September 23, 2022

Northern Arc Capital Limited: Rating downgraded for one issuer forming part of pooled NCD programme – Northern Arc Pooled Bond Issuance XIX

Summary of rating action

Sr. No.	Borrower Name	Instrument*	Initial Rated Amount (Rs. crore)	Previous Rated Amount (Rs. crore)	Current Rated Amount (Rs. crore)	Rating Action
1	Varthana Finance Private Limited (erstwhile Thirumeni Finance Private Limited)	NCD	25.00	8.33	4.17	[ICRA]BBB-(Stable); rating downgraded from [ICRA]BBB (Negative)
2	ASA International India Microfinance Limited	NCD	17.00	2.83	0.00	[ICRA]BBB- (Negative); withdrawn
3	Aye Finance (P) Ltd.	NCD	32.00	10.67	0.00	[ICRA]BBB+ (Stable); withdrawn
4	Kanakadurga Finance Limited	NCD	32.00	10.67	5.33	[ICRA]BBB- (Stable); outstanding

**Instrument details are provided in Annexure-1*

ICRA also has a rating outstanding on the other rated facilities/instruments of the following entities:

Varthana Finance Private Limited: Refer to this link for details

Aye Finance (P) Limited: Refer to this link for details

ASA International India Microfinance Limited: Refer to this link for details

Rationale

The ratings for the non-convertible debenture (NCD) programme are based on the stand-alone credit profiles of each of the issuing entities. The pooled bond issuance (PBI) transaction also has a common external credit enhancement in the form of a corporate guarantee to the extent of 5.0% of the initial value of the total PBI principal amount provided by Northern Arc Capital Limited (NACL; rated [ICRA]A+ (Stable)/[ICRA]A1+). The common guarantee shall be used to meet shortfalls, if any, in debt servicing of any of the issuing entities. The transaction stipulates a defined payment mechanism to ensure that the guarantor is required to fund the designated account prior to the due date. ICRA notes that any additional disruptions on account of the Covid-19 pandemic and the consequent impact on macro-level economic activity could have a bearing on the credit profiles of the underlying borrowers.

The common guarantee cover is expected to increase with the gradual amortisation of the PBI debentures. As per the terms of the transaction, when the guarantee (which is set at 5% of initial PBI principal) exceeds 10.00% of the aggregate outstanding principal of the PBI debentures, the guarantee cap is expected to be reset to 10.00% of the aggregate outstanding principal of the PBI debentures.

Varthana Finance Private Limited (erstwhile Thirumeni Finance Private Limited)

The rating downgrade factors in the continued stress on Varthana's portfolio on the back of the prolonged unfavourable operating conditions for the school financing sector during the pandemic. With the third wave of the pandemic delaying the reopening of schools, Varthana's asset quality deteriorated further in H2 FY2022 and Q1 FY2023. The Gross stage 3 (GS3) of the company deteriorated to 15.4% as of June 2022 and 12.0% as of March 2022 from 10.3% as of September 2021 (2.9% as of March 2021). As of March 2022, Rs. 45.8 crore (24%) of the restructured book had slipped into the GS3 bucket. In addition, the company had a sizable standard restructured book at 15.2% of the portfolio as of March 2022. ICRA takes note of the stress in the restructured book, as repayments have commenced for this portfolio and were in various overdue buckets as of June 2022. Going forward, with the reopening of majority of the schools from the academic year 2022-23 onwards, ICRA expects the operating conditions for school financing to improve steadily. As such, incremental slippages in asset quality performance is expected to be controlled in the near term. However, the recoveries and improvement in the stressed portfolio levels is expected to be gradual over the next few quarters.

ICRA also notes that Varthana's asset quality pressure, consequently, impacted its net profitability which moderated to 0.2% in FY2022. Further, Varthana reported a net loss of 5.3% (provisional, annualised) in Q1 FY2023 largely due to increased credit & provision costs. Varthana's ability to keep its credit & provision cost and operating efficiencies under control would be crucial for incremental profitability. ICRA notes that the company increased its total provisions from 7.5% as of March 2021 to 11.9% as of March 2022; though, the GS3 provision coverage remained similar at 54.2% as of March 2022 vis-à-vis 52.7% as of March 2021.

The rating also factors in the limited incremental funding obtained by the company in recent quarters, with the company being able to raise modest debt funding of about Rs. 77 crore in FY2022 and about Rs. 48 crore in 5MFY2023, largely from existing NBFC lenders and through securitisation transactions. The company was also in breach of some of the financial covenants with its lenders and has received temporary relaxation from some of them. In backdrop of this, Varthana's ability to restrict any adverse action from existing lenders and secure sufficient incremental funds for envisaged portfolio scale-up in FY2023 would be monitorable.

The rating continues to factor in the experience of its senior management team, led by Mr. Steve Hardgrave and Mr. Brajesh Mishra, who have adequate understanding of the target segment. ICRA also takes comfort from the significant number of institutional investors in the company, who have supported the company in raising capital in the past. With a capital raise of Rs. 105 crore undertaken in FY2022, Varthana is adequately capitalised for its current scale of operations and is not envisaging any immediate plans for further equity infusion. Varthana's leverage metrics improved in FY2022, with its managed gearing at 1.1 times as on June 2022 (1.1 times as of March 2022) vis-à-vis 1.9 times as of March 2021. The CRAR has also improved to 56.2% as of June 2022. Varthana's liquidity profile is adequate at present. However, it would be crucial to diversify its funding profile and secure longer-tenure funding at competitive rates to support its liquidity profile over the next few quarters as the portfolio expands.

ASA International India Microfinance Limited and Aye Finance (P) Ltd.

ICRA has withdrawn the rating assigned to the non-convertible debentures (NCDs) of ASA International India Microfinance Limited and Aye Finance (P) Ltd. at the request of the trustee and in accordance with ICRA's policy on the withdrawal of credit ratings as the rated instruments have been redeemed with no amount outstanding against the same.

Key rating drivers and their description

Varthana Finance Private Limited (erstwhile Thirumeni Finance Private Limited)

Credit strengths

Adequate capitalisation profile– Varthana raised capital of about Rs. 105 crore in FY2022, which supported the capital structure of the company, in view of the headwinds on the asset quality front. With Varthana maintaining its scale of operations rangebound (AUM of Rs. 957.8 crore as of March 2022 and Rs. 928.6 crore as of June 2022), the managed gearing of the company improved to 1.1 times as of June 2022 (1.1 times as of March 2022) from 1.9 times as of March 2021. The CRAR improved to 56.2% as of June 2022 (55.4% as of March 2022), compared to 33.5% in March 2021. Considering the current capitalisation level, the company is not envisaging any immediate plans for equity infusion.

Experienced senior management team– Varthana has an experienced management team, led by Mr. Steve Hardgrave and Mr. Brajesh Mishra, who have adequate understanding of the target segment. The company augmented its senior management team in FY2021, including the Chief Business Officer, Chief Risk Officer, Head of Collections, Head of Legal and Head of Credit. The company is backed by investors like ChrysCapital, LGT Capital Invest Mauritius, Elevar Equity Management Limited, Omidyar Network, Kaizen Private Equity, etc.; most of these investors participated in the capital raise of Rs.105 crore undertaken in FY2022.

Credit challenges

Asset quality indicators continue to remain under pressure – Varthana's Gross stage 3 deteriorated to 15.4% as of June 30, 2022 (12.0% as of March 31, 2022) compared to 2.9% as of March 31, 2021. This may be attributed to the higher level of slippages witnessed given the prolonged disruption in the operations of schools and correspondingly, the fee collections. The Net Stage 3 also remained at elevated levels of 6.5% as of June 30,2022. The second wave of the pandemic coincided with the resumption of repayments for the loan restructured in FY2021, leading to increased slippages from the restructured book. Further, with the re-opening of schools delayed on account of the third wave of the pandemic in Q4FY2022, improvement in collections was significantly restricted during FY2022. As of March 2022, the Covid restructured book stood at Rs 191 crore (19.9% of the AUM), of which, Rs 45.8 crore had slipped into GS3 category. The total standard restructured book as of March 2022 stood at Rs. 145.2 crore (15.2% of the AUM). ICRA takes note of the stress in the restructured book; a sizeable portion of restructured book, where repayments have commenced are in various softer delinquency buckets, apart from the slippages detailed above. On the other hand, backed by some recoveries, the security receipts outstanding, received from sale of assets to the ARC during the last fiscal, moderated from about Rs. 31.2 crore in March 2021 to Rs 26.1 crore in March 2022 and further to Rs 23.9 crore in June 2022.

ICRA notes that while the GS3 provision coverage improved to 54.2% as on 31 March 2022 vis-à-vis 52.7% as on March 2021, the net stage 3 to net worth ratio increased to 12.5% as of June 2022 (10.6% as of March 2022) from 3.7% as of March 2021 due to increased slippages. As of March 31, 2022, the total provisions stood at Rs. 113.3 crore (11.9% of the portfolio) which includes a management overlay of Rs. 40.9 crore (4.3% of the portfolio). The company has access to the SARFAESI Act; the top 20 nonperforming advances (NPAs; 26.6% of the NPAs in March 2022) in entirety and 95% of the portfolio are secured, which could limit the ultimate losses, though repossession of the property and recovery of dues may take time. As of March 31, 2022, about Rs 218.8 crore of the portfolio was under litigation through this forum. Going forward, Varthana's ability to effect recoveries from its stressed asset book and restrict incremental slippages would be critical for improving the asset quality performance and would be a key monitorable from the rating perspective.

Subdued profitability indicator– Varthana's profitability continues to be weak, given the stressed asset quality performance of the company, with its PAT/AMA at 0.2% in FY2022 (-0.6% in FY2021). In Q1 FY2023, the company reported a net loss of 5.3% (provisional, annualised) due to the elevated credit & provision costs of 9.5% (provisional, annualised) vis-à-vis 3.4% in FY2022 (5.0% in FY2021). Increased collection efforts and other initiatives to augment IT and internal MIS increased the operating expense ratio (operating expenses/AMA) to 6.8% (provisional; annualised) in Q1 FY2023 and 5.5% in FY2022 from 4.4% in FY2021. Varthana's ability to bring back its credit & provision costs and operating efficiencies under control would be crucial for incremental profitability going forward.

Ability to secure adequate debt funding critical for business growth– Varthana's debt funding was restricted over the last two years on account of the pandemic, which along with the management's decision to follow a more cautious approach for new business, resulted in a rundown of its loan book. The company has a limited incremental funding of about Rs. 77 crore in FY2022 and about Rs. 48 crore in 5MFY2023, raised largely from existing NBFC lenders and through securitisation transactions. In addition, Varthana also raised equity capital of about Rs. 105 crore in FY2022, supporting the modest disbursements undertaken during the year, in addition to its liquidity requirements. Going forward, given that there is no immediate equity raise plans, it would be critical for the company to secure adequate debt funding in H2 FY2023, which would enable them to maintain adequate liquidity and make incremental disbursements. ICRA notes that the company currently has about Rs 245 crores of debt funding in pipeline and securing firm sanctions from the same in a timely manner remains to be seen.

ICRA also notes that the company was in breach of some financial covenants with its lenders and has received temporary relaxations from some lenders. In backdrop of this, Varthana's ability to restrict any adverse action from existing lenders and secure incremental funds for envisaged portfolio scale-up in FY2023 would be key monitorable.

Moderate scale of operations– With a portfolio size of Rs. 957.8 crore as on March 2022 (Rs 928.6 crore as of June 2022), VFPL's current scale of operations remains moderate. The company was cautious on incremental disbursements in FY2022, aggregating Rs. 117.9 crore vis-à-vis Rs. 106.2 crore in FY2021 (Rs. 459.5 crore in FY2020). In Q1 FY2023, Varthana was able to sustain its disbursements at Rs.38.4 crore, in line with the disbursement made during Q4 FY2022. The disbursements are expected to gain momentum from H2 FY2023 onwards, with the company targeting an AUM in the range of around Rs. 1,500 crore by March 2023.

Liquidity position: Adequate

Varthana's ALM profile was adequate as on March 31, 2022 with no negative cumulative mismatches in any of the buckets. The company has repayment obligations of Rs. 124.1 crore over September 2022 to December 2022 against which it had unencumbered cash and liquid investment of Rs. 82.7 crore as of August 2022. With monthly collections of Rs. 20–25 crores, as seen in the recent months, Varthana's liquidity position is adequate.

VFPL's borrowing profile comprised of ECBs, NBFCs, NCDs from FIs, securitisation and bank borrowings accounting for 38%, 28%, 20%, 5% and 8% of the overall borrowing as of March 2022. ICRA notes that the company's borrowings have an average tenure of about 4 years, while the loans have a contractual tenure, averaging about 6-8 years. It is, therefore, crucial to improve the funding diversity and secure longer-tenure loans as the portfolio expands.

Rating sensitivities

Positive factors – ICRA could revise the outlook to positive or upgrade the rating if Varthana is able to demonstrate a sustained improvement in its asset quality and scale of operations, leading to an improved earnings profile.

Negative factors – ICRA could revise the outlook to negative or downgrade the rating if the asset quality continues to remain weak, thereby exerting further pressure on the earnings and liquidity profile of the company. Inability to secure incremental funding lines in a timely manner could also negatively impact the rating.

Key rating assumptions

In the present PBI programme, the servicing of each repayment is primarily the obligation of the individual issuer. Thus, for rating the said bonds, the approach has been to factor in the likelihood of an individual borrower defaulting on its debt obligations (which is a function of its stand-alone credit rating). Any shortfall in meeting the scheduled payouts to the NCD holders is to be met through the common guarantee till it is available. However, since the common guarantee quantum is small (initially only 5% of the total outstanding amount and capped at 10%), the resulting probability of default on the PBI would not be materially lower than the default probability of the stand-alone debt of the individual issuers. Thus, the benefit of the credit enhancement is minimal. Hence, there is no rating uplift due to the presence of the guarantee (from ICRA's stand-alone rating on the individual entities).

Analytical approach

The rating action is based on the credit profile of the underlying issuers.

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

About the company

Varthana Finance Private Limited (erstwhile Thirumeni Finance Private Limited)

Varthana is a non-deposit taking non-banking financial company, incorporated in Cochin (Kerala) in June 1984. It was acquired by the current promoters – Mr. Steve Hardgrave and Mr. Brajesh Mishra in May 2012 and commenced financing operations in January 2013. As on March 31, 2022, the promoters held an 10.6% stake in the company with the balance held by institutional investors (83.6%), individual investors (2.4%) and an employee share ownership trust (3.4%). Varthana offers credit facilities to private schools, including affordable private schools, for improvement, capacity expansion and growth. It operates in 15 states and 1 Union Territory, including Karnataka, Maharashtra, Madhya Pradesh, Tamil Nadu, Odisha, Rajasthan, and Chhattisgarh, with its head office in Bengaluru. As on June 30, 2022, Varthana had a loan book of Rs.928.6 crore.

The previous detailed rating rationale is available on the following link: Click here

Key financial indicators (audited)

Company Name	FY2020	FY2021	FY2022
Total income (Rs. crore)	227.4	211.6	190.7
Profit after tax (Rs. crore)	15.3	-7.7	2.5
Net worth (Rs. crore)	403.1	386.7	495.2
Assets under management (Rs. crore)	1,104.0	1,044.8	957.8
Total assets (Rs. crore)	1,225.9	1,164.4	1048.7
Return on managed assets (Rs. crore)	1.3%	-0.6%	0.2%
Return on net worth (Rs. crore)	3.9%	-1.9%	0.6%
Gearing (times)	2.0	1.9	1.1
Gross Stage 3 (%)	7.1%	2.9%	12%
Net Stage 3 (%)	4.3%	1.5%	5.5%
Solvency (Net stage 3/Net worth)	11.3%	3.7%	10.6%
CRAR (%)	36.8%	35.7%	55.4%

Source: Company, ICRA Research; All ratios as per ICRA's calculations; Amount in Rs. crore

Status of non-cooperation with previous CRA: Not applicable

Any other information: None

Rating history for past three years

S. No.	Instrument	Borrower Name	Amount Rated (Rs. crore)	Amount Outstanding (Rs. crore)	Current Rating (FY2023): Date & Rating in FY2023		Chronology of Rating History for the Past 3 Years: Date & Rating in FY2022			Date & Rating in FY2021			Date & Rating in FY2020
					September 23, 2022	May 31, 2022	Mar 11, 2022	Dec 10, 2021	Jun 04, 2021	Dec 31, 2020	Dec 18, 2020	May 27, 2020	Aug 02, 2019
1	Northern Arc Pooled Bond Issuance XIX	ASA International India Microfinance Limited	17.00	0.00	[ICRA]BBB- (Negative) withdrawn	[ICRA]BBB- (Negative)	[ICRA]BBB - (Stable)	[ICRA]BBB- (Stable)	[ICRA]BBB- (Stable)	[ICRA]BBB (Negative)	[ICRA]BBB (Stable)	[ICRA]BBB (Stable)	[ICRA]BBB (Stable)
		Varthana Finance Private Limited (erstwhile Thirumeni Finance Private Limited)	25.00	4.17	[ICRA]BBB- (Stable)	[ICRA]BBB (Negative)	[ICRA]BBB (Negative)	[ICRA]BBB (Negative)	[ICRA]BBB (Stable)	[ICRA]BBB (Stable)	[ICRA]BBB (Stable)	[ICRA]BBB+ (Negative)	[ICRA]BBB +(Stable)
		Aye Finance (P) Ltd.	32.00	0.00	[ICRA]BBB+ (Stable) withdrawn	[ICRA]BBB+ (Stable)	[ICRA]BBB + (Stable)	[ICRA]BBB+ (Stable)	[ICRA]BBB+ (Stable)	[ICRA]BBB+ (Stable)	[ICRA]BBB+ (Stable)	[ICRA]BBB+ (Stable)	[ICRA]BBB (Stable)
		Kanakadurga Finance Limited	32.00	5.33	[ICRA]BBB- (Stable)	[ICRA]BBB- (Stable)	[ICRA]BBB - (Stable)	[ICRA]BBB- (Stable)	[ICRA]BBB- (Stable)	[ICRA]BBB- (Negative)	[ICRA]BBB- (Negative)	[ICRA]BBB- (Negative)	[ICRA]BBB -(Stable)

Complexity level of the rated instrument

Instrument	Complexity Indicator
Northern Arc Pooled Bond Issuance XIX	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

Transaction Name	ISIN	Borrower Name	Date of Issuance	Coupon Rate	Scheduled Maturity Date*	Amount Rated (Rs. crore)	Current Rating
Northern Arc Pooled Bond Issuance XIX	INE746T07082	ASA International India Microfinance Limited	July 2019	Blended yield of 13.36%	August 2022	0.00	[ICRA]BBB- (Negative) withdrawn
	INE125T07162	Varthana Finance Private Limited (erstwhile Thirumeni Finance Private Limited)			February 2023**	4.17	[ICRA]BBB- (Stable)
	INE501X07133	Aye Finance (P) Ltd.			August 2022	0.00	[ICRA]BBB+ (Stable) withdrawn
	INE104W07112	Kanakadurga Finance Limited			February 2023**	5.33	[ICRA]BBB- (Stable)

**NCD rated for all borrowers*
*** Changed to February 2023 from August 2022 following the revision in the terms of the transaction*

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.

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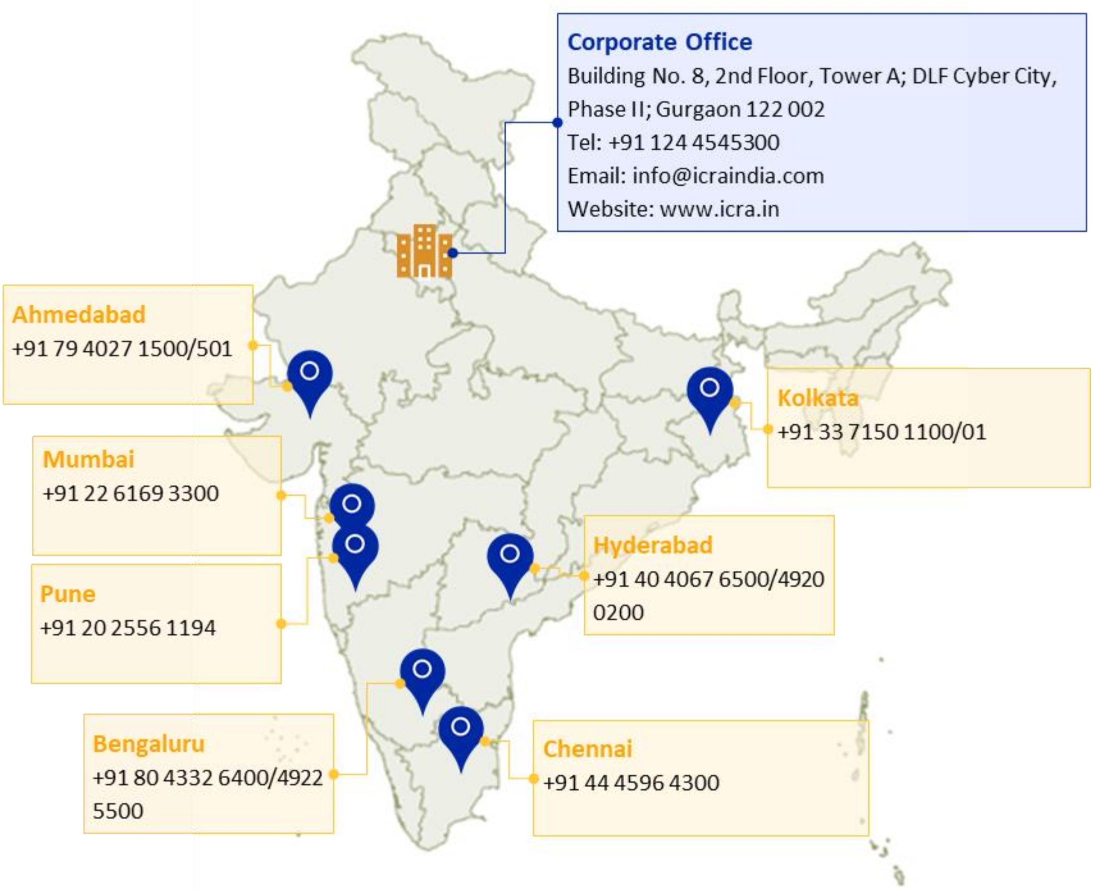

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