

Rating Rationale for Development Credit Bank's Lower Tier II (Subordinate) Bonds Issue of INR 1 billion

Brickwork Ratings has assigned BWR A- (Pronounced BWR A Minus) with 'stable' outlook to Development Credit Bank's (DCB) proposed subordinate bonds issue of Rs 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 financials statement and information and clarifications provided by the issuer.

The rating reflects several positive factors including, significant ownership of the promoter, comfortable capital adequacy and leverage, and improving low cost deposits and spread. The rating is partially affected by increasing NPAs, negative net profit, decreasing non-interest income, high operating cost structure, and limited branch network. We understand from our interactions with the bank's new management team that they have put in a strategy to address all the current issues.

The meltdown in the international financial market, along with the economic crises in the domestic market, had badly affected Development Credit Bank's performance, particularly the bank's asset quality during FY 09. As a result, the bank's gross and net NPAs have increased to 8.8% and 3.9% respectively in FY09. The increase in non-performing assets was largely due to chasing unsecured retail accounts which resulted in large scale default in unsecured personal loans and a few corporate loans. The bank has since discontinued such aggressive lending and adopted stringent provisioning norms in personal loans portfolio, as a conservative approach.

While the bank's cost of funds at 8.62% was significantly higher than that of its peers, the bank has shown higher returns at 12.65%. The real estate loans sensitive exposure had been just 5.24%, less than one third of the bank's peers. Similarly, the bank's capital market exposure at 1.98% was significantly lower than that of the peers' average. The bank's revenue has been more from the interest income and the non interest income of the bank has been significantly lower than that of its peers.

The bank's Tier 1 capital at 11.62% was significantly higher than that of its peers. The total capital however had been less than the peers and the bank needs to supplement its capital to sustain its growth plan envisaged in the current financial year. Brickwork calculates leverage that assesses bank's capital adequacy with reference to both on and off balance sheet exposures. Development Credit Bank has shown a better leverage of 12.88 in FY 09 as compared to 17.63 in FY08.

Table I: DCB's Performance Indicators

Criteria (Rs. Crore)	FY 09	FY 08	FY 07
Total Assets	5,943	7,582	5,262
Deposits	4,646	6,074	4,415
Advances	3,274	4,068	2,658
Investments	1,622	2,134	1,846
Non-Performing Assets			
Gross NPAs	8.78%	1.49%	5.14%
Net NPAs	3.88%	0.66%	1.64%
Income			
Net Interest Income	197	174	120
Non-Interest Income	120	173	092
Profit			
Operating Profit	75	109	41
Net Profit	(88)	38	7
CRAR (Basel II)	13.44%	13.38%	11.34%
Tier I (Basel II)	11.62%	11.82%	8.4%
ROA	(1.48%)	0.60%	0.17%
CASA	31%	24%	28%
Cost to Income Ratio	76.3%	68.5%	80.7%

The bank has grown its asset base intermittently over the years, largely driven by fluctuating growth in retail and wholesale loan portfolio. As a result, the bank's asset base has achieved a negative growth of 21.61% to reach Rs 5,943 crore in FY 09 as against Rs. 7,582 crore in FY 08. However, the bank's asset growth showed an increase of 44.00% in FY08. The bank has attributed the following reasons for the slump in the

business during the financial year 2008-09 such as sudden change in the business environment, large scale default in un-secured personal loans, anxiety corporate loans, and reduction in trade volumes.

The bank's deposits have decreased by 23.51% to stand at Rs. 4,646 crore during FY 09 as against Rs.6, 074 crore in FY 08. However, the bank's retail to total deposits and low cost CASA deposits have increased to 67.9% and 30.9% respectively in FY 09. The bank had a comfortable low cost deposits base as on 31st March 2009, which is significantly higher than its peers' average. During the year, the bank has also managed to reduce its dependence on bulk deposits.

Negative growth was also witnessed in the bank's loan portfolio during the year. The bank's advances have decreased to Rs. 3,274 crore in FY 09 with a negative growth rate of 19.51% as compared to Rs. 4,068 crore in FY 08. However, the bank's credit to deposit ratio has increased from 66.97% in FY 08 to 70.46% in FY 09. The bank's exposure to un-secured personal loans, commercial vehicle & construction equipments loans, large corporate loans, and micro-finance accounted for 71.99% of the total loans disbursed during FY 09. Notably, the bank has reduced the exposure to personal loans and corporate loans from Rs. 699 crore and Rs. 1,846 crore to Rs. 330 crore and Rs. 933 crore respectively. The bank's exposure to sensitive sectors was within the bank's lending limit. As a result, the bank had a manageable exposure to real estate sectors (5.24% of the advances). Currently no NPA and restructuring was reported in the real estate sector. The bank's commercial real estate stood at 2.87% of the total net advances as on 31st March 2009.

The major weakness of the bank has been its increasing non-performing assets. The bank's gross and net NPAs have increased from 1.49% and 0.66% to 8.78% and 3.88% respectively during the financial year 2008-09. The spurt in NPAs was largely due to un-secured personal loans and large corporate loans.

The bank has reported increase in net interest income from Rs. 174 crore in FY 08 to Rs.197 crore in FY 09 with a growth rate of 13.21%; in spite of marginal decrease in the return on advances. However, the bank's non-interest income had come down drastically on account of reduction in the trade volumes during the year. As a result, the non-interest income stood at Rs 120 crore in FY 09 as against Rs 173 crore in FY 08. Because of this, the bank's operating income and profits decreased by 8.64% and 31.19% respectively in FY 09. Further, the decrease in operating profits and increase in provisions had affected the bank's profitability badly. As a result, the bank had reported net loss during the year.

Table II: DCB's Financials

Financials (Rs Crore)	2008-09	2007-08
Interest Income	645	562
Interest Expenses	448	388
Net Interest Income	197	174
Other Income	120	173
Operating Income	317	347
Operating Expenses	242	238
Operating Profits	75	109
Provisions & Contingencies	163	71
Profit After Tax	-88	38

The bank has been maintaining a comfortable capital adequacy ratio over the years. During FY 09, the bank's capital adequacy ratio under Basel I stood at 13.44%, which is 6 bps higher than the previous year figure of 13.38%. However, the tier I capital had come down from 11.82% in FY 08 to 11.62% in FY09. The capital adequacy and tier I ratio under Basel II stood healthier at 11.30% and 11.50% in FY 09.

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

The bank's capital adequacy under Basel II stood at 13.30% during FY 09, which is significantly lower than its peers' average of 14.36%. However, the bank's tier I capital was 292 bps higher than its peers' average of 8.58%. It is observed that the bank's capital

adequacy under Basel I during FY 09 was at 13.44% and Tier I capital at 11.62%. The CRAR is expected to improve further with the proposed issue of Lower Tier II bonds of Rs 100 crore.

The bank's leverage was lowest among the peer banks during FY 09 which was 6.63% lower than its peers' average of 19.51.

Table III: DCB Vs Peer Group FY 2009

Key Ratios	DCB	Peers
Capital Adequacy (Basel II)		
CRAR	13.30%	14.36%
Tier I	11.50%	8.58%
Leverage	12.88	19.51
Asset Quality (As % of Advances)		
Gross NPA	8.78%	2.03%
Net NPA	3.88%	0.90%
Earnings		
NIM	2.80%	2.82%
ROA	(1.48%)	1.11%
Cost to Income Ratio	76.30%	51.24%
Liquidity		
CASA	30.94%	25.78%
Credit Deposit Ratio	70.46%	68.70%
Operating Ratios		
Cost of Funds	8.62%	6.87%
Return on funds	12.65%	9.25%

The bank's asset quality had deteriorated significantly during the year. The gross and net NPAs stood at 8.78% and 3.88% respectively during FY 09, which is 6.75% and 2.88% higher than its peers' average of 2.03% and 0.90% respectively.

The bank's net interest margin (2.80%) was slightly lower than its peers' average (2.82%) during FY 09. However, the bank had reported negative return on assets (-1.48%) during the year as compared to 1.11% for peer banks. Further, the bank's cost to income ratio was significantly higher than its peers' average. The bank has been taking steps to improve the cost to income ratio.

DCB branch network has a very high correlation with the distribution of Ismaili community in India. The cities like Mumbai, Hyderabad & Ahmedabad, which have a high proportion of the Ismaili community have a significantly higher network of DCB branches. Being a community bank, if the strategy to access deposits from the Ismaili community is leveraged, DCB has an advantage in terms of generating low cost deposits. During FY 09, the bank's low cost deposits stood at 30.94%, which is 5.16% higher than its peers' average of 25.78%. However, the bank's credit deposit ratio was 176 bps higher than its peers' average of 68.70%

The bank's cost of funds stood at 8.62% as on 31st March 2009, which is significantly (1.75%) higher than its peers' average. Similarly, the return on funds was 340 bps higher than its peers' average of 9.25%.

Shortcomings:

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

- a) The bank's gross and net NPAs have increased from 1.49% and 0.66% respectively in FY08 to 8.78% and 3.88% respectively in FY09.
- b) The bank's network is very limited. It could have a bearing on its performance.
- c) The bank has received 171 applications amounting to Rs 175.31 crore during the year for loan restructuring.

Mitigants:

The bank has been taking appropriate steps to lessen the impact of the above said deficiencies on margins. During FY 09, the bank had quickly de-risked its balance sheet, reduced its exposure on un-secured personal loans and large corporate loans. Further the bank had reduced its dependence on bulk deposits. As a result, retail deposits have increased from 52% in FY 08 to 68% in FY 09. During the year, the bank's retail un-secured to total retail advances was down to 22% in FY 09 from 37% in the previous year. On cost reduction front, the bank had downsized its manpower during the year. With a comfortable capital adequacy, Ismaili community's loyalty, promoter presence, modern

systems and infrastructure and a strong management, the bank is expected to tide over the crises.

Bank Profile:

Incorporated in 1995, Development Credit Bank is positioned as a bank for micro and macro SMEs with special emphasis on Ismaili community. The bank delivers full range of retail and wholesale business banking products. Being a small bank, it has implemented loan strategies such as rationale participation in large corporate banking and selective participation in microfinance and agricultural loans. The bank has 80 branches, 116 ATMs, and 6 lakh customer base as on 31st March 2009. Going forward, the bank will grow its retail, mid corporate, SMEs, and treasury with a customer centric approach and concentrate on secured lending and diversified portfolio.

Shareholding Pattern (As on 31st March 2009)

Shareholders	Stake
Promoters	25.10%
Foreign	15.79%
Retail	59.11%

Industry Snapshot:

Over the years, Indian banking sector has benefited from a stable macro economic environment with unparallel systemic support from the Indian government. Financial year 2009 witnessed deterioration in the global financial condition, which tightened the liquidity position and affected the credit off-take. Nevertheless, Indian banking sector has skillfully tided over the crises with ample support and measures to stimulate the economy from the government and RBI.

As scheduled, the banks have successfully implemented the Basel II norms during financial year 2009 in spite of financial crises 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.

While economic activity seems to be picking up, Indian banking industry is gearing for a notable operational growth. Nonetheless, continuous monitoring and timely corrective action would be necessary as the crises have not been fully blown over and weakness felt earlier could have repercussion on growth, margins etc. for some more time to come. While leveraging the banking technology, the banks may resort to cross-selling and up-selling of various products and services to increase their revenues.

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 DCB is specific to the proposed Lower Tier II bonds issue of Rs 100 crore.

Brickwork expects the bank to improve its performance in order to sustain its envisaged growth plan during the current financial year. It is expected that the bank will focus on improving its asset quality with the help of adequate risk asset coverage, comfortable risk adjusted capital, retention of good people and technology driven banking operations, prudent lending, avoiding large un-secured exposures and widen its range of products and services to generate uninterrupted income stream. Brickwork expects that the revival strategy of the new management team should yield better results in the form of turnaround in the performance in the next one year. The lending focus for Housing & SME's is also a function of economic environment. As such, Brickwork has assigned Stable outlook for the Bank's issue.

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