

ESAF Small Finance Bank Limited

December 01, 2017

Ratings

Facilities/Instruments	Amount (Rs. crore)	Rating ¹	Rating Action
Long-term Bank Facilities\$	30.17 (reduced from 349.58)	CARE A-; Negative [Single A Minus; Outlook: Negative]	Revised from CARE A-; Stable [Single A Minus; Outlook: Stable]
Total Facilities	30.17 (Rs. Thirty crore and Seventeen lakh only)		
Commercial Paper\$	330.00* (Rs. Three Hundred and Thirty crore only)	CARE A1 [A One]	Reaffirmed
Tier II Bond issue (Proposed)	125 (Rupees One Hundred and Twenty Five crore only)	CARE A-; Negative [Single A Minus; Outlook: Negative]	Assigned

Details of instruments/facilities in Annexure-1

*Outstanding amount of Rs.305 crore as on November 23, 2017

\$-transferred from ESAF Microfinance and Investments Private Limited consequent to execution of Business Transfer Agreement (BTA)

Detailed Rationale & Key Rating Drivers

The ratings assigned to the bank facilities and debt instruments of ESAF Small Finance Bank Ltd (ESAF SFB) factor in the experience of the promoter & management team in the lending business, the group's significant experience in microfinance loans, access to diversified and low cost resource profile and increase in scale of operations. The ratings are, however, constrained by moderation in asset quality post demonetization in trend with industry, geographically concentrated loan portfolio and limited diversification in loan portfolio which mainly consists of micro finance loans. The ratings also take note of adequate capitalization levels of ESAF SFB and relatively high net NPA to networth. The ratings also factor in the inherent risks associated with the microfinance industry including socio-political and regulatory risks.

In view of significant increase in opex arising from commencement of banking operations, ability of ESAF SFB to grow its loan book and timely mobilization of core equity capital is critical to credit prospects of the bank. Ability of the SFB to diversify its loan portfolio across products and geographies, improve its asset quality and capital adequacy while increasing its scale of operations are the key rating sensitivities.

Outlook: Negative

In trend with MFI industry, the asset quality of MFI loan portfolio has witnessed significant moderation. 90+dpd has increased from 0.17% of AUM as on March 31, 2016 to 4.35% of AUM as on March 31, 2017. Though it has witnessed further moderation in Q1FY18 to 5.67%, with significant growth in portfolio, it has improved to 5.53% as on September 30, 2017. While current month collection efficiency (current month demand vs. collection) continue to improve in the past six month ended September 2017 to 95.0% from the level of 91.8% in April 2017, collection efficiency (including cumulative overdue) stood at 64.10% in the month of September 2017. This is on account of lower recoveries in

¹Complete definition of the ratings assigned are available at www.careratings.com and other CARE publications

delinquent accounts especially in the state of Maharashtra and Madhya Pradesh which were impacted post demonetisation. Same has resulted in significant increase in net NPA to networth from 1.06% in March 2017 to 42.06% in June 2017 and further to 45.33% in September 2017. Extent of under recovery in these delinquent accounts is likely to result in need for additional provisions during next few quarters.

Detailed description of the key rating drivers

Key Rating Strengths

Experience of promoter and management team

ESAF SFB was promoted by ESAF Microfinance and Investments Private Limited (EMFIL) which holds 93.10% stake and Mr. K Paul Thomas, who holds 6.90% stake in the SFB as on March 31, 2017. Mr. K Paul Thomas is the Managing Director and CEO of the bank. Earlier, he was the Chairman of EMFIL. He holds Masters' Degree in Business Administration and has over 31 years of industry experience, of which more than 21 years are in the microfinance sector. He has also worked with IFFCO, world's largest cooperative owned fertilizer company before starting ESAF. He is one of the Directors in Microfinance Institutions Network (MFIN) and Chairman of KAMFI (Kerala Association of Microfinance Institutions). He is supported by well experienced team which has rich experience in the financial services and microfinance sector. The Board of ESAF SFB consists of 7 Directors including 4 Independent directors who have rich experience in microfinance and banking industry.

Adequate capitalization levels; However, capital infusion is critical to bank's growth and credit prospects

As on March 31, 2017, networth of ESAF SFB stood at Rs.306 crore. CAR and Tier I CAR of ESAF SFB stood at 16.27% and 13.39% as on March 31, 2017 against regulatory requirement of 15.00% and 7.50% respectively. The bank has raised PDI of Rs.48 crore in June 2017 and Tier II bond of Rs.25 crore in September 2017. CAR and Tier I CAR stood at 16.96% and 12.73% respectively as on September 30, 2017. The bank expects to mobilise fresh equity of around Rs.200 crore during H2FY18. Timely infusion of capital is critical for the growth and credit prospects of the bank.

Increase in scale of operations

Effective from February 22, 2017 as per BTA entered between EMFIL and ESAF SFB, entire loan book of EMFIL stands transferred to ESAF SFB. During FY17, total disbursements amounted to Rs.2,706crore (PY: Rs.2,388 crore) resulting in increase in loan portfolio from Rs.1,317 crore as on March 31, 2016 to Rs.1,483 crore as on March 31, 2017. During FY17, EMFIL reported consolidated PAT of Rs.42 crore on a total income of Rs.431 crore as against PAT of Rs.34 crore on a total income of Rs.318 crore in FY16.

The bank made disbursement of Rs.1,818crore during H1FY18. Subsequently, loan portfolio increased by 55% to Rs.2,292crore as on September 30, 2017. AUM stood at Rs.2,890crore as on September 30, 2017 against Rs.2,327 crore as on March 31, 2017. As on September 30, 2017, total deposits stood at Rs.1,043crore (Rs.409 crore as on March 31, 2017). During H1FY18, ESAF SFB reported total income of Rs.275 crore. On account of higher operating expenses due to commencement of small banking operations and higher provisions for NPAs (Rs.35 crore), the bank reported before tax loss of Rs.12 crore in Q1FY18. With significant growth in disbursements and loan portfolio, the bank reported PAT of Rs.5 crore in Q2FY18. During H1FY18, the bank reported loss of Rs.49 crore. NIM decreased from 7.64% in FY16 to 5.13% in FY17 on account of increase in total assets which includes investments of Rs.579 crore (majorly towards SLR requirement). ROTA also decreased from 2.49% in FY16 to 1.81% in FY17.

Access to diversified resource Profile

During FY17, the bank mobilized deposits to the tune of Rs.409 crore. Of the total deposits, CASA proportion stood at 18.17%. As on September 30, 2017, total deposits increased to Rs.1,043 crore. CASA proportion stood at 13.11% as on September 30, 2017. With the conversion into SFB, apart from mobilizing deposits, ESAF SFB has various funding options available in the form of money market borrowings (on inclusion in the Second Schedule to RBI Act, 1934), IBPC, bank lines of credit, certificate of deposits etc. The bank has issued IBPC amounting to Rs.195 crore during Q2FY18. With diversified funding sources available and access to deposits, the cost of funds is expected to come down. Deposits are mobilized at around 8-9%. Total borrowings stood at Rs.3,283 crore as on September 30, 2017 which includes deposits of Rs.1,043 crore and refinance loans of Rs.982 crore from FIs such as NABARD, SIDBI, etc.

Key Rating Weaknesses***Moderation in asset quality post demonetization in trend with the industry; however improvement witnessed in collection efficiency in the past few months***

Post demonetization, the bank has witnessed deterioration in asset quality. GNPA and NNPA stood at 0.53% (Rs.7.85 crore) and 0.25% (Rs.3.60 crore) as on March 31, 2017. The company has availed RBI dispensation for classification of NPAs. Without considering RBI dispensation, 90+ DPD stood at Rs.101 crore (4.35% of AUM) as on March 31, 2017. As on June 30, 2017, GNPA and NNPA (on AUM basis) stood at 5.67% and 4.34% respectively. Supported by growth in portfolio, asset quality witnessed marginal improvement and GNPA and NNPA (on AUM basis) stood at 5.53% and 4.12% respectively as on September 30, 2017. In absolute terms, GNPA and Net NPA stood at Rs.159.83 crore and Rs.116.39 crore respectively as on September 30, 2017.

Out of total GNPA of around Rs.160 crore, the bank has provided Rs.43 crore until September 2017 and the incremental provisioning requirement will have an impact on the profitability in FY19.

Collection efficiency for the current month (excluding overdue of earlier months) has declined from 99.5% in Oct 2016 to 91.25% in Feb 2017. Subsequently, it has shown improvement to 95.0% in Sep 2017. Further, incremental overdue of the total portfolio has declined from the range of Rs.10-12 crore per month during Jan 2017 to June 2017 to around Rs.6-8 crore per month in Q2FY18 indicating improvement in recovery from delinquent accounts. However, Net NPA in relation to networth stood relatively high at 45.33% as on September 30, 2017.

Geographical concentration of loan portfolio

ESAF SFB has presence in 93 districts across 10 states with 296 branches as on March 31, 2017. Kerala continues to constitute the major portion with 67% share of AUM as on March 31, 2017 (P.Y 67%), followed by Tamil Nadu at 17% (P.Y 15%) and Maharashtra at 8% (P.Y 9%). Other states namely Chhattisgarh, Madhya Pradesh, Bihar, Puducherry, Karnataka, West Bengal and Jharkhand constitute the rest. As on March 31, 2017, top 5 Districts are Thrissur (15%), Palakkad (14%), Trivandrum (7%), Alappuzha (5%) and Malappuram (5%). Although strong presence in a particular region helps the bank to understand the dynamics of the region, it is exposed to geographical concentration risk. ESAF SFB has also recently ventured into gold loans, LAP, micro housing loans and business loans.

Prospects

Transformation from NBFC to SFB offers various benefits including ability to offer wider range of products both on assets and liability side, access to diversified funding sources, access to low cost funds, increased regulatory supervision and support. On commencement of SFB operations and consequent increase in operating expenses resulted in moderation in pre-provision profit of ESAF SFB in H1FY18. In view of the same, ability of ESAF SFB to grow its loan book and reduce cost of funds by increasing share of low cost funds is critical to improve operating profits. Timely mobilization of core equity

capital is critical to growth & credit prospects of ESAF SFB. Ability of the SFB to diversify its loan portfolio across products and geographies, improve its asset quality and improve its capital adequacy while increasing its scale of operations are the key rating sensitivities.

Analytical approach:

Standalone

Applicable Criteria

[Criteria on assigning Outlook to CreditRatings](#)

[CARE's Policy on Default Recognition](#)

[Financial ratios – Financial sector](#)

[Bank - CARE's Rating Methodology For Banks](#)

[Criteria for Short Term Instruments](#)

About the Company

ESAF Small Finance Bank Limited (ESAF SFB) commenced its banking operations from March 10, 2017. ESAF SFB is a subsidiary of ESAF Microfinance and Investments Private Limited (EMFIL) which holds 93.10% stake and rest is held by Mr. K. Paul Thomas, Founder and Chairman of EMFIL. Based on the direction of RBI to fold the financial and lending business of EMFIL to ESAF SFB, the Board of Directors and shareholders of EMFIL had decided on 27th January 2017 and 27th February 2017 respectively, to transfer its financial business including assets, liabilities (excluding NCDs) and employees on a going concern basis to ESFB for a lump sum consideration of Rs.7 crore which is to be discharged on mutual agreement.

ESAF SFB's board consists of 7 directors including 4 Independent Directors. As on March 31, 2017, the SFB was operating in 93 districts across 10 states with loan portfolio of Rs.1,483crore.

During FY17, EMFIL (Consolidated) reported PAT of Rs.42 crore on a total income of Rs.431 crore. During H1FY18, ESAF SFB reported total income of Rs.275 crore and net loss of Rs.49 crore.

Brief Financials (Rs. crore)	EMFIL	EMFIL (Consolidated)
	FY16 (A)	FY17 (A)
Total operating income	318	431
PAT	34	42
Interest coverage (times)	1.38	1.49
Total Assets	1,743	2,965
Net NPA (%)	0.00	0.25
ROTA (%)	2.49	1.81

A: Audited

Status of non-cooperation with previous CRA:

Not Applicable

Any other information:

Not Applicable

Rating History for last three years: Please refer Annexure-2

Note on complexity levels of the rated instrument: CARE has classified instruments rated by it on the basis of complexity. This classification is available at www.careratings.com. Investors/market intermediaries/regulators or others are welcome to write to care@careratings.com for any clarifications.

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Annexure-1: Details of Instruments/Facilities

Name of the Instrument	Date of Issuance	Coupon Rate	Maturity Date	Size of the Issue (Rs. crore)	Rating assigned along with Rating Outlook
Fund-based - LT-Term Loan	-	-	October 2018	30.17	CARE A-; Negative
Fund-based - LT-Cash Credit	-	-	-	-	Withdrawn
Commercial Paper	-	-	0-364 days	330.00	CARE A1
Bonds-Tier II Bonds	-	-	-	125.00	CARE A-; Negative

Annexure-2: Rating History of last three years

Sr. No.	Name of the Instrument/Bank Facilities	Current Ratings			Rating history			
		Type	Amount Outstanding (Rs. crore)	Rating	Date(s) & Rating(s) assigned in 2017-2018	Date(s) & Rating(s) assigned in 2016-2017	Date(s) & Rating(s) assigned in 2015-2016	Date(s) & Rating(s) assigned in 2014-2015
1.	Fund-based - LT-Proposed fund based limits	-	-	-	-	-	1)CARE BBB+ (23-Oct-15)	1)CARE BBB (21-Oct-14)
2.	Fund-based - LT-Term Loan	LT	30.17	CARE A-; Negative	-	1)CARE A-; Stable (02-Feb-17) 2)CARE A- (04-Nov-16)	1)CARE BBB+ (23-Oct-15)	1)CARE BBB (21-Oct-14)
3.	Fund-based - LT-Cash Credit	LT	-	-	-	1)CARE A-; Stable (02-Feb-17) 2)CARE A- (04-Nov-16)	1)CARE BBB+ (23-Oct-15)	1)CARE BBB (21-Oct-14)
4.	Commercial Paper	ST	330.00	CARE A1	-	1)CARE A1 (15-Feb-17)	-	-
5.	Bonds-Tier II Bonds	LT	125.00	CARE A-; Negative	-	-	-	-

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