

ICRA Lanka reaffirms the issuer rating of Union Bank of Colombo PLC

September 13, 2018

Instrument	Rated Amount (LKR Mn)	Rating Action
Issuer rating	N/A	[SL]BBB (Stable); Reaffirmed

Rating action

ICRA Lanka Limited, subsidiary of ICRA Limited, a group company of Moody's Investors Service, has reaffirmed the issuer rating of Union Bank of Colombo (UBC or the Bank) at [SL]BBB (Pronounced SL triple B). The outlook on the rating is stable.

Rationale

The reaffirmation of the rating factors in the 70% shareholding by Culture Finance Holdings Ltd (CFHL), an affiliate of the private equity investor Texas Pacific Group (TPG). TPG presently has five representatives in the 12-member Board of UBC. The rating takes note of the experienced senior management team and adequate risk management systems. The bank's capital structure is adequate with common equity tier-I (CET-1) of 19.36% in June 2018, which would support business expansion over the medium term. The rating nevertheless takes note of the bank's modest size (asset base at LKR 114.4 Bn as on June 31, 2018), franchise and profitability indicators (RoA¹ 0.4% and RoE² 2.6% for CY2017) and, its moderate resource profile (CASA³ 23% on June 31, 2018). ICRA Lanka notes that the bank's corporate exposures are quite concentrated. The target segments (SMEs and retail) of the bank is expected to be highly competitive thus ability to generate adequate returns going forward, would be crucial from a profitability perspective. Further, improvement in operating efficiency and deposit profile would be crucial from a rating perspective.

Outlook: Stable

ICRA Lanka believes that UBC will continue to benefit from the support from TPG. The outlook may be revised to 'Positive' in case of a steady improvement in the resource and earnings profile as portfolio expands, while keeping the asset quality under control. The outlook may be revised to 'Negative' in case of weakening in the asset quality, profitability or capital profile.

Key rating drivers

Credit strengths

Demonstrated support from TPG: Union Bank of Colombo was incorporated in 1995 and presently the bank offers its services through 67 branches. TPG acquired 70% stake of UBC in 2014 through its affiliate Culture Financial Holdings Limited (CFHL). TPG has special regulatory permission to hold upto 75% stake

¹ Return on Asset (post tax)

² Return on Equity

³ Current Accounts and Savings Accounts

(as against the regulatory cap of 10%) till 2029. TPG infused LKR 11.36 Bn capital to the bank in CY2014 and has subscribed to warrants of LKR 65.5 Mn which could be exercised, if required, to infuse further capital of about LKR 3.49 Bn. UBC's board comprises of 12 directors including 5 independent directors and five representatives from TPG. TPG representatives are actively involved in the various sub-committees of the Board and also provide managerial support to the senior management team.

Commensurate risk management system and controls: The bank implemented a new risk based pricing module for its corporate and SME clientele. The module is expected to improve loan sourcing, strengthen the quality of the portfolio and maximise the return from a loan account. The bank has a comprehensive internal audit mechanism, which involves undertaking planned audits at branches and prepare a risk scorecard for each branch by assigning a rating. Based on the risk rating, the audit team conducts its random audit and trigger based exercises. The audit committee actively attends to audit findings and closely follows up on the audit observations, if any. UBC is using a core banking system which covers all the product modules. The bank operates a transactional banking platform which provides support to its corporate and SME clientele.

Comfortable overall asset quality indicators: some weakness observed in the SME segment quality: UBC's GNPA⁴ increased to 3.18% in Jun-18 from 2.69% in Dec-17 (2.40% in Dec-16). GNPA increased mainly because of weakness in the SME portfolio performance. SMEs were impacted by the weakened liquidity conditions and the adverse weather conditions that prevailed in CY2017; SME segmental GNPA stood at 6.98% as of Jun-18. The bank is closely monitoring the development and has tightened its SME sourcing to control incremental slippages. The rating continues to take note of the high NPAs in the subsidiary, UB Finance (GNPA at about 12.66% on December 31, 2017). Going forward, ability to keep the group level NPAs under control by restricting incremental slippages and, improving the bank's own provision coverage⁵, which is presently moderate at about 23% on June 30, 2018, would be crucial. Solvency⁶ profile however is under control at about 8.5% as on June 31, 2018.

Adequate capital structure: UBC's CET-I and CAR stood at 19.36% and 19.36% respectively as of Jun-18. ICRA notes the capital structure is adequate to meet its envisaged growth over the medium term. The bank has to meet CBSL's minimum core capital requirement of LKR 20 Bn on December 31, 2020; UBC reported LKR 17.8 Bn as core capital in Jun-18. ICRA Lanka expects timely support from TPG by way of exercising the warrants, and infusing capital, when required, to meet the core capital requirement.

Credit challenges

Subdued earnings profile: The banks NIM moderated to 2.87% in CY2017 as compared to 3.06% in CY2016 because of the increase in the cost of funds. The bank has taken measures to rationalise its portfolio and maximise the returns on the portfolio. As a result, the bank was able to improve its NIM during the latest 6 months to 3.06%. The overall profitability of the bank is affected by its high cost to income ratio ⁷of 90.69% in H1CY2018 (94.50% in CY2017) and higher credit costs (0.27%) during H1CY2018 (0.23% in CY2017). The Bank's ROA stood subdued at 0.43% for H1CY2018 (0.43% in CY2017).

⁴ Gross NPA = Gross NPA (excluding IIS)/Gross portfolio (excluding IIS)

⁵ Provision coverage = Provision/Gross NPA

⁶ Solvency = Net NPA/Net worth

⁷ Cost to income = Total expenses excluding credit cost/Total income

Modest scale and franchise: UBC focuses on corporate, SME and retail segments, it offers term loans, personal loans, import/export loans, mortgage loans, asset backed loans and credit cards to its customers. Scale of operations was modest with total asset base of LKR 114 Bn spread across its 67 branches. The corporate banking segment accounted for 46% of the portfolio followed by SME exposure at 34% and retail exposures at 20% as of June 2018. The bank is expected to focus on better quality SME and retail portfolio, which is backed by fixed collateral.

Weak resource profile: The bank's funding is largely in the form of deposits, which accounted for 74% of the total debt as on June 31, 2018. UBC would have to increase the share of CASA deposits going forward, which stood stable and moderate at about 23-24% over the last two years. The credit to deposit ratio was high at about 103% as on June 31, 2018; the share of other borrowings (including repos) remained high at 26% as on June 31, 2018 (30% in December 31, 2017). The bank's ability to reduce its share of other borrowings would be crucial from a liquidity perspective as the portfolio expands going forward.

Analytical approach: For arriving at the ratings, ICRA has applied its rating methodologies as indicated below.

Links to applicable criteria: [ICRA Lanka's Credit Rating Methodology for Banks](#)

About the company:

UBC, incorporated in 1995, is a small LCB accounting for about 1% market share of the Sri Lankan banking sector assets as on March 31, 2018. After a Restructuring process in 2003, which included Union Bank transferring Rs 978 Mn of NPAs and Rs 600 Mn of Cash to an SPV in return for low yielding long term Deep Discount Bonds (DDB), the bank has raised capital from various investors. The bank was listed on the main board of the Colombo Stock Exchange with an IPO offering in March 2011. UBC acquired controlling in National Asset Management Limited (NAMAL) and The Finance and Guarantee Company Limited (TF&G) subsequently renamed TF&G to UB Finance (a licensed finance company). As on December 31, 2017, it holds about 51% of the share capital in NAMAL and 73% share capital in UB Finance (81% of the total voting rights). In 2014, UBC received equity infusion of about LKR 11.4 Bn from Culture Finance Holdings Ltd (CFHL), an affiliate of the private equity investor TPG; CHFL presently holds about 70% of the share capital. CHFL also subscribed to about 218 Mn share warrants, which could result in further equity infusion of LKR 3.4 Bn, if exercised and, increase CHFL's shareholding to 75%. Given the restrictions on bank shareholdings in Sri Lanka, special approval was granted by Central Bank of Sri Lanka (CBSL) to CHFL to hold the above percentages till 2019 and is required to reduce to 15% thereafter.

During the year ended December 31, 2017, UBC reported a PAT of LKR 461 Mn on a total asset base of LKR 119 Bn as compared to a PAT of LKR 451 Mn on a total asset base of LKR 93 Bn in the previous financial year. For H1CY2018, UBC reported a PAT of LKR 253 Mn on a total asset base LKR 114 Bn.

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