Rating Rationale for Lakshmi Vilas Bank's Lower Tier II (subordinated) Bonds Issue of Rs. 100 crore or INR 1 billion

Issue Rating: BWR A	Outlook: Stable

Brickwork Ratings has assigned BWR A (Pronounced BWR A) with 'stable' outlook to Lakshmi Vilas Bank proposed lower Tier II bonds Issue of INR 100 crore or INR 1 billion. The Brickwork Rating BWR A signifies 'Adequate Safety' and the Rating Outlook further signifies the direction of the rating being stable in the near term. Brickwork has relied upon the audited financial statements and information and clarifications provided by the issuer.

The rating factored the bank's satisfactory capital adequacy, lower term loans component in its assets, and concentration of its branches in semi urban and rural areas. The rating has further factored the bank's current rights issue, which would help the bank not only to augment its capital structure and also to sustain its growth momentum. The rating is partially affected by increasing NPAs, higher leverage, lower profits and non-interest income, and limited branch network. More over, the bank's branch concentration in a single state and lower low cost deposits are limiting factors.

The year 2008-09 was a tough year for the banking industry, particularly for the old private sector banks in terms of increasing credit deployment, sustaining the asset quality and provisions, improving the profitability, and controlling the asset restructuring. In spite of depression in the domestic market and financial turbulence in the international financial market, the Lakshmi Vilas Bank has posted decent financial performance in FY 09. As a result, the bank's total business mix has increased by 33% to Rs 12,606 crore in FY 09 from Rs. 9, 477 crore for the same period a year ago.

During FY 09, the bank has increased its asset base from Rs 6520.60 crore in FY 08 to Rs 8317.25 crore in FY 09 with a growth rate of 27.55%, which is higher than the previous year growth of 11.90%. However, the bank's net worth has increased 8.63% during FY 09. As a result, the leverage, which assesses the bank's net worth with reference to on and off balance sheet items, has increased to 18.67 in FY 09 as compared to 16.12 in FY 08.

Table I: LVB's Performance Indicators

Criteria (Rs Crore)	FY 09	FY 08	FY 07
Total Assets	8317.25	6520.61	5826.78
Deposits	7360.9	5618.48	5019.87
Advances	5245.83	3858.78	3612.70
Investments	1863.06	1693.68	1309.30
Income			
Interest Income	657.61	506.06	418.26
Non-Interest Income	106.98	82.48	56.72
Net Interest Income	153.53	124.13	119.08
Profit			
Operating Profit	108.85	90.17	73.58
Net Profit	50.30	25.27	17.58
Non-Performing Assets			
Gross NPAs	2.71%	3.51%	3.57%
Net NPAs	1.24%	1.55%	1.58%
CRAR	10.09%	12.73%	12.43%
Tier I	8.63%	10.53%	9.93%
ROA	0.71%	0.41%	0.33%
ROE	11.54%	5.64%	5.12%

The bank has grown its asset base over the years, largely driven by robust growth in deposits and strong growth in advances. During FY 09, the bank's deposits base have achieved a growth of 31.00% to reach Rs 7,360 crore as against Rs. 5,618 crore in FY 08. Similarly, the bank's advances showed an increase of 36.00% to Rs 5,245 crore in FY09 as compared to Rs 3,858 crore in FY 08. The increased priority sector credit and agricultural credit have contributed for the growth in the bank's business during the financial year 2008-09.

Though the Bank witnessed good deposit growth during FY 09, the bank has failed to achieve any growth in CASA deposits which have decreased to 16.77% and stand at Rs. 1,235.29 crore during FY 09 as against 21.67% to Rs.1,217.70 crore in FY 08. However, the bank's term deposits to total deposits have increased to 83.21% in FY 09 as compared to 78.32% in FY 08.

During the year, the bank's term loans to advances have increased to 38.96% in FY 09 as compared to 33.89% in FY 08. However, the bank's term loans component was significantly lower than its peers' average of 43.17% in FY 09. The bank's secured loans to total loans have decreased marginally to 90.95% in FY 09 from 91.63% in FY 08. Nevertheless, the bank's secured loans by tangible asset have shown healthy growth of 36.47% in FY 09. The bank's gross advances have been largely concentrated in Tamil Nadu and Maharashtra, which contributed 67.29% of total advances during FY09. With high secured loans, 72.75% of risk weighted assets have less than 100% risk weight.

The bank's credit to deposits ratio has increased to 71.26% in FY09 to 68.68% in FY08. With lower term loans and healthy growth in credit deposits ratio, the bank has deftly managed the domestic financial crises during the year. The bank's exposure to real estate sectors has increased by 73 bps to 9.42% in FY09 from 8.69% in FY08. On the other hand, the bank's commercial real estate advances increased to Rs 73 crore in FY 09 from Rs 37 crore for the same period a year ago with a growth rate of 94%, which is a cause for concern. During FY 09, the bank has restructured 85 accounts amounting to Rs 171.33 crore, which is 3.27% of total advances.

Investment decisions are based on internal risk – return trade off as per Risk Management Policy approved by the Bank's Board and consistent with the regulatory guidelines. The bank's investments have increased to Rs. 1863 crore in FY 09 from Rs 1693 crore in FY 08 with a growth rate of 10%. Consequently, the bank's risk adjusted yield on investments has increased to 8.07% in FY 09 as against 7.74% in FY 08.

During FY 09, the bank's capital adequacy ratio under Basel I decreased by 264 bps to 10.09% as compared to the previous year figure of 12.73%, which further decreased to 9.58% in Q2 FY 10. Similarly, the tier I capital had come down from 10.53% in FY 08 to 8.63% in FY09. The bank's capital adequacy under Basel II stood at 10.29% in FY 09, which decreased to 9.73% in Q2 FY 10.

The major weakness of the bank has been its non-performing assets over the years. However, the bank has reduced its gross and net NPAs during FY 09. The bank's gross and net NPAs have decreased to 2.71% and 1.24% respectively in FY 09 as compared to 3.51% and 1.55% respectively in FY 08. Nevertheless, the bank's gross and net NPAs have increased to 2.91% and 1.55% respectively in Q2 FY 10.

Table II: LVB's Financials

Financials (Rs Crore)	2008-09	2007-08
Interest Income	657.61	506.06
Interest Expenses	504.07	381.93
Net Interest Income	153.53	124.13
Other Income	106.99	82.48
Operating Income	260.52	206.61
Employees Expenses	78.45	63.04
Other Operating Expenses	31.91	20.59
Operating Profits	108.85	90.17
Provisions & Contingencies	58.55	64.90
Profit After Tax	50.30	25.27

The bank has reported an increase in net interest income from Rs. 124 crore in FY 08 to Rs.153 crore in FY 09 with a growth rate of 23.68%. Similarly, the bank's non-interest income had increased by 29.70% from Rs 82 crore in FY 08 to Rs 106 crore in FY 09. Because of this, the bank's operating income and profits increased by 20.71% and 99.05% respectively in FY 09.

BWR has analyzed the performance of LVB vis-à-vis its peers in certain key parameters as given in the table below. BWR rating methodology has defined peer banks as those with closely similar size/operation as that of LVB.

The bank's capital adequacy under Basel I stood at 10.09% during FY 09, which is significantly lower than its peers' average of 13.30%. Similarly, the bank's tier I capital was 361 bps lower than its peers' average of 12.24%. The CRAR is expected to improve further with the proposed issue of Lower Tier II bonds of Rs 100 crore and also right issue of Rs 265 crore.

The bank has highest leverage among its peer banks during FY 09 which was 18.67 as against the peer group average of 14.13.

Table III: LVB Vs Peer Group

Key Ratios (FY 09)	LVB	Peers
Capital Adequacy (Basel I)		
CRAR	10.09%	13.30%
Tier I	8.63%	12.24%
Leverage	18.67	14.13
Asset Quality (As % of Advances**)**		
Gross NPA	2.71%	1.91%
Net NPA	1.24%	0.74%
Earnings		
ROE	11.54%	19.24%
ROA	0.71%	1.24%
Cost to Income Ratio	58.07%	59.02%
Liquidity		
CASA	16.77%	21.69%
Credit Deposit Ratio	71.26%	67.34%
Operating Ratios		
Cost of Funds	6.73%	6.41%
Return on funds	9.05%	9.02%

The bank's asset quality has improved significantly during the year. In spite of that, the gross and net NPAs stood at 2.71% and 1.24% respectively during FY 09, which were 80 bps and 50 bps higher than its peers' average of 1.91% and 0.74% respectively.

During the year, the bank's return on assets and return on equity stood at 0.71% and 11.54% as compared to 1.24% and 19.24% for peer banks. Further, the bank's cost to income ratio was marginally lower than its peers' average. The bank has been taking steps to improve the cost to income ratio, as a result, the bank's return on assets improved to 0.94% in Q2 FY 10.

It is observed that LVB branch network has a very high concentration in Tamil Nadu. Being a regional bank, it is expected that LVB would have an advantage over other private sector banks in terms of generating low cost deposits. However, the bank's low cost deposits stood at 16.67%, which is 492 bps lower than its peers' average of 21.69%. The bank's credit deposit ratio was 392 bps higher than its peers' average of 67.34%.

The bank's cost of funds stood at 6.73% as on 31st March 2009, which is significantly (32 bps) higher than its peers' average of 6.41%. Similarly, the return on funds was 3 bps higher than its peers' average of 9.02%.

Shortcomings:

While analyzing LVBs performance for FY 2009, a few shortcomings as under have been noticed.

a) The bank's gross and net NPAs have increased from 2.71% and 1.24% respectively in FY09 to 2.90% and 1.55% respectively in Q2 FY 10.
b) The Bank has received 154 applications amounting to Rs.240 crores during the year for loan restructuring.
c) The bank's low cost deposits base is a cause for concern, which has decreased to 16.77% in FY 09 from 21.67% in FY 08.
d) The bank's network is very limited and concentrated largely in a single state. It could have a bearing on its performance.

Mitigants:

The bank has initiated appropriate steps to lessen the impact of the above said deficiencies on its performance and improve the quality of its assets and contain NPAs. During Q2 FY 10, the bank has improved its profitability to Rs 22 crore from Rs 6.92 for the same period a year ago. Further, the bank has restructured its administrative structure recently by decentralizing the function of administrative office in order to ensure greater bank-client interaction. With issue of lower tier II bonds and rights equity, the bank is expected to improve its performance with emphasis on maintaining good quality of the assets. Further, the bank is planning to add 22 branches in tier II and III cities in the current financial year to achieve the business targets envisaged in the bank's business plan which is also expected to help in mobilizing more low cost deposits.

Bank Profile:

Incorporated in 1926, Lakshmi Vilas Bank is positioned as a bank for small and medium sized corporate. The bank delivers full range of retail and corporate business banking products. Its presence in rural and semi urban markets had made the bank to implement niche marketing strategies. The bank has 251 branches, 120 ATMs, and 14.5 lakh customer base as on 31st March 2009. Going forward, the bank is extending its financial services like bancassurance, mutual fund distribution, credit cards, and money transfer etc. as one stop shop to its customers.

Shareholding Pattern (As on 31st March 2009)

Shareholders	Stake
Promoters	7.24%
Foreign	2.23%
Retail	74.37%
Financial Institutions	16.16%

Industry Snapshot:

Over the years, the Indian banking sector has benefited from a stable macro economic environment. The financial year 2009 witnessed a steady deterioration in the global financial conditions, which tightened the liquidity position and affected the credit off-take. The Indian banking sector has skillfully tided over the crisis with unparalleled support and measures to stimulate the economy from the government and RBI. While economic activity seems to be picking up, nevertheless caution and continuous monitoring need to be kept by the Banks till the crisis completely blows over.

As scheduled, the banks have successfully implemented the Basel II norms during financial year 2009 in spite of financial crisis in the domestic market. The public sector banks especially have shown a positive growth on account of proactive measures taken by the government during the year.

Rating Outlook:

The rating assigned by Brickwork Ratings (BWR) is based on CAMEL-TP framework, which is used to assess the Bank's financial fundamentals and risk exposures. The rating assigned to LVB is specific to the proposed Lower Tier II bonds issue of Rs 100 crore.

Brickwork expects that the bank would take appropriate steps to contain any further strain on asset quality and going forward, would bring stability is its performance by focusing on improving its asset quality, capital adequacy, low cost deposits and technology driven banking operations.

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