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STOCK BROKING PVT. LTD.



CITY UNION BANK
(INITIATING COVERAGE REPORT)



*(BUSINESS IS NOT SCIENCE, IT'S MUCH
MORE AN "ART OF ECONOMICS")*





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Analyst: Avinash Tanawade 022 67141442

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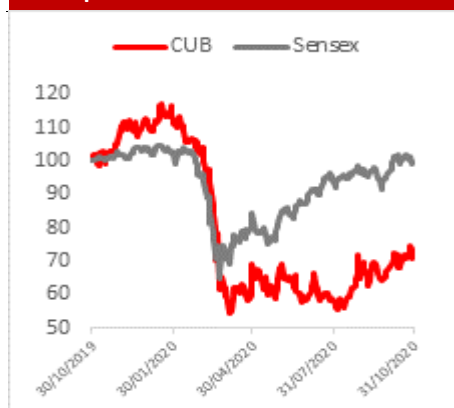
BUY

Current Price	158
Target Price	198
Upside (%)	25
52 Week Range	110/249

Key Share Data

Market Cap (Rs.Bn)	117
Market Cap (US\$ Mn)	1564
No of o/s shares (Mn)	738
Face Value	1
BSE Code	532210
NSE Code	CUB
Bloomberg	CUBK:IN

Price performance



% Shareholding	Sep-20	Jun-20
FII	18.67	21.65
DII	27.52	30.10
Others	53.81	48.25
Total	100	100

SLOW AND STEADY WINS THE RACE

City Union Bank (CUB) is one of the very few banks, which has reported consistent returns (RoA & RoE above 1.5% & 15% for the last 12 yrs except for FY20) over the years. The returns were supported by stable margins (NIM above 3% for the last 10 yrs) and better operating efficiency (C/I ratio below 45% for the last 20 yrs). Bank has a strong understanding of local markets (ie. Tamil Nadu) and focused largely on working capital finance to small manufacturers and traders. Its lending philosophy is founded on the principle of providing small-ticket secured loans (~1:1 loan to collateral ratio) that helps it to control asset quality. **Over the years, the bank has been growing steadily with a conservative approach and aims to continue with this strategy for the next two or three years before embarking on an aggressive growth trajectory.** We strongly believe that there is an ample opportunity for the Bank in the years to come to expand its presence across the length & breadth of the country and become a major player in the National Banking Space.

Asset quality to bounce back strongly: The bank's stable asset quality was supported by its granular nature of advances, high level of collateralization, and greater exposure towards working capital facilities (over 2/3 of advances). However, we believe slippages will be elevated in the next 2-3 quarters not just for CUB but also for the whole banking industry as the asset classification standstill benefit ended on Aug 31, 2020. According to management, economic activity has improved on the ground in the last few months, with customer transactions at 80-85% of pre-covid levels. Customer interactions have been encouraging from an asset quality standpoint. **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 have conservatively estimate slippage for FY21 at 4.1% and FY22 at 2.5% and GNPA/ NNPA at 5.5/2.5% in FY21 and 4.1/1.8% in FY22. **Even though the NPA level looks elevated, we expect minimum risk as 99% of total lending is secured in nature, which helps in the easy recovery.** Historically, the bank's average LGD has been maintained at ~30% for the last few years.

Strong Liability Franchise: CUB has a granular deposit base, with top 20 deposits constitutes less than 7% and only 11% of the total deposits are above Rs 2 Cr high, resulting in a stable liability profile. Its deposits also have a higher maturity. Furthermore, 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. The bank balances its asset-liability by lending to small businesses (classified as retail) through retail term deposits that help maintain the spread.

Operating efficacy remained intact: CUB has been able to contain its opex growth better than its peers, which is evident from its cost to income ratio (C/I ratio) at 43% in FY20 compared with 50%-74% for midcap peers. The bank's small size and niche positioning generate better pricing power on the lending front leading to higher spread (above 3% for the last 10 yrs). Furthermore, Bank continued to upgrade and strengthen its Information Technology framework to ensure smooth and secure customer friendly Banking. It is this digital strategy traction that has aided in the employees per branch metric to decline from 10-11 to 8 in the last few years.

Outlook and valuation

CUB 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. With ~70% of the branches in rural and semi urban regions, the bank's asset quality will have a relatively lower impact of the pandemic. **At CMP, the stock trades at 2.1 times its one-year forward book value, lower than its three-year historical average of 2.8 times and peak valuation of 3.8 times book value. We assign a P/AB (x) of 2.2 to FY23E Adj BVPS of INR 90 and arrive at a Target Price of Rs 198.**

Financials (In INR Mn)

Year	NII	PPOP	PAT	ROA	ROE	Adj. BVPS	P/ABVPS
FY20	16752	13414	4763	1.0	9.4	61	2.6
FY21E	18778	15225	3721	0.7	6.8	64	2.5
FY22E	21232	17425	8145	1.4	13.5	76	2.1
FY23E	25298	21045	10728	1.6	15.6	90	1.8



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Small in size but great on returns...

CUB has a unique business model, which sustained better returns (RoA & RoE above 1.5% & 15% for last 12 yrs except for FY20) across various business cycles. Bank's small size and niche positioning provide a better pricing power on the lending front leading to higher returns on its assets as well as equity employed.

Core Business Performance	FY17	FY18	FY19	FY20	FY21e	FY22e	FY23e
<i>Nil/ avg. total assets (%)</i>	3.6	3.8	3.8	3.5	3.7	3.8	3.9
<i>Non-interest income/ avg. total assets (%)</i>	1.4	1.4	1.2	1.4	1.4	1.4	1.4
<i>Opex/ avg. total assets (%)</i>	2.1	2.0	2.1	2.1	2.0	2.1	2.1
<i>PPOP/ avg. total assets (%)</i>	3.0	3.2	2.9	2.8	3.0	3.2	3.2
<i>Provisions/ avg. total assets (%)</i>	0.9	1.1	0.7	1.6	2.0	1.1	1.0
<i>Return on Avg. assets (%)</i>	1.5	1.6	1.6	1.0	0.8	1.5	1.7
<i>Leverage (x)</i>	10.1	9.7	9.5	9.4	9.4	9.4	9.5
<i>Return on equity (%)</i>	15.2	15.3	15.2	9.4	7.2	14.4	15.8

(Source: Company, Dalal & Broacha Research)

We believe the bank is capable of maintain higher returns while continuing with its business strategy as a niche banker for small companies due to its better understanding of southern market and high yielding working capital loans oriented business model.

Superior return matrix as compared to its peers

ROE (%)	Axis Bk	CUB	DCB Bk	HDFC BK	ICICI Bk	IndusInd Bk	KVB	Kotak Bk	RBL Bk	FEDERAL Bk	Karnataka Bk
FY07	21.0	22.0	3.2	19.5	13.4	7.1	16.5	11.4	2.9	21.4	15.1
FY08	17.6	21.8	8.1	17.7	11.7	6.9	18.5	11.4	7.2	13.6	18.5
FY09	19.1	19.9	(15.2)	17.2	7.8	11.7	18.6	7.5	9.2	12.1	18.2
FY10	19.2	20.6	(14.6)	16.3	8.0	19.5	22.6	13.5	5.5	10.3	9.9
FY11	19.3	23.5	3.9	16.7	9.7	19.3	22.3	14.5	1.7	12.0	9.6
FY12	20.3	24.9	8.1	18.7	11.2	19.3	20.8	14.7	5.9	14.4	9.8
FY13	18.5	22.3	11.7	20.3	13.1	17.8	19.0	15.6	6.7	13.9	12.8
FY14	17.4	18.9	14.8	21.3	14.0	17.6	13.5	13.8	5.3	12.6	10.5
FY15	17.8	16.3	14.5	19.4	14.5	19.0	12.1	14.1	10.1	13.7	14.0
FY16	16.8	15.5	11.9	18.3	11.6	16.6	12.9	11.0	11.2	6.0	11.7
FY17	6.8	15.2	10.8	17.9	10.7	15.3	12.6	13.2	12.2	9.8	10.8
FY18	0.5	15.3	10.9	17.9	6.8	16.5	6.1	12.5	11.5	8.3	6.7
FY19	7.2	15.2	12.0	16.5	3.2	13.3	3.3	12.2	12.2	9.8	9.2
FY20	2.1	9.4	11.2	16.4	7.3	14.7	3.6	13.1	5.6	11.1	7.9

(Source: Company, Dalal & Broacha Research)



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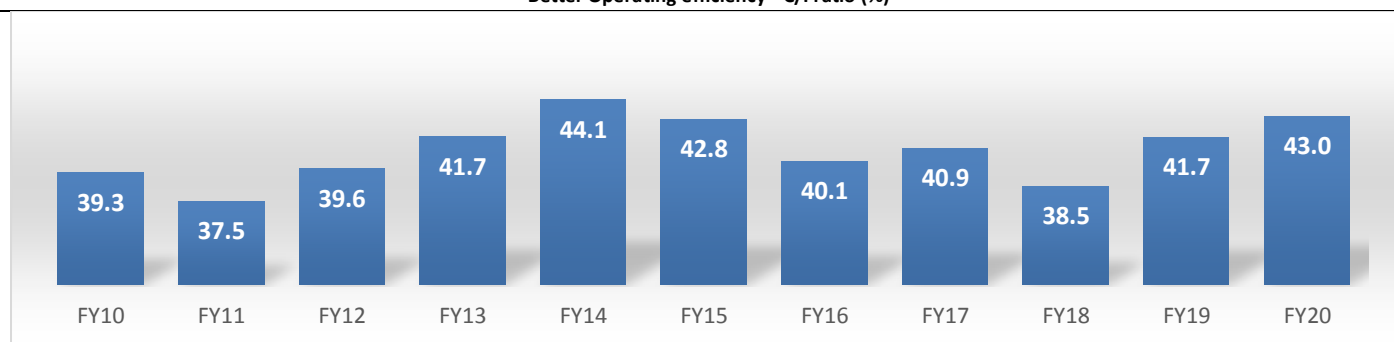
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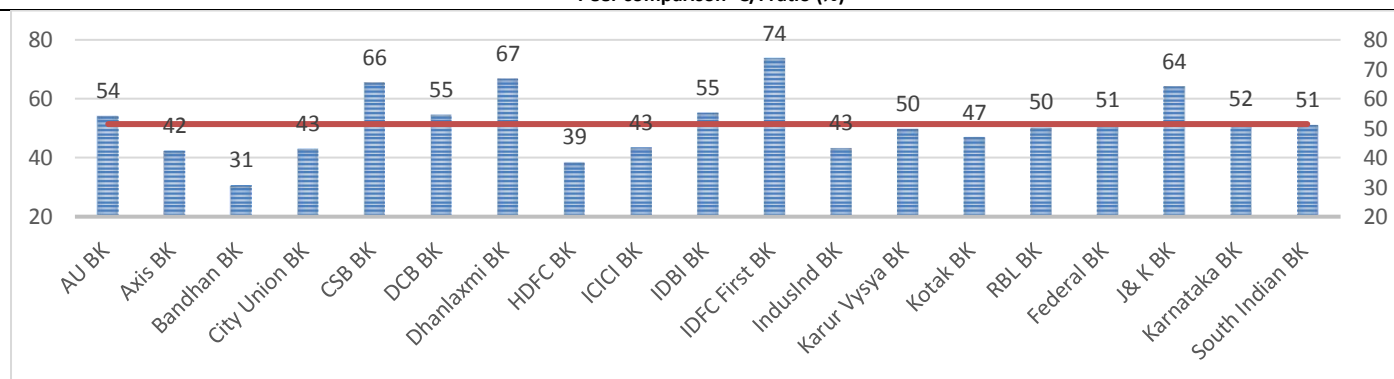
Operating efficiency

CUB is one of the best in terms of operating efficiency. Its C/I ratio stood at 43% in FY20 compared with 50%-74% for midcap peers. The bank's superior opex control was supported by its (1) intelligent HR strategy working to keep a young, efficient workforce (2) a contained, focused branch expansion strategy and (3) strong traction for digital strategy. While the bank is more than 100 years old, it did not shy away from adopting newer technology and landscape. Bank continued to upgrade and strengthen its IT framework to ensure smooth and secure customer friendly Banking. It is this digital strategy traction that has aided in the employees per branch metric to decline from 10-11 to 8 in the last few years. Furthermore, the bank has managed to shift transaction value materially from branches to non-branch channels. Share of non-branch channels has increased to ~90% from 60% few years back. Besides, bank's branch expansion strategy was centered around Tamil Nadu first and then South India. This was helpful from an opex ratio perspective as branches within catchment areas where the bank is previously active and has better brand recall tend to break even faster.

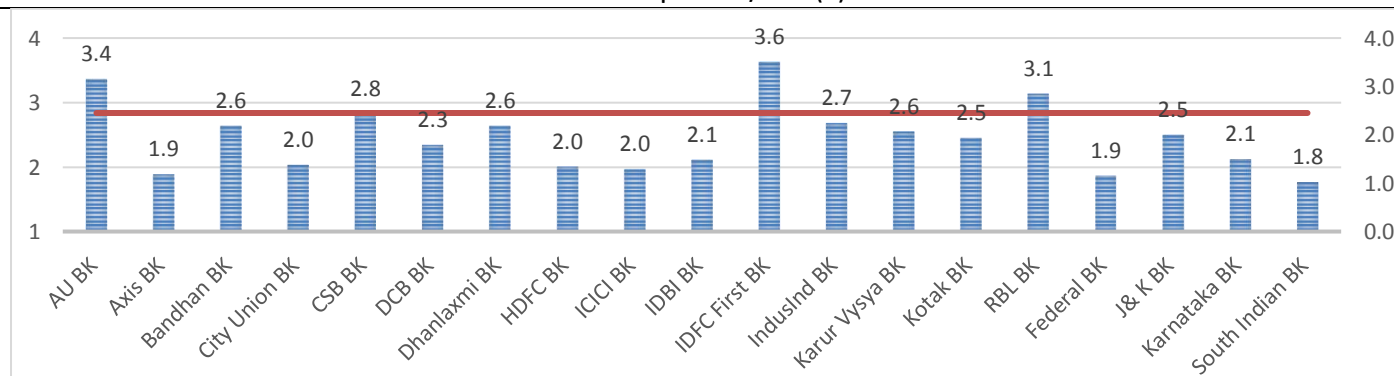
Better Operating efficiency - C/I ratio (%)



Peer comparison- C/I ratio (%)



Peer comparison- C/I ratio (%)



(Source: Company, Dalal & Broacha Research)



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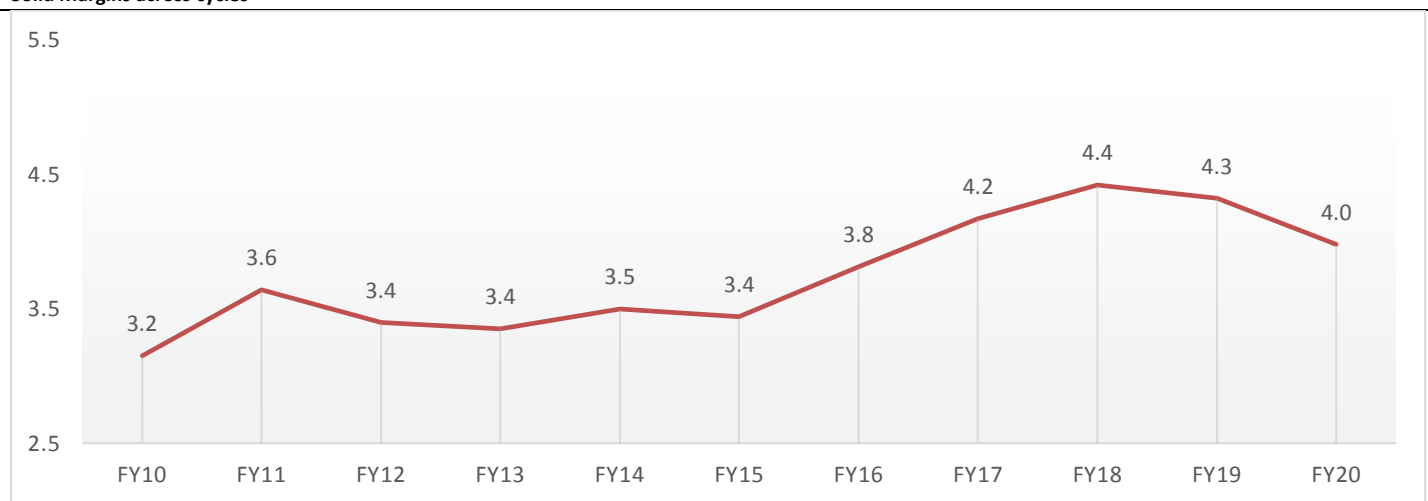
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Margins maintained across cycles

The bank has maintained its NIMs above 3% for over a decade across economic cycles. This was possible due to the bank's focus on the SME/MSME segment that is high yielding and wherein re-pricing is possible. Besides, higher churn due to greater proportion of short-term loans (working capital loans) and extensive knowledge about its market dynamics the bank has been able to manage its yields on advances across business cycles.

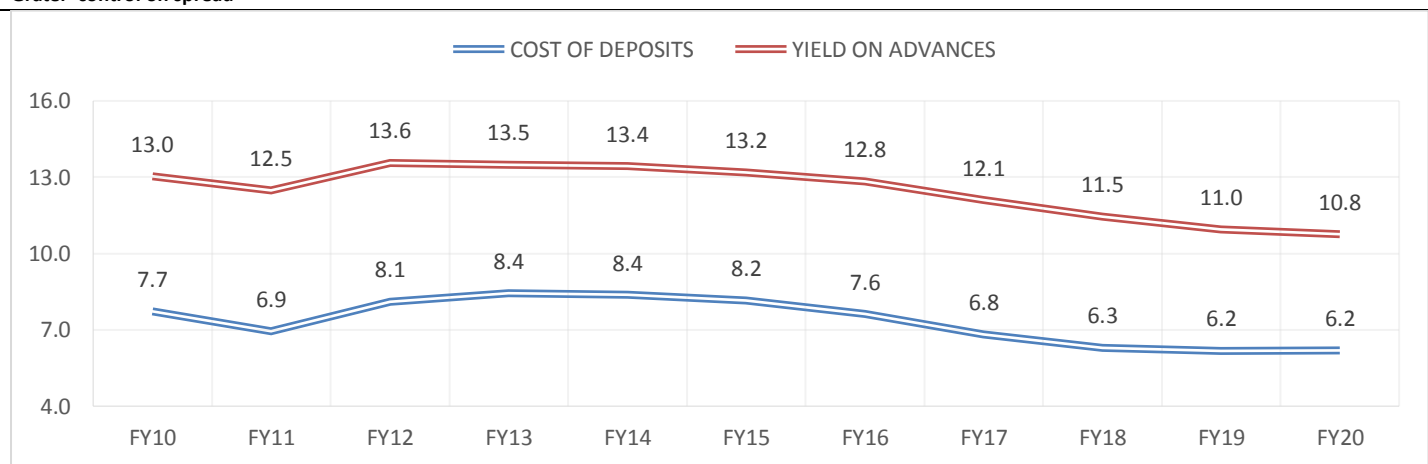
Solid Margins across cycles



(Source: Company, Dalal & Broacha Research)

Unlike most banks, which maintain a higher CASA base to control their cost of deposits, CUB is able to maintain high margins on account of the higher premium it is able to command from its niche market of SME and traders. Right product to right customer enables the bank to charge a premium, which helps sustain the spread. Besides, ~95% of its loan book is on a floating basis enabling frequent repricing of its book, which helps to maintain NIM above 3%.

Grater control on spread



(Source: Company, Dalal & Broacha Research)



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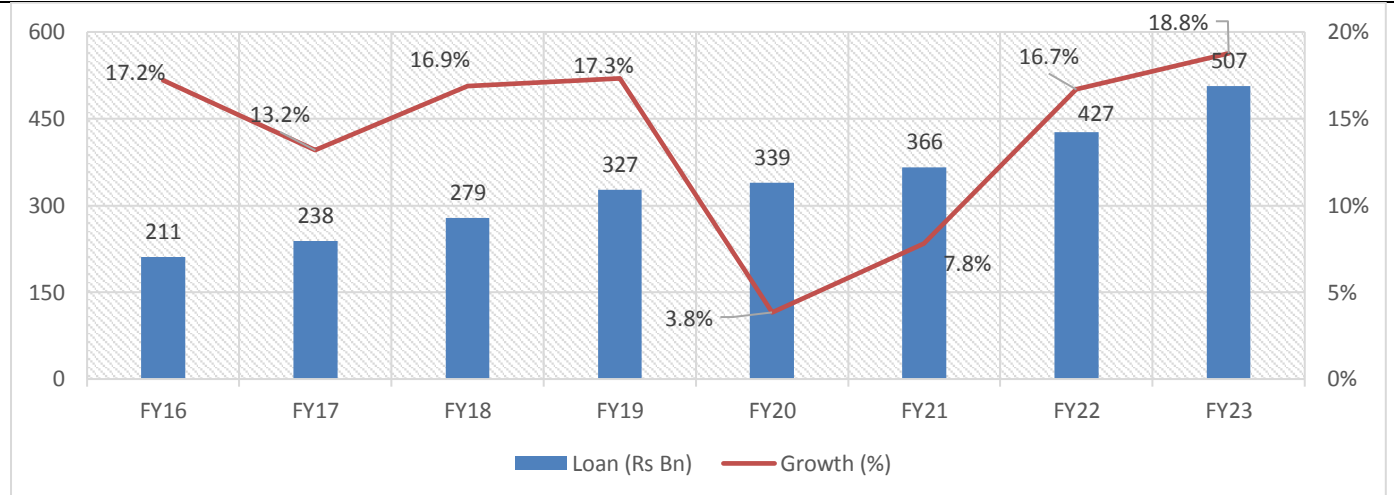
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Conservative approach towards lending (one mantra "Growth with additional risk say No, No...")

Over FY06-13, CUBK delivered 29% CAGR in loans maintaining ~60% average lending through working capital and the rest comprised term loans. Post that growth has moderated to 15% CAGR over FY14-FY19 due to slowdown in economic activities, decline in the share of gold loan book (22% in FY13 to 8% in FY18), drought conditions in parts of South India and disruptions caused by demonetization and roll-out of GST. Bank follows a conservative approach, which sacrifices balance sheet growth to an extent, but lends comfort as far as underlying asset quality is concerned. Bank has focused on remaining the sole banker or part of small group of banks (maybe two-three banks); maintaining low ticket sizes and stringent collateralization in these loans. We have factored in a loan CAGR of 14% over FY20-23E. 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.

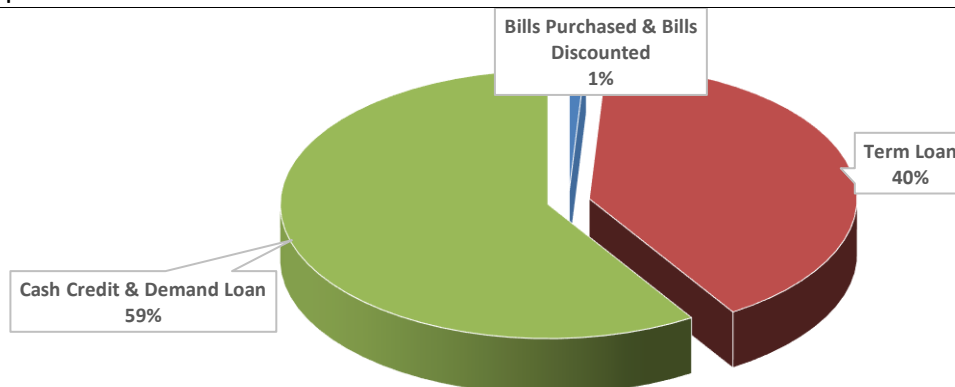
Loan growth will pick up.....



(Source: Company, Dalal & Broacha Research)

Most lenders have changed their focus (or strategies) from either the product or the customer or both over the long periods of their history (due to challenges e.g. corporate). CUB, on the other hand, has sustained a disciplined approach to lending entailing focus on working capital finance to small manufacturers and traders. We strongly believe that there is an ample opportunity for the Bank in the years to come to expand its presence across the length & breadth of the country and become a major player in the National Banking Space.

Products Composition



(Source: Company, Dalal & Broacha Research)



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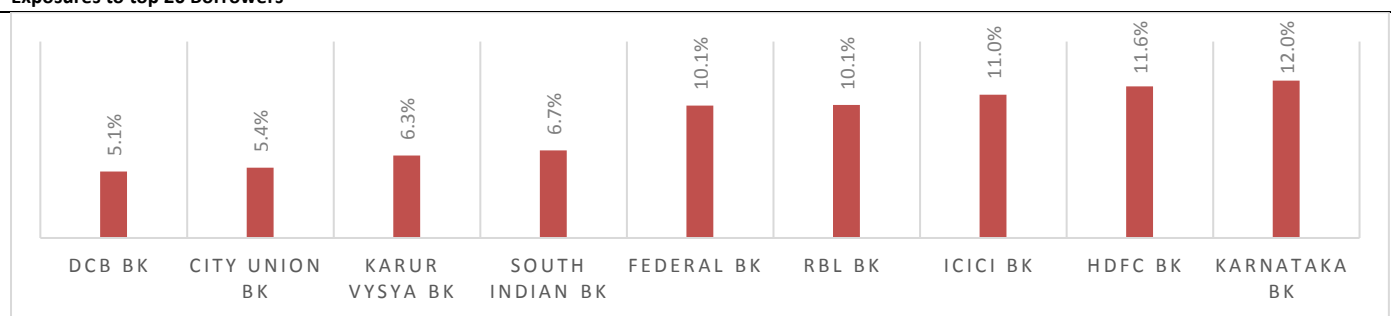
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Granular loan franchise among mid-cap banks:

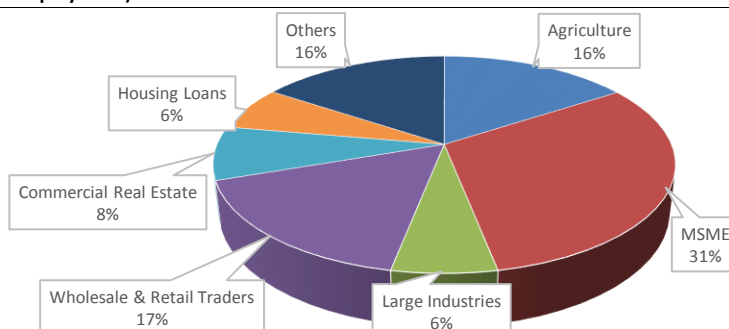
CUB's granularity of loans is typified by its share of top 20 borrowers in total loans, which stood at just 5.4% in FY20 compared with 5%-12% for other banks. The bank's average MSME ticket is significantly lower than ticket sizes for large private sector banks, which tend to operate at a much larger ticket size range. At the same time, Small Finance Banks (mostly microfinance lead) do not pose a real threat as they operate at a much lower loan ticket size range. Therefore, the major competitors for CUB are its key Tamil Nadu-focused mid-sized peers like Karur Vysya Bank, Federal Bank and unlisted Tamilnad Mercantile Bank. Among its mid-sized peers, we believe CUB is better placed owing to its relatively superior asset quality.

Exposures to top 20 Borrowers



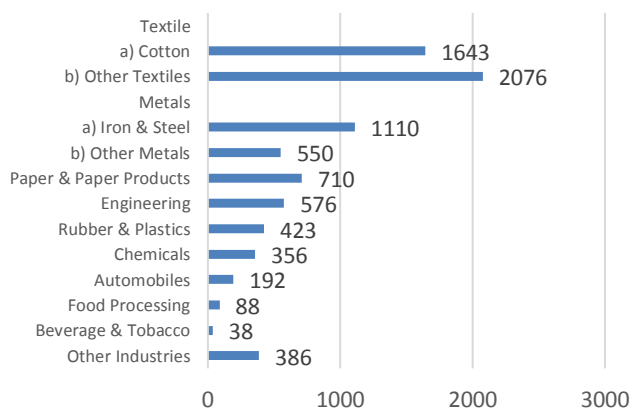
(Source: Company, Dalal & Broacha Research)

Well Diversified Loan Book (Sectoral Deployment)



(Source: Company, Dalal & Broacha Research)

Advances to Major Industries (Rs C)



Industry Name	Amount (in Rs Cr)	% of Advances
Advances to Major Industries	8149.6	24%
All other advances (Agri, Trade, Service, Gold Loan, etc.)	26426.6	76%
Advances	34576.2	100%



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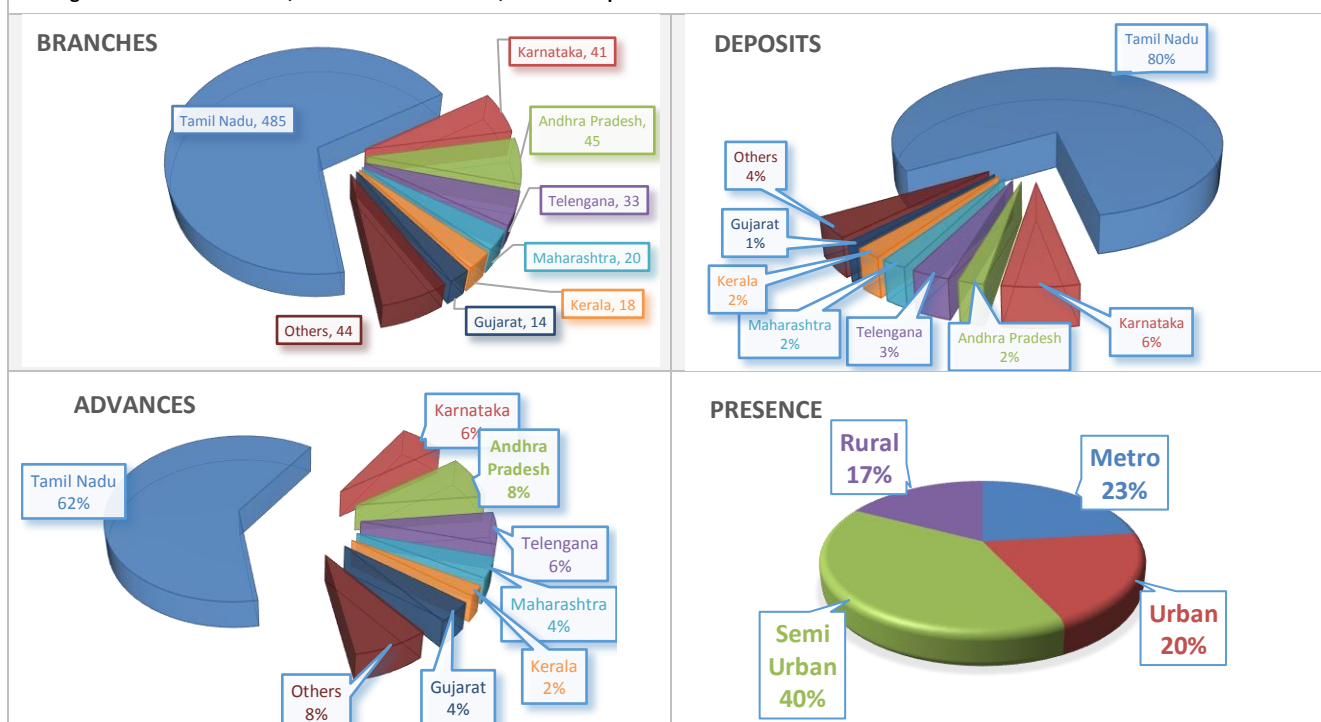
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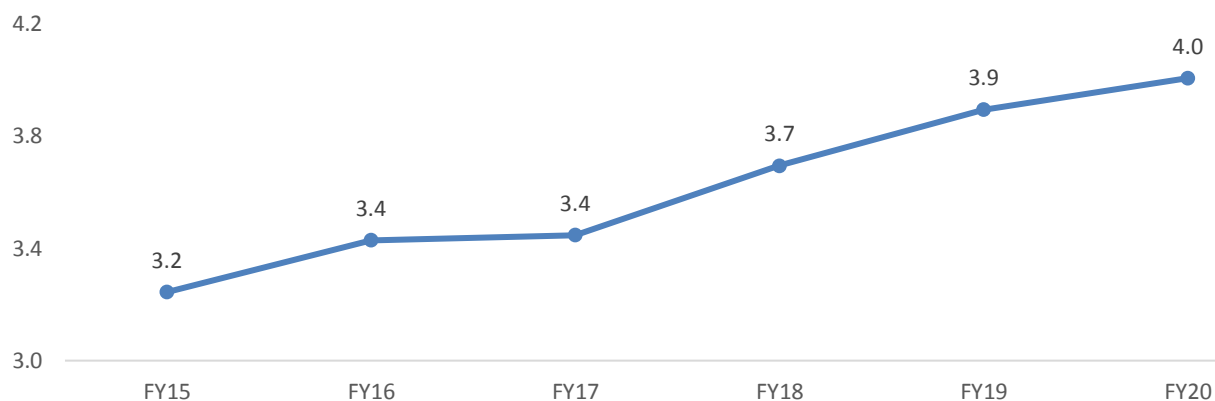
Significant headroom for growth in Tamil Nadu

CUB is not looking to become a pan-India bank overnight, rather it chooses to focus primarily on South India and, within that, on its home state of Tamil Nadu. Its branch share in Tamil Nadu, which could be regarded as a very rough proxy for market share, is 4.0% as of FY20. We believe CUB has a lot of headroom in terms of penetrating in Tamil Nadu as well as in south India. Its understanding of local businesses, relationships and knowledge of the niche business segments in southern India could support its expansion. Due to personal attention to their needs, access to top management and quick turnaround time, Small companies usually chose regional banks in their respective home states over other large banks.

Strong foothold in Tamil Nadu, with ~69% of branches, ~80% of deposits and ~62% of loans



Exposures to top 20 Borrowers



(Source: Company, Dalal & Broacha Research)



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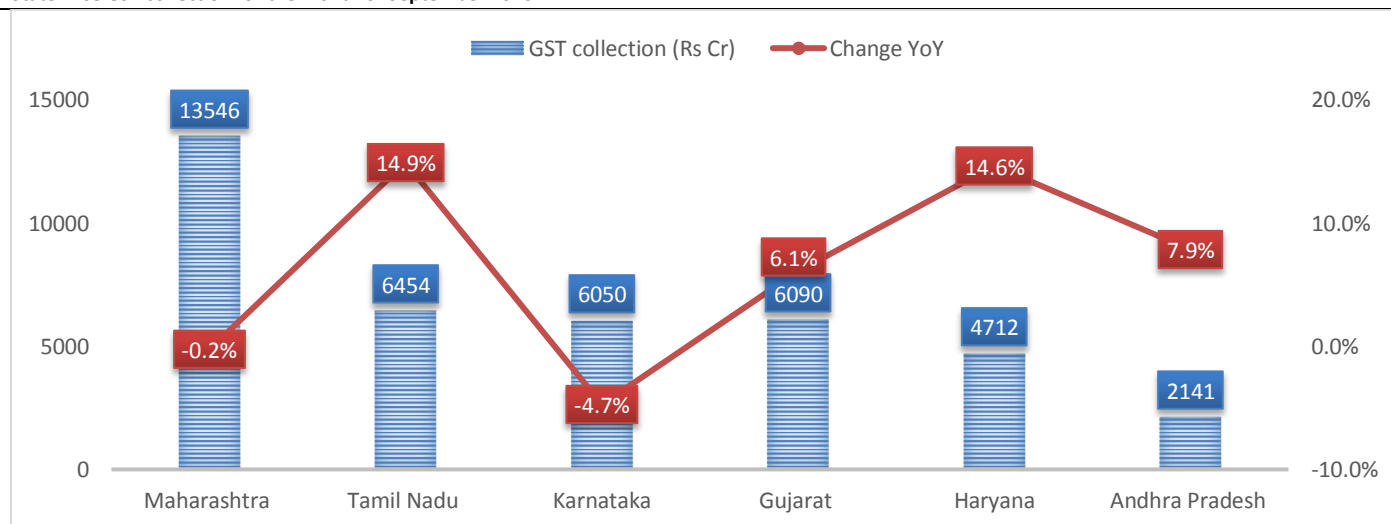
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Tamil Nadu's economy appears to be returning to normal

As far as Tamil Nadu is concerned, it is the second largest state economy after Maharashtra, contributing at least 8% to India's national GDP. Against the all-India average GDP growth figure of 4.2% in FY20, the State reported a GSDP growth rate of 8.03%, which was almost double the former. It was for the third consecutive year, when Tamil Nadu clocked higher economic growth rate than the national average. According to former RBI Governor C Rangarajan, Tamil Nadu's economy will revive to pre-Covid-19 level in next two months (by December 2020). With a significant part of the economy resuming, primary indicators like GST collections, Vehicle registration, collections from petrol, and electricity usage are showing strong signs of improvement.

State wise GST collection for the month of September 2020



(Source: Company, Dalal & Broacha Research)

While Vehicle registration in Tamil Nadu increased by 17.2% YoY in Sep 2020, State's revenue from stamp duty & registration fees grew by 0.8% YoY at Rs 1,064.62 Cr in Sep 2020. Furthermore, State's GST collections rose by 15% YoY, which was way higher than the country's GST collections growth of 4% YoY in Sep 2020, indicating stronger economic recovery is in sight. Even compared to other developed states such as Maharashtra, Karnataka and Gujarat, Tamil Nadu's Sep GST collections were much better.

In order to support economy, state government is looking to take various measures, which includes steps like extending employment guarantee scheme to urban areas, free distribution of rice to card holders beyond Nov 2020, increase capital expenditure by Rs 10,000 Cr and set up a Rs 3,200 Cr fund to support construction workers. We believe Tamil Nadu's economy will recover faster than the country's overall economy.



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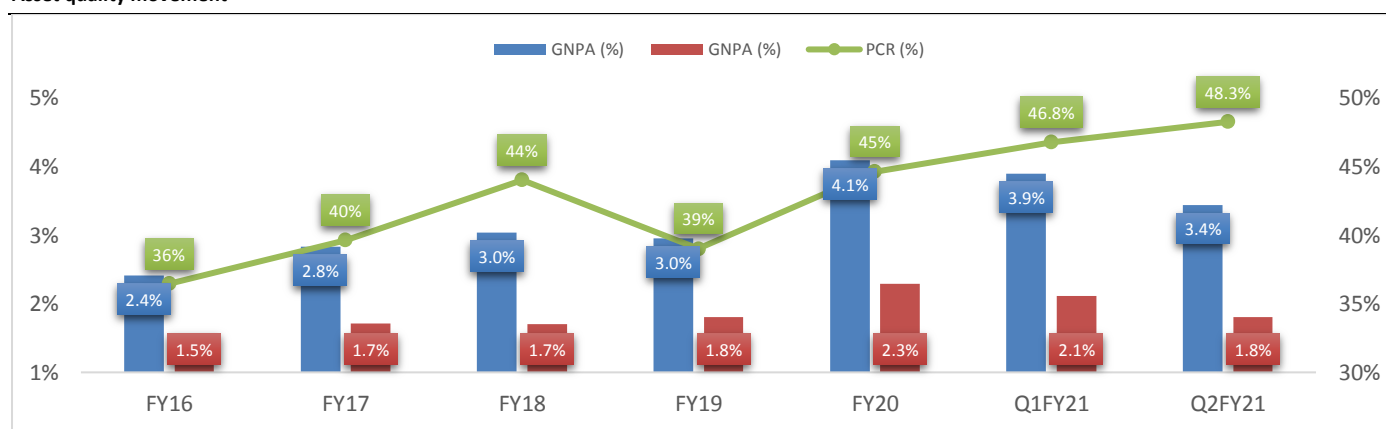
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Asset quality deteriorated but broadly remained stable over past few years

(Business is not science, it's much more an "Art of Economics")

Bank has built its business model on a prudent lending philosophy, which emphasised on granular nature of advances, high level of collateralization and greater focus towards working capital facilities (over 2/3 of advances). While small ticket size mitigates concentration risk with no single large account turning into NPA, secured lending ensures paring of losses in case of default as the bank maintains ~1:1 loan to collateral ratio. Going forward, we believe slippages will be elevated in the next 2-3 quarters not just for CUB but also for whole banking industry as the asset classification standstill benefit ended on Aug 31, 2020. According to management, economic activity has improved on the ground in last few months, with customer transactions at 80-85% of pre-covid levels. Bank's customer interactions have been encouraging from an asset quality/slippage standpoint. Lower exposures to stressed segments like hotels, restaurants and theatres will reduce the probability of future unexpected surprises.

Asset quality movement



(Source: Company, Dalal & Broacha Research)

During Q2FY21, the bank's slippages were nil due to standstill levied by the Supreme Court, while pick up in recoveries pushed GNPA/NNPA lower at 3.4/1.8% vs 3.9/2.1% QoQ. PCR rose to 48.3% (vs 46.8% QoQ). Bank has made an additional COVID-related provisions of Rs 1.15bn during Q2, taking the total stock of such provisions to ~Rs 3.17bn (~89bps). The bank's Collection efficiency for the month of Sep stood at 90%, with term loan accounts saw repayments of 86% and working capital accounts saw repayments of 94%. As of June '20, 12.45% of the accounts had not serviced even a single EMI. This number has declined further to 4.09%, indicating improving trends as far as the underlying stress is concerned. We believe that the management commentary, in the past few months, has been in line with what the numbers have to show. The SMA0, SMA1 and SMA2 accounts amounted to Rs 0.63bn, Rs 2.25bn and Rs 1.09bn as of October-end, implying a total overdue book then of Rs 3.97bn, which is 111 bps of total advances.

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 have conservatively estimate slippage for FY21 at 4.1% and FY22 at 2.5% and GNPA/ NNPA at 5.5/2.5% in FY21 and 4.1/1.9% in FY22. Even though NPA level looks elevated, we expect minimum risk as 99% of total lending are secured in nature which helps in easy recovery. Historically, bank's LGD has been maintained at <30%. Post GFC, CUB had the highest proportion of loans restructured (10%) and majority of those loans survived (only 2% slipped into NPAs in successive years). Latest restructuring can be more successful compared to earlier restructuring cycles since the current framework is applicable mostly to those businesses which had been repaying on time pre-covid.

Repayment Status of Accounts – Position as of 30th Sep 2020: Moratorium period along with repayment made in the Sep-20

	1 MONTHLY INSTALLMENT / INTEREST	2 MONTHLY INSTALLMENT / INTEREST	3 MONTHLY INSTALLMENT / INTEREST	4 MONTHLY INSTALLMENT / INTEREST	5 MONTHLY INSTALLMENT / INTEREST	6 MONTHLY INSTALLMENT / INTEREST	FOR THE MONTH OF SEP-20
LOAN A/CS	87%	75%	66%	61%	56%	51%	86%
CCOD A/CS	99%	95%	94%	94%	93%	91%	94%
TOTAL	90%	82%	78%	76%	73%	68%	90%



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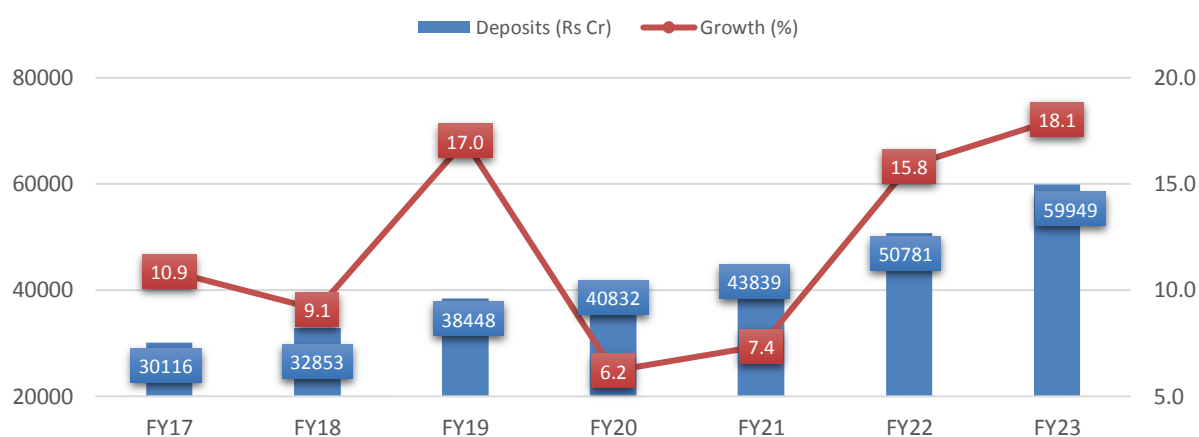
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Focus mainly on retail based term deposit mobilisation....

CUB'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. The bank's top 20 deposits constitute less than 7% and only 11% of the total deposits are above Rs 2 Cr. While there has been a pick-up in CASA after demonetization, this proportion still remains below industry average of 30%. Furthermore, its CASA ratio of ~25%, does not play a major role in controlling cost of funds. According to management, it is part of their funding model to keep CASA ratio relatively low but, focus on retail deposits (including TD). Meanwhile, the bank has a healthy asset liability management with 67% of deposits and 51% of advances having maturity period of one to three years in FY20. The bank balances its asset-liability by lending to small businesses (classified as retail) through retail term deposits that help maintain the spread.

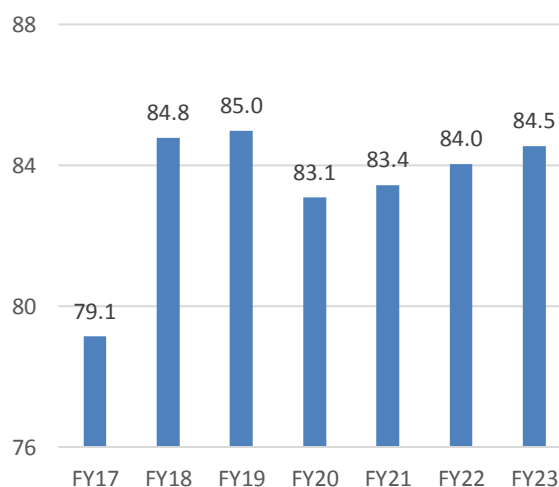
Strong liability franchise



CASA (%)



Credit To Deposit ratio (%)



(Source: Company, Dalal & Broacha Research)



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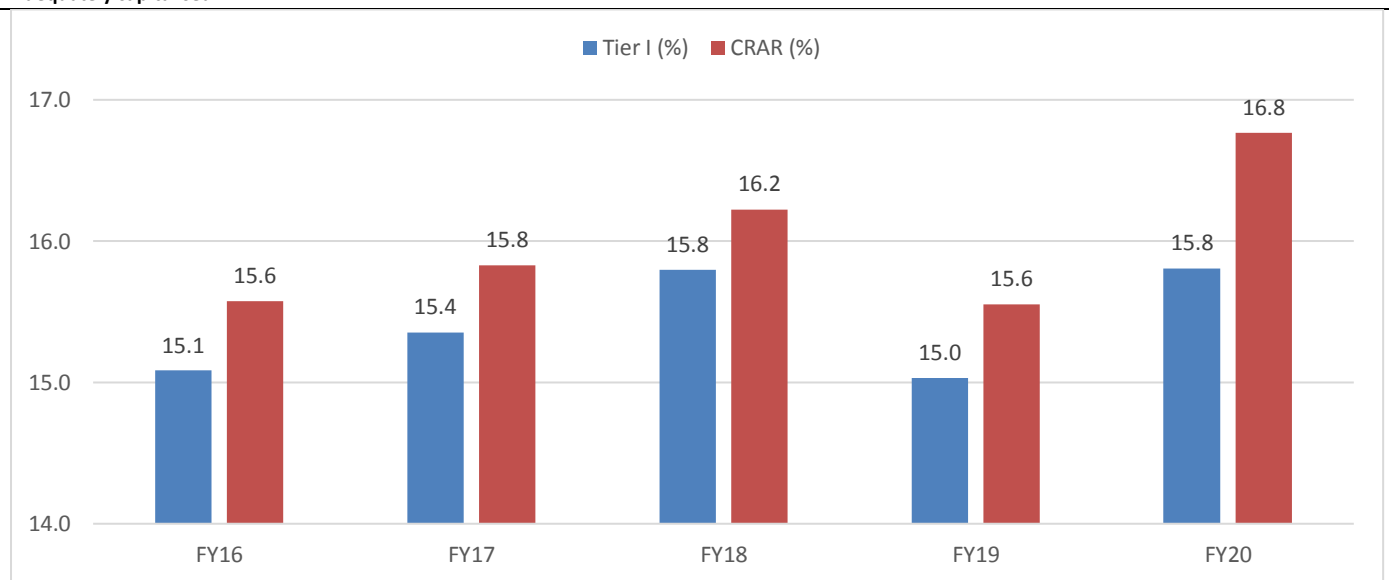
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Better capitalization to support credit growth

CUB has maintained healthy capitalization levels, with Tier I and CRAR at 15.8% and 16.8% (as % of risk weighted assets) as on Mar 31, 2020. Bank has a strong track record of maintaining capital adequacy ratio higher than minimum regulatory requirements. Its capital position remains supported by its stable earnings which provide adequate accruals.

Adequately capitalised



(Source: Company, Dalal & Broacha Research)

Moreover, Bank has demonstrated track record of raising equity capital through rights issue or preferential issue as and when required, to support growth. We believe that CUB's capitalization will remain adequate over the medium term in the normal course of operations.



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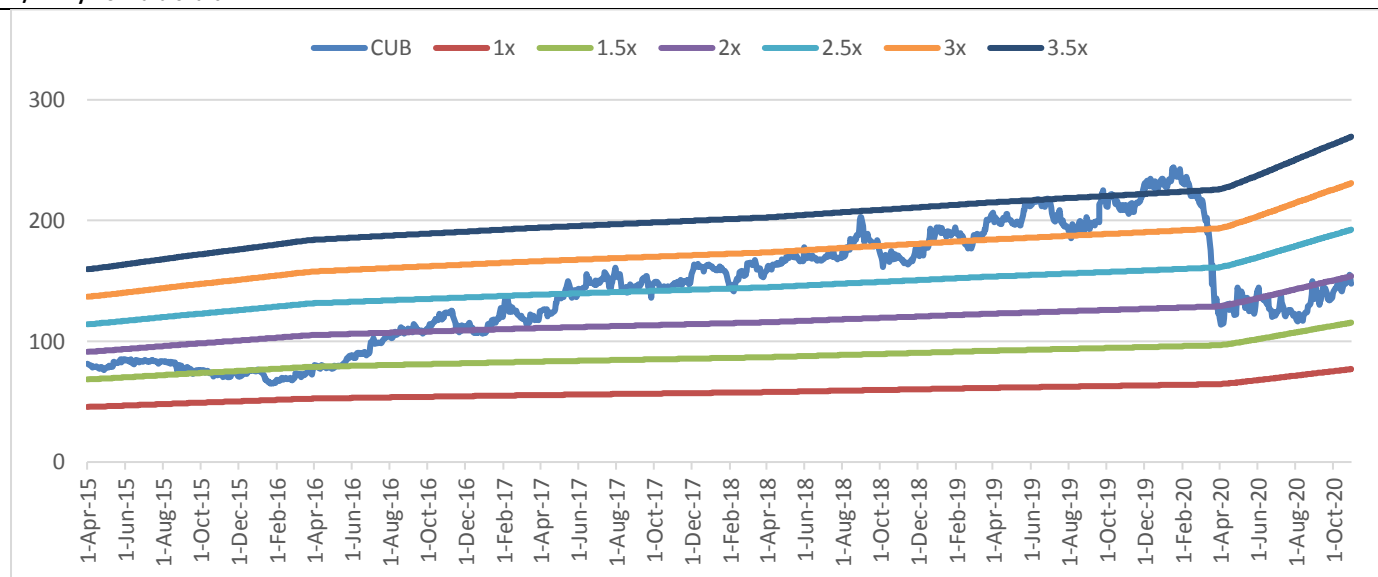
Outlook & Valuation

City Union Bank has all the right ingredients, which includes 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. Besides, focus on small-ticket sole banker model, understanding of southern India's niche business segments, viz MSME, traders and agri loans, and stronger economic recovery will drive higher loan growth.

With ~70% of the branches in rural and semi urban regions, the bank's asset quality will have a relatively lower impact of the pandemic. We believe the bank's profitability will remain under pressure in FY21 due to slower credit offtake & higher provisions. However, we expect better recovery in FY22 and FY23, supported by stable margin and higher loan growth. We expect the bank's RoA/RoE to moderate to 0.7%/7% in FY21 and recover back to 1.5%/14.1% in FY22.

At the current price, the stock trades at 2.0 times its one-year forward book value, lower than its three-year historical average of 2.8 times and peak valuation of 3.8 times book value. We assign a P/AB (x) of 2.2 to FY23E Adj Book Value per share of INR 90 and arrive at a Target Price of Rs 198.

P/BV 1 yr forward chart



(Source: Dalal & Broacha Research)



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P&L (Rs mn)	FY20	FY21	FY22	FY23
Interest Earned	41686	43438	47190	57035
Interest Expended	24934	24660	25958	31736
NII	16752	18778	21232	25298
Other Income	6799	6974	8099	9468
Net Income	23551	25752	29331	34767
Opex	10137	10527	11906	13722
PPOP	13414	15225	17425	21045
Provisions	7551	10251	6536	6703
PBT	5863	4974	10889	14342
Tax	1100	1254	2744	3614
PAT	4763	3721	8145	10728

BS (Rs mn)	FY20	FY21	FY22	FY23
Capital	735	735	735	735
Reserves	52223	55665	63199	73122
Deposits	408325	438385	507810	599493
Borrowings	20324	17885	18779	20094
Other Liabilities	15726	18145	19687	21269
Total	497333	530816	610211	714714
Cash & Bank	47216	45961	52713	57812
Investments	91168	98996	113775	132731
Advances	339274	365763	422761	502093
Fixed Assets	2452	2545	2692	2875
Other Assets	17225	17552	18272	19204
Total	497335	530818	610213	714716

Ratios (%)	FY20	FY21	FY22	FY23
Growth (%)				
NII	4.0	12.1	13.1	19.2
Operating profit	8.2	13.5	14.4	20.8
Net profit	-30.2	-21.9	118.9	31.7
Advances	3.8	7.8	15.6	18.8
Deposits	6.2	7.4	15.8	18.1
Returns (%)				
ROA	1.0	0.7	1.4	1.6
ROE	9.4	6.8	13.5	15.6
Asset quality (%)				
GNPA	4.1	5.5	4.1	3.0
NNPA	2.3	2.5	1.9	1.5
PCR	45	56	54	51
Delinquencies	3.3	4.1	2.5	2.2
Credit Cost	2.3	2.9	1.7	1.4
Operating Ratio (%)				
NIM	3.7	3.8	3.9	3.9
Cost to Income Ratio	43.0	40.9	40.6	39.5
Opex/ Avg assets	2.1	2.0	2.1	2.1
Other Inc to total Inc	14.0	13.8	14.6	14.2
Business Ratios (%)				
Credit to Deposit Ratio	83.1	83.4	83.3	83.8
Investments to Deposit	22.3	22.6	22.41	22.1
CASA	25.0	25.0	24.9	24.7
RWA / Assets	65.3	67.8	68.3	68.8
CAR	16.8	16.1	15.7	15.3
Per share (Rs)				
EPS	6	5	11	15
ABVPS	61	64	76	90
P/E	24	31	14	11
P/ABVPS	2.6	2.5	2.1	1.8

Source: Dalal & Broacha Research)



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