February 26, 2024

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 I*

Rationale

The rating action factors in the strong parentage of Fedbank Financial Services Limited (FFSL) with Federal Bank Limited (FBL) holding a 61.65% stake in the company. FBL's shareholding declined to the current level (from 72.75% as of September 2023) following the initial public offering (IPO), which involved a fresh equity infusion of Rs. 600.0 crore and an offer for sale (OFS) amounting to Rs. 492.3 crore in November 2023. FFSL is expected to remain FBL's subsidiary and shall continue to draw managerial, operational and financial support from the bank, when required.

The rating factors in FFSL's strengthened capitalisation profile, following the equity infusion of Rs. 600.0 crore during the IPO. As a result, its gearing[1] stood at 3.8 times and the capital-to-risk weighted assets ratio (CRAR) was 25.8% (Tier-I of 21.7%) as of December 2023 vis-à-vis 5.4 times and 17.9% (Tier-I of 15.1%), respectively, as of March 2023. The rating also considers FFSL's improving profitability on the back of the strong scale-up of operations and controlled credit costs.

FFSL's product mix is fairly diversified, comprising gold loans, medium-ticket loan against property (LAP), small-ticket LAP, unsecured business loans, and housing loans. It also has a small exposure to construction finance and structured finance, though it stopped disbursements for the same from FY2022. The company's assets under management (AUM) increased at a compound annual growth rate (CAGR) of 45% during March 2019 to March 2023, supported by branch additions. It grew by 18% in 9M FY2024. FFSL caters to customers with moderate credit profiles, mostly self-employed non-professional borrowers, and 41% of the portfolio is without a prior credit history as per the credit bureau report. Further, given the steep growth, the company's book has moderate seasoning, especially in the non-gold segments (including small ticket size LAP to micro and small enterprises, housing loans and business loans).

Notwithstanding the moderate portfolio seasoning and the customer profile, the asset quality trajectory has been largely under control, supported by prudent underwriting. The collection efficiency (excluding wholesale, gold and business correspondent loans) stood at ~99% in 9M FY2024, providing comfort. FFSL's ability to maintain healthy asset quality over the medium term remains key from a credit perspective.

Key rating drivers and their description

Credit strengths

Strong parentage with well-demonstrated track record of support – FFSL was promoted by FBL in 1995 and is a subsidiary of the bank, which held 61.65% as of December 2023 (72.75% as of September 2023). FBL's shareholding declined following the IPO in November 2023 with a fresh capital infusion of Rs. 600.0 crore and OFS of Rs. 492.3 crore (Rs. 76.7 crore by FBL and Rs. 415.6 crore by TrueNorth LLP, a private equity firm). However, FBL would continue to hold a majority stake in FFSL over the medium term. As the company is strategically important to FBL, FFSL draws managerial and operational support from the bank. The Managing

[1] *Managed gearing was 4.6 times as of December 2023 vis-à-vis 6.1 times as of March 2023*

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, for which it earns fee income.

Further, FFSL has received financial support from FBL in the form of regular capital infusions (Rs. 59 crore in FY2020, Rs. 58.6 crore in FY2021 and Rs. 148 crore in FY2022). FBL also provides credit lines {working capital facilities, term loans and non-convertible debentures (NCDs)}; the outstanding amount was Rs. 915 crore (11.5% of the overall borrowings) as of December 2023.

Strengthened capitalisation profile, following recent equity raise via IPO – FFSL's capital profile has strengthened with a gearing of 3.8 times and a CRAR of 25.8% (Tier-I of 21.7%) as of December 2023 vis-à-vis 5.4 times and 17.9% (Tier-I of 15.1%), respectively, as of March 2023. The improvement was driven by the fresh capital infusion of Rs. 600 crore in November 2023. Over the last few years, the company has received regular capital infusions, which helped it maintain a strong growth. ICRA expects FFSL to operate at a leverage of less than 6.0 times over the medium term.

Improving profitability – FFSL's profitability has improved over the last two years, with the company reporting a return on managed assets (RoMA) of 2.1% in 9M FY2024 as well as FY2023 vis-à-vis 1.6% in FY2022 (1.2% in FY2021), supported by higher gains from direct assignment and limited incremental credit costs. The net interest margin remained healthy at 7.4% in FY2023 and 7.1% in 9M FY2024 (7.5% in FY2022), notwithstanding the increase in the cost of funds and leverage, on account of better yields and the upfronting of gains from direct assignment. Going forward, the margins are expected to be maintained at the current levels despite the rising borrowing cost, amid the systemic interest rate trajectory, as the company focuses on high-yielding products. FFSL's credit cost (provisions and write-offs/average managed assets) declined to 0.6% in FY2023 as well as 9M FY2024 from 1.3% in FY2022 and 1.4% in FY2021 due to the steady asset quality and the improvement in the stage 2 assets with the rundown of the restructured book. Investments in branch and information technology (IT) infrastructure continued to keep the operating expense ratio in the range of 4.8-5.1% in FY2021 and 9M FY2024. ICRA expects economies of scale to lead to a moderate reduction in the cost-to-income ratio, which would support FFSL's profitability further in the medium term.

Credit challenges

Moderate portfolio seasoning and customer profile – FFSL's AUM increased at a robust CAGR of 42% over the past six years to Rs. 10,714 crore as of December 2023 from Rs. 1,422 crore as of March 2018. As of December 2023, its AUM comprised gold loans (32%), LAP (26%), small/medium-ticket LAP (19%), business loans (16%), housing loans (7%) and other loans (1%). Over the last few years, FFSL has increased the diversification in the portfolio by foraying into retail products like housing loans, personal loans, and unsecured business loans. Further, in the LAP segment, FFSL has forayed into small ticket sized LAP and lowered the average ticket size for small/medium ticket sized LAP. The mix between the secured and unsecured portfolio was ~84:16 as of December 2023. The company is expected to retain its focus on the secured retail segments, viz. mortgage and gold loans.

However, ICRA notes that the portfolio seasoning is low, especially in the recently launched and long-tenured product segments such as business loans, small-ticket LAP, housing finance and personal loans, which accounted for 43% of the AUM as of December 2023. It typically caters to customers with a moderate credit profile, mostly self-employed non-professional borrowers in urban and semi-urban locations. Its top 10 branches, located in cities, accounted for ~40% of the total portfolio as of December 2023. Further, ICRA takes note of the high share of exposures with a loan-to-value (LTV) in excess of 75% in the company's gold loan portfolio. Nevertheless, it has kept its asset quality under control, with gross non-performing assets (GNPA) at 2.2% as of December 2023 (2.0% as of March 2023). There was a sizeable uptick in gold auctions in FY2023 and 9M FY2024, which helped the company keep its gold loan delinquencies under control. Also, the stage 2 assets improved to 4.2% as of December 2023 (4.6% as of March 2023) from 8.7% as of March 2022 due to the rundown of the restructured book (predominantly non-gold loan segments).

ICRA notes that the stage 3 provision coverage increased to 24.5% as of December 2023 from 22.2% as of March 2023. The company maintained an overall provision cover of 1.4% on the loan book as of December 2023 (1.4% as of March 2023), down from 2.0% as of March 2022 due to the improvement in the stage 2 assets.

Environmental and social risks

Environmental considerations: Given the service-oriented business of FFSL, its direct exposure to environmental risks/material physical climate risks is not significant. Lending institutions can be exposed to environmental risks indirectly through their portfolio of assets, though such risks are not material for FFSL as its lending operations primarily encompass gold loans and loan against property. Nevertheless, there is increasing interest from policymakers towards identifying the exposure of financing companies to carbon emissions through their financing activities. This process is, however, in an early stage and ICRA expects any adverse implications to manifest only over a longer time horizon, giving financing companies adequate time to adapt and minimise the credit implications.

Social considerations: With regard to social risks, data security and customer privacy are among the key sources of vulnerability for lending institutions as material lapses could be detrimental to their reputation and invite regulatory censure. FFSL has not faced any significant lapses in this regard. It serves the financing needs of a relatively underserved category of borrowers, which supports social inclusion and economic development.

Liquidity position: Strong

FFSL's asset-liability maturity (ALM) profile reflects positive cumulative mismatches across the near-and-medium-term maturity buckets, supported by the favourable matching of the average tenor of the assets and liabilities, and comfortable on-balance sheet liquidity. The company had on-balance sheet liquidity (cash and bank balance, liquid mutual funds, investments in Government securities and fixed deposits) of Rs. 1,394.2 crore and unutilised bank lines of Rs. 321.0 crore, as on December 31, 2023, compared to principal repayments (including working capital demand loans) of Rs. 997.7 crore falling due in the subsequent three months. This, coupled with the sizeable share of the short-term product (gold loan; 32% of AUM as of December 2023) and average monthly collections (excluding wholesale, gold and business correspondent loans) of ~Rs. 145 crore (between April 2023 and December 2023), supports the liquidity profile. Further, ICRA notes that FFSL has good financial flexibility as it is a subsidiary of FBL. This, coupled with the high likelihood of support from the parent, augurs well for the company's liquidity profile.

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 profile and asset quality on a sustained basis.

Analytical approach

Analytical Approach	Comments
Applicable rating methodologies	Rating methodology for non-banking finance companies
Parent/Group support	The rating factors in FFSL's strong parentage as it is a subsidiary of FBL and the well-demonstrated track record of support. FFSL draws managerial, operational and financial support from FBL, as evident from the common board members, regular capital infusions, credit lines, business sourcing arrangements and shared brand name.
Consolidation/Standalone	Standalone

About the company

Fedbank Financial Services Limited (FFSL) is registered with the Reserve Bank of India (RBI) as a non-deposit taking non-banking financial company (NBFC). It was incorporated in 1995 and received a licence to operate as an NBFC in 2010. FFSL is a subsidiary of Federal Bank Limited (FBL), which had held a 100% stake in the company until FY2018. In FY2019, TrueNorth LLP acquired a 17% stake in FFSL and another 9% (total 26%) in FY2020. The company concluded its IPO and OFS in November 2023, which resulted in a decline in FBL and TrueNorth LLP's shareholding to 61.7% and 8.8%, respectively, as of December 2023.

The company primarily provides gold loans, LAP, business loans, personal loans, and housing loans. FFSL is also engaged in sourcing loans (housing loans, auto loans, personal loans, small and medium-sized enterprise (SME) loans) for its parent. As on December 31, 2023, it had a presence in 17 states/Union Territories with a 609-branch network including 437 gold loan branches and 172 micro, small and medium enterprise (MSME) hubs.

The AUM, as on December 31, 2023, was Rs. 10,714 crore (Rs. 9,070 crore as on March 31, 2023). 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 the 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	FY2022	FY2023	9M FY2024
	INDAS	INDAS	INDAS
Total income	884	1,215	1,195
Profit after tax	103	180	177
Total managed assets	6,982	10,038	12,518
Return on managed assets	1.6%	2.1%	2.1%
Gearing (times)	4.3	5.4	3.8
Managed gearing (times)	4.7	6.1	4.6
Gross stage 3	2.2%	2.0%	2.2%
CRAR	23.0%	17.9%	25.8%

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

Instrument	Current Rating (FY2024)				Chronology of Rating History for the Past 3 Years		
	Type	Amount Rated (Rs. crore)	Amount Outstanding (Rs. crore)	Date & Rating in FY2024	Date & Rating in FY2023	Date & Rating in FY2022	Date & Rating in FY2021
				Feb 26, 2024	Feb 01, 2023	Feb 11, 2022	Feb 15, 2021
1 **Commercial paper programme**	Short term	1,000.00	0.00	**[ICRA]A1+**	**[ICRA]A1+**	**[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: Click Here

Annexure I: Instrument details

ISIN	Instrument Name	Date of Issuance / Sanction	Coupon Rate	Maturity Date	Amount Rated (Rs. crore)	Current Rating and Outlook
NA	**Commercial paper programme – Unutilised**	NA	NA	NA	1,000.00	[ICRA]A1+

Source: Company

Annexure II: 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.

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