India Ratings Places IIFL Finance's NCDs and Perpetual Debt on Rating Watch with Negative Implications

Mar 13, 2024 | Financial Institution

India Ratings and Research (Ind-Ra) has placed IIFL Finance Limited's (IIFL) debt instrument ratings on Rating Watch with Negative Implications as follows:

Details of Instruments

Instrument Type	Date of Issuance	Coupon Rate	Maturity Date	Size of Issue (million)	Rating assigned along with Outlook/ Watch	Rating Action
Non-convertible debentures (NCDs)*	-	-	-	INR2,500	IND AA/Rating Watch with Negative Implications	Placed on Rating Watch with Negative Implications
Perpetual debt (Tier 1 instrument)*#	-	-	-	INR3,000	IND AA-/ Rating Watch with Negative Implications	Placed on Rating Watch with Negative Implications

*Yet to be issued

#Perpetual debt instruments are subject to coupon deferring if capital levels fall below the regulatory minimum, or if the servicing of coupon leads to capital levels falling below the regulatory minimum, or if the servicing of coupon leads to a loss after tax or an increase in loss after tax, and requires prior approval from the regulator, even if the capital levels then are above the regulatory minimum.

Analytical Approach

Ind-Ra has taken a consolidated view of the business and financial risk profiles of IIFL Finance and its subsidiaries - IIFL Home Finance Ltd (79.59% stake; debt rated 'IND AA'/Rating Watch with Negative Implications) and IIFL Samasta Finance Ltd (99.51%; debt rated 'IND AA'/Rating Watch with Negative Implications), collectively referred to as the IIFL Finance group, while arriving at the ratings. This is because of the significant operational, financial and managerial integration among the entities. Also, all the entities operate under a common brand. The rating reflect the sizeable franchisee of the group in segments such as affordable housing finance, gold loans and microfinance loans. It also factors in the distribution network and geographically widespread presence of the group. Furthermore, the entity is adequately capitalised due to healthy internal accruals and infusion of equity capital in the housing finance business.

Detailed Rationale of the Rating Action

The Rating Watch with Negative Implications reflects the recent regulatory developments, wherein the Reserve Bank of India (RBI) has imposed restrictions on IIFL from sanctioning/disbursing or assigning/securitising gold loans due to material supervisory concerns. The RBI's main concerns were related to deviations in certifying the purity and net weight of the gold at the time of sanction of loans and at the time of auction upon default; breaches in the loan-to-value ratio; cash collection and disbursements over the statutory limit; and non-compliance with the standard auction process. Ind-Ra would monitor the developments on this front and will resolve the Rating Watch with Negative Implications post the resolution of concerns raised by the RBI and normalisation of operations.

List of Key Rating Drivers

Strengths

- Significant player in major segments, but regulatory issue would impact franchisee growth
- Adequate capitalisation
- Granularisation of loan book with reasonable mix of high-yielding and safer asset classes

Weakness

- Profitability under pressure due to regulatory overhang
- Evolving funding profile

Detailed Description of Key Rating Drivers

Significant Player in Major Segments, but Regulatory Issue Would Impact Franchisee Growth: IIFL Finance's consolidated asset under management (AUM) stood at INR774 billion at end-3QFY24 (FY23: INR646.4 billion), growing at a CAGR of 18.27% over FY19-3QFY24. This was largely driven by retail orientation of the book which has increased to 95.6% of AUM (FY19: 83.6%) and increasing geographical presence to 4,679 branches (FY19: 1,977 branches). Gold (31.9% of AUM) and microfinance (MFI, 15.6%) loans primarily led with 35.3% and 43.9% CAGRs during FY19-3QFY24; however, home loans (33% of AUM) grew at a CAGR of 16.2% during the period. Due to the restriction on incremental disbursement of gold loans, Ind-Ra expects a rundown of the gold portfolio, which is a shorter tenure book. Although the other segments would continue their normal operations, there would be an impact on overall AUM growth.

IIFL Finance has created a sizeable presence in segments with MFI and gold finance, being among the top two players in these segments. IIFL Home Finance is the largest player in the affordable housing segment with AUM of INR255 billion (at end-3QFY24) in an industry with AUM of INR920 billion-950 billion. Also, it has created substantial physical infrastructure, comprising 2,721 branches for the gold loan business, 1,572 branches for MFI loans and 386 network points for the housing finance business. IIFL has also created a presence in the unsecured business and personal loan segment through the digital mode. IIFL intends to reduce wholesale exposure (3QFY24: 3.7%; FY19: 14.5%) further in the medium term.

Adequate Capitalisation: IIFL Finance's consolidated capitalisation remained adequate with a tangible net worth of INR117.8 billion as of 3QFY24 (FY23: INR102.0 billion; FY22: INR64.7 billion). The improvement in networth was complemented by an improving return on assets profile (9MFY24: around 3.8%; FY20: around 1.5%), augmented by a capital raise of INR22.0 billion in IIFL Home Finance in FY23 and earlier capital infusions by Fairfax and Capital group. The gross leverage improved to 3.65x at end-December 2023 (FY21: 6x). The group's capitalisation is further supported by the increasing share of the off-balance sheet portfolio of 39% at end-3QFY24 (FY21: 24.8%). This leads to optimum utilisation of capital and better return ratios. Given the regulatory overhang and continuous payment/collections from gold loan customers, there would be higher liquidity in the medium term, which would ultimately lead to a reduction in leverage for the group.

On a standalone basis, IIFL Finance 's capitalisation remains adequate with a tier 1 ratio of 12.54% at end-3QFY24 (FY23: 12.85%, FY22: 16.02%) with gross leverage (debt/equity) at 3.3x (3.4x, 3.7x). IIFL Home Finance had a tier 1 ratio of 40.08% at end-3QFY24 (FY23: 39.2%, FY22: 21.1%) with gross leverage at 2.6x (2.7x, 5.3x). Furthermore, IIFL Samasta Finance had a tier 1 ratio of 18.46% at end-3QFY24 (FY23: 13.5%, FY22: 15.9%) with gross leverage at 4.6x (5.5x, 5.3x).

Recently, the RBI has increased risk weights for unsecured consumer loans (including credit card receivables), by 25% to 125% from 100% earlier. It has also increased risk weights for bank exposure to non-bank finance companies (NBFCs) by 25% (over and above the risk weight associated with the given external rating) in all cases where the extant risk weight as per external rating of NBFCs is below 100% along with detailed guidelines for exclusion of loan segments. The above regulation impacts 4% of IIFL Finance's total loan book and 15% of its total borrowings, reducing its consolidated tier-1 ratio by 40bp. The impact on cost of borrowings remains a monitorable.

Granularisation of Loan Book with Reasonable Mix of High-yielding and Safer Asset Classes: Retail orientation of the loan portfolio started in FY19, when IIFL Finance sold its commercial vehicle business and started scaling down wholesale and volatile verticals namely real estate and capital market financing. It has high-yielding segments such as gold, MFI and digital loans and also has presence in safer asset classes such as mortgage. Even the gold loan business, while offering high yields, has minimal through-the-cycle credit cost. IIFL has delivered 16.7% AUM CAGR between FY19 and FY23, driven by its retail portfolio (20.5% CAGR). Consequently, its retail book's share in the total AUM increased to 95.1% at end-March 2023 (FY19: 83.6%). Gold and MFI loans primarily led with 35.3% and 43.9% CAGRs, respectively, during FY19-FY23.

Within its retail portfolio, gold and MFI loans remained key growth drivers, contributing 47.5% to the total AUM as on 31 December 2023 and fetching 19% and 24.4% yield, respectively. IIFL Finance has also grown its mortgage business (42.6% of AUM) which has modest credit cost. Over the medium term, IIFL Finance plans to reduce its real estate exposure to make the loan book more granular. Under the commercial real estate exposure, the group finances the completion of projects already funded by it and looks at small-ticket construction finance through IIFL Home Finance. The capital market portfolio comprises loans against shares towards known customers of IIFL Securities.

Profitability Under Pressure due to Regulatory Overhang: Gold loans constitute a significant proportion of the AUM, and it was a high yielding (around 19% yield) book; therefore, restrictions on making incremental disbursements would have an impact on the group's profitability. However, IIFL reported comfortable return on assets of 3.3% in FY23. The earnings were supported by an increase in assignment income, which meaningfully improved to INR5.1 billion in FY23 (FY21: INR1.3 billion), and a decline in credit cost to 2.35% (3.77%). IIFL is one of the few big NBFCs to have an asset-light model, as reflected in its reliance on off-book (including direct assignment and co-lending portfolios). The proportion of off-book portfolio rose to 39% as of 3QFY24 (FY21: 24.8%). The asset-light model has benefitted liquidity while keeping borrowing costs under control at 9.07% in 3QFY24 (4QFY22: 8.6%). Consequently, spreads improved to 8.1% in 3QFY24 (FY22: 6%). As a result, IIFL Finance was able to invest in scaling up the infrastructure to 4,679 branches in 3QFY24 (FY19: 1,947 branches) which will lead to significant operating leverage ahead as major part of capex is already done.

IIFL Finance's consolidated gross NPAs and net NPAs were 1.7% and 0.9%, respectively, during 3QFY24 (FY23: 1.8%/1.1% and FY22: 3.2%/1.8%). The provision coverage ratio for 3QFY24 stood at 49.7% while the total provisions coverage ratio (including standard asset provisioning) was 151%. Also, gold (31.9% of AUM as of 3QFY24) and home finance (33% of AUM) are larger segments of business, primarily secured and have shown a resilient performance even during the COVID-19 pandemic with less volatility in terms of asset quality. Moreover, MFI business is performing adequately post the removal of pricing cap and delinquencies are under check for the industry post the pandemic.

Evolving Funding Profile: As of 3QFY24 on a consolidated basis, excluding securitisation, the borrowings were largely driven by term loans (54%) and refinance (18%); 24% of funding is through debentures and remaining through commercial papers (4%) and securitisation (1%). Further during 2QFY24, IIFL Finance was able to borrow USD50 million from US International Development Financial Corporation for financing affordable housing loans, USD100 million from IFC World Bank and INR25 billion from National Housing Bank (IND AAA/Stable), which has supported the overall funding cost. The share of capital market funding in the borrowing profile remains limited and is a rating monitorable in the medium term. Furthermore, the impact of the regulatory development on IIFL's ability to mobilise funding will be a key monitorable.

Liquidity

Adequate: At 3QFYE24, IIFL Finance on consolidated basis had the cumulative surplus of 21.0% of assets until one year, and as on 5 March 2024, there was an additional cushion of unutilised bank lines of INR66.45 billion against scheduled debt obligations of INR70.97 billion during December 2023 - June 2024. Furthermore, IIFL has received a credit line of USD200 million from Fairfax India, which provides additional comfort. The tenure of MFI and gold loans (47.5% of AUM) is largely shorter than that of the borrowed funds, while the asset-liability maturity profile remains comfortable.

Rating Sensitivities

The Rating Watch with Negative Implications indicates that the ratings may be either downgraded or affirmed. The agency will continue to monitor the impact of the restriction on gold loan sanctioning/disbursing or assigning/securitising in the medium term. The agency will resolve the Rating Watch with Negative Implications post the removal of the regulatory overhang on IIFL's operations.

ESG Issues

ESG Factors Minimally Relevant to Rating: Unless otherwise disclosed in this section, the ESG issues are credit neutral or have only a minimal credit impact on IIFL Finance, due to either their nature or the way in which they are being managed by the entity. For more information on Ind-Ra's ESG Relevance Disclosures, please click here. For answers to frequently asked questions regarding ESG Relevance Disclosures and their impact on ratings, please click here.

About the Company

IIFL Finance began its operations in 2006. As of 3QFY24, it had AUM of INR730.7 billion and operated through 4,679 branches and 8.0 million customers. IIFL Home Finance constitutes 42.6% of the total AUM, followed by IIFL Finance (standalone) and IIFL Samasta at 40.8% and 16.7% of AUM, respectively.

KEY FINANCIAL INDICATORS - CONSOLIDATED

Parameters	9MFY24	FY23	FY22
Assets (INR billion)	590	530	459.1
Equity (INR billion)	117.8	102.0	64.7
Profit after tax (INR billion)	15.4	16.1	11.9
Return on average assets	3.81	3.25	2.74
Return on managed assets	2.5	2.78	2.48
Equity/ assets (%)	19.97	19.25	14.09
Source: Ind-Ra, IIFL Finance * Annualised			

Status of Non-Cooperation with previous rating agency

Not applicable

APPLICABLE CRITERIA

Non-Bank Finance Companies Criteria

Evaluating Corporate Governance

Policy for Placing Ratings on Rating Watch

The Rating Process

Financial Institutions Rating Criteria

Rating History

Instrument Type	Current Rating/Rating Watch			Historical Rating/Outlook	
	Rating Type	Rated Limits (million)	Rating	22 February 2024	16 January 2024
NCDs	Long-term	INR2,500	IND AA/Rating Watch with Negative Implications	IND AA/Positive	IND AA/Positive
Perpetual debt (Tier 1 instrument)	Long-term	INR3,000	IND AA-/Rating Watch with Negative Implications	IND AA-/Positive	-

Complexity Level of the Instruments

Instrument Type	Complexity Indicator
NCDs	Low
Perpetual debt (tier 1 instrument)	High

For details on the complexity levels of the instruments, please visit https://www.indiaratings.co.in/complexity-indicators.

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