

Union Bank of Colombo PLC: Rating reaffirmed

Aug 16, 2021

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

Rating action

ICRA Lanka Limited has reaffirmed the Issuer Rating of Union Bank of Colombo PLC (“UBC” / “the Bank”) at [SL]BBB (pronounced as S L Triple B) with Stable outlook.

Rationale

The rating reaffirmation takes into account the strategic and financial support received from Texas Pacific Group (TPG) through its affiliate, Cultural Financial Holdings Ltd (CFHL) which held a 70.84% stake as of March 2021. TPG has 3 representatives in the 9-member Board of Directors of the Bank and provides strategic support to the senior management team. Furthermore, ICRA Lanka also considers favourably the Bank’s comfortable capital position, backed by TPG. The Bank continued to maintain comfortable Capital Adequacy Ratios with core capital and total capital adequacy ratio of 15.61% and 15.88%, respectively as in March 2021 (regulatory requirement of 8.00% and 12.00%, respectively). While the rating takes note of the minimum regulatory core capital requirement of LKR 20 Bn to be met by end of CY2022, ICRA Lanka takes comfort from the warrants issued¹ to CFHL, maturing in Sep 2022 and which could be exercised to meet the regulatory requirement and expects TPG to provide timely and adequate capital to UBC, if required. However, ICRA Lanka takes cognisance of the Bank’s weak subsidiary; UB Finance Company Limited (Rated [SL] BB/Negative), which operates below the minimum regulatory capital requirement. The rating also takes comfort from the Bank’s liquidity profile with improvements witnessed over the past 1.5 years mainly on account of the increased investments in GSECs. Also, the Bank reported improvement in the short-term (less than 12 months) bucket with positive cumulative mismatch of 24.24% as on Mar-21, from 14.48% as on Mar-20.

ICRA Lanka takes note of the Bank’s stretched asset quality indicators with gross NPA ratio of 6.05% in Dec-20 which was further aggravated amidst the moderation of the loan portfolio during CY2020. Additionally, the Bank had a 34% concentration in the SME segment as on March 2021, which has been the most vulnerable segment, in terms of asset quality; the SME segment accounted for 77% of the gross non-performing loans as on March 2021. The Bank has reported improved Current Account and Savings Account (CASA) ratio (30.46% as on March 2021), however, the limited franchise constraints it to be below the Licensed Commercial Bank (LCB) sector average (36.88% as on March 2021). Finally, ICRA Lanka has noted the improved profitability indicators of the Bank with Return on Assets (RoA) at 0.91% in Q1CY2021 vis-à-vis 0.57% in Q1CY2020, however, factors the lower profitability in comparison to industry averages. Going forward, improvement in asset quality and earnings would be crucial from a rating perspective.

¹ The warrants issued in 2014 for a period of 6 years matured in 2020. However, the Board of Directors decided to extend the warrants by further two years, i.e., until 30th Sep, 2022. Further, the exercise price was revised to a price that is equivalent to the average closing price per share for the five-day period that immediately precedes the exercise of warrants.

Outlook: Stable

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

Key rating drivers:

Credit strengths

Strategic and financial support from a leading global private equity firm; TPG- With a presence of over 25 years in the country, UBC currently offers its services through a network of 67 branches. Though a small-sized bank, representing about 1% of the total assets in the Licensed Commercial Banking (LCB) sector, UBC is strongly supported by one of the leading global private equity firms, Texas Pacific Group (TPG). TPG acquired 70% of UBC in 2014 for a total consideration of LKR 11.9 Bn through its affiliate company, Cultural Financial Holdings (CFHL), and held a stake of 70.84% as on Mar-2021. TPG has a long-term interest in the Bank since it has special regulatory permission to hold a 75% stake till 2029, as compared to the regulatory cap of 10% for a single party. As per such permission, TPG is required to reduce its stake in UBC to 15% by 2029. UBC's board comprises of nine directors, of which TPG has three representatives on the board. These representatives provide strategic support to the Bank at board and sub-committee levels.

Comfortable capital position- Backed by TPG, UBC maintains a comfortable capital position. The Bank witnessed comfortable capital adequacy ratios also supported by its modest portfolio growth. UBC reported a core capital adequacy ratio of 15.61% as in Mar-21 vis-à-vis 16.66% as on Dec-20 (regulatory requirement of 8.00% as on Mar-21). Further, the company reported a total capital adequacy ratio of 15.88% against a regulatory requirement of 12.00% as on Mar-21. ICRA Lanka takes note and continues to monitor the performance of subsidiary of the Bank, UB Finance Company Limited (UBF; rated [SL]BB/Negative) where the Bank is planning to either divest the subsidiary completely or to infuse further capital (about LKR 1.85 Bn) to the subsidiary for it to meet the minimum regulatory capital requirement. ICRA Lanka expects the Bank to meet the LKR 20 Bn regulatory core capital requirement by end of CY2022 with its internal generation as the core capital stands at LKR 18.2 Bn as on Mar-21. ICRA Lanka also take comfort of CFHL's option to exercise the warrants (~ LKR 3 Bn or 3% of RWAs) issued to it by the Bank which will mature in September 2022. The capital support from the parent is expected to be forthcoming, if required.

Improved Funding Profile with better CASA indicators- ICRA Lanka notes the Bank's improved Current and Savings Account ratio ("CASA") of 30.46% as on Mar-21 in comparison to 29.75% as on Dec-20; however, still remains below the LCB sector average of 36.88% as on Mar-21 mainly due to moderate franchise strength. In terms of gearing, UBC maintained moderate gearing with 5.73 times as on March-21 (5.67 times as on Dec-20). The deposit concentration of the Bank was moderate with the top 10 depositors accounting for 18% of the total deposits as on Mar-21. In terms of the overall funding profile, public deposits accounted for about 80% of total debt as in Mar-21, while the balance was contributed by banks loans and other debt instruments.

Healthy liquidity profile- UBC reported a positive short-term (less than 12 months) cumulative mismatch of 24.24% as on Mar-21, which is an improvement from 14.48% reported as on Mar-20. The improvement is attributable to the increase in the short-term investments including unit trusts. UBC maintained an all-currency liquidity coverage ratio (LCR) of 192.95% as on Mar-21 vis-à-vis 459.60% as on Dec-20 (Regulatory requirement of 90.00%). The sharp decline in the LCR in Q1CY2021 was mainly due to an improvement in

the credit demand which resulted in unwinding of investments categorised under LCR for loan disbursements. Furthermore, the bank reported domestic currency liquid asset ratio of 27.71% as on Mar-21 (29.08% as on Dec-20) against a regulatory requirement of 20.00%. During the CY2020, the investments in G-secs increased by about LKR 10 Bn, amidst the muted loan growth. However, with the slight pickup in the loan growth in Q1CY2021, the Bank's investments in G-secs have somewhat reduced.

Credit challenges

Modest franchise strength- Being a relatively small-sized bank, UBC reported a total asset base of LKR 124,796 Mn as on Mar-21 which accounted for only ~1% of the total LCB sector asset base. UBC's key products include overdraft facilities, credit card and retail mortgage-backed loans and operates with a modest franchise network of 67 branches as on Mar-21. The Bank's segments include corporate, SME and retail which accounted for 47%, 34% and 19%, respectively of the gross loan book as on Mar-21. The strengthened credit underwriting terms and the subdued economic growth which hindered private sector credit growth mainly contributed to the portfolio moderation of 12% in CY2020.

Stretched asset quality indicators- The Bank's gross NPA ratio increased to 6.05% as on Dec-20 from 5.03% as on Dec-19. While the NPA increase is largely due to the challenging macro environment during the period, ICRA Lanka notes that the overall portfolio moderation (by about 12%) during the period has also contributed to the same. GNPA ratio somewhat improved to 5.85% as on Mar-21 with the slight portfolio growth in Q1CY2021. The fresh NPA generation of the bank was lower at 2.15% in CY2020 in comparison to ~3% in prior years. However, the constraints on the recovery actions amidst the disruptions caused to legal procedures in the country due to the pandemic, resulted in continued pressure on the absolute NPA levels. ICRA Lanka notes that the Bank's moderate asset quality indicators are primary due to its SME portfolio, which accounted for 77% of the total GNPA as on Mar-21. The Bank has taken steps such as strengthening its credit underwriting and establishing risk management systems in order to improve its asset quality levels. Furthermore, with the lockdown restrictions being lifted, the legal proceedings can be commenced again which will ease-off pressure in the recovery actions. UBC maintained a provision coverage (IFRS) of 61.64% as on Mar-21. Going forward, the Bank's ability to bring down the NPA levels while controlling incremental slippages would be crucial.

Marginally improved earnings in Q1CY2021; but continues to remain lower than the systemic average- UBC reported marginally improved operating profit/ATA of 1.35% in Q1CY2021 as compared to 1.28% for the same period in CY2020. The Bank also reported an operating profit/ATA of 1.13% in CY2020 as compared to 1.45% in CY2019. The improved performance in Q1CY2021 was mainly attributable to an improvement in the Bank's efficiency levels and high other income. UBC reported an improved operating cost to operating income ratio of 66.50% for Q1CY2021 in comparison to 74.51% for Q1CY2020. Furthermore, the operating expenses including employee expenses too somewhat reduced in Q1CY2021. The operating expenses/ATA for Q1CY2021 was 3.28% (3.53% for Q1CY2020). However, the above effect was somewhat negated by the Net Interest Margin ("NIM") moderation and the increased credit cost. The Bank reported a NIM of 3.18% for Q1CY2021 (3.26% in Q1CY2020). NIM for CY2020 was 3.16% (3.62% in CY2019). The lower AWPLR which prevailed from CY2020, the interest rate rebates, rates caps imposed on certain products under CBSL directives in order to support the Covid19 affected customers mainly caused this moderation. UBC's credit cost (Provision/ATA) more than doubled in Q1CY2021 to 0.63% as compared to 0.29% for the same period in previous financial year. Credit cost for CY2020 was 0.60% (0.32% in CY2019). The Bank has provided conservatively to account for the prevalent macro environment. The high Profit After Tax (PAT) in Q1CY2021 was mainly attributable to the reduced tax charge. The retrospective and related adjustments on application of IFRS 12, resulted in a reduced tax charge. The PAT/ATA improved to 0.91% for Q1CY2021 compared to 0.57% in Q1CY2020, however still remains below the LCB sector average of 1.45% in Q1CY2021 (1.02% in Q1CY2020).

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 Bank:

UBC, incorporated in 1995, is a small Licensed Commercial Bank (LCB) accounting for about 1% market share of the Sri Lankan banking sector assets as on March 31, 2021. After a Restructuring process in 2003, which included Union Bank transferring LKR 978 Mn of NPAs and LKR 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 interest in National Asset Management Limited (NAMAL) and The Finance and Guarantee Company Limited (TF&G), subsequently renamed UB Finance (a licensed finance company). As on March 31, 2021, 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 Financial Holdings Ltd (CFHL), an affiliate of the private equity investor TPG; CHFL presently holds about 70.8% of the equity share capital. CHFL also subscribed to about 218 Mn share warrants, which could result in further equity infusion, 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 reduce the holding to 15% by 2029.

During the year ended December 31, 2020, UBC reported a PAT of LKR 577 Mn on a total asset base of LKR 122,943 Mn as compared to a PAT of LKR 710 Mn on a total asset base of LKR 121,754 Mn in the previous financial year. For Q1CY2021, UBC reported a PAT of LKR 282 Mn on a total asset base LKR 124,796 Mn.

Key financial indicators (Audited)

LKR Mn	CY2019	CY2020	Q1CY2020	Q1CY2021
Net Interest Income	4,479	3,870	1,031	985
Profit after Tax	710	577	180	282
Networth	17,510	18,090	17,600	18,227
Loans and Advances	77,358	67,518	78,266	71,609
Total Assets	121,754	122,943	131,196	124,796
Return on Equity	4.16%	3.24%	4.10%	6.22%
Return on Assets (on PAT)	0.57%	0.47%	0.57%	0.91%
Gross NPA	5.03%	6.05%	5.11%	5.85%
Capital Adequacy Ratio (BASEL III)	16.75%	16.95%	15.81%	15.88%
Adjusted Gearing (times)	5.79	5.67	6.31	5.73

Rating history for the last three years:

Instrument	Amount Rated (LKR Mn)	Amount Outstanding (LKR Mn)	Current Rating	Chronology of Rating History for the past 3 years			
				CY2021 Aug 2021	CY2020 July 2020	CY2019 Aug 2019	CY2018 Aug 2018
Issuer Rating	N/A	N/A	[SL] BBB (Stable)	[SL] BBB (Stable)	[SL] BBB (Stable)	[SL] BBB (Stable)	



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