

FOR IMMEDIATE RELEASE

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ICRA Lanka Reaffirms the issuer rating of [SL]BBB for Union Bank of Colombo PLC

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

The rating continues to factor in the 70% shareholding by Culture Finance Holdings Ltd (CFHL), an affiliate of the private equity investor Texas Pacific Group (TPG). TPG presently has 5 representatives in the 11 member Board of UBC. The rating takes note of the experienced senior management team and adequate risk management processes and systems which supported the improvement in the asset quality (Gross NPAs stood at 2.73% on March 31, 2017 as compared with 3.55% on December 31, 2015;). The bank's capital structure is comfortable with Tier-I at 21.0% in March 2017, which would support business expansion over the medium term. The rating nevertheless takes note of the bank's modest size (asset base at LKR 100.1 Bn as on March 31, 2017), franchise, profitability indicators (RoA¹ 0.5% and RoE² 2.6% for CY2016) and, its moderate deposit profile (CASA³ 23% on December 31, 2016). ICRA Lanka notes that the bank's corporate exposures are quite concentrated. The target segments (corporate, upper-tier SMEs and retail) of the bank is expected to be highly competitive thus ability to generate adequate fee and non-interest income going forward, would be crucial from a profitability perspective. Further, improvement in operating efficiency and deposit profile would be crucial.

UBC has a modest scale of operations with total asset base at LKR 100 Bn as on March 31, 2017; it recorded a robust advances growth of about 37% in CY2016. The bank had about 65 branches and 120 ATMs as on December 31, 2016. Over the recent past, UBC has steadily increased the share of retail exposure (11% on December 31, 2016 as compared to 6% on December 31, 2015) with a corresponding moderation in corporate exposure (47% on December 31, 2016 as compared to 52% on December 31, 2015). Going forward, UBC is expected to focus on the corporate and retail/personal segments; ICRA Lanka notes that the bank's corporate exposures are quite concentrated with top 20 exposure accounting for 65% of the total corporate portfolio.

The asset quality improved in 2016, as a result of improvements made on credit underwriting and overall risk management systems. The bank reported a gross NPA of 2.4% on December 31, 2016 when compared to 3.6% on December 31, 2015, however gross NPA slightly increased to 2.7% on March 2017, mainly due to slippages in 1-2 accounts. SME segment NPA is high because of past legacy exposures; corporate and retail segment NPAs are quite modest. The rating continues to take note of the high NPAs in the subsidiary, UB Finance (GNPA at about 13.84% on December 31, 2016). Going forward, ability to keep the group level NPAs under control by restricting incremental slippages and, improving the bank's own provision coverage⁴, which is presently moderate at about 30% on March 31, 2017, would be crucial. Good capital profile nevertheless supports the solvency⁵ profile which was about 7% as on March 31, 2017.

¹ RoA-Return on Asset (post tax)

² RoE-Return on Equity

³ Current Account and Savings Account

⁴ (GNPA-NNPA)/GNPA

⁵ Net NPA/networkth

The bank's funding is largely in the form of deposits, which accounted for 70% of the total debt as on March 31, 2017. 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 financial years. The credit to deposit ratio was high at about 107% as on December 31, 2016 as the advances grew by about 38% during 2015 vis a vis the deposit growth of about 37%; the share of other borrowings (including repos) remained high at 30% as on March 31, 2017 (29% in December 31, 2015).

UBC has a comfortable capital profile with core capital at 21.0% as on March 31, 2017, which is likely to support the medium term growth plans of the bank. Further, the warrants subscribed by CFHL, if exercised, would result in further infusion of about LKR 3.4 Bn. ICRA expects the timely infusion of capital from CFHL by conversion of these warrants, if the minimum regulatory capital for the commercial banks are enhanced to Rs 20 Bn; UBC's networth stood at 16.9 Bn as on March 31, 2017. ICRA Lanka does not expect that the bank would require any significant equity capital over the 2-3 year period assuming RWA to grow by 30-32% CAGR and, modest internal generation of about 3-4% per annum.

The bank's overall earnings profile is characterised by declining Net Interest Margin (NIM) as the bank has increased its focus to the lower yielding segments and because of increase in systemic rates; NIMs stood at 3.1% in CY2016 (3.2% in Q1CY2017) as compared with 3.4% in CY2015. The above along with high cost to income ratio impacted the net profitability of the bank, although the provision cost have moderated (0.2% in CY2016 as compared to 0.3% in CY2015; 1.3% in CY2014). Going forward, the ability to scale-up without adversely impacting credit quality and by improving operating efficiency would be critical for incremental profitability.

Entity Profile

UBC, incorporated in 1995, is a small LCB accounting for about 1% market share of the Sri Lankan banking sector assets as on December 31, 2016. 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 to UB Finance (a licensed finance company). As on December 31, 2016, it holds about 51% of the share capital in NAMAL and 66% share capital in UB Finance (75.6% 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 equity 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 above percentages and reduce the same to 15% by 2029.

UBC recorded net profit of LKR 451 Mn on a total asset base of LKR 93 Bn for the CY2016 vis a vis a net profit of LKR 221 Mn on a total asset base of LKR 70 Bn for the CY2015. During Q1CY2017, the bank reported a net profit of LKR 95 Mn on a total asset base of LKR 100 Bn. The bank reported the GNPA ratio and NNPA ratio at 2.73% and 1.91% respectively on March 31, 2017. The core capital adequacy ratio of the bank stood at 21.0% and total capital adequacy ratio was 20.4%.

The bank recorded a consolidated group net profit of LKR 553 Mn on a total asset base of LKR 100 Bn for the CY2016 and, a net profit of LKR 120 Mn on a total asset base of LKR 108 Bn for the quarter ended March 31, 2017.

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