September 30, 2020 Revised

Summary of rating action

Instrument*	Previous Rated Amount (Rs. crore)	Current Rated Amount (Rs. crore)	Rating Action
Subordinated Debt Programme	20.00	20.00	[ICRA]AA-(Stable); reaffirmed
Non-convertible Debentures	170.00	56.70	[ICRA]AA-(Stable); reaffirmed
Subordinated Debt Programme	5.00	5.00	[ICRA]AA-(Stable); reaffirmed and withdrawn^
Bank Lines	27.77	27.77	[ICRA]AA-(Stable); reaffirmed and withdrawn^^

**Instrument details are provided in Annexure-1; ^Withdrawn basis publicly available information regarding redemption of the instruments, as also confirmed by AU; ^^Withdrawn as amount has been repaid, as confirmed by AU*

Rationale

The rating reaffirmation factors in the continued ramp-up in AU Small Finance Bank Limited's (AU) liability franchise, its track record of stable and comfortable asset quality (gross NPA % of 1.7% as on June 30, 2020), and its ability to report healthy profitability despite the costs related to transition to a small finance bank (SFB) and a challenging operating environment. While share of wholesale deposits remains high in AU's deposits mix (bulk deposits accounted for 60% share in term deposits as on June 30, 2020) as compared to the mid-sized private sector banks, its cost of funds continues to decline with increased focus on raising retail deposits. The declining cost of funds has partly offset the impact of investments in lower-yielding securities, to comply with statutory requirements and AU's profitability remains healthy with reported return on average assets (RoA) and return on average equity (RoE) (excluding gains on partial divestment of stake in Aavas) of 1.6% and 15.8% in FY2020 as well as Q1FY2021.

ICRA favourably notes that AU has been relatively better at ramping up its liability franchise compared with other SFBs. However, given the growth plans, AU would need to continuously strengthen its liability profile to include a larger share of retail liabilities, which will also drive its liquidity profile. Notwithstanding the expectation of calibrated growth over the near term, a high growth rate over the medium to long term also poses challenges of increased leverage and regular need to raise capital as the internal accruals are likely to be lower than the growth capital requirements. Nevertheless, the capitalisation level remains adequate with Tier-I of 18.5% and total CRAR of 21.7% as on June 30, 2020. Also, ICRA draws comfort from AU's demonstrated track record of capital raisings, the latest being in FY2019 and FY2020, whereby it raised equity from Camas Investments Pte Ltd, an indirect wholly-owned subsidiary of Temasek Holdings Private Limited. ICRA also notes that AU has a residual stake of ~6% in Aavas Financiers Limited (Aavas) with market value of about Rs. 600 crore, which can be monetised to further augment the net worth.

AU's asset quality has stayed under control with a range-bound gross NPA ratio of 1.7% to 2.1% during past few years (1.7% as on June 30, 2020). However, while AU has more than two decades of experience in the vehicle finance segment and about a decade of experience in MSME segment, its track record in the small and mid-corporate segments (~ 16% of AUM) remains relatively limited. Thus, the bank's ability to maintain the asset quality as it grows and diversifies gradually into other segments while maintaining its underwriting standards will remain a key monitorable over the medium to long term. In the near term, ICRA believes that the asset quality is likely to come under pressure, especially for select profiles/segments linked to sectors such as travel & tourism, hospitality, freight movement, discretionary retail, due to the ongoing pandemic and the resulting slowdown.

The rating remains constrained by the relatively high geographical as well as product concentration given the focused approach adopted by the bank. While AU has, over the years, expanded its operations to 12 states, its portfolio remains geographically concentrated with Rajasthan accounting for over 40% of the portfolio as on June 30, 2020, followed by Madhya Pradesh, Maharashtra and Gujarat. AU' strong track record in Rajasthan however provides comfort.

Key rating drivers and their description

Credit strengths

Stable and comfortable asset quality trajectory; though, some weakening in current environment is likely – While ICRA believes that the asset quality is likely to come under pressure, especially for select segments, due to the ongoing pandemic and the resulting slowdown, it is noted that AU's asset quality has stayed under control with a range-bound gross NPA ratio of 1.7% to 2.1% during past few years (1.7% as on June 30, 2020). Further, the provision cover has been improving (63.7% in June 2020 compared to 52.5% in March 2020 and 37.4% in March 2019) and remains sufficient in relation to the expected loss-given defaults on most of the underlying asset classes.

AU has more than two decades of experience in the vehicle finance/wheels segment (accounting for 42% of the total portfolio as on June 30, 2020) and about a decade of experience in MSME segment (accounting for 37% of the total portfolio as on June 30, 2020). Though, its track record in other segments remains relatively limited. Post conversion into an SFB, the bank has started new products like business banking, gold loans, unsecured personal/ consumer durable loans[1] Within the vehicle/wheels finance segment, the increased focus on used vehicles will remain a monitorable. Also, a large part of the bank's borrowers are new to credit. While AU has historically demonstrated good control over asset quality, these profiles could be more exposed to volatility in incomes during current challenging environment. The risk is, however, somewhat mitigated by the secured nature of lending, granular book, complete in-house business model, management's long-standing experience in its primary area of operations, and adequate lending spreads that provide a cushion to cover the credit costs.

Healthy profitability, notwithstanding near-term impact expected because of Covid-19 – AU's net interest margins have moderated on transitioning to a bank owing to the requirements to invest in lower-yielding government securities to comply with the statutory liquidity ratio (SLR) requirements, besides the decline in lending spreads amid competition. However, the yield pressure has been partially offset by the decline in the cost of funds. Hence, despite moderation, the profitability remains healthy with RoA and RoE (excluding gains on partial divestment of stake in Aavas) of 1.6% and 15.8% in FY2020 as well as Q1FY2021, which continues to result in healthy internal accruals. Going forward, the bank's ability to continue to raise low-cost retail deposits, increase the fee-based income with an increased distribution network, and cross-sell banking products to existing customers while keeping the operating and credit costs in control will remain key for further improving the profitability over the medium term. In the near term, given the likely slippages due to the pandemic, ICRA expects the credit costs to increase in FY2021, thereby affecting the profitability of the bank.

Satisfactory ramp-up in liability profile; high growth targets can, however, keep the share of bulk deposits high – AU has demonstrated a healthy ramp-up in its liability profile since its transition to an SFB three years ago. It has been able to build a deposit base of Rs. 26,734 crore (as on June 30, 2020) with a YoY increase of 35%. The deposits account for about 2/3rd of the bank's external liabilities (including securitisation), followed by refinance from FIs that constituted ~1/5th of the external liabilities as on June 30, 2020. Further, with incremental funds being in the form of deposits and refinance

[1] *Both CD and PL are primarily targeted towards exiting bank customers and account for less than 0.5% of AUM*

from FIs, and decline in systemic rates, AU has witnessed a decline in the cost of funds over the last three years, with incremental cost of funds having been 7.3% in FY2020 and 6.0% in Q1FY2021 compared to 7.7% in FY2019. In FY2020, the cost of funds for AU stood at 7.7% compared to 7.9%, 8.4% and 9.6% in FY2019, FY2018 and FY2017, respectively.

Notwithstanding the healthy ramp-up in the deposit base, AU will need to continuously strengthen its liability profile to improve the granularity of the deposit base by garnering a larger share of retail liabilities. The share of CASA is relatively lower than mid-size private sector banks (having higher vintage). Further, as on June 30, 2020, deposits of a ticket size of over Rs. 2 crore constituted about 60% of AU's term deposits, though it is noted that 67% of AU's bulk term deposits are non-callable, thereby partially offsetting liquidity risks. Going forward, given the likely growth over the medium to long term and despite the expectations of continued growth in the share of retail liabilities (on the back of performance in the last two quarters), ICRA expects bulk deposits to continue to constitute a large share of the liability profile. In this context, ICRA notes that the liability-side pressure could remain and shall be a key monitorable.

Credit challenges

Relatively high geographical as well as product concentration with modest scale of operations – AU's loan book grew at a four-year CAGR of 39% during FY2016 to FY2020. However, despite the above-industry average growth, its scale of operations remains moderate in relation to universal banking sector peers. As on June 30, 2020, its AUM was Rs. 30,036 crore compared to Rs. 30,893 crore as on March 31, 2020 and Rs. 24,246 crore as on March 31, 2019. Further, while AU has over the years expanded its operations to 12 states, its portfolio remains geographically concentrated given the focused approach adopted by the bank. Rajasthan still accounts for over 40% of the portfolio as on June 30, 2020 followed by Madhya Pradesh (16%), Maharashtra (13%), and Gujarat (11%). These states also accounted for 84% of AU's branches and 68% of the deposits (excluding CDs) mobilised by the bank. Nevertheless, AU's strong track record in Rajasthan provides comfort. Also, AU has historically been present in the vehicle and MSME finance segment, thereby resulting in high concentration of the product portfolio towards these segments. As on June 30, 2020, the vehicle and MSME finance segments had shares of 42% and 37%, respectively, in AU's assets under management (AUM).

Growth will require regular capital raising and monitoring of ability to maintain asset quality and granularity in liabilities – As the loan book grows, the bank may require additional capital raisings as the internal accruals are likely to be lower (despite healthy profitability) than the growth capital requirements. Also, ICRA believes that as the bank expands it may face challenges such as maintaining asset quality and granularity in liabilities. Nevertheless, AUs capitalisation level remains comfortable with Tier-I of 18.5% and total CRAR of 21.7%[2] as of June 2020, though it is likely to moderate over the medium term. Also, ICRA draws comfort from AU's demonstrated track record of capital raisings, the latest being in FY2019 and FY2020, whereby it raised equity from Camas Investments Pte Ltd, an indirect wholly-owned subsidiary of Temasek Holdings Private Limited (a national wealth fund owned by the Government of Singapore). As a part of this capital raising, the bank received equity capital aggregating Rs. 300 crore in FY2019 through preferential allotment and an upfront consideration of Rs. 175 crore against the allotment of warrants. The conversion of warrants to equity shares led to additional capital infusion of Rs. 525 crore in FY2020. Supported by capital infusion and healthy internal accruals over last two years, AU's net worth has doubled to Rs. 4,588 crore in June 2020 from Rs. 2,281 crore in March 2018. During this period, AU also benefited from ~1% stake sale in Aavas for aggregate consideration of Rs. 113 crore. ICRA notes that AU has a residual stake of ~6% in Aavas with market value of about Rs. 600 crore, which can be monetised to further augment the net worth.

[2] *Regulatory requirement for SFBs is CRAR of 15%*

Liquidity position: Strong

AU maintained a liquidity coverage ratio (LCR) of 150% as on June 30, 2020 (against requirement of 80% as on June 30, 2020) to create adequate cushion in the ongoing uncertain scenario. To manage its liquidity risks, the bank has maintained sizeable excess government securities eligible for SLR. Hence, it can avail liquidity support from the RBI through reverse repo against excess SLR investments and the marginal standing facility scheme, in case of urgent liquidity needs. The bank also maintained a sizeable liquid non-SLR book. AU's access to the call money market/inter-bank money market window also provides comfort.

Further, while AU's asset liability maturity profile is typically characterised by modest gaps in the near-term buckets, it can access unutilised refinance lines of over Rs. 2,000 crore from development finance institutions to plug these gaps. Moreover, given AU's focus on priority sector lending, it can securitise the loans at short notice to meet urgent liquidity needs. As on June 30, 2020, against requirement of maintaining 75% lending under PSL, 85% of AU's loans were PSL compliant. Also, AU holds a residual stake of ~6% in Aavas with market value of about Rs. 600 crore (in Sep-20), which can be monetised, if required.

Rating sensitivities

Positive triggers – ICRA may revise the outlook to Positive or upgrade the long-term rating if AU is able to further strengthen its liability profile/deposit franchise with a higher share of retail deposits (CASA and term deposits) in line with mid-sized private sector banks, while maintaining adequate capitalisation, asset quality and profitability.

Negative triggers – Pressure on the bank's ratings could arise if there is a sustained deterioration in the asset quality (GNPA>4%), thereby impacting the profitability. A significant deterioration in the capitalisation or weakening of the liquidity profile could also exert pressure on the ratings.

Analytical approach

Analytical Approach	Comments
Applicable Rating Methodologies	ICRA's Credit Rating Methodology for Non-Banking Finance Companies Rating Methodology for Banks
Parent/Group Support	Not Applicable
Consolidation / Standalone	Standalone

About the company

AU is a scheduled commercial bank, which has transitioned from an asset financing NBFC to an SFB. While it was incorporated in 1996 as an NBFC, it commenced SFB operations on April 19, 2017. AU has an established market position in Rajasthan, and has expanded operations to Maharashtra, Gujarat, and other states over the years. As of June 30, 2020, it had 594 branches across 12 states and 1 union territory. Over 80% of its branches are in the four states of Rajasthan, Gujarat, Maharashtra and Madhya Pradesh.

AU operates in the retail asset financing segment, with the vehicle financing segment accounting for ~42% of its AUM. Its product portfolio also includes MSME and SME financing, construction finance, loans to NBFCs, business banking, gold loans, home loans, agri-SME loans, unsecured personal loans (PL) and consumer durables (CD). AU's liability product offerings include current accounts, savings accounts, recurring & term deposits, transaction banking, as well as a bouquet of third-party mutual funds and insurance covers among others.

During its early years of operations, AU (formerly Au Financiers (India) Limited) 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. In September 2015, the Reserve Bank of India (RBI) granted in-principle approval to AU for setting up an SFB. On December 20, 2016, AU got the final licence and it converted into an SFB on April 19, 2017. Further, the bank got listed on stock exchanges in July 2017 and was granted scheduled commercial bank status in November 2017.

AU reported a profit after tax (PAT) of Rs. 675 crore on a total asset base of Rs. 42,143 crore in FY2020 compared to PAT of Rs. 382 crore on a total asset base of Rs. 32,623 crore in FY2019. Further, AU achieved PAT of Rs. 201 crore in Q1 FY2021 compared to Rs. 190 crore in the corresponding period in the previous year. As of June 30, 2020, the net worth stood at Rs. 4,588 crore with a reported capital adequacy of 21.7%.

Key financial indicators

	FY2018	FY2019	FY2020	Q1FY2021
PAT	292	382	675	201
Net worth	2,281	3,163	4,377	4,588
Assets under management	16,188	24,246	30,893	30,036
Total assets	18,833	32,623	42,143	44,267
Return on average assets (%)	2.0%	1.5%	1.8%	1.9%
Return on average net worth (%)	13.7%	14.0%	17.9%	17.9%
Gearing (times)	6.8	8.9	8.3	8.3
CRAR (%)	19.3%	19.3%	22.0%	21.7%
Gross NPAs (%)	2.0%	2.0%	1.7%	1.7%
Net NPAs (%)	1.3%	1.3%	0.8%	0.6%
Net NPA/Net worth (%)	7.4%	9.3%	5.0%	3.6%

Source: AU's financial results, ICRA research; Note: Amounts in Rs. crore; All figures and ratios are as per ICRA's calculations/adjustments

Status of non-cooperation with previous CRA: Not applicable

Any other information: None

Rating history for last three years

	Instrument	Current Rating (FY2021)				Rating History for the Past 3 Years			
		Type	Amount Rated	Amount Outstanding	Rating	FY2020	FY2019	FY2018	
					Sep 30, 2020	Aug 30, 2019	Jun 29, 2018	Mar 08, 2017	Jan 11, 2017
1	Non-convertible Debentures	Long-Term	56.7	56.7	[ICRA]AA- (Stable)	[ICRA]AA- (Stable)	[ICRA]AA- (Stable)	[ICRA]A+ (Stable)	[ICRA]A+ (Stable)
2	Non-convertible Debentures	Long-Term	113.3	-	Rating Withdrawn	[ICRA]AA- (Stable)	[ICRA]AA- (Stable)	[ICRA]A+ (Stable)	[ICRA]A+ (Stable)
3	Subordinated Debt	Long-Term	20.0	20.0	[ICRA]AA- (Stable)	[ICRA]AA- (Stable)	[ICRA]AA- (Stable)	[ICRA]A+ (Stable)	[ICRA]A+ (Stable)
4	Subordinated Debt	Long-Term	5.0	-	Rating Withdrawn	[ICRA]AA- (Stable)	[ICRA]AA- (Stable)	[ICRA]A+ (Stable)	[ICRA]A+ (Stable)
5	Bank Lines	Long-Term	27.77	-	Rating Withdrawn	[ICRA]AA- (Stable)	[ICRA]AA- (Stable)	[ICRA]A+ (Stable) /[ICRA]A1+	[ICRA]A+ (Stable) /[ICRA]A1+

*Source: ICRA research; Note: LT: Long term, ST: Short term; *As on June 30, 2020; Amount in Rs. crore*

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 / Sanction	Coupon Rate	Maturity Date	Amount Rated (Rs. crore)	Current Rating and Outlook
INE949L07535	Non-convertible Debenture	16-03-2017	8.63%	16-03-2021	56.70	[ICRA]AA-(Stable)
INE949L08111	Subordinated Debt	6-08-2013	11.84%	3-07-2019	5.00	[ICRA]AA-(Stable) Withdrawn
INE949L08160	Subordinated Debt	19-11-2015	11.07%	19-05-2021	20.00	[ICRA]AA-(Stable)
-	Term Loan	28-09-2015	8.75%	28-03-2020	27.77	[ICRA]AA-(Stable) Withdrawn

Source: AU

Annexure-2: List of entities considered for consolidation: Not applicable

Corrigendum:

Rationale dated September 30, 2020 has been modified with revision as detailed below:

Along with reference to the 150% LCR maintained by AU as on June 30, 2020, regulatory requirement of 80% LCR has been highlighted.

Analyst Contacts

Karthik Srinivasan
+91 22 6114 3444
karthiks@icraindia.com

Manushree Saggar
+91 124 4545 316
manushrees@icraindia.com

Deep Inder Singh
+91 124 4545 830
deep.singh@icraindia.com

Sandeep Sharma
+91 22 6114 3472
sandeep.sharma@icraindia.com

Relationship Contact

L. Shivakumar
+91-22-6114 3406
shivakumar@icraindia.com

Media and Public Relations Contact

Ms. Naznin Prodhani
Tel: +91 124 4545 860
communications@icraindia.com

Helpline for business queries

+91-9354738909 (open Monday to Friday, from 9:30 am to 6 pm)

info@icraindia.com

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.

For more information, visit www.icra.in

ICRA Limited

Corporate Office
Building No. 8, 2nd Floor, Tower A; DLF Cyber City, Phase II; Gurgaon 122 002
Tel: +91 124 4545300
Email: info@icraindia.com
Website: www.icra.in

Registered Office
1105, Kailash Building, 11th Floor; 26 Kasturba Gandhi Marg; New Delhi 110001
Tel: +91 11 23357940-50

Branches

Mumbai	+ (91 22) 24331046/53/62/74/86/87
Chennai	+ (91 44) 2434 0043/9659/8080, 2433 0724/ 3293/3294
Kolkata	+ (91 33) 2287 8839 /2287 6617/ 2283 1411/ 2280 0008
Bangalore	+ (91 80) 2559 7401/4049
Ahmedabad	+ (91 79) 2658 4924/5049/2008
Hyderabad	+ (91 40) 2373 5061/7251
Pune	+ (91 20) 020 6606 9999

ICRA ratings should not be treated as recommendation to buy, sell or hold the rated debt instruments. ICRA ratings are subject to a process of surveillance, which may lead to revision in ratings. An ICRA rating is a symbolic indicator of ICRA's current opinion on the relative capability of the issuer concerned to timely service debts and obligations, with reference to the instrument rated. Please visit our website www.icra.in or contact any ICRA office for the latest information on ICRA ratings outstanding. All information contained herein has been obtained by ICRA from sources believed by it to be accurate and reliable, including the rated issuer. ICRA however has not conducted any audit of the rated issuer or of the information provided by it. While reasonable care has been taken to ensure that the information herein is true, such information is provided 'as is' without any warranty of any kind, and ICRA in particular, makes no representation or warranty, express or implied, as to the accuracy, timeliness or completeness of any such information. Also, ICRA or any of its group companies may have provided services other than rating to the issuer rated. All information contained herein must be construed solely as statements of opinion, and ICRA shall not be liable for any losses incurred by users from any use of this publication or its contents.