Fincare Small Finance Bank Limited
January 18, 2019

Ratings

Facilities	**Amount (Rs. crore)**	**Rating[6]**	**Rating Action**
Long-term Bank Facilities	125.38	**CARE A; Stable (Single A; Outlook: Stable)**	Revised from CARE A-; Positive (Single A minus)
Sub-Total	**125.38 (Rs. One hundred Twenty five crore and thirty eight lacs only)**		
Long term instruments-Non-convertible Debenture	35.00 (Thirty five crore only)	**CARE A; Stable (Single A; Outlook: Stable)**	Revised from CARE A-; Positive (Single A minus)

Details of instruments/facilities in Annexure-1

Detailed Rationale & Key Rating Drivers

The revision in rating to the bank facilities/instrument of Fincare Small Finance Bank Limited (FSFB) takes into account sizeable infusion of fresh equity of Rs.140 crore majorly from holding company Fincare Business Services Limited (FBSL). The rating also takes note of improvement in the operational performance in H1FY19.

The rating continues to derive strength from the successful transition from NBFC-MFI to Small Finance Bank (SFB), its experienced promoters and management team to manage various banking operations, strong investor profile, who have demonstrated continual support to bank by infusing funds over the years with latest infusion in H1FY19, as growth capital, its diversified resource base, healthy asset quality indicators (post one-time credit cost of Rs.130 crore incurred in FY18 for the demonetization affected portfolio), and satisfactory liquidity position as evidenced in comfortable asset quality maturity profile.

The ratings are however constrained by lack of diversity in earnings profile, marginal borrower profile, moderate geographic concentration, and the inherent risk involved in the microfinance segment including socio-political intervention risk and unsecured nature of lending. Going forward, maintaining a healthy capital adequacy and asset quality levels, would be crucial. Also, ability to grow the loan portfolio and geographically diversify the operations, improve earnings and profitability, successfully stabilize the operations as an SFB (Small Finance Bank) including raising low cost retail deposits and diversify the product mix would remain the key rating sensitivities.

Detailed description of the key rating drivers

Experienced promoters and management team: The Managing Director (MD) and Chief Executive Officer (CEO), Mr. Rajeev Yadav has over 25 years of diversified experience in financial services across NBFCs and HFC. Prior to this, he was the India CEO at GE Money, which included an NBFC and HFC business across diversified retail products. He is assisted by senior management team having rich experience in the financial services and microfinance sector. Further, there has been induction of senior management team with extensive experience in banking and finance for managing various banking operations. The overall operations are governed by the Board of Directors at FSFB consisting of eminent members from across banking, financial services, consulting and social sector.

Transition to SFB, new asset classes introduced albeit portfolio still largely microfinance focused: FSFB had commenced its banking operations on July 21, 2017. Post transition to SFB, bank opened around 43 branches (all newly setup) till the end of July 2018, in the Tier-1 and Tier-2 cities. The pace of branch addition was moderate as the bank focused on addressing asset quality issues post demonetization. FSFB has introduced new products like loan against property, loan against gold, institutional finance (loans to Micro, small and medium enterprises, NBFCs, and NBFC-MFIs) under assets side, and various deposits products under liability side. Its portfolio however, continues to

[1]*Complete definition of the ratings assigned are available at www.careratings.com and other CARE publications*

remain majorly tilted towards microfinance loans. Bank's AUM stands at Rs.2,899 crore as on September 30, 2018, with share of MFI portfolio of around 84.93% (86.24% as on June 30, 2018).

Strong investor base and support: FSFB had a strong investor base with True North, who holds around 17.78% in FBSL (holding company), and 3.86% directly in FSFB, as on September 30, 2018. The investors of FBSL include several marquee names such as TA Associates, Tata Opportunities Funds, Leapfrog Investments, SIDBI, Kotak Mahindra Life, Edelweiss Tokio Life, etc. During FY17, the investors had infused Rs.200 crore in the holding company, FBSL towards transition to SFB. Investors have infused funds in the form of equity in FBSL, in during FY17 and FY18, towards indemnification of losses due to increase in credit cost, caused by demonetization.

FBSL has in turn infused Rs.75 crore in the form of Tier-2 capital (sub-debt). Moreover the bank has also raised another Rs.25 crore in the form of sub-debt from other FIs, which has helped it to maintain its CAR and Tier-1 at 23.30% and 18.07% as on March 31, 2018 (48.44% and 48.44% as on March 31, 2017), even after posting losses of Rs.97.55 crore, due to provision for NPA and write-off of Rs.130.39 crore in FY18.

During August 2018, FBSL (holding company) and other existing investors have infused fresh equity of around Rs.140 crore in bank, during September 2018. The recent infusion, will help the bank to further scale its operations. Moreover bank is also planning to raise further equity funds into bank to provide the required growth capital to support its growing scale of operations.

Improvement in the asset quality parameters but risks associated with marginal borrower profile remains: FSFB's asset quality parameters, which was impacted significantly due to demonetization, has improved with satisfactory performance of fresh disbursement post demonetization, and bank taking a one-time credit cost hit. FSFB has taken prudent write-off of around Rs.130 crore, which has helped the bank to contain its asset quality ratios, with GNPA and NNPA at 0.94% & 0.72% as on March 31, 2018 as against the peak GNPA and NNPA of 6.61% & 4.34% respectively as on June 30, 2017. During H1FY19, asset quality continue to remain comfortable, with Net NPA improving to 0.41% as on June 30, 2018, and further improving moderately to 0.35% as on September 30, 2018. The performance of the unseasoned non-MFI portfolio remains to be seen, and its performance will be critical for bank to maintain its asset quality in future. With significant share of advances continuing to remain exposed to the marginal borrower profile, FSFB will continue to face the challenge of risks associated with such segment including political and operational.

Diversified resource profile, with bank repaying high cost of bank loans with wholesale deposits: Post the transition to SFB, FSFB has raised significant deposit (both wholesale and retail) which has helped reduce its average cost of borrowings. FSFB has repaid around Rs.450 crore of its grandfathered loans, as a result the share of grandfathered loans in the overall liabilities, has reduced from 97% as on June-17 to 20% as on June-18, and further reducing to 12% as on September-2018. As on September 30, 2018, the share of deposit in the liability profile is around 59%. Further developing a strong retail deposit base and garnering low cost CASA deposit would remain key to its profitability.

Key Rating Weaknesses

Substantial loss incurred during FY18 owing to portfolio write-off and high operating cost (for transition to SFB); albeit improvement in financial performance in H1FY19: Interest yield has decreased on a comparable basis, primarily on account of interest reversal for substandard assets, reduction in high yield MFI segment, and diversification into secured asset classes such as LAP and Loan against gold, where the yield are relatively lower compared to microfinance. After the conversion into SFB, interest expense to averaged borrowed funds have decreased, mainly owing to bank replacing high cost debt with lower cost term deposits. Due to change in the resource mix, NIM has improved from 8.89% in FY17 to 9.71% in FY18. However with bank incurring high operational cost for the setup of new branches in the form of rentals, employee cost, and IT related expense, bank's cost to income ratio deteriorated further from 63.50% in FY17 to 76.85% in FY18. Moreover, due to one-time credit cost of Rs.130 crore, FSFB's net profitability has taken a hit, with bank posting a loss of Rs.97.55 crore during FY18.

During H1FY19, bank financial performance has improved with bank reporting PAT of Rs.42.33 crore on a total income of Rs.302.13 crore. Bank witnessed improvement in NIM margins on the backdrop of rising interest income from the portfolio added during the last quarter FY18 (AUM increased from Rs.1,655 crore in Dec-17 to Rs.2,135 crore in Mar-18), and during current financial year. The cost to income ratio though reduced, continues to remain high at 66.17% for H1FY19. With bank planning to convert some of its existing asset only banking outlets into full-fledged brick and mortar branches, operational expenses are expected to remain high over the next few years. Along with high operational expenses, negative carry associated with maintaining regulatory reserve requirement, is expected to keep FSFB's profitability indicators constrained.

Moderate geographic concentration: Bank's geographic concentration has increased during FY18, with Top-3 state exposure increasing from 59.80% as on March-17 to 71.49% as on March-18. The rise in the geographic concentration was owing to bank's relatively lower disbursement to the earlier key states of Maharashtra and Madhya Pradesh, since they were majorly affected by demonetization. The single state concentration remained high at around 29.94% as on March-18 as against 22.15% as on March -17. Going forward, ability of bank to diversify its area of operation will be critical to reduce geographic concentration risk.

Industry Risk: Microfinance lending continues to be key lending segment for the company. The microfinance industry continues to be impacted by the inherent risk involved viz. socio-political intervention risk and regulatory uncertainty and risks emanating from unsecured lending.

Prospects
On account of various events post demonetization, collection efficiency of the MFIs/SFBs has deteriorated. This has impacted the asset quality of the MFIs/SFBs leading to increase in credit costs. Consequently, the profitability of the MFIs/SFBs took a severe hit in FY18 on account of higher provisioning costs. However, with much of the credit cost being absorbed by the MFI's/SFBs during FY18, and given the market potential, the sector is likely to continue its high growth going forward with MFIs/SFBs continuing to attract funds and improving operational efficiencies to maintain profitability.

Liquidity position
FSFB's liquidity profile remains satisfactory, with no cumulative mismatches across maturities as per structured liquidity statement as on November 30, 2018, due to shorter tenor loans portfolio, which majorly encompasses MFI loans.

Analytical approach: Standalone. Combined view of FSFB and Future Financial Services Private Limited (FFSPL) taken till FY17, since both FSFB and FFSPL shared common management and promoters until all assets and liabilities of FFSPL was acquired by FSFB through a slump sale concluded on October 1, 2016.

Applicable Criteria
CARE's Criteria on assigning Outlook to Credit Ratings
CARE's Policy on Default Recognition
Financial ratios – Financial sector
CARE Methodology for Non-Banking Financial Companies
CARE's Rating Methodology for Banks

About the Company
Fincare Small Finance Bank Limited (FSFB) (erstwhile Disha Microfin Limited), is a small finance bank, which started it banking operations on July 21, 2017, post receipt of final license from RBI on May 12, 2017. As on September 30, 2018, FSFB operates in 10 states and one Union Territory with branches, covering around more than 12.50 lakh active borrowers with asset under management (AUM) of Rs.2899 crore.

Brief Financials (Rs. crore)	FY17^ (A)	FY18 (A)
Total operating income	266	351
PAT	26	-98
Interest coverage (times)	1.42	0.24
Total Assets	1,188	2,269
Net NPA (%)	0.38	0.72
ROTA (%)	2.45	-5.64

A: Audited; ^Combined figures of FSFB (for 12 months) & FFSPL (for 6 months)
Status of non-cooperation with previous CRA: Not Applicable

Any other information: Not Applicable
Rating History for last three years: Please refer Annexure-2

Note on complexity levels of the rated instrument: *CARE has classified instruments rated by it on the basis of complexity. This classification is available at www.careratings.com. Investors/market intermediaries/regulators or others are welcome to write to care@careratings.com for any clarifications.*

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Annexure-1: Details of Instruments/Facilities

Name of the Instrument	Date of Issuance	Coupon Rate	Maturity Date	Size of the Issue (Rs. crore)	Rating assigned along with Rating Outlook
Term Loan-Long Term	-	-	May 31, 2020	99.65	CARE A; Stable
Term Loan-Long Term-Proposed	-	-	-	25.73	CARE A; Stable
Debentures-Non Convertible Debentures	January 03, 2017	10.90%	January 13, 2020	35.00	CARE A; Stable

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 2018-2019	Date(s) & Rating(s) assigned in 2017-2018	Date(s) & Rating(s) assigned in 2016-2017	Date(s) & Rating(s) assigned in 2015-2016
1.	Term Loan-Long Term	LT	125.38	CARE A; Stable	1)CARE A-; Positive (24-Sep-18)	1)CARE A-; Stable (09-Oct-17) 2)CARE A-; Stable (18-May-17)	1)CARE BBB+; Stable (17-Feb-17) 2)CARE BBB+ (03-Oct-16) 3)CARE BBB+ (07-Sep-16)	-
2.	Debentures-Non Convertible Debentures	LT	35.00	CARE A; Stable	1)CARE A-; Positive (24-Sep-18)	1)CARE A-; Stable (09-Oct-17) 2)CARE A-; Stable (18-May-17)	1)CARE BBB+; Stable (17-Feb-17)	-
3.	Commercial Paper	ST	-	-	1)Withdrawn (19-Sep-18)	1)CARE A2+ (09-Oct-17) 2)CARE A2+ (29-May-17)	-	-