August 30, 2019

AU Small Finance Bank Limited: Rating reaffirmed

Summary of rating action

Instrument*	Previous Rated Amount (Rs. crore)	Current Rated Amount (Rs. crore)	Rating Action
Bank Lines	80.00	27.77	[ICRA]AA-(Stable); reaffirmed
Non-convertible Debentures	320.00	170.00	[ICRA]AA-(Stable); reaffirmed
Subordinated Debt Programme	35.00	25.00	[ICRA]AA-(Stable); reaffirmed
Total	**435.00**	**222.77**	

**Instrument details are provided in Annexure-1*

Rationale

The rating reaffirmation factors in the continued ramp-up in AU Small Finance Bank Limited's (AU) liability franchise, its stable and comfortable asset quality, and adequate profitability despite its transition to a small finance bank (SFB). While share of wholesale deposits remains high in AU's deposits mix, its cost of funds continues to decline with incremental funds being in the form of deposits and refinance from financial institutions (FIs). Hence, the impact of investments in lower-yielding securities, to comply with statutory requirements, was partially offset and AU's profitability remains adequate with reported return on equity (RoE) of 14.0% in FY2019 and 23.3%[1] in Q1 FY2020, which continues to result in healthy internal accruals.

While AU has been relatively better at ramping up its liability franchise compared with other SFBs, ICRA notes that given the growth plans, AU would need to continuously strengthen its liability profile to include a larger share of retail liabilities, which will also drive its liquidity profile. A high growth rate also poses challenges of increased leverage and regular need to raise capital as the internal accruals are likely to be lower than the growth capital requirements. While the capitalisation level remains adequate with Tier-I of 15.5% and total CRAR of 18.6% as on June 30, 2019[2], it is gradually moderating. The recent capital raise and other divestment plans are likely to take care of the capital requirements till FY2021, after which AU may need to raise further capital.

AU's asset quality has remained under control with a stable gross NPA ratio of 2.1% as on June 30, 2019 compared to 2.0% in March 2019 and 2.0% in March 31, 2018. However, while AU has more than two decades of experience in the vehicle finance segment and about a decade of experience in MSME segment, its track record in other segments remains relatively limited. Thus, the bank's ability to maintain the asset quality as it grows and diversifies into other segments while maintaining its underwriting standards will remain a key monitorable.

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[1] *Positively impacted by profit on sale of 0.8% stake in Aavas Financiers Limited for Rs. 77 crore; excluding the resulting post-tax income, the adjusted RoE stood at 14.7% for Q1 FY2020*

[2] *If Q1FY2020 PAT is included, total CRAR was 19.5% & tier I CRAR was 16.5% as on June 30, 2019*

The rating remains constrained by the relatively high geographical as well as product concentration. While AU has, over the years, expanded its operations to 11 states, its portfolio remains geographically concentrated with Rajasthan accounting for over 40% of the portfolio as on March 31, 2019, followed by Maharashtra (15%), Madhya Pradesh (13%) and Gujarat (12%). Nevertheless, AU's dependence on these states has been gradually declining. Also, its strong track record in Rajasthan provides comfort. AU has historically been present in the vehicle and MSME finance segment, thereby resulting in high concentration of the product portfolio towards these segments. As on June 30, 2019, the vehicle and MSME finance segments had shares of 42% and 33%, respectively, in AU's assets under management (AUM).

Outlook: Stable

ICRA believes AU will continue to benefit from its track record of more than two decades of credit underwriting and lending operations in its mainstay vehicle finance segment, which should keep slippages under control. The bank is also expected to continue to strengthen its liability franchise over the medium term with a focus on granular retail deposits, which should augur well for the cost of funds and hence profitability. The outlook may be revised to Positive if the bank is able to further strengthen its liability profile with a higher share of retail deposits (CASA and term deposits), in line with private sector banks, while maintaining its asset quality and profitability. The outlook may be revised to Negative if there is a significant deterioration in AU's capitalisation, asset quality or profitability.

Key rating drivers

Credit strengths

Stable and comfortable asset quality trajectory; however, the new businesses are relatively less seasoned and AU remains exposed to moderate credit profile borrowers – AU's asset quality has stayed under control with a stable gross NPA ratio of 2.1% as on June 30, 2019 compared to 2.0% in March 2019 and 2.0% in March 31, 2018. Further, the provision cover has been improving (40.5% in June 2019 compared to 37.4% in March 2018) and remains sufficient in relation to the loss-given defaults on most of the underlying asset classes. ICRA notes that while AU has more than two decades of experience in the vehicle finance segment (accounting for 42% of the total portfolio as on June 30, 2019) and about a decade of experience in MSME segment (accounting for 33% of the total portfolio as on June 30, 2019), its track record in other segments remains relatively limited. Post conversion into an SFB, the bank has started new products like business banking, gold loans, home loans, agri-SME loans, unsecured personal loans (PL) and consumer durables (CD)[3]. Its ability to maintain the asset quality as it grows in these segments and diversifies into other segments remains a key monitorable. Within the vehicle finance segment, the increased focus on used vehicles will also remain a monitorable. In this regard, ICRA notes AU's ambitious growth targets. The bank's ability to maintain its underwriting standards while achieving the growth target would be critical. A large part of AU's borrowers are not credit tested and are exposed to volatility in incomes. The risk is, however, somewhat mitigated by the secured nature of lending, granular book, complete in-house business model, management's long-standing experience in its primary area of operations, and adequate lending spreads that provide a cushion to cover the credit costs.

Adequate profitability despite transition to SFB – AU's net interest margins have moderated on transitioning to a bank and the consequent requirements to invest in lower-yielding government securities to comply with the statutory liquidity ratio (SLR) requirements, besides the decline in lending spreads amid competition. However, the yield pressure was

[3] *Both CD and PL are primarily targeted towards exiting bank customers*

partially offset by the lower cost of funds. Hence, despite moderation, the profitability remains adequate with reported RoE of 14.0% in FY2019 and 23.3% in Q1 FY2020, which continues to result in healthy internal accruals. Going forward, the bank's ability to continue to raise low-cost retail deposits, increase the fee-based income with an increased distribution network, and cross-sell banking products to existing customers while keeping the operating and credit costs in control will remain key for improving profitability from the currently adequate level.

Healthy ramp-up in liability profile; ambitious growth targets can, however, keep the share of bulk deposits high – AU has demonstrated a healthy ramp-up in its liability profile since its transition to an SFB two years ago. It has been able to build a deposit base of Rs. 19, 849 crore (as on June 30, 2019) with a YoY increase of 99%. The deposits now account for 2/3rd of the bank's external liabilities (including securitisation), followed by refinance from FIs that constituted 1/5th of the external liabilities as on June 30, 2019. Further, with incremental funds being in the form of deposits and refinance from FIs, AU has witnessed a decline in the cost of funds over the last two years, with incremental cost of funds in the range of 7.1-7.8% during the last eight quarters. In FY2019, the cost of funds for AU stood at 7.9% compared to 8.5% and 9.6% in FY2018 and FY2017, respectively.

Notwithstanding the healthy ramp-up in the deposit base, AU needs to continuously strengthen its liability profile to improve the granularity of the deposit base by garnering a larger share of retail liabilities. As on June 30, 2019, deposits of a ticket size of over Rs. 1 crore[4] constituted about 65% of AU's deposits, though it is noted that 64% of AU's bulk term deposits are non-callable, thereby partially offsetting liquidity risks. Further, the share of CASA is relatively lower than mid-size private sector banks (having higher vintage) at 11% of external liabilities and 17% of total deposits (including certificates of deposit) as on June 30, 2019. Going forward, given the growth plans and despite the expectations of continued growth in the share of retail liabilities, ICRA expects bulk deposits to continue to constitute a large share of the liability profile. In this context, ICRA notes that the liability-side pressure could remain and shall be a key monitorable.

Credit challenges

High growth rate can pose challenges such as regularly raising capital, maintaining granularity in liabilities and asset quality – Given its growth targets, AU's leverage has been increasing. Though the capitalisation level remains adequate with Tier-I of 15.5% and total CRAR of 18.6%[5] as of June 2019[6], it has moderated compared to the previous year. To fund the incremental growth, the bank will require additional capital raisings as the internal accruals are likely to be lower than the growth capital requirements. In this regard, AU has a demonstrated track record of capital raisings, the latest being in FY2019, whereby it issued equity shares and warrants on a preferential basis to Camas Investments Pte Ltd, an indirect wholly-owned subsidiary of Temasek Holdings Private Limited (a national wealth fund owned by the Government of Singapore). As a part of this capital raising, the bank received equity capital aggregating Rs. 300 crore in FY2019 through preferential allotment and an upfront consideration of Rs. 175 crore against the allotment of warrants. The warrants will lead to additional capital infusion of Rs. 525 crore by December 2019.

Supported by capital infusion and internal accruals, AU's net worth increased to Rs. 3,163 crore in March 2019 from Rs. 2,281 crore in March 2018. In Q1 FY2020, AU also benefited from the 0.8% stake sale in Aavas for Rs. 77 crore, which increased its net worth to Rs. 3,361 crore as on June 30, 2019. Following this, AU has a residual stake of 6.4% in Aavas,

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[4] *As per RBI, deposits below Rs. 2 Crore are classified as retail deposits*

[5] *Regulatory requirement for SFBs is CRAR of 15%*

[6] *If Q1FY2020 PAT is included, total CRAR was 19.5% & tier I CRAR was 16.5% as on June 30, 2019*

which can be monetised to further augment the net worth. With these plans, AU seems to be well placed for its growth capital requirements till FY2021, after which it will need to raise capital to meet its targeted growth plans.

Relatively high, albeit improving, geographical as well as product concentration with modest scale of operations – AU grew at a three-year CAGR of 43% during FY2016 to FY2019. However, despite the above-industry average growth, its scale of operations remains moderate in relation to universal banking sector peers. As on June 30, 2019, its AUM was Rs. 25,610 crore compared to Rs. 24,246 crore as on March 31, 2019 and Rs. 16,188 crore as on March 31, 2018.

Further, while AU has, over the years, expanded its operations to 11 states, its portfolio remains geographically concentrated with Rajasthan accounting for over 40% of the portfolio as on March 31, 2019 followed by Maharashtra (15%), Madhya Pradesh (13%) and Gujarat (12%). These states also accounted for 86% of AU's branches and 68% of the deposits (excluding CDs) mobilised by the bank. Nevertheless, ICRA notes that AU's dependence on these states has been gradually declining. Also, AU's strong track record in Rajasthan provides comfort. AU has historically been present in the vehicle and MSME finance segment, thereby resulting in high concentration of the product portfolio towards these segments. As on June 30, 2019, the vehicle and MSME finance segments had shares of 42% and 33%, respectively, in AU's assets under management (AUM).

Liquidity position

AU maintained an average liquidity coverage ratio (LCR) of 98.3% in Q1 FY2020 against the regulatory requirement of 80% for SFBs. Further, while its asset liability maturity profile as on March 31, 2019 was characterised by modest gaps in buckets up to six months, it has unutilised refinance lines of over Rs. 2,000 crore from development finance institutions to plug these gaps. Also, AU holds a 6.4% stake (Rs. 700-800 crore) in Aavas, which can be monetised (once the lock-in period ends in September 2019). The bank's liquidity position will also be augmented by the second tranche of capital from Temasek, which is due for infusion in December 2019. Moreover, given AU's focus on priority sector lending, it can securitise the loans at short notice to meet urgent liquidity needs.

To manage its liquidity risks, the bank has maintained excess government securities eligible for SLR. With an SLR holding of Rs. 5,150 crore as on June 30, 2019 against the requirement of Rs. 4,391 crore, it can avail liquidity support from the RBI through reverse repo against excess SLR investments and the marginal standing facility scheme, in case of urgent liquidity needs. The bank also maintained a liquid non-SLR book of Rs. 2,060 crore as on June 30, 2019. AU's access to the call money market/inter-bank money market window also provides comfort.

Analytical approach

Analytical Approach	Comments
Applicable Rating Methodologies	ICRA's Credit Rating Methodology for Non-Banking Finance Companies
Parent/Group Support	Not applicable
Consolidation/Standalone	Standalone

About the company

AU is a scheduled commercial bank, which has transitioned from an asset financing NBFC to an SFB. While it was incorporated in 1996 as an NBFC, it commenced SFB operations on April 19, 2017. AU has an established market position in Rajasthan, and has expanded operations to Maharashtra, Gujarat, and other states over the years. As of June 30, 2019, it had 418 branches and 81 asset centres across 11 states. Over 80% of its branches are in the four states of Rajasthan, Gujarat, Maharashtra and Madhya Pradesh.

AU operates in the retail asset financing segment, with the vehicle financing segment accounting for 42% of its AUM. Its product portfolio also includes MSME and SME financing, construction finance, loans to NBFCs, business banking, gold loans, home loans, agri-SME loans, unsecured personal loans (PL) and consumer durables (CD). AU's liability product offerings include current accounts, savings accounts, recurring & term deposits, transaction banking, as well as a bouquet of third-party mutual funds and insurance covers among others.

During its early years of operations, AU (formerly Au Financiers (India) Limited) was primarily engaged in vehicle financing through funds raised from high net worth individuals in Jaipur. Over the years, the company raised equity from private investors at regular intervals and expanded its product portfolio. In September 2015, the Reserve Bank of India granted in-principle approval to AU for setting up an SFB. On December 20, 2016, AU got the final licence to set up the SFB and on April 19, 2017, it converted into an SFB. Further, the bank got listed on stock exchanges in July 2017 and was granted scheduled commercial bank status in November 2017.

AU reported a profit after tax (PAT) of Rs. 382 crore on a total asset base of Rs. 32,623 crore in FY2019 compared to PAT of Rs. 292 crore on a total asset base of Rs. 18,833 crore in FY2018. Further, AU achieved PAT of Rs. 190 crore in Q1 FY2020 compared to Rs. 77 crore in the corresponding period in the previous year. As of June 30, 2019, the net worth stood at Rs. 3,361 crore with a reported capital adequacy of 18.6%.

Key financial indicators (audited)

	FY2018	FY2019	Q1 FY2019	Q1FY2020
PAT	292	382	77	190
Net worth	2,281	3,163	2,843	3,361
Assets under management	16,188	24,246	17,747	25,610
Total assets	18,833	32,623	20,942	33,762
Return on average assets (%)	2.0%	1.5%	1.5%	2.3%*
Return on average net worth (%)	13.7%	14.0%	13.2%	23.3%*
Gearing (times)	6.9	9.0	5.9	8.6
CRAR (%)	19.3%	19.3%	20.7%	18.6%[7]
Gross NPAs (%)	2.0%	2.0%	2.2%	2.1%
Net NPAs (%)	1.3%	1.3%	1.4%	1.3%
Net NPA/Net worth (%)	7.4%	9.3%	7.4%	8.6%

*Source: AU's financial results, ICRA research; Amounts in Rs. crore; *Positively impacted by Rs. 71 crore profit on sale of partial stake in Aavas*

[7] *If Q1FY2020 PAT is included, total CRAR was 19.5% & tier I CRAR was 16.5% as on June 30, 2019*

Status of non-cooperation with previous CRA: Not applicable

Any other information: None

Rating history for last three years

	Instrument	Current Rating (FY2020)				Chronology of Rating History for the Past 3 Years			
		Type	Amount Rated (Rs. crore)	Amount Outstanding (Rs. crore)	Date & Rating	Date & Rating in FY2019	Date & Rating in FY2018		Date & Rating in FY2017
					Aug-19	Jun-18	Mar-17	Jan-17	Mar-16
1	Bank Lines	Long-Term	27.77	27.77*	[ICRA]AA- (Stable)	[ICRA]AA- (Stable)	[ICRA]A+ (Stable) /[ICRA]A1+	[ICRA]A+ (Stable) /[ICRA]A1+	[ICRA]A+ (Stable) /[ICRA]A1+
2	Non-convertible Debentures	Long-Term	170.00	170.00*	[ICRA]AA- (Stable)	[ICRA]AA- (Stable)	[ICRA]A+ (Stable)	[ICRA]A+ (Stable)	[ICRA]A+ (Stable)
3	Subordinated Debt	Long-Term	25.00	25.00*	[ICRA]AA- (Stable)	[ICRA]AA- (Stable)	[ICRA]A+ (Stable)	[ICRA]A+ (Stable)	[ICRA]A+ (Stable)

**As of June 30, 2019*
Source: ICRA research

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 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
INE949L07535	Non-convertible Debenture	16-03-2017	8.63%	16-03-2021	170.00	[ICRA]AA- (Stable)
INE949L08111	Subordinated Debt	6-08-2013	11.84%	3-07-2019	5.00	[ICRA]AA- (Stable)
INE949L08160	Subordinated Debt	19-11-2015	11.07%	19-05-2021	20.00	[ICRA]AA- (Stable)
-	Term Loan	28-09-2015	8.75%	28-03-2020	27.77	[ICRA]AA- (Stable)

Source: AU

Annexure-2: List of entities considered for consolidation: Not applicable

ANALYST CONTACTS

Karthik Srinivasan
+91 22 6114 3444
karthiks@icraindia.com

Manushree Saggar
+91 124 4545 316
manushree@icraindia.com

Deep Inder Singh
+91 124 4545 830
deep.singh@icraindia.com

Deepak Narang
+91 124 4545442
Deepak.narang@icraindia.com

RELATIONSHIP CONTACT

L. Shivakumar
+91-22-6114 3406
shivakumar@icraindia.com

MEDIA AND PUBLIC RELATIONS CONTACT

Ms. Naznin Prodhani
Tel: +91 124 4545 860
communications@icraindia.com

Helpline for business queries:

+91-9354738909 (open Monday to Friday, from 9:30 am to 6 pm)

info@icraindia.com

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ICRA Limited

Corporate Office
Building No. 8, 2nd Floor, Tower A; DLF Cyber City, Phase II; Gurgaon 122 002
Tel: +91 124 4545300
Email: info@icraindia.com
Website: www.icra.in

Registered Office
1105, Kailash Building, 11th Floor; 26 Kasturba Gandhi Marg; New Delhi 110001
Tel: +91 11 23357940-50

Branches

Mumbai	+ (91 22) 24331046/53/62/74/86/87
Chennai	+ (91 44) 2434 0043/9659/8080, 2433 0724/ 3293/3294,
Kolkata	+ (91 33) 2287 8839 /2287 6617/ 2283 1411/ 2280 0008,
Bangalore	+ (91 80) 2559 7401/4049
Ahmedabad	+ (91 79) 2658 4924/5049/2008
Hyderabad	+ (91 40) 2373 5061/7251
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