Hem Securities
Building your wealth through values

BROKING | INVESTMENT BANKING | RESEARCH | DISTRIBUTION | DEPOSITORY | PMS

Five-Star Business Finance Limited

SUBSCRIBE

IPO Report

07th Nov' 22

Snapshot

Five-Star Business Finance Ltd is an NBFC-ND-SI providing secured business loans to micro-entrepreneurs and self-employed individuals, each of whom are largely excluded by traditional financing institutions. Company is headquartered in Chennai, Tamil Nadu with a strong presence in south India and all of its loans are secured by its borrowers' property, predominantly being SORP.

VALUATION

Company is bringing the issue at price band of Rs 450-474 per share at p/b multiple of 3.84x on FY22 basis.

Company having the fastest Gross Term Loans growth among peers has strong return and growth metrics and a significant potential addressable market. Also, company is among the select institutions to develop an underwriting model that evaluates the cash-flows of small business owners and self-employed individuals in the absence of traditional documentary proofs of income has strong on-ground collections infrastructure leading to its ability to maintain a robust asset quality.Company has access to diversified and cost-effective long-term financing with a conservative approach to asset liability and liquidity management and experienced, cycle-tested leadership with an experienced longstanding promoter, and a professional management team and supported by marquee investors.Hence looking after all above,we recommend "Subscribe" on issue.

Price Band (Rs./Share)	**450-474**
Opening date of the issue	**09th Nov'2022**
Closing Date of the issue	**11th Nov'2022**
No of shares pre issue	291,366,120 Eq Shares
Issue Size	Rs 1960 Cr
Offer For Sale	43,555,666-41,350,317 Eq Shares
Face Value (Rs/ share)	Rs 1/share
Bid Lot	31
BIDDING DETAILS	
QIBs (Including Anchor)	50% of the offer (Approx 20,675,158 Eq Shares)
Non-Institutional	15% of the offer (Approx 6,202,548 Eq Shares)
Retail	35 % of the offer (Approx 14472.611 Eq Shares)
Lead managers	ICICI Securities, Edelweiss Financial, Kotak Mahindra Capital, Nomura Financial
Registrar to the issue	KFin Technologies Ltd.

WHAT WE LIKE

Fastest Gross Term Loans growth among compared peers with more than ₹30,000 million in Gross Term Loans, with strong return and growth metrics and a significant potential addressable market

While company's Gross Term Loans has grown to at a CAGR of 49.73% (between March 31, 2018 and March 31, 2022), company's growth has primarily been volume led with consistent ATS and steady yields. Company had the highest return on Gross term Loans, across the period covering Financial Years 2022, 2021 and 2020 which was 7.5%, 7.1% and 7.8%, respectively. Such returns are due to lending to customers at consistently superior yields and then controlled costs. While company have the best asset quality among lenders engaged in extending MSME business loans, with other lenders reporting 90+ DPD more than 2%. Company also had the lowest credit cost of 0.7% among the compared peers engaged in extending MSME business loans in Financial Year 2021.

Experienced, cycle-tested leadership with a longstanding promoter, professional management team and supported by marquee investors

Company's founder, Promoter, and Chairman and Managing Director, Lakshmipathy Deenadayalan, has been associated with FiveStar for the past 20 years. He has a deep understanding of customer behavior and its business and operations. Company's Shareholders include marquee investors, including affiliates of TPG Capital, Sequoia Capital, Matrix Partners, Norwest Venture Partners, KKR and TVS Capital Funds Limited .

Access to diversified and cost-effective long-term financing with a conservative approach to asset liability and liquidity management

Company is able to access borrowings at a competitive costs due to its stable credit history, strong credit ratings, equity capital position and low leverage, and risk management policies. As of June 30, 2022, company borrowed from 17 private sector banks, seven public sector banks, 13 NBFCs, one mutual fund, and 14 other entities; and its outstanding borrowings were ₹7,300.28 million from private sector banks, ₹5,852.95 million from public sector banks, ₹3,657.00 million from NBFCs, ₹1,501.27 million from mutual funds, and ₹6,891.70 million from other entities, as of the same date.

COMPANY BACKGROUND

Over 95% of company's loan portfolio comprises loans from between ₹0.1 million to ₹1.0 million in principal amount, with an average ticket size ("ATS" and calculated as the average disbursed sum per customer during the period/year) of ₹0.29 million, ₹0.27 million, ₹0.28 million, ₹0.26 million and ₹0.31 million in the three months ended June 30, 2022 and June 30, 2021, and the Financial Years 2022, 2021 and 2020, respectively. During the three months ended June 30, 2022 and June 30, 2021, and the Financial Years 2022, 2021 and 2020, company have provided loans to more than 205,000 customers in total. Company had an active loan base of 230,175 and 217,745 as of June 30, 2022 and March 31, 2022, respectively.

Company target customers:

• in urban and semi-urban locations, as well as in the rural markets of India, where faster growth is expected in bank credit activity as financial awareness increases;

• who typically derive income from "everyday" cash and carry businesses with a focus on services;

• with household net cash-flows of approximately ₹25,000 to ₹40,000 per month;

• who can provide collateral (typically land and building of approximately ₹1.0 million in value; and

• whose family will act as co-applicants on the loan.

Company had an extensive network of 311 branches, as of June 30, 2022, spread across approximately 150 districts, eight states and one union territory, with Tamil Nadu, Andhra Pradesh, Telangana and Karnataka being company's key states. Such key states collectively accounted for approximately 85% of company's branch network by number, as of June 30, 2022. Company started its operations in Chennai, Tamil Nadu and have increased the scale of its operations through growth in number of branches by adopting a calibrated strategy of contiguous expansion across geographies where there is substantial demand for its offering. As of June 30, 2022, approximately 95% of company's branches were located in cities and towns with populations up to one million. Company secure financing from diversified sources of capital, including term loans; proceeds from loans securitized; proceeds from the issuance of NCDs; issuances of principal protected market linked debentures; and proceeds from loans assigned from banks, financial institutions, mutual funds, and other domestic and international development financial institutions, as applicable to meet company's capital requirements.

In addition, company's ESG framework has a strong focus on the social element of its business and company seek to improve financial inclusion and the standard of living of its customers. For instance, company's focus on recruiting locally not only strengthens its networks and improves market intelligence within the semi-urban, urban and rural communities in which company operate, but it also provides viable employment opportunities within such communities. In addition, company's focus on business loans means its products underpin commerce within these communities and likely lead to a better standard of living for its borrowers.

INVESTMENT RATIONALE	
Fastest Gross Term Loans growth among compared peers with more than ₹30,000 million in Gross Term Loans, with strong return and growth metrics and a significant potential addressable market	Company had the highest average return on Gross Term Loans of 7.5% among compared peers with more than ₹30,000 million in Gross Term Loans, across the period covering Financial Years 2022, 2021 and 2020; and for each of those Financial Years, company's return on Gross Term Loans was 7.5%, 7.1% and 7.8%, respectively. Such returns are a result of company's ability to lend to customers at consistently superior yields and then control its costs through initiatives including: • reduction in cost of borrowings • use of technological advancements to drive improvement in productivity and bring down operational costs, • robust collections infrastructure; and • effective risk containment and continuous monitoring leading to low credit costs, low branch costs and efficiency in hiring through local talent pools. Among compared peers, company is among the three best for Stage 3 Gross Term Loans as a percentage of Gross Term Loans (company had a Stage 3 Gross Term Loans to Gross Term Loans of 1.05%) as of March 31, 2022, while company have the best asset quality as engaged in extending MSME business loans, with other lenders reporting 90+ DPD more than 2%. According to CRISIL, company also had the lowest credit cost of 0.7% among the compared peers engaged in extending MSME business loans in Financial Year 2021 (Financial Year 2022: 0.8%; Financial Year 2020: 1.5%), due to asset quality .
Among the select institutions to develop an underwriting model that evaluates the cash-flows of small business owners and self-employed individuals in the absence of traditional documentary proofs of income	Fundamental elements of company's underwriting model, include: • loans are given to the household where all household members whose cash-flows are factored in to evaluate the proposal or those who have a current or potential claim on the property being mortgaged, shall be included as co-applicants to the loan proposal; • deliberately focusing on services oriented businesses with majority of the target market comprising individuals that are typically impacted by macro down-cycles last, while being first to emerge from such cycles; • multiple physical verification touchpoints by company's Business and Collection teams and its Field Credit Teams to assess applicants and collateral; • SORP collateral focus; • all activities carried out as part of company's underwriting process are undertaken by its employees, which ensures staff accountability.
100% in-house sourcing, comprehensive credit assessment and robust risk management and collections framework, leading to good asset quality	Company's 100% in-house sourcing, comprehensive credit assessment and robust risk management and collections framework allows it to identify, monitor and manage risks inherent in its operations. Catering primarily to small business owners and selfemployed customers while maintaining asset quality requires a special skillset in absence of traditional income evidence, such that lending to these borrowers is based on an assessment of their income and cash-flows through various methods. Company's organizational structure is such that almost all of its business and collections team members are also responsible for collections. Company had a 4,381-member business and collections team including 3,424 Business Officers and Collection Officers catering to 230,175 loan accounts, as of June 30, 2022. Company's business and collections team (which includes Business Officers, Branch Managers and Supervisory and Head Office support layers) focusses on early warning signals and company have localized teams to monitor cases that show signs of delinquency.

OBJECTS OF OFFER

The objects of the Offer are to (i) to carry out the Offer for Sale; and (ii) achieve the benefits of listing the Equity Shares on the Stock Exchanges. Company will not receive any proceeds from the Offer and all such proceeds will go to the Selling Shareholders.

RISKS

Company securitize a portion of its receivables to banks and other financial institutions. Such securitization is undertaken by company on the basis of its internal estimates of funding requirements and availability of other sources of funds, and may vary from time to time. During the three months ended June 30, 2022 and 2021 the Financial Year 2022, company did not securitize any assets, and during the Financial Years 2021 and 2020, company securitized assets worth ₹7,857.90 million and ₹3,988.63 million, respectively. As of June 30, 2022, June 30, 2021, March 31, 2022, March 31, 2021, March 31, 2020, company's receivables securitized were ₹3,910.87 million, ₹7,461.13 million, ₹4,840.10 million, ₹8,181.56 million and ₹3,339.60 million, constituting 7.38%, 16.30%, 9.55%, 18.40% and 8.58% of its Gross Term Loans, respectively. Any change in RBI or other regulators in relation to securitizations by NBFCs could have an adverse impact on company's securitization program. In the event the bank or financial institution with whom company have securitized its receivables does not realize the receivables due under loans that have been securitized, the relevant bank or financial institution could enforce the underlying credit enhancements provided by company. Should such banks or financial institutions seek to enforce the underlying credit enhancements, such as fixed deposits, provided up to a specified percentage of the underlying loan, it could have an adverse effect on company's results of operations.

INDUSTRY OVERVIEW

MSME sector in India
Growth drivers
High credit gap in the target customer segment: Less than 15% of approximately 70 million odd MSMEs have access to formal credit in any manner as of March 2022. High risk perception and the prohibitive cost of delivering services physically have constrained traditional institutions' ability to provide credit to underserved or unserved MSMEs and self-employed individuals historically. As a result, they resort to credit from informal sources. This untapped market offers huge growth potential for financial institutions. As stated earlier, the credit gap was estimated at around ₹ 58.4 trillion as of 2017 (Source: IFC report named Financing India's MSMEs released in November 2018), and is estimated to have widened further to around ₹85 trillion as of fiscal 2022.
Increased data availability and transparency:With increased digital initiatives by the MSMEs, the shift towards their formalisation and digitisation has created a plethora of data points for lenders that would help improve the efficacy of credit assessment and gradually enable provision of credit to hitherto underserved customer segments. For example, the quantum of retail digital payments has catapulted from ₹ 140 trillion in fiscal 2017 to ₹457 trillion in fiscal 2022. Within UPI, the quantum of person-to-merchant payments has zoomed from ₹6.2 trillion in fiscal 2021 to ₹15.9 trillion in fiscal 2022. This increase has created a digital footprint of customers, which can be potentially used for credit decision making, along with other relevant parameters such as customer demographics, business details, credit score, and personal situation of the borrower.
Growth in branch network of players in small business loans segment : Over past few years, players offering small business loans segment have expanded their branch network with the intent to serve a larger customer base. To illustrate, the cumulative branch network of five small business lenders (Five Star, Shriram City Union, Vistaar, Veritas and Aye) has expanded at an 8% CAGR between fiscal 2018 and 2022, even while the NBFC universe and the economy were impacted by the IL&FS crisis, a slowdown in growth. In fiscal 2020 and the Covid-19 pandemic. Five Star Business Finance witnessed a CAGR of 23% over the same period; it had 300 branches as of March 2022. In the future also, it is expected lenders with a strong focus on MSME lending and healthy competitive positioning to continue to invest in branch expansion. With increasing branch network, customer acquisition and credit penetration of small business loans will also increase.
Reduction in risk premiums due to information asymmetry : In the absence of reliable information about small businesses, it becomes difficult for lenders to assess the creditworthiness of the borrower. Hence, lenders often charge a credit risk premium from these customers, leading to higher interest rates. By leveraging technology and using a combination of traditional data (bureau data, financial statements, credit score), nontraditional data (payments, telecom, provident fund contribution and psychometric data), and government data (Aadhaar, GST), lenders would be able to gain greater insight into their customers' data, thereby increasing the accuracy of customer assessments. This would reduce the level of asymmetry in information and could lower the credit risk premium over a period.
Increasing competition with entry of new players and partnerships between them More players in consumer-facing businesses with a repository of data (such as e-commerce companies and payment service providers) are expected to enter the lending business, intensifying competition. For example, In June 2018, Amazon India launched a platform for lenders and sellers, wherein sellers can choose loan offers from various lenders at competitive rates. In August 2021, Meta (earlier known as Facebook) partnered with Indifi Technologies to provide loans to small businesses that advertise on its platform. Incumbent traditional lenders will increasingly leverage the network of their partners and/or digital ecosystem to cross-sell products to existing customers, tap customers of other lenders, and also cater to new-to-credit customers. This will expand the market for MSME loans.
Reduction in TAT and increased use of technology With the availability of multiple data points and technological advancement, TAT for lending to MSMEs has been continuously declining. This too will drive the demand for MSME loan

Financials (Mn)	Q1FY23	FY22	FY21	FY20
Total Income	3390.59	12561.69	10512.55	7873.20
Total Expenses	1533.09	6064.42	5381.38	3887.04
Pre Provision Profit	1857.50	6497.27	5131.17	3986.16
Provisions	-4.11	455.18	366.77	493.42
PBT	1861.61	6042.09	4764.40	3492.74
Tax	467.28	1506.64	1174.46	873.50
PAT	1394.33	4535.45	3589.94	2619.24
Eq Cap	291.37	291.34	256.45	255.82
Net Worth	38,569.75	37,103.51	23,181.72	19,445.80
EPS	4.79	15.57	14.00	10.24
Book Value	132.37	127.35	90.39	76.01
NIM %	19.17	17.68	16.00	16.69
Cost To Income ratio	32.25	36.91	34.30	38.97
CRAR %	69.93	75.20	58.86	52.94
ROE%	14.79	13.86	16.85	15.35
ROA%	8.63	7.16	6.99	7.31
Avg Yield on Gross Term Loan	24.15	24.05	24.178	24.18

(Source: RHP)

Peer Comparison

FY22	ROA%	ROE%	NIM %	Yield on Advances %	GNPA%	NNPA%
AU Small Finance bank	1.9	16.4	5.4	12.1	2.0	0.5
Shriram City Union Finance	2.9	12.7	9.9	20.5	6.3	3.3
Aaavas Financiers	3.6	13.7	6.5	12.8	1.0	0.8
Home First Finance	3.9	12.6	6.2	12.5	2.3	1.8
Aptus Value Hosuing	7.3	15.1	11.4	17.2	1.2	0.9
Five Star Finance	***7.5***	***15.0***	***14.9***	***24.7***	***1.1***	***0.7***

(Source: RHP)

DISCLAIMER

HEM Securities Limited ("Research Entity or HSL") is regulated by the Securities and Exchange Board of India ("SEBI") and is licensed to carry on the business of broking, depository services, merchant banking services, Portfolio Management Services and other related activities. Broking services offered by HEM Securities Limited are under SEBI Registration No.: INZ000168034.

This Report has been prepared by HEM Securities Limited in the capacity of a Research Analyst having SEBI Registration No. INH100002250 and distributed as per SEBI (Research Analysts) Regulations 2014. This report does not constitute an offer or solicitation for the purchase or sale of any financial instrument or as an official confirmation of any transaction. The information contained herein is from publicly available data or other sources believed to be reliable. This report is provided for assistance only and is not intended to be and must not alone be taken as the basis for an investment decision. The user assumes the entire risk of any use made of this information. Each recipient of this report should make such investigation as it deems necessary to arrive at an independent evaluation of an investment in the securities of companies referred to in this document (including the merits and risks involved), and should consult his own advisors to determine the merits and risks of such investment. This should not be construed as invitation or solicitation to do business with HSL. The investment discussed or views expressed may not be suitable for all investors.

This information is strictly confidential and is being furnished to you solely for your information. This information should not be reproduced or redistributed or passed on directly or indirectly in any form to any other person or published, copied, in whole or in part, for any purpose. This report is not directed or intended for distribution to, or use by, any person or entity who is a citizen or resident of or located in any locality, state, country or other jurisdiction, where such distribution, publication, availability or use would be contrary to law, regulation or which would subject HSL and associates / group companies to any registration or licensing requirements within such jurisdiction. The distribution of this report in certain jurisdictions may be restricted by law, and persons in whose possession this report comes, should observe, any such restrictions. The information given in this report is as of the date of this report and there can be no assurance that future results or events will be consistent with this information. This information is subject to change without any prior notice. HSL reserves the right to make modifications and alterations to this statement as may be required from time to time. HSL or any of its associates / group companies shall not be in any way responsible for any loss or damage that may arise to any person from any inadvertent error in the information contained in this report. HSL is committed to providing independent and transparent recommendation to its clients. Neither HSL nor any of its associates, group companies, directors, employees, agents or representatives shall be liable for any damages whether direct, indirect, special or consequential including loss of revenue or lost profits that may arise from or in connection with the use of the information. Our proprietary trading and investment businesses may make investment decisions that are inconsistent with the recommendations expressed herein. Past performance is not necessarily a guide to future performance .The disclosures of interest statements incorporated in this report are provided solely to enhance the transparency and should not be treated as endorsement of the views expressed in the report.

We offer our research services to clients as well as our prospects. Though this report is disseminated to all the customers simultaneously, not all customers may receive this report at the same time. We will not treat recipients as customers by virtue of their receiving this report.

HSL and its associates, officer, directors, and employees, research analyst (including relatives) worldwide may: (a) from time to time, have long or short positions in, and buy or sell the securities thereof, of company(ies), mentioned herein or (b) be engaged in any other transaction involving such securities and earn brokerage or other compensation or act as a market maker in the financial instruments of the subject company/company(ies) discussed herein or act as advisor or lender/borrower to such company(ies) or have other potential/material conflict of interest with respect to any recommendation and related information and opinions at the time of publication of research report or at the time of public appearance.

Investments in securities market are subject to market risks, read all the related documents carefully before investing.