

Annexure - I
Rating Rationale
ESAF Small Finance Bank Limited

Ratings

Facilities/Instruments	Amount (Rs. crore)	Rating ¹	Rating Action
Tier II Bonds (Basel III) #	125.00	CARE A; Negative (Single A; Outlook: Negative)	Reaffirmed; Outlook revised from Stable
Total Long-term Instruments	125.00 (Rs. One Hundred Twenty-Five Crore Only)		
Certificate Of Deposit	500.00	CARE A1+ (A One Plus)	Reaffirmed
Total Short-term Instruments	500.00 (Rs. Five Hundred Crore Only)		

Details of instruments/facilities in Annexure-1

#Tier II Bonds under Basel III are characterised by a 'Point of Non-Viability' (PONV) trigger due to which the investor may suffer a loss of principal. PONV will be determined by the Reserve Bank of India (RBI) and is a point at which the bank may no longer remain a going concern on its own unless appropriate measures are taken to revive its operations and thus, enable it to continue as a going concern. In addition, the difficulties faced by a bank should be such that these are likely to result in financial losses and raising the Common Equity Tier I capital of the bank should be considered as the most appropriate way to prevent the bank from turning non-viable. In CARE's opinion, the parameters considered to assess whether a bank will reach the PONV are similar to the parameters considered to assess rating of Tier II instruments even under Basel II. CARE has rated the Tier II bonds under Basel III after factoring in the additional feature of PONV.

Detailed Rationale & Key Rating Drivers

The ratings assigned to the debt instruments of ESAF Small Finance Bank (ESAF SFB) continue to factor in experience of the promoter & management team in the lending business, the group's significant experience in microfinance loans, adequate capitalization levels and adequate liquidity position. The ratings are, however, constrained by regionally concentrated nature of business, limited diversification in loan portfolio which mainly consists of micro finance loans and moderate asset quality.

The ratings also take note of moderation in profitability indicators in FY21 (refers to period from April 01 to March 31) and H1FY22 (refers to period from April 01 to September 31) on account of higher credit cost due to impact of COVID-19 pandemic on the asset quality of the bank.

With credit cost increasing from 2.52% in FY21 to 5.28% in H1FY22, ESAF SFB reported loss of Rs. 107 crore in H1FY22 as against profit of Rs. 130 crore in H1FY21 (PAT of Rs. 105 crore in FY21). The loss coupled with high growth in advances led to decline in capitalisation levels with bank reporting total CAR of 20.84% as on September 30, 2021 as against 24.23% as on March 31, 2021. The company is in the process of mobilising fresh equity capital and filed draft red herring prospect (DRHP) with SEBI in July 2021. Timely mobilization of equity capital is critical for strengthening the CAR levels and absorb any further increase in credit cost.

Asset quality of the bank has moderated with GNPA and NNPA increasing to 6.70% and 3.88% as on March 31, 2021 as against 1.53% and 0.64% as on March 31, 2020. Bank has restructured advances of Rs. 1,664 crore under covid-19 resolution framework 1.0 and 2.0. Gross stressed assets (GNPA + Standard Restructured assets) stood at 22.25% as on September 30, 2021 (6.92% as on March 31, 2021). Consequent to restructuring GNPA remained almost stable at 6.31 % as on September 30, 2021.

¹Complete definition of the ratings assigned are available at www.careedge.in and other CARE Ratings Ltd.'s publications

Outlook: Negative

The outlook has been revised to 'Negative' on expectation of continued pressure on asset quality considering the ongoing impact of Covid-19 which may negatively affect the profitability in the immediate term. ESAF SFB has disbursed relief loans to existing customers which constitute 28% of gross advances as on September 30, 2021. These loans are extended for the purpose of income generation activities of the borrowers in the MFI sector. Performance of restructured portfolio and relief loan book remains key monitorable considering the impact of COVID-19 induced pandemic on the borrowers. The bank is in the process of raising equity through IPO to shore up its capitalisation and fund the growth in loan portfolio. The outlook may be revised to stable if the bank is able to mobilise substantial equity capital in a timely manner or demonstrates satisfactory asset quality performance with sharp reduction in restructured loan portfolio and relief loan portfolio.

Rating Sensitivities**Positive Factors: Factors that could lead to positive rating action/upgrade:**

- Increase in the scale of operations along with significant reduction in gross stressed assets and improvement in capital adequacy levels
- Improvement in geographical diversification and product diversification

Negative factors - Factors that could lead to negative rating action/downgrade:

- Further weakening of asset quality parameters along with fall in overall CAR below 18%.
- Weak asset quality performance of relief loans

Detailed description of the key rating drivers**Experience of promoter and management team**

ESAF SFB was promoted by Mr K Paul Thomas, who is the founder of the ESAF group and holds 6.94% stake in ESAF SFB as on September 30, 2021. He has over 33 years of industry experience, of which more than 25 years are in the microfinance sector. He is supported by well-qualified and experienced management team having rich experience in the banking and financial services sector. As on September 30, 2021 the bank's board consisted of eight Directors including four independent directors who have rich experience in banking and financial services industry.

Adequate capitalisation levels

Bank's CAR and Tier 1 CAR stood comfortable at 24.23% and 21.54% respectively as on March 31, 2021 as against 24.03% and 20.99% as on March 31, 2020 (Minimum regulatory requirement of 15% and 7.5%). ESAF SFB raised Tier 1 capital aggregating to Rs. 162.58 crore via private placement in March 2021. However, on account of higher growth in advances coupled with loss in H1FY22 (the bank reported loss of Rs. 107 crore) capitalisation levels declined. Total CAR and Tier 1 CAR declined to 20.84% and 18.68% respectively as on September 30, 2021. The bank's tangible net worth stood at Rs.1,316 crore as on March 31, 2021 (Rs.1,246 crore September 30, 2021).

Significant growth in advances in FY21 & H1FY22; however, share of MFI loans continues to be high

ESAF SFB's gross advances grew by 27% during FY21 and stood at Rs. 8,415 crore as on March 31, 2021 (PY: Rs. 6,607 crore) and during H1FY22, advances grew by 13% as compared to March 31, 2021 and stood at Rs. 9,471 crore as on September 30, 2021. The bank ventured into new products like LAP (Loan against Property), business loans, corporate loans, gold loan, etc. Nevertheless, the microfinance loan book stood at 87% of the advances as on September 30, 2021 (85% of the AUM as on March 31, 2021) as against 93% of the AUM as on March 31, 2020. Next to MFI loans, gold loans stood at Rs. 567 crore as on September 30, 2021. Bank has also disbursed Relief Loan to its non- delinquent customers in H1FY22 in order to support the income generation capability of the clients which stood at Rs. 2,660 crore as on September 30, 2021 (28% of advances).

Significant improvement in deposits in FY21 and H1FY22

The bank's resource profile majorly consisted of deposits followed by borrowings and sub-debt at 73%, 12% and 2% of total borrowings as on March 31, 2021 (PY: 85%, 10% and 2%, respectively, as on March 31, 2020). The total deposits grew by 28% during FY21 and stood at Rs. 8,999 crore as on March 31, 2021 as against Rs.7,028 crore as on March 31, 2020 (PY: Rs.4,317 crore).

During H1FY22, deposits grew by 19% and stood at Rs.10,688 crore as on September 30, 2021. In terms of granularity of deposits, 76% of total deposits were below the ticket size of Rs.1 crore as on September 30, 2021. The bank's CASA (as % total deposits) stood at 19.42% as on March 31, 2021 (PY: 13.66% as on March 31, 2020) and 21.36% as on September 30, 2021.

Moderation in profitability metrics during FY21 and H1FY22

The bank reported PAT of Rs. 105 crore on a total income of Rs.1,767 crore during FY21 as against Rs.190 crore on a total income of Rs.1,546 crore during FY20. During FY21, the interest income (as a % of average interest earning assets) reduced to 16.30% (PY: 18.39%) on account of increase in slippages & increase share of low yield advances and the cost of funds (as a % of average interest-bearing liabilities) declined to 7.60% in FY21 (PY: 8.72%), thereby NIM declined to 8.47% in FY21 (PY: 9.60%). The operating expenses (as a % of average total assets) improved to 5.81% in FY21 from 7.28% in FY20. PPOP witnessed improvement of around 28% to Rs. 416 crore in FY21 from Rs. 325 crore in FY20. Credit costs (as % average total assets) 2.52% in FY21 from 0.83% in FY20. Bank held additional Rs. 40 crore of provision on account of Covid-19 as on March 31, 2021. Thus, with decline in yields and increase in credit cost, bank reported ROTA of 0.97% in FY21 as against 2.31% in FY20.

During H1FY22, bank reported loss of Rs. 107 crore as against PAT of Rs. 130 crore in H1FY21. With further increase in slippages in H1FY22, NIM declined to 7.11% (PY:9.42% in H1FY21). PPOP declined to Rs. 203 crore in H1FY22 from Rs. 265 crore in H1FY21. Credit cost increased to 5.28% in H1FY22 as ESAF increased provisions for non-performing accounts. With moderation in asset quality and restructured accounts in place credit cost is expected to further impact the profitability in near term.

Moderation in asset quality parameters during FY21 and H1FY22

Asset quality moderated in FY21 with Gross NPA and net NPA stood at 6.70% and 3.88% as on March 31, 2021 as against 1.53% and 0.64% as on March 31, 2020. Benefitting from restructuring framework, GNPA and NNPA maintained at 6.31% and 2.13% respectively as on September 30, 2021. Standard restructured advances stood at 15.95% of gross advances as on September 30, 2021. Gross stressed assets (GNPA+Standard Restructured advances) stood at 22.25% as on September 30, 2021.

Regional concentration of loan portfolio

ESAF SFB's AUM continues to remain concentrated in Kerala at 51% of AUM as on September 30, 2021 (56% as on March 31, 2021). The top two states constitute 73% of the overall portfolio as on September 30, 2021. The bank has improved its presence to 21 states across 552 branches as on September 30, 2021 (21 states across 483 branches as on September 30, 2020).

Impact of Covid-19

Gross NPA and net NPA moderated and stood at 6.70% and 3.88% as on March 31, 2021 as against 1.53% and 0.64% as on March 31, 2020. During H1FY22, with grant of relief measures such as OTR and ECLGS, GNPA was

maintained at 6.31% as on September 30, 2021. With subdued operations, collection efficiency has remained moderate during H1FY22, however, collections have improved September 2021 onwards. ESAF has also disbursed relief loan to its borrowers in order to support their income generation capability who were impacted by covid-19 pandemic.

Liquidity: Adequate

As per structural liquidity statement of the bank as on September 30, 2021, the bank does not have negative cumulative mismatches up to 6-month time bucket. Also, the Liquidity Coverage Ratio (LCR) stood comfortable at 162% as on September 30, 2021. In addition, the bank had excess SLR investments of Rs.1,292 crore as on September 30, 2021 which remained favorable from the liquidity perspective.

Analytical approach: Standalone

Applicable Criteria

[Criteria on assigning 'Outlook' and 'Credit Watch' to Credit Ratings](#)

[CARE's Policy on Default Recognition](#)

[Financial Ratios-Financial Sector](#)

[CARE's Rating Methodology for Banks](#)

[Rating Basel III - Hybrid Capital Instruments issued by Banks](#)

[Criteria for Short term Instruments](#)

About the Bank

ESAF Small Finance Bank (ESAF SFB) is a Kerala-based Small Finance Bank (SFB), which has commenced its banking operations on March 10, 2017. The bank was promoted by Mr K. Paul Thomas who is a part of the Kerala-based ESAF group operating in Microfinance space from 1995 and set up ESAF Microfinance & investments Pvt. Limited (EMFIL) in 2007. EMFIL subsequently got SFB license and started its banking operations from March 2017 onwards. ESAF SFB is currently focused in retail banking business with presence in micro-finance, housing finance, business loans, loan against property (LAP), gold loans and providing financing solutions for marginal customers who lack access to the formal banking and financing channels while providing a comprehensive banking and digital platform for all.

The bank received Scheduled status from RBI on December 27, 2018. As on September 30, 2021, ESAF Financial Holdings Private Limited held 62.46% of the shareholding in ESAF SFB, while Mr Paul Thomas holding 6.94%, ESAF Swasraya Multi State Agro Co- operative Society Ltd holding 4.98%, PNB Metlife India Insurance holding 4.75%, Muthoot Finance Ltd holding 4.16%, Bajaj Allianz Life Insurance Company holding 3.89%, PI Ventures holding 1.94%, ICICI Lombard General Insurance Company holding 1.38% and individual investors holding the remaining. As on September 30, 2021, the bank has 524 branches with Rs.8,651 crore of deposits and AUM of Rs.7,820 crore.

Financial Performance

(Rs. Crore)

For the period ended / as at March 31,	2019	2020	2021
	(12m, A)	(12m,A)	(12m,A)
<u>Working Results</u>			
Interest Income	1,032	1,413	1,641
Non Interest Income	109	133	126
Total Income	1,141	1,546	1,767
Interest Expenses	458	621	720
Operating Expenses (Incl. Depreciation)	453	601	632
Provisions (excl tax)	102	68	274

For the period ended / as at March 31,	2019	2020	2021
	(12m, A)	(12m,A)	(12m,A)
PAT	90	190	105
<u>Financial Position</u>			
Deposits	4,317	7,028	8,999
Tangible Networth	888	1,073	1,316
On book Advances	4,548	6,548	8,168
Gross Advances	4,587	6,607	8,415
Investments	1,531	1,734	1,932
Total Assets	7,052	9,459	12,303
<u>Key Ratios (%)</u>			
<u>Profitability</u>			
Interest Income/Avg Interest Earning Assets	19.53	18.39	16.30
Interest Expenses / Avg Interest Bearing Liabilities	8.97	8.72	7.60
Interest Spread	10.56	9.68	8.70
Net Interest Margin (NIM)	9.75	9.60	8.47
Operational Expenses / Avg Total Assets	7.71	7.28	5.81
Return on total assets	1.53	2.31	0.97
Return on network	14.78	19.42	8.83
<u>Solvency</u>			
Overall Gearing (times)	6.81	7.69	8.14
Capital Adequacy Ratio	27.59	24.03	24.23
Tier I Capital Adequacy Ratio	23.30	20.99	21.54
Credit/Deposit ratio	105.36	93.16	90.76
<u>Asset Quality</u>			
Gross NPA to Gross Advances (%)	1.61	1.53	6.70
Net NPA to Net Advances (%)	0.77	0.64	3.88
Net NPA to Tangible Network (%)	3.96	3.93	24.05

A: Audited

Status of non-cooperation with previous CRA: Not Applicable

Any other information: Not Applicable

Rating History for last three years: Please refer Annexure-2

Covenants of rated instrument / facility: Detailed explanation of covenants of the rated instruments/facilities is given in Annexure-3

Complexity level of various instruments rated for this company: Annexure 4

Annexure-1: Details of Instruments / Facilities

Name of the Instrument	ISIN	Date of Issuance	Coupon Rate	Maturity Date	Size of the Issue (Rs. crore)	Rating assigned along with Rating Outlook
Tier II Bonds (Basel III)-I	INE818W08016	30-Dec-2017	10.50%	30-Dec-2024	20.00	CARE A; Negative
Tier II Bonds (Basel III)-II	INE818W08024	28-Mar-2018	11.50%	28-Mar-2025	20.00	CARE A; Negative
Tier II Bonds (Basel III)-III	INE818W08032	01-Jun-2018	11.50%	01-Jun-2025	40.00	CARE A; Negative
Tier II Bonds (Basel III) (Proposed)	-	-	-	-	45.00	
Certificate of Deposits (Proposed)	-	-	-	-	500.00	CARE A1+

Annexure-2: Rating History of last three years

Sr. No.	Name of the Instrument/Bank Facilities	Current Ratings			Rating history			
		Type	Amount Outstanding (Rs. crore)	Rating	Date(s) & Rating(s) assigned in 2021-2022	Date(s) & Rating(s) assigned in 2020-2021	Date(s) & Rating(s) assigned in 2019-2020	Date(s) & Rating(s) assigned in 2018-2019
1	Fund-based - LT-Term Loan	LT	-	-	-	-	1)Withdrawn (06-Mar-20)	1)CARE A; Stable (25-Jan-19)
2	Bonds-Tier II Bonds	LT	125.00	CARE A; Negative	-	1)CARE A; Stable (05-Mar-21)	1)CARE A; Stable (06-Mar-20)	1)CARE A; Stable (25-Jan-19)
3	Certificate Of Deposit	ST	500.00	CARE A1+	-	1)CARE A1+ (05-Mar-21)	1)CARE A1+ (06-Mar-20)	1)CARE A1+ (12-Mar-19)

* Long Term / Short Term

Annexure-3: Detailed explanation of covenants of the rated instrument / facilities: NA**Annexure 4: Complexity level of various instruments rated for this company**

Sr. No	Name of instrument	Complexity level
1	Bonds-Tier II Bonds	Simple
2	Certificate Of Deposit	Simple

Note on complexity levels of the rated instrument: CARE Ratings Ltd. has classified instruments rated by it on the basis of complexity. Investors/market intermediaries/regulators or others are welcome to write to care@careedge.in for any clarifications.

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About CARE Ratings Limited:

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