

ESAF Small Finance Bank Limited

February 25, 2022

Rating

Facilities/Instruments	Amount (Rs. crore)	Rating ¹	Rating Action
Proposed Tier II Bonds (Basel III) #	300.00	CARE A; Negative (Single A; Outlook: Negative)	Assigned
Total Long-term Instruments	300.00 (Rs. Three hundred crore only)		

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, the difficulties faced by a bank should be such that these are likely to result in financial losses and raising the Common Equity Tier I capital of the bank should be considered as the most appropriate way to prevent the bank from turning non-viable. In CARE Ratings Ltd's opinion, the parameters considered to assess whether a bank will reach the PONV are similar to the parameters considered to assess rating of Tier II instruments even under Basel II. CARE Ratings Ltd has rated the Tier II bonds under Basel III after factoring in the additional feature of PONV.

Detailed Rationale & Key Rating Drivers

The ratings assigned to the debt instruments of ESAF Small Finance Bank Limited (ESAF SFB) continue to factor-in the experience of the promoter and management team in the lending business, the group's significant experience in microfinance loans, adequate capitalisation levels and adequate liquidity position. The ratings are, however, constrained by regionally concentrated nature of business, limited diversification in loan portfolio, which mainly consists of micro finance loans and moderate asset quality.

The ratings also take note of moderation in profitability indicators in FY21 (refers to the period April 01 to March 31) and 9MFY22 (refers to the period April 01 to December 31) on account of higher credit cost due to impact of COVID-19 pandemic on the asset quality of the bank. The loss coupled with high growth in advances led to decline in capitalisation levels with bank reporting total capital adequacy ratio (CAR) of 19.26% as on December 31, 2021, as against 24.23% as on March 31, 2021. The company is in the process of mobilising fresh equity capital and filed draft red herring prospect (DRHP) with SEBI in July 2021. Timely mobilisation of equity capital is critical for strengthening the CAR levels and absorb any further increase in the credit cost.

The asset quality of the bank has moderated with gross non-performing assets (GNPA) and net non-performing assets (NNPA) increasing to 6.70% and 3.88% as on March 31, 2021, as against 1.53% and 0.64% as on March 31, 2020. The bank has outstanding restructured advances of Rs.1,282 crore as on December 31, 2021, under COVID-19 resolution framework 1.0 and 2.0. Gross stressed assets (GNPA + Standard Restructured assets) stood at 18.25% as on December 31, 2021 (6.92% as on March 31, 2021). Consequent to restructuring, GNPA and NNPA stood at 6.57% and 1.98% as on December 31, 2021.

Outlook: Negative

The negative outlook reflects continued pressure on asset quality considering the ongoing impact of Covid-19, which may negatively affect the profitability in the immediate term. ESAF SFB disbursed relief loans to the existing customers, which constitute 31% of gross advances as on December 31, 2021. These loans are extended for the purpose of income generation activities of the borrowers in the MFI sector. The performance of restructured portfolio and relief loan book remains a key monitorable, considering the impact of COVID-19-induced pandemic on the borrowers. The bank is in the process of raising equity through IPO to shore up its capitalisation and fund the growth in the loan portfolio. The outlook may be revised to stable if the bank is able to mobilise substantial equity capital in a timely manner or demonstrates satisfactory asset quality performance with sharp reduction in the restructured loan portfolio and relief loan portfolio.

Rating Sensitivities

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

- Increase in the scale of operations along with significant reduction in gross stressed assets and improvement in capital adequacy levels.
- Improvement in geographical diversification and product diversification.

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

- Further weakening of asset quality parameters along with fall in overall CAR below 18%.
- Weak asset quality performance of relief loans.

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

Detailed description of the key rating drivers

Key Rating Strengths

Experience of promoter and management team

ESAF SFB was promoted by Mr K Paul Thomas, who is the founder of the ESAF group, and holds 6.94% stake in ESAF SFB as on September 30, 2021. He has over 33 years of industry experience, of which more than 25 years are in the microfinance sector. He is supported by a well-qualified and experienced management team having rich experience in the banking and financial services sector. As on September 30, 2021, the bank's board consisted of eight directors, including four independent directors who have rich experience in the banking and financial services industry.

Adequate capitalisation levels

Bank's CAR and Tier 1 CAR stood comfortable at 24.23% and 21.54%, respectively, as on March 31, 2021, as against 24.03% and 20.99% as on March 31, 2020 (minimum regulatory requirement of 15% and 7.5%). ESAF SFB raised Tier 1 capital aggregating to Rs.162.58 crore via private placement in March 2021. The bank's tangible net worth stood at Rs.1,316 crore as on March 31, 2021. However, on account of higher growth in advances coupled with loss in 9MFY22 (the bank reported loss of Rs.51 crore), the capitalisation levels declined. Total CAR and Tier 1 CAR declined to 19.26% and 16.81% as on December 31, 2021.

Significant growth in advances in FY21 and 9MFY22; however, share of MFI loans continues to be high

ESAF SFB's gross advances grew by 27% during FY21 and stood at Rs.8,415 crore as on March 31, 2021 (PY: Rs.6,607 crore) and during 9MFY22, advances grew by 27% as compared with March 31, 2021, and stood at Rs.10,682 crore as on December 31, 2021. The bank ventured into new products like Loan against Property (LAP), business loans, corporate loans, gold loan, etc. Nevertheless, the microfinance loan book stood at 87% of the advances as on December 31, 2021 (85% of the assets under management [AUM] as on March 31, 2021) as against 93% of the AUM as on March 31, 2020. Next to MFI loans, gold loans stood at Rs.606 crore as on December 31, 2021. The bank has also disbursed Relief Loan to its non-delinquent customers in 9MFY22 in order to support the income generation capability of the clients, which stood at Rs.3,283 crore as on December 31, 2021 (31% of advances).

Significant improvement in deposits in FY21 and 9MFY22

The bank's resource profile majorly consisted of deposits followed by borrowings and sub-debt at 84%, 14% and 2% of the total borrowings as on March 31, 2021 (PY: 85%, 12% and 3%, respectively, as on March 31, 2020). The total deposits grew by 28% during FY21 and stood at Rs.8,999 crore as on March 31, 2021, as against Rs.7,028 crore as on March 31, 2020 (PY: Rs.4,317 crore).

During 9MFY22, deposits grew by 30% and stood at Rs.11,695 crore as on December 31, 2021. The bank's current account savings account (CASA; as percentage total deposits) stood at 19.42% as on March 31, 2021 (PY: 13.66% as on March 31, 2020) and 21.76% as on December 31, 2021.

Key Rating Weaknesses

Moderation in profitability metrics during FY21 and 9MFY22

The bank reported PAT of Rs.105 crore on a total income of Rs.1,767 crore during FY21 as against Rs.190 crore on a total income of Rs.1,546 crore during FY20. During FY21, the interest income (as a percentage of average interest earning assets) reduced to 16.30% (PY: 18.39%) on account of increase in slippages and increase share of low yield advances and the cost of funds (as a percentage of average interest-bearing liabilities) declined to 7.60% in FY21 (PY: 8.72%), thereby NIM declined to 8.47% in FY21 (PY: 9.60%). The operating expenses (as a percentage of average total assets) improved to 5.81% in FY21 from 7.28% in FY20. PPOP witnessed improvement of around 28% to Rs.416 crore in FY21 from Rs.325 crore in FY20. Credit costs (as percentage average total assets) 2.52% in FY21 from 0.83% in FY20. The bank held additional Rs.40 crore of provision on account of Covid-19 as on March 31, 2021. Thus, with decline in yields and increase in credit cost, the bank reported return on total assets (ROTA) of 0.97% in FY21 as against 2.31% in FY20.

During Q3FY22, the bank reported a profit of Rs.57 crore on a total income of Rs.566 crore as against loss of Rs.92 crore during Q2FY22. On a cumulative basis, the loss stood at Rs.51 crore during 9MFY22 as against loss of Rs.107 crore during H1FY22. (PAT of Rs.62 crore in 9MFY21). During 9MFY22, the bank reported PPOP of Rs.334 crore (Rs.359 crore in 9MFY21). With moderation in asset quality and restructured accounts in place, credit cost is expected to further impact the profitability in the near term.

Moderation in asset quality parameters during FY21 and 9MFY22

Asset quality moderated in FY21 with GNPA and NNPA stood at 6.70% and 3.88% as on March 31, 2021, as against 1.53% and 0.64% as on March 31, 2020. Benefitting from restructuring framework, GNPA and NNPA maintained at 6.57% and 1.98%, respectively, as on December 31, 2021. Standard restructured advances stood at 11.68% of gross advances as on December 31, 2021 (15.95% as on September 30, 2021). Gross stressed assets (GNPA+Standard Restructured advances) stood at 18.25% as on December 31, 2021 (22.25% as on September 30, 2021).

Regional concentration of loan portfolio

ESAF SFB's AUM continues to remain concentrated in Kerala at 49% of AUM as on December 31, 2021 (56% as on March 31, 2021). The top two states constitute 71% of the overall portfolio as on December 31, 2021. The bank has improved its presence to 21 states across 552 branches as on September 30, 2021 (21 states across 483 branches as on September 30, 2020). During Q3FY22, ESAF SFB expanded into two new states and currently has presence in 23 states as on December 31, 2021.

Impact of Covid-19

Gross NPA and net NPA moderated and stood at 6.70% and 3.88% as on March 31, 2021, as against 1.53% and 0.64% as on March 31, 2020. During 9MFY22, with grant of relief measures such as OTR and ECLGS, GNPA was maintained at 6.57% as on December 31, 2021. Collection efficiency has witnessed improvement from September 2021 onwards. ESAF has also disbursed relief loan to its borrowers in order to support their income generation capability who were impacted by Covid-19 pandemic.

Liquidity: Adequate

As per structural liquidity statement of the bank as on December 31, 2021, the bank does not have negative cumulative mismatches up to 6-month time bucket. Also, the liquidity coverage ratio (LCR) stood comfortable at 149% as on December 31, 2021. In addition, the bank had excess SLR investments of Rs.1,448 crore as on December 31, 2021, which remained favourable from the liquidity perspective.

Analytical approach: Standalone

Applicable Criteria

[Criteria on assigning 'Outlook' and 'Credit Watch' to Credit Ratings](#)

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

[Financial Ratios-Financial Sector](#)

[CARE's Rating Methodology for Banks](#)

[Rating Basel III - Hybrid Capital Instruments issued by Banks](#)

[Criteria for Short term Instruments](#)

About the Bank

ESAF Small Finance Bank (ESAF SFB) is a Kerala-based Small Finance Bank (SFB), which has commenced its banking operations on March 10, 2017. The bank was promoted by Mr K. Paul Thomas who is a part of the Kerala-based ESAF group operating in Microfinance space from 1995 and set up ESAF Microfinance & investments Pvt. Limited (EMFIL) in 2007. EMFIL subsequently got SFB license and started its banking operations from March 2017 onwards. ESAF SFB is currently focused in 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 the 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. As on September 30, 2021, ESAF Financial Holdings Private Limited held 62.46% of the shareholding in ESAF SFB, while Mr Paul Thomas holding 6.94%, ESAF Swasraya Multi State Agro Co-operative Society Ltd holding 4.98%, PNB Metlife India Insurance holding 4.75%, Muthoot Finance Ltd holding 4.16%, Bajaj Allianz Life Insurance Company holding 3.89%, PI Ventures holding 1.94%, ICICI Lombard General Insurance Company holding 1.38%, and individual investors holding the remaining. As on December 31, 2021, total deposits of the bank stood at Rs.11,695 crore and AUM stood at Rs.10,682 crore.

Brief Financials (Rs. crore)	FY20(A)	FY21(A)	9MFY22(P)
Total operating income	1,546	1,767	1,501
PAT	190	105	-51
Interest coverage (times)	1.52	1.58	1.58
Total Assets	9,459	12,303	15,531
Net NPA (%)	0.64	3.88	1.98
ROTA (%)	2.31	0.97	NM

A: Audited; P: Provisional

Status of non-cooperation with previous CRA: Not Applicable

Any other information: Not Applicable

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

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

Complexity level of various instruments rated for this company: Annexure 4

Annexure-1: Details of Instruments / Facilities

Name of the Instrument	ISIN	Date of Issuance	Coupon Rate	Maturity Date	Size of the Issue (Rs. crore)	Rating assigned along with Rating Outlook
Proposed Tier II Bonds (Basel III)	-	-	-	Proposed	300.00	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 2021-2022	Date(s) & Rating(s) assigned in 2020-2021	Date(s) & Rating(s) assigned in 2019-2020	Date(s) & Rating(s) assigned in 2018-2019
1	Fund-based - LT-Term Loan	LT	-	-	-	-	1)Withdrawn (06-Mar-20)	1)CARE A; Stable (25-Jan-19)
2	Bonds-Tier II Bonds	LT	125.00	CARE A; Negative	1)CARE A; Negative (07-Jan-22)	1)CARE A; Stable (05-Mar-21)	1)CARE A; Stable (06-Mar-20)	1)CARE A; Stable (25-Jan-19)
3	Certificate Of Deposit	ST	500.00	CARE A1+	1)CARE A1+ (07-Jan-22)	1)CARE A1+ (05-Mar-21)	1)CARE A1+ (06-Mar-20)	1)CARE A1+ (12-Mar-19)
4	Bonds-Tier II Bonds	LT	300.00	CARE A; Negative				

* Long Term / Short Term

Annexure-3: Detailed explanation of covenants of the rated instrument / facilities: NA**Annexure 4: Complexity level of various instruments rated for this company**

Sr. No	Name of instrument	Complexity level
1	Bonds-Tier II Bonds	Complex

Note on complexity levels of the rated instrument: CARE Ratings Ltd. 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 CARE Ratings Limited:

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With an established track record of rating companies over almost three decades, we follow a robust and transparent rating process that leverages our domain and analytical expertise backed by the methodologies congruent with the international best practices. CARE Ratings Limited has had a pivotal role to play in developing bank debt and capital market instruments including CPs, corporate bonds and debentures, and structured credit.

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