February 01, 2023 (Revised)

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

While reaffirming the rating, ICRA continues to factor in the strong parentage of Fedbank Financial Services Limited (FFSL), which is a subsidiary of Federal Bank Limited (FBL; 73.21% stake in FFSL). 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.

The rating also considers FFSL's adequate capitalisation with a net worth of Rs. 1,258 crore and a gearing of 4.6 times as on September 30, 2022, besides the fairly diversified product mix comprising gold loans, loan against property, small/medium ticket loan against property (LAP), business loans, housing loans, construction finance and structured finance. Over the last three years, it has received regular capital infusions to support the growing loan book, the latest being Rs. 200 crore through a rights issue in FY2022. Moreover, the company plans an incremental capital raise by Q1 FY2024, either through an initial public offering (IPO) by way of a fresh issue and offer for sale, or a rights issue or a private equity raise, subject to market conditions and other considerations. Post the capital raise, the parent would continue to hold a majority stake in the company. The rating also factors in FFSL's improving profitability with the improvement in the scale of operations.

The rating, however, factors in the moderate, albeit improving, scale of operations and the limited seasoning of the non-gold segments (including small ticket size LAP facility to micro and small enterprises, housing loans and business loans). Also, FFSL's non-gold loan portfolio remains concentrated in the southern states. Nonetheless, it has expanded its presence in the western and northern states over the past few years.

Moreover, notwithstanding the moderate portfolio seasoning, the asset quality trajectory has been largely under control. The gross non-performing assets (GNPAs) increased upon the implementation of the revised Income Recognition and Asset Classification (IRAC) guidelines and slippages in the legacy construction finance loan book. However, the collection efficiency (excluding wholesale, gold and business correspondent loans) stood at ~99% in H1 FY2023, providing comfort. FFSL's ability to maintain the same and a healthy asset quality over the medium term would remain imperative from a credit perspective.

Key rating drivers and their description

Credit strengths

Strong parentage with well-demonstrated track record of support – FFSL is a subsidiary of FBL, which held a 73.21% stake as on September 30, 2022. As it is strategically important to FBL, FFSL draws managerial and operational support from the bank. The Managing 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, on which it earns fee income.

Further, FFSL receives financial support from FBL in the form of regular capital infusions (FBL infused Rs. 59 crore in FFSL 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)} and the outstanding amount was Rs. 707.44 crore as on September 30, 2022. FBL is expected to continue holding a majority stake in FFSL.

Adequate capitalisation – FFSL is adequately capitalised with a net worth of Rs. 1,258 crore and a gearing of 4.6 times as on September 30, 2022. The capital-to-risk weighted assets ratio (CRAR) stood at 19.6% and the tier I ratio was 16.3% as of September 30, 2022. Over the last three years, the company has received regular capital infusions to support its growing loan book, the latest being Rs. 200 crore through a rights issue in FY2022. FFSL plans to operate at a maximum leverage of 6 times. Its ability to raise capital regularly to support its ambitious growth plan over the medium term and maintain prudent capitalisation will be a key credit monitorable. ICRA notes that the company plans an incremental capital raise by Q1 FY2024, either through an IPO by way of a fresh issue and offer for sale, or a rights issue or a private equity raise, subject to market conditions and other considerations. Post the capital raise, the parent would continue to hold a majority stake in the company.

Improving profitability – FFSL's profitability improved in FY2022 with the company reporting a profit after tax (PAT) of Rs. 103.5 crore, return on assets (RoA) of 1.7%, and return on equity (RoE) of 10.4% compared to Rs. 61.9 crore, 1.3% and 8.1%, respectively, in FY2021. The company's profitability improved further in H1 FY2023 as it reported a PAT of Rs. 89.9 crore, RoA of 2.6% and RoE of 14.9%, led by higher interest spreads and lower credit costs. FFSL had reported credit costs {provisions/average total assets (ATA)} of 1.4% in FY2022 compared to 1.5% in FY2021 due to the deterioration in the asset quality amidst the challenging external environment. However, the credit cost was lower at 0.8% in H1 FY2023. Investment in branch infrastructure continues to keep the cost-to-income ratio at the same level compared to previous periods with operating expense/ATA) of 5.6% in H1 FY2023 compared to 5.2% and 4.9% in FY2022 and FY2021, respectively. Going forward, ICRA expects a gradual reduction in operating expenses/ATA due to economies of scale.

Credit challenges

Moderate portfolio seasoning and scale of operations, albeit improving – While FFSL's assets under management (AUM) increased at a sharp pace to Rs. 7,292 crore as of September 30, 2022 from Rs. 1,422 crore as of March 2018, the scale of operations remains moderate. Even though the company's product mix is fairly diversified, comprising gold loans (35%), LAP (24%), small-ticket LAP (18%), business loans (15%), housing loans (6%), construction finance and structured finance (1%) and other loans (1%) as on September 30, 2022, the overall portfolio is likely to remain dominated by gold loans and LAP over the medium term. Further, within the LAP segment, FFSL forayed into small ticket size LAP and lowered the average ticket size for small/medium ticket sized LAP. However, the portfolio seasoning is low for the recently launched products of business loans, housing finance, and personal loans, which accounted for 21% of AUM as on September 30, 2022.

Notwithstanding the moderate portfolio seasoning, the asset quality trajectory has been largely under control. The GNPAs stood at 2.27% as of September 30, 2022. Earlier, given the implementation of the revised IRAC guidelines and slippages in the legacy construction finance loan book, the GNPAs had increased, and the stage 2 assets (on book) remained elevated at 6.1% as of September 30, 2022 primarily due to the assets restructured under Covid-19-related relief schemes. ICRA notes that the stage 3 provision coverage declined to 22% as of September 30, 2022 and March 31, 2022 from 32% as of March 31, 2021. Also, there was a sizeable uptick in the gold auctions conducted by the company in FY2022. The adequate recovery performance (with recovery of entire principal and sizeable share of accrued interest and other charges), however, provides comfort. A large proportion of the LAP, business loans and housing loans is extended to self-employed non-professional borrowers. FFSL's ability to maintain the same and a healthy asset quality over the medium term would remain imperative from a credit perspective.

Geographical concentration – FFSL's gold loan portfolio remained concentrated in the southern states of Karnataka (20%), Andhra Pradesh and Telangana (20%) and Tamil Nadu (11%) as of September 30, 2022. Nonetheless, since FY2020, the company has expanded its presence in the western and northern states and increased the gold loan share in Maharashtra to 18% and Gujarat to 15% as of September 30, 2022. Considering its established position in the southern states, the geographical mix of FFSL's gold loan portfolio is likely to remain skewed towards these states over the medium term.

FFSL's non-gold loan portfolio remained concentrated in Tamil Nadu (22%), Karnataka (21%), Maharashtra (19%), Andhra Pradesh and Telangana (13%) and Gujarat (12%) as of March 31, 2022. To diversify the operations geographically, the company expanded the non-gold loan business in the states/Union Territories (UTs) of Rajasthan, Andhra Pradesh and Telangana, Punjab, Madhya Pradesh and Delhi since FY2022 and the business reported strong traction in Andhra Pradesh in the first year. The geographical concentration of the non-gold loan products is expected to reduce over the medium term. FFSL's ability to maintain the asset quality in the new geographies will be critical over the medium term.

Liquidity position: Adequate

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 the modest on-balance sheet liquidity. As of October 31, 2022, the company had on-balance sheet liquidity (cash and bank balances, liquid mutual funds, investments in Government securities and fixed deposits) of Rs. 509 crore and unutilised bank lines of Rs. 595 crore compared to principal repayments (including working capital demand loans) of Rs. 1,257 crore falling due in the subsequent three months. This, coupled with the sizeable share of the short-term product (gold loan; 35% of AUM as of September 30, 2022) and average monthly collections (excluding wholesale, gold and business correspondent loans) of Rs. 88 crore (average monthly collections from April 2022 to September 2022) supports the liquidity profile. Further, ICRA notes that FFSL has good financial flexibility, by virtue of being a subsidiary of FBL. This, along 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 will arise in case of a deterioration in the asset quality and earnings profile on a sustained basis. A change in the credit profile or support philosophy of the parent may also be a credit negative.

Analytical approach

Analytical Approach	Comments
Applicable rating methodologies	Rating methodology for non-banking finance companies Rating Approach – Implicit support from Parent or Group
Parent/Group support	The rating factors in FFSL's strong parentage by virtue of being a subsidiary of FBL, and 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). Until FY2018, FBL held a 100% stake in FFSL. In FY2019, TrueNorth LLP acquired a 17% stake in FFSL and another 9% (total 26%) in FY2020. The company provides gold loans, LAP, business loans, personal loans, housing loans, loans to NBFCs and construction finance. It also sources loans (housing loans, auto loans, personal loans, small and medium-sized enterprise (SME) loans) for its parent. As on March 31, 2022, it had a presence in 15 states/UTs with a 516-branch network including 407 gold loan branches and 109 micro, small and medium enterprise (MSME) hubs.

The AUM, as on September 30, 2022, was Rs. 7,292 crore (September 30, 2021: Rs. 5,247 crore). 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, and SME loans for parent company).

Key financial indicators

Fedbank Financial Services Limited	FY2021/Mar-21	FY2022/Mar-22	H1 FY2022/Sep-21	H1 FY2023/Sep-22
Total income	698	884	408	549
Profit after tax	62	103	33	90
Net worth	835	1,154	1,069	1,258
Loan book (net)	4,552	5,645	4,903	6,638
Total assets	5,466	6,556	5,748	7,412
Return on assets	1.3%	1.7%	1.2%	2.6%
Return on net worth	8.1%	10.4%	7.0%	14.9%
Gross gearing (times)	5.2	4.3	4.1	4.6
Gross NPA	1.0%	2.2%	2.3%	2.3%
Net NPA	0.7%	1.8%	1.6%	1.8%
Solvency (Net stage 3/Net worth)	3.9%	8.7%	7.3%	9.4%
CRAR	23.5%	23.0%	25.6%	19.6%

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 (FY2023)				Chronology of Rating History for the Past 3 Years		
		Type	Amount Rated (Rs. crore)	Amount Outstanding (Rs. crore)	Date & Rating in FY2023	Date & Rating in FY2022	Date & Rating in FY2021	Date & Rating in FY2020
					Feb 01, 2023	Feb 11, 2022	Feb 15, 2021	-
1	**Commercial paper programme**	Short term	1,000	460	**[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
INE007N14DA7	Commercial paper programme	Feb 21, 2022	6.08%	Feb 21, 2023	50	[ICRA]A1+
INE007N14DB5	Commercial paper programme	Feb 23, 2022	6.08%	Feb 23, 2023	50	[ICRA]A1+
INE007N14DC3	Commercial paper programme	Mar 02, 2022	6.04%	Mar 02, 2023	100	[ICRA]A1+
INE007N14DD1	Commercial paper programme	Mar 04, 2022	6.04%	Mar 03, 2023	50	[ICRA]A1+
INE007N14DJ8	Commercial paper programme	Nov 18, 2022	8.14%	June 15, 2023	50	[ICRA]A1+
INE007N14DJ8	Commercial paper programme	Nov 18, 2022	8.14%	June 15, 2023	160	[ICRA]A1+
NA	Commercial paper programme – Unutilised	NA	NA	NA	540	[ICRA]A1+

Source: Company; Commercial paper outstanding as on December 31, 2022

Annexure II: List of entities considered for consolidated analysis: Not applicable

Corrigendum

The rating rationale document dated February 01, 2023 has been corrected with the revision as detailed below:

1) Methodology for ***Rating Approach – Implicit support from Parent or Group*** is added in Page-3.

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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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