AU Small Finance Bank Limited

July 27, 2022

Ratings

Facilities/Instruments	Amount (Rs. crore)	Rating[1]	Rating Action
Tier-II Bonds	300.00	CARE AA; Stable (Double A; Outlook: Stable)	Assigned
Tier-II Bonds	150.00	CARE AA; Stable (Double A; Outlook: Stable)	Assigned
Tier-II Bonds	200.00	CARE AA; Stable (Double A; Outlook: Stable)	Reaffirmed
Total long-term instruments	**650.00 (Rs. Six hundred fifty crore only)**		
Certificate of deposit	500.00	CARE A1+ (A One Plus)	Reaffirmed
Total short-term instruments	**500.00 (Rs. Five hundred crore only)**		

Details of instruments/facilities in Annexure-1.

Detailed rationale and key rating drivers

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, improvement in asset quality parameters during FY22 (refers to the period April 1 to March 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

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

- Significant scale-up of operations with broad basing the advances in terms of products and geographical spread along with maintaining asset quality and profitability on a sustained basis

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

- Deterioration in asset quality, with gross non-performing assets (GNPA) increasing to more than 4% on a sustained basis
- Deterioration in capital adequacy parameters with capital adequacy ratio (CAR) falling below 17% on a sustained basis
- Moderation in profitability parameters with return on total assets (ROTA) falling below 1% on a sustained basis

Detailed description of the key rating drivers

<u>Key rating strengths</u>

Continued growth momentum in business:

The company commenced operations as a SFB from April 2017 and got the status of a Scheduled Commercial Bank (SCB) in November 2017. In the five years of operations as a SFB, the bank has been able to ramp up its operations from 474 touchpoints as on March 31, 2018, to 953 touchpoints (new and converted) across 20 states and two Union Territories, with 29,883 employees on roll, as on June 30, 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 Rs.18,819 crore as on March 31, 2018 to Rs. 68,936 crore as on March 31, 2022 and further to Rs.70,902 crore as on June 30, 2022.
As per the Reserve Bank of India (RBI) guidelines, AUSFB will be eligible to apply for conversion into a universal bank or after a review, RBI may increase its scope of activities after a satisfactory track record of five years of operating as a 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 priority sector reducing from 75% to 40%, the bank's asset strategy would largely continue in

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

line with the current asset profile, and CARE Ratings Limited (CARE Ratings) does not expect the bank to have significant exposure to large-ticket corporate lending for the medium-term, even in case of conversion into a universal bank.

Comfortable capitalisation:
Despite undertaking significant growth in the loan book, AUSFB continues to be sufficiently capitalised as on March 31, 2022 and June 30, 2022, helped by regular capital infusions by way of Qualified Institutional Placement (QIP), stake sale in Aavas Financiers Limited, and steady internal accruals. The bank reported a capital adequacy ratio (CAR) of 19.36% (March 31, 2021: 23.36%) and Tier-I CAR of 18.39% (March 31, 2021: 21.53%) as on June 30, 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.
AUSFB has demonstrated its ability to raise capital in the past, the latest being Rs.626 crore in the month of March 2021. Furthermore, the restriction of promoters to keep their shareholding of a minimum 26% is no longer applicable from April 20, 2022, as the bank completed its five years of its operations as a SFB. 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 SFB in FY18. The deposit franchise has consistently increased from Rs.7,923 crore as on March 31, 2018, to Rs. 52,585 crore as on March 31, 2022, and further to Rs. 54,631 crore as on June 30, 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 retail deposits, AUSFB offered higher interest rates on saving accounts as compared to mainstream banks and undertook extensive marketing exercises. 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 38.8% as on June 30, 2022. The bank continues to granularise 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 49% as on March 31, 2022, and further to 53% as on June 30, 2022, which increases stability in the liability profile. Bulk deposits (over Rs.2 crore) constituted around 47% of the term deposits, as on June 30, 2022. A majority (63%) of the bulk deposits are non-callable, which prevents volatility due to premature withdrawals. While the bank has been increasing its depositor base and the proportion of CASA in the past four years of operating as a 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 a 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 a 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 all the universal banks, ranging between 5-5.5%.
The net interest income (NII) is growing consistently, in line with the growth in advances and deposits. The operating expenses of AUSFB continue to be high and may not come down significantly in the medium-term as the bank is in the expansion phase and because of the digital push. Credit cost[2] improved significantly to 0.6% during FY22 (FY21: 1.5%) 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 2.5%). For FY22, AUSFB reported a NIM of 5.37% (FY21: 5.05%) on account of lower cost of funds and ROTA of 1.88% due to lower credit cost. During Q1FY23, the bank reported profit after tax (PAT) of Rs.268 Crore on total income of Rs. 1,979 Crore as compared to PAT of Rs.346 crore on total income of Rs.1,978 crore during Q4FY22. The decline in PAT is on account of mark to market (MTM) and realised loss of Rs. 55 crore booked in Q1FY23.

[2] Credit cost includes provisions on standard assets and provision for diminution in value of investments

Key rating weaknesses

Improving asset quality after stress during Q4FY21 and Q1FY22:

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 98% 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 1.96% as on June 30, 2022, due to improved collection efficiency of 105% during Q1FY23 and upgrade of various slipped accounts back to standard book in the current year. As on June 30, 2022, the COVID restructured constituted 2.1% of gross advances, respectively, and the provision cover stood at 2.3% of the gross advances, providing cushion against asset quality shocks. Furthermore, the bank has reported that for approximately 99% of the restructured advances billing has commenced and that 16% provision coverage which stood at Rs. 170 crore is sufficient going forward; based on its experience against standard restructured advances of Rs. 1,044 crore outstanding as on June 30, 2022.

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 a SFB, it started new products like business banking, gold loan, agri loan, home loan, etc. As on June 31, 2022, the total wheels segment comprised 37% of the AUM, secured business loans (SBL) was 34%, and other products (which are relatively new) comprised the remaining 29% of the AUM, 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 is yet to be seen.

Regional concentration:

As on June 30, 2022, AUSFB's distribution network is spread around 20 states having 953 touchpoints. Of the 953 touchpoints, 369 touchpoints (39%) are located in Rajasthan, followed by Gujarat having 141 touchpoints (15%), and Madhya Pradesh having 128 touchpoints (13%). These top three states account for 66% of the total branch distribution. In terms of AUM as well, the top three states of Rajasthan, Madhya Pradesh, and Maharashtra collectively constituted 69% of the AUM. The state of Rajasthan alone comprised 40% of the AUM, whereas Maharashtra constituted 12%, and Madhya Pradesh constituted 17%.

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.

Liquidity: Strong

While the ALM profile has certain negative mismatches within the one-year liquidity bucket, it is within the approved limits. 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 FY22. AUSFB's liquidity coverage ratio (LCR) stood at 129% for the quarter-ended June 30, 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 a SFxB, 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.

Analytical approach: Standalone

Applicable criteria

Policy on default recognition
Rating Outlook and Credit Watch
Financial Ratios – Financial Sector
Bank
Short Term Instruments

About the company

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 a SFB from the RBI in December 2016, and commenced banking operations from April 2017. The company received the status of a SCB in November 2017. Post becoming a SFB, it has expanded its product portfolio and geographical footprint. As on June 30, 2022, it has established operations across 953 banking touchpoints serving around 30.7 lakh customers across 20 states and 2 union territories with an employee base of 29,883.

Brief Financials (Rs. crore)	March 31, 2021 (A)	March 31, 2022 (A)	June 30, 2022 (UA)
Total operating income	6,402	6,915	1979
PAT	1,171	1,130	268
Adjusted PAT*	600	1,130	268
Interest coverage (times)	1.84	1.68	1.47
Total Assets#	51,491	68,936	70,902
Net NPA (%)	2.18	0.50	0.56
ROTA (%)	2.50	1.88	1.53
Adjusted ROTA (%)*	1.28	1.88	1.53

A: Audited; UA: Unaudited
Note: All Analytical ratios are as per CARE Ratings' calculations.
*Adjusted for gain from sale of stake in Aavas Financiers Limited.
#Total Assets are adjusted for deferred tax asset

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 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
Bonds- Tier-II Bonds	Proposed	-	-	-	200.00	CARE AA; Stable
Bonds- Tier-II Bonds	Proposed	-	-	-	300.00	CARE AA; Stable
Bonds- Tier-II Bonds	Proposed	-	-	-	150.00	CARE AA; Stable
Certificate of deposit	INE949L16BJ4	NA	NA	August 30, 2022	225.00	CARE A1+
Certificate of deposit	Proposed	7-365 days	-	-	275.00	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 (Rs. 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+ (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 (23-Mar-22)	-	-
4	Bonds- Tier-II Bonds	LT	300.00	CARE AA; Stable				
5	Bonds- Tier-II Bonds	LT	150.00	CARE AA; Stable				

*Long term/Short term.

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

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

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

Annexure-5: Bank lender details for this company

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

Note on 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:
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