AU Small Finance Bank Limited

April 04, 2023

Facilities/Instruments	Amount (₹ crore)	Rating[1]	Rating Action
Tier II Bonds	200.00	CARE AA; Stable	Reaffirmed
Tier II Bonds	300.00	CARE AA; Stable	Reaffirmed
Tier II Bonds	150.00	CARE AA; Stable	Reaffirmed
Certificate Of Deposit	500.00	CARE A1+	Reaffirmed

Details of instruments in Annexure-1.

Rationale and key rating drivers

The reaffirmation of the ratings assigned to the debt instruments of AU Small Finance Bank Limited (AUSFB) factor in the continued momentum of growth in business and size, post-conversion into a small finance bank (SFB) in April 2017, the establishment of deposit franchise along with a sizeable current account savings account (CASA) deposits, and a moderately-diversified advances portfolio with a largely secured lending portfolio. The ratings also factor-in the experience of the management team, comfortable capitalisation levels supported with periodic equity capital raise, continuous improvement in asset quality parameters during H2FY22 and 9MFY23 (refers to the period April 1 to December 31) after being impacted due to COVID-19-related stress, and healthy profitability.

The ratings are, however, constrained by moderate seasoning in AUSFB's new asset verticals, including business banking, home loans, and two-wheeler financing, the regional concentration of advances and deposits as well as the relatively moderate size as compared to mid-sized private sector banks.

Rating sensitivities: Factors likely to lead to rating actions

Positive factors: Factors that could lead to positive rating action/upgrade

- Sustained improvement in scale of operations along with improvement in product & geographical diversification.
- Scale-up of deposits with increase in CASA and retail deposits base becoming more comparable to mid-sized private sector banking peers

Negative factors: Factors that could lead to negative rating action/downgrade

- Deterioration in asset quality, with Gross NPA increasing to more than 4% on a sustained basis
- Deterioration in capital adequacy parameters with CAR falling below 17% on a sustained basis
- Moderation in profitability parameters with ROTA falling below 1% on a sustained basis

Analytical approach: Standalone

Outlook: Stable

CARE Ratings Limited (CARE Ratings) believes that AUSFB shall continue to maintain its steady growth in advances, deposits and healthy profitability profile over the medium term while maintaining stable asset quality and comfortable capitalization levels.

Detailed description of the key rating drivers:

Key strengths

Continued growth momentum in business

The company commenced operations as an SFB from April 2017 and got the status of a Scheduled Commercial Bank (SCB) in November 2017. In the six years of operations as an SFB, the bank has been able to ramp up its operations from 474 touchpoints as on March 31, 2018, to 1,015 touchpoints (new and converted) across 21 States and 3 Union Territories, with 27,700+ employees on roll, as on December 31, 2022 (March 31, 2021: 744 touchpoints). AUSFB, the largest SFB in India, in terms of asset size, has seen steady growth in the total assets increasing from ₹18,819 crore as on March 31, 2018 to ₹68,936 crore as on March 31, 2022 at a CAGR of 38% and further to ₹80,566 crore as on December 31, 2022. As per the Reserve Bank of India (RBI) guidelines, AUSFB is eligible to apply for conversion into a universal bank or after a review, RBI, may increase its scope of activities as AUSFB has a satisfactory track record of five years of operating as an SFB. However, the conversion would be subject to RBI approval. While the bank would benefit from conversion into a universal bank with the minimum threshold of lending to

[1]Complete definition of the ratings assigned are available at www.careedge.in and other CARE Ratings Ltd.'s publications

priority sector reducing from 75% to 40%, the bank's asset strategy would largely continue in line with the current asset profile, and CARE Ratings does not expect the bank to have significant exposure to large-ticket corporate lending for the medium term.

Comfortable capitalisation boosted by QIP

Despite undertaking significant growth in the loan book, AUSFB continues to be sufficiently capitalised, helped by regular capital infusions by way of Qualified Institutional Placement (QIP), the latest being ₹2,000 crore in August 2022 and steady healthy internal accruals. The bank also raised Tier-II capital of ₹500 crore during 9MFY23. The bank reported a capital adequacy ratio (CAR) of 21.97% (March 31, 2021: 23.37% and March 31, 2022: 20.99%) and Tier-I CAR of 20.05% (March 31, 2021: 21.54% and March 31, 2022: 19.69%) as on December 31, 2022, which were well above the minimum regulatory requirement of 15% and 7.5%, respectively. As AUSFB continues to grow its book at a fast pace, it would require regular capital infusions in addition to internal accruals, which alone may not be sufficient to support growth over the medium term. Going ahead, CARE Ratings expect AUSFB to maintain sufficient cushion over the minimum regulatory requirements. Furthermore, the restriction of the promoters to keep their shareholding of a minimum 26% is no longer applicable from April 2022, as the bank completed its five years of its operations as an SFB. During May 2022, AUSFB's board approved the increase in authorised capital from ₹350 crore to ₹1,200 crore. The bank announced bonus issue (1:1) and the same was successfully done on June 12, 2022 resulting in capitalisation of its reserves.

Diversified resource profile with a strong growth in deposit base

AUSFB has transformed its liabilities profile by developing its deposit base since becoming a bank in FY18 (refers to the period April 1 to March 31). The deposit franchise has consistently increased with deposits increasing from ₹7,923 crore as on March 31, 2018, to ₹52,585 crore as on March 31, 2022, and further to ₹61,101 crore as on December 31, 2022. Initially, CASA deposits growth was slow as compared to total deposit growth, which resulted in the CASA ratio falling from 26.9% as on March 31, 2018, to 14.5% as on March 31, 2020. With a focus on increasing CASA deposits, AUSFB continues to offer higher interest rates on saving accounts as compared to mainstream banks and undertakes extensive marketing exercises to increase its CASA deposits. The bank has a strategy of generating deposits from urban markets and lending in the rural markets. The bank is increasing its touchpoints in urban areas to garner more retail deposits. As a result, the bank was able to improve its CASA ratio to at 23.00% as on March 31, 2021, and to 37.3% as on March 31, 2022 and further to 38.41% as on December 31, 2022. The bank continues to granularize its deposit book with a focus on increasing retail deposits. The share of retail term deposits to total term deposits (excluding CD) has gone up from 30% as on March 31, 2019, to 50% as on March 31, 2022, and further to 53% as on December 31, 2022, which increases stability in the liability profile. Bulk deposits (over ₹2 crore) constituted around 47% of the term deposits, as on December 31, 2022. While the bank has been increasing its depositor base and the proportion of CASA in the past five years of operating as an SFB, it is relatively lower compared to few mid-sized private sector banks, and the scaling-up of the CASA over the next few years would be a key rating sensitivity for the bank.

Consistent track record of healthy earnings performance

Post conversion to an SFB and access to deposits, the cost of funds has declined over the past three years for AUSFB, as it has increased the proportion of CASA and retail term deposits, further helped by lowering of the systemic interest rates. Also, as majority of advances (around 80%) of AUSFB are to the unorganised segment, which typically has a higher yield compared to the organised segment, the net interest margin (NIM) for AUSFB is higher than the universal banks, ranging between 5- 5.5%. The net interest income (NII) is growing consistently, in trend with the growth in advances and deposits. For FY22, AUSFB reported a NIM of 5.37% (FY21: 5.05%) on account of lower cost of funds. The operating expenses of AUSFB continues to be high and may not come down significantly in the medium-term as the bank is actively spending on business expansion, capacity building and investments in digital initiatives. Credit costs improved significantly to 0.60% during FY22 (FY21: 1.50%) supported by notable improvement in asset quality. AUSFB reported a return on total assets (ROTA) of 1.88% for FY22 (FY21: 1.28%, adjusted for gains from stake sale of Aavas Financiers Limited including which, the ROTA was 2.50%).

The interest rates have hardened since Q4FY22 onwards and the cost of funds have been inching upwards for the banking sector as a whole. However, banks have been able to pass on interest rate hikes and they are experiencing NIM expansion due to the timing difference between rise in yields on advances and cost of deposits. But going forward, CARE expects the NIMs of bank sector to be impacted as cost of deposits rising.

For the nine months ended December 31, 2022, AUSFB continued to see growth in net interest income with interest income growing at 39.80% year on year following advances growth of 38.4% year on year. However, the non-interest income was impacted by mark to market loss on the investments due an increasing interest rate scenario while the fee-based income continued to increase resulting in non-interest income to marginally grow by 2.80% year on year for 9MFY23. The bank's operating cost grew by 49.65%, which resulted in PPOP showing moderate growth of 8.69% for 9MFY23 as compared with 9MFY22. The credit costs were lower by 43% year on year for 9MFY23, which helped the bank report PAT growth of 28.01% y-o-y for 9MFY23.

Improving asset quality after COVID-induced stress

AUSFB has historically been able to manage its asset quality to comfortable levels, despite having significant exposure to segments that are more vulnerable to an economic downturn. About 90% of loans are retail which provides granularity and 93% of the advances of AUSFB are secured, which provides comfort, in terms on eventual loss on the portfolio. The gross NPA levels of AUSFB hovered around 1.7%-2.1% between FY18 and FY20, rising to peak levels of 4.3% as on March 31, 2021, and June 30, 2021, due to the impact of COVID-19 on its borrowers. Wheels and Secured Business Loans – the two biggest segments for AUSFB – saw higher slippages during COVID-19 period of FY21 and FY22. The asset quality has since been improving quarter on quarter from the peak of June 2021, with the gross NPA reducing to 1.98% as on March 31, 2022, and to 1.81% as on December 31, 2022, due to post COVID-19 improved environment increasingly supporting borrowers' cashflows and repayment behaviour which aided recoveries/ resolutions of stressed cases significantly resulting in improved collection efficiency over 105% during 9MFY23. As on December 31, 2022, the COVID restructured accounts constituted 1.4% of gross advances, and the provision cover stood at 2.02% of the gross advances, providing cushion against asset quality shocks.

Key weaknesses

Limited product diversification and lower seasoning of non-vehicle/non-SBL portfolio

AUSFB has witnessed significant portfolio growth in the MSME segments in the past few years. Post conversion to an SFB, it started new products like business banking, gold loan, agri loan, home loan, etc. As on December 31, 2022, the total wheels segment comprised 35% of the gross advances, secured business loans (SBL) was 32%, and other products (which are relatively new) comprised the remaining 33%, reflecting concentration in wheels and the MSME segment. However, the bank has scaled up its efforts to diversify into other products such as business banking, agri MSME, personal loan, home loan, etc. Furthermore, the seasoning of the portfolio built up in these products as well as new geographies is still low, and their performance over cycles is yet to be seen.

Regional concentration and relatively moderate size

As on December 31, 2022, AUSFB's distribution network is spread around 21 States and 3 Union Territories having 1,015 touchpoints out of which 394 touchpoints (39%) are located in Rajasthan, followed by Gujarat having 144 touchpoints (14%), and Madhya Pradesh having 134 touchpoints (13%) accounting for 66% of the total branch distribution. The top three states collectively constituted 67% of the advances and 60% of the deposits as on December 31, 2022. The company intends to leverage its branch network to drive greater and deeper penetration in the Western and Northern states of India in which it operates, focusing on low and middle-income individuals and businesses that have limited or no access to formal banking and finance channels, spanning rural, semi-urban and urban markets.

Although, AUSFB has seen strong growth in the last few years, its asset size continues to be relatively smaller as compared to private sector universal banks in India.

Liquidity: Adequate

The asset liabilities maturity (ALM) profile of AUSFB as on December 31, 2022, had no negative cumulative mismatches as per the Structural Liquidity Statement in time buckets up to one month. In order to manage the gaps in an optimum manner, AUSFB has been focusing on increasing granular deposit, wherein, retail term deposits and savings deposits has grown significantly during 9MFY23. AUSFB's liquidity coverage ratio (LCR) stood at 123% for the quarter-ended December 31, 2022, as against the regulatory requirement of 100%. AUSFB has maintained sufficient excess statutory liquidity ratio (SLR) and high-quality non-SLR instruments, which can be readily used for repo or liquidated in the secondary market. Furthermore, it can also resort to rupee borrowing in the form of CDs, term money, securitisation of portfolio, and re-finance from various domestic financial institutions (NABARD, SIDBI, MUDRA, NHB, and others) in case of liquidity need. Furthermore, the bank's status as an SFB, has increased its resource raising ability by providing access to facilities like LAF, MSF and call money market to meet any liquidity requirement. Also, the bank has availability of excess priority sector lending (PSL) portfolio over and above regulatory requirement with optionality to capitalise on the same through the right mix of securitisation and PSLC.

Environment, social, and governance (ESG) risks

- 9% of Wheels book are covered under the green portfolio and the bank is focusing on customising loan products to cater exclusively to Electric Vehicle (EV) customers.
- Digital technologies like tab-based banking and video banking have reduced customers' branch visits and carbon footprint.
- The bank is investing in energy-efficient alternatives to methodically manage carbon footprint.
- The bank has 30% Branches in unbanked rural centers
- Over 1,93,000 customers were provided financial services under Jan Dhan Yojana
- Financial literacy camps at rural branches.

- The bank has participated in the PM-KUSUM (Pradhan Mantri Kisan Urja Suraksha Evam Utthaan Mahabhiyan) Scheme, whereby it has initiated funding solar energy projects. Furthermore, the bank has installed a 1.25 MW solar plant in Rajasthan.
- About 7% of the bank's workforce comprised females as on March 31, 2022

Applicable criteria

Policy on default recognition
Financial Ratios - Financial Sector
Rating Outlook and Credit Watch
Short Term Instruments
Rating Basel III - Hybrid Capital Instruments issued by Banks
Bank

About the company and industry

Industry Classification

Macro Economic Indicator	Sector	Industry	Basic Industry
Financial Services	Financial Services	Banks	Private Sector Bank

AU Small Finance Bank Limited (erstwhile AU Financiers (India) Limited) was incorporated in 1996 as a non-banking finance company (NBFC) and started the CV lending business in 2003 as a franchisee originator for HDFC Bank under 'Channel Business' and later moved to lend on its own books since 2007. Over the years, the company forayed into the MSME/SME, housing loans and structured financing and other types of vehicle financing as well.
The company received the license of an SFB from the RBI in December 2016, and commenced banking operations from April 2017 and received the status of a SCB in November 2017. Post becoming an SFB, it has expanded its product portfolio and geographical footprint. As on December 31, 2022, it has established operations across 1,015 banking touchpoints serving around 35.7 lakh customers across 21 States and 3 Union Territories with an employee base of 27,700+.

Brief Financials (₹ crore)	March 31, 2021 (A)	March 31, 2022 (A)	9MFY23 (UA)
Total income	6,402	6,915	6,632
PAT	1,171	1,130	1,003
Adjusted PAT*	600	1,130	1,003
Total Assets#	51,491	68,936	80,566
Net NPA (%)	2.18	0.50	0.51
ROTA (%)	2.50	1.88	1.79
Adjusted ROTA (%)*	1.28	1.88	1.79

A: Audited UA: Unaudited; Note: 'the above results are latest financial results available'
Note: All Analytical ratios are as per CARE Ratings' calculations.
*Adjusted for gain from sale of stake in Aavas Financiers Limited.
Total Assets adjusted by DTA and intangible assets

Status of non-cooperation with previous CRA: Not applicable.

Any other information: Not applicable.

Rating history for the last three years: Please refer Annexure-2

Covenants of the rated instruments/facilities: Detailed explanation of the covenants of the rated instruments/facilities is given in Annexure-3

Complexity level of the various instruments rated: Annexure-4

Lender details: Annexure-5

Annexure-1: Details of instruments

Name of the Instrument	ISIN	Date of Issuance (DD-MM-YYYY)	Coupon Rate (%)	Maturity Date (DD-MM-YYYY)	Size of the Issue (₹ crore)	Rating Assigned along with Rating Outlook
Bonds- Tier-II Bonds	INE949L08442	03-08-22	9.30%	03-08-32	350.00	CARE AA; Stable
Bonds- Tier-II Bonds	INE949L08434	03-08-22	9.30%	13-08-32	100.00	CARE AA; Stable
Bonds- Tier-II Bonds	INE949L08426	03-08-22	9.30%	23-08-32	50.00	CARE AA; Stable
Bonds- Tier-II Bonds	Proposed	-	-	-	150.00	CARE AA; Stable
Certificate of deposit	Proposed	7-365 days	-	-	500.00	CARE A1+

Annexure-2: Rating history for the last three years

Sr. No.	Name of the Instrument/Bank Facilities	Current Ratings			Rating History			
		Type	Amount Outstanding (₹ crore)	Rating	Date(s) and Rating(s) assigned in 2022-2023	Date(s) and Rating(s) assigned in 2021-2022	Date(s) and Rating(s) assigned in 2020-2021	Date(s) and Rating(s) assigned in 2019-2020
1	Fund-based - LT-Term Loan	LT	-	-	-	1)Withdrawn (23-Mar-22)	1)CARE AA-; Stable (30-Mar-21)	1)CARE AA-; Stable (30-Mar-20) 2)CARE AA-; Stable (04-Apr-19)
2	Certificate Of Deposit	ST	500.00	CARE A1+	1)CARE A1+ (27-Jul-22)	1)CARE A1+ (23-Mar-22)	1)CARE A1+ (30-Mar-21)	1)CARE A1+ (30-Mar-20) 2)CARE A1+ (04-Apr-19)
3	Bonds-Tier II Bonds	LT	200.00	CARE AA; Stable	1)CARE AA; Stable (27-Jul-22)	1)CARE AA; Stable (23-Mar-22)	-	-
4	Bonds-Tier II Bonds	LT	300.00	CARE AA; Stable	1)CARE AA; Stable (27-Jul-22)	-	-	-
5	Bonds-Tier II Bonds	LT	150.00	CARE AA; Stable	1)CARE AA; Stable (27-Jul-22)	-	-	-

*Long term/Short term.

Annexure-3: Detailed explanation of the covenants of the rated instruments/facilities: Not available.

Annexure-4: Complexity level of the various instruments rated

Sr. No.	Name of the Instrument	Complexity Level
1	Bonds- Tier-II Bonds	Complex
2	Certificate of deposit	Simple

Annexure-5: Lender details

To view the lender wise details of bank facilities please click here

Note on the complexity levels of the rated instruments: CARE Ratings has classified instruments rated by it on the basis of complexity. Investors/market intermediaries/regulators or others are welcome to write to care@careedge.in for any clarifications.

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About us:
Established in 1993, CARE Ratings is one of the leading credit rating agencies in India. Registered under the Securities and Exchange Board of India, it has been acknowledged as an External Credit Assessment Institution by the RBI. With an equitable position in the Indian capital market, CARE Ratings provides a wide array of credit rating services that help corporates raise capital and enable investors to make informed decisions. With an established track record of rating companies over almost three decades, CARE Ratings follows a robust and transparent rating process that leverages its domain and analytical expertise, backed by the methodologies congruent with the international best practices. CARE Ratings has played a pivotal role in developing bank debt and capital market instruments, including commercial papers, corporate bonds and debentures, and structured credit.

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