ESAF Small Finance Bank Limited

December 27, 2022

Ratings

Facilities	Amount (₹ crore)	Rating[1]	Rating Action
Tier-II Bond (Basel-III)-I	125.00	CARE A; Negative (Single A; Outlook: Negative)	Reaffirmed
Tier-II Bond (Basel-III)-II	300.00	CARE A; Negative (Single A; Outlook: Negative)	Reaffirmed
Total long-term instruments	**425.00 (₹ Four hundred and twenty-five crore only)**		
Certificate of deposits	500.00	CARE A1+ (A One Plus)	Reaffirmed
Total short-term instruments	**500.00 (₹ Five 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. The 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 the most appropriate way to prevent the bank from turning nonviable.

Detailed rationale and 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 business, adequate capitalisation levels albeit moderation during FY22 (refers to the period April 01 to March 31) 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 characterized by relatively high gross stressed assets. It is worthwhile to note that the bank has shown significant reduction in gross stressed assets (GSA) which has come down from 18.25% as on December 31, 2021 to 12.48% as on March 31, 2022 and further to 9.33% as on June 30, 2022. However, with seasoning of relief loan book, there was slight uptick in GSA during September 2022 quarter with significant increase in credit cost profitability witnessing moderation in FY22. However, with sharp increase in PPOP supported by high growth, bank's profitability witnessed improvement in H1FY23 (refers to the period April 01 to September 30).

The asset quality of the bank continued to remain moderate with GNPA and NNPA of 7.83% and 3.92% as on March 31, 2022 and witnessed slight increase to 8.11% and 4.34% as on September 30, 2022 with seasoning of relief loan portfolio. Timely mobilisation of equity capital is critical for strengthening the CAR levels to support growth.

<u>Outlook: Negative</u>

Earlier CARE Ratings had revised the outlook from 'Stable' to 'Negative' in the month of January 2022 on expectation of continued pressure on asset quality & profitability considering the impact of COVID-19. As expected credit cost in FY22 increased to ₹418 crore (PY: Rs.274 crore) thereby impacting profitability of the bank. Supported by strong growth in advances during H2FY22 and continuation of the same in H1FY23, pre-provisioning profit (PPOP) improved from ₹203 crore in H1FY22 to ₹288 crore in H2FY22 and further to ₹451 crore in H1FY23. Going forward PPOP is expected to remain relatively stable. However, increase in delinquencies in relief loan portfolio resulted in slight uptick in GSA during Q2FY23. In the near term, performance of the relief loan portfolio remains monitorable and arresting further slippage from this portfolio is key to improve asset quality. The outlook remains 'Negative' with the asset quality continuing to remain moderate with declining but high share of relief loans which constitutes 31.56% of gross advances as on September 30, 2022. The bank is in the process of raising capital to shore up its capitalisation and fund the growth in loan portfolio. The outlook may be revised to stable if the bank is able to mobilise substantial equity capital or demonstrates satisfactory asset quality performance with significant reduction in stressed assets.

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

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:

- Fall in overall CAR below 18% on a sustained basis.
- Further weakening of asset quality

Detailed description of the key rating drivers

Key rating strengths

Experience of promoter and management team:
ESAF SFB was promoted by K Paul Thomas, who is the founder of the ESAF group, and holds 6.94% stake in ESAF SFB as on September 30, 2022. He has over 34 years of industry experience, of which more than 25 years are in the microfinance sector. He is supported by well-qualified and experienced management team having rich experience in the banking and financial services sector. As on September 30, 2022, the bank's board consisted of eight directors, including five independent directors who have rich experience in banking and financial services industry.

Adequate capitalisation levels:
On account of advances growth of 42% in FY22, bank's CAR and Tier-1 CAR has witnessed moderation to 18.64% and 16.16% respectively as on March 31, 2022 as against 24.23% and 21.54% as on March 31, 2021, however, the same remains adequately above the regulatory requirements (minimum regulatory requirement of 15% and 7.5%). CAR and Tier I CAR improved to 21.18% and 18.80% respectively as on September 30, 2022 aided by profit accretion and diversification in portfolio during H1FY23. The bank's tangible net worth stood at ₹1,347 crore as on March 31, 2022 (₹1,506 crore September 30, 2022). CARE Ratings notes that the bank is in the process of raising capital by way of private placements/bond issuances to shore up the capital adequacy requirements over the medium term. CARE Ratings expects the CAR levels to remain adequate, as the bank is expected to remain profitable in the medium term despite the relatively higher share of gross stressed assets.

Significant growth in advances in FY22; however, share of MFI loans continues to be high:
ESAF SFB's gross advances grew by 42% during FY22 and stood at ₹11,637 crore as on March 31, 2022 (PY: ₹8,168 crore) and advances stood at ₹11,845 crore as on September 30, 2022. The bank ventured into non-MFI products like Loan against Property (LAP), business loans, corporate loans, gold loan, agri loan etc. Nevertheless, the microfinance loan book stood at 83.4% of the advances as on March 31, 2022 as against 84.6% of the AUM as on March 31, 2021. Next to MFI loans, gold loans stood at ₹1,056 crore as on March 31, 2022 (8.7% of AUM). CARE Ratings expects the proportion of MFI loans to remain high in the medium term.

Significant improvement in deposits in FY22:
The bank's resource profile majorly consists of deposits (72.6% of total liabilities as on March 31, 2022) followed by borrowings. The total deposits grew by 42% during FY22 and stood at ₹12,815 crore as on March 31, 2022 as against ₹8,999 crore as on March 31, 2021 which has further improved to ₹13,520 crore as on September 30, 2022. In terms of granularity of deposits, 70.5% of total deposits stood below the ticket size of ₹1.0 crore as on March 31, 2022. The bank's current account savings account (CASA; as percentage of total deposits) stood at 22.84% as on March 31, 2022 (19.42% as on March 31, 2021).

Key rating weaknesses

Moderate profitability metrics during FY22 owing to losses reported during H1FY22 however improvement witnessed post H2FY22:
The bank's profitability has been impacted on account higher provisioning during FY21 and FY22. During FY22, the bank's total income witnessed growth of 21.5% and stood at ₹2,148 crore (FY21: ₹1,767 crore) aided by healthy increase in interest income of 18.2% and in non-interest income by 64.6% aided by pickup in disbursements. Consequently, the bank's Net Interest Income (NII) has increased by 24.5% and stood at ₹1,147 crore (FY21: ₹922 crore) on account of growth in advances. The bank's net interest margin witnessed decline to 7.66% in FY22 (FY21: 8.47%) on account of decline in yield on advances on account of interest reversals due to NPA slippages. Aided by increase in CASA deposits, the bank's cost of deposits reduced to 6.22% during FY22 as against 7.54% during FY21.
The bank's operational efficiency parameters remained stable with operational expenses/ average total assets at 5.76% in FY22 compared to 5.81% in FY21. The bank's Pre-Provisioning Operating Profit (PPOP) improved by 18% to ₹492 crore in FY22 as against ₹416 crore in FY21. However, on account of higher provisioning (excluding tax) of ₹418 crore in FY22 as against ₹274

crore in FY21, the bank reported lower profit of ₹55 crore in FY22 as against ₹105 crore in FY21. ROTA stood low at 0.37% in FY22 (FY21: 0.97%). Increase in provisioning cost is mainly on account of elevated slippages witnessed during FY22 post second wave of COVID-19 and additional provisioning made for the restructured portfolio. However, it may be noted that the profitability of the bank has witnessed significant improvement from Q3FY22 onwards. The bank reported net profit of ₹162.2 crore during H2FY22 as against net loss of ₹107.5 crore in H1FY22. Furthermore, profitability momentum was maintained by the bank during H1FY23 and reported PAT of ₹164 crore with ROTA of 1.83% during H1FY23. Ability of the bank to limit incremental slippages remains critical to maintaining the earnings profile. CARE Ratings expects the profitability to remain relatively stable in H2FY23. However, the bank is expected to report better profits in FY23 than FY22 levels.

Moderate asset quality parameters despite improvement witnessed post H1FY22:
The asset quality parameters of the bank stood moderate with GNPA% and NNPA% at 8.11% and 4.34% respectively as on March 31, 2022 as against 6.70% and 3.88% as on March 31, 2021 due to the impact of the second wave of COVID-19 on the credit profile of borrowers. However, it may be noted that the asset quality parameters of the bank have been on an improving trend post peaking in September 2021. Gross stressed assets (GNPA+ Standard Restructured advances) stood at 10.46% as on September 30, 2022 which improved from 23.88% as on September 30, 2021 due to decline in outstanding restructured advances with rundown in restructured book (2.34% of advances as on September 30, 2022). Net stressed assets/Net worth stood at 49.35% as on September 30, 2022 (136.65% as on September 30, 2021. Furthermore, the bank had also disbursed relief loans to its borrowers in order to support their income generation capability who were impacted by covid-19 pandemic. Relief loans outstanding as on September 30, 2022 stood at ₹3,738 crore (31.56% of gross advances) on which the delinquencies were relatively higher compared to the micro banking loan book. Going forward, ability of the bank to limit incremental slippages from relief loan portfolio 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's AUM continues to remain concentrated in Kerala at 45.6% of AUM as on March 31, 2022 (55.9% as on March 31, 2021). The top three states constitute 77.0% of the overall portfolio as on March 31, 2022. The bank has its presence to 21 states across 576 branches as on September 30, 2022.

Liquidity: Adequate
As per structural liquidity statement of the bank as on September 30, 2022, the bank does not have negative cumulative mismatches up to one-year time bucket. Also, the liquidity coverage ratio (LCR) stood comfortable at 155.7% as on September 30, 2022. In addition, the bank consistently maintains excess SLR investments which provide cushion to the bank's liquidity profile. Liquidity is also supported by the refinance lines available to it from SIDBI, NABARD and MUDRA.

Analytical approach
Standalone

Applicable criteria
Criteria on Assigning 'Outlook' or 'Rating Watch' to Credit Ratings
Policy on Default Recognition
Financial Ratios-Financial Sector
Rating Methodology - Banks
Criteria for Rating Basel III - Hybrid Capital Instruments issued by Banks
Criteria for Short Term Instruments

About the company
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 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, 2022, ESAF Financial Holdings Private Limited held 62.46% of the shareholding in ESAF SFB, while 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 September 30, 2022, total deposits of the bank stood at ₹13,520 crore and AUM stood at ₹11,845 crore.

Brief Financials (₹ crore)	March 31, 2021 (A)	March 31, 2022 (A)	September 30, 2022 (Prov)
Total income	1,767	2,148	1,507
PAT	105	55	164
Total Assets	12,303	17,643	18,177
Net NPA (%)	3.88	3.92	4.34
ROTA (%)	0.97	0.37	1.83

A: Audited; Prov: Provisional.

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 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-I	INE818W08016	30-12-2017	10.50%	30-12-2024	20.00	CARE A; Negative
Bonds-Tier II bonds-I	INE818W08024	28-03-2018	11.50%	28-03-2025	20.00	CARE A; Negative
Bonds-Tier II bonds-I	INE818W08032	01-06-2018	11.50%	01-06-2025	40.00	CARE A; Negative
Bonds-Tier II bonds-I	Proposed	-	-	-	45.00	CARE A; Negative
Bonds-Tier II bonds-II	INE818W08081	31-03-2022	11.25%	30-04-2032	20.00	CARE A; Negative
Bonds-Tier II bonds-II	Proposed	-	-	-	280.00	CARE A; Negative
Certificate of Deposits	Proposed	-	-	-	500.00	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 (₹ 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 (06-Mar-20)
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)
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)
4	Bonds-Tier II Bonds	LT	300.00	CARE A; Negative	-	1)CARE A; Negative (25-Feb-22)	-	-

*Long term/short term.

Annexure-3: Detailed explanation of the covenants of the rated instruments/facilities: Not Applicable. No financial/non-financial covenants stipulated.

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

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

Annexure-5: Bank lender details for this company: Not applicable

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.

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About us:
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