December 31, 2019

Small Industries Development Bank of India: Rating reaffirmed

Summary of rating action

Instrument*	Previous Rated Amount (Rs. crore)	Current Rated Amount (Rs. crore)	Rating Action
Bonds	5,000.00	5,000.00	[ICRA]AAA(Stable); reaffirmed
Total	**5,000.00**	**5,000.00**	

**Instrument details are provided in Annexure-1*

Rationale

The rating continues to draw comfort from Small Industries Development Bank of India's (SIDBI) position as an apex financial institution (FI) for the promotion and development of the micro, small and medium enterprises (MSME) sector in India. SIDBI was established under an Act of Parliament in 1990 and is jointly owned by the Government of India (GoI; 15.4%), public sector banks (PSBs), insurance companies and other FIs. Some of the largest shareholders are State Bank of India (SBI; rated [ICRA]AAA(Stable)/[ICRA]A1+), Life Insurance Corporation of India (LIC) and National Bank for Agriculture and Rural Development (NABARD; rated [ICRA]AAA(Stable)/[ICRA]A1+). Given its current capitalisation levels, SIDBI's requirement for capital support remains limited in the near to medium term. However, in the absence of any single dominant shareholder or promoter, future capital raising, if any, will remain dependent on the willingness of the respective shareholders. ICRA notes that the GoI directly controls all the shareholders of SIDBI.

The GoI appoints the Chairman, two whole-time directors, two nominee directors and three directors including one from the officials of the state financial corporations (SFCs), while three directors are nominated by the PSBs and FIs owned or controlled by the GoI. Moreover, to ensure that SIDBI operates with a competitive cost structure, the GoI facilitates access to rural infrastructure development funds (RIDFs; MSME funds)[1]. MSME funds accounted for ~59% of the total debt as on September 30, 2019 and ~50% as on March 31, 2019 (~40% as on March 31, 2018). The GoI has also extended support by providing guarantees for some of its foreign currency borrowings, drawn under various multilateral and bilateral agreements, which along with MSME fund allocations have helped to maintain a diverse and competitive source of funds. This enhances SIDBI's capabilities in meeting the refinancing needs of PLIs and for on-lending to the MSME sector at competitive rates. Further, the rating factors in SIDBI's healthy capitalisation levels (CRAR of 27.11%) and acceptable leverage[2] levels of 8.58 times as on March 31, 2019 (compared to the permissible leverage limit of 12 times allowed by the Reserve Bank of India; RBI). ICRA, however, notes that any regulatory change requiring SIDBI to align itself with Basel III norms could impact its overall capitalisation levels to some extent.

The current capitalisation levels allow SIDBI to remain well placed to sustain its growth momentum in FY2020 while maintaining competitive funding costs through higher RIDF allocations. Furthermore, a significantly large refinance book is backed by matching liabilities of equal tenure (MSME funds) and supports the overall liquidity position of the entity. The liquidity profile is further supported by the standby lines from banks that remain unutilised.

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[1] MSME fund is created out of deposits from scheduled commercial banks (SCBs) against their shortfall in priority sector lending (PSL) targets

[2] Leverage is defined as total borrowings including MSME fund / Net owned funds (NOF)

While reaffirming the rating, ICRA takes note of the impact on SIDBI's profitability in H1 FY2020 because of its exposure to IL&FS and its subsidiary, IL&FS Financial Services Limited, amounting to Rs. 945 crore, which was fully provided for in H1 FY2020. Besides this, sizeable slippages in the direct lending book in FY2019 have driven an increase in the NNPA/Net advances[3] to 0.69% as on March 31, 2019 from 0.24% as on March 31, 2018. Further, the asset quality of the direct lending book remains weak and will continue to be weighed down by the weak macroeconomic indicators. Consequently, the absolute gross NPA, including non-performing investments, increased to Rs. 2,160 crore as on March 31, 2019 from Rs. 1,312 crore as on March 31, 2018. However, the overall solvency metrics (NNPA/NOF) remain comfortable at 1.9% as on March 31, 2019. Also, given the strong growth in the refinancing programme, with counterparties majorly comprising banks, the overall asset quality indicators are likely to remain at strong levels.

MSME fund allocations for SIDBI have increased consistently over the past few years, and ICRA notes the significant importance of MSME fund allocations for maintaining SIDBI's overall cost of funds. A substantial drop in allocations will remain a key rating sensitivity as it can impact SIDBI's future profitability. Furthermore, the refinancing extended out of the MSME funds is subject to a cap on the gross lending spread. While this cap has not changed in the recent past, any narrowing of the gross lending spreads could impact SIDBI's overall profitability, which, in turn, could impact its return metrics.

Key rating drivers and their description

Credit strengths

Important policy institution; strategic importance to GoI – SIDBI commenced operations in 1990 under the Small Industries Development Bank of India Act, 1990, with the key objective of promoting, financing and developing the MSME sector. It also serves as a nodal agency for all institutions engaged in similar activities. Additionally, SIDBI functions as the principal financial institution for coordinating the operations of other institutions that finance the MSME sector. Given its role in supporting the MSME sector, SIDBI remains of strategic importance to the GoI. As on September 30, 2019, SBI held a majority stake of 16.73%, followed by the GoI at 15.40% and LIC at 14.25%. The rest is held by other PSBs and Government insurance companies. ICRA, however, takes note that in the absence of a single dominant shareholder or promoter, future capital raising, if any, will remain dependent on the ability and willingness of all the shareholders to contribute capital in a timely manner. Nevertheless, given the current capitalisation levels, the requirement for capital support remains limited in the near to medium term.

Strong resource profile supported by MSME fund allocations – SIDBI's resource profile is supported by its access to cheaper MSME fund deposits, which are provided by banks against their shortfalls in meeting PSL targets. As of March 31, 2019, the total borrowings under the MSME fund programme stood at Rs.65,436 crore, which comprised 50% of its overall borrowings for FY2019, and increased further to ~59% as on September 30, 2019. For FY2020, ICRA expects MSME fund deposits to account for a significant percentage of SIDBI's incremental borrowings. This is expected to lead to an overall competitive cost of funds for the entity. Further, the MSME fund allocation for SIDBI has increased consistently over the years and stands at Rs. 40,000 crore for FY2020 against Rs. 30,000 crore for FY2019 and Rs. 20,000 crore for FY2018. Continued allocations under MSME funds will remain important for SIDBI for maintaining a competitive

[3] *NNPA/Net Advances (includes advances and credit substitutes/investments)*

cost of funds, business volumes and profitability. MSME fund deposits are further supplemented by domestic and overseas borrowings contracted under various bilateral and multilateral agreements at competitive rates.

Comfortable capitalisation as per current dispensation for AIFIs[4] –The RBI has allowed SIDBI to borrow up to a leverage (debt/net owned funds) of 12 times till July 31, 2020 vis-à-vis 10 times that financial institutions like SIDBI are allowed as per RBI regulations. Against this, SIDBI's leverage stood at 8.58 times as on March 31, 2019 and is expected to increase further to 9.6-10 times by March 31, 2020. Despite the increasing leverage, its exposure to various banks, which attract low-risk weights, results in strong capital adequacy levels with a CRAR of 27.11% (entirely Tier I) as on March 31, 2019. ICRA notes that while the capital adequacy remains comfortable, any change in the method of computing capital adequacy (for aligning with Basel III) could impact the overall capital metrics, mainly due to the higher risk weights assigned to lower-rated exposures or banks.

Overall asset quality at strong levels – The gross and net NPA improved to 0.63% and 0.21%, respectively, as on March 31, 2019, from 0.93% and 0.26%, respectively, as on March 31, 2018, although the improvement was partly due to a sharp increase in overall advances. Moreover, a major part of the total slippages for SIDBI in FY2019 was on account of its investment exposure to IL&FS. As a result, the gross non-performing investment (GNPI) increased to Rs. 1,292 crore as on March 31, 2019 (fully provided for in H1 FY2020) from Rs. 410 crore as on March 31, 2018, while the GNPA decreased marginally to Rs. 868 crore from Rs. 902 crore during this period. In FY2020, slippages from the direct lending book as well as a few stressed NBFCs (~4.3% of NOF as on March 31, 2019) will remain a key rating monitorable. Despite this, SIDBI's overall asset quality is supported by low NPAs in the refinance book, which accounted for 90% of its lending portfolio as on March 31, 2019. As its NPAs are from its direct lending activity, SIDBI's GNPAs and NNPAs stood at 6.93% and 1.86%, respectively, as on September 30, 2019, resulting in weak asset quality in direct lending activity. However, given the relatively higher slippages, SIDBI's solvency metrics remain at strong levels. Furthermore, SIDBI is carrying adequate provision against the slipped exposures.

Credit challenges

Competitiveness linked to availability of low-cost RIDF deposits/MSME funds allocation – SIDBI's growth prospects remain linked to the extent of coverage achieved by SCBs in meeting their PSL targets. As SCBs progressively achieve higher PSL targets, the overall funding options under MSME funds could drop, thereby affecting the growth prospects in the long term. Moreover, the MSME fund allocation of Rs. 90,000 crore for FY2018-20 has, to a major extent, supported SIDBI's overall growth. Additionally, PSL shortfalls are allocated to other eligible AIFIs like Micro Units Development & Refinance Agency Ltd. (MUDRA), National Housing Bank (NHB) and National Bank for Agriculture and Rural Development (NABARD). The annual allocation to SIDBI will also remain dependent on its relative importance compared to other AIFIs, which could result in lower allocations in case of increased allocation or preference towards other AIFIs.

Growth dependent on prevailing liquidity conditions –The rapid growth witnessed in FY2019 was supported by the tighter liquidity conditions in the banking sector with credit growth outpacing deposit growth, resulting in increased demand for refinance from SIDBI. Normally, banks meet liquidity or funding gaps by resorting to resource mobilisation via wholesale deposits. However, higher rates due to tighter liquidity, along with the costs linked to maintaining a CRR

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[4] All India Financial Institutions

and SLR on the wholesale deposits, make refinance from SIDBI or other AIFIs a cheaper alternative. Conversely, in a surplus liquidity scenario, demand for refinance could get impacted as wholesale deposit rates trend downwards. As the tenure of SIDBI's funding is for three years, there could be a decline in business volumes and profits after 3-4 years though this will also reduce SIDBI's borrowing and leverage levels. As the deposits from SIDBI are of a longer tenure and do not require the maintenance of a CRR/SLR and certain capital costs, refinancing from SIDBI will remain attractive for borrowers.

Modest earnings profile mainly driven by regulated margins in refinance book – SIDBI's earnings profile remains modest with a gross interest spread of 1.09% and NIM/ATA of 1.95% as on March 31, 2019, which has moderated over the last two years from 2.22% in FY2018 and 2.59% in FY2017. The rapid expansion of the MSE/RIDF deposit-backed refinance book during this period, which has a cap on the gross lending spreads, has weighed on the overall margins. Going forward, any regulatory change, resulting in the narrowing of spreads, will remain a key monitorable for SIDBI's profitability. However, the relatively large indirect lending book, with counterparties majorly comprising banks, has kept the overall asset quality metrics at strong levels resulting in low operating and credit costs. Accordingly, the PBT/ATA has not been impacted beyond the moderation caused by the change in the advance mix for SIDBI, with the same moderating to 1.89% in FY2019 from 2.08% in FY2018. The rapid expansion of the balance sheet has kept the return on assets range-bound at 1.4-1.5% over the last three years while the return on net worth has improved with an increase in absolute profitability (in line with the higher scale) to 11.70% as on March 31, 2019 from 8.24% as on March 31, 2017. In H1 FY2020, a provision for the IL&FS exposure resulted in a relatively higher credit cost of ~0.98% of the average total assets, resulting in a moderation in profitability with PBT/ATA of 1.58% (1.89% in FY2019) while PAT/ATA was 1.22% (1.47% in FY2019).

Weak asset quality of direct lending book – The direct lending book contributed to 7% of the total net advances as on March 31, 2019 and 60% of NOF. The GNPA and NNPA levels in this business remained elevated at 6.93% and 1.86%, respectively, as on September 30, 2019, marginally lower than 6.92% and 2.08%, respectively, as on March 31, 2019. Going forward, ICRA expects the asset quality indicators to remain relatively weaker, particularly against the backdrop of the challenging economic condition. Nevertheless, as the indirect lending book remains significantly large, the overall asset quality indicators remain comfortable for SIDBI.

Liquidity position: Superior

Refinance against RIDF deposits contributes to a significantly large percentage of the total advances. As these advances are covered against RIDF deposits with a similar maturity of 3 years, the overall ALM profile remains well matched to a large extent. Further, the entity reported positive cumulative gaps across all maturity buckets as on August 31, 2019. Moreover, SIDBI had unutilised bank lines of Rs. 21,000 crore, besides undrawn RIDF deposits of Rs. 20,000 crore, as on September 30, 2019, which can be drawn to meet any shortfall/funding gaps in the future. Besides this, with sovereign backing, SIDBI has the flexibility to raise domestic and overseas funds to meet funding shortfalls, if any.

Rating sensitivities

Negative triggers – ICRA could assign a Negative outlook or downgrade the rating if there is a dilution in the role of SIDBI as a policy institution for the development of the MSE sector and hence its importance to the GoI.

Analytical approach

Analytical Approach	Comments
Applicable Rating Methodologies	ICRA Rating Methodology for Banks
Parent/Group Support	ICRA expects SIDBI to remain important to the GoI for supporting the growth of the MSME sector in India, and expects the GoI to provide financial support, including MSME fund allocation and capital to SIDBI, if required
Standalone/Consolidated	For arriving at the rating, ICRA has considered the standalone financials of SIDBI. However, in line with its limited consolidated approach, ICRA has factored in the capital requirement of SIDBI’s subsidiaries, Micro Units Development & Refinance Agency Ltd.(MUDRA), SIDBI Venture Capital Limited and SIDBI Trustee Company Limited. In ICRA’s view, MUDRA, SIDBI Venture Capital Limited and SIDBI Trustee Company Limited will remain self-sufficient in meeting their capital requirements in the near to medium term

About the company

SIDBI is the apex financial institution for the MSME sector. Currently, SBI is the largest shareholder with a stake of 16.73%, followed by the GoI at 15.40% and LIC at 14.25%. Other PSBs and institutions own the remaining share in the entity. SIDBI provides refinance to primary lending institutions like banks, state financial corporation (SFCs) and state industrial development corporations (SIDCs), etc, which, in turn, lend to units in the MSME sector. SIDBI also provides direct finance to the MSME sector by way of long-term loans, working capital facilities, discounting/rediscounting bills of exchange, etc. SIDBI is responsible for developing and refinancing all institutions, which are in the business of lending to micro/small business entities engaged in manufacturing, trading and service activities. It partners with state/regional-level coordinators to provide finance to last mile financiers of small/micro business enterprises.

In FY2019, on a standalone basis, SIDBI reported a net profit of Rs. 1,952 crore on an operating income of Rs. 9,916 crore compared with a net profit of Rs. 1,429 crore on an operating income of Rs. 6,600 crore in the previous year. In H1 FY2020, SIDBI reported a net profit of Rs. 986 crore on an operating income of Rs. 6,139 crore.

Key financial indicators (audited) – Standalone

	FY2018 Audited	FY2019 Audited	H1 FY2020 Unaudited
Net interest income	2,097	2,579	1,554
Profit before tax	1,962	2,503	1,283
Profit after tax	1,429	1,952	986
Net advances	95,291	1,36,230	1,44,348
Total assets	1,08,869	1,55,861	1,67,883
% Tier 1	26.73%	27.11%	
% CRAR	26.73%	27.11%	
% Net interest margin / Average total assets	2.22%	1.95%	1.92%
% Net profit / Average total assets	1.52%	1.47%	1.22%
% Return on net worth	9.60%	11.70%	11.16%
% Gross NPAs	0.93%	0.63%	0.79%
% Net NPAs	0.26%	0.21%	0.43%
% Provision coverage excl. technical write-offs	72.23%	66.29%	45.56%
% Net NPA/ Net worth	1.68%	1.75%	3.54%

All ratios as per ICRA calculations
Amount in Rs. crore
Source: SIDBI, ICRA research

Status of non-cooperation with previous CRA: Not applicable

Any other information: None

Rating history for past three years

Sr. No.	Name of Instrument	Current Rating (FY2020)				Chronology of Rating History for the Past 3 Years		
		Type	Rated amount (Rs. crore)	Amount Outstanding (Rs. crore)	31-December 2019	Date & Rating in FY2019	Date & Rating in FY2018	Date & Rating in FY2017
						Dec 17, 2018		Dec 22, 2016
1	Bonds	Long Term	5,000	5,000	[ICRA] AAA (stable)	[ICRA] AAA (stable)	-	[ICRA] AAA (stable) withdrawn

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 click here

Annexure-1: Instrument details

ISIN	Instrument Name	Date of Issuance / Sanction	Coupon Rate	Maturity Date	Amount Rated (Rs. crore)	Current Rating and Outlook
NA	Bonds	Yet to be placed	Yet to be placed	Yet to be placed	3,635	[ICRA]AAA(stable)
INE556F08JK7	Bonds	26-Apr-19	7.95%	26-Apr-22	1,365	[ICRA]AAA(stable)

Source: SIDBI

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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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