February 11, 2022

Fedbank Financial Services Limited: Rating reaffirmed

Summary of rating action

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

**Instrument details are provided in Annexure-1*

Rationale

The rating reaffirmation factors in the strong parentage of Fedbank Financial Services Limited (FFSL), which is a subsidiary of 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, credit lines extended by FBL, business sourcing arrangements and shared brand name. The rating also considers FFSL's diversified product mix and adequate capitalisation. The rating, however, factors in the moderate scale of operations and the limited seasoning of the non-gold segments (including small ticket size loan against property (LAP) facility to micro and small enterprises, housing loans and business loans).

FFSL witnessed a deterioration in asset quality in recent quarters, in line with industry trend. The gross non-performing assets (GNPA) increased to 2.27% as of September 30, 2021 from 1.04% as of March 31, 2021, given the challenging operating environment. The GNPA further increased 3.59% as of December 31, 2021 following the implementation of revised income recognition and asset classification guidelines. ICRA also takes note that following the correction in gold prices in H2 FY2021, the share of portfolio with loan-to-value (LTV) in excess of 75% has increased as of March 2021 and September 2021 vis-à-vis March 2020. Further, there has been an uptick in the gold auctions conducted by the company. The adequate recovery performance (with recovery of entire principle and sizable share of accrued interest and other charges) provides comfort.

The borrower profile, which largely includes micro, small and medium enterprises (MSMEs), is marginal with limited credit history and has been significantly impacted by the Covid-19 pandemic-induced disruptions. This, coupled with the challenging portfolio environment, is expected to result in high portfolio vulnerability over the near term. While the improvement in the collection efficiency (excluding wholesale, gold and business correspondent loans) to ~99% in Q2 FY2022 (94% in Q1 FY2022 and 96% in Q4 FY2021) provides comfort, FFSL's ability to maintain the same and a healthy asset quality over the medium term would remain critical from a credit perspective. The rating also considers the high geographical concentration of the portfolio and the company's moderate earnings profile.

On January 11, 2021, FBL disclosed to the stock exchanges that FFSL's board of directors has approved the initiation of the initial public offering (IPO) process by way of a fresh issue and offer for sale, subject to market conditions, receipt of applicable approvals including from the Securities and Exchange Board of India (SEBI) and other considerations. FFSL would remain a subsidiary of FBL following the IPO. The transaction is, however, in early stages and exact details are yet to be finalised. ICRA would continue to monitor the developments and take appropriate rating action on further clarity regarding the transaction.

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 September 30, 2021. The balance is held by TrueNorth LLP, a private equity firm, which acquired its first stake in FFSL in November 2018. As it is strategically important to FBL, FFSL draws managerial and operational support from the bank. The Managing Director (MD) &

Chief Executive Officer (CEO), and an executive director of FBL are on FFSL's board. The company is also engaged in distribution activities for the parent, on which it earns a fee income (~5% 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, Rs. 58.6 crore in 9M FY2021 and Rs. 148 crore in Q1 FY2022), working capital facilities (Rs. 100 crore as on September 30, 2021) and credit lines (term loans and non-convertible debentures (NCDs); borrowing outstanding of Rs. 899.14 crore as on September 30, 2021). FBL is expected to continue to hold a majority stake in FFSL over the medium term.

Diversified product mix with large share of secured loans and increasing granularity – FFSL has a diversified product mix comprising gold loans (43%), LAP (38%), construction finance (1.8%), structured finance (1%), unsecured business loans (12%), housing loans (4%) and other loans (1%) as on September 30, 2021. As on September 30, 2021, the mix between the secured and unsecured portfolio was ~87%:13%. 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 in the portfolio by foraying into retail products like housing loans, personal loans, and unsecured business loans. Further, within the LAP segment, FFSL forayed into small ticket size LAP and lowered the average ticket size for medium ticket size LAP.

Adequate capitalisation – FFSL is adequately capitalised with a net worth of Rs. 1,069.45 crore and a gearing of 4.09 times as on September 30, 2021. Over the last three years, it has received regular capital infusions to support the growing loan book. In FY2019, TrueNorth LLP made its first investment in FFSL of Rs. 169 crore, followed by a second tranche of Rs. 112 crore in FY2020. In FY2020 and H1 FY2021, FFSL raised ~Rs. 159 crore through a rights issue. The CRAR was 25.59% as on September 30, 2021, improving from 23.52% as on March 31, 2021 supported by internal accruals. FFSL plans to operate at a maximum leverage of 6-6.5 times. Its ability to raise capital regularly to support its aggressive growth plan over the next four years and keep the gearing within acceptable limits will be a key credit monitorable.

On January 11, 2021, FBL disclosed to the stock exchanges that FFSL's board has approved the commencement of the process of IPO by way of a fresh issue and offer for sale, subject to market conditions, receipt of applicable approvals including from SEBI and other considerations. The size of the IPO, portion of offer for sale (if any), price and other details with respect to the proposed IPO will be determined in due course. FFSL would, however, remain a subsidiary of FBL following the IPO. Going forward, the change in the company's shareholding and its linkages with FBL would remain a key monitorable.

Credit challenges

Moderate scale of operations with low seasoning in non-gold business; deterioration in asset quality in recent quarters – FFSL's assets under management (AUM) increased to Rs. 5,247 crore as of September 30, 2021 from Rs. 1,422 crore as of March 2018. The scale of operations, however, remains limited. The portfolio seasoning is low for the recently launched products of business loans, housing finance, and personal loans. However, the share of these products in the total AUM was low at 16% as on September 30, 2021, providing comfort.

FFSL witnessed a deterioration in asset quality in recent quarters, in line with industry trend. The gross non-performing assets (GNPA) increased to 2.27% as of September 30, 2021 from 1.04% as of March 2021, given the challenging operating environment. Stage 2 assets increased to 4.23% as of September 30, 2021 from 2.78% as of March 31, 2021 largely on account of the assets restructured under Covid-19-related relief schemes. The GNPA further increased 3.59% as of December 31, 2021 following the implementation of revised income recognition and asset classification guidelines. FFSL has also accounted for COVID-related management overlay provision, thereby resulting in increase in total provision cover.

ICRA also takes note of the moderation in the security coverage of the gold portfolio with a significant increase in the share of portfolio with an LTV in excess of 75%, following the correction in gold prices. After peaking in August 2020, gold prices declined in the following months and were lower by ~15% as of March 2021. While there has been some recovery in the current fiscal, prices remain about 10% below the August 2020 level. Following the correct in gold prices in H2 FY2021, the share of portfolio with LTV in excess of 75% has increased as of March 2021 and September 2021 vis-à-vis March 2020. There has also been an uptick in the gold auctions conducted by the company. The adequate recovery performance (with recovery of entire principle and sizable share of accrued interest and other charges) provides comfort. A large proportion of the LAP, business loans and housing loans is extended to self-employed non-professional borrowers. While the improvement in the collection efficiency (excluding wholesale, gold and business correspondent loans) to ~99% in Q2 FY2022 (94% in Q1 FY2022 and 96% in Q4 FY2021) provides comfort, FFSL's ability to maintain the same and a healthy asset quality over the medium term would remain critical from a credit perspective.

Geographical concentration – FFSL's gold loan portfolio remains concentrated in the southern states of Karnataka (24%), Andhra Pradesh and Telangana (23%) and Tamil Nadu (14%). In FY2021 and H1 FY2022, FFSL expanded its presence in the western and northern states and increased the gold loan share in Maharashtra to 15% and Gujarat to 12% as compared to FY 2020. Considering its established position in the southern states, the geographical mix of the company's gold loan portfolio is likely to remain skewed towards these states over the medium term.

FFSL's non-gold loan portfolio remains concentrated in Tamil Nadu (22%), Karnataka (25%), Maharashtra (18%), Andhra Pradesh and Telangana (11%) and Gujarat (14%). To diversify the operations geographically, FFSL expanded the non-gold loan business in the states/Union Territories (UTs) of Rajasthan, Andhra Pradesh and Telangana, Punjab, Madhya Pradesh and Delhi in FY2020 and FY2021 and the business reported strong traction in Andhra Pradesh in the first year. The geographical concentration for non-gold loan products is expected to reduce over the medium term. FFSL's ability to maintain the asset quality in the new geographies will be critical over the medium term.

Moderate profitability despite growth in revenue – With the increase in the share of high-yielding unsecured products in the AUM (~12% as of September 2021 from 3% in FY2019), the average yield on loans improved to 16.5% in H1 FY2022 from 16.1% in FY2021 and 15.2% in FY2020. Despite the tightening liquidity in the non-banking financial companies (NBFC) space, FFSL maintained its cost of borrowings at sub-8%. Its overall revenue was further supported by fee and commission income from the distribution business for FBL. Fee income moderated to Rs. 11.3 crore in H1 FY2022 and Rs. 23.9 crore in FY2021, primarily due to the slowdown in disbursements.

With the increase in the economies of scale, the cost-to-income ratio improved to 60.2% in FY2021 and 57.2% in H1 FY2022 from 69.3% in FY2020. The high credit costs, however, kept the profitability level under pressure. FFSL reported a profit after tax (PAT) of Rs. 61.7 crore in FY2021 (return on assets (RoA) of 1.3%) and Rs. 33.4 crore (RoA of 1.2%) in H1 FY2022 compared to a PAT of Rs. 39.1 crore (RoA of 1.3%) in FY2020. Going forward, the company's ability to limit the credit costs as well as operating expenses on the back of its expansion plans would be critical.

Liquidity position: Adequate

As of December 31, 2021, the company had liquidity (including undrawn bank lines) of Rs. 711 crore while cumulative debt, and interest repayment stood at Rs. 660.54 crore for the next three months and Rs. 975.22 crore for the next six months. The sizeable share of the short-term product (gold loan) provides support to the overall liquidity position. Further, timely support from FBL is expected, which provides comfort on the liquidity front.

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 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 FBL, 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 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 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. As on March 31, 2021, it had a presence in 12 states/UTs with a network of 301 gold branches, 59 SME finance hubs and 2,130 employees.

The AUM, as on September 30, 2021, was Rs. 5,247 crore (including securitised portfolio). 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 fee and commission income

Key financial indicators

Fedbank Financial Services Limited	FY2020	FY2021	H1 FY2022*
Total income (Rs. crore)	466.52	697.72	408.34
Profit after tax (Rs. crore)	39.14	61.68	33.40
Net worth (Rs. crore)	691.16	834.73	1,069.45
Loan book (net; Rs. crore)	3,686.52	4,552.14	4,902.88
Total assets (Rs. crore)	4,086.19	5,466.30	5,747.90
Return on assets (%)	1.26%	1.29%	1.19%
Return on net worth (%)	6.81%	8.08%	7.02%
Gross gearing (times)^	4.66	5.19	4.09
Gross NPA (%)	1.47%	1.04%	2.27%
Net NPA (%)	1.08%	0.71%	1.56%
Solvency (Net stage 3/Net worth)	5.77%	3.87%	7.32%
CRAR (%)	17.89%	23.52%	25.59%

Source: *Company, ICRA Research; *Provisional figures; ^Includes subordinate debt. All ratios as per ICRA's calculations*

Status of non-cooperation with previous CRA: Not applicable

Any other information: None

Rating history for past three years

	Instrument	Current Rating (FY2022)				Chronology of Rating History for the Past 3 Years		
		Type	Amount Rated (Rs. crore)	Amount Outstanding as of Jan 31, 2022 (Rs. crore)	Date & Rating in FY2022	Date & Rating in FY2021	Date & Rating in FY2020	Date & Rating in FY2019
					Feb 11, 2022	Feb 15, 2021	-	-
1	Commercial Paper Programme	Short Term	1,000.00	100.00	[ICRA]A1+	[ICRA]A1+	-	-

Source: *Company, ICRA Research*

Complexity level of the rated instrument

Instrument	Complexity Indicator
Commercial Paper Programme	Very Simple

The Complexity Indicator refers to the ease with which the returns associated with the rated instrument could be estimated. It does not indicate the risk related to the timely payments on the instrument, which is rather indicated by the instrument's credit rating. It also does not indicate the complexity associated with analysing an entity's financial, business, industry risks or complexity related to the structural, transactional, or legal aspects. Details on the complexity levels of the instruments are available on ICRA's website: www.icra.in

Annexure-1: Instrument details

ISIN	Instrument Name	Date of Issuance / Sanction	Coupon Rate	Maturity Date	Amount Rated (Rs. crore)	Current Rating and Outlook
INE007N14CZ6	Commercial Paper Programme	January 24, 2022	6.20%	December 23, 2022	100.00	[ICRA]A1+
NA	Commercial Paper Programme – Unutilised	NA	NA	NA	900.00	[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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