AU Small Finance Bank Limited

June 29, 2018

Summary of rated instruments

Instrument	Amount Rated (Rs. crore)	Amount outstanding (Rs. crore)	Rating Action
Bank Lines	725.00	80.00	[ICRA]AA-(Stable); Upgraded from [ICRA]A+ (Stable); [ICRA]A1+ withdrawn[1]
Non-convertible Debenture Programme	790.00	320.00	[ICRA]AA-(Stable); Upgraded from [ICRA]A+ (Stable)
Subordinate Debt Programme	50.00	35.00	[ICRA]AA-(Stable); Upgraded from [ICRA]A+ (Stable)
Total	**1,565.00**	**435.00**	

Rating action

ICRA has upgraded the long-term rating assigned earlier to bank lines, non-convertible debenture and subordinate debt programme of AU Small Finance Bank Limited (AU) to [ICRA]AA- (pronounced ICRA double A minus) from [ICRA]A+ (pronounced ICRA A plus). The outlook on the long-term ratings is Stable. ICRA has also withdrawn rating of [ICRA]A1+ on short term bank lines of the Bank as there is no amount outstanding against the rated instruments.

Rationale

The rating upgrade factors in AU's ICRA successful transition into a small finance bank (SFB) with the bank diversifying its liability mix to include retail deposits, and controlling its asset quality parameters (gross NPAs at 2.0% (90d+) as on March 31, 2018 as against 1.9% (120d+) as on March 31, 2017), while maintaining business growth and adequate capitalisation with capital to risk weighted assets ratio (CRAR) of 19.3% and net worth of Rs. 2,281 crore as on March 31, 2018. The capitalisation profile would get strengthened further with the proposed equity infusion of Rs. 1,000 crores (Rs 475 crore received on 28th June 2018 while remaining may come on or before December 2019). The rating also factors in AU's experienced management team and their extensive local knowledge, the bank's track record of nearly two decades of operations, and its well-established franchise network.

The bank's credit profile, however, is constrained by limited seasoning in some of the new lines of business and its relatively vulnerable borrower profile with a large part consisting of segments that are exposed to income shocks and assessed income-based credit assessment process. The risk is largely mitigated by the secured nature of lending, the complete in-house business model, management's strong knowledge of the primary area of operations, and the adequate lending spreads that provide cushion to cover credit costs. AU's portfolio has a relatively high geographical concentration with Rajasthan accounting for around 52% of the portfolio as on March 31, 2018, though ICRA notes that the bank has a strong track record in Rajasthan. Moreover, delinquencies in the Rajasthan portfolio are lower than the portfolio average across all segments. Also, in line with expectations, AU's profitability indicators moderated post transition to the SFB with reported return on average assets (PAT/ATA) of 2.0% and return on average equity (RoE) of

[1] *ICRA has withdrawn rating of [ICRA]A1+ on short term bank lines of the Bank as there is no amount outstanding against the rated instruments.*

13.7% in FY2018 (vs 3.8% and 20.4%, respectively, in FY2017 after adjusting for the Aavas sale). This was due to investment in lower-yielding securities to comply with statutory liquidity ratio (SLR) requirements along with increased operating expenditure.

Overall, the bank's ability to continue growing its deposit base, manage asset liability mismatches, and profitably grow business volumes while controlling the asset quality would be key rating sensitivities.

Outlook: Stable

ICRA believes AU will continue to benefit from its experienced management team and their extensive local knowledge, the bank's track record of nearly two decades of operations, and its well-established franchise network. The outlook may be revised to Positive if the bank continues to grow at a healthy pace while maintaining its profitability and asset quality along with strengthening its capital position and deposit profile further. The outlook may be revised to Negative if there is a significant deterioration in AU's asset quality or profitability.

Key rating drivers

Credit strengths

Successful transition into SFB - AU commenced operations as an SFB from April 19, 2017. Since then, it has successfully augmented its systems and internal controls for meeting the SFB requirements. The bank expanded its distribution network and had 377 branches and 97 asset centres, as on March 31, 2018 (vs 301 asset centres as on March 31, 2017). AU also expanded its suite of product offerings and services and widened the management spectrum to head the new divisions. The bank also complied with various SFB licence requirements like promoter shareholding of more than 26% (stood at 32.7% for AU as on March 31, 2018), majority directors on the board should be independent (three out of five of AU's directors are independent), at least 50% of the portfolio should be below Rs. 25 lakh (58% of the portfolio met this criteria as on March 31, 2018), 25% of the branches should be in unbanked areas (was fulfilled by April 19, 2018), etc. By March 31, 2019 AU needs to meet the priority sector lending (PSL) requirement (75% of its adjusted net bank credit (ANBC) as on the last balance sheet date). As on March 31, 2018, 71% of its advances qualified for PSL.

Strengthening of liability profile, however, need to continuously increase retail liabilities remain high: AU has built a reasonable liability profile with Rs 7,923 crore of deposits (43% of funding mix including securitization) as on March 31, 2018, with 32% of Deposits excluding Certificate of Deposits being in the form of CASA deposits. AU's deposit growth rate has been one of the highest in the peer SFB set, with majority of depositors being new to AU (83% as on March 31, 2018). However, given the growth plans, AU would need to continuously strengthen its liability profile to include a larger share of retail liabilities.

Demonstrated ability to grow business volumes while diversifying the portfolio mix - AU has grown at a healthy CAGR of 42% over the past three years, with its assets under management growing to Rs. 16,038 crore and the loan book to Rs. 13,328 crore as on March 31, 2018. The bank's portfolio is largely focussed on retail with vehicle loans (45%), Micro, small and medium enterprises (31%) and small and medium enterprises (5%), accounting for 81% of the total portfolio as on March 31, 2018. Small and mid-corporate lending is mainly in the form of loans to NBFCs (10%), construction finance (5%) and business banking (4%). The banking platform provides AU with opportunities for further diversification into other asset segments such as home loans, agricultural, gold loans, consumer durable loans, business banking, working capital, and overdraft facilities.

Asset quality under control - Asset quality remained under control, with gross NPA ratio of 2.0% as on March 31, 2018 compared to 1.9% on March 31, 2017. The slight increase was due to the transition of NPA classification to 90+dpd from 120+dpd coupled with increased slippages in the relatively unseasoned MSME/SME segment (constituting 36% of the total portfolio as on March 31, 2018). Going forward, the bank's ability to maintain asset quality as it grows and diversifies into other segments like such business banking, agricultural - SME loans, gold loans, home loans remains a key monitorable.

Experienced management team, adequate risk management systems - The bank has an experienced management team, with adequate knowledge in the relevant line of business. The risk management and control systems are quite strong with a complete end-to-end in-house model of operations covering activities from sourcing to collection. Direct selling agents, customer associates, and referrals are only limited to lead generation.

Good capitalisation and liquidity profile - AU's capitalisation profile is adequate with total CRAR of 19.3% and net worth of Rs. 2,281 crore as on March 31, 2018. Further, the July 2017 listing resulted in improved access to equity raising. Going forward, the capitalisation profile is expected to improve further with the bank's plan to raise Rs. 1,000 crore from Camas Investments Pte Limited (an indirect and wholly-owned subsidiary of Temasek Holdings Private Limited, a national wealth fund owned by the Government of Singapore) through preferential allotment of shares and convertible warrants. Out of Rs. 1,000 crore, Rs. 475 crore received on 28^{th} June, 2018 (equity + 25% of the warrant application money) while the rest is expected to come on or before December 2019. ICRA expects the proposed capital infusion to be sufficient to fund AU's growth over the next two-three years. AU's liquidity profile was comfortable with positive cumulative mismatches up to the 1-year time bucket, as on December 31, 2017. Further, the granting of the scheduled commercial bank status provides AU with the option of raising short-term funds from the RBI via the liquidity adjustment facility.

Credit challenges

Vulnerable target borrower segment - A large part of AU's borrower profile is not credit tested and is exposed to income shocks. Further, credit appraisal is based on assessed income. The risk is somewhat mitigated by the secured nature of lending, the complete in-house business model, management's strong knowledge of the primary area of operations, and adequate lending spreads that provide cushion to cover credit costs.

Moderation in profitability on transition to SFB: In line with expectation, the bank's profitability indicators moderated post transition to SFB with reported PAT/ATA of 2.0% and RoE of 13.7% in FY2018 (vs. 3.8% and 20.4% respectively in FY2017 after adjusting for Aavas sale) largely on the back of lower margins and increased operating expenses. Despite the reduction in cost of funds from 9.6% in FY2017 to 8.4% in FY2018 with the increase in the deposit base, net interest margins reduced with the bank making investments in lower-yielding securities to comply with statutory liquidity ratio (SLR) requirements. This along with increased operating expenditure of 5.3% of the average assets in FY2018 as against 4.5% in FY2017 as a result of branch network expansion, impacted profitability. With most of the branch expansion already in place, we expect operating costs to peak in FY2018, and economies of scale to kick in going forward. The Bank's ability to successfully raise low cost deposits, increase fee-based income with increased distribution network and cross sale of banking products to existing customers while keeping credit costs in control remain key profitability drivers.

Relatively high geographical concentration - The bank's portfolio remains geographically concentrated with Rajasthan accounting for 52% of the portfolio as on March 31, 2018 followed by Maharashtra (13%), Gujarat (12%) and Madhya Pradesh (12%), which together accounted for 89% of the portfolio mix. However, ICRA notes the strong track record in Rajasthan and the lower delinquencies in the Rajasthan portfolio compared to the portfolio average across all segments.

Limited seasoning of new businesses - While AU has more than two decades of experience in the vehicle finance segment (accounting for 44% of the total portfolio as on March 31, 2018), its track record in other segments remains relatively limited. Also, post conversion into an SFB, the bank has started new products like business banking, gold loans, agri - SME loans and consumer durables. The performance of its recently originated portfolio needs to be seen.

Ability to hire and retain manpower - Given the relatively higher operational intensity associated with AU's target segment, the bank's ability to hire and retain manpower along with scaling up its processes and systems, in line with growth, would remain key monitorables.

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 Company

About the company

AU Small Finance Bank (erstwhile Au Financiers (India) Limited) was incorporated in 1996 as a non-banking finance company (NBFC) by Mr. Sanjay Agarwal. During the early years of operation, the company was primarily engaged in vehicle financing through funds raised from high net worth individuals in Jaipur. Over the years, the company raised equity from private investors at regular intervals and expanded its product portfolio to include MSME/construction finance and loans to NBFCs/ Housing finance companies. In September 2015, the Reserve Bank of India granted in-principle approval to AU for setting up a small finance bank. On December 20, 2016, AU got the final licence to set up the SFB and on April 19, 2017, it converted into an SFB. Further, the bank got listed on stock exchanges in July 2017 and was granted scheduled commercial bank status in November 2017.

AU reported profit after tax of Rs. 292 crore on a total asset base of Rs. 18,833 crore in FY2018 compared to profit after tax of Rs. 822 crore on a total asset base of Rs. 9,781 crore for FY2017. The net worth stood at Rs. 2,281 crore as on March 31, 2018 compared to Rs. 1,988 crore as on March 31, 2017.

Key Financial Indicators

Amounts in Rs. Crore	FY 2017	FY 2018
PAT	822.0	292.0
Net Worth	1,987.6	2,281.2
Assets under management	10,734	16,038
Total Assets	9,781.2	18,832.8
Return on Average Assets (%)	10.2%	2.0%
Return on Average Equity (%)	54.9%	13.7%
Gearing (times)	3.6	6.8
CRAR (%)	23.0%	19.3%
Gross NPAs (%)	1.9%	2.0%
Net NPAs (%)	1.2%	1.3%
Net NPA/Net worth (%)	4.0%	7.4%

Source: AU, ICRA research

Status of non-cooperation with previous CRA: Not applicable

Any other information: None

Rating history for last three years:

	Instrument	Current Rating (FY2019)				Chronology of Rating History for the past 3 years			
		Type	Amount Rated (Rs. crore)	Amount Outstanding (Rs. crore)	June 2018	FY2018 March 2017	FY2018 January 2017	FY2017 March 2016	FY2016 October 2015
1	NCD	Long Term	320	320	[ICRA]AA- (Stable)	[ICRA]A+ (Stable)	[ICRA]A+ (Stable)	[ICRA]A+ (Stable)	[ICRA] A (Stable)
2	Bank Lines	Long Term/ Short term	80	80	[ICRA]AA- (Stable)/ [ICRA]A1+ withdrawn*	[ICRA]A+ (Stable)/ [ICRA] A1+	[ICRA]A+ (Stable)/ [ICRA] A1+	[ICRA]A+(Stable)/ [ICRA] A1+	NA
3	Subordinate Debt Programme	Long Term	35	35	[ICRA]AA- (Stable)	[ICRA]A+ (Stable)	[ICRA]A+ (Stable)	[ICRA]A+ (Stable)	NA

Source: ICRA research
**ICRA has withdrawn rating of [ICRA]A1+ on short term bank lines of the Bank as there is no amount outstanding against the rated instrument*

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	Instrument name	Date of Issuance	Coupon Rate	Maturity Date	Amount Rated (Rs crore)	Current Rating
INE949L07535	Non-convertible debenture	16-03-2017	8.63%	16-03-2021	170.00	[ICRA]AA- (Stable)
INE949L08202	Non-convertible debenture	22-03-2017	8.74%	23-03-2020	50.00	[ICRA]AA- (Stable)
INE949L08210	Non-convertible debenture	22-03-2017	8.50%	24-09-2018	100.00	[ICRA]AA- (Stable)
INE949L08061	Subordinated Debt	24-01-2013	12.06%	30-07-2018	10.00	[ICRA]AA- (Stable)
INE949L08111	Subordinated Debt	6/8/2013	11.84%	3/7/2019	5.00	[ICRA]AA- (Stable)
INE949L08160	Subordinated Debt	19-11-2015	11.07%	19-05-2021	20.00	[ICRA]AA- (Stable)
n/a	Term Loan 1	24-09-2015	10.45%	31-08-2018	1.12	[ICRA]AA- (Stable)
n/a	Term Loan 2	25-08-2015	9.25%	30-09-2018	6.36	[ICRA]AA- (Stable)
n/a	Term Loan 3	28-09-2015	8.75%	28-03-2020	64.85	[ICRA]AA- (Stable)
n/a	Term Loan (unutilized)	n/a	n/a	n/a	7.67	[ICRA]AA- (Stable)

Source: AU

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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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