Suryoday Small Finance Bank Limited

October 10, 2017

Ratings

Instruments/facilities	Rated Amount (Rs. crore)	Rating[1]	Rating Action
Non-Convertible Debenture	110	**CARE A-; Stable [Single A Minus; Outlook :Stable]**	**Reaffirmed**
Commercial Paper	175	**CARE A1 [A One]**	**Reaffirmed**
Bank Facilities	150	**CARE A-; Stable/ CARE A1 [Single A Minus; Outlook: Stable] / [A One]**	**Reaffirmed**
Total	**435 (Rupees four hundred and thirty five crore only)**		

Details of instruments/facilities in Anneuxre-1
Note: All facilities/Instruments were transferred from Suryoday Microfinance Ltd (SMFL; rated CARE A-; Stable/CARE A1) to Suryoday Small Finance Bank Limited upon approval of registrar of companies, Maharashtra, for change of name from Suryoday Micro Finance Limited to Suryoday Small Finance Bank Limited dated January 13, 2017.

Rating Rationale and Key Rating Drivers

The rating factors in Suryoday Small Finance Bank's experienced promoters and management team, strong investor profile, diversified resource base and comfortable liquidity position. The ratings also factor the comfortable capitalization level which is expected to take care of provisioning/write-off of loans. The rating however takes note of the deterioration in the collection efficiency and asset quality post demonetization which has impacted the profitability in the short term. The rating are also constrained by moderate geographic concentration and lack of diversity in earnings profile and the inherent risk involved in the microfinance segment including socio-political intervention risk and due to unsecured lending. Going forward, the ability of the bank to improve its collection efficiency in micro finance portfolio and overall asset quality and maintain adequate capitalization levels would be crucial. Also, ability to grow the loan portfolio and geographically diversify the operations, improve earnings and profitability, successfully stabilize the operations as an SFB (Small Finance Bank) including raising low cost deposits and refinance loans and consequently diversify the product mix would remain the key rating sensitivities.

Detailed description of the key rating drivers
Key Rating Strengths
Experienced management team

SSFB has been carrying out micro lending activities since 2009 and has gained reasonable experience in the group lending business. SMFL was promoted by Mr. R Baskar Babu, Managing Director and Chief Executive Officer, who has extensive experience of over 25 years in banking & financial sector having previously Cholamandalam, HDFC Bank and GE Commercial Finance. He is assisted by senior management team having rich experience in the financial services and microfinance sector.

With the transition into a SFB, the product mix is expected to gradually move towards LAP, MSME and affordable housing loans; although JLG loans would continue to contribute to the product mix majorly. The bank has consequently appointed business heads for each of the product verticals. The general banking branches are expected grow to 36 by the end of FY18. Also, given the larger scope of operations as an SFB, a number of new departments such as Treasury, Risk, IT, Legal & Compliance and Liability have been created and senior personnel with extensive experience from the banking domain have been appointed. Core banking Solution has also been implemented for transition to banking operations.

[1] *Complete definition of the ratings assigned are available at www.careratings.com and other CARE publications*

Strong Investor base and comfortable capital adequacy ratio and low overall gearing

The company has a strong investor base in Sarva Capital (Formerly LOK Capital, 9.55%), International Finance Corporation (6.85%), DMW Mauritius Ltd (6.84%), Responsability Participations Mauritius (4.95%), Gaja Capital Fund II Limited (4.71%). SSFB has been able to raise equity capital from investors and promoters on a continued basis. During FY17 company raised Rs.289.27 crores by way of Rights issues, Private Placement issues and Preferential Allotment issues in various tranche. As on March 31, 2017, SMFL's CAR was 53.62% with Tier I ratio of 47.95%. Overall gearing ratio was at 2.04 times as on March 31, 2017 as compared to 4.84 times as on March 31, 2016.

Diversified resource base and comfortable liquidity profile

The company has raised debt from various sources mainly through Term loans from banks and NCDs from constituting 45.53% and 34.61% respectively of the overall debt of Rs.1,021.57 crore as on March 31, 2017. SSFB has also accessed both Securitization (PTC) and Assignment route for tapping funds. The off-balance sheet portfolio as on March 31, 2017 stood at Rs.132 crore (Rs.56.85 crore as on March 31, 2016).

As on March 31, 2017, SSFB's liquidity profile was comfortable with positive mismatches across the time buckets up to 1 year. The liquidity profile was comfortable due to shorter tenure of majority of its loan portfolio as compared to its borrowings. Further the bank's SLR stood at Rs.460.3 crore which is 45.9% of the net demand and time liabilities as against 20% required by RBI guidelines. The proportion of the secured debt from banks and capital markets is likely to come down as the proportion of deposits and refinance loans increases; however ability of the SSFB to raise capital and diversify borrowings through deposits is key rating sensitivity.

Key Rating Weaknesses

Impact on asset quality

SSFB had been able to maintain asset quality at comfortable levels over the years. However, demonetization resulted in the overall collections of SSFB declining to around 90% for the period November 8, 2016-March 31, 2017 as against nearly 100% collections previously. As a result of demonetization, SSFB witnessed sharp deterioration in asset quality during FY17. SSFB's Gross NPA ratio increased sharply to 6.15% (P.Y.: 0.16%) and Net NPA ratio to 3.80% (P.Y.: 0.04%) as on March 31, 2017.

As per RBI rules, bank has to make 25% provision on substandard unsecured loan and 100% provision on doubtful unsecured loan. SSFB's provision expenses sharply increased to Rs.13.85 crore from Rs.4.52 crore in FY17. The bank observed significant deterioration asset quality post demonetisation primarily in the state of Maharashtra, which constitute 33% of total outstanding portfolio. As on June 30, 2017, SSFB's GNPA and NNPA stood at 8.40% and 5.65% respectively.

Impact on profitability

SSFB's portfolio grew at a compounded annual growth rate (CAGR) of 25% over a period of three years ended March 31, 2017. During the same period, the company's total income grew by CAGR of 47%. In FY17, SSFB's total income increased by 28% to Rs.253.64 crore while PAT decreased by 45% to Rs.15.10 crore. The declined in the PAT was mainly on account of sharp increase in provisions and operating expenses, which increased by 169% and 75% respectively. The sharp increase in provisions and operating expenses was mainly on account of demonetization as well as higher branch cost on account of conversion into SFB. Net Interest Margin and Return on Total Assets (ROTA) stood at 9.90% and 1.08% for FY17 as against 10.70% and 2.82% respectively for FY16. SSFB is investing in technology, branch set-up and manpower significantly during the transitional period of converting into a Small Finance Bank (SFB) which will impact profitability in the medium term. During Q1FY18, SSFB reported net loss of Rs.3.66 crore on the total income of Rs.62.96 crore. During Q1FY18, SSFB's ROTA stood at -0.93%. The decline in profitability was mainly on account of increase in operating and provision expenses.

Geographical concentration

SSFB is exposed to regional concentration risk as the company's operations are largely concentrated in four states (Maharashtra, Tamil Nadu, Odisha and Gujarat) which contributed 89% (87% in FY16) to the overall owned loan portfolio as on March 31, 2017. Furthermore, Maharashtra constituted 33% of the portfolio as on March 31, 2017 (39% as on March 31, 2016).

Operational risks due to cash transactions

Transactions in micro-financing operations are generally on cash basis as disbursements and collections are made in cash. This exposes companies to high degree of operational risks. However, recently SSFB has shifted all the disbursements to NEFT route, which is expected to reduce to operational risk involved in cash operations. Disbursements are made from HO to a designated bank branch nearest to the branch generally one day prior to disbursement to the clients while cash collections made from the clients are transferred from the SSFB branch to a designated bank branch via a security van on the same day.

Lack of diversity in earnings

Over 99% of SSFB portfolio consists of joint liability loans to women borrowers therefore their entire earnings are from micro-finance business. However, transformation from MFI to SFB, the earnings profile is expected to diversify in the medium term.

Industry Prospects

On account of various events post demonetization, collection efficiency of the MFIs/newly converted SFBs has deteriorated. This has impacted the asset quality of the MFIs/SFBs leading to increase in credit costs. It is expected that the loss on account of this event is likely to be in the range of 5-10% of the total loan portfolio for the sector. Given the current situation and any further deterioration in the situation from hereon, the profitability of the MFIs/SFBs are expected to take a hit in FY18 on account of higher provisioning costs. Overall FY18 is expected to be a challenging year for the sector with growth expected to moderate on the back of demonetization as the MFIs/SFBs will primarily concentrate on overhaul of entire operations to minimize future losses. The portfolio growth for the sector is expected to be around 25 to 30% y-o-yin FY18 as compared to 50-60% y-o-y growth achieved in the past few years. However given the market potential, the sector is likely to continue its high growth post normalization of situation with MFIs continuing to attract funds and improving operational efficiencies to maintain profitability. The credit view will continue to factor in risks associated with unsecured lending, socio-political intervention, geographic concentration and operational risks related to cash based transaction, it also takes into account the expected transformation from NBFC to SFB which offers various benefits including ability to offer wider range of products both on assets and liability side, reduce cost of funds, increased regulatory supervision and support. In the near term there is a likelihood of increase in operating costs which is expected to partially offset the benefits from reduction in cost of funds. However, ability of Suryoday SFB's to manage the transition from NBFC to SFB smoothly & manage attendant risks while growing its business will be key rating sensitivities.

Analytical approach: Standalone

Applicable Criteria
Criteria on assigning Outlook to credit ratings
CARE's policy on default recognition
Criteria for short term instruments
Criteria for Non-Banking Financial Companies
Financial ratios – Financial Sector
Bank - CARE's Rating Methodology for Bank

About the Company

Incorporated in November 2008, Suryoday Small Finance Bank (SSFB) (erstwhile Suryoday Microfinance Ltd) is a Mumbai based small finance bank. SSFB commenced group lending business w.e.f. May 2009. Under the JLG model, SSFB provides micro loans to individual members in the group with each group consisting of five members and 2-6 groups forming a centre. The loans are provided to individual members in a group based on the mutual guarantee from members wherein each member is jointly responsible for the loan repayment of the centre. As on March 31, 2017, SSFB had Assets under Management (AUM) of Rs.964.14 crore including managed portfolio of Rs.132.06 crore as on March 31, 2017. The operations of SSFB are spread across eight states and one union territory i.e. Maharashtra, Tamil Nadu, Odisha, Chhattisgarh, Gujarat, Madhya Pradesh, Karnataka, Puducherry and Rajasthan. As on March 31, 2017, SSFB was operating in 116 districts through 217 Mircro Finance Branches and 4 Bank Branches with 7.5 lakh active borrowers (Individual & JLG). The total workforce as on March 31, 2017 stood at 2156 employees including 1121 loan officers. The company was founded by Mr. R Baskar Babu, also Managing Director and Chief Executive Officer (MD & CEO) of SMFL. He has extensive experience of over 24 years in banking & financial sector having previously worked in Cholamandalam, HDFC Bank and GE Commercial Finance.

In August 2016, RBI granted final approval to Suryoday to set up a Small Finance Bank (SFB). Suryoday Small Finance Bank commenced its operations as a Small Finance Bank on 23rd January, 2017. As on July 28, 2017, the Bank had 16 bank branches in 5 states.

Brief Financials (Rs. crore)	**FY16 (A)**	**FY17 (A)**
Total operating income	199	254
PAT	27	15
Interest coverage (times)	1.44	1.21
Total Net Assets	1193	1604
Net NPA (%)	0.04	3.80
ROTA (%)	2.82	1.08

A- Audited

Status of non-cooperation with previous CRA: Not Applicable

Any other information: Not Applicable

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

***Note on complexity levels of the rated instrument:** CARE has classified instruments rated by it on the basis of complexity. This classification is available at www.careratings.com. Investors/market intermediaries/regulators or others are welcome to write to care@careratings.com for any clarifications.*

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Annexure-1: Details of Instruments/Facilities

Name of the Instrument	Date of Issuance	Coupon Rate (%)	Maturity Date	Size of the Issue (Rs. crore)	Rating assigned along with Rating Outlook
Non-Convertible Debenture	12-Jan-2017	11.15%	10-Jan-2020	60	CARE A-; Stable
Non-Convertible Debenture	6-Dec-2016	11.15%	6-Dec-2019	50	CARE A-; Stable
Commercial Paper	-	-	Upto 1 Year	175	CARE A1
Bank Facilities (Proposed)	-	-	-	150	CARE A-; Stable/ CARE A1

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 2017-2018	Date(s) & Rating(s) assigned in 2016-2017	Date(s) & Rating(s) assigned in 2015-2016	Date(s) & Rating(s) assigned in 2014-2015
1.	Fund-based/Non-fund-based-LT/ST	LT/ST	150.00	CARE A-; Stable / CARE A1	-	1)CARE A-; Stable / CARE A1 (15-Dec-16) 2)CARE A- / CARE A1 (29-Aug-16)	-	-
2.	Commercial Paper	ST	175.00	CARE A1	-	1)CARE A1 (15-Dec-16)	-	-
3.	Debentures-Non Convertible Debentures	LT	60.00	CARE A-; Stable	-	1)CARE A-; Stable (15-Dec-16)	-	-
4.	Debentures-Non Convertible Debentures	LT	50.00	CARE A-; Stable	-	1)CARE A-; Stable (08-Feb-17)	-	-

CARE Ratings
Professional Risk Opinion

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