Edelweiss Custodial Services Limited Revised

December 22, 2017

Summary of rated instruments

Instrument*	Previous Rated Amount (Rs. crore)	Current Rated Amount (Rs. crore)	Rating Action
Short-term Non-Fund Based Bank Lines	2,000.00	2,000.00	[ICRA]A1+; Reaffirmed
Total	**2,000.00**	**2,000.00**	

Rating action

ICRA has reaffirmed the rating of [ICRA]A1+ (pronounced ICRA A one plus) for Short-term Non-Fund Based Bank Lines of Rs. 2,000 crore of Edelweiss Custodial Services Limited (ECdSL).

Rationale

The ratings favourably factor in the Edelweiss Group's diversified business profile, its demonstrated track record and established position as a diversified financial service provider and its robust risk management systems. While the Group commenced operations in 1996 as a capital markets oriented player, it has successfully diversified into various credit and non-credit businesses in the financial sector over the years. While reaffirming the ratings, ICRA has taken note of the close linkages among the Group entities given the common promoters and senior management team, shared brand name, and strong financial and operational synergies. Furthermore ICRA expects EFSL to continue to provide financial, managerial and operational support to all the key Group companies. The ratings also take into account the improvement in the Group's operational metrics, its adequate capitalisation and healthy liquidity position which provide it with enhanced financial flexibility. The ratings also take into account the scaling up of the credit business, which has emerged as a key revenue and profit driver for the Group, and the wealth and asset management businesses, which were supported by the improved performance of the capital markets in the last few quarters. The strengths are partially off-set by credit and concentration risks in the Group's wholesale lending segments, risks associated with the distressed asset business given the focus on large ticket-size single-credit exposures coupled with the evolving nature of the industry and the exposure to volatility in capital markets. However, the Group's demonstrated ability to maintain adequate asset quality coupled with the emphasis on risk management practices provides comfort. The ratings also take into account the group's relatively high leverage with adjusted gearing of 5.60 times as on September 30, 2017. However the recent capital infusion (Rs. 1,528 crore raised in November 2017 through Qualified Institutional Placement) provides some comfort. While the Group has consistently attempted to improve and diversify its resource profile, it remains exposed to refinancing risks, owing to bunching up of repayment obligations over the next two fiscals. However, the Group's demonstrated ability to raise funds from banks and capital markets and its adequate liquidity cushion (~10% of total assets) provide some comfort. The group's strategic endeavour for incubating new businesses early stage of some of the Group's recent ventures, including insurance and agri-value, has resulted in moderate consolidated profitability. The gradual improvement in the profitability in the past fiscal, supported by the groups' conscious efforts to improve operational efficiency, provides comfort. While reaffirming the rating ICRA has taken note of the group's plan to expand the custodial and clearing member services. ECdSL benefits from the strong presence of the group in the broking and allied capital market services. Going forward, the Group's ability to scale up the new businesses, in alignment with its core strategy, realize commensurate returns from its investments while maintaining a stable asset quality remains critical from a credit perspective.

Outlook: Stable

ICRA believes that Edelweiss Group will continue to benefit from its diversified business profile, its demonstrated track record and established position in capital markets related businesses and its robust risk management systems. The outlook may be revised to 'Positive' if there is a substantial and sustained improvement in the group's profitability, leading to an improvement in its financial risk profile. The outlook may be revised to 'Negative' if there is significant deterioration in the asset quality of the credit book and profitability indicators, thereby adversely affecting its financial risk profile.

Key rating drivers

Credit strengths

Diversified revenue streams with presence in credit (wholesale and retail) and non-credit (broking, investment banking, asset management and wealth management) segments - Edelweiss Group is a diversified financial services player engaged in credit, capital markets and other advisory businesses. The Group commenced operations in the capital markets related business, and has established its position as a leading entity in the institutional equity broking and investment banking segments over the years. In a bid to diversify its revenue streams and reduce the dependence on capital markets, the Group forayed into other segments like credit (wholesale lending in FY2006 and retail lending in FY2011), distressed assets (FY2010), and life insurance (FY2012). The diversification in revenue streams has reduced the Group's exposure to cyclical movements in domestic capital markets. On a consolidated basis, EFSL's total operating income1 increased from Rs. 2,599 crore in FY2016 to Rs. 3,748 crore in FY2017, registering a 44% growth supported by a healthy growth in investment banking, other fee income and trading income. With the scaling up of the credit business, net interest income continues to be the key revenue driver contributing 33% of the operating income in FY2017. The Group's investment banking and fee income, trading and broking businesses contributed 25%, 18% and 8% of the operating income respectively in FY2017.

Steady growth in loan book with growth across segments - Over the years, the Group has been able to incubate and scale-up various non-capital markets businesses as demonstrated by its established position and improved operational metrics in these businesses. Moreover, the credit business has emerged as the key revenue and profit driver of the Group, which was traditionally a capital markets player. As on September 30, 2017, the Group's loan book stood at Rs 32,540 crore (Rs. 20,014 crore as on March 31, 2016), consisting of wholesale (64% of loan book) and retail segments (36%). The wholesale segment primarily includes structured collateralised credit (24% of the overall loan book) extended to promoters and corporates, real estate financing (23%) and distressed assets credit (17%). The retail segment includes a diverse mix of retail mortgage (14% of the overall loan book), loan against shares (11%), SME and business loans (9%) and agri and rural financing (2%).

Comfortable asset quality of its lending portfolio supported by the underwriting and risk management practices – The Group has strong risk management practices to ensure stable asset quality in the collateralised credit and real estate financing segments. The Group also maintains adequate collateral cover of two times in the wholesale financing segments. The Group's reported asset quality indicators deteriorated marginally with gross non-performing assets (NPA) at 1.74% of overall advances (as compared to 1.59% as on March 31, 2017) and net NPAs at ~0.66% as on September 30, 2017. This can be partly attributed to the group shifting to 90+ days past due (DPD) NPA recognition for the NBFCs. The Group's ability to maintain asset quality across business cycles while achieving targeted portfolio growth, amidst competitive pressures would be closely monitored by ICRA and would remain a key rating sensitivity.

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[1] Operating income is computed net of interest expenses

Strong presence in investment banking and institutional equity broking; asset and wealth management also increasing in scale – Edelweiss Group continues to hold a leading position in the investment banking and institutional equity businesses. With average daily volume of Rs. 7,000 crore in FY2017, Edelweiss is among the leading institutional broking entities in the country. The other capital markets businesses include proprietary trading and investments, wealth and asset management. The Group offers wealth management advisory to its high net worth clients with assets under advice of Rs. 76,300 crore as on September 30, 2017 as compared with Rs. 29,500 crore as on March 31, 2016. The Group is also engaged in asset management with assets under management of Rs. 22,100 crore as on September 30, 2017 with special focus on alternative assets.

Healthy liquidity profile supported by the Group's treasury operations - The Group has an active treasury function which enhances its liquidity position. The Group had an adequate liquidity cushion of Rs. 4,800 crore as on September 30, 2017 (~10% of total assets) in the form of undrawn bank lines, fixed deposits, government securities and liquid mutual funds, which further enhances its financial flexibility. The consolidated capitalisation (calculated based on the RBI norms for NBFCs) remained adequate at 16.75% as on September 30, 2017.

Gradual improvement in profitability metrics, though it continues to trail behind peers - Over the past few years, the Group has endeavoured to improve its operational efficiencies, which is reflected in the improvement in the cost to income ratio across businesses. Consequently, the company reported an improvement in net profitability with return on assets (RoA) increasing from 1.00% in FY2016 to 1.34% in FY2017 despite a contraction in net interest margin during the same period. The Group's consolidated net interest margins moderated from 3.48% of average total assets (ATA) in FY2016 to 3.01% of ATA in FY2017, following a sharp increase in ATA in FY2017. During FY2017, the Group reported a net profit of Rs. 609 crore (RoE of 15.22%) as compared with Rs. 414 crore (RoE of 12.12%) in FY2016. However, the profitability levels trail behind peers, with the newer businesses like the loss-making insurance business continuing to remain a drag on the overall profitability. The RoA of the Group would be higher at 1.61% in FY2017, excluding the losses in the insurance business. In H1FY2018, the Group reported a PAT of Rs. 406 crore as compared with a PAT of Rs. 284 crore in H1FY2017.

Credit weaknesses

Exposed to credit risk in the wholesale credit business; limited seasoning of the asset reconstruction business - The Group remains exposed to credit risk given its high concentration in wholesale lending, particularly structured collateralised funding and real estate segments which are inherently risky in nature. The structured collateralised funding to corporates and real estate together contributed 47% of the credit portfolio as on September 30, 2017. In ICRA's view the seasoning of the asset reconstruction industry remains limited. Also, the ability of asset reconstruction companies (ARCs) to judiciously acquire new assets while maintaining a comfortable capital structure and competitive cost of borrowings remains a key rating sensitivity. In ICRA's view, any delay or inability in resolution of delinquent assets could impact the company's profitability and liquidity profile and will remain a key rating monitorable.

High gearing levels; given the increasing prominence of the credit business particularly wholesale lending, ability to maintain ALM remains critical – The gearing of the Group remains high at 6.32 times as on March 31, 2017 vis-a-vis 6.35 times as on March 31, 2016. The adjusted gearing, excluding the collateralised borrowing and lending operations and other liquid assets in the Balance Sheet Management Unit, would be lower at 5.20 times as on March 31, 2017. The adjusted gearing increased to 5.60 times as on September 30, 2017 (~7.7 times on a reported basis). The total borrowings at a consolidated level increased from Rs. 27,773 crore as on March 31, 2016 to Rs. 33,379 crore as on March 31, 2017. The Group has a diversified resource profile with the dependence on bank borrowings declining with fund raising from other sources like masala bonds and subordinated debt. The share of long term liabilities in the total liabilities has been increasing over the years in line with the increase in the credit book, which is long term in nature. Over the past three years, the Group's debt levels increased keeping pace with the scaling up of the credit business. However, ICRA takes note of the recent capital raising of Rs. 1,528 crore by EFSL through Qualified Institutional

Placement issue in November 2017, which would help the group in future growth and temper the gearing levels at the consolidated level over the near to medium term. The Group's ability to maintain comfortable asset liability matching in future would be a key rating monitorable.

Exposed to the inherent cyclicality in capital markets; ability to scale up operations in the non-core business and align it with the core business strategy remains critical – The Group remains exposed to the inherent volatility in capital markets as its various businesses are directly or indirectly linked to the performance of the capital markets. The Group has ventured into various businesses to diversify its revenue profile and reduce its dependence on the capital markets. The Group has also expanded its presence in managing warehouses to further consolidate and improve its presence in commodity distribution and commodity financing. The Group entered into a life insurance joint venture with Tokio Marine Insurance in 2011, which however has been making losses and remains a drag on the Group's overall profitability. The life insurance business is expected to break even in FY2022. The Group's ability to report profits in the insurance business and other new ventures like agri-value would be a key driver for its overall profitability and would remain a key rating sensitivity.

Analytical approach: For arriving at the ratings, ICRA has applied its rating methodologies as indicated below**.**

Links to applicable criteria:
[ICRA's Credit Rating Methodology for Non-Banking Finance Companies]

About the company

Edelweiss Financial Services Limited
Edelweiss Financial Services Ltd (EFSL), the holding company of the Edelweiss Group of companies, was incorporated in 1995 by first generation entrepreneurs to offer investment banking services primarily to technology companies. Currently, Edelweiss Group is engaged in wholesale and retail financing, distressed assets resolution, commodity financing, corporate debt syndication and debt restructuring, institutional and retail equity broking, corporate finance advisory, wealth advisory and asset management. The Group forayed into housing finance in FY2011 and into life insurance in FY2012.
In H1FY2018, the Group reported a PAT of Rs. 406 crore as compared with a PAT of Rs. 284 crore in H1FY2017.

Edelweiss Custodial Services Limited
Edelweiss Custodial Services Limited (ECdSL) is a SEBI registered Custodian & Designated Depository Participant (DDP) and a Professional Clearing Member (PCM). Incorporated in the year 2008, it is engaged in the business of providing securities custody and clearing services to domestic and foreign investors. The range of clients serviced includes Foreign Institutional Investors (FII), Foreign Portfolio Investors (FPI), Domestic AIFs (Alternative Investment Funds) and Domestic Body corporate. The company reported a net profit of Rs. 11.47 crore on an operating income of Rs. 25.47 crore in FY2017 as compared to a net loss of Rs. 0.80 crore on an operating income of Rs. 5.51 crore in FY2016. The company had a networth of Rs. 86.81 crore as on March 31, 2017.

Key Financial Indicators (Audited) (Consolidated for EFSL)

	FY2016	FY2017
Total Income	5,268	6,619
Profit after Tax	414	609
Net worth	3,675	4,329
Loan Book	20,014	27,608
Total Assets	36,985	44,823
Return on Assets	1.00%	1.34%
Return on Equity	12.12%	15.22%
Gross NPA	1.40%	1.59%
Net NPA	0.50%	0.60%
Capital Adequacy Ratio	18%	17%
Gearing	6.35	6.32
Adjusted Gearing	4.95	5.20

Status of non-cooperation with previous CRA: Not applicable

Any other information: None

Rating history for last three years:

	Instrument	Current Rating (FY2018)				Chronology of Rating History for the past 3 years			
		Type	Amount Rated (Rs. crore)	Amount Outstanding (Rs. crore)	Date & Rating Dec-17	FY2018 Jun-17	FY2017 Mar-17	FY2016 -	FY2015 -
1	Short-term Non-Fund Based Bank Lines	Short Term	2,000.00	1,250.00	[ICRA]A1+	[ICRA]A1+	[ICRA]A1+	-	-

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 No	Instrument Name	Date of Issuance / Sanction	Coupon Rate	Maturity Date	Amount Rated (Rs. crore)	Current Rating and Outlook
-	Short term Non Fund Based Bank Lines – Allocated	NA	NA	NA	1,250.00	[ICRA]A1+
-	Short term Non Fund Based Bank Lines - Proposed	NA	NA	NA	750.00	[ICRA]A1+

Source: Edelweiss Custodial Services Limited

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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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