

Bank promoted NBFC skewed towards secured book...SUBSCRIBE

Business Overview:

- ⇒ Fedbank Financial Services Ltd. (FedFina) is a retail focused NBFC promoted by The Federal Bank Limited. It is one among 5 private banks promoted NBFCs in India.
- ⇒ FedFina has a well-tailored suite of products targeted to match customers' needs, which includes mortgage loans such as housing loans; small ticket LAP; and medium ticket LAP, unsecured business loans, and gold loans.
- ⇒ The NBFC is focused on catering to the MSMEs and the emerging self-employed individuals ("ESEIs") sector. According to the CRISIL Report, these segments is largely unaddressed by lending institutions in India.
- ⇒ FedFina is headquartered in Mumbai, Maharashtra. It believes that long operating history, track record, management expertise and the "Federal Bank" brand has enabled it to establish a competitive position in the markets and create trust among customers, lenders, regulators and investors.
- ⇒ As of June 30, 2023, FedFina is present in 17 states and UT across India with a strong presence in Southern and Western regions of India. These states contribute more than 75% of India's GDP in FY23. They have 3,732 employees engaged across their 584 branches.
- ⇒ As on March 31, 2023, FedFina has the 3rd fastest AUM growth among NBFCs in the peer set in India with a 3Y CAGR of 33% between FY20-23, and the 4th fastest yoy AUM growth of 42% for Q1FY24. It is the fastest growing gold loan NBFC in India among the peer set as of March 31, 2023 and has the fastest yoy growth among gold loan NBFCs in India as on June 30, 2023.
- ⇒ As on June 30, 2023, 86.2% of total Loan Assets are secured against tangible assets, namely gold or customer's property. Its mortgage loans, gold loans and unsecured business loans had an AUM of Rs. 47bn, Rs. 31.2bn and ₹ 14.9bn in Q1FY24. Gross NPA is 2.26% and Net NPA was 1.76% as on June 30, 2023.
- ⇒ FedFina has the 2nd and 3rd lowest cost of borrowing among the MSMEs, gold loan and MSME & gold loan peer set in India in FY23 and Q1FY24, respectively. It had the 3rd highest growth in disbursement among the peer set with a 3Y CAGR of 35% between FY20-23.
- ⇒ It has been rated "AA" by CARE for NCDs since 2022, and "AA-" by India Ratings and Research for NCDs and bank loans since 2018.

Valuation and Views: At the upper price band on fully diluted basis, Fedbank Financial Services is valued at 2.6x FY23 P/B. The issue is attractively priced vs 3.9x of its peers set average. We have a "Subscribe" rating to the issue on the back of (1) Federal Bank brand; (2) Experienced management team; (3) Focus on Retail credit; (4) diversified book across Mortgage, Gold and Unsecured MSME loans.

Issue Size & Market Cap	
Type of Issue	Rs. Bn
Fresh Issue	6.0
Offer for Sale	4.9
Total Issue Size	10.9
Post-Issue Market cap*	51.7

*At Upper Price Band

Issue Break-Up	
	Shares in Mn
Total Issue*	78.0
Employee Reservation	0.7
Net Offer	77.3
Reservation for	% of Net Offer
QIB	50%
NII (HNI)	15%
Retail	35%

Indicative Offer Timeline	Indicative Date
Bid/Offer Opening Date	22nd Nov 2023
Bid/Offer Closing Date	24th Nov 2023
Listing Date	30th Nov 2023

Use of Net Proceeds
Augmentation of Tier – I capital base to meet future capital requirements

General Information	
BRLMs	ICICI Securities, BNP Paribas, Equirus Capital, JM Financial
Registrar	Link Intime India

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Shareholding Pattern & Selling Shareholders in OFS

Shareholding Pattern

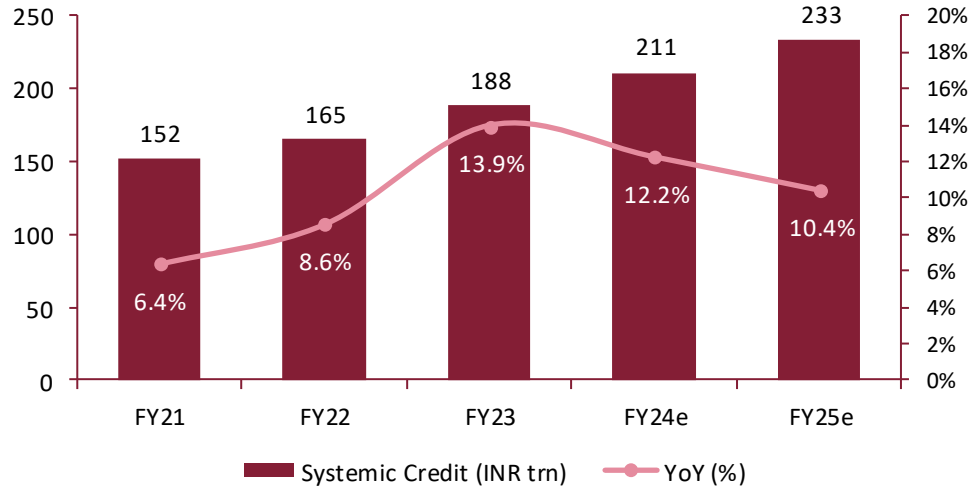
	Pre Issue		Type	Offer # of shares (in Mn)	Post Issue	
	# of shares (in Mn)	%			# of shares (in Mn)	%
Promoter & Promoter Group	235.7	72.3%	OFS	-5.5	230.2	62.4%
Public	90.4	27.7%	New + OFS	48.3	138.7	37.6%
Total	326.1	100.0%			368.9	100.0%

Selling Shareholders	Type	# of Shares (in Mn)	OFS* (in Mn)
The Federal Bank Limited	Promoter	5.5	766
True North Fund VI LLP	Public	29.7	4,156
Total		35.2	4,923

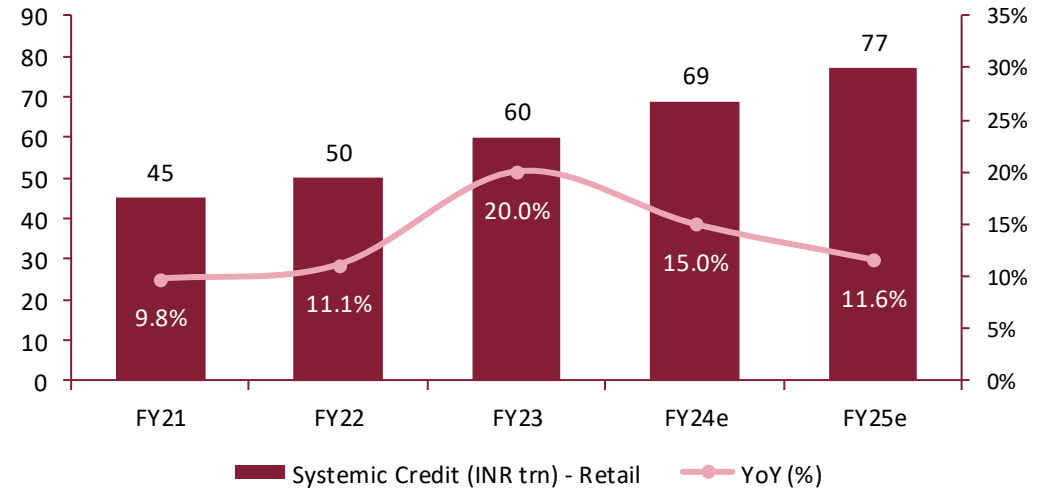
*At Upper Price Band

Industry

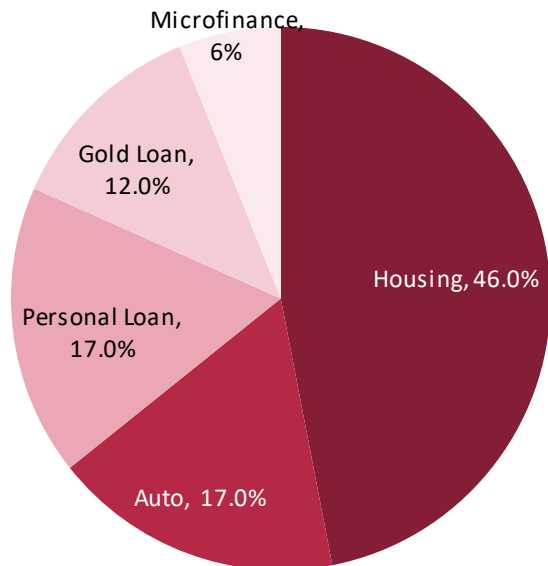
Systemic Credit (INR trn) (10-12% CAGR FY23-25)



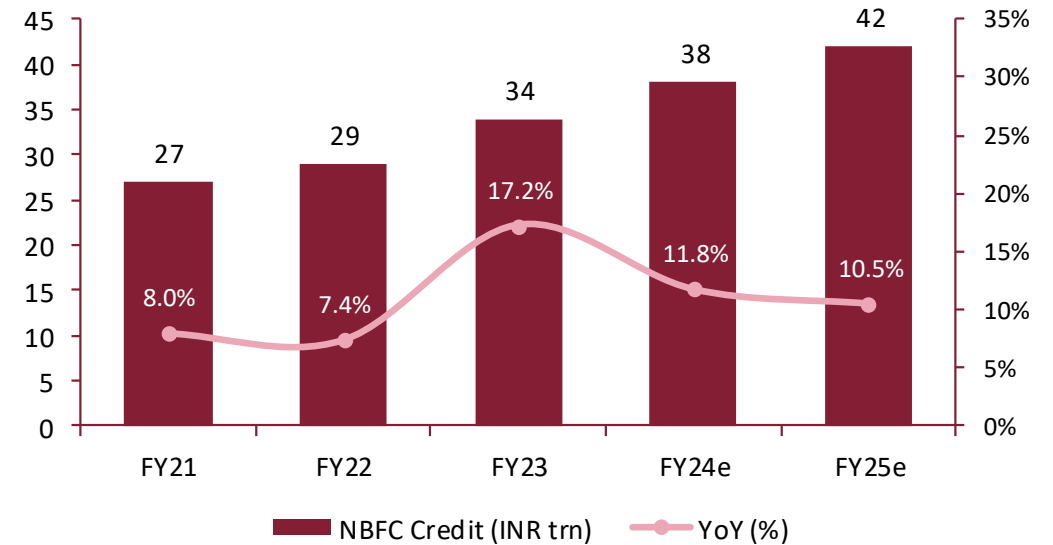
Retail Systemic Credit (INR trn) (13-15% CAGR FY23-25)



FY23 Retail Credit Mix (%)

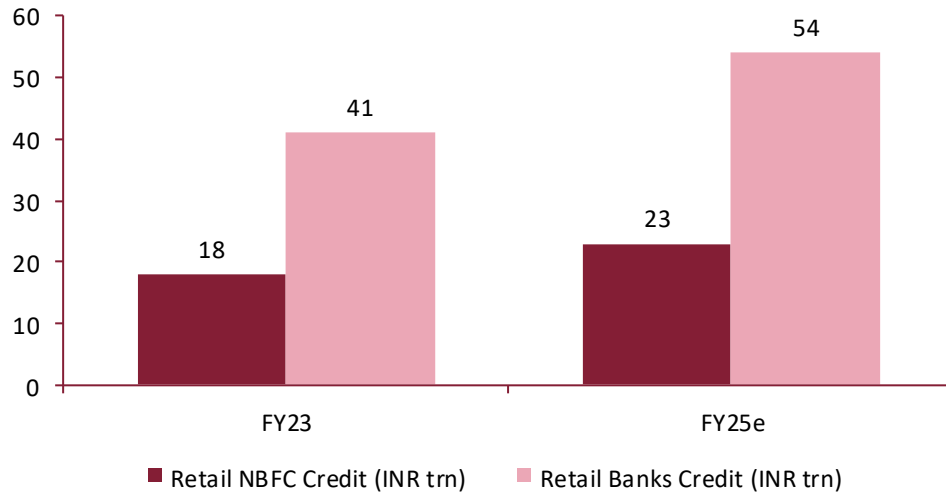


NBFC Credit (INR trn) (12-14% CAGR FY23-25)

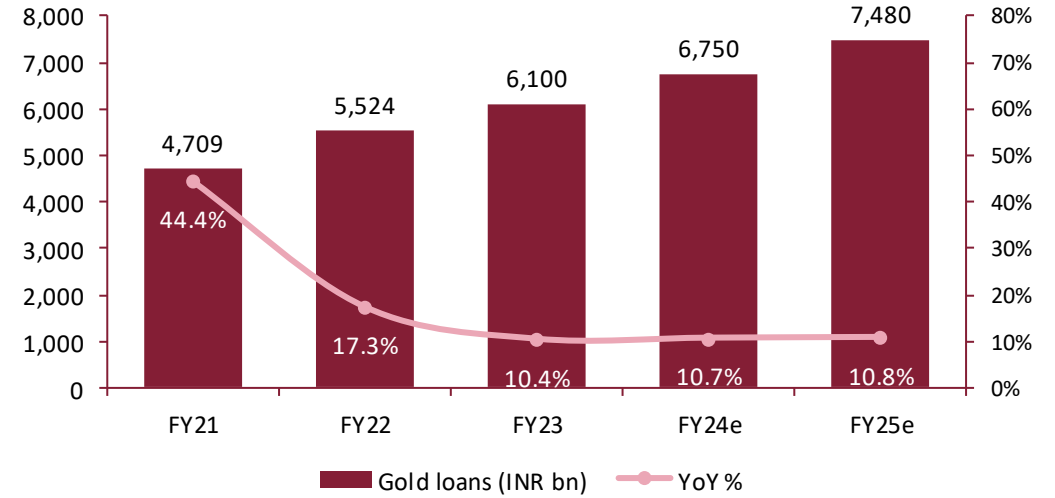


Industry

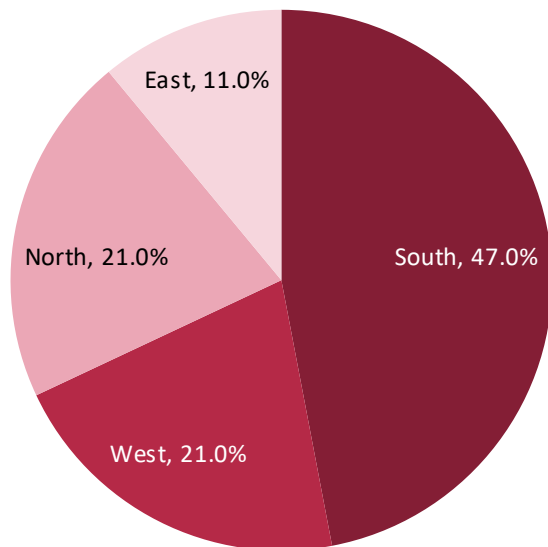
Retail Credit NBFC vs Banks (INR trn)



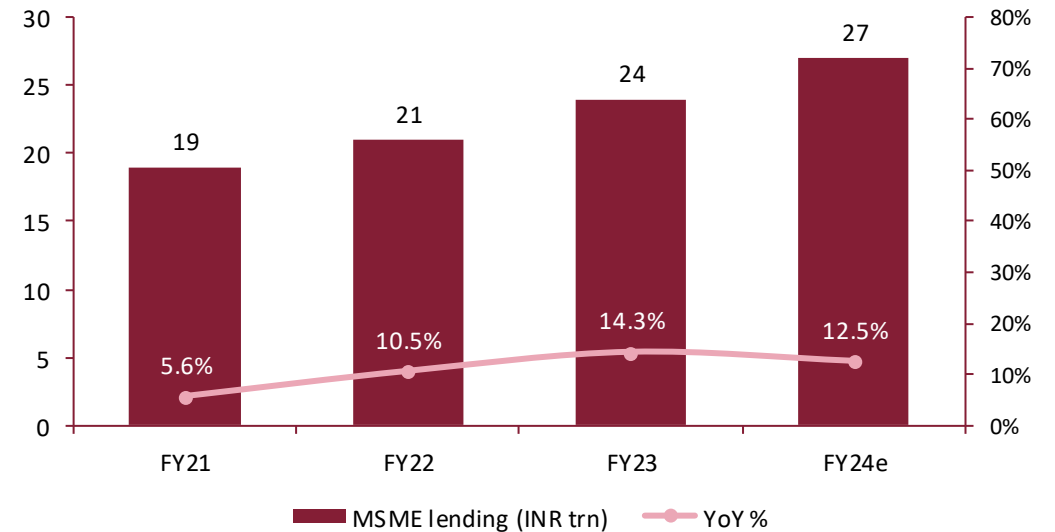
Gold Loans (INR bn) (10-12% CAGR FY23-25)



FY23 Share of Gold Loans NBFC (%)



MSME Lending (INR trn)



Strengths

FedFina is present in large, underpenetrated markets with strong growth potential

- ⇒ The Indian retail credit market grew at a strong pace over the last few years from Rs. 30 trn in FY18 to Rs. 60 trn in FY23, and it constituted 32% of total systemic credit in India. Retail credit is expected to further grow at a CAGR of 14-15% between FY23-25. The credit gap is much larger in case of ESEIs.
- ⇒ The share of organized gold loan financiers has increased from 56-58% in FY17 to ~61-63% in FY23. Further, as of March 2023, the gold pledged with financiers constituted around 7% of the 28,000 tons of gold holdings in Indian households.
- ⇒ Portfolio of MSME loans with ticket size between Rs. 1mn and Rs. 10mn is expected to grow at 14-16% CAGR over FY23-25.
- ⇒ NBFC credit is expected to grow at a higher rate of 13-14% in FY24, as compared to 12-14% expected for banking credit. The credit growth is expected to be driven by the retail vertical, including housing, auto, and microfinance segments.
- ⇒ As on June 30, 2023, AUM across various products was 33.1% for gold loans, 25.3% for medium ticket LAP, 24.5% for small ticket LAP and housing loans and 15.8% for unsecured business loans.
- ⇒ Housing finance and gold loans cover 46% and 12% of the retail loans industry, respectively, in India in FY23.
- ⇒ As on June 30, 2023, top five states in terms of AUM constituted 78% of total AUM, while top three states in terms of AUM contributed towards 53.6% of total AUM.

Focused on retail loan products with a collateralized lending model targeting individuals and the emerging MSME sector

- ⇒ As on June 30, 2023, 86.2% of their total Loan Assets are secured against tangible assets, namely customer's gold or property. Average ticket size was Rs. 0.13mn.
- ⇒ Out of the collateral for medium ticket LAP and small ticket LAP, 77.4% of collateral is self-occupied residential or commercial property as of June 30, 2023.
- ⇒ As on June 30, 2023, average LTV on total Loan Assets with property collateral at the time of sanctioning the loan was 51.4%. The value of collateral property generally appreciates over time. In addition, LTV at the time of sanction further reduces over the term of the loan as the loan is serviced.

Strong underwriting capability and presence in select customer segment combined with robust risk management capabilities focused on effective underwriting and collections

- ⇒ The percentage of retail installment loans which are underwritten is represented by the sanction to login ratio, which was 40.1% and 45.3% in Q1FY24 and FY23, respectively
- ⇒ As on June 30, 2023, FedFina has an independent quality assurance team of 219 employees for mortgage loans, gold loans and unsecured business loans.
- ⇒ As June 30, 2023, 2.22% of employees were in internal audit function and such personnel conduct periodic audits across sales, operations, credit, customer service, branch operations and other support functions.
- ⇒ While FedFina focusses on the underserved category of the Indian retail loan market, it follows prudent customer selection policies with 86.7% of their customers having an established credit history, and 77.9% of credit rated borrowers rated with a CIBIL score greater than 650 or CMR score less than or equal to 6 as on June 30, 2023.

Strengths

Well diversified funding profile with an advantage of lower cost of funds

- ⇒ Average cost of borrowing was 2.2% and 7.7% for Q1FY24 and FY23. It has the ability to access borrowings at a competitive cost due to stable credit history, credit ratings, conservative risk management policies and strong brand equity.
- ⇒ In addition, cost of incremental borrowings, being new loans sanctioned in the relevant period, reduced from 8.36% in FY21 to 7.02% in FY22. It increased to 8.02% in FY23 due to an increase in interest rates. Cost of incremental borrowings during Q1FY24 was 8.57%.
- ⇒ It has historically secured financing from diversified sources of capital from banks, financial institutions, mutual funds and other financial institutions, including term loans, proceeds from loans securitized, proceeds from the issuance of NCDs, proceeds from loans assigned and commercial papers, to meet capital requirements. In addition, it has access to capital from Promoter, Federal Bank.
- ⇒ As of June 30, 2023, outstanding borrowings were Rs. 31.1bn from private sector banks, Rs. 28.3bn from public sector banks, Rs. 2bn from an NBFC, Rs. 1.5bn from a foreign bank, and Rs. 13.2bn from other entities. As of June 30, 2023, total borrowings aggregated to Rs. 76.2bn, comprising primarily of term loans of Rs. 64.5bn, NCDs of Rs. 7.8bn and commercial papers of Rs. 3.9bn.
- ⇒ As of June 30, 2023, Securitized portfolio across leading public sector banks and private sector banks aggregating to Rs. 11.8bn.

Technology driven company with scalable operating model

- ⇒ During FY21 to Q1FY24, FedFina has invested an aggregate amount of Rs. 256mn in information technology and digital systems. Its continuing investment in technology systems enable to improve recoveries and reduce operating expenses, cost of customer acquisition and credit costs over time.
- ⇒ It also enables to expand efficiency through automations and further deepen customer engagement with digital touchpoints and maximize digital delivery. It leverages information technology platforms to drive economies of scale through increase in productivity, reduce turnaround time in processing and reduce transaction costs.

Strategies

Continue to deliver consistent and one of the industry leading return matrices building on past performance

Focus on performance of large branch network and extracting operating leverage

- ⇒ There is a huge demand-supply gap in the MSME loan segment, especially in lower ticket size segments. The MSME loans segment has been growing strongly with a 4Y CAGR of 18% between FY19-23 and the overall MSME portfolio is expected to grow at 12-14% CAGR between FY23-25. As on March 31, 2023, the top 15 states accounted for 92% of the overall MSME loans portfolio, based on the value of the overall MSME loans outstanding.

Continue to invest in technology and digitization initiatives

- ⇒ FedFina has invested Rs. 4.8mn, Rs. 9.8mn, Rs. 82.6mn, Rs. 128.4mn and Rs. 40.1mn in information technology and digital systems, in the three-months periods ended June 30, 2023 and June 30, 2022, and Fiscals 2023, 2022 and 2021, respectively, constituting 0.13%, 0.40%, 0.70%, 1.48% and 0.58% of its revenue from operations during the same periods.
- ⇒ FedFina has implemented automated, digitized technology-enabled services to increase customer offerings. It plans to continue investing in technology and digitization and to ensure information technology systems continue to help with several functions, including loan origination, credit underwriting, risk management, collections, customer service and retention.
- ⇒ This will help improve recoveries and reduce operating expenses, cost of customer acquisition and credit costs over time.

Continue to invest in talent and employee training to achieve industry leading productivity parameters

- ⇒ The business model requires FedFina to hire a large number of sales employees and as on June 30, 2023, it had 2,878 sales employees.

Capitalize on understanding of customer as a foundation for customer retention and customer acquisition

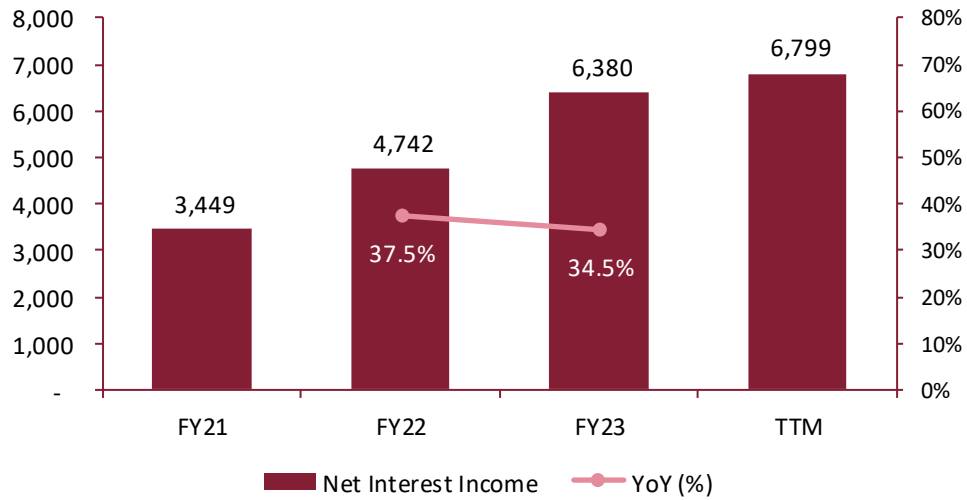
- ⇒ As of FY23, the MSME credit demand is estimated to be around Rs. 117trn, of which 21% of demand was met through formal financing. Historically, there has been a perception of high risk and prohibitive costs for delivering services physically and that has constrained the ability of traditional institutions to provide credit to underserved or unserved MSMEs and self-employed individuals. As a result, such borrowers resort to credit from informal sources.

Key Risks

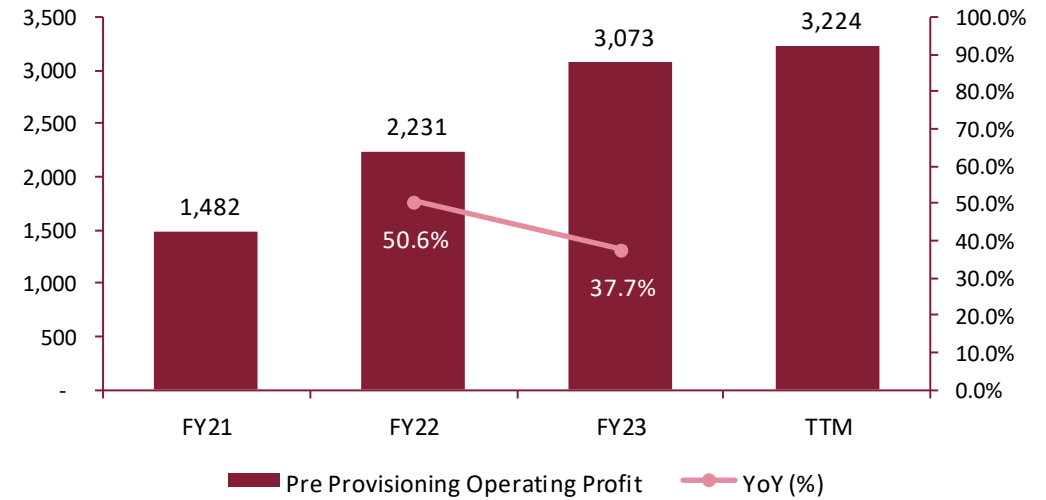
- ⇒ As on June 30, 2023, 93.7% of gross AUM was located in Gujarat, Maharashtra, Telangana, Andhra Pradesh, Tamil Nadu, Karnataka, Puducherry and Delhi. Accordingly, Fedfina operations are concentrated in six states and two union territories and any adverse developments in these regions could have an adverse effect on business and results of operations.
- ⇒ Inability to maintain capital adequacy ratio could adversely affect business, results of operations and financial performance.
- ⇒ Business depends on a well-regarded and widely known brand, as well as the brand and reputation of Promoter, Federal Bank, and the Federal Bank group entities, and any failure to maintain, protect and enhance brand would harm business.
- ⇒ Any deterioration in the performance of any pool of receivables securitized and assigned to banks and other institutions may adversely impact its financial performance.
- ⇒ FedFina has a huge concentration of loans to emerging self-employed individuals (“ESEI”) and micro, small and medium enterprises (“MSME”), and as of June 30, 2023, ESEI and MSME comprise 45.22% and 64.75% of total loan profiles, respectively. The risk of non-payment or default by borrowers may adversely affect business, results of operations and financial condition.
- ⇒ A significant portion of business is derived from gold loan products and the loss of business in relation to such gold loan products could adversely affect business and prospects.

Fedbank Financial Services : Financial story in charts

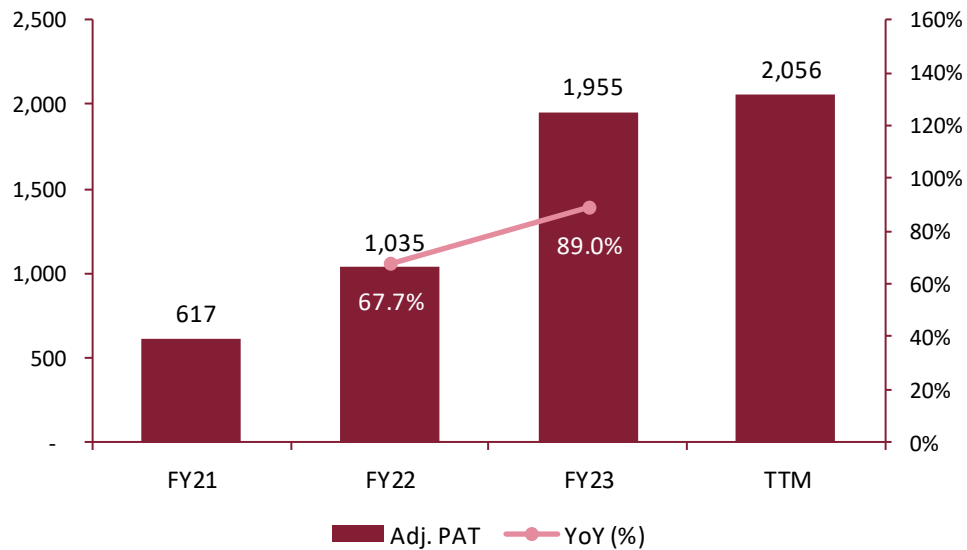
Net Interest Income (Rs. Mn)



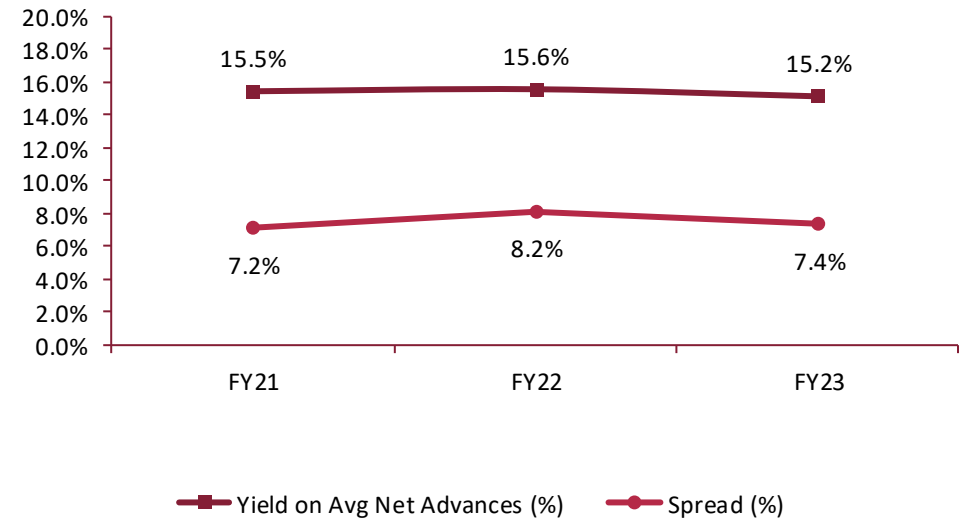
Operating Profit (Rs. Mn)



Adj. PAT (Rs. Mn)

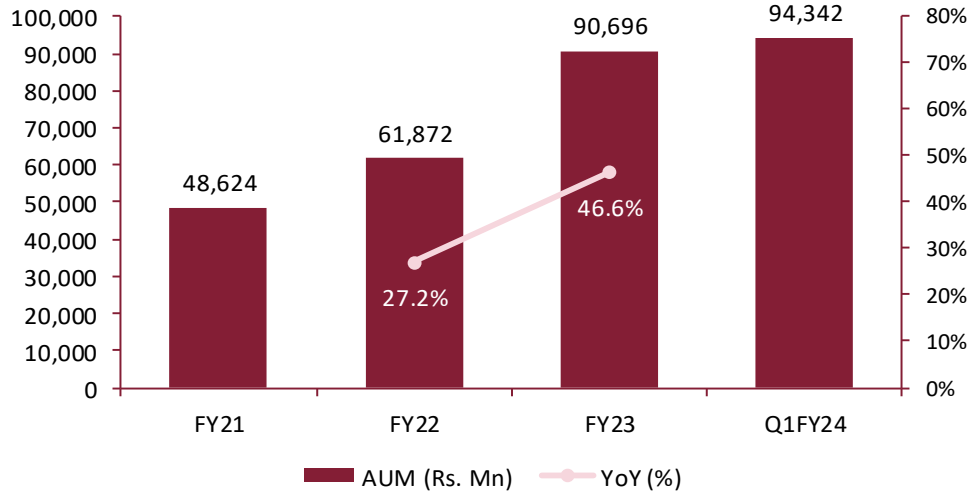


Yield (%) & Spread (%)

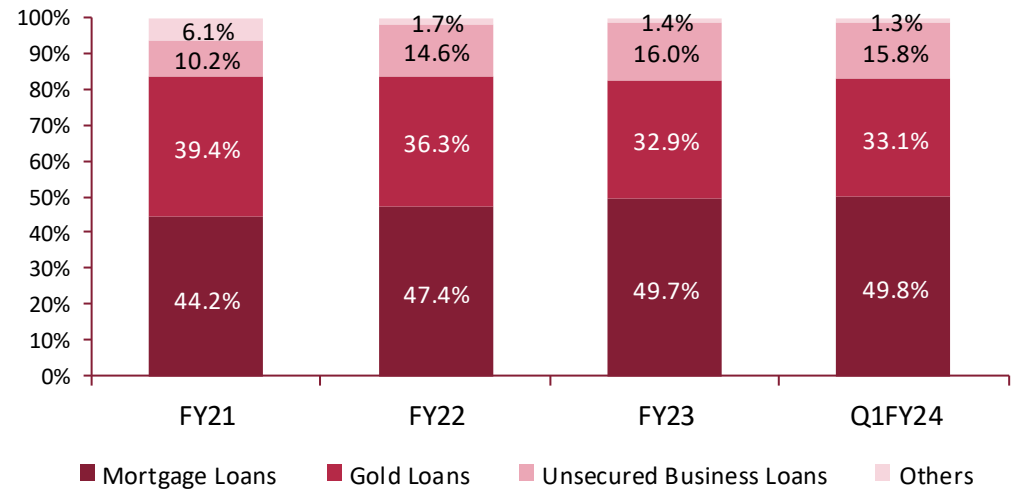


Fedbank Financial Services : Financial story in charts

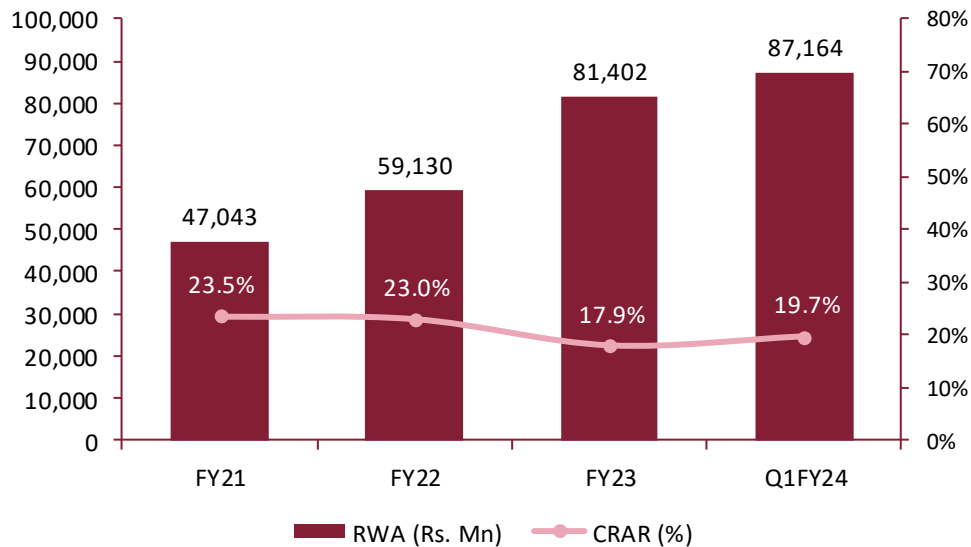
AUM (Rs. Mn)



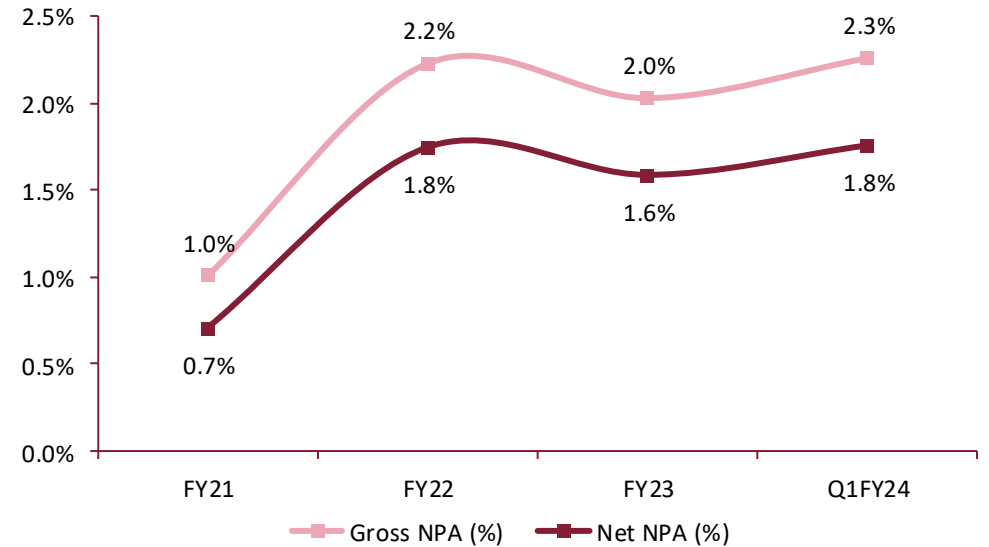
AUM Mix (%)



Risk Weighted Assets (Rs. Mn) & CRAR (%)



Gross NPA (%) & Net NPA (%)



Peer Performance - FY23

FY23 Peer Performance (Rs. Mn)	Fedbank Financial Services Limited	Five Star Business Finance	Aptus Value Housing Finance	Muthoot Finance	Manappuram Finance	IIFL Finance	SBFC Finance
AUM	90,696	69,148	67,380	632,098	354,523	646,380	49,428
YoY AUM growth (%)	46.6%	36.5%	30.1%	8.9%	17.2%	26.2%	54.8%
Shareholders Equity	13,557	43,395	33,393	210,619	89,799	51,149	17,273
CRAR %	17.9%	67.2%	80.8%	31.8%	31.7%	20.4%	31.9%
NII	6,380	12,325	7,825	66,695	32,425	20,125	3,789
PAT	1,955	6,035	5,030	34,735	12,663	8,055	1,498
NIM %	8.2%	20.6%	13.1%	9.3%	11.5%	8.5%	NA
PAT %	16.1%	39.5%	44.6%	32.9%	26.2%	19.7%	20.2%
Yield on Avg Net Advances (%)	15.2%	24.1%	NA	16.4%	19.7%	24.5%	15.9%
Cost of Borrowings (%)	7.8%	6.8%	NA	7.4%	8.1%	8.7%	8.2%
Spread (%)	7.4%	17.3%	9.7%	9.0%	11.7%	15.8%	7.7%
Gross NPA (%)	2.0%	1.4%	1.2%	3.8%	1.3%	1.8%	2.4%
Net NPA (%)	1.6%	0.7%	0.9%	NA	1.1%	1.1%	1.4%
Provision Coverage ratio (%)	22.2%	49.3%	25.0%	NA	NA	NA	42.0%
Net interest Income/Avg. AUM	8.4%	NA	NA	11.0%	9.9%	3.5%	NA
Operating Expenses/Avg. AUM	5.7%	7.3%	2.8%	3.5%	4.8%	2.3%	5.7%
Credit cost/Avg. AUM	0.6%	0.3%	0.6%	0.1%	0.1%	NM	0.8%
PAT/Avg. AUM	2.4%	10.1%	8.4%	5.7%	3.9%	1.4%	3.7%
ROAE (%)	14.4%	15.0%	16.1%	17.6%	15.0%	16.9%	9.9%
RoAA (%)	2.3%	8.0%	7.8%	4.9%	4.5%	3.4%	2.9%
Valuation							
Price	140	802	288	1,337	154	595	90
No. of Shares	369	292	499	401	846	381	1,064
BVPS	53	149	67	525	106	134	16
P/Bx	2.6	5.4	4.3	2.5	1.4	4.4	5.5

INDSEC Rating Distribution

BUY : Expected total return of over 15% within the next 12-18 months.

HOLD : Expected total return between 0% to 15% within the next 12-18 months.

SELL : Expected total return is negative within the next 12-18 months.

NEUTRAL: No investment opinion, stock under review.

Note: Considering the current pandemic situation, the duration for the price target may vary depending on how the macro scenario plays out. Therefore, the duration which has been mentioned as a period of 12-18 months for upside/downside target may be higher for certain companies.

DISCLOSURE

DISCLOSURE

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Since inception company's focus has been on research. In view of its research capabilities ISFL focused mainly on institutional business and is today empaneled with most of the local financial institutions, insurance companies, banks and mutual funds. ISFL has grown from being a medium size broking outfit to become one of the largest capitalized Indian broking company offering the complete range of broking services.

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