March 07, 2022

SK Finance Limited (erstwhile Ess Kay Fincorp Limited): Ratings upgraded

Summary of rating action

Instrument*	Previous Rated Amount (Rs. crore)	Current Rated Amount (Rs. crore)	Rating Action
Non-convertible Debentures	35.0	35.0	[ICRA]A+ (Stable); upgraded from [ICRA]A (Stable)
LT-Market Linked Debentures	150.0	150.0	PP-MLD [ICRA]A+ (Stable); upgraded from PP-MLD [ICRA]A (Stable)
Long-term Fund-based Term Loan	275.0	275.0	[ICRA]A+ (Stable); upgraded from [ICRA]A (Stable)
Total	**460.0**	**460.0**	

**Instrument details are provided in Annexure-1*

Rationale

The upgrade in the long-term ratings of SK Finance Limited (SKFL) factors in its demonstrated ability to scale up its business (assets under management (AUM) grew by 22.3% in 9M FY2022 and 14.4% in FY2021) while maintaining healthy capitalisation and controlling slippages despite the challenging operating environment. The capitalisation profile improved in 9M FY2022, supported by the recent equity raise of Rs. 150 crore in December 2021 (total equity raise of Rs. 487 crore in 9M FY2022). This led to a higher reported capital adequacy of 33.3% as on December 31, 2021 and lower leverage of 2.4x compared with 27.7% and 3.4x, respectively, as on March 31, 2021.

ICRA also favourably notes that the company has been able to control fresh slippages despite the challenging operating environment, notwithstanding the marginal increase in the gross stage 3% to 4.9% as on December 31, 2021 from 4.1% as on March 31, 2021 (4.0% as on March 31, 2020). ICRA also notes that collections have recovered post the initial dip in Q1 FY2022 as reflected by the collection efficiency (excluding prepayments) of 99% in December 2021 compared to 89% in May 2021.

Moreover, while SKFL's reported gross non-performing advances (GNPAs) would increase following the recent clarification by the Reserve Bank of India (RBI) on Income Recognition and Asset Classification (IRAC) norms, the credit costs are not likely to be significantly impacted given the relatively higher provisions carried by the company under IndAS norms. The ratings also factor in SKFL's established franchise in Rajasthan with good knowledge of and track record in the local market, the track record of adequate profitability notwithstanding the ongoing pressures, and the adequately diversified borrowing profile for the scale of operations.

The ratings are, however, constrained by SKFL's high geographical and product concentration. While the company has, over the years, expanded its reach to 10 states, the home state of Rajasthan still accounted for 62% of the portfolio as on December 31, 2021 (though lower than 94% six years ago). Further, as the strong growth has been consistently accounted for by the vehicle loan segment, its share in SKFL's AUM remains ~88%. Also, while the share of the used vehicle segment moderated to 71% of the AUM in December 2021, it remains the largest business area for the company. As SKFL primarily operates in the used vehicle financing segment, its customers are mostly first-time borrowers, single vehicle and small business owners, who are susceptible to economic shocks and have limited income buffers.

ICRA notes that SKFL has gained traction in the micro, small and medium enterprise (MSME) lending space to cater to a similar category of low and middle-income group borrowers and its share in the AUM has increased to ~12%. Thus, the delinquencies in the softer buckets could remain volatile for the company. Overall, SKFL's ability to profitably grow the scale of operations while maintaining comfortable asset quality and capitalisation would be a key monitorable.

Key rating drivers and their description

Credit strengths

Good knowledge of and track record in the local market; established franchise in Rajasthan – SKFL is promoted by Mr. Rajendra Setia, who along with his family members holds an equity share of ~39% in the company (as on December 31, 2021). The company, under the leadership of Mr. Setia, has a long track record of over two decades in the local vehicle financing market, whereby it has established a retail franchise in Rajasthan and gained good understanding of the local market. Also, it is backed by established equity investors such as Norwest Venture Partners X – Mauritius (Norwest), TPG Capital, Baring Private Equity India AIF and Evolvence India (Evolvence), which together held 53.7% equity as of December 31, 2021. SKFL's board of directors comprises two promoter directors, two independent directors and two investor nominee directors.

Healthy capitalisation – SKFL's capitalisation stands augmented, supported by the equity infusion of Rs. 337 crore in Q1 FY2022 and Rs. 150 crore in Q3 FY2022. Following this, the net worth increased to ~Rs. 1,541 crore as on December 31, 2021 from Rs. 971 crore in March 2021 (Rs. 879 crore in March 2020). Over the last four years, multiple rounds of equity raises have facilitated a sustained improvement in the leverage to a comfortable level of 2.4x as on December 31, 2021. This provides cushion for absorbing asset-side shocks, if any, emanating from the ongoing challenging operating environment. This also puts the company in a good position for the medium term with sufficient headroom for growth.

Given the augmented net owned funds, SKFL's capitalisation, in terms of capital adequacy, also improved with a capital to risk weighted assets ratio (CRAR) of 33.3% as on December 31, 2021. However, ICRA notes that SKFL has outlined a road map for strong growth (compound annual growth rate (CAGR) of 30%+ over the medium term), which is likely to increase the leverage from the current level. In this regard, growth capital from investors is expected to be forthcoming, if required, to maintain prudent capitalisation.

Track record of adequate profitability, notwithstanding ongoing pressures – Given the relatively vulnerable target borrower profile, SKFL commands high lending yields. While the yields have softened over the past few years with the diversification into the new vehicle and small and medium enterprise (SME) loan segments and decline in systemic rates, they remain high as reflected by the ~18% yield on average loans in 9M FY2022 with a five-year average of ~21%. Further, with the improvement in its competitive position and the systemic decline in interest rates, SKFL's cost of funds declined to 10.2% in FY2021 and further to 9.8% in 9M FY2022 from 11.7% in FY2019, leading to a reduction in the lending spreads to 7.7% in 9M FY2022 from 8.9% in FY2021. Due to this, the net interest margins (NIMs) declined to 8.9% in FY2021 and further to 8.2% in 9M FY2022 from 11.3% in FY2019. The company's operating expenses remained relatively high at 5.1% of managed assets in 9M FY2022 (despite significant improvement in recent years) due to the cost-intensive business model and rapid branch expansion.

Nevertheless, SKFL has maintained a track record of healthy profitability with a five-year average return on assets (RoA) of 2.5% and return on equity (RoE) of 14%. Even in FY2021, despite the challenging operating environment, the company achieved an RoA of 2.2% and an RoE of 9.8%. The RoA and RoE for 9M FY2022 were 2.3% and 9.1%, respectively. ICRA notes that profitability remains under pressure in FY2022 compared to the pre-Covid-19 pandemic period due to declining NIMs amid the challenging operating environment. However, as the operating expenses stabilise with economies of scale, the profitability is expected to improve, provided SKFL can maintain good control on fresh slippages over the medium term.

Adequately diversified borrowing profile for the scale of operations – SKFL's borrowing profile is adequately diversified, with sources including debt markets (~41% of the total borrowings as on December 31, 2021), term loans and working capital lines from banks (45%), term loans from financial institutions (FIs; ~7%) and securitisation (~7%). As of December 31, 2021, the company had borrowing relationships with over three dozen financial institutions. It also continues to raise funds through securitisation/direct assignments, with such on-balance sheet and off-balance sheet borrowings amounting to 7% of the total borrowings as of December 31, 2021 (14% as on March 31, 2021). Also, with an improvement in its competitive position and a systemic decline in interest rates, SKFL's cost of funds improved to 9.8% in 9M FY2022 from 10.2% in FY2021 and 11.2% in FY2020.

Credit challenges

Exposure to relatively weak borrower profiles, which are susceptible to economic shocks and have limited income buffers – As SKFL primarily operates in the used vehicle financing segment, its customers are mostly first-time borrowers and single vehicle and small business owners, who are susceptible to economic shocks and have limited income buffers. Thus, the delinquencies in the softer buckets could remain volatile for the company. Nevertheless, while ICRA believes that the asset quality, especially for select asset segments, weakened due to the likely impact of the pandemic, it is noted that SKFL has demonstrated satisfactory asset quality over the years (excluding the adverse impact witnessed during the demonetisation drive). While the 30+ days past due (dpd) remains high (13% as on December 31, 2021 with five-year average of 19%) due to the inherently weak credit profiles of the borrowers and the nature of the business, the 90+ dpd has remained range-bound with an average of ~5% during this period and 4.4% as on December 31, 2021.

ICRA notes that SKFL has disbursed Rs. 28 crore under the Emergency Credit Line Guarantee Scheme (ECLGS). It has restructured loans affected by the second wave of the pandemic and restructured advances stood at 1.82% of the AUM as on December 31, 2021. The company holds a provision of 30% on restructured assets. Thus, the optical impact of the relief availed by the borrowers on the reported asset quality has been limited. However, it is noted that SKFL's asset quality metrics have deteriorated marginally on account of fresh slippages as reflected by the gross stage 3% of 4.9% as on December 31, 2021 compared to 4.1% as on March 31, 2021. At the same time, the gross stage 2% improved to 9.6% from 11.6% during this period. Further, the provision cover on the overall book reduced to 3.7% as on December 31, 2021 (vis-à-vis 4.7% as on March 31, 2021), though it remains adequate.

ICRA also notes that collections have recovered post the initial dip in Q1 FY2022 as reflected by the collection efficiency of 99% (excluding prepayments) in December 2021 compared to 89% in May 2021. While the reported gross NPAs for the company would increase following the RBI's recent clarification on IRAC norms, the credit costs are not likely to be impacted significantly, given the relatively higher provisions carried by the company under IndAS norms. Going forward, SKFL's ability to control fresh slippages will remain a key monitorable, especially given the ongoing challenging operating environment. In this regard, it is noted that the company's healthy capitalisation level provides adequate cushion for absorbing asset-side shocks, if any.

High, albeit improving, geographical and product concentration – SKFL has expanded the scale of its operations in the last few years with its AUM increasing to Rs. 4,178 crore as on December 31, 2021 from Rs. 1,282 crore as on March 31, 2018. Further, it expanded its reach to seven states in India through a network of ~359 branches as on March 31, 2021 and added three more states in 9M FY2022. However, it remains a regional player with the home state of Rajasthan still accounting for 62% of the portfolio as on December 31, 2021 though concentration has moderated compared to 94% in March 2014. The balance portfolio is primarily in Gujarat, Maharashtra, Madhya Pradesh and Punjab & Haryana.

Moreover, as the vehicle loan segment has consistently accounted for the company's growth, its share in SKFL's AUM remains ~88% (though lower than 98% five years ago). Also, while the share of the used vehicle segment moderated to 71% of the AUM in December 2021, it remains the largest business area for the company. Nevertheless, ICRA notes that SKFL has gained traction in the MSME lending space to cater to a similar category of low and middle-income group borrowers and its share in the AUM has increased to ~12%.

Liquidity position: Strong

The short-to-medium tenure of the loans extended by SKFL (average tenure of 3.5 to 4 years) matches well with the weighted average tenure of the term facilities availed by it and reflects positively in the asset-liability maturity (ALM) profile. Thus, SKFL's

ALM profile, in the normal course of business, is characterised by positive cumulative mismatches across all buckets up to 1 year. Further, while collections dipped during the initial and peak months of the pandemic, it is noted that the company was carrying sufficient liquidity backup as on December 31, 2021 and had positive cumulative mismatches across all buckets up to 1 year for all quarters. The on-balance sheet liquidity of Rs. 764 crore (cash and liquid investments), coupled with undrawn working capital lines of ~Rs. 63 crore, is adequate to manage the debt servicing burden of ~Rs. 727 crore up to June 2022.

Rating sensitivities

Positive factors – The ratings could be upgraded on a sustained improvement in the profitability (RoA>3.0%) and competitive position through a healthy growth in the scale while maintaining comfortable asset quality and capitalisation.

Negative factors – Pressure on the ratings could emerge on a significant deterioration in the asset quality and/or the capitalisation profile (gearing worsening to over 4x on a sustained basis) or weakening in the liquidity and earnings profile of the company.

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

Incorporated in 1994, SKFL is a Jaipur (Rajasthan) headquartered non-banking financial company (NBFC) registered with the RBI. It primarily finances used light commercial vehicles, multi-utility vehicles, cars, tractors and two-wheelers. It also advances SME loans. SKFL had a network of 409 branches as on December 31, 2021 across 10 states, namely Rajasthan, Gujarat, Maharashtra, Madhya Pradesh, Punjab, Haryana, Chhattisgarh, Uttarakhand, Himachal Pradesh and Delhi, though concentration towards Rajasthan remains high with a share of ~62% in the portfolio. As on December 31, 2021, the AUM stood at Rs. 4,178 crore.

The promoter group, viz. Mr. Rajendra Setia and his family members, held 38.7% equity share in the company as on December 31, 2021. Other key equity investors include Northwest Venture Partners, TPG Capital, Evolvence and Baring India with equity shareholding of 24.52%, 18.96%, 5.57% and 4.67%, respectively, as of December 31, 2021.

Key financial indicators

Amount (Rs. crore)	FY2019	FY2020	FY2021	9M FY2022
	Audited	Audited	Audited	Unaudited
Total Income	343	564	683	575
PAT	63	79	91	86
Net Worth	563	879	971	1,541
Gross Loan Book	1,810	2,948	3,422	4,185
Total Assets	2,254	3,644	4,465	5,462
Return on Average Assets	3.7%	2.7%	2.2%	2.3%
Return on Average Equity	16.6%	10.9%	9.8%	9.1%
Gearing (times)	2.8	2.9	3.4	2.4
CRAR (%)	34.1%	31.7%	27.7%	33.3%
Gross Stage 3 (%)	4.2%	4.0%	4.1%	4.9%

Amount (Rs. crore)	FY2019	FY2020	FY2021	9M FY2022
	Audited	**Audited**	**Audited**	**Unaudited**
Total Income	343	564	683	575
Net Stage 3 (%)	2.6%	2.4%	1.9%	2.4%
Solvency (Net Stage 3/Net Worth (%))	8.4%	8.1%	6.7%	6.3%

Source: *SKFL, ICRA Research*

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 (Rs. crore)	Mar 07, 2022	Dec 23, 2021	Nov 08, 2021	Oct 28, 2021	Sep 08, 2021	Date & Rating in FY2021	Date & Rating in FY2020	Date & Rating in FY2019
										-	-	-
1	Non-convertible Debentures	Long Term	35.0	35.0	[ICRA]A+ (Stable)	[ICRA]A (Stable)	-	-	-	-	-	-
2	LT-Market Linked Debentures	Long Term	150.0	150.0	PP-MLD [ICRA]A+ (Stable)	PP-MLD [ICRA]A (Stable)	PP-MLD [ICRA]A (Stable)	-	-	-	-	-
3	Long-term Fund-based Term Loan	Long Term	275.0	275.0	[ICRA]A+ (Stable)	[ICRA]A (Stable)	[ICRA]A (Stable)	[ICRA]A (Stable)	[ICRA]A (Stable)	-	-	-

Source: *ICRA Research*

Complexity level of the rated instruments

Instrument	Complexity Indicator
Non-convertible Debentures	Simple
Long-term Fund-based Term Loan	Simple
LT-Market Linked Debentures	Complex

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/ Bank Name	Instrument Name	Date of Issuance/ Sanction	Coupon Rate	Maturity Date	Amount Rated (Rs. crore)	Current Rating and Outlook
INE124N08075	NCD	Dec 29, 2021	9.25%	Jun 29, 2024	35.0	[ICRA]A+ (Stable)
INE124N07564	MLD	Nov 12, 2021	GSEC Linked	Jan 12, 2024	150.0	PP-MLD [ICRA]A+ (Stable)
NA	Term Loan 1	Jul 02, 2021	NA	Jun 10, 2022	100.0	[ICRA]A+ (Stable)
NA	Term Loan 2	Aug 05, 2021	NA	Feb 25, 2025	50.0	[ICRA]A+ (Stable)
NA	Term Loan 3	Aug 04, 2021	NA	Jun 27, 2024	25.0	[ICRA]A+ (Stable)
NA	Term Loan 4	Oct 18, 2021	NA	Dec 30, 2024	100.0	[ICRA]A+ (Stable)

Source: *SKFL*

Please click here to view details of lender-wise facilities rated by ICRA

Annexure-2: List of entities considered for consolidated analysis: Not Applicable

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