CareEdge RATINGS

Northern ARC Capital Limited

October 07, 2024

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

Details of instruments/facilities in Annexure-1.

Rationale and key rating drivers

The rating assigned to the commercial paper 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 NACL's diversified client base with presence across asset classes and revenue diversification to an extent through fee-based income. The rating also takes note of improved profitability, stable asset quality indicators and good growth in the assets under management (AUM) especially in retail exposures in FY23 and FY24. Rating also takes note of capital raise by issuing compulsory convertible preference shares (CCPS) amounting to ₹382 crore in April 2024 and IPO listing of the company on September 24, 2024, through which, it raised ₹500 crore from the market.

However, the rating is constrained by client concentration risk 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 towards wholesale through diversification into the retail segment largely via co-lending/business correspondence arrangements with other non-banking financial companies (NBFCs) and fintechs. Within the retail segment, exposure to unsecured personal loan has increased significantly in the last three years, where the company has limited track record. The company also has its direct presence in MFI, where the portfolio is originated through its subsidiary Pragati Finserv Private Limited (Pragati) and direct presence in secured MSME (LAP), where portfolio is originated through its own branch network.

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 key rating drivers:

Key strengths

Established track record of operations and Well-established risk management systems

NACL has been in the lending, fund management, and debt placement business for over 15 years and has established relationships with several investors, including banks, NBFCs, mutual funds, offshore investors, and private wealth firms, among others. NACL has enabled funding for over 300 partner institutions in segments including microfinance, affordable housing finance, small business loans, commercial vehicle (CV) finance, agricultural 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. NACL's board consists of nine directors, including four independent directors and three nominee directors. NACL has a strong senior management team to manage functions, such as risk, business, and technology, among others.

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

Over the years, NACL has 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 and risk teams assess credit risk profiles of entities at time of onboarding and on a continuous basis, which is reviewed by the credit committee. NACL has developed strong underwriting guidelines for onboarding clients across asset classes. Due diligence conducted by risk and origination teams measure the entity's quality against underwriting guidelines, including an assessment of 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 transactions monthly. The collection and recovery status are monitored daily. Apart from monitoring at the HO, field visits are conducted by NACL's risk monitoring team, where team members visit offices or branches of each client. NACL has strengthened the risk management systems by deploying field level personnel for monitoring the portfolio. NACL's strong risk policies mitigate inherent risks associated with these asset classes.

NACL has its own in-house technology platform called Nimbus, which is an end-to-end curated credit platform. 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 and international) and debt seekers to a common, curated platform. There is system integration with partners through NPoS – a cloud based co-lending platform. NACL also has its wealth management platform, Altifi, which enables retail investors to invest in transactions under-written by the company.

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 32% in FY24 and stood at ₹11,710 crore as on March 31, 2024 as against ₹8,872 crore as on March 31, 2023. As on March 31, 2024, NACL's AUM comprised advances to clients (NBFCs and MFIs) (35%), advances to retail via partners (26%), investment in debt instruments (13%), Direct Retail through branch network (20%), Corporate Finance (Mid-Market) (5%) and investments in alternative investment funds (AIF) (1%). NACL has forayed into secured MSME (LAP) through its own branch network. In addition to sector diversification, NACL is also focusing on segment diversification. Over s, share of direct to customer segment has been going up. Retail exposures through partners comprise 26% of the AUM as on March 31, 2024, as against 18% as on March 31, 2023.

In FY23, NACL completed the transaction of business transfer of S.M.I.L.E Microfinance and ventured into direct retail lending of MFI loans through Pragati (a wholly owned subsidiary of NACL) acting as BC partner and ventured into direct retail lending of secured MSME LAP, SCF and education loans (EL). Total direct to customer book (partnership + direct retail) stood at 46% of the AUM as on March 31, 2024 (PY:33%). NACL also lends to mid-market (Non-Fis) clients, which comprises 5% AUM as on March 31, 2024. To maintain the retail book's asset quality, NACL invested in building a 75 member robust collection framework with manpower and technology to ensure gatekeeping throughout credit cycle of the customer.
Going forward, CARE Ratings expects direct-to-customer exposure to increase and will continue to monitor its performance.

Comfortable capitalisation levels

NACL's capital adequacy ratio (CAR) and Tier-I CAR declined to 18.26% and 18.07% as on March 31, 2024, against 20.77% and 20.15%, respectively, as on March 31, 2023, considering growth in AUM. Gearing levels increased to 4.0x (per CARE Ratings' calculation) as on March 31, 2024, against 3.8x as on March 31, 2023. The company raised ₹382 crore as CCPS in April 2024 and raised another ₹500 crore through IPO listing in September 2024. The present capitalisation levels will be sufficient to fund growth envisaged by the management in the medium term.

Diversified funding profile

Of the total borrowings, share of bank term loans stood at 63% as on March 31, 2024 (PY: 62%), followed by external commercial borrowings (ECBs)/offshore at 8% (PY: 15%), domestic NCDs at 11% (PY: 17%), loans from FIs at 10% (PY: 6%), CP at 5% (PY:1%) and PTC at 3% (PY: 0%). With respect to investor-wise share of borrowings, 68.7% is from banks, followed by financial institutions (including offshore funds) (22.1%), from NBFCs (6.5%) and mutual funds and wealth management firms (2.6%).

Stable asset quality indicators

GNPA and net NPA (NNPA) improved in the last three years considering improved recoveries and write-offs. GNPA and NNPA stood at 0.45% and 0.08%, respectively, as on March 31, 2024, against 0.77% and 0.40%, respectively, as on March 31, 2023, considering write-off amounting ₹323 crore as on March 31, 2024. The company write-offs loans in partnership based lending book, when the portfolio crosses 90+ DPD, however, realisation from partners FLDG is subsequently shown as recovery. Among the direct-to-customer segment, partnership-based loans had 90+ DPD of 0.36% as on March 31, 2024, against 1.13% as on March 31, 2023. The company has a default loss guarantee (DLG) cover against the book. With growing direct to customer book, the company has also set up a separate collections team to facilitate partners as required. CARE Ratings expects asset quality to remain stable in the medium term.

Improved profitability indicators in FY24 and revenue diversification through fee-based income

NACL's profit after tax (PAT) improved significantly in FY24 to ₹280 crore on standalone basis (₹318 crore on consolidated basis) in FY24 from ₹225 crore on standalone basis (₹242 crore on consolidated basis) in FY23. The net interest margin (NIM) improved in FY24 from FY23 considering an improvement in yields, with an increase in the proportion of the direct-to-customer book. Opex (excluding fee and commission expenses) stood at ₹305 crore in FY24, considering increase in the retail book. Pre-provision operating profit (PPOP) grew by 46% (y-o-y) to ₹499 crore in FY24 from ₹341 crore in FY23. The credit cost, as a percentage of total assets, increased to 1.19% in FY24 from 0.45% in FY23 considering net write off amounting to ₹98 crore.

NACL reported a ROTA of 2.71% in FY24 against 2.66% in FY23. CARE Ratings expects profitability to remain stable in the medium term.

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. In FY24, fee-based income stood at ₹42 crore against ₹56 crore in FY23.

Key weaknesses

Client concentration risk

Top 10 exposures account for 12% of the AUM (PY: 15%) and 63% of the net worth (PY: 75%) as on March 31, 2024. CARE Ratings observes that the company's ability to keep its asset quality under control remains critical, since slippage in high ticket loans, may have a significant impact on asset quality and profitability.

Significant increase in non-institutional loan book from FY23; performance of which remains a key monitorable

NACL primarily worked as an arranger to raise debt capital for small and mid-size companies, especially intermediate finance (Fis) in the past. However, a gradual shift is being observed from intermediate lending to direct to customer credit. It has been taking steps to reduce the concentration towards intermediate lending exposures. NACL also increased its exposure to the direct retail segment, with MFI loans through Pragati as BC partner, through direct secured MSME LAP, SCF and education loans since FY23. Partnership-based loans constitute 26% of the overall AUM, of which 19% of the portfolio is towards consumer finance. The intermediate lending, direct-to-customer (partnership and retail) and corporate finance composition stood at 49%, 46% and 5% respectively, as on March 31, 2024. Performance of the direct-to-customer book remains a key monitorable.

Liquidity: Adequate

The liquidity profile is adequate, with no negative cumulative mismatches in any of time buckets in the asset liability management (ALM) statement as on June 30, 2024. The company had cash and cash equivalents of ₹522 crore and un-availed lines of credit stood at ₹274 crore as on June 30, 2024, with loan coverage ratio (LCR) higher than required regulatory levels.

Applicable criteria

Definition of Default
Rating Outlook and Rating Watch
Financial Ratios - Financial Sector
Short Term Instruments
Non Banking Financial Companies

About the company and industry

Industry classification

Macroeconomic 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, through securitisation, debentures, and co-lending. It also provides loans to these entities and generally invests in subordinated tranches of securitisation pools. 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. NACL expanded 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. NACL ventured into Retail through MFI, Supply Chain Finance (SCF), LAP, Education Loan.

NACL has four wholly owned subsidiaries:

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

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

iii) Pragati Finserv Private Limited, which was incorporated in FY21 to offer 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.

On a fully-diluted basis, 23.55% stake of NACL is held by IIFL Special Opportunities Fund and its series, 20.74% stake is held by Leapfrog Financial Inclusion India Limited, 17.93% is held by Augusta Investments Pte Limited, 9.42% is held by Eight Roads Investments Mauritius (II) Limited, 6.88% is held by Dvara Trust, 5.33% is held by Accion Africa-Asia Investment Company, 4.85% is held by Sumitomo Mitsui Banking Corporation, and the remaining by Northern Employee Welfare Trust, and the company's directors and senior management as on June 30, 2024,.

Brief Financials (₹ crore) (Standalone)	FY23(A)	FY24(A)
Total income	1,257	1,848
PAT	225	280
Interest coverage (times)	1.54	1.52
Total assets	9,136	11,552
Net NPA (%)	0.40	0.08
ROTA (%)	2.66	2.71

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

Status of non-cooperation with previous CRA: Not applicable

Any other information: Not applicable

Rating history for last three years: Annexure-2

Detailed explanation of 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 (DD-MM-YYYY)	Coupon Rate (%)	Maturity Date (DD-MM-YYYY)	Size of the Issue (₹ crore)	Rating Assigned and Rating Outlook
Commercial Paper-Commercial Paper (Standalone)	INE850M14CD8	30-08-2024	9.15%	02-05-2025	25.00	CARE A1+
Commercial Paper-Commercial Paper (Standalone)	INE850M14BY6	29-02-2024	9.90%	28-02-2025	100.00	CARE A1+
Commercial Paper-Commercial Paper (Standalone)	INE850M14CB2	16-08-2024	9.60%	14-08-2025	50.00	CARE A1+
Commercial Paper-Commercial Paper (Standalone)	INE850M14CA4	22-08-2024	9.60%	21-08-2025	50.00	CARE A1+
Commercial Paper-Commercial Paper (Standalone)	Proposed	-	-	-	275.00	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	Commercial Paper-Commercial Paper (Standalone)	ST	500.00	CARE A1+	-	1)CARE A1+ (26-Oct-23) 2)CARE A1+ (31-Aug-23)	1)CARE A1+ (01-Sep-22)	1)CARE A1+ (02-Mar-22) 2)CARE A1+ (02-Sep-21)

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	Commercial Paper-Commercial Paper (Standalone)	Simple

Annexure-5: Lender details

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

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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