AXIS TRUSTEE

ATSL/CO/18-19/ 10477
February 26, 2019

To,
BSE,
Corporate Debt Segment
25th Floor, P J Towers,
Dalal Street,
Mumbai-400001

Dear Sirs,

Re.: The Karur Vysya Bank Limited – Revision in Rating for Lower Tier II Bond aggregating to Rs. 300 crores ISIN - INE036D09013

We write in our capacity as Debenture Trustees to the captioned Non-Convertible Debentures issued by the company.

In this connection, we would like to inform you that the Credit Rating agency, ICRA Limited (ICRA) vide their press release dated February 22, 2019 has revised credit rating from [ICRA] A+ (Negative) to [ICRA]A (Stable of the captioned NCDs. The rating letter of ICRA is enclosed herewith for your reference.

This is for your information and record.

Thanking you.

Yours faithfully,
For Axis Trustee Services Limited

AXIS TRUSTEE SERVICES LTD. MUMBAI

Mangalagowri Bhat
Senior Manager

CC:

The Karur Vysya Bank Limited Treasury Department, Gayathri Towers, 2nd Floor, 954, Appasaheb Marathe Marg, Prabhadevi, Mumbai - 400 025	**THE LAKSHMI VILAS BANK LTD.** Administrative Office Salem Main Road, Karur - 639006 Tamil Nadu, INDIA
LIFE INSURANCE CORPORATION OF INDIA Investment Department, 6th Floor, West Wing, Central Office, Yogakshema, Jeevan Bima Marg, Mumbai - 400021	

The Karur Vysya Bank Limited

February 22, 2019

Summary of rated instruments

Instrument*	Previous Rated Amount (Rs. crore)	Current Rated Amount (Rs. crore)	Rating Action
Basel III Compliant Tier-II Bonds[1]	1,200.00	1,200.00	[ICRA]A(hyb) (Stable); revised from [ICRA]A+(hyb) (Negative)
Lower Tier II Bonds Programme	300.00	300.00	[ICRA]A (Stable); revised from [ICRA]A+ (Negative)
Certificates of Deposit Programme	3,000.00	3,000.00	[ICRA]A1+; reaffirmed
Total	**4,500.00**	**4,500.00**	

** Instrument details are provided in the Annexure-1*

Rationale

The revision in the long-term rating considers Karur Vysya Bank's (KVB) higher-than-anticipated stress in the corporate and commercial[2] segments; ICRA therefore expects the bank' asset quality to further weaken from current levels and exert pressure on its overall credit risk profile. The expected weakening in asset quality would keep its profitability at subdued levels and thereby impact internal generation for the envisaged portfolio growth of about 15-20% CAGR over the next 2-3 years. ICRA notes that while the bank's capital profile is currently adequate(Tier-1 stood at 14.1% as of December 2018), it would be required to raise equity capital during FY2021 to achieve the envisaged growth, while maintaining a buffer of 1.5% over the Tier-1 regulatory requirement. ICRA however factor in the bank's established franchise in South India, high share of retail deposits (94% as of December 2018) and its comfortable liquidity profile (liquidity coverage ratio stood at 265% as of December 2018).

Outlook: Stable

ICRA expects the bank to maintain a comfortable liquidity and an adequate capital profile in relation to its envisaged growth. The outlook may be revised to 'Negative' in case there is a higher-than-expected weakening in its asset quality impacting its financial risk profile. The outlook may be revised to 'Positive' if the bank improves its asset quality and earnings while maintaining a comfortable capital and liquidity profile.

Key rating drivers

Credit strengths

Established retail franchise – KVB has an operational track record of more than 10 decades with an established retail franchise in South India. The bank's branch network stood at 782 as of December 2018, of which 83% are in Tamil Nadu, Andhra Pradesh, Telengana and Karnataka. The bank's Board comprises of 11 members, including the Managing Director and Chief Executive Officer (Mr. P. R Seshadri) and 5 independents. Its net advances book grew by about 5% YoY to Rs. 46,005 crore and the deposits grew 3% YoY to Rs. 58,624 crore (as in December 2018). The bank's advances to the

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[1] *The letters "hyb" in parenthesis suffixed to a rating symbol stand for "hybrid", indicating that the rated instrument is a hybrid subordinated instrument with equity like loss-absorption features; such features may translate into higher levels of rating transition and loss severity vis-à-vis conventional debt instruments. The rated Tier II bonds under Basel III are expected to absorb losses once the "point of non-viability" (PONV) trigger is invoked.*

[2] *Exposure under Rs.25 crore*

commercial and corporate segments constituted 35.1% and 28.3% of the total gross advances, respectively, as of December 2018, followed by retail and agriculture at 19.3% and 17.3% respectively.

Adequate capitalization at present; critical to raise capital to achieve envisaged growth – KVB has an adequate capitalization at present, supported by an equity infusion during Q3 FY2018 (about Rs. 892 crore) via a rights issue, while growth remained moderate in relation to the private sector average. The bank's risk weighted assets (RWA) declined by 1% YoY in December 2018 even as the net advances grew by 5% over the same period. The bank's overall capital adequacy under Basel-III remained adequate at 14.6% (CET-I ratio of 14.1%) as of December 2018 compared to 13.9% (CET-I at 13.4%) as December 2017. However, with subdued internal generation because of asset quality pressures and higher provision requirement, it would need to raise capital during FY2021 to achieve the envisaged growth plan, while maintaining a buffer of 1.5% over the Tier-1 regulatory requirement.

Credit challenges

Further weakening expected in asset quality and solvency profile – ICRA takes note of the sharp increase in the corporate SMA 1&2 from 1.3% in September 2018 to 2.8% in December 2018 and the management guidance on other stress in the corporate and commercial segments, which would keep the incremental net slippage rate[3] at elevated levels of about 2.0-2.3% during FY2020 vis a vis 2.4% in 9MFY2019 (3.8% in FY2018).

KVB's gross NPAs had already increased to 8.5% in December 2018 from 3.6% in March 2017(6.6% in March 2018), because of stress in some large corporate exposures and in its commercial segment. The corporate segment witnessed sharp rise in gross NPA to 20.5% as of December 2018 from 3.6% as of March 2017 (15.5% in March 2018) while it increased to 5.7% as of December 2018 from 4.8% as in March 2017 (3.3% in March 2018) in the commercial segment; the gross NPA in the retail and agri segments stood at 1.9% an 1.7% respectively as of December 2018. The corporate and commercial segment NPAs are expected to increase further over the next 4-5 quarters in view of the increase in the SMA 1&2 and identified stress in these segments. Considering 15% advances growth and net slippages in the range of 2.0-2.3% during FY2020, ICRA expects the Gross NPA to remain at elevated levels by March 2020. As in December 2018, the bank has net security receipts (SRs) of about Rs 372 crore (0.8% of net advances).

The bank's solvency profile (net NPA/ Net worth) that weakened to 36.1% in December 2018 (29.7% in March 2018) from 20.5% in March 2017, is expected to deteriorate further in view of the increase in the slippages and low internal generation.

ICRA takes note of the bank's focus on the retail, agriculture and the commercial segments to increase granularity of advances. The bank's corporate segment advances declined by 6% YoY in December 2018 while its overall net advances grew by 5% YoY during the same period. ICRA also takes cognizance of the bank's measures to strengthen its internal controls, including augmenting its senior risk management team and centralizing its credit operations by monitoring its workflow. The bank is in the process of implementing digital workflow across its loan products (retail, working capital loans and term loans among others), which is likely to be fully operational by Q4FY2019. Going forward, the bank's ability to contain incremental slippages besides undertake effective recoveries would be key from a rating perspective.

Profitability likely to remain subdued – KVB's net interest margin remained comfortable at 3.5% in 9MFY2019 (3.6% in FY2018) as compared with the 3-year average of 3.2% (FY2015-FY2017). Its operating expenses also remained stable at about 2.4% in 9MFY2019. However, the bank's credit cost increased to 1.6% and 2.0% in FY2018 and 9MFY2019 respectively, as compared to the previous 3-year average of 0.7%, because of the weakening in asset quality and the increase in provision coverage for ageing NPAs. Overall, the bank reported net profitability of 0.3% in 9MFY2019 (0.5% in

[3] *Of standard advances*

FY2018) as compared with the previous 3-year average of 1.0%. Given the current provision coverage (41.7% as of December 2018) and the management' vision to increase the same to about 50-55% over the next 12-18 months, ICRA expects the credit cost to remain elevated in FY2019 and FY2020 in the case of limited improvement in recoveries going forward.

Moderate deposit profile – KVB's CASA ratio improved to 29.8% as of December 2018 from about 27.7% as of March 2017 although it is below the private sector average of about 43-45%. ICRA also takes note of the gradual reduction in the share of large deposits (above Rs. 5 crore) in total term deposits to 6% in December 2018 from 8% in March 2018 (9% in March 2017). The bank's ability to improve its deposit profile as credit growth picks up would be critical for its overall liquidity and earnings.

Liquidity position

The bank's liquidity coverage ratio (LCR) stood at 265% as of December 2018, above the RBI's requirement of 100% as on January 1, 2019. The bank's liquidity profile remains comfortable with positive cumulative gap of 14% of total assets in the less than 1-year bucket as of November 2018. The high share of retail deposits (94% as of December 2018) provides additional comfort on the liquidity. The bank's ability improve its CASA ratio and keep the share of bulk deposits under control would be crucial for maintaining a comfortable liquidity profile.

Analytical approach

Analytical Approach	Comments
Applicable Rating Methodologies	ICRA's Credit Rating Methodology for Banks
Parent/Group Support	Not applicable
Consolidation/Standalone	The rating is based on the standalone financial statements of KVB

About the Bank

Incorporated in 1916 by the local trader community, The Karur Vysya Bank Limited (KVB) is one of the old private sector banks in the country. As of December 2018, it had a network of 782 branches, of which 83% is located in Tamil Nadu, Andhra Pradesh, Telengana and Karnataka.

For FY2018, KVB registered a net profit of Rs. 346 crore on a total asset base of Rs. 66,929 crore as on March 31, 2018 compared to a net profit of Rs.606 crore on a total asset base of Rs.61,808 crore as on March 31, 2017.

Key financial indicators

	FY2017	FY2018	Q3FY2018 (unaudited)	Q3FY2019 (unaudited)
Net Interest Income	2,074	2,298	562	581
Profit before tax	883	504	96	24
Profit after tax	606	346	71	21
Net advances	40,908	44,800	43,792	46,005
Total assets (net of revaluation reserve)	61,808	66,929	66,531	67,590
%CET-1	11.9%	13.9%	13.4%	14.1%
%Tier 1	11.9%	13.9%	13.4%	14.1%
%CRAR	12.5%	14.4%	13.9%	14.6%
%Net Interest Margin	3.4%	3.6%	3.4%	3.4%
%Net Profit / ATA	1.0%	0.5%	0.4%	0.1%
%Return on Average Net Worth	12.6%	6.1%	5.0%	1.3%
% Gross NPAs	3.6%	6.6%	5.9%	8.5%
% Net NPAs	2.5%	4.2%	3.9%	5.0%
% Provision coverage excl. technical write off	30.4%	38.2%	36.2%	41.7%
% Net NPA/ Net worth	20.5%	29.7%	27.3%	36.1%

Source: KVB and ICRA research; Amounts in Rs. crore

Status of non-cooperation with previous CRA: Not applicable

Any other information: None

Rating history for last three years:

S. No	Instrument	Type	Rated amount (Rs. crore)	Amount Outstanding (Rs. crore)	Current Rating Feb 2019	FY2019 Jan 2019	FY2019 Aug 2018	Chronology of Rating History for the past 3 years FY2018 July 2017	FY2017 May 2016	FY2016 April 2015
1	Basel III compliant Tier II Bonds	Long term	1,200.00	-^	[ICRA]A (hyb) (stable)	[ICRA]A+(hyb) (negative)	-	-	-	-
2	Lower Tier II Bonds Programme	Long term	300.00*	150.00	[ICRA]A (stable)	[ICRA]A+ (negative)	[ICRA]A+ (negative)	[ICRA]A+ (stable)	[ICRA]A+ (stable)	[ICRA]A+ (positive)
3	Certificates of Deposit Programme	Short term	3,000.00	NA	[ICRA]A1+	[ICRA]A1+	[ICRA]A1+	[ICRA]A1+	[ICRA]A1+	[ICRA]A1+

*Source: KVB, ^ - yet to be placed; *Rs.150 crore yet to be placed*

Complexity level of the rated instrument:

ICRA has classified various instruments based on their complexity as "Simple", "Complex" and "Highly Complex". The classification of instruments according to their complexity levels is available on the website www.icra.in

Annexure-1: Instrument Details

ISIN No	Instrument Name	Date of Issuance / Sanction	Coupon Rate	Maturity Date	Amount Rated (Rs. crore)	Current Rating and Outlook
NA#	Basel III compliant Tier II Bonds	NA	NA	NA	1,200.00	[ICRA]A (hyb) (Stable)
INE036D09013	Lower Tier II Bonds Programme	25-Sep-2009	9.86%	25-Sep-2019	150.00	[ICRA]A (Stable)
NA	Lower Tier II Bonds Programme	-	-	-	150.00*	[ICRA]A (Stable)
NA	Certificates of Deposit Programme	-	-	-	3000.00	[ICRA]A1+

 # Yet to be placed; Source: KVB

Annexure-2: List of entities considered for consolidated analysis

Not Applicable

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About ICRA Limited:

ICRA Limited was set up in 1991 by leading financial/investment institutions, commercial banks and financial services companies as an independent and professional investment Information and Credit Rating Agency.

Today, ICRA and its subsidiaries together form the ICRA Group of Companies (Group ICRA). ICRA is a Public Limited Company, with its shares listed on the Bombay Stock Exchange and the National Stock Exchange. The international Credit Rating Agency Moody's Investors Service is ICRA's largest shareholder.

For more information, visit www.icra.in

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