Northern Arc Capital Limited

October 26, 2023

Facilities/Instruments	Amount (₹ crore)	Rating[1]	Rating Action
Commercial paper	500.00 (Enhanced from 300.00)	CARE A1+	Reaffirmed

Details of instruments/facilities in Annexure-1

Rationale and key rating drivers

The rating assigned to the commercial paper (CP) issue of Northern Arc Capital Limited (NACL) derives strength from its established track record of operations, well-established risk management systems, comfortable capitalisation levels and adequate liquidity position. The rating factors in the diversified client base of NACL with presence across asset classes and revenue diversification to an extent through fee-based income. The rating also takes note of the improvement in profitability and stable asset quality indicators along with good growth in the assets under management (AUM), especially in retail exposures during FY23. The AUM increased from ₹6,874 crore as on March 31, 2022 to ₹8,566 crore as on March 31, 2023, with increase in the share of non-institutional book from 17.5% to 30.8%.

The rating is, however, constrained by client concentration risk, exposure to entities with marginal risk profiles that are relatively risky, and exposure to the non-institutional (retail) segment where the track record is low. Over the years, the company has been gradually reducing its exposure to wholesale through diversification into the retail segment through own channels and through co-lending arrangements with non-banking financial companies (NBFCs)/ fintechs. Within the retail segment, exposure to unsecured personal loan (PL) has increased significantly in FY22 and FY23. The company also has its direct presence in microfinance institution (MFI) loans wherein the portfolio is originated through its subsidiary, Pragati Finserv Private Limited (Pragati). Together, PL and MFI loans (retail exposure) accounted for 21% AUM as on March 31, 2023.

Rating sensitivities: Factors likely to lead to rating actions

Positive factors – Factors that could individually or collectively, lead to positive rating action/upgrade:

Not applicable

Negative factors – Factors that could individually or collectively, lead to negative rating action/downgrade:

- Weakening of asset quality parameters, with gross non-performing assets (GNPA) of above 3% on a sustained basis.
- Decline in profitability levels, with return on total assets (ROTA) of below 1% on a sustained basis.
- Weakening of capital adequacy levels below 18%.

Analytical approach: Standalone

Detailed description of the key rating drivers

Key strengths

Established track record of operations

NACL has been in the funding and debt issuances placement business for over 10 years and has established relationships with several investors, including banks, NBFCs, mutual funds, offshore investors, private wealth firms, etc. NACL has enabled funding for more than 200 partner institutions in various segments like microfinance, affordable housing finance, small business loans, commercial vehicle (CV) finance, agricultural finance, corporate finance, and consumer finance. NACL is a board-led management-driven company, with Ashish Mehrotra as its Managing Director and CEO, P. S. Jayakumar as non-executive independent chairman and Dr Kshama Fernandes as non-executive vice-chairperson. The board of NACL consists of 10 directors, including four independent directors and three nominee directors. NACL has a strong senior management team to manage various functions, such as risk, business, technology, etc.

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

Well-established risk management systems

NACL has, over the years, developed a well-established risk management system. The risk policy and risk framework are approved by the Risk Committee, which is a sub-committee of the board. The credit team and the risk team assess the credit risk profiles of entities at the time of onboarding and on a continuous basis, and the same is reviewed by the credit committee. NACL has developed strong underwriting guidelines for the onboarding of clients across asset classes. The due-diligence conducted by the origination team measures the quality of the entity vis-à-vis the underwriting guidelines, including an assessment of the origination or credit or collection processes, adequacy and quality of MIS systems, corporate governance and management. CARE Ratings Limited (CARE Ratings) notes that the risk systems have been built with geographical and district-wise risk factors and triggers to manage its portfolio diversification.

For regular tracking of the portfolio, NACL has a risk analytics team that tracks performance of all the transactions on a monthly basis. The collection and recovery status are monitored on a daily basis by the operations team. Apart from monitoring at the HO, field visits are conducted by the risk monitoring team of NACL, wherein the risk monitoring team members visit the offices or branches of each client. NACL has strengthened the risk management systems by deploying field level personnel for monitoring the portfolio. The strong risk policies developed by NACL mitigate the inherent risks associated with these asset classes.

NACL has its own in-house Nimbus Platform, which is an end-to-end solution, and the company has an internal IT team for maintaining the same. Nimbus enables access to diverse financial products for enterprises in a seamless, efficient, and convenient manner. The platform aims to bring together a diverse set of investors (domestic as well as international) and debt seekers to a common, curated platform. In terms of co-lending, there is system integration with the co-lending partners. NACL also has its wealth management platform, Altifi, which enables retail investors to invest in transactions under-written by the company.

Revenue diversification through fee-based income

NACL earns fund-based income from loans to its clients and other direct exposure, and fee-based income from professional fees earned on activities including securitisation, loan syndication, bond, and other structured finance transactions. During FY23, fee-based income stood at ₹56 crore (i.e., 0.66% of the average total assets) as against ₹64 crore in FY22 (i.e., 0.96% of the average total assets). CARE Ratings observes during FY23, that NACL has increased exposure to the non-institutional segment, while exposure to securitisation has reduced, thus resulting in a decline in fee-based income.

Presence in diversified asset classes with increase in proportion of non-institutional book

NACL started with MFI asset class in FY11 and subsequently diversified into affordable housing finance (AHF) in FY12, small business loans (SBL) in FY13, CV finance in FY14, agri loans in FY15, corporate loans in FY16 and consumer finance in FY20, loan against property (LAP) in FY22, education loan (EL) and supply chain finance (SCF) in FY23, respectively.

NACL's fund-based AUM grew significantly by 25% in FY23 and stood at ₹8,566 crore as on March 31, 2023 as against ₹6,874 crore as on March 31, 2022. As on March 31, 2022, NACL's AUM comprised advances to clients (NBFCs and corporates) (51%), investment in debt instruments (14%), investments in alternative investment funds (AIF) (3%), and advances to retail via co-lending partners (19%). In terms of asset classes, as on March 31, 2023, the share of MFI (inclusive of SFB) has reduced during the year to 27% from 29% as on March 31, 2022, followed by small business loans to 27% (PY: 27%), consumer finance increased to 21% (PY: 15%), CV finance to 11% (PY:14%), corporate finance to 8% (PY: 8%), AHF to 2%, Agri to 2%, LAP and SCF at 2% and 1%, respectively (PY: AHF and Agri : 3% and 2%, respectively). NACL has forayed into LAP through its own branch network. In addition to asset class diversification, NACL is also focusing on segment diversification. Over the years, it has been gradually shifting from institutional credit to non-institutional credit. Retail exposures through co-lending partners comprise 19% of the AUM as on March 31, 2023, as against 16% as on March 31, 2022 (24% of the AUM as on June 30, 2023). During FY23, NACL has completed the transaction of business transfer of S.M.I.L.E Microfinance and has ventured into direct retail lending of MFI loans through Pragati (a wholly-owned subsidiary of NACL) acting as BC partner and also ventured into direct retail lending of LAP, SCF and education loans (EL). The total non-institutional book (co-lending + direct retail) stood at 31% of the AUM as on March 31, 2023. NACL also lends to mid-market (non-financial institutions [FIs]) clients which comprises around 8% of the AUM as on June 30, 2023.

Going forward, CARE Ratings expects the non-institutional exposure to increase and will continue to monitor the performance of the same.

Total AUM (fund based+ non-fund-based) stood at ₹8,730 crore as on March 31, 2023 as against ₹7,111 crore as on March 31, 2022. NACL also has presence in fund management through its subsidiary, Northern Arc Investment Managers Private Limited, and currently has funds outstanding of ₹2,776 crore as on March 31, 2023.

Comfortable capitalisation levels

NACL's capital adequacy ratio (CAR) and Tier-I CAR declined to 20.77% and 20.15% as on March 31, 2023 as against 22.79% and 22.08%, respectively, as on March 31, 2022, on account of growth in AUM. The gearing levels increased to 3.8x (as per CARE Ratings' calculation) as on March 31, 2023, as against 3.5x as on March 31, 2022. The present capitalisation levels will be sufficient to fund the growth envisaged by the management in the current financial year.

CARE Ratings notes that the company will require to raise capital in the medium term to enable higher growth in AUM, going forward.

Diversified funding profile

Of the total borrowings, the share of bank term loans increased to 61% as on March 31, 2023 from 56% in March 31, 2022, followed by external commercial borrowings (ECBs)/offshore at 27% (PY: 28%), domestic non-convertible debentures (NCDs) at 4% (PY: 6%) (of which NCD from banks comprise 20% of the domestic NCD), loans from FIs at 6% (PY: 8%), CP at 1% (PY: 4%), and sub-debt at 1%. With respect to investor-wise share of borrowings, 75% is from banks, followed by FIs (including offshore funds) (22%), and mutual funds and wealth management firms (4%).

Stable asset quality indicators

The company was maintaining good asset quality levels since inception. However, there was moderation in asset quality parameters during FY21, with increased slippages due to the COVID-19 pandemic. However, the GNPA and net NPA (NNPA) improved to 0.49% and 0.18%, respectively, as on March 31, 2022, on account of improved recoveries and write-off during FY22. GNPA and NNPA stood at 0.77% and 0.40%, respectively, as on March 31, 2023 (0.50% and 0.19%, respectively, as on June 30, 2023). Among the non-institutional segment, direct origination loans had 0+ DPD% of 7.65% and 90+ of 1.13% as on March 31, 2023, as against 6.97% and 0.81% as on March 31, 2022, respectively. However, the company has a first loss default guarantee (FLDG) cover against the said book. With growing non-institutional book, the company has also set up a separate collections team in order to facilitate the partners as and when required.

CARE Ratings expects asset quality to remain stable over the medium term.

Improved profitability indicators in FY23

NACL's profit after tax (PAT) improved significantly in FY23 to ₹225 crore in FY23 from ₹164 crore in FY22. The net interest margin (NIM) improved to 6.88% in FY23 from 5.42% in FY22 on account of an improvement in yields, with an increase in the proportion of the non-institutional book. The fee-based income (as a percentage of the average total assets) declined to 0.66% in FY23 from 0.96% in FY22. The opex to average total asset increased to 4.22% in FY23 from 2.99% in FY22, on account of increase in the non-institutional book. The company has also opened branches for LAP in FY23. Pre-provision operating profit (PPOP) grew by 30% (y-o-y) to ₹345 crore in FY23 from ₹266 crore in FY22. The credit cost, as a percentage of total advances, improved to 0.49% in FY23 from 0.58% in FY22 on account of improved asset quality and reduced provisions. Thus, with the improvement in the NIM and reduction in credit cost, NACL reported a ROTA of 2.66% in FY23 as against 2.45% in FY22. In Q1FY24, NACL reported a PAT of ₹59 crore as against a PAT of ₹50 crore in Q1FY23. NACL reported a ROTA of 2.57% in Q1FY24 as against 2.55% in Q1FY23.

CARE Ratings expects profitability to remain stable over the medium term.

Key weaknesses

Client concentration risk

With significant exposure of NACL being wholesale in nature, the top 10 exposures account for 16% of the AUM (PY: 18%) and 72% of the net worth (PY: 72%) as on March 31, 2023. CARE Ratings observes that the ability of the company to keep its asset quality under control remains critical, since slippage in high ticket loans, if any, will have a significant impact on the asset quality and profitability.

Exposure to marginal risk profiles, which are relatively risky

NACL invests in the subordinated tranches of the securitisation transactions, which are exposed to a higher credit risk as compared to the senior tranche of the securitisation transactions. NACL also takes exposures to subordinate tranches by way of investing in sub-debt and investing in Class-A units of alternate investment funds. However, the share of subordinated exposures have been decreasing in the last two years ended March 31, 2023. The share of subordinated exposures has come down from 13.36% as on March 31, 2021, to 8.72% as on March 31, 2022, and further to 5.35% as on March 31, 2023. In terms of ratings, 6% of the securitisation exposure, 28% of the loan exposure (excluding retail exposure), and 1% of the NCD exposure, as on March 31, 2023, has ratings of lesser than BB+ or unrated.

Significant increase in the non-institutional loan book during FY23; however, performance of this book remains a key monitorable

NACL primarily works as an arranger to raise debt capital for small and mid-size companies, especially FIs. However, a gradual shift is being observed from institutional lending to retail credit. It has been taking steps to reduce the concentration towards institutional exposures. NACL has also increased its exposure to the direct retail segment, with MFI loans through Pragati as BC partner, through direct LAP, SCF and education loans during FY23. The institutional and non-institutional (co-lending and retail) composition stood at 69% and 31%, respectively, as on March 31, 2023. The performance of the non-institutional book remains a key monitorable.

Liquidity: Adequate

The liquidity profile is adequate, with no negative cumulative mismatches in any of the time buckets in the asset liability maturity (ALM) as on June 30, 2023. As on the same date, the company had cash and cash equivalents of ₹522 crore. Also, NACL has un-availed lines of credit of ₹90 crore as on August 21, 2023.

Applicable criteria

Policy on default recognition
Financial Ratios - Financial Sector
Rating Outlook and Credit Watch
Short Term Instruments
Non Banking Financial Companies
Policy on Withdrawal of Ratings

About the company and industry

Industry classification

Macro-economic Indicator	Sector	Industry	Basic Industry
Financial Services	Financial Services	Finance	Non Banking Financial Company (NBFC)

NACL is primarily engaged in enabling small and medium-sized NBFCs and fintechs to access debt capital, including by way of securitisation, debentures, and co-lending. It also provides loans to these entities and generally invests in the subordinated tranches of securitisation pools arranged by it. In addition, the company also lends to mid-market corporates and retail customers. The company is registered with the Reserve Bank of India (RBI) as a non-deposit taking systemically-important NBFC and started NBFC activities in 2008 with focus on the microfinance sector, mainly to small and medium-sized MFIs. Later, NACL expanded the scope of its NBFC activities to include AHF, SBL, CV, agricultural finance (AF), corporate finance (CF), and consumer finance. NACL has also diversified into direct retail segments in FY22; and ventured into retail via MFI, SCF, LAP, and education loans.

NACL has five subsidiaries, namely:

i) Northern Arc Investment Adviser Services Private Limited, which is in the business of facilitating investments and acts as an advisor to provide financial/investment advice to both, Indian and foreign investors.

ii) Northern Arc Investment Managers Private Limited, which is carrying on the business of the investment company and also provides portfolio management services to offshore funds and all kinds of AIFs.

iii) Pragati Finserv Pvt Ltd, which was incorporated in FY21 with the aim of offering small-ticket loans through an efficient, agile, and scalable digital platform to under-served rural and semi-urban areas of the country.

iv) Northern Arc Foundation.

v) Northern Arc Securities Private Limited

As on March 31, 2023, on a fully-diluted basis, 25.6% stake of NACL is held by IIFL Special Opportunities Fund and its series, 22.6% stake is held by Leapfrog Financial Inclusion India Limited, 19.5% is held by Augusta Investments Pte Limited, 10.3% is held by Eight Roads Investments Mauritius (II) Limited, 7.5% is held by Dvara Trust, 5.8% is held by Accion Africa-Asia Investment Company, 5.3% is held by Sumitomo Mitsui Banking Corporation, and the remaining by Northern Employee Welfare Trust, and directors and senior management of the company.

Brief financials (₹ crore)	FY22 (A)	FY23(A)	Q1FY24(UA)
Total operating income	876	1,261	400
PAT	164	225	59
Interest coverage (times)	1.55	1.54	1.48
Total assets	7,812	9,136	9,294
Net NPA (%)	0.18	0.40	0.19
ROTA (%)	2.45	2.55	2.57

A: Audited UA: Unaudited. Note: The above results are the latest financial results available.

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/facilities

Name of the Instrument	ISIN	Date of Issuance	Coupon Rate	Maturity Date	Size of the Issue* (₹ crore)	Rating Assigned along with Rating Outlook
Commercial paper	INE850M14BU4	08-09-2023	9.10%	07-12-2023	30	CARE A1+
Commercial paper	INE850M14BT6	24-08-2023	9.10%	23-11-2023	20	CARE A1+
Commercial paper	INE850M14BS8	27-06-2023	9.10%	25-06-2024	100	CARE A1+
Commercial paper	INE850M14BQ2	19-06-2023	9.25%	17-06-2024	100	CARE A1+
Commercial paper	Proposed	-	-	-	250	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 2023-2024	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
1	Commercial paper-Commercial paper (Standalone)	ST	500.00	CARE A1+	1)CARE A1+ (31-Aug-23)	1)CARE A1+ (01-Sep-22)	1)CARE A1+ (02-Mar-22) 2)CARE A1+ (02-Sep-21)	1)CARE A1+ (08-Sep-20)

*Long term/Short term.

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

Annexure-4: Complexity level of various instruments rated

Sr. No.	Name of the Instrument	Complexity Level
1	Commercial paper-Commercial paper (Standalone)	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.

Contact Us

Media Contact	Analytical Contacts
Name: Mradul Mishra Director **CARE Ratings Limited** Phone: +91-22-6754 3596 E-mail: mradul.mishra@careedge.in **Relationship Contact** Name: Pradeep Kumar V Senior Director **CARE Ratings Limited** Phone: +91-2850-1001 E-mail: pradeep.kumar@careedge.in	Name: P Sudhakar Director **CARE Ratings Limited** Phone: +91-44-2850 1003 E-mail: p.sudhakar@careedge.in Name: Ravi Shankar R Associate Director **CARE Ratings Limited** Phone: +91-44-2850 1016 E-mail: ravi.s@careedge.in Name: Sakshi Arora Lead Analyst **CARE Ratings Limited** E-mail: sakshi.arora@careedge.in

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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