February 15, 2021

Fedbank Financial Services Limited: [ICRA]A1+ assigned

Summary of rating action

Instrument*	Current Rated Amount (Rs. crore)	Rating Action
Commercial Paper Programme	1,000.00	[ICRA]A1+ assigned
Total	**1,000.00**	

**Instrument details are provided in Annexure-1*

Rationale

The assigned rating factors in the strong parentage of Fedbank Financial Services Limited (FFSL), which is a subsidiary of The Federal Bank Limited (FBL; 74% stake in FFSL). FFSL draws managerial, operational and financial support from FBL, as evident from the common board members, regular capital infusions, access to credit lines (extended by FBL), business sourcing arrangements and the shared brand name. The rating also considers FFSL's diversified product mix and its adequate capitalisation.

The rating also factors in the moderate scale of operations and the limited seasoning of businesses like small ticket size loan against property (LAP facility to micro and small enterprises), housing loans and business loans. While the asset quality is comfortable at present, with reported gross non-performing assets (GNPAs) of 0.95% as on December 31, 2020 (1.87% without factoring in the Supreme Court's stay order on NPA recognition after the moratorium ended on August 31, 2020), the portfolio vulnerability remains high, especially in the current operating environment. The borrower profile, which largely includes micro, small and medium enterprises (MSMEs), is marginal and has been significantly impacted by the Covid-19 pandemic-infused disruption. While the collection efficiency improved to ~95% in November 2020, FFSL's ability to maintain the same and a healthy asset quality over the medium term is critical from a credit perspective. The rating also factors in the geographical concentration of operations with the southern states of Tamil Nadu, Karnataka and Andhra Pradesh accounting for ~62% of the loan book as on March 31, 2020. FFSL's profitability is moderate, with a return on assets (RoA) of 1.26% in FY2020 and 1.03% in H1 FY2021, impacted by the high operating expenditure (upfronting operating costs for expansion plans) and credit costs (Covid-19-related provisioning). FFSL's ability to scale up its businesses while improving its profitability and maintaining the gearing within an acceptable limit will remain a key monitorable.

Key rating drivers and their description

Credit strengths

Strong parentage and well-demonstrated track record of support – FFSL is a 74% subsidiary of FBL (as on December 31, 2020). The balance is held by TrueNorth LLP, a private equity firm, which acquired its first stake in FFSL in November 2018. FFSL draws managerial and operational support from FBL, given its strategic importance to FBL. FFSL's board of directors consists of six members including three from FBL. FBL's Managing Director and Chief Executive Officer, Chief Financial Officer and an Independent Director are on FFSL's board. FFSL is also engaged in distribution activities for the parent, on which it earns a fee income (5-7% of the total interest and fee income comes from the distribution business). Further, FFSL receives financial support from FBL in the form of regular capital infusions (FBL infused Rs. 59 crore in FFSL in FY2020 and Rs. 58.6 crore in 9M FY2021), working capital facilities (Rs. 100 crore as on November 30, 2020) and credit lines (term loans and non-convertible debentures (NCDs); borrowing outstanding of Rs. 1,128.04 crore as on November 30, 2020). FBL is expected to continue to hold a majority stake in FFSL over the medium term. TrueNorth is also expected to provide capital support from time to time to help FFSL achieve its growth targets.

Diversified product mix with large share of secured loans and increasing granularity – FFSL has a diversified product mix comprising gold loans (36%), LAP (42%), construction finance (4%), structured finance (4%), unsecured business loans (7%), housing loans (2%) and microfinance loans and personal loans (4%) as on September 30, 2020. The mix between the secured and unsecured portfolio was 87:13 as on September 30, 2020. However, the overall portfolio is likely to remain dominated by gold loans and LAP over the medium term. Over the last two years, FFSL increased the granularity of the portfolio by foraying into products like housing loans, microfinance and personal loans, and unsecured business loans. Further, within the LAP segment, FFSL forayed into small ticket size LAP and also lowered the average ticket size in medium ticket size LAP.

Adequate capitalisation with marginal increase in gearing – FFSL's regulatory capital adequacy ratio remained strong at 24.06% as on September 30, 2020, while the leverage was 5.15 times. Over the last three years, there have been regular capital infusions to support the growing loan book. In FY2019, TrueNorth made its first investment of Rs. 168.60 crore in FFSL, followed by a second tranche of Rs. 112.48 crore in FY2020. In FY2020 and H1 FY2021, FFSL raised ~Rs. 159 crore through a rights issue. The CRAR of 24.06% (as on September 30, 2020) factors in the Tier II bonds of Rs. 250 crore subscribed by FBL. FFSL is expected to receive further capital support over the medium term on a need basis. FFSL plans to operate at a maximum leverage of 7 times. Its ability to raise capital regularly to support its aggressive growth plan (CAGR of ~31% over the next five years) and keep the gearing within acceptable limits will be a key credit monitorable.

Credit challenges

Moderate scale of operations with low seasoning in segments other than gold loan – With a loan book of Rs. 4,063 crore as on September 30, 2020, FFSL's scale of operations is moderate. It has posted an aggressive growth at a CAGR of 39% over the past four years. The portfolio seasoning is low for the recently launched products, i.e. business loans, structured finance, housing finance, and microfinance and personal loans. However, the share of these products in the total assets under management (AUM) was low at 18% as on September 30, 2020, providing comfort.

Marginal profile of borrowers – FFSL targets customers with a daily income of Rs. 500-Rs. 4,000 and the credit profile of such borrowers remain exposed to income shocks. About 91% of the LAP, business loan and housing loans are extended to self-employed non-professional borrowers. This segment has been significantly impacted by the pandemic-infused disruption and the collection efficiency dropped to ~52% in June 2020. With the moratorium ending in August 2020, the collection efficiency has gradually improved to 97%+ in January 2021. FFSL's ability to maintain the collection efficiency and the healthy asset quality over the medium term is critical from a credit perspective. While the asset quality is comfortable at present, with GNPAs of 0.95% as on December 31, 2020 (1.87% without factoring in the Supreme Court's stay order on NPA recognition after the moratorium ended on August 31, 2020), the portfolio vulnerability remains high especially in the current operating environment, given the underlying borrower profile and the limited seasoning of the portfolio.

Geographical concentration – FFSL's gold loan portfolio remains concentrated in the southern states of Karnataka (29%), Andhra Pradesh (29%) and Tamil Nadu (19%). Although it expanded its presence in the western and northern states in FY2020, the share of these territories in the total gold loan portfolio remains low. Considering the company's established position in the southern states, the geographical mix of the gold loan portfolio is likely to remain skewed towards these states over the medium term. The non-gold loan portfolio remains concentrated in Tamil Nadu (22%), Karnataka (29%), Maharashtra (24%) and Gujarat (16%). With a view to diversify the operations geographically, FFSL expanded the non-gold loan business in the states/Union Territories (UTs) of Rajasthan, Andhra Pradesh, Telangana, Punjab, Madhya Pradesh and Delhi in FY2020 and the business reported strong traction in Andhra Pradesh in the first year itself. The geographical concentration of the non-gold loan products is expected to reduce over the medium term. FFSL's ability to maintain the asset quality in the new geographies over the medium term will be critical.

Moderate profitability despite growth in revenue – With the increase in the share of high-yielding unsecured products in the loan book (17% as of September 2020 from 3% in FY2019), the average yield on loans improved to 15.95% in H1 FY2021 from 15.21% in FY2020 and 13.56% in FY2019. Despite the tightening liquidity in the non-banking financial company (NBFC) space, FFSL maintained its cost of borrowing at sub-10%. Its overall revenue was further supported by fees and commission income from the distribution business for FBL. The fee income moderated in H1 FY2021, primarily due to the slowdown in disbursements. Despite the improvement in total revenues in FY2020, the profitability was impacted by the increase in operating expenses. The cost-to-income ratio increased to 69% in FY2020 from 59% in FY2019. However, with the new branches attaining breakeven and the economies of scale in play, the cost-to-income ratio improved to 61% in H1 FY2021. The credit cost increased marginally to 0.69% in FY2020 from 0.19% in FY2019 partly due to a Covid-19-related additional provision of Rs. 8.2 crore. The credit cost increased further to 1.86% in H1 FY2021 on account of a Covid-19-related provision of Rs. 42

crore. In FY2020, FFSL reported a profit after tax (PAT) of Rs. 39.14 crore compared to Rs. 36.13 crore in FY2019. In FY2020, the RoA was 1.26% (1.99% in FY2019) and the return on equity (RoE) was 6.81% (10.06% in FY2019). In H1 FY2021, FFSL reported a PAT of Rs. 22.15 crore, RoA of 1.03% and RoE of 6.30%.

Liquidity position: Adequate

As on November 30, 2020, FFSL had unencumbered cash and liquid investments of Rs. 339 crore and unutilised bank lines of Rs. 457 crore. The available liquidity adequately covers the debt obligations for the next four months. The asset-liability maturity profile as on September 30, 2020 showed a cumulative positive mismatch (cumulative inflows over cumulative outflows) in all the buckets. FFSL has borrowings of up to 5 years while it has extended loans with a higher tenor (>15 years). However, the sizeable share of the short-term product (gold loan) provides support to the overall liquidity position. The average collection efficiency, which reduced to ~52% during the pandemic-impacted period of June 2020, registered a gradual improvement to ~94% in September 2020 and ~95% in October 2020 and November 2020. Further, timely support from FBL is expected. Thus, the liquidity position is adequate.

Rating sensitivities

Positive factors – Not applicable

Negative factors – Pressure on the rating could arise in case of a change in the credit profile of the parent, FBL, or a significant change in the shareholding or a major decline in the linkages with the parent. Pressure will also arise in case of a deterioration in the earnings and asset quality on a sustained basis.

Analytical approach

Analytical Approach	Comments
Applicable Rating Methodologies	Non-Banking Financial Companies Methodology
Parent/Group Support	Support from The Federal Bank Limited, the parent company
Consolidation/Standalone	For arriving at the rating, ICRA has considered the standalone financials of FFSL

About the company

Fedbank Financial Services Limited (FFSL) is registered with the Reserve Bank of India (RBI) as a systemically important non-deposit taking non-banking financial company (NBFC-ND-SI). It was incorporated in 1995 and received the licence to operate as an NBFC in 2010. FFSL is a subsidiary of The Federal Bank Limited (FBL). Up to FY2018, FBL held a 100% stake in FFSL. In FY2019, TrueNorth LLP acquired a 17% stake in FFSL and another 9% (total 26%) in FY2020. The company provides gold loans, LAP, business loans, personal loans, housing loans, loans to NBFCs and construction finance. FFSL is actively engaged in sourcing loans (housing loans, auto loans, personal loans, SME loans) for its parent company. As on March 31, 2020, FFSL had a presence in 12 states/Union Territories (UTs) with a network of 301 branches and 1,800 employees.

The AUM, as on September 30, 2020, was Rs. 4,187 crore (including securitised portfolio) with 87% secured and 13% unsecured. The operations are divided into three categories: retail lending (gold loans, LAP, business loans, personal loans, housing loans), wholesale lending (loans to NBFCs and construction loans) and distribution business (sourcing housing loans, auto loans, personal loans, SME loans for parent company). While retail loans and wholesale loans generate interest income and fee income for the company, the distribution business contributes to its fees and commission income. As on September 30, 2020, the mix between retail and wholesale lending was 85% and 15%.

Key financial indicators (audited)

Fedbank Financial Services Limited	FY2019	FY2020	6M FY2021*
Total income (Rs. crore)	255.80	466.07	318.91
Profit after tax (Rs. crore)	36.13	39.14	22.15
Net worth (Rs. crore)	458.62	691.15	714.14
Loan book (net; Rs. crore)	2,006.62	3,686.52	3,987.31
Total assets (Rs. crore)	2,150.61	4,086.18	4,549.21
Return on assets (%)	1.99%	1.26%	1.03%
Return on net worth (%)	10.06%	6.81%	6.30%
Gross gearing (times)^	3.49	4.66	5.15
Gross NPA (%)	2.28%	1.47%	1.13%
Net NPA (%)	1.93%	1.08%	0.73%
Solvency (Net stage 3/Net worth)	8.46%	5.77%	4.16%
CRAR (%)	21.61%	17.89%	24.06%

*Source: Company, ICRA research; * Provisional numbers; ^Includes subordinate debt; All ratios as per ICRA calculations*

Status of non-cooperation with previous CRA: Not applicable

Any other information: None

Rating history for past three years

	Instrument	Current Rating (FY2021)				Chronology of Rating History for the past 3 years		
		Type	Amount Rated (Rs. crore)	Amount Outstanding as of Jan 31, 2021 (Rs. crore)	Date & Rating in FY2021	Date & Rating in FY2020	Date & Rating in FY2019	Date & Rating in FY2018
					Feb 15, 2021	-	-	-
1	CP Programme	Short Term	1,000.00	Nil	**[ICRA]A1+**	-	-	-

Complexity level of the rated instrument

ICRA has classified various instruments based on their complexity as "Simple", "Complex" and "Highly Complex". The classification of instruments according to their complexity levels is available on the website click here

Annexure-1: Instrument details

ISIN No	Instrument Name	Date of Issuance / Sanction	Coupon Rate	Maturity Date	Amount Rated (Rs. crore)	Current Rating and Outlook
NA	CP Programme	NA	NA	7-365	1,000.00	[ICRA]A1+

Source: *Company*

Annexure-2: List of entities considered for consolidated analysis

Not applicable

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About ICRA Limited:

ICRA Limited was set up in 1991 by leading financial/investment institutions, commercial banks and financial services companies as an independent and professional investment Information and Credit Rating Agency.

Today, ICRA and its subsidiaries together form the ICRA Group of Companies (Group ICRA). ICRA is a Public Limited Company, with its shares listed on the Bombay Stock Exchange and the National Stock Exchange. The international Credit Rating Agency Moody's Investors Service is ICRA's largest shareholder.

For more information, visit www.icra.in

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