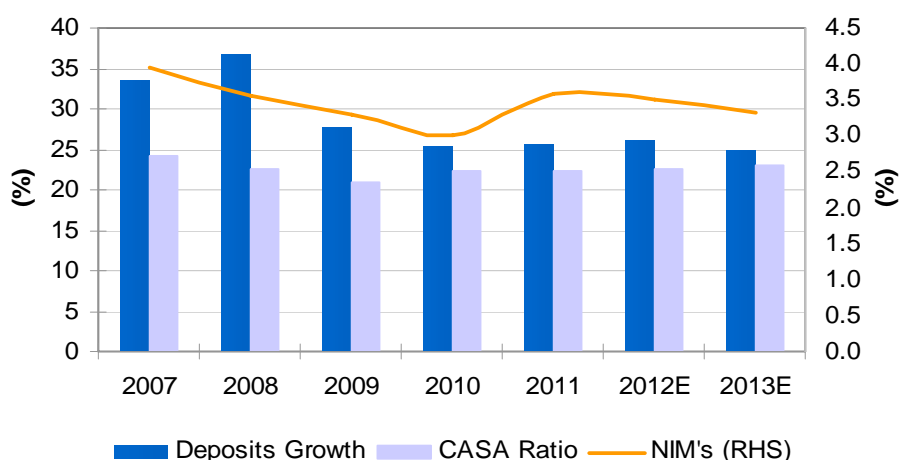
**Exhibit No. 2: Breakup of Advances (FY11)**



## High deposit growth trajectory of 25% plus likely over FY11-13E on the back of attractive franchise concentrated in South India.

Historically, CITUNI has remained strongly associated with the highly banked South Indian region. It has experienced healthy deposit CAGR of 30% in the past five years and in FY11 as well deposit growth was strong at 25% Y-o-Y. The bank's low cost CASA deposit, despite being comparatively lower than industry, has remained stable at ~22% over FY08-11. Bulk of CASA is driven by its savings bank deposits as current account balances contribute ~40% of CASA balances and ~9% of total deposits. We expect deposits to post 25% plus CAGR over FY09-11E.

**Exhibit No. 3: Strong Deposit Growth & Stable CASA Ratio**



Source: Company, Edelweiss Research

At Q1FY12 end, CITUNI had 259 branches and 280 ATMs fairly distributed across rural (15%), semi-urban (33%), urban (33%), and metro (19%) areas, with over 75% of its branches in South India and Tamil Nadu contributing ~63% of branches. Over the next three years, CTIUNI plans to increase the number of branches to 500 almost doubled the current number of branches. Further, instead of expansion across geographies within India, the bank is looking at a concentrated cluster approach to ensure better branch productivity. Going forward, CTIUNI intends to focus outside South through which it expects to: (i) maintain its CASA at current levels; (ii) lower cost of deposits.

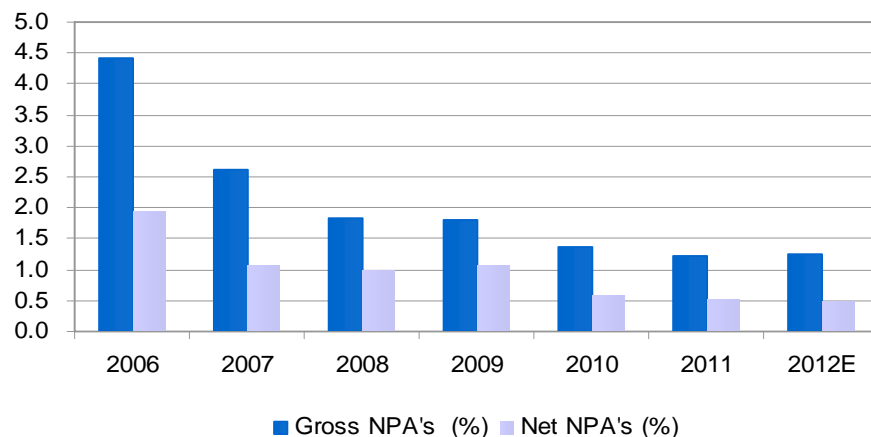
## Healthy asset quality, provision coverage in line with RBI norms, limited restructuring

### Healthy asset quality, provision coverage in line with RBI norms, limited restructuring.

City Union Bank's Gross NPA and Net NPA are one of the lowest amongst the small cap banks. Gross and Net NPA's stood at 1.22% and 0.51% respectively as of June 2011. The asset quality has improved significantly from FY07 to FY11; Gross NPA's declined from 2.62% to 1.22%, while net NPA's declined from 1.09% to 0.52%. Over past four years management has diversified its loan book by disbursing small ticket loans backed by adequate collaterals. Over 95% of the CITUNI's loan book is secured by immovable property. We expect marginal increase in Gross NPA's and Net NPA's going forward due to higher incremental slippages. Capital Adequacy Ratio (CAR) stands at 12.75% (Tier I capital at 11.84%) at the end of FY10 -11, which is ahead of RBI norm of 9% and leaves the bank enough capital to fund its future growth.

Provision coverage (including technical write-offs) for the quarter Q1FY12 stood at 76% was in line with stipulated RBI norms of 70%. The bank's outstanding restructured assets were at ~Rs. 263 crore (~2.7% of advances) at end of Q1FY12. Total stressed assets (restructured advances + Gross NPA) are at comfortable levels of 3.96%. We expect the asset quality to remain stable and at comfortable levels in coming quarters.

**Exhibit No. 4: Improving Asset Quality**



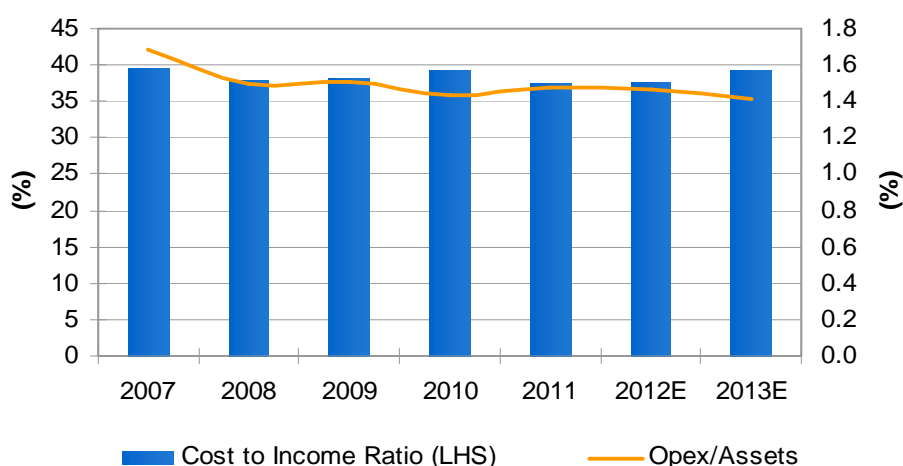
**Source:** Company, Edelweiss Research

Year End	Gross NPA (%)				Net NPA (%)			
	FY09	FY10	FY11	FY12E	FY09	FY10	FY11	FY12E
<b>City Union</b>	1.8	1.4	1.2	1.2	1.1	0.6	0.5	0.5
<b>Federal</b>	2.6	3.0	3.5	3.8	0.3	0.5	0.6	0.6
<b>ING VYSYA</b>	1.9	3.0	2.3	2.5	1.2	1.2	0.4	1.0
<b>Karnataka</b>	3.7	3.5	3.4	3.2	1.0	1.0	0.9	0.9
<b>HDFC Bank</b>	2.0	1.4	1.1	1.0	0.6	0.3	0.2	0.2

## Strong Operating Efficiency

**Strong operating efficiency compare to leading players:** City Union Bank's Cost to income ratio has been stable at 38% from FY08 to FY11 due to management's focus of improving productivity. Going forward, operating cost is expected to rise significantly with strong additions to distribution capabilities, however even stronger growth in revenues would more than offset the effect. As a result we expect Cost to Income ratio to increase marginally to 39.2% in FY13E as compared to 37.5% in FY11. The improvement would primarily be driven by increased employee productivity and technology focus.

**Exhibit No. 5: Strong Operating Efficiency**



Source: Company, Edelweiss Research

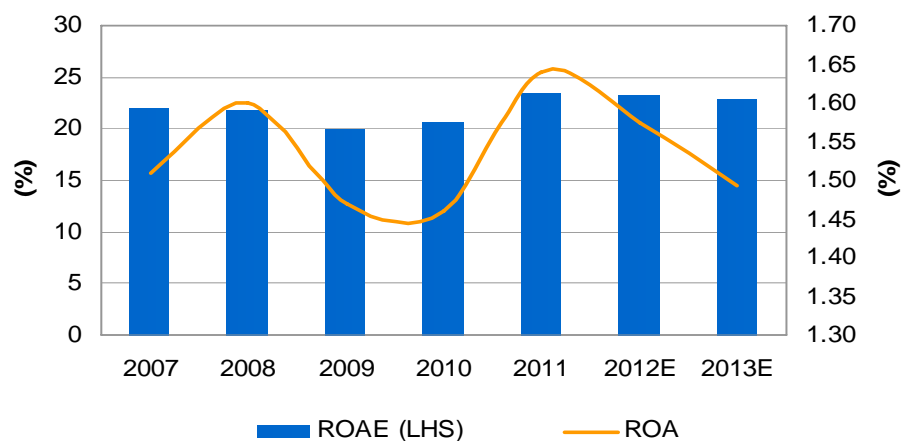
CITUNI has enjoyed high operating efficiency reflected in Operating Expenditure to Assets ratio (at 1.5%) compared to the industry. We expect Opex/Assets ratio to remain in stable at ~1.46% in FY12E led by employee rationalisation efforts and focus on productivity levels. Post FY13, we believe significant operating leverage could accrue once the bank has set up most of its branches and would enjoy benefits of economies of scale.

**Investment book less sensitive to interest rate volatility:** City Union Bank's investment book is insulated from MTM losses arising out of interest rate volatility. We expect minimal impact of increase in interest rates on the bank's investment book as it maintains a SLR of close to 25% with over 90% of the investments under Held to Maturity (HTM) and 0% in Held for Trading (HFT) category.

## Outlook &amp; Valuations

**Attractive Valuations; one of the best return ratios and asset quality in the industry; initiate coverage with “BUY”**

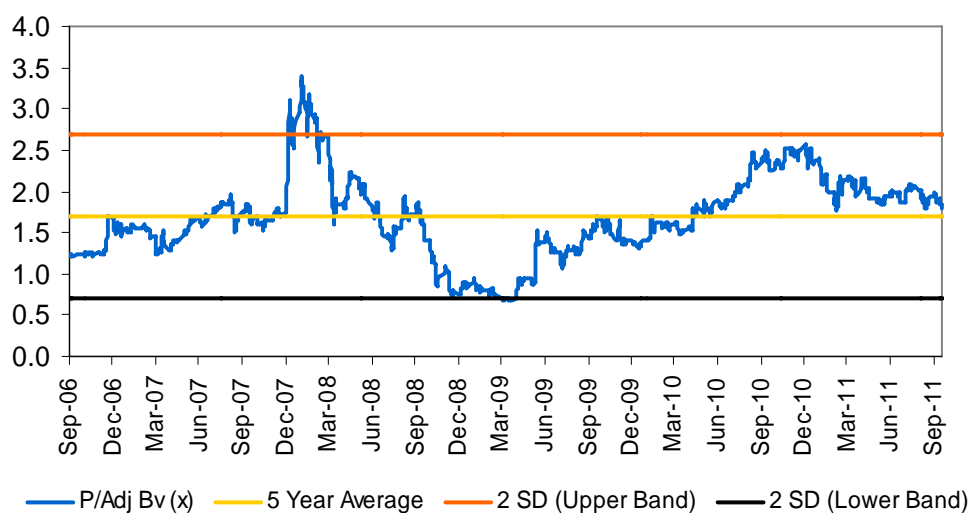
We believe City Union Bank is an attractively priced bank compared to its peers at 1.3x FY13E adjusted book and 5.9x FY13E earnings, delivering sustainable ROEs of around +22% and ROA's of 1.5%. We believe the bank's NIMs will be in the range of 3.3% - 3.5% driven by advances growth, repricing of high cost liabilities and improvement in CASA ratio going forward. Its return ratios are likely to expand significantly given the strong management focus on loan book growth, reducing NPAs, and operating efficiency. Given its extensive reach in South India and the comfortable capital adequacy ratio (CAR) of 12.75% (Basel II) and provisioning coverage ratio (PCR) at 76% leaves the bank enough capital to fund its future assets growth. All these make a strong case for the stock to trade at premium valuations compare to peer group valuations. We believe going forward continued strong performance will drive a re-rating in the stock.

**Exhibit No. 6: ROE and ROA above industry average**

Source: Company, Edelweiss Research

**Comparative Valuations (FY13E)**

Comparative Valuations (FY13E)	CMP	P/E (x)	P/ABV (x)	ROAE (%)	ROA (%)	NIM's (%)
<b>City Union Bank</b>	<b>45</b>	<b>5.9</b>	<b>1.4</b>	<b>22.8</b>	<b>1.5</b>	<b>3.3</b>
HDFC Bank	483	16.8	3.3	21.1	1.9	4.4
Yes Bank	307	8.3	1.8	24.4	1.5	2.5
Federal Bank	415	14	1.2	13.8	1.3	3.5

**Exhibit No. 7** City Union Bank: Price / Adjusted Book Value

**Source:** Company, Edelweiss Research

Historically, City Union Bank has been trading on an average at 1.7x its adjusted book value. We value City Union Bank at 1.7x FY13E adjusted book value, implying **Mar'2013 target price of Rs 60 (Upside potential of 33%)**. Hence, we initiate coverage on the stock with a **"BUY"** recommendation.



## Financial Statements

Income Statement (Rs. Cr)	FY09	FY10	FY11	FY12E	FY13E
Interest Income	804	957	1218	1575	1959
Interest Expenses	562	678	798	1056	1342
Net Interest Income	243	278	420	519	616
Other Income	124	144	157	189	208
Net Total Income	366	422	577	707	824
Provision for Employees	65	80	102	127	155
Operating Expenses	41	52	72	90	111
Depreciation	16	14	17	19	20
Other Expenses	18	21	26	31	36
Total expenses	140	166	216	267	323
Pre Provision Profits	227	256	361	441	501
Provisions and Contingencies	48	61	79	101	98
Net Profit Before Tax	178	195	282	340	403
Provision for Tax	63	43	67	82	97
Fringe Benefit Tax	0	0	0	0	0
Net Profit After Tax	122	152	215	258	306
EPS (Rs.)	3.8	3.8	5.3	6.4	7.6

Operating Ratio's (%)	FY09	FY10	FY11	FY12E	FY13E
Other Income /Total Income	13.3	13.0	11.4	10.7	9.6
Interest Expe / Interest Earned	69.8	70.9	65.5	67.1	68.5
Yield on Funds	9.7	9.2	9.3	9.6	9.5
Yield on Advances	12.9	12.1	12.0	12.2	12.0
Yield on Investments	6.9	6.9	7.2	7.1	7.2
Cost of Funds	6.8	6.5	6.1	6.4	6.5
Cost of Deposits	7.6	7.3	6.7	7.2	7.3
Interest Spread	2.4	2.2	2.8	2.7	2.6
Net Interest Margins (Calc)	3.3	3.0	3.6	3.5	3.3
Return on Average Equity	19.9	20.5	23.5	23.2	22.8
Return on Assets	1.5	1.5	1.6	1.6	1.5
Cost to Income	38.1	39.3	37.5	37.7	39.2
Operating Exp / Assets	1.5	1.4	1.5	1.5	1.4
Tax Rate (%)	35.3	21.8	23.8	24.0	24.0

Growth Metrics (%)	FY09	FY10	FY11	FY12E	FY13E
Net Interest Income	21.4	14.7	51.0	23.5	18.8
Total Expenses	27.0	18.9	30.5	23.2	21.0
Pre Provision Profits	25.8	12.8	41.1	22.1	13.7
Provisions and Contingencies	8.7	25.0	30.5	27.6	-2.6
Net Profit After Tax	20.0	24.8	41.0	20.3	18.6

Balance Sheet (Rs. Cr)	FY09	FY10	FY11	FY12E	FY13E
<b>SOURCES OF FUNDS</b>					
Share Capital	32	40	41	41	41
Total Reserves	629	786	966	1177	1426
Networth	661	826	1007	1217	1467
Deposits	8207	10285	12914	16272	20340
Borrowings	40	40	186	149	201
Other Liabilities & Provisions	343	409	484	601	791
<b>TOTAL LIABILITIES</b>	<b>9251</b>	<b>11559</b>	<b>14592</b>	<b>18239</b>	<b>22799</b>
<b>APPLICATION OF FUNDS</b>					
Cash & Balances with RBI	595	869	1052	1277	1596
Balances with Banks & money at Call	290	232	234	257	283
Net Investments	2397	3210	3616	4286	5472
Advances	5645	6833	9255	11847	14809
Fixed Assets	41	63	69	75	83
Other Assets	282	352	365	497	557
<b>TOTAL ASSETS</b>	<b>9251</b>	<b>11559</b>	<b>14592</b>	<b>18239</b>	<b>22799</b>

Balance Sheet Ratio's	FY09	FY10	FY11	FY12E	FY13E
Credit-Deposit (%)	68.8	66.4	71.7	72.8	72.8
Credit Growth (%)	24.4	21.0	35.4	28.0	25.0
Deposit Growth (%)	27.7	25.3	25.6	26.0	25.0
Gross NPA (%)	1.8	1.4	1.2	1.2	1.3
Net NPA (%)	1.1	0.6	0.5	0.5	0.6
Provision Coverage (%) (Ex - Technical Write-Off)	37.0	52.0	56.3	60.0	53.8
CASA Ratio (%)	20.9	22.4	22.3	22.5	23.0
Capital Adequacy (%) (Basel 2)	0.0	13.5	12.8	12.1	11.5

Valuation Metrics	FY09	FY10	FY11	FY12E	FY13E
Price To Earnings (P/E)	11.8	11.8	8.5	7.0	5.9
Diluted EPS (Rs.)	3.8	3.8	5.3	6.4	7.6
EPS Growth (%)	20.0	-0.1	39.1	20.3	18.6
No. of Shares in Crore	32.0	40.0	40.5	40.5	40.5
DPS (Rs.)	0.5	0.8	0.9	1.0	1.2
Dividend Payout (%)	13.1	19.7	16.0	15.8	15.8
Dividend Yield (%)	1.1	1.7	1.9	2.3	2.7
Book Value (Rs.)	20.7	20.7	24.9	30.1	36.2
Price to Book Value	2.2	2.2	1.8	1.5	1.2
Adjusted Book Value (Rs.)	17.7	18.7	22.7	27.6	35.2
Price to Adjusted Book Value (x)	2.5	2.4	2.0	1.6	1.3

**Disclosure:**

The author of this report do not hold shares in the company.

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