ESAF Small Finance Bank Limited

July 04, 2024

Instruments	Amount (₹ crore)	Rating[1]	Rating Action
Tier-II bonds (Basel III)-I	80.0	CARE A; Stable	Reaffirmed
Tier-II bonds (Basel III)-II	20.0	CARE A; Stable	Reaffirmed
Lower Tier-II bonds (Basel II)-I	150.0	CARE A; Stable	Reaffirmed
Lower Tier-II bonds (Basel II)-II	130.0	CARE A; Stable	Reaffirmed
Certificate of deposit	500.0	CARE A1+	Reaffirmed

Details of instruments/facilities in Annexure-1.

Tier-II bonds under Basel-III are characterised by a 'point of non-viability' (PONV) trigger, due to which, the investor may suffer a loss of principal. PONV will be determined by the Reserve Bank of India (RBI) and is a point at which, the bank may no longer remain a going concern on its own unless appropriate measures are taken to revive its operations, and thus, enable it to continue as a going concern. In addition, difficulties faced by a bank should be such that these are likely to result in financial losses, and raising bank's Common Equity Tier-I capital should be considered the most appropriate way to prevent it from turning nonviable.

Rationale and key rating drivers

Ratings assigned to debt instruments of ESAF Small Finance Bank Limited (ESAF SFB) continue to factor in its established track record in the lending business especially in microfinance business with consistent increase in scale of operations, adequate capitalisation levels post successful completion of IPO in November 2023, and adequate liquidity position. Ratings also take note of improving profitability indicators with return on total assets (ROTA) of 1.84% in FY24 as against 1.60% in FY23. However, ratings are constrained by regionally concentrated business, limited diversification in loan portfolio, which mainly consists of micro finance loans. Ratings factor in moderating asset quality indicators with increase in gross non-performing assets (GNPA) and net NPA (NNPA) levels owing to higher slippages. GNPA stood at 4.76% as on March 31, 2024, as against 2.49% 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:

- Increasing scale of operations while maintaining adequate capitalisation levels.
- Improving asset quality with net stressed assets/Net worth below 10%.
- Improving in geographical diversification and product diversification.

Negative factors

- Deteriorating capitalisation with overall capital adequacy ratio (CAR) below 18%.
- Weakening asset quality performance with gross stressed assets of above 7% of advances.

Analytical approach: Standalone

Outlook: Stable

The 'Stable' outlook factors in CARE Ratings Limited's (CARE Ratings) expectation that ESAF Small Finance Bank will be able to maintain profitability, while maintaining adequate capitalisation levels with growing scale of operations.

Detailed description of key rating drivers

Key strengths

Established track record of the bank

ESAF SFB is promoted by K Paul Thomas, who is the promoter of the Kerala-based ESAF group, operating in the microfinance space since 1995 (ESAF Microfinance started its operations as an NGO as Evangelical Social Action Forum) and set up ESAF Microfinance & Investments Private Limited (EMFIL) in 2007. EMFIL subsequently got small finance bank (SFB) license and started its banking operations from March 2017 onwards. K Paul Thomas holds 6.06% stake in ESAF SFB as on March 31, 2024. He has over 34 years of industry experience, of which, more than 25 years are in the microfinance sector. He is supported by a well-

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

qualified and experienced management team, having rich experience in the banking and financial services sector. As on March 31, 2024, the bank's board consisted of 11 directors, including five independent directors, two nominee directors and one non-executive director apart from Chairman, MD and one executive director, having rich experience in the banking and financial services industry.

Adequate capitalisation levels
With completion of equity raise of ₹ 390.7 by way of IPO in November 2023, internal accruals and Tier-II capital raise of ₹280 crore in FY24, capital adequacy levels of bank improved in FY24 with CAR and Tier I CAR at 23.27% and 19.70% respectively as on March 31, 2024, and stood adequately above the regulatory requirements. CARE Ratings expects CAR levels to remain adequate, as the bank is expected to remain profitable in the medium term.

Significant growth in loan book in FY24, however proportion of MFI portfolio continues to remain high
The bank's gross advances increased by 32.9% in FY24 from ₹14,118 crore as on March 31, 2023, to ₹18,772 crore as on March 31, 2024. The bank ventured into non-MFI products such as gold loan, loan against property (LAP), business loans, corporate loans, and agriculture loan, among others. However, microfinance loan book continues to remain high at 68.6% (PY: 71.9%). Next to MFI, Gold loan (Including Agri Gold) constitutes 15.4% of the total advances as on March 31, 2023 (13.4% as on March 31, 2023) and corporate loans forms 4.9% of loan portfolio. CARE Ratings expects the proportion of MFI loans to remain high in the medium term.

Significant growth in deposits in FY24; however, current account savings account (CASA) proportion still remains moderate
The bank's resource profile majorly consists of deposits (76.3% of total liabilities as on March 31, 2024) followed by borrowings. The bank's total deposits grew by 35.5% in FY24 and stood at ₹19,868 crore as on March 31, 2024, as against ₹14,666 crore as on March 31, 2023. In terms of granularity of deposits, 79.5% of total term deposits stood below the ticket size of ₹1.0 crore as on March 31, 2024. The bank's CASA (as a percentage of total deposits) stood at 22.66% as on March 31, 2024, as against 21.39% as on March 31, 2023.

Improving profitability metrics
In FY24, the bank's total income witnessed growth of 35.6% and stood at ₹4,260 crore as against ₹3,142 crore in FY23 aided by healthy increase in interest income of 33.8% in line with growth in advances. Further, non-interest income increased by 53.5% aided by increased commission income and increase in treasury income although recovery from written off accounts witnessed reduction in FY24.

Consequently, the bank's net interest income (NII) has increased by 29.0% and stood at ₹2,370 crore (FY23: ₹1,836 crore). The bank's net interest margin (NIM) witnessed improvement from 9.71% in FY23 to 10.25% in FY24 considering improvement in yield on advances. The bank's operational expenses/ average total assets increased from 6.51% in FY23 to 7.13% in FY24. The bank's Pre-Provisioning Operating Profit (PPOP) improved by 30.1% to ₹1,163 crore in FY24 from ₹894 crore in FY23. However, considering higher provisioning with continued high slippages, credit cost remained at 2.56% in FY24 as against 2.58% in FY23. The bank reported improvement in profitability with profit after tax (PAT) of ₹426 crore in FY24 as against ₹302 crore in FY23. ROTA witnessed marginal improvement from 1.60% in FY23 to 1.84% in FY24. The bank's ability to limit incremental slippages remains critical to maintain its earnings profile.

Key weaknesses
Further moderation in asset quality witnessed in FY24
In FY24, GNPA and NNPA witnessed moderation and stood at 4.76% and 2.26% as on March 31, 2024 (March 31, 2023: 2.49% and 1.13%). The bank's NNPA/ net worth also witnessed moderation from 9.42% as on March 31, 2023, to 16.92% as on March 31, 2024. The moderation in asset quality was attributed mainly on account of issues at grass route levels including change in cash flow pattern of the customers post pandemic and high churn of employees at business correspondents (BC). To address the same The bank's board has approved to reduce the concentration of BC and has decided to discontinue certain specific part of the existing scope of business correspondent services being provided by the major BC partner and takeover the business operations directly from the BC partner.
Gross stressed assets (GNPA + Standard Restructured advances + SR) stood at 4.84% as on March 31, 2024, as against 3.17% as on March 31, 2023, despite the decline in outstanding restructured advances with rundown in restructured book. Standard restructured advances reduced to ₹15 crore as on March 31, 2024 (PY: ₹96 crore). Net stressed assets/net worth stood at 17.49% as on March 31, 2024 (14.59% as on March 31, 2023). Furthermore, the bank had earlier disbursed relief loans to its borrowers who were impacted by COVID-19 pandemic to support their income generation capability until June 2022, post which the bank

has stopped disbursement. Relief loans outstanding as on March 31, 2024, stood at ₹738 crore (3.93% of gross advances) on which delinquencies were relatively higher compared to the micro banking loan book. Going forward, the bank's ability to limit incremental slippages would be critical. At the same time, the bank's loss absorption capacity with adequate pre-provisioning income and adequate Tier I capital is satisfactory.

Regional concentration of loan portfolio with improvement in single state concentration
ESAF SFB continues to be concentrated majorly in Kerala, followed by Tamil Nadu. Kerala constitutes 36.4% of the portfolio (March 31, 2023: 42.1%) and Tamil Nadu constitutes 21.7% of the portfolio as on March 31, 2024 (March 31, 2023: 22.2%). Top three states constitute 68.8% of the portfolio as on March 31, 2024, as against 72.9% of the overall portfolio as on March 31, 2023. The bank has its presence to 23 states and two UTs across 753 branches as on March 31, 2024.

Liquidity: Adequate

Per the bank's structural liquidity statement as on March 31, 2024, it does not have negative cumulative mismatches up to one-year time bucket. Liquidity coverage ratio (LCR) stood comfortable at 139.12% as on March 31, 2024. In addition, the bank consistently maintains excess SLR investments, which provides cushion to its liquidity.

Environment, social, and governance (ESG) risks:

ESAF SFB provides financial access to the unbanked and rural population. With a focus on financial inclusion, the bank aims to reach more rural geographies and extend financial deepening through customised products and services. The bank has adopted a CSR Policy, which contributes an average of up to 5% of the bank's total net profit in the last three fiscal years to carry out social initiatives. The bank recognises the importance of being socially responsible and contributing to uplift the poor, marginalised and needy segments of the society. Given the nature of the bank's business, consumption of resources is limited. With the Green Protocol, Environment Policy and ESG Policy in place, the bank makes the best effort to procure energy-efficient products. Greater adoption of digital platforms has brought in increased efficiencies of operations and additionally ensures substantially reduced dependency on paper. In FY22-23, the bank adopted an E-Signature process for disbursing micro loans.

Applicable criteria

Definition of Default
Rating Outlook and Rating Watch
Bank
Financial Ratios - Financial Sector
Short Term Instruments
Rating Basel III - Hybrid Capital Instruments issued by Banks

About the company and industry

Industry classification

Macroeconomic indicator	Sector	Industry	Basic industry
Financial services	Financial services	Banks	Other bank

ESAF SFB is a Kerala-based small finance bank (SFB), which commenced banking operations on March 10, 2017. The bank was promoted by K. Paul Thomas who is part of the Kerala-based ESAF group operating in microfinance space from 1995 (ESAF Microfinance started its operations as an NGO as Evangelical Social Action Forum) and set up ESAF Microfinance & investments Private Limited (EMFIL) in 2007. EMFIL subsequently received SFB license and started banking operations from March 2017 onwards. ESAF SFB is currently focused on retail banking business with presence in micro-finance, housing finance, business loans, loan against property (LAP), gold loans and providing financing solutions for marginal customers, who lack access to formal banking and financing channels, while providing a comprehensive banking and digital platform for all. The bank received Scheduled status from RBI on December 27, 2018.

ESAF Small Finance Bank completed the process of IPO in November 2023 and raised ₹390.70 crore through fresh issue of shares. As on March 31, 2024, ESAF Financial Holdings Private Limited held 52.94% of the shareholding in ESAF SFB, while Paul Thomas held 6.06%, ESAF Swasraya Multi State Agro Co-operative Society Limited held 4.35%, PNB Metlife India Insurance held 3.74%, Muthoot Finance Limited held 3.64%, Bajaj Allianz Life Insurance Company held 3.06%, PI Ventures held 1.70%, ICICI Lombard General Insurance Company held 1.21% and others (including NRI, FPI among others) stood at 23.3%. As on March 31, 2024, the bank's total deposits stood at ₹19,868 crore and gross advances stood at ₹ 18,772 crore.

Brief Financials (₹ crore)	March 31, 2023 (A)	March 31, 2024 (A)
Total operating income	3,142	4,260
PAT	302	426
Total Assets	20,185	26,040
Net NPA (%)	1.13	2.26
ROTA (%)	1.60	1.84

A: Audited UA: Unaudited; Note: these are latest available financial results

Status of non-cooperation with previous CRA: Brickwork Ratings placed ratings of ESAF Small Finance Bank Limited under Issuer Not Cooperating vide its PR dated April 04, 2024, considering non-submission of requisite information for reviewing ratings on time.

Any other information: Not applicable

Rating history for last three years: Annexure-2

Covenants of rated instrument / facility: Annexure-3

Complexity level of 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
Tier II Bonds (Basel III) -I	INE818W08016	December 30, 2017	10.50%	December 30, 2024	20.00	CARE A; Stable
Tier II Bonds (Basel III) -I	INE818W08024	March 28, 2018	11.50%	March 28, 2025	20.00	CARE A; Stable
Tier II Bonds (Basel III) -I	INE818W08032	June 1, 2018	11.50%	June 1, 2025	40.00	CARE A; Stable
Tier II Bonds (Basel III)- II	INE818W08081	March 31, 2022	11.25%	April 30, 2032	20.00	CARE A; Stable
Lower Tier-II bonds (Basel II)	INE818W08099	September 04, 2023	11.25%	May 04, 2029	85.00	CARE A; Stable
Lower Tier-II bonds (Basel II)	INE818W08107	February 29, 2024	11.10%	February 28, 2034	60.00	CARE A; Stable
Lower Tier-II bonds (Basel II)	INE818W08123	March 20, 2024	11.00%	April 20, 2030	85.00	CARE A; Stable
Lower Tier-II bonds (Basel II)	INE818W08115	March 20, 2024	11.10%	April 20, 2031	50.00	CARE A; Stable
Certificate Of Deposit	Proposed	-	-	Proposed	500.00	CARE A1+

Annexure-2: Rating history for 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 2024-2025	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
1	Bonds-Tier II Bonds	LT	80.00	CARE A; Stable	-	1)CARE A; Stable (22-Feb-24) 2)CARE A; Stable (01-Aug-23) 3)CARE A; Stable (04-Jul-23)	1)CARE A; Negative (27-Dec-22)	1)CARE A; Negative (07-Jan-22)
2	Certificate Of Deposit	ST	500.00	CARE A1+	-	1)CARE A1+ (22-Feb-24) 2)CARE A1+ (01-Aug-23) 3)CARE A1+ (04-Jul-23)	1)CARE A1+ (27-Dec-22)	1)CARE A1+ (07-Jan-22)
3	Bonds-Tier II Bonds	LT	20.00	CARE A; Stable	-	1)CARE A; Stable (22-Feb-24) 2)CARE A; Stable (01-Aug-23) 3)CARE A; Stable (04-Jul-23)	1)CARE A; Negative (27-Dec-22)	1)CARE A; Negative (25-Feb-22)
4	Bonds-Lower Tier II	LT	150.00	CARE A; Stable	-	1)CARE A; Stable (22-Feb-24)	-	-

						2)CARE A; Stable (01-Aug-23)		
5	Bonds-Lower Tier II	LT	130.00	CARE A; Stable	-	1)CARE A; Stable (22-Feb-24)	-	-

LT: Long term; ST: Short term

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

Annexure-4: Complexity level of instruments rated

Sr. No.	Name of the Instrument	Complexity Level
1	Bonds-Lower Tier II	Simple
2	Bonds-Tier II Bonds	Simple
3	Bonds-Tier II Bonds	Simple
4	Certificate Of Deposit	Simple

Annexure-5: Lender details: Not applicable

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