

India Ratings Assigns Spandana Sphoorty Financial's NCDs 'IND A'/Stable

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India Ratings and Research (Ind-Ra) has rated Spandana Sphoorty Financial Limited's (Spandana) debt instruments as follows:

Instrument Type	ISIN	Date of Issuance	Coupon Rate (%)	Maturity Date	Size of Issue (billion)	Rating/Outlook	Rating Action
Non-convertible debentures (NCDs)*	-	-	-	-	INR1.5	IND A/Stable	Assigned
Market-linked debentures*	-	-	-	-	INR0.75	IND A/Stable	Assigned

*Yet to be issued

KEY RATING DRIVERS

Comfortable Capital Buffers and Leverage levels: Spandana's capital buffers substantially improved in 2HFY20 and 1QFY21, supported by INR3.76 billion raised from the net proceeds of its initial public offer listing in August 2019 and higher internal accruals, respectively raising its total equity to INR26,406.2 billion at the end of 1QFY21. Its tier I capital adequacy ratio and leverage (debt-equity ratio) was 52.97% and 1.18x, respectively, at end-June 2020 (FYE20: 47.3% and 1.16x, FYE19: 38.6% and 1.75x). Ind-Ra estimates the leverage of the company to remain modest in the short to medium term even in the event of elevated credit cost under stress test, providing enough cushion to absorb the shock. Even in steady-state operations, the agency expects the company to build leverage gradually while keeping it below 4.0x.

Liquidity Indicator - Adequate: Spandana's short-term liquidity (up to one year) is adequate, with an asset funding surplus (short-term assets less short-term liabilities as a percentage of total inflows) at 24.0% at end-September 2020. As of September 2020, Spandana had cash and cash equivalents totalling INR4.48 billion and unutilised bank lines of around INR4.50 billion that could cover two months of repayment assuming nil inflows. Spandana also maintains an assignment pipeline with banks, which could be considered to be a significant source of liquidity, given that the banks provide them a sanction letter accordingly. As at end-September 2020, around 40% of its funding is through pass through certificates and direct assignment transactions; Although the company did not do any transactions in 1HFY21 owing to negligible demand from lenders, it is likely to pick-up in 2HFY21.

The company was able to avail moratorium from 18 of its lenders in March 2020 and May 2020 for the debt outstanding of around INR0.76 billion. It has repaid all its dues subsequently in April 2020 and June 2020. At end-September 2020, 53% of its funding is through term loans from financial institutions and around 40% was through pass through certificates and direct transactions and only 7% was through NCDs and sub-debt. Hence, Spandana's expectation for high AUM growth in FY21 and FY22 would require it to deepen its relationships with its existing lenders and diversify its funding profile. Ind-Ra would expect the company to maintain adequate on-balance sheet liquidity to tide over any short-term disruptions in funding.

Adequate Profitability Metrics: Spandana's profitability metrics have been healthy over the past three years, supported by its tight control on the operating expenses and high yields on advances. The return on assets stood at 6.6% and 6.1% in FYE19 and FYE20, respectively, supported by the low leverage. It was 3.5% (annualised) in 1QFY21; this decline was primarily due to a higher provisioning because of the pandemic. The company had made additional cumulative provisions, amounting to about 4.9% of the on-balance sheet portfolio in 4QFY20 (INR1.29 billion) and 1QFY21 (INR0.89 billion), in view of the pandemic. The operating expenses as a proportion of assets and credit costs as a proportion of net advances, were 4.1% and 9.2% in 1QFY21 and 4.4% and 5.8% in FY20 (FY19: 3.8% and 1.1%). The credit costs were high in FY20 on account of the additional provisions made due to pandemic and also due to the write-offs of INR1.25 billion related to the new portfolio (ex-old AP portfolio). As on 31 March 2020, the old AP portfolio outstanding is nil.

The company's loan yields have reduced recently. Spandana's yield on incremental microfinance loans was 21.0% as against 24.0% in 3QFY20, this is in line with peers' and the regulatory guidelines to maintain spread of 10.0% between yields and funding costs. The company has shifted from weekly and fortnightly to fortnightly and monthly collection mode of repayment from its borrowers. While this may deliver operational efficiencies, Ind-Ra expects that higher collection frequency to be more in sync with borrowers' cash flows; this could result in a modest uptick in delinquencies. Spandana reports an average pre-provisioning operating profits of around 15.0% (annualised), which as per Ind-Ra's stress test is adequate to cover the high credit costs spread over FY21 and FY22. However, the near-term profitability could be impacted by the pandemic provisions, decline in incremental yields and modestly higher steady state credit costs as bulk of the AUM seasons and the collection efficiency declines.

Delinquencies Likely to Rise as Pandemic-related Challenges Manifest: Spandana's monthly collection efficiency (excluding overdues and prepayments) have

been around 98.5% between October 2019 and February 2020. The nationwide lockdown and COVID-19 moratorium for borrowers between April and August 2020 led to a drastic drop in monthly collection efficiency on AUM to 2.9% in April 2020 from 80.2% in March 2020 and 98.7% in February 2020. However, with relaxations in lockdown and Spandana's collection efforts, the monthly collection efficiency (including overdues and excluding prepayments and foreclosures) on AUM improved to 77.8% in August 2020. At end-August, 2020, about 10% of the company's total borrower base was under complete moratorium since April 2020. The management confirms the collection efficiency further improving to around 101.8% in September 2020. A further improvement in the collections and keeping the credit cost under control would be crucial in view of the additional provisions created for the pandemic.

Spandana is exposed to idiosyncratic and systemic risks, which are inherent in unsecured MFI lending. As at end December 2019, 90 days past due on AUM was at 0.4% compared to 0.1% at end-March 2019. The modest deterioration in asset quality was primarily on account of a political unrest in certain districts of Karnataka and floods in Kerala in 1HFY20. Spandana's AUM have experienced several events including AP crisis, demonetisation, floods and cyclones and socio-political issues which primarily led to eminent asset quality issues after one to two quarters of the event. While Ind-Ra expects a modest uptick in delinquencies with seasoning and change in collection frequencies, the asset quality would remain a key monitorable.

Vulnerable to Key Person Risk; Stability in Second Line of Management Imminent: Spandana was established in 2003 by Padmaja Reddy, who is the promoter and managing director (MD) holding 15.99% stake in the company on 30 September 2020 and has nearly two decades of experience in the microfinance industry. Although the company is guided and supervised by the nine-member board of directors, the day-to-day management of operations and funding are dependent on the MD, exposing it to the key person risk. Also, the company has witnessed some churn in the senior management team with chief financial officer, chief risk officer and company secretary resigning almost simultaneously in FY19 and FY20. Hence, though the company has benefitted with the involvement of an experienced MD, it needs to build a stable and experienced senior management team in the medium term. Development of this leadership is a key rating driver for Spandana.

RATING SENSITIVITIES

Positive: Development of a strong second line of management, maintain strong operating metrics while operating at adequate capital and liquidity buffers and asset quality profile even while scaling the AUM profile could lead to a positive rating action.

Negative: Signs of significant deterioration in Spandana's profitability and capital impairment, arising from an increase in non-performing loans that significantly impact asset quality or leverage (above 4.0x), or deterioration in the liquidity position could lead to a negative rating action.

COMPANY PROFILE

Spandana was incorporated in 2003 as a non-banking financial company after it took over the microfinance operations of a non-governmental organisation started by Ms. Padmaja Reddy in 1998. The company was classified as a non-banking financial company – microfinance institution in 2015. On 30 June 2020, Spandana had operations in 18 states/union territories spanning 281 districts with AUM outstanding of INR 66.75 billion. The active member base and number of credit assistants stood at 2.51 million and 5,883, respectively, on 30 June 2020.

FINANCIAL SUMMARY

Particulars	FY20	FY19
Total assets (INR million)	60,988	50,836
Total equity (INR million)	25,999	16,843
Net income (INR million)	3,367	3,087
Return on average assets (%)	6.0	6.6
Equity/assets (%)	42.6	33.1
Capital adequacy ratio (%)	47.4	39.6
Source: Company annual report, Ind-Ra		

COMPLEXITY LEVEL OF INSTRUMENTS

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Applicable Criteria

[Financial Institutions Rating Criteria](#)
[Non-Bank Finance Companies Criteria](#)

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