March 16, 2020

Indostar Capital Finance Limited: Rating reaffirmed

Summary of rating action

Instrument*	Previous Rated Amount (Rs. crore)	Current Rated Amount (Rs. crore)	Rating Action
Commercial Paper	1,250	1,250	[ICRA]A1+; reaffirmed

**Instrument details are provided in Annexure-1*

Rationale

While arriving at the ratings, ICRA has taken a consolidated view of the credit profiles of Indostar Capital Finance Limited (ICF) and its subsidiary Indostar Home Finance Private Limited (IHFPL), referred to as the Group, owing to the common management, shared infrastructure, as well as the strategic importance of IHFPL to the Group.

The rating continues to draw strength from ICF's comfortable capitalisation with consolidated gearing of 2.3 times, capital adequacy of 27.6% and solvency (Net Stage 3/Net Worth) of 10.8% as of December 31, 2019. Further, ICRA notes that as per the share subscription agreement dated January 31, 2020, ICF shall issue equity shares and compulsorily convertible preference shares to Brookfield group for a total consideration of Rs. 1,225 crore. Successful consummation of the aforesaid transaction would be imperative to provide the company adequate cushion for absorbing any asset side shocks and shall place the company well for growth over the medium term.

The rating also factors in the company's adequate liquidity profile with a sound policy of maintaining ~15% of net worth in liquid investments and undrawn bank lines at all times. Further, the company has adopted a conservative approach during the ongoing liquidity squeeze for the NBFC sector, wherein higher on-balance sheet liquidity is being maintained. Also, while there has been a moderation in ICF's borrowing profile with fund raising trajectory suggesting challenges, successful onboarding of Brookfield is expected to provide support in this regard.

While reaffirming the rating, ICRA has taken cognizance of ICF's limited track record in retail lending, concentration in wholesale book, asset quality pressures and weak profitability indicators. ICF's asset quality has come under pressure during past few quarters with Gross Stage 3 and Net Stage 3 at consolidated level increasing to 4.3% and 3.4% respectively in December 2019 from a level of 2.6% and 1.6% respectively in March 2019. This deterioration in asset quality has been primarily driven by a sizeable slippage in the wholesale loan book, which continues to remain under pressure and timely debt servicing is yet to be tested given that sizeable proportion of portfolio which is under moratorium. Also, ICFs organically originated CV portfolio has witnessed considerable increase in slippages in recent quarters, in line with the broader industry trend amid ongoing challenging operating environment. Nevertheless, the company has demonstrated control on asset quality in the SME and housing finance segments, though these loan books remain relatively less seasoned and performance across economic cycles remains to be established.

Notwithstanding the increased share of higher yielding CV finance business in the portfolio of ICF, the increased borrowing cost during past one year has constrained an improvement in the lending spreads and net interest margins. Further, the decline in loan book has resulted in an adverse movement in cost structure with increased operating cost. Moreover, weakened asset quality has manifested into a spurt in credit costs for ICF. As a result, already modest profitability of ICF amid growing scale of operations in new business segments, has weakened as reflected by ROA and ROE of 1.5% and ROE 4.7% in 9MFY2020 compared to 2.5% and 10.1% respectively in FY2019. These profitability pressures are likely to sustain over the near term, given the asset quality challenges and elevated operating costs due to large infrastructure set up by

ICF to expand its retail lending footprint. In this regard, the company's ability to scale up the AUM over the medium term by leveraging the existing infrastructure network and partnerships while maintaining prudent underwriting standards and hence good control over incremental slippages will remain key determinant of the profitability trajectory hereon.

Key rating drivers and their description

Credit strengths

Comfortable capitalisation - ICF's capitalisation continues to remain comfortable with consolidated net worth (net of goodwill) of Rs. 2,795 crore, gearing of 2.3 times, capital adequacy of 27.6% and solvency (Net Stage 3/Net Worth) of 10.8% as of December 31, 2019. While the leverage level has eased post March 2019 (peak gearing of 3.3 times in March 2019) due to conservative/declining portfolio trajectory thereafter, ICRA expects the gearing to increase considerably from current level with the growth in retail portfolio over the medium term. The company is however expected to maintain a prudent capitalization level commensurate with the underlying portfolio mix and comfort is drawn from its flexibility to raise equity funds from capital markets. In this regard, ICRA has taken note of the ongoing transaction, wherein as per the share subscription agreement dated January 31, 2020, ICF shall issue equity shares representing 21.09% of the expanded voting share capital and compulsorily convertible preference shares representing 8.44% of the expanded voting share capital to Brookfield group for a total consideration of Rs. 1,225 crore. Successful consummation of the aforesaid transaction would be imperative to provide the company adequate cushion for absorbing any asset side shocks and shall place the company well for growth over the medium term.

Comfort from experienced management team and high involvement of institutional sponsors - ICF's sponsors have played an active role in the company's decision making since inception. The risk committee which is responsible for managing risk at an overall level is composed of both investor and independent directors, and the credit committee is constituted by nominees of the investors. As a result, the company gains from the involvement of the key institutional sponsors and their longstanding experience in the Indian and global markets. Further, the company has onboarded senior professionals with established expertise and track record in the respective product segments, which augurs well for achieving the envisaged roadmap while maintaining prudent underwriting standards and risk philosophy. ICRA notes that ICF's investor base is likely to strengthen further on successful completion of the ongoing transaction with the Brookfield group.

Credit challenges

Asset quality pressures - ICF's asset quality has come under pressure during past few quarters with Gross Stage 3 and Net Stage 3 at consolidated level increasing to 4.3% and 3.4% respectively in December 2019 from a level of 2.6% and 1.6% respectively in March 2019 (1.6% and 1.0% respectively in March 2018). As a result, the company's solvency metric (Net Stage 3/ Net Worth) has also weakened and stood at 10.8% in December 2019 (6.1% in March 2019 and 2.9% in March 2018). This deterioration in asset quality has been primarily driven by a sizeable slippage in the wholesale loan book, which continues to remain under pressure and timely debt servicing is yet to be tested given that sizeable proportion of portfolio which is under moratorium. Also, ICFs organically originated CV portfolio has witnessed considerable increase in slippages in recent quarters, in line with the broader industry trend amid ongoing challenging operating environment. Moreover, while the gross non-performing loans outstanding in ICF's overall CV financing book (including the acquired loan book) stood lower at Rs. 195 crore as on December 31, 2019 compared to Rs. 223 crore in March 31, 2019, the quantum of non-performing loans for this segment peaked at Rs. 265 crore as on June 30, 2019. Herein, the company has also written off sizeable quantum of CV loans during 9MFY2020. Nevertheless, the company has demonstrated control on asset quality in the SME and housing finance segments, though these loan books remain relatively less seasoned and performance across economic cycles remains to be established. Going forward, ICF's asset quality trajectory shall be a key monitorable because of the concentrated nature of wholesale exposures and the relatively low seasoned SME, housing and CV financing portfolios.

Moderation in borrowing profile with fund raising trajectory suggesting challenges; though, successful onboarding of Brookfield may ease the situation - ICF has over the years established relationships with banks and investors to diversify its lender base. As on September 30, 2019, it had active funding relationships with about 30 banks, six financial institutions and 12 mutual funds. Also, the company had, over the years, progressively moved the finding mix to include balanced mix of borrowings from banks and debt markets. Notwithstanding the aforesaid, ICRA however notes that impact of the ongoing risk averseness towards the NBFC sector on ICF cannot be ruled out given the trajectory of portfolio, borrowings and cost of funds over past few quarters. While ICF regularly mobilised funds from banks and assignment/securitization transactions during 9MFY2020, it raised minimal funds from markets. As a result, the funding mix has shifted in favor of banks. Nevertheless, ICRA observes that the company's dependence upon commercial paper borrowings stands evaporated compared to the level seen in March 2018. This, whether planned or unplanned, is a positive for the ALM profile. Going forward, the company's ability to leverage its established relationships with diversified lender base will remain critical and hence will be a monitorable. A prolonged impact, if any, on its ability to mobilise funds from banks/debt markets/money markets at competitive rates will be a credit negative, though the recent developments are expected to augur well on this front.

Weak profitability indicators - Notwithstanding the increased share of higher yielding CV finance business in the portfolio of ICF, the increased borrowing cost during past one year has constrained an improvement in the lending spreads and net interest margins. Further, the decline in loan book has resulted in an adverse movement in cost structure with increased operating cost. Moreover, weakened asset quality has manifested into a spurt in credit costs for ICF, whereby provisions and write-offs during 9MFY2020 amounted to 3.0% of total assets (annualized) compared to 0.2% in FY2019. As a result, already modest profitability of ICF amid growing scale of operations in new business segments, has weakened as reflected by ROA and ROE of 1.5% and ROE 4.7% in 9MFY2020 compared to 2.5% and 10.1% respectively in FY2019. These profitability pressures are likely to sustain over the near term, given the asset quality challenges and large infrastructure set up by ICF to expand its retail lending footprint. In this regard, the company's ability to scale up the AUM over the medium term by leveraging the existing infrastructure network and partnerships while maintaining prudent underwriting standards and hence good control over incremental slippages will remain key determinant of the profitability trajectory hereon.

Limited track record in retail lending and concentration in wholesale book – While ICF has a track record of eight years in wholesale financing, its experience in the retail lending segment is limited as it started SME lending in FY2016, and CV Financing and Housing Finance in FY2018. Also, while the company's wholesale portfolio has experienced a churn, especially in the real estate segment where the prepayments have been high in the past, the wholesale loan book is characterized by concentration towards few borrower groups and hence asset quality is susceptible to lumpy slippages, despite established credit appraisal and risk management processes in place. ICRA also notes that about 2/3rd of ICF's wholesale loan book is currently under moratorium with majority of the exposure to real estate segment, and hence debt servicing ability is yet to be tested for these accounts especially given the risks arising from ongoing slowdown in the real estate sector. Nevertheless, ICRA notes that ICF targets reputed borrower groups/developers with an established track record of timely debt servicing. Also, all corporate loans have a security cover of over 1.5 times, with real estate loans having a security cover of over 2.5 times. All project cash flows are escrowed and the loan is structured in a manner that enables mandatory prepayments and hence early repayment of loans. The company also sells down some part of the real estate loans originated. The company's ability to prudently calibrate the expansion in the retail segments and thereby further improve granularity of the portfolio, while maintaining underwriting standards and hence asset quality, and profitability will be key monitorable going forward.

Liquidity position: Adequate

ICF has a sound policy of maintaining ~15% of net worth in liquid investments and undrawn bank lines at all times. Further, the company has adopted a conservative approach during the ongoing liquidity squeeze for the NBFC sector, wherein higher on-balance sheet liquidity is being maintained. As of December 31, 2019, the company's ALM profile reflected scheduled debt repayments of Rs. 959 crore over the next six months (Rs. 1,730 crore over the next twelve months), against which, the inflows from loan repayments were estimated at Rs. 1,064 crore (Rs. 2,243 crore over the next twelve months), and the cash & liquid investments held by the company aggregated about Rs. 400 crore (cash & bank balances, and investments in term deposits and mutual funds). Besides, the undrawn bank lines stood at Rs. 471 crore, and the company has ability to securitise loans to manage liquidity. This provides comfort over the liquidity profile of the company, though ICRA notes that liquidity profile of ICF will remain sensitive to the actual pace of repayments. Evolving asset quality profile of the wholesale loan book will hence remain a key monitorable as it accounts for sizeable portion of the principal repayment estimates.

Rating sensitivities

Positive triggers – Not Applicable

Negative triggers – The rating could be downgraded if there is a further increase in the vulnerability of the wholesale loan book or the asset quality deteriorates significantly with solvency metric (Net Stage 3/Tier 1) deteriorating to a level over 20% on a sustained basis. Pressure on the ratings could also emerge if the challenges in funding access continue for a prolonged period and/or liquidity profile weakens. Inability to improve the profitability would also be a credit negative.

Analytical approach

Analytical Approach	Comments
Applicable Rating Methodologies	ICRA's Credit Rating Methodology for Non-Banking Finance Companies ICRA's Credit Rating Methodology for Housing Finance Companies Financial Consolidation and Rating Approach
Parent/Group Support	Not Applicable
Consolidation/Standalone	Consolidation. While arriving at the ratings, ICRA has taken a consolidated view of the credit profiles of Indostar Capital Finance Limited (ICF) and its subsidiary Indostar Home Finance Private Limited (IHFPL), referred to as the Group, owing to the common management, shared infrastructure, as well as the strategic importance of IHFPL to the Group.

About the company

ICF is a systemically important NBFC. It offers long-term wholesale funding to corporates, used and new vehicle financing for transporters, loans to SME borrowers, and home finance through its wholly-owned subsidiary IHFPL. As of December 31, 2019, the assets under ICF's management (at consolidated level) aggregated Rs. 10,222 with 44% share of commercial vehicle (CV) finance book, 25% share of real estate corporate funding segment, 6% share of non-real estate corporate funding, 18% share of SME finance and 8% share of housing finance book.

While ICF commenced lending operations in 2011 with a primary focus on wholesale lending, it ventured into SME finance in FY2015, followed by used and new vehicle financing for transporters and loans to SME borrowers in FY2018. The proportion of CV financing has increased substantially (to 44% in Dec'19 from 9% in Sep'18) post the acquisition of Rs.

3,514-crore CV portfolio (AUM basis) from IIFL in March 2019. With the acquisition of the CV portfolio from IIFL, the branch network of the company increased from 161 branches to 322 branches, before being rationalized to 233 during 9MFY2020.

ICF got listed on stock exchanges in May 2018 and received a fresh equity infusion of Rs. 700 crore. ICF is sponsored by a group of financial institutions including Everstone Capital, Goldman Sachs, CDIB Capital etc. Indostar Capital (ICF Mauritius), a company incorporated in Mauritius, has a majority shareholding in ICF with 57.0% stake as on December 31, 2019. ICF Mauritius is promoted by the sponsors of ICF. As of December 31, 2019, the promoter group's stake in ICF stood at 60.74%.

As per the share subscription agreement dated January 31, 2020, ICF shall issue to Brookfield group equity shares representing 21.09% of the expanded voting share capital and compulsorily convertible preference shares representing 8.44% of the expanded voting share capital for a total consideration of Rs. 1,225 crore. Further, as per the share purchase agreement dated January 31, 2020, Brookfield group shall purchase from ICF Mauritius, aggregate of: (a) five million equity shares (tranche 1) and (b) such additional number of equity shares held by ICF Mauritius (up to a maximum of three million equity shares) which together with the tranche 1 shares, the subscription securities and the securities acquired from public shareholders pursuant to the open offer, amount to 40% of the expanded voting share capital.

In FY2019, the company on a standalone basis reported a net profit of Rs. 255 crore on an asset base of about Rs. 12,254 crore compared to a net profit of Rs. 212 crore on an asset base of Rs. 7,273 crore in FY2018. In 9MFY2020, the company reported a net profit of Rs. 80 crore.

On a consolidated basis, the company reported a net profit of Rs. 241 crore in FY2019 on an asset base of about Rs. 12,277 crore compared to a net profit of Rs. 200 crore on an asset base of Rs. 7,273 crore in FY2018. In 9MFY2020, the company, on a consolidated level, reported a net profit of Rs. 97 crore on an on-book asset base of about Rs. 9,449 crore.

Key financial indicators – Indostar Capital Finance Limited

Amounts in Rs. Crore	Standalone			Consolidated		
	FY2018	FY2019	H1FY2020	FY2018	FY2019	9MFY2020
Accounting Standard	Ind-AS	Ind-AS	Ind-AS	Ind-AS	Ind-AS	Ind-AS
PAT	212	255	80	200	241	97
Adjusted Net Worth*	2,084	2,730	2,810	2,075	2,706	2,795
Assets under Management (AUM)	6,009	11,187	10,010	6,060	11,735	10,222
Return on Average Assets	3.3%	2.6%	1.4%	3.1%	2.5%	1.5%
Return on Average Equity	10.6%	10.6%	5.8%	10.2%	10.1%	4.7%
Gearing (times)	2.4	3.3	2.8	2.4	3.3	2.3
Adjusted Net Worth/ AUM	34.4%	23.3%	28.1%	34.2%	23.1%	27.3%
CRAR*	31.6%	24.0%	25.7%			
Gross Stage 3 (%)	1.6%	2.6%	3.7%	1.6%	2.6%	4.3%
Net Stage 3 (%)	1.0%	1.6%	3.0%	1.0%	1.6%	3.4%
Net Stage 3/ Adjusted Net Worth	2.9%	6.0%	9.7%	2.9%	6.1%	10.8%

*Source: ICF, ICRA research; *Adjusted for Rs. 300 crore Goodwill*

About the subsidiary i.e. Indostar Home Finance Private Limited

Incorporated in January 2016, IHFPL is a housing finance company (HFC) registered with the National Housing Bank (NHB). It is a wholly-owned subsidiary of ICF. IHFPL offers housing loans with a focus on the affordable housing segment, with ticket sizes ranging from Rs. 3 lakh to Rs. 30 lakh. As of September 30, 2019, IHFPL's on-book loan portfolio stood at Rs. 613 crore compared to Rs.528 crore in March 2019 and Rs. 51 crore in March 2018.

In FY2019, the company reported a net loss of Rs. 19 crore on an asset base of about Rs. 566 crore compared to a net loss of Rs. 11 crore on an asset base of Rs. 60 crore in FY2018. In H1FY2020, the company reported a net profit of Rs. 15 crore on an asset base of about Rs. 692 crore.

Key financial indicators – Indostar Home Finance Private Limited

Amounts in Rs. Crore	FY2018	FY2019	H1FY2020
PBT	(11)	(19)	10
PAT	(11)	(19)	15
Net Worth	50	172	186
Loan Book	51	528	613
Return on Average Assets	-29.8%	-6.1%	4.6%
Return on Average Equity	-34.8%	-17.2%	16.3%
Gearing (times)	0.1	2.2	2.6
CRAR	209.6%	58.3%	54.6%
Gross Stage 3 (%)	0.0%	0.1%	0.4%
Net Stage 3 (%)	0.0%	0.1%	0.3%
Net Stage 3/ Net Worth	0.0%	0.3%	1.1%

Source: IHFPL, ICRA research

Status of non-cooperation with previous CRA: Not applicable

Any other information: None

Rating history for last three years

	Instrument	Current Rating (FY2020)				Chronology of Rating History for the Past 3 Years		
		Type	Amount Rated (Rs. Crore)	Amount Outstanding* (Rs. Crore)	Date & Rating	Date & Rating in FY2019	Date & Rating in FY2018	Date & Rating in FY2017
					Mar 16, 2020	Dec 31, 2018	Sep 21, 2017	Aug 01, 2016
1	Commercial Paper	ST	1,250	-	[ICRA]A1+	[ICRA]A1+	[ICRA]A1+	[ICRA]A1+

*Source: ICRA research; Amount in Rs. Crore; * As on December 31, 2019*
Note: LT: Long-term; ST: Short-term

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
NA	Commercial Paper	NA	NA	7-365 Days	1,250	[ICRA]A1+

Source: ICF, ICRA research; Amount in Rs. Crore

Annexure-2: List of entities considered for consolidation

Company Name	Ownership	Consolidation Approach
Indostar Capital Finance Limited	Rated Entity	Rated Entity
Indostar Home Finance Private Limited	Subsidiary	Full Consolidation
Indostar Asset Advisory Private Limited	Subsidiary	Full Consolidation

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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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