

Rating Rationale for Andhra Bank's Issue Rating

Andhra Bank

Issue Rating: BWR AA+

Brickwork Ratings has assigned BWR AA+ (Pronounced BWR Double A plus) for the following securities of Andhra Bank.

INR. 4.65 Billion Perpetual Bonds Issue - BWR AA+

INR.10.00 Billion Upper Tier II Bonds Issue - BWR AA+

The bank's overall asset quality seems good with declining trend in NPAs. The bank's slippage has declined by 17% as of 31st March 2008 and the delinquency ratio stood at 0.72% in the same period, which compares favorably to its peers. Further, the efficient cash-management system coupled with higher income helped the bank to improve its cost to income ratio to 47.2% from the previous of level of 50.1%. The rating factored majority ownership of the Government of India, favorable operating spread and returns, lower NPA, less risky loan portfolio, higher Tier 1 capital and leverage. However, the bank's operation largely concentrated in the state of Andhra Pradesh might be a limiting factor.

The rating reflects several factors including, majority ownership of the Government of India, favorable operating spread and returns, lower NPA, less risky loan portfolio, higher Tier 1 capital and leverage. The bank's concentration in a single state as well as lower CASA deposits are limiting factors. While bank's cost of funds at 6.12% is slightly higher than that of peers, the bank has shown higher returns at 9.25% and higher spreads at 3.14% in FY08. Further, the NIM grew by 48 bps to reach a level of 3.42% in the 2Q09. Even though the bank has shown higher returns, the bank's loan portfolio does not appear riskier. The gross NPAs have declined to 1.07% compared to 1.88% of peers. The real estate loans sensitive exposure has been just 7.94%, less than half of that of bank's peers. The bank's term loan exposure at 41.95% is lower than the peer average.

QII Financials

(INR billions)
(As on 30th Sep'08)

Total Deposits	505.51
Gross Advances	364.37
Interest Income	13.28
Non-Interest Income	1.35
Interest Expense	8.94
Net Profit	1.61
Net Interest Margin	3.42%
C-D Ratio	72.29%
Gross NPAs	1.03%
CRAR	13.43%
CASA Deposits	34.13%

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The bank's return has been more from the interest income which is almost 71 basis points more than its peers. The non interest income of the bank has been marginally lower than that of peers. The return on average assets at 1.16% has been higher by 19 basis points.

The bank's Tier 1 capital has been relatively adequate at 8.54%. The total capital however has been less than the peers and bank needs to supplement its capital. Brickwork calculates leverage that assesses bank's capital adequacy with reference to both on balance and off balance sheet exposures. Andhra Bank has shown a reasonable leverage of 16.4 compared to its peer group at 21.3.

The bank's lower cost CASA deposits have come down to 33.6%. Bank's credit deposit ratio has been higher than its peers. These imply possible liquidity pressure. The bank however has shown adequate growth in branch expansion as well as technology platform that can help grow its business.

Overall, the rating reflects that Andhra Bank carries a stable outlook, good risk management system, sensible risk asset coverage, lower gross NPA and adequate risk adjusted capital. The bank's operations that are largely focused on South India, particularly in Andhra Pradesh might be a concern for future growth.

Bank Profile:

The bank has a growing presence in South India but majority of its branches are located in the state of Andhra Pradesh.

Andhra Bank, a mid sized public sector bank incorporated in 1923, was nationalized in 1980. The bank offers retail banking, small and medium enterprise (SME) banking, treasury and financial institutional services.

The Government of India (GoI) is a major shareholder of Andhra Bank with a stake of 51.55%.

Shareholding Pattern

Shareholders	Stake
GoI	51.55%
Financial Institutions	12.71%
Foreign	19.42%
Retail	16.32%

Headquartered in Hyderabad the bank services 18 million customers. During the financial year 2008, the bank opened 84 branches, and 151 ATMs. The bank's delivery network consists of 1388 branches, 64 extension counters, 38 satellite offices and 685 ATMs as of 30th September 2008.

Quarterly Analysis:

As on 30th September 2008, with INR 869.48 billion business, Andhra bank has benefited from a positive reputation with its client base and local market area. The bank continued to have good asset quality. This is accomplished by adherence to its well defined loan policy and disciplined credit culture.

The bank reported record quarterly operating income of INR 2.78 billion for the second quarter ended September 30, 2008, up 19.92% on year-on-year growth. The interest income on advances continued to be major contributor to the bank's top line performance

with a 29.5% growth. The bank has managed to keep the operating expenses growth to 9.8% year-on-year basis. Profit after tax (PAT) was up 6.8% to INR 1.61 billion from INR 1.51 billion as on 30th September 2007. However, non-interest income for the quarter ended September 30, 2008 decreased by 14.4%.

Asset quality of the bank remained sound. Gross NPAs as a percentage of gross advances declined to 1.03 at September 30, 2008 from 1.35 at September 30, 2007.

The bank's capital adequacy ratio improved to 13.43% at September 2008 from 11.33% for the same period a year ago. Likewise, CASA deposits as a percentage to total deposits improved from 32.03% to 34.13%.

Business Outlook:

The bank is well positioned to sustain its operations and has ability to continue branch expansion on meaningful scale

The bank's total business has increased by 20.5% to reach INR 839.93 billion as on 31st March 2008 from INR 696.87 billion during the previous year. This high growth was sustained in spite of 23.55% growth recorded in the previous year 2006-07.

The bank's total deposits stood at INR 494.36 billion, a growth of 19.3% as on 31st March 2008, compared to INR 414.54 billion a year ago. In line with mid-sized public sector banks in India, Andhra Bank is also predominately funded through term deposits. The term deposits of Andhra bank account for 66.7% of total deposits. The bank's composition of low-cost deposits to total deposits stood at 33.6%,

which is lower than the peers' average. The bank's cost of deposits increased from 5.32% on 31st March 2007 to 6.58% during the year 2008.

Capital Adequacy:

The bank's capital adequacy ratio is slightly lower than its peers' average

The Andhra Bank has reported total capital adequacy ratio of 11.61% as on 31st March 2008 compared to 11.33% for the same period a year ago, which has been above 11% for the sixth year in a row when compared to RBI prescribed norm of 9%. The bank's tier-I ratio was stood at 8.54%, which compare favorably with that of its peers. In addition, the bank has achieved capital adequacy ratio of 13.43% as on 30th September 2008.

The bank raised subordinated debt of INR 7.0 billion at coupon of 9.15% during January 2008 to augment its capital funds. The bank's capital levels are acceptable given the Government of India (GoI) ownership, bank's risk profile of earning assets and strong internal capital generation, combined with management's focus on operational efficiency. The bank expects that migration to Basel II norms would not result in any adverse impact on its capital ratio.

Asset Quality:

The bank's asset quality trends remain stable, sound and consistent compared to its peer group

The bank's asset quality remains strong and showed stable trends during 2007-08. During the period, the bank focused on maintaining a sound asset quality that helped reduce gross NPAs to 1.07% from 1.41% in the previous

year. Meanwhile net NPAs also came down to 0.15% from 0.17%. As on 31st March 2008, the bank has recovered an amount of INR 903 million under SARFAESI Act.

The bank's gross credit increased 22.4% to reach INR 345.57 billion from the previous level of INR 282.33 billion, leading to increase in credit to deposit ratio to 70.1% from 68.3%. The bank's priority sector advances grew 16.4% to INR 132.98 billion as on 31st March 2008. The total priority sector advances constituted 47.1% of adjusted net bank credit increased from 41.1% in the previous year.

The bank's total investment to total assets stood at 26.33% as on 31st March 2008, on par with the peer group average. The bank's provisions coverage for non-performing assets stood at 85.39% as on 31st March 2008.

The bank has diversified loan portfolio with exposures to top ten industries is 33.05% of gross bank credit. Further the bank does not have an exposure of more than 6% of gross credit to any single sector. Geographically, the bank's credit exposure is over 50% to metro region.

Profitability:
The bank's ROA has been 13 basis points higher than that of peers.

The Andhra bank is one of the profitable mid-sized public sector banks in India, with total income of INR 48.71 billion as on 31st March 2008, reflecting the continued buoyancy in the bank's core business income, fee based income and focus on healthy asset-quality contributed to the improvement in the profitability. An operating profit of the bank

increased to INR 10.56 billion from INR 9.31 billion, registering an increase of 13.5%. The bank's net profit also increased to INR 5.76 billion as on 31st March 2008 from INR 5.38 billion with growth rate of 7%.

The interest income of the bank contributed 88% of total income on expected lines. The bank's total net interest income grew to INR 42.89 billion as on 31st March 2008, an increase of 29.4% - higher than the peer group average. The bank's non-interest income has also shown a similar trend, where it has surged by 30.1% to reach INR 5.81 billion from INR 4.46 billion in the previous year.

The bank's net worth stood at INR 32.49 billion as on 31st March 2008 and return on average net worth improved to 17.97% from the previous level of 17.78%.

The bank's total advance to total asset ratio stood at 60.5%, which is higher than its peer group average of 57.80%. The bank's operating expenditures have increased by 33% and largely in line with total income that increased 29.5%.

When compared with its public sector peer group banks, the bank's net interest margin at 2.86% is satisfactory but it declined from the level of 3.20%. The bank's return on assets also marginally dropped to 1.16% from 1.31% in the previous year. These declines in return on assets and net interest margin are largely attributed to increased cost of funds and subdued credit demand.

Investment Portfolio:

The bank's approach to investment management is sound and consistent with regulatory and internal guidelines

The bank has well defined risk management system and investment decisions are based on internal risk – return trade off and consistent with the regulatory guidelines. The bank's risk management is strengthened by undertaking the stress testing and back testing of the investment portfolio at quarterly intervals, besides daily monitoring of duration and value at risk.

The bank's investments have increased to INR 148.98 billion as on 31st March 2008 from INR 143.00 billion as on 31st March 2007 with marginal growth of 4.18%. The bank investment into SLR securities constituted 88% of the total investments amounting to INR 131.56 billion, which was 25.82% of net demand and time liabilities.

The bank's interest income from investments increased by 16.9% from INR 8.96 billion during 2006-07 to INR 10.48 billion in 2007-08 and during the period, the profit on sale of investments registered an increase of 121.9% with rupee profit of INR 1.19 billion. This is largely attributed to favorable market conditions and prudent portfolio management. The bank's yield on investments increased to 8.27% during 2007-08 from 7.34% in 2006-07.

The bank has made profit of INR 33 million on foreign exchange transactions during the year 2007-08 with marginal growth rate of 3.6%. The bank recorded a merchant turnover of INR 250.77 billion during 2007-08 compared to INR 208.59 billion in the previous year, an increase of 20.2%.

Management of Risk:

The bank has sound integrated risk management policy and its risk management system is adequate in relation to the peer group.

The board of directors of the bank has a given the responsibility of setting up the strategic risk policy for the management of credit risk, market risk and operational risk. Based on the recommendation of the credit risk management committee of the board, the bank has developed well defined loan policy. Further more, the bank uses stress test and back test as key risk management tools for capturing credit and market risk.

In order to bring the consistency in loan processing, the bank has formulated standards for presentation of credit proposals, financial covenants, rating standards, and benchmarks, delegation of credit approving powers, prudential limits on large credit exposures, asset concentrations, standards for loan collateral, portfolio management, loan review mechanism, risk concentrations, risk monitoring and evaluation, pricing of loans, etc.

The bank's overall asset quality is strong due to its diversified loan portfolio but also its proactive risk management relating to large exposures and concentrations. The bank has relatively low degree of credit risk concentration, in particular to industry concentration to the property sector, while this exposure appears well diversified and closely monitored.

In line with industry, the bank has a well defined market risk framework and the market

risk was managed through asset-liability management policy and investments policy.

The bank manages its liquidity risk through gap analysis for maturity mismatches based on residual maturity. It manages its funding and daily liquidity on an integrated basis and the bank supplements its liquidity management with stress tests and contingency funding planning. Furthermore, the bank's operational risks in the area of credit, people and technology are reviewed on quarterly basis.

Significant Developments:

The bank is opening its second representative office in the New Jersey city in the state of New Jersey in USA after successful experience of Dubai representative office in 2006. In this regard, the bank already obtained the necessary approval from the Reserve Bank of India and the Federal Reserve Bank, USA.

The bank announced that it would establish a joint venture life insurance company along with Bank of Baroda and Legal & General Group Plc of UK to augment its growing non-interest income. Andhra bank will have shareholding of 30% in the venture and already shareholders agreement is signed. In addition, Bank is in the process of forming a Joint Venture in Malaysia in association with Bank of Baroda and Indian Overseas Bank.

The bank has launched two new schemes during the year 2007-08 namely AB Mahila Soubhagya (Debt Swapping Scheme of SHGs) and AB Rakshak Soubhagya (Debt Swapping for Farmers) intended to reduce the indebtedness of the borrowers. In addition, the bank also launched AB double deposit scheme on 8th August 2008.

Rating Outlook:

The rating reflects Andhra Bank's ownership structure, (majority stake held by Government of India), its diversified income stream, adequate capital adequacy as well as its healthy asset quality.

Brickwork Ratings (BWR) issue rating is based on CAMEL-TP framework, which is used to assess the bank's financial fundamentals and risk exposures. The rating assigned to Andhra Bank is specific to the proposed Tier I perpetual bonds issue of Rs. 200 crores or INR 2.0 billion.

The ratings factored the quality of risk weighted assets, low cost deposit base, comfortable growth in income, decline in gross NPA, and adequate capital. However, with the current changing economic conditions, a key challenge for Andhra Bank during the second half of 2009 will be managing the risks associated with credit, market and liquidity. Andhra bank's high business concentration in south India may be a limiting factor.

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Annexure I

(As on 31st March 2008)

S.No	Key Ratios	Andhra Bank	Peers
1.1	Operating Ratios		
	Cost of Deposits	6.11%	6.08%
	Cost of Borrowings	6.35%	5.75%
	Cost of Funds	6.12%	6.01%
	Return on Funds	9.25%	8.75%
	Spread	3.14%	2.75%
	Net Interest Margin	2.86%	2.55%
1.2	Earnings (As % of Assets)		
	Interest Income	7.58%	6.87%
	Interest Expense	5.07%	4.88%
	Net Interest Income	2.51%	1.99%
	Loan Loss provision	0.17%	0.33%
	Non-Interest income	1.17%	1.20%
	Non-Interest Expense	2.06%	2.12%
	PBT	1.61%	1.07%
	Taxes	0.59%	0.19%
	PAT	1.02%	0.87%
1.3	Profitability		
	Return on Assets (ROA)	1.16%	0.97%
	Return on Equity (ROE)	17.97%	19.97%
1.4	Asset Quality (As % of Advances)		
	Gross NPA	1.07%	1.88%
	Net NPA	0.15%	0.63%
	Real Estate Loans	7.94%	15.68%
	Term Loans	41.95%	57.86%
1.5	Capital Adequacy		
	Tier 1	8.54%	7.59%
	Total Capital	11.61%	11.85%
	Leverage	16.4	21.34
1.6	Liquidity		
	CASA	33.60%	35.97%
	Credit Deposit Ratio	70.01%	67.39%
1.7	Market Statistics		
	Price to Book Value	1.11	0.95
	PE Ratio	6.24	4.79

Annexure II

Andhra Bank - Common Size Profit & Loss Statement (% of Total Income)					
Financials	31-Mar-08	31-Mar-07	31-Mar-06	31-Mar-05	31-Mar-04
I. Total Income (INR Billion)	48.71	37.62	31.32	30.35	29.05
Interest Income	88.10%	88.13%	87.20%	75.10%	76.50%
Non-Interest Income	11.90%	11.87%	12.80%	24.90%	23.50%
II. Expenditure					
Interest on Deposits	57.03%	48.13%	44.33%	37.21%	42.64%
Interest on Borrowings	0.86%	1.07%	1.80%	1.12%	1.09%
Other Interest	1.03%	1.24%	1.93%	1.63%	1.58%
Employee Expenses	10.46%	14.59%	15.74%	17.78%	14.09%
Other Operating Expenses	8.93%	10.22%	11.65%	9.55%	8.57%
Other Provisions & Contingencies	2.92%	4.10%	1.62%	13.11%	7.68%
Taxes	6.96%	6.35%	7.44%	2.47%	8.39%
III. Profit (INR Billion)	5.75	5.37	4.85	5.20	4.63
Net Profit for the Year	11.80%	14.30%	15.80%	19.20%	15.80%
Dividend Pay-out Ratio	39%	40%	40%	23%	28%
Earnings Per Share (In Rs.)	11.87	11.09	11.78	13	11.48
Book Value per Share (In Rs.)	67	65.08	59.67	45.93	36.31
Number of Outstanding Shares (In Million.)	485	485	485	400	400

Andhra Bank - Common Size Balance Sheet (% of Total Assets)					
Financials	31-Mar-08	31-Mar-07	31-Mar-06	31-Mar-05	31-Mar-04
Liabilities					
Capital	0.86%	1.02%	1.19%	1.22%	1.48%
Reserves & Surplus	4.88%	5.62%	5.92%	4.39%	3.82%
Subordinated Debts	1.97%	1.01%	1.55%	1.92%	1.59%
Deposits (INR Billion)	494.36	414.54	339.22	275.50	229.36
Demand Deposits	7.79%	7.70%	7.59%	7.82%	8.21%
Savings Bank Deposits	21.53%	22.41%	22.70%	22.61%	23.49%
Term Deposits	58.03%	57.09%	53.12%	53.75%	53.18%
Borrowings in India	0.19%	1.16%	0.93%	1.41%	3.12%
Borrowings Outside India	0.85%	0.48%	0.93%	1.59%	0.00%
Other Liabilities & Provisions	3.89%	3.61%	6.06%	5.28%	5.10%
TOTAL LIABILITIES (INR Billion)	565.92	475.40	406.69	327.28	270.20
Assets					
Cash & with RBI Balances	8.66%	6.20%	9.49%	6.34%	7.57%
Inter-Banks / Call Money	1.40%	2.26%	3.14%	4.43%	1.96%
Investments	26.33%	30.08%	28.14%	32.53%	38.18%
Advances (INR Billion)	342.38	278.89	221.00	175.16	128.85
(i) Working Capital Loans	35.12%	33.45%	31.67%	31.05%	27.88%
(ii) Term Loans	25.38%	25.21%	22.67%	22.47%	19.81%
Fixed Assets	0.39%	0.40%	0.47%	0.57%	0.67%
Other Assets	2.72%	2.39%	4.41%	2.61%	3.94%
TOTAL ASSETS (INR Billion)	565.92	475.40	406.69	327.28	270.20

(INR 1 billion = INR 100 Crore)