Small Finance Banks' Capital Raising Gains Momentum in Q2 FY23

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CareEdge RATINGS

Synopsis

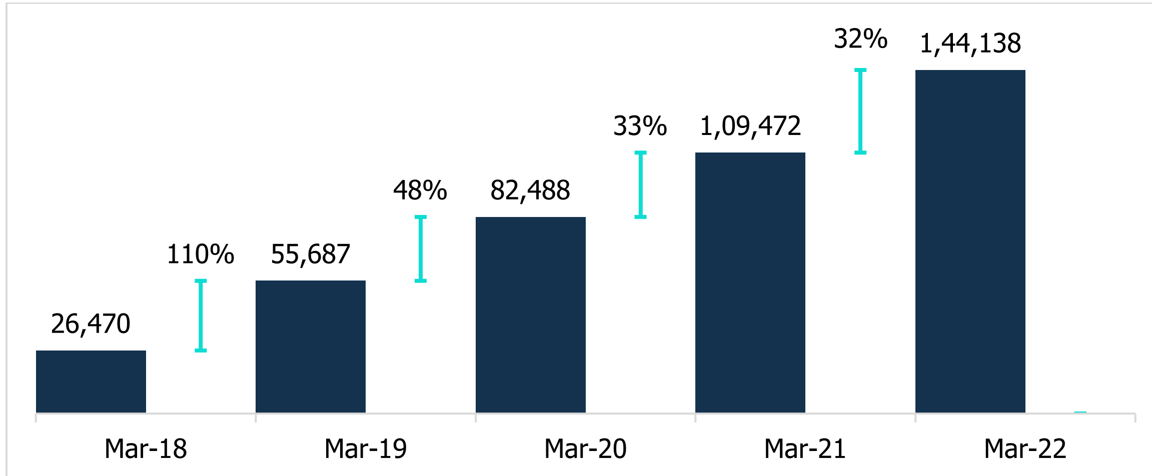
- Though Small Finance Banks (SFBs) are still a small part of the banking sector with a 1.14% market share in advances and 0.71% in deposits as of March 31, 2022, their good deposit mobilisation and outreach to the under-banked have helped them gain more share.
- With strong focus on liabilities franchise, SFBs have improved their credit deposit ratio sharply and achieved significant diversification in the loan book along with strong growth in advances. Going forward, the share of non-microfinance portfolio is expected to increase significantly in the medium to long term.
- The advances book has grown at a four-year CAGR of around 40% as compared to private sector banks, which grew at a CAGR of 18% in the past four years ended March 31, 2022.
- The total advances have grown 24% (Y-o-Y) while deposits rose by 32% (Y-o-Y) in FY22. CareEdge Ratings expects the industry to maintain advances growth rate of 24% in FY23 as some of the SFBs face constraints on capital.
- Growth rate for the industry is likely to exceed FY22 levels in case capitalisation improves. Capital raising by SFBs gained momentum in Q2FY23 and is expected to continue.
- Aggregate Risk Weighted Assets of SFBs stood at Rs. 1,12,382 crore as of March 31, 2022. Considering a 2% cushion over the regulatory capital requirement and a CAGR of 30% in advances during FY23-24, the industry needs to raise capital of around Rs. 4,000 crore. Though the regulations allow SFBs to have higher proportion of Tier-II capital as compared to Universal banks due to limited demand for Tier II issuances, SFBs capitalisation is skewed towards Tier-I. CareEdge Ratings expects the same to continue going forward too.

Liabilities Profile Undergo Change with Sharp Improvement in CD Ratio

As most of the SFBs transitioned from being NBFCs/MFIs, the major challenges faced by them in the initial years was the mobilisation of deposits. SFBs have built a good deposit base by setting up liability focused branches initially. The proportion of deposits in total liabilities has steadily increased and correspondingly the proportion of borrowings has declined in the past four years. The deposit share in total liabilities has increased from 38% as on March 31, 2018, to 72% as on March 31, 2022. With the growth in deposits, the Credit to Deposit ratio has gradually improved to around 93% as on March 31, 2022, from 176% as on March 31, 2018. Further, with the replacement of borrowings with deposits, the average cost of funds declined from 8% for FY18 to 5.9% for FY22.

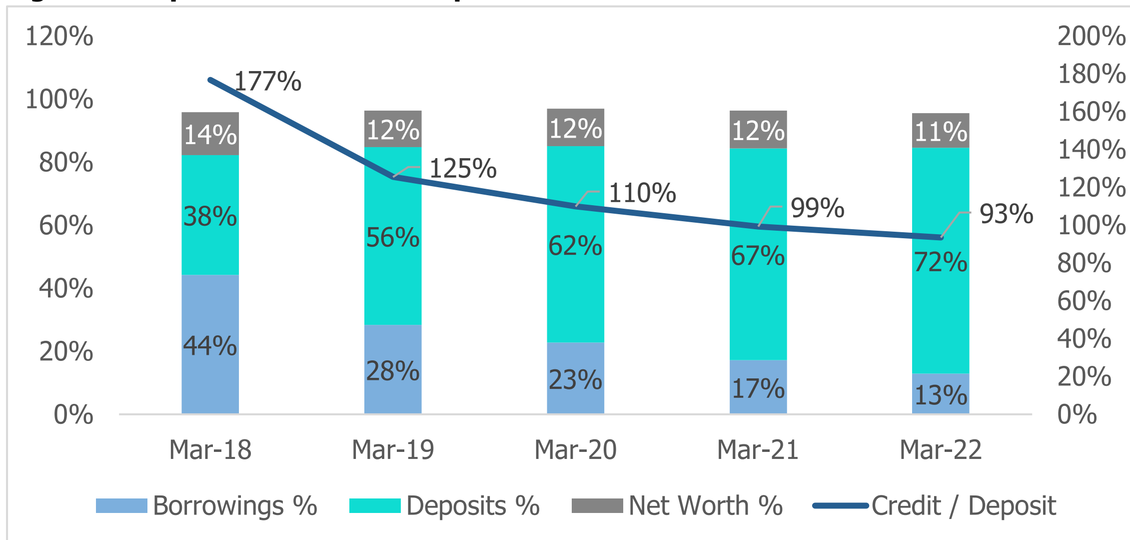
The deposits of SFBs grew at a CAGR of 40% during FY18 to FY22 as against CAGR of 16% for private sector banks, which although on a smaller base, has helped SFBs gain market share.

Figure 1: Growth in Deposits (in Rs.cr)



Source: Company Data, CareEdge Calculations

Figure 2: Deposit Mobilisation Improves CD Ratio

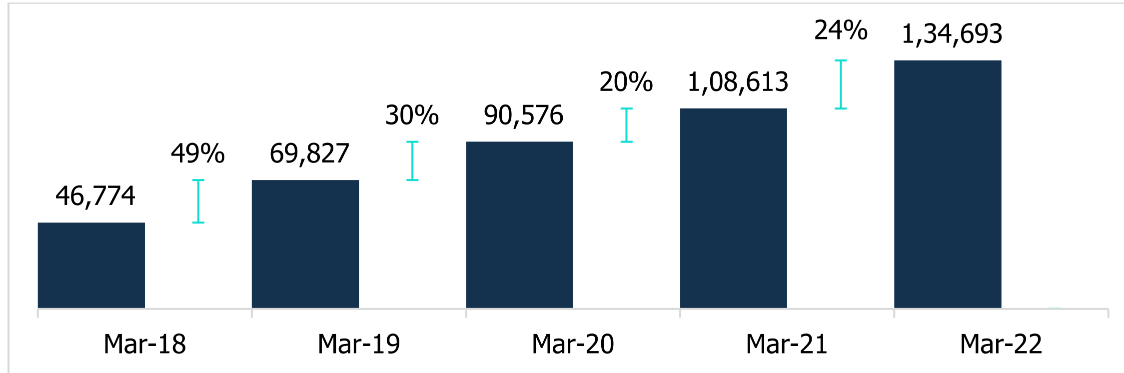


Source: Company Data, CareEdge Calculations

Share of Non-MFI Loan Book to Rise

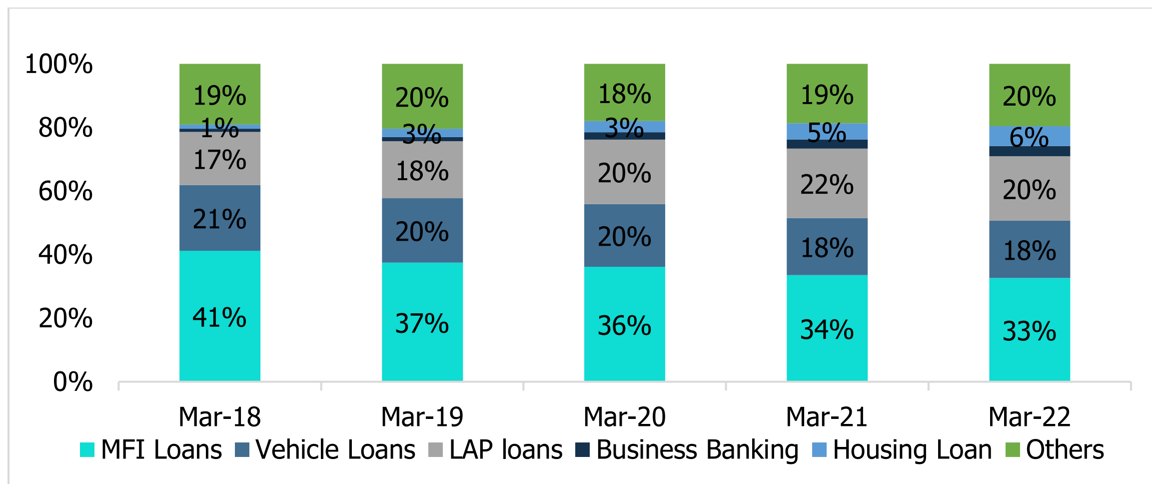
The advances book represented a four-year CAGR of around 40% as compared to private sector banks, which grew at CAGR of 18% in the last 4 years ended March 31, 2022. SFBs' share in advances of the banking industry has gone up from 0.4% as on March 31, 2018, to 1.14% as on March 31, 2022.

Figure 3: Growth in Advances



Source: Company Data, CareEdge Calculations

Figure 4: Trend in Portfolio Composition

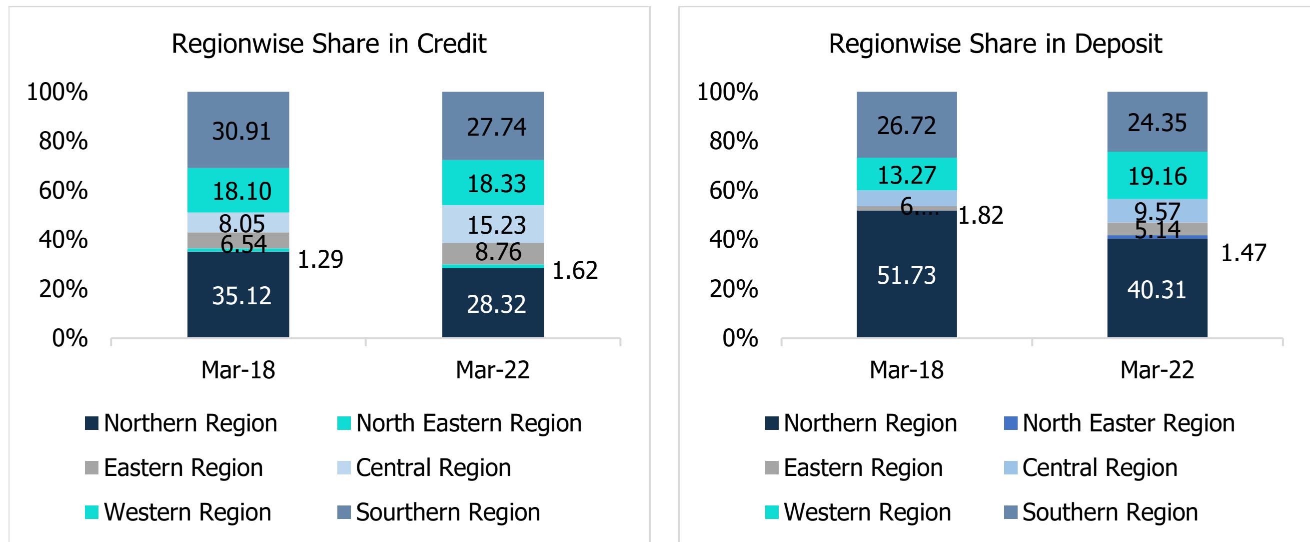


Source: Company Data, CareEdge Calculations

Majority of the SFBs have transitioned from microfinance institutions, thus, resulting in micro-loans dominating the loan book for the SFB industry. However, there has been a gradual shift in proportion towards non-MFI segment with focus of SFBs on secured products like Loan against Property (LAP), Vehicle Loans, Home Loans and Loan against Gold resulting. The share of MFI Loans declined from 41% of advances as on March 31, 2018 to 33% as on March 31, 2022 and the share of secured loans (as a % total advances) increased from 44% as on March 31, 2018 to 56% as on March 31, 2022. While share of MFI is lower at aggregate level, many of the SFBs had higher exposure to MFI loans in FY21 & FY22. Same had adversely impacted the asset quality and profitability in FY21 & FY22 due to impact of COVID. In order to mitigate impact of such event risk, CARE expects many of these SFBs to increase the focus towards non-MFI loans, thereby result in further increase in share of non-MFI loans in the medium to long term.

Improving Financial Inclusion across Region Region-wise Share in Credit and Deposits

Figure 5: Region wise Share

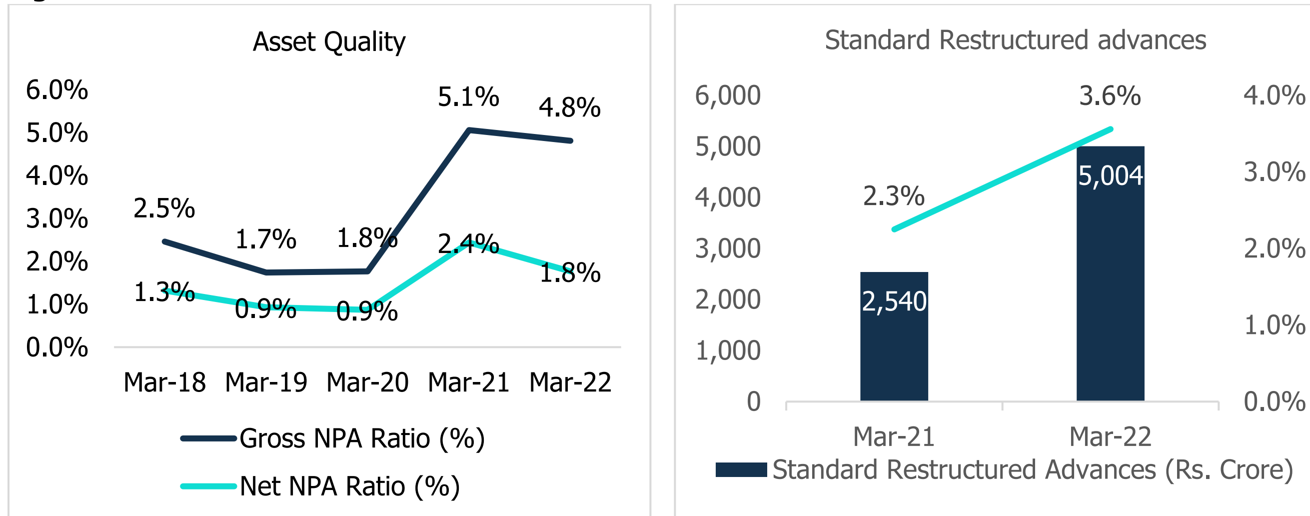


Source: Company Data, CareEdge Calculations

SFB's key objective of furthering financial inclusion, the share of Eastern, North-Eastern and Central regions in total advances/deposits of SFBs increased significantly in the last four years ended March 31, 2022, and at the same time, the share of southern and northern region witnessed decline though witnessed growth in absolute terms.

Asset Quality – Impacted by Covid-19 Induced Pandemic

Figure 6: Stressed Assets Movement



Source: Company Data, CareEdge Calculations

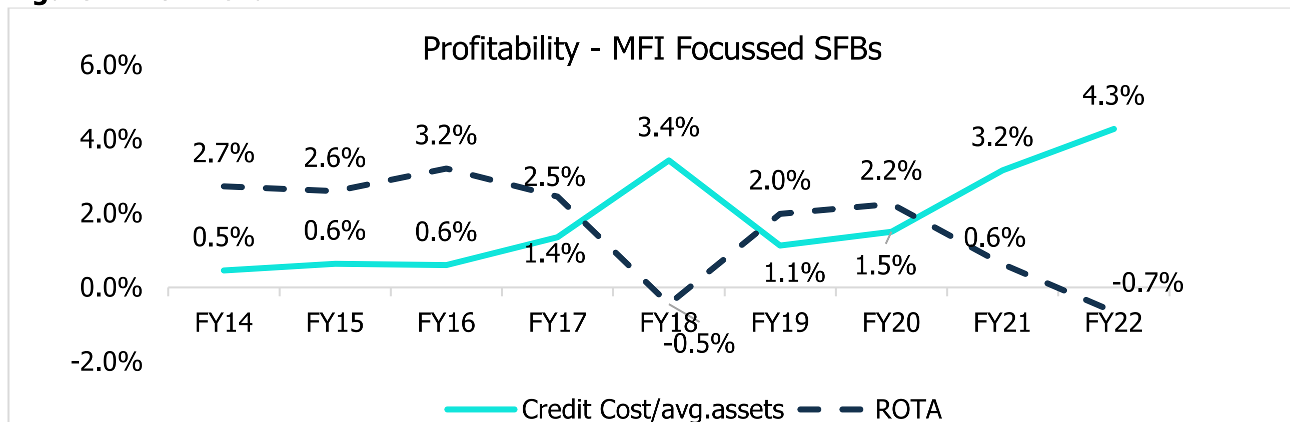
The asset quality of all lenders has been impacted in the last two years due to the Covid-19-induced economic slowdown and movement restrictions across the country. Among the various lenders, besides MFIs, SFBs were more severely impacted due to exposure to relatively weaker borrower segment. Moreover, SFBs with larger exposure to unsecured loan book relatively more severely impacted.

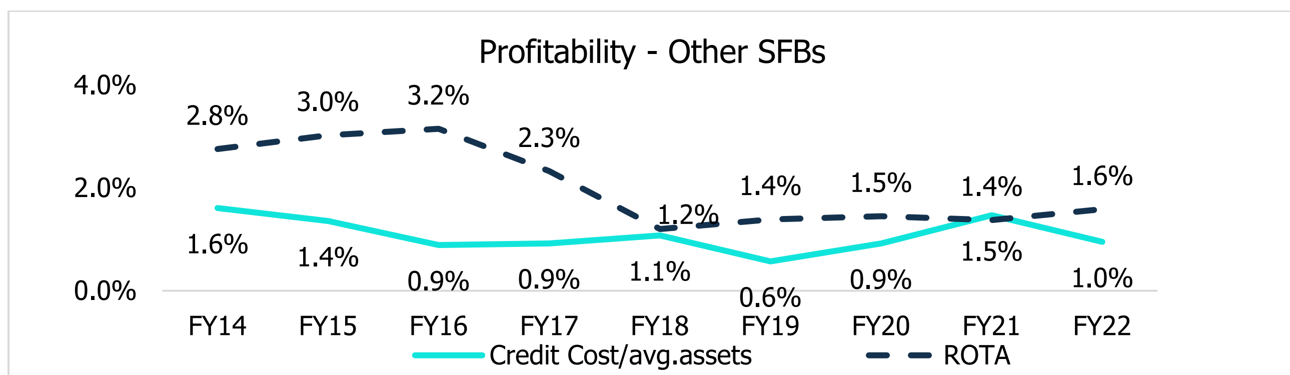
With the severity of Covid-19 subsiding and the resumption of economic activity, the NPA levels have declined during FY22 but continued to remain higher than pre-Covid levels. In addition to NPAs, there is stress in the advances book in the form of restructured assets. Gross stressed assets (GNPA+ Standard Restructured advances) for SFBs stood at 8.4% as on March 31, 2022. The standard restructured book has nearly doubled during FY22 and remains high at 3.6% of gross advances as on March 31, 2022, which is higher than the restructured book of the overall banking sector (around 2% of gross advances). Any slippages from the restructured book is one of the medium-term risks faced by the SFBs.

In comparison to SFBs, the private sector banks witnessed improvement in the asset quality over the last three years on account of resolution of the large corporate accounts and limited incremental slippages from corporate segment. In addition to this, various relief measures and regulatory packages announced by the government and the regulators have reduced the extent of slippages in universal banks. Going forward, with a rundown of the legacy loan book, asset quality of SFBs is expected to improve.

Profitability of SFBs Largely Influenced by Exposure to MFI Asset Class
Due to the increase in slippages with Covid-19 induced pandemic, credit costs witnessed an increase through higher provisioning and write-offs, which severely impacted the overall profitability of SFBs and within this, the impact was higher for the MFI focused SFBs.

Figure 7: ROTA Chain



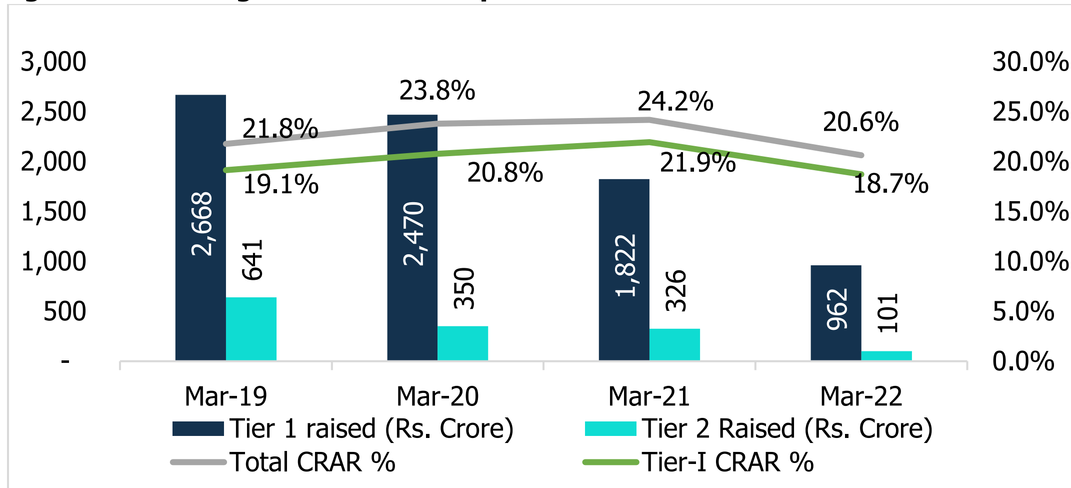


Source: Company Data, CareEdge Calculations
*SFBs having exposure of more than 25% its loan book to MFI is classified as MFI focused and rest as other SFB. (Three SFBs are classified as other SFBs and rest are classified as MFI focused SFBs)

MFI focused SFBs are more prone to event risks and have seen two major events during the last 5 years namely demonetization and Covid. The above charts depict the impact of credit cost on return on total assets for MFI focused SFBs and other SFBs. The charts clearly indicate that MFI focused SFBs were more severely impacted as their credit costs increased significantly post demonetization and covid-19, which led to relatively sharper decline in ROTA as compared to non-MFI focused SFBs. Going forward, with economic recovery in place, and with relatively lower stress in the loan portfolio, the profitability is expected to improve for the overall industry.

Capital raise gaining momentum in Q2FY23

Figure 8: Declining trend in fresh capital mobilization in FY21 & FY22



Source: Company Data, CareEdge Calculations

With the continuing asset quality challenges faced by the SFBs, SFBs now also face a challenge in mobilizing fresh capital. Post demonetisation, the capital cushion improved with fresh equity mobilization by few of the SFBs. However, this was depleted partly on account of rise in credit cost during the COVID-19 pandemic. Moreover, the incremental capital raise also represents a declining trend, while the advances continue to grow at higher rate.

There were 5 SFBs in the market planned to raise funds via the IPO route for sum of Rs.5,600 crore on aggregate basis. Of which, around Rs.3,000 crore consists of fresh issue. Most of the SFBs filed the DRHP more than 6 months to a year back; however, have been unable to raise equity within expected timeline. Further, the volatility in the capital markets along with reduction in level of risk appetite in the equity markets poses uncertainty on equity raise.

The capital raise remains a key challenge for the SFBs with deferment of IPOs in FY22 & Q1FY23 largely due to unfavorable equity market scenario and moderate performance of SFBs during FY22. However, with majority of SFBs already absorbing credit cost and growth coming back to the sector, capital mobilization has gained momentum. In the quarter ended September 2022, SFBs raised equity and Tier II Capital aggregating to Rs. 3,275 crore as against Nil in Q1FY23. Many more SFBs also reviving their capital raising plans including IPOs. To achieve a growth rate of 30% CAGR during FY23-FY24, most of the SFBs need to mobilise capital. Considering 2% cushion over regulatory capital requirement and 30% CAGR growth, SFBs would require to raise fresh capital of Rs. 4,000 crore during FY23-24.

The regulations allow SFBs to raise Tier II capital to the extent of 100% of Tier I capital; however, at present the proportion of Tier II capital is significantly lower for the industry. The Tier I CAR stood at 18.7% for the industry

as on March 31, 2022, whereas Tier II CAR stood at 1.9% only. There is huge scope for the industry to raise Tier II Capital funds. However, with limited demand for Tier II Capital from investors, CareEdge Ratings do not expect increase in proportion of Tier II Capital in the near to medium term.

Outlook

CARE expects the credit cost of SFBs to show meaningful reduction in FY23 with reduction in NNPA levels and creation of adequate provision in the past two fiscals. Advances growth for the industry is expected to be around 24% in FY23. However, in respect of many of the SFBs, present level of capital would be adequate to grow the book in the range of 15 to 20% only. CARE also notes that major chunk of this growth will be garnered by SFBs with comfortable capitalisation level or SFBs which can generate healthy accruals. CARE expects many of the SFBs to report advances growth below industry growth in FY23 unless the capitalization improves.

Annexure

History of Small Finance Banks

The Union Budget for FY15 cited the need for differentiated small banks to further the financial inclusion in India; following which RBI published the draft guidelines for licensing of Small Finance Banks on June 17, 2014. The first SFB became operational in April 2016on receipt of final license from RBI. During FY17 and FY18, ten SFBs received approval and became operational, and further, during FY22, two more SFBs received the license. Many of SFBs converted from MFIs/Local Area Banks/NBFCs. As on date there are 12 SFBs operational. At the end of FY22, total business of SFBs stood at Rs.2.79 lakh crore with deposits of Rs.1.44 lakh crore and advances of Rs.1.35 lakh crore. The key objective of setting up SFBs was furthering financial inclusion by means of provision of savings vehicles primarily to unserved and underserved sections of the population, and supply of credit to small business units, small and marginal farmers, micro and small industries, and other unorganized sector entities, through high technology-low-cost operations.

Below is a list of Small Finance Banks along with their Size, Regional Presence and Product Profile:

Figure 9: Brief profile of Small Finance Banks:

Small Finance Bank	Regional Presence	AUM (Rs.cr)	Top 3 Products
AU Small Finance Bank	Northern, Central, Western	47,831	Wheels-36.2%; MSME-34.5%; Business banking-6.0%
Equitas Small Finance Bank	Southern, Western	20,597	Small Business Loan-34.4%; Vehicle Finance-24.5%; MFI-19.0%
Ujjivan Small Finance Bank	Southern, Western, Northern, Central	18,160	MFI-68.0%; HL-15.1%; MSE Loan-9.4%
Jana Small Finance Bank	Southern, Western, Central	14,115	MFI-53%; MSME and Housing Loan-35.6%
ESAF Small Finance Bank	Southern, Western	12,131	MFI-83.1%; Gold Loan-6.2%; Corporate loan-3.2%
Utkarsh Small Finance Bank Limited	Eastern, Central	9,931	MFI-80.6%; Retail assets-8.5%; HL-3.5%
Fincare Small Finance Bank Limited	Southern, Western	7,541	MFI-75.7%; LAP-12.0%; Gold Loan-5.5%
Suryoday Small Finance Bank	Western, Southern, Eastern	5,063	MFI-66.9%; Housing Loan-9.0%; Loan to NBFC-7.5%
Capital Small Finance Bank	Northern	4,635	Agriculture-38.0%; HL & LAP-24.1%; MSME-23.3%
North East Small Finance Bank	North-Eastern	1,745	MSME-54%; Agriculture-28.1%; MFI & Others-17.9%
Shivalik Small Finance Bank	Central	1,126	Retail Loan (HL & LAP)-49%; Gold Loan-31%; Business Loan-9%
Unity Small Finance Bank	Western, Southern,Northern	2,419	MFI -29%; SME, MSME & Business Banking -47%

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