Can Small Finance Banks make it big?

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RADHIKA MERWIN

For Uma Chandra, who does tailoring at home, the loan offered by Ujjivan Small Finance Bank has helped fund her children's education. From not having a bank account (not even the Centre's much-hyped Jan Dhan account), Uma now has an account for managing her loan and savings transactions — a giant leap forward from her regular dealings with money-lenders, who charge exorbitant interest rates.

For many low-income earners and small businesses, often underserved by traditional commercial banks, the new format small finance banks (SFBs), have made basic banking services more accessible.

But how has the journey been for these SFBs, with a chunk of them transitioning from being a microfinance institution (MFI)? Undoubtedly bumpy and challenging.

Of the 10 players which have been granted SFB licence by the RBI, eight were MFIs.

The demonetisation shocker brought in a whole set of unexpected challenges for these fledgling 'banks'. The massive cash crunch led to sharp rise in delinquencies, put growth and branch expansion plans on the back-burner and threw earnings forecasts out of whack. Very recently, the RBI staying its ground on listing norms has once again unnerved investors.

Is the worst over for the SFBs? Will the wheels of fortune turn? To find out the answer, we trace the journey of these SFBs over the past two to three years.

The big picture

Anticipated hiccups: The huge potential for micro-credit in India is evident in the strong growth witnessed by MFIs. Between FY13 and FY15 — before SFBs licences were granted — loan growth for most of these MFI-turned-SFB players (compounded annual growth rate) averaged 40-100 per cent.

But there were several challenges expected in transitioning into SFBs. One, SFBs have to comply with cash reserve (CRR) and statutory liquidity (SLR) requirements, which was expected to impact profitability. Two, garnering low-cost retail deposits was critical to cushion the erosion in profitability. Lastly, asset (loan) diversification was also imperative, but a tough task for players which depend heavily on their MFI business.

The Demo blow: But demonetisation served a hard blow on business growth and earnings. This is because the MFI business depends on cash to a great extent. Hence, limited supply of currency, disruption in borrowers' cash flows etc. led to slowdown in loan growth and a sharp rise in delinquencies. Unfortunately, what began as a cash-crunch problem, snow-balled into political instigation, misleading borrowers — playing havoc on group repayment behaviour and collections.

Demonetisation-led large write-offs and provisioning continued in FY18, impacting performance.

Signs of recovery: After peaking in the second and third quarter of FY18, GNPAs have been trending down in the first half of FY19. The collection efficiencies of most these banks' microfinance portfolio are now back to pre-demonetisation levels of 98-99 per cent. Loan growth too is back to pre-demonetisation levels.

Way forward: For all players, loan diversification will be critical, though aggressive growth can hurt profitability and asset quality. The key challenge, however, lies in ramping up low-cost retail deposits to cushion profitability. Most players have been offering high interest rates to draw in deposits and rely heavily on bulk deposits. This is unlikely to change in a hurry. In the current scenario, when deposit growth for traditional banks has also been modest, scaling up low-cost deposits will remain a challenge. A key overhang on players such as Equitas and Ujjivan is the RBI's norm which requires them to list their banking subsidiary within three years and maintain minimum promoter shareholding in the bank (at least 40 percent) for a period of five years from the date of commencement of their business.

The micro picture

Of the ten SFBs, three players are listed. AU Small Finance was listed in July 2017; the stock has gained over 70 per cent from its listing price.

Equitas Holdings — the holding company of Equitas Small Finance Bank — and Ujjivan Financial Services — the holding company of Ujjivan Small Finance — that listed in April-May 2016, have had a bumpy ride on account of demonetisation. After sky-rocketing 60-100 per cent post listing, their stock prices tumbled after demonetisation. Just as the performance of these banks and stock prices started to recover, the RBI's clarification this October that small finance banks need to be listed within three years of their operations (discussed later), resulted in stock prices crashing once again.

We do some number crunching on the financial performance of all SFBs over the past few years, and look at their earnings prospect over the next three to five years.

Equitas Holdings

Equitas Holdings began operations in September 2016. Demonetisation led to sharp rise in delinquencies, though the company's relatively better diversified loan portfolio helped mitigate the risk to some extent.

In FY18, the bank went on to de-risk its portfolio, with MFI loans declining by 30 per cent YoY and constituting about 28 per cent of the portfolio, down from about 53 per cent in FY16. While there has been no overhang of the impacted portfolio (during demonetisation) since the March quarter, the bank's GNPAs moved up to 3.36 per cent in the September quarter, due to change in recognition of NPAs (from month end to daily). Going ahead, GNPAs should normalise around these levels.

On the loan front, the management expects the share of MFI to come down to about 20 per cent over the next three to five years.

While the bank's cost-to-income ratio is likely to moderate (as much of the expansion is done), shift towards lower yield portfolio, and dependence on bulk deposits (70 per cent) could impact profitability. How well the bank is able to leverage its branch network to garner low-cost CASA deposits will be critical.

A key overhang on the stock is the RBI's listing norms which requires it to list Equitas SFB by September 2019 and maintain 40 per cent promoter shareholding till September 2021. The board is considering various options without the need to go in for an IPO, to cushion the blow for existing investors. Equitas Holdings plans to dilute up to 60 per cent of its holdings in the bank in favour of its existing shareholders.

At the current price of ₹118 the stock trades at 1.5 times FY20 book, which is attractive. However, investors can wait for clarity on the SFB listing before investing.

Ujjivan Financial Services

Ujjivan launched its small finance bank in February 2017. At the time of transitioning into an SFB, MFI loans were still a chunk of the (about 98 per cent) of its loans. Demonetisation led to lower collection efficiencies and rise in GNPAs. In FY18, the company's focus was to contain losses and improve quality of loan book.

Loan growth has scaled up to 24 per cent in the first half of FY19, led by growth in non-MFI segments. While MSE and affordable housing have been ramping up rapidly, new offerings like personal loans, two-wheeler loans, wholesale lending to NBFCs etc. are in a nascent stage.

The bank had deferred rolling out of bank branches on account of demonetisation. It expects to reach 475 branches by end-March 2019; by the end of FY20, the bank expects to convert 48 assets centres into branches and set up another 50-odd new branches.

Cost-to-income ratio shot up to 77 per cent in Q2 of this fiscal and with the proposed branch expansion, this figure may need watching. The management, however, expects cost-to-income to come down to 55 per cent in the next three years.

Overall, the management expects a 30 per cent growth this fiscal and plans to diversify to 50:50 MFI vs non-MFI loans in the next five years. This appears an aggressive target to achieve. Impact on earnings due to lower yields on non-MFI portfolio will need watching. Also, CASA stood at 9 per cent as of September 2018. This needs to be scaled up significantly to cushion earnings pressure. On the positive side, Ujjivan's well-spread operations across states mitigates geographic risk.

At the current price of ₹241, the stock trades at 1.3 times FY20 book, which is attractive. However, here too, the SFB listing requirement is a key risk. Management is considering various options.

Au Small Finance Bank

AU Small Finance Bank (formerly Au Financiers (India)), was the only NBFC that was allowed to set up an SFB. It began its banking operations in April 2017. Unlike Ujjivan or Equitas that depended on their MFI business, AU Small Finance already had a well-diversified loan book with retail focus — when it became an SFB. Hence, demonetisation had a relatively lower impact on the company. But the bank's profitability too slipped in FY18 on the back of transitioning into an SFB. In addition, the company was following a 120-day norm to classify bad loans, which was to move to a 90-day norm in FY18. However, the return ratios are well within expected lines, and GNPAs are still a comfortable 2 per cent in FY18.

The bank, quickly ramping up its low-cost deposit base, has also helped mitigate the pressure on profitability. That said, the company's ability to ramp up deposit base further, while keeping costs under control, will be critical to sustain profitability. Also, the company's operations are mostly concentrated in Rajasthan, Gujarat, Maharashtra, and Madhya Pradesh.

At the current price of ₹630 the stock trades at 4.5 times FY20 book. Investors with a two-to-three year horizon can invest in the stock.

Fincare Small Finance Bank

Fincare Business Services acts as the holding company for Fincare Small Finance Bank that commenced banking operations in July 2017.

While demonetisation impacted its performance in FY18, most of the issues, have been resolved. Collection efficiency of the new portfolio post April 2017 is at 99.91 per cent. The gross NPAs have started declining over the last two to three quarters. Loan growth has also sprung back in the latest September 2018 quarter.

While the growth has returned in the MFI portfolio, much like other players, Fincare too is looking to diversify its portfolio, though at a calibrated pace. Non-MFI loans include loan against gold and institutional finance. Fincare has also started two-wheeler loans and is looking to get into affordable housing in the beginning of next year, which will take time to scale up.

The bank is looking to diversify only gradually — 70:30 towards MFI: non-MFI loans over the next 12 months. On the funding side, much like other players, chunk of the deposits are bulk and scaling up CASA will be important. That said, a calibrated diversification should keep the pressure on profitability and asset quality at bay.

Capital Small Finance Bank

A local area bank (LAB), operating in five districts of Punjab, Capital Small Finance Bank transitioned into an SFB in April 2016. At the time of transitioning, the bank had 47 branches and 80 per cent of its business in the rural and semi-urban areas. Being an LAB, the bank's portfolio was already well-diversified. Demonetisation did impact the bank, though the extent was relatively lower than MFI-turned SFB players.

In the two years of operations, the bank has added 59 branches and has started expanding outside of Punjab into Delhi, Haryana and Chandigarh. Majority of the bank's direct agri credit is under the Kisan Credit Card Scheme. As of September 2018, while the loan growth remained healthy, net profit slipped owing to sharp rise in provisioning.

We have collated the information on other SFBs in the table. There is very limited information on North East Small Finance Bank that started operations in Oct 2017.

Scan the QR code to catch insightful bytes from the top management of a few banks

EQUITAS HOLDINGS

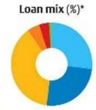
	FY13	FY14	FY15	FY16	FY17	FY18	1H FY19
Loans (₹ cr)	1,484	2,486	4,010	6,125	7,182	8,238	9,981
% Y-o-Y growth		67.5	61.3	52.7	17.3	14.7	36.2
Net profit	32	74	107	167	159	31	85
% Y-o-Y growth		132.9	43.5	56.8	-4.6	-80.3	221.1

Deposits as of 1H FY19 **₹5,877 crore**

Key ratios (%)	FY15	FY16	FY17	FY18	1H FY19
CASA (portion of deposits)			18	35	34
ROE	11.2	13.3	8.92	1.4	8.5#
ROA	3	3	2	0.27	1.37#
Gross NPA	1.1	1.34	3.53	2.72	3.36*
Net NPA	0.8	0.94	1.47	1.44	1.98

*During 1HFY19, non-performing assets are identified on a daily basis instead of month end; # for Sept quarter

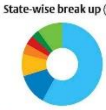
Loan mix (%)*



- Micro finance....27
- Vehicle Finance....25
- Small business loans....38
- MSE Finance....5
- Corporate loans....4
- Others....1

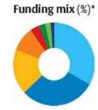
*as of September 2018

State-wise break up (%)*



- Tamil Nadu....58.3
- Maharashtra....12.1
- Karnataka....8.7
- Madhya Pradesh....4.1
- Rajasthan....3.6
- Gujarat....3.1
- Others....10.1

Funding mix (%)*



- Term deposits....33.2
- Refinance....30
- CASA....17.6
- CD....9.6
- Debenture....3.7
- Sub-ordinated debt....2.4
- CBLO....2.2
- Term loans....1.3

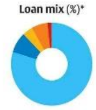
UJJIVAN FINANCIAL SERVICES

	FY13	FY14	FY15	FY16	FY17	FY18	1H FY19
Loans (₹ cr)	1,126	1,617	3,274	5,389	6,380	7,560	8,317
% Y-o-Y growth		43.6	102.4	64.6	18.4	18.5	24.7
Net profit	32.9	58.4	75.8	177.2	207.7	7.3	89
% Y-o-Y growth		77.5	29.8	133.8	17.2	-96.5	NA

Deposits as of 1H FY19 **₹4,188 crore**

Key ratios (%)	FY15	FY16	FY17	FY18	1H FY19
CASA (portion of deposits)			3	3.7	9
ROE	13.7	18.3	14.1	0.4	9.9
ROA	2.5	3.7	2.9	0.1	1.7
Gross NPA	0.07	0.15	0.28	3.6	1.9
Net NPA	0.02	0.04	0.03	0.7	0.3

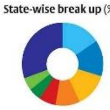
Loan mix (%)*



- Group loans....79.8
- Micro individual loans..8.2
- MSE Finance....4.2
- Affordable housing....6.4
- Others....1.4

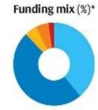
*as of September 2018

State-wise break up (%)*



- Tamil Nadu....15.8
- West Bengal....14.1
- Karnataka....13.3
- Maharashtra....9.8
- Gujarat....6.5
- Bihar....5.2
- Haryana....4.9
- Others....30.4

Funding mix (%)*



- Refinance....39
- Deposits....49
- NCDs....5
- Term loans....5
- Others....2

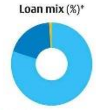
AU SMALL FINANCE

	FY13	FY14	FY15	FY16	FY17	FY18	1H FY19
Loans (₹ cr)	3,704	4,449	5,568	8,221	10,734	16,038	20,219
% Y-o-Y growth		20.1	25.2	47.6	30.6	49.4	66.0
Net profit	80	92	140	212	305	292	168
% Y-o-Y growth		15.0	52.2	51.4	43.9	-4.3	29.0

Deposits as of 1H FY19 **₹10,798 crore**

Key ratios (%)	FY15	FY16	FY17	FY18	1H FY19
CASA (portion of deposits)				32	26
ROE	21.9	27.7	20.4	13.7	12.9
ROA	2.8	3.1	2.7	1.7	1.6
Gross NPA	1.4	1.3	1.8	2	2
Days Past Due	180	150	120	90	90

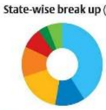
Loan mix (%)*



- Retail (including vehicle, small business loans etc.)....80
- Small and Mid-corporate....19
- Others....1

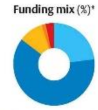
*as of September 2018

State-wise break up (%)*



- Rajasthan....41
- Madhya Pradesh....12
- Maharashtra....17
- Gujarat....12
- Delhi....8
- Punjab....4
- Others....6

Funding mix (%)*



- Refinance....23.2
- Deposits....62.2
- NCDs....9.6
- Term loans....1.7
- Others....3.3

FINCARE SMALL FINANCE

	FY16	FY17	FY18	1H FY19
Loans (₹ cr)	1,042	1,314	2,135	2,899
% Y-o-Y growth	60.0	26.1	62.5	99.0
Net profit (₹ cr)	2.67	9	-98	43

*The business of Future Financial Services was merged with Disha in 2016. Hence FY17 numbers are not comparable to earlier years

Deposits as of 1H FY19 **₹1,440 crore**

Key ratios (%)	FY17	FY18	1H FY19
CASA (portion of deposits)		5.1	5.5
ROE	4.7	-24.8	32.5
ROA	0.9	-6.4	4.7
Gross NPA	0.8	0.95	1.4

Funding mix (%)* *as of Sep 2018*

- Deposits....59
- Grandfathered loans*....12
- Refinance....22
- Others....7

*bank loans taken in the past

MFI loans: 85% of portfolio as of Sept 2018

Top 3 states in terms of portfolio as of Sept 2018: Tamil Nadu (32%); Gujarat (20.6%); Karnataka (18%)

CAPITAL SMALL FINANCE BANK

	FY16	FY17	FY18	1H FY19
Loans (₹ cr)	1,149	1,370	1,853	2,227
% Y-o-Y growth	23.7	19.2	35.3	39.0
Net profit (₹ cr)	13.7	15	19	6
% Y-o-Y growth	-3.5	9.5	26.7	-38.9

Deposits as of 1H FY19 **₹3,231 crore**

Key ratios (%)	FY17	FY18
CASA (portion of deposits)	39.5	39.9
ROE	12.5	8.98
ROA	0.63	0.64
Gross NPA	1.02	1.14

Loan mix (%) *as of FY18*

- Agri....40.9
- Services....26.1
- others....32.9

SURYODAY SMALL FINANCE

	FY17	FY18
Loans (₹ cr)	964.00	1,759
% Y-o-Y growth	-7.3	82.5
Net profit (₹ cr)	15.1	10.1
% Y-o-Y growth	-45.0	-33.1

Commencing banking operations in Jan 2017, Suryoday too faced rise in delinquencies in FY17 and FY18. However, for loans disbursed from Jan 2017, delinquencies have fallen substantially. The bank is looking to diversify into other loans such as LAP, MSME and CV loans.

Deposits as of FY18 **₹830 crore**

Key ratios (%)	FY18
CASA (portion of deposits)	11
Gross NPA	3.54

Deposit mix (₹ crore) *as of FY18*

- CASA....82.7
- Retail term deposits....226.2
- Bulk deposits....492.3
- CDs....29.4

MFI loans: 95% of portfolio as of FY18

Top 4 States in terms of portfolio as of FY18: Maharashtra; Tamil Nadu; Odisha; Gujarat

UTKARSH SMALL FINANCE

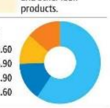
	FY17	FY18
Loans (₹ cr)	1,613	3,210
% Y-o-Y growth	12.6	99.0
Net profit (₹ cr)	4.8	-63

The bank began its journey in January 2017 and its earnings in FY18 were in the red owing to demonetisation-led write-offs. Collection efficiency is gradually returning to normalcy. The bank is looking to diversify into MSME, housing and other loan products.

Deposits as of FY18 **₹2,193 crore**

Key ratios (%)	FY18
CASA (portion of deposits)	5.3
Gross NPA	1.85

Funding mix (%) *as of FY18*



- Deposits....59.60
- Non-Convertible Debentures....14.90
- Refinance....11.90
- Others....13.60

MFI loans: 88% of portfolio as of FY18

Top 4 States in terms of branch netwrok as of FY18: Bihar, Uttar Pradesh; Maharashtra; Madhya Pradesh

ESAF SMALL FINANCE BANK

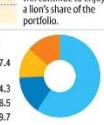
	FY17	FY18
Loans (₹ cr)	1,481	3,155
% Y-o-Y growth	-23.1	113.0
Net profit (₹ cr)	0.7	26.9

Commencing operations in March 2017, the bank has 104 retail branches and 297 ultra small branches as of March 2018. According to the latest annual report, agricultural lending and small ticket loans will continue to enjoy a lion's share of the portfolio.

Deposits as of FY18 **₹2,523 crore**

Key ratios (%)	FY18
CASA (portion of deposits)	10
Gross NPA	3.79

Loan mix (%) *as of FY18*



- Agriculture and Allied....57.4
- Advances to industries eligible as priority sector....14.3
- Services....8.5
- Personal Loans and others....19.7

Top 3 States in terms of portfolio as of FY18: Kerala (57.7%); Tamil Nadu (22%); Maharashtra (7%)

JANA SMALL FINANCE

Jana Bank started banking operations on March 28, 2018. The bank has launched 157 bank branches. By end-2019, Jana Bank's 500 branches will be operational in 19 States

%	FY15	FY16	FY17
Loan growth	83.3	192.0	16.6
Net profit growth		113.0	6.3
ROE	9.45	13.9	7.3
ROA	2	2.02	1.28
GNPA	0.73	0.25	0.69
Net NPA	0.49	0.18	0.55

Source: Annual Reports, Company

The Hindu Business Line, Dec 17, 2018

BIG STORY

Can small finance banks make it big?

Ten players were granted small finance bank licences in 2015. How has the journey been for these banks, with a chunk of them transitioning from being micro-finance institutions? After taking a hard hit post demonetisation, growth and delinquencies are slowly returning to normalcy. But is the worst over? What lies ahead for these fledgling banks? p2

The Hindu Business Line, Dec 17, 2018

FD Watch **Fincare SFB**

A safe avenue with attractive rates

Fincare Small Finance Bank offers 9% for 24- to 36-month deposits

PARVATHA VARDHINI C

Rates offered by private and public sector banks on their fixed deposits are still nothing to write home about. Many non-banking finance companies offer deposit rates that are better than bank interest rates, for the same tenure.

However, apart from the usual credit risk, the recent liquidity crisis faced by the NBFC segment pegs up the risk factor of this segment as a whole.

In this scenario, investors looking for safe avenues to park their money without compromising too much on returns can consider deposits of small finance banks (SFBs).

Being recent entrants, these banks have been offering good rates on their fixed deposits to woo customers.

Benefits

SFBs focus on the under-served sections of the economy such as small business units, small and marginal farmers, and micro and small industries. But while these banks carry restrictions on their lending activity (75 per cent of loans in priority sector and at least 50 per cent loans of less than ₹25 lakh), there is no such curb on deposit taking.

Besides, unlike NBFC deposits that have no insurance cover, SFB deposits are covered by the Deposit Insurance and Credit Guarantee Corporation of India (DICGC). Each depositor is insured up to ₹1 lakh for both principal and interest. For calculating this limit, all deposits across branches of the same bank are aggregated. SFBs are also required to maintain a much higher capital adequacy ratio than normal banks. Thus, SFB deposits are safe for investors who don't have much appetite for risk.

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Most SFBs offer attractive rates for one- to three-year deposits. Among these, Fincare SFB offers 9 per cent for 24-36-month deposits. Investors can park a portion of their surplus in this deposit under the cumulative option. A two- to three-year window is also ideal as it provides opportunity to re-invest at higher rates as interest rates move up over the medium term.

Fincare's offer is superior to what's given by traditional banks. Most public sector banks offer only 6-7 per cent interest rate for this bucket. Private sector banks give up to 8 per cent for the same period. NBFCs such as Shriram Transport Finance offer a similar 9 per cent for three-year deposits under the non-cumulative option. Mahindra Finance also offers 9 per cent, but only for 33-40-month online deposits.

Hence, these options are not an apple-for-apple comparison with that of Fincare. Besides, the risk-reward aspects of NBFC deposits are also different from those of SFBs. Investors who don't have the risk appetite for NBFC deposits or have enough exposure to the same, can consider SFB deposits as a diversifier.

About Fincare

Fincare SFB commenced operations in July 2017. It has a presence across Tamil Nadu, Karnataka, Andhra Pradesh, Gujarat, Maharashtra, Madhya Pradesh, Puducherry, Haryana, Delhi and Rajasthan.

While the bulk of its lending is still to the micro-finance segment, Fincare is looking to diversify its portfolio. The bank has also bounced back quite well from the impact of demonetisation, improving its loan growth and profits since then.

Advantages

- Superior interest rates for 1-3-year deposits
- Insured up to ₹1 lakh for both principal and interest
- Wide branch network in South

Comeback

The bank has bounced back quite well from the impact of demonetisation, improving its loan growth and profits since then

The Hindu Business Line, Dec 17, 2018